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Corporate Tax

USA

White & Case LLP

chambers.com

2020

USA

Law and Practice

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1. Types of Business Entities Commonly Used, Their Residence and Their Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

In the USA, the four most common forms of business organisations are sole proprietorships, partnerships, limited liability companies (LLCs) and corporations. While the corporation remains the entity of choice for most large businesses, primarily due to liability protection, LLCs have become increasingly popular over the last several decades, and also offer increased liability protection. Each form has distinct tax and non-tax advantages and disadvantages, some of which are discussed below.

It is useful to note at the outset that an entity's treatment for tax purposes does not need to align with its treatment for non-tax purposes. For example, certain entities can make an election (a so-called check-the-box election), which can change the way in which the Internal Revenue Service (IRS) will treat the business for tax purposes. Thus, if an individual chooses to set up his or her business as an LLC (which, as discussed below, is generally taxed as a "pass-through" entity), they can nevertheless choose to have the business taxed as a corporation.

A sole proprietorship can be used where a single individual owns and operates a business. In such a case, the income and other tax attributes (such as deductions and credits) generated by the business are attributed to the sole proprietor and taxed at the tax rates applicable to individuals. In addition, the sole proprietor is personally liable for all of the obligations of the business (both tax and non-tax). For this reason, new business owners tend to gravitate towards one of the other entity forms that limit the business owner's exposure to the liabilities of the business (eg, an LLC).

Where two or more individuals own a business together, the arrangement is – by default – treated as a *general* partnership. In a general partnership, each of the partners is liable for all of the partnership's obligations, which means that each partner in a general partnership is at risk of losing more than the capital that they contribute to the partnership. In contrast to a general partnership, a *limited* partnership is an arrangement whereby the business owners enter into a contract (referred to as a "limited partnership agreement") pursuant to which a single general partner is responsible for the management of the business, and one or more limited partners act as investors, with very limited or no managerial power. Similar to a general partnership, the general partner in a limited partnership is liable for all of the obligations of the business. The limited partners, however, are only at risk for their own capital contribution to the limited partnership. If a limited partner begins to exercise a level of managerial control indicative of a general partner, however, it could lose its limited liability protection and become exposed to all of the limited partnership's obligations.

Much like a limited partnership, an LLC is an arrangement whereby the business owners (referred to as "members") enter into a contract that sets out the rights of each party. Like the limited partners in a limited partnership, each LLC member's exposure to the LLC's obligations is limited to the amount of that member's individual capital contributions. Unlike a limited partnership, however, an LLC need not necessarily have a general partner with managerial responsibility and unlimited liability. Instead, the management of the LLC and allocation of liabilities is determined contractually and can involve any number of the LLC's members.

For tax purposes, both partnerships (general and limited) and LLCs are referred to as "pass-through" or "flow-through" entities, meaning that the entity's income and other tax attributes (such as depreciation, basis and losses) are attributed to the individual partners or members based on their ownership interest in the entity rather than to the entity itself. Accordingly, the entity itself is not generally subject to taxation. As noted above, however, the members of an LLC may choose to "check the box" and have the LLC treated as a corporation for tax purposes.

Stakeholders generally have the flexibility to allocate the income, losses and tax attributes generated by the entity amongst each other in any way they see fit (subject to a complex set of legal rules designed to ensure that partners or members cannot engage in tax avoidance schemes that do not reflect the economics of their business arrangement). In light of the flexibility offered by limited partnerships and LLCs, and the fact that they are not automatically subject to tax at the entity level, such entities are often used to form investment funds (such as private equity, venture capital and hedge funds). In addition, LLCs and partnerships are especially beneficial in business ventures where it is desired that deductions and losses flow through to investors so as to reduce taxable income from other sources (eg, real estate and energy projects).

Unlike the pass-through entities described above, corporations themselves are subject to tax. Accordingly, profits earned by a corporation are taxed once at the corporate level and a second time after they are distributed to the corporation's shareholders as dividends. This is commonly referred to as "double taxation" and is the primary drawback of organising a business in the corporate form.

Despite double taxation, the corporate form remains popular for various reasons, three of which are described below. First, the corporate form is favoured by companies that want to raise capital by issuing widely held, publicly traded securities. This is primarily because corporations are easier to administer than other entity forms, making it simpler to deal with a large number of shareholders (due in part to the fact that a corporation is taxable as an entity separate from its owners so there is no need to engage in complicated accounting in order to allocate the corporation's various tax attributes to its individual shareholders). Second, corporations can be used as "blocker entities" to protect foreign or not-for-profit investors from being subject to tax on the business's income, and from being required to file tax returns and deal with the IRS. Third, although people are becoming more familiar with the use of LLCs and partnerships, many people are simply more familiar with and comfortable using a traditional corporation.

1.2 Transparent Entities

See discussion in **1.1 Corporate Structures and Tax Treatment** regarding partnerships and LLCs. A US partnership or LLC generally is treated as a transparent entity for US federal tax purposes unless a "check-the-box" election is made to treat such entity as an association taxable as a corporation. SubChapter S corporations (closely held corporations that elect to be treated as a pass through) and certain trusts also may be fiscally transparent in the USA.

1.3 Determining Residence

Irrespective of the type of entity chosen, businesses with cross-border operations should be aware of their potential tax exposure in the countries or jurisdictions in which they operate. Where and to what extent an entity may be taxed depends, in part, on its tax "residence." For example, under current law, the USA taxes worldwide income; for example, all of the profits of a corporation organised in the USA are taxed in the USA (subject to various deferral rules), regardless of the country in which such profits are generated. The following is a general summary of how tax residence is determined based on the type of entity that is chosen.

- Corporations – for a domestic corporation (a corporation formed under US federal or state laws), the USA generally imposes a net income tax on the corporation's worldwide income (again, subject to various deferral rules). For a foreign corporation, however, the USA generally imposes a net income tax only on income earned or otherwise "sourced" in the USA (subject to certain anti-deferral rules) that is effectively connected to a US trade or business conducted by the foreign corporation. The existence of a tax treaty can also have an impact on whether or to what extent profits or other sources of income are taxed in the USA.
- Flow-through entities – as discussed above, partnerships and LLCs are not themselves subject to income tax. Instead, partners and members are taxed based on the underlying investments of the entity and the activities of the business. Accordingly, the tax residence of partnerships and LLCs (whether or not they are formed in the USA) is less important than where the assets of the business are located and where the business is conducted. For example, a non-US member of an LLC formed outside the USA will still be subject to US tax on its share of any income of the LLC that is effectively connected to a US trade or business of the LLC. Also, the USA generally imposes tax on any US person who earns income from a flow-through entity regardless of where the business operates. Again, the existence of a tax treaty may affect the analysis.

1.4 Tax Rates

Perhaps the most important threshold question for determining the appropriate organisational form is the applicable tax rate (not taking into account the impact of a reduced rate of taxation that may be available pursuant to an applicable tax treaty and taxes that may also be imposed by individual states and their political subdivisions).

- Corporations – the tax rate on the earnings of a corporation is a flat 21%. Dividends paid to a US person are generally subject to a 20% tax, plus an additional 3.8% "net investment income tax." Dividends paid by a US corporation to a non-US person generally are subject to a 30% withholding tax (subject to reduction by applicable income tax treaties). Accordingly, earnings of a US corporation are subject to two layers of tax that may exceed 40% once the earnings are distributed to its shareholders.
- Pass-through entities – income generated by pass-through entities such as partnerships and LLCs is "passed through" to the owners and is therefore subject to taxation at the individual or corporate tax rates, as the case may be. The highest graduated individual tax rate on ordinary income is 37%. The highest graduated rate on net capital gains and qualified dividends is 20%. Individuals are also subject to an additional 3.8% "net investment income tax", which generally applies to passive type income (such as dividends, interest and capital gains). Some individuals may be eligible for a 20% pass-through deduction on some or all of their pass-through income.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

A corporation's taxable income is its gross income for the year minus allowable deductions. Gross income is similar but not identical to financial profits computed under Generally Accepted Accounting Principles (which are similar but not identical to International Accounting Standards). Gross income can include receipts from sales, dividends received, interest collected, income from rents and royalty payments, and capital gains. Deductions include all "ordinary and necessary" expenses of the business, which typically include compensation (ie, payroll) expenses, repairs and maintenance expenses, taxes, licences, interest payments, depreciation and depletion, advertising and marketing, and deductible amounts paid to provide employee benefits. Corporations are generally required to calculate gross income on an accrual basis, but certain smaller businesses can account for gross income using a cash or modified cash accounting method.

