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Foreign Taxpayers

In the second of a three-part series on tax planning for foreign buyers of U.S. homes, tax lawyers Carl A. Merino, Dahlia B. Doumar and Henry P. Bubel consider indirect ownership structures, exploring the use of foreign blocker corporations and foreign partnerships. The authors write that each option presents ''a fundamental trade-off'' between buyers' ability to continue to use the property and the ability to keep the property out of their taxable U.S. estates.

Tax Planning for Foreign Couples Buying U.S. Homes: Ownership Through Foreign Corporations and Partnerships

BY CARL A. MERINO, DAHLIA B. DOUMAR AND HENRY P. BUBEL

In the first installment of this series,[1] we discussed U.S. income and estate tax considerations for foreign buyers of U.S. real estate with the example of a nonresident alien couple buying a condominium apartment in New York City. We focused on the tax consequences of direct ownership and steps a non-U.S. couple might take to mitigate their U.S. estate tax exposure.

In this second installment, we move on to indirect ownership structures, exploring the use of foreign blocker corporations and foreign partnerships. The use of trusts (both foreign and domestic) is covered in the third installment.

Many foreign investors prefer to take ownership of U.S. real property through one or more entities, whether to limit personal liability associated with ownership of the property, reduce direct exposure to the U.S. tax system or for the increasingly elusive goal of preserving anonymity.[2]

The following examples illustrate some of the tax advantages and disadvantages of these different structuring options. As discussed below, each of these options presents a fundamental trade-off between the couple's ability to continue to use the property and their ability to keep the property out of their taxable U.S. estates.

[1] 212 DTR J-1, 11/2/16.

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Foreign 'Blocker' Corporations

Traditionally, foreign nationals who wanted to avoid direct U.S. tax exposure have invested in U.S. real estate through foreign ''blocker'' corporations. Although not as efficient as direct ownership from an income tax

[2] Indirect ownership structures still offer tax benefits and liability protection, but they provide much less anonymity than they used to in the wake of the Foreign Account Tax Compliance Act, the Common Reporting Standard, proposed new reporting requirements for foreign-owned disregarded entities and new Financial Crimes Enforcement Network ''know-your-customer'' rules recently announced by the U.S. Treasury Department.

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standpoint, a foreign blocker corporation offers a potential (but not necessarily impregnable) shield against U.S. estate taxes.[3]

Moreover, the corporation, rather than the shareholders, is the taxpayer for income tax purposes, although the shareholders may nonetheless have to be identified in tax filings.

Income Taxes

Foreign corporations are subject to the same two federal income tax regimes as nonresident aliens, but at different tax rates on certain taxable gains:

- Foreign corporations are taxed at a 35 percent rate at the federal level, net of deductions, on income that is effectively connected with the conduct of a trade or business in the U.S.[4]

- Foreign corporations are taxed at a flat 30 percent rate at the federal level, without offsetting deductions, on fixed or determinable annual or periodical income (FDAP) from U.S. sources (generally, dividends, interest, rents, royalties and other portfolio income that isn't effectively connected with a U.S. trade or business), unless the rate is reduced by a tax treaty or a provision of the Internal Revenue Code. As with nonresident alien individuals, foreign corporations are exempt from income taxes on eligible portfolio interest and interest on certain bank deposits.[5]

Investments in U.S. Real Estate. Foreign corporations also are taxed on gains from the sale of real property situated in the U.S. under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).[6] Unlike individuals, they aren't entitled to a preferential rate for long-term capital gains, which are taxable to corporations at the same 35 percent rate as other types of income.

Moreover, if a foreign corporation sells real property located in New York City or otherwise earns income from such property, it will be subject to three levels of tax—federal income tax at a rate of 35 percent, New York state corporate franchise tax at an effective rate of 8.165 percent (including a Metropolitan Transportation Authority surcharge) and a New York City corporation tax at a rate of 8.85 percent, resulting in an effective income tax rate of more than 46 percent (after deducting state and local income taxes).

FIRPTA Withholding Tax. When a foreign corporation (or other non-U.S. person) sells U.S. real estate, the buyer generally is required to withhold 15 percent of the gross consideration (including the assumption of any debts) paid for the property regardless of the seller's actual FIRPTA gains.[7]

In some situations, the buyer and seller can obtain a withholding certificate from the Internal Revenue Service, reducing the amount of FIRPTA tax that must be withheld by the buyer, by filing IRS Form 8288-B, Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests. Otherwise, the foreign corporation would have to file a tax return to obtain a refund of the excess taxes withheld.

Rental Income and Net Election. Although passive rental income generally is taxed at a 30 percent rate (without any offsetting deductions), corporations can make the same ''net election'' that we discussed in connection with individual owners in the first article of this series to treat the rental income as if it was income effectively connected with the conduct of a trade or business in the U.S., which is taxed on a net basis after taking into account depreciation and other applicable deductions.[8] The election is made on the corporation's federal income tax return.[9]

Branch Profits Tax. Section 884 imposes a 30 percent tax on earnings from a U.S. trade or business carried on by a foreign corporation through a U.S. branch (including a partnership or wholly owned disregarded entity) to the extent such earnings are deemed to have been repatriated.[10] The tax also can apply to gains from the sale of interests in U.S. real estate even if there is no associated trade or business.[11]

If a foreign corporation sells real property located in New York City or otherwise earns income from such property, it will be subject to three levels of tax.

