

U.S. Houses and Other Private Use Assets Held by Non-resident Aliens in the United States

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Roadmap

- Fact Patterns
- Big Picture Tax Issues
- Corporate Structures
- Flow-Through Structures
- Trust Structures
- Practical Problems

Fact Patterns

- Nonresident alien (or NRA couple) buys a home for own use, possibly with the intention of renting it out when not in the U.S.
- NRA buys home for use by U.S. relative (or NRA relative, e.g. a foreign student)
- NRA buys home in anticipation of moving to the U.S.
- NRA buys home to live in the U.S. for a number of years before moving back to home country
- In many fact patterns, NRA's spouse or heirs may be (or become) U.S. persons

Big Picture Tax Issues

- Upon Acquisition
 - ◆ FIRPTA (Foreign Investment in Real Property Tax Act of 1980) withholding (Federal and state)
 - ◆ Financing
- During Ownership
 - ◆ Effect on resident status
 - ◆ Tax on rental income
 - ◆ Consequences of personal use of asset (if held by an entity)
- Upon sale
 - ◆ Capital gains or ordinary income rates
- Upon gift or inheritance
 - ◆ Gift tax issues
 - ◆ Basis calculation
 - ◆ Estate tax issues
 - ◆ Consequences to heirs
- Filing Requirements Throughout

Issues Upon Acquisition

■ FIRPTA Withholding

- ◆ Buyer (foreign or domestic) must withhold 15% of amount realized by seller unless seller obtains withholding certificate to reduce or eliminate withholding or provides proof of being a U.S. person
- ◆ A foreign seller who applies for a withholding certificate must establish that there was no unsatisfied withholding obligation when seller bought the property
- ◆ Therefore, when buying the property, a foreign seller must keep records of compliance with withholding requirements, such as proof of seller being a U.S. person or withholding certificate and/or proof of payment of any tax that was required to be withheld, if any, since this will become relevant when client later sells the property

Issues Upon Acquisition (cont.)

■ Financing

- ◆ Sometimes all-cash purchases
- ◆ If foreign buyer becomes U.S. resident, buyer may wish to deduct interest on the first \$750,000 (\$1 million after 2025) of their loan amount as qualified residence indebtedness under 163(h)
 - If that is a possibility, loan must be secured and obtained before or no later than 90 days after closing of the purchase

Issues During Ownership

- Effect on resident status
 - ◆ Ownership of real property itself does not necessarily constitute U.S. residence, but could be a factor in tiebreaker tests.
 - E.g., closer connection test, treaty tiebreaker, determining domicile for estate and gift tax purposes
 - ◆ Could also be relevant in determining residence for purposes of state tax
 - ◆ Also potentially relevant to establishing loss of residence for purposes of foreign country's tax

Issues During Ownership (cont.)

■ Tax on rental income

◆ If owned by foreign individual

- Is rent effectively connected? Consider making section 871(d) election
- Is shareholder tenant a withholding agent?

◆ If a foreign corporation

- Same issues as foreign individual, plus:
- Trade-off of depreciation vs. potential increase of FIRPTA gain
- Branch profits tax

◆ If a domestic corporation

- Rent taxed at 21%, distributions to foreign shareholder subject to withholding
- Accumulated earnings tax (discussed later)

Issues During Ownership – Personal Use of Entity Property (1)

- No issue if home owned directly by individual
- If corporation owns the home, likely that income will not be imputed to a shareholder who makes personal use of property
 - ◆ Section 482 may not apply because it requires two businesses and the mere ownership of shares does not cause a shareholder to be treated as a business
 - This issue was raised in the partnership context in *Dolese v. Commr.*, 811 F. 2d 543 (10th Cir. 1987), but, in that case, the Tax Court and the 10th Circuit held that taxpayer and his partnership were engaged in businesses which entered into transactions with each other
 - ◆ But IRS takes the view that the corporation has made a distribution of the fair value of the use of the property
 - ◆ This view was upheld in *G.D. Parker v. Commissioner*, T.C. Memo 2012-327 – discussed later
 - ◆ Determining fair market value of use value can also be tricky
 - E.g., shareholder's family members have access to holiday home all year, but stay there for only three months
 - Or, property held in rental pool or, as in the case of a yacht or aircraft, for charter
 - ◆ What if the person using the home is simply a guest?

