Foreign Direct Investment in the US – Guidance for the European Investor

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1 Executive Summary

On July 2, 2019, the Bureau of Economic Analysis released the 2018 numbers for foreign direct investment (FDI) in the US. Total 2018 FDI was $273 billion and of that figure, European investors accounted for $116 billion or roughly 42% of the total of FDI. This figure also makes Europe the number one region on the globe for investment value in the US.

Getting started on a US acquisition or “greenfield” project in the US can be daunting for the first-time European investor. This paper provides guidance for European businesses investing in the US. We describe the key decisions the European investor must make regarding the location and structure of the US investment and include general guidance on managing the US taxation of the investment. It is hoped this information will also be the basis for seeking further advisory contact.

2 Investor Due Diligence

The level of European direct investment in the US continues to hold despite increasing friction between the US and Europe over trade matters and, more recently, the validity of digital sales taxes in Europe (France, UK, Austria and others). Both the US Congress and President Trump have threatened retaliation against France for enacting a digital sales tax (DST) retroactive to January 1, 2019, the first DST to go into effect. This conflict over tax sovereignty, if it continues, could likely have a chilling effect on some European investment in the US if the US decides to follow through on her threats of retaliation.

The rest of the European investment story remains positive, however. The tax advantages under the Tax Cuts and Jobs Act (TCJA) that the US Congress passed at the end of 2017 are largely responsible for the sustained interest of European investors in the US. The business-friendly provisions in the

TCJA, particularly the double-digit US corporate tax rate reduction to 21%, had an immediate and positive impact on the financial bottom line of most US businesses in corporate form, whether US or foreign owned.

Where and how does the European investor begin its US due diligence? This paper provides some guidance to the European investor on key fiscal and related factors to consider in deciding where to set up the US investment and how to structure it beneath the European investor group. The factors presented here should be included in the first chapter of any European investor's US business plan.

In addition to the US tax rules, there is a myriad of state and local tax (SALT) regimes across all 50 states in the US. In our experience, the SALT burden on the business location can be a significant factor in the location decision and thus deserves reference here in the US investor roadmap. Depending on the specific sector of the European investor's business, there will be other regulatory and legal issues to consider, of course, e.g., intellectual property protection, environmental regulation and compliance, energy issues, product liability, labor law, supply chain management, contracting, privacy law, employment law, corporate law, etc. These collateral issues are within Womble Bond Dickinson's competence but are beyond the scope of this roadmap.

3 Investor Choice of Location

The first decision an investor must make after the management commitment to invest in the US is the investment location. In our experience, the location decision is based on one or more of the following factors:

By Target Acquisition

In fact, the majority of European investment in the US by value is through the acquisition of an existing US business (the Target). The US Target can be a competitor or a peer, such as a key partner in the US distribution (or supply) chain for the products of the European business. Often there are cost and other efficiencies for the investor to simply stay in the geographical location of the Target company since that is where the personnel (know-how) and capital assets of the Target are based.

By Supply Chain Network

The location of sector suppliers can be a major factor in the European investor decision where to locate. A good example of this is the automotive industry. Suppliers and their original end manufacturers (OEMs) have a common business interest in locating in close geographic proximity and usually within the same state. Similarly, investors will want to go where there is a concentration of natural resources that are essential to producing the final product, as is the case for wood products (timber), food manufacturing (crops, farmland), and other agricultural-based products (dairy, livestock). The nature and kind of human capital that is concentrated in a particular city or region is also a resource that can drive investor location decision (e.g., Silicon Valley, Research Triangle Park, Boston, and any large state University clusters).

By Distribution Network

Some European investors may have established a US customer base without ever having created a US taxable presence in the process. A manufacturer of heavy industrial products may sell initially in the US through an independent distributor. The European manufacturer's transaction chain through the US distributor (e.g, via buy-sell or commission) generally can be structured in such a way to avoid US tax on sales to the US customers. The investor may wish to locate in proximity to the distributor, in particular if that distribution relationship continues after the US investment is in place. This preservation of the pre-investment distribution chain is not uncommon in the case of European manufacturers of heavy industrial equipment.

By Customer Base

This is the corollary to the supply chain factor above. In the last 20 years, sector clusters driven by largely foreign OEM location decisions have evolved in regions of the US like the South and Southeast. Typically, the supply chains follow the investing OEMs. As more OEMs follow the first pioneer OEM to a particular geographic location, the sector cluster is quickly created. For certain mature industries like automotive and aviation, it is rare if not excluded that the next foreign OEM in that sector coming to the US will want to invest outside of an existing geographic sector cluster.

