



AMERICAN **BAR** ASSOCIATION

Tax Section

2024 MIDYEAR TAX MEETING

HYATT REGENCY
SAN FRANCISCO, CA

Home Away From Home:
Nonresident Ownership of U.S.
Homes

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Roadmap

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

Basic 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

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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)

Big Picture Tax Issues

- 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
- In addition to tax, confidentiality concerns at every stage

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
 - Exception for personal home up to \$300,000
 - Reduction for purchase up to \$1.0 million
 - When buying the property, a foreign buyer must keep records of compliance with withholding requirements because proof of compliance at time of purchase will be relevant when foreign client later sells the property
 - Examples
 - Nonforeign affidavit received at time of original purchase
 - Withholding certificate issued at time of original purchase plus proof of payment of amount specified in withholding certificate

Issues Upon Acquisition – Geographic Targeting Orders (1)

- Report must be filed by title company where:
- Purchase price of residential real property is in the amount of \$50,000 or more in the City or County of Baltimore in Maryland or \$300,000 or more in the areas listed on next slide.
- Purchase made without a bank loan or other similar form of external financing by a financial institution that has both an obligation to maintain an anti-money laundering program and an obligation to file Suspicious Activity Reports
- Purchase is made, at least in part, using currency or cashier's check, certified check, traveler's check, personal check, business check, money order in any form, funds transfer, or virtual currency
- Purchase is made by a "Legal Entity", defined as:
 - Corporation
 - Limited Liability Company
 - Partnership
 - Other similar business entity
 - Not clear if it includes trusts (which in most cases are not business entities and at least to trust lawyers are technically not entities at all)

Issues Upon Acquisition – Geographic Targeting Orders (2)

- Most recent update was April 21, 2023

https://www.fincen.gov/sites/default/files/shared/508_Order_April2023REGTO.pdf

| | | | |
|------------|--|----------------------|--|
| State | County/City | Massachusetts | Suffolk or Middlesex |
| Texas | Bexar, Tarrant, Dallas, Harris, Montgomery, or Webb | Illinois | Cook |
| Florida | Miami-Dade, Broward, or Palm Beach | Maryland | Montgomery, Anne Arundel, Prince George's, or Howard |
| New York | Boroughs of Brooklyn, Queens, Bronx, Staten Island, or Manhattan in New York City, | Virginia | Arlington or Fairfax, or the cities Alexandria, Falls Church, or Fairfax |
| California | San Diego, Los Angeles, San Francisco, San Mateo, or Santa Clara | Connecticut | Fairfield or Litchfield |
| Hawaii | Hawaii, Maui, Kauai, or Honolulu, or the City Honolulu | Colorado | Adams, Arapahoe, Clear Creek, Denver, Douglas, Eagle, Elbert, El Paso, Fremont, Jefferson, Mesa, Pitkin, Pueblo, or Summit |
| Nevada | Clark | District of Columbia | |

Issues Upon Acquisition

- Financing
 - If foreign buyer intends to become U.S. resident, buyer may wish to deduct interest on the first \$750,000 (\$1 million after 2025) of the loan amount
 - To be qualified residence indebtedness under 163(h), loan must be secured and obtained
 - Prior to closing or
 - Not later than 90 days after closing

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
 - Potentially relevant to establishing loss of residence for purposes of foreign country's tax

Issues During Ownership

- Tax on rental income
 - If owned by a foreign individual
 - Is rent effectively connected? Consider making section 871(d) election
 - Is shareholder tenant a withholding agent?
 - If owned by a foreign corporation
 - Same issues as for a foreign individual
 - Trade-off of depreciation vs. potential increase of FIRPTA gain at time of sale
 - Branch profits tax
 - If owned by 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 Property Owned by NRA
 - No issue if home is owned directly by individual
- Personal Use of Property Owned by Corporation
 - If corporation owns the home, risk exists that income will be imputed to a shareholder who makes personal use of property
 - Section 482 may or may not apply because
 - Generally, Section 482 requires two businesses, and the mere ownership of shares does not cause a shareholder to be treated as a business
 - However, here the shareholder is a customer of corporate landlord
- This issue was raised in the partnership context in *Dolese v. Commr.*, 811 F.2d 543 (10th Cir. 1987)
 - Held that taxpayer and his partnership were engaged in businesses which entered into transactions with each other

