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Ask U$

ADVICE, STRATEGY AND KNOW-HOW ON DOING BUSINESS IN THE U.S.

TAX AND FINANCIAL CONSIDERATIONS ON DOING BUSINESS IN THE U.S.

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Ask U$ is an information suite broken out into a series of easy to read Guides that address the key areas you need to consider when doing business in the world's most powerful market. Each individual guide has been written by professionals in their field who have provided advice and insight on the most crucial elements you need to keep in mind to create a compliant, effective and successful presence in the U.S.. In addition to this Guide, there are five other guides in the series that cover:

- Marketing in the U.S.
- Establishing Your Business
- Immigration
- People, Patents and Partners
- Public Relations

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Tax and Financial Considerations on Doing Business in the U.S.

By Kevin McLoughlin, Joe Bollard and Dave Barry of Ernst & Young

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INTRODUCTION

Relative to Ireland, the U.S. has one of the most complex tax systems in the world, with many taxes applicable at the federal, state, local county and municipal level, which combined will typically equate to a tax burden in excess of 40%.

There are no uniform rules on the definition of taxable income or indeed the apportionment of income among the various tax jurisdictions, with a firm's tax burden dependent on the states, counties, municipalities, etc. in which it operates and earns taxable income. As a consequence, the advice of a tax accountant or attorney is practically indispensable to any newcomer doing business in the U.S..

This guide highlights the key tax issues facing an Irish company expanding into the U.S. with a view to providing a broad overview of the factors that should be considered in an attempt to minimize the tax burden in the U.S..

The issues addressed in this guide have been captured under the following headings:

- Objectives in Tax Planning
- Setting Up Operations in the U.S. – The Alternatives
- Transfer Pricing
- Key Risk Areas
- U.S. Domestic Tax – A Snapshot

OBJECTIVES IN TAX PLANNING

Irish companies are ideally placed to pursue a tax strategy that facilitates a long-term group effective tax rate on U.S. source profits of below 20%.

The strategy should involve capitalizing on the opportunities offered by the Irish tax regime (including 0%, 10%, 12% and 25% tax rates) and minimizing the group's tax burden in the relatively high-tax U.S. jurisdiction where the combined state and federal tax rate can exceed 40%.

The ability to earn profits for tax purposes in Ireland is restricted by transfer pricing regulations under U.S. law. This topic is addressed in more detail later, but in essence, transactions between associated persons must occur at arms length prices. Therefore, in a situation where a company's business model necessitates the establishment of a subsidiary in the U.S.[1], that subsidiary must earn a profit commensurate with its functions and the economic risks it undertakes.

To achieve the desired objective of maximizing the group's profits subject to tax in Ireland it will be necessary to maximize the risk/reward ratio in favor of the Irish parent company. This may involve the Irish-based entity funding all R & D efforts and holding all intellectual property (including that obtained through acquisitions) in an IP intensive industry. Similarly, the majority of economic risks (inventory, foreign exchange, receivables, warranty etc.) associated with a distribution activity in the U.S. would also need to be assumed by its Irish parent.

In such a structure, the U.S. entity would assume minimal risks and as a consequence, in line with arms length principles, the profits it should earn in respect of its functions will be relatively low, reflecting that reduced risk.

Therefore, when planning its expansion into the U.S. market, a company should seek to develop a tax strategy with the following characteristics:

a) minimize the global effective tax rate, thereby maximizing earnings-per-share and contributing to shareholder value on a sustained basis;

b) offer the opportunity of competitive advantage in terms of pricing based on returns computed on an after-tax basis;

c) where possible, defer the cash-flow burden associated with tax expense in a manner consistent with a) above;

d) seek to structure acquisitions in a manner which fits or can be integrated into an existing structure in order to minimize the resulting transactional tax costs;

e) an acceptable level of operational and financial statement risk;

f) maintain flexibility while sustaining long-term planning;

g) ease of administration and management.

It is crucial to remember that as a business evolves, so too will the group's optimal tax structure and thus the group will need to manage its tax structure on an ongoing basis.

The strategy should involve capitalizing on the opportunities offered by the Irish tax regime (including 0%, 10%, 12% and 25% tax rates) and minimizing the group's tax burden in the relatively high-tax U.S. jurisdiction where the combined state and federal tax rate can exceed 40%.

SETTING UP OPERATIONS IN THE U.S. – THE ALTERNATIVES

There are a number of ways an Irish company expanding into the U.S. can structure it activities, with the best fit for any given company dependent on the stage of development it is at and the anticipated level of U.S. presence required.

