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Home Thoughts From Abroad: Foreign Purchases of U.S. Homes

By Michael J.A. Karlin and Stanley C. Ruchelman

Michael J.A. Karlin is with Karlin & Peebles LLP in Beverly Hills, Calif. Stanley C. Ruchelman is with the Ruchelman Law Firm in New York.

Foreign persons buy homes in the U.S. for a variety of reasons — for personal use during temporary or indefinite stays that may be long-term, such as a job posting in the U.S., or short-term, such as a vacation. The U.S. home may be one of several homes they live in during the year, moving around the world with the seasons. They may buy homes for children who may be nonresident aliens (such as students) or may be U.S. residents or even U.S. citizens. For foreign persons, the tax position of home ownership in the U.S. is not quite as attractive as it is for U.S. persons. Foreign persons must juggle exposure to capital gains taxes, estate and gift taxes and, in many cases, imputed rental income, as well as concerns about privacy, without the benefit of many of the tax exemptions and deductions and other favorable treatment bestowed on U.S. residents.

In this report, the authors look at the issues faced by foreign owners of U.S. homes held primarily for personal use by the owners and their families. The report had its genesis in a panel presentation at the 2006 autumn meeting of the American Bar Association Section of Taxation in Denver.

Table of Contents

Prologue

Your real estate partner comes into your office, saying: ''We have a new client, Mr. NRA, who is buying the most expensive house in town.

Here is what he wants to do:

- not buy it in his own name;
- not pay rent;
- not pay estate tax, should he die;
- not pay gift tax, should he give it away;
- not file a tax return; and
- not pay tax when he sells the property.

'''No sweat,' I told him; 'we can do it; my tax partner is the smartest planner in town.'''

Is it doable? Does our quiver hold enough tax planning arrows to meet all those goals?

I. Introduction

This report is concerned with a seemingly simple subject — how to plan the acquisition, ownership, and

disposition, by sale, exchange, gift, or bequest, of residential real property in the U.S. for a nonresident alien client.

For many Americans, as we are regularly reminded, the purchase of a home is the single largest financial transaction of our lives, and because it is the policy of the federal and state governments to encourage home ownership, this investment benefits from extraordinary tax advantages. We are not required to report as income the economic benefit derived from rent-free occupation of the property nor, as a practical matter, do we report as a gift the rent-free use of our property by family members, even those whom we are not obligated to support;[1] we are allowed to deduct interest on mortgage loans when the proceeds (up to $1 million) are used to buy or improve the property or (up to $100,000) are used for any form of consumption;[2] we can deduct the cost of state and local property taxes;[3] if the home qualifies, deductions are available for home offices; and we can exempt up to $250,000 (or $500,000 if filing a tax return jointly with a spouse) of gain from sale of our principal residence.[4] Tax credits subsidize the installation of energy-efficient devices.[5] We have established the most sophisticated market in the world to securitize our home loans, offer those mortgage-backed securities loans tax free to foreigners[6] and many domestic financial institutions and investment funds, and, out of an essentially illiquid financial asset, create the liquidity needed to drive down the cost of our mortgages. We can even rent the home out a few days a year without paying tax on the rental income.[7] For most Americans, the estate tax is not an issue, and their mortgages are deductible in full from the value of their estates.[8] In short, homeownership is a deal that fewer and fewer adult Americans can resist with no obvious fiscal drawbacks and many long-term financial benefits, the subprime lending mess notwithstanding.

Foreign persons buy homes in the U.S. for a variety of reasons — for personal use during temporary or indefinite stays that may be long term, such as a job posting in the U.S., or short term, such as a vacation. The U.S. home may be one of several homes they live in during the year, moving around the world with the seasons. They may buy homes for children who may be nonresident aliens (such as students) or may be U.S. residents or even U.S. citizens. They may also buy permanent homes for their own use in preparation for moving to the U.S. or they may remain the owners of homes they lived in before leaving the U.S. and ceasing to be residents. In some cases, the homes may have a mixed use, such as a vacation residence that is put into a rental pool.

For most of these foreign persons, the tax position is not quite as attractive as it is for U.S. persons. Foreign persons must juggle exposure to capital gains taxes, estate and gift taxes, and, in many cases, imputed rental income, without the benefit of many of the tax exemptions and deductions and other favorable treatment bestowed on U.S. residents.

In this report we look at the issues faced by foreign owners of U.S. homes held primarily for personal use by the owners and their families. We try to answer the question in the prologue so that we can live up to the praise from our real estate partner.

II. Overview

Foreign buyers of U.S. homes face tax issues on acquisition of the property, during the ownership of it, and on disposition of it, whether by sale or exchange or by gift or bequest. In this part, we provide an overview of these issues as well as privacy considerations. In Part III, we show how these play out depending on the structure of ownership chosen by the foreign owner. In Part IV we look at what happens if the owner of the property becomes a U.S. person, either by immigration or because of a gift or bequest. In Part V, we take a brief look at the Stop Tax Haven Abuse Act, a legislative proposal of which some elements would affect the structures described in this report. Finally, in Part VI, we consider some other issues that affect the purchase of a home by a foreign person.

