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Impulse Buying in the Wake of Tax Reform: Reconsidering Structures for Foreign Ownership of U.S. Real Estate

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Whatever the reason — stable government, attractive pricing relative to foreign markets, or simple convenience — individuals who are neither citizens nor residents of the United States (that is, non-resident aliens (NRAs)) continue to buy U.S. properties for personal purposes. Without proper structuring, ownership of U.S. property by an NRA leads to undesirable income and estate tax consequences. Absent treaty relief or election, income derived from rental of the property will be subject to 30% withholding.[1] Upon the sale of the U.S. property, the NRA will be subject to 15% withholding on the gross sales proceeds.[2] If the property is transferred without full and adequate consideration, the difference between the fair market value of the property and the consideration received is subject to U.S. gift taxation.[3] If the U.S. property is not sold or given away prior to death, it will be subject to inclusion in the gross estate of the NRA and subject to U.S. estate taxation.[4]

Different structures and strategies have emerged over time to avoid one or more of the undesirable tax effects of ownership of U.S. real estate. Foreign corporations, partnerships, and trusts have been and will continue to be used as entities for ownership of U.S. real estate to good tax effect. Each has its own limitations. For the entity-phobic, the simplicity of direct ownership is seductive but brings with it near certain estate tax exposure, as well as other adverse side effects.

How have these choices been affected by the reforms of the 2017 tax act?[5]

Direct Ownership

In addition to simplicity and avoiding the costs of entity formation and maintenance, direct ownership assures an NRA of preferential capital gain treatment on sale of the U.S. property. Whether or not U.S. estate tax is paid at the owner's death, inclusion in the owner's gross estate results in a basis adjustment or fair market value by operation of §1014(a)(1). Otherwise, direct ownership tends to be a bad idea. Lack of an entity to limit liability leaves the owner's other personal assets exposed. Rental income is rarely eligible for treaty relief and, therefore, subject to 30% gross withholding, although tenants are not necessarily aware of this obligation. While the 2017 tax act doubled base amount of the estate, gift, and generation-skipping transfer tax exemption of §2010(c), that increase is of limited relevance or assistance to an NRA. First, the increase is temporary, sunsetting for transfers made and decedents dying after December 31, 2025. Second, absent qualification for treaty-based relief, the estate tax credit for individuals who are neither citizens nor domiciliaries of the United States at the time of death is limited to $13,000, yielding an exemption for no more than $60,000 of U.S.-situs assets (including real estate).[6] There is no corresponding credit or exemption against U.S. gift tax.

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[1] §871(a)(1)(A). Withholding can be avoided by election under §871(d). *See* Reg. §1.871-10.

All section references are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations thereunder, unless otherwise indicated.

[2] §1445(a). Withholding can be avoided by obtaining a withholding certificate pursuant to Reg. §1.1445.3.

[3] §2501(a). The exception for property transfers by NRAs under §2501(a)(2) is limited to transfers of intangible property.

[4] §2101(a).

[5] Pub. L. No. 115-97.

[6] §2102(6)(1). The temporary increase in the U.S. estate tax ex-

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Trusts

Properly drafted and funded prior to purchase of the U.S. property, trusts remain the superior entity choice for acquisition and ownership of U.S. property because of certainty in the estate tax treatment and availability of preferential capital gain treatment on sale of the property. The trust is funded with cash; the cash is used to purchase the property. Irrevocable inter vivos trusts are frequently used in U.S. estate planning to avoid U.S. estate taxation on the assets comprising the corpus of the trust so as to avoid inclusion of the gross estate of the settlor or beneficiaries of the trust. As long as the settlor is not a beneficiary and retains no powers affecting the beneficiaries' interests in the trust or a general power of appointment under §2041, there is no risk of estate inclusion at the settlor's death.[7] The settlor or a beneficiary may even act as trustee as long as the fiduciary's discretion is limited by an ascertainable standard.[8]

Rental income may be subject to 30% gross withholding (depending on whether the trust is foreign or domestic). Regardless of residence, a trust structure will allow the net rental income to qualify for the 20% deduction for qualified business income provided §199A as enacted by the 2017 tax act, assuming the statute's requirements are otherwise statisfied.[9] While there is still significant uncertainty as to how the tax relief provided by §199A will be applied to trusts, the statute clearly contemplates its availability.

The trust alternative suffers from two primary disadvantages. First, estate tax relief will be lost if the settlor is a beneficiary. Second, the trust is a poor alternative if the U.S. property was acquired before undertaking the planning. Any transfer of property to a trust which is effective to avoid U.S. estate taxation at the death of the settlor will be a taxable gift. Even U.S. estate tax treaties that provide estate tax relief often do not provide gift tax relief.

