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Corporate Tax

Law and Practice – USA

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The 'Law & Practice' sections provide easily accessible information on navigating the legal system when conducting business in the jurisdiction. Leading lawyers explain local law and practice at key transactional stages and for crucial aspects of doing business.

Contributed by White & Case LLP **Authors:** Kim Marie Boylan, Brian Gleicher, David Dreier, Nicholas L. Wilkins

Law and Practice

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White & Case LLP ‘s lawyers in its Global Tax practice include approximately 90 tax professionals who work seamlessly in 13 jurisdictions across the globe. The practice continues to grow and receive recognition for its wide spectrum of tax services, including its Corporate Tax work.

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1. Types of Business Entity, Residence and Tax Treatment

1.1 Corporate Structures and Tax Treatment

In the United States, the four most common forms of business organisations are sole proprietorships, partnerships, limited liability companies (“LLCs”), and corporations. While the corporation remains the entity of choice for most large businesses, primarily due to liability protection, LLCs have become increasingly popular over the last several decades, and also offer increased liability protection. Each form has distinct tax and non-tax advantages and disadvantages, some of which are discussed below.

It is useful to note at the outset that an entity’s treatment for tax purposes does not need to align with its treatment for non-tax purposes. For example, certain entities can make an election (a so-called “check-the-box” election), which can change the way in which the Internal Revenue Service (“IRS”) will treat the business for tax purposes. Thus, if an individual chooses to set up his or her business as an LLC (which, as discussed below, is generally taxed as a “pass-through” entity), they can nevertheless choose to have the business taxed as a corporation.

Sole Proprietorship

A sole proprietorship can be used where a single individual owns and operates a business. In such a case, the income and other tax attributes (such as deductions and credits) generated by the business are attributed to the sole proprietor and taxed at the tax rates applicable to individuals. In addition, the sole proprietor is personally liable for all of the obligations of the business (both tax and non-tax). For this reason, new business owners tend to gravitate towards one of the other entity forms which limit the business owner’s exposure to the liabilities of the business (eg, an LLC).

Pass-Through Entities: Partnerships and LLCs

Where two or more individuals own a business together, the arrangement is – by default – treated as a *general* partnership. In a general partnership, each of the partners is liable for all of the partnership's obligations, which means that each partner in a general partnership is at risk of losing more than the capital that they contribute to the partnership. In contrast to a general partnership, a *limited* partnership is an arrangement whereby the business owners enter into a contract (referred to as a "limited partnership agreement") pursuant to which a single general partner is responsible for the management of the business, and one or more limited partners act as investors, with very limited or no managerial power. Similar to a general partnership, the general partner in a limited partnership is liable for all of the obligations of the business. The limited partners, however, are only at risk for their own capital contribution to the limited partnership. If a limited partner begins to exercise a level of managerial control indicative of a general partner, however, it could lose its limited liability protection and become exposed to all of the limited partnership's obligations.

Much like a limited partnership, an LLC is an arrangement whereby the business owners (referred to as "members") enter into a contract that sets out the rights of each party. Like the limited partners in a limited partnership, each LLC member's exposure to the LLC's obligations is limited to the amount of that member's individual capital contributions. Unlike a limited partnership, however, an LLC need not necessarily have a general partner with managerial responsibility and unlimited liability. Instead, the management of the LLC and allocation of liabilities is determined contractually and can involve any number of the LLC's members.

For tax purposes, both partnerships (general and limited) and LLCs are referred to as "pass-through" or "flow-through" entities, meaning that the entity's income and other tax attributes (such as depreciation, basis and losses) are attributed to the individual partners or members based on their ownership interest in the entity rather than to the entity itself. Accordingly, the entity itself is not generally subject to taxation. As noted above, however, the members of an LLC may choose to "check the box" and have the LLC treated as a corporation for tax purposes.

Stakeholders generally have the flexibility to allocate the income, losses and tax attributes generated by the entity amongst each other in any way they see fit (subject to a complex set of legal rules designed to ensure that partners or members cannot engage in tax avoidance schemes that do not reflect the economics of their business arrangement). In light of the flexibility offered by limited partnerships and LLCs, and the fact that they are not automatically subject to tax at the entity level, such entities are often used to form investments funds (such as private equity, venture capital, and hedge funds). In addition, LLCs and partnerships are especially beneficial in business ventures where it is desired that deductions and losses flow through to investors so as to reduce taxable income from other sources (eg, real estate and energy projects).

Corporations

Unlike the pass-through entities described above, corporations themselves are subject to tax. Accordingly, profits earned by a corporation are taxed once at the corporate level and a second time after they are distributed to the corporation's shareholders as dividends. This is commonly referred to as "double taxation" and is the primary drawback of organising a business in the corporate form.

Despite double taxation, the corporate form remains popular for various reasons, three of which are described below. First, the corporate form is favoured by companies that want to raise capital by issuing widely held, publicly traded securities. This is primarily because corporations are easier to administer than other entity forms, making it simpler to deal with a large number of shareholders (due in part to the fact that a corporation is taxable as an entity separate from its owners so there is no need to engage in complicated accounting in order to allocate the corporation's various tax attributes to its individual shareholders). Second, corporations can be used as "blocker entities" to protect foreign or not-for-profit investors from being subject to tax on the business's income, and from being required to file tax returns and deal with the IRS. Third, although people are becoming more familiar with the use of LLC and partnerships, many people are simply more familiar with and comfortable using a traditional corporation.

1.2 Determining Residence

Irrespective of the type of entity chosen, businesses with cross-border operations should be aware of their potential tax exposure in the countries or jurisdictions in which they operate. Where and to what extent an entity may be taxed depends, in part, on its tax "residence." For example, under current law, the United States taxes worldwide income; for example, all of the profits of a corporation organised in the United States are taxed in the United States (subject to various deferral rules), regardless of the country in which such profits are generated. The following is a general summary of how tax residence is determined based on the type of entity that is chosen.

- *Corporations*. For a domestic corporation (a corporation formed under US federal or state laws), the United States generally imposes a net income tax on the corporation's worldwide income (again, subject to various deferral rules). For a foreign corporation, however, the United States generally imposes a net income tax only on income earned or otherwise "sourced" in the United States (subject to certain anti-deferral rules) that is effectively connected to a US trade or business conducted by the foreign corporation. The existence of a tax treaty can also have an impact on whether or to what extent profits or other sources of income are taxed in the United States.

- *Flow-Through Entities*. As discussed above, partnerships and LLCs are not themselves subject to income tax. Instead, partners and members are taxed based on the underlying investments of the entity and the activities of the business. Accordingly, the tax residence of partnerships and LLCs (whether or not they are formed in the United States) is less important than where the assets of the business are located and where the business is conducted. For example, a non-US member of an LLC formed outside the United States will still be subject to US tax on its share of any income of the LLC that is effectively connected to a US trade or business of the LLC. Also, the United States generally imposes tax on any US person who earns income from a flow-through entity regardless of where the business operates. Again, the existence of a tax treaty may affect the analysis.

