Tax and trade considerations for US inbound investment

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Foreword

For over a half a century, the United States has served as a leader in foreign investment and business opportunities. This has been attributable in part to a relatively strong US economy; the US dollar as the reserve currency; political stability; and, until recently, a US federal income tax framework that has been relatively stable since the 1980s. Recent significant changes in US tax and trade policy have created a new uncertainty. As always, big change presents big opportunities—for risk as well as reward. Smart investors will be tracking developments, as they continue to arise, and proactively addressing the landscape for investment in the United States.

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US market conditions generally

Regardless of recent changes in tax and trade policy, the United States remains an attractive jurisdiction for incenting foreign-based (inbound) investment. It remains the largest recipient of foreign direct investment (FDI) in the world, both in the form of foreign acquisitions of ongoing US enterprises, and of foreign "organic" or greenfield activities in the US economy. Foreign enterprises have current investments of over $4 trillion in the United States, an investment level that continues to rise year after year.

The US market-oriented economy is one of the largest and most technologically powerful in the world. With a population in excess of 330 million and gross domestic product in excess of $26 trillion, the United States offers a robust business and consumer marketplace opportunity. Most Americans are considered "high income" as defined by the World Bank. Consumer spending exceeded $17 trillion in 2022. In addition to individual consumers, US federal and state governments buy needed goods and services, predominately in the private marketplace.

Diversified US industries

Abundant natural resources and skilled labor have helped the United States become one of the leading industrial powers of the world, with highly diversified and technologically advanced industries including software and information technology, aerospace, automobiles, electronics and telecommunications. Silicon Valley, California, for example, has become the center of advanced technology research and development (R&D)— computer microchips, software, and other high-tech products and services—as well as a focal point for venture capitalists seeking out young start-up companies. New York is the financial hub of the United States and has been instrumental in developing public stock exchanges as well as financial products and services that are used worldwide. US natural resources (including, for example, timber and arable land, coal, petroleum, and minerals) are the foundation for a host of homegrown industries. The resulting demand for products and resources has led to the growth and development of consumer products companies, ranging from automobile and aerospace manufacturers to retailers that offer a range of household products and commercial needs.

Probusiness regulations

US industrial growth is nurtured and facilitated by pro-business commercial regulations. US businesses generally enjoy greater flexibility than their counterparts in Western Europe and Japan regarding decisions to expand capital expenditures, hire or lay off workers, and develop new products. The United States also has a significant, productive nonunionized labor pool. Twenty-eight out of the 50 US states have adopted "right-to-work" laws that preclude labor unions from requiring union membership (or payment of costs equivalent to union representation) as a condition for employment. A well-educated labor market, access to advanced technology, and a strong framework for intellectual property protection set the stage for onshore R&D opportunities. These opportunities historically have been a key attraction for foreign investors, as the US continues to register more international patents than any other country.

US businesses have also benefited from robust and transparent customs and trade regulations. These regulations facilitate the international movement of goods, while protecting consumers from hazardous and prohibited articles, and domestic industry and labor from unfair foreign competition. For example, antidumping (AD) and countervailing duty (CVD) regulations protect US businesses from material economic injury resulting from imports being sold into the United States at less than fair value or by reason of imports being subsidized by foreign governments. Intellectual property rights recordation and enforcement regulations allow agencies to detect, interdict, and investigate imports of counterfeit and infringing grey market goods. Finally, despite recent increases in tariffs, US trade rules generally permit importers some ability to mitigate liability. Customs duty reduction, refunds, or deferment rules offer many opportunities to lower import costs into the United States.

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Strong US finanacial markets

US financial markets play a significant role in attracting and maintaining robust foreign investment. The United States features deep, liquid, and accessible capital markets. The strength of the financial services industry has made New York's Wall Street a global capital for foreign investment, and the US stock and commodities exchanges are well known for creating stable and well-regulated investor environments.

The US insurance industry is also a significant factor for success in the US marketplace, offering a wide range of insurance products and services to protect an enterprise's downside risk.

US political framework

The United States is a federal republic with a long history of political stability. It comprises 50 states, the District of Columbia, the Commonwealth of Puerto Rico, and a small number of territories. The political system is based on a division of powers between the states and the federal government. Within the federal government and each state government, there is also a separation of powers among three branches of government: legislative, executive, and judicial.

Some national laws have requirements limiting what individual states may do. Other laws, including federal tax rules, are more of a foundation that states may choose to adopt or exceed.

Each state has its own political subdivisions, and each has its own set of laws governing the conduct of business within its jurisdiction. State-level law may interact with, or operate parallel to, federal laws. For example, state corporate agencies govern the formation and conduct of juridical business organizations, which, if publicly traded on a US stock exchange are also subject to regulation by the US Securities and Exchange Commission. Nonetheless, there is no single governmental agency or body that determines all laws and regulations applicable to all businesses.

This guide is an introduction to the significant body of federal and state commercial and tax regulations that affect the investment decisions of foreign businesses in the United States. In many cases, particularly at the federal level, the tax laws can be seen as striking a balance between inbound investment and protecting US fiscal interests. The same is true at the state level, where the reality of state-specific fiscal considerations and the individuality of state regulations can also result in states competing with each other for inbound investment. Inbound investors should take these factors into consideration when determining whether to invest in the United States—and how and where to do so.

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General structure of US tax system

Corporate and individual income taxes and other levies discussed below are imposed by the federal government, state governments, and municipalities.

The US Department of the Treasury (US Treasury) is the agency of the United States government that is tasked with managing federal revenue.

The Internal Revenue Service (IRS) is a bureau of the US Treasury that has the operational charge of collecting tax and administering federal tax laws. Those laws are contained in Title 26 of the US Code, generally referred to as the Internal Revenue Code (Code). The most recent overall version of the Code was adopted in 1986. Since then, the US Congress has adopted numerous amendments to the Code (including a significant "Tax reform" package—known as the Tax Cuts and Jobs Act—in December 2017).

Consequently, legal documents and memoranda discussing the Code often cite it as the "Internal Revenue Code of 1986, as amended." The Code is supplemented by regulations, notices, and rulings issued by the US Treasury and the IRS. Federal taxes include income taxes (the regular tax and an alternative minimum tax (AMT)), employment taxes, estate and gift taxes, and excise taxes on certain goods and services.

The United States does not have a federal-level value-added tax (VAT) or sales tax system.

Many of the US states, however, impose sales or use taxes in addition to income and other (real and personal property, gross receipts, etc.) taxes. Each state's tax laws are adopted by the state legislature and are administered and enforced by a state tax agency. Integration of state and federal tax systems differs from state to state, with some states generally conforming to the federal income tax base and others taking a more independent view of state-level taxable income, particularly as the federal tax rules have recently been affected by tax reform. State corporate income tax rates currently range from 0–12 percent, and are established independently of the federal corporate tax rate.

Several states offer tax benefits or incentives for inbound investors, particularly for local manufacturing activities.

The structure of the US tax system, plus the availability of state and local investment incentives (many of which are negotiated with the state and local tax authorities on a case-by-case basis), make it critical for inbound investors to consider both federal and state tax implications of the US activities—even (and perhaps especially) in the early stages of US commercial activities.

Foreign automotive manufacturer opens plant in United States

An Asian automotive manufacturer opens plant in United States An Asian automotive manufacturer desired to establish its first US automotive plant in the Southeastern United States. The company requested assistance from KPMG with site selection, location analysis, incentive negotiation, and tax structuring. The KPMG team researched 40 potential locations, and provided specific data including large manufacturing sites (1000+ acres), infrastructure, workforce availability and projected cost, degree of unionization, proximity to supplier network, taxes, incentives, and credits. KPMG developed a site selection matrix for analyzing and ranking sites by predetermined criteria, and assisted the client in narrowing its search to four finalist states. Once a final site was chosen, KPMG assisted company officials with negotiation of a customized incentive package as well as a comprehensive project agreement containing state and local assistance in excess of $300 million, including tax abatements credits, grants, land, infrastructure/site development, and training assistance. In addition, KPMG advised the company on federal and state tax issues related to ownership and entity structuring for its new US operations.

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General structure of US import and export system

Import laws are imposed by the federal government and generally are administered by US Customs and Border Protection (CBP), an agency of the Department of Homeland Security. Importers in the United States benefit from the transparent and uniform customs and tariff laws associated with its membership in the World Trade Organization (WTO). The United States also currently has free trade agreements with 20 countries, offering duty-free or reduced duties on a wide range of imported products.

US customs laws are contained in Title 19 of the US Code, supplemented by regulations, notices, and public letter rulings issued by CBP. CBP has the operational charge of assessing and collecting customs duties, taxes, and fees incident to international trade, as well as enforcing compliance with customs and border security laws and import laws administered by other government agencies (e.g., by the Food and Drug Administration, the Consumer Product Safety Commission, etc.).

CBP operates through 20 field operations offices and 10 Centers of Excellence and Expertise (CEE), managing 328 ports of entry throughout the United States. As part of recent modernization efforts, each CEE is aligned to a specific industry to provide uniquely tailored import and compliance support to businesses.

In the early 1990s, Congress adopted the Customs Modernization Act (Mod Act), which fundamentally altered the historical relationship between importers and CBP. In effect, the Mod Act placed on importers the legal responsibility to exercise "reasonable care" for customs compliance. CBP generally enforces its laws through postimport, risk-based audits known as "focused assessments," which consider the effectiveness of an importer's internal controls over import operations to assess compliance and revenue risks.

While the United States does not assess taxes or duties on goods exported from the United States, the United States imposes various export control laws that are intended to serve the national security, foreign policy nonproliferation, and short supply interests of the United States by regulating or restricting access to certain goods, services, technology, and technical data by certain countries, entities and foreign persons. If a particular item (good, service, or technical data) is controlled for export purposes, then a license or authorization may be required from the US government in order to "export" the item, unless its exportation is prohibited altogether. Further, financial transactions may be prohibited with certain individuals, entities or countries for US persons and companies.

There are several government agencies that regulate the exportation of items from the United States. The key government agencies include, but are not limited to, the Department of Commerce's Bureau of Industry and Security, the Department of State's Directorate of Defense Trade Controls, and the US Department of the Treasury's Office of Foreign Assets Control.

The structure of the US import and export system, coupled with the potential for significant fines or penalties for noncompliance, makes it critical for inbound investors to consider import (and, where US-based regional distribution is contemplated, export) implications of their US activities, including opportunities to mitigate import and compliance costs where possible.

Recent developments

Foreign direct investment to the United States—current snapshot

Foreign direct investment in the United States (FDIUS) is alive and well, and the United States remains a top investment destination from a global perspective. In 2022, according to the US Bureau of Economic Analysis (BEA) cumulative FDIUS exceeded $5.25 trillion—up from approximately $5.04 trillion in 2021. Per preliminary BEA statistics, new FDI, i.e., capital expenditures for acquisition, establishment or expansion of US businesses, totaled approximately $177.50 billion for 2022, up 8.7 percent from $272.8 billion in 2017. Expenditures decreased $185.1 billion, or 51 percent, from $362.6 billion (revised) in 2021 and were below the annual average of $298.8 billion for 2014–2021.

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According to the BEA, for 2022, Japan is the top investing country, with approximately $712 billion in invested capital. Following the Japanese investors were multinational enterprises from the United Kingdom (approximately $663.4 billion of cumulative investment) and The Netherlands (approximately $617.1 billion in cumulative investment). Canada (approximately $589.3 billion of cumulative investment) and Germany (approximately $431.4 billion of cumulative investment) rounded out the top five inbound investment jurisdictions.

With respect to industry distribution, 31.1 percent of 2022's new FDIUS occurred in the manufacturing industry, with chemical manufacturing seeing the largest piece of new manufacturing investment ($121.5 billion) and machinery ($9.9 billion). There were also notable expenditures in the information sector ($28.2 billion). In 2022, greenfield investment expenditures were $8.1 billion, with the largest—$5.3 billion—made in the manufacturing industry.

In terms of location for FDIUS, for 2022, California received the most investment, totaling $29 billion, followed by Texas ($20.7 billion) and Illinois ($10.9 billion).

US Tax and trade policy reforms

The COVID-19 pandemic and the Russia-Ukraine war have created commodity shortages, price changes and serious disruptions in supply chains. Those supply factors have prompted changes in US industrial policy and commitment of unprecedented new resources to the US economy intended to advance technology research, development, and investment. The growing climate crisis has also resulted in commitment of extraordinary resources to promote renewable clean energy.

The American Rescue Plan Act, enacted in 2021 in response to the COVID-19 pandemic provided $1.9 trillion to support the US economy. The economic stimulus and relief provided by ARPA has resulted in an extraordinarily rapid recovery by the US economy, exceeding that of most of the rest of the world. The US unemployment rates have been historically low and recession has been avoided. Inflation, though high, has been easing.

The Creating Helpful Incentives to Produce Semiconductors and Science Act of 2022 (CHIPS Act) directly addressed supply chain issues in semiconductors. The CHIPS Act provided $52.7 billion for semiconductor research, development, manufacturing, and workforce development in the US It also provided $10 billion to invest in regional innovation and technology hubs, $1.5 billion to advance wireless technology, as well as educational opportunities in science and technology fields and expanding research at the Department of Energy.

Congress passed and the President signed into law in August 2022 an important climate and energy bill. The Inflation Reduction Act provides some $386 billion in tax credits, grants, and loans for a broad range of investments in clean energy. These include credits for production of clean electricity, for clean fuel and electric vehicles, and for other clean energy transportation and infrastructure projects.

In addition to these tax initiatives, Congress, back in March, 2020, enacted the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) to provide emergency relief to taxpayers in response to the COVID-19 pandemic. The CARES Act, among other things, loosens certain restrictions introduced by the 2017 Tax Cuts and Jobs Act (TCJA) on taxpayers to provide businesses with greater liquidity during the uncertain economic times, and business loans to qualifying small businesses.

Political changes have also catalyzed a movement to alter the existing international trade landscape. The Trump Administration's concern with trade deficits and alleged unfair trade practices that it believes harm the United States' economy has resulted in proposals and executive action intended to reform existing trade relationships and laws. Most notably, the renegotiation of the North American Free Trade Agreement is intended to modernize the agreement and facilitate trade among the parties. The result was the new US-Mexico-Canada Agreement (USMCA).

President Trump exercised various executive powers to introduce or significantly increase tariffs and quotas in order to further US trade objectives and protect US industries. Most notably, the President imposed 25 percent tariffs on steel imports and 10 percent tariffs on aluminum imports (with limited exemptions carved out for certain countries), as well as an additional 25 percent tariff on approximately $50 billion in specified imported products of Chinese origin (with a potential to impose the tariff on another $200 billion worth of imports). These actions have spurred retaliatory tariffs by trading partners on US goods, threatening to trigger a global trade war. However, it still remains to be seen whether these trade actions are short-term negotiating tactics put in place to obtain more favorable trade concessions, or whether they should be viewed to be fundamental long-term trade policies. Notwithstanding the current volatility and uncertainty over the final direction of trade reform, importers are already taking steps to evaluate their supply chain's current risk profile given various contingent scenarios, including considering whether manufacturing in the United States may be the practical answer for products subject to increased trade costs, and/or whether customs duty programs may mitigate import costs for those companies unable to relocate manufacturing onshore.

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Part 1

Structuring an inbound investment

Initial federal income tax considerations in structuring a US inbound investment

Not all commercial enterprises are the same, and commercial differences often will translate into structuring differences when an inbound investor first approaches the US market. Potential commercial liability issues, the need for a storefront or other physical place of business (and its location), the extent local management and/or labor is required, the anticipated "ramp-up" period needed for a new business venture—are just some of the factors that play a part in determining the commercial (and consequently, tax) profile an inbound company will want to present to US clients and customers in the short, medium, and long term.

Though US tax reform changes and complicates the pre-2018 and post-2017 analysis, at a very high level, whether, to what extent, and in what manner an inbound investor is taxable in the United States—both on the federal and the state levels—is dependent on the quantity and quality of its physical, commercial, and management presence in the United States. At one end of the spectrum, it is possible to have minimal business activity and decision-making onshore, and, as a result, for an inbound investor to be subject to little or no US federal-level tax.

A simple (nonexclusive) example of this kind of commercial activity is pure investment activity: an inbound investor purchases US stocks or bonds. The inbound investor has no need to be present in the United States to collect interest or dividends, and makes no ongoing management decisions that create yields on its investment(s); no additional manpower or commercial activities are needed for the inbound investor to earn revenue. The inbound investor has minimal involvement with the US marketplace, and, as discussed further below, its US federal income tax liability will be assessed at a flat rate and collected via a withholding mechanism. This rate ranges from 0–30 percent, depending on the type of income earned, its economic connectivity with the United States, and the availability of special US rates—including under an applicable tax treaty the United States may have with an inbound investor's home country. Minimal tax documentation (e.g., tax returns) is necessary in this commercial format.

At the other end of the spectrum are active physical business operations. Manufacturing and sales, for example, might require production facilities, warehousing and delivery infrastructure, and local headcount that includes the requisite associated manpower as well as management authorized to contract with customers and to make other significant business decisions. In this case, the inbound investor will have the same business activities—and resulting revenues and expenditure—as a homegrown business. Nonetheless, there are several key differences between business activities effectively run through a US branch, and those conducted by a US company—most notably that a US corporation can act as a "blocker," shielding the inbound investor from liability (legal/commercial as well as residence country tax) with respect to its US activities.

Consequently, most investors at this end of the spectrum prefer to house their US business activities within a US taxable corporation. Also, as discussed further below, such entity's US federal income tax liability will be assessed in the same manner and at the same rates as any other local corporation, including the allowance of the same types of deductions. Depending on the specific type of business entity (if any) that an inbound chooses for its operations, its US federal income tax returns would also be the same as, or very similar to, those of a homegrown US business.

As one might suspect, the middle of the spectrum—where more than passive investment, yet less than the full spectrum of enterprise activities, occurs—is generally the most confusing to inbound investors. The US tax rules, like most others in the world, do not contain bright-line tests for whether and when an inbound investor's activities cross the line from taxable on only a withholding basis (and potentially, under an applicable tax treaty, completely exempt from tax), to taxable pursuant to the income tax rules. Consequently, we include a more detailed introduction to all three segments of the commercial/tax spectrum below.

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Defining the spectrum of inbound tax: "Sourcing" income

As a preliminary matter, let's define the spectrum of US taxation. Subject to exceptions discussed below, US taxation—as applied to inbound investors—generally is limited to income that is treated as economically arising, or "sourced," in the United States. For these purposes, the "United States" generally includes the 50 states and the District of Columbia (otherwise known as Washington, DC) but does not include Puerto Rico, Guam, or any of the other US territories or possessions.

Different source rules apply to different types of income. As a general matter, and subject to certain fact-based exceptions, the following rules apply:

- Interest is sourced in accordance with the residence of the obligor. Consequently, interest paid by a US corporation is US-source income, while interest paid by a foreign corporation is foreign-source income.
- Dividends are sourced based on the residence of the corporation making the distributions. Dividends, if paid by a corporation organized in the United States, are US-source income.
- The source of rental or leasing income is based on the place of use of the relevant property.
- Royalties and license fees are sourced based on the place of use or exploitation.
- Services fees are sourced based on place of performance.
- Gain from the sale of personal property other than inventory generally is sourced based on the residence of the seller.
- Generally, income from the sales of self-produced inventory is sourced entirely based on the place of production. If a non-US corporation sells inventory property that is produced entirely outside the United States and imported for US sale, the income is treated as 100 percent foreign source—however, only if the inventory is not sold through the foreign corporation's US sales branch. To the extent that the sales are attributable to a US sales branch, the default rule provides that 50 percent of the sales income would be allocated to the place of production (US versus foreign) and 50-percent to the place of sale, based on where title to the goods was passed from seller. A taxpayer may elect to apply an alternative allocation methodology based on US transfer pricing principles.

In addition, special rules apply to income from software and digital content transactions and from certain industries such as international shipping and communications.

Notably, if the source of income cannot be determined, the US rules default to treatment as US-source (and, consequently, subject to US taxation). Therefore, it is critical for an inbound investor to perform a sourcing analysis of each potential income stream to avoid unnecessary US tax liability.

One end of the spectrum: Withholding taxes on US-source income not connected with a US business

As a general matter, the US withholding tax rules apply to US-source income that is classified as "fixed or determinable, annual or periodical" (FDAP) income.

The term "FDAP income" describes a broad class of income, and generally includes all types of gross income earned by a foreign person, as long as the income is not effectively connected with the conduct of a trade or business in the United States, or otherwise excepted from the definition. Royalties, rents, license fees, and commissions and other income related to services (including travel and expense reimbursements) are typical examples of FDAP income payments. FDAP also includes interest, dividends, and certain types of fee income relating to various financial products and services.

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As a general matter, and subject to some very important exceptions, FDAP income specifically excludes gains from the sale of property. (For example, see below for a discussion of the special rules that apply to the sale of real property.) In addition, because the United States collects certain international transportation fees, and excise tax on insurance premiums, in lieu of withholding tax, FDAP income does not include those items.

The character of income as an item of FDAP income (or not)—e.g., as services fees or royalties, dividends or interest, sales or rental income—is determined based upon US federal income tax principles, and as noted above, drives the specific source rule that applies in each case. It is possible for a single payment stream to represent two types of income, e.g., sales and services. In that case, the payments must be separated and characterized. (And if that is not possible, the payment stream presumptively is characterized as the more expensive type of income from the US tax perspective.)

US withholding tax may be imposed under one of two regimes, both generally named for the portion of the Code containing the relevant rules: (i) "Chapter 3," also known as "income tax" withholding, or (ii) "Chapter 4," also known as "FATCA" withholding. (FATCA is an acronym for the Foreign Account Tax Compliance Act, the official name of the legislation adopting the rules.)

The Chapter 3 and FATCA regimes are interactive to some extent, although they were enacted with very different legislative objectives. Each is discussed below.

Chapter 3—Income tax withholding tax

Chapter 3 withholding is about the imposition and collection of tax from inbound investors whose activities do not rise to the level of a US trade or business (USTB).

As noted above, inbound investors are subject to a flat-rate withholding tax on their US-source, FDAP income. The statutory rate is 30 percent, and is imposed on the gross amount of the payment. Withholding tax, however, may be reduced or even eliminated if the income is benefited under US internal law, or if the inbound investor qualifies for benefits under an applicable income tax treaty.

Two of the most advantageous US internal law benefits are for "portfolio interest" and for inventory purchases. Interest qualifying as portfolio interest and paid to a foreign lender is exempt from US withholding tax, even if the lender would not otherwise be eligible for tax treaty benefits.

