

International Tax Structures

for Americans Living Abroad

Foreign Earned Income Exclusion Structure #2

Offshore Consultant Disregarded Entity LLC Payment Processor

A consultant working overseas receives salary and dividends from a foreign corporation, indirectly through a U.S. Limited Liability Company (which is classified as a Disregarded Entity for U.S. tax purposes), to claim the Foreign Earned Income Exclusion to reduce his U.S. tax liability. This structure is an ideal situation in which a taxpayer intends to receive a salary from a foreign corporation, but is unable to open a U.S. bank account to process customer payments.

Summary of the the Foreign Earned Income Exclusion (\$911)

The Foreign Earned Income Exclusion (FEIE) allows U.S. citizens or resident aliens living and working abroad to exclude a certain amount of foreign-earned income from U.S. federal income tax. To qualify, you must have a tax home in a foreign country and meet either the bona fide residence test or the physical presence test.



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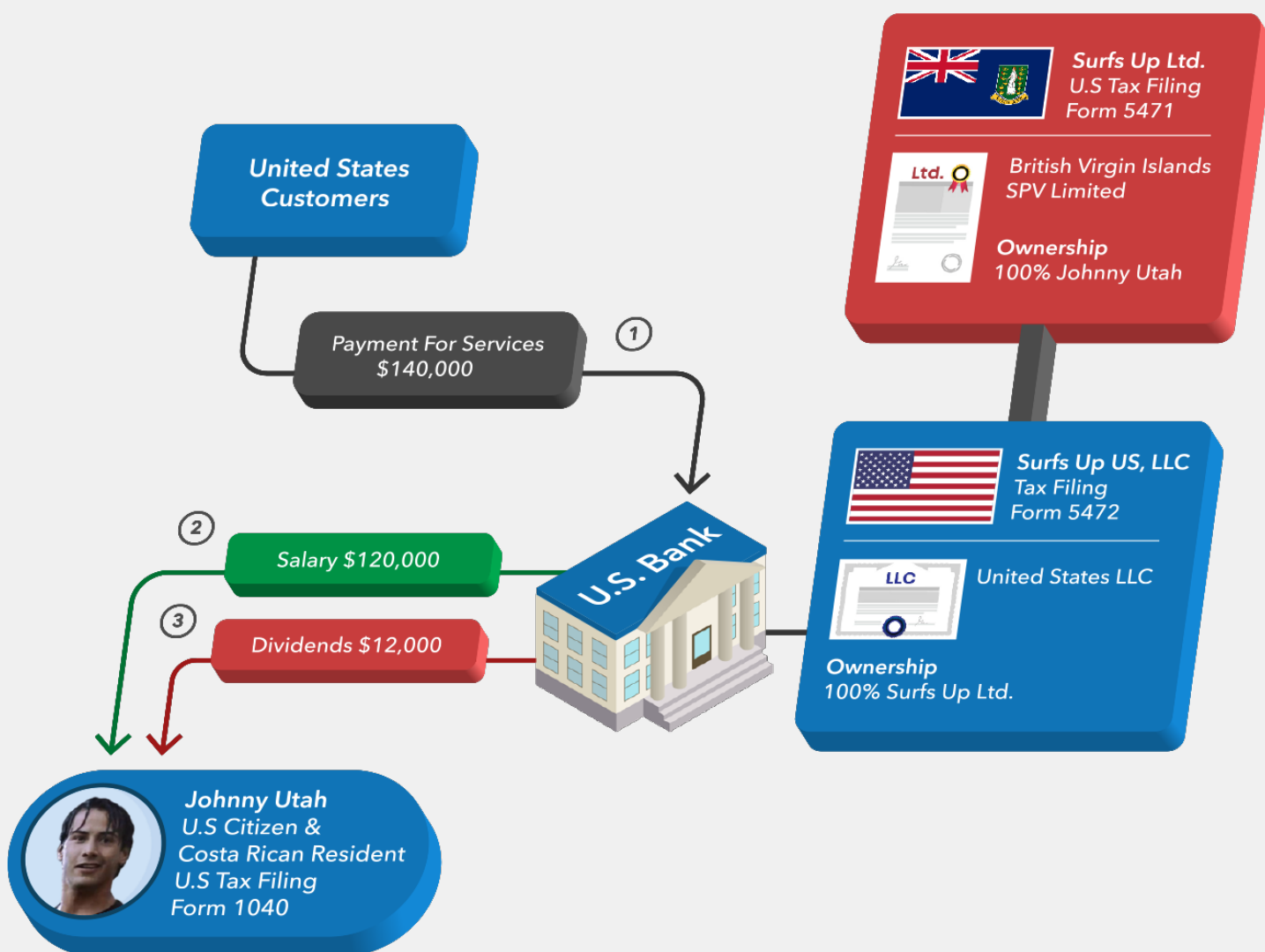
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Structure Background

