Coming to America

An Introduction to Tax Planning for U.S. Inbound Transactions

By Michael W. Domanski

Type of Entity

U.S. Tax[1] Treatment

A U.S. corporation owned by a foreign investor is subject to U.S. federal income tax on its worldwide income. The U.S. corporation's income is taxed again, at the shareholder level, when it is repatriated in the form of nondeductible dividends. The U.S. corporation may attempt a tax-deductible repatriation of earnings, such as in the form of payments of interest or management fees. "Corporation" for this purpose means a C corporation,[2] as S status[3] is not available to a corporation with a nonresident alien shareholder.[4]

Conversely, the income of a branch, partnership, or limited liability company (LLC) passes through and is taxed only once, to the owner of the branch, to the partners, or to the members of the LLC, unless the business elects to be taxed as a corporation.[5] A foreign branch owner, partner, or LLC member is generally subject to U.S. income tax on U.S. source income of the branch, partnership, or LLC. Unless excepted by a treaty, profits of a U.S. partnership or branch that are not reinvested in the U.S. are subject to a U.S. withholding tax, whether or not they are repatriated.

The U.S. is a member of a comprehensive multinational network of treaties that acts to reduce or eliminate withholding taxes on certain types of income (e.g., interest, dividends, royalties) being paid to parties resident in countries that are signatories to these treaties. However, because U.S. branches, partnerships, or LLCs owned by foreign investors do not qualify as U.S. "residents" for U.S. tax purposes,[6] this U.S. business may be ineligible for U.S. treaty benefits in the context of payments being made to or from the U.S. The lack of U.S. treaty benefits could be significant if the U.S. business will make substantial payments to, or receive substantial payments from, non-U.S. third parties. In these situations, treaty relief may still be available through a treaty between the foreign investor's country of residence and the non-U.S. counterparty's country of residence. Therefore, a foreign investor should carefully consider the cross-border withholding tax implications of operating in the U.S. as a branch, partnership, or LLC.

Foreign Tax Treatment

Foreign jurisdictions generally recognize pass-through of income from their residents' investments in U.S. partnerships and branches. Many foreign jurisdictions provide relief from double taxation in these situations. In contrast, the income of an entity taxed as a U.S. C corporation is subject to U.S. income tax and generally does not pass through to shareholders, foreign or domestic. However, certain profits of a U.S. corporation (e.g., "passive" income or income from portfolio investments) could be subject to immediate income tax in the foreign country if it has an "anti-deferral" or "controlled foreign corporation" tax regime similar to Subpart F of the U.S. Internal Revenue Code. A U.S. LLC may be treated as a pass-through or non-pass-through entity from a foreign tax perspective depending on the terms of its formation documents and related factors (e.g., whether the entity has centralized management/continuity of life or allows for the free transferability of interests in the entity).

Inbound Movement of Assets

As a preliminary matter, a foreign investor should be aware that, whenever property is transferred cross-border between related parties, both countries' tax authorities will have a vested interest in the transfer price ascribed by the parties to that transaction.[7] Transfer prices determine the cost of goods sold and depreciation/amortization deductions, and thus the amount of income recognized on the transaction, in the respective countries. Transfer prices reflecting reasonable, arm's length amounts have a better chance of withstanding such scrutiny. The extent of documentary proof required for transfer pricing varies by the countries involved in the transaction.

Property

In general, a foreign investor can finance its U.S. business with debt or equity. If third-party financing is not attractive, structuring the movement of cash to a U.S. corporation as a capital contribution is an option. Although it will not generate interest expense deductions in the U.S., it will also not result in taxable interest income in the foreign country or a U.S. withholding tax. Transferring the cash to the U.S. corporation pursuant to a loan is another approach, but it still may not achieve the desired U.S. interest expense deductions unless certain requirements are met. First, the transaction must be respected as debt for U.S. tax purposes (e.g., existence of a loan document, arm's length interest rate).[8] Second, interest payments must actually be made (not just accrued) by the U.S. corporation and they must not have been funded by additional capital contributions from the foreign investor to the U.S. subsidiary.[9] Finally, the U.S. corporation must comply with the U.S. earnings stripping regime.[10]

The earnings stripping rules were established to prevent a foreign parent company from excessively "stripping" the earnings of its U.S. subsidiary with tax-deductible interest payments, rather than with non-tax-deductible dividends. The regime specifically focuses on interest paid or accrued by a U.S. corporation to a foreign related party that is not subject to U.S. withholding tax at the 30 percent statutory rate.

