The Graduate Tax Program Presents:


Which U.S. tax issues should be considered in establishing a business enterprise in the U.S. for foreign owners? The discussion will include the provisions of the Tax Cuts and Jobs Act that affect such investments, including the new 21 percent corporate tax rate; the revised limitation on interest deductions; and the base erosion and anti-abuse tax.

Date: Wednesday, March 6, 2019
Time: 12:30 p.m.–2:00 p.m. (Light lunch will be served at 12:15 p.m.)
Location: New York Law School, W420
185 West Broadway, New York, NY 10013
RSVP: www.nyls.edu/TaxLawRSVP
CLE: 1.5 credits in Areas of Professional Practice (NY transitional and nontransitional)
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Speakers: Professor Alan I. Appel ’76, Distinguished Practitioner; Professor of Law; Director, International Tax Program; and Co-Director, Center for Business and Financial Law, NYLS
Leonard Schneidman, Managing Director, Andersen Tax
TAX PLANNING FOR U.S. BUSINESS OPERATIONS
OF FOREIGN-OWNED ENTERPRISES

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March 6, 2019
INTRODUCTION

• Key organizational, operational and repatriation tax issues relating to establishing a foreign-owned U.S. enterprise.
• Analysis assumes a foreign corporation that is entitled to the benefits available under a United States Income Tax Treaty (the Treaty).
• Critical tax issues relate to U.S. taxation of the enterprise, its shareholders and employees.
Most Common Basic Structures

- **Subsidiary**
- Corporation often formed in Delaware

- No legal entity formed, but the state of activity require registration

- LLC often formed in Delaware
- Can be limited partnership, but it is more complex from an organization perspective
## Typical Life Cycle of Foreign-Owned U.S. Operation

<table>
<thead>
<tr>
<th>Stage</th>
<th>Legal and Operational Characteristics</th>
<th>U.S. Tax Characteristics</th>
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</thead>
<tbody>
<tr>
<td>Infant</td>
<td>Use of unrelated third parties (e.g. distributors; no (or very limited) physical presence; no additional business structure.</td>
<td>None</td>
</tr>
<tr>
<td>Toddler</td>
<td>Physical presence; limited functions performed (e.g. “ancillary and preparatory” activities); form of business structure (i.e. branch or subsidiary) not significant</td>
<td>Certain activities may be conducted in U.S. without giving rise to taxable presence (i.e. “permanent establishment”); payroll and employee tax issues appear.</td>
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<tr>
<td>Adolescent</td>
<td>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.</td>
<td>Nature and amount of activities drive U.S. operational tax results; increased payroll and employee tax issues.</td>
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<tr>
<td>Young Adult</td>
<td>Distribution or other significant elements of business conducted by U.S. operation; employee headcount rises.</td>
<td>Increased activities typically give rise to increase in amount of U.S. tax; need for professional tax planning becomes apparent; continued employee tax issues.</td>
</tr>
<tr>
<td>Adult</td>
<td>Manufacturing or other production activities commenced; headcount rises.</td>
<td>Need for operational tax planning increases (e.g. intellectual property migration).</td>
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Form of Organization - Subsidiary

• Formation of a corporate subsidiary is not a taxable event.
• Subsidiary will pay both U.S. federal and state income taxes on its income.
• Dividends paid by the subsidiary subject to withholding tax reduced by the Treaty.
• Dividend payments are not deductible by the subsidiary.
• Subsidiary generally avoids any engagement in a U.S. trade or business by the foreign parent.
• Transactions between the subsidiary and its parent are generally subject to “arms-length” transfer pricing rules.
U.S. Corporate Subsidiary Tax

- U.S. earns 100, pays 21 federal income tax.
- FC has no U.S. tax filing obligation by virtue of owning U.S. Co, does not pay any U.S. tax on the income of U.S. Co as it is earned.
- When (if) U.S. Co distributes profits to FC in the form of a dividend, dividend withholding tax can apply. Rate is 30% subject to treaty reduction. Obligation to pay the tax does not arise until a dividend is paid.
Reportable Transactions of Foreign-Owned U.S. Subsidiaries

• Form 5472 – 25% (or more) foreign-owned U.S. subsidiaries must annually report transactions entered into with its foreign owner.

