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Investing in the United States

A Guide for Chinese Companies

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Enclosed is KPMG's new resource titled *Investing in the United States: A Guide for Chinese Companies*. The main objective of this guide is to help management teams and board members make informed decisions before building a business or investing in the United States.

There are several compelling reasons for Chinese companies to consider investing in the United States. Despite global recessionary pressures, the United States is maintaining its status as a vibrant and thriving marketplace with stable economic, political, and legal structures offering a wealth of opportunities for foreign companies and investors.

While the U.S. marketplace is ripe with opportunities, many challenges and risk-management requirements must be considered before executing on a U.S. investment strategy. It is important to carefully read through this guide and consult with investment, legal, and tax advisers to further appreciate and understand the challenges that any major investment decision can bring.

KPMG hopes the enclosed general guide can help investors benefit from the opportunities that the United States has to offer. KPMG member firms in the United States, China, and across the globe are pleased to discuss investment options and risks with you in greater detail and share the insights of our audit, tax, and advisory partners and professionals.

Sincerely,



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CHAPTER ONE

Investing in the United States: Opportunities and Challenges

Overview

For decades, the United States has served as a beacon for foreign investments and business opportunities. Two significant factors, a relatively strong economy and political stability, are powerful attractions to foreign entrepreneurs and established businesses alike, and result in a steady increase in direct foreign investment through mergers and acquisitions. The strong economy, coupled with technological innovation, has created robust consumer demand in the U.S. marketplace that has steadily boosted gross domestic product (GDP). In addition, the seamless tradition of transition from one presidential administration to the next has supported business and consumer confidence.

However, the recent global recession affected growth significantly in the United States. The recession has been followed by a gradual recovery. Even with a strengthening economy and political stability there are barriers, risks, and challenges that Chinese investors must address to establish a foothold in the United States and thrive.

The content below will cover some of the opportunities and the challenges common to investing in the United States.

Reasons for Investing in the United States

Now more than ever, there are several compelling reasons for Chinese companies to consider investing in the United States. Positive investment factors can be categorized into the following components:

- A favorable economic environment
- Access to advanced technology
- Government policies and regulations, including tax incentives
- Access to new markets

Favorable Economics

A favorable economic environment for Chinese investors is bolstered by Chinese currency appreciation, significant foreign exchange reserves,

and distressed businesses and assets in the United States.

Because of the recent economic downturn globally, there are opportunities for acquiring business assets at lower valuations in the United States. Assets, particularly real estate, have depreciated considerably in value from peak levels in 2006–07. Encouraged by healthy U.S. dollar reserves and a favorable yuan-to-dollar exchange rate, Chinese companies can look to capitalize on the opportunity of purchasing assets in the United States at lower cost. With the U.S. economy improving and other economic environments stabilizing, these lowered costs may soon begin to rise.

Advanced Technology

Access to advanced technology also forms a solid investment foundation in the United States. The United States is well known for innovation in consolidated information and technology (IT) infrastructure, which is not readily available in China.¹ Therefore, Chinese firms are increasingly considering acquiring U.S. companies for increased access to technical innovation and advanced techniques. A recent 2010 poll of Chinese enterprises conducted by the China Council for the Promotion of International Trade revealed that 60 percent of the respondents believe that the United States has a favorable investment environment due to easy access to high technologies and the availability of a rich and diversified labor pool.²

Government Incentives

Added to the investment mix are U.S. government policies and regulations that are considered favorable by foreign investors. The United States is an attractive destination for foreign companies because several U.S. states and cities offer tax credits and other investment incentives to attract global manufacturer investments. These locales recognize that new factory construction can create jobs for their area residents, particularly in states most impacted by the recession. In addition, under the Real Estate Revitalization Act of 2010, the U.S.

federal government is planning to lower or eliminate the U.S. taxes currently imposed on foreign investors of U.S. commercial real estate, a sector that has been particularly impacted over the past few years.

The United States also provides a strong regime of intellectual property rights protection and enforcement, which is a key attraction for investing in research and development (R&D). The United States is the center for global innovation and ranks first in research and development expenditures worldwide.³ Foreign investors come to the United States to invest in R&D and to commercialize the results of their creativity in their own countries and globally.

Access to New Markets

In addition to demand for Chinese goods from U.S. consumers—one of the world's largest markets—the North American Free Trade Agreement (NAFTA) gives U.S.-based Chinese manufacturing companies open access to distribution networks across North America. This provides cross-border trade with neighboring countries such as Mexico and Canada. With this, Chinese companies not only tap the U.S. market but also use their U.S. operations as a base to expand into neighboring markets.

From June 2009 to June 2010, U.S. imports from China increased 37.1 percent.⁴ To meet the growing demand, Chinese investors are creating production and distribution centers in the United States by acquiring businesses and assets.⁵ Also, the U.S. trade deficit grew exponentially from \$27.2 billion in June 2009 to \$49.2 billion in June 2010.⁶

Chinese investments into the United States increased 360 percent in the first half of 2010 compared to the same time period in 2009, according to Chinese government figures.⁷ In 2009, Chinese companies announced new direct investments in the United States of nearly \$5 billion—up from an average of \$500 million a year ago, according to New York City–based economic consultancy Rhodium Group.⁸

Why a Chinese Automotive Company Invested in the United States

BYD (www.byd.com), located in Shenzhen, Guangdong province, China, is one of China's top independent automobile manufacturers and a world leader in green technology. It has its manufacturing roots in batteries, but since 2003 has manufactured and sold a number of gasoline-powered small cars in China.

In 1999, BYD opened its R&D center in the United States, named BYD America Corp. Further, in September 2008, MidAmerican Energy Holdings Co, a unit of Warren Buffet's Berkshire Hathaway Inc., invested in BYD by purchasing a 10 percent stake. David Sokol, chairman of MidAmerican Energy Holdings, said, "We are working with BYD on developing charging technologies and infrastructure that would help promote plug-in hybrid and all-electric vehicles."

In 2008, the company announced its plans to enter the U.S. market in 2011 with a range of pure electric and plug-in hybrid vehicles. The company believed that the U.S. market is the most important in its global market strategy. BYD did not see the year 2008 a good time to enter a new market, because the recession brought auto sales down 18 percent in the United States and automakers cut capacity to reduce output.

BYD is considering setting up an assembly plant and North American sales headquarters in Los Angeles, California. The state is seen as a good U.S. base for the firm following planned commencement of sales of its "e6" electric crossover model in the U.S. market from 2011.

Installing a U.S. headquarters in Los Angeles could prepare the company for distribution of its product throughout the United States and set the stage for release of its all-electric "e6" crossover vehicle. The investment required to set up a Greenfield plant in California would be significant and may take BYD a long period of time to fund.

BYD is also in talks to supply powertrain systems to U.S. and European automakers, a senior company executive said. "We are in talks with American and European automakers to supply powertrain systems, including batteries," said Henry Li, general manager of BYD Auto Exports Division. "The idea is that we will pick one American and two European automakers."

Risks and Challenges

A relatively strong economy makes the United States an extremely competitive marketplace that rewards efficiency, productivity, and integrity while mandating rigorous compliance with the nation's complex rules and regulations. As the U.S. economy improves, the cost of doing business in the United States may rise. This would require a corresponding higher level of investment in order to compete with established domestic businesses.

Federal, state, and local regulations require a healthy knowledge of tax, commercial, and labor laws. For instance, the Fair Labor Standards Act establishes federal minimum wage provisions for hourly workers. The Fair Minimum Wage Act of 2007 amended the federal minimum wage to \$7.25 per hour, effective July 24, 2009. In addition, many states have their own minimum wage laws. With the federal increase, more states are below the federal wage and some states have phased increases like the federal government. However, when an employee is subject to both the state and federal minimum wage laws, the employee is entitled to the higher of the two minimum wages.

Corporate scandals in the late 1990s contributed to a crackdown by federal regulators and increased scrutiny of how publicly owned businesses operate. The Sarbanes-Oxley Act of 2002, which requires publicly owned Securities and Exchange Commission (SEC) registered companies to document financial-reporting controls, has heightened compliance standards and has increased the cost of compliance while also improving financial reporting transparency.

Overcoming some of the risks and challenges inherent with investing in the United States may become clearer when compared with potential opportunities in the same areas. The following sections highlight this point.

Marketplace

An abundance of natural resources and skilled labor have helped the United States become one of the leading industrial powers in the world. Its highly diversified



and technologically advanced industries include petroleum, steel, motor vehicles, aerospace, telecommunications, chemicals, electronics, food processing, consumer goods, lumber, and mining. The strength in the financial services industry has made New York's Wall Street a global capital for foreign investment, as is London and Hong Kong. The recession of 2008–09 created uncertainty in the global marketplace. A gradual recovery, however, has opened the doors of opportunity again. The recovery has boosted the confidence of industry players to invest further in the U.S. marketplace.

Economy

The United States market-oriented economy currently is one of the largest and most technologically powerful in the world, with a 2009 GDP of \$14.26 trillion⁹ or median household income of \$70,597.¹⁰ Private individuals and businesses make many of the decisions that drive the economy and the federal and state governments buy needed goods and services predominantly in the private marketplace. U.S. businesses enjoy greater flexibility than their counterparts in Western Europe and Japan regarding decisions to expand capital expenditures, lay off workers, and develop new products. At the same time, they face higher barriers to enter their rivals' home markets than foreign firms face when entering the United States. The U.S. economy witnessed negative growth during the recession, but has recovered gradually since the second half of 2009.¹¹ The inflation rate declined sharply to a level below zero in 2009.¹² However, it increased to a modest level in 2010. The unemployment rate has been consistently increasing since 2007, but most recently has declined from its highest point and is expected to average around 9.5 throughout 2010.¹³ Despite such recessionary effects, the U.S. economy has witnessed rapid technological advancements with a skilled labor force.¹⁴

U.S. companies are at the forefront of many technology-driven industries, especially computers, medical equipment, aerospace, and military materiel. However, the onrush of

Why a Chinese Construction Company Invested in the United States

China Construction America, Inc. (CCA) www.chinaconstruction.us is a wholly owned subsidiary of China State Construction Engineering Corporation Limited (CSCEC). CSCEC is the largest construction and real estate development company and the largest residential building contractor in the world. It is a FORTUNE Global 500 company, ranking No.187 in 2010 and one of the Top 225 International Contractors, ranking No.22 by ENR.

CCA provides an array of construction services, including program management, construction management, general contracting, design & build, heavy construction, and real estate development. Through competitive bidding alongside big local contractors, CCA has been awarded and completed local projects of all kinds. These include government housing projects, major luxury hotels, high schools and universities, roads and bridges, railroads and stations.

Ning Yuan became president of CCA in 2000. Under his leadership, the company has made historic progress in the highly-competitive American construction market. New contracts for the company increased from \$11 million in 2001 to \$500 million in 2009.

"CCA had a very hard time to get contracts when we just started business in the U.S." said Mr. Yuan, "however, with sustained efforts, we have established a foothold in the American mainstream market. Nowadays, we win one contract after another and many owners even come to us looking for opportunities to work with us. We experienced a rebirth in 2005 when we instituted an aggressive growth platform."

CCA initiated the business model of general contracting brought forth by finance and investment and has successfully put it in operation of Baha Mar Cable Beach Resort Project. This project, with a total investment of \$3.6 billion, occupies a land area of 1,000 acres, which includes 6 luxury brand hotels, a hotel style apartment building, a time-share vacation village, a Las Vegas style recreation center, an 18-hole golf course, 5000 square meters of world class brand stores, and other amenities. Construction will start within the year of 2010.

With an emphasis on infrastructure projects, CCA is successfully rooted in the mainstream construction market in the United States. The company won the \$407 million Alexander Hamilton Bridge Renovation project in NYC and placed CCA in the ranks with local major contractors. Also, CCA was recently awarded a contract for the North Charleston Coliseum Renovation Project in South Carolina which represents one of the many public works invested by local governments and undertaken by CCA.

Other significant projects by CCA include:

- Chancery Building of the Embassy of P.R. China in USA: "Luban Prize," the most prestigious award in the construction industry of China
- The USC Honors Residence Hall: 2009 Leadership in Energy & Environmental Design (LEED®) Gold.
- Yankee Stadium Station: 2008 Project of the Year by the Design-Build Institute of America
- NYSDOT Ramp X in New York: the first infrastructure work by a Chinese contractor; 2008 Tappan Zee Award by the American Society of Civil Engineers
- USC Aiken Center, South Carolina: the first college project by a Chinese contractor
- The Marriott Harlem Hotel, New York: the first Construction Management contract by a Chinese contractor

CCA has a 25-year successful track record in the United States. The company is proud of its strong team of executives in the United States along with the seasoned construction professionals with advanced construction and management technologies.



Why a Chinese Bank Invested in the United States

China Construction Bank Corporation (CCB) (www.ccb.com) is a commercial bank engaged in retail banking, corporate banking, investment management, and lending services. Additionally, CCB offers wealth management, and credit card services. The bank conducts operations primarily in China. CCB is headquartered in Beijing, China and employs 301,537 people.

In 2009, CCB held an opening ceremony for its New York branch. The opening extended CCB's global presence and marked a significant milestone in CCB's global strategy. According to a company-issued press release at the time of the branch opening, CCB's Chairman Guo Shuging stated that the United States is one of China's most important trade and economic partners, and that China is currently the United States' second largest trading partner.

Establishing the branch in New York significantly improved CCB's ability to provide worldwide services to its customers, and enable the bank to better facilitate Chinese-American economic and trade investment and financial cooperation. It also showed confidence in the U.S. market by investing during turbulent economic times felt across the globe. America did not elude the grasp of a global recession. Nonetheless, CCB saw fit to establish a beachhead on U.S. soil.

As the initial operating platform in the United States, CCB's New York branch has used its extensive financial resources, robust global network, and solid infrastructure when providing premium financial services to its clients, including multinational corporations and financial institutions.

The bank's chairman said that the New York branch enables CCB to better facilitate Chinese-American economic and trade investment and financial cooperation, and helps CCB make significant progress toward a vision of being a truly global bank.

CCB is one of the largest commercial banks in China, ranked second in terms of market capitalization among all listed banks in the world, and is among global industry leaders in terms of profitability, according to the company Web site.

technology has contributed to the development of a “two-tier labor market” in which those at the bottom lack the education, professional knowledge, or technical skills of those at the top and fail to get comparable pay, health insurance coverage, and other benefits. Since 1975, practically all the gains in U.S. household income have gone to the top 20 percent of households.

Population and Wealth

The United States has a population near 310 million people. Of this total, about half constitute the employable labor force.

The population comprises about 79.6 percent white; 12.9 percent black; 4.6 percent Asian; 1.7 percent multiracial; and 1.2 percent American Indian, Alaska native, Hawaiian native, or other Pacific island native.¹⁵ Although Hispanics make up a large minority of the population, the group is not broken out separately because the U.S. Census Bureau considers “Hispanic” to mean a person of Latin American descent (including persons of Cuban, Mexican, or Puerto Rican origin) living in the United States who may be of any race or ethnic group (white, black, Asian, etc.).

The United States is a wealthy country. The median household income of \$70,597 puts the United States behind only Switzerland and Ireland.¹⁶ The U.S. consumer is considered one of the pillars of the economy, and the steady increase in consumption of goods and services has been fueled by low inflation, low unemployment, and confidence in continued economic stability. However, income inequality in the country has been increasing since the late 1970s and is set to rise further as consumers struggle with the collapse in the U.S. housing market and the broader economic slowdown.

GDP Growth and Stability

The U.S. economy has proven to be remarkably resilient to the immediate effects of natural disasters and terrorism. The terrorist attacks on Sept. 11, 2001 had an intense but relatively short-term impact on U.S. financial markets. United States, NATO, and coalition military engagements in Iraq and Afghanistan required major shifts of U.S. resources to the military. Hurricane Katrina caused

extensive damage along the Gulf Coast in August 2005, but had a small impact on the year’s national GDP growth. Soaring oil prices in 2005 and 2006 threatened to cause inflation and unemployment, but the economy continued to grow through 2006. (Imported oil now accounts for about two-thirds of U.S. consumption.)¹⁷ Despite the U.S. stock market crash in 2008 and the recent recession, the U.S. economy has gradually improved.¹⁸ According to the Economic Intelligence Unit (EIU), the economic recovery will help reduce the federal budget deficit in 2010–11, though it will remain large. Some states and municipalities are grappling with severe financial pressures and are introducing strict measures to rein in deficits.

Long-term challenges facing the United States that may affect stability include inadequate investment in economic infrastructure, rapidly rising medical and pension costs, stagnant income in the lower economic groups, and sizable trade and budget deficits. U.S. exports fell to \$1.55 trillion in 2009, from \$1.83 trillion in 2008; imports fell to \$1.93 trillion from \$2.52 trillion; and the trade balance reached a deficit of \$374.9 billion, down from \$698.8 billion.

Political System

Compared to other nations, the United States has a long history of political stability. The United States is a federal republic consisting of 50 states, the District of Columbia, the Commonwealth of Puerto Rico, and a number of small territories. The political system is based on a division of powers between the states and federal government. Within the federal government and each state government there also is a separation of power among the three branches of government: legislative, executive, and judicial.

Many federal and state laws and agencies protect the consumer and the economy from what are determined to be unacceptable business practices. Nationally, these agencies include the Federal Trade Commission, the Securities and Exchange Commission, the Environmental Protection Agency, the Food and Drug Administration, and the Equal Employment Opportunity Commission.

Some national laws have requirements limiting what individual states may do. Other laws are more of a foundation that states may choose to exceed. Each state has its own political subdivisions and each has its own set of laws governing the conduct of business within its jurisdiction. There is, therefore, no single governmental agency or body that determines all of the laws and regulations applicable to all businesses. There are no federal corporate laws. However, there is a significant body of federal and state regulations that affect the investment decisions of foreign businesses in the United States.

For example, the federal government controls national defense and the use of federal lands and natural resources; it restricts ownership of communications industries (domestic radio, television, telephone, and telegraph), and the use of public utilities, including domestic transportation. Some states have banned, or are considering bans on, foreign investments in agricultural land. In addition, the United States has a dual banking system. Both the federal government and the states regulate banking depending on the type of banking charter an institution obtains—national or state. For example, banks and thrift institutions with a national charter are regulated by the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS), respectively. Both the OCC and OTS are bureaus of the U.S. Treasury Department. Also, at the federal level, the Federal Reserve and the OTS regulate bank holding companies and thrift holding companies, respectively.

An institution also can choose to obtain a state bank charter and elect to be either a member of the Federal Reserve System or not. If the institution is a state member bank, it is regulated by the specific charter issuing state and the Federal Reserve. If the institution is a state non-member bank, it is regulated by the specific charter issuing state and the Federal Deposit Insurance Corporation (FDIC). A national bank or thrift charter “preempts” state regulation where both federal banking law and state banking law might apply to a given institution.

Industries

The United States has an abundance of natural resources that have been used to develop a host of homegrown industries that have expanded their operations abroad. Timberlands have been cultivated to contribute to forest products, wood, and paper. Oil, natural gas, and coal reserves have fueled the development of multinational energy companies. Rivers power hydroelectric plants, and the moderate temperatures and fertile soil have been cultivated to develop an extensive agricultural industry in fruits, vegetables, and livestock. New York is the financial hub of the United States, and has been instrumental in developing public stock exchanges as well as financial products and services that are used worldwide. Silicon Valley, in California south of San Francisco and centered around San Jose, has become the center of advanced technology research and development, from silicon chips used in computers and software to venture capitalists that invest in and nurture young start-up companies. The demand for products and resources has led to the growth and development of consumer-product companies, ranging from automobile and aerospace manufacturers to retailers that offer a range of household products and commercial needs.

Foreign Investment Remains Strong

U.S. economic policy generally welcomes foreign investment, viewing it as a means to promote capital formation, employment, productive capacity, and new technology. To reduce risks, companies and individuals spread their investments worldwide. The United States is viewed by many as a favorable jurisdiction for preservation of capital because of its political and economic stability. Since the 1990s, foreign direct investment has increased dramatically. Foreign direct investment inflows to the United States stood at \$148.5 billion in 2009, down from \$316.1 billion in 2008.¹⁹ Further, the inward direct investment is expected to increase in 2010 and in the coming years.²⁰ The Economic Intelligence Unit forecasts the inward direct investments to cross

the \$200 billion mark in 2012 and \$300 billion mark in 2014.²¹ A key factor in this growth is the large, reasonably homogenous, and largely unfettered market available in the United States.²²

Future Trends

The United States was the eighth most attractive business location in the world in the historical period (2005–09), but its rank deteriorates to thirteenth during the forecast period (2010–14), largely as a result of a relative deterioration in its macroeconomic environment and in the availability of financing.²³ Concerns about national indebtedness, security, international relations, and the relationship between special interests and public policymaking weigh on the relative ranking of the U.S. business environment over the forecast period.²⁴

Despite the slippage in score and rank between the historical and forecast periods, as one of the world's largest economies the United States will likely remain an indispensable business destination. It has a long-running reputation for a favorable business climate that will likely remain intact during the forecast period. Policies toward private enterprise and competition are very favorable. Apart from certain security-sensitive sectors, such as energy, foreign investment faces relatively few restrictions. The United States also features deep, liquid, and accessible capital markets, which gradually regained liquidity during 2009, a flexible labor market, and well-established intermodal infrastructure systems.

Foreign interest in establishing a business presence in the United States is expected to continue in light of proposals to institute import restrictions, voluntary import curbs, and increases in reporting requirements.

Of note is the emergence of multinational corporations from high growth and emerging markets. Exports of these emerging multinationals are increasingly competitive with those of the United States, Europe, and Japan. As these companies develop

from simply exporting to manufacturing abroad, they most likely will seek to establish and protect a stake in the American market.

The level of sophistication of foreign businesses entering the United States has increased substantially over the past decade. Yet newcomers, as well as seasoned Chinese investors, must be wary of evolving barriers and challenges in order to succeed, thrive, and prosper.



A man in a light blue shirt and tie is standing and presenting to an audience in a meeting room. He is holding a blue pen in his right hand and gesturing with his left hand. In the foreground, the back of a person's head and shoulders is visible, looking towards the presenter. A whiteboard with some faint diagrams is visible in the background.

CHAPTER TWO

How to Invest

Overview

The U.S. market offers significant opportunities for foreign investors. The continued strong demand from over 310 million people for goods and services has resulted in a trade balance in the early 21st century that currently favors foreign exporters. But the business of exporting goods and services to the United States can be complicated by a host of duty and tariff-related challenges that often make building or buying a business in the United States a better long-term decision.

The United States offers numerous financial incentives to build a business, and buying a business may be a cheaper alternative. But the decision whether to buy or build a business in the United States is also governed by a host of factors—geographic, demographic, financial, and industrial—that need to be studied by foreign investors before making a commitment.

Buy or Build

The decision whether to buy or build a business often hinges on a number of factors, including industry maturity, financial considerations, the potential for success, internal capacity, and supplier and customer availability. For instance, if the investor is a foreign telecommunications company, it is probably faster and less expensive to buy a company that already has procured the necessary licensing and infrastructure than it is to start at the beginning. If the investor is a foreign retailer, however, it may be easier to purchase real estate and build an operation that utilizes an existing brand and products.

Whether to buy or build often is a difficult decision. The build option offers the significant advantages of business confidentiality; the opportunity to use existing technology and intellectual capital; and the ability to further build brand, product, and service recognition. Disadvantages of the build decision include difficulty financing when there is no track record and stretching a management team beyond its regular duties. The buy decision often allows for complete investigation of a target and the ability to negotiate a specific price and terms without concern about

the cost overruns and delays that often occur with the internal build decision. Disadvantages of the buy decision include a long, drawn-out negotiation and closing process that may sometimes collapse, and the true cost of the acquisition may be much higher than the price originally intended.

Mergers and Acquisitions

Companies use mergers and acquisitions as alternatives to internal expansion. Mergers and acquisitions take many different forms, ranging from “friendly” mergers of two companies to “hostile” takeovers of publicly traded companies. In the United States, there are a number of securities and tax regulations governing mergers and acquisitions. Therefore, companies considering this option should seek not only financial and tax advice, but also legal advice when contemplating a merger or acquisition in the United States.