Corporations are generally taxed equally on all types of income, so there is no reduced rate applicable to corporations for capital gains. A corporation cannot, however, use capital losses to reduce its ordinary income; capital losses of a corporation can generally only be used to offset the capital gains of the corporation. Generally there are no special exemptions for distributions from the "capital" of a corporation. The US rules provide that a distribution is a taxable dividend to the extent the corporation has any current or accumulated earnings and profits (thus payments are deemed to be made out of earnings before they are treated as a return of capital), although a corporation that receives a dividend from another corporation is generally entitled to a special "dividends received" deduction ranging from 50% to 100%.

2.2 Special Incentives for Technology Investments

The US Internal Revenue Code provides special incentives for certain industries and activities, the most important of which are aimed at encouraging corporations to develop new, and refine existing, technology by offering tax incentives to corporations engaging in research and development activities. Corporations may claim a deduction or credit for certain research and experimental expenditures incurred in connection with the corporation's trade or business that represent research and development costs in the experimental or laboratory sense. In addition, a special research credit may be claimed by corporations in connection with incremental research expenses. Note, however, that a corporation claiming the research credit must generally reduce its research and experimental expenditures deduction by the amount of the credit.

2.3 Other Special Incentives

The US Internal Revenue Code also provides special incentives for a handful of other industries and businesses, including clean energy (eg, advanced energy credit, credit for electricity produced from renewable sources), railroads (eg, railroad track maintenance credit) and pharmaceuticals (eg, orphan drug credit). Businesses should generally consult with their tax counsel or tax preparer to determine their eligibility for special tax credits.

A 100% first-year deduction generally is allowed for certain qualified new and used property acquired and placed in service between 27 September 2017 and 2023.

2.4 Basic Rules on Loss Relief

When a corporation operates at a net loss for a given taxable year, it incurs a net operating loss (commonly referred to as an "NOL"), which can be used to offset taxable income in other tax years. In general, a corporation cannot use an NOL from a given tax year to offset taxable income from prior years (no "NOL carryback") but can use the NOL to offset income from future years with no expiry (an indefinite "NOL carryforward"). The use of an NOL deduction is limited to 80% of income in the year the NOL carryforward is used.

In contrast to an NOL, in order to combat certain transactions considered to be "tax shelters", the US tax rules limit an individual's use of certain losses in situations where the individual does not have significant capital "at risk", and where the individual does not materially participate in the business generating the loss. These limitations generally apply to individuals who incur these losses directly or through the ownership of pass-through entities or other "closely held" corporations.

Different rules apply to individuals and corporations with respect to the tax treatment of capital gains and losses. For individuals, capital gains and losses are first characterised as long-term (underlying asset held for more than one year) or short-term (underlying asset held for one year or less). For individuals, short-term capital losses are first applied to offset short-term capital gains. Long-term capital losses are then applied to offset long-term capital gains. If there is a net short-term capital loss, it would then be applied to offset the net long-term capital gain.

If a net capital gain results at the end of this netting process, tax rates lower than the normal tax rates applicable to ordinary income will apply. The tax rate applicable to most net capital gain is no higher than 15% for most taxpayers. For individuals who fall within the 10% or 12% ordinary income tax bracket, some or all of the net capital gain may not be taxed. However, if an individual's taxable income is subject to the maximum individual tax rate, then a 20% tax rate is applied to the taxpayer's net capital gain. There are, however, some exceptions to these general rules. For example, where net capital gains are realised from selling collectibles, the capital gains tax rate will be 28%. If the end result is a net short-term capital gain, instead of a net capital gain computed as described above, that gain would be subject to the same graduated tax rates as ordinary income.

If an individual ultimately realises a net capital loss instead – ie, the capital losses exceed capital gains – the net capital loss may be used to reduce other income, such as wages, up to an annual limit of USD3,000, or USD1,500 if the individual is married and filing separately. Capital losses may also be carried over to subsequent years.

In contrast, unlike the rules that apply to individuals, corporations do not enjoy preferential tax treatment on their long-term capital gains, and there is no deduction against income for capital losses that exceed capital gains. A corporation first nets its capital losses against its capital gains. If the corporation has excess capital losses, the losses are carried back three years and applied against capital gains. If capital losses cannot be applied to capital gains from the preceding years, the capital losses are carried forward (up to five years) and are applied to capital gains that the corporation may realise. A corporation cannot arbitrarily pick which year the loss may be used to offset capital gains: the losses must be used in the earliest year in which there are net capital gains.

2.5 Imposed Limits on Deduction of Interest

Corporations are subject to limitations on certain types of deductions. In particular, interest deductions are generally limited to 30% of the "adjusted taxable income" of the company. Excess interest deductions may be carried forward and used in later years. Under the so-called AHYDO rules, certain interest on high-yield obligations is deferred or disallowed. Also, because interest can only be payable on instruments treated as debt for US tax purposes, US tax rules can treat instruments as equity (resulting in non-deductible dividends or other payments instead of interest), notwithstanding that the instruments are labelled as or otherwise in the form of debt instruments. In particular, recent Treasury Regulations can apply to treat certain related-party debt instruments as equity. Other US tax rules can limit deductions connected to acquisitions whose principal purpose is to secure the benefit of a deduction.

In addition, there is a limit on a taxpayer's ability to deduct "net business interest" (ie, business interest expenses minus business interest income) that applies to a business conducted through a corporation or a pass-through vehicle such as an LLC or partnership. A taxpayer is now only generally permitted to deduct net business interest equal to 30% of the taxpayer's "adjusted taxable income" – which generally is equal to taxable income (excluding certain deductions such as interest, taxes and, in tax years beginning prior to 2022, depreciation, amortisation and depletion). In addition, this interest limitation does not apply to certain small businesses with average annual gross receipts of USD25 million or less. Any business interest deduction disallowed under this limitation generally can be carried forward to future taxable years. At the taxpayer's election, the interest limitation does not apply to interest incurred by the taxpayer in any real property trade or business.

2.6 Basic Rules on Consolidated Tax Grouping

In general, an "affiliated group" of corporations may file a consolidated income tax return covering all group members. An "affiliated group" is a chain of corporations owned by a common parent in which 80% of the vote and value of each corporation is generally directly or indirectly owned by the parent corporation. Subject to limited exceptions, foreign corporations may not file a consolidated return.

There are several advantages and disadvantages to filing a consolidated return. One of the most important advantages is the general ability to use losses generated by one corporation in the group to offset the taxable income of another corporation in the group; related corporations that do not file a consolidated return are generally not able to use losses of one corporation to offset income from another. Thus, the corporation with the income would be required to separately account for and pay taxes on its taxable income, while the corporation with the losses would generally owe no taxes and would carry the losses forward, as described above. In addition, corporations filing a consolidated return are generally not required to pay taxes on inter-corporate dividends. Corporations within the same affiliated group may also defer inter-corporate profits arising as a result of sales or services exchanged within the group. There are also certain disadvantages to filing a consolidated return (including the administrative burden), discussion of which is beyond the scope of this text.