By Key US Employees

For European services companies but also for small and medium sized manufacturers (mostly privately owned), we have seen investors go to the location that is influenced by the US geographic preference of key US employees. These key US employees are often former US-based sales agents or personnel of a local partner of the investor who the investor then takes on as a full-time employee and executive of the US business. Similarly, the location decision can be influenced by an executive or executives based in the European business who may lead the US investment project and be seconded to the US business for the initial start-up years to get the business up and running and integrated with the supply chain, for example, of the European business.

By State Incentive Program

As the European investor knows, the granting of economic and fiscal incentives to a specific company as incentive for investment is considered illegal state aid under European Union law. In contrast, in the US such incentive grants are common practice and are sometimes available to both US and foreign groups. The only federal issue for these state benefits is the US taxation of those benefits. The state pursuit of medium to large investors is highly competitive, particularly for the kind of investment that is employee intensive. A manufacturing base is a common kind of employee intensive operation for which state incentive programs are designed. But there are other investment variations that the incentive programs benefit, including US and regional corporate headquarters, shared services centers, and regional logistical hubs. The US investment friendly provisions in the TCJA and the recent record of success of the US economy encouraged a surge in foreign investment which in turn increased state competition for this increased investment.

State incentive programs often derive from state legislation. Local government bodies will also participate in developing a company specific incentive package which will add value to the overall state incentive package. The European investor needs to know before it begins its due diligence that in order to qualify for consideration for a state incentives package it must have what we call a “defined investment project”, that is, the investor is able to demonstrate that it is ready to set the investment project in motion once the state makes the incentives decision. This is done by the investor providing significant detail regarding the investment site and building requirements, energy use and transportation access, the amount and kind of capital investment, the number of employees anticipated, and how the employee number will evolve over the initial five years of the project. The investor typically must represent to the state that its project is competitive, that is, but for the state award of the incentives package, the investor would not otherwise decide invest in that state. As a practical matter, this means that the investor must genuinely engage in incentive discussions with at least one other state in order to qualify for another state's incentive program.

The amount of the state level incentive available for a defined investment project is usually determined in part by a formula that is related to the number of employees associated with the project and their respective salary levels. Typically the incentive relates to the amount of state wage tax that corresponds to the reported salaries. The formula can be further calibrated depending on the prosperity of the region of the state where the investment is intended. The state incentives portion of the investment location analysis is critical and complex. Qualified outside counsel can help the investor manage all aspects of the incentive process to a successful conclusion which is to obtain from state and local authorities the maximum amount of incentives for the company in a specific location for its specific business.

By State Business Climate (including SALT)

We consider business climate a more subjective factor from the ones above but it is worth mentioning here. How an investor values a state for its business climate depends on the facts and circumstances of the investor and its defined US investment. There are national publications that like to generate reader interest by producing annual lists that measure the relative value of each state's business climate. Such ratings alone are of little value for what is ultimately best for the defined investment project.

State business climate typically includes state income tax, sales tax (state and local), use taxes, property taxes and other tax levies (SALT). Over time, the SALT landscape of a state has become a more important component of the investment location decision as pressure increases on states to lower their corporate income tax rates. There can be material differences between locations across state lines and even within the same state. Again, it can be of value to engage qualified outside counsel to help the investor quantify the SALT benefits and burdens specific to the defined investment project and the location options.

4 Investor Choice of US Business Presence

The next basic decision a European investor needs to make is the business structure of the US investment. This decision includes up to three elements: (i) the form of the US business presence, (ii) the type of legal entity that will own the US investment and (iii) the structure of the first tier European owner (the European parent) of the US investment.

There is no "one size fits all" approach to the US investment structure. How the US investment is structured will generally depend on the kind of business activity on the ground in the US, the tax profile of the foreign investor (e.g., how it wants to be taxed in its home jurisdiction on the results of its US investment), whether the investor is a public or private company, and what other foreign jurisdictions might be involved in the investment structure. Following is a list of the typical US business presence.

Limited Representative office

The rep office is typically the first step that a European investor will make to establish a physical location in the US, for example, when the investor does not already have customers in the US or when it begins to develop more intensely an existing US customer base. The rep office can function as a local marketing arm of the foreign investor and for network building and information gathering purposes. The European investor's tax planning goal in this case should be to set up the physical rep office location in the US without the rep office creating a taxable presence for the investor (tax presence also referred to as a US trade or business, tax nexus, a branch or, where a bilateral US tax treaty applies, a permanent establishment (see below)). The tax nexus that the rep office creates for the investor will subject investor's US sales to US tax, an unintended result. US trade or business status will create US tax return and information filing obligations and, in most cases, state and local tax filings.

