

Doing Business in the United States

A guide to the key tax issues 2020



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2020 Foreword

Doing Business in the United States

These are incredibly challenging times for multinational companies and businesses. The global COVID-19 pandemic has created economic upheaval and a level of uncertainty to a degree not seen in many years. Trade disputes continue globally and the congressional and presidential election are scheduled in the United States in November 2020.

In light of these developments and their already significant effects on US tax and trade policy, we are releasing online our annual guide, *Doing Business in the United States*. The guide discusses the more common tax provisions of interest to global multinational companies expanding or starting business in the United States. Included are updates and new guidance from Treasury and the IRS, as well as practical insights. This latest edition includes several key sections:

- Summaries of key tax law changes enacted on March 27, 2020, as part of the CARES Act as well as state-level trends.
- An expanded section on customs duties and import tariffs to reflect the higher profile of trade issues in the past year, and major developments such as the USMCA trade agreement, the US-China ‘Phase One’ agreement, and US responses to various global ‘digital tax’ legislation in different countries.
- Key US tax policy issues for global companies to stay informed of in 2020.

On the state tax level, responses to the US Supreme Court’s *Wayfair* decision could subject more inbound companies to state indirect taxes. Additionally, different state-by-state conformity to the TCJA and CARES Act creates considerable state tax confusion and uncertainty. Finally, inbounds need to keep abreast of continued activity on BEPS Action Plan Actions 1 (the digital economy) — both Pillar One, the Re-allocation of taxing rights, and Pillar Two, Global anti-base erosion mechanism — and 2 (hybrid mismatch arrangements).

We will update this material periodically throughout the year as developments warrant. Of course, while *Doing Business in the United States* provides an introduction to the US tax system and concepts, please contact any of the PwC specialists listed throughout the guide for more detailed insights on the issues covered.

As you look to expand, continue, or start your business in the United States, I hope our guide helps you identify the opportunities and help address the challenges during these complex times.

Yours sincerely,

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CARES Act updates

The 'Coronavirus Aid, Relief, and Economic Security Act' (CARES Act), signed into law by President Donald Trump on March 27, 2020, included significant tax provisions and other measures to assist individuals and businesses impacted by the economic effects of the COVID-19 pandemic. Tax relief measures for businesses include a five-year net operating loss (NOL) carryback (including a related technical correction to the 2017 tax reform act), a change in Section 163(j) interest deduction limitations, accelerated AMT refunds, payroll tax relief, a temporary suspension of certain aviation excise taxes, a tax credit for employers who retain employees, and a 'qualified improvement property' technical correction to the 2017 tax reform act. Tax relief measures for individuals include 'recovery rebate checks,' special rules for the use of retirement accounts, and charitable giving provisions.

CARES Act provisions of particular interest to inbound companies are highlighted in the applicable sections in this guide.

I.



I. Key US tax policy issues

2020 has proven to be an eventful year. The COVID-19 pandemic (and its economic impact), continuing shifts in global policy, as well as US presidential and congressional elections on the horizon, will have a significant impact on foreign investment in the United States in 2020.

The federal government has taken a number of steps to address the health and economic impacts of the COVID-19 pandemic. In March, three separate pieces of legislation were enacted, including the CARES Act, a \$2.3 trillion economic relief package with tax and non-tax measures to provide liquidity and promote workforce retention. Additional legislation may be considered. The Treasury Department and the IRS delayed certain tax deadlines and provided other administrative relief following President Trump's national emergency declaration. The Administration also has provided some tariff relief.

In December, a year-end tax package was enacted as part of legislation funding the federal government through the end of the current fiscal year (September 30, 2020). It renewed more than 30 expired or expiring tax provisions through the end of 2020, including controlled foreign corporation (CFC) look-through treatment. It also modified certain provisions of the 2017 Tax Cuts and Jobs Act (the Act), expanded retirement savings incentives, provided disaster tax relief, and repealed certain Affordable Care Act tax provisions. However, it did not include a package of proposed technical corrections to the Act.

After having been stalled for several years, the Senate approved four protocols amending existing US income tax treaties with Japan, Luxembourg, Spain, and Switzerland that entered into force in 2019. However, three proposed new income tax treaties with Chile, Hungary, and Poland are still awaiting Senate action. The Treasury Department hopes to negotiate new tax treaties in 2020.

Thousands of pages of federal regulations implementing the 2017 tax reform law have been issued, including guidance regarding the base erosion and anti-avoidance tax (BEAT), anti-hybrid rules, and the business interest expense limitation under Section 163(j). However, many questions remain, and significant guidance still needs to be finalized. The Treasury Department has set a goal of completing all 2017 tax reform regulatory guidance by October 1, 2020.

At the same time, governments around the world are rethinking longstanding tax principles regarding taxation of cross-border activities at a time of public debate over whether companies are paying their 'fair share' of taxes. The OECD Inclusive Framework is continuing to work toward its goal of producing a final report to the G20 by the end of 2020 on a consensus solution to the tax challenges arising from the digitalization of the economy. The proliferation of unilateral measures, such as digital services taxes, has heightened the urgency to reach agreement on a multilateral approach.

The Congressional tax-writing committees are monitoring global tax developments and have expressed support for a multilateral approach. Implementation of any OECD consensus solution likely will require US tax law changes and modification of existing tax treaties. As a result, US international tax provisions enacted as part of the Act may be subject to change.

The 2020 elections could change control of the White House and the balance of power in Congress, affecting prospects for tax legislation in 2021 and beyond. President Trump and Democratic presidential candidates have laid out very different tax policy agendas. The President has signaled his intent to propose additional tax cuts for middle-income individuals and business. Democratic candidates have proposed tax increases on business and higher-income individuals to fund various initiatives. It remains to be seen whether the COVID-19 pandemic and the dramatic increases in deficit-financed federal spending to combat the coronavirus and stabilize the US economy will cause the candidates to revise their campaign tax plans.

Enactment of major changes to the current tax laws, such as a corporate tax rate increase, is likely to require unified control of the White House and Congress. Alternatively, the changes would have to reflect the priorities of both Democrats and Republicans. A change in White House control could have important consequences for regulatory and administrative actions taken by President Trump.

Future US tax policy also may be impacted by large and growing federal budget deficits. Prior to the COVID-19 pandemic, the Congressional Budget Office (CBO) projected a federal deficit of \$1 trillion in 2020, with deficits averaging \$1.3 trillion per year and totaling \$13.1 trillion over the 10-year budget period (2021-2030). Debt held by the public is projected to increase from 79% of GDP in 2019 to 98% at the end of 2030.

The 2017 tax reform law sunsets nearly all individual and pass-through business tax provisions after 2025. In addition, key business provisions are set to become more restrictive. This includes limits on interest deductions beginning in 2022 and tightened international tax rules beginning in 2026. If Congress were to immediately extend all Act provisions, as well as extend other expiring tax provisions, federal budget deficits would increase by \$2.1 trillion plus \$200 billion in debt service over 10 years. Further, the 10-year budget cost rises with each passing year.

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II.



II. Federal tax issues

A. Taxes on corporate income

1. Corporate income tax

US taxation of income earned by non-US persons depends on whether the income has a nexus with the United States and the level and extent of the non-US person's presence in the United States.

Prior to the enactment of US tax reform legislation on December 22, 2017 (the Act), a non-US corporation engaged in a US trade or business was taxed at a 35% US corporate tax rate on income from US sources effectively connected with that business (ECI). However, the Act significantly revised the federal tax regime. The Act permanently reduced the 35% corporate income tax rate on ECI to a 21% flat rate for tax years beginning after December 31, 2017. Certain US-source income (e.g., interest, dividends, and royalties) not effectively connected with a non-US corporation's business continues to be taxed on a gross basis at 30%.

2. Alternative minimum tax (AMT)

AMT previously was imposed on corporations other than S corporations and small C corporations (generally those with three-year average annual gross receipts not exceeding \$7.5 million). The tax was 20% of alternative minimum taxable income (AMTI) in excess of a \$40,000 exemption amount (subject to a phase-out). AMTI was computed by adjusting the corporation's regular taxable income by specified adjustments and 'tax preference' items. Tax preference or adjustment items could arise, for example, if a corporation had substantial accelerated depreciation, percentage depletion, intangible drilling costs, or non-taxable income.

The Act repealed the corporate AMT effective for tax years beginning after December 31, 2017, and provided a mechanism for prior-year corporate AMT credits to be refunded by the end of 2021.

Tax readiness insight: Under the Act, companies with AMT credit carryforwards may claim a refund of 50% of the remaining credits (to the extent the credits exceed regular tax for the year) in tax years beginning in 2018, 2019, and 2020. Companies may claim a refund of any AMT credit carryforwards remaining after 2020 in the tax year beginning in 2021.

This was modified by the CARES Act. The CARES Act also accelerates the recovery of remaining credits for prior-year AMT liability by allowing companies to claim a refund of the remaining credits in 2018 or 2019.

Inbound insight: On January 16, 2020, the IRS announced via its website that refunds of alternative minimum tax credits (MTCs) as provided under the Act are not subject to ‘sequester’ under the provisions of federal budget legislation. The announcement reversed the prior Office of Management and Budget (OMB) decision to sequester all MTC refunds, as communicated by the IRS in March 2018. Taxpayers now may expect full payment of MTC refund claims filed under the provisions of Section 53(e) as enacted under the Act.

3. Gross transportation income taxes

Foreign corporations and nonresident alien individuals are subject to a yearly 4% tax on their US-source gross transportation income, which has an exception for certain income treated as effectively connected with a US trade or business. Transportation income is any income derived from, or in connection with, either:

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

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

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

4. Base erosion and anti-abuse tax (BEAT)

The ‘base erosion and anti-abuse tax’ (BEAT) was enacted by the Act as Section 59A of the Internal Revenue Code. The Act targeted US tax-base erosion by imposing an alternative minimum corporate tax liability on corporations (other than RICs, REITs, or S corporations) that, together with their affiliates, have average annual gross receipts for the three-year period ending with the preceding tax year of at least \$500 million and that make certain base-eroding payments to related foreign persons during the tax year that constitute 3% (2% for certain banks and securities dealers) or more of all their deductible expenses apart from certain exceptions. The most notable of these exceptions are the net operating loss (NOL) deduction, the new dividends received deduction for foreign-source dividends, the new deduction for foreign-derived intangible income (FDII) and the deduction relating to the global intangible low-taxed income (GILTI), qualified derivative payments defined in the provision, and certain payments for services.

The BEAT is imposed to the extent that 10% of the taxpayer’s ‘modified taxable income’ generally, US taxable income determined without regard to any base erosion tax benefit or the base erosion percentage of the NOL deduction exceeds the taxpayer’s regular tax liability net of most tax credits. (For certain banks and securities dealers, the percentage is 11%.)

A base erosion payment generally is any amount paid or accrued by the taxpayer to a related foreign person with respect to which a deduction is allowable or that is in connection with the acquisition of property subject to depreciation or amortization, or for reinsurance payments. The category also includes certain payments to certain entities treated as ‘surrogate foreign corporations’ or entities related to them under the anti-inversion rules of Section 7874.

Final regulations were issued on December 2, 2019. They address the mechanics of determining, among other things, the applicable taxpayer status, a taxpayer’s base erosion percentage, and a taxpayer’s modified taxable income. They also address the application of the BEAT rules to certain partnerships, banks, registered securities dealers, insurance companies, and consolidated groups, and provide an anti-abuse rule that generally disregards certain transactions undertaken with a principal purpose of avoiding the BEAT rules.

Proposed regulations were also issued on December 2, 2019. They provide additional guidance on determining the aggregate group, allow taxpayers an election to waive deductions for purposes of calculating their base erosion percentage, and provide certain rules applicable to partnerships.

The BEAT provision is effective for base erosion payments paid or accrued in tax years beginning after December 31, 2017. For tax years beginning after December 31, 2025, the percentage of modified taxable income that is compared against the regular tax liability increases to 12.5% (13.5% for certain banks and securities dealers) and allows all credits to be applied in determining the US corporation’s regular tax liability. Special rules apply for banks and insurance companies.

Tax readiness insight: Since the BEAT tax rate is significantly lower than the regular corporate tax rate and the BEAT is imposed only to the extent it exceeds regular tax liability, taxpayers without significant amounts of base erosion tax benefits in many cases would not be subject to any additional tax under the BEAT. However, because the regular tax liability to which the BEAT tax liability is compared is computed after reduction for tax credits other than those specifically added back, a taxpayer whose taxes are significantly reduced through tax credits (e.g., a US shareholder with significant amounts of foreign tax credits associated with subpart F, GILTI, or foreign-source income) could be subject to tax under the BEAT even when the taxpayer does not have significant amounts of base erosion payments.

Tax readiness insight: Some observers have questioned whether the BEAT provision may conflict with US tax treaties. This provision, which is restricted to payments made to related foreign parties, is an example of the potential tension between certain provisions in the Act and US tax treaty obligations.

B. Other federal taxes

1. Sales taxes

The United States does not impose a federal sales tax, value-added tax (VAT), or federal goods and services tax (GST).

Inbound insight: The United States is one of the few countries that does not have a federal indirect sales tax or VAT/GST. This deviation from the global norm requires additional communication and business performance analysis for senior management of non-US parent companies, who are more familiar with doing business in territories with a VAT/GST system. Inbound companies should be made aware that in the United States indirect taxes can be levied at both the state and local levels.

For sales taxes, there are over 13,000 state and local taxing jurisdictions. But when one accounts for other state and local indirect taxes in addition to sales taxes (e.g., telecommunications taxes), there could be more than 48,000 separate state and local tax levies. The local jurisdictions in a state also could have different indirect tax rules from the state in which the city is located (e.g., the state of Colorado's rules differ from those of many local jurisdictions within Colorado).

The states generally impose a sales tax collection and remission liability on a seller once a minimum threshold is met with respect to either the number of sales transactions into or within a state or the dollar amount of sales into or within a state.

Liability for state and local sales taxes was governed by a physical presence nexus standard prior to the US Supreme Court's decision in *South Dakota v. Wayfair* (June 21, 2018). That decision voided the physical presence nexus standard and upheld South Dakota's statutory nexus standard of delivery into the state of more than \$100,000 of sales or 200 or more transactions. Since the decision, most states that impose sales taxes have adopted similar standards.

2. Customs duties and import tariffs

a. Introduction

The US framework of customs duties and import tariffs is extremely important to US Inbound companies. Not only can duty/tariff rates have a significant impact on the supply-chain costs of US operations, but changes in compliance requirements also can as well.

In addition to these more granular changes described above, recent developments in US trade policy also may have a significant impact on US inbound and global supply chains from cost and security perspectives. Further, US customs and export control rules can affect how US inbounds conduct business globally when their US entity is a party to the transactions and must comply with new, stricter compliance requirements.

The past year has seen important developments on the trade front. These include US ratification of the United States-Mexico-Canada Agreement (the replacement for the North American Free Trade Agreement); the US-China agreement on a 'phase one' trade deal; US responses to EU digital services tax proposals as well as a major win for the United States in a WTO challenge to subsidies paid by some EU Member States to certain manufacturers; significant changes to steel and aluminum tariffs; and termination of preferential status of India and Turkey under the Generalized System of Preference (GSP) program. US inbound companies also have needed to monitor any potential impacts arising from the departure of the UK from the EU.

On top of those developments, since February, US inbound companies also have had to manage substantial disruptions to their supply chains and distribution channels due to COVID-19. Some targeted customs relief has been established for companies on the front lines of the fight against COVID-19, such as the recent grant by the United States Trade Representative (USTR) of multiple exclusions from Section 301 tariffs on Chinese-origin medical supply products. Additionally, the White House on April 18, 2020, issued an executive order granting a temporary 90-day deferral on ordinary duty (excluding Sections 232 and 301) payment obligations to relieve cash pressures on US importers.

Inbound Insight: The bottom line is that it is imperative for US inbound companies to be agile and stay informed to make the right decisions regarding their trade activity; to keep their supply chains cost-efficient and flexible; to improve the efficiency of their regional operations; and to keep their overall operating strategy in line with the needs of customers in today's complex and fluid trade environment.

b. The US framework

All goods imported into the United States are subject to customs entry requirements. US law requires the importer or its legal agent to file with US Customs and Border Protection (Customs) the declared value, quantity, classification, and origin of the merchandise, and provide information and documentation necessary for Customs to properly assess duties, collect accurate statistics, and determine whether any other applicable requirements apply. Goods imported into the US are dutiable or duty-free in accordance with their classification under the applicable subheading of the Harmonized Tariff Schedule of the US. The tariff classification also identifies eligibility for special programs and free-trade agreement preferences.

When goods are dutiable on an 'ordinary' basis, *ad valorem*, specific, or compound duties may be assessed. *Ad valorem* duties – the type most often applied – are based on a percentage of the value of the merchandise, such as 7% *ad valorem*. A specific duty is assessed at a specified amount per unit of measure (weight or quantity), such as 6.8 cents per dozen. A compound duty is a combination of both a specific rate and an *ad valorem* rate, such as 0.8 cents per kilo plus 8% *ad valorem*. In addition to ordinary duties, the President has authority under US law to impose tariffs on select products and for specified time periods in response to specific conditions (e.g., to address national security concerns). In such cases, these tariffs are assessed in addition to the ordinary duties.)

Inbound insight: Consistently increasing global trade tensions have resulted in an unprecedented implementation of tariff frameworks affected a broad scope of products imported into the US from myriad origins. Companies should take caution in the current environment and consider the impact of punitive tariffs in their inbound supply chains.

In addition to *ad valorem*, specific, or compound duties and potential tariffs, other fees typically are assessed in connection with the importation of merchandise in the United States. Two of the most common fees are the Merchandise Processing Fee (MPF) and the Harbor Maintenance Fee (HMF), both assessed *ad valorem*. MPF is assessed at 0.3464% of the dutiable value of the imported merchandise with a minimum fee of \$26.79 and a maximum fee of \$519.76 per entry (i.e., import transaction), while HMF is calculated at 0.125% of the dutiable value of imported merchandise vessel shipments arriving through identified ports. While exceptions apply to MPF assessments, there generally are no exceptions from HMF for commercial import transactions.

In cases where imported merchandise subsequently is exported (whether in the same condition as imported or as an input in the US production of another product) or destroyed within a period of five years, importers may be able to obtain refunds on up to 99% of the duties and fees paid upon importation through Duty Drawback. In addition to the ordinary duties and fees eligible for refund, certain tariffs also may be eligible for Duty Drawback.

As applicable, duties, tariffs, and fees are assessed based on the value that is declared for the imported merchandise at the time of importation (i.e., customs value). US customs law requires that the value of the goods be properly declared, regardless of the dutiable status of the merchandise. Customs value generally is based on the price paid by the importer when purchasing the foreign merchandise for export to the United States. When imports result from a transaction between related parties, the price paid to a related entity may serve as the basis of customs value, provided it can be demonstrated that the relationship did not affect the price.

Liability for the payment of duty, tariffs, and other customs fees becomes fixed at the time an entry is filed with Customs, although the amount of duty owed may change subsequently if any of the information declared on entry is later determined to be inaccurate. The obligation for payment falls on the entity in whose name the entry is filed, the 'importer of record.' The importer of record has a legal obligation to exercise reasonable care, as defined under US customs regulations, in all aspects of its importing activity.

Inbound insight: Foreign companies operating in the current trade environment are more likely to experience increased risks and customs-driven costs in their inbound supply chains. Developing a strategic understanding of US-specific customs risk management practices and opportunities to reduce the costs of importation is essential to successful inbound operations.

3. Excise taxes

The US government imposes excise taxes (including retail excise taxes) on a wide range of goods and activities, including air transportation of persons and property, gasoline and diesel fuel used for transportation, wagering, foreign insurance, and manufacturing of specified goods (e.g., certain sporting goods, firearms and ammunition, vaccines, alcohol, and tobacco), as well as retail sales of other specific goods (e.g., heavy trucks and trailers). The excise tax rates are as varied as the goods and activities on which they are levied. For example, a federal excise tax of 7.5% is levied on domestic commercial air passenger transportation, whereas the federal excise tax imposed on motor fuel generally is 18.3 cents per gallon of gasoline and 24.3 cents per gallon of diesel fuel. Many states and cities also impose their own excise taxes on certain goods and activities.

4. Stamp taxes

There is no federal-level stamp tax; however, state and local governments frequently impose stamp taxes at the time of officially recording a real estate or other transaction. In many state and local jurisdictions, this is also referred to as a real property transfer tax. The state or local transfer tax on real estate generally is imposed on the recording of the transfer of the transferred deed. In some states, the transfer tax also is imposed on the transfer of a controlling interest in an entity that owns real property.

5. Capital gain taxes

The corporate tax rate on long-term capital gains currently is the same as the tax rates applicable to a corporation's ordinary income. (By contrast, individuals may be eligible for a lower rate on long-term capital gain than on short-term capital gain or ordinary income.)

6. Accumulated earnings tax

Corporations (other than S corporations, domestic and foreign personal holding companies, corporations exempt from tax under Subchapter F of the Internal Revenue Code, and passive foreign investment companies) accumulating earnings and profits for the purpose of avoiding shareholder personal income tax are subject to a penalty tax in addition to any other tax that may be applicable. The accumulated earnings tax equals 20% of 'accumulated taxable income.' Generally, accumulated taxable income is the excess of taxable income with certain adjustments, including a deduction for regular income taxes, over the dividends paid deduction and the accumulated earnings credit. Note that a corporation may be able to justify the accumulation of income, and avoid tax, based on its reasonable business needs.

Inbound insight: The IRS in Chief Counsel Advice (CCA) 201653017 concluded that the taxpayer was a 'mere holding or investment company' and therefore subject to the accumulated earnings tax. The IRS further concluded that the taxpayer remained subject to the tax even though it lacked the liquidity needed to make distributions

to its shareholder. This CCA serves as an important reminder that the accumulated earnings tax continues to be an issue raised by revenue agents during audits. The foreign parent of an inbound should be prepared to respond to questions related to the tax, especially those related to operations and reasonable needs of the business. In advance of an audit, companies should determine whether they are operating an active trade or business, or merely a holding or investment company. If operating an active trade or business, companies should have a documented plan that outlines how any accumulated E&P will be used to provide for the reasonable needs of the business. Companies also should review their criteria for making dividend distributions, as well as their history of dividend distributions.

7. Personal holding company tax

US corporations and certain foreign corporations that receive substantial ‘passive income’ and are ‘closely held’ may be subject to personal holding company tax. The personal holding company tax, which is levied in addition to the regular tax, is 20% of undistributed personal holding company income.

8. Payroll taxes affecting employers

Compensation paid to employees for services performed within the United States constitutes wages generally subject to (1) federal income tax withholding, (2) Federal Insurance Contributions Act (FICA) taxes (i.e., social security, Medicare, and Additional Medicare), and (3) the Federal Unemployment (FUTA) tax, unless an exception applies. For employees sent to the United States by their foreign employer, there is a de minimis federal income tax exception for amounts less than \$3,000 and visits of less than 90 days. Also, certain treaty provisions may eliminate the need to withhold income taxes (but generally not the need to report) to the extent requisite documentation is gathered.

Similarly, foreign employers often rely on totalization agreements between the United States and other countries and gather a requisite certificate of coverage, to exempt wages for services performed in the United States from FICA taxes. If such relief is not available, and another exemption does not apply, the foreign employer must withhold social security taxes equal to 6.2% of wages for the employee and pay 6.2% for the employer, up to \$137,700 of wages in 2020, and Medicare taxes equal to 1.45% for the employee and 1.45% for the employer. **Note:** There is no cap on wages subject to Medicare taxes. The employer also must withhold an additional employee-only 0.9% Additional Medicare tax on wages above \$200,000. FUTA tax, imposed on the employer only, is between 0.6% and 6.0% (depending on credits for state unemployment taxes) on the first \$7,000 of wages paid to an employee. See [Appendix B](#) for a list of current US social security totalization agreements.

A foreign employer generally must withhold, make timely deposits, and file quarterly and annual employment tax returns, including Forms 941 and 940, and annual wage statements, including Forms W-2 and W-3, in its name and employer identification number unless such statements are filed by a properly authorized third party.

Inbound insight: Corporate officers or other employees traveling to the United States for only a short period of time may generate employment tax liabilities because their US-source earnings are wages for federal income tax, FICA, and FUTA purposes (including a portion of equity and deferred compensation granted in the foreign country). Wage withholding requirements may apply even if the business traveler employees do not acquire a US social security number. Tracking travel days within the United States and gathering documentation to support exemption of US-source wages from withholding, if applicable, is critical.

In addition, states may impose state income tax, state unemployment tax, workers' compensation insurance tax, and other state-level benefit requirements at varying rates depending on state law and the nature of employees' activities.

The federal supplemental withholding rates, when applicable, remain at 22% on supplemental income below \$1 million in the aggregate and 37% on supplemental income in excess of \$1 million in the aggregate.

9. Environmental tax

Importers, manufacturers, and sellers of ozone-depleting chemicals (ODCs), or imported products manufactured using ODCs, are subject to environmental taxes calculated based on the weight of the ODCs. If the weight of the ODC cannot be determined, the ODC tax is calculated based on the listed product set forth in a table provided by the IRS (such table is provided in the instructions to Form 6627). If the weight cannot be determined, the tax is 1% of the entry value of the product.

The oil spill tax is a per-barrel tax imposed on crude oil received at a US refinery; petroleum products entered into the United States for consumption, use, or warehousing; and domestic crude oil exported from the United States if not previously subject to the oil spill tax. These taxes are reported on Forms 6627 and 720.

C. US trade or business

Generally, a foreign corporation engaged in a US trade or business is taxed on a net basis at regular US corporate tax rates on income from US sources that is effectively connected with that business and also is subject to a 30% branch profits tax on the corporation's effectively connected earnings and profits to the extent treated as repatriated to the home office. The branch tax can be reduced or eliminated under an applicable US tax treaty.

In addition, a foreign corporation is subject to a 30% tax on the gross amount of certain US-source income not effectively connected with that business (see section II.P.1, below, with respect to withholding on certain payments to non-US persons); such 30% tax potentially may be reduced or eliminated under an applicable US tax treaty. (These 30% rates were not changed by the Act.)

There is no definition in the tax statute of the term trade or business within the United States – instead, that concept has been developed mainly by the IRS and court decisions through a facts-and-circumstances analysis. A foreign corporation needs to consider the nature and extent of its economic activities in the United States, either directly or through its agents. The following have been considered to be important factors by the courts and/or the IRS:

- The business must have a profit motive.
- Activities generally must be ‘considerable, continuous, and regular.’
- Ministerial, clerical, or collection-related activities generally are not sufficiently profit-oriented to constitute a US trade or business.
- Isolated activities generally do not rise to the level of a trade or business.

An agent’s activities in the United States may result in a US trade or business.

D. Effectively connected income

If a non-US person has a US trade or business, the question arises as to what income is ‘effectively connected’ to such US trade or business.

All US-source active income earned by a non-US person is treated as effectively connected. Passive-type income and gain from the sale of capital assets are treated as effectively connected to a non-US person’s US trade or business only if a connection with the US trade or business exists. Such a connection exists if the passive-type income or capital gain is derived from assets used in the US trade or business (the asset use test) or if the activities conducted in the US trade or business are a material factor in the production of the passive-type income or capital gain (the business activities test).

Certain types of foreign-source income generated through a US office can be effectively connected income. These include:

- Rents or royalties for use of intangible property outside the United States that are derived in the active conduct of a US trade or business
- Foreign-source dividends or interest derived in active conduct of banking business in the United States, or received by a corporation the principal business of which is trading in stocks or securities for its own account
- Gain from the sale outside the United States of inventory property and property held for sale to customers, when the sale is made through a US office or fixed place of business, unless the property is sold for use outside the United States and a non-US office materially participates in the sale.

Tax readiness insight: The Act added a new provision treating gain derived by a non-US person from the disposition on or after November 27, 2017, of a partnership interest as effectively connected income to the extent the partner would have had effectively connected gain if the partnership had sold all of its assets. The prior law was unclear on

this issue, although the IRS took a position consistent with the provision added by the Act in a ruling that was held to be invalid in a US Tax Court decision, which is being appealed by the IRS. The Act also imposes withholding (on transfers after December 31, 2017) equal to 10% of the amount realized by the partner on the disposition of a partnership interest; in the event the buyer fails to withhold the tax, the partnership must withhold on distributions to the buyer to satisfy the withholding obligation. On December 29, 2017, the IRS temporarily suspended the withholding requirement for dispositions of publicly traded partnerships and on April 2, 2018, the IRS temporarily suspended the withholding requirement on a partnership if the buyer fails to withhold the tax.

1. New sourcing rule for certain inventory sales

The Act modifies Section 863(b) with respect to income, profits, and gain from the sale of inventory produced by the taxpayer by sourcing such amounts entirely to the place of production rather than by reference to the location of production and sales, effective for tax years beginning after 2017.

