How To Conduct Distribution Operations in the United States

Chiu & Wang, Inc
Premier Tax Services

The advice in this communication is not intended or written by Chiu & Wang, Inc. to be used, and cannot be used, by a client or any other person or entity for the purpose of (i) avoiding penalties that may be imposed on any taxpayer or (ii) promoting, marketing or recommending to another party any matters addressed therein.

All information provided is of a general nature and is not intended to address the circumstances of any particular entity or individual. Although we endeavor to provide timely and accurate information, there cannot be no guarantee that such information is accurate as of the detail is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

Selling Products to the U.S. Customers Directly

- What activities will you be conducting in the United States?
- Will you keep inventory in the United States?

Activities

- If your activities are ***considerable, continuous and regular,*** you may be considered engaging in the conduct of a trade or business in the United States.
  - Any income effectively connected with the conduct of a U.S. trade or business is taxable in the United States.
- If you hire an agent and this agent has authority to negotiate and conclude contracts on your behalf, you may be deemed to be engaged in the conduct of a U.S. trade or business
- If you keep inventory in the United States, very likely you will be deemed to be engaged in a U.S. trade or business.

Effectively Connected Income

- Generally, income, gain, or loss from sources within the U.S. will be treated as effectively connected with the conduct of a trade or business within the United States.
- If you have an office or fixed place of business in the United States and earn foreign source rents or royalty income that is derived in the active conduct of U.S. trade or business, this foreign source income is also considered effectively connected income.
- Sale of inventory will be considered U.S. source income if the inventory title passes within the U.S.
- If you have an office or fixed place of business in the United States, and the U.S. office materially participates in the sale (solicitation of orders, negotiation of contract, and performance of significant services necessary for the consummation of the sales which are not the subject of a separate agreement), the sales income will be considered U.S. source income regardless where the inventory title passes.

Sourcing Rules for Inventory Produced Directly by You Outside the U.S.

- The gross income (sales minus cost of sales) on the sale is divided into income attributable to sales activity and production activity.
- There are three methods that determine gross attributable sales activity and production activity:
  - 50/50 method (default method),
  - Independent factory price method (elective method), or
  - Books and records method (subject to prior consent of the IRS)
- If your production assets are located outside of the U.S., income attributable to production activity should be foreign source income.

How To Minimize U.S. Tax Exposure?

- Avoid passing title, beneficial ownership, and risk of loss of inventory to the purchaser within the United States.
- Avoid conducting any considerable, regular and continuous activities in United States
  - If you're from a country that has signed an income tax treaty with the United States, you may be protected by the treaty
- Avoid granting authority to negotiate and conclude contract to an agent
- If you cannot do any of the above, please contact us.

Conduct U.S. Distribution Operations Through a Branch

- Not a separate legal entity, simply an extension of a foreign corporation
- Branch taxable income is gross income effectively connected with the conduct of a U.S. trade or business minus deductions connected with such income
- Taxed at regular corporate tax rates with the maximum federal rate of 35% plus state taxes
- Also subject to branch profits tax and branch-level interest tax

Branch Profits Tax

- 30% on foreign corporation's effectively connected earnings and profits not reinvested in the United States – Dividend Equivalent Amount
- Based on increase or decrease of U.S. net equity – U.S. assets minus U.S. liabilities
- Could be reduced by an income tax treaty with the U.S.

Branch-Level Interest Tax

- Interest paid by the U.S. trade or business is treated as if it were paid by a U.S. corporation and subject to tax at 30%
- Excess of interest allocated to the U.S. trade or business over the interest paid by such trade or business is treated as interest paid by its U.S. subsidiary and subject to tax at 30%
- Could be reduced by an income tax treaty with the U.S.

Pros and Cons of Operating Through a Branch

- Pros
  - U.S. taxes paid by the branch may be used as a credit again head office's home tax
  - Transactions between U.S. branch and head office are disregarded
- Cons
  - The branch may expose the foreign corporation to U.S. tax on other activities
  - Branch profits tax and branch-level interest tax are complex and difficult to control

Conduct U.S. Distribution Operations Through a U.S. Subsidiary

- Taxed on worldwide income at a maximum federal rate of 35%
- Dividends and interest paid to foreign parent are subject to withholding tax at 30% (or a lower rate if there is a tax treaty)
- Transactions with related parties are subject to an arm's length standard – the transfer pricing rules
- Deductibility of interest expense paid to related parties is subject to limitations:
  - Earning stripping rule
  - Matching principle

Pros and Cons of Operating Through a Subsidiary

- Pros
  - Easy to control second-level tax (e.g., dividend and interest withholding tax)
  - The ability to leverage a U.S. subsidiary through third-party debt or intercompany debt is greater than a branch
- Cons
  - Transactions with foreign parent must meet arm's length standard

Where To Go From Here?

- There are ways to minimize U.S. tax impact legally.
- For example, you can consider limiting the risks born and functions performed by the U.S. subsidiary so that profits allocated to the U.S. subsidiary can be limited.
- If you want to know more about it, please call us at: (562) 463-3818, or send us an e-mail at: info@chiu-wang.com.

Final Words

- The statements contained in this document do not represent our opinion or recommendation. In compiling these statements, we are relying upon the relevant provisions of the Internal Revenue Code of 1986, as amended, the regulations thereunder, and the judicial and administrative interpretations thereof. These authorities are subject to change, retroactively and/or prospectively, and any such changes could affect the validity of our conclusions. We will not update these statements for subsequent changes or modifications to the law and regulations or to the judicial and administrative interpretations thereof. We strongly suggest that you consult your advisor for any appropriate actions.