In addition, payments to a foreign person for the purchase of physical inventory (including materials and work-in-process as well as finished goods) generally fall outside the scope of FDAP income and are not subject to US withholding tax. (Although, as noted earlier, if the inventory sales rise to the level of a USTB, or if the foreign person sells through a US sales branch, the resulting income will be at least in part subject to US income taxation.) It is important, however, to ensure that there is not a personal service component related to sales transactions (e.g., installation, maintenance, or training), as the service component could be separated from the underlying sales transaction and constitute FDAP income. As noted above, special rules also apply to transfers of software programs.

Chapter 4—FATCA withholding tax

Unlike Chapter 3 withholding, FATCA's primary objective is not imposing and collecting revenue. FATCA was promulgated as a response to tax evasion by US taxpayers who fail to self-report their foreign assets and income from those assets, and uses withholding tax as a means of achieving US taxpayer compliance.

The current system of US income tax reporting relies on US taxpayers to voluntarily self-report all income earned, wherever in the world earned. FATCA was motivated by Congressional hearings that illuminated how foreign financial institutions (FFIs) assisted US customers in hiding assets behind the curtain of bank secrecy laws. FATCA combats tax evasion by US taxpayers, by compelling FFIs to disclose to the IRS certain information regarding the identity and ownership of US taxpayers who own substantial financial interests in an FFI itself, or hold money and assets in financial accounts maintained at such FFIs.

Additionally, FATCA requires certain nonfinancial foreign entities that are deemed to present a high risk of facilitating US tax evasion to disclose the identity of all substantial, direct, and indirect owners that are US persons. Information reported by these foreign entities is used by the IRS to identify unreported foreign assets and income of US taxpayers.

If noncompliant with the disclosure rules, these foreign entities are penalized with a 30 percent withholding tax imposed on their own US-source FDAP income that is not otherwise connected with the conduct of a USTB. FATCA withholding cannot be alleviated pursuant to an income tax treaty; it can only be eliminated based on payee documentation asserting FATCA-compliant or excepted status.

Due to its underlying purpose, FATCA's scope is materially different than that of Chapter 3 withholding. First, FATCA generally applies to US-source FDAP income that would typically be received by financial intermediaries, e.g., interest, dividends, broker fees and commissions, and other financial payments. Due to their financial nature, US-source insurance premiums (i.e., premiums paid on policies

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KPMG provides competent authority assistance to Indian organization

An Indian company faced a proposed Indian tax adjustment based on a recharacterization of services income from a US affiliate as "fees for included services" covered under the royalty article of the US-India Income Tax Treaty. As services income, the fees would have avoided Indian income taxation, but as royalties, the fees would have been subject to a 10 percent Indian withholding tax. KPMG assisted the US taxpayer with a request for competent authority assistance, and was able to prove to both governments that the overwhelming majority of the services rendered were not technology related. As a result, the two governments reached an agreement that resulted in India withdrawing most of its proposed adjustments.

insuring US risks) are subject to FATCA, despite those payments being excluded from Chapter 3 withholding. In addition, pending upcoming future guidance, FATCA applies to gross proceeds from the sale of any property of a type that can produce US-source interest or dividends (e.g., proceeds from the sale of US stock or US debt instruments). These gross proceeds do not constitute FDAP income and generally are not US-source payments, but once guidance is issued, nonetheless can be subject to FATCA withholding.

In contrast to Chapter 3 withholding, the FATCA rules explicitly exclude nonfinancial payments, including (among other things) payments for nonfinancial services, payments for the use of property, office and equipment leases, software licenses, and interest on outstanding accounts payable arising from the acquisition of goods or services.

Interaction of Chapter 3 and Chapter 4 withholding taxes

Responsibility for the application of both the Chapter 3 and the FATCA rules sits with the withholding agent (e.g., the person or persons liable or responsible for making the withholdable payment). Both Chapter 3 and FATCA withholding taxes are assessed and collected by a withholding agent who collects documentation from the payee (generally one of the IRS Form W-8 series), confirming that the payee is a non-US person. The IRS Form W-8 also contains the foreign payee's representations regarding FATCA status and eligibility for treaty claims, where appropriate. The withholding agent uses these representations to determine the withholding tax liability, and, if tax is owed, withholds the tax from the payment and remits payment to the IRS.

Notably, the total amount withheld—taking into account both regimes—may not exceed 30 percent of the amount of the payment. In this respect, "FATCA goes first." That is, the withholding agent first determines whether 30 percent FATCA withholding applies. If so, FATCA withholding is credited against any Chapter 3 withholding that may otherwise apply, and no additional tax is collected. If no FATCA withholding applies, the withholding agent then determines whether and to what extent Chapter 3 withholding applies (i.e., at the 30 percent general rate or at a lower rate pursuant to a statutory exemption or treaty benefit).

Reduced withholding taxes under treaties

The United States has a network of bilateral income tax treaties covering more than 60 countries. This network includes all of the Organisation for Economic Co-operation and Development (OECD) member countries and encompasses many other countries with significant trade or investment with the United States.

As noted above, treaties may reduce the withholding rate below 30 percent. The specific applicable rate depends both on the type of income that is paid—dividends, interest, royalties, etc.—and on the treaty itself. Withholding tax rates are generally ineligible for any kind of "most favored nation" provisions, and the rates available under some treaties can vary significantly from those available under other treaties (e.g., generally a reduction to 0–15 percent for dividends, and varying rates for different types of royalties).

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Perhaps as importantly, treaties may sometimes change the definitions or sourcing rules applicable under internal law for specific types of income. For example, although as noted above, royalties generally are viewed as sourced where the underlying intangibles were used or exploited—so royalties arising from a right to use a patent in the US market are treated as US-source income—treaties may instead allow royalties to be sourced based on an alternative rule negotiated by the treaty countries. As an example, the US-Spain Tax Treaty generally sources royalties based on the residence of the payor, unless the royalty is attributable to a permanent establishment (PE) in Spain or the United States (in which case the royalty would be Spanish or US-source, respectively). As another example, although most treaties generally would define a royalty as a payment for the use of copyrights, patents, trademarks, designs or secret formulas or process, certain treaties, including the US-India Tax Treaty, also include payments for the use of certain industrial, commercial, or scientific equipment (which might otherwise be viewed as rental income). These types of provisions can change the very nature of an income stream, or the scope of a country's tax jurisdiction with respect to specific payments, the characterization of which, in the first instance, may not align with the designation of the payment in the underlying documents.

Please note, although tax treaties generally cover the same types of income and are similar to each other in terms of overall structure and objective, they are individually negotiated documents. Balance of trade, level of economic development, historical political and tax policy positions, and other factors can play a part in the priorities different treaty partners bring to the negotiating table. Consequently, treaty terms and benefits can vary, and inbound investors should understand the nuances of the specific treaty applicable to them and the payments they receive and make. In case of any disagreement with respect to the application of the treaty to an item of income subject to a tax treaty (e.g., regarding the nature of a payment, the amount recognized as income, or the appropriateness of the rate applied), the "competent authorities" of the treaty jurisdictions may assist in settling the dispute. See https://www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z for a current treaty list.

Withholding tax compliance issues

There are two sides to "compliance" when it comes to withholding, and inbound investors, particularly those who might be on both sides, e.g., of intercompany withholdable payments. These investors should understand both to avoid unnecessary over-withholding and secondary liability for under-withholding.

On the payee side, and as noted above, foreign persons must provide a payor (or other withholding agent) with documentation that helps the payor to determine the appropriate amount of withholding.

While the default withholding tax rate is 30 percent, for example, a foreign payee may state a claim for a lower rate (potentially including zero) based on the provisions of an applicable income tax treaty. There is no centralized database or other resource for a payor to determine eligibility for treaty benefits. The payor must determine the appropriate level of withholding based on information provided by the foreign payee, including specific representations with respect to the payee's treaty status. The representations generally are made on one of the forms in the IRS Form W-8 series. Foreign individual payees generally provide an IRS Form W-8BEN to claim treaty benefits, although in cases where the payor must determine withholding on personal services payments, IRS Form 8233 is used. Foreign entity payees generally provide IRS Form W-8BEN-E to support payments received, and owned, by the payee.

If a payment is made through a foreign payment agent or intermediary (i.e., to another person that owns the income), it would be appropriate for the foreign agent to provide the payor with an IRS Form W-8IMY. The form is accompanied by a withholding statement identifying the ultimate owner/payee of the income, plus documentation (e.g., an IRS Form W-8BEN-E) relevant to establishing that person's entitlement to treaty benefits, if any.

On the payor side, withholding agents report annually to the IRS the amount of the payments they have made subject to Chapter 3 and FATCA, the persons receiving the payment, the amount of any tax withheld, and the basis for any withholding tax reduction. This reporting is done on IRS Forms 1042-S (done on a payee-by-payee basis) and 1042 (showing the aggregate amount of payments made and taxes remitted by the withholding agent, for the relevant reporting period). Foreign payees receive a copy of the IRS Form 1042-S with respect to payments made to them.

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The other end of the spectrum: Establishing (and paying tax as) a US business entity

At the other end of the spectrum, an inbound investor may choose to operate through a US business entity. This may be appropriate, for example, for relatively mature business operations, for business activities expected to mature quickly, or for an enterprise needing limited liability for its US-based activities.

Choice of business entity

Because there generally is no federal-level company law in the United States, business entities must be formed and operated under the auspices of state laws, which differ by jurisdiction. Nonetheless, it is possible to have a high-level discussion of the various types of legal entities available in the United States, and their varying tax implications. In considering options, an inbound investor should consider several factors in choosing the appropriate business entity, including commercial liability of the owners for the activities of the entity; flexibility of management, capital, and ownership structure; tax treatment of the entity and distributions to its owners; the suitability of the entity for expanding operations; and the ease and cost of selling or terminating the entity.

In addition, inbound investors should consider the home country tax consequences of holding ownership interests in, and receiving distributions from, a US entity. For example, many non-US countries have a foreign exemption system for income earned outside the country, or they exempt qualifying dividends received from foreign subsidiaries. Or, an investor's home country may treat an entity differently for tax purposes than the United States does, creating timing or character differences in an owner's inclusion of income earned by or through the entity. Notably, US taxation at the entity level—or current inclusion of the entity's tax results at the owner level—may be favorable if US business activities are generating losses (although loss recapture provisions should be considered), but unfavorable if the activities are significantly profitable.

For commercial purposes and at a high level, an inbound investor's choices are as follows: corporation, general or limited partnership, or a limited liability company (LLC). (For these purposes, we will treat sole proprietorships and branch offices as "in the middle of the spectrum," the tax considerations for which are discussed below.)

For US federal income tax purposes, investors generally choose between entities that are taxable and entities that are not (referred to as "pass-throughs" or "fiscally transparent"). It is possible in some cases for investors to establish entities that may generally default to taxable or pass-through status, then change their tax status.

Although there are a few limited elections that may apply in narrow factual circumstances (e.g., qualified real estate investment trust subsidiaries), corporations generally are respected as taxpaying "persons," separate from their owners. Consequently, corporations are taxable on profits earned at the entity level at a flat 21 percent tax rate, which has been in place and effective. inbound corporations are also subject to a minimum tax, enacted in 2022 with the Inflation Reduction Act. That 15 percent minimum tax is based on financial statement income, and it is imposed generally on inbound companies with $100 million in US earnings and $1 billion in worldwide earnings. In addition, shareholders of a corporation are subject to tax on dividend distributions. As noted above, dividends paid to inbound investors by a US corporation constitute "US-source FDAP income" and are therefore subject to 30 percent US withholding tax (which may be reduced under treaty). In addition, inbound investors may qualify for a "participation" exemption in their home country on dividends received from a US subsidiary.

Whether a corporation pays dividends for US tax purposes is dependent on the earnings and profits (E&P) of the corporation. Distributions are treated as made from current and accumulated E&P and constitute dividends to the extent of that E&P, regardless of whether the person receiving the dividend was a shareholder when the corporation derived the E&P. Distribution amounts in excess of E&P are treated as nontaxable return of capital (regardless of whether the corporation has unrealized appreciation in its assets); any remaining amounts are treated as capital gains. As previously noted, and subject to the discussion of real property interests below, most gains from the sale of stock generally are sourced in accordance with the residence of the seller. Consequently, the amount of a distribution treated as capital gain generally is nontaxable to a foreign shareholder.

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Thus, the US tax system (unlike some others) requires US corporations to first pay out dividends before permitting return of paid-in capital amounts, and does not permit any optional allocation in this regard.

Note also that a distribution may be a dividend if there is current E&P, even if there is an accumulated E&P deficit. The analysis is substantially the same if the new US business is acquired and elects to be classified as a corporation (or if the new US business is owned by another US holding corporation owned by foreign parent and the distributions are made by the holding company).

In contrast, partnerships and other pass-through entities (e.g., grantor or "simple" trusts) are not taxable at the entity level; nor are distributions by pass-through entities to their partners or owners generally subject to US income tax when made. (However, a partnership's income could be subject to tax in its owners' home country(ies), either on a current basis or at the time of distribution.) Partnerships can be fairly flexible vehicles in terms of determining different rights, obligations and benefits of the various owners, and may enable partners to tailor allocations and distributions more specifically to the needs of the partners—particularly if investors foresee additional partners coming into the picture in the future.

Significantly, if a pass-through entity is treated as conducting a USTB, it may create a "middle of the spectrum" scenario for its partners, in the same way that a branch office would. Thus, although a pass-through entity may be appropriate for more passive activities and investments (and a viable choice for other commercial activities), many inbound investors prefer the relative simplicity of a corporate structure—particularly if the activities generate significant deductions (reducing taxable profits), and withholding tax can be mitigated under a treaty. In later years, a corporate entity may have an easier time making acquisitions of, or other business combinations with, US targets, or adding new business lines. In addition, it is possible to "consolidate" multiple corporate entities for tax purposes. This enables tax losses in one entity to offset taxable profits in another entity, and income, deduction, gain, and loss on transactions between commonly controlled entities can be deferred for US federal income tax purposes.

Finally, an inbound investor can consider using an LLC. For commercial purposes, the LLC is similar to a corporation. For tax purposes, however, the LLC is not a taxable person (unless an entity classification election, check-the-box election, is made to treat the LLC as a regarded or fiscally opaque entity—see discussion below). If the LLC is wholly owned, its default status for US federal tax purposes is an entity disregarded from its owner (i.e., a branch), and its income and deductions are treated as that of its owner's. If an LLC has multiple owners, its default status is a partnership for US federal income tax purposes. Note, an LLC would not be eligible for US treaty benefits. Because of its structural similarity to a corporation, an LLC is likely to be viewed as a corporation for foreign tax and commercial purposes. As a result, despite not being subject to US federal income tax at the entity level (in the absence of a check-the- box election), and depending on the relevant home country jurisdiction, an owner may not be subject to tax on the LLC's income until distribution (and, even then, a distribution may be eligible for participation exemption or other foreign tax benefits), although the LLC would not have US treaty protection.

Compliance issues for foreign-owned US corporations

A foreign-owned US corporation generally will file an annual federal income tax return on an IRS Form 1120. The Form 1120 is the tax return filed by all US corporations, regardless of "parentage." Further, the corporation generally must file the return regardless of whether it has taxable income. The IRS Form 1120 generally is due by the 15th day of the fourth month after the end of its tax year. The corporation can file IRS Form 7004 to request an automatic six-month extension of time to file its tax return, which generally is due by the regular due date of the tax return. An extension of time to file a tax return does not extend the due date for the payment of taxes. Corporations generally must make estimated tax payments when their estimated annual taxes are at least $500. Estimated tax payments are due on a quarterly basis. Penalties can apply when a corporation does not make timely estimated payments.

A US corporation that is at least 25 percent foreign owned or a foreign person that is engaged in a USTB, e.g., a taxable branch office, must also file an IRS Form 5472 to report certain related-party transactions. In addition to providing information describing the foreign shareholder and the relevant related person, the type and amount of the related-party transaction are reported on the form as well as certain additional information about the domestic corporation and its foreign shareholder, including whether the foreign shareholder was a participant in any cost sharing arrangement. IRS Form 5472 must be attached to the corporation's income tax return and filed by the due date of that return.

A US corporation may have other filing obligations, depending on its particular business and assets. For example, a corporation with employees would need to comply with employment tax filing obligations (including filing IRS Forms 941 and 943), while a corporation that

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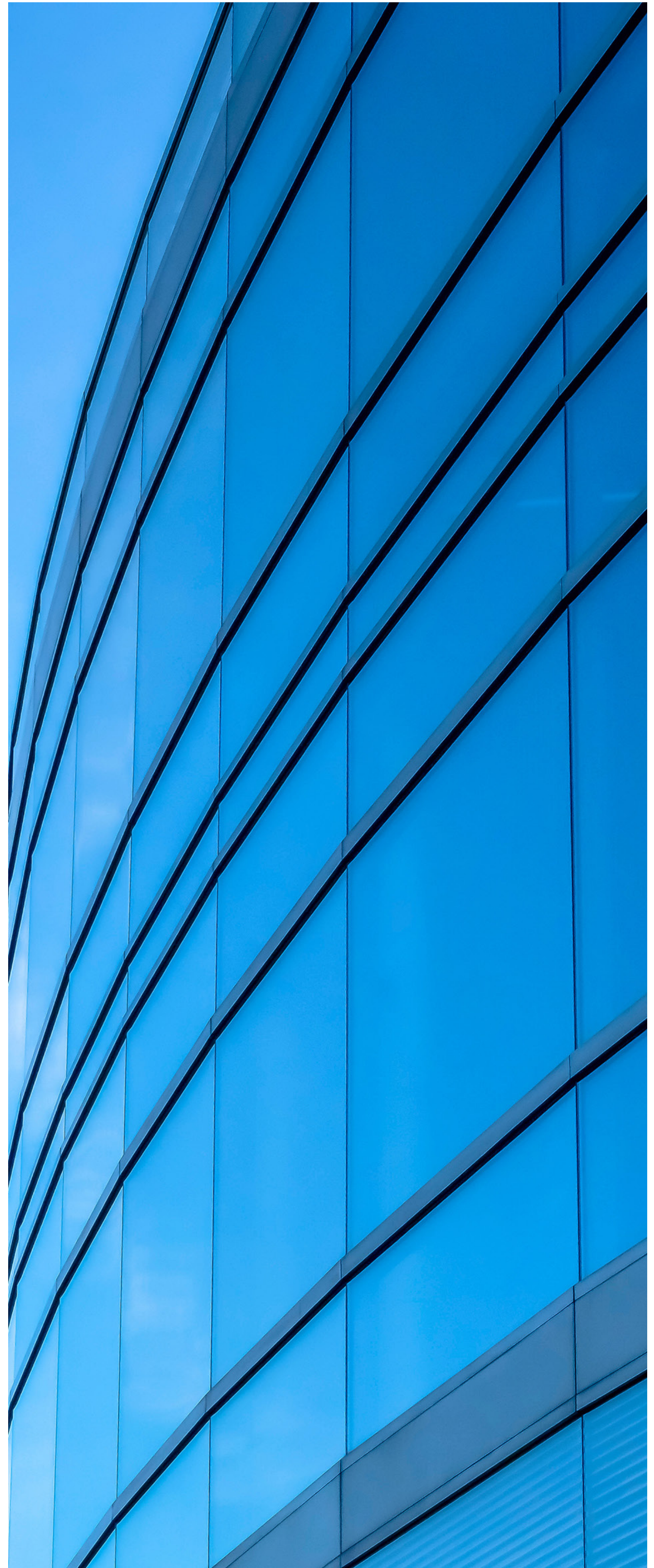
owned certain foreign corporations may need to file IRS Form 5471 (relating to controlled foreign corporations (CFCs)) or IRS Form 8621 (relating to passive foreign investment companies (PFICs). The constructive ownership rules for determining CFC status sweep in a large number of foreign corporations that as CFCs and require many US shareholders to file Form 5471. That is, if two subsidiaries, US and foreign, are commonly owned by a foreign parent, the parent's ownership of the foreign subsidiary's stock generally will be attributed to the US subsidiary. As a result, the foreign subsidiary is treated as a CFC even though, in fact, it is a brother-sister company to the US entity. IRS guidance generally limits the potential filing obligations to only US shareholders that hold a direct or indirect interest of 10 percent of the vote or value of the foreign corporation (e.g., IRS Form 5471) in circumstances where a foreign corporation is only a CFC under the circumstances described above (commonly referred to as "downward attribution"). In spite of this guidance, the analysis can become complicated. A US corporation also may be required to file income tax returns with one or more US states and certain municipalities.

Elections to change the US tax treatment of a business entity

Depending on the type of business entity selected, an inbound investor may be able to change the US tax classification (i.e., alter its tax treatment for US federal income tax purposes) from the defaults discussed above. Note, this does not alter the entity's commercial treatment; nor does it necessarily change the way foreign tax authorities view the business entity (although there may be an effect on the entity's ability to access the benefits of an otherwise applicable income tax treaty). Such a change in tax classification would be made on an IRS Form 8832, which is informally referred to as making a "check-the- box election." At a very high level, US corporations cannot change their default US tax treatment. However, elections may be made to treat LLCs and partnerships—which both, default to pass-through entities—as corporations. A change in tax classification can be treated as a taxable transaction. (Some types of businesses, e.g., tax-exempt organizations, insurance companies, certain real estate investment vehicles, etc., are also precluded from changing their US tax classification.)

A check-the-box election can be filed at any time during the life of a business entity, but an entity can only change its tax status once every 60 months (not counting an election as to its status upon formation). Once filed, an election can go into effect up to 75 days before filing, or up to one year after filing. If not otherwise indicated, the effective date of the election is the filing date of the form.



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The middle of the spectrum: Liability for tax on income effectively connected with the conduct of a US trade or business

General US tax rules for a foreign entity engaged in a US trade or business

As discussed above, the middle of the spectrum is for business activities conducted by inbound investors. If the US business activities are significant enough to create an economic nexus within the United States, net effectively connected income (ECI) with such nexus—known as a USTB—is subject to US federal income tax at the same rates that apply to other domestic businesses (taking into account the 21 percent corporate rate, as discussed above).

In addition, and as discussed further below, although transactions between branches and their home offices generally are disregarded for tax purposes, repatriation of USTB earnings, interest paid by the USTB, or interest deemed to be received by the inbound investor, is subject to branch profits tax or branch-level interest tax, respectively. The branch taxes were enacted to create parity between a foreign corporation engaged in a trade or business through a branch office, and a foreign corporation engaged in a trade or business indirectly through a US subsidiary.

Whether income is taxed as ECI is a case-by-case determination that depends on the nature and extent of the foreign investor's activities in the United States. Generally, an inbound investor will be treated as having a USTB if the investor performs personal services within the United States or engages in other business activities (e.g., sales) onshore. Business activities may create a USTB if performed directly through the inbound investor's employees or through agents, and if the activities are deemed to be "considerable, continuous, and regular."

