

# Tax FAQ for U.S. Inbound Transactions

## Understanding US Persons, Non-US Persons and issues related to doing business in the United States

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### Introduction

Foreign individuals and companies do business in the United States for a variety of reasons, including accessing US capital and financing, US markets or US strategic partners. Whatever the reason, foreign businesses have a variety of options in structuring their US operations, including:

- export tangible product into the US;
- license intangibles into the US;
- send a service provider to the US from time to time;
- establish a branch office in the US;
- form a subsidiary in the US;
- partner in a US joint venture.

It is critical for foreign businesses to understand how the US taxes<sup>1</sup> these various activities.

### Who or What is a "US Person"?

As a general proposition, the US taxes "US Persons" differently from "non-US Persons." US Persons are taxable in the US on their worldwide income. Non-US Persons are generally taxable in the US only on US source income.

"US Persons" are individuals who are US citizens or residents, and entities, such as corporations, partnerships and LLCs, formed under the laws of a state or the United States.

Whether an individual is a US citizen or an entity is formed in the United States is typically straightforward. Determining whether someone is a US resident, however, requires some analysis. An individual may be a US resident by satisfying one of two tests, the "Green Card Test" or the "Substantial Presence Test." An individual satisfies the "Green Card Test" if he or she is a US permanent resident for immigration purposes and, thus, holds what is known as a "green card." An individual satisfies the "Substantial Presence Test" if he or she has been physically present in the US for:

- 31 days in the current year; and
- 183 days over the three year period including the current year and two prior years.

For purposes of computing the days present in the US, in the current year are counted one for one (1:1), previous year days are counted one for three (1:3) and days from two years prior are counted one for six (1:6).<sup>2</sup>

Individuals and entities that are not US Persons under the above tests will be considered non-US

Persons for US tax purposes. The determination of whether an individual or entity is a US Person must be made each year as facts and circumstances may have changed, especially with regard to testing for US resident status.

#### **How are US Persons Taxed for US Income Tax Purposes?**

The US subjects US Persons to taxation on their worldwide income.<sup>3</sup>

#### **Individuals**

Generally, a foreign individual who is or becomes a US Person for US tax purposes must file an individual tax return, such as Form 1040 “U.S. Individual Income Tax Return” with the Internal Revenue Service (IRS). He or she will report and be taxed on worldwide income, after allowable exclusions, exemptions and deductions. Tax rates which presently apply to individuals range from 10% to 35% on ordinary income, such as wages and interest, and 15% on qualified dividends and long-term capital gains. Credits against US tax may be available for foreign tax paid on foreign source income and gain.

#### **Corporations**

A foreign business which incorporates in the US and US corporate subsidiaries of foreign businesses are US Persons for US tax purposes subject to US income tax on a worldwide basis. Corporations generally file a corporate tax return, such as Form 1120 “U.S. Corporation Income Tax Return” with the IRS. In general, the income of a corporation is subject to two levels of tax.<sup>4</sup> First, net income (both ordinary and capital) of a corporation is taxed at the entity level at graduated rates which presently range from 15% to 35%. Second, when distributions of profits to shareholders are made, the shareholders are taxable on the distributions. Generally, the tax rate for individuals on dividends and capital gains is 15%. Withholding may apply to non-US Persons shareholders at 30%, unless a lower treaty rate applies.

#### **Partnerships/Multi-Member LLCs**

A US partnership or multi-member LLC taxed as a partnership for US income tax purposes reports its worldwide income to the IRS on Form 1065 “U.S. Return of Partnership Income.” Partnerships and multi-member LLCs taxed as partnerships are subject to one level of tax. Income, gain, deduction and loss of the partnership or multi-member LLC from whatever source are passed through to the owners according to the agreement among the owners. The owners reflect the income, gain, deduction and loss (subject to certain limitations) on their own tax returns according to the rules that apply to each owner — for example, if the owner is a US Person for US tax purposes, he would include on his own tax return, subject to exclusion, exemptions and deductions, his share of the partnership or LLC’s worldwide income.<sup>5</sup> Later distributions of previously taxed earnings, are generally not taxable to the owners.

