Chapter 3

Setting Up the Business

Whether it is a new or existing export-import business, the legal form, or structure, will determine how the business is to be conducted, its tax liability, and other important considerations. Each form of business organization has its own advantages and disadvantages, and the entrepreneur has to select the one that best fulfills the goals of the entrepreneur and the business. (For questions to consider before starting a business, see International Perspective 3.1.)

Selection of an appropriate business organization is a task that requires accounting and legal expertise and should be done with the advice of a competent attorney or accountant.

OWNERSHIP STRUCTURE

In this section, we examine different forms of business organizations: sole proprietorships, partnerships, corporations, and limited liability companies.

Sole Proprietorships

A sole proprietorship is a firm owned and operated by one individual. No separate legal entity exists. There is one principal in the business who has total control over all export-import operations and who can make decisions without consulting anyone. The major advantages of sole proprietorships are as follows:

1. They are easy to organize and simple to control. Establishing an export-import business as sole proprietorship is simple and inexpensive and requires little or no government approval. At the state level,

registration of the business name is required, while at the federal level, sole proprietors need to keep accurate accounting records and attach a profit or loss statement for the business when filing individual tax returns (Schedule C, Internal Revenue Service Form 1040). They must operate on a calendar year and can use the cash or accrual method of accounting.
2. They are more flexible to manage than partnerships or corporations. The owner makes all operational and management decisions concerning the business. The owner can remove money or other assets of the business without legal or tax consequences. He or she can also easily transfer or terminate the business.
3. Sole proprietorships are subject to minimal government regulations versus other business concerns.
4. The owner of a sole proprietorship is taxed as an individual, at a rate lower than the corporate income tax rate. Losses from the export-import business can be applied by the owner to offset taxable income from other sources. Sole proprietors are also allowed to establish tax-exempt retirement accounts (Harper, 1991; Cheeseman, 2006a).

The major disadvantage of running an export-import concern as a sole proprietorship is the risk of unlimited liability. The owner is personally liable for the debts and other liabilities of the business. Insurance can be bought to protect against these liabilities; however, if insurance protection is not sufficient to cover legal liability for defective products or debts, judgment credi-

INTERNATIONAL PERSPECTIVE 3.1. Establishing an Appropriate Business Organization: Pointers

- Does the entrepreneur intend to be the sole owner of the export-import business? If not, how many people have an ownership interest?
- Does the entrepreneur need additional capital and/or expertise?
- What legal form provides the greatest flexibility for management?
- What legal form affords the most advantageous tax treatment for the business concern and individual entrepreneurs?
- Which legal structure is easy and less expensive to establish and subject to a low degree of government regulation?
- How important is it to limit personal liability of owners?
- Which legal structure is the most appropriate in light of the goals and objectives of the export-import business?

tors' next recourse is the personal assets of the owner. Another disadvantage is that the proprietor's access to capital is limited to personal funds plus any loans that can be obtained. In addition, very few individuals have all the necessary skills to run an export-import business, and the owner may lack certain skills. The business may also terminate upon the death or disability of the owner.

Partnerships

A partnership is an association of two or more persons to carry on as co-owners of a business for profit. "Persons" is broadly interpreted to include corporations, partnerships, or other associations. "Co-ownership" refers to a sharing of ownership of the business and is determined by two major factors: share of the business profits and management responsibility. The sharing of profits creates a rebuttable presumption that a partnership exists. The presumption about the existence of a partnership is disproved if profits are shared as payment of a debt, wages to an employee, interest on a loan, or rent to a landlord.

> *Example:* Suppose Gardinia Export Company owes Kimko Realty $10,000 in rent. Gardinia promises to pay Kimko 20 percent of its business profits until the rent is fully paid. Kimko realty is sharing profits from the business but is not presumed to be a partner in the export business.

Although a written agreement is not required, it is advisable for partners to have some form of written contract that establishes the rights and obligations of the parties. Since partnerships dissolve upon the death of any partner that owns more than 10 percent interest, the agreement should ascertain the rights of the deceased partner's spouse and that of surviving partners in a way that is least disruptive of the partnership.

A partnership is a legal entity only for limited purposes, such as the capacity to sue or be sued, to collect judgments, to have title of ownership of partnership property, or to have all accounting procedures in the name of the partnership. Federal courts recognize partnerships as legal entities in such matters as lawsuits in federal courts (when a federal question is involved), bankruptcy proceedings, and the filing of informational tax returns (profit and loss statement that each partner reports on individual returns). The partnership, however, has no tax liability. A partner's profit or loss from the partnership is included in each partner's income tax return and taxed as income to the individual partner (Cooke, 1995; Cheeseman, 2006b).

Partners are personally liable for the debts of the partnership. However, in some states, the judgment creditor (the plaintiff in whose favor a judgment is entered by a court) must exhaust the remedies against partnership property before proceeding to execute against the individual property of the partners.

What are the duties and powers of partners? The fiduciary duty that partners owe the partnership and the other partners is a relationship of trust and loyalty. Each partner is a general agent of the partnership in any business transaction within the scope of the partnership agreement. For example, when a partner in an import business contracts to import merchandise, both the partner and the partnership share liability unless the seller knows that the partner has no such authority. In the latter case, the partner who signed the contract will be personally liable but not the partnership. A partner's action can bind the partnership to third parties if his or her action is consistent with the scope of authority, that is, expressed or implied authority provided in the partnership agreement (Cheeseman, 2006a).

Limited Partnerships

A limited partnership is a special form of partnership which consists of at least one general (investor and manager) partner and one or more limited (investor) partners. The general partner is given the right to manage the partnership and is personally liable for the debts and obligations of the limited partnership. The limited partner, however, does not participate in management and is liable only to the extent of his or her capital contribution. Any person can be a general or limited partner, and this includes natural persons, partnerships, or corporations. Limited partners have no right to bind the partnership in any contract and owe no fiduciary duty to that partnership or the other partners due to the limited nature of their interest in the partnership.