Although the phrase "considerable, continuous, and regular" seems to establish a relatively high threshold for taxable activity, the reality is that inbound investors can be surprised with adverse results from this case-by-case subjective test. For example, even a single commercial activity—if significant enough in the context of the overall business—can trigger taxable status. For example, the IRS has ruled that a horse that entered and won a single US race established a USTB with respect to its foreign owner, despite that the horse was raised and trained offshore, and only entered the United States for the race. Additionally, the activities must be more than merely incidental, ministerial, or clerical to create a USTB. Such activities are generally too far removed from the actual production of income (unless they are, in themselves, the enterprise's income-producing activities, e.g., IT support services to outside customers).

In addition, the US statutory rules contain exceptions for foreign corporations that trade in stocks, securities, or commodities for their own account, or through a resident broker, commission agent, custodian, or other agent. This exception applies regardless of the volume of the investor's transactions. Note, however, that the exception is discontinued if at any time during the taxable year, the inbound investor does not trade for its own account, has an office or fixed place of business (OFPB) in the United States through which, or by the direction of which, the transactions in stocks, securities, or commodities are executed. With respect to trading commodities, this exception only applies if the commodities are of a kind customarily dealt in on an organized commodity exchange and if the transaction is of a kind customarily consummated at such place. Furthermore, there is some uncertainty as to whether lending activities (e.g., loan origination) are eligible for the stock and securities exceptions. Therefore, while an inbound investor may be able to trade debt instruments without triggering US income tax liability, the investor should consider whether negotiating or renegotiating debt terms creates a risk of its activities being taxable.

As noted above, if an inbound investor is seen as having a USTB, it is subject to US federal income tax on its ECI. ECI generally includes US-source FDAP income and capital gains as well as certain types of foreign-source income.

US-source FDAP and capital gains are considered effectively connected to a USTB if either of the following two tests is met:

1. The income or gain is derived from assets used in or held for use in the active conduct of a USTB (the "asset use test").
2. The activities of the USTB are a material factor in the realization of the income (the "business activities test").

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Importantly, once the existence of a USTB is established, even US-source income not factually connected with the relevant US business activities may be included as ECI. The so-called "residual force of attraction" rule is a significant trap for unwary inbound investors. The most common scenario includes an inbound investor that has a USTB conducting sales of one item, while the inbound investor sells another item into the United States. (A well-known example from the US tax regulations involves business machines being sold through the USTB, while the inbound investor sells fine wines directly into the United States from offshore.) Even if the USTB has nothing to do with the additional sales, the US-source gains from those sales may be included as ECI and taxed accordingly.

Foreign-source income also may be treated as ECI, but only in very limited circumstances. The following items of foreign-source income may be considered ECI if the foreign investor
(i) has an OFPB in the United States,
(ii) such income is attributable to OFPB, and (iii) such OFPB's income consists any of the following:

- Rents or royalties for the use of intangible property (e.g., patents, copyrights, goodwill) outside the United States derived in the active conduct of a trade or business within the United States
- Dividends, interest, or gains from the sale of stock and financial instruments derived from carrying on banking, financing, or similar business in the United States, or received by a corporation whose principal business is trading in stock and securities for its own account
- The sale or exchange of inventory outside of the United States through the US OFPB, if the inventory will be used inside the United States.

Recall that our prior discussion regarding use of business entities was limited to nonbusiness (non-USTB) activities. This is because, if an inbound investor uses a partnership to engage in a USTB, each foreign partner is, in turn, treated as engaged in that USTB. Foreign partners in such partnerships generally are subject to withholding by the partnership on their allocable shares of the partnership's "effectively connected taxable income" (i.e., gross ECI less allocable deductions). Foreign corporate partners are subject to withholding at 21 percent and foreign individual partners at 37 percent.

Additionally, there is a 20 percent deduction for noncorporate owners (i.e., owners who are individuals, trusts, or estates) of certain partnerships, S corporations, and sole proprietorships. Qualified taxpayers are allowed a deduction of 20 percent of "qualified business income" earned in a qualified trade or business, subject to certain limitations. Qualified business income is defined as the net amount of qualified items of income, gain, deduction, and loss with respect to a qualified trade or business that are treated as ECI.

Partnerships required to make tax distributions might consider reviewing, and if necessary, revising their partnership agreements to take this deduction into account. Any reduction in the amount of required tax distributions could enhance the partnership's cash flow. From a planning perspective, taxpayers should consider the potential effects of the new deduction on how they organize their operations and on future reporting. It should be noted, however, that this deduction expires after 2025. The temporary nature of this provision complicates planning, and should be considered by taxpayers in evaluating whether to continue to operate in pass-through form or convert to corporate form to take advantage of the new, lower corporate tax rates, though taxpayers should also keep in mind the potential consequences of unwinding a corporate structure if the deduction sunsets without extension. Taxpayers will likely need to model the anticipated effect of the deduction to help assess the implications on future planning.

Provisions in the Code regarding sales of US partnership interests by foreign investors dictate the treatment of gain from such sales. If a US partnership was engaged in a USTB, a foreign partner's sale of its partnership interest is treated as ECI, if and to the extent a sale of the partnership's assets would result in ECI gain. A withholding regime that applies in the context of this type of sale generally requires a transferee or buyer to withhold 10 percent from the foreign partner's sales proceeds. [However, US Treasury and the IRS issued final regulations under section 1446(f) providing several exceptions to the general withholding requirement, two of which are, in essence, de minimis rules relating to ECI.

Branch profits and branch-level interest taxes on USTB

As noted above, to place USTBs—including those held through partnership entities (referred to collectively as "branches")—on par with corporate subsidiaries, the US federal tax rules impose branch profits and branch-level interest taxes on equity and debt-like payments made to the foreign home office.

The branch profits tax applies to the branch's "effectively connected earnings," when such earnings are "deemed repatriated" from the United States at the end of the tax year. Significantly, this means that the tax could be imposed even if there is no actual repatriation of cash to

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the foreign home office. The amount deemed repatriated is referred to as the dividend equivalent amount (DEA). The branch profits tax is assessed at 30 percent of the gross DEA.

At a high level, the DEA is the branch's US-source effectively connected earnings and profits (ECE&P), plus any net decrease or minus any net increase in the branch's US net equity. ECE&P generally includes the E&P that are attributable to ECI. US net equity is the sum of cash on hand plus adjusted basis of the assets connected with the US business, less liabilities. In essence, the DEA is the net effectively connected earnings that are not reinvested in the USTB assets, plus previously retained earnings withdrawn from the USTB during the taxable year.

The branch-level interest tax treats interest paid by a USTB as if paid by a domestic corporation, and consequently, subject to US withholding tax.

In addition, the branch-level interest tax requires comparing the amount of interest allowed as a deduction in computing the branch's ECI to the amount of interest paid by the branch to its foreign home office. If the deductible amount exceeds the paid amount, the excess is treated as if it were interest paid by a wholly owned domestic subsidiary, again subject to withholding.

Reduced USTB taxes under treaties

As in the withholding tax discussion above, inbound investors that qualify for the benefits of an income tax treaty between the United States and their home country could potentially receive significant relief from US tax as it relates to a USTB's earnings and various forms of repatriation. As noted earlier, a US LLC is not itself eligible for US tax treaty benefits.

First, income tax treaties generally raise the threshold for triggering income tax liability on US business activities. As discussed above, such activities are taxable under US internal rules (i.e., statutory laws, regulations and IRS rulings and other pronouncements) if they are treated as "considerable, continuous, and regular" in nature. This threshold is somewhat vague, and can be exceeded in a surprisingly wide range of cases.

An applicable tax treaty modifies the threshold, instead applying a PE concept. As opposed to the primarily activities-focused USTB test, the PE standard introduces more of a physical situs test. Its application is therefore more easily predicted, and, to the extent commercially realistic, avoided. Thus, for example, if an inbound investor provided services to US customers and did so entirely from abroad (e.g., remote IT support), it could avoid having a taxable US PE. Note, while the PE standards found in US tax treaties generally are consistent with historic OECD PE principles, as a result of the OECD's Base Erosion and Profit Shifting (BEPS) Project—Action 7, specifically—many OECD member jurisdictions are in various stages of adopting new PE standards.

A PE generally is defined as an "office or fixed place of business through which the business of an enterprise is wholly or partly carried on." A situs is "fixed" if it is reasonably identifiable as a site and it has some degree of continuity or permanence. Although treaties may vary (particularly older ones), the following are generally included as "places" of business for treaty purposes:

- A place of management
- A branch
- An office
- A factory
- A workshop
- A place for extracting natural resources (e.g., a mine, quarry or forest)
- A building site or an installation or exploration site, if the activity lasts for more than a specified number of months (usually 12).

In addition, the physical situs must be a place "of business," which is generally understood as a sustained or continual commercial activity. As a general matter, and subject to the factual context, merely "preparatory or auxiliary" activities are explicitly excluded from being business activities even though they are generally conducted at a physical site. Examples of "preparatory or auxiliary" activities may include:

- Use of facilities for storage, display or delivery of goods, or maintenance of a stock of goods for these purposes
- Maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or for collecting information for the enterprise
- Other activities that have a preparatory or auxiliary character for the enterprise, such as advertising or the supply of information
- Combinations of these types of activities, if the combination of activities results in an overall activity that is preparatory or auxiliary.

Mere ownership of a domestic subsidiary will not by itself create a PE for foreign shareholders. In contrast, if an inbound investor owns interests in a US partnership, and if the partnership in turn has a US PE, the investor will also be treated as having a US PE.

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KPMG assists Canadian IT provider with PE concerns

A Canadian IT service provider had multiple short-term and midterm projects ongoing at several job sites within the United States; the US projects were staffed by Canadian residents who traveled to the US job sites. The Canadian company was concerned that its US services activities created a US PE under the US- Canada Income Tax Treaty, and consequently, that its related income would be subject to US federal income taxation. The company was also concerned that it would have similar taxable nexus issues in the various states in which its employees were providing services. KPMG helped the client trace its mobile employees' US activities and ultimately determined that the client had no US PE, and minimal state income tax obligations. KPMG was also able to assist with federal and state income tax return filing obligations. Finally, KPMG helped the company establish ongoing internal guidelines and protocols as well as personnel tracking mechanisms, to avoid taxable status in the future.

Additionally, nonphysical business activities (e.g., certain agent activities) can also create a PE for an inbound investor. Dependent agents that have and habitually exercise the right to conclude contracts in the name of the inbound investor can trigger PE status—unless the dependent agents are only performing activities that, if conducted directly by the inbound investor, would not create a PE (e.g., preparatory or auxiliary activities described above). Thus, for example, a local agent that finds customers, negotiates contract terms, and concludes contracts on behalf of an inbound investor puts the investor at significant risk of US taxation. Even activities that fall short of onshore contract conclusion can carry risk, particularly if the inbound investor only superficially participates in the contract negotiation or execution.

On the other hand, independent agents do not create a US PE for an inbound investor, even if they regularly conclude contracts on the investor's behalf. To be respected as independent, however, an agent must be legally and economically independent of the inbound investor, e.g., the agent must be a separate business entity that acts on behalf of several different principals, so that its economic situation is not primarily aligned with, or dependent upon, the inbound investor. In addition, the agent must be rendering services to the inbound investor in the ordinary course of its business.

Finally, it should be noted that some US tax treaties—such as with Canada and India, among others—contain services PE provisions. Under those provisions, notwithstanding that no physical office or place of business exists, an inbound investor may have a PE if its employees or other agents are physically in the United States and if their US presence or economic contribution to the investor's global enterprise is sufficiently large.

The US-Canada Tax Treaty, for example, contains two tests; if either is met, the inbound investor is treated as having a US PE. (The treaties containing personal service PE provisions can vary widely; please check applicable treaties carefully for an understanding of the relevant rules.) The first test evaluates the magnitude of individual service providers working on behalf of the inbound investor, while the second focuses on the US presence of the investor as a whole.

- **Individual services test.** This test is met if:
  - Services are performed by an individual who is present in the United States for at least 183 days during any 12-month period (testing period), and
  - During the testing period, more than 50 percent of the investor's gross revenue from active business activities is due to the individual services.
- **Project test.** This test is met if the investor's enterprise provides services in the United States for at least 183 days during any 12-month period on the same project or connected projects. To be connected, projects must be both commercially and geographically coherent.

Once a PE is established, an inbound investor is taxable only on business profits "attributable to" the PE. Such business profits must generally be factually related to the assets or activities of the PE, in

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order to be subject to US taxation. In particular, the "force of attraction" rule described above, is turned off. (In the example discussed, because profits from the sale of fine wines were completely unrelated to the assets or activities of the US business, they would fall outside the scope of US taxation.)

Finally, applicable tax treaties may reduce or eliminate the US withholding tax rate on branch profits and branch-level interest—from the 30 percent statutory rate to rates consistent with those for dividends and interest under the treaty.

Base erosion and anti-abuse tax

One of the enumerated goals of the tax system is to "level the playing field" between US-parented multinational groups and their foreign-parented counterparts. In particular, some provisions address what is viewed as inappropriate US income tax base erosion, including a minimum tax (the base erosion and anti-abuse tax (BEAT)) that targets deductible payments made from a US entity to foreign related entities.

BEAT applies to US corporations that are not taxed on a flow-through basis (i.e., corporations that are not eligible for special regimes, such as would apply to S Corporations, Regulated Investment Companies, and Real Estate Investment Trusts (REITs)), if they meet two requirements: (i) the US corporation (or group of US corporations) is a member of a sizable multinational group, i.e., a group having prior three-year average domestic gross receipts of least $500 million, and (ii) the US corporation's (or group's) targeted base erosion payments represent at least 3 percent of its otherwise allowable tax deductions. (The threshold is 2 percent for certain banks and securities dealers.) Certain deductions—notably including net operating loss (NOL) deductions not attributable to base erosion payments—are not taken into account for these purposes. BEAT also applies to foreign corporations engaged in a USTB, for purposes of determining their ECI tax liability.

There are four types of targeted base erosion payments:

1. Amounts paid or incurred by the taxpayer to foreign related parties, for which a deduction is allowable
2. Amounts paid in connection with the acquisition of depreciable or amortizable property from the foreign related party
3. Cross-border reinsurance payments made to related parties
4. Purchase proceeds paid to related parties that, with the US corporation, are members of an "inverted" group

There are several explicit and practical exceptions to the provision's scope for otherwise deductible payments,

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including, but not limited to, payments that would otherwise be included in the US corporation's cost of goods sold (which are viewed as reductions to gross income as opposed to deductions, and therefore outside the scope of BEAT) as well as payments for activities that effectively amount to back-office services (cost component only).

Because BEAT is a minimum tax, liability is measured as the excess of a hypothetical tax over a version of taxes paid by the US corporation.

The hypothetical tax is applied at a rate that increases over time—5 percent for 2018, 10 percent until 2025, and 12.5 percent from 2026 onward. (Banks and registered securities dealers are subject to a one-percentage-point higher BEAT rate in every year: 6 percent for 2018, 11 percent for 2019–2025, and 13.5 percent thereafter.)

The base of the hypothetical tax is a modified taxable income amount, which increases the US corporation's taxable income by otherwise deductible, targeted base erosion payments as well as the portion of NOLs attributable to such payments. Significantly, base erosion payments that are subject to Chapter 3 withholding (as discussed above) are not added back to modified taxable income. Otherwise, these additions to taxable income are akin to a clawback of the tainted deductions. The amount treated as taxes paid is the 21 percent corporate rate applied to normal taxable income, except that the US corporation does not get the benefit of a substantial portion of its tax credits. This has the effect of reducing taxes paid. Notably, until 2026, US corporations retain the benefit of its Research and Experimentation (R&E) and certain general business credits for purposes of this calculation.

Compliance issues for foreign corporations engaged in a USTB

A foreign corporation engaged in a USTB is required to annually file IRS Form 1120-F, US Income Tax Return of a Foreign Corporation, to report any US income, gains, losses, deductions, credits, and to calculate its US income tax liability. This form must be filed regardless of whether the corporation had US-source income from the USTB (i.e., the inbound investor may have an obligation to file a "zero" return).

The IRS Form 1120-F must also be filed by foreign corporations that are claiming a US federal income tax refund, and foreign corporations that had non-ECI US-source income, the tax liability on which had not been fully satisfied through withholding.

Even if a corporation believes that its activities do not constitute a USTB and its income is therefore not taxable as ECI, corporations conducting limited activities in the United States may find it prudent to file a protective Form 1120-F. This is because the Code penalizes factual situations that are not flagged with a US tax return, where the inbound investor is ultimately found to have a USTB. Specifically, the Code disallows deductions and credits attributable to the ECI-related gross income (Disallowance Rule), effectively resulting in gross-basis taxation.

Consider, for example, an inbound investor that "tests" the US market with a stream of inbound sales. The investor does not open a US office, but engages in sales through mobile sales agents. The inbound investor's commercial results are poor—in fact, on a stand-alone basis the activities result in a net loss—and the inbound investor discontinues its efforts. The inbound investor does not file an IRS Form 1120-F (either because the investor did not know about the filing obligation, or because, having generated losses and owing no income taxes, the investor decided there was no reason to file). Several years pass, and the IRS opens an inquiry (or the inbound investor is in negotiations to sell its business and is subject to due diligence on its US activities). What's the exposure?

First, instead of having a loss, by application of the Disallowance Rule, the inbound investor is subject to US federal income tax on gross income related to its US sales activities (at a tax rate of 21 percent). In addition, because the statute of limitations for assessing any tax is benchmarked from the tax return filing date, failure to file a tax return results in the IRS having an unlimited period to audit, propose adjustments, and collect any foregone taxes. (See discussion below for the "normal" statute of limitations rules.)

Foreign corporations that are relying on certain treaty benefits (i.e., the elevated "PE" threshold for determining if US activities comprise a taxable nexus) are required to file an IRS Form 8833, stating their "treaty-based return position." Foreign corporations file an IRS Form 8833 in relation to claims for reducing the tax exposure from the disposition of a US real property interest; changing the source of an item of income or deduction per treaty definitions; or claiming a foreign tax credit for a specific foreign tax, which would not have otherwise been allowed by the Code. An IRS Form 8833 also is required from foreign corporations that receive payments or income items totaling more than $100,000, that have relied on treaty provisions to determine their country of residence.

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KPMG assists private equity firm with European acquisition

A US private equity client engaged KPMG to assist with the acquisition of a European target. During due diligence, KPMG found that the target had engaged in US business activities for several years prior to the acquisition, but had not filed IRS Forms 1120-F or IRS Forms 8833 for any period, and had paid no income or withholding taxes with respect to its US-source income. The client was facing federal income tax delinquencies based on the target's gross income earned during the period, plus interest and various nonpayment and nonfiling penalties, with no statute of limitations protection. KPMG assisted the client in scoping its exposure and in establishing a purchase price escrow with the seller. The exposure represented approximately 15 percent of the gross target purchase price. Postclosing, KPMG assisted the client in remediation and factual development that culminated in KPMG filing successful IRS petitions for penalty relief as well as delinquent tax and information returns.

Investments in US real property

Special consideration would need to be given to any inbound investment that involves US real property.

Let's start at the back end, i.e., the treatment of dispositions of US real property and interests in real property, to understand the US federal income tax consequences that could apply. Those consequences dictate the structure for holding real property investments.

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) treats a foreign investor's gain or loss from the disposition of US real property and certain investments in US real property as if such gain or loss was ECI. Consequently, even though gains from a foreign seller's sale of property generally are foreign-source income (and therefore outside the scope of US taxation) and despite gains from the sale of property generally being excluded from FDAP income, the FIRPTA rules would tax FIRPTA gains at regular US income tax rates. These rules can be triggered even in situations where nonrecognition treatment might otherwise apply to defer taxation.

The FIRPTA rules generally cover US real property and various types of interests therein (unless the seller has interests solely as a creditor). This applies to direct interests in S real property, including land and improvements, mines, wells, natural deposits, and certain personal property associated with real property.

The FIRPTA rules also apply to interests in an entity that is or was a US real property holding corporation (USRPHC) during a prior five-year testing period. A USRPHC is a corporation, the balance sheet of which shows significant US real property interests (USRPIs). More specifically, a corporation is a USRPHC if, based on fair market value, its USRPIs comprise at least 50 percent of the sum of its USRPIs, foreign real property interests, and other assets used or held for use in a trade or business. US corporations are presumed to be USRPHCs unless the foreign investor rebuts the presumption by obtaining certain documentation from the US corporation. Foreign investors also may be subject to FIRPTA on dispositions of interests in partnerships, trusts, or estates that hold significant USRPI assets, or on dispositions of USRPIs by partnerships, trusts, or estates.

The FIRPTA tax is levied through a withholding mechanism, and purchasers generally are tasked with the role of withholding agent. The purchaser of any USRPI from a foreign person is required to withhold 15 percent of the gross amount realized by the foreign seller upon disposition of the property. In certain cases, e.g., a disposition of a USRPI by a US trust or estate with a foreign beneficiary, the applicable rate increases to 21 percent. The withholding agent must remit the tax to the IRS by the 20th day following the transaction; remittances are reported on IRS Form 8288.

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The foreign seller may in certain circumstances be eligible for a certificate from the IRS, reducing or eliminating the amount of withholding.

Note, the withholding tax collected by the buyer is not the inbound investor's final tax liability, and the withheld amount may often exceed such liability, particularly once selling and other expenses are taken into account. In those cases, the inbound investor may file a claim for refund.

Significantly, direct interests in a foreign corporation, even if its entire balance sheet comprises USRPIs, fall outside the scope of the FIRPTA rules. However, a foreign corporation that distributes a USRPI must withhold a tax of 21 percent of the gain resulting from the distribution.

Inbound investors should carefully consider their options for structuring an investment in US real property. The most viable choice of entity will depend, among other things, on the outcome of modeling exercises that take into account the nature and extent of proposed income or losses of the new US business, the intended asset mix of any entity holding the real property investments, the anticipated frequency and nature of distributions, and the time frame and proposed structure for any potential disposition.

In addition, inbound investors need to understand their obligations if they are purchasing USRPIs from other foreign persons. Withholding agent requirements apply regardless of whether the purchaser is a US or foreign person or entity, and withholding agents are jointly and severally liable for any withholding failures. It therefore is critical for inbound investors acquiring USRPIs to obtain any pretransaction documentation necessary for determining whether withholding is needed, and to withhold and report properly.

KPMG assists investment firm with real estate investment

An East Asian investment fund owned several pieces of US real estate, and needed advice related to the sale of prior investments and the acquisition of new US real estate investments. The KPMG Real Estate practice assessed the ownership structure for the historical investments, to quantify the potential US tax cost of a disposition of those assets. KPMG also established a baseline structure for the acquisition of the new properties, including financing, and assisted with the cash flow modeling for ongoing maintenance and ultimate liquidation of the new properties. KPMG also performed a cost-benefit analysis and made additional recommendations regarding potential REIT status for the ownership vehicle.

