Planning for the Global Private Client: Real Estate or Business Assets in the United States

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Case Study

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- Non-resident/non-citizen of the US looking to expand into the US through acquisition of real estate – taking advantage of depressed prices
- Not worried about tax in home country (i.e., structures in place)
- Concerned about US income tax and US estate tax
  - Income tax at corporate level is (currently) 35%, with a second level of tax on dividends paid to non-treaty-country based individuals of 30%
  - Income tax for individuals and trusts for the benefit of individuals at rates ranging up to 39.6% for “ordinary” income and 20% to long-term capital gain
  - Estate tax imposed at rate of 40% on assets considered "situated" in the US at the taxpayer's death (with $60,000 estate tax exemption)

Discussion Overview

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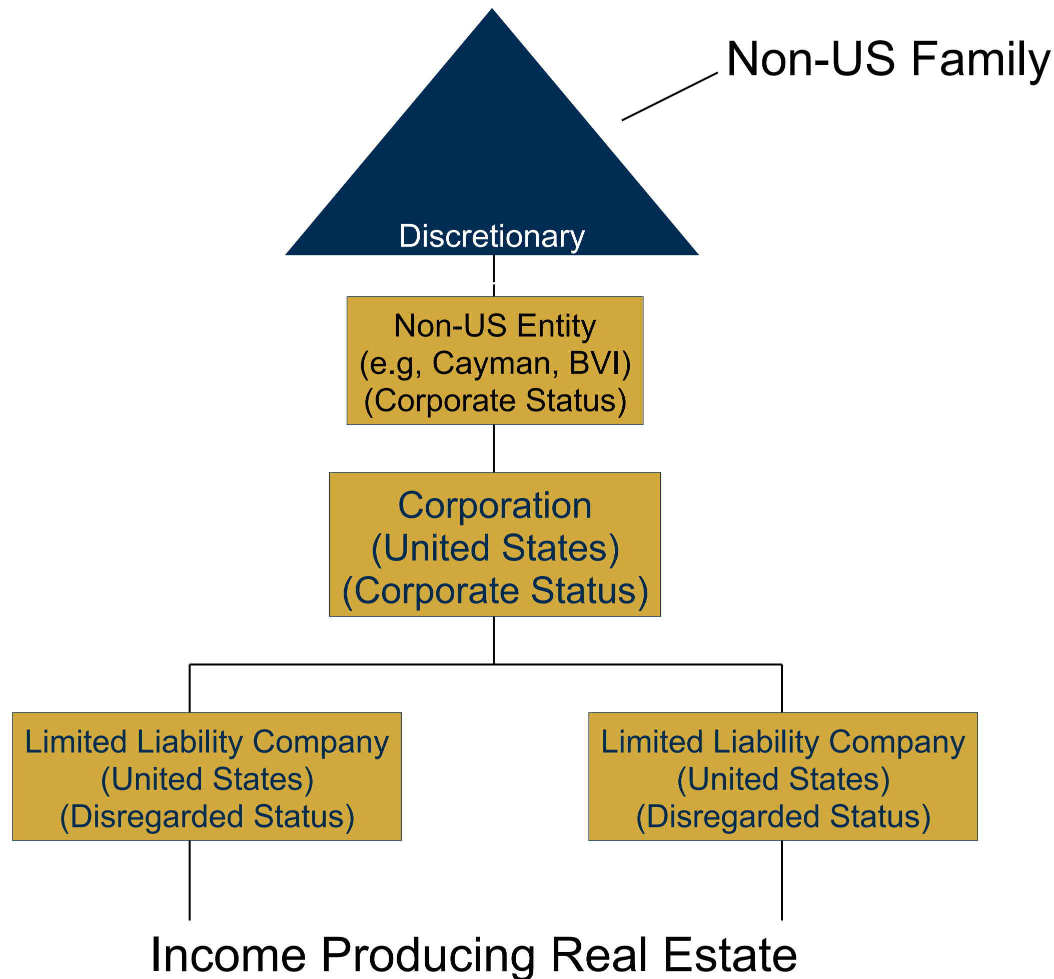
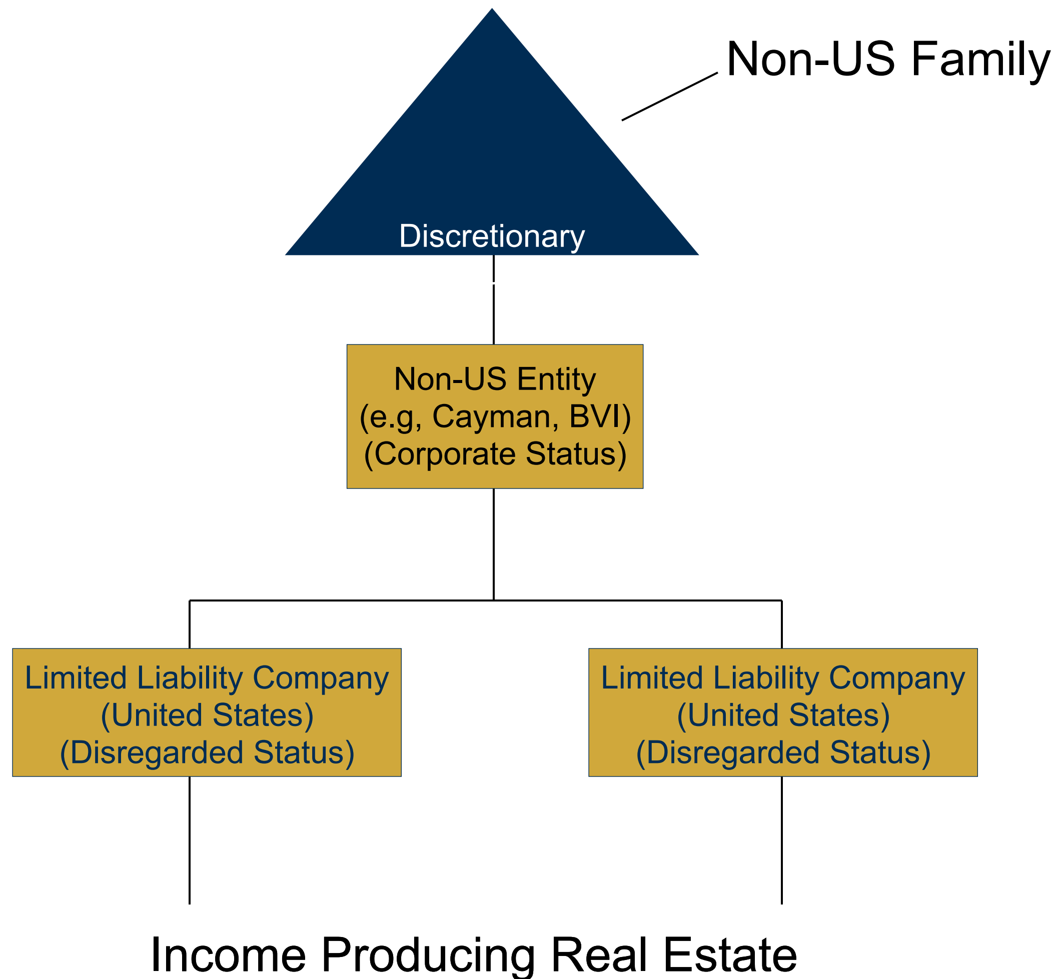
- Classic Case: Everybody's Doing It
- Choice of Entity: Guiding Principles
- Structure Alternatives: Traps for the Unwary
- Achieving Efficiency for Income Tax
- US Estate Tax Analysis of "Income Tax Efficient Structure“
- Improving Our Outcome for Income Tax