US trade or business status is not an election for the European investor. Provisions in bilateral US tax treaties can mitigate if not eliminate the risk of US trade or business status, provided the European investor activities respect the narrow definition of permanent establishment in the treaty. The tax treaties the US has with European countries contain a definition of permanent establishment. In contrast, under US tax law, whether a foreign investor has a US trade or business is a facts and circumstances determination. There is no real guidance in the US tax code or regulations, and limited insight in the few rulings and cases that exist. The permanent establishment concept offers a significant benefit to cross-border businesses with its narrowing of the US trade or business concept.

Representative office with after-sales services to US customer base

This is a variation of the limited rep office presence, above. The European investor sells services or product directly to US customers through a modest, wholly-owned operation in the US for marketing (as above) and for the performance of after-sales services for its products. Direct sales involvement by the rep office increases the risk of creating a US trade or business for the investor but such risk can be significantly mitigated under the applicable US tax treaty.

Sales office for US customers

In this structure, the investor sets up its US location with personnel and resources to actively generate sales to US customers and begin to create a material market presence in the US. The sales office may generate income from its sales activity which is taxable in the US but, with proper planning, the revenue that the European investor earns on the sales should not be taxable in the US.

Manufacturing presence

The European investment statistics show that a significant portion of foreign direct investment (by value) occurs through the foreign investor acquisition of an existing US business. Manufacturing is the most common sector in which the European investor builds its US business from scratch (greenfield investment). The greenfield manufacturing project is also the kind of European investment for which there is fierce competition for the US location decision of that investor. As described above, the value of state incentives programs are directly related to the number of persons the US business will employ and their salary levels.

Consulting and other high-end services

High-margin business consulting is another example of a European investment that may constitute a greenfield situation. Usually the investor will use US personnel for US consulting to US customers. What is duplicated from the home country are the consulting lines and the revenue model that has already been proven in the home market.

Disruption of the digital business model to international tax norms

A word about digital business models should be included in a discussion on direct investment structures. The rapid growth of the digital economy has made less critical the need for a business in one jurisdiction to have a physical presence in another jurisdiction in order to attract and retain customers. For one, digital goods and services can be easily delivered through the internet to the consumer almost anywhere in the world. With regards to traditional tangible goods, the proliferation of digital platforms has dramatically changed the purchase and delivery of physical products domestically and cross border.

In the digital economy, the ownership of high value intellectual property can be transferred to a low tax jurisdiction and generate income there in connection with the digital supply chain. Goods and services can be sold and supplied into the customer ("market") jurisdiction without the revenue those sales generate being taxed in the market jurisdiction (putting aside VAT liability on consumption in that jurisdiction). The seller of the digital goods and services need not have a physical presence in any of the jurisdictions where the customer is located and therefore under current international tax principles cannot be subject to tax in that jurisdiction, without more. This offers the digital business model a significant advantage over the local bricks and mortar operations for digital goods and services that can be delivered through the internet or those goods that can be purchased on the internet from remote sellers (i.e., sellers established outside the market jurisdiction).

If properly planned, the business can realize its revenue in a low tax jurisdiction while its competitors based in the market jurisdiction are usually subject to the higher market jurisdiction tax burden. There are two perceived inequities in this dynamic. First, the digital platform and supply chain allows a business to "have scale without mass" in the market jurisdiction. Scale refers to a significant customer base and mass refers to a physical presence in the market jurisdiction. The physical presence of the business in the market jurisdiction would create a taxable presence for the business and thus there would be some tax liability on the revenue the business generated from the customer sales in the market jurisdiction. There would be some notion of tax parity in the market jurisdiction for the local business and the foreign business. (For VAT purposes, such tax parity exists in large part due to the 2015 VAT regime which aligned place of taxation rules on B2C digital services for so-called remote seller and local sellers.)