• A “reportable transaction” is any transaction with the foreign owner involving, inter alia:
  – sales and purchases of inventory
  – Rents and royalties (other than intangibles)
  – Sales, purchases, and amounts paid or received for the use of intangibles
  – Commissions paid or received
  – Interests paid or received
  – Amounts loaned or borrowed, excluding open accounts incurred in the ordinary course of business

• A transaction is reportable even if monetary consideration is not required or is only part of the contemplated consideration
Form of Organization - Branch

• A branch is simply an extension of the parent company’s home office.
• Foreign parent is taxable on income “attributable” to the U.S. trade or business conducted by the branch.
• Under the Treaty, tax limited to income which is attributable to the parent’s “permanent establishment” (i.e. the branch office).
• In addition to regular corporate income tax, operating through a branch triggers the possible application of a “branch profits” tax.
Form of Organization – Branch (cont.)

• The branch profits tax essentially replicates the 30% tax on dividends payable by a U.S. subsidiary to its foreign parent.
• The tax base generally includes after-tax earnings and profits effectively connected with the foreign parents' U.S. trade or business to the extent not reinvested in the U.S. trade or business.
• The Treaty generally reduces the branch profits tax rate.
U.S. Branch Tax

- FC, because it is engaging in business in the U.S., is required to file a U.S. tax return and pay taxes on the income attributable to the U.S. business like a U.S. corporation.
- FC is also liable annually for a “branch profits tax” that replicates the dividend withholding tax that is involved in the corporate subsidiary.
- BPT is based on a formula and can be payable even if no cash is sent back to FC.
- In example, unless a Treaty reduces the rate, or the income is reinvested in business assets, the BPT would be $23.70
Form of Organization - Partnership

- A partnership or LLC is not subject to tax.
- Its partners, however, are considered to be engaged in the partnership’s business and taxed on their allocable share of the partnership’s effectively connected income.
- A corporate partner is also subject to the branch profits tax on its allocable income.
- Failure of a foreign corporate partner to timely file a U.S. tax return will lead to the loss of otherwise available tax deductions.
  - Filing a protective Form 1120F
U.S. LLC Tax

- An LLC is a pass through (or transparent or translucent) entity for U.S. tax purposes, unless it elects to be treated as a corporation.
- If it has a single owner, it is “disregarded” for U.S. tax purposes and all activities are deemed engaged in by the owner (but, not for corporate law purposes).
- In this case, the LLC is disregarded, and the U.S. tax results are identical to those on prior slides for branches.
- FC files U.S. tax return, pays corporate level tax of 21% and is liable for branch profits tax based on a formula.
Withholding Obligations of Foreign-Owned U.S. Enterprises

• Payments of U.S. sourced interest, dividends, royalties, and compensation for services are subject to 30% income tax withholding.
  – Withholding tax is subject to reduction or elimination under an applicable tax treaty.

• Foreign owner is obligated to file an appropriate Form W-8 with the U.S. payor to avoid withholding under either regular income tax or the Foreign Account Tax Compliance Act (“FATCA”), or to claim treaty benefits.

• Partnerships are obligated to withhold U.S. income tax on the distributive share of effectively connected income allocated to a foreign partner whether or not paid.
Once the Structure is Set:

• How do you fund the operation?
  – Equity
  – Debt
  – License of IP
  – Provision of services

• All dependent on what U.S. business is doing
  – Full entrepreneurial model
  – Limited risk model

• Analyze any intercompany activity for transfer pricing concerns
Capitalization – Funding The Operation

• Generally better to fund U.S. direct investment via debt rather than equity.
  – Interest deductible whereas dividends are not.
  – Debt can be repaid tax free.
  – Treaty reduces withholding tax on interest.
• But not always the case (e.g. U.S. operation running at a loss).
Capitalization – Debt vs. Equity – Effect of Tax Reform Act