Whereas a general partnership may be formed with little or no formality, the creation of a limited partnership is based on compliance with certain statutory requirements. The certificate of limited partnership must be executed and signed by the parties. It should include certain specific information and be filed with the secretary of state and the appropriate county to be legal and binding. The limited partnership is taxed in exactly the same way as a general partnership. A limited partner's losses from an export-import business could be used to offset income generated only by other passive activities, that is, investments in other limited partnerships (passive loss rules). They cannot be used against salaries, dividends, interest, or other income from portfolio investments. Both types of partnership can be useful in international trade. They bring complimentary assets needed to distribute and/or commercialize the product or service. The combination of skills by different partners usually increases the speed with which the product/service enters a market and generally contributes to the success of the business. Limited partners may also be useful when capital is needed by exporters or importers to prepare a marketing plan, expand channels of distribution, increase the scope and volume of goods or services traded, and so on. However, potential exists for conflict among partners unless there exists a partnership agreement that eliminates or mitigates any sources of conflict. If limited partners become involved in marketing or other management decisions of the export-import firm, they are considered general partners and, hence, assume unlimited risk for the debts of the partnership (Anderson and Dunkelberg, 1993; Cheeseman, 2006a).

Corporations

A corporation is a legal entity separate from the people who own or operate it and created pursuant to the laws of the state in which the business is incorporated. Many export-import companies prefer this form of business organization due to the advantage of limited liability of shareholders. This means that shareholders are liable only to the extent of their investments. These companies could be sued for any harm or damage they cause in the distribution of the product, and that incorporation limits the liability of such companies to the assets of the business. Other advantages of incorporation are *free transferability of shares, perpetual existence, and ability to raise additional capital by selling shares in the corporation.* However, most of these companies are closely held corporations; that is, shares are owned by few shareholders who are often family members, relatives, or friends, and not traded on national stock exchanges.

Export-import corporations as legal entities have certain rights and obligations: they can sue or be sued in their own names, enter into or enforce contracts, and own or transfer property. They are also responsible for violation of the law. Criminal liability includes loss of a right to do business with the government, a fine, or any other sanction.

If an export-import company that is incorporated in one state conducts intrastate business (transacts local business in another state), such as selling merchandise or services in another state, it is required to file and qualify as a “foreign corporation” to do business in the other state. Conducting intrastate business usually includes maintaining an office to conduct such business. Using independent contractors for sales, soliciting orders to be accepted outside of the state, or conducting isolated business transactions do not require qualification to do business in another state. The qualification procedure entails filing certain information with the secretary of state, payment of the required fees, and appointing a registered agent that is empowered to accept service of process on behalf of the corporation.

The process of forming a corporation (incorporating) can be expensive and time consuming. A corporation comes into existence when a certificate of incorporation, signed by one or more persons, is filed with the secretary of state. The corporation code in every state describes the types of information to be included in the articles of incorporation. Generally, they include provisions such as the purpose for which the corporation is organized, its duration, and powers of the corporation.

Many businesses incorporate their companies in the state of Delaware even when it is not the state in which the corporation does most of its business. This is because Delaware has laws that are very favorable to businesses' internal operations and management. It is even more ideal for companies that plan to operate with little or no surpluses or that have a large number of inaccessible shareholders, making obtaining their consent difficult when needed (Friedman, 1993).

One of the main disadvantages of a corporation as a form of business organization is that its profits are subject to double taxation. Tax is imposed by federal and state governments on profits earned by the company, and later, those profits are taxed as income when distributed to shareholders. Companies often avoid this by increasing salaries and bonuses for their owners and reporting substantially reduced profits. In this way, the income will be subject to tax when the owners or shareholders receive it rather than at the corporate level *and* the individual level.

It is important that export-import companies maintain a separate identity from that of their owners. This includes having a separate bank account, export/distributor contracts in the name of the company, hold stockholders meetings, and so on. In circumstances in which corporations are formed without sufficient capital or when there is a nonseparation of corporate and personal affairs, courts have disregarded the corporate entity. The implication of this is that shareholders may be found personally liable for the debts and obligations of the company. The corporate entity is also disregarded in cases in which the corporation is primarily used to defraud others and for similar illegitimate purposes, such as money laundering, trade in narcotics, or funneling money to corrupt officials (bribery).

Directors and officers of export-import companies owe a duty of trust and loyalty to the corporation and its shareholders. Directors and officers must act within their scope of authority (duty of obedience) and exercise honest and prudent business judgment (duty of care) in the conduct of the affairs of the corporation. In the absence of these, they could be held personally liable for any resultant damages to the corporation or its shareholders. Breach of duty of obedience and care by directors and officers of an export-import company could include one or more of the following:

- *Investment of profits:* Investment of profits from export-import operations in a way that is not provided in the articles of incorporation or corporate bylaw.
- *Corporate decisions:* Making export-import decisions without being adequately informed, in bad faith, and at variance with the goals and objectives of the company.

S Corporations

The subchapter S Revision Act of 1982 divides corporations into two categories: S corporations and C corporations, that is, all other corporations. If an export company elects to be an S corporation, it has the best of advantages of a corporation and a partnership. Similar to a corporation, it offers the benefits of limited liability, but still permits the owner to pay taxes as an individual, thereby avoiding double taxation. One advantage of paying taxes at the level of the individual shareholder is that export-import companies' losses could be used to offset shareholders' taxable income from other sources. It is also beneficial when the corporation makes a profit and when a shareholder falls within a lower income tax bracket than the corporation. However, the corporation's election to be taxed as an S corporation is based on the following preconditions:

1. *Domestic entity:* The corporation must be a domestic entity, that is, it must be incorporated in the United States.
2. *No membership in an affiliated group:* The corporation cannot be a member of an affiliated group (not part of another organization).
3. *Number of shareholders:* The corporation can have no more than seventy-five shareholders.
4. *Shareholders:* Shareholders must be individuals or estates. Corporations and partnerships cannot be shareholders. Shareholders must also be citizens or residents of the United States.
5. *Classes of stock:* The corporation cannot have more than one class of stock.
6. *Corporate income:* No more than 20 percent of the corporation's income can be from passive investment income (dividends, interest, royalties, rents, annuities, etc.).

Failure to maintain any one of the previous conditions will lead to cancellation of the S corporation status. Another election after cancellation of status cannot be made for five years.