1.3 Tax Rates

Perhaps the most important threshold question for determining the appropriate organisational form is the applicable tax rate (not taking into account the impact of a reduced rate of taxation that may be available pursuant to an applicable tax treaty and taxes that may also be imposed by individual states and their political subdivisions). The United States also has an alternative minimum tax that may be applicable where, for example, the taxpayer has certain tax preference items that reduce its normal income tax below a set threshold.

- *Corporations*. The highest graduated rate on the earnings of a corporation is 35%, which currently applies to annual income over USD18.33 million. Dividends paid to a US person are generally subject to a 20% tax, plus an additional 3.8% "net investment income tax." Dividends paid by a US corporation to a non-US person generally are subject to a 30% withholding tax (subject to reduction by applicable income tax treaties). Accordingly, earnings of a US corporation are subject to two layers of tax that may exceed 50% once the earnings are distributed to its shareholders.
- *Pass-Through Entities*. Income generated by pass-through entities such as partnerships and LLCs is "passed-through" to the owners and is therefore subject to taxation at the individual or corporate tax rates, as the case may be. The highest graduated individual tax rate on ordinary income is 39.6%. The highest graduated rate on net capital gains and qualified dividends is 20%. Individuals are also subject to an additional 3.8% "net investment income tax," which generally applies to passive type income (such as dividends, interest and capital gains).

2. Key Features of the Tax Regime

2.1 Calculation of Taxable Profits

A corporation's taxable income is its gross income for the year minus allowable deductions. Gross income is similar but not identical to financial profits computed under Generally Accepted Accounting Principles (which are similar but not identical to International Accounting Standards). Gross income can include receipts from sales, dividends received, interest collected, income from rents and royalty payments, and capital gains. Deductions include all "ordinary and necessary" expenses of the business, which typically include compensation (ie, payroll) expenses, repairs and maintenance expenses, taxes, licences, interest payments, depreciation and depletion, advertising and marketing, and deductible amounts paid to provide employee benefits. Corporations are generally required to calculate gross income on an accrual basis, but certain smaller businesses can account for gross income using a cash or modified cash accounting method.

Corporations are generally taxed equally on all types of income, so there is no reduced rate is applicable to corporations for capital gains. A corporation cannot, however, use capital losses to reduce its ordinary income; capital losses of a corporation can generally only be used to offset the capital gains of the corporation. Generally there are no special exemptions for distributions from the "capital" of a corporation. The US rules provide that a distribution is a taxable dividend to the extent the corporation has any current or accumulated earnings and profits (thus payments are deemed to be made out of earnings before they are treated as a return of capital), although a corporation that receives a dividend from another corporation is generally entitled to a special "dividends received" deduction ranging from 70% to 100%.

2.2 Special Incentives for Technology Investments

The US Internal Revenue Code provides special incentives for certain industries and activities, the most important of which are aimed at encouraging corporations to develop new, and refine existing, technology by offering tax incentives to corporations engaging in research and development activities. Corporations may claim a deduction or credit for certain research and experimental expenditures incurred in connection with the corporation's trade or business that represent research and development costs in the experimental or laboratory sense. In addition, a special research credit may be claimed by corporations in connection with incremental research expenses. Note, however, that a corporation claiming the research credit must generally reduce its research and experimental expenditures deduction by the amount of the credit.

2.3 Other Special Incentives
The US Internal Revenue Code also provides special incentives for a handful of other industries and businesses, including clean energy (eg, advanced energy credit, credit for electricity produced from renewable sources), railroads (eg, railroad track maintenance credit) and pharmaceuticals (eg, orphan drug credit). Businesses should generally consult with their tax counsel or tax preparer to determine their eligibility for special tax credits.

2.4 Basic Rules on Loss Relief
When a corporation operates at a net loss for a given taxable year, it incurs a net operating loss (commonly referred to as an "NOL"), which can be used to offset taxable income in other tax years. In general, a corporation can use an NOL from a given tax year to offset taxable income from the two prior years (an "NOL carryback") and the following 20 years (an "NOL carryforward").

In contrast to an NOL, in order to combat certain transactions considered to be "tax shelters," the US tax rules limit an individual's use of certain losses in situations where the individual does not have significant capital "at risk", and where the individual does not materially participate in the business generating the loss. These limitations generally apply to individuals who incur these losses directly or through the ownership of pass-through entities or other "closely held" corporations.

Different rules apply to individuals and corporations with respect to the tax treatment of capital gains and losses. For individuals, capital gains and losses are first characterised as long-term (underlying asset held for more than one year) or short-term (underlying asset held for one year or less). For individuals, short-term capital losses are first applied to offset short-term capital gains. Long-term capital losses are then applied to offset long-term capital gains. If there is a net short term capital loss, it would then be applied to offset the net long-term capital gain.

If a net capital gain results at the end of this netting process, tax rates lower than the normal tax rates applicable to ordinary income will apply. The tax rate applicable to most net capital gain is no higher than 15% for most taxpayers. For individuals who fall within the 10% or 15% ordinary income tax bracket, some or all of the net capital gain may not be taxed. However, if an individual's taxable income is subject to the maximum individual tax rate, then a 20% tax rate is applied to the taxpayer's net capital gain. There are, however, some exceptions to these general rules. For example, where net capital gains are realized from selling collectibles, the capital gains tax rate will be 28%. If the end result is a net short term capital gain, instead of a net capital gain computed as described above, that gain would be subject to the same graduated tax rates as ordinary income.

If an individual ultimately realizes a net capital loss instead, ie, the capital losses exceed capital gains, the net capital loss may be used to reduce other income, such as wages, up to an annual limit of USD3,000, or USD1,500 if the individual is married and filing separately. Capital losses may also be carried over to subsequent years.

In contrast, unlike the rules that apply to individuals, corporations do not enjoy preferential tax treatment on their long-term capital gains, and there is no deduction against income for capital losses that exceed capital gains. A corporation first nets its capital losses against its capital gains. If the corporation has excess capital losses, the losses are carried back three years and applied against capital gains. If capital losses cannot be applied to capital gains from the preceding years, the capital losses are carried forward (up to five years) and are applied to capital gains that the corporation may realize. A corporation cannot arbitrarily pick which year the loss may be used to offset capital gains: the losses must be used in the earliest year in which there are net capital gains.

2.5 Limits on Deduction of Interest
Corporations are subject to limitations on certain types of deductions. In particular, interest deductions are subject to limitations under the so-called "earnings stripping" rules in certain circumstances where the debt-to-equity ratio exceeds 1.5:1 and the interest expenses exceeds 50% of the "adjusted taxable income" of the company. Similarly, under the so-called "AHYHO" rules, certain interest on high-yield obligations is deferred or disallowed. Also, because interest can only be payable on instruments treated as debt for US tax purposes, US tax rules can treat instruments as equity (resulting in non-deductible dividends or other payments instead of interest), notwithstanding that the instruments are labelled as or otherwise in the form of debt instruments. In particular, recent Treasury Regulations can apply to treat certain related party debt instruments as equity. Other US tax rules can limit deductions connected to acquisitions whose principal purpose is to secure the benefit of a deduction.

2.6 Basic Rules on Consolidated Tax Grouping
In general, an "affiliated group" of corporations may file a consolidated income tax return covering all group members. An "affiliated group" is a chain of corporations owned by a common parent in which 80% of the vote and value of each corporation is generally directly or indirectly owned by the parent corporation. Subject to limited exceptions, foreign corporations may not file a consolidated return.

