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Taking Your First Steps in the United States? Here Are Key Tax and HR Issues to Consider Before Putting Boots on the Ground

I. State vs. Federal Taxation - nexus

Businesses operating in the US are subject to two levels of income taxation, federal and state. However, the existing double taxation treaty between the US and Belgium is only applicable at the federal level and not the states. This can be a source of confusion for many Belgian companies expanding their business into the US market and getting ready to put boots on the ground. Although you may have no taxable presence due to treaty protection at the federal level, there *may* be exposure to taxation at the state level. Due to a landmark US Supreme Court case decided in June 2018, a taxable presence (a "nexus" in tax speak) in one of the 50 states can be created not only by a physical presence but by mere *economic* presence. The implication is that a company could be exposed to state taxation in most of the 50 states without having a single office or full-time employee anywhere in the US. While each state has enacted its own tax laws, there are some common trip wires.

What to Watch For

1. **Economic Presence:** Annual sales in excess of $100,000 in a state or more than 200 transactions may create a taxable presence (economic nexus) in most states. Nexus requires sales tax administration and filing obligations and possibly income tax filings.
2. **Physical Presence**
   a. **Onsite Services:** Employees working temporarily in a state—perhaps engaged in installation, maintenance, training, and the like even for a few days may create state nexus.
   b. **Assets:** Inventory, machinery, or other assets (e.g., inventory in consignation, machine rental or operational lease, demo item) situated in the United States is considered by most states to be indicative of nexus.
   c. **Employees:** Employees based in a state working from their home offices, including those employed through a PEO, are a strong indication of nexus.

The Impact of Compliance Obligations

Depending on the state where nexus has been established, the following will most likely be required:

1. Obtain an EIN number
2. Qualify to do business (if only to get a Secretary of State number which may be required for the next step)
3. Register for various types of tax such as sales/use tax, corporate income tax, payroll tax, and personal property tax.
4. File sales/use tax returns and payroll tax returns, potentially monthly
5. File income tax returns and personal property tax returns annually

Sales tax rates approach 10% in some states, which may have a significant impact on competitive pricing if mishandled. And other potential tax obligations are critical to assessing the US business's potential tax burden as it expands into the US market.

Caution: Change Coming

As of this writing, most double taxation treaties, including US-Belgium, do not consider the mere presence of inventory for delivery or display purposes a condition that creates a permanent establishment for federal tax purposes. But we expect this issue to be revisited and revised—and soon. Discussions about this issue at the OECD level are under way. The influence of the US Supreme Court's ruling allowing states to characterize taxable presence based on economic activity has likely been profound —showing the way for other countries to tax e-commerce.

Recommendation

Before starting the business on US soil, it is prudent to discuss the operational aspects of the new venture with a US tax specialist. Very often, it is possible to limit the number of taxing jurisdictions to which the business will be exposed by making minor modifications to the business plan. This advance planning will simplify and limit your administrative costs.

II. Inventory in the US- Permanent establishment consideration

If the only physical presence in the US is inventory stored at a 3PL warehouse to fulfill orders received on the web site, this does typically not constitute a permanent establishment at the federal level (per Article 5 of the double taxation treaty). However, as discussed above, it will create a physical presence in the state(s) in which the inventory is located.

Customs consideration: Customs duty is assessed on the value of the first sale on US soil. Thus, shipping goods to the 3PL warehouse does not constitute a sale. The duty will be assessed on the sales price to the US customer.

Recommendation

From a federal tax standpoint, the ownership of inventory alone in the US, probably does not warrant the establishment of a US subsidiary but a foreign corporation will have to register and file for sales tax and income tax purposes in the various states where nexus has been created. Further, we strongly recommend the filing of a protective return Form 1120F at the federal level to formally invoke the treaty protection discussed earlier.

III. Use of Independent Contractors

Retaining independent contractors is a popular approach for putting boots on the ground with a minimum of administrative overhead. But rules about classifying personnel in the "gig" economy are evolving and regulators and the courts are creating tougher standards for "independence." For example, the California State Supreme Court, in *Dynamex Operations West, Inc., v. Superior Court* (April 2018), ruled that an independent contractor classification must meet the following tests:

1. The worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact.
2. The worker performs work that is outside the usual course of the hiring entity's business.
3. The worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed.

It is obvious that a salesperson working in an independent contractor relationship with the company would not pass the second test.

Recharacterization of the status of an independent contractor as an employee by a taxing authority is potentially costly, especially for a foreign corporation. In addition to social costs and probable penalties, the "employee" would imply that the company has a permanent establishment in the US and nexus in the state, thus requiring the company to file prior years' income tax returns.

On the other hand, it has become more attractive from an income tax perspective for US individuals to operate as independent contractors. Companies may find it harder to convince a person who they cannot legally classify as an independent contractor to become an employee. Keep in mind that independent contractors themselves may not be conversant in the rules, using legal entities such as "C" corporations or LLCs, even though they might truly function as "employees."