The tax may be avoided if the corporation disposes of all of its U.S. real property and otherwise terminates any U.S. trade or business activities before repatriating the proceeds.[12] Moreover, the tax may not apply at all (or may apply at a reduced rate) to corporations formed in certain treaty jurisdictions.[13]

[3] This structure may not be advisable for individuals in every jurisdiction.

[4] See Sections 871 and 882 of the Internal Revenue Code of 1986, as amended. No deduction is allowed if the corporation doesn't file a tax return.

[5] See Sections 881(c) and (d).

[6] See Sections 897 and 1445.

[7] See Section 1445(a).

[8] See Section 882(d). The depreciation deductions will reduce the corporation's tax basis in the property, potentially increasing gains on a future sale. To the extent that depreciation deductions exceed the income from the property, there may be loss carryforwards available to offset future gains.

[9] The election generally remains in effect for subsequent years unless revoked. Procedures for making and revoking an election are discussed in Treas. Reg. Section 1.871-10.

[10] The tax is imposed on the ''dividend equivalent amount'' and is intended to put foreign corporations that conduct business in the U.S. through an unincorporated branch in the same after-tax position as foreign corporations that operate in the U.S. through taxable corporate subsidiaries. See IRS Notice 86-17, 1986-2 C.B. 379.

[11] See Treas. Reg. Sections 1.897-1(f)(1), (f)(2)(ii).

[12] See Treas. Reg. Sections 1.884-2T(a)(1), (2). There are a number of procedural requirements, as well as a three-year prohibition on effectively connected income and use of the same U.S. assets by certain related parties.

[13] The branch profits tax doesn't apply to eligible corporations formed in certain countries whose tax treaties predate the tax and haven't been amended since it was introduced in 1987, including China, Korea, Norway, Cyprus, Egypt and Pakistan, among others. The branch profits tax also doesn't apply to treaty-eligible corporations formed in France, the U.K., the Netherlands, Mexico, Australia and Japan that own 80 percent or more of a U.S. ''branch'' (including a wholly

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It is assumed for purposes of this case study that any sales would be structured to avoid triggering the branch profits tax.

Tax and CRS Disclosures. Individuals owning 50 percent or more of the voting stock of the foreign corporation (directly or indirectly) must be identified on the corporation's Form 1120-F, U.S. Income Tax Return of a Foreign Corporation (although there may not be any tax return to file until the property is actually sold unless it is rented out in the interim).

In addition to possibly having to be identified on the foreign corporation's tax returns after a sale of the underlying property (or in the event that the property is rented out), the couple likely will face various disclosures under local know-your-customer rules in the jurisdiction in which the corporation is organized and wherever it opens a bank account. There may be reporting back to their home country in some cases if that jurisdiction is one of the more than 100 countries that have committed to automatic exchange of information with other participating jurisdictions under the Common Reporting Standard (CRS) developed by the Organization for Economic Cooperation and Development (OECD).[14]

Many offshore financial centers (including the Cayman Islands, Bermuda, the British Virgin Islands, Panama and Mauritius, among others) have committed to the automatic exchange of information under the CRS at this point, although most are in the second tranche that isn't expected to begin reporting until 2018. Moreover, a participating jurisdiction won't necessarily exchange information with all other participating jurisdictions.

Tax Reporting Issues for U.S. LLC Subsidiaries. Foreign corporations (and foreign partnerships) often use wholly owned Delaware limited liability companies to acquire U.S. real estate because banks and other parties sometimes prefer to deal with a domestic entity. The LLC also may add an extra layer of liability protection.

An LLC with only one owner generally is disregarded for most federal tax purposes.[15] However, recently proposed Treasury regulations under Section 6038A would require any U.S. disregarded entity with a foreign owner to apply for an employer identification number and file a modified version of IRS Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business, upon funding.[16]

The foreign owner would have to authorize the U.S. entity to act as its agent to receive any IRS summons. Additionally, Form 5472 requires disclosure of the foreign corporation's owners and the EIN application currently requires entities to name an individual who has effective control over the entity as a ''responsible party.''

Additionally, the U.S. Treasury Department now requires title insurers to determine the identities of the owners of any limited liability companies that buy residential real estate in six major metropolitan areas in all-cash transactions above certain dollar thresholds set by geographic area. The geographic areas include all five boroughs of New York City, Miami-Dade County and the two counties immediately to the north (Broward and Palm Beach), Los Angeles County, San Francisco along with San Mateo and Santa Clara counties, San Diego County and Bexar County, Texas, which includes San Antonio.[17] This requirement doesn't apply to purchases made by wire transfer.[18]

CRS Implications of U.S. LLC Subsidiaries. Owners also may need to consider the impact of a lower-tier entity on the CRS classification—and consequent reporting obligations—of the parent company in its jurisdiction.

For example, based on current OECD guidance, a foreign holding company that only holds real estate generally wouldn't be considered a financial institution for CRS purposes, but an upper-tier holding company in a participating jurisdiction potentially could be treated as a financial institution (with actual registration and reporting obligations) if it, in turn, is managed by a financial institution.[19]

Accordingly, a lower-tier subsidiary in the U.S. potentially could have reporting implications in other countries, although guidance in this area remains in flux.

