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Doing business in the United States

A guide to the key tax issues

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Foreword

Doing business in the United States

For the second year in a row, global business leaders rate the United States as their most important market for overseas investment and growth, in *PwC's 19th Annual Global CEO Survey*.

But while there are many attractions to the US market that drive this positive view, doing business in the United States can be challenging.

Global CEOs surveyed also indicated that a clearly understood, stable, and effective tax system is a top priority for society today.

How does the US regime measure up against this standard?

The United States has a complex system of federal, state, and local levels of taxation. And when surveyed by PwC and the Organization for International Investment, CFOs of US subsidiaries of foreign businesses agreed that improving the tax system is the number-one action that would strengthen the United States as an investment location.

So I think we can comfortably say that the US tax system is one aspect of doing business in the United States that requires careful navigation. Further, current debates regarding US tax policy and reform and ever-evolving legislative activity combine to create a challenging environment for companies doing business in the United States—but also unique opportunities.

I fully appreciate these particular 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 overcome the confusion and complexity, and identify the critical insights that will enhance business performance and effectively manage risk.

This publication 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.

Yours sincerely,

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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.

2015 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 currently 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,

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

Nonresident alien individuals from, and foreign corporations organized in, countries with an equivalent exemption provided to US persons may be eligible for an exemption from this tax, provided certain detailed conditions are met.

US-flagged vessels engaged in US international trade also may be subject to a federal tonnage tax.

B. Other federal taxes

1. Sales taxes

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

Inbound insight: *The United States is one of the few countries that does not have a federal indirect sales tax or VAT/GST. 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 VAT/GST system. Inbound companies should be made aware that in the United States indirect taxes are levied at the state and local levels, consisting of more than 13,000 jurisdictions.*

2. Customs duties and import tariffs

All goods imported into the United States are subject to customs entry and are 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.

The applicable duty rates generally are applied to the value of the imported merchandise that is declared at the time of importation (i.e., customs value). Customs value generally is based on the price paid by the importer when purchasing the foreign merchandise for export to the US. When imports result from a transaction between related parties, the price paid to a related entity may serve as the basis of customs value, provided it can be demonstrated that the relationship did not affect the price.

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.

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 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 on log-term capital gains 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 20% 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 may be able to 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 federal income tax 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 often rely on totalization agreements between the United States and other countries for 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 $118,500 of wages in 2016, 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. See Appendix B for a list of current US social security totalization agreements

A foreign employer generally must withhold, make timely deposits, and 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.

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 (see section *I.P.1*, below, with respect to withholding on certain payments to non-US persons).

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 following have been considered by the courts and/or the IRS:

- 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 as to 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's effectively connected earnings and profits (E&P) to the extent they are treated as distributed, based on any decrease in the branch's US net equity for the year. The branch profits tax on profits may be reduced or eliminated entirely if a relevant treaty so provides. The tax does not apply in the year the foreign corporation terminates its US trade or business. 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 — that is, it is a proxy for dividends paid by a US subsidiary.

With certain exceptions, a 30% (or lower treaty rate) branch profits tax is imposed on interest treated as paid by the US branch to foreign lenders. The tax also 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 the activities of an enterprise rise to a level of a PE in a contracting state. The existence of a PE is important because it 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:

- there is a fixed place of business through which the business of an enterprise is wholly or partly carried on, or
- 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* below.

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.*

Inbound insight: *The US 2016 Model Income Tax Treaty does not adopt the proposed broadening of the definition of a PE recommended by the OECD in the BEPS initiative, other than an anti-abuse rule relating to the splitting up of contracts under which a PE is determined based on the length of presence in the host jurisdiction. Residents of any country that is considering negotiating or renegotiating an income tax treaty with the United States should closely monitor the status of negotiations and analyze benefits under a treaty that incorporates the 2016 Model's provisions.*

G. Group taxation

An affiliated group of US 'includible' corporations, consisting of a US parent and its US 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 taxpayer on par with an uncontrolled taxpayer by requiring inter-company prices to meet the arm's-length standard.

The arm's-length standard 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 adjust taxable income and tax payable in the United States. After a transfer pricing adjustment, a multinational company may face potential double tax, paying tax on the same income in two countries. If the related party to the adjustment is in a country that has a tax treaty with the US, multinational companies may request ‘competent authority’ relief from double taxation and there may be arbitration provisions.

In seeking to avoid potential transfer pricing penalties, US taxpayers may prepare contemporaneous transfer pricing documentation. A protective approach available to companies may be to seek an advance pricing agreement (APA) with the IRS, unilaterally, or with the IRS and another tax authority, bilaterally, covering inter-company pricing.

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 being able 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.*

Inbound insight: *In December 2015, Treasury and the IRS issued proposed regulations that would require annual US country-by-country (CbC) reporting for US-parented multinational enterprise (MNE) groups. Inbound companies should review the proposed regulations — including the proposed effective date — closely to determine how they could be affected by the new rules.*

I. Thin capitalization

Thin capitalization rules may apply to disallow interest payments related to 'excess' debt and to recharacterize such payments as dividends. In addition, the taxpayer's interest expense deduction can be limited and suspended if more than 50% of the adjusted taxable income of a 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.

Inbound insight: *Use of debt to finance US operations continues to be recognized as part of an acceptable capital structure. However, inbound companies should study the proposed regulations under Section 385 (discussed below in Section VIII, Financing US operations) to determine how those regulations affect existing financing structures and those under consideration for future use.*

J. Controlled foreign corporations (CFCs)

Under the Subpart F regime of the Internal Revenue Code, a CFC is any foreign corporation with respect to which US shareholders (defined below) 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. For these purposes, a US shareholder is any US person owning (directly, indirectly through foreign intermediaries, or constructively) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation.

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.

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. An inbound investor is permitted to invest in an existing S corporation's business by forming a partnership structure with the S corporation.*

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.

US 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 or losses

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.

For corporations, capital losses are allowed only as an offset to capital gains. (Non-corporate taxpayers can deduct up to $3,000 against ordinary income in a tax year.) 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 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.

b. Subpart F rules

In the case of CFCs, certain types of undistributed income are taxed currently to certain US shareholders (Subpart F income). More specifically, in situations in which a foreign corporation is a CFC for an uninterrupted period of 30 days or more during any taxable year, every US shareholder owning at year-end 10 percent or greater of the total combined voting power of all classes of stock entitled to vote of such a foreign corporation (US shareholder) must include in gross income its pro rata share of the Subpart F income earned by the CFC, regardless of whether the income is distributed to the US shareholders.

With certain exceptions, Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another (i.e., income that is separated from the activities that produced the value in the goods or services generating the income). In particular, Subpart F income includes insurance income, foreign base company income, and certain income relating to international boycotts and other violations of public policy.

There are several subcategories of foreign base company income, the most common of which are foreign personal holding company income (FPHCI), foreign base company sales income (FBCSI), and foreign base company services income (FBCSvI). FPHCI is passive income (e.g., dividends, interest, royalties, and capital gains). FBCSI and FBCSvI are sales and services income earned in cross-border related-person transactions. There are a number of common exceptions that may apply to exclude certain income from the definition of Subpart F income, including exceptions relating to highly taxed income, certain payments between related parties, and active business operations.

In situations in which the US shareholder is a domestic corporation, the domestic corporate shareholder may claim a foreign tax credit for such Subpart F inclusions pursuant to a mechanism similar to indirect FTCs discussed below. Furthermore, certain rules track the E&P of a CFC that have been included in the income of US shareholders as Subpart F income to ensure that such amounts (known as previously taxed income or PTI) are not taxed again when they are actually distributed to the US shareholders.

c. PFIC rules

Income derived with respect to passive foreign investment companies (PFICs) also is subject to special rules designed to eliminate the benefits of deferral. A PFIC is defined as any foreign corporation if, for the tax year, 75% or more of its gross income is passive income (the 'income test') or at least 50% of its assets produce, or are held for the production of, passive income (the 'asset test'). For purposes of these tests, "passive income" includes dividends, interest, gains from the sale or exchange of investment property and rents and royalties (other than rents and royalties that are received from unrelated parties in connection with the active conduct of a trade or business). By contrast, income derived from the performance of services does not constitute 'passive income.'

