

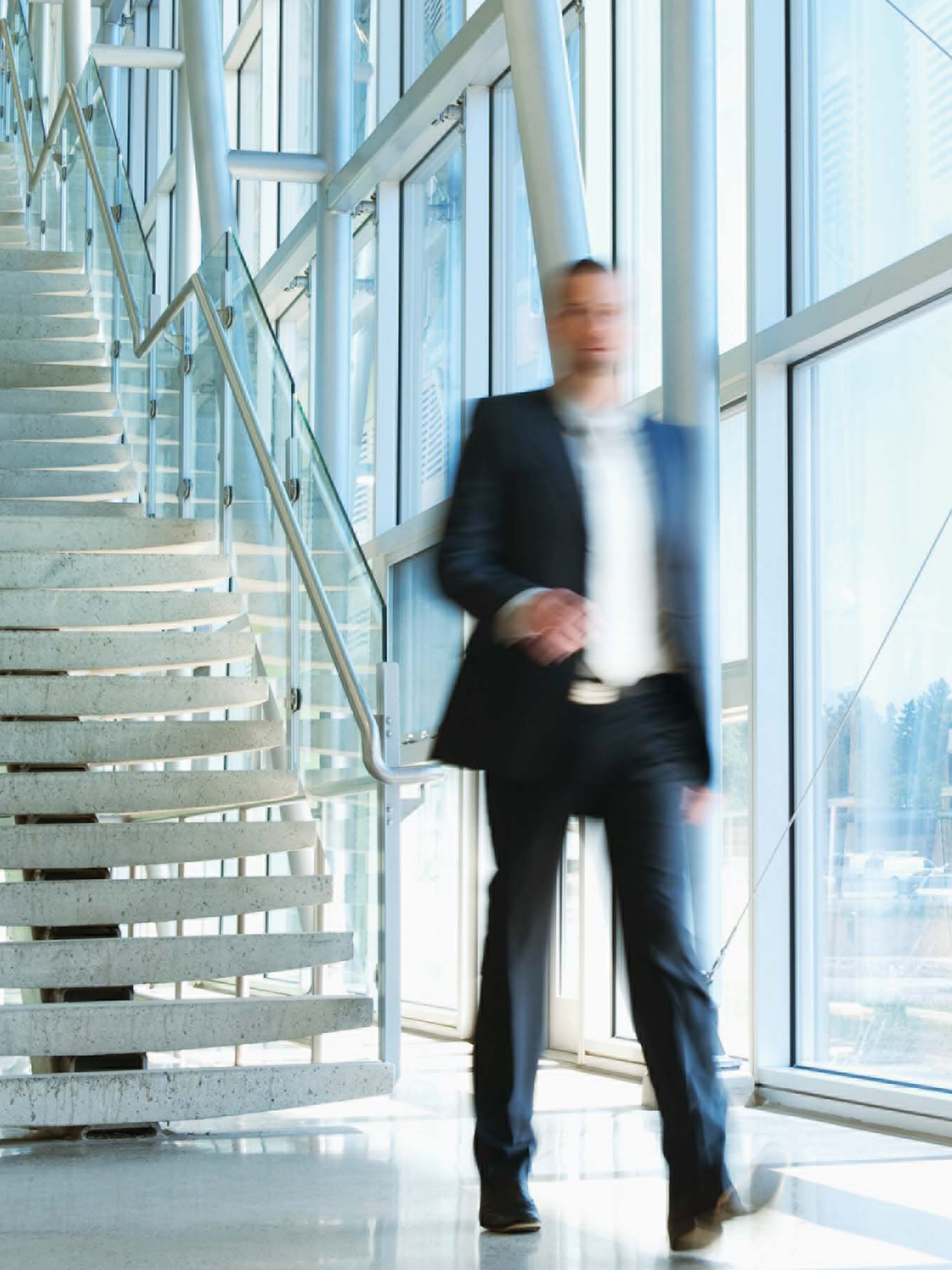


# Step by step, helping you succeed in the US

The inbound guide to  
US corporate tax



Building a better  
working world



## The inbound guide to US corporate tax

Inbound foreign direct investment has long played an important role in the US economy. Foreign companies with operations in the United States invest billions of dollars here. They employ millions of US workers and offer very competitive levels of compensation. Their investments help to modernize the US capital stock, and they are important contributors to the US manufacturing sector. Majority owned US affiliates of foreign parents accounted for nearly 4.7% of total US private output in 2011. In addition, these affiliates accounted for 9.6% of US private investment, 15.9% of US private research and development spending, and employed about 5.6 million people in the United States. Indeed, President Obama affirmed the value of investments by foreign-domiciled companies to the US economy and made a commitment to treat all investors in a fair and equitable manner so that the United States remains the “destination of choice for investors around the world.”<sup>1</sup>

Investment in the United States remains an attractive proposition despite a decline since the beginning of the global economic and financial downturn. According to a US Department of Commerce report,<sup>2</sup> the United States has been the world’s largest recipient of foreign direct investment since 2006. Foreign affiliates held net US assets worth \$3.9 trillion in 2012, which includes a net inflow of \$166 billion in 2012. Although this amount represents a decrease from the \$230 billion of foreign direct investment in 2011, it is still above the 2009 financial crisis low of \$150 billion.

The majority of this investment still comes from Japan, Canada, Australia and the European Union. Collectively, investors from these jurisdictions accounted for more than 80% of foreign direct investment in

the United States. Although investment inflows from emerging markets remain relatively small overall, the investments from emerging market jurisdictions have increased dramatically from just a decade ago.

As the world’s largest economy, the United States provides abundant opportunities in which to operate, an innovative and productive workforce, excellent infrastructure, appropriate legal protections, a predictable regulatory environment, and lucrative consumer and business-to-business markets. It also delivers a tax code that covers more than 17,000 pages – not to mention common law precedent. Although not all provisions necessarily apply to inbound investors, you must navigate your way through sometimes vague (and often confusing) tax regimes at the national, state and local levels to maximize the possibilities and manage the risks. Missteps and missing information can create undue risk and affect the ultimate success of your cross-border operations.

We know that every business has a unique set of circumstances and attributes that trigger specific tax obligations. That said, there are certain overarching policies and approaches that can help make the process of doing business in the US smoother. This handbook is designed to provide you with a ready guide to some of that information. However, we urge you to consult with a qualified and trusted advisor before you make any significant business or tax-related decisions to more fully understand what impact the US tax code and financial landscape may have on your corporate entity.

We wish you every success doing business in the US.

<sup>1</sup>“U.S. Inbound Foreign Direct Investment,” Executive Office of the President Council of Economic Advisers, June 2011.

<sup>2</sup>“Foreign Direct Investment in the United States,” US Department of Commerce and the President’s Council of Economic Advisers, October 2013.

# Contents

Viewing the US tax landscape .....	01
Understanding corporate tax – a look at the fundamentals .....	02
Who has to pay? .....	02
How much is the tax?.....	03
Tax rates at a glance .....	03
Who doesn't have to pay? .....	04
Determining your taxable income .....	05
The US tax code and inbound investors .....	05
Structuring your US business entity and activities .....	06
Forms of enterprise and their tax implications .....	06
Establishing a US corporation .....	10
Some special investment structures .....	10
Financing your US investments .....	11
Other potential corporate tax liabilities .....	12
State and local tax .....	12
Transfer pricing and documentation .....	12
Sales and use taxes .....	13
Human capital and personal tax .....	13
Tax treaties .....	16
Controversy, misconceptions and potential trouble spots .....	17
Glossary .....	18

# Viewing the US tax landscape

In the US, responsibility for writing and approving federal tax law rests with Congress and the President. The Department of the Treasury issues regulations that interpret tax law. The Internal Revenue Service (IRS) enforces tax laws, collects taxes, processes tax returns, issues tax refunds and turns collected taxes over to the US Treasury, which, in turn, pays the various government expenses. Trade and tariff law enforcement and duty collection are the responsibility of various agencies within the Customs and Border Protection agency.

