

# *Doing business in the United States*

A guide to the key  
tax issues

2014





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# Foreword

All would agree that the United States has a complex tax system that significantly affects business decisions and business operations. Or more precisely, after taking into account federal, state, and local levels of taxation, the United States has many complex tax systems.

This complexity creates significant challenges for companies doing business in the United States: navigating the law and administrative processes, managing risk related to tax issues, and avoiding pitfalls that can trip up even the most sophisticated without constant and thorough vigilance. Businesses need to allocate significant resources to compliance and governance focused on tax matters. And, of course, the environment in which business operates today makes understanding and addressing these challenges an even more important endeavor for finance and non-finance executives alike.

At the same time, there are opportunities for companies seeking to conduct business in the United States. According to the PwC-Organization for International Investment's 2014 Insourcing Survey, the percentage of insourcing CFOs who say the US offers a better business environment compared to other advanced countries increased 35 points since 2011 (from 23% to 58%). Nearly two-thirds of CFOs anticipate increased investment in the United States within the next 12 months, and more than half expect to increase employment over that same period. With an understanding of the incentives built into the applicable tax policies and the potential to achieve enhanced after-tax results from business operations through understanding the effect of US tax rules, businesses can enhance their delivery in this important metric of performance.

The individual circumstances and objectives of foreign businesses either currently doing or looking to do business in the United States can vary greatly. Each company will have a particular set of perspectives in regard to its operations in the United States as compared to US-based companies.

I fully appreciate these unique challenges and opportunities having spent most of my career in senior tax executive roles in non-US companies with substantial US operations. It is often frustrating, but always rewarding, to navigate through the confusion and complexity and identify the key insights that will enhance business performance and effectively manage risk.

This guide is intended to leverage PwC's extensive experience in regard to US operations of foreign businesses to provide a broad understanding of the basic tax implications of business operations in the United States, as well as to offer helpful observations into the tax consequences for foreign companies.

I believe you will find it a useful guide through the many challenges and opportunities.

However, as a guide, it can only be a starting point. PwC has a global network of multidisciplinary tax professionals who have deep, practical experience in assisting businesses investing into the United States. We stand ready to help in any way we can.

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# I. Federal tax issues

## A. Taxes on corporate income

### 1. Corporate income tax

US taxation of income earned by non-US persons depends on whether the income has a nexus with the United States and the level and extent of the non-US person's presence in the United States. A foreign corporation engaged in a US trade or business is taxed at regular US corporate tax rates, but only on income from US sources that is effectively connected with that business, and at 30% on US-source income not effectively connected with that business. By contrast, US-resident corporations are taxed based on their worldwide income.

The US corporate income tax (CIT) rate is based on a progressive rate schedule; however, an alternative minimum tax provides for a flat rate with fewer deductions.

2014 taxable income		US corporate income tax		
Over (\$)	But not over (\$)	Pay (\$)	+% on excess	of the amount over (\$)
0	50,000	0	15	0
50,000	75,000	7,500	25	50,000
75,000	100,000	13,750	34	75,000
100,000	335,000	22,250	39	100,000
335,000	10,000,000	113,900	34	335,000
10,000,000	15,000,000	3,400,000	35	10,000,000
15,000,000	18,333,333	5,150,000	38	15,000,000
18,333,333			35	0

The 39% tax rate applies to taxable income between \$100,000 and \$335,000 to eliminate the benefit of the 15% and 25% rates, and the 38% tax rate applies to taxable income between \$15,000,000 and \$18,333,333 to eliminate the benefit of the 34% rate. Special rules apply to personal service corporations and personal holding companies.

### 2. Alternative minimum tax (AMT)

An AMT is imposed on corporations other than S corporations and small C corporations (generally those not having three-year average annual gross receipts exceeding \$7.5 million). The tax is 20% of alternative minimum taxable income (AMTI) in excess of a \$40,000 exemption amount (subject to a phase-out). AMTI is computed by adjusting the corporation's regular taxable income by specified adjustments and 'tax preference' items. Tax preference or adjustment items could arise, for example, if a corporation has substantial accelerated depreciation, percentage depletion, intangible drilling costs, or non-taxable income.

### 3. Gross transportation income taxes

Foreign corporations and nonresident alien individuals are subject to a yearly 4% tax on their US-source gross transportation income that is not effectively connected with a US trade or business. Transportation income is any income derived from, or in connection with,

1. the use (or hiring or leasing) of any vessel or aircraft, or
2. the performance of services directly related to the use of any vessel or aircraft.

## B. Other federal taxes

### 1. Sales taxes

The US does not impose a federal sales tax or value-added tax (VAT).

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**Inbound insight:** Not having a federal sales tax or VAT is unusual in terms of typical tax systems around the globe. This deviation from the global norm requires additional communication and business performance analysis for senior management of non-US parent companies, who are more familiar with doing business in territories with a more common mix of income and consumption taxes.

### 2. Customs duties and import tariffs

All goods imported into the United States are subject to customs entry and are dutiable or duty-free in accordance with their classification under the applicable items in the Harmonized Tariff Schedule of the United States. The classification also identifies eligibility for special programs and free trade agreement preferential duty rates.

When goods are dutiable, ad valorem, specific, or compound duty rates may be assessed. An ad valorem rate, the type most often applied, is a percentage of the value of the merchandise, such as 7% ad valorem. A specific rate is a specified amount per unit of measure (weight or quantity), such as 6.8 cents per dozen. A compound rate is a combination of both an ad valorem rate and a specific rate, such as 0.8 cents per kilo plus 8% ad valorem. US Customs and Border Protection (CBP) requires that the value of the goods be properly declared regardless of the dutiable status of the merchandise.

Payment of duty becomes due at the time an entry is filed with CBP. The obligation for payment is on the person or firm in whose name the entry is filed, the importer of record. The importer of record has a legal obligation to exercise reasonable care in all aspects of its importing activity.

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**Inbound insight:** This area can be overlooked by foreign businesses not familiar with the US rules. Opportunities can arise through careful consideration of the application of intercompany transfer prices and other aspects of the duty obligation.



### **3. Excise taxes**

The US government imposes excise taxes on a wide range of goods and activities, including gasoline and diesel fuel used for transportation, air travel, manufacturing of specified goods, and indoor tanning services. A new fee on health plans under the Affordable Care Act (ACA), called the Patient-Centered Outcomes Research Institute (PCORI) fee, is reported and paid as an excise tax as well.

The excise tax rates are as varied as the goods and activities on which they are levied. For example, the excise imposed on indoor tanning services is 10% of the amount paid for the services, while the excise imposed on the sale of coal mined in the United States is the lower of \$1.10 per ton or 4.4% of the sale price.

### **4. Stamp taxes**

There is no federal-level stamp tax. However, state and local governments frequently impose stamp taxes at the time of officially recording a real estate or other transaction. The state or local sales tax on real estate may be a stamp tax on the documents recording the transfer of the real estate.

### **5. Capital gain taxes**

The corporate tax rate on long-term capital gains currently is the same as the tax rates applicable to a corporation's ordinary income. (By contrast, individuals may be subject to a lower rate on long-term capital gain than on short-term capital gain.) Thus, the maximum corporate rate is 35%, excluding the additional phase-out rates. However, differences may arise where AMT is imposed.

### **6. Accumulated earnings tax**

Corporations (other than S corporations, domestic and foreign personal holding companies, corporations exempt from tax under Subchapter F of the Internal Revenue Code, and passive foreign investment companies) accumulating earnings and profits for the purpose of avoiding shareholder personal income tax are subject to a penalty tax in addition to any other tax that may be applicable. The accumulated earnings tax equals 15% of 'accumulated taxable income.' Generally, accumulated taxable income is the excess of taxable income with certain adjustments, including a deduction for regular income taxes, over the dividends paid deduction and the accumulated earnings credit. Note that a corporation can justify the accumulation of income, and avoid tax, based on its reasonable business needs.

### **7. Personal holding company tax**

US corporations and certain foreign corporations that receive substantial 'passive income' and are 'closely held' may be subject to personal holding company tax. The personal holding company tax, which is levied in addition to the regular tax, is 20% of undistributed personal holding company income.

## **8. Payroll taxes affecting employers**

All payments for employment within the United States are wages subject to (1) federal income tax withholding, (2) Federal Insurance Contributions Act (FICA) taxes (i.e., social security and Medicare), and (3) the Federal Unemployment (FUTA) tax, unless an exception applies. For employees sent to the United States by their foreign employer, there is a de minimis exception for amounts less than \$3,000 and visits of less than 90 days; also, certain treaty provisions may eliminate the need to withhold income taxes (but generally not the need to report).

Similarly, foreign employers usually rely on treaty relief for workers employed in the United States with respect to social security and Medicare taxes. If such relief is not available, the foreign employer must pay and withhold social security taxes equal to 6.2% of wages for the employer and 6.2% for the employee, up to \$117,000 in 2014, and Medicare taxes equal to 1.45% for the employer and 1.45% for the employee. Note: There is no cap on wages subject to Medicare taxes. The employer also must withhold an additional 0.9-percent Medicare tax on wages above \$200,000. The FUTA tax is between 0.6 and 6.0% (depending on credits for state unemployment taxes) on the first \$7,000 of wages paid to an employee.

A foreign employer generally must file quarterly and annual employment tax returns and annual wage statements (Forms W-2) in its name and employer identification number unless such statements are filed by a properly authorized third party.

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***Inbound insight:*** *Corporate officers traveling to the United States for only a short period of time may generate employment tax liabilities because their earnings are wages for FICA and FUTA purposes and US-source income (including a portion of equity and deferred compensation granted in the foreign country) for wage withholding purposes.*

## **9. Environmental tax**

Importers, manufacturers, and sellers of petroleum or other ozone-depleting chemicals (ODC) are subject to an environmental tax calculated per weight of the ODC used in the manufacture of the product. The tax is determined under an exact or table method provided in the instructions to Form 6627. If the weight cannot be determined, the tax is 1% of the entry value of the product.

## **C. US trade or business**

Generally, a foreign corporation engaged in a US trade or business is taxed at regular US corporate tax rates on income from US sources that is effectively connected with that business and at 30% on US-source income not effectively connected with that business.

There is no definition in the tax statute of a trade or business within the United States—instead, that concept has been developed mainly by the IRS and court decisions through a facts-and-circumstances analysis. The foreign corporation needs

to consider the nature and extent of its economic activities in the United States, either directly or through its agents:

- The business must have a profit motive.
- Activities generally must be ‘considerable, continuous, and regular.’
- Ministerial, clerical, or collection-related activities generally are not sufficiently profit-oriented to constitute a US trade or business.
- Isolated activities generally do not rise to the level of a trade or business.
- An agent’s activities in the United States may result in a US trade or business.

## ***D. Effectively connected income***

If a non-US person has a US trade or business, the question arises what income is ‘effectively connected’ to such US trade or business. All US-source active income earned by a non-US person is treated as effectively connected. Passive-type income and gain from the sale of capital assets are treated as effectively connected to a non-US person’s US trade or business only if a connection with the US trade or business exists. Such a connection exists if the passive-type income or capital gain is derived from assets used in the US trade or business (the asset use test) or the activities conducted in the US trade or business are a material factor in the production of the passive-type income or capital gain (the business activities test).

Certain types of foreign-source income generated through a US office can be effectively connected income. These include:

- Rents or royalties for use of property outside the United States that are derived in the active conduct of a US trade or business.
- Foreign-source dividends or interest derived in active conduct of banking business in the United States, or received by a corporation the principal business of which is trading in stocks or securities for its own account.
- Gain from the sale outside the United States of inventory property and property held for sale to customers, unless the property is sold for use outside the United States and a non-US office materially participates in the sale.

## ***E. Branch income***

Tax rates on branch profits are the same as on corporate profits. US tax law also imposes a 30% branch profits tax in addition to US corporate-level income taxes on a foreign corporation’s US branch earnings and profits for the year they are effectively connected with a US business. The taxable base for the branch profits tax is increased (decreased) by any decrease (increase) in the US net equity of the branch. The branch profits tax on profits may be reduced or eliminated entirely if a relevant treaty so provides. The purpose of the branch profits tax is to treat US operations of foreign corporations in much the same manner as US corporations owned by foreign persons.

## **I. Federal tax issues**

With certain exceptions, a 30% (or lower treaty rate) branch profits tax is imposed on interest payments by the US branch to foreign lenders. In addition, the tax applies if the amount of interest deducted by the branch on its US tax return exceeds the amount of interest actually paid during the year.

## **F. Permanent establishment (PE)**

Multinational entities, such as corporations and partnerships, face a variety of tax systems in the countries where they operate. To reduce or eliminate double taxation between countries, promote cross-border trading, and alleviate the burden of administration and enforcement of tax laws, countries typically enter into income tax treaties outlining how parties to the treaty (contracting states) will be taxed on income earned in each contracting state.

Income tax treaties contain an article describing whether an enterprise has created a PE with a contracting state. The existence of a PE is important because an enterprise establishing sufficient contact with a contracting state to rise to the level of a PE gives the contracting state the right to tax the enterprise's income attributable to the PE. This includes income from carrying on a business in the contracting state and passive income, such as interest, dividends, and royalties.

A PE generally means:

1. there is a fixed place of business through which the business of an enterprise is wholly or partly carried on, or
2. an agent acting on behalf of the enterprise has and habitually exercises the authority to conclude contracts binding on the enterprise.

For further discussion of US tax treaties, see section III, US tax treaties.

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***Inbound insight:*** *In certain circumstances, foreign businesses can consider making protective filings with the IRS related to their exposure to taxation in the United States. This option should be analyzed carefully to determine the circumstances when it should be considered.*

## **G. Group taxation**

An affiliated group of US 'includible' corporations, consisting of a parent and subsidiaries directly or indirectly 80% owned, generally may offset the profits of one affiliate against the losses of another affiliate within the group by electing to file a consolidated federal income tax return.

A foreign incorporated subsidiary may not be consolidated into the US group, except for certain Mexican and Canadian incorporated entities. A partnership may not be included in a consolidated return, even if it is 100% owned by members of an affiliated group, since a partnership is not a corporation. However, a member's earnings that flow through from a partnership are included as part of the consolidated group's taxable income or loss.

Filing on a consolidated (combined) basis is also allowed (or may be required or prohibited) under the tax laws of certain states.

Sales, dividends, and other transactions between corporations that are members of the same group generally are deferred or eliminated until such time as a transaction occurs with a non-member of the group. Losses incurred on the sale of members of the group are disallowed under certain circumstances.

## **H. Transfer pricing**

Transfer pricing regulations govern how related entities set internal prices for the transfers of goods, intangible assets, services, and loans in both domestic and international contexts. The regulations are designed to prevent tax avoidance among related entities and place a controlled party on par with an uncontrolled taxpayer by requiring an arm's-length standard.

The arm's-length standard generally is met if the results of a controlled transaction are consistent with results that would have been realized if uncontrolled taxpayers had engaged in a similar transaction under similar circumstances. If a company is not in compliance with the arm's-length standard, the IRS may increase taxable income and tax payable in the United States. After a transfer pricing adjustment, a multinational company may face double tax, paying tax on the same income in two countries. Multinational companies may request 'competent authority' relief from double taxation through a tax treaty.

To avoid potential transfer pricing penalties, one avenue available to companies may be to obtain an advance pricing agreement (APA) with the IRS, unilaterally, or with the IRS and another tax authority, bilaterally, covering inter-company pricing.

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**Inbound insight:** *The IRS currently is devoting more resources to auditing inbound companies with a specific focus on intangible and financing transactions. These developments place an increased emphasis on inbound companies to demonstrate results consistent with the arm's-length standard. They also serve as a reminder for an inbound company to revisit its intercompany pricing policies and intercompany agreements to ensure that those policies and the terms of those agreements are consistent with how the company actually operates its business in the United States.*

## **I. Thin capitalization**

Thin capitalization rules may apply to disallow interest payments related to 'excess' debt and to recharacterize such payments as dividends. The taxpayer's interest expense deduction can be limited and suspended if more than 50% of the adjusted taxable income of a thinly capitalized corporation (with similar rules for a corporate partner in a partnership) is sheltered by interest paid to a related party (or paid to a third party but guaranteed by the related party) that is not subject to US tax on the income.

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**Inbound insight:** Use of debt to finance US operations continues to be recognized as part of an acceptable capital structure. However, the amount of debt used and the cost of that debt to the US business in the case of intercompany debt can be subject to careful scrutiny, so a thorough analysis to support the decisions made should be performed.

## J. Controlled foreign companies (CFCs)

Under the Subpart F regime of the Internal Revenue Code, a CFC is any foreign corporation with respect to which US shareholders own more than 50% of either the voting power of all classes of stock entitled to vote or the total value of all classes of the corporation's stock on any day during the foreign corporation's tax year.

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**Inbound insight:** The acquisition of a US business by a foreign acquirer can result in both foreign ownership above the US business and CFCs underneath the US business. Particular care should be taken in dealing with the complex issues that can arise in this circumstance.

## K. S corporations

Corporations with 100 or fewer shareholders, none of whom may be corporations, that meet certain other requirements may elect to be taxed under Subchapter S of the Internal Revenue Code and thus are known as S corporations. S corporations are taxed in a manner similar, but not identical, to partnerships. That is, all tax items, such as income and deductions, flow through to the owners of the entity. Thus, S corporations generally are not subject to US federal income tax at the corporate level.

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**Inbound insight:** Only US citizens or residents may be shareholders of an S corporation. As a result of this requirement and the requirement that S corporation shareholders cannot be corporations or partnerships, S corporations generally are not a form of business organization available to be selected by inbound companies.

## L. Determining income

### 1. Inventory valuation

Inventories generally are stated at the lower of cost or market on a first-in, first-out (FIFO) basis. Last-in, first-out (LIFO) may be elected for tax purposes on a cost basis only and generally requires book and tax conformity.

The tax law requires capitalization for tax purposes of several costs allocable to the manufacturing process that frequently are expensed as current operating costs for financial reporting (e.g., the excess of tax depreciation over financial statement depreciation).



## **2. Capital gains**

Gains or losses on the sale or exchange of capital assets held for more than 12 months are treated as long-term capital gains or losses. Gains or losses on the sale or exchange of capital assets held for 12 months or less are treated as short-term capital gains or losses. The excess of net long-term capital gain over net short-term capital loss is considered net capital gain.

Capital losses are allowed only as an offset to capital gains. An excess of capital losses over capital gains in a tax year may be carried back three years and carried forward five years to be used against (offset) capital gains.

For dispositions of personal property and certain nonresidential real property used in a trade or business, net gains are first taxable as ordinary income to the extent of the previously allowed or allowable depreciation or amortization deductions, with any remainder generally treated as capital gain. For other trade or business real property, net gains generally are taxed as ordinary income to the extent that the depreciation or cost recovery claimed exceeds the straight-line amount, with any remainder treated as capital gain.