PFIC status is determined on an annual basis. However, the PFIC 'taint' in some cases may continue throughout an investor's holding period even after the foreign corporation ceases to qualify as a PFIC unless the investor makes a special election (as discussed below). Certain US shareholders of a CFC may be exempt from the PFIC rules with respect to that CFC.

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 investor in the PFIC to be either taxed currently on its proportionate share of the PFIC's ordinary earnings and capital gains each year (i.e., the QEF regime) or taxed annually on the increase in value, if any, of the PFIC stock (i.e., the mark-to-market regime).

If the US investor does not make either a QEF or mark-to-market election with respect to its PFIC stock, the US investor is subject to taxation under the default, excess distribution regime. Under this regime, 'excess distributions' are subject to special tax and interest charge rules. 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 (or the US person's actual or deemed holding period, if shorter). Furthermore, gains on dispositions of PFIC stock generally are treated as excess distributions.

The excess distribution is allocated ratably to each day in the US investor's actual or deemed holding period. Any amount allocated to a prior tax year in the holding period in which the foreign corporation qualified as a PFIC (a 'prior PFIC year') is subject to tax at the highest marginal tax rate in effect for that year. All other amounts are included in income currently as ordinary income.

The special tax amounts for prior PFIC years also are 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. Finally, PFICs can be owned indirectly through other entities, including other PFICs, under ownership attribution rules.

Once a foreign corporation qualifies as a PFIC at any time during a US person's holding period for stock in such foreign corporation, it remains a PFIC in such US person's hands unless a timely QEF election or mark-to-market election is made. Alternatively, the US investor could 'purge' the PFIC taint from the prior portion of its holding period (and pay any applicable tax and interest) or seek relief to file the relevant election retroactively as of the beginning of its holding period, if certain requirements are satisfied.

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 the sum 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.

The Protecting Americans from Tax Hikes (PATH) Act, signed into law on December 18, 2015, made several modifications to Sections 897 and 1445 (i.e., FIRPTA). Notably, the law provides a new exception for investments held by certain foreign pension funds.

Inbound insight: *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 using the straight-line method over 27.5 years. Nonresidential real property is depreciated by using 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 is also 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.

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 specified 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 aggregate 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 through 2014.For tax years beginning in 2015, the PATH Act made these amounts permanent. For tax years beginning after 2015, the $500,000 and $2 million amounts are indexed for inflation.

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.

The PATH Act extended bonus depreciation for five years, generally through 2019 (through 2020 for certain longer-lived and transportation property). The percentage is phased down from 50 percent by 10 percent per calendar year beginning in 2018 (2019 for certain longer-lived and transportation property). Thus, for qualified property (other than certain longer-lived and transportation property) the percentage for property placed in service in 2018 is 40 percent, and for 2019 is 30 percent. These percentages apply to certain longer-lived and transportation property placed in service one year later.

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 22% 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

Under Section 199, taxpayers are generally 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 most corporate taxpayers, the deduction generally will mean a federal income tax rate of 31.85% on QPA income, although certain oil- and gas-related QPA receives a less generous reduction that equates to a federal income tax rate of 32.9%. 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 domestic production gross receipts (DPGR). The deduction is generally 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: DPGR less the sum of cost of goods sold allocable to such receipts and other expenses, losses, or deductions that are properly allocable to such receipts.

Inbound insight: *The Section 199 deduction applies to a variety of US domestic production activities, including the production of tangible personal property, qualified films, the 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 an 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 retirement plans

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 plan 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 under which employees earn a right to a retirement benefit based on their years of service and compensation and/or other factors, payable beginning at their retirement and generally continuing for life. The employer contributes on an on-going basis to pre-fund the amount of retirement income that ultimately will be owed to employees under the plan. 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' and profit-sharing plans, under which employees' benefits are based on the value of their individual accounts. The 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 because 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, may offer 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.

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 United States 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 *N.5* below.

The IRS in July 2014 finalized regulations under Section 174 that are considered taxpayer favorable. The final regulations address several issues related to whether the subsequent sale or use of tangible property created through research is deductible, clarify 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.

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 must 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 United States, 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. A recent IRS revenue ruling concluded that the 1% excise tax under Section 4371(3) no longer will apply to premiums paid for reinsurance policies issued by one foreign reinsurer to another foreign reinsurer even if the underlying risks are US risks. Insurance premiums are not subject to withholding taxes (other than under FATCA; see discussion below).

Inbound insight: *Forming a captive insurance company may not make sense for every business. However, if suitable, a captive may result in meaningful tax and non-tax benefits. A business seeking to insure risks that currently are uninsured (or underinsured) should consider a captive arrangement. If a business with multiple entities needs insurance, a captive arrangement may provide an adequate level of risk protection required by the group.*

N. Credits and incentives

1. Temporary credits and incentives made permanent

The PATH Act included retroactive, permanent extension of the research credit and other business and individual tax provisions; more than 30 other expired provisions were renewed retroactively for either five or two years.

The general business incentives that were made permanent by the PATH Act include the following:

- research credit
- increased Section 179 'small business' expensing limit
- subpart F exception for active financing income
- 15-year straight-line cost recovery for qualified leasehold improvement property, qualified restaurant property, and retail improvement property
- wage credit for employers of active-duty military members
- 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.

The general business incentives extended by the PATH Act to either 2016 or 2019 include:

- look-through treatment of payments between related CFCs under the foreign personal holding company rules
- seven-year recovery period for motor sports entertainment complexes
- work opportunity tax credit
- special expensing rules for qualified film and television productions and
- allocation of new markets tax credit.

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 the taxpayer.

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, for 2015:

- investment credit
- work opportunity credit
- biodiesel and renewable fuels credit
- research credit

- low-income housing 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
- low sulfur diesel fuel production credit
- distilled spirits credit
- advanced nuclear power facility production credit
- non-conventional source fuel 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
- mine rescue team training credit
- agricultural chemicals security credit for eligible businesses
- differential wage payment credit
- carbon dioxide sequestration credit
- a portion of the qualified plug-in electric drive motor vehicle credit for vehicles that will vary based on the date of purchase
- small-employer health insurance credit.

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. The PATH Act extended this credit through 2019.

5. Research credit

The research tax credit under Section 41 is available for companies that make qualified research expenditures (QREs) to develop new or improved products, manufacturing processes, or software in the United States.

The PATH Act made the research credit a permanent provision of the Internal Revenue Code. The credit was first enacted in 1981 on a temporary basis to help increase research spending in the United States, and has been extended on a temporary basis numerous times since then.

The research credit generally is computed by calculating current-year QREs 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. Under final regulations issued in February 2015, the ASC may be claimed on an amended return for a tax year ending after February 27, 2015 — provided the taxpayer has not previously claimed research credits for such year — as well as on the taxpayer's original return for such year. 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.

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.

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 United States 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. Anti-'inversion' developments

Most US inbound companies no doubt are aware of recent US developments regarding so-called 'inversions.' Both the executive and legislative branches of the US government continue to focus on these transactions.

On the administrative front, Treasury and the IRS on November 19, 2015, issued Notice 2015-79 (the Notice), announcing their intent to issue further regulations to limit cross-border merger transactions that the government characterizes as 'inversions' and certain post-inversion transactions, expanding on guidance previously issued in Notice 2014-52. Notice 2015-79generally applies to transactions undertaken on or after November 19, 2015.

The Notice's provisions are generally grouped into three categories. First, the Notice provides three new rules under Section 7874 designed to make it 'more difficult for US companies to invert.' The guidance includes the following:

- Requiring that the 'substantial business activities' test (described below) be satisfied only if the foreign acquiring corporation is tax resident in the applicable foreign jurisdiction.
- Limiting the ability of the new foreign parent of the combined group to be organized in a jurisdiction other than that in which the foreign target company was organized before the combination.

- Clarifying that the regulations at Reg. sec. 1.7874-4T apply to any property (including active business assets) acquired with a principal purpose of avoiding the purposes of Section 7874, regardless of whether the transaction involves an indirect transfer of 'specified nonqualified property.'

