

The U.S. Tax System

SECTION 1.01	Corporate Income Taxes	3
SECTION 1.02	Federal Income Tax	3
(a)	Other Federal Taxes	5
(b)	Federal Taxes Applicable to a U.S. Branch of a Foreign Corporation	5
(c)	Branch profits tax	5
(d)	Foreign Investors In U.S. Real Property Act of 1980 (FIRPTA)	5
SECTION 1.03	State Income Tax	5
(a)	General Corporate Franchise Tax	6
(b)	State Franchise Taxpayer Rate	6
(c)	General Corporation Tax	7
(d)	Miscellaneous	7
SECTION 1.04	State and Local Individual Taxes	7
(a)	Individual Income Tax	7
(b)	Tax Base and Rates	8
SECTION 1.05	Payroll taxes	8
(a)	Federal Insurance Contributions Act (FICA)	8
(b)	Federal Income Tax Withholding (FIT)	9
(c)	Federal Unemployment Tax (FUTA)	9
(d)	Periodic Deposits	9
(e)	Withholding Tax Applicable to Foreign Partners	9
(f)	Workers Compensation	9
SECTION 1.06	Record keeping	9
SECTION 1.07	Failure to pay taxes	10
SECTION 1.08	Reference Sources	10
APPENDIX I.	Glossary of Specific Types of Income	11
APPENDIX II.	SPECIAL U.S. FEDERAL TAX PROVISIONS APPLICABLE TO FOREIGN CONTROLLED U.S. CORPS ...	13
Table 1	Federal corporate income tax rates	4
Table 2	General tax liabilities	4
Table 3	State income tax liabilities at a glance for New York State and City	7
Table 4	Failure to pay taxes	10

The U.S. Tax System

All corporations operating in the United States (U.S.) are subject to an array of federal, state and local taxes. The taxes for which an entity will be held responsible are a function of the classification under which a business chooses to incorporate in the U.S. and how it conducts operations in regards to this treatment. The amount a corporation must pay will vary according to the type of business entity it selects, the gross revenues, and the number of persons it employs. Once the net taxable income is determined from business operations generated by the taxable presence in the U.S., some reductions to taxable income may apply through royalties or fees. Transfer pricing of goods and interest expenses can also be utilized, under certain conditions, to reduce taxable income.

U.S. law allows taxpayers to elect to treat domestic and foreign entities (unless specifically prohibited) as either partnerships or corporations for federal income tax purposes. This provision removes the issues of management characteristics, dissolution provisions or restrictions on the transfer of non-publicly traded interests.

Once a taxable presence exists and the best structure put in place to reduce U.S. taxable income of such presence, then the issue becomes whether to operate via a U.S. subsidiary or a branch. A corporation needs to examine the applicable income tax treaty to determine whether it (a) exempts the foreign corporation as a qualified treaty resident from Branch Level Tax, (b) exempts the foreign corporation from U.S. withholding taxes upon dividends paid by the foreign corporation attributable to U.S. earnings, or (c) exempts the foreign corporation from Branch Level Interest Tax. In the absence of these exemptions, the U.S. subsidiary form will usually be preferred. If one or more of these exemptions exists, the branch might prove a better option from the tax standpoint.

In the United States, taxes categories fall into five main business classifications:

- Income Taxes
- Self-Employment Taxes
- Employment Taxes
- Gross Receipts
- Excise Taxes

Taxes are collectable at all times under the same terms on the federal level. However, each state sets its own tax filing requirements. A company's state tax liability will vary depending whether it is incorporated in a particular state and/or conducts business in that particular state. In addition, cities and counties may require their own tax liabilities (generally referred to as 'local' taxes). Businesses making taxable retail sales generally hold a Sales and Use Tax Permit. In this dual federal-state system, each government agency levies income taxes on all business earnings and requires businesses to file separately with both agencies. In some cases, these agencies may require the filing and paying of estimated taxes on a set periodic basis.

In the broadest terms, taxes are assessed on revenues and expenses from:

- Operating activities (cost of doing business)
- Revenue generating activities (sales)
- Personal income



Every U.S. Corporation subject to income tax is required to file an annual income tax return based on either a calendar or fiscal period. The return is due by the fifteenth day of the third month following the close of the taxable year. You elect when to file your company's first tax return; this period need not coincide with your financial accounting period. Cash and accrual methods are acceptable although corporations general employ the latter.

