Bloomberg BNA

Daily Tax Report®

Corporate Taxes

Dahlia B. Doumar and Carl A. Merino of Patterson Belknap Webb & Tyler and CPA Michael L. Chen discuss how business profits of a foreign corporation generally are taxed in the U.S. and suggest possible holding company structures that a foreign parent corporation can use to help insulate itself from direct U.S. tax exposure while taking advantage of treaty exemptions to reduce federal income taxes.

Entering the U.S. Without Entering Its Tax System: Holding Company Structures for U.S. Operations

BY DAHLIA B. DOUMAR, CARL A. MERINO AND MICHAEL L. CHEN

Foreign companies entering the U.S. market for the first time will want to consider how their operations can be structured to minimize U.S. taxes. Although sales into the U.S. can be arranged in some cases to keep profits offshore, a sufficient presence ''on the ground'' can pull sales income (and possibly other income) into the U.S. tax system.

This article discusses how business profits of a foreign corporation generally are taxed in the U.S. and suggests possible holding company structures that a foreign parent corporation can use to help insulate itself from direct U.S. tax exposure while taking advantage of treaty exemptions to reduce federal income taxes.[1]

Dahlia B. Doumar and Carl A. Merino are partner and counsel respectively at the New York City law firm of Patterson Belknap Webb & Tyler LLP. Michael L. Chen, CPA, is a founder and partner of CWS CPA LLP, a New York City-based accounting firm. *The authors would like to thank Lauren C. Pignataro, an associate at Patterson Belknap Webb & Tyler LLP, for her assistance in preparing this article.*

Federal Income Taxation of Business Profits: General Rules in the Absence of a Treaty

Foreign corporations are taxed under Section 882(a) of the Internal Revenue Code of 1986, as amended, at graduated rates topping out at 35 percent on ''taxable income which is effectively connected with the conduct of a trade or business in the United States'' (hereinafter, ''effectively connected income''). A flat 30 percent tax applies under I.R.C. Section 881(a) to certain types of passive income, including interest, dividends, royalties, rents and annuities. There are a number of exemptions under the code and applicable treaties.

A foreign corporation doesn't have effectively connected income if it isn't engaged in a trade or business in the U.S.[2] For example, a foreign corporation potentially could earn millions of dollars in revenue selling

[1] As discussed later in this article, most treaties don't cover state income taxes. However, a holding company structure can help to shield the ultimate parent from direct state tax exposure.

[2] A foreign partner of a partnership (domestic or foreign) engaged in a U.S. trade or business will itself be deemed to be so engaged on account of the partnership's activities per I.R.C. Section 875(1). Similarly, many states impose corporate income taxes on out-of-state corporate partners of partnerships that conduct business in-state.

 ISSN 0092-6884

goods to U.S. customers without generating any effectively connected income if:

- title to the goods sold and risk of loss pass outside the U.S., and
- the corporation's activities in the U.S. don't rise to the level of a trade or business.

However, the determination of whether a foreign company (or other foreign person) is engaged in a U.S. trade or business is ''highly factual'' and depends on the facts and circumstances of each case.[3] Courts historically have focused on whether such activities, including the activities of the foreign person's agents in the U.S., were ''considerable, continuous and regular.''[4]

Broadly stated, a foreign company sending employees or other agents into the U.S. or otherwise establishing a physical presence (for example, servers or other assets) might be considered to be engaged in a U.S. trade or business. However, there is no bright-line test.

Federal Income Taxation Of Business Profits Under a Treaty

The U.S. business profits of a foreign corporation that is eligible for tax benefits under an income tax treaty generally aren't subject to federal income taxes unless the corporation has a ''permanent establishment'' in the U.S. As with a trade or business, there is no bright-line test for what constitutes a permanent establishment, but it generally requires a more substantial physical presence or greater level of activity.[5]

As with a trade or business, there is no bright-line test for what constitutes a permanent establishment, but it generally requires a more substantial physical presence or greater level of activity.

