
Coming to America

U.S. Tax Planning for
Foreign-Owned U.S.
Operations

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U.S. Tax Planning for Foreign-Owned U.S. Operations

Introduction

This Guide is intended to outline some of the key U.S. tax issues that should be considered in establishing a foreign-owned U.S. business enterprise in the United States. Of course, foreign is a relative notion. Used herein, it means a non-U.S. business entity (assumedly a corporation) owned by non-U.S. shareholders. As can be seen from the *Tax Checklist for Foreign-Owned U.S. Operations*, the issues range from organizational and operational to repatriation of earnings and exit strategies. There are, of course, a number of home country legal and tax issues that must also be considered in structuring an outbound investment (i.e., from a non-U.S. jurisdiction into the United States).

Tax Checklist for Foreign-Owned U.S. Operations

ORGANIZATIONAL STRUCTURE

- Non-presence
 - Use of agents or distributors
- Choice of entity
 - Branch
 - Subsidiary
 - Joint Venture
 - Partnerships
 - Limited Liability Company (LLC)
- Capitalization
 - Debt
 - Equity
 - Common stock
 - Preferred stock

OPERATIONAL STRUCTURE

- Taxation of enterprise
 - Federal
 - State and local
- Taxation of employees
 - U.S. citizens
 - Foreign nationals

REPATRIATION OF EARNINGS

- Dividends
 - Withholding (effect of tax treaties)
- Interest
 - Deductibility
 - Withholding (effect of tax treaties)
- Sales
 - Taxability to foreign seller
 - Arms-length standard (related party)
- Royalties
 - Deductibility
 - Arm's-length standard (related party)
 - Withholding (effect of tax treaties)

EXIT STRATEGIES

- Liquidation
- Trade sale
 - Asset vs. stock sale
 - Sale of U.S. real property
- Initial public offering

Typical Life Cycle of Foreign-Owned U.S. Operations

It should be noted that the tax issues increase in importance as the enterprise advances through the typical life cycle of a foreign-owned operation.

STAGE	LEGAL OPERATIONAL CHARACTERISTICS	U.S. TAX CHARACTERISTICS
Seed	Use of unrelated third parties (e.g., distributors; no (or very limited) physical presence; no additional business structure	None
Start-up	Physical presence; limited functions performed (e.g., <i>ancillary and preparatory</i> activities); form of business structure (i.e., branch or subsidiary) not significant	Certain activities may be conducted in U.S. without giving rise to taxable presence (i.e., <i>permanent establishment</i>); payroll and employee tax issues appear.
Growth	Increased physical presence; activities directly connected to the business conducted (e.g., sales solicitation and customer support; research and development); tax consequences of choice of entity become important.	Nature and amount of activities drive U.S. operational tax results; increased payroll and employee tax issues.
Expansion	Distribution or other significant elements of business conducted by U.S. operation; employee headcount rises.	Increased activities typically give rise to increase in amount of U.S. tax; need for professional tax planning becomes apparent; continued employee tax issues.
Mature	Manufacturing or other production activities commenced; headcount rises.	Need for operational tax planning increases (e.g., intellectual property migration).

This Guide focuses on the organizational and operational U.S. tax questions to be considered by a hypothetical foreign-owned U.S. enterprise that intends to conduct business activities in the United States. The critical tax issues relate to the U.S. taxation of the enterprise, its shareholders and its employees, although, at times, these considerations may be unrelated.

This Guide assumes that the foreign owner is a company, treated for U.S. tax purposes as a corporation that invests directly in the U.S. and, under the terms of the applicable United States Income Tax Treaty (Treaty), is a resident of the foreign jurisdiction that satisfies the Limitation on Benefits article of the Treaty. Therefore, the foreign owner is eligible for the benefits available under the Treaty.

Form of Organization

There are several ways in which a foreign company can operate a business in the U.S. The exact legal form the U.S. operation will take often depends on the nature of the business and the scale of the intended operation.

