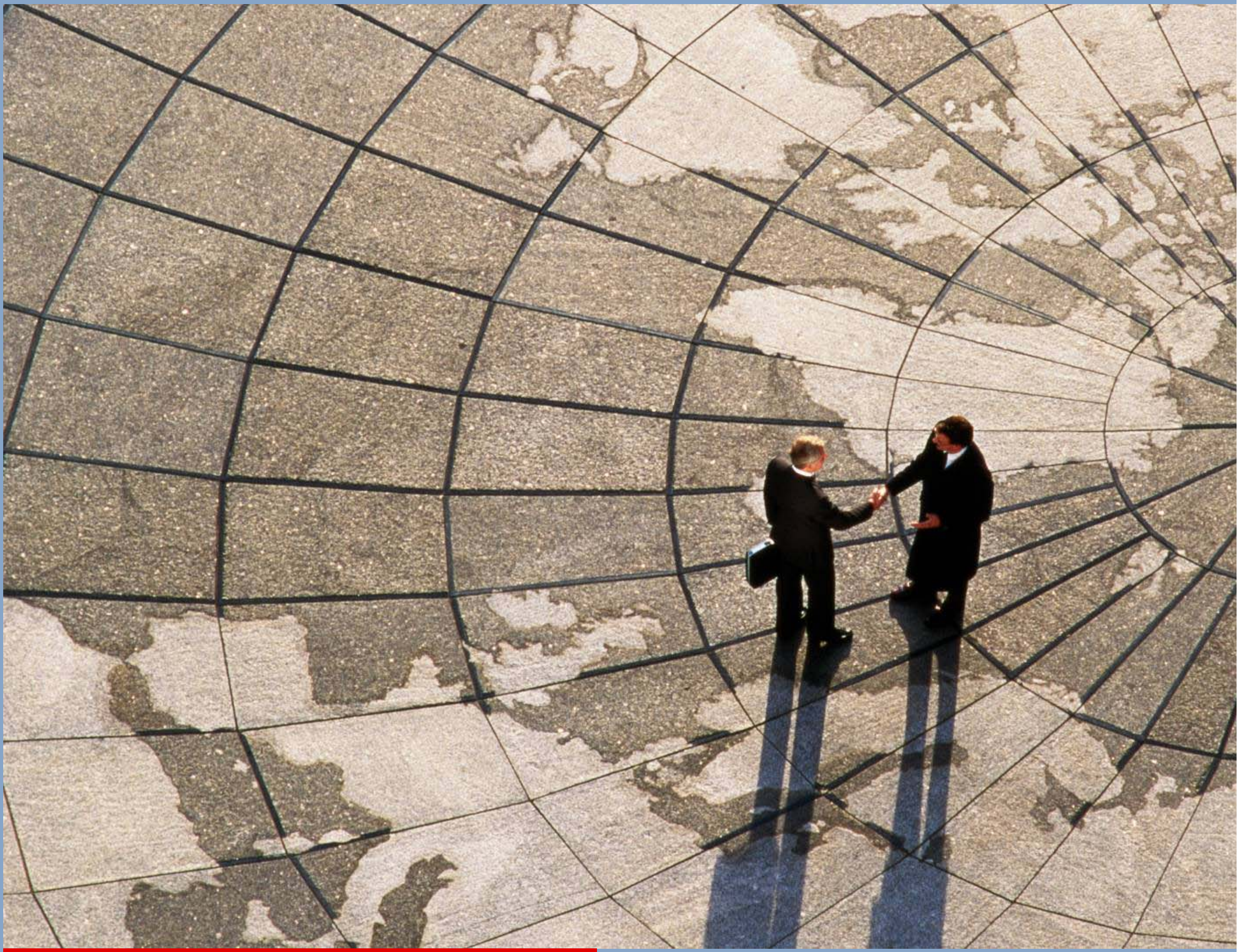

Doing Business in the United States 2008

May 2008

BDO International

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Introduction

The aim of this publication, which has been prepared for the exclusive use of BDO Member Firms and their clients and prospective clients, is to provide background information for setting up and running a business in the United States, in compliance with the legislation in force on 31 January 2008. It is of use to anyone who is thinking of establishing a business in the United States as a separate entity, as a branch of a foreign company or as a subsidiary of an existing foreign company, and to anyone who is considering coming to work or live permanently in the United States.

The publication describes the business environment in the United States and outlines the financial and legal implications of running, or working for, a US business. The most important issues are included, but it is not feasible to discuss every subject in detail within this format. Accordingly, *Doing Business in the United States* 2008 is written in general terms and is not intended to be comprehensive. If you would like to know more, please contact the BDO Member Firms with which you normally deal, who can provide you with information on any further issues and on the impact of any legislation subsequent to 31 January 2008.

BDO International is a worldwide network of accounting and consulting firms, called BDO Member Firms, serving international clients. Each BDO Member Firm is an independent legal entity in its own country. The network is coordinated by BDO Global Coordination BV, incorporated in the Netherlands, with an office in Brussels, Belgium, where the Global Coordination Office is located.

Founded in Europe in 1963, it has grown to be the fifth largest in the world – the BDO network now has 629 offices in 111 countries, with more than 31 500 partners and staff providing professional auditing, accounting, tax and consulting services on every continent.

BDO's special skills lie in applying its local knowledge, experience and understanding of the international context to provide an integrated global service. In BDO, common operating and quality control procedures are not a constraint on innovation and independence of thought, but the starting point. It is a vigorous organisation committed to total client service.

BDO's reputation derives from consistently offering imaginative and objective advice within the client's time constraints. BDO Member Firms take pride in their clients' success and their relationships with them. It is a personal relationship that combines the benefits of professional knowledge, integrity and an entrepreneurial approach, with an understanding of a client's business and an ability to communicate effectively. This ensures the highest-quality objective professional service, tailored to meet the individual needs of every client, whether they be governments, multinational companies, national or local businesses, or private individuals.

Doing Business in the United States 2008 has been written by BDO Seidman LLP, the US Member Firm of BDO. Its contact details may be found on page 58 of this publication.

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1. The business environment

General information

Geography

The United States of America is a federation of 50 legally independent states with its capital in Washington DC. The 48 contiguous states cover an area of 4560 km from east to west and 2280 km from north to south. The other two states are Alaska, which borders northwest Canada, and Hawaii, a group of islands in the Pacific Ocean. Other US possessions include the territories of Puerto Rico, Guam, American Samoa, the Northern Mariana Islands and the US Virgin Islands. Canada and Mexico border the USA and thus present additional and relatively accessible markets.

The capital, Washington DC, has a population of 550 521. The five largest cities are New York (8 143 197), Los Angeles (3 844 829), Chicago (2 842 518), Houston (2 016 582) and Philadelphia (1 463 281) – all population figures are US Census Bureau estimates as at 1 July 2005. Four other cities have populations of over 1 million.

Government

The United States is a presidential republic, in which the President is both head of state and head of the executive branch of government. Presidents are elected every four years, indirectly by means of an Electoral College. Each State of the Union has a number of Electoral College votes (indirectly in proportion to its population). Thus California, the most populous state, has 55 Electoral College votes, whereas the least populated States have 3 votes, as does Washington DC. There are currently 538 members of the Electoral College. The Presidential candidate winning the most votes in any State takes that State's Electoral College votes, on a winner-takes-all basis (except in Maine and Nebraska). Thus it is possible for a candidate to win the popular vote but still lose the election (as last happened in 2000). Presidential elections are held on the first Tuesday in November. No President may hold office for longer than two consecutive terms. The current (and 43rd) President of the United States is George W Bush, of the Republican Party. His second term ends this year, and his successor will be elected in November 2008.

The legislative branch of government is the US Congress, which consists of two houses – the Senate and the House of Representatives. The Senate consists of 100 members, two for each State, and is presided over by the Vice-President. The senatorial term is six years. Senatorial elections take place every two years, with a third of all senators up for election each time. The House of Representatives has 438 members, one for each congressional district. Both Senate and House elections are won on a simple plurality, first-past-the-post system. Currently, the Democratic Party has a narrow majority in both houses of Congress.

Much legislative power remains with the States, each of which has its own elected legislature and is presided over by a directly elected Governor.

Language

The official language of the United States is English.

Currency

The unit of currency is the US dollar (USD). There are 100 cents in one dollar. At the time of going to press (early May 2008), the US dollar was quoted against the euro at USD 1.5492 = EUR 1.

The economy

The United States is one of the world's largest and most vigorous business markets with annual economic growth of about 2% based on a constant demand for new and improved products and services. With over 200 US cities each numbering 100,000 or more inhabitants, the total population is currently more than 290 million and is expected to surpass 400 million by the year 2050. The country's real gross domestic product (GDP) was USD 13.971 million million (EUR 9.018 million million) in the 3rd quarter of 2007. Estimated per capita annual income averaged USD 45 594 (EUR 29 425) in 2007.

Weights and measures

The US uses a variant of the Imperial system of weights and measures.

Business entities

General commercial law

Under the federal system, federal and state governments share governmental powers. In certain areas, activities such as interstate commerce (shipments or activities crossing state lines) are subject to both federal and state laws. Foreign capital is treated in much the same manner as domestic capital. Investments from abroad, including the acquisition of US business by foreign persons, are not generally restricted, except in regulated industries such as aviation, banking, insurance, utilities, and, in some cases, agriculture.

Due to the reporting requirements, especially federal, when purchasing property or acquiring domestic businesses, foreign companies intending to do business in the US should obtain competent legal counsel.

Forms of business enterprise

US law allows for various forms of business organisation, primarily sole proprietorships, partnerships (general or limited), limited-liability companies, limited-liability partnerships and corporations. There is no federal business corporation law, and each state has its own laws and regulations for forming businesses and establishing proprietorships, partnerships and branch offices. Establishing a branch requires only registration with state and municipal authorities.

Employment and labour relations

Availability of labour

About 70% of the US population (approximately 203 million persons) comprises the available labour pool. About 6% of this pool remained unemployed in early 2003. In contrast to many other countries, workers in the US are responsive to opportunities that require relocation. This mobility facilitates finding and employing an adequate work force.

Employer/employee relations

Labour (trade) unions represent approximately 15.5% of the total labour force, varying significantly by industry and region. They constitute an important aspect of employer/employee relations, which should be considered when choosing locations. Usually organised into 'locals', they negotiate with management on collective contracts for employees. They do not represent company or plant management, and, in general, do not participate in management decisions.

Non-union companies are not required to establish employment contracts, but usually make various personnel policies known to employees upon hiring.

In 2003, gross hourly earnings, including overtime, averaged approximately USD 15 (EUR 9.75) per hour. The standard working week is 40 hours, over five days, with overtime being paid at a percentage of the regular hourly rate. In the case of termination, it is customary to give employees a two-week notice, or more, if specified in the terms of employment. Federal law makes it illegal to discriminate on the grounds of sex, race, nationality, or religion in employment, training, and related matters, and some states have additional employment and protection requirements. The following federal benefit programmes protect employees:

Social security

This covers nearly all employees, providing retirement and disability benefits. The employer and employees share costs equally. For rates, see Chapter 7.

Unemployment compensation

Unemployment compensation and the benefits to employees vary from state to state. The cost to employers generally averages 3.2% of the first USD 7000 (EUR 4525) of wages.

Other benefits

Most employment arrangements, union or non-union, provide for the following:

- *Holidays* are observed by most companies and employees receive basic pay for them. Companies generally observe between six and eight federal holidays per year and may also observe state, local, and other holidays
- *Vacations* vary from one to four weeks' paid leave, depending on level of employment, years of service and other criteria. There is no legal requirement to grant a paid period of leave, but most companies do grant employees paid vacation time
- *Healthcare and life insurance* costs are usually shared by employer and employee, with reduced-rate premiums for group plans
- *Pension plans* are offered by many companies and employer-maintained plans cover about 70% of the work force through voluntary or contractual agreements supplementing social security retirement payments. Eligibility and the amount of benefits depend on the individual's earnings and number of years of contribution to the plan.

The basic social security plan generally provides for:

- monthly reduced benefit, beginning at the minimum age of 62
- disability benefits under certain circumstances
- death benefits to dependants
- certain elements of medical coverage.

Companies are not required to provide supplementary profit-sharing or retirement programmes, but many do offer them.

Family and Medical Leave Act of 1993 (FMLA)

Most eligible employees are entitled to a total of up to 12 working weeks of unpaid leave during any 12-month period for the following purposes:

- the birth of a son or daughter of the employee and the care of such son or daughter
- the placement of a son or daughter with the employee for adoption or foster care
- the care of spouse, son, daughter, or parent of the employee who has a serious health condition
- a serious health condition of the employee that makes the employee unable to perform the essential functions of his or her position.

Work permits

A foreign worker must obtain a visa to become employed in the United States. Such visas are issued to two basic categories of person: immigrants and non-immigrants. Immigrants are those who wish to enter the United States on a permanent basis. Visas for these individuals are usually more difficult to obtain and are generally allocated according to a system of preferences based on annual quotas. Non-immigrant visas are for temporary periods. The US consular office at US embassies and consular posts world wide issue these visas. While there are many categories of non-immigrant visa classifications, the classifications used most often by foreign business people are the following:

- B-1 *visas* (*temporary business visitors*) This visa is issued to a foreign citizen visiting the US for brief and limited business activity on behalf of a foreign employer. Such visas are issued for an initial period not exceeding six months and may be extended for an additional six-month period under certain circumstances.
- E-1 *and* E-2 *visas* (*treaty traders and investors*)**.** Where a treaty of friendship, commerce and navigation exists between the US and certain countries, an E-1 or E-2 visa may be issued. E-1 visas are for the sole purpose of carrying out trade between the US and the foreigner's home country. An E-2 visa is for the furtherance of a business venture in the US in which the foreigner or the foreign employer has a substantial capital investment. These visas are issued for an initial period of one year and may be renewed for additional periods of two years indefinitely
- H *visa* (*temporary employees or trainees*. These visas may be granted to foreigners coming to the US to perform a particular service or acquire training for use in a foreign country
- L-1 *visa* (*intra-company transferee*). L-1 visas are issued to foreign managers, executives or individuals with specialised knowledge who have been employed by the foreign employer for at least one year abroad. This visa is ideal for an individual who will be sent to set up or supervise a US operation. The L-1 is issued for up to three years, subject to renewals not to exceed a total period of seven years. As with the E-1, E-2 and H visas, the foreigner may receive payment for services from a US source.

It should be noted that due to the complexity and timing of obtaining visas, legal advice should be sought and sufficient time should be allotted for the issuance of the appropriate visas.

2. Finance and investment

Banking and local finance

Sources and methods of financing

Among the many sources of capital and credit in the US are venture capitalists, private investors, commercial banks, institutional lenders and investment banks or underwriters, which arrange most of the larger-issue, long-term financing. Foreign banks may conduct business and lend to foreign companies in the specified free-trade zones (New York, San Francisco, Houston and Miami).

Banks

National banks receive their charter from and are monitored by the Comptroller of the Currency, US Treasury Department. They must be members of the Federal Reserve System (an independent central banking authority controlling the supply of money and credit, holding banking-system reserves and regulating member banks) and the Federal Deposit Insurance Corporation (FDIC). State banks are organised under State law, and regulated and supervised by State banking authorities, similar to the national system. Most are members of the Federal Reserve System.

Short-term financing

Commercial banks usually provide lines of credit, bankers' acceptances or letters of credit for short-term financing, and may require security depending on the borrower's reputation and familiarity to the bank. Entities usually have substantial core capital supplemented by borrowings. Rates are based on the size and type of borrowing, collateral, term and purpose of the loan and many other factors.