Article 5 of the U.S. Model Income Tax Convention of Nov. 15, 2006 (the ''Model Treaty''), defines a permanent establishment as a ''fixed place of business through which the business of an enterprise is wholly or partly carried on.'' The U.S. Model Technical Explanation accompanying the Model Treaty (the ''Technical Explanation'') provides:

> [A] general principal to be observed in determining whether a permanent establishment exists is that the place of business must be ''fixed'' in the sense that a particular building or physical location is used by the enterprise for the conduct of its business, and that it must be foreseeable that the enterprise's use of this building or other physical location will be more than temporary.

Under Article 5 of the Model Treaty, permanent establishments include, among other things, places of management, branches, offices, factories, workshops, mines, oil and gas wells, quarries and certain construction sites or installations put in place for more than a year. There are exceptions for facilities used solely to store, display or deliver merchandise belonging to the enterprise and the maintenance of a stock of goods solely for storage, display or delivery or for processing by another enterprise. This carve-out can be particularly helpful for a foreign company selling goods to U.S. customers without a physical storefront (e.g., through online sales).

Article 5 also carves out fixed places of business that exist solely for the purpose of purchasing goods or merchandise, collecting or supplying information, advertising or other activities of a ''preparatory or auxiliary character'' for the enterprise.

Activities of Agents

An enterprise generally won't be deemed to have a permanent establishment solely on account of the activities of an ''independent agent'' acting in the ordinary course of such agent's trade or business (i.e., an independent contractor working on a non-exclusive basis who isn't otherwise economically dependent on the enterprise).[6] However, the activities of employees, as well as agents who regularly exercise contracting authority on behalf of the enterprise (other than for ancillary matters), can be imputed to the enterprise.[7]

Although the particulars of each treaty vary, most reflect the general principles laid out in the Model Treaty. The permanent establishment threshold under a typical treaty can give a foreign corporation that doesn't have significant assets or employees on the ground some leeway to operate in the U.S. before its business profits are subject to federal income taxes. Moreover, even if a foreign corporation has a permanent establishment in the

[3] See Rev. Rul. 88-3, 1988-1 C.B. 268.

[4] See *Pinchot v. Commissioner*, 113 F.2d 718, 719 (2d Cir. 1940) (taxpayer who leased various properties, paid expenses and property taxes and sold and purchased property through a U.S. agent was engaged in a U.S. trade or business because ''[the] management of real estate on such a scale for income producing purposes required regular and continuous activity of the kind of which is commonly concerned with the employment of labor; the purchase of materials; the making of contracts; and many other things which come within the definition of business . . . within the commonly accepted meaning of that word'').

[5] For example, in Rev. Rul. 55-617, 1955-2 C.B. 774, the Internal Revenue Service concluded that sales made by an apparently general commission agent caused a foreign corporation to be engaged in a U.S. trade or business for tax purposes, but weren't sufficient to create a permanent establishment under the U.S.-Belgium income tax treaty.

[6] See Article 5(6) of Model Treaty and accompanying Technical Explanation. This generally is the case outside of the treaty context as well, but the law isn't always as clear cut. For example, there was no imputation from a U.S. supplier filling customer orders and collecting fees for a foreign corporation in the absence of a formal (dependent) agency relationship in *Amalgamated Dental Co. v. Commissioner*, 6 T.C. 1009 (1946). However, in *de Amodio v. Commissioner*, 34 T.C. 894 (1960), aff'd, 229 F.2d 623 (3d Cir. 1962), the Tax Court held that the purchase and management of real estate holdings by independent real estate agents on behalf of the foreign owner caused the owner to be engaged in a U.S. trade or business.

[7] See Article 5(5) of Model Treaty and accompanying Technical Explanation. Note that contracting authority limited to ancillary activities (for example, service contracts for the enterprise's business equipment) wouldn't by itself be sufficient to cause an agent's activities to be imputed to the enterprise, even if exercised on a regular basis.

  DTR ISSN 0092-6884

U.S., only business profits attributable to the permanent establishment are taxable under most treaties (including Article 7 of the Model Treaty).

