

Talking Points

International Tax Representation

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Companies planning to expand their international operations need to consider a wide variety of factors: Foreign demand for the company's products and services; transparency and cost efficiency of foreign subsidiaries; operating, investing, financing and non-cash expenses; and the impact of international expansion on the company's aggregate tax burden.

For companies expanding their foreign operations, international tax representation offers important advantages over overseas permanent establishments. The objective of this article is to explain international tax representation structures, compare and contrast such structures with permanent establishment forms, and specify the business conditions where international tax representation constitutes the preferred mode of foreign expansion.

Types of Permanent Establishments

The appropriate form of a company's international presence depends on the nature and expected intensity of the enterprise's anticipated foreign activities. International corporate expansion typically occurs in three phases:

PHASE 1: Companies with limited international business relations may not require any permanent establishment abroad. In this phase of the company's international development, cross-border transactions chiefly involve singular sales to foreign buyers. The volume of international business is not large enough to justify the establishment of a foreign facility.

PHASE 2: As companies widen their foreign operations to satisfy growing demand in the target markets, international tax representation becomes a useful instrument that enables enterprise managers to manage global tax liabilities while keeping core corporate functions at home.

PHASE 3: Eventually, the company's international expansion strategy mandates cross-border mergers and acquisitions, foreign joint ventures, and greenfield investments in the target markets. In these instances, the company needs permanent establishments to support foreign subsidiary manufacturing, international marketing and distribution, business process outsourcing, and related global activities.

The first and third phases are already well known and widely used by international companies. However, only a few companies take full advantage of international tax representation as an intermediary mode of foreign expansion. Indeed, many corporate managers migrate directly from Phase 1 to Phase 3, setting up permanent establishments before such entities are necessitated by actual business conditions in target foreign markets. Experience shows that companies in Phase 2 of international development (e.g., accumulating foreign inventories but not yet engaged in overseas manufacturing and distribution), international tax representation provides greater flexibility, transparency, and tax benefits than permanent establishments.

Preconditions for International Tax Representation

National-level legislation specifies the rules governing how companies may operate without a permanent establishment in particular countries. But the general framework for tax representation is provided in international treaties (e.g., the OECD Model Treaty) as well as bilateral double taxation agreements.

Because permanent establishments represent the threshold at which companies become liable to corporate taxation in host economies, international tax representation serves as a tax planning tool that lowers the overall tax burden of foreign operations.

As a rule of thumb, an international tax representation scenario (Phase 2 above) should meet the following criteria:

- no employees working abroad
- by foreign jurisdiction, neither the nature of the activities carried out abroad nor the physical infrastructure require setting up a permanent establishment

Components of International Tax Representation

International tax representation structures possess the following elements:

1. Companies opting for international tax representation use foreign subcontractors and overseas warehousing facilities that are not owned by the represented entity.
2. Due to the prohibition on direct involvement with foreign employees, tasks related to the company's core business remain domestic. Management of customer orders and stock flows, production, finance, quality assurance, risk management, and other core business functions are performed at company headquarters and other domestic facilities.
3. As a specialized service provider, international tax representatives are responsible for settling all foreign tax liabilities. They represent the company during tax audits and other proceedings with foreign tax authorities. International tax representatives should liaise with the Chief Financial Officer of the represented company. Through their regular reports and advisory services, these tax representatives proactively support the company's decision making procedures.
4. Specialised providers of international logistics and warehousing services should operate according to the instructions

received from the represented company's management team. Due to strict shipment and customs documentation requirements in foreign markets, they should closely cooperate with the company's designated international tax representative.

Advantages of International Tax Representation

As described above, when foreign operations are carried out in tax representation structures, core business competencies and responsibilities are kept at home while some financial and logistics tasks are outsourced to foreign service providers. This arrangement provides a number of advantages over permanent establishments.

The international tax representative acts as the company's early warning system, while specialized subcontractors provide regular feedback on foreign operations. Strategic decision making remains with the company, allowing enterprise managers to adapt quickly to changing business conditions in foreign markets.

Furthermore, international tax representation is a universal tax planning tool. Unlike other tax planning instruments that involve specific institutions or licenses (e.g. customs warehouses, consignment stocks, triangulation transactions, deferred import VAT settlement licenses, etc.) international tax representation faces few boundaries that limit the structure's foreign applications.

International tax representation solutions are not specific to any industry. For inventory sales, imports, purchase of spare parts, distant sales to individuals, broadcasting services, and other cross-border transactions, international tax representation is a useful tool for almost every industry.

SWOT Comparison: Permanent Establishment vs. International Tax Representation

A SWOT analysis (Strengths, Weaknesses, Opportunities, Threats) illustrates the relative virtues and demerits of permanent establishments and international tax representation.