An exception to capital gain treatment exists to the extent that losses on business assets were recognized in prior years. A net loss from the sale of business assets is treated as an ordinary loss. Future gains, however, will be treated as ordinary income to the extent of such losses recognized in the five immediately preceding years.

## **3. Dividend income**

A US corporation generally may deduct 70% of dividends received from other US corporations in determining taxable income. The dividends-received deduction is increased from 70% to 80% if the recipient of the dividend distribution owns at least 20% but less than 80% of the distributing corporation. Generally, dividend payments between US corporations that are members of the same affiliated group are deferred or eliminated until a transaction with a third party occurs. With minor exceptions, a US corporation may not deduct any amount of dividends it receives from a foreign corporation.

## **4. Stock dividends**

A US corporation can distribute a tax-free dividend of common stock proportionately to all common stock shareholders. If the right to elect cash is given, all distributions to all shareholders are taxable as dividend income whether cash or stock is taken. There are exceptions to these rules, and extreme caution must be observed before making such distributions.

## **5. Interest income**

Interest income generally is includible in the determination of taxable income.

## **6. Rental income**

Rental income generally is includible in the determination of taxable income.

## **7. Royalty income**

Royalty income generally is includible in the determination of taxable income.

## **8. Partnership income**

The income (loss) of a partnership passes through to its partners, so that the partnership itself is not subject to tax. Thus, each partner generally accounts for its distributive share of the partnership's taxable income.

## **9. Foreign income (Subpart F income) of US taxpayers**

### **a. In general**

Generally, a US corporation is taxed on its worldwide income, including foreign branch income earned and foreign dividends when received. Double taxation is avoided by means of foreign tax credits; alternatively, a deduction may be claimed for actual foreign taxes that are paid.

In the case of CFCs, certain types of undistributed income are taxed currently to the US shareholders (Subpart F income). Generally, Subpart F income includes income that is easily transferred to a low-tax jurisdiction.

### **b. PFIC rules**

Income from certain passive foreign investment companies (PFICs)—defined as any foreign corporation if, for the tax year, 75% or more of its gross income is passive or at least 50% of its assets produce, or are held for the production of, passive income—also is subject to special rules designed to eliminate the benefits of deferral.

There are three regimes under the PFIC rules: (i) the excess distribution regime, which is the default regime; (ii) the qualified electing fund (QEF) regime; and (iii) the mark-to-market regime. The latter two regimes are elective and cause the US shareholder in the PFIC to be either taxed currently on its proportionate share of the PFIC's ordinary earnings and capital gains each year (the QEF regime) or taxed annually on the increase in value, if any, of the PFIC stock (the mark-to-market regime).

If the US shareholder does not make either a QEF or mark-to-market election for the first year of ownership, the US shareholder is subject to taxation under the default, excess distribution regime. Under this regime, if a PFIC makes an actual distribution, the distribution generally will be treated as an excess distribution to the extent it exceeds 125% of the average of the distributions made with respect to the stock over the three immediately preceding years. The excess distribution is spread over the taxpayer's holding period, and the amount allocated to each year in the holding period is subject to tax at the highest marginal tax rate in effect for that year.

This tax amount also is subject to an interest charge, which is designed to eliminate the benefit of the tax deferral that arises out of having an overseas investment for which no current US income taxes are paid. Furthermore, gains on disposition of

PFIC stock generally are treated as excess distributions as well. Finally, PFICs can be owned indirectly through other entities, including other PFICs, under ownership attribution rules.

If the US shareholder desires to apply either the QEF or mark-to-market regime after the first year of its holding period, it must 'purge' the PFIC taint of the prior portion of its holding period (and pay any applicable tax and interest) or seek relief to file the relevant election retroactively at the beginning of its holding period.

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**Inbound insight:** *Given the different tax consequences under each regime, it is important that a US investor in a foreign corporation timely and accurately identify whether the foreign corporation is a PFIC to timely determine whether one of the elections should be made.*

## 10. Dispositions of interests in US real property (FIRPTA)

In general, under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), gain or loss from the disposition by a foreign person of a US real property interest (USRPI) is treated as if the gain or loss were effectively connected to the conduct of a US trade or business and, accordingly, is subject to US income tax under normal graduated tax rates.

A USRPI includes any interest, other than an interest solely as creditor, in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the US Virgin Islands. The term 'real property' includes: (1) land and unsevered natural products of the land; (2) improvements; and (3) personal property associated with the use of real property. In addition to a direct interest in US real property, a USRPI includes an interest in a domestic corporation if, at any time during the shorter of (1) the period after June 18, 1980, during which the taxpayer held the interest or (2) the five-year period ending on the date of the disposition of the interest in the corporation, the domestic corporation was a US real property holding company (USRPHC).

In general, a domestic corporation is a USRPHC if the fair market value of its USRPIs equals or exceeds 50% of the fair market value of (1) its USRPIs, (2) its interests in real property located outside the United States, plus (3) any other of its assets that are used or held for use in a trade or business.

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**Inbound insight:** *It should be noted that the FIRPTA rules presume that an interest in a domestic corporation (other than an interest solely as a creditor) is a USRPI and therefore is subject to tax upon disposition unless, prior to the disposition of shares in the corporation, the shareholder requests a statement from the corporation that its shares are not USRPIs and the corporation provides the requested statement on a timely basis. If the presumption is not rebutted, the disposition is subject to the FIRPTA rules regarding reporting and withholding.*

## ***M. Corporate deductions***

### **1. Depreciation and amortization**

Depreciation deductions are allowances that may be taken for capital outlays for tangible property. For property placed in service after 1986, capital costs must be recovered by using the modified accelerated cost recovery system (MACRS) method. Depending on the type of tangible property, the general cost recovery periods are 3, 5, 7, 10, 15, 20, 27.5, and 39 years (31.5 years for property placed in service before May 13, 1993). The cost recovery methods and periods are the same for both new and used property. Most tangible personal property falls in the three-, five-, or seven-year class.

Property placed in the three-, five-, seven-, or 10-year class is depreciated by first applying the 200% declining-balance method and then switching to the straight-line method when use of the straight-line method maximizes the depreciation deduction. Property in the 15- or 20-year class is depreciated by using the 150% declining-balance method and later switching to the straight-line method. An election may be made to use the alternative depreciation system (basically, the straight-line method over prescribed lives).

Residential rental property generally is depreciated by the straight-line method over 27.5 years. Nonresidential real property is depreciated by the straight-line method over 39 years (31.5 years for property placed in service before May 13, 1993).

An election to use the straight-line method over the regular recovery period or a longer recovery period also is available. Alternatively, taxpayers may elect to use the 150% declining-balance method over the regular recovery period for all property other than real property. The 150% declining-balance method is required for AMT purposes.

For most tangible personal and real property placed in service in the United States after 1980 but before January 1, 1987, capital costs were recovered using the accelerated cost recovery system (ACRS), which applied accelerated methods of cost recovery over periods specified by statute. The general ACRS recovery periods were 3, 5, 10, 15, 18, and 19 years.

Special rules apply to automobiles and certain other 'listed' property. Accelerated depreciation deductions can be claimed only if the automobile is used 50% or more for qualified business use as defined in related regulations. Further, for automobiles placed in service after 1986, the allowable yearly depreciation deduction cannot exceed specific dollar limitations.

Separate methods and periods of cost recovery are specified by statute for certain tangible personal and real property used outside the United States.

Rapid amortization may be allowable for certain pollution control facilities.

Tax depreciation is not required to conform to book depreciation. Tax depreciation generally is subject to recapture on the sale or disposition of certain property, to the extent of gain, which is subject to tax as ordinary income.

The cost of most intangible assets generally is capitalized and amortizable ratably over 15 years.

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***Inbound insight:*** Companies with a large amount of fixed assets can benefit from careful analysis of current depreciation methods, for regular tax, AMT, and E&P purposes. Proper classification of assets and the application of the correct recovery periods can have a substantial impact on current-year taxable income and E&P.

## **2. Section 179 deduction**

Corporations can elect to expense, up to a statutory amount per year, the cost of certain eligible property used in the active conduct of a trade or business, subject to a taxable income limitation and to a phase-out of the deduction. This is commonly referred to as the Section 179 deduction.

Tax cuts enacted in 2003 temporarily increased the maximum dollar amount that may be deducted under Section 179 from \$25,000 to \$100,000 and also increased the phase-out amount from \$200,000 to \$400,000. These amounts have been further modified and extended several times on a temporary basis, increasing to a high of \$500,000 and \$2 million, respectively, for tax years beginning in 2010 and 2011, and then to \$125,000 and \$500,000, respectively, for tax years beginning in 2012, before reverting to the permanent amounts of \$25,000 and \$200,000, respectively, for tax years beginning in 2013 and thereafter. The American Taxpayer Relief Act of 2012 (ATRA) signed into law on January 2, 2013, increases the maximum amount and phase-out threshold in 2012 and 2013 to the levels in effect in 2010 and 2011 (\$500,000 and \$2 million, respectively). For tax years beginning in 2014, the amounts reverted to \$25,000 and \$200,000, respectively.

## **3. Bonus depreciation**

A 50% special first-year depreciation allowance (i.e., bonus depreciation) applies (unless an election out is made) for new MACRS property with a recovery period of 20 years or less, certain computer software, water utility property, and certain leasehold improvements acquired after December 31, 2007. The special allowance applies for regular income tax and AMT purposes. No AMT adjustment is made if the special allowance is used. The special allowance does not apply to property that must be depreciated using the alternative depreciation system or to 'listed property' not used predominantly for business. The special allowance reduces basis before regular depreciation is figured. Claiming bonus depreciation on automobiles also may affect the first-year depreciation limits on such automobiles.

ATRA extended bonus depreciation through December 31, 2013 (December 31, 2014, for long-production-period property (LPPP) and certain aircraft). This provision had been set to expire on December 31, 2010 (December 31, 2011, for LPPP

## I. Federal tax issues

and certain aircraft), as extended by the Small Business Jobs Act of 2010.

- ATRA did not extend 100% bonus depreciation, which expired at the end of 2011.
- ATRA extended for one year, to tax years beginning in 2013, the provision allowing a corporation to elect to accelerate AMT credits in lieu of bonus depreciation.

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**Inbound insight:** Due to the numerous changes in the law related to depreciation deductions, a review of prior years and a forecast of future years should be completed regularly.

### 4. Depletion

For natural resource properties other than timber and certain oil and gas properties, depletion may be computed on a cost or a percentage basis.

Cost depletion is a method of depletion applied to exhaustible natural resources, including timber, which is based on the adjusted basis of the property. Each year, the adjusted basis of the property is reduced, but not below zero, by the amount of depletion calculated for that year. The current-year cost depletion deduction is based on an estimate of the number of units that make up the deposit and the number of units extracted and sold during the year.

Percentage depletion is a method of depletion applied to most minerals and geothermal deposits, and, to a more limited extent, oil and gas. Percentage depletion is deductible at rates varying from 5% to 25% of gross income, depending on the mineral and certain other conditions. Percentage depletion may be deducted even after the total depletion deductions have exceeded the cost basis. However, percentage depletion is limited to 50% (100% for oil and gas properties) of taxable income from the property (computed without allowance for depletion). Generally, percentage depletion is not available for oil or gas wells. However, exceptions exist for natural gas from geopressurized brine and for independent producers of oil and gas.

### 5. Goodwill

The cost of goodwill generally is capitalized and amortizable ratably over 15 years.

### 6. Start-up expenses

Generally, start-up expenditures must be amortized over a 15-year period; however, certain taxpayers may elect to deduct some expenses in the tax year in which the trade or business begins.



## 7. US manufacturing deduction

Over the last several decades, various tax incentive systems were enacted in the United States to encourage exports but later were repealed, including the extraterritorial income (ETI) regime, which was repealed as a result of a World Trade Organization (WTO) ruling that the ETI regime favored US goods and violated the national treatment provisions of the General Agreement on Tariffs and Trade. In response, the United States enacted the American Jobs Creation Act of 2004, which introduced a phase-out repeal of ETI and introduced the domestic production activities deduction under Section 199, seeking to compensate US manufacturers for the loss of ETI benefits.

Under Section 199, taxpayers are allowed a 9% deduction for qualified production activities (QPA) income (subject to a taxable income limitation). The deduction is available to all taxpayers actively engaged in QPA. For corporate taxpayers, the deduction generally will mean a federal income tax rate of 31.85% on QPA income. Importantly, the deduction also applies in calculating the AMT.

There is a limit on the amount of the deduction equal to 50% of W-2 wages allocable to QPA (subject to a specific effective date). The deduction is not allowed for taxpayers that incur a loss from their production activities or have an overall loss (including a carryover loss) from all activities.

A taxpayer's QPA income is calculated using the following formula: domestic production gross receipts less the sum of cost of goods sold allocable to such receipts and other expenses, losses, or deduction which are properly allocable to such receipts.

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***Inbound insight:*** The Section 199 deduction applies to a variety of US domestic production activities, including the production of tangible personal property, qualified films, construction of real property, and the development of computer software. Because the Section 199 deduction is a permanent deduction, any overlooked deductions can be claimed on amended federal income tax return.

## 8. Bad debt

Bad debt resulting from a trade or business may be deducted in the year the debt becomes worthless. Determining the date the debt becomes worthless may present difficulty.

## 9. Charitable contributions

Deductions for allowable charitable contributions may not exceed 10% of a corporation's taxable income computed without regard to certain deductions, including charitable contributions themselves. Deductions for contributions so limited may be carried over to the five succeeding years, subject to the 10% limitation annually.

## **10. Employee benefit plans (retirement plans and expenses)**

The Internal Revenue Code provides incentives for employers to provide retirement benefits to workers, including employee pension, profit-sharing, and stock bonus plans. The employer is allowed a current deduction for contributions made to fund the retirement benefits and pay expenses; the employees' tax liability is deferred until the benefits are paid.

These programs are subject to the Employee Retirement Income Security Act of 1974 (ERISA), which governs eligibility, vesting, spousal rights, fiduciary duties, reporting and disclosure, and other related issues, as well as to the extensive requirements for tax qualification under the Internal Revenue Code. Qualified retirement plans must not discriminate in favor of highly compensated employees, and are subject to additional rules regarding eligibility, vesting, benefit accrual, funding, spousal rights, and fiduciary duties.

For-profit, non-government employers generally have two types of available plans. The first category is the defined benefit plan, often simply known as a pension plan, to which an employer contributes on an on-going basis to cover the amount of retirement income owed to employees under the plan (which will vary based on years of service, average salary, and/or other factors), beginning at their retirement and generally continuing for life. Any investment gains or losses will not affect the amount of benefits paid to participants but will affect the amount an employer must contribute to cover its obligation.

The second category is the defined contribution plan, including the commonly offered '401(k) plan,' to which an employer's contributions (if any) are allocated among the separate accounts of participating employees. Investment gains or losses and the history of contributions will affect the value of a participant's account at retirement but will not affect an employer's contributions since the employer is not obligated to ensure any specified level of benefit in the plan. A 401(k) plan also provides employees a pre-tax means of saving for their own retirement, and permits the employer to match these contributions.

Non-profit employers, including charities and government entities, have similar retirement plans, although some different requirements apply. Small employers and self-employed individuals also have similar options available but may be subject to different requirements.

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**Inbound insight:** *The rules applicable to employee benefit plans, in terms of application to both a US business and its employees, can create particular complexity for businesses with non-US parent companies. This is often due to the interaction between the employee benefit plans at the parent company and the US business, as well as the movement of employees into and out of the US for varying periods of time.*

## **11. Fines and penalties**

No deduction generally is allowed for fines or penalties paid to the government for violation of any law.

## **12. Bribes, kickbacks, and illegal payments**

An amount paid, directly or indirectly, to any person that is a bribe, kickback, or other illegal payment is not deductible.

## **13. Taxes**

State and municipal taxes are deductible expenses for federal income tax purposes.

## **14. Research or experimental expenditures**

Corporations can elect under Section 174 to expense all research or experimental (R&E) expenditures that are paid or incurred during the tax year or to defer the expenses for 60 months. Taxpayers also can make a special election under Section 59(e) to amortize their research expenditures over 120 months. A portion of the research expenditures may qualify for a research tax credit that is described in section I. N. 5.

The IRS in September 2013 issued proposed regulations under Section 174 that are considered taxpayer favorable. The proposed regulations would address several issues related to whether the subsequent sale or use of tangible property created through research is deductible, amend the existing regulations clarifying the depreciable property rule, clarify that integration testing could qualify as an R&E expense, provide a definition of ‘pilot model,’ and introduce the ‘shrink-back’ rule concept to the Section 174 context.

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***Inbound insight:*** *The proposed regulations would apply to any tax year ending on or after the publication date of a Treasury decision adopting these rules as final regulations. The IRS, however, states that it will not challenge return positions consistent with the proposed regulations. Thus, taxpayers may rely on the proposed regulations until the date the final regulations are published in the Federal Register.*

## **15. Other significant items**

- No deduction generally is allowed for a contingent liability until such liability is fixed and determinable.
- Costs incurred for entertainment must meet strict tests to be deductible. The deduction for business meal and entertainment expenses generally is 50% of the expenses incurred. There are also limitations on the deductibility of international and domestic business travel expenses.
- Royalty payments, circulation costs, mine exploration, and development costs, and other miscellaneous costs of carrying on a business are deductible, subject to certain conditions and limits.

## **16. Net operating losses (NOLs)**

An NOL is generated when business deductions exceed gross income in a particular tax year. An NOL may be carried back to offset past income and possibly obtain a refund or carried forward to offset future income. Generally, a loss may be carried back two years and, if not fully used, carried forward 20 years.

Special rules regarding NOLs may apply (1) to specified liability losses or (2) if a taxpayer is located in a qualified disaster area.

Complex rules may limit the use of NOLs after reorganization or other change in corporate ownership. Generally, if the ownership of more than 50% in value of the stock of a loss corporation changes, a limit is placed on the amount of future income that may be offset by losses carried forward.

## **17. Payments to foreign affiliates**

A US corporation generally may claim a deduction for royalties, management service fees, and interest charges paid to foreign affiliates, to the extent the amounts are actually paid and are not in excess of what it would pay an unrelated entity (i.e., are at arm's length). US withholding on these payments may be required.

## **18. Premium payments to captive insurance companies**

A US corporation generally may claim a deduction for insurance premiums paid, even though the insurance is purchased from an affiliated insurance company (captive insurance company). To be treated as insurance for tax purposes, the insurance arrangement has to involve the transfer of insurance risk, result in adequate risk distribution, and meet commonly accepted notions of insurance under US tax principles. If the captive insurance company is domiciled outside the US, the premium payments would be subject to an excise tax of 4% on direct premiums (other than for life insurance) and 1% on life insurance and reinsurance premiums. However, the excise tax may be exempt under a tax treaty. Insurance premiums are not subject to withholding taxes (other than under FATCA; see discussion below).