Tax readiness insight: The provision is included in the portion of the Act that addresses the foreign tax credit. Its principal effect is to treat all income from the sale of inventory manufactured in the United States as domestic sourced. However, it also applies to foreign corporations selling into the United States inventory manufactured outside of the United States. Under prior law, 50% of the income from the sale of inventory into the United States ordinarily would be US sourced and, thus, under the limited force of attraction rule, would be taxable as ECI (unless exempted by treaty). As that will no longer be the case under the Act, the situations in which the income from such sales would constitute ECI are narrowed. Recently issued proposed regulations would treat income derived from the sale of foreign produced inventory as US source if the income is considered attributable to a US office.

If the income is attributable to a US office, the proposed regulations generally would treat 50% of the total sales income as allocable to the US office and, therefore, US sourced.

E. Branch income

US tax law imposes a 30% branch profits tax on a foreign corporation's US branch's effectively connected earnings and profits (ECE&P) to the extent they are treated as distributed, based on any decrease in the branch's US net equity for the year. The branch profits tax may be reduced or eliminated under an applicable US tax treaty. The tax does not apply in the year the foreign corporation terminates its US trade or business. The purpose of the branch profits tax is to treat US operations of foreign corporations in a manner similar to US corporations owned by foreign persons – that is, it is a proxy for the US tax on dividends paid by a US subsidiary to a foreign person.

With certain exceptions, a 30% (or lower treaty rate) branch-level interest tax is imposed on interest treated as paid by a US branch to foreign lenders. This applies both to interest paid by the branch and to a portion of the interest paid by the home office to the extent taken into account in determining the corporation's tax on effectively connected income.

F. Elective entity classification ('check-the-box')

For US federal income tax purposes, the Internal Revenue Code and the Treasury regulations prescribe the classifications of business entities and organizations. Whether an organization is an entity separate from its owners for US federal income tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

Inbound insight: The LLC is a popular form of business entity organization in the United States because of the limited liability for owners, as determined under state law, as well as flexibility under the 'check-the-box' regulations. That is, a US LLC has the default classification of either a disregarded entity or partnership (depending on the number of owners), but is eligible to make an entity classification election to change from the default classification to the classification of corporation for US income tax purposes.

A business entity with two or more members is classified for US federal income tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded. If the entity is disregarded, its activities are treated in the same manner as a branch, division, or sole proprietorship. An entity formed as a corporation under US state law is treated 'per se' as a corporation and cannot elect transparent status.

The initial classification of a business entity depends on the prescribed default classification. The default classification is based on several factors, including whether the entity is domestic (organized or incorporated in the United States) or foreign (not organized or incorporated in the United States).

With respect to foreign entities, the regulations deem certain entities as 'per se' corporations. 'Per se' corporations must retain the default classification of corporation and may not elect classification as a partnership or disregarded entity. Any other foreign entity generally has the default classification of corporation if all owners have limited liability, or the default classification of partnership (or disregarded entity) if one or more owners has unlimited liability.

An eligible foreign entity that is not classified as a 'per se' corporation may elect a classification that departs from the default classification. The election is subject to specific procedural rules and is made by filing Form 8832, *Entity Classification Election*, with the IRS.

G. Permanent establishment (PE)

A PE generally means:

- There is a fixed place of business in the source state through which the business of an enterprise is wholly or partly carried on, or
- A dependent agent acting on behalf of the enterprise that has and habitually exercises in the source state the authority to conclude contracts binding on the enterprise (a deemed PE).

Other rules and exceptions also apply. This is a very factual determination that requires a full understanding of a company's particular facts and circumstances. [Read more about US tax treaties.](#)

Inbound insight: In certain circumstances, foreign businesses may consider making protective filings with the IRS related to their exposure to taxation in the United States (including protection of the right to claim deductions and credits). A protective return also starts the running of the statute of limitations on the right of the IRS to assess taxes. This option should be analyzed carefully to determine the circumstances when it should be considered.

Inbound insight: The 2016 US Model Income Tax Treaty did not adopt the proposed broadening of the definition of a PE included as an option by the OECD as a result of BEPS and incorporated into the 2017 OECD Model Convention and Commentary, other than an anti-abuse rule relating to the splitting up of contracts under which a PE is determined based on the length of presence in the host jurisdiction. Residents of any country that is considering negotiating or renegotiating an income tax treaty with the United States should closely monitor the status of negotiations and analyze the availability of potential benefits under a treaty that incorporates the 2016 US Model's provisions.

H. Group taxation

An affiliated group of US 'includible' corporations, consisting of a US parent and its US subsidiaries directly or indirectly 80% owned, generally may offset the profits of one affiliate against the losses of another affiliate within the group by electing to file a consolidated federal income tax return.

A foreign incorporated subsidiary may not be consolidated into the US group, except for (i) certain Mexican and Canadian incorporated entities, (ii) certain foreign insurance companies that elect to be treated as domestic corporations, and (iii) certain foreign corporations that are considered 'expatriated' under the so-called 'anti-inversion' rules and are thus deemed to be domestic for income tax purposes. A partnership may not be included in a consolidated return, even if it is 100% owned by members of an affiliated group, since a partnership is not a corporation. However, a member's earnings that flow through from a partnership are included as part of the consolidated group's taxable income or loss.

Filing on a consolidated (combined) basis also is allowed (or may be required or prohibited) under the tax laws of certain states.

Sales, dividends, and other transactions between corporations that are members of the same consolidated-return group generally are deferred or eliminated until such time as a transaction occurs with a non-member of the group. Losses incurred on the sale of stock of group members are disallowed under certain circumstances.

I. Transfer pricing

Transfer pricing regulations govern how related entities set internal prices for the transfers of goods, intangible assets, services, and loans in both domestic and international contexts. The regulations are designed to prevent tax avoidance among related entities and place a controlled taxpayer on par with an uncontrolled taxpayer by requiring inter-company prices to meet the arm's-length standard.

The arm's-length standard generally is met if the results of a controlled transaction are consistent with results that would have been realized if uncontrolled taxpayers had engaged in a similar transaction under similar circumstances. If a company is not in compliance with the arm's-length standard, the IRS may adjust taxable income and tax payable in the United States. After a transfer pricing adjustment, a multinational company may face potential double tax, paying tax on the same income in two countries. If the related party to the adjustment is in a country that has a tax treaty with the United States, multinational companies may request 'competent authority' relief from double taxation and there may be arbitration provisions.

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

Inbound insight: The IRS currently is devoting more resources to auditing inbound companies with a specific focus on intangible and financing transactions and on permanent establishments. These developments place an increased emphasis on inbound companies being able to demonstrate results consistent with the arm's-length standard. They also serve as a reminder for an inbound company to revisit its intercompany pricing policies and intercompany agreements to analyze whether those policies and the terms of those agreements are consistent with how the company actually operates its business in the United States.

Inbound insight: In 2016, rules went into effect in many foreign jurisdictions that require companies to submit master file, local file, and country-by-country documentation under OECD Action 13/Chapter V of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the Transfer Pricing Guidelines). By the end of 2017, many US inbound companies were required to file these reports in relevant jurisdictions. By the end of 2019, the United States was not able to negotiate competent authority agreements for the exchange of country-by-country reports with several jurisdictions. As a result, many companies had to act quickly to achieve compliance with local filing requirements. As governments continue to receive information at the local level and through treaty and exchange mechanisms, companies should expect increased controversy and scrutiny of their intercompany transactions and value chains because of these disclosures.

J. Limitation on deduction for interest expense

The prior-law earnings stripping rules were replaced under the Act by a set of rules under which the deduction of business interest expense is limited essentially to the taxpayer's business interest income plus 30% of the taxpayer's 'adjusted taxable income.' These rules, including changes made by the CARES Act, are described in section *II.M.18* below.

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

K. Controlled foreign corporations (CFCs)

Under the subpart F regime of the Internal Revenue Code, a CFC is any foreign corporation with respect to which US shareholders own more than 50% of either the voting power of all classes of stock entitled to vote or the total value of the corporation's stock on any day during the foreign corporation's tax year. For these purposes, a US shareholder is any US person owning (directly, indirectly through foreign intermediaries, or constructively) 10% or more of the total value of shares of all classes of stock or of the total combined voting power of all classes of stock entitled to vote of a foreign corporation. (The Act added the value threshold to the definition.)

Inbound insight: The acquisition of a US business by a foreign acquirer can result in both foreign ownership above the US business and CFCs underneath the US business. Particular care should be taken in dealing with the complex issues that can arise in this circumstance.

L. S corporations

Corporations with 100 or fewer shareholders, none of whom may be corporations or partnerships, that meet certain other requirements may elect to be taxed under Subchapter S of the Internal Revenue Code and thus are known as S corporations. S corporations are taxed in a manner similar, but not identical, to partnerships. That is, all tax items, such as income and deductions, flow through to the owners of the entity. Thus, S corporations generally are not subject to US federal income tax at the corporate level.

Inbound insight: Only US citizens, resident aliens, certain trusts, and tax-exempt entities may be shareholders of an S corporation. Because of this requirement and the requirement that S corporation shareholders cannot be corporations or partnerships, S corporations generally are not a form of business organization available to inbound companies. An inbound investor is permitted to invest in an existing S corporation's business by forming a partnership structure with the S corporation.

M. Determining income

1. Inventory valuation

Inventories generally are stated at the lower of cost or market on a first-in, first-out (FIFO) basis. Last-in, first-out (LIFO) may be elected for tax purposes on a cost basis only and, if elected, also must be used in financial reports issued to shareholders and creditors.

US tax law requires capitalization for tax purposes of several costs allocable to property produced and property acquired for resale, including costs that frequently are expensed as current operating costs for financial reporting (e.g., cost variances) and differences between book and tax costs (i.e., the excess of tax depreciation over financial statement depreciation).

2. Capital gains or losses

Gains or losses on the sale or exchange of capital assets held for more than 12 months are treated as long-term capital gains or losses. Gains or losses on the sale or exchange of capital assets held for 12 months or less are treated as short-term capital gains or losses.

For corporations, capital losses are allowed only as an offset to capital gains. An excess of capital losses over capital gains in a tax year may be carried back three years and carried forward five years to be used to offset capital gains.

For dispositions of personal property and certain nonresidential real property used in a trade or business, net gains are first taxable as ordinary income to the extent of the previously allowed or allowable depreciation or amortization deductions, with any remainder generally treated as capital gain. For other trade or business real property, net gains generally are taxed as ordinary income to the extent that the depreciation or cost recovery claimed exceeds the straight-line amount, with any remainder treated as capital gain.

An exception to capital gain treatment exists to the extent that losses on business assets were recognized in prior years. A net loss from the sale of business assets is treated as an ordinary loss. Future gains, however, will be treated as ordinary income to the extent of such losses recognized in the five immediately preceding tax years.

For capital loss deductions by individuals, see section VII.F.9.e. below

3. Dividend income

For tax years beginning before January 1, 2018, a US corporation generally may deduct 70% of dividends received from other US corporations in determining taxable income. The dividends-received deduction (DRD) is increased from 70% to 80% if the recipient of the dividend distribution owns at least 20% but less than 80% of the distributing corporation and 100% if the recipient owns 80% or more of the distributing corporation and does not

file a consolidated return with the distributing corporation. Generally, dividend payments between US corporations that are members of a consolidated group are eliminated from gross income. With minor exceptions, a US corporation may not deduct any amount of dividends it receives from a foreign corporation. For tax years beginning after December 31, 2017, the Act reduced the 70% DRD to 50% and the 80% DRD to 65%.

A 100% DRD is provided for the foreign-source portion of dividends received by a US corporation from certain foreign corporations with respect to which it is a US corporate shareholder. The 100% DRD applies to distributions made after December 31, 2017.

4. Stock dividends

A US corporation can distribute a tax-free dividend of common stock proportionately to all common stock shareholders. If the right to elect cash is given, then all distributions to all shareholders are taxable as dividend income whether cash or stock is taken. There are exceptions to these rules, and extreme caution must be observed before making such distributions.

5. Interest income

Interest income generally is includible in the determination of taxable income. **Note:** Interest income affects the Section 163(j) interest deduction limitation discussed below.

6. Rental income

Rental income generally is includible in the determination of taxable income.

7. Royalty income

Royalty income generally is includible in the determination of taxable income.

8. Partnership income

The income (loss) of a partnership passes through to its partners, so that the partnership itself is not subject to tax. Thus, each partner generally includes in taxable income its distributive share of the partnership's taxable income (or loss).

9. Foreign income of US taxpayers

a. Move toward US territorial tax system

Generally, a US corporation is taxed on its worldwide income, including foreign branch income earned and foreign dividends when received. Double taxation is avoided by means of foreign tax credits; alternatively, a deduction may be claimed for actual foreign taxes that are paid.

A major element of the Act is the addition of a 100% deduction (DRD) for the foreign-source portion of dividends received by US corporate shareholders from certain foreign corporations, effective for distributions made after December 31, 2017. Foreign tax credits (and foreign tax deductions) are disallowed for foreign taxes paid on amounts eligible for the abovementioned 100% DRD.

b. Subpart F rules

In the case of CFCs, certain types of undistributed income are taxed currently to certain US shareholders (subpart F income). More specifically, in situations in which a foreign corporation is a CFC, every US shareholder owning at year-end 10% or greater of the total value of shares of all classes of stock or the total combined voting power of all classes of stock entitled to vote of such a foreign corporation (US shareholder) must include in gross income its pro rata share of the subpart F income earned by the CFC, regardless of whether the income is distributed to the US shareholders.

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

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

In situations in which the US shareholder is a domestic corporation, the domestic corporate shareholder may claim a foreign tax credit (discussed below) for CFC-level foreign taxes paid with respect to subpart F income. Furthermore, certain rules track the E&P of a CFC that have been included in the income of US shareholders as subpart F income so that such amounts (known as previously taxed income or PTI) are not taxed again when they are actually distributed to the US shareholders.

c. GILTI

The Act requires a US shareholder to include in income the 'global intangible low-taxed income' (GILTI) of its CFCs, effective for tax years of foreign corporations beginning after 2017. Note: Despite the name, this provision is not limited to low-taxed income from intangible assets. Rather, it applies to the shareholder's pro rata share of the CFC's total net income (apart from certain specified income categories such as subpart F income and income effectively connected with a US trade or business), less a deemed 10% return on the CFC's tangible assets.

The full amount of GILTI is includible in the US shareholder's income, and is then reduced through a 50% deduction in tax years beginning after December 31, 2017, and before January 1, 2026, and a 37.5% deduction in tax years beginning after December 31, 2025. A corporate taxpayer generally also can claim a credit for 80% of the CFC-level foreign taxes associated with GILTI.

Tax readiness insight: The GILTI regime effectively subjects a US shareholder to tax at a reduced rate on its CFCs' combined net income above a routine equity return on tangible depreciable business assets that is not otherwise subject to US tax or specifically excluded. Depending on the extent to which a corporate taxpayer's GILTI is offset by expenses or losses, it may have little or no residual US tax liability with respect to such income if its CFCs overall are subject to tax at a rate of at least 13.125%.

d. PFIC rules

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

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

There are three regimes under the PFIC rules: (i) the excess distribution regime, which is the default regime; (ii) the qualified electing fund (QEF) regime; and (iii) the mark-to-market regime. The latter two regimes are elective and cause the US investor in the PFIC to be either taxed currently on its proportionate share of the PFIC's ordinary earnings and capital gains each year (i.e., the QEF regime) or taxed annually on the increase in value, if any, of the PFIC stock (i.e., the mark-to-market regime). US shareholders generally are subject to special reporting requirements with respect to an investment in a PFIC.

If the US investor does not make either a QEF or mark-to-market election with respect to its PFIC stock, the US investor is subject to taxation under the default, excess distribution regime. Under this regime, 'excess distributions' are subject to special tax and interest charge rules. If a PFIC makes an actual distribution, the distribution generally will be treated as an excess distribution to the extent it exceeds 125% of the average of the distributions made with respect to the stock over the three immediately preceding years (or the US person's actual or deemed holding period, if shorter). Furthermore, gains on dispositions of PFIC stock generally are treated as excess distributions.

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

The special tax amounts for prior PFIC years also are subject to an interest charge, which is designed to eliminate the benefit of the tax deferral that arises out of having an overseas investment for which no current US income taxes are paid. Finally, PFICs can be owned indirectly through other entities, including other PFICs, under ownership attribution rules.

Dividends from PFICs do not qualify for the 100% DRD when received by US corporate taxpayers or for the reduced rate of taxation on qualified dividend income when received by US individual taxpayers.

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

Inbound insight: Given the different tax consequences under each regime, it is important that a US investor in a foreign corporation identify whether the foreign corporation is a PFIC in order to timely determine whether one of the elections should be made.

10. Dispositions of interests in US real property by non-US persons (FIRPTA)

In general, under the FIRPTA rules — which derive their name from the legislation that added them to US tax law, the Foreign Investment in Real Property Tax Act of 1980 — gain or loss from the disposition by a foreign person of a US real property interest (USRPI) is treated as if the gain or loss were effectively connected to the conduct of a US trade or business and, accordingly, is subject to US income tax under normal graduated tax rates, plus, in the case of a corporate taxpayer, a potential branch profits tax equal to 30% of the effectively connected earnings and profits, to the extent treated as if repatriated from the US. Withholding of tax generally is required on any disposition of a USRPI.

A USRPI includes any interest, other than an interest solely as creditor, in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the US Virgin Islands. The term 'real property' includes: (1) land and unsevered natural products of the land; (2) improvements; (3) personal property associated with the use of real property; and (4) an interest in a partnership to the extent the partnership holds USRPIs. In addition to a direct interest in US real property, a USRPI includes an interest in a domestic corporation if, at any time during the shorter of (1) the period after June 18, 1980, during which the taxpayer held the interest or (2) the five-year period ending on the date of the

disposition of the interest in the corporation, the domestic corporation was a US real property holding company (USRPHC).

In general, a domestic corporation is a USRPHC if the fair market value of its USRPIs equals or exceeds 50% of the fair market value of the sum of (1) its USRPIs, (2) its interests in real property located outside the United States, plus (3) any other of its assets that are used or held for use in a trade or business.

Inbound insight: The FIRPTA rules presume that an interest in a domestic corporation (other than an interest solely as a creditor) is a USRPI and, therefore, its owner is subject to tax upon disposition unless, prior to the disposition of shares in the corporation, the shareholder requests a statement from the corporation that its shares are not USRPIs, the corporation provides the requested statement on a timely basis, and a notice is provided to the IRS containing information with respect to the disposition and attaching the statement. If the presumption is not rebutted, the disposition is subject to the FIRPTA rules regarding reporting and withholding.

N. Corporate deductions

1. Depreciation and amortization

Depreciation deductions are allowances that may be taken for capital outlays for tangible property. For tangible property placed in service after 1986, capital costs must be recovered by using the modified accelerated cost recovery system (MACRS) method. Depending on the type of property, the general cost recovery periods are 3, 5, 7, 10, 15, 20, 27.5, and 39 years (31.5 years for nonresidential real property placed in service before May 13, 1993). The cost recovery methods and periods are the same for both new and used property. Most tangible personal property falls in the three-, five-, or seven-year class.

Property placed in the three-, five-, seven-, or 10- year class generally is depreciated by first applying the 200% declining-balance method and then switching to the straight-line method when use of the straight-line method results in a larger depreciation deduction than the 200% declining-balance method. Property in the 15- or 20-year class generally is depreciated by using the 150% declining-balance method and later switching to the straight-line method.

Residential rental property generally is depreciated by using the straight-line method over 27.5 years. Nonresidential real property generally is depreciated by using the straight-line method over 39 years (31.5 years for property placed in service before May 13, 1993).

An election may be made to use the alternative depreciation system (basically, the straight-line method over generally longer prescribed lives). An election to use the straight-line method over the regular recovery period is also available for property subject to the 200% or 150% declining-balance method. Alternatively, taxpayers may elect to use the 150% declining-balance method over the regular recovery period, rather than the 200% declining-balance method, for all property other than real property.

The 150% declining-balance method is required for AMT purposes. However, as noted above, corporate AMT is repealed for tax years beginning after December 31, 2017.

Special rules apply to automobiles and certain other 'listed' property. Accelerated depreciation deductions can be claimed only if the automobile is used 50% or more for qualified business use as defined in related regulations. Further, for automobiles placed in service after 1986, the allowable yearly depreciation deduction cannot exceed specific dollar limitations.

Separate methods and periods of cost recovery are specified by statute and IRS guidance for certain tangible personal and real property used outside the United States (under the alternative depreciation system).

Rapid amortization may be allowable for certain pollution control facilities.

Tax depreciation generally does not conform to book depreciation. Further, tax depreciation generally is subject to recapture on the sale or disposition of certain property, to the extent of gain, which is subject to tax as ordinary income.

The cost of most intangible assets is capitalized and amortized ratably over 15 years.

Inbound insight: Companies with a large amount of fixed assets can benefit from careful analysis of current depreciation methods for regular tax and E&P purposes. Proper classification of assets and the application of the correct recovery periods can have a substantial impact on current-year taxable income and E&P.

CARES Act update: The CARES Act makes a technical correction to the Act to provide a 15-year recovery period for qualified improvement property (QIP). This technical correction would make QIP placed in service after December 31, 2017, eligible for bonus depreciation. This technical correction is effective as if enacted as part of the Act.

2. Section 179 deduction

Corporations can elect to expense, up to a specified statutory amount per year, the cost of certain eligible property used in the active conduct of a trade or business, subject to a taxable income limitation and to a phase-out of the deduction based on total capital spend. This is commonly referred to as the Section 179 deduction. What constitutes property eligible for the Section 179 deduction is very broad. It generally means any tangible property or computer software that is 'Section 1245 property' (i.e., property that has been or could have been subject to depreciation or amortization) acquired by purchase for use in the active conduct of a trade or business.

Varying amounts and thresholds applied to tax years beginning before January 1, 2018.

For property placed in service in tax years beginning after December 31, 2017, the Act increased the dollar limitation to \$1 million, while increasing the cost of property subject to the phase-out to \$2.5 million. The new dollar limitations are indexed for inflation for tax years beginning after December 31, 2018.

3. Bonus depreciation

A 50% special first-year depreciation allowance (i.e., ‘bonus’ depreciation) applies (unless an election out is made) for new (i.e., property with respect to which the original use begins with the taxpayer) MACRS property with a recovery period of 20 years or less, certain computer software, water utility property, and certain improvements to leased or owned real property acquired after December 31, 2007 (but before September 28, 2017), and placed in service before December 31, 2017 (December 31, 2018, for certain aircraft and longer production period property).

For property acquired before September 28, 2017, and placed in service during 2018 (2019, for certain aircraft and longer production period property), the bonus depreciation percentage is reduced to 40%. For property acquired before September 28, 2017, and placed in service during 2019 (2020, for certain aircraft and longer production period property), the bonus depreciation percentage is reduced to 30%. Thereafter, bonus depreciation no longer will be available for property acquired before September 28, 2017.

The special allowance applies for regular income tax and AMT purposes. No AMT adjustment is made if the special allowance is used. The special allowance does not apply to property that must be depreciated using the alternative depreciation system or to ‘listed property’ not used predominantly for business. The special allowance reduces basis before regular depreciation is figured. Claiming bonus depreciation on automobiles also may affect the first-year depreciation limits on such automobiles.

The Act replaced 50% bonus depreciation with 100% bonus depreciation and expanded the property eligible for such benefit by repealing the original-use requirement for certain property and including certain film, television, and live theatrical production property as qualified property. Thus, for certain new and used property acquired and placed in service after September 27, 2017, and before January 1, 2023 (January 1, 2024, for certain aircraft and longer production period property), taxpayers may expense immediately the entire cost of such property. For qualified property placed in service in calendar years 2023, 2024, 2025, and 2026 (2024, 2025, 2026, and 2027 for certain aircraft and longer production period property), 100% is reduced to 80%, 60%, 40%, and 20%, respectively.

4. Depletion

For natural resource properties other than timber and certain oil and gas properties, depletion may be computed on a cost or a percentage basis.

Cost depletion is a method of depletion applied to exhaustible natural resources, including timber, which is based on the adjusted basis of the property. Each year, the adjusted basis of the property is reduced, but not below zero, by the amount of depletion calculated for that year. The current-year cost depletion deduction is based on an estimate of the number of units that make up the deposit and the number of units extracted and sold during the year.

Percentage depletion is a method of depletion applied to most minerals and geothermal deposits, and, to a more limited extent, oil and gas. Percentage depletion is deductible at rates varying from 5% to 22% of gross income, depending on the mineral and certain other conditions. Percentage depletion may be deducted even after the total depletion deductions have exceeded the cost basis. However, percentage depletion is limited to 50% (100% for oil and gas properties) of taxable income from the property (computed without allowance for depletion). Generally, percentage depletion is not available for oil or gas wells; exceptions exist for natural gas from geopressurized brine and for independent producers of oil and gas.

5. Goodwill

The cost of goodwill generally is capitalized and amortized ratably over 15 years, beginning in the month the goodwill is acquired.

6. Start-up expenses

Generally, start-up expenditures must be amortized over a 15-year period beginning in the month in which the active trade or business begins; however, certain taxpayers may elect to deduct some expenses in the tax year in which the trade or business begins.

7. US manufacturing deduction

For tax years beginning before January 1, 2018, Section 199 generally provides taxpayers with a 9% deduction for qualified production activities (QPA) income (subject to a taxable income limitation). The deduction is available to all taxpayers actively engaged in QPA. For most corporate taxpayers, the deduction generally will mean a federal income tax rate of 31.85% on QPA income, although certain oil- and gas-related QPA receive a less generous reduction that equates to a federal income tax rate of 32.9% for tax years beginning before January 1, 2018. The deduction also applies in calculating the AMT.

There is a limit on the amount of the deduction equal to 50% of W-2 wages allocable to domestic production gross receipts (DPGR). The deduction generally is not allowed for taxpayers that incur a loss from their production activities or have an overall loss (including a carryover loss) from all activities.

A taxpayer's QPA income is calculated using the following formula: DPGR less the sum of cost of goods sold allocable to such receipts and other expenses, losses, or deductions that are properly allocable to such receipts.

Inbound insight: The Section 199 deduction applied to a variety of US domestic production activities, including the production of tangible personal property, qualified films, the construction of real property, and the development of computer software. Because the Section 199 deduction was a permanent deduction, overlooked deductions generally can be claimed on an amended federal income tax return.

The Act repealed Section 199 for tax years beginning after December 31, 2017.

8. Bad debt

Bad debt resulting from a trade or business may be deducted in the year the debt becomes wholly or partially worthless. Determining the date the debt becomes worthless may present difficulty.

9. Charitable contributions

Deductions for allowable charitable contributions may not exceed 10% of a corporation's taxable income computed without regard to certain deductions, including charitable contributions themselves. Deductions for contributions so limited may be carried over to the five succeeding years, subject to the 10% limitation annually.

CARES Act update: The CARES Act increased the 10% limit to 25% for the 2020 tax year. The CARES Act increased the limitation on certain charitable contributions of food inventory from 15% to 25% for the 2020 tax year.

10. Employee retirement plans

The Internal Revenue Code provides incentives for employers to provide retirement benefits to workers, including employee pension, profit-sharing, and stock bonus plans. The employer is allowed a current deduction up to certain limits for contributions made to fund the retirement benefits and pay plan expenses; an employee's tax liability is deferred until the benefits are paid.

These programs are subject to the Employee Retirement Income Security Act of 1974 (ERISA), which governs eligibility, vesting, spousal rights, fiduciary duties, reporting and disclosure, and other related issues, as well as to the extensive requirements for tax qualification under the Internal Revenue Code. Qualified retirement plans must not discriminate in favor of highly compensated employees, and are subject to additional rules regarding eligibility, vesting, benefit accrual, funding, spousal rights, and fiduciary duties.

For-profit, non-government employers generally have two types of available plans. The first category is the defined benefit plan under which employees earn a right to a retirement benefit based on their years of service and compensation and/or other factors, payable beginning at their retirement and generally continuing for life. The employer contributes on an on-going basis to pre-fund the amount of retirement income that ultimately will be owed to employees under the plan. Any investment gains or losses will not affect the amount of benefits paid to participants but will affect the amount an employer must contribute to cover its obligation.

The second category is the defined contribution plan, including the commonly offered '401(k) plan' and profit-sharing plans, under which employees' benefits are based on the value of their individual accounts. The employer's contributions (if any) are allocated among the separate accounts of participating employees. Investment gains or losses and the history of contributions will affect the value of a participant's account at retirement but will not affect an employer's contributions because the employer is not obligated to ensure any

specified level of benefit in the plan. A 401(k) plan also provides employees a pre-tax means of saving for their own retirement, and permits the employer to match these contributions.

Non-profit employers, including charities and government entities, may offer similar retirement plans, although some different requirements apply. Small employers and self-employed individuals also have similar options available but may be subject to different requirements.

Inbound insight: The rules applicable to employee benefit plans, in terms of application to both a US business and its employees, can create particular complexity for businesses with non-US parent companies. This is often due to the interaction between the employee benefit plans at the parent company and the US business, as well as the movement of employees into and out of the United States for varying periods.

11. Fines and penalties

No deduction generally is allowed for fines or penalties paid to the government for violation of any law for amounts paid or incurred before the enactment date of the Act (i.e., before December 22, 2017).

For amounts paid or incurred on or after December 22, 2017, all payments to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law are nondeductible, unless such payments constitute restitution or are paid to come into compliance with the law and are identified as such in the underlying court order or settlement agreement.