Classic Case:
Everybody's Doing It

Typical Investment Structure into US



Another Approach: No US Subsidiary



But is that the Most Efficient?
Choice of Entity: Guiding Principles

Structuring Alternatives for Ownership of US Assets

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- Asset and liability protection necessitates use of legal entity to own assets
- Domestic Entity Alternatives and Tax Implications –
  - Corporations – 35% tax at corporate level, 0%-15%-30% (depending upon treaty qualification) to shareholder when distributed
  - Limited Liability Companies, Partnerships -- generally "flow-through", income tax imposed at rate of 20%-39.6% to each member's allocable share, and ***no tax on distributions***

Foreign Alternatives

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- Putting aside "home-country" labels such as "exempted company", "SRL", and the like, US classifies non-US entities as
  - Corporations – taxed in own right with distributions taxable to shareholders (depending upon citizenship/residency)
  - Partnerships – generally not taxed in own right, but income "flow-through" to partners
  - Disregarded entities ("DRE") – i.e., entities which are ignored such that their owners are considered to own, operate and earn the assets and income realized within

"Check-The-Box" Alternatives

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- Available to "foreign eligible entities" -- generally all non-US entities not listed as "per se" corporations – See list at US Treasury Regulation Section 301.7701-2(b)(8)
- If no election, "foreign eligible entities" default to:
  - Multi-member where at least one member has general liability -- Partnership
  - Single or Multi-member where no member has general liability -- Corporation
- If election, foreign eligible entities become:
  - Multi-member – Partnership (notwithstanding no liability)
  - Single-member -- DRE

