

# U.S. – International Corporate Tax Planning

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## Corporate Taxation in the U.S.

U.S. or Foreign Shareholders

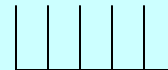


U.S. – Inc.

Operations:

- in U.S.
- outside U.S.

Foreign Corporation



Foreign Co.

Branch Operations:

- in U.S.
- outside U.S.

Corporate rates

Federal

First \$100,000	22%
\$100,000 - \$10m	34%
Over \$10mm	35%

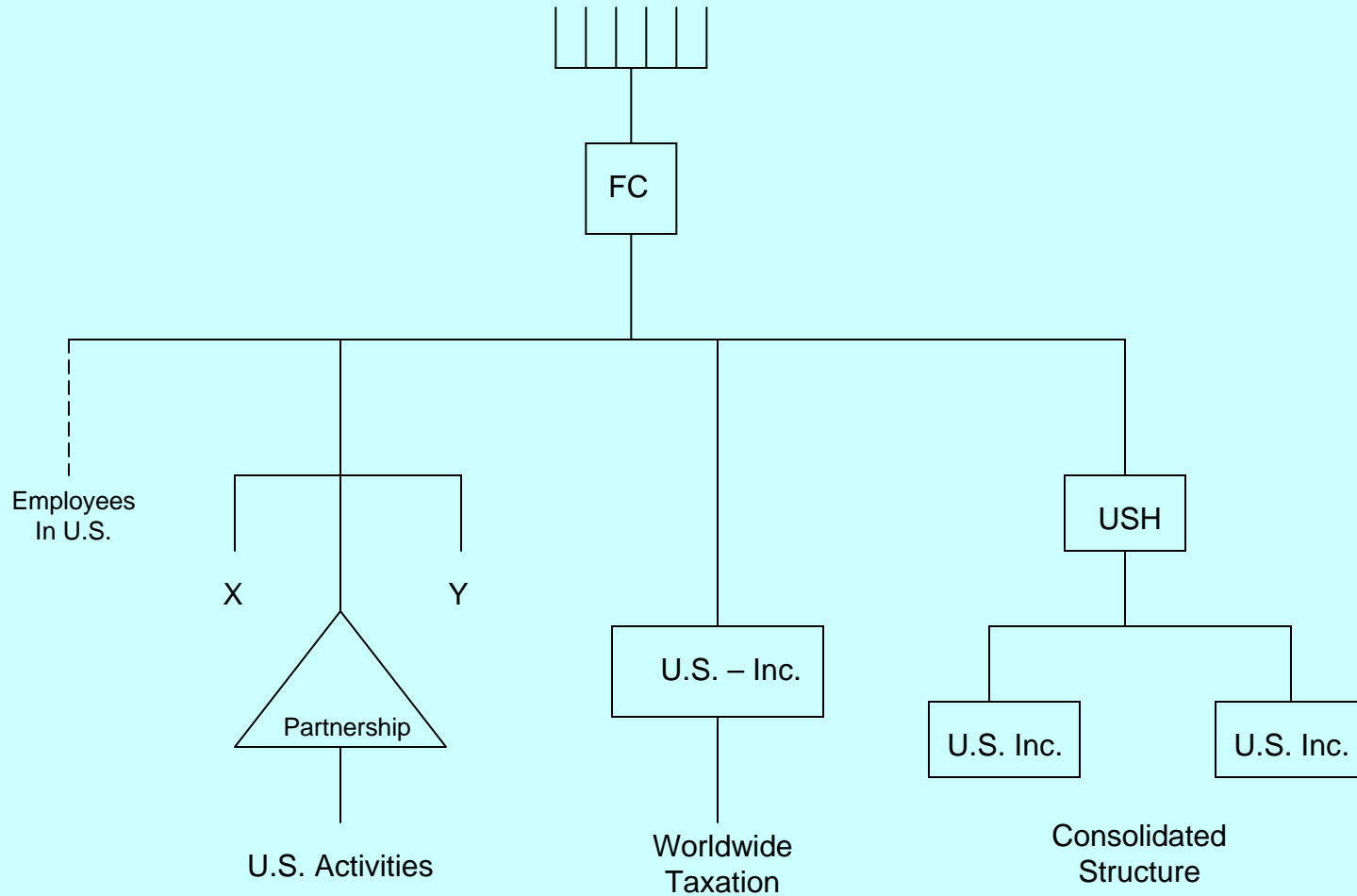
State – 0 - 12%

– average effective rate 5 – 6%

Federal Tax on Dividends

- U.S. Shareholders	15%
- Foreign Shareholders	30% or lower treaty rate
- Branch Profits Tax	30% on “dividend equivalent” or lower treaty rate

## Entering the U.S. Tax System



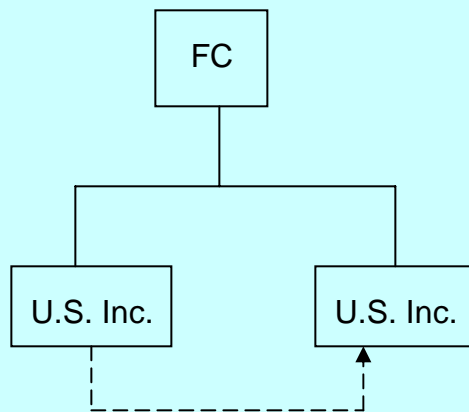
## Expanding into the U.S.