2.7 Capital Gains Taxation

Unlike individuals, corporations do not enjoy preferential tax treatment on their long-term capital gains. All capital gains, whether long-term or short-term, are subject to the corporate tax rate. Moreover, capital losses may only be applied to offset capital gains. If a corporation has excess capital losses, the losses are carried back three years and applied against capital gains. If capital losses cannot be carried back, they are carried forward five years and are applied to capital gains that the corporation may realise. A corporation cannot arbitrarily pick which year to apply the loss to: the losses must be used in the earliest year in which there are net capital gains. If capital losses are not used to offset capital gains within the relevant timeframe, the losses are deemed forfeited. When a net capital loss is carried to another tax year, it is treated as a short-term loss. The capital loss does not retain its original identity as either long-term or short-term. Corporations may not use capital losses to either produce or increase net operating losses in the year in which the capital loss is carried back.

2.8 Other Taxes Payable by an Incorporated Business

In addition to the US federal income taxes imposed on incorporated businesses, such businesses may also be subject to numerous other taxes, including state, local and municipal income taxes, a range of withholding taxes, sales and other transfer taxes, employment and payroll taxes and, for non-US businesses, taxes imposed under the Foreign Investment in Real Property Tax Act of 1980 (commonly referred to as FIRPTA).

2.9 Incorporated Businesses and Notable Taxes

In addition to the US federal income taxes imposed on incorporated businesses, such businesses may also be subject to numerous other taxes, including state, local and municipal income taxes, a range of withholding taxes, sales and other transfer taxes, employment and payroll taxes and, for non-US businesses, taxes imposed under FIRPTA.

To prevent companies from stripping earnings out of the USA through deductible payments made to related foreign parties, the USA applies a base erosion minimum tax (commonly referred to as "BEAT"). BEAT applies to corporations with average annual gross receipts of USD500 million or more that made deductible payments to foreign affiliates that are at least 3% (2% for banks and securities dealers) of the corporation's total deductions for the year. The tax is structured similar to an "alternative minimum tax" and applies to (i) domestic US corporations and (ii) non-US corporations in computing the tax on their income "effectively connected" to the conduct of a US trade or business.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Closely held businesses in the USA typically operate in non-corporate form, usually as sole proprietorships, partnerships or LLCs. Partnerships and LLCs are either treated as pass-through entities for US federal income tax purposes or are eligible to elect such treatment through the check-the-box rules. The income earned by a pass-through entity is not subject to tax at the entity level, but rather is allocated to the owners of the entity, who are then subject to tax on the income. This single level of taxation can be more favourable than the double level of taxation applicable to US corporations and their shareholders. Further, with an entity treated as a pass-through for tax purposes, any tax losses that the entity has generally pass through to the owners and may be used to offset the owner's other income, subject to certain limitations. In addition, there is a temporary deduction for certain income of pass-through entities, available for taxable years beginning before 1 January 2026. The provision allows US individuals, trusts and estates to deduct up to 20% of certain "qualified business income" earned through pass-through entities, such as partnerships and limited liability companies taxed as partnerships. This deduction is not available to corporate owners of pass-through entities.

Partnerships and LLCs have other advantages over corporations unrelated to the double taxation that generally results from a corporate form of operation. Partnerships and LLCs (treated as pass-throughs for tax purposes) can make special allocations of income, gains, losses, deductions and credits among their owners to reflect complex economic arrangements. Non-tax considerations also make partnerships and LLCs desirable, such as limited liability for their owners and flexible governance arrangements, although the extent of these advantages depends on the particular laws of the state of the entity's organisation.

While partnerships and LLCs are generally the preferred form of entity to operate a closely held business, a "Sub-chapter S Corporation" is sometimes used (albeit less frequently now that people have become more comfortable using LLCs). A Sub-chapter S Corporation is a hybrid between a partnership and a corporation where (i) tax is generally not imposed on the entity but instead the income and losses generally pass through to its owners (similar to a partnership for tax purposes) and (ii) it follows certain corporate rules for distributions, redemptions and reorganisations for corporations. Nonetheless, for non-tax purposes, an S Corporation must still observe all corporate formalities applicable under state law, and does have the liability protections normally afforded corporations.

In order for a corporation to qualify as a Sub-chapter S Corporation, it must meet numerous requirements, including:

- having 100 or fewer shareholders;
- having no non-US resident shareholders;
- having only one class of stock;
- having only shareholders that are individuals, estates, certain trusts and certain tax-exempt organisations; and
- conducting a business that is not a financial institution, an insurance company or certain other types of businesses.

Despite these detailed requirements, a Sub-chapter S Corporation is often the preferred form of entity for a pre-existing corporation that is seeking to achieve pass-through taxation because the conversion itself does not generally result in tax, whereas a conversion from a corporation to a partnership or LLC would result in a taxable liquidation.

Despite the advantages of operating as a pass-through entity, some closely held US businesses will choose to operate as corporations for a variety of reasons, including facilitating an initial public offering and to rely on the robust and settled case law governing corporations in certain states. Additionally, non-US persons generally favour conducting business in the USA through corporations rather than pass-through entities in order to avoid incurring a requirement to file a US tax return, thereby becoming subject to the investigatory authority of the Internal Revenue Service, and due to certain US tax laws that specifically eliminate some of the benefits of pass-through taxation for certain non-US persons.

3.2 Individual Rates and Corporate Rates

While entity-level corporate tax rates may be lower than individual tax rates, various factors and rules exist that discourage individual professionals (eg, architects, engineers, consultants, accountants) from forming corporations taxed as corporations to earn income for their services. As discussed above, corporations and their shareholders are subject to two levels of taxation that, when combined, are greater than the generally applicable individual income rates. Nonetheless, if earnings are not distributed to shareholders, then the corporate form may offer tax savings.

Accordingly, there are rules governing personal service corporations that prevent individual service providers from utilising corporate entities to reduce their tax burden. A personal service corporation performs personal services as its principal business, and such services are substantially performed by the corporation's employee-owners. If a corporation is deemed a personal service corporation, the IRS may allocate the income, deductions, credits, exclusions and other allowances of the corporation between the corporation and its employee-owners in certain circumstances.

3.3 Accumulating Earnings for Investment Purposes

Passive activity loss rules limit the deductions and credits that closely held corporations and personal service corporations can claim with respect to passive activities. Under these rules, losses and credits derived from passive activities cannot be used to offset income from other non-passive activities. A passive activity is a trade or business activity in which the taxpayer does not materially participate; this generally means a regular, continuous and substantial involvement in the operations of the activity, which, in some instances, is interpreted to be over 500 hours of participation. In addition, in certain circumstances, an "accumulated earnings tax" of up to 20% can apply to earnings of a corporation that are not distributed, to the extent that such accumulated earnings are beyond the reasonable needs of the business.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Individuals are generally taxed at the preferential long-term capital gains rate on the sale of shares in a closely held corporation that have been held for a period of more than one year. Short-term capital gains on the sale of shares held for one year or less are taxed at the same rate as ordinary income. The long-term capital gains rates applicable to individual taxpayers are 0%, 15% or 20%, depending on the income tax bracket of the taxpayer. "Qualified" dividends (dividends paid by US and certain non-US corporations with respect to stock held by the owner for a certain minimum holding period) are also taxed at the preferential capital gains rate. Dividends received by individuals and capital gains from the sale of shares in a corporation may also be subject to an additional 3.8% tax as "net investment income".

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

The taxation of dividends and gains applicable to individuals holding shares in a publicly traded corporation are the same as those applicable to those who hold shares in a closely held corporation. Thus, individuals are generally taxed at the preferential long-term capital gains rate on the sale of shares in a publicly traded corporation that have been held for a period of more than one year. Short-term capital gains on the sale of shares held for one year or less are taxed at the same rate as ordinary income. The long-term capital gains rates applicable to individual taxpayers are 0%, 15% or 20%, depending on the income tax bracket of the taxpayer. "Qualified" dividends (dividends paid by US and certain non-US corporations with respect to stock held by the owner for a certain minimum holding period) are also taxed at the preferential capital gains rate. Dividends received by individuals and capital gains from the sale of shares in a corporation may also be subject to an additional 3.8% tax as "net investment income".

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Non-US persons may be subject to either of two different US federal income tax regimes, or both. The first regime applies to certain items of income (generally passive in nature) from US sources that are not treated as "effectively connected" with the conduct of a US trade or business (so-called FDAP income). The second regime applies to net income that is treated as "effectively connected with the conduct of a US trade or business."