The possible choices for the organizational form of the U.S. operation include:

- Subsidiary
- Branch
- Partnership or Limited Liability Company (LLC)

Subsidiary. The formation of a corporate subsidiary is generally not a taxable event. However, the corporate subsidiary would have to pay U.S. federal and state income taxes on its taxable income. Dividends paid by the wholly owned subsidiary are subject to a withholding tax which under the Treaty is reduced from the statutory rate of 30% to a lower rate, typically 10% but in some cases to either zero or 5%. Dividends paid from the U.S. subsidiary to its foreign parent are not deductible for U.S. corporate income tax purposes.

Operating through a separately incorporated U.S. subsidiary generally avoids any engagement in U.S. business by the foreign parent, provided that the U.S. subsidiary does not act as an agent for the foreign parent. As a general matter, the mere fact that a parent company owns a U.S. subsidiary does not, in itself, create a permanent establishment of the parent. It is crucial, however, to avoid any attribution of the subsidiary's activities as, for example, an agent of its parent. Thus, if the U.S. subsidiary is acting as a commission agent for the sale of its foreign parent's goods, it is important that the subsidiary, which will likely be considered a dependent agent, does not have the ability to contractually bind the foreign parent. Transactions between the foreign parent and its U.S. subsidiary are generally governed by the arm's-length standard imposed by the U.S. tax law. The U.S. tax law prevents companies from shifting income in an abusive fashion by giving Internal Revenue Service authority to reallocate income and deductions among commonly controlled companies if it determines that such action is necessary to prevent evasion of taxes or to clearly reflect income.

Branch. U.S. branches are easy to establish and administer and are simply an extension of the non-U.S. company's home office. When the foreign company operates through a branch, the company is taxable in the U.S. on the income *effectively connected* with its U.S. trade or business. Under the Treaty, only those profits attributable to a permanent establishment of the foreign company are taxable business profits in the U.S. A critical tax question thus becomes determining the amount of income that is properly *attributable* to the branch under the Treaty. This amount is taxable at rates applicable to U.S. corporations which, currently, are a maximum of 35% for federal tax purposes. Most states in the U.S. also impose tax on the income of a corporation that has some form of activities within that state.

In addition to subjecting the non-U.S. company to regular corporate income tax, operating the U.S. business through a branch triggers the possible application of a branch profits tax. The branch profits tax essentially replicates the 30% withholding tax on dividends payable by a U.S. subsidiary to its foreign parent company. The tax base for the branch profits tax generally includes after-tax earnings and profits that are effectively connected with the foreign corporation's U.S. trade or business (effectively connected earnings and profits, or ECEP) to the extent that such ECEP is not reinvested in the U.S. trade or business by the close of the taxable year or is sent home in a later taxable year. Tax treaties may limit the effect of the branch profits tax, more or less in the same way as withholding taxes on dividends from a domestic subsidiary are limited.

Partnership or LLC. Operating through a partnership (either domestic or foreign) or an LLC, which is generally taxed as a partnership, engages its partners in the U.S. trade or business conducted by the partnership or LLC. Thus, while the partnership or LLC is not subject to tax, the foreign partner or LLC member is taxable on its allocable share of the partnership or LLC's effectively connected income. In addition, if the foreign partner is a corporation, the activities of the partnership constitute a branch of

the foreign corporation triggering the application of the branch profits tax, as described previously. Failure of the foreign partner or member to timely file a U.S. tax return will lead to the loss of otherwise available tax deductions producing, in effect, a tax on gross receipts.

Capitalization

Another choice to be made by the foreign company is whether to capitalize the U.S. venture with debt, equity or a combination of the two. From a U.S. tax standpoint, it is generally better to fund U.S. direct investment via debt rather than equity. But there are important limitations and exceptions to this proposition and effective tax planning requires careful study and periodic review.

There are three main tax reasons to capitalize the U.S. operation with debt rather than equity.