There are several advantages and disadvantages to filing a consolidated return. One of the most important advantages is the general ability to use losses generated by one corporation in the group to offset the taxable income of another corporation in the group; related corporations that do not file a consolidated return are generally not able to use losses of one corporation to offset income from another. Thus, the corporation with the income would be required to separately account for and pay taxes on its taxable income, while the corporation with the losses would generally owe no taxes and would carry the losses back or forward, as described above. In addition, corporations filing a consolidated return are generally not required to pay taxes on inter-corporate dividends. Corporations within the same affiliated group may also defer inter-corporate profits arising as a result of sales or services exchanged within the group. There are also certain disadvantages to filing a consolidated return (including the administrative burden), discussion of which is beyond the scope of this text.

2.7 Capital Gains Taxation

Unlike individuals, corporations do not enjoy preferential tax treatment on their long-term capital gains. All capital gains, whether long-term or short-term, are subject to the corporate tax rate. Moreover, capital losses may only be applied to offset capital gains. If a corporation has excess capital losses, the losses are carried back three years and applied against capital gains. If capital losses cannot be carried back, they are carried forward five years and are applied to capital gains that the corporation may realise. A corporation cannot arbitrarily pick which year to apply the loss to: the losses must be used in the earliest year in which there are net capital gains. If capital losses are not used to offset capital gains within the relevant time frame, the losses are deemed forfeited. When a net capital loss is carried to another tax year, it is treated as a short-term loss. The capital loss does not retain its original identity as either long-term or short-term. Corporations may not use capital losses to either produce or increase net operating losses in the year in which the capital loss is carried back.

2.8 Other Taxes on Transactions

In addition to the US federal income taxes imposed on incorporated businesses, such businesses may also be subject to numerous other taxes, including state, local and municipal income taxes, a range of withholding taxes, sales and other transfer taxes, employment and payroll taxes and, for non-US businesses, taxes imposed under the Foreign Investment in Real Property Tax Act of 1980 (commonly referred to as FIRPTA).

2.9 Other Notable Taxes

In addition to the US federal income taxes imposed on incorporated businesses, such businesses may also be subject to numerous other taxes, including state, local and municipal income taxes, a range of withholding taxes, sales and other transfer taxes, employment and payroll taxes and, for non-US businesses, taxes imposed under the Foreign Investment in Real Property Tax Act of 1980 (commonly referred to as FIRPTA).

3. Division of Tax Base Between Corporations and Non-Corporate Business

3.1 Closely Held Local Businesses

Closely-held businesses in the United States typically operate in non-corporate form, usually as sole proprietorships, partnerships or LLCs. Partnerships and LLCs are either treated as pass-through entities for US federal income tax purposes or are eligible to elect such treatment through the check-the-box rules. The income earned by a pass-through entity is not subject to tax at the entity level, but rather is allocated to the owners of the entity, who are then subject to tax on the income. This single level of taxation can be more favorable than the double level of taxation applicable to US corporations and their shareholders. Further, with an entity treated as a pass-through for tax purposes, any tax losses that the entity has generally pass through to the owners and may be used to offset the owner's other income, subject to certain limitations.

Partnerships and LLCs have other advantages over corporations unrelated to the double taxation that generally results from a corporate form of operation. Partnerships and LLCs (treated as pass-throughs for tax purposes) can make special allocations of income, gains, losses, deductions and credits among their owners to reflect complex economic arrangements. Non-tax considerations also make partnerships and LLCs desirable, such as limited liability for their owners and flexible governance arrangements, though the extent of these advantages depends on the particular laws of the state of organization.

While partnerships and LLCs are generally the preferred form of entity to operate a closely held business, a "Sub-chapter S Corporation" is sometimes used (albeit less frequently now that people have become more comfortable using LLCs). A Sub-chapter S Corporation is a hybrid between a partnership and a corporation where (i) tax is generally not imposed on the entity but instead the income and losses generally pass-through to its owners (similar to a partnership for tax purposes) and (ii) it follows certain corporate rules for distributions, redemptions and reorganizations for corporations. Nonetheless, for non-tax purposes, an S corporation must still observe all corporate formalities applicable under state law, and does have the liability protections normally afforded corporations.

In order for a corporation to qualify as a Sub-chapter S Corporation, it must meet numerous requirements, including:

- having 100 or fewer shareholders;
- having no non-US resident shareholders;
- having only one class of stock;

- having only shareholders that are individuals, estates, certain trusts and certain tax-exempt organizations; and
- conducting a business that is not a financial institution, an insurance company or certain other types of businesses.

Despite these detailed requirements, a Sub-chapter S Corporation is often the preferred form of entity for a pre-existing corporation that is seeking to achieve pass-through taxation because the conversion itself does not generally result in tax, whereas a conversion from a corporation to a partnership or LLC would result in a taxable liquidation.

Despite the advantages of operating as a pass-through entity, some closely held US businesses will choose to operate as corporations for a variety of reasons, including facilitating an initial public offering and to rely on the robust and settled case law governing corporations in certain states. Additionally, non-US persons generally favor conducting business in the United States through corporations rather than pass-through entities in order to avoid incurring a requirement to file a US tax return, thereby becoming subject to the investigatory authority of the Internal Revenue Service, and due to certain US tax laws that specifically eliminate some of the benefits of pass-through taxation for certain non-US persons.

3.2 Corporate Rates and Individual Rates

While entity level corporate tax rates may be lower than individual tax rates, various factors and rules exist that discourage individual professionals (eg, architects, engineers, consultants, accountants) from forming corporations taxed as corporations to earn income for their services. As discussed above, corporations and their shareholders are subject to two levels of taxation which, when combined, are greater than the generally applicable individual income rates. Nonetheless, if earnings are not distributed to shareholders, then the corporate form may offer tax savings.

Accordingly, there are rules governing personal service corporations that prevent individual service providers from utilizing corporate entities to reduce their tax burden. A personal service corporation is a corporation that performs personal services as its principal business, and such services are substantially performed by the corporation's employee-owners. If a corporation is deemed a personal service corporation, the IRS may allocate the income, deductions, credits, exclusions and other allowances of the corporation between the corporation and its employee-owners in certain circumstances.

3.3 Accumulation Earnings for Investment Purposes

Passive activity loss rules limit the deductions and credits that closely-held corporations and personal service corporations can claim with respect to passive activities. Under these rules, losses and credits derived from passive activities cannot be used to offset income from other non-passive activities. A passive activity is a trade or business activity in which the taxpayer does not materially participate; this generally means a regular, continuous and substantial involvement in the operations of the activity, which, in some instances, is interpreted to be over 500 hours of participation. In addition, in certain circumstances, an "accumulated earnings tax" of up to 20% can apply to earnings of a corporation that are not distributed, to the extent that such accumulated earnings are beyond the reasonable needs of the business.