#### **Single Member LLCs**

A single member LLC is disregarded for US federal income tax purposes. Income, gain, deduction and loss of a single member LLC is reported directly on the income tax return of its owner. The single member LLC does not file an income tax return with the IRS. A US Person who is the sole owner of the LLC will report all worldwide income, gain, deduction and loss on her income tax return. A non-US Person that owns a single member LLC doing business in the US will be treated as doing business in the US, if the LLC is engaged in a US trade or business.

#### **Are Non-US Persons Liable for US Income Taxes?**

The US generally taxes non-US Persons on “territorial income,” not “worldwide income.” Territorial income taxed by the US includes:

- Income effectively connected with a US trade or business (ECI), and
- US source income that is not effectively connected with US trade or business.

Absent application of a superseding tax treaty (discussed below), ECI, after allowable exclusions, exemptions and deductions, is taxed at graduated rates. These are the same rates that apply to US citizens, residents and corporations (as the case may be). In the case of a foreign partner's share of a partnership's ECI, the ECI is subject to 35% withholding.

US source income that is not ECI such as non-bank interest and dividends is taxed at a flat 30% rate (or lower treaty rate, as discussed below) on the gross amount (no deductions). The 30% tax is paid through withholding by the payor who remits the withheld tax to the IRS.

#### What is Income Effectively Connected with a US Trade or Business (ECI)?

Generally, a non-US Person is engaged in a US trade or business if he or she:

- Performs personal services in the US;
- Owns and operates an unincorporated business in the US selling services, products or merchandise; or
- Is an owner in a partnership or LLC, that is engaged in a trade or business in the US.

If a non-US Person is engaged in a US trade or business, all income, gain, or loss for the tax year that the non-US Person earns from sources within the US (other than certain investment income) is treated as ECI and subject to US tax at graduated rates. This applies whether or not there is any connection between the income and the trade or business being carried on in the US during the tax year.

#### What is US Source Income?

US source income typically includes interest, dividends, rents and royalties from US sources. Basic US sourcing rules are as follows:<sup>6</sup>

Type of Income:	US Source if:
Salaries, wages, other compensation	Services are performed in the US
Business income: Personal Services Sale of inventory – purchased Sale of inventory – produced	Services are performed in the US Sale takes place in US Production allocated to US
Dividends	The payer corporation is formed in the US
Interest	The payer of the interest is a resident of the US
Rent	The rented property is located in the US
Royalties – patents, copyrights, etc.	The property subject to the royalty is used in the US
Royalties – Natural resources	The property subject to the royalty is located in the US
Sale of Real Property	The real property is located in the US
Sale of Personal Property	The seller's tax home is in the US
Pensions	The services that earned the pension were performed in the US

#### Are There Other Significant Taxes?

The US federal government imposes other types of taxes as well, such as estate and gift taxes, employment taxes, and miscellaneous excise taxes. State and local jurisdictions may impose taxes as well.

## Employment Taxes

Employers must withhold 6.2% from an employee's pay and withhold the same amount from the employer's own resources for Social Security payments, until the employee has earned \$106,800 (for 2010). The tax rate for Medicare payments is 1.45% through employee withholding and a like amount from the employer's own resources. There is no wage base limit for Medicare tax.<sup>7</sup>

An employer who must withhold and pay Social Security and Medicare taxes should be aware that these taxes are what is known as "trust fund taxes", that is, the employer collects the employee's portion directly from the employee and holds this money in trust for the government until it is paid over. Individuals responsible for collecting and paying trust fund taxes and who do not perform this duty may be personally responsible for the payment of the taxes.