Limited Liability Companies

This form of business organization combines the best of all the other forms. It has the advantages of limited liability and no restrictions on the number of owners or their nationalities (as in the case of S corporations). It is taxed as a partnership, and, unlike limited partnerships, it does not grant limited liability on the condition that the members refrain from active participation in the management of the company. To be taxed as a partnership, a limited liability company (LLC) can possess any of the following attributes: two or more persons as associates, objectives to carry on business and divide gains, limited liability, centralized management and continuity, and free transferability of interests (Cheeseman, 2006b). Such a company can be formed by two or more persons (natural or legal) and its articles of incorporation filed with the appropriate state agency. Limited liability companies provide the advantage of limited liability, management structure (participation in management without being subject to personal liability), and partnership tax status. It has become a popular form of business for subsidiaries of foreign corporations as well as small-scale and medium-sized businesses (August, 2004).

BUSINESS OR TRADE NAME

A sole proprietorship or partnership that is engaged in an export-import business can operate under the name of the sole proprietor or one or more of the partners. There are no registration requirements with any government agency. However, if the sole proprietorship or partnership operates under a fictitious name, it must file a fictitious business name statement with the appropriate government agency. Most states also require publication of the trade name in a local newspaper serving the area where the business is located.

> *Example:* Suppose John Rifkin wants to operate an export-import business (sole proprietorship) under the name “Global.” This is commonly stated as: “John Rifkin doing business as Global.”

Corporations are required to register their business name with the state. It is important to obtain permission to use a trade name before incorporation. This is intended to ensure that (1) the trade name does not imply a purpose inconsistent with that stated in the articles of incorporation, and (2) the trade name is not deceptively similar to registered and reserved names of other companies incorporated to do business in the state. The secretary of state or other designated agency will do a search before authorizing the party to use the name (Cheeseman, 2006a).

Unlike the effect of corporate name registration, registration of fictitious names does not prevent the use of the same name by others. This is because most states do not have a central registry of fictitious business names and that registration of such names is simply intended to indicate the person doing business under the trade name. To avoid registration of a similar trade name, it is advisable to check records of counties as well as local telephone directories for existing fictitious business names (McGrath, Elias, and Shena, 1996).

Another important issue is the potential problems that ensue when such names are used as trademarks to identify goods or services. Suppose John Rifkin intends to use the trade name "Global" to market his perfume imports. It is important to ensure that the same or similar name is not being used or registered with the U.S. Patent and Trademarks Office by another party prior to Rifkin's use of "Global" as a mark. The basic principles also apply in the case of corporations. If Rifkin used "Global" as a trademark in connection with his trade or business for some time, he acquires exclusive use of the mark regardless of the previous registration of the same or similar mark by others. Once a trader acquires a reputation in respect of his mark, then it becomes part of his goodwill, which is regarded by law as part of personal property that may be sold or licensed.

BANK ACCOUNTS, PERMITS, AND LICENSES

An export-import firm must open a bank account with an international bank that can accommodate specialized transactions such as letters of credit, foreign exchange payments, forfeiting, and so on. Some international banks have subsidiaries in importing countries that can verify the creditworthiness of foreign buyers. Sole proprietors and partnerships can open a bank account by submitting an affidavit of the fictitious business name statement to the bank with the initial deposit. In the case of a corporation, banks often require articles of incorporation, an affidavit that the company exists, and its tax identification number. It is important to check with the city or county to determine if permits or business licenses are required.

LOCATION AND USE OF PROFESSIONAL SERVICES

When the export-import business is small, it is economical to use one's home as an office during the early phase of the operations. Besides saving money and travel time, using a portion of a home provides opportunities for deduction of expenses related to the business. All of the direct expenses for the business part of the home, for example, painting or repairs, are deductible expenses. The business use of a home may, however, provide the wrong impression to credit-rating agencies or clients who may decide to pay an impromptu visit. Another problem with using one's home is that it may violate a city's bylaws that prohibit the conduct of any trade or business in an area that is zoned strictly for residential purposes. Homeowner's insurance coverage may not cover business equipment, merchandise, or supplies. It may be advisable to rent from a company with extra space or rent an office with basic services.

The use of professional services (use of attorneys, accountants, and consultants) is important not only during the early stages of the business but throughout its operation as an informal source of guidance on liability, expansion, taxes, and related matters. If the entrepreneur does not have sufficient resources to pay for such services, many professionals are willing to reduce rates, defer billing, or make other arrangements.

ORGANIZING FOR EXPORT: INDUSTRY APPROACH

The Small Business Administration (SBA) states that, besides multinational firms such as General Motors or IBM, there are many small-scale industries that export their output. For many of these companies, there are a number of organizational issues that need to be addressed to achieve an optimal allocation of resources. Some of the issues include (1) the level at which export decisions should be made, (2) the need for a separate export department, and (3), if the decision is made to establish a separate department, its organization within the overall structure of the firm including coordination and control of several activities. Such organizational issues involve three related areas:

1. *Subdivision of line operations based on certain fundamental competencies:* This relates to functional (production, finance, etc.), product, and geographical variables. A firm's organizational structure is often designed to fit its corporate strategy, which is in turn responsive to environmental realities (Albaum, Stradskov, and Duerr, 2002).
2. *Centralization or decentralization of export tasks and functions:* Centralization is generally advantageous for firms with highly standardized products, product usage, buying behavior, and distribution outlets. Advantages from centralization also tend to accrue to firms

(1) with few customers and large multinational competitors, and (2) with high R & D to sales ratio and rapid technological changes.

3. *Coordination and control:* Coordination and control of various activities among the various units of the organization is determined by the information-sharing needs of central management and foreign units.

Conventional business literature suggests that the choice of organizational structure determines export performance. The development of formal structures becomes important as the firm grows in size and complexity as well as to respond to internal and external changes. The adoption of flexible organizational structure can partly offset the disadvantage arising from formal organizational structure (Enderwick and Ranayne, 2004).

A study by Beamish et al. (1999) shows that the organizational structure within which a firm manages its exports has a significant impact on export performance. It also suggests that management commitment to internationalize by establishing a separate export department increases firms' export performance.

Organizational Structures

An international company can organize its export-import department along functional, product, market, or geographical lines. Some firms organize their international division at headquarters based on functional areas. Under this arrangement, functional staff (marketing, finance, etc.), located at the head office, serve all regions in their specialties. Such a structure is easy to supervise and provides access to specialized skills. However, it could lead to coordination problems among various units as well as duplication of tasks and resources. It is generally suitable for companies that produce standardized products during the early stages of international operations.

