

## **U.S. Real Estate and Other Private Use Assets Held by Non-Resident Aliens in the United States**

Tax Rules, Succession Planning, CFCs, Alternatives

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THURSDAY, NOVEMBER 5, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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# Planning for Inbound U.S. Investments through Foreign Trusts

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November 5, 2020

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# Introduction

## Presentation Outline

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- ▶ Introduction:
  - ▶ “Much has changed; much remains the same.”
- ▶ Fundamental tax issues and concepts
  - ▶ Relevant trust income tax rules
  - ▶ Relevant estate and gift tax rules
- ▶ Planning for investments
  - ▶ General considerations
  - ▶ Portfolio assets
  - ▶ Real estate
    - ▶ Investment real estate
    - ▶ Personal residences and vacation homes
  - ▶ Businesses
  - ▶ Concluding thoughts; Q & A’s

# Key Definitions

## Trust

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- ▶ “An arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts”. Reg. § 301.7701-4(a)
- ▶ Certain trusts are not trusts for tax purposes:
  - ▶ Business trusts – but a trust that is the sole member of a disregarded entity is still a trust and is not reclassified as an association
  - ▶ Investment trusts if there is a power to vary the interests of the beneficiaries or there are multiple classes of beneficiaries
- ▶ Certain arrangements in civil law jurisdictions may be treated as trusts
  - ▶ Foundations, e.g., Liechtenstein Stiftung – see AM 2009-012
  - ▶ Usufructuary and bare property and rights to property treated as life estate and remainder interest

## Key Definitions

### Foreign or Domestic

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- ▶ A Trust is a domestic trust for tax purposes (Reg. §301.7701-7) only if:
  - ▶ A U.S. court can exercise primary supervision over the administration of the trust (“Court test”); and
  - ▶ At least one U.S. person has authority to control all substantial decisions of the trust (“Control test”)
- ▶ Any trust that is not domestic is foreign
- ▶ The Control test can cause a domestic trust to become foreign where:
  - ▶ Substantial decisions broadly defined
  - ▶ Any substantial decision can be controlled by a foreign person (not necessarily in a fiduciary capacity)
  - ▶ Trustee (or protector) becomes foreign
  - ▶ But: Regs. allow trust 12 months from date of cessation as domestic trust to make changes to give control over all substantial decisions to U.S. persons
- ▶ The Court test will be failed if U.S. court's attempt to assert jurisdiction or supervise administration of the trust would cause the trust to migrate from the U.S.

# Key Definitions

## Grantor or Non-Grantor Trust

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- ▶ **Grantor trust**
  - ▶ A grantor trust is considered wholly owned by the grantor and is treated as an extension of the grantor
  - ▶ Grantor trust status results from application of specific statutory rules
    - ▶ Sections 673-677 (various powers or rights retained by the grantor or, in some cases, “non-adverse parties”, meaning non-beneficiaries)
    - ▶ Section 678 (person other than grantor can vest trust property or income in himself)
    - ▶ Section 679 (foreign trust with any U.S. beneficiary created by U.S. grantor or by NRA who becomes U.S. person within five years)
    - ▶ Can apply to just a portion of the trust
  - ▶ Section 672(f) limits application of grantor trust classification where grantor not a U.S. person to revocable trusts and trusts solely for the benefit of the grantor and/or grantor’s spouse – see slide 7
  
- ▶ **Non-grantor trust**
  - ▶ A non-grantor trust is a separate taxpayer.
  - ▶ Grantor trusts become non-grantor trusts on death of the grantor
  - ▶ Because the grantor trust rules are different for US and foreign persons, a trust that is a grantor trust may become a nongrantor trust or vice versa if the grantor’s taxpayer status changes.