• Under the Act, corporate tax rate reduced to 21%
• May not be advantageous to reduce the income of the U.S. subsidiary by use of leverage since the tax rate in the foreign parent’s jurisdiction may be higher
• Non-deductibility of dividends less significant
• Interest subject to new, more restrictive earnings-stripping rules
Debt – Characterization

• Despite significant tax stakes, no statutory rules distinguishing debt from equity.
  – Case law has established a number of factors to be considered, including, a sum certain due on a set date, documentation, thin or adequate capitalization, creditworthiness (although no one factor is conclusive).
  – The U.S. tax authorities have recently issued regulations to address whether an interest in a corporation should be treated as stock or debt. The regulations change the characterization of certain purported related-party debt instruments to stock.
Debt – Limitations on Deduction of Interest

• Even if an investment is properly characterized as debt, there are several limitations on the deduction of interest.
  – No interest deduction for accrued but unpaid interest until it is paid to a related foreign entity.
  – General limitation on deductibility of net business interest expense, exceeding 30% of EBITDA, if average annual gross receipts for trailing three years exceed $25MM.
Limits on Interest Deductibility Sec. 163(j)

- 2017 Tax Act Change
  - Applies to all interest paid/accrued on a debt incurred in a trade or business without regard to the type of business entity (exception for small business with average gross receipts of $25 million or less)
  - Deduction is limited to the sum of:
    - Business interest income of the taxpayer for the tax year
    - 30% of adjusted taxable income (essentially, EBITDA for years prior to 1/1/2022, and EBIT thereafter), including increases as a result of a distributive share in an S corporation or partnership
    - Floor plan financing interest
  - A taxpayer may elect to exclude from these limitations any real property trade or business and any farming business
  - Business interest not allowed as a deduction may be carried forward indefinitely
  - Rules applied at the entity level for S corporations and partnerships, with modifications
Case Study – Manufacturing in U.S.

Foreign Parent

100%

U.S. Manufacturing Subsidiary

Sale

U.S. Customers

Comments

• Capitalization
  – Generally better to use debt rather than equity financing
  – Interest deductible, subject to limitations
  – Principal repayment is tax free
  - Treaty rate reduction on withholding tax

• Characterization – debt vs. equity
  – Thin capitalization is major issue

• Limitations on interest deductibility
  – Accrued but unpaid interest
  – Section 163(j) limit on net business interest deductibility

• Transfer pricing – Sec. 482
  – Arm’s-length requirement for pricing both tangible and intangible 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 – Staffing

• Choice between U.S. employees and foreign employees often seconded by the foreign parent.

• Use of foreign employees raises questions for both the employees and the foreign parent.

• For the foreign employees the issue is whether his continued employment will give rise to U.S. tax residence (and tax on worldwide income).
  – *Substantial presence* (i.e. day count) or *green card* tests

• For the foreign parent, the presence of its foreign workers in the U.S. raises the possibility that their activities will give rise to a U.S. trade or business attributed to the parent.
Case Study – Creation of PE through Activities of Seconded* Employees

Issues

• Do the seconded employees carry on the business of FP or USS?
• Is there a “place of business” in the U.S. through which the seconded employees operate?
• Is the U.S. place of business “fixed”?

*A secondment arrangement is one where one legal entity transfers its employees to work for a related or unrelated entity in another country for a specified period of time.
Repatriation of Profits – (Including Royalties and Inbound Sales)

• Profits can be repatriated to the foreign parent in a number of ways:
  – Dividends
  – Interest
  – Royalties
  – Income on “inbound sales”

• The utilization of royalty or interest payments, if available, is often a tax-efficient means to extract profits from the U.S. enterprise.
  – Treaty typically reduces withholding tax to zero.
Repatriation of Profits