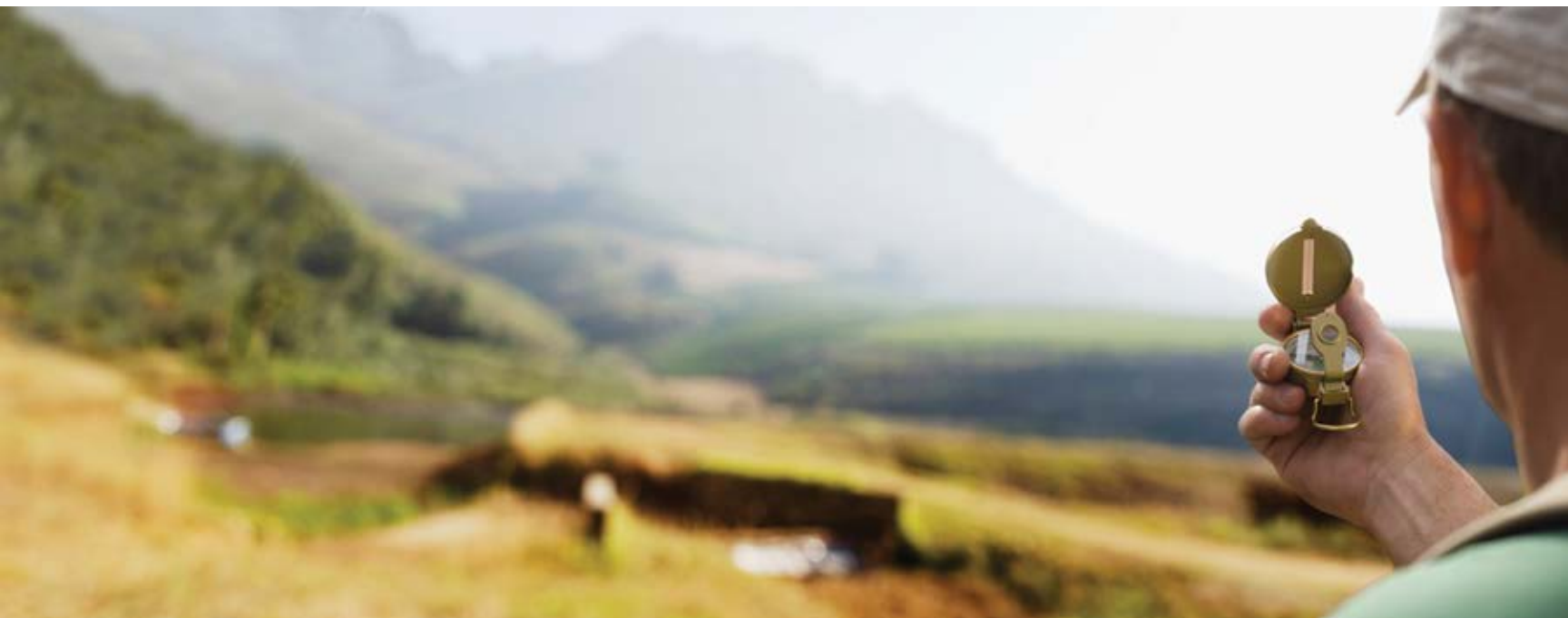
It is safe to say that the US has one of the most complex tax systems in the world. In addition to federal tax authorities, there are state and local government agencies within this country's 50 states. These tax boards and agencies are responsible for developing and enforcing their own jurisdictional laws in cooperation with federal regulators.

Although the US does not impose a value-added tax or stamp duty, every person, organization and company in the US is subject to income taxation. Income must be reported, and taxes must be calculated and paid. Even exempt organizations must file a return and, if certain criteria are not met, the tax-exempt status can be revoked.

Income includes wages, interest, dividends, profits on investments, pension payments and more. The US uses a "pay as you go" approach for income taxes. Taxes on the wages paid to an individual are deducted and sent directly to the taxing authorities. Corporate taxes are paid quarterly.

The annual corporate tax return is due by the 15th day of the third month after the close of the company's fiscal year; the filing date for individual taxpayers is 15 April.

A corporation can request and is entitled to a six-month extension to file its return. In general, 100% of the corporation's tax liability must be paid through quarterly installments during the year the income is earned. These estimated payments are due on the 15th day of the fourth, sixth, ninth and twelfth months of the company's fiscal year.



# Understanding corporate tax – a look at the fundamentals

Every transaction has a tax consequence. At the same time, each non-US business operating in this country has a unique set of facts and circumstances that shape those consequences and create a range of tax obligations, based primarily upon the US Internal Revenue Code (IRC or the Code) and related regulations.

## Who has to pay?

US individuals, corporations and their foreign branches must pay US federal, state and local tax on their worldwide income. By contrast, foreign corporations and their US branches and partnerships are subject to US tax only on their income that is effectively connected to a US trade or business (ECI) or income that is fixed, determinable, annual or periodic (FDAP).

**FDAP** income includes US source interest, dividends, rents and royalties and generally does not include capital gains.<sup>3</sup> Although US source interest and dividend income is taxed as FDAP, several statutory exemptions may apply. These exemptions include:

- ▶ Bank deposit interest paid by a US banking institution to a foreign person
- ▶ Portfolio interest from third-party debt obligations held for investment purposes, which can include original issue discount interest
- ▶ Short-term interest on instruments with a maturity of 183 days or less

**ECI** must be associated with US-based activity that rises to the level of a **US trade or business**. Any company, including a branch of a foreign corporation, can conduct a US

trade or business. There is no comprehensive definition of a US trade or business beyond the premise that activity in pursuit of profit that is considerable, continuous, regular and substantial is necessary to establish a trade or business. Isolated or occasional activities and passive investment activities are usually insufficient to create ECI. Case law generally provides clarification based on measurement of the owner's level of activity.

The chart below shows some examples of corporate activities and when they constitute a trade or business.

If the foreign corporation is resident in a country that has an income tax treaty with the US, however, business profits are taxable by the US only to the extent that the income

is attributable to a **permanent establishment** (PE) in the US. Although the definition of income that is effectively connected to a US trade or business is similar to the definition of profits attributable to a PE in many treaties, there are some differences. In general, a PE requires a more stable or permanent business connection with the US. So it is possible for a foreign enterprise to be engaged in a US trade or business without rising to the level of a permanent establishment. Thus, in a case where the PE provisions of a treaty apply, the income would not be subject to US tax. However, an annual tax return must still be filed.

### Determining trade or business

Activity	Trade or business	Not a trade or business
Ownership of real property	▶ Rental property that is actively managed by the owner or through agents	▶ Land held for pure investment ▶ Rental property subject to something like a triple net lease
Interest in natural resources	▶ Working interest if the owner supervises and provides day-to-day control	▶ Royalty interest ▶ Working interest if owner turns over day-to-day control to an independent operator
Sales of property	▶ Multiple sales of inventory property	▶ Sale of investment property
Money lending	▶ Lending to "customers"	▶ Investing in bonds
Personal services	▶ Personal services, whether performed as an employee or an independent contractor, are always a trade or business subject to certain <i>de minimis</i> exceptions	
Representative offices	▶ Active solicitation of sales	▶ Purely promotional activities, such as advertising or gathering and dispersing information

<sup>3</sup>Interest is generally sourced according to the residence of the debtor.

## How much is the tax?

ECI is taxed on a net basis at graduated rates comparable to the tax imposed on US corporations. That is from 34% for companies with taxable income of more than \$75,000 and less than \$10 million, up to a 35% minimum rate on net taxable income of more than \$10 million for federal tax purposes.

**Branches and partnerships** that have ECI are subject to the branch profits tax. Similar to the tax treatment of a corporation that issues dividends, the branch profits tax is a 30% tax on deemed withdrawals from the branch. The tax base is essentially the branch earnings for the year, less the amounts reinvested in the US.

Tax on **FDAP** is withheld at the source on a gross basis at a 30% statutory rate. However, this rate can be reduced by treaty provided that the recipient is eligible for treaty benefits.

In addition to the federal tax liability, US income can be taxed at the state and local levels. State tax rates vary from 0% to 13%, and the state income tax paid is deductible for federal income tax purposes.<sup>4</sup> Given the possibilities for multiple taxation, it is not unusual for a corporation to have a US effective marginal tax rate between 38% and 40%.

## Tax rates at a glance

The chart below provides a basic list of the potential taxes and tax rates that may be levied on an inbound company. Not all of the taxes will apply to every investor and may vary according to the maturity of the business. Also, some of these taxes may be reduced depending upon such factors as reinvestment, treaty provisions and other exemptions or exceptions. Be sure to check with your professional services advisor to see that you have addressed all relevant and potentially relevant areas of tax liability.

Nature of tax	Rate
Corporate income	35%
Capital gains	35%
State and local tax	Various by each state and locale
Withholding tax, including:	30% (applicable to payments to nonresidents)
▶ Dividends	
▶ Interest	
▶ Royalties and rents	
▶ US-situs services	
Customs and duty	0%-20% (depending upon circumstances)
Branch profits	30%
Branch interest	30%
Personal holding company (undistributed passive income)	15%
Accumulated earnings (excessive)	15%
<b>Payroll</b>	
▶ Federal unemployment insurance	▶ 6.0% on first US\$7,000 of wages
▶ Workers' compensation insurance	▶ Various according to state laws and nature of work
▶ Social security (on wages up to US\$113,700)	▶ 6.2% (employer contribution) ▶ 6.2% (employee contribution)
▶ Medicare Tax	▶ 1.45% (employer contribution) ▶ 1.45% (employee contribution)

<sup>4</sup> More details on state and local tax (SALT) can be found later in this handbook.



