

Estate Planning and Income Tax Issues for Nonresident Aliens Owning US Real Estate

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October 24, 2014

1. Introductory Matters.

(A) A “nonresident alien” (“**NRA**”) means an individual who is not a US citizen, and who is not a resident of the US for US income tax purposes or US transfer tax purposes.

(1) The “transfer taxes” include the gift tax, estate tax, and generation-skipping transfer tax.

(2) The tests of residency for US income tax purposes are (i) the green card test, and (ii) the substantial presence test.¹

(3) The test of residency for US transfer tax purposes is whether the individual is domiciled in the US, which means generally establishing a residence in the US with the intent to reside in the US permanently.²

(4) Examples of a typical NRA: A foreign individual who is simply investing in US real estate, or a foreign individual who owns a residence in the US but whose principal residence is elsewhere.

(B) The focus will be on creating an ownership structure that is as tax efficient as possible, and that also meets the client’s other planning needs. The tax issues relate to both US income taxes and US transfer taxes.

(1) There may be conflicting goals in minimizing US estate taxes and US income taxes.

(C) Partnerships are “flowthrough” entities, meaning that the tax items (including gain on the sale of property) flow directly to the partners without a first level of tax at the entity level like a corporation.

(1) Reference to a “partnership” includes a multi-member LLC because multi-member LLCs are taxed as partnerships for US income tax purposes (default classification under the check the box rules).

(2) An eligible foreign corporation may also elect to be treated as a partnership for US income tax purposes under the check the box rules.³

¹ I.R.C. §7701(b).

² Regs. § 20.0-1(b)(1).

(D) An NRA can not be a shareholder of an S corporation⁴, so the references to corporations in this outline are to C corporations and not S corporations. Importantly, C corporations are not “flowthrough” entities.

(E) Trust Classification Issues for US Tax Purposes.

(1) A trust will be a domestic trust for US tax purposes only if it passes both the “court test” (the primary supervision of the administration of the trust is by a US court), and the “control test” (a US person must control all “substantial decisions” of the trust).⁵

(F) Blacklist issues.

(1) Many foreign jurisdictions have prepared “blacklists” of other jurisdictions that they view as “tax havens”. If an entity formed in a blacklist jurisdiction is utilized as part of an investment structure, the home country will typically impose penalties.

(a) For example, some countries will include the British Virgin Islands (BVI) and the Cayman Islands on their blacklist, and therefore entities formed in those jurisdictions will want to be avoided.

(b) For example, New Zealand seems to be a “safe” jurisdiction for many South Americans. So you may see New Zealand limited partnerships, for example. Also, Scottish limited partnerships.

(G) Variables to consider when determining the “right” ownership structure.

(1) Use of property.

(a) Will the property be used for residential use or for investment/rental purposes? If residential use of the property, who will be using the property?

(2) Value of property.

(a) The greater the value, the more likely that tax structuring costs will be acceptable.

(3) Sophistication level of the foreign investor.

(a) The level of complexity that the foreigner is willing to accept in the structure may depend on sophistication level.

³ Regs. § 301.7701-3.

⁴ I.R.C. §1361(b)(1)(C).

⁵ I.R.C. §7701(a)(30)(E).

- (4) Likely holding period of property.
 - (a) If a shorter holding period, the risk of estate tax exposure is less.
- (5) Age of purchaser.
 - (a) The older the purchaser, the greater the risk of estate tax exposure.
- (6) Applicable treaties (income tax or transfer tax) with home-country.
 - (a) If a treaty with home country is in effect, this may lessen the tax burden on some of the entity structures.
- (7) Home country blacklist.
- (8) Comparative income tax rates and transfer tax rates.
 - (a) As estate tax rates increase, the more important it may be to structure to avoid the estate tax. Current estate tax rate is 40%; lower than it was a few years ago.
- (9) Who is intended to benefit from the income and appreciation in the property?
 - (a) The investor only? The family members of the investor? If family members are intended to benefit, a trust may be a good alternative.
- (10) Desire for confidentiality/privacy.
 - (a) Some ownership structures provide a greater degree of privacy.
- (11) Avoidance of US personal income tax returns.

2. **Summary of US Estate Tax Issues for an NRA**

- (A) If an asset has a “situs” in the US, then the asset is subject to the US estate tax.⁶
- (B) Real estate located in the US is a US situs asset.
- (C) An NRA who dies owning US real estate is subject to the US estate tax. The available credit is \$13,000, which is equivalent to \$60,000 of value. Each dollar above \$60,000 is subject to the US estate tax, with rates starting at 26% and rising to a top marginal rate of 40% at \$1 million.

