Taking Your First Steps in the United States? Here Are Six Key Tax and HR Issues to Consider Before Putting Boots on the Ground

1. State vs. Federal Taxation

Businesses operating in the United States are subject to two levels of taxation, federal and state. However, the existing double taxation treaty between the United States and Belgium is not applicable to the states—a source of confusion for many Belgian companies expanding their business into the US market and getting ready to put boots on the ground. Although you may have no taxable presence due to treaty protection at the federal level, you *may* have exposure to taxation at the state level. Due to a landmark US Supreme Court case decided in June 2018, a taxable presence (a “nexus” in tax speak) in one of the 50 states can be created not only by a physical presence but by mere *economic* presence. The implication is that you could be exposed to state taxation in most of the 50 states without having a single office or full-time employee anywhere in the United States. While each state has enacted its own tax laws, there are some common trip wires.

What to Watch For

1. **Economic Presence:** Do you have more than $100,000 annual sales in a state or more than 200 transactions? This small level of activity will create a taxable presence (economic nexus) in most states, which causes sales tax administration and filing obligations and possibly income tax filing.
2. **Physical Presence**
    a. **Onsite Services:** Do you have employees working temporarily in a state—perhaps engaged in installation, maintenance, training, and the like? A few days’ presence may be enough to create state nexus.
    b. **Assets:** Do you have inventory, machinery, or other assets (e.g., inventory in consignation, machine rental or operational lease, demo item) situated in the United States? Most states consider assets to be indicative of nexus.
    c. **Employees:** Are there employees based in a state working from their home offices? Payrolled employees is a strong indication of nexus.

The Impacts of Compliance Obligations

Depending on the state where you have a taxable presence, you will most likely need to:

1. Qualify to do business (if only to get a secretary of state number required for the next step)
2. Register for various types of tax such as sales/use tax, corporate income tax, payroll tax, and personal property tax
3. File sales- and use-tax returns and payroll tax returns, potentially monthly
4. File income tax returns and personal property tax returns annually

Sales tax rates approach 10% in some states, which may have a significant impact on competitive pricing. And other potential tax obligations are critical to assessing your business's potential tax burden as you expand into the US market.

Caution: Change Coming

As of this writing, most double taxation treaties, including US-Belgium, do not consider the mere presence of inventory for delivery or display purposes a condition that creates a permanent establishment for federal tax purposes. But count on this matter to be revisited and revised—and soon. Discussions about this issue at the OECD level are under way. The influence of the US Supreme Court's ruling allowing states to characterize tax presence based on economic activity has likely been profound—showing the way for other countries on how to tax e-commerce.

2. Use of Independent Contractors

Retaining independent contractors is a popular approach for putting boots on the ground with a minimum of administrative overhead. But rules about classifying personnel in the "gig" economy are evolving; regulators and the courts are creating tougher standards for "independence." For example, the California State Supreme Court, in *Dynamex Operations West, Inc., v. Superior Court* (April 2018), ruled that an independent contractor classification must meet the following test:

1. The worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact.
2. The worker performs work that is outside the usual course of the hiring entity's business.
3. The worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed.

It is obvious that a salesperson working in an independent contractor relationship with your company would not pass the test's second provision.

Getting it wrong has costs. Recharacterization of the status of an independent contractor as an employee by a taxing authority is potentially costly, especially for a foreign corporation. In addition to social costs and probable penalties, the revelation of a misclassification would likely imply that a company has a permanent establishment in the United States and nexus in the state, requiring a company to file prior years' income tax returns.

But getting it right has challenges, too. With the latest US tax legislation, it has become more attractive from an income tax perspective for US individuals to operate as independent contractors. Companies may find it harder to convince a person who they cannot legally classify as an independent contractor to become an employee. Keep in mind that independent contractors themselves may not be conversant in the rules, relying on legal entities such as "C" corporations or LLCs, though they might truly function as "employees." Their lack of awareness, and their legal "shield," may not protect you.

The debate over classification will continue. It is almost inevitable that rules for independent contractor status will become more restrictive and penalties for misclassification assessed faster and more harshly. Conditions change; keep abreast of developments.

3. Setting Up the Right Legal Entity

If your US business activity is such that it is creating state nexus and/or federal permanent establishment, in the absence of a US subsidiary, the Belgian parent company must qualify to do business as a non-resident corporation in the various states and register with the IRS, etc.. as having an unincorporated US branch. This is not necessarily a bad tax situation but it may be time to consider setting up a US entity to: (1) prevent the Belgian corporation from becoming a US taxpayer and (2) take advantage of a limited liability entity in the United States to provide some legal protection to the parent company.

In most cases, and in our experience, a Belgian corporation starts up its US business by: (1) establishing a "C" corporation subsidiary (an Inc.), (2) in the state of Delaware, which is (3) wholly owned by the parent company. We'll take each in turn.

"C" Corporation

The alternative to a "C" corporation is a limited liability company (LLC) but for US tax purposes an LLC is a fiscally transparent entity. This means that the LLC does not exist for tax purposes and the LLC's owner(s) pay tax directly on their share of the profit, thereby avoiding one level of taxation.

