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ESTABLISHING A BUSINESS PRESENCE IN THE UNITED STATES

A NEW LOOK FOLLOWING THE TAX CUTS AND JOBS ACT

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INTRODUCTION

Traditionally, the United States has had one of the world's highest corporate income tax rates.

A combined effective federal and state rate as high as 39% exceeded France, Germany and the UK, and gave many a foreign business pause in establishing a US presence, despite the obvious attractions of US markets and its centers of innovation.

However, the new Tax Cuts and Jobs Act (TCJA)[1] slashed the federal corporate income tax rate to 21%, and has brought with it a new perspective on doing business in the US.

Here, we briefly look at how foreign businesses establish a US presence, and whether the TCJA has had any impact on this tax and liability driven analysis. But first an understanding of how foreigners are taxed in the US.

TAXATION OF FOREIGNERS IN THE US: ECI AND FDAP

Most know that US persons are taxed on their world-wide income.

Conversely, foreigners pay US Tax on income that is either effectively connected to a US trade or business ("Effectively Connected Income" or "ECI") or on US sourced income which is 'fixed, determinable, annual or periodic' and not effectively connected with a trade or business within the US ("FDAP" income).

There is no pinpoint definition of what constitutes a US 'trade or business', but clearly it must be of a regular or continuous character. This includes, generally, profits from selling in the US goods whether sourced or supplied inside or outside the US and personal services performed in the US.

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[1] Signed into law on December 22, 2017

So, while ECI generally covers income foreigners actively produce from US trade or business, FDAP is mostly on interest, dividends, royalties, rents and other fixed and determinable passive investment income received from a US source.

The way ECI and FDAP is taxed and collected differs too. ECI is taxed on net income, while FDAP is taxed on a gross basis. ECI is taxed at prevailing US marginal taxation rates, while FDAP is taxed at a flat 30% rate (potentially reduced or eliminated under an applicable income tax treaty). FDAP is collected at source; that is, the person paying the FDAP income to the foreigner is required to withhold, and pay the tax to the US Internal Revenue Service ("IRS").

While US reach on foreigners seems wide, there are a number of exceptions for both ECI and FDAP which limit this. Payment to foreigners of interest on US bank deposits is generally exempt from tax, for example, and so too is interest paid on portfolio debt held for investment. FDAP gains derived from the sale of securities and other personal property (other than those primarily holding real property interests) are generally excluded.

Significantly, where there is an income tax treaty with the foreigner's country of residence, ECI may be taxed only to the extent the foreigner's connection with the US is sufficient to give rise to a "permanent establishment" in the US (a "PE"), usually triggered by having an office in the US.[2]

ENTERING THE US MARKET

CHOICE OF ENTITY

A foreign business usually establishes a PE through a subsidiary or branch.

By 'subsidiary', we mean a corporation or similar traditional structure, including limited liability partnerships, limited partnerships, and general partnerships. All are 'formed' at state level, and the choice of state may have little, if any, connection to the place where the foreign business operates. For example, Delaware is a familiar choice for its evolved corporate regime, with few foreign businesses incorporating there intending to operate there.

Branches, though, are 'unincorporated', but still may require registration in the state where they operate. As we shall see, liability and tax concerns serve to prefer subsidiaries over branches.

US 'subsidiaries' also include 'limited liability companies', affectionately called 'LLCs'. Popular in the US, they allow for the novelty of one-stop 'pass-through' taxation and limited liability. In contrast,

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[2] Although the individual states within the US follow US federal taxation concepts and generally seek to have their taxation rules conform to US federal rules, a state's rules may differ from federal taxation, and other states' laws. Furthermore, since the individual states are not parties to income tax treaties between the US and foreign countries, certain taxes, reduced or eliminated for federal tax purposes, may still be payable on a state level. This could be particularly true of ECI free of federal income tax under a treaty for a foreigner who does not have a PE, but still taxed at state or local level. In addition, a foreigner conducting business directly in the US may be subject to county, city and other local taxes, including taxes on gross receipts and real estate and business personal property taxes. For these and other reasons it needs no mention that entering the US requires competent and comprehensive federal, state and local tax and legal advice.

elsewhere, limited liability and ‘pass-through’ taxation are mutually exclusive. Your entity choice determines which you’ll have: a corporation for limited liability or a partnership or sole proprietorship for pass-through taxation.

A further US novelty is that you can also sometimes elect how you would like your entity to be taxed.