## **N. Credits and incentives**

### **1. Temporary credits and incentives extended**

Numerous temporary tax provisions that expired at the end of 2011 were renewed retroactively to January 1, 2012, and extended through December 31, 2013, as part of ATRA. As of this printing, these provisions have not been renewed for 2014. Congress may pass legislation renewing and extending (retroactively to January 1, 2014) at least some of these provisions later in 2014.

The general business incentives that were renewed and extended by ATRA include the following:

- increased Section 179 expensing limit of \$500,000 with a \$2 million phase-out threshold and an expanded definition of Section 179 property
- research credit
- subpart F exception for active financing income
- look-through treatment of payments between related CFCs under the foreign personal holding company rules.
- 15-year straight-line cost recovery for qualified leasehold improvements, restaurant buildings and improvements, and retail improvements
- seven-year recovery period for motor sports entertainment complexes
- work opportunity tax credit
- wage credit for employers of active-duty military members
- railroad track maintenance credit
- special expensing rules for qualified film and television productions
- new markets tax credit
- mine rescue team training credit
- expensing of advanced mine safety equipment
- enhanced charitable deduction for contributions of food property
- treatment of some dividends of regulated investment companies (RICs)
- RICs considered qualified investment entities under FIRPTA
- special rules for qualified small business stock
- reduction in S corporation recognition period for built-in gains tax

## **2. Foreign tax credit (FTC)**

Generally, in any year, a taxpayer can choose whether to take as a credit (subject to limitation) or as a deduction foreign income, war profits, and excess profit taxes paid or accrued during the tax year to any foreign country or US possession. An FTC reduces US income tax liability dollar for dollar, while a deduction reduces US income tax liability at the marginal rate of the taxpayer.

For taxpayers with an NOL for the year, the FTC is of no value in such year. However, a benefit might be received either in an earlier year (through a refund of previously paid taxes) or a later year (through a reduction of future taxes). Note also that a taxpayer has the ability to switch from credit to deduction (or from deduction to credit) at any time in a 10-year period commencing when the foreign taxes were paid or accrued. Generally, an FTC may be carried back one year and, if not fully used, carried forward 10 years.

The FTC goes beyond direct taxes to include foreign taxes paid 'in lieu of' a tax on income, war profits, or excess profits that otherwise generally would be imposed. It also includes deemed-paid (indirect) taxes paid for certain US corporate shareholders of non-portfolio foreign corporations when actual or deemed dividends are received. The FTC system has numerous limitations to mitigate potential abuses of the credit by taxpayers.

### **3. General business credit**

Various business credits are available to provide special incentives for the achievement of certain economic objectives. In general, these credits are combined into one ‘general business credit’ for purposes of determining each credit’s allowance limitation for the tax year. The general business credit that may be used for a tax year is limited to a tax-based amount. In general, the current year’s credit that cannot be used in a given year because of the credit’s allowance limitation may be carried back to the tax year preceding the current year and carried forward to each of the 20 years following the current year.

In general, the current-year business credit is a combination of the following credits (as of this writing, some of these credits have expired, but may be renewed retroactively by Congress):

- investment credit
- work opportunity credit
- alcohol fuels credit
- research credit
- low-income housing credit
- enhanced oil recovery credit
- disabled access credit for certain eligible small businesses
- renewable electricity production credit
- empowerment zone employment credit
- Indian employment credit
- employer social security credit
- orphan drug credit
- new markets tax credit
- small employer pension plan startup cost credit for eligible employers.
- employer-provided child care credit
- railroad track maintenance credit
- biodiesel fuels credit
- low sulfur diesel fuel production credit
- marginal oil and gas well production credit
- distilled spirits credit
- advanced nuclear power facility production credit
- non-conventional source production credit
- new energy efficient home credit
- energy efficient appliance credit
- a portion of the alternative motor vehicle credit
- a portion of the alternative fuel vehicle refueling property credit
- Hurricane Katrina housing credit
- Hurricane Katrina employee retention credit
- Hurricane Rita employee retention credit
- Hurricane Wilma employee retention credit
- mine rescue team training credit
- agricultural chemicals security credit for eligible businesses
- differential wage payment credit
- carbon dioxide sequestration credit
- a portion of the new qualified plug-in electric drive motor vehicle credit for vehicles that will vary based on the date of purchase



#### **4. Employment credits**

A ‘work opportunity tax credit’ is available for employment of certain targeted groups of individuals who are viewed as difficult to employ. ‘Creditable’ wages generally are the first \$6,000 of wages paid to each qualified employee for the year. The credit is 40% of creditable wages, for a maximum credit of \$2,400. ATRA extended this credit through 2013.

#### **5. Research credit**

The research tax credit under Section 41 is available for companies that make qualified research expenditures to develop new or improved products, manufacturing processes, or software in the United States. The credit was enacted in 1981 on a temporary basis to help increase R&E spending in the United States. Since then the research credit has been extended about 15 times, most recently as part of ATRA, retroactive to January 1, 2012, and is available with respect to qualified research expenses (QREs) incurred before January 1, 2014.

The research credit generally is computed by calculating current-year QRE over a base. The base is calculated using either the regular research credit (RRC) method or the alternative simplified credit (ASC) method. Under the RRC method, the credit equals 20% of QREs for the tax year over a base amount established by the taxpayer in 1984–1988 or by another method for companies that began operations after that period.

The ASC equals 14% —for the 2009 tax year and thereafter—of QREs over 50% of the average annual QREs in the three immediately preceding tax years. If the taxpayer has no QREs in any of the three preceding tax years, the ASC may be 6% of the tax year’s QREs. The taxpayer must make a timely ASC election on Form 6765 attached to an originally filed return filed by the due date for that return (including extensions).

Taxpayers using the RRC also may take a 20% credit for incremental payments made to qualified organizations for basic research. For tax years ending after August 8, 2005, taxpayers also may take the Energy Research Consortium Credit, which provides a 20% credit for expenditures on qualified energy research undertaken by an energy research consortium.

The deduction for R&E expenditures (see section I.M.14 above) must be reduced by the entire amount of the credit unless an election is made to reduce the amount of the credit.

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**Inbound insight:** *The application of the research credit rules when a US business is compensated for its R&E costs by a foreign parent or other foreign related party often is misunderstood.*

*The rules provide that in determining a taxpayer's research tax credit, all members of the same controlled group of corporations should be treated as a single taxpayer. Companies often net the reimbursement against their current QREs, resulting in lost opportunities to utilize available credits. This area should be reviewed closely if US entities are being reimbursed by related foreign entities for any potentially qualified activities.*

*In light of the proposed regulations under Section 174, taxpayers should evaluate their QREs to determine the possible impact of the new rules regarding pilot models, integration testing, and 'shrinkback.'*

*Congress may extend the credit, retroactively to January 1, 2014, by the end of 2014.*

## 6. Inbound investment incentives

There generally are no specific incentives related to inbound investment at the federal level, other than certain portfolio debt and bank deposit exceptions. The portfolio debt exception enables nonresidents and foreign corporations to invest in certain obligations (which must meet certain statutory requirements to qualify as 'portfolio debt') in the US without being subject to US income (or withholding) tax on the interest income.

## 7. Qualified private activity bonds

Interest income received on certain qualified private activity bonds generally is exempt from federal income tax. This enables a business enterprise to issue the bonds at a lower interest rate.

## O. Administrative issues

### 1. Withholding

#### a. Withholding on payments to non-US persons

Under US domestic tax laws, a foreign person generally is subject to 30% US tax on its US-source income. Persons making US-source payments ('withholding agents'), such as US-source interest, dividends, and royalties, to foreign persons generally must withhold 30% of the payment amount as tax withheld at source. In other situations, withholding agents may apply a lower rate of withholding if the payee is eligible for a reduced rate under a tax treaty or by operation of the US tax laws. See the latest edition of IRS Publication 515.

The United States has entered into various income tax treaties with countries in order to avoid double taxation of the same income and to prevent tax evasion. See Appendix A below or the latest edition of IRS Publication 901 for a summary of

the benefits resulting from these treaties. See also the discussion of tax treaties in section III below.

The ability to apply a reduced rate depends on whether the withholding agent receives valid documentation evidencing the foreign payee's eligibility for a lower rate of withholding. Valid documentation includes Form W-8. Since there are various Forms W-8, the payee must determine which one is the correct form to be completed.

Form W-8BEN, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding*, is the most commonly used Form W-8. That version is used to establish that the payee is not a US person and is the beneficial owner of the income for which Form W-8BEN is being provided. Form W-8BEN also can be used to claim a reduced rate of withholding based on an applicable income tax treaty. Note: Form W-8BEN is used only by individuals. Entities use Form W-8BEN-E.

In addition to Form W-8BEN, other forms that can be provided by a foreign payee to reduce or eliminate withholding are:

- Form W-8ECI, *Certificate of Foreign Person's Claim That Income Is Effectively Connected With the Conduct of a Trade or Business in the United States*, is provided by a non-US entity that is engaged in a US trade or business.
- Form W-8EXP, *Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding*, is provided by non-US governments or non-US tax-exempt organizations.
- Form W-8IMY, *Certificate of Foreign Intermediary, Foreign Flow Through Entity, or Certain US Branches for United States Tax Withholding*, is provided by a non-US flow-through entity (e.g., partnership) that is not engaged in a US trade or business. Form W-8IMY must be accompanied by Form W-8 or Form W-9 for the underlying owners and withholding statement.

Treaty claims made by nonresident alien individuals that provide independent personal services in the US are made on Form 8233, *Exemption from Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual*, instead of on Form W-8BEN.

Forms W-8BEN, W-8ECI, and W-8EXP generally are valid for three years plus the year of receipt. New forms are required prior to the expiration of three years if there is a change in the information disclosed by the payee on the forms. Form W-8IMY is valid indefinitely unless there is a change in the information disclosed by the payee on the forms. Form 8233 is valid for only one year.

### *b. Withholding on payments to US persons*

All US and non-US entities are responsible for information reporting and backup withholding for payments made to US non-exempt recipients, including US individuals, partnerships, LLCs, and non-corporate banks. Backup withholding at the current rate of 28% is required if the US non-exempt recipient fails to provide a proper taxpayer identification number (TIN) prior to payment or if the payor is instructed to backup withhold by the IRS.

## I. Federal tax issues

Payments made to US exempt recipients are not subject to reporting or backup withholding and such recipients are not required to provide a TIN. Exempt recipients include governments (federal, state, and local), tax-exempt organizations under IRC Section 501(a), individual retirement plans, international organizations, foreign central banks of issue, and most corporations.

Payments made to US non-exempt recipients for dividends, gross proceeds, interest, compensation for services, rents, royalties, prizes, awards, and litigation awards, among others, must be reported. A proper TIN should be obtained from all US payees to avoid backup withholding. A TIN is best obtained by receiving a Form W-9, *Request for Taxpayer Identification Number and Certificate*, from US payees, including exempt recipients. The IRS's TIN Matching Program also can be utilized to verify names or TINs with IRS records to ensure accuracy.

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**Inbound insight:** *The US reporting and withholding rules apply whether payments are made to related or unrelated parties. This means that the appropriate Form W-8 or W-9 must be provided to a company making a payment to a related party.*

*Non-US companies that are controlled by US persons or that earn more than a certain amount of US-source income are classified as US payors. As a result, these companies must report all reportable payments made to a US non-exempt recipient. Also, if the US non-exempt recipient fails to provide its TIN in the proper manner, backup withholding must be imposed and remitted to the IRS.*

## 2. Information reporting

### a. Reporting payments to non-US persons

Any taxes withheld on payments made to foreign payees must be reported to the IRS on Form 1042, *Annual Withholding Tax Return for US Source Income of Foreign Persons*. Form 1042 must be filed with the IRS on or before March 15 following the calendar year in which the income subject to reporting was paid, unless an extension of time to file is obtained. Form 1042 must be filed if a Form 1042-S is filed (see below), even if there is no withholding on the payment.

A withholding agent must file with the IRS and furnish to each foreign payee Form 1042-S, *Foreign Person's US Source Income Subject to Withholding*. Form 1042-S is the information return used by withholding agents to report US-source payments paid to foreign payees. Form 1042-S must be filed with the IRS and furnished to the foreign payee on or before March 15 following the calendar year in which the income subject to reporting was paid, unless an extension is obtained. Form 1042-S is required whether or not withholding on the payments has occurred.

### b. Reporting payments to US persons

A US entity engaged in a trade or business that during the calendar year makes payments to a US non-exempt payee totaling \$600 or more must report the amount of the payments on Form 1099-MISC, *Miscellaneous Income*. Payments subject to

Form 1099-MISC reporting include compensation for services (other than wages paid to employees), rents, royalties, commissions, gains, and certain types of interest. US payers are responsible for reporting the payment whether made by cash, check, or wire transfer. Amounts paid by payment card (including debt, credit, and procurement) are not subject to Form 1099-MISC reporting by the payor.

Form 1099-MISC must be furnished to payees no later than January 31 of the year subsequent to the year of payment and must be filed with the IRS by February 28 of the year following the payment. Requests to extend these dates maybe made, but extensions are not automatic.

If the payor is required to file 250 or more Forms 1099-MISC, it must file the forms electronically with the IRS by use of the Filing Information Returns Electronically (FIRE) system. If Forms 1099-MISC are filed electronically, the due date for filing with the IRS is extended from February 28 to March 31.

The payor also must file Form 945, *Annual Return of Withheld Federal Income Tax*, to report any backup withholding. Form 945 must be filed with the IRS by January 31 of the year succeeding the year of payments.

### **c. FATCA**

FATCA, the Foreign Account Tax Compliance Act, was enacted in 2010 to prevent and detect offshore tax evasion. While the name may imply that FATCA is directed at financial institutions, many global companies outside the financial services industry may be affected if they have entities in their worldwide network falling under the purview of FATCA, or have operational areas that make or receive payments subject to FATCA.

Since before FATCA applied, multinational enterprises that are withholding agents have been obligated to report, withhold on payments, and document payees, but FATCA will require changes to these activities and impose additional requirements for transactions with non-US entities. FATCA mandates that multinational businesses evaluate entity payees differently, engage in withholding on certain gross proceeds transactions (a change from historic processes), and report different information to the IRS.

The withholding provisions of FATCA are scheduled to begin in July 2014. Compliance with FATCA may require changes to existing systems and processes across business units and regions, the renewal of policies and day-to-day practices, and new tasks such as registering with the IRS.

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***Inbound insight:*** Many non-US companies with business operations in the United States have non-US companies engaged in activities such as holding shares, financing, and treasury or insurance operations. These activities require a careful review of the companies throughout the corporate group to determine the appropriate application of the FATCA rules.

## **I. Federal tax issues**

### *i. FATCA compliance obligations*

FATCA imposes new registration, due diligence reviews, information reporting, and tax withholding obligations on entities that qualify as foreign financial institutions (FFIs). By as early as April 2014, legal entities with FFI characteristics must determine whether they are, in fact, FFIs and should register with the IRS.

Multinational corporations should examine their treasury centers, retirement funds, and holding companies, to name a few examples, to ensure that they do not meet the definition of an FFI. Properly identifying the FATCA status of each entity in a large organization is expected to take significant time and effort, because the final FATCA regulations impose several different income and asset tests at both the entity level and the global organization level.

Regardless of FATCA status, obligations are imposed on payors of US-source fixed or determinable, annual, or periodical (FDAP) income, which include many multinational corporations. These companies must have processes and procedures in place to identify and categorize non-US payees for FATCA purposes, report, and potentially apply 30% withholding tax to avoid being liable for the withholding tax and potential penalties. Even if a foreign entity is not an FFI, FATCA still requires the recipient of a US-source payment to establish its FATCA status with appropriate documentation.

FATCA also extends existing reporting and withholding requirements and impose withholding on US FDAP payments to FFI entities that do not report certain information regarding their US accounts to the IRS. This withholding tax also applies to the same types of payments to certain nonfinancial foreign entities (NFFEs) that do not provide information on their substantial (i.e., greater-than-10%) US owners to a withholding agent.

### *ii. FATCA exemptions*

There are several important exemptions from FATCA to the withholding of tax on US-source payments. For example, FATCA withholding should not apply when the payee provides to the withholding agent appropriate documentation demonstrating that the payee is not subject to withholding. Even though withholding under FATCA does not apply, in that case reporting still is required. The withholding agent also must evaluate whether reporting and withholding apply under current information reporting rules.

NFFEs that either have no substantial US owners or that properly identify these owners to withholding agents should not be subject to withholding, nor should NFFEs that are deemed by the IRS to represent a low risk of US tax evasion, such as publicly traded companies and their affiliates, and those engaged in active trades or businesses. A withholdable payment to a documented US entity is not subject to the 30% tax, but reporting applies.

### *iii. Actions to comply with FATCA*

Multinational corporations need a FATCA compliance program to ensure that all necessary FATCA classifications, documentation, monitoring, and reporting



are undertaken. This process should be documented in a series of policies and procedures ensuring that the process has controls that can be replicated and tested. Further, the program, which should highlight changes in business practices that may be necessary for FATCA compliance, would be intended to inform senior management that all areas of the organization have been reviewed according to requirements.

*iv. How FATCA works*

FATCA compels compliance by imposing withholding obligations that offer a significant financial incentive to stakeholders to do their part to comply. Specifically, FATCA generally requires multinational businesses and FFIs to withhold 30% on payments that meet the definition of a ‘withholdable payment’ when made to non-compliant payees. The term ‘withholdable payment’ generally refers to the gross amount of most types of US-source income, such as interest or dividends on US securities, as well as gross proceeds from the sale or redemption of US securities.

However, the US Treasury and IRS have narrowed the scope of FATCA withholding to apply to specific types of entities identified in the legislation and to those persons that are deemed to pose a significant risk of tax evasion. As an example, withholding does not apply to certain payments made in the ordinary course of a trade or business, such as most payments for services. To utilize any FATCA exception, documentation of the character and source of payment is required; therefore, proper reporting still will be required despite the withholding exceptions.

*v. The impact of IGAs*

To mitigate certain foreign legal impediments to FATCA compliance, intergovernmental agreements (IGAs) have been negotiated between the US Treasury and other governments. Under certain IGAs, including most of the IGAs signed as of this writing (with more to be finalized), information will be exchanged directly between the IRS and the foreign taxing authority. This obligates entities in IGA jurisdictions to report information to their government that may not have been required or permitted in the past.

Assessing FATCA’s impact will require identifying whether an IGA may apply to the entity or payment stream at issue. Provisions in the final regulations or any IGA that provide more favorable results may be utilized. This likely will increase the complexity of the process, due in part to the multiple paths to compliance (e.g., regulations or an IGA). The regulators have focused on having consistent requirements in each IGA, but there are noticeable differences in the agreements signed to date. For an MNC, this will require an analysis of the applicable FATCA rules across all jurisdictions in which it operates.

*vi. Companies with FFIs in their groups*

FATCA imposes the most significant obligations on FFIs. Companies engaged in nonfinancial businesses may think that few or none of their foreign entities constitute an FFI. However, the definition of an FFI is broad and includes more types of entities than one might expect.