12. Bribes, kickbacks, and illegal payments

An amount paid, directly or indirectly, to any person that is a bribe, kickback, or other illegal payment is not deductible.

13. Taxes

State and municipal taxes imposed on businesses are deductible expenses for federal income tax purposes. **Note:** Individual taxpayers, unlike corporations, are subject to a limitation of \$10,000 on the deduction for state and local taxes. See section VII.F.9.a. below.

14. Research or experimental expenditures

For tax years beginning before January 1, 2022, corporations can elect under Section 174 to expense all research and experimental (R&E) expenditures that are paid or incurred during the tax year or to defer the expenses for 60 months. Taxpayers also can make a special election under Section 59(e) to amortize their research expenditures over 120 months. A portion of the research expenditures may qualify for a research tax credit that is described in section O.5 below.

For tax years beginning after 2021, the Act repealed expensing of Section 174 R&E expenditures, including software development costs, and requires such US based expenditures to be capitalized and amortized over a five-year period, beginning with the midpoint of the tax year in which the specified R&E expenditures were paid or incurred. R&E expenditures that are attributable to research that is conducted outside the United States will have to be capitalized and amortized over a period of 15 years.

Inbound insight: Treating software development costs as R&E expenditures for purposes of Section 174 effectively revokes Rev. Proc. 2000-50 for tax years beginning after 2021. Under Rev. Proc. 2000-50, taxpayers may currently expense certain software development costs. Similarly, the requirement to capitalize R&E expenditures will eliminate the ability of taxpayers to make Section 59(e) elections for R&E expenditures incurred after 2021.

The IRS in July 2014 finalized regulations under Section 174 that are considered taxpayer favorable. The final regulations address several issues related to whether the subsequent sale or use of tangible property created through research is deductible, clarify the depreciable property rule, clarify that integration testing could qualify as an R&E expense, provide a definition of ‘pilot model,’ and introduce the ‘shrink-back’ rule concept to the Section 174 context. The final regulations were not affected by the Act.

15. Net operating losses (NOLs)

An NOL is generated when business deductions exceed gross income in a particular tax year. NOLs generated in tax years ending before January 1, 2018, may be carried back to offset past income and possibly obtain a refund or carried forward to offset future income. Generally, a loss generated in tax years ending before January 1, 2018, may be carried back two years and, if not fully used, carried forward 20 years.

Special rules regarding NOLs generated in tax years ending before January 1, 2018, may apply (1) to specified liability losses or (2) if a taxpayer is located in a qualified disaster area.

Under the Act, NOLs generated in tax years ending after December 31, 2017, generally may not be carried back and must instead be carried forward indefinitely. (For carrybacks and carryforwards of NOLs by individuals, see section VII.F.9.e. below.)

Inbound insight: The conference agreement to the Act indicated that the modifications to the NOL carryback and carryforward rules were intended to apply to tax years beginning after December 31, 2017. Technical correction legislation has been proposed to amend the Act to be consistent with legislative intent. Pending possible enactment of such legislation, fiscal-year taxpayers with NOLs in tax years ending in 2018 will be unable to carry back these losses.

Furthermore, for NOLs generated in tax years beginning after December 31, 2017, the NOL deduction is limited to 80% of taxable income (determined without regard to the deduction).

Complex rules may limit the use of NOLs after a reorganization or other change in corporate ownership. Generally, if the ownership of more than 50% in value of the stock of a loss

corporation changes, a limit is placed on the amount of future income that may be offset by losses carried forward.

CARES Act update: The CARES Act allows an NOL from tax years beginning in 2018, 2019, or 2020 to be carried back for five years. The provision temporarily removes the current-law taxable income limitation to allow an NOL to fully offset income. The provision also makes a retroactive technical correction to the Act to allow NOLs arising in a tax year beginning in 2017 and ending in 2018 to be carried back two years.

An NOL limitation applicable to pass-through businesses and sole proprietors is modified to permit utilization of excess business losses for tax years beginning before January 1, 2021.

The CARES Act provision includes technical corrections to the Act clarifying (1) treatment of excess business losses that are carried forward and treated as part of the taxpayer's NOL, (2) that excess business losses are determined without regard to any deduction under Sections 172 or 199A, and (3) that excess business losses are determined without regard to any deductions, gross income, or gains attributable to any trade or business of performing services as an employee (e.g., wages).

16. Payments to foreign affiliates

Subject to certain limitations, a US corporation generally may claim a deduction for royalties, management service fees, interest charges, and other items paid to foreign affiliates, to the extent the amounts are actually paid and are not in excess of what it would pay an unrelated entity (i.e., they are at arm's length). Timing of the deductions is impacted by a provision adding a matching principle that generally provides that the deduction can only be claimed on payment, rather than when accrued. US tax on the recipient, collected through withholding, of these payments generally is required. Under certain circumstances, however, such payments may give rise to a BEAT liability for the US payor, as discussed above. See also discussion of new hybrid rules further.

17. Premium payments to captive insurance companies

A US corporation generally may claim a deduction for insurance premiums paid, even if the insurance is purchased from an affiliated insurance company (captive insurance company). To be treated as insurance for tax purposes, the insurance arrangement must involve the transfer of insurance risk, result in adequate risk distribution, and meet commonly accepted notions of insurance under US tax principles.

If the captive insurance company is domiciled outside the United States, the premium payments would be subject to an excise tax of 4% on direct premiums (other than for life insurance) and 1% on life insurance and reinsurance premiums. However, the excise tax may be exempt under a tax treaty. A 2016 IRS revenue ruling concluded that the 1% excise tax under Section 4371(3) will not apply to premiums paid for reinsurance policies issued by one foreign reinsurer to another foreign reinsurer even if the underlying risks are US risks. Insurance premiums are not subject to withholding taxes (other than under FATCA).

Note: Consider the impact of the Act on inbound companies with one or more captive insurance structures with respect to both direct and reinsurance business. In particular, the BEAT provisions discussed above may have specific implications for companies making payments to non-US captive insurance companies.

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

Inbound insight: The IRS has identified certain ‘micro’ captive insurance arrangements as ‘transactions of interest.’ This designation imposes additional reporting requirements on businesses engaging in the identified transactions. Penalties may apply for failure to disclose the required information. Businesses considering a captive insurance arrangement should be mindful of reporting requirements and determine whether they may apply.

18. Interest expense deduction limitation: Section 163(j)

Under the Act, Section 163(j) limits US net business interest expense deductions to the sum of business interest income, 30% of ‘adjusted taxable income’ (ATI), and floor plan financing interest of the taxpayer for the tax year, effective for tax years beginning after 2017.

The Section 163(j) interest limitation broadly applies to the ‘business interest’ of any taxpayer (regardless of form) and regardless of whether the taxpayer is part of an ‘inbound’ group or an ‘outbound’ group. Section 163(j) applies regardless of whether the interest payment is to a foreign person or a US person, and regardless of whether such person is related or unrelated. ATI is roughly equivalent to EBITDA until January 1, 2022, when ATI roughly would be equivalent to EBIT. Disallowed business interest expense can be carried forward indefinitely.

CARES Act update: The CARES Act increases the 30% adjusted taxable income limitation to 50% for tax years beginning in 2019 and 2020. For 2019, this provision does not apply to partnerships and instead partners may deduct 50% of their distributive share of the partnership’s excess business interest in 2020 without regard to Section 163(j). The provision also allows a taxpayer (including partnerships) to elect to use its 2019 adjusted taxable income for its 2020 limitation.

On April 2, 2018, Treasury and the IRS released Notice 2018-28, which provided interim guidance with respect to Section 163(j). They then issued proposed regulations on November 23, 2018. The proposed regulations address the mechanics of determining the interest expense limitation and clarify the application of the limitation to consolidated groups, RICs, REITs, partnerships, controlled foreign corporations, and other foreign corporations. Notably, they expand upon (and depart from) the statutory text by introducing a broad new definition of ‘interest’ solely for the purposes of Section 163(j) that includes certain interest equivalents.

Tax readiness insight: The statute is unclear on a number of points, such as with respect to disallowed interest expense carryforwards from prior-law Section 163(j). Some of these points, such as the one related to disallowed interest expense carryforwards from prior-law Section 163(j), were addressed in the proposed regulations. Pursuant to the proposed regulations, such disallowed interest expense carryforwards may be carried forward to the new Section 163(j) regime.

19. Hybrid transactions and hybrid entities: Section 267A

Section 267A regarding hybrid entities and hybrid transactions denies a deduction for interest and royalty payments paid or accrued by a US corporation to a related foreign party pursuant to a ‘hybrid transaction’ or made by or to a ‘hybrid entity’ if (i) there is no income inclusion by the foreign related party for foreign purposes (based on country of residence), or (ii) the related party is allowed a deduction for foreign purposes, provided the non-inclusion of deduction is the result of hybridity. Section 267A applies with respect to tax years that begin after December 31, 2017.

On April 7, 2020, Treasury and the IRS finalized regulations with respect to Section 267A. They provide certain clarifications with respect to the scope of Section 267A as applied to hybrid arrangements involving the payment of interest or royalties by certain branches, reverse hybrid entities, and other hybrid mismatch arrangements. On the same date, proposed regulations addressing certain related rules, including the anti-conduit regulations, also were issued.

Tax readiness insight: As an example, Section 267A eliminates tax benefits for certain hybrid debt transactions that allow a US corporation a deduction for interest expense while the related foreign corporation typically does not have an income inclusion because the payment is viewed as a dividend (rather than interest income) and not taxed under a participation exemption regime. The regulations also treat as a hybrid transaction the payment of interest on a debt obligation when the recipient is not expected to include the interest payment in income within 36 months of the payment. There are no grandfather or transition rules for structures currently in place.

The provision is modeled after the OECD’s BEPS Action 2 (Hybrid Mismatch Arrangements) report on hybrid transactions and includes rules similar to BEPS Action 2, including imported mismatch rules, and rules denying deductions for interest and royalties where the recipient of the payment engages, directly or indirectly, in a hybrid transaction that is considered to offset the recipient’s income inclusion. The direction in Section 267A to the Treasury Department to provide regulations or other guidance sets forth a detailed itemization of specific categories of guidance, which includes coverage of conduit transactions, structured transactions, and certain preferential tax regimes. Treasury also is directed to issue guidance on the application of the rules to branches (foreign and domestic) and domestic corporations, even if such branches or corporations do not meet the statutory definition of any hybrid entity.

20. FDII

Under the Act, for tax years beginning after 2017 and before January 1, 2026, new Section 250 allows as a deduction an amount equal to 37.5% of a domestic corporation's foreign-derived intangible income (FDII) plus 50% of the GILTI amount included in gross income of the domestic corporation under new Section 951A (discussed above). For tax years beginning after December 31, 2025, the deduction is reduced to 21.875% and 37.5%, respectively. If, in any tax year, the domestic corporation's taxable income is less than the sum of its FDII and GILTI amounts, then the 37.5% FDII deduction and the 50% GILTI deduction are reduced proportionally by the amount of the difference.

FDII is determined by subtracting a deemed 10% return on the domestic corporation's tangible assets from its deduction-eligible income (DEI), which comprises its total net income (apart from certain specified categories such as subpart F and GILTI inclusion income, foreign branch income, and CFC dividends). This net amount is then multiplied by a fraction, the denominator of which is the corporation's DEI and the numerator of which is its net income from sales of property to foreign persons for foreign use or from services provided to persons, or with respect to property, located outside the United States. Thus, despite its name, FDII is not limited to sales or licenses of intangible property, or services provided using intangible property.

Tax readiness insight: Together, the Act's GILTI tax and FDII deduction provide a 'carrot and stick' approach to taxing income from exploiting intangible property (IP). If a US-parented group holds its IP offshore, any returns from exploiting that IP will be taxed at a rate of at least 10.5%, considering foreign and US tax. If the same group holds its IP in the United States, the 37.5% FDII deduction for sales and services income provided to unrelated foreign persons effectively provides an effective tax rate of at least 13.125% on returns to the same IP. The small rate differential significantly decreases the advantage under prior law of holding IP offshore.

Tax readiness insight: Some observers have questioned whether FDII could be considered as violating US World Trade Organization (WTO) obligations, if it was viewed as an export subsidy, similar to the former Foreign Sales Corporation (FSC) rules. Taxpayers should consider potential future changes in law to mitigate against a possible WTO challenge when considering transactions that would qualify for the FDII deduction.

21. Other significant items

- No deduction generally is allowed for a contingent liability until such liability is fixed and determinable.
- Under the Act, amounts paid or incurred after December 31, 2017, with respect to business entertainment expenses are not deductible, but business meals generally remain 50% deductible. There are also limitations on the deductibility of international and domestic business travel expenses.

- Royalty payments, circulation costs, mine exploration and development costs, and other miscellaneous costs of carrying on a business are deductible, subject to certain conditions and limits.
- Compensation paid by a publicly traded corporation to its CEO, CFO, and three additional officers is generally subject to a \$1 million per-year deduction limit. P.L. 115-97 eliminated the prior-law exception for performance-based compensation and extended the deduction limit to all compensation payments, including payments after termination of employment. The limitation now also applies to certain privately held corporations that have public debt and certain foreign corporations that trade on US exchanges through American Depository Receipts (ADRs).

O. Credits and incentives

1. Temporary credits and incentives made permanent

The Protecting Americans from Tax Hikes (PATH) Act, signed into law on December 18, 2015 (PATH Act), included retroactive, permanent extension of the research credit and certain other business and individual tax provisions; more than 30 other expired provisions were renewed retroactively for either two or five years.

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

- research credit
- increased Section 179 ‘small business’ expensing limit (increased by the Act from \$500,000 to \$1 million; see discussion above)
- subpart F exception for active financing income
- 15-year straight-line cost recovery for qualified leasehold improvement property, qualified restaurant property, and retail improvement property
- wage credit for employers of active-duty military members
- enhanced charitable deduction for contributions of food property
- treatment of some dividends of regulated investment companies (RICs)
- RICs considered qualified investment entities under FIRPTA
- special rules for qualified small business stock
- reduction in S corporation recognition period for built-in gains tax.

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

- look-through treatment of payments between related CFCs under the foreign personal holding company rules

- seven-year recovery period for motorsports entertainment complexes
- work opportunity tax credit
- special expensing rules for qualified film and television productions
- allocation of new markets tax credit.

On December 20, 2019, President Trump signed H.R. 1158 and H.R. 1865 into law, extending the following to the end of 2020:

- look-through treatment of payments between related CFCs under the foreign personal holding company rules
- seven-year recovery period for motorsports entertainment complexes
- work opportunity tax credit
- empowerment zone employment credit
- allocation of new markets tax credit (note: H.R. 1865 also increased the new markets tax credit limitation from \$3.5 million in 2019 to \$5.0 million in 2020).

CARES Act update: The CARES Act provides a new temporary refundable 50% employee retention credit for employers subject to full or partial business suspension due to the COVID-19 emergency, or for employers whose gross receipts have significantly declined due to COVID-19 (defined as a reduction in gross receipts of more than 50% when compared to the same quarter in 2019). The credit is to be applied against the employer's share of social security tax. The amount of qualified wages (including health benefits) eligible for the credit with respect to any individual employee is limited to \$10,000, so the maximum credit for any employee is \$5,000. (The credit generally is reduced by the payroll Work Opportunity Tax Credit, the payroll research credit, the family leave credit under Section 45S, and the payroll tax credits under the Families First Coronavirus Response Act; employees for whom the Work Opportunity Tax Credit is allowed are not eligible for the retention credit.) Any excess payments will be refunded. Employers can claim an advance of the credit by reducing their federal payroll tax deposits, and/or by filing Form 7200; all reduced deposits and Forms 7200 will be reconciled at the end of the quarter on Form 941.

2. Foreign tax credit (FTC)

Generally, in any year, a taxpayer can choose whether to take as a credit (subject to limitation) or as a deduction foreign income, war profits, and excess profit taxes paid or accrued during the tax year to any foreign country or US possession. An FTC reduces US income tax liability dollar for dollar, while a deduction reduces US income tax liability at the marginal rate of the taxpayer.

For taxpayers with an NOL for the year, the FTC is of no value in such year. However, a benefit might be received either in an earlier year (through a refund of previously paid taxes) or a later year (through a reduction of future taxes). Note also that a taxpayer has the ability

to switch from deduction to credit at any time in a 10-year period commencing when the foreign taxes were paid or accrued. Generally, an FTC may be carried back one year and, if not fully used, carried forward 10 years. **Note:** FTCs associated with GILTI inclusions may not be carried back or carried forward.

The FTC goes beyond direct taxes to include foreign taxes paid ‘in lieu of’ a tax on income, war profits, or excess profits that otherwise generally would be imposed. It also includes deemed-paid (indirect) taxes paid for certain US corporate shareholders of non-portfolio foreign corporations. FTCs (and foreign tax deductions) are disallowed for foreign taxes paid on amounts that are eligible for the new 100% DRD. The FTC system has numerous other limitations to mitigate potential abuses of the credit by the taxpayer.

Tax readiness insight: As discussed throughout this guide, the Act includes several provisions that affect the availability and use of FTCs.

3. General business credit

Various business credits are available to provide special incentives for the achievement of certain economic objectives. In general, these credits are combined into one ‘general business credit’ for purposes of determining each credit’s allowance limitation for the tax year. The general business credit that may be used for a tax year is limited to a tax-based amount. In general, the current year’s credit that cannot be used in a given year because of the credit’s allowance limitation may be carried back to the tax year preceding the current year and carried forward to each of the 20 years following the current year.

In general, the current-year business credit is a combination of the following credits for 2020:

- Investment credit
- Work opportunity tax credit
- Biofuel producer credit
- Biodiesel and renewable diesel fuels credit
- Research credit
- Low-income housing credit
- Disabled access credit for certain eligible small businesses
- Renewable electricity, refined coal, and Indian coal production credit
- Indian employment credit
- Employer social security credit
- Orphan drug credit (reduced by the Act from 50% to 25%)
- New markets tax credit

- Small-employer pension plan startup cost credit for eligible employers
- Employer-provided child care credit
- Railroad track maintenance credit
- Low sulfur diesel fuel production credit
- Distilled spirits credit
- Non-conventional source fuel production credit
- New energy-efficient home credit
- Energy-efficient appliance credit
- A portion of the alternative motor vehicle credit
- A portion of the alternative fuel vehicle refueling property credit
- Mine rescue team training credit
- Agricultural chemicals security credit
- Employer differential wage payments credit
- Carbon dioxide sequestration credit
- A portion of the qualified plug-in electric drive motor vehicle credit for vehicles that will vary based on the date of purchase.

4. Employment credits

A ‘work opportunity tax credit’ is available for employment of certain targeted groups of individuals who are viewed as difficult to employ. ‘Creditable’ wages generally are the first \$6,000 of wages paid to each qualified employee for the year. The credit is 25% of creditable wages for employees who worked for at least 120 hours but fewer than 400 hours and 40% of creditable wages for employees who worked for at least 400 hours, for a maximum credit of \$2,400.

5. Research credit

The Credit for Increasing Research Activities under Section 41 (R&D credit) is available for companies that incur qualified research expenditures (QREs) to develop new or improved products, manufacturing processes, or software in the United States.

Tax readiness insight: The Act did not include any provisions making changes to Section 41.

The PATH Act made the R&D credit a permanent provision of the Internal Revenue Code.

The credit was first enacted in 1981 on a temporary basis to help increase research spending in the United States, and had been extended on a temporary basis numerous times since then.

The credit generally is computed by calculating current-year QREs over a base. The base is calculated using either the regular research credit (RRC) method or the alternative simplified credit (ASC) method. Under the RRC method, the credit equals 20% of QREs for the tax year over a base amount established by the taxpayer in 1984-1988 or by another method for companies that began operations after that period.

The ASC equals 14% — for the 2009 tax year and thereafter — of QREs over 50% of the average annual QREs in the three immediately preceding tax years. If the taxpayer has no QREs in any of the three preceding tax years, the ASC will be 6% of the tax year's QREs. Under final regulations issued in February 2015, the ASC may be claimed on an amended return for a tax year ending after February 27, 2015 — provided the taxpayer has not previously claimed research credits for such year — as well as on the taxpayer's original return for such year. Taxpayers using the RRC also may take a 20% credit for incremental payments made to qualified organizations for basic research. For tax years ending after August 8, 2005, taxpayers also may take the Energy Research Consortium Credit, which provides a 20% credit for expenditures on qualified energy research undertaken by an energy research consortium.

The deduction for R&D expenditures (see section *II.M.14* above) must be reduced by the entire amount of the credit unless an election is made to reduce the amount of the credit.

Inbound insight: The application of the research credit rules when a US business is compensated for its R&D costs by a foreign parent or other foreign related party often is misunderstood.

The rules provide that in determining a taxpayer's research tax credit, all members of the same controlled group should be treated as a single taxpayer. Companies often net the reimbursement against their current QREs, resulting in lost opportunities to utilize available credits. This area should be reviewed closely if US entities are being reimbursed by related foreign entities for any potentially qualified activities.

6. Inbound investment incentives

There generally are limited incentives related to inbound investment at the federal level, such as: (1) the exemption from taxation on interest paid on qualifying portfolio debt short-term debt and bank deposits and (2) safe harbor exemptions from net income taxation of income from trading in securities and regulated commodities. The portfolio debt exception enables nonresidents and foreign corporations to invest in certain obligations (which must meet certain statutory and regulatory requirements to qualify as 'portfolio debt') in the United States without being subject to US income tax (or withholding) on the interest income. The short-term debt exception provides an exemption for interest on debt obligations with a stated maturity of 183-days or less. The bank deposit exception allows non-US investors to deposit funds in US banking institutions without being subject to US

tax on the interest earned, provided that the investment meets the statutory definition of a ‘deposit’ and the funds are held by persons carrying on a banking business, or certain other regulated institutions. These exemptions do not apply if the interest income is earned in the conduct of a US trade or business.

There also are statutory securities and commodities trading safe harbors that provide exceptions from being treated as engaged in a US trade or business for non-US persons trading in stocks, securities, or regulated commodities through a resident broker, commission agent, custodian, or other independent agent. Certain state and local benefits also may be available.

7. Qualified private activity bonds

Interest income received on certain qualified private activity bonds generally is exempt from federal income tax. This enables a business enterprise to issue the bonds at a lower interest rate. The Act preserves this exemption, but repeals the interest exemption for advance refunding bonds issued after 2017.

P. Anti-‘inversion’ developments

Most US inbound companies no doubt are aware of recent US developments regarding cross-border transactions characterized as ‘corporate inversions.’ Both the executive and legislative branches of the US government continue to express concern about these transactions; however, the focus shifted in 2017 from taking administrative actions to make it more difficult for US companies to invert and reduce the tax benefits of inversions to enacting tax reform legislation to make US companies more competitive and the United States a more attractive place to do business.

On the *administrative front*, final Section 385 regulations were published May 14, 2020.. Treasury and the IRS on October 13, 2016, released final and temporary regulations under Section 385 that address whether certain instruments between related parties are treated as debt or equity. The government made significant changes to the proposed regulations in response to public comments, significantly narrowing the application of the final rules. In addition, the IRS eliminated the application of the Section 385 documentation requirements. However, controversy remains, and Treasury may take administrative steps to revoke or further modify the regulations. (For discussion of the Section 385 regulations, see Section IX below.)

On the *legislative front*, certain changes made by the Act to the US international tax system take away some of the incentives to engage in inversion transactions, such as by significantly lowering the US corporate income tax rate and repealing the corporate AMT.

Moreover, the Act includes a number of provisions that may have the effect of making inversion transactions less attractive, including making dividends paid by inverted companies to US individual shareholders ineligible for the lower tax rate for qualified dividend income, tightening interest deductibility limitations for all companies (thus making it more difficult to erode the US tax base through interest payments), imposing the BEAT (which has especially

strict provisions targeted specifically at inverted companies), and making it more difficult for non-US-parented companies to engage in transactions to de-control their CFCs.

Q. Administrative issues

1. Withholding

a. Withholding on payments to non-US persons

Under US tax laws, a foreign person generally is subject to 30% tax on the gross amount of certain US-source income (other than capital gains) that is not effectively connected with a US trade or business. Persons making certain types of payments ('withholding agents'), such as US-source interest, dividends, and royalties, to foreign persons generally must withhold 30% of the gross payment as tax withheld at source and deposit it with the US government. In other situations, withholding agents may withhold at reduced rates if the payee certifies it is eligible for a reduced rate or exemption under a tax treaty or by operation of US tax law (e.g., portfolio interest exemption). The withholding agent generally is liable for 100% of any tax that should have been collected through withholding but was not. Penalties and interest also may apply. See the latest edition of IRS Publication 515.

Withholding also may be required on the purchase from a non-US person of an interest in US real estate (which may include shares in a US company holding primarily US real estate) or a partnership interest if the partnership is or has been engaged in the conduct of a US trade or business or holds US real estate interests.

The United States has entered into income tax treaties with more than 60 countries in order to avoid double taxation of income and to prevent tax evasion. See Appendix A or the IRS website for a summary of the benefits resulting from these treaties. The ability to apply a reduced rate of withholding depends on whether the withholding agent receives timely and valid documentation certifying the foreign payee's eligibility for a lower rate of tax that it can reliably associate with a payment. Valid documentation includes documentation provided using a withholding certificate (from the Form W-8 series). Since there are various types of Forms W-8 (e.g., W-8BEN, W-8BEN-E, W-8IMY, etc.), the payee must determine the correct form to be completed. The withholding agent must review the withholding certificate for completeness and for inconsistencies prior to reducing the rate of withholding.

Form W-8BEN, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)*, is used to establish that an individual is not a US person and is the beneficial owner of the income in relation to which the form is being provided. Form W-8BEN also can be used by the individual to claim a reduced rate of withholding based upon an applicable income tax treaty. Treaty claims made by nonresident alien individuals who provide independent personal services in the United States are made on Form 8233, *Exemption from Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual*, instead of on Form W-8BEN.

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

In addition to Form W-8BEN or Form W-8BEN-E, the following forms may be provided by a non-US payee to establish that it is eligible for no or a reduced withholding rate:

- Form W-8ECI, *Certificate of Foreign Person's Claim That Income Is Effectively Connected With the Conduct of a Trade or Business in the United States*, is provided by a non-US entity or individual that is engaged in a US trade or business and describes for the withholding agent what income it is paying that is effectively connected with such US trade or business.
- Form W-8EXP, *Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding and Reporting*, is provided by non-US governments, non-US foundations, or non-US tax-exempt organizations. Tax-exempt organizations also must provide either the date a determination letter was issued by the IRS regarding their status under Section 501(a) or an opinion from US legal counsel that the entity substantially meets the exemption requirements of Section 501(a).
- Form W-8IMY, *Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain US Branches for United States Tax Withholding & Reporting*, is provided by non-US flow-through entities (e.g., partnerships and trusts), intermediaries, and US branches that are not engaged in a US trade or business. Form W-8IMY is used to indicate that the payee is not the beneficial owner of the payment and generally must be accompanied by Forms W-8 and/or Form W-9 for the actual beneficial owners (i.e., the partners, investors, account holders, etc.) and a withholding statement that allocates the income to these beneficial owners.

Forms W-8BEN, W-8BEN-E, W-8ECI, and W-8EXP generally are valid until the end of the third full calendar year from the date the form is signed (expiring December 31 of that year). New forms are required prior to the form expiring. Additionally, a new form is required if there is a change in circumstances that causes the information disclosed by the payee on the forms to become unreliable. For some purposes (not applicable if treaty benefits are claimed), the forms can remain valid indefinitely absent a change in circumstances. Forms W-8IMY are valid indefinitely unless there is a change in the information disclosed by the payee on the forms. Form 8233 is valid for only one year. The IRS updates the forms periodically; persons completing these forms for the first time or renewing an existing form must use the most current version.

b. Withholding on payments to US persons

All US and non-US entities are responsible for information reporting and backup withholding for payments made to US non-exempt recipients, including US individuals, partnerships, and certain limited liability companies (LLCs). Backup withholding at the current rate of 24%

(for any payments made on or after January 1, 2018; the rate for prior payments was 28%) is required if the US non-exempt recipient fails to provide a taxpayer identification number (TIN) in the proper manner prior to payment or if the payor is instructed to backup withhold by the IRS. Payors that fail to impose backup withholding when required are liable for 100% of the withholding that should have been made but was not.

Payments made to US exempt recipients are not subject to information reporting or backup withholding, and such recipients are not required to provide a TIN. Depending on the payment, exempt recipients include governments (federal, state, and local), tax-exempt organizations under Section 501(a), individual retirement plans, international organizations, foreign central banks of issue, and most corporations and financial institutions.

Payments made to US non-exempt recipients for dividends, gross proceeds from the sale of stock, interest, compensation for services, rents, royalties, prizes, awards, and litigation awards, among others, must be reported. A proper TIN should be obtained from all US payees to avoid backup withholding. A TIN is best obtained (and can be required) by receiving a valid Form W-9, Request for Taxpayer Identification Number and Certification, from US non-exempt payees, including exempt recipients. The IRS's TIN Matching Program can be utilized to verify names or TINs with IRS records to ensure accuracy.