A. Big-Picture Issues

Although in any given case a particular issue may prove to be of particular importance, in many cases, as the introductory colloquy suggests, planning will revolve around four key objectives:

- minimizing tax on sale of the property so as to pay, if possible, no more than the preferential rate of tax on long-term capital gains of individuals;
- avoiding paying 30 percent withholding taxes on imputed rent (or actual rent paid to avoid the uncertainties of imputed rent);
- avoiding estate tax should the owner die while still owning the property, and still obtaining a step-up in basis; and
- minimizing compliance and contact with the U.S. tax system — many foreigners have a deep-rooted

[1] *See* note 38 *infra* and accompanying text.

[2] Section 163(h). All unprefixed references to sections are to sections of the Internal Revenue Code of 1986, as amended.

[3] Section 164 (regular income tax); taxes are not deductible in computing income subject to the alternative minimum tax. Section 56(b)(1)(A)(ii).

[4] Section 121.

[5] Section 25D.

[6] *See* sections 871(h) and 882(c) and especially reg. section 1.871-14(d).

[7] Under section 280A(g), if a taxpayer uses the home during the tax year as a residence and rents it for less than 15 days during the tax year, the income derived from such use is not included in gross income but no deduction, otherwise allowable because of the rental use, is allowed. Under section 280A(d), a taxpayer is treated as using a home as a residence if he uses it for personal purposes for a number of days during the tax year that exceeds the greater of 14 days or 10 percent of the number of days during such year for which the home is rented at a fair rental. For this purpose, the home is not treated as rented at a fair rental for any day for which it is used for personal purposes.

[8] This is true at least until 2011, when the unified credit for gift and estate taxes theoretically will revert to pre-2001 levels (exemption equivalent amount of $1 million). However, it is essentially politically certain that Congress will take action either to eliminate the estate tax or, perhaps more likely, to increase the unified credit to an exemption equivalent amount of $3.5 million or more.

aversion to having to file personal income tax returns in the U.S. or having an individual taxpayer identification number.

It will be readily apparent that accomplishing all of those objectives is extremely difficult. Every structure, from direct ownership to a multitier corporate structure, may involve compromise on one or more of the objectives, and the adviser's role may be to identify each particular client's most important concern and offer a plan principally addressing that concern. In this context, prioritization of goals is extremely important.

B. Acquisition

The acquisition of real property, as with any asset, has no immediate consequences to the buyer. A purchase from an unrelated seller is not a taxable event for the buyer. Nevertheless, several tax issues associated with the acquisition of a home by a foreign person deserve attention.

1. FIRPTA withholding. Like any buyer, the foreign buyer is a withholding agent for purposes of the 1980 Foreign Investment in Real Property Tax Act and must therefore either obtain a certification of nonforeign status or withhold 10 percent of the purchase price (or some lesser amount if the seller produces a withholding certificate from the IRS).[9] Buyers must also be alert to state withholding tax requirements.

In almost any transaction handled with the participation of a title company, an escrow company, or a lender or other real estate professionals, those requirements will likely be known and implemented.

However, foreign buyers have a special need to maintain good records following their purchase. When the foreign buyer later seeks to sell the property, the buyer turned-seller may wish to obtain a FIRPTA withholding certificate to reduce the amount of tax withheld based on a calculation of the seller's maximum tax liability. That calculation requires the seller not only to compute FIRPTA gain but also to establish that he had no unsatisfied withholding liability based on compliance with section 1445 when he purchased the property.[10] All too often, the authors have been asked to assist foreign sellers of real estate who couldn't locate their records concerning the purchase of the property or locate the attorney who represented them in that transaction and therefore could not demonstrate compliance with FIRPTA withholding at the time of an earlier purchase. As a result, it was difficult to obtain a FIRPTA withholding certificate at the time of sale.

2. Financing. Foreign buyers also have to be alert to the financing of the price of a home being acquired in anticipation of a move to the U.S. Not infrequently, those buyers pay all cash or at least they don't obtain a mortgage loan at the time of the purchase. Once they become resident, they might wish to deduct interest on the first $1 million of their loan amount as qualified residence indebtedness.[11] However, the buyers will be unable to do so unless the loan was obtained by them and secured by the home within 90 days of the date of purchase.[12]

3. Tax residence. The ownership or availability of a home in the U.S. does not by itself make a foreign person a U.S. resident for tax purposes. Nevertheless, such ownership can have an effect on the application of the rules for determining whether an alien is a resident alien.[13]

First, the ownership or availability of a permanent home is the first tiebreaker in virtually all tax treaty provisions dealing with individuals who are resident both in the U.S. and another country under the respective internal laws of the two countries.[14]

Second, whether or not a foreign individual resides in a treaty country, he may seek to apply the foreign tax home/closer connection test to avoid being treated as a resident alien.[15] That test applies to individuals present in the U.S. between 31 and 182 days during the calendar year when the addition of one-third of the days in the preceding calendar year and one-sixth of the days in the second preceding calendar year takes the total days of presence in that period to 183 or more. The closer connection portion of the test looks at the individual's personal and family ties to the U.S. and compares them with his ties to the foreign country. Plainly, the ownership of a home that is regularly used for personal purposes is a factor to be considered in the application of the test — there being an obvious difference between a vacation home used just a few days a year and a home used for longer or more frequent stays.