Interest rates generally vary depending on the prime rate, which fluctuates in response to the economy and the value of the dollar, among other factors. A bank's best customers can usually receive the prime rate or less, whereas others pay an agreed-upon amount in excess of the prime rate.

Equipment and real-estate leasing are available through several sources. While this can raise the cost of money, it can also provide additional liquidity and help conserve working capital.

Long-term financing

Institutional lenders, insurance companies and pension funds provide long-term financing. By lending against real-estate mortgages, for example, they provide funds for constructing and equipping business facilities. Interest rates are normally determined based upon the borrower's credit rating, collateral, provisions for sinking funds or early redemption, and the lender's perception of future inflation. Federal and State securities laws govern the sale of bonds to the general public.

Equity markets

Investment bankers and underwriters also arrange financing through equity securities (stock), sold to the general public in compliance with federal and state regulations. Shares in US corporations differ from those in most other countries in the following ways:

- US corporate shares are registered in the name of the shareholder or designated nominee
- a designation of par value is of little significance and bears no relevance to real value.

There are extensive secondary trading markets for both stocks and bonds, principally the New York Stock Exchange, the American Stock Exchange and the National Association of

Securities Dealers Automated Quotation (NASDAQ), and a broad over-the-counter market. Daily security trades are routinely reported in the newspapers and on the Internet.

Foreign inter-company lending

The US has thin-capitalisation and earnings-stripping rules that affect the interest deduction in the US, when a foreign parent (or related entity) lends money to a US subsidiary.

Thus, consideration must be given to the debt-to-equity ratio of the transaction. If the ratio exceeds 1.5 to 1, limitations may be placed on the interest-expense deduction allowed. These rules may be changed in the near term.

Offshore financing

An important source of offshore financing for US investors is the Eurodollar market. Eurodollar loans are available from commercial banks and Eurodollar bonds can be sold.

Regulatory agencies

Anti-trust and anti-competitive practices

Anti-trust (anti-monopoly) legislation protects the basic competitive environment in the United States and the general public interest. There are no statutory price controls in the United States, except in certain regulated industries such as electric and natural gas companies, and anti-trust and related statutes prohibit price discrimination, restricted competition and deceptive advertising. Price setting or collusion is also strictly prohibited by federal and state laws, and subject to heavy penalties. The Federal Trade Commission (FTC) and the Anti-trust Division of the Department of Justice are responsible for enforcing anti-trust policies, and have assured and demonstrated non-discrimination against foreign investors.

Consumer and environmental protection

Federal and state laws require that products be properly labelled and adequately quality-controlled to protect public health and safety. The following federal agencies administer these laws:

Table 1

Agency	Responsibility
Food and Drug Administration	Content and labelling of foods, drugs, cosmetic and therapeutic devices
US Department of Agriculture	Quality of meats, milk and other foods
US Department of Transportation	Vehicle quality and safety
Federal Trade Commission	Labelling of non-food and non-drug products and false advertising
Environmental Protection Agency	Prevention or elimination of pollution

States have their own environmental standards, enforced through voluntary compliance or court action when necessary. Prospective investors need to be familiar with these standards and can contact the individual States' environmental agencies for further information.

Import and export controls

The US is a member of the General Agreement on Tariffs and Trade (GATT) and the World Trade Organisation (WTO), and is committed to the free international exchange of goods and services, and to reducing existing tariffs and other trade barriers.

The US Bureau of Customs is responsible for monitoring imports. It is possible to obtain a binding ruling on tariff classification and rate of duty by supplying to the Commissioner of Customs a complete description of the goods imported, including cost of manufacture and intended use. From time to time, quotas and/or taxes limiting the quantity of certain imports are imposed to protect domestic industry.

Exports are free of duties and proceeds are free of exchange controls, subject to US foreign policy requirements on trade with certain countries.

Reporting requirements for foreign investors

The Bureau of Economic Analysis (BEA) of the US Department of Commerce has developed comprehensive reporting requirements to track certain foreign activities in the US for analytical and statistical purposes. The reports cannot be used for purposes of taxation, investigation or regulation, and disclosure of information in these reports is immune from legal process. The following activities are tracked:

- acquisition of a 10% or more voting interest in a US enterprise by a foreign person
- acquisition of a US business enterprise by an affiliate of a foreign person that has merged into the affiliate
- acquisition of real estate by a foreign person for business purposes, no matter what the size
- transactions between a US affiliate and its foreign parent
- formation of a new foreign affiliate if done by a US controlling entity or person
- creation of a joint venture between a US and foreign person
- total acquisitions during a fiscal year of real estate and business interests by a foreign person.

Patents, trademarks and copyrights

The US Department of Commerce, Bureau of Patents and Trademarks grants patents for 20 years, with exclusive rights to the holder. Trademarks are also registered with the Bureau of Patents and Trademarks for a renewable 20-year period. Generic terms cannot be registered.

Copyrights cover computer software, books, periodicals, lectures, sermons, plays, musical compositions, motion pictures, works of art, drawings, photographs, maps, models and advertising. A copy or sample must be deposited with the Copyright Office. Books and periodicals must first be published, carry a copyright notice and be filed (two copies) with the Library of Congress. Copyrights are valid for the life of the creator plus 50 years, or, for a corporation, 75 years from the date of first publication. The theft of trade secrets, which are protected under US law, raiding a competitor for key personnel, or industrial espionage are considered unfair methods of competition.

Accounting and auditing requirements

Governance of financial reporting

Historically, financial reporting in the United States has been heavily regulated and, as a result, the country has one of the most detailed and structured accounting and reporting requirements in the world. These requirements have been developed by professional bodies and, for publicly held companies, also by the Securities and Exchange Commission (SEC).

The Financial Accounting Standards Board (FASB), an independent organisation, through the issuance of its Statements of Financial Accounting Standards (SFAS), is the predominant body responsible for establishing generally accepted accounting principles (GAAP) used in the preparation of financial statements.

The SEC administers the federal securities laws, including financial reporting rules and regulations. These laws include the Securities Act of 1933, governing the registration of securities to be sold in interstate public offerings, and the Securities Exchange Act of 1934, which deals with the periodic filing requirements of publicly held companies and the rules covering their applicable trading markets.

Many changes in US regulation have occurred with the passage in July 2002 of the Public Company Accounting Reform and Investor Protection Act of 2002, also known as the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act). The Sarbanes-Oxley Act is far-reaching and may be the most significant reform to the securities laws since they were enacted in the 1930s. It establishes a Public Company Accounting Oversight Board (PCAOB) to oversee public accounting firms, establishes new rules and sanctions for public accounting firms that audit public companies, and clearly places responsibility for public-company financial statements with corporate officers. It also gives the SEC general oversight over the PCAOB and the ultimate responsibility for enforcing the provisions of the Sarbanes-Oxley Act.

The Sarbanes-Oxley Act establishes fundamental changes on how audit committees, management and auditors carry out their respective responsibilities and interact with each other. It lays out specific requirements for each of these parties with regard to corporate responsibilities, auditor regulation and independence, and financial reporting. It also provides for enhanced and, in some cases, new criminal penalties for corporate fraud. The scope of the Sarbanes-Oxley Act is very broad. Public companies subject to the Sarbanes-Oxley Act include both domestic and foreign firms that are registered with the SEC as well as those companies that have filed registration statements under the Securities Act of 1933, which are not yet effective. Additionally, public accounting firms subject to the Sarbanes-Oxley Act are not limited to domestic firms. Any foreign public accounting firm that prepares or furnishes an audit report with respect to a public company or participates in the audit of a significant foreign subsidiary of a public company that is registered with the SEC is subject to the Act, including the rules of the PCAOB.

Statutory reporting requirements

There is no legal requirement for a privately owned company to prepare financial statements unless the company operates in a regulated industry or the financial statements are required by an agreement (a bank loan, for example). However, most companies registered with the SEC are required to file the following reports:

- F*orm* 10-K, containing two or three years' (depending on the amount of revenues reported and the market value of the company's securities held by non-affiliates) comparative audited financial statements, a comprehensive analysis by management of its financial condition and results of operations, certain disclosures regarding the business, its directors and executives, trading market and securities holders, and other schedules to be filed with the SEC annually currently within either 60 or 90 days of a company's fiscal year-end depending on the market value of the company's securities held by non-affiliates. In addition to the report on the company's financial statements, large public companies also are required to have their auditor audit and report on internal controls over financial reporting.
- F*orm* 10-Q, containing unaudited quarterly financial statements (reviewed by the independent auditor in accordance with the US attest standards) and a comprehensive analysis by management of its financial condition and results of operations to be filed with the SEC currently within either 40 or 45 days after the

end of each of a company's first three fiscal quarters, depending on the market value of the company's securities held by non-affiliates.

- *Form* 8-K, a report describing certain specific significant events, such as the acquisition of a business, to be filed with the SEC ordinarily within four business days of the occurrence of the event.

In addition, public companies generally prepare annual stockholders' reports containing financial information similar to that included in Form 10-K.

Foreign companies whose securities are traded on a US stock exchange, NASDAQ or the Over-the-Counter Bulletin Board (OTCBB) or are otherwise registered with the SEC must file reports with the SEC including:

- *Form* 20-F, containing three years of comparative audited financial statements, a comprehensive analysis by management of its financial condition and results of operations, certain disclosures regarding the business, its directors and executives, trading market, security holders, and risk factors faced by the company and other schedules, to be filed with the SEC annually within six months of a company's fiscal year-end. Financial statements may be presented using local accounting principles with reconciliation to US GAAP and must be audited in accordance with US auditing standards;
- *Form* 6-K, containing unaudited interim financial statements if released to home-country shareholders (the statements must be translated into English but can be filed in the same format as they are released in the home country) or a report describing significant events, such as the acquisition of a business, to be filed with the SEC promptly following the disclosure of the event or financial information.

Under certain conditions, foreign companies that seek to acquire a publicly traded US company may be required to file financial and other information with the SEC, and such information would also be available to the general public.

Books and records

Federal and State laws require entities to maintain books and records to support the information shown in tax returns. In addition, the record-keeping requirements of certain industries (for example, banking, insurance and securities brokerage) are regulated to some extent by both federal and State regulatory bodies.

Companies subject to SEC jurisdiction are required by law to:

- keep reasonably detailed books and records which accurately and fairly reflect the transactions in and disposition of the company's assets
- devise and maintain a system of internal accounting controls which will provide reasonable assurance that:
  - transactions are properly recorded in accordance with management's authorisation
  - financial statements are prepared in conformity with GAAP and accountability for assets is maintained
  - access to company assets is permitted only with management's authorisation.

While there is no specific requirement as to where the books and records must be kept, normal practice is to maintain them at the company's principal place of business. For federal income tax purposes, books and records must be maintained for specified time periods, which may be longer under various state laws.

In 2003, the SEC issued rules requiring management of public companies to evaluate and report on the effectiveness of a company's internal-control structure and procedures for financial reporting in each annual report. The rules also require a company's auditors to attest to, and report on, management's annual evaluation. The rules have been deferred until 2008 for smaller public companies.

Auditors and auditing requirements

The SEC requires public companies to have their financial statements audited. Privately held companies are not required by law to have their financial statements audited. However, many are required to do so by banks or other creditors. Companies in certain industries that are supervised by government agencies (banking and insurance, for example) may be required to undergo an annual audit.

A company's independent auditors must generally be certified public accountants and are normally appointed by the company's management or board of directors. In the case of publicly held companies, this appointment is made by the audit committee and may be ratified by the shareholders. Auditors are subject to strict independence rules prescribed by the American Institute of Certified Public Accountants (AICPA) and those that audit public companies must also adhere to even stricter rules promulgated by the SEC. These rules are intended to ensure that the auditor is independent in both fact and appearance and is therefore in a position to issue an unbiased opinion on the financial statements. Direct and material indirect financial interests in audit clients are prohibited.

The auditors' report, qualified or unqualified, is based on reporting standards established by the Auditing Standards Board (ASB) for private companies and by the PCAOB for public companies. It should state whether, in the auditors' opinion, the financial statements fairly represent the financial position of the company in accordance with GAAP in the United States. In certain circumstances, the auditor may be unable to render an unqualified opinion on the financial statements, in which case either a qualified or adverse opinion would be issued or the auditor may disclaim an opinion.

In a qualified report, a separate explanatory paragraph should be included as to the reasons for the qualification. The SEC will generally not accept an auditors' report that is qualified as to either audit scope or the accounting principles used. An audit opinion may also be modified due to going-concern uncertainties, which is also accepted by the SEC.

Some companies that do not require or desire audits may engage an accountant to perform review or compilation services instead. A review report indicates that the accountant is not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with GAAP. On the other hand, in a compilation, an accountant reads the financial statements to determine whether they are free of obvious material errors, but no assurances are given as to the accuracy and/or integrity of the financial statements.

Auditing standards

The standards to which auditors who audit private companies must adhere are established by the ASB as *Statements on Auditing Standards*, which are more comprehensive than those of most other countries. In addition, many accounting firms have internal standards that may impose stricter standards on personnel than those required by the profession.

The Sarbanes-Oxley Act has resulted in fundamental changes with regard to the SEC's involvement in the establishment of auditing standards that must be applied in an audit of a public company. Through its oversight of the PCAOB, the SEC has been given the authority and is required to establish or adopt auditing and related attestation standards, including quality-control and independence standards for audits of public companies. The PCAOB has established its own professional auditing standards (i.e. auditing, attestation, quality-control, ethics and independence standards) for registered public accounting firms rather than delegate that authority as permitted under the law. Recognising that establishing standards will take several years, the PCAOB initially adopted existing American Institute of Certified Public Accountants (AICPA) and Accounting Standard Board (ASB) auditing, attestation, quality-control, ethics and independence standards. However, the PCAOB has already adopted certain additional standards that go beyond those that apply to private companies (for example, standards for auditing a company's internal controls and for audit documentation) and further standards are expected.

Accounting profession

Certified public accountants (CPAs) must be licensed by the States in which they practice and are thus governed by various State ethics rules. For privately held companies, the principal professional accounting body is the AICPA, which is responsible for establishing rules on professional ethics and auditing and reporting standards applicable to its members. Virtually all of practicing CPAs are members of the AICPA.

Prior to the passage of the Sarbanes-Oxley Act, the accounting profession was essentially self-regulated. The passage of the Sarbanes-Oxley Act effectively eliminates self-regulation for accountants who practise before the SEC.

All accounting firms that audit public companies are required to register with the PCAOB. This requirement also extends to foreign accounting firms that audit a public company (a foreign private issuer as well as a US company) or a significant foreign subsidiary of a public company. Such registered firms serving more than 100 public companies will be subject to annual quality reviews conducted by the PCAOB. All other firms will be reviewed, at a minimum, on a triennial basis. Under the SEC's rules, all members of a firm's international network are considered to be one firm and, thus, are subject to the SEC's and PCAOB's rules for public-company clients.

Form and content of financial statements

The form and content of the financial statements of most privately held companies are governed by professional standards established by the FASB and the AICPA. Publicly held companies and companies in certain regulated industries, however, are governed by the applicable regulatory body, such as the SEC. Financial statements should be prepared in accordance with GAAP and contain at least the following elements:

- a balance sheet
- an income statement
- a statement of changes in stockholders' equity
- a statement of comprehensive income
- a statement of cash flows
- notes to the financial statements, including a summary of the company's accounting policies.

It is general practice to present financial statements in comparative form, and publicly held companies are required to do so. The contents of the financial statements, including the footnotes, are the responsibility of management, regardless of who has actually prepared them or whether they are audited. If the financial statements are audited, non-compliance with GAAP will generally result in either a qualified or an adverse auditors' opinion.

