Doing Business in the U.S

American State & Local Taxes[1]

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Introduction

Israeli businesses are accustomed to thinking of taxes as being imposed by a single level of government, as is the case in Israel. As a result, some Israeli businesses may be misled into thinking that American taxes also are imposed at one level only. The size and prominence of the United States government's Internal Revenue Service may reinforce that false impression.

In fact, however, all of America's 50 states, the District of Columbia and thousands of American cities, villages and other municipalities levy taxes on income, on the transfer of real property, and on sales and purchases of goods and services.

In addition, Israel's income tax treaty with the United States does not cover state taxes. Thus, state taxes can be imposed even in circumstances when federal income taxes would not be relevant.

State and local tax liabilities can be substantial. Therefore, U.S. businesses dedicate considerable time and resources to planning for and defending against the imposition of these taxes. Israeli businesses wanting to compete in the United States must act accordingly. At a minimum, Israeli businesses must be aware of the existence of these taxes so that they, like their American competitors, can seek expert assistance in planning their entry into a state and their operations there after initial entry. This introduction to American state and local taxes is intended to make Israelis aware of some of the pitfalls and planning opportunities these taxes present. However, it is not a substitute for obtaining expert state and local tax advice. Further, the tax traps and planning opportunities identified are examples only and may apply to some businesses but not to others.

I. Getting Started: Choice of Entity and State of Formation

Background: Experience shows that Israeli businesses entering the United States tend to form new corporations under Delaware law to conduct their United States business. While that might be an appropriate decision for some businesses, there are alternatives that should be considered. A different choice might be more appropriate for other businesses. A partial list of considerations includes:

• For corporations and LLCs, forming in Delaware might lead to an unnecessary duplication of annual fees paid to secretaries of state, as those fees also will be required to be paid to the state where the business' headquarters are located.

• If the business generates losses while affiliates are or will be operating at a profit, there may be a state income tax advantage to using a SMLLC. Doing so may allow one business'

losses to be offset against its affiliate's gains where that would not be possible under a corporate form.

• Corporations generally are subject to two levels of income taxes, while LLCs and partnerships generally are not.

II. Setting Up Shop: Obtaining Tax Benefits and Controlling "Tax Presence"

Background: States and cities are eager to attract new businesses, and many of both send business development delegations to Israel. A business looking to establish an office in the United States should investigate the potentially available tax and investment incentives and should schedule meetings with local business development offices. Tax incentives may include making equipment and other purchases nontaxable, providing a sharing of sales tax collections, allowing for vacations from property taxation and other benefits.

Apart from the location of headquarters facilities, businesses must carefully consider where they will have other offices, warehouses or property. Having an office, warehouse or property in a state might create a sales tax collection responsibility where there otherwise would not be such an obligation. Such an office can be created by something as simple as having a salesperson use his home to store goods, meet with clients or receive payments or correspondence from clients. Businesses need to set guidelines for what salespeople can and cannot do. Failure to do so can cause the business to have a substantial annual tax liability that will not be discovered for years.

III. Selling: Making Goods and Services Cheaper for Customers and Complying With State and Local Remittance Requirements

Background: State and local sales and use taxes may be the most important taxes for Israeli businesses selling into the United States. Almost every state and thousands of cities and other municipalities impose sales and use taxes. These taxes are an important source of state and local revenue and may be imposed at combined state and local tax rates of up to 9 percent of the purchase price of goods or services.

Sales and use taxes generate substantial potential exposure for businesses and for business owners, executives and employees. In addition, the taxes can be large enough that they can affect purchasing decisions by potential customers. Tax planning here is essential, as is the careful organization of a business's responsibilities so that all taxes are being properly collected and remitted to the states. The first step in complying with sales tax requirements is to complete required tax registrations with the states.

In addition, the most effective tax planning occurs in cooperation with the states, obtaining the states' acknowledgement that specific sales are partially or wholly nontaxable. An alternative type of sales tax planning relies on the seller's lack of tax presence in the market state.

IV. Annual Taxes on Business Activities: Income Taxes, Gross Receipts Taxes and Other Taxes

Background: State business activity taxes are not covered by Israel's income tax treaty with the United States. These taxes can be imposed even when the Israeli business is not subject to federal income taxation. These taxes can apply even when a business only contact with a state is through its licensee's use of a trademark, patent or copyright in the state.

Most states and some large cities levy taxes on businesses generating revenue in the jurisdiction. Income taxes are the most common type of these "business activity" taxes, but several large jurisdictions collect taxes on gross receipts, gross profits and other alternative bases. Traditional planning for income taxes may not be effective against these alternative taxes, although other planning is possible depending on the taxpayer's status.

1. Almost all states impose some type of direct tax on business activities. These include income taxes, franchise taxes based on net income, gross receipts taxes and others.

2. Unlike sales taxes, business activity taxes are not passed through to customers but instead are imposed directly on businesses.

3. Unlike federal income taxes, these state taxes are not subject to Israel's tax treaty with the United States.

4. Companies licensing trademarks, patents, copyrights and other intellectual property may be treated as having tax presence in a state merely because the licensee uses the trademark, patent, copyright or other intangible in the state.

Example: An Israeli business licenses the use of its manufacturing patent and trademarks to its United States subsidiary. The subsidiary pays a royalty to the Israeli parent. The subsidiary uses the patent in its manufacturing operations in South Carolina and sells its manufactured goods in 10 states across the country.

a. The Israeli parent will be subject to South Carolina income tax as a result of the licenses. In addition, the parent's lack of physical presence in other states where the patent and trademarks are used may not prevent the parent from being taxable in those states.

b. The Israeli parent also may be treated as being subject to business activity taxes in the 10 states where the protected goods are sold.

c. The Israeli parent may be subject to income taxes in South Carolina and the other states even if it does not have a United States "permanent establishment" for federal income tax purposes and is not subject to federal income taxation.

5. In general, businesses are not required to register for business activity taxes. However, registration may be required for other purposes.

6. Estimated tax payments may be required for business activities taxes.

7. State business activity taxes may be deductible in computing the business's federal income tax liability. However, taxes owed to one state generally are not deductible in determining business activity tax liabilities owed to other states.

8. Transfer pricing agreements.

a. A well drafted transfer pricing agreement, supported by a pricing study performed by a qualified expert, can reduce state income taxes and franchise taxes based on net income.

b. However, transfer pricing agreements may not reduce gross receipts taxes.

i. States increasingly are using these taxes to avoid traditional income tax planning, including tax reduction through the use of transfer pricing agreements with out-of-state affiliates.

ii. Some states deny corporations deductions for royalties and interest paid to affiliates.

iii. Since 2002, New Jersey, Ohio, Kentucky and Texas have enacted gross receipts or gross profits taxes. These taxes are imposed on sales revenue or sales revenue less costs of goods sold.

9. Other tax planning is possible, specific to each taxpayer's facts.

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1. From the upcoming Hebrew language publication "American State and Local Taxes: Risks and Opportunities - What Israeli Businesses Must Know". For the complete publication, please contact David A. Fruchtman at the e-mail address below.

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