Formation of U.S. Limited Liability Companies

Potential Tax Trap for Unwary Non-U.S. Investors and Business Owners Entering the U.S. Market

By Bari Zahn, Esq.

Forming a U.S. LLC is often the first step to investing in the United States. For U.S. federal tax purposes, owners of an LLC (formed anywhere in the world) may choose to have their LLC treated as a partnership, a disregarded entity ("DRE"), or as a "C-corporation." A U.S. LLC generally defaults under special tax rules to a partnership or a DRE (where the LLC is wholly owned), unless a special tax election is made, commonly known as a "check-the-box" (CTB) to treat the LLC as a C-corporation. Although, LLCs are pervasive in U.S. business organizational structures, one of the most consequential common errors made by international clients entering the U.S. markets is to first form a U.S. LLC and hold it directly.

U.S. Estate, Gift, and Income Tax Considerations

If a non-U.S. individual (either directly or via a non-U.S. partnership) invests through, or operates a U.S. business via a U.S. LLC, such non-U.S. person is immediately exposed to a 40% federal estate and gift tax regime; a risk many fail to consider. There also may be income tax inefficiencies in operating U.S. businesses directly through a U.S. LLC, this is especially true with U.S. real estate.

Filing U.S. Income Tax Returns in the Non-U.S. Individual or Business Name

In addition to the U.S. estate, gift, and potential income tax inefficiencies of conducting a U.S. business through an LLC (whether a U.S. or foreign LLC), any non-U.S. individual or entity that chooses to do so, likely will be engaged in a U.S. "trade or business" which means that such non-U.S. individual or entity generally must file a U.S. federal income tax return in the individual or entity name. As many non-U.S. individuals are often averse to providing the Internal Revenue Service ("IRS") with their name and other personal information (or business and financial information related to their non-U.S. companies) to avoid disclosure of sensitive information to the IRS many U.S. tax advisors may advise international clients to set up a U.S. C-corporation as a possible solution.

Conclusion

Clearly, U.S. LLCs are used in U.S. organizational structures for commercial business reasons, and it is common to find a series of separate LLCs, which allow for the formation of distinct lines of business, or to hold separate real estate blocks and other assets, insulating each business line and asset from the potential liabilities of the other business lines. However, when considering entering the U.S. market, it is essential to remember that each non-U.S. investor's situation is unique, and many factors must be considered in determining the best structure for the client, not to mention the importance of the order and steps to be taken in setting up a U.S. business structure utilizing LLCs. So, before you move forward with your U.S. business operations or investments, be sure to consult a U.S. tax advisor with broad knowledge in setting up U.S. organizational structures using LLCs for optimal international income, estate, and gift tax efficiencies.

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Bari Zahn brings over 20 years of success at some of the most highly regarded global law firms to her own, bespoke law firm. Ms. Zahn, who started her legal career at the United States Tax Court, has extensive experience counseling clients on a wide array of international and domestic transactions. Prior to founding Zahn Law Group, she managed the largest, Chinese-owned law firm in New York, where she cultivated and continues to serve a large China-related practice. With a lifelong background in tax, Ms. Zahn handles transactions for businesses and global families worldwide, providing clients with sophisticated, cross-border and domestic tax structuring and planning advice. Also on the tax side, she counsels real estate firms and international investors, entrepreneurs, family offices, private foundations, and other business owners, as well as advising high-net-worth domestic and global families on their trust and estate related matters. As a general counsel, Ms. Zahn represents clients with corporate, employment and other legal issues and on the management side, she creates and supervises legal teams for clients across the globe, ranging from startups to Fortune 500 companies, who hire Ms. Zahn for her legal supplier diversity expertise.