

# The U.S. Tax System

## Executive Summary

All corporations operating in the United States (U.S.) are subject to an array of federal, state and local taxes. The definition of corporation covers any foreign corporation that engages in 'substantial, continuous, and regular activities.' Any corporation incorporated under the U.S. law, with limited exceptions, is subject to the U.S. federal tax system. Any exemptions would be via a tax treaty. This section introduces the principal taxes international companies are most likely to pay.

Tax liabilities, a function of how a company incorporates for business in the U.S. and how it conduct operations in regards to this treatment, fall into five main business classifications: income, self-employment, employment, gross receipts and excise taxes. Taxes may be collectable in the state of incorporation as well as the state(s) where business is conducted. In addition, localities often set their own tax liabilities. Common local boundaries include cities, counties, towns, and public school districts. Tax assessments broadly cover operating revenues, revenue generating activities and personal income.

Payment calculations consider the business entity, gross revenues, and number of persons employed. The final calculation provides the net income, which is then multiplied by the applicable corporate tax rate. Royalties, fees, and, under set conditions, transfer pricing, may reduce taxable income, as will choosing to operate via a U.S. subsidiary or a branch. The 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. Further reductions can come via how the company structures its functions, which are dependent on income source and type.

U.S. corporations subject to income tax file an annual income tax return based on either a calendar or fiscal period. A company elects when to file its first tax return; this period need not mirror the financial accounting period. In general, U.S. tax accounting principles follow GAAP. The filing deadline for all individual tax returns is April 15.

While taxes are collectable at all times under the same terms on the federal level, each state sets its own tax filing requirements. Businesses making taxable retail sales generally hold a Sales and Use Tax Permit. In this bi-level 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 periodic filing and paying of estimated taxes.

Part of the tax process is keeping records. Aside from the business reasons for keeping good records, the records inform the preparation and support the filed tax returns. The IRS may ask to examine these records at any time. With some exceptions, the law does not specify the kind of records that must keep nor the system of record keeping so long as the taxable annual income is clear.

U.S. law provides criminal penalties for tax evasion, failure to file tax returns and/or failure to pay the proper amount of taxes. Penalties range from fines to prison terms. Failure to follow information reporting requirements and failure to supply a taxpayer identification number (SSN or EIN) also carries financial penalties. The IRS strictly enforces payroll tax rules. Penalty waivers only apply if you can show reasonable cause rather than willful neglect.

## Principal Tax Categories

- ***Corporate Income Taxes***

The U.S. tax system treats a corporation as a separate and distinct entity from its shareholders, taxing earnings once at the corporate level and taxing remaining income again at the shareholder (personal) level upon distribution. Limited exclusions and exceptions apply.

- ***Federal Corporate Income Tax***

The U.S. does not consider shareholder status. A treaty with Turkey covers treatment of a



taxable presence as created by a foreign person with “effectively connected income” to provide relief from double taxation. Subject to limited exceptions, only U.S. source income is subject to tax (generally 30% flat rate of gross), rendering an item’s source extremely important to a foreign corporation. The Alternative Minimum Tax ensures that all corporations with economic income will pay some federal income tax. The Branch Profits Tax restores the withholding tax from dividend distributions. U.S. branch profits not reinvested in the U.S. may be liable for a 30% tax. A treaty may exempt these earnings or reduce the tax rate.

- ***State Corporate Income Tax***

State corporate income tax is generally payable on that portion of a corporation’s total U.S. net income derived from operations within the state and may apply only to income derived from in-state customers. Not all states have a state income tax. A state may tax an S corporation as a true corporation, assessing corporate and personal income taxes on the amount distributed to the owners. Some states subject non-corporations to an unincorporated business tax (taxes corporate profit once as business income, and again as personal income of the sole proprietor, partners or members). States may tax real property transfers, mortgage recording, sales and use. States may impose a corporate franchise tax on corporations doing business, employing capital, owning or leasing property, or maintaining a state office in that state. State or localities may impose a general corporation tax on business corporations. Most states offer incentives for new businesses and enterprise zones.

- ***Federal Personal Income Taxes***

U.S. residents are subject to tax on their worldwide income, which is computed similarly to that of a U.S. corporation. Foreign nationals residing here are taxed on the same basis as U.S. citizens on U.S. source income. The top stated tax bracket applicable to ordinary income is 39.6%. Rates differ for long-term capital gains and capital losses. 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 U.S. source income is subject to a flat 30% tax (or lower treaty rate) on a gross basis. Unless actually connected with a U.S. trade or business, capital gains are exempt.

- ***State and Local Personal Income Taxes***

States and localities may impose a tax on an individual’s earned and unearned taxable income. An individual’s residency status determines the tax. State source income generally includes income, gains, losses, or deductions included in federal adjusted gross income from services performed in State, business carried on in State, real or tangible personal property located in State, and share of income or loss from a partnership sourced to State.

- ***Real Property Taxes and Utility Taxes:***

Almost every level of state and local government entities impose property taxes to raise monies to pay for local services. Rates vary widely. States and localities may impose taxes on utility service charges, e.g. electric, telephone and natural gas.

- ***Payroll taxes***

Federal law requires that employers withhold, deposit, report, and/or pay a variety of taxes. Rates are often set or supplemented at the state level. Employer/employee taxes include:

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|------------------------------------------------------------|----------------------------------------------------------------|
| • <b><i>Federal Insurance Contributions Act (FICA)</i></b> | • <b><i>Periodic Deposits</i></b>                              |
| • <b><i>Federal Income Tax Withholding (FIT)</i></b>       | • <b><i>Withholding Tax Applicable to Foreign Partners</i></b> |
| • <b><i>Federal Unemployment Tax (FUTA)</i></b>            | • <b><i>Workers Compensation Insurance</i></b>                 |

- ***Sales Taxes***

Each state and locality has the power to levy a tax on products sold to the end user. These taxes apply to the final sales price. The retailer collects the sales tax at point of purchase. Not all states or localities impose a sales tax.