Second, the Notice announces rules intended to 'reduce the tax benefits of inversions.' The new rules would:

- Expand the scope of 'inversion gain' to include certain income inclusions so that they cannot be offset by losses or other attributes.
- Require that all net unrealized built-in gain in CFC stock be recognized, without regard to the amount of the CFC's undistributed E&P, if the transaction terminates the status of the foreign subsidiary as a CFC or substantially dilutes the interest of a US shareholder in the CFC.

Third, the Notice modifies certain rules announced in Notice 2014-52, including:

- Modifying the application of the foreign group nonqualified property rules under Notice 2014-52 to exclude (i) certain property that gives rise to income described in the PFIC insurance exception, and (ii) certain property held by domestic corporations engage in the active conduct of an insurance, banking, or financing business.
- Providing a de minimis exception to the 'non-ordinary course distribution' rules under Notice 2014-52.
- Clarifying that the rule set forth in Notice 2014-52 with respect to decontrolling or diluting an expatriated entity's CFC in post-inversion transactions applies to the *percentage* of CFC stock (by value).

The foregoing modifications to Notice 2014-52 generally are taxpayer-friendly and address unintended consequences of Notice 2014-52. Significantly, the Notice does not include rules limiting deductions for cross-border payments made by inverted entities; however, an accompanying press release indicates that such rules could be issued in the 'coming months.'

On April 4, 2016, Treasury and the IRS issued temporary (T.D. 9761) and proposed regulations under five Code sections that, as the government indicated in Notice 2015-79, are intended to cross-border merger transactions that the government characterizes as 'inversions' and certain post-inversion transactions. The temporary regulations incorporate rules Treasury and the IRS had previously announced in Notice 2014-52 and Notice 2015-79 (collectively, the Notices), with some modifications and changes. However, the temporary regulations also include several new rules. The text of the proposed regulations is the same as that of the temporary regulations.

The most significant of the new rules in the temporary inversion regulations applies to make it more likely that a transaction will be treated as an inversion if the foreign corporation that acquires a US target has made other acquisitions of one or more US companies in the 36-month period preceding the acquisition.

The temporary regulations are generally grouped into two categories. First, the temporary regulations include rules under Section 7874 that are designed to make it more difficult for US companies to redomicile to another country. These temporary regulations under Sections 7874 and 367 provide the following rules:

- Disregarding certain stock of a foreign acquiring corporation where that foreign acquiring corporation has made other acquisitions of US entities in the 36-month period preceding the acquisition.
- Disregarding certain disproportionate distributions made by the domestic target prior to the acquisition, designed to prevent US companies from shrinking their sizes prior to a transaction.
- Disregarding certain stock of a foreign acquiring corporation that holds predominantly passive assets.
- Addressing the impact of subsequent transfers of foreign acquiring company stock on the expanded affiliated group rules in current regulations.
- Providing that where an inversion transaction involves a business combination with a foreign target corporation, the foreign parent of the combined group must be tax resident in the same country as the former parent of the historic foreign target corporation.

Second, the temporary regulations include rules under Sections 7874, 367, 304, 956, and 7701(l) that address post-transaction steps that taxpayers may undertake with respect to US-owned foreign subsidiaries, intended to make it more difficult to access foreign earnings without incurring added US tax. These temporary regulations include the following rules:

- Guidance under Section 956(e) that would treat as 'US property' post-inversion acquisitions by CFCs of the debt or equity interests in the new foreign parent corporation or certain foreign affiliates, regardless of whether the funds involved were made available to a US shareholder.
- Guidance under Section 956 that implements the principles of Notice 88-108 and its progeny so as to exclude certain short-term obligations from the definition of 'obligation' for purposes of Section 956.
- Section 7701(l) guidance that would maintain CFC status for existing foreign subsidiaries of the US company, even when the new foreign parent or another foreign affiliate makes an equity investment that gives it a majority interest.
- Section 367(b) guidance that would cause a US shareholder to take into account its Section 1248 amount and recognize any residual gain where there is a dilution in the US shareholder's interest in a CFC, even if the CFC remained a CFC, without regard to an E&P limitation.
- Guidance under Section 7874 expanding the definition of inversion gain to include certain income inclusions from transactions undertaken by CFCs.
- Guidance under Section 304 that would tighten the limitation under Section 304(b)(5)(B) and thereby further limit the ability to bypass the former US parent company (in a deemed disposition of the CFC's E&P) where the new foreign parent sells shares of the former US parent company to a lower-tier CFC.

The temporary regulations are subject to various effective dates. Broadly, rules implementing provisions that were announced in Notice 2014-52 are effective as of the dates announced in that Notice (in most cases, September 22, 2014); provisions that were announced in Notice 2015-79 are effective as of the dates announced in that Notice (in most cases, November 19, 2015); and provisions that had not previously been announced in the Notices are effective as of April 4, 2016.

Also on April 4, 2016, Treasury and the IRS issued proposed regulations under Section 385 addressing whether an interest in a related corporation is treated as stock or indebtedness, or as in part stock and in part indebtedness. Those proposed regulations are discussed below in *Section VIII, Financing US operations*.

On the legislative front, several Congressional Democrats continue to support bills proposed in 2014 to curb perceived abuses involving cross-border mergers and the use of low-tax foreign jurisdictions. In addition, the Democratic presidential candidates have announced anti-inversion proposals.

House Ways and Means Committee Ranking Member Sander Levin (D-MI) and member Lloyd Doggett (D-TX) introduced the Stop Corporate Inversions Act of 2015 (H.R. 415). Senate Minority Whip Dick Durbin (D-IL) and Sen. Jack Reed (D-RI) introduced a companion Senate bill (S. 198) (together, the Levin/Durbin bills). The Levin/Durbin bills would apply Section 7874 to treat a foreign company as a US company (for US federal income tax purposes) where there is greater than 50% continuity of ownership by the predecessor US company's shareholders -- rather than the current 80%. The bills also would treat a foreign company as a US company if both (1) its management and control, and (2) significant business operations remain in the United States, while it does not have substantial business activities in its country of incorporation. The Levin/Durbin bills are similar to an Obama Administration proposal in its FY 2017 Budget.

Rep. Doggett also introduced the Stop Tax Haven Abuse Act (H.R. 297), and Sen. Sheldon Whitehouse (D-RI) introduced a companion bill (S. 174) (together, the Doggett/Whitehouse bills). The Doggett/Whitehouse bills propose Section 7874 modifications similar to the Levin/Durbin bills but have a wider scope. Their provisions would, among other things, tighten foreign financial reporting requirements further, repeal check-the-box entity classification rules, treat certain foreign corporations managed and controlled in the United States as US corporations, and echo previous proposals addressing 'excess' IP-related income of CFCs, intangibles transfers, and interest expense deductibility.

A bill introduced on April 14, 2015, by Sen. Bernie Sanders (I-VT) — The Corporate Tax Dodging Prevention Act of 2015 — would enact several changes to the Code that are intended to prevent corporations from sheltering profits in 'tax havens' like Bermuda and the Cayman Islands and to eliminate tax breaks for companies that 'ship' jobs and factories overseas.

Additional inversion-related bills might be introduced later this year. For example, some Democratic lawmakers have expressed interest in a proposal by Democratic presidential candidate Hillary Clinton to impose an 'exit tax' on the untaxed foreign earnings of inverting US companies.

Inbound insight: *The legislative prospects of the bills mentioned above introduced by Democrats are uncertain, especially given Republican control of both chambers of Congress and the uncertain outlook for tax reform. However, if some features of the bills were enacted as part of any legislative vehicle, they would have a significant adverse impact, including possible unintended consequences. Companies that would be affected by these proposals should remain vigilant about the possibility that one or more of these 'anti-abuse' proposals might be used as revenue-raising provisions to help offset the cost of unrelated legislation. This possibility may be particularly important if Congress delays consideration of corporate tax reform until after 2016.*

P. 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 (other than capital gains) that is not effectively connected with a US trade or business. Persons making such US-source payments ('withholding agents'), such as US-source interest, dividends, and royalties, to foreign persons generally must withhold 30% of the gross payment 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 US tax law (e.g., portfolio interest exemption). The withholding agent is liable for 100 percent of any missed withholding tax. See the latest edition of *IRS Publication 515*.