Issues During Ownership

- Personal Use of Property Owned by Corporation
- IRS takes view that corporation made a distribution of the fair value of the use of the property
 - See *G.D. Parker v. Commissioner*, T.C. Memo 2012-327
 - Determining fair market value of use value
 - One view: shareholder's family members have access to holiday home all year, but stay there for only three months
 - Opposite view: no attempt to rent the property and shareholder's personal possessions are maintained on property for 12 months
 - Third view: 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 of the shareholder

Issues During Ownership

- Personal Use of Property Owned by Corporation
- *G.D. Parker v. Commissioner*
 - Facts:
 - NRA owns Foreign Corp
 - Foreign Corp owns U.S. Corp
 - U.S. Corp 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 holding:
 - U.S. Corp. constructively made distribution of fair market value of use of property reduced by any rent paid
 - U.S. Corp was liable for withholding tax at 30% to the extent it had E&P.
 - Issue of E&P amount was remanded and the parties settled

Issues During Ownership

- Personal Use of Property Owned by Corporation
- Issues and comments regarding *G.D. Parker*
 - 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.
 - 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
 - Apply FIRPTA withholding at 15% on the remaining amount of the distribution,
 - subject to reduction by withholding certificate
 - Any overwithholding in this situation can be refunded to shareholder if an ITIN is obtained and a Form 1040NR is filed

Issues During Ownership

- Personal Use of Property Owned by Partnership
- Law is unclear 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
- Personal Use of Property Owned by 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 – 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 can/should be taken?

Issues During Ownership

- Rent
 - Rent paid should reduce imputed use distributions
 - Rent arguably includes user's payment of expenses (e.g., interest, taxes, insurance, maintenance, etc.)
 - See Rev. Rul. 73-522 (noting that under Reg. Section 1.61-8(c), rental income for lessor includes any expenses paid by lessee)
 - Rent is subject to 30% tax if property directly held by foreign person

Issues During Ownership

- Deductions
 - As a rule, individuals cannot deduct expenditures associated with home used for personal purposes
 - Exceptions provided for qualified residence interest and property taxes
 - Itemized deductions, now come with caps
 - Nonresident aliens entitled to itemized deductions that are allocated or apportioned to effectively connected income
 - Domestic corporation can deduct expenses subject to limitations:
 - 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 may claim deductions to the extent allocated or apportioned to effectively connected income
 - Tax return must be timely filed
 - If not, no deductions and 30%tax is imposed on any rent paid

Privacy and Confidentiality

- Ownership of real estate is generally a matter of public record
- Use of entities may help
- Nevertheless, many countries, including most offshore havens, now implementing beneficial ownership registries, now including the United States (see next slide)

Privacy and Confidentiality

- Corporate Transparency Act enacted by the National Defense Authorization Act of 2020 requires beneficial ownership information reporting requirements for companies formed or operating in the U.S.
 - Requirement will be administered by FinCEN (the agency that administers FBARs)
- “Beneficial owner” is defined as an individual who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise, exercises substantial control over the entity or owns or controls not less than 25% of the ownership interests of the entity. Does not include
 - a minor child
 - a nominee, intermediary, custodian, or agent on behalf of another individual
 - an employee of the reporting company
 - an individual whose only interest in the reporting company is through a right of inheritance
 - a creditor unless creditor exercises substantial control or owns or controls 25% or more of the entity.
- The Act does not define “substantial control” or explain how to measure “25% or more ownership”

Privacy and Confidentiality

- FinCEN may only disclose ownership information upon request by:
 - Federal agency engaged in national security, intelligence, or law enforcement
 - State, local, or Tribal law enforcement agency
 - Federal agency on behalf of a law enforcement agency, prosecutor, or judge of another country
 - Financial institution subject to customer due diligence requirements, with consent by the reporting company
 - U.S. federal functional regulator or other appropriate regulatory agency
 - Probably not subject to FOIA request
- When is reporting required?
 - New reporting company: Report at time of formation or registration
 - Reporting company formed or registered before the enactment: Within 2 years after the effective date of enactment.
 - Changes: Not later than 1 year after the date on which there is any reportable change
- Penalties:
 - Fine of \$10,000
 - Imprisonment of up to two years