This section summarizes the general tax liabilities for the majority of corporations located in the U.S. Underpinning the federal system are state liabilities that vary from state to state. Localities (counties, cities, villages) will bring to bear their own liabilities. Delaware and New York provide a good base for comparison (Delaware is corporate home to many entities; New York has the most international companies in operation and can be used to highlight city tax codes).

Section 1.01 Corporate Income Taxes

The U.S. tax system treats a corporation as a separate and distinct entity from its shareholders. Earnings are taxed once at the corporate level and the remaining income taxed again at the shareholder (personal) level upon distribution. Inter-company dividends may be excluded under some conditions. The exception is the S corporation, which is taxed only once on the corporation's entire net profit (a shareholder working for an S corporation must declare himself an employee and pay payroll taxes).

Section 1.02 Federal Income Tax

Any corporation incorporated under U.S. law, with limited exceptions, is subject to U.S. federal tax system tax liabilities on their worldwide income. The U.S. does not consider shareholder status. Foreign tax treaties and credits provide relief from double taxation, for example a foreign person is taxable in the U.S. only if she is conducting an activity through a "permanent establishment" be it an office, branch, or factory, operated by the foreign person or a dependent agent authorized to conclude contracts on behalf of the foreign person.

Barring any treaty, a taxable presence is created if the foreign person has "effectively connected income" with a U.S. trade or business conducted within the U.S. The U.S. and Turkey have such a treaty in place. Treaty terms are discussed elsewhere in this document; foreign tax credit terms are not.

A company may reduce the scope of its taxable presence by isolating functions that would not create such a presence in the U.S. Should one operate a foreign company in the U.S. through an unincorporated branch, he/she would make him/herself subject to corporate income tax only on the income from his/her U.S. business operation. However, profits not reinvested in the U.S. and not covered by a tax treaty may be subject to a 30% tax.

Taxable income is an aggregate of gross income items reduced by a similar aggregate of deductible items. Gross income generally includes all sources of income except those specifically stated by law to be otherwise to create wealth for the business. Gains are not taxable until recognized. Asset appreciation can be generally delayed until the sale, exchange or conversion of the item or property. To determine a company's tax liability, its net income is multiplied by the applicable corporate tax rate. (Source: TRP)



Table 1 Federal corporate income tax rates

Greater than (in 000's)	Less than or equal to (in 000's)	Pay (000's)	+ %
\$0	\$50		15
50	75	\$7.5	25
75	100	13.75	34
100	335	22.25	39
335	10,000	113.9	34
10,000	15,000	3,400.0	35
15,000	18,333	5,150.0	38
18,333	-	35% of taxable income	-

Corporations may use general business tax credits to reduce their tax liability. Tax credits include, but are not limited to, investment credit, research, targeted jobs, and low income housing credit. This credit offsets the first \$25,000 of tax liability plus 75% of the balance.

The table below provides a general guide to the types of taxes each entity classification is responsible for filing. State and local requirements will vary. Finally, taxes may be collectable both in a corporation's state of incorporation as well as the state(s) where it conducts business.

Table 2 General tax liabilities

		Sole proprietor	Partnership	Partner in a partnership (individual)	Corporation or S corporation	S corporation shareholder
INCOME TAX		X		x	x	x
ANNUAL RETURN OF INCOME			X			
SELF-EMPLOYMENT TAX* (net earnings from self-employment (excluding church employee income) >\$400 or church employee income > \$108.28)		X		x		
EMPLOYEE**	Social security and medicare taxes and income tax withholding	X	X		x	
	Federal unemployment (futa) tax	X	X		x	
	Depositing employment taxes	X	X		x	
ESTIMATED TAX	Firms expecting payments > \$1000	X		x		x
	Firms expecting payments > \$500				X	
EXCISE TAXES***		x	X		x	
ANNUAL RETURN OF INCOME			X			
<p>* Self-employment tax is a social security and Medicare tax the payments of which contribute to your coverage under the social security system. ** Employers withhold part of these taxes from employee's wages and pay a matching amount. *** Required if you manufacture, sell, or use certain products, operate certain kinds of businesses, receive payment for various kinds of services and facilities. Excise taxes vary by state and include environmental taxes, communications and air transportation taxes, fuel taxes.</p>						
<p>Employment taxes: Before paying employment taxes, you must determine if an individual is an employee or an independent contractor. Classification carries implications and liability. As the employer, you are liable if individual is misclassified to avoid withholding or payment of taxes.</p>						
<p>Federal Income: Social security and Medicare taxes pay for benefits that workers and their families receive under the Federal Insurance Contributions Act (FICA). FICA taxes are levied on both the employer and employee, and withheld by the employer.</p>						
<p>Federal Unemployment (FUTA) Tax: Part of the federal and state program under Federal Unemployment Tax Act (FUTA) that pays unemployment compensation to workers who lose their jobs. FUTA tax is separate from social security and Medicare taxes and withheld income tax. Source: IRS</p>						



