
by Leonard Schneidman

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Synopsis
This article written by Leonard Schneidman, a Managing Director of WTAS LLC, outlines the key tax issues relating to the organization, operation, repatriation of profits and exit of a French-owned U.S. business. The article describes the three organizational forms, (subsidiary, branch and partnership), highlighting their pros and cons. It further describes the considerations involved in deciding whether to capitalize the venture with debt or equity financing. And it discusses the tax issues involved in staffing the U.S. business with either U.S. or French nationals. Finally, it considers the various means to repatriate the profits of the U.S. business as well as exit the investment.
This article outlines some of the key U.S. tax issues that should be considered in establishing a French-owned U.S. business enterprise. As can be seen from “Tax Checklist for Foreign-Owned U.S. Operations” (Exhibit A, at the end of this article), the issues range from organizational and operational structure to the repatriation of earnings and exit strategies. Note that the tax issues increase in importance as the enterprise advances through the typical life cycle of a foreign-owned operation (Exhibit B).

The article focuses on the organizational and operational U.S. tax questions to be considered by a hypothetical French-owned enterprise that intends to conduct business activities in the United States. The critical tax issues relate to the U.S. taxation of the enterprise, its shareholders, and its employees, although at times, these considerations may be unrelated. Two case studies — one on sale and distribution into the United States and the other on manufacturing in the United States — are provided in Exhibit C.

I. Form of Organization

There are several ways in which a foreign company can operate a business in the United States. The exact legal form the U.S. operation will take often depends on the nature of the business and scale of the intended operation.

The possible choices for the organizational form of the U.S. operation include:

- subsidiary;
- branch; or
- partnership or limited liability company.

A. Subsidiary

The formation of a U.S. corporate subsidiary is generally not a taxable event. However, the subsidiary would have to pay U.S. federal and state taxes on its taxable income. Dividends paid to the French enterprise by the wholly owned subsidiary are subject to a withholding tax rate that under the treaty is limited to 15%.

This article assumes that the French enterprise is a company, treated for U.S. tax purposes as a corporation, that invests directly in the United States and is a resident of France that satisfies the limitation on benefits article of the France-U.S. income tax treaty. Therefore, the French company is eligible for the benefits available under the treaty.
either 0 percent or 5 percent. The tax rate on dividend income is reduced to 5 percent if the beneficial owner is a company that owns at least 10 percent of the voting stock of the dividend payer.

To the extent that the French company owns 80 percent or more of the voting power of the U.S. corporation for a 12-month period and meets specified conditions in the LOB article, the rate is reduced to zero. Dividends paid by the U.S. subsidiary to its French parent are nondeductible for U.S. corporate income tax purposes.

By operating through a separately incorporated U.S. subsidiary, the foreign parent generally avoids any engagement in U.S. business, if the U.S. subsidiary does not act as an agent for the foreign parent. Generally, the mere fact that a parent company owns a U.S. subsidiary does not in itself create a permanent establishment of the parent. It is crucial, however, to avoid any attribution of the subsidiary’s activities— for example, as an agent—to its parent.

Thus, for example, if the U.S. subsidiary is acting as a commission agent for the sale of its French parent’s goods, it is important that the subsidiary, which will likely be considered a dependent agent, not have the ability to contractually bind the French parent. Transactions between the foreign parent and its U.S. subsidiary are generally governed by the arm’s-length standard imposed by section 482. Section 482 prevents companies from abusively shifting income by giving the IRS the authority to reallocate income and deductions among commonly controlled companies if it determines that this action is necessary to preclude evasion of taxes or clearly reflect income.

B. Branch

U.S. branches are easy to establish and administer and are simply an extension of the non-U.S. company’s home office. When the French company operates through a branch, the company is taxable in the United States on the income effectively connected with its U.S. trade or business. Under the treaty, only those profits attributable to a PE of the French company are taxable business profits in the United States.

A critical tax question thus becomes determining the amount of income that is properly attributable to the branch under the treaty. This amount is taxable at rates applicable to U.S. corporations— currently, a maximum of 35 percent for federal tax purposes. Most states in the United States also impose tax on the income of a corporation that has some form of activity within that state.

In addition to subjecting the non-U.S. company to regular corporate income tax, operating the U.S. business through a branch triggers the possible application of a branch profits tax. The branch profits tax essentially replicates the 30 percent withholding tax on dividends payable by a U.S. subsidiary to its foreign parent company. The tax base for the branch profits tax generally includes after-tax earnings and profits that are effectively connected with the French corporation’s U.S. trade or business (effectively connected earnings and profits, or ECEP) to the extent that those ECEP are not reinvested in the U.S. trade or business by the close of the tax year or are sent home in a later tax year.