## I. Federal tax issues

Although the rules provide various exceptions, the following are types of entities that may be FFIs:

- **Non-US retirement funds and foundations**—Non-US retirement funds whose gross income is primarily attributable to investing, reinvesting, or trading in financial assets and are professionally managed by another entity are classified as investment entities. However, certain retirement funds entitled to receive benefits under a tax treaty are examples of retirement funds that are not FFIs under FATCA.
- **Treasury centers, holding companies, and captive finance companies**—These types of entities are specifically identified in the definition of an FFI. Among the activities relevant in assessing whether a legal entity is treated as an FFI are:
  - cash pooling
  - securitization and factoring activities
  - hedging activities (including whether hedges are entered into with affiliates or with ‘customers’)
  - customer financing operations
  - offshore cash deployment and investment strategies
  - in-house bank and external credit or ‘banking’-type operations.
- **Special-purpose entities and banking-type subsidiaries**—Although frequently utilized to access lower-cost sources of funding for operations or acquisitions, the mix of activities in which these entities are engaged and how income is derived may cause them to fall within the FFI definition.
- **Captive insurance companies**—Generally, captive insurance companies may not be deemed FFIs for FATCA purposes because they do not have any cash value or annuity contracts. However, such captives still should evaluate their business operations to determine if they fall within as another category of FFI. These other categories may include depository institutions, custodial institutions, investment entities, and certain holding companies and treasury centers.

When an MNC determines that it has entities within its global structure that meet the above definition, the MNC should determine if it may qualify for an exception. One of the primary exceptions covers holding companies and treasury centers that are part of a group that is determined to be ‘nonfinancial’. The status of ‘nonfinancial’ is based on the ratios of active vs. passive income and assets, as well as the income generated by the holding companies and treasury centers.

If an MNC cannot qualify for any exceptions, it must properly register all of its entities that are FFIs. To avoid the 30% withholding tax on US-source payments it receives, each FFI must use the IRS’s online FATCA portal to execute an FFI agreement, confirm its due diligence, and receive a new identification number, the Global Intermediary Identification Number or GIIN. The FFIs will use their GIINs on all documentation they provide.

vii. *Companies that make US-source cross-border payments*

FATCA generally applies when a multinational business makes a withholdable payment. From a practical perspective, a large range of payors can be impacted—just about any multinational business that makes payments falling within this definition will experience the impact of FATCA. As a result, global organizations should focus their efforts on payment details such as:

- which legal entity or department is authorizing the payment
- which legal entity or department is making the payment
- the recipient of the payment
- documentation of the recipient
- source (and US federal income tax sourcing) of the payment
- the character of the payment.

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***Inbound insight:*** *Accuracy of payment details is imperative when dealing with FATCA. Multinationals with outbound payments from the United States should ensure internal governance of the cross-border payments is sound and that payments are reflective of any transfer pricing arrangements in place.*

viii. *Expansive definition of a withholdable payment*

The term ‘withholdable payment’ generally refers to the gross amount of US-source FDAP income, and can include other types of US-source income not otherwise subject to withholding under Chapter 3 of the IRC. For example, gross proceeds from the sale of certain property are included in the definition.

Treasury functions, accounts payable departments, and other areas of a global organization may make many withholdable payments. The following are a few common examples of third-party or intercompany payments that may be included in the definition:

- |  |  |
|--|--|
| • interest and dividends   | • insurance or reinsurance premiums paid for insuring US risk  |
| • bank and custodial fees  |  |
| • advisory and broker fees associated with merger and acquisition activity | • gross proceeds from derivatives, swaps, and other hedging arrangements, typically performed by the treasury function |

Certain payments made in the ordinary course of business are not treated as withholdable payments under FATCA. However, some of these payments (such as payments for services, rents, and royalties) remain subject to existing information reporting and withholding requirements. Certain obligations in existence on July 1, 2014, are considered ‘grandfathered’ and are not subject to FATCA withholding.

## **I. Federal tax issues**

### *ix. Obligation to identify payees and remit tax*

As a core concept of FATCA, payors of a withholdable payment must ask, ‘who is the payee?’ and ‘is it FATCA compliant?’ Government forms, such as the W-8BEN and W-8IMY, currently relied upon to document payees, are being modified to accommodate FATCA. In addition, the recently released regulations that harmonize the FATCA requirements with the existing IRC Chapter 3 withholding requirements have altered the way in which documentation can be used and have also modified the way in which other types of information can be used to facilitate proper withholding and reporting.

Importantly, the FATCA regime also requires withholding agents to commence 30% FATCA withholding on withholdable payments beginning on July 1, 2014 (with withholding on gross proceeds beginning in 2017).

Payors will need to use the new documents to ensure that their counterparties are FATCA compliant or exempt from withholding. For example, if the withholding agent receives sufficient documentation, such as a global intermediary identification number (GIIN) from an FFI or a valid Form W-8, withholding is not required (although reporting still must be completed).

### *x. Companies that are receiving US-source payments*

Those entities within a group receiving withholdable payments may be subject to 30% FATCA withholding if they cannot provide proper documentation. These may include a nonfinancial entity located outside the United States, which may be treated as an NFFE and subject to FATCA withholding if it fails to timely and properly identify itself to its withholding agent.

### *xi. The cost of noncompliance*

Businesses that do not adhere to the new obligations under FATCA may face a variety of consequences, with possible loss of 30% of the value of specific payments being of foremost concern. Consistent with other US information reporting regimes, a payor that fails to deduct and remit FATCA withholding when required will be liable for 100% of the amount not withheld as well as related interest and penalties.

## **3. Filing requirements**

### *a. Tax period*

US corporate taxpayers are taxed on an annual basis. Corporate taxpayers may choose a tax year that is different from the calendar year. New corporations may use a short tax year for their first tax period, and corporations changing tax years also may use a short tax year.

### *b. Tax returns*

The US tax system is based on the principle of self-assessment. A corporate taxpayer must file an annual tax return (generally Form 1120) by the 15th day of the third month following the close of its tax year. A taxpayer can obtain a six-month extension to file its tax return, provided it timely and properly files Form 7004 and deposits the full amount of any tax due. Failure to timely file may result in penalties.

4. Important tax return due dates for businesses

Form No.	Title	Purpose	Due date
W-2	Wage and Tax Statement	Employers must provide employees with statements regarding total compensation and amounts withheld during year.	Must be sent to employees on or before January 31, with copies to the Social Security Administration.
1099 series	Various	Information returns to be provided to recipients of dividends and distributions, interest income, non-employee compensation, miscellaneous income, etc.	Must be sent on or before January 31.
1120 series, including 1120S (for S corporations)	US Corporation Income Tax Return	Income tax returns for domestic corporations or foreign corporations with US offices.	March 15 (Form 7004 may be filed to obtain an automatic six-month filing extension)
Schedule K-1	Partner's Share of Income, Deductions, Credits, etc.	Information returns to be provided to partners by partnerships.	March 15
1065	US Return of Partnership Income	Information returns to be filed by partnerships.	April 15 (Form 7004 may be filed to obtain an automatic five-month filing extension)
State income tax returns	Various	Income tax returns for states where corporation carries on trade/business.	Varies, often April 15

5. Payment of tax

A taxpayer's tax liability generally must be prepaid throughout the year in four equal estimated payments and fully paid by the date the tax return is initially due for that year. For calendar-year corporations, the four estimated payments are due by the 15th days of April, June, September, and December. For fiscal-year corporations, the four estimated payments are due by the 15th days of the fourth, sixth, ninth, and 12th month of the tax year. Generally, no extensions to pay are allowed. Failure to pay the tax by the due dates can result in estimated tax and late payment penalties and interest charges.

The installment payments must include estimates of regular corporate income tax, AMT, environmental tax, and, for foreign corporations, the tax on gross transportation income. To avoid a penalty, corporations must calculate the installment payments based on at least 25% of the lesser of (i) the tax shown on the

## I. Federal tax issues

current tax return or (ii) the prior year's tax liability, provided that the tax liability was a positive amount in the prior year and that such year consisted of 12 months. However, corporations with taxable income of at least \$1 million (before use of NOLs or capital loss carryforwards) in any of the three preceding years may not calculate the installment based payment on the prior year's tax liability, except in determining the first installment payment. Instead, such corporations must calculate the installment payments based on the tax shown on the current tax return.

Corporations with more than \$1 billion in assets must make estimated tax payments that are 100.25% of the amount otherwise due in July, August, or September of 2014. Such overpayments will be balanced out in October, November, or December of 2014 when payments of 99.75% of the amount otherwise due will be paid by corporations with more than \$1 billion in assets.

### 6. Audit cycle

Many large and mid-size businesses are under continuous audit by the IRS and state tax authorities. The audits may include the entire list of taxes for which the business is liable. Smaller business and persons with lower incomes generally are subject to audit on a random basis of if their returns are selected for audit based on certain criteria.

### 7. Audit programs (CAP)

The IRS Compliance Assurance Program, or CAP, is a collaborative pre-filing program in which the taxpayer and the IRS examination team work together to resolve potential tax issues before the taxpayer files its next tax return. Taxpayers with assets greater than \$10 million are eligible to apply for admission to CAP.

Entering CAP can be a risk-mitigation strategy for taxpayers. Through participation in CAP, taxpayers can minimize or eliminate their tax risk by gaining certainty regarding tax positions prior to filing a tax return.

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**Inbound insight:** *Inbound companies were excluded from CAP in its initial form as a pilot program. When CAP was made permanent in March 2011, the IRS opened it to applications from inbound companies, thereby expressing a willingness to work with inbounds to determine the effectiveness of CAP for such taxpayers.*

*The main IRS concerns regarding inbound participation in CAP included:*

- *The availability and accessibility of required documentation on a real-time basis: and*
- *Issues based on the laws of the foreign jurisdiction where the inbound company is based, such as differences between the financial accounting systems of that country and the United States (e.g., GAAP vs. IFRS) and the possible lack of US-style certified financial statements.*

*The IRS attempts to address these issues by requiring adjustments to the CAP Memorandum of Understanding (MOU) for inbound companies seeking to participate in CAP.*

## 8. Statute of limitations

The IRS generally has three years after an original return is filed to assess income taxes. A return will be deemed to have been filed on its due date, even if the return is actually filed on an earlier date.

## 9. Topics of focus for tax authorities

Currently, the IRS is focused on ‘abusive payments’ related to contribution to capital of a corporation, domestic manufacturing deduction, foreign earnings repatriation, foreign tax credit ‘generators,’ repairs vs. capitalization change in accounting method, research credit claims, transfer of intangibles/offshore cost sharing, withholding taxes, and worker classification as employee or independent contractor.

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**Inbound insight:** Increased cross-border information sharing along with the OECD BEPS initiative (discussed in section IV.B below) are likely to affect audits of inbound companies in the near future, perhaps tempered by short-term IRS budget and resource issues.

## 10. Tax shelters

Treasury regulations require taxpayers to disclose transactions determined to be abusive or possibly abusive. Current information on these transactions, known as listed and reportable transactions, is available from the IRS website.

## 11. Accounting for income taxes

For US federal tax purposes, the two most important characteristics of a tax method of accounting are timing and consistency. If the method does not affect the timing for including items of income or claiming deductions, it is not an accounting method and generally IRS approval is not needed to change it. To affect timing, the accounting method must determine the year in which an income or expense item is to be reported.

In general, to establish an accounting method, the method must be consistently applied. Once an accounting method has been adopted for federal tax purposes, any change must be requested by the taxpayer and approved by the IRS. Changes in accounting methods cannot be made through amending returns. The two most common methods of accounting are the accrual basis and cash basis methods.

## 12. Penalties

Civil and criminal penalties may be imposed for failing to follow the Internal Revenue Code when paying US taxes. The civil penalty provisions may be divided into four categories: delinquency penalties, accuracy-related penalties, information reporting penalties, and preparer, promoter, and protester penalties. Many, but not all, of these provisions include exceptions for reasonable cause in not complying. In addition, many include rules as to how the penalties interact with the other penalties.

## ***I. Federal tax issues***

These four main civil penalty categories may further be divided. First, the delinquency penalties may be divided into failure to file, failure to pay, and failure to make timely deposits of tax. Failure to make timely deposits of tax applies to taxpayers required to make installment payments and withholding tax payments.

Second, the penalties relating to the accuracy of tax returns are divided into the negligence penalty, the substantial understatement penalty, substantial overstatement of pension liabilities, substantial estate or gift tax valuation underestimates, and the valuation penalties. These penalties also are coordinated with the fraud penalty to eliminate any stacking of the penalties. Again, like other provisions, the fraud penalty is not intended to be imposed as a stacked penalty.

The third category of penalties is the information reporting penalties. These penalties may be imposed on those who have a duty only to report information to the IRS.

The fourth category of civil penalties consists of the preparer, promoter, and protester penalties. The return preparer penalty applies with respect to a position on a return for which the preparer did not have substantial authority. Also included in this category is a penalty for willful or reckless attempt to understate the tax liability of another person. In addition, return preparer penalties may be imposed for failure to furnish a copy of a return or claim for refund to the taxpayer, sign the return or claim for refund, furnish his or her identifying number, or file a correct information return.

Other promoter and protestor penalties include a penalty for promoting abusive tax shelters, aiding and abetting the understatement of tax liability, and filing frivolous income tax returns. A court may award sanctions and costs if a person institutes or maintains a proceeding primarily for delay, takes a position that is frivolous, or unreasonably fails to pursue available administrative remedies.

In addition to these major civil penalties, there are international tax-related penalties for failures other than timely and accurate filing—e.g., willful failure to report international boycott activity, failure of an agent to furnish a notice of a false affidavit relating to the withholding tax on dispositions of US real property interests, failure of a US person to furnish information relating to CFCs and controlled foreign partnerships, and failure of a US person to report foreign bank accounts. Pension and employee benefit-related tax penalties are intended to protect the policy reasons for the tax incentives including, most notably, early withdrawal of pension funds. Another group of specialized penalties applies to tax-exempt organizations.

Criminal penalties exist for situations when the failures to stay within the tax system are more egregious. Although applicable to corporate taxpayers, they are applied more frequently to individuals.

In addition to the penalty provisions, interest at statutory rates generally applies to underpayments of tax.



### 13. Elective entity classification ('check-the-box')

For US federal income tax purposes, the Internal Revenue Code and the Treasury regulations prescribe the classifications of business entities and organizations. Whether an organization is an entity separate from its owners for US federal income tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

A business entity with two or more members is classified for US federal income tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded. If the entity is disregarded, its activities are treated in the same manner as a branch, division, or sole proprietorship.

The initial classification of a business entity depends on the prescribed default classification. The default classification is based on several factors, including whether the entity is domestic (organized or incorporated in the United States) or foreign (not organized or incorporated in the United States).

With respect to foreign entities, the regulations deem certain entities as 'per se' corporations. 'Per se' corporations must retain the default classification of corporation and may not elect classification as a partnership or disregarded entity. Any other foreign entity generally has the default classification of corporation if all owners have limited liability, or the default classification of partnership (or disregarded entity) if one or more owners has unlimited liability.

An eligible foreign entity that is not classified as a 'per se' corporation may elect a classification that departs from the default classification. The election is subject to specific procedural rules and is made by filing Form 8832, *Entity Classification Election*, with the IRS.

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**Inbound insight:** *The limited liability company (LLC) is a popular form of business entity organization in the US because of the limited liability for owners, as determined under state law, as well as flexibility under the 'check-the-box regulations.' That is, a US LLC has the default classification of either a disregarded entity or partnership (depending on the number of owners), but is eligible to make an entity classification election to change from the default classification to the classification of corporation for US income tax purposes.*

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## II. State and local tax issues

Foreign companies with activity in the United States often are surprised that such activity may trigger both federal and state-level taxes. Even more surprising is that there are no uniform rules among the states as to whether state tax liability attaches; in some cases, significant state tax liabilities may be imposed even if little or no US federal tax obligations exist.

Foreign companies may not have experience dealing with taxing authorities within a country that have such broad taxing powers.

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**Inbound insight:** *Several aspects of state taxation are critical for owners of non-US companies to understand, including a state's power to tax, income apportionment among multiple states, filing methodologies, tax base issues, treatment of foreign-source income, transfer pricing adjustment considerations, registration requirements, and indirect taxes.*

### A. Activities that could subject a foreign entity to state tax

A state's power to impose a tax is derived from the US Constitution and may be limited by the Commerce Clause of the Constitution, the Due Process Clause of the Constitution, federal statutes, such as Public Law (P.L.) 86-272, and state law, such as 'doing business' statutes.

US treaties generally do not apply to state taxation, unless specifically mentioned in the treaty or if a state voluntarily follows treaty provisions. A foreign entity should understand the various bases for state taxation that may subject its activities to state taxation.

A state generally may impose its tax on an entity to the extent a sufficient 'nexus,' or taxable connection, exists between the entity and the state. While US federal taxation generally requires a threshold level of activity of being 'engaged in a trade or business' or having a 'permanent establishment,' mere physical presence in a state, such as having employees or property in the state, generally may be sufficient for nexus to exist for state taxation purposes. Thus, a foreign company may not have a permanent establishment in a particular state, but it may have sufficient nexus to that state to become subject to that state's taxes.

States also may assert that a foreign corporation has nexus through the in-state activities of an agent or affiliate. Some states also have applied 'economic' nexus or 'factor presence' principles.

Economic nexus could be deemed to exist between a state and a company based on the presence of intangible property in a state. For example, the license of trademarks to a company located in a state could create nexus for the out-of-state licensor on the basis that the intangibles are 'present' in the state. A 'factor presence' standard establishes nexus based on a certain level of sales activity into a state even in the absence of physical presence in the state. States such as California, Ohio, and Washington have enacted factor presence standards for certain taxes. California's factor presence statute, for example, provides that an entity is doing business with the state if the entity's California sales exceed \$500,000.

One statute that may protect inbound companies is P.L. 86-272, under which a state is prohibited from imposing an income tax if the only business activity in the state is the solicitation of sales of tangible personal property, provided that the orders are approved and shipped or delivered from outside the state. As the language of the provision indicates, the protection applies only to income tax and the sale of tangible personal property. Service activities and other non-tangible property sales are not protected.

With broad nexus concepts, state tax jurisdictions may appear to have a greater reach than US federal tax provisions with respect to taxing non-US entities. However, there is one US federal tax requirement that does not apply to state taxation. A non-US entity that is neither engaged in a trade or business within the United States nor has a permanent establishment in the United States still may be subject to withholding tax on US-source income that is ‘fixed or determinable annual or periodical income,’ such as interest, dividends, or royalties. From a state tax perspective, the receipt of interest or dividends by itself generally will not create nexus. The receipt of royalties also generally will not create nexus for state taxation, unless such royalties are derived from in-state intangible property that is deemed to create ‘presence’ in a state that has adopted an economic nexus rule.