(a) OTHER FEDERAL TAXES

The U.S. tax system imposes additional taxes to ensure that all corporations with economic income will pay some federal income tax. These taxes include the Alternative Minimum Tax (AMT) with a base rate of 20%, Accumulated Earnings Tax (AET) with a base rate of 39.6%, and the Personal Holding Company Tax (PHCT) that imposes a 39.6% rate on the undistributed personal holding company income of closely held corporation. An affiliated group of U.S. corporations - but not foreign corporations—may elect to file a consolidated income tax return.

(b) FEDERAL TAXES APPLICABLE TO A U.S. BRANCH OF A FOREIGN CORPORATION

A foreign corporation engaged in a U.S. trade or business is subject to U.S. tax at regular corporate income tax rates on taxable income effectively connected with such trade or business. Engaging in a U.S. trade or business requires that the foreign corporation engage in substantial, continuous, and regular activities in the U.S. The source and type of income determines if it is effectively connected to a U.S. trade or business. A corporation may be exempt under certain tax treaty criteria. (Source: Thelen, Reid & Priest, LLC)

Income not connected with a U.S. trade or business is taxed on a gross basis at a flat rate of 30% (or lower treaty rate) only if such income is U.S. source income and then only to certain sources. In some instances, a corporation may use a net basis rather than the 30% flat gross. In addition, some items are excluded from tax, including a proportionate part of dividends and interest paid by a U.S. corporation that derives more than 80% of its gross income from active foreign business income. Subject to limited exceptions, only U.S. source income is subject to tax, rendering an item's source extremely important to a foreign corporation. Common income types from US source items include:

- Interest or dividend income
- Royalties
- Gain on sale of non-depreciable personal property other than inventory, inventory or intangibles

(c) BRANCH PROFITS TAX

The Branch Profits Tax ("BPT") seeks to correct the disparity between doing business in the U.S. through a branch versus a subsidiary by restoring the withholding tax from dividend distributions. BPT exists independently of and in addition to a foreign corporation's tax on effectively connected income, generally assessed at a 30% tax on effectively connected after-tax earnings to the extent they are not reinvested in U.S. property. A treaty may exempt earnings from the BLT or reduce the tax rate; however, most foreign firms prefer to conduct their U.S. operations as wholly owned U.S. subsidiaries rather than as U.S. branches.

(d) FOREIGN INVESTORS IN U.S. REAL PROPERTY ACT OF 1980 (FIRPTA)

FIRPTA makes clear that foreign corporations are subject to U.S. taxation when they realize a gain from disposition of a "United States real property interest." This gain is treated as income and generally subject to a maximum 35% tax rate.

Section 1.03 State Income Tax

Under the U.S. system, states retain the right to impose and collect taxes. State income is generally payable on that portion of a corporation's total U.S. net income derived from operations within the state. Each state uses an apportionment formula to determine the amount subject to the tax. Some states apply this apportionment only to income derived from customers



in the state. For example, if a company conducts business in State A but only 25% of its customers reside in State A, it pays tax only on that 25% portion of its customer base.

To a great extent, states and localities compete with each other for a company's business, offering wage, sales and utility tax reductions and incentives. Not all states have a state income tax or impose real property ownership tax. For example, Delaware is considered a corporation-friendly state with few state and local tax liabilities, the Chancery court and a very friendly business administration office. Most states offer special tax incentives for doing business in special enterprise zones. In New York, these "Empire Zones" (New York being the "Empire State"), are geographically defined areas where businesses have access to vacant land, existing industrial and commercial infrastructure, a skilled workforce and power and water supplies. Special categories exist for new businesses. Using New York State and New York City as examples, the table below outlines typical state and local taxes and fees that may be applicable to a business. Requirements and amounts vary over time.