### Factors

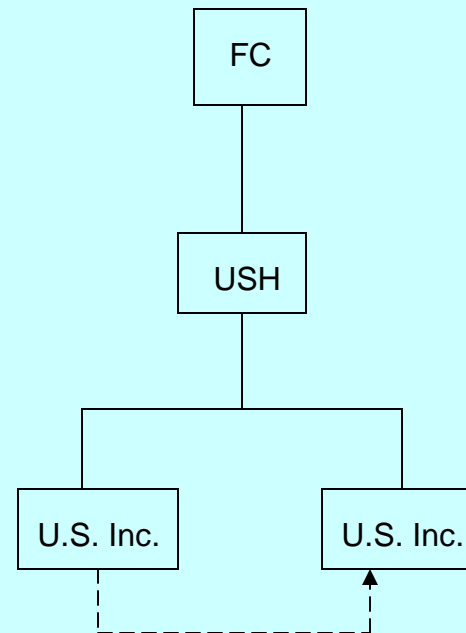
- (1) Existence of trade or business in U.S. [§1.864-7]
- (2) Income tax treaties
- (3) Attributes of partnership apply to partners
- (4) State taxes can be a major factor
  - (a) California Unitary Tax System
  - (b) Worldwide vs. “Water’s Edge” taxation

## Intercompany Debt

Alt. #1



Alt. #2



Alt #1

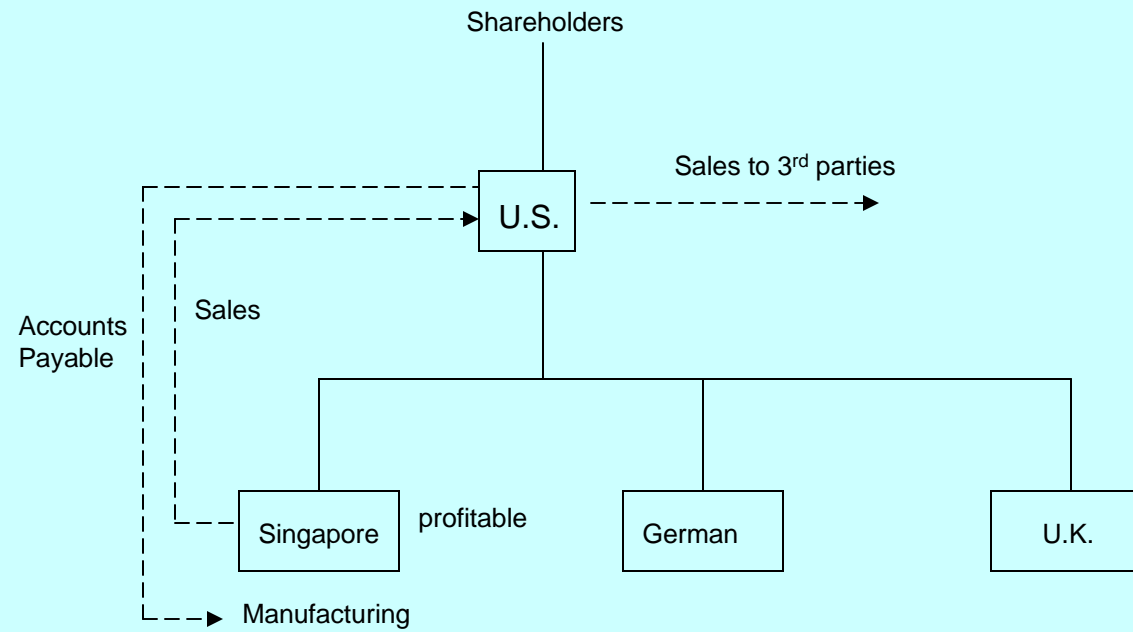
- Documentation can be problematic
- Withholding taxes can apply on disregarded loans
- Sale of subsidiaries generally tax-free

Alt #2

- Intercompany debt eliminated in consolidation
- Sale of subsidiaries will be taxable

Note: Special rules apply to real estate holding companies.

