

Home Sweet Home Away From Home

ABA Section of Taxation
Committee on US Activities of
Foreigners and Tax Treaties

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Panel

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Your real estate partner comes into your office, saying:

- “We have a new client, Mr. NRA, who is buying the most expensive house in town
- “Here is what he wants to do—
 - ◆ “Not buy it in his own name
 - ◆ “Not pay rent
 - ◆ “Not pay estate tax, should he die
 - ◆ “Not pay gift tax, should he give it away
 - ◆ “Not file a tax return
 - ◆ “Not pay tax when he sells the property”
- “No sweat, I told him; we can do it; my tax partner is the smartest planner in town”

Is it doable?

Does our quiver hold enough tax
planning arrows to meet all
those goals?

Introduction

- Foreign persons buy homes in the United States
 - Personal use during temporary stays which may be:
 - ◆ Long-term
 - ◆ Short term or vacation
 - Permanent home in preparation for moving to the United States
 - Homes for children who may be or become
 - ◆ Nonresident aliens (e.g., students)
 - ◆ Resident aliens or U.S. citizens
- In some cases, the home may be rented out
 - E.g., a resort home or condominium in a rental pool

Big Picture Tax Issues

- Issues arise
 - During period of ownership
 - On sale or exchange
 - On gift
 - On death
- These issues include:
 - Effect on residence status
 - Income tax/withholding on rental income, actual and imputed
 - Capital gains
 - Basis computation issues (including depreciation)
 - FIRPTA and state withholding
 - Gift tax, estate tax and generation skipping tax
 - Consequences to U.S. heirs

Big Picture Tax Issues

■ Issues During Period of Ownership:

- Residence status of alien in most cases not directly affected by ownership of U.S. home
- But . . . ownership and occupancy of home (and size/value of home compared to foreign home) may affect:
 - ◆ Foreign tax home – closer connection test
 - ◆ Tax treaty tiebreaker
 - ◆ Determination of domicile for estate and gift tax
 - ◆ Residence for state tax purposes
 - ◆ Loss of residence for purposes of foreign country's tax

Big Picture Tax Issues

■ Issues During Period of Ownership (cont'd.):

- If corporation holds property, must rent be charged to shareholders or related users?
- Traditional approach: Personal use of corporate property and less than FMV rent -- disallowance of deductions to corporation and constructive dividend
 - ◆ E.g., *Transport Manufacturing & Equipment Company v. Commr.*, 434 F.2d 373 (8th Cir. 1970), *affg.* TC Memo 1964-190, involving use at less than FMV of corporate-owned property by shareholder, officer or related party; *Yarbrough Oldsmobile Cadillac Inc., et al. v. Commr.*, TC Memo 1995-538; *Nicholls, North, Buse Co. v. Commr.*, 56 TC 1225 (1971); *Offshore Operations Trust v. Commr.*, TC Memo 1973-212; *but see Sparks Farm, Inc. v. Commr.*, TC Memo 1988-492
 - ◆ **Consequences:**
 - Constructive dividend equal to excess of FMV over rent paid
 - If corporation is domestic and has E&P, 30% withholding tax
 - If corporation is foreign, possible branch profits tax (but query if foreign corporation is engaged in U.S. trade or business)

Big Picture Tax Issues

- Issues During Period of Ownership (cont'd.):
 - Section 482 may require rental income to be imputed to corporation
 - ◆ If a foreign corporation, would rent be effectively connected?
 - ◆ Expenses are allowed, but imputed rent could exceed expenses
 - ◆ Also, a constructive dividend could be asserted
 - If rent from family members or shareholders is actually charged or imputed
 - ◆ 30% tax unless section 871(d) election made or income actually is effectively connected; no treaty reductions
 - ◆ 30% withholding will be required unless foreign owner provides Form W-8ECI
 - ◆ Renter must file Forms 1042 and 1042-S
 - Deductibility of expenses if home is personally owned
 - ◆ NRA cannot deduct or capitalize interest, taxes, repairs, expenses
 - ◆ Section 280A limits deductions and losses for dual use property, unless personal use limited to 14 days/10% of days held for “fair rental”