Inbound insight: The US reporting and withholding rules apply whether payments are made to related or unrelated parties. This means that the appropriate Form W-8 or Form W-9 must be provided to a party making a payment to a related party. Note that a non-US company (e.g., one that has custody of the funds made to a non-US beneficial owner) also may be a withholding agent.

Non-US companies that are controlled by US persons or that earn more than a certain amount of US-source income are classified as US payors. As a result, these companies must report all reportable payments made to US non-exempt recipients on Forms 1099. Also, if the US non-exempt recipient fails to provide its TIN in the proper manner, backup withholding must be imposed and remitted to the IRS.

c. Withholding on purchases of partnership interests

Under the Act, a foreign partner's gain or loss from the sale or exchange of a partnership interest is treated as effectively connected with a US trade or business to the extent the foreign partner would have had effectively connected gain or loss if the partnership had sold all of its assets in a taxable sale at fair market value and allocated the gain or loss to the foreign partner in the same manner as non-separately-stated income and loss (i.e., generally the partner's distributive share). The provision (Section 864(c)(8)) applies to a foreign partner that directly or indirectly owns an interest in a partnership that is engaged in a US trade or business.

A provision added to Section 1446 (which generally requires a partnership to withhold tax on effectively connected taxable income (ECTI) allocable to a foreign partner) requires the transferee of a partnership interest to withhold 10% of the amount realized on the

acquisition of a partnership interest if any portion of the gain is treated as ECI under the new provision unless the transferor certifies that it is not a foreign person. At the request of the transferor or transferee, Treasury may prescribe a reduced amount of withholding tax if Treasury determines that the reduced amount will not jeopardize the collection of tax on the amount of gain treated as ECI under the provision. If the transferee fails to withhold the tax, the partnership is required to withhold tax from future distributions to the transferee partner.

The provision treating gain or loss on the sale of a partnership interest as ECI became effective for sales, exchanges, and dispositions after November 27, 2017. The withholding tax provision, however, became effective for sales, exchanges, and other dispositions after December 31, 2017, although, as noted below, under Notice 2018-08, the withholding provision is suspended temporarily with respect to dispositions of publicly traded partnership interests.

Inbound insight: The withholding provisions in Section 1446(f) mean that any purchaser of an interest in a partnership (domestic or foreign, including an LLC treated as a partnership for US tax purposes) must determine whether any portion of the gain realized by the transferor is ECI to the transferor. If so, the purchaser will be obligated to impose the withholding tax unless the purchaser receives an affidavit of non-foreign status from the transferor, or certain other certifications described in IRS guidance or regulations.

Note: On December 29, 2017, the IRS issued Notice 2018-08, providing that withholding on dispositions of interests in publicly traded partnerships under Section 1446(f) is suspended until additional guidance is issued. Notice 2018-08 indicates that the forthcoming guidance will be prospective and will include transition rules that are intended ‘to allow sufficient time’ to prepare for implementation of the rules. In addition, Notice 2018-08 requests comments on how the rules should be applied to publicly traded partnerships, and whether a similar suspension or additional guidance is needed for dispositions of non-publicly-traded partnership interests.

On April 2, 2018, the IRS issued Notice 2018-29, providing interim guidance regarding the procedures for withholding under Section 1446(f). The Notice was meant to apply while regulations were being drafted by Treasury and the IRS. The Notice suspended the liability of partnerships for tax that should have been withheld by transferees but was not. Transferees are directed to use procedures under Section 1445 (relating to transfers of US real property interests by foreign persons), specifically Form 8288, *U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests*, and Form 8288-A, *Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests*, to report the disposition and withholding tax within 20 days of the transaction. The Notice also sets forth guidance for various types of certifications that can be provided by the transferor or the partnership to the transferee that could reduce or eliminate the amount required to be withheld.

2. Information reporting

a. Reporting payments to non-US persons

Any taxes withheld on payments made to non-US payees must be reported to the IRS on Form 1042, *Annual Withholding Tax Return for US Source Income of Foreign Persons*. Form 1042 must be filed with the IRS on or before March 15 following the calendar year in which the income subject to reporting was paid, unless an extension of time to file is obtained. Form 1042 must be filed if a Form 1042-S is required to be filed (see below), even if there is no withholding on the payment (e.g., because of an applicable tax treaty).

A withholding agent must file with the IRS and furnish to each foreign payee Form 1042-S, *Foreign Person's US Source Income Subject to Withholding*. Form 1042-S is the information return used by withholding agents to report US-source payments paid to specific non-US payees. Form 1042-S must be filed with the IRS and furnished to the non-US payee on or before March 15 following the calendar year in which the income subject to reporting was paid, unless an extension is obtained. Form 1042-S is required whether or not withholding applied to the payments. Form 1042-T is used to transmit Forms 1042-S to the IRS when forms are filed on paper. Financial institutions must file Forms 1042-S electronically (even if less than 250 forms), as must any withholding agent that files 250 or more forms for a calendar year. While special rules apply to partnerships, in general partnerships with more than 100 partners must file Forms 1042-S electronically. Electronic filing is done by use of the Filing Information Returns Electronically (FIRE) system.

b. Reporting payments to US persons

A US entity engaged in a trade or business that during the calendar year makes payments to a US non-exempt payee totaling \$600 or more must report the amount of the payments on Form 1099-MISC, *Miscellaneous Income*. Payments subject to Form 1099-MISC reporting include compensation for services (other than wages paid to employees), rents, royalties (reporting required for amounts beginning at \$10), commissions, gains, and certain types of interest. US payers are responsible for reporting the payment whether made by cash, check, or wire transfer. Amounts paid by payment card (including debt, credit, and procurement) or through third-party payment networks (i.e., internet payment service providers) are not subject to Form 1099-MISC reporting by the payor.

Form 1099-MISC must be furnished to payees no later than January 31 of the year subsequent to the year of payment and must be filed with the IRS by February 28 of the year following the payment if filed on paper or March 31 if filed electronically. Requests to extend these dates may be made, but extensions are not automatic.

If the payor is required to file 250 or more Forms 1099-MISC, it must file the forms electronically with the IRS by use of the FIRE system. If Forms 1099-MISC are filed electronically, the due date for filing with the IRS is by March 31, with the exception of Forms 1099-MISC that contain income reported in Box 7 as "Nonemployee Compensation." Those forms must be filed with the IRS, either on paper or electronically, by January 31 of the year following payment. Beginning for 2020 payments that are due

to be reported in 2021, amounts that were reportable in Box 7 of the Form 1099-MISC will now be reported on a new Form 1099-NEC, *Nonemployee Compensation*. The January 31 due date will apply for both filing with the IRS and furnishing copies to recipients.

The payor also must file Form 945, *Annual Return of Withheld Federal Income Tax*, to report any backup withholding. Form 945 must be filed with the IRS by January 31 of the year succeeding the year of payments.

c. FATCA

FATCA, the Foreign Account Tax Compliance Act, was enacted in 2010 to prevent and detect offshore tax evasion by US persons. FATCA seeks to compel disclosure of US persons' ownership of foreign accounts, interests, and assets. While the name may imply that FATCA is directed at financial institutions, many global companies outside the financial services industry may be affected if they have entities in their worldwide network falling under the purview of FATCA because they are investment entities, holding companies, or other types of entities that fall within the broad definition of 'financial institution' found in the FACTA regulations. Companies also may be subject to FATCA where they hold financial accounts outside the United States or have operational units that make or receive payments subject to FATCA.

FATCA added chapter 4 (Sections 1471-1474) to the Internal Revenue Code. FATCA requires many foreign financial institutions (FFIs) to enter into agreements with the IRS under which they undertake procedures to identify which of their accounts are held by certain US persons and annually report information regarding such accounts to the IRS. An FFI that has entered into such an agreement is known as a 'participating FFI.' In addition, some nonfinancial foreign entities (NFFEs) must report information regarding certain direct or indirect US owners to withholding agents.

Non-compliance with FATCA triggers a 30% withholding tax on certain US-source fixed or determinable, annual, or periodical (FDAP) payments. However, IRS regulations provide for various exceptions, such as categories of FFIs or NFFEs that are eligible for lightened compliance obligations. As discussed below, the IRS issued proposed regulations in December 2018 providing that withholding on gross proceeds from the disposition of securities issued by US persons will not become subject to withholding under FATCA, contrary to prior guidance.

Inbound insight: Many non-US companies with business operations in the United States have non-US companies within their affiliated group that engage in activities such as holding shares, financing, and treasury or insurance operations. These activities require a careful review of the companies throughout the corporate group to determine the appropriate application of the FATCA rules.

i. FATCA compliance obligations

FATCA imposes registration, due diligence, information reporting, and tax withholding obligations on entities that qualify as FFIs. Legal entities with FFI characteristics must

determine whether they are, in fact, FFIs and, if so, whether they are required to register with the IRS.

Multinational corporations (MNCs) should examine their treasury centers, retirement funds, and holding companies, to name a few examples, to determine whether they meet the definition of an FFI. Properly identifying the FATCA status of each entity in a large organization can take significant time and effort and must be repeated regularly, because the final FATCA regulations impose several different income and asset tests at both the entity and global organization levels. In addition, the IRS has entered into intergovernmental agreements (IGAs) with many nations that contain certain modifications or clarifications that apply to entities in the particular jurisdiction. See Section *iv. The impact of IGAs*, below. Note that these IGAs are separate from any income tax treaties.

Regardless of FATCA status, obligations are imposed on withholding agents with respect to US-source FDAP income, which include many MNCs. These companies must have processes and procedures in place to identify and categorize non-US payees for FATCA purposes, report, and potentially apply 30% withholding tax to avoid being liable for the withholding tax and potential interest and penalties. Even if a foreign entity is not an FFI, FATCA still requires the recipient of a US-source payment to establish its FATCA status with appropriate documentation including, for certain types of NFFEs, information regarding US persons that own (directly or indirectly) more than 10% of the NFFE.

ii. FATCA exemptions

There are several important exemptions from FATCA withholding on US-source FDAP payments. For example, FATCA withholding should not apply when the payee provides to the withholding agent appropriate documentation demonstrating that the payee is not subject to withholding (i.e., the entity documents its FATCA status and provides all required information to the withholding agent, and that status is not ‘nonparticipating FFI’). Even though FATCA withholding does not apply, reporting still is required. The withholding agent also must evaluate whether reporting and withholding apply under the information reporting rules discussed in the previous section.

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

NFFEs that either have no substantial US owners or that properly identify these owners to withholding agents should not be subject to withholding, nor should NFFEs that are deemed by the IRS to represent a low risk of US tax evasion, such as publicly traded companies and their affiliates, and those engaged in active trades or businesses. A withholdable payment made to a documented non-US entity is not subject to FATCA withholding, but reporting may apply.

iii. Actions to comply with FATCA

MNCs need a FATCA compliance program to ensure that all necessary FATCA classifications, documentation, monitoring, and reporting are undertaken. This process should be documented in a series of policies and procedures ensuring that the process has controls that can be replicated and tested. Further, the program should highlight changes in business practices that may be necessary for FATCA compliance, and inform senior management that all areas of the organization have been reviewed according to requirements.

iv. The impact of IGAs

To mitigate certain foreign legal impediments to FATCA compliance, IGAs have been negotiated between the US Treasury and other governments. Under certain IGAs, known as Model 1 IGAs, information is exchanged directly between the IRS and the foreign taxing authority. This obligates entities in IGA jurisdictions to report information to their government that may not have been required or permitted in the past. Other IGAs, known as Model 2 IGAs, provide that local governments will direct FFIs resident in the jurisdiction to report directly to the IRS.

Assessing FATCA's impact requires identifying whether an IGA applies to the entity at issue. Provisions in the final regulations or in any IGA that provide more favorable results may be utilized. Treasury has focused on negotiating consistent requirements in each IGA, but there are noticeable differences in the agreements signed to date. For an MNC, this will require an analysis of the applicable FATCA rules across all jurisdictions in which it operates.

v. Companies with FFIs in their groups

FATCA imposes the most significant obligations on FFIs. Companies engaged in nonfinancial businesses may think that few or none of their foreign entities constitutes an FFI. However, the definition of an FFI is broad and includes more types of entities than one might expect.

Although the rules provide various exceptions, the following are types of entities that may be FFIs:

- **Non-US retirement funds and foundations** – Non-US retirement funds whose gross income is primarily attributable to investing, reinvesting, or trading in financial assets and that are professionally managed by another entity are classified as investment entities and therefore are FFIs. However, certain retirement funds entitled to receive benefits under a tax treaty are examples of retirement funds that are treated as 'exempt beneficial owners' and therefore not required to enter into FFI agreements with the IRS.
- **Treasury centers, holding companies, and captive finance companies** – These types of entities are specifically identified in the definition of an FFI. However, if such entities satisfy certain requirements and are part of a nonfinancial group of companies, they may be excepted from being FFIs. Among the activities relevant in assessing whether a legal entity is treated as an FFI are:

- cash pooling
- securitization and factoring activities
- hedging activities (including whether hedges are entered into with affiliates or with ‘customers’)
- customer financing operations
- offshore cash deployment and investment strategies
- in-house bank and external credit or ‘banking’-type operations.
- **Special-purpose entities and banking-type subsidiaries** – Although these entities frequently are utilized to access lower-cost sources of funding for operations or acquisitions, the mix of activities in which these entities are engaged and how income is derived may cause them to fall within the FFI definition.
- **Captive insurance companies** – Generally, captive insurance companies are not FFIs for FATCA purposes if they do not issue cash value or annuity contracts. However, such captives still should evaluate their business operations to determine if they fall within another category of FFI. These other categories may include depository institutions, custodial institutions, investment entities, and certain holding companies and treasury centers.

When an MNC determines that it has entities within its global structure that are FFIs, the MNC should determine if such entities may qualify for an exception from FFI status. One of the primary exceptions covers holding companies and treasury centers that are part of a group that is determined to be ‘nonfinancial.’ The status of ‘nonfinancial’ is based on the ratios of active vs. passive income and assets, as well as the income generated by FFIs within the group.

If an entity is an FFI, the MNC has to determine whether the FFI must become a participating FFI (or a reporting FFI under an IGA), or if it qualifies for deemed-compliant or exempt beneficial owner status. If the entity does not qualify for such status, it must properly register with the IRS. To avoid the 30% withholding tax on withholdable payments it receives, each FFI must use the IRS’s online FATCA portal to execute an FFI agreement, confirm its due diligence, and receive an identification number, the Global Intermediary Identification Number, or GIIN.

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

FATCA withholding and reporting generally apply when a multinational business makes a withholdable payment (i.e., a payment of certain US-source FDAP income). From a practical perspective, a large range of payors can be affected—just about any multinational business that makes payments falling within this definition will experience the impact of FATCA. As a result, global organizations should focus their efforts on payment details such as:

- which legal entity or department is authorizing the payment
- which legal entity or department is making the payment
- the recipient of the payment
- documentation of the recipient
- source (US federal income tax sourcing) of the payment
- the character of the payment.

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

vii. Expansive definition of a withholdable payment

The term ‘withholdable payment’ generally refers to the gross amount of US-source interest, dividends, certain insurance premiums, and any financial payment etc., and can include other types of US-source income not otherwise subject to withholding under Chapter 3 of the Internal Revenue Code.

Treasury functions, accounts payable departments, and other areas of a global organization may make withholdable payments. The following are a few common examples of third-party or intercompany payments that may be included in the definition:

- interest and dividends
- bank and custodial fees
- advisory and broker fees associated with merger and acquisition activity
- insurance or reinsurance premiums paid for insuring US risk

Note: Proposed regulations would eliminate the obligation to impose FATCA withholding on gross proceeds from the sale of assets that produce US-source interest or dividends. Treasury and the IRS cite complexity and the impact of FATCA intergovernmental agreements on compliance as reducing the need to impose withholding on gross proceeds. Withholding agents are permitted to rely on the proposed regulations immediately. (Reg-132881-17 published December 2018)

Certain nonfinancial payments are not treated as withholdable payments under FATCA. However, some of these payments (such as payments for services, rents, and royalties) remain subject to existing information reporting and withholding requirements. Certain obligations in existence on July 1, 2014, are considered ‘grandfathered’ and are not subject to FATCA withholding.

viii. Obligation to identify payees and remit tax

As a core concept of FATCA, payors of a withholdable payment must ask, ‘who is the payee?’ and ‘is the payee FATCA compliant?’ IRS forms, such as W-8BEN-E and W-8IMY, enable payees and intermediaries to certify both their FATCA status and information relevant to Chapter 3 of the Code. In addition, the regulations that harmonize the FATCA requirements with the existing Chapter 3 withholding requirements have altered the way in which documentation can be used and also have modified the way in which other types of information can be used to facilitate proper withholding and reporting.

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

ix. Companies that receive US-source payments

Those entities within a group receiving withholdable payments may be subject to 30% FATCA withholding if they cannot provide proper documentation. These may include an NFFE located outside of the United States, which may be treated as a ‘passive NFFE’ and subject to FATCA withholding if it fails to timely and properly identify itself to its withholding agent and provide information regarding its ownership.

x. The cost of noncompliance

Businesses that do not adhere to the obligations under FATCA may face a variety of consequences, with possible loss of 30% of the value of specific payments being of foremost concern. Consistent with other US information reporting regimes, a payor that fails to deduct and remit FATCA withholding when required will be liable for 100% of the amount not withheld as well as related interest and penalties.

3. Filing requirements

a. Tax period

US corporate taxpayers are taxed on an annual basis. Corporate taxpayers may choose a tax year that is different from the calendar year. New corporations may use a short tax year for their first tax period, and corporations changing tax years also may use a short tax year.

b. Tax returns

The US tax system is based on the principle of self-assessment. Legislation enacted in 2015 changed filing dates for corporate, partnership, and certain other returns filed for tax years beginning after December 31, 2015. As a result of the legislation, a calendar-year corporate taxpayer generally must file an annual tax return (generally Form 1120) by the 15th day of the fourth month following the close of its tax year (April 15). Such C corporations also receive a six-month automatic extension to file if a timely request is filed. Failure to timely file may result in penalties.

4. Important tax return due dates for businesses

Form	Title	Purpose	Due date
W-2, W-3	Wage and Tax Statement	Employers must provide employees with statements regarding total compensation and amounts withheld during the year.	Must be sent to employees on or before January 31, with copies to the Social Security Administration.
1099 series	Various	Information returns to be provided to the IRS and recipients of dividends and distributions, interest income, non-employee compensation, miscellaneous income, etc.	Must be sent to recipients on or before January 31. Must be filed with the IRS on or before January 31, February 28, or March 31, depending on the type of filing and whether the filing is electronic or on paper.
1120 series, including 1120S (for S corporations) and 1120F (for foreign corporations)	US Corporation Income Tax Return	Income tax returns for domestic corporations or foreign corporations with US offices.	C corporations- April 15 for calendar-year returns (Form 7004 may be filed to obtain an automatic six-month filing extension for tax years beginning before January 1, 2026). S corporations- March 15 for calendar-year returns, with six-month maximum extensions.*
Schedule K-1	Partner's Share of Income, Deductions, Credits, etc.	Information returns to be provided to partners by partnerships.	March 15
1065	US Return of Partnership Income	Information returns to be filed by partnerships.	March 15 for calendar-year returns (Form 7004 may be filed to obtain an automatic six-month extension)
1094/1095 series (ACA reporting)	Employer-provided health insurance offer and coverage and Transmittal of Information Returns	Statements to covered individuals and full-time employees of health coverage offered and provided by month during the year; transmittal of statements to IRS.	For 2020, Forms 1095 were to have been provided to employees and covered individuals by March 2, 2020, with copies and Forms 1094 sent to the IRS by February 28 (March 31 if filing electronically)

Form	Title	Purpose	Due date
940	Employer's Annual Federal Unemployment (FUTA) Tax Return	Report of employee wages for FUTA purposes, FUTA taxes, and applicable state credit reductions.	January 31
State income tax returns	Various	Income tax returns for states where corporation carries on trade/business.	Varies, often April 15

* Due to the COVID-19 pandemic, the IRS announced a filing postponement for certain tax returns (and payments) which were due to be filed between April 1, 2020 and July 15, 2020. If a covered return or payment is due during this timeframe, a taxpayer has until July 15, 2020 to file the return or make a timely payment. The postponement period includes Form 1120 and Form 1120-F. Additionally, the postponement period includes Form 1065 and Form 1120-S, but again, only if those forms were due between April 1, 2020 and July 15, 2020. For example, the postponement only applied to a Form 1065 if it was not a calendar year partnership and its due date fell within that timeframe. Also, if the extended due date fell within this time period, the relief was available granting an additional time through July 15, 2020. See IRS Notice 2020-18, Notice 2020-20, and Notice 2020-23 for complete lists of returns covered by the postponement period. ** States also announced filing postponements for tax returns due to COVID-19 that vary by state.

5. Payment of tax

A taxpayer's tax liability generally must be prepaid throughout the year in four equal estimated payments and fully paid by the original due date of the tax return. For calendar-year corporations, the four estimated payments are due by the 15th days of April, June, September, and December. For fiscal-year corporations, the four estimated payments are due by the 15th days of the fourth, sixth, ninth, and 12th month of the tax year. Generally, no extensions to pay are allowed. Failure to pay the tax by the due dates can result in estimated tax and late payment penalties as well as interest charges.

The installment payments must include estimates of regular corporate income tax and, for foreign corporations, the tax on gross transportation income, although not all of these taxes are reported through Form 1120. (Although some of these other taxes are reported on forms other than the 1120 series, they may require similar estimated payments through regular deposits of taxes throughout the year.) To avoid a penalty, corporations must calculate the installment payments based on at least 25% of the lesser of (i) the tax shown on the current tax return, or (ii) the prior year's tax liability, provided that the tax liability was a positive amount in the prior year and that such year consisted of 12 months. However, corporations

with taxable income of at least \$1 million (before use of NOLs or capital loss carryforwards) in any of the three preceding years may not calculate the installment based payment on the prior year's tax liability, except in determining the first installment payment. Instead, such corporations must calculate the installment payments based on the tax shown on the current year's tax return.

In 2017, corporations with \$1 billion or more in assets were required to make estimated tax payments in the months of July, August, or September in varying amounts (although not altering the overall amount required to be paid in for the year. That special rule was applicable for payments in 2017, but was not applicable for payments in 2018 and 2019. However, in 2020, these same corporations will be required to make estimated tax payments in varying amounts.

Inbound insight: Certain corporations with income that varies during the year (i.e., especially when a majority of the income is received at the end of the year) might be able to lower the amount of one or more required installments by using the adjusted seasonal installment method and/or the annualized income installment method.

The annualized income installment is the product of the tax on the corporation's taxable income for the corresponding portion of the tax year on an annualized basis, and reduced by all prior required installments for the tax year. A corporation can choose between using the standard monthly periods or either of two optional monthly periods. An election to use either of the two optional monthly periods is effective only for the year of election. The election must be made on or before the date required for the first installment payment. Adjusted seasonal installments may be used only if the average of the corporation's taxable income for the same six-month period in the three preceding years was 70% or more of annual taxable income.

6. Audit cycle

Traditionally, the IRS focus on large businesses consisted of examinations that would cover most items reported on an entity's tax return. The IRS has moved away from this traditional examination structure to more streamlined and issue-focused examinations. Smaller businesses and individuals with lower incomes and less complicated tax returns generally have always been subject to similar issue-focused examinations.

The IRS Large Business and International Division (LB&I) has implemented procedures in its efforts to move away from continuous audits of large corporate taxpayers. These changes have allowed the IRS to conduct issue-focused examinations, resulting in limited-scope examinations for this group of taxpayers. As part of these changes in examination processes, the IRS in January 2017 began announcing 'compliance campaigns' identifying areas of non-compliance. The IRS has announced over 50 compliance campaigns. The campaigns cover issues such as the Section 199 deduction, US distributors of imported goods with losses or minimal profits, structures used to repatriate funds tax-free into the United States, the Section 965 transition tax, as well as several Form 1120-F compliance issues. The IRS will continue to announce additional campaigns.

7. Audit programs (CAP)

The IRS Compliance Assurance Program, or CAP, is a collaborative pre-filing program in which the taxpayer and the IRS examination team work together to resolve potential tax issues before the taxpayer files its next tax return.

Entering CAP can be a risk-mitigation strategy for taxpayers by gaining certainty regarding tax positions prior to filing a tax return. Due to the change in focus to more limited-scope examinations by LB&I as discussed above, LB&I reviewed the role of CAP, and announced modifications to CAP for tax years 2019 and beyond. LB&I had not added any new participants to the program since 2016, as the IRS was actively reviewing the program. Along with the CAP modification announcement, LB&I announced it expected to review new CAP applicants for the 2020 tax year, but only new applicants that are publicly traded corporations with assets of \$10 million or more.

Inbound insight: The September 2018 announcement by LB&I ended continuing speculation about the CAP program, as although only a limited number of companies are in the program, a majority of those companies view the CAP program as an improvement over the more traditional examination process. As the program will now continue, any inbound companies that had been considering CAP now have the opportunity to apply for the program. The IRS accepts applications between September 1 and October 31.

8. Statute of limitations

The IRS generally has three years after an original return is filed to assess income taxes. A return will be deemed to have been filed on its original due date, even if the return is actually filed on an earlier date. If a return is filed on extension, the limitations period generally is computed from the filing date. In most instances, the IRS will request a taxpayer extend, by formal agreement, the statute of limitations when a tax year is under examination.

It is important to note that certain provisions of the Internal Revenue Code may allow for an extended statute of limitations in certain circumstances. Most relevant to inbound entities is Section 6501(c)(8), which provides for an extended limitations period when a taxpayer has failed to report certain information related to foreign entities and transfers. Some of this information is reported on Forms 5471, 5472, and 926. Under Section 6501(c)(8), the limitations period remains open until the taxpayer provides the required information and may be limited when there is reasonable cause for the failure to provide the information.

9. Topics of focus for tax authorities

Currently, the IRS continues to focus on certain activities related to Form 1120-F filing requirements, the domestic manufacturing deduction, foreign earnings repatriation, repairs vs. capitalization change in accounting method, research credit claims, transfer of intangibles/offshore cost sharing, withholding taxes, foreign tax credits, and certain sales of partnership interests and S corporation distributions. The IRS also has announced it will focus on Section 965 (the transition tax provision added by the Act) issues to its enforcement focus as well as other provisions introduced by the Act.

Inbound insight: Increased cross-border information sharing among tax authorities along with the OECD BEPS initiative (discussed in Section VI below) are likely to affect audits of inbound companies, perhaps tempered by current IRS budget and resource issues, the impact of COVID-19 on the IRS workforce, and the need to focus on tax relief provisions in the CARES Act.

Inbound insight: To implement the Act, the IRS and Treasury have issued a significant amount of guidance relating to many issues such as GILTI, FDII, and Section 163(j). The IRS accordingly will focus its examination efforts on many of these issues as there potentially could be inconsistency in application and interpretation of the rules. It is anticipated that there will be future controversy based on certain interpretations of these provisions.

10. Tax avoidance transactions

Treasury regulations require taxpayers to disclose transactions determined to be abusive or possibly abusive. Current information on these transactions, known as listed and reportable transactions, is available from the IRS website. Certain standards for penalty relief differ with respect to these transactions, and taxpayers should use diligence when reporting matters related to these transactions.

11. Income tax accounting methods

For US federal tax purposes, the two most important characteristics of a tax method of accounting are timing and consistency. If the method does not affect the timing for including items of income or claiming deductions, it is not an accounting method and IRS approval generally is not needed to change the

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

In general, in order to establish an accounting method, the method must be consistently applied. Once an accounting method has been adopted for federal tax purposes, any change must be requested by the taxpayer and approved by the IRS. Changes in accounting methods cannot be made through amending returns. The two most common methods of accounting are the accrual-basis and cash-basis methods.

12. Penalties

Civil and criminal penalties may be imposed for failing to follow the Internal Revenue Code. The civil penalty provisions may be divided into four categories: delinquency penalties; accuracy-related penalties; information reporting penalties; and preparer or promoter penalties. Many, but not all, of these provisions include exceptions for reasonable cause if there is non-compliance. In addition, many include rules as to how a particular penalty interacts with the other penalties.

These four main civil penalty categories may further be divided. First, the delinquency penalties may be divided into failure to file, failure to pay, and failure to make timely deposits of tax. Failure to make timely deposits of tax applies to taxpayers required to make installment payments and withholding tax payments.

Second, the penalties relating to the accuracy of tax returns are divided into the negligence penalty, the substantial understatement penalty, substantial overstatement of pension liabilities, substantial estate or gift tax valuation underestimates, and the valuation penalties. These penalties are coordinated, along with the fraud penalty, to eliminate any stacking of the penalties. Again, like other provisions, the fraud penalty is not intended to be imposed as a stacked penalty.

The third category of penalties is the information reporting penalties. These penalties may be imposed on those who only have a duty to report information to the IRS.

The fourth category of civil penalties generally applies to tax return preparers or promoters of potentially abusive transactions. These penalties may apply for either negligent or willful behavior and have different standards of review.

The government also may seek penalties when a taxpayer takes a frivolous position in administrative or judicial proceedings.

