# Getting a Grip on Tax Issues

German companies face new tax issues when they enter the North American market

*Expert insights into current tax issues are provided by Robert Misey, a Milwaukee attorney specializing in international and domestic taxation; he assists clients with respect to U.S.-German cross-border tax issues. He was previously with the IRS Chief Counsel.*

Many German companies are currently viewing the U.S. as an attractive market for their products. As these German companies enter the U.S. markets, they will face some new tax issues. This article surveys the U.S. rules of international taxation encompassing these tax issues, which will often involve looking at the Germany-United States Income Tax Convention of 1989 as amended ("the treaty").

Let us assume that a German manufacturer, DeutschCo, has nominal exports to the U.S., but wants to expand U.S. sales. The U.S. expansion will replicate DeutschCo's German distribution center, which includes a sales office. Deutsch Co will periodically detail a few German sales persons and quality control specialists for approximately six months to ensure the proper functioning of DeutschCo's unique distribution software used at the U.S. distribution center. When the U.S. operations become profitable, DeutschCo expects to repatriate cash to Germany.

DeutschCo will have to deal with the following major issues:

- Should DeutschCo structure its expansion into the U.S. through a branch or a subsidiary?
- What kind of exposure does DeutschCo have to state taxes?
- What are the U.S. tax consequences to the German employees working in the U.S.?

**„"DeutschCo. has the choice of operating the distribution center as a U.S. subsidiary or as a branch of DeutschCo. in the U.S."**

**1. Structure in the U.S.**

DeutschCo has the choice of operating the distribution center as a U.S. subsidiary ("USSub") or as a branch of DeutschCo in the U.S. There are several differences between the two types of organizations. Even if DeutschCo forms a limited liability company ("LLC") in the U.S., DeutschCo will have to choose whether it will treat LLC as a USSub or branch for tax purposes under the entity classification regulations.

**a. U.S. Subsidiary**

A USSub of DeutschCo would incur corporate income tax at rates ranging from fifteen to thirty-five percent. DeutschCo and USSub must allocate a proportional basis of DeutschCo's general and administrative expenses to reduce USSub's income. Unless USSub runs afoul of the anti-treaty shopping provisions, USSub can deduct payments to DeutschCo for royalties, interest, and management fees, without incurring a withholding tax. USSub should incur a five percent withholding tax when repatriating a cash dividend to DeutschCo. DeutschCo should receive an indirect foreign tax credit on receipt of a dividend for USSub's share of U.S. income taxes paid. Because USSub is subject to U.S. taxation, DeutschCo will want to place all U.S. activities in USSub to avoid inadvertent treatment of DeutschCo as a U.S. permanent establishment. A permanent establishment that earns effectively connected income in the U.S. would incur U.S. tax in addition to the U.S. tax that USSub would already be paying.

Under the treaty, a permanent establishment is a fixed place of business through which a foreign business conducts its local operations. If DeutschCo were to operate the distribution center and sales office as a branch, DeutschCo would obviously have a permanent establishment due to its fixed place of business, which this article will discuss later. But if DeutschCo operates in the U.S. through a USSub, a permanent establishment may inadvertently result from the activities of DeutschCo employees in the U.S. For example, because the treaty states that an office constitutes a permanent establishment, DeutschCo will want to avoid having any of its employees use the sales office at the U.S. distribution center. The treaty does exempt a mere warehouse, without any other type of activities, from treatment as a permanent establishment.

An inadvertent permanent establishment may also result from DeutschCo giving its DeutschCo employees operating in the U.S. the contracting authority of an agent. Under the agency test, a dependent agent of DeutschCo may constitute a permanent establishment if the agent has the authority to contract on behalf of DeutschCo in the U.S and the agent "habitually exercises" that authority. Although the treaty does not define the phrase "habitually exercise", the exercise of authority to negotiate and enter into con-

tracts once or twice is probably habitual. The more the employee exercises this authority, the more likely the I.R.S. would deem it habitual. DeutschCo should not have an inadvertent permanent establishment from its employees' involvement in the construction of the U.S. distribution center provided that the construction activity lasts less than one year. In addition to avoiding an inadvertent permanent establishment, DeutschCo should ensure that USSub does not have any transfer pricing exposure. Transfer pricing refers to the price that related corporations charge each other for tangible property, intangible property, services, and loans. Transfer pricing receives substantial scrutiny from the I.R.S.'s international examiners, who may impose additional tax and a twenty to forty percent penalty if the prices are not at arm's length. The best way to avoid a transfer pricing adjustment when audited and to avoid a penalty is to document the pricing practices as required by the regulations or to enter an advance pricing agreement. In our hypothetical, intercompany transactions could arise from the sale of goods, the transfer of technology, the provision of services, or constructive loans based on generous payment terms.

