**Establishing a Business Entity in the United States**

Philip Stein & Associates, Ltd is the largest U.S. tax accounting firm in Israel. We have been guiding Israeli companies and entrepreneurs who want to set up an entity in the United States for over 40 years. This E-book is meant to give you general guidance to help you make the best decision on how to set up your business and avoid common tax problems that new companies regularly confront.

• This E-book will give you some basic knowledge about the U.S. tax system.

• After you read this E-book, we invite you to contact our experienced staff to answer your questions.

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Chapter 1: Choose an Entity............................................3

Chapter 2: How Do I Fund My U.S. Operations?.............5

Chapter 3: Getting Started...............................................8

Chapter 4: Tax Considerations........................................9

Chapter 5: Employees and Contractors........................11

Chapter 6: Equity Awards...............................................13

Chapter 1

The first decision you need to make is what entity you want to use to operate your business. The three most popular options are:

A. U.S. Corporation

B. Limited Liability Company (LLC)

C. Branch of an Israel Company

**U.S. Corporation**

This is an entity for active businesses operating in the Unites States, it is most appropriate for people who are looking to hire employees and set up a physical office. We can help you set up the corporation in a matter of days so you can start running your business as soon as possible. In addition, we will help you get an Employer Identification Number (EIN), register your business in the states you are doing business in, help you set up your payroll for your employees and help you open a bank account. Your U.S. customers will be most comfortable doing business with this type of entity.

**LLC**

This is a transparent entity for U.S. tax purposes and is very appropriate for businesses who are not yet ready to set up physical operations in the U.S. but want to have a legal entity to transact business. This entity can easily be converted to a regular corporation as the business grows. This entity provides liability protection for the shareholders and even though it does not pay tax, your customers will feel comfortable doing business with it. We will help you get an Employer Identification Number (EIN), register your business in the states you are doing business in, help you set up your payroll for your employees and help you open a bank account. Your U.S. customers will be very familiar with this type of entity.

**Branch**

You have no need to open a new legal entity, but it potentially exposes your worldwide corporate activities to U.S. tax jurisdiction. In certain cases, we recommend filing a “protective” tax return to lessen your exposure to U.S. tax. We would recommend analyzing your company’s sales process to see if operating as a branch is appropriate. We will help you get an Employer Identification Number (EIN), register your business in the states you are doing business in and help you open a bank account.

Chapter 2:

*Once you have chosen to set up a U.S. entity, the next most important decision is how to initially fund it. The reason we mention initially is that the way you fund your U.S. operations may change over the life of your company. The three most popular options are:*

*A. Capital Contribution*

*B. Debt*

*C. Transfer Pricing*

**Capital Contribution**

If you are going to fund your U.S. operation via capital contributions, your U.S. entity will have to issue shares or membership interests (for LLC’s) in exchange for cash. All of these transactions will have to be documented and the only way to recover your investment will be when the entity is sold. Choosing this option puts the least amount of pressure on your U.S. entity since there is no obligation to pay the monies back.

**Debt**

This does not require any issuance of additional shares; however, the debt needs to be documented and must have an interest rate that is acceptable to the IRS. While interest payments do not have to be paid on a yearly basis; when interest payments are made a withholding of 17.5% will be required. Lending to your U.S. entity allows for the possibility for a return of this investment prior to the sale of the U.S. entity.

*“Using debt can be the primary way of financing the activity of a U.S. subsidiary. In addition, it can also be a component of your financial structure when combined with capital investment and transfer pricing.—Philip Stein, CEO”*

**Transfer Pricing**

Transfer Pricing is a universal tax term that defines how related parties transact business. The United States tax system allows many ways for you to fund your operations by buying, selling or paying fees to your entity. The overriding principal is that any transaction between your U.S. entity and your Israeli entity must be “arms-length”. In other words, the financial transaction between you and your U.S. entity must be priced similar to what you would pay a 3rd party.

Several examples of how you could use transfer pricing to fund your U.S. operations are:

A. Cost Plus – You would agree to cover all or some of the costs of your U.S. operations and then add a percentage mark-up to all payments.

B. Resale Price Method – You would sell your product to your U.S. entity and they would resell it for a profit.

C. Cost Sharing – You would agree to share development costs based on a future sales or profit allocation.

D. Low Risk Distributor – Your Israeli entity relieves your U.S. operation of all or most of its operational risk in exchange for a small sales commission. It is very important that whatever strategy you choose that both your Israeli and U.S. tax advisors are comfortable with the method and percentage of allocations.

Chapter 3:

First you need to pick a state to incorporate in. From our experience, Delaware is the most popular state to incorporate in because of its ease of registration, low cost and easy yearly maintenance. There is an annual franchise tax filing and annual agent fee. Based on your facts and circumstances and where you are doing business, you may prefer to choose one of the other 49 states. In order to open your door for business, your U.S. entity needs an Employer Identification Number (EIN). We can help you fill out Form SS-4 to get your EIN. This process can be expedited if you have a U.S. person who can sign the form. Once you have your EIN, you need to evaluate what other states you are transacting business in and register to do business in those states. These registrations give you rights and fulfill obligations to conduct business in that particular state. Once you complete these registrations, you will be obligated to file annual returns in that state unless you can find an exception to file those forms.