The preferred option for any given company will depend on its particular business model and it is important to choose a structure that is compatible with the way the group anticipates conducting its business in the U.S.. The key point to remember here is to do nothing purely for tax reasons but, nevertheless, a company should not do anything commercially without first considering the tax consequences of its actions.

The optimal structure and related contractual arrangements will differ depending on whether the company anticipates selling products or providing services in the U.S., the seniority of the people it will have in the U.S., and the dependency of any U.S. subsidiary on its parent.

Following is a summary of some of the common structures used by companies when expanding overseas,

[1]In the early stages of a company's expansion the most appropriate structure for its activities may not in fact necessitate the establishment of a subsidiary. This topic is discussed further in the next section.

together with an explanation as to when a particular structure may be suitable. The list is far from exhaustive but should convey an idea of the type of issues that need to be considered when deciding how best to structure a proposed expansion into the U.S. marketplace.

(1) A Representative Office

A representative office is the easiest way for a company commencing activities in the U.S. and does not require the incorporation of a separate legal entity.

It is permissible to establish a representative office in the U.S. without triggering a corporate income tax presence for the Irish head parent so long as the activities that the U.S. office provides are limited in nature.

Examples of the services which it could provide to the Irish parent include advertising and promotional activities, market research, the purchase of goods, and the storage of goods on behalf of the head office.

It is crucial to remember that as a business evolves, so too will the group's optimal tax structure and thus the group will need to manage its tax structure on an ongoing basis.

A representative office is most appropriate in the very early stages of a company's expansion, with the possibility of transitioning to a branch or subsidiary structure as and when the activities conducted in the U.S. escalate.

A periodic review of its continued suitability as a vehicle for a company's U.S. activities is crucial to ensure that a company does not inadvertently trigger a taxable presence in the U.S. by virtue of the representative office's activities exceeding the ancillary nature of the permissible services.

(2) A Branch Structure

A branch structure is similar in nature to a representative office in that it does not necessitate the incorporation of a separate legal entity.

The benefit of having a branch rather than a representative office is that the range of activities that can be performed in the U.S. by the branch are greatly increased. The branch will however, due to the increased level of activities, represent a taxable presence for the Irish company in the U.S. and give rise to a requirement to register and account for U.S. corporate income tax on the branch's profits.

A branch structure is probably most suited to situations where it is anticipated that the branch will occur losses in the near term with the opportunity for the U.S. branch's trading losses to be set against the Irish head office's trading profits.

In the converse situation, where the branch is profitable, the Irish company will get a credit in respect of any corporate income tax paid in the U.S. on the profits of the branch which will also be subject to tax in Ireland. However, owing to the differential in tax rates, it is unlikely that any incremental tax would be due on that income in Ireland.

Caution needs to be exercised if a company is considering using a branch structure, as it has the potential to expose a disproportionate share of a company's profits to the higher U.S. tax rate. There is also a risk that intellectual property/marketing intangibles may build up in the U.S. over a period of time. This may give rise to larger U.S. tax liabilities in the longer term if the group is successful in the U.S. marketplace, than might otherwise have arisen.

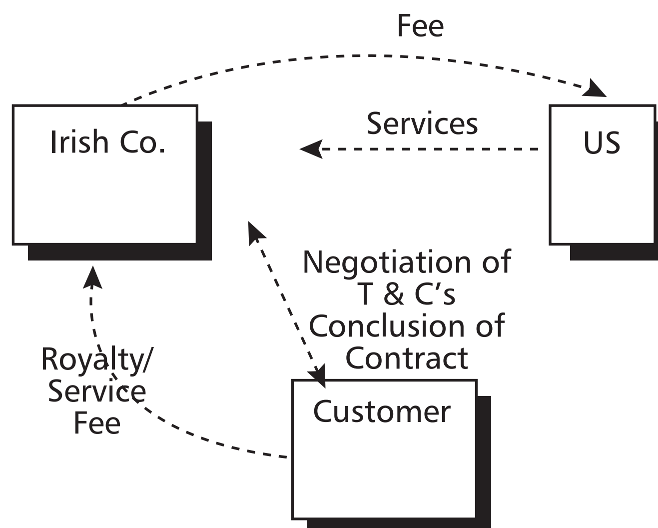
(3) U.S. Subsidiary acts as a Service Provider

In a situation where a company wins a substantial contract, perhaps for the provision of both products and services, and the terms of the contract are such that at least some of the services it is obligated to provide under the contract must be provided in the U.S. over a protracted period, the incorporation of a special purpose subsidiary may be the best option. Using a subsidiary to perform the services that must be delivered in the U.S. can ensure that the majority of the profits on the contract are subject to the low Irish corporate tax rate as distinct from the significantly higher combined U.S. federal and state tax rates.