Estate and Gift Taxes

As a U.S. situs asset, stock in a U.S. corporation held by a non-U.S. person at death is includible in the decedent's estate.[20] Stock in a foreign corporation isn't a U.S. situs asset and thus isn't includible in the estate of a non-U.S. decedent, even if the corporation itself holds U.S. situs assets, and gifts of corporate stock (domestic or foreign) by such person aren't subject to U.S. federal gift taxes.[21]

However, it is critical to observe corporate formalities. Otherwise, there is a risk that U.S. or other tax au-

owned limited liability company). The tax applies at reduced rates to corporations formed in many other treaty jurisdictions.

[14] According to the OECD website, 101 countries have signed on as of July 26, 2016. See https://www.oecd.org/tax/transparency/AEOI-commitments.pdf. See also https://www.oecd.org/tax/bahrain-lebanon-nauru-panama-and-vanuatu-have-now-committed-to-the-international-standard-of-automatic-exchange-of-financialaccount-information-to-tackle-tax-evasion-and-avoidance.htm.

[15] See Treas. Reg. Section 301.7701-2(c)(2)(i). Note that disregarded entities are still ''regarded'' and treated as separate entities for federal employment and excise tax purposes. See Treas. Reg. Section 301.7701-2(c)(2)(iv).

[16] See REG–127199–15, published in 81 Fed. Reg. 28784 (May 10, 2016).

[17] See news release, U.S. Treasury Department, ''FinCEN Expands Reach of Real Estate 'Geographic Targeting Orders' Beyond Manhattan and Miami'' (July 27, 2016), available at https://www.fincen.gov/news/news-releases/fincen-expands-reach-real-estate-geographic-targeting-orders-beyond-manhattan. A table of dollar thresholds broken down by geographic area is available at https://www.fincen.gov/sites/default/files/shared/Title_Ins_GTO_Table_072716.pdf.

[18] See FinCEN Frequently Asked Questions, Question 4 (''What methods of payment are covered under Section II.A.2.iv. of the GTOs?''), available at https://www.fincen.gov/sites/default/files/shared/GTO_Phase_2_FAQs%20_081916.pdf.

[19] See OECD CRS-related Frequently Asked Questions, Section VIII(A), Question 4 (June 2016). See https://www.oecd.org/tax/automatic-exchange/common-reporting-standard/CRS-related-FAQs.pdf.

[20] See Sections 2101(a), 2103, 2104(a); Treas. Reg. Section 20.2104-1(a)(5).

[21] As discussed in the first part of this series, a non-citizen domiciled abroad is subject to U.S. federal gift taxes only with respect to real and tangible personal property situated in the U.S. See Sections 2501(a), 2511(a).

thorities may treat the corporation as an alter ego of its owners.

■ **Planning Point:** If the owners plan to regularly use the property, they may want to consider entering into a lease or usage agreement with the corporation or otherwise formalizing the rights of shareholders to use the corporation's property.[22] Regular use of the property by the shareholders without any formalized right to do so potentially raises questions as to whether the shareholders are respecting the corporate form. This is less of an issue if the couple doesn't plan to use the property. Note that the corporation will need ongoing contributions to cover property taxes and maintenance fees in any event.[23]

Case Study: Acquisition and Sale Of Apartment With Foreign Corporation

In the first part of this series, we considered a fact pattern in which a married couple purchased a condominium apartment in New York City. Each spouse was a nonresident for income, gift and estate tax purposes, neither spouse was a current or former U.S. citizen, long-term resident or New York domiciliary, and there was no applicable estate, gift or income tax treaty.[24]

It is important to fund the corporation first and for the corporation (rather than the corporation's owners) to buy the apartment.

They purchased the apartment for $5 million cash (including any transaction costs) and without any financing. The apartment appreciated in value to $8 million by the time of any potentially taxable event (e.g., a sale or death).

We assumed that 2016 income and estate tax rates would apply and that the apartment would have been owned for more than one year at the time of any taxable disposition. We also assumed that the closing costs for any subsequent sale, including the broker's commission, attorneys' fees and New York state and city real estate transfer taxes, would total 8 percent of the purchase price ($640,000), reducing the amount realized to $7.36 million.[25]

In this case study, we assume the same facts as in the first article, except that instead of buying the apartment directly, the couple incorporates and funds a corporation outside the U.S. with $5 million cash and the corporation (either directly or through a wholly owned limited liability company) then purchases the apartment for $5 million.[26] Any additional carrying charges are funded through the corporation. The apartment isn't rented out.

■ **Planning Point:** Either spouse could provide the cash for the purchase of the apartment because a deemed gift of stock by a non-U.S. person isn't subject to gift tax. However, it is important to fund the corporation first and for the corporation (rather than the corporation's owners) to buy the apartment. The transfer of the property to a foreign corporation could trigger FIRPTA withholding and reporting obligations. It also increases the risk that the property (which itself is still a U.S. situs asset) will be subject to estate tax if either spouse continues to use the property without paying fair market rent or otherwise retains certain impermissible ''strings.'' If property is transferred during a decedent's lifetime for less than adequate and full consideration (including consideration for future use of the property) or with certain other strings attached, such as control over the beneficial enjoyment of the property, the property may be pulled back into the decedent's taxable estate.[27]

If the corporation sells the apartment for $8 million, the amount realized (assuming 8 percent closing costs), would again be $7.36 million. Absent capital improvements or depreciation, the corporation's basis would still be $5 million and the corporation's taxable gain would be $2.36 million.