"Business" v. "Non-Business" Income

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- Non-US persons "engaged" in US business are subject to tax on "effectively connected" income at marginal rates applicable to US persons
  - Pay tax on "net" basis, after taking into account effectively connected gross income and deductions
  - Gains from sale of real property considered “effectively connected” income subject to US tax
- US persons not engaged in US business are subject to flat 30% tax on gross amounts but gains tax exempt
  - Dividends, interest, royalties, rents, but not gains from sale of non-effectively connected assets

Attribution of Activities: Imputed Status & "Engaged in Business"

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- Non-US persons who invest indirectly in US through partnership or trust are attributed the activities of the underlying partnership or trust
- If partnership or trust is "engaged" in business in US, the partner or beneficiary will be considered so engaged.
  - Limited to no involvement irrelevant
- Similarly, if partnership or trust is not engaged, partner or beneficiary attributed that lack of business
  - Complete and total control over activities is irrelevant

Real Estate Income: Both Effectively Connected and Not

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- Gain on sale is "effectively connected income" – Non-US person is deemed "engaged in business“ and taxed thereon
  - 20% capital gain tax for long-held non-inventory property allocable to individuals or trusts for the benefit of individuals
  - 39.6% ordinary income tax for inventory property (e.g., condo units) allocable to individuals/trusts
- Operating Income (i.e., rent) is "non-effectively connected"
  - 30% withholding on **gross rent** (i.e., no "netting" for building depreciation, losses, etc.) – bad result
  - Solution – elect to treat rent as "effectively connected income", imposing graduated tax system on "net" rental income (maximum current rate of 39.6%). No longer withheld at source; US tax return required

Branch Profits Tax

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- “Second-level” tax applicable to a foreign corporation engaged in US business through a "branch“ or flow-through
- Dividend "equivalence" tax – designed to reduce disparity between non-US corporations with subsidiaries (and subject to dividend withholding) and those operating directly (i.e., who would otherwise avoid withholding)
- Imposed at "prevailing" dividend rates when non-US corporation fails to reinvest in US business – based upon so-called "dividend equivalent amount"; i.e., effectively earnings "withdrawn" from US branch operations

Withholding Tax on Income

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- Non-US persons (individuals, partnerships, and corporations) subject to withholding tax of 30% with respect to "non-effectively connected" income.
- Non-effectively connected income generally includes dividends, interest, royalties, rent, annuity payments
- Eligible for reduction by treaty (i.e., where investor satisfies "limitations on benefits" clause)
- Under FIRPTA, however, the buyer must withhold 10% of the gross purchase proceeds when purchasing assets from a non-US seller, including an LLC with a single non-US owner

Other Act to Balance: Estate Tax at Client's Death

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- US "situs" assets are subject to estate tax at rate of 40% upon death of non-domiciliary of the United States
- Assets considered situated in the United States include:
  - Real estate owned directly
  - Stock in US corporate issuers owned directly
  - Debt of US obligors (except "portfolio debt")
  - Assets not otherwise considered US situs but held in trust where both (a) trust is considered includible in taxpayer's gross estate for US estate tax purposes (e.g., revocable trusts) and (b) original assets contributed to trust were US situs – i.e., "asset" tainting.

What are Non-US Situs Assets?