# Key Definitions

## Grantor

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- ▶ For U.S. tax purposes, the grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust. Reg. § 1.671-2(e) (1)
- ▶ Grantor does not include:
  - ▶ Person who creates a trust but makes no gratuitous transfers to the trust
  - ▶ Person who funds a trust with an amount that is directly reimbursed to such person within a reasonable period of time and makes no other gratuitous transfers to the trust
- ▶ Special rule where nominal grantor is corporation or partnership. Treas. Reg. § 1.671-2(e)(4)
  - ▶ Gratuitous transfer for personal purpose of shareholder or partner treated as a constructive distribution to shareholder or partner and partner or shareholder will be treated as the grantor
  - ▶ This rule prevents using entities to create perpetual grantor trusts.

# Taxation Rules

## Grantor Trust

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### ▶ Taxation of Income and Gains

- ▶ When the grantor is not a U.S. person, grantor trust characterization is available (for domestic or foreign trust) only if:
  - ▶ (i) it is a revocable trust; or
  - ▶ (ii) during lifetime of grantor, only grantor or spouse can receive distributions (income or capital); or
  - ▶ (iii) transition rules applicable to pre-September 19, 1995 trusts
- ▶ NRA grantor taxed only on ECI and U.S. source FDAP income

### ▶ Distributions

- ▶ Grantor trust distributions are treated as gifts from the foreign grantor; no gift tax unless property is tangible property located in U.S.; no taxable income to U.S. recipient; but U.S. recipient must report the distribution (no matter how small) on Form 3520 Part III (not IV)
- ▶ Undercompensated use of foreign trust property treated as distribution to U.S. beneficiary, taxable if trust has DNI or UNI.

# Taxation Rules

## Non-Grantor Trust

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- ▶ Foreign nongrantor trust
  - ▶ Trust taxed like an NRA, i.e., on ECI and U.S. source FDAP income
  - ▶ Like individuals, trusts are entitled to preferential rates on long-term capital gains, depreciation recapture and gains on collectables
  - ▶ Trust deducts distributions to beneficiaries, but must allocate deduction between U.S. and non-U.S. income
  
- ▶ Beneficiaries of foreign nongrantor trust
  - ▶ Trust distributable net income (DNI) must be computed using U.S. rules, basically taxable income computed as if trust were U.S. individual plus tax exempt income; DNI of foreign trust includes all capital gains (unlike domestic trust)
  - ▶ Beneficiaries taxed on DNI required to be distributed and on actual distributions that carry out DNI, with character preserved (but NRA beneficiary not taxed on distributions attributable to non-U.S. income)
  - ▶ Distributions carry out credits for foreign and U.S. tax paid by trust
  - ▶ Distributions treated as coming first from DNI, then from oldest UNI, then as capital

## Non-Grantor Trusts (cont'd)

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- ▶ Distribution of less than all of DNI for any year:
  - ▶ Distribution carries out proportionate part of each class of income, deduction and credit
  - ▶ For example, trust cannot choose to distribute capital gain and not ordinary income or to distribute foreign source income but not U.S. source income
  - ▶ But consider effect of dividing trust into separate shares – section 663(c) – or instrument making special allocations of classes of income that have economic effect.
  
- ▶ Interest charge on UNI distributions by foreign trust to U.S. beneficiaries
  - ▶ U.S. beneficiaries taxed on distributions out of DNI accumulated in prior years (UNI), all income is ordinary, and interest is paid on tax under “throwback rule” although interest doesn’t apply for years the U.S. beneficiary was foreign.
  - ▶ In the case of distributions to foreign beneficiaries the throwback rule applies but the character of amounts distributed is retained so that only US source income is taxed.
  - ▶ Very graciously, section 668(b) provides that the tax plus interest charge may not exceed 100% of the accumulation distribution