The United States has entered into income tax treaties with various countries in order to avoid double taxation of 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 documentation provided using 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 and Reporting (Individuals)*, is used to establish that an individual is not a US person and is the beneficial owner of the income related to which the Form is being provided. Form W-8BEN also can be used to claim a reduced rate of withholding based upon an applicable income tax treaty. ***Note:*** Beginning in 2014, Form W-8BEN is used only by individuals. Entities use Form W-8BEN-E.

Form W-8BEN-E, *Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities)*. Among other purposes (e.g., FATCA), this form is used to establish that the payee is not a US person and is the beneficial owner of the income related to which the Form W-8BEN-E is being provided. Form W-8BEN-E also can be used to claim a reduced rate of withholding based upon an applicable income tax treaty. ***Note:*** Form W-8BEN-E is used only by entities. Individuals use Form W-8BEN.

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

- 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 or individual that is engaged in a US trade or business and describes for the withholding agent what income it is paying that is effectively connected with such US trade or business.
- Form W-8EXP, *Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding and Reporting*, is provided by non-US governments, non-US foundations, or non-US tax-exempt organizations.

- Form W-8IMY, *Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding & Reporting*, is provided by a non-US flow-through entity (e.g., partnership) that is not engaged in a US trade or business and non-US intermediaries. Form W-8IMY is used to indicate that the payee is not the beneficial owner of the payment and generally must be accompanied by Forms W-8 and/or Form W-9 for the actual beneficial owners and a withholding statement that allocates the income to the beneficial owners.

Treaty claims made by nonresident alien individuals who provide independent personal services in the United States 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-8BEN-E, W-8ECI, and W-8EXP generally are valid for three years from the date the form is signed. 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. For some purposes (not applicable if treaty benefits are claimed), the forms can remain valid indefinitely absent a change in circumstances. 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, and limited liability companies (LLCs). Backup withholding at the current rate of 28% is required if the US non-exempt recipient fails to provide a taxpayer identification number (TIN) in the proper manner prior to payment or if the payor is instructed to backup withhold by the IRS. Payors that fail to impose backup withholding when required are liable for 100% of the missed withholding.

Payments made to US exempt recipients are not subject to reporting or backup withholding, and such recipients are not required to provide a TIN. Depending on the payment, 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 and financial institutions.

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 (and can be required) by receiving a valid Form W-9, *Request for Taxpayer Identification Number and Certification*, from US payees, including exempt recipients. The IRS's TIN Matching Program can be utilized to verify names or TINs with IRS records to ensure accuracy.

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. Note that a non-US company (e.g., one that has custody of the funds made to a non-US beneficial owner) also may be a withholding agent.*

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 U.S. 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 (reporting required for amounts beginning at $10), 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) or through third-party payment networks (i.e. internet payment service provider) 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, hold financial accounts outside the United States or have operational areas that make or receive payments subject to FATCA.

FATCA added chapter 4 (Sections 1471-1474) to the Internal Revenue Code. FATCA requires many foreign financial institutions (FFIs) to enter into agreements with the IRS under which they undertake procedures to identify which of their accounts are held by certain US persons and annually report information regarding such accounts to the IRS. An FFI that has entered into such an agreement is known as a 'participating FFI.' In addition, some nonfinancial foreign entities (NFFEs) must report information regarding certain direct or indirect US owners to withholding agents. Non-compliance with FATCA triggers a 30% withholding tax on certain US-source fixed or determinable, annual, or periodical (FDAP) payments (and, beginning in 2019, on gross proceeds from the disposition of debt or equity securities issued by US persons). However, IRS regulations provide for various exceptions, such as categories of FFIs or NFFEs that are eligible for lightened compliance obligations.

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

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. FATCA compliance obligations

FATCA imposes registration, due diligence reviews, information reporting, and tax withholding obligations on entities that qualify as FFIs. Legal entities with FFI characteristics must determine whether they are, in fact, FFIs and, if so, whether they are required to register with the IRS.

Multinational corporations (MNCs) should examine their treasury centers, retirement funds, and holding companies, to name a few examples, to determine whether they meet the definition of an FFI. Properly identifying the FATCA status of each entity in a large organization can take significant time and effort and must be repeated regularly, 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 FDAP income, which include many MNCs. 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 interest and 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 including, for certain types of NFFEs, information regarding US persons that own (directly or indirectly) more than 10% of the NFFE.

ii. FATCA exemptions

There are several important exemptions from FATCA to the withholding of tax on US-source FDAP 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 (i.e., the entity documents its FATCA status and provides all required information to the withholding agent, and that status is not 'nonparticipating FFI' or 'limited FFI'). Even though FATCA withholding does not apply, reporting still is required. The withholding agent also must evaluate whether reporting and withholding apply under the information reporting rules discussed in the previous section.

Treasury regulations provide a number of categories of FFIs that may be treated as deemed-compliant with FATCA or as 'exempt beneficial owners.' These categories of FFIs have characteristics that are considered to present a lower risk of use for tax evasion and accordingly do not have to enter into an FFI agreement with the IRS (though they may still have to register) and generally will not be required to perform the same due diligence and reporting that participating FFIs must perform.

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 made to a documented US entity is not subject to the 30% tax, but reporting may apply.

iii. Actions to comply with FATCA

MNCs 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 should highlight changes in business practices that may be necessary for FATCA compliance, and would be intended to inform senior management that all areas of the organization have been reviewed according to requirements.

iv. 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, known as Model 1 IGAs, 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. Other IGAs, known as Model 2 IGAs, provide that local governments will direct FFIs resident in the jurisdiction to report to the IRS.

Assessing FATCA's impact requires identifying whether an IGA may apply to the entity at issue. Provisions in the final regulations or in any IGA that provide more favorable results may be utilized. The IRS and Treasury have focused on negotiating 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.

v. 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.

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 and therefore are FFIs. However, certain retirement funds entitled to receive benefits under a tax treaty are examples of retirement funds that are treated as 'exempt beneficial owners' and therefore not required to enter into FFI agreements with the IRS.
- **Treasury centers, holding companies, and captive finance companies**—These types of entities are specifically identified in the definition of an FFI. However, if such entities satisfy certain requirements and are part of a nonfinancial group of companies, they may be excepted from being FFIs. 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 these entities frequently are 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 are not FFIs for FATCA purposes if they do not issue cash value or annuity contracts. However, such captives still should evaluate their business operations to determine if they fall within 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 are FFIs, the MNC should determine if such entities may qualify for an exception from FFI status. 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 FFIs within the group.

If an entity is an FFI, the MNC has to determine whether the FFI must become a participating FFI (or a reporting FFI under an IGA), or if it qualifies for deemed-compliant or exempt beneficial owner status. If the entity does not qualify for such status, it must properly register with the IRS. 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.

vi. Companies that make US-source cross-border payments

FATCA withholding and reporting generally applies when a multinational business makes a withholdable payment (i.e., a payment of certain US-source FDAP income, and, beginning in 2019, gross proceeds from the disposition of debt and equity securities issued by US persons). From a practical perspective, a large range of payors can be affected—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.

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

vii. Expansive definition of a withholdable payment

The term 'withholdable payment' generally refers to the gross amount of US-source interest, dividends, insurance premiums, and any financial payment etc., and can include other types of US-source income not otherwise subject to withholding under Chapter 3 of the IRC. For example, beginning in 2019, gross proceeds from the sale of certain property that produces US-source interest or dividends are included in the definition.

Treasury functions, accounts payable departments, and other areas of a global organization may make 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
- bank and custodial fees
- advisory and broker fees associated with merger and acquisition activity
- insurance or reinsurance premiums paid for insuring US risk
- gross proceeds from derivatives, swaps, and other hedging arrangements, typically performed by the treasury function.

Certain nonfinancial payments 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.

viii. 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 the payee FATCA compliant?' IRS forms, such as W-8BEN-E and W-8IMY, enable payees and intermediaries to certify both their FATCA status and information relevant to Chapter 3. In addition, the regulations that harmonize the FATCA requirements with the existing 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.

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

ix. Companies that receive 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 an NFFE located outside of the United States, which may be treated as a 'passive NFFE' and subject to FATCA withholding if it fails to timely and properly identify itself to its withholding agent and provide information regarding its ownership.

x. 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. Legislation enacted in 2015 changed filing dates for corporate, partnership, and certain other returns filed for tax years beginning after December 31, 2015. As a result of the new legislation, a calendar-year corporate taxpayer generally must file an annual tax return (generally Form 1120) by the 15th day of the fourth month following the close of its tax year (April 15). Such C corporations also receive a five-month automatic extension to file, through September 2015. Failure to timely file may result in penalties.

