Shore to Shore

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Investing Through a Foreign Corporation?

Do Your Really Want One?

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**IBM has one, GM has one, Bausch & Lomb has one.
So why don't I have one? Mark Merric takes a look at the pitfalls of individuals investing abroad through a foreign entity**

The standard promotional proposal for the creation of international business companies or foreign corporations usually begins with the following sales pitch: IBM has an Irish non-resident business company, GM has Irish non-resident business company, Bausch & Lomb has an Irish non-resident business company. Therefore, you too should have an Irish non-resident business company.

Unfortunately, such an analogy fails to recognize a fundamental tax difference between an individual investing abroad through a foreign corporation compared to a international company manufacturing and selling abroad.

Conversely, many US investors wish to invest abroad. However, they also do not wish to have any individual liability exposure attributable to such foreign investments.

Therefore, many times, an investor will create a wholly owned foreign corporation and then the foreign corporation will invest abroad. [1] If such foreign corporation is classified as a corporation for U.S. tax purposes[2], this article analyzes the pitfalls of using a wholly owned foreign corporation as a tool for investing abroad and compares the wholly owned foreign corporation to the alternative, a foreign limited liability company (FLLC).

It should be noted that until recently there were few, if any, foreign jurisdictions that had FLLC statutes. Therefore, in the past, a FLLC was not a feasible alternative. However, since several tax free jurisdictions, such as the Isle of Man, Nevis, or Anguilla, have enacted limited liability statutes that are very similar to US limited liability statutes, a FLLC has become a viable alternative to the foreign corporation.

Problem

Unfortunately, a foreign corporation is classified as a controlled foreign corporation (CFC) for US tax purposes.[3] For certain foreign corporations, this issue may be fixed by checking the box so that the foreign corporation is taxed as a flow through entity. Which foreign corporations can make the election as well as the mechanics of the check the box election were discussed in the June and September issues of *Shore to Shore*.[4] For purposes of this article, it is assumed the check the box election was or could not made and the foreign corporation is taxed as a US C corporation. Conversely, it is assumed that the foreign LLC does check the box so that it is taxed as either a flow through or a disregarded entity.[5]

In regard to a US investor investing through a CFC, a CFC has four negative tax consequences that are not present when comparing it to the alternative entity, a US investor investing through a FLLC.

Analysis

A CFC has the following four primary disadvantages when it is compared to an FLLC:

1. capital losses in a CFC are not deductible until the CFC is liquidated;
2. the CFC converts all capital gains into ordinary income;
3. double taxation of US dividend income; and
4. no step-up in basis on the death of the shareholder under IRC §1014.

1. Capital losses not deductible

Unlike a FLLC, a CFC is only a partial flow-through entity. Portfolio or investment income flows through and is taxed to the US investor, irrespective of whether or not the investment income is distributed to the US investor. On the other hand, losses do not flow through to the US investor.[6] Instead, such losses are suspended in time until the CFC is liquidated.

For example, assume a US investor contributes $1,000,000 to a CFC that invests in foreign securities. During the year, the CFC sustains a capital loss from the sale of securities of $200,000. Such loss would not flow through to the US investor's return like it would if the foreign securities were owned by a FLLC. Therefore, the $200,000 loss would not be offset against any capital gains the US investor had from investments outside the CFC.

Further, unlike a domestic C corporation, a CFC is not entitled to either a net operating loss or capital loss carry forward. Therefore, the $200,000 net operating loss or capital loss would not be carried forward and offset in a subsequent year against future income or capital gains of the CFC. Instead, the $200,000 loss would be suspended in time until the US investor liquidated the CFC.

2. Conversion of capital gains into ordinary income

Whether or not the income of a CFC is distributed, to the extent of accumulated earnings and profits, a shareholder is taxed as a dividend on any amount of investment income (subpart F income[7]) that is earned by the CFC[8]. Therefore, if the CFC realizes any capital gains, the capital gains increase accumulated earnings and profits, and irrespective of whether or not the proceeds are distributed to the shareholder, the shareholder will report the capital gains currently as a dividend and pay tax based on the ordinary rates.

For example, assume that the US investor contributed $1,000,000 to a wholly owned CFC. The CFC invested in foreign growth securities and realized a capital gain of $200,000 during the year. Assuming that there were no other earnings in the CFC, the accumulated earnings and profits of the CFC would be $200,000. To the extent of the accumulated earnings and profits, a US shareholder of a CFC is taxed on the earnings of the CFC as a dividend. Therefore, the US investor will pay ordinary income tax rates on $200,000 of dividend income. Currently, there is a 19.6 per cent difference in the highest ordinary income tax rate and the capital gain rate. Based on our example, a US investor investing through a CFC would pay an additional $39,200 in taxes. The incremental tax is exclusively attributable to the CFC converting capital gain to ordinary income.

3. Double taxation of US dividend income

Similar to a domestic C corporation, a CFC corporation is a separate entity and pays a separate tax on its US source income. The prior examples have assumed that all income of the CFC was foreign source income. Therefore, under the prior examples, the CFC did not incur any US tax at the corporate level. However, what happens when a CFC invests in US securities?