In addition to these civil penalties, there are international tax-related penalties for failures other than timely and accurate filing — e.g., willful failure to report international boycott activity, failure of a US person to furnish information relating to CFCs and controlled foreign partnerships, and failure of a US person to report foreign bank accounts. Pension and employee benefit-related tax penalties are intended to protect the policy reasons for the tax incentives including, most notably, early withdrawal of pension funds and the requirement

that funds in qualified plans be used solely for the benefit of the participants and not the employer. Another group of specialized penalties applies to tax-exempt organizations.

Criminal penalties exist for situations when the failures to comply with the Internal Revenue Code are more egregious and the actions are willful. Criminal penalties apply to both business and individual taxpayers.

In addition to the penalty provisions, interest at statutory rates generally applies to underpayments of tax and is asserted automatically. Interest is not subject to abatement, except in very limited circumstances.

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III.



III. State and local tax issues

Foreign companies with activity in the United States often are surprised that such activity may trigger both federal and state-level taxes. Even more surprising, there are no uniform rules among the states as to whether state tax liability attaches; in some cases, significant state tax liabilities may be imposed even if little or no US federal tax obligations exist.

Foreign companies may not have experience dealing with taxing authorities within a country that has such broad taxing powers.

Inbound insight: Several aspects of state taxation are critical for non-US companies, including a state's power to tax, income apportionment among multiple states, filing methodologies, tax base issues, treatment of foreign-source income, transfer pricing adjustment considerations, registration requirements, and indirect taxes.

Inbound insight: In the United States, limits on federal taxation do not always translate into state limitations. For example, a foreign entity's income may be excluded from federal taxable income by US income tax treaty, but that income still may be taxable by a state. States may not require physical presence to assert tax jurisdiction; economic presence may be deemed sufficient to create nexus. Companies performing cross-border restructuring work should consider state tax implications even when minimal or no US federal taxes are expected.

A. Activities that could subject a foreign entity to state tax

A state's power to impose a tax is derived from the US Constitution and may be limited by the Commerce Clause of the Constitution; the Due Process Clause of the Constitution; federal statutes, such as Public Law (P.L.) 86-272; and state laws, such as 'doing business' statutes.

US treaties generally do not apply to state taxation, unless specifically mentioned in the treaty or if a state voluntarily follows treaty provisions. A foreign entity should understand the various bases for state taxation that may subject its activities to state taxation.

A state generally may impose its tax on an entity to the extent a sufficient 'nexus,' or taxable connection, exists between the entity and the state. While US federal taxation generally requires a threshold activity level of being 'engaged in a trade or business' or having a 'permanent establishment,' mere physical presence in a state, such as having employees or property in the state, generally is sufficient for nexus to exist for state taxation purposes. States also may assert that a foreign corporation has nexus through the in-state activities of an agent or affiliate. Further, 'economic nexus' is often asserted by states as sufficient to meet state tax jurisdictional requirements. Thus, a foreign company may not have a permanent establishment in a particular state, but it may have sufficient nexus with that state to become subject to that state's taxes.

Economic nexus could be deemed to exist between a state and a company based on the presence of intangible property in a state. For example, the license of trademarks to a company located in a state could be deemed to create nexus for the out-of-state licensor on the basis that the intangibles are ‘present’ in the state. Economic nexus also could be deemed to exist under a ‘factor-presence’ standard based on a certain level of sales activity into a state (regardless of physical presence). California, Ohio, Washington, and certain other states have enacted factor-presence standards for certain taxes. For example, California’s factor-presence statute provides that an entity is doing business with the state if the entity’s California sales exceed \$500,000 (adjusted annually for inflation). In November 2016, the Ohio Supreme Court ruled that the state’s commercial activity tax economic threshold for nexus was constitutional.

A federal statute that may protect inbound companies is P.L. 86-272, under which a state is prohibited from imposing an income tax if the only business activity in the state is the solicitation of sales of tangible personal property, provided that the orders are approved and shipped or delivered from outside the state. As the language of the provision indicates, the protection applies only to income tax and the sale of tangible personal property. Service activities and other non-tangible property sales are not protected. Because non-income-based taxes, such as net worth and gross receipts taxes, are not protected, many states actively assert nexus on foreign entities for such taxes.

With broad nexus concepts, state tax jurisdictions may appear to have a greater reach than US federal tax provisions with respect to taxing non-US entities. However, there is one US federal tax requirement that does not apply to state taxation. A non-US entity that is neither engaged in a trade or business within the United States nor has a permanent establishment in the United States still may be subject to withholding tax on US-source income that is ‘fixed or determinable, annual, or periodical income,’ such as interest, dividends, or royalties. From a state tax perspective, the receipt of interest or dividends by itself generally should not be deemed to create nexus. The receipt of royalties also generally should not be deemed to create nexus for state taxation, unless such royalties are derived from in-state intangible property that is deemed to create ‘presence’ or is used in a state that has adopted an economic nexus rule. However, with more states asserting an ‘economic nexus’ standard, the receipt of interest, dividends, or royalties becomes increasingly susceptible to claims of nexus from those states where such income streams derive.

Nexus and treaty considerations are applicable to US state gross receipts taxes as well. For example, Washington State imposes a Business and Occupations Tax. A Washington state decision highlights the risk that a multinational corporation may have a state tax obligation without incurring a US federal tax obligation. In that decision, Washington was successful in imposing its gross receipts tax on a foreign entity otherwise protected from US federal income tax when the entity had no physical presence in the state, but received royalties from in-state sources. The hearing officer, responding to the taxpayer’s argument that the state’s tax on royalties would result in double taxation because the royalties are taxed in Germany, stated that the taxpayer should be able to exclude such income taxed by Washington from its German tax base, thus avoiding double taxation. The officer added that “the treaty does not cover

Washington’s tax on royalties (or any state or local tax, for that matter), and thus, implicitly, the treaty permits taxation of royalties by Washington under Washington’s tax system.”

Inbound insight: Although the June 21, 2018, US Supreme Court decision in *South Dakota v. Wayfair* explicitly addressed the South Dakota sales tax, the decision removes the physical presence requirement from Commerce Clause consideration, which impacts both state income tax and state sales tax. Prior to *Wayfair*, many states enacted economic nexus standards for income tax purposes under the belief that the physical presence standard applied only to sales tax. Conversely, some companies may have interpreted a physical presence requirement to apply to state income taxes as well and, accordingly, may have taken the position that state income tax economic nexus standards are unconstitutional.

Following *Wayfair*, with physical presence no longer a constitutional standard for state taxation, companies that satisfied state-specified income tax economic nexus standards but were not filing state income tax returns in reliance of a physical presence standard potentially could be subject to taxation for past, present, and future years. In 2019, several states, including Hawaii, Indiana, Massachusetts, Pennsylvania, and Texas, enacted by statute or regulation some measure of economic nexus to their income or franchise tax.

Inbound insight: As applied to non-US companies, the application of P.L. 86-272 brings with it potential complications, including: (1) if virtual connections following *Wayfair* can create nexus, can virtual connections constitute an ‘in-state’ activity that exceeds solicitation such that the protections of P.L. 86-272 are lost; (2) if P.L. 86-272 protection applies only when a company’s in-state activity is solicitation, will the same protection apply if a company has no activity in a state, and (3) will a state apply P.L. 86-272 to foreign commerce?

Inbound insight: States generally do not follow US tax treaties, but rather adopt different rules on whether a state has tax jurisdiction over a company (i.e., whether the company has nexus in the state). The concept of nexus, which has been evolving over a number of years, is both complex and subject to unexpected results. This is a topic that can create confusion within senior management of a non-US parent company, especially when unanticipated state disputes arise due to the perceived limited activities in that state.

B. Dividing up taxable income among the states: multistate apportionment

Non-US entities may be familiar with the US federal tax concept of effectively connected income — that is, being taxed on income that is derived from a US business. However, for state tax purposes, a percentage of the entire net income of an entity (or group of entities, as discussed below) may be subject to tax by a state. That percentage generally relates to the proportionate level of activity the entity has within the state as compared with its activity outside the state.

Activity may be measured by the relative in-state sales, property, payroll, or any combination of the three. Some states weight sales activity greater than property and payroll. A current trend among states is a move to a single-sales weighted apportionment factor. Using a single-sales factor results in the state increasing its taxable reach among out-of-state taxpayers because the absence of in-state property and payroll does not serve to dilute the apportionment percentage assigned to the state, as would be the case for a state that incorporates a property or payroll factor.

Complexities arise when states do not uniformly apportion income. For example, the assignment of service income to a particular state may be treated in various ways. Some states source service income to the location where the provider incurs the greater cost in performing the service. Other states employ a marketplace approach, sourcing to where the customer receives the benefit of the service.

Sales of tangible personal property generally are sourced to the state of destination. One exception applies to the extent a state has a ‘throwback’ rule. Under throwback, sales are sourced to the state of origin if the taxpayer does not have nexus with the destination state or country.

Inbound insight: The potential combination of (1) a state asserting nexus based merely on a company having a certain threshold level of sales in a state with (2) a single-sales-factor apportionment regime and (3) US treaties not binding the state could result in substantial state income tax liability for an inbound company.

C. Tax filings include more than just the in-state entity

States vary in their treatment of reporting income among affiliates. ‘Separate company’ states require a taxpayer to report only the income of the taxable entity. ‘Unitary combined’ states may require a unitary group of corporations — which may be different from a ‘consolidated group’ for federal tax purposes and which may include different members from state to state — to file as a combined group regardless of whether a particular entity has nexus with the state. This unitary group could consist only of US corporations (a ‘water’s-edge’ filing) or could include all global entities (a ‘worldwide’ filing).

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

Generally, states that give taxpayers an option between water’s-edge and worldwide provide worldwide filing as the default, as does California; taxpayers must elect to file water’s-edge returns. In California, a water’s-edge election, which must be made on a timely filed original return, is an 84-month commitment. Note that some state elections have different filing and approval requirements. For example, Montana requires that a water’s-edge election must be filed within 90 days of the start of the tax year and must be approved by the state Department of Revenue.

A California water's-edge combined report generally will include a foreign corporation to the extent of its effectively connected income (income derived from or attributable to sources within the United States). Note that California does not recognize provisions of US treaties. Thus, to the extent treaties limit the application of effectively connected income provisions of the Internal Revenue Code, California does not follow the limitations. Any CFC (to the extent of its subpart F income over its E&P) is included in the California water's-edge combined report as well. Wisconsin has a similar rule regarding effectively connected income; a non-US corporation includes only US-source income (effectively connected income as defined by the Code) and related apportionment factors in determining Wisconsin taxable income.

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

As noted above, composition of the group may vary among states. Some states may exclude '80/20' companies and may define such companies in various ways (generally, companies with 80% or more activity outside the United States). Other states may require certain taxpayers to be excluded from a reporting group based on their business. For example, a financial institution may be excluded from a reporting group because it either apportions its state taxable income in a fashion different from its other related affiliates or it is subject to tax on a different tax base such as gross receipts.

A development that has gained importance in recent years involves states including 'tax haven' entities within a reporting group. States that otherwise would impose (or allow as a taxpayer election) a water's-edge return limited to US companies have been expanding their reach to include non-US entities incorporated or doing business in certain foreign jurisdictions.

Alaska, Connecticut, the District of Columbia, Kentucky, Montana, Oregon (until 2017), Rhode Island, and West Virginia include such entities to varying degrees. The Multistate Tax Commission has approved a model tax haven statute that other states could adopt. During the 2019-20 legislative sessions, at least eight states, including Pennsylvania and Massachusetts, have proposed establishing or expanding tax haven laws. Inbound companies doing business in these states should be aware that non-US entities could be included in unitary state returns by virtue of their incorporation or activity in identified 'tax haven' jurisdictions.

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

Inbound insight: States continue to trend toward adopting mandatory unitary combined reporting. The 2019 tax year is the first year of Kentucky's and New Jersey's newly enacted combined reporting regimes.

D. Adjustments to federal taxable income

The starting point for determining US state taxable income generally is an entity's federal taxable income. If an entity has no federal taxable income, this does not mean that it has no state taxable income. Some states may require an addback of a foreign corporation's income that is exempt from federal tax by treaty. Other states may require federal taxable income to be calculated on a pro forma basis as if a treaty did not apply.

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

Another discrepancy between US federal and US state taxable income arises due to related-party expenses. Certain expenses, such as royalties and interest, may be deductible for US federal tax purposes, but if such expenses are paid to a foreign or domestic related party, those expenses may have to be added back to taxable income for US state purposes. While most states have a foreign treaty exception to the addback, the particular treaty must be analyzed because states may consider a US treaty that calls only for a lower tax rate to be different from a US treaty that exempts all the income from tax.

For example, a Washington tax review officer ruled in 2016 that a German pharmaceutical company had economic nexus in the state due to its receipt of royalties paid when its products were sold in Washington, even though the business had no physical presence in the state. The officer also determined that a tax treaty between the United States and Germany implicitly permits states to tax royalties. Although the treaty would protect against discrimination created by the state business and occupation tax, the officer found no prohibited discrimination occurred.

E. Treatment of foreign-source income

While the treatment of foreign-source income technically is an issue for US domestic entities, the complexities of how such income is treated may be important to non-US entities with federal and state tax reporting obligations.

US shareholders of CFCs may be required to include a portion of the foreign entity's undistributed earnings in their federal taxable income. This deemed income is commonly referred to as subpart F income. For state tax purposes, if the state starts with federal taxable income, the 'deemed' dividend will be included in the state tax base. States differ regarding the extent to which the subpart F deemed dividend and the Section 78 dividend gross-up are subject to a DRD.

California employs unique rules with regard to foreign-source income. California requires that a water's-edge filer include a portion of certain CFC income and apportionment factors. The

portion to be included is computed using a ratio of the CFC's subpart F income to its total E&P (its 'inclusion ratio'). Dividends paid between unitary group members are eliminated to the extent the dividends are paid from previously taxed income. There also is a 75% deduction for certain dividends not eliminated (i.e., paid from excluded income).

Some states have acknowledged that their existing dividends received deductions relating to foreign dividends or to subpart F income will extend to Section 965 income. Other states may not have a general deduction for dividends or subpart F income, but may provide for apportionment relief. Some states have enacted legislation dealing directly with Section 965 income. Other states have been silent, which makes the state tax treatment of Section 965 income uncertain.

State taxing regimes providing less than a 100% deduction and/or providing an expense disallowance result in a portion of Section 965 income being subject to tax in certain states, including Connecticut, Idaho, Maine, Massachusetts, New Jersey, and Utah. Additionally, state dividends received deductions may be conditioned on a certain level of CFC ownership. Accordingly, ownership of less than 80% in a CFC also may trigger state tax considerations for Section 965 income. Finally, in states that do not conform to Section 965 (e.g., California and Minnesota), actual cash distributions made in subsequent years may be subject to state tax as a foreign dividend and not exempt as previously taxed income.

There also are many issues regarding the state tax treatment of GILTI and the corresponding Section 250 deduction, such as whether the state conforms to the relevant Code changes; whether the state includes GILTI income in its taxable base; whether the state adopts the Section 250 deduction; whether the state has a dividend received deduction or other modification that will apply to the included GILTI income; how included GILTI income is reflected in the state's apportionment factor; and, if all or a portion of the GILTI income is not taxable, whether the state requires expenses associated with such income be added back. Complications also arise due to states that may not conform to federal consolidated return regulations. Because proposed regulations provide that certain GILTI and Section 250 calculations are performed pursuant to the federal consolidated return regulations, there could be significant differences between federal and state calculations in states that do not follow such regulations.

F. States with transfer pricing adjustment power

Many states have Code Section 482-type powers to adjust the income of taxpayers (Section 482 contains the Code's transfer-pricing provisions). Many states also have authority to adjust apportionment factors to fairly represent the extent of the taxpayer's business activity in the state (known generally as UDITPA section 18 powers). States may force combined reporting on certain taxpayers regardless of whether intercompany transactions are at arm's length. Further, states may disallow interest expense to a foreign affiliate under their Section 482-type authority, even if the IRS has not adjusted that same payment. These are concerns for domestic and foreign companies alike, but it may come as a surprise to non-US companies that US states have broad income adjustment powers that mirror federal powers.

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

G. Statutory state addbacks

Many states have statutory modifications that can result in disallowance of certain intercompany expenses, different treatment of certain types of income, and other adjustments to the tax base.

Several states, including Alabama, Arkansas, Georgia, and New Jersey, require that certain intercompany expenses (interest, royalties, intangibles) that were deductible for federal income tax purposes are disallowed when computing taxable income, unless they qualify for certain exceptions.

Two common exceptions to a state's addback rule are: (1) when the related member is located in a foreign country with a US income tax treaty and (2) when the amount is subject to tax in another state or foreign jurisdiction. Complexities arise, and not every state with an addback rule provides either or both exceptions; some states require the existence of a US income tax treaty and that the amount was subject to tax.

Inbound insight: A state may disallow deductions for certain interest or royalties paid to a related foreign entity, even though allowed under federal tax law.

Inbound insight: The overlap of related-party interest expenses and the IRC Section 163(j) limitation may create significant reporting confusion in certain states.

H. Indirect tax considerations

State 'indirect taxation' generally refers to any state tax that is not based on income. The most common indirect tax is a state's sales and use tax; other indirect taxes include franchise taxes, real estate transfer taxes, telecommunications taxes, commercial rent taxes, and hotel occupancy taxes. The indirect taxes that apply depend on the nature of the company's business activities. A non-US company might be surprised at the number of indirect taxes that it has to consider.

Inbound insight: While appearing similar at first, a VAT is much different from a state sales or use tax, both with respect to incidence of taxation and items subject to tax. In addition to states, thousands of local municipalities within states levy sales and use taxes (sometimes with different rules than the states).

On June 21, 2018, the US Supreme Court in *South Dakota v. Wayfair* ruled that physical presence no longer was required for state sales taxation. The Court concluded that nexus was 'clearly sufficient' when South Dakota imposed a sales tax collection and remittance requirement on a seller where, on an annual basis, the seller (1) delivered more than \$100,000 of goods or services into the state or (2) engaged in 200 or more separate transactions for the delivery of goods or services into the state.

Non-US companies often sell directly to US customers without engaging in any other activities in the United States. The act of selling into the United States, by itself, typically may not create a federal tax liability or federal tax filing obligation. However, these same sales now could create a sales tax registration, compliance, and possibly collection responsibility under state law.

Certain states assert nexus due to the use of affiliate marketers for out-of-state sellers. Affiliate marketing is an internet-based marketing practice under which an in-state third party promotes the products or services of an out-of-state seller by providing a link on its website to those products or services and the out-of-state seller compensates the in-state third party for such promotion. Some states have enacted legislation that creates a rebuttable presumption that an out-of-state seller engaging in affiliate marketing with an in-state third party has nexus and therefore is required to collect sales tax.

Affiliate marketing nexus provisions allowed states to impose a sales tax collection responsibility on sellers in the absence of a physical presence. With Wayfair negating the physical presence requirement, many of these affiliate marketing nexus provisions may be moot as the remote seller may have economic nexus with the state based on the volume of its sales into the state.

As discussed above, one of the nexus protections for state income and franchise taxes is P.L. 86-272, but that statute does not apply to non-income taxes. Accordingly, an entity with employees engaged only in the solicitation of sales of tangible personal property within a state, which otherwise is protected from income tax nexus under P.L. 86-272, still may be subject to a state's sales and use tax and other non-income tax based taxes (e.g., franchise taxes based on net worth).

Once a company has nexus to a state with respect to sales and use taxes, that company must register with the state's tax department, file sales tax returns, and pay its sales tax liabilities. Depending on the volume of sales, the company may be required to file returns on an annual, quarterly, or monthly basis. Sales tax generally is imposed on retail sales, leases, rentals, barter, or exchanges of tangible personal property and certain enumerated services unless specifically exempted or excluded from tax.

Sales tax generally is imposed in the jurisdiction in which the 'sale' occurs. The definition of 'sale' differs from jurisdiction to jurisdiction; however, the definition generally includes both (1) consideration and (2) transfer of title, right to use, or control (possession) in the case of tangible property and completion of the service act in the case of a service.

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

All retail sales of tangible personal property are taxable unless entitlement to an exemption or exclusion is established. When tangible personal property is sold, and the purchaser intends to resell the property, the sale is not a retail sale; rather, it is a sale for resale. A resale exemption is allowed because the intermediate sale does not represent the ultimate sale or final consumption of the tangible personal property. The burden of proving that an exemption such as sale for resale applies is on the seller, although a timely accepted and properly completed exemption certificate received from the purchaser may relieve the seller of liability for an improperly claimed exemption.

In 2016, a US appellate court upheld a unique state sales/use tax reporting rule enacted by Colorado that requires retailers that sell products to Colorado customers, but do not collect and remit Colorado use tax, to report certain information about such purchases to the customers and to the Colorado Department of Revenue. The law generally requires non-collecting retailers to (1) notify Colorado purchasers that sales or use tax is due on certain purchases, (2) provide an annual report to certain Colorado purchasers of their purchases for the year, and (3) provide an annual statement to the Colorado Department of Revenue listing their Colorado customers and the total amount paid for Colorado purchases in the prior calendar year. A petition for rehearing at the US appellate court was denied April 1, 2016, and a petition for certiorari at the US Supreme Court was denied December 12, 2016. As a result, the US appellate court's decision stands, and non-collecting retailers selling into Colorado may be subject to this notice and reporting requirement. Other states, such as Louisiana and Vermont, have enacted similar notice and reporting requirements.

Inbound insight: Inbound companies sometimes are surprised to learn of state-level taxes that are not imposed on income, such as the Ohio commercial activity tax (CAT), the Washington State Business and Occupancy Tax, and the Nevada Commerce Tax. Inbounds should monitor all taxes imposed by each state in which they do business.

I. Local taxation

Cities that impose their own income tax modeled after their respective state's combined unitary reporting methodology include New York City; Portland, Oregon; and Detroit, Michigan.

Compliance complexities multiply because US taxation geographies are further divided within states, and some US cities have significant taxing powers. A non-US entity doing business in Kentucky or Ohio may be subject to dozens of individual city returns since many cities in those states impose separate income tax filing obligations. Further, these local income taxes often are imposed on pass-through entities, such as partnerships, in addition to corporations.

In addition, cities may impose local-level sales and use taxes. Administratively, the sales taxes usually are collected by and remitted to the state, and then allocated to the localities. Generally, the rules for the localities are modeled after the rules for the states, but this is not always the case. The rules can vary from jurisdiction to jurisdiction. Overall, there are thousands of indirect taxing jurisdictions in the United States. Any non-US company doing business in the United States should be aware of all the various indirect taxes that may be imposed.

J. Credits and incentives: state and local

From a US state and local tax perspective, there are two main methods for incentivizing business: statutory credits and discretionary incentives.

Statutory credits typically are offered to all qualifying companies within a jurisdiction and, in certain circumstances, can be claimed retroactively. Discretionary incentives, on the other hand, typically must be negotiated between the taxpayer and the state and local governing bodies or economic development groups prior to commencement of the project.

1. Statutory credits

State and local governments have become more competitive in offering tax credits to attract and retain growing companies for the purpose of promoting economic development. Today there are hundreds of statutory tax credits available as a result of this competition.

A number of these credits mimic the federal credits discussed above, but usually apply to activities performed only in a given state or local jurisdiction. Such credits may include:

- hiring and jobs tax credits
- investment tax credits
- technology investment tax credits
- alternative and renewable energy tax credits
- research and development credits
- training credits
- contribution credits
- port tax credits.

2. Discretionary incentives

State and local governments continue to add to the increasing complex array of economic incentives to encourage private-sector investment.

The types of incentives offered vary significantly depending on jurisdiction and industry. The majority of incentives are based, at least partially, on increases in workforce and capital investment in property. A number of other factors such as the location of the project, wages of employees, amount and types of benefits offered to employees, and type of investments, also may be considered.

Incentives can take many forms, such as:

- property tax abatements
- sales tax exemptions
- infrastructure grants
- training grants
- cash grants
- withholding tax rebates
- reduced financing
- utility tax exemptions
- construction fee waivers.

Inbound insight: Federal tax reform may bring with it considerable US state tax incentive opportunities by encouraging capital growth in the United States and promoting competition among states for new jobs, retained jobs, and capital investment. Companies planning to increase their US footprint and promote domestic job expansion will foster competition among states for those jobs through negotiated incentives.

Inbound insight: Federal tax reform (the Act) added the Opportunity Zone program. Although a federal program, investors should consider the availability of additional economic incentives from local and state governments since opportunity zones are designated by governors to be areas of economic distress.

K. Abandoned and unclaimed property (AUP)

An area unique to doing business in the United States is state legislation surrounding abandoned and unclaimed property (AUP). All 50 states, as well as the US jurisdictions of the District of Columbia, Puerto Rico, the US Virgin Islands, and Guam, have specific laws as to the treatment of AUP.

AUP is property held by a business that is due to another entity (i.e., a business, individual, or government agency). State laws require businesses to turn these amounts over to the state administrators after a specified period known as the dormancy period. Commonly, businesses are required to review uncashed disbursements (such as payroll, vendor payables, and customer refunds), unutilized receivable credits, unredeemed gift certificates and merchandise credits, customer deposits, unidentified remittances, and any other unresolved liabilities on the books and records of the company. Each industry has specific areas of potential property types that should be examined for compliance with state AUP laws.

Any amounts of AUP are paid in full to the state on an annual basis, and the state retains the records and funds for the payee or owner to come forward and claim the amounts directly from the state. This creates a dollar-for-dollar liability for businesses with aged unresolved liabilities or uncashed checks.

If AUP is identified, the amounts are payable to the states based on sourcing rules, as opposed to a nexus standard. The sourcing rules were developed through a series of Supreme Court cases and are reaffirmed directly in many state laws. The sourcing rules indicate that property is to be remitted to the state of the last known address on the books and records of the business.

If that information is not available, not collected, or associated with the specific property, the amounts would be due to the state of incorporation or state of domicile of the business. For any past-due property that is remitted, depending on the state, interest and penalties may be assessed. Therefore, businesses can easily have a large potential AUP exposure. The states also require that their specific state regulations be followed for any amounts potentially due to the state, meaning businesses need to consider multiple state rules related to AUP.

Audits for AUP are conducted either by the state directly, or more commonly, by a third-party audit firm. Third-party audit firms often are paid on a contingency basis and hence have an incentive to pursue large settlement offers. They also may seek to expand the audit to multiple states. Generally speaking, an AUP audit is a lengthy process that drains internal resources.

As AUP is not a tax, some states view AUP as an additional non-tax source of revenue. States utilize a 'lookback period' during audits to determine unremitted properties. The lookback period varies by state, but generally covers 10 reporting years (or 11 to 15 calendar years, depending on the property type and dormancy period). If a business does not have records for the entire lookback period, the state may calculate estimates to cover these periods. All amounts derived from calculations are due to the state of incorporation or state of domicile as 'owner unknown' property.

A proactive self-initiated program to quantify AUP liabilities affords businesses the ability to manage the process through 'self-audits' and 'voluntary disclosure programs' offered by states. These options still require a comprehensive review of all divisions and property types; however, rather than the review being controlled/managed by a third-party auditor, it is done by the business itself and/or consultant engaged. Interest and penalties on past-due property often are waived by the state, and the review itself is not as lengthy as an audit.

Inbound insight: AUP is a unique reporting responsibility in the United States. This dollar-for-dollar liability and reporting requirement are applicable to all companies and all industries, and unlike other taxes, do not rely upon a nexus standard.

L. Mergers and acquisitions considerations

When selling a business, the first state-level issue a seller should examine is whether state gain is different than federal gain. Under certain circumstances, when the seller's tax basis in the assets sold is different for state purposes than it is for federal purposes, the amount of state gain or loss could be different.

In particular, when a corporate subsidiary is being sold from a consolidated group, a difference in basis may exist in those states that do not conform to the federal consolidated return rules – in particular, the investment adjustment rules under Reg. sec. 1.1502-32. Generally, in addition to adjusting the basis of the stock of a subsidiary for contributions to capital and return of capital, the investment adjustment rules provide that the basis of the stock of a subsidiary may be adjusted for items of income, gain, deduction, and loss taken into account by the subsidiary while a member of the consolidated group.

State basis differences in the context of a sale of business assets also may result in a difference between federal and state gain. For states that apply different depreciation methodologies than federal (e.g., California), the state basis of the depreciated assets may be higher or lower depending on whether the state depreciation methodology is applied at an accelerated or decelerated rate.

Several states have enacted legislation along the lines of the Uniform Division of Income for Tax Purposes Act (UDITPA). These rules classify income as either business or nonbusiness. Business income is apportioned among the states in which a corporation does business. In contrast, nonbusiness income typically is allocated to a particular state (e.g., commercial domicile for the sale of an intangible, physical location for real and tangible personal property). Upon the sale of assets or stock of a business, the fundamental inquiry in UDITPA states will be whether the income or gains constitute business income.

A state's apportionment factors are intended to fairly apportion income resulting from business operations. Arguably, however, ordinary apportionment does not fairly reflect the results of unusual business transactions, such as the isolated sale of a business. Not every state provides clear guidance as to whether the receipts from the sale of a business should be included in the sales factor. As a result, determining how to source receipts from the sale of a business may be exceedingly complex.