# Foreign Grantor Trust

## Before and After the Grantor's Death

Time	Before Grantor's Death	After Grantor's Death
Income earned	All trust income is treated as grantor's – but foreign and favored U.S. income not taxed	All trust income is treated as trustee's – but foreign and favored U.S. income not taxed
Income actually (or required to be) distributed to U.S. beneficiary in year earned	Distribution treated as gift by grantor to beneficiaries <ul style="list-style-type: none"> <li>• No U.S. income tax</li> <li>• No U.S. gift tax if made outside United States or gift complete when trust funded</li> </ul>	<ul style="list-style-type: none"> <li>• Taxable to beneficiary when distributed</li> <li>• Capital gains treatment available</li> </ul>
Income accumulated and distributed to U.S. beneficiary in later year	<ul style="list-style-type: none"> <li>• U.S. beneficiary must file Form 3520 no matter how small the distribution (and must be able to demonstrate trust is a grantor trust)</li> </ul>	<ul style="list-style-type: none"> <li>• Taxable to beneficiary when distributed</li> <li>• Capital gains taxed as ordinary income</li> <li>• Interest on deferred tax</li> </ul>

Credit allowed to distributee for foreign and U.S. taxes paid by trust

## Anti-Avoidance Rules

### Indirect distributions and loans of trust property

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- ▶ Section 643(h) counteracts avoidance of tax on distribution by foreign trust to U.S. beneficiary through untaxed intermediary
  - ▶ Amount paid to U.S. person derived directly or indirectly from foreign trust is treated as distribution by foreign trust
  - ▶ Regulations narrow and define scope of this rule
- ▶ Section 643(i) provides that:
  - ▶ If foreign trust makes loan of cash or marketable securities to a U.S. grantor or beneficiary, loan is treated as a distribution
  - ▶ If foreign trust allows a U.S. person to use any other trust property, the fair market value of the use of the property is treated as a distribution
  - ▶ Therefore, these rules do not apply if the trust is domestic or the beneficiary is foreign
  - ▶ Note: If the trust has no DNI or UNI, practical impact may be limited

# Fundamental Gift and Estate Tax Rules

## U.S. Gift and Estate Taxation of Foreign Persons

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- ▶ U.S. citizens are subject to gift tax and estate tax on worldwide assets and may be allowed a credit, either under the Code or a treaty, for foreign gift and/or estate tax paid on assets having a situs in the foreign country imposing the tax
- ▶ U.S. residents are taxed the same as citizens, but residence for gift and estate tax purposes means domicile
- ▶ Nonresident aliens are subject to U.S. gift, estate and GST tax only on U.S. situs assets

## Situs Rules for Gifts

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- ▶ Gift tax is imposed on gifts by a nonresident alien of real or personal tangible property located in the U.S. but not on intangible property (except in the case of certain expatriates). Section 2501.
- ▶ Gift tax is imposed on an expatriate who is subject to tax under section 877(b) for the taxable year who makes a gift of shares of stock of U.S. corporations, debt obligations of U.S. persons and shares of stock of a controlled foreign corporation (“CFC”) to the extent the value consists of U.S. situs assets owned by the foreign corporation. Sections 2501 and 2511. For this purpose, CFC means that the expatriate owned (directly or indirectly) at least 10% of the voting stock and owned (directly, indirectly or constructively) at least 50% of the voting power or value of shares of stock of a foreign corporation.

## Situs Rules for Estates

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- ▶ Estate tax is imposed on tangible personal property located in the U.S., stock of U.S. corporations, and debt obligations of U.S. persons.
- ▶ Estates of expatriates who were subject to tax under section 877(b) are also subject to tax on shares of stock of a CFC (see definition in preceding slide) to the extent the value consists of U.S. situs assets owned by the foreign corporation. Section 2107.
- ▶ Section 2105 provides that certain assets are not U.S. situs: insurance on the life of a nonresident alien, bank deposits and other obligations the interest payments on which are excluded from tax for a nonresident alien under section 871, works of art on loan for exhibition purposes and stock in a regulated investment company to the extent it owns assets that are not considered U.S. situs.