Issues During Ownership – Personal Use of Entity Property (2)

■ G.D. Parker case (2012)

- ◆ Facts: Typical structure (NRA owns Foreign Corp, which owns U.S. Corp, which owns residential property). Only U.S. Corp was before the court, not Foreign Corp. nor NRA
- ◆ Court did not impute income to U.S. Corp.
- ◆ Court held U.S. Corp. had made constructive distribution of fair market value of use of property (minus any rent) and was liable for withholding tax at 30% to the extent it had E&P. This issue was remanded and the parties settled

■ Issues and comments

- ◆ No withholding on constructive distribution by Foreign Corp. to NRA
- ◆ Since NRA not before the court, no discussion of whether NRA was subject to gift tax to the extent properties used by relatives
- ◆ Distribution reduced to the extent of rent actually paid
- ◆ Issue not addressed by *G.D. Parker*: If U.S. Corp. was a USRPHC, withholding not limited to E&P. Rather, U.S. Corp must either:
 - Withhold 30% on amount of distribution, subject to reduction by tax treaty, or
 - Withhold 30% on amount estimated to be a dividend from earnings and profits and then apply FIRPTA withholding at 15% on the remaining amount of the distribution, subject to reduction by withholding certificate
- ◆ Any overwithholding in this situation can only be refunded to shareholder

Issues During Ownership – Personal Use of Entity Property (3)

- Partnerships: Law is unclear as to whether a partnership has a similar issue
 - ◆ A constructive distribution by a partnership should not be taxable, since it doesn't appear to be a distribution of money
 - ◆ But such a distribution would reduce basis
- Foreign trust:
 - ◆ A U.S. beneficiary (e.g., grantor's relative) who uses property may have received a distribution of the fair market value of the use of the property – IRC section 643(i)
 - ◆ If not reported on Form 3520 under actual method, distribution will be taxable as income under default method, even if trust has no income
- Armageddon: Corporate structure, owned by foreign trust, with property occupied by U.S. relative who pays no rent and fails to file Form 3520
 - ◆ What remedial action be taken?

Issues During Ownership (cont.)

■ Rent

- ◆ Rent paid should reduce imputed use distributions
- ◆ Rent arguably includes user's payment of expenses (e.g., interest, taxes, insurance, maintenance, etc.) – see Revenue Ruling 73-522 (noting that under Reg. sec. 61-8(c), if lessee pays any expenses of lessor such payments are additional rental income of lessor)
- ◆ Rent is subject to 30% tax if property directly held by foreign person

■ Deductions

- ◆ As a rule, individuals cannot deduct expenditures associated with home used for personal purposes.
 - Exc. Qualified resident interest and property taxes
 - Itemized deductions, now come with caps
- ◆ Nonresident aliens not entitled to itemized deductions
 - This applies also when property is held through a trust or partnership.
- ◆ Domestic corporation can deduct expenses, but:
 - Not to the extent attributable to personal use by shareholder
 - Section 280A limits deductions and losses for dual use property, unless personal use limited to 14 days/10% of days held for “fair rental”
- ◆ Foreign corporation
 - If engaged in trade or business (or elects to be ETB under section 882(d)), same position as domestic corporation but must file return
 - If not ETB (or fails to file return), no deductions and tax at 30% on any rent paid

Issues on Sale or Exchange

- ◆ Mandatory gain recognition and taxation (Section 897)
 - 20% tax rate for capital gains of NRAs, 25% for recapture income
 - 21% tax rate for corporations on net income after reduction for net operating loss carryovers
 - Branch profits tax on gain if property is owned by foreign corporation
 - Credit allowed for tax withheld under Section 1445
- ◆ Basis
 - If home used in trade or business, may require depreciation adjustment

Issues on Sale or Exchange (cont.)

