US Tax Treatment of Foreign Limited Liability Companies

By Terry Coxon, World Money Analyst Team

WORLD MONEY ANALYST
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A non-US (foreign) limited liability company is a versatile and comparatively simple vehicle for US investors who want access to a wider range of non-US financial institutions. This report summarizes the tax principles that come into play for a US citizen or resident who owns a foreign LLC.

No affirmative election. If a foreign LLC does not make an affirmative election by filing Form 8832 with the IRS, it is classified by default as a foreign corporation. Assuming that you intend to use your foreign LLC to hold investments (and not to run a business), you almost certainly should file an election to have the LLC classified either as a partnership or as a disregarded entity (i.e., a sole proprietorship) for US income tax purposes. Such an election can be retroactive for as many as 75 days. As a practical matter, it is good practice to file the election promptly after the company has been organized.

Partnership treatment. If there is more than one distinct Member (such as an LLC owned partly by you and partly by one of your children), the company can avoid being classified as a foreign corporation by electing to be treated as a partnership. As such, the company would file a partnership tax return each year. Then you as a Member would include your share of the company's income, gains, deductions and credits on your personal tax return, as would each of the other Members include those items on their own returns.

There generally is no income tax on transferring assets to an LLC that has elected partnership treatment. However, if you transfer stocks, bonds or other securities that are worth more than you paid for them, and if more than 80% of the company's assets consist of cash and securities, and if the result is that you diversify your holdings to even a modest degree (because another Member contributed something different), you will recognize any built-in gain on the transfer, just as though you had sold the securities.

There generally is no income tax on distributions from an LLC that has elected partnership treatment. However, if the total distributions you receive ever exceed the total of (1) the cash you transferred to the LLC, plus (2) the cost of the investments you transferred to the LLC, plus (3) your share of the LLC's net income, any excess will be a capital gain.

Disregarded entity. If the LLC is owned by just one distinct Member, such as yourself, it can avoid classification as a foreign corporation by electing to be a "disregarded entity." In that case, the LLC doesn't file an income tax return; instead, as the Member who owns the entire company, you would include all of the company's income, deductions and credits on your own tax return. It's as though the company is simply a financial account that you own.

Even if an LLC has more than one Member, if all the Members are indistinct from one another for income tax purposes, the LLC nonetheless can elect to be a disregarded entity (and may not be eligible to be treated as a partnership). For example…

You and your grantor Trust. For income tax purposes, you and the grantor Trust (such as a "living trust") that you funded are one and the same person. So even if the LLC were owned partly by you as an individual and partly by your grantor Trust and there are no other Members, the LLC could still elect to be a disregarded entity.

You can transfer assets of any kind to a foreign LLC that is your own disregarded entity without triggering any income tax consequences – even if the assets are highly appreciated. For income tax purposes, you are transferring the property to yourself. Distributions work the same way; a distribution by the LLC to your Trust has no income tax consequences because (for income tax purposes) you are transferring property to yourself.

Funding by You and Your Spouse

An LLC that is owned entirely by husband and wife as community property can elect either to be a disregarded entity or a partnership. So if an LLC is funded solely by community property (contributed by you and your spouse), it can elect either to be disregarded or to be a partnership. However, if any interest in the LLC derives from separate property, the LLC is not eligible to be a disregarded entity and, except in unusual cases, should elect to be a partnership.

If you live in a community property state, and either you or your spouse wants to transfer what is now separate property to the LLC, consider first entering into a "transmutation agreement." A transmutation agreement is a simple legal instrument (sometimes just one page) by which husband and wife agree that specified items of separate property shall be transmuted into community property. This would allow you to fund the LLC solely with community property and thereby allow the LLC to be a disregarded entity.

If you do not live in a community property state, and both you and your spouse want to transfer what is now separate property to the Trust's LLC, the LLC can elect to be treated as a partnership for income tax purposes. Assuming that most of the LLC's assets will consist of cash and securities, a contribution of appreciated property to the LLC might trigger capital gain tax. However, you can avoid the potential for tax if, before making the contribution, each of you makes a gift of a 50% interest in the separate property to the other spouse. Doing so would eliminate the potential for tax by preventing the transfers to the LLC from effecting a diversification of assets for either of you.

If you are not certain whether an LLC funded by both you and your spouse is eligible to elect to be a disregarded entity, you should consult with a tax attorney or accountant. If you cannot arrive at a clear answer to the question, to avoid uncertainty, the LLC should elect to be treated as a partnership.

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