## Changing Situs

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- ▶ Treaties may change the situs rules.
- ▶ Holding assets through trusts does not change situs; rather, a “look through” rule applies.
- ▶ Holding assets through a foreign corporation may change the situs of assets. However, note:
  - ▶ Could be challenged as a sham if no business purpose and/or corporate formalities not followed
  - ▶ CFC and PFIC tax regimes may apply if foreign corporation has one or more U.S. shareholders
  - ▶ Use of check the box elections may avoid problems or create opportunities
- ▶ Step transaction could apply to impose tax if situs is altered shortly before a transfer is made.

## Some Troublesome Situs Issues

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- ▶ Situs of cash -- treated as tangible personal property in old rulings.
- ▶ Situs rules for partnerships and disregarded entities uncertain.
  - ▶ See *Suzanne Pierre v. Commissioner*, 133 T.C. No. 2 (2009)
- ▶ Retirement plans and deferred compensation -- situs and source may depend upon nature of plan and whether or not the plan is a U.S. qualified plan.
- ▶ Inconsistent classification by different countries.
- ▶ U.S. situs assets held in a trust subject to section 2035-2038 “strings” provisions will be subject to U.S. estate tax at the death of the grantor if the assets are situated in U.S. either when the trust was funded or at the time of the grantor’s death. Section 2104(b).

## Gift and Estate Tax on Foreign Persons' U.S. Situs Assets

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- ▶ Tax rates are same as for U.S. donors and U.S. decedents but applicable credit amount is zero for gifts and \$60,000 for estates.
- ▶ Marital and charitable deductions are more limited.
- ▶ Treaties might change not only situs rules but also applicable credit amounts and marital and charitable deduction rules.
- ▶ Deductions are allowed only in the proportion U.S. estate bears to the worldwide estate except for nonrecourse debt. Incurring debt inside an entity may reduce U.S. estate tax value. Deductions require reporting worldwide assets on Form 706NR.
- ▶ Applicable marital property regime determines what is owned by estate of a foreign decedent.

# Estate and Gift Taxes

## Application to Foreign Trusts

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### ▶ Estate Tax:

- ▶ Retained interest rules apply to foreign trusts and foreign transferors
  - ▶ Section 2036 (transfer of property with interest or power retained by transferor)
  - ▶ Section 2038 (revocable trusts and trusts if grantor has power to alter beneficial enjoyment, whether or not the trust is revocable)
  - ▶ Section 2041 (general power of appointment)
  - ▶ Section 2035 (relinquishment of section 2036 – 2041 rights within three years preceding death)
- ▶ Foreign trusts not established in contemplation of U.S. rules often may contain retained interest provisions
- ▶ Retained interest rules are similar to but not co-extensive with the grantor trust rules
- ▶ Distribution by grantor trust may be treated as gift by grantor if gift was not complete when trust was funded

### ▶ Gift Tax

- ▶ A completed transfer by an NRA to a foreign trust can be a taxable gift

# Generation Skipping Transfers

## Application to NRAs and Foreign Trusts

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- ▶ The generation skipping transfer (“GST”) tax applies to gifts and estates of nonresident alien donors and decedents to the extent the transfers are subject to U.S. gift and estate tax.
- ▶ The same exemption from GST tax that applies to U.S. donors and decedents applies to nonresident alien donors and decedents. This exemption is now \$5.25MM

## Section 1014 Basis Adjustments for Foreign Decedents

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- ▶ A basis adjustment is allowed in U.S. for assets inherited from a foreign decedent even if assets are not subject to U.S. estate tax (i.e., generally foreign assets).
  - ▶ Note, however, that assets likely will not acquire new basis in recipient's foreign residence country
- ▶ Basis adjustment applies in limited circumstances to assets held in trust funded by foreign person – section 1014(b)(2) and (3)
  - ▶ Section 1014(b)(2) applies to property transferred to a trust where the decedent had the right to the income or to direct the payment of income and the right to revoke the trust.
  - ▶ Section 1014(b)(3) applies to property transferred to a trust where the decedent had the right to the income or to direct the payment of income and the right to amend, revoke or terminate the trust and change the beneficial enjoyment of the property.