1. Interest payments are deductible by the U.S. payor whereas dividend payments are not.
2. Debt principal can be repaid tax free, whereas a partial repayment of an equity investment may give rise to dividend treatment to the extent of current and accumulated earnings and profits of a U.S. subsidiary corporation.
3. Under the Treaty, withholding tax on interest is typically reduced below the statutory 30% rate.

However, there can be tax and non-tax reasons why the foreign company might not want to finance its U.S. operations with debt. For example, increased debt would not reduce current taxes if the U.S. operations were otherwise incurring losses. Also, increased debt can sometimes increase the current overall tax rate because of the way the home country taxes interest, as distinguished from dividend, income.

Since interest is payable only with respect to a debt instrument, the U.S. tax characterization of the underlying instrument as debt must be respected. If the debt instrument is re-characterized as equity, the payments to the foreign recipient will be re-characterized as non-deductible dividends and possibly subject to higher U.S. withholding tax.

Despite the significant stakes, there are no statutory rules in the U.S. tax law governing whether the U.S. payor is *thinly-capitalized* so that the purported debt is treated as equity. U.S. case law, while it does not provide hard and fast rules, has established a number of factors to be considered.

The U.S. tax authorities have recently issued regulations to address whether interests in a corporation should be treated as stock or debt. The regulations introduce new documentation requirements for related-party debt to be characterized as debt (rather than stock) for U.S. tax purposes and change the characterization of certain purported related-party debt instruments to stock.

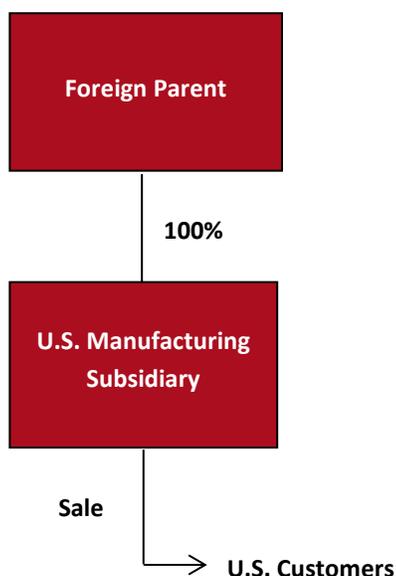
Even if an instrument is properly characterized as debt, U.S. tax law contains several limitations on the deduction of interest expense. The simplest limitation applies to accrued but unpaid interest. A U.S. company, regardless of its method of accounting, is not entitled to a current interest expense deduction for accrued but unpaid interest owed to a foreign-related entity unless such interest is currently includable in the income of the foreign-related entity.

More complicated are the U.S. *earnings stripping* rules. Under these rules, if the issuer has a debt-to-equity ratio that exceeds 1.5 to 1, certain interest deductions of the U.S. debtor are deferred. Thus, *disqualified interest* paid or accrued during the taxable year may be deferred. Disqualified interest is generally interest paid or accrued to a related party if no, or a treaty-reduced rate of, U.S. tax is imposed with respect to such interest. The disallowance, however, is limited to the corporation's *excess interest expense* defined as the excess of the corporation's net interest expense over the sum of 50% of the adjusted taxable income of the corporation.

The interest on all related-party loans is covered by the U.S. earnings-stripping rules. In addition, the rules can apply to third-party loans, if two conditions are met: (1) no, or a treaty-reduced rate of, U.S. withholding tax is imposed on the gross amount of the interest paid; and (2) the loan is guaranteed by a related foreign person. Thus, any form of credit support received from a foreign parent in connection with a borrowing may result in the application of the earnings-stripping rules to that borrowing.

The following example illustrates the principal U.S. tax considerations relating to a foreign-owned U.S. manufacturing operation.

Case Study – Manufacturing in U.S.