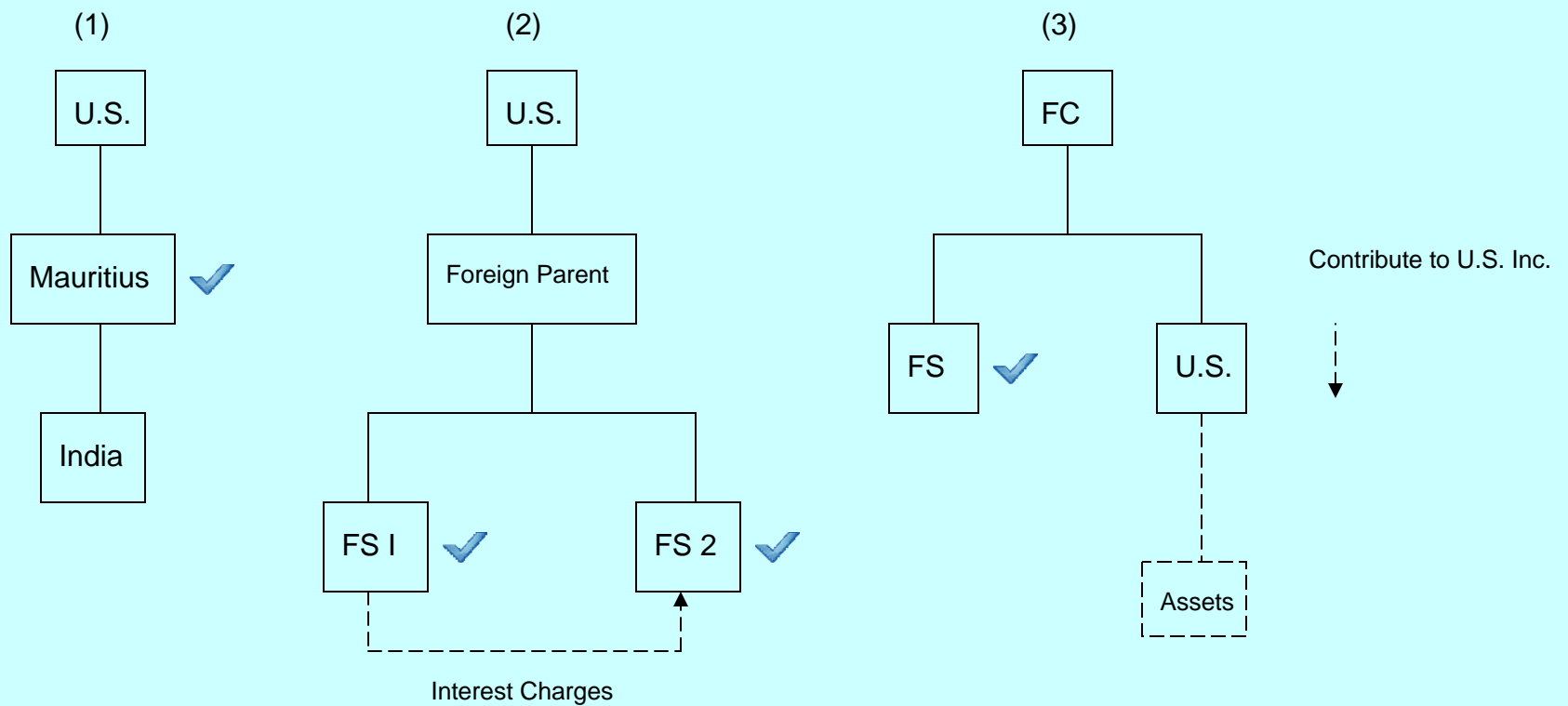
## Intercompany Payables – A Frequent Problem



### Issues

1. Outstanding debt from U.S. parent for over 90 days treated as a loan
2. Deemed dividend applies under “Subpart F” rules
3. U.S. Inc. must accrue interest payable at fair market value [§482]
4. Withholding tax [30%] may apply [§1441]
5. Tax provision impacted – may cause restatement of financials