⁶ I.R.C. §2103.

(1) For example, if an NRA dies in 2014 owning a condo in Florida with a value of \$500,000, the US estate tax that will be due is \$142,800 (\$155,800, less \$13,000 credit).

(2) For example, if an NRA dies in 2014 owning a commercial property in Florida with a value of \$2,000,000, the US estate tax that will be due is \$732,800 (\$745,800, less \$13,000 credit).

(D) Stock in foreign corporations is not subject to US estate tax.⁷ Stock in a domestic corporation is subject to the US estate tax.⁸

(E) Partnership interests may be subject to the US estate tax.

(1) The situs rules for partnership interests is not clear as they are not covered in the relevant “situs” statutes in the Internal Revenue Code.

(2) The position of the I.R.S. appears to be that a partnership is deemed “sited” in the US if the partnership primarily does business in the US. However, there is debate about whether this is the correct standard and this issue is currently unresolved. This issue is probably similar with LLC interests. If the IRS is successful in this argument, then a partnership (domestic or foreign) that owns US real estate would likely be subject to the US estate tax.

(3) The possible tests are: (1) the situs is where the partnership primarily does business, (2) the situs is based on place or organization (like a corporation), (3) determine the situs of the partnership’s assets on an asset by asset basis (for example, US real estate owned by the partnership would be a US situs asset), or (4) situs is based on the residence of the owner (which is a common legal rule for determining the situs of intangible assets).

(F) Life insurance proceeds received by an NRA are not subject to the US estate tax.

3. **Summary of US Gift Tax Issues for an NRA**

(A) A transfer of US real estate by an NRA will be subject to US gift tax.⁹

(B) A gift of “intangible property” by an NRA is not subject to the US gift tax.¹⁰ This creates a very broad exception that should be easy to plan around.

(C) Only gift tax annual exclusion (\$13,000) is available. Above that, gift tax will apply with rates starting at 26% and rising to a top marginal rate of 40%.

(1) The annual exclusion for gifts to a non-citizen spouse is \$145,000 in 2014.

⁷ Regs. §20.2105-1(f).

⁸ I.R.C. §2104.

⁹ I.R.C. §2501(a)(1).

¹⁰ I.R.C. § 2501(a)(2).

(D) The lifetime gift tax exemption (currently \$5.34 million) is not available to NRAs.

4. **Summary of US Income Taxation of Rental Income From US Real Estate.**

(A) An NRA is only subject to US income tax on (i) US source income that is not effectively connected with the conduct of a US trade or business, and (ii) income that is effectively connected with the conduct of a US trade or business.¹¹

(1) All rental income from US property is US source income.¹²

(B) The taxation of the rental income depends on whether the income is income “effectively connected with the conduct of a US trade or business”, or as passive rental income. This determination is dependent on the particular facts of each case. This can range from ownership of one property on a triple net lease (clearly passive investment income), to ownership of multiple properties with substantial management activities (clearly effectively connected with the conduct of a US trade or business).

(C) Passive rental income of a foreign person (foreign individual or corporation) is subject to a 30% tax on the gross amount.¹³ The 30% tax is collected by withholding at the source of the income.¹⁴ Therefore, the tenant paying rent to a foreign person is required to withhold this amount (and submit to the I.R.S.).

(D) If the rental income is “effectively connected with the conduct of a US trade or business”, then the income is taxed on a net basis after applicable deductions.¹⁵

(E) If the owner is a foreign corporation, then the branch profits tax may also apply. The branch profits is an additional tax of 30% imposed on the “effectively connected earnings and profits” of a foreign corporation that are not reinvested in the corporation’s business.¹⁶

5. **Other US Income Tax Issues.**

(A) If an NRA owns an asset at death, then the income tax basis in the asset is increased to the date of death value (basis “step-up”).

(B) Treaties with home-country may be applicable.

(1) For example, the branch profits tax typically will be reduced or inapplicable if the foreign investor is from a favorable US treaty country and the foreign investor utilizes a home-country/treaty company. In that case, the use of

¹¹ I.R.C. §872(a).

¹² I.R.C. §861(a)(4).

¹³ I.R.C. §871(a)(1)(A) and §881(a)(1).

¹⁴ I.R.C. §§1441 and 1442.

¹⁵ I.R.C. §871(b).

¹⁶ I.R.C. §884(a), (b).

such a company to directly own the US real estate may provide the best tax results.

(C) FIRPTA (Foreign Investment in Real Property Tax Act).

