



## INTERNATIONAL PLANNING FOR FOREIGN NATIONALS

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### Practice Areas

- Tax / Exempt Organizations
- International Law
- Trust, Estate & Probate

### Admissions

- California
- Tax Court

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# Overview

- Foreign Investment in U.S. Real Estate
- Foreign Trusts With U.S. Beneficiaries



# Foreign Investment in U.S. Real Estate

## **Foreign Direct Investment in U.S. Real Estate over the last decade**

(Statistics from the Bureau of Economic Analysis):

1998 = \$39.1 billion

1999 = \$39.4 billion

2000 = \$40.9 billion

2001 = \$38.3 billion

2002 = \$40.5 billion

2003 = \$28.6 billion

2004 = \$28.7 billion

2005 = \$28.4 billion

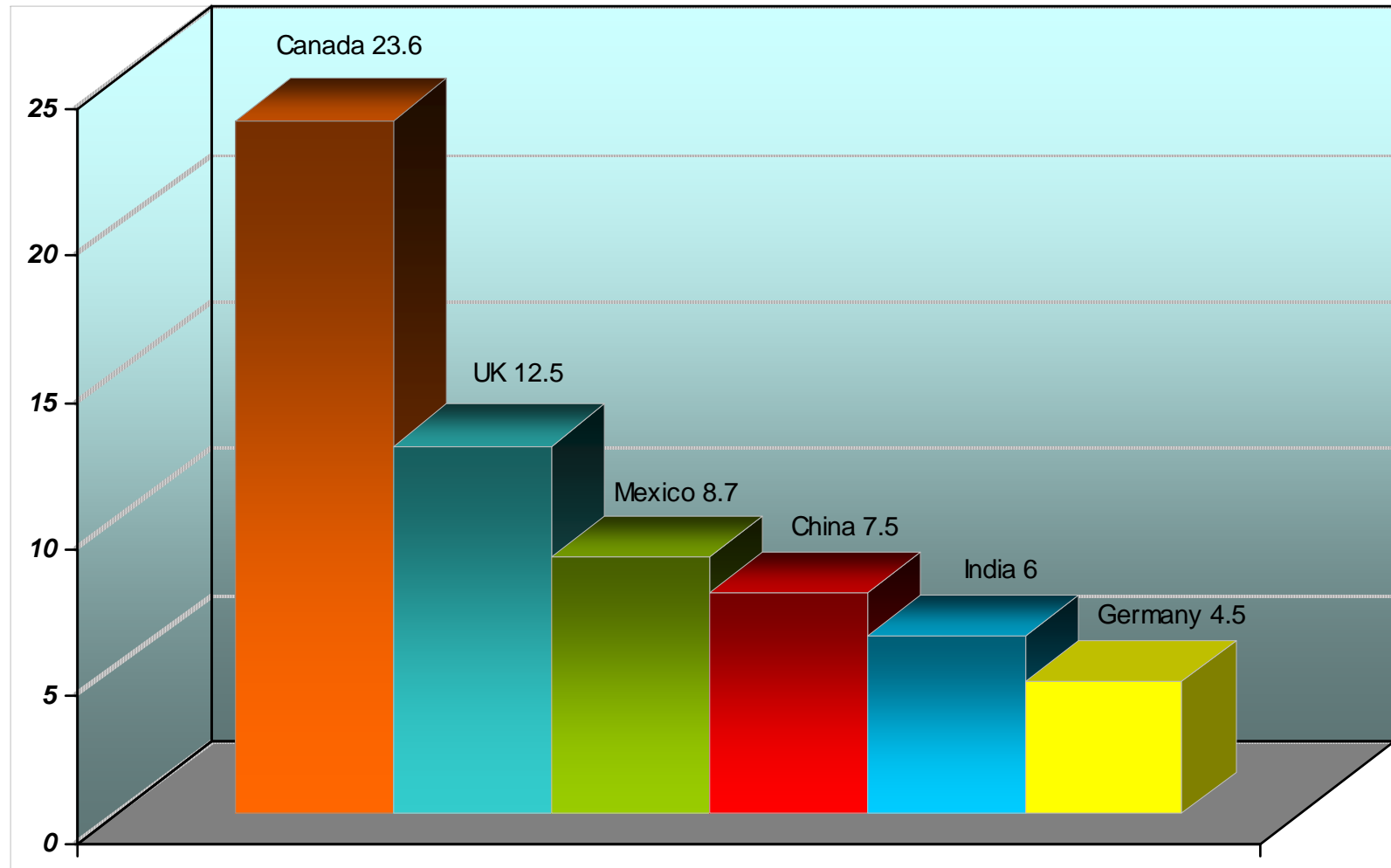
2006 = \$34.1 billion

2007 = \$43.5 billion



# Country of Origin of Recent Foreign Investment

(Research Division of the National Association of Realtors in 2008)