3.4 Sales of Shares in Closely Held Corporations

Individuals are generally taxed at the preferential long-term capital gains rate on the sale of shares in a closely-held corporation that have been held for a period of more than one year. Short-term capital gains on the sale of shares held for one year or less are taxed at the same rate as ordinary income. The long-term capital gains rates applicable to individual taxpayers are 0%, 15% or 20%, depending on the income tax bracket of the taxpayer. "Qualified" dividends (dividends paid by US and certain non-US corporations with respect to stock held by the owner for a certain minimum holding period) are also taxed at the preferential capital gains rate. Dividends received by individuals and capital gains from the sale of shares in a corporation may also be subject to an additional 3.8% tax as "net investment income".

3.5 Sales of Shares in Publicly Traded Corporations

The taxation of dividends and gains applicable to individuals holding shares in a publicly traded corporation are the same as those applicable to those who hold shares in a closely-held corporation. Thus, individuals are generally taxed at the preferential long-term capital gains rate on the sale of shares in a publicly traded corporation that have been held for a period of more than one year. Short-term capital gains on the sale of shares held for one year or less are taxed at the same rate as ordinary income. The long-term capital gains rates applicable to individual taxpayers are 0%, 15% or 20%, depending on the income tax bracket of the taxpayer. "Qualified" dividends (dividends paid by US and certain non-US corporations with respect to stock held by the owner for a certain minimum holding period) are also taxed at the preferential capital gains rate. Dividends received by individuals and capital gains from the sale of shares in a corporation may also be subject to an additional 3.8% tax as "net investment income".

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Non-US corporations may be subject to either of two different US federal income tax regimes, or both. The first regime applies to certain items of income (generally passive in nature) from US sources that are not treated as "effectively connected" with the conduct of a US trade or business (so-called "FDAP" income). The second regime applies to net income that is treated as "effectively connected with the conduct of a US trade or business."

Payments of US source FDAP income made to non-US persons are generally subject to US withholding tax at a rate of 30%, subject to certain exemptions and reductions (described further below). FDAP income subject to this type of withholding generally includes interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments. In order to determine whether a particular type of income is "US source," the US tax rules provide specific sourcing rules for each income item. For example, interest income is generally deemed to be from US sources if it is paid by a person that is a resident of the United States for tax purposes or by a US corporation on a bond, note, or other interest-bearing obligation. Dividend income paid by a corporation is also generally US-sourced if it is paid by a corporation incorporated in the United States. Rental income is sourced by reference to the location or place of use of the leased property. Royalties are sourced in the place of use (or the privilege of use) of the property for which the royalties are paid. Gain derived from the sale of personal property is generally sourced by the residence of the seller (subject to certain exceptions, including for inventory property, depreciable property and sales attributable to an office or other fixed place of business in the United States). Thus, such gains of a nonresident alien individual or non-US corporation are generally exempt from US federal withholding tax, unless they are treated as being effectively connected with the conduct of a US trade or business (see discussion under FIRPTA).

The 30% withholding tax may be reduced or eliminated pursuant to a provision of US tax law, or a tax treaty between the United States and the country in which the recipient of the income is resident. For example, withholding tax for US source interest may be eliminated under the statutory "portfolio interest" exemption. Interest generally qualifies as "portfolio interest" where the underlying loan instrument is issued in registered (as opposed to bearer) form and certain other requirements are met, including that the beneficial owner of the obligation holds less than 10% of the issuing corporation's stock and is not a bank.

US income tax treaties may also operate to reduce (or eliminate) the statutory rate of withholding on FDAP items – such as interest, dividends and royalties – to 0% (often for interest) or 5-15% (often for certain dividends and royalties). In each case, the reduced treaty withholding rate is only available to a treaty person who: (i) qualifies as a resident of the treaty country within the meaning of the treaty, (ii) is a beneficial owner of the passive income item at issue, and (iii) otherwise satisfies any applicable limitation on benefits provisions of the treaty. Common tax treaties that non-US persons utilize when investing into the United States are those between the United States and the Netherlands, Ireland, and Luxembourg.

An additional withholding may be imposed under the Foreign Account Tax Compliance Act ("FATCA"), which is a US tax regime enacted in 2010 in order to prevent US persons from evading US tax by holding income-producing assets through accounts at Foreign Financial Institutions ("FFIs") or through other non-US entities (Non-Financial Foreign Entities – "NFFEs"). FATCA generally requires FFIs to identify US account holders and report them to the IRS (either directly or by reporting to the FFI's home country, which will then share such information with the IRS pursuant to an applicable intergovernmental agreement). In addition, non-US entities that are not FFIs (ie, NFFEs) and are passive entities are generally required to provide information regarding their ownership to withholding agents, including identifying any substantial US owners (generally, US owners that hold an interest greater than 10% in the passive NFFE). FFIs and NFFEs that do not comply with the requirements of FATCA incur a 30% withholding tax on payments to them of certain categories of US source passive investment income, as well as on gross proceeds from the sale or other disposition of debt or equity interests in US issuers.

4.2 Primary Tax Treaty Countries

The primary tax treaty countries that foreign investors use to make investments in US corporate stock or debt are the Netherlands, Ireland, and Luxembourg.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

If an entity is a resident of a Contracting State within the meaning of an income tax treaty (ie, the United States or the treaty partner) and satisfies the requirements of the limitations of benefits provision of the treaty (to the extent that one exists in the treaty), that entity is generally entitled to the benefits of an income tax treaty between the United States and a foreign country. However, there are certain circumstances in which the US tax authorities will challenge the use of treaty country entities by non-treaty country residents.

Certain treaties to which the US is a party contain a limitations of benefit ("LOB") clause that is intended to prevent "treaty shopping", and is premised on the idea that an entity that is a resident of a Contracting State must have some connection to that country in order to be eligible for the income tax treaty benefit in question. While the LOB provisions may differ in treaties, it is common for the provision to enumerate a number of objective tests that can be used to establish entitlement to treaty benefits, such as a public company test, an ownership and base erosion test, an active trade or business test, and a derivative benefits test. An entity that fails these tests may nonetheless apply to the competent authority for a determination that it did not engage in treaty shopping and is still entitled to treaty benefits.

In addition to applying any LOB provisions in the applicable tax treaty, the United States may challenge the use of treaty country entities through various economic substance and substance over form doctrines. These doctrines are discussed in further detail in **7.1 Overarching anti-avoidance provisions**, below, and include both judicially created doctrines and more specific statutory and regulatory provisions (eg, a regulatory provision disregarding intermediate entities in conduit financing arrangements). Thus, for example, if the treaty country entity is a mere conduit or if its involvement is an unnecessary step engaged in for tax avoidance, the United States may disregard the treaty country entity and apply tax treaties (if any) according to what it views as the true substance of the transaction. However, the US has specifically recognized investment holding companies as serving a valid business purpose, with the result that they will generally be respected.