4. Gift tax. Foreign buyers sometimes buy homes for U.S. relatives. The relative might be a U.S. resident, but frequently the relative will be a child who is a student on a nonimmigrant student F or J visa. Buyers need to be warned that making a gift of real property located in the U.S. may subject them to gift tax (whether or not the relative is resident for U.S. income tax purposes), whereas a gift of cash funds through an interbank transfer that is used to purchase the home can readily be structured to avoid gift tax, as long as the cash is not used to purchase a property owned by the donor.[16] How the fund transfers are handled can make a significant difference.

C. Ownership and Occupation

1. Deductions. As a general matter, an individual cannot deduct expenditures associated with a home that is used for personal purposes. The principal exceptions are for qualified residence interest and property taxes, which are both itemized deductions.

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[9]Section 1445(a).

[10]Reg. section 1.1445-3(c)((1)(ii) and (3).

[11]Section 163(h).

[12]For the 90-day rule, see Notice 88-74, 1988-2 C.B. 385, applying the tracing rules of reg. section 1.163-8T.

[13]Section 7701(b).

[14]In most U.S. income tax treaties, the dual residence tiebreaker is set out in report 4; *see* U.S. model income tax treaty of 2006, art. 4(3), *Tax Treaties* (CCH loose-leaf), vol. 1, para. 209.

[15]Section 7701(b)(3)(B) and reg. section 301.7701(b)-2.

[16]*Davies v. Commissioner*, 40 T.C. 525 (1963), *acq.*, 1966-1 C.B. 2.; *De Goldschmidt-Rothschild v. Commissioner*, 168 F.2d 975 (2d Cir. 1948).

Nonresident aliens are not entitled to itemized deductions because they are taxed on a gross basis on U.S.-source income not effectively connected with a U.S. trade or business. That nondeductibility will also apply when the property is held through a trust or partnership, although in the case of a trust, expenses to maintain trust assets may reduce distributable net income. However, if the acquisition is structured through a corporation, as we will see, expenses related to maintaining the property may be allowed but personal use of the property will involve actual or imputed rental issues.

2. Imputed rental income. When the home is owned directly by an individual, there is no income tax consequence to its occupation by the owner, nor does it appear that, as a practical matter, the IRS seeks to impose income tax or gift tax consequences when property is used by relatives, even adult children to whom parents no longer owe a duty of support.

However, the moment the home is owned by an entity, the possibility that imputed rental should be charged comes into play. In the case of a home owned by a corporation, personal use by a shareholder or officer is quite likely to attract imputed rental income for the corporation if actual rent is not paid at a fair market rate. When the home is owned by a partnership, the picture is cloudier but there is certainly some risk that rent-free use will result in the imputation of rental income. The $250,000 or $500,000 exemption for gain derived from the sale of a principal residence may be jeopardized if the owner of the property is a partnership. By contrast, it appears that personal use of property held in trust does not give rise to imputed income to the trust, nor is it even treated as a distribution to the beneficiaries.[17]

3. Tax compliance. As long as a home produces no income, there is no need for a nonresident alien owner to file a tax return except for the year of sale. Because the deductions (mortgage interest, property taxes, and so on) associated with a home held by an individual for personal or family use are not available to the nonresident alien, there is no reason to file a return just to preserve the benefit of those deductions. Nonetheless, a mortgage lender may insist on receipt of an individual TIN from the owner.

Similarly, a foreign trust does not need to file a U.S. return simply because it holds a U.S. home that is used exclusively by beneficiaries and related family members.

Neither a foreign or a domestic partnership nor a foreign corporation are required to file a U.S. return unless they are engaged in a U.S. trade or business or receive fixed or determinable annual or periodic income, such as rent, from U.S. sources. Imputed rental income would trigger an obligation to file a return.

If the home is held through a domestic corporation, the corporation must file a return even if it has no income. The imputed income issue may also cause compliance requirements.

[17]*H.B. Plant v. Commissioner*, 30 B.T.A. 133 (1934), *aff'd*, 76 F.2d 8 (2d Cir. 1935), and *Alfred I. duPont Testamentary Trust v. Commissioner*, 66 T.C. 1976, *aff'd*, 574 F.2d 1332 (5th Cir. 1978). *See* dicta in *Dickman v. Commissioner*, 465 U.S. 330 (1984).

D. Disposition

1. Income tax. Under FIRPTA, foreign persons are subject to tax on gains from sale or exchange of a U.S. real property interest, which fairly obviously includes real property used as a home, as well as associated personal property.[18]

A nonresident alien can qualify for the section 121 $250,000 exclusion on the sale of a principal residence, assuming the alien meets the general requirements for the exclusion. The IRS appears to have accepted that.[19] Of course, in many cases, if the alien is using the home as a principal residence, he is likely to be a resident alien under the substantial presence test, but that is not invariably the case. For example, an alien may be a former resident who sold the home after ceasing to be a resident.[20] Less commonly, the exemption may be available to a peripatetic alien whose U.S. home is the principal residence even though he does not meet the substantial presence test or, in a case that would entail a combination of unusual facts, is nonresident by virtue of a treaty tiebreaker.

The $500,000 exclusion for married couples is not available because it requires the filing of a joint return and nonresident aliens generally cannot file joint returns.[21] Therefore, a couple seeking to maximize the exclusion would need to be joint owners of the house and each would need to qualify separately for the $250,000 exclusion; that is, each would have had to have owned their joint interest in the home for at least two years and lived in the home as their main home for at least two years. If those requirements cannot be met, the couple should sell the home in a year when both are still resident aliens.

