

Global tax guide to doing business in the United States

Overview

The US imposes corporate and personal income tax on its residents (including US subsidiaries of foreign entities) in respect of income and gains earned worldwide, subject, however, to certain exceptions with respect to non-US corporate income. Federal income tax is imposed under the provisions of the Internal Revenue Code of 1986, as amended, and income tax regulations issued by the US Department of Treasury. Non-residents who carry on a trade or business in the US, who are employed in the US or who otherwise derive gross income from activities effectively connected to the US are also subject to US income tax.

Most of the separate states within the United States also impose corporate and personal income taxes on corporations and individuals residing or carrying on business within the state. However, certain states do not impose a corporate and/or individual income tax, opting instead to derive tax revenues from other activities within the state. For example, Nevada does not impose a corporate income tax on corporations doing business within the state, but does impose an excise tax on gambling and similar revenues; Florida does not impose a personal income tax but it does impose a corporate income tax. Accordingly, each state must be considered separately as to the tax regime that it imposes.

Generally, the classification of an entity for federal income tax purposes as a corporation or partnership will be respected for state income tax purposes as well, and taxable income for state income tax purposes is computed in a manner similar to the computation of federal taxable income under the Internal Revenue Code. In this regard, most states require taxpayers to start with their federal adjusted gross income in computing their separate state income tax liability. However, each state provides for certain modifications to federal adjusted gross income in the calculation of state tax liability, including the provision of specified tax incentives for various activities within the state, and, in some cases, the requirement to add back certain deductions otherwise allowable under federal law in computing federal income tax liability.

The Internal Revenue Code also imposes a withholding tax on non-residents who receive dividends, certain interest payments, rents, royalties or certain other forms of gross income from activities that are not effectively connected with the US. The US payor of any such amounts is responsible for withholding and remitting this tax on behalf of the non-resident recipient. In some cases, the non-resident recipient may also be responsible for filing certain US income tax returns in connection with the receipt of such income as well. The US withholding tax laws with respect to payments to non-residents is complex.

The US has an extensive income tax treaty network that may reduce or eliminate the withholding tax rate on all or certain types of such income. For example, the US-UK income tax treaty eliminates withholding tax on most cross-border interest and royalty payments and reduces the rate on dividends to 0%, 5% or 15%, depending on the circumstances.

The US is not a signatory to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI). Rather, the US relies on the limitation on benefits provisions in its existing income tax treaties and the provisions of its domestic law to implement the Base Erosion and Profit Shifting standards.

No uniform federal sales or property tax is imposed on corporate and individual taxpayers. However, a variety of targeted federal excise taxes are imposed on the production, distribution and/or sales of certain products within the US. For example, the Internal Revenue Code imposes excises taxes on the manufacture, distribution and/or sales of alcoholic beverages and firearms.

At the state level, in addition to corporate and personal income tax, most states impose a sales and use tax on the

sale or use of tangible personal property within the state (generally based on the ultimate destination of the product). In certain cases, such tax applies to the provision of intangible property, as well as on the provision of specified services within a state.

In addition, virtually all states and their local political subdivisions impose annual property taxes on real, commercial and residential property within the taxing jurisdiction. Many of these states and local political subdivisions impose property tax on business personal property as well. Specific additional taxes, including realty transfer taxes, may also be imposed in certain states where real estate or certain specified commercial activities are an essential revenue source.

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Legal system

The US and the separate states and territories generally operate under a common law legal system. While the ability to make federal law is within the exclusive domain of the federal government, the laws of each state are within the scope of the state's legislative authority. For example, while the federal government has the authority to regulate interstate trade and commerce within the US, the states have the right to, among other things, regulate the incorporation and dissolution of companies and other business entities under applicable state law, as well as the property rights of businesses and individuals residing within the states.

Taxation authorities

The federal tax system in the US is administered by the Internal Revenue Service (IRS). State income tax and sales taxes are administered by each state's taxing authority (with varying names, but each commonly referred to as a department of revenue). Various local taxes are administered at the local level.

Take for example a corporate or individual resident of New York City. The IRS collects federal income taxes owed by the resident, while the New York Department of Taxation and Finance collects state income taxes as well as state sales taxes and other statewide taxes; and the New York City Department of Finance collects applicable local income, sales and property taxes. However, many state revenue departments will often collect various local taxes on behalf of local political subdivisions and distribute the tax revenues to those localities.