Issues on Sale or Exchange

- **Mandatory gain recognition and taxation under 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
 - If property is owned by a foreign corporation, branch profits tax will be due on the dividend equivalent amount arising from the gain, without any benefit available from an NOL
 - Credit allowed for tax withheld under Section 1445
- **Basis**
 - If home is used in a trade or business, the basis may require an adjustment to recognize the effect of depreciation

Issues on Sale or Exchange

- Availability of net operating loss carryovers
 - Regs. Sections 1.874-1 and 1.882-4(a) deny losses and deductions when a foreign taxpayer fails to file U.S. income tax returns on a timely basis
 - Timely means filed means filing not later than 18 months after the due date of the current year's return
 - Failing to file does not mean that allowable depreciation is not taken into account in computing basis
- Sale of principal residence exclusion – Section 121
 - Technically can apply to NRAs
 - Often unavailable except for departing residents

Issues on Sale or Exchange

- 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
 - Unavailable for corporation that if shareholder uses property without a lease
 - Inapplicable to exchange for foreign real property
 - Special rules for exchanges between related persons

Issues on Sale or Exchange

- 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
 - All gain must be recognized from sale of U.S. assets and tax due must be paid
 - Funds must be ring-fenced outside the U.S. for three full taxable years following the close of the year of termination
 - Statute of limitations must be extended by 3 years
- Corporation sells a home and buys another:
 - The reinvestment may not qualify to defer BPT if new property is not used in a U.S. trade or business – no increase in U.S. net equity
 - By definition, the alternative is not a termination of the business

Issues on Sale or Exchange

- 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
 - 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
 - N.Y.S. imposes 8.82% withholding tax on the realized capital gain
 - The seller must file Form IT-2663 to report estimated income taxes in connection with the sale; no tax is due in the event of a loss, but form must be filed in any event

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 \$11.70 million in 2021 is not allowed to NRA – Section 2505(a)
- In California, gift may cause property tax re-assessment

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 estate tax treaty
 - Only 14 estate tax treaties exist, plus the Canadian income tax treaty which contains estate tax provisions

Issues at Death

- Deductions are allowed in computing taxable estate only if worldwide estate of NRA 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; see *Estate of Johnstone v. Commr* (1952).
 - Estate tax imposed upon the value of a decedent's net estate
 - Nonrecourse loan is claim against property securing the debt, only
 - Recourse loan is a claim against the entire estate and should be prorated based on values in the U.S. and outside the U.S.

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
- Confidentiality is also often an issue

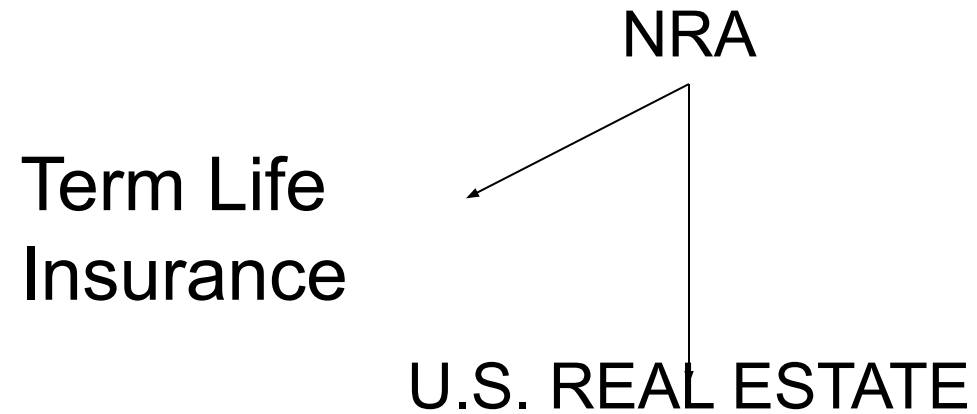
STRUCTURING ALTERNATIVES

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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