Withholding at 10 percent of the amount realized will be required on the sale if the seller's interest is held directly or held by a foreign corporation or a foreign partnership.[22] If the seller is a domestic partnership or trust, the purchaser has no withholding obligation under FIRPTA; instead, the domestic partnership or trust is the seller and it must withhold U.S. tax at 15 percent or 35 percent of the foreign partner's or beneficiary's share of the gain.[23]

[18]Section 897(a).

[19]*See* IRS Publication 519, *U.S. Tax Guide for Aliens*, Chapter 3. Section 897(e) bars the application of nonrecognition provisions, but section 121 provides for exclusion of gain from gross income rather than for nonrecognition. It does not appear that section 897(e) overrides a provision for an exclusion from gross income.

[20]Section 7701(b)(2)(B).

[21]*But see* section 6013(g), which permits the filing of a joint return by a couple, one of whom is a U.S. citizen or resident alien and the other is a nonresident alien, provided that the latter agrees to be treated as a resident alien for all purposes and to waive treaty benefits.

[22]Section 1445(a).

[23]Section 1445(e)(1) and reg. section 1.1445-5(c). *See* text accompanying notes 103 and 104, *infra*.

States may also require withholding when a nonresident individual or entity sells real property situated in the state.[24]

A section 1031 exchange generally is not an option for property held for personal use. But it is possible to imagine circumstances in which a property originally held as a residence for the foreign investor is converted to a rental property. In those circumstances, a section 1031 exchange should be possible. It should be remembered, however, that the property would have to be exchanged for other real property situated in the U.S. because foreign and U.S. real property are not considered to be of like kind.[25]

2. Gift tax. The gift by a nonresident alien[26] of real estate located in the U.S. is subject to gift tax at the same rates that apply to a gift by a U.S. citizen or resident alien but without the unified credit that would shelter up to $1 million in lifetime gifts.[27] By contrast, a gift of an intangible asset, such as shares of stock or of a partnership interest, is not subject to gift tax. An alien contemplating the gift of U.S. real property should consider transferring the property to a domestic corporation in a section 351 tax-free incorporation or to a partnership in a section 721 transfer. A gift of the stock or partnership interest could be made later without triggering gift tax. In comparison, a transfer to a foreign corporation would require recognition of any appreciation in the value of the property unless the corporation is eligible to elect under section 897(i) to be treated as a domestic corporation for FIRPTA purposes.

We describe below the impact of a gift of property subject to a debt secured by a mortgage on the property.

3. Estate tax. The taxable estate of a nonresident alien is subject to the estate tax.[28] The rates again are the same as for residents, but subject to some limited exceptions in the case of decedents who were domiciled in treaty countries. The unified credit, which in 2008 will reach an exemption equivalent of $3.5 million, is also unavailable. Instead, the credit available to nonresident aliens is equivalent to an exemption of just $60,000, an amount that has not increased for decades.

The taxable estate of a nonresident alien is limited to property situated in the U.S.[29] Real property held directly is situated in the U.S., as is stock of a domestic corporation.[30] Tangible property located at the home is also part of the taxable estate; there is a limited exception for artwork that applies only to works on loan for purposes of exhibition at a public gallery or museum or in transit to or from the exhibition under the loan.[31] Stock of a foreign corporation is situated outside the U.S. even if the only asset of the corporation is U.S. real property. The position with partnership interests is unclear and is discussed in more detail below in the particular context of a partnership that owns a property held for personal use by the partners.

It should not be assumed that the value of a home or other real property is reduced by any debt secured by a mortgage. In fact, under a fungibility concept long espoused by the IRS, debt may be deducted only to the extent the estate establishes the worldwide assets and liabilities of the decedent and deducts the U.S. proportion of the liabilities. That proportion is determined by multiplying the worldwide liabilities by a ratio in which U.S.-situated assets are the numerator and the worldwide assets are the denominator.[32] Under the fungibility rule, this treatment applies even to a note secured by a mortgage or deed of trust on U.S. real property.[33] However, in the case of a nonrecourse debt, the Tax Court has ruled, with IRS acquiescence, that only the value of the equity of redemption is includable. For that reason, if a nonresident alien purchases a home with a mortgage, it is desirable that the mortgage be nonrecourse.[34] It may not be sufficient to rely on procedural rules that have the practical but not theoretical effect of making the loan nonrecourse.[35]

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[24]*E.g.*, Revenue and Taxation Code sections 18662 and 18668 (California) — California even requires withholding on sales by California resident individuals; C.R.S. 39-22-604.5 (Colorado); §10-912 of the Maryland Tax-General Article; Tax Law report 22, § 663 (New York); section 12-8-580 (South Carolina). The scope of withholding, rates, filing procedures, and the availability of refunds vary considerably.

[25]*See* section 1031(h)(1), enacted by the Revenue Reconciliation Act of 1989, P.L. 101-239. Before 1989 it was possible for an alien to rent out the home and resume status as a nonresident (in either order) and later exchange the property for property outside the U.S.

[26]Note that the definition of a nonresident alien for purposes of subtitle B of the Internal Revenue Code, dealing with estate, gift, and generation-skipping taxes, is not governed by section 7701(b). Rather, whether an alien is a resident is determined by the more subjective test of whether the alien is domiciled in the U.S. ''A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.'' Reg. section 20.0-1(b)(1).