Generally, receipts from the sale of tangible and real property of a business are sourced to the state location of such assets. However, sourcing receipts derived from the sale of intangible property, such as stock of a corporation or equity interest in a pass-through entity, is more complicated because intangibles, by their nature, do not have a fixed geographical location. Certain states provide more guidance than others with respect to determining how to source the sale of an intangible.

Business acquisitions also can create significant state and local transfer tax liabilities depending on the structure of the transaction and the nature of the assets being conveyed. The sale of business assets, particularly tangible assets, can give rise to sales tax, unless an exemption applies.

In addition, the sale of owned or leased real property may be subject to real estate transfer tax in several jurisdictions. Real estate transfer taxes often are required to be paid at the time of recording the deed. A minority of states impose an indirect real estate transfer tax upon the direct or indirect transfer of an entity based on ownership interests and certain leasehold interests (e.g., long-term leases, below-market leases, and leasehold improvements) in real property.

M. State tax impact of federal tax reform

The Act brings with it considerable state tax complexities. It still is unclear how the states will react to particular federal changes made by the Act.

States vary in how they follow federal law. Some states automatically adopt federal changes; these states will have to determine proactively whether to decouple from tax reform provisions. Some states that use a fixed conformity date may not adopt tax reform changes automatically; these states may decouple from specific tax reform provisions when they update their federal conformity dates. Other states adopt specific Code provisions, based on a current or fixed date, thereby introducing additional complexity. It remains uncertain whether states will adopt all, some, or none of the federal tax reform provisions enacted by Congress.

Tax readiness insight: Provisions of the Act that have created significant state tax issues (discussed elsewhere in this guide) include the e, taxation of global intangible low-taxed income (GILTI), the deduction for foreign-derived intangible income (FDII), the interest expense limitation, and full expensing of certain purchases.

US inbound companies will find it difficult to estimate accurately their state income tax liabilities due to the different methods of federal conformity and the possibility that states may pass legislation to adopt or decouple from certain provisions of the Act. These companies should follow the legislatures of the states in which they do business to determine how their state tax liabilities will be affected.

With the federal tax rate reduction, the significance of the state income tax component of a company's overall effective tax rate will increase substantially. State taxes may be even more significant if states choose to adopt the base-broadening measures included in the Act without a corresponding state rate cut.

Tax readiness insight: While many provisions of the Act are beneficial to US inbound companies, the new provisions will be adopted by the states in a variety of ways. States already decouple from many of the provisions of the IRC, thus creating a bewildering array of state tax liability calculations that differ from federal tax liability calculations. This is not expected to change under the Act as states that automatically conform to the IRC determine whether they wish to follow certain provisions of the Act and states that do not conform determine if they wish to benefit from certain provisions. There could be a considerable amount of state legislative activity as states determine how they want to conform to or decouple from the new federal tax system.

US inbound companies should expect that this legislative process will take time and that it will be difficult for them to accurately estimate their state tax liabilities until states have deliberated on these issues. It is recommended that US inbound companies follow closely the state legislatures of the states in which they do business so they are prepared to respond to any tax law changes occurring at the state level.

Inbound Insight: With the taxation of foreign income through Section 965 and GILTI and the 100% federal deduction for most foreign dividends under Section 245A, companies are likely to see more distributions to the US from foreign subsidiaries. The expected tax-free federal result may not always translate the same for state tax purposes. Companies will experience the same federal and state tax differences around basis determinations for states that don't adopt Section 965 or GILTI. Whether states follow federal consolidated return regulation treatment adds another layer of complexity.

The CARES Act included business tax provisions with potential state tax implications.

Section 163(j) limitation. Applicable to tax years beginning in 2019 and 2020, the Section 163(j) 30% adjusted taxable income limitation is increased to 50%. A taxpayer may elect to use its 2019 ATI for its 2020 limitation. Additionally, a taxpayer may elect out of the increased Section 163(j) limitation.

Inbound companies should review state tax conformity to federal law in order to determine whether the temporary 50% limit and the associated elections will apply. The increased limitation may provide certain taxpayers with relief. However, any measure of limitation brings with it the same state tax complexities that existed before the CARES Act, including applying the limitation in states that have related-party addbacks; calculating the limitation in separate company reporting states and combined states that do not apply federal consolidated return treatment; calculating and applying the carryforward when entities enter or leave a combined group; and addressing different calculations across states with varying treatments.

Net operating losses. The CARES Act removes the 80% limitation for NOL deductions in tax years beginning before January 1, 2021, and allows the carryback of losses from tax years beginning in 2018, 2019, and 2020 for up to five years.

Inbound companies should review state tax conformity to federal law in order to determine whether the temporary NOL limit relaxation will apply. Additionally, analyzing whether states conform to IRC Section 172 is not always straightforward. Companies must consider whether a state conforms specifically to the calculation of the NOL deduction in Section 172(a). For example, a state may define its state NOL with reference to the "federal [NOL] as calculated under Section 172." Section 172(c) provides the calculation for the federal operating loss. However, if the state makes no reference to the deduction under Section 172(a), arguably the deduction, and its associated limitation, may not be adopted by the state.

Full expensing for qualified improvement property (QIP)

Effective "as if included in" the TCJA, the CARES Act allows QIP to qualify for full expensing retroactive to assets placed in service after December 31, 2017. The change is made in Section 168(e)(3)(E) by adding a new category of 15-year property for QIP as defined in Section 168(e)(6).

Nonconformity to the IRC or to Section 168(k) specifically raises state tax issues, including federal/state basis discrepancies, modifications to state taxable income, and financial statement book-to-tax differences. Since numerous states have decoupled from or modify Section 168(k), these nonconformity issues will continue to be an issue for taxpayers after the CARES Act.

Because the QIP change is made outside of Section 168(k), when states adopt the IRC that includes the changes from the CARES Act (whether immediately or when they update their IRC conformity) they also will adopt the QIP change outside of bonus depreciation/full expensing.

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IV.



IV. US tax treaties

The United States has in place bilateral income tax treaties with more than 60 countries. The US government enters into such treaties for several reasons, including:

- to encourage international trade and investment
- to promote cooperation among countries in enforcing and administering tax laws
- to promote information exchange
- to reduce or eliminate double taxation and excessive taxation.

US income tax treaties typically cover various categories of income, including:

- business profits
- passive income, such as dividends, interest, and royalties
- income earned by teachers, trainees, artists, athletes, etc.
- gains from the sale of personal property
- real property income
- employment income
- shipping and air transport income
- income not otherwise expressly mentioned (i.e., other income).

The categories of income covered vary from treaty to treaty, and no two treaties are the same. [Appendix A](#) summarizes the benefits (reduced rates of tax collected through withholding) resulting from US tax treaties.

To be eligible for treaty benefits, it is necessary to satisfy the conditions of the residency article as well as certain other requirements. These include, importantly, when applicable, the limitation on benefits (LOB) article (discussed below). In general, an individual is treated as a resident of the country in which the individual is subject to tax by reason of domicile, residence, or citizenship. A corporation generally is treated as resident in the country in which it is subject to tax by reason of its place of management, place of incorporation, or similar criteria. US domestic rules contain provisions that address the treatment of the availability of treaty benefits to income received by fiscally transparent entities; some US treaties also address fiscally transparent entities.

The vast majority of US tax treaties contain LOB articles. LOB articles are anti-‘treaty-shopping’ provisions that are designed to deny treaty benefits when the party seeking the

benefits does not have sufficient connection to the jurisdiction in which it is resident to support the application of the treaty. In recent years, the US Treasury has made it a priority to renegotiate the more commonly used treaties that did not have LOB articles. Two of those treaties — with Hungary and Poland — have been renegotiated but not yet ratified.

LOB articles provide objective tests (e.g., ownership-base erosion test and publicly traded company test) to determine whether an entity is appropriately claiming treaty benefits or was created merely to obtain treaty benefits. As new treaties are negotiated, the United States has been adding more restrictive provisions to the LOB tests; as a result, a company that is not engaged in treaty shopping nonetheless may fail the tests. If objective tests are not met, a country's competent authority may grant treaty benefits with respect to a specific item of income upon request by the taxpayer, if the competent authority determines that the establishment, acquisition, or maintenance of the entity and the conduct of its operations did not have as one of its principal purposes the obtaining of treaty benefits.

Inbound insight: In 2016, the US Treasury released a new version of the US Model Treaty, which is the starting point for US treaty negotiations. The 2016 Model Treaty reflects a shift in focus by the US Treasury in its treaty policy away from encouraging bilateral trade and investment and toward incorporating more restrictive provisions designed to prevent the use of income tax treaties to facilitate 'stateless income.' It is unclear whether treaty partners negotiating income tax treaties with the United States will be willing to accept such restrictive and complex LOB provisions, but residents of any country that is considering negotiating or renegotiating an income tax treaty with the United States should closely monitor the status of negotiations and analyze whether they could qualify for benefits under a treaty that incorporates the 2016 Model's provisions.

The US tax treaty network includes treaties with most European countries and other major trading partners, including Mexico, Canada, Japan, China, Australia, and the former Soviet Union countries. There are many 'gaps' in the US tax treaty network, particularly in Africa, Asia, the Middle East, and South America. A new treaty with Chile was signed in 2010 but has yet to be ratified.

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

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

In July 2019, the US Senate approved protocols to the US tax treaties with Spain, Switzerland, Japan, and Luxembourg, without any reservations. In August 2019, Treasury announced the entry-into-force dates of the protocols to the US tax treaties with Japan (August 30, 2019) and Spain (November 27, 2019).

There are continued efforts to expand the network of countries that have adequate tax information exchange agreements with the United States. In addition to its bilateral income tax treaties, the United States currently is a party to over 30 tax information exchange agreements, which provide the legal basis for exchanges of information between tax administrations.

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

On November 24, 2016, the OECD released the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI). In brief, the MLI is an agreement among OECD member states to swiftly and cohesively amend each of their bilateral tax treaties to give effect to the OECD's BEPS project. Although the United States participated in the discussion process, the United States has not signed the MLI.

Inbound insight: As noted in the state and local tax discussion above, states are not restricted in their taxing powers by federal limitations such as 'engaging in a trade or business,' having a 'permanent establishment,' or treaty restrictions.

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V.



V. Transfer pricing

Transfer pricing is a term used to describe intercompany pricing arrangements relating to transactions between related entities. These can include transfers of intangible property, tangible goods, or services, as well as loans or other financing transactions, which can occur across local, state, or international borders.

Due to growing government deficits, many jurisdictions are putting additional pressure on transfer pricing in order to secure a larger portion of entities' profits for their tax bases. This can result in the risk of tax assessments, double taxation of the same income by two jurisdictions, and penalties for failure to properly allocate income among two or more jurisdictions. Therefore, virtually all large MNCs should regularly review their international transfer pricing strategies and potential risks.

Transfer pricing applies to a wide range of intercompany transactions, including transactions involving:

- tangible goods (e.g., manufacturing, distribution)
- services (e.g., management services, sales support, contract R&D services)
- financing (e.g., intercompany loans, accounts receivable, guarantees, debt capacity)
- intangible property (e.g., licenses, royalties, cost sharing transactions, platform contribution transactions, sales of intangibles).

The international standard for determining the appropriate transfer price is the arm's-length principle. Under this principle, transactions between two related parties should produce results that do not differ from those that would have resulted from similar transactions between independent companies under similar circumstances. This principle is cited in the US transfer pricing rules (Code Section 482 and the Treasury regulations thereunder), the Transfer Pricing Guidelines, and the UN Transfer Pricing Manual for Developing Countries. There are some countries (e.g., Brazil) that do not follow the international application of the arm's-length principle.

If a transaction between related parties is priced differently than if it were between unrelated parties, the IRS has authority under Section 482 to reallocate income or expenses to reflect the amounts that would have resulted had the transaction been conducted at arm's length.

The Section 482 regulations are extensive and attempt to address a full range of transactions in light of the arm's-length standard. In practice, however, it is not easy to determine the appropriate arm's-length result based on a given set of facts and circumstances. Transactions in goods and services may embody unique, company or industry-specific elements that are difficult to compare with transactions involving other companies. The Section 482 regulations concede the rarity of identical transactions, and instead attempt to determine the arm's-length results based on the 'best method' rule.

1. Best method rule

The Section 482 regulations provide several methods to test whether a price meets the arm's-length standard, but provide no strict priority of methods. No method invariably will be considered to be more reliable than another. Instead, every transaction reviewed under Section 482 must be judged under the method that, under the facts and circumstances, provides the most reliable measure of an arm's-length result (i.e., the 'best method').

The selection of a method also varies depending on the type of transaction. For example, the regulations provide five specified methods for transactions involving tangible property, and six specified methods for service transactions, while only three are specified for transactions involving intangible property. Methods not specified in the regulations are also potentially applicable. Note that while each method is important to understand, an examination of each is beyond the scope of this discussion.

2. Comparability factors

To determine the best method for a particular transaction, the relative reliability of a method must be evaluated on the degree of comparability between the controlled transaction or taxpayers and the uncontrolled comparables applied under the method, taking into account certain factors. While a specific comparability factor may be of particular importance in applying a method, each method requires an analysis of all the factors that affect comparability under that method.

3. Quality of data and assumptions

Whether a method provides the most reliable measure of an arm's-length result also depends upon the reliability of the assumptions and the sensitivity of the results to possible deficiencies in the data and assumptions.

The completeness and accuracy of the data affect the ability to identify and quantify those factors that would affect the result under any particular method. Likewise, the reliability of the results derived from a method depends on the soundness of assumptions made in applying the method. Finally, the sensitivity of results to deficiencies in data and assumptions may have a greater effect on some methods than others. In particular, the reliability of some methods depends heavily on the similarity of property or services involved in the controlled and uncontrolled transaction, while other methods rely on broad comparisons of profitability.

4. Arm's-length range

The Section 482 regulations recognize that a method is likely to produce a range of arm's-length results and provide that a taxpayer will not be subject to adjustment if the taxpayer's results fall within such an arm's-length range. The arm's-length range ordinarily is determined by applying a single pricing method selected under the best method rule to two or more uncontrolled transactions of similar comparability and reliability.

The comparables used for the uncontrolled transactions must be sufficiently similar to the controlled transaction. If material differences exist between the two transactions, adjustments must be made in order for the uncontrolled transaction to have a similar level of comparability and reliability. In many cases, the reliability of the analysis will be improved by adjusting the range through the application of a valid statistical method, often the interquartile range of results.

5. Penalties and documentation

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

Under Section 6662(e), the transfer pricing penalty generally is equal to 20% of the underpayment of tax attributable to the transfer pricing misstatement, but increases to 40% of the underpayment of tax for larger adjustments. Having contemporaneous transfer pricing documentation that satisfies the requirements under Section 6662(e) in place at the time the tax return is filed can help provide protection against these penalties.

Another avenue for avoiding potential transfer pricing penalties can be an advance pricing agreement (APA) – an agreement between a government and a taxpayer that provides prospective ‘certainty’ for a defined term regarding covered intercompany transactions. APAs can be unilateral (between the taxpayer and the IRS), bilateral (with the IRS and another tax authority), or multilateral (with the IRS and more than one other tax authority).

Tax readiness insight: The Act generally does not alter the arm’s-length standard as reflected in US domestic law and relevant treaties, although it does alter the statutory language for the definition of intangibles and for certain valuation methods in the context of intangible transfers. Thus, the related-party components of the calculations under the BEAT and the GILTI calculations still will require compliance with the arm’s-length standard. From a foreign perspective, companies also must also weigh the impact of OECD initiatives in evaluating the tax results of their operating models and capital structure. Finally, the US move to a lower corporate tax rate may invite scrutiny of foreign jurisdictions to the extent changes are made to existing intercompany policies.

Tax readiness insight: The Act added Section 367(d)(4), which states explicitly that the definition of intangible property includes workforce in place, goodwill, going concern value, and any other item of intangible value. This definition applies for purposes of Sections 367 (relevant to outbound restructurings) and 482 (intercompany transfer pricing).

The Act also amended Sections 367 and 482 to codify certain valuation principles reflected in the current Section 482 regulations with respect to transfers of intangible property. Specifically, the Act authorizes the IRS to apply the ‘realistic alternatives’ principle and to value transfers of multiple intangibles (or intangibles and services, for

example) on an aggregate basis. These changes apply to transfers in tax years beginning after December 31, 2017.

The expanded definition of intangibles and codification of the IRS's preferred valuation principles could particularly affect IRS scrutiny of transactions or restructurings involving high-value or hard-to-value intangibles, including those involving multiple interrelated elements (such as the implementation of a cost-sharing arrangement). The changes for the most part reflect provisions that had previously been incorporated in regulatory guidance under Section 367 and Section 482, but the IRS may be further encouraged in its enforcement efforts by the fact that these valuation principles, coupled with an all-encompassing definition of intangibles, are now set forth in the governing statute.

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VI.



VI. The OECD's BEPS project

A. OECD BEPS implementation and addressing the challenges of the digitalization of the economy

The uncertainties for US and non-US MNCs created by global tax issues and disputes likely will remain for some time. The impact of US tax reform continues to be closely monitored by other countries as they consider whether to introduce their own unilateral and multilateral reforms.

The OECD Inclusive Framework – which is committed to implementing the BEPS minimum standards – now has nearly 140 member countries and continues to expand. Under a mandate of the G20, the OECD seeks consensus among this large and diverse group of countries on the implementation and monitoring of the BEPS Project, and on the accelerated project reviewing the tax challenges of digitalization.

Meanwhile, the EU has taken a more active role in tax policy, implementing (and going beyond) the BEPS recommendations, reviewing and overruling domestic tax measures and rulings of Member States, and seeking agreement among its members and the international community regarding short-term and long-term measures to tax digital activities.

Digitalization of the economy

The taxation of the digitalization of the global economy continues to be a focus for policymakers and MNCs.

Background

Following the G20's request in 2017 for the OECD to accelerate its post-BEPS review of the tax challenges of digitalization, 2018 saw significant developments in terms of the OECD's progress in exploring a global solution that could be agreed to by the Inclusive Framework countries. At the same time, unilateral measures have been developed by individual countries and the EU in lieu of a global agreement. Proponents of regional and unilateral measures claim they are necessary to encourage international agreement and meet short-term revenue needs and perceptions of fairness in the tax system. However, some US officials publicly have expressed concern regarding these measures, arguing that they create transatlantic trade barriers by discriminating against US businesses.

OECD efforts

Building on the 2015 BEPS Action 1 Report, the OECD in March 2018 released an Interim Report that included an in-depth analysis of the changes to business models and value creation arising from digitalization. The Interim Report stated that the following characteristics are frequently observed in certain highly digitalized business models:

- cross-jurisdictional scale without mass
- reliance on intangible assets
- the importance of data, user participation, and their synergies with intellectual property.

Describing the potential implications for international tax rules, the Interim Report identified the positions that different countries hold, which drive their approach to possible solutions. Some countries take the position that no action is needed, others consider there is a need for action that would take into account user contributions (i.e., in ‘digital’ business models), and still others consider that any changes should apply to the economy more broadly. The Interim Report paved the way for the OECD to move forward toward a long-term multilateral solution in the next phase of work.

In early 2019 the OECD announced that the Inclusive Framework would step up efforts toward reaching a global solution to the growing debate over how to best tax multinational enterprises in a rapidly digitizing economy. Its ongoing work focuses on two central ‘pillars’ identified in a Policy Note released after the Inclusive Framework’s January 2019 meeting.

The first pillar focuses on how the existing rules that divide up the right to tax the income of multinational enterprises among jurisdictions, including traditional transfer-pricing rules and the arm’s-length principle, could be modified to take into account the changes that digitalization has brought to the world economy. This requires a re-examination of the so-called ‘nexus’ rules – namely how to determine the connection a business has with a given jurisdiction to produce a taxing right – and the rules that govern how much profit should be allocated to the business conducted there.

The Inclusive Framework has considered proposals based on the concepts of marketing intangibles, user contribution, and significant economic presence, and how they can be used to modernize the international tax system to address the tax challenges of digitalization. Currently, the Inclusive Framework is considering a ‘Unified Approach’ to Pillar One that would create a new taxing right for market jurisdictions even when a MNC does not have a physical presence there, and would create a new three-tiered profit allocation system that departs from the arm’s-length principle in some respects. The new system would likely introduce enhanced binding dispute tools to better prevent and resolve transfer pricing controversies.

A second pillar aims to resolve remaining BEPS issues and explores two sets of interlocking rules designed to give jurisdictions a remedy in cases where income is subject to no or only very low taxation. The main components of Pillar Two are an income inclusion regime (based on a global foreign minimum tax rate) and a denial of deductions regime for under-taxed payments.

The designs of both pillars are subject to further negotiation and discussion among the members of the Inclusive Framework throughout 2020. The OECD hopes to be able to achieve a political consensus in 2020 and present a report to the G20 by the end of the year, with further efforts to implement any new system in the forthcoming years.

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VII.



VII. Individual tax issues

The United States levies tax on its citizens and resident aliens on their worldwide income. Nonresident aliens are taxed on their US-source income and income effectively connected with a US trade or business (with certain exceptions). For discussion of how the United States determines the residence status of an alien, see section VI.D. Residence, below.

A. Personal income tax rates

For individuals, the top income tax rate for 2020 is 37%, except for long-term capital gains and qualified dividends (discussed below).

Tax readiness insight: The Act reduced individual tax rates, but the number of tax brackets remains at seven. The Act sunsets many individual tax provisions after 2025, including the lower rates.

2020 income tax rates and brackets

Single taxpayers

Taxable income	Tax rate:
\$0-\$9,700	10%
\$9,701-\$39,475	12%
\$39,476-\$84,200	22%
\$84,201-\$160,725	24%
\$160,726-\$204,100	32%
\$204,101-\$510,300	35%
\$510,301+	37%

Married taxpayers filing jointly

Taxable income	Tax rate:
\$0-\$19,750	10%
\$19,751-\$80,250	12%
\$80,251-\$171,050	22%
\$171,051-\$326,600	24%
\$326,601-\$414,700	32%
\$414,701-\$622,050	35%
\$622,051+	37%

Head-of-household taxpayers

Taxable income	Tax rate:
\$0-\$14,100	10%
\$14,101-\$53,700	12%
\$53,701-\$85,500	22%
\$85,501-\$163,300	24%
\$163,301-\$207,350	32%
\$207,351-\$518,400	35%
\$518,401+	37%

Married taxpayers filing separately

Taxable income	Tax rate:
\$0-\$9,875	10%
\$9,876-\$40,125	12%
\$40,126-\$85,525	22%
\$85,526-\$163,300	24%
\$163,301-\$207,350	32%
\$207,351-\$311,025	35%
\$311,026+	37%

Standard deduction amounts

The 2020 standard deduction amounts are as follows:

- Single or married filing separately: \$12,400
- Married filing jointly: \$24,800
- Head of household: \$18,650

Taxpayers who have reached age 65 (or who are blind) receive an additional standard deduction of \$1,300 for married taxpayers or \$1,650 for unmarried taxpayers who are not a surviving spouse.

The Act eliminated personal and dependent exemptions.

Notes

1. Long-term gains from capital assets held for more than one year are taxed at rates of 0%, 15%, or 20%. Short-term gains from capital assets held for one year or less are taxed as ordinary income. The maximum federal income tax rate on capital gains is 20% for assets held for more than one year (23.8% if the net investment income tax discussed below applies). The maximum federal income tax rate on 'qualified dividends' received from a domestic corporation is 20% (23.8% if the net investment income tax discussed below applies). See Section VII.E.2 below.

2. Nonresident aliens may not take advantage of head-of-household status or joint return rates, nor are they entitled to the standard deduction. However, a US citizen or resident with a nonresident alien spouse may qualify for head of household status in certain circumstances.
3. Elections may be made by couples if one spouse is a nonresident alien at the end of the tax year and the other is a US citizen or resident, whereby no nonresident alien period is recognized and the couple may file jointly as full-year US citizen/resident.
4. The Act adjusts the individual tax brackets and certain other individual provisions for inflation based on a concept known as 'chained CPI.'
5. A 'head-of-household taxpayer' is a person who pays for more than half of the household expenses, is considered unmarried for the tax year, and has a qualifying child or dependent.

B. Alternative minimum tax (AMT)

In lieu of the tax computed using the above rates, the individual AMT may be imposed under a two-tier rate structure of 26% and 28%. For tax year 2020, the 28% tax rate applies to taxpayers with taxable incomes above \$197,900 (\$98,950 for married individuals filing separately).

Under the Act, for tax years beginning after December 31, 2017, and before January 1, 2026, the AMT exemption amount is increased to \$109,400 for married taxpayers filing a joint return (half this amount for married taxpayers filing a separate return), and \$70,300 for all other taxpayers (other than estates and trusts). The phase-out thresholds increase to \$1 million for married taxpayers filing a joint return and \$500,000 for all other taxpayers (other than estates and trusts).

These amounts are indexed for inflation. As a result, for 2020 the AMT exemption amount is \$113,400 for married taxpayers filing a joint return (half this amount for married taxpayers filing a separate return), and \$72,900 for all other taxpayers (other than estates and trusts), and the phase-out thresholds are \$1,036,800 for married taxpayers filing a joint return and \$518,400 for all other taxpayers (other than estates and trusts).

The AMT is payable only to the extent it exceeds the regular net tax liability. The foreign tax credit is available for determining AMT liability to the extent of the foreign tax on the foreign-source AMT income (AMTI), subject to certain limitations.

AMTI generally is computed by starting with regular taxable income, adding tax preference deductions (claimed in the computation of regular taxable income), and making special adjustments to some of the tax items that were used to calculate taxable income. For example, the taxpayer must add back all state and local income taxes deducted in computing regular taxable income.

For nonresident aliens with a net gain from the sale of US real property interests, the AMT is calculated on the lesser of AMTI (before the exemption) or the net gain from the sale of the US real property interest.

Tax readiness insight: The individual AMT had a significant effect for taxpayers living in states with high income taxes because the deduction for state and local income taxes was excluded from the AMT computation. Due to certain provisions of the Act, including the increased AMT exemption, the \$10,000 limitation on the state and local tax deduction, and the repeal of miscellaneous itemized deductions, it is expected that fewer taxpayers will be affected by the AMT.

C. State and local income taxes

Most states, and a number of municipal authorities, impose income taxes on individuals working and/or residing within their jurisdictions. (For more information, see section III, State and local tax issues, above.)

D. Residence

The determination of an alien individual's residence status for federal income tax purposes is made using a set of relatively objective tests. These rules generally treat the following individuals as residents:

- Lawful permanent residents (i.e., 'green card' holders). Resident alien status generally continues until the green card is formally relinquished. Thus, individuals who hold green cards but leave the United States to live abroad indefinitely or permanently generally will continue to be classified and taxed as resident aliens until the green card is relinquished and Form I-407 is filed (expiration of the green card by itself has no impact for tax purposes). Complex rules apply to individuals who relinquish their green cards if they held the green card in at least eight of the 15 years prior to relinquishment. In light of these rules, professional advice should be sought prior to obtaining or relinquishing a green card, or if eligible to claim nonresident alien status under a treaty.
- Individuals who meet the 'substantial presence test.' An individual meets this test if present in the United States for at least 31 days in the current year and a combined total of at least 183 equivalent days during the current year and prior two years. For the purposes of the 183-equivalent-day requirement, any part of a day the individual is present in the United States during the current calendar year counts as a full day; each day in the preceding year counts as one-third of a day; and each day in the second preceding year counts as one-sixth of a day. Note that an individual who has less than 183 days of US presence in the current tax year and can establish a 'tax home' in, and a 'closer connection' to, another country for the entire year still may qualify to be treated as a nonresident alien, even if the three-year, 183-equivalent-day requirement is met. Exceptions also are available for certain visa types; and certain Mexican and Canadian residents who commute to work in the United States.

Special rules apply when determining the portion of the year an individual will be treated as a resident or nonresident in the first and last years of residency. Special rules also may apply to those who are nonresident aliens for a temporary period of time.

Inbound insight: Resident alien status often results in lower US tax than nonresident alien status, due to increased allowable deductions and credits and lower tax rates for certain married taxpayers. Consequently, certain nonresident aliens may choose to elect resident alien status if specific requirements are met. Note that resident alien status triggers enhanced reporting requirements under FATCA (discussed above). For example, resident aliens may be required to file Form 8938, Statement of Specified Foreign Financial Assets.

The United States has income tax treaties with a number of countries for the purpose of minimizing double taxation. If there is a tax treaty in effect between the United States and an individual's country of residence, the provisions of the treaty may be used to effectively override US resident alien status determined under domestic law for purposes of calculating US income tax.

Under many of these treaties, a non-US-citizen individual classified as an income tax resident under the internal laws of both the United States and his or her home country who can show that a 'permanent home' is available only in the home country generally will be classified as a nonresident alien for purposes of calculating US income tax (or under a series of other tests, if necessary) if the individual chooses to utilize the benefits of the treaty. A form must be filed to claim nonresident alien status as the result of a tax treaty. (For more information, see Section IV, US tax treaties, above, and Appendix A for a summary of certain investment income tax treaty benefits.)