It is important to have the Irish parent enter into the contract with the U.S. customer, conduct all negotiations in Ireland, execute the contract in Ireland and have the Irish parent manage performance of the contract. Structuring the contractual arrangements in this manner will ensure that the gross contract revenues accrue to the Irish parent.

The U.S. subsidiary would be incorporated solely to employ the individuals who will deliver the services on the ground, with the employees in question often being seconded from the Irish parent in the initial stages of the contract. The Irish parent will then conclude a formal service agreement with its U.S. subsidiary for the provision of services, effectively on a sub-contract basis. The U.S. firm would typically be remunerated on a cost plus basis[2] in respect of the services rendered to the Irish parent.

Such a structure, in addition to ensuring that the majority of the profits on a contract properly accrue to the Irish parent company as the contracting entity, is very easy to administer. It also provides a U.S. base from which to conduct future marketing and lead generation activities.



[2]Essentially the costs the U.S. company incurs in delivering the services plus a small profit margin expressed as a percentage of those cost.

(4) U.S. Subsidiary acts as a Commission Agent

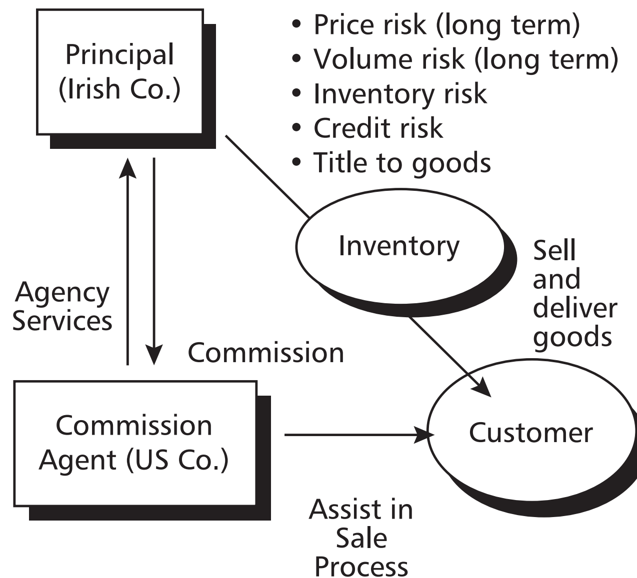
Where a company wishes to establish a sales and marketing presence in the U.S., consideration could be given to using a commission agent structure.

In this scenario, a U.S. subsidiary is incorporated to employ the US based sales and marketing team. This subsidiary will then be contracted to generate sales for the Irish parent company[3].

It is important to ensure that the commission agent neither concludes contracts nor takes title to goods. It merely presents customers with the products and prices offered by the Irish parent company.

Limiting the activities of the U.S. subsidiary in this manner is the key to limiting the level of profits that will be subject to corporate income tax in the U.S..

It is important that only the Irish company can actually accept orders from and conclude contracts with the customer. Furthermore, it will be necessary for the group to be able to provide clear evidence that these functions take place in Ireland.

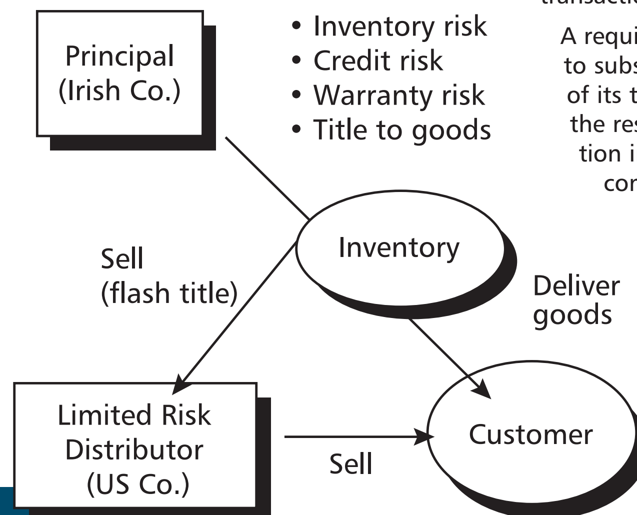


(5) U.S. Subsidiary acts as a Limited Risk Distributor

Where for operational reasons, or owing to the seniority of the sales executives situated in the U.S., it is necessary for contracts to be entered into by the U.S. subsidiary, consideration should be given to structuring the inter-company contract in a manner that leaves most of the risk (and therefore reward) with the Irish parent company.

