

U.S. Taxation of Foreign Companies

How to do Business
In the United States

 New York . Los Angeles

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TAXATION OF FOREIGN COMPANIES

FOREIGN CORPORATION

A foreign corporation, for U.S. tax purposes, is any corporation not organized in the U.S., in any state or the District of Columbia or is a “U.S. Possession Corporation” (Guam, U.S. Virgin Island, American Samoa, etc).

DOMESTIC CORPORATION

A “domestic” corporation is created or organized in the United States or under the law of the United States or of any State. A domestic corporation is subject to U.S. taxation on its worldwide income. This means income earned within the United States, as well as abroad, is subject to U.S. taxation. Relief for any double taxation of this worldwide income may be provided by a U.S. foreign tax credit or treaty relief.

FOREIGN CORPORATION

Income earned is subject to U.S. income tax under two situations:

- Net effectively connected income with a U.S. trade or business is taxed at graduated rates from 15 to 35% plus any state/local taxes.
- Fixed or determinable periodic U.S. source income not effectively connected with a U.S. trade or business is taxed at a 30% rate (e.g., U.S. source investment income).

Exception: Tax treaties often specify a lower rate on non-effectively connected income or exempt income that is effectively connected but not attributable to a permanent establishment in the U.S.

- The presence of a “Permanent Establishment” in the U.S. is a fact and circumstance test used to determine if the corporation is conducting a trade or business in the U.S.

SOURCING OF INCOME

Refers to where income is treated as earned for U.S. tax purposes. This is important because most foreign source income of foreign corporations is not subject to U.S. tax except for certain types of foreign source income effectively connected with a U.S. trade or business.

TAXATION OF FOREIGN COMPANIES

EFFECTIVELY CONNECTED INCOME

Effectively connected income is income that is effectively connected with the conduct of a U.S. trade or business. It consists of income that is attributable to economic activity in the U.S. and may also include a narrowly defined class of income from sources outside the U.S. Such effectively connected income is subject to the U.S. graduated tax rates.

Example: If FC, a foreign corporation, engages in the manufacture of computers in Santa Fe, New Mexico, then those activities would cause FC to be engaged in business within the United States. All of the U.S. income derived from manufacturing those computers in the United States would be effectively connected income.

U.S. SOURCE INCOME

Periodic Income – This includes fixed, determinable annual or periodic gains, profits and income such as interest, dividends, rents, royalties, wages and sales of capital assets. These are effectively connected only if they are effectively connected with a U.S. trade or business.

Example: Interest income on a trade receivable acquired in the conduct of a U.S. business would be effectively connected income.

- **Trade or Business** – As applied to a foreign person, a U.S. trade or business will be found to exist if there is regular, continuous, and considerable business activity in the U.S. (e.g. Permanent Establishment). Isolated or sporadic business transactions will not generally be considered a trade or business.
- **Other Situations** – The U.S. tax laws and regulations do not offer a comprehensive definition of a “U.S. trade or business” and rely on the regulations and precedents in assessing whether or not the facts and circumstances of each business situation conducted in the United States is “regular,” “continuous,” and “considerable.”

TAXATION OF FOREIGN COMPANIES

EFFECTIVELY CONNECTED INCOME

FOREIGN SOURCE

- **Income** – Only effectively connected if the foreign corporation has an office or fixed place of business in the U.S. that was a material factor in earning the income.

Office or fixed place of business in the U.S. could be an office, factory, store or other fixed location. The office of an agent can sometimes be considered an office or fixed place of business of the foreign corporation.

Exception: Many treaties provide for the exclusion of income earned in the U.S. by a foreign corporation provided the foreign corporation does not have a permanent establishment in the U.S. Permanent establishment as previously indicated is a “facts and circumstances” test and is often defined in the treaty. The foreign corporation must also be a resident of the treaty country.

TAXATION OF FOREIGN COMPANIES

DEDUCTIONS AND CREDITS

Deductions and credits are allowed only if associated with effectively connected income.

Important: A foreign corporation must file a timely, true and accurate return to claim its deductions and credits. If not, it could lose its deductions and get taxed on its gross effectively connected income.

TAX ON NON-EFFECTIVELY CONNECTED INCOME

Foreign corporations with U.S. source income that is not effectively connected are taxed at 30% (or lower treaty rate) of gross income. No deductions or credits are allowed.

