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Minimizing the Sting of International Taxes for U.S. Owner-Managed Businesses

"When it comes to taxes, corporate America is getting a bit less corporate. And a bit less American. Fueled by a wave of inversions, a record 54 companies in the Standard & Poor's 500 Index of leading U.S. firms are now at least partially exempt from the corporate income tax. That's more than twice the number four years ago."

--Zachary Mider, Bloomberg Business (*Ten Percent of S& 500 Companies Avoid Paying US Taxes*, April 15, 2015)

Mr. Mider's opinions are shared by many. The article cited above goes on to describe how a number of companies have capitalized on the opportunity to merge with foreign partners or competition, effectuating a transfer of headquarters outside the United States. The maneuvers fall into the general category of "inversion;" the details of inversion are not relevant to this article, but the impact is resounding.

The United States has one of a few remaining tax systems that taxes the worldwide profits of an entity incorporated in the country. Unlike the majority of systems in the world, where earnings are taxed where earned, the long arm of the U.S. system eventually requires a U.S. tax be paid on foreign earnings upon a repatriation event (i.e. payment or dividend).

Behind all the political rhetoric of calling United States companies "un-American" or "un-patriotic," it is apparent that there is more driving corporate behavior than misplaced desire to be un-American or un-patriotic. Rather, the most significant factor behind many of the 54 companies participating in the wave of inversions is economics rather than an ulterior motive.

A common denominator shared by almost all of the companies who have participated in inversions is the globalization of their organization. In many cases, including Medtronic Plc. or Mylan NV, the businesses have significant international organizations. A review of many inversion participants shows net income attributed outside the United States is greater than inside the country. In order to compete, these companies seek to find ways to reduce the tax burden.

The United States corporate community carries one of the highest effective tax rates in the world. Meanwhile, countries in Europe and Asia have adopted a territorial tax system and only tax income earned in that country. Remaining income is generally exempt from tax.

EXAMPLE

Consider a middle market precision manufacturing business. When originally established in the late 1960s, home markets consisted of other businesses manufacturing elsewhere in the rust belt.

Flash-forward to today – the company maintains a similar structure but it also has production and supply facilities in Europe and Asia. The overall business is very profitable with Europe and Asia generating 70% of net income and expanding.

In the current arrangement, all of the profit generated in Europe and Asia will eventually pay a U.S. tax on those earnings. Since the U.S. currently has the highest corporate tax rate, the return of 70% profit to the U.S. is particularly foolish (because of the additional tax burden).

The dichotomy of the systems pressures management and the board of many multinational companies. In many cases, companies more than 10 years old are structured to account for tax dynamics that were in place years prior and maintenance has been neglected. The rise of international markets and foreign-based customers draws smaller enterprises into international competition. The additional competition forces management to address all non-productive costs. In many cases, a change for tax purposes does not change the overall operation of the business. In the right circumstances, the reduction in cash taxes paid can be substantial.

In our example, the foreign earnings would be more valuable to shareholders without the additional tax. Without an additional tax drag, management could reinvest the savings into investments outside the U.S., generating an additional return without the additional tax of the U.S.

When looking through political rhetoric and examining inversion as a competitive strategy, it is apparent that an inversion is not a tax dodge but rather, for many companies, the inversion or similar transactions are entered into to remain competitively viable.

How Owner-Managed Business Can Benefit

It is common for owner-managed businesses to look at situations similar to that described above and conclude the actions of large multi-national businesses do not have applicability in the context of a smaller business. The truth is, there is applicability to the owner-managed business.

It is an economic truth that a business facing an income tax rate higher than its competition is at a disadvantage. A 10% tax rate difference between the U.S. and foreign competition will wipe out a majority of profit earned by the U.S. based enterprise. Furthermore, studies of inverted companies (including their investment prospectus and subsequent results) indicate that utilization of tax breaks provides resources for reinvestment that a U.S.-based business may not have.

If you can't beat them, join them. There are a number of tax incentives available to the owner-managed business that can have a significant

impact on the economics of international business.

Tax Opportunities for Owner-Managed Businesses

1. Explore the opportunities presented by the IC-DISC (Interest Charge Domestic International Business Corporation) for exports. This incentive can provide a 16% permanent tax savings on exports, allowing exporters the opportunity to reinvest into its international business courtesy of the Tax Code. *(Visit the Resource Library at LHarrisPartners.com to download a white paper on this topic.)*

2. Another opportunity is the ability to examine, identify, and implement customs and duty savings on products imported or exported.

3. The U.S. provides for research and development tax credits. Owner-managed businesses are nimble and often have not uncovered the significant permanent tax savings offered by the research and experimentation portion of the Code.

4. Finally, there are a series of international tax reform measures that have been proposed or are pending in front of Congress. Once the dust settles, the owner-managed business stands to recognize a windfall against its competition.

For more information on issues relating to international business taxes, contact:

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