The U.S. distribution subsidiary will earn a lower profit than a full risk distributor because of its reduced risks and functions.

The Limited Risk Distributor (LRD) will buy product from the Irish parent and resell it to customers, but under contractual terms that leave most of the risk and therefore reward with the Irish parent.



TRANSFER PRICING

A key tax risk for an Irish company transacting with an affiliated U.S. company arises in relation to exposure to challenge by the Internal Revenue Service ("IRS") on the profits earned by its U.S. subsidiary, or that the Irish company itself has a liability to U.S. taxes.

These risks can be mitigated through concluding intra-group agreements that support the transfer pricing methodology pursued in the U.S.. These intra-group pricing arrangements should be underpinned by a transfer pricing study which satisfies the contemporaneous documentation requirements of the U.S. transfer pricing regulations.

Following is an overview of the relevant regulations, related penalties and documentation requirements:

Overview of Regulations

The U.S. rules concerning transfer pricing, which govern transactions between related companies, are guided largely by the Internal Revenue Code and Treasury Regulations. The Treasury Regulations are designed to prevent avoidance of U.S. tax by shifting taxable income from the U.S. to a foreign jurisdiction and to give the IRS broad authority to allocate income or deductions between related entities if it determines such allocation is necessary to prevent evasion of taxes or to reflect the income of such related entities.

The Regulations establish the "Arm's Length Standard," i.e. the prices charged by one affiliate to another in inter-company transactions involving the transfer of goods, services or intangibles yield results that are consistent with the results that would have been realized if unaffiliated third parties had engaged in the same transaction under the same circumstances.

A requirement is placed on the taxpayer to substantiate the appropriateness of its transfer pricing, i.e. to compare the results of the related party transaction in question to the results of comparable transactions between unaffiliated third parties under comparable circumstances. Furthermore, the taxpayer's transfer pricing methodology should be reasonable in light of the facts and circumstances and should produce the most reliable measure of an arm's length result.

To avoid the imposition of penalties that might otherwise apply, the taxpayer must have contemporaneous documentation that supports the reasonableness of its transfer prices, and these documents must be readily available to the IRS.

[3] The function of actively generating sales leads could not be performed by a representative office. The marketing activities permitted to be conducted through a representative office are more limited and ancillary in nature.

Potential Penalties

The penalties which may apply where a company fails to substantiate the appropriateness of its inter-company transfer pricing are as follows:

20% penalty for substantial valuation misstatements:

- The claimed transfer price is more than 200% or less than 50% of the arm's length amount;
- The net Section 482 adjustment exceeds the lesser of $5 million or 10% of gross receipts.

40% penalty for gross valuation misstatements:

- The claimed transfer price is more than 400% or less than 25% of the arm's length amount;
- The net Section 482 adjustment exceeds the lesser of $20 million or 20% of gross receipts.

Penalty Provisions – Reasonable Cause Exception

As outlined above, to avoid the imposition of penalties that might otherwise apply, the taxpayer must be able to illustrate that they:

- selected and applied the most accurate arm's length measurement method under the principles of the best method rule;
- prepared documentation which establishes that the taxpayer reasonably concluded that the best method was selected;
- provided the documentation within 30 days of an IRS request to do so.

10 Principal Transfer Pricing Documents Required

1. An overview of the taxpayer's business, including an analysis of economic and legal factors that affect the pricing of property or services;
2. A description of the taxpayer's organizational structure (including organizational charts) covering all related parties engaged in transactions potentially relevant under Section 482 of the Code;
3. Any document explicitly required by the regulations under Section 482;
4. A description of the method selected and the reason why the method was selected;
5. A description of the alternative methods considered and rejected and an explanation for such rejections;
6. A description of the controlled transactions and internal data used to analyze them;
7. A description of the comparables used, how comparability was evaluated, and what adjustments were made;
8. An explanation of the economic analysis and projections relied on;
9. A description of any relevant transfer pricing data obtained after the tax year end and before filing a tax return;
10. A general index of the principal and background documents, and a description of the taxpayer's record keeping system.

KEY RISK AREAS

As discussed, with careful planning a company can maximize its structural and contractual relationships so as to minimize the tax burden of expanding into a foreign market.