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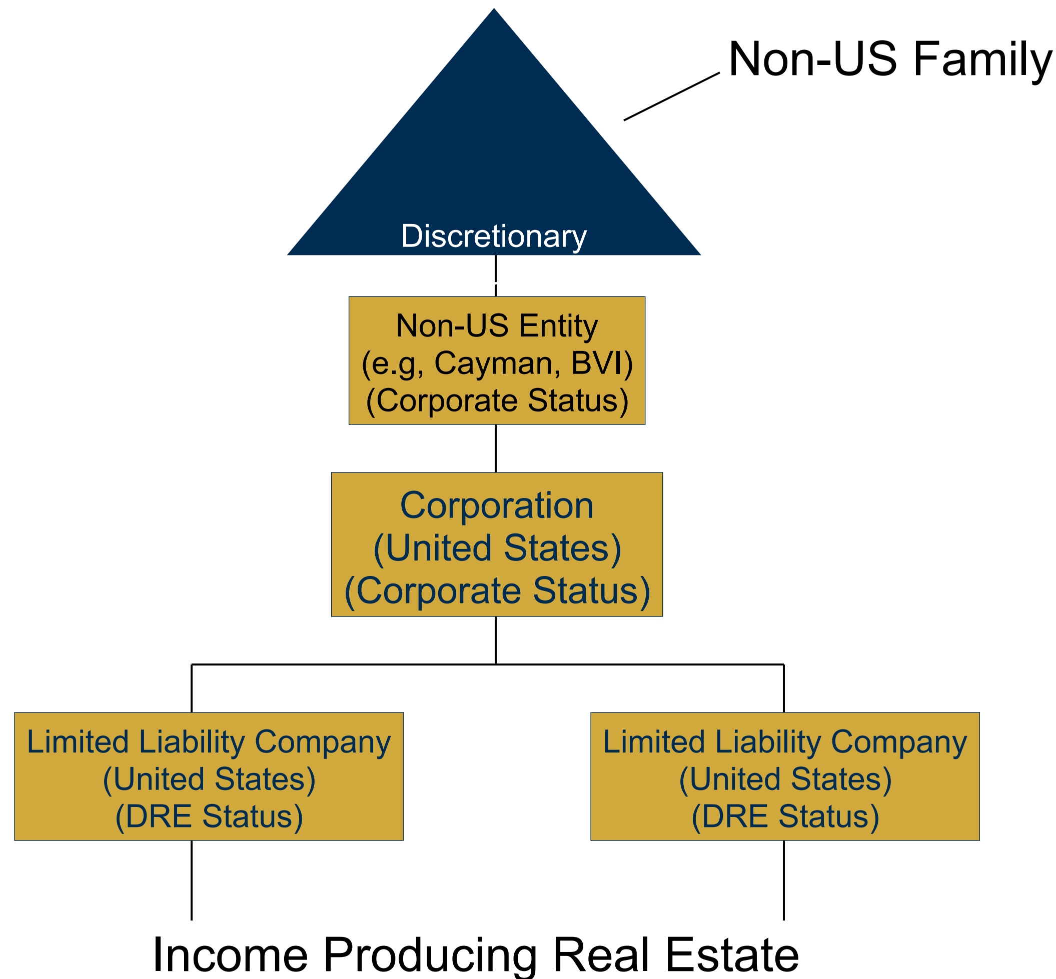
- Non-US real estate
- Non-US corporate shares
- Tangible Property located outside of US
- Bank deposits (including those located in US)
- "Portfolio" debt instruments issued by US persons (must be "registered"; bearer bonds no longer qualify).
- "Intangible personal property the written evidence of which is not treated as being the property itself, if it is not issued by or enforceable against a resident of the United States or a domestic corporation or governmental unit"

Structure Alternatives: Traps for the Unwary

Typical Investment Structure into US



Tax Treatment in Traditional Structure

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- Double layer of US income tax
  - Income "passes through" the LLC – no US tax
  - US corporation, as a US taxpayer, is taxed at rates of 35% on rental income *and* disposition income (no preferential capital gains rate of 20%)
  - Remaining rent, when distributed to non-US company, is withheld on at 30% rate (FDAP income)
  - 54.5% effective tax rate in structure – expensive!
- Solution is to eliminate US corporation, right?