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Leverage

A foreign investor may find that it is beneficial from a US federal income tax perspective to fund its investment in a US corporation through a mix of debt and equity. Debt funding may lower the foreign investor's overall US federal income tax burden because the US corporation may generally deduct interest to reduce its US federal income tax by 21 percent of each dollar of interest paid. While the foreign investor can be subject to US federal income tax on the interest paid by the US corporation, the rate of tax may be lower (default of a 30 percent rate through withholding, potentially reduced or eliminated by treaty). However, a loan to a US corporation raises several issues that must be considered.

Debt versus equity characterization

General principles. First, a loan to a US corporation will provide interest deductions to the US corporation only if the loan is considered to be debt for US federal income tax purposes. Whether a loan is debt for such purposes generally is determined pursuant to longstanding judicial precedent that looks at all relevant facts and circumstances through the lens of several factors. At a high level, the keystone of "debt" for US federal income tax purposes is the existence of an obligation for the purported borrower to repay to the lender a sum certain, on a

specified date or on demand, including interest. More specifically, whether an arrangement constitutes valid debt for US tax purposes is based on some combination of the following factors, the exact mix, focus, and relative weight of which depend on the relevant court and the fact at issue:

- Label of the instrument as debt or as equity
- The existence of a fixed maturity date
- The source of payments, e.g., the extent of which repayment depends on corporate earnings
- Right to enforce payment
- Whether, as a result of the advances, the lender has a right to participate in management of the issuer
- Status in relation to regular corporate creditors
- Intent of the parties at the time of issuance and as evident in their course of conduct
- Whether there is identity/ proportionality of interest between debtholder and stockholder
- The thinness of the issuer's capital structure in relation to the debt
- The ability of the issuer to obtain credit from outside sources on the same or similar terms
- The manner in which the borrower used the advances (e.g., to acquire capital assets, which may signal equity treatment, or to finance daily operations, which is generally seen as a sign of debt)
- Whether regular payments are made in fact, and, in the event of a default, whether the lender acted as an unrelated creditor would
- Whether there is a reasonable expectation that the advance will be repaid.

Proper documentation and use of arm's-length terms can help support the treatment of an instrument as debt under the general principles noted above.

Debt-equity treatment per regulations

US Treasury regulations promulgated under Code section 385 can treat certain instruments issued by a domestic corporation that would otherwise constitute debt under general principles as equity for US federal income tax purposes. These rules can apply to debt issued by a domestic corporation to certain members of the issuer's "expanded group" (generally, corporations connected through direct or indirect 80 percent stock ownership, other than corporations that join in the same consolidated return for US federal income tax purposes).

The "documentation" rules of the section 385 regulations were postponed several times and now have been withdrawn. Nonetheless, inbound investors should think carefully about detailed documentation and recordkeeping with respect to their related-party debt instruments (including, for example, for US participants of global cash pooling arrangements), and should establish and respect arm's-length terms.

The section 385 regulations also include reclassification or "recast" rules, which remain in effect. These reclassification rules can apply to recharacterize indebtedness issued by a US corporation as stock in the corporation if:

1. The debt is issued as a distribution to a shareholder, in exchange for stock of a related corporation, or in exchange for assets in an intercompany reorganization, or

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Multimedia communications group settles share-based compensation awards

A French multinational, multimedia communications group engaged The KPMG Global Incentive Compensation Services group for assistance in settling share-based compensation awards that vested for its globally mobile employees. The project required that the KPMG team determine the applicable tax settlement rates for cross-border, French-sourced awards for 70 participants across 24 countries, considering country-specific sourcing rules, tax withholding rates, and the individual global mobility policies of each employee's employing entity within the global group. In addition to providing the applicable tax settlement rates for the client to share with its share plan administrator, KPMG prepared global payroll reports to help the local payroll providers to comply with reporting and tax withholding obligations. The team also worked with the client's share plan administrator to reconcile excess cash due to share rounding. The result was the accurate settlement of employees' awards—delivering the maximum number of shares available—along with timely global payroll compliance.

2. Within 36 months before or after the debt's issuance, the issuer engages in a distribution to a shareholder, a purchase of stock in a related corporation, or an intercompany reorganization with some amount of nonstock consideration (the per se rule).

As of publication of this guide, the reclassification or "recast" section 385 regulations remain in effect. There have been previous indications that these regulations may be modified or withdrawn, but there have not been any recent concrete developments indicating a modification or withdraw is imminent.

Interest expense limitation

As a result of legislation passed in 2017, taxpayers generally may not deduct net business interest expense in excess of 30 percent of the taxpayer's "adjusted taxable income." This limitation is contained in section 163(j) and generally applies to all interest deductions, including interest payments to both related and unrelated parties. In addition to domestic corporations, the interest limitation generally applies to entities classified as partnerships for US federal income tax purposes and foreign corporations. Detailed regulations have been promulgated to implement this provision, including to define "interest" and "adjusted taxable income." At a very high level, "adjusted taxable income" is similar to earnings before interest and taxes.

To the extent interest expense deduction is disallowed in a tax year under section 163(j) it generally is carried forward and treated as paid in each subsequent tax year. Thus, the disallowed interest expense may be deducted in a subsequent tax year, subject to the section 163(j) limitation.

Timing of interest deductions

US federal income tax rules also prescribe the taxable year in which an interest expense may be allowed as a deduction. While a US corporation will generally use the accrual method of accounting, if interest is payable to a foreign party "related" to the US corporation, the US corporation generally cannot deduct interest prior to payment. This rule often prevents a US corporation from taking a deduction for interest expense without the potential US federal income taxation of the interest income related to such deduction.

Hybrid transactions

The United States also has a variety of rules to help neutralize the effects of hybrid mismatch arrangements by denying deductions for interest and royalty payments to certain non-US related persons that directly or indirectly result in a deduction/noninclusion outcome by reason of certain

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hybridity. Very broadly, these anti-hybrid rules are in keeping with OECD and ATAD II trends taking steps to preclude "double nontaxation" of income.

More specifically, the tax rules disallow a deduction for interest or royalty payments made to certain foreign persons pursuant to hybrid and branch mismatch arrangements that result in a deduction/noninclusion outcome by reason of such hybridity. The antihybrid rules also apply imported mismatch rules designed to guard against conduit arrangements. Although the US antihybrid rules are generally consistent with OECD BEPS Action 2 and ATAD II, it is notable that the US antihybrid rules also apply to interest-free loan arrangements and deductions on net equity (e.g. notional interest deductions). The US hybrid and branch mismatch arrangement rules (including imported mismatch rules), however, generally do not apply to domestic-parented multinational group structures. As such, these rules generally only apply to US inbound structures.

Mobile executive compensation issues

Even if an inbound investor decides to form a US business entity, it may want the benefit of having experienced employees onshore.

Often, an inbound investor will accomplish this by assigning a foreign, "home office" employee to work for a new US entity for an extended period of time, on a full-time basis during that period. A seconded employee in this situation generally is treated as an employee of the US host entity for the duration of the international assignment.

Consequently, the secondee is treated in the same manner as any other US employee—for example, receiving an IRS Form W-2 reflecting the secondee's US compensation and any income tax withholding. In some situations, seconded employees may remain on the home office payroll, with the US "host" entity agreeing to reimburse the home office for the employee's costs. In this situation, a shadow payroll may need to be established to meet the employer's reporting and withholding obligations. Due to differing tax rates between the home and host country and the provision of assignment-related allowances, the individual's secondment arrangement may also include a tax equalization or tax protection provision to approximate the individual's tax burden in the home country with any incremental income taxes being paid by the employer.

In some situations, seconded employees may continue participating in their home office's deferred or incentive compensation plans, and their various rights may vest during their assignment to the United States. For example, a secondee may arrive in the United States with stock options that are generally subject to a substantial risk of forfeiture (e.g., upon leaving employment before performing a specified period of service). Subject to applicable treaty provisions, if this risk of forfeiture lapses while the employee is on US assignment, the secondee's stock options are likely subject to US tax. Moreover, if the stock options have exercise prices that were discounted from fair market value when granted, the unvested stock options might be treated as deferred compensation and are potentially includable in income at vesting under US employment taxation rules (and could be subject to a 20 percent additional income tax on top of regular US income tax).

A secondee (and under a tax equalization agreement, the employer) could face even more US tax if the secondee vests in, accrues benefits under, or receives a distribution from, a foreign pension plan during the secondee's US tenure. With advance planning, an inbound investor could identify each employee's risks, so that adverse US tax consequences can be mitigated or avoided altogether. Just as an example, deferred compensation could potentially be triggered before the secondee transfers to the United States, if acceleration gave the secondee a better tax result based on comparative individual tax rates and availability of tax credits or other offsetting benefits.

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Acquiring existing US operations

Instead of establishing a new US business, an inbound investor may want to acquire a preexisting US target company. In this circumstance, it is important for an inbound investor to understand the US federal income tax consequences of an acquisition, including the differences in tax treatment between an acquisition of the stock of a company and the acquisition of its assets and liabilities. In addition, because not all target companies (particularly groups of companies) are ideally organized from an inbound investor's perspective, inbounds may need to understand and consider the US federal income tax implications of post-acquisition transactions.

Acquisitions in general

The US federal income tax implications of the acquisition of a US target corporation are quite complex, and can vary in part depending on whether the buyer acquires the target's stock or its assets and liabilities, and whether the acquisition is a tax-free or taxable transaction.

A number of conditions generally need to be satisfied in order for an acquisition to be treated as a tax-free acquisition or "reorganization."

An inbound Investor can ensure taxation of a transaction as an asset sale by either purchasing the target's assets, or, in certain circumstances, purchasing the target's stock and making an election under section 338 of the Code ("section 338 election") to treat the stock sale as a deemed sale of assets (for purposes of determining the US federal income tax treatment of the sale). The availability of a section 338 election depends on a number of factors, some of which are discussed below.

Taxable asset acquisitions

The US target company generally recognizes gain (or loss) in a taxable asset acquisition based on any appreciation (or depreciation) in its assets. In addition, the target's shareholders generally would be subject to US federal income tax when they receive the proceeds from the acquisition, either as dividend distributions from the target (if the proceeds are distributed to the shareholders and the target has sufficient E&P), or gain on the disposition of target stock (if the proceeds are retained by the target). The seller's sensitivity to recognizing gain on an asset sale depends on its particular circumstances, including the amount of the gain and the availability of NOL carryforwards or credits that could reduce the tax on the gain. The target typically retains its tax attributes (such as NOLs, disallowed business interest expense, and tax credit carryforwards, and E&P) and its tax liabilities in a taxable asset acquisition.

An inbound investor may prefer an asset purchase to a stock purchase because of the opportunity to increase the basis in the target's assets. In general, when a buyer purchases a target's assets, the buyer obtains a "cost basis" in the assets equal to the purchase price (which can include assumed liabilities and other adjustments). The total purchase price is allocated among the different "classes" of the purchased assets under a detailed set of rules, with residual amounts allocated to goodwill or going concern value. After an acquisition, the buyer depreciates or amortizes its newly acquired assets based on its cost basis; further, some of the cost of certain tangible assets may be immediately expensed on acquisition (although this benefit is phasing out and will expire at the end of 2026). Intangibles such as goodwill generally are amortized over a 15-year straight-line recovery period when they are acquired in an asset acquisition (actual or deemed under a section 338 election). As a practical matter, the buyer's cost basis generally equals fair market value. The increased basis (along with increased deductions) is an important factor that could influence an inbound investor to negotiate an asset acquisition.

Taxable stock acquisitions

A taxable stock acquisition generally results in US federal income tax consequences to the target's shareholders, but not the target itself. The shareholders recognize gain or loss based on their basis in the target's stock. A taxable stock acquisition generally results in capital gain to the target's shareholders, and individual shareholders may benefit from a reduced capital gains tax rate. A seller may prefer to sell the stock of a target, rather than its assets, because the target itself does not recognize gain on a stock sale.

An inbound investor that acquires the stock of a US target will have a cost basis in the stock generally equal to the acquisition price. The target's basis in its assets is the same as before the acquisition, and the target retains its tax attributes (though such attributes may be subject to limitation where there has been a change of control in the target). An inbound investor may find a stock acquisition attractive when the target has desirable tax attributes such as NOL carryovers, although use of preacquisition tax attributes may be limited.

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A foreign person that acquires the stock of a US target that has E&P will be subject to US tax on the distribution of the E&P (even though earned before the person became a shareholder), although the US dividend withholding rate may be reduced under a tax treaty when all applicable requirements (e.g., holding period) are satisfied.

"Section 338" elections

For legal and other nontax reasons, it is often easier to undertake a stock acquisition than an asset acquisition. However, as noted above, an asset acquisition has the benefit of providing the buyer with a "step-up" in asset basis. In the context of certain types of stock acquisitions, i.e., in which the purchaser acquires a controlling block of target stock within a relatively short period of time, it is possible to get the tax benefits of both, via an election under section 338 of the Code.

Corporate purchasers that acquire at least 80 percent of the vote and value of a target corporation's stock from unrelated persons in a single taxable transaction, or in a series of transactions that occur within a 12-month period, may make one of two types of section 338 elections.

Under a section 338(g) election, which is unilaterally made by the purchaser, the target is deemed to sell all of its assets, and its liabilities are deemed to be assumed by "new" target, with "old" target recognizing gain or loss on the deemed sale. The purchaser is treated as having acquired "new" target, which is liable for tax on any gain from the deemed sale of old target's assets (however, the buyer and seller often negotiate as to which party, contractually, will bear the economic cost of this tax). Old target's attributes may offset gain realized on the deemed sale of old target's assets, but New target does not succeed to old target's tax attributes (so benefits such as excess loss or credit carryforwards would disappear). However, new Target would be treated as having a new (often higher) cost basis in its assets. As a result, new target would enjoy higher depreciation or amortization deductions with respect to such assets or, on a sale of assets, could be treated as having less taxable gain. Note, the target's shareholders remain subject to tax on any gain from the sale of their target stock.

Alternatively, if the target is a subsidiary in a US consolidated group that will join the buyer's consolidated group (or a subchapter S corporation), it may be possible for the buyer and seller to make a joint section 338(h) (10) election, to treat the transaction as a deemed asset sale and liquidation of the "old" target for US federal income tax purposes. This election is often advantageous because, while it involves a taxable deemed asset sale, the sellers often recognize limited or no additional gain on the disposition of their shares. Both parties (and, in the case of an S Corporation target, each of its shareholders) must consent to this election.

As discussed in more detail below, the ability of taxpayers to immediately write off the cost of acquisitions of tangible property may increase the incentive for buyers to structure taxable acquisitions as actual or deemed (e.g., pursuant to a 338 election) asset purchases, rather than stock acquisitions.

Tax-"free" acquisitions

When certain conditions are met, an acquisition may be partially or fully tax free to both the target and its shareholders (such an acquisition,

US acquisition by a European energy company

A European energy company was considering a major US acquisition. The acquisition was for cash, requiring parent company borrowing pushed down to the acquired company. The company was concerned about the effect of potential changes in US tax law on the treatment of related-party debt. It was also concerned about the potential— eventually realized— US Treasury regulations affecting related-party debt. The KPMG legislative group, along with KPMG international tax specialists, met with business and tax management of the company to assist in its assessment of current and potential US tax risk, and the structuring of the proposed acquisition to mitigate such risks.

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is a "Reorganization"). Although often referred to as tax free, a Reorganization is more accurately described as tax-deferred, as any built-in gain (or loss) is generally preserved in the basis of the property acquired. Typically, the target corporation in a Reorganization does not recognize any gain or loss on the transfer of its assets to the acquiring corporation, but inherits the target corporation's asset basis. Tax attributes of the target corporation generally are also inherited by the acquiring corporation (although the use of those attributes may be subject to various limitations). The shareholders of the target corporation generally do not recognize gain or loss on the exchange of target for acquiring corporation shares. There are a number of different acquisition transactions that can qualify as a Reorganization, and each type of transaction has its own set of requirements that must be satisfied. Acquisition transactions that can qualify for Reorganization treatment generally include:

- Legal mergers and consolidations, in which the target shareholders receive, in whole or significant part, shares of the acquiring corporation (or its direct parent corporation)
- Stock-for-stock acquisitions in which the acquiring corporation acquires 80 percent or more of the stock of a corporation solely in exchange for the voting stock of the acquiring corporation (or its direct parent)
- Stock-for-asset acquisitions in which the acquiring corporation acquires substantially all the assets of another corporation in exchange solely for voting stock of the acquiring corporation (or its direct parent) or in exchange for such voting stock and a limited amount of money or other property ("boot").

Where boot is received in a Reorganization, US federal income tax generally is imposed on the lesser of the gain realized by the seller or the amount of boot received. This gain limitation rule can provide significant planning opportunities.

Note that, in addition to the general rules that apply to Reorganizations, there are a number of special rules that can apply when non-US persons, such as inbound investors, acquire a US target. For example, certain "anti-inversion" rules potentially can override the generally applicable nonrecognition rules, or otherwise result in adverse US federal income tax consequences. In general, the anti-inversion rules impose certain adverse US federal income tax consequences when a foreign acquirer directly or indirectly acquires substantially all of the property of a US target, and the historical shareholders of the US

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target own more than a certain threshold of the foreign acquirer's stock. When certain conditions are satisfied, the foreign acquirer is treated as a US corporation for US federal income tax purposes. Even when these conditions are not satisfied, a number of rules can apply that result in adverse US federal income tax consequences.

In addition, a separate set of rules applies to transfers of property from the United States, which can impose US federal income tax when a non-US corporation acquires a US target in a Reorganization, or acquires its assets in an otherwise tax-free subsidiary liquidation. These rules generally deny nonrecognition treatment for appreciated assets that are transferred outside the United States (while still deferring loss) except for transfers of stock where certain other requirements are met. Further, additional rules can apply when certain intangible property is transferred, which can result in a deemed license and royalty transaction subject to the US transfer pricing rules.

Mergers

One common acquisition transaction is a merger, which may be treated as an acquisition of assets (where the acquirer survives), or an acquisition of shares (where the target survives). Mergers can be taxable or tax-free transactions. Mergers may be preferable to legal asset or share acquisition transactions because mergers can provide a method acquire all of the shares of a target without the need to negotiate and obtain consent from all minority shareholders of the target.

Another benefit of a merger is that the requirements to qualify as a Reorganization may be easier to satisfy in a merger as opposed to another form of acquisition.

Acquisition vehicles

In general, inbound investors should consider using a US company as an acquisition vehicle to acquire a US target company. First, a non-US acquisition vehicle could be subject to adverse US federal income tax consequences following the acquisition. For example, a non-US company that acquires the assets and liabilities of a US target and then engages in a USTB could be subject to US federal income tax on its ECI (as discussed earlier). Non-US companies that are engaged in a USTB must allocate and apportion expenses (including interest expense) against ECI. Also, a non-US company engaged in a USTB through a branch may be subject to a branch profits tax (BPT) when its effectively connected E&P is repatriated (or deemed repatriated) at a statutory rate of 30 percent (or lower treaty rate). A mechanical formula applies to determine its BPT liability. By contrast, a non-US company operating in the United States through a US subsidiary will not be subject to US withholding tax on the subsidiary's E&P until it is repatriated by the US subsidiary. Thus, the non-US shareholder can control the timing of the US withholding tax imposed on the repatriation of its US subsidiary's E&P.

Second, the use of a US acquisition corporation may facilitate the tax-efficient use of leverage in certain circumstances. For example, a buyer can capitalize a US acquisition corporation with a combination of debt and equity. In this case, future interest expense paid by the

U.S. multinational acquires Canadian multinational

A US multinational (USMNC) with significant foreign operations acquired a Canadian multinational (CMNC) with US and Canadian operations, resulting in a combined company worth approximately $25 billion. After the acquisition, however, both USMNC and CMNC (through its US holding company) had approximately $12 billion of non US assets trapped under the US entities. KPMG was able to develop and execute "out-from-under" planning to move a significant portion of these assets out of the US taxation system in a tax efficient manner. Ultimately, this planning covered approximately 80 percent of the client's foreign asset value that had been trapped under the United States.

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KPMG assists with sell-side due diligence and legal entity rationalization

A South Korean acquirer was planning a stock acquisition of a US-based multinational target group. The US target required sell side due diligence assistance and engaged KPMG, one of its historical service providers, to participate in the due diligence process on its behalf. When the South Korean acquirer subsequently undertook post-acquisition integration, it asked KPMG to assist in harmonizing the two multinational groups, including a legal entity rationalization project that resulted in the elimination of approximately 50 nonessential business entities.

US corporation on the debt may be deductible in computing the US consolidated group's US federal income tax liability. In general, only US corporations are eligible to join in a consolidated group (which is the US version of group-wide tax combination or fiscal unity).

Third, the use of a US acquisition corporation may facilitate the tax-free post-acquisition integration of a target. As mentioned above, the US federal tax laws contain complex provisions that may require gain recognition for what would otherwise be tax-free acquisitions when the acquisition corporation is a non-US entity.

Fourth, the use of a US acquisition corporation may result in the ability to deduct certain acquisition costs on a US tax return. Often non-US acquirers are unable to obtain any US federal tax benefit for costs related to the acquisition of a US target company.

Limitations on target net operating losses and other tax attributes

As discussed further below, US corporations that generate NOLs may carry those losses into other taxable periods, to partially offset taxable income and reduce tax liability in those years. In general, NOLs arising in 2018 and thereafter may be carried forward indefinitely (but not carried back to prior years), and may only be used to offset 80 percent of taxable income for the relevant year.

Additionally, there are special rules that limit the use of a target's NOLs and certain other tax attributes (such as capital loss carryovers, certain net unrealized built-in losses, tax credit carryforwards, and disallowed business interest expense carryovers) when there is a change of control of the target. These rules are aimed at preventing trafficking in favorable tax attributes. After a qualifying "ownership change"—which generally is tested with respect to a rolling, three-year period—the preownership change NOLs and other specific attributes can be used only up to specified limits. At a high level, the loss limitation rules are triggered if, during the testing period, there has been a change in corporate stock ownership or a shift in equity structure that results in one or more shareholders increasing their aggregate percentage ownership of the target, by more than 50 percent (by value).

There also are special rules for corporations that file US consolidated returns. These rules limit the ability of a consolidated group to deduct NOL carryovers or carrybacks (and certain unrealized built-in losses) incurred by a group member in a year when it was not a member of the group (a separate return limitation year, or SRLY).

Acquisitions or reorganizations of bankrupt or insolvent corporations generally are subject to the same rules as corporations that are not bankrupt or insolvent, although certain special rules apply to a corporation in bankruptcy proceeding.

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Post-acquisition planning

Restructuring: "Out from under" planning

As discussed further below, the US federal income tax system includes a series of complicated rules (e.g., foreign tax credit, anti-deferral/"subpart F," the Global Intangible Low-Taxed Income (GILTI), and BEAT), that apply to foreign entities owned by US entities. In addition, although the United States has a fairly robust network of income tax treaties with other jurisdictions, it may be beneficial to explore the use of non-US treaties or other networks. For example, although US tax treaties could mitigate withholding taxes on dividends from foreign subsidiaries to their US shareholders, restructuring may enable the group to access non-US treaties or other regimes (e.g., European Union Directives) that provide more favorable withholding rates.