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***Inbound insight:*** *It is critical to understand that states generally do not follow US tax treaties, but rather adopt different rules on whether a state has tax jurisdiction over a company (i.e., does the company have nexus to the state). The concept of nexus to tax in a state has been evolving over a number of years and is both complex and subject to unexpected results. This is a topic that can create confusion within senior management of a non-US parent company, especially when disputes arise with states that are not anticipated due to the perceived limited activities in that state.*

### **B. Dividing up taxable income among the states: multistate apportionment**

Non-US entities may be familiar with the US federal tax concept of effectively connected income—that is, being taxed on income that is derived from a US business. However, for state tax purposes, a percentage of the entire net income of an entity (or group of entities, as discussed below) may be subject to tax by a state. That percentage generally relates to the proportionate level of activity the entity has within the state as compared with its activity outside the state.

Activity may be measured by the relative in-state sales, property, payroll, or any combination of the three. Some states weight sales activity greater than property and payroll. A current trend among states is a move to a single-sales weighted apportionment factor. Using a single-sales factor results in the state increasing its taxable reach among out-of-state taxpayers because the absence of in-state property and payroll does not serve to dilute the apportionment percentage assigned to the state, as would be the case for a state that incorporates a property or payroll factor.

## II. State and local tax issues

Complexities arise as states do not uniformly apportion income. For example, the assignment of service income to a particular state may be treated in various ways. Some states source service income to the location where the provider incurs the greater cost in performing the service. Other states employ a marketplace approach, sourcing to where the customer receives the benefit of the service.

Sales of tangible personal property generally are sourced to the state of destination. One exception applies to the extent a state has a 'throwback' rule. Under throwback, sales are sourced to the state of origin if the taxpayer does not have nexus with the destination state or country.

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**Inbound insight:** *The potential combination of (1) a state asserting nexus based merely on a company having a certain threshold level of sales in a state with (2) a single-sales factor apportionment regime and (3) US treaties not binding the state could result in substantial state income tax liability for an inbound company.*

### **C. Tax filings include more than just the in-state entity: combined, water's edge, worldwide filing methodologies, and tax havens**

States vary in their treatment of reporting income among affiliates. 'Separate company' states require a taxpayer to report only the income of the taxable entity. 'Unitary combined' states may require a unitary group of corporations—which may be different from a US consolidated group, and which may include different members from state to state—to file as a combined group regardless of whether a particular entity has nexus with the state. This unitary group could consist only of US corporations (a 'water's-edge' filing) or could include all global entities (a 'worldwide' filing).

Generally, states that give taxpayers an option between water's-edge and worldwide provide worldwide filing as the default, like California, and taxpayers must elect to file water's-edge returns. In California, a water's-edge election, which must be made on a timely filed original return, is an 84-month commitment. A California water's-edge combined report generally will include a foreign corporation to the extent of its effectively connected income (income derived from or attributable to sources within the United States). Note that California does not recognize provisions of US treaties. Thus, to the extent treaties limit the application of effectively connected income provisions of the Internal Revenue Code, California does not follow the limitations. Any controlled foreign corporation (to the extent of its Subpart F income over its earnings and profits) is included in the California water's-edge combined report as well. Wisconsin has a similar rule regarding effectively connected income.

Accordingly, the risk exists that a single entity's presence in a US state could bring the income of a global group of affiliated entities within the taxing power of that state.

As noted above, composition of the group may vary among states. Some states may exclude '80/20' companies and may define such companies in various ways

(generally, companies with 80% or more activity outside the United States). Other states may require certain taxpayers to be excluded from a reporting group based on their business. For example, a financial institution may be excluded from a reporting group because it either apportions its state taxable income in a fashion different from its other related affiliates or it is subject to tax on a different tax base such as gross receipts.

A development that has gained importance in recent years involves states including ‘tax haven’ entities within a reporting group. States that would otherwise impose (or allow as a taxpayer election) a water’s-edge return limited to US companies have been expanding their reach to include non-US entities incorporated or doing business in certain foreign jurisdictions.

Alaska, the District of Columbia, Montana, Oregon, and West Virginia include such entities to varying degrees. The Multistate Tax Commission has approved a model tax haven statute that other states could adopt. Inbound companies doing business in these states should be aware that non-US entities could be included in unitary state returns by virtue of their incorporation or activity in identified ‘tax haven’ jurisdictions.

### ***D. Adjustments to federal taxable income***

The starting point for determining US state taxable income generally is an entity’s federal taxable income. If an entity has no federal taxable income, this does not mean that it has no state taxable income. Some states may require an addback of a foreign corporation’s income that is exempt from federal tax by treaty. Other states may require federal taxable income to be calculated on a pro forma basis as if a treaty did not apply.

Another discrepancy between US federal and US state taxable income arises due to related-party expenses. Certain expenses, such as royalties and interest, may be deductible for US federal tax purposes, but if such expenses are paid to a foreign or domestic related party, those expenses may have to be added back to taxable income for US state purposes. While most states have a foreign treaty exception to the addback, the particular treaty must be analyzed because states may consider a US treaty that calls only for a lower tax rate to be different from a US treaty that exempts all the income from tax.

### ***E. Treatment of foreign-source income***

While the treatment of foreign-source income technically is an issue for US domestic entities, the complexities of how such income is treated may be important to non-US entities with federal and state tax reporting obligations.

For US federal tax purposes, domestic corporations receiving dividends from foreign affiliates are not allowed a dividends-received deduction (DRD) as they would for dividends from a domestic subsidiary. Rather, the foreign dividends are included in taxable income and the taxpayer may receive a credit for foreign taxes paid. Some states may allow a deduction for all or a portion of dividends received from a foreign entity.

## II. State and local tax issues

US shareholders of foreign controlled corporations (CFCs) may be required to include a portion of the foreign entity's undistributed earnings in their federal taxable income. This deemed income is commonly referred to as Subpart F income. For state tax purposes, if the state starts with federal taxable income, the 'deemed' dividend will be included in the state tax base. States differ with regard to the extent to which the Subpart F deemed dividend and the Section 78 dividend gross-up are subject to a DRD.

California employs unique rules with regard to foreign-source income. California requires that a water's-edge filer include a portion of certain CFC income and apportionment factors. The portion to be included is computed using a ratio of the CFC's Subpart F income to its total earnings and profits (its 'inclusion ratio'). Dividends paid between unitary group members are eliminated to the extent the dividends are paid from previously taxed income. There also is a 75% deduction for certain dividends not eliminated (i.e., paid from excluded income).

### ***F. States with transfer pricing adjustment power***

Many states have IRC Section 482-type powers to adjust the income or apportionment factors of taxpayers (known generally as UDITPA section 18 powers). States may force combined reporting on certain taxpayers regardless of whether intercompany transactions are at arm's length. Further, states may disallow interest expense to a foreign affiliate under their Section 482-type powers, even if the IRS has not adjusted that same payment. These are concerns for domestic and foreign companies alike, but it may come as a surprise to non-US companies that US states have broad income adjustment powers that mirror federal powers.

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***Inbound insight:*** *A state may disallow deductions for certain interest or royalties paid to a related foreign entity, even though allowed by the IRS.*

### ***G. Indirect tax considerations***

State indirect taxation generally is any state tax that is not based on income. The most common indirect tax is a state's sales and use tax, but other indirect taxes include franchise taxes, real estate transfer taxes, telecommunications taxes, commercial rent taxes, and hotel occupancy taxes. The indirect taxes that apply depend on the nature of the company's business activities. A non-US company might be surprised at the number of indirect taxes that it has to consider.

The nexus-creating activities outlined in the discussion above apply generally to state income and franchise taxation. A non-US company's exposure to sales and use taxes differs slightly from that for income and franchise purposes in that a state is precluded from imposing its sales and use tax obligations on an entity unless that entity has a physical presence in the state.

Concepts of economic nexus or an intangible presence are not relevant for sales and use tax purposes; however, states continue to push the bounds of what a 'physical' presence encompasses. Concepts of combined and consolidated reporting

also are not relevant for sales tax purpose, as each entity is a separate taxpayer for sales and use tax purposes. As a result, states have been aggressive in imposing agency or affiliate nexus as a means of bringing out-of-state companies into their taxing jurisdiction.

In certain states, a recent trend is the establishment of nexus due to the use of affiliate marketers for out-of-state sellers. Affiliate marketing is an internet-based marketing practice under which an in-state third party promotes the products or services of an out-of-state seller by providing a link on its website to those products or services and the out-of-state seller compensates the in-state third party for such promotion. Recently, some states have enacted legislation that creates a rebuttable presumption that an out-of-state seller engaging in affiliate marketing with an in-state third party has nexus and therefore is required to collect sales tax.

As discussed above, one of the nexus protections for state income and franchise taxes is P.L. 86-272, but that statute does not apply to non-income taxes. Accordingly, an entity with employees engaged only in the solicitation of tangible personal property within a state, which otherwise is protected from income tax nexus under P.L. 86-272, still may be subject to a state's sales and use tax and other non-income-based taxes (e.g., franchise taxes based on net worth).

Once a company has nexus to a state with respect to sales and use taxes, that company must register with the state's tax department, file sales tax returns, and pay its sales tax liabilities. Depending on the volume of sales, the company may be required to file returns on an annual, quarterly, or monthly basis. Generally, sales tax is imposed on retail sales, leases, rentals, barter, or exchanges of tangible personal property and certain enumerated services unless specifically exempted or excluded from tax.

Sales tax generally is imposed in the jurisdiction in which the 'sale' occurs. The definition of 'sale' differs from jurisdiction to jurisdiction; however, the definition generally includes both (1) consideration and (2) transfer of title, right to use, or control (possession) in the case of tangible property and completion of the service act in the case of a service.

All retail sales of tangible personal property are presumed to be taxable sales unless the contrary is established. When tangible personal property is sold, and the purchaser intends to resell the property, the sale is not a retail sale; rather, it is a sale for resale. A resale exemption is allowed because the intermediate sale does not represent the ultimate sale or final consumption sale of the tangible personal property. The burden of proving that a sale is not a sale at retail is on the seller unless an exemption applies. For example, the collection of a resale certification from purchasers generally supports the position that the sale is an exempt sale for resale.

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***Inbound insight:*** While appearing similar at first, a VAT is much different than a state sales or use tax, both with respect to incidence of taxation and items subject to tax. Further, not only states, but thousands of separate jurisdictions within states, levy sales and use taxes.

### ***H. Local taxation***

Cities that impose their own income tax modeled after their respective state's combined unitary reporting methodology include New York City; Portland, Oregon; and Detroit, Michigan. A non-US entity doing business in Kentucky or Ohio could find itself subject to dozens of individual city returns, as many cities in those states impose separate income tax filing obligations. Compliance complexities multiply because US taxation geographies are further divided within states and some US cities have significant taxing powers.

In addition, these and other cities impose local level sales and use taxes. Administratively, the sales taxes usually are collected by and remitted to the state, and then allocated to the localities. Generally, the rules for the localities are modeled after the rules for the states, but this is not always the case. The rules can vary from jurisdiction to jurisdiction. Overall, there are thousands of indirect taxing jurisdictions in the United States. Any non-US company doing business in the United States should be aware of all the various indirect taxes that may be imposed.

### ***I. Credits and incentives: state and local***

From a US state and local tax perspective, there are two main methods for incentivizing business: statutory credits and discretionary incentives.

Statutory credits typically are offered to all qualifying companies within a jurisdiction and can, in certain circumstances, be claimed retroactively. Discretionary incentives, on the other hand, typically must be negotiated between the taxpayer and the state and local governing bodies or economic development groups prior to commencement of the project.

#### ***1. Statutory credits***

State and local governments have become more competitive in offering tax credits to attract and retain growing companies for the purpose of promoting economic development. Today there are hundreds of statutory tax credits available as a result of this competition.

A number of these credits mimic the federal credits discussed above, but usually apply to activities performed only in a given state or local jurisdiction. Such credits may include:

- hiring and jobs tax credits
- investment tax credits
- alternative and renewable energy tax credits
- research and development credits
- contribution credits
- port tax credits.



## **2. Discretionary incentives**

State and local governments continue to add to the increasing complex array of economic incentives to encourage private-sector investment.

The types of incentives offered vary significantly depending on jurisdiction and industry. The majority of incentives are based, at least partially, on increases in workforce and capital investment in property. A number of other factors such as the location of the project, wages of employees, amount and types of benefits offered to employees, and type of investments, also may be considered.

Incentives can take many forms, such as:

- property tax abatements
- infrastructure grants
- training grants
- cash grants
- withholding tax rebates
- reduced financing
- utility tax exemptions
- construction fee waivers.

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### ***III. US tax treaties***

The United States has in place bilateral income tax treaties with more than 60 countries. The US government enters into such treaties for several reasons, including:

- to stimulate international trade and investment
- to promote cooperation among countries in enforcing and administering tax laws
- to promote information exchange
- to reduce or eliminate double taxation and excessive taxation.

US income tax treaties typically cover various categories of income, including:

- business profits
- passive income, such as dividends, interest, and royalties
- income earned by teachers, trainees, artists, athletes, etc.
- gains from the sale of personal property
- real property income
- employment income
- shipping and air transport income
- income not otherwise expressly mentioned.

The categories of income covered vary from treaty to treaty, and no two treaties are the same. Appendix A summarizes the benefits (reduced withholding rates) resulting from US tax treaties.

To gain treaty benefits, it is necessary to satisfy the conditions of the residency article as well as certain other requirements. In general, an individual is treated as a resident of the country in which the individual is subject to tax by reason of domicile, residence, or citizenship. A corporation generally is treated as resident in the country in which it is subject to tax by reason of its place of management, place of incorporation, or similar criteria. US domestic rules contain provisions that address the treatment of the availability of treaty benefits to income received by fiscally transparent entities; some US treaties also address fiscally transparent entities.

The vast majority of US tax treaties contain limitation on benefits (LOB) articles. LOB articles are anti-‘treaty-shopping’ provisions that are designed to deny treaty benefits when the party seeking the benefits does not have sufficient connection to the jurisdiction in which it is resident to support the application of the treaty. In recent years, US Treasury has made it a priority to renegotiate the more commonly used treaties that did not have LOB articles. Two of those treaties—the US treaties with Hungary and Poland—have been renegotiated but have not yet been ratified.

LOB articles provide objective tests (e.g., ownership-base erosion test, publicly traded company test, or active trade or business test) to determine whether an entity is appropriately claiming treaty benefits or was created merely to obtain treaty benefits. Even if objective tests are not met, a country's competent authority may grant treaty benefits upon request by the taxpayer.

The US tax treaty network includes treaties with most European countries and other major trading partners, including Mexico, Canada, Japan, China, Australia, and the former Soviet Union countries. There are many 'gaps' in the US tax treaty network, particularly in Africa, Asia, the Middle East, and South America. A new treaty with Chile was signed in 2010 but has yet to be ratified.

There are continued efforts to expand the network of countries that have adequate tax information exchange agreements with the United States. In addition to its bilateral income tax treaties, the United States currently is a party to more than 23 tax information exchange agreements, which provide the legal basis for exchanges of information between tax administrations.

In addition, the US Treasury has signed more than 25 bilateral intergovernmental agreements (IGAs) related to the implementation of the FATCA information reporting and withholding tax provisions (discussed above). Treasury also has announced that 22 other jurisdictions have reached agreements in substance and will be treated as having IGAs in effect with the US.

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***Inbound insight:*** As noted in the state and local tax discussion above, states are not restricted in their taxing powers by federal limitations such as 'engaging in a trade or business,' having a 'permanent establishment,' or treaty restrictions.

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## ***IV. Transfer pricing***

Transfer pricing is a term used to describe intercompany pricing arrangements relating to transactions between related entities. These can include transfers of intellectual property, tangible goods, or services, as well as loans or other financing transactions, which can occur across local, state, or international borders. Due to growing government deficits, many jurisdictions are putting additional pressure on transfer pricing in order to secure a portion of entities' profits for themselves. This can result in the risk of double taxation, penalties for failure to properly allocate income among two or more jurisdictions, or the risk of inefficient allocations of functions, assets, or risks between related parties. Therefore, virtually all large multinationals require consideration of international transfer pricing strategies and potential risks.

### ***A. Elements of transfer pricing***

Transfer pricing applies to a wide range of intercompany transactions, including transactions involving:

- tangible goods (e.g., manufacturing, distribution)
- services (e.g., management services, sales support, IT services)
- financing (e.g., intercompany loans, accounts receivable, guarantees)
- intangibles (e.g., royalties, cost sharing, buy-in payments, sales of intangibles).

The international standard for determining the appropriate transfer price is the arm's-length principle. Under this principle, transactions between two related parties should not differ from those that would be made between independent companies under similar circumstances. This principle is cited in the US transfer pricing rules (IRC Section 482 and the Treasury regulations thereunder), the OECD Transfer Pricing Guidelines, and the UN Manual for developing countries.

If a transaction between related parties is priced differently than if it were between unrelated parties, the IRS may treat the transaction as though it had not been conducted at arm's length and reallocate income and expenses accordingly, or alternatively re-characterize the transaction consistent with the actual conduct of the parties.

The Section 482 regulations are extensive and attempt to address a full range of transactions in light of the arm's-length standard. In practice, however, it is not easy to determine the appropriate arm's-length result based on a given set of facts and circumstances. Transactions in goods and services may embody unique, company or industry-specific elements that are difficult to compare with other companies. The Section 482 regulations concede the rarity of identical transactions, and instead attempt to determine the arm's-length results based on the 'best method' rule.

## **1. Best method rule**

The Section 482 regulations provide several methods to test whether a price meets the arm's-length standard. Although there is no strict priority of methods, and no method invariably will be considered to be more reliable than another, every transaction reviewed under Section 482 must be judged under the method that, under the facts and circumstances, provides the most reliable measure of an arm's-length result (the 'best method').

The selection of a method also varies depending on the type of property. For example, the regulations provide five methods for transactions involving tangible property, while only three are available for transactions involving intangible property. Note that while each method is important to understand, an examination of each is beyond the scope of this discussion.

## **2. Comparability factors**

To determine the best method available, the relative reliability of a method is based on the degree of comparability between the controlled transaction or taxpayers and the uncontrolled comparables, taking into account certain factors. While a specific comparability factor may be of particular importance in applying a method, each method requires an analysis of all the factors that affect comparability under that method.

## **3. Quality of data and assumptions**

Whether a method provides the most reliable measure of an arm's-length result also depends upon the reliability of the assumptions and the sensitivity of the results to possible deficiencies in the data and assumptions.

The completeness and accuracy of the data affect the ability to identify and quantify those factors that would affect the result under any particular method. Likewise, the reliability of the results derived from a method depends on the soundness of such assumptions. Finally, the sensitivity of results to deficiencies in data and assumptions may have a greater effect on some methods than others. In particular, the reliability of some methods depends heavily on the similarity of property or services involved in the controlled and uncontrolled transaction.