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 in *de minimis* amounts

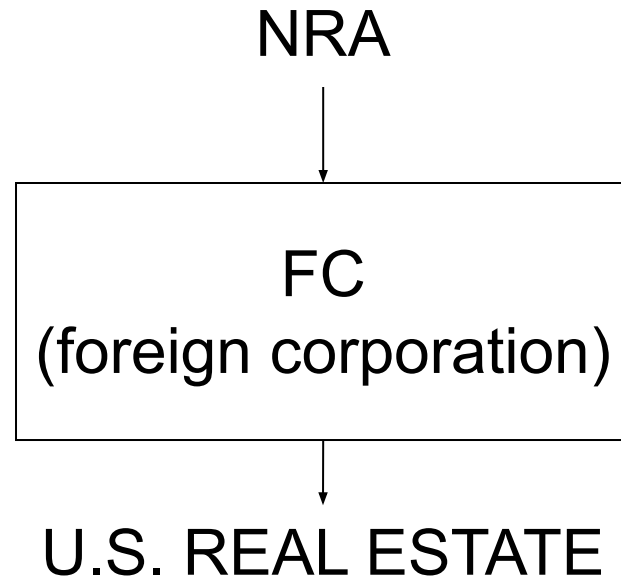
Direct Ownership

- 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 (usually available only to former U.S. residents)

CORPORATE STRUCTURES

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Foreign Corporation



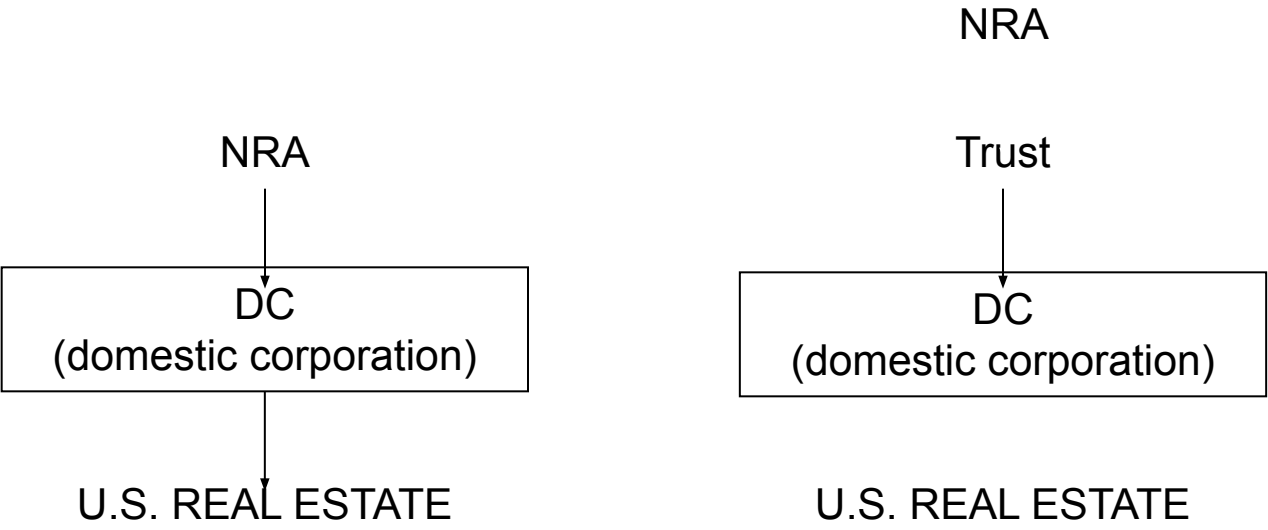
Foreign Corporation

- 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,” if applicable
 - Does not apply if proceeds reinvested, but must be reinvested in U.S. trade or business, not another home that will be used for personal purposes

Foreign Corporation

- 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
 - While taxpayers may not be able to disregard corporation established for business reason, the IRS may challenge corporation as an alter ego of NRA
 - Note: On death, basis of stock is stepped up but no step-up in basis of property

Domestic Corporation Owned by NRA or Trust



Domestic Corporation

- A domestic corporation that owns the real property may be owned by
 - Foreign corporation
 - Trust or
 - Individual

Domestic Corporation

- 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
 - Note FinCEN requirements mentioned earlier
 - No tax returns due by individuals prior to (and possibly even upon) sale event
 - Risk of two levels of tax, unless corporation liquidated post-sale and recognition of all gain (see next slide)
 - No capital gains preference (less important since 2017)
 - Imputed income