## Who doesn't have to pay?

In general, the income of foreign corporations that are not engaged in a US trade or business is not subject to US tax. However, there are a number of exceptions to this rule.

For example, foreign corporations that have US source income can be subject to both US and foreign tax. In this case, double tax relief can be provided to the extent that the foreign jurisdiction has an exemption system or a foreign tax credit mechanism. Also, US corporations that own an interest in controlled foreign corporations or a foreign corporation with substantial passive income are subject to US tax on those foreign earnings, as well as tax in the foreign jurisdiction. In this case, the potential for double taxation can be addressed through the application of the US foreign tax credit. The US foreign tax credit mechanism allows for an offset of foreign taxes paid up to the amount of US tax levied on an item of income.

**Example.** Let's look at the fact pattern for a non-US company selling into the United States to see if there is a federal income tax liability. A European company (Company), which is eligible for treaty benefits, performs custom manufacturing. Company delivers about 40% of its sales to US-based customers. To date, all employees and facilities are in its home country and all sales orders are approved there. Company wants to hire full-time sales representatives in the US. These representatives will solicit sales orders but they will not have the authority to bind Company contractually. Company will not provide them with office space, either directly or through reimbursement, and they must submit all their orders to the home country headquarters for review and shipping with approval. These US representatives will not perform any services related to training, warranty or repair, account collection or after-sale activities.

Because Company is eligible for treaty benefits, the PE requirements of the treaty would apply to determine whether there is a US tax liability. In the present case, the activities of Company should not rise to a federally taxable PE even though

the sales representatives are employees of Company that are stationed in the US on a full-time basis. There are, however, some things that Company must do.

Company must:

- ▶ Establish a US payroll, generally by opening US bank account(s) and hiring a US payroll services bureau to handle disbursements, withholdings and filings
- ▶ Obtain US and appropriate state taxpayer identification numbers, local business license (if and where applicable) and state tax registrations
- ▶ File annually a treaty-based (information disclosure only) Form 1120-F
- ▶ For those states where Company has nexus, collect and remit sales tax on taxable sales, which may be limited to tangible personal property, unless the goods are resold by each of its customers (in which case resale documentation would need to be provided)
- ▶ Review state nexus rules; register and file where needed for state income, franchise and gross receipts taxes
- ▶ File and pay any applicable customs on tangible goods imported into the US
- ▶ File and pay state and local use tax on office purchases if due where state and local sales tax was not incurred on such purchase
- ▶ File and pay local business personal property tax, if applicable, upon taxable business personal property at office spaces

Because US-based activities are solely the solicitation of sales and Company is solely engaged in the sale of tangible personal property, many states may extend certain federal protections and Company would not be liable for any state and local income-based taxation. However, such federal law, by its own terms, only applies to US domestic corporations so some states may not extend such protections to foreign corporations. Nevertheless, some tax liability may arise from state and local capital-based, net worth, business or other franchise tax activities, especially in the home states of the representatives.



# Determining your taxable income

Income for tax purposes is generally computed according to US generally accepted accounting principles, adjusted for statutory tax provisions. That means that taxable income generally does not equal income for financial reporting purposes.

When a foreign parent chooses to do business in the US through US corporations, the US corporations may choose to consolidate their earnings and losses for federal income tax purposes. For the most part, a corporation can be included in a consolidated group if it is at least 80% owned by another US corporation (in terms of vote and value). The stock ownership parent-subsidary chain is broken, however, by an intervening corporation that is non-includible.

## Deductions

Generally, companies are permitted to deduct the expenses incurred that are ordinary and necessary for the trade or business. However, expenditures that create an asset with a useful life of more than one year may need to be capitalized.

## Depreciation

A depreciation deduction is available for the cost of most assets with a useful life of more than one year (except land) used in a trade or business or held for the production of income (such as rental property). The schedules for depreciation are based upon when the property was put into use in the US.

## Losses

If allowable deductions exceed a corporation's gross income, the excess is called a net operating loss (NOL). In general, NOLs may be carried back 2 years and forward 20 years to offset taxable income for those years. Capital losses can be carried forward five years and carried back three years solely to offset capital gains. However, the carryback is only available if the capital loss does not create or increase an NOL.

The IRC addresses potential abuse of loss deductions in what is called the "Section 382 limitation," which limits the amount of income that can be offset by NOL carryovers after an ownership change. Section 382 is designed to effectively prevent shifting an unfettered loss deduction from one group of corporate owners to a new group. Corporations are subject to this limitation if they undergo an ownership change and have a current year loss, NOL carryforwards or unrealized losses. Losses that cannot be deducted in a particular tax year because of the Section 382 limitation can be carried forward.

## Inventories

Inventory is usually valued for tax purposes at cost.

## The US tax code and inbound investors

Among the thousands of provisions in the US tax code, there are a number that are of special interest to inbound investors. Be sure to check with your US tax advisor, using this list as a starting point, to confirm that you have addressed all the areas that could generate tax liability or other tax risk.

Tax code	Area of impact
§163(j)	Earnings stripping limitations
§1441	Withholding taxes
§267(a)3	Limitation on deductions: "matching rule"
§304	Related-party stock sale transactions
§881	Conduit regulations (payments through intermediary companies)
§894	Reverse hybrid, fiscal transparency
§41	Research credit
§861	Source of income rules
§382	Net operating loss limitations
§385	Thin capitalization limitations on interest deductions
§482	Arm's-length transfer pricing between related entities
§338	Share acquisition elections in M&A
§897	FIRPTA (special taxation rules for US real estate transactions)
§168	Depreciation
§199	Domestic manufacturing deduction
§882/884	Branch taxation

# Structuring your US business entity and activities



There are number of ways in which your inbound company can structure business activities in the US, depending upon your business model. What is important is choosing a structure that is compatible with the way the group anticipates operating in the US. Just remember not to do anything purely for tax reasons. That said, there will be tax consequences to your choices, so be sure to consider those in advance as well.

US tax authorities assume that a business purpose exists for so-called “greenfield” opportunities – opportunities that are largely unexplored and undefined. Based on that premise, investors are allowed to arrange their operations as they see fit. Initial transactions in a greenfield investment are presumed to be for some business purpose and not solely for the purpose of tax avoidance.

## Forms of enterprise and their tax implications

How you structure your long-term operations in the US effectively defines how you will be taxed, so the choice can have a potentially significant impact on profitability. U.S. Treasury regulations generally allow many business entities to choose classification as a corporation, partnership or entity disregarded from its parent. There are flow-through entities, unincorporated branches and Limited Liability Companies (LLCs). There are distributor and manufacturer representatives, joint ventures and partnerships. Where will the head office be located and which activities will go on in the US? Each choice has its own implications, complications and criteria. The various ownership structures also have

financing, legal liability and growth flexibility issues. So given several viable structures that could work for your business, how do you decide which one to choose? Typical business models include a representative office, branch office or wholly owned subsidiary.

## Representative office

A representative office is the easiest option for a company starting to do business in the US. You do not have to incorporate a separate legal entity and you will not trigger a corporate income tax,<sup>5</sup> as long as the activities are limited in nature. That would include such ancillary and support activities as advertising and promotional activities, market research and the purchase of goods on behalf of the headquarters office. A representative office is most appropriate in the very early stages of your corporation's business presence in the US. Then, you may want or need to transition to a branch or subsidiary structure as your business in the US grows. You and your advisor should periodically review the suitability of your structure and its activities to make sure that you are not inadvertently triggering a taxable presence in the US by exceeding the permissible activities.

<sup>5</sup> Limited activities may be conducted in the US without triggering a US federal income tax liability (see US trade or business discussion); however, such activities often incur state or local tax obligations.

## Branch

A branch structure is similar in nature to a representative office in that it does not require incorporating a separate legal entity. The benefit of having a branch rather than a representative office is that the range of activities that can be performed by a US branch office can be substantially increased. That will, however, constitute a taxable presence in the US, which means that you must annually account for and file US corporate income tax on the branch's profits.

Generally, the branch is subject to a corporate tax rate of up to 35%<sup>6</sup> in the US. In addition, any remittance of post-tax profits by the branch to the head office is subject to branch remittance tax of 30%. However, US tax treaties typically reduce the branch remittance tax.