Payments of US-source FDAP income made to non-US persons are generally subject to US withholding tax at a rate of

30%, subject to certain exemptions and reductions (described further below). FDAP income subject to this type of withholding generally includes interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations and emoluments. In order to determine whether a particular type of income is "US source", the US tax rules provide specific sourcing rules for each income item. For example, interest income is generally deemed to be from US sources if it is paid by a person that is a resident of the USA for tax purposes or by a US corporation on a bond, note, or other interest-bearing obligation. Dividend income paid by a corporation is also generally US-sourced if it is paid by a corporation incorporated in the USA. Rental income is sourced by reference to the location or place of use of the leased property. Royalties are sourced in the place of use (or the privilege of use) of the property for which the royalties are paid. Gain derived from the sale of personal property is generally sourced by the residence of the seller (subject to certain exceptions, including for inventory property, depreciable property and sales attributable to an office or other fixed place of business in the USA). Thus, such gains of a non-resident alien individual or non-US corporation are generally exempt from US federal withholding tax, unless they are treated as being effectively connected with the conduct of a US trade or business (see discussion under FIRPTA in **5.3 Capital Gains of Non-residents**).

The 30% withholding tax may be reduced or eliminated pursuant to a provision of US tax law, or a tax treaty between the USA and the country in which the recipient of the income is resident. For example, withholding tax for US-source interest may be eliminated under the statutory "portfolio interest" exemption. Interest generally qualifies as "portfolio interest" where the underlying loan instrument is issued in registered (as opposed to bearer) form and certain other requirements are met, including that the beneficial owner of the obligation holds less than 10% of the issuing corporation's stock and is not a bank.

US income tax treaties may also operate to reduce (or eliminate) the statutory rate of withholding on FDAP items – such as interest, dividends and royalties – to 0% (often for interest) or 5-15% (often for certain dividends and royalties). In each case, the reduced treaty withholding rate is only available to a treaty person who (i) qualifies as a resident of the treaty country within the meaning of the treaty, (ii) is a beneficial owner of the passive income item at issue and (iii) otherwise satisfies any applicable limitation on benefits provisions of the treaty.

An additional withholding may be imposed under the Foreign Account Tax Compliance Act (FATCA), which is a US tax regime enacted in 2010 in order to prevent US persons from evading US tax by holding income-producing assets through accounts at Foreign Financial Institutions (FFIs) or through other non-US entities (Non-Financial Foreign Entities, or NFFEs). FATCA generally requires FFIs to identify US account-holders and report them to the IRS (either directly or by reporting to the FFI's home country, which will then share such information with the IRS pursuant to an applicable intergovernmental agreement). In addition, non-US entities that are not FFIs (ie, NFFEs) and are passive entities are generally required to provide information regarding their ownership to withholding agents, including identifying any substantial US owners (generally, US owners that hold an interest greater than 10% in the passive NFFE). FFIs and NFFEs that do not comply with the requirements of FATCA incur a 30% withholding tax on payments to them of certain categories of US-source passive investment income.

4.2 Primary Tax Treaty Countries

The primary tax treaty countries that foreign investors use to make investments in US corporate stock or debt are the Netherlands, Ireland and Luxembourg.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

If an entity is a resident of a Contracting State within the meaning of an income tax treaty (ie, the USA or the treaty partner) and satisfies the requirements of the limitations of benefits provision of the treaty (to the extent that one exists in the treaty), that entity is generally entitled to the benefits of an income tax treaty between the USA and a foreign country. However, there are certain circumstances in which the US tax authorities will challenge the use of treaty country entities by non-treaty country residents.

Certain treaties to which the USA is a party contain a limitations of benefit (LOB) clause that is intended to prevent "treaty shopping", and is premised on the idea that an entity that is a resident of a Contracting State must have some connection to that country in order to be eligible for the income tax treaty benefit in question. While the LOB provisions may differ in treaties, it is common for the provision to enumerate a number of objective tests that can be used to establish entitlement to treaty benefits, such as a public company test, an ownership and base erosion test, an active trade or business test, and a derivative benefits test. An entity that fails these tests may nonetheless apply to the competent authority for a determination that it did not engage in treaty shopping and is still entitled to treaty benefits.

In addition to applying any LOB provisions in the applicable tax treaty, the USA may challenge the use of treaty country entities through various economic substance and substance over form doctrines. These doctrines are discussed in further detail in **7.1 Overarching Anti-avoidance Provisions** and include both judicially created doctrines and more specific statutory and regulatory provisions (eg, a regulatory provision disregarding intermediate entities in conduit financing arrangements). Thus, for example, if the treaty country entity is a mere conduit or if its involvement is an unnecessary step engaged in for tax avoidance, the USA may disregard the treaty country entity and apply tax treaties (if any) according to what it views as the true substance of the transaction. However, the USA has specifically recognised investment holding companies as serving a valid business purpose, with the result that they will generally be respected.

4.4 Transfer Pricing Issues

The USA has one of the oldest and most mature transfer pricing regimes. In addition, in 2010, the IRS reorganised its international division to focus its resources on the enforcement of transfer pricing rules and regulations and resolve transfer pricing disputes, among other things. The increasing complexity of transfer pricing disputes has led the IRS to require substantial evidentiary support from the taxpayer. At the outset, an inbound investor will have to be prepared to substantiate the transfer pricing methodology chosen, among other things. Treasury regulations provide penalty protection if a taxpayer prepares and maintains contemporaneous transfer pricing substantiation documents at the time they file the relevant tax return. The principal documents required include the following:

- an overview of the company's business, including an analysis of the economic and legal factors that affect the pricing of its goods or services;
- descriptive statements of the taxpayer's organisational structure covering all relevant parties engaged in transactions potentially relevant under Section 482, including foreign affiliates whose transactions directly or indirectly affect the pricing of property or services in the USA;
- any documentation explicitly required by Section 482;
- a description of the method selected and an accompanying explanation of why that method was selected, including an evaluation of whether the regulatory conditions and requirements for application of that method, if any, were met;
- a description of the alternative methods that were considered and an explanation as to why they were not selected;
- a description of the controlled transactions, including terms of sale, and any internal data used to analyse those transactions;
- a description of the comparables that were used, how comparability was evaluated, and if any adjustments were made;
- an explanation of the economic analysis and projections relied upon in developing the method;
- a description or summary of any relevant data that the taxpayer obtains after the end of the tax year and before filing a tax return, which would help determine if a taxpayer selected and applied a specified method in a reasonable manner; and
- a general index of the principal and background documents, and a description of the record-keeping system used for cataloging and accessing those documents.

This is not an exhaustive list, as background documents on the assumptions, conclusions and positions contained in the principal documents may also be requested.

The IRS's focus on transfer pricing has not abated. For example, the IRS Large Business and International Division focused on related-party transactions, particularly on the transfer of funds to related pass-through entities or shareholders.

For inbound investors, knowledge of the adversarial nature of the complex US transfer pricing regime is important. IRS audits can be time consuming and costly.

4.5 Related-Party Limited Risk Distribution Arrangements

Section 482 of the Internal Revenue Code employs the arm's-length standard. As such, where a limited-risk distributor purchases products for resale from a related party, the price at which the products are purchased (ie, the transfer price) must be arm's-length. This, in turn, is dependent upon the functions performed and risks assumed by the distributor. Thus, with respect to a limited-risk distributor, the transfer price should be respected if the profits earned by the limited-risk distributor are comparable to the profits earned by an unrelated distributor performing similar functions and, likewise, assuming limited risks.

