Tax Automation and its Implications for Non-residents and Foreign Entities

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Abstract

This study explores the advantages and challenges associated with tax automation for foreign individuals and entities engaged in business activities within the United States. The article examines the significance of tax automation in addressing the complexities of U.S. tax regulations and policies applicable to foreign individuals and entities earning income in the United States, whether directly or indirectly. Tax automation has provided valuable guidance in navigating the tax regulations for foreign individuals and entities to ultimately reduce compliance risks, improve work efficiency, and promote the rationality of tax planning. At the same time, tax automation opens up challenging issues of stability and security of technology, as well as the need for an enhanced competency of tax professionals to develop specialized expertise in matters relevant to foreign individuals and entities. The article addresses both the opportunities and challenges of tax automation for foreign individuals and entities by providing a series of measures, including a deeper analysis of activities that trigger U.S tax reporting requirements, and an understanding of the various tax forms needed throughout the tax process.

Keywords: Taxation; Tax Automation; Non-residents; Foreign Entities.

1. Introduction

The prevalence of artificial intelligence has brought about drastic changes in the evolution of how taxation is conducted. The innovation of technology has increasingly received widespread attention for the accuracy of tax automation when it comes to preparing tax returns and planning for tax purposes.

This is particularly advantageous for foreign individuals classified as non-residents, as well as foreign entities, as it provides greater flexibility and assurance in maintaining timely and comprehensive compliance with all tax reporting obligations associated with conducting business activities in the United States. While the progress of tax automation has improved the level of compliance and efficiency, it also poses new challenges and requirements to the existing tax software that need to be tailored towards non-residents and foreign entities. The heightened complexity and variability of tax policies and regulations applicable to foreign individuals and entities, combined with concerns regarding the security and stability of tax software, necessitate that tax professionals possess greater expertise and heightened awareness of business activities involving foreign individuals and entities. It is crucial to effectively identify and promptly respond to the challenges posed by the various taxation triggers and form requirements of non-residents and foreign entities. This article begins with the significance of tax automation in easing tax compliance and planning purposes for the benefit of non-residents and foreign entities. The article will delineate the tax automation process, encompassing the collection of relevant data, the determination of applicable tax types, the calculation of precise withholding and payment amounts, and the timely completion of the requisite tax forms for submission to the Internal Revenue Services (IRS). The article will proceed to tackle risks and challenges brought about by the reliance on tax automation in the context of foreigners with business activities in the United States. The challenges also include the potential of planning for the various entity structures ideal for tax optimization towards non-residents and foreign entities. The article will end with a proposal on a series of targeted adjustment measures aiming to provide both theoretical and practical guidance to improve the use of tax automation for non-residents and foreign entities.

2. Impact of Tax Automation for Non-residents and Foreign Entities

2.1. Improvement of Tax Compliance with Better Work Efficiency and Reduced Workload

The development of tax automation has drastically changed how tax preparation is conducted in the United States. Previously, foreign individuals classified as non-residents for tax purposes had to endure a painfully long process to complete a simple individual tax return, known as Form 1040-NR. Generally, whether a foreign individual is required to file a U.S. individual tax return depends on their visa type, the type of income received, and the source of that income under IRS regulations. Foreign individuals who typically need to file a U.S. individual tax return are those who have engaged in a trade or business in the United States, generating income such as wages, interest, dividends, rental income, scholarships or fellowship grants, and gambling winnings [1]. The process of determining the type of income generated by foreign individuals has evolved beyond manual classification, such as identifying whether the income constitutes Effectively Connected Income (ECI) or Fixed, Determinable, Annual, or Periodical (FDAP) income. This is in parallel for foreign entities that are engaged in a trade or business in the U.S., whereby the income type is crucial for determining the appropriate tax rate and withholding. Tax automation has simplified the process of determining the type of income generated by foreign individuals and entities by requesting the general documents that apply and reviewing their appropriateness for full compliance with IRS guidelines. Determining the income type and source is crucial for proceeding with tax preparation and for selecting the correct tax forms, such as the W-8BEN and/or W-8BEN-E, to submit to the respective U.S. withholding agent or financial institution responsible for paying the income. These specific tax forms are used to certify foreign status and, if applicable, to claim reduced withholding tax rates under a tax treaty. It is important to note that Forms W-8BEN and W-8BEN-E are not filed with the IRS. Tax automation

plays a crucial role in completing these forms accurately, based on the income type and the withholding requirements applicable to the foreign individual or entity. The tax concepts and automation integration described above also apply to foreign entities engaged in stock investments in the United States, enabling them to efficiently track U.S. tax obligations for proper withholding and reporting. Additionally, tax automation can achieve seamless integration with business operating systems, such as enterprise resource planning (ERP) systems, allowing for efficient data transmission and verification.