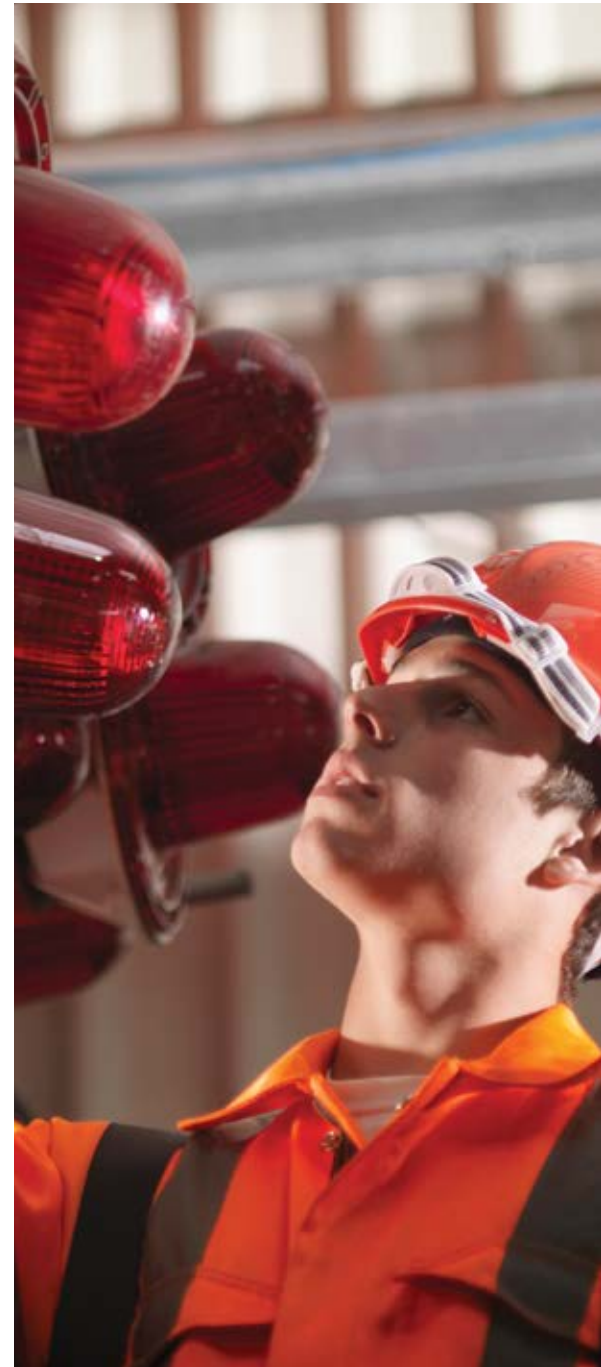
A branch structure is suitable when you anticipate incurring losses in the near future or repatriating profits on a current basis. The US branch's trading losses can be offset against the home office's trading profits. In a reverse situation, where the branch is profitable, the parent company may also be subject to tax in the home country on the US profits.

Keep in mind that an inbound corporation considering a branch structure may expose a disproportionate share of the parent company's profits to a higher US tax rate since attributing the profits to branch activities requires arm's-length consideration. There is also a risk that intangibles such as intellectual property and brand identity may build up in the US over time. That could give rise to larger US tax liabilities in the longer term as the group becomes more successful in the US marketplace because these intangibles would necessitate attributing more of the profits to the branch.

## Subsidiary

In a subsidiary structure, the inbound company incorporates a wholly owned subsidiary in the US, making it a separate legal identity distinct from the parent company. This can be used to cap any risks that may be inherent in a branch option. The profits earned by the US subsidiary would be liable to tax in the US at up to 35%<sup>7</sup>. Further, the repatriation of profits (dividend distribution) by the US subsidiary to the parent is subject to a withholding tax of 30%. However, US tax treaties typically reduce the dividend withholding tax.

The chart on the following page provides a high-level look at some of the considerations specific to each of the three typical models.



<sup>6</sup> In addition, many US states also levy income or capital-based taxes.

<sup>7</sup> In addition, many US states also levy income or capital-based taxes.

## Typical subsidiary model considerations

Considerations	US incorporated subsidiary	US branch operations	US representative office
Allowed functions	A US subsidiary incorporated by a foreign parent company is not subject to specific limitations/restrictions with respect to its activities other than general limitations, e.g., export control and antitrust rules. With respect to US acquisitions by foreign investors, reporting requirements may apply.	Notwithstanding general limitations (see Subsidiary), no specific restrictions apply to US branch operations.	Activities are limited to ancillary and support activities, e.g., advertising, market research and purchases on behalf of foreign-based headquarters.
US federal taxation	<b>Income</b> – taxed at US rates, progressive from 15% to 35%.	<b>Income</b> – branch's profits if effectively connected to a trade or business in the US are taxed at US rates, progressive from 15% to 35%.	<b>Income</b> – the representative office should not generate income that is effectively connected to a US trade or business. Therefore, there should be no income tax.
	<b>Losses</b> – can be carried back 2 years or forward 20 years. Losses can offset US consolidated group's current and future earnings.	<b>Losses</b> – can be carried back 2 years or forward 20 years. Losses may be available to offset foreign parent company income depending upon the rules in the foreign parent company jurisdiction.	<b>Losses</b> – as tax is levied on a gross basis by means of withholding, no usage of losses is applicable for US tax purposes.
	<b>Dividends</b> – subject to 30% US withholding tax at source unless reduced or eliminated under an applicable treaty.	<b>Dividends</b> – a 30% branch profits tax on deemed withdrawals from the branch, as well as a 30% branch interest tax may be levied by means of withholding tax. Both branch profits and branch interest tax may be reduced under an applicable tax treaty.	<b>Dividends</b> – the representative office should not be able to repatriate dividends.
State taxation*	Apportioned income of the US subsidiary is subject to income tax. It may be mandatory to file a group combined return if the affiliated entities are operating as a unitary business. The income and apportionment would be reported on a water's-edge basis, i.e., reporting of the US business activities of the US entities and certain foreign entities with sufficient US activity under the state guidance.	Apportioned income of the foreign corporation. As the income and apportionment factors of a combined group may include certain foreign entities, a combined report could be required for multiple foreign entities in limited situations.	Maintenance of a place of business and the employment of labor may be sufficient to constitute doing business in the state. Agency nexus may be created if a market is created or maintained within the state. Apportioned income of the foreign corporation. As the income and apportionment factors of a combined group may include certain foreign entities, a combined report could be required for multiple foreign entities in limited situations.
Formation requirements	Corporate formation is governed by state law. State law usually does not provide for a minimum or maximum of capital or number of shareholders. However, capital usually has to be paid before issuance of authorized shares.	With the exception of branches of foreign banks, no special rules apart from registration requirements exist. In particular, no minimum capitalization and no audit requirement exist; however, US branch has to keep and maintain adequate books.	Apart from registration requirements, no specific rules apply.
Liability	Limited liability.	As a US branch is not regarded as a legal entity, the headquarters company is held liable.	Same as US branch.

\* Massachusetts Corporate Excise Tax is used as an example in this discussion. Each state may apply somewhat different rules of taxation to these illustrations.



### Distributor or manufacturer's representative?

Where foreign parent decides to use a US subsidiary to handle the US sales, that US subsidiary usually acts as either a distributor or as a manufacturer's representative. In a choice between the two, the IRS is more likely to assert that a foreign corporation transacting business through a wholly owned US subsidiary acting as a manufacturer's representative may give rise to a US taxable presence for the foreign parent. In that case, the profits attributable to that presence are taxable in the US. If a dependent agent – a manufacturer's representative, for example – has the authority to enter into contracts in the name of the foreign principal and routinely exercises that authority, a taxable presence does exist.

To avoid this, you must make sure that your subsidiary does not have the power to bind or contract on behalf of the foreign parent.

These are some of the typical characteristics of a manufacturer's representative company:

- ▶ Represents the manufacturer in the process of soliciting sales orders, which are then sent to such manufacturer for acceptance or rejection
- ▶ Earns a fixed commission based on actual accepted sales
- ▶ Provides a service
- ▶ Does not sell in its own name (i.e., the customers are customers of the manufacturer)
- ▶ Does not take title to product or bear risk of loss
- ▶ Has the sales force in place as its only valuable intangible
- ▶ Does not usually bear inventory risks, currency risks, returned sales risk or bad debt risk
- ▶ Bears only sales-related costs

The manufacturer's representative would be expected to show an annual profit. However, since a manufacturer's representative is a service provider that bears little risk, its profit generally will be lower than the profit of a successful trading company. This type of entity also is expected to clear goods through Customs at their resale price (i.e., the price to the ultimate customer) and is not expected to collect sales tax (which is done by the foreign manufacturer). Generally, to the extent the

manufacturer's representative company meets these characteristics, it should not create a PE for its foreign manufacturer.

### Trading companies

These are some of the characteristics that apply to a trading company:

- ▶ Buys goods at a fixed price and resells them "as is" for whatever the market will bear
- ▶ Develops its own customers, not the manufacturer's
- ▶ Takes title to product and bears risk of loss
- ▶ Has valuable intangibles that include goodwill and the assembled sales force in place
- ▶ May or may not bear inventory risks
- ▶ May or may not bear currency risks
- ▶ May or may not bear returned sale risks
- ▶ Generally does bear bad debt risks

The trading company is expected to show profits over a reasonable period of years. It also clears goods through Customs at their transfer price value and handles all meaningful contacts for the group of companies with the customer. This entity is likely the only sales tax vendor obligated to collect and remit on all of its sales into states where it habitually solicits sales orders. Generally, to the extent the trading company meets these characteristics, it should not create a PE for its foreign manufacturer.

