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CHOICES OF U.S. ENTITIES FOR INBOUND INVESTORS

Foreign investors desiring to acquire or establish a business in the United States are faced with a multiple choice of entities. This article identifies some of the most popular entity structures which foreign investors and business owners often use and some advantages and disadvantages of each.

C Corporations

A “C” corporation is often a more attractive alternative to foreign business owners than to U.S. owners. Because C corporation profits and losses do not flow through to its owners, foreign owners generally do not need to file U.S. income tax returns. Instead, the corporation itself is liable for federal corporate income tax (at rates up to 35 percent) and files IRS Form 1120. Although dividends paid out of current or accumulated earnings and profits to a foreign shareholder are subject to U.S. withholding tax at a rate of 30 percent, this rate could be significantly reduced if favorable treatment is available under a tax treaty. Furthermore, gain on the liquidation or sale of stock of the C corporation by a foreigner generally is not subject to U.S. tax, with the exception of U.S. real property holding companies (unless the corporation first sells all of its assets in taxable transactions and takes certain other steps).

Limited Liability Companies and Partnerships

Some foreign investors in U.S. real estate, or other areas when capital gain may be generated, will invest through a U.S. pass-through entity (perhaps first through a foreign trust) to take advantage of lower U.S. long-term capital gain rates.

1. Limited Liability Companies

Two developments in the last 20 years have greatly expanded the choices for structuring such investments or businesses. The first was the introduction and gradual acceptance of limited liability companies (LLCs). The second was the adoption by the IRS of the "check-the-box" regulations allowing taxpayers to elect to classify many non-corporate business entities either as C corporations or as flow-through entities for U.S. tax purposes. Under these regulations, an eligible entity is classified either as a C corporation, a partnership if it has more than one member, or, if it is owned by just one person or entity, a "disregarded entity” (DRE).

As a DRE, an LLC can be useful in limiting its owner's legal liability (to the assets held in the LLC) while preserving "flow-through" income tax treatment. These two factors, combined with a lack of restrictions on types of owners and relative flexibility regarding profit and loss allocations, have made LLCs a popular choice of entity in the U.S.

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However, if the LLC is treated as a partnership for U.S. tax purposes, a foreign member's "allocable share" of profits will be subject to tax, and the partnership is required to remit "withholding" tax on the allocated income, whether or not any cash is distributed. The LLC must annually file IRS Form 8804, Annual Return for Partnership Withholding Tax, to report the withheld tax. Foreign and domestic partners must also report their shares of the LLC's income or loss on their own federal income tax returns.

Beginning on January 1, 2017, foreign owners of entities treated as disregarded for tax purposes and wholly owned by foreign persons must file IRS Form 5472 to report their U.S. activities. Failure to file Form 5472 results in an initial penalty of $10,000 per entity.

2. Limited Partnerships

A limited partnership (LP) consists of one or more general partners with unlimited liability, and one or more limited partners with liability limited to their respective capital contributions. Like flow-through LLCs, an LP is required to "withhold" U.S. income taxes on foreign partner allocated profits. Moreover, while an LP will be treated almost identically to multi-member LLCs under U.S. tax law, it may be regarded differently under the tax law of the foreign owner's residence country.

3. Limited Liability Partnerships

A limited liability partnership (LLP) is similar in form to an LP, except it does not require a general partner – but does require at least two limited partners. Typically, LLPs are slightly less complicated and less expensive to set up than LPs – but do not differ much from LPs with respect to available "flow-through" income tax treatment and limited liability for partners. Similar to LPs, an LLP will be required to "withhold" U.S. income taxes on foreign partner allocated profits and may also be regarded differently under foreign tax laws.

Given the complexity of U.S. tax laws in this area, foreign persons should consult reputable tax advisors and legal counsel before making any decisions with respect to inbound investment structures.

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