If you have completed the above, you now have everything you need to open a U.S. bank account. When choosing a bank, you need to explain to your potential banker your business needs and the fact that there will be transactions and cash movements between your U.S. and Israeli bank accounts. We have found several banks that are set up to serve this population.

**Chapter 4:**

*While the United States has a federal tax system, you will also have to deal with state and local (city) tax authorities. In addition to corporate taxation on your profits, you also need to evaluate your company’s obligation to sales tax on products or services that you are selling. Also, you need to be aware that most of the 50 states in the U.S. have their unique income tax systems with different and independent tax filings. In any state that you have an employee, you will need to withhold both federal and state (and maybe city) payroll taxes. A summary of the main categories of taxes you may be liable for are:*

A. Corporate Income Tax

B. Sales Tax

C. Payroll

D. Franchise Tax

“*Sales tax compliance is one of the biggest challenges companies face in their due diligence process” --Fred Kahn, Partner*

**Corporate Income Tax**

Since 2018 the federal corporate income tax rate is a flat 21%. The state corporate income tax rates range from 3% to 12%. **Sales Tax** Sales Tax has gone through many changes in the recent past, and it is essential to carefully evaluate if your product or service is subject to sales tax. In addition, sales tax is only imposed on the end-user, meaning sales to distributors or wholesalers should be exempt from having to collect sales tax. Each state has a different threshold based on the volume and value of the sales, which will determine if you need to collect sales tax in that state.

**Payroll Tax**

There are several payroll taxes an employer needs to know about. On a federal level, you are obligated to pay taxes known as FICA, Medicare and FUTA. On a local level, you will also need to pay unemployment insurance and workman’s compensation. These taxes are deductible and must be remitted with the processing of your payroll, which is generally twice a month in the U.S.

**Franchise Tax**

A franchise tax is a government levy (tax) charged by some U.S. states to certain business organizations such as corporations and partnerships with a nexus in the state. A franchise tax is not based on income, rather, the typical franchise tax calculation is based on the net worth of or capital held by the entity.

**Chapter 5:**

*The U.S. does not have a statutory definition of who is an employee. Nonetheless, in general, if you are controlling how a person works, they are in most cases considered an employee and entitled to related benefits. In addition, you will have withholding obligations to federal and state tax authorities. Another important consideration will be if you are going to hire local U.S. employees or relocating Israeli hires to the U.S. If you choose to relocate an Israeli employee, you are required to obtain a working visa before their arrival in the U.S. Also, it is a generally accepted practice to offer a relocation package. Some of the more common benefits provided to U.S. employees (these are generally not mandated by law) are:*

A. Health Insurance

B. Pension

C. Options/RSU’s

**Health Insurance**

For small companies (less than 50 employees) health insurance is not mandatory, however the common practice is to offer it as a benefit. However, even for companies of less than 50 people, you are not allowed to offer this benefit to some employees and not to every full-time person on your payroll.

**Pension**

This, like health insurance, cannot be discriminatory. There are a number of pension options available to U.S. companies, the most popular being a 401(k). These plans allow a deferral of up to $18,500 and the employer can match contributions. These plans have penalties for withdrawal before age 59 1⁄2.

**Options/RSU’s**

Employee stock option plans are used as a means to have employees share monetarily in the future success of the company. While these plans can be regulated (qualified) or non-regulated (non-qualified), the IRS requires that option grants to U.S. employees must be according to the fair market value of the stock at the time of the grant. RSU stands for “Restricted Stock Unit” and provides stock awards of the company after a certain period of vesting.

Chapter 6:

*While not required by law, most Hi-Tech companies offer some type of equity compensation plans to their employees. These awards vest over time and must be priced at Fair Market Value in accordance with IRC Section 409A. It is very important to examine both U.S. and Israel tax rules when making these awards to employees who may be subject to tax in both jurisdictions. The most popular equity awards are:*

*A. Incentive Stock Options (ISO)*

*B. Nonqualified Stock Options*

*C. Restricted Stock Units (RSU)*

**Incentive Stock Option**

There are several rules about these type of options; they are:

1. No yearly award can exceed $100,000

2. Restrictions on owners

3. Cannot be sold less than 2 years after the grant

4. Must be held 1 year from exercise

5. Can be eligible for capital gain treatment

**Nonqualified Stock Option (ISO)**

There are no strict rules regarding this type of option (except for IRC Section 409A mentioned above). They are taxed in the same way as compensation on exercise and subject to immediate withholding like any other payroll item.

**Restricted Stock Units (RSU)**

These are taxed as ordinary income as they vest and usually appear in publicly traded companies. Upon vesting the value of the RSU’s are compensatory and subject to withholding.

We hope that this E-book guides you on your first steps in setting up a U.S. entity. We realize you may have many questions about the contents of this E-book and invite you to turn to us to ensure that your venture into the U.S. is a successful one.

While we believe you will find this E-book invaluable to help you make the right choices, this E-book should not be used as a substitute for professional advice