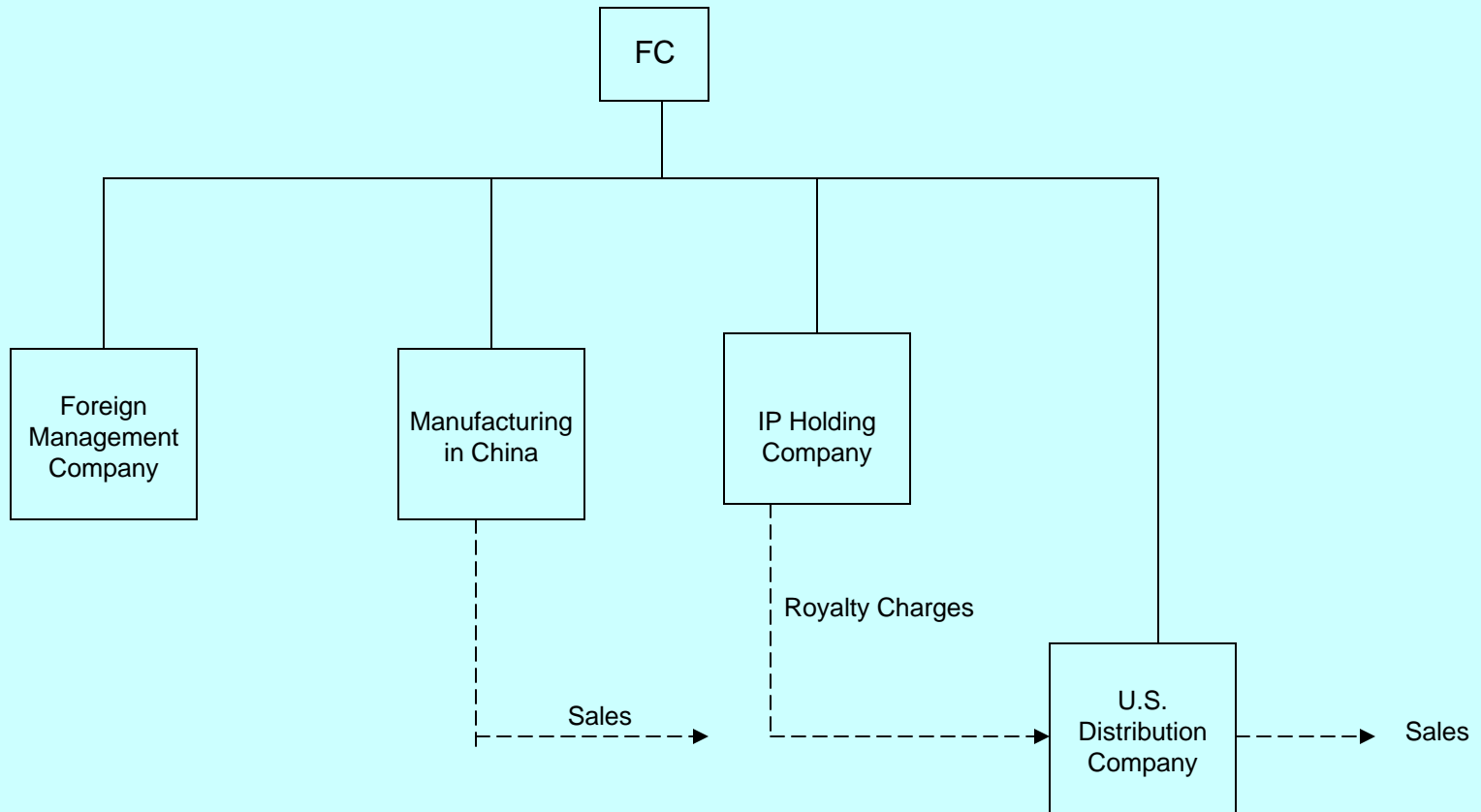
## Check the Box Applications



### Check the Box:

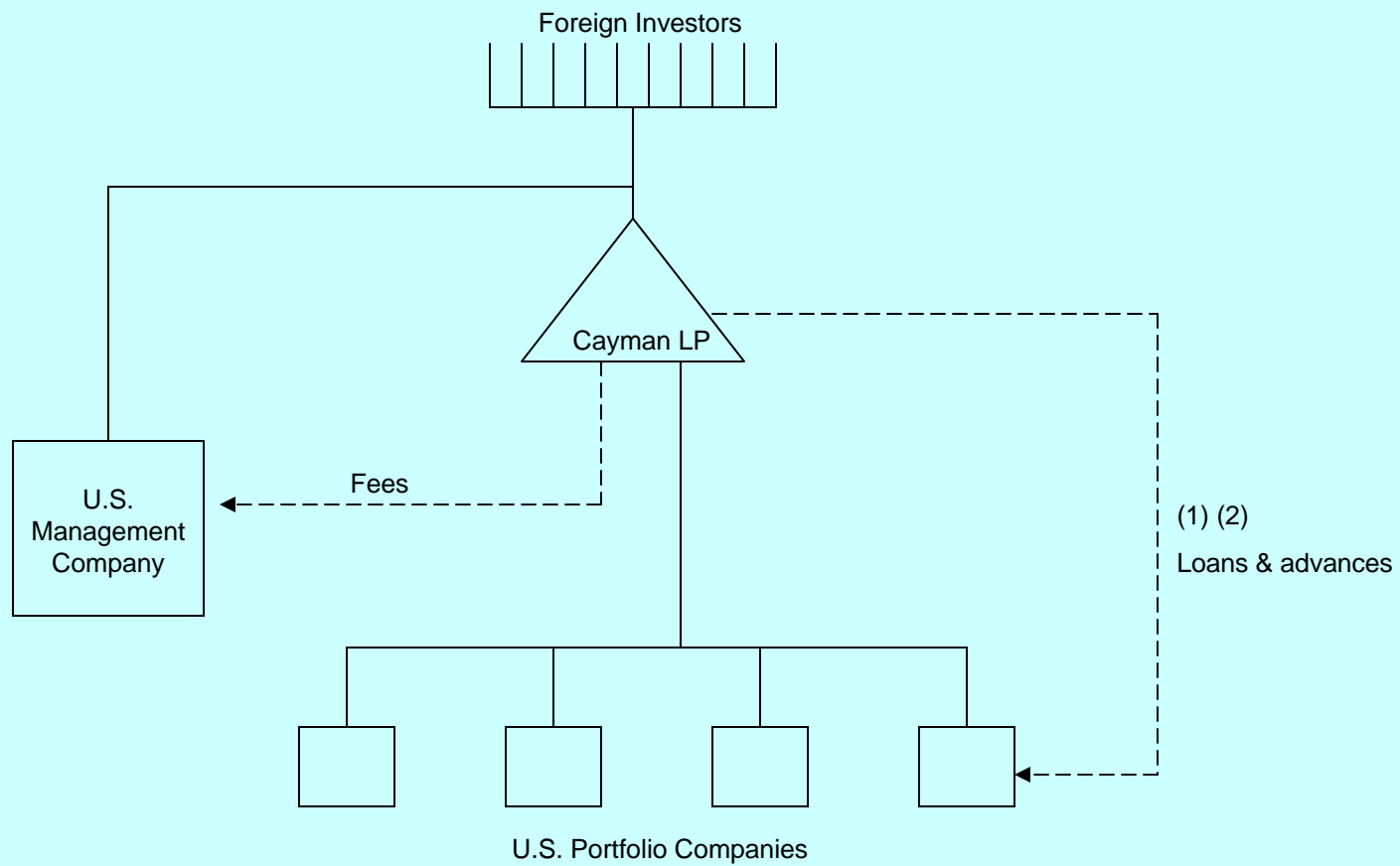
- Avoids Subpart F Income
- Reduces foreign tax
- Steps up the tax basis of assets

## IP Licensing Opportunities under Scrutiny



- Royalty charges lower U.S. profits
- Tax treaty may eliminate U.S. tax withholding

# Investment Fund Structures



## Issues

1. U.S. lending activity may be a U.S. trade or business
2. Withholding taxes at 30%

**Hong Kong**  
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**Income Tax Checklist for Foreign Corporations  
Doing Business in the United States**

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## Tax Checklist for Foreign Corporations Doing Business in the U.S.

This checklist can be used to identify potential tax problems whenever a foreign company forms a U.S. subsidiary or conducts business in the U.S. directly as a branch, or invests through a partnership that has an active business in the U.S.

1. Foreign corporations are generally taxable on the following income:
  - a) U.S. investment income that is fixed or determinable such as interest, dividends, rents and royalties (taxed at 30% or possibly lower under an income tax treaty);
  - b) U.S. source income from the active conduct of a trade or business; and
  - c) Foreign source income that is “effectively connected with a U.S. trade or business.”

Corporate tax up to 35% applies on (b) and (c).
2. A second level of tax may be imposed on income generated by a foreign corporation, referred to as branch profits tax. This tax is equivalent to a withholding tax on dividends paid by a U.S. corporation to its foreign parent. A 30% tax rate applies unless reduced by an income tax treaty.
3. Income tax treaties can reduce or eliminate U.S. income taxes. However, most treaties have provisions that prevent the benefits of applying under “treaty shopping” provisions that generally restrict the use of a treaty to companies owned 50% or more by residents of the treaty country.
4. Most states and some cities in the U.S. impose their own income taxes. These taxes are often computed without reference to federal rules. Many states don’t recognize income tax treaty provisions that are negotiated by the federal government. It can often be the case that while there is no federal tax, state and city taxes may be due.
5. Certain industries and activities in the U.S. are subject to special income tax rules, e.g. insurance income and income from the sale of U.S. real property. This checklist is not intended to cover special industry provisions.
6. Other taxes may apply to activities in the U.S., e.g. federal excise taxes on certain goods or services, state and local property taxes, sales taxes, and payroll taxes. These taxes are not considered in the comments below.