## Establishing a US corporation

Corporations in the US are established in accordance with the law of the state in which the business is incorporated. Although the corporate laws of most states are similar, certain states (e.g., Delaware) are more flexible than others. It is a common practice to incorporate in a state with liberal incorporation laws and then qualify the corporation in any other states where you want to operate by applying for a certificate of authority to do business. A corporation generally comes into legal existence as soon as its certificate of incorporation is filed with the secretary of state's office in the state of incorporation.

Generally, most states do not prescribe a minimum or maximum number of shareholders. Further, there are generally no minimum capitalization requirements, except for corporations engaged in banking, insurance or related activities. Most states require subscribed capital to be fully paid in before authorized shares are issued. Qualified legal counsel should always be obtained when establishing corporation or any other US legal entity. Many US states allow for the formation of an entity known as an LLC.

Under the check-the-box (CTB) regulations in the US, taxpayers may elect corporate or non-corporate status as their federal income tax designation for any domestic or foreign business entity, as long as the entity is not designated by the regulations as being a per se corporation. A per se corporation is an entity that is specifically treated as corporate under the US tax laws, with no option available to taxpayers to change the tax status.

An eligible entity with two or more members may elect to be classified as either a corporation or a partnership; an eligible entity with one member may elect to be classified as either a corporation or a disregarded entity (i.e., a branch).

Transactions entered into by a disregarded entity are treated as entered into by the owner of the disregarded entity. Transactions between a disregarded branch and its owner are generally ignored for US federal income tax purposes.

## Some special investment structures

### Joint ventures

Joint ventures are any combination of two or more enterprises associated for the purpose of accomplishing a single business objective. For legal and tax purposes, if two unrelated incorporated or unincorporated businesses agree to conduct business as a non-corporate joint venture, the venture is normally considered a partnership, limited in scope or duration. Corporate joint ventures consist of two entities that form a corporation to carry out a specific business objective.

### Holding companies

As an inbound company, you may want to invest directly in the US or you may choose to make step-down investments in this country using tax-friendly intermediary jurisdictions. These intermediary holding companies help to plan the effective utilization of the various streams of income (from the step-down operating companies) either for future investments or for further expansion. Although there are others, key holding

company jurisdictions may be the Netherlands, Belgium, Luxembourg and the UK.

The concept of business purpose is particularly important for holding companies. Any holding company structure established purely for minimizing taxes in the US is very likely to be challenged. In fact, various income tax treaties that the US has entered have very strict anti-avoidance provisions that deny tax treaty benefits to companies set up for treaty shopping and tax avoidance purposes. If you are considering using holding company structures, be sure to pay careful attention from a business planning perspective and document the reasons and business purposes to support your choices.



## Real estate REITs and REMICs

The foreign acquisition of US commercial properties declined substantially in 2008 from all time high levels in 2007. The decline in foreign acquisition covered all types of US commercial real estate ranging from a 93% year-over-year decline in retail space in 2008 to a 57% decline in office space. Based on the broader economy, the commercial market is projected to improve in 2011.<sup>8</sup>

Foreign investors are able to invest directly in US real estate or indirectly. Among the indirect instruments are real estate investment trusts (REITs), which result when investors provide a specified amount of money that is pooled to purchase the real property, or real estate mortgage investment conduits (REMICs) wherein money is pooled to buy mortgage securities. REITs and REMICs generally are not taxed on their real estate-related income or capital gain. Taxation usually occurs at the investor level.

A foreign investor in a US real property interest is taxed on the income from the property and upon the disposition of the property. During the ownership phase, the investor is taxed on the income connected with US real property in a manner similar to the taxation of any US source income. If the foreign investor sells the real property interest, however, the sale is subject to tax under the Foreign Investment in Real Property Tax Act (FIRPTA).

The FIRPTA rules subject any gain on the disposition of an interest in US real property to US income tax by treating such gain as income effectively connected with a US trade or business. Protection from FIRPTA under the US tax treaties is generally not available. Foreign investors are initially

subject to a 10% withholding tax on the gross amount realized from the sale of a US real property interest. That withholding tax is then offset against the capital gains tax due once the tax return is filed.

## Financing your US investments

Inbound US transactions can be financed through debt or equity. In general, interest on debt incurred by a US corporation is deductible. The debt vs. equity debate in the related party context has been a contentious one. Substance over form is frequently raised by the IRS in the context of distinguishing between debt and equity for tax purposes. There is no bright-line test in the Code or in case law to distinguish debt from equity, but IRC Section 385 (thin capitalization rules) states that the following factors will be considered, although no single factor is controlling:

1. Whether there is a written, unconditional promise to pay on demand, or on a specified date, a sum certain in money in return for an adequate consideration, and to pay interest
2. Whether there is subordination to or preference over any indebtedness of the corporation
3. The ratio of debt to equity of the corporation
4. Whether there is convertibility into the stock of the corporation
5. The relationship between holdings of stock in the corporation and holdings of the interest in question

Even if an instrument is considered debt under the rules of IRC Section 385 and associated case law, the deduction of associated interest may still be limited. Under IRC Section 482 (arm's-length transfer pricing), the IRS has the authority to reallocate deductions, including interest deductions, between related parties to reflect the arm's-length standard.

Finally, the US federal income tax provisions under IRC Section 267(a)(3) (Matching Rule) and IRC Section 163(j) (Earnings Stripping Rule) must be satisfied before the interest expense realized by the US subsidiary can be deducted. Applying IRC Section 267 generally defers the deductibility of interest until such time as it is actually paid, as opposed to merely accrued. IRC Section 163(j) limits the deduction for interest on certain types of related-party debt (or debt that is guaranteed by a foreign related party) if the debt to equity ratio exceeds 1.5:1.0 and there is excess interest expense. Generally speaking, if interest expense is less than one-half of annual cash flow (i.e., cash-basis EBITDA), there should not be "excess interest expense." If the earnings stripping rules apply, then any excess interest expense cannot be deducted until a later year.

There are complex rules that govern the initial application of the earnings stripping rules (i.e., when a foreign multinational first acquires a US target from a US seller). If circumstances such as these are representative of your company, be sure to consult a US tax advisor.

<sup>8</sup> "Foreign Investment in US Real Estate: Current Trends and Historical Perspective," The National Association of Realtors, June 2010.

# Other potential corporate tax liabilities

In addition to the activities and structures that generate federal income tax liability, inbound companies – depending upon where they locate and how they conduct their business – can also be subject to state, regional and municipal taxes, as well as to employment tax liabilities.

## State and local tax

One misconception of inbound companies coming to the US is that doing business in the United States is the same as doing business in the 50 individual states; not so. Much like individual countries in other parts of the world have their own tax laws, the separate states within the US also have specific regulations within their own taxing jurisdictions. The same may also be true for certain cities and regions within the states. Many US indirect taxes are imposed at the state and local level (e.g., gross receipts, franchise, real property and business personal property taxes). Further, many state and local jurisdictions provide tax credits and incentives opportunities for business investment within the jurisdiction (e.g., jobs credits, training credits and negotiated incentives).

States with jurisdiction to impose an income-based tax upon a multistate corporation or a group of corporations must first determine the state's taxable base – the total taxable income under state law – and then determine the state's share of that

income – the state's apportioned taxable income. The state taxable income for a corporation or group of related corporations is dependent upon the computational rules and methods that each state applies.

Although states vary on the methods permitted or required to file an income tax return, the general methods are separate return, nexus-combination, unitary combined reporting and consolidated reporting. Your state and local tax advisor will help you determine which method would apply to your inbound entity.

State tax rates vary from 0% to 12%. However, state income tax paid is deductible for federal tax purposes. Although state income taxes are generally based upon federal income tax concepts, the underlying rules vary from state to state.

In general, states may choose whether to conform to the federal IRC. Some states opt for "fixed" conformity, which means that they follow the IRC as of a certain date. Other states practice "rolling" conformity, automatically updating their reference to the IRC on a continual basis and thus conforming to the most recent version of the Code.

As a general rule, states are not party to tax treaties between the US and foreign nations. That means that a foreign corporation may be subject to state tax even though it is not subject to US federal tax pursuant to a tax treaty. Take, for example, a Foreign Corporation (FC) eligible for US treaty benefits. The FC stores inventory on consignment in a state, accepts sales orders in its home country and fills the US sales from the stock of consigned goods. In keeping with the treaty, the FC's US activities may not rise to the level of a permanent establishment, so FC may not be subject to US federal income tax. However, depending upon the state, there may be income or other state tax ramifications. Since there are 50 states with different rules, be sure to consult your state and local tax

professionals to discuss the tax ramifications of any activity in a particular locale.