Note on Updates to Model Treaty

The U.S. Treasury Department announced proposed updates to the Model Treaty on May 20, 2015.[8] The updates attempt to address concerns about base erosion, profit-shifting and other tax-avoidance behavior, including potential misuse of permanent establishments.[9] Relevant provisions are highlighted below, but these proposals generally don't change the above analysis or the suggested holding company structures discussed in the double holding company structure discussion below.

State and Local Tax Considerations

A detailed discussion of state and local taxes is beyond the scope of this article, but it is important to highlight a few key areas where federal and state tax laws diverge.

First and foremost, U.S. income tax treaties generally don't cover state and local income taxes. Thus, a foreign corporation that is exempt from federal income taxes because it doesn't have a permanent establishment in the U.S. may nonetheless have a sufficient presence to be subject to corporate income or similar taxes in one or more U.S. states.

Another key difference is that a foreign corporation's tax base for state tax apportionment purposes may not be limited to its federal taxable income. If a foreign corporation is part of a group of companies operating as a ''unitary business'' (a single business or economic unit) a state potentially may tax the foreign corporation on its worldwide income from such unitary business (including income from foreign sources) attributable to that state, regardless of whether such amounts are includable in income at the federal level.[10] Even if a foreign corporation isn't directly taxable, its income still may be required to be included on the tax return of an affiliate in a state that requires combined reporting for unitary businesses, although some states limit inclusion of foreign affiliates in these reports.

Finally, many states have done away with the requirement that a corporation have a physical presence in order to be subject to corporate income, franchise or gross receipts taxes, particularly where an out-of-state company is actively soliciting business within the state or licensing its intellectual property to an in-state affiliate.[11] Most departments of revenue require only a minimal level of contact to assert income tax nexus. For example, according to Bloomberg BNA's 2015 Survey of State Tax Departments (Vol. 22, No. 4), 38 states, the District of Columbia and New York City would consider ownership of a web server in-state to be sufficient to establish nexus. Many also would consider shared space on a third party's network of in-state servers to be sufficient to create nexus.[12]

A few states, including Ohio, Connecticut, California and New York, have introduced ''bright-line'' nexus rules where an out-of-state company can be subject to corporate income taxes without regard to its actual contacts with the state if sales to in-state customers exceed certain dollar thresholds.[13]

---

[8] See news release, U.S. Department of the Treasury, ''Treasury Releases Select Draft Provisions for Next U.S. Model Income Tax Treaty'' (May 20, 2015), available at http://www.treasury.gov/press-center/press-releases/Pages/jl10057.aspx.

[9] Among other things, these provisions serve to prevent the use of permanent establishments to avoid paying taxes in both treaty countries, restrict treaty benefits for certain types of ''mobile'' income (including interest and royalties), bar former U.S. companies from treaty benefits after an inversion, revise the limitation-on-benefits article (including taxpayer-friendly provisions making it easier for certain companies to qualify for benefits) and switch off treaty benefits when certain changes are made to either country's tax laws. Even if finalized, these proposed updates (which are subject to further revision) wouldn't impact treaties already in force. However, they are an indication of the U.S. Treasury Department's current negotiating position and may be reflected in new treaties or future amendments to some existing treaties.

[10] See *Barclays Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298 (1994); *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983). For example, the New York Tax Appeals Tribunal ruled in 2008 that an Indian corporation must include worldwide income in its New York tax base in accordance with state tax regulations even though foreign source income generally wouldn't be included in its federal taxable income. The court also noted the irrelevance of the U.S.-India tax treaty for state tax purposes. See *Matter of Infosys Technologies Ltd.*, DTA No. 820669 (N.Y. Tax App. Trib. Feb. 21, 2008).

