Bloomberg BNA

Daily Tax Report®

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Small Business

James McCann of Kleinberg Kaplan looks at the range of U.S. tax considerations foreign small business owners face when considering relocation or an expansion of operations to the U.S. International small businesses ''can fall within a significant advisory gap—too complex for smaller, domestically focused accounting firms, and too small for large, multinational professional advisers,'' McCann writes.

Coming to America: U.S. Tax Planning for Foreign Small Business Owners

BY JAMES MCCANN

The U.S. has been called a ''nation of immigrants.'' This article is concerned with a particular type of immigrant—entrepreneurs and small business owners considering relocating or expanding their operations to the U.S.

More specifically, this article considers U.S. tax planning for ''the international small business'' (or ISB), meaning a business that is:

- operated as a sole proprietorship or through a private, typically closely held, entity;
- either owner-operated or operated with significant owner participation in day-to-day activities; and
- generally owned and operated by persons who are neither U.S. citizens nor U.S. green card holders. That is, the ISB's U.S. tax nexus is due to its physical presence or activities in the U.S. (and not due to having U.S. owners).

ISBs share common fact patterns and issues, and from a tax perspective can be sharply distinguished from purely domestic businesses as well as multinational ''big business.'' They can fall within a significant advisory gap—too complex for smaller, domestically focused accounting firms, and too small for large, multinational professional advisers. This article is intended to help remediate this gap by providing a high-level overview of U.S. tax issues, planning opportunities and traps.

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Taxation of Individuals

An ISB's owners and employees may owe U.S. income tax by reason of being physically present in the U.S. Its owners may also owe U.S. tax on the ISB's income, even if they have no personal connection with the U.S. (this is discussed in more detail below).

The first step to understanding these exposures is to determine whether you are (or may become) a ''U.S individual,'' because the U.S. has different income tax regimes for U.S. and foreign individuals.

Taxation of U.S. Individuals

U.S. individuals include U.S. citizens, green card holders and individuals with a substantial presence in the U.S. They are generally subject to U.S. federal income tax on their worldwide income at graduated rates of up to 20 percent for long-term capital gains and 39.6 percent for all other income, plus various social and state and local taxes.

The ''all in'' marginal income tax rate for a U.S. individual in New York City may exceed 50 percent.

The substantial presence test typically determines whether individuals associated with an ISB are U.S. individuals. An individual won't meet the substantial presence test in any year in which he or she spends less than 31 days in the U.S. An individual will meet the substantial presence test in any year in which he or she spends 183 days or more within the U.S.

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Between these extremes, whether an individual meets the substantial presence test generally depends on time spent within the U.S. over a three-year rolling period. Immigration status, with limited exceptions, is generally irrelevant for purposes of applying the substantial presence test.

Taxation of Non-U.S. Individuals

Foreign individuals are generally subject to U.S. federal income tax only on U.S.-source income.

Significantly different tax regimes apply to U.S.-source business and non-business income. Thus, as a threshold matter, it is necessary to determine whether income is associated with a U.S. business.

U.S. Business Income

In general a U.S. business requires the presence of ''regular, continuous and substantial'' activities in the U.S., although in practice these criteria have been found to be satisfied due to even very limited U.S. activities. Thus, most of the time, it is fairly clear whether or not a U.S. business exists.

Example 1. Mere ''business travel'' within the U.S. generally wouldn't give rise to a U.S. business.

Example 2. Opening an office (or other fixed place of business) in the U.S. would generally establish the presence of a U.S. business. However, because the relevant legal standards are ill-defined and because there are special exceptions and rules for particular activities, each situation should be considered on its own facts.

Example 3. Solely trading stocks or securities for one's own account is statutorily excluded from being a U.S. business (even if carried out through a U.S office).

Example 4. Even though a non-U.S. person may not directly engage in any U.S. business activities, he may be deemed to have a U.S. business through U.S.-based agents, such as a partner or employees.