- Often the business activity contemplated is the sale of inventory products by the foreign parent to the U.S. customers – i.e. “inbound sales”.
  - Various planning techniques are available to divide the total profit to be realized on the sale so as to minimize the income attributable to the U.S. affiliate. Still desirable?
  - Lower corporate tax rate and participation exemption in foreign parent own jurisdiction may obviate the need to limit U.S. taxation.
  - Critical that the activities of the foreign parent do not constitute engaging in a U.S. trade or business through a permanent establishment, either directly or through agency.
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 – Sec. 482
  - “Arm’s-length” requirement for pricing both tangible and intangible property and services
- State tax implications
Exit Strategies

• Sale of corporate subsidiary
  – Stock vs. assets
  – Tax-free or taxable
  – In general, so long as the parent does not have a permanent establishment in the U.S. and the U.S. subsidiary is not a ‘U.S. Real Property Holding Corporation,’ the parent will not be subject to U.S. tax on any gain from the sale of the stock of the subsidiary.

• Liquidation of corporate subsidiary
  – Treated as if the subsidiary sold its assets at fair market value thus subjecting any asset appreciation to U.S. tax in the corporate subsidiary.
  – The distribution of the assets to the foreign parent is tax-free to the parent unless U.S. subsidiary was parent of a consolidated group.
Exit Strategies – Partnership That Engages In Business in U.S.

• In asset sale
  – P recognizes gain of 900 on asset sale
  – FP is allocated 450 of gain
  – P is required to make estimated payments of taxes of FP at highest marginal rate, absent an exception
  – P files form 1065, K-1 and form 8805 (reporting income allocated to FP)
Exit Strategies From Partnership

• Prior to TCJA
  – Rev. Rul. 91-32 – IRS position is that tax to FP is the same as asset sale
  – Grecian Magnesite 149 T.C. 3 (2017), held that Rev. Rul. 91-32 was wrong and that under Sec. 741/751 there was no tax due by FP (absent FIRPTA application). Current Status: On Appeal to the D.C. Circuit.
  – Even if Rev. Rul. 91-32 was correct, there was no withholding obligation on the part of the buyer or P
Exit Strategies From Partnership

• Post TCJA
  – § 864(c)(8): Sale of partnership interest is taxable to the extent the FP would have had U.S. taxable income if the partnership sold all of its assets
    ▪ Effective for dispositions on or after 11/27/2017
  – § 1446(f): 10% withholding applies to amount realized from sale
    ▪ Effective for dispositions on or after 1/1/2018
  – Ultimate tax may be higher or lower
Notice 2018-29 – Exceptions To 10% Withholding

• Certification of non-foreign status (W-9) of transferor
• Three de minimis rules
  – Certification of transferor to transferee that no gain will be realized
    ▪ If gain is realized, but not recognized, transferor must submit certification that satisfies the requirements of Treas. Reg. 1.1445-2(d)(2) as if it applies to Sec. 1446(f)
  – Certification provided by the partnership that if the partnership sold all of its assets as FMV the amount of gain that would have been effectively connected with a U.S. trade or business would be less than 25% of the total gain
Notice 2018-29 – Exceptions

• Third de minimis (cont’d)
  – Transferor provides certification that for immediately prior tax year and two preceding tax years less than 25% of total distributive share for each year was effectively connected to a U.S. trade or business.
    ▪ Immediately preceding tax year means most recent tax year of transferor that includes the partnership year that ends with or in the transferor’s tax year,
    AND
    ▪ For which form 8805 and K-1 were filed by the time of the disposition
Example – Is There Withholding?

- FP cannot provide U.S. person certification
- FP would realize gain, and cannot provide certification of no gain
- FP cannot provide the certification of < 25% ECI for last three years, as FP only owned the interest for two years
- Will P provide a certification of de minimis ECI on a hypothetical sale of all of its assets?
  - Will P put itself at risk? What if P is fund of funds? Can it certify?
- So, there is withholding
Example – How Much Withholding?