2.2. Reduce the Risk of Non-Compliance and Strict Penalties for Missed Forms

The implementation of tax automation for foreign entities creates numerous significant effects. In traditional tax management, the limitations of manual processes increase the likelihood of missing crucial tax forms and withholding requirements, as well as making calculation errors across various business transactions that trigger tax compliance obligations. For example, under the branch profits tax (BPT), the foreign entity or its tax adviser must determine whether the income in question triggers additional tax withholding requirements. Foreign entities with U.S. business operations that earn income classified as effectively connected income (ECI) are subject to a 30% branch profits tax [2]. The BPT applies when a foreign entity conducts U.S. business operations directly rather than through a U.S. subsidiary. In other words, foreign entities must be mindful of the 30% tax that may apply on top of any income they earn in the United States. It is important to note that the IRS does not automatically notify foreign entities of their branch profits tax obligations. This is where tax automation is able to fill in the gap by timely and accurately notifying foreign entities of the branch profit tax via its integration in the business's ERP. Tax automation is then reflected in the filing of the yearly tax return of the 1120-F. Penalties for failing to pay the branch profits tax can become severe, especially if Form 1120-F is not filed. If Form 1120-F is filed but the branch profits tax is not paid, the penalty is 0.5% per month on the unpaid tax, up to a maximum of 25% [3]. However, if Form 1120-F is not filed and the branch profits tax is not paid, the penalty increases to 5% of the unpaid tax per month. Additionally, interest is charged daily on top of the penalty, which can amount to 8–9% annually [4]. Foreign entities must also pay attention to income that triggers specific state tax reporting obligations under the concept of state nexus. State nexus occurs when a business has a connection to a U.S. state that gives the state the right to tax or regulate the business [5]. The typical activities that create nexus are from physical presence such as an office or having an employee working in the state, economic presence such has having a customer having a product shipped to his/her respective state, affiliated relationships such as partnering with in-state companies, and services performed such as providing services to people in that state. Tax automation is able to provide state tax guidance, ensuring complete compliance with all the relevant forms and tax-specific concepts appropriate to foreign corporations.

2.3. Cohesively Identify Tax Burden Through Strategic Tax Planning

Tax automation provides a holistic analysis tool and powerful data support to give tax support to non-residents and foreign entities. In the tax automation systems, both non-residents and foreign entities are able to obtain detailed tax data in real time. Through an in-depth analysis of tax information provided by a tax automation system, non-residents and foreign entities can identify potential tax-saving opportunities and develop strategic tax planning around the various tax concepts applicable to foreign taxpayers. For example, Form 1042-S is

issued to report U.S.-source income that is subject to withholding tax and is paid to non-U.S. persons, such as foreign individuals, entities, or governments. Suppose a foreign individual is classified as a non-resident for U.S. tax purposes and receives dividends from a U.S.-based company. Consequently, the individual receives a Form 1042-S indicating a 30% tax withholding. However, if the individual is from Canada, they should only be taxed at 15% instead of 30%, pursuant to the U.S.-Canada tax treaty [6]. To claim this reduced rate, the Canadian individual must file Form 1040-NR, attach the Form 1042-S received from the custodian institution responsible for paying the dividends, and submit Form 8833 to claim the tax treaty benefit, thereby obtaining a refund for the excess withholding [7]. Tax planning can then be applied by determining the tax treaty benefits that exist between the foreigner's country of residence and the United States, as well as the type of income expected to be received based on the nature of the business activity in the U.S. Additionally, foreign non-residents can be classified as residents for U.S. tax purposes if they meet the substantial presence test [12]. Although there is a five-year exemption from this test for certain visa holders, such as those on F visas, tax automation systems can accurately identify the appropriate tax classification for the foreign individual to enable more effective tax planning. For foreign entities, tax planning is better managed through tax automation systems, given the various tax rates that apply depending on the type of income foreign entities earn in the U.S. For instance, the concept of branch profits tax can be avoided if a foreign entity establishes a U.S.-based subsidiary, which can "block" the 30% branch profits tax, as income is then distributed to the foreign entity in the form of dividends [8]. Although U.S.-based subsidiaries are subject to a flat 21% corporate tax rate on all income earned, effective tax entity structuring, tailored to the nature of the foreign entity, can achieve tax-optimized outcomes through strategic planning. By simulating tax burdens under different tax rates associated with various income types, foreign entities can choose the most advantageous tax planning path. The application of strategic tax planning, supported by tax automation systems, enables foreign non-residents and entities not only to comply with and legally adhere to tax reporting requirements but also to effectively leverage tax treaties and manage tax burdens. This ultimately improves market competitiveness for foreign entities operating in the United States.