# Income Tax Residency

- Who is a Foreign Person?
  - Individual Nonresident Aliens
    - o Substantial Presence Test I.R.C. § 7701(b)(7)(B)
      - Exceptions for Certain Visa Holders (J, F, and M visas and certain diplomatic or consular visas/status, etc.)
    - o Not Green Card Holders –
      - Treas. Reg. Section 301.7701(b)-1(b)
    - o Not U.S. Citizens
  - Foreign Corporations
  - Foreign Trusts (court/control test)
  - Income Tax Treaty Overrides - Article 4



# U.S. Taxes on Foreign-Owned Real Estate

- FDAP - Rents and 30% Gross Withholding
  - Election Can Be Filed to Be Taxed as Income Effectively Connected with a U.S. Trade or Business to Achieve “Net Taxation” (Depreciation, Interest, etc.)
    - Nonresident Aliens - Section 871(d), Regs. §1.871-10(d)(1)(ii) and Regs. §1.871-10(d)(3)
    - Foreign Corporations - Section 882(d), Regs. §1.882-2(a)
    - Election may not be revoked without the consent of the Secretary
- No Withholding Tax on “Portfolio Interest” Debt (Creative Financing)
- FIRPTA Rules – Applies to Sales/Transfers



# U.S. Taxes on Real Estate Sales (FIRPTA)

- FIRPTA Taxable Gains - Section 897(a)
  - Sale or Transfer of “US Real Property Interest”
    - Taxpayer treated as if engaged in a U.S. trade or business and as if such gain or loss were effectively connected with such trade or business”
  - “US Real Property Interest” Includes More than Fee Simple Interests
    - Stock in U.S. Real Property Holding Corporation (50% test)
    - Partnership Interests (50% / 90% test)
    - Interests in Trusts/Estates
    - Personal Property “Associated” With Use of Real Property (e.g., furnishings in rented space)
  - Does Not Include Interest “Solely as a Creditor”



# U.S. Taxes on Real Estate Sales (FIRPTA)

## Withholding Mechanism

- 10% Gross Amount – Provisional, Not Final
- Withholding Agents – Liable Parties
  - Escrow Agents
  - Trust Accounts - Law Firms
  - Accounting Firms - Control Funds
  - Personal Liability for Withholding Tax



# U.S. Taxes on Real Estate Sales (FIRPTA)

- Final Tax Calculated on Actual Gain
  - Individual vs. Corporate Tax Rates (15% vs. 35%)
    - Loss Properties
    - Return Required – Refund and Claim for Refunds?
  - Limited Non-recognition transactions (e.g., 1031)
    - Regulatory Compliance/Relief Required



# U.S. Taxes on Real Estate Sales (FIRPTA)

## How to Reduce Withholding?

- Application for Reduced (or Zero) Withholding Certificate
  - ITIN must be obtained prior to the sale or transfer
  - Application must be submitted to IRS prior to close of escrow
  - A withholding agent has no liability if it retains the funds in escrow until notified by the IRS
- Situations
  - Low or No Gain, Available Losses to Offset, Installment Sales, Adequate Security



## U.S. Taxes on Real Estate Sales (FIRPTA)

- Inapplicability of FIRPTA for Certain Electing Foreign Corporate Sales of Real Estate
  - 897(i) Election May be Made by Certain Foreign Corporations to be Treated as Domestic Corporation
  - Income Tax Treaty – Article 25 Non-Discrimination
    - Mexican Corporation is treated as “domestic” corporation only for purposes of Sections 897, 1445 withholding tax
    - Not a domestic corporation for other purposes



# U.S. Taxes on Real Estate Sales (FIRPTA)

## Foreign Corporate Sellers

- Branch Profits Tax - Section 884
  - 30% Tax on “Dividend Equivalent Amount”
  - U.S.-Mexico Tax Treaty – Article 11A
    - 5% Treaty Rate on “Dividend Equivalent Amount”
    - 897(i) Election Does Not Override Branch Profits Tax



# 1031 Exchanges

## Nonresidents of California & Foreign Persons – Eligible

- Property held for productive use in a trade or business or for investment (property held for productive use in a trade or business may be exchanged for property held for investment, and vice versa)
- Must Comply with Section 1445 Regulations (Notice of Non-Recognition)



