

Tax Considerations for Foreign Investment in the U.S.



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Foreign investors looking to enter the U.S. market often ask us “should I form an LLC or a corporation?” Understanding an LLC’s reporting requirements (being that it is a legal, but not a tax paying entity) and how it differs from a corporation is crucial. We have outlined below common Federal tax considerations assuming a singular foreign investor.

U.S. LLC

A U.S. LLC with only one owner is disregarded for U.S. tax purposes. As a result, the LLC would not file a U.S. income tax return of its own. Instead, its income and related expenses would be reported by its owner on their tax return. This commonly causes a foreign tax mismatch at the parent country’s level since the U.S. deems the parent to be the taxpayer and the foreign country typically deems the subsidiary to be the taxpayer.

If the foreign member was an individual, their share of LLC profits would be considered income effectively connected to a U.S. trade or business (ECI). This income would be subject to U.S. tax on a net income basis at the regular graduated rates (max rate is currently 37%). The member would file a Form 1040-NR (Non-Resident) on an annual basis to report and pay any tax due on this income. Filing is required even if the entity isn’t profitable, and no tax is due. If profitable, the foreign member would be expected to make quarterly estimated payments that cover 90% of the current year tax or 100% of the prior year tax as applicable. The 1040-NR would be used to claim credit for the estimated taxes paid throughout each quarter of the year.

If the foreign member was a corporate entity, its share of LLC profits would be reportable on Form 1120-F U.S. Income tax return of a Foreign Corporation and subject to the current federal corporate tax rate of 21%. Filing is required, regardless of profitability. The U.S. LLC’s net income would also be subject to the branch profits tax at 30% (or lower treaty rate) for any of the U.S. LLC’s accumulated earnings that are not reinvested in the LLC. The intricacies of the branch profits tax and related calculation are beyond the scope of this article, but the underlying concept is meant to mimic the taxation of dividend distributions to shareholders of a U.S. corporation. The branch profits tax would be calculated and reported on the foreign corporation’s Form 1120-F.

It’s important to note that under either of the ownership scenarios above, the Form 5472 Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business would be required to report related party transactions including, but not limited to, capital transactions, remittances to/from the foreign owner or debts payable to/from them. Care must be taken that related party transactions are always at “arm’s length”. The individual filer files the 5472 with a proforma corporate income tax return; the corporate filer submits twice; one for the U.S. LLC and another for the foreign corporation.

U.S. Corporation

A U.S. corporation would report its activity on a Form 1120 U.S. Corporation Income Tax Return and be taxed on its net income at the current federal rate of 21%. Filing is required regardless of whether the corporation has taxable profits. In addition to reporting net income, the annual report must also include the Form 5472 to disclose related party transactions (as above). The corporation would be required to withhold tax on any dividend distributions to its foreign shareholder at a rate of 30% (or lower treaty rate), typically within three business days following the close of the quarter-monthly period in which the payment was made. Withholding of this tax would be reported by the corporation annually by filing Form 1042/1042-S.

At the shareholder level, the tax effects are similar for both a foreign individual and foreign corporation. Dividend distributions to a foreign shareholder are withheld at a 30% rate (or lower treaty rate) by the U.S. corporation. Provided the foreign shareholder has no other U.S.-sourced income and adequate tax was withheld on the dividends, the Form 1040-NR (foreign individual) or Form 1120-F (foreign corporation), would not be required to be filed.

The above are simplified scenarios; further considerations in choice of entity would include additional state income tax (depending on nexus), estate tax implications, and future exit strategies. When asking “what should I form?” the answer will always be “it depends.”