Consequently, an inbound investor that acquires a US target company should consider moving any non-US subsidiaries "out from under" its newly acquired US target company. Note, the sooner after acquisition a restructuring occurs, the more likely it can be done before additional asset appreciation could trigger or increase restructuring costs. (Along these lines, it can be particularly important to restructure quickly, when non-US subsidiaries hold high-growth assets, such as intellectual property.) The US target may be able to claim foreign tax credits or use other tax attributes (such as NOLs) to minimize the actual cash tax imposed on the gain.

An inbound investor that acquires US corporations that are members of separate US consolidated groups should consider integrating the corporations into a single US consolidated group in order to generate US federal income tax efficiencies. The tax costs for integrating separate consolidated groups can vary greatly, although it may be possible to structure the integration of consolidated groups as a Reorganization.

In addition, although preexisting groups often have extra (e.g., dormant or otherwise unused, or duplicative) entities in their organizational chart, group combinations highlight and exacerbate the "carrying costs" of maintaining an inefficient structure. Investors should consider the benefits of post-acquisition restructuring that eliminates unnecessary entities and related costs.

Spin-offs

An inbound investor also may want to consider a post-acquisition spin-off restructuring transaction. In a spin-off (or split-off), one corporation (the distributing corporation) typically distributes stock of a second corporation (the controlled corporation) to the distributing corporation's existing shareholders, either pro rata or in exchange for some of the distributing corporation's outstanding shares. A spin-off is a complex transaction, and taxpayers can—and often do—request a private ruling from the IRS to confirm certain issues related to a transaction's qualification as a tax-deferred Reorganization.

There are many requirements that need to be satisfied in order for a spin-off to be tax-deferred, including the following:

- The spin-off transaction must not be used as a device for the tax-free distribution of E&P.
- The distributing corporation and the controlled corporation must each be engaged immediately after the spin-off transaction in the active conduct of a trade or business, and meet certain five-year requirements regarding the active conduct of the business before the transaction.
- There must be either a distribution of all the controlled corporation's stock, or a distribution of least 80 percent and the balance retained does not have the principal purpose of US federal income tax avoidance.
- The spin-off must satisfy corporate business purpose requirements.
- The shareholders must have continuity of proprietary interest after the spin-off transaction.

Furthermore, a spin-off that is tax-deferred to the shareholders may still result in corporate-level gain at the distributing corporation on the distribution in certain circumstances. For example, very generally, corporate level gain is recognized when, immediately after the distribution, a shareholder holds a 50 percent or greater interest in the distributing corporation or a distributed subsidiary that is attributable to stock that was acquired by "purchase" within the preceding five-year period.

Corporate-level gain also may be recognized when there is an acquisition of 50 percent or more of either the distributing or controlled corporation pursuant to a plan during a two-year period before and after the spin-off. For this purpose, there are various safe harbor rules under which a spin-off transaction will not be considered part of a plan.

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Part 2

Highlights of the US tax system

Part 1 discussed the three paradigms under which an inbound investor could structure its US business activities. Each paradigm has its benefits and burdens, and the appropriate one for each inbound investor will depend on, among other things, the level of onshore versus offshore control desired and sustainable by each inbound investor; the commercial need for physical presence, decision-making capacity, or a business entity within the United States; and the stage of the enterprise's overall maturity.

Notably, the USTB and US PE standards are applied to onshore activities on a continuous basis. But the organizational structure adopted for opening day may not fit (or may not be followed carefully) after several years of "real" activities.

Many foreign-owned businesses begin their US activities with a very light US presence, and (particularly with tax treaty benefits) can avoid a significant income and withholding tax burden. As their enterprises mature, however, the need to shield the foreign home office from US commercial liability, and the desire to avoid the resource drain of monitoring and controlling US tax risk (along with the increasing IRS pressure on USTB and US PE issues), prompt many inbound investors to adopt a corporate structure. This is particularly the case for inbound investors whose

US business activities generate significant deductions. An inbound investor would not be considered to have a USTB if the investor's US business activities are conducted solely by a US corporation.

Therefore, in this section, we have assumed that the inbound investor will incorporate its US business activities (i.e., will establish a US taxpaying entity), and we walk through highlights of the US corporate tax system. In addition, because the inbound investor should understand the income tax implications of its US employees, this also provides a high-level introduction of the US individual income tax rules.

Taxation of corporations

A corporation (and an eligible entity that elects to be classified as a corporation for US federal income tax purposes) is a taxable entity that is taxed on its net profits at the corporate level. Distributions of the corporation's E&P (very generally, its after-tax income) to the shareholders are taxed as dividends.

A domestic corporation, for US tax purposes, is one created or organized under the laws of the United States, any US state, or the District of Columbia. The situs of a corporation's management and control does not determine its residency for US tax purposes. Subject to a few narrow exceptions, a dually incorporated corporation, or a corporation that is formed in the United States but also is treated as a tax resident by another country (e.g., because the US corporation is managed and controlled in the United Kingdom or the Netherlands) generally is treated as a US corporation for US federal income tax purposes.

(Such a corporation would need to check the "tie-breaker" rules under any applicable tax treaty between the United States and the other jurisdiction to confirm residence treatment between those two countries.)

US corporations are subject to current US corporate tax on their worldwide income. This means that any income—regardless of whether sourced in the United States or elsewhere—earned by a US corporation is subject to US federal income tax and must be reported on the US corporation's federal income tax return (the IRS Form 1120).

In addition, income a US corporation generated through the activities of a foreign subsidiary corporation, is subject to US tax either under a quasi-territorial system, featuring a participation exemption regime with current taxation of certain foreign subsidiary income, including a minimum tax on most foreign subsidiary earnings, and new measures to combat erosion of the US tax base.

In addition, the United States employs a "classical tax system." In addition to the corporation being subject to tax on its earnings, noncorporate (and some corporate) shareholders of the corporation are subject to tax if and to the extent such earnings are distributed as dividends. As discussed above, such dividends to foreign shareholders generally are subject to 30 percent withholding tax, although withholding may be reduced or even eliminated entirely under the auspices of an applicable income tax treaty.

Note that in 2022 a new corporate alternative minimum tax regime (the CAMT) was enacted that is based on an adjusted measure of financial statement income. The CAMT is a minimum tax based on financial statement income that applies to "applicable corporations" for tax years beginning after December 31, 2022. In general, an "applicable corporation" is one that has an average annual "adjusted financial statement income" (AFSI) of $1 billion over a three-year period. The determination of whether a taxpayer is an "applicable corporation" and thus subject to the CAMT and, if an applicable corporation, the determination of the taxpayer's CAMT liability are both based on the taxpayer's AFSI, although the calculation

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of AFSI differs for purposes of determining whether a corporation is an application corporation versus determining whether a corporation owes a CAMT liability. Overall, the CAMT is a very complex and novel new tax regime, and as of the date of this publication many of the operative rules of the CAMT await needed regulatory guidance from Treasury.

In addition, a new nondeductible one percent excise tax (the buyback tax) on certain corporate stock repurchases was also enacted in 2022. The buyback tax generally applies to publicly traded US corporations, and is imposed on the value of the stock repurchased by the US corporation (and certain affiliates) minus the value of the stock issued by that corporation during a taxable year. Under the statute, purchases of stock of a publicly traded foreign corporation by a US subsidiary of that foreign corporation are also subject to the excise tax at the US subsidiary level. In initial guidance (Notice 2023-2), Treasury indicated an intent to issue regulations that would apply the buyback tax to repurchases by a publicly traded foreign corporation of its own stock to the extent the repurchases were "funded" by a US subsidiary. The term "fund" could be interpreted very broadly, and the effect of this "funding rule" would be to dramatically expand the application of the buyback tax to foreign-parented groups. While many comments critical of the "funding rule" have been submitted, as of the date of publication is it not clear whether the rule will be included in regulations (and if so, what modifications may be made).

Corporate tax rates

As indicated above, beginning January 1, 2018, taxable income (gross income less deductions) of a corporation is taxed at a flat 21 percent rate. Corporate capital gains generally are taxed at the same rates as ordinary income. The above rates are applied to taxable income in determining the gross amount of tax. The tax may be reduced by allowable credits, such as the foreign tax credit.

Corporate taxable income

Taxable income is calculated as gross income less allowable deductions.

Gross income for US tax purposes is broadly defined as income from any source and includes gross income derived from business; gains derived from dealings in property; passive income, such as interest, rents, royalties, dividends; and compensation for services, including fees, commissions, and similar items. Gross income is calculated as gross receipts minus cost of goods sold. In addition, certain items of income (e.g., certain interest on state and local bonds) may be excluded from gross income.

Gross income can be determined under several accounting methods, including the accrual method (which generally is required for corporations). Other methods are available for special situations or special taxpayers. The method of accounting used for tax purposes may differ from that used for financial reporting purposes. However, an accrual basis taxpayer generally may not defer the recognition of revenue beyond the year in which it is recognized for financial reporting purposes except for an elective one-year deferral of certain advance payments).

Most businesses in which the production, purchase, or sale of merchandise is an income-producing factor must maintain inventories. In computing cost of sales, inventories generally must be valued at historical cost, unless the lower of cost or market method has been adopted, or the inventory is subnormal. Several inventory cost identification methods are available, including the first-in, first-out method, the last-in, first-out (LIFO) method, and the average cost method. However, if the LIFO method is used, the inventory must be valued at cost, and all annual financial statements to creditors and shareholders must be prepared using the LIFO method. International accounting standards do not permit the use of LIFO for financial statements.

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Once gross income is determined, allowable deductions are subtracted from gross income to determine taxable income. Generally, corporations may deduct all "ordinary and necessary" business expenses paid or accrued during the year in carrying on a trade or business. Payments that provide a benefit beyond the tax year generally need to be capitalized, thus the deduction for the expense is deferred.

Determining allowable deductions can be complex because of the many permissible deductions, special limitations that may apply, specific requirements to capitalize expenditures rather than deduct them currently (or vice versa), and, in some cases, lack of clarity in interpretations of the law.

Common examples of expenditures that qualify as deductions from gross income include the following:

- **Interest.** Subject to important limitations discussed above, a taxpayer may deduct interest on indebtedness.
- **Depreciation.** A taxpayer is allowed to recover a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in its business. Such an allowance serves as a means of recovering the cost of a taxpayer's capital outlays for tangible property. The Modified Accelerated Cost Recovery System (MACRS) generally provides for the recovery of the depreciation allowance over the life of the property to be accelerated relative to the straight-line approach common for financial reporting purposes. In addition, certain business assets acquired and placed into service after September 27, 2018, and before 2023 may be immediately expensed. This expensing regime broadens the applicability of bonus depreciation relative to previous legislation, allowing taxpayers to immediately expense both new and used property that it places into service. The 100 percent immediate expense depreciation rule applies through 2022 and then ratably phases down over the succeeding five years. However, assets placed into service outside the US are not eligible for use of MACRS or immediate expensing and instead are generally depreciated using a straight-line approach.
- **Other business expenses.** Examples of other business expenses include compensation, employee benefits, taxes (note, foreign taxes may either be deducted or credited, based on taxpayer election), R&D, repairs and maintenance, bad debts, travel and meals expenses, rent, leasehold, royalties, and franchise fees. Many of these deductions are subject to complex limitations.

Although some exceptions apply in narrow circumstances, US corporations generally may not deduct dividends that are paid. Nondeductible expenses also include "excessive" executive compensation, entertainment expenses, excessive termination payments made in connection with corporate takeovers (golden parachutes), and expenses and interest related to the production of certain property (these items are capitalized into the property's basis).

Foreign-derived intangible income.

At a very high level, the foreign-derived intangible income (FDII) regime is designed to incentivize US corporations (including those that are members of a foreign-parented multinational group) to use the United States as an export hub. Notably, FDII benefits are not available to non-US or noncorporate entities. Certain corporations eligible for special US taxing regimes, e.g., domestic corporations that are REITS, are precluded from taking advantage of FDII benefits.

In effect, the FDII rules provide a 13.125 percent effective tax rate on certain export income earned directly by a US corporation. The rate increases to 16.406 percent starting in 2026. Like (and, in fact, in conjunction with) the GILTI rules, the reduced tax rate on FDII income is subject to limitation if the taxpayer has losses.

Qualifying income may arise from export sales, leases, and licenses of property, or from services transactions, but different eligibility requirements apply with respect to property transactions as opposed to services transaction. For property transactions—sales, leases and licenses (let's refer to them collectively as "sales")—two separate requirements must be satisfied for income to qualify for FDII benefits: (i) sales must be to an unrelated foreign person (although it is possible to accomplish this through sales through related foreign intermediaries), and (ii) the transferred property must be for the ultimate customer's foreign use, consumption, or disposition. Notably, the FDII rules do not contain US content requirements; the benefits are generated by the mere act of exporting property from the United States.

FDII also is available for services provided any person, or with respect to any property, not located in the United States. Note that the "sourcing" rules discussed above have no bearing here; where the service provider's act is not at issue. In addition, the services may be provided to a related foreign person, so long as that person does not provide "substantially similar services" to persons located in the United States.

Corporate relief from losses

An NOL is defined as the excess of the deductions permitted for a tax year over the gross income of the taxpayer for that year.

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Although there are exceptions, in general (1) an NOL arising in a tax year beginning before January 1, 2018, can be used to fully offset taxable income in a subsequent year, and (2) and carried forward 20 years. An NOL arising in a tax year beginning after December 31, 2017, generally can be carried forward indefinitely but cannot offset more than 80 percent of taxable income.

Limits are imposed on the NOLs generated by dual-resident corporations. In addition, as described above, certain limitations may apply to NOLs and other tax attributes on an "ownership change" or other events.

Corporations' capital losses may be deducted only against capital gains. Unused corporate capital losses generally may be carried back three years and forward five years and used to offset capital gains in such years.

Corporate tax credits

Domestic corporations are allowed certain credits, within limits, against their US taxes. These credits, unlike deductions, reduce the US tax dollar for dollar. The rules for computing the credits are complex. Credits include:

- **Foreign tax credit.** Discussed in further detail below.
- **Research and experimentation credit.** The R&E credit is a permanent credit allowed for increased expenditure (relative to expenditure over the taxpayer's recent tax years) on R&E related to business products and processes. Note that the Code requires R&E expenditures to be capitalized and amortized over a five-year period (or a 15-year period for expenditures attributable to foreign research). The Code further precludes the complete double counting of benefits with respect to the same expenditures. To the extent that a R&E credit is claimed for a given year, the amount of R&E expenditures required to be capitalized in that year is generally reduced by the excess of the credit amount for that year over the amount allowable as a deduction in that tax year for those R&E expenditures.
- **Work opportunity credit.** A work opportunity credit is allowable for certain wages paid to newly hired members of certain disadvantaged groups that have special employment needs.
- **Other credits.** There are a variety of credits tailored to encourage investment in certain activities or types of property, with a wide range of requirements and limitations.

Affiliated groups of companies

Certain affiliated groups of US corporations may join in the filing of a consolidated tax return for all members of the group—instead of filing separate income tax returns for each member—provided stock ownership requirements are met and a proper election is timely made. Filing one return for all members of the group is largely a tax

KPMG assists moving and relocation company with cross-border transactions

A Brazilian moving and relocation company that was considering expanding its activities into the US market sought assistance with managing a high Brazilian tax burden. KPMG was able to help enhance the company's intragroup cross-border transactions (management fees and other logistic charges) by helping it to transfer the paying agent's activities from Brazil into the United States. KPMG analysis took into consideration the US transfer pricing impact of having the US subsidiary act as paying agent for all affiliated companies and third-party providers. The project also considered the necessary investments in US operations to establish appropriate substance as well as benchmarking of intercompany transactions and drafting of new intercompany and third-party agreements.

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computation mechanism and does not convert the group into a single corporation; however, complex regulations apply to provide rules for intercompany transactions, and for dispositions of stock in member corporations. Each member of the group is severally liable for the total tax liability of the entire group.

Generally, only US corporations are permitted to be included in an affiliated group; therefore, an inbound investor must have at least two US corporations (with one US corporation owning the other or, in the case of three or more corporations, as a common owner). Other non- permitted group members include tax-exempt organizations, possessions corporations, regulated investment companies, real estate investment trusts, and corporations that departed from the same group less than 60 months before. Life insurance companies are subject to limitations on their ability to file a consolidated return with other types of companies.

Stock ownership requirement

The stock ownership requirements for a group of corporations to file a tax return on a consolidated basis are generally as follows:

1. The parent corporation of the group must directly own 80 percent or more of the stock (by vote and value) of at least one subsidiary in the group.
2. Each other subsidiary in the group must be, in the aggregate, at least 80 percent directly owned (by vote and value of stock) by the parent and/or other subsidiaries in the group.

For this purpose, certain preferred stock (very generally, nonvoting, nonconvertible preferred stock with more debt-like terms) is not treated as "stock."

Treatment of group losses

Losses incurred by members of a group during the period of consolidation can be used to offset profits of other members of the group, in determining the group's ultimate US federal income tax liability. However, losses incurred by a corporation prior to joining the group (referred to as SRLY losses) may not be used to offset profits of other group members. Limitations on the use of losses may also exist to the extent the loss represents a built-in loss that existed before the member joined the group.

"Dual consolidated losses" are subject to special rules. These rules limit the deduction for losses incurred by (1) a domestic corporation that is a member of a US consolidated group, where that corporation is also subject to tax on a residence basis in a foreign country; and (2) a domestic corporation with a foreign branch or an ownership interest in a foreign hybrid entity (i.e., hybrid entity separate unit). The rules effectively prevent "double-dipping" the same NOL deductions in two jurisdictions.

The US has an extensive network of tax treaties providing mechanisms for resolving transfer pricing disputes between jurisdictions so as to avoid double taxation. Specifically, these treaties contain mutual agreement procedure articles, which generally enable the competent authorities of each jurisdiction to interact with each other to resolve treaty disputes. In addition, the IRS has an advance pricing agreement (APA) program under which the IRS and taxpayers agree on pricing for controlled-party transactions. APAs can be either between the IRS and specific taxpayers (unilateral), or also involve countries that have income tax treaties with the United States (bilateral or multilateral). According to the US Treasury's most recent annual APA report, 77 APAs were executed during 2022, of which 10 were unilateral, 66 were bilateral, and 1 was multilateral.

While similar in concept, the nuances of the US customs requirements differ from the IRS transfer pricing rules. The customs rules also may diverge from tax laws for the purpose of determining whether the buyer and seller of imported goods are related in the first instance. The customs definition of a "related party" arguably provides a lower threshold from the OECD definition of "associated enterprises," potentially deeming parties that would be considered to be unrelated for tax purposes to be related for customs purposes. Thus, coordination between the US tax and trade systems is essential for inbound enterprises.

Taxation of corporate combinations

Tax-deferred treatment generally is afforded to certain qualifying incorporation, liquidation, and reorganization transactions (including Reorganizations, as described above). In these transactions, a transferor's gain or loss in transferred assets or stock may be deferred in whole or in part until the time that the stock or assets received in the transaction are disposed of.

These transactions include:

- Transfers of property to corporations by persons that control (meaning the transferors own stock representing at least 80 percent of total voting power and at least 80 percent of each nonvoting class of stock) the transferee corporation, in exchange for stock of the transferee corporation
- Complete liquidations of subsidiaries that are at are at least 80 percent owned by the corporate parent

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- Reorganizations (as described above)
- Corporate recapitalizations, including changes in the capital structure of the corporation
- Certain transactions constituting a mere change in identity, form, or place of organization of one corporation

Corporate transactions that are cross-border, such as incorporations, liquidations, and reorganizations that are US outbound, US inbound, or foreign to foreign, are subject to a number of additional rules to, among other things, prevent untaxed gains and earnings from leaving US tax jurisdiction permanently or prevent the importation of a net built-in loss in assets.

Tax deferral also is provided for certain "like-kind" exchanges of real property. A taxable gain also can be deferred when property is compulsorily or involuntarily converted (such as by eminent domain) into property which is similar or related in service or use. In these transactions, the recognition of gain is deferred until the disposal of the replacement property.

Taxation of US-owned foreign corporations

Although inbound investors rarely choose to establish US corporate entities and then have those US corporate entities in turn establish foreign entities, this organizational structure could arise (e.g., in the acquisition context, where the target is a US-based multinational). In those circumstances, it is important for inbound investors to understand the US federal income tax implications of having a "sandwich" (i.e., foreign-US-foreign) structure.

Income earned by foreign subsidiaries generally is not subject to US taxation until the income is distributed to the US shareholder as a dividend. The United States, however, employs a series of "anti-deferral" rules, which cause certain foreign subsidiary earnings to be recognized as current income of a US corporation even though not actually distributed. These rules, discussed below, force a US corporation to include in its gross income its current inclusion of a foreign corporation's GILTI, albeit at a reduced US tax rate.

At the same time, earnings that maintain eligibility for deferral at the foreign subsidiary level, are exempt from a US shareholder's income when in fact repatriated. This participation exemption regime generally allows a US corporation that owns at least 10 percent (by vote or value) of a foreign corporation that is not a PFIC, a 100 percent dividends-received deduction (100 percent DRD) for the foreign-source portion of dividends received from the foreign corporation. The 100 percent DRD is available only to domestic C corporations that are neither Real Estate Investment Trusts nor Regulated Investment Companies. A corporate US shareholder may not claim a foreign tax credit or deduction, for foreign taxes paid or accrued with respect to any dividend allowed a 100 percent DRD.

Per the antihybrid rules discussed above, a 100 percent DRD is not available for any hybrid dividend payment (e.g., that is treated as interest by the payer but as a dividend by the recipient). Even though the 100 percent DRD is disallowed, a corporate US shareholder may not claim a foreign tax credit or deduction, for foreign taxes paid or accrued with respect to any hybrid dividend. Additionally, under temporary regulations, a 100 percent DRD may also be partially or fully disallowed with respect to E&P arising from certain dispositions and dividends paid in connection with a disposition of the stock of certain foreign corporations.

Current taxation of foreign earnings

The "subpart F" rules. As noted above, a US shareholder is generally not subject to US tax on a foreign corporation's retained earnings, unless the earnings are subject to one of several anti-deferral rules. These rules, which are in subpart F of the Code (and are the basis for the nickname "subpart F income" for income to which they apply), apply to income earned by CFCs. CFCs are foreign corporations that are majority-owned by "US shareholders," who are US persons that themselves own at least 10 percent (by vote or value) of the foreign corporation. As discussed in part 1, broadly applicable constructive ownership rules apply for these determinations.

