

THE LAND OF OPPORTUNITY?

Thinking of branching out? Hefty tax issues may await Australian companies entering the US market, warns

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The US may be an attractive market for Australian products, but as Australian companies enter the US markets, they are bound to hit taxing times.

The rules of international taxation that govern these tax issues fall under the Australia-United States Income Tax Convention 1982 as amended ("the treaty").

To understand the implications of the tax issues, let's assume that an Australian manufacturer, AusCo, has nominal exports to the US, but wants to expand US sales. The US expansion will replicate AusCo's Australian distribution centre, which includes a sales office. AusCo will periodically detail a few Australian sales people and quality control specialists for approximately six months to ensure the proper functioning of AusCo's unique distribution software used at the US distribution centre. When the US operations

become profitable, AusCo expects to repatriate cash to Australia.

AusCo will have to deal with the following two issues:

- Should it structure its expansion into the US through a branch or a subsidiary?
- What are the US tax consequences to the Australian employees working in the US?

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

Subsidiary

A USSub of AusCo would incur corporate income tax at rates ranging from 15 to 35 per cent. AusCo and USSub should allocate a proportion of AusCo'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 AusCo for royalties and interest while incurring a 10 per cent withholding tax. Management fees for services performed in Australia should not incur any US tax.

USSub should cop a 15 per cent withholding tax when repatriating a cash dividend to AusCo. AusCo should receive an indirect foreign tax credit on receipt of a



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dividend for USSub’s share of the US income taxes paid.

AusCo 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 IRS’s international examiners, who may impose additional tax and a 20 to 40 per cent 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 case, 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.

AusCo should ensure that the activities of its sales people detailed to the US do not inadvertently result in a permanent establishment of AusCo subject to tax in the US.

Branch

If the operations of AusCo’s US branch constitute a permanent establishment, the effectively connected income generated would incur federal tax at rates ranging from 15 to 35 per cent. The branch can take deductions related to the taxed activities, which include general and administrative expenses calculated proportionally between the branch and its AusCo 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 AusCo headquarters.

In lieu of withholding on a dividend, the IRS imposes a complex system of branch taxation on three separate tax bases:

1. Profits from AusCo’s branch operations that are deemed repatriated from the US under the branch profits tax rules.
2. Interest deemed paid by the branch to foreign lenders.
3. Excess interest that is apportionable to effectively connected income of AusCo but not deemed paid by the branch.

The IRS imposes the branch profits tax, the most relevant of the three, on a branch’s US earnings that are deemed repatriated to Australia. The branch profits tax is designed to approximate the US withholding tax imposed on a US subsidiary for dividends to its foreign shareholders.

Because the repatriation of branch profits does not involve actual remittances, AusCo would have to segregate its US branch’s earnings from other earnings.

More specifically, the branch profits tax applies to after-tax earnings that are effectively connected to AusCo’s US opera-

tions to the extent that AusCo does not reinvest those earnings in the US. The IRS imposes the branch profits tax at a 15 per cent treaty rate and is in addition to the regular US corporate income tax on the effectively connected income.

Although AusCo’s branch will incur both US taxes on the branch’s effectively connected income and Australian tax, AusCo can avoid double taxation with a foreign tax credit.

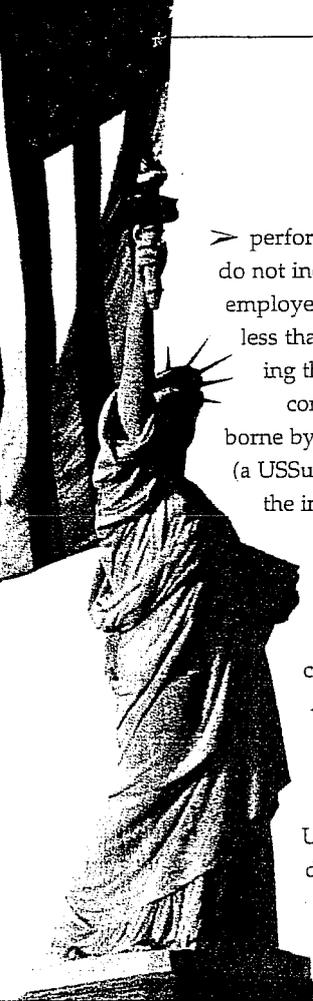
If AusCo expects the US operations to lose money in the first few years, a branch would permit the US losses to reduce AusCo’s taxable income in Australia.

Regardless of whether AusCo operates in the US as USSub or as a branch, AusCo should evaluate the tax structure of a particular US state for sales, use, and income taxes, that may be as high as 9 per cent.

The Australian individuals who work for AusCo will be concerned about any exposure to a US federal tax liability from their assignment to the US distribution centre. An Australian individual’s US federal tax liability depends on two levels of inquiry. First, is the individual a US citizen or resident? Second, if the individual is a non-resident in the US, does the treaty exempt the individual from taxation?

Non-residents are individuals that are not US citizens and have failed to meet the residency requirements. If the individuals are non-resident, the treaty determines their tax exposure. The US taxes its citizens or residents on their worldwide income. Assuming that the Australian individuals are not US citizens, US taxation on worldwide income will still occur if they are residents under both the Internal Revenue Code and the treaty.

Under the treaty, salaries, wages, and other similar remuneration earned by the Australian individuals for services ➤



> performed in the US do not incur US tax if the employee is in the US for less than 183 days during the year and the compensation is not borne by a US employer (a USSub or branch). If

the individual meets this test, no US tax is due on the compensation.

More specifically, if the Australian individuals are in the US for less than 183 days, their US taxation depends on

whether they are employees of either a US employer (USSub or branch) or of AusCo. If the Australian individuals are employees of AusCo, they do not have a US tax liability, and should file a Form 1040NR that discloses the treaty position and reports the excluded amount. But if the Australian individuals are employees of either USSub or branch, they will face a US tax liability, which requires withholding of 30 per cent of their compensation, the filing of a Form 1040NR with limited deductions and exemptions, and possible liability for US social security tax. They may also be liable for state income taxes depending on the respect the various states provide the treaty.

The US tax treatment of AusCo's US operations and these Australian individuals are at odds. The paradox is that if the

Australian individuals are employees of either USSub or branch, AusCo avoids any inadvertent permanent establishment status as described above, but for the individuals to avoid US tax, AusCo must employ them, which may result in AusCo having an inadvertent permanent establishment that the US can tax.

The US tax issues may sound complicated but, as in most cases, prudent planning will pay off and should enable the tax professional to provide for an efficient US operation. ■

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