THE CROSSROADS OF EB-5 INVESTMENT, U.S. TAX COMPLIANCE, AND PROPER TAX PLANNING

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You have your project, you have your investors, you have your loans in place, and your USCIS filings are complete. Now, what comes next?

The EB-5 process is intricate and complex for all parties involved at any stage. With the increase in oversight anticipated from the new U.S. Congress, tax compliance and planning will become more critical to the success of any EB-5 project.

In this article, we will discuss accounting and tax matters pertaining to the project loan model. The loan model represents the majority of EB-5 investments made into qualifying programs. Under the loan model, individual EB-5 investors do not make a loan to a project directly but, rather, make an equity investment in a New Commercial Enterprise (NCE), which in turn makes a loan to the EB-5 Job Creating Entity (JCE). This model is accepted by the U.S. Citizenship and Immigration Services (USCIS) as a qualifying investment.

The administrative accounting oversight of a NCE is often overlooked and not properly budgeted. This is a common concern because NCE managers and general partners frequently underestimate the extent of accounting and tax compliance required to maintain the NCE. Not only is accounting record-keeping important for project management and reporting, but the U.S. tax system has required considerably more compliance by international investors in recent years. This article will provide insight into the complexity of tax law compliance, internal accounting requirements, investor reporting, and the need for proper documentation. In addition, it will discuss liability exposure for not properly withholding taxes.

STRUCTURING AN NCE

In general, limited liability companies (LLCs) and limited partnerships (LPs) are the preferred investment vehicle for NCEs. The default classification of these entities is to be treated as pass-through entities for U.S. income tax purposes; thus, all items of income (loss), deductions, and credits pass through to each of the members or partners as stipulated in the operating agreement or limited partnership agreement of the entity.

As a general practice, most of these entities are organized for the limited purpose of raising EB-5 capital and making a loan to a JCE. Thus, the income generated is the interest from the loan. Administrative expenses incurred by the entity are also allocated to the members or partners based on the operating agreement or limited partnership agreement of the entity. An understanding of these agreements is critical to ensure the proper allocation of income and expenses. In addition, a careful review of transactions with the manager or general partner of the NCE or regional center is essential to recognizing accounting and tax implications. Please note that there are significant compliance concerns regarding transactions of this nature, which are beyond the scope of this article.

NCE OPERATIONS

In order to properly record transactions in the NCE books and records, an understanding of the legal structure, business plan, loan agreement, private placement documents, and operating agreements or limited partnership agreements is crucial. From an accounting perspective, the NCE is responsible for properly allocating income, expenses, credits, and any preferred return to the members or partners of the entity. Capital accounts for each member or partner must be kept, along with an accurate accounting of the activity of the NCE for accounting and income tax purposes.

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Proper internal controls on the disbursement of loan draws to the JCE should be considered, and all distributions should be in compliance with the legal terms and conditions of the loan and other related documents. The NCE and JCE are two separate legal entities and should be respected as such in the day-to-day operations. Commingling funds or paying expenses on behalf of related parties or other entities not outlined in the signed loan agreement or business plan should be avoided. In addition, an ongoing review of the loan activity must be undertaken to make sure compliance is being properly maintained.

WITHHOLDING REQUIRED BY NCE

The Internal Revenue Service (IRS) has passed regulations requiring U.S. entities taxed as partnerships to withhold taxes on income allocable to foreign partners. The type and rate of the withholding differs based on the type of income allocable to the foreign partner. Any taxable interest or other form of taxable fixed, determinable, annual or periodic income (FDAP income) received from the partnership will be subject to 30% withholding for federal income tax purposes, unless reduced or eliminated pursuant to a double tax treaty agreement. Withholding on FDAP income, such as interest is based on the gross amount received, rather than the net amount (gross minus expenses). In order to reduce or eliminate withholding taxes pursuant to a double tax treaty agreement, an investor will have to provide proper IRS documentation to the entity.

Entities are liable for ensuring the proper amount of taxes is withheld for each foreign investor. There are various steps an entity may take to ensure that it is treating foreign investors in the proper manner and in accordance with the requirements of the Internal Revenue Code. The burden and liability exposure of tax withholding is on the NCE and its officers.

Since EB-5 investors are typically nonresidents and are classified as nonresident aliens, until they obtain U.S. permanent residency, a majority will not have IRS tax identification numbers. Entities must ensure that foreign investors who do not already have Individual Taxpayer Identification Numbers (ITINs) obtain them.

With an ITIN, the partnership can withhold taxes on behalf of a foreign investor, and investors can be confident that the IRS will credit them for the taxes withheld on their behalf, with certainty. Depending on what country a foreign investor is from, he or she may be eligible for a reduced rate of withholding. If the foreign investor's country of citizenship or residence has a tax treaty with the United States, the foreign investor can complete certain tax forms based on his or her specific circumstances to claim the tax treaty benefits and become eligible for a lower withholding rate or no withholding at all.

Once an EB-5 investor is considered a U.S. tax resident, either because of a "green card" or "substantial presence", no withholding is required by the entity. However, the NCE must document this change in tax status.

IMPACT ON INVESTORS

In general, investors are subject to withholding taxes while they are considered nonresidents for U.S. income tax purposes. As income and losses are passed through to the investors, each investor is responsible for reporting and timely filing a U.S. income tax return for his or her respective share of what is received from the NCE. To remain in compliance with the Internal Revenue Code, investors may be required to file an income tax return annually. Depending on each investor's individual facts and circumstances, they may be required to file a Form 1040NR, U.S. Nonresident Alien Income Tax Return, or a Form 1040, U.S. Individual Income Tax Return. If the only U.S. source income the investor received while considered a nonresident for U.S. income tax purposes relates to interest from the NCE, the investor may not be required to file a tax return, as long as the withholding is satisfied at the appropriate rate.

Investors who did not receive their green cards and enter the country will be considered nonresident aliens for U.S. tax purposes, unless they meet the IRS's "substantial presence test" which stipulates that they will be required to file a Form 1040, if they are physically present in the United States on at least:

1. 31 days during the current year, and
2. 183 days during the 3-year period including the current year and the two years immediately prior, counting:
   - All the days they were present in the current year,
   - 1/3 of the days they were present in the first year before the current year, and
   - 1/6 of the days they were present in the second year before the current year.

Because most foreigner investors are typically not familiar with the complexity of the U.S. income and estate tax regimes, it is crucial that each investor consults with a licensed CPA or tax attorney, in order to ensure that the most advantageous tax positions for the foreign investor have been taken.

Taxation of U.S. Tax Residents and Citizens

Once an investor becomes a U.S. tax resident by meeting the "green card" or "substantial presence" test, the investor will be taxed on his or her worldwide income.

It is crucial that foreign investors begin income and estate tax planning during the preliminary stages of the EB-5 process. As well as being subject to income tax on worldwide income, investors may be subject to U.S. estate tax (death tax) on their worldwide assets. The estate tax is a tax on the investor's right to transfer property upon his or her death. There are various tax strategies available to investors, based on their specific facts and circumstances, that could be utilized prior to the investor becoming a U.S. tax resident.

In summary, the above provides an overview of several key aspects of administrative accounting and U.S. tax compliance requirements in the EB-5 process from the investor and NCE business perspective. These requirements are burdensome and need to be considered as part of the overall budget of the NCE. In addition, the investor needs to become familiar with the tax and related compliance implications of obtaining a green card, and the associated timing considerations to ensure adequate tax planning. ■

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