Unlike the State and Federal governments, New York City taxes S corporations as true corporations, imposing both the corporate tax and a personal income tax on the amount distributed to the owners. New York City partnerships, sole proprietorships, and LLCs are subject to an unincorporated business tax (the "UBT") which, like the corporate income tax, taxes corporate profit both as business income, and again as personal income of the sole proprietor, partners or members. (Source: Thelen, Reid & Priest, LLC)

Note that before any business can be conducted, a tax identification number, whether it is an Employer Identification Number (EIN) or a Social Security Number (ID), must be requested. Businesses with employees must have an EIN (sole proprietors with no employees have the option of using their social security number as the tax ID number). A company uses its EIN to pay employees' withholding taxes and deposit these funds with the IRS. Corporations need an EIN number to open a bank account. In addition, the EIN is used for tracking a businesses' social security and unemployment payments. Employers are also required to pay federal unemployment taxes, but are given a credit for amounts paid to the State.

An out-of-state corporation must be authorized by the state in which it wants to do business. A filing fee for foreign authority should be expected and a certificate of existence from the jurisdiction in which the corporation is organized should be attached to the application.

(a) GENERAL CORPORATE FRANCHISE TAX

States may impose a corporate franchise tax on state and foreign corporations doing business, employing capital, owning or leasing property, or maintaining an office in that state. This tax may income or capital based (or both), and subject to "MTA". Many states tax only an apportioned share of a corporation's income or capital, even if the corporation is organized under state law. For example, a foreign corporation doing business in NY is taxed only on NY's share of its worldwide income; operating through a U.S. subsidiary or U.S. branch has little tax consequence in New York. Foreign corporations operating through a branch are required to report their worldwide income to the NY authorities where its NY business is part of a unitary business that includes its worldwide operation. In most cases, to avoid this reporting requirement, non-U.S. corporations conduct U.S. business in the form of a U.S. subsidiary rather than a branch.

(b) STATE FRANCHISE TAXPAYER RATE

A state franchise taxpayer determines tax by applying the appropriate rate to alternative state tax bases. The return employs the tax base that yields the highest tax.



(c) GENERAL CORPORATION TAX

State or localities may impose a general corporation tax on business corporations. In NY, this tax parallels the state franchise tax on business and capital allocated to the city or county.

(d) MISCELLANEOUS

States may also impose taxes on real property transfers, mortgage recording, and sales and use.

Table 3 State income tax liabilities at a glance for New York State and City

Source: New York State Department of Taxation & Finance

(See Section X for licenses and registrations required for tax purposes)

TAX/FEE	DESCRIPTION
Sales and Related Taxes (State & City)	Both City and State impose a tax on sale or use of various tangible items at a percentage of the retail price. The tax is applied to the final price at time of purchase.
Commercial Rent Tax (CRT)	Imposed only in Manhattan south of 96th Street for commercial activity, where annual base rent is \$100,000 or more, before the 25% rent reduction.
Real Estate Tax and Related Charges	If a retail business owns the building in which it operates, the business is subject to real estate and other related charges.
Unincorporated Business Tax	Imposed on taxable income of every unincorporated business in NYC, including those conducted by individuals and partnerships. The tax rate is 4% on unincorporated business taxable income. Unincorporated business includes any trade, business, profession, or occupation engaged in by an individual or unincorporated entity.
General Corporation Tax (GCT)	Imposed annually on corporations doing business in the City in a corporate or organized capacity.
Commercial Motor Vehicle Tax	Imposed on use of commercial non-passenger motor vehicles used principally within the city and motor vehicles regularly used for passenger transportation.
Water and Sewer Charges	City businesses are billed for water usage based on consumption. The water bill also contains a sewer charge.
Cigarette Tax	City and State impose sales and tobacco taxes on cigarettes. Retail establishments must buy cigarettes with tax stamps affixed to them from a licensed wholesaler.
Beer, Wine and Liquor License Tax	Imposed on retail sale of beer, wine or liquor, for on- and off-premise consumption.