## Special Rules for Transfers to Noncitizen Spouse

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- ▶ Estate tax marital deduction is not allowed unless assets pass to a qualified domestic trust (“QDOT”)
  - ▶ Some treaties allow a limited marital deduction
  - ▶ Consider marital property regime
  - ▶ Consideration-furnished test (i.e., contribution tracing) applies for joint property
  - ▶ Post-death funding of QDOT allows deduction; might have collateral tax consequences in the U.S. or another country
  - ▶ Bank or bond requirement for large QDOTs;
  - ▶ Termination of QDOT requirement if surviving spouse becomes U.S. citizen
  - ▶ Special rule for retirement assets
  - ▶ QDOTs rules may conflict with forced heirship rules and limited or complete lack of recognition of foreign trusts in civil law countries – can a civil law foundation be structured as a QDOT?
- ▶ Gift tax annual exclusion allowed for \$143,000 in 2013 (indexed annually)
- ▶ The problem created by the limitation on marital deductions is that if an NRA dies, the price of the marital deduction for U.S. situs assets is that the assets remain in U.S. taxing jurisdiction until the surviving spouse’s death

## Foreign Tax Credits

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- ▶ The Code allows a gift tax credit only for foreign gift tax imposed on expatriates who are subject to the special gift tax not imposed on other nonresident aliens. Section 2501(a)(3)(B)
- ▶ The Code allows an estate tax credit for estate tax actually paid to another country with respect to property having a situs in such country. Section 2014

## Saving Clause and Credits in Treaties

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- ▶ U.S. tax treaties contain a “saving clause” which preserves the right of U.S. to tax its citizens.
- ▶ Treaties generally allow estate of U.S. citizen domiciled in treaty country to take a foreign tax credit for all taxes imposed by country of domicile except for taxes imposed on assets, like U.S. real estate, for which U.S. has primary taxing rights under the treaty.
- ▶ Absent treaty, there is double tax exposure due to limits on allowable foreign tax credits.

## Fact Pattern

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- ▶ 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.

# Planning for Investment: General Considerations

## Before Planning Begins

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- ▶ Understand investor characteristics
  - ▶ Type, location, family structure, etc.
  - ▶ Is the investor planning or contemplating a move to the United States?
- ▶ Ascertain investment characteristics and objectives:
  - ▶ Use: Personal use, business, or investment
  - ▶ Types of income generated: rents, interest, dividends, capital gains, services
  - ▶ Capital: Equity, debt (many possible types)
  - ▶ Exit plan: Anticipated timing and method
- ▶ Consider entity choices: wholly-owned, joint venture, passive investment vehicle (e.g., REIT)
- ▶ Withholding and compliance issues
- ▶ Gift, estate and generation skipping tax issues
- ▶ Remember investor's foreign residence considerations, e.g., tax, inheritance laws

# Planning for Investment: General Considerations

## Objectives Drive Structure

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- ▶ Tax objectives:
  - ▶ Avoid cross-border double taxation
  - ▶ Mitigate taxation of operating income, if possible (e.g., via consolidated return and other ways of consolidating income)
  - ▶ Avoid double taxation of corporate earnings (incl. via branch profits tax)
  - ▶ Obtain long-term capital gains taxation of sale proceeds
  - ▶ Avoid gift and estate taxes; planning for generation-skipping
  - ▶ Limit tax over-withholding (e.g., on FIRPTA disposition, partnership ECTI)
  - ▶ Limit investor's contact with U.S. tax system, to extent possible
  - ▶ Pre-immigration planning
  
- ▶ Non-tax objectives:
  - ▶ Limited liability
  - ▶ Preserve confidentiality
  - ▶ Estate planning, including facilitating intra-family transfers