## **4. Arm's-length range**

Due to the difficulty in determining a pricing method that produces the most reliable measure of an arm's-length result, the Section 482 regulations also provide that a taxpayer will not be subject to adjustment if a method's results fall within an arm's-length range. The arm's-length range ordinarily is determined by applying a single pricing method selected under the best method rule to two or more uncontrolled transactions of similar comparability and reliability. The comparables used for the uncontrolled transactions must be sufficiently similar to the controlled transaction. If material differences exist between the two transactions, adjustments must be made for the uncontrolled transaction to have a similar level of comparability and reliability.

### 5. Penalties and documentation

The US transfer pricing regulations encourage taxpayers to make a serious effort to comply with the arm's-length standard in setting prices for controlled transactions; report an arm's-length result on their income tax return; document their transfer pricing analysis; and provide documentation to the IRS upon request.

Failure to comply with these regulations can result in large adjustments and significant penalties under Section 6662(e). The penalty generally is equal to 20% of the underpayment of tax attributable to the misstatement, but increases to 40% of the underpayment for a gross valuation misstatement when the deviation in the actual and correct price is 400% or more (or 25% or less). Having contemporaneous transfer pricing documentation in place at the time the tax return is filed can help provide protection against these penalties.

Another avenue for avoiding potential transfer pricing penalties can be an advance pricing agreement (APA)—an agreement between a government and a taxpayer that provides prospective 'certainty' for a defined term regarding covered intercompany transactions. APAs can be unilateral (between the taxpayer and the IRS), bilateral (with the IRS and another tax authority), or multilateral (with the IRS and more than one other tax authority).

In the future, other approaches for avoiding penalties for certain controlled transactions without the need for documentation or APAs may become available. For example, the United States is considering providing safe harbors for certain types of routine transactions, such as distribution functions of inbound companies. The US view on this approach is similar to that outlined by the OECD. However, the United States intends to implement any such policy in a bilateral fashion that would require reaching a separate agreement with each treaty partner. As a result, it likely will take some time before safe harbors become a component of US tax policy.

### B. The OECD's BEPS project

The OECD in July 2013 published an Action Plan that addresses the perceived flaws in international tax rules that were discussed in the OECD's February 2013 Base Erosion and Profit Shifting (BEPS) report. The 40-page Action Plan contains 15 separate action points or workstreams, some of which are further split into specific actions or outputs. The Plan is focused on addressing these issues in a coordinated, comprehensive manner, and was endorsed by G20 leaders and finance ministers at their summit in St. Petersburg in September 2013.

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**Inbound insight:** *According to the Plan, most of the actions will take one to two (or more) years to complete. However, it may take considerably longer to fully implement these changes. Meanwhile, there are indications that the BEPS project and related developments already are leading to a material shift in the behavior of tax authorities.*

Governments, revenue authorities, and businesses all will have material roles to play if the proposed changes are to be implemented.

The Action Plan calls for fundamental changes to the current mechanisms and the adoption of new consensus-based approaches, including anti-abuse provisions, designed to prevent and counter base erosion and profit shifting. These generally fall under the following three areas:

- New international standards must be designed to ensure the coherence of corporate income taxation at the international level.
- A realignment of taxation and relevant substance is needed to restore the intended effects and benefits of international standards, which may not have kept pace with changing business models and technological developments.
- The actions implemented to counter BEPS cannot succeed without further transparency, or without certainty and predictability for business.

The 15 workstreams in the Plan are:

- the digital economy
- hybrid mismatch arrangements
- CFC regimes
- financial payments
- harmful tax practices
- treaty abuse
- PE status
- transfer pricing and intangibles
- transfer pricing and risks/capital
- transfer pricing and other high-risk transactions
- data and methodologies
- disclosure of aggressive tax planning
- transfer pricing documentation
- dispute resolution mechanisms
- a multilateral instrument.

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**Inbound insight:** Companies should monitor the progress of the OECD workstreams, especially with regard to the OECD's specific focus areas. Companies proactively should perform internal risk assessments of their existing and planned structures, considering the increased focus on 'substance' and the potential for more transparency and public disclosure of their tax return information and allocation of profits around the world. Since many of the Plan's changes are directed at US businesses, companies with US operations should pay particular attention to changes in the behavior of US tax authorities even before any parts of the Plan are implemented in the United States.

# V. Individual tax issues

The United States levies tax on its citizens and residents on their worldwide income. Nonresident aliens are taxed on their US-source income. For discussion of how the United States determines the residence status of an alien, see section V. D. Residence, below.

## A. Personal income tax rates

The American Taxpayer Relief Act of 2012 (ATRA) permanently extended the 2001 and 2003 individual tax rates that were set to expire on December 31, 2012, for most taxpayers. ATRA added a new top individual income tax rate of 39.6% and a new top rate of 20% for capital gains and qualified dividends.

Single taxpayers—2014 (1)			
Taxable income in \$			
Over	Not over	Tax on column 1 in \$	Tax on excess (%)
0	9,075	0	10
9,075	36,900	907.50	15
36,900	89,350	5,081.25	25
89,350	186,350	18,193.75	28
186,350	405,100	45,353.75	33
405,100	408,750	117,541.25	35
408,750		118,188.75	39.6

Married couples filing jointly and surviving spouses—2014 (1, 2)			
Taxable income in \$			
Over	Not over	Tax on column 1 in \$	Tax on excess (%)
0	18,150	0	10
18,150	73,800	1,815.00	15
73,800	148,850	10,162.50	25
148,850	226,850	28,925.00	28
226,850	405,100	50,765.00	33
405,100	457,600	109,587.50	35
457,600		127,962.50	39.6



Married individuals filing separately—2014 (1)			
Taxable income in \$			
Over	Not over	Tax on column 1 in \$	Tax on excess (%)
0	9,075	0	10
9,075	36,900	907.50	15
36,900	74,425	5,081.25	25
74,425	113,425	14,462.50	28
113,425	202,550	25,382.50	33
202,550	228,800	54,793.75	35
228,800		63,981.25	39.6

Head of household—2014 (1, 2)			
Taxable income in \$			
Over	Not over	Tax on column 1 in \$	Tax on excess (%)
0	12,950	0	10
12,950	49,400	1,295.00	15
49,400	127,550	6,762.50	25
127,550	206,600	26,300.00	28
206,600	405,100	48,434.00	33
405,100	432,200	113,939.00	35
432,200		123,424.00	

## Notes

1. The maximum federal income tax rate on capital gains is 20% for assets held for more than 12 months (23.8% if the net investment income tax discussed below applies). The graduated rates of tax apply to capital gains from assets held for 12 months or less.
2. Nonresident aliens may not take advantage of head-of-household status or joint return rates. However, a US citizen or resident with a nonresident alien spouse may do so.

## B. Alternative minimum tax (AMT)

In lieu of the tax computed using the above rates, the individual AMT may be imposed under a two-tier rate structure of 26% and 28%. The 26% rate is applied to the first \$179,500 (\$89,750 for married individuals filing separate returns) of a taxpayer's alternative minimum taxable income (AMTI) in excess of an exemption amount; thereafter, the 28% rate is applied.

The exemption amount for 2014 is \$82,100 for married couples filing jointly or surviving spouses, \$41,050 for married individuals filing separate returns, and \$52,800 for single individuals. If AMTI exceeds \$156,500 for married couples filing jointly (\$78,250 for married individuals filing separate returns and \$117,300

## **V. Individual tax issues**

for other taxpayers), the exemption is reduced by 25% of the excess amount. The exemption and phase-out amounts are indexed annually.

The AMT is payable only to the extent it exceeds the regular net tax liability. The foreign tax credit is available for determining AMT liability to the extent of the foreign tax on the foreign-source AMTI, subject to certain limitations.

AMTI generally is computed by starting with regular taxable income, adding tax preference deductions (claimed in the computation of regular taxable income), and making special adjustments to some of the tax items that were used to calculate taxable income. For example, the taxpayer must add back all state and local income taxes deducted in computing regular taxable income.

For nonresident aliens with a net gain from the sale of US real property interests, the AMT is calculated on the lesser of AMTI (before the exemption) or the net gain from the sale of the US real property interest.

## **C. State and local income taxes**

Most states, and a number of municipal authorities, impose income taxes on individuals working or residing within their jurisdictions. (For more information, see section II, State and local tax issues, above.)

## **D. Residence**

The determination of an alien individual's residence status is made using a set of relatively objective tests. These rules generally treat the following individuals as residents:

- *All lawful permanent residents for immigration purposes (i.e., 'green card' holders).* Resident alien status generally continues until the green card is formally relinquished. Thus, individuals who hold green cards but leave the United States to live abroad indefinitely or permanently generally will continue to be classified and taxed as resident aliens until the green card is relinquished. Complex rules also apply to individuals who relinquished their green cards if they held the green card in at least eight of the 15 years prior to relinquishment. In light of these rules, professional tax advice should be sought prior to obtaining or relinquishing a green card.
- *Individuals who meet a 'substantial presence test.'* An individual meets this test if present in the United States for at least 31 days in the current year and a total of 183 equivalent days during the current year and prior two years. For the purposes of the 183-equivalent-day requirement, each day the individual is present in the United States during the current calendar year counts as a full day; each day in the preceding year counts as one-third of a day; and each day in the second preceding year counts as one-sixth of a day. Note that an individual who can establish a 'closer connection' to his or her home country still may qualify as a nonresident, even if the 183-equivalent-day requirement

is met. Other exemptions are also available for certain students, teachers, or trainees; employees of foreign governments and international organizations; certain individuals with medical problems that arise while in the United States; and certain Mexican and Canadian residents who commute to work in the United States.

Special rules apply when determining the portion of the year an individual will be treated as a resident or nonresident in the first and last years of residency.

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***Inbound insight:*** Resident alien status often results in lower US tax than nonresident alien status, due to increased allowable deductions and lower tax rates for certain married taxpayers. Consequently, certain nonresident aliens may choose to elect resident alien status, if specific requirements are met. Note that with resident alien status comes enhanced reporting requirements under FATCA (discussed in detail above). Resident aliens must file Form 8938, Statement of Specified Foreign Financial Assets.

The United States has income tax treaties with a number of foreign countries for the purpose of eliminating double taxation. If there is a tax treaty in effect between the United States and an individual's home country, the provisions of the treaty may override the US resident alien rules.

Under many of these treaties, an individual classified as an income tax resident under the internal laws of both the United States and his or her home country who can show that a 'permanent home' is available only in the home country generally will be classified as a nonresident alien for purposes of US income tax law under a series of other tests, if necessary. A form must be filed to claim nonresident alien status as the result of a tax treaty. (For more information, see section III, US tax treaties, above, and Appendix A for a summary of tax treaty benefits.)

## **E. Other taxes**

### **1. Social security contributions**

For 2014, social security tax (old-age, survivors, and disability) is withheld at 6.2% on the first \$117,000 of wages paid to resident and nonresidents who work as employees in the United States. Medicare hospital insurance taxes are withheld on 1.45% of all employee wages with no dollar cap.

Social security tax for resident self-employed individuals equals 12.4% of the first \$117,000; Medicare hospital insurance taxes equals 2.9% of all net self-employment income of residents. Nonresident aliens are not subject to social security and Medicare hospital insurance taxes on self-employment income.

For wages received in tax years beginning after December 31, 2012, the employee portion of Medicare hospital insurance tax is increased by an additional 0.9% on wages received in excess of \$250,000 for a married couple filing a joint return,

## **V. Individual tax issues**

\$125,000 for a married individual filing a separate return, and \$200,000 for all other individuals (these thresholds are not indexed for inflation). Similarly, for tax years beginning after 2012, the Medicare portion of the self-employment tax rates is increased by an additional 0.9% (i.e., to 3.8%) for self-employment income in excess of those threshold amounts.

Social security and Medicare hospital insurance taxes are not deductible when determining an employee's taxable income for income tax purposes. However, a deduction is allowed for an amount equal to one-half of the combined self-employment social security and Medicare hospital insurance taxes that are imposed.

Note that the United States has entered into totalization agreements with several nations for the purpose of avoiding double taxation of income with respect to social security taxes. These agreements must be taken into account when determining whether any alien is subject to US social security and Medicare hospital insurance taxes or whether any US citizen or resident alien is subject to the social security taxes of a foreign country. (For a list of countries with which the United States has totalization agreements, see Appendix B.)

Beginning in 2013, a new 3.8% 'unearned income Medicare contribution' tax applies to the lesser of (1) the taxpayer's net investment income for the tax year or (2) the taxpayer's excess modified adjusted gross income over a threshold amount (generally, \$200,000; \$250,000 for a married couple filing a joint return). The tax, which is in addition to regular income tax liability, applies to all individuals subject to US taxation other than nonresident aliens. Net investment income generally includes nonbusiness income from interest, dividends, annuities, royalties, and rents; income from a trade or business of trading financial instruments or commodities; income from a passive-activity trade or business; and net gain from the disposition of nonbusiness property.

### **2. Capital gains taxes**

The maximum federal regular income tax rate on capital gains is 20% for assets held for more than 12 months (23.8% if the net investment income tax, discussed above, applies). The graduated income tax rates apply to capital gains from assets held for 12 months or less.

### **3. Consumption taxes**

The United States does not have a federal-level consumption tax.

### **4. Net wealth/worth taxes**

The United States does not have a federal level net wealth/worth tax.

## **5. Inheritance, estate, and gift taxes**

The United States imposes a federal estate tax on the fair market value of assets that an individual transfers or is deemed to transfer at death. Individuals who are US citizens or residents are subject to federal estate tax on their worldwide assets (usually including life insurance proceeds). Individuals who are nonresident aliens are subject to US federal estate tax on only US-situs assets and other special rules may apply. It can be difficult to determine whether a particular individual is resident for estate tax purposes.

For 2014, there is a \$5.34 million per-person estate, gift, and generation-skipping transfer tax exemption amount. The top tax rate is 40%.

The purpose of the gift tax is to prevent the lifetime transfer of assets without estate tax liability. Similarly, a generation-skipping tax exists to prevent avoidance of tax by skipping generations when making large transfers of assets.

Note that assets bequeathed or given to an individual's spouse are exempt from estate and gift tax otherwise imposed at death or the time of the gift, provided the spouse is a US citizen.

## **6. Property taxes**

The United States does not have a federal-level property tax.

## **7. Luxury and excise taxes**

The United States does not have federal-level luxury taxes. However, the federal and state governments impose excise taxes on a variety of goods. For example, federal and state excise taxes are imposed on gasoline and diesel fuel used for transportation. The excise taxes are levied item by item and lack any uniformity in rates.

# **F. Income determination**

## **1. Employment income**

Citizens, resident aliens, and nonresident aliens are taxed on compensation earned for work performed in the United States, regardless of when or where payments are made, absent a treaty or Internal Revenue Code provision to the contrary. (Citizens and resident aliens are taxed on compensation earned for work performed anywhere in the world, regardless of where or when payments are made).

Employees generally are not taxed on reimbursements for either personal living expenses (i.e., food and lodging) or for travel expenses while in 'travel status,' subject to various limitations and substantiation requirements. However, reimbursements for similar expenses of a spouse or dependent are taxable. Note that being in 'travel status' requires a temporary absence from an individual's

tax home. Assignments for more than one year in a single work location are not considered to be temporary, regardless of all other facts and circumstances.

After-tax dollars contributed by the taxpayer to a pension are partially taxable. The component of the pension payment that represents a return of the after-tax contribution amount paid is not subject to tax.

### 2. Equity compensation

Multiple types of equity compensation are used by US companies, including stock options and various payment rights based on stock. The taxation of these different instruments varies.

If a taxpayer receives an option to buy or sell stock or other property as payment for services, the taxpayer may have income when the option is received (the grant), when the option is exercised (to buy or sell the stock or other property), or when then the option or property acquired through the exercise of the option is sold or otherwise disposed of. The timing, type, and amount of income inclusion depend on whether the taxpayer receives a non-statutory stock option or a statutory stock option. Generally, taxpayers may have income when a non-statutory stock option is received and when it is exercised. Upon grant and exercise of a statutory stock option, however, taxpayers generally do not include any amount in income until the stock purchased by exercising the option is sold.

Foreign nationals who are granted stock options prior to the start date of their residency in the United States may be subject to US income tax at exercise on all or part of the realized income at such time. In most cases, when a foreign national who is a resident alien exercises an option to buy foreign stock, the spread between the option price and the fair market value of the stock at the time of exercise is subject to US income tax. A portion of the spread will be treated as foreign-source (to the extent allocable to services rendered in the foreign country). As a result, even though the full spread will be subject to tax in the United States, a foreign tax credit generally may be claimed to reduce or eliminate the US income tax (assuming foreign tax is paid on this income).

In a situation that is often overlooked, if a foreign national returns to his or her home country and exercises an option that was granted before the taxpayer started residency in the United States but vested while the taxpayer was in the United States, a portion of the income could be subject to US taxation because it is attributed to the period during which he or she performed services in the US.

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**Inbound insight:** *Stock options or restricted stock units that are granted or become vested while an individual is working in the United States may be subject to Section 409A. Section 409A imposes various requirements on equity compensation; a violation of these requirements may result in an additional 20% tax plus an interest penalty on the value of the compensation. Foreign nationals should review these grants to see if Section 409A applies and whether any changes must be made before working in the United States.*

### **3. Business income**

When an individual works for himself or herself, that individual generally is deemed to have self-employment income. Self-employment income is taxed under US law in a manner similar to employment compensation. However, a self-employed individual often may have more ability to deduct business expenses than an employee. Citizens and resident alien individuals may (subject to certain exceptions) be subject to increased social security contributions in the United States on self-employment income earned while resident in the United States (see section V.E.1., Social security contributions, above).

### **4. Capital gains**

Capital gains of a citizen or resident alien are included in worldwide income and are subject to US taxation (see section V.E.2., Capital gains taxes, above).

Nonresident aliens are taxed at 30%, collected by withholding at the source of the payment, on US-source net capital gains if they are in the United States for 183 days or more during the tax year in which the gain occurs. The operation of this provision is limited to situations in which an alien is not otherwise taxed as a resident under the substantial presence test (see section V.D., Residence, above). Capital gains from US real property interests are taxable regardless of US presence.

### **5. Dividend income**

Dividend income received by a citizen or resident alien is subject to US tax, whether it is from US or foreign sources.

Nonresident aliens' US-source dividends generally are subject to a flat 30% tax rate (or lower treaty rate), usually withheld at source.

### **6. Interest income**

Interest income received by a citizen or resident alien is subject to US tax, whether it is from US or foreign sources.

Nonresident aliens' US-source interest is generally subject to a flat 30% tax rate (or lower treaty rate), usually withheld at source. Note that certain 'portfolio interest' earned by a nonresident alien generally is exempt from tax.

### **7. Rental income**

Rental income received by a citizen or resident alien is subject to US tax, whether it is from US or foreign sources.

Nonresident aliens' US-source rents are generally subject to a flat 30% tax rate

(or lower treaty rate), usually withheld at source. However, a nonresident alien can elect to report real property rental income net of expenses, subject to tax at graduated rates.