A foreign individual's U.S. business income is generally subject to U.S. federal income tax at graduated rates up to 20 percent for long-term capital gain and 39.6 percent for all other income (that is, the same rates that apply to U.S. individuals). In addition, such an individual is required to file a U.S. income tax return even if he or she has (overall) a taxable loss.

Significantly, a foreign individual failing to timely file a U.S. income tax return is generally denied any deductions.

Examples of income from a U.S. business include compensation for services performed within the U.S. and gain from the sale of inventory in the U.S.

Other U.S. Income

A non-U.S. individual's other U.S.-source income is generally subject to a flat 30 percent U.S. federal income tax, typically paid through withholding. This may include dividends from U.S. companies, interest from U.S. obligors, and rents and royalties derived from property located in the U.S. Significantly, a non-U.S. individual's capital gain income is generally not subject to U.S. income tax, unless it is connected to a U.S. business.

A foreign individual is generally not required to file a U.S. tax return if he or she doesn't have a U.S. business.

Income Taxes and Beyond

In addition to income taxes applicable to the individuals and entities associated with an ISB, foreign small business owners planning activity in the U.S. should consider:

- U.S. tax compliance can be difficult and expensive;
- becoming a U.S. taxpayer in particular can trigger a host of reporting requirements;
- foreign persons' gains from sales of U.S. real property are subject to taxation as business income;
- state and local taxes can be significant; and
- employers are responsible for payroll taxes and withholding.

Taxation of the Entity and Its Owners

If the ISB is organized as a legal entity, the U.S. tax treatment of it and its owners depends upon many factors, including how it is organized, where it is organized, whether it has made a U.S. entity classification election and what it is doing within the U.S. The following examples are intended to highlight some essential concepts and issues.

Example 1. The ISB is organized as a U.K. limited partnership. It makes no U.S. entity classification election, and thus it is classified as a partnership for U.S. tax purposes and its income ''flows through'' to its owners.

If it doesn't have a U.S. business, then its foreign owners shouldn't be required to file U.S. tax returns merely by reason of being owners. (But recall that its U.S. owners are subject to worldwide U.S. income taxation, and thus owners who are considered U.S. individuals—under the substantial presence test discussed above, or otherwise—are subject to U.S. income tax on the ISB's worldwide income.)

If it does have a U.S. business, then the U.K. LP and all of its owners will be required to file U.S. income tax returns. The U.K. LP must pay U.S. withholding tax on its U.S. business income allocated to foreign owners, and its owners must pay any incremental U.S. tax above what is withheld (or receive a refund of over-withheld tax).

Example 2. The ISB is organized as a U.K. limited partnership, but elects to be classified as a corporation for U.S. tax purposes.

In this case, if it is engaged in a U.S. business, it would be required to file a U.S. corporate tax return and pay U.S. corporate taxes on its income from this business. However, it wouldn't be required to pay U.S. tax on its foreign income, and its foreign owners wouldn't have any U.S. income tax obligations merely by reason of their ownership interests.

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Example 3. The ISB is organized as a U.S. corporation. It is subject to U.S. corporate income tax on its worldwide income, even income earned outside the U.S. Its foreign owners have no U.S. income tax obligations merely by reason of their ownership interests (though they may have U.S. estate tax exposure on such interests).

From just a tax perspective, using a U.S. corporation as an ISB is generally a poor idea, unless it is limited to being used as a vehicle for U.S.-based operations.

In the author's experience, Examples 2 and 3 are the more common approaches, to protect ISB owners from being required to file U.S. income tax returns (this is particularly true when the owners include passive investors or persons not involved in U.S. business operations).

Costs of Noncompliance

Tax compliance for ISBs can be difficult and expensive. In particular, becoming a U.S. person (such as by reason of the substantial presence test) may raise a host of complex compliance obligations, such as special reporting requirements for interests in foreign bank accounts, interests in non-U.S. legal entities, and gifts or bequests from foreign sources.