- Availability of net operating loss carryovers
 - ◆ Regs. secs. 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
- Sale of principal residence exclusion – Section 121
 - ◆ Technically can apply to NRAs
 - ◆ But facts will often make section unavailable except for departing individuals
- Like-Kind Exchange - Section 1031
 - ◆ Exchanges of real property held for use in a trade or business or for investment: property acquired for use in trade or business, or property that has been held for use in trade or business but currently inactive
 - Unavailable for personal use property
 - Inapplicable to exchange for foreign real property
 - ◆ Special rules for exchanges between related persons

Issues on Sale or Exchange (cont.)

- 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
 - ◆ Note that if the corporation sells a home and buys another:
 - The reinvestment may not qualify because the property may not be used in a U.S. trade or business and the purchase would not increase the U.S. net equity
 - The alternative, using the termination of the trade or business rule, may not work either because of the three-year non-reinvestment rule and three-year extension of statute of limitations (even if the new home is purchased through a different foreign corporation)

Issues on Sale or Exchange (cont.)

- FIRPTA withholding if owner is foreign
 - ◆ 15% withholding imposed on gross amount realized
 - ◆ Excess withholding can be avoided based on calculation of gain
 - See IRS Form 8288-B and Rev. Proc. 2000-35, 2000-2 CB 211
 - ◆ Some states require withholding on sale by nonresidents
 - E.g. California requires 3.33% withholding on sale by residents and nonresidents alike
 - May be reduced with Form 593-C for full exemption, 593-E to show gain is much less than sale price

Issues Upon Gift

- Gift tax applies to gifts of real property located in the United States, but not to gifts of stock in USRPHCs
 - ◆ 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 \$157,000 in 2020 – Section 2523(i)(2)
- Unified gift tax credit of \$11.58 million is not allowed to NRA – Section 2505(a)

Issues at Death

- In estate of nonresident aliens, 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

Issues at Death (cont.)

- Deductions are allowed in computing taxable estate only if worldwide estate of noncitizen nonresident decedent is part of information report 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 differs. *Estate of Johnstone v. Commr.* (1952)
 - Estate tax imposed upon the value of a decedent's net estate.
 - Nonrecourse loan: debt collected only from property mortgaged to secure the debt and not from the estate generally, so the full amount of the debt should be excluded
 - Recourse loan: collected from the estate generally and a part of that estate is not being taxed in the United States, so only a proportionate part of the debt to be deducted

Planning Objectives

- Minimize tax on sale of the property so as to pay, if possible, just one level of tax, either at capital gains tax rate (20%) or corporate income tax rate (21%)
- Eliminate or mitigate the consequences of personal use of entity-held property
- Avoid estate tax should the owner die while still owning the property and maximize basis step-up
- Deal with the consequences of U.S. heirs and users of the property
- Minimize compliance and contact with U.S. tax system

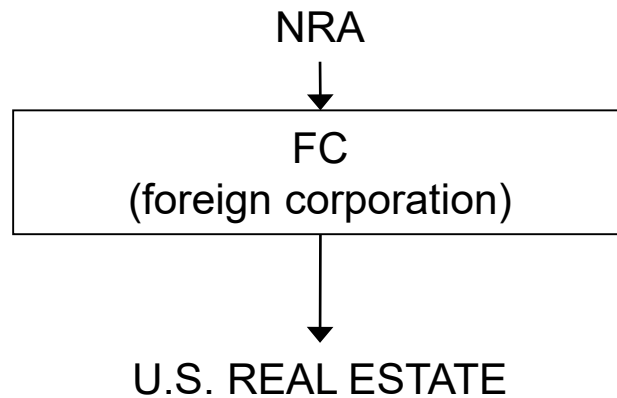
Structuring Alternatives

- 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
 - ◆ Trust
- 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

- Preferential rate 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 and ease of transfer on gift or death
- No tax on use by owner and very unlikely that IRS will assert gift tax on use by relatives and friends
- Cost-efficient and understandable solution for estate tax if combined with purchase of 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
 - ◆ Section 121 exemption may apply if home was principal residence