Self-employed individuals are subject to self-employment taxes, including a 12.4% Social Security component and a 2.9% Medicare component. The income earned by a partnership (or multi-member LLC taxed as a partnership) and allocated to the partners (or members) may be subject to self-employment tax. The partners (or members) themselves will be responsible for timely paying the self-employment taxes.

## State and Local Taxes

States and localities also have certain taxing powers. Many states impose income taxes on the income of persons living or doing business in their jurisdiction. In addition, many states and some localities impose sales and use taxes on the sale of certain goods and services. Typically, the seller of the goods and services is responsible to collect the sales and use the tax from the purchaser and remit the tax to the proper government agency. Most states and localities treat these taxes as "trust fund" taxes (see above). Certain localities impose ad valorem property taxes on personal and/or real property located in its jurisdiction.

### What is the Effect of US Income Tax Treaties?

The US currently has income tax treaties with 65 countries. In general, under a US income tax treaty, covered persons benefit from concessions intended to avoid double taxation. A foreign individual or business should consult the treaty between the US and his home country to see if the treaty varies the basic US tax rules described above. Treaties frequently contain provisions such as the following:

### Business Income

Absent a treaty, a foreign individual or business engaged in a trade or business in the United States is taxed at regular US rates on the income that is effectively connected with a trade or business. Under most US income tax treaties, a foreign individual or business may be exempt from US tax on its business profits derived from a US business unless those profits are attributable to a "permanent establishment" in the US. The treaty will provide guidelines as to what constitutes a "permanent establishment." Note, the US Model Treaty provides that the presence in the US of one or more "dependent agents" that act on behalf of the foreign enterprise and habitually exercise authority to conclude contracts on behalf of the enterprise can be treated as a "permanent establishment".

### Income from Employment and Independent Personal Services

Generally, the performance of personal services in the United States by a nonresident alien is considered a trade or business in the United States.

A treaty may alter this rule by providing that a person performing services of an independent character in the United States are taxable only in their home country unless the individual has a fixed base regularly available to him in the United States. If he does, he is taxable in the United

States on the portion of the income attributable to the US fixed base.

Income related to the performance of dependent personal services in the United States is typically subject to the basic rule. However, under some treaties such income may be exempt under certain circumstances. Special rules may also apply to certain service providers such as, entertainers and sportsmen, students and business apprentices, and directors.

#### **Fixed or Determinable, Annual or Periodic Income (FDAP)**

Generally, all FDAP (including interest, dividends and royalties) paid to a non-US Person is subject to a flat withholding tax at 30%. A treaty may provide for lower withholding on these items.

#### **Summary**

A foreign individual or entity wishing to conduct business in the US should find out if a treaty exists between the US and his home country. If one does exist, it might vary (in a favorable way) the basic rules of US income taxation described above. Finally, it is also worth noting that typically only residents of the contracting state are entitled to the benefits under a treaty. Persons that are not residents of the contracting state may try to derive the benefits of a treaty by forming an entity in one of the contracting states to serve as a conduit for income earned in the other contracting state, such as reduced withholding on interest or dividends. The treaty will likely limit the ability to take advantage of the concessions in this manner.

#### **Are there "Antiavoidance" Provisions?**

The IRS has many arrows in its quiver to ensure that the US collects its "fair share" of taxes. These include transfer pricing rules, interest stripping provisions and branch profits and interest taxes.

#### **Transfer Pricing**

Taxpayers with affiliates located in lower tax jurisdictions may seek to reduce their income subject to US income tax by using transfer pricing arrangements that artificially shift income away from (or deductions to) the US, in favor of the lower tax jurisdiction.

To combat these abuses, the transfer pricing rules give the IRS the power to distribute, apportion or allocate items of income, gain or loss between such organizations as necessary to prevent evasion of taxes or clearly to reflect the income of any such businesses. Essentially, the IRS can adjust US income by tweaking items of income and expense to reflect an arm's-length price.