Business vehicles

Business entities in the US are incorporated, organized or formed under the laws of each state. To the extent such business entities are formed in one state but operate in several states, they generally will be subject to the corporate and tax laws of each state in which they operate. In all states, the most common business entities are corporations,

limited liability companies and partnerships (general or limited). Many states provide for certain variations of the foregoing entities, including limited liability partnerships. While it is also possible to use a trust to carry on business in the US, it is not commonly done due to a number of complexities.

Partnerships

A state law partnership (whether general, limited or limited liability partnership) is generally treated as fiscally transparent for US federal income tax purposes. That is to say, it is treated as a “pass-through entity.” While such entities are required to file annual information returns with the IRS (and most states), it is the partners of the partnership, rather than the partnership itself, who are subject to income tax on their allocable share of the partnership’s income, gains as well as losses, deductions and credits.

A partnership formed under state law and otherwise operating within the US may have one or more non- resident (that is, non-US) partners. Non-resident partners of a domestic US partnership that is engaged in a trade or business in the US or with US-source investments are subject to complex US federal withholding tax rules on distributions of income to such non-resident partners, subject to applicable income tax treaty conventions governing US tax treatment of such payments.

Corporations

Corporations are incorporated under applicable state law. In all states, shareholders are generally not liable for the corporation’s debts. Corporations can be incorporated quickly (often in a single day) in any state in which the incorporators intend to begin a trade or business by filing with the applicable state agency the articles of incorporation and paying a filing fee. The state jurisdiction of incorporation does not impact the corporation’s federal income tax liability. Often the choice of jurisdiction is based on the particular state corporation laws and their impact on the desired internal governance structure of the corporation.

For federal and, in most cases, state tax purposes, corporations are not pass-through entities but instead are subject to taxation on income earned at the corporate level and again on income distributed or paid out to the corporation’s shareholders. These are commonly referred to as “C-corporations.” Consequently, corporations are subject to “double taxation” insofar as the corporation itself is subject to federal income tax on its income (in addition to any applicable state income tax) and the shareholders are also subject to federal and applicable state income tax on amounts received from the corporations by dividends or redemptions in excess of their investment in such corporations.

In contrast to C-corporations, the Internal Revenue Code allows certain shareholders (generally, individuals who are US citizens or residents) to incorporate a corporation under state law that is treated as a pass-through entity under federal tax law. Specifically, a corporation formed under state law that would otherwise be treated as a C-corporation for federal tax purposes may elect to be treated as a pass-through entity, commonly known as an “S-corporation.” Similar to other pass-through entities, an S-corporation is not subject to federal income tax at the entity level; rather the income and gains, as well as losses, deductions and credits are passed through to the shareholders, who must report such items on their separate returns. However, unlike other pass-through entities such as partnerships, S-corporations must pass through such items on a pro rata basis to their shareholders, and thus have less flexibility in their tax treatment than other pass-through entities, such as state-law partnerships and limited liability companies (see below) that are taxed as partnerships for federal income tax purposes. Despite their tax transparency, S-corporations continue to retain the liability protections of corporations under state law. The federal tax laws governing S-corporations are complex, and not all states recognize the pass-through nature, for state income tax purposes, of S-corporations.

As with domestic partnerships, a corporation formed under state law and operating within the United States may have one or more non-resident shareholders. Non-resident shareholders of a domestic C-corporation are subject to US withholding tax rules on distributions of income to such non-resident shareholders, subject to reduction or elimination under an applicable income tax treaty.

Limited liability companies

All states permit the organization under applicable state law of a limited liability company (LLC). As with other business entities, an LLC can be formed quickly, usually within one day. Generally, an LLC provides the members with protection from the liabilities of the LLC in the event that the LLC is insolvent or wound up, and in this regard is similar to a state-law corporation. However, absent an election to be treated as a C-corporation, an LLC formed under state law that has more than one member is treated as a partnership for federal income tax purposes (and usually for state income tax purposes, though this should always be verified), and so retains the status of a “pass-through entity” for

tax purposes similar to that of state-law partnerships, thereby avoiding the double taxation inherent in the C-corporation structure. A wholly owned LLC is treated as a “disregarded entity” of its owner (that is, it is ignored for most tax purposes), absent an election to be treated as a C-corporation.

Foreign corporation (with or without a US branch)

A foreign corporation that carries on a trade or business in the US is subject to tax on gross income derived from such activities. The determination of whether a corporation is carrying on business in the US is very fact-specific and does not depend on whether the foreign corporation formally has a branch in the US.

If the foreign corporation is resident in a country with which the US has an income tax treaty, and if it is eligible to claim treaty benefits, it will generally be exempt from US withholding tax on its business profits except to the extent that the profits were earned through a permanent establishment in the US.