None of these compliance obligations is obvious or simple. Compliance failures may be subject to harsh sanctions.

Example. A foreign citizen (including a green card holder) may be deported if convicted for making a false statement on a tax return, even if the statement is associated with a relatively small tax underpayment and carries no criminal sanctions.

Pre-Immigration Planning Is Important

As noted above, U.S. individuals are subject to U.S. federal income tax on their worldwide income. This tax may apply to income accruing or earned before an individual had any connection with the U.S.

Example. A foreign individual owns a house outside the U.S. If she becomes a U.S. individual and subsequently sells the house, she will be required to pay U.S. income taxes on any gain realized, even due to pre-immigration appreciation. Similar considerations may apply to deferred compensation and other income that hasn't yet been realized.

The U.S. anti-deferral regimes may also be problematic.

Example. A foreign individual owns various investments through a wholly owned foreign corporation. He becomes a U.S. individual, and the corporation subsequently sells these investments. The individual is taxed by the U.S. on the entire gain on the sale, including gain attributable to pre-immigration appreciation.

Furthermore, because the investments are owned through a wholly owned foreign corporation, he is taxed at the higher ordinary income rates (up to 39.6 percent) rather than the long-term capital gain rates (20 percent) that would apply if he held the investments directly.

Many of these issues may be addressed with the right pre-immigration planning. In addition, there may be circumstances where it is beneficial to defer taking a loss or deduction until the taxpayer becomes a U.S. person. Pre-immigration planning should also take into account U.S. estate and gift taxes, which are beyond the scope of this article.

U.S. Real Property

Foreign persons are subject to U.S. income tax on gains from sales of U.S. real property under a special law—the Foreign Investment in Real Property Tax Act, or FIRPTA—that deems any such gains to be business income. FIRPTA incorporates complex and occasionally harsh rules that are intended to ensure the collection of these taxes.

Rents from U.S. real property are also subject to U.S. income tax. Depending on the owner's level of activity in the U.S., rent may constitute business or non-business income (e.g., contrast an actively managed property and a property subject to a triple-net lease). It is generally preferable to have rent taxed as business income, to permit tax deductions for the significant expenses typically associated with ownership of real estate, such as property taxes, mortgage interest and depreciation.

Fortunately, non-U.S. persons may elect to have rents taxed as business income even though they might constitute non-business income under general tax principles.

FIRPTA and anti-inversion rules may make it extremely difficult or costly to modify a U.S. real estate holding structure once it is put into place.

There are a variety of legal structures used by foreign persons to invest in U.S. real estate, largely to mitigate U.S. tax issues. Key considerations for any structure include protection from U.S. estate tax (a significant economic issue for foreign individuals, as U.S. estate tax of 40 percent could otherwise apply to the unencumbered value of the property), protection from U.S. income tax filing obligations, preserving preferential long-term capital gain rates where applicable and the intended use of the property (personal use, long-term rental property, speculation).

These considerations may conflict, and thus a structure that works for one person may not work for another. Furthermore, a structure that works when implemented may become problematic due to changes in circumstance or law. Note that FIRPTA and anti-inversion rules may make it extremely difficult or costly to modify a U.S. real estate holding structure once it is put into place.

A Tax Treaty May Help

The U.S. is a party to many income tax treaties. These treaties may benefit an ISB by, for example, mitigating U.S. taxes or permitting tax credits in the ISB's home country for U.S. taxes paid.

Example. An ISB takes customer orders from a U.S. call center, stores and ships inventory from a U.S. warehouse, and accepts customers' returns at that warehouse. Under U.S. domestic law principles, the ISB would be subject to U.S. income tax on any profit from those activities. Under a U.S. income tax treaty, however, the ISB may be able to avoid any U.S. income tax on those activities, based on the idea that they don't constitute a ''permanent establishment.''