(1) When a foreign person disposes of US real property, 10% of the amount realized must be withheld by the transferee, regardless of the amount of the foreign person's gain.¹⁷ The withheld amount is not the final tax obligation but is treated as an advance payment. A foreign person still must file the applicable US income tax return to calculate the tax due, and the amount withheld is credited against that tax.

6. **Summary of US Income Tax Issues Upon Sale by the NRA or related entities.**

(A) Gain upon the sale of a US real property interest is US source and therefore subject to US income tax.¹⁸ And such gain by an NRA or a foreign corporation is treated as if effectively connected with a US trade or business.¹⁹

(B) A sale of US real estate by an individual will result in capital gain. If long term (holding period of more than one year), then favorable long term capital gains rate will be available (currently 20%).

(C) A sale of US real estate by a domestic corporation will result in gain, but the favorable long term capital gains rate does not apply to corporations, and therefore the gain will be subject to ordinary income tax rates at the corporate level (top corporate rate is currently 35%). Any dividend from the domestic corporation to the NRA shareholder will be subject to a 30% withholding tax.

(D) A sale of US real estate by a foreign corporation will result in gain, but the favorable long term capital gains rate does not apply to corporations, therefore the gain will be subject to ordinary income tax rates at the corporate level (top corporate rate is currently 35%).

(1) The branch profits tax may also apply.²⁰ Generally, a 30 percent tax on the after-tax earnings of a US branch of a foreign corporation attributable to its income that is effectively connected with its conduct of a US trade or business to the extent such earnings are not reinvested in such US trade or business. Gain from a foreign corporation's disposition of US real property is treated as effectively connected with a US trade or business and is therefore subject to the branch profits tax.²¹

¹⁷ I.R.C. §1445(a).

¹⁸ I.R.C. §861(a)(5).

¹⁹ I.R.C. §897(a)(1).

²⁰ I.R.C. §884.

²¹ I.R.C. §897(a)(1).

- (a) If branch profits tax applies, potential for a combined 60% rate on gains.
 - (b) Branch profits tax may be reduced or eliminated by treaty.
 - (c) Branch profits tax does not apply to a complete termination.
- (E) A sale of US real estate by a domestic partnership will result in gain, and the gain flows through to the partners. Therefore, the favorable long term capital gains rate will be available.
- (F) A sale of US real estate by a foreign partnership will result in gain, and the gain flows through to the partners. Therefore, the favorable long term capital gains rate will be available.
- (G) A sale of US real estate by a domestic trust will result in gain. The favorable long term capital gains rate would be available because a trust is taxable in the same manner as an individual.
- (H) A sale of US real estate by a foreign trust will result in gain. The favorable long term capital gains rate would be available because a trust is taxable in the same manner as an individual.

7. **Direct Ownership by NRA**

- (A) Advantages.
- (1) Simplest form of ownership.
 - (2) Favorable long term capital gains rate applies upon sale.
 - (3) Step-up in basis on death to the date of death value of property.
- (B) Disadvantages.
- (1) Included in the NRA's estate upon death, and therefore estate tax will be payable on value above \$60,000.
 - (2) Would require probate in Florida. How is the property distributed by will?
 - (3) No privacy.
 - (4) Unlimited liability.
- (C) Additional Planning Options.
- (1) Might use single member LLC to own for privacy purposes, for liability protection, and/or to avoid probate on death of owner.

- (2) If owner is insurable, consider term life insurance to cover the possibility of the US estate tax.

8. **Ownership by a Domestic Corporation.**

(A) Advantages.

- (1) Allows for a transfer during life that will not be subject to the US gift tax because it is a transfer of intangible property.

(B) Disadvantages.

- (1) Favorable long term capital gains rate is not available, and therefore gain is taxed at corporate rate (currently up to 35%).
- (2) US estate tax exposure if stock owned on death because stock in a US corporation is a US situs asset.
- (3) Dividends from a domestic corporation to NRA will be subject to 30% withholding (unless applicable treaty).
- (4) Step-up in basis of the stock upon death of NRA, but no step-up in basis of real estate.

9. **Ownership by a Foreign Corporation**

(A) Advantages.

- (1) Avoids US estate tax on death because stock in a foreign corporation is not a US situs asset for US estate tax purposes.
- (2) Allows for a transfer during life that will not be subject to the US gift tax because it is a transfer of intangible property.

(B) Disadvantages.

- (1) Favorable long term capital gains rate is not available, and therefore gain is taxed at corporate rate (currently up to 35%).
- (2) Additional 30% branch profits tax will apply to rental income and upon sale of the property (unless applicable treaty).
- (3) 10% FIRPTA withholding applies upon sale of property (because it is a sale by a foreign person).
- (4) Step-up in basis of the stock upon death of NRA, but no step-up in basis of real estate.