A foreign corporation that is subject to US corporate income tax (i.e., because it is engaged in the conduct of a trade or business in the US and, if it is eligible for the benefits of a US income tax treaty, has a permanent establishment in the US) will be subject to US income tax as well as branch profits tax (see details below).

As noted, the tax code imposes a 30% withholding tax (subject to reduction or elimination by treaty) on payments to non-resident individuals and foreign corporations on US-source income that is not “effectively connected” with a US business. Generally, the US payor (e.g., a corporation paying dividends to a foreign shareholder, or an LLC making distributions to its members that include one or more foreign members) will withhold the applicable amount from such payments and remit the tax to the IRS.

Financing a company subsidiary

Equity financing

Contributions for shares

Contributions to the capital of a corporation in exchange for shares are not treated as gross income of the corporation for federal income tax purposes. Contributions of cash in exchange for shares are generally not taxable to the shareholder. Contributions of appreciated property in exchange for shares are generally not taxable to the shareholder if it and the other shareholders making contributions in exchange for shares are in control of the corporation.

Contributions without taking additional shares

Depending on the circumstances, the corporation may be deemed to issue shares to the shareholder in exchange for the contribution.

Distributions

Distributions to a shareholder are generally taxed as a dividend to the extent that the corporation has either current or accumulated earnings and profits. Distributions in excess of the corporation’s current and accumulated earnings and profits are treated as non-taxable return of capital to the extent of the shareholder’s basis in the shares of the corporation. Distributions in excess of basis are treated as gain from the sale or other disposition of the shares. Because non-residents are generally not subject to US tax on gain from the sale of shares of a corporation (unless the corporation is a US real property–holding corporation), distributions to a non-resident shareholder in excess of the shareholder’s basis are often not subject to US tax even though such distributions result in taxable gain to a US resident shareholder.

Debt financing

Withholding tax implications

US corporations are permitted to borrow funds from related or third parties without the receipt of borrowed funds being treated as gross income for tax purposes. Furthermore, there are no US tax consequences on the repayment of the principal amount of such debt. Interest payments are subject to income tax (or withholding tax, in the case of non-residents who are not considered to be engaged in a US trade or business) on the recipient. The payor may

generally take a current deduction or, in certain cases, capitalize such interest payments, subject to certain limitations on the amount of such deduction. Subject to significant exceptions for portfolio interest and bank deposit interest, interest income received by a foreign corporation from US sources and not effectively connected with the conduct of a US trade or business is subject to a 30% withholding tax. As previously mentioned, the withholding tax rate may be reduced or eliminated under an applicable income tax treaty. For example, the Canada-United States Tax Convention eliminates withholding tax on cross-border interest payments (other than participating interest).

Thin capitalization

The characterization on the use of funds by taxpayers as either debt or equity, particularly in the cross-border context, is a topic of great concern to the IRS. A significant body of common-law jurisprudence, as well as statutory and regulatory actions, has arisen over many decades on this topic. In this arena, the thin capitalization of a purported foreign or domestic borrower, relative to the debt considered to be incurred, is a factor that the IRS and the courts regard as indicative of a debt instrument being more akin to equity. This may, along with other factors, cause a debt instrument to be recast for tax purposes as equity, resulting in, among other things, the loss of deductions attributable to that financing.

There is no objective standard as to what constitutes a thinly capitalized borrower for this purpose. However, taxpayers devote a great deal of consideration to properly supporting their equity or debt financing in order to avoid these issues. Due to the complexity of structured debt, equity and hybrid instruments, as well as the distinct tax treatment of debt and equity financing under the Internal Revenue Code and the potential for abuse, the US has sought to limit certain tax benefits attributable to debt financing, including limitations on business interest expense deductions.

Stamp tax

The US does not impose a stamp tax in respect of debt or equity financing.

Corporate income tax

Income tax rate

For taxable years beginning on and after January 1, 2018, the federal corporate income tax rate on general active business income is 21%. State corporate income tax rates vary widely and, as noted, certain states do not impose a corporate income tax at all.

Capital gains and losses

For corporations, capital gains are taxed in the same manner as ordinary income, while capital losses can, subject to limitations, be used to offset only capital gains in the year incurred. The excess capital loss may generally be carried forward with limitations to be applied against taxable capital gains in other years. The Internal Revenue Code restricts the use of capital losses (as well as net operating losses) by a corporation following an acquisition of control of the corporation.