Likewise, U.S. income tax treaties generally reduce or even eliminate U.S. tax on U.S.-source interest, dividends, royalties and certain other types of income.

There are a number of conditions and limitations to claiming the benefits of U.S. income tax treaties, which vary treaty by treaty but share certain themes. The primary condition is that a person must be a resident of a country to claim the benefits of its tax treaties.

The most important secondary limitation is the ''limitation on benefits'' article, which generally requires a substantial nexus between a person and the country whose treaty is being claimed.

Example. A Luxembourg entity can't claim the benefits of the U.S.-Luxembourg income tax treaty merely because it is organized in Luxembourg; it needs to have substantial Luxembourg business activities, or some minimum degree of U.S. and Luxembourg ownership, or satisfy some other criteria.

There are other limitations on the ability to claim the benefits of a particular U.S. income tax treaty.

Example. An individual who files U.K. income tax returns as a resident nondomiciliary (and thus is generally only subject to U.K. income tax on income remitted to the U.K.) is entitled to only limited benefits under the U.S.-U.K. income tax treaty.

A U.S. tax filing is often required to claim the benefits of a U.S. income tax treaty. Failing to make this filing on a timely basis may effectively forfeit the ISB's ability to benefit from the treaty.

Finally, U.S. income tax treaties aren't binding on the 50 states (and their subdivisions). Certain states may give effect to these treaties by computing state taxable income by reference to federal taxable income, but many don't.

Example. New York computes New York taxable income based on federal taxable income but requires the addition of any income excluded by reason of a tax treaty. Thus a non-U.S. person could find herself required to pay New York but not federal income tax.

Local Taxes May Be Significant

Most states and some cities impose personal and corporate income taxes. These taxes may be applied based on where the ISB is organized, where it is doing business (i.e., the location of its offices and personnel) and where its customers are located.

Example. An ISB with a New York City office would have federal, New York state and New York City income tax obligations, and (if classified as a corporation for U.S. tax purposes) a marginal corporate income tax rate approaching 50 percent on its undistributed profits and 65 percent on distributed profits. If it has customers or otherwise is doing business in other states, it may also have income tax obligations in those other states.

In addition, most states and some cities impose sales or use taxes. These taxes may be applied based on where a product or service is delivered, even if outside the place of the ISB's regular commercial domicile.

Payroll Taxes

Employers are required to withhold income and other taxes from employees' wages, and pay those taxes to the Internal Revenue Service. Similar obligations apply under state and local tax law. Because payroll compliance is complex, many employers run payroll through third-party payroll companies.

Failure to satisfy payroll tax obligations raises obvious and not-so-obvious issues. Obvious issues include the employer's legal obligation to pay these taxes, and penalties and interest applicable to late payment. Not-so-obvious issues include the fact that an employee who falls behind on his or her U.S. income taxes may have a financial incentive to walk away from this liability—which may be counterproductive to the employer, who has invested time and money in establishing the employee in the U.S.

No payroll withholding is required for wages paid to ''independent contractors.'' This may create a strong incentive to classify workers as independent contractors rather than employees (in particular, if the ISB hasn't committed to a permanent U.S. presence). However, this approach needs to be taken with care, as the distinction between employees and independent contractors is highly fact dependent.

Example. An independent contractor typically has multiple customers, and thus it may be problematic to classify a worker as an independent contractor if he only works for the ISB.

It is also worth noting that independent contractors are (personally) required to pay estimated income taxes on a quarterly basis, and also bear a larger share of social taxes as compared to employees. Finally, taking an aggressive position regarding independent contractor classification can be dangerous, as the ISB would be responsible for (unsatisfied) payroll taxes.

Conclusion

Every U.S.-based business has several important partners—the federal, state and local governments, acting through the IRS and other taxing authorities. These partners won't provide capital or expertise to the venture, but will share in its success. The immigrant ISB should begin its U.S. tax planning before coming to America, and before admitting these new partners.

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