Acquiring businesses has become a major activity both globally and in the United States. There are certain strategies and procedural matters involved in an effective acquisition process. Those not experienced in mergers and acquisitions may need assistance from investment banking firms, business brokers, bankers, business advisers, financial consultants, valuation analysts, accounting firms, and law firms. These resources can assist in identifying potential targets, analyzing potential targets, valuing the target, evaluating the tax consequences, negotiating the contract, and integrating the target into existing operations.

Joint Ventures and Strategic Alliances

If good acquisition targets are not available, a joint venture or strategic alliance may be a viable way to enter the U.S. market. These alliances offer a way to grow and to obtain specific knowledge that would be very costly or time consuming to achieve alone. The nature of an alliance demands cooperation and trust and is often designed to share risk.

A *strategic alliance* is a cooperative arrangement between two or more organizations designed to achieve a shared strategic goal. There are two

general types of alliances: Equity-based and non-equity-based.

- *Equity-based alliances* include minority stock investments, joint ventures, and at the extreme end, majority investments.
- *Non-equity-based alliances* tend to be governed primarily by contractual arrangements that specify the responsibilities of each party, the mode of operation of the alliance, and the considerations involved in expansion or termination.

Going Public

Some foreign companies may opt to sell shares to the public in an initial public offering (IPO) designed to raise capital to expand operations into the United States. The advantages and disadvantages of going public in the United States are numerous, and a foreign company thinking about engaging in an IPO should seek advice from an experienced financial adviser and legal counsel.

Sound management is the most important characteristic if a company is to be successful in obtaining public financing. Underwriters and the investing public look first to the quality, integrity, and experience of management as a key indicator that an investment will be protected and enhanced. Companies with relatively inexperienced management have gone public successfully, but usually only under exceptional circumstances, such as when a company’s products or services are believed to have extraordinary potential. Other important characteristics are the company’s size, earnings performance, and potential for growth. In evaluating whether the public will be interested in purchasing the securities of a company, a comparison review of industry peers should take place. This review should include sales and earnings performance over the past five years.

Federal and State Tax Incentives

Foreign companies considering investing in the United States often are confronted with a maze of legal, financial, and fiscal complications, including their first exposure to the U.S. tax system. The tax code includes incentives designed to

encourage capital formation, attract foreign investment, and reduce the federal and state tax burdens of those qualifying for the incentives. For maximum benefit, a foreign investor should have advanced knowledge of these incentives to properly plan and execute their investment strategy.

Greenfield Investments

The United States is one of many countries that offer incentives for so-called “greenfield” investments that create new production capacity and jobs, transfer technology and know-how, or lead to linkages to the global marketplace. Greenfield investments can include expansions or new facilities and often qualify for subsidized loans and other tax incentives from the federal, state, and local governments.

Government Loans

The federal government provides financial and managerial assistance to small businesses through the Small Business Administration (SBA). A small business is defined as one that is independently owned and operated and is not dominant in its field. The SBA offers a variety of loan programs to eligible small business concerns that are unable to borrow on reasonable terms from conventional lenders. Qualifying standards for small business loans are set by the agency for each industry.

The amount of SBA guarantees and direct loans available is set annually by Congress. The SBA may not make or guarantee a loan if a business can obtain funds on reasonable terms from a bank or private source. A borrower, therefore, must first seek private financing before applying to the SBA. The SBA also licenses, regulates, and provides financial assistance to privately owned and operated small business investment companies. These firms make venture or risk investments by supplying equity capital and extending unsecured loans or loans not fully collateralized to small enterprises, thus enabling those small firms to boost employment. SBA loans are available to foreign-owned companies that have incorporated in the United States.



CHAPTER THREE

Types of Entities

Overview

A foreign enterprise may operate in the United States through a variety of legal forms, including corporations, general partnerships, limited partnerships, limited liability companies (LLCs), and U.S. branches. Tax and non-tax concerns can influence a business choice of legal structure. As discussed below, certain entities may elect to be classified for U.S. tax purposes in a manner different than their legal form.

Common reasons to use a separate legal entity include the limited liability accorded by state law to the owners of qualifying entities (but generally not to general partnerships), and an improved ability to access capital markets for investment capital. Limited partnerships and LLCs often provide more flexibility than other types of entities in permitting preferred returns and other non-traditional profit sharing relationships. Finally, in some industries, federal or state regulators may require that an enterprise be conducted through a corporation.

Unlike other countries, the United States has no federal company law, and the rules regarding the formation, operation, and dissolution of business entities are generally defined by state law rather than federal law. The following is a brief, general overview of these state laws. However, because there are 50 states and the District of Columbia, these rules can and do vary to a considerable extent. Consequently, careful attention to the specific rules of each appropriate jurisdiction is required, and consider consultation with tax and legal advisers about the laws and regulations which may be relevant to a particular investment.

Corporations

A corporation is a creature of state law and all U.S. states have enacted laws regarding the formation and operation of corporations. The philosophy of regulating corporations varies from state to state. Generally, the State of Delaware has the reputation for having the least restrictive approach toward regulating corporations. Consequently, numerous corporations with little other connection to Delaware have been organized there. Other states have adopted, in whole or in part, provisions of the Model Business

Corporation Act (MBCA). The MBCA is a model set of law prepared by the Committee of Corporate Laws of the Section of Business Law of the American Bar Association. States adopting the MBCA generally impose greater restrictions on corporate activities. Because of its broad application, this overview will use the MBCA as its basis for discussion.

If a corporation is to operate in one state, it usually will be incorporated under the laws of that state. However, if the corporation will engage in interstate commerce (that is, operate in more than one state), the choice of a state of incorporation should factor in initial and annual taxes, favorable incorporation laws, and the level of restrictions on corporate activities. After a corporation has been formed in a particular state, it will be necessary for it to obtain permission from other state governments before doing business in those other states. Permission is obtained by qualifying to do business in these other states.

General Characteristics

A corporation is a legal form of organization used to carry on a business enterprise. It is recognized by law to be an entity separate and distinct from its shareholders, directors, and officers. A corporation has several important characteristics, including the power to enter into contracts and to hold property in its own name, to sue and be sued in its own name, continuity of life, and free transferability of ownership interests. Ordinarily, the liability of corporate shareholders for the acts of the corporation is limited to their investment in its stock. Management of the corporation is centralized in its board of directors.

Formation

To form a corporation, an attorney should be consulted before following some of the required steps, such as:

- Preparing the articles of incorporation, which would include such information as:
 - Corporate name
 - Duration of life of the corporation (which can be indefinite)

- Corporate purpose
- Number and classes of authorized shares of stock
- Signing and authenticating the articles of incorporation
- Filing the articles of incorporation, accompanied by specified fees, with the incorporating state
- Receiving a certificate of incorporation issued by the secretary of state
- Paying for shares of stock to the corporation by its shareholders
- Preparing the bylaws, which are the internal rules and regulations for the structuring and operation of the corporation
- Holding an organizational meeting of the board of directors to adopt the bylaws, elect officers, and transact other business

Share Capital

Some states provide that a minimum amount of capital be paid in. The Model Business Corporation Act requires no such minimum. Under this law, corporations are permitted to issue one or more classes of stock with or without par value and with differing preferences, limitations, voting power, and liquidation rights. The articles of incorporation must disclose the capital structure of the company. Shares with par value must be issued for consideration at least equal to the par value. Shares without par value may be issued for consideration fixed by the board of directors or by the shareholders if the articles of incorporation reserve such rights to them. Payment for shares issued may be made in cash or other property or in labor or actual services performed for the corporation.

A wide range of sources of capital—a description of which is beyond the scope of this guide—is available in the United States. Short-term, medium-term, and long-term credit is available and public offerings of stock or bonds may also be used to generate additional capital.

Administration and Annual Meetings

All powers of the corporation are vested in the board of directors unless otherwise provided in the articles of

incorporation. Under the Model Business Corporation Act, directors need not be residents of the state of incorporation unless the articles of incorporation so require. The directors are generally elected by the shareholders at the annual meeting of shareholders. The day-to-day responsibility of operating the corporation is delegated by the board of directors to the corporation's officers. The officers of a corporation normally consist of a president, a secretary, and a treasurer, who are elected by the board. Other officers, including vice presidents, assistant secretaries, and others, may be elected or appointed.

Shareholder meetings generally are held at least annually or as provided in the corporate bylaws. Shareholders must be notified of the time and place of the meeting. Shareholders generally elect the board of directors and approve or reject management decisions requiring shareholder approval (such as mergers or liquidations). Under the Model Business Corporation Act, shareholders who hold at least 10 percent of the shares and are entitled to vote may call special shareholder meetings in addition to the annual meeting.

Annual Accounts

State incorporation laws generally do not contain detailed requirements regarding annual accounts; they merely provide that a corporation keep correct and complete books and records of account. Financial statements typically are prepared in accordance with generally accepted accounting principles (GAAP) issued under the authority of the Financial Accounting Standards Board, and as required by the authority of various government agencies, especially the SEC. There is no mandatory "statutory audit" requirement in the United States unless the company is either subject to regulations by the

SEC or another authority, such as federal and state insurance regulators and other financial services industry regulators.

It is quite common for audited financial statements to be required by bank financing agreements, shareholder agreements, or other commercial agreements. Companies in regulated industries may be subject to different bases of accounting and reporting for specific purposes. Federal income tax requirements often require specific accounting methods and recordkeeping for certain items, which usually need to be reconciled with financial accounting reports on the annual income tax return.

Generally Accepted Accounting Principles

The generally accepted accounting principles used in the United States for the preparation of financial statements have resulted from the actions of three successive standard-setting bodies and from prevailing practice in those areas where these standard-setting bodies have not acted. The current accounting standard-setting body is the Financial Accounting Standards Board (FASB). Its predecessors, the Accounting Principles Board and the Accounting Procedures Committee of the American Institute of Certified Public Accountants, promulgated many accounting principles that are still applicable today.

Securities and Exchange Commission

The SEC, a federal regulatory body, enforces U.S. securities laws. Periodic reports must be filed with the SEC by:

- Companies with 500 or more investors and \$10 million or more in assets; or
- Companies that list securities on major U.S. stock exchanges such as the New York Stock Exchange and NASDAQ; or
- Companies whose securities are quoted on the Over-the-Counter Bulletin Board (OTCBB).

Filing deadlines for annual and quarterly reports of U.S. domestic registrants vary by class of issuer as follows:

Issuer Classification	Public Float Exceeds	Days After Period-End	
		Annual Report	Quarterly Report
Large Accelerated Filer	\$700 million	60 days	40 days
Accelerated Filer	\$75 million	75 days	40 days
Non-accelerated Filer		90 days	45 days



Issuer classification is based on the public float (market value of the voting and nonvoting common equity held by nonaffiliates) and other criteria. Extensions of due dates (15 days for Form 10-K and five days for Form 10-Q) are available if unreasonable effort or expense will be required to file the reports on time. The reports are available to the public online at www.sec.gov and must be furnished to shareholders.

The form and content of most periodic reports required to be filed with the SEC are stated in Regulation S-K and Regulation S-X and are further explained in other SEC guidance such as Financial Reporting Releases and Staff Accounting Bulletins issued periodically by the SEC. The SEC generally requires that the published financial statements and other financial disclosures be presented in conformity with generally accepted accounting principles. Filings with the SEC may require more detail, usually in the form of additional footnote disclosures and supplemental schedules supporting the basic financial statements.

Foreign companies investing and raising capital in the United States may face different SEC filing requirements as compared to their U.S. domestic competitors. Companies that meet the following criteria should follow

the “foreign private issuer” rules promulgated by the SEC.

A foreign private issuer is any issuer (other than a foreign government) incorporated or originated under the laws of a jurisdiction outside of the United States unless:

- More than 50 percent of its outstanding voting securities are directly or indirectly owned of record by U.S. residents
- Any of the following applies:
 - The majority of its executive officers or directors are U.S. citizens or residents
 - More than 50 percent of its assets are located in the United States
 - Its business is administered principally in the United States

Generally speaking, a foreign private issuer faces less stringent reporting and disclosure requirements under the SEC as compared to a U.S. domestic issuer. Some of the benefits of being a foreign private issuer are:

- Quarterly reports on a Form 10-Q and current reports on Form 8-K are not required.
- A foreign private issuer can choose to use U.S. GAAP, International Financial Reporting Standards (IFRS), or its local

accounting standards as its basis of reporting. In addition, no reconciliation to U.S. GAAP is required if the issuer adopts the English version of the IFRS issued by the International Accounting Standards Board (IASB).

- A foreign private issuer is not subject to the SEC’s accelerated filing requirement and can file its annual report on the Form 20-F six months after its fiscal year-end, until the fiscal year ending on or after December 15, 2011 when the deadline will shorten to four months.
- Although a foreign private issuer must also comply with the Sarbanes-Oxley Act (SOX), a number of exemptions in areas such as audit committee independence and use of non-GAAP financial measures are available.

A company should consult with legal experts to determine whether it qualifies as a foreign private issuer and consequently the applicable filing, reporting, and disclosure requirements.

Audit Requirements

Generally, an independent, certified public accountant must audit the financial statements that companies file with the SEC or other regulatory authority (hereinafter referred to as a public company). Auditors of public companies, referred to as “registered public accounting firms,” are required



to register with the Public Company Accounting Oversight Board (PCAOB). Individual states also issue licenses to certified public accountants. The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to error or fraud. The auditor also expresses an opinion on whether the financial statements present fairly, in all material respects, the financial position of the company as of the balance sheet date. The auditor also certifies that the company's statements of its operations and its cash flows conform with generally accepted accounting principles.

Ensuring reliable financial statements is management's responsibility. Management is responsible for adopting sound accounting policies and internal controls that will, among other things, help ensure that transactions are initiated, authorized, recorded, processed, and reported consistent with management's assertions embodied in the financial statements. Thus, the fair presentation of financial statements in conformity with generally accepted accounting principles is an implicit and integral part of management's responsibility. The PCAOB establishes auditing standards in the United States for public companies. The

Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA) establishes auditing standards for non-public companies. Upon establishment of the PCAOB in 2002, the PCAOB adopted the pronouncements of the AICPA as those existed on April 16, 2003, and has subsequently issued additional standards and interpretive guidance.

State Filing Requirements

In addition to any income tax returns that are due, the laws of most states require that domestic and foreign corporations authorized to do business within a state file an annual report with the state. These reports typically contain information regarding the corporation's business, its officers and directors, its capital structure, the amount of property located within the state, and the amount of business transacted within the state.

Insolvency

When a corporation becomes insolvent, is unable to obtain new financing, or is otherwise facing financial distress, it must evaluate alternatives with its creditors and formulate a plan of reorganization, either out-of-court or through the use of the Federal Bankruptcy Code. To this point, the corporation must first determine if the reorganization should take place in-court or out-of-court, and second, determine if the business should be liquidated or if it can be reorganized. An out-of-court restructuring, if it can be accomplished, is typically preferable because it is generally less disruptive to management and may be less expensive.

A reorganization can take many forms and include a financial restructuring of the balance sheet (e.g., debt for equity swap to reduce leverage), a recapitalization by a plan sponsor, a sale of the company in its entirety, an orderly liquidation of the company, a sale of non-core assets, an operational restructuring (rejection or renegotiation of key contracts, plant floor consolidations, negotiations with unions, etc.) or some combination of the above. A bankruptcy filing is typically voluntary, but may be ordered by a bankruptcy court based on the petition of creditors.

Cash and working capital management are critical components in any restructuring, because cash is scrutinized closely by creditors, and must be a key focus of the treasury team. Cash should be forecast over a short period of time (typically 13 weeks) and done so with scrupulous attention to detail. A corporation working with its creditors to restructure its capital structure or operations should be prepared to answer questions and respond to diligence requests. Credibility is critical during the restructuring process, and management should work with advisors to determine how value can be created and assume that creditors will expect to see significant cost-cutting initiatives considered.

In any restructuring, the corporation works closely with its creditors and typically drives the restructuring process with its advisors and those of its creditors. Although management and shareholders continue to operate the company while a plan of reorganization is developed, a committee of the company's creditors, comprised of various creditor classes, will have significant influence on the reorganization process. If the reorganization of the company is done in court, the bankruptcy court and the U.S. Trustee review and approve legal aspects and a plan of reorganization to determine that it meets the criteria for confirmation and that the proposed plan is in the best interest of all creditors.

Under any of these scenarios, all creditors' claims are classified according to their structural priority. Generally speaking, the senior claims in the capital structure of a company must be satisfied before a junior creditor receives any distribution of value. Shareholders would be entitled to a distribution only if all creditors are paid in full.

Value is a key driver in any reorganization, and different stakeholders may view the concept of value differently. After the valuation of assets to be distributed to claimants in a plan of reorganization is agreed upon, the assets are distributed to creditors pursuant to the plan of reorganization. In any reorganization, the debtor will attempt to renegotiate



creditors' claims and restructure the business so it can continue to operate. Creditors are often willing to renegotiate their claims because they would receive less if the reorganization failed and liquidation became necessary. Claimants may receive cash, a restructured debt security, equity in the company, or some combination thereof. The creditors generally have no further means of redress against the bankrupt debtor.

If a corporation is unable to restructure its balance sheet and operations successfully, it may choose to liquidate its operations. It will adopt a board resolution recommending the method under which it will accomplish the liquidation. A statement of intent to dissolve is executed by the corporation and is filed with the appropriate state authorities. The corporation will continue in existence long enough to wind up its affairs, collect assets, dispose of properties, discharge liabilities, and distribute assets to its shareholders. A corporation also may be involuntarily liquidated by a court in an action by a shareholder when it is established that the directors or shareholders are deadlocked regarding management of the corporation; that the directors are acting illegally, oppressively, or fraudulently; or that corporate assets are being wasted. Also, a creditor or group of creditors may force liquidation in certain circumstances.

Mergers and Consolidations

Corporate mergers and consolidations are permitted under virtually every state's laws. To accomplish a merger or consolidation, a resolution must be approved by both companies' boards and shareholders. The laws typically require the approval of at least a majority of the shareholders; most states, however, require a larger margin of consent.

Stock Markets

The U.S. stock market is composed of various stock exchanges and an over-the-counter (OTC) market. The major stock exchanges are the New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotation system

(NASDAQ). There are also several smaller, regional stock exchanges throughout the country. Issues traded on the NYSE and the NASDAQ generally are those of large, widely held companies. The exchanges impose various rules regarding financial standing, corporate governance, and public ownership. The over-the-counter market involves trading of securities not listed on an exchange.

Federal Securities Laws

The Securities Act of 1933 (1933 Act) is designed, through requirements for filing a registration statement with the SEC and a related prospectus, to provide full disclosure of all pertinent facts in connection with the sale of securities to the public in interstate commerce or through the mail. Financial statements for certain periods included in a prospectus must be audited by a certified public accountant. A copy of the prospectus must be furnished to the buyer of the registered security. Some securities are exempt from registration; others may not have to be registered because they do not constitute a public offering or because they are solely within the boundaries of one state; other stock offerings below the thresholds specified in the 1933 Act and its regulations may also be exempt from registration.

Questions of whether or not an offering of securities must be registered under the 1933 Act and what form of registration is required are legal issues and should be determined by attorneys for the company and its underwriters. The SEC does not pass judgment on the merits of a security, but attempts to ensure that all material information is disclosed in a prospectus that must be furnished to the security holder. The 1933 Act also specifies civil and criminal penalties for the improper issuance of securities.

In April 1990, the SEC adopted Rule 144A, which provides a safe harbor from the registration requirements of the 1933 Act for resales of restricted securities to "qualified institutional buyers," as defined. The provisions of Rule 144A have increased the participation in the U.S. capital markets of foreign

companies that had previously rejected the U.S. market because of the additional information and financial disclosures required in U.S. registration filings. Rule 144A is available to securities issued by foreign companies that are listed on foreign securities exchanges but are not listed on a U.S. securities exchange or NASDAQ.

The Securities Exchange Act of 1934 (1934 Act) regulates the trading of securities after they have been issued. Additionally, securities exchanges, brokers, securities associations, transfer agents, and others are regulated by the 1934 Act. Issuers of securities subject to the 1934 Act must register them with the SEC and must file an annual Form 10-K, quarterly Forms 10-Q, and certain other reports updating the original registration. Financial statements included in Form 10-K are required to be accompanied by an independent auditors' report; the 1934 Act requires that quarterly financial statements be reviewed by an auditor but does not require filing or an auditors' review report. Additionally, listed companies must comply with the listing and reporting requirements of the exchanges on which they are listed.

State Securities Registration

Intrastate sales of securities (those sold exclusively within one state) are regulated by the states through their securities commissions. Reporting requirements vary greatly from state to state. Most require the licensing of dealers in securities and require registration of securities. Therefore, each state's laws must be evaluated to determine whether they apply to a sale within the state. Securities listed on stock exchanges and securities issued to a limited number of persons may be exempt from the operative provisions of state securities laws.

Partnerships

A partnership is an association of two or more persons to act as co-owners of a business for profit. It is a legal entity only to the extent that it can own property and can sue or be sued (in most states) in its own name.

A partnership agreement may be either oral or written. However, if the business is to last for more than one year, some states require that the agreement, known as the articles of partnership, be in writing. Generally, partnership agreements should be written to help resolve potential disputes among the partners. In certain circumstances, for example in states that have adopted the Uniform Partnership Act (discussed below), a written partnership agreement is required.

There is a high degree of similarity of partnership laws in states that have adopted the Uniform Partnership Act (UPA). The UPA outlines the principal aspects of doing business as a partnership, including the rules for determining the existence of a partnership, the relationship of partners to persons dealing with the partnership, the relationship of the partners to one another, the property rights of a partner, and the rules for dissolving a partnership. In addition to the UPA or other partnership laws, partnerships must comply with local requirements for licenses, permits, and name registration.

The partnership form of business enterprise lets investors pool their capital, ideas, and management abilities. This pooling of assets may contribute to the establishment of a successful business.

Each member of a general partnership has unlimited liability for the partnership's debts, and each partner may be held jointly and severally liable for all partnership obligations. Thus, the partnership's ability to borrow funds is limited by the credit of the individual partners. A transfer of a partner's interest in the business may require the approval of the other partners. Under the UPA, an assignment of a partner's interest in the partnership does not itself cause the dissolution of the partnership; however,

dissolution is affected by the death or bankruptcy of any partner.

Limited Partnerships

A limited partnership is similar to a general partnership in that it is an association of co-owners formed to own a business. A limited partnership has at least one general partner and at least one limited partner. The liability of a limited partner is limited to the amount that partner invests in the partnership. The liability of a general partner for the partnership's obligations is unlimited.

The Uniform Limited Partnership Act (ULPA), which has been adopted by many states, sets out the requirements for creating a limited partnership and establishes the rights and liabilities of the members. If the laws of the state are not strictly followed, the limited partnership may be considered to be a general partnership, exposing the limited partners to unlimited liability for the partnership's obligations.

Under the ULPA, a written agreement, usually called the articles of partnership, must be filed with state officials. This agreement sets out the names of the general and limited partners, the partnership business, the required contributions of each partner, and other general information regarding the partnership and the rights of the partners between themselves.

General partners are subject to unlimited liability for the debts of the partnership and are solely responsible for the management of the business. Limited partners may neither take part in the management of the business nor let their names be used in the partnership name. Violation of these rules may cause limited partners to be treated as general partners.

Withdrawal of a limited partner usually will not terminate the limited partnership. However, the withdrawal of all general partners will cause the partnership to be dissolved by operation of law.

Joint Ventures

Generally, a joint venture is an unincorporated business formed by two or more persons. It is essentially a partnership formed for a specific,

limited purpose, and the laws governing both are basically the same. Once the business purpose of a joint venture is accomplished, it usually is dissolved. There is no distinction between the taxation of a joint venture and that of a partnership.

In most states, joint ventures are not recognized as legal entities apart from their participants. Some states limit the permissible acts of the joint venturers and their ability to legally bind each other.