Section 1.04 State and Local Individual Taxes

(a) INDIVIDUAL INCOME TAX

States may impose a tax on the taxable income of individuals. An individual’s status determines the tax. In NY, residents are generally subject to tax on all earned (e.g., wages) and unearned (e.g., interest) income. Nonresidents, by contrast, pay income tax only on income from NY sources. (Source: TRP)

- (i) State Resident. For income tax purposes, an individual is considered a NY resident if (i) domiciled in NY or (ii) maintains a permanent home in NY and spends more than 183 days in NY during the year.
- (ii) Nonresidents. For income tax purposes, nonresidents include all individuals that are not NY residents for any part of the calendar year. Nonresidents are subject to tax only on income from NY sources. NY source income generally includes income, gains, losses, or deductions included in federal adjusted gross income from:



- Services performed in New York.
- Business carried on in New York.
- Real or tangible personal property located in New York.
- Share of income or loss from a partnership sourced to New York.

(b) TAX BASE AND RATES

Federal adjusted gross income, with certain modifications, can be used to calculate taxable New York source income. New York employs a graduated tax rate while other states impose a tax on the individual's gross income with few modifications, e.g. New Jersey, which does not utilize federal adjusted gross income as a starting point. (Source: TRP)

- (i) City Individual Income Tax. The extent to which an individual is subject to NYC taxes is determined by status, generally set forth in state guidelines.
- (ii) City Resident Income Tax. A city may impose a graduated income tax on its residents. In NYC, resident income tax is imposed on the same taxable income subject to NY income tax, based on the same income, adjustments and deductions. NYC personal income tax rates vary by filing status and by city taxable income. Current rates range from 3.08% to 4.46% for taxable years beginning in 1998.

U.S. Residents are subject to tax on their worldwide income. A U.S. resident's taxable income is computed similarly to that of a U.S. corporation. Foreign nationals residing in the U.S. -- nonresident aliens -- are taxed on the same basis as U.S. citizens on income derived from U.S. sources. Income type determines how such income is taxed. The maximum stated tax rate applicable to a U.S. Resident's ordinary income is 39.6%. Rates for long term capital gains and capital losses differ. Residents may take tax credits against their U.S. income for taxes paid to foreign countries.

Income effectively connected to a U.S. trade or business is generally taxed at graduated rates on a net basis. Non-business (FDAP) U.S. source income is subject to a flat 30% tax (or lower treaty rate) on a gross basis. Capital gains are generally exempt from U.S. tax unless actually connected with a U.S. trade or business. However, capital gains from disposition of U.S. real property interests are deemed to be effectively connected with a U.S. trade or business, and therefore subject to U.S. tax.

The filing deadline for all individual tax returns is April 15.

Section 1.05 Payroll taxes

(a) FEDERAL INSURANCE CONTRIBUTIONS ACT (FICA)

All resident working persons of the U.S. are subject to FICA taxes. Social security and Medicare taxes pay for benefits that workers and their families receive under the FICA. FICA taxes are levied on both the employer and employee, and withheld by the employer. The employer and employee each contribute 6.2% (total 12.4%) of wages. The employee tax rate for Medicare is 1.45% (amount withheld). The employer tax rate for Medicare tax is also 1.45% (2.9% total). Maximum wages subject to Social Security is \$87,000. There is no ceiling on wages subject to the Medicare tax.

- (i) Social Security pays for benefits under the old-age (retirement), survivors, and disability insurance portion of FICA.
- (ii) Medicare pays for benefits under FICA hospital insurance.



(b) FEDERAL INCOME TAX WITHHOLDING (FIT)

Employers are required to withhold income taxes from employee paychecks based on each employee's marital status, amount of wages earned, and the number of withholding allowances.

(c) FEDERAL UNEMPLOYMENT TAX (FUTA)

In addition to federal funding requirements, most states require employers to report and pay federal unemployment tax (FUTA). Sole proprietorships and partnerships do not pay FUTA on owners' compensation.

(d) PERIODIC DEPOSITS

Employers are required to make periodic deposits of withheld Income tax, Social Security and Medicare. Substantial penalties exist for failure to make timely deposits.

(e) WITHHOLDING TAX APPLICABLE TO FOREIGN PARTNERS

Partnerships withhold tax in accordance with the classification of their U.S. source income:

- (i) Noneffectively Connected U.S. Source Income. This income can be fixed or determined on an annual or periodic basis ("FDAP"). A foreign partner may include this income in her distributive share of partnership income.
- (ii) Effectively Connected U.S. Source Income. Should any portion of this income be allocated to a foreign partner and the income connected, withholding is required. Corporate partners must withhold an amount equal to the highest corporate tax rate as applied to the foreign partner's allocable share or connected income. Withholding paid on behalf of a foreign partner is credited towards the partners U.S. income tax liability. (Source: TRP)

(f) WORKERS COMPENSATION

Like payroll taxes, employers are responsible for financing worker's compensation insurance. "Workers Comp" covers disability income and medical expense benefits for job-related injuries to your employees. State law sets premium rates and compensation rules and regulations. Rates vary by employee classification, e.g. office worker versus construction worker.