[22] If the shareholders will have the right to use the property without paying fair market rent, they could be deemed to have received constructive distributions from the corporation. However, unless the corporation has actual earnings, the deemed distributions shouldn't be taxed as dividends.

[23] Charging rent is one way to accomplish this, but it is important for the corporation to file a tax return and make a net election under Section 882(d) so that it can use depreciation deductions to offset the rental income.

[24] As noted in the first article, individuals who give up their citizenship and ''long-term residents'' (valid green card holders for eight of the last 15 years) who cease to be lawful permanent residents may be subject to an exit tax under Section 877A, as well as a special transfer tax regime under Section 2801 on subsequent gifts and bequests to U.S. persons.

[25] As discussed in the first article, New York City imposes a transfer tax of 1.425 percent on the seller. (The rate is 2.625 percent in the case of commercial real estate or if two or more apartments are sold at the same time.) New York state imposes a 0.4 percent transfer tax on the seller and a 1.0 percent ''mansion'' tax (where consideration on the sale of a residence exceeds $1 million) on the buyer. The buyer and seller are each liable for transfer taxes that the other fails to pay. The broker's commission typically is 5 percent to 6 percent of the purchase price.

[26] It is assumed that further contributions would be made as needed to provide the corporation with sufficient funds to pay any maintenance charges and property taxes.

[27] Under Section 2036, the gross estate of a decedent includes the value of property transferred by the decedent by trust or otherwise other than for adequate and full consideration where the decedent has retained for his or her life or for any period not ascertainable without reference to his or her death or for any period that doesn't actually end before his or her death either the possession or enjoyment of the property, the right to the income therefrom or the right (alone or in conjunction with any other person) to designate who shall possess or enjoy the property or the income therefrom. Certain other retained powers over the beneficial enjoyment of the property can cause it to be pulled back into the decedent's estate under Section 2038.

Thus, rent-free use of U.S. situs property transferred to a foreign corporation (or a foreign partnership or trust) may present estate tax risks that are partially attenuated if the property was acquired by the foreign corporation in the first instance (i.e., because U.S. situs property was never transferred in the first place and so no rights with respect to such property could be said to have been ''retained''). However, the risk of the corporation or partnership being ''collapsed'' by the IRS isn't completely eliminated just by funding the corporation or partnership first if corporate (or partnership) formalities aren't otherwise respected.

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There would be no step-up in the corporation's basis in the property on account of either spouse's death since no portion of the property would have been acquired from a decedent. Accordingly, the gain would be the same whether the apartment was sold before or after the death of either spouse.

Assuming there are no deductions at the New York state or city level, but that New York state and city taxes are deductible against federal income taxes, the total income tax burden would be $1,087,010 ($685,456 federal, $192,694 state and $208,860 city).[28] This is significantly higher than the income tax burden if the couple held the property directly ($230,910 to $680,152, depending on whether the apartment was sold while both spouses were still alive), but significantly less than the total U.S. burden of $1,763,710 in a sale following the death of either spouse once one factors in the estate tax.[29]

Two-Tiered Blocker Structure

Some foreign buyers prefer to use a two-tiered holding company structure—either two foreign corporations or a foreign parent with a U.S. corporate subsidiary. A U.S. corporation that holds primarily U.S. real estate generally will be treated as a U.S. real property holding corporation, the sale of which would be potentially taxable to its foreign owner under FIRPTA as an interest in U.S. real property.[30]

However, if the U.S. subsidiary sold all of its U.S. real estate in a taxable sale, it could be liquidated without triggering a second level of tax (in much the same way that a foreign corporation that has disposed of all of its U.S. real estate could be liquidated without triggering the branch profits tax).[31] Note that if the lower-tier subsidiary holding the property is a foreign corporation, the lower-tier corporation itself could be sold without triggering FIRPTA tax.[32]

■ **Planning Point:** If multiple U.S. properties are acquired, separate holding corporations could be used for each property so that the proceeds can be distributed to the parent without triggering branch profits or FIRPTA taxes. Segregation of the underlying properties in separate subsidiaries also may be desirable from a liability protection standpoint (i.e., so as to isolate liabilities associated with any one property).

[28] This assumes a full deduction at the federal level for state and city income taxes paid. Although alternative minimum tax (AMT) applies to corporations, it is less likely to come into play here because of the higher tax rate on capital gains for corporations and the lower AMT rate (relative to individuals).

[29] Calculations for these amounts are discussed in the first article of this series.

[30] A U.S. corporation is a U.S. real property holding corporation for purposes of the FIRPTA tax if the fair market value of its U.S. real property interests equals or exceeds 50 percent of the sum of (1) its U.S. real property interests, (2) interests in real property located outside the U.S. and (3) other assets held for use in a trade or business (such as inventory, depreciable property and patents and other intellectual property). See Section 897(c)(2).

[31] See Section 897(c)(1)(B).

