

# TAXATION

## LEGAL ISSUES IN THE UNITED STATES

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**As you prepare to launch your Australian business in the United States, taxation ought to be one of your foremost considerations. Understanding the US tax system, and ensuring your US tax affairs are both efficient and fully compliant, will benefit your business both in the US and in Australia.**

### THE US TAX SYSTEM

#### Income taxes

The US levies income taxes at a federal, state and local level.

Federal income tax is levied on a corporation's 'taxable income' (revenues less deductible costs). The statutory rate was reduced from 35 per cent to 21 per cent from 1 January 2018.

State income tax is also levied on 'taxable income' where such income is allocable to a state in which the taxpayer has a taxable presence. The rate varies from state to state, ranging from 0 per cent in six states (four of which impose a gross receipts tax) to 12 per cent in Iowa.

There are a range of local taxes that corporations must be aware of and comply with, such as city taxes (like San Francisco gross receipts tax) and taxes on specialty items (such as luxury items, alcohol and tobacco).

#### Indirect taxes

##### Sales tax

Sales taxes are levied at the state and/or local level in the US and are charged on the sale of goods and services. Five states have no sales tax, while California has the highest state rate at 7.25 per cent. Local municipalities may also charge a separate sales tax.

##### Use tax

The Use Tax is imposed on transactions that would have been subject to the sales tax if both buyer and seller were located in the same state. It is usually imposed on the use, storage or consumption of tangible personal property in the state.

##### Property tax

Property taxes are administered at the local government level, and are payable on both residential and commercial properties

##### Payroll taxes

Employers in the US are obliged to withhold personal income taxes, social security and medicare taxes from employees' pay checks, and remit these amounts to the Internal Revenue Service (IRS) on the employees' behalf.



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## Choice of entity

### Corporation (Corp)

Corporate subsidiaries are effectively a standalone entity taxed on their activities in the United States. A Corp creates two distinct layers of taxation – once at a corporate level, and once at a shareholder level upon distribution of profits.

### Limited Liability Companies (LLC)

LLCs, much like branches or partnerships, are not taxed separately like C corps. Instead, all profits effectively 'pass through' to the LLC's members, who are subject to US taxation (at both federal and state level, although some states do tax LLCs separately). Any members based overseas will therefore be required to file a US tax return.

## Timing of income taxation

### Tax returns

US federal and state income tax returns are filed annually. Returns for C corps are due to be filed no later than 15 April following the accounting period end (assuming a calendar year end), while LLCs and partnerships must file tax returns by 15 March following the accounting period end. Six-month filing extensions are available, but must be applied for in advance of the initial filing deadline.

### Payment of income taxes

Although extensions are available for the filing of federal and state returns, dates for payment cannot be deferred. Companies in taxpaying positions must generally make estimated payments throughout the course of the year, in April, June, September and December (assuming a calendar year end).

## Growing your business

### Income taxed on net basis

US corporations are taxable on their worldwide income on a net basis.

## Deductions

US corporations are allowed to deduct expenses from their income before computing any income tax payable. In accordance with IRS rules, deductible expenses must be 'ordinary and necessary' in the course of business. For example, such expenses would include:

- › cost of goods sold
- › employee expenses
- › sales and marketing costs

### Interest limitation

Under the new tax reforms, from 1 January 2018 a US company is only able to deduct interest expense of up to 30 per cent of its 'adjusted taxable income' (for example, earnings before interest, taxes, depreciation and amortisation (EBITDA) prior to 2022; earnings before interest and taxes (EBIT) from 2022).

Any amount of interest expense beyond this threshold will not be currently deductible but can be carried forward and deducted in a future year as permissible.

### Carry forward of Net Operating Losses (NOLs)

If a US company incurs NOLs in an accounting period after 1 January 2018, it can no longer offset those losses against profits on which tax was paid in prior years ('NOL carry backs'), except for limited situations. Instead, companies are able to carry forward such NOLs indefinitely, offsetting the losses against taxable profits as and when they arise in the future.

### Net Operating Loss income limitation

The new tax reforms also introduced a limitation on the amount of NOL that a corporation may deduct in a single tax year. The amount is restricted to the lesser of the NOL carryover, or 80 per cent of a company's taxable income (before NOL).

## CASE STUDY – Australian TechCo to broach US market with first US office

### Challenge

A Sydney based start-up company in the e-commerce space ('TechCo') is looking to establish its first US office to build its brand in the US and also seek US capital.

### Critical Thoughts

A number of tax questions are key to successfully establishing the US office:

- Location – many states offer tax credits, rebates, and/or grants to build in-state operations
- Entity structure – while an LLC legal form is simpler, any foreign groups establish a subsidiary in C corporation form to avoid pulling the foreign parent into the US tax net
- Funding – funding start-up costs through debt-versus-equity financing has different tax costs and must be analysed carefully
- Transfer pricing – establishing up-front transfer pricing policies between the US subsidiary and Australian parent should clarify the allocation of profits between the US and Australia and hopefully avoid double taxation risks

### Outcome

By carefully considering the critical tax components of building their US operations, TechCo is able to establish a US team, build brand recognition, and increase US sales in a tax-efficient manner.

## Cross border transactions

### Transfer pricing

US companies providing services to a related party must ensure that all transactions (the provision of services, purchase of equipment, royalty payments, loans and interest payments) are conducted at 'arm's length' (similar to commercial terms between two unrelated third parties). This is particularly true where two related parties are in different tax jurisdictions, where tax authorities are wary of the potential for profits to be shifted into low-tax regimes. US tax rules require annual documentation of the arm's-length pricing on related party transactions to avoid penalties should the IRS assess additional tax liability on such transactions in a tax audit. Thus, documenting and applying even basic transfer pricing policies is crucial for companies with international operations.

### Withholding Taxes

Under US domestic law, payments of royalties and interest to overseas businesses are subject to a default withholding tax of 30 per cent, meaning that the US company making the payment must withhold 30 per cent of the amount in question, and declare and pay this amount to the IRS. Depending on the tax rules of the recipient's country of residence, the recipient would ordinarily expect to then take a foreign tax credit in respect of the income withheld by the US tax authorities.

The US has a Double Tax Treaty in place with Australia, under which the 30 per cent standard rate of withholding is reduced to 10 per cent. The Australian recipient of the payments would then claim a foreign tax credit when preparing its Australian tax return, subject to Australian tax rules.

### Profit repatriation

Similar to the rules regarding interest and royalty payments outlined above, US corporate businesses repatriating profits in the form of dividends to an overseas parent must ordinarily withhold 30 per cent of the dividend amount and pay such to the IRS. The foreign parent typically may claim a foreign tax credit

for the amount withheld by the US company, subject to home country tax rules.

Because of the Double Taxation Treaty in place between the US and Australia, while US companies still have to make a withholding on any dividends paid to an Australian parent company, the rate is reduced to 15 per cent, with the Australian company claiming a Foreign Tax Credit in respect of the withheld Australian tax return.

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