The following types of income are subject to the 30% withholding rule: Fixed or Determinable Annual or Periodic (FDAP) Income, lump sum distributions, OID, contingent sales of intangibles, and contingent sales of timber, coal and iron, all of which are contingent on the productivity, use or disposition of the intangible.

FDAP Income – This is the type of income that is of a recurring nature such as interest, dividends, rents and royalties.

This 30% tax may be reduced or eliminated by treaty.

Interest on deposits with U.S. banks and portfolio interest that is not effectively connected with a U.S. trade or business is exempt from the 30% tax. This is available only to foreign corporations and nonresident aliens.

Real Property Income – Foreign corporations with non-effectively connected income from U.S. real property (e.g., rents) may elect to treat the income as effectively connected. This allows for the offset of deductions and the use of the graduated rates of tax (15% to 35% on net rental income instead of 30% on gross rental income).

TAXATION OF FOREIGN COMPANIES

FOREIGN INVESTMENT IN U.S. REAL PROPERTY

The U. S. real property interest is defined as either real property located in the United States or the Virgin Islands or stock in certain domestic corporations.

Gains from sales of property by a foreign corporation often qualify as capital gains and are not subject to U.S. tax unless connected with a U.S. trade or business.

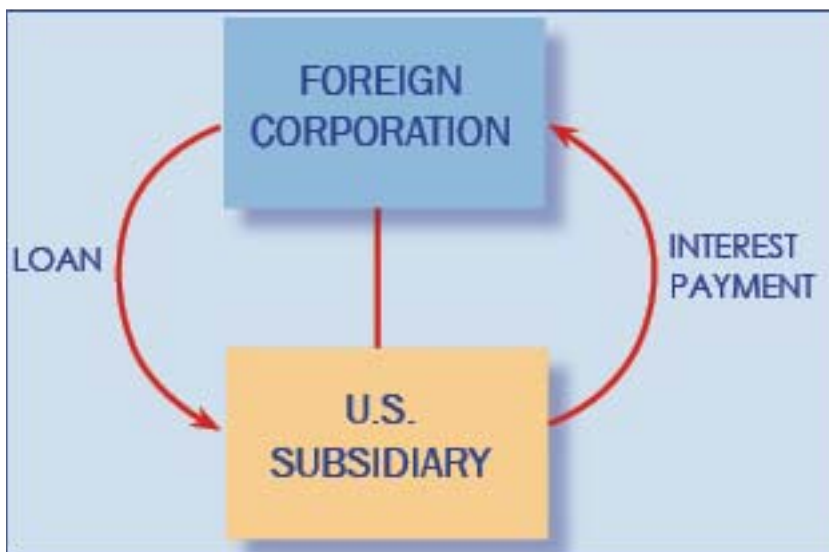
However, a foreign corporation's gains/losses from the sale of U.S. real property, including the sale of stock in a U.S. corporation with 50% or more of the FMV of its assets in U.S. real property, are always treated as effectively connected with a U.S. trade or business. (Foreign investment in Real Property Tax Act of 1980.) Thus, gains on the dispositions of U.S. real property are taxed at the graduated rates of tax and not the 30% tax on non-effectively connected income.

There is also a possible withholding tax of 10% required by the purchaser of a U.S. real property interest from a foreign person.

TAXATION OF FOREIGN COMPANIES

INBOUND FINANCING CONSIDERATIONS

It was common practice before the enactment of harsher tax rules relating to interest expense for foreign companies that planned to set up a U.S. trade or business to fund that trade or business with as much debt as possible. The tax advantages were that the U.S. trade or business could deduct the interest paid to its foreign parent and, secondly, the 30% withholding rate on the gross amount of interest paid to a foreign parent could be reduced to zero by the use of various U.S. income tax treaties.



Current law provides limitations on the deductibility of interest payments that may apply even if the debt is not recharacterized as equity under the thin capitalization doctrine. These earning-stripping provisions generally limit the magnitude of interest deductions in certain situations where payments are made to related taxpayers who have no or reduced U.S. income tax liability. The limits may apply to loans made by foreign shareholders in circumstances where a tax treaty exempts or reduces U.S. withholding on interest payments.

FILING REQUIREMENTS

Foreign corporations with effectively connected income must file form 1120-F by the 15th day of the 6th month after the end of the year if they have no office or place of business in the U.S. With a U.S. office or place of business they must file form 1120-F by the 15th day of the 3rd month. Both dates can be extended.