[32] Some buyers may reduce the price they are willing to pay to take into account the taxes the subsidiary would owe if it were to sell the property directly.

Pros and Cons of Foreign Blocker Structure

Given the higher income tax rates, the lack of a step-up in basis at death and a third level of tax if the property is located in New York City, a foreign blocker structure may not make sense for a couple that plans to sell the property in the near term, particularly if the estate tax exposure could be managed inexpensively with life insurance.

Additionally, there is some risk that the IRS could attempt to disregard the foreign blocker corporation if its sole asset is a U.S. apartment held for personal use if the couple or their family make substantial use of the property without either paying rent or formalizing their right to use the property as shareholders and paying due heed to corporate formalities.

Further, if they have U.S. heirs to whom they expect to pass the property, this structure could be very inefficient in the long run, as it could create phantom income and compliance issues for the future U.S. owners, who may be subject to the passive foreign investment company rules or the ''Subpart F'' regime for controlled foreign corporations, depending on their level of ownership and attribution from other family members.[33]

This structure may be more viable for a couple if their children or other heirs aren't U.S. citizens or residents and aren't expected to become U.S. citizens or residents in the future. This structure also may be suitable for a couple with non-U.S. heirs that plans to build a real estate investment portfolio (for example, with lower-tier subsidiaries to compartmentalize each holding) or for a group of foreign investors who wish to pool resources to invest in U.S. real property and who have separate planning needs.

Foreign Partnerships

Using a foreign partnership—or a foreign limited liability company that elects to be treated as a partnership for U.S. tax purposes—to hold U.S. real property is more tax efficient from an income tax standpoint than using a foreign corporation.

The income of a foreign partnership generally is taxable at the partner level, so if the couple acquires the apartment through a foreign partnership they potentially can enjoy the benefit of a 20 percent rate for long-term capital gains at the federal level (plus New York state income taxes) instead of the 35 percent corporate tax rate on an eventual sale, and without an additional New York City-level tax.[34]

However, using a partnership introduces an element of uncertainty regarding potential estate tax exposure. Moreover, as partners, they would both have to file income tax returns in the U.S. if the partnership sold or rented out the property.

Case Study: Sale of Apartment By Foreign Partnership

In this example, the facts are the same as with the foreign blocker corporation, except that the couple

[33] See generally Sections 951 to 965 and Sections 1291 to 1298.

[34] New York City imposes an unincorporated business tax (UBT) on certain unincorporated businesses, but gains from the sale of real estate by someone other than a developer wouldn't be subject to UBT in most cases.

forms and funds a foreign partnership (or a foreign limited liability company that elects to be treated as a partnership for U.S. tax purposes) with cash from an offshore account and the partnership buys the apartment for $5 million. The amount realized on the sale is $7.36 million (the same $8 million sale price as before, net of 8 percent closing costs).

The cash transfers should be sequenced in the same manner as for a foreign corporation—i.e., either or both spouses would fund the foreign partnership and the foreign partnership would subsequently buy the apartment (possibly through a wholly owned LLC)—so as to avoid a transfer of U.S. real estate by either spouse. As with a transfer of U.S. situs assets to a foreign corporation, the transfer of U.S. situs assets to a foreign partnership coupled with any impermissible ''strings'' carries a risk that the property could be pulled back into the decedent's estate for U.S. estate tax purposes.

■ **Planning Point:** As discussed in the previous section, foreign corporations and partnerships alike will often form a U.S. limited liability company that is disregarded for (most) U.S. tax purposes to buy the property. The same additional disclosures that would apply to a U.S. disregarded entity owned by a foreign corporation (such as Form 5472 filing obligations under the proposed Section 6038A regulations and possible additional CRS reporting) would apply if the disregarded entity was owned by a foreign partnership.[35]

Sale While Both Spouses Are Still Alive

If the partnership sells the property while both owners are still alive, the taxable gain would still be $2.36 million (based on the same assumptions as before), but the tax rate would be lower than for a corporation. Ignoring any deductions or credits, the federal capital gains tax would be $472,000 (20 percent) and New York state income tax would be $208,152 (8.82 percent)—$680,152 in total (the same as if the couple held the property directly and sold the property before either spouse died).

Sale After One Spouse Dies

Absent certain elections, there would be no initial step-up in the partnership's basis in the underlying property upon the death of either spouse.[36] The surviving spouse's outside basis in the partnership interest acquired from the decedent may be stepped up (or stepped down if the property has lost value) if he or she receives the partnership interest by bequest, devise or inheritance (even though the interest wasn't subject to estate taxes in the U.S.).[37] However, any step-up in basis would be diminished by applicable discounts to take into account that what the decedent actually owned was a non-controlling interest in a partnership that held the underlying property.

If the surviving spouse becomes the sole owner of the partnership, then the partnership will be deemed to liquidate for income tax purposes and the surviving spouse will take a substituted basis in the property equal to his or her basis in the partnership interest received from the decedent.