# Planning for Investment: General Considerations

## The Role of Trusts in Planning for NRAs

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- ▶ Foreign individuals often have goals that are hard to reconcile:
  - ▶ Depending on the investment, no taxation or at most one level of taxation
  - ▶ Confidentiality
  - ▶ Minimal or no personal contact with the U.S. tax administration
  - ▶ No exposure to U.S. estate tax
  - ▶ If investment will be held for more than a brief period, succession planning
  
- ▶ Foreign and sometimes domestic trusts can be used to achieve some or all of these goals
  - ▶ Sometimes a domestic trust can be preferable to a foreign trust. For example:
    - ▶ Vehicle for holding a personal residence
    - ▶ E.g., QDOT must be domestic and have domestic trustees
  - ▶ For NRAs, meeting the tax law definition of a domestic trust can be a challenge because all control has to be in the hands of U.S. persons

- ▶ FATCA imposes 30% withholding on non-compliant foreign entities commencing July 1, 2014.
- ▶ Almost any vehicle an NRA chooses for holding U.S. investments is likely to be an FFI because it will be classified as an “investment entity”. Reg. § 1.1471-5(e)(1)(iii). A trust will be an FFI if it has primarily passive investments and a trustee or investment manager that is itself an FFI. A trust with an individual trustee and individual investment manager will be a nonfinancial foreign entity (NFFE). Reg. section 1.1471-5(e)(4)(v) Examples 5 and 6.
- ▶ FATCA compliance is more difficult for an FFI than it is for a NFFE, but most trusts are likely to be FFIs. An NFFE can avoid withholding by certifying that it has no “substantial” U.S. beneficiaries (10% or more interest) or disclosing who they are.

## FATCA (cont'd)

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- ▶ An FFI may become compliant by registering with the IRS to become a “participating FFI” and undertaking the responsibility to file annual FATCA reports and perform some withholding functions. The FFI may do the registering itself or rely on a sponsoring FFI to do the registration. FFIs that are resident in countries with which the U.S. has an Inter-Governmental Agreement (IGA) must comply with the IGA to be FATCA compliant. Such FATCA compliant FFIs will be issued a Global Intermediary Identification Numbers (GIINs) which may be the ticket you have to have punched in order to open accounts in the future. This is part of the effort to divide the financial world into good and bad guys.
- ▶ A trust that is an FFI can also avoid withholding by becoming an Owner-Documented FFI, but it will not obtain a GIIN. Reg. sec. 1.1471-5(f)(3). It will avoid withholding only as to payments made through the withholding agent with whom the trust has made arrangements, one of which requires disclosure to the withholding agent of foreign as well as U.S. beneficiaries.
- ▶ A trust has to take one of the steps described above to avoid withholding whether or not it has U.S. beneficiaries.

# Portfolio Investments

## Choices

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- ▶ Direct ownership
- ▶ Corporate structure
- ▶ Trust
- ▶ Corporation or other form of entity owned through trust

# Portfolio Investments

## Direct Ownership

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- ▶ Advantages:
  - ▶ Simplicity
  - ▶ Availability of income treaties and estate and gift tax treaties to the investor
  - ▶ No FATCA compliance required
  
- ▶ Disadvantages
  - ▶ Need to deal with succession planning
  - ▶ Even if succession is clear, probate or other procedures may be required to transfer U.S. portfolio assets
  - ▶ If no estate tax treaty is available, estate tax exposure on U.S. equities

# Portfolio Investments

## Corporate Structure

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- ▶ Foreign corporation is often recommended for U.S. portfolio assets
  - ▶ Eliminates estate tax exposure
  - ▶ No income tax on realized capital gains, except from disposition of USRPI's
  - ▶ No income tax return filings, unless tax on U.S. source investment income not fully withheld
  