# California Taxes on Real Estate Sales

- Sale of CA Real Property Interest
  - Different Definitions from FIRPTA
- Withholding
  - 3 1/3% Gross Amount (Provisional)
  - Applicable Rate Multiplied by Reportable Gain (New Rates)
  - Certain Transfers are Not Subject
    - Sale Price Less Than \$100,000
    - Principal Residence
    - California Corporation or Partnership (or Qualified in CA)
    - Involuntary Conversions and Foreclosures



# U.S. Estate Taxes on Real Estate

- U.S. Estate Tax
  - U.S. Citizens and Domiciles – Worldwide Estate
  - Non-U.S. Domiciles (Foreign Individuals)
    - U.S. Situs Property Only
      - U.S. Real Estate and Stock in US Corporation, including USRPHC
      - Partnership Interests? Domestic vs. Foreign?
    - \$60,000 Exemption
    - Use of Foreign Corporations or Foreign Nongrantor Trusts to Own Real Estate
    - Term Life Insurance If U.S. Assets Not Significant



# Foreign Trust or Domestic Trust

- Current Trust Classification Rules Under The Small Business Job Protection Tax Act of 1996 (the “Act”)
  - “Court” Test
    - Satisfied if a U.S. court is able to exercise primary supervision over the administration of the trust
  - “Control” Test
    - Satisfied if the power to make all “Substantial Decisions” is held by a U.S. person. “Substantial Decisions” include investment decisions, the power to litigate or arbitrate claims, and the power to name successor trustees



# Foreign Trusts – Taxation of U.S. Beneficiaries

- Prior to Act, U.S. beneficiaries of foreign grantor trusts were generally not subject to U.S. taxation on any distributions from the foreign trust. Rev. Rul. 69-70.
- Prior to the Act, U.S. beneficiaries of foreign nongrantor trusts were always subject to U.S. taxation (albeit at a fairly favorable rate).
- Under the Act, the U.S. taxation of U.S. beneficiaries is based on a compounded interest calculation that is charged against accumulated income that is distributed (known as an accumulation distribution).
- The Act changed the interest rate applicable to accumulation distributions from foreign trusts from simple interest at a fixed rate of 6 percent to compound interest determined in the same manner as interest imposed on underpayments of tax under Section 6621(a)(2).



# Foreign Accumulation Trusts – Throwback Tax

- If U.S. beneficiary receives distribution in excess of beneficiary's share of trust's "distributable net income" ("DNI"), the excess is characterized as an "accumulation distribution" to the extent of such beneficiary's respective share of the trust's "undistributed net income" ("UNI"). Sections 665 – 668.
- DNI for a particular tax year equals the trust's worldwide income, including foreign-source income, income exempt under treaties, and capital gains net of capital losses. Sections 643(a), 643(a)(6). UNI is the amount by which the trust's DNI for a given year exceeds the sum of the trust's distributions for that year and the U.S. taxes imposed on the trust's DNI for that year (if any).
- Accumulation distributions are "allocated to preceding years" (the so-called "throwback" rule) according to Section 666 and taxed as if distributed in such prior years. Throwback distributions are also ordinary income regardless of whether the original income was capital gain to the trust.
- Once throwback tax is calculated, interest is charged against the tax based on the floating rate imposed on underpayment of tax under Section 6621(a)(2), with compounding.
- If adequate records of the trust are not available to determine the proper application of the accumulation distribution rules to any distribution, the distribution is treated as an accumulation distribution out of income earned during the first year of the trust.



# Foreign Accumulation Trusts – Throwback Tax

## Very Basic Hypothetical Illustration:

- Assumptions:
  - Trust formed in 2001 and funded with US\$1,000,000
  - Trust generates \$100,000 annually from 2001-2020, and makes no distributions, so on 12/31/2020 trust has \$3,000,000 in assets and \$2,000,000 of UNI
  - On 12/31/2020 trust distributes \$600,000 to U.S. beneficiary, whose average taxable income and marginal rate for 2018-2020 was \$70,000 and 35 percent, respectively.
  - Interest rate imposed on throwback tax based on floating underpayment rate.
  
- Under these assumptions:
  - Throwback tax of approximately \$140,000
  - Interest charge of approximately \$284,000
  - Of \$600,000 distribution, \$424,000 consumed by federal income taxes



# Foreign Accumulation Trusts – Throwback Tax

- Possibilities to Mitigate Harsh Throwback Tax
  - Trust Uses UNI to Pay Premiums On Life Insurance, Which is Paid to U.S. Beneficiaries in lieu of Trust Distributions?
  - Trust Acquires Appreciating Capital Assets Instead of Ordinary Income Producing Assets and Distributes Capital Assets to U.S. Beneficiaries
    - Carryover Basis
    - Favorable Capital Gain on Subsequent Sale