4.4 Transfer Pricing Issues

The United States has one of the oldest and most mature transfer pricing regimes. In addition, in 2010, the IRS reorganised its international division to focus its resources on the enforcement of transfer pricing rules and regulations and resolve transfer pricing disputes, among other things. The increasing complexity of transfer pricing disputes has led the IRS to require substantial evidentiary support from the taxpayer. At the outset, an inbound investor will have to be prepared to substantiate the transfer pricing methodology chosen, among other things. Treasury regulations provide penalty protection if a taxpayer prepares and maintains contemporaneous transfer pricing substantiation documents at the time they file the relevant tax return. The principal documents required include the following:

- an overview of the company's business, including an analysis of the economic and legal factors that affect the pricing of its goods or services;
- descriptive statements of the taxpayer's organisational structure covering all relevant parties engaged in transactions potentially relevant under Section 482, including foreign affiliates whose transactions directly or indirectly affect the pricing of property or services in the US;
- any documentation explicitly required by Section 482;
- a description of the method selected and an accompanying explanation of why that method was selected, including an evaluation of whether the regulatory conditions and requirements for application of that method, if any, were met;
- a description of the alternate methods that were considered and an explanation as to why they were not selected;
- a description of the controlled transactions, including terms of sale, and any internal data used to analyse those transactions;
- a description of the comparables that were used, how comparability was evaluated, and if any adjustments were made;
- an explanation of the economic analysis and projections relied upon in developing the method;
- a description or summary of any relevant data that the taxpayer obtains after the end of the tax year and before filing a tax return, which would help determine if a taxpayer selected and applied a specified method in a reasonable manner; and
- a general index of the principal and background documents, and a description of the record keeping system used for cataloging and accessing those documents.

This is not an exhaustive list, as background documents on the assumptions, conclusions, and positions contained in the principal documents may also be requested.

The IRS's focus on transfer pricing and on inbound distributors specifically has not abated. For example, in June 2016, the IRS inaugurated a campaign to target possible transfer pricing noncompliance by US distributors of foreign parents' goods. It has been reported that the IRS campaign is focused on the activities of inbound distributors in five states and, at the time of the announcement, was expected to grow fairly rapidly.

For inbound investors, knowledge of the adversarial nature of the complex US transfer pricing regime is important. IRS audits can be time consuming and costly.

4.5 Related Party Limited Risks Distribution Arrangements

Section 482 of the Internal Revenue Code employs the arm's-length standard. As such, where a limited-risk distributor purchases products for resale from a related party, the price at which the products are purchased (ie, the transfer price) must be arm's-length. This, in turn, is dependent upon the functions performed and risks assumed by the distributor. Thus, with respect to a limited-risk distributor, the transfer price should be respected if the profits earned by the limited-risk distributor are comparable to the profits earned by an unrelated distributor performing similar functions and, likewise, assuming limited risks.

4.6 Variation from OECD Standards

The United States has a comprehensive transfer pricing regime, which it currently believes sufficiently addresses the issues raised by BEPS Actions 8 through 10. Thus, the US transfer pricing regulations are generally viewed as being consistent with the OECD standards. A question remains, however, regarding how the OECD guidelines will be interpreted by other countries and, thus, there remains a possibility that the guidelines will be interpreted by other countries in a way that results in differences.

5. Key Features of Taxation of Non-local Corporations

5.1 Taxation of Non-local Corporation Versus Local Subsidiaries

Non-US entities may operate in the United States either through a subsidiary structure or through a branch. In a subsidiary structure, the foreign parent entity incorporates a wholly-owned corporate subsidiary in the United States, making it a separate corporate legal entity distinct from the foreign parent. The US subsidiary is liable for US tax on all profits earned by the US subsidiary, at up to a 35% federal corporate income tax rate (plus applicable state or other taxes). Further, the repatriation of profits (a dividend distribution) by the US subsidiary to the foreign parent is generally subject to a withholding tax of 30%, subject to treaty relief.

Conversely, a non-US entity may operate in the United States through a branch, which can be a legal entity separate from the non-US entity if such entity is a pass-through entity such as a partnership or LLC, or can be an office or other fixed place of business that is not a legal entity. Because a branch is not a US corporation, the income from the US branch passes through to the non-US entity. The non-US entity would then report, and be subject to, US tax on the income that is "effectively connected" to the US business at normal US corporate tax rates (up to 35% federal tax plus applicable state or other taxes). The non-US entity with effectively connected income operating through a branch may also be subject to a branch-level tax of 30% (which may be reduced pursuant to a tax treaty). The branch profits tax is imposed on the repatriation of the earnings from a US branch to its foreign home office. In addition, the tax is applicable to excess interest paid or accrued on liabilities booked in the United States. Interbranch interest and certain exempt interest in bank deposits are exempt from the branch profits tax. Thus, the intent behind the branch profit tax provisions is to put the earnings and profits of a branch of a foreign corporation deemed remitted to its home office on equal footing with the earnings and profits of a US subsidiary that has paid out dividends to its foreign parent.

5.2 Capital Gains of Non-residents

In general, capital gain derived by non-US persons (including non-US corporations) from the disposition of stock issued by a US entity is not subject to US tax. If a non-US person sells the stock of a US entity that holds substantial US real property, however, such gain might be subject to US tax under the Foreign Investment Real Property Tax Act ("FIRPTA"). FIRPTA generally applies to impose US net income tax at regular graduated rates on the sale of a US corporation if 50% or more of the fair market value of the corporation consists of US real property (or consisted of US real property within the previous five years), and on the sale of a pass-through entity (such as a partnership or LLC) to the extent the partnership or LLC owns any US real property.

5.3 Change of Control Provisions

Generally, there are no change of control provisions that could apply to trigger tax or duty charges upon the disposal of an indirect holding higher up in the overseas group. Judicially developed doctrines such as the sham transaction and economic substance doctrines may operate to pierce arrangements structured for tax avoidance purposes.

5.4 Determining the Income of Foreign-owned Local Affiliates

Mandatory formulas are not used to determine the income of foreign-owned local affiliates selling goods or providing services in the United States. Rather, pursuant to the US transfer pricing rules and regulations, a taxpayer must select an appropriate pricing method to test the arm's-length nature of its transfer prices. While formulas are used in transfer pricing, the values in the formula are derived from uncontrolled transactions. For example, a cost-plus arrangement applies a formula whereby the entity is reimbursed for its costs and provided with an arm's-length markup, but this markup is derived from the markup earned in uncontrolled transactions, and should therefore not be seen as a "mandatory formula."

In the context of services, a transfer pricing method referred to as the services cost method ("SCM") provides for reimbursement at cost with no markup; essentially a cost-plus 0%. The SCM may only apply to "specified covered services." While this may be viewed as a formulaic approach, the SCM is an elective method.

5.5 Deductions for Payments by Local Affiliates

Where a non-US affiliate charges a related US entity for management and administrative expenses incurred by it, the costs charged will be determined against the "arm's-length" standard. In certain cases, the SCM may apply (see above).

5.6 Contraints on Related Party Borrowing

In light of the benefits that can be obtained from interest deductions, combined with the availability of exemptions from withholding on interest payments, related party debt is subject to special scrutiny, including under (i) earnings stripping rules, (ii) related-party debt rules for certain large group entities, and (iii) general substance over form principles of the US tax rules.

Under the US "earnings stripping" rules, a deduction for interest paid by a corporation to (or guaranteed by) a related lender may be disallowed to the extent the interest exceeds

50% of the adjusted taxable income of the corporation if the payor corporation's debt-to-equity ratio is greater than 1.5:1 on the last day of its taxable year (and if other conditions are met).