Joint ventures also can be conducted in corporate form. In some situations, the members of a joint venture that would otherwise be treated as a partnership for federal income tax purposes may elect to be treated as directly conducting the venture's activities and taxed directly.

Limited Liability Companies

Another form of entity is the limited liability company (LLC). LLCs are neither partnerships nor corporations under applicable state law, but they generally provide limited liability to their owners for obligations of the business. See below for a discussion of the tax classification of LLCs.

Branches

A foreign investor can establish a branch in the United States with relative ease. A foreign corporation seeking to conduct business in one of the states must obtain a license to do business from that state. This procedure also applies to a U.S. corporation organized under the laws of another state. State approval to do business within the state usually is granted as a matter of course as long as no other corporation is doing business under the same name and as long as the business that the corporation intends to pursue is one permitted under state law. Some states, however, restrict branch operations of regulated industries, such as banking and insurance.

A U.S. branch of a foreign corporation may be subject to the branch profits tax in addition to the regular federal corporation income tax (see Chapter 4).

Elective Classification Regime for Tax Purposes

Independent of the legal classification of entities, the so-called "check-

the-box” rules of U.S. federal tax regulations permit an election of entity classification (as a corporation, partnership, or disregarded entity) under certain circumstances. For example, any domestic, unincorporated business entity (such as a general or limited partnership, or a limited liability company) with two or more members generally may elect to be treated as either a partnership or a corporation for federal income tax purposes. A single-member, unincorporated business entity may elect to be treated as a corporation or to be disregarded (treated as not separate from its owner) for federal income tax purposes. These “check-the-box” regulations remove any uncertainty regarding the classification of partnerships for U.S. tax purposes.

Acquisition of Existing Companies

A foreign national may obtain shares in an existing U.S. company. A few industries, however, are subject to restrictions on foreign ownership, including those involving the exploitation of natural resources, communications, shipping, nuclear plants, power-generating facilities, and aviation. Additionally, some states have restricted foreign investment in real estate. Securities and antitrust laws should also be considered when making a stock investment in a U.S. company.

In acquiring the entire ownership interest in an existing U.S. corporation, a foreign entity may acquire either the assets or the shares of the target corporation. The tax considerations of whether the transaction should be a purchase (by offering cash and similar consideration) or a tax-free reorganization (by exchanging voting shares in the acquiring corporation for at least 80 percent of the shares or substantially all of the assets of the U.S. target corporation) are complex.

CHAPTER FOUR

Taxation

Overview

The United States is a federal union that includes the 50 states, the District of Columbia, the Commonwealth of Puerto Rico, and a number of smaller territories. Corporate and individual income taxes and other levies discussed below are imposed by the federal government, state governments, and municipalities. Federal taxes include income taxes (the regular tax and an alternative minimum tax), employment taxes, estate and gift taxes, and excise taxes on certain goods and services. The U.S. federal tax laws are contained in Title 26 of the U.S. Code, generally referred to as the Internal Revenue Code (Code).

The United States does not have a value added tax, or VAT, system, but many of the U.S. states impose sales or use taxes in addition to income and other (real and personal property) taxes.

Federal Business Taxes

As discussed in the previous chapter, businesses can operate through a variety of legal forms, including corporations, general partnerships, limited partnerships, limited liability companies, and sole proprietorships. Both tax and non-tax concerns influence a business's choice of entity.

A corporation is a taxable entity, taxed on its net profits at the corporate level. Distributions of the corporation's after-tax income to the shareholders are taxed as dividends, although generally at a preferential rate.

Domestic corporations are subject to taxes on their worldwide income. A foreign corporation active in the United States is taxed on certain U.S. investments and other passive net income and on net income that is effectively connected with the conduct of a trade or business in the United States. A foreign corporation not engaged in a U.S. trade or business is taxed on certain U.S. source gross investment and other passive income. Gains from the disposition of U.S. real property interests are taxable to foreign corporations whether or not otherwise engaged in a U.S. business.

A domestic corporation, for U.S. tax purposes, is one created or organized under the laws of the United States, any

U.S. state, or the District of Columbia. A foreign corporation, for U.S. tax purposes, is one created or organized in any other place. The situs of a corporation's management and control does not determine its residency for U.S. tax purposes.

Taxable Income

Taxable income is gross income, less exempt income, less deductions. The amount of tax due is determined by multiplying taxable income (or alternative minimum taxable income) by the applicable tax rate. Credits (including foreign tax credits) may be available to reduce federal income tax liability.

Gross income for U.S. tax purposes is broadly defined as income from any source and includes gross income derived from business; gains derived from dealings in property; passive income, such as interest, rents, royalties, dividends; and compensation for services, including fees, commissions, and similar items. Gross income is not, however, equivalent to gross receipts; gross receipts are reduced by the cost of goods sold to determine gross income. Interest received on certain bonds issued by states and municipalities in the United States is exempt from federal taxation.

Dividends received by a corporation from other domestic corporations are not exempt from tax, but all, or a portion of such dividends, may be deductible by the recipient, depending on the ownership relationship between the payor and recipient. Dividends between members of an affiliated group filing a federal consolidated return may be eliminated for tax purposes.

Gross income can be reflected under several accounting methods, including the accrual method. Other methods are available for special situations. The method of accounting used for tax purposes may differ from that used for financial reporting purposes.

All businesses in which the production, purchase, or sale of merchandise is an income producing factor must maintain an inventory. In computing cost of sales, inventories generally must be valued at historical cost. Several inventory costing methods are available, including the

first-in, first-out (FIFO) method and the last-in, first-out (LIFO) method. However, if the LIFO method is used, the inventory must be valued at cost, and all annual financial statements to creditors and shareholders must be prepared using the LIFO method. International accounting standards do not permit the use of LIFO for financial statements. Dealers in securities are generally required to value securities held in inventory at their fair market value.

Once gross income is determined, allowable deductions are subtracted from gross income to determine taxable income. Generally, corporations may deduct all "ordinary and necessary" business expenses paid or accrued during the year in carrying on a trade or business. Payments that provide a benefit beyond the tax year generally need to be capitalized, thus the deduction for the expense is deferred.

Determining allowable deductions can be complex because of the many permissible deductions, special limitations that may apply, specific requirements to capitalize expenditures rather than deduct them currently (or vice versa), and, in some cases, lack of clarity in interpretations of the law.

Examples of expenditures that qualify as deductions from gross income include:

- **Interest.** Under a special rule, the deduction for interest payable to certain related foreign persons may have to be deferred until the foreign creditor reflects the interest in income (when the interest is received). Interest is not deductible, however, on (1) indebtedness incurred to carry tax-exempt obligations, or (2) if the debt is treated as equity. (Also see the [Thin Capitalization: Earnings-Stripping Rules](#) section in this chapter).
- **Depreciation.** A taxpayer is allowed to recover the cost of certain property used in its business through annual depreciation deductions. The Modified Accelerated Cost Recovery System (MACRS) is a system of annual deductions for recovering the cost of a taxpayer's capital outlays for tangible property. MACRS eliminates the need to determine the useful

life of each asset, the selection of a depreciation method, and a salvage value by classifying property into 1 of 10 broadly defined classes, each with its own recovery period.

- **Domestic Production Activities.** A deduction is permitted for a percentage of income attributable to “qualified domestic production activities.” The deduction is being phased in at a rate of 6 percent for 2007 through 2009, and 9 percent in 2010 and thereafter. The deduction is equal to the percentage of the taxpayer’s net income from qualified production activities, but may not exceed either the same percentage of the taxpayer’s regular taxable income (or alternative minimum taxable income) or 50 percent of the wages paid by the taxpayer during the year that are allocable to qualified production activities.
- **Other Business Expenses.** Examples of other business expenses include compensation, employee benefits, taxes (foreign taxes may not be deducted if a foreign tax credit is claimed), research and development, repairs and maintenance, bad debts, travel and entertainment expenses, rent, leasehold, royalties, and franchise fees. Many of these deductions are subject to complex limitations.

Dividends paid by corporations to non-corporate shareholders are generally nondeductible except in the case of specialized investment companies, although a preferential rate of tax may apply to an individual dividend recipient. Nondeductible expenses also include “excessive” compensation, excessive termination payments made in connection with corporate takeovers (golden parachutes), and expenses and interest related to the production of tax-exempt income.

Relief from Losses

A net operating loss is defined as the excess of the deductions permitted for a tax year over the gross income of the taxpayer for that year. The net operating loss for a tax year is carried first to the earliest year to which such loss may be

carried and then to each succeeding year, and is applied to the extent that taxable income exists for each of those years, producing a refund or a reduction in tax liability.

Net operating losses can generally be carried back 2 years and carried forward 20 years. However, recently enacted legislation provides for an extended carryback period of up to five years for net operating losses incurred in tax years beginning or ending in 2008 or 2009. To apply this extended carryback period, most calendar year-end taxpayers must have made an election by September 15, 2010. For fiscal year-end taxpayers, the deadline to elect to benefit from the extended carryback period may last up to August 2011 in some cases. Limits are imposed on the net operating losses generated by dual-resident corporations.

In the event of a change in corporate ownership, the deduction for net operating losses is limited. An ownership change is deemed to occur if there is a change in the stock ownership of the corporation or an equity structure shift (a merger or reorganization transaction) that, generally described, results in a 50 percent change in the ownership of the corporation relative to the ownership during the prior three-year period.

Corporations’ capital losses may be deducted only against capital gains. Unused corporate capital losses generally may be carried back three years and forward five years and used to offset capital gains in such years.

Tax Credits

Domestic and foreign corporations are allowed certain credits, within limits, against their U.S. taxes. These credits, unlike deductions, reduce the U.S. tax dollar for dollar. The rules for computing the credits are complex. Credits include:

- **Foreign Tax Credit.** A foreign tax credit is allowable, within limits, for foreign taxes paid on foreign source income subject to U.S. tax. This essentially is a mechanism for U.S. corporations to reduce or eliminate international double taxation of the same income. The foreign tax credit also is available to a foreign corporation for foreign taxes paid with respect to foreign

source income effectively connected with the conduct of a trade or business within the United States, but the credit cannot be used to offset the branch profits tax.

- **Research and Development Credit.** A research and development credit has been allowable for increased expenditures for research and development of business products and processes, but this credit expired on December 31, 2009, and as of August 31, 2010, it has not been extended.
- **Work Opportunity Credit.** A work opportunity credit is allowable for certain wages paid to newly hired members of certain disadvantaged groups that have special employment needs.
- **Other Credits.** There are a variety of credits tailored to encourage investment in certain activities or types of property, with a wide range of requirements and limitations.

Affiliated Groups of Companies

Certain affiliated groups of corporations may elect to file a consolidated tax return for all members of the group—instead of filing separate income tax returns for each member—provided stock ownership requirements are met and a proper election is made. Filing one return for all members of the group is simply a tax computation mechanism and does not convert the group into a single corporation. Each member of the group is jointly and severally liable for the total tax liability of the entire group.

Generally, only U.S. corporations are permitted to be included in an affiliated group. Under certain limited conditions, corporations organized in Canada or Mexico may join in the filing of a consolidated return. In addition, certain corporations are not permitted to join in the filing of a consolidated return. These include foreign corporations, tax-exempt organizations, possessions corporations, regulated investment companies, and real estate investment trusts. Life insurance companies are subject to limitations on their ability to file a consolidated return with other types of companies.



Stock Ownership Requirements

The stock ownership requirements for a group of corporations to file a tax return on a consolidated basis are generally as follows:

- The parent corporation of the group must directly own 80 percent or more of the stock of at least one subsidiary in the group.
- Each other subsidiary in the group must be at least 80 percent directly owned by the parent and/or other subsidiaries in the group.

Treatment of Group Losses

Losses incurred by members of a group during the period of consolidation can be used to offset profits of other members of the group. However, losses incurred by a corporation prior to joining the group (referred to as separate return limitation year losses) may not be used to offset profits of other group members or be carried back by such members to pre-consolidation tax years. Limitations on the use of losses may also exist to the extent the loss represents a built-in loss that existed before the member joined the group.

Dual consolidated losses are subject to special rules. These rules limit the deduction for losses incurred by (1) a domestic corporation that is a member of a U.S. consolidated group and that is also subject to tax on a residence basis

in a foreign country; and (2) a domestic corporation with a foreign branch or an ownership interest in a foreign hybrid entity, i.e., hybrid entity separate unit.

Corporate Combinations

Tax-free treatment is generally afforded for certain incorporation, liquidation, and reorganization transactions. In these transactions, a transferor's basis in stock or assets may be adjusted and recognition of gain or loss deferred until the time that the stock or assets received in the transaction are disposed of. These transactions include:

- Transfers of property to corporations by persons that are in 80 percent or more control of the corporation, solely in exchange for stock or securities of the corporation
- Complete liquidations of subsidiaries that are 80 percent or more owned by the corporate parent
- Statutory corporate merger or consolidation transactions
- Stock-for-stock acquisitions in which the acquiring corporation acquires 80 percent or more of the stock of a target corporation solely in exchange for its own stock or the stock of a parent corporation
- Stock-for-asset acquisitions in which the acquiring corporation acquires substantially all the assets of a target

corporation in exchange for its own stock or the stock of a parent corporation

- Corporate divisions such as spin-off, split-off, and split-up transactions
- Corporation recapitalizations, including changes in the capital structure of the corporation
- Corporate migrations, such as a change in the place of incorporation
- Reorganization of insolvent corporations

Corporate transactions that are cross-border, such as incorporations, liquidations, and reorganizations that are U.S. out-bound, U.S. in-bound, or foreign-to-foreign, are subject to special rules to prevent untaxed gains and earnings from leaving the U.S. tax jurisdiction.

Tax-free treatment also is provided when business or investment property is exchanged for property of a like kind (excluding stocks, securities, or property held for sale). A gain also can be deferred when property is compulsorily or involuntarily converted (such as by eminent domain) into property which is similar or related in service or use. In these transactions, the recognition of gain is deferred until the disposal of the replacement property.



Taxation of Partnerships

Partnerships generally are treated for federal income tax purposes as pass-through entities, meaning they are not subject to tax at the entity level. Each partner is subject to tax on its share of each item of the partnership's income and loss. The liability for tax arises regardless of whether the partnership's profits are distributed or retained. Most U.S. states, but not all, tax the partners, not the partnership. Withholding generally applies to a foreign person's allocable share of partnership income.

Any domestic, unincorporated business entity with two or more members generally may elect to be treated as either a partnership or a corporation for federal income tax purposes. Single-member unincorporated business entities may elect to be treated as a corporation or to be disregarded (treated as not separate from its owner) for federal income tax purposes. The elective classification of entity regime for tax purposes discussed in Chapter 3 is also generally applicable to non-U.S. entities, although certain non-U.S. entities are treated automatically as corporations for U.S. tax purposes.

Tax Rates

Taxable income (gross income less deductions) of a corporation was taxed at rates ranging from 15 percent through 38 percent in 2009. Corporate capital gains generally are taxed at the same rates as ordinary income.

The above rates are applied to taxable income in determining the gross amount of tax. The tax is then reduced by allowable credits, such as the foreign tax credit.

Corporations also are subject to the alternative minimum tax (AMT) if a re-computation of tax using this method is higher than the tax computed at the regular rates. The tax base for the AMT eliminates or defers certain preferential treatments for income and deductions that are allowed under the regular tax provisions. A "tentative" tax is computed on the alternative minimum taxable income in excess of an exemption amount (up to \$40,000), at the rate of 20 percent. The amount by which this "tentative" tax exceeds the regular tax is imposed as the AMT. Any AMT imposed on a corporation is available as a credit in later years when the regular tax exceeds the "tentative" tax, limited to that excess.

Administration

The federal tax administration agency in the United States is the Internal Revenue Service (IRS). States have separate tax administration agencies.

Tax Return Filing Requirements

The United States uses a self-assessment system where all taxpayers are required to compute their own tax liability for the tax period. Corporate tax returns are due on or before the 15th day of the third month following the close of the tax year. The full amount of tax owed for the year is required to be paid on or before the due date of the tax return (without extensions). An automatic extension for six months is available. Estimated tax payments are required on a quarterly basis. Foreign corporations with U.S. source income generally must adhere to these time limits as well. If a filing is delayed more than 18 months beyond its initial due date, the IRS claims to have the ability to deny the corporate taxpayer the benefit of deductions, meaning the foreign corporation risks being taxed on its gross income if it fails to file within 20.5 months of the end of its tax year.

Rulings

Advance rulings may be obtained from the IRS on many tax issues. The IRS usually will not consider taxpayer-specific rulings on issues that are factual in nature, but general guidance such as U.S. Treasury regulations, revenue rulings, notices, and revenue procedures is available.

Judicial System

There are two judicial vehicles for taxpayers to dispute an IRS determination of a tax deficiency:

- Under a prepayment dispute mechanism, the taxpayer can file a petition with the U.S. Tax Court to contest the deficiency (before paying the amount of the deficiency)
- Alternatively, the taxpayer can pay the amount of the deficiency and, after filing a timely claim for refund, file a suit for refund either in a federal district court or with the Court of Federal Claims

Decisions of the U.S. Tax Court, federal district courts, and the Court of Federal Claims may be appealed to the U.S. Circuit Courts of Appeals and, ultimately, to the U.S. Supreme Court.

Foreign Investors

A “foreign investor” in this section refers to both nonresident aliens and foreign corporations, unless indicated otherwise. A foreign investor generally is subject to U.S. income tax on two types of income:

- Certain U.S. source income that is not effectively connected with a U.S. trade or business
- Income that is effectively connected with a U.S. trade or business

A 30 percent withholding tax usually is imposed on U.S. source income that is not effectively connected with a U.S. trade or business. In contrast, income that is effectively connected with a U.S. trade or business generally is subject to two levels of tax: a regular income tax on net income earned and a withholding tax on income distributed or remitted to the foreign investor. In addition, a foreign investor also may be subject to taxes on its disposition of real property and certain interests in real property.

Taxes on Effectively Connected Income

Foreign corporate investors are subject to U.S. federal income tax on income that is effectively connected with a U.S. trade or business. For this purpose, absent application of a treaty, the concept of permanent establishment does not apply.

All U.S. source “fixed or determinable annual or periodical income” (FDAP) and capital gains are considered effectively connected to a U.S. trade or business if either of the following two tests is met:

- The income or gain is derived in the active conduct of a U.S. trade or business (the “asset use test”)
- The activities of the U.S. trade or business are a material factor in the realization of income (the “business activities test”)

FDAP income is a descriptive term relating to a class of income, rather than a highly technical definition. It includes items such as interest, dividends, rents, certain wages, and annuities (fixed amounts, paid periodically) as well as items that are potentially equivalent to these income types, such as royalties paid in one lump sum. The U.S. resident payor’s perspective—and not the foreign taxpayer’s—is applied to determine whether any income item is FDAP.

The United States also applies a “force of attraction rule” and deems all income earned by a foreign investor from U.S. sources, other than FDAP and capital gains, to be effectively connected with a U.S. trade or business.

As a practical matter, this rule may apply when a foreign seller has a U.S. trade or business and, unrelated to that U.S. trade or business, sells certain property within the United States. The income from the sale of unrelated property is treated as U.S. source income. The force of attraction rule treats such income as effectively connected income. This force of attraction rule does not apply when a treaty overrides U.S. domestic tax law and a permanent establishment concept is applied.

Foreign source income generally is not treated as effectively connected to a U.S.

trade or business. However, it will be treated as effectively connected income if the foreign entity has an office in the United States to which the income is attributable, and the income consists of:

- Rents or royalties for the use of certain intangible property outside the United States or gains from the sale or exchange of such property, or
- Dividends, interest, or gains from the sale of stock and financial instruments derived from carrying on banking, financing, or similar business in the United States, or received by a corporation whose principal business is trading in stock and securities for its own account

Generally, foreign investors are not subject to tax in the United States on capital gains, including gains from the sale of stock of other foreign corporations and gains from the sale of stock of U.S. domestic corporations, unless such gains are effectively connected with a U.S. trade or business. Special rules apply with respect to dispositions of certain U.S. real property and certain U.S. real property holding corporations.

If a partnership engages in a U.S. trade or business, each foreign partner is treated as engaged in that trade or business. Foreign partners in such partnerships are generally subject to tax withholding by the partnership on their allocable share of the effectively connected taxable income of the partnership.

Branch Taxes

Branch Profits Tax

The branch profits tax treats a branch like a corporation by imposing two levels of tax. A foreign investor that engages in a U.S. trade or business is not only subject to tax on its effectively connected income, but also is subject to certain branch taxation, including the branch profits tax, and the branch-level interest tax. The purpose of the branch profits tax is to protect the classic two-tier taxation regime that the United States imposes on corporations (first by taxing the corporate earnings and profits at the corporate level, and second, by taxing the shareholders on certain distributions of earnings and profits treated as dividends).



In general, the branch profits tax imposes a tax on the profits of a foreign corporation's U.S. business operations that are "deemed repatriated" from the United States at the end of the tax year. In effect, the branch profits tax treats a U.S. branch of a foreign corporation as if it were a U.S. subsidiary that pays a dividend annually in an amount equal to its U.S. business profits that are not reinvested in the U.S. business during that year. The deemed dividend amount is subject to a 30 percent tax.

The amount deemed repatriated is referred to as the "dividend equivalent amount," and is defined as U.S. source effectively connected earnings and profits increased by net "disinvestment" in the branch for the year (defined as a decrease in "U.S. net equity"), and decreased by net positive investment in the branch, or an increase in U.S. net equity. Effectively connected earnings and profits generally means the earnings and profits that are attributable to income effectively connected with (or treated as effectively connected with) the conduct of a trade or business in the United States. U.S. net equity is the sum of cash on hand and adjusted basis of the assets connected with the U.S. business, less liabilities.

In general, an asset is a U.S. asset if all of the income generated by the asset is effectively connected income and any gain realized on a disposition of the asset would also be effectively connected income. U.S. net equity and the value of U.S. assets are determined as of the close of the foreign corporation's tax year. Exemptions or reduced rates may apply under relevant income tax treaties.

Branch-Level Interest Tax

The branch-level interest tax treats interest paid by a foreign corporation's U.S. trade or business as if it were paid by a domestic corporation, thus potentially subjecting it to 30 percent U.S. withholding tax if the lender is a foreign person. In addition, the branch-level interest tax allows the United States to impose a corporate-level tax on the excess of the amount of interest deductible by a foreign corporation over the amount of interest treated as paid

by U.S. businesses operated by the foreign corporation.

A foreign corporation must compare the amount of interest allowed as a deduction in computing effectively connected income to the amount of interest paid by the foreign corporation's U.S. trade or business. If the foreign corporation's deduction exceeds the amount of interest paid by the U.S. trade or business, the excess is treated as if it were interest paid by a wholly owned domestic subsidiary to the foreign corporation, thus subjecting it to 30 percent withholding. Exemptions or reduced rates may apply under relevant income tax treaties.

FIRPTA—Dispositions of U.S. Real Property Interests

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) treats a foreign investor's income or gain (or loss) from the disposition of U.S. real property and certain investments in U.S. real property as if such gain or loss was effectively connected with a U.S. trade or business and taxed at regular income tax rates. A U.S. real property interest generally includes any interest in real property located in the United States or in the U.S. Virgin Islands and any interest (other than solely as a creditor) in a domestic corporation that is or was a U.S. real property holding corporation. An interest in real property includes direct interests in U.S. real property, including land and improvements, mines, wells, natural deposits, and personal property associated with real property. A U.S. real property holding corporation is a corporation that holds U.S. real property interests with a fair market value of at least 50 percent of the sum of the fair market values of its U.S. real property interests plus its interests in real property located outside the United States and its other assets that are used or held for use in a trade or business.

The transferee (buyer) of any U.S. real property interest generally is required to deduct and withhold (under special withholding rules) a tax equal to 10 percent of the amount realized by the foreign transferor (seller) upon disposition of the property and remit it to the IRS. The foreign investor may enter

into a prior agreement with the IRS to reduce the amount of withholding. The withholding tax collected by the buyer is not the final tax liability. A refund may be claimed if the withholding tax exceeds the maximum tax liability.