Limited-risk distributor arrangements are also subject to potential challenge under agency principles. If the distributor bears insufficient risks, it may be treated as the agent of the parent. This could subject the parent to taxation as it is treated as being engaged in a US trade or business through the agent distributor.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The USA has a comprehensive transfer pricing regime, which it currently believes sufficiently addresses the issues raised by BEPS Actions 8 through 10. Thus, the US transfer pricing regulations are generally viewed as being consistent with the OECD standards. A question remains, however, regarding how the OECD guidelines will be interpreted by other countries and, thus, there remains a possibility that the guidelines will be interpreted by other countries in a way that results in differences.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims are Settled

When the IRS and a taxpayer resolve a transfer pricing dispute, it is common for the IRS to impose a transfer pricing adjustment as well as collateral adjustments. A common collateral adjustment is one that conforms a taxpayer's accounts to reflect the initial transfer pricing adjustment. For example, if a corporation paid above-arm's length consideration to its parent company, the excess amount may be recharacterised as a dividend. There are also procedures that may apply to allow a taxpayer to make payments to conform its accounts and avoid conforming adjustments.

Where the related party is also a US taxpayer, the IRS will ordinarily make a correlative adjustment to the related party to avoid double taxation. If the related party is not a US taxpayer but is a resident of a country with which the USA has a tax treaty (and the parties are eligible for the benefits of the tax treaty), the IRS may work with the foreign government to achieve a result that avoids double taxation. This process is governed by the mutual agreement procedure (MAP) established under the treaty and the IRS's requirements and procedures set forth in Revenue Procedure 2015-40.

A key challenge of the MAP process is that treaties ordinarily provide only that the tax authorities endeavour to avoid taxation in contravention of the treaty. Accordingly, relief is not guaranteed. However, a more recent trend is for treaties to also provide an arbitration option to provide relief even where the initial negotiations were unsuccessful, although many treaties do not contain such provisions.

5.2 Taxing Differences

Non-US entities may operate in the USA either through a subsidiary structure or through a branch. In a subsidiary structure, the foreign parent entity incorporates a wholly owned corporate subsidiary in the USA, making it a separate corporate legal entity distinct from the foreign parent. The US subsidiary is liable for US tax on all profits earned by the US subsidiary, at a 21% federal corporate income tax rate (plus applicable state or other taxes). Further, the repatriation of profits (a dividend distribution) by the US subsidiary to the foreign parent is generally subject to a withholding tax of 30%, subject to treaty relief.

Conversely, a non-US entity may operate in the USA through a branch, which can be a legal entity separate from the non-US entity if such entity is a pass-through entity such as a partnership or LLC, or can be an office or other fixed place of business that is not a legal entity. Because a branch is not a US corporation, the income from the US branch passes through to the non-US entity. The non-US entity would then report, and be subject to, US tax on the income that is "effectively connected" to the US business at normal US corporate tax rates (21% federal tax plus applicable state or other taxes). The non-US entity with effectively connected income operating through a branch may also be subject to a branch-level tax of 30% (which may be reduced pursuant to a tax treaty). The branch profits tax is imposed on the repatriation of the earnings from a US branch to its foreign home office. In addition, the tax is applicable to excess interest paid or accrued on liabilities booked in the USA. Inter-branch interest and certain exempt interest in bank deposits are exempt from the branch profits tax. Thus, the intent behind the branch profit tax provisions is to put the earnings and profits of a branch of a foreign corporation deemed remitted to its home office on equal footing with the earnings and profits of a US subsidiary that has paid out dividends to its foreign parent.

5.3 Capital Gains of Non-residents

In general, capital gain derived by non-US persons (including non-US corporations) from the disposition of stock issued by a US entity is not subject to US tax. If a non-US person sells the stock of a US entity that holds substantial US real property, however, such gain might be subject to US tax under the Foreign Investment Real Property Tax Act. FIRPTA generally applies to impose US net income tax at regular graduated rates on the sale of a US corporation if 50% or more of the fair market value of the corporation consists of US real property (or consisted of US real property within the previous five years), and on the sale of a pass-through entity (such as a partnership or LLC) to the extent the partnership or LLC owns any US real property.

5.4 Change of Control Provisions

Generally, there are no change of control provisions that could apply to trigger tax or duty charges upon the disposal of an indirect holding higher up in the overseas group. Judicially developed doctrines such as the sham transaction and economic substance doctrines may operate to pierce arrangements structured for tax avoidance purposes.

5.5 Formulas Used to Determine Income of Foreign-owned Local Affiliates

Mandatory formulas are not used to determine the income of foreign-owned local affiliates selling goods or providing services in the USA. Rather, pursuant to the US transfer pricing rules and regulations, a taxpayer must select an appropriate pricing method to test the arm's-length nature of its transfer prices. While formulas are used in transfer pricing, the values in the formula are derived from uncontrolled transactions. For example, a cost-plus arrangement applies a formula whereby the entity is reimbursed for its costs and provided with an arm's-length mark-up, but this mark-up is derived from the mark-up earned in uncontrolled transactions, and should therefore not be seen as a "mandatory formula."

In the context of services, a transfer pricing method referred to as the services cost method (SCM) provides for reimbursement at cost with no mark-up; essentially a cost-plus 0%. The SCM may only apply to "specified covered services." While this may be viewed as a formulaic approach, the SCM is an elective method.

5.6 Deductions for Payments by Local Affiliates

Where a non-US affiliate charges a related US entity for management and administrative expenses incurred by it, the costs charged will be determined against the "arm's-length" standard. In certain cases, the SCM may apply (see **5.5 Formulas Used to Determine Income of Foreign-owned Local Affiliates**).

5.7 Constraints on Related-Party Borrowing

In light of the benefits that can be obtained from interest deductions, combined with the availability of exemptions from withholding on interest payments, related-party debt is subject to special scrutiny, including under (i) related-party debt rules for certain large group entities and (ii) general substance over form principles of the US tax rules. Related-party interest deductions are also subject to the limitation of 30% of adjusted taxable income that applies to all corporations.

Treasury regulations regarding debt between related entities set forth certain documentation requirements that must be complied with in order for a purported debt instrument issued and held by certain members of an "expanded group" to be treated as debt for US federal income tax purposes. These regulations only apply to a purported debt instrument issued by a US corporation and held by a member of such US corporation's expanded group (which generally is a corporation directly or indirectly connected by at least 80% common ownership). Currently, the regulations do not generally apply to purported debt instruments issued by non-US corporations (and the Department of Treasury has proposed the removal of these documentation requirements completely). The regulations provide that issuers of purported debt instruments need to prepare and complete documentation establishing that such instrument meets the following four essential indebtedness factors:

- it provides for an unconditional obligation to pay a certain sum on demand or at one or more fixed dates;
- it establishes that the holder has the rights of a creditor to enforce the obligations thereunder;
- there is a reasonable expectation of repayment of the obligations under the instrument, pursuant to the issuer's financial position; and
- the holder of the instrument undertakes actions evidencing a valid debtor-creditor relationship.

In addition, these regulations treat certain purported debt instruments as equity for tax purposes in certain other circumstances, notwithstanding that the documentation requirements are met.

In order for an instrument to be treated as debt for US tax purposes, US tax rules provide that the instrument must satisfy certain criteria that establish that the instrument, in substance, is a debt instrument. Deference is given to a variety of judicially developed factors and other factors set forth in the US tax rules, such as:

- whether the instrument provides for an unconditional obligation to pay a certain sum at specified maturity;
- whether the instrument is subordinated to other indebtedness of the corporation;
- the level of capitalisation of the company (the debt-to-equity ratio);
- the source of payments;
- the intent of the parties to create a debtor-creditor relationship;
- the ability of the debtor to make required interest and principal payments (based on reasonable projections); and
- whether the instrument provides for a right to enforce payments.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

US taxation of foreign income differs depending on whether the income is earned directly by a US corporation or indirectly through a foreign subsidiary of that US corporation.

US corporations are subject to tax on their worldwide direct income; the USA does not have a territorial system for direct income. Accordingly, the same tax rules generally apply to income earned by a US corporation inside and outside the USA. This worldwide taxability often results in the income of a US corporation earned outside the US being taxed twice, by both the USA and the foreign jurisdiction. In order to address instances of double taxation, the US tax law generally permits a US corporation to credit certain taxes paid to foreign jurisdictions against its US taxes, subject to limitations.