Recently issued Treasury regulations regarding debt between related entities set forth certain documentation requirements that must be complied with in order for a purported debt instrument issued and held by certain members of an "expanded group" to be treated as debt for US federal income tax purposes. These regulations only apply to a purported debt instrument issued by a US corporation and held by a member of such US corporation's expanded group (which generally is a corporation directly or indirectly connected by at least 80% common ownership). Currently, the regulations do not generally apply to purported debt instruments issued by non-US corporations. The regulations provide that issuers of purported debt instruments need to prepare and complete documentation establishing that such instrument meets the following four essential indebtedness factors:

- it provides for an unconditional obligation to pay a certain sum on demand or at one or more fixed dates;
- it establishes that the holder has the rights of a creditor to enforce the obligations thereunder;
- there is a reasonable expectation of repayment of the obligations under the instrument, pursuant to the issuer's financial position; and
- the holder of the instrument undertakes actions evidencing a valid debtor-creditor relationship.

In addition, these regulations treat certain purported debt instruments as equity for tax purposes in certain other circumstances, notwithstanding that the documentation requirements are met.

In order for an instrument to be treated as debt for US tax purposes, US tax rules provide that the instrument must satisfy certain criteria that establish that the instrument, in substance, is a debt instrument. Deference is given to a variety of judicially developed factors and other factors set forth in the US tax rules, such as:

- whether the instrument provides for an unconditional obligation to pay a certain sum at specified maturity;
- whether the instrument is subordinated to other indebtedness of the corporation;
- the level of capitalisation of the company (the debt-to-equity ratio);
- the source of payments;
- the intent of the parties to create a debtor / creditor relationship;
- the ability of the debtor to make required interest and principal payments (based on reasonable projections); and
- whether the instrument provides for a right to enforce payments.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

US corporations are subject to tax on their worldwide income (subject to various deferral rules); the United States does not currently have a territorial system. Accordingly, the same tax rules that apply to income earned by a US corporation in the US apply to income earned by a US corporation in a foreign jurisdiction. This worldwide taxability often results in the income of a US corporation earned overseas being taxed twice, by both the US and the foreign jurisdiction. In order to address instances of double taxation, the US tax law generally permits a US corporation to credit certain taxes paid to foreign jurisdictions against its US taxes, subject to limitations.

6.2 Taxation on Dividends from Foreign Subsidiaries

Dividends received by US corporations from their foreign subsidiaries are generally taxed at the ordinary 35% US corporate income tax rate. US taxes on these dividends, however, can generally be reduced by certain non-US taxes paid by the foreign subsidiary paying the dividends (the so-called "indirect foreign tax credit"). In order to be eligible for this indirect foreign tax credit, the US shareholder corporation must own 10% or more of the interest in the foreign subsidiary at the time the dividend is received.

6.3 Use of Tangibles

Intangibles developed by US corporations may be used by non-US subsidiaries. However, when related entities use such intangibles, the IRS expects the US entity to charge the related non-US subsidiary a fee for such use, which is an "arm's-length" price – ie, a price that the US corporation would charge if the related entity were a separate company operating at arm's length. Royalties earned by the US entity from the licensing arrangement are subject to US tax.

6.4 Taxation of Income of Non-local Subsidiaries Under CFC-type Rules

Pursuant to the US "controlled foreign corporation" ("CFC") rules, a US corporation can be taxed on the income of its foreign subsidiaries before the foreign subsidiary distributes such amounts. The CFC rules prevent the deferral of US taxes through the accumulation of profits in foreign subsidiaries through a mechanism that accelerates US tax on certain undistributed earnings of a CFC. A CFC is a foreign corporation where more than 50% of the stock by vote or value is owned by "US shareholders." For this purpose, a US shareholder is a US person who owns 10% or more of the total combined voting power of all classes of stock entitled to vote in the foreign corporation.

Once a foreign corporation is classified as a CFC, its US shareholders must currently report and pay tax on a portion of certain types of income of the CFC (including certain related-party sales and services income and passive income, such as interest, dividends and royalties), through what is effectively an annual deemed dividend. Further, gain on the sale of a CFC's shares is generally treated as a dividend rather than capital gain to the extent the earnings and profits of the CFC were not previously subject to US taxation. Actual distributed dividends paid by a CFC may not be subject to tax if the dividend is paid out of previously taxed income – ie, income that was previously subject to US tax under the CFC rules.

This treatment contrasts with income earned by foreign branches of US corporations, which is currently subject to full US corporate income tax.

6.5 Rules Related to the Substances of Non-local Affiliates

In order for transactions involving non-local affiliates to be respected, the non-local affiliate must have substance. The IRS may challenge transactions by analyzing the substance of the non-local affiliate operations. The substance is what will generally control the tax treatment, rather than the form. The various judicially created doctrines (one of which has now been codified) that may be applicable in this regard are discussed below, under **7.1 Overarching Anti-avoidance Provisions**.

6.6 Taxation on Gain on the Sale of Shares in Non-local Affliates

When US corporations sell shares of their foreign subsidiaries, any resulting capital gains are generally taxed at the ordinary corporate income tax rate of 35%. If a foreign jurisdiction also imposes a tax on the sale, however, then the US corporation might be eligible for a foreign tax credit to reduce the US corporate income tax applicable to the sale. Additionally, as noted above, if the foreign subsidiary that is sold by the US corporation is a CFC, then special rules apply to the sale, which may treat a portion of the gain as a dividend rather than a capital gain. While dividends and capital gains are currently taxed at the same rate for US corporations, the distinction may have significant consequences (both beneficial and harmful) for the purposes of calculating applicable foreign tax credits and offsetting capital gains against capital losses.

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

There are four primary judicial doctrines commonly invoked by the IRS to invalidate tax structures or transactions: the economic substance doctrine, the business purpose doctrine, the step transaction doctrine, and the sham transaction doctrine. All four are utilized by the IRS to determine the substance of the transaction over its form (substance-over-form is also sometimes used as a separate doctrine). These doctrines sometimes overlap in their application.

Traditionally, courts have used either a one- or two-pronged test to determine whether a transaction has economic substance. Under the one-pronged test, a transaction has economic substance if, viewed objectively, a non-tax business purpose exists for the transaction. Under the two-pronged test, the first prong is objective – does the transaction, viewed objectively, have economic substance? The second prong is subjective – does the taxpayer have a subjective business purpose for the transaction? Some courts that apply a two-pronged test apply the two prongs conjunctively (whereby both elements must be satisfied) and some apply the test disjunctively (whereby satisfying either prong will satisfy the test).

The economic substance doctrine was codified in 2010. Under Section 7701(o)(1) of the Internal Revenue Code, a transaction has economic substance if the transaction changes the taxpayer's economic position in a meaningful way (apart from Federal income tax effects), and the taxpayer has a substantial purpose for entering into the transaction (apart from Federal income tax effects). This section expressly provides "[t]he determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this section had never been enacted." As a result, the codification of the doctrine has had little substantive impact on when the doctrine will be applied.