### **A. Is a foreign parent or foreign affiliate doing business in the U.S.?**

1. In order to avoid exposure to federal and state income taxes, it is often recommended that foreign companies minimize or avoid altogether any direct business activities in the U.S. Typically, a U.S. subsidiary is formed to conduct activities in the U.S. to insulate a foreign parent company or its affiliates from U.S. tax exposure. While a U.S. subsidiary will usually protect foreign affiliates from being taxed in the U.S., the IRS can still reallocate income and deductions to the U.S. under transfer pricing rules provided in Internal Revenue Code (IRC) Section 482.
2. Foreign income can be taxed in the U.S. If a foreign company maintains an office in the U.S., foreign income attributable to the U.S. office can be taxed as “effectively connected income”. {IRC Sec. 864, 882}. Generally, a foreign company is considered to have

effectively connected income if it maintains an office or fixed place of business in the U.S. or if it engages in certain activities described in the Income Tax Regulations including the use of an exclusive agent, or if officers and directors of the foreign company regularly conclude contracts in the U.S. {Treas. Reg. 1.864-7}.

3. Article 5 of most income tax treaties exempt foreign companies from U.S. taxation if their presence in the U.S. is minimal and does not constitute a “permanent establishment” (PE). See Exhibit B for an example of the definition of permanent establishment (PE). While income tax treaties may exempt certain activities from being taxed, many states, e.g. California, do not recognize tax treaties and may still assess income taxes even with minimal activities in the state.
4. Foreign companies doing business directly in the U.S. are subject to “branch profits” taxation, a second level of tax that is similar to tax on dividends paid by a domestic corporation. The application of the branch profits tax often makes it difficult to do effective tax planning. Branch profits tax is completely avoided by conducting activities in the U.S. through a U.S. subsidiary. This is the principal reason that foreign companies form a U.S. subsidiary to conduct business in the U.S.

**B. Does the foreign company have related party transactions with an affiliated entity in the U.S.? Does proper documentation exist to support the charges?**

1. The IRS can reallocate income and deductions between related parties if it is determined that non-arms length pricing improperly lowered the U.S. tax.
2. Transfer pricing rules require that contemporaneous documentation be maintained to support arms length pricing for related party transactions. If the IRS increases the tax due to improper pricing, an additional 40% penalty can be imposed if documentation supporting the pricing is not maintained. Transfer pricing rules may be applied to any related party transaction, including sales, management fees, interest charges, stewardship costs, and royalties. {IRC Sec. 482}.
3. Detailed reporting of related party transactions may be required on IRS Forms 5471 or 5472. Significant penalties apply for non-reporting.

**C. Does a U.S. company have intercompany debt or payables or receivables with a foreign parent or affiliate?**

1. Excessive debt: If a foreign parent or affiliate loans or guarantees the debt of a U.S. company, interest deductions in the U.S. may be limited. {IRC Sec. 163(j)}. If the debt to equity ratio exceeds 1.5 to 1 or “60/40,” the limitation will apply. {IRC Sec. 163(j)}.
2. Thin capitalization: If related party debt of a U.S. subsidiary to a foreign affiliate exceeds 3 to 1, the IRS may treat all or part of the related party debt as equity. Interest and debt repayments may be reclassified as nondeductible dividends if the company has positive earnings and profits. {IRC Sec. 385}.

3. Intercompany receivables: A foreign parent may contribute operating capital or extend lines of credit to a U.S. affiliate. If loan balances or intercompany trade receivables are not paid down timely or do not over turn within 90 days, the following may result:
  - a. Interest expense may be imputed to the U.S. subsidiary; and
  - b. Withholding tax may be imposed on the imputed interest.

If the U.S. company is operating at a loss, deductions for imputed interest will not likely create any tax benefit, but the withholding tax will create a current tax liability. Reduced treaty tax rates may not apply if the required tax forms (W-8BEN, 1042 and 1042S) are not filed. {Treas: Reg. Sec. 1.482-7}.
4. Intercompany payables: When a U.S. subsidiary lends money or extends payment terms on a trade receivable balance, the following may result:
  - a. The loan or receivable may result in imputed interest income being recognized;
  - b. Additional income tax will be incurred.
5. Generally Accepted Accounting Principles: For public companies, the resulting adjustments related to the above provisions can be particularly burdensome for financial reporting:
  - a. An unrecorded tax liability may be treated as a prior period adjustment and the financial statements will need to be corrected; or
  - b. The company's accrual for taxes will be increased.

**D. Holding structures**

**Is the foreign company investing in, or doing business in the U.S. through a partnership?**

1. The activities of a partnership are attributed to the partners. When a foreign company owns an interest in either a foreign or U.S. partnership that conducts an active business in the U.S., the foreign company is treated as having an unincorporated branch in the U.S. In addition to federal and state income tax on net earnings, the foreign company may be liable for branch profits tax. Due to these tax risks, a foreign company that owns an interest in a partnership with U.S. activities should consider whether holding the partnership interest through a U.S. corporation is advisable. {IRC Sec. 875, 882, 884}.