Withholding Taxes on Certain U.S. Source Income

Certain types of U.S. source income, which are not effectively connected with a U.S. trade or business, are subject to 30 percent withholding. The principal types of this income include:

- FDAP income
- Certain original issue discount on debt obligations when payments of principal or interest are received or when the obligations are sold
- Certain gains from the sale of patents and other intangible property to the extent the proceeds are contingent on the future productivity, use, or disposition of the property

Other types of U.S. source income that are not effectively connected with a U.S. trade or business and are not subject to the 30 percent withholding regime include:

- Gains from the sale of capital assets and other property, except U.S. real property interests
- Interest received on certain deposits with banks and certain other financial institutions
- Interest on certain obligations issued by U.S. state and local governments
- Original issue discount on certain short-term debt obligations

Subject to certain transition rules, the recently enacted "Foreign Account Compliance Act" legislation imposes a 30 percent withholding tax on certain payments made after December 31, 2012 to (1) foreign financial institutions (FFIs) that fail to comply with certain new disclosure requirements concerning U.S. accounts; and (2) foreign entities (other than FFIs) that fail to certify they have no substantial U.S. owners or, alternatively, disclose the identities of such owners. A substantial U.S. owner generally means a U.S. individual, trust, partnership, or

estate that owns directly or indirectly 10 percent of a foreign entity. A substantial U.S. owner also includes a privately held U.S. corporation that owns 10 percent of a foreign entity.

Payments subject to this new withholding regime include FDAP income that is not effectively connected to a U.S. trade or business and gross proceeds from the sale or other disposition of a stock or security that can give rise to payment of U.S. source dividends or interest. The purpose of this new withholding regime is to expand reporting of U.S. persons' offshore investment activities.

Sourcing of Income Rules

The sourcing rules for gross income are organized by categories of income, including interest, dividends, personal service income, rents, royalties, and gains from the disposition of property. Dividends and interest generally are sourced based on the residence of the payor. In the case of a corporate payor, the determination is based on whether the corporation is domestic or foreign. Thus, interest and dividends paid by a domestic corporation generally are considered U.S. source. In contrast, dividends and interest paid by a foreign corporation generally are considered foreign source. Rents and royalties are sourced based on where the underlying property is used. Numerous exceptions apply to these general rules.

Foreign Investor Operating through a Domestic Corporation

The discussion above dealing with the taxation of income effectively connected with a U.S. trade or business and withholding at source on certain U.S. source income was based on a general assumption that the foreign corporation itself is operating the U.S. trade or business through a branch or a partnership (i.e., through a pass-through entity). A foreign investor may choose instead to invest in the United States through a domestic corporation. A foreign investor planning to operate through a domestic corporation should consider the following points: transfer pricing, earnings-stripping rules, check-the-box rules, and domestic reverse hybrids.



Transfer Pricing

The IRS is authorized to make transfer pricing adjustments in transactions between commonly controlled entities if the price set by the parties is not at arm's length. The rules apply to organizations that are owned or controlled, either directly or indirectly, by the same interests. For example, the IRS is authorized to make transfer pricing adjustments between a foreign investor and its wholly owned domestic corporation.

The IRS is authorized to allocate income, deductions, and other tax items between commonly owned or commonly controlled organizations as necessary to prevent evasion of taxes or to clearly reflect the parties' income. In the case of a transfer or license of intangible property, the income from the transfer must be "commensurate with the income attributable to the intangible." Thus, the transfer pricing rules generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been unrelated parties dealing at arm's length.

Advance pricing agreements addressing transfer pricing issues may be obtained from the IRS.

If a foreign shareholder owns directly or indirectly stock representing at least 25 percent of the vote or value in a U.S. corporation, the U.S. corporation must complete and file Form 5472 ("Information Return of a 25 percent Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Under Sections 6038A and 6038C of the Internal Revenue Code)"), on an annual basis, to report certain transactions with related foreign and U.S. parties (e.g., sales of inventory, interest payments made or received). This form allows the U.S. tax authorities to properly audit the transfer pricing of such transactions. The failure to file one or more Form(s) 5472 may result in a penalty of \$10,000 for each such failure. The penalty also can be applied for failure to maintain adequate records.

A foreign corporation engaged in a U.S. trade or business also is required to file Form(s) 5472 to report certain transactions with related foreign and U.S. parties.

Thin Capitalization: Earnings-Stripping Rules

The United States applies earnings-stripping rules to certain taxpayers, including U.S. corporations owned by foreign corporations. If certain other

conditions are met, a corporation's interest deduction is limited when the corporation makes a substantial (in proportion to its income) interest payment to a foreign related person who is not subject to U.S. tax in whole or part on that interest payment. A corporation's interest deduction is also limited when the corporation makes a substantial interest payment to an unrelated U.S. or foreign person who is not subject to U.S. gross basis taxation in whole or in part on that interest payment, providing that a foreign related person has guaranteed the corporation's underlying debt. A foreign person is not subject to U.S. gross basis taxation in whole or part if, for example, the foreign person is eligible to claim a reduced or zero rate of withholding under a U.S. tax treaty.

A corporation will be subject to the earnings-stripping rule if it has:

- Excess interest for the tax year (net interest expense in excess of 50 percent of the adjusted taxable income), and
- A debt-to-equity ratio at the end of the taxable year in excess of 1.5 to 1.

to certain aspects of the taxation of domestic reverse hybrid entities.

Deferral of Deductions

A deduction for expenses payable to certain related foreign persons generally may need to be deferred until the foreign person reflects the payment in income (when received).

Treaties

In addition to the U.S. and foreign statutory rules for the taxation of foreign income of U.S. persons and the U.S. income of foreign nationals, bilateral income tax treaties limit the amount of income or withholding tax that may be imposed by one treaty partner on residents of the other treaty partner. For example, treaties often reduce or eliminate withholding taxes imposed by a treaty country on certain types of income, such as dividends, interest, and royalties, paid to residents of the other treaty country. For another example, treaties set the standard for taxation of the business activities of a resident of the other treaty country (known as a “permanent establishment”).

Treaties also include provisions governing the creditability of taxes imposed by the treaty country in which income is earned in computing the amount of tax owed to the other country by its residents with respect to that income. Treaties also provide procedures under which inconsistent positions taken by the treaty countries on a single item of income or deduction may be mutually resolved by the two countries.

The United States has a network of bilateral income tax treaties covering more than 60 countries. This network includes all of the OECD member countries and encompasses many other countries with significant trade or investment with the United States.

The United States has entered into a series of bilateral tax treaties that eliminate withholding tax on dividends paid by one corporation to another corporation that owns at least 80 percent of the stock of the dividend paying corporation (often referred to as “direct dividends”), provided that certain conditions are met. The elimination of withholding tax under these circumstances is intended to

reduce further the tax barriers for direct investment between the treaty countries.

The benefit of lower withholding rates under a tax treaty can be denied if payments are made to partnerships or certain hybrid entities, for instance certain entities that are not treated as fiscally transparent by the interest holder’s state of residence. This will be the case with respect to a foreign partner of a partnership if the following circumstances are present:

- The partner or member of the entity is not subject to tax on the payment by the treaty jurisdiction.
- The tax treaty does not contain a provision that addressed the treaty of items paid to partnerships.
- The treaty jurisdiction does not impose a tax on distribution of the item to the partner or member of the entity.

Special rules also allow the U.S. tax authorities to deny the benefit of lower withholding rates under an applicable income tax treaty in those cases where it has been determined that the treaty resident recipient of the U.S. source FDAP income is acting as a conduit entity in a conduit financing arrangement.

See Appendices for a table listing the current U.S. treaties.

International Considerations

A foreign investor may want to consider the following factors when deciding how to operate a business within the United States. This discussion assumes that a foreign parent corporation has purchased U.S. business assets (including real property).

Choice of Entity

If a foreign corporation makes an acquisition of business assets (including real property) located in the United States, it must decide whether to operate its new U.S. business as a corporate or pass-through entity.

As a general rule, a foreign corporation’s U.S. tax posture may be simplified from an operational standpoint if it chooses corporate status. For example, incorporation following acquisition may provide a discrete opportunity to infuse debt into the United States, if desirable.

If a corporation meets these requirements, any interest paid to a related person will be treated as disqualified interest and disallowed as a deduction to the extent of the excess interest expense for the year. Disallowed interest may be carried over to future years.

Check-the-Box Rules and Domestic Reverse Hybrids

Under the United States’ check-the-box rules discussed in Chapter 3, a foreign investor has flexibility with respect to an “eligible entity” and may elect how an entity will be classified for U.S. federal income tax purposes. For example, an investor may structure its investment as a “domestic reverse hybrid entity” (as an entity that is classified as a corporation for U.S. federal income tax purposes but as a partnership under foreign law). This structure may allow startup losses to flow through to the entity’s foreign investors for foreign tax purposes while the entity retains the benefits of operating through an entity classified as a corporation for U.S. federal income tax purposes, which may also provide an opportunity to introduce cashless leverage into such entity. Special rules apply with respect

In later years, it also may be easier to integrate the new U.S. business interests with other U.S. targets that operate through U.S. corporations if the new U.S. business is itself a corporation for U.S. income tax purposes.

In contrast, if the new U.S. business is operated as a branch or pass-through entity (or as a disregarded limited liability company that is treated as a branch or as a partnership), consideration must be given to:

- Interest expense allocation (to the extent debt is infused into the new U.S. business branch)
- Compliance with U.S. branch-profit tax rules
- Compliance with the U.S. branch-level interest tax rules

If the new U.S. business is operated as a partnership (in contrast to a limited liability company that is treated as a branch), it is possible that any anticipated losses from the new U.S. business will flow through to the foreign partner for foreign tax purposes and possibly, depending on the partner's foreign jurisdiction, offset its operating income. Consideration also must be given to whether the new U.S. business will be profitable. If the pass-through entity is profitable and its income flows through to the foreign partner, attention must be given to the home country's rules for avoiding double taxation (for example, exemption of the U.S. income or granting credits for the U.S. tax imposed on the income).

Alternatively, operating the new U.S. business through a reverse hybrid (an entity that is treated as a corporation for U.S. federal income tax purposes and as a pass-through entity for foreign law purposes) may allow income and losses from the new U.S. business to flow through to the foreign parent while still retaining the operational benefits of operating as a corporation for U.S. income tax purposes. Current dual consolidated loss rules will not adversely affect the reverse hybrid. Other issues to be considered if such a structure is contemplated include eligibility for treaty benefits; therefore, these decisions require careful planning.

In all of these cases, special considerations would apply to structuring real estate investments under FIRPTA. The most viable choice of entity will likely depend on the outcome of modeling exercises that take into account the nature and extent of proposed income or losses of the new U.S. business.

Classification of Distributions from the United States to the Foreign Country

If the new U.S. business elects to be treated as a corporation for U.S. tax purposes, distributions out of its earnings and profits—which are similar to retained earnings for financial accounting purposes but calculated under U.S. tax principles—will be treated as dividends for U.S. tax purposes under the dividends article of the relevant foreign income tax treaty. Under the U.S. tax system, distributions are attributed to current and accumulated earnings and profits before being treated as a return of capital or capital gains. (A distribution may be a dividend if there are current earnings and profits even if there is an accumulated earnings and profits deficit.) The analysis is substantially the same if the new U.S. business is acquired and elects to be classified as a corporation (or if the new U.S. business is owned by another U.S. holding corporation owned by foreign parent and the distributions are made by the holding company).

If the new U.S. business operates as a pass-through entity, to the extent its U.S. earnings are not reinvested in its U.S. business, such amounts will be considered remitted to its home office. Such remittances are termed a “dividend equivalent amount” and may be subject to the branch profits tax rules.

Leveraging

The initial acquisition and formation of the new U.S. business assets may provide a unique opportunity to introduce leverage—without the investment of cash—into the U.S. operations. The ultimate desirability of leverage requires detailed forecasting of the new U.S. business and its current and expected profitability.

Exit and FIRPTA

If the new U.S. business is a pass-through entity, any disposition of its

interests would be a taxable event for U.S. tax purposes. In contrast, if the new U.S. business were a corporation, a disposition of a top-tier U.S. holding company would only be taxable if it were a U.S. real property holding company. To determine whether FIRPTA applies, it is necessary to determine whether the new U.S. business is a U.S. real property holding company. To make that determination, the foreign parent must make the factual and legal conclusions as to what percentage of the new U.S. business's assets are real property or permanent fixtures on real property. Regardless of whether pass-through or corporate status is chosen, an exit from the U.S. tax jurisdiction via a disposition of a foreign holding company generally is not subject to U.S. tax (including tax under FIRPTA).

State and Local Corporate Income and Franchise Taxes

Currently, 46 states and the District of Columbia impose corporate income and/or franchise taxes. In addition, some states impose income taxes on unincorporated businesses (limited liability companies and partnerships). Some cities also impose corporate income taxes.

A true “franchise tax” is levied for the privilege of doing business in the state. The franchise tax base can be measured by a corporation's income, net worth, or a combination of both. In many states, the term “franchise tax” refers

to the state's income tax, but in other states a corporation can be subject to both an income tax and a net-worth based franchise tax. Nexus, tax base, apportionment, and filing methods, described below, apply to income taxes and taxes based on net worth.

Because laws vary significantly from jurisdiction to jurisdiction, a company should review the laws in each of the states in which it does business to determine its specific tax obligations. However, there are some general principles that can be considered.

Nexus

For a state to tax a corporation, there must be a connection between the corporation and the state. This connection is referred to as "nexus." The nexus standards are significantly different than the federal standard of "trade or business" or "permanent establishment." Nexus generally is established by having property (real or personal, owned or leased) or personnel, employees, or independent agents located in the state. Some states allow a limited amount of activity in the state without subjecting the company to tax. A growing number of states assert that a taxpayer has nexus based on economic connections with the state, such as having customers in the state. A federal law restricts states' authority from imposing income tax on certain out-of-state sellers of tangible personal property. This law applies only to income

taxes and not to other taxes, including franchise taxes based on net worth.

Tax Base

In general, the state income tax base is based on federal taxable income with certain modifications. Accordingly, a non-U.S. taxpayer that does not have any taxable income for federal tax purposes, for example, because its income is protected by treaty or because it does not have a permanent establishment in the United States, also may have no taxable income in the state. Nevertheless, some states provide that a taxpayer that is protected by treaty from federal taxes must prepare its state tax return based on federal income "as if" the treaty provisions did not apply. Additionally, a state may impose a filing requirement and a minimum tax on taxpayers that do not have taxable income for federal tax purposes.

States apply a variety of "addition or subtraction modifications" to federal taxable income to determine their own tax base. Examples of modifications include depreciation, the deduction for domestic production activities, dividends, state income taxes, foreign source income and taxes, corporate-shareholder transactions, net operating losses, and transactions with related entities that generate deductions for interest or royalties.

Apportionment

Instead of employing the federal approach of looking to the source of each type of

income and expense to determine the appropriate place for imposing tax, states generally allow a multistate taxpayer to pay tax on a portion of its total tax base. The amount of the tax base apportioned to the state is determined using a formula that approximates the relative percentage of income attributable to the state. Traditionally, this formula is based on relative percentages of property, payroll, and sales attributable to the state. However, the formula varies widely from state to state and sometimes depends on the industry sector.

Filing Methods

Only a few states follow the federal consolidated return principles. Instead, states have enacted a variety of filing methods. Some states require each corporation to file a separate return. Other states allow or require related entities to file on a combined basis using the unitary business approach. Unlike the federal consolidated return rules, the unitary business approach generally does not look at objective factors, such as percentage of ownership, to determine whether companies are required to be included in the return (whether they are "unitary"). Instead, states look at a number of subjective factors in determining whether there is a unitary business, including functional integration, centralization of management, and economies of scale. States also differ on their inclusion or exclusion of foreign entities within the unitary group.





Sales and Use Taxes

Because treaty provisions typically do not extend to taxes imposed by subnational levels of government (other than with respect to nondiscrimination), foreign companies doing business in the United States unwittingly may be subject to U.S. state and local sales and use tax laws. These taxes may be imposed directly on a foreign company or a state may impose liability indirectly by requiring the seller to collect taxes from a purchaser. These levies can represent a significant cost of doing business in the United States.

Currently, 45 states and the District of Columbia, as well as thousands of local governments, impose sales and use taxes. Most localities impose taxes on the same items taxed by the state.

Imposition of Sales Taxes

A sales tax usually is levied on the gross consideration derived from retail sales, transfers, or rentals of tangible personal property and selected services in the state. Sales tax usually is imposed at the place of delivery, determined without regard to the shipping terms of the sales contract. The taxes are usually collected by the seller then remitted to the state, which in turn distributes the taxes to the proper locality. If the seller fails to collect tax, the seller may be liable for the taxes due. If the seller is not required to collect tax on the sale, the purchaser may be required to remit use taxes directly to the state.

Requirements to Collect Sales and Use Taxes

A seller can be required to collect sales and use taxes only if it has a physical presence in the taxing jurisdiction. A physical presence may be established by sending employees or representatives into the state, by establishing an office or other place of business in the state, or by owning property in the state. In addition, the activities of an in-state third party can render an out-of-state company subject to the state's sales and use tax laws.

Use Taxes

A use tax is imposed on the use, storage, or consumption of tangible personal property and taxable services in a state. The use tax generally is applied when a sales tax was not paid previously

in the taxing state. The use tax base, exemptions, and rates generally parallel those under the sales tax. Many states impose a use tax even though the goods were first used outside the state, but allow a credit for sales taxes previously paid to another state.

Sales Tax Base

The sales tax is measured by the gross sales price of the tangible personal property or services. Finance, interest, or carrying charges may be excluded from the tax base, although some states may require these charges to be separately stated. Likewise, many states exclude transportation charges, but may require these charges to be separately stated. Many states permit certain deductions from the sales and use tax base, including trade-ins, discounts, coupons, rebates, returns, and allowances.

Sale for Resale and Other Exemptions

Many states exempt property purchased for resale or that becomes part of tangible personal property that is to be resold. Other exemptions may apply. For example, exemptions (or a reduced rate) may be available for purchases of manufacturing equipment or property used or consumed in the manufacturing process, intra-company transfers, or certain businesses that are prevalent within a state.

Record-Keeping Requirements

Most states require a seller to obtain a resale or exemption certificate from the purchaser to verify the nontaxable status of a transaction. Some states require the use of a specific form or specific language. Others permit a uniform exemption certificate that is accepted by a number of states. Failure to follow a state's specific record-keeping requirements can cause the seller to be liable for uncollected sales taxes.

Other Taxes

- **Property Taxes.** Taxes assessed on real and personal property are characterized as "ad valorem" taxes because the tax is assessed on the value of the property on a prescribed assessment date each year.
- **Special Taxes and Fees.** State and local governments may impose a number of other taxes, including taxes on special

commodities (alcohol, tobacco, and motor fuel), fees for business and professional licenses, and taxes on special types of businesses, such as banking or insurance.

Taxation of Individuals

Taxation of Residents

The taxable income of a U.S. resident is computed by:

1. Determining gross income
2. Subtracting certain "above-the-line" deductions to arrive at adjusted gross income
3. Subtracting personal exemption amounts, and
4. Subtracting either the "standard" deduction or the total of "itemized" deductions.

Each is discussed in greater detail in this section.

Graduated tax rates are applied to the taxpayer's taxable income depending on the taxpayer's filing status. The amount of regular tax owed may be offset by available credits, including foreign tax credits. A separate tax computation is required to determine the AMT on the alternative minimum tax base. The tax liability is the larger of the regular tax liability or the AMT.

The gross income of citizens and resident aliens generally includes income from all sources, including but not limited to wages, salaries, interest, dividends, business profits, rents, royalties, income from partnerships, annuities, premiums, and gains from the sale of real and personal property. Specified items are excluded from gross income, including gifts, inheritances, proceeds from certain life insurance policies, and qualifying state or municipal bond interest. U.S. citizens and residents living abroad may also be eligible to exclude from U.S. taxable income certain foreign earned income and foreign housing costs.

Certain deductions are allowed in computing adjusted gross income. Deductions allowed in computing adjusted gross income include certain medical and health savings account contributions and some retirement savings contributions.

Other deductions, either itemized deductions or the standard deduction, are allowed in computing taxable income. Itemized deductions include home mortgage interest, state and local income or sales taxes, certain work-related expenses, and foreign taxes not claimed as a credit. Limitations apply to most itemized deductions. In addition, limitations (based on adjusted gross income) on total itemized deductions apply. Individual taxpayers who do not itemize their deductions are entitled to a standard deduction. The standard deduction amount varies according to a taxpayer's filing status and is indexed for inflation.

In addition to the itemized or standard deduction, U.S. residents are entitled to a personal exemption deduction for themselves and a dependent exemption deduction for each dependent. These exemption amounts are indexed for inflation.

After all allowable deductions and personal exemptions are subtracted from gross income to determine taxable income, the appropriate tax rate is applied to compute tax liability. Graduated tax rates apply, ranging from 10 percent to 35 percent for the 2009 tax year. The appropriate tax rate schedule depends on the taxpayer's filing status: married couples filing joint returns, heads of households, single persons, and married individuals filing separate returns.

Certain credits are allowed against the tax due, including the foreign tax credit, which is calculated subject to applicable limitations. Foreign tax in excess of applicable limitations may be carried back 1 year and forward 10 years. Other credits may also be available, including the child- and dependent-care credit, the child tax credit, and certain education credits. Income tax withheld from wages, interest, and dividends and any estimated tax payments are applied against the tax due.

An alternative minimum tax is imposed on individuals and corporations when their AMT liability exceeds their regular tax liability. The AMT is imposed on individuals at a rate of 26 percent of alternative minimum taxable income in excess of an exemption amount

determined by filing status.

The exemption is phased out for individuals with incomes above certain thresholds. The alternative minimum taxable income is the taxpayer's regular taxable income increased by certain "preference" amounts and disallowing certain deductions and credits. In general, the AMT applies a lower tax rate to a broader tax base than the regular tax.

Taxation of Foreign Individuals

A foreign citizen who is a U.S. resident for U.S. tax purposes is taxed by the United States in the same manner as a U.S. citizen, meaning worldwide income is subject to U.S. income tax. When computing taxable income, a U.S. resident is entitled to claim the same deductions and personal exemptions available to a U.S. citizen.

A foreign citizen who is a nonresident for U.S. tax purposes is taxed only on (1) FDAP income from U.S. sources, and (2) income effectively connected with a U.S. trade or business. Deductions and exemptions available to nonresidents are limited.

The general concepts of FDAP income, U.S. trade or business, effectively connected income, and the source of income rules (discussed earlier in this chapter) are fully applicable to nonresident individuals. In the case of individuals, income from personal services performed in the United States as an employee or independent contractor is treated as income effectively connected with a U.S. trade or business.

In addition to U.S. federal income tax, individuals may also be subject to state and local income taxes.

Qualification as a Resident Alien or Nonresident Alien

A foreign citizen is generally treated as a nonresident for U.S. tax purposes unless the individual qualifies as a resident. A resident is defined as an individual who is either a lawful permanent resident, or an individual who meets the substantial presence test.

A lawful permanent resident is an individual who has been granted the right to reside permanently in the United States. This permit often is called a

"green card." An individual who meets the substantial presence test is a person who has been in the United States for at least 31 days in the current calendar year and 183 days during the current and two preceding years, counting all the days of physical presence in the current year, one-third of the days in the first preceding year, and one-sixth of the days in the second preceding year.

An individual may be both a nonresident and a resident during the same tax year. This may occur in the year a foreign citizen arrives or departs from the United States. For an individual who meets only the green card test, residence begins on the first day of the calendar year in which the individual is physically present in the United States as a lawful permanent resident and will generally cease on the day this status officially ends.

Residence under the substantial presence test generally begins the first day during the year in which the individual is physically present in the United States. An individual generally will cease to be a resident during the part of the year following their last day of physical presence in the United States provided certain conditions are met. A period of up to 10 days of presence in the United States will not be counted for the purpose of determining an individual's residency start date; those days of presence will be counted, however, for the purpose of determining whether the 183-day component of the substantial presence test has been met. Treaty definitions of residency may override the U.S. statutory definition.

