Tax Considerations & Due Diligence for US Inbound Investors

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CLAYTON & McKERVEY

Today's Presenter

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As an owner within Clayton & McKervey's Small and Mid-sized Entity department, Tim supports Clayton & McKervey's Transaction Service practice while leading the firm's China practice. Joining the firm in 2001, his experience includes entity and organizational structure, U.S. tax planning and compliance, mergers and acquisitions, and repatriation strategies. Tim's specialties include: quality of earnings, due diligence, tax structuring, U.S. and China tax compliance, international tax structuring, Chinese currency controls and repatriation strategies. Tim also facilitates the firm's quarterly CFO/Controller Roundtables and, with the help of the firm's team of Mandarin-speaking accountants, leads Clayton & McKervey's Mandarin Roundtables.

Agenda

- Clayton & McKervey and International Services
- Typical Life Cycle of an Inbound US Business
- Tax Considerations
- Entity Capitalization, Compliance & Registrations
- Transaction Services/Due Diligence Considerations
- Common Questions & Considerations
- Michigan Advantage

Clayton & McKervey International Services

About Clayton & McKervey

- Founded in 1953
- 35 years working with international clients
- Helped hundreds of foreign-owned companies with acquisitions and organic investments in the US

Life Cycle of an Inbound US Business

- » Direct sales of foreign entity
- » Treaty Protected Activities (TPL)
- » US subsidiary – cost-plus sales support
- » US subsidiary – US sales of parent’s products
- » US subsidiary – assembly and manufacturing
- » US subsidiary – acquisitions
- » Exit considerations

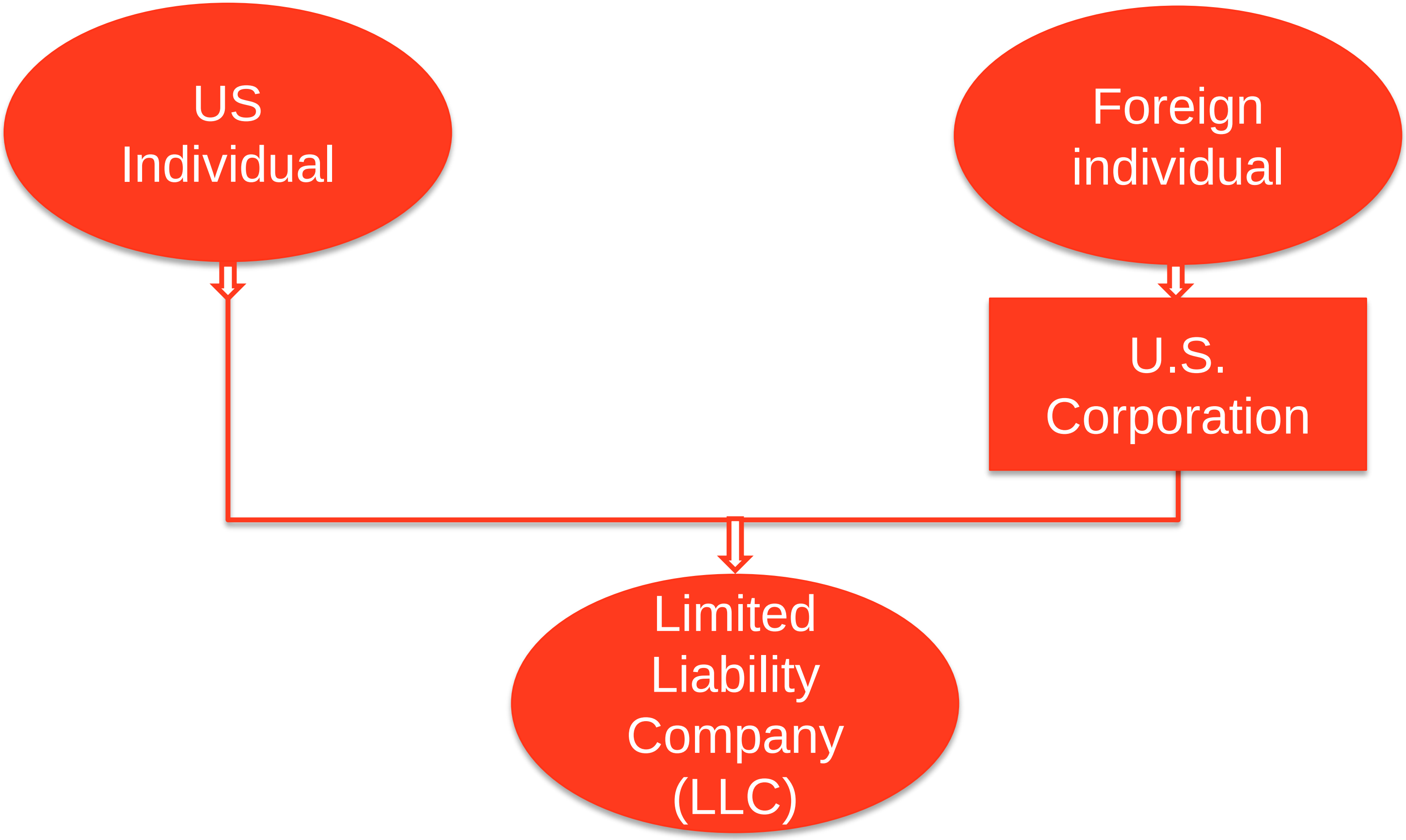
Structuring in the U.S.