Company law of certain foreign countries or unions, such as the Directives of the European Union, cause parent companies to require that their US subsidiaries maintain their books and records and prepare their financial statements in accordance with the accounting principles followed by the parent. This is acceptable under US standards, but in order to comply with US recordkeeping rules, a separate set of financial statements may need to be prepared in accordance with US GAAP.

Group financial statements

Consolidated financial statements are generally required if a company controls more than 50% of the voting shares of another company. In addition, US GAAP defines a class of entities called 'variable interest entities' (VIEs), in which the owners either have little equity at risk or do not absorb losses, benefit from gains, or make decisions. A VIE is consolidated by its 'primary beneficiary', which is the entity that absorbs more than half of fluctuations in the VIE's value, earnings, or cash flows. A subsidiary's year-end should ordinarily coincide with that of the parent. Where there are different year-ends (up to three months' difference is acceptable), appropriate disclosures should be made.

Exchange controls

The general policy of the United States is to admit and treat foreign capital on the basis of equality with domestic capital. Foreign investors may transfer or repatriate their capital freely, invest anywhere in the United States and in almost any industry. Foreign investment is limited by law in sensitive sectors of the economy such as communications, airlines, shipping, mining on federal lands and power generation.

Investment incentives

See Chapter 4.

3. The tax system

Tax structure and taxing authorities

Taxes are levied by the federal, State and local governments. Federal tax law is set forth in the Internal Revenue Code (IRC) of 1986, enacted and amended by Congress. The Treasury Department issues interpretive regulations and administers the federal law through the Internal Revenue Service (IRS).

Principal US taxes

Taxes on income and gains

These include:

- corporation income tax
- individual income tax
- income tax on trusts and estates.

Taxes on transactions

These include:

- sales and use taxes
- excise tax
- customs duties.

Taxes on transfers of wealth

These include:

- gift tax
- estate tax
- generation-skipping transfer tax
- inheritance tax.

State and local taxes

These include:

- real estate taxes
- personal property taxes

Taxes on payroll

These include:

- federal insurance contributions (social security)
- unemployment tax
- medical care tax.

Income tax structure

Under the US system, the federal government taxes all income that does not fall within one of the specific exclusions set out in the Internal Revenue Code (IRC). Income taxes are imposed on corporations, individuals, trusts and estates. The federal rates are progressive. Most corporations and estates may use either the calendar year or a fiscal-year ending (subject to certain limitations) but individuals, partnerships, and trusts generally must use the calendar year.

Federal tax rates

Federal tax consists of regular income tax and the alternative minimum tax (AMT). The top corporate income tax rate is 35%. The top income tax rate for individuals, trusts and estates is 35%, although the effective top rate may exceed 35% in some cases because of the phase-out of itemised deductions and personal exemptions. Capital gains are included in taxable income in the same way as any other income. However, long-term capital gains for sales or exchanges after 5 May 2003, and before 1 January 2011, are generally taxed up to a 15% maximum rate for individuals, trusts and estates. In addition, recent tax legislation has enacted a 15% tax rate for dividends paid from US corporations and certain qualified foreign corporations, effective up to and including 31 December 2010.

The purpose of AMT is to ensure that all taxpayers with substantial economic income pay at least some tax. The rate is 20% of the excess of the alternative minimum taxable income over the alternative minimum taxable income exemption-amount reduced by the alternative minimum foreign tax credit for corporations. For other taxpayers, the rate is 26% and 28% for tax years beginning after 1993. It is imposed on taxable income plus specified tax preferences, and is paid only to the extent it exceeds the regular income tax.

For full details, see Chapter 4 for corporate tax rates and Chapter 5 for individual tax rates.

International aspects

Domestic corporations and US citizens and residents are subject to tax on their world wide income. Foreign corporations and non-resident aliens are taxed at the same rates as domestic entities on income effectively connected with the conduct of a US trade or business. In addition, the United States imposes a tax on the US branch profits of a foreign corporation, unless the profits are reinvested in the United States.

US-source fixed or determinable annual or periodical income paid to foreigners, such as interest, dividends, rents and royalties, is subject to tax at a flat 30% (or lower treaty rate) if this income is not effectively connected with the conduct of a US trade or business. Interest paid by banks, savings institutions and insurance companies generally is not subject to this 30% tax. The tax is withheld at source by the payer.

The United States is bound by an extensive network of tax treaties, which reduce or eliminate the 30% flat tax on many forms of income. These treaties contain various provisions mitigating double taxation and require the treaty parties to appoint competent authorities to resolve disagreements. However, recourse to a competent authority rarely gives satisfactory results.

Tax administration

Federal taxes are administered and collected by the IRS, an agency of the US Treasury Department.

Corporate taxpayers

Compliance

The US tax system is based on self-assessment. The taxpayer files a return reporting taxable income and computing the tax. If the return is not filed by the due date (including extensions), the IRS may assess the tax or begin a proceeding in court to collect the tax without assessment any time after the due date.

Tax return

The federal income tax return of a corporation is due on the 15th day of the third month after the end of the tax year. An automatic six-month extension may be obtained by filing an application with the IRS.

The return must disclose all items of gross income and deductions and show the corporation's balance sheet at the beginning and end of the tax year, and reconcile taxable income with book (financial statement) income. Foreign-controlled corporations must also submit Form 5472, disclosing information on transactions with related entities. US persons owning 5% or more of a foreign corporation may be required to file Form 5471, disclosing similar information.

Payroll-tax reports generally are filed on a quarterly and/or annual basis, by the end of the month following the quarter or year.

Payment and collection

All payments of federal corporate income tax must be made to a financial institution that qualifies as a 'federal tax depositary'. Advance estimated income tax payments are due in four instalments, on the 15th day of the fourth, sixth, ninth, and twelfth months of the tax year. The balance of tax due must be paid by the 15th day of the third month after the end of the tax year. Payroll taxes (social security and withheld taxes from employees) are due at various times depending on the amounts.

Tax audits

The IRS can assess additional tax within three years of the due date for the return, or three years of the date it is filed, if filed after the original due date. A six-year assessment period applies if the taxpayer omits items of income which amount to more than 25% of the gross income reported in the return. Taxes due on account of fraud may be assessed at anytime.

Non-corporate taxpayers

Compliance and returns

Non-corporate federal taxpayers include individuals, estates and trusts. Taxpayers must file annual returns of income, which are generally due on the 15th day of the fourth month after the tax year ends. Individuals may obtain an automatic six-month extension of this due date by filing an application with the IRS. Trusts may obtain an automatic six-month extension by filing an application with the IRS. For federal tax purposes, partnerships and limited-liability companies with more than one owner which do not elect to be treated as a corporate entity are treated as transparent entities and are not taxable although they must file information returns.

Withholding on wages and salaries

Tax on income from employment is collected by deduction at source by the employer. When employment begins, the employee must give his or her employer an Employee's Withholding Allowance Certificate (Form W-4), which sets forth the withholding allowance that the employee is entitled to claim, based on his deductions and credits.

Foreign personnel

Foreign nationals resident in the United States are subject to the same compliance requirements as US citizens.

Exit permits

Departing aliens must declare their income tax liability and obtain a certificate from the director of the local IRS district. This certificate must state that the alien has complied with all obligations imposed on him or her by the income tax laws. The certificate, or proof that no certificate is necessary, must be presented upon departure. Certificates are not required for:

- foreign diplomats, their families, and servants
- alien students and industrial trainees
- certain aliens visiting for pleasure or business
- certain aliens in transit

- certain aliens admitted to the United States on border-crossing identification cards
- alien military trainees
- alien residents of Canada or Mexico who frequently commute to the United States for employment and whose wages are subject to withholding.

4. Taxes on business

Introduction

Domestic corporations are subject to tax on their world wide income. A domestic corporation that owns one or more controlled foreign corporations is generally not taxed in the United States on the income of the foreign corporation(s). However, certain types of income or transactions may cause US taxation under very complex rules. Foreign corporations are taxable only on US-source income. A domestic corporation is a corporation organised or created under the laws of the United States, any of its states or territories or the District of Columbia.

Foreign investors conducting activity in the United States may have a tax-return filing requirement if there is an actual or potential permanent establishment. This applies even when a treaty exemption is in force. The non-filing of a US tax return may subject the foreign investors to penalties and loss of US deductions in the event that it is determined that a taxable permanent establishment exists.

Taxable entities

Until recently, US entities were classified for US tax purposes based upon a set of four 'corporate characteristics'. The presence or absence of these characteristics would determine whether an entity constituted a corporation or a 'pass-through' entity.

Entity classification election

In 1996, the IRS finalised regulations enabling certain business entities to select their own classification for US tax purposes. These regulations, known as the 'check-the-box rules', are available only to 'eligible entities', which are unincorporated entities not automatically classified as corporations ('*per se* corporations') and which are not trusts. An eligible entity may generally elect to be treated as a partnership, corporation or a disregarded entity.

A 'hybrid' entity is a foreign company that is classified as a corporation for foreign tax purposes but elects to be treated as a partnership for US tax purposes. A 'reverse hybrid' entity is the converse; that is, an entity that is treated as a partnership abroad but as a corporation in the United States after the election is made. In addition, an electing entity may be required to wait 60 months before reclassifying its entity type (depending on when the first election was made).

As stated, certain business entities ('*per se* corporations') are automatically classified as corporations for US tax purposes. In this regard, the IRS regulations provide a list of foreign organisations classified as *per se* corporations for US tax purposes. Notably, certain exceptions to the parameters set forth apply. As such, it is imperative that the proper entity (i.e. an entity that is eligible to elect alternative treatment) be established when structuring operations designed to utilise hybrid entities. In certain jurisdictions, this task can require careful planning.

An eligible entity may affirmatively elect its classification by filing Form 8832, Entity Classifications Election, within 75 days of inception with the Internal Revenue Service Center. Alternatively, the election can be made at any time; however, it may have US tax implications.

The term 'corporation' may include an unincorporated association that has made an election to be treated as a corporation. A corporate member of a partnership is subject to tax on its share of the partnership's profits (see partnerships).

In addition to Form 8832, the IRS has released (and is seeking comment on) newly proposed Form 8858, Information Return of US Persons With Respect to Foreign

Disregarded Entities. The proposed form would be filed by US persons who own a foreign disregarded entity (FDE), directly, indirectly or constructively. For purposes of proposed Form 8858, a FDE is a foreign entity that is disregarded as separate from its owner for US tax purposes. Reporting on Form 8858 would be required for annual accounting periods of tax owners of FDEs beginning after 31 December 2003.

S-Corporations

Certain small business corporations can elect to be treated for tax purposes in a manner similar to partnerships. A corporation that makes this election is known as an 'S-corporation'. A small business corporation is a domestic corporation with only one class of stock and no more than 100 shareholders. These shareholders must be citizens, resident aliens, estates or specified types of trusts. For taxable years beginning after 1997, certain tax-exempt organisations may also be shareholders. Family members within six generations may count as one shareholder under the 100-shareholder limitation. A small business corporation may own up to 100% or more of another corporation. If the ownership is equal to 100% and the subsidiary corporation could otherwise be a small business corporation except for the presence of a disqualified corporate shareholder, an election is available to treat the subsidiary as a transparent entity.

Limited-liability company

A Limited liability company (LLC) is a statutory business entity formed with articles of organisation or an operating agreement, which is filed with the appropriate State agency.

The principal advantage of an LLC over an S-corporation is that an LLC has no restrictions on the number or types of owners. An LLC also allows for multiple classes of share ownership and for foreign ownership. Under the check-the-box rules, if an LLC is not classified as a corporation, it is classified as either a partnership (more than one owner) or if there is a single owner, it is disregarded for tax purposes and it becomes, for example, a US branch of a foreign entity.

Partnerships and joint ventures

Tax treatment

A partnership doing business in or having income from sources within the United States must file a return of income for its tax year, regardless of the amount of income or loss. The partnership is not a taxable entity and it files only an information return. Each partner reports the partner's share of the partnership's income or loss on the partner's own income tax return.

A partnership's business income is computed in substantially the same way as that of a corporation, except that it is not entitled to the special deduction for dividends received and may not gross up foreign dividends for foreign taxes paid. The partners' shares of each of specified categories of income and deductions are disclosed separately on the return.

Generally, elections affecting the partnership's taxable income are made by the partnership. However, the election to credit or deduct foreign taxes is made by each partner. A partner's share of the partnership's income, deductions and credits generally is determined by the partnership agreement, but it will be ignored by the IRS if it lacks substantial economic effect.

Each partner must include all partnership items in the partner's own return in the same amount and manner as reported by the partnership unless the partner expressly notifies the IRS. If the partner fails to do so, the IRS can unilaterally recompute the tax to conform to the partnership's method of reporting. Severe penalties are imposed if a partnership fails to file a return.

Taxation of foreign partners

A foreign corporation or non-resident alien that is a partner in a US or foreign partnership doing business in the United States is taxable on the partner's share of the partnership's:

- income (including capital gains) effectively connected with the conduct of a US trade or business
- US-source fixed or determinable annual or periodic income.

A non-corporate resident alien partner is taxed on the partner's share of the US partnership's world wide income and capital gains.

Withholding by a US or foreign partnership is required on a foreign partner's share of US effectively connected income. The rate of withholding is 35% for corporate shareholders and non-corporate shareholders. The foreign partner then needs to file a US tax return and may offset the withholding tax against the actual tax liability, usually generating a refund.

Joint ventures

Absent an election to the contrary (i.e. a check-the-box election), a joint venture is treated as a partnership for US tax purposes.

Limited-liability partnership

A limited-liability partnership (LLP) has also become a common business entity and is primarily used by professional individuals and organisations further to limit the liabilities of their members.

Corporate income tax

Income

Gross income

Gross income includes gross profits from all sources including services and the sale of merchandise and other property, which must be inventoried.

Inventory valuation

Any method of valuation of inventory (stock-in-trade or work-in-process) that is not specifically prohibited by the tax law and accords with sound commercial accounting principles is acceptable, provided that it is used consistently at the beginning and end of the tax year. However, the amounts of overhead that must be included in the inventory costs of manufacturers and sellers are prescribed by law and extensive IRS regulations. Inventory may be valued at cost or at the lower of cost or market value (replacement cost). Reserves for anticipated future losses may not be deducted.

Inventory costs may be computed under either the first-in first-out (FIFO) or last-in first-out (LIFO) methods. If the LIFO method is elected, inventory may only be valued at cost, and not at market value, which may be lower. The method selected must be used consistently. The taxpayer may change from the FIFO method to the LIFO method without permission, but a change from LIFO to FIFO, on the other hand, requires IRS consent. The LIFO method may be used only if it is also used for financial-reporting purposes and it is permissible to report lower inventory values for financial-statement purposes.

Capital gains and losses

Capital gains and losses of a corporation are taxed at the same rate as ordinary income. Capital losses are deductible only against capital gains. Unused capital losses are generally carried back three years and forward five years and deducted against any capital gains for those years. There are relief provisions for:

- exchanges of stock or securities in connection with corporate mergers and reorganisations
- exchanges of certain other investment or business property
- involuntary conversions of property.

Interest

Interest earned is taxable in the year in which it is accrued or received. Any foreign income tax withheld may be deducted or used as a foreign tax credit against the corporation's income tax. Interest earned on most obligations of state and local governments is exempt from federal taxation. The states are prohibited from taxing interest on certain US obligations.