The second perceived inequity is the ability of multinationals to set up the relevant digital business in a low tax jurisdiction (by law or by tax ruling) so that the revenues earned in the market jurisdiction were subject to low or no taxation when earned. Such tax structures, largely US to Europe and Europe to Europe, were set up within the parameters of existing international tax norms under national laws and tax treaties. The matrix of international tax rules which made this and other kinds of tax arbitrage possible was largely tolerated. The G-20 decided in 2013 to kind off a tax policy project that would identify those structures in the matrix that were considered overly aggressive and seek to find solutions to mitigating if not eliminating the use of these structures to move income from high tax jurisdictions into very low tax jurisdictions. The plan to make taxation proposals to address the developments in the digital economy was put on hold until 2017 when an entirely separate project was born of the original BEPS project. The G-20 has endorsed the work to date of the OECD project team and the project is on an ambitious timeline. In addition, the scope of the project has now gone beyond a digital economy focus. Fundamental changes to international taxation that could affect all sectors, not just digital, are on the table.

The next milestone in the project is to get G-20 approval for detailed rule proposals the OECD team will deliver before the end of 2019. If the G-20 accepts the team's proposals, as it has done every other time, it will be a significant step toward getting the proposals adapted into law in some jurisdictions. On both the BEPS project and in enacting "proprietary" international tax legislation in the 2017 TCJA, the US has demonstrated its ability to "go it alone" and reject multilateral initiatives while at the same time participating in the formulation of those initiatives. We are closely monitoring the OECD project and will continue to provide analysis that will help business to prepare for what fundamental changes in taxation might emerge in both the home jurisdiction and the market jurisdictions, US and foreign.

The function of US income tax treaties to enhance cross-border investment

The US has a bilateral income tax treaty with virtually every country in Europe, including a treaty with every member state of the European Union. Tax treaties are in principle intended to ease the tax burden on cross-border trade between the two treaty countries. This is done by providing for a common approach to the taxation of cross-border payments and investments, and to provide a mechanism to eliminate the risk of double taxation on cross-border investment between the two treaty countries.

5 Investor Choice of Direct Investment Vehicle

The following is a list of the various ways a European investor can structure its investment in the US. Which structure will be best for the investor will depend on many factors such as the structure of the European shareholder, the kind of activity intended, the sector, and the location of customers, to name a few. Each kind of investment vehicle brings with it a set of US tax planning considerations.

US corporation

The use of a US corporation, or C corporation, is the most common choice for the first tier US investment vehicle in the ownership structure. Profits and losses of the US business are captured in the C corporation and subject to US corporate tax at the corporate level. The C corporation can distribute dividends to its European shareholder, typically at a reduced US withholding tax rate for payments to qualified residents of the US treaty partner. The treaty withholding tax rates for dividends vary between 5 and 15%, compared to the US statutory rate of 30%. If the dividend is taxable to the shareholder on receipt, the shareholder may get some double taxation relief through a credit for the US withholding tax paid on the dividend. In addition, the dividend received may be exempt from corporate tax in the jurisdiction of the shareholder.

US branch of the European parent

The European parent can invest directly in a US business without setting up a US corporation. In the case of the European corporate shareholder, this direct investment is referred to as a US trade or business, a branch, or a permanent establishment (if applicable treaty exists). The branch will be taxable in the US on a net basis, that is, it will be able to determine its US tax liability by taking into account US income and expense allocable to the branch. There is an additional level of tax on branch earnings that are remitted to the European parent called the branch profits tax. The tax is collected through withholding at the branch level. The statutory branch profits tax rate is 30%. This is reduced to 5% under most bilateral US treaties.

US Permanent establishment – defined thresholds for US taxation

The concept of the "permanent establishment" is well-developed under international tax treaty law. It is a very important modifier to the much broader concept of a US branch or under domestic tax law. A US branch is not defined in the Internal Revenue Code but refers to the US trade or business of a foreign corporation. The US trade or business concept applies to both foreign corporate and individual investors.

US permanent establishment planning usually involves a foreign investor that wants to engage in a business activity in the US without creating a US taxable presence and the corresponding US tax reporting and return obligations. For purposes of the European investor's US planning, the permanent establishment concept provides certainty that does not exist under domestic law. A permanent establishment is defined by activities that the European investor can conduct through a physical presence that do not create a taxable presence (safe harbors). If the activities of the foreign investor are within these safe harbors, US tax nexus can be avoided. This treaty protection allows the European investor to get into the US market to a certain extent before its activities create a taxable nexus for it.