[11] Physical presence is still required in order for a state to assert nexus for sales tax purposes under *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). However, courts have chipped away at the physical presence requirement for income tax purposes. See, e.g., *Geoffrey Inc. v. S.C. Tax Comm'n*, 313 S.C. 15 (1993), cert denied, 510 U.S. 992 (1993) (out-of-state intellectual property holding company subject to corporate income taxes on licensing fees paid by in-state affiliate for use of intellectual property in-state); *Tax Comm'r of W. Va. v. MBNA Am. Bank N.A.*, 220 W. Va. 163 (2006), cert denied, 551 U.S. 1141 (2007) (MBNA found to have nexus with West Virginia for corporate income tax purposes notwithstanding its lack of physical presence because it continuously and systematically engaged in direct mail and phone solicitation and promotion of its credit cards in West Virginia); *Lanco Inc. v. Dir., Div. of Taxation*, 188 N.J. 380 (2006), cert. denied, 551 U.S. 1131 (2007) (physical presence not required in order for out-of-state intellectual property holding company to be subject to New Jersey corporate income taxes on licensing fees from a New Jersey affiliate). But see *Griffith v. ConAgra Brands Inc.*, 229 W. Va. 190 (2012) (declining to extend earlier *MBNA* decision to out-of-state licensor where there was no active solicitation in West Virginia); *AccuZIP Inc. v. Dir., Div. of Taxation*, 25 N.J. Tax 158 (2009) (holding that sales of computer software to New Jersey customers didn't create nexus for corporate income tax purposes and distinguishing facts from those of earlier *Lanco* decision).

[12] Whether they would prevail in court in each instance is another matter.

[13] See, e.g., Ohio Rev. Code Ann. Section 5751.01(I)(3); Conn. Gen. Stat. Sections 12-216a, 12-216b; Conn. Info. Pub. 2010(29.1) (Dec. 28, 2010); Cal. Rev. & Tax. Code Section 23101; N.Y. Tax Law Section 209.1. Note that the New York and Connecticut statutes decline to assert bright-line nexus with respect to a non-U.S. corporation that doesn't have effective connected income (i.e., an otherwise taxable presence somewhere in the U.S.). Also, New York City hasn't adopted the bright-line economic nexus rules introduced by New York State (except for certain credit card issuers). See N.Y.C. Admin. Code Section 11-653.

Foreign corporations may find themselves having to pay state or local income taxes well before they have any federal income tax liability.

The bottom line is that foreign corporations, particularly those from treaty countries, often face a lower threshold for tax jurisdiction at the state level than at the federal level and thus may find themselves having to pay state or local income taxes well before they have any federal income tax liability.[14] As discussed in the next section, this increases the importance of inserting a corporate layer between the foreign parent company and its U.S. operations.

Double Holding Company Structure: An Illustration

A foreign corporation may be able to reduce its overall exposure to the U.S. tax system without compromising its eligibility for treaty exemptions on its U.S. business profits through the use of a double holding company structure. The following example illustrates how this arrangement might work with a foreign corporation that won't have a significant physical presence in the U.S.

Assumed Facts

A Country X corporation eligible for benefits under a treaty based on the Model Treaty (''Parent'') is about to enter the U.S. market. Parent and its affiliates are engaged primarily in online sales of goods and services. During the early stages, neither Parent nor any of its affiliates will have employees, office space or other significant physical assets in the U.S. (other than perhaps storage space it rents to hold inventory). The business will operate as needed through independent contractors, none of whom will have authority to enter into contracts on behalf of Parent or its subsidiaries other than for ancillary matters.

The first and most critical step is to create a Country X corporate subsidiary of Parent (''Foreign Holdco''), which will serve as a designated holding company for Parent's U.S. operations. Foreign Holdco would then set up a wholly owned limited liability company (LLC), typically in Delaware, through which it would operate in the U.S.[15] No entity classification election would be made, so the LLC would be a ''disregarded entity'' or branch of Foreign Holdco for most federal (and state) tax purposes.[16]

Purpose of Foreign Holdco

Foreign Holdco serves as a foreign ''blocker,'' putting an extra corporate layer between Parent's foreign operations and the U.S. tax system while still preserving eligibility for treaty benefits.

As a wholly owned subsidiary incorporated in the same country as Parent, Foreign Holdco would be eligible for the same exemptions as Parent under the limitation-on-benefit provisions of most modern tax treaties. Thus, if Foreign Holdco had effectively connected income from the LLC's operations in the U.S., such income wouldn't be subject to federal income taxes as long as Foreign Holdco's U.S. presence through the LLC didn't rise to the level of a permanent establishment.[17] Because the LLC would be a disregarded entity in the absence of an election, Foreign Holdco would remain the relevant taxpayer.