Organization of export operations along product lines is suitable for firms with diversified product lines and extensive R & D activities. Under this structure, product division managers become responsible for the production and marketing of their respective product lines throughout the world. Even though this structure poses limited coordination problems and promotes cost efficiency in existing markets, it leads to duplication of resources and facilities in various countries and inconsistencies in divisional activities and procedures.

Organization along geographical lines is essentially based on the division of foreign markets into regions that are, in turn, subdivided into areas/subsidiaries. The regions are self-contained and obtain the necessary resources for marketing and research. This structure is suitable for firms with homogenous products that need efficient distribution and product lines that have similar technologies and common end-use markets (Albaum, Stradskov, and Duerr, 2002). It allows firms to respond to the changing demands of the market. This organizational approach makes coordination of tasks difficult when new and diverse products are involved. It also leads to duplication of certain tasks at the regional level. Certain companies adopt a mixed structure to manage international marketing activities. This structure combines two or more competencies on a worldwide basis. This approach is described as follows:

> Instead of designating international boundaries, geographical area divisions or product divisions as profit centers, they are all responsible for profitability. National organizations are responsible for country profits, geographical area divisions for a group of national markets and product divisions for worldwide product profitability. (Albaum et al., 1994, pp. 469-470)

A separate export department within a firm may become necessary as overseas sales volume increases. However, the provision of additional resources for a separate department is not warranted at the early phase of market entry, since such activities can often be handled by domestic marketing units.

GENERAL PRINCIPLES OF TAXATION

The United States levies taxes on the worldwide income of its citizens, residents, or business entities. The United States, the Netherlands, and Germany are some of the few countries that impose taxes on the basis of worldwide income; most other countries tax income only if it is earned within their territorial borders. For U.S. tax purposes, an individual is considered a U.S. resident if the person (1) has been issued a resident alien card (green card), (2) has been physically present in the United States for 183 days or more in the calendar year, or (3) meets the cumulative presence test: this test may be met if the foreign individual was present in the United States for at least 183 days for the three-year period ending in the current year. In establishing cumulative presence, days present in the current year are added to one-third of the days present in the preceding year and one-sixth of the days in the second preceding year. An alien is treated as a resident if the total equals or exceeds 183 days.

Example of cumulative presence test: If Jim (a U.K. citizen) was in California for sixty-six days in 2003, thirty-three days in 2004, and 162 days in

2005, he would be considered a U.S. resident for 2005 (162 + [33 ÷ 3] + [66 ÷ 6] = 184 days). Jim may, however, rebut this presumption by showing that he has a closer connection to the United Kingdom than the United States, or that his regular place of business is in the United Kingdom.

A company incorporated in the United States is subject to tax on its worldwide income, as in the case of U.S. citizens and residents. A partnership is not treated as a separate legal entity, and, hence, it does not pay taxes. Such income is taxed in the hands of the individual partners, whether natural or legal entities.

Example 1

Suppose Joan, a U.S. citizen, has an export-import business as a sole proprietor and also works as manager in a fast-food restaurant. The profit from the business is added on to her employment income. If the business operates at a loss, the loss will be subtracted from her employment or other income thus reducing the tax payable.

Example 1A: Joan's Income Tax Liability as Sole Proprietor

	Year 1	Year 2
Joan's salary	30,000	31,500
Export-import profit (loss)	12,000	(8,500)
Total income	42,000	23,000
Personal exemption	(2,500)	(2,500)
Itemized deduction	(10,000)	(10,000)
Taxable income	29,500	10,500

Example 1B: Joan's Income Tax under A Corporation

Taxable income of export-import company	48,000
Less corporate income tax (15%)	(7,200)
Distributed dividend to Joan	40,800
Dividend tax on Joan's individual tax return	(11,887)
Total corporate and individual income tax	19,087

As illustrated in Example 1B, a corporation's income is subject to double taxation, first at the corporate level and then on the individual income tax return. Such incidences of double taxation are often reduced when deductions and other allowances are applied against taxable income. If earnings are left in the business, the tax rate may be lower than what would be paid by a sole proprietor. If the export-import business is incorporated as an S corporation, earnings are taxed only once at the owner's individual tax rate. Payment of Social Security tax is also avoided by withdrawing profits as dividends.

TAXATION OF EXPORT-IMPORT TRANSACTIONS

Taxation of U.S. Resident Aliens or Citizens

U.S. citizens and resident aliens are taxed on their worldwide income. In general, the same rules apply irrespective of whether the income is earned in the United States or abroad. Foreign tax credits are allowed against U.S. tax liability to mitigate the effects of taxes by a foreign country on foreign income. It also avoids double taxation of income earned by a U.S. citizen or resident, first in a foreign country where the income is earned (foreign source income) and in the United States. Such benefits are available mainly to offset income taxes paid or accrued to a foreign country and may not exceed the total U.S. tax due on such income.

Example 2

Nicole, who is a U.S. resident, has a green card. She exports appliances (washers, dryers, stoves, etc.) to Venezuela and occasionally receives service fees for handling the maintenance and repairs at the clients' locations in Caracas and Valencia. Last year, she received $9,000 in export revenues (taxable income) and $3,500 in service fees (taxable income). No foreign tax was imposed on Nicole's export receipt of $9,000. However, she paid $2,200 in taxes to Venezuela on the service fees. Nicole also received $15,000 from her part-time teaching job at a community school (taxable income). Assume a 30 percent U.S. tax rate.

Source of Income	Taxable Income	Tax Liability
Venezuela	9,000	2,700
Venezuela	3,500	2,200
United States	15,000	4,500
Total income	**27,500**	**9,400**

$$\text{Foreign tax limit } 5 \text{ U.S. tax liability } 3 \; \frac{\text{Taxable income from all foreign sources}}{\text{Total taxable worldwide income}}$$

The credit is the lesser of creditable taxes paid ($2,200) or accrued to all foreign countries (and U.S. possessions) or the overall foreign tax credit limitation ($3,750). The foreign tax credit limitation = 30 percent (27,500) × 12,500 ÷ 27,500 = $3,750.

If the foreign tax credit limitation is lower than the foreign tax owed (i.e., suppose the foreign tax was greater than $3,750), the excess amount can be carried back two years and forward five years to a tax year in which the taxpayer has an excess foreign credit limitation.