**b. Branch**

Assuming that the operations of DeutschCo's U.S. branch constitute a permanent establishment, the effectively connected income generated would similarly incur federal tax at rates ranging from fifteen to thirty-five percent. The branch can take deductions appropriate to the taxed activities, which include general and administrative expenses calculated on a proportional basis between the branch and its DeutschCo headquarters, assuming that the branch can show it has benefited from these expenditures. A disadvantage is that the branch, as a non-corporate entity, cannot deduct payments for royalties, management fees, or interest to its DeutschCo headquarters.

In lieu of withholding on a dividend, the I.R.S. imposes a complex system of branch taxation on three separate tax bases:

1) Profits from DeutschCo's branch operations that are deemed repatriated from the U.S. under the branch profits tax rules;

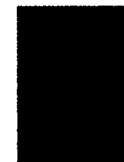
2) Interest deemed paid by the branch to foreign lenders; and

3) Excess interest that is apportionable to effectively connected income of DeutschCo but not deemed paid by the branch.

The I.R.S. imposes the branch profits tax, the most relevant of the three, on a branch's U.S. earnings that are deemed repatriated to Germany. The branch profits tax is designed to approximate the U.S. withholding tax imposed on a U.S. subsidiary for dividends to its foreign shareholders. Because the repatriation of branch profits does not involve actual remittances, DeutschCo would have to segregate its U.S. branch's earnings from other earnings. More specifically, the branch profits tax applies to after-tax earnings that are effectively connected to DeutschCo's U.S. operations to the extent DeutschCo does not reinvest those earnings in the U.S. The I.R.S. imposes the branch profits tax at a five percent treaty rate and is in addition to the regular U.S. corporate income tax on the effectively connected income.

Although DeutschCo's branch will incur both U.S. taxes on the branch's effectively connected income and German tax, DeutschCo can avoid double taxation with a foreign tax credit.

If DeutschCo expects the U.S. operations to lose money the first few years, a branch would permit the U.S. losses to reduce DeutschCo's taxable income in Germany.



**2. State Tax Issues**

Because the states, counties, and municipalities are not parties to the treaty, some states do not respect the treaty. As a result, DeutschCo may be exempt from U.S. federal tax pursuant to various treaty provisions, but subject to various state taxes. Although a review of each state's respect of the treaty is beyond the scope of this article, DeutschCo should know it may have some state tax exposure.

**a. State Income tax**

The state of USSub's incorporation can tax USSub even if USSub does not conduct any business there. If USSub has activities in most states, the tax professional should consider the states of Nevada or Delaware due to their minimal reporting requirements and tax. USSub can incorporate in either state even if USSub organizes its distribution center elsewhere (i.e., distribution center is in Wisconsin).

When a corporation earns income from business activities sourced in states outside the state of incorporation, the source states will use their apportionment factors to tax a portion of the corporation's income. However, there must be a sufficient contact or nexus with a particular state before the state can impose a tax. USSub would still have to file tax returns in the state where the distribution center is located because the distribution center would likely constitutes nexus.

In addition to a state income tax, many states have a franchise (or capital based) tax that applies if the corporation has royalties in the state.

**b. State Sales and Use Tax**

Generally imposed on the ultimate consumer, state sales tax applies to the transfer of property (goods) and/or selected services at retail. The burden of proving that the tax does not apply lies with the seller unless the seller receives a certificate of exemption from the purchaser. The most common exemption is for non-retail sales because the policy of the sales tax is to tax the ultimate consumer on a retail sale. When goods are sold and the purchaser intends to resell the property, the sale is an exempt resale sale and not a retail sale.

A state may impose sales tax on intrastate sales, and not interstate sales. All states that levy a sales tax also levy a use tax, which is an excise tax imposed on using, storing, or consuming goods in a state. The primary purpose of the use tax is to protect in-state merchants from the competition of out-of-state sellers whose sales do not bear sales tax. Although sellers pass-on the sales and use tax to the ultimate consumer, the sellers usually collect and remit the tax. As with state income taxation, an out-of-state company must have nexus to incur liability for a state's sales or use tax. If a business does not have nexus with a state, then the responsibility for collecting

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and remitting the sales or use tax reverts to the purchaser. However, if the business has nexus, which varies by state, the business must collect and remit sales tax.