**Is the foreign company a subsidiary of a U.S. company?**

2. When a U.S. company owns or controls more than 50% of a foreign company, complicated tax rules under "Subpart F" of the Internal Revenue Code may apply. Income of a foreign subsidiary is deemed to be distributed and corporate tax at the U.S. level will apply even though funds are not actually distributed. {IRC Sec. 951-965}. In general, if a foreign company owns a U.S. company, other foreign affiliates should not be owned by the U.S. subsidiary due to these rules. {IRC Sec. 951-965}.

**Does the foreign company own more than one U.S. subsidiary?**

3. Filing consolidated returns will often reduce the U.S. tax burden. When a foreign parent holds more than one U.S. subsidiary, consideration should be given to forming a new U.S. company to hold the U.S. subsidiaries. Alternatively one of the subsidiaries can become the parent of the other U.S. subsidiaries. The U.S. group of companies can then elect to file a consolidated tax return. This election allows the losses of one or more companies to offset the income of other companies in the consolidated group. {IRC Sec. 1502, 1504}.
4. Is a U.S. affiliate or U.S. subsidiary of a foreign company:
  - a. liquidating;
  - b. transferring assets to a foreign affiliate;
  - c. merging into a foreign affiliate; or
  - d. reincorporating in a foreign jurisdiction?

The immediate tax costs of these transactions are often prohibitive. Detailed analysis is required. {IRC Secs. 332, 351, 367, 368, 7874}.

**E. Does the foreign company need to file a federal or state tax return?**

1. Foreign companies generally need to file a federal income tax return (Form 1120F) and report income and expenses and pay corporate tax whenever they conduct business in the U.S. If a foreign company does not file an income tax return by the prescribed time, deductions can be denied, resulting in the company being taxed on gross income.
2. In order to claim the benefits of an income tax treaty, a tax return must be filed no later than the date prescribed in the Income Tax Regulations.
3. In early years, companies in the start-up mode often generate losses. Income tax returns are often not filed. While there may be no taxable income to report, nonfiling will have the following negative consequences:
  - a. Deductions in the early years can be disallowed and will not carry over as an offset of future years' income; and
  - b. Certain start-up expense costs can only be deducted when tax and accounting elections are made in timely filed returns. Nonfiling may cause the company to forgo favorable tax elections.

**F. Is the foreign company subject to state income taxes?**

1. Most states usually impose a state income tax in the 5-10% range on net income generated in the particular state. Some states (Nevada, Florida, Texas, Alaska, and Washington) do not impose income taxes but assess taxes on sales or on factors other than income. Many states, e.g. California, do not follow federal rules for determining taxable income and don't recognize exemptions that may apply under tax treaties negotiated at the federal level. A foreign company will often be exempt under federal rules but have substantial state tax liabilities under state rules, so getting state tax issues resolved up front is critical.

2. State income and state payroll taxes are frequently the biggest challenge for foreign companies entering the U.S. in part, because state taxes are often ignored in the early stages of business. The states tend to be far more aggressive with penalties for corporate nonfiling compared to the Internal Revenue Service.
3. Case Study of State Income Tax Disaster

The following is a frequent fact pattern for a foreign company:

Aussie Co was based in Sydney. It had twenty subsidiaries around the world. The company seconded five engineers to an unrelated U.S. technology company in Silicon Valley under a three-year consulting contract. Aussie Co billed the U.S. customer for the five engineers from its headquarters in Sydney. An independent payroll company in California was engaged to process the monthly payroll for the five engineers on behalf of Aussie Co.

Aussie Co's consulting income was exempt from federal tax under Article 5 of the U.S. – Aussie Income Tax Treaty since the five engineers working on the premises of a customer did not constitute a permanent establishment. However, California does not recognize tax treaty exemptions. The payroll returns for the engineers triggered a state audit. The California Franchise Tax Board (FTB) sent a demand for a corporate tax return to the senior engineer at the address listed on the payroll tax returns. Because corporate income tax returns were not submitted, the FTB imposed a substantial tax on an arbitrary net income. This is California's standard approach in order to force companies to comply and file a corporate return.

In order to remove the tax assessment, Aussie Co and its twenty affiliates had to do the following:

- a. Convert their financial statements to conform to California rules including currency conversions and California tax accounting rules on Aussie Co's worldwide operations;
- b. Consolidate the worldwide accounting for net income into one combined entity;
- c. Based on the company's worldwide net income, Aussie Co then had to apportion income and expenses to the specific activities in California; and
- d. Pay the tax on (c) in addition to interest and penalties.

The actual tax was minor compared to the cost for accounting for the worldwide operations and for tax returns that had to report worldwide income under California tax rules.

**Solution:** Aussie Co should have formed a California subsidiary to employ the five engineers. The income tax and compliance costs for a single U.S. subsidiary would have been minor in comparison. By forming a U.S. subsidiary, the operating results of the foreign parent and its foreign affiliates would not need to be reported. (Allocation of income and deductions {Sec. 482} and form 5472 may still be required).