Dividends

Dividends must be included in income in the year in which they are received. A corporate shareholder generally may deduct 70% of dividends received from a taxable domestic corporation. The deduction is 80% if the corporation is 20% or more owned, and 100% for certain 80% or more owned domestic corporations.

Dividends received from a foreign corporation may qualify for the dividends-received deduction. The deduction is available only to the extent that the dividend represents income realised from a trade or business carried on in the United States by the foreign corporation. The payer corporation cannot be a foreign personal holding company or a passive foreign investment company. In addition, the corporate shareholder must own at least 10% (by vote and value) of the foreign corporation's stock. No foreign tax credit is allowed for any taxes paid or accrued on the US-source portion of the dividend received.

Dividends paid are not deductible except in specialised cases, such as regulated investment companies and certain insurance companies. If foreign income tax is withheld on a dividend, it may be deducted as a tax or used as a foreign tax credit against the shareholder's US income tax.

A domestic corporation owning 10% or more of a foreign corporation's voting stock may claim a credit against its US income tax for income taxes paid by the foreign corporation to a foreign country (or US possession). This credit is the same proportion of the taxes paid by the foreign corporation as the dividends received are of the corporation's undistributed earnings. Different methods of computation are required depending on the year in which the earnings were accumulated. The tax claimed as a credit must be included in taxable income by grossing up the net dividend received.

Royalties

Royalties constitute taxable income. Any foreign income tax withheld may be deducted or used as a credit against the corporation's US income tax.

Management fees

Management and service fees are taxable when accrued or received, depending on the taxpayer's method of accounting. Management fees received for services performed in the United States are US-source income, even if performed for a foreign entity. An arm's length transfer price is necessary when computing a reasonable related-party management fee. Stiff penalties could be imposed where contemporaneous documentation does not exist.

Deductions

Depreciation

The allowable deduction for depreciation (cost recovery) of tangible assets used in the trade or business is computed using specific rates fixed by law, regardless of the amount charged in the financial accounts of the business. No depreciation is allowed on the cost of land.

Assets are classed according to deemed useful life, expressed in years. Certain year classes qualify for reducing-balance depreciation at twice the straight-line rate, others for reducing-balance depreciation at 1.5 times the straight-line rate, and the remainder to straight-line depreciation. Automobiles and trucks (cars and lorries), for example, are in the five-year class, which is depreciated at twice the straight-line rate on the reducing-balance method. Since the normal depreciation rate would be 20% per annum on a straight-line basis, the actual rate of depreciation applied to this asset class is 40% per annum, on a reducing-balance basis.

Table 2 below shows the applicable depreciation rates for each class of asset.

Table 2

Depreciation period	Normal depreciation rate (per annum)	Actual depreciation rate	RB or SL	Typical asset in class
3 years	33.33%	66.67%	RB	Special handling devices for food and beverage manufacture Special tools for the manufacture of finished plastic products, fabricated metal products, and motor vehicles Products with an ADR class life of 4 years or less
5 years	20.00%	40.00%	RB	Information systems Computers, peripherals Aircraft (of non-air transport companies) Automobiles and trucks Petroleum drilling equipment Property with ADR class life of more than 4 years and less than 10 years
7 years	14.29%	28.57%	RB	All other property not assigned to another class Office furniture, fixtures and equipment Property with ADR class life of more than 10 years and less than 16 years
10 years	10.00%	20.00%	RB	Assets used in petroleum refining and certain food products Vessels and water-transportation equipment Property with ADR class life of 16 years or more and less than 20 years
15 years	6.67%	10.00%	RB	Telephone distribution plants Municipal sewage-treatment plants Property with ADR class life of 20 years or more and less than 25 years

20 years	5.00%	7.50%	RB	Municipal sewers Property with ADR class life of 25 years or more
27.5 years	3.64%	3.64%	SL	Residential rental property (not including hotels or motels)
39 years	2.56%	2.56%	SL	Non-residential real property

Amortisation

The cost of intangible personal property that has a limited life, such as patents, copyrights or contracts, may be recovered through amortisation deductions over the property's life. A company may elect to amortise its organisational (formation) and business start-up expenses over 60 months. Start-up costs and organisation costs of over USD 5000 (EUR 3225) may have to be amortised over 180 months. Costs of intangibles that have an indefinite life, such as goodwill, trademarks or trade names, were not amortisable prior to 1993. Now, most intangible costs that are not specifically amortisable under the provisions discussed above are amortisable over a 180-month (15-year period) beginning with the month in which such an intangible was acquired. Such acquisition must have occurred in tax transactions subject to income tax.

Interest expense

Interest is generally deductible when it is accrued or paid, depending on the accounting method, but not if it is incurred to purchase or carry tax-exempt securities. Furthermore, the IRS may disallow a deduction claimed for interest if the payer has a high debt-equity ratio, and a current deduction may not be fully available for interest paid or accrued to a related foreign party that is not subject to US tax when the debt to equity ratio exceeds 1.5 to 1.0. These rules are generally referred to as the 'earnings-stripping rules'.

According to the earnings-stripping rules, if interest deductions exceed 50% of adjusted profit before interest and depreciation, then the excess is disqualified if paid to a related party that benefits from a reduced treaty rate of withholding tax on interest or is otherwise tax-exempt. The amount of interest expense disqualified may be carried forward to future years.

Employee remuneration

Remuneration for employee services is deductible if reasonable in amount and an ordinary and necessary business expense. Remuneration related to the cost of construction or acquisition of capital assets must be capitalised as part of asset cost.

Bad debt

All businesses may deduct specific debts that become wholly or partially worthless.

Deduction for certain production activities

For years beginning after 31December 2004, taxpayers (corporate and non-corporate) engaging in production activities (mainly manufacturing and certain other activities) are entitled to a deduction equal to 3% of qualified production expenditure (rising to 6% in 2007, 2008, and 2009, and 9% thereafter). The deduction cannot exceed 50% of qualified production wages and cannot exceed taxable income (before the deduction but after tax loss carry-over claimed).

Other deductions

The following are other common types of deduction:

- charitable contributions
- depletion
- rents

- repairs
- royalties
- taxes (excluding US income taxes and certain penalty taxes).

Non-deductible items

Expenditures that are not deductible from taxable income include:

- any expenditure that is not an ordinary and necessary business expense
- capital expenditures such as improvements to business premises, legal costs connected with the acquisition of capital assets and expenses of raising capital
- general reserves against anticipated future losses.

Entertainment expenses are not deductible unless they are directly related to or associated with the active conduct of the corporation's trade or business. No deduction is permitted for the cost of entertainment facilities, such as resorts and hunting lodges, and deductible meal and entertainment expenses are subject to a 50% disallowance. Business gifts exceeding USD 25 (EUR 16) per donee are generally not deductible. Special rules apply to employee achievement awards.

Net operating losses

Losses from business operations may be offset against income of any type (including capital gains) arising in the same tax year. Any net operating loss is generally carried back to reduce taxable income for the prior two years. Any balance of the loss may be deducted from taxable income earned in the next 20 years. A corporation may elect to waive the carry-back of a loss and only carry it forward. Special provisions expedite the refunding of the tax reductions resulting from loss carry-backs. The deduction of a net operating loss of an acquired corporation may be limited depending on acquisition price and future net income of the acquired corporation.

Computation of tax

Taxable income is the sum of all gross income, including capital gains, less the total of all allowable deductions. The gross tax liability is computed by applying the corporate tax rates to taxable income.

Current corporate tax rates

The 2008 corporate tax rates are as shown in Table 3.

Table 3

Taxable income (USD)	Tax rate (%)
First 50 000	15
Next 25 000	25
Next 25 000	34
Next 235 000	39
Next 9 665 000	34
Next 5 000 000	35
Next 3 333 333	38
More than 18 333 333	All at 35

Tax credits

Credits against the gross tax liability are allowed for the following:

Foreign taxes paid on foreign-source income

Applied separately to each of nine categories of income, including (but not limited to), passive income, high withholding-tax interest, financial-services income and shipping income, this credit is limited to the same ratio of the US tax as the foreign-source income bears to world wide taxable income. Any foreign income tax paid or accrued, which exceeds the credit limitation, may be carried back for two years and carried forward for five years.

A US corporation receiving a dividend from a foreign corporation of which it owns at least 10% of the voting stock may claim a foreign tax credit for the taxes paid by the foreign corporation attributable to the dividend. Special rules apply to income received from more than 50% US-owned foreign corporations.

General business credit

The general business credit for a taxable year is the total of the general business-credit carry-forwards carried to that taxable year, the current-year general business credit, and the general business-credit carry-backs carried to that taxable year. The current-year general business credit includes the research credit, the work-opportunity credit, and the welfare-to-work credit, as well as certain other credits. The general business credit may not exceed a limitation based on the amount of tax liability. Any excess credit may be carried back one year and carried forward 20 years. For tax years beginning before 1998, the excess or unused amount could be carried back three years and forward 15 years.

Research credit

A research credit is generally available for certain research expenses paid or incurred up to 31 December 2007. The research credit is the sum of 20% of the excess of the qualified research expenses for the current tax year over the base-period amount and 20% of the basic research payments made to a qualified organisation. An alternative incremental computation may be elected and a research credit for start-up companies is also available. The deduction for research expenses must be reduced by the amount of the research credit. The deduction does not need to be reduced if a reduced credit is taken. The credit is subject to the carry-back and carry-forward rules under the general business credit.

Work-opportunity credit

The work-opportunity credit is available to employers who pay wages to an individual who is a member of one of eight categories of disadvantaged groups. The credit is available for wages paid or incurred to a qualified individual who begins work after 30 September 1996 and before 1 January 2008. The credit is equal to 40% of the first USD 6000 (EUR 3875) (or USD 3000 (EUR 1925) for qualified summer youth employees) paid to each targeted group member during the first year of employment and 25% in the case of wages attributable to individuals meeting only minimum employment levels. The deduction for these wages must be reduced by the amount of the credit.

Welfare-to-work credit

A welfare-to-work credit is available to employers of long-term family-assistance recipients who begin work after 31 December 1997 and before 1 January 2008. The credit is equal to 35% of the qualified first-year wages and 50% of the qualified second-year wages. The amount of qualified wages taken into account with respect to an individual for any year cannot exceed USD 10 000 (EUR 6450). Thus, the maximum credit an employer can take with respect to an employee is USD 8500 (EUR 5475) for the two years. The deduction for these wages must be reduced by the amount of the credit.

Other credits

In addition to the above, there are many other credits that are available based upon the location, financials, etc. surrounding the corporation. Please contact your local BDO Member Firm office for more information.

Alternative minimum tax

For tax years beginning in 2003, certain small corporations will not be subject to the AMT. For corporations that do not qualify as a small corporation, the tentative minimum tax for the tax year is 20% of the excess of the alternative minimum taxable income (AMTI) over the AMTI exemption amount reduced by the AMT foreign tax credit. The AMT amount is generally taxable income plus tax preferences and adjustments less a USD 40 000 (EUR 25 825) exemption.

The more common corporate preferences and adjustments are:

- adjusted current earnings (ACE)
- excess depreciation
- deferred income from certain instalment sales
- deferred profit on some long-term contracts
- bad-debt reserves of financial institutions.

AMT is paid only to the extent that it exceeds regular income tax. In addition to being liable for corporate income tax, a corporation that improperly retains excessive earnings at the request of its shareholders may be subject to an accumulated earnings tax.

Depreciation on assets placed in service after 1986 is generally computed under the Modified Accelerated Cost Recovery System (MACRS) for regular tax purposes and under the Alternative Depreciation System (ADS) for AMT purposes. ADS usually generates lower depreciation than MACRS. A net operating loss may generally be carried back two years and forward 20 years for both regular income tax and AMT purposes. The AMT net operating loss must be computed separately, using AMT rules.

Generally, the only credit allowed against the AMT is the foreign tax credit. AMT paid for prior years will be allowed as a credit against the income tax in a subsequent year to the extent this tax exceeds the tentative AMT in the subsequent year.

Related corporations

The Internal Revenue Code contains many intricate rules governing related corporations, which are designed to prevent tax avoidance through use of the corporate form. Corporations controlled by the same interests are called controlled groups. A controlled group may consist of parent and subsidiary corporations and/or brother-sister corporations.

Many corporate tax benefits and allowances available to a controlled group are restricted so as not to exceed those of a single corporation.

Consolidated income tax returns

Consolidated income tax returns may be filed by the US members of an affiliated group. An affiliated group is a chain of corporations connected through 80% or more stock ownership (both voting power and value with the exception of certain non-voting and non-convertible preferred stock) with a common parent corporation. The following corporations are generally not includible in a consolidated income tax return filing:

- foreign corporations
- life insurance companies
- regulated investment companies
- real estate investment trusts (REITs)
- domestic international sales corporations (DISCs)
- tax-exempt corporations
- S-corporations.

One of the most important advantages of filing a consolidated return is that it allows for offsetting the losses of one member corporation against the income of other members of the group. It also permits the group to defer the reporting of a gain from an inter-company sale of property until the property is sold outside the group or the purchasing member claims tax-depreciation deductions.

The principal disadvantage of filing a consolidated return is having to comply with the very complex and binding IRS regulations that govern them. Once elected, the consolidated return filing procedure may not be discontinued without IRS consent, which is difficult to obtain. Another significant disadvantage is the disallowance of a deduction for any loss recognised on the disposal of stock of a subsidiary. Furthermore, many States do not permit the filing of consolidated returns. Eligibility depends on the particular State in which a taxpayer does business. Some States, such as California, may require combined returns for unitary businesses in certain circumstances. Lesser disadvantages of filing a consolidated return include the deferral of deductions for losses on inter-company transactions and the additional recordkeeping required. On balance, however, the advantages of a consolidated return usually outweigh the disadvantages.

Taxation of foreign corporations

A foreign corporation is subject to US income tax on income derived from business conducted in the United States and on passive income from US sources. In many cases, the US tax liability of the foreign corporation is governed by a tax treaty. In general, a treaty limits the taxation of US industrial and commercial activities to the profits attributable to a permanent US establishment, and may also provide for lower withholding tax rates on passive income.

Trading as a branch, partnership or LLC

Subject to any applicable double taxation treaty, a foreign corporation trading in the United States as a branch, partnership or LLC is subject to US income tax on the income effectively connected with the conduct of its trade or business within the United States, including profits from operations, capital gains, interest, dividends, rents and other income that arises from the US business.

The tax liability of a foreign corporation on effectively connected income is determined in the same manner as that of a domestic corporation. Separate accounts must be maintained for the branch operation and elaborate rules are provided for determining whether interest, dividends and other passive income are attributable to the branch.

Fixed or determinable annual or periodical income from US sources which is not effectively connected with the US business is taxed at the flat 30% statutory or lower treaty rate. However, a foreign corporation or non-resident alien individual may elect to treat investment income from US real estate as effectively connected, to take advantage of deductions and lower tax rates.

In general, any income derived from assets used in the US business is effectively connected income. Income also is effectively connected if the activities of the US branch contributed materially to earning the income. Home-office expenses, including interest, which can be allocated to branch activities, are also deductible.

Under the Foreign Investment in Real Property Tax Act (FIRPTA), a gain from the disposal of a foreign-owned interest in US real estate is taxable and subject to withholding. Other capital gains are generally exempt from US tax if they are neither effectively connected with the conduct of a US trade or business nor fixed or determinable annual or periodical income from sources within the United States.

Branch profits tax

Unless they are reinvested in the United States, a supplementary tax is usually imposed on the profits of a US branch of a foreign corporation. The branch tax is intended to impose the same US tax on a branch as that imposed on a US subsidiary of a foreign corporation that repatriates profits. The tax base generally is the branch's taxable income reduced by US and foreign income taxes and the profits reinvested in the branch.