Big Picture Tax Issues

■ Issues on Sale or Exchange

- Mandatory gain recognition and taxation (section 897)
 - ◆ 15% tax rate for NRAs, 25% for recapture income
 - ◆ 34%/35% tax rate for corporations on net income after reduction for net operating loss carryovers
 - ◆ Branch profits tax if foreign corporation owned property
 - ◆ Credit allowed for tax withheld under section 1445
- Basis
 - ◆ If home used in trade or business, may require depreciation adjustment
- Availability of net operating loss carryovers
 - ◆ Regs. §§ 1.873-1 and 1.882-4(a) deny losses and deductions if no tax returns filed during ownership period but basis may still be reduced by “allowable” depreciation
 - ◆ *But see Swallows Holding, Ltd. v. Commr.*, 126 TC __, No. 6 (2006)
- Sale of principal residence exclusion – section 121
 - ◆ Technically can apply to NRAs
 - ◆ But facts will often make section unavailable
- Section 1031 unavailable if personal use property; cannot in any event exchange into foreign real property

Big Picture Tax Issues

■ Issues on Sale or Exchange (cont'd.)

- Branch level taxes if owner is foreign corporation
 - ◆ Branch profits tax of 30% on effectively connected earnings, without reduction for net operating loss carryovers
 - ◆ Opportunity to reduce branch profits tax through termination of trade or business
 - ◆ Three-year non-reinvestment rule and three-year extension of statute of limitations
- FIRPTA withholding if owner is foreign
 - ◆ 10% withholding imposed on gross amount realized
 - ◆ \$300,000 exemption where buyer will use property as principal residence – primarily for protection of buyer (note: exemption is only from withholding, not from FIRPTA taxation)
 - ◆ Excess withholding can be avoided based on maximum tax
 - ◆ See IRS Form 8288-B and Rev. Proc. 2000-35, 2000-2 CB 211
 - ◆ Some states require withholding on sale by nonresidents

Big Picture Tax Issues

■ Issues at Time of Gift of U.S. Real Property Interest

- Gift tax applies to gifts of real property located in the United States, but not to gifts of stock in USRPHC
 - ◆ Gifts by NRA of intangible property are not subject to gift tax – section 2501(a)(2)
- No marital deduction for gift to noncitizen spouse – section 2523(i)(1)
 - ◆ Annual exclusion for gift to noncitizen spouse is increased to \$100,000 – section 2523(i)(2)
- Unified gift tax credit of \$1.0 million is not allowed to NRA – section 2505(a)

Big Picture Tax Issues

■ Issues at Death When Owning U.S. Real Property Interest

- U.S. real property and shares of U.S. corporations are subject to estate tax
- No step-up in basis of underlying real property if NRA decedent owns shares of domestic USRPHC
- Unified credit is limited to \$13,000, which covers \$60,000 of taxable estate – section 2102(b); credit may be augmented by treaty
- Deductions are allowed in computing taxable estate only if worldwide estate of noncitizen nonresident decedent is included in U.S. estate tax return – section 2106(b)
- Deductions against taxable estate must be prorated based on the ratio that U.S. situs assets bears to worldwide assets – section 2106(a)
 - ◆ Treatment of recourse v. nonrecourse mortgages

Planning – Introduction

- Tension between capital gains taxation on sale and estate and gift taxation on gratuitous transfer
 - Individual ownership
 - ◆ 15% tax on capital gains and 25% tax on recapture gains
 - ◆ Estate and gift taxes imposed on gross value of U.S. property in the absence of a worldwide report of assets
 - ◆ Step-up on death (including via section 754); not on lifetime gift
 - Corporate ownership
 - ◆ 34%/35% corporate income tax on gains
 - ◆ Potential 30% branch profits tax or dividend withholding tax on repatriation of sales proceeds
 - ◆ If corporation is used to own U.S. real estate or shares of USRPHC, no gift tax and, if corporation is foreign or estate tax treaty applies, no estate tax
 - ◆ At death, step-up on shares but not on underlying property

Structuring Alternatives

- Possible structures include
 - Direct ownership
 - Foreign corporation
 - Domestic corporation owned by NRA, FC, or trust
 - Noncorporate entity
 - ◆ Single member disregarded entity
 - ◆ Partnership or entity classified as a partnership
 - Trusts
- U.S. entity classification rules apply for all purposes
 - Entity will be classified consistently for income tax, estate, gift and generation skipping taxes and reporting
 - States usually require consistency with Federal classification