US partnership

In our experience, the corporation is the preferred entity for the first tier in the US ownership structure. If either a US or foreign partnership is chosen as the US direct investment structure, the partners, not the partnership, will be subject to US tax on partnership distributions and allocations, depending on the activities of the partnership in the US. In addition to the filing of a US partnership return, the partnership will be subject to a set of complex IRS reporting requirements related to the US activities of the partnership that will be attributed to its foreign partners and distributions and allocations to those partners under the partnership agreement. Individual foreign partners will be subject to US estate tax on the US assets of the partnership. In order to avoid US estate tax, the individual partner can set up a foreign corporation to hold its partnership interest. The US through its "check the box" entity classification rules offers the European investor the opportunity to use for corporate liability purposes a limited liability corporation that it can treat as a partnership for US tax purposes. The foreign investor will also want to make certain what the entity classification is for the direct foreign shareholder of the US structure for US tax purposes. The foreign investor may prefer to use a flow through structure beneath the first tier US corporation, which can be achieved with a conventional partnership structure or through the flexibility of the US check the box entity classification rules.

Foreign partnership

A foreign entity can also benefit from the US check the box rules for planning for the US taxation of the foreign parent. In the US inbound context, the entity characterization is mostly relevant for the direct foreign shareholder of the first tier US entity.

US entity classification or "check the box" rules

The US has unique and well established rules for determining the classification of US and foreign entities for US tax purposes as a corporate entity or as a flow through entity. These rules are referred to internationally as the "check the box" rules because in most cases, the entity classification can be elected by "checking" the appropriate box on IRS Form 8832 at the time when the classification becomes relevant for both US and foreign entities for doing business. If no timely election is made for the US and foreign entities in a US investment structure, a default entity classification can apply which could lead to unintended results in terms of US taxation. This default classification is often a trap for the unwary foreign investor as the entity classification election cannot be made retroactive.

US estate tax jurisdiction for company shares

A foreign person can be subject to US estate tax if such person owns, or is treated as owning, US property at the time of death. US property includes shares in a US corporation. It does not include shares in a foreign corporation that holds shares in a US corporation.

The generous US estate tax exemptions for US persons do not apply to a foreign person. In order to avoid this estate tax risk with respect to a direct holding of shares in a US company, the individual European investor will typically use a foreign company in his or her home jurisdiction as the shareholder of the US company that holds the US investment. In this case, the European investor will want to be sure that the foreign entity is treated as a corporation and not as a partnership for US tax purposes. This is where the US "check the box" entity classification rules can also come into play.

6 Investor Activities Pre-US Business

A key planning consideration for the European investor is to control the timing for when that investment becomes subject to US tax. The European investor should take care to avoid creating tax nexus in the pre-tax start-up phase which is typically before the US investment or acquisition entity is formed.

There are several ways in which the European investor can unknowingly create a taxable presence in the US before its investment goes operational. The investor's pre-investment activities should be carefully reviewed to determine whether the investor has become subject to US tax. The investor will want to insure that any material costs are incurred after the investment becomes subject to US tax.

A significant physical presence of non-US employees of the European investor in the US can create a US taxable presence for the investor, US tax liability for the employee, and a US payroll tax withholding obligation for the investor.

7 Ongoing US Business

Once the investment structure is in place, the investor will want the taxation of the ongoing US business to remain efficient. Under the TCJA, a US company can elect bonus depreciation for certain capital assets it has acquired. Bonus depreciation is a 100% write off of the capital asset in the year it is acquired.

There are a number of ongoing US filing obligations in connection with foreign ownership of a US business including US tax returns and information returns. Where certain US tax treaty benefits come into play, the investor may need to file IRS Form 8833 to disclose its entitlement to those treaty benefits. Similarly, the US entity will need to obtain withholding tax certificates from the investor in order to mitigate or eliminate US withholding tax rates on payments it might make to the investor such as interest, dividends, and royalties. The US statutory withholding rate is 30%.

Usually there will be significant financing of a European start-up business in the US. The TCJA introduced a new limitation on interest deductions equivalent to 30% of the US corporate debtor's adjusted gross income, a defined term.

In addition, typically there will be other transactions between the US business and its European parent group which will need to be analyzed, structured, and documented in compliance with US and home country tax compliance standards for transactions between related parties (transfer pricing).

State and local tax (SALT) planning will need attention as well. This includes state income tax planning and the management of non-income taxes such as state and local sales and property taxes. Generally, the state corporate income tax base conforms to the Federal rules but there are certain adjustments at the state level that can modify the Federal income tax base for the state tax return. In addition, US tax treaties do not apply to state income taxes per se, so that certain US tax benefits conferred under an applicable income tax treaty do not automatically apply to determining the state's right to tax the business.

8 Collateral Issues for the US Business

This guidance covers some of the key decisions for the European investor to consider in deciding where and how to put its US investment structure in place and to operate it in a tax efficient way. Tthere are many other US legal issues that the European investor needs to consider when setting up and running its business.