Fast Facts:

The form of entity in which a foreign investor does business in the U.S. can have dramatic tax consequences for the foreign investor as well as for the U.S. business unit. The transfer of employees and property across borders can also raise significant tax issues.

Unless excepted by a treaty, the earnings stripping rules generally act to defer the interest expense deductions (or a portion thereof) unless the U.S. corporation earns sufficient income in the U.S. or is adequately capitalized (i.e., has a debt-to-equity ratio of 1.5 to 1). As a result, loans from the foreign investor to the U.S. corporation may not be the best approach if the various requirements noted above cannot be satisfied.

A foreign investor may contribute tangible assets (such as equipment) to the capital of a U.S. corporation. Alternatively, the foreign corporation could lease or sell these assets to the U.S. corporation. While leasing would generate an expense deduction in the U.S., the payments would likely be taxed in the foreign country and possibly be subject to U.S. withholding tax.[11] The alternatives are essentially the same in the case of intellectual property. However, since intellectual property can appreciate in value over time, and in view of its revenue stream, it may be advisable to have such property "reside" in the lower tax jurisdiction.

The effective tax rates of the U.S. and the foreign country ultimately determine the structure of cross-border transactions. It is not tax-rational to produce an expense deduction (e.g., via a loan, lease, or license) in the U.S. if the corresponding income inclusion in the foreign country will be taxed at a rate in excess of the U.S. tax rate.

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Employees

The movement of employees into and out of the U.S. raises many issues, not the least of which is the employees' legal standing to work in the U.S. At the foreign employee level, an employee who is neither a citizen nor a resident of the U.S. is permitted to earn only a de minimis amount of compensation in the U.S. free of U.S. federal income tax.[12] At the foreign company level, an employee of the foreign parent must take care to limit his or her activities in the U.S. to avoid establishing a U.S. business or branch of the foreign company that is separate and distinct from a preexisting U.S. subsidiary of the foreign parent. For example, an employee of the foreign company who signs contracts in the U.S. that legally bind the foreign parent could be deemed a "dependent agent" of the foreign company. Thus, the foreign parent could be treated as doing business in the U.S. through the activities of its employee, resulting in the establishment of a U.S. business that is taxed separately from the U.S. subsidiary.[13] To avoid this problem, the employee could be made an employee of the U.S. subsidiary, the U.S. subsidiary charging a fee to the foreign parent for the employee's services.

Foreign nationals working at least half the year in the U.S. are considered U.S. tax residents, subject to U.S. federal income tax on their worldwide income.[14] While a treaty may override this result, higher taxes in the employee's country of origin could persuade the foreign employee to seek U.S. resident status. And a treaty may enable a foreign national to collect social security benefits in his home country after having paid lower U.S. social security tax. A treaty notwithstanding, a foreign employee who changes his tax residence to the U.S. may be subject to tax in his country of origin on a deemed sale of his assets.

Outbound Movement of Assets

Property

The movement (repatriation) of cash or other assets from the U.S. to the foreign investor is frequently accomplished through a distribution. If the U.S. company is a pass-through entity, the distribution is often a non-event for U.S. tax purposes because the investor has already been subject to U.S. federal income tax on the U.S. business profits. However, if the U.S. company is a C corporation, this distribution will generally be treated as a taxable dividend (and possibly subject to U.S. withholding tax) to the extent of the current and accumulated earnings and profits (E&P) of the U.S. company (computed after taking into account any U.S. corporate-level taxes paid).[15] Distributions from a U.S. corporation in excess of E&P are treated as a nontaxable return of basis to the extent thereof, and then as capital gain on deemed sale of the stock. It may be possible to exempt such capital gain from U.S. withholding tax.