Solution? No! – "Branch Profits Tax" & FIRPTA Withholding

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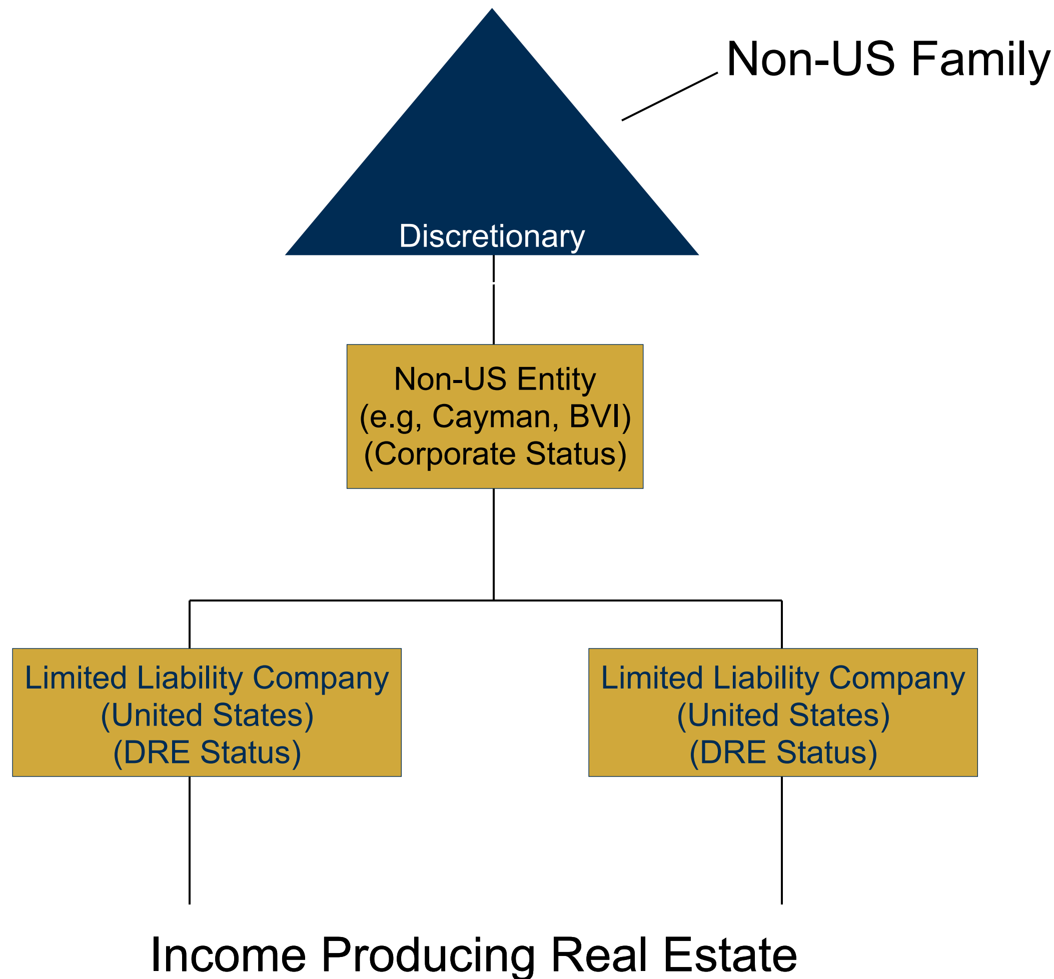

Double Layer of Tax Remains!

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- Use of foreign "corporate" blocker to hold direct/indirect interests in assets giving rise to "effectively connected income" is very tax-expensive
- While blocker solves "estate tax" in the United States (i.e., client owns non-US shares at death “situated” outside the US by statute)
  - There remains corporate level income tax (at non-US entity level) on "effectively connected income" – i.e., generally US source income – at rates of 35% – *and*
  - There is a second-level tax on "branch profits" for the blocker, resulting in additional layer of 30% tax on "dividend equivalent amount" – essentially amounts available for distribution
- Effective tax rate remains at 54.5%