If there is no effectively connected income, no U.S. tax return is needed provided the U.S. tax is fully paid through withholding at its source.

TAXATION OF FOREIGN COMPANIES

SELECTION OF ENTITY

U.S. Corporations – taxed on their worldwide income.

Foreign Corporations – Generally taxed only on their U.S. sourced income.

Options:

- U.S. Corporation
- U.S. Branch of Foreign Corporation
- General Partnership
- Limited Partnership
- Limited Liability Company

U.S. CORPORATION

Most foreign investors have chosen the U.S. subsidiary form of operation for the following reasons:

- Liability exposure limited to the U.S. subsidiary
- Penetration into the U.S. market may be easier for a U.S. subsidiary
- Local financing may be easier for a U.S. subsidiary
- 100% owned U.S. subsidiary is possible
- Subsidiary is separately taxed in the U.S. - shareholders are taxed generally on dividend distributions
- Management is flexible
- Easy transferability of ownership
- Marketing considerations

U.S. Branch of Foreign Corporation

- U.S. branch is taxed generally in the U.S. on only U.S. source income
- Branch level tax (30% or lower by Treaty) may apply if earnings are not reinvested in U.S. assets
- Parent is liable for branch's actions
- Foreign corporation must file Form 1120-F in the U.S. reporting the branch's operations. Allocation of expenses is necessary.

TAXATION OF FOREIGN COMPANIES

SELECTION OF ENTITY

GENERAL PARTNERSHIP

- Partners are taxable in the U.S. on the partnership's operations
- Partners have unlimited liability for partnership debts
- Transferability is more restricted
- Foreign partner corporations must file Form 1120-F similar to that of a U.S. branch
- Must comply with complex withholding rules explained later
- Branch profits tax must be considered

LIMITED PARTNERSHIP

- Partners are taxable in the U.S. on partnership operations
- Liability is limited to contributions for a limited partner
- Limited partners are excluded from control of the business (If they become involved they have unlimited liability)
- Foreign partner corporations must file Form 1120-F similar to that of a U.S. branch
- Must comply with complex withholding rules explained later
- Branch profits tax must be considered

LIMITED LIABILITY COMPANY

- Relatively new type of entity so rules are still being developed
- Must meet state requirements
- Provides limited liability to members
- Taxed as a partnership if properly organized
- Members are taxed in the U.S. on LLC's operations
- Option for foreign persons since they cannot be "S" Corporation shareholders
- Must comply with complex withholding rules explained later
- Branch profits tax must be considered

TAXATION OF FOREIGN COMPANIES

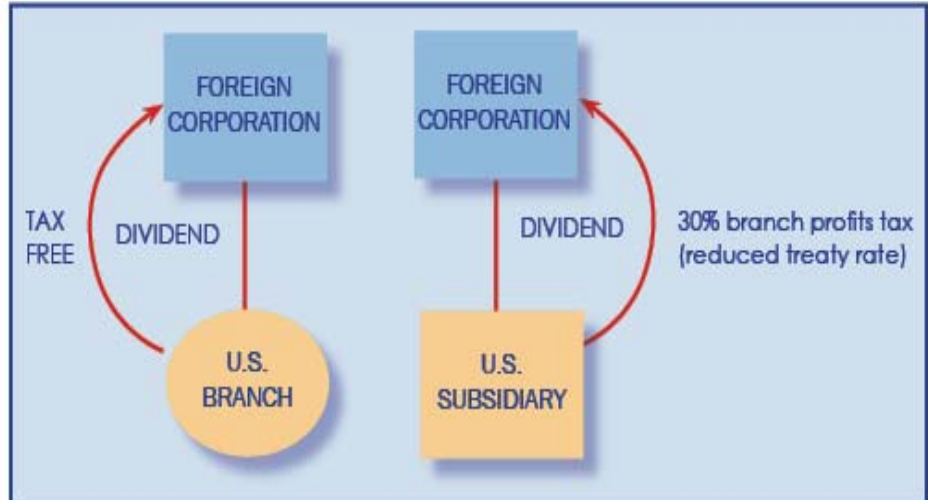
INCOME FROM U.S. SUBSIDIARIES

Generally, dividends, interest and royalties paid by a U.S. subsidiary to a foreign parent will be subject to a 30% U.S. withholding tax or lower rate if provided by treaty.

