A Non-U.S. Company's Guide to Doing Business in the U.S.: Understanding Federal Taxes

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The global economy is becoming increasingly integrated, and companies are routinely able to access markets throughout the world. For decades, the United States has maintained a robust economy and a strong market for imported goods. This article discusses some of the basic U.S. federal income tax principles that apply to non-U.S. companies doing business in the U.S. Later articles will explore common strategies for entering the U.S. market, monetizing and protecting intellectual property, and other topics relevant to companies entering the U.S. market.

U.S. Federal Income Tax Returns

Tax return filing standards apply to non-U.S. persons differently based on whether they are individuals, fiscally transparent entities, or corporations. Under U.S. tax law, a non-U.S. business entity will be classified based on its legal attributes. The U.S. will always treat certain entities listed in the U.S. Treasury Regulations as corporations ("per se corporations"). Other types of legal entities will be categorized according to certain "default" rules. For example, if an entity affords limited liability to its equity owners, it will be treated as a corporation by default. If not, the entity would generally be treated as a partnership (or disregarded entity, if there is only one owner). Notwithstanding the default classification applicable to an entity, some entities may choose to be treated in a certain way by electing such treatment (this is often referred to as a "check-the-box" election). So, for example, a default partnership could elect to "check the box" to become a corporation for U.S. tax purposes. Note that this election does not change the legal entity in any way except for its treatment under U.S. income tax law.

Non-U.S. individuals must file U.S. income tax returns to report income taxable in the U.S.

Under U.S. income tax principles, a fiscally transparent entity is treated by default as a partnership. That is, the tax liability resulting from a partnership's activities will be attributed directly to its owners. A partnership must file a U.S. tax return reporting its U.S. activity for the year, but it is the owners that must pay any applicable tax on this activity. Thus, both the partnership and its owners have a U.S. tax return filing obligation if the partnership generates income taxable in the U.S.

Disclaimer: This article is not legal advice. It is provided solely for informational and educational purposes and does not fully address the complexity of the issues or steps businesses or employers must take under applicable laws.

Unlike fiscally transparent entities, non-U.S. corporations file U.S. income tax returns and pay U.S. income tax on their taxable income. The owners of non-U.S. corporations have no U.S. income tax return filing obligation until those owners receive income that is taxable in the U.S., usually in the form of a dividend paid by the corporation.

U.S. Federal Income Tax Liability

Non-U.S. persons (individuals and corporations alike) are subject to federal income tax on their income that is effectively connected to a U.S. trade or business ("Effectively Connected Income" or "ECI"). The tax is imposed at the same rates as applicable to U.S. persons, and, like U.S. persons, non-U.S. persons may offset ECI by the amount of permitted expenses and deductions that are connected with their U.S. trade or business.

Usually, income will be considered ECI if one of two tests is met. First, the "business activities test," looks to whether the non-U.S. person's activities in the U.S. are a material factor in generating income. The other test, the "asset use test," looks to determine whether income is generated from an asset used or held for activities in the U.S.

Because ECI earned by a non-U.S. partnership would be subject to tax only once (at the equity owner level), but ECI earned by a non-U.S. corporation would be subject to tax when earned by the corporation and again when distributed to the corporate shareholders, U.S. tax law imposes a special tax on fiscally transparent entities operating a branch in the U.S. This branch profits tax is in addition to the tax on ECI, generally, and is intended to put fiscally transparent entities and corporations on the same footing with respect to U.S. income tax liability.

Non-U.S. individuals and non-U.S. corporations are also subject to a flat 30 percent tax on all fixed, determinable, annual, or periodic income that is derived from sources within the U.S. (also known as "FDAPI"). FDAPI includes any interest, dividends, rents, salaries, wages, and similar income received from U.S. sources, and cannot be offset or reduced by expenses or deductions associated with the income.

Generally, a U.S. payer is required to withhold 30 percent of payments made to a non-U.S. person. However, such withholding is not required if the income is effectively connected with the conduct of a U.S. trade or business and such income is included in the non-U.S. person's gross income on their U.S. tax return. Therefore, the withholding requirement applies only to FDAP income.

Modification by Treaty

To reduce or eliminate double taxation between countries, promote cross-border trading, and alleviate the burden of administration and enforcement of tax laws, countries typically enter into income tax treaties outlining how residents of the "contracting states" will be taxed on income earned in each contracting state. These treaties can alter the general tax rules applicable to non-U.S. persons.

Under income tax treaties, the ability of the U.S. to impose an income tax is predicated on the person having created a "permanent establishment" in the U.S. If applicable, the provisions of the tax treaty supersede the discussion in the preceding sections, because the concept of Effectively Connected Income is supplanted by the permanent establishment analysis under the treaty. Once a person has established a permanent establishment in the U.S., all of that person's income from the permanent establishment becomes subject to taxation in the U.S.

Treaties can also include provisions reducing withholding taxes or tax rates applicable to specific types of income.

The determination of whether an income tax treaty will alter the U.S. tax position of a non-U.S. business is fact specific and should be evaluated carefully.

Summary

Non-U.S. businesses are subject to a set of alternative tax reporting and rate structures that depend on the type of business and type of income generated, and as well as the application of tax treaties. Entering the U.S. market is therefore an opportunity for non-U.S. companies to evaluate their existing and expected operations, and to take action to implement an efficient tax structure that is most appropriate for their circumstances.

About the Authors

David Brandon is a tax and business attorney who regularly counsels business enterprises, nonprofit organizations, and investors with respect to the tax aspects of domestic and cross-border mergers, acquisitions, sales, joint ventures, commercial transactions, financings, reorganizations, spin-offs, and other significant transactions. In this context he aids clients in structuring tax-free reorganizations, crafting transfer pricing strategies and applying tax treaty principles, implementing strategies responsive to U.S. tax reform, and, where appropriate, counseling clients with respect to obtaining tax opinions and letter rulings. David enjoys learning about his client's commercial and charitable activities abroad and has experience assisting U.S. persons abroad and non-U.S. persons in the United States.

Bryce Parkllan is a tax and business attorney with experience in international tax compliance for multinational businesses, investment funds, and tax-exempt organizations operating in the U.S. and U.S. territories. He assists clients in structuring cross-border acquisitions, integrating legal entities, and ensuring full utilization of U.S. federal tax incentives. Bryce was previously an associate with KPMG LLP, where he focused on international tax consulting and compliance for Fortune 500 companies and high net-worth individuals with international holdings.