4. Important tax return due dates for businesses

Form	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.	C corporations- April 15 (Form 7004 may be filed to obtain an automatic five-month filing extension for tax years beginning before January 1, 2026). S corporations- March 15 for calendar-year returns, or 2.5 months after close of year-end, with six-month maximum extensions.
Schedule K-1	Partner's Share of Income, Deductions, Credits, etc.	Information returns to be provided to partners by partnerships.	March 15

Form	Title	Purpose	Due date
1065	US Return of Partnership Income	Information returns to be filed by partnerships.	March 15 (Form 7004 may be filed to obtain an automatic six-month extension)
1094/1095 series (ACA reporting)	Employer-provided health insurance offer and coverage and Transmittal of Information Returns	Statements to covered individuals and full-time employees of health coverage offered and provided by month during the year; transmittal of statements to IRS	For 2016, Forms 1095 are to be provided to employees and covered individuals by January 31, 2017, with copies and Forms 1094 sent to the IRS by February 28 (March 31 if filing electronically)
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 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 year’s tax return.

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 businesses and individuals with lower incomes generally are subject to audit if their returns are selected based on certain criteria.

The IRS Large Business and International Division (LB&I) is looking to move away from continuous audits of large corporate taxpayers. LB&I has been working on removing the distinction between the Coordinated Issue Cases (CIC) and the Industry Cases (IC). LB&I plans, over the next two years, to focus on specific issues to address many future corporate audits through campaigns. However, many large corporations may see changes in how issues are identified on audits due to the input of centralized classification teams that have been put in place to review all the CICs in the field.

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 by gaining certainty regarding tax positions prior to filing a tax return. Due to significant changes in LB&I staffing and the need to focus on non-compliant taxpayers, LB&I currently is reviewing the role CAP will play in its new structure. LB&I has determined that it will not be adding any new participants to the CAP program in 2016.

Inbound insight: *As one might suspect from LB&I's decision not to add new participants to the CAP program in 2016, the future of the program remains uncertain. LB&I Commissioner Douglas O'Donnell has noted that CAP might not have a place in the new LB&I, which recently underwent a major reorganization. Inbound companies that have been considering CAP should monitor closely developments related to the future of CAP and what might replace it.*

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.

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

Inbound insight: *LB&I has released over 110 International Practice Units (IPUs) since 2014. These IPUs provide guidance to IRS examiners in addressing a range of issues involving US federal income taxation of cross-border activities. The IRS has classified its IPUs according to a new organizational scheme, the 'International Matrix,' which reflects an updated LB&I approach to cross-border issues generally. Some of those issues include income shifting, inbound financing, and repatriation/withholding. This organizational scheme reflects growing IRS awareness of how taxpayers and their advisors may consider cross-border US federal income tax issues. For example, the previous IRS taxonomy did not distinguish between concerns of inbound and outbound taxpayers.*

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. In order to affect timing, the accounting method must determine the year in which an income or expense item is to be reported.

In general, in order 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 a particular penalty interacts with the other penalties.

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 only have a duty 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, and failure of a US person to furnish information relating to CFCs and controlled foreign partnerships, failure of a US person to report foreign bank accounts. Pension and employee benefit-related tax penalties are intended protect the policy reasons for the tax incentives including, most notably, early withdrawal of pension funds. Another group of specialized penalties apply 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.

Inbound insight: *The LLC is a popular form of business entity organization in the United States 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.*

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, 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.

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.*

Inbound insight: *In the United States, federal tax concepts do not always translate into state concepts. Activities that do not result in US federal reporting may result in state tax reporting requirements. For example, companies should note that a foreign entity's income may be excluded from federal taxable income by US income tax treaty, but that income still may be taxable by a state. Not all states require physical presence to assert tax jurisdiction; economic presence may be deemed sufficient to create nexus. Companies performing cross-border restructuring work should also consider the state tax implications.*

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 with 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 be deemed to 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. California, Ohio, Washington, and certain other states have enacted factor presence standards for certain taxes. For example, California's factor presence statute provides that an entity is doing business with the state if the entity's California sales exceed $500,000 (adjusted annually for inflation). Recent developments include Alabama and Tennessee enacting factor-presence nexus standards in 2015.

A federal 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. Because non-income-based taxes, such as net worth and gross receipts taxes, are not protected, many states actively assert nexus on foreign entities for such taxes.

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 should not be deemed to create nexus. The receipt of royalties also generally should not be deemed to 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. However, with more states asserting an 'economic nexus' standard, the receipt of interest, dividends, or royalties becomes increasingly susceptible to claims of nexus from those states where such income streams derive.

Inbound insight: *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., whether the company has nexus in the state). The concept of nexus, which has been evolving over a number of years, 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 unanticipated state disputes arise 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.

Complexities arise when 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.

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, and 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).

Inbound insight: *A non-US entity's income and apportionment factors may be included in a state return. Even on a water'- edge return, companies with certain levels or types of activity in the US could be included in the combined group, and many states differ on their interpretation and calculation of 'US activity' compared to worldwide activity.*

Generally, states that give taxpayers an option between water's-edge and worldwide provide worldwide filing as the default, like California; 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 CFC (to the extent of its Subpart F income over its E&P) is included in the California water's-edge combined report as well. Wisconsin has a similar rule regarding effectively connected income.

Some water's-edge states, like Illinois, include foreign entities in the group if more than 20% of their activity is in the United States.

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, Connecticut, the District of Columbia, Montana, Oregon, and West Virginia include such entities to varying degrees. Rhode Island has its own unique tax haven law. The Multistate Tax Commission has approved a model tax haven statute that other states could adopt. At the time of this publication, at least eight several states, including Colorado and Massachusetts, are proposing establishing or expanding tax haven laws. 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.

***Inbound insight**: Under a 'tax-haven' inclusion rule, a non-US entity's income and apportionment factors may be included in a state combined return if it is incorporated in or doing business in a 'tax haven' country. Many of the tax haven laws consider only an entity's country of incorporation or whether any business activity exists in a country. There is generally no inquiry into whether an entity has a legitimate business purpose.*

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.

Additionally, states may expand their reach beyond taxing a foreign entity's effectively connected income. For example, in one case, the Alaska Supreme Court ruled that the state did not expressly adopt Section 882 provisions that limit foreign corporate dividend income to US effectively connected income. Alaska's 80% foreign dividend-received deduction (DRD) serves as an exception to the state's general adoption of the section. As a result, an Alaska taxpayer was required to apply the state's 80% DRD to its foreign dividends rather than exclude them entirely under Section 882.

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 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.

US shareholders of 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 regarding 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 E&P (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.

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

***Inbound insight**: Businesses are facing increasing scrutiny of their intercompany transactions; over a dozen states have exercised Section 482-type powers during audits. Inbounds should proactively look at their domestic footprint and consider preparing transfer pricing reports for domestic transactions that support their business activities.*

G. Indirect tax considerations

State 'indirect taxation' generally refers to any state tax that is not based on income. The most common indirect tax is a state's sales and use tax; 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. For example, in November 2015 the Alabama Department of Revenue issued a regulation establishing economic nexus when an out-of-state retailer makes retail sales of greater than $250,000 of tangible personal property into the state. Many states have enacted 'click-through' nexus standards, providing generally that an out-of-state retailer has nexus due to the in-state presence of a person who, for a commission or other consideration, directly or indirectly refers potential customers to the retailer (by a website link or otherwise).

Concepts of combined and consolidated reporting also are not relevant for sales tax purposes, 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 stature does not apply to non-income taxes. Accordingly, an entity with employees engaged only in the solicitation of sales 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 tax 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, barters, 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.

Issues arise regarding the taxation of software. States vary in their treatment depending on whether the software is custom-made or off-the-shelf. The method of delivery may control whether tax applies – for example, physical delivery on a CD or flash drive, an electronic download from a website, access to a hosted cloud environment, and application accessed through a browser. States have taken substantially different positions on whether these unique types of software and cloud technologies are taxable, and, if so, where these sales are deemed to occur (that is, where the sales would be taxable.)