Whether the death of either spouse before the apartment is sold has an effect on the amount of gain recognized on a post-mortem sale thus depends on how the property is received by the surviving spouse (and applicable discounts).[38]

Uncertainty Regarding Estate Tax Treatment Of Foreign Partnerships

There is some uncertainty regarding the estate tax treatment of partnership interests. Some older IRS authorities and cases suggest that if a foreign partnership is a ''juridical person'' (i.e., an entity which can sue or be sued in its own name apart from its owners), then interests in the partnership will be considered non-U.S. situs assets.[39] Another revenue ruling held that the situs of a partnership interest was where it conducted business (albeit in the context of a tax treaty).[40]

If the partners plan to make use of the apartment, they will face some of the same issues as with a foreign corporation—i.e., the possible need to charge rent or at least formalize their right to use the property.

The Treasury situs regulations generally treat intangible personal property as U.S. situs property for estate tax purposes if it is issued by or enforceable against a U.S. resident, corporation or governmental unit and as non-U.S. situs property if it isn't issued by a U.S. resident, corporation or governmental unit, but the regulations don't address interests in partnerships.[41]

The IRS adopted a ''look-through'' approach to foreign partnerships in a controversial 1991 revenue ruling

[35] Some planners employ a double partnership structure with a lower-tier foreign partnership. Our discussion assumes use of a single foreign partnership (possibly with a disregarded entity below it).

[36] It may be possible to obtain a partial step-up in basis with respect to the successor partner's allocable share of the underlying property (reducing the capital gains tax on a subsequent sale) by making a Section 754 election. However, there are a number of factors (including whether the discounted value of the assets exceeds their basis) that would have to be considered in determining whether such an election would be advisable.

[37] See Rev. Rul. 84-139, 1984-2 C.B. 168 (discussing step-up in basis with respect to non-U.S. situs assets inherited from a non-U.S. decedent pursuant to Sections 1014(a), (b)(1) and (b)(9)(C) and Treas. Reg. Section 1.1014-2(b)(2)).

[38] We note that it may be possible in some cases for the couple to elect to treat the partnership as a disregarded entity if they own their interests in the entity as community property. See Rev. Proc. 2002-69, 2002-2 C.B. 831. Although this possibly could be beneficial from an income tax standpoint, this could increase their estate tax exposure. Accordingly, we have assumed that the couple would treat the entity as a partnership for U.S. tax purposes.

[39] See G.C.M. 18718, 1937-2 C.B. 476 (citing *Puerto Rico v. Russell & Co.*, 288 U.S. 476 (1933), and *Sanchez v. Bowers*, 70 F.2d 715 (2d Cir. 1934), for the proposition that a juridical entity in France was respected as a separate entity for U.S. estate tax purposes.

[40] See Rev. Rul. 55-701, 1955-2 C.B. 836. It isn't clear how this ruling would be applied if the partnership's only activity is holding U.S. real property.

[41] See Treas. Reg. Section 20.2104-1(a)(4) and 20.2105-1(c).

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for purposes of characterizing the gains recognized by a foreign partner from the sale or exchange of an interest in a foreign partnership that conducts a trade or business in the U.S. through a fixed place of business. A portion of the gain may be taxed as effectively connected business income (at ordinary income rates) to the extent of the unrealized appreciation in value of the partnership's U.S. business assets, rather than being excluded from income as a capital gain.[42]

The ruling is being litigated before the U.S. Tax Court,[43] but some practitioners worry that the IRS potentially could be emboldened to stake out a similar position in the estate tax context if it prevails in the current litigation. The bottom line is that the estate tax treatment of foreign partnerships remains unsettled.[44] There may be similar issues at the state level as well.[45]

■ **Planning Point:** If the partners plan to make use of the apartment, they will face some of the same issues as with a foreign corporation—i.e., the possible need to charge rent or at least formalize their right to use the property in their capacity as partners in order to reduce the risk of the partnership being ignored for estate tax purposes. If the partnership charges rent (including to lease out the property to someone else), the partners will need to file federal and New York state income tax returns and make ''net elections'' to claim offsetting deductions for depreciation and other related expenses.[46] Note that if the partnership doesn't charge rent, it will need ongoing contributions to cover property taxes and maintenance fees.

Post-Mortem Planning With 'Box-Checkable' Entities

One option to possibly reduce estate tax uncertainty is to use a foreign entity (such as a Cayman Islands exempted company) that is considered a body corporate—and thus, a juridical person—under local law, but that is eligible for flow-through treatment under the ''check-the-box'' regulations and to elect to treat the company as a partnership for U.S. tax purposes by filing IRS Form 8832, Entity Classification Election.[47] This also preserves the option of possibly checking the box again to convert the partnership into a corporation at a later time.

■ **Planning Point:** The initial election to treat the company as a partnership should be made when the company is first formed. Otherwise, it can't change its election again to be taxed as a corporation for five years without permission from the IRS (and even then only after a greater-than-50-percent change in ownership).[48]

Retroactive Elections

An entity classification election may be made with retroactive effect up to 75 days prior to the date the election is filed. Thus, when a nonresident dies owning a foreign partnership or disregarded entity that holds U.S. situs assets, the executor could file an election (together with the surviving partner) within the first 75 days to convert the entity into a corporation for U.S. tax purposes effective prior to the decedent's death so that the decedent will be considered to have died owning a more definitively non-U.S. situs asset (i.e., stock of a foreign corporation).