The rate of branch tax is the same as the statutory dividend withholding tax rate, currently 30%. However, if the foreign corporation and the majority of its beneficial individual owners are resident in a treaty country, the branch tax rate is reduced to the treaty rate applicable to direct investment dividends.

Interest paid by the branch is treated as if paid by a US corporation, thus is US-source and subject to the 30% statutory withholding tax. However, the tax may be reduced or eliminated by another provision of the Internal Revenue Code or by a tax treaty if the majority of the foreign corporation's beneficial individual owners are residents of the treaty country. This treatment also applies to interest deductions allocated to the branch which exceed the branch's interest payments.

Income from US subsidiaries

Profits

The profits of foreign-owned US subsidiaries are taxable in the same manner as those of any other domestic corporation.

Dividends

A US subsidiary must withhold a 30% income tax on dividends paid to its foreign parent unless a lower withholding rate applies under a tax treaty. Most treaties provide a lower rate, some as low as 5% or zero percent in some instances. No withholding is required if the dividends are effectively connected with the conduct of a US trade or business by the foreign parent.

Interest

A US corporation must withhold an income tax at the 30% statutory or lower treaty rate on interest paid, unless the interest is paid to a non-10% shareholder or related party. Several treaties reduce or eliminate this tax for interest paid to residents of the treaty country.

Royalties

A 30% income tax must be withheld from royalties for the use of patent rights and from copyright royalties that are US-source unless the payment is subject to a lower treaty rate.

Capital gains

If a foreign parent corporation realises a capital gain on the disposal of its investment in a US subsidiary, no US tax liability is incurred unless FIRPTA applies. FIRPTA is aimed at taxing US real-estate interests held by non-US taxpayers. Stock in a US company, which has had 50% of its assets consisting of US real estate at any time in the previous five years, qualifies as a US real-estate interest.

Service fees

Arm's-length payments for items such as management services, technical assistance and use of know-how may be made by a US subsidiary to its foreign parent. Such payments are tax-deductible business expenses if they benefit the US subsidiary and are not primarily stewardship expenses of the parent. If these services are performed in the United States, the payment may be subject to the 30% statutory withholding tax unless a lower rate applies under a treaty. Transfer pricing will always be an issue when dealing with a foreign owner.

Treaty-relief limitations

A foreign taxpayer using treaty relief to avoid US tax may need to file a treaty-based return even in the absence of US tax liability. In most of its treaties, the United States has introduced extensive limitation-of-benefits provisions, and new regulations have been issued so that the IRS can treat another party as the owner of income to deny treaty relief for certain financing transactions involving interest or royalties, for example.

Taxation of foreign operations

Branch income

The income of a foreign branch of a US domestic corporation is subject to US income tax for the year in which it is earned, whether or not it is repatriated. Income tax payments may be deferred if foreign income cannot be remitted to the United States because of foreign law or government action. The foreign tax paid by the branch may be deducted or it may be claimed as a credit against the US income tax liability attributable to the branch's income.

Income from foreign subsidiaries:

The income of a foreign subsidiary of a US domestic company is not generally subject to US tax until it is repatriated through management fees, royalties, rents, interest or dividends. However, a domestic corporation is subject to US tax on its interest in certain income of a controlled foreign corporation (CFC), which is incorporated outside the United States but controlled by US shareholders. A foreign corporation is controlled by US shareholders if more than 50% of its stock (by voting power or value) is owned on any day of the corporation's tax year by US persons owning 10% or more of the corporation's voting power. Income currently taxable to a 10% or more US shareholder (known as 'Subpart-F income') includes:

- income from insurance or reinsurance of US risks
- foreign personal holding company income (passive investment income)
- foreign base company sales income (income from sales to or purchases from a related person, of property produced and sold for use outside the CFC's country of incorporation)
- foreign base company services income (income from services performed for a related person outside the CFC's country of incorporation)
- foreign base company shipping income
- foreign base company oil related income
- bribe and boycott income.

Certain items of income will be excluded from Foreign Base Company Income under the following exceptions: (1) the *de minimis* rule applies if the sum of a CFC's gross Foreign Base Company Income and gross insurance income is less than the smaller of 5% of gross income and USD 1 million (EUR 645 500); (2) the full-inclusion exception, which applies if more than 70% of the CFC's gross income and gross insurance income is Foreign Base Company Income, subject to certain exceptions, and will be determined separately for purposes of allocating and apportioning deductions; and (3) the high-tax exception, which provides that income of a CFC not formed or availed of to reduce taxes will generally not be Foreign Base Company Income.

Investment in US property

The US shareholders of a controlled foreign corporation must generally include in income as a 'deemed dividend' a pro rata share of the increase in the earnings invested by the controlled foreign corporation in US property for the taxable year (to the extent of earnings and profits). No increase occurs, however, to the extent that the Internal Revenue Code excludes the increase from gross income.

'United States property' is defined to include the following four basic types of property:

- tangible property located in the United States
- stock of a domestic corporation
- obligations of US persons
- certain items like patents and copyrights used in the United States.

In addition, US property includes trade or service receivables that are both acquired from related US persons and due from US persons.

If a controlled foreign corporation guarantees or pledges its assets to secure the obligation of a US person, the controlled foreign corporation is treated as holding that obligation. The same treatment may apply under certain conditions if a US shareholder pledges most or all of the stock of the controlled foreign corporation.

Transfer pricing

The Internal Revenue Code (IRC) Section 482 regulations give the Internal Revenue Service (IRS) broad authority to allocate income or deductions between related entities if it determines that such allocations are necessary to prevent evasion of taxes or clearly to reflect the income of such related entities. The IRC Section 482 regulations go on to state that the standard against which any transaction between related parties will be judged is that of the same or similar transaction carried out by a taxpayer dealing at arm's length with an uncontrolled taxpayer. The Organisation for Economic Cooperation and Development (OECD) has developed similar transfer-pricing guidelines, which are also based on the arm's length principle.

The IRC Section 482 regulations and the OECD Guidelines provide several methods for determining inter-company prices, and require that the 'best' or 'most appropriate' method be employed to determine arm's length pricing for inter-company transactions related to tangible products, intangible property, services, loans, and cost-sharing arrangements. The 'best' or 'most appropriate' method is defined as the method that produces the most reliable measure of an arm's-length result for the controlled transaction in question, considering all of the facts and circumstances of the transaction.

The United States, under the IRC Section 6662, and an increasing number of other countries also, have extensive transfer-pricing documentation requirements, which state that this documentation generally should be prepared contemporaneously with filing a company's tax return in order to avoid a potential imposition of penalties.

Foreign tax credit

US domestic corporations are taxed on their world wide income. In order to prevent the double taxation that could result on income derived from foreign sources, the United States allows a credit for foreign tax paid or accrued. The credit can offset current-year income tax and if an excess credit results, the credit may be carried back one year and forward 10 years. The person entitled to the credit is the person who bears legal liability under foreign law for the tax. Tax will be considered paid by the taxpayer even if another party to a direct or indirect transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's foreign tax liability. In addition, the IRC provides that a domestic corporation that owns at least 10% of the voting stock of a foreign corporation from which it receives dividends shall be deemed to have paid the same proportion of foreign income taxes imposed upon the foreign corporation as the amount of such dividends bears to such foreign corporation's post-1986 undistributed earnings.

The foreign tax credit will be subject to limitation. There are two separate types of income called 'baskets' for this purpose. In order to calculate the amount of FTC available to reduce US tax, a determination must be made of which foreign taxes are associated with the income in each basket. In addition, the look-through rules control certain inclusions with respect to controlled foreign corporations. In general, the dividend look-through rules state that dividends paid by a CFC to its US shareholders will be assigned to the shareholder's separate limitation categories on the basis of the ratio that the CFC's earnings and profits attributable to each separate limitation category bears to the CFC's total earnings and profits.

Capital gains

Gains on sales of shares in foreign subsidiaries or on disposals of foreign-branch assets by a US corporation are subject to US income tax.

Dividends

Dividends from non-US sources are subject to US income tax for the tax year in which they are received. Distributions from previously taxed Subpart-F income are tax-exempt.

Interest income

Interest income from foreign operations is subject to US income tax when accrued or received, subject to relief for foreign withholding tax.

Royalties received

Foreign royalties are taxable when accrued or received, with credit for foreign withholding taxes.

State and local taxes

Introduction

Various taxes are imposed by the District of Columbia, the 50 States and their respective counties, cities and other local jurisdictions. The Commonwealth of Puerto Rico and US possessions also impose taxes. The major taxes imposed by the States are corporate income taxes, including franchise taxes based on income, taxes on capital, sales and use taxes and individual income taxes.

A foreign company with a presence in the United States may be subject to tax at the State and local level notwithstanding treaty protection from the federal tax system. A company will be subject to State and local tax if it has a sufficient connection (a nexus) in the jurisdiction. The nexus standards for the various State and local taxes may be quite minimal, including the conduct of solicitation activities in a State. For State corporate income tax purposes, federal legislation (commonly referred to as Public Law 86-272) provides immunity from a State's corporate income tax for activities limited to solicitation of orders for tangible personal property where the orders are accepted in another State and the goods are shipped from another State. Public Law 86-272 protection generally does not apply to capital value or other non-income based taxes, or to solicitation of orders for sales of intangibles or services. Such protection also may be limited for foreign companies.

State corporate income tax

For States that impose an annual tax on corporate income, the 'legal entity' approach is used, which means that the amount of tax depends not only on the entity's total taxable income, but also on how that income is apportioned between the different States. Most States use federal taxable income before the deduction of State taxes as the starting point, but a number of adjustments can be made depending on the State concerned. In these States, a company with zero taxable income for federal tax purposes due to a treaty exemption generally will have zero taxable income for State and local corporate income tax purposes. However, several large States, including California, New York and New Jersey, compute State taxable income by using federal taxable income determined without regard to certain federal deductions and exemptions, including any federal treaty exemptions.

State corporate tax rates vary from state to state. Some of the higher tax rates are found in states such as California (8.84%) and New York (7.5%) while other states such as Nevada or Wyoming have no state corporate income tax. In addition, some cities or local governmental units also levy corporate income taxes.

Generally, each state taxes part of the profits of in-State businesses according to the legal entity's or taxpayer's apportioned profit, which is arrived at by using a three-factor formula based on property, payroll and sales.

Generally, each State taxes part of the profits of in-State businesses according to the legal entity's or taxpayer's apportioned profit, which is arrived at by using a three-factor formula based on property, payroll and sales. Different States use different apportionment formulae, as well as different definitions of what constitutes property, payroll and sales. Some States use only a sales factor in an effort to attract capital and labour-intensive businesses to their State.

Certain States utilise a 'unitary' approach for corporate income tax purposes, which may ignore the separate existence of legal entities that conduct a 'unitary' business. There are no clear guidelines as to what constitutes a unitary business, and different States have different views, but the following points should be taken into account:

- ownership
- common management
- centralised operations, such as purchasing, marketing, bookkeeping, etc
- intra-group loans and guarantees
- intra-group trading.

Some States, such as California, extend the unitary concept world wide, so that the total world wide operations and profits of a multinational group can be accounted for as a unitary business. Due to heavy pressure from the international community, several States, including California, allow for a 'water's edge' election, under which companies can elect to restrict their taxable operations and profits to those attributable to the United States.

The lack of conformity by and among States in defining their corporate income tax system provides taxpayers with the opportunity to structure business activities in a tax-efficient manner. A business may arrange the type of entity and the location of the corporate headquarters, property, payroll and sales operations to reduce taxes in particular States, with minimal impact on the company's day-to-day operations.

Other State business taxes

Several states, such as Michigan, Indiana, Ohio, Texas and Washington, impose hybrid taxes containing elements of a tax based on gross receipts and a tax based on corporate income. Many states, including Pennsylvania, impose taxes based on capital values or net worth, either as a stand-alone tax or as an integral component of the corporate tax system.

Sales and use taxes

Sales and use taxes are imposed by 45 States and the District of Columbia, as well as their respective counties, cities and other local jurisdictions. There are over 80 000 sales and use tax jurisdictions nationwide. Sales tax is generally imposed on the sale of tangible personal property and certain services, determined on a destination-based approach. Use taxes are complementary taxes imposed on the use, storage or consumption of tangible personal property and certain services and are imposed to the extent sales taxes were not remitted. Companies are required to collect and remit sales and use tax on the sale of taxable products in States in which the company has nexus, which includes any physical presence in the State. Purchasers are required to remit use tax on purchases for which sales and use taxes have not been collected.

There are various methods available to minimise a company's sales and use tax burden, including participation in managed compliance agreements, proper choice of entity planning, and maximising the use of industry-specific exemptions (e.g. manufacturing credits or exemptions).

Property taxes

Real estate taxes are assessed and collected by city, county or other local authorities. These taxes provide funds for public services, including education, fire and police services, roads, sanitation and street lighting. They are assessed on property owners at varying levels according to appraised values. Agricultural property may be taxed at lower rates. Many jurisdictions also impose property taxes on personal property located in the jurisdiction.

Real-estate transfer taxes

Many States, cities, and counties impose a tax on the transfer of certain interests in real estate, including leasehold improvements. Some States, such as New York, impose the tax on indirect transfer of real estate, such as the transfer of an interest in an entity owning real estate. There are limited exemptions to the taxability of real-estate transfers, including transfers pursuant to mergers or transfers where there is no change of economic interest.

Stamp taxes

Many types of commercial and legal documents must be stamped to denote the payment of taxes. The rate may be fixed or based on value. In general, documents need not be stamped unless they are executed in the United States or they relate to property situated in the United States or a transaction carried out in the United States. The effect of failure to stamp a document is that the document may not be legally admissible as evidence. Penalties may be payable for late stamping.

Unclaimed property:

Unclaimed property is any unpaid property that has not been claimed by the rightful owner within a legally defined period of dormancy. All States, the District of Columbia, Puerto Rico and the US Virgin Islands impose a period of dormancy ranging from one to 15 years depending on the State and the type of property. After the defined period, the property holder is generally required to transfer the property to the State of the owner's last known address until the rightful owner of the property claims the property. Many commercial domicile States, including Delaware, have become increasingly aggressive in pursuing unclaimed property from businesses organised in their State. A company's business activities can be structured to minimise its exposure to unclaimed property.

Additional taxes

Other State and local taxes include:

- individual income tax
- gift, estate and inheritance taxes
- gross receipts taxes imposed on utilities and telecommunications
- severance taxes on oil and gas
- motor vehicle and driver's licences.

State and local tax credits and other financial incentives

Companies planning to locate in the United States or expand an existing location in the United States may be eligible for various state and/or local tax credits or other cash and in-kind resources to assist with relocation or expansion. All 50 States, and many local municipalities within these States, offer incentives to businesses that invest in property, plant, or equipment and create jobs for a community. There are wide variations among locations in the types and amount of incentives available. Most of these benefits require notice of intent prior to making investment or creating jobs.

Depending on the State and local municipal government where the project is to be located, the incentives offered may be one or both of the following types:

1) ‘As of right’ incentives are available automatically to any company meeting the relevant criteria for capital investment and/or job creation
2) Discretionary incentives must be negotiated with the relevant government(s)

Specific examples of the types of incentives that may be available from US State and/or local governments include the following:

Table 4

Tax Incentives	Non-tax Incentives
• Job/Hiring tax credits	• Low-interest financing
• Capital investment tax credits	• Tax-exempt bond financing
• Withholding tax rebates	• Cash grants or rebates
• Property tax abatements	• Training and employee relocation grants
• Sales and use tax exemptions	• Hiring and screening assistance
• Location-specific tax credits	• Industry-targeted grants and loans
• Industry-targeted tax credits	• Tax increment bond financing
• Corporate headquarter tax credits	
• R&D tax credits	
• Alternate energy credits	

The business may be required to enter into long-term agreements with State and or local government where the project is to be located. Incentive packages offered by State and/or local government should be considered in the context of the business’s tax structure, financial position, and overall corporate objectives.