[27]Interspousal gifts to a nonresident alien are not subject to the unlimited marital deduction. However, the annual exclusion is increased to $100,000 for an interspousal gift. *See* section 2523(i).

[28]Sections 2101 and 2102.

[29]Section 2106.

[30]Section 2104(a).

[31]Section 2105(c).

[32]*See also* section 2601(b).

[33]*Rodiek v. Commissioner*, 33 B.T.A. 1020 (1936), *aff'd*, 87 F.2d 328 (2d Cir. 1937).

[34]*See* reg. section 20.2053-7; *Johnstone Est. v. Commissioner*, 19 T.C. 44 (1952), *acq.*, 1953-1 C.B. 5.

[35]A few state laws provide that a mortgage secured by an owner-occupied residence is nonrecourse. *See, e.g.,* Code of Civil Procedure (California) section 580b. Another provision found in many state laws is a bar on deficiencies when the buyer's obligation is seller-financed and such an obligation will be treated as nonrecourse. Many states also have rules that bar deficiencies after a foreclosure proceeding under the power of sale given by statute or the mortgage or deed of trust, but if state law permits an election of alternative remedies, the loan will not

(Footnote continued on next page.)

E. Privacy

1. Ownership of property. Legal title to real estate is generally a matter of public record in the U.S. Foreign investors, often to a greater extent than their domestic counterparts, are concerned about liability and privacy in relation to their ownership of U.S. residential real estate. Privacy is a particular concern for the very wealthy who do not want to have residential addresses made available through public land records readily accessible on the Internet.

Foreign investment nontax reporting rules may require some level of disclosure of ownership to the government. There are two sets of rules that may be relevant to home buyers. The first is the International Investment and Trade in Services Survey Act, administered by the Bureau of Economic Analysis (BEA) of the Department of Commerce.[36] The foreign direct investment rules do not require disclosure to the government of ultimate beneficial owners of ''business enterprises'' engaged in foreign investment, and in any event the information is nonpublic and may be used by the government only for statistical purposes. The BEA requires a survey to be completed for any investment if the total assets of a newly acquired or established entity are more than $3 million or the transaction involves the acquisition of 200 or more acres of U.S. land. It also requires quarterly and annual reports if the amount of investment exceeds $30 million and a survey every five years when the minimum drops to $10 million. The next such survey will cover 2007 and the forms will be required to be filed in 2008.

The second set of possibly relevant rules is the Agricultural Foreign Investment Disclosure Act, administered by the Farm Services Agency of the Department of Agriculture.[37] The agricultural foreign investment rules would be relevant to a foreign home buyer who purchased a farm or ranch. Those rules pose a more serious obstacle to privacy because the reports are a matter of public record. Disclosure of beneficial ownership can be avoided only by having at least three tiers of entities between the ultimate owner and the property.

For most other purposes, privately held trusts and other entities offer some measure of protection from the inquisitive public. Trusts do not have to be registered in the U.S. The names of trustees may appear on real estate records; beneficial owners concerned about privacy should not act as trustees and should not include their own name as part of the name of their trust. In the case of corporations and limited liability companies, public registration is required. However, the names of the owners are not a matter of public record in most states, with New York being a notable exception. In the case of limited partnerships, public registration is required but only the name of the general partner must appear in the public records; whereas in the case of a general partnership, registration is not technically required but may be necessary as a practical matter, in which case at least one partner's name will become a matter of public record.

Finally, as a general matter, law enforcement authorities concerned with criminal investigations can usually determine the ownership of property or compel its disclosure.

2. Filing tax returns. Many nonresidents do not want to file U.S. income tax returns or have any contact at all with the U.S. tax system at the federal or state level. Of these, most do not want to file returns during the period of ownership and some object to filing returns even on sale of the property.

This antipathy to the U.S. tax system does not necessarily mean that the nonresidents do not wish to pay tax, but they would more gladly do so if it could be done anonymously, in the same way that they can invest in the U.S. securities markets largely without having to identify themselves to the U.S. tax authorities.

Our system of taxing real estate transfers, whether by sale or exchange or by gift or bequest, does not facilitate anonymity. Anonymity will come at a cost, most notably by requiring the use of some form of entity that cannot be fiscally transparent and therefore prevents the availability of preferential rates of capital gains tax.

The tax authorities, federal and to some extent state, have the power in some circumstances to require disclosure of the identities of the ultimate owners of real property. The scope of this power depends on the chosen structure; however, anyone who has filled in a Form 5472, ''Information Return of a 25 Percent Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Under Sections 6038A and 6038C of the Internal Revenue Code),'' or answered question 5 of Schedule K of Form 1120 or question S of Form 1120-F likely has come across some disclosure requirements.

III. Structuring Alternatives

In this part of the report, we consider the various ways a foreign person might structure the ownership of a residence. In particular, we look first at the simplest possible approach — direct ownership — and then at alternatives, including the use of corporate, partnership, and trust structures, and some possible combinations. The use of these structures for foreign investors is well known, and this report is not intended to be a detailed review of issues common to all foreign investment in U.S. real estate. We make mention of these issues but the focus is on how they play out in the case of real property held primarily for personal use.