3. Obstacles Faced by Non-residents and Foreign Entities under Tax Automation

3.1. Complexity of Tax Regulation and Policies

Tax regulations and policies specific to foreign non-residents and foreign entities are incredibly difficult to understand and implement, primarily due to their frequent updates and complex content. The Foreign Account Tax Compliance Act (FATCA) is a complex and constantly evolving tax law. Regulations, forms, guidance, and enforcement policies under FATCA are updated regularly, making compliance challenging. The IRS frequently updates FATCA-related forms, such as Forms W-8BEN, W-8BEN-E, and 8966, as well as FATCA certification requirements. Not only do the guidance and reporting requirements for these withholding forms change, but specific forms must also be submitted to their corresponding custodians, rather than directly to the IRS. This means that not all forms required under FATCA are filed with the IRS; instead, many forms must be submitted to various institutions [9]. For example, Form W-8BEN must be submitted to the custodian or financial institution responsible for paying the foreign non-resident or foreign entity, not to the IRS. In other words, tax withholding forms are submitted to the U.S. withholding agent or financial institution that is paying the income, rather than to the IRS. For instance, if a foreign entity is expected to receive dividends from a U.S. brokerage,

then the tax withholding form W-8BEN-E must be submitted to the brokerage firm. While a foreign entity earning interest or royalties from a U.S. company must submit the tax withholding form to the U.S. company responsible for paying out such interest and royalties. Various tax forms, on the other hand, such as Forms 5472 and 1042-S, must be submitted to the IRS and not to the U.S. withholding agent. Another reason for the complexity of FATCA is the ongoing intergovernmental agreements (IGAs) established under its framework. The United States has over 100 IGAs with different countries under FATCA, and each agreement may have country-specific rules and local implementation timelines that are subject to change over time [10]. Additionally, there are significant technological and administrative burdens, as foreign financial institutions (FFIs) are required to update their internal systems to comply with new reporting formats, data fields, and certification requirements [11]. Foreign non-residents are also often unaware of their reporting obligations, or the treaty benefits that affect FATCA withholding. Although tax professionals are available to guide foreign non-residents and entities through various tax reporting requirements, tax policies can often be interpreted differently under the same regulation, which further increases tax risks.

3.2. Security of Data and Information under Tax Automation

The stability and security of data and information stored within tax automation systems are crucial for long-term productivity. In this context, stability and security refer to the frequency of system malfunctions and the protection of sensitive tax information. Understanding potential malfunctions and vulnerabilities is essential to evaluating the performance of tax automation in serving foreign non-residents and foreign entities. Frequent malfunctions or unusually slow system performance can be burdensome, as they directly affect the accuracy and efficiency of tax data processing. This may lead to tax declaration delays, data loss, and other tax-related issues. Additionally, instability and weak protections within tax information systems can result in late tax filings, which are often associated with severe penalties, thereby increasing economic losses and tax risks. Weak cybersecurity and inadequate privacy measures can further cause data breaches. Such breaches may require the re-entry of data to complete tax reporting requirements, which is time-consuming and reduces work efficiency. Therefore, ensuring the securitization of data and the stability of data processing is critically important to maximize the effectiveness and usability of tax automation.

3.3. Competency of Tax Professionals with the Usage of Tax Automation

Perhaps one of the most important obstacles in the implementation of tax automation is the competency and skill of tax professionals responsible for handling tax matters for foreign non-residents and foreign entities. Given the constant innovation brought about by technology and tax automation, the role of tax professionals has become even more critical in navigating tax regulations and policies. The advancement of tax automation means that tax professionals need to have a deeper understanding of general tax law and accounting principles to accurately interpret the tax information provided by various tax software. Additionally, tax professionals must continuously update their technological skills to navigate information technology, tax regulations, data analysis, and other aspects related to the use of technology in tax management. This means that tax professionals require more advanced skills and knowledge to fully leverage the benefits of tax automation. A lack of proficiency in either the fundamental understanding of taxation or in technological skills can ultimately affect work efficiency,

leading to inaccurate data and incorrect tax compliance for foreign non-residents and foreign entities. Given the constant changes in tax regulations and policies, tax professionals must be able to quickly adapt and learn about these changes to ensure accurate and complete tax compliance. In reality, many tax professionals lack up-to-date tax knowledge aligned with the latest policies and regulations. This consequently makes it more difficult and time-consuming to apply tax regulations effectively for tax planning and risk management. There are numerous nuances involved in fully taking advantage of deductions, as they often come with specific conditions and operational procedures. These complexities further emphasize the need for tax professionals to be more competent not only in complying with current tax regulations but also in proactively planning to achieve optimal tax outcomes.