U.S. BRANCHES

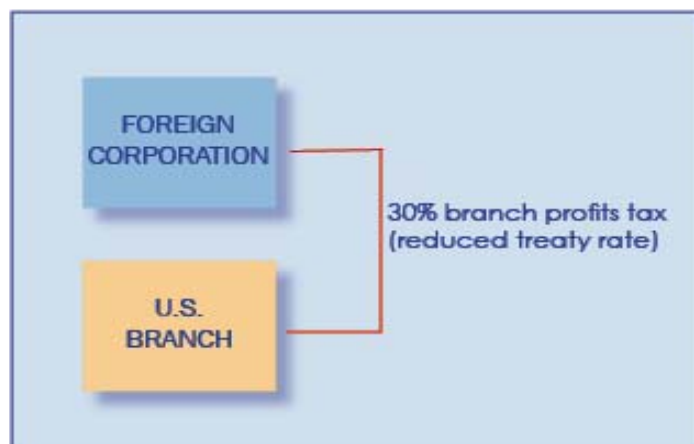
Generally, a U.S. branch operation constitutes income effectively connected with a trade or business in the U.S. and is subject to graduated rates of tax.

Pre-1986 Branch vs. U.S. Subsidiary Advantage



Post-1986 Branch Tax Equalization

Branch level tax may be imposed on foreign corporations engaged in a U.S. trade or business in addition to the regular income tax. The rationale for the branch profits tax is to make the taxation of dividends remitted from a branch to a foreign parent equal in tax consequence to the repatriation of a dividend from a U.S. subsidiary to a foreign parent. Historically, if a foreign company decided to be a branch in the U.S., there was no tax consequence when the branch remitted a dividend to its parent.



Branch level tax is 30% of after-tax earnings effectively connected with their U.S. trade or business to the extent these after tax earnings are not reinvested in the U.S. business.

TAXATION OF FOREIGN COMPANIES

U.S. BRANCHES

Treaties may reduce the 30% branch level tax or exempt the earnings altogether provided the shareholders of the foreign corporation are not treaty shopping.

Branch level interest tax may also be imposed at 30% on interest paid by the U.S. branch to a foreign person not engaged in such a business. In addition, branch level interest tax may also be imposed on the excess, if any, of the interest deducted on the branch's U.S. tax return (1120-F) over the amount actually paid during the year.

The branch level interest tax may be overridden by treaty just like the branch level profits tax.

TAXATION OF FOREIGN COMPANIES

PARTNERSHIPS: GENERAL, LIMITED AND LIMITED LIABILITY COMPANIES

Partnerships are not subject to Federal tax itself; instead, partners (members) are subject to U.S. tax. This general rule may not apply at the State/Local level.

Important: U.S. withholding is required by the partnership on a foreign partner's allocable share of effectively connected income even though not distributed.

Withholding is required regardless of the tax liability of the foreign partner.

Withholding rate is the highest U.S. tax rate applicable to the foreign partners (i.e., 35% for corporations and 35% for individuals).

Quarterly estimated payments of withholding are required based upon quarterly effectively connected income distributable to the foreign partner not on the amount actually distributed.

The amount withheld is treated as a distribution and credited against the partner's U.S. tax liability.

REPORTING REQUIREMENTS

There are various forms a Partnership is required to obtain from a Partner to determine a Partner's Foreign status.

Form 8804 "Annual Return for Partnership Withholding Tax" must be filed by a partnership with effectively connected income with one or more foreign partners even with no withholding requirement.

Form 8805 "Foreign Partners Information Statement of Withholding Tax" must be filed to show the amount of tax withheld for a foreign partner. This form is filed by the Partnership as well as by each Partner to claim withholding credit.

Form 8813 is used to make the withholding tax payment to the I.R.S.

