



We are pleased to send you this first issue of Meaden & Moore's International Tax News and hope you find the content useful. We would appreciate your feedback on our efforts to raise awareness of critical international tax issues.

Please send any suggestions or topics you would like us to address to William Harwood at wharwood@meadenmoore.com or call us at (216)-928-5411.

UPCOMING ISSUES

- 10/50 Corporations-New Issues, New Challenges
- Interest Allocation Election Under New Section 864(f)
- Nuts & Bolts of Allocation and Apportionment
- Canadian Tax Issues of Concern to U.S. Businesses with Operations in Canada
- Sale of an LLC Interest Holding a Controlling Interest in a Foreign Corporation

Foreign Pass-Through Entities Face New U.S. Tax Regime

■ **Operating a foreign business, the financial results of which appear on U.S. income tax returns, will subject the owner to complex rules on the recognition of foreign currency gain or loss.**

These rules to apply if:

- the foreign operation conducts business in a currency other than the U.S. Dollar, "functional currency test"
- the foreign operation is transparent for U.S. tax purposes, "the branch test"

Historically, U.S. tax transparency for foreign operations was relatively uncommon, generally limited to un-incorporated foreign sales offices. More substantial operations have usually been conducted through a local, corporate-type entity. Corporate entities accomplished two objectives:

1. Foreign incorporation adds predictability and stability to transactions, taxation, employment, and other business regulation.
2. Financial risk is limited to the assets actually contributed to the foreign entity.

The practice of using traditional corporate entities for foreign operations changed dramatically in 1997 when the IRS issued "check the box" regulations. These regulations permit U.S. taxpayers to treat many corporate-type foreign entities as pass-throughs for U.S. tax purposes. Check-the box ushered in a dramatic increase in the number of foreign pass-through companies

owned by U.S. taxpayers. And since 1997, IRS has struggled with the wide ranging tax ramifications of allowing U.S. taxpayers to merely declare whether foreign companies should be treated as corporations, or instead as pass-through entities.

It is no surprise that tax planners pushed the limits by leveraging "check-the-box" regulations.

The IRS battle with these aggressive techniques now includes proposed rules concerning gains and losses on branch currency transactions. The rules target the rising abuse and provide clarification to the process of branch taxation. This certainty comes at the cost of adding considerable complexity to an already difficult aspect of U.S. taxation.

Transition from the Old to the New Rules

Both the old and proposed new rules take the approach that currency gain or loss is not recognized until there is a transaction between the branch and the U.S. owner or an affiliate. However, under the new rules, certain transactions will no longer trigger a U.S. tax event.

■ **U.S. taxpayers must not only draw a distinction between transactions that give rise to gain or loss, and those that do not, but also determine the amount and character of the gain or loss. As a result, the new rules require substantially more detailed recordkeeping.**

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These new rules are only in “proposed” form, and technically taxpayer’s are not required to conform their tax accounting. The question remains, should we comply now or wait for IRS to officially implement them?

In general we would recommend adoption of the new rules. (Please note that each business circumstance requires proper analysis). The IRS is unlikely to change its position on when to recognize gain or loss on certain branch transactions. The new rules address a number of aggressive, tax motivated transactions designed to play the timing of gain and loss recognition.

■ The new rules, while only in proposed form, contain a toothy motivation.

Under the proposed regulations taxpayers can make certain elections which may be of considerable benefit. Furthermore, these elections are only available to those taxpayers who have accounted for their branch operations in conformity with the old regulatory proposals.

■ In essence, IRS is telling us that these rules reflect the proper way to account for a foreign branch.

Those who conform to the proposals will be rewarded

with favorable treatment, including a relatively permanent deferral of accumulated foreign currency gains. IRS also states that those who conform now will be considered to have previously acted reasonably and in accordance with the IRS policy.

■ IRS promises no downside, and some potential upside.

Consider these relatively straightforward events, all of which promise to have the tax accountants wringing their hands:

- The branch sells its building, or
- The branch distributes cash or property to the U.S. parent, or
- The branch sells inventory to the parent, or
- The parent reclaims assets for use in U.S. operations, or
- The parent sells the branch

To discuss your unique circumstances, and how they fit into these important rules please contact the International Tax Professionals at Meaden & Moore at (216) 241-3272 or visit us on the web at www.meadenmoore.com

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