

Report

Fall 2010

Global positioning

Planning helps avoid international tax surprises

Don't break the rule

The transfer-for-value rule
can trigger income tax liability

What have you got to lose?

Year-end tax planning for
investment and retirement accounts

Tax Tips

Estimated tax penalties,
home office deductions and more

SILICON VALLEY OFFICE

Three Lagoon Drive, Suite 400
Redwood City, CA 94065
tel 650 / 365.4646
fax 650 / 368.4055

www.seiler.com

A Member of HLB International

SAN FRANCISCO OFFICE

220 Montgomery, Suite 300
San Francisco, CA 94104
tel 415 / 392.2123
fax 415 / 392.1720

Global positioning

Planning helps avoid international tax surprises

Not long ago, international business was the domain of large corporations. Today, the Internet, advances in freight and logistics, and other developments have made global markets accessible to even the smallest businesses.

But just because some barriers have been lowered doesn't mean doing business internationally is easy. In fact, it's a complex process that requires a company to establish the necessary infrastructure, develop an understanding of foreign cultures, and prepare for a new tax environment. Careful tax planning can help you set up your international business in a manner that minimizes worldwide taxes and maximizes cash flow. Let's take a closer look at some of the issues you should consider.

Corporate structure

There are many ways to do business abroad, including direct exporting, a joint venture with a foreign partner, acquiring a foreign company, or establishing a new foreign subsidiary or division. The right strategy depends on several factors, including the laws of the country in which you wish to do business and the level of control you seek.



The structure of your global operations also has significant tax implications. Suppose, for example, that your business operates as an S corporation. Without careful planning, you may find yourself subject to double taxation on foreign income, paying corporate-level taxes in the foreign country *and* individual-level taxes in the United States.

Many countries have treaties with the United States that provide for low or no withholding taxes on cross-border payments, but there may be exceptions.

You can minimize or eliminate double taxation by setting up a hybrid structure — that is, one that's treated as a taxable entity in one country and a pass-through entity in another — and filing the appropriate elections. These structures allow foreign corporate-level taxes to flow through to the individual owners as credits against U.S. income tax. There may still be double taxation, however, to the extent that the foreign tax rates are higher than an owner's U.S. income tax rate.

Corporate structure also affects a company's ability to take advantage of foreign losses or to defer U.S. taxes on foreign income. For example, if a foreign operation is structured as a hybrid entity or as a branch or division, the owners may enjoy significant tax benefits by deducting foreign losses (subject to passive activity loss rules and other restrictions).

Should you consider an IC-DISC?

The interest charge–domestic international sales corporation (IC-DISC) provides closely held companies with an opportunity to reduce or defer foreign income taxes on exports of U.S.-produced goods without establishing a physical presence abroad.

An IC-DISC is a tax-exempt “paper” corporation set up to receive tax-deductible commissions on export sales. The maximum commission is the greater of 4% of gross receipts from sales of qualified export property or 50% of net income on those sales. If certain requirements are met, commission payments to an IC-DISC allow an exporter to convert ordinary income (currently taxable at rates as high as 35%) into qualified dividend income (currently taxed at 15%).

As of this writing, the favorable tax rate for qualified dividends is set to expire at the end of 2010. Unless Congress extends the 15% rate, dividends will be taxed as ordinary income. (Check with your tax advisor for the latest information.)

Even without the benefit of lower tax rates, however, an IC-DISC offers another significant tax advantage: It allows the exporter to defer tax on up to \$10 million in commissions held by the IC-DISC (that is, not distributed to the exporter) in exchange for modest interest payments to the IRS.

On the other hand, if you’re doing business in a country with low taxes, operating through a foreign subsidiary may allow you to defer U.S. taxes on foreign income (subject to limitations). For some companies, an interest charge–domestic international sales corporation (IC-DISC) can provide similar benefits at a low cost. (See “Should you consider an IC-DISC?” above.)

Income tax withholding and credits

It’s critical to understand a foreign country’s income tax laws, regulations and procedures. It’s particularly important to consider withholding taxes. If your company doesn’t have a physical presence in a country, the country may impose significant withholding taxes on your company’s gross income.

Many countries have treaties with the United States that provide for low or no withholding taxes on cross-border payments, but there may be exceptions. For example, some countries may not extend international treaty rights to certain types of entities, such as limited liability companies (LLCs).