- Purpose of the entity
- Repatriation plan
- Ownership of intellectual property
- Permanent establishment
- Tax rates

Entity Structure

- Corporation
- Limited Liability Company (LLC) ; Check the box options
  - Most common is LLC taxed as a corporation
- Partnership
  - Requires withholdings and tax filing
  - Typically use a US blocker corporation
- Branch/Disregarded Entity
  - Double taxation regardless of cash flow to home country
  - Liability exposure

Example – LLC Partnership



Capitalization

Capitalization

- Debt v Equity
  - Profit repatriation impact
    - Interest paid to parent and limits on deductibility
  - Security of investment
  - 100% equity is most common

Compliance & Registrations Requirements

Compliance

- Foreign activity reporting
  - Direct/indirect foreign owners
  - Form 5472 information return of a 25% foreign owned US corporation
    - Reports intercompany activity
  - Form 1042 annual withholding for US source income (treaty or lack of treaty sets withholding rates)
  - Transfer pricing, requires arms-length on all cross border transactions
- Employees working in the US
  - Foreign bank accounts & investments
  - Worldwide income & fringe benefits

Registrations

- Corporate registration
- Federal tax ID number application, SS-4
- State and Local Tax registrations
- Department of Commerce, Bureau of Economic Analysis
  - Initial investment, acquisitions, recurring
  - Tracking direct foreign investment in the US

Due Diligence and Transaction Service Considerations

It is Different

- Must be a US transaction teacher and client advocate
  - LOIs and asset or stock purchase agreements
  - Financial/tax/legal/environmental/HR/vendor/customer due diligence
  - Cash free/debt free
  - Professional fees, legal, CPA, investment banker, environmental
  - Adds credibility to the target
- A relationship likely already exists between buyer and target
  - Have to vet what has been shared verbally and on paper
  - Have to vet any verbal commitments
  - Key advisors on both sides are often left out

Transaction Considerations

- Stock versus asset, buyer may not know there are options
- Tax-free reorganization considerations
  - Asset sale tax treatment on stock purchase
  - An approved vendor status must be maintained
  - S Corp target wishing to sell less than 100% or buyer wanting to buy less than 100%
  - Target has significant legal contracts
  - Target has undesired assets
- Buyer financing and approval
- Engagement scope creep

Transaction Considerations

- » Considerations for foreign investors
- » Location of real property may restrict acquisition
- » Restrictions based on products or customers of target
- » Foreign Investment in Real Property Act (FIRPTA)
- » Foreign asset control requirements

Due Diligence Considerations

- General considerations
  - Quality of earnings
  - Net working capital
  - Defining debt of the Target
  - Tax review

Due Diligence Considerations

- Additional considerations
  - Logistic
    - Language and terminology differences
    - Decisions makers half way around the world
    - Layers of decision makers
    - Time zones
    - Used to their way (Target and their advisors will be wanting the US way)

Due Diligence Considerations

- Additional considerations
  - Target with foreign subsidiary tax compliance
  - Target with net operating losses
  - Duplication or omissions in quality of earnings reports
    - Related party activity/carve outs
  - State tax filings or lack of
  - Transfer pricing

Due Diligence Considerations

Transfer pricing can be the largest, and most overlooked, tax issue:

- » Cross-border transfer prices drive how much taxes are paid by country
- » Every multinational company has a transfer pricing issue
- » Transfer pricing audits can lead to substantial additional tax payments, interest, non-deductible penalties and double tax
- » Some companies have minimal transfer pricing report
- » Many middle-market companies are now IRS audit targets for the first time

Due Diligence Considerations

Key question: How much taxable income does each location earn?