In addition to codifying the economic substance doctrine, a penalty provision was added for underpayments and understatements of tax attributable to the disallowance of claimed tax benefits for transactions lacking economic substance. The penalty is generally 20%, but will increase to 40% if the taxpayer fails to disclose in its tax return the relevant facts of the item at issue. Disclosure must be made on the form prescribed by the IRS (currently Form 8275 or 8275R). Unlike many accuracy-related penalties, there is no exception for reasonable cause.

The business purpose doctrine sets forth the requirement that a transaction be driven by some business consideration other than the reduction of tax. To determine the intent of the taxpayer, many factors have been considered by the courts, including:

- whether the taxpayer had profit potential;
- whether the taxpayer cited a non-tax business reason for entering into the transaction;
- whether the taxpayer considered the market risk of the transaction;
- whether the taxpayer funded the transaction with its own capital;
- whether the entities involved in the transaction were entities separate and apart from the taxpayer;
- whether the entities involved in the transaction engaged in legitimate business before and after the transaction; and
- whether the steps leading up to the transaction were engaged at arms-length.

The step transaction doctrine applies to multi-step transactions. Under this doctrine, certain formal steps of an integrated transaction can be ignored for US tax purposes in certain circumstances. Courts apply one (or more) of the following three tests to ascertain whether transactions are integrated for tax purposes:

- the binding commitment test;
- the mutual independence test; or
- the end result test.

The binding commitment test asks if, at the time of the first transaction, there existed a binding commitment to commence the second transaction. The mutual interdependence test focuses on the relationship between the steps and asks whether the success of one step depends on the success of the series of steps. The end result test asks whether a series of transactions are actually steps of a larger, overall transaction designed to meet a final result.

The sham transaction doctrine also looks at the substance of a transaction. A sham transaction can either be a sham in fact or a sham in substance. A sham in fact is a transaction where the economic activity that generates the tax benefit at issue did not, in fact, occur. A sham in substance is a transaction that actually occurred, but the only economic effect is the creation of a tax benefit.

In the partnership context, certain "anti-abuse" Treasury regulations have been issued with the purpose of ensuring that the income tax treatment of each partnership transaction is consistent with the intent of the US partnership tax rules. In addition, a host of specific statutory and administrative provisions may invalidate specific transactions or subject them to adverse treatment, including, for example, with respect to disguised sales, related party losses, mixing bowl transactions, issuances of profits interests, and various others.

8. Other

8.1 Regular Routine Audit Cycle

In the United States, taxpayers are generally obliged to file tax returns with the IRS on an annual basis, but there is not a regular, routine audit cycle. In general, the IRS may audit a tax return for three years after the due date of the tax return or the date it was filed, whichever is later. If there has been a substantial omission of gross income on the return, the statute of limitations is extended to six years. The taxpayer and IRS can agree to extend the statute of limitations. This often happens when a statute of limitations for a year under audit is due to expire and the IRS has not yet completed its audit. It is important to note that there is no statute of limitations where a required return has not been filed or where the IRS alleges that there has been fraud. This can be a trap for the unwary where, for example, a non-US person has a US income tax filing obligation but fails to file the required return.

Whether or to what extent a taxpayer may be subject to audit depends, in part, on the nature of the taxpayer, ie,individual or smaller entity versus large entity.

Individuals and Smaller Entities

Individuals and organisations that do not meet the requirements of the IRS's Large Business & International ("LB&I") Examination Process may be subject to an audit for any year. For such taxpayers, the IRS uses several methods for selecting a tax return for audit, including random selection and computer screening, related examinations, and information-matching.

Some returns will be selected for audit simply based on a statistical formula where the IRS compares returns against "norms" for similar returns. The "norms" are developed from audits conducted by the IRS as part of its National Research Program. A return also may be selected for an audit because it involves an issue or transaction with other taxpayers whose returns have been selected for audit. This may occur, for example, where the return of a business partner or investor has been selected for audit. In addition, since 1984, certain investment transactions are required to be registered with the IRS by the investment organiser as a tax shelter. Any person who claims a loss, deduction, credit or other tax benefit or who reports any income from the tax shelter must report the tax shelter registration number on the relevant return. While this is not a guarantee of an audit, the likelihood of an audit is increased if an investment is classified as a tax shelter by the IRS. Information matching may result in an audit where, for example, a bank issues an interest statement but the income reported on a return does not match. Other methods for audit selection may occur; for example, where there is a local compliance initiative.

If a return is selected for audit, the IRS will notify the taxpayer by mail. There have been a number of phone and email "scams" in recent years as a result of various data breaches and many people have, unfortunately, responded to these fake requests and either lost a considerable amount of money or released Trojan horse programs into their computer systems. The IRS has warned about these scams and reiterated that they will not initiate an audit by telephone or email. The IRS encourages people who receive such scam calls or emails to report them to the IRS.

Assuming an audit is undertaken, it will be managed either by mail or through an in-person interview to review relevant records. The interview may be held at an IRS office or at the taxpayer's home or office. The IRS will request various documents that the examining agent wishes to see. Additional requests may follow. The length of the audit is dependent on the facts and circumstances.

LB&I Taxpayers

The LB&I Division of the IRS serves entities (including pass-through entities such as partnerships) with assets greater than USD10 million. Some LB&I taxpayers are audited every year. The IRS recently announced a new examination process for all LB&I audits, effective 1 May 2016. For taxpayers that were already under audit on that date, changes will be made in the execution and resolution phases of the audit.

The new process is intended to provide an "organisational approach" for conducting an audit. Under the new procedures, the IRS has stated that it is seeking to work transparently and collaboratively with the taxpayer, and to engage the taxpayer in the development of the audit steps and potential timeline of the audit.

The IRS views the examination process as having three phases: planning, execution, and resolution.

In the planning phase, communication is stressed. This stage is where the scope of the audit will be set. Once LB&I determines the issues that will be audited, the audit team is expected to work with the taxpayer to establish steps that will allow the audit to be completed in a timely manner. Better communication is intended to result in a more effective audit. The IRS will try to leverage technology to increase efficiency and to explain to the taxpayer each issue that is being considered in the audit.

The issue team concept of the planning phase is new. The issue team is comprised of LB&I employees who will work with taxpayer personnel who are knowledgeable about a given issue in an attempt to establish the facts and the parties' respective positions. The end result of this phase is the examination plan.

In the execution phase, the facts will be developed and the auditor's position developed. As noted above, the IRS has broad investigatory authority and will seek information in the form of documents and possibly through interviews of current and often former employees. Where a taxpayer fails to respond to a request in a timely manner, enforcement procedures will be undertaken. Issue development is the goal of this phase, and the IRS will seek to reach agreement on relevant facts.

The IRS has announced that it is moving toward a more issue-based approach to audits and, in 2017, released its first 13 campaigns that will be a significant focus for LB&I. This new audit strategy is aimed at addressing identified compliance risks, but the campaign program does not mean that these will be the only areas examined in an audit.

In the resolution phase, the goal is to try to reach agreement, if possible, on the issues examined during the audit. An audit may be concluded in one of three ways:

- a "no change," where the tax return is accepted as it was filed;
- "agreed," where the IRS proposes changes and the taxpayer agrees with the changes; or
- "unagreed," where the IRS has proposed changes but the taxpayer disagrees with some or all of the proposed changes.