There is a significant tax cost (and risk) to this election if the property has appreciated in value. The partnership is deemed to contribute its assets to a new corporation in exchange for stock and to distribute the stock to its partners.[49] Although the contribution of property to a corporation in exchange for a controlling (80 percent or greater) interest in the corporation ordinarily is afforded nonrecognition as a contribution to capital, the deemed contribution of U.S. real property to a foreign corporation is treated as a taxable sale of the property to the corporation under FIRPTA.[50]

Moreover, the gains could be taxed as ordinary income at top marginal rates if the property is depreciable in the corporate transferee's hands.[51] There is a risk that the IRS could take the position that the property is depreciable once it is in the hands of a corporation even if the corporation doesn't actually rent out the property or otherwise place it in service.[52]

This tax is still less than the potential estate tax liability that would result if the IRS were to look through the partnership (or disregarded entity) to the underlying assets. However, it isn't clear that there actually would be an estate tax liability, particularly for a foreign partnership, given the continuing uncertainty regarding the situs of partnership interests and what many practitioners would consider reasonable arguments for why interests in foreign partnerships should be considered non-U.S. situs assets. The executor would want to carefully consider whether it made sense to generate taxable gains—and affirmatively trigger an income tax return filing obligation—to avoid estate taxes that may not actually be owed. The election is less costly if the property hasn't significantly appreciated in value, but there still could be FIRPTA withholding and reporting obligations.

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[42] See Rev. Rul. 91-32, 1991-1 C.B. 107.

[43] See *Grecian Magnesite, Mining, Indus. and Shipping Co. v. Commissioner*, T.C. No. 19215-12. There also have been legislative and administrative proposals to codify the ''aggregate'' approach of Rev. Rul. 91-32.

[44] See, e.g., Richard A. Cassell, Michael J.A. Karlin, Carlyn McCaffrey and William P. Streng, ''U.S. Estate Planning for Nonresident Aliens Who Own Partnership Interests,'' 99 Tax Notes 1683 (June 16, 2003); Omer Harel, ''Rethinking the U.S. Estate Tax on Nonresident Aliens,'' 64 Tax Notes Int'l 77 (Oct. 3, 2011).

[45] In Advisory Opinion TSB-A-08(1)M, the New York State Department of Taxation and Finance announced that it would ignore disregarded entities for estate tax purposes. The opinion didn't cover entities with multiple owners.

[46] See Section 871(d); Treas. Reg. Section 1.871-10.

[47] Generally, unless it has been identified by the IRS as a ''per se'' corporation for U.S. tax purposes, a foreign entity whose owners have limited liability will be treated as a corporation if it makes no election and as a partnership or disregarded entity (depending on whether it has more than one member) if it elects flow-through treatment.

[48] See Treas. Reg. Section 301.7701-3(c)(1)(iv).

[49] See Treas. Reg. Section 301.7701-3(g)(1). These transactions are deemed to occur immediately before the close of the day before the day the election is effective. See Treas. Reg. Section 301.7701-3(g)(3)(i).

[50] Section 897(e) and the regulations thereunder generally override nonrecognition treatment when U.S. real property is contributed by a non-U.S. person to a foreign corporation, except under very limited circumstances.

[51] See Section 1239.

[52] If the property already is being rented out at the time of transfer, it will be more difficult to argue that this provision doesn't apply.

Considerations for Single-Member Foreign Entities

If a non-U.S. person dies owning a single-member entity that has elected to be disregarded for U.S. tax purposes and which holds U.S. situs assets, there may be stronger reasons in some situations to retroactively convert the entity into a foreign corporation for tax purposes even if this triggers taxable gains. The entity classification regulations determine an entity's classification ''for federal tax purposes,'' with carve-outs only for employment taxes and certain excise taxes. Thus, the IRS potentially could disregard the entity and treat the decedent as having owned the underlying property at death. However, there are countervailing arguments based on a 2009 Tax Court case for why a disregarded entity might still be ''regarded'' and treated as something akin to a foreign corporation for purposes of the estate tax situs rules based on the treatment of the entity as a body corporate under local law.

There are arguments based on a 2009 Tax Court case for why a disregarded entity might still be ''regarded'' and treated as something akin to a foreign corporation for purposes of the estate tax situs rules.

The Tax Court held in *Pierre v. Commissioner*[53] that the check-the-box regulations don't apply for purposes of valuing gifts and sales to irrevocable grantor trusts. The Tax Court concluded that valuing gifts and sales of interests in an LLC to the trusts as if the underlying assets were being transferred would ignore the entity-level property rights and restrictions created under state law that one would need to consider in valuing the property for gift tax purposes.

Although *Pierre* was focused on valuation issues (and has been cited in other valuation cases), the Tax Court's analysis was premised on the idea articulated in an earlier Supreme Court case that ''[a] fundamental premise of transfer taxation is that State law creates property rights and interests, and Federal tax law then defines the tax treatment of those property rights.''[54] On the other hand, the entity classification regulations specifically provide that ''[whether] an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.''[55]

It remains to be seen whether *Pierre*'s holding will be extended beyond the valuation context,[56] but it does lend support to the argument that a foreign limited liability company that has elected to be a disregarded entity for certain U.S. tax purposes should still be ''regarded'' for the purpose of determining whether its owner died owning shares in a company or the underlying assets. It also arguably weakens the case for making what may be an unnecessary (and possibly very costly) retroactive election after death.

