International Trade & Title: Security & Tax Concerns—Part 2

By Jim Giermanski and Mitch McGhee

LAST MONTH WE COVERED THE SIGNIFICANCE of the passing of title in international sales and its impact on security liability. Now we will examine how the country where title transfer occurs can affect a domestic company's tax liability—adversely or beneficially.

Taxation

The *United Nations Convention on Contracts for the International Sale of Goods* (CISG) treats the transactional aspect of a contract and not property aspects. There are no articles within the CISG that specifically treat the passing of title. But this doesn't mean that there aren't tax implications to the agreements made between the parties to a transaction. The U.S. tax code treats the question of title transfer and taxation:

> "For the purposes of Part I (section 861 and following), Subchapter N, Chapter 1 of the Code, and the regulations thereunder, a sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss..." (IRC Sec. 1.861-7, Sale of personal property, as cited in *Tax Analysts*, February 2002, p. 1.)

When a domestic company and a foreign company enter into a transaction, the country where the title of ownership passes normally determines where the income is sourced. Why is this an issue to the parties involved? Put simply, it determines under whose tax jurisdiction the income from the sale will fall. Other issues that also come into play are whether it's personal or real property and, if it's personal property, if it is purchased inventory or manufactured inventory.

Real property is sourced based on its location (IRC Sections 861(a)(5) and 862(a)(5)). The general rule for personal property is that the residence of the seller determines the sourcing of the gain. Therefore, a U.S. resident selling personal property would generate U.S. source income from the sale of personal property, and a nonresident would generate foreign source income. As is the case in many situations dealing with the tax code, there are exceptions to this rule. One exception deals with inventory and is divided into two categories: purchased and produced. IRC Section 865 contains the source rules for personal property sales, while IRC Sections 861, 862, and 863 deal with the sale of inventory property.

Purchased inventory provides the greatest opportunities to structure transactions to minimize the company's U.S. tax liability. This is because the income from the sale of purchased inventory is sourced in the country where the sale/passing of title takes place. Since the parties involved can negotiate where this occurs, the seller and buyer can determine where they would like the transaction to be subject to taxation first. Because the U.S. taxes its citizens and residents on worldwide income, there are mechanisms in place to reduce/eliminate double taxation. Foreign taxpayers aren't subject to U.S. taxation unless they have effectively connected income or U.S. source income. Let's look at two possible scenarios:

SCENARIO 1

Assume that Powers International Inc. (a U.S. company) has foreign-source income of $10,000,000 and worldwide income of $30,000,000, and a U.S. tax liability on the foreign-source income is $3,500,000. But it also has foreign taxes of $2,500,000 eligible to be used as a credit against its U.S. tax liability. The company currently is negotiating a deal with Smith Group, Pty., Ltd., a South African firm, that would result in an additional $5,000,000 of income. If the sale is considered to be U.S.-source income, Powers International could owe an additional $1,750,000 to the U.S. Treasury, depending on the applicable tax provisions.

If the sale is considered foreign-source income, Powers International's U.S. tax liability could actually be reduced. If the taxes it paid on the sale exceeded $1,750,000, then its worldwide tax liability would increase by $1,750,000. Its U.S. tax liability, however, would decrease by the amount of the foreign tax exceeding $1,750,000—assuming the foreign tax on this transaction doesn't exceed $2,750,000. This amount was determined as follows: $3,500,000 U.S. tax liability on foreign-source income (this assumes a margin U.S. tax rate of 35%) minus $2,500,000 of foreign tax plus the $1,750,000 of U.S. tax liability on the additional income (($3,500,000 – $2,500,000) + $1,750,000). This is because the foreign tax credit rules limit the total of the credit to the amount of U.S. tax liability on foreign-source income. In this situation, Powers International might desire to have the sale be treated as foreign-source income.

SCENARIO 2

Now assume Powers International Inc. has no foreign-source income or foreign taxes that would be eligible for the foreign tax credit and that it is at the 35% marginal tax rate. If the company has an opportunity to make a sale to Smith Group, Pty., Ltd., the location of the sale could determine the worldwide tax liability of Powers International. If the South African tax liability is 35% of the income or less, then worldwide tax liability would be the same whether the sale occurred in the U.S. or in a foreign location. If the South African tax liability exceeds 35% of the income, however, then Powers International would have a worldwide tax liability that exceeded its U.S. tax liability for the current year—again, because of the limit placed on the amount allowed as a credit against U.S. taxes. In this situation, Powers International should prefer to have the sale occur in the U.S. to minimize worldwide tax liability.

In both scenarios, it's assumed that the only foreign taxes paid would be eligible for the foreign tax credit. It's also assumed that the additional income would be placed in the same "basket" for determining the eligible amount of foreign taxes. (There are very complex issues involved in determining the foreign tax credit, the treatment of which is not the purpose of these examples.) Depending on a nation's tax code, the buyer and seller have options to minimize tax liability. But this option isn't without some restrictions.

There are two important considerations that directly influence a firm's tax strategy as it relates to title transfer. If the transaction is determined to be structured primarily for the purpose of tax avoidance, the title-passage strategy may be denied by the IRS, and the sourcing will be determined by other factors, such as where the negotiations took place, where the agreement was executed, the location of the property itself, or how payment was made (IRC Reg. 1.861-7 (c)). In order to show another motivation for selecting a particular point to transfer title, the security considerations mentioned in Part 1 could be used to justify the transfer of title at a given location.

Personal property that one produces doesn't qualify for the title-passage rule. It must be allocated between the country of manufacture and the country where the sale occurs. Because of this requirement, there is less flexibility in sourcing the income to a particular country. The portion of the income that isn't allocated to the country of production still can provide some planning opportunities for the parties involved in the transaction.

In general, the importance of title transfer, while clear, often isn't appreciated because of the subtle yet critical dimensions of security liability, tax liability, and their associated risks and costs. Understanding the importance of title transfer is very critical in limiting risks and costs, especially at this time of globalization and all that it brings. ■

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