Achieving Efficiency for Income Tax

Solution

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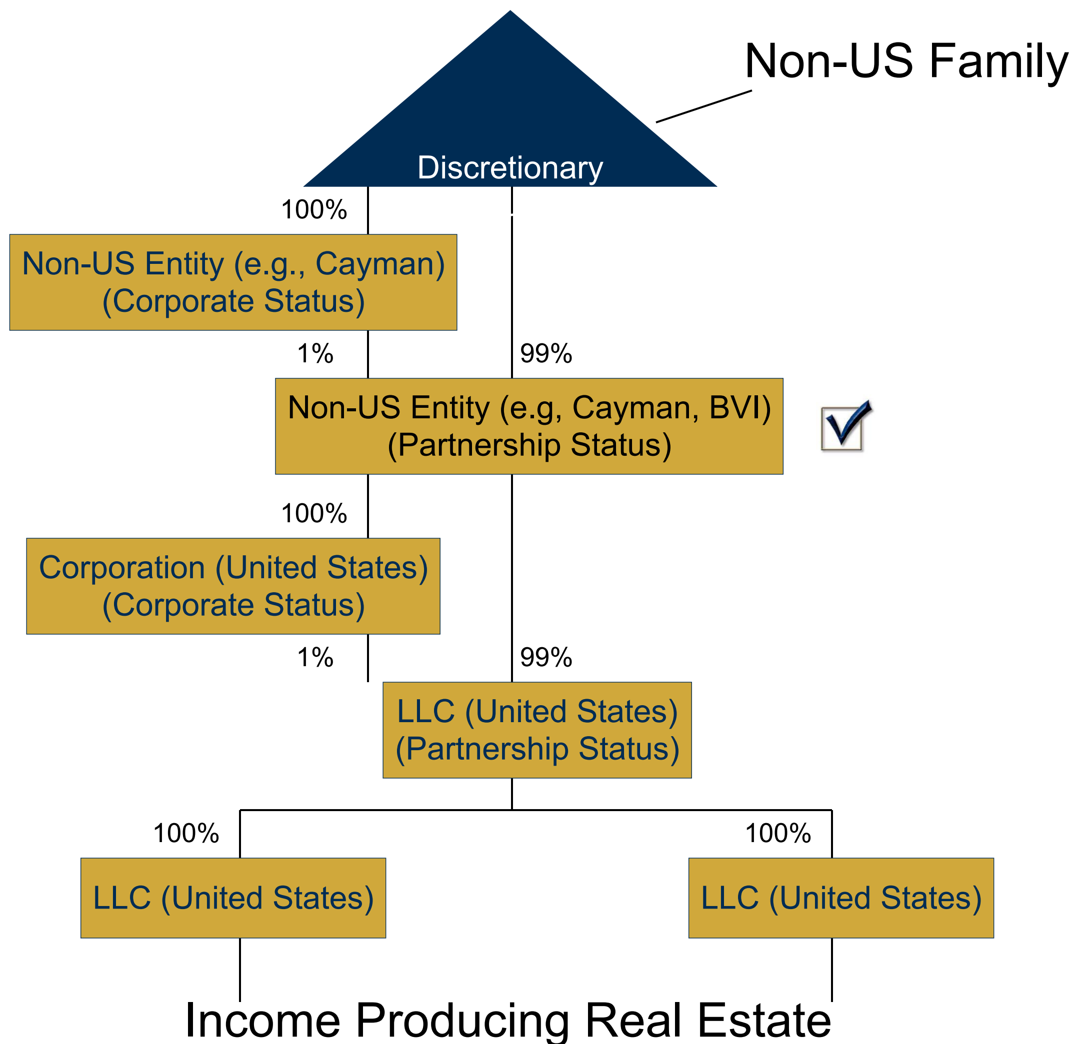
- Use trusts and deemed partnerships (including "check-the-box" elections) to avoid branch profits tax
  - Branch profits tax is only imposed on corporations
  - Non-US company (e.g., BVI) elects to be treated as a partnership for US federal income tax purposes – no BPT
  - Results in single layer of tax (at individual – i.e., non-corporate rates) by isolating tax to "effectively connected income" only
  - Still must solve for US *estate* tax with foreign eligible entity

Structure Solution



Tax Treatment of Structure

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- Single layer of US income tax
  - Income "passes through" structure with respect to the 99% of allocable income – taxed at 39.6% graduated rates on "net" income (i.e., allowable depreciation and expense deductions) for rental income
  - In case of sale of property held longer than one year, gains on sale (and allocable to 99% stream) are subject to tax at 20%
  - 1% allocable to US corporate and non-US corporate piece subject to double layer of tax – 54.5% effective tax rate
- Upon sale, LLC Partnership entity delivers a Form W-9 and there is no “FIRPTA” withholding
- Effective tax rate for sale is thus about 20% for overall structure – an immediate 34.5% (approx.) tax savings over corporate structure of 54.5%

US Estate Tax Analysis
of
"Income Tax Efficient Structure"

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At Death, Does the Client Own “US Situs“ Assets?

- At death, the client “owns” (via trust) only shares in “checked” entities treated as partnership/flow-through for US tax
- Estate tax in US requires “US situs” assets, which include:
  - "intangible personal property the written evidence of which is not treated as being the property itself, if it is issued by or enforceable against a resident of the United States or a domestic corporation or governmental unit"
- In past, practitioners have interpreted this provision as including “partnership interests”

Use of "Non-US" Partnership as Estate Tax Blocker!