Foreign Corporation



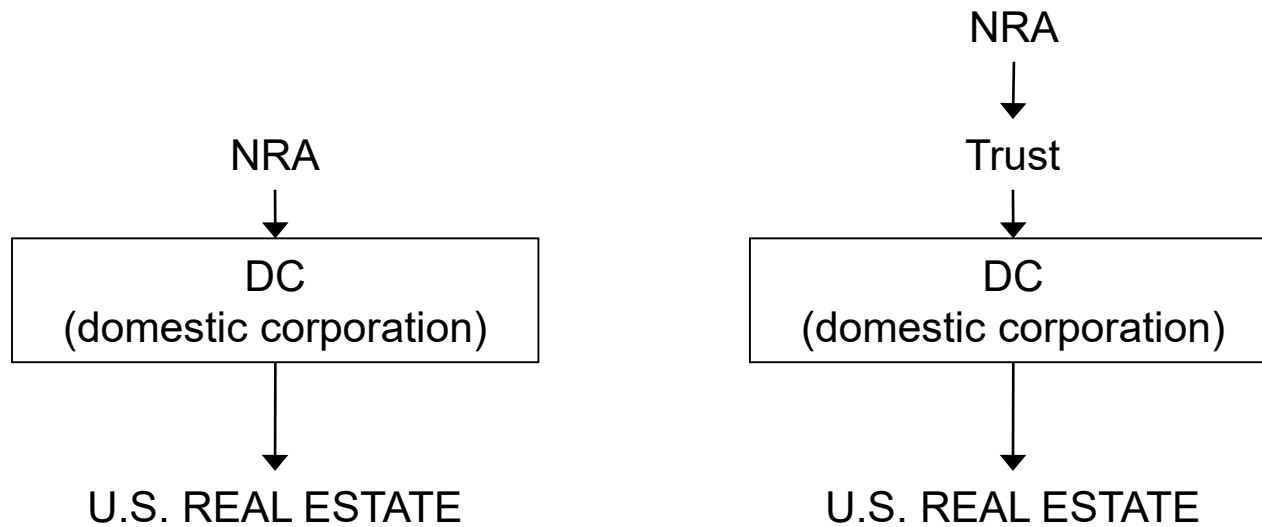
Foreign Corporation

- FC taxed at rates of up to 21% at Federal level
 - ◆ State and local taxes must be considered
- 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
 - ◆ Commercial anonymity, but
 - 50% or greater shareholder disclosed on Form 1120
 - 25% or greater shareholder must be identified on Form 5472 if U.S. corporation engages in related party transactions
 - Reporting extends to foreign corporation engaged in U.S. trade or business
 - ◆ 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

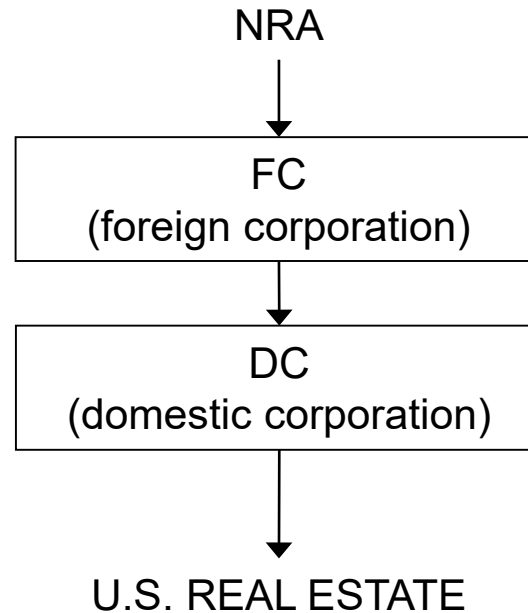
Domestic Corporation Owned by NRA or Trust



Domestic Corporation Owned by NRA or Trust

- DC taxed at up to 21% plus state and local taxes
- DC dividends subject to 30% withholding (may be reduced by treaty)
 - ◆ Avoid double tax by accumulating earnings and deferring distributions until liquidation when DC is no longer a USRPHC
 - ◆ Liquidation rules more liberal than BPT termination rules
 - ◆ N.B.
 - Liquidation accelerates income from installment sale
 - Accumulated earnings tax
 - Liquidation-reincorporation
- NRA generally doesn't file U.S. tax return
 - ◆ 25% 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)
 - ◆ DC stock may be transferred during life free of gift tax