A British Virgin Islands SPV, Surfs Up Ltd. (owned wholly by Johnny Utah, a U.S. citizen and Costa Rican resident), provides services to customers based in the United States for advisory consultation related to the surfing industry.

The vast majority of clients from this business are based in the United States and pay for services using a U.S. credit or debit card. Due to strict banking laws in the United States and foreign countries, Johnny found it was essentially impossible to open a U.S. bank account for the British Virgin Islands company to accept payments.

As a solution, Surfs Up US, LLC was formed as a United States (Delaware) subsidiary owned wholly by Surfs Up Ltd.. The subsidiary was able to open a U.S. bank account, accept payments from U.S. customers, and receive credit, making it easier to conduct business worldwide.



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Subsidiary Classified as a Disregarded Entity

As a Single-Member LLC, Surfs Up US, LLC is classified as a disregarded entity for Federal tax purposes per Treasury Regulation § 301.7701-3. This means the U.S. LLC is disregarded for Federal Tax purposes, as if it does not exist, and all transactions and trade are carried out by its parent owner, Surfs Up Ltd., a foreign corporation.

Not ‘Engaged in a U.S. Trade or Business’ in the United States

The primary purpose of the United States LLC is to easily collect payment from U.S. customers, obtain credit (primarily via credit cards), pay for expenditures, and easily conduct business through the use of the domestic banking system. Surfs Up US, LLC also owns a virtual mailbox in the state of Florida in order to receive U.S. mail. Based on these circumstances, the foreign corporation is determined not to be “conducting business” in the United States solely by owning a U.S. LLC for banking and mailing purposes per Internal Revenue Code §862 and related definitions found in §864. Johnny’s operations as the sole shareholder and employee are all based in a foreign country. The subsidiary disregarded entity or the foreign parent maintains a Permanent Establishment in the United States within the meaning of Article 5 of the OECD Model Convention with respect to taxes. As a result, neither Surfs Up Ltd. nor its U.S. subsidiary, Surfs Up US, LLC, conducts business in the United States and has no direct U.S. tax liability.

Throughout the year, clients send payments for services, which are deposited into a U.S. bank account held by Surfs Up US, LLC. Funds from this bank account pay for administrative expenses for the business and also pay a salary and dividends to Johnny during the year. The parent British Virgin Islands corporation does not have a bank account.

Johnny did not travel to the United States during the year and qualifies for the Foreign Earned Income Exclusion under both the bona fide residence test and the physical presence test per Internal Revenue Code §911. As the performance of work is based on where the work was performed, rather than the location of the customer, all income is considered foreign-source income. Furthermore, his salary from a foreign corporation while working in a foreign country is not subject to U.S. Social Security and Medicare tax, as per Internal Revenue Code §3121.

Monetary Transactions & Accounting

1. The total payments from U.S. customers for consultation services were \$140,000 throughout the year. This gross income is deposited into a bank account in the name of Surfs Up US, LLC.
2. During the same calendar year, a salary of \$120,000 was paid to Johnny.
3. In addition to his salary, \$12,000 of dividends from retained earnings were also paid to Johnny before the end of the year.
4. Surfs Up, Ltd. earned a total of \$140,000 for consultation income, paid \$120,000 of salary expenses to Johnny, had other administrative expenses of \$8,000 throughout the year, resulting in a Net Income of \$12,000.