Tax treaties may limit the effect of the branch profits tax, more or less in the same way they limit withholding taxes on dividends or interest from a domestic subsidiary. Thus, the reduction in tax applicable to dividend income provided for in article 10 of the France-U.S. treaty would be applicable to the branch profits tax imposed on a French operation as long as the corporation meets the LOB test in article 30 of the treaty. Therefore, the French company operating through a branch in the United States may be subject to a 5 percent branch profits tax in addition to the regular corporate tax if it fails to meet the requirements for the zero rate.

C. Partnership or LLC

Operating through a partnership— either domestic or foreign— or an LLC, which is generally taxed as a partnership, the French company engages its partners in the U.S. trade or business conducted by the partnership or LLC. Thus, while the partnership or LLC is not subject to tax, the foreign partner or LLC member is taxable on its allocable share of the partnership’s or LLC’s effectively connected income. Also, if the foreign partner is a corporation, the activities of the partnership constitute a branch of the foreign corporation, triggering the application of the branch profits tax, as described previously. The failure of the foreign partner or member to timely file a U.S. tax return will lead to the loss of otherwise available tax deductions, producing, in effect, a tax on gross receipts.

II. Capitalization

Another choice to be made by the French company is whether to capitalize the U.S. venture with debt,
equity, or a combination of the two. From a U.S. tax standpoint, it is generally better to fund U.S. direct investment through debt rather than equity. But there are important limitations on and exceptions to this proposition, and effective tax planning requires careful study and periodic review.

There are three main tax reasons to capitalize the U.S. operation with debt rather than equity:

- interest payments are deductible by the U.S. payer whereas dividend payments are not;
- debt principal can be repaid tax free, whereas a partial repayment of an equity investment may give rise to dividend treatment to the extent of current and accumulated earnings and profits of a U.S. subsidiary corporation; and
- under the treaty, the withholding rate on interest is reduced to 15 percent.

However, there can be tax and nontax reasons why the French company might not want to finance its U.S. operations with debt. For example, increased debt would not reduce current taxes if the U.S. operations were otherwise incurring losses. Also, increased debt can sometimes result in an increase of the current overall tax rate because of the way the home country taxes interest, as distinguished from dividend, income.

Because interest is payable only regarding a debt instrument, the U.S. tax characterization of the underlying instrument as debt must be respected. If the debt instrument is recharacterized as equity, the payments to the foreign recipient will be recharacterized as nondeductible dividends and might be subject to higher U.S. withholding tax.

Despite the significant stakes, there are no statutory rules in the code governing whether the U.S. payer is thinly capitalized so that the purported debt is treated as equity. Case law, while it does not establish hard-and-fast rules, has established a number of factors to be considered.16

Even if an instrument is properly characterized as debt, there are several limitations in U.S. tax law on the deduction of interest expense. The simplest limitation applies to accrued but unpaid interest. A U.S. company, regardless of its method of accounting, is not entitled to a current interest expense deduction for accrued but unpaid interest owed to a foreign related entity unless that interest is currently includable in the income of the foreign related entity.17

More complicated are the earnings stripping rules in section 163(j). Under these rules, if the issuer has a debt-to-equity ratio that exceeds 1.5 to 1, some interest deductions of the U.S. debtor are deferred. Thus, disqualified interest paid or accrued during the tax year may be deferred. Disqualified interest is generally interest paid or accrued to a related party if no, or a treaty-reduced rate of, U.S. tax is imposed regarding that interest. The disallowance, however, is limited to the corporation’s excess interest expense, defined as the excess of the corporation’s net interest expense over 50 percent of the adjusted taxable income of the corporation.18

The interest on all related-party loans is covered by the earnings stripping rules. Also, the rules can apply to third-party loans if two conditions are met:

- no, or a treaty-reduced rate of, U.S. withholding tax is imposed on the gross amount of the interest paid; and
- the loan is guaranteed by a related foreign person.

Thus, any form of credit support received from a foreign parent in connection with a borrowing may result in the application of the earnings stripping rules to that borrowing.

III. Personnel

Another decision facing the French investor concerns the staffing of the U.S. enterprise. This often involves deciding between U.S. employees and foreign employees, often seconded or otherwise made available by the French parent.

The use of U.S. employees paid by the U.S. company does not result in tax consequences for either the employee or the foreign parent. The use of foreign employees, however, raises issues for both the employees and the French parent. The principal issue for the foreign employee relates to the likelihood that his continued employment in the United States will give rise to U.S. tax residency and, hence, U.S. taxation of his worldwide income.