For many incentives, companies are advised to make applications *prior to* proceeding with the purchase of land, buildings, machinery and equipment as well as the hiring and/or training of personnel. Doing so helps the applicant company avoid problems with governmental ‘public purpose’ provisions, which say that public funds should be given only to those companies that would not proceed with their investment and/or hiring plans *without* the public financial assistance.

Value added tax

The United States does not have a federal or local value added tax, but see above for state sales and use taxes.

5. Taxes on individuals

Income tax

For US federal income tax purposes, all individual taxpayers are considered as either US-resident individuals, whether alien or citizen, or as non-resident aliens. Residents are subject to US federal income tax on world wide income and capital gains, but they are generally able to claim relief for foreign taxes.

US *citizens*

The United States taxes its citizens on their world wide income, no matter where they may be resident for tax purposes. If resident abroad, they may be entitled to exclude a certain amount of foreign earned income ('the foreign earned income exclusion'). The maximum exclusion in 2008 is USD 87 600 (EUR 56 550).

Non-resident aliens

Non-resident aliens are subject to US federal income tax on the following income only:

- income from personal services rendered in the United States
- income (including capital gains) effectively connected with the conduct of a US trade or business
- US-source fixed or determinable annual or periodic income.

US *residents*

US residents, whether citizens or not, are subject to tax on their world wide income, including compensation, capital gains, interest, dividends, rents, royalties, professional fees, pensions, annuities and alimony.

Determination of US*-residence status*

The concept of residence is not to be confused with domicile, which is used as a basis for the US gift, estate and generation-skipping transfer taxes. A US domiciliary is generally an individual who lives in the United States with the intention of residing in the country permanently. Domicile is thus determined by intent and supported by circumstantial evidence. For federal income tax purposes, the concept of residence is used to determine liability. An alien is treated as a US-resident for the year if he or she:

- has the right to reside permanently in the United States as an immigrant at any time during the calendar year (the green-card test) or
- is present in the United States for a substantial period of time (the substantial-presence test)

Substantial-presence test

The substantial-presence test is met in the current year if an individual is present in the United States on at least 31 days during the year, and the sum of the number of days he or she was present in the United States during the current year and the two preceding calendar years, when multiplied by the applicable multiplier, is at least 183. An alien present in the United States for less than 31 days in any tax year will not be classified as a resident for that year under this test.

Example

Lionel Jones, a British national, was present in the United States during the following periods:

Year	Period in US	Number of days
2006	1 July – 31 Dec	184
2007	All year	365
2008	1 Jan – 31 Jan	31

Jones's residence test is calculated as follows:

Year	Multiplier	Days present	Total
2006	1/6	184	31
2007	1/3	365	122
2008	1	31	31
			184

Since the total days computed under this test exceed 182, Jones meets the substantial presence test for 2008, even though he left the country on 31 January. However, if he had left on 29 January, he would have been a non-resident. If he had left on 30 January, he would also have been a non-resident as he would not have had 31 US days in the current year even though he would have had 183 days in total under the look-back rules. Furthermore, in certain circumstances, tax treaties may override residence rules.

An alien meeting the substantial presence test may nevertheless be treated as a non-resident if he or she is present in the United States for less than 183 days during the tax year; establishes that his or her connections with a foreign country are closer than those with the United States; and that he or she has a 'tax home' (generally, the individual's principal place of business) in that country. Residence in the United States does not automatically exclude a foreign tax home.

Thus, in the above example, Jones is taxed as a resident alien for 2007, since he was present in the United States for 183 days or more, but if he can establish that he has a tax home in another country and demonstrate his close connections to it, he will be treated as a non-resident alien for 2008.

Any day on which an individual is unable to leave the United States because of a medical condition that arose while he or she was present in the United States is not treated as a US day for the substantial presence test.

An alien classified as a US-resident for three consecutive years and who is a US-resident during one of the next three years, will be subject to US tax as a resident for all intermediate years on his or her effectively connected US business income and other US-source income.

An alien moving to the United States late in a year will fail to satisfy the substantial presence test for that year. Nevertheless, the individual may elect part-year resident status for that year provided he or she meets this test for the following year. A further election enables the alien to file a joint return with his or her spouse for the entire year. To qualify for the part-year resident election, the alien:

- may not be a US-resident for the year preceding the election year
- must be present in the United States for at least 31 consecutive days in the election year

- must be present in the United States for at least 75% of the number of days in the period beginning with the first day of the 31-day US presence test and ending with the last day of the election year.

Treatment of the family unit

There are five so-called filing statuses for individual taxpayers, as follows:

- single
- married filing jointly
- married filing separately
- head of household
- qualifying widow(er) with dependent child

Married couples may file joint income tax returns, which are usually more advantageous than separate returns, as the rate schedule for a joint income tax return subjects a substantially higher amount of income to the lower tax rates (see below, under 'Tax rates'). A joint return may not be filed if either spouse is a non-resident alien, but a married couple comprising a US citizen or resident and a non-resident alien may elect to file a joint return if they agree to be taxed on their world wide income. A similar election is available if the non-resident alien becomes a US resident during a tax year.

For federal tax purposes, a marriage means only a legal union between a man and woman as husband and wife. However, a man and a woman who are living together in a 'common-law marriage' on the last day of the tax year will be considered married for the whole year if that common-law marriage is recognised either in the State where it began or in the State where the couple is living. A man and woman who are living apart after divorce or who are legally separated under a separate maintenance decree on the last day of the tax year are considered to be unmarried for the whole year and may file for that year as single or as heads of household. Status as married or legally separated under a divorce or separate maintenance decree is determined by State law.

A head of household is an unmarried person or a person who is considered unmarried on the last day of the tax year, has paid more than half of the cost of keeping up a home for the tax year, and has or has had a 'qualifying person' living with him or her in the home for more than half the year (ignoring temporary absences). A 'qualifying person' is a child or grandchild aged no older than 18, a parent, or other relative who meets certain tests. Head of household status is more advantageous from a tax point of view than single status.

A taxpayer may file as a qualifying widow(er) with dependent child for any tax year if that taxpayer was unmarried at the end of that tax year, his or her spouse died in either of the immediately two preceding tax years, was entitled to file a joint return with his or her spouse in the year in which the spouse died, and has a dependent child in respect of whom the taxpayer is entitled to claim an exemption (allowance).

Children below the age of 18 who have earned income are generally assessed separately on that income. The unearned income of a child under 18 (below the age of 24 for a dependent child who is a full-time student unless the child meets certain earned-income requirements) is charged to tax at the highest rate applicable to either parent, if that income exceeds the sum of (a) USD 900 (EUR 575) and (b) the greater of USD 900 and the itemised deductions applicable to the child's unearned income. A parent may, however, elect to include a child's income in his or her return if the child's only income is from interest and dividends, and that income exceeds USD 900 and is less than USD 9000 (EUR 5800). These threshold and ceiling amounts are quoted at their 2008 values.

Income from employment

All remuneration, including most benefits and facilities derived from employment, is taxable. Fringe benefits are included in remuneration at fair market value. These include living allowances, housing allowances, costs of educating children and vacations. Tax exemption or deferment is available for some benefits, such as:

- qualified pension and profit-sharing plans
- health and accident plans
- reimbursed moving expenses
- meals or lodging furnished for the employee's convenience

Deductions

An individual may deduct any necessary travelling expenses (excluding travelling between home and work) and other ordinary and necessary expenses incurred in the performance of his or her duties. Dues and subscriptions to employment-related organisations and publications are deductible, as are entertainment expenses subject to the rules previously discussed for corporations.

If an employer reimburses an employee for his or her expenses, the employer may deduct the reimbursement. The reimbursement is not taxable income to the employee in this case, provided that he or she has properly accounted to the employer for the reimbursed expenses.

If the individual is an employee, other business-related deductions are allowable only as miscellaneous itemised deductions, and therefore only deductible if:

- the employee does not claim the standard deduction (see below)
- to the extent that they exceed 2% of adjusted gross income

Moving-expense reimbursements attributable to employment may be included in gross income. If specified conditions are met, an adjustment to income may be allowable for a limited amount of moving expenses.

Remuneration received by foreign personnel

Subject to applicable double taxation treaties, remuneration received for services rendered in the United States is considered derived from US sources unless:

- the services are performed by a non-resident alien temporarily present in the United States for not more than 90 days during the tax year
- the remuneration does not exceed USD 3000 (EUR 1925)
- the services are performed for:
  - A non-resident alien or foreign partnership or corporation not engaged in trade or business in the United States
  - A foreign business branch of a US citizen or resident, or a domestic partnership or corporation.

Foreign pensions

Foreign-source pensions received by persons resident in the United States are taxable. Pensions paid to non-resident aliens are generally taxable in the United States at the lower of 30% and the treaty rate if the services were performed in the United States.

Salary tax

There is withholding of taxes and social security contributions from earnings. See Chapter 3, under 'Withholding from wages and salaries'.

Business profits

The business profits of individuals carrying on a business or profession in the United States are taxed similarly to those of corporations, and the same deductions are generally available.

Deductions

If the individual is self-employed, business-related expenses are deductible in arriving at net income subject to tax.

Moving expense reimbursements attributable to self-employment may be included in gross income. If specified conditions are met, an adjustment to income may be allowable for a limited amount of moving expenses.

Net operating losses

Losses from business operations may be offset against income of any description (including capital gains) arising in the same tax year. Generally, a net operating loss in excess of current income is carried back two years and then forward 20 years. An individual may elect to waive the carry-back of a loss and only carry it forward.

Capital gains

The maximum tax rate on adjusted net long-term capital gains (property held for more than 12 months) is 15%. A maximum rate of 25% will be imposed to the extent of any prior depreciation attributable to gains from the sale of real property. The sale of collectibles such as stamps, antiques, gems, and most coins that have been held in excess of 12 months will be taxed at a maximum rate of 28%. A 0% rate will apply to those small-income taxpayers who would otherwise be in a 10% or 15% tax rate. Capital losses are deductible against capital gains and up to USD 3000 (EUR 1925) of ordinary income. Unused capital losses are carried forward for the individual's lifetime. Relief provisions are available for:

- sales or exchanges of principal residences
- exchanges of stock or securities in connection with corporate reorganisations
- exchanges of certain other investment or business property
- involuntary conversions of property.

Net capital gains on the sale of property not owned for more than 12 months are taxed at ordinary income rates.

Dividends

The same 15% (or 5% or zero) maximum tax rate that applies to net long-term capital gains also applies to dividends paid by most domestic and foreign corporations.

Deductions and allowances

The following personal expenses are deductible as itemised deductions:

- state and local income taxes
- real estate taxes
- personal property taxes
- charitable contributions to US charities (subject to limitations based on adjusted gross income)
- mortgage interest attributable to a first and second residence (limited to USD 1 million (EUR 645 500) in qualified indebtedness)
- investment interest up to the amount of investment income
- medical and dental expenses to the extent they exceed 7.5% of adjusted gross income
- casualty and theft losses to the extent they exceed USD 100 for each loss and 10% of adjusted gross income for all losses during the year.

Itemised deductions must be reduced by 3% of adjusted gross income exceeding certain amounts. The amounts are USD 159 950 (EUR 103 250) and USD 79 975 (EUR 51 625) for married persons filing separate returns. This reduction cannot exceed 80% of itemised deductions. The limitation is being phased out and for 2008 and 2009 only one-third of the reduction will apply. For these computations, the following deductions are ignored:

- investment interest
- medical expenses
- casualty or theft losses
- wagering losses (which are deductible only to the extent of wagering gains).

Investment interest exceeding net investment income and personal (consumer) interest is not deductible. Disallowed investment interest may be carried over and deducted in future years against investment income.

Standard deduction

A standard deduction may be claimed if it is greater than the taxpayer's itemised deductions. For taxable years starting in 2008, the standard deduction is USD 10 900 (EUR 7025) for joint returns; USD 5450 (EUR 3525) for a single person or a married person filing separately, and USD 8000 (EUR 5175) for a head of household.

Personal exemptions

Individual taxpayers are entitled to personal exemptions for themselves and their dependants. These exemptions benefit only lower-income taxpayers. For 2008, the amount of the personal exemption per dependant is USD 3500 (EUR 2250) and the deduction for personal exemptions is phased out beginning at an adjusted gross income (AGI) of:

• Single	USD 159 950
• Married filing jointly	USD 239 950
• Married filing separately	USD 119 975
• Head of household	USD 199 950

Credits

An individual is entitled to a credit against US federal income tax for foreign taxes paid on foreign income subject to US tax. The credit is limited to the same proportion of the US tax as the foreign-source income is of total world wide income. An individual is also potentially entitled to other miscellaneous credits, including a child tax credit (maximum USD 1000 for 2008).

Rates of income tax

The rates are graduated, and separate rate schedules are provided for single taxpayers, married couples filing joint returns, married couples filing separate returns and unmarried heads of households. The 2008 rate schedules are as follows:

Table 5

Single taxpayers – taxable income (USD)	Rate (%)
First 8025	10
Next 24 525	15
Next 46 300	25
Next 85 700	28
Next 193 150	33
Remainder over 357 700	35
Married couples filing jointly – taxable income (USD)	
First 16 050	10
Next 49 050	15
Next 66 350	25
Next 68 850	28
Next 157 400	33
Remainder over 357 700	35
Married couples filing separately – taxable income (USD)	
First 8025	10
Next 24 525	15
Next 33 175	25
Next 34 425	28
Next 78 700	33
Remainder over 178 850	35
Heads of household – taxable income (USD)	
First 11 450	10
Next 32 200	15
Next 69 000	25
Next 69 750	28
Next 175 300	33
Remainder above 357 700	35

The effective top rate on marginal income may exceed 35% in some situations because of the phase-out of itemised deductions and personal exemptions.

There is no separate rate schedule for qualifying widow(er)s, to whom the married filing jointly rates apply.

Alternative minimum tax (AMT)

Individuals are also subject to AMT. The individual tax rate is the sum of 26% of the first USD 175 000 (USD 87 500 if married filing separately) and 28% of any additional alternative minimum taxable income (special rules apply for capital gains, but generally net long-term capital gains will be taxed at the same maximum capital-gains rates applicable for regular tax purposes). This rate is applied to the AMT base. The AMT is paid only to the extent that it exceeds the regular income tax.

The AMT base is taxable income plus tax preferences, less an exemption. Without Congressional action, the exemption amount for 2008 will be USD 45 000 (EUR 29 050) for married individuals filing a joint return, USD 33 750 (EUR 21 775) for a single individual and USD 22 500 (EUR 14 525) for a married person filing separately. This exemption is phased out for higher-income individuals. The phase-out is equal to USD 25 for each US dollar of AMT taxable income exceeding USD 150 000 (EUR 96 825) for joint-return filers and USD 112 500 (EUR 72 625) for unmarried individuals. The exemption is completely phased out when AMT taxable income reaches USD 325 200 (EUR 209 925) for joint-return filers and USD 282 500 (EUR 182 350) for unmarried individuals.