Foreign Holdco also serves an important state tax function. As discussed earlier, income tax treaties generally don't cover state and local taxes, so a foreign corporation could be subject to income taxes (or included on an affiliate's return) in one or more U.S. states regardless of whether its business profits are exempt from income taxes at the federal level—even without a significant physical presence. The best way for Parent to reduce its state tax exposure is to set up its U.S. operations through a corporate subsidiary (Foreign Holdco) from the outset. Foreign Holdco may need to file state or local tax returns, but could help to insulate Parent while preserving the group's overall eligibility for treaty exemptions at the federal level.

Purpose of LLC

Operating through one or more wholly owned (and disregarded) LLCs allows Foreign Holdco to potentially limit its general corporate liability without prematurely

[14] A foreign corporation could be subject to state income taxes before it is subject to federal income taxes even in the absence of a treaty. For example, a state may assert tax nexus with a foreign corporation based on contacts with the state (or even sales beyond a certain threshold) that may not be sufficient for it to be considered to be engaged in a U.S. trade or business for federal income tax purposes.

[15] More than one LLC might be used for liability purposes.

[16] Treasury Regulations Sections 301.7701-2(c)(2)(i), -3(b). Note that single-member LLCs are still treated as separate entities for payroll and certain federal excise tax purposes. Treas. Reg. Section 301.7701-2(c)(2)(v). Additionally, some states still impose certain entity-level taxes on single-member LLCs, although most follow the federal entity classification for income tax purposes.

[17] Proposed paragraph 7 of Article 1 of the updated Model Treaty would deny treaty exemptions and other benefits in certain situations where an enterprise of one treaty state derives income from the other treaty state that is attributable to a permanent establishment outside of its own country of residence. The provision would apply when either (1) the profits of the permanent establishment are subject to a combined effective tax rate that is less than 60 percent of the general rate of company tax in the enterprise's country of residence, or (2) the country of residence doesn't tax the income attributable to the permanent establishment and the permanent establishment is situated in a third country that doesn't have a comprehensive income tax treaty in force with the source country. This provision is purportedly designed to prevent opportunities for ''stateless income'' that isn't taxed in either country—for example, the source country exempts the business profits of a foreign enterprise from income tax because it doesn't have a permanent establishment in the source country, but the country of residence exempts the same profits because they are attributable, under its tax laws, to a permanent establishment located in a third country. As currently drafted, it potentially could reach arrangements where the income is fully taxed in a third country. That said, where Foreign Holdco has a permanent establishment in its country of residence to which the income is attributed and remains taxable on that income at comparable rates in its country of residence, this provision shouldn't have any bearing on applicable treaty exemptions.

  DTR ISSN 0092-6884

forgoing treaty benefits.[18] Further, the LLC gives Foreign Holdco the option of switching from a branch to a corporate subsidiary structure in the U.S. without a full corporate restructuring if and when Foreign Holdco ceases to be eligible for treaty benefits.

For example, as the LLC begins to retain local staff and establish a physical presence in the U.S., its activities may reach a tipping point at which Foreign Holdco would be considered to have a permanent establishment in the U.S. and would be subject to federal income taxes on the business profits attributable to that permanent establishment. Foreign Holdco could convert its LLC ''branch'' into a corporate subsidiary for income tax purposes up to 75 days retroactively by filing IRS Form 8832, Entity Classification Election.[19]

Following the election, the LLC would be taxed as a corporation on the same income.[20] There wouldn't necessarily be any change in aggregate tax burden if all of Foreign Holdco's income is from the U.S. business, as many treaties align withholding rates (and exemptions, where applicable) for taxes on dividends and branch profits.

Alternatively, Foreign Holdco could simply continue to operate through disregarded entities and file returns directly.