COMMENTS

- Capitalization
 - Generally better to use debt rather than equity financing
 - Interest deductible
 - Principal repayment is tax free
 - Treaty rate reduction on withholding tax
- Characterization – debt vs. equity
 - Thin capitalization
- Limitations on interest deductibility
 - Accrued but unpaid interest
 - Earnings stripping
 - Disqualified interest
 - Excess interest expense
 - Parent loan guaranty
- Transfer pricing
 - Arm’s length requirement for pricing both tangible property and services
- Licensing
 - Foreign parent may have valuable intangibles it intends to license to U.S. manufacturing subsidiary.
 - Royalty deductible
 - Treaty rate reduction for royalty payments
- State tax considerations
 - Borrowing by operating subsidiary

Personnel

Another decision facing the foreign investor is the staffing of the U.S. enterprise. This often involves deciding between U.S. employees or the use of foreign employees, often seconded or otherwise made available by the foreign parent.

The use of U.S. employees payrolled by the U.S. company raises no particular issues for either the employee or the foreign parent. The use of foreign employees, however, raises issues for both the employees and the foreign parent. The principal issue for the foreign employee relates to likelihood that

his continued employment in the U.S. will give rise to U.S. tax residency and, hence, U.S. taxation of the employee's worldwide income.

Under U.S. tax law, an alien individual is treated as a resident of the U.S. for a calendar year if such alien satisfies either of the following two tests:

1. The individual is a lawful permanent resident of the U.S. under the immigration laws, at any time during the calendar year (the *green card* test); or
2. The individual is physically present in the U.S. for a sufficient number of days to satisfy the *substantial presence* test. An alien is substantially present if either (i) he is physically present in the U.S. for 183 days or more during the calendar year, or (ii) the sum of the days calculated on a weighted average, spent in the U.S. during the most recent three-year period equals or exceeds 183 days.

The presence of foreign workers in the U.S. raises the possibility that their activities will give rise to the conduct of a U.S. trade or business by their employer. Since the foreign corporation is able to claim the benefits of a U.S. income tax treaty, the threshold of taxable presence is raised by the requirement that it must have a *permanent establishment* in the U.S., in order to be subject to tax on its business profits. A permanent establishment, as discussed below, is generally defined as an office or fixed place of business, but can also arise from the activities of certain agents, including employees, in the U.S. For example, if the foreign corporation sends employees to the U.S., personal services performed within the U.S. by such employees on behalf of the foreign corporation may constitute the conduct of a U.S. trade or business through a permanent establishment of the foreign corporation. Income attributable to that business would be subject to U.S. corporate income tax as well as to the branch profits tax, described above. It is, therefore, generally preferable, if possible, to place any foreign employees working in the U.S. in the employ and on the payroll of the U.S. affiliate.

Repatriation of Profits (Including Royalties and Inbound Sales)

The foreign direct investor has a number of means by which it can repatriate the profits of its U.S. operations. These include the payment of interest or dividends by the U.S. enterprise to the foreign owner, discussed previously under *Capitalization*. In addition, the foreign parent can, where appropriate, charge a royalty to the U.S. company for use of parent-owned intellectual property, such as patents, copyrights or know-how. Finally, the foreign parent could structure its inbound sales so that the parent's income from such sales would not be taxable in the U.S.

The utilization of royalties, if applicable, is often a tax-efficient means to extract profit from the U.S. enterprise. An arm's-length royalty is deductible by the U.S. business while, under the terms of the Treaty, the withholding tax rate is reduced from 30% to zero generally for *royalties*, as defined. The tax treatment of any royalty income in the foreign country should, of course, also be taken into consideration.