TAXATION OF FOREIGN COMPANIES

FOREIGN CONTROLLED CORPORATIONS

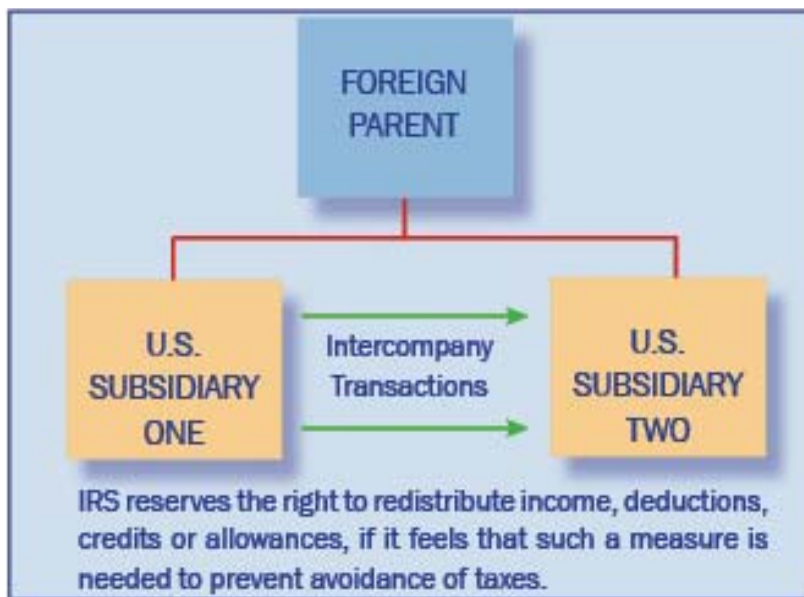
ANNUAL INFORMATION REPORTING REQUIREMENTS

Domestic corporations that are at least 25% owned by foreign persons as well as all foreign corporations engaged in a U.S. trade or business may be required to file Form 5472 with their U.S. federal income tax return. A duplicate copy must also be filed with the Internal Revenue Service in Philadelphia.

Form 5472 discloses shareholder information and also transactions with 25% shareholders and other foreign related parties including individuals.

INTERCOMPANY TRANSACTIONS – TRANSFER PRICING

The IRS may reallocate income, deductions, etc., among two or more organizations that are controlled by the same interests (I.R.C. Section 482) so that the arms length standard can be achieved.



PENALTIES

In order to encourage compliance with the arms length standard, certain penalties are imposed that could amount to 20% to 40% of the tax attributable to any IRS adjustment to properly reflect income.

To avoid the imposition of these penalties documentation must be maintained before the tax return is filed for each year.

The IRS expects requested documentation to be provided within 30 days of the request. This documentation consists of the following:

TAXATION OF FOREIGN COMPANIES

INTERCOMPANY TRANSACTIONS – TRANSFER PRICING

1. Overview of the business, economic and legal factors that affect the pricing of products and services.
2. Description of organizational structure, including all related parties.
3. Any documents required by Section 482 regulations.
4. Description of transfer pricing being used and reasons for usage.
5. Explanation for not selecting other methods.
6. Description of controlled transactions and internal data used to analyze them.
7. Description of the comparables used, how comparability was evaluated and what adjustments were made.
8. An explanation of the economic analysis and projections relied on in developing the transfer pricing method.
9. Index of principal and background documents and a description of your record keeping system

In addition to these principal documents, background documents supporting the assumptions and conclusions in the principal documents, such as segment profit and loss statements, general ledgers and contracts, must be provided to the IRS.

These documentation rules are generally effective for years beginning after December 31, 1993.

ADVANCED PRICING AGREEMENT

Advanced pricing agreement can be applied for by a taxpayer to help avoid any penalties provided there has been no change in relevant facts and circumstances in the current year.

TAX CONSIDERATIONS IN ACQUIRING A BUSINESS IN THE U.S.

- Purchase of stock or purchase of assets.
- How can highest tax basis in assets be achieved?
- How to achieve amortization or deduction of amounts paid in excess of book value?
- Structure for consolidated U.S. tax return filing to allow for offset of loss and profitable entities, i.e., U.S. holding company.
- How to minimize state and local income taxes and property taxes – many states do not allow consolidated tax returns?
- Should purchase be done with capital or with loans - adequate capitalization must be considered?
- Should borrowing be done in the United States or through the foreign parent – deductibility of interest and withholding taxes must be considered?
- Will the profits be repatriated or reinvested in the United States? Withholding taxes must be considered on dividends.
- Exposure to prior tax liabilities of target company, last IRS or state tax examination.
- Exposure to state and local taxes for jurisdictions in which the target corporation did not file.
- Maximize utilization of losses and other tax attributes that may exist in a target corporation. Rules regarding net operating loss utilization with change of ownership must be considered.
- Intercompany pricing on the purchase of goods and services from foreign related parties must be evaluated for arms length standard.
- U.S. tax reporting requirements of foreign owned U.S. corporations (Form 5472) must be considered.
- State and local transfer taxes and sales taxes must be considered on the purchase of business assets.
- Payroll taxes for retained employees must be properly planned.

FOREIGN NATIONALS IN THE U.S.