Section 897(i) Election To Defer Recognition of Gain

One way to possibly avoid triggering taxable gain from a check-the-box election is to make a concurrent election under Section 897(i) to treat the foreign corporation as a domestic corporation for FIRPTA purposes, which would cause the corporation to be treated as a U.S. real property holding corporation on account of the underlying real estate.

The benefit of this election is that the deemed contribution of U.S. real property to the corporation would now be afforded nonrecognition treatment under the FIRPTA regulations because the transferee corporation itself would be considered a U.S. real property interest.[57] Because the tax effect of this election is limited to the FIRPTA provisions, the decedent would still be considered to have died holding stock in a foreign corporation for estate tax purposes, keeping the corporation out of the decedent's U.S. estate (assuming appropriate corporate formalities have been observed).

■ **Planning Point**: There is a deferred tax cost to this election. The foreign owner may be taxed on a subsequent sale of the corporation (albeit likely at long-term capital gain rates) because the corporation itself would be a U.S. real property interest under FIRPTA. If the corporation sells the property, it will be taxed at an effective rate of more than 46 percent based on federal, New York state and New York City corporate tax rates.[58] Moreover, there are detailed filing and disclosure obligations.[59]

In order to qualify for the Section 897(i) election, the corporation must be entitled to nondiscriminatory treatment under a U.S. treaty. However, the treaty doesn't have to be an income tax treaty. Even if the entity is formed in a jurisdiction that doesn't have an income tax treaty with the U.S., there may be a friendship, commerce or navigation treaty with the requisite nondiscrimination provision. Most such treaties don't include ''limitation-on-benefit'' provisions comparable to what one would find in a typical modern income tax treaty, making it easier for the entity to qualify for treaty benefits (and thus, the Section 897(i) election) even if the

[53] 133 T.C. 24 (2009).

[54] See *Pierre* at 29 (citing *Morgan v. Commissioner*, 309 U.S. 78 (1940)). Courts will similarly look to applicable foreign law to define property rights where applicable. See, e.g., *Estate of Lepoutre v. Commissioner*, 62 T.C. 84 (1974); *Vandenhoeck v. Commissioner*, 4 T.C. 125 (1944).

[55] See Treas. Reg. Section 301.7701-1(a).

[56] *Pierre*'s holding has been applied to the valuation of charitable contributions in the income tax context. See *RERI Holdings I, LLC v. Commissioner*, 143 T.C. 41 (2014).

[57] See Treas. Reg. Sections 1.897-3(a) and 1.897-6T(a)(7), Ex. 5, 8-10.

[58] The corporation also would be subject to the branch profits tax as a foreign corporation, but a sale could be structured to avoid this tax.

[59] See Treas. Reg. Sections 1.897-3(c) and (d).

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owners don't reside in the country in which the company is organized.[60]

Pros and Cons Of Foreign Partnership Structure

The flexibility of the foreign partnership structure offers some advantages over a foreign corporation—most notably, more favorable income tax treatment, albeit with less certainty regarding potential estate tax exposure.

If there is a possibility that the property may be inherited by a U.S. citizen or resident (in which case a foreign corporation would be an extremely inefficient tax structure), a foreign partnership may be a better alternative, particularly as the owners could still check the box to treat the entity as a corporation (possibly with a concurrent Section 897(i) election to avoid a gain recognition event) at a later time if it turns out that the property will be inherited by non-U.S. persons.

That said, there is no IRS authority or case law directly addressing whether entity classification elections filed post-mortem with effective dates on or prior to the date of death will be given full effect for estate tax purposes. Moreover, as discussed previously, one may be better off leaving well enough alone and not ''checking the box'' to change the entity classification if the assets are already held by a foreign partnership.

■ **Planning Point:** Because the federal gift tax doesn't apply to gifts of intangible property by a nonresident alien, one might later make gifts of the partnership interests to one's children or to a trust for their benefit without triggering gift taxes.[61] However, if the property ultimately will be held in trust it would be cleaner from a tax standpoint (and would reduce ''tail'' risk of an inadvertent estate tax inclusion) to first fund the trust and then acquire the property through the trust in the first instance. Tax considerations in using trusts to acquire real property, which may offer more clarity from an estate tax standpoint, are discussed at greater length in the third and final installment of this series.

[60] A change made by the Economic Recovery Tax Act of 1981 in the wording of Section 897(i)(1)(B) regarding ''any treaty obligation of the United States'' was ''apparently intended to clarify that this election is applicable to nondiscrimination clauses under U.S. treaties of friendship, commerce, and navigation, as well as U.S. income tax treaties.'' See Caballero, Feese, and Plowgian, 912-2nd T.M., U.S. Taxation of Foreign Investment in U.S. Real Estate, Section III.H (citing Pub. L. No. 97-34, Section 831(d)).

[61] See Section 2511. There is some risk that the IRS could attempt to look through the partnership interest by applying the partnership anti-abuse rules, but there is little precedent for this. Also, leverage in the partnership potentially could give rise to FIRPTA gains to the extent that the transferor's share of such liabilities as a partner exceeds his or her outside basis in the transferred interest (determined without regard to his or her share of the liabilities). See Section 752(d).