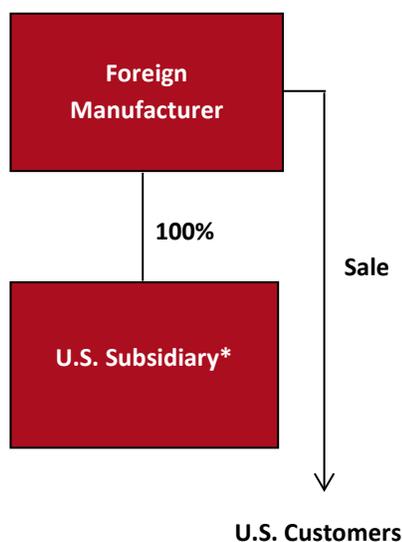
Often the business activity being contemplated is the sale of inventory products by a foreign company to customers located in the U.S. – so called *inbound* sales. There are a number of tax planning techniques that may be appropriate for a non-U.S. seller, for example, a foreign manufacturer, to minimize its U.S. tax burden. The essence of this planning is to divide the total profit to be earned with respect to the importation and sale of inventory between the foreign manufacturer and its related U.S. affiliate. The planning goal is to minimize the role that the U.S. affiliate plays in the transaction in order to support less income being allocated to it. In addition, it is critical that the activities of the foreign manufacturer do not constitute engaging in a U.S. trade or business through a permanent establishment, either

directly or through the agency rules described below. So long as the foreign manufacturer is not so engaged, any gain on the sale of its inventory products will not be subject to U.S. tax.

A permanent establishment is generally defined as an office or fixed place of business but can also arise from the activities of certain agents. There are generally two types of agents – dependent and independent. Under the Treaty, typically the presence and activities of a dependent agent will give rise to a permanent establishment only if the agent has and habitually exercises an authority to conclude contracts in the name of the enterprise. An independent agent, on the other hand, does not create a permanent establishment so long as it is acting in the ordinary course of its business.

The following example highlights the U.S. tax considerations involved in *inbound sales* by a foreign manufacturer.

Case Study – Sale and Distribution in U.S.



COMMENTS

- Branch vs. subsidiary
 - Effect of *branch profits tax*
- Legal relationship of U.S. Subsidiary and Foreign Parent
 - Distribution
 - Commission agent
 - *Buy Sell* arrangement
- Economic functionality of U.S. Subsidiary
 - Sales solicitation and support
 - *Skinny* distributor
- Effect of tax treaty
 - Permanent establishment
 - Dependent vs. independent agent
- Transfer pricing
 - *Arm's-length* requirement for pricing both tangible property and services
- State tax implications

*Assumes choice of U.S. subsidiary

Exit Strategies

The tax planning for the sale or other disposition of a U.S. business operation is beyond the scope of this booklet. However, in general terms, it can be stated that the tax treatment on the sale of the U.S. business depends on several key variables. The first is whether the transaction is a sale of assets (often favored by the buyer) or a sale of an interest in the business entity—in the case of a corporate subsidiary, a sale of stock. Next to be considered is whether the sale should be structured as taxable or tax-free (under the U.S. tax law reorganization provisions). It should be noted that the choice of form of organization may affect the appropriate exit strategy. For example, only a corporation can engage in a tax-free reorganization.

A foreign parent company can typically exit its U.S. investment in one of two ways. It can liquidate its U.S. holding or it can sell it. Liquidation is the easiest method of exit as it doesn't require the involvement of an unrelated third party. For U.S. tax purposes, a corporate liquidation of a wholly

owned subsidiary of a foreign corporation generally is treated as if the corporation sold all its assets (both tangible and intangible) at their fair market value, thereby subjecting any asset appreciation to U.S. corporate income tax. The distribution of the assets to the foreign parent company is tax-free to the parent. This tax treatment is typically favorable, particularly when compared with the tax treatment of a dividend—as distinguished from a liquidating—distribution, which may be subject to a withholding tax (potentially reduced under the Treaty).

On the other hand, if the foreign parent sells the stock of the U.S. subsidiary, so long as the parent does not have a permanent establishment in the U.S., in general, it will not be subject to U.S. tax on any gain from such sale. However, special rules apply if 50% or more of the assets of the U.S. subsidiary are U.S. real property interests.

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