## Transfer pricing and documentation

Transfer pricing is a complex yet interesting challenge for multinational companies, which must establish appropriate prices at which goods, services, financial instruments and even intellectual property are transferred among their affiliated companies. These pricing practices are subject to complex, changing regulations that affect the subsidiaries, supply chains and competitive strategy.

Pricing decisions determine where profit will be recognized. Consequently, this is an issue of great concern for national and state governments because the distribution of profits has a direct impact on the collection of tax revenues. Over the past several years, the need for – and importance of – contemporaneous transfer pricing documentation has increased considerably, due not just to the process itself but also to the growing trend among taxing authorities worldwide to share information.

Treasury regulations require that taxpayers prepare 10 principal documents, along with any background or supporting materials, at the time the relevant tax return is filed (contemporaneous).

These are the required documents:

- ▶ An overview of the company's business, including economic and legal factors that affect pricing of its products or services
- ▶ A description of the company's organizational structure, including all related parties whose activities are relevant to transfer pricing
- ▶ Any document explicitly required by the regulations under Section 482 (e.g., documentation of non-routine risks and cost-sharing agreements)



- ▶ A description of the method selected and the reason it was selected
- ▶ A description of the alternative methods that were considered and an explanation of why they were not selected
- ▶ A description of the controlled transactions (including terms of sale) and any internal data used to analyze them
- ▶ A description of the comparables used, how comparability was evaluated and what adjustments were made
- ▶ An explanation of the economic analysis and projections relied upon in developing the method
- ▶ A description or summary of any relevant data that the company obtains after the end of the year and before filing a tax return
- ▶ An index of principal and background documents

The documentation is submitted to the IRS upon request in the event of an audit – within 30 days of the request. However, it must be dated on or before the tax return filing date or it will not provide penalty protection.

In today's environment of accountability and global transparency coupled with the rising threat of increased taxation, it is almost impossible to avoid disagreements with taxing authorities. Please refer to the section of this handbook we call "Controversy, misconceptions and potential trouble spots" for more information on transfer pricing controversy.

## Sales and use taxes

There is no federal sales tax or value-added tax in the US. However, most states and many municipalities levy sales taxes. Combined

rates, including local rates, can range as high as 11%. These sales taxes are usually assessed on the final consumer purchase, with wholesale transactions remaining tax exempt. As a general rule, all sales of tangible personal property occurring within a state's borders are subject to sales tax unless specifically exempted by statute. Sales of services and intangible property (e.g., software) can also be subject to sales tax though this varies from state to state. It is the seller's responsibility to collect and remit sales tax, typically passing the cost on to the consumer.

Use taxes are a tax on the use, storage or consumption of tangible personal property by a business itself, within a state's borders. Use taxes are effectively a complement to sales tax.

## Human capital and personal tax

Human capital is an area that can become quite challenging for an inbound company, especially if the home country headquarters is left to deal with the diverse and often complex requirements of federal and multistate taxing jurisdictions. Many businesses coming to the US decide to outsource some or all of their human resource management activities such as payroll and benefits administration since these areas require considerable local knowledge.

The taxation of foreign nationals working in the US depends on the residency status of the individual. Generally, foreign nationals may be considered resident aliens if they are lawful permanent residents (green card holders) or if their physical presence in the United States lasts long enough under a substantial presence test. Under the substantial presence

test, a foreign national is deemed to be a US resident if the individual fulfills two conditions. The first is simply that the individual is present in the US for at least 31 days during the current year. The second condition, the "183-day rule," is somewhat more complex. The individual will meet the 183 day rule is considered to have been present for at least 183 days during a consecutive three-year test period that includes the current year, using the following formula: 100% of current year days, 33.33% of the first preceding year and 16.67% of the second preceding year. Using this formula, being in the US an average of 122 days during each of three consecutive years causes a foreign national to be considered a US resident under the substantial presence test.

Resident aliens, like US citizens, are subject to tax on their worldwide income regardless of source. A nonresident alien is subject to US tax at graduated rates on income that is effectively connected with a US trade or business and on US-source investment income (e.g., dividends, royalties and rental income) on a gross basis at a flat rate of 30%.

In general, a nonresident alien who performs personal services as an employee in the United States at any time during the tax year is considered to be engaged in a US trade or business. An exception to this rule applies to a nonresident alien performing services in the US and meeting all three of the following conditions:

1. The services are performed for a foreign employer.
2. The employee is present no more than 90 days during the tax year.
3. Compensation for the services does not exceed \$3,000.

These conditions are similar to those contained in many income tax treaties, although the treaties often expand the time limit to 183 days and increase or eliminate the maximum dollar amount of compensation.

### **Social security tax**

Under the Federal Insurance Contributions Act (FICA), social tax is imposed on wages or salaries received by individual employees to fund retirement benefits paid by the federal government. For 2010, the social tax of 15.3%, which includes a 12.4% old-age, survivors and disability tax and a 2.9% Medicare tax, is imposed on the first \$106,800 of annual employment income. However, no limit applies to the amount of wages subject to the Medicare portion of the social tax. Half of the tax is withheld from the employee's wages and half is paid by the employer. During 2011, there is a one-year temporary 2% reduction in the employee portion of the Old-Age, Survivors and Disability tax.

Here is an important note: FICA tax is imposed on compensation for services performed in the United States, regardless of the citizenship or residence of the employee or employer. So unless there is a specific exception in place, nonresident alien employees who perform services in the United States are subject to FICA tax.

### **Federal unemployment tax**

Federal unemployment tax (FUTA) is imposed on the wage payments that employers make to their employees for the services performed within the US regardless of the citizenship or residency of the employer or employee. The 2010 tax rate is 6.2% on the first \$7,000 of wages of each employee. In 2011, a 0.2% surcharge on the FUTA tax rate was scheduled to expire on June 30. Most states also have unemployment taxes that are creditable against FUTA tax when paid. Self-employed individuals are not subject to FUTA tax.

### **Employer reporting and withholding**

An employer – whether US or foreign – is responsible for withholding and remitting US income and social taxes from the wages of resident and nonresident alien employees. The employer is also responsible for reporting the compensation income of its employees working in the US. When a foreign employer does not have a US employer identification number, the reporting and withholding responsibilities are often handled by a US affiliate of the foreign employer.

### **Visas**

In general, foreign nationals who wish to enter the United States for any purpose must obtain visas. US immigration laws clearly distinguish between foreign nationals seeking temporary admission (non-immigrants) and those intending to remain in the United States permanently (immigrants). Different non-immigrant visas authorize a variety of activities in the United States, including visiting, studying and working. The categories are identified by combinations of letters and numbers that authorize the particular visas – for example, B-1 visitors for business. Every non-immigrant category permits a maximum length of stay and a range of permissible activities. Permanent resident or immigrant visas, which are commonly referred to as green cards, are issued to those intending to reside permanently in the United States. Immigrant visa holders may live and work in the United States with few restrictions. Individuals seeking permanent residence in the US should consult a qualified immigration attorney, as well as a qualified tax advisor, to make sure they understand their obligations.



# Tax treaties

The US has income tax treaties with more than 60 foreign countries, providing substantial benefits by reducing or eliminating the 30% withholding tax on US source FDAP income. In addition, US business profits can only be taxed to the extent that the foreign person's involvement in the United States rises to the level of a permanent establishment. Generally, a PE does not include activity that is considered auxiliary and preparatory. The threshold for a PE is higher than the threshold of a US trade or business, and an entity that might otherwise be subject to US net tax on ECI can be exempted under an applicable treaty from paying federal income tax if its level of activity does not rise to the threshold of a PE. The exemption from paying tax does not exempt the foreign person from otherwise applicable filing obligations (e.g., an annual income tax return).

What may come as a surprise to treaty countries is that under the US Constitution, treaties and laws passed by Congress are the "supreme Law of the Land" and have equal authority. That means US statutory guidance requires only that "due regard" be given to treaties. In addition, US case law generally supports the idea that precedence be given to the most recently enacted authority. Thus, it is possible for Congress to enact laws overriding existing US treaty commitments. Even when the treaties are upheld, they do not govern taxation by the individual states.

To combat potential abuse of the treaty system, the US tax authorities have tried to limit the extension of treaty benefits to residents of a treaty country that satisfy three conditions:

- 1. Economic ownership** – the resident must economically or beneficially own the income.
- 2. Tax ownership** – the resident must be subject to tax on the income imposed by the treaty country as a resident of that country. An example of rules limiting treaty benefits due to tax ownership are the regulations regarding hybrid entities under IRC Section 894.
- 3. Economic nexus** – the resident must have a sufficient economic nexus with the treaty country to establish that it is not merely using the country to obtain a tax advantage. Two restrictions on nexus are the Limitation on Benefits (LOB) articles, which define additional qualifications beyond mere residence that must be met, and triangular provisions, which deny or reduce benefits for certain income earned through a third-country PE.