Filing Status

Generally, spouses must be citizens or residents of the United States at all times in the year before a joint return can be filed. However, in certain situations, a joint return may be permitted if this requirement is not met.

An election also is available for first-year residents, married or unmarried, to be treated as part-year residents if they do not otherwise qualify as residents. Certain U.S. presence tests must be met to qualify for this first-year election. Special rules apply to qualify for head-of-household status.

Taxable Income of Nonresidents

Segregated Income

A nonresident is generally subject to U.S. tax only on income from U.S. sources, with certain exceptions. This income is divided into two categories, each of which is taxed separately:

- Investment and other passive income that is not effectively connected with a U.S. trade or business. Such income is taxed at a flat 30 percent rate (or lower treaty rate) with no deductions allowed.
- Income that is effectively connected with a U.S. trade or business, including employment income. This income, less allowable deductions, is taxed at the regular graduated income tax rates that apply to U.S. citizens and residents.

As stated above, nonresidents generally are only entitled to deductions from income that is effectively connected with their U.S. trade or business. The standard deduction is not available to a nonresident individual. Subject to certain exceptions, nonresidents are generally allowed only one personal exemption.

Nonresidents employed by a foreign entity and working in the United States on short-term assignments are entitled to tax exemptions, subject to conditions. Income tax treaties provide more extensive exemptions than are otherwise available exemptions for employees on short-term assignments.

Nonresidents may elect to treat income derived from real property as effectively connected even though they are not otherwise engaged in a U.S. trade or business. This election permits real property income to be taxed on a net basis, rather than at the 30 percent flat rate otherwise applicable to rents and other fixed and determinable income from U.S. sources.

Nonresident's Capital Gains, Excluding Real Estate

Subject to limited exceptions, a nonresident individual generally does not have to pay taxes on capital gains arising from the sale or exchange of assets, provided those gains are neither from U.S. real property interests, nor otherwise effectively connected with a U.S. trade or business.

Payroll Taxes and Withholding Requirements

The federal government imposes payroll taxes, including Social Security taxes and unemployment insurance taxes. Employers are required to withhold from the salaries and wages of their employees amounts representing their income taxes and Social Security taxes.

Withholding at the source is required by payors of U.S. FDAP income to nonresident aliens at a flat 30 percent rate or lower treaty rate, when applicable.

State and local governments also require that income taxes be withheld from wages.

Estate and Gift Taxes

The United States has a gift and estate tax system that applies to taxable gifts of property made by an individual during life and taxable bequests made at death. The U.S. estate tax is being phased out between 2002 and 2009, and is scheduled to be fully repealed in 2010 before being reinstated at earlier rates. The gift tax will remain in effect after 2009, but with a reduced maximum tax rate.

One system of estate and gift taxation applies to U.S. citizens and foreign citizens domiciled in the United States. A separate system applies to foreign citizens who are not domiciled in the United States. (An individual is domiciled in the United States if he or she actually resides here and has the intention to remain in the United States indefinitely.) An individual domiciled in the United States may thus be either a resident alien or a nonresident alien for U.S. tax purposes.

Federal Excise Taxes

The federal government imposes excise taxes on the manufacture, sale, or use of numerous goods and services in the United States. The producer, seller, or importer of these products or services generally must collect and remit the applicable taxes to the federal government. These taxes include, among others, taxes on motor fuels, communications, air transportation, certain heavy trucks and tractors, tires, highway use, vaccines, foreign insurers, alcohol, tobacco, sporting goods, firearms, and ozone-depleting chemicals.





CHAPTER FIVE

Financial Reporting Requirements

Overview

The U.S. securities market comprises several thousand companies that are registered with the Securities and Exchange Commission and whose shares are publicly traded. The bedrock of the U.S. securities system is full disclosure in the form of accurate financial reporting of results and known risks to current and potential investors. The principal enforcer of securities regulations is the SEC, which was formed in 1934.

The history of investing in U.S. public companies is replete with economic booms and busts that are often followed by legislation designed to further protect the investing public. The boom in share prices of Internet companies in the late 1990s, for instance, was followed by a bust that resulted in an array of financial scandals involving improper financial accounting and outright fraud.

Sarbanes-Oxley Act of 2002

As a result of these scandals, the U.S. Congress passed the Sarbanes-Oxley Act of 2002, which includes wide-ranging legislation that established new or enhanced disclosure and ethical standards for U.S. public company boards and management, and created new regulations for public accounting firms. The Sarbanes-Oxley Act contains 11 titles, or sections, ranging from additional corporate board responsibilities to new criminal penalties, and requires the SEC to enforce the law.

Section 404 of the Sarbanes-Oxley Act requires a company's management and external auditor to report on the adequacy of the entity's internal control over financial reporting (ICOFR). This has tended to be the most costly aspect of the legislation for companies to implement because documenting and testing important financial controls requires significant effort. To reduce this burden for smaller companies, the U.S. Congress passed a law in July 2010 exempting "non-accelerated filers" from the requirement to have the external auditor report on the adequacy of the entity's internal control over financial reporting. However, the law does not eliminate the requirement for non-

accelerated filers to perform their own assessment of internal control over financial reporting. Non-accelerated filers are generally defined as issuers with an aggregate worldwide market value of less than \$75 million.

Management's assessment of internal controls and the external auditor's audit of the company's internal controls are both performed in the context of a top-down, risk-based approach that requires management to base both the scope of its assessment and the evidence gathered on the risk of material misstatement in the financial statements.

Requirements for Public Companies and Rules for U.S. Domestic Registrants Issuers

All companies that are registered with the SEC are legally required to disclose financial results on a periodic basis—usually quarterly and annually—in financial statements filed with the SEC. Public companies' year-end financial statements must be audited and quarterly financial statements must be reviewed by an independent registered public accounting firm. Private companies doing business in the United States are not subjected to the array of financial disclosures that govern their public counterparts. Foreign private issuers (see below) are also afforded more flexibility than domestic issuers.

Financial Statement Requirements

Public companies in the United States have the right to raise capital through public securities offerings. Public securities offerings are governed by strict financial disclosure requirements that are outlined in the following pages. Due to the complexity of compliance regulations and the complicated steps associated with these offerings, a foreign company seeking financing through the issuance of equity or debt is strongly urged to work with experienced advisers on how best to manage this task.

This section provides a high-level summary of the financial statement requirements in federal securities laws. It focuses on the requirements for public offerings, but also summarizes

customs in the Rule 144A market, as well as the special rules applicable to "foreign private issuers" (a term that covers most non-U.S. issuers other than foreign governments). To enhance the discussion, we have provided examples using actual dates. These dates are based on a company with a fiscal year ending December 31.

Public Offerings

Public securities offerings are registered with the SEC under the Securities Act of 1933, which requires filing a registration statement with the SEC and the distribution to potential investors of a prospectus in connection with the offering. The registration statement and prospectus must contain a basic package of financial statements and other financial information regarding the issuer's financial condition and fiscal results.

The 1933 Act and the related rules and regulations detail the disclosure requirements through the use of "forms" (particularly Forms S-1 and S-3). These forms, in turn, specify the items that must be disclosed under Regulation S-K and Regulation S-X. Regulation S-K largely deals with textual disclosures and S-X with financial statement disclosures.

The following table summarizes the scope of the basic financial statement requirements for all registered offerings. Note that much of this basic information can be incorporated by reference for issuers eligible to use Form S-3, and for certain issuers filing registration statements on Form S-1. Issuers who are eligible for incorporation by reference will want to consult their legal and investment advisers before electing to incorporate all required financial information by reference. For marketing purposes, companies often include the financial information directly in the printed offering document.

The Basic Requirements for All Public Offerings – U.S. Domestic Registrants

Annual Audited Financial Statement

- Balance Sheets:
 - Audited balance sheets as of the end of the two most recent fiscal years
 - If the issuer has been in existence less than one year, an audited balance sheet as of a date within 135 days of the date of filing the registration statement
- Income, Cash Flow, and Equity Statements:
 - Audited income statements, statements of cash flows, and stockholders' equity covering each of the three most recent fiscal years, or such shorter period as the issuer (and its predecessors) has been in existence
- Under certain circumstances, audited financial information may cover 9, 10, or 11 months rather than a full fiscal year for one of the required years.
- Audited financial statements for an issuer must be accompanied by an audit report issued by independent accountants that are registered with the Public Company Accounting Oversight Board.

Interim Unaudited Financial Statements

- Balance Sheet:
 - An interim, unaudited balance sheet as of the end of the most recent three-, six-, or nine-month period following the most recent audited balance sheet
- Income Statements:
 - Interim, unaudited statements of income and cash flows for any stub period covered by an interim balance sheet, together with statements of income and cash flows for the corresponding three-, six-, or nine-month stub period of the prior year

Selected Financial Information – S-K Item 301

- Selected income statement and balance sheet data for each of the last five fiscal years (or for the issuer and its predecessors, if shorter) and any interim period included in the financial statements (together with comparative information for the corresponding interim period of the prior year)
- The purpose of the selected financial data is to highlight certain significant trends in the registrant's financial condition and results of operations, and must include:
 - Net sales or operating revenues
 - Income (loss) from continuing operations
 - Income (loss) from continuing operations per common share
 - Total assets
 - Long-term obligations and redeemable preferred stock
 - Cash dividends declared per common share
- The selected financial data may also include additional items that would enhance an understanding of the issuer's financial condition and results of operations.

Acquired Company Financial Information and *Pro Forma* Financial Information – S-X Rule 3-05 and S-X Article 11

- Depending on the size of the acquisition and its significance to the issuer (which is measured in various ways, not all of them intuitive), registrants should present audited annual financial statements for the acquired company's most recent one, two, or three fiscal years, plus appropriate unaudited interim financial statements, under S-X Rule 3-05.
- Where acquired company financial statements are included in a registration statement (and in certain other instances), pro forma financial information under S-X Article 11

Ratio of Earnings to Fixed Charges for Debt – S-K Item 503(d)

- If debt securities are being registered, a ratio of earnings to fixed charges for each of the last five fiscal years and for the latest interim period presented
- For preferred securities, a ratio of combined fixed charges and preference dividends to earnings
- If the proceeds from the sale of debt or preferred equity will be used to repay outstanding debt or to retire other securities and the change in the ratio would be 10 percent greater, a pro forma ratio for the most recent fiscal year and the latest interim period presented

Supplementary Financial Information – S-K Item 302

- For issuers that have registered securities under Section 12(b) or 12(g) of the Securities Exchange Act of 1934—generally, equity securities listed on the NYSE or quoted on NASDAQ—certain additional selected financial data for each full quarter within the two most recent fiscal years and any subsequent interim period for which financial statements are included. This information is not required for IPO prospectuses.

Management's Discussion and Analysis

Registration statements must contain or incorporate by reference a "management's discussion and analysis" section (the MD&A). The purpose of the MD&A is to provide investors with the information necessary to understand an issuer's financial condition, changes in financial condition, and results of operations. It is the place where management interprets the financial statements for investors. A well-written MD&A will focus on trends and uncertainties in the marketplace and will identify the key drivers of the issuer's results. It will explain the issuer's business as management sees it, separately discussing each segment's performance if material to an understanding of the business as a whole. It also will identify and discuss the key metrics that management uses to evaluate the business's performance and financial health. Many MD&A sections include a general discussion of the issuer's future prospects under a subheading such as "outlook," and some issuers even go so far as to give specific earnings guidance for the following quarter or the current or following fiscal year.

In recent years, the SEC has expanded the line-item disclosure requirements for the MD&A, adding specific requirements for off-balance sheet arrangements, long-term contractual obligations, certain derivatives contracts, and related-party transactions as well as critical accounting policies. Drafting the MD&A section of the disclosure can be time consuming and requires close coordination among the issuer's financial team, its independent auditors, and its counsel. For the SEC's most sweeping explanation of the purpose of MD&A disclosure, see the guidance release that became effective on December 29, 2003 at the SEC website: http://www.sec.gov/about/offices/oia/oia_corpfin/genprinc.pdf.

Internal Control over Financial Reporting

An IPO will involve close scrutiny of a company's internal control over financial reporting. Once a company's initial registration statement is effective, Section 404 requires an annual, formal

assessment by management of the issuer's internal control over financial reporting, as well as an attestation report by the issuer's independent auditors if the issuer's market value exceeds \$75 million. Compliance with Section 404 can be a major undertaking for a newly public company, although the SEC has adopted rules that let an IPO issuer wait until its second annual report to provide management's assessment and an auditor's attestation.

Domestic issuers that are large accelerated filers and accelerated filers (see definitions below) currently are required to include management's assessment of internal control over financial reporting and the independent auditor's attestation report in annual reports filed on Form 10-K. If an entire annual report is incorporated by reference into a registration statement (as is the case with a registration statement on Form S-3), the Section 404 reports and disclosures also will be part of the registration statement.

When Does Financial Information Go "Stale"?

Understanding the timing requirements for the provision of financial statements is as critical as understanding the scope of the financial information required. The determination of when financial statements go "stale" is always a consideration, and planning to have the necessary financial information prepared on time is an essential part of the offering process.

The staleness rules vary for different categories of issuers. In particular, the rules distinguish between large accelerated filers, accelerated filers, IPO issuers, loss corporations, and delinquent filers. For these purposes:

A large accelerated filer is an issuer (other than a small business issuer) that has:

- An aggregate worldwide market value of the voting and nonvoting common equity held by its nonaffiliates of \$700 million or more, as of the last business day of its most recently completed second fiscal quarter
- Been subject to the requirements of Section 13(a) or 15(d) of the 1934 Act

for a period of at least 12 calendar months

- Filed at least one annual report with the SEC pursuant to Section 13(a) or 15(d) of the 1934 Act.

An accelerated filer is an issuer meeting the same conditions, except that it has an aggregate worldwide market value of the voting and nonvoting common equity held by its nonaffiliates of \$75 million or more, but less than \$700 million, as of the last business day of its most recently completed second fiscal quarter.

An IPO issuer is a company that was not subject to the SEC's reporting requirements prior to filing the registration statement (a first-time filer or a voluntary filer).

A loss corporation is a company that does not expect to report positive income after taxes for the most recently ended fiscal year and for at least one of the two prior fiscal years.

A delinquent filer is a company that is subject to the SEC's reporting requirements, but has not filed all reports that are due.

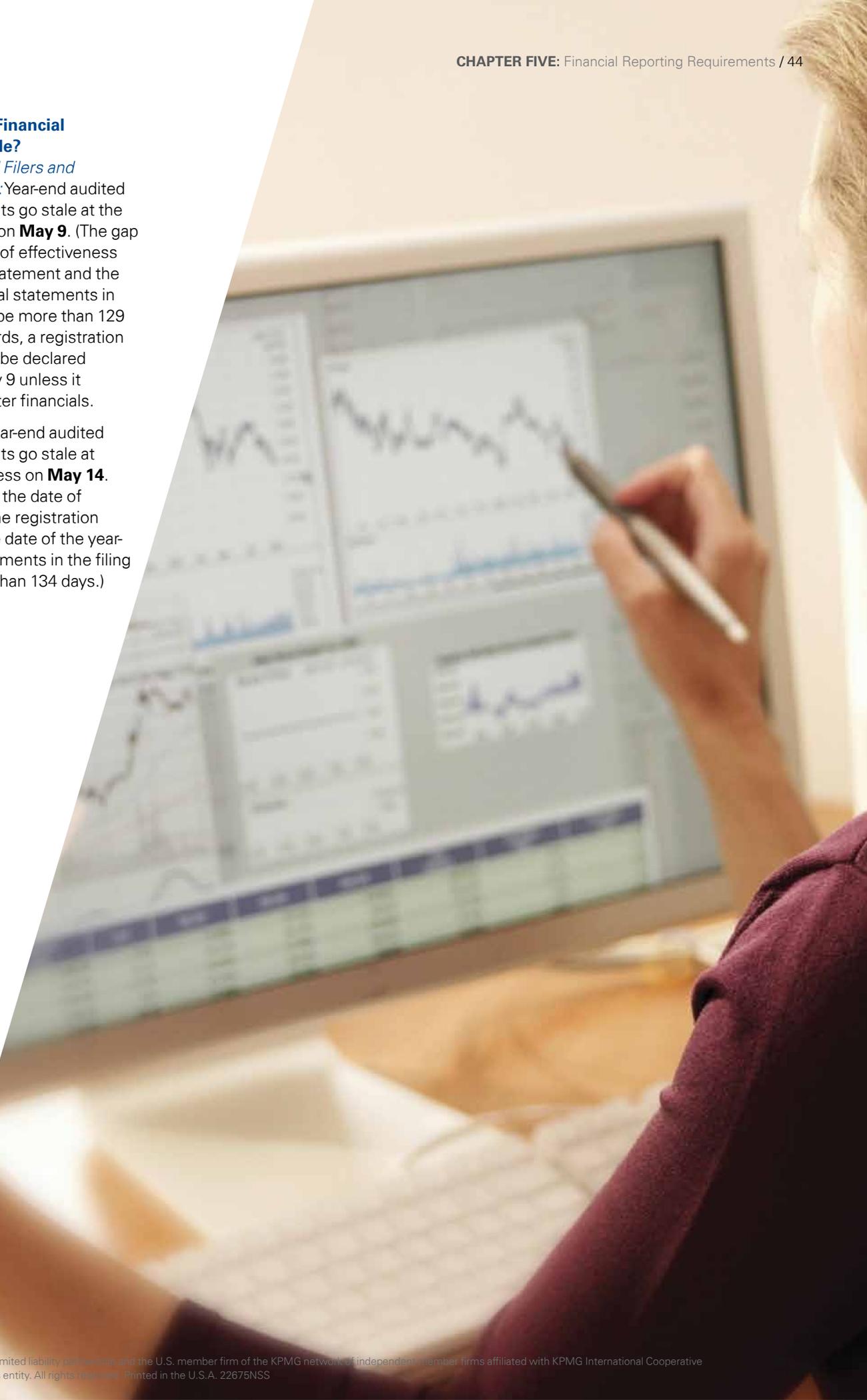
Staleness of Financial Statements

The staleness of financial statements is measured by the number of days between the date of effectiveness of the registration statement (or, by analogy, the pricing date of a Rule 144A offering if the underwriters desire to mirror SEC requirements) and the date of the financial statements in the filing, as summarized below. For any of the time frames noted below, if the last day before the financials go stale is a Saturday, Sunday, or U.S. federal government holiday, Rule 417 under the 1933 Act allows the filing to be made on the next business day, effectively postponing the staleness date.

The staleness of financial statements also dictates the information required in a registration statement's initial filing. The SEC will not review a filing with financial statements that fail to comply with the staleness rules on the filing date.

When Do Year-End Financial Statements Go Stale?

- *Large Accelerated Filers and Accelerated Filers:* Year-end audited financial statements go stale at the close of business on **May 9**. (The gap between the date of effectiveness of a registration statement and the date of the financial statements in the filing may not be more than 129 days.) In other words, a registration statement cannot be declared effective after May 9 unless it includes first quarter financials.
- *All Other Filers:* Year-end audited financial statements go stale at the close of business on **May 14**. (The gap between the date of effectiveness of the registration statement and the date of the year-end financial statements in the filing may not be more than 134 days.)



The staleness rules can be difficult to follow. Below is a summary of the staleness rules, presented in the form of a time line.

When do financial statements go stale? At the close of business on the following dates (for issuers with a fiscal year ended December 31)

Feb 14	Mar 1	Mar 16	Mar 31	May 9	May 14	Aug 7	Aug 12	Nov 6	Nov 11
Third-quarter financial statements of IPO issuers, loss corporations, and delinquent filers	Third-quarter financial statements of large accelerated filers	Third-quarter financial statements of accelerated filers	Third-quarter financial statements of all other filers	Year-end financial statements of large accelerated filers and accelerated filers	Year-end financial statements of all other filers	First-quarter financial statements of large accelerated filers and accelerated filers	First-quarter financial statements of all other filers	Second-quarter financial statements of large accelerated filers and accelerated filers	Second-quarter financial statements of all other filers

Note that the most recent interim financial information filed with the SEC must always be included in a registration statement.

Additional Financial Information That Is Typically Included

In addition to the formal requirements of Regulation S-K and Regulation S-X, it is customary to include certain other information in the offering document that may be material or convenient for investors in considering the financial condition of the issuer. The three most common examples are described below.

Other Financial Data and Non-GAAP Financial Measures

A page of summary financial data is routinely included in the offering document's "summary box." Although there are no specific requirements for this key marketing page, it usually contains an income statement, a balance sheet, and other financial data for the last three to five fiscal years. It usually also includes the results from the most recent interim period and the comparable interim period of the prior year. These disclosures are similar to the ones required on the "selected financial data" page that appears later in the disclosure document. Where appropriate from a disclosure or marketing perspective, additional operational metrics are also included in the summary under a heading such as "other financial data." These metrics will vary with the type of issuer and will be selected based on the criteria that management and the investment community monitor to evaluate performance or liquidity.

Typical examples include comparable store sales data for a retailer, capital expenditures for a manufacturer, and subscriber numbers for a cable television company. If non-GAAP financial measures are included in the summary (such as Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) or adjusted EBITDA), this is where they usually appear.

Recent Financial Results

If a significant amount of time has passed since the most recent financial statements included in the offering document, it may be appropriate to include a review of the quarter in progress (or recently ended) in the "summary box" before full financial statements for that quarter are required. Examples of "recent results" disclosures are most common after a quarter is completed but before financial statements for that quarter have become available. The issuer and the underwriters will want to tell the market as soon as possible about any positive improvement in operating trends at the conclusion of a good quarter.

If the recent results are negative, recent results disclosure may be advisable to avoid any negative surprises for investors when the full quarterly numbers become available. For example, the issuer may be aware that its sales are trending down in the current quarter, or that significant charges will be taken in connection with an acquisition after it closes. Even if Wall Street analysts may be anticipating such an event, it is preferable to disclose this information in the offering document itself. At the "road show" meetings,

prospective investors may ask about the results for the most recent (or almost) completed quarter. Presenting information in the offering document will facilitate a discussion of these results.

Recent Developments

The likely consequences of recent material developments also may be disclosed in the "summary box" or the MD&A section. For example, it is customary to discuss a material recent or proposed acquisition, whether or not audited financials of the acquired or to-be-acquired business are required to be presented. This practice will often result in a "recent developments" paragraph in the summary or MD&A and a discussion of the transaction's impact on items such as margins and debt levels. The disclosure also may include a discussion of any special charges or anticipated synergies expected to result from the pending event or acquisition.

Rules for Foreign Private Issuers

What Is a "Foreign Private Issuer"?

A "foreign private issuer" is an issuer (other than a foreign government) incorporated or organized under the laws of a jurisdiction outside the United States, unless more than 50 percent of its outstanding voting securities are directly or indirectly owned of record by U.S. residents, and any of the following applies:

- The majority of its executive officers or directors are U.S. citizens or residents
- More than 50 percent of its assets are located in the United States

- Its business is administered principally in the United States

Key Ways in Which Foreign Private Issuers Are Treated Differently than Domestic U.S. Issuers

Under U.S. federal securities laws and the rules and practice of the SEC, foreign private issuers are not regulated in precisely the same way as domestic U.S. issuers. In particular, foreign private issuers are allowed a number of key benefits not available to domestic U.S. issuers, covered in the following sections.

SEC Staff Policy on Confidential Submission

Foreign private issuers that are registering for the first time with the SEC generally may submit registration statements on a confidential basis to the SEC staff. By contrast, domestic U.S. companies must file their registration statements publicly. Confidential submission can be a significant advantage because the procedure

allows the complicated issues often encountered in an initial SEC review to be resolved behind closed doors. A foreign private issuer still must file its registration statement publicly prior to going on a road show or selling its securities. It also will have to file any future registration statements publicly.