Taxation of Foreign Persons in the United States (Nonresident Aliens, Branches, or Foreign Corporations)

Foreign firms use different channels when marketing their products in the United States. They often commence to sell goods through independent distributors until they gain sufficient resources and experience. As their export volume grows, they may wish to directly export to their U.S. customers and market their products by having their employees occasionally travel to the United States in order to contact potential clients, identify growing markets, or negotiate sales contracts. As the company becomes more successful in the market, it may decide to establish a branch or subsidiary in the United States.

Foreign persons engaged in U.S. trade or business are subject to U.S. taxation on the income that is "efficiently connected" with the conduct of U.S. trade or business. This includes U.S.–source income derived by a nonresident alien, foreign corporation, or U.S. branch from the sale of goods or provision of services. "Effectively connected income" may be extended beyond U.S.–source income to include certain types of foreign-source income that was facilitated by use of a fixed place of business or office in the United States.

> *Example:* Amin, a Brazilian software exporter, opens a small sales office in Hammond, Indiana, in order to sell in the United States and Canada. Canadian sales (foreign-source income) are generally considered "effectively connected" since income is produced through the U.S. sales office in Indiana. Amin's sales in the United States (through U.S. branch or subsidiary) are also subject to U.S. tax due to permanent establishment in the United States or income from U.S. trade or business.

A foreign corporation or nonresident alien that exports goods/services to the United States through a fixed place of business or office can claim deductions for expenses, losses, foreign taxes or claim a tax credit for any foreign income taxes, that is, foreign- and U.S.–source effectively connected income. The credits are not used to offset U.S. withholding or branch profits tax and allowable only against U.S. taxes on "effectively connected income." While a tax deduction reduces taxable income by the amount of a given expense, tax credits are a dollar for dollar reduction of U.S. income tax by the amount of the foreign tax.

Model tax treaties that the United States entered with many trading nations contain the following common provisions:

- Foreign person's (nonresident alien, foreign corporation, U.S. branch) export profits are exempt from U.S. tax unless such profits are attributable to a permanent establishment maintained in the United States, that is, a fixed place of business, or when U.S.–dependent agents have authority to conclude sales contracts on behalf of the company.

  Example: Donga Inc., a trading company incorporated in Monaco, exports ceiling fans to the United States. Its sales agents spend two months every year traveling across the United States to market/promote sales with major clients. When they receive orders, they forward them to the home office for final approval. The agents do not sign purchase orders or sales contracts.

  Donga Inc. is not subject to U.S. taxes since (1) the agents do not have contracting authority and (2) the company does not have permanent establishment in the United States.

- Marketing products in the United States through independent agents or distributors does not create a permanent establishment and thus no tax liability in the United States.
- Income from personal services provided by nonresident aliens in the United States are normally exempt unless the employee is present in the United States for over 183 days or paid by a U.S. resident. Income derived by professionals (accountants, doctors, etc.) are exempt unless attributable to a fixed place of business in the United States.

Taxation of U.S. Exports

In general, U.S. companies that export their goods overseas will incur no tax liability in the importing country if:

1. They undertake their exports through independent distributors (they have non taxable presence in the importing country).
2. Their agents/employees overseas do not have authority to conclude sales contracts on behalf of the U.S. exporter.
3. The services performed are attributable to a fixed place of business in the host country.

An export-import firm may enter a foreign market by establishing a branch in a foreign country. Branches are often used to retain exclusive control of overseas operations or to deduct losses on initial overseas activities. However, they can be incorporated abroad when such operations become profitable, to enable the firm to defer any U.S. income taxes owed on profits until they are remitted to the United States. A branch is not a separate corporation; it is considered an extension of the domestic corporation. One of the major disadvantages of operating a branch is that it exposes the domestic firm to liability in a foreign country. Foreign branch taxes are paid when they are earned (not when remitted to the United States, as in the case of a foreign corporation), and losses are reported when incurred. Foreign taxes paid or accrued on branch profits are eligible for foreign tax credits (see Figure 3.1).

An export-import firm can enter a foreign market by establishing a separate corporation (subsidiary) to conduct business. The parent corporation and subsidiary are separate legal entities and their individual liabilities are limited to the capital investment of each respective firm. Foreign taxes are paid when the subsidiary receives the income, but U.S. taxes are paid when distributed to shareholders as a dividend. Foreign taxes paid (a ratable share) are eligible for a tax credit at the time of distribution of dividend to the U.S. taxpayer. A U.S. shareholder (parent firm) can also claim a proportional share of a dividends-received deduction.

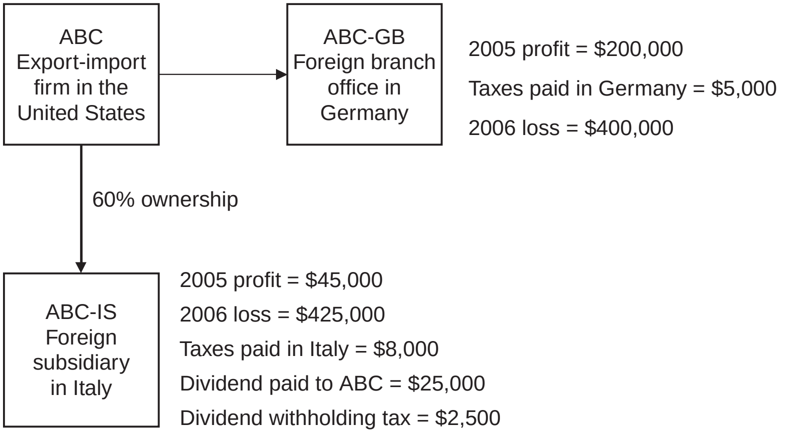

FIGURE 3.1. Taxation of Foreign Subsidiaries and Branches

Example

1. The 2005 profit ($200,000) of the German branch is taxable to ABC export-import firm in 2005. Remittance of reported earnings to the United States is not required for tax purposes. However, 2005 profits earned by the Italian subsidiary are subject to tax in the United States only when remitted; that is, taxes could be deferred until remitted to the U.S. parent.
2. The 2006 losses by ABC-GB can be used to offset ABC's 2006 taxable income from its U.S. operations. However, ABC-IS's losses cannot be used to reduce ABC's 2006 taxable income. The $425,000 loss incurred can only be used to reduce profits earned in other years and distributed as dividend to ABC company.
3. Taxes paid by ABC-GB to Germany can be claimed to offset ABC's U.S. taxes due on its profits. In the case of ABC-IS's taxes paid on its profits to Italy, ABC can claim a foreign tax credit for the taxes withheld on its dividend receipts for the given year. This does not reduce all or most of the foreign taxes incurred or paid on the subsidiary's profits, since it is limited only to taxes withheld from a foreign subsidiary's dividend remittances. The introduction of the "deemed paid foreign tax credit" was intended to remedy this inequity. Under this method, the U.S. shareholder (ABC) will be deemed to have paid a portion of ABC-IS's foreign taxes, corresponding to the proportion of dividends received and not on any withholding taxes on the dividends distributed. However, the deemed paid foreign tax credit is available to U.S. companies that own at least 10 percent of the foreign subsidiary's voting stock at the time of distribution and is based only on actual dividends paid. It is also limited only to corporate U.S. shareholders.

