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

1. State vs. Federal Taxation

Businesses operating in the United States are subject to two levels of taxation: federal and state. However, the protections available in existing double taxation treaties between the United States and other countries are applicable only at the federal level and are not recognized by the states. This is a source of confusion for many foreign 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, you *may* have 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 you could be exposed to state taxation in most of the 50 states without having a single office or full-time employee anywhere in the United States. While each state has enacted its own tax laws, there are some common trip wires.

What to Watch For

1. **Economic Presence:** Do you have more than $100,000 annual sales in a state or more than 200 transactions? This small level of activity will create a taxable presence (economic nexus) in most states, which requires sales tax administration and filing obligations and possibly income tax filings.
2. **Physical Presence**
   - **Onsite Services:** Do you have employees working temporarily in a state—perhaps engaged in installation, maintenance, training, and the like? A few days' presence may be enough to create state nexus.
   - **Assets:** Do you have inventory, machinery, or other assets (e.g., inventory in consignation, machine rental or operational lease, demo items) situated in the United States? Most states consider assets to be indicative of nexus.
   - **Employees:** Are there employees based in a state working from their home offices? Payrolled employees is a strong indication of nexus.

The Impacts of Compliance Obligations

Depending on the state where you have a taxable presence, you will most likely need to:

1. Qualify to do business (if only to get a secretary of state number required for the next step)
2. Register for various types of tax such as sales/use tax, corporate income tax, payroll tax, and personal property tax
3. File sales and use tax returns and payroll tax returns, potentially monthly
4. 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 not applied correctly. And other potential tax obligations are critical to assessing your business's overall tax burden as you expand into the US market.

Caution: More Change Coming

As of this writing, most double taxation treaties, do not consider the mere presence of inventory for delivery or display purposes to be a condition that creates a permanent establishment for federal tax purposes. But count on this matter 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 define tax presence to include mere economic activity has been profound and is showing other countries the way to tax e-commerce.

Recommendation

Before embarking on the adventure of setting up on US soil, it is critical to discuss your business model with a US tax specialist. Very often, with small modifications designed to minimize exposure to US taxation   it is possible to limit the number of jurisdictions in which you will be exposed to taxation, thereby simplifying and limiting your administrative costs.

2. Use of Independent Contractors

Retaining independent contractors is a popular approach for putting boots on the ground with a minimum of administrative overhead. But the statutes applicable to hiring personnel in the "gig" economy are evolving; 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 as an independent contractor with your company would not pass the second test.

Getting it wrong can be costly. Recharacterization of the status of an independent contractor to an employee by a taxing authority can be expensive, especially for a foreign corporation. In addition to additional taxes and penalties, the misclassification would likely imply that the company has a permanent establishment in the United States and nexus in the state which would require the company to file prior years' income tax returns.

But getting it right presents challenges, too. Due to the US tax rules, it is more beneficial, from an income tax perspective, for US individuals to operate as independent contractors. Thus, companies may find it harder to convince a hiring candidate who they cannot legally classify as an independent contractor to become an employee. Keep in mind that independent contractors may not be conversant with the tax rules, using intermediate legal entities such as

"C" corporations or LLCs. Their lack of awareness, and their legal "shield," may not protect you.

The debate over classification will continue. It is inevitable that rules for independent contractor status will become more restrictive and penalties for misclassification assessed aggressively. Conditions change; keep abreast of developments.

Caution

We are often contacted by foreign companies that have received, without having made the request, a letter from the IRS with a federal registration number and an express request for tax filings since the beginning of the U.S. activity.
Of course, these requests are usually triggered when the US tax authorities systematically match the income reported by self-employed persons to the tax filings of companies.

Recommendation

If you feel like you will need full-time employees, consider establishing a US subsidiary.

3. Setting Up the Right Legal Entity

If your US business activity is sufficient to create state nexus and/or federal permanent establishment, in the absence of a US subsidiary, the foreign 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. A branch is not necessarily a bad tax structure, but it may be time to consider establishing a US entity to: (1) prevent the foreign 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 assets of parent company.

In most cases, and in our experience, a foreign corporation starts up its US business 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 below.

"C" Corporation

A popular alternative to a "C" corporation is a limited liability company (LLC), but for US tax purposes an LLC is a fiscally transparent entity. This means that the LLC does not exist for tax purposes and the LLC's owner(s) pay tax directly on their share of the 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 this advantage due to the branch profits tax. A single member LLC owned by a foreign corporation subjects the foreign owner to US and state income taxation as a non-resident corporation and at the federal level, additional branch profits tax subject to tax treaty limitations. Generally speaking, it is not desirable for your foreign entity to obtain a US tax identification number and file US tax returns.

An LLC can be converted to a "C" corporation for US tax purposes via a special election filed with IRS.

Recommendation

Avoid LLCs and establish an Inc. it is simpler and cheaper to set up than an LLC and keeps the foreign owner(s) out of the US tax regime. Then, there is no need for the special election to convert the LLC.

State of Delaware

Let us return for a minute to where we started. In the United States, companies are taxed at two levels: federal in every case, and by the states where there is nexus. However, nexus is different than the state of incorporation.