However, where most companies err is not so much at the planning stage, but rather in the ongoing implementation of their selected tax strategy.

Having incorporated a U.S. subsidiary to avoid the Irish parent company running the risk of having a tax presence in the U.S., it is crucial that the independent nature of the separate legal entities is respected. It is equally important to ensure that the activities carried out in the U.S. and Ireland are in accordance with the tax strategy and can be documented as taking place in Ireland or the U.S. as appropriate. Failure to do so can result in either the Irish parent being regarded as having a U.S. tax presence or the profits attributable to the U.S. subsidiary under U.S. transfer pricing regulations being substantially more than necessary.

Some of the key operational "do's and don'ts" are as follows:

- All commercial and operational decisions should be taken by Irish based employees of the Irish parent to show that full control and management authority are exercised in Ireland;
- All customer contracts should be negotiated and executed in Ireland by Irish based employees of the Irish parent.
- Irish company employees who stay abroad beyond one month (cumulative per calendar year) should be formally assigned to the foreign subsidiary for the duration of their stay;
- Employees of the Irish parent that are based abroad should not have the authority to execute contracts;
- Foreign employees should not have the authority to negotiate or execute contracts on behalf of the Irish parent;
- A clear audit trail should be available in the event of an audit from the Internal Revenue Service;
- The board of directors of the Irish parent should consist of a majority of Irish resident directors;
- All board meetings should be held in Ireland. All strategic decisions should be considered and executed at the board meetings. All documentation relating to board meetings should be prepared in Ireland;
- Foreign input should be documented and presented to Irish management for decision and/or agreed action;
- Communication of all issues resolved and/or action items agreed should be made from Ireland;
- Final approval and/or release should be clearly shown to have issued from Irish based management of the Irish parent;
- No work relating to the drafting, finalization or amendment to customer contracts should be done outside Ireland or by non Irish based employees of the Irish parent;
- Foreign based employees must not agree to terms and conditions which have not been agreed in advance through written communication by Irish management.

U.S. DOMESTIC TAX – A SNAPSHOT

The U.S. tax jurisdiction is divided among the federal government, the fifty states and the local counties and municipalities. This has resulted in a maze of taxes in the form of franchise, license, stamp, estate, property and other taxes.

A snapshot of the primary taxes is provided under the following categories:

1. Federal Corporate Income Tax;
2. State and Local Income Taxes;
3. Sales and Use Taxes; and
4. Payroll Registration and Personal Taxes.

(1) U.S. Federal Corporate Income Tax

The U.S. has a graduated system of corporation tax. Corporations pay 15% on the first U.S.$50,000 of taxable income, rising in a series of graduated steps to approximately 33% for income in excess of U.S.$335,000 and reaching 35% for amounts over U.S.$18.3m.

These rates apply to both the worldwide income of U.S. corporations and to the income of foreign corporations that are effectively connected with a U.S. trade or business.

Where most companies err is not so much at the planning stage, but rather in the ongoing implementation of their selected tax strategy.

In addition, corporations are subject to a 20% Alternative Minimum Tax (AMT) on AMT income if this amount exceeds the regular tax on regular income. AMT income is computed by making adjustments to regular taxable income, which consists of adding back all or a portion of certain adjustments that are otherwise allowable in computing regular income taxes.

(2) State and Local Income Taxes

Comparisons of tax rates levied by states are not entirely meaningful because the definition of taxable income varies by state. Furthermore, there are no uniform rules on the apportionment of income among the various jurisdictions. Consequently, the advice of a tax accountant or attorney is indispensable to any corporation operating in multiple states to avoid risking over taxation, since some items of income are likely to be taxed more than once!

States have the right to impose income tax on a corporation operating in multiple states only if that corporation establishes sufficient presence ("nexus") in that particular state. Soliciting the sales of services or storage of inventory in a state will often create taxable nexus. However, for state income tax purposes only, a federal statute provides that the solicitation of sales of tangible personal property will not cause nexus to exist.

SUMMARY OF MAIN STATE AND LOCAL TAXES AND RANGE OF THE APPLICABLE RATES:

TAX CATEGORY	APPROXIMATE RATE RANGE	TYPICAL TAX BASE
INCOME	0% to 12+%* *Higher with some local income taxes, e.g. New York*	U.S. federal taxable income with adjustment
FRANCHISE	0% to 1.275%	Capital plus surplus (debt in some states)
SALES AND USE	0% to 11%	Purchase price of taxable item or service
PROPERTY	1% to 7%	Total fair market value of property
PAYROLL AND UNEMPLOYMENT	0% to 10%	Specified portion of compensation paid

(3) Sales and Use Taxes

There are no federal sales or value-added tax in the U.S.. However, most states and many municipalities levy sales taxes. Combined rates, including local rates, can range as high as 11% (Alabama).