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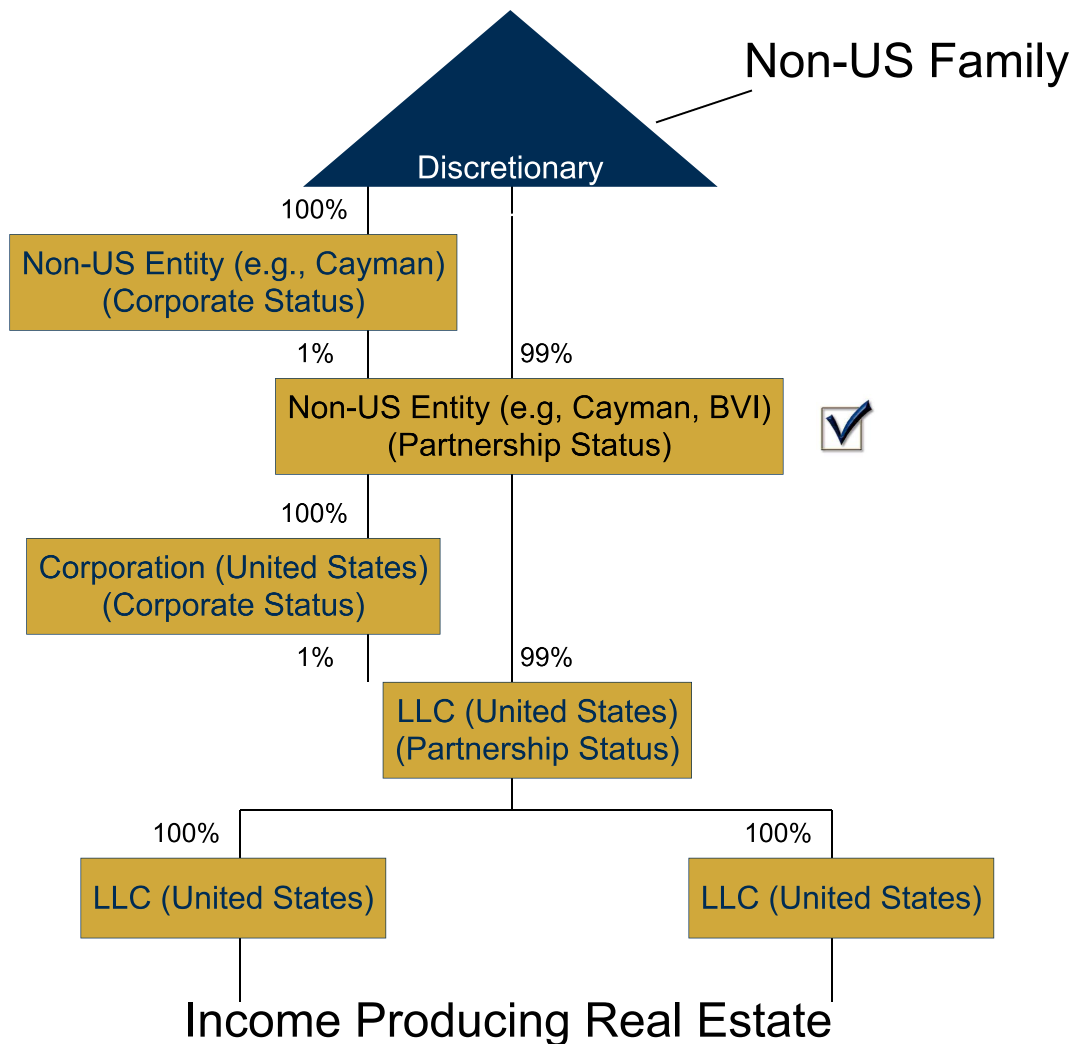
- Use of so-called "foreign eligible entities" for which a check-the-box election is made
  - Corporate in form, flow-through for US income tax
  - Ownership of shares therein does not permit shareholder to "enforce" rights against a US resident
  - Aren't those shares "written evidence" considered the "property itself" – the baseline for estate tax inclusion?
- Where checked entity shares are "located" outside of the US at the death of the taxpayer, they should not be "situated" in the US (despite flow-through nature for US federal *income* tax) – i.e., no US federal estate tax
- If structured properly, use of the discretionary trust should keep assets (i.e., US assets) out of "gross estate" inclusion as well – "belts and suspenders"

Structure Solution



Summary

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- Implementation of "flow-through" structure to reduce effective US federal *income* tax rate from 54.5% to approximately 35% on US income and 20% on capital gains
- Ensure US *income* tax is imposed on rental income on a "net" basis as opposed to a "gross" withholding basis
- Manage US *estate* tax exposure using foreign partnership blocker – i.e., "check-the-box"

CAN WE IMPROVE OUR OUTCOMES FOR INCOME TAX?

INTEREST AS DEDUCTIBLE EXPENSE

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- Interest paid is deductible by payor, thus reducing its net taxable income
- Interest received is taxable to the lender, except if the interest is received by:
  - A tax-exempt entity
  - Certain non-US lenders with available income tax treaty benefits (e.g., United Kingdom lenders)
  - "Portfolio Interest" paid to a non-US lender
- Portfolio interest is broadly defined as interest paid to a non-US lender that is not "related" to the borrower or based upon profits or other contingencies.