- ▶ Disadvantages of corporate structure:
  - ▶ Consider effect on entitlement to treaty withholding tax rates
  - ▶ Offshore corporation may create home country tax issues
  - ▶ Corporate structure may create severe problems for owners or beneficiaries who are or become U.S. persons
  - ▶ Succession planning – the good old days of issuing bearer shares and putting them in a safe are over
  
- ▶ Estate and gift tax treaties may permit individuals to invest in U.S. securities free of estate tax concerns

# Portfolio Investments

## Foreign Trust

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- ▶ Advantages:
  - ▶ Vehicle for succession planning and probate avoidance
  - ▶ Can be structured to avoid exposure to U.S. estate taxes on U.S. equities
  
- ▶ Disadvantages
  - ▶ May be unable to take advantage of treaty withholding rates
  - ▶ FATCA compliance, especially if large class of mobile beneficiaries
  - ▶ May be unable to step-up basis of assets on death, which would matter if any of the heirs are U.S. persons
  - ▶ Possible unwillingness of institutional trustees to directly own U.S. assets
  
- ▶ Foreign trust combined with foreign corporation may offer advantages of foreign corporation, with trust as vehicle for succession planning

## Portfolio Investments

### Use of Domestic Trust to Facilitate Use of Portfolio Interest Exemption

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- ▶ U.S. corporate and government bonds are generally in registered form
  - ▶ Only requirement for an NRA to obtain portfolio interest exemption (tax and withholding) is to provide Form W-8BEN – don't even need an ITIN for this
- ▶ But many obligations are not in registered form
  - ▶ IRS considers that a typical UCC promissory note is not in registered form
  - ▶ Many obligations (e.g., consumer receivables, interest on judgments) cannot as a practical matter be put into registered form
  - ▶ In some cases, the well-advised can get registered form provisions included in the obligation from the beginning or can negotiate note modification
- ▶ Alternative: Establish a domestic trust meeting requirements for investment trusts (Reg. §301.7701-4(c); §1.871-14(d))
  - ▶ If trust interests in registered form, underlying obligation need not be (Beneficiaries (including transferees) are treated as owners of their trust interests
  - ▶ Can use for a single obligation – does not have to be a pool
  - ▶ Borrower's cooperation not required

# Investing in Real Estate

## Individual Ownership (incl. via “disregarded entity”)

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- ▶ Possible advantages
  - ▶ Long-term capital gain treatment on sale
  - ▶ Single level of tax
  - ▶ Profits/losses offset
  - ▶ No imputed income for personal use property
  - ▶ LLC provides limited liability; holding LLC can provide “presence” for residence purposes
  - ▶ Potential anonymity through LLC ownership
  
- ▶ Possible disadvantages
  - ▶ If LLC is disregarded entity, exposure to gift tax on gift of LLC interest
  - ▶ Estate tax exposure
  - ▶ Must file individual income tax return; may have to file partnership return

# Investing in Real Estate

## Individual Ownership (through partnership)

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- ▶ Possible additional advantages
  - ▶ Likely no gift tax imposed on gift of LLC interest
  - ▶ Possible argument against estate tax liability, especially if LLC not engaged in trade or business; possible enhancement if offshore LLC treated as partnership inserted in structure
- ▶ Possible additional disadvantages
  - ▶ Must file partnership tax return as well as individual return
  - ▶ Withholding (and potential over-withholding) under section 1446

# Investing in Real Estate

## Corporate Ownership

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- ▶ Possible advantages
  - ▶ No U.S. estate or gift tax on transfer of foreign stock, unless acquisition facts subject to, e.g., “step transaction” attack
  - ▶ If structure through U.S. subsidiary, no branch profits tax
  - ▶ Possible consolidation of U.S. profits and losses in U.S. subsidiary
  - ▶ No individual income tax filings (but generally won’t provide anonymity for ultimate beneficial owner)
  