These sales taxes are almost always assessed on the final consumer purchase, with wholesale transactions remaining tax exempt.

As a general rule, all sales of tangible personal property occurring within the state's borders are subject to sales tax unless specifically exempted by statute.

All sales of services and intangible property (e.g. software) are not subject to sales tax unless specifically provided by statute.

"Use" taxes are a tax on the use, storage, or consumption of tangible personal property within a state's borders and are effectively a complement to sales tax.

It is permissible to establish a representative office in the U.S. without triggering a corporate income tax presence for the Irish head parent so long as the activities that U.S. office provides are limited in nature.

It is the responsibility of the seller to collect and remit sales tax with the cost passed to the consumer. However, if a state cannot force the seller to collect (i.e no nexus over the seller) it can force the purchaser to pay upon discovery during audit.

(4) Payroll Registration and Personal Taxes

The tax burden on individuals is low in the United States compared with other industrialized nations.

Irish individuals seconded to a U.S. company will be subject to U.S. income tax and the U.S. company will be required to comply with payroll reporting for these individuals. The individuals will be required to request a U.S. social security number and complete IRS Form W-4 for employer withholding.

The U.S. company should ensure that all new employees, both secondees and local hires have social security numbers and complete the Form W-4.

The U.S. company should ensure that all new employees, both secondees and local hires, have social security numbers and complete the Form W-4.

Where an Irish company has individuals in the U.S. on short term projects and these individuals remain on the Irish payroll, they will be exempt from U.S. taxation under the treaty. Although the treaty provides protection for these individuals from taxation for a presence of up to 183 days, the Irish entity runs exposure to U.S. taxation by having its employees present in the U.S. There is a trade off between the administrative burden of seconding employees and their liability for U.S. tax on one hand and the exposure of the Irish company to U.S. taxation on the other. Best practice would dictate that employees whose stay in the U.S. is expected to extend beyond one month (cumulative per calendar year) be seconded to the U.S. subsidiary.

Summary of the primary employer payroll tax responsibilities;

a) Employer's Duty to Withhold Taxes: Employers are required to provide to each employee an IRS Form W-4. Once completed by each employee, the employer can withhold income taxes from the employee's wages at the applicable rate. If an employee does not provide this Form to the employer, the employer must withhold at a statutorily provided rate.

b) Social Security Taxes: A combined tax rate of 15.3%, (7.65% each), is imposed on both the employer and employee. The rate consists of a 6.2% component for old age, survivors, and disability insurance (OASDI) and a 1.45% component for Medicare. The OASDI rate applies to net earnings within the OASDI earnings base which is U.S.$90,000 for 2005. The Medicare rate applies to all net earnings since there is no limit on the amount of earnings subject to the Medicare portion of the tax.

c) Unemployment Compensation: A tax rate of 6.2% is imposed on the first U.S.$7,000 of wages paid to a "covered employee" by an employer who employs one or more persons in covered employment in each of 20 days in a year, each day being in a different week, or who has payroll for covered employment of at least U.S.$1,500 in a calendar quarter in the current or preceding calendar year. Because employers are allowed credits against the 6.2% rate through participation in state unemployment insurance laws, the net rate actually paid by most employers is 0.8% except when credit reductions are in effect in a state. The unemployment tax also applies to any person who paid total cash wages of $1,000 or more to a household employee during any calendar quarter in the current or preceding calendar year.

CONCLUSION

The issues that need to be considered from a corporate tax perspective when a company is planning its expansion into the U.S. marketplace can be quite complex depending on a company's particular circumstances.

Accordingly, the need to obtain timely advice when considering an expansion into the U.S. marketplace cannot be overemphasized. Key issues to be bear in mind are:

- Plan early to avoid costly mistakes;
- The business model should always drive the tax planning;
- As the business evolves, so too will the optimal tax structure;
- Inter-group group pricing arrangements need to be properly documented to avoid exposure to an IRS challenge on the level of profits subject to U.S. tax;
- The ongoing management of the evolving structure is crucial to ensure that the objectives of a given strategy are realized.

NOTES:

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