Foreign Private Issuers May Use IFRS or Local GAAP, but Must Reconcile to U.S. GAAP

U.S. domestic companies must prepare U.S. GAAP financial statements. The financial statements of foreign private issuers, however, may be prepared using U.S. GAAP, IFRS, or their local GAAP. If local GAAP is used, the consolidated financial statements (both annual and interim) must include footnote reconciliation to U.S. GAAP.

The SEC currently allows foreign private issuers to file financial statements using IFRS, as issued by the IASB without a reconciliation to U.S. GAAP. In these situations, the financial statements must

contain an explicit, unqualified statement of compliance with that version of IFRS, and the auditor's report must refer to IASB-issued IFRS. An entity could satisfy this requirement by asserting that the financial statements comply with both IASB-issued IFRS and a jurisdictional version of IFRS (e.g., IFRS as adopted by Australia). The elimination of the U.S. GAAP reconciliation requirement for foreign private issuers using IFRS does not change the applicability of other filing requirements—for example, the requirement that the financial statements be audited in accordance with PCAOB standards.

Most listed European issuers are required by their local regulations to use IFRS for their primary consolidated financial statements. By contrast, Chinese and Indian issuers typically compile their primary financial statements under U.S. GAAP.



Foreign Private Issuers Are Not Required to Report Quarterly

Unlike domestic U.S. issuers who must file quarterly reports, foreign private issuers are not required to file quarterly statements with the SEC if their home country reporting requirements do not call for quarterly reports. Still, many foreign private issuers choose to report quarterly for marketing reasons. The SEC's rules also permit a foreign private issuer's registration statement to contain financial information that is more "stale" than allowed for domestic U.S. issuers. In particular, there is no requirement for interim unaudited financial statements if the registration statement becomes effective less than nine months after the end of the last audited financial year, unless the issuer has already published more current interim financial information. After that time, a foreign private issuer must provide interim unaudited consolidated financial statements (reconciled to, or prepared in accordance with, U.S. GAAP, if applicable) covering at least the first six months of the fiscal year.

Foreign Private Issuers May Report in Any Currency

Foreign private issuers may present their financial statements in any currency they deem appropriate, but only one currency may be used. If the reporting currency is not the U.S. dollar, then U.S. dollar-equivalent financial statements (or convenience translations) may be included, but only for the most recent financial year and interim periods.

Financial Statements of an Acquired Foreign Business

When a "foreign business" is acquired, financial statements of the business may be required under S-X Rule 3-05, depending on the significance of the acquisition. Financial statements of foreign private issuers must normally be presented in U.S. GAAP or IFRS as issued by the IASB, or reconciled to U.S. GAAP if local GAAP is used. However, S-X Rule 3-05(c) effectively allows the inclusion of local GAAP financials without quantitative reconciliation when the acquired business is below the 30 percent level

for all of the significance tests on a U.S. GAAP or IFRS basis, depending on the basis used by the issuer.

Financial Statements of a Foreign Equity Investment

For significant investments that are accounted for under the equity method, the financial statements of equity investees that are prepared under local GAAP (that is, they are not prepared under U.S. GAAP or IFRS as issued by the IASB) do not have to be reconciled to U.S. GAAP unless either the income test or the investment test (see Regulation S-X Rule 1-02 (w)) criteria is greater than 30 percent (calculated on a U.S. GAAP or IFRS basis depending on the basis used by the issuer). A description of the differences in accounting methods is required, however, regardless of the significance levels.

Rule 144A Transactions

Rule 144 allows the public resale of restricted and control securities if a number of conditions are met. "Restricted securities" are securities acquired in unregistered, private sales from the issuer or from an affiliate of the issuer. Investors typically receive restricted securities through private placement offerings, Regulation D offerings, employee stock benefit plans, as compensation for professional services, or in exchange for providing "seed money" or start-up capital to the company. Rule 144(a) (3) identifies what sales produce restricted securities. "Control securities" are those held by an affiliate of the issuing company. An affiliate is a person such as a director or large shareholder having a relationship of control with the issuer. Control means the power to direct the management and policies of the company in question, whether through the ownership of voting securities, by contract, or through other means. If you buy securities from a controlling person or affiliate, you take restricted securities, even if they were not restricted when owned by the affiliate.

The disclosure document in a Rule 144A offering typically is modeled after the public offering prospectus. This holds

true for financial statements as well. While the line item disclosure rules of the 1933 Act do not strictly apply to private offerings under Rule 144A, it has become standard practice to follow these rules as if they applied to Rule 144A offerings, with only limited exceptions. In many situations, lenders and other financing sources will insist on including financial disclosure in the Rule 144A offering circular that is in all material respects consistent with the financial statement requirements that would apply to a registration statement filed with the SEC. Rule 144A offerings typically are sold off the desk to buyers who expect substantially the same level of disclosure that they would receive in a public deal. Additionally, since the Rule 144A offering circular is likely to be followed in a matter of weeks by a registered exchange offer prospectus (at least in Rule 144A offerings with registration rights) and the buyers of the offered securities will thereby receive full 1933 Act disclosure shortly after the closing, most practitioners elect whenever possible to provide substantially equivalent disclosure to prospective purchasers before the closing as well. Therefore, Rule 144A offering circulars typically follow the public offering rules described above.

It is not uncommon for a group working on a Rule 144A deal to decide to dispense with a particular financial statement requirement if the team determines that that particular item will not materially alter the total mix of information provided, or if there is another way to disclose the item that the S-X requirement is targeting. After all, Rule 144A(d)(4)'s information requirement is very modest and calls only for the issuer's most recent balance sheet and profit and loss and retained earnings statements, and similar financial statements for such part of the two preceding fiscal years as the issuer has been in operation (the financial statements should be audited to the extent reasonably available).

A more flexible approach can also be justified by the fact that the negligence-based liability standards of Sections

11 and 12 of the 1933 Act do not apply to Rule 144A deals. Notably, this makes it more difficult for disgruntled purchasers to sue an issuer because it requires the purchaser to file suit under Section 10(b) of the 1934 Act (the well-known Rule 10b-5 claim for securities fraud) and prove that the issuer made fraudulent representations or omissions in connection with the offering. Rule 10b-5 does apply to Rule 144A offerings, but it is more difficult for disgruntled purchasers to demonstrate the requisite “scienter” (or full knowledge and awareness) required to establish a valid 10b-5 claim. As a result, it is common to provide only two years of audited financial statements in a Rule 144A transaction where a registration statement would require including three years. This is true for the issuer and for material acquired businesses. This decision has been taken in a number of deals, particularly where the issuer is already in its third or fourth fiscal quarter, because the third year of audits will likely be completed in the natural course of business before the exchange offer registration statement is required to be filed. Other working groups have elected to exclude some of the finer elements of the financial information requirements when they have determined that such additional information would not materially alter the total mix of information presented. Examples include some of the details of the required guarantor footnotes, the separate financial statements of subsidiaries in secured deals, and some details of executive compensation. Although the industry custom is to follow the public offering rules as if they applied to a 144A offering, there is no requirement in Rule 144A to do so, and some working groups will conclude that every detail of the information called for in a registration statement is not required to provide 144A investors with full and fair disclosure.

As the full impact of Sarbanes-Oxley has made itself felt upon the private equity community and smaller public companies (for whom the additional administrative expenses may be material), there has

been an increase in “144A-for-life” debt financings. These transactions are identical to regular Rule 144A offerings, except that they do not offer bond investors any registration rights and they do not require the bond issuers to become or remain voluntary filers of 1934 Act reports. Because these offerings will not be followed within a few weeks by a registered exchange offer prospectus that is fully compliant with S-X, some management teams are concluding that “144A-for-life” disclosure documents can more freely dispense with non-core S-X requirements than would be the case in a Rule 144A offering with registration rights. There is no clear consensus among practitioners at this time as to whether, or to what extent, such additional flexibility is appropriate.

Audit Requirements

An audit of the financial statements is performed before the financial statements are released (typically on an annual basis), and typically is commenced before the year-end (the date to which the financial statements relate) and completed after the year-end.

The following are the stages of a typical audit:

Planning and Risk Assessment

Timing: Typically commenced before year-end, but continues throughout the audit

Purpose: Planning involves developing an overall audit strategy for the expected conduct and scope of the audit. The objectives of planning are to:

- Obtain an understanding of the company’s business, its industry, accounting policies, and financial performance
- Understand and evaluate the design and implementation of entity-level controls relevant to the audit
- Assess risks of material misstatement of the financial statements, including fraud risks
- Develop an audit strategy in response to those risks

- Develop a planned audit approach for significant accounts and disclosures

Control Evaluation

Timing: Before and/or after year-end

Purpose: In control evaluation, the auditor obtains an understanding of the client’s accounting activities and evaluates its controls in order to assess the risk of significant misstatement for each audit objective, and plans the substantive audit work. The extent of control evaluation and testing varies significantly depending on the control environment.

Substantive Procedures

Timing: Primarily after year-end (see note regarding hard and fast closes below)

Purpose: In substantive testing, the auditor performs substantive audit procedures to respond to the risk of significant misstatements relevant to components of the financial statements.

Notes: Some audits involve a “hard close” or “fast close” where certain substantive procedures can be performed before year-end. For example, if the year-end is December 31, the hard close may provide the auditors with figures as of November 30. The auditors would audit income and expense movements between January 1 and November 30, so that after year-end, it is only necessary for them to perform audit procedures on the December income and expense movements and the December 31 balance sheet. In some countries and accounting firms, these are known as “roll-forward” procedures.

Completion

Timing: At the end of the audit

Purpose: During completion, the auditor evaluates the overall results of audit procedures performed and the audit findings and formulates and issues an audit opinion on the financial statements taken as a whole.

CHAPTER SIX

Labor

Overview

The U.S. Department of Labor (DOL) oversees working conditions, retirement and healthcare benefits, collective bargaining, unemployment insurance, workplace safety, wage and hour regulations, and collection of economic statistics. DOL programs are administered by component agencies and offices, including regional offices network; field, district, and area offices; and grantees and contractors.

Executive Compensation

U.S. companies use five basic means to compensate executives: base salary, short-term and long-term incentives, retirement and deferred compensation plans, employee benefits, and perquisites. In a typical U.S. corporation, the chief executive officer and other top executives are paid salary plus short-term incentives or bonuses that may be in the form of restricted stock, options, or other incentive compensation. Short-term incentives usually are formula driven and have some performance criteria attached reflecting the role of the executive. Bonuses are after-the-fact and may be discretionary. Executives also may be compensated with a mixture of cash and shares. Such shares are almost always subject to vesting restrictions (including substantial risks of forfeiture, generally based on continued service with the company or its performance). A long-term incentive plan generally runs for three to five years, although some pay at separation from service or retirement. Vesting can be based on length of service, performance, or both.

Minimum Wage

Most employers are subject to the minimum wage provisions of the federal Fair Labor Standards Act (FLSA). Federal minimum wage as of 2010 is \$7.25 per hour and is mandatory for all employees covered by the FLSA. The FLSA also requires covered employees to be paid overtime pay at the rate of not less than one and one-half times the regular rate for each hour in excess of 40 hours in a week. Management and executive personnel generally are excluded from the overtime and minimum wage provisions. Several states have minimum wage requirements that may require a

higher wage be paid in some situations. Exemption to the minimum wage requirement is available in certain cases.

Occupational Safety and Health

The Occupational Safety and Health Act (OSHA) of 1970 addresses workplace safety and health threats, such as toxic chemical exposure, excessive noise levels, mechanical dangers, heat or cold stress, and unsanitary conditions. The act also provides for workplace safety research, information, education, and training. The Occupational Safety and Health Administration issues and enforces standards to prevent work-related injuries, illnesses, and deaths.

Unions

Labor unions in the United States function as legally recognized representatives of workers in numerous industries. Their chief activities include collective bargaining over wages, benefits, and membership's working conditions, and on representing members if management attempts to violate contract provisions. American unions also can be an important political force, both through membership mobilization and coalitions with other organizations around issues such as immigrant rights, trade policy, healthcare, and living wage campaigns.

Totalization Agreements

According to the U.S. Social Security Administration, the United States has entered into international social security agreements often referred to as "totalization agreements," with Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, Norway, Poland, Portugal, South Korea, Spain, Sweden, Switzerland, and the United Kingdom. The agreements provide relief from double social security tax. Thus, only one country, not both, will impose its social security tax, eliminating double social security taxation where an individual would otherwise be subject to tax under both systems. The agreements also provide for totalized benefits where coverage under both systems is combined so that an individual can qualify for benefits

under one or both systems. Under U.S. law, an alien may not elect totalized U.S. benefits unless the alien has six quarters of actual coverage under the U.S. Social Security system. U.S. totalization agreements do not apply to Medicare benefits, and U.S. citizens or residents are prohibited from taking a credit or deduction for foreign social security taxes paid that are the subject of a totalization agreement.

Equal Opportunity

U.S. law prohibits discrimination on the basis of race, color, sex, religion, or national origin. Additionally, sexual harassment in the workplace is considered discriminatory and is, therefore, illegal. Specific legislation prohibits discrimination against workers between the ages of 40 and 70. Also, equal pay must be provided to workers performing identical jobs regardless of sex.

The Labor Department oversees equal employment opportunity laws for federal government employees. The Equal Employment Opportunity Commission is an independent federal agency that oversees professional equality in private employers. Foreign businesses should be aware of several acts of legislation that cover equal opportunity among U.S. workers.

- Title VII of the Civil Rights Act prohibits employment discrimination based on race, color, religion, sex, or national origin.
- The Equal Pay Act prohibits sex-based wage discrimination for equal work.
- Additional legislation prohibits discrimination based on disabilities or age (for those between 40 and 70 years of age), and defines sexual harassment as discrimination.

Termination

The FLSA has no requirements for notice to an employee prior to termination or layoff. In certain cases, employers must give the workers advanced notice of mass layoffs or plant closure. For instance, The Worker Adjustment and Retraining Notification Act (WARN) provides specific information on advance notice, employer responsibility,

and workers' rights during mass layoffs or plant closure. In addition, some states may have requirements for employee notification prior to termination or layoff.

Employee Benefits

Unemployment Compensation

Workers who lose their jobs often are eligible for benefits under a program financed by separate federal and state payroll taxes. Generally, employees must lose their jobs through no fault of their own and must have worked a minimum number of weeks or earned a minimum amount of wages, set by each state, before benefits are granted. Weekly unemployment benefits are usually a percentage of lost wages, up to a limit set by the state, and generally are paid for a 26-week period. Additional

weeks of benefits are paid by the federal government in states with high unemployment rates.

The federal unemployment tax is applied to pay the administrative costs of the states. The tax, paid by employers, is 6.2 percent of the first \$7,000 of an employee's wages but may be offset by state payments. The state tax is used to pay for benefits, and the rate is set by each state. Employers may credit up to 5.4 percent of the state payments against federal unemployment tax liability.

Unemployment Insurance

Unemployment insurance (UI) programs provide unemployment benefits to eligible workers who become

unemployed through no fault of their own and meet eligibility requirements determined on a state-by-state basis.

Eligible workers receive benefits from various programs within the UI umbrella, including:

- Federal-State UI
- Disaster unemployment assistance
- Federal employee unemployment compensation (UC)
- Ex-service member UC
- Trade readjustment allowances

Immigration

The U.S. Citizenship and Immigration Services mandates that employees in the United States who are not citizens or



lawful permanent residents (green card holders), and who do not hold a visa that authorizes them to work in the United States must apply for an Employment Authorization Document (EAD). EADs are issued in a number of categories, including renewal, replacement, and interim. The Office of Business Liaison educates the U.S. business community on employment, business, investment, training, and employer education-related immigration issues.

Social Security

Social Security benefits are paid to a worker or the worker's family upon his or her retirement, disability, or death if the worker has insured status under the Social Security Act. The benefits are funded by taxes levied on employers, employees, and the self-employed. A reduced benefit will be paid to an individual who retires before the Social Security Administration's designated retirement age. According to the U.S. Social Security Administration, the retirement age increases incrementally from age 65 to 67 based on year of birth. Benefits also are available to dependents of retired or disabled workers based on a certain percentage of the worker's benefit. For example, a worker's spouse can receive a benefit equal to half that of the worker's while the worker is still alive and may receive full benefits upon the worker's death if the spouse is of full retirement age. Benefits are also available to dependents or surviving children.

No citizenship or residency requirements are generally imposed for an individual to receive Social Security retirement, survivor, or dependency benefits. However, benefits paid to an alien as a dependent or survivor of a covered employee will be suspended when the alien has been outside the United States for six consecutive months, except where the relationship upon which the benefit is based lasted at least five years.

Medicare Benefits

Medicare benefits include hospital, medical, and drug insurance. Generally, individuals who are age 65 and over and who are entitled to monthly Social Security retirement benefits are entitled

to hospital insurance benefits. These benefits are generally available to resident citizens (and certain aliens) age 65 or over even if they are ineligible for Social Security benefits. Generally, the federal government pays 80 percent of the cost of covered services (including doctors' services, diagnostic tests, and other medical services). An annual deductible fee is imposed on patients, and patients generally pay the remaining 20 percent of the cost of the services. A monthly premium also is charged for medical insurance.

Imposition of Tax

FICA

The Social Security tax is imposed on employers and employees under the Federal Insurance Contributions Act (FICA) and is imposed on self-employed individuals under the Self-Employment Contribution Act (SECA). The FICA tax is based on wages with respect to employment, generally including all remuneration for employment. Remuneration in excess of an annually adjusted FICA cap (\$106,800 for 2010) and certain non-cash and indirect payments are excluded from the definition of FICA wages. The FICA tax is imposed at the same rate (6.2 percent for 2010) on both the employee and the employer, up to the FICA cap. The employer is required to collect the employee's portion of the tax by means of a payroll deduction and to remit this amount along with the employer's portion of the tax to the government.

Medicare

There is also a hospital insurance tax of 1.45 percent of Medicare wages imposed at the same rate on both the employer and the employee. Medicare does not have a cap and applies to almost all wages. The employer collects Medicare in the same way that FICA is collected and paid. However, this tax will increase by 0.9 percent starting in 2013 for employees with income above \$200,000 (\$250,000 for married couples filing jointly).

Health Benefits

Starting in 2014, employers with more than 50 employees will be required to provide full-time employees with health benefits. Failure to do so and pay at least

60 percent of the premium costs will be subject to a per-person penalty.

SECA

The self-employment tax is imposed on the income of self-employed individuals if such earnings exceed \$400 for the taxable year. Earnings subject to the tax are limited by the same annual earnings ceiling that limits the FICA tax. The self-employment tax is not imposed on nonresident aliens. This tax is paid as an addition to the income tax. Net earnings from self-employment include gross income derived from a trade or business, less trade or business expenses (excluding the net operating loss deduction), plus the individual's distributive share of income or loss from a business carried on as a partnership. Certain items are specifically excluded from self-employment income: interest, dividends, capital gains, and rentals (and associated deductions) from real property and personal property leased unless they are received by the individual in the course of his or her business as a real estate dealer. The general rate of self-employment tax for the 2009 tax year is 15.3 percent up to the federal FICA cap amount (\$106,800). The rate consists of two parts: 12.4 percent for Social Security and 2.9 percent for Medicare. The Social Security portion of the self-employment tax applies only to the initial \$106,800 of income for the 2009 tax year. There is no limit to the amount that is taxable under the 2.9 percent Medicare portion of the self-employment tax, according to the U.S. Social Security Administration. Self-employed individuals can claim an income tax deduction for 50 percent of the actual self-employment tax incurred. Social Security totalization agreements have been concluded with some foreign countries, which may reduce or eliminate the U.S. self-employment tax. Self-employment tax is computed on Schedule SE of Form 1040 and paid along with any income tax due on Form 1040. It may not be reduced by the foreign tax credit.

CHAPTER SEVEN

Banking

Overview

The U.S. banking sector is a competitive industry that provides retail and commercial financial services to individuals, small and medium-sized enterprises, and large corporations. Banks are a subset of the overall U.S. financial services industry, which includes non-bank financial services providers such as investment banking firms, insurance companies, private equity firms, specialty leasing and finance companies, real estate firms, and mutual funds.

In the United States, the legal definition of a “bank” is important because banks are chartered by the federal and state governments, and only banks can accept demand deposits. As a result, these banks are subject to extensive regulations and oversight by various regulators. The type of charter a bank has determines the nature of the activities, products, and services it can offer customers.

Bank customers tend not to distinguish between banks by charter type. Instead, they evaluate banks based on their brand name, size, products, and service offerings. The largest banks are money center banks and other large full-services banks (Citigroup, JP Morgan Chase, Bank of America, Wells Fargo). Most U.S. banks are small to medium-sized institutions that operate primarily in their local community or region.

Significant changes in the financial services industry over the past decade have let banks increase the number of services they offer while the number of banks has decreased. The factors causing these changes include consolidation, deregulation, globalization, and increased competition from nonbank financial services companies. Specifically, the 1999 Gramm-Leach-Bliley Act allowed banking, investment banking, and insurance underwriting to be provided by a single financial services company.

More recently, the banking industry has experienced significant turmoil that has continued to change the banking landscape. In response to the events of the past few years, in July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) was signed into law, setting the stage for a

restructuring of the supervision of the financial services industry. Highlights of the Dodd-Frank Act that will impact the banking industry include:

- Increasing the supervisory role of the Federal Reserve Board (the Fed) to include all companies that own an insured depository institution, as well as all large, nonbank financial firms that could threaten the financial system whether or not they own an insured depository institution
- Creating a process to liquidate failed financial firms in an orderly manner and placing limitations on the federal government’s authority to support large individual firms
- Creating an independent Bureau of Consumer Financial Protection to oversee consumer regulations
- Implementing comprehensive regulation of all over-the-counter derivatives
- Limiting the extent of bank proprietary trading and investments in hedge funds and private equity funds (commonly referred to as the Volcker Rule) and limiting bank swaps activities (known as the “Lincoln Amendment”)

The new law requires more than 60 studies to be conducted and for more than 200 regulations to be written. Until these are complete, the full impact of Dodd-Frank will not be known.

Examples of services typically provided by full-service banks include checking and savings accounts, cash management, letters of credit, business loans, credit and debit cards, foreign exchange, interest rate derivatives, insurance, leasing, brokerage, investment banking, mutual funds, real estate services, trade finance for international transactions, asset-based lending/leasing, and trust services. Many large banks also have a specialized small business advisory group that assists companies in managing their business.

The U.S. Banking System at a Glance

Unlike banks in many countries, U.S. banks are not intended to be government owned and managed. They provide deposit facilities for the general

public, provide loans for businesses and individuals, and perform various financial services. The only major government banks that actively participate in the banking system are the 12 Federal Reserve banks, which function as a central bank and whose policies are set by the Board of Governors of the Federal Reserve System.

The U.S. banking system can be classified into two broad groups: commercial banks and thrift institutions. Commercial banks are oriented primarily to commercial activity with corporate customers, although they do provide services to individuals. Thrift institutions traditionally have had the primary function of encouraging personal savings and home buying through mortgage lending, though their activities have expanded beyond this.

Commercial Banks

Commercial banking in the United States operates under a dual regulatory system. A commercial bank can be either federally chartered by the Comptroller of the Currency as a national bank or chartered by the state in which it will operate as a state bank. In either case, the bank is owned by its shareholders. Examples of large commercial banks include Citigroup, Bank of America, and J.P. Morgan Chase and Co. National banks must be members of the Federal Reserve System.

State banks are regulated by state authorities. They may elect, but are not required, to join the Federal Reserve System. National banks must have their deposits insured by the Bank Insurance Fund (BIF), which is managed by the Federal Deposit Insurance Corporation (FDIC). State banks may have their deposits insured by the state or by the BIF. Certain capital requirements are imposed.

All depository institutions, including national banks, must maintain a reserve of a certain percentage of deposits, set by the Federal Reserve, with the Federal Reserve Bank of their district. Restrictions on the maximum rate of interest commercial banks can pay have been removed.

To attract corporations as their main customers, commercial banks generally

specialize in accepting corporate demand and time deposits and making commercial loans. They also attract retail banking business by accepting savings and demand deposits and making consumer, mortgage, and small-business loans. Commercial banks often have departments that make international loans and deal in letters of credit and collections. Large commercial banks are likely to be dealers in foreign exchange and may provide trust services.