A. Direct Ownership

Fairly obviously, the simplest way for a foreign individual to acquire real property in the U.S. is to purchase it outright. That approach has the virtue of (comparative) simplicity. It is easy to understand. It avoids the cost of

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be treated as nonrecourse for estate tax purposes even if the lender would be most likely to elect power of sale foreclosure.

[36]International Investment and Trade in Services Survey Act, 22 U.S.C. 46, sections 3101-3108; regulations at 15 CFR Part 801.

[37]Agricultural Foreign Investment Disclosure Act, 7 U.S.C. Chapter 66, sections 3501-3508; regulations at 7 CFR Part 781.

establishing and maintaining a foreign blocker corporation. It eliminates imputed rental issues,[38] it assures long-term capital gains treatment on a sale more than one year after the purchase, and in some cases, it even permits the use of the principal residence exclusion under section 121. Gain for heirs who take the property on the owner's death may be eliminated, as the successors will obtain a step-up in basis.

The key disadvantages are the need to deal with privacy, which can be addressed relatively straightforwardly, the treatment of losses, and the estate tax.

1. Privacy. As noted earlier, legal title to real property is a matter of public record. When direct ownership of property is deemed desirable, privacy can nevertheless be improved through completely transparent vehicles, which largely replicate the tax, but not necessarily the nontax, results of direct ownership. To be fully effective, these devices must be put in place before the property is acquired.

a. Single-member LLC. A single-member domestic LLC would be disregarded as an entity separate from its owner for federal and state income tax purposes but would offer some limited liability protection and a significant level of privacy in most states. One notable exception is New York, where the names of the stakeholders in an LLC must be published for limited liability to exist.

LLCs are not cost-free, however. Apart from annual fees, some states, like California, have special taxes on LLCs. Moreover, they may create income tax and estate planning issues in the foreign owner's home country. Countries are split between those, like the United Kingdom, that for the purposes of their own tax treat U.S. LLCs as corporate bodies[39] and those, like France, that will conform their treatment of the LLC to the U.S. treatment.[40] Further, an interest in an LLC is personal property, which means that its devolution may be governed primarily by the laws of the foreign owner's domicile, whereas devolution of real estate directly held would be governed by the law of the state in which it was located.

Some care needs to be exercised to avoid having the LLC be treated as a partnership. While there are advantages and disadvantages to partnership classification, as discussed below, none should come about through inadvertence. In particular, if the home is owned by more than one person, the owners should do so as joint owners, each choosing whether to do so through his own LLC. There is an exception in the case of a couple married under community property laws, under which the IRS allows the couple to choose whether the LLC should be treated as having one or more than one owner.[41]

b. Grantor trust. Another privacy alternative is the grantor trust. The simplest form of grantor trust would be a revocable living trust. The enactment of section 672(f) in 1996 narrowed the application of the grantor trust rules when the grantor is a foreign person. Nevertheless, a revocable trust will be a grantor trust during the owner's lifetime, even if the owner is a nonresident alien.[42] An irrevocable trust can also qualify as a grantor trust under section 672(f) if the only beneficiaries that may receive distributions during the grantor's lifetime are the grantor or the grantor's spouse. However, that would limit the flexibility of the trustees to allow the use of the property to nondependent members of the grantor's family, as often occurs when the foreign owner has acquired the property for the use of adult children, particularly children attending college in the U.S. Both types of trusts lose their status as grantor trusts on the death of the grantor, even if a surviving spouse exists, although if the survivor was a grantor, the trust will remain a grantor trust regarding the survivor's share.

Normally, the trust will be formed under the law of the state where the property is located, but that will not always be the case. The foreign individual may own homes in more than one state but may wish to form only one trust. The choice of trust jurisdiction may also be influenced by regulatory considerations. Some foreign owners may wish to form the trust in a state that offers superior asset protection, longer perpetuity periods, or

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[38]There is no dispute that the owner of a residence derives no income from his enjoyment of the residence. Moreover, regarding the use of the residence by family members, the IRS has been warned off this area by the Supreme Court in *Dickman v. Commissioner*, 465 U.S. 330 (1984): ''It is not uncommon for parents to provide their adult children with such things as the use of cars or vacation cottages, simply on the basis of the family relationship. We assume that the focus of the Internal Revenue Service is not on such traditional familial matters.''

[39]*See* Her Majesty's Revenue and Customs DT 19853, *available at* http://www.hmrc.gov.uk/manuals/dtmanual/DT198-53A.htm (viewed July 8, 2007). It may be noted that HMRC will not give credit to a U.K. member of an LLC for U.S. tax paid unless the U.K. member is a company under U.K. law holding at least 10 percent of the shares. To the best of the authors' knowledge, this interpretation has not been tested in the U.K. courts.

[40]*See* paragraph 2(b)(iv) of report 4 (Residence) of the France-U.S. income tax treaty, which treats partnerships and similar entities as passthrough entities qualifying for treaty benefits to the extent owned by a resident of one of the two treaty jurisdictions. The technical explanation prepared by the Treasury Department in 1994 in connection with the approval process by the Senate expressly states that an LLC is an entity that is similar to a partnership.

[41]*See* Rev. Proc. 2002-69, 2002-2 CB 831, *Doc 2002-22999, 2002 TNT 197-5*. The procedure applies to marriages governed by the community property laws not only of states but also of U.S. possessions and foreign countries. The concept of community property is recognized principally in continental Europe and in Latin America.