Under the subpart F rules, a US shareholder can be subject to tax when a CFC earns certain income, even though the CFC does not make any distributions. This results in the US shareholder having "phantom income"—income for US tax purposes, without the corresponding cash to pay the tax on the income. Further, unlike a pass-through regime, the shareholder is not treated as earning the CFC's income directly. Rather, an amount calculated under the subpart F rules (subpart F inclusion) is included in the shareholder's income as ordinary income (and subject to tax at ordinary rates). Subject to certain limitations, the US shareholder may be eligible for a foreign tax credit with respect to the subpart F inclusion.

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The current income inclusion under the subpart F regime occurs only when the CFC earns certain types of income, referred to as "subpart F income." There are many categories of subpart F income. One category includes items that are commonly considered "passive," such as dividends, interest, royalties, rents, and annuities. (Note, an alternative set of anti-deferral provisions—the PFIC rules—can apply if a US shareholder owns an interest in a foreign corporation that does not qualify as a CFC but that earns this type of passive income.) Under another category, subpart F income includes income from transactions involving the purchase or sale of property to a related person, or the provision of services to a related person. The related-party sale rules can even pick up transactions involving entities that otherwise are disregarded from the CFC for US tax purposes. There are a number of exceptions that can apply to the related-party transaction rules, including exceptions for property manufactured by a CFC, property sold in the CFC's country, and services performed in the CFC's country.

Separately, certain exceptions apply in calculating the subpart F inclusion, including an exception that generally applies when a class of a CFC's income is subject to tax at a rate of at least 18.9 percent in the country in which it operates. Under this rule, the adverse subpart F consequences are minimized when a CFC operates outside the United States in a high-tax jurisdiction relative to the US corporate tax rate.

In general, active income earned by a CFC from unrelated persons does not result in current subpart F income inclusions. Nonetheless, there is separate set of subpart F rules that can result in the US shareholder being subject to tax on those earnings. These rules apply when the CFC owns "US property," which generally includes tangible property located in the United States, certain intangible property acquired or developed for use in the United States, related-party stock, and related-party loans and guarantees.

There are a number of exceptions to these rules, including exceptions for certain normal commercial transactions. In addition, the impact of these rules has been limited significantly, with the issuance of US Treasury regulations that reduce the amount of the earnings subject to US tax to only those that would be eligible for the 100 percent DRD if actually distributed by the foreign corporation to the US shareholder.

The "GILTI" rules. Tax reform added an additional layer of anti-deferral rules, known as the GILTI rules. The GILTI rules operate similarly to the subpart F regime and subject 10 percent US corporate shareholders (by vote or value) to current US tax on certain CFC income, albeit at a reduced tax rate. Certain income is already subject to current US taxation or otherwise eligible for special taxing rules, and excluded from GILTI: ECI, subpart F income, income excluded from subpart F under the "high-tax exception," foreign oil and gas extraction income, certain financial services income, and related-party dividends. Furthermore, remaining income—that would otherwise be subject to GILTI inclusion—is eligible for another reduction, equal to a deemed, routine (10 percent) return on the CFC's tangible depreciable asset basis, to the extent such assets give rise to GILTI income. The exempt return on the CFC's tangible asset basis is eligible for the 100 percent DRD, and thus, is fully exempt from US tax.

As noted above, GILTI inclusions are subject to US tax at a reduced tax rate. The effective tax rate on GILTI is 10.5 percent through 2025, then increases to 13.125 percent thereafter. This benefit may be limited if the US shareholder otherwise has losses. A US shareholder may be eligible to claim a foreign tax credit with respect to a GILTI inclusion, subject to a 20 percent haircut.

A US shareholder increases its basis in its CFC stock by the amounts that it includes in income under the subpart F rules or GILTI rules. In order to avoid double taxation, the US shareholder is not subject to tax when these previously taxed earnings are distributed by the foreign corporation, although its basis in the CFC stock is reduced by the amount of the distribution. The US shareholder also may be subject to special rules upon a sale of CFC stock, which can treat all or part of any gain on the sale as a dividend.

Foreign tax credits

As noted above, most income earned by a US corporation is subject to federal income taxation regardless of where earned. Foreign-earned (foreign-source) income is therefore vulnerable to taxation in multiple jurisdictions.

The foreign tax credit essentially is a mechanism for US corporations to reduce or eliminate international double taxation of the same income. (The US foreign tax credit rules serve the same conceptual purpose as participation exemption regimes do in other countries.)

The foreign tax credit generally is allowable for foreign taxes paid on foreign-source income subject to US tax. A US person that claims the "direct" credit (i.e., credit for taxes paid directly by that person) must bear the economic cost of the underlying tax (by paying or accruing the tax) and be legally obligated to do so. A foreign tax is creditable only if it is imposed on income, such as an income tax or a tax imposed on gross receipts or sales. Further, the tax must be paid to a foreign country, which includes political subdivisions like cities and provinces. Regulations issued

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in early 2021 substantially modified the existing standard for determining creditability of a foreign tax, and now require that foreign tax rules correspond quite closely to US tax rules, especially with respect to cost recovery (allowable deductions). These regulations also introduced an "attribution requirement" under which taxes imposed by a foreign country are creditable in the United States only in situations in which the country imposing the tax has sufficient nexus with the activities of the taxpayer. Taxpayers should carefully examine the underlying local tax regime that imposes the foreign tax to ensure that it qualifies for a US foreign tax credit.

In addition to a credit for foreign taxes directly imposed on the US taxpayer, US corporate shareholders are eligible for a deemed paid credit for foreign taxes paid or accrued on any current inclusions under the subpart F rules.

Additionally, US shareholders of CFCs are eligible for a deemed paid foreign tax credit on GILTI inclusions, subject to a 20 percent haircut.

The credit is nonrefundable, i.e., there is a limitation imposed on the amount of foreign tax credits that can be claimed in order to prevent taxpayers from using the credits to offset income earned in the United States (US-source) that is unrelated to the foreign tax. At a high level, the credit is limited to the US federal income tax liability on the related income. The limitation does not apply to stand-alone items of income.

Instead, a taxpayer's foreign tax credit limitation is determined separately for the taxpayer's separate foreign tax credit "baskets." There currently are four baskets: (i) passive category income, (ii) general category income, (iii) foreign branch income, and (iv) GILTI. Foreign taxes paid with respect to income in one basket may not be credited against income in another basket.

Excess foreign tax credits may be carried over to other taxable years. Currently, the rules permit carryovers to the first prior, and 10 succeeding, taxable years.

Alternatively, taxpayers can choose to deduct the foreign taxes rather than take a foreign tax credit. All foreign taxes must be treated the same way for a particular year. Although a taxpayer can choose between claiming a credit or taking a deduction each year, it cannot do both in the same year.

Interaction of US corporate tax system and Pillar 2

Notwithstanding the adoption of the Corporate AMT, the US tax system has not implemented Pillar 2 rules (nor, as of the date of this report, does it appear that the US will enact Global Anti-Base Erosion (GloBe) rules in the near or intermediate future).

The subpart F and GILTI regimes do not qualify as an Income Inclusion Rule (IIR), but the OECD Inclusive Framework has confirmed that subpart F and GILTI, in its current form, meets the definition of a CFC tax regime under the GloBE rules. Although taxes paid under CFC tax regimes may be taken into account when determining if any (or how much) Top-Up Tax may be imposed under a Pillar 2 IIR or UTPR, the Inclusive Framework also confirmed that the numerator in a QDMTT ETR calculation should not include taxes paid to another jurisdiction under a CFC tax regime. Notably, a special allocation methodology for GILTI taxes has been promulgated by the Inclusive Framework, but no allocation mechanism currently exists for CAMT taxes paid that are attributable to non-US earnings. Effectively, the Pillar 2 rule order is set forth as follows: (1) QDMTT, (2) GILTI/subpart F, (3) IIR, and (4) UTPR.

In light of the new rule order, we anticipate that the United States will provide foreign tax credits (FTCs) for taxes paid under QDMTTs, although FTCs for taxes paid under an IIR or UTPR seem unlikely. Such credits for taxes paid under a QDMTT may not provide a tax benefit, however, because in practice many multinationals are excess credit in the GILTI basket.

Due to Pillar 2's unfavorable treatment generally provided to FTCs and nonrefundable general business credits (e.g., R&D credits), it is possible for the profits of certain domestic corporations or groups to be considered "low-taxed" for purposes of the Pillar 2 ETR calculation, and thus exposed to the IIR (if an inbound taxpayer) or a UTPR (if a domestic-parented multinational).

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Transfer pricing

Transfer pricing refers to the pricing of goods, services, and intangible assets that are transferred between related parties, which are parties that have a direct or indirect ownership or control relationship, such as different divisions of a multinational corporation located in different countries.

Like most other jurisdictions, the United States has "transfer pricing" rules that are designed to ensure that transactions effected between commonly controlled persons (e.g., corporations, partnerships, and their various owners) reflect arm's-length pricing. The rules address the concern that enterprises under common control could enter into transactions on nonmarket terms, consequently distorting the taxable income and deductions recognized by the parties in the different jurisdictions in which they operate. For example, if Parent Corp. wholly owned Sub 1 (a resident of a high-tax jurisdiction) and Sub 2, tax authorities are concerned that Sub 1 could undercharge Sub 2 on intercompany transactions, so that Sub 1 would earn less taxable income than appropriate.

The US transfer pricing rules authorize the IRS to make adjustments to the income, deductions, or other tax items reported by commonly controlled taxpayers in order to reflect the appropriate amount of their respective income and deductions.

The transfer pricing rules apply in a wide range of transactions between related parties, including: (i) transfer of tangible goods, which includes the transfer of physical items such as raw materials, finished products and inventory, (ii) provision of services such as marketing, R&D, management and administrative services, (iii) transfer of intangible property, which includes transfer of intellectual property such as patents, trademarks, copyrights, trade secrets etc., (iv) financial transactions such as provision of loans, guarantees and other financial assistance, (v) cost sharing arrangements, which includes the sharing of costs and risks associated with the development of intangible property.

The US transfer pricing rules and the transfer pricing guidelines issued by the OECD Guidelines that most countries around the world follow are largely consistent but with some differences, such as a safe harbor rule in the US regulations for interest payments that relies on the US applicable federal rate.

Recent changes to the OECD Transfer Pricing Guidelines, as part of the OECD BEPS project, have increased the alignment of OECD guidelines with the US rules in some areas, such as valuation of intangibles, while certain differences of emphasis (e.g., relative importance of contractual terms and location of decision-making functions) remain.

The US transfer pricing rules provide a number of "specified methods" for determining whether a particular transaction satisfies the arm's length standard, but allow other unspecified methods to be used under the overarching principle that the best, i.e., most reliable, method should be used based on the specific facts and circumstances. Under certain transfer pricing methodologies, the determination of an arm's length price is made by direct reference to comparable transactions under comparable circumstances, while other methodologies perform the analysis indirectly by comparing the profit outcome of one of the controlled parties to the profits of comparable companies. Thus, in order to price a controlled-party transaction, a transfer pricing methodology must be chosen, and comparable uncontrolled transactions or companies must be selected.

If the IRS disagrees with a group's transfer pricing, it may propose penalties in addition to an adjustment in US federal income tax liability. For example, the IRS can impose a 20 percent penalty when there are certain misstatements on a return, and a 40 percent penalty in the case of certain gross valuation misstatements. These penalties can arise when the adjustment to the price charged on an individual transaction exceeds certain thresholds, or when the total amount of all transfer pricing adjustments in a taxable year exceeds certain dollar amounts. Taxpayers can protect themselves against penalties by preparing contemporaneous documentation, meeting specified standards, supporting the appropriateness of their transfer pricing and consistency with the arm's-length standard. For these purposes, documentation generally is "contemporaneous" when it is in existence at or before the time the taxpayer files its tax return for the year covered by the documentation, and the documentation is provided to the IRS within 30 days of a request for its production.

Transfer pricing documentation must include ten principal documents to meet the penalty protection standard, as well as satisfying certain other requirements. The principal documents include, among others:

1. An overview of the taxpayer's business and a description of the taxpayer's organizational structure
2. A description of the method selected and an explanation of why that method was selected

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3. A description of alternative methods that were considered and an explanation of why they weren't selected
4. A description of controlled transactions and internal data used to analyze those transactions; a description of the comparables that were used, how comparability was evaluated and what (if any) adjustments were made
5. An explanation of the economic analysis and projections relied upon in developing the method.

OECD's BEPS Action 13 is one of the 15 actions that make up the OECD/G20 BEPS project. The aim of the Action 13 is to address transfer pricing documentation and Country-by-Country Reporting (CbCR) to enhance transparency for tax administrations to ensure that profits are taxed where economic activities occur, and value is created.

The United States has adopted BEPS Action 13 through the implementation of CbCR requirements. CbCR requires multinational enterprises to provide the IRS with a detailed breakdown of their global operations, including revenue, profits, employees, and taxes paid in each jurisdiction where they operate. US-based multinational enterprises with annual revenue of $850 million or more are required to file CbCR reports with the IRS.

Common related-party transactions that are evaluated under the transfer pricing rules include tangible good sales, licenses and other transfers of intangibles, financing, and service transactions. Specific rules and pricing methods, including safe harbor pricing mechanisms, apply to different types of related-party transactions. For example, in the case of a transfer or license of intangible property, the income from the transfer must be "commensurate with the income attributable to the intangible." The US rules permit the IRS, under certain circumstances, to use hindsight in evaluating whether the terms of an intangible transfer were arm's length, and to adjust the price via ongoing royalties. In addition, the US transfer pricing regulations include a special regime for "cost sharing arrangements," in which parties agree to contribute rights, resources and capabilities to a joint development effort, share the ongoing R&D costs, and split the rights to exploit any successfully developed intangibles.

Concerning related-party import transactions, it is important to note that these transactions are subject to additional customs arm's-length requirements, different than the transfer pricing laws that may be applicable from an IRS perspective. The arm's-length customs laws are discussed in further detail below.

Taxation of individuals

Taxation of US residents or citizens

The taxable income of a US resident is computed by the following:

1. Determining gross income
2. Subtracting certain "above-the-line" deductions to arrive at adjusted gross income
3. Subtracting either the "standard" deduction or the total of "itemized" deductions

Each is discussed in greater detail in this section.

Graduated tax rates are applied to the taxpayer's taxable income depending on the taxpayer's filing status. The amount of regular tax owed may be offset by available credits, including foreign tax credits. A separate tax computation is required to determine the AMT on the alternative minimum tax base. The tax liability is the larger of the regular tax liability or the AMT.

The gross income of citizens and resident aliens generally includes income from all sources, including but not limited to wages, salaries, interest, dividends, business profits, rents, royalties, income from partnerships, annuities, premiums, and gains from the sale of real and personal property. Specified items are excluded from gross income, including gifts, inheritances, proceeds from certain life insurance policies, and qualifying state or municipal bond interest. US citizens and residents living abroad may also be eligible to exclude from US taxable income certain foreign-earned income and foreign housing costs.

Certain deductions, known as "above-the-line" deductions, are allowed in computing adjusted gross income. These include certain medical and health savings account contributions and some retirement savings contributions.

Other deductions, either itemized deductions or the standard deduction, are allowed in computing taxable income. Subject to various limitations, itemized deductions include home mortgage interest, state and local income or sales taxes, real estate and personal property taxes, charitable contributions, disaster losses, unreimbursed medical and dental expenses, and foreign taxes not claimed as a credit. Individual taxpayers who do not itemize their deductions are entitled to a standard deduction. The standard deduction amount varies according to a taxpayer's filing status and is indexed for inflation

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After all allowable deductions are subtracted from gross income to determine taxable income, the appropriate tax rate, ranging from 10 percent to 37 percent, is applied to compute the tax liability. The appropriate tax rate schedule depends on the taxpayer's filing status: married couples filing joint returns, heads of households, single persons, and married individuals filing separate returns. Certain credits are allowed against the tax due, including the foreign tax credit, which is calculated subject to applicable limitations.

Foreign tax credits in excess of applicable limitations may be carried back 1 year and forward 10 years. Other credits may also be available, including the child-and dependent-care credit, the child tax credit, and certain education credits. Income tax withheld from wages, interest, and dividends and any estimated tax payments are applied against the tax due.

The AMT is imposed on individuals at a rate of either 26 or 28 percent of alternative minimum taxable income in excess of an exemption amount determined by filing status. The exemption amount is phased out for individuals with incomes above certain thresholds. The alternative minimum taxable income is the taxpayer's regular taxable income increased by certain "preference" amounts and disallowing certain deductions and credits. In general, the AMT applies a lower tax rate to a broader tax base than the regular tax.

Individuals may also be subject to the net investment income tax (NIIT) in addition to regular income taxes. The NIIT is a 3.8 percent surtax paid on net investment income such at capital gains, dividends, and rental and other income after allowable deductions. The NIIT applies only applies to higher-income individuals whose income exceeds certain thresholds.

Many states also impose income tax on individuals. The tax base generally is based on federal taxable income with certain modifications.

Residents generally are subject to tax on income from all sources but may receive a credit for taxes paid to other jurisdictions. Nonresidents of a state generally are subject to tax on income earned from in-state activity or from sources within the state. A few states allow a credit for nonresidents on taxes paid to the resident state.

Taxation of non-US individuals

A foreign citizen who is a US resident for US tax purposes is taxed by the United States in the same manner as a US citizen, meaning worldwide income is subject to US income tax. When computing taxable income, a US resident is entitled to claim the same deductions and personal exemptions available to a US citizen.

A foreign citizen who is a nonresident for US tax purposes is taxed only on (1) FDAP income from US sources, and (2) income effectively connected (or treated as effectively connected) with a USTB. Deductions and exemptions available to nonresidents are limited.

The general concepts of FDAP income, USTB, ECI, and the source of income rules that apply to inbound investors generally (discussed above) are fully applicable to nonresident individuals. Furthermore, in the case of individuals, income from personal services performed in the United States as an employee or independent contractor is treated as income effectively connected with a USTB.

In addition to US federal income tax, individuals may also be subject to state and local income taxes.

Qualification as a US resident alien versus nonresident alien

A foreign citizen generally is treated as a nonresident for US tax purposes unless the individual qualifies as a resident. A resident is defined as an individual who is either a lawful permanent resident, or an individual who meets the substantial presence test.

A lawful permanent resident is an individual who has been granted the right to reside permanently in the United States. This permit often is called a "green card." An individual who meets the substantial presence test is a person who has been in the United States for at least 31 days in the current calendar year and 183 days during the current and two preceding years, counting all the days of physical presence in the current year, one-third of the days in the first preceding year, and one-sixth of the days in the second preceding year.

An individual may be both a nonresident and a resident during the same tax year. This may occur in the year a foreign citizen arrives or departs from the United States. For an individual who meets only the green card test, residence begins on the first day of the calendar year in which the individual is physically present in the United States as a lawful permanent resident and generally will cease on the day this status officially ends.

Residence under the substantial presence test generally begins the first day during the year in which the individual is physically present in the United States. Individuals generally will cease to be a resident during the part of the

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year following their last day of physical presence in the United States provided certain conditions are met. A period of up to 10 days of presence in the United States will not be counted for the purpose of determining an individual's residency start date; those days of presence will be counted, however, for the purpose of determining whether the 183-day component of the substantial presence test has been met. Treaty definitions of residency may override the US statutory definition.

Filing status for US and non-US residents

Generally, spouses must be citizens or residents of the United States at all times in the year before a joint return can be filed. However, in certain situations, a joint return may be permitted if this requirement is not met. An election also is available for first-year residents, married or unmarried, to be treated as part-year residents if they do not otherwise qualify as residents. Certain US presence tests must be met to qualify for this first-year election. Special rules apply to qualify for head-of household status.

Additional non income tax regimes

Payroll taxes and withholding requirements

The US federal government imposes payroll taxes, including Social Security taxes and unemployment insurance taxes. Employers are required to withhold from the salaries and wages of their employees amounts representing their income taxes and Social Security taxes.

This regime generally applies to employees who are non-US individuals who are working in the United States on secondment or international assignment.

Withholding at the source is required by payors of US FDAP income to nonresident aliens at a flat 30 percent rate or lower treaty rate, when applicable.

State and local governments also may require that income taxes be withheld from wages.

Estate and gift taxes

The United States has a gift and estate tax system that applies to taxable gifts of property made by an individual during life and taxable bequests made at death. One system of estate and gift taxation applies to US citizens and foreign citizens domiciled in the United States.
A separate system applies to foreign citizens who are not domiciled in the United States. An individual is domiciled in the United States if he or she actually resides here and has the intention to remain in the United States indefinitely, as evidenced by all the facts and circumstances.
An individual domiciled in the United States may thus be either a resident alien or a nonresident alien for US income tax purposes.

A number of states also impose taxes on estates or bequests made at death.

Federal excise taxes

The US federal government imposes excise taxes on the manufacture, sale, or use of numerous goods and services in the United States. The producer, seller, or importer of these products or services generally must pay the applicable taxes to the federal government. These taxes include, among others, taxes on motor fuels, crude oil and imported petroleum products, communications, air transportation, certain heavy trucks and tractors, tires, highway use, gas-guzzlers, vaccines, premiums paid to foreign insurers, alcohol, tobacco, sporting goods, firearms, chemicals and derivative substances, and ozone-depleting chemicals. Companies may be required to obtain registrations, permits, and bonds to conduct the activity.

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Overview of US federal tax administration

General structure

The primary source of tax rules in the United States is Title 26 of the Code. The Code currently in effect was adopted by the US Congress in 1986, and since then has been regularly amended and supplemented.

The US Treasury Department of the US federal government has responsibility for, among other things, printing and minting all US currency and coins, managing US government debt instruments, and assessing and collecting all federal taxes. Specific to tax, the US Treasury promulgates the tax regulations and other formal guidance that interpret the Code and negotiates US income tax treaties.

The administration of US federal income tax rules and the collection of revenue the task of the Internal Revenue Service (IRS), a bureau of the US Treasury. In this capacity, the IRS collaborates with the US Treasury Office of Tax Policy in drafting tax regulations and issuing interpretive guidance. The IRS also has an enforcement role in the US tax system, pursuant to which the IRS processes and audits federal tax returns. The IRS Office of Chief Counsel advises the IRS with respect to administration and enforcement in specific cases, and also has primary responsibility for working with the US Treasury on regulations and other forms of guidance. Disputes with respect to tax adjustments determined by the IRS may be resolved in one of several different courts, described below.

US federal income tax treaties

As discussed above, the United States has negotiated and entered more than 60 income tax conventions with various other jurisdictions. (For a complete listing of US tax treaties and access to treaty documents, see https://www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z.) Note: US income tax treaties do not apply with respect to state or local income taxes, sales or use taxes, or estate and gift taxes.

Treaties are negotiated by the US Treasury with its counterpart in the treaty partner jurisdiction, and are signed when agreement is reached on the treaty terms. Nonetheless, a signed treaty does not enter into force until the United States and the treaty partner jurisdiction each approve the treaty under their respective internal laws. For the United States, the President of the United States must sign a treaty, and the US Senate must ratify it by a two-thirds majority. The treaty comes into effect when both the United States and the treaty partner have ratified the treaty and appropriately notified the other partner of the ratification.

