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Accessing US Capital: Understanding the US Tax Perspective

Isaac Grossman*
Morrison Cohen LLP

Non-US companies should understand the concerns US investors have when making capital investments abroad in order to smoothly structure and, ultimately negotiate, a mutually beneficial arrangement, says Isaac Grossman of Morrison Cohen LLP.

There is an African proverb that says, "Not to know is bad; not to wish to know is worse." In order to properly access US investment capital, a non-US company (an "Issuer") and its advisors should understand not only the local non-US tax consequences, but also the potential US tax consequences, facing US investors with respect to the investment. The purpose of this article is to identify some of the key US tax concerns facing US investors making a capital investment outside the US so an Issuer can knowledgably respond to US investors' questions about the investment and, if necessary, tweak certain terms of the investment in a manner that will make the investment more tax efficient from a global perspective.

US Income Tax Status of the Issuer

From an investor's perspective it is important to understand the US income tax status of the Issuer. The US tax consequences of an investment in a corporation are very different from the US tax consequences of an investment in a partnership or other similar pass-through entity. In general, the activities of a partnership are attributed directly to its owners and the income generated by the partnership is treated as though it was generated directly by its owners. In contrast, the activities of a corporation are considered "blocked" by the corporate veil and the owners are generally treated as simply earning passive investment income (dividends and capital gains) from the corporation.

The US income tax status of a non-US entity is determined by reference to US tax principles. There are generally three types of entities from a US income tax perspective; a sole proprietorship, a partnership, and a corporation. Absent a special tax election made with the US tax authorities, a foreign entity will default into its US tax status based on the level of limited liability under local laws and the number of its owners. If there is limited liability for all the owners with respect to the debts and obligations of the entity, then the entity will default to corporate status. If there is potential liability for the owners with respect to the entity's debts and obligations, then the entity will default to a partnership (if it has more than one owner) or a sole proprietorship (if it has only one owner). Alternatively, a non-US company (other than a public limited company) can make an election with the US tax authorities on IRS Form

* Isaac P. Grossman is a partner and chair of the tax department at Morrison Cohen LLP, in New York. He is a graduate of Harvard Law School, has an LL.M. from NYU School of Law, and has been in practice for almost forty years.

8832 (a “check the box” election) to be treated as a partnership, corporation, or sole proprietorship (if it has only one owner).

Special US Status

If a foreign company is treated as a corporation for US income tax purposes, as described above, it may also be labeled with a special US status. such as a passive foreign investment company (“PFIC”) or a controlled foreign corporation (“CFC”). A passive foreign investment company is a foreign corporation with respect to which (a) 75% or more of its gross income is passive income, or (b) at least 50% of its assets are held for the production of passive income. A controlled foreign corporation is a foreign corporation more than 50% of who’s voting power or value is owned by US persons that hold at least 10% of the vote or value of the company. The special rules for PFICs and CFCs were designed to limit the deferral of US tax by US taxpayers making investments through non-US corporations. The application of these rules will typically require that all, or substantially all, of the income/profit generated by these entities will be taxable in the US, even absent a distribution of that income/profit to the US owners.

US Tax Status of the Instrument

An investment may be made in a variety of forms. The classic forms of investment are debt and equity investments. Again, it is the US tax characterization of the instrument as debt or equity (and not local laws) that will determine the US tax consequences of the investment for the US owner. Unfortunately, after years of debate, the US tax authorities have yet to provide clear guidelines on the distinction between debt and equity investments. At its core, a debt investment is an unconditional promise to pay a sum certain in money on a fixed date with a fixed rate of interest that is not subordinated to equity. In contrast, equity at its core, is an investment that provides a holder with a right to vote, a right to share in current earnings and right to liquidation proceeds. From a US tax perspective, it is the issuer of the instrument that characterizes the instrument as either debt or equity at the time of issuance. The line between debt and equity blurs when an instrument labeled as debt provides for a maturity date that extends for several decades or provides for contingent interest that economically mirrors changes in equity value. The distinction also blurs when an instrument is labeled as equity but provides for only a fixed rate of return, has no voting rights and includes a mandatory redemption date.

The US tax treatment of interest income and the return of principal generated by a debt instrument is different from the treatment of pass-through income, dividends and capital gains generated by an equity investment. The differences include not only tax rates (described below) but also the scope of tax reporting required in the US with respect to the investment.

It is worth noting that interest may be required to be reported as income in the United States, even if not currently paid by the Issuer. Similarly, accreting dividends and redemption premiums on certain equity instruments that include debt like features, such as mandatorily redeemable preferred stock, may be required to be reported as income in the United States, even if not currently paid by the Issuer.

US Tax Rates

A US corporate investor will generally apply a single tax rate to all its income — passive or active. In contrast, a US individual investor will pay a lower tax rate on long term capital gains and certain dividends, than the tax rate imposed on interest and pass-through operating income. As a general rule, it is preferable for a US investor to receive exit proceeds (long term capital gain), rather than dividends or interest. Further, it is preferable for a US investor to receive dividends, rather than interest, assuming the relevant foreign country has a fulsome income tax treaty with the United States.

As noted above, the characterization of any amounts received by a US investor as interest, dividends, or proceeds will be determined under US tax principles. For example, a redemption of equity that is, in form, structured as a payment made in exchange for a stock of a corporation may not be treated proceeds from the sale of that stock, but may instead be considered a dividend for US income tax purposes.

Local Tax Obligations

Many US investors are fearful of triggering local tax and tax filing obligations. As a result, most private equity funds require that the fund receive local tax advice before an investment is made in any foreign jurisdiction confirming that the investment will not trigger local tax or tax filing obligations directly upon investors. Local tax and tax filing obligations typically exclude gross withholding taxes and withholding tax (and refund) forms, and similar information returns.

Availability of Tax Information

In order to properly report income from a foreign investment, a US taxpayer must receive basic tax information from the issuer of the investment instrument. For example, the holder of a debt instrument should receive information annually regarding the amount of interest paid or accrued to that holder. Similarly, the holder of an equity instrument should receive annual information regarding any distributions made by the Issuer to that holder. In addition, the owner of an interest in a partnership or similar pass-through entry must receive a report from the company identifying its share of any operating income and loss of the company for the relevant tax period. Finally, the US owner of equity in a PFIC or CFC has substantial annual reporting requirements with respect to income and assets of the entity. In sum, an Issuer should expect annual requests from its US investors for tax information that the investors will need to satisfy their US tax reporting obligations. Many investors will demand written assurance upfront before making an investment that additional tax information will be provided upon request.

Financial Reporting

US investors are most familiar with GAAP financial reporting. Many non-US companies that are public generally use international financial reporting standards (IFRS), rather than GAAP. Even private companies may use IFRS for financial reporting. US investors may require some assistance to properly understand the differences in financial reporting methods.

In sum, cross border investments can be tricky because often parties are coming from different perspectives. Understanding the issues that may concern US investors can help non-US companies smoothly structure and, ultimately negotiate, a mutually beneficial arrangement with US investors.