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.

In 2016, a US appellate court upheld a unique state sales/use tax reporting rule enacted by Colorado that requires retailers that sell products to Colorado customers, but do not collect and remit Colorado use tax, to report certain information about such purchases to the customers and to the Colorado Department of Revenue. The law generally requires non-collecting retailers to (1) notify Colorado purchasers that sales or use tax is due on certain purchases, (2) provide an annual report to certain Colorado purchasers of their purchases for the year, and (3) provide an annual statement to the Colorado Department of Revenue listing their Colorado customers and the total amount paid for Colorado purchases in the prior calendar year. Inbound companies should monitor this development, as subsequent appeals are expected. If the decision stands, retailers selling into Colorado will be subject to this notice and reporting requirement.

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. In addition to states, thousands of local municipalities within states levy sales and use taxes (sometimes with different rules than the states).*

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 may be 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
- technology investment tax credits
- alternative and renewable energy tax credits
- research and development credits
- training 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
- sales tax exemptions
- infrastructure grants
- training grants
- cash grants
- withholding tax rebates
- reduced financing
- utility tax exemptions
- construction fee waivers.

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, the US Treasury has made it a priority to renegotiate the more commonly used treaties that did not have LOB articles. Two of those treaties — with Hungary and Poland — have been renegotiated but not yet 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. The US has been adding more restrictive provisions to the LOB tests so that a company that is not engaged in treaty-shopping nonetheless may fail the tests. If objective tests are not met, a country's competent authority may grant treaty benefits with respect to a specific item of income upon request by the taxpayer, if the competent authority determines that the establishment, acquisition, or maintenance of the entity and the conduct of its operations did not have as one of its principal purposes the obtaining of treaty benefits.

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.

Inbound insight*: Tax treaties reduce US withholding taxes to encourage foreign companies to invest in the United States. When both countries have the right to tax an item of income under the treaty, the treaty seeks to avoid double taxation by requiring one of the countries to allow a credit for the other country's tax (or to exempt the income from its own tax).*

Tax treaties help the US economy by allowing US companies to more efficiently conduct their businesses abroad and by making the United States more hospitable to foreign investment, which creates and sustains millions of American jobs.

Many of the treaties and protocols awaiting Senate ratification were signed by the Treasury Department several years ago. The protracted period of ratification could send a signal, inadvertently, to all US tax treaty partners that the US does not value the benefits of tax treaties and that the expansion, improvement, and modernization of the US bilateral tax treaty network is not a priority. Given the unilateral actions that many foreign governments are considering as a consequence of issues raised in the OECD Base Erosion and Profit Shifting process, this sends the wrong signal at the wrong time.

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 over 30 tax information exchange agreements, which provide the legal basis for exchanges of information between tax administrations.

In addition, the US Treasury has signed many bilateral intergovernmental agreements (IGAs) related to the implementation of the FATCA information reporting and withholding tax provisions (discussed above).

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.*

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 intangible 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 larger portion of entities' profits for their tax bases. This can result in the risk of tax assessments, double taxation of the same income by two jurisdictions, and penalties for failure to properly allocate income among two or more jurisdictions. Therefore, virtually all large MNCs require consideration of international transfer pricing strategies and potential risks.

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, contract R&D services)
- financing (e.g., intercompany loans, accounts receivable, guarantees, debt capacity)
- intangible property (e.g., licenses, royalties, cost sharing transactions, platform contribution transactions, 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 produce results that differ from those that would have resulted from similar transactions 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. There are some countries (e.g., Brazil) that do not follow the international application of the arm’s-length principle.

If a transaction between related parties is priced differently than if it were between unrelated parties, the IRS has authority to reallocate income or expenses to reflect the amounts that would have resulted had the transaction been conducted at arm’s length.

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 transactions involving 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 (i.e., the 'best method').

The selection of a method also varies depending on the type of transaction. For example, the regulations provide five specified methods for transactions involving tangible property, six specified methods for service transactions, while only three are specified for transactions involving intangible property. Methods not specified in the regulations are also potentially applicable. 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 for a particular transaction, the relative reliability of a method must be evaluated on the degree of comparability between the controlled transaction or taxpayers and 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 assumptions made in applying the method. 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, while other methods rely on broad comparisons of profitability.

4. Arm's-length range

The Section 482 regulations recognize that a method is likely to produce a range of arm's-length results and provide that a taxpayer will not be subject to adjustment if the taxpayer's results fall within such 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 in order for the uncontrolled transaction to have a similar level of comparability and reliability. In many cases, the reliability of the analysis will be improved by adjusting the range through the application of a valid statistical method, often the interquartile range of results.

5. Penalties and documentation

The Internal Revenue Code imposes penalties if a taxpayer receives an IRS transfer pricing adjustment exceeding certain thresholds. The penalties do not apply, however, if the taxpayer has prepared and documented a reasonable transfer pricing analysis supporting its reported transfer pricing.

Under Section 6662(e), the transfer pricing penalty generally is equal to 20% of the underpayment of tax attributable to the transfer pricing misstatement, but increases to 40% of the underpayment of tax for larger adjustments. Having contemporaneous transfer pricing documentation that satisfies the requirements under Section 6662(e) in place at the time the tax return is filed can 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 may become available for avoiding adjustments or penalties for certain controlled transactions without the need for documentation or APAs. 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 such safe harbors become a component of US tax policy.

V. The OECD's BEPS project

A. OECD BEPS Action Plan

Since 2012, G20 countries and the OECD have pursued an initiative to reform international tax regimes by addressing opportunities for base erosion and profit shifting (BEPS). On October 5, 2015, the OECD released final recommendations from its BEPS project, which then were endorsed by the G20 leaders at their summit in Antalya, Turkey, on November 15-16. A number of non-G20 countries also have been involved in work on the Action Plan and contributed to the proposals.

The OECD's BEPS Action Plan categorized its various focus areas into three themes: addressing substance; coherence of the international tax system; and transparency. Substance actions seek to align taxing rights with the relevant value-adding activity. Coherence actions aim to remove gaps and 'black holes' among countries' tax systems. Transparency actions look to provide significant additional disclosure to tax authorities. In addition to the various actions grouped under these three themes, the BEPS Action Plan also seeks to address digital business, improve dispute resolution, and create a multilateral instrument for rapid updating of bilateral tax treaties. Finalized proposals for all these items were included in the package of measures released by the OECD.

There are three fundamental ways in which the OECD's work on BEPS will have a practical impact:

- First, and most obvious, there will be the direct application of the BEPS package itself, whether through changes to tax treaties (by amendment of the OECD model tax treaty or the multilateral instrument) and transfer pricing guidelines, or through changes to domestic legislation as a result of individual recommendations of the BEPS Action Plan.
- Second, there will be unilateral actions by some countries, regardless of OECD efforts to discourage such actions. Countries adopting unilateral measures may do so because they disagree with the direction of the BEPS package or think the recommendations do not go far enough.
- Third, and perhaps most important, there will be a behavioral impact — specifically, in emboldening the behavior of tax authorities. This is likely to mean more aggressive and more protracted challenges by tax authorities, higher thresholds for obtaining advance rulings, and increased tax controversies in general.

B. Increased risk of double taxation

Historically, the goal of the OECD has been to promote global economic growth and development through the unfettered exchange of goods and services, and the movement of capital, technology, and persons across borders. To that end, the OECD's focus has been on eliminating impediments to cross-border flows, such as double taxation, by expanding income tax treaty networks, by establishing clear rules for governments with respect to taxing companies with a limited presence in their jurisdictions, and by reducing gross basis withholding taxes.

The OECD BEPS project, by contrast, has been focused on eliminating so-called 'double non-taxation.' In this quest, the OECD also has sought to coordinate action among participating governments in order to avoid increasing the risk of unrelieved double taxation. It is unclear, however, how well the OECD will succeed in its coordination efforts. As a consequence, there are serious concerns that one outcome of the BEPS project could be a surge in instances of double taxation and tax disputes worldwide.

C. Departing from consensus-building OECD model

The rapid pace of the BEPS project, with discussion drafts being released and finalized quickly (sometimes with less than 30 days allowed for public comments), conflicts with the traditional approach of OECD consensus building. True consensus around a single solution chosen from an array of options can be difficult to achieve under such short deadlines. The difficulty of harmonizing the divergent views of source and residence countries, and of the developed OECD economies and the developing non-OECD G20 economies, has proven challenging.