#### **Thin Capitalization (Interest Stripping)**

There are also limitations on the use of debt financing to reduce US source income. These limitations are directed at minimizing a US entity's ability to reduce its US taxable income through interest payments to a foreign equity holder. The interest stripping rules set forth factors which indicate that a loan by an equity holder is, in fact, equity.

The IRS can also limit the deductibility of certain interest in order to prevent "earnings stripping." The rules limit a corporation's deduction of "disqualified interest."

#### **Branch Profits and Branch Interest Taxes**

When a foreign business operates a branch in the US, the IRS imposes tax on the US branch in order to put the US branch on equal footing with a US subsidiary of a foreign business. A dividend distribution to a foreign parent of a US subsidiary would be taxed as US source income

to the foreign parent. However, absent that special rule the distributions from a US branch of a foreign business would not be.

Similarly, when a US subsidiary makes interest payments to a foreign parent, the interest is US source income subject to US tax to the foreign parent, while an interest payment from a US branch of a foreign business is not US source income.

Branch profits and branch interest taxes equalize the treatment of US subsidiaries of foreign businesses and US branches of foreign businesses. The branch profits tax imposes a tax on the net profits of a US branch, “the dividend equivalent amount,” that would otherwise escape US tax on dividends, unless the net profits are reinvested in the US. Meanwhile, the branch level interest tax recharacterizes the US branch of a foreign company as a US subsidiary so that the interest paid is US source income and taxable in the US.

#### US Persons FAQ Summary

Persons doing business in the US are either “US Persons” or “Non-US Persons” for federal income tax purposes. A foreign person may be a “US Person” for US tax purposes if certain tests are met. The US taxes “US Persons” on their “worldwide income” and “Non-US Persons” only on their “territorial income.” Besides income taxes, other taxes may also apply such as employment taxes and state and local taxes. Treaties are an additional layer of authority that must be considered. Finally, tax anti-avoidance provisions exist to ensure the US collects its “fair share” of taxes. Understanding these basic rules relating to US inbound activities may help foreign businesses, owners and service providers avoid “tax surprises” and may even pave the way for more tax efficient outcomes when structuring US activities.

For more information on tax issues for your business, please contact [Chip Wry](#).

**This article is not intended to constitute legal or tax advice and cannot be used for the purpose of avoiding penalties under the Internal Revenue Code or promoting, marketing or recommending any transaction or matter addressed herein.**

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#### Footnotes.

1. This paper focuses on the liability of foreign individuals and businesses for US federal income taxes. As discussed briefly in later sections, foreign individuals and businesses must also be aware of other taxes that may apply — such as state income taxes or federal and state excise, employment, self-employment, sales and use, and property taxes.
2. There are exceptions to this general rule. For example, certain days of presence in the United States do not count for the substantial presence test. In addition, a person who can establish a “closer connection to a foreign country,” despite satisfying the substantial presence test, may be treated as a nonresident. For further discussion of these exceptions, see IRS Publication 519 “U.S. Tax Guide for Aliens.”
3. Foreign taxpayers whose home jurisdiction imposes tax on a territorial basis may be unfamiliar with this approach.
4. Certain small business corporations may make what is known as an “S election” and be subject to one level of tax. S Corporations may be of limited use in the foreign business context because S corporations, among other restrictions, cannot have nonresident aliens as shareholders. Only US citizens, US resident aliens, US estates and certain US trusts may be shareholders.
5. For the treatment of partners or members who are not US Persons for US tax purposes, see discussion below.
6. There are several exceptions to the sourcing rules which apply, for example, to interest income and personal services. See IRS Publication 519, “U.S. Tax Guide for Aliens,” for more information.
7. The United States has entered into an agreement with some countries, called Totalization Agreements, for the purpose of avoiding double taxation of income with respect to social security taxes. This agreement should be taken into account when determining whether income

is subject to the United States Social Security/Medicare tax.