Under section 7701(b), an alien individual is treated as a resident of the United States for a calendar year if he satisfies either of the following two tests:

- The individual is a lawful permanent resident of the United States under the immigration laws at any time during the calendar year (the green card test).
- The individual is physically present in the United States for a sufficient number of days to satisfy the substantial presence test. An alien is substantially present if either:
  - he is physically present in the United States for 183 or more days during the calendar year; or
  - the sum of the days (calculated on a weighted average) spent in the United States during the most recent three-year period equals or exceeds 183.

17Section 267(a)(3).
18Section 163(j)(2)(B).
The presence of foreign workers in the United States raises the possibility that their activities will give rise to the conduct of a U.S. trade or business by their employer. Since the French corporation is able to claim the benefits of a U.S. income tax treaty, the threshold for taxable presence is raised by the requirement that the corporation have a PE in the United States in order to be subject to tax on its business profits. A PE, as discussed below, is generally defined as an office or fixed place of business but can also arise from the activities of some agents, including employees, in the United States.

For example, if the French corporation sends employees to the United States, personal services performed within the country by those employees for the French corporation may constitute the conduct of a U.S. trade or business through a PE of the corporation. Income attributable to that business would be subject to U.S. corporate income tax as well as the branch profits tax, described above. It is therefore generally preferable, if possible, for the company to place any foreign employees working in the United States in the employ and on the payroll of the U.S. affiliate.

IV. Repatriation of Profits

The French direct investor has a number of means by which it can repatriate the profits of its U.S. operations. These include the payment of interest or dividends by the U.S. enterprise to the French owner, discussed in Section II of this article. Also, the French parent can, when appropriate, charge a royalty to the U.S. company for the use of parent-owned intellectual property, such as patents, copyrights, or know-how. Finally, the French parent could structure its inbound sales so that its income from those sales would not be taxable in the United States.

The use of royalties, if applicable, is often a tax-efficient means to extract profit from the U.S. enterprise. An arm’s-length royalty is deductible by the U.S. business, while under the terms of the treaty, the withholding tax rate is reduced from 30 percent to 0 percent for royalties. The tax treatment in France of any royalty income should also be taken into consideration.

Often, the business activity being contemplated is the sale of inventory products by a foreign company to customers located in the United States — a so-called inbound sale. There are a number of tax planning techniques that may be appropriate for a non-U.S. seller to minimize its U.S. tax burden. The essence of this planning is to divide the total profit to be earned regarding the importation and sale of inventory between the French manufacturer and its related U.S. affiliate. The planning goal is to minimize the role that the U.S. affiliate plays in the transaction in order to support less income being allocated to it. It is also critical that the activities of the French manufacturer do not constitute engaging in a U.S. trade or business through a PE — either directly or through the agency rules described below. As long as the French manufacturer is not so engaged, any gain on the sale of its inventory products will not be subject to U.S. tax.

As noted above, a PE is generally defined as an office or fixed place of business but can also arise from the activities of some agents. There are generally two types of agents: dependent and independent. Under article 5.4 of the treaty, the presence and activities of a dependent agent will give rise to a PE only if the agent has and habitually exercises an authority to conclude contracts in the name of the enterprise. An independent agent, on the other hand, does not create a PE as long as it is acting in the ordinary course of its business.

V. Exit Strategies

The tax planning for the sale or other disposition of a U.S. business operation is beyond the scope of this article. However, in general, the tax treatment of the sale of the U.S. business depends on several key variables. The first is whether the transaction is a sale of assets (often favored by the buyer) or a sale of an interest in the business entity — for a corporate subsidiary, a sale of stock. Next to be considered is whether the sale is structured as taxable or tax free under the code’s reorganization provisions. Note that the choice of organizational structure may affect the appropriate exit strategy. For example, only a corporation can engage in a tax-free reorganization.

A French parent company can typically exit its U.S. investment in one of two ways. It can liquidate its U.S. holding, or it can sell it. Liquidation is the easier method of exit since it doesn’t require the involvement of an unrelated third party. For U.S. tax purposes, a corporate liquidation of a wholly owned subsidiary of a French corporation generally is treated as if the corporation sold all its assets at their fair market value, thereby subjecting any asset appreciation to U.S. corporate income tax. The distribution of the assets to the French parent company is tax free. This tax treatment is typically favorable, particularly when compared with the tax treatment of a dividend, as distinguished from a liquidating, distribution — which may be subject to a 5 percent withholding tax rate under the treaty.