Instead of setting forth a consensus on key issues, the OECD in several reports has presented a 'menu' of options to address base erosion concerns, in order to meet prescribed deadlines. For example, access to treaties likely will become more uncertain for MNEs, as competing subjective general anti-avoidance rules and main-purpose tests are proposed to prevent treaty shopping. Also of concern, proposals intended to prevent 'artificial avoidance' of permanent establishment (PE) status consist primarily of options for lowering the PE threshold.

D. Most significant impacts for taxpayers

With regard to specific Action Plan items, the most significant impacts on taxpayers are likely to be in the following areas:

- tax treaty access becoming more constrained and in some cases uncertain
- increases in transfer pricing documentation, new 'country-by-country' (CbC) reporting requirements, and the wider transparency agenda necessitating company information system changes
- increased focus on conduct as a relevant test in assessing transfer pricing compliance
- increases in assertions of PE and erratic interpretation of PE profit attribution rules
- restrictions in the relief for interest and other financial payments
- rise in the level of cross-border controversy and number of disputes.

E. Ongoing efforts

While almost all the OECD's 2015 BEPS project objectives were achieved with the release of the final reports on October 5, 2015, some related work by the OECD continues in 2016 and beyond. This ongoing work relates to the following:

- transfer pricing aspects of financial transactions
- attribution of profit to Pes — no changes are anticipated in the authorized OECD approach but additional guidance will be needed in how it applies to commissionaire structures and similar arrangements
- use of profit-split methods — clarification of existing guidelines
- implementation of hard-to-value intangibles proposals — clarification regarding the practical approach that will be required
- other related work such as treaty abuse and hybrid arrangements.

F. Proposed country-by-country (CbC) regulations

Treasury on December 21, 2015, released proposed CbC reporting regulations. The proposed regulations would require annual CbC reporting by a US person that is the ultimate parent entity of a multinational enterprise (MNE) group and that had at least $850 million in annual consolidated group revenue for the preceding annual accounting period.

The new reporting requirements are proposed to be effective for tax years of the ultimate parent entity of a US MNE group that begin on or after the date of publication of final regulations. Thus, the new reporting rules would apply for 2017 tax filings, at the earliest, for calendar-year US-headquartered multinational corporations (MNCs). Unilateral actions by other countries may require filings in those countries by US MNCs at an earlier date.

In response to Treasury's release of the proposed regulations, House Ways and Means Committee Chairman Kevin Brady (R-TX) issued a statement that the guidance will be reviewed and that "Congress will not allow Treasury to move forward with BEPS policies that enable foreign governments to misuse information reporting and exploit American companies." Ways and Means Subcommittee on Tax Policy Chairman Charles Boustany (R-LA) introduced legislation (H.R. 4297) that would delay Treasury providing CbC reporting to foreign tax authorities and provide for Treasury to suspend future reporting to another country if that nation does not safeguard the confidentiality of the reported information.

VI. Individual tax issues

The United States levies tax on its citizens and resident aliens 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 *VI. 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—2016 (1)

Taxable income in $			
Over	Not over	Tax on column 1 in $	Tax on excess (%)
0	9,275	0.00	10
9,275	37,650	927.50	15
37,650	91,150	5,183.75	25
91,150	190,150	18,558.75	28
190,150	413,350	46,278.75	33
413,350	415,050	119,934.75	35
415,050		120,529.75	39.6

Married couples filing jointly and surviving spouses—2016 (1, 2)

Taxable income in $			
Over	Not over	Tax on column 1 in $	Tax on excess (%)
0	18,550	0.00	10
18,550	75,300	1,855.00	15
75,300	151,900	10,367.50	25
151,900	231,450	29,517.50	28
231,450	413,350	51,791.50	33
413,350	466,950	111,818.50	35
466,950		130,578.50	39.6

Married individuals filing separately—2016 (1)

Taxable income in $			
Over	Not over	Tax on column 1 in $	Tax on excess (%)
0	9, 275	0.00	10
9, 275	37,650	927.50	15
37,650	75,950	5,183.75	25
75,950	115,725	14,758.75	28
115,725	206,675	25,895.75	33
206,675	233,475	55,909.25	35
233,475		65,289.25	39.6

Head of household—2015 (1, 2)

Taxable income in $			
Over	Not over	Tax on column 1 in $	Tax on excess (%)
0	13,250	0.00	10
13,250	50,400	1,325.00	15
50,400	130,150	6,897.50	25
130,150	210,800	26,835.00	28
210,800	413,350	49,417.00	33
413,350	441,000	116,258.50	35
441,000		125,936.00	39.6

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. The maximum federal income tax rate on 'qualified dividends' received from a domestic corporation is 20% (23.8% if the net investment income tax discussed below applies).
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 $186,300 ($93,150 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 2016 is $83,800 for married couples filing jointly or surviving spouses, $41,900 for married individuals filing separate returns, and $53,900 for single individuals. If AMTI exceeds $159,700 for married couples filing jointly or surviving spouses ($79,850 for married individuals filing separate returns and $119,700 for other unmarried 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 and Form I-407 filed (expiration of the green card by itself has no impact for tax purposes). Complex rules apply to individuals who relinquish 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. Exceptions also are 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.

***Inbound insight**: Resident alien status often results in lower US tax than nonresident alien status, due to increased allowable deductions and credits 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 resident alien status triggers 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, a non-US-citizen 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 (or under a series of other tests, if necessary) if the individual chooses to utilize the benefits of the treaty. 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 2016, social security tax (old-age, survivors, and disability) is withheld at 6.2% on the first $118,500 of wages paid to resident and nonresidents who work as employees in the United States. Medicare hospital insurance taxes are withheld at 1.45% of all employee wages with no dollar cap.

Social security tax for resident self-employed individuals equals 12.4% of the first $118,500; 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, $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 by employees when determining their taxable income for federal income tax purposes. However, for self-employed individuals, 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 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 3.8% 'unearned income Medicare contribution' tax applies on 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; and $125,000 for a married individual filing a separate return). The tax, which is in addition to the 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 only on US-situs assets; other special rules may apply. It can be difficult to determine whether a particular individual is resident for estate tax purposes.

For 2016, there is a $5.45 million per-person estate, gift, and generation-skipping transfer tax exemption amount. The top tax rate is 40%. Note that states may impose inheritance taxes with lower exemption levels.

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

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, 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 and resident aliens are taxed on compensation earned for work performed anywhere in the world, regardless of where or when payments are made. 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.

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 of more than one year in a single work location are not considered to be temporary, regardless of facts and circumstances.

A qualified retirement plan may allow a participant to contribute funds on an after-tax basis. When benefits are paid to the participant at retirement, the portion of the pension payment that represents a return of the after-tax contribution amount paid is not again 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 an employee or service provider receives an option to buy or sell stock as payment for services, the taxpayer generally recognizes income when the option is exercised (to buy or sell the stock or other property) or when the employee's right to the stock becomes vested (i.e., the employee cannot forfeit the property). Certain options delay income until the stock 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 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 may 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 United States.

***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 (i.e., self-employment tax) in the United States on self-employment income earned while resident in the United Sates (see section *VI.E.1., Social security contributions*, above).

4. Capital gains

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

A nonresident alien is taxed at 30%, collected by withholding at the source of the payment, on US-source net capital gains if the person is 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 *VI.D., Residence*, above). Capital gains from US real property interests are taxable regardless of US presence, and also may be subject to a special withholding at source based on the sales price of the property (see discussion above of FIRPTA).

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. The maximum federal income tax rate on 'qualified dividends' received from a domestic corporation or a qualified foreign corporation is 20% (23.8% if the net investment income tax discussed above in section *VI.E.1* applies).

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 the total of '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 are typically 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 2016, the threshold amounts are $311,300 for joint filers and surviving spouses; $285,350 for head-of-household filers; $259,400 for single filers; and $155,650 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 2016 is $12,600 for married couples filing a joint return or surviving spouses; $6,300 for single individuals and married individuals filing separate returns; and $9,300 for heads of household. 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 2016, such an individual who is married or a surviving spouse may increase the standard deduction by $1,250; if 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 United States must use the same rules as US citizens to determine who is a dependent and for whom dependency exemptions can be claimed.