By default, an LLC with one owner is taxed as a disregarded entity, and with more than one, a partnership so that the taxable income is passed through to the owners, with the result that, in most cases, there is only one level of taxation. Even though income is taxed once in the hands of its owners, the LLC still, in concept, affords limited liability, protecting its owners from personal liability for the debts of the LLC.

An LLC may also be taxed as a corporation. If so elected, for tax purposes, it operates as traditional corporation, with two levels of taxation: once at the corporate level, and again at the owner level.

But that’s not all. Even traditional corporations can be taxed as pass-through entities. This is what we call ‘Subchapter S corporations’ or, affectionately, ‘S-Corps’.

While all this sounds wonderful, the bad news for foreigners is that pass-through tax liability coupled with limited liability generally isn’t a good idea as it gives rise to US federal withholding tax obligations, and potential loss of double taxation treaty benefits. Moreover, foreigners cannot be shareholders in S Corps.

Using branches or partnerships are also generally not good ideas. Here, with no limited liability, the foreign parent would be exposed to the liabilities of the US business, and potentially accrue US tax and filing obligations.

So, foreign businesses almost always establish a US presence through a traditional US corporation (called ‘C corporations’ or ‘C Corps’) or LLC’s taxed as a corporation for US income tax purposes. Here, the subsidiary would act as a ‘blocker’ shielding the foreign parent from ECI and from liability for the subsidiary’s operations. Since it would be a PE, the subsidiary would have ECI and would pay US corporate income tax, plus a 30% withholding tax on dividends actually paid to the foreign parent, usually reduced by treaty.

In contrast, a branch would still be a PE, subject to the prevailing US corporate tax rate, and a 30% ‘branch profits’ remittance tax, also usually reduced by treaty, but payable whether or not actually remitted to the non-US corporate parent.

In addition to making more tax and liability sense, C Corps should be familiar in foreigners’ hands, with constitutional and corporate governance structures similar to their cousins in other common law countries. An LLC taxed as a corporation may be preferred because it is administratively easier to operate than a C corp.

STRUCTURING RELATIONSHIPS

For liability and tax reasons, worrying about the type of entity 'maybe for nought if inadvertently the subsidiary acts as the non-US parent's agent. Getting the parent-subsidiary relationship correct is therefore crucial.

This relationship can be modeled differently, and includes using: (i) an independent distributor model; (ii) commission model; or (iii) consignment model.

In the first, parent and subsidiary act as independent principals. The subsidiary sells as principal product purchased from the non-US parent, bearing payment and other risks.

The commission model sees the US subsidiary act as sales representative or commission agent for the parent. Here, it is the non-US parent who sells to the customer, and bears credit and other risks.

The consignment model is similar to the first except that title in the goods only passes to the subsidiary when it makes a sale to its US customer.

In any of these, if the subsidiary acts as an 'agent' or extension of the parent, ECI and liability for the US operations could be attributed to the parent. The commission model is most prone to this, where a key consideration would be ensuring that the parent approves sales in writing outside the US.

The relationship should ensure that pricing or commission structures are at arm's length, and fair market value. Conceivably, a parent could charge its subsidiary a premium for its product, resulting in little taxable profit in the subsidiary. IRS 'transfer pricing rules' (beyond our scope here) work to keep taxable profits with the subsidiary. Keeping contemporaneous documentation supporting pricing used and obtaining competent accounting, tax and legal advice can help navigate these complex rules, and is essential, generally, in structuring this relationship.

TCJA: A NEW ERA

The TCJA has, if anything, served to reinforce existing analysis for establishing in the US, and, certainly, with its headlining reduction in the federal corporate income tax rate has made the case for using 'blocker' entities, even with their two tier taxation, more compelling.

The TCJA further significantly reduces the attraction to foreigners of tax-transparent entities by reversing a recent Tax Court decision to provide that gains from a foreigner's sale of a US partnership interest, to the extent that it is attributable to the partnership's ECI, will be subject to US income tax.

The TCJA also moved away from a hallmark of US global taxation, by taxing foreign subsidiaries of US corporations at foreign, rather than US corporate rates, and exempting from tax dividends attributable to foreign earnings paid to US corporations by their 10% or more foreign subsidiaries. These, and other cash repatriating provisions significantly improve corporate bottom-line, and substantially soften the impact of the two-tier taxation system implicit in using non tax- transparent vehicles.