US tax authorities limit access to preferential treaty rates to entities that have economic ownership of the income eligible for treaty benefits.

Access to treaty benefits may be limited to the extent that the entity subject to tax does not have an economic nexus with the jurisdiction that is granting treaty benefits. Most US treaties have an LOB article that prevents nonresidents from obtaining treaty benefits by establishing intermediary entities in treaty countries. The goal is to limit treaty benefits to bona fide residents who serve a particular business purpose in a country.



# Controversy, misconceptions and potential trouble spots

Ernst & Young LLP understands both the inbound and outbound aspects of doing business in the US. We have worked with inbound investors and non-US companies doing business in the United States for many decades, so we've learned some valuable lessons on behalf of our clients. Likewise, we've seen some common pitfalls that can ensnare even confident, sophisticated business people. Here are a few of the misconceptions we've heard, mistakes we've seen made and pitfalls we can help you avoid.

## Transfer pricing controversy

One consequence of this expanding global marketplace is the increasing potential for double taxation – the result of two or more taxing authorities attempting to tax the same profits because they do not agree with your transfer pricing. Experience tells us that the best plan is to assume controversy will happen and be prepared with a strategy for managing. Among the options are advance pricing agreements (APAs), Competent Authority relief and arbitration.

## Accidental expatriates

Employees living and working outside their home country are typically referred to as expatriates. That arrangement would generally involve your human resource department and include a predetermined contract that takes into account the tax and other business ramifications for both the individual and the company, at home and abroad. But what happens when the employee or contractor is sent to the US for only a short-term assignment or immediate business requirement without following formal procedures? Depending upon some clear – and less clear – factors and

circumstances, such as length of stay or amount of compensation earned while in the US, you may have created an accidental expatriate. The activities of these individuals can carry significant risk for you and your employees, primarily:

- ▶ Noncompliance with US immigration, tax and social security laws
- ▶ Double taxation of business profits by the home country and the US
- ▶ Assessment of penalties
- ▶ Failure to properly budget and allocate costs
- ▶ Employee exposure to taxation related to short-term international business travel

Keep in mind that although our handbook is specific to inbound companies doing business in the US, accidental expatriates can arise in other countries as well. The best approach is not to take any overseas business travel lightly, and to make sure that your local and US human resource professionals are involved in any contract and placement processes.

## Treaties and state tax liability

Foreign investors in the United States should also keep in mind that availability of treaty benefits to offset the federal taxation of income may not necessarily apply to mitigating state income tax. As a general rule, states are not a party to tax treaties between the United States and foreign nations. In fact, some states, such as California, do not recognize the PE article of the US income tax treaties and do not contain any other rules that would exempt income generated by activities in their state from state income tax. For example, assume a Foreign Corporation (FC) sells goods on

an arm's-length basis to its wholly owned US subsidiary, a California corporation (US Sub), on consignment. US Sub then sells the goods on its own behalf to independent retailers and wholesalers throughout the United States. FC has no employees in the US and conducts no other business in the US. Pursuant to the treaty, FC's US activities may not rise to the level of a permanent establishment, so FC may not be subject to US federal income tax. However, the apportioned net California source income generated by the activities would be subject to California income tax. That means FC would need to file in California to report its worldwide income and apportion that to California based on that state's tax laws.

# Glossary

Every country has its share of acronyms and business idioms that serve as a kind of shorthand. Here are some of the most common terms that you are likely to encounter as you do business in the United States, including some of the ones used in this guide. Although many of them are used universally in the global marketplace, others are specifically American.

## Acronyms

**CTB:** check-the-box regulations in the US that allow eligible business entities to elect corporate or noncorporate status as their federal income tax designation

**DRE:** disregarded entity, for US taxation purposes; the entity is treated as transparent and its income, expenses, assets, etc., are those of (and taxed to) its sole owner

**ECI:** income that is effectively connected to a US trade or business associated with activity that is considerable, continuous, regular and substantial; used to determine which foreign corporations and their US branches and partnerships are subject to US tax

**FDAP:** fixed, determinable, annual or periodic income; such as dividends, interest and royalties. Exceptions to FDAP include:

- ▶ Gains derived from the sale of real or personal property (including market discount and option premiums, but not including original issue discount)
- ▶ Items of income excluded from gross income, without regard to the US or foreign status of the owner of the income, such as tax-exempt municipal bond interest and qualified scholarship income

**FICA:** Federal Insurance Contributions Act; a social tax imposed on wages or salaries received by individual employees to fund retirement benefits paid by the federal government

**FIRPTA:** Foreign Investment in Real Property Tax Act; the US law that applies to the sale of interests held by nonresident aliens and foreign corporations in real property located within the United States

**FUTA:** Federal Unemployment Tax Act; imposed on the wage payments employers make to their employees, regardless of the citizenship or residency, for services performed within the US

**IRC:** Internal Revenue Code; comprises the basic federal tax law for the United States

**IRS:** Internal Revenue Service; the agency of the US government responsible for enforcing tax laws, collecting taxes, processing tax returns and issuing tax refunds

**LLC:** limited liability company; an entity created under state law. From a federal tax perspective, an LLC is an eligible entity that

can elect to be treated as either a partnership, a corporation or a disregarded entity; from a state business law perspective, LLCs limit member liability protection that a corporation offers to its shareholders

**LOB:** limitation of benefits; defined in the various tax treaties between the US and other countries

**NOL:** net operating loss; a period in which a company's allowable tax deductions are greater than its taxable income, resulting in a negative taxable income, generally occurring when a company has more expenses than revenues during the period

**PE:** permanent establishment; a fixed place of business through which the business of an enterprise is wholly or partly carried on, which the OECD says includes a place of management, a branch, an office or a factory

**REIT:** real estate investment trusts; a corporation or business trust that pools investor funds to purchase real estate assets and elects special tax treatment that eliminates most entity level taxes

**REMIC:** real estate mortgage investment conduits

**USRPI:** US real estate (or shares in a US real property holding corporation) owned directly by the foreign investor

## Words of art

**Anti-conduit rules:** The anti-conduit rules allow the Internal Revenue Service to disregard the participation of intermediate entities in financing structures if the intermediate entity

has been included in the structure for the purpose of reducing US withholding taxes. For example, a foreign parent corporation, resident in a jurisdiction that does not have an income tax treaty with the United States, loans money to one of its foreign subsidiaries, which is resident in a jurisdiction that does have an income tax treaty with the United States that reduces the rate of US withholding on interest payments to zero.

The foreign subsidiary, in turn, makes a loan of such money to a US subsidiary of the foreign parent. Under the anti-conduit rules, the “back-to-back” loans could be re-characterized as a loan directly from the foreign parent to the US subsidiary. As re-characterized, the interest payments on the loan would be subject to 30% US withholding tax rather than the reduced rate that would have applied had the form of the transaction been respected.

**Branch profits tax:** The branch profits tax, which simulates the tax treatment of a corporation that issues dividends, is a 30% tax on deemed withdrawals from a branch. The tax base for the branch profits tax is the dividend equivalent amount, which is essentially the branch earnings for the year, less the amounts reinvested in the United States. In some cases, the 30% branch profits tax can be reduced or eliminated by treaty provided that the applicable treaty addresses the branch profits tax and certain residency requirements are met.

**Branch interest tax:** In general, interest paid on loans that are taken out to benefit a US branch is subject to branch interest tax regardless of whether the US branch or its foreign parent actually pays the interest. The branch interest tax, like the branch

profits tax, simulates the tax treatment of a US subsidiary of a foreign parent. Thus, a 30% withholding tax is levied on the deemed interest payment, subject to reduction by treaty.

**C corp:** C corporations are established in accordance with the law of the state of incorporation. Although the corporate laws of most states are similar, those of certain states (Delaware, for example) are more flexible than others. A C corporation has a separate legal identity distinct from its shareholders. This can be used to cap any risks that may be inherent in a branch or partnership. Use of a C corporation also prevents US profits and losses from flowing up to the shareholders. The profits earned by a C corporation are subject to tax in the US at graduated rates. The maximum rate is 35%. If a C corporation distributes its profits, the profits are subject to a second level of tax at the shareholder level.

**Earnings stripping:** The earnings stripping rules under IRC Section 163(j) are designed to prevent the earnings and profits of highly leveraged corporations from being removed from the US tax net in the form of interest. The “earnings stripping” rules limit the deduction for interest on certain types of related-party debt (or debt that is guaranteed by a foreign related party) if the debt to equity ratio exceeds 1.5:1.0 and there is excess interest expense. Generally speaking, if interest expense is less than one-half of annual cash flow (i.e., cash-basis EBITDA), there should not be “excess interest expense.” If the earnings stripping rules apply, then any excess interest expense cannot be deducted until a later year.