Partnerships

While entities taxable as partnerships (in whatever form they may take for state law purposes: LLC, LP, LLP, LLLP) are also eligible for the 20% deduction against qualified business income under §199A and allow the non-corporate partners to enjoy the benefit of preferential capital gain treatment, the efficacy of a partnership to avoid U.S. estate taxation remains uncertain. To whatever degree the U.S. Tax Court's *Grecian Magnesite Mining* decision may have suggested that a foreign partner's interest in the underlying assets of the partnership was not subject to U.S. estate taxation,[10] that conclusion would seem to be undercut by the 2017 tax act's codification, in new subsection (8) of §864(c), of the Internal Revenue Service's position in Rev. Rul. 91-32. Strategies to convert partnerships to corporations and thereby avoid U.S. estate taxation by making retroactive check-the-box elections may be, as the saying goes, ''too cute by half.'' There simply is no business purpose.[11]

Corporations

If an NRA uses a corporation to acquire and own a U.S. property, either the corporation must be foreign or the NRA's ownership of the U.S. corporation must be through a foreign corporation in a tiered entity structure in order for the property to avoid U.S. estate taxation at the death of the foreign owner.[12] The tiered structure also has the advantage of avoiding not only FIRPTA[13] withholding on a sale of the property by the U.S. corporation, but also any U.S. income taxation on disposition of the U.S. property by sale of the shares of the foreign corporation. However, the market for such purchasers may be limited to other NRAs inasmuch as there will be no basis adjustment for either the shares of the U.S. corporation or the U.S. corporation's interest in the U.S. property.

Traditionally, the primary disadvantage of corporate ownership of real estate has been the lack of preferential capital gains treatment otherwise available to individuals who own the U.S. property either directly or through an entity taxable as a partnership. This disadvantage is significantly blunted by the 2017 tax act's reduction of the corporate income tax rate under §11 from 35% to 21%.

In light of the certainty in the estate tax treatment and the corporate income tax reduction to a level

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emption is of some relevance under certain U.S. treaties. *See* generally Thomas Bissell, *The New Enhanced Lifetime Exemption Under Most U.S. Estate Tax Treaties*, 47 Tax Mgmt. Int'l J. 403 (June 8, 2018). For example, Article XXIXB of the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital (the ''Canada-U.S. Tax Treaty'') provides limited estate tax relief based on a portion of the U.S. tax exemption determined by the ratio of the decedent's U.S. situs assets to worldwide assets.

[7] *See* §2036 (right to possess or enjoy trust property or receive trust income or determine who will possess or enjoy trust property or receive trust income) or §2038 (right to alter, amend, revoke, or terminate beneficial enjoyment).

[8] *See Jennings v. Smith*, 161 F2d 74 (2d Cir. 1947); §2041(6)(1)(A).

[9] *See* Robert E. Ward, *Tax Relief Is Not Just for U.S. Persons: The 20% Reduction for Qualified Business Income Under New Code Section 199A*, 47 Tax Mgmt. Int'l J. 204 (Mar. 9, 2018).

[10] *See Grecian Magnesite Mining, Indus. & Shipping Co., SA v. Commissioner*, 149 T.C. No. 3 (July 13, 2017); Miller and Brody, *Foreign Corporation Not Taxable on Redemption of Partnership Interests: Tax Court Rejects Rev. Rul. 91-32*, 46 Tax Mgmt. Int'l J. 428 (Aug. 11, 2017) at n.35.

[11] *See* Notice 2001-17; David H. Schnabel, *Revisionist History: Retroactive Federal Tax Planning*, 60 The Tax Lawyer 685 at nn.137–138.

[12] *See* §2104(a).

[13] Foreign Investment in Real Property Tax Act of 1980.

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close to the 15% and 20% capital gain rates available to individuals, ownership of U.S. property through corporate entities may bear reconsideration. This entity choice may be particularly appropriate if the U.S. property interest was acquired prior to consultation with a tax adviser. In such a case, a transfer of the U.S. property to a trust settled by the NRA would be a taxable event, triggering a gift tax unsheltered by any U.S. credit or exemption coupled with a U.S. reporting requirement to file a Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return. In contrast, contribution of the U.S. property to a U.S. corporation in exchange for stock should qualify as a non-recognition event, assuming the requirements of §351 are met.[14]

There are two traps for the unwary in connection with the transfer of a U.S. property by an NRA to a U.S. corporation. First, while satisfaction of the requirements of §351 will avoid gain recognition for U.S. tax purposes, transfer of the U.S. property to the U.S. corporation may nonetheless be a taxable event for home country purposes. If this is the case, it may be preferable to plan out of U.S. non-recognition treatment, especially if the U.S. tax paid on transfer to the U.S. corporation is creditable against the foreign tax. In such a circumstance, any gain recognized by the NRA on transfer of the property to the corporation in exchange for its stock will be added to the corporation's basis in the property.[15] Second, proper sequencing of the steps by which the tiered structure is implemented matters. If the shares of the U.S. corporation are transferred to a foreign corporation, the anti-inversion rules of §7874 become applicable.

Conclusion

While availability of the 20% deduction for qualified business income under §199A will continue to make trusts the preferred entity of choice for ownership of U.S. real estate by an NRA, the reduction in corporate tax rates is responsive to one of the primary concerns about corporate ownership of U.S. real estate and makes corporate entities more attractive in circumstances in which the tax adviser is consulted after the NRA's acquisition of the property.

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[14] Another consideration when the planning occurs post-acquisition of the U.S. property would be potential applicability of state real property transfer taxes. *See,* e.g., Annotated Code of Maryland §12-103(a)(1), which imposes a recordation tax based on the fair market value consideration received for the conveyance.

[15] §362(a).

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