Deemed paid tax credit (DPTC) is calculated as follows:

$$\text{DPTC} = \frac{\begin{array}{l}\text{Dividends paid to U.S. corporate}\\ \text{shareholders from post-1986}\\ \text{undistributed earnings}\end{array}}{\begin{array}{l}\text{Accumulated post-1986}\\ \text{undistributed earnings}\end{array}} \times \begin{array}{c}\text{Post-1986 creditable}\\ \text{taxes paid or accrued}\\ \text{byforeign subsidiary}\end{array}$$

$$\text{DPTC} = \frac{\$25{,}000}{\$45{,}000} \times 8{,}000 = \$4{,}444$$

ABC's U.S. Tax Liability:

Dividend	$25,000
DPTC	$4,444
Gross income	$29,444
Corporate tax (35%)	$10,305
Gross U.S. tax liability	$10,305
Less DPTC	($4,444)
Less dividend tax withheld	$2,500
Net ABC tax liability	$3,361.00

Taxation of Controlled Foreign Corporations

A controlled foreign corporation (CFC) is a foreign corporation in which U.S. shareholders own more than 50 percent of its voting stock or more than 50 percent of the value of its outstanding stock on any of the foreign corporation's tax year. Rules governing CFCs are concerned with preventing U.S. businesspersons from escaping high marginal tax rates in the United States by operating through controlled corporations in a foreign country that imposes little or no tax. The parent company could sell goods or services to a foreign subsidiary and manipulate prices so that most of the profits are allocated to the subsidiary in a country that imposes little or no tax, thus avoiding U.S. and foreign taxes. The CFC could also be used as a base company to make sales outside its country of incorporation or as a holding company to accumulate passive investment income such as interest, dividends, rent, and royalties.

U.S. shareholders must report their share of CFC's subpart F income each year. Subpart F income includes foreign base company income (foreign base sales, services, shipping, and personal holding company income), CFC's income from insurance of U.S. and foreign risks, boycott-related income and bribes, and other illegal payments.

A U.S. shareholder is subject to tax on the subpart F income only when the foreign corporation is a CFC for at least thirty days during its tax year. A U.S. shareholder of a CFC must then include his or her pro rata share of the subpart F income as a deemed dividend that is distributed on the last day of the CFC's tax year or the last day on which CFC's status is retained (McDaniel, Ault, & Repetti, 1981; Ogley, 1995).

> *Example:* Monaco corporation, located in Hong Kong, is a CFC owned by XYZ Company of San Diego, California. Monaco corporation buys computer parts from XYZ Company and sells about 80 percent of the parts in

other Asian countries. The remainder is sold to retailers in Hong Kong. Profits earned from sales in foreign countries are foreign base sales income, that is, subpart F income, and taxable to XYZ Company during the current year. Sales to foreign countries of goods manufactured by Monaco in Hong Kong would not constitute foreign base sales income.

Taxation of Domestic International Sales Corporations

Taxation of domestic international sales Corporations (DISCs) is discussed in Chapter 15.

Deductions and Allowances

Export-import businesses may deduct ordinary and necessary expenses. Ordinary and necessary expenses are defined by the Internal Revenue Service as follows:

> An ordinary expense is one that is common and accepted in your type of business, trade, or profession. A necessary expense is one that is helpful and appropriate for your trade, business, or profession. An expense does not have to be indispensable to be considered necessary. (Internal Revenue Service, 1996a, p. 6)

When one starts the export-import business, all costs are treated as capital expenses. These expenses are a part of the investment in the business and generally include

1. the cost of getting started in the business before beginning export-import operations, such as market research, expenses for advertising, travel, utilities, repairs, employee's wages, salaries, and fees for executives and consultants; and
2. business assets such as building, furniture, trucks, etc., and the costs of making any improvements to such assets, for example, a new roof, new floor, and so on. The cost of the improvement is added to base value of the improved property.

The cost of specific assets can be recovered through depreciation deductions. Other start-up costs can be recovered through amortization; that is, costs are deducted in equal amounts over sixty months or more. Organizational costs for a partnership (expenses for setting up the partnership) or corporation (costs of incorporation, legal and accounting fees etc.) can be amortized over sixty months and must be claimed on the first business tax return. Once the business has started operations, standard business deductions are applied against gross income. Standard business deductions include the following:

1. *General and administrative expenses:* Office expenses such as telephones, utilities, office rent, legal and accounting expenses, salaries, professional services, dues, and so forth. These also include interest payments on debt related to the business, taxes (real estate and excise taxes, estate and employment taxes), insurance, and amortization of capital assets.
2. *Personal and business expenses:* If an expense is incurred partly for business and partly for personal purposes, only the part that is used for business is deductible. If the export-import business is conducted from one's home, part of the expense of maintaining the home could be claimed as a business expense. Such expenses include mortgage interest, insurance, utilities, and repairs. To successfully claim such limited deductions, part of the home must be used exclusively and regularly as the principal place of business for the export-import operation or as a place to meet customers or clients. Similarly, automobile expenses to conduct the business are deductible. If the car is used for both business and family transportation, only the miles driven for the business are deductible as business expenses. Automobile-related deductions also include depreciation on the car; expenses for gas, oil, tires, and repairs; and insurance and registration fees (Internal Revenue Service, 1996b).
3. *Entertainment, travel, and related business expenses:* Expenses incurred entertaining clients for promotion, travel expenses (the cost of air, bus, taxi fares), as well as other related expenses (dry cleaning, tips, subscriptions to relevant publications, convention expenses) are tax deductible (Internal Revenue Service, 1996c).