Branch profits tax

The branch profits tax is imposed on foreign corporations and is equal to 30% of the “dividend equivalent amount” for the tax year. This tax is in addition to the corporate-level tax imposed on taxable income effectively connected with a US business. A foreign corporation is subject to the branch profits tax if it owns an interest in a partnership, or a trust, or an estate that is engaged in a US trade or business or has income treated as effectively connected with the conduct of a trade or business in the US. The branch profits tax generally is reduced or eliminated under an applicable income tax treaty to the same extent that dividends are reduced or eliminated.

Computation of taxable income

Taxable base

An individual taxpayer is generally subject to tax on his or her worldwide gross income less certain allowable deductions and credits. A corporate taxpayer is subject to tax on its taxable income from carrying on its business.

Taxable income is generally considered to be gross income less deductible expenditures, to which any credits are applied.

Deductions

A business taxpayer is generally permitted to deduct its current operating expenses from adjusted gross income. As a general rule, capital expenses must be capitalized into the basis of the property to which such expenditures are dedicated and are not currently deductible. However, the Internal Revenue Code provides for certain exceptions to that rule, including depreciation expense.

Income tax reporting

Domestic corporations, and foreign corporations that carry on business in the US or that dispose of certain US property during a taxable year, are required to file an annual corporate income tax return. Non-resident individuals and foreign corporations subject to withholding tax due to their being considered to be engaged in the conduct of a US trade or business are also required to file certain federal tax returns for the year of the withholding.

Corporate tax returns generally must be filed within five months of the fiscal year-end of the corporation in order to avoid late filing penalties. Estimated installment tax payments are required in respect of current-year taxes. Interest on any unpaid tax balance will start accruing from the due date of the return on which such tax was required to be paid.

Cross-border payments

Transfer pricing

US transfer pricing rules generally conform to the arm's length principle of the Organisation for Economic Co-operation and Development (OECD), although special deemed royalty provisions apply to the transfer of intangible property. Section 482 of the Internal Revenue Code permits the IRS to impose a transfer pricing adjustment in respect of a transaction between related parties that is not made on arm's length terms or that does not meet certain conditions. US taxpayers can be subject to significant penalties if the IRS determines that a transfer pricing adjustment is appropriate and the taxpayer cannot produce upon request contemporaneous documentation regarding the transactions subject to the transfer pricing rules.

Withholding tax on nonresident income

For individuals who are US citizens and residents, capital gains from assets that are held for more than one year are subject to a maximum income tax rate of 20% and capital losses may, subject to limitations, be used to offset capital gains. However, in certain circumstances, capital gains may be upwards of 28% in the case of the sale or exchange of certain properties referred to as "collectibles" (normally artwork, jewelry and related high-value personal items), or up to 25% of the gain on certain depreciable property. Some taxpayers will also be subject to a 3.8% tax on their net income, which includes capital gains and other investment income.

A non-resident's excess capital gains from US sources over capital losses from US sources are subject to US income tax (often enforced by withholding tax) if such gains are effectively connected with a US business (including, for this purpose, capital gains from the sale of a US real-property interest) or may be subject to withholding tax if the non-resident otherwise resides within the US for a certain period of time within such taxable year, unless such gains are exempted under an applicable income tax treaty. As described herein, payments made by a US person to a non-resident (including non-resident partners and shareholders) in respect of certain types of interest payments, rents, royalties, dividends, management fees, and administration fees are subject to a 30% withholding tax. However, the rate may be reduced under an applicable income tax treaty.

Payroll taxes

US employee withholding for income taxes and imposition of payroll taxes

US employers paying remuneration to employees are required to withhold and pay over to the IRS income and

related Social Security and Medicare taxes on behalf of such employees. To the extent an employee may be subject to both US and foreign social security taxes, a Social Security Totalization Agreement may eliminate double payroll taxation for a US employer with employees outside the US or a foreign employer with employees in the US.

Employment insurance

Employers are also required to withhold from each employee's compensation and pay over to the IRS the employee's allocable share of premiums under the federal unemployment insurance program.

State payroll taxes

States also impose similar income and unemployment insurance payroll taxes that must be withheld by an employer from each employee's compensation.

Indirect taxes

Goods and services tax

The US does not impose any value-added tax on the final, domestic consumption of most goods and services supplied in the US. However, as noted previously, the US does impose certain excise taxes on specified goods manufactured, distributed or used within the US.

Harmonized sales tax

There is no federal sales tax. Each state authorizes and imposes its own sales and use tax on goods sold to residents of such state.

Land transfer tax

There is no specific federal land transfer tax. However, as a general matter, any gain from the sale of real property is includible in federal gross income.

A transfer tax is payable in certain states on any acquisition of real property. In certain states, the transfer tax is payable regardless of whether the acquisition is in respect of a legal or a beneficial interest in real property, subject to specified exceptions.

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