Key Takeaways

Regardless of the structure chosen, a foreign corporation establishing a U.S. presence must carefully weigh the federal, state, local and foreign tax impact of its operations (including sales and payroll taxes) against other business concerns. Following are some key takeaways:

■ **Importance of Foreign Holdco.** Perhaps the most critical step for a foreign business is to set up a Foreign Holdco. Even if there is no applicable treaty (or the company's physical presence in the U.S. will create a permanent establishment whose profits would be taxable under a treaty), a Foreign Holdco can help to insulate the ultimate parent from U.S. federal and state tax exposure.

■ **Impact of Treaty and Use of LLC.** Operating through a disregarded entity while claiming treaty benefits could mean the difference between a 35 percent corporate tax rate on current income and an outright exemption at the federal level. This will be particularly meaningful if the foreign corporation anticipates generating significant operating income during the interim period before it has a sufficient presence on the ground to create a permanent establishment.[21]

■ **State and Local Taxes.** Tax treaties generally offer no protection from state and local taxes. This increases the importance of setting up Foreign Holdco to act as a ''blocker'' for the ultimate parent early in the process.

■ **Siloing Assets.** Consideration might be given to holding certain assets that could otherwise create a taxable presence in a separate corporation in order to avoid imputation to the rest of the business and possibly delay the creation of a permanent establishment in the U.S. This also could help to prevent Foreign Holdco from creating tax nexus with some U.S. states.

■ **Potential Treaty Planning With Debt.** Even after checking the box on the LLC and forgoing the treaty exemption on business profits, Foreign Holdco or Parent could capitalize the (now corporate) subsidiary with debt and possibly claim a treaty exemption on the interest.[22] Subject to deduction limitations under I.R.C. Section 163(j) and other provisions, this also could reduce the subsidiary's taxable income in the U.S.[23]

■ **Other Tax Considerations.** A foreign company establishing a U.S. presence will have other tax and regulatory obligations to consider, such as sales tax and payroll registration. There also will be information returns and other reports to file with various agencies, including the Internal Revenue Service, the U.S. Treasury Department and the U.S. Department of Commerce.[24]

■ **Evolving Strategy.** A company's federal, state, local and foreign tax exposure may change significantly over time, so it is important to periodically reassess earlier planning. A tax structure that works in the early stages of a business likely will need to be adjusted as business needs evolve.

---

[18] It also may be easier in other respects (for example, opening a bank account) to operate through a ''recognized'' domestic entity.

[19] This assumes no prior entity classification election was made.

[20] Because disregarded entities are still ''regarded'' as separate entities for payroll tax purposes under Treas. Reg. Section 301.7701-2(c)(2)(v), the change in classification wouldn't result in a change in employer for payroll tax purposes.

[21] If the U.S. business isn't expected to generate current income and the plan is to ultimately sell it at a gain, the foreign parent might simply operate through a domestic corporation from the get-go, particularly if it anticipates selling the operations to a foreign buyer, as the sale of a domestic corporation by its foreign parent generally isn't subject to income taxes in the U.S. (assuming the subsidiary doesn't hold significant U.S. real property or mineral resources).

[22] The foreign parent likely wouldn't be eligible for the ''portfolio interest'' exemption in I.R.C. Section 881(c)(2) on account of its ownership of the U.S. subsidiary/debtor. See I.R.C. Section 881(c)(3).

[23] Note that proposed amendments to Articles 3, 11, 12 and 21 of the Model Treaty would deny treaty benefits for payments of interest, royalties and certain other types of ''mobile'' income if such items are subject to preferential tax treatment in the other state. For example, a taxpayer in one state may not be eligible for the treaty exemption on royalties from the other state if its own state of residence exempts royalties from income or taxes them at a substantially lower rate than other types of income. There are a number of exceptions (including where certain ''substantial activities'' requirements are satisfied).

[24] The U.S. Department of Commerce requires filings for certain foreign direct investments in the U.S. and U.S. direct investments abroad. See U.S. Department of Commerce, Bureau of Economic Analysis, ''A Guide to BEA's Direct Investment Surveys,'' available at http://www.bea.gov/surveys/fdiusurv.htm.