**Nexus:** The connection between a state and the significant presence of a potential taxpayer that gives the state the constitutional right to impose a tax.

**Per se corporation:** An entity that is specially treated as corporate under the US tax laws, with no option available to taxpayers to change the tax status (unlike check-the-box).

**Resident alien:** Generally, foreign nationals may be considered resident aliens if they are lawful permanent residents of the US (green card holders) or if their physical presence in the United States lasts long enough under a substantial presence test. Under the substantial presence test, a foreign national is deemed to be a US resident if the individual fulfills two specific conditions. First, the individual is present in the US for at least 31 days during the current year. Second, the individual is considered to have been present for at least 183 days during a consecutive three-year test period that includes the current year, using the following formula: 100% of current year days, 33.33% of the first preceding year and 16.67% of the second preceding year. Using this formula, an average of 122 days’ presence during each of three consecutive years causes a foreign national to be considered a US resident under the substantial presence test.

**S corp:** An S corporation, unlike a C corporation, passes through profit or net losses to its shareholders. The pass-through nature of the income means that the corporation’s profits are only taxed at the shareholder level, thus avoiding the double taxation of C corporation income. However, an S corporation is similar to a C corporation in that it provides limited liability to its shareholders. S corporations have specific formation requirements. If owned by non-US persons, S corporation status is lost; however, inbound investors often are faced with the opportunity to buy an existing S corporation from its US owners.

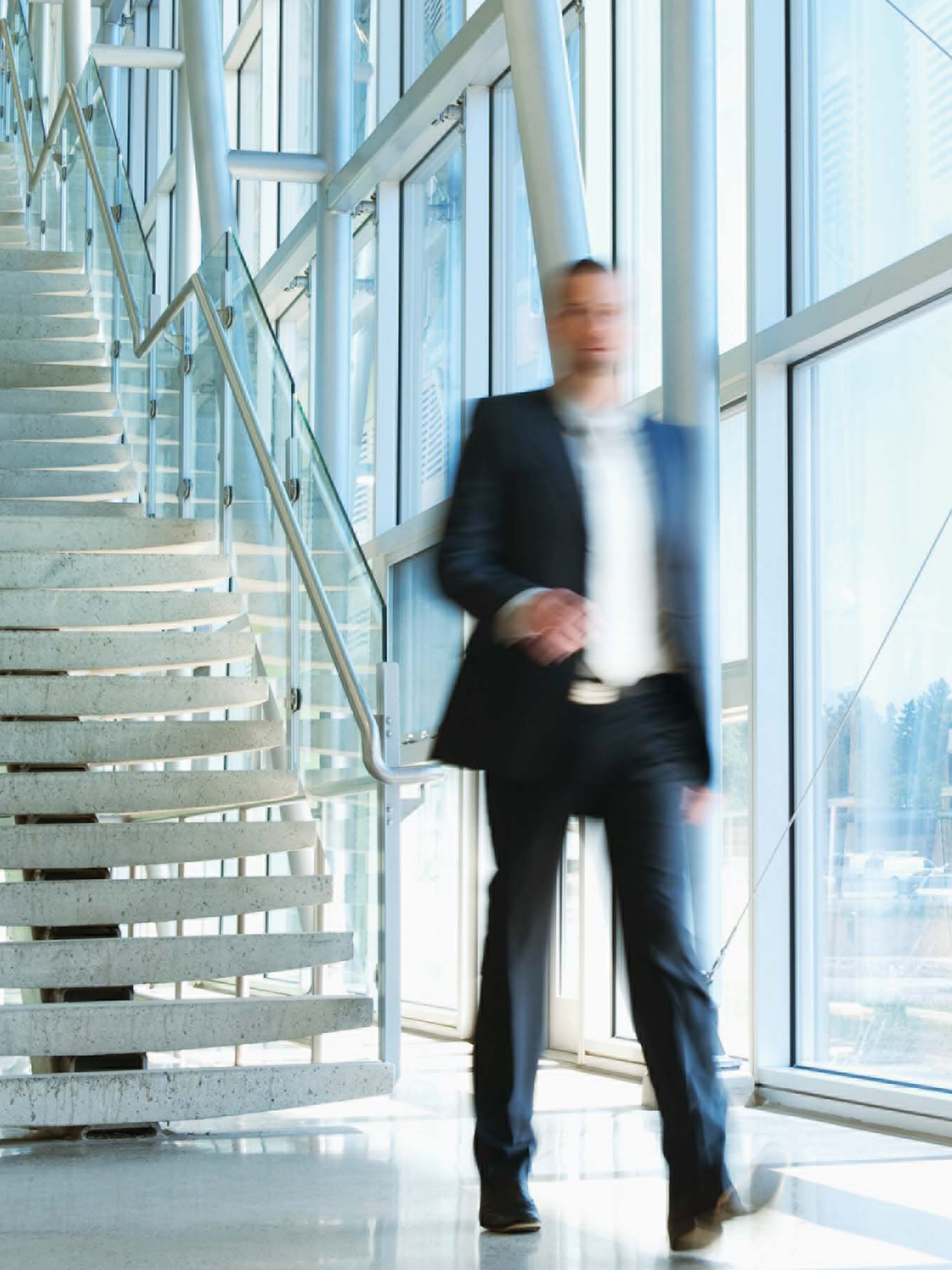
**Thin cap:** Thin cap stands for thin capitalization. If a corporation is thinly capitalized, it has a high debt to equity ratio. There is no bright-line test in the Code or in case law to distinguish debt from equity, but IRC Section 385 states that the following factors will be considered, although no single factor is controlling:

1. Whether there is a written, unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration, and to pay interest
2. Whether there is subordination to or preference over any indebtedness of the corporation
3. The ratio of debt to equity of the corporation
4. Whether there is convertibility into the stock of the corporation
5. The relationship between holdings of stock in the corporation and holdings of the interest in question

**Trade or business:** There is no comprehensive definition of a US trade or business; it is largely defined by case law. In order to make a determination of whether a trade or business exists, the owner's level of activity must be measured. Activity in pursuit of profit that is "considerable, continuous and regular" is necessary to establish a trade or business.









# Contacts

For more information about services for inbound investors, contact any member of Ernst & Young LLP's US Inbound Team or your local EY member firm office.

## US – International Tax Services Inbound Team

Lilo A. Hester	+1 202 327 5764	lilo.hester@ey.com
Stephen F. Jackson	+1 212 773 8555	steve.jackson@ey.com
Katherine Loda	+1 212 773 6634	katherine.loda@ey.com
Margaret (Peg) O'Connor	+1 202 327 6229	margaret.oconnor@ey.com
Kerry Plutte	+1 212 773 5396	kerry.plutte@ey.com

## US Global Tax Desks abroad

### Canada – Ernst & Young LLP (Canada)

George Guedikian	+1 416 943 3878	george.b.guedikian@ca.ey.com
------------------	-----------------	------------------------------

### China

#### Ernst & Young (China) Advisory Limited

David Allgaier	Shanghai	+86 21 2228 3136	david.allgaier@cn.ey.com
----------------	----------	------------------	--------------------------

#### Ernst & Young Asia-Pacific Services (HK) Limited

Joe Kledis	Hong Kong	+61 2 9248 5881	joe.kledis@hk.ey.com
------------	-----------	-----------------	----------------------

### Germany – Ernst & Young GmbH

Klaus Metz	+49 89 14331 16976	klaus.metz@de.ey.com
------------	--------------------	----------------------

### Israel – Kost Forer Gabbay and Kasierer

Ilan Ben-Eli	+972 3 623 2552	ilan.beneli@il.ey.com
--------------	-----------------	-----------------------

### United Kingdom – Ernst & Young LLP (UK)

Rebecca Attwell	+44 207 951 3294	rattwell@uk.ey.com
-----------------	------------------	--------------------

Cliff Tegel	+44 207 951 1417	ctegel@uk.ey.com
-------------	------------------	------------------

## EY

Assurance | Tax | Transactions | Advisory

### About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit [ey.com](http://ey.com).

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

### About Ernst & Young's International Tax Services

Executives are constantly looking to align their global tax position with their overall business strategy. We help you manage your tax responsibilities by leveraging our global network of dedicated international tax professionals – working together to help you manage global tax risks, meet cross-border reporting obligations and deal with transfer pricing issues.

EY's multidisciplinary teams help you assess your strategies, assisting with international tax issues, from forward planning, through reporting, to maintaining effective relationships with the tax authorities. We help you build proactive and integrated global tax strategies that address the tax risks of today's businesses and achieve sustainable growth.

© 2014 Ernst & Young LLP.  
All Rights Reserved.

SCORE No. YY3383  
1408-1295767 SE  
ED none

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

[ey.com](http://ey.com)