US corporations with foreign subsidiaries are generally exempt from federal income tax through a participation exemption allowing the US corporation to fully deduct dividends received from the subsidiary. This exemption is subject to numerous limitations and requirements. Further, the USA has base erosion and minimum tax provisions that are imposed on multinational groups.

6.2 Non-deductible Local Expenses

Deductions and limitations on deductions in the USA are governed by statute.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends received by US corporations from their foreign subsidiaries are generally exempt from US taxation via a 100% dividends received deduction. In order to qualify for this exemption, the US corporation must own at least 10% of the vote or value of the foreign subsidiary. There are also holding period and foreign tax benefit restrictions.

6.4 Use of Intangibles

Intangibles developed by US corporations may be used by non-US subsidiaries. However, when related entities use such intangibles, the IRS expects the US entity to charge the related non-US subsidiary a fee for such use, which is an "arm's-length" price; ie, a price that the US corporation would charge if the related entity were a separate company operating at arm's length. Royalties earned by the US entity from the licensing arrangement are subject to US tax.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Pursuant to the US "controlled foreign corporation" (CFC) rules and the "GILTI" rules discussed below, a US corporation can be taxed on the income of its foreign subsidiaries before the foreign subsidiary distributes such amounts. The CFC rules were designed to prevent the deferral of US taxes through the accumulation of profits in foreign subsidiaries through a mechanism that accelerates US tax on certain undistributed earnings of a CFC. A CFC is a foreign corporation where more than 50% of the stock by vote or value is owned by "US shareholders." For this purpose, a US shareholder is a US person who owns 10% or more of the total combined voting power or value of all classes of stock in the foreign corporation.

Once a foreign corporation is classified as a CFC, its US shareholders must currently report and pay tax on a portion of certain types of income of the CFC (including certain related-party sales and services income and passive income, such as interest, dividends and royalties), through what is effectively an annual deemed dividend. Further, gain on the sale of a CFC's shares is generally treated as a dividend rather than capital gain to the extent the earnings and profits of the CFC were not previously subject to US taxation.

US corporations with CFCs are also subject to a minimum tax provision that effectively works as a deemed dividend. This minimum tax, imposed on earnings above a set return, is at a reduced rate.

This treatment contrasts with income earned by foreign branches of US corporations, which is subject to full US corporate income tax (although certain deductions might apply to reduce the US corporate income tax on foreign-derived income).

In addition to the tax imposed by the CFC rules, the TCJA added another tax imposed on the US shareholders of a CFC, which is based on a foreign corporation's "global intangible low-taxed income" (GILTI). In general, GILTI equals the CFC's aggregate net income, reduced by 10% of the CFC's adjusted tax basis in depreciable tangible personal property. Corporate US shareholders in a CFC generally are subject to an effective tax rate of 10.5% on their GILTI. The application of foreign tax credits (for taxes imposed by a foreign jurisdiction on the GILTI income) potentially can reduce or eliminate the GILTI tax imposed on a US corporation.

It should be noted that in order to transition to the amended tax rules that now apply to US owners of foreign corporations, the TCJA imposed a tax (for the last taxable year of the foreign corporation that began prior to 1 January 2018) on the deemed repatriation of all accumulated earnings and profits held in CFCs that had not been previously taxed in the USA.

6.6 Rules Related to the Substance of Non-local Affiliates

In order for transactions involving non-local affiliates to be respected, the non-local affiliate must have substance. The IRS may challenge transactions by analysing the substance of the non-local affiliate operations. The substance is what will generally control the tax treatment, rather than the form. The various judicially created doctrines (one of which has now been codified) that may be applicable in this regard are discussed below, under **7.1 Overarching Anti-avoidance Provisions**.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

When US corporations sell shares of their foreign subsidiaries, any resulting capital gains are generally taxed at the ordinary corporate income tax rate of 21%. If a foreign jurisdiction also imposes a tax on the sale, however, then the US corporation might be eligible for a foreign tax credit to reduce the US corporate income tax applicable to the sale. Additionally, as noted in **6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules**, if the foreign subsidiary that is sold by the US corporation is a CFC, then special rules apply to the sale, which may treat a portion of the gain as a dividend rather than a capital gain (which may be eligible for the "dividends received deduction" described in **6.3 Taxation on Dividends from Foreign Subsidiaries**). While dividends and capital gains are currently taxed at the same rate for US corporations, the distinction may have significant consequences (both beneficial and harmful) for the purposes of calculating applicable foreign tax credits and offsetting capital gains against capital losses.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

There are four primary judicial doctrines commonly invoked by the IRS to invalidate tax structures or transactions: the economic substance doctrine, the business purpose doctrine, the step transaction doctrine, and the sham transaction doctrine. All four are utilised by the IRS to determine the substance of the transaction over its form (substance-over-form is also sometimes used as a separate doctrine). These doctrines sometimes overlap in their application.

Traditionally, courts have used either a one or two-pronged test to determine whether a transaction has economic substance. Under the one-pronged test, a transaction has economic substance if, viewed objectively, a non-tax business purpose exists for the transaction. Under the two-pronged test, the first prong is objective – does the transaction, viewed objectively, have economic substance? The second prong is subjective – does the taxpayer have a subjective business purpose for the transaction? Some courts that apply a two-pronged test apply the two prongs conjunctively (whereby both elements must be satisfied) and some apply the test disjunctively (whereby satisfying either prong will satisfy the test).

The economic substance doctrine was codified in 2010. Under Section 7701(o)(1) of the Internal Revenue Code, a transaction has economic substance if the transaction changes the taxpayer's economic position in a meaningful way (apart from federal income tax effects), and the taxpayer has a substantial purpose for entering into the transaction (apart from federal income tax effects). This section expressly provides "[t]he determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this section had never been enacted." As a result, the codification of the doctrine has had little substantive impact on when the doctrine will be applied.

In addition to codifying the economic substance doctrine, a penalty provision was added for underpayments and understatements of tax attributable to the disallowance of claimed tax benefits for transactions lacking economic substance. The penalty is generally 20%, but will increase to 40% if the taxpayer fails to disclose in its tax return the relevant facts of the item at issue. Disclosure must be made on the form prescribed by the IRS (currently Form 8275 or 8275-R). Unlike many accuracy-related penalties, there is no exception for reasonable cause.

The business purpose doctrine sets forth the requirement that a transaction be driven by some business consideration other than the reduction of tax. To determine the intent of the taxpayer, many factors have been considered by the courts, including:

- whether the taxpayer had profit potential;
- whether the taxpayer cited a non-tax business reason for entering into the transaction;
- whether the taxpayer considered the market risk of the transaction;
- whether the taxpayer funded the transaction with its own capital;
- whether the entities involved in the transaction were entities separate and apart from the taxpayer;
- whether the entities involved in the transaction engaged in legitimate business before and after the transaction; and
- whether the steps leading up to the transaction were engaged at arm's length.

The step transaction doctrine applies to multi-step transactions. Under this doctrine, certain formal steps of an integrated transaction can be ignored for US tax purposes in certain circumstances. Courts apply one (or more) of the following three tests to ascertain whether transactions are integrated for tax purposes:

- the binding commitment test;
- the mutual independence test; or
- the end result test.

The binding commitment test asks if, at the time of the first transaction, there existed a binding commitment to commence the second transaction. The mutual interdependence test focuses on the relationship between the steps and asks whether the success of one step depends on the success of the series of steps. The end result test asks whether a series of transactions are actually steps of a larger, overall transaction designed to meet a final result.

The sham transaction doctrine also looks at the substance of a transaction. A sham transaction can either be a sham in fact or a sham in substance. A sham in fact is a transaction where the economic activity that generates the tax benefit at issue did not, in fact, occur. A sham in substance is a transaction that actually occurred, but the only economic effect is the creation of a tax benefit.

In the partnership context, certain "anti-abuse" Treasury regulations have been issued with the purpose of ensuring that the income tax treatment of each partnership transaction is consistent with the intent of the US partnership tax rules. In addition, a host of specific statutory and administrative provisions may invalidate specific transactions or subject them to adverse treatment, including with respect to disguised sales, related-party losses, mixing bowl transactions and issuances of profits interests.