While it is not the "tax paradise" as many think, the State of Delaware does provide companies much flexibility in terms of corporate purposes and taxation. If you incorporate in most states *other than* Delaware, you will need to file returns for the life of the corporation—whether there is a state presence or not. This would be a major administrative obligation for a large percentage of IMS's clients, which can and do relocate after gaining a better understanding of desirable business locations or when conditions demand change.

For example, if you incorporate in Delaware and set up an office in New York, you will still need to qualify to do business in the state of New York. However this qualification to do business could be withdrawn if you move out of New York; all tax compliance obligations would cease. No Delaware income tax obligation would exist unless nexus was established there.

A final observation: Delaware seems to us the *lingua franca* of state incorporation law in the United States. Of the dozens of business lawyers IMS has worked with across the United States, our experience is that they almost universally understand their own state laws—*and Delaware*.

Caution

In our experience, a vast majority of companies move in the years following their first establishment and all of them who did not incorporate in Delaware regret it...

Wholly Owned by the Foreign Parent

A few points here. If the US corporation is owned by the individual who also owns the foreign corporation (i.e., a sister company), the owner may need to obtain a US tax ID and file US tax returns at some point. Generally speaking, the double taxation treaties offer more benefits to foreign corporate owners rather than foreign individual owners.
Typically, the US subsidiary is going to be financed by the trade credit with its foreign counterpart. The foreign corporation can easily transform its trade receivable into loans and or capital if it is the parent company. This is not so easily done if the foreign corporation is only an affiliate.

Caution

In the case where the US company and the foreign company are directly owned by the same individual; if the financing of the subsidiary is done by the foreign company this can quickly lead to suspicions of abuse of property.

4. Business Models

The role of the subsidiary

There are two basic models for the operation of a subsidiary. Either the subsidiary buys and resells the goods or services of its parent company, i.e., a distribution subsidiary, or the subsidiary supports the parent company's business from a technical and sales support perspective but the parent company continues to sell directly to its US customers, i.e., an agent subsidiary.

The distribution subsidiary

Of course, this is a classic approach that partially isolates the parent company from the risks of the US market and adds that US substance that many market entrants desire. In this case, the subsidiary performs all the functions and assumes all the risks of a distributor in that is has to manage inventory and administer to its customers. This business model creates transfer pricing issues that apply not only to the purchase of products but also to parent company financing and management charges.

The agent subsidiary

This model is most often implemented to: (1) support an already existing import flow when the support can no longer be provided from Europe or (2) sell strategic products where the US customer requires direct contact with the manufacturer, publisher or developer.

In this case, the subsidiary does not contract with US customers but works only for the parent company and most often its services are valued at total costs plus a generally low percentage mark-up.

This simple approach, which greatly limits the administrative work and the transfer pricing issue to the percentage of result, is a less expensive method of setting up and can be a good way to start up a subsidiary.

In this case, the subsidiary charges all of its US costs plus the mark-up to the foreign parent, and pays a small US tax.

Caution

Of course, you can switch from one model to another - preferably at the end of the fiscal year. Also, this model will not protect the parent company from developing an economic presence in states with a large volume of sales.

5. Transfer Pricing

Transfer pricing rules apply to the pricing of transactions between two related parties—in our case, a foreign parent and US subsidiary. For example, the foreign parent management typically sets the prices for the goods and services sold to a US distribution subsidiary. If pricing is high, more profit stays in the foreign country. If pricing is low, more of the profit flows to the United States. 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 relationships with related parties, no matter the size of the companies. This topic must therefore be addressed.

First, transfer pricing regulations apply to more than the exchange of good or services. They apply to *all* transactions within a group, 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. Admittedly, preparing documentation that meets the US regulations can be daunting in the start-up years. Nevertheless, your pricing strategy can be benchmarked to avoid major adjustments by the tax authorities.

6. Employee Transfers

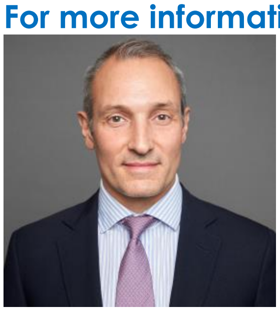
Transferring employees from the parent company to the US subsidiary is usually a key to success in the US market. A transferred employee will embody the culture of the parent company, have deep knowledge of the products and services, enhance the credibility of a new entrant in the US, and will maintain 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:

- Cost of Living Differential: It is usually understood that an equivalent purchasing power must be offered to the employee.
- Tax Differential: The employee may pay more tax in the United States than the home country.
- Social Coverage Differential: Insurance and benefits coverage for the transferee must be maintained.

Typically, all moneys given to the transferee in the United States should be considered salary or taxable fringe benefits including:

- Lodging
- Most moving expenses
- Company-provided car
- Tuition for children
- Plane tickets for spouse and children A detailed analysis of the full costs of salaries, benefits, and taxes usually brings the pros and cons and trade-offs of a potential transfer into focus—allowing problem areas to become known in advance.

For more information contact:



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