- Auditor red flags: subsidiaries incurring losses or generating minimal profits
- “Is this company shifting profits off-shore – not paying its fair share of taxes?”

Review transfer pricing documentation for the acquisition Target:

- Transfer pricing documentation is an explanation as to why pricing is correct
- If a report does not make sense to you, it will not convince a tax auditor
- IRS now requests transfer pricing documentation as part of every audit

Key Takeaways

- You may end up being a transaction teacher and advocate
- Your client:
  - Has options on their legal structure
  - Has options on what they buy and how much
  - Has options on how they capitalize their investment
  - Needs due diligence
  - Will have additional compliance reporting
  - Will want to know the tax incentive policies available
  - Needs a repatriation strategy
  - Needs a transfer pricing study

Common Questions

Common Questions and Considerations

- Holding company
- Tax incentive policies
- Registered capital requirements
- Tax authority relationship
- Transfer pricing
- Repatriation

Is a Holding Company Necessary?

- Purpose of having a holding company
- Tax treaty impact
- Cash flow consideration

Tax Incentive Policies

- Federal level
- State level
- County/City level

List of Available Incentive Policies

By Business Activities

- Research and Experimentation Tax Credit
- IC-Disc for US export
- Industrial Facility Tax Abatement
- Tax abatements
- Employment grants
- Rehabilitation credits
- Financing support

Minimum Registered Capital Requirement

- Align with your business plan
- Equity investment vs. loan

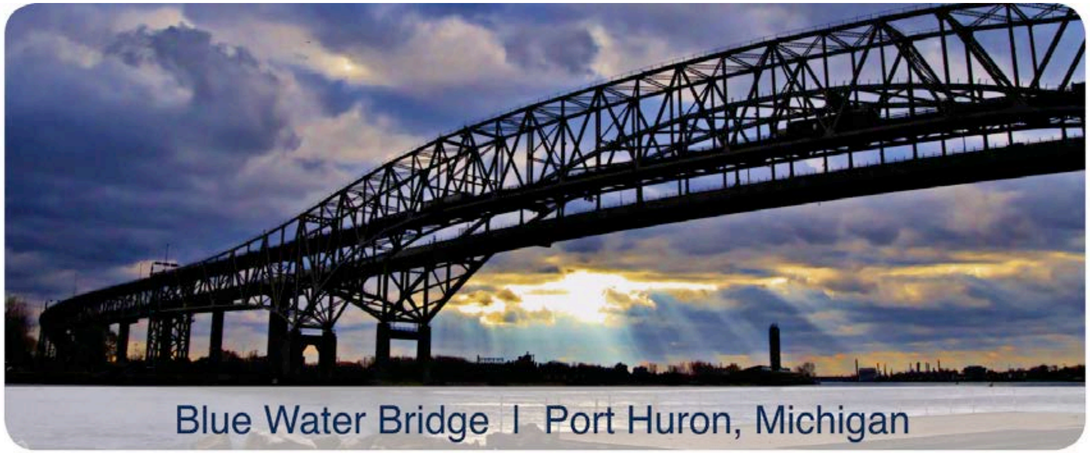
Other Planning Opportunities

- Transfer pricing – risk mitigation with economic benefit
- Repatriation strategies

Michigan Advantage

State Apportionment

- General apportionment
  - Sales, payroll and property
- Michigan apportionment
  - Sales only
- Tax rate is 6% of apportioned sales



Sales – Use Tax

- Services – EXEMPT
- Industrial Processing – EXEMPT
- Resale – EXEMPT
- FDIs are used to VAT

Easy Entry

- Quick & easy to set up
- Low cost on incorporation and annual fee

Questions & Answers

Clayton & McKervey is a full-service public accounting firm specializing in international tax, assurance and accounting services. Headquartered in metro Detroit, the firm services middle-market, growth-driven companies competing in the global marketplace. Our team helps entrepreneurs grow their businesses overseas, from planning and preparation through all stages of operations. We also help foreign-owned companies, from start-ups to multinational corporations, establish operations in the US.

Our focus is exclusively on for-profit entities which has allowed us to specialize in business advisory services, such as succession planning, estate planning, transaction services, transfer pricing, international tax consulting, Research & Experimentation tax credits, and more.

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