8. Other

8.1 Regular Routine Audit Cycle

In the USA, taxpayers are generally obliged to file tax returns with the IRS on an annual basis, but there is not a regular, routine audit cycle. In general, the IRS may audit a tax return for three years after the due date of the tax return or the date it was filed, whichever is later. If there has been a substantial omission of gross income on the return, the statute of limitations is extended to six years. The taxpayer and IRS can agree to extend the statute of limitations. This often happens when a statute of limitations for a year under audit is due to expire and the IRS has not yet completed its audit. It is important to note that there is no statute of limitations where a required return has not been filed or where the IRS alleges that there has been fraud. This can be a trap for the unwary where, for example, a non-US person has a US income tax filing obligation but fails to file the required return.

Whether or to what extent a taxpayer may be subject to audit depends, in part, on the nature of the taxpayer; ie, individual or smaller entity versus large entity.

Individuals and organisations that do not meet the requirements of the IRS's Large Business & International (LB&I) Examination Process may be subject to an audit for any year. For such taxpayers, the IRS uses several methods for selecting a tax return for audit, including random selection and computer screening, related examinations and information matching.

Some returns will be selected for audit simply based on a statistical formula where the IRS compares returns against "norms" for similar returns. The "norms" are developed from audits conducted by the IRS as part of its National Research Program. A return may also be selected for an audit because it involves an issue or transaction with other taxpayers whose returns have been selected for audit. This may occur, for example, where the return of a business partner or investor has been selected for audit. In addition, since 1984, certain investment transactions are required to be registered with the IRS by the investment organiser as a tax shelter. Any person who claims a loss, deduction, credit or other tax benefit or who reports any income from the tax shelter must report the tax shelter registration number on the relevant return. While this is not a guarantee of an audit, the likelihood of an audit is increased if an investment is classified as a tax shelter by the IRS. Information matching may result in an audit where, for example, a bank issues an interest statement but the income reported on a return does not match. Other methods for audit selection may occur; for example, where there is a local compliance initiative.

If a return is selected for audit, the IRS will notify the taxpayer by mail. There have been a number of phone and email "scams" in recent years as a result of various data breaches and many people have, unfortunately, responded to these fake requests and either lost a considerable amount of money or released Trojan horse programs into their computer systems. The IRS has warned about these scams and reiterated that it will not initiate an audit by telephone or email. The IRS encourages people who receive such scam calls or emails to report them to the IRS.

Assuming an audit is undertaken, it will be managed either by mail or through an in-person interview to review relevant records. The interview may be held at an IRS office or at the taxpayer's home or office. The IRS will request various documents that the examining agent wishes to see. Additional requests may follow. The length of the audit is dependent on the facts and circumstances.

The LB&I Division of the IRS serves entities (including pass-through entities such as partnerships) with assets greater than USD10 million. Some LB&I taxpayers are audited every year. The IRS recently announced a new examination process for all LB&I audits, effective 1 May 2016. For taxpayers that were already under audit on that date, changes will be made in the execution and resolution phases of the audit.

The new process is intended to provide an "organisational approach" for conducting an audit. Under the new procedures, the IRS has stated that it is seeking to work transparently and collaboratively with the taxpayer, and to engage the taxpayer in the development of the audit steps and potential timeline of the audit.

The IRS views the examination process as having three phases: planning, execution and resolution.

In the planning phase, communication is stressed. This stage is where the scope of the audit will be set. Once LB&I determines the issues that will be audited, the audit team is expected to work with the taxpayer to establish steps that will allow the audit to be completed in a timely manner. Better communication is intended to result in a more effective audit. The IRS will try to leverage technology to increase efficiency and to explain to the taxpayer each issue that is being considered in the audit.

The issue team concept of the planning phase is new. The issue team is comprised of LB&I employees who will work with taxpayer personnel who are knowledgeable about a given issue in an attempt to establish the facts and the parties' respective positions. The end result of this phase is the examination plan.

In the execution phase, the facts will be developed and the auditor's position developed. As noted above, the IRS has broad investigatory authority and will seek information in the form of documents and possibly through interviews of current and often former employees. Where a taxpayer fails to respond to a request in a timely manner, enforcement procedures will be undertaken. Issue development is the goal of this phase, and the IRS will seek to reach agreement on relevant facts.

The IRS has announced that it is moving towards a more issue-based approach to audits and, in 2017, released its first 13 campaigns that will be a significant focus for LB&I. Numerous additional campaigns have been announced since then, while a few campaigns have concluded. This new audit strategy is aimed at addressing identified compliance risks, but the campaign programme does not mean that these will be the only areas examined in an audit.

In the resolution phase, the goal is to try to reach agreement, if possible, on the issues examined during the audit. An audit may be concluded in one of three ways:

- a "no change," where the tax return is accepted as it was filed;
- "agreed," where the IRS proposes changes and the taxpayer agrees with the changes; or
- "unagreed," where the IRS has proposed changes but the taxpayer disagrees with some or all of the proposed changes.

If no agreement is reached, the taxpayer may opt to attempt resolution of an issue through various alternative dispute resolution options, including accelerated issue resolution, early referral to appeals, fast-track settlement, or fast-track mediation. Alternatively, the taxpayer could "protest" the proposed changes and attempt to resolve the unagreed issues with the IRS Office of Appeals. To the extent resolution of an issue would result in double taxation and an income tax treaty exists between the countries at issue, the taxpayer could attempt to seek relief through the competent authority process. Through this process, the representatives of the two treaty countries attempt to negotiate an agreement to resolve the dispute.

Tools exist to resolve disputes before they occur, including pre-filing agreements, advanced pricing agreements for transfer pricing issues, and private letter rulings. In addition, where an issue affects a particular industry, it is possible that the issue could be resolved on an industry-wide basis.

To the extent an audit is not fully resolved, the taxpayer may pursue litigation. In the USA, litigation may be pursued in the United States Tax Court after the IRS issues a notice of deficiency. The taxpayer need not pay the deficiency in order to litigate its dispute in the Tax Court. Alternatively, the taxpayer could choose to pay the asserted deficiency, file a claim for refund, and later file a lawsuit in either the United States Court of Federal Claims or the relevant United States District Court. The decision as to choice of forum will generally depend, in large part, on an analysis of the relevant law in that court and the court to which a decision would be appealed.

9. BEPS

9.1 Recommended Changes

The USA has a comprehensive tax regime, which it believes satisfactorily addresses the issues raised by the BEPS Action Plan. Although the USA has only adopted one of the BEPS Actions, it does not oppose many of the concepts. Indeed, many of the underlying policies of the BEPS Action Plan are already reflected in US law or in bilateral treaties signed by the USA.

Country-by-country reporting, as recommended by BEPS Action 13, is the only proposal that the USA has adopted thus far. Action 13 proposed that countries require their multinational enterprises to report the following information annually and for each tax jurisdiction in which they do business:

- information pertaining to global business operations and transfer pricing policies ("master file" documentation);
- detailed transactional transfer pricing documentation that identifies material, related-party transactions, amounts involved and the company's analysis of the transfer pricing determinations made with respect to those transactions ("local file" documentation); and
- a country-by-country report (hereinafter "CbC report").

The CbC report is required to identify the amount of revenue, profit before income tax, and income tax paid and accrued. It also requires multinational enterprises to report the number of personnel employed, stated capital, retained earnings and tangible assets in each tax jurisdiction. Finally, the CbC report should identify each entity within the corporate group doing business in a particular tax jurisdiction, and provide a description of the business activities each entity is engaged in. Action 13 envisions that the CbC reports will be exchanged automatically pursuant to double tax conventions and under tax information exchange agreements.