## **8. Exempt income**

Certain items are generally exempt from personal income tax. Three common types of tax-exempt income include interest from municipal bonds, the value of inherited property, and property received as a gift.

Conversely, some types of income that enjoy preferential tax treatment in an individual's home country may not enjoy the same tax treatment in the United States. For example, certain retirement-type accounts in foreign jurisdictions are treated as 'look-through' entities for US tax purposes.

## **9. Deductions**

### *a. Employment expenses*

Employees may be able to claim an itemized deduction for certain 'ordinary and necessary' unreimbursed work-related expenses. Common deductions include travel expenses and transportation costs (other than commuting to and from work), business entertainment and gifts, computers and cell phones if required for the taxpayer's job and for the convenience of the employer, uniforms, and home office expenses.

The deduction for employment expenses of an employee is subject to the floor on 'miscellaneous' itemized deductions equal to 2% of adjusted gross income. Various other limitations and strict substantiation requirements apply. Nonresident aliens in 'travel status' may deduct commuting expenses; however, citizens and resident aliens generally may not, because they typically are not in 'travel status.'

### *b. Personal deductions*

Citizens and resident aliens can deduct, as itemized deductions, the following common personal expenditures:

- qualified residence mortgage interest
- most state and local income taxes and property taxes
- expenses incurred in producing income subject to the miscellaneous itemized deductions floor equal to 2% of adjusted gross income
- medical expenses, casualty, disaster, and theft losses, and charitable contributions, subject to limitations
- child and dependent care expenses.

Certain personal expenses are allowed as deductions against gross income (so-called 'above-the-line' deductions), including alimony and certain student loan interest.



Nonresident aliens may deduct, subject to limitations, casualty and theft losses incurred in the United States, contributions to US charitable organizations, and state and local income taxes.

Individuals whose adjusted gross income exceeds a threshold amount are subject to a phase-out rule that reduces their itemized deductions. For 2014, the threshold amounts are \$305,050 for joint filers and surviving spouses; \$279,650 for head-of-household filers; \$254,200 for single filers; and \$152,525 for married taxpayers filing separately.

*c. Interest expenses (other than qualified residence interest)*

No deduction is allowed for personal interest, such as on a car loan. However, interest paid on investment debt is deductible, but only to the extent that there is net investment income (i.e., investment income net of investment expenses other than interest). Disallowed excess investment interest expense may be claimed as a deduction in subsequent years, to the extent of net investment income.

*d. Standard deductions*

Instead of itemizing deductions, citizens and resident aliens may claim a standard deduction. The basic standard deduction for 2014 is \$12,400 for married couples filing a joint return or surviving spouses; \$6,200 for single individuals and married individuals filing separate returns; and \$9,100 for heads of households. These amounts are adjusted annually for inflation. Nonresident aliens may not claim a standard deduction.

Individuals—including resident aliens—who are blind or age 65 or over are entitled to a higher standard deduction. For 2014, such an individual who is married or a surviving spouse may increase the standard deduction by \$1,200; of such an individual is single or a head of household, the additional standard deduction is \$1,550. If an individual is both blind and age 65 or over, the standard deduction may be increased twice.

*e. Personal allowances*

Citizens and resident aliens are allowed a personal exemption for themselves, for their spouse (subject to exceptions), and for each of their dependents (who must be citizens or residents of the United States, Canada, or Mexico).

Nonresident aliens are entitled to only one personal exemption, except that those from Canada or Mexico also can claim a personal exemption for their spouse if the spouse had no gross income for US tax purposes and was not the dependent of another taxpayer. In addition, taxpayers can claim exemptions for dependents who meet certain tests. Residents of Mexico, Canada, or nationals of the US must use the same rules as US citizens to determine who is a dependent and for which dependency exemptions can be claimed.

## ***V. Individual tax issues***

Pursuant to tax treaties, certain residents of South Korea and certain students and business apprentices from India may be able to claim exemptions for their spouse and dependents.

For 2014, the personal exemption amount is \$3,950, subject to reduction for individuals whose adjusted gross income exceeds a threshold amount (the same amount as for the itemized deduction phase-out, above). The personal exemption is adjusted annually for inflation.

### ***f. Losses***

An individual's capital loss deduction is generally limited to the individual's capital gains plus an additional amount of \$3,000. Individuals may carry over any unused net capital loss to later tax years, subject to the annual \$3,000 limit on using net capital loss against ordinary income.

Losses incurred by individuals that are attributable to an activity not engaged in for profit (i.e., hobby losses) are generally deductible only to the extent of income produced by the activity.

Taxpayers with net operating losses (NOLs) may carry their losses forward and back to certain tax years. The general NOL carryback period is the two years preceding the year the loss was incurred. If the NOL is not fully used on the carryback, the loss may be carried forward for 20 tax years following the year the loss was incurred.

## ***G. Foreign tax relief and tax treaties***

### **1. Foreign tax relief**

Taxpayers (generally US persons and foreign persons with effectively connected US trade or business income) may claim a credit against US federal income tax liability for certain taxes paid to foreign countries and US possessions. Foreign income, war profits, and excess profits taxes are the only taxes that are eligible for the credit. Taxpayers may choose to deduct these taxes with no limitation or, alternatively, claim a credit subject to limitations.

### **2. Tax treaties**

The United States has tax treaties with a number of foreign countries. Under these treaties, residents (not necessarily citizens) of foreign countries are taxed at a reduced rate, or are exempt from US taxes, on certain items of income they receive from sources within the United States. These reduced rates and

exemptions vary among countries and specific items of income. Under these same treaties, residents or citizens of the US are taxed at a reduced rate, or are exempt from foreign taxes, on certain items of income they receive from sources within foreign countries. Most income tax treaties contain what is known as a 'saving clause' that prevents a citizen or resident of the United States from using the provisions of a tax treaty to avoid taxation of US-source income. (For more information, see section III, US tax treaties, above, and Appendix A.)

The United States also has entered into totalization agreements for the purpose of avoiding double taxation of income with respect to social security taxes with various countries, which are listed in Appendix B. (See also discussion of social security taxes in section V.E.1, above.)

## ***H. Other tax credits and incentives***

### **1. Child Tax Credit**

Citizens, resident aliens, and nonresident aliens may claim a child tax credit if the qualifying dependent child is a citizen, national, or resident of the United States. If the child is under the age of 17 at the end of 2014, a tax credit is allowed for up to \$1,000 per child. The amount of the credit is reduced once the taxpayer's income reaches certain thresholds. If the taxpayer has one or more qualifying children and more than \$3,000 of earned income, the taxpayer may be entitled to a refund of up to 15% of earned income that exceeds \$3,000.

### **2. New Markets Tax Credit**

The New Markets Tax Credit (NMTC), enacted by Congress as part of the Community Renewal Tax Relief Act of 2000, permitted individual and corporate taxpayers to receive a credit against federal income taxes for making 'qualified equity investments' in qualified community development entities. The credit expired at the end of 2013 but may be reinstated by Congress on a retroactive basis before the end of 2014.

### **3. Other tax credits**

Numerous other tax credits exist at the federal, state, and local levels to provide incentives for specified investments or activities.

## ***I. Tax administration***

### **1. Tax period**

The US tax year for individuals generally is the same as the calendar year, i.e., January 1 through December 31.

## **2. Tax returns**

Individual income tax returns (Form 1040) are due on the 15th day of the fourth month after the end of the tax year (i.e., April 15) unless that day is a Saturday, Sunday, or federal holiday, in which case the return is considered timely filed on the next business day. A taxpayer who cannot file by that deadline may receive an automatic six-month extension of time to file Form 1040. To do so, the taxpayer must file Form 4868, *Application for Automatic Extension of Time to File US Individual Income Tax Return*, by the due date for filing the return. Note that filing for an extension does not extend the time to pay taxes. If the amount due is not paid by the regular due date, interest will accrue and penalties may apply.

Married individuals generally may file a joint return only if each is either a citizen or a resident. However, if only one spouse is a full-year or part-year citizen or resident, a joint return may be filed if both spouses agree to be taxed as full-year residents on their combined worldwide income.

Generally, joint filing will result in a lower tax liability than separate returns. This determination can be made with certainty only after a thorough review of the taxpayers' facts and circumstances. Married nonresident aliens (i.e., both spouses are nonresident aliens) may not file joint returns and must use the tax table for married persons filing separate returns. Nonresident aliens may not file as heads of household.

## **3. Payment of tax**

If federal income tax is owed, payment is due on April 15 to avoid interest and penalties for non-payment. The due dates for state income taxes may vary. Estimated tax payments may be required during the year (see below).

Most types of US-source income paid to a foreign person are subject to a withholding tax of 30%, although a reduced rate or exemption may apply if stipulated in the applicable tax treaty. In general, a person who pays US-source income to a foreign person must withhold the proper amount of tax, report the payment on Form 1042-S, and file a Form 1042 by 15 March of the year following the payment.

Income tax generally must be withheld from employee compensation. Citizens, resident aliens, and nonresident taxpayers with income not subject to withholding (e.g., self-employment income, interest, dividends, or capital gains) generally must make quarterly payments of estimated tax due April 15, June 15, September 15, and January 15. (States also may require estimated income tax payments.) Nonresident aliens who do not have any income subject to payroll withholding tax must make three estimated tax payments (rather than four) due June 15, September 15, and January 15, with 50% due with the first payment.

#### 4. Audit cycle

An audit is an IRS review of an individual's accounts and financial information to ensure information is being reported correctly and to verify the amount of tax reported on the individual's tax return is accurate. An individual's tax return may be examined for a variety of reasons, and the examination may take place in several ways. Returns are chosen by computerized screening, by random sample, or by an income document matching program. After the examination, if any changes to the individual's tax are proposed, the taxpayer either can agree with the changes and pay any additional tax owed, or disagree with the changes and appeal the decision.

In the event of a disagreement, the IRS has an appeals system. If a taxpayer does not reach an agreement with the IRS Office of Appeals, or if the taxpayer does not want to appeal the case to that office, in most instances the taxpayer may challenge the IRS assessment in the US Tax Court without paying the contested additional tax before litigation.

If taxpayers overpay their tax, there is a limited amount of time in which to file a claim for a credit or refund. Taxpayers can claim a credit or refund by filing Form 1040X and mailing it to the IRS Service Center where the original return was filed. A separate form must be filed for each year or period involved, along with an explanation of each item of income, deduction, or credit on which the claim is based. If the claim is denied, the taxpayer generally can challenge the denial in federal court.

#### 5. Statute of limitations

Generally, the IRS has three years after a return is due or filed, whichever is later, to make tax assessments. That particular date also is referred to as the statute expiration date. The statute of limitations also will limit the time taxpayers have to file a claim for credit or refund.

### *J. Other issues*

#### 1. Treatment of flow-through business entities

Certain legal entities are 'flow-through entities' (e.g., partnerships and S corporations). Income accrued by such entities is not taxed at the entity level. Instead, the income 'flows through' to the owners or shareholders, who are then taxed on the revenues.

**Note:** Certain types of foreign entities—including some pension funds and other investment vehicles—are treated as foreign trusts for US tax purposes and may have filing requirements in addition to the US income tax reporting of the underlying income.

## **2. Foreign exchange issues**

Although the United States does not have foreign exchange controls, any ‘United States person’ who has a foreign financial account (or a signature authority over such account) during the year may be required to file a report with the US Treasury Department by June 30 of the following year. The term ‘United States person’ includes a citizen or resident of the United States or a person in and doing business in the United States. The form need not be filed if the value of all foreign financial accounts does not exceed \$10,000 at any time during the year.

Schedule B (Interest and Ordinary Dividends) of Form 1040 requires taxpayers to state whether they had a financial interest in (or signature authority over) a financial account located in a foreign country, or received a distribution from or were the grantor of or transferor to a foreign trust.

Note also the new requirement under FATCA for resident aliens to file Form 8938, *Statement of Specified Foreign Financial Assets*. (This form is not limited to bank accounts.)

In addition, if cash equal to or in excess of \$10,000 is brought into or sent out of the United States at any time in the year, it must be reported to the US Customs Service.

## **3. Work permits**

Individuals who plan to move to the United States for temporary assignments must apply for and obtain, from the US Citizenship and Immigration Services (USCIS), visas that permit them to work in the United States. Typically, the visa will be a non-immigrant visa, such as an E, H, or L visa. Those who plan to remain on a non-US payroll and work for a relatively short time period in the United States (e.g., several weeks) may be able to obtain a B-1 visa (business visitor visa). The type of visa will depend on the nature of the proposed function in the United States and the proposed duration of the stay.

Note that other types of visas, such as F, M, J, and Q visas, which generally allow the individual to work in the United States as a teacher or trainee, have their own specialized rules and limitations.

A visa that permits an individual to work in the United States for several years may take several months to obtain. As the USCIS rules are extremely complex, professional advice from an immigration attorney should be sought well in advance of any intended move to the US.

A non-immigrant visa is usually limited to a fixed number of years. An immigrant visa for permanent residence (a green card) allows individuals to remain indefinitely in the United States, even if they change employment or cease to work.

**Note:** Advice should be sought prior to applying for permanent residence to make sure that all benefits and obligations that are involved are correctly understood.

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***Inbound insight:*** *Obtaining a green card is more complex than obtaining a non-immigrant visa; the process usually takes much longer, and the tax implications of having a green card are complex.*

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## ***VI. Health care***

An employer's costs to provide health care for its employees generally are deductible to the employer, and the cost of the plan and the benefits provided generally are tax-free to the employee.

The Affordable Care Act (ACA) changed the healthcare landscape in the United States, affecting individuals, insurers, employers, and the federal and state governments. Qualified healthcare plans in the United States must comply with ACA requirements, such as coverage to age 26 for children, first-dollar coverage for preventive care, and elimination of preexisting conditions exclusions and annual and lifetime maximums. These requirements are in addition to the pre-ACA requirements applicable to group health plans, including HIPAA (privacy of health information, notices, etc.), COBRA (continuation coverage following certain qualifying events), and mental health parity. An excise tax penalty is imposed for failure to satisfy these requirements. Other fees and penalties also may apply to health plans under the ACA.

Individuals living in the United States must maintain minimum essential coverage or face a tax penalty. Qualifying coverage provided by an employer will satisfy the minimum essential coverage requirement for individuals, as will coverage under any governmental program, such as Medicare or Medicaid. Individual and family coverage may be purchased on the new state-based or federally assisted exchanges (also called the 'marketplace').

The exchanges first became available January 1, 2014. Individuals may enroll for exchange coverage during an annual enrollment period beginning in October before the beginning of the calendar year and continuing through March. Enrollment for 2014 ended on March 31, 2014. Families with income below certain thresholds who do not have access to minimum affordable coverage from an employer or a governmental plan may qualify for subsidized coverage on the exchanges.

The requirement to maintain coverage applies to US citizens, permanent residents, and foreign nationals who qualify as resident aliens. It does not apply to nonresident aliens. US citizens living abroad for a calendar year (whose income qualifies for exclusion under Code Section 911) are treated as having minimum essential coverage for the year.

Employers with at least 50 full-time equivalent employees—determined across the controlled group, and based on 30 hours of service a week, but excluding any hours of service for which an employee does not receive US-source income—must offer health coverage to at least 95% of their full-time employees or pay a large penalty if one of their full-time employees obtains subsidized coverage on an exchange. If the coverage offered by the employer does not satisfy the 'minimum affordable coverage' requirement, the employer must pay a penalty with respect to each employee who obtains subsidized coverage on an exchange. In addition to these penalties, new reporting and disclosure requirements, taxes, and industry fees are imposed under the ACA.



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## ***VII. Financing US operations***

### ***A. Debt vs. equity***

#### **1. IRS Information Document Request (IDR)**

Companies often finance the operations of their global business through intercompany loans. In determining whether intercompany loans are truly debt in nature or whether they are, in fact, equity transactions, the IRS has developed a 13-part Information Document Request (IDR), which includes a request for financial data for years outside of the particular audit cycle.

If the IRS finds the transaction to appear more like equity than debt in nature, the interest deduction taken on a company's tax return associated with the 'debt' will be denied. For companies that have recently increased their debt level, it is likely that the IRS will focus even more on this issue, potentially auditing future years when the intercompany debt exponentially increases.

The factors the IRS will consider—which are based on relevant case law—include whether:

- an arm's-length rate of interest was charged and interest payments were made
- the debt is evidenced by written documents such as notes
- the debt has a fixed maturity date and scheduled payments
- there is an expectation that the debt will be repaid with free working capital
- security is given for the advances
- the borrower is adequately capitalized
- the borrower is able to obtain adequate outside financing from third-party sources.

While no one particular factor or set of factors is controlling, case law has established that the objective facts of a taxpayer's situation must indicate the intention to create an unconditional obligation to repay the advances. Although courts consider both the form and the economic substance of the advance, the economic substance is deemed more important. The more a related-party financing arrangement resembles a loan that an external lender would make to the borrower, the more likely the advance will be considered debt.

#### **2. Key Tax Court decision**

A US Tax Court opinion from 2012 in which the court upheld the taxpayer's debt characterization of US intercompany debt—while a 'memorandum decision' that does not serve as binding precedent—is important because it indicates the Tax Court's current approach to debt vs. equity determinations. Note that the Tax Court is the federal trial-level court that hears most federal tax cases.

In particular, at a time when the IRS has been aggressively challenging taxpayers' intercompany financing arrangements, in this case the Tax Court applied a principled approach based on traditional debt vs. equity factors as established by case law. Note that the debt vs. equity determination is based on a taxpayer's particular facts and circumstances.

## VII. Financing US operations

The issue in *NA General Partnership & Subsidiaries v. Commissioner*, T.C. Memo. 2012-172, was whether an advance made by the taxpayer's non-US parent to its US group constituted debt or equity and, therefore, whether the taxpayer was entitled to interest expense deductions. The court, ruling in favor of the taxpayer, upheld the taxpayer's treatment of the advance as debt.

The Tax Court applied a traditional debt vs. equity analysis, examining a series of factors developed by courts. Because appeal of the case would lie in the US Court of Appeals for the Ninth Circuit, the Tax Court focused on case law developed by that circuit, which considers the following factors relevant to determine whether an advance is debt or equity:

- the name given to the documents evidencing the indebtedness
- the presence of a fixed maturity date
- the source of the payments
- the right to enforce payments of principal and interest
- participation in management
- a status equal or inferior to that of regular corporate creditors
- the intent of the parties
- 'thin' or adequate capitalization
- identity of interest between creditor and stockholder
- payment of interest only out of 'dividend' money
- the corporation's ability to obtain loans from outside lending institutions.

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***Inbound insight:*** *The Tax Court's analysis reflects that courts generally look to whether the borrower has the ability to generate sufficient cash flows to service and repay the debt. Interestingly, the test is often applied by looking at operating cash flow, i.e., whether the borrower would have the ability to generate sufficient operating cash flows to service the debt without being forced to sell its assets.*

### 3. General approach of courts

#### *a. Source of payments*

Courts often consider the source of payments in analyzing whether an instrument is debt or equity. In particular, if repayment depends on earnings or is to come from a restricted source, equity characterization may be indicated.