U.S. Tax Filing Compliance

5. **Form 1040 (Johnny Utah).** Based on his U.S. worldwide income of \$132,000, he elects a Foreign Earned Income Exclusion to exclude his salary of \$120,000 on [Form 2555, Foreign Earned Income](#). After also claiming the Standard Deduction of \$12,000, his taxable income is reduced to \$0. He must also file Form [5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations](#), in relation to his ownership of Surfs Up, Ltd., to satisfy the reporting requirements of Internal Revenue Code §6038. As a result of all retained earnings being paid to Johnny as related party dividends, the taxable portion of Global Intangible Low-Taxed Income (GILTI) is \$0 per Internal Revenue Code §951A.
6. **Pro Forma Form 1120 & Form 5472 (Surfs Up US, LLC).** Foreign-Owned Disregarded Entities must generally file [Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business](#), to disclose foreign ownership of United States LLCs and also report certain reportable transactions per Internal Revenue Code §6038. As a result, this disclosure was prepared, disclosing both Johnny's Salary and Dividends as a related party.

Summarized Tax Returns and Financial Statements

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Surfs Up Ltd.
Income Statement

Consultation Income	\$140,000
Salary Expense	\$120,000
Administrative Expenses	\$8,000
Net Income	\$12,000
Dividends Paid	\$12,000
Retained Earnings	\$0

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Form 1040 Johnny Utah (Single)

Salary	\$120,000
Dividends	\$12,000
Total Income	\$132,000
Standard Deduction	- \$12,000
Foreign Earned Income Exclusion	- \$120,000
Federal Taxable Income	\$0

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Form 1120 Foreign Owned DE
Surfs Up US, LLC

Form 5472	Salary	\$120,000
	Dividends	\$12,000

Form 5471 (Surfs Up Ltd.)

Net Income	\$12,000
Related Party Dividends Exemption	\$-12,000
Taxable GILTI	\$0

Resulting Tax Implications

As a result of this structure and his income, the Federal personal U.S. tax liability of Johnny Utah is \$0. No state income tax is due, as he is not a resident of any U.S. state, nor has any income been sourced in any U.S. state.

Effective Tax Rate

Gross Income from All Sources	\$140,000
Gross Expenses from All Sources	\$8,000
Total Net Income	\$132,000
Federal Income Tax	\$0
Effective Tax Rate (Single)	0%

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Compliance Warning. A Foreign-Owned United LLC classified as a Disregarded Entity for Federal Tax Purposes comes with compliance risks to be aware of, including:

- Failure to file the proper Form 5472 disclosure results in a penalty of \$25,000.
- Based on the activity and nature of the business, a U.S. Trade or Business could be established, resulting in negative tax implications.
- Federal banking laws identifying a U.S. person as the beneficial owner could result in improper tax reporting and other compliance issues if foreign operations exist.
- Economic substance issues may also arise, resulting in compliance issues with the IRS.

About the Author



Marcus Marcial is a seasoned tax professional with experience predominantly dealing with International Taxation. Originally from Southern California, he attended Hunter College in New York City and has resided abroad for many years.

While employed at the IRS, he learned from examining and preparing tax returns for individuals residing and businesses operating offshore. After leaving the IRS, he started his own tax firm, helping various international clients with tax compliance, accounting, and consultation.



To schedule a consultation to discuss the structures and tax law references found in this document or for a custom structure, tax filing, planning, and strategy, visit <https://pacifico.tax/schedule-consultation>

DISCLAIMER

The International Tax Structures included in this publication are hypothetical structures and set of circumstances and tax rates that do not apply to any particular taxpayer and for any purpose. The information included in this tax structure is non-transferable or reusable, as each taxpayer's situation is factually unique.

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