Nevertheless, its provisions are not all corporate friendly, and require careful advice in choice of entity and relationship structure. For example, the TCJA eliminated carrybacks for the deduction of net operating losses (NOLs),[3] limiting the use of NOLs, and introduced certain limitations on deductions for 'excess' net business interest expense.

Furthermore, in exchange for the tax exemption on dividends from foreign subsidiaries, the TCJA requires any US shareholder owning 10% or more of a foreign corporation to include in its income for the 2017 taxable year its proportionate share of the foreign corporation's undistributed profits, to be taxed at rates ranging from 8% to 15.5% for corporate shareholders and 9.05% to 17.54% for individual shareholders. This has double-edged implication, not only for increasing the tax obligations of US portfolio companies in which foreigners may be invested, but also may result in considerable phantom income to foreigners who are invested in tax transparent structures.

SPECIAL CONSIDERATIONS FOR PRIVATELY OWNED BUSINESSES

While the TCJA has, for foreign businesses, certainly been favorable from a federal corporate income tax perspective, taxation is never simple and there are further factors which affect this analysis.

One in particular is the Federal estate tax consequences of privately owned foreign businesses.

US citizens and residents are subject to US Federal estate taxation on their worldwide estates at death. Any assets they transfer at death are subject to this tax, but they are entitled to an exclusion amount of $11,180,000. This is an inflation adjusted amount off $10,000,000 which has been doubled from $5,000,000 by the TCJA and is scheduled to revert back to the inflation adjusted equivalent of $5,000,000 in 2025. Married couples with proper planning in place can transfer up to double that amount in value to their heirs without estate tax. Otherwise, a person's estate in excess of that amount is taxed at a rate of 40%.

Notably, the TCJA left a non-citizen/non-resident with the same reality he faced under prior law. A non-citizen/non-resident is subject to US Federal estate tax only on US situs assets owned at death. For estate tax purposes, US situs assets include a broad range of real, tangible and intangible property located in the US or where the issuer of securities or other property is located in the US or is a US person. However, whereas US citizens and residents are endowed with a generous exclusion amount, a non- citizen/non-resident is limited to an exclusion amount of only $60,000. Their US estates will reach the 40% rate at a value of $1,000,000.

In addition, many of the avenues available to US citizen/residents to reduce the size of their estates during their lifetime are not available to non-citizen/non-residents. For example, because debt is often used to fund business ventures, foreign private investors often think that debt will serve as a Dollar for Dollar deduction against their US estates and thus reduce their potential Federal estate tax liability. However, the deductibility of a non- citizen/non-resident's debt is limited by a fraction the

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[3] However, the TCJA allows now for indefinite carry forwards of NOL's.

nominator of which is the value of his US estate and the denominator of which the value of his worldwide estate.

Many foreign private investors make use of trusts, foundations and other types of vehicles to own their business enterprises. US tax law subjects these structures to the same type of scrutiny that are imposed on similar structures used by US citizen/residents for estate planning purposes. In general, if a donor has not fully parted with dominion and control of his assets and/or the power to determine who can enjoy the use of his assets, or if a beneficiary or related party holds certain powers over such structures, US tax law will look through the structure to the natural person and subject the US situs assets to US Federal estate tax upon the death of such person. Frequently, the tax laws of a foreign jurisdiction are more permissive when it comes to the retention of such powers by donors, beneficiaries and related parties.

For these reasons, it is very important for a foreign business owner to consider the estate tax consequences of entering the US market. Fortunately, many of the structures which facilitate good income tax planning for foreign businesses serve as good estate tax planning structures as well.

CONCLUSION

The substantial reduction in the federal corporate income tax rate heralded by the TCJA effectively removes what the World Economic Forum calls the primary ‘problematic factor’ for doing business in the US and entrenches the US as a viable destination for foreign investment.

The TCJA reinforces the tried and tested structure for establishing a presence in the US. While using ‘blocker’ entities has long been the preferred route, the TCJA’s assault on the tax rate makes this structure considerably more attractive.

Care though needs to be exercised, and competent US legal and taxation advice is essential in this analysis. This is particularly true in privately owned foreign businesses and in assessing state and local taxes.

All this considered, the TCJA is bound to increase foreign business interest in the US. The world is much smaller than it ever was, and a sea change in the corporate tax structure of the second largest world economy, may be an opportunity too good to miss.

FOR MORE INFORMATION

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