

**Tax: US AND AUSTRALIAN TAX EXPERTS DAN CASSIDY AND THEO SAKELL UNRAVEL THE COMPLEXITIES OF DOING BUSINESS IN AMERICA.**



## Complying with Uncle Sam

IMAGINE THAT A MEDIUM-SIZED software company comes to you with a plan to sell its latest application to the heavy hitters in Silicon Valley or to Microsoft. This is the company's first foray into the US. The owners see huge potential for sales and profits.

You, on the other hand, see a complicated US tax system ruled by the heavy-handed Internal Revenue Service (IRS), different income tax rates in each of the 50 states, countless sales tax rates that differ by municipality, estate taxes and gift taxes. However, you also see the opportunity to help the client through the tax challenges in a way that will help them bring home maximum allowable profits, and avoid IRS scrutiny.

### Get advice and choose the appropriate structure

Many businesses interested in doing work in the US make the mistake of waiting until they have established their business there before getting advice. This could cost them significantly in the long run. It's imperative to choose the right structure from the beginning. Should the business be structured as a branch or subsidiary? If the wrong structure is chosen it is often too expensive to restructure. As the type of structure is contemplated, the business should also consider its exit strategy from the very beginning. Does

the business hope to sell its US subsidiary to a US company? Does it plan to sell it to an Australian company? Does it plan to sell the US entity as part of the Australian entity? Does it plan to take the US entity public?

Most businesses that enter the US expect that their business will succeed and produce profits. However, there is also the risk it will fail. When structuring the business it's important to consider what tax relief is available if the business does fail. The best structure that assumes the business will be profitable may not be the best structure to claim losses if the business fails. Often it is best to create a structure for losses or significant appreciation, or one that's flexible enough to get benefits on both sides, but not necessarily the maximum benefit on either side.

Another question is how the business will be funded. Will the business be capitalised with debt or equity? Be aware of US earning stripping rules,

### In general, it's better for Australians to work in the US under a visa rather than a green card



which may limit the ability of the US subsidiary to deduct interest paid to a related party. Similarly, beware of Australia's thin capitalisation rules, which can permanently deny debt deductions for Australian businesses with controlled offshore entities or offshore businesses. The balance between debt and equity needs to be determined to comply in both Australia and the US while maintaining commercial flexibility. It is generally preferable to equity-fund the US subsidiary to avoid creating a problem in the US under earning stripping rules and to limit any adverse Australian thin capitalisation impacts. You should determine the maximum level of debt funding permitted to attain utmost flexibility on repayments and charging interest. Also be aware of US interest withholding taxes of up to 10 per cent of gross interest paid or credited.

Australian entities doing business in the US must also be aware of American employment taxes and employee tax rules. In general, it's better for Australians to work in the US under a visa rather than a green card. Look after Australian employees to make sure they're complying with IRS rules – and that they file US tax returns. Australians working in the US must have the appropriate visa, know how much time they can stay and work, and understand the tax impact of their employment package.

### Doing business in the US – the challenges

There are definite opportunities and challenges to doing business in the US. The first challenge, and perhaps the biggest, is dealing with the complex US tax laws.

The tax differential between Australia and the US is significant. Usually it's 10–15 per cent, and in the extreme it can be up to 40 per cent!

The Australian perception that the IRS is a serious organisation that vigorously enforces US tax laws is accurate. US taxes are perhaps the highest in the world and enforcement is strict, much stricter than in many regions such as Asia. The IRS is especially strict in administering transfer pricing policies and any attempt to strip profits out of the US back to Australia through transactions and charges. Businesses will have to navigate around transfer pricing rules in both countries.

Tax rates differ significantly. An Australian businessperson will typically pay a flat 30 per cent income tax rate via a company, although this would not be a final tax. That number could be much higher in the US, where the federal income tax rate is up to 35 per cent. Australian businesses will also be liable for a US dividend withholding tax to get money back to Australia from the US via dividends. Depending on how the Australian business is structured going into the US, there could be >

> additional taxes. If the Australian business's US business is structured as a C Corp and holds more than 10 per cent via an Australian company, it will pay an additional 5 per cent tax. Otherwise, the US dividend withholding tax could be as high as 15 per cent. Add that up and it could be greater than 50 per cent of every dollar spent on US taxes.

Not all Australian companies are aware that many US states have their own income taxes. The rates vary from state to state and in some cases come close to 10 per cent. Furthermore, the individual states are not parties to international income tax treaties. This means that protections Australians may assume they have under the Australian United States Income Tax Treaty may not protect them from state taxes. In particular, Australian businesses that are exempt from US taxes because their activities do not rise to the level of a permanent establishment in the US may still be subject to significant state income taxes.

Most individual states also have a sales tax. Unlike Australia's GST, not all sales taxes are automatically passed on to consumers and aren't easily tracked. Australian companies must learn about the intricacies of the US sales tax system and understand how to apply the taxes to goods and services sold in a way that they can be recouped.

Another major issue for privately held Australian companies is how the US tax laws impact the personal taxes owed by the owners of these companies on eventual repatriation of US profits to these owners. As the US has one of the highest personal individual tax rates in the world, this is especially important to Australian owners who are seeking to maximise after-tax returns from their offshore operations. A fundamental flaw in Australia's international tax rules is the general inability to obtain foreign business income tax offsets in Australia for US federal and state income taxes paid on profits generated in the US. Typically, maximum effective tax rates of up to 70 per cent can be incurred. These challenges are further compounded by the practical inability to use Australian trusts to

conduct businesses in the US. Businesses should consider some alternative structures to reduce their effective tax rates.

In addition to income and sales taxes, Australian individuals with US business interests could be subject to US estate taxes upon death. US estate taxes are based on the fair market value of the assets held at death, with rates as high as 45 per cent.

## **The opportunities**

To try to nullify the big challenges of doing business in the US, there are many solutions for how to structure a business. In the US a business can be structured as a Limited Liability Company (LLC) or a Limited Liability Partnership (LLP). The way in which existing business is structured in Australia may allow the business to adopt more transparent tax outcomes in the US as well. The business structure may allow the Australian business to get full foreign income tax offsets for US taxes. However, such structuring is complex particularly from a US tax perspective. It requires an Australian individual or trust to be the member of the LLC or partner of the LLP and for such Australian individuals or entities to file US tax returns and pay US income taxes.

No doubt, US taxes are significant and the tax code is complicated. But it's the land of many opportunities. For the Australian company intent on taking advantage of these, early planning and expert execution could lead to successes with high profit potential. ■

**Dan Cassidy is tax principal international tax with Clark Nuber in Seattle, Washington. He has extensive experience assisting inbound and outbound companies navigate the US tax system. Reach him at [dcassidy@clarknuber.com](mailto:dcassidy@clarknuber.com).**

**Theo Sakell is partner and executive director in the tax consulting division of Pitcher Partners, an independent member firm of Baker Tilly International, in Melbourne, Australia. He heads the firm's international tax specialisation and advises on the structuring and financing of inbound and outbound transitions and inpatriate and expatriate planning. Reach him at [theo.sakell@pitcher.com.au](mailto:theo.sakell@pitcher.com.au).**