In June 2016, the Treasury Department released final regulations that require annual CbC reporting by US entities that are the ultimate parent entity of a multinational enterprise with annual revenue of USD850 million or more. The IRS has issued Form 8975 (Country-by-Country Report) and the accompanying Schedule A (Tax Jurisdictions and Constituent Entity Information), along with accompanying instructions for both forms. Rev. Proc. 2017-23 describes the process for filing Form 8975 and Schedule A for reporting periods on or after 1 January 2016 but prior to the required reporting period as prescribed in Treasury Regulations §1.6038-4 (TD 9773). On 30 March 2018, the IRS released Notice 2018–31, modifying the CbC reporting requirements for certain MNEs qualifying as specified national security contractors. The IRS intends to amend Regs. Sec. 1.6038–4 to reflect this guidance.

Citing confidentiality concerns and adequate data security protocols, the USA has opted to enter into specific bilateral agreements on the basis of double tax conventions or tax information exchange agreements, rather than sign the multilateral competent authority agreement for the automatic exchange of CbC reports. The USA has signed bilateral competent authority arrangements with over 50 treaty partners for the exchange of CbC reports, with more competent authority arrangements still being negotiated.

9.2 Government Attitudes

The USA believes that its existing tax statutes, rules and regulations sufficiently address the issues raised by the BEPS recommendations, and is generally supportive of the OECD's BEPS initiative. Representatives of the US Treasury Department have actively participated in various OECD working committees, and have negotiated to ensure that US interests are properly represented and protected. There is some concern amongst US lawmakers, however, that BEPS proposals may allow foreign jurisdictions to unfairly target US-developed intellectual property, even in the absence of critical factors such as local IP development, assumption of entrepreneurial risk and presence of significant assets.

9.3 Profile of International Tax

International tax has a high public profile in the USA. However, as discussed above, the USA believes that its current regime already addresses the key BEPS proposals.

9.4 Competitive Tax Policy Objective

BEPS reforms have had a modest impact on US tax laws and their interpretation, administration and enforcement. Currently, implementation of tax reform is a significant issue for the USA.

9.5 Features of the Competitive Tax System

No information has been provided in this jurisdiction.

9.6 Proposals for Dealing with Hybrid Instruments

BEPS Action Plan, Action 2, is intended to help neutralise the effect of cross-border hybrid mismatch arrangements that produce multiple deductions for a single expense or a deduction in one jurisdiction with no corresponding taxation in the other jurisdiction. The USA has certain rules intended to address certain of the arrangements covered in BEPS (eg, dual consolidated loss rules under Section 1503(d) of the Code, which limit use of a loss in a consolidated return where such loss can also be used in a foreign jurisdiction; or denial of treaty benefits for certain payments through hybrid entities under Section 894 of the Code), that pre-date BEPS. Additionally, the USA has adopted new Section 267A, which is in line with Action 2. Section 267A denies deductions for interest or royalties paid to a related foreign person in accordance with a hybrid transaction or hybrid entity if such amounts are excludable from income or entitled to a deduction under the local tax laws of the related person's country.

9.7 Territorial Tax Regime

As discussed in further detail in **6.1 Foreign Income of Local Corporations**, the USA taxes the worldwide income of local corporations but has some aspects of a territorial tax regime with respect to foreign subsidiaries. The USA already has certain restrictions on the deductibility of interest under Section 163(j).

9.8 CFC Proposals

As discussed above, the USA has some aspects of a territorial tax regime. The USA has recently significantly expanded the definition of CFCs. First, Section 958(b)(4), which generally prevented foreign-owned stock from being attributed downward to a domestic subsidiary, was repealed. Now, a US person can be attributed ownership of a foreign corporation when determining CFC status. Second, the definition of "US Shareholder" was altered. Previously, a US Shareholder was defined as a US person who owned, directly or indirectly, at least 10% of the voting power of the stock of a CFC. Now, the 10% includes both vote and value of the stock of a CFC. That is, non-voting stock is no longer excluded from the 10% calculation for purposes of determining whether a taxpayer is a US Shareholder. Together, these changes have turned many foreign corporations that were not previously CFCs into CFCs.

9.9 Anti-avoidance Rules

The US tax system currently has judicially created anti-avoidance doctrines (economic substance, business purpose, substance over form, step transaction, sham transaction) in addition to rules and regulations that address anti-avoidance. Furthermore, certain US tax treaties have limitation on benefits provisions consistent with the limitation on benefits provision in the 2016 US Model Treaty.

9.10 Transfer Pricing Changes

The USA has one of the oldest and most mature transfer pricing regimes in the world, and the general view is that the US transfer pricing rules are consistent with the BEPS Actions. Thus, the general view is that there will not be radical changes.

The application of transfer pricing rules to intangibles has been a source of controversy in the USA. Since the early 2000s, and as recently as 2016, the IRS has voiced the view that transfer pricing disputes involving intangibles is a significant focus for the USA.

There are two new regimes affecting the taxation of intellectual property. The first, Section 951A, addresses GILTI, and aims to reduce the incentive to relocate intangibles to low-tax jurisdictions. GILTI imposes a tax on profits accrued by foreign affiliates in excess of 10% of the group's tangible overseas capital investment (excluding depreciation). Until 2025, the effective rate for GILTI will be 10.5% and taxpayers can claim an 80% credit for foreign taxes attributable to GILTI. After 2025, the effective rate increases to 13.125%. On 13 September 2018, the IRS issued Section 951A proposed regulations. The second, Section 250(a)(1)(A), addresses foreign-derived intangible income (FDII), and aims to incentivise development of intangibles in the USA. FDII allows taxpayers to deduct a portion of income earned from exporting products derived from certain (generally intangible) assets held in the USA. Until 2025, the effective tax rate on FDII is 13.125%. After 2025, the effective tax rate rises to 16.406%.

9.11 Transparency and Country-by-country Reporting

By adopting final regulations mandating the submission of country-by-country reports by US multinational enterprises with annual revenue of USD850 million or more, the USA has made clear that it is in favour of promoting greater transparency and country-by-country reporting. However, the USA has raised concerns regarding the misuse of taxpayer information and confidentiality, and the administrative and enforcement burdens associated with adhering to the proposals for greater transparency and country-by-country reporting. In addition, there is concern that US taxpayers will be forced to simultaneously comply with multiple conflicting tax rules, which carries with it increased tax burdens and compliance costs, and defending disputes in multiple jurisdictions. Moreover, leakage of confidential or proprietary, competitive information remains a significant concern.

9.12 Taxation of Digital Economy Businesses

The USA has implemented base erosion and minimum tax provisions that, while not specific to digital economy businesses, would apply to such businesses.

9.13 Digital Taxation

The USA generally opposes any approach that would isolate digital economy businesses rather than apply generally and also opposes individual country approaches to taxation of the digital economy. In fact, in July 2019, the Office of the United States Trade Representative initiated an investigation under Section 301 of the Trade Act of 1974 to determine whether France's digital services tax is "unreasonable or discriminatory" or otherwise actionable under Section 301. A determination is expected by July 2020. The USA prefers arriving at a mutually agreed-upon approach through the OECD's Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, supporting the Modified Residual Profit Split method.

9.14 Taxation of Offshore IP

Offshore intellectual property deployed within the USA may result in taxation under generally applicable US principles. In particular, royalties paid to foreign recipients are among the categories of income subject to withholding tax. The 30% withholding rate may be reduced by treaty.

9.15 Other General Comments

There are no other general comments in this jurisdiction.

White & Case LLP has more than 90 tax professionals in multiple jurisdictions across the Americas, Europe, the Middle East, Africa and Asia-Pacific. The firm provides local tax law advice in the USA, the UK, France, Germany, Russia, Mexico, Poland, Slovakia, the Czech Republic, Turkey and Spain to public and private corporations, pass-through entities, joint ventures, funds, governmental entities, sovereigns and individuals. It has a significant non-transactional tax practice, including tax controversies at the administrative level, as well as civil and criminal litigation, transfer pricing, internal investigations, treaty requests and competent authority. Key practice areas are M&A, private equity, capital markets, project development and finance, and real estate. The firm won two deal awards at the 2019 International Tax Review Awards for seminal transactions.

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