[42]Small Business Job Protection Act of 1996, section 1904(d)(2) (uncodified). Note that practitioners generally use the word ''revocable,'' which is also used in the caption to the statute, but the more precise formulation is that the grantor must have ''the power to revest absolutely in the grantor title to the trust property . . . exercisable solely by the grantor without the approval or consent of any other person or with the consent of a related or subordinate party who is subservient to the grantor.'' The expressions ''related or subordinate party'' and ''subservient to the grantor'' are terms of art that are subject to statutory and regulatory definition and explanations. Section 672(a)-(c); reg. section 1.672(a)-1, (b)-1, and (c)-1.

the ability to form a private trust company. The trust can also be formed offshore, where trustee fees are typically lower than in the U.S., or in the foreign owner's home country. Consideration should also be given to the interaction of the trust with the overall estate plan and to the potential location of successor beneficiaries.

Foreign owners need to understand that a trust of which they are the trustees will not offer much privacy. Full privacy means having to select a trustee, with all the competing considerations (cost, flexibility, financial strength, and trustworthiness) involved in the use of institutional trustees, professional trustees, family members, and friends, or any combination. If the foreign owners start out as trustees, the same considerations will nevertheless affect the selection of successor trustees even if their only role is to distribute the property to the successor beneficiaries.

2. Treatment of losses. Although FIRPTA treats gain or loss from the sale of U.S. real property interests as effectively connected with a U.S. trade or business, it also provides that in the case of an individual, the loss will be taken into account only to the extent it is incurred in a trade or business or in a transaction entered into for profit, or if it qualifies as a casualty or theft loss.[43] A home acquired for occupation by a foreign owner or members of his family will generally not qualify for deduction by an individual (or a trust), whereas losses may be available if property is held through a corporation. Even if the loss is allowed, typically that type of owner does not have effectively connected income against which the loss can be claimed to reduce tax.

3. Estate tax. The biggest tax issue relating to direct ownership, including ownership through one of the transparent vehicles described in the preceding paragraphs, is the exposure to the U.S. estate tax should the foreign owner die before selling the property. Perhaps the simplest way of addressing the liability is through life insurance, the proceeds of which will not be includable in the estate of a nonresident alien.[44] Term life insurance, in particular, is relatively inexpensive, especially compared with the costs of establishing and maintaining offshore corporate structures. Insurance may not always be available. Some U.S. life insurance companies do not offer competitive rates for nonresidents, but there is no requirement that the insurance company be based in the U.S. The amount of the insurance may have to be adjusted if property values increase. But in many cases this may be the easiest way to fund the payment of the estate tax.

A second way of dealing with the tax is to sell the property before death. The proceeds of sale of real property held for personal use held in a bank account at the time of death (even a U.S. bank account) will not be includable in a nonresident alien's gross estate for estate tax purposes. How easy or difficult this alternative may prove will depend on practical factors, such as the ability to anticipate death and the personal desires of an aging homeowner. Clearly, death from a lingering illness allows for this type of planning, provided the individual is physically residing in other property outside the U.S. and is competent to sign a deed or to execute a power of attorney — death from an accident or a virulent illness does not. Further, it comes at a cost of recognizing gain on any sale, albeit at reduced rates.

A third planning device is to make sure that any loan is nonrecourse to the foreign owner so that the full amount of the loan is effectively deductible.[45]

Some care needs to be exercised with installment sales. If the buyer is a U.S. person, the installment debt owed by the buyer will have a U.S. situs for estate tax purposes.[46] That can be avoided if the interest on the debt is structured as portfolio interest, which means that the debt should not be evidenced by a promissory note that is in negotiable form. Rather, the note should be in registered form within the meaning of the portfolio debt rules. Thus, it should not be payable ''to order'' and the foreign holder of the note should deliver an IRS Form W-8BEN to the buyer.[47] The problem disappears if the obligor is not a U.S. resident.[48]

Finally, estate tax may be less of a consideration if the country of the owner's domicile provides for an estate tax that is imposed at higher marginal rates than in the U.S. and that allows a credit for the U.S. estate tax. Such a credit may be provided unilaterally under the laws of the country or it may be required by an estate tax treaty between the country of domicile and the U.S.

B. Ownership Through a Corporate Structure

In many cases, foreign home buyers will be told that the simplest way to avoid estate and gift taxes is to have the property owned through a corporate structure, generally with a foreign corporation somewhere in the chain of ownership. That advice is not only simple but simplistic. But whether it is actually right depends on what the client's principal concerns are.

If we look at structuring the acquisition of a home in light of the big-picture issues described above, the use of a structure with a foreign corporation has only one clear tax advantage — that shares of such a corporation are indubitably not located in the U.S. for purposes of the estate tax.[49] But the use of a corporation raises concerns with all the other issues, including the imputation of rental income, the potential for double taxation of income

[43]Sections 897(b) and 165(c).

[44]Section 2105(a).

[45]*See* note 35 *supra* and accompanying text.

[46]*See* section 2104(c) (estate tax definition of location of debts) and section 7701(a)(30) (definition of U.S. person).

[47]Section 871(h) and reg. section 1.871-14.

[48]The definition of residence here is set out in section 865, not section 7701(b), and a U.S. citizen who resides abroad under that definition is a nonresident for these purposes.