E&P for this purpose are those either (1) accumulated as of the beginning of the current taxable year or (2) generated during the current taxable year. E&P generated during the current taxable year are determined as of the close of the current taxable year. Thus, a corporation making a distribution at a time when it has no current E&P or has a deficit in its accumulated E&P account (negative accumulated E&P) should take care in assuming that the distribution will not be a dividend. E&P generated by the corporation

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in the balance of the taxable year could transform the distribution into a "nimble dividend."[16]

Since dividend income will likely be subject to income tax in the home country, it may be desirable to structure the payment in an alternate manner to generate a corresponding expense deduction in the U.S. For example, the foreign parent could charge the U.S. company a regular fee as compensation for the various management and supervisory functions provided by the foreign company. It may be possible to exempt this management fee from U.S. withholding tax. Also, the foreign investor could charge the U.S. company a royalty for the use of any intellectual property developed by the foreign company that has been integrated into the U.S. business.

Employees

The return of employees who have been long-term residents of the U.S. implicates various U.S. federal tax issues, many of which depend on whether the individual holds a U.S. Green Card, owns U.S. real property, or has been living in the U.S. for at least eight years.

A U.S. Green Card holder generally is considered to be a U.S. tax resident even after she has moved back to her country of origin.[17] Thus, it may be preferable to terminate this Green Card status once she has left the U.S. Although a treaty may provide relief from double taxation, maintaining a Green Card generally obligates the individual to continue filing U.S. individual income tax returns.

Foreign nationals are subject to the U.S. FIRPTA (Foreign Investment in Real Property Tax Act) tax regime on their sales of U.S. real property.[18] A U.S. withholding tax generally applies to the gross proceeds of such sales. There are exceptions to the withholding tax scheme, and a tax refund mechanism is available. But it may be advisable for a foreign employee who owns a U.S. home to sell the home while he or she is still considered a U.S. tax resident.

When a foreign national who is a U.S. tax resident moves back to his country of origin, he must file a U.S. federal income tax return for the final calendar year in which he resided in the U.S.[19] He may also be required to obtain a "sailing permit"—clearance from the Internal Revenue Service to leave the U.S., in return for security (e.g., a bond and a closing agreement with the IRS) that the taxpayer has satisfied or will satisfy all of his U.S. federal tax liabilities.[20] Finally, if the individual lived in the U.S. during 8 of the past 15 years, and his income or net worth exceeds certain thresholds in the departure year, he may be subject to U.S. income tax on certain types of U.S. source income for the next 10 years.[21] ◆

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Footnotes

1. All subsequent references to "U.S. tax" mean U.S. federal income tax.
2. This means a corporation governed by the rules of Subchapter C of the Internal Revenue Code of 1986, as amended (IRC).
3. This refers to U.S. corporations that are subject to the unique rules of Subchapter S of the IRC by which they are treated like partnerships for U.S. tax purposes.
4. IRC § 1361(b)(1)(C).
5. See generally Treasury Regulation § 301.7701-3.
6. U.S. partnerships and LLCs may qualify as U.S. residents for treaty purposes if they elect to be treated as corporations from a U.S. tax perspective.
7. For U.S. transfer pricing principles, see IRC § 482 and the Treasury Regulations promulgated thereunder.
8. IRC § 385; *Fin Hay Realty Co v US,* 398 F2d 694 (CA 3, 1968).
9. IRC § 267(a)(3).
10. IRC § 163(j).
11. IRC §§ 861, 1441, and 1442.
12. IRC § 864.
13. *Id.*
14. IRC § 7701(b).
15. IRC §§ 301, 302, and 316.
16. Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 8.02[3] (7th ed 2000). For example, if a corporation had $10 of current-year E&P and a deficit of $20 of accumulated E&P (at the beginning of the current year), one might erroneously conclude that a $10 distribution in the current year would not be treated as a dividend because the negative accumulated E&P would be deemed to offset the positive current E&P.
17. IRC § 7701(b).
18. IRC §§ 894 and 1445.
19. IRC § 7701(b).
20. IRC §§ 7701(n) and 6039G.
21. IRC § 877.