In the United States, the tax rules in treaties are of equal rank to the tax provisions in the Code; neither is a superior source of US tax law. In the event of inconsistencies between a treaty and the Code provisions, US courts have developed a "later-in-time" rule, pursuant to which the most recently enacted rule is generally considered the operative rule.

Tax return filing requirements

The United States uses a self-assessment system in which all taxpayers are required to compute and report their own tax liability for the tax period. Most corporate income tax returns are due on or before the 15th day of the fourth month following the close of the tax year. The full amount of tax owed for the year is required to be paid on or before the due date of the tax return (without extensions). A corporation may request an automatic six-month extension to file its income tax return. Partnership returns are due on the 15th day of the third month following the close of the tax year, and partnerships may also request an automatic extension of six months to file their return.

Estimated tax payments are required on a quarterly basis, and taxpayers must deposit certain taxes, e.g., employment tax or tax withheld from payments of FDAP income to foreign persons, more frequently.

Tax returns that are filed with the IRS are subject to a "statute of limitations," which limits the period of time that the IRS can adjust the amount of self-assessed tax reported by the taxpayer. The IRS generally has three years from the date a return is filed (or the due date of the return, if later) to assess any additional tax, although that period can be increased in certain situations. For example, the period for assessing income tax is extended to six years when a taxpayer omits gross income that amounts to more than 25 percent of the income reported on its return.

Importantly, there is no limitations period for making adjustments to a fraudulent return or for a year in which no return has yet been filed. In those cases, the period during which the IRS can assess additional tax for the relevant year remains open indefinitely.

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Federal tax rulings

Advance legal rulings may be obtained from the IRS Office of Chief Counsel on many tax issues. The IRS Office of Chief Counsel usually will not consider taxpayer-specific rulings on issues that are factual in nature, and regularly publishes a "no-rule" list (that includes, for example, whether an inbound investor's onshore activities constitute a USTB or a US PE).

However, taxpayers may otherwise apply for a private letter ruling (PLR) addressing other issues that are relevant to transactions they are executing or tax return positions they would like to take. A PLR can be relied upon only by the specific taxpayer that receives the PLR. The IRS Office of Chief Counsel generally is required to make PLRs publicly available, but taxpayer-identification information is redacted before public disclosure. PLR requests require payment of a fee, which can vary based on the underlying requested ruling and can vary from year to year. Currently, the fee for a PLR is $38,000, unless a specific fee is otherwise provided, and reduced fees are available in certain circumstances.

The IRS examination and appeals process

During 2019, the IRS redesigned the Coordinated Industry Case ("CIC") examination program and replaced it with the Large Corporate Compliance ("LCC") Program. In describing the attributes of the program, senior IRS personnel have indicated that the selection processes will rely on new IRS data analysis capabilities, aligning the LCC Program with the data analysis approach being used in the compliance campaign process, enabling the IRS to be better able to identify the entities and issues that pose the most significant compliance risks. In 2021, the IRS initiated the Large Partnership Compliance ("LPC") Program, which is modeled after the LCC Program, and is full underway in its selection of applicable partnerships for audit. IRS has also increased its examinations of Global High Wealth taxpayers and their enterprise activities, high-income taxpayers, and high-income nonfilers.

Additionally, the IRS selects returns for audits based on "campaigns" that identify specific tax issues. At the beginning of 2017, the IRS rolled out 13 campaigns, each campaign focusing on an issue that represents a risk of noncompliance, rather than on the size and complexity of a taxpayer. As of 2022, there were 54 active and 22 "retired" campaigns. The IRS has an internal appeals organization, which a taxpayer may use to resolve certain disagreements with the IRS, generally with respect to an examination, without going to court. The "Independent Office of Appeals (Appeals" is within the IRS and, as its name provides, is independent of the IRS's audit function. The Appeals is allowed to take into account the likely resolution of an issue in court in settling disputed issues. A taxpayer requests an appeal by submitting a formal written protest within a required time frame, which generally is 30 days from receipt of an IRS letter explaining the right to appeal an IRS [examination] determination. For cases that qualify for appeals, an "Appeals Officer" will hold a conference (conducted by phone or in-person) with the taxpayer before resolution of the case.

Tax aspects of the US judicial system

The US federal court system is made up of federal district courts and other specialized trial courts. These courts' decisions in matters of US taxation are reviewed by one the circuit courts of appeal, which, in turn, are subject to discretionary review by the US Supreme Court. The US Tax Court is a specialized court that has jurisdiction to review the IRS's determinations, while the US Court of Federal Claims has more general jurisdiction over claims against the United States.

Twelve of the circuit courts of appeal hear appeals of district court and US Tax Court decisions based on the geographic location of the taxpayer. The Court of Appeals for the Federal Circuit hears appeals from the Court of Federal Claims.

As delineated above, three different types of trial courts are available to adjudicate federal income tax disputes between taxpayers and the IRS: the US Tax Court, the Court of Federal Claims, and the federal district courts (i.e., there are one or more federal courts within each circuit with jurisdiction to hear the particular taxpayer's claims). District courts and the Court of Federal Claims are bound to follow the precedent of their own circuit court of appeal; but all trial courts and circuit courts of appeal are required to follow precedent of the US Supreme Court. The US Tax Court follows precedent of the circuit court of appeal in which the taxpayer is located. As a practical matter, however,—particularly when one of the courts is deciding an issue for which there is no precedent within that circuit —they will consider how that issue has been decided by the other courts.

Taxpayers generally have the ability to choose which of the three courts will hear a tax dispute, and will often take differences in legal precedents into account. There are other differences, however, that taxpayers consider in choosing a tax dispute forum. Although not an exclusive list, below are some of the material differences taken into account when choosing which court is most appropriate for a given dispute.

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- **Payment of the proposed deficiency.** The US Tax Court is a "prepayment" forum, which allows taxpayers to petition for a hearing prior to paying the proposed deficiency on income taxes, although interest on any underpayment continues to accrue while the case is pending in that court. The ability to dispute tax on a prepayment basis in the US Tax Court also is generally available for transfer tax (estate and gift tax) disputes. In contrast, the federal district courts and Court of Federal Claims are "refund" jurisdictions; taxpayers are required to pay the deficiency and then bring suit for a refund.
- **Specialized judges.** The US Tax Court only hears tax disputes, and all cases are decided by "bench trial" (i.e., by a presiding judge) with no option for a jury trial. The federal district courts and the Court of Federal Claims are general courts that adjudicate disputes in a wide range of substantive areas, and the judges for those cases are not tax specialists. It is possible for a case to be submitted to a jury in a federal district court, but no jury is available in the Court of Federal Claims.
- **Representation of the opposing party.** IRS attorneys are responsible for representing the government before the US Tax Court. However, the taxpayer faces attorneys from the US Department of Justice if they appeal from a US Tax Court decision or when it sues for a refund, in either the federal district court or the Court of Federal Claims, and in appeals before a US Circuit Court of Appeals. The government is represented by the Solicitor General's Office in matters before the US Supreme Court.

Decisions of the US Tax Court, federal district courts, and the Court of Federal Claims may be appealed to the US Circuit Courts of Appeal, and ultimately, a petition for discretionary review (a "writ of certiorari") can be filed with the US Supreme Court.

Nonfederal income taxes

State-level income and franchise taxes

Currently, 45 states and the District of Columbia impose corporate income taxes. In addition, some states impose income taxes on unincorporated businesses (LLCs and partnerships). Some cities also impose corporate income taxes. Each US state has a separate tax administration agency.

A true "franchise tax" is levied for the privilege of doing business in the state. The franchise tax base can be measured by a corporation's income, net worth, or a combination of both. In many states, the term "franchise tax" refers to the state's income tax, but in other states a corporation can be subject to both an income tax and a net-worth-based franchise tax. Nexus, tax base, apportionment, and filing methods, described below, apply to income taxes and taxes based on net worth.

Because laws vary significantly from jurisdiction to jurisdiction, a company should review the laws in each of the states in which it does business to determine its specific tax obligations. However, there are some general principles that can be considered.

Nexus

For a state to tax a corporation, there must be a connection between the corporation and the state. This connection is referred to as "nexus." The nexus standards differ significantly from the federal standard of "trade or business" or "permanent establishment." US tax treaties do not apply at the state or local level, although some states have adopted statutes that effectively apply those provisions at the state level. Nexus can be established by having property (real or personal, owned or leased) or personnel, employees, or independent agents located in the state. However, some states allow a limited amount of activity in the state without subjecting the company to tax. For corporate income tax purposes, many states assert that a taxpayer has nexus based on economic connections with the state, such as having customers in the state, or deriving income from in-state sources. Although there is a federal law that restricts states' ability to impose income tax on certain out-of-state sellers of tangible personal property that conduct limited activities in the state, this law applies only to state income taxes and not to other taxes, including franchise taxes based on net worth.

State income tax base

In general, the state income tax base is based on federal taxable income with certain modifications. Accordingly, a non-US taxpayer that does not have any taxable income for federal tax purposes, for example, because its income is protected by treaty or because it does not have a PE in the United States, also may have no taxable income in the state. Nevertheless, some states provide that a taxpayer that is protected by treaty from federal taxes must prepare its state tax return based on federal income "as

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if" the treaty provisions did not apply. Additionally, a state may impose a filing requirement, a gross receipts tax, a minimum tax, and/or a net-worth-based tax on taxpayers that do not have taxable income for federal tax purposes.

States apply a variety of "addition or subtraction modifications" to federal taxable income to determine their own tax base. Examples of modifications include depreciation, the deduction for domestic production activities, dividends, state income taxes, foreign-source income and taxes, corporate-shareholder transactions, NOLs, and transactions with related entities that generate deductions for interest or royalties. The modifications required by each state vary significantly.

Apportionment

Instead of employing the federal approach of looking to the source of each type of income and expense to determine the appropriate place for imposing tax, states generally allow a multistate taxpayer to pay tax on a portion of its total tax base. The amount of the tax base attributable to the state is determined using a formula that approximates the relative percentage of income-producing activity attributable to the state.

Traditionally, this formula is based on relative percentages of property, payroll, and sales attributable to the state. However, many states currently look only to the relative percentage of sales in the state. The formula varies widely from state to state and sometimes depends on the industry sector.

Filing methods

Only a few states follow the federal consolidated return principles. Instead, states have enacted a variety of filing methods. Some states require each corporation to file a separate return. Other states allow or require related entities to file on a combined basis using the unitary business approach. Unlike the federal consolidated return rules, the unitary business approach generally does not look solely at objective factors, such as percentage of ownership, to determine whether companies are required to be included in the return (whether they are "unitary"). Instead, states look at a number of subjective factors to determine whether a unitary business exists, including functional integration, centralization of management, and economies of scale. States also differ on their inclusion or exclusion of foreign entities within the unitary group.

State conformity to the IRC

Nearly every state corporate income tax conforms in some manner to the Code. Rolling or current conformity states are tied to the Code for the tax year in question, meaning they adopt all changes to the Code as passed by Congress unless the state passes legislation to decouple from specific provisions. Static or fixed-date conformity states tie to the Code as of a particular date (e.g., January 1, 2023), meaning the state legislature must act to incorporate subsequent federal changes into the state tax code. Typically, most fixed-date states update their conformity to the Code each year by enacting legislation advancing the date of the Code to which the state conforms. For example, several states have not updated their conformity to the Code to include provisions of the 2017 TCJA or subsequent federal tax law changes, or decoupled from certain aspects of those changes. It is necessary to look at each states' law to determine whether the state has updated its conformity to reflect changes to the Code or whether the state has decoupled from any federal changes.

Most states begin the computation of state corporate taxable income with federal taxable income using the specified version of the Code. The provisions below create unique complexities for state corporate income tax purposes.

- **Limits on interest deductibility.** As discussed above, stricter US earnings stripping rules generally disallow the deduction of net interest expense to the extent it exceeds 30 percent of a taxpayer's adjusted taxable income. This limitation, which is computed at the filer level for federal purposes, can create state complexities because the entities included in a federal consolidated return filing is often different than the entities include in the state filing. In addition, over 20 states currently have rules that disallow the deduction of interest or intangible-related interest paid to related parties. Coordinating the state related-party limitations and federal general interest limits in these states can also present complications.
- **Net operating loss limitations.** Some states start their computation of state taxable income with an amount equal to federal taxable income before NOLs and special deductions (e.g., dividends-received deductions and the deduction for FDII). Those states typically provide a state NOL carryforward based on the amount of the loss allocated or apportioned to the state for the year. Other states use the federal NOL with certain modifications. Taxpayers will need to confirm which formulation is applicable. Effective for losses arising in tax years beginning after December 31, 2017, the TCJA limited the federal NOL deduction to 80 percent of the taxpayer's taxable income, as determined without regard to the NOL deduction. The TCJA also eliminated the NOL carryback and removed the 20-year carryforward restriction on NOLs in favor of an

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unlimited carryforward. The CARES Act temporarily, and retroactively, reinstated the carryback and lifted the 80 percent limitation for certain years. States' conformity with these changes varies widely. A few states piggybacked the federal-level computation of NOLs, and also incorporated all the changes made by both the TCJA and CARES Act. However, most states adopted some, but not all, of these changes. Taxpayers need to confirm each state's NOL provisions. in each state in which they are filing returns.

- **GILTI.** As discussed above, the TCJA modified the historical federal tax treatment of income earned through foreign subsidiaries. Prior to the TCJA, income was taxed when it was repatriated in the form of a dividend unless it fell within the subpart F provisions. Tax reform retained the subpart F provisions and added new provisions to subject income earned by foreign subsidiaries to US taxation in the year in which it is generated. (See the explanations of subpart F and GILTI above.)

In states that conform with the TCJA, GILTI is to be included in the state tax base unless an exclusion applies. A number of states have taken the position that GILTI is sufficiently similar to subpart F income that the state's subpart F exclusion or dividends-received deduction that applies to subpart F likewise applies to exclude GILTI. In those states, GILTI is excluded or deducted from the state tax base. Because GILTI is not taxable in those states, they also take a position that taxpayers do not receive a deduction under section 250.

In states where GILTI is taxable, taxpayers will need to consider how to account for GILTI in the apportionment factor and whether or not the section 250 deduction applies.

State and local sales and use taxes

Because treaty provisions typically do not extend to taxes imposed by subnational levels of government, foreign companies doing business in the United States unwittingly may be subject to US state and local sales and use tax laws. These taxes may be imposed directly on a foreign company, or a state may impose liability indirectly by requiring the seller to collect taxes from a purchaser. These levies can represent a significant cost of doing business in the United States.

Currently, 45 states and the District of Columbia impose sales and use taxes, and many localities have their own sales and use tax rates that are applied in addition to the state sales and use tax rate. Often, the state administers both sales and use tax and distributes a portion of the tax collected to the localities. A few localities administer their own sales and use taxes and in these localities, the state sales and use tax base (the amount upon which sales and use tax is imposed) can be different from the local sales and use tax base.

Sales taxes

A sales tax usually is levied on the gross consideration derived from retail sales, rentals, or other transfers of tangible personal property and selected services in the state. Sales tax usually is imposed at the place of delivery, determined without regard to the shipping terms of the sales contract. The taxes are usually collected by the seller then remitted to the state, which in turn distributes the taxes to the proper locality. If the seller fails to collect tax, the seller may be liable for the taxes due. If the seller is not required to collect tax on the sale, the purchaser may be required to remit use taxes directly to the state in which the purchaser uses the taxable item or service.

The sales tax is generally measured by the gross sales price of the tangible personal property or services. Finance, interest, or carrying charges may be excluded from the tax base, although some states may require these charges to be separately stated on the invoice for the exclusion to apply. Likewise, many states exclude transportation charges, but may require these charges to be separately stated. Many states permit certain deductions from the sales and use tax base, including trade-ins, discounts, coupons, rebates, returns, and allowances.

Many states exempt property purchased for resale or that becomes part of tangible personal property that is to be resold. Other exemptions may apply. For example, exemptions (or a reduced rate) may be available for purchases of manufacturing equipment or property used or consumed in the manufacturing process, intracompany transfers, or certain businesses that are prevalent within a state.

Most states require a seller to obtain a resale or other exemption certificate from the purchaser to verify the nontaxable status of a transaction. Some states require the use of a specific form or specific language. Others permit

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a uniform exemption certificate that is accepted by a number of states. Failure to follow a state's specific recordkeeping requirements can cause the seller to be liable for uncollected sales taxes.

Use taxes

A use tax is imposed on the use, storage, or consumption of tangible personal property and taxable services in a state. The use tax generally is applied when a sales tax was not paid previously in the taxing state. The use tax base, exemptions, and rates generally parallel those under the sales tax. Many states impose a use tax even though the goods were first used outside the state, but allow a credit for sales taxes previously paid to another state.

Requirements to collect sales and use taxes

Historically, a seller could be required to collect sales and use taxes only if it had a physical presence in the taxing jurisdiction. Physical presence could be established by sending employees or representatives into the state, by establishing an office or other place of business in the state, or by owning property or inventory in the state. In addition, the activities of an in-state third party often rendered an out-of-state company subject to the state's sales and use tax laws.

On June 21, 2018, the US Supreme Court (the Court) overturned the "physical presence" standard in *South Dakota v. Wayfair, Inc.*, 585 US ___ (2018). In this seminal decision, the Court declined to overturn a South Dakota law mandating that all retailers with over $100,000 of sales into the state or 200 sales transactions to in-state customers collect and remit sales taxes. Many states have now adopted standards similar to South Dakota's. Given that physical presence is no longer the prevailing standard that states are bound by and that taxpayers can rely on, sellers may now be required to collect and remit sales and use taxes in jurisdictions where they lack a physical presence but meet the economic or sales transactions thresholds. Most states do not provide different rules for, or explicitly carve-out, foreign sellers making sales to customers in the United States and tax treaties generally to not apply to state sales and use taxes.

Other state and local taxes

Property taxes

Taxes assessed by state and local governments on real and personal property are characterized as "ad valorem" taxes because the tax is assessed on the value of the property on a prescribed assessment date each year.

Special taxes and fees

State and local governments may impose a number of other taxes, including taxes on special commodities (alcohol, tobacco, and motor fuel), fees for business and professional licenses, and taxes on special types of businesses, such as banking or insurance.

Information service provider seeks to manage state sales tax compliance

A U.K. information service provider was concerned about US state sales tax compliance relating to recently acquired US companies. The company reached out to KPMG to help it reduce tax exposure in the preacquisition period and ensure appropriate post-acquisition compliance. The analysis required a thorough understanding of the business activities being performed and the underlying taxability of the services being performed. KPMG assisted the client with the process of entering into voluntary disclosure agreements with a number of states so that it could satisfactorily resolve preacquisition exposure and develop an appropriate post-acquisition process for ongoing compliance.

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US International Trade and Customs Administration

Importing into the United States

Goods arriving into the United States must be "entered' by the importer of record, who is generally the "owner" of the goods (or a party with a requisite financial interest in the goods) or a licensed customs broker authorized to act on behalf of the owner. An "entry" of goods requires that the importer of record file the necessary documents for CBP to determine whether the goods may be released from CBP custody, including providing the necessary documents containing information for duty assessment and statistical purposes, and a surety bond to cover any potential duties, taxes, and charges that may accrue upon the imported goods.

The goods may then be examined by CBP, and, assuming no legal or regulatory violations have occurred, released into the stream of US commerce. Then the entry summary documentation is filed and estimated duties are deposited with CBP. The entry "liquidates," or is considered final, generally 314 days after the date the entry summary is filed, or one year by operation of law. Importers generally have an opportunity to make adjustments or changes to the information on the customs entry until the entry liquidates, and also have an opportunity to file a protest to challenge certain decisions by CBP, including liquidation, within 180 days of the day of liquidation.

Importers are statutorily required to exercise "reasonable care" to make entries of goods, and report the necessary information to CBP, including the declared value, classification, and rate of duty, and provide such other documentation or information as is necessary to enable CBP to properly assess duties, collect accurate statistics, and determine whether any other applicable requirement of law is met. Failure to exercise reasonable care may subject the importer to customs penalties.

Binding rulings/internal advice

Importers may request binding written rulings from CBP concerning prospective transactions in order to fully understand the consequence of transactions prior to filing entry. The binding ruling program enables importers and other interested parties to obtain binding preentry decisions pertaining to various customs requirements. Importers may similarly request written "internal advice" from CBP with respect to a specific import transaction regardless of whether the transaction is prospective, current, or completed. Importers may also file protests within specified time periods after the liquidation of a filed entry, to contest certain adverse decisions made by CBP against the importer.

Classification of imported goods

Part of the entry process into the United States, the goods must be "classified" according to the Harmonized Tariff Schedule of the United States (HTSUS), which enables CBP to assess the correct duties, collect accurate statistics, and assess whether other legal requirements (e.g., punitive tariffs or quotas) are applicable. The classification of goods is important because duty rates, including punitive and preferential duty rates (such as those under free trade agreements), vary depending on the applicable classification code and will also subject certain goods to quotas, restraints, embargoes, or other restrictions. The act of classifying goods requires an importer to be familiar with the HTSUS and the General Rules of interpretation (and the instrument upon which it is based, the international Harmonized Commodity Description and Coding System). There are currently over 17,000 unique classification numbers in the HTSUS, categorized into 99 chapters. The corresponding general duty rates typically range from 0 percent to over 40 percent. However, since 2018, the United States has introduced additional tariffs as high as 25 percent on specified imported goods from China, and up to 200 percent on some Russian products, assessed in addition to general duty rates, determined in part by the HTSUS classification.

Country-of-origin designation

The country of origin (origin) of a product is important for several reasons, including the rate of duty, eligibility for special programs, admissibility, quota, and procurement by government agencies and marking requirements. Generally, the nonpreferential rules of origin require that imported goods are either "wholly obtained" in a country (i.e., the good is wholly the growth, product or manufacture of a particular country), or undergo a "substantial transformation" in a country if the product consists in whole or in part of materials from more than one country. There are also more specific preferential rules of origin, for example, applicable to free trade agreements that must be considered on a case-by-case basis.

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In the current high-tariff environment, origin designation issues have received heightened attention as importers are becoming more strategic in their supply chain and trade compliance operations in order to effect favorable changes to the origin of goods in order to mitigate the impact of high tariffs. For instance, many companies are considering manufacturing goods outside of China to avoid tariffs on Chinese goods.

Customs valuation

When goods are imported into the customs territory of the United States its customs value must be determined. Under the Trade Agreements Act of 1979, the preferred method of appraisement is "transaction value." In the event the goods cannot be appraised on the basis of transaction value, alternative valuation methods are considered in the following order: transaction value of identical goods; transaction value of similar goods; deductive value; computed value; and values if other values cannot be determined (fallback value).