• Amount realized on sale includes relief of liabilities
• Under Notice 2018-29, FP can certify the amount of liabilities based on K-1 for a partnership year that closed no more than 10 months before the date of transfer (Sec. 7.02)
  – Transfer occurred in March 2018. The K-1 for 2016 is outside the 10 month window. The K-1 for 2017 has not yet been received
• P could certify based on most recently prepared K-1 (2016), but will P be willing to certify? If not, withholding is required (Sec. 7.03)
• Section 8 of the Notice provides that if transferee does not receive certification in Sec. 7.02 or Sec. 7.03, then withholding required is the entire amount realized without regard to liabilities
• Thus, transferee would pay the entire purchase price to IRS
Proposed Regulations – § 1.864(c)(8)-1

• Released Dec. 20, 2018
• Provide guidance under § 864(c)(8) and do not address withholding under § 1446(f)
• Provide the methodology for calculating the amounts of capital gain or loss and/or ordinary gain or loss resulting from the sale of foreign partner’s interest in a partnership that would be deemed effectively connected and taxable in the U.S.
• Contain a treaty coordination rule
State and Local Taxes – SALT

• Three most important SALT considerations for foreign investors:
  – The lack of a permanent establishment is irrelevant
  – The U.S./Foreign Country Income Tax Treaty is irrelevant for State purposes
  – Owners and employees can be personally liable for unpaid state taxes
The lack of a permanent establishment is irrelevant

- U.S. treaties with many countries say PE required before U.S. can tax
- States do not have a similar requirement
  - Employee or representative in state, even temporarily, may be sufficient
  - Developing “economic nexus” concepts in many states may subject more companies to state tax
SALT (cont.)

• The U.S./Foreign Country Income Tax Treaty is irrelevant for state purposes
  – U.S./Foreign country treaties generally apply to prevent double taxation
  – These treaties are not applicable for state purposes
  – In some states, if one company has nexus this may require all affiliated companies to file a “worldwide combined” return

• Uncollected sales/use tax liability can represent the largest potential exposure

• Owners/employees can be responsible for a business’s unpaid sales taxes, use taxes, or other taxes.
SPEAKER BIOGRAPHIES
Professor Alan I. Appel specializes in international and domestic tax planning. He is on the Board of Advisors for the Journal of International Taxation and the Journal of Taxation and Regulation of Financial Institutions. He was formerly Council Director for the International Tax Committees as well as the Chair of the U.S. Activities of Foreigners and Tax Treaties Committee of the American Bar Association Section of Taxation. Professor Appel holds a J.D. from New York Law School and an L.L.M. from New York University. At New York Law School, he is the Director of the International Tax Program. He teaches courses in International Tax, Corporate Tax, and Federal Income Tax. Prior to joining New York Law School, he spent 13 years in the New York office of Bryan Cave Leighton Paisner LLP (formerly Bryan Cave LLP).
Leonard Schneidman

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Len Schneidman has over 40 years of experience in international taxation. His work includes counseling clients on structuring and operation of private investment funds, advising high net worth foreign investors on U.S. investments and activities, helping U.S. and non-U.S. corporate clients with tax-efficient structuring of their business operations, and advising clients on the reporting of undisclosed income and/or foreign financial assets from offshore accounts through the IRS Offshore Voluntary Disclosure Program (OVDP) or Streamlined Filing Compliance Procedures, and Report of Foreign Bank and Financial Accounts (FBAR).

Len has had significant involvement with issues of U.S. international tax policy and tax reform, including chairmanship of the ABA’s U.S. Activities of Foreigners and Tax Treaties Committee and co-chairmanship of the ABA’s Task Force on International Tax Reform.

Len is a frequent speaker, presenting annually at the NYU Federal Tax Institute and at private equity and hedge fund tax programs. A prolific writer on tax matters, Len is author of the treatise, “U.S. Taxation of Foreign Portfolio Investors: A Practical Guide to Taxation in the U.S. Capital Markets” and has edited a Practicing Law Institute treatise on “Sovereign Wealth Funds - A Legal, Tax and Economic Perspective.” Before joining Andersen Tax, Len practiced with several large law firms, including a position as tax department Chair.

EDUCATION

- Hobart College, BA (Economics)
- Harvard Law School, LLB
- New York University School of Law, LLM (Taxation)

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