Chart 1 summarises the advantages and disadvantages of a forming permanent establishments abroad:

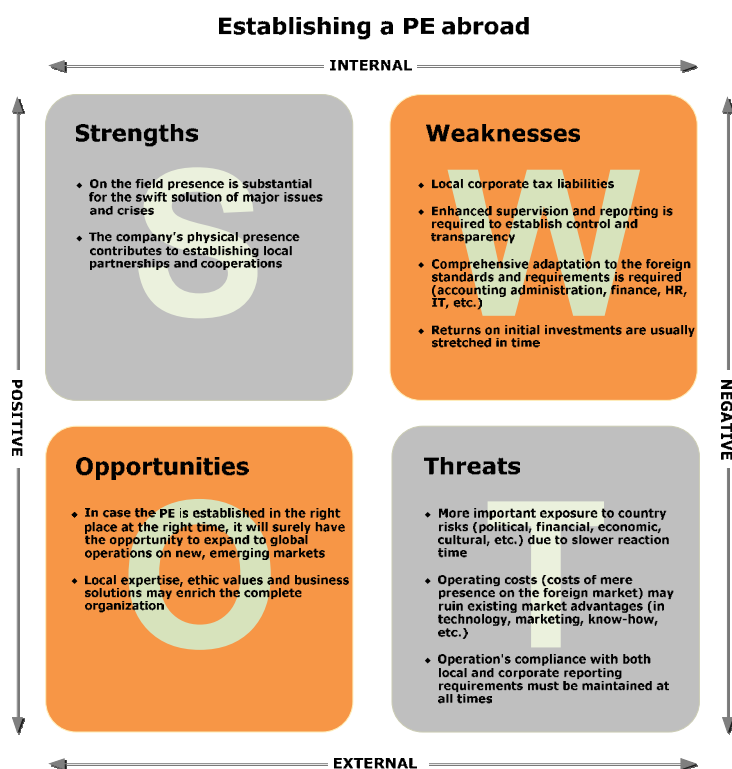
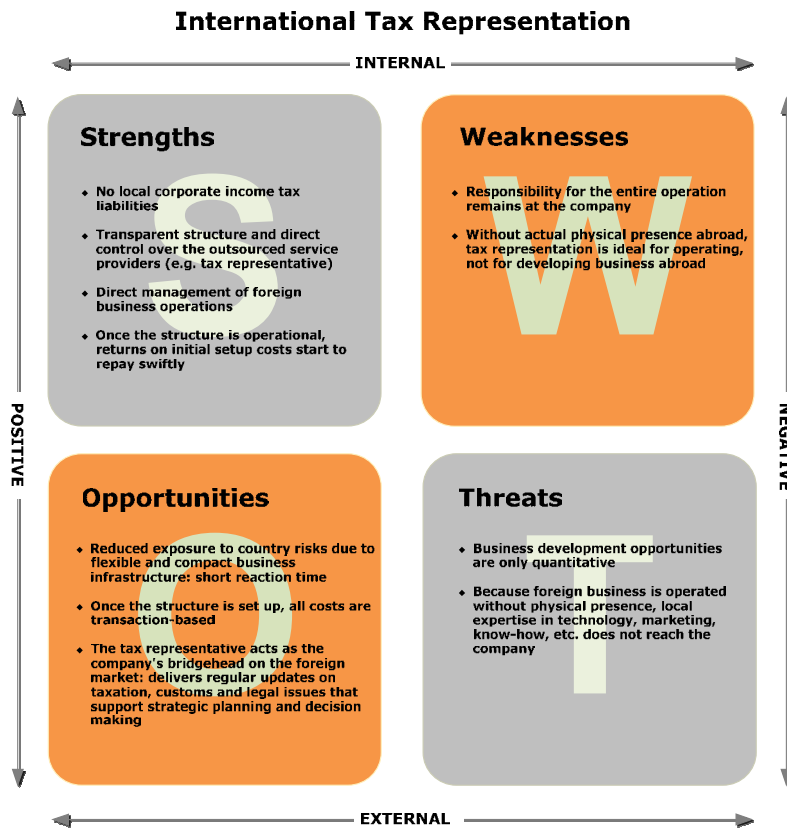


Chart 2 shows the advantages/disadvantages of creating an international tax representation instead of a permanent establishment:



This SWOT analysis indicates that in Phase 2-type scenarios where companies are in the early stages of foreign expansion, international tax representation is more cost-efficient, transparent, and flexible than a permanent establishment. Case studies suggest that companies may save as much as 40 percent of the costs of forming and operating a permanent establishment by employing an alternative international tax representation structure.

Limits of International Tax Representation

Notwithstanding these advantages, international tax representation has several limitations:

Firstly, foreign tax liability is a crucial issue in international tax representation. In the case of fiscal representation (i.e., tax representation services provided to enterprises seated outside the European Union), corporate managers must deal carefully with the joint and mutual responsibility for the represented company's foreign tax liabilities. By standard procedure, fiscal representatives require bank guarantees to cover their exposures. Practically, this is the cost of transparency: hands-on management of the foreign operations and real time access to the backup documentations on one hand and the bank guarantee to cover for the legally

set liabilities of the fiscal representative on the other. For tax representation services provided to companies seated in the EU, no bank guarantee is required but responsibility for the foreign tax liabilities remains with the company.

Secondly, international tax representation is ideal for operating but not for building foreign businesses. Tasks related to business building (customer service, marketing, etc.) can only be carried out by external subcontractors in the tax representation structure. Once company management determines to undertake a major expansion of foreign operations, reliance on subcontractors may no longer suffice and a permanent establishment should be formed. However, international business practice shows that such a transition (migration from Phase 2 to Phase 3) usually follows years of operation in a tax representation structure.

Conclusion

In summary, international tax representation is a universal tax planning tool that complies with foreign tax laws while strengthening the company's ability to manage its overall tax liabilities at the corporate level. The most important feature of international tax representation is that it keeps corporate income taxation in the country where the company is seated. Under tax representation structures, international operations must not involve employees (foreign or domestic) and physical infrastructures should be limited to rented properties. Due to these structural limitations, tax representation is the ideal solution for companies operating foreign businesses but not for companies seeking to build their offshore businesses.

About the Author

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