Bank Holding Companies

Because the activities in which banks may engage are limited by law, bank holding companies are formed. These holding companies own stock of one or more banks and also own stock in other subsidiaries that perform activities closely related to banking as permitted by the Federal Reserve Board, such as leasing, credit card operations, mortgage lending, securities underwriting and dealing, and bookkeeping services. The holding company generally does not engage in any independent operations, except perhaps to serve as a funding vehicle for all companies in the group.

Edge Act Corporations

Edge Act corporations are chartered by the Federal Reserve with the purpose of stimulating and aiding the financing of foreign commerce of the United States. They are authorized to perform many international banking services, but only outside of the United States. They may also invest in foreign corporations. Other U.S. banks may invest in Edge Act corporations. Loans and deposits must be directly related to international trade.

Thrift Institutions

Thrift institutions, traditionally oriented to the local community and individual consumers, take a wide variety of forms such as mutual savings banks and savings and loan associations. The distinctions between them are increasingly more of historical significance than of practical effect. Thrifts may be owned either by shareholders or by their depositors. They can be chartered by a state or by the federal Office of Thrift Supervision. Note that with the passage of the Dodd-Frank Act in July 2010, the Office

of Thrift Supervision was abolished, with all supervisory and rule-making authority over thrifts granted to the federal government. Federally chartered thrifts must have their deposits insured by the Savings Association Insurance Fund (SAIF), which merged in 2006 with the BIF, managed by the FDIC. State-chartered thrifts may have their deposits insured by the state or by the SAIF.

Credit Unions

Credit unions are nearly identical to thrift institutions, except that depositors are restricted to a particular constituency. Most credit unions are associated with corporations or governmental agencies, and members are usually employees of the related organization. Like thrift institutions, they promote savings among their members and provide sources of credit for them. They obtain funds by selling shares to members and through savings deposit accounts on which they pay interest. They may be chartered either by the federal government or by the state in which they operate. Credit unions are rapidly becoming full-service competitors of banks.

Export-Import Bank

The Export-Import Bank is the official export credit agency of the United States. It allows the U.S. government to subsidize export financing. Export financing is provided to domestic and foreign manufacturers by the U.S. Export-Import Bank (<http://www.exim.gov>). The Ex-Im Bank authorized \$21 billion in loans in 2009, supporting about \$26.4 billion of U.S. exports. It has supported more than \$400 billion of U.S. exports in its 75-plus year history.

The Ex-Im Bank offers guarantees, direct loans, discounted loans, commercial and political risk insurance, and importer financing. It supports, among others:

- Small-business exports
- Export-credit insurance
- Transportation exports
- Working capital guarantees

The Ex-Im Bank does not compete with private-sector banks, but provides services that private companies are unwilling or unable to provide.





CHAPTER EIGHT

Importing to and Exporting From the United States

Import Controls

The U.S. Customs and Border Protection Service (CBP) administers import laws and regulations. The majority of permanent imports do not require a license, but they must be declared to U.S. Customs with a description including country of origin and tariff classification. Customs then determines the amount of duty to be paid on the import.

Reasonable Care

Businesses that import goods into the United States are subject to the Customs Modernization Act (MOD Act), which came into effect in 1993. Under the MOD Act, the concepts of “informed compliance” and “shared responsibility” emerged. The CBP is responsible for informing members of the trade community of their rights and duties under the various trade regulations and laws. It is the shared responsibility of the trade community as well as CBP for carrying out the requirements. One of the major requirements of “shared responsibility” is importers’ duty to use “reasonable care” when entering, classifying, and determining the value of imported goods. CBP is responsible for fixing the classification and the value of the goods. When an importer fails to use reasonable care, there can be delays in the release of goods by CBP, or even the assessment of fines and penalties up to the value of the goods.

Classification

The CBP is assigned the role of administering the entry of goods into the United States. Extensive regulations governing the entry of goods are outlined under Title 19 of the Code of Federal Regulations. Goods that are imported into the United States are required to be identified and assigned a value. The process of identification is called classification.

Identification can be divided into two separate forms of classification:

- The nature of the product
- The country or countries in which the product was made

Understanding the nature of a specific item lets an importer and the CBP determine the proper tariff rate.

The proper tariff code and rate are derived from the Harmonized Tariff Schedule of the U.S. (HTS). Tariffs differ for each foreign nation. As a consequence, knowing the country of origin lets the importer and the CBP determine which tariff will apply. This is particularly true in the application of free trade agreements.

Valuation

Goods entering the United States for immediate consumption require a value to be declared. The law applicable to valuation is included in the U.S. Tariff Act of 1930, as amended, but within the confines of the U.S. commitment to the General Agreement on Tariffs and Trade (GATT) Customs Valuation Code, and the successor World Trade Organization (WTO) provisions relating to customs valuation.

Imports are valued according to a hierarchy of alternate methods. But they are not alternative methods in the sense that the CBP may use any method it chooses. Nor may the CBP reject information provided if based on the use of generally accepted accounting procedures.

Transaction value is used in the vast majority of cases. The order of valuation is:

- Transaction value
- Transaction value of identical merchandise and similar merchandise
- Deductive value
- Computed value

Free Trade Agreements

The United States has maintained its commitment to trade liberalization by its support for the WTO. While maintaining its support of the WTO, the United States also has pursued trade liberalization with other nations. As a result, the U.S. government has entered into various free trade agreements. The United States has active bilateral trade agreements with Australia, Bahrain, Chile, Israel, Jordan, Morocco, Oman, Peru, and Singapore. The active multi-lateral trade agreements that the United States has signed

include the North American Free-Trade Agreement (NAFTA) and the Central America-Dominican Republic Free Trade Agreement (CAFTA – DR). The United States is also a party to the GATT, overseen by the WTO, along with 152 other countries. U.S. trade agreements with Panama, Korea, and Colombia are pending congressional approval. In order to take advantage of free trade agreements, the rules of origin must be consulted to verify that an import qualifies for beneficial treatment under the free trade agreement.

Export Controls

The Commerce, State, and Treasury departments administer and enforce U.S. export-control laws and regulations. U.S. government authorization, in the form of an export license or license exception, may be required for the export of commodities, software, or technology, including the transfer of controlled technology to foreign nationals in the United States or abroad. The export-control rules also include restrictions on exports to prohibited end users, proscribed end uses, and embargoed or sanctioned countries.

The regulatory regime that governs exports is significantly different from that of imports. The U.S. export laws and regulations are intended to serve various governmental interests and objectives, including:

- Prevent acts of terrorism and the proliferation of weapons of mass destruction
- Restrict the export of commodities, software, and technology that could contribute to the military potential of U.S. adversaries
- Advance U.S. foreign policy and economic goals

These goals take the form of the U.S. regulations that control the export of commercial and defense-related commodities, software, and technology.





Exports from the United States could require adherence to one or more of the following regulations:

- Export Administration Regulations (EAR)
- International Traffic in Arms Regulations (ITAR)
- Office of Foreign Assets Control Regulations (OFACR)

There are numerous federal agencies that are responsible for the administration and enforcement of export regulations. The most significant are:

- The Department of Commerce, Bureau of Industry and Security (BIS), administers the EAR
- The Department of Treasury, Office of Foreign Assets Control (OFAC), administers the OFACR

- The Department of State, Directorate of Defense Trade Control, administers the ITAR
- The Department of Homeland Security, Customs and Border Patrol, enforces the EAR, ITAR, OFACR, as well as other export-related laws and regulations

Violating U.S. export laws and regulations, as well as other U.S. laws and regulations, such as the Foreign Corrupt Practices Act, may result in the imposition of substantial monetary fines or penalties, seizure or forfeiture of goods, criminal prosecution, greater government scrutiny, negative publicity, and the suspension of export privileges.

CHAPTER NINE

Other Legal Considerations

Overview

U.S. law is extensive and complex when it comes to government controls regulating business activities. Foreign companies are well advised to consult with legal counsel regarding foreign investments, antitrust regulation, intellectual property, consumer protection, and immigration.

Anti-Money Laundering and Bribery Laws

The United States has instituted tough sanctions against money laundering and bribing government officials in foreign nations. The USA PATRIOT Act of 2001 included provisions to help prevent and detect international money laundering and terrorism financing and prosecute those responsible. The act requires financial institutions to monitor clients' accounts and report suspicious activity regarding the transfer of funds abroad, especially into countries where there has been a history of money laundering or terrorist activities.

The Foreign Corrupt Practices Act (FCPA), enacted in 1977 and amended in 1998, prohibits corrupt payments to foreign officials for the purpose of obtaining or keeping business. The anti-bribery provisions of the FCPA make it unlawful for a U.S. person, U.S. companies and issuers, and certain foreign issuers of securities traded in the United States, to directly or indirectly make a corrupt payment or provide other things of value to a foreign official for the purpose of obtaining or retaining business. Corrupt payments through intermediaries or other third parties are also prohibited. The phrase "foreign government official" has been interpreted by the U.S. Department of Justice (DOJ) and SEC to broadly include employees of government or state-owned entities, and nongovernmental organizations (NGOs). The books and records provisions, requiring companies to make and keep books and records that accurately and fairly reflect the transaction of companies and to devise and maintain an adequate system of internal accounting controls, applies to all issuers of securities listed in the United States. Since 1998, the

FCPA also applies to foreign firms and persons who take any act in furtherance of such a corrupt payment while in the United States. In recent years, the DOJ and SEC have greatly increased their enforcement of the FCPA, and the size of fines, penalties, and other sanctions imposed, against both companies and individuals.

Restrictions on Foreign Investment

At present, there are no substantial restrictions imposed by the federal government on foreign investment in the United States. A few industries are, however, subject to restrictions—these include those involving the exploitation of certain natural resources, communications, shipping, nuclear and other power-generating facilities, and aviation. Some states have restricted certain foreign investments in certain cases, such as in agricultural land. The federal government, through the Commerce and Agriculture departments, imposes substantial reporting requirements for foreign investments in the United States.

Under the International Investment Survey Act of 1976, most foreign investments in U.S. business enterprises (including ownership of real estate for profit-making purposes) in which foreign persons own a 10-percent or more voting interest (or the equivalent) must be reported to the Commerce Department's Bureau of Economic Analysis. Certain exceptions from reporting are provided for small investments. However, if the acquisition involves the purchase of 200 acres or more of U.S. land, it must be reported regardless of the total cost of the acquisition. Violations of these requirements may result in the imposition of civil or criminal penalties. Additional reporting is required every five years in benchmark surveys. Information gathered under the International Investment Survey Act is kept confidential and may be used only for analytical or statistical purposes.

The Agriculture Department requires reporting by foreign persons who acquire or transfer interests in agricultural land. Unlike the information obtained under the International

Investment Survey Act, the information reported to the Agriculture Department is not confidential.

The Committee on Foreign Investment in the United States (CFIUS) at the Treasury Department is charged with implementing the Exon-Florio Amendment to the 1988 Trade Act (part of the Omnibus Trade and Competitiveness Act of 1988). Under this amendment, the president can monitor and restrict foreign investment in the United States if such investment might impair U.S. national security. The authority under this provision generally applies to foreign acquisitions, mergers, and takeovers in the United States if the president determines that the foreign actions would threaten national security.

Antitrust Regulation

The essential elements of U.S. antitrust laws are contained in four key statutes: the Sherman Act, the Clayton Act, the Robinson-Patman Act (amending the Clayton Act), and the Federal Trade Commission Act. The statutes are broadly worded and designed to ensure free and competitive markets in the United States. They encourage market forces to freely influence supply and demand.

Section 1 of the Sherman Act prohibits all contracts, combinations, and conspiracies in restraint of trade. Section 2 of the Sherman Act prohibits monopolization or attempts to monopolize interstate commerce. Section 7 of the Clayton Act is a sweeping provision that prohibits corporations engaged in commerce from acquiring stock or assets of another corporation if the effect of the acquisition would be to substantially lessen competition or would tend to create a monopoly in any line of commerce in any section of the country. The Clayton Act also exempts labor unions and agricultural cooperatives from federal antitrust laws. Section 5 of the Federal Trade Commission Act prohibits unfair methods of competition and deceptive or unfair acts or practices affecting commerce. Section 2 of the Robinson-Patman Act restricts discriminatory buying or pricing, with



the intent of securing evenhanded treatment of customers regardless of buying power.

The antitrust laws are enforced by the Antitrust Division of the U.S. Department of Justice and by the Federal Trade Commission. Criminal and civil actions can be brought against violators. Actions may also be brought by the Federal Trade Commission to prevent and restrain violations through the use of cease-and-desist orders. Private parties (customers, suppliers, or competitors) who can prove injury under the antitrust laws can institute actions that, if successful, entitle the damaged party to treble damages.

Several specific activities are prevented by the antitrust laws without an inquiry into their effect on competition. These are so-called “per se” violations. Other activities are determined to be unreasonable under the application of the rule of reason. Under the rule of reason, a court will examine whether the particular activity adversely affects competition. Per se violations include price fixing, horizontal market division, group boycotts, exclusive dealing, and tying arrangements (that is, where the seller conditions the sale of a certain product on the purchase of another).

Mergers and acquisitions may be prohibited under Section 7 of the Clayton Act, Sections 1 or 2 of the Sherman Act, or under Section 5 of the Federal Trade Commission Act. Additionally, a merger may violate Section 8 of the Clayton Act, which prohibits a person from acting as a director of two or more competing corporations. The Justice Department issues guidelines that set forth the standards it uses to determine whether to contest an acquisition or merger. These guidelines are advisory only and are not binding on the government or the courts.

For antitrust purposes, mergers are classified as horizontal, vertical, or conglomerate. A horizontal merger occurs when the participants have competed directly with each other in relevant product and geographical markets. A vertical acquisition involves the acquisition of a former supplier or a customer. A conglomerate merger occurs where the merging companies are not competitors, customers, or suppliers. Factors used to determine whether a particular merger violates the antitrust laws include a lessening of actual competition in the relevant product and geographical markets, the sizes of the corporations involved, and the reduction of potential competition.

The Hart-Scott-Rodino Act requires advance notification of a proposed acquisition in certain cases. Parties to large mergers must notify the Federal Trade Commission and the Antitrust Division of the Justice Department of their plans and wait 15 to 30 days for the agencies to evaluate the plans and decide whether to object and seek to block the merger. Mergers are subject to the advance notification requirements if three tests are met: (1) the transaction affects commerce, (2) either (a) one of the parties has sales each year or assets of \$126.9 million or more and the other party has sales or assets of \$12.7 million or more at any time, (b) the amount of stock the acquirer has is valued at \$253.7 million at any time, and (3) the value of the transaction is \$63.4 million. The thresholds are recalculated annually based upon the gross national product.

Intellectual Property

U.S. patent law remains the same regardless of the inventor's citizenship. When individuals believe they have products that warrant patent protection, they can apply to the U.S. Patent office in Washington. Patents are issued to individual inventors who can then license their rights.

Under the Tariff Act of 1930, the International Trade Commission investigates infringement claims in international trade (rather than federal patent litigation). U.S. copyright protection follows "original works of authorship," giving the owner exclusive rights to sell or reproduce their work. Trademark rights in the United States, unlike many countries, are acquired through common law "use requirements" rather than through first registration. U.S. law defines trade secrets as a form of property, and protects their holders against disclosure by improper means. (Laws do not protect against disclosure by fair means.)

Consumer Protection

Federal and state laws protect consumers against a variety of unscrupulous business practices. Several federal and state agencies are involved in consumer protection. Also important to consider are federal agencies with regulations for specific industries. The pertinent areas of consumer protection in the United States include consumer product safety, food and drug safety, product labeling, product liability, motor vehicle safety, and consumer credit safeguards.

- The Food and Drug Administration, an agency of the U.S. Department of Health and Human Services, regulates the safety of food, drugs, blood products, medical equipment, radiation-emitting devices, transplant tissue, and cosmetics. The FDA also assesses and suggests protections for emerging hazards such as bioterrorism.
- The U.S. Consumer Product Safety Commission (CPSC) protects consumers from products that pose a fire, electrical, chemical, or

mechanical hazard, or products that can injure children. The CPSC has jurisdiction over more than 15,000 types of consumer products used in the home, sports, recreation, and schools.

- The Food Safety and Inspection Service (part of the U.S. Department of Agriculture) ensures that meat, poultry, and egg products are safe and correctly labeled and packaged.
- The Federal Trade Commission's jurisdiction includes protection of U.S. consumers.
- The Fair Credit Reporting Act regulates the collection, dissemination, and use of consumer credit information by consumer reporting agencies. In the event of identity theft, the Fair Credit Reporting Act provides for "fraud alerts" that can be placed on credit files, and free copies of file information to victims of identity theft.

Immigration Laws

A nonresident alien who wishes to do business in the United States must consider the nation's immigration laws. The Immigration and Nationality Act contains the law relating to the entry of aliens and is administered by the Department of Homeland Security. The rules applicable to nonresident aliens who wish to do business in the United States are briefly discussed below.

An "alien" under the immigration laws is any person who is not a citizen or national of the United States.

Immigrants are aliens who seek to enter the United States on a permanent basis, while nonimmigrants seek admittance on a temporary basis. Certain numerical limitations applicable to immigrants do not apply to nonimmigrants. In preparing for a journey to the United States, an alien, if not exempt from the visa requirement as a citizen of Canada, Bermuda, or the Visa Waiver Program nations, should apply abroad to a U.S. consulate or embassy for an appropriate visa. A visa may not be granted until satisfactory evidence is submitted to show that the alien will be able to proceed to the United States. This

includes assurance that the alien will obtain any exit permits and visas that may be needed for transit to the port of embarkation. In an effort to improve border security in response to terrorism, new legislation now requires stricter handling of visa applications, as well as supplemental visa applications to help inform the consular officer's judgment about visa eligibility. Supplemental application rules apply to all male, nonimmigrant visa applicants between the ages of 16 and 45, and to all student and exchange visitors, regardless of nationality or other factors.

Under the Immigration and Nationality Act, all visitor visa applicants are presumed to be applicants for immigration. To qualify for a nonimmigrant visa, applicants must demonstrate the purpose and specific length of their trip, and that they have binding ties (such as permanent residence) outside the United States.

Following is a partial listing of the visa classifications for nonimmigrants.

- *A visas* apply to ambassadors, public ministers, or career diplomatic or consular officers and their immediate families. This visa classification also, upon the basis of reciprocity, applies to certain other officials and employees of foreign governments as well as the attendants and personal employees of these officials. These visas are not applicable to the typical foreign investor, though the holders of such visas may invest in the United States.
- *B visas* are granted to aliens having residence in foreign countries they do not intend to abandon and who are visiting the United States temporarily for business or pleasure. The B-1 visa is assigned to temporary visitors for business, and their holders may engage in legitimate commercial or professional activities. B-1 visa holders may not engage in purely local employment or labor for hire. Holders of B-1 visas are usually issued a six-month stay, which can be extended. The B-2 visa is a tourist visa and is used by individuals on pleasure trips.

It is generally valid for a minimum of 30 days.

- **E visas** are granted to “treaty traders” and “treaty investors.” These are aliens who enter the United States to carry on substantial trade between the United States and the foreign state of which they are nationals, or who enter the United States to develop and direct enterprises in which an alien has invested or is actively in the process of investing a substantial amount of capital pursuant to a treaty of friendship, commerce, and navigation. Such visas also are applicable to spouses and unmarried children under 21 accompanying the treaty trader or treaty investor.
- **F visas** generally apply to alien students, their spouses, and their children. Holders must apply for employment authorization if they wish to work off campus.
- **H-1B visas** are for professional jobs requiring a minimum of a bachelor’s degree (or equivalent, obtained through education and/or experience) in a certain academic field.
- **J visas** are granted to alien students, scholars, trainees, teachers, or others of similar description (and their spouses and children) for the purpose of teaching, studying, observing, or otherwise participating in educational and/or cultural exchange programs. Applicants must be accepted into an exchange program through a designated sponsoring organization before obtaining a visa.
- **L visas** are designed to let firms transfer alien employees to the United States for continued employment in the United States by the same or an affiliated enterprise. The alien must have been employed continuously for one year in the past three years by a firm, corporation, or other legal entity, or an affiliate or subsidiary thereof, and must serve in a managerial or executive capacity or possess specialized knowledge. Recipients of L visas may be admitted for an initial period of three years and may be

granted extensions until their duties are completed. Holders of L visas are permitted to have their spouses and unmarried children join them in the United States.

- **M visas** apply to aliens, their spouses, and their minor children who temporarily enter the United States solely for the purpose of pursuing a full course of study at an established vocational or other recognized nonacademic institution.

Generally, aliens must possess valid, unexpired visas and passports in order to enter the United States. In lieu of a visa, a returning resident may present a reentry permit.

Aliens admitted as nonimmigrants cannot remain permanently in the United States under that status. Aliens who fail to maintain the nonimmigrant status under which they were admitted by the Immigration and Nationality Act or who fail to comply with the conditions of such status may be subject to deportation. Aliens who entered as nonimmigrants are also subject to deportation if it is established that the aliens were inadmissible at the time of entry. The Illegal Immigration Reform and Immigrant Responsibility Act, signed into law in 1996, broadened the types of criminal activities for which aliens can be deported. The Real ID Act of 2005 also increased the enforcement of existing immigration laws and regulations.

Aliens applying for immigrant status (those seeking to enter the United States on a permanent basis) generally are subject to quotas restricting the number of such individuals who may come into the United States during the calendar year. Spouses, minor children, and parents of citizens of the United States and special immigrants (generally immigrants lawfully admitted to the United States for permanent residence who are returning from temporary visits abroad) are exempt from the quotas.

Exchange Controls

On March 1, 2003, the U.S. Customs Service was divided and integrated into

two new federal agencies under the U.S. Department of Homeland Security. These agencies are U.S. Customs and Border Protection, which regulates international trade, enforces trade laws, and collects import duties; and U.S. Immigration and Customs Enforcement, which identifies vulnerabilities in national security.

Under the Currency and Foreign Transactions Reporting Act, individuals crossing into or out of the United States must disclose to U.S. Customs and Border Protection when they are carrying more than \$10,000 in currency or monetary instruments. There is no limit on the total amount of monetary instruments that individuals may take into and out of the United States.