Related Party Interest

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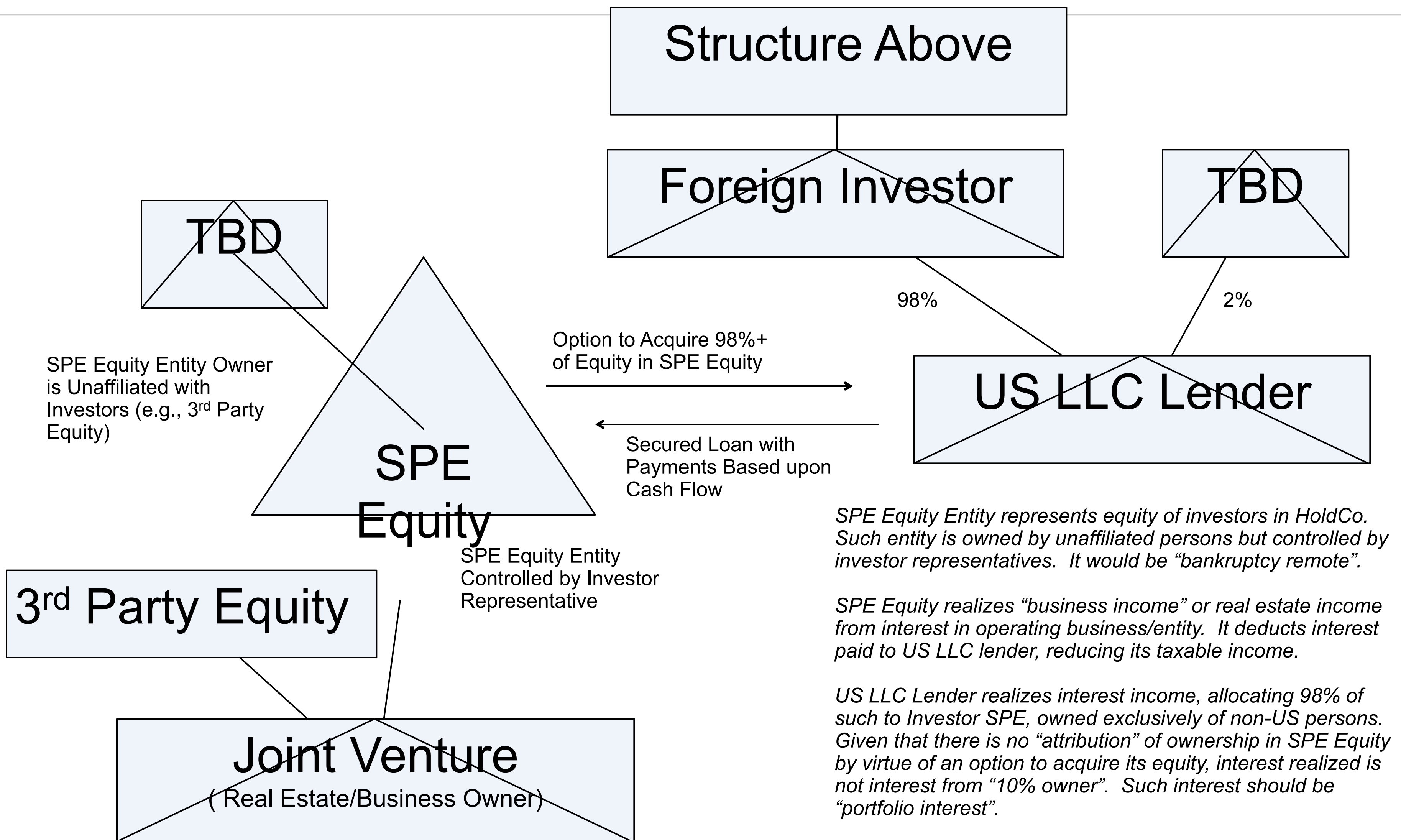
- Paying a related party means that the interest paid is subject to withholding at a flat rate equal to 30% of the gross interest paid.
- For such purposes, “related” is defined to mean a relationship in which the lender owns, by attribution of rules of constructive ownership, at least 10% of the borrower.
- Thus typically a problem for a foreign family
- However, the definition of “related” person does not include a domestic partnership lender which holds an option to acquire equity in the borrower.
  - Although the lender enjoys “upside” benefits in the project/business via an option to acquire equity, that upside is not considered “equity” in the borrower/payor.

Tax-free interest with option on equity



SPE Equity Entity represents equity of investors in HoldCo. Such entity is owned by unaffiliated persons but controlled by investor representatives. It would be “bankruptcy remote”.

SPE Equity realizes “business income” or real estate income from interest in operating business/entity. It deducts interest paid to US LLC lender, reducing its taxable income.

US LLC Lender realizes interest income, allocating 98% of such to Investor SPE, owned exclusively of non-US persons. Given that there is no “attribution” of ownership in SPE Equity by virtue of an option to acquire its equity, interest realized is not interest from “10% owner”. Such interest should be “portfolio interest”.

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