Some common preferences for individuals are:

- excess depreciation
- tax-exempt interest on specified private activity bonds
- charitable contributions of appreciated property
- deferred income from certain instalment sales
- percentage depletion
- intangible drilling costs
- incentive stock options;
- passive losses
- state and local taxes
- interest expense
- medical expense
- miscellaneous itemised deductions

State income taxes

Many states impose a state income tax on individuals, using residence to determine whether the individual is taxable on all income or only income from that state.

Gift and estate taxes

The United States has a gift tax, an estate tax and a generation skipping tax that it charges on transfers of wealth either during life or at death. In addition to the US federal government, each of the states may also impose wealth transfer taxes.

The United States imposes a gift tax on the donor for the lifetime transfer of property by gift. US citizens and non-US citizens domiciled in the United States are subject to the gift tax on gifts of tangible and intangible property made anywhere in the world. Non-US citizens not domiciled in the United States (for ease of reference these individuals will be called 'non-domiciliary[ies]) are subject to gift tax on gifts of tangible property situated in the United States at the time of the gift. Examples of tangible property situated in the United States would include real estate, cars, and cash located in the United States. US stocks and bonds are intangible assets and therefore are not subject to the gift tax. Note, as discussed below, although US stocks are not subject to the US gift tax, they are subject to the estate tax.

For example, suppose individual A is a non-domiciliary of the United States. A has a child living in the United States and wishes to provide the child with a residence. A owns a residence in the United States and makes a gift of the residence to his child. Since the real estate is a tangible asset located in the United States this gift would be subject to the US gift tax.

Individual B, on the other hand, is an executive working for a major international corporation with offices in the United States. B is transferred to the United States and moves to the United States with his family. B purchases a residence in the United States and places the title in his name and the name of his wife, C. The source of the funds to purchase the house came from B's assets. B by titling the residence in his and C's name quite likely has made a gift of real estate to his wife, C, of a one-half undivided interest in real estate located in the United States. Such a gift would be subject to the US gift tax.

Domicile in the United States

The determination of the domicile of a non-US citizen is a vital element in determining whether that individual will be subject to the US gift tax on his or her worldwide gifts (and US estate tax on his or her world wide assets). The test of domicile for these purposes is entirely different from the test used to determine whether the individual is a resident of the United States for income tax purposes. For this reason, it is possible to be resident in the United States for income tax purposes and not be domiciled in the United States for purposes of the gift (and estate) tax.

A person is considered domiciled in the United States if he or she is present in the United States and if he or she has the intent to remain in the United States indefinitely. This test is a subjective test because a finding of domicile depends on the intent of the individual involved. The courts and the Internal Revenue Service look to certain objective factors to assist in determining the intent of the individual involved. Some of the factors that have been considered in the past include:

- place of residence
- length of time at residence
- social and community contacts
- declarations of intent
- green card or visa
- bank accounts
- physicians
- motives of changing residence
- rent vs. own a home
- place of business

No one factor is necessarily determinative, but certainly attaining a green card (permanent-residence visa) would be a factor that would generally result in a conclusion that an individual is domiciled in the United States. Likewise, an executive who has moved to the United States as a result of a temporary assignment for no more than three to five years has a greater likelihood of being able to defend a position that he or she is not domiciled in the United States. This is simply because the individual does not have the intent to remain indefinitely as evidenced by his or her employment agreement and immigration status.

Suppose individual D is an executive who has moved to the United States in connection with a three-year assignment by her employer. D is not a US citizen. She has moved to the United States with her family. They are renting their home and have not sold their residence in their home country. D's visa is a temporary visa and her expressed intent to her employer and others in her community is that she will be returning to her home country upon completing her three-year assignment. D should not be considered domiciled in the United States for purposes of application of the US gift or estate tax.

Gift tax

Annual Exclusion.

Smaller gifts are excepted from the gift tax. This exception is called the 'annual exclusion' The annual exclusion is occasionally adjusted for inflation, but currently the annual exclusion amount for a gift to any one individual is USD 12 000 (EUR 7750). The gift can be made in cash or property, but the value of the gift must be equal to or less than USD 12 000. US citizens and non-US citizens whether domiciled or not domiciled in the United States can take advantage of the annual exclusion. Because a gift to be eligible for the annual exclusion must be a gift of a present interest to the donee, gifts to a trust or gifts of interests in a limited partnership or limited-liability company require special considerations that are beyond the scope of this publication.

Suppose an individual, E, was not a US citizen but he has a green card and has lived in the United States for 20 years and intends to remain in the United States indefinitely. E is domiciled in the United States and is subject to the US gift tax on his worldwide gifts. E makes gifts of USD 12 000 to each of his five children during the calendar year. Because these gifts are outright gifts of USD 12 000 or less they qualify for the annual exclusion. There are no gift taxes and no filings with the Internal Revenue Service are necessary.

Applicable Exclusion (Credit) Amount.

In addition to the annual exclusion, US citizens and non-US citizens who are domiciled in the United States are entitled to a lifetime applicable exclusion amount (also known as unified credit exemption equivalent). To the extent that the lifetime exclusion amount is used during lifetime to apply against the gift tax it will, in effect, reduce the amount of the applicable exclusion available to apply against the estate tax at death. The applicable exclusion amount available for taxpayers who have never made prior taxable gifts is USD 1 000 000 (EUR 645 500). There is no applicable exclusion amount for non-domiciliaries. Thus, if a non-domiciliary makes a gift of tangible property situated in the United States and the value of the property exceeds the annual exclusion of USD 12 000, gift taxes will be owed to the Internal Revenue Service.

Take the case of F, an individual who is not a US citizen, but who has a green card and has lived in the United States for ten years and intends to remain in the United States indefinitely. She makes a gift to her child of real estate worth USD 1 012 000. F has never made any prior taxable gifts. Although F must file a gift tax return by 15 April of the following year, no gift taxes will be due because the gift qualifies for the annual exclusion of USD 12 000 and the applicable exclusion amount of USD 1 000 000. If F had been a non-domiciliary the amount of the gift in excess of USD 12 000 would have been subject to the US gift tax.

Marital Deduction.

Gifts to spouses who are US citizens are eligible for the unlimited marital deduction. Gifts to a spouse who is not a US citizen will not qualify for the marital deduction, but a special increase in the annual exclusion applies in this case. The annual exclusion for gifts to a non-US citizen spouse is adjusted annually for inflation and in 2008 the annual exclusion amount is USD 128 000 (EUR 82 625).. Further details may be found in *Estate Tax for Non-Residents United States of America* 2008.

By way of example, suppose G, an individual, who is not a US citizen, makes a gift of US real estate to his wife, who is a US citizen. The value of the real estate is USD 5 000 000. Since the gift is to a US citizen spouse, the gift is eligible for the unlimited marital deduction. . If G's spouse had been a non-US citizen the gift would not have been eligible for the marital deduction. The annual exclusion amount would be USD 128 000.

Charitable Deduction.

Gifts to certain charitable organisations meeting specific requirements as set forth in the US tax laws are eligible for an unlimited charitable deduction. For US citizens and non-US citizens domiciled in the United States, those gifts may be made to charitable organisations located in or outside the United States. Non-domiciliaries, however, are generally limited to gifts to US-based charitable organisations.

Suppose H, a non-domiciliary, met officials from a non-US charity at a hotel in New York City to transfer by gift certain artwork that he had in safekeeping at a vault in a museum also located in New York. The artwork was transferred to the non-US charity in New York. Since the art is tangible property located in the United States. the gift is subject to US gift tax. The gift would not be eligible for the unlimited charitable deduction because the gift was made to a non-US charity. If the value of the artwork exceeded USD 12 000, gift taxes would be due and payable by 15 April of the year following the year of the gift.

Gift tax rates

The US gift tax is a progressive tax with increasing tax rates based on the current year's taxable gifts combined with prior lifetime gifts. The 2008 rate structure is the same as the rate structure for estate tax purposes.

Table 6

Value of taxable gifts (USD)	Rate of tax (%)
First 10 000	18
Next 10 000	20
Next 20 000	22
Next 20 000	24
Next 20 000	26
Next 20 000	28
Next 50 000	30
Next 100 000	32
Next 250 000	34
Next 250 000	37
Next 250 000	39
Next 250 000	41
Next 250 000	43
Remainder over 1 500 000	45

The maximum tax rates are changing as follows:

2008 and 2009	45%
2010	35%
2011-	55%

Even though the gift and estate rate structures are identical, the gift tax is generally a more favourable tax because the gift tax does not impose a tax on the tax (it is tax-exclusive, and there is no need to 'gross up' the gift) as long as the donor lives for three years beyond the date of the gift.

Suppose H, an individual, who is a non-domiciliary, makes a gift in 2008 of a US residence to her child. The residence has a value of USD 1 512 000. H has never made taxable gifts prior to 2008.

Taxable gifts prior to annual exclusion:	USD 1 512 000
Less annual exclusion:	12 000
Taxable gift	1 500 000
Gift tax	**USD 555 800**

Reporting the receipt of a gift or inheritance from a foreigner

The US gift tax is a tax on the donor, not the donee. Despite this fact, the Internal Revenue Service requires that the recipient report the gift (or inheritance or bequest) if the gift was made by an individual who is not considered a 'US person' and the aggregate gifts received from foreigners during the year exceeds USD 100 000 (EUR 64 550). Gifts in excess of USD 10 000 (EUR 6450) from foreign corporations or partnerships must also be reported. Generally, a 'US person' is a person considered resident in the United States for US income-tax purposes. Thus, if a non-resident individual who is not a US citizen makes a gift to an individual who is resident in the US for US income-tax purposes, the recipient must report the gift on a Form 3520. Generally, Form 3520 would be due by 15 April of the year following the year of receipt of the gift. Failure to report the receipt of the gift could result in penalties of up to 25% of the value of the gifted property.

Suppose J, an individual living in the US and a US citizen, receives a gift of stock worth USD 125 000 in 2008 from her uncle who is a national of and is domiciled in the United Kingdom. Even though the gift is not a US taxable gift because it is a gift of intangible property by a non-domiciliary, J must still report the receipt of the gift on Form 3520 filed by 15 April 2009. Failure to report the gift could result in the imposition of a penalty equal to 25% of the value of the gift, i.e. USD 31 250.

Estate taxes

The United States also imposes an estate tax on the transfer of assets to beneficiaries upon the death of an individual. The decedent's estate is required to pay the estate tax. Estate-tax returns are due nine months after the date of death. The estates of US citizens and individuals who are not US citizens, but who are domiciled in the United States at the time of their death, must consider the world wide assets of the decedent. Estates of non-domiciliaries (as stated above this is a defined term for purposes of this publication to mean a non-US citizen who is <u>not</u> domiciled in the United States) are only required to compute the estate tax based upon assets that are situated in the United States.

Suppose K, an individual, who was not a US citizen, but had held a green card and had been resident with his family in the United States for decades, dies. He had the intent to remain in the United States indefinitely. As a domiciliary of the United States, K is taxable on his world wide estate. K owned a residence in the United States with a fair market value of USD 1 000 000 and real estate in foreign countries worth USD 5 000 000. He also had an investment portfolio worth USD 20 000 000. K had made no taxable gifts during his lifetime and he died leaving his entire estate to his children. The US estate tax is imposed on K's estate. The executor responsible for administering K's estate is also responsible for filing an estate-tax return and paying the estate tax from the decedent's estate generally prior to distributions to the beneficiaries. In this example, K's gross taxable estate would be USD 26 000 000.

If K had not been domiciled in the United States his gross estate would have included only those assets situated in the United States. Clearly, his US residence would be situated in the United States. Likewise, his foreign real estate would clearly not be situated in the United States As discussed below, however, more detail about his investment portfolio would have to be obtained to determine what portions of the portfolio, if any, would be considered situated in the United States.

Assets situated in the United States

Executors of the estates of non-domiciliaries must determine which assets are considered situated in the United States to determine the assets subject to US estate tax. As stated previously, it is important to note that the status of an asset as situated in the United States varies when applying the gift tax and the estate tax. The following list is a brief overview of assets considered to be situated in the United States for the purpose of estate tax.

- Tangible property located in the United States at the time of death is generally considered situated in the United States. Examples would include real estate, cars, furnishings, art and jewellery. Works of art imported into the United States solely for public exhibition purposes are not included. The personal effects of a non-domiciliary who dies while in transit through the United States are not situated in the United States. Neither is merchandise that happens to be in transit through the United States when a non-domiciliary owner dies.
- US corporate stock. Many non-US executives acquire stock in a US corporation as a result of their employment in the United States. That stock would be included in their US gross estates for purposes of determining the US estate tax due. Also, ownership of an interest in a US mutual fund is generally considered ownership of stock in a US corporation and is included in the gross estate. Some funds, however, are unit investment trusts and the prevailing view is the estate must look to the holdings of the fund to determine if the assets are situated in the United States. The prevailing view is that stock options would be situated in the United States.
- Debt obligations of a US person or government entity are situated in the United States, but there are significant exceptions.
- Partnership interests are generally situated where the predominant business of the partnership is carried on. The authority on where partnership interests are situated

is sparse and therefore there is a degree of uncertainty when dealing with partnership interests.

- Beneficial interests in trusts in which the trust owns assets situated in the United States
- Revocable-type transfers subject to inclusion due to Internal Revenue Code Sections 2035-2038 will be included in the gross estate if property transferred is situated within the United States at the date of death or at the time of the transfer. Typically these types of transfer occur most frequently when contributing property to a trust. For this reason, a non-domiciliary should be cautious when funding trusts with assets considered situated in the United States, such as US real estate or US stocks.

Considered not to be situated in the United States are:

- life insurance proceeds on the life of an individual who is not a US citizen and is not domiciled in the United States
- bank deposits in the United States are not situated in the United States as long as not effectively connected with US trade or business. It should be noted that deposits in US brokerage firms unless deposited with a bank affiliate will not qualify for this exception and would therefore be included in the gross estate as an obligation of a US person.
- bank deposits with the foreign branch of a US corporation or US partnership if the branch is in commercial banking business are not considered situated in the United States
- certain portfolio debt obligations issued after 18 July 1984, if the interest on the obligation received by the decedent before death would be eligible for the exemption from withholding tax
- stock issued by a corporation that is not a US domestic corporation, even if the certificate is physically located in the United States.

Marital deduction

As with gift tax, bequests to spouses who are US citizens are eligible for an unlimited marital deduction. Bequests to spouses who are not US citizens are not entitled to any marital deduction. A significant difference between the gift and estate tax, however, is that a bequest to a 'qualified domestic trust', also known as a 'QDOT' will make the transfer eligible for the unlimited marital deduction. This qualified domestic trust can either be funded pursuant to the terms of the deceased spouse's will or by the surviving spouse who establishes the trust prior to the due date of the estate-tax return. The trust is solely for the benefit of the surviving spouse during his or her lifetime, and must have a US trustee. Income must be distributed from the trust on at least an annual basis. The trustee may make distributions from the principal of the trust to the surviving spouse, but generally distributions of principal will incur the estate tax. Upon the death of the surviving spouse, the deferred US estate tax, will then become due. A full discussion of the qualified domestic trust and US marital deduction is beyond the scope of this article. For further details, refer to *Estate Tax for Non-Residents United States of America* 2008.

Suppose that neither L, an individual, nor her spouse is a US citizen. L is domiciled in the United States for US estate-tax purposes. When L dies no portion of the bequests to her spouse will qualify for the marital deduction unless L's will causes the bequest to her spouse to be contributed to a qualified domestic trust. In the alternative, L's spouse could form a qualified domestic trust with the bequest and if the trust is established on a timely basis the bequest would qualify for the marital deduction.

Charitable deduction

As with gift tax, bequests to certain charitable organisations are eligible for an unlimited charitable deduction. In the case of a non-domiciliary, however, those charitable organisations must be US charitable organisations.