Section 1.06 Record keeping

Part of the tax process is keeping records. Aside from the business reasons for keeping good records—monitoring progress, preparing accurate financial statements, identifying sources of receipts (separate business and non-business), tracking deductible items— you will need this information to prepare and support your tax returns, as the IRS may ask to examine your records at any time.

With some exceptions, the law does not specify the kind of records a company must keep nor the system of record keeping so long as its taxable annual income is clear. The needs of the business will be the determinate so long as it provides one with a summary of business transactions and shows gross income. A company will also need to maintain supporting documents, for example sales slips, paid bills, invoices, receipts, and deposit slips. The overarching categories include gross receipts (the income a company receives from its business) and purchases (the items a company buys and resells to customers; as manufacturer or producer, one should include the cost of all raw materials or parts purchased to manufacture into finished products). These records will feed into end-of-year inventory valuation.



Section 1.07 Failure to pay taxes

The U.S. law provides criminal penalties for tax evasion, failure to file tax returns and/or failure to pay the proper amount of taxes. These penalties range from fines to prison terms. Financial penalties are incurred from the due date for failure to file or pay. Failure to follow information reporting requirements and failure to supply your taxpayer identification number (SSN or EIN) also carries financial penalties. The IRS strictly enforces payroll tax rules. Penalties for non-payment of payroll taxes can be very steep with owners, partners, and even corporate shareholders personally liable for non-payment. Penalty waivers only apply if you can show reasonable cause rather than willful neglect. The table below outlines the period of limitations for federal tax failures.

Table 6 Failure to pay taxes

Actions	Period of limitations:
Additional tax is owed outside of situations (2), (3), and (4), below	3 years
Failure to report reportable income exceeding 25% of gross income shown on return	6 years
Filing a fraudulent income tax return	No limit
Not filing a return	No limit
Claiming a credit or refund* after you file your return	Later of: 3 years or 2 years after tax paid

Section 1.08 Reference Sources

Doing Business in the United States, Thelen Reid & Priest, LLC
New York State Department of Taxation & Finance
New York Loves Small Business
NYBIZTAX
State of Delaware
Internal Revenue Service
Small Business Administration
US Chamber of Commerce