If deductions from the export-import business are more than the income for the year, the net operating loss can be used to lower taxes in other years. All of the previously listed expenses have to be specifically allocated and apportioned between foreign- and domestic-source income.

INTERNATIONAL TRANSFER PRICING

Transactions between unrelated parties and prices charged for goods and services tend to reflect prevailing competitive conditions. Such market prices cannot be assumed when transactions are conducted between related parties, such as a group of firms under common control or ownership. If a parent company sells its output to a foreign marketing subsidiary at a higher price, it moves overall gains to itself. It if charges a lower price, it will shift more of the overall gains to the subsidiary. Even though transfer prices do not affect the combined income or absolute amount of gain or loss among related persons or "controlled group of corporations," they do shift income among related parties in order to take advantage of differences in tax rates.

In the following example, the combined income remains at $1,000 for the steel export regardless of the transfer price used to allocate income between the parent and subsidiary. If the tax rate is 30 percent in United States and 40 percent in Spain, the U.S. parent company can use higher transfer price for its controlled sale (Option B) to reduce its worldwide taxes:

Option A: 1,000 × 40 percent = $400 (Spain's rate)
Option B: 1,000 × 30 percent = $300 (U.S. rate)

In cases where U.S. companies operate in low-tax jurisdictions, income can be shifted to a low-tax subsidiary. This has the advantage of U.S. tax deferral until the foreign subsidiary repatriates its earnings through dividend distribution.

Example

	U.S. Parent Co. (Steel Co.) in Detroit, Michigan	U.S. Subsidiary in Madrid, Spain
Option A	Production Cost = 1,000	Cost of sales = 1,000
		Selling expense = 200
	Sale to subsidiary = 1,000	Sales revenue = 2,200
	Net Profit = $0	Net Profit = $1,000
Option B	Production cost = 1,000	Cost of sales = 2,000
		Selling expense = 200
	Sales to subsidiary = 2,000	Sales revenue = 2,200
	Net Profit = $1,000	Net Profit = $0

U.S. regulation (Section 482) on transfer pricing is largely intended to ensure that taxpayers report and pay taxes on their actual share of income arising from controlled transactions. The appropriateness of any transfer price is evaluated on the basis of the arm's length or market value standard (see International Perspective 3.2). For example, in the case of loans extended by a U.S. parent company to its overseas subsidiary, the Internal Revenue Service has successfully imposed an arm's length interest charge (a charge that would be paid by unrelated parties under similar circumstances).

Tax Treaties

Income tax treaties are entered into by countries to reduce the burden of double taxation on the same activity and to exchange information to prevent

INTERNATIONAL PERSPECTIVE 3.2.
Transfer Pricing Methods

A number of factors are considered in the determination of comparable prices between parties dealing at arm's length transactions: contractual terms, such as provisions pertaining to volume of sales, warranty, duration or extension of credit, functions performed such as marketing, R & D, etc., and risks assumed including responsibility for currency fluctuations, credit collection, or product liability. Other factors include economic market conditions (similarly of geographical market, competitive conditions in industry and market) as well as nature of property or services transformed.

In the case of sale of tangible goods between related parties, arm's length charge is determined by using the following methods:

- The comparable uncontrolled price method: prices on the sale of similar goods to unrelated parties.
- Resale price method: resale price to unrelated parties using gross profit margin.
- Cost plus method: cost plus method is used in situations in which products are manufactured and sold to related parties.
- Comparable profits method: this method uses profit level indicators such as rate of return on operating assets, etc., of uncontrolled parties to adjust profit levels of each group.
- Profit split method: allocation of profit between related parties based on the relative value of the contribution to the profit of each party.

In the performance of services to related parties, the regulations do not require that a profit be made on the change for services unless the services are an integral part of the business activity of the providing party, that is, the principle activity of the service provider is that of rendering such services to related or unrelated parties.

tax evasion. Tax treaty partners generally agree on rules about the types of income that a country can tax and the provision of a tax credit for any taxes paid to one country against any taxes owed in another country.

The United States has entered into a number of tax treaties with approximately sixty countries. They include Canada, China, EU countries, India, Japan, South Korea, Mexico, New Zealand, South Africa, and many transition economies of Central and Eastern Europe. In most countries, the treaty prevails over domestic law. In the United States, if there is a conflict between a treaty provision and domestic law, whichever is recently enacted will govern the transaction.

The following are some of the common treaty provisions with regard to business profits.

- The export profits of an enterprise of one treaty country shall be taxable only in that country unless the enterprise carries on business in the other treaty country through a permanent establishment situated therein. The importing country may tax the enterprise's profits that are attributable to that permanent establishment (U.S. Model Income Tax Treaty, 7.1).
- Permanent establishment is meant to describe a fixed place of business through which the business of an enterprise is wholly or partially discharged. It includes a place of management, a branch, an office, a factory, a workshop, a mine, or any other place of extraction of natural resources. It is assumed to be a permanent establishment only if it lasts or the activity continues for a period of more than twelve months (U.S. Model Income Tax Treaty, 5.3).
- Permanent establishment shall not include certain auxiliary functions such as purchasing, storing, or delivering inventory (U.S. Model Income Tax Treaty, 5.4).
- An enterprise is deemed to have a permanent establishment in a treaty country if its employees conclude sales contracts in its name. If a Canadian exporter sends its sales agents to enter into a contract with a U.S. firm in New York, the Canadian company shall be deemed to have a permanent establishment in the United States even if it does not have an office in the United States (U.S. Model Income Tax Treaty, 5.5).
- Permanent establishment is not imputed in cases where a product is exported through independent brokers or distributors, regardless of whether these independent agents conclude sales contracts in the name of the exporter (U.S. Model Income Tax Treaty, 5.6).

CHAPTER SUMMARY

Ownership Structure

The forms of business organizations are sole proprietorship, partnership, and corporation.

Business or Trade Name

Corporations are required to register their trade name with the state. Sole proprietorships and partnerships are required to register with the appropriate government agency if they operate under a fictitious name.

Bank Accounts, Permits, and Licenses

1. Opening a bank account: It is advisable to open an account with an international bank.
2. An export/import firm can be operated from a home during the early phase of the business. All direct expenses related to the business are tax deductible.
3. The use of professional services is important as a source of guidance on liability, taxes, expansion, and related matters.
4. Permits and licenses: It is important to check with the city or county to determine if permits or business licenses are required.