Administrative expenses and debts of the decedent

For an estate of a non-domiciliary, administrative expenses and debts are only deductible based on the ratio of US-*situs* assets to world wide assets. Thus, disclosure of world wide assets would be required to take the deductions for administrative expenses and debts of the decedent. Many estates of non-domiciliaries are reluctant to disclose world wide assets to the Internal Revenue Service, in which case none of the expenses or debts are deductible.

The non-deductibility of debts of the decedent can have a significant impact on the size of the non-domiciliary's estate-tax liability where the decedent owned US real estate with significant mortgages on the property. The debt would not reduce the value of the property for the purposes of estate tax. The major exception to this rule is where the mortgage or debt is a non-recourse debt. If the debt is a non-recourse debt (the decedent was not individually liable and the lender could only look to the property to pay the debt) then the debt is fully deductible against the value of the property to determine the amount included in the US gross estate.

Estate tax rates

US estate tax is a progressive tax with increasing tax rates based on the taxable estate combined with taxable gifts. The rate structure is the same as the rate structure for gift tax, purposes except that in the year of repeal (2010) the tax rate is zero. See Table 3 for the rates.

The maximum tax rates are changing as follows:

2008 and 2009	45%
2010	0%
2011-	55%

Exemption and foreign death-tax credit

For US citizens and non-US citizens domiciled in the United States, the applicable credit amount (also known as the unified credit exemption equivalent) in 2007 for individuals who have made no prior taxable gifts is USD 2 000 000 (EUR 1 291 000). For estate-tax purposes only (not gift taxes) the applicable exclusion amount is changing as follows. In the case of estates of decedents dying during 2009 the exclusion amount increases to USD 3 500 000 (EUR 2 259 225). For non-domiciliaries the applicable credit amount is limited to USD 60 000 (EUR 38 725) (or a unified credit of USD 13 000 (EUR 8400).

A foreign death-tax credit is available to US citizens and non-US citizens domiciled in the United States. The foreign death tax credit is allowed for the amount of any estate, inheritance, legacy, or succession taxes paid to any foreign country with respect to property located in that foreign country and included in the decedent's US gross estate.

A non-domiciliary is not entitled to any foreign death-tax credit unless otherwise provided for by treaty. See below.

Suppose that an executive, M, moved to the United States as part of a temporary assignment. The executive was not a US citizen, but had applied for a green card, had bought a house in the United States and sold his residence in his home country. His immediate family lives with him in the United States. M's residence is worth USD 300 000 and he has stock in his U.S. employer with a value of USD 700 000. M dies while on assignment. If M is considered domiciled in the United States (as is likely) his applicable credit amount for estate tax purposes would be USD 2 000 000. If M is not domiciled in the United States the residence and the stock valued at USD 1 million in total are US-*situs* assets and the applicable credit amount for estate tax purposes is only USD 60 000.

Generation-skipping tax

In addition to the gift and estate tax, the United States also imposes a generation-skipping tax on gifts and bequests from a grandparent to a grandchild (or the equivalent as defined by statute and regulations). Transfers to trusts that benefit grandchildren at the time of establishment or in the future may also be subject to the generation-skipping tax. The US generation-skipping tax involves a complex set of rules designed to ensure collection of a wealth transfer tax at each generation level. The generation-skipping tax is imposed in addition to any gift or estate tax that is otherwise due. Unlike the gift and estate tax, the generation-skipping tax has a flat rate equal to the maximum federal estate tax rate. As discussed above, the maximum rate for 2008 is 45%, decreases to 35% in 2009, becomes nil in 2010 and subsequently reverts to 55%.

Lifetime transfers to grandchildren are eligible for the annual exclusion of the same amount as the gift tax annual exclusion (USD 12 000 in 2008) with the exception that transfers to trusts must meet additional requirements to qualify for the generation-skipping annual exclusion.

A generation-skipping exemption may be applied to outright transfers to grandchildren or allocated to trusts that have future potential to incur the generation-skipping tax. The generation-skipping exemption is available to US citizens and non-US citizens regardless of their domicile. The generation-skipping exemption for 2008 is USD 2 000 000 and is changing as follows. In 2009, it becomes USD 3.5 million and is zero in 2010.

The generation-skipping tax is applicable to non-domiciliaries only if the transfer is subject to the US gift or estate tax.

2001 Tax Act

The US wealth-transfer taxes are currently in a state of flux. Current US tax law causes a reduction in maximum rates and increases in the estate-tax applicable exclusion and generation-skipping exemption in 2009. Estate tax and generation-skipping tax are generally repealed for 2010. The maximum gift-tax rates are likewise being reduced, but the applicable exclusion amount for gift-tax purposes remains at USD 1 million. Unlike the estate and generation-skipping tax, the gift tax will remain in place in 2010 with a maximum rate of 35%. In the year of repeal (2010) a carry-over basis régime will exist (with certain complex modifications) for federal income-tax purposes. Thus, although there will be no estate tax, a beneficiary will generally receive a basis equal to the basis held by the decedent. The result of this carry-over basis from the decedent will be that the beneficiary will have a gain when the property is sold measured by the decedent's basis rather than by the fair market value of the property at the time of the decedent's death.

In the year 2011 the entire scheme provided in the 2001 Act is scheduled to 'sunset' and the state of the law prior to the 2001 Act will return. Thus, the gift, estate and generation-skipping tax will return to their status prior to the 2001 Tax Act. The current administration would very much like to make the repeal permanent. Although the Republican Party currently controls the Presidency, the 2006 elections have placed the Democratic Party in majority control of both legislative branches of the US Congress. Accordingly, the success of an effort permanently to repeal the estate and generation-skipping tax is uncertain. Permanent repeal will become even less likely if the Democrats win the 2008 presidential election. Estate planning in the meantime will have to take into consideration the potential for substantial change in the US system of taxation on the transfer of wealth.

Expatriation to avoid tax

Internal Revenue Code section 877 imposes certain special rules as to income, gift and estate taxation for ten years after a US citizen and a long-term resident expatriates with the intent to avoid paying tax. A complete discussion of section 877 is beyond the scope of this publication. Suffice it to say that if section 877 applies to the decedent, his or her estate will be required to include a portion of the value of a foreign corporation in their gross estate if:

- at the time of death the decedent owned directly or indirectly through certain foreign entities, 10% or more of the voting power of stock in the foreign corporation; and

- at the time of death the decedent owned, directly or indirectly, through certain foreign entities, or is deemed to own through application of certain constructive ownership rules, more than 50% of the voting power or value of the stock of the foreign corporation. Interests of others are attributed to the decedent through application of the certain-attribution rules.

Treaties

The United States has a number of estate-tax treaties with other countries. For a full list, see the Appendix.

Acts of the US Congress and international treaties are of equal force. Generally, if it is clear it was the intent of Congress, a subsequent US statute will prevail over a treaty provision. Likewise, a subsequent treaty provision will prevail over a prior act of Congress. A treaty-based return position must be disclosed on Form 8833 to be attached to the return for each position taken.

Generally, these treaties make credits available to estates of US citizens and non-US citizens domiciled in the United States for death taxes paid to the relevant treaty partner. In addition, they provide certain rules for determining the *situs* of property. In some cases these rules differ from those set forth under the US tax law discussed above. The estate-tax treaties are also used to determine the credit allowable to estates of citizens and non-citizens domiciled in the United States and to determine the property includible in the estates of non-domiciliaries who come within the scope of the treaties.

State inheritance or estate taxes

In addition to the federal wealth-transfer taxes described above, each of the 50 States of the United States may also impose wealth-transfer taxes. Many States do impose an estate or inheritance tax. The computation of such a tax can vary widely from State to State and certainly can differ from the federal estate-tax computation. Unless a decedent resided in a certain State, the estate or inheritance tax will be limited to only those assets situated in that State. If a decedent resided in a particular State, that State may attempt to impose its estate or inheritance tax on the world wide estate, much like the federal estate tax. A full discussion of the various State estate and inheritance taxes is beyond the scope of this publication.

6. Other taxes

State and local taxes

For State and local taxes, see under Chapters 4 and 5.

Excise taxes

Federal excise taxes are imposed on a variety of US-produced goods and services, including:

- ozone-depleting chemicals
- foreign insurance and reinsurance policies
- alcohol
- tobacco
- air transportation
- gasoline and petroleum
- tyres
- heavy trucks and trailers
- non-commercial aviation fuel
- diesel fuel (unless used on a farm for farming purposes)
- coal
- high petrol-consumption automobiles
- firearms

Customs duties

Customs duties are imposed on imported goods at varying rates subject to several exemptions. The US income-tax basis of property imported into the United States from a related party cannot exceed the value claimed for customs purposes.

7. Social Security Contributions

Social security system

The compulsory social security system in the United States has two elements:

- old age, survivors and disability insurance (OASDI) and
- medical care insurance (Medicare)

Both employers and employees contribute equally to both systems.

Employer contributions

All employers are required to contribute to the federal social security system to fund retirement and health benefits for employees. Employers also pay a federal unemployment tax, which supplements the unemployment-benefit systems of the various States. Contributions are based on a percentage of employees' remuneration. OASDI contributions are subject to an earnings ceiling, whereas Medicare is payable on all earned income.

OASDI is payable at 6.2% up to a maximum per employee, which is adjusted annually. For 2008, the ceiling is USD 102 000 (EUR 65 850). The rate of Medicare contributions is 1.45%. Hence the combined rates for employers in 2008 are as follows:

Table 7

Gross earnings (USD)	Contribution rate (%)
First 102 000	7.65
Remainder above 102 000	1.45

Generally, foreign employers of non-resident aliens performing services in the United States also must make these contributions.

Employee contributions

Employees must also pay contributions to the US social security system, at the same percentage rate of their earnings as is paid by their employer (see Table 7).

Generally, non-resident aliens employed in the United States must pay social security contributions in the same way as US citizens or residents. The United States has social security (totalisation) agreements with several foreign countries. These eliminate dual coverage and contributions for the same remuneration. For a full list, see the Appendix.

Contributions by self-employed persons

Self-employed individuals pay social security contributions for retirement and health benefits based on a fixed percentage of their self-employment income, up to a maximum amount. In effect, the self-employed individual pays both the employer and employee portions of the tax, and then receives a tax deduction equal to the employer portion of the tax (i.e. half the total tax). However, they do not pay unemployment taxes.

Contributions by foreign workers

Foreign workers employed in the United States may receive social security benefits in the same manner as US workers once a satisfactory US contributions history has been established. Certain social security agreements with other countries allow the transfer of a foreign contributions history to become part of the US contributions history. Benefits are paid only for retirement, disability or death.

8. BDO *Seidman* LLP

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BDO Seidman LLP also has offices in Chicago, Houston, Los Angeles, New York, Philadelphia and 27 other US towns and cities. It also has an exclusive Alliance Program comprising independently owned and managed CPA firms in locations throughout the United States.

Double Taxation Agreements

The United States has income or income and capital tax treaties in effect with the following jurisdictions:

Australia	Indonesia	Portugal
Austria	Ireland	Romania
Bangladesh	Israel	Russia
Barbados	Italy	Slovakia[2]
Belarus[1]	Jamaica	Slovenia
Belgium	Japan	South Africa
Canada	Kazakhstan	Spain
China	Korea	Sri Lanka
Cyprus	Kyrgyzstan[1]	Sweden
Czech Republic[2]	Latvia	Switzerland
Denmark	Lithuania	Tajikistan[1]
Egypt	Luxembourg	Thailand
Estonia	Mexico	Trinidad and Tobago
Finland	Morocco	Tunisia
France	The Netherlands	Turkey
Germany	New Zealand	Turkmenistan[1]
Greece	Norway	Ukraine
Hungary	Pakistan	United Kingdom
Iceland	The Philippines	Uzbekistan[1]
India	Poland	Venezuela

[1] The treaty with the former USSR
[2] The treaty with the former Czechoslovakia

Treaties have been concluded with Argentina, Aruba, Bulgaria and the Netherlands Antilles, but these are not yet in force.

The United States also has a limited insurance-transactions treaty with Bermuda and limited transport-tax treaties with:

Argentina	Fiji	Marshall Islands
Bahamas	Hong Kong	Panama
Bahrain	Isle of Man	Peru
Bolivia	Jersey	Saudi Arabia
Brazil	Jordan	Singapore
Chile	Liberia	St Vincent and the Grenadines
Colombia	Malaysia	Taiwan
El Salvador	Malta	United Arab Emirates

Estate-tax treaties

The United States has concluded treaties to avoid double taxation on gifts and inheritances with:

Australia	Greece[1]	South Africa[1]
Austria	Ireland[1]	Sweden
Denmark	Italy[1]	Switzerland[1]
Finland[1]	Japan	United Kingdom
France	Netherlands[1]	
Germany	Norway[1]	

[1] The treaty covers estates and inheritances only

Social security treaties

The United States has bilateral social security agreements with:

Australia	Greece	Portugal
Austria	Ireland	Québec
Belgium	Italy	Spain
Canada	Japan	Sweden

Chile	Korea	Switzerland
Finland	Luxembourg	United Kingdom
France	Netherlands	
Germany	Norway	

Agreements have also been concluded with the Czech Republic, Denmark and Mexico, but these are not yet in force.

Exchange-of-information agreements

The United States has concluded treaties providing for mutual exchange of information by its tax authorities with the tax authorities of the following countries and territories:

American Samoa	Dominican Republic	Mexico
Antigua and Barbuda	Grenada	Netherlands Antilles
Aruba	Guyana	Peru
Bahamas	Honduras	Puerto Rico
Barbados	Isle of Man	St Lucia
Costa Rica	Jamaica	Trinidad and Tobago
Dominica	Marshall Islands	

There is also a treaty of mutual assistance in tax matters between the OECD and the Council of Europe, which has been given effect in the United States and Azerbaijan, Belgium, Denmark, Finland, France, Iceland, Italy, the Netherlands, Norway, Poland and Sweden.

BDO Member Firm Offices

BDO Member Firms have offices in the following countries:

Angola	Hungary	Peru
Argentina	India	Philippines
Australia	Indonesia	Poland
Austria	Ireland	Portugal
Bahamas	Isle of Man	Qatar
Bahrain	Israel	Reunion
Belgium	Italy	Romania
Bolivia	Jamaica	Russia
Botswana	Japan	Saudi Arabia
Brazil	Jersey	Senegal
British Virgin Islands	Jordan	Serbia
Bulgaria	Kazakhstan	Seychelles
Canada	Korea	Singapore
Cape Verde	Kuwait	Slovakia
Cayman Islands	Latvia	Slovenia
Chile	Lebanon	South Africa
China (PRC)	Liechtenstein	Spain
Colombia	Lithuania	Sri Lanka
Comoros	Luxembourg	Suriname
Croatia	Macao	Sweden
Cyprus	Madagascar	Switzerland
Czech Republic	Malaysia	Taiwan
Denmark	Malta	Thailand
Dominican Republic	Mauritius	Trinidad & Tobago
Ecuador	Mexico	Tunisia
Egypt	Morocco	Turkey
El Salvador	Mozambique	Turkmenistan
Estonia	Namibia	Ukraine
Fiji	Netherlands	United Arab Emirates
Finland	Netherlands Antilles	United Kingdom
France	New Zealand	United States of America
Germany	Nigeria	Uruguay
Gibraltar	Norway	Vanuatu
Greece	Oman	Venezuela
Guatemala	Pakistan	Vietnam
Guernsey	Panama	Zambia
Hong Kong	Paraguay	Zimbabwe

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