If no agreement is reached, the taxpayer may opt to attempt resolution of an issue through various alternative dispute resolution options, including accelerated issue resolution, early referral to appeals, fast-track settlement, or fast-track mediation. Alternatively, the taxpayer could "protest" the proposed changes and attempt to resolve the unagreed issues with the IRS Office of Appeals. To the extent resolution of an issue would result in double taxation and an income tax treaty exists between the countries at issue, the taxpayer could attempt to seek relief through the competent authority process. Through this process, the representatives of the two treaty countries attempt to negotiate an agreement to resolve the dispute.

Tools exist to resolve disputes before they occur, including pre-filing agreements, advanced pricing agreements for transfer-pricing issues, and private letter rulings. In addition, where an issue affects a particular industry, it is possible that the issue could be resolved on an industry-wide basis.

To the extent an audit is not fully resolved, the taxpayer may pursue litigation. In the United States, litigation may be pursued in the United States Tax Court after the IRS issues a notice of deficiency. The taxpayer need not pay the deficiency in order to litigate its dispute in the Tax Court. Alternatively, the taxpayer could choose to pay the asserted deficiency, file a claim for refund, and later file a lawsuit in either the United States Court of Federal Claims or the relevant United States District Court. The decision as to choice of forum will generally depend, in large part, on an analysis of the relevant law in that court and the court to which a decision would be appealed.

9. BEPS

9.1 Recommended Changes

The United States has a comprehensive tax regime, which it believes satisfactorily addresses the issues raised by the BEPS Action Plan.

Country-by-Country reporting, as recommended by BEPS Action 13, is the only proposal that the United States has adopted thus far. Action 13 proposed that countries require their multinational enterprises to report the following information annually and for each tax jurisdiction in which they do business:

- information pertaining to global business operations and transfer pricing policies ("master file" documentation);
- detailed transactional transfer-pricing documentation which identifies material, related party transactions, amounts involved, and the company's analysis of the transfer-pricing determinations made with respect to those transactions ("local file" documentation); and
- a country-by-country report (hereinafter "CbC report").

The CbC report is required to identify the amount of revenue, profit before income tax, and income tax paid and accrued. It also requires multinational enterprises to report the number of personnel employed, stated capital, retained earnings and tangible assets in each tax jurisdiction. Finally, the CbC report should identify each entity within the corporate group doing business in a particular tax jurisdiction, and provide a description of the business activities each entity is engaged in. Action 13 envisions that the CbC reports will be exchanged automatically pursuant to Double Tax Conventions and under Tax Information Exchange Agreements.

In June 2016, the Treasury Department released final regulations that require annual CbC reporting by US entities that are the ultimate parent entity of a multinational enterprise with annual revenue of USD850 million or more. The IRS has issued Form 8975 (Country-by-Country Report) and the accompanying Schedule A (Tax Jurisdictions and Constituent Entity Information), along with accompanying instructions for both forms. Rev. Proc. 2017-23 describes the process for filing Form 8975 and Schedule A for reporting periods on or after 1 January 2016 but prior to the required reporting period as prescribed in Treasury Regulations §1.6038-4 (TD 9773).

Citing confidentiality concerns and adequate data security protocols, the United States has opted to enter into specific bilateral agreements on the basis of double tax conventions or tax information exchange agreements, rather than sign the multilateral competent authority agreement for the automatic exchange of CbC reports. To date, the US has signed bilateral Competent Authority Arrangements with Belgium, Brazil, Canada, Denmark, Guernsey, Iceland, Ireland, the Isle of Man, Jamaica, Latvia, Malta, the Netherlands, New Zealand, Norway, the Republic of Korea, Slovakia and South Africa for the exchange of CbC reports.

9.2 Government Attitude

The US believes that its existing tax statutes, rules and regulations sufficiently address the issues raised and addressed by the BEPS recommendations, and is generally supportive of the OECD's BEPS initiative. Representatives of the US Treasury Department have actively participated in various OECD working committees, and have negotiated to ensure that US interests are properly represented and protected. In a recent interview discussing the OECD's work on transfer pricing and attribution of profits to a permanent establishment, former Deputy Assistant Secretary of International Tax Affairs at the Treasury Department, Robert Stack, stated that, at the time the BEPS proposals were being negotiated and drafted, the "United States really had to be very forceful in explaining that we would not join a consensus on a document that did not come closer to reflecting the arm's-length standard than what those earlier drafts were doing." There is some concern amongst US lawmakers, however, that BEPS proposals may allow foreign jurisdictions to unfairly target US-developed intellectual property, even in the absence of critical factors such as local IP development, assumption of entrepreneurial risk, presence of significant assets, etc.

9.3 Profile of International Tax

International tax has a high public profile in the US. However, as discussed above, the US believes that its current regime already addresses the key BEPS proposals.

9.4 Competitive Tax Policy Objective

BEPS reforms have had a modest impact on US tax laws and their interpretation, administration and enforcement. Currently, tax reform is a significant issue for the United States.

9.5 Proposals for Dealing with Hybrid Instruments

BEPS Action Plan, Action 2, is intended to help neutralise the effect of cross-border hybrid mismatch arrangements that produce multiple deductions for a single expense or a deduction in one jurisdiction with no corresponding taxation in the other jurisdiction. While the US has certain rules intended to address certain of the arrangements covered in BEPS (eg, dual consolidated loss rules under Section 1503(d) of the Code, which limit use of a loss in a consolidated return where such loss can also be used in a foreign jurisdiction; or denial of treaty benefits for certain payments through hybrid entities under Section 894 of the Code), such rules generally predate BEPS, and no legislative proposals addressing other aspects of Action 2 are currently active.

9.6 Territorial Tax Regime

The United States does not have a territorial tax regime, and already has certain restrictions on the deductibility of interest under Section 163(j).

9.7 Anti-avoidance Rules

The US tax system currently has judicially created anti-avoidance doctrines (economic substance, business purpose, substance over form, step transaction, sham transaction) in addition to rules and regulations that address anti-avoidance. Furthermore, certain US tax treaties have limitation on benefits provisions consistent with the limitation on benefits provision in the 2016 US Model Treaty.

9.8 Transfer Pricing Changes

The United States has one of the oldest and most mature transfer pricing regimes in the world, and the general view is that the US transfer pricing rules are consistent with the BEPS actions. Thus, the general view is that there will not be radical changes.

The application of transfer pricing rules to intangibles has been a source of controversy in the United States. Since the early 2000s, and as recently as 2016, the IRS has voiced the view that transfer pricing disputes involving intangibles is a significant focus for the United States.

9.9 Transparency and Country by Country Reporting

By adopting final regulations mandating the submission of country-by-country reports by US multinational enterprises with annual revenue of $850 million or more, the United States has made clear that it is in favour of promoting greater transparency and country-by-country reporting. However, the US has raised concerns regarding the misuse of taxpayer information and confidentiality, and the administrative and enforcement burdens associated with adhering to the proposals for greater transparency and country-by-country reporting. In addition, there is concern that US taxpayers will be forced to simultaneously comply with multiple conflicting tax rules, which carries with it increased tax burdens and compliance costs, and defending disputes in multiple jurisdictions. Moreover, leakage of confidential or proprietary, competitive information remains a significant concern.

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