Orlando	Horizon Air	2115	4:22P	C20	On-Time	Portland	Alaska	320	2:01P	211	Wax 2:20P	Portland		
Orlando	Horizon Air	2130	8:30P	219C	On-Time	Portland	United	1157	2:25P	214	On-Time	Portland		
Orlando	Alaska	190	4:15P	D6	On-Time	Portland	Los Angeles	370	2:47P	216	On-Time	Portland		
Orlando	Southwest	1375	5:50P	36	On-Time	Portland	Los Angeles	1175	1:56P	218	On-Time	Portland		
Orlando	Horizon Air	2380	8:55P	C20	On-Time	Portland	Los Angeles	468	1:52P	219	Wax 4:10P	Portland		
Orlando	Horizon Air	2634	4:55P	C26	On-Time	Portland	Los Angeles	1065	1:55P	214	On-Time	Portland		
Orlando	Alaska	530	2:41P	C17	On-Time	Portland	Los Angeles	590	1:43P	21	On-Time	Portland		
Orlando	Southwest	1348	8:55P	214	On-Time	Portland	Maui Kona	91	2:55P	22	On-Time	Portland		
Orlando	Horizon Air	2532	2:55P	C28	On-Time	Portland	Westford	Horizon Air	2290	1:01P	218D	On-Time	Portland	
Orlando	United	830	1:30P	36	Delayed	Portland	Winnipeg	Alaska	587	1:55P	22	On-Time	Portland	
Orlando	American	1734	2:15P	48	Wax 4:25P	Portland	Winnipeg	Westford	142	4:13P	27	On-Time	Portland	
Orlando	United	100	1:10P	36	Wax 1:20P	Portland	Winnipeg	United	480	4:40P	32	On-Time	Portland	
Orlando	United	480	1:10P	310	Wax 1:20P	Portland	Winnipeg	San-Country	280	1:40P	210	Wax	Portland	
Orlando	American	1880	1:20P	48	Wax 1:30P	Portland	Winnipeg	Northern	172	1:25P	24	On-Time	Portland	
Orlando	Southwest	2720	1:10P	20	On-Time	Portland	Winnipeg	Commercial	6221	1:51P	22	On-Time	Portland	
Orlando	Southwest	2028	1:10P	20	On-Time	Portland	Winnipeg	Horizon Air	2362	1:16P	C2P	On-Time	Portland	
Orlando	American	180	1:20P	48	Wax 1:30P	Portland	Winnipeg	New York - JMW	178	1:50P	32	Wax 2:00P	Portland	
Orlando	American	1022	1:20P	48	On-Time	Portland	Winnipeg	Heath	Commercial	1880	1:50P	211	On-Time	Portland
Orlando	Alaska	182	2:20P	C20	On-Time	Portland	Winnipeg	Alaska	314	2:17P	210	On-Time	Portland	
Orlando	Frontier	124	1:40P	42	On-Time	Portland								
Orlando	United	524	1:40P	91	On-Time	Portland								
Orlando	United	480	1:40P	32	On-Time	Portland								
Orlando	Alaska	178	1:25P	C18	On-Time	Portland								
Orlando	United	1210	9:00P	30	Wax 9:10P	Portland								
Orlando	Frontier	2100	2:25P	27	On-Time	Portland								
Orlando	Horizon Air	2176	2:20P	C20	On-Time	Portland								
Orlando	Horizon Air	2680	1:50P	C28	On-Time	Portland								
Orlando	Horizon Air	2420	2:20P	C20	On-Time	Portland								
Orlando	Horizon Air	2621	4:55P	C10	On-Time	Portland								
Orlando	Alaska	187	2:40P	36	Wax 2:50P	Portland								

Wednesday, July 23, 2008 1:00PM

Wednesday, July 23, 2008 1:00PM



CHAPTER TEN

KPMG's U.S. High Growth Markets Practice



KPMG's U.S. High Growth Markets Practice

KPMG's U.S. High Growth Markets (HGM) practice provides audit, tax, and advisory services to U.S.-based companies in their pursuit of outbound investment opportunities in high growth and emerging markets such as China, India, Brazil, Russia, Mexico, and Vietnam. In addition, HGM provides services to high growth market-based companies with inbound investment interest in the United States.

Working with professionals across KPMG International's network of member firms, our U.S. High Growth Markets service providers combine global reach, local knowledge, and in-depth industry experience to help companies and investors make the most of their high growth market opportunities. For U.S.-based companies expanding into one of these markets, or foreign-based companies looking to invest in the United States, KPMG can offer help as a service provider of choice.

Our China member firm and U.S. China practice work closely with companies and investors to help navigate complex and dynamic high growth markets by assisting with inbound and outbound investment strategies, market entry studies, transaction assistance, royalty revenue protection, and fraud and mismanagement investigations.

Contacts

For more information about how to invest in the United States, please contact KPMG's U.S. High Growth Markets practice at us-hgmpracticemb@kpmg.com.

About KPMG

KPMG LLP, the audit, tax and advisory firm (www.us.kpmg.com), is the U.S. member firm of KPMG International Cooperative ("KPMG International"). KPMG International's member firms have 140,000 professionals, including 7,900 partners, in 146 countries.

Member Firms

For a list of KPMG member firms, please access our Web site at www.kpmg.com.



Appendices

Useful Links

CIA World Fact Book—U.S. (<https://www.cia.gov/library/publications/the-world-factbook/geos/us.html>)

Commodity Futures Trading Commission (<http://www.cftc.gov/>)

Congressional Budget Office (<http://www.cbo.gov/>)

Department of Agriculture (<http://www.usda.gov/>)

Agricultural Research Service (<http://www.ars.usda.gov/>)

Economic Research Service (<http://www.ers.usda.gov/>)

National Agricultural Statistics Service (<http://www.nass.usda.gov/>)

Department of Commerce (<http://www.commerce.gov/>)

Bureau of Industry and Security (<http://www.bis.doc.gov/>)

Economic Development Administration (<http://www.eda.gov/>)

Economics and Statistics Administration (<https://www.esa.doc.gov/>)

Bureau of the Census (<http://www.census.gov/>)

Bureau of Economic Analysis (<http://www.bea.gov/>)

International Trade Administration (<http://trade.gov/index.asp>)

Invest in America Initiative (<http://trade.gov/investamerica/>)

Patent and Trademark Office (<http://www.uspto.gov/>)

Department of Health and Human Services (<http://www.hhs.gov/>)

Food and Drug Administration (<http://www.fda.gov/>)

Department of Homeland Security (<http://www.dhs.gov/>)

Citizenship and Immigration Services (<http://www.uscis.gov/>)

Customs and Border Protection (<http://www.cbp.gov/>)

Department of Justice (<http://www.justice.gov/>)

Antitrust Division (<http://www.justice.gov/atr/>)

Tax Division (<http://www.justice.gov/tax/>)

Department of Labor (<http://www.dol.gov/>)

Bureau of Labor Statistics (<http://www.bls.gov/>)

Employment Standards Administration (<http://www.dol.gov/esa/>)

Occupational Safety and Health Administration (<http://www.osha.gov/>)

Department of State (<http://www.state.gov/>)

Bureau of Economic, Energy, and Business Affairs (<http://www.state.gov/e/eeb/>)

InfoUSA (<http://usinfo.state.gov/usa/infousa/>)

U.S. Embassies (<http://usembassy.state.gov/>)

Department of the Treasury (<http://www.treasury.gov/>)

Comptroller of the Currency, Administrator of National Banks (<http://www.occ.gov/>)

Financial Management Service (<http://www.fms.treas.gov/>)

Internal Revenue Service (<http://www.irs.gov/>)

Office of Thrift Supervision (<http://www.ots.gov/>)

Environmental Protection Agency (<http://www.epa.gov/>)

Equal Employment Opportunity Commission (<http://www.eeoc.gov/>)

Export-Import Bank of the United States (<http://www.exim.gov/>)

Federal Reserve System (<http://www.federalreserve.gov/>)

Federal Trade Commission (<http://www.ftc.gov/>)

Bureau of Competition (<http://www.ftc.gov/bc/>)

Bureau of Economics (<http://www.ftc.gov/be/>)

Bureau of Consumer Protection (<http://www.ftc.gov/bcp/>)

General Services Administration's USA.gov (<http://www.usa.gov/>)

Government Accountability Office (<http://www.gao.gov/>)

International Trade Commission (<http://www.usitc.gov/>)

The ITC Interactive Tariff and Trade Data Web (<http://dataweb.usitc.gov/>)

Joint Economic Committee, U.S. Congress (<http://www.jec.senate.gov/>)

Joint Committee on Taxation, U.S. Congress (<http://www.house.gov/jct/>)

Office of the U.S. Trade Representative (<http://www.ustr.gov/>)

Securities and Exchange Commission (<http://www.sec.gov/>)

Electronic Data Gathering, Analysis, and Retrieval (EDGAR) Database (<http://www.sec.gov/edgar.shtml>)

Small Business Administration (<http://www.sba.gov/>)

Business.gov (<http://www.business.gov/>)

Stock Exchanges

American Stock Exchange (<http://www.amex.com/>)

NASDAQ (<http://www.nasdaq.com/>)

New York Stock Exchange (<http://www.nyse.com/>)

U.S. Copyright Office (<http://www.copyright.gov/>)

White House, Executive Office of the President (<http://www.whitehouse.gov/>)

Office of Management and Budget (<http://www.whitehouse.gov/omb/>)

Budget of the U.S. Government (<http://www.whitehouse.gov/omb/budget/>)

Current U.S. Treaties*Treaty Chart as of August 2010*

The following chart contains the general withholding tax rates that are applicable to dividend, interest and royalty payments by U.S. corporations to non-residents that are eligible for benefits under an applicable income tax treaty currently in force. Depending upon the facts and circumstances, however, a different rate may apply (e.g., interest contingent on profits may not be eligible for the lowest treaty rate). Recent treaties reduce the U.S. branch profits tax from thirty percent to the lower withholding rate applicable to dividends paid by qualifying companies. Payments to conduit companies, partnerships and other transparent entities are subject to domestic law requirements that may disallow the lower withholding rates provided by a tax treaty.

Country	Dividends		Interest ¹	Royalties
	Individuals, companies (%)	Qualifying companies ² (%)		
Armenia ³	-.4	-.4	0 ⁵	0
Australia	15	0/5 ⁶	10	5
Austria	15	5	0	0/10 ⁸
Azerbaijan ³	-.4	-.4	0 ⁵	0
Bangladesh	15	10	10	10
Barbados	15	5	5	5
Belarus ³	-.4	-.4	0 ⁵	0
Belgium	15	0/5 ⁷	0	0
Bermuda ⁹	-.4	-.4	-.4	-.4
Bulgaria	10	5	5	5
Canada	15	5	0	0/10 ¹⁰
China (People's Rep.)	10	10	10	10 ¹¹
Cyprus	15	5 ¹²	10	0
Czech Republic	15	5	0	0/10 ¹³
Denmark	15	0/5 ¹⁴	0	0
Egypt	15	5 ¹²	15	15
Estonia	15	5	10	5/10 ¹⁵
Finland	15	0/5 ¹⁴	0	0 ¹³
France	15	0/5 ¹⁶	0	0
Georgia ³	-.4	-.4	0 ⁵	0
Germany	15	0/5 ¹⁷	0	0
Greece	-.4	-.4	0 ¹⁸	0 ¹⁹
Hungary	15	5	0	0
Iceland	15	5 ¹²	0	0/5 ²⁰
India	25	15	15	10/15 ¹⁵
Indonesia	15	10 ²¹	10	10
Ireland	15	5	0	0
Israel	25	12.5 ¹²	17.5	10/15 ¹³
Italy	15	5 ²²	0/10 ²³	0/5/8 ²⁴
Jamaica	15	10	12.5	10

Country	Dividends		Interest ¹	Royalties
	Individuals, companies (%)	Qualifying companies ² (%)		
Japan	10	0/5 ²⁵	10	0
Kazakhstan	15	5	10	10 ²⁶
Korea (Rep.)	15	10 ¹²	12	10/15 ¹³
Kyrgyzstan ³	⁴	⁴	0 ⁵	0
Latvia	15	5	10	5/10 ¹⁵
Lithuania	15	5	10	5/10 ¹⁵
Luxembourg ²⁷	15	5	0	0
Mexico	10	0/5 ⁴¹	15	10
Moldova ³	⁴	⁴	0 ⁵	0
Morocco	15	10 ¹²	15	10
Netherlands	15	0/5 ²⁸	0	0/15 ²⁹
Netherlands Antilles ³⁹	⁴	⁴	³⁹	⁴
New Zealand	15	15	10	10
Norway	15	15	0	0
Pakistan	⁴	15 ³⁰	⁴	0 ³¹
Philippines	25	20 ³²	15	15
Poland	15	5	0	10
Portugal	15	5 ³³	10	10
Romania	10	10	10	10/15 ¹³
Russia	10	5	0	0
Slovak Republic	15	5	0	0/10 ³⁴
Slovenia	15	5 ²¹	5	5
South Africa	15	5	0	0
Spain	15	10 ²¹	10	5/8/10 ³⁵
Sri Lanka	15	15	10	5/10 ³⁶
Sweden	15	0/5 ¹⁴	0	0
Switzerland	15	5	0	0
Tajikistan ³	⁴	⁴	0 ⁵	0
Thailand	15	10	15	5/8/15 ⁴⁰
Trinidad and Tobago	⁴	⁴	⁴	0/15 ³⁷
Tunisia	20	14 ²¹	15	10/15 ¹⁵
Turkey	20	15	15	5/10 ¹⁵
Turkmenistan ³	⁴	⁴	0 ⁵	0
Ukraine	15	5 ³⁸	0	10
United Kingdom	15	0/5 ²⁸	0	0
Uzbekistan ³	⁴	⁴	0 ⁵	0
Venezuela	15	5	10	5/10 ¹⁵

1. The rates shown are those applied to interest paid by general obligators and interest other than “portfolio interest” and other than categories of interest that are exempt under domestic law. Many treaties provide special withholding rates for bank loans and commercial credit transactions, for which the text of the treaty should be consulted.
2. Unless otherwise indicated, the lower rate applies if the corporate shareholder owns at least 10 percent of the voting stock or the share capital of the U.S. corporation, depending on the applicable treaty. A number of U.S. treaties do not permit (or contain restrictions on) reduced withholding in the case of dividends paid by RICs and REITs. In addition, some treaties impose additional requirements on certain trust and pension funds with regard to reduced withholding tax on dividend payments.
3. The treaty concluded between the United States and the former USSR.
4. The domestic rate applies; there is no reduction under the treaty.
5. The reduced rate applies only to interest on credits, loans, and other forms of indebtedness connected with the financing of trade between the United States and the former USSR countries except where the interest is received from the conduct of a general banking business.
6. The zero rate of withholding tax on dividend payments is available to a company that is the beneficial owner of the dividends and is a resident of the other Contracting State if the company has owned directly 80 percent or more of the voting power of the company paying the dividends for the 12-month period ending on the date the dividends are declared and the company satisfies either the “publicly traded” test under Article 16 (Limitation on Benefits) or the company is granted the benefits of the zero rate provision by the competent authority of the source state.
7. Eligibility for the zero rate of withholding where the company

paying the dividend is a U.S. resident is available if the beneficial owner of the dividend is a Belgian resident company that has owned directly or indirectly 80 percent or more of the voting power of the company paying the dividend for the 12-month period ending on the date on which entitlement to the dividend is determined and the Belgian company:

- i. Satisfies the “publicly traded” test of Article 21 (Limitation on Benefits); or
- ii. Satisfies the “ownership-base erosion” and “active trade or business” tests of Article 21; or
- iii. Satisfies the “derivative benefits” test of Article 21; or
- iv. Has received a favorable determination from the competent authority of the source state.

Eligibility for the zero rate of withholding where the company paying the dividends is a Belgian resident is available if the beneficial owner of the dividend is a U.S. resident company that has owned directly shares representing at least 10 percent of the capital of the dividend-paying company for a 12-month period ending on the date the dividend is declared.

- 8. The higher rate applies to film royalties.
- 9. The tax treaty between the United States and Bermuda (dealing with income of insurance companies) entered into force with certain reservations on December 2, 1988, and is effective as follows: (1) for excise taxes on insurance premiums paid to foreign insurers, for premiums paid or credited on or after January 1, 1986; (2) for income taxes on business profits derived by an insurance enterprise, for profits derived in taxable years beginning on or after January 1, 1988; and (3) for the government mutual assistance provisions with certain exceptions, for taxable years not barred by the statute of limitations of the jurisdiction requesting assistance. A reservation to the treaty provides that the treaty exemption from U.S. insurance excise taxes will not apply to premiums allocable to insurance coverage for periods after December 31, 1989.
- 10. The lower rate applies to computer software, patents, and know-how.
- 11. In the case of rental of industrial, commercial, or scientific equipment, the withholding rate is imposed on 70 percent of the gross royalties.
- 12. The lower rate applies if the corporate shareholder has owned at least 10 percent of the voting stock of the U.S. corporation for the portion of the taxable year preceding the payment of the dividend and for the whole of the prior taxable year.
- 13. The lower rate applies to copyright royalties, films, and certain other intellectual property.
- 14. The zero rate of withholding tax on dividend payments is available to a company that is the beneficial owner of the dividends and is a resident of the other Contracting State if the company has owned directly or indirectly through one

or more residents of either Contracting State 80 percent or more of the voting stock of the company paying the dividends for the 12-month period ending on the date on which entitlement to the dividends is determined, and the company:

- i. Satisfies the “publicly traded” test, or
- ii. Satisfies the “ownership-base erosion” and “active trade or business” tests, or
- iii. Satisfies the “derivative benefits” test, or
- iv. Is granted the benefits of the zero rate provision by the competent authority of the source state.

Refer to the “Limitation on Benefits” article of the relevant treaty for additional information concerning application of these tests.

- 15. The lower rate applies to equipment leases.
- 16. The zero rate of withholding tax on dividend payments is available to a company that is the beneficial owner of the dividends and is resident of the other Contracting State if the company has owned, directly or indirectly through one or more residents of either the United States or France, 80 percent or more of the voting stock of the company paying the dividends for the 12-month period ending on the date on which entitlement to the dividends is determined and that company:
 - i. Satisfies the “publicly traded” test of Article 30
 - ii. Satisfies the “ownership-base erosion” and “active trade or business” tests of Article 30
 - iii. Satisfies the “derivative benefits test” of Article 30; or
 - iv. Is granted the benefits of the zero rate provision by the competent authority of the source state.
- 17. The zero rate of withholding tax on dividend payments is available to a company that is the beneficial owner of the dividends and is resident of the other Contracting State if the company has owned directly 80 percent or more of the voting stock of the company paying the dividends for the 12-month period ending on the date on which entitlement to the dividends is determined and that company:
 - i. Satisfies the “publicly traded” test of Article 28 (Limitation on Benefits), or
 - ii. Satisfies the “ownership-base erosion” and “active trade or business” tests of Article 28, or
 - iii. Satisfies the “derivative benefits” test of Article 28, or
 - iv. Is granted the benefits of the zero rate provision by the competent authority of the source state.
- 18. The treaty rate does not apply to corporate shareholders controlling more than 50 percent of the voting stock of the U.S. corporation.
- 19. The zero rate of withholding does not apply to royalties for motion picture and television.
- 20. The 5 percent rate applies to royalties for:
 - (i) Motion picture and television
 - (ii) Trademarks and any information concerning industrial,



commercial, or scientific experience provided in connection with a rental or franchise agreement that includes rights to use a trademark.

21. The lower rate applies if the corporate shareholder owns 25 percent or more of the voting stock (or in some cases share capital) of the U.S. corporation.
22. The 5 percent rate applies if the corporate shareholder has owned more than 25 percent of the voting stock of the U.S. corporation for the 12-month period ending on the date the dividend is declared.
23. The zero percent rate of withholding applies to (i) certain interest paid to, guaranteed, or insured by qualified government entities; (ii) interest paid or accrued with respect to a sale on credit of goods, merchandise, or services provided by one enterprise to another enterprise; or (iii) interest paid or accrued in connection with the sale on credit of industrial, commercial, or scientific equipment. The 10 percent rate applies to all other interest.
24. The 0 percent rate applies to royalties for a copyright of literary, artistic, or scientific work (excluding royalties for computer software, motion pictures, films, tapes, or other means of reproduction used for radio or television broadcasting). The 5 percent rate applies to royalties for the use of, or the right to use, computer software or industrial, commercial, or scientific equipment; the 8 percent rate applies in all other cases.
25. The zero rate of withholding tax on dividend payments is available to a company that is the beneficial owner of the dividends and is a resident of the other Contracting State if that company has owned directly or indirectly more than 50 percent of the voting stock of the company paying the dividends for the 12-month period ending on the date on which entitled to the dividends is determined and that company:
 - i. Has owned directly or indirectly 80 percent or more of the voting power of

- the company paying the dividends prior to October 1, 1998
- ii. Satisfies the “publicly traded” test of Article 22 (Limitation on Benefits)
 - iii. Satisfies the “ownership-base erosion” and “active trade or business” tests of Article 22; or
 - iv. Is granted the benefits of the zero rate provision by the competent authority of source state.
26. The withholding tax on payments for the right to use industrial, commercial, or scientific property can, at the election of the beneficial owner, be computed on a net basis.
 27. The treaty does not apply to income paid to exempt Luxembourg holding companies.
 28. The zero rate of withholding tax on dividend payments is available to a company that is the beneficial owner of the dividends and is a resident of the other Contracting State if that company has owned directly 80 percent or more of the voting power of the company paying the dividends for the 12-month period ending on the date the dividends are declared and that company:
 - i. Has owned directly or indirectly 80 percent or more of the voting power of the company paying the dividends prior to October 1, 1998
 - ii. Satisfies the “publicly traded” test of Article 23
 - iii. Satisfies the “derivate benefits” test of Article 23; or (iv) has received a favorable determination from the competent authority of the source state.
 29. The 15 percent rate applies if the royalty is paid to a permanent establishment of a Netherlands enterprise located in a third jurisdiction and the aggregate rate of tax imposed by the Netherlands and the third jurisdiction is less than 60 percent of the U.S. corporate income tax rate.
 30. The lower rate applies if the corporate shareholder owns more than 50 percent of the voting power of the U.S. corporation.
 31. Royalties for motion picture and television are subject to a 30 percent rate.
 32. The lower rate applies if the corporate shareholder has owned at least 10 percent of the voting stock of the U.S. corporation for the portion of the taxable year preceding the payment of the dividend and for the whole of the prior taxable year.
 33. The lower rate applies if the corporate shareholder directly owns at least 25 percent of the capital of the U.S. corporation for an uninterrupted period of two years prior to the date of payment of the dividend.
 34. The 10 percent rate applies to royalties for any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for industrial, commercial, or scientific equipment, or for information concerning industrial, commercial, or scientific experience.
 35. The 5 percent rate applies to royalties for copyright of literary, artistic, or scientific works; the 8 percent rate applies to industrial royalties and royalties for motion pictures and films, tapes, or other means of reproduction used for radio or television broadcasting; the 10 percent rate applies to all other royalties.
 36. The 5 percent rate applies to rentals for the use of tangible personal (movable) property.
 37. The 0 percent withholding rate applies to royalties derived from copyrights, or rights to produce or reproduce any literary, dramatic, musical, or artistic work.
 38. The 5 percent rate applies if the Ukrainian company owns at least 10 percent of the voting stock in the U.S. company (or, if the U.S. company does not have voting stock, at least 10 percent of the authorized capital).
 39. In a note dated June 29, 1987, the Netherlands Antilles and Aruba governments were notified that the U.S. government was terminating the U.S.-Netherlands Antilles and the U.S.-Aruba income tax treaties.
- The termination of both treaties was effective as of January 1, 1988. On July 10, 1987, the U.S. government modified the June 29 notice of termination to provide that Article VIII of both treaties (which exempts interest paid by U.S. persons to corporations and residents of the Netherlands Antilles and Aruba from U.S. tax) will continue in force after December 31, 1987. A protocol to the U.S.-Netherlands Antilles Income Tax Treaty entered into force and became effective on December 30, 1996. The protocol to the limited income tax treaty terminates the current U.S. tax exemption on interest paid to (1) Antilles companies that are not U.S.-owned (i.e., not controlled foreign corporations), (2) U.S.-owned Antilles companies on non-eurobond debt, and (3) U.S.-owned Antilles companies on eurobond debt issued after October 15, 1984.
40. The 5 percent rate applies to royalties for copyrights, including films; the 8 percent rate applies to royalties for the use of industrial, commercial or scientific equipment; the 15 percent rate applies to royalties for patents, trademarks, and for scientific works.
 41. The zero rate of withholding tax on dividends payments is available to a company that is the beneficial owner of the dividends and is a resident of the other Contracting State if that company has owned directly 80 percent or more of the voting stock of the company paying the dividends for the 12-month period ending on the date the dividends are declared and the company:
 - i. Prior to October 1, 1998, owned directly or indirectly 80 percent or more of the voting stock of the company paying the dividends, or
 - ii. Satisfies the “publicly traded” test of Article 17 (Limitation on Benefits), or
 - iii. Satisfies the “derivative benefits” test of Article 17, or
 - iv. Has received a determination from the relevant competent authority that it is entitled to the zero rate.



U.S. Federal Holidays

- New Year's Day (January 1)
- Dr. Martin Luther King Jr.'s Birthday (third Monday in January)
- George Washington's Birthday (third Monday in February)
- Memorial Day (last Monday in May)
- Independence Day (July 4)
- Labor Day (first Monday in September)
- Columbus Day (second Monday in October)
- Veterans Day (November 11)
- Thanksgiving Day (fourth Thursday in November)
- Christmas Day (December 25)

Map of the United States



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Chapter 5

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