[49]Section 2104(a). However, the foreign taxpayer must respect the corporate formalities or risk an assertion by the IRS that the corporation is a mere alter ego or agent of the taxpayer. Nonetheless, the prejudice of the U.S. tax law against disregarding the corporate form voluntarily chosen by the taxpayer is very strong, as most famously demonstrated in *Moline Properties v. Commissioner*, 319 U.S. 436 (1943) (corporation formed at urging of mortgage holder to hold real estate must be recognized as separate entity), and the innumerable cases that have cited it.

and gain at corporate and perhaps shareholder levels, the loss of preferential rates on long-term capital gains, and the lack of a step-up in basis on death for the inside basis in the U.S. asset.

1. Entity classification. The U.S. entity classification rules must be applied to any foreign entity through which a home is acquired. This report does not review the entity classification regulations but any adviser must be thoroughly acquainted with them, especially in relation to foreign entities.[50] Such entities will have a default classification and over 80 of them are classified as per se corporations. With the expansion of the European Union, not all per se entities are listed in the regulations.[51] In most cases, a foreign entity with limited liability for its members has a default classification as a corporation but is often an eligible entity that can elect to change its default classification.

As it happens, the regulatory list of per se corporations does not include entities established under most, but not all, of the traditional tax haven jurisdictions. Thus, all entities in the Bahamas, the British Virgin Islands, the Cayman Islands, the Channel Islands, and Malta can make an election to change status. Therefore, essentially every entity in such a jurisdiction is an eligible entity that can elect out of its default classification. In Cyprus and Gibraltar, public limited companies are listed as per se corporations, and in Panama the *sociedad anonima* is by default a corporation.

One other point on classification: The check-the-box regulations have a ''relevance rule'' that might act as a trap for the unwary. According to the regulations, a foreign eligible entity's classification is relevant when its classification affects the liability of any person for federal tax or information purposes. One can imagine circumstances in which it might be desirable to change the default classification of a foreign entity, only to discover that no person's liability for tax or information reporting would be affected by the classification. For example, suppose a foreign company holds title to a home. The payment of rent to the foreign company would be subject to withholding at a rate of 30 percent regardless of whether it was classified as a partnership or corporation, so the liability would not be affected. Nor would there be any requirement for the entity or any foreign owner to file a tax return.[52]

Making an election to treat the entity as other than its default classification would have an effect on the date of the election, but the election would cease to have effect five years later (that is, 60 months after relevance ceases) and classification would be determined either by default or by election on the first day classification again became relevant.[53] It's not clear how all this works if classification is not relevant until a particular event takes place, at which point classification becomes relevant going back before — in some cases long before — the event took place. For example, the death of a foreign owner with U.S. heirs may cause the classification to become relevant not just going forward but looking backward as well. Suppose the entity in question would be classified by default as a corporation. Would a check-the-box election to treat the entity as a partnership result in a deemed corporate liquidation or would it cause the entity to be treated as always having been a partnership? We pose these questions without answering them, but they have obvious practical consequences for planners.

2. Imputed income. Whether a corporation is domestic or foreign, we need to consider the possibility that the use of the home by the owner or his family will give rise to imputed income. The historic approach to a situation in which a corporation allows its controlling shareholder or his family to make personal use of corporate property has been to deny deductions to the corporation and to treat the excess of fair rental value over any actual rent as a constructive dividend.[54]

That treatment may not be much of a deterrent to foreign owners of a special purpose vehicle that owns the home in the U.S. A foreign owner may not be seeking deductions for expenses, which might only generate a loss that could not be used. A constructive distribution by a foreign corporation would not be taxed to the foreign owner. A constructive distribution by a domestic corporation would be taxed only if the corporation had earnings and profits — which it might well not. Otherwise, the distribution would simply result in a reduction in the foreign owner's basis in the shares in the domestic corporation — and that too may have no adverse impact if the corporation owned a single asset and was intended for liquidation following the ultimate sale of the property. In that case, the liquidation would be tax free under section 897(c), provided that sufficient notice is filed with the IRS so that an early termination will occur regarding its status as a U.S. real property holding corporation.[55]

Therefore, one may wonder whether the IRS would forgo the traditional approach or combine it with an

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[50]Reg. section 301.7701-2 and -3.

[51]*See* Notice 2007-10, *Doc 2006-25615, 2006 TNT 247-13*, which addresses the status of a Bulgarian *Aktsionemo Druzhestvo* as a per se corporation in advance of its inclusion in published regulations.

[52]However, an election to treat the entity as a partnership would be required if the foreign owner decided he wanted to elect to treat the rent as ECI under section 871(d).

[53]Reg. section 301.7701-3(d)(3).

[54]*E.g.*, *Transport Manufacturing & Equipment Company v. Commissioner*, 434 F.2d 373 (8th Cir. 1970), *aff'g* T.C. Memo. 1964-190, involving use at less than fair market value of corporate-owned property by shareholder, officer, or related party; *Yarbrough Oldsmobile Cadillac Inc. et al. v. Commissioner*, T.C. Memo. 1995-538, *Doc 95-10350, 95 TNT 222-35*; *Nicholls, North, Buse Co. v. Commissioner*, 56 T.C. 1225 (1971); *Offshore Operations Trust v. Commissioner*, T.C. Memo. 1973-