When a CFC invests in US securities there are principally three types of income that may be generated: (1) gains on sale of securities (i.e. capital gains), (2) interest income, and (3) dividend income. A CFC is a foreign corporation, and foreign corporations are exempt from paying tax on the gains from the sale of securities[9]. Further, almost all interest income earned by a CFC will qualify for the portfolio interest exemption [10], and therefore, this interest income will not be subject to US taxation. However, there is no exemption for dividend income on US stocks received by a foreign corporation[11]. The result is that a double tax is incurred with respect to US dividend income: once at the corporate level and a second time as a deemed distribution under the CFC rules.

4. No step-up in basis on death of a US shareholder

[Please note that since the publication of this article the Service has repealed

Under IRC §1014, for most types of property, the basis of property received from a decedent on the death of an individual steps up to the fair market value of the property. Therefore, if there is any inherent gain in such property for income tax purposes, such inherent gain escapes income taxation when the property is subsequently sold by the person receiving the property from the decedent.

Unfortunately, a CFC which is also classified as a foreign personal holding company (FPHC) is not allowed a step up in basis[12]. A FPHC is any foreign corporation where 50 per cent or more of such foreign corporation is owned by five or fewer US persons and over 60 per cent of the foreign corporation's income is from portfolio sources[13]. In our example, all of the income is from portfolio sources and one US person owns 100 per cent of the foreign corporation. Therefore, the CFC is also classified as a FPHC, and the CFC does not receive a step-up in basis on the death of the shareholder. Not only does the CFC not receive a step-up in basis, if the fair market value of the CFC is less than the shareholder's basis, the CFC receives a step-down in basis[14]. This is obviously the worst of both worlds.

Solution

A foreign LLC has none of the aforementioned negative tax consequences that are created when a US investor invests through a CFC. If a capital loss is incurred in a FLLC, it flows through and is deducted on the US shareholder's individual tax return. Capital gains also flow through the FLLC and are reported on the US shareholder's individual tax return, thereby receiving the preferential 20 per cent capital gain rate. US dividend income is only taxed once, and on the death of a shareholder, a foreign LLC receives a step up in basis to fair market value[15].

Conclusions

In the past, many US investors were mistaken in making the analogy that they were taxed similarly to an international company that manufactures and sells abroad. Unfortunately, when a US shareholder invests through a foreign corporation, generally such an entity is classified as a CFC for US tax purposes with the following four negative tax consequences: (1) capital losses are suspended in time until the CFC is liquidated; (2) capital gains are converted into ordinary income; (3) there is double taxation on US source dividend income; and (4) there is no step-up in basis on the death of a shareholder of an investment CFC. All of these disadvantages can be easily avoided by using a FLLC. Since there are several tax-free jurisdictions, such as the Isle of Man, Nevis, and Anguilla, which have enacted limited liability statutes that are very similar in legal structure to US limited liability statutes[16]. An FLLC for foreign investment purposes is a much better alternative than a foreign corporation.

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1 Sometimes a US Investor will use a US entity for investing in foreign securities. However, many times for asset protection purposes, a US investor has an asset protection trust (APT) as part of their financial planning structure. One benefit of an APT is the positioning of client's assets to avoid the uncertainty of the U.S. court system and have the final legal battle in a foreign jurisdiction with favorable asset protection legislation. A US entity is subject to the personal jurisdiction of the US courts. On the other hand, a foreign entity, properly structured is not.

2 Also, certain foreign corporations may "Check the Box" to be a flow through entity and solve this problem. *See* Mark Merric, *Check the Box Rules Part I and Check the Box Rules Part II*, Shore to Shore, June 1998 and September 1998.

3 Generally, if more that 50 percent of the voting power of the value of the foreign corporation is owned by US shareholders who own at least ten percent of the foreign corporation, the corporation is considered a CFC. IRC § 957(a), § 951(a), and § 951(b).

4 *See Endnote 2.*

5 The default rule of classification of a foreign LLC is a corporation. An affirmative check the box election must be made to make it a flow through entity. *See Endnote 2.*

6 IRC § 951(a).

7 IRC § 952(a), § 954(a), § 552(a).

8 IRC § 951(a).

9 Treas. Reg. § 1.1441-2(b)(2)(i) states that capital gains are not FDAP. Also, § 865 sources the sale of personal property as foreign source income. Stock is personal property, and a non-resident alien does not pay income tax on foreign source income, with limited exceptions for a fixed place of business.

10 IRC § 881(c)(2).

11 IRC § 881(a).

12 IRC § 1014(b)(5).

13 IRC § 552(a).

14 IRC § 1014(b)(5).

15 The shareholder's membership interest in a FLLC automatically steps up in basis to fair market value. However, the FLLC must make an IRC § 754 basis adjustment election in the year of the shareholder's death for the property in the FLLC to receive a step up in basis.

[16] Nevis and Anguilla have all enacted FLLC legislation that provides for "charging order" protection similar to many US limited partnership and limited liability company statutes.