Organizational Issues

Export decisions should be made regarding the need for a separate export department, coordination and control of various activities, organizational structure of the export-import department.

Common Organizational Structures

These are organizations along functional lines, organizations along geographical lines, and organizations based on product or market.

Taxation of Export-Import Business

Foreign persons' export profits are exempt from U.S. tax unless such profits are attributable to a permanent establishment maintained in the United States. Similarly, U.S exports will not be subject to tax in the importing country unless the firm has a fixed place of trade or business in the importing country or its agents in the latter country have authority to conclude contracts on behalf of the U.S. exporter.

Deductions and allowances include organizational costs, general and administrative expenses, personal and business expenses, entertainment, travel, and other related business expenses.

Transfer pricing is intended to ensure that taxpayers report and pay tax on their actual share of income arising from controlled transactions. There are several methods used to estimate an arm's length charge for transfers of tangible property: the comparable uncontrolled price method, the resale price method, the cost plus method, the comparable profits method, and the profit split method.

REVIEW QUESTIONS

1. What are the major disadvantages of running an export-import business as a partnership?
2. Are partnerships recognized as legal entities? Discuss.
3. Both general and limited partnerships may be useful forms of organization for export-import businesses. Why/why not?
4. What is an S corporation?
5. What types of professional services are needed when you start an export-import business?
6. State three typical organizational structures of firms that are engaged in international trade. Is a separate export department necessary for a manufacturing firm with limited exports?
7. ABC Company is incorporated in Florida although all its business activities are done in France. Its management office is located in Amsterdam, where the board of directors holds their regular meeting. The shareholders are from U.K. and Denmark and hold their annual meeting in Vienna. What is ABC's residence for tax purposes?
8. Are U.S. exporters subject to income tax in importing countries? What are the tax implications of establishing a trading firm as a branch (as opposed to a subsidiary) in foreign countries?

CASE 3.1. GLOBALIZATION AND THE SHRINKING TAX BASE

Many developed countries are confronted with declining tax revenues from multinational corporations. The recent European Commission proposal attempts to harmonize the tax base in the EU to limit the shrinking corporate tax yield. In view of the pressure to increase shareholder value, multinationals feel obligated to use complex tax avoidance strategies. In high tax jurisdictions, such as the United Kingdom, for example, investment inflows tend to lead to an increase in debt and a reduction in equity of the acquired firms. This often leads to large payments in tax allowable interest to foreign parent companies thus reducing taxable income. Thin capitalization rules intended to limit repatriation of profits through high interest charges on intragroup borrowings does not appear to be effective. These rules have not been able to prevent multinationals from transforming pre-interest profits into pre-tax losses in high tax jurisdictions.

A study by the *Financial Times* noted that eight of the top twenty non-oil multinationals operating in the United Kingdom paid little or no tax to the U.K. treasury in 2002. It indicates that in many cases, profits are being reduced by transfer pricing and intergroup charges. This includes, but is not limited to, overinvoicing imports and underinvoicing exports. A multinational, for example, sells goods to other group companies at below market prices while the subsidiary resells it at market prices, thereby ensuring that profits are made in low tax jurisdictions. Enforcement of existing rules has proven difficult. Comparing operating margins between sister companies and other competitors, etc., is often difficult because of the multinational company's different regional structures and mixes of product. Tax authorities do not have sufficient information relative to their multinational clients to effectively enforce the rules. One study estimates the total tax losses to the U.S. treasury from artificial transfer pricing at approximately $53 billion in 2001 (see Tables 3.1 and 3.2).

Here are other examples:

> The Asda Group, which was acquired by Wal-Mart (United Kingdom), declared pre-tax profits of £608 million in 2002. This shrinks at Asda's parent (Wal-Mart United Kingdom) to £209 million due to interest and amortization of goodwill on the acquisition. Not taking into account deferred taxation, the tax charge was at £88 million despite Asda profits of over £405 million.
>
> Deferred tax assets of the four largest investment banks in the United Kingdom amounted to over $1.1 billion in 2002. This allows them to pay less tax in the future by carrying forward their losses.
>
> In January 2002, Glaxo Smith Kline, the pharmaceutical firm, was presented with $5.2 billion bill for extra taxes (not paid due to transfer pricing) and interest by the U.S. government pertaining to revenues owed since the late 1980s.

Questions

1. Do you think countries' efforts to limit transfer pricing are effective?
2. What other ways are available to limit transfer pricing?

TABLE 3.1. Top Ten Sources of Lost U.S. Taxes Due to Overinvoicing of Imports/Underinvoicing of Exports, 2001

U.S. Export (Import)	Tax Loss at 34% (Million U.S. $)	Income Shifted (Million U.S. $)
Japan	10,154 (2,591)	29,864 (7,622)
Germany	3,475 (2,072)	10,221 (6,093)
Netherlands	2,484 (1,446)	7,299 (4,254)
Canada	2,375 (1,164)	6,987 (3,425)
Mexico	2,365 (1,095)	6,954 (3,220)
United Kingdom	2,237 (767)	6,578 (2,255)
Philippines	1,451 (653)	4,269 (1,921)
France	1,217 (537)	3,579 (1,578)
S. Korea	1,039 (465)	3,055 (1,368)
China	970 (449)	2,853 (1,322)

Source: Pak and Zdanowicz, 2002.

TABLE 3.2. Selected List of Abnormally Low Export/High U.S. Import Prices (2001)

U.S. Export	Destination	Price ($)
Bovine animals—live	Mexico	20.65/unit
Multivitamins	Finland	1.34/kg
Dynamite	Canada	1.24/kg
Radial tires—bus/truck	United Kingdom	11.74/unit
Diamonds	India	13.45/carat
Aluminum ladders	Hong Kong	1.75/unit
U.S. Import	**Source**	**Price ($)**
Multivitamins	China	1,868.77/kg
Plastic buckets	Czech Republic	973/unit
Fence posts—treated	Canada	1,853.50/meter
Wood Moldings	Bolivia	1,124/meter
Toilet/facial tissue	China	4,121/kg
Briefs and panties	Hungary	739/dozen

Source: Pak and Zdanowicz, 2002.