For 2016, the personal exemption amount is $4,050, 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 generally is 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) generally are 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 *VI.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 has not reached the age of 17 by the end of the year, 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.

2. New Markets Tax Credit

The New Markets Tax Credit, 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 PATH Act extended the credit through 2019.

3. Other tax credits

Numerous other tax credits exist at the federal, state, and local levels to provide an incentive 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 U.S. 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 whether or not an extension to file is received.

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 by the return filing due date (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 March 15 of the year following the payment unless that day is a Saturday, Sunday, or federal holiday, in which case the return is considered timely filed on the next business day.

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 information reporting

Although the Unites 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

In general, individuals who plan to live and work in the United States for a temporary work assignment must obtain work authorization. However, in certain instances, a traveler may be eligible for admission to the US as a B-1 Business Visitor, which is a visitor status rather than a work authorization status.

It is important to note, however, that whether or not one qualifies for admission as a B-1 Business Visitor, or is required to obtain work authorization, depends on the nature of the intended activities in the United States, the intended duration of stay in the United States, and whether the traveler, or the traveler's foreign employer, will be paid by a US entity.

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

There are two types of lawful status for non-US citizens residing in the US — non-immigrant status and permanent resident status. Non-immigrant status is limited to a fixed number of years. Permanent resident status (i.e., a green card) allows individuals to remain in the US indefinitely, even if the permanent resident changes employment or ceases 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.

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.*

VII. Healthcare

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, except in the case of certain discriminatory plans.

The Affordable Care Act (ACA), enacted in 2010, 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 offering coverage to age 26 for children, first-dollar coverage for preventive care, and elimination of preexisting condition 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 US-based 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 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 January. 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. Beginning in 2016 for the 2015 calendar year, applicable large employers and entities providing health insurance to individuals must provide tax forms to covered individuals and full-time employees, and to file statements with the IRS. These forms are discussed in the chart in section *I.P.4* above.

VIII. Financing US operations

A. Debt vs. equity

1. Proposed Section 385 regulations

On April 4, 2016, together with a set of anti-inversion regulations under Section 7874 and four other Code sections, Treasury and the IRS issued proposed regulations under Section 385 addressing whether an interest in a related corporation is treated as stock or indebtedness, or as in part stock and in part indebtedness (the 'Proposed Regulations'). The Proposed Regulations appear to be intended to limit the effectiveness of certain types of tax planning by characterizing related-party financings as equity, even if they are in form straight debt instruments. The types of transactions targeted appear to include debt through note distributions in the inbound and outbound context, and debt repatriation in the outbound context.

Note: The application of the Proposed Regulations is not limited to these types of transactions. The Proposed Regulations instead would apply generally to characterize as equity broad categories of related-party debt transactions that routinely arise in the ordinary course of operations in both the domestic and international context. The Proposed Regulations therefore could have a profound impact on a range of modern treasury management techniques, including cash pooling.

Inbound insight*: The IRS mentioned in Notices 2014-52 and 2015-79 that it was considering rules to limit the ability of inverted companies to engage in 'earnings-stripping' transactions through the use of debt. However, the proposed regulations under Section 385 are broader and apply regardless of whether a corporate group is inverted.*

The Proposed Regulations generally would apply to financial instruments issued after April 4, 2016, with effect from the date 90 days after regulations are issued in final form. Given this effective date, taxpayers must consider the potential impact of the Proposed Regulations on current transactions.

The key operational rules in the Proposed Regulations are the following:

- Prop. Reg. Secs. 1.385-3 and 1.385-4 would characterize as equity (i) notes distributed to a related shareholder, (ii) notes issued to acquire equity of a related entity, and (iii) notes distributed to a related entity as boot in an asset reorganization. The rules also generally would characterize as an equity investment loans to related entities within a 72-month period centered on the date of the loan that (i) distribute dividends, (ii) acquire equity in related entities, or (iii) distribute boot in asset reorganizations.
- Prop. Reg. Sec. 1.385-2 would provide a new contemporaneous documentation requirement for related-party debt. Taxpayers would be required to document both the commercial terms of the lending and an analysis of the creditworthiness of the borrower within 30 days of the lending. Taxpayers also would be required to document events after the loan, such as payments of principal and interest and events of default and similar events within 120 days of such events. If these contemporaneous documentation requirements are not satisfied, the financing generally would be characterized as equity.
- Prop. Reg. Sec. 1.385-1(d)(1) would provide that the IRS on exam (but not taxpayers) may bifurcate a single financial instrument issued between related parties into a combination of debt and equity.

Inbound insight: *Companies and tax practitioners considering any acquisition of a US business entity by a foreign business entity, as well as certain inbound restructuring transactions, will need to carefully consider the full scope of the proposed new rules, and the possible adverse US consequences arising from their application. In the meantime, the Administration and certain members of Congress are expected to continue to discuss potential legislation in this area, while other members point to the need for comprehensive US tax reform.*

2. IRS 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.

Inbound insight: The BEPS initiative includes proposed restrictions on the deductibility of related-party debt based on either a group's worldwide debt to equity ratio or a percentage of earnings before interest, taxes and amortization (EBITA). Similar proposals are pending before the US Congress. Inbound companies should monitor these developments and the possible adverse impact on existing structures.

3. Key Tax Court decision

A large body of case law has developed as to whether an instrument is characterized as debt or equity. A US Tax Court memorandum 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:*** 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.

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 have been heard by 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 and
- the corporation's ability to obtain loans from outside lending institutions.

***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.*

4. General approach of courts

a. Source of payments

While each court may not apply precisely the same factors, the 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.

b. Subordination to creditors

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

c. 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.

***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.*

d. 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.

e. 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 in favor of 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);
- to the extent funds are denominated in a non-functional currency, foreign currency gains or losses must be accounted for and net foreign currency gain of a CFC borrower could give rise to subpart F income; and
- 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, including requirements for annual withholding tax returns for US-source income of foreign persons and the availability of treaty benefits
- subpart F and Section 956 issues to the extent there are CFC depositors, even if the cash pool itself is not a CFC or has relatively low earnings. Because these consequences can be highly adverse, it generally seems advisable not to have any US member borrow from a cash pool with CFC depositors.

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. (See also the discussion above of the proposed Section 385 regulations.)*

IX. Setting up a US tax department

The organization and operation of the tax function vary greatly between industries and home countries and even between individual businesses. Click *here* for more information on our Tax Function of the Future thought leadership series.

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.

Inbound insight: *Managing within the requirements of differing financial accounting standards, and often multiple accounting systems, within the United States and outside creates challenges both in financial accounting and tax compliance. This puts a premium on using technology and other efficiency tools to allow continued focus on other aspects of the tax function's accountabilities within the United States.*

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.

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.*

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.

Inbound insight: *The changing global environment in respect to tax magnifies the importance of the cultural and governance differences that can exist between the United States and the country of the parent company. Now more than ever, these differences must be considered in developing a tax strategy and risk management policy.*

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 global (such as OECD) and 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

- **Tax Function of the Future**: Leverage the advancement of technology, data, and analytical capabilities to address the growing external pressures and operational challenges faced by the tax function to ensure that tax compliance, financial statement reporting, and other obligations of the tax department are fully satisfied.

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.

For more information, please contact any of PwC's US inbound specialists listed in Appendix C.

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, interest, and royalties, made to foreign persons. In other situations, withholding agents may apply reduced rates or be exempted from the requirement to withhold tax at source when there is a tax treaty between the foreign person's country of residence and the United States that provides for such reduction or exemption.

The United States has entered into various income tax treaties with countries in order to avoid double taxation of 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* (%)
Non-treaty	30	30	30	30/30/30
Treaty rates:				
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)	10 (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)

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* (%)
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
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 (24, 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

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* (%)
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)
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).
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. Under domestic law rules, even where the treaty does not contain a specific rule related to conduits, the IRS may recharacterize financing transactions that form a conduit financing arrangement to deny treaty benefits.
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.

Appendix B: List of countries with which the United States has entered into social security totalization agreements

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

Appendix C: PwC's US inbound specialists

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