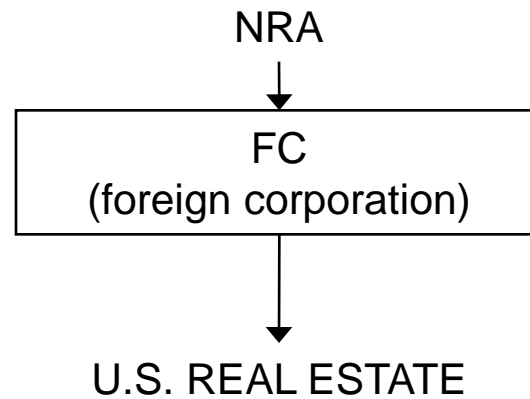
Direct Ownership

■ Direct ownership or U.S. real property

● Allows for –

- ◆ Preferential rates of taxation on long-term capital gains
- ◆ Step-up in basis for transfers at death
- ◆ Use of “disregarded entity” may in some cases be advisable for liability protection or privacy
- ◆ Cost-efficient and understandable solution for estate tax when combined with the purchase of a term life insurance to fund estate tax
 - ◆ NRA must be insurable
 - ◆ Amount of insurance should reflect changes in value
 - ◆ Cost of insurance must be reasonable in light of coverage – but premiums may be cheaper than costs of complex structure
 - ◆ Insurance is not included in taxable estate or subject to income tax
 - ◆ Estate tax may be creditable against home country taxes

Foreign Corporation



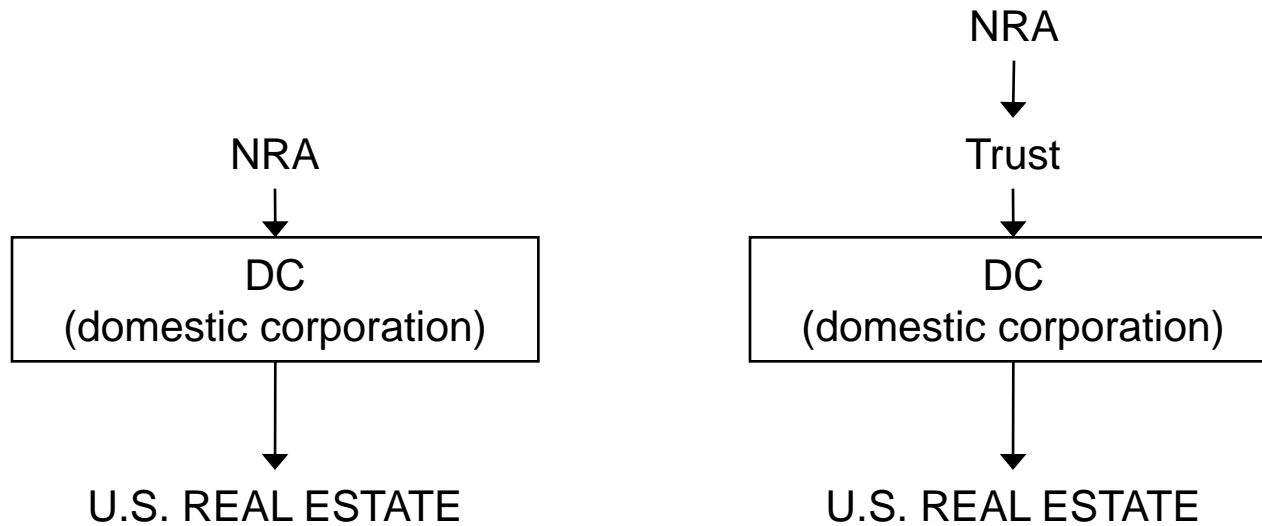
Foreign Corporation

- FC taxed at rates of up to 35% (plus state and local taxes)
 - No long-term capital gains preference
- 30% branch profits tax exposure
 - May be reduced or eliminated by treaty
 - Does not apply to “complete termination”
- Sale of stock of FC not subject to U.S. tax
 - Purchaser may demand price reduction to compensate for “transferred” tax liability and non-tax corporate liabilities
 - Loss of full use of net operating loss
 - Local transfer taxes may apply
- Estate and gift tax protection
 - May be lost if corporate structure is disregarded by NRA

Domestic Corporation

- A domestic corporation that owns the real property may be owned by:
 - foreign corporation;
 - trust; or
 - individual
- Advantages and disadvantages of corporate ownership
 - Anonymity, but 50% or greater shareholder disclosed on Form 1120; also subject to reporting on Form 5472 if engaged in certain related party transactions
 - No tax returns due by individuals prior to (and possibly even upon) sale event
 - Risk of two levels of tax; no capital gains preference
 - Imputed income