The debate over classification will continue. It is almost inevitable that rules for independent contractor status will become more restrictive and penalties for misclassification assessed faster and more harshly. As conditions change, keeping abreast of developments is critical.

Recommendation

If full-time US resources are needed, it is probably time to establish a US subsidiary.

IV. Use of PEO – Employer of Record

A Professional Employer Organization ("PEO") is an outsourcing firm that provides various employee-related services to businesses. Such services might include payroll processing, payroll tax filings, workers' compensation insurance, health benefits, employers' practice and liability insurance, retirement plans, regulatory compliance, workforce management, human resources, safety and risk mitigation, and training and development. PEOs charge an administrative or service fee and are reimbursed by their clients for the payroll expenses and the employers' share of payroll taxes and unemployment insurance.

Legally, the PEO is the co-employer that enters into a contract with its client (the company) and is not a party to employees' employment contracts. The PEO assumes some of the employer's duties, such as payroll and payroll tax administration and filings under its own tax identification numbers and serves as the employer of record for payroll tax and unemployment insurance purposes. However, the client company continues to direct the employees' day-to-day activities and continues to manage the employees' work responsibilities.

Caution

It is important to note that a PEO arrangement does not necessarily protect a foreign client company from creating a permanent establishment in the US. While the PEO may serve, for example, as the employer of record for payroll tax compliance purposes, the employees still perform services on behalf of the company and the employee's work is wholly devoted to the company, as if the company was the employer of record. Thus, the use of a PEO does not preempt a foreign company's obligation to determine whether a permanent establishment has been created based on analysis of US tax laws and relevant income tax treaties that apply to the activities of its US employees and any US located assets.

V. Why and when to set up an entity in the US

There are many business reasons for which it makes sense to set up a US subsidiary including:

- **Credibility**: Market credibility in the eyes of a potential partner is enhanced.
- **Attraction of mid-size and small business**: Mid-size and small US businesses typically buy from local vendors as opposed to foreign vendors. A US subsidiary can open this market.
- **Support in time zone**. Even large businesses prefer vendors that operate in a nearby time zone that can answer questions or offer technical support.
- **National preference**. We do not believe the national preference is necessarily that strong in the US, except in specific industries. Most important is a very strong value proposition for the product or services offered. Competition is the US market is fierce and a US presence may make the difference to potential US customers.

Tax and administrative reasons -

- **Customs duty**: With a US subsidiary acting as a distributor, i.e. buying from the foreign parent and reselling to the US customer, the first sale on US soil is to the subsidiary, hence a reduced basis for customs duty. Of course, rarely will the customs duty saving pay for the cost of the subsidiary, but it will contribute and make importation much simpler.
- **Insurance**: A US insurer will typically only insure US corporations.
- **People**: Employees will most likely create a permanent establishment in the US, so a US subsidiary keeps the foreign parent outside the US tax regime.
- **US credit card merchant account**: To avoid the payment rejection on the foreign website, a US payment system is needed and will only be available to a US corporation. In most cases, a US SSN will be required, although we can navigate that last hurdle.
- **Tax**: Again, if you only have inventory in the USA, you may not need to incorporate, but adding a US bank account, people you do need to take the plunge.

Why do most foreign company incorporate in the US:
At the end of the day, why do most foreign companies take the plunge? It is the lawyers of course! In order to insulate, as much as possible, the foreign business from legal exposures arising in the litigious US.

VI. Setting Up the Right Legal Entity

If the US business activity is creating state nexus and/or federal permanent establishment in the absence of a US subsidiary, the Belgian parent company must qualify to do business as a non-resident corporation in the various states and register with the IRS, etc.. as having an unincorporated US branch. This is not necessarily a bad tax situation, but it may be time to consider setting up a US entity to: (1) prevent the Belgian corporation from becoming a US taxpayer and (2) take advantage of a limited liability entity in the United States to provide some legal protection to the parent company's assets.

In most cases, and in our experience, a Belgian corporation starts business in the US by: (1) establishing a "C" corporation subsidiary (an Inc.), (2) in the state of Delaware, which is (3) wholly owned by the parent company. We will discuss each point in turn.

"C" Corporation

The alternative to a "C" corporation is a limited liability company (LLC), but for US tax purposes an LLC is by default a fiscally transparent entity. This means that the LLC does not exist for tax purposes and the LLC's owner(s) pay US tax directly on the LLC profit, thereby avoiding one level of US taxation.

This attribute makes the LLC the entity of choice for US taxpayers. Foreign taxpayers, however, generally do not enjoy the same advantages. Since an LLC is transparent, the foreign owner is pulled into the US tax regime as if a US branch had been created. The branch would be liable for US corporate income taxes and potential branch profits taxes. Generally, it is not desirable for a foreign entity to file US tax returns. An LLC can be converted to a "C" corporation by way of an election filed with IRS.

Recommendation

Establishing a "C" corporation is simpler than forming an LLC. There is usually no need to set up an LLC and then make an election to change its tax status.

