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Choice of Entity Form for Foreign Businesses Operating in the US

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For foreign businesses operating in the U.S., the choice of an entity form can have long-term consequences, both in the financing of the business as well as its operating activities.

If the foreign company decides to operate as a US branch, without incorporating in one of the 50 states, the default rules of Regulations Sec. 301.7701 should be carefully examined in order to determine the type of tax regime the entity will be subject to in the U.S.

Under default rules, foreign corporations whose shareholders have limited liability in the country where they incorporated are classified as C-Corporations. In some cases, the option exists to make a check-the-box election for the foreign corporation to be taxed at the individual level, either as a partnership or as a sole proprietorship.

Among the advantages of taxation at the individual level are generally lower tax rates and avoidance of double taxation. On the other hand, C-corporations have certain tax advantages, including foreign tax credits with respect to dividends received from non-U.S. subsidiaries in which the corporation owns a greater than 10 percent interest. Moreover, individual tax rates on dividends may be as low as 5 percent in some cases.

Check-the-box elections under Sec. 301.7701 cannot take effect more than 75 days before and 12 months after the election is filed. Once an election is made, another election to change the classification may not be made during the 60 months following the effective date of the initial election. If the company failed to file an election during the last three years, relief may be available under Rev. Proc. 2009-41 and 2009-39.

Foreign corporations must also be aware of the United States Branch Profits Tax. After-tax earnings of a US branch that are not reinvested in the business by the end of the tax year or that are repatriated in a later tax year may be subject to an additional 30 percent branch level tax. This tax may be reduced or eliminated by any applicable double taxation treaty.

Foreign entities wishing to open a subsidiary in the US instead of operating as US branches have a wide range of entity forms to choose from, including some hybrid ones, such as LLCs, which provide corporate shell protection while allowing for flow-through taxation at the individual level. A tax professional must be consulted in order to determine the form the new entity should take, after weighting all alternatives available.

One thing we emphasize to clients is that it is not only the type of taxation regime that should be of concern, but also the legal standing of the company as an entity independent of its owner. While there are many entity forms that provide corporate shell protection, corporations also allow for free transferability of ownership interests and continued life of the business, without requiring consent from the other shareholders. These advantages are not available to partnerships, LLCs, and LLPs.

If you have any questions concerning this matter, please contact us at your convenience.