On the other hand, if the French parent sells the stock of the U.S. subsidiary, as long as the parent does not have a PE in the United States, it generally will not be subject to U.S. tax on any gain from that sale. However, special rules apply if 50 percent or more of the assets of the U.S. subsidiary are U.S. real property interests.

19This, of course, assumes that the U.S. tax rate applied to the income of the U.S. affiliate (including state and local taxes) is higher than the effective tax rate that would otherwise be paid by the manufacturer in France.

20Reg. section 1.367(e)-2(b). There are special rules that apply to allow the deferral of gain recognition and immediate taxation for business assets that the French parent will continue to use in a U.S. trade or business and for some U.S. real property assets.

21Section 332.
Exhibit A. Tax Checklist for Foreign-Owned U.S. Operations

A. Organizational Structure
   • Non-presence
     — Use of agents or distributors
   • Choice of entity
     — Branch
     — Subsidiary
     — Joint venture
     — Partnership
     — LLC
   • Capitalization
     — Debt
     — Equity
     • Common stock
     • Preferred stock

B. Operational Structure
   • Taxation of enterprise
     — Federal
     — State and local
   • Taxation of employees
     — U.S. citizens
     — French nationals

C. Repatriation of Earnings
   • Dividends
     — Withholding (effect of tax treaties)
   • Interest
     — Deductibility
     — Withholding (effect of tax treaties)
   • Sales
     — Taxability to foreign seller
     — Arm’s-length standard (related party)
   • Royalties
     — Deductibility
     — Arm’s-length standard (related party)
     — Withholding (effect of tax treaties)

D. Exit Strategies
   • Liquidation
   • Trade sale
     — Asset sale vs. stock sale
     — Sale of U.S. real property
   • Initial public offering

Exhibit B. Typical Life Cycle of a Foreign-Owned U.S. Operation

<table>
<thead>
<tr>
<th>Stage</th>
<th>Legal and Operational Characteristics</th>
<th>U.S. Tax Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Infant</td>
<td>Use of unrelated third parties; no (or very limited) physical presence; no additional business structure.</td>
<td>None.</td>
</tr>
<tr>
<td>Toddler</td>
<td>Physical presence; limited functions performed; form of business structure not significant.</td>
<td>Some activities may be conducted in the United States without giving rise to taxable presence; payroll and employee tax issues appear.</td>
</tr>
<tr>
<td>Adolescent</td>
<td>Increased physical presence; activities directly connected to the business conducted; tax consequences of choice of entity become important.</td>
<td>Nature and amount of activity drive U.S. operational tax results; increased payroll and employee tax issues.</td>
</tr>
<tr>
<td>Young Adult</td>
<td>Distribution or other significant elements of business conducted by U.S. operation; employee head count rises.</td>
<td>Increased activities typically give rise to increase in amount of U.S. tax; need for professional tax planning becomes apparent; continued employee tax issues.</td>
</tr>
<tr>
<td>Adult</td>
<td>Manufacturing or other production activities commenced; head count rises.</td>
<td>Need for operational tax planning increases.</td>
</tr>
</tbody>
</table>
Figure 1. Case Study 1 - Sale and Distribution in U.S.

Comments
- Branch vs. subsidiary
  - Effect of branch profits tax
- Legal relationship of U.S. subsidiary and foreign parent
  - Distribution
    * Commission agent
    * Buy-sell arrangement
- Economic functionality of U.S. subsidiary
  - Sales solicitation and support
  - "Skinny" distributor
- Effect of tax treaty
  - Permanent establishment
    * Dependent vs. independent agent
- Transfer pricing — section 482
  - Arm's-length requirement for pricing both tangible property and services
- State tax implications

* Assumes choice of U.S. subsidiary.

Figure 2. Case Study 2 - Manufacturing in U.S.

Comments
- Capitalization
  - Generally better to use debt rather than equity financing
    - Interest deductible
    - Principal repayment is tax free
    - Treaty rate reduction on withholding tax
- Characterization — debt vs. equity
  - Thin capitalization
- Limitations on interest deductibility
  - Accrued but unpaid interest
  - Earnings — stripping
    * Disqualified interest
    * Excess interest expense
    * Parent loan guaranty
- Transfer pricing — section 482
  - Arm's-length requirement for pricing both tangible property and services
- Licensing
  - Foreign parent may have valuable intangibles it intends to license to U.S. manufacturing subsidiary
    * Royalty deductible
    * Treaty rate reduction for royalty payments
- State tax considerations
  - Borrowing by operating subsidiary

* Assumes choice of U.S. subsidiary.