The availability of foreign tax credits is crucial to avoiding taxation of income by both the foreign country and the United States. Withholding taxes paid to another country generally entitle your company to a dollar-for-dollar direct credit against U.S. tax liability.

But if you operate through a foreign subsidiary, it’s a bit more complicated. The subsidiary pays corporate-level taxes on foreign income, which becomes taxable in the United States when it’s distributed to the parent. The parent can claim an indirect tax credit for foreign taxes paid, subject to certain ownership requirements and limitations on the amount of the credit for certain types of income.

Indirect taxes

Don’t overlook indirect taxes, such as customs duties and value-added tax (VAT). Duties vary substantially from country to country and even from product to product. And there may be opportunities to minimize duties by categorizing products in a certain way or by unbundling products and reassembling the components after they’re imported.

A VAT is similar to sales tax, except it's imposed on the amount of value added at each level of the production process. Generally, the seller is responsible for collecting and remitting the tax, offset by any VAT the seller has paid to others.

More than 140 countries have VATs, and the rules vary dramatically from country to country. VAT rates generally fall between 15% and 25%. In some countries, VAT registration is required even if you don't have a physical presence there. Where registration isn't required, voluntary

registration may provide advantages, including quicker refunds of excess tax payments.

If goods will be stored in inventory for an extended period of time, consider using a bonded warehouse to defer customs duties and VAT.

Learn the language

Doing business abroad requires you to learn a new business language, and we've introduced just a few important terms. With the help of a tax advisor, you can translate these concepts into international business success. ©

Don't break the rule

The transfer-for-value rule can trigger income tax liability

A primary reason to create an estate plan is to ensure that your family is financially secure after you're gone. Life insurance typically is a key component of an estate plan because it provides an income source for loved ones. And, generally, the policy's death benefits won't be includible in the beneficiaries' taxable income.

To keep a policy you already own out of your taxable estate or to achieve other planning goals, it may make sense to transfer the policy for "valuable consideration." But income tax traps exist. So before making such a transfer, it pays to become familiar with the transfer-for-value rule.

The rule overview

When the transfer-for-value rule applies, the transferee — the person receiving the policy — will be subject to ordinary income taxes on the policy proceeds, excluding the consideration paid for the policy and any premiums or other charges he or she pays after the transfer.



The transfer-for-value rule is intended to discourage speculation in insurance policies by people who lack an insurable interest. An insurable interest is a legitimate reason for someone to be insured against your death — typically, this means the person would suffer

a financial hardship. Examples of people with an insurable interest on you could include your spouse, child and business partner.

Unfortunately, the rule's design doesn't necessarily jibe with its underlying rationale. For example, though the rule contains several exceptions, there isn't one for transfers to children or other family members who typically *do* have an insurable interest.

So what are the exceptions? One is when the transfer is made to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer. Be aware that this exception doesn't apply in reverse, when the transfer is to an officer or shareholder.

The pitfall

One reason the transfer-for-value rule is so dangerous is that the term "transfer" goes well beyond an outright sale or physical transfer of a policy. A transfer can occur, for example, when you name a beneficiary or assign someone an interest in the policy.

A transfer won't trigger income taxes unless the transferee provides "valuable consideration," but this aspect of the rule can be treacherous as well.

Valuable consideration isn't limited to money. It can be virtually anything of value to the transferor — the person transferring the policy or interest.

The transfer-for-value rule is intended to discourage speculation in insurance policies by people who lack an insurable interest.

It's logical to assume that the transfer-for-value rule won't apply to a gift of a policy or of an interest in a policy. In most cases, that's true, but even gift transfers should be examined closely to avoid the transfer-for-value trap.

The thought process

Including life insurance in your estate plan is a no-brainer, but if you plan to transfer a policy, you'd best stop and give plenty of thought before moving forward. The transfer-for-value rule is a tax trap you can easily fall prey to, so consult your tax advisor before taking action. ☺

What have you got to lose?

Year-end tax planning for investment and retirement accounts

As the economy continues to limp toward recovery, many people are finding that their investment portfolios are a mixed bag of gains and losses. As year end approaches, it's smart to review your situation and consider strategies that can minimize capital gains tax and use capital losses to your tax advantage.