State of Delaware

US companies are taxed at two levels: federal and in the states where nexus has been established. Many states also require annual tax return filings for companies incorporated in that state. Delaware, however, is not one of those states and it also offers much flexibility with respect to the corporate purposes that are allowed, which makes Delaware a popular state for incorporations.

Delaware companies are subject to an annual franchise tax, but income tax filings are not required unless the company is doing business in the state. State income tax filings in other states are then required as the US business expands and selects desirable business locations or when conditions demand relocation.

For example, if the US subsidiary incorporates in Delaware and sets up an office in New York, it will still need to qualify to do business in the state of New York. But this qualification to do business could be withdrawn if it moves out of New York and all tax compliance obligations would cease.

A final observation: Delaware seems to us the *lingua franca* of state incorporation law in the US. Of the dozens of business lawyers with which IMS has collaborated, our experience is that they understand their own state laws but also the advantages of incorporating in Delaware.

Caution

In our experience, a vast majority of companies relocate their US business in the years following incorporation and those that did not incorporate in Delaware regret not doing so.

Wholly Owned by the Belgian Parent

If the US corporation is owned by the Belgian individual who ultimately owns the Belgian corporation (i.e., a sister company), the individual shareholder may need to obtain a US tax ID and file US tax returns at some point. Alternatively, the double taxation treaty offers more benefits to corporate owners.

Typically, the US subsidiary will be financed by trade credit with its Belgian parent company. The parent company can easily transform these trade receivables into loans and/or paid-in-capital as needed. This is not so easily done if the foreign corporation is not the parent.

VII. Business Models

The role of the subsidiary

There are two typical approaches for the operation of a US subsidiary: (1) the subsidiary buys and resells the goods or services of its parent company, i.e., a distribution operation or (2) the subsidiary supports the parent company with sales support, marketing and technical services, while the parent company continues to sell directly to its US customers, i.e., an agent subsidiary.

The distribution subsidiary

This is a classic model that partially insulates the parent company from the risks of the US market and adds the US presence that many market entrants desire. In this case, the subsidiary manages and administers to its customers. Transfer pricing issues apply not only to the purchase and resale of goods but also to financing and management charges.

The agent subsidiary

It is an organization that is most often set up either: (1) to support an already existing export flow when the support can no longer be done from Europe or (2) for companies that sell strategic products to US customers that want direct contact with the manufacturer, publisher, or developer based in Europe but also want a local contact.

In this model, the US subsidiary does not contract with US customers but works only for the parent company and most often, its services are billed at prices equal to total costs plus a low mark-up percentage. The subsidiary effectively pays US income taxes on its mark-up.

This very simple approach greatly limits the administrative work and the transfer pricing issue and is a less expensive model in the start-up phase of the US business. However, this model will not protect the parent company from creating an economic presence in states with a large volume of sales.

Caution

Of course, switching from one model to another is possible - preferably at the end of the fiscal year.

VIII. Transfer Pricing

Transfer pricing refers to the pricing of transactions between related parties—in our case, a Belgian parent and US subsidiary. For example, the Belgian parent company management typically sets the price for the goods and services provided to the US subsidiary. If it is high, more profit stays in Belgium. If it is low, more of the profit flows to the US. However, the taxing authorities in both countries require that the pricing between the related parties be conducted at “arm’s length,” as if the parties were unrelated.

The US transfer pricing regulations apply to all US taxpayers that have transactions with related parties, no matter the size of the companies or transactions. This topic must therefore be addressed in all cases. Further, the transfer pricing regulations apply to all transactions within a group of related taxpayers, including interest on loans and advances, management fees, leasing of tangible property, use and licensing of intangible property, etc.

The IRS requires all US taxpayers to compile transfer pricing documentation that demonstrates arm's length pricing each year prior to the filing of the tax return. Many taxpayers utilize outside consultants to prepare transfer pricing reports for this purpose because preparing documentation that meets the US regulations can be daunting in the start-up years. Nevertheless, the pricing can be benchmarked to avoid major adjustments.

IX. Employee Transfers

Transferring employees from the parent company to the US subsidiary is usually a key to success in the US market. A transferred employee will embody the culture of the parent company, have deep knowledge of the products and services, enhance the credibility of a new entrant in the US, and will maintain an easier level of communication that draws on relationships with colleagues in the home country. Successful employee transfers are planned and prepared well in advance of the physical transfer. In addition to addressing sometimes complex visa requirements, a potential transfer needs to address three core considerations:

1. **Cost of Living Differential:** It is usually understood that an equivalent purchasing power must be offered to the employee.
2. **Tax Differential:** The employee may pay more tax in the US than Belgium.
3. **Social Coverage Differential:** Insurance and benefits coverage may differ as to coverage and cost.

Typically, all compensation, fringe benefits and allowances given to the employee in the US should be considered taxable wages including:
- Lodging
- Most moving expenses
- Company car
- Tuition for children
- Plane tickets for spouse and children

A detailed analysis of the full costs of salaries, benefits, and taxes is necessary so that problem areas can be addressed in advance of the transfer.

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