4. Obstacles Strategies to Fully Utilize Tax Automation for Non-residents and Foreign Entities

4.1. Complexity Enhance Training for Tax Professionals on Tax Regulations and Tax Technology

Given the complexity and continuous updates in tax policies and regulations, it is vital for tax professionals not only to stay informed about the latest tax laws but also to be competent in addressing the various tax concerns of non-residents and foreign entities. In addition, tax professionals must be able to thoroughly navigate tax software, such as tax information management systems, to deliver high-quality tax compliance and planning advice to non-residents and foreign entities. Both federal and state tax laws, which can trigger tax reporting, withholding, and payment requirements, must be accounted for by tax professionals to ensure full adherence to IRS regulations. A combination of continuous learning and training will help develop more competent tax professionals equipped to handle current and future tax concerns. To foster a culture of continuous improvement, various resources should be made available to enhance tax knowledge and develop the skills needed to adapt to innovative tax technology. There are numerous resources that can be utilized to facilitate effective professional training. These measures include regular internal training sessions on specific tax policies conducted by tax professionals both within and outside the firm. This includes inviting tax experts from certified organizations and institutions to provide guidelines and best practices for interpreting the latest tax regulations, ensuring timely compliance with recent changes. Furthermore, providing access to online learning platforms with articles, podcasts, and learning modules gives tax professionals the flexibility to engage in self-study to enhance their knowledge and awareness of taxation. Another effective measure is encouraging tax professionals within relevant firms to attend external tax seminars and forums to exchange experiences with industry peers, thereby broadening their perspectives and deepening their understanding of tax regulations. It is also beneficial to incorporate assessments and evaluations to reinforce the knowledge gained and identify areas for improvement, ensuring the effectiveness of the learning platform for tax professionals. The ultimate goal is to develop competent and skilled professionals who can provide better services to non-residents and foreign entities.

4.2. Real Time Monitoring of Transactions by Foreign Entities and Documented Information for Non-residents

Establishing real-time monitoring mechanisms is important to fully capture tax policies and changes in tax regulations and to understand their impact on the tax burden, business strategy, and financial planning of both

non-residents and foreign entities. For foreign entities, real-time monitoring of transactions enables efficient business operations by allowing tax implications to be quickly considered. Non-residents, on the other hand, must pay close attention to the timing of transactions and the substantial presence test to maximize tax efficiency. Various tax policy changes can be monitored through government websites, updates provided by tax consulting firms, information from tax departments, and other industry communication platforms. As new information arises, it is important to stay informed and to clearly communicate updates to key stakeholders to ensure effective tax reporting and compliance.

4.3. Use Data Analytics to Provide Tax Planning

While tax automation enables the smooth collection of past transactions to generate accurate tax reporting, it also provides key data insights that can support proactive tax planning for non-residents and foreign entities. Data analytics can be particularly beneficial for foreign entities with large transaction volumes, allowing them to leverage advanced tools and technologies such as data mining, machine learning, and predictive analysis to process and analyze data effectively. Non-residents and smaller foreign entities can also utilize data analytics for tax planning by focusing on the nature of their specific transactions to generate relevant insights for managing tax burdens. Furthermore, the use of data analytics can assist in planning for future large transactions, serving as a valuable metric for evaluating how such non-recurring transactions may impact taxation in the context of normal business operations.

5. Epilogue

All in all, tax automation brings both exciting opportunities and challenges in creating accurate and efficient tax compliance with the IRS for non-residents and foreign entities. Given the complexity of taxation in the United States, the risks of noncompliance and penalties are high, making it vital to have a fundamental understanding of various tax reporting and withholding requirements. This requires increased awareness and involvement from key stakeholders, particularly tax professionals responsible for managing the nuanced tax matters of non-residents and foreign entities in the U.S. By applying various measures to enhance competitiveness, the evolution of tax automation can support sustainable development for non-residents and foreign entities.

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