Take inventory

You can offset capital gains with capital losses. And if your losses exceed your gains, you can offset the excess against up to \$3,000 in ordinary income (with unused losses carried forward to future years). Be sure to check your state's laws

regarding capital losses because they may differ from federal law.

Net short-term gains are taxed as ordinary income, while net long-term gains enjoy a lower tax rate — generally 15% for taxpayers in the middle and higher brackets. But as of this writing that rate is scheduled to increase to 20% in 2011 if Congress doesn't take action. Check with your tax advisor for the latest information.

If as year end approaches it looks like rates will indeed go up next year, you might want to sell appreciated investments by Dec. 31 to take advantage of the 15% rate. But if you have a net gain for the year and want to reduce your 2010 tax bill, consider selling underperforming investments to generate losses to absorb the gain.

Watch out for wash sales

What if you still have high hopes for a poor-performing investment? One option is to sell the investment at a loss to generate tax benefits and then reinvest to keep your portfolio intact.

For this strategy to work, you must beware of the wash sale rule, which prohibits a loss deduction if you acquire substantially the same security within 30 days before or after the sale. To avoid a wash sale, you can 1) sell the investment at a loss and wait 31 days to reinvest, or 2) buy replacement securities first and wait 31 days to sell the original investment. Either way, you assume the risk of price fluctuations during the 30-day waiting period.

What about retirement savings?

Can you use losses on stocks, bonds or mutual funds held in IRAs, 401(k) plans or other retirement accounts to generate tax benefits? Unfortunately, in most cases, the answer is no.

Traditional IRAs and employer-sponsored plans generally are funded with pretax dollars. Even if they've suffered substantial losses, if you sell the investments and close the account, the



amount you withdraw will be treated as taxable ordinary income.

You may, however, be able to deduct losses in a Roth IRA, traditional IRA or employer plan if you've built up a sufficient tax basis through nondeductible contributions. Suppose, for example, that you've made \$30,000 in nondeductible contributions to a traditional IRA but the IRA's current value is only \$20,000. If you close the IRA, you'll realize a \$10,000 loss.

The loss has limited value, though. To deduct the loss you'll be required to close any other traditional IRAs you own. Plus, the loss can be deducted only as a miscellaneous itemized deduction. Such deductions are subject to a 2% of adjusted gross income (AGI) floor, so you'll enjoy a tax benefit only if your total miscellaneous deductions exceed 2% of your AGI.

For a traditional IRA that has lost value, consider converting it to a Roth IRA. Why? Doing the conversion while the IRA's value is depressed can minimize the tax hit. Plus, if you convert in 2010, you can defer the income and report half on your 2011 return and the other half on your 2012 return.

Look at the big picture

Investment decisions should never be based on taxes alone. But taking taxes into account in your planning can help improve your after-tax return. ©

tax TIPS

Avoiding estimated tax penalties

To avoid penalties, your estimated tax payments or withholding must equal at least 90% of your tax liability for 2010 or 100% of your 2009 tax (110% if your 2009 AGI was more than \$150,000 or, if married filing separately, more than \$75,000). If you make estimated tax payments and are in danger of falling short of the requirements this year, consider increasing your withholding to reduce or even eliminate penalties.

Although you can make up the shortfall by increasing your last estimated tax payment (due Jan. 15, 2011), doing so won't relieve you from penalties for underpayments earlier in the year. Taxes withheld by Dec. 31 from salary or bonuses, on the other hand, are treated as if they were withheld ratably throughout the year.

So, unlike a large, fourth-quarter estimated tax payment, a big increase in year-end withholding can help you avoid underpayment penalties. ☺

How to accelerate home office deductions

Many companies conduct cost segregation studies of their facilities to identify building components eligible for accelerated depreciation. If your home office qualifies for the home office deduction, a similar study may allow you to boost your write-offs.



Ordinarily, the business portion of your home is treated as nonresidential real property and depreciated over 39 years. A cost segregation study may identify opportunities to allocate a portion of the cost to building components properly

classified as personal property and depreciated over as little as three, five or seven years. Examples include certain equipment, built-in cabinets and modular units, movable partitions, wall and floor coverings, light fixtures, and telephone wiring. ☺

Wash sale isn't always a dirty word

The article “What have you got to lose?” on page 5 warns that the wash sale rule prohibits you from deducting a loss on the sale of a security if you acquire substantially the same security within 30 days before or after the sale. But the rule doesn't prevent you from selling stock or other securities to recognize a *gain* and then buying back the same stock or security immediately to keep your portfolio intact.