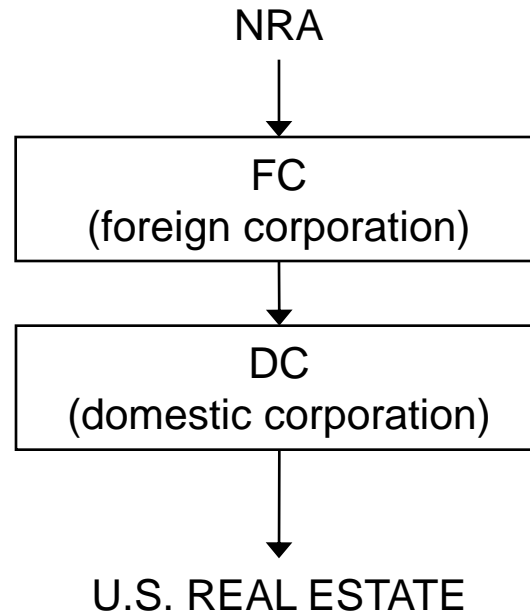
Domestic Corporation Owned by NRA or Trust



Domestic Corporation Owned by NRA or Trust

- DC taxed at up to 35% plus state and local taxes – no capital gains preference
- DC dividends subject to 30% withholding (may be reduced by treaty)
 - Avoid double tax by liquidating DC when no longer a USRPHC (beware accelerating installments, AET, liquidation-reincorporation)
 - Liquidation rules more liberal than BPT termination rules
- NRA generally doesn't file U.S. tax return
 - 50% shareholders disclosed on DC's U.S. return
 - NRA subject to U.S. income tax on sale of domestic USRPHC
 - Unless treaty applies, U.S. estate tax on stock of DC (NRA's home country may allow credit)
- Potential estate tax exposure without step-up in basis for real property, but no gift tax exposure

Domestic Corporation Owned by Foreign Corporation



Domestic Corporation Owned by Foreign Corporation

■ DC

- Taxed at up to 35% plus state and local taxes - no capital gains preference
- No 18-month rule or section 871(d) election required for DC to claim deductions
- No branch profits tax; instead, DC dividends subject to 30% withholding (may be reduced by treaty)

■ NRA

- Pre-sale, does not file U.S. tax return, but may be identified in Form 5472
- Avoids double tax by liquidating DC when no longer a USRPHC (beware accelerating installments, AET, liquidation-reincorporation) and IRS is notified of early termination [Note : Under Regs, § 332 can work even if DC is USRPHC]
- Taxed on sale of DC stock if it is a USRPHC
- Not taxed on sale of FC stock; purchaser may demand price reduction
- Estate and gift tax protection

■ Consider separate DC for each property, if blending profits and losses is not important

■ Direct ownership by FC may be preferred if

- Refinancing is contemplated
- Constructive dividends on personal use are a concern
- Branch profits tax exposure is less important

Single Member Entities

- For U.S. purposes, single member entity is generally the same as direct ownership
- No imputed rent issue
- Possible estate planning opportunities:
 - Electing corporate status for foreign owner pre-mortem or (within 74 days of death) retroactive to one day before death, if NRA's advisers are "plugged in"
 - ◆ May trigger tax under FIRPTA (unless § 897(i) election is available)
 - ◆ But may avoid U.S. estate tax if entity is foreign
 - ◆ May not be possible if within 5 years of prior CTB election
 - Pre-mortem, adding a second owner to convert direct ownership interest into partnership interest

Partnerships – Foreign or Domestic

■ Income Tax

- Foreign or domestic
 - ◆ Where relevant, distinction based on place of organization
 - ◆ Either way, one level of tax and long-term capital gains rates available to individual partners
 - ◆ Section 1446 will apply either way if partnership has ECI
 - ◆ Payments (rent, sale proceeds) to foreign partnership will be subject to withholding by payor (tenant, buyer) under section 1441 and 1445
- Use of home may require income to be imputed – section 707(a)
- Transfer to partnership entitled to nonrecognition, but notice to IRS needed to avoid FIRPTA withholding

■ Gift Tax

- Gift of intangible by NRA generally not subject to gift tax
- No difference between foreign and domestic partnership

Partnerships – Foreign or Domestic

■ Estate Tax

- Situs is the critical factor
- Rules for partnership interests still unclear
 - ◆ IRS position: Partnership interest has U.S. situs if partnership engaged in U.S. trade or business
 - Apparently irrespective of relative sizes of U.S. business and other activities and assets
 - What if partnership is not actually engaged in trade or business but has income deemed effectively connected under section 897(a) or NRA made net rental income election under section 871(d)?
 - ◆ Other possibilities:
 - Situs based on residence of partner (*mobilia sequuntur personam*)
 - Place of organization
 - Look-through (partnership as aggregate)

Partnerships – Foreign or Domestic

■ Estate Tax (cont'd.)

