

## An Overview of Federal Taxes

---

Taxes in the United States are levied at the federal, state, and sometimes local levels of government. Federal taxes include individual and business income taxes, capital gains taxes, estate taxes, payroll taxes, unemployment insurance taxes, and others. The State of Michigan levies personal income taxes, sales taxes, use taxes, and a form of value-added corporate tax - the Single Business Tax. Individual income taxes are not covered here.

Business Tax Rates - 2005	
<b>Federal Corporate Income Tax</b>	
<b>Rate</b>	
\$0-50,000	15%
\$50,000-\$75,000	25%
\$75,000-\$100,000	34%
\$100,000-\$335,000	39%
\$335,000-\$10,000,000	34%
\$10,000,000-\$15,000,000	35%
\$15,000,000-\$18,333,333	38%
\$18,333,333 +	35%
<b>Federal Partnership Withholding Tax</b>	
<b>Rate</b>	
• Corporate foreign partners	35%
• Noncorporate foreign partners	35%
<b>Federal Payroll Taxes</b>	
<b>Rate/base amount</b>	
• Medicare	
-Employee	1.45%
-Employer	1.45%
• Social Security	
-FICA base	\$90,000.00
-Maximum FICA tax (employee)	\$5,580.00
-Maximum FICA tax (employer)	\$5,580.00
• Unemployment Tax	
-FUTA-base	\$7,000.00
-FUTA rate	.8%

### Federal Corporate Taxes

Corporations are subject to a set of graduated income taxes based on net income, or profits (generally gross revenue minus deductible costs). Deductible costs include interest, materials, wages and depreciation.

The federal **Alternative Minimum Tax (AMT)** prevents corporations from using deductions, credits and exclusions to eliminate or significantly reduce tax liability. The AMT is a flat rate of 20 percent, applied to a broader base and narrower set of deductions than the traditional federal corporate income tax. If a company's regular federal tax liability is less than the liability calculated under AMT rules, the AMT must be paid.

## Payroll Taxes – Federal and State

Payroll Taxes include taxes employers are required to withhold from the paychecks of their employees, as well as taxes employers are required to pay directly, on behalf of their employees. Detailed rules determine which wages and benefits are taxable, which employees are taxable, and what exemptions are available. Generally, employers will be responsible for payroll taxes for workers classified as “employees,” but not for “independent contractors.” Employees vs. independent contractors are discussed further under the “employees” section above.

Taxes employers must withhold include federal, state, and sometimes local income taxes.

The federal **FICA taxes** are comprised of Social Security and Medicare taxes. One half of the FICA tax a business pays is withheld from employees and the other half paid directly by the business. Currently, employers must withhold 6.2 percent of employees’ wages for social security and 1.45 percent for Medicare and pay a matching amount for each. For 2005, the social security “wage base” is \$90,000; further earnings are exempt from social security tax.

Employers in the Detroit Region must pay **federal (FUTA)** directly; these are not withholdings from employee paychecks. The federal FUTA tax is currently a flat 6.2 percent rate imposed on the first \$7,000 of wages paid to each employee annually (beyond the first \$7,000 there is no further tax liability for that employee). A credit of up to 5.4 percent may be claimed to reflect paid state unemployment taxes, lowering the FUTA rate down to a maximum of 0.8 percent. The FUTA rate is scheduled to decrease, though the decrease may be postponed.

## Taxation Issues for Foreign Companies

United States domestic corporations and residents are subject to corporate income tax on their entire *worldwide* income, including capital gains, regardless of source. Residency rules consider corporations and general partnerships to be residents if incorporated or organized under United States laws. As resident corporations repatriate proceeds to their foreign parent companies, the transfers become subject to a flat 30 percent withholding tax, though credits and deductions are available with certain tax treaty countries, reducing and in some cases eliminating this secondary tax.

### Tax Relief

Your company may be eligible to reduce its tax burden significantly due to aggressive business attraction programs offered the State of Michigan and county and local governments in the Detroit Region.

The Detroit Regional Economic Partnership works closely with the public sector to help clients take advantage of available incentive programs. Contact us for a consultation.

Non-resident aliens and companies are only subject to tax on income derived from U.S. sources, as determined by the sourcing rules of the Internal Revenue Service. Sourced income that is deemed “effectively connected” with the conduct of a U.S. trade or business will be subjected annually to the graduated net progressive federal income tax rates of up to 34% for corporate investors and 31% for individuals. However, most of the tax treaties define the effectively connected income as derived from a “permanent establishment” within the United States, meeting certain criteria as a fixed place of business in order to be taxable under the net progressive corporate rates.

A 30 percent flat withholding tax at the source of payment applies to gross passive income for non-residents, though this rate is lowered for qualified residents of tax treaty countries. However, such passive income is only taxed if deemed “fixed or determinable, annual or periodic” (FDAP), such as interest, dividends, royalties and rents. Income from the sale of capital assets, such as corporate stock is not considered FDAP income unless “effectively connected” with a U.S. trade or business.

In addition to corporate income taxes, foreign companies may also be subject to branch profits taxes or branch-level interest taxes, intended to place foreign companies operating through branch offices in a similar tax position to those operating through an incorporated U.S. subsidiary. The branch profits tax is a flat 30 percent tax levied on profits (*after* effectively connected income taxes) that are not reinvested in the U.S. branch company. As withholding taxes apply to the dividend distributions of corporate subsidiaries, branch taxes function similarly as a secondary tax, though double-taxation at the corporate level puts foreign branches at a tax disadvantage to domestic firms. Several countries have tax treaties with nondiscrimination clauses eliminating the branch tax altogether.

Transactions between a foreign corporation and its parent company are regulated by the Internal Revenue Service's transfer pricing rules. To prevent tax avoidance through pricing schemes, "arm's length" prices must be used in the various transactions between parent companies and subsidiaries. The IRS has broad authority to reallocate assets where transfer pricing rules have not been followed.

The above commentary merely scratches the surface of the highly complex and technical issues involved in international taxation. Space does not permit a proper elaboration of the concepts introduced, which any business planning international business structures should pursue with an expert who can help tailor a solution in light of the company's unique financial structure and country of origin.