Another factor courts frequently consider is whether the relevant instruments are subordinated to creditors.

#### *b. Intent of the parties*

Courts frequently consider objective indications of the parties' intent to determine whether they intended to enter into a debtor-creditor relationship. In the Tax Court case discussed above, the IRS also argued that the parties' post-transaction conduct did not demonstrate intent to form a genuine debtor-creditor relationship. The IRS focused on the delayed interest payments, and the short-term loan from the foreign parent to the borrower to fund interest payments on the loan.

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***Inbound insight:*** *The IRS has challenged intercompany debt arrangements by using hindsight evidence to assert that the behavior of the parties subsequent to the arrangement's inception reveals that the parties never truly intended to create a debtor-creditor relationship. In general, existing case law suggests that it is not appropriate to re-characterize debt as equity by using hindsight evidence based on circumstances that the parties reasonably did not anticipate at the onset.*

#### *c. Inadequate capitalization*

In general, if a corporation is thinly capitalized, advances made to the corporation are more likely to be characterized as equity. Courts generally focus their analysis of a corporation's capitalization on its debt-to-equity ratio.

#### *d. Ability to obtain outside financing*

Courts have held that evidence that a purported debtor could have obtained loans from outside sources on comparable terms points toward a debt characterization, whereas evidence that a debtor could not have obtained such loans points toward an equity characterization.

## **B. Cash pooling**

Many corporate groups take advantage of so-called cash pooling arrangements (either physical or notional), in which credit and debit positions of multiple members of a group generally are concentrated in a single account (either physically or notionally). US tax consequences should be considered with respect to these cash pooling arrangements. Specifically, if a US group member is asked to join a cash pool, various US tax issues must be considered.

If the US member only deposits funds with (i.e., lends to) the cash pool, the tax issues include:

- intercompany interest rates must be adequate and at arm's-length (consider the safe harbor rate under Section 482)
- requirements for annual withholding tax returns for US-source income of foreign persons
- Foreign Bank and Financial Account (FBAR) and FATCA reporting requirements.

If the US member draws on (i.e., borrows from) the cash pool, additional US tax issues that must be considered include:

- interest deductions
- withholding tax/conduit issues
- subpart F issues to the extent there are CFC depositors.

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***Inbound insight:*** *If US subsidiaries of a US group member are required to join the cash pool, these considerations apply to each US participant in the pool. Consider using a subpool to manage multiplicity of issues.*

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## VIII. Setting up a US tax department

The organization and operation of the tax function varies greatly between industries and home countries and even between individual businesses. At its core, the drivers of the choices in this area are based on the demands and objectives of the business in five key areas, underpinned by eight critical tax enablers:

### Key areas

- Tax accounting
- Compliance
- Planning
- Controversy
- Advocacy

### Critical tax enablers

- Organizational structure
- Connectivity
- Process
- Document management
- Technology/automation
- Data collection/manipulation
- Decision management
- Stakeholder management and communication

Tax departments in the United States allocate a material amount of resources toward compliance and tax accounting in light of the complex nature of the tax systems and the significant emphasis placed on compliance and reporting requirements by management. This emphasis can be a significant demand on the focus of the tax department and finance function as a whole, requiring a material budget allocation as compared to that for other ordinary finance activities. The taxpayer must look to organizational- or technology-based solutions to address the magnitude of the responsibilities in this area.

Further, due to the many levels of taxation at the federal, state, and local levels, businesses in the United States often need to manage simultaneously numerous disputes on differing tax issues at each level, placing burdens on the company's budgets and resources. There may be tax accounting implications due to the number and size of tax disputes that can be open at any given time.

Finally, as is the case in a number of countries, the tax affairs of businesses operating in the United States are under increasing scrutiny by public and political institutions and the media. This focus requires increased attention to stakeholder management in the decision-making and risk-management processes and additional thought into the implications of the tax positions of the business beyond the financial statement and balance sheet drivers.

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***Inbound insight:*** Senior management of non-US companies often is surprised to learn the level of investment in tax compliance required in the United States. Understanding the resources and budget that will be necessary for these activities—in addition to the desired investment in planning and risk management—is critical.

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## *How can PwC help?*

As can be seen from the discussion above, the complexity of US tax law has a profound effect on foreign-owned US operations and, importantly, the return on investment. These complexities, coupled with the comparatively high US corporate income tax rate, provide incentive to manage efficiently US businesses while ensuring that effective tax rate remains competitive. In our experience with US inbound activities, we are seeing increased activity from the tax authorities in the areas of jurisdiction to tax, income shifting, inbound financing, repatriation, and withholding.

PwC's US Inbound Tax practice comprises a national network of cross-disciplinary professionals dedicated to understanding the unique nuances faced by foreign-based MNCs. We provide technical support and end-to-end view of issues to assist MNCs in formulating their US inbound policies. We have identified, developed, implemented, and documented a wide variety of strategies to help foreign MNCs meet their business needs while maintaining a competitive effective tax rate.

In the current challenging economic environment, we can work together on:

- **Acquisitions and dispositions:** Evaluate the US tax implications of US inbound acquisitions and dispositions designed to implement key initiatives
- **Business and tax alignment:** Align cross-border business and tax objectives
- **Compliance:** Address compliance requirements with respect to US federal and state tax laws, particularly targeted areas such as transfer pricing and FACTA
- **US income tax treaties and competent authority:** Determine the applicability and desirability of obtaining the benefits of US tax treaties in the context of cross-border financing and investment, as well as international mergers, acquisitions, and dispositions
- **US tax benefits:** Consider federal and state tax benefits, including credits and incentives available to US inbound companies
- **Legislative and regulatory services:** Monitor real-time developments on fast-moving US federal and state legislative and regulatory developments and their impact on business planning
- **Audit support:** Respond to IRS and state revenue agency challenges, including proper characterization of US inbound financings as debt versus equity.

Our approach is designed to identify tax opportunities and help manage efficiently adverse tax outcomes, so that the US business of a foreign MNC plays its part in implementing a globally effective and integrated approach to tax planning for the group and so that desired tax outcomes are integrated seamlessly into business objectives and operations.

# Appendix A

## Summary of US tax treaty benefits

Under US domestic tax laws, a foreign person generally is subject to 30% US tax on its US-source income. US persons making payments ("withholding agents") to foreign persons generally must withhold 30% of payments, such as dividends and royalties, made to foreign persons. In other situations, withholding agents may apply reduced rates or be exempted from withholding tax at source when there is a tax treaty between the foreign person's country of residence and the United States.

The United States has entered into various income tax treaties with countries in order to avoid double taxation of the same income and to prevent tax evasion. The table below, from IRS Publication 901 (April 2013), summarizes the benefits resulting from these treaties.

Recipient	Dividends paid by US corporations in general (%) (1)	Dividends qualifying for direct dividend rate (%) (1, 2)	Interest paid by US obligors in general (%)	Royalties* (%)
<b>Non-treaty</b>	30	30	30	30/30/30
<b>Treaty rates:</b>				
Australia (3)	15 (23)	5 (23, 24)	10 (5, 21)	5/5/5
Austria (3)	15 (9)	5 (9)	0 (19)	0/10/0
Bangladesh (3)	15 (22)	15 (22)	10 (11, 19)	10/10/10
Barbados (3)	15 (9)	5 (9)	5	5/5/5
Belgium (3)	15 (27, 28)	5 (24, 27, 28)	0 (19)	0/0/0
Bulgaria (3)	10 (27, 28)	5 (27, 28)	5 (19, 21, 27)	5/5/5
Canada (3)	15 (22)	5 (22)	0 (19)	0/10/0
China, People's Republic of (3)	10	10	10	10/10/10
Commonwealth of Independent States (CIS) (8)	30	30	0 (7)	0/0/0
Cyprus (3)	15	5	10	0/0/0
Czech Republic (3)	15 (9)	5 (9)	0	10/0/0
Denmark (3)	15 (27, 28)	5 (24, 27, 28)	0 (20)	0/0/0
Egypt	15 (4)	5 (4)	15 (4)	30/0/15 (3)
Estonia (3)	15 (9)	5 (9)	10 (20)	10/10/10
Finland (3)	15 (27, 28)	5 (24, 27, 28)	0 (20)	0/0/0
France (3)	15 (22)	5 (22, 24)	0	0/0/0
Germany (3)	15 (27, 28)	5 (24, 27, 28)	0 (19)	0/0/0
Greece (4)	30	30	0	0/30/0

Appendix A: Summary of US tax treaty benefits

Recipient	Dividends paid by US corporations in general (%) (1)	Dividends qualifying for direct dividend rate (%) (1, 2)	Interest paid by US obligors in general (%)	Royalties* (%)
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(Continued)

Hungary (3)	15	5	0	0/0/0
Iceland (3)	15 (15, 22)	5 (15, 22)	0 (20)	5/5/0
India (3)	25 (9)	15 (9)	15 (12)	15/15/15
Indonesia (3)	15	10	10	10/10/10
Ireland (3)	15 (22)	5 (22)	0	0/0/0
Israel (3)	25 (9)	12.5 (9)	17.5 (12, 17)	15/10/10
Italy (3)	15 (22)	5 (22)	10 (23)	8/8/0
Jamaica (3)	15	10	12.5	10/10/10
Japan (3, 25)	10 (27, 28)	5 (27, 28)	10 (26, 27)	0/0/0
Kazakhstan (3)	15 (16)	5 (16)	10	10/10/10
Korea, South (3)	15	10	12	15/10/10
Latvia (3)	15 (9)	5 (9)	10 (20)	10/10/10
Lithuania (3)	15 (9)	5 (9)	10 (20)	10/10/10
Luxembourg (3)	15 (29)	5 (9)	0 (4)	0/0/0
Malta (3)	15 (27, 28)	5 (27, 28)	10 (19)	10/10/10
Mexico (3)	10 (22)	5 (22, 24)	15 (18)	10/10/10
Morocco	15 (3)	10 (3)	15 (3)	10/10/10
Netherlands (3)	15 (24)	5	0	0/0/0
New Zealand (3)	15	5 (22, 24)	10	5/5/5
Norway (3)	15	15	10	0/0/0
Pakistan (4)	30	15	30	0/30/0
Philippines (3)	25	20	15	15/15/15
Poland (3)	15	5	0	10/10/10
Portugal (3)	15 (9)	5 (9)	10	10/10/10
Romania (3)	10	10	10	15/10/10
Russia (3)	10 (16)	5 (16)	0	0/0/0
Slovak Republic (3)	15 (9)	5 (9)	0	10/0/0
Slovenia (3)	15 (22)	5 (22)	5	5/5/5
South Africa (3)	15 (9)	5 (9)	0 (19)	0/0/0
Spain (3)	15 (9)	10 (9)	10	10/8/5 (10)



## Appendix A: Summary of US tax treaty benefits

Recipient	Dividends paid by US corporations in general (%) (1)	Dividends qualifying for direct dividend rate (%) (1, 2)	Interest paid by US obligors in general (%)	Royalties* (%)
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(Continued)

Sri Lanka (3)	15 (30)	15 (30)	10 (19)	10/10/10
Sweden (3)	15 (27, 28)	5 (24, 27, 28)	0	0/0/0
Switzerland (3)	15 (9)	5 (9)	0 (19)	0/30/0
Thailand (3)	15 (9)	10 (9)	15 (12)	15/5/5
Trinidad & Tobago (3)	30	30	30	15/30/0 (14)
Tunisia (3)	20 (9)	14 (9)	15	15/15/15
Turkey (3)	20 (9)	15 (9)	15 (6, 12)	10/10/10
Ukraine (3)	15 (16)	5 (16)	0	10/10/10
United Kingdom (3, 25)	15 (22)	5 (22, 24)	0 (20)	0/0/0
Venezuela (3)	15 (22)	5 (22)	10 (20, 21)	10/10/10

### Notes

\* Please note the tax rates and associated footnotes appearing in the 'Royalties' column in the table address three types of royalties, as denoted in the most recent IRS publication: industrial royalties, motion picture and television copyright royalties, and 'other' copyright royalties. The slashes '/' between each figure and associated footnote(s) are meant to demarcate these three types of royalties, respectively.

1. No US tax is imposed on a dividend paid by a US corporation that received at least 80% of its gross income from an active foreign business for the three-year period before the dividend is declared.
2. The reduced rate applies to dividends paid by a subsidiary to a foreign parent corporation that has the required percentage of stock ownership. In some cases, the income of the subsidiary must meet certain requirements (e.g., a certain percentage of its total income must consist of income other than dividends and interest). For Italy, the reduced rate is 10% if the foreign corporation owns 10% to 50% of the voting stock (for a 12-month period) of the company paying the dividends. For Japan, dividends received from a more than 50% owned corporate subsidiary are exempt if certain conditions are met.
3. The exemption or reduction in rate does not apply if the recipient has a PE in the United States and the property giving rise to the income is effectively connected with this PE. Under certain treaties, the exemption or reduction in rate also does not apply if the property producing the income is effectively connected with a fixed base in the United States from which the recipient performs independent personal services. Even with the treaty, if the income is not effectively connected with a trade or business in the United States by the recipient, the recipient will be considered as not having a PE in the United States under IRC Section 894(b).

## **Appendix A: Summary of US tax treaty benefits**

4. The exemption or reduction in rate does not apply if the recipient is engaged in a trade or business in the United States through a PE that is in the United States. However, if the income is not effectively connected with a trade or business in the United States by the recipient, the recipient will be considered as not having a PE in the United States to apply the reduced treaty rate to that item of income.
5. Interest determined with reference to the profits of the issuer or one of its associated enterprises is taxed at 15%.
6. Contingent interest that does not qualify as portfolio interest is treated as a dividend and is subject to the rates under those columns, as appropriate.
7. The exemption applies only to interest on credits, loans, and other indebtedness connected with the financing of trade between the US and the CIS member. It does not include interest from the conduct of a general banking business.
8. The tax rates in the US treaty with the former USSR still apply to the following countries: Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, and Uzbekistan.
9. The rate in column 2 applies to dividends paid by a RIC or a real estate investment trust (REIT). However, that rate applies to dividends paid by a REIT only if the beneficial owner of the dividends is an individual holding less than a 10% interest (25% in the case of Portugal, Spain, and Tunisia) in the REIT.
10. The rate is 8% for copyrights of scientific work.
11. The rate is 5% for interest (i) beneficially owned by a bank or other financial institution (including an insurance company) or (ii) paid due to a sale on credit of any industrial, commercial, or scientific equipment, or of any merchandise to an enterprise.
12. The rate is 10% if the interest is paid on a loan granted by a bank or similar financial institution. For Thailand, the 10% rate also applies to interest from an arm's-length sale on credit of equipment, merchandise, or services.
13. This is the rate for royalties for the use of, or the right to use, industrial, commercial, and scientific equipment. The rate for royalties for information concerning industrial, commercial, and scientific know-how is subject to the rate in column 5 ('other royalties').
14. The rate is 15% for copyrights of scientific work.
15. Amounts paid to a pension fund or employee benefit organization that are not derived from the carrying on of a business, directly or indirectly, by the fund or organization are exempt.
16. The rate in column 2 applies to dividends paid by a RIC. Dividends paid by a REIT are subject to a 30% rate.
17. An election can be made to treat this interest income as if it were industrial and commercial profits taxable under article 8 of this treaty.
18. The rate is 4.9% for interest derived from (i) loans granted by banks and insurance companies and (ii) bonds or securities that are regularly and substantially traded on a recognized securities market. The rate is 10% for interest not described in the preceding sentence and paid (i) by banks or (ii) by the buyer of machinery and equipment to the seller due to a sale on credit.

19. The rate is 15% (10% for Bulgaria; 30% for Germany and Switzerland) for contingent interest that does not qualify as portfolio interest.
20. The rate is 15% for interest determined with reference to (i) receipts, sales, income, profits, or other cash flow of the debtor or a related person, (ii) any change in the value of any property of the debtor or a related person, or (iii) any dividend, partnership distribution, or similar payment made by the debtor to a related person.
21. Interest received by a financial institution is tax exempt. For Venezuela, the rate is 4.95% if the interest is beneficially owned by a financial institution (including an insurance company).
22. The rate in column 2 applies to dividends paid by a RIC or REIT. However, that rate applies to dividends paid by a REIT only if the beneficial owner of the dividends is (i) an individual (or pension fund, in the case of France or New Zealand) holding not more than a 10% interest in the REIT, (ii) a person holding not more than 5% of any class of the REIT's stock and the dividends are paid on stock that is publicly traded, or (iii) a person holding not more than a 10% interest in the REIT and the REIT is diversified.
23. Interest paid or accrued on the sale of goods, merchandise, or services between enterprises is exempt. Interest paid or accrued on the sale on credit of industrial, commercial, or scientific equipment is exempt.
24. Dividends received from an 80%-owned corporate subsidiary are exempt if certain conditions are met.
25. Exemption does not apply to amount paid under, or as part of, a conduit arrangement.
26. Interest is exempt if (i) paid to certain financial institutions, or (ii) paid on indebtedness from the sale on credit of equipment or merchandise.
27. Amounts paid to a pension fund that are not derived from the carrying on of a business, directly or indirectly, by the fund are exempt. This includes amounts paid by a REIT only if the conditions in footnote 31 are met. For Sweden, to be entitled to the exemption, the pension fund must not sell or make a contract to sell the holding from which the dividend is derived within two months of the date the pension fund acquired the holding.
28. The rate in column 2 applies to dividends paid by a RIC or REIT. However, that rate applies to dividends paid by a REIT only if the beneficial owner of the dividends is (i) an individual or a pension fund holding not more than a 10% interest in the REIT, (ii) a person holding not more than 5% of any class of the REIT's stock and the dividends are paid on stock that is publicly traded, or (iii) a person holding not more than a 10% interest in the REIT and the REIT is diversified. Dividends paid to a pension fund from a RIC, or a REIT that meets the above conditions, are exempt. For Sweden, the pension fund must also satisfy the requirements in footnote 30.
29. The exemption does not apply if the recipient of the gain is an individual who is present in the United States for more than 119 days during the year.
30. The rate applies to dividends paid by a REIT only if the beneficial owner of the dividends is (i) an individual holding less than a 10% interest in the REIT, (ii) a person holding not more than 5% of any class of the REIT's stock and the dividends are paid on stock that is publicly traded, or (iii) a person holding not more than a 10% interest in the REIT and the REIT is diversified.

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## ***Appendix B***

### ***List of countries with which the United States has entered into social security totalization agreements***

Australia	France	Norway
Austria	Germany	Poland
Belgium	Greece	Portugal
Canada	Ireland	South Korea
Chile	Italy	Spain
Czech Republic	Japan	Sweden
Denmark	Luxembourg	Switzerland
Finland	Netherlands	United Kingdom



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