**"German individuals who work for DeutschCo. will be concerned about any exposure to a U.S. federal tax liability"**

Robert Misey

### 3. U.S. Taxation of German Individuals in the U.S.

The German individuals who work for DeutschCo will be concerned about any exposure to a U.S. federal tax liability from their assignment to the U.S. distribution center. A German individual's U.S. federal tax liability depends on two levels of inquiry. First, is the individual a U.S. citizen or resident? Second, if the individual is a nonresident alien in the U.S., does the treaty exempt the individual from taxation?

The U.S. taxes its U.S. citizens or residents on their worldwide income. Assuming that the German individuals are not U.S. citizens, U.S. taxation on worldwide income will still occur if they are residents under both the Internal Revenue Code and the treaty.

Non-resident aliens are individuals that are not U.S. citizens and have failed to meet the residency requirements. If the individuals are nonresident aliens, the treaty determines their tax exposure.

Under Article 16 of the treaty, salaries, wages, and other similar remuneration earned by the German individuals for services performed in the U.S. do not incur U.S. tax if the employee is present in the U.S. for less than 183 days during the year and the compensation is not borne by a U.S. employer (a U.S. subsidiary or branch). If the individual meets this test, no U.S. tax is due on the compensation. Although the first alternative (the $10,000 alternative) is simple, the second alternative merits further discussion.

If the German individuals are in the U.S. for less than 183 days, their U.S. taxation depends on whether they are employees of either a U.S. employer (USSub or branch) or of DeutschCo. If the German individuals are employees of DeutschCo, they do not have a U.S. tax liability, and should file a Form 1040NR that discloses the treaty position and reports the excluded amount. But if the German individuals are employees of either USSub or branch, they have a U.S. tax liability, which requires withholding of thirty percent of their compensation, the filing of a Form 1040NR with limited deductions and exemptions, and possible liability for the U.S.'s social security system.

Employers of employees in the U.S. must withhold and remit the employee portion of the social security tax ("FICA") on all remuneration paid. In addition the employer must pay their portion of the social security tax. For 2000, a rate of 6.2 percent applies to the first $72,600 of compensation for the old-age, survivors, and disability insurance portion ("OASDI") for both employee and employer. The Medicare rate of 2.9 percent applies to all compensation.

The U.S. has a totalization agreement with Germany that can eliminate the U.S. social security tax for the first five years a German individual works in the U.S. To obtain the exemption, the employer must transfer the employee to a U.S. location and receive a certificate of coverage from the Federal Minister of Finance.

Please note that the federal tax treatment of DeutschCo's U.S. operations and these German individuals are at

odds. If the German individuals are employees of either USSub or branch, DeutschCo avoids any inadvertent permanent establishment status as described above. But for the individuals to avoid U.S. tax, DeutschCo must employ them, which may result in DeutschCo having an inadvertent permanent establishment that the U.S. can tax.

The German employees may also be liable for state income taxes depending on the respect the various states provide the treaty.

### Conclusions

When expanding into the U.S., DeutschCo faces several key tax issues. First, DeutschCo must decide whether to operate as a subsidiary or a branch. Second, DeutschCo will try to minimize the burden of a variety of state taxes. Finally, DeutschCo will want to minimize the tax burden on its German personnel in the U.S.

The federal tax impact of operating as a USSub or as a branch is fairly comparable. If the sales are purely U.S. sales, both will pay tax at marginal rates of fifteen to thirty-five percent of their income while paying a five percent tax on repatriation through either the branch profits tax or withholding on dividends from USSub. A branch will result in several administrative inconveniences, such as accounting for all the branch taxes, while a subsidiary will require a review of transfer pricing.

With respect to state taxes, if DeutschCo decides to operate in the U.S. through a USSub, USSub will incur income tax in the state of incorporation. If USSub or DeutschCo has sufficient nexus in other states, those other states may impose tax based on their apportionment rules. Most states have a sales and use tax for which the U.S. activities may create nexus, resulting in registration to collect and remit the tax, unless a specific exemption applies.

Assuming that the German employees are nonresident aliens in the U.S., they will incur tax on their U.S. source income unless both the employees are in the U.S. for less than 183 days and DeutschCo bears the cost. The U.S.-German totalization agreement on social security may exempt the German employees from any U.S. social security tax.

Despite the presence of these new issues, prudent planning will enable the tax professional to provide for an efficient U.S. operation.

*by Robert Misey*

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Editorial Office:

Editor: Inge Orth
Associate Editor: Richard Jacob
GACC Photographer: Thomas Dzimian

Advertising Coordination: Inge Orth
Telephone: (212) 974-8850 Fax: (212) 315-2183
mail: iorth@gaccny.com

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S+L PARTNERS

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Fax: (0221) 207 1929
mail: slpartners@netcologne.de

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