10. **Ownership by a Foreign Corporation with Domestic Corporation Subsidiary That Owns the Property.**

(A) Advantages.

(1) Avoids US estate tax on death because stock in a foreign corporation is not a US situs asset for US estate tax purposes.

(2) Avoids the branch profits tax (because the income is not earned by a foreign corporation).

(B) Disadvantages.

(1) Favorable long term capital gains rate is not available, and therefore gain is taxed at corporate rate (currently up to 35%).

(2) Dividends from a domestic corporation to a foreign corporation are subject to 30% withholding (unless applicable treaty). Therefore, potentially a 60% combined rate.

11. **Ownership by a Domestic Partnership.**

(A) Advantages.

(1) One level of income tax (flowthrough) on all income, and favorable long term capital gains rates are available upon sale.

(2) Allows for a transfer during life that will not be subject to the US gift tax because it is a transfer of intangible property.

(3) **MAY** allow for avoidance of US estate tax on death, if the partnership interest is not considered to have a “situs” in the US for US estate tax purposes (if the situs test is the residence of the owner of the intangible asset).

(4) On death of a partner, basis step-up may be available for real estate owned by the partnership if the partnership has in effect a §754 election.

(B) Disadvantages.

(1) Some uncertainty regarding situs of partnership interest for US estate tax purposes.

12. **Ownership by a Foreign Partnership.**

(A) Advantages.

(1) Same as for domestic partnership. And in addition:

(2) May be additional layer of US estate tax protection over a domestic partnership (if the situs rule is the place of organization of the partnership).

(B) Disadvantages.

(1) Some uncertainty regarding situs of partnership interest for US estate tax purposes.

13. **Ownership by a Foreign Corporation Electing to be Taxed as Partnership for US Income Tax Purposes.**

(A) Advantages.

(1) Same advantages as for foreign partnership. And in addition:

(2) May be an additional layer of US estate tax protection over a foreign partnership (if situs rule for corporations is applicable).

(B) Disadvantages.

(1) Some uncertainty regarding situs of stock for US estate tax purposes (is it stock or a partnership interest for this purpose?).

14. **Ownership by an Irrevocable Trust.** For these purposes, assume that the NRA transfers cash to a Florida trust, which then acquires the US property. The beneficiaries of the Trust are family members of the NRA. The NRA is not a beneficiary of the Trust.

(A) Advantages.

(1) Only one level of potential US income tax, and lower long-term applicable capital gains tax rate is available.

(2) No US gift tax issues.

(3) On death of the NRA, the Trust property is not subject to the US estate tax.

(B) Disadvantages.

(1) No basis step-up in property on the death of the NRA.

(2) Will require the NRA to give up some beneficial ownership and control in favor of beneficiaries to achieve the desired protection against the US estate tax.

(3) Generally more expensive to set up and administer.

15. **Other Trust Issues.**

(A) Foreign investor (settlor of the trust) as a permissible discretionary beneficiary of the trust.

(1) The settlor could also be a discretionary beneficiary of the trust if the trust is established in a jurisdiction that permits the settlor to be a beneficiary without subjecting the trust assets to the claims of a creditor of the settlor. If not, then desired US estate tax protection will not be achieved on the death of the settlor.

(a) Domestic jurisdictions that permit this include Alaska, Delaware, and Nevada, and many foreign jurisdictions also permit this.

(2) This type of trust will add an additional level of set up and administration costs.

(B) Classification of Trust as Domestic or Foreign for US Tax Purposes.

(1) In many cases, you can structure the trust to achieve the desired tax classification.

(2) If all beneficiaries are non-US persons, then a foreign trust may be better because foreign source income is not subject to the US income tax.

(3) If any beneficiaries are US persons, then a foreign trust may have some negative US tax implications:

(a) “Throwback rules” may apply to undistributed foreign income when later distributed to US beneficiaries.

(b) May be additional reporting requirements if the trust is a foreign trust.

(i) On receipt of a distribution by a US beneficiary from a foreign trust, the US beneficiary must file Form 3520 disclosing the distribution.

(ii) US beneficiary may have additional filing requirements for an interest in a foreign trust under the new “FATCA” rules.

16. **Recent Articles.**

(A) “Foreign Investment in U.S. Real Property”, by Amy P. Jetel and Elliott H. Murray, Probate & Property (May/June 2012).

(B) “Foreign Investment in U.S. Real Property: Navigating Through the Income, Estate, and Gift Tax Traps:”, by Datan Dorot, Florida Bar Journal (May 2011).