Why would you want to recognize a gain? One reason is to lock in the current low rate on long-term capital gains. If you expect capital gains tax rates to go up after 2010 (and, as of this writing, they will do so, absent new legislation), you may be better off recognizing the gain now rather than paying higher taxes in the future. ☺



George D. Marinos, CPA

Expertise: High net-worth individuals; closely-held businesses; real estate; tax planning and compliance for individuals, partnerships and corporations; personal service organizations.

Education: BS, Accounting, University of San Francisco, 1990.



David M. Sacarellos, CPA

Expertise: Real estate; high net-worth individuals; multi-generational families; family office; private foundations.

Education: BS, Accounting, San Jose State, 1987; MS in Taxation, Golden Gate University, 1993.

Developments Affecting California Taxpayers

California Taxpayers are Assessed Underpayment Penalties — California taxpayers with prior year adjusted gross income (AGI) exceeding \$150,000 (\$75,000 for married filing separately) are required to pay 110% of the tax shown on the return for the preceding taxable year. This provision is often referred to as the “safe-harbor” rule. However, starting in 2009 California also requires individual taxpayers with California AGI equal to or greater than \$1 million (\$500,000 for married filing separately) to pay 90% of the current year tax or be subject to the underpayment of estimated tax penalty. There is no prior-year safe harbor for these taxpayers. The Franchise Tax Board this past summer mailed tax notices of balance due to taxpayers who underpaid their 2009 personal income tax payments. To avoid the underpayment penalty for 2010 state estimated tax payments, taxpayers with an unexpected increase in income in 2010 should annualize their income and make an additional payment in the quarter in which the income increased.

Limited Relief for Taxpayers Assess with Underpayment Penalties — Although the prior-year safe harbor provisions do not apply for taxpayers with AGI of \$1 million or more, there is one exception. A taxpayer is not subject to the penalty if, in the prior year, the taxpayer had a liability of \$500 or less (\$250 for married filing separately); and made all payments in the prior year through withholding. Otherwise, a taxpayer may request abatement of the underpayment penalty if the underpayment is due to a casualty, disaster, or other unusual circumstance and it would be inequitable to impose the penalty; or the taxpayer retired after age 62 or became disabled in 2008 or 2009 and the underpayment was due to reasonable cause.

California Estimated Tax Payments are Different than the Federal Percentages — Individual and corporate estimated tax payments are required to be paid in the following manner: First quarter: 30%; second quarter: 40%; third quarter: 0% and fourth quarter: 30%. (Federal payments are required to be made 25% in each quarter.) However, there is an optional method to pay estimated taxes that may be advantageous to some California taxpayers: The annualized income installment method.

California Taxpayers Can Use the Annualized Income Installment Method — The annualized income installment method annualizes a taxpayer’s tax at the end of each period based on income, deductions, and other items relating to events that occurred from the beginning of the taxable year through the end of the installment period. This method might benefit taxpayers who do not receive taxable income evenly during the year. The annualization option allows taxpayers to match their estimated tax payments to the actual period when they earned the income. Generally, a taxpayer whose income is received early in the year will not benefit by using the annualized installment method because their first payment is disproportionately large. California generally follows federal law with respect to the annualized income installment method with one important difference: the required payment percentages. The required payments for the annualized method are First quarter: 27%; second quarter: 63%; third quarter: 63% and fourth quarter: 90%. (Federal payments are First quarter: 22.50%; second quarter: 45%; third quarter: 67.50% and fourth quarter: 90%.) Taxpayers who use the annualized income installment method for any payment due date must use it for all payment due dates. Also, Form FTB 5805, *Underpayment of Estimated Tax by Individuals and Fiduciaries* (or Form FTB 5806 for corporations) must be attached to the California return.

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Did You Know ... In the 1940s, the FCC assigned television’s Channel 1 to mobile services (two-way radios in taxicabs, for instance) but did not renumber the other channel assignments. That’s why TV sets have channels 2 and up, but no channel 1.

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