- ▶ Possible disadvantages
  - ▶ Corporate tax rates on sale of properties (no preferred capital gain rate)
  - ▶ Can sell foreign holding company tax-free but purchaser may wish to discount price since no basis step-up at U.S. corporate level
  - ▶ Double taxation of profits, except on liquidation of structure following sale of all FIRPTA properties

# Investing in Real Estate

## Trusts

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- ▶ Direct ownership of real estate by a foreign trust is impractical, due to the reluctance of foreign trustees to own U.S. real estate directly and virtual impossibility of securing conventional financing
- ▶ May be able to solve this problem by using a (domestic) disregarded entity or partnership
- ▶ Trust will be taxed like an NRA on trust's share of income and gains
- ▶ Compared to direct ownership by NRA, trust may serve estate tax and succession planning purposes

# Investing in Personal Residence or Vacation Home

## Structure Options – Ownership through Foreign Corporation

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- ▶ Possible advantages
  - ▶ No gift or estate tax on transfer of foreign corporate stock, unless subject to attack under judicial doctrine (e.g., step-transaction, substance over form, etc.)
  - ▶ Generally no individual income tax or compliance issues (although IRS might try to impute income and consequential reporting, depending upon surrounding facts)
- ▶ Possible disadvantages
  - ▶ Sale proceeds taxed at corporate rates
  - ▶ On death of owner, no step-up of inside basis

# Investing in Personal Residence or Vacation Home

## Structure Options – Ownership through Trust

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- ▶ Possible advantages
  - ▶ Sale proceeds taxed at individual capital gain rates
  - ▶ If foreign settlor transfers cash to irrevocable non-grantor trust, which purchases property, no gift tax
    - ▶ Can advance funds for maintenance/repairs in same way
    - ▶ If trust purchases settlor's property, must be at FMV
  - ▶ If foreign settlor retains no “strings” under sections 2035-2038 and no general power of appointment, no U.S. estate tax at settlor's death
    - ▶ If trust settled for spouse, settlor might nevertheless accompany spouse to use property under *Gutchess v. Commissioner*, 46 T.C. 554 (1966)
    - ▶ If property left to heirs at death of spouse, settlor must pay fair rental value to use property (not just, e.g., utilities and taxes)
    - ▶ Must not be any informal/implied agreement permitting settlor to use property
    - ▶ Settlor should not be trustee, unless possibly discretion subject to enforceable standard; preferable to have independent trustee

# Investing in Personal Residence or Vacation Home

## Structure Options – Ownership through Trust (cont'd)

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- ▶ Possible disadvantages
  - ▶ If U.S. beneficiaries use foreign trust-owned property, fair value of use treated as distribution (but taxable only if available DNI or UNI; reportable on Form 3520 in all events)
    - ▶ No similar problem if domestic trust used, but may be greater reporting if use domestic trust
  - ▶ No basis step-up at death of settlor or beneficiaries because property not included in any estate
  - ▶ If trust settled for spouse under *Gutchess* case, divorce risk
    - ▶ Might be ameliorated if settlor furnishes carrying costs by way of bona fide loans

## FIRPTA Withholding

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- ▶ Buyer (foreign or domestic) must withhold 15% of amount realized by seller unless it 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

# Investing in Business

## Limited Role of Foreign Trusts

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- ▶ Trusts generally do not invest directly in business. They do invest in corporations, partnerships and other entities
- ▶ In the context of foreign investment in U.S. business enterprises, the use of foreign trusts is limited
  - ▶ Primarily used for estate tax and succession planning
  - ▶ If the trust invests in a pass-through entity that is engaged in a U.S. trade or business
    - ▶ It will be deemed to be engaged in the trade or business. Section 875.
    - ▶ It will be taxed like an NRA and will have to file tax returns
    - ▶ Any foreign beneficiaries that receive distributions will also have to file returns, on the basis that they too are deemed to be engaged in a U.S. trade or business. Sections 875 and 667(e).

## Concluding Remarks and Questions?

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- ▶ **Thank you for your attention!**