**G. State of Incorporation**

1.1. Corporations can be formed in any state and are permitted to conduct business throughout the U.S.

Delaware

New businesses are often advised to incorporate in Delaware even though their operations are located in other states due to the following:

- a. Corporate laws in Delaware have a long history and are well established;
- b. Provisions in the Delaware statutes are viewed as being very protective to officers and directors. This is viewed by many legal advisors as a good defense against class-action lawsuits particularly if the company has product liability concerns or is going public.
- c. Many large and well known public companies are incorporated in Delaware giving the perception that a company incorporated in Delaware has good governance.

Delaware has no income tax. It does have an annual franchise tax which is partly based on the number of shares issued. Caution needs to be taken regarding the company's capital structure which can if not properly set up, can create a significant annual tax.

If a company is incorporated in Delaware, it is still required to report its income and file corporate income tax returns annually in states where it is conducting business. Therefore, incorporating in Delaware results in an additional tax return and filing fee. The annual benefits of incorporating in Delaware are seen by many advisors cosmetic rather than a substantial need in states where business is initially conducted. A U.S. corporation can usually move its state of incorporation to Delaware any time in the future if the need arises.

California

A company can incorporate in California, or it can conduct business in California as a foreign company if it has registered with the California Secretary of State. The corporate income taxes in California are generally the same; e.g. if a Delaware company conducts business in California, it is required to obtain a certificate of qualification from the Secretary of State and file annual tax returns.

**Notes:**

1. References above are to Internal Revenue Code of 1986, as amended.
2. The comments in this checklist and accompanying exhibits are general in nature and are not intended to be comprehensive. Tax planning should be undertaken only with the assistance of qualified advisors.

**Exhibits**

Exhibit A: List of IRS tax forms that may need to be filed

Exhibit B: Article 5 of U.S. China Income Tax Treaty, definition of "Permanent Establishment"

**EXHIBIT A**

**PARTIAL LIST of IRS TAX FORMS**

<b>Form Number</b>	<b>Name of Form</b>
90-22.1	TD F 90-22.1 (PDF) Report of Foreign Bank and Financial Accounts
W-8BEN	Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding
W-8ECI	Certificate of Foreign Person's Claim for Exemption from Withholding on Income Effectively Connected with the Conduct of a Trade of Business in the United States
W-8IMY	Certificate of Foreign Intermediary, Foreign Partnership, or Certain U.S. Branches for U.S. tax withholding
926	Return by a U.S. Transfer of Property to a Foreign Corporation
1042	Annual Withholding Tax Return for U.S. Source Income of Foreign Persons
1042S	Foreign Person's U.S. Source Income Subject to Withholding
1120F	U.S. Income Tax Return of Foreign Corporation
5471	Information Return of U.S. Persons with Respect to Certain Foreign Corporations
5472	Information Return of 25% Foreign Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business
5713	International Boycott Report
8804	Annual Return for Partnership Withholding Tax
8805	Foreign Partner's Information Statement of Section 1446 Withholding Tax
8832	Entity Classification Election
8833	Treaty-Based Return Position Disclosure
8858	Transactions Between Foreign Disregarded Entity of a Foreign Tax Owner and the Filer or Other Related Entities
8865	Return of U.S. Persons with Respect to Certain Foreign Partnerships
8873	Extraterritorial Income Exclusion

**EXHIBIT B** Permanent Establishment (“PE”)

Article 5 of the U.S.-China Income Tax Treaty defines a PE as follows:

*1. For the purposes of this Agreement, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.*

*2. The term “permanent establishment” includes especially:*

*a) a place of management; b) a branch; c) an office; d) a factory; e) a workshop; and f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.*

*3. The term “permanent establishment” also includes:*

*a) a building site, a construction, assembly or installation project, or supervisory activities in connection therewith, but only where such site, project or activities continue for a period of more than six months; b) an installation, drilling rig or ship used for the exploration or exploitation of natural resources, but only if so used for a period of more than three months; and c) the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where such activities continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any twelve month period.*

*4. Notwithstanding the provisions of paragraphs 1 through 3, the term “permanent establishment” shall be deemed not to include:*

*a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;*  
*b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;*  
*c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;*  
*d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise*  
*e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;*  
*f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs a) through e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.*

*5. Notwithstanding the provisions of paragraphs 1 and 2, where a person, other than an agent of an independent status to whom paragraph 6 applies, is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that Contracting State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.*

*6. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other Contracting State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he will not be considered an agent of an independent*

*status within the meaning of this paragraph if it is shown that the transactions between the agent and the enterprise were not made under arm's-length conditions.*

*7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other Contracting State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.*