Appendix I. Glossary of Specific Types of Income

TERM	DEFINITION
Business Profits	The gross income of a business, other than a service business, includes its gross profit from the sale of goods less costs of goods sold. Gross income of a service business is gross receipts.
Dividends	A corporate distribution of earnings and profits to its shareholders is includible in the shareholder's gross income as a dividend. However, a corporate shareholder is generally entitled to a deduction equal to 70% of the dividends received from taxable domestic corporations. A 20% or more shareholder is generally eligible for an 80% deduction, and a member of an affiliated group of corporations (generally an 80% or more shareholder) may elect to exclude 100% of the dividends received from another group member.
Stock dividend	With certain exceptions, dividends are not included in gross income, but instead require the basis of the original shares to be apportioned among the old and the new shares.
A distribution of property	Included in gross income at an amount equal to the property's fair market value (net of any liabilities assumed by the distributee or attached to the property distributed).
Royalties	Includes payments for use of certain property rights (for example, patents, trademarks, know-how and other intangibles) and are includible in gross income. Under certain circumstances, payments received as royalties for the transfer of such property rights may qualify for capital gains treatment.
Interest	Interest, other than that received on obligations of a U.S. state, territory, or possession or that of their political subdivisions, is includible in gross income. Interest income, with respect to below market loans, original issue discount obligations, and certain deferred payment sales may be imputed to the holder of such obligations.
Gains from the Sale of Capital Assets	<p>Gains from the sale or exchange of capital assets are generally included in gross income. Generally, a capital asset is any property other than:</p> <ul style="list-style-type: none"> a) Inventory. b) Real or depreciable property used in a trade or business. c) Receivables arising from services rendered or from the sale of inventory d) Certain other assets described in the Internal Revenue Code. <p>Net capital gain (net gain from all sales and exchanges of capital assets held for more than one year less any net loss from the sale or exchange of capital assets held one year or less) is currently taxed at regular corporate rates.</p> <p>Although the tax rate applicable to net capital gain does not vary with that of ordinary income, the treatment of capital losses does. Corporate capital losses are deductible only against corporate capital gains. Therefore, losses can not be used to decrease the corporation's ordinary income. However, when a corporation has capital losses in excess of capital gains, such net losses may be carried back three years and forward five years. In such situations, the corporation must generally apply the losses in chronological order beginning with the earliest carryback year.</p> <p>Note that net gains from the sale of certain assets excluded from the definition of capital assets (that is, depreciable property used in a trade or business, and held over one year) may nonetheless receive capital gain treatment. However, all or a portion of the gain will be treated as ordinary income to the extent of any depreciation taken prior to its sale. Generally, this recapture of depreciation does not apply to the disposition of real property unless it was placed in service before 1987 and depreciated other than on a straight-line basis. If a net loss results, however, it is deductible as an ordinary loss</p>
Currency Gains	Gross income generally includes gains attributable to changes in exchange rate when payments are not received in U.S. dollars with respect to the following: (a) acquisition of a debt instrument and receipt of income with respect thereto, or becoming an obligor under a debt instrument; (b) receipt of an item of income after the date of accrual of such item; (c) entering into or acquiring any forward contract, futures contract, option or similar financing arrangement; and (d) disposition of non-U.S. dollar denominated currencies.
Exceptions From Gross Income	<p>Nontaxable Exchanges. No gain or loss is recognized if business or investment property is exchanged solely for property of the same character (a like-kind exchange). Any gain deferred may instead be recognized in a future transaction. Gain may be recognized, however, when any property is received in addition to the like-kind property.</p> <p>Nontaxable Income. The following income items received by a U.S. corporation may not be taxable:</p> <ul style="list-style-type: none"> a) Interest on certain local government obligations. b) Contributions to the capital of a corporation, with certain exceptions. c) Income exempt by treaty. d) Certain life insurance proceeds. <p>1.2.2 Deductions. Unless provided in the Internal Revenue Code, expenditures are not deductible in arriving at taxable income. In addition, the tax accounting rules (timing) under which items are</p>



deductible are not necessarily the same as the tax accounting rules under which items are recognized as income.

Business Expenses. U.S. corporations are entitled to deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. However, some expenses, although ordinary and necessary from a business standpoint, are never deductible (for example, lobbying expenditures). Even if otherwise ordinary and necessary, expenditures which are capital in nature will not be deductible currently. These capital expenditures are generally deductible only through depreciation, depletion or amortization over the recovery periods of the property or through inclusion in the basis of property in determining gain or loss. In addition, other expenses are deductible subject to limitation.

Depreciation. A corporation cannot deduct at once the full cost of assets which have a determinable useful life exceeding one year. This cost must be capitalized and recovered, through depreciation deductions, over its useful life. The deduction for depreciation is based on the modified accelerated cost recovery system ("MACRS").

Depletion. A deduction for depletion is permitted with respect to wasting assets, such as natural resource deposits and timber. Depletion deductions are calculated under the cost or percentage method.

Amortization. The cost of many intangible assets (for example, patents, trademarks, franchises and goodwill) can be recovered through a deduction for amortization on a straight-line basis over a fifteen-year period.

Interest. Generally, all interest paid or accrued during the taxable year is deductible. However, interest payments are not deductible when the debt is recharacterized as equity. Likewise, interest incurred to purchase or carry obligations yielding tax exempt interest is not deductible. Special deferral rules may limit the deductibility of certain interest expense incurred in a particular taxable year.

Bad Debt. Bad debts are generally deductible when they become wholly or partially worthless during the taxable year.

State and Local Taxes. Many states, as well as some municipalities, impose income, property, and sales and use taxes on corporations. The tax rates and the tax bases vary from state to state, but such taxes are deductible in computing federal taxable income.

Other Expenditures. Certain expenditures which would otherwise be capitalized may, at the election of the U.S. corporation, be currently deducted. Some of the deductions are subject to recapture.

Net Operating Losses ("NOLs"). A NOL exists where deductions exceed gross income in a particular year. A corporation may deduct NOLs in arriving at taxable income. NOLs generally are carried back two years and forward twenty years. Although losses are applied in chronological order beginning with the earliest carryback year, an election can be made to only carry forward such NOLs. Restrictions and limitations on the deductibility of NOLs by a corporation exist.