This attribute makes the LLC the entity of choice for US taxpayers. Foreign taxpayers, however, generally do not enjoy this advantage. The LLC is deemed a US branch or partnership (depending on the number of owners) and the owners are pulled into the US tax regime. The IRS requires that the branch or the foreign partners be subjected to the same taxation as a "C" corporation, which might even require payment of withholding tax by the LLC on behalf of the foreign owners to assure collection of the tax. Generally, it is not such a good idea that your foreign entity file US tax returns.

State of Delaware

Return for a minute to where we started. Companies are taxed at two levels: federal in every case for all of your US business, and by the states where you have nexus. You are not, however, taxed in the US based on your state of incorporation.

While it is not the "tax paradise" that many people think, the State of Delaware does provide companies some flexibility in terms of incorporation. For example, if you incorporate in most states *other than* Delaware, you will need to file returns for the life of the corporation—whether there is a state presence or not. This would be a major administrative obligation for a large percentage of IMS's clients, which can and do relocate after gaining a better understanding of desirable business locations or when conditions demand change.

So, for example, if you incorporate in Delaware and set up an office in New York, you would still need to qualify to do business in the state of NY. But this qualification to do business could be closed if you move out of NY; all compliance obligations would be terminated.

A final observation: Delaware seems to us the *lingua franca* of state incorporation law in the United States. Of the dozens of business lawyers IMS has worked with across the United States, our experience is that they almost universally understand their state laws—*and Delaware*.

Wholly Owned by the Belgian Parent

A few points here. If the US corporation is owned by the individual who ultimately owns the Belgian corporation (i.e., a sister company), they may need to obtain a US tax ID and file US tax returns at some point. And the double taxation treaty offers more benefits to corporate owners.

Typically, the US subsidiary is going to be financed by the trade credit with its Belgian counterpart. The foreign corporation can easily transform its trade receivable into loans and or capital if it is the parent company. This is not so easily done if the foreign corporation is only an affiliate.

4. Business Models

Once a US subsidiary is established, there are two common operating models:

1. The US subsidiary is a full-fledged distributor of the parent's products and or services, or
2. The US subsidiary operates as an agent (e.g., it provides sales and technical support in the US market while the parent company still sells directly to US customers)

The second option has recently become less attractive, since the parent company may generate economic nexus in states where it has sales. (See "State vs. Federal Tax" above.) That said, operating as an agent is clearly an easier, less expensive route, since there is no inventory or customer accounting to manage. Typically, the value of services provided by the US subsidiary in this case is a total of expense plus a small percentage mark-up. The US subsidiary is then profitable and liable for a small amount of taxes.

5. Transfer Pricing

Transfer pricing deals with the pricing between two related parties—in our case, a Belgian company with common ownership. With a Belgian parent and US subsidiary, the Belgian parent management typically sets the price for the goods and services for sale to the US subsidiary. If it is high, more profit stays in Belgium. If it is low, more of the profit flows to the United States. However, the taxing authorities in both countries require that the pricing between the related parties be conducted at "arm's length," as if the parties were unrelated.

The US transfer pricing regulations apply to all US taxpayers that have relationships with related parties, no matter the size of the transactions. This topic must therefore be addressed.

First, transfer pricing regulations apply to more than the exchange of good or services. They apply to *all* transactions within a group, including interest on loans and advances, management fees, leasing of tangible property, use and licensing of intangible property, etc.

The IRS requires all US taxpayers to assemble transfer pricing documentation that demonstrates arm's length pricing each year prior to the filing of the tax return. Many taxpayers utilize outside consultants to prepare transfer pricing reports for this purpose. Admittedly, preparing documentation that meets the US regulations can be daunting in the start-up years. Nevertheless, your pricing strategy can be benchmarked to avoid major adjustments.

6. Employee Transfers

Transferring employees from the parent company to the US subsidiary is usually a key to success in the US market. A transferred employee will embody the culture of the parent company, have deep knowledge of the products and services, enhance the credibility of a new entrant in the US, and will maintain an easier level of communication that draws on relationships with colleagues in the home country. Successful employee transfers are planned and prepared well in advance of the physical transfer. In addition to addressing sometimes complex visa requirements, a potential transfer needs to address three core considerations:

- **Cost of Living Differential:** It is usually understood that an equivalent purchasing power must be offered to the employee.
- **Tax Differential:** The employee may pay more tax in the United States than Belgium.
- **Social Coverage Differential:** What insurance and benefits coverage will the employee have and at what cost?

Typically, all moneys given to the employee in the United States should be considered salary or they will be taxed as fringe benefits including:

- Lodging
- Most moving expenses
- Company-provided car
- Tuition for children
- Plane tickets for spouse and children

A detailed analysis of the full costs of salaries, benefits, and taxes usually brings the pros and cons and trade-offs of a potential transfer into focus—allowing problem areas to become obvious.

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