The transaction value of imported goods is the price actually paid or payable for the goods, excluding international freight, insurance, and other specific charges, when sold for exportation to the United States, plus amounts equal to:

1. The packing costs incurred by the buyer
2. Any selling commission incurred by the buyer
3. The value, apportioned as appropriate, of any assist (i.e., items provided, directly or indirectly, by the buyer of the imported goods, free of charge or at a reduced cost, for use in the production or sale of goods for export to the US)
4. Any royalty or license fee that the buyer is required to pay, directly or indirectly, as a condition of the sale
5. The proceeds of any subsequent resale, disposal, or use of the imported goods that accrue, directly or indirectly, to the seller.

Related-party transactions

Determining whether parties are related is important to establish that the declared value was settled at an arm's length. The customs law definition of "related" parties differs, and may provide a lower threshold, from the OECD definition of "associated enterprises" used to determine whether parties are related for tax or IRS purposes. Accordingly, it is possible that member firms of the same multinational group may not be considered to be related for tax purposes but are treated as related for customs purposes.

Under the customs definition, related persons include:

- Members of the same family; any officer or director of an organization and such organizations
- An office or director of an organization and an officer or director of another organization, if each such individual is also an officer or director in the other organization; partners, employer and employee
- Any person directly or indirectly owning, controlling, or holding with power to vote, 5 percent or more of the outstanding voting stock or shares of any organization and such organization
- Two or more persons directly or indirectly controlling, controlled by, or under common control with, any person.

CBP's arm's-length rules also differ from the arm's-length requirements under US income tax regulations, for example under the Code.

Accordingly, CBP has generally determined that the fact that the importer's transfer pricing methodology satisfies one of the IRS methods is not determinative of whether it is an acceptable transaction value for customs purposes. Rather, a related-party import transaction will be considered acceptable only if it satisfies one of CBP's arm's-length requirements: either the circumstances of sale test or it closely approximates one of the test values as provided in the customs law.

Circumstances of sale test

Under the circumstances of sale test, the transaction value between a related buyer and seller is acceptable if an examination of the circumstances surrounding the sale of the imported merchandise indicates that the relationship did not influence the price actually paid or payable. In this context, information provided to CBP in a transfer pricing study may be relevant in examining the circumstances of sale but the weight given to the information will vary depending on the details set forth in the study. Instead, CBP views that the customs "all costs plus profit" method is the most objective method of satisfying the circumstances of sale test. Under this method, if it is shown that the price for goods is adequate to ensure recovery of all costs, plus a profit that is equivalent to the firm's overall profit realized over a representative period of time, in sales of merchandise of the same class or kind, it would demonstrate that the price has not been influenced by the relationship.

An alternative method of establishing the acceptability of a transaction value in a related-party transaction is to demonstrate that it closely approximates specific test

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values pertaining to identical or similar goods exported at or about the same time as the imported merchandise under review. CBP requires that the test values be values previously determined by CBP under an actual appraisement of imported merchandise. If there are no previous importations of identical or similar merchandise that were appraised by CBP under the transaction, deductive, or computed valuation methods, then test values acceptable to CBP may not exist.

Where an importer's transfer pricing policy allows or contemplates potential retroactive transfer pricing or compensating adjustments between the seller and buyer, it is important to recognize these adjustments may have customs consequences: either an obligation to report upward adjustments and pay additional customs duties, or an opportunity to seek a refund of customs duties for downward adjustments.

CBP has established specific requirements to determine whether a transfer pricing adjustment affects the eligibility of transaction value (or the transfer price) as the basis of customs value, including potential eligibility for duty refunds. Thus it is important that importers ensure that their transfer pricing policy takes these customs requirements into account.

Antidumping duty (AD) and countervailing duty (CD)

AD and CVD are additional duties that may be assessed on imported goods intended for sale in the United States at abnormally low prices. These low prices are the result of unfair foreign trade practices that give some imports an unearned advantage over competing US goods. For example, "dumping" is the practice of attempting to sell products in the US at lower prices than those same products would bring in the producer's home market. It also includes trying to sell a product in the United States at a price lower than it costs to manufacture an item.

Subsidizing is the practice by some governments of providing financial assistance to reduce manufacturers' costs in producing, manufacturing, or exporting particular goods. Countervailing duties are assessed to "level the playing field" between domestic and subsidized imported goods. The US Department of Commerce and International Trade Commission determine whether goods are subject to AD or CVD; the former also determining whether specific products are in scope of an existing AD or CVD order.

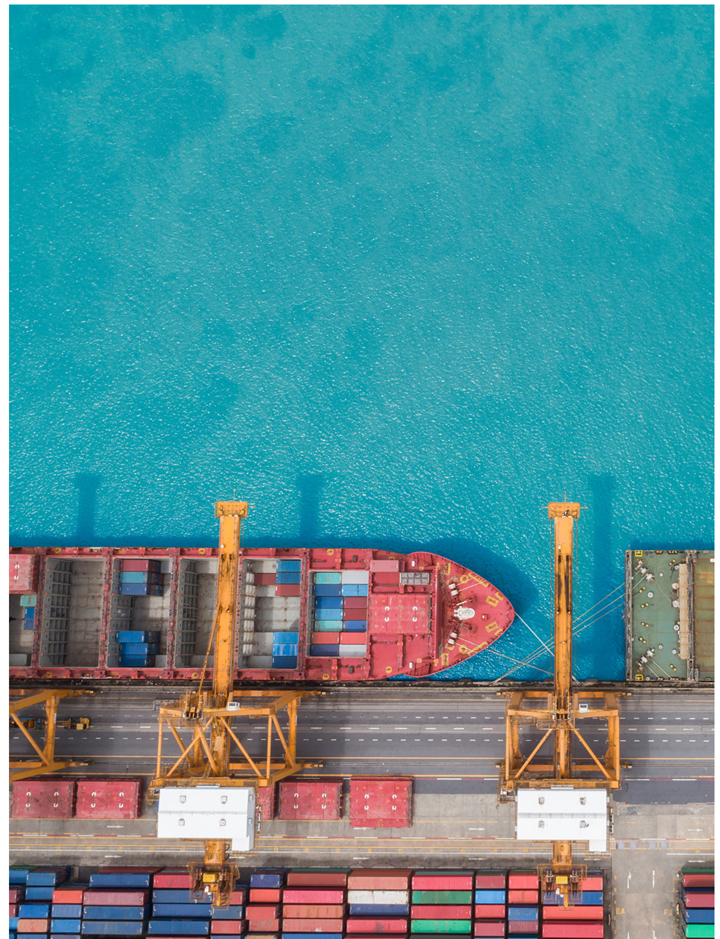
Customs audits

CBP takes a risk-based approach to assess import compliance with trade laws and regulations. The audit reviews provide a systematic approach to data collection and analysis to determine the likelihood of noncompliance, which includes assessing risks by reviewing corporate controls over trade compliance.

CBP's Office of Regulatory Audit is responsible for auditing importers involved in international trade compliance with laws and regulations governing the importation and exportation of goods. The Focused Assessment

(FA) Program is an example of a risk-based approach to audits. [It initially entails an assessment of the importer's internal controls related to compliance with custom laws and regulations and identifying internal control deficiencies. The compliance component relates to an assessment of the importer's actual compliance with relevant CBP laws and regulations and determining the cause of any identified noncompliance. The FA Program comprises three phases: Pre-Assessment Survey (PAS), Assessment Compliance Testing (ACT), and Follow-up.

During the PAS phase, auditors evaluate the risk of material noncompliance with CBP laws and regulations relating to the importer's import activity through an assessment of its internal control. The ACT and Follow-up phases are performed as necessary for areas found to represent an



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unacceptable risk during the PAS. Generally, during an ACT, auditors perform more extensive compliance testing to determine a compliance rate or quantify the loss of revenue relating to noncompliance identified in the PAS. The Follow-up phase is performed, as necessary, to verify corrective actions taken by the importer to address identified internal control deficiencies, and, if applicable, validate the importer's quantification of the loss of revenue resulting from self-testing.

A second type of customs audit is the Quick Response Audit. Quick Response Audits are single-issue audits with a narrow focus that covers a variety of audits that have limited objectives as opposed to the complete evaluation of a company's customs activities in the FA Program.

In case of dispute, the United States has a federal system of judicial review of CBP decisions and/or customs issues that starts with the trial court known as the United States Court of International Trade (CIT), comprising nine judges appointed by the President for lifetime tenure.

The CIT, located in New York City, has national jurisdiction and concurrent remedial powers like any other federal district court. However, the CIT has exclusive, albeit limited, subject matter jurisdiction, generally over civil actions arising from import transactions (28 USC. 1581). Appeals from the CIT are reviewed by the Court of Appeals for the Federal Circuit, whose decisions, in turn, can be appealed to the United States Supreme Court.

Customs seizures, penalties, and liquidated damages

Many laws define what constitutes prohibited goods or behavior but do not provide a remedy to be enforced regarding that prohibited goods or as a consequence of that behavior. Section 1595a(c) is the primary seizure and forfeiture statute CBP uses to enforce myriad civil laws, both customs laws and laws and regulations of other agencies.

CBP also has the authority to issue penalties to importers and others engaged in international trade. 19 USC. § 1592 is the primary civil penalty statute and permits CBP to assess monetary penalties (or fines) against parties who make material false statements, acts or omissions in connection with their importations. The material false statements, acts, or omissions must result from the parties' negligence, gross negligence, or fraudulent conduct. Typical examples of such violations include undervaluation, misdescription/misclassification of goods, overvaluation, AD/CVD order evasion, improper country-of-origin declarations or markings, or improper claims for preference under a free trade agreement or other duty preference program. Penalties are applicable to both revenue and nonrevenue violations.

A liquidated damage is a predetermined penalty assessed against importers that have violated the conditions of their customs bond. Importers who receive penalties or liquidated damages claims generally can submit a petition to CBP requesting cancellation or mitigation of the penalty or liquidated damage. In particular, CBP's Prior Disclosure statute, 19 USC. § 1592(c)(4), permits a party to voluntarily disclose the circumstances of a violation of 19 USC § 1592. The disclosure must be made before, or without knowledge of, the commencement of a formal investigation of the violation. In return, monetary penalties are significantly reduced. For example, in the case of a negligence violation, a valid prior disclosure will reduce the penalty amount to the interest owed on any revenue loss resulting from the violation.

Duty savings and other programs

Under certain conditions, importers may reduce or defer customs duties and other charges through programs permitted by CBP. These programs generally require an initial investment and ongoing monitoring to ensure that specific CBP requirements are satisfied.

Free trade agreements

The United States also currently has bilateral and/or multilateral free trade agreements (FTA) with 20 countries, offering duty-free or reduced duties on a wide range of imported products. Only those goods that satisfy the respective FTA's rules are eligible for duty preferences. The United States also has unilateral programs, such as the Generalized System of Preferences, which offers duty-free treatment to goods of designated beneficiary countries.

Foreign-Trade Zones

Foreign-Trade Zones (FTZ) are secure areas under CBP supervision that are physically located in the United States, but are generally considered outside custom territory. Located in or near CBP ports of entry, they are the United States' version of what are known internationally as free trade zones. Foreign and domestic goods may be moved into an FTZ for operations not otherwise prohibited by law, including storage, exhibition, assembly, manufacturing, and processing. Retail sale, however, is prohibited. All zone activity is subject to public interest review. FTZ sites are subject to the laws and regulations of the United States as well as those of the states and communities in which they are located.

Under zone procedures, the usual formal CBP entry procedures and payments of duties are not required on the foreign goods unless and until the goods are removed from the FTZ and enter CBP territory for domestic consumption,

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at which point the importer will generally pay duties applicable to the imported goods. Importers operating a zone are also subject to completion of certain forms upon admission to the zone, with the entry requirements discussed above applying upon withdrawal from the zone. Certain domestic goods moved into the zone as zone restricted status may be considered exported upon admission to the zone for purposes of excise tax rebates and drawback.

CBP duty and federal excise tax, if applicable, are paid when the goods are transferred from the zone for consumption. While in the zone, goods are not subject to US duty or excise tax. Goods may be exported from the zone free of duty and excise tax. Goods may remain in an FTZ indefinitely, whether or not subject to duty.

First Sale for Export

As explained above, under US law, the preferred method of valuing imported goods for customs purposes is the transaction value, or the price actually paid or payable for goods sold for exportation to the United States. In multitiered sales or supply chains involving foreign middlemen, (i.e., when there are multiple sales of the imported goods prior to their importation into the United States), the First Sale for Export principle allows US importers to use the price paid in the "first" or "earlier sale" as the basis for the customs value of the goods rather than the price the importer ultimately paid for the goods, as long as that earlier sale can be documented as being a sale for exportation to the US and the importer meets all other CBP requirements. Because the value attributable to earlier sales may be lower than in the subsequent sale to the importer, use of the First Sale rule can significantly reduce the duties paid by importers.

Duty drawback

Companies are constantly looking for opportunities to reduce costs affecting bottom-line profitability, including those related to the import and export of finished goods and raw materials. One method of doing this is by claiming the drawback, or refund, of up to 99 percent of the customs duties, taxes, and fees paid on imported goods that are subsequently exported or destroyed.

There are three basic types of drawback: manufacturing, unused merchandise, and rejected merchandise. In 2018, the drawback rules were significantly streamlined, and all drawback refunds will be available for goods exported within five years of importation. The right to claim drawback generally belongs to the ultimate exporter; however, the exporter may waive the drawback right and assign it to the importer or an intermediary party.

Drawback claims, regardless of type, require support in the form of import, manufacturing (if applicable), and export documentation, as well as evidence of inventory controls (a method of linking imported and exported items). In addition, special considerations apply when filing drawback claims for exports to Canada and Mexico as provided for in the USMCA.

Manufacturing drawback

Manufacturing drawback is generally the most common but also the most complex of the three drawback types. In general, manufacturing drawback refunds may be claimed on imported articles used in the manufacture of goods that are subsequently exported or destroyed within five years of importation.

Rejected or unused goods drawback

Generally, unused goods drawback involves refunds for imported goods that are unused in the United States prior to exportation or destruction, and rejected goods drawback concerns goods that is exported or destroyed because it does not conform to specifications or is defective at the time of importation.

Defective value allowance

US importers may be eligible for a refund of duties from CBP for goods ordered from its foreign suppliers and which are partially damaged or defective at the time of importation.

Customs duties are generally assessed ad valorem, that is, as a percentage of the value of an imported item. If an imported item is damaged or defective at the time of importation (e.g., a latent defect existed in the goods), the importer may request a refund, generally by filing a "protest," of the duties for the diminution in value resulting from the damage or defect. Generally, the diminution in value can be supported by the cost of bringing the imported item to its "nondefective" condition (e.g., the repair costs under warranty) or, if the goods are resold at a lower value, the reduction in price if the importer can prove a correlation to the extent of the damage. This opportunity has been used by importers in cases of recalls for defective goods to recover duties paid on the defective goods (e.g., automotive importers).

Customs-Trade Partnership Against Terrorism

The Customs-Trade Partnership Against Terrorism (C-TPAT) program is a voluntary public-private sector partnership which recognizes that CBP can provide the highest level of cargo security only through close cooperation with the

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principal stakeholders of the international supply chain such as importers, carriers, consolidators, licensed customs brokers, and manufacturers.

Today, more than 11,400 certified partners in a variety of roles within the trade community have been accepted into the program. These partners include importers/exporters, US/Canada highway carriers, rail and sea carriers, licensed US customs brokers, and Mexican and Canadian manufacturers.

When an entity joins C-TPAT, an agreement is made to work with CBP to protect the supply chain, identify security gaps, and implement specific security measures and best practices. Applicants must address a broad range of security topics and present security profiles that list action plans to align security throughout the supply chain. C-TPAT members are considered to be of low risk, and are therefore less likely to have shipments subjected to examination at a US port of entry.

C-TPAT partners enjoy a variety of benefits including reduced number of CBP examinations, front-of-the-line inspections, shorter wait times at the border, and eligibility to participate in the Importer Self-Assessment (ISA) program (see below).

Importer Self-Assessment program

The ISA program is a joint government-business initiative designed to build cooperative relationships that strengthen trade compliance. It is based on the premise that importers with strong internal controls achieve the highest level of compliance with customs laws and regulations. The ISA program provides a means to recognize and support importers that have implemented such systems.

All importers who are members of the C-TPAT may apply for participation in the ISA program. CBP will then assess the importer's readiness to assume the responsibilities of ISA. The ISA program is primarily based on the development and use of established business practices and internal control designed specifically for an importer's CBP operations. The importer may structure internal controls and procedures to meet its individual needs.

ISA Importers may potentially receive the following benefits:

- CBP can provide guidance as requested (for compliance assistance, risk assessments, internal controls, CBP audit trails, data analysis support, etc.).
- The importer will be removed from CBP's Regulatory Audit audit pool established for Focused Assessments, and for drawback and FTZs if requested by the importer.
- The importer will have access to key liaison officials and will be assigned a national account manager.
- The importer will be entitled to receive free of charge entry summary trade data, including analysis support.
- With regard to Prior Disclosures, if CBP becomes aware of errors in which there is an indication of a violation of 19 USC. § 1592, CBP will provide a written notice to the importer of such errors and allow 30 days from the date of the notification for the importer to file a Prior Disclosure.
- In the event that civil penalties or liquidated damages are assessed against an importer, the importer's participation in ISA will be considered as a mitigating factor in the disposition of the case.
- The importer will enjoy greater business certainty because a system of internal control helps to ensure compliant transactions.

Anti-Forced Labor

CBP has been particularly focused on efforts to eliminate the import of goods made with forced labor into the US with the ultimate goal of eliminating the use of forced labor in supply chains. To achieve this, CBP historically relied on issuing Withhold Release Orders (WROs) and Findings targeting goods suspected or known to be made wholly or in part with forced labor. WROs and Findings are limited in scope to the particular product(s) named in the WRO or Finding; however, with the passage of the Uyghur Forced Labor Prevention Act (UFLPA) in 2021, CBP has the authority to detain goods suspected of being made wholly or in part with forced labor, regardless of the type of product.

The UFLPA took effect in June 2022 and was passed in response to alleged forced labor practices in the Xinjiang Uyghur Autonomous Region (XUAR) of China, which includes forced labor camps and extensive forced labor practices including forced relocation and forced admittance to "re-education camps." The law establishes a rebuttable presumption that the importation of any goods produced or manufactured wholly or in part in XUAR is made with forced labor. If an importer's goods are detained, the importer must establish by clear and convincing evidence that the goods were not made with forced labor.

CBP has released extensive guidance related to responding to detention of goods, recommending that importers proactively conduct due diligence including supply chain mapping, supplier audits, regular screening, and incorporating language supportive of human rights into supplier contracts, among other recommendations.

Additionally, C-TPAT importers, exporters, and foreign manufacturers must address the threat of forced labor in the company's risk assessment methodology. In addition, they must demonstrate how they address this threat through a documented social compliance program –

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generally referred to as a social responsibility program or "responsible sourcing."

Some of the key elements of a social compliance program are included in the C-TPAT program but should be expanded to include the threat of forced labor.

CBP Reconciliation Program

CBP's Reconciliation Prototype Program (Reconciliation) allows the importer, using reasonable care, to file entry summaries with CBP with the best available information, albeit incomplete, at the time of importation. These entries are then flagged to advise CBP that certain entry information, such as the declared value, remain outstanding or uncertain. At a later date, prior to either the end of 12 or 21 months of the import date (depending on the issue to be reconciled), the importer files a Reconciliation entry that provides the correct or missing information. For example, the Reconciliation program is helpful to declare retroactive transfer price adjustments to the price of previously imported goods in related-party transactions.

Export controls and sanctions

There is a complicated network of federal agencies and interrelated regulations that govern exports from the United States, generally referred to as "export controls." Export controls regulate the shipment or transfers of controlled items, software, technology, or services out of the US or to non-US persons.

The US Government controls exports of sensitive equipment, software, and technology as a means to promote its national security interests and foreign policy objectives. Similarly, the US Government prohibits business transactions with certain individuals, entities and countries who present threats to the national security, foreign policy, or economy of the United States.

Under the current export control and sanction system, there are three primary US government agencies that administer regulations: US Departments of State, Commerce, and the US Treasury.

US Department of State, Directorate of Defense Trade Controls

The US Department of State's defense trade controls are contained in the Arms Export Control Act (AECA) and the International Traffic in Arms Regulations (ITAR). The Directorate of Defense Trade Controls (DDTC) regulates the temporary import and the permanent and temporary export of defense articles and services involving items on the US Munitions List (USML). The USML generally covers items with inherent military applications.

Violations of the AECA and the ITAR defense controls can result in both civil and criminal penalties, and willful violations can carry penalties greater than $1 million per violation, 20 years imprisonment, or both. In addition, civil penalties may be imposed in addition to criminal penalties exceeding $1 million per violation.

US Department of Commerce, Bureau of Industry and Security

The Bureau of Industry and Security (BIS) administers and enforces the Export Administration Regulations (EAR), which regulate the export and reexport of commercial commodities and technology, as well as less sensitive military items.

Violations of the EAR may be subject to both criminal and administrative penalties. Criminal penalties can exceed $1 million per violation and up to 20 years in prison, or both. Administrative penalties may be over $300,000 per violation or twice the value of the transaction, whichever is greater. Administrative penalties may also include the denial of export privileges.

US Department of the Treasury, Office of Foreign Assets Controls

The Office of Foreign Assets Control (OFAC) of the US Treasury administers and enforces economic and trade sanctions based on US foreign policy and national security goals against targeted foreign countries and regimes, terrorists, international narcotics traffickers, those engaged in activities related to the proliferation of weapons of mass destruction, and other threats to the national security, foreign policy, or economy of the United States.

Penalties for violations of OFAC regulation are subject to criminal penalties exceeding $1 million per violation and civil penalties exceeding $300,000 per violation.

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Committee on Foreign Investment in the United States

The Committee on Foreign Investment in the United States (CFIUS) reviews certain foreign investments to determine if they present a threat to national security. It is an interagency group, chaired by the Secretary of Treasury and includes the Secretaries of Homeland Security, Commerce, Defense, State, Energy and Labor, the Attorney General, the Director of National Intelligence, the United States Trade Representative and the Director of the Office of Science and Technology Policy.

When a transaction requires CFIUS approval, the foreign investor and the target company jointly prepare the notice. The review period may take up to 30 calendar days upon acceptance of the notice. CFIUS then determines whether to clear the transaction or begin an investigation. If national security concerns have not been resolved following the investigation, CFIUS will make a formal recommendation to the President about whether to clear or block the transaction. The President may then decide whether to suspend, prohibit, or impose conditions on the deal. CFIUS can also clear a transaction subject to conditions to mitigate perceived risks.

Failure to abide by mitigation agreements may result in penalties up to $250,000 per violation or the value of the transaction, whichever is greater.

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