Currency Losses. A corporation may deduct losses attributable to changes in exchange rates when payments are not made in U.S. dollars under certain conditions.

Nondeductible Items

- a) Dividends.
- b) Illegal bribes and kickbacks.
- c) Penalties for violation of any law.
- d) Certain key man life insurance premiums.
- e) Political contributions.
- e) Lobbying expenditures.

(Source: Thelen, Reid & Priest, LLC)



Appendix II. Special U.S. Federal Tax Provisions Applicable to Foreign Controlled U.S. Corporations

Deferral of Related Party Deductions A U.S. corporation generally may not deduct amounts owed to a related foreign person until actually paid or until the related foreign recipient reports the payment as effectively connected income. This deferral rule generally applies only to types of expenses called "fixed or determinable annual or periodic" ("FDAP"). However, any FDAP item is deductible as accrued if such foreign related person is exempt from U.S. taxation pursuant to a treaty obligation.

Anti-Earnings Stripping A foreign corporation engaged in business within the U.S. is potentially subject to the limitation upon the deductibility of interest under the Anti-Earnings Stripping rules. A U.S. corporation may be prevented from deducting a portion of its interest paid ("disqualified interest"). However, any disqualified interest may be carried forward three years ("excess limitation carry forward"). Limitations apply.

Transfer Pricing Related party transactions that use prices or values that would have been used by unrelated parties are respected. However, such transactions are closely scrutinized to ensure the clear reflection of income, and such scrutiny has particularly increased in recent years in respect of foreign-owned companies. The U.S., in order to closely monitor such transactions, requires additional reporting and disclosure. To avoid severe penalties for underreporting income as a result of an IRS transfer pricing adjustment, the U.S. requires that a taxpayer develop substantial documentation to support its transfer prices. A foreign corporation engaged in business within the U.S. must use the arm's length standard, as set forth under the Transfer Pricing Rules, to determine its taxable income.

Withholding Tax Rates Applicable to Certain Payments

Obligation to Withhold. U.S. corporations must withhold, subject to treaty reduction, at a rate of 30% on certain payments made to foreign persons. These items generally include interest, dividends, rents, and royalties, provided these items are not effectively connected to a business conducted by the payee within the U.S. The business of a U.S. subsidiary is generally not viewed as the business of its foreign parent corporation. In addition, withholding is generally required at a rate of 10% on a purchase of a United States real property interest from a foreign person.

Portfolio Interest Exemption. The portfolio interest exemption (which reduces interest withholding from 30% to zero) generally does not apply when the foreign parent corporation owns more than 10% of voting power.

Possible Treaty Reductions. The U.S. and foreign jurisdictions enter into income tax treaties to reduce double taxation. Typically, U.S. treaties will reduce the withholding tax rate applicable to payments of dividends, interest and royalties.

Anti-Conduit Rules. Anti-conduit rules prevent foreign controlled U.S. corporations from using an intermediate (conduit) entity in order to obtain a more favorable U.S. tax result than would be obtained if the foreign parent corporation engaged in the particular transaction directly with its U.S. subsidiary. Thus, a foreign parent cannot "treaty shop" by using an intermediary party in a favorable treaty jurisdiction. The anti-conduit rules apply specifically for items noted in

FIRPTA Withholding. Withholding is generally required at a rate of 10% upon a foreign person's disposition of a "United States real property interest" ("USRPI"). For these purposes, a USRPI will include any interest in real property located in the U.S., and any equity interest in a "United States real property holding corporation" ("USRPHC"). A USRPHC generally means any domestic corporation if 50% or more of its trade or business



assets constitute USRPIs. The withholding obligation cannot exceed the transferor's maximum tax liability relating to the disposition of the USRPI. Gain from a disposition of a USRPI will be treated as income, which is effectively connected with the conduct of a trade or business within the U.S. See Section 3.1.1 below.

Special Tax Return Filings A U.S. corporation that (a) has at least one direct or indirect 25% foreign shareholder (by vote or value) at any time during its taxable year and (b) has reportable transactions is required to file an annual report on Form 5472 with its U.S. federal income tax return.

Deferral of Related Party Deductions A foreign corporation engaged in business within the U.S. is potentially subject to the same limitations upon deductibility of accrued expenses owed to a related foreign person.

(Source: Thelen, Reid & Priest, LLC)