Executives of foreign corporations expecting to work in the U.S. have an opportunity to predetermine their U.S. income tax during the period of transfer to, or departure from, the United States. (U.S. individual tax rates vary from 10% to 35%.)

However, the rules for the taxation of “resident aliens” and “nonresident aliens” must be understood to properly plan for the assignment.

BACKGROUND

A. Determining whether an individual is a resident or nonresident alien is important:

1. Residents are taxed on their worldwide income.
2. Nonresidents are only taxed on U.S. source income.

B. Definition of resident and nonresident aliens

1. The Tax Reform Act of 1984 codified the definition of resident alien.

Note: A nonresident alien, by definition, is an alien who is not a resident alien.

2. On April 27, 1992, the IRS published final regulations on the definition of a resident alien.
 - a. The regulations clarified the law.
 - b. For years beginning after December 31, 1991, the regulations require tax return disclosure in certain situations.
3. Residents of both the United States and a foreign country with which the United States has an income tax treaty may be treated as nonresident aliens of the United States.

RESIDENT ALIENS UNDER UNITED STATES LAW

A. Permanent resident test - green card holders

B. Substantial presence test

1. An alien satisfies the test if he or she is:

- a. present in the U.S. during the calendar year on at least 183 days, or
- b. present during the calendar year for at least 31 days, and the number of days present in the calendar year, when added to the sum of one-third the number of days present during the first preceding calendar year and one-sixth the number of days present during the second preceding calendar year, equals or exceeds 183 days.

2. Exceptions to the general rule:

Physical presence in the U.S. for any part of a day counts as a full day. However, an alien can exclude certain days, such as days he or she qualifies as an exempt individual, in certain situations is unable to leave the U.S. due to a medical condition, is in transit between two points outside of the U.S., or is a regular commuter residing in Canada or Mexico (IRS Form 8843). Exempt individuals may include diplomats, teachers, students or professional athletes.

An individual who meets the substantial presence test may still be considered a nonresident alien for the current year if he or she is physically present in the United States for fewer than 183 days in the current year with a “tax home” in a foreign country to which he or she is more closely connected than the United States.

Note: Tax regulations require that Form 8840 must be fully completed when claiming the closer connection exception.

WHEN RESIDENT STATUS BEGINS OR ENDS

A. Permanent resident test

1. Generally, the start date is the first day of the individual's presence in the United States with a green card.
2. Generally, the end date is the date the resident alien no longer has a green card.

B. Substantial presence test

1. Generally, the start date is the first day during the calendar year when the individual is present in the United States, and the end date is the last date the individual is physically present in the United States.
2. Exception to the general rule

Any presence not exceeding 10 days (de minimis presence) during which the alien has a closer connection to a foreign country than to the United States is not counted in determining residency starting or termination date.

Notes:

- (1) Tax regulations require a statement to disregard de minimis presence in the year residency begins or ends.
- (2) Days excluded under the de minimis presence test count in determining whether the substantial presence test is met.

ELECTING TO BE A RESIDENT ALIEN

- A. First year election to be treated as a resident
 - 1. Generally applies if the individual is physically present in the United States for 31 consecutive days and 75% of those days from the start of the 31-day period to the end of the year.
 - 2. The residency election is effective on the first day of the 31 consecutive-day period.
- B. Election of nonresident alien to file joint return with U.S. citizen or resident spouse
 - 1. By making the election both individuals agree to be treated as U.S. citizens or residents for the entire year.
 - 2. Election can be made in two situations:
 - a. When alien is a nonresident at end of the tax year.
 - b. When nonresident alien spouse becomes a U.S. resident during the tax year.

IMPACT OF INCOME TAX TREATIES ON “DUAL RESIDENT TAXPAYERS”

- A. A dual resident taxpayer is an individual who is considered a resident of the United States under its laws and also a resident of a treaty country under its laws.
- B. Under the treaty, this individual will be considered a resident of the United States or the foreign country based on “tie-breaker” provisions in the treaty.
- C. If the individual claims a treaty benefit (as a nonresident of the United States), the individual is treated as a nonresident of the United States for purposes of computing his or her income tax liability for that portion of the year that the individual was considered a dual resident taxpayer.
- D. Tax regulations require that a dual resident taxpayer who claims a treaty benefit file Form 1040NR (U.S. Nonresident Alien Income Tax Return) with the IRS in Philadelphia, PA, and attach a fully completed Form 8833.