E. Other taxes

1. Social security contributions

For 2020, social security tax (old-age, survivors, and disability) is withheld at 6.2% on the first \$137,700 of wages paid to resident and nonresidents who work as employees in the United States. Medicare hospital insurance taxes are withheld at 1.45% of all employee wages with no dollar cap.

Social security tax for resident self-employed individuals equals 12.4% of the first \$137,700; Medicare hospital insurance taxes equals 2.9% of all net self-employment income of residents. Nonresident aliens generally are not subject to social security and Medicare hospital insurance taxes on self-employment income.

The employee portion of Medicare hospital insurance tax is increased by an additional 0.9% on wages received in excess of \$250,000 for a married couple filing a joint return, \$125,000 for a married individual filing a separate return, and \$200,000 for all other individuals (these thresholds are not indexed for inflation). Similarly, the Medicare portion of the self-employment tax rates is increased by an additional 0.9% (i.e., to 3.8%) for self-employment income in excess of those threshold amounts.

Social security and Medicare hospital insurance taxes are not deductible by employees when determining their taxable income for federal income tax purposes. However, for self-employed individuals, a deduction is allowed for an amount equal to one-half of the combined self-employment social security and Medicare hospital insurance taxes that are imposed.

Note that the United States has entered into ‘totalization agreements’ with several nations for the purpose of avoiding double taxation of income with respect to social security taxes and allowing individuals who participate in more than one social security system to qualify for benefits that would not be available under domestic law. These agreements must be taken into account when determining whether any employee is subject to US social security and Medicare hospital insurance taxes or is subject to the social security taxes of a foreign country. (For a list of countries with which the United States has totalization agreements, see Appendix B.)

The following visa classes of nonresident aliens typically are exempt from US social security and Medicare taxes: A, C-1/D, F, G, H, J, M, and Q.

A 3.8% ‘unearned income Medicare contribution’ tax applies on the lesser of (1) the taxpayer’s net investment income for the tax year or (2) the taxpayer’s excess modified adjusted gross income over a threshold amount (generally, \$200,000; \$250,000 for a married couple filing a joint return and surviving spouses; and \$125,000 for a married individual filing a separate return). The tax, which is in addition to the regular income tax liability, applies to all individuals subject to US taxation other than nonresident aliens. Net investment income generally includes nonbusiness income from interest, dividends, annuities, royalties, and rents; income from a trade or business of trading financial instruments or commodities; income from a passive-activity trade or business; and net gain from the disposition of nonbusiness property.

2. Capital gains taxes

The maximum federal regular income tax rate on capital gains for assets held for more than 12 months is 20% (23.8% if the net investment income tax, discussed above, applies). Note: Nonresident aliens who have US-source capital gains or qualified dividends that are not ECI are subject to a 30% rate on such income. The graduated income tax rates apply to capital gains from assets held for 12 months or less. Note: Capital gains from the sale of certain types of assets, such as collectibles or ‘Section 1250 property,’ could be subject to higher rates. Long-term capital gains also are added to the income that is used for AMT calculations.

There are three capital gains income thresholds. Under the Act, these thresholds apply to maximum taxable income levels for 2020, as follows:

Long-term capital gains rate	Single taxpayers	Married filing jointly	Head of household	Married filing separately
0%	Up to \$40,000	Up to \$80,000	Up to \$53,600	Up to \$40,000
15%	\$40,001-\$441,450	\$80,001-\$496,600	\$53,601-\$469,050	\$40,001-\$248,300
20%	Over \$441,451	Over \$496,601	Over \$469,051	Over \$248,301

3. Consumption taxes

The United States does not have a federal-level consumption tax.

4. Net wealth/worth taxes

The United States does not have a federal-level net wealth/worth tax.

5. Inheritance, estate, and gift taxes

The United States imposes a federal estate tax on the fair market value of assets that an individual transfers or is deemed to transfer at death. The United States also imposes a federal gift tax as well as a federal generation-skipping transfer tax. The purpose of the gift tax is to prevent the lifetime transfer of assets without estate tax liability. The purpose of the generation-skipping transfer tax is to prevent avoidance of tax by skipping generations when making large transfers of assets.

Individuals who are US citizens or residents (domiciliaries) are subject to federal estate tax on their worldwide assets (usually including life insurance proceeds). Individuals who are nonresident aliens are subject to US federal estate tax only on US-situs assets; other special rules may apply. Nonresident in this context means a non-US citizen who is not domiciled in the United States for estate/gift tax purposes. It can be difficult to determine whether a particular individual is resident for estate tax purposes.

The estate, gift, and generation-skipping transfer per-person tax exemption amount was set at \$5 million for 2011 and is indexed for inflation for later years. For 2017, the inflation-indexed exemption amount was \$5.49 million.

The Act doubled the estate, gift, and generation-skipping transfer tax exemption amount for estates of decedents dying and gifts made after December 31, 2017, and before January 1, 2026. That is, the Act increases the basic exclusion amount from \$5 million to \$10 million. The \$10 million amount is indexed for inflation occurring after 2011. For 2020, the inflation-indexed exemption amount is \$11,580,000.

The top tax rate is 40%. Note that states may impose inheritance taxes with lower exemption levels.

Assets bequeathed or given to an individual's spouse are exempt from estate and gift tax otherwise imposed at death or the time of the gift, provided the spouse is a US citizen.

6. Property taxes

The United States does not have a federal-level property tax, but local real and personal property taxes (e.g., real estate taxes on residences) may apply.

7. Luxury and excise taxes

The United States does not have federal-level luxury taxes. However, federal and state governments impose excise taxes on a variety of goods. For example, federal and state excise taxes are imposed on gasoline and diesel fuel used for transportation. The excise taxes are levied item by item and lack any uniformity in rates.

F. Income determination

1. Employment income

Citizens and resident aliens are taxed on compensation earned for work performed anywhere in the world, regardless of where or when payments are made (with certain exceptions). Nonresident aliens are taxed on compensation earned for work performed in the United States, regardless of when or where payments are made, absent a treaty or Internal Revenue Code provision to the contrary.

Employees generally are not taxed on reimbursements (or direct provision of benefits) for either personal living expenses (i.e., food and lodging) or for travel expenses while ‘away from home’ for business purposes, subject to various limitations and substantiation requirements. However, reimbursements for similar expenses of a spouse or dependent are taxable. Note that being ‘away from home’ requires a temporary absence from an individual’s tax home. Assignments of more than one year in a single work location are not considered to be temporary, regardless of facts and circumstances.

A qualified retirement plan may allow a participant to contribute funds on a before-tax or an after-tax basis. Similar treatment may be available for participation in a foreign pension plan via treaty. When benefits are paid to the participant at retirement, the portion of the pension payment that represents a return of the after-tax contribution amount paid is not again subject to tax. Otherwise taxable retirement distributions also may be either exempt from US tax or subject to special rates of US tax under a treaty.

2. Equity compensation

Multiple types of equity compensation are used by US companies, including stock options and various payment rights based on stock value. The taxation of these different instruments varies.

The timing, type, and amount of income inclusion depend on whether the taxpayer receives a non-statutory (nonqualified) stock option or a statutory stock option (also known as an incentive stock option). If an employee or service provider receives a nonqualified option to buy stock as payment for services, the taxpayer generally recognizes income when the option is exercised (to buy the stock or other property). Upon grant and exercise of an incentive stock option, however, taxpayers generally do not include any amount in income for regular tax purposes until the stock purchased by exercising the option is sold.

Foreign nationals who are granted stock options prior to the start date of their residency in the United States may be subject to US income tax at exercise on all of the realized income if they are US residents at such time. In most cases, when a foreign national who is a resident alien exercises an option to buy foreign stock, the spread between the option price and the fair market value of the stock at the time of exercise is subject to US income tax. A portion of the spread may be treated as foreign-source (to the extent allocable to services rendered in the foreign country). As a result, even though the full spread will be subject to tax in the United States, a foreign tax credit generally may be claimed to reduce the US income tax (assuming foreign tax is paid on this income).

In a situation that is often overlooked, if a foreign national returns to his or her home country and exercises an option that was granted before or during the taxpayer's residency in the United States and vested after at least one US workday, a portion of the income could be subject to US taxation because it is attributed to the period during which he or she performed services in the United States.

Inbound insight: Stock options, stock appreciation rights, or restricted stock units that are granted and become vested after the individual has performed work in the United States may be subject to Section 409A. Section 409A imposes various requirements on equity compensation; a violation of these requirements may result in an additional 20% tax plus an interest penalty on the value of the compensation. Foreign nationals should review these grants to see if Section 409A applies and whether any changes must be made before working in the United States.

3. Business income

When an individual works for himself or herself, that individual generally is deemed to have self-employment income. Self-employment income is taxed under US law in a manner similar to employment compensation. However, a self-employed individual often may have more ability to deduct business expenses than an employee. Citizens and resident alien individuals may (subject to certain exceptions) be subject to increased social security contributions (i.e., self-employment tax) in the United States on self-employment income earned while resident in the United States (see section VII.E.1., *Social security contributions*, above). Nonresident aliens are rarely exposed to the self-employment tax.

4. Capital gains

Net capital gains of a citizen or resident alien are included in worldwide income and are subject to US taxation (see section VII.E.2., *Capital gains taxes*, above). The excess of net long-term capital gain over net short-term capital loss is considered net capital gain. A nonresident alien is taxed at 30%, generally collected by withholding at the source of the payment, on US-source net capital gains from intangible property if the person is in the United States for 183 days or more during the tax year in which the gain occurs. Capital gains from US real property interests are taxable regardless of US presence, and also may be subject to a special withholding at source based on the sales price of the property (see discussion above of FIRPTA).

5. Dividend income

Dividend income received by a citizen or resident alien is subject to US tax, whether it is from US or foreign sources. The maximum federal income tax rate on ‘qualified dividends’ received from a domestic corporation or a qualified foreign corporation is 20% (23.8% if the net investment income tax discussed above in section *VII.E.1* applies).

Nonresident aliens’ US-source dividends generally are subject to a flat 30% tax rate (or lower treaty rate), usually withheld at source.

6. Interest income

Interest income received by a citizen or resident alien is subject to US tax, whether it is from US or foreign sources.

Nonresident aliens’ US-source interest is generally subject to a flat 30% tax rate (or lower treaty rate), usually withheld at source. Note that certain ‘portfolio interest’ earned by a nonresident alien generally is exempt from tax.

7. Rental income

Rental income received by a citizen or resident alien is subject to US tax, whether it is from US or foreign sources.

Nonresident aliens’ US-source rents are generally subject to a flat 30% tax rate (or lower treaty rate), usually withheld at source. However, a nonresident alien can elect to report real property rental income net of expenses, subject to tax at graduated rates.

8. Exempt income

Certain items are generally exempt from federal personal income tax. Two common types of tax-exempt income include interest from municipal bonds and property received as a gift or bequest.

Conversely, some types of income that enjoy preferential tax treatment in an individual’s home country may not enjoy the same tax treatment in the United States. For example, certain retirement-type accounts in foreign jurisdictions are treated as ‘look-through’ entities for US tax purposes.

9. Deductions

a. Employment expenses

For years before 2018, employees may have been able to claim an itemized deduction for certain ‘ordinary and necessary’ unreimbursed work-related expenses. Common deductions included travel expenses and transportation costs (other than commuting to and from work),

business entertainment and gifts, computers and cell phones if required for the taxpayer's job and for the convenience of the employer, uniforms, and home office expenses. The Act repealed this itemized deduction.

The deduction for employment expenses of an employee was subject to the floor on the total of 'miscellaneous' itemized deductions equal to 2% of adjusted gross income. Various other limitations and strict substantiation requirements apply.

b. Personal deductions.

Under rules as modified by the Act, citizens and resident aliens may deduct, as itemized deductions, the following common personal expenditures:

- qualified residence mortgage interest
- state and local income taxes and property taxes up to an aggregate of \$10,000
- medical expenses, certain casualty, disaster, and theft losses, and charitable contributions, subject to limitations

Certain personal expenses are allowed as deductions against gross income (so-called 'above-the-line' deductions).

Nonresident aliens may deduct, subject to limitations, certain casualty and theft losses incurred in the United States, contributions to US charitable organizations, and state and local income taxes (subject to the same \$10,000 limit).

CARES Act update: The CARES Act provides a partial 'above-the-line' deduction up to \$300 for charitable contributions and modification of limitations on charitable contributions in 2020 for individuals who do not itemize. Additional charitable giving modifications include increases in the limitations on deductions for charitable contributions in 2020 by individuals who itemize, as well as corporations, among other changes.

c. Interest expenses (other than qualified residence interest)

No deduction is allowed for personal interest, such as on a car loan. However, interest paid on investment debt is deductible, but only to the extent that there is net investment income (i.e., investment income net of investment expenses other than interest). Disallowed excess investment interest expense may be claimed as a deduction in subsequent years, to the extent of net investment income.

d. Standard deductions

Instead of itemizing deductions, citizens and resident aliens may claim a standard deduction. The basic standard deduction for 2020 is \$24,800 for married couples filing a joint return; \$12,400 for single and married filing separate individuals; and \$18,650 for heads of household. These amounts are adjusted annually for inflation. Nonresident aliens (including dual-status residents) may not claim a standard deduction.

Individuals – including resident aliens – who are blind or age 65 or over are entitled to a higher standard deduction. For 2020, such an individual who is married may increase the standard deduction by \$1,300; if such an individual is unmarried and not a surviving spouse, the additional standard deduction is \$1,650. If an individual is both blind and age 65 or over, the standard deduction may be increased twice.

e. Personal allowances

The Act eliminated personal exemptions.

Tax readiness insight: The net effect of the increased standard deduction and elimination of personal exemptions under the Act will be a benefit to many taxpayers, but may be a detriment to others.

f. Losses

An individual's capital loss deduction generally is limited to the individual's capital gains plus an additional amount of \$3,000 (\$1,500 for married filing separately). The additional loss is not permitted to nonresident aliens. Individuals may carry over any unused net capital loss to later tax years, subject to the annual \$3,000/\$1,500 limit on using net capital loss against ordinary income.

Losses incurred by individuals that are attributable to an activity not engaged in for profit (i.e., hobby losses) generally are deductible only to the extent of income produced by the activity.

Taxpayers with net operating losses (NOLs) may carry their losses forward and back to certain tax years. The general NOL carryback period is the two years preceding the year in which the loss was incurred. If the NOL is not fully used on the carryback, the loss may be carried forward for 20 tax years following the year in which the loss was incurred. (For carrybacks and carryforwards of NOLs by corporations, see section II.N.15. above. For capital losses of corporations, see section II.M.2. above.)

G. Foreign tax relief and tax treaties

1. Foreign tax relief

Taxpayers (generally US persons and foreign persons with effectively connected US trade or business income) may claim a credit against US federal income tax liability for certain taxes paid to foreign countries and US possessions. Foreign income, war profits, and excess profits taxes are the only taxes that are eligible for the credit. Taxpayers may choose to deduct these taxes with no limitation or, alternatively, claim a credit subject to limitations.

2. Tax treaties

The United States has bilateral tax treaties with more than 60 foreign countries. Under these treaties, residents (not necessarily citizens) of foreign countries are taxed at a reduced rate

or are exempt from US taxes on certain items of income they receive from sources within the United States. These reduced rates and exemptions vary among countries and specific items of income.

Under these same treaties, residents or citizens of the United States are subject to foreign taxation at a reduced rate, or are exempt from foreign taxes, on certain items of income they receive. All US income tax treaties contain what is known as a 'saving clause' that reserves the right for a country to deny tax treaty benefits to its own residents. In US treaties, the saving clause always applies to US citizens and residents, and always includes exceptions. (For more information, see *Section IV, US tax treaties*, above, and Appendix A.)

Most US tax treaties contain anti-abuse provisions that restrict the eligibility for treaty benefits to persons meeting eligibility criteria aimed at preventing persons becoming resident in a treaty country for the principal purpose of gaining access to the treaty.

The United States also has entered into totalization agreements, in part for the purpose of avoiding double taxation of income with respect to social security taxes with various countries, which are listed in *Appendix B*. (See also discussion of social security taxes in *Section VII.E.1*, above.)

H. Other tax credits and incentives

1. Child tax credit

Citizens, resident aliens, and nonresident aliens from certain countries may claim a child tax credit if the qualifying dependent child is a citizen, national, or resident of the United States. Under the Act, if the child has not reached the age of 17 by the end of the year, a tax credit is allowed for up to \$2,000 per child with a social security number (of which up to \$1,400 is refundable). The amount of the credit is reduced once the taxpayer's income reaches \$400,000 for joint filers and \$200,000 for all others. The Act also provides a nonrefundable credit for a qualifying dependent other than a qualified child with a social security number; this credit is available for a qualified child with an individual taxpayer identification number (ITIN) but not a social security number.

2. New Markets Tax Credit

The New Markets Tax Credit (NMTC) permits individual and corporate taxpayers to receive a credit against federal income taxes for making 'qualified equity investments' in qualified community development entities. The Act preserves the NMTC's existing authorization through 2019. On December 20, 2019, President Trump signed H.R. 1158 and H.R. 1865 into law, extending the NMTC to the end of 2020.

3. Other tax credits

Numerous other tax credits exist at the federal, state, and local levels to provide an incentive for specified investments or activities.

I. Tax administration

1. Tax period

The US tax year for individuals generally is the same as the calendar year, i.e., January 1 through December 31.

2. Tax returns

Individual income tax returns (the Form 1040 series) are due on the 15th day of the fourth month after the end of the tax year (i.e., April 15) unless that day is a Saturday, Sunday, or federal holiday, in which case the return is considered timely filed on the next business day. A taxpayer who cannot file by that deadline may receive an automatic six-month extension of time to file Form 1040. To do so, the taxpayer must file Form 4868, *Application for Automatic Extension of Time to File US Individual Income Tax Return*, by the due date for filing the return.

Note that filing for an extension does not extend the time to pay taxes. If the amount due is not paid by the regular due date, interest will accrue and penalties may apply whether or not an extension to file is received. There also is an automatic two-month automatic extension for US citizens and residents who are living outside of the country on April 15 (Form 4868 is not required to obtain this extension).

Married individuals generally may file a joint return only if each is either a citizen or a resident on the last day of the tax year. However, if only one spouse is a citizen or resident on the last day of the tax year, a joint return may be available to be filed if both spouses agree to be taxed as full-year residents on their combined worldwide income.

Generally, joint filing will result in a lower tax liability for married individuals than separate returns. This determination can be made only after a thorough review of the taxpayers' facts and circumstances. Married nonresident aliens (i.e., both spouses are nonresident aliens and do not qualify to be treated as resident on December 31) may not file joint returns and must use the tax table for married persons filing separate returns. Nonresident aliens may not file as heads of household. **Note:** Couples that both qualify as nonresident aliens under general rules may in some instances elect to be treated as residents of the United States (if certain requirements are met, including resident status in the subsequent year), which can then be coupled with elections under Sections 6013(g) or (h) to ultimately allow joint filing.

3. Payment of tax

If federal income tax is owed, payment is due by the original return filing due date prior to extensions (April 15) to avoid interest and potential penalties for non-payment. The due dates for state income taxes may vary. Estimated tax payments may be required during the year (see below).

Most types of US-source investment income paid to a nonresident alien are subject to a withholding tax of 30%, although a reduced rate or exemption may apply if stipulated in the applicable income tax treaty. In general, a person who pays US-source income to a foreign person must withhold the proper amount of tax, report the payment on Form 1042-S, and file a Form 1042 by March 15 of the year following the payment unless that day is a Saturday, Sunday, or federal holiday, in which case the return is considered timely filed on the next business day.

Income tax generally must be withheld from employee compensation. Citizens, resident aliens, and nonresident taxpayers with income not subject to withholding (e.g., self-employment income, interest, dividends, or capital gains) generally must make quarterly payments of estimated tax due April 15, June 15, September 15, and January 15. (States also may require estimated income tax payments.) Nonresident aliens who do not have any income subject to payroll withholding tax must make three estimated tax payments (rather than four) due June 15, September 15, and January 15, with 50% due with the first payment.

4. Audit cycle

An audit is an IRS review of an individual's accounts and financial information to ensure information is being reported correctly and completely and to verify the amount of tax calculated on the individual's tax return is accurate. An individual's tax return may be examined for a variety of reasons, and the examination may take place in several ways. Returns are chosen by computerized screening, by random sample, or by an income document matching program. After the examination, if any changes to the individual's tax are proposed, the taxpayer either can agree with the changes and pay any additional tax owed, or disagree with the changes and appeal the decision.

In the event of a disagreement, the IRS has an appeals forum. If a taxpayer does not reach an agreement with the IRS Office of Appeals, or if the taxpayer does not want to appeal the case to that office, in most instances the taxpayer may challenge the IRS assessment in the US Tax Court without paying the contested additional tax before litigation.

If taxpayers overpay their tax, there is a limited amount of time in which to file a claim for a credit or refund. Taxpayers can claim a credit or refund by filing Form 1040X with the IRS at the address specified in the Form 1040X instructions. A separate form must be filed for each year or period involved, along with an explanation of each item of income, deduction, or credit on which the claim is based. If the claim is denied, the taxpayer generally can challenge the denial through the IRS administrative appeals process or in federal court (other than the Tax Court).

5. Statute of limitations

Generally, the IRS has three years after a return is due or filed, whichever is later, to make tax assessments. That particular date also is referred to as the statute expiration date. The statute of limitations also will limit the time taxpayers have to file a claim for credit or refund. If a return is filed on extension, the limitations period runs from the date of filing the return and not the extended due date.

J. Other issues

1. Treatment of flow-through business entities

Certain legal entities are ‘flow-through entities’ (e.g., partnerships and S corporations). Income accrued by such entities is not taxed at the entity level. Instead, the income ‘flows through’ to the owners or shareholders, who are then taxed on the revenues. The Act provides a 20% deduction to domestic owners of flow-through entities against their qualified business income for tax years beginning after December 31, 2017, and before January 1, 2026. Complex rules apply with respect to this new deduction.

Note: Certain types of foreign entities – including some pension funds and other investment vehicles – are treated as foreign trusts for US tax purposes and may have filing requirements in addition to the US income tax reporting of the underlying income.

2. Foreign information reporting

Although the United States does not have foreign exchange controls, any ‘United States person’ who has a foreign financial account (or signature authority over such account) during the year may be required to file a report with the US Treasury Department by April 15 of the following year, with an automatic extension to October 15. (Note: If the federal income tax due date is extended because April 15 falls on a weekend or legal holiday, this deadline is extended as well. The term ‘United States person’ includes a citizen or resident of the United States or a person in and doing business in the United States. The form need not be filed if the aggregate value of all foreign financial accounts does not exceed \$10,000 at any time during the year.

Schedule B (Interest and Ordinary Dividends) of Form 1040 requires taxpayers to state whether they had a financial interest in (or signature authority over) a financial account located in a foreign country, or received a distribution from or were the grantor of or transferor to a foreign trust.

Note also the requirement under FATCA for resident aliens to file Form 8938, Statement of Specified Foreign Financial Assets. (This form is not limited to bank accounts.) Resident aliens who file as nonresident aliens under treaty for the entire tax year are not required to file Form 8938.

In addition, if cash equal to or in excess of \$10,000 is brought into or sent out of the United States at any time in the year, it must be reported to the US Customs Service.

3. Work permits

In general, individuals who plan to live and work in the United States for a temporary work assignment must obtain work authorization. Since US immigration rules are extremely complex, professional advice from an immigration attorney should be sought well in advance of any intended move to the United States.

In certain instances, a traveler may be eligible for admission to the United States as a B-1 Business Visitor, which is a visitor status rather than a work authorization status.

It is important to note, however, that whether one qualifies for admission as a B-1 Business Visitor, or is required to obtain work authorization, may depend on the nature of the intended activities in the United States, the intended duration of stay in the United States, and whether the traveler, or the traveler's foreign employer, will be paid by a US entity.

A visa that permits an individual to work in the United States for several years may take several months to obtain. Note that visa type can affect the impact of US tax rules as well as eligibility for a social security number or ITIN.

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

Inbound insight: Obtaining a green card is more complex than obtaining a non-immigrant visa; the process usually takes much longer, and the tax implications of having a green card are complex.

Inbound insight: US immigration rules have become a controversial topic and could be changed by Congress or the Administration. Businesses should stay focused on the potential for changes to these rules.

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VIII.



VIII. Healthcare

An employer's costs to provide health care for its employees generally are deductible to the employer, and the cost of the plan and the benefits provided generally are tax-free to the employee, except in the case of certain discriminatory plans.

The Affordable Care Act (ACA), enacted in 2010, changed the healthcare landscape in the United States, affecting individuals, insurers, employers, and the federal and state governments.

Healthcare plans in the United States must comply with ACA requirements, such as allowing parents to keep their children on their health plans until age 26, first-dollar coverage for preventive care, and elimination of preexisting condition exclusions and annual and lifetime maximums. These requirements are in addition to the pre-ACA requirements applicable to group health plans, including those mandated by HIPAA (privacy of health information, notices, etc.), COBRA (continuation coverage following certain qualifying events), and mental health parity.

An excise tax penalty is imposed for failure to satisfy these plan design mandates. Other fees and penalties, such as the Patient Centered Outcome Research Institute fee, also may apply to health plans under the ACA.

Starting in 2014, individuals living in the United States were required to maintain minimum essential coverage or face a tax penalty. As discussed below, for calendar years ending on and after December 31, 2018, the individual penalty for not maintaining minimum essential coverage is \$0, which effectively eliminates the individual mandate. Individual and family coverage still may be purchased on the state-based or federally assisted exchanges (also called the 'marketplace').

The exchanges first became available January 1, 2014. Individuals may enroll for exchange coverage during the annual enrollment period beginning in the fall before the beginning of the calendar year and continuing through mid-December. The open enrollment period has not been established for 2021 enrollment. Families with income between 100 and 400% of the federal poverty level who do not have access to minimum affordable coverage from an employer or a governmental plan may qualify for subsidized coverage on the exchanges. For 2020, the upper limit for subsidy eligibility at the single person level is an annual salary of \$49,960.

Before January 1, 2019, the ACA imposed a penalty on US citizens, permanent residents, and foreign nationals who qualify as resident aliens who did not maintain minimum essential coverage. This mandate did not apply to nonresident aliens. US citizens living abroad for a calendar year (whose income qualifies for exclusion under Code Section 911) are treated as having minimum essential coverage for the year.

The Act did not repeal the employer mandate, under which ‘applicable large employers’ must offer health coverage to at least 95% of their full-time employees or pay a penalty equal to \$2,750 (indexed) multiplied by each full-time employee (excluding the first 30 employees) if one of their full-time employees obtains subsidized coverage on an exchange. If the coverage offered by the employer is not adequate or affordable, the employer must pay a \$3,860 penalty (indexed) with respect to each employee who obtains subsidized coverage on an exchange. ‘Applicable large employers’ are those with at least 50 full-time equivalent employees — determined across the controlled group ² and based on 30 hours of service a week, but excluding any hours of service for which an employee does not receive US-source income.

Applicable large employers and entities providing health insurance to individuals must provide tax forms to covered individuals and full-time employees and file statements with the IRS. These forms are discussed in the chart in section II.P.4 above.

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IX.



IX. Financing US operations

A. Debt vs. equity

1. Section 385 regulations

During 2016, Treasury and the IRS issued final and now-expired temporary regulations under Section 385 addressing whether an interest in a related corporation is treated as equity or indebtedness, or as in part stock and in part indebtedness (the ‘385 Regulations’). The 385 Regulations are intended to limit the effectiveness of certain types of tax planning by characterizing related-party financings as equity, even if they are in form ordinary debt instruments. The types of transactions targeted include debt arising through the distribution of notes or loans, primarily in the inbound context.

Note: Application of the 385 Regulations is not limited to these types of transactions. The 385 Regulations instead apply generally to characterize as equity broad categories of related-party debt transactions that routinely arise in the ordinary course of operations in both the domestic and international context. The 385 Regulations therefore have a profound impact on a range of modern treasury management techniques, including cash pooling.

On November 4, 2019, Treasury issued final regulations that revoke the documentation requirements in the 385 Regulations effective as of that date (the Final Regulations).

Note: The 2016 Proposed Regulations that provided exceptions for certain short-term debt instruments and provided additional rules regarding partnerships and consolidated groups were finalized on May 14, 2020, without any substantive change.

Inbound insight: Because of the deferred effective date of the documentation requirements under Notice 2017-36 and the reliance language in the proposed regulations issued in September 2018, taxpayers effectively were never required to satisfy the now-removed documentation requirements.

Inbound insight: A taxpayer’s documentation of related-party loan arrangements (such as a comparability analysis in relation to the conduct of similarly situated unrelated parties) remains important for substantiating the arrangement’s treatment as indebtedness under traditional common law debt/equity analysis.

The 385 Regulations generally apply to financial instruments issued after April 4, 2016, or instruments issued before that date that have undergone certain types of significant modifications. Instruments issued after April 4, 2016, but before January 19, 2017, are subject to certain transition rules. The key remaining operational rules in the 385 Regulations are the following:

- Reg. secs. 1.385-3 and 1.385-4 (the Distribution Rules) characterize as equity (i) notes distributed to a related shareholder, (ii) notes issued to acquire equity of a related entity, and (iii) notes distributed to a related entity as boot in an asset reorganization.
- The Distribution Rules also treat as stock a debt instrument that is issued as part of a series of transactions that achieves a result similar to the distribution of a debt instrument (the Funding Rule).
- The rules also generally characterize as an equity investment loans to related entities within a 72-month period centered on the date of the loan that (i) distribute dividends, (ii) acquire equity in related entities, or (iii) distribute boot in asset reorganizations (the per se Funding Rule).