- If partnership not engaged in U.S. trade or business:
 - ◆ Partnership interest has no U.S. situs but
 - ◆ Partnership interest is stepped-up on death; section 754 election should be made
- Retained interest
 - ◆ If NRA contributes property to partnership but retains right to live there, section 2036 may apply: *Estate of Lorraine C. Disbrow v. Commr.*, TC Memo 2006-34
 - ◆ This issue can be addressed by FMV lease

Ownership Through Trust

- Attractive vehicle for newly acquired property
 - Irrevocable trust (domestic or foreign) formed with cash
 - ◆ Cash transfer not subject to gift tax – cash is intangible property
 - Trust uses cash to acquire U.S. real property
 - ◆ Acquisition of property from unrelated seller does not affect corpus of gift
 - ◆ N.B. – different result if settlor sells the U.S. real property to the trust; see *Davies v. Commr.*, 40 T.C. 525 (1963), and *De Goldschmidt-Rothschild v. Commr.*, 168 F.2d 975 (2d Cir. 1948)
 - Beneficiary who lives in the house rent-free or for below-market rent does not have imputed income
 - ◆ *H.B. Plant v. Commr.*, 30 B.T.A.133 (1934), *affd.* 76 F.2d 8 (2d Cir. 1935), and *Alfred I. duPont Testamentary Trust v. Commr.*, 66 T.C. 1976, *affd.* 574 F.2d 1332 (5th Cir. 1978)
 - ◆ See dicta in *Dickman v. Commissioner*, 465 U.S. 330 (1984): “It is not uncommon for parents to provide their adult children with such things as the use of cars or vacation cottages, simply on the basis of the family relationship. We assume that the focus of the Internal Revenue Service is not on such traditional familial matters”
 - Trust is taxed as individual (entitled to 15% LTCG rates)

Ownership Through Trust (cont'd.)

- At time of settlor's death, there is no transfer of property; therefore, no estate tax even though trust corpus at time of death consists of U.S. real property
- Note: No basis step-up because property not included in estate
- Settlor can use property in certain circumstances without subjecting his estate to estate tax under section 2036(a):
 - Settlor must not have a right to trust income
 - That right should not exist where the trust has an independent trustee and the trustee has complete discretion over the use of trust assets
 - ◆ *Commr. v. Irving Trust Co.*, 147 F.2d 946(2d Cir. 1945), and *Sherman v. Commr.*, 9 T.C. 594 (1947)
- The benefit may be forfeited where –
 - An informal agreement allows settlor to control the income
 - Creditors of the settlor can reach trust assets (precludes formation of trust in many US jurisdictions due to “self-settled trust” issues)
 - The settlor is the trustee
 - The trustee's discretion is subject to an enforceable standard

What If NRA's Family Includes U.S. Persons?

- Reconsider use of corporations in planning
 - Foreign corporation may become a CFC or PFIC
 - Basis step-up doesn't apply to property held by FC or DC
- Trusts also require careful planning:
 - Consider effect of section 672(f)
 - Foreign trust may give rise to “throwback” taxation and long-term capital gains taxed at ordinary income rates unless distributed in year realized
 - Grantor trust that becomes ordinary trust may give rise to reporting under foreign gift and trust reporting rules (section 6048(a) and Form 3520)
 - Consider domesticating trust

What If the NRA Has Already Died?

■ Foreign corporation

- No estate tax but FC may become a CFC or PFIC (depending on percentage U.S. ownership)
- Consider domestication and application of Regs. §1.897-5(c)(4) and Notice 2006-46
- If FC has E&P, income inclusion may be required under section 367

■ Domestic corporation

- Estate tax on DC
- Corporate level capital gains tax to extract property
- Shareholder level tax on liquidation but may be limited due to step-up
- For DC, including newly domesticated FC, consider S election
 - ◆ 10-year delay before sale to avoid two levels of tax
 - ◆ Meantime, may be able to do section 1031 exchange

■ In either case, consider liquidating corporation, particularly if there is not much taxable appreciation

A Litany of Practical Issues

- Setting up entities
 - Opening bank accounts – this has become a real challenge
 - Obtaining ITINs (miserably difficult) and EINs (relatively easy)
 - Establishing no “unsatisfied withholding liability”
- Managing the property
 - Filing tax returns
 - Recordkeeping
 - Annual real estate tax reductions for “principal residences”
 - Local transfer taxes on “tax-free” transfers
 - Respecting structure
 - US Dept. of Commerce reporting may apply
- Basis
- Privacy
- Home country taxation