Domestic Corporation Owned by Foreign Corporation



Domestic Corporation Owned by Foreign Corporation

■ DC

- ◆ Taxed at 21% plus state and local taxes
- ◆ No 18-month rule to claim deductions, although case law acknowledges that at some point the right to claim deductions ceases
- ◆ No Section 871(d) election required for DC to claim deductions
- ◆ No branch profits tax but dividends subject to 30% withholding tax, subject to treaty

■ NRA

- ◆ Pre-sale, does not file U.S. tax return, but may be identified in Form 5472 and in U.S. tax return if NRA owns more than 25% of shares indirectly
- ◆ Avoids double tax by accumulating earnings and deferring distributions until liquidation when DC is no longer a USRPHC – but beware of Accumulated Earnings Tax
- ◆ NRA is not taxed on sale of FC stock. However, most purchasers likely will insist on buying the property
- ◆ Liquidation rules more liberal than BPT termination rules
- ◆ Notes:
 - Liquidation accelerates income from installment sale
 - Accumulated earnings tax
 - Liquidation-reincorporation
 - Section 332 liquidation of DC can defer tax for FC even if DC is a USRPHC
- ◆ Estate and gift tax protection

■ The structure has many significant drawbacks:

- The personal use issues identified above
- No step-up on death of ultimate owner
- Very difficult situation for any U.S. heirs and trust beneficiaries
- May pose significant home country tax problems

Domestic Corporation Owned by Foreign Corporation

- Consider separate DC for each property, if blending profits and losses is not important
 - ◆ This structure facilitates tax-free cash distributions following sale of a property
- 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
 - ◆ Personal use issues relating to withholding
 - But note potential withholding tax on rent, including expense reimbursements

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"
 - "Transfer" occurs at C.O.B. of the day preceding CTB election
 - May trigger tax under FIRPTA (unless sec. 897(i) election available)
 - But may avoid U.S. estate tax if entity is foreign, so weigh tax on pre-death appreciation v. estate tax
 - May not be possible if death occurs within 5 years of prior CTB election that was not made at formation
 - ◆ 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 subject to withholding by payor (tenant, buyer) under Sections 1441 and 1445

◆ Use of home may require income to be imputed – Section 707(a); see *Dolese v. Commr.*, 811 F. 2d 543 (10th Cir. 1987)

◆ 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)?
 - If partnership holds property exclusively for personal use by partner(s), is it engaged in a trade or business?
 - Other possibilities:
 - Situs based on residence of partner (*mobilia sequuntur personam*)
 - Place of organization
 - Look-through (partnership as aggregate – but less likely following Tax Court decision in *Grecian Magnesite*)
 - Double partnership structure may maximize taxpayer favorable arguments (foreign partnership, including checked entity, owns U.S. partnership that owns property)

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 to push down stepped-up basis
- ◆ Retained interest
 - If NRA contributes property to partnership but retains right to live in property, Section 2036 may apply: *Estate of Lorraine C. Disbrow v. Commr.*, TC Memo 2006-34
 - This issue is typically 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) (although taxpayer won, on the facts) 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 (except U.S. beneficiary of foreign trust – see next slide)
 - *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. Commr.*, 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 20% LTCG rates)

Ownership Through Trust (cont'd.)

- Section 643(i): If a foreign trust permits the use of trust property by a grantor or a beneficiary (or a related person) who is a U.S. person, the fair market value of such use is treated as a distribution by the trust to the U.S. person.
 - ◆ Related party under sections 267 and 707(b)
 - ◆ Reportable on Form 3520 every year

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
- 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 U.S. 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 (including if owned by a foreign nongrantor trust with one or more U.S. beneficiaries)
 - ◆ 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 nongrantor 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 Reg. secs. 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
 - 5-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”
 - ◆ Funding the entity (at the beginning and throughout its existence)
- Managing the property
 - ◆ Filing tax returns
 - ◆ Recordkeeping
 - ◆ Annual real estate tax reductions for “principal residences”
 - ◆ Local transfer taxes on “tax-free” transfers
 - ◆ Respecting structure
 - ◆ U.S. Dept. of Commerce and Dept. of Agriculture reporting may apply
- Basis
- Privacy
- Home country taxation

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