Also on November 4, 2019, Treasury and the IRS issued an Advance Notice of Proposed Rulemaking (ANPR) announcing their intent to issue proposed regulations that would streamline the Distribution Rules. The ANPR provides that the per se Funding Rule would be withdrawn and future proposed regulations would treat a debt instrument as funding a distribution or economically similar transaction only if there is a sufficient factual connection between the two.

Inbound insight: Companies and tax practitioners considering any acquisition of a US business entity by a foreign business entity, as well as certain inbound restructuring transactions, need to consider the full scope of the remaining Section 385 regulations, and the possible adverse US consequences arising from their application. Additionally, existing judicial principles still need to be followed, including documenting that there is adequate support for treatment of an instrument as debt or equity for US federal income tax purposes.

Inbound insight: Although Treasury and the IRS announced in the ANPR that they intend to make the Distribution Rules more streamlined and targeted, future regulations would apply only prospectively. As a result, the ANPR effectively is a request for comments on how best to streamline and target the Distribution Rules. Thus, the Distribution Rules (including the per se Funding Rule) continue to apply, and taxpayers should continue to evaluate how those regulations apply to their debt instruments.

2. IRS IDR

Companies often finance the operations of their global business through intercompany loans. In determining whether intercompany loans are truly debt in nature or whether they are, in fact, equity transactions, the IRS has developed a 13-part Information Document Request (IDR), which includes a request for financial data for years outside of the particular audit cycle.

If the IRS finds the transaction to appear more like equity than debt in nature, the interest deduction taken on a company's tax return associated with the 'debt' will be denied. For companies that have recently increased their debt level, it is likely that the IRS will focus even more on this issue, potentially auditing future years when the intercompany debt exponentially increases.

The factors the IRS will consider—which are based on relevant case law—include whether:

- an arm’s-length rate of interest was charged and interest payments were timely made
- the debt is evidenced by written documents such as notes
- the debt has a fixed maturity date and scheduled payments
- there is an expectation that the debt will be repaid with free working capital
- security is given for the advances
- the borrower is adequately capitalized
- the borrower is able to obtain adequate outside financing from third-party sources.

While no one particular factor or set of factors is controlling, case law has established that the objective facts of a taxpayer’s situation must indicate the intention to create an unconditional obligation to repay the advances. Although courts consider both the form and the economic substance of the advance, the economic substance is deemed more important. The more a related-party financing arrangement resembles a loan that an external lender would make to the borrower, the more likely the advance will be considered debt.

Inbound insight: The OECD’s BEPS initiative includes proposed restrictions on the deductibility of related-party debt based on either a group’s worldwide debt to equity ratio or a percentage of earnings before interest, taxes, depreciation, and amortization (EBITA). Early versions of the Act included a worldwide leverage test, but such a test was not included in the Act’s interest expense deduction limitation discussed above.

3. Key Tax Court decision

A large body of case law has developed as to whether an instrument is characterized as debt or equity. A US Tax Court memorandum opinion from 2012 in which the court upheld the taxpayer’s debt characterization of US intercompany debt – while a ‘memorandum decision’ that does not serve as binding precedent – is important because it indicates the Tax Court’s current approach to debt vs. equity determinations. Note: The Tax Court is the federal trial-level court that hears most federal tax cases.

In particular, at a time when the IRS has been aggressively challenging taxpayers’ intercompany financing arrangements, in this case the Tax Court applied a principled approach based on traditional debt vs. equity factors as established by case law. Note that the debt vs. equity determination is based on a taxpayer’s particular facts and circumstances.

The issue in *NA General Partnership & Subsidiaries v. Commissioner*, T.C. Memo. 2012-172, was whether an advance made by the taxpayer’s non-US parent to its US group constituted debt or equity and, therefore, whether the taxpayer was entitled to interest expense deductions. The court, ruling in favor of the taxpayer, upheld the taxpayer’s treatment of the advance as debt.

The Tax Court applied a traditional debt vs. equity analysis, examining a series of factors developed by courts. Because appeal of the case would have been heard by the US Court of Appeals for the Ninth Circuit (the IRS did not appeal the decision), the Tax Court focused on case law developed by that circuit, which considers the following factors relevant to determine whether an advance is debt or equity:

- the name given to the documents evidencing the indebtedness
- the presence of a fixed maturity date
- the source of the payments
- the right to enforce payments of principal and interest
- participation in management
- a status equal or inferior to that of regular corporate creditors
- the intent of the parties
- ‘thin’ or adequate capitalization
- identity of interest between creditor and stockholder
- payment of interest only out of ‘dividend’ money
- the corporation’s ability to obtain loans from outside lending institutions.

Inbound insight: The Tax Court’s analysis reflects that courts generally look to whether the borrower has the ability to generate sufficient cash flows to service and repay the debt as an important factor. Interestingly, the test is often applied by looking at operating cash flow, i.e., whether the borrower would have the ability to generate sufficient operating cash flows to service the debt without being forced to sell its assets.

4. General approach of courts

a. Source of payments

While each court may not apply precisely the same factors, the courts often consider the source of payments in analyzing whether an instrument is debt or equity. In particular, if repayment depends on earnings or is to come from a restricted source, equity characterization may be indicated.

b. Subordination to creditors

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

c. Intent of the parties

Courts frequently consider objective indications of the parties' intent to determine whether they intended to enter into a debtor-creditor relationship. In the Tax Court case discussed above, the IRS also argued that the parties' post-transaction conduct did not demonstrate intent to form a genuine debtor-creditor relationship. The IRS focused on the delayed interest payments, and the short-term loan from the foreign parent to the borrower to fund interest payments on the loan.

Inbound insight: The IRS has challenged intercompany debt arrangements by using hindsight evidence to assert that the behavior of the parties subsequent to the arrangement's inception reveals that the parties never truly intended to create a debtor-creditor relationship. In general, existing case law suggests that it is not appropriate to recharacterize debt as equity by using hindsight evidence based on circumstances that the parties reasonably did not anticipate at the onset.

d. Inadequate capitalization

In general, if a corporation is thinly capitalized, advances made to the corporation are more likely to be characterized as equity. Courts generally focus their analysis of a corporation's capitalization on its debt-to-equity ratio.

e. Ability to obtain outside financing

Courts have held that evidence that a purported debtor could have obtained loans from outside sources on comparable terms points in favor of debt characterization, whereas evidence that a debtor could not have obtained such loans points toward an equity characterization.

B. Cash pooling

Many corporate groups take advantage of so-called cash pooling arrangements (either physical or notional), in which credit and debit positions of multiple members of a group generally are concentrated in a single account (either physically or notionally). US tax consequences should be considered with respect to these cash pooling arrangements.

Specifically, if a US group member is asked to join a cash pool, various US tax issues must be considered. If the US member only deposits funds with (i.e., lends to) the cash pool, the tax issues include:

- intercompany interest rates must be adequate and at arm's length (consider the safe harbor rate under Section 482);
- to the extent funds are denominated in a non-functional currency, foreign currency gains or losses must be accounted for and net foreign currency gain of a CFC borrower could give rise to subpart F income or GILTI;
- requirements for annual withholding tax returns for US-source income of foreign persons; and
- Foreign Bank and Financial Account (FBAR) and FATCA reporting requirements.

If the US member draws on (i.e., borrows from) the cash pool, additional US tax issues that must be considered include:

- interest deductions, including thin capitalization issues the interest deduction deferral rules, and the interest disallowance rules for payments involving a hybrid entity;
- withholding tax and conduit issues, including requirements for annual withholding tax returns for US-source income of foreign persons and the availability of treaty benefits;
- subpart F and Section 956 issues to the extent there are CFC depositors, even if the cash pool itself is not a CFC or has relatively low earnings. (see Tax readiness insight below with respect to Section 956.);
- Section 59A (BEAT) issues arising with cross-border payments; and
- Potential recharacterization of debt as equity under Section 385.

Inbound insight: If US subsidiaries of a US group member are required to join the cash pool, these considerations apply to each US participant in the pool. Consider using a subpool to manage the multiplicity of issues, including treaty qualification considerations. (See also the discussion above of the Section 385 regulations.)

Tax readiness insight: The cost of financing likely will increase in light of the Act. All taxpayers (e.g., both inbound and outbound) are subject to new interest deduction limitations for both related-party and third-party debt.

Tax readiness insight: In November 2018, Treasury issued proposed regulations limiting the application of Section 956 for US corporate shareholders. In general (and with certain exceptions), under Section 245A and the proposed Section 956 regulations, respectively, neither an actual dividend to a corporate US shareholder, nor such a shareholder's amount determined under Section 956, will result in additional US tax.

On May 23, 2019, Treasury and the IRS published final regulations under Section 956 that largely adopt the 2018 proposed regulations, but with two important substantive changes. First, the final regulations provide a new ordering rule that sources the hypothetical distribution solely from a CFC's Section 959(c)(2) previously taxed earnings and profits and Section 959(c)(3) earnings and profits. Second, the final regulations reduce the potential Section 956 amount with respect to a US shareholder that is a domestic partnership at the partnership level, to the extent that a domestic corporate partner of the partnership would be entitled to a Section 245A DRD if the partnership received its share of the tentative Section 956 amount directly as a distribution from the CFC.

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X.



X. Setting up a US tax department

The organization and operation of a US Tax department may vary greatly depending on organizational structure, industry, home country, and even the culture of each individual business.

The drivers of the choices in this area relate to key success factors of the Tax function as they pertain to functional areas throughout the tax lifecycle. The Tax department's level of success largely depends on its ability to deploy critical tax enablers related to data, technology, people, organization, and process.

A. Tax key success factors

The following broad considerations are the basis on which Tax should establish benchmarks and objectives for the US Tax department:

- Tax cost
- Tax risk (financial and reputational)
- Efficiency and effectiveness
- Sustainability of tax positions.

B. Functional areas – The tax lifecycle

A US Tax department may handle some or all of the following areas:

- Planning
- Tax accounting and reporting
- Tax return compliance
- Controversy
- Advocacy.

C. Critical tax enablers

Technology and data analytics

Technology and data analytics solutions have the potential to enhance every aspect of the tax lifecycle, from planning to controversy and advocacy. Quick access to accurate data for scenario analysis using self-service analytics and visualization tools can provide insights to enable planning decisions.

Tax accounting and compliance technology solutions have evolved with capabilities to automate workflow, data collection, calculations, and tax return preparation and filing. In addition, Enterprise Resource Planning (ERP) systems can be configured to help businesses extract tax sensitized data to enable more efficient compliance and tax reporting processes in areas such as corporate income tax, indirect taxes, and transfer pricing..

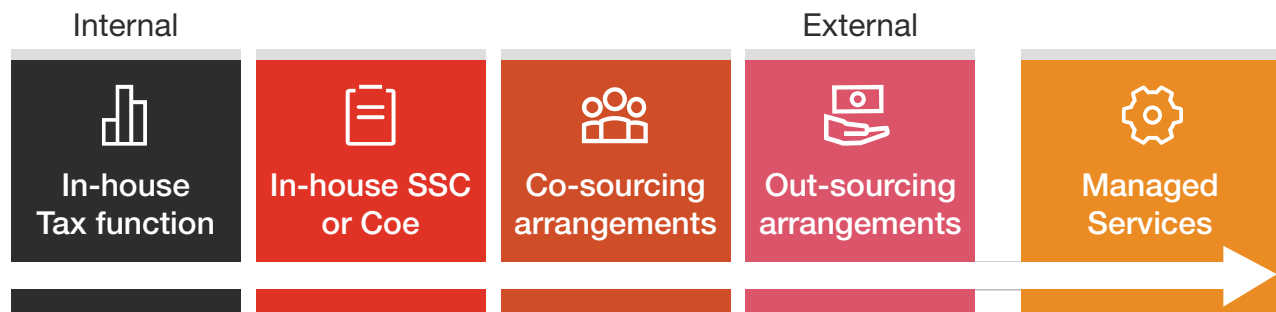
Furthermore, advancements in sharing and storage of tax-related data have improved the ability to respond timely to tax authorities with accurate information. Technology also can improve the way Tax collaborates across functions and geographies through the management of data. There is unforeseen potential in the power of emerging Artificial Intelligence (AI) and Machine Learning (ML) capabilities to automate and streamline the way the Tax function operates.

People/organization

- Professional skill sets

Skill requirements for Tax professionals are expanding. The complex tax environment, coupled with emerging technologies that likely are already deployed in other functions, requires Tax professionals to be not only proficient in tax rules, but also skilled in technology applications and the management of internal projects to implement such technologies and related projects.

- Tax operating models



Possible approaches to executing tax activities range from completely ‘in-house’ to use of a third-party service provider for comprehensive delivery of services pertaining to the tax lifecycle. An organization may deploy one or more of these options depending on a variety of factors, including availability of technology and people with the required skill sets.

Process

Regardless of the operating model deployed, the Tax function needs to have clearly defined processes, enabled by technology, to effectively meet tax requirements:

- Implementation and documentation of Tax processes and controls
- Collaboration outside typical Tax boundaries/stakeholder management
- Managing a changing workforce
- Documents and records management.

D. Key considerations

- The cost of efficiency and effectiveness

US Tax departments are challenged to manage the complexity of changing tax laws while executing tax planning and operations efficiently and effectively. A material amount of resources is allocated to tax accounting and compliance due to complex rules, high volume of activities, and the risk associated with inaccurate or unsustainable tax filings and positions. Tax functions therefore need to prioritize funding for the technology, people/organization, and process solutions needed to address the magnitude of responsibilities in this area.

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

Tax readiness insight: US and other global tax reforms have further complicated tax accounting, financial reporting, and tax compliance activities. Taxpayers now must calculate and report the impact of law changes in income tax provision calculations and reflect these changes in upcoming tax filings. Significant effort is needed to secure accurate source data, capture, and test all required changes to tax technology solutions.

Managing financial and reputational risk

Due to the many levels of taxation — federal, state, and local — businesses in the United States often need to manage simultaneously numerous tax audits on differing issues at each level, placing burdens on a company's budgets and resources. In addition, there may be financial statement impact due to the nature of tax positions taken and the number and magnitude of tax disputes that are ongoing at any given time. Easy access to accurate data, in the format needed to support tax positions, is essential to managing financial risk.

Inbound insight: Senior management of non-US companies often is surprised to learn the level of investment required for tax operations in the United States. Understanding the resources and budget that will be necessary for these activities – in addition to the desired investment in planning and risk management – is critical.

Finally, as is the case in a number of countries, the tax affairs of businesses operating in the United States are under increasing scrutiny by public institutions and the media. This focus requires increased attention to cross-functional stakeholder management, informed decision-making, and risk-management processes with additional considerations regarding the reputational risk to the business, beyond financial statement and balance-sheet drivers.

Inbound insight: The changing global environment in regard to tax magnifies the importance of the cultural and governance differences that can exist between the United States and the country of the parent company. Companies must consider these differences when developing a tax strategy, governance, and risk management policy.

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How can PwC help

The United States remains a favorable destination for global investment and offers a competitive environment in which to do business. However, the accelerating pace of change in US regulations and policy, combined with a more complex global environment, including unexpected developments such as the COVID-19 pandemic, amplify the need for layered planning. Global companies doing business in the United States should be even more vigilant with respect to their US tax situation and management of their US operations.

Our US Inbound Tax practice specifically focuses on helping you formulate your US inbound tax strategies so you can understand your business needs and meet your goals in the United States.

In the current challenging economic environment, we advise on:

- financing your US operations in a tax-efficient manner
- planning for growth through tax-efficient transactions and deals
- transforming your value chain
- navigating the complex, multi-tiered US tax law system
- addressing your supply chains and other trade-related issues
- meeting tax and trade compliance obligations arising in the wake of the Act, USMCA and other key trade agreements, the *'Wayfair'* decision, and other recent developments
- complying with multiple tax reporting requirements at all levels of government
- setting up your tax department in the United States.

Our approach is designed to identify tax opportunities and help address potentially adverse tax outcomes, so that the US business of a foreign multinational corporation plays its part in implementing a globally effective and integrated approach to tax planning for the group and tax outcomes are integrated seamlessly into business objectives and operations.

As businesses move to improve processes in customs and trade, many are considering how software solutions can automate compliance processes, reduce errors, and leverage international trade information and research. Technology use in trade currently is focused primarily on Enterprise Resource Planning (ERP) systems that are designed as part of company-wide systems and, in some cases, stand-alone software packages. Integration of ERP source data provides visibility to the supply chain, enables opportunities to lower customs duties, and improves compliance. Noncompliance can result in fines, delays, lost goods, revoking of trade privileges, and reputational damage.

As complexity in trade increases, technology will be pursued for more strategic analysis and planning. Emerging technologies, including artificial intelligence and machine learning, will more efficiently automate access to and manipulation of data for greater insights and decision making.

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Appendix A

Summary of US tax treaty benefits

Under US domestic tax laws, a foreign person generally is subject to 30% US tax on a gross basis on certain types of US-source income. US persons making payments ('withholding agents') to foreign persons generally must withhold 30% of payments, such as dividends, interest, and royalties, made to foreign persons. In other situations, withholding agents may apply reduced rates or be exempted from the requirement to withhold tax at source either under domestic law exceptions or when there is a tax treaty between the foreign person's country of residence and the United States that provides for such reduction or exemption.

The United States has entered into income tax treaties with more than 60 countries to avoid double taxation of income and to prevent tax evasion. The table below, taken from the IRS website, summarizes the benefits resulting from these treaties. Taxpayers should check the IRS website for updates and changes.

Recipient	Dividends paid by US corporations in general (%) (1)	Dividends qualifying for direct dividend rate (%) (1, 2)	Interest paid by US obligors in general (%)	Royalties* (%)
Non-treaty	30	30	30	30/30/30
Treaty rates				
Australia (3)	15 (23)	5 (23, 24)	10 (5, 21)	5/5/5
Austria (3)	15 (9)	5 (9)	0 (19)	0/10/0
Bangladesh (3)	15 (22)	10 (22)	10 (11, 19)	10/10/10
Barbados (3)	15 (9)	5 (9)	5	5/5/5
Belgium (3)	15 (27, 28)	5 (24, 27, 28)	0 (19)	0/0/0
Bulgaria (3)	10 (27, 28)	5 (27, 28)	5 (19, 21, 27)	5/5/5
Canada (3)	15 (22)	5 (22)	0 (19)	0/10/0
China, People's Republic of (3)	10	10	10	10/10/10
Commonwealth of Independent States (CIS) (8)	30	30	0 (7)	0/0/0
Cyprus (3)	15	5	10	0/0/0
Czech Republic (3)	15 (9)	5 (9)	0	10/0/0

Denmark (3)	15 (27, 28)	5 (24, 27, 28)	0 (20)	0/0/0
Egypt	15 (4)	5 (4)	15 (4)	30/0/15 (3)
Estonia (3)	15 (9)	5 (9)	10 (20)	10/10/10
Finland (3)	15 (27, 28)	5 (24, 27, 28)	0 (20)	0/0/0
France (3)	15 (22)	5 (22, 24)	0	0/0/0
Germany (3)	15 (27, 28)	5 (24, 27, 28)	0 (19)	0/0/0
Greece (4)	30	30	0	0/30/0
Hungary (3)	15	5	0	0/0/0
Iceland (3)	15 (15, 22)	5 (15, 22)	0 (20)	5/5/0
India (3)	25 (9)	15 (9)	15 (12)	15/15/15
Indonesia (3)	15	10	10	10/10/10
Ireland (3)	15 (22)	5 (22)	0	0/0/0
Israel (3)	25 (9)	12.5 (9)	17.5 (12, 17)	15/10/10
Italy (3)	15 (22)	5 (22)	10 (23)	8/8/0
Jamaica (3)	15	10	12.5	10/10/10
Japan (3, 25)	10 (27, 28)	5 (24, 27, 28)	10 (26, 27)	0/0/0
Kazakhstan (3)	15 (16)	5 (16)	10	10/10/10
Korea, South (3)	15	10	12	15/10/10
Latvia (3)	15 (9)	5 (9)	10 (20)	10/10/10
Lithuania (3)	15 (9)	5 (9)	10 (20)	10/10/10
Luxembourg (3)	15 (29)	5 (9)	0 (4)	0/0/0
Malta (3)	15 (27, 28)	5 (27, 28)	10 (19)	10/10/10
Mexico (3)	10 (22)	5 (22, 24)	15 (18)	10/10/10
Morocco	15 (3)	10 (3)	15 (3)	10/10/10
Netherlands (3)	15 (24)	5	0	0/0/0
New Zealand (3)	15	5 (22, 24)	10	5/5/5
Norway (3)	15	15	0	0/0/0
Pakistan (4)	30	15	30	0/30/0
Philippines (3)	25	20	15	15/15/15
Poland (3)	15	5	0	10/10/10
Portugal (3)	15 (9)	5 (9)	10	10/10/10

Romania (3)	10	10	10	15/10/10
Russia (3)	10 (16)	5 (16)	0	0/0/0
Slovak Republic (3)	15 (9)	5 (9)	0	10/0/0
Slovenia (3)	15 (22)	5 (22)	5	5/5/5
South Africa (3)	15 (9)	5 (9)	0 (19)	0/0/0
Spain (3)	15 (22, 27)	5 (22, 24, 27, 30)	0 (15, 19, 30)	NA/0/0/0/0 (10, 30)
Sri Lanka (3)	15 (30)	15 (30)	10 (19)	10/10/10
Sweden (3)	15 (27, 28)	5 (24, 27, 28)	0	0/0/0
Switzerland (3)	15 (9)	5 (9)	0 (19)	0/30/0
Thailand (3)	15 (9)	10 (9)	15 (12)	15/5/5
Trinidad & Tobago (3)	30	30	30	15/30/0 (14)
Tunisia (3)	20 (9)	14 (9)	15	15/15/15
Turkey (3)	20 (9)	15 (9)	15 (6, 12)	10/10/10
Ukraine (3)	15 (16)	5 (16)	0	10/10/10
United Kingdom (3, 25)	15 (22)	5 (22, 24)	0 (20)	0/0/0
Venezuela (3)	15 (22)	5 (22)	10 (20, 21)	10/10/10

Notes

* Please note the tax rates and associated footnotes appearing in the 'Royalties' column in the table address three types of royalties, as denoted in the most recent IRS publication: industrial royalties; motion picture and television copyright royalties; and 'other' copyright royalties. The slashes '/' between each figure and associated footnote(s) are meant to demarcate these three types of royalties, respectively.

1. No US tax is imposed on a dividend paid by a US corporation that received at least 80% of its gross income from an active foreign business for the three-year period before the dividend is declared.
2. The reduced rate applies to dividends paid by a subsidiary to a foreign parent corporation that has the required percentage of stock ownership. In some cases, the income of the subsidiary must meet certain requirements (e.g., a certain percentage of its total income must consist of income other than dividends and interest). For Italy, the reduced rate is 10% if the foreign corporation owns 10% to 50% of the voting stock (for a 12-month period) of the company paying the dividends. For Japan, dividends received from a more-than-50-percent-owned corporate subsidiary are exempt if certain conditions are met.

3. The exemption or reduction in rate does not apply if the recipient has a PE in the United States and the property giving rise to the income is effectively connected with this PE. Under certain treaties, the exemption or reduction in rate also does not apply if the property producing the income is effectively connected with a fixed base in the United States from which the recipient performs independent personal services. Even with the treaty, if the income is not effectively connected with a trade or business in the United States by the recipient, the recipient will be considered as not having a PE in the United States under Section 894(b).
4. The exemption or reduction in rate does not apply if the recipient is engaged in a trade or business in the United States through a PE that is in the United States. However, if the income is not effectively connected with a trade or business in the United States by the recipient, the recipient will be considered as not having a PE in the United States to apply the reduced treaty rate to that item of income.
5. Interest determined with reference to the profits of the issuer or one of its associated enterprises is taxed at 15%.
6. Contingent interest that does not qualify as portfolio interest is treated as a dividend and is subject to the rates under those columns, as appropriate.
7. The exemption applies only to interest on credits, loans, and other indebtedness connected with the financing of trade between the US and the CIS member. It does not include interest from the conduct of a general banking business.
8. The tax rates in the US treaty with the former USSR still apply to the following countries: Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, and Uzbekistan.
9. The rate in column 2 applies to dividends paid by a RIC or a real estate investment trust (REIT). However, that rate applies to dividends paid by a REIT only if the beneficial owner of the dividends is an individual holding less than a 10% interest (25% in the case of Portugal, Spain, and Tunisia) in the REIT.
10. The rate is 8% for copyrights of scientific work.
11. The rate is 5% for interest (i) beneficially owned by a bank or other financial institution (including an insurance company) or (ii) paid due to a sale on credit of any industrial, commercial, or scientific equipment, or of any merchandise to an enterprise.
12. The rate is 10% if the interest is paid on a loan granted by a bank or similar financial institution. For Thailand, the 10% rate also applies to interest from an arm's-length sale on credit of equipment, merchandise, or services.
13. This is the rate for royalties for the use of, or the right to use, industrial, commercial, and scientific equipment. The rate for royalties for information concerning industrial, commercial, and scientific know-how is subject to the rate in column 5 ('other royalties').

14. The rate is 15% for copyrights of scientific work.
15. Amounts paid to a pension fund or employee benefit organization that are not derived from the carrying on of a business, directly or indirectly, by the fund or organization are exempt.
16. The rate in column 2 applies to dividends paid by a RIC. Dividends paid by a REIT are subject to a 30% rate.
17. An election can be made to treat this interest income as if it were industrial and commercial profits taxable under article 8 of this treaty.
18. The rate is 4.9% for interest derived from (i) loans granted by banks and insurance companies and (ii) bonds or securities that are regularly and substantially traded on a recognized securities market. The rate is 10% for interest not described in the preceding sentence and paid (i) by banks or (ii) by the buyer of machinery and equipment to the seller due to a sale on credit.
19. The rate is 15% (10% for Bulgaria; 30% for Germany and Switzerland) for contingent interest that does not qualify as portfolio interest.
20. The rate is 15% for interest determined with reference to (i) receipts, sales, income, profits, or other cash flow of the debtor or a related person, (ii) any change in the value of any property of the debtor or a related person, or (iii) any dividend, partnership distribution, or similar payment made by the debtor to a related person.
21. Interest received by a financial institution is tax exempt. For Venezuela, the rate is 4.95% if the interest is beneficially owned by a financial institution (including an insurance company).
22. The rate in column 2 applies to dividends paid by a RIC or REIT. However, that rate applies to dividends paid by a REIT only if the beneficial owner of the dividends is (i) an individual (or pension fund, in the case of France or New Zealand) holding not more than a 10% interest in the REIT, (ii) a person holding not more than 5% of any class of the REIT's stock and the dividends are paid on stock that is publicly traded, or (iii) a person holding not more than a 10% interest in the REIT and the REIT is diversified.
23. Interest paid or accrued on the sale of goods, merchandise, or services between enterprises is exempt. Interest paid or accrued on the sale on credit of industrial, commercial, or scientific equipment is exempt
24. Dividends received from an 80-percent-owned corporate subsidiary are exempt if certain conditions are met.
25. Exemption does not apply to amount paid under, or as part of, a conduit arrangement. Under domestic law rules, even where the treaty does not contain a specific rule related to conduits, the IRS may recharacterize financing transactions that form a conduit financing arrangement to deny treaty benefits.

26. Interest is exempt if (i) paid to certain financial institutions, or (ii) paid on indebtedness from the sale on credit of equipment or merchandise
27. Amounts paid to a pension fund that are not derived from the carrying on of a business, directly or indirectly, by the fund are exempt. This includes amounts paid by a REIT only if the conditions in footnote 30 are met. For Sweden, to be entitled to the exemption, the pension fund must not sell or make a contract to sell the holding from which the dividend is derived within two months of the date the pension fund acquired the holding.
28. The rate in column 2 applies to dividends paid by a RIC or REIT. However, that rate applies to dividends paid by a REIT only if the beneficial owner of the dividends is (i) an individual or a pension fund holding not more than a 10% interest in the REIT, (ii) a person holding not more than 5% of any class of the REIT's stock and the dividends are paid on stock that is publicly traded, or (iii) a person holding not more than a 10% interest in the REIT and the REIT is diversified. Dividends paid to a pension fund from a RIC, or a REIT that meets the above conditions, are exempt. For Sweden, the pension fund must also satisfy the requirements in footnote 30.
29. The exemption does not apply if the recipient of the gain is an individual who is present in the United States for more than 119 days during the year.
30. The rate applies to dividends paid by a REIT only if the beneficial owner of the dividends is (i) an individual holding less than a 10% interest in the REIT, (ii) a person holding not more than 5% of any class of the REIT's stock and the dividends are paid on stock that is publicly traded, or (iii) a person holding not more than a 10% interest in the REIT and the REIT is diversified.

Appendix B

Social security totalization agreements

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

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

Appendix C

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