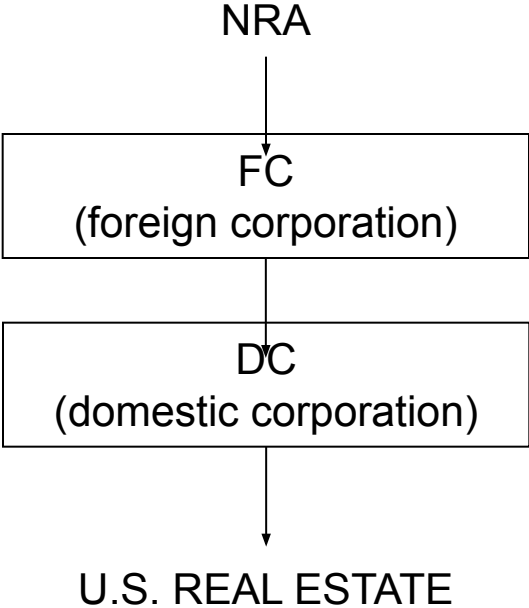
Domestic Corporation Owned by NRA or Trust

- DC taxed at up to 21% plus state and local taxes
 - Unlike for individuals, state and local taxes should be deductible
- 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
 - No accumulated earnings tax exposure if shareholder is NRA
 - Limited personal holding company tax exposure if domestic corporation is a real estate corporation having adjusted ordinary income from rents
 - Liquidation rules more liberal than BPT termination rules. But note:
 - Liquidation accelerates income from installment sale
 - Liquidation-reincorporation

Domestic Corporation Owned by NRA or Trust

- NRA generally is not required to file U.S. tax return or obtain an ITIN
- 25% shareholders disclosed on DC's U.S. return
- NRA subject to U.S. income tax on sale of domestic USRPHC (such transactions are therefore very rare)
- 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% or treaty rate withholding

Domestic Corporation Owned by Foreign Corporation

- 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 no longer a USRPHC – but beware 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

Domestic Corporation Owned by Foreign Corporation

- N.B.
 - Liquidation accelerates income from installment sale
 - 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 of U.S. real property 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 by shareholder is less of an issue, as there should be no withholding tax on “constructive dividend”
 - But note potential withholding tax on rent, including expense reimbursements

FLOW THROUGH STRUCTURES

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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 pass-thru entity as a pre-mortem tax plan, 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 is made
 - But may avoid U.S. estate tax if entity is foreign, so weigh tax on pre-death appreciation v. estate tax (but note inversion problem)
 - 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
 - Rev. Rul. 55-701: 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?

Partnerships – Foreign or Domestic

- Estate Tax
 - Other possibilities:
 - Situs based on residence of partner (*mobilia sequuntur personam*)
 - Place of organization
 - Look-through (partnership as aggregate – consistent with Section 1446(f) approach)
 - 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
 - If partnership not engaged in U.S. trade or business, is organized outside the U.S., and is treated as an entity
 - Partnership interest has no U.S. situs
 - Partnership interest is stepped-up on death
 - Section 754 election should be made to push down stepped-up basis
- Retained interest
 - 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 domestic or foreign trust formed with funds wired from foreign bank account
 - Wire transfer from foreign bank is not subject to gift tax
 - Funds at bank should be intangible property
 - Even if not, gift is made outside the U.S. when funds are wired -- PLR 200340015
- Trust uses proceeds 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)

Ownership Through Trust

- 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

- 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
 - As noted earlier, how is fair market value determined if property not used for entire year? (See slide 12)

Ownership Through Trust

- 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)

Ownership Through Trust

- 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

PRACTICAL ISSUES

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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 CFC or PFIC (depends on percentage U.S. ownership)
 - Consider domestication and application of Reg. Section 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 on death
 - 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

Questions?

The above presentation is based on the completeness and accuracy of facts and assumptions stated above and of any other information provided to us. If any of the foregoing is not entirely complete or accurate, it is imperative that we be informed immediately, as the inaccuracy or incompleteness could have a material effect on our conclusions. We are relying upon the relevant provisions of the Internal Revenue Code of 1986 as amended, the regulations thereunder, any applicable treaty, and the judicial and administrative interpretations thereof, which are subject to change or modification by subsequent legislative, regulatory, administrative, or judicial decisions. Any such changes also could have an effect on the validity of our conclusions.

In addition, it should be understood that presentations of this nature are for purposes of discussion and necessarily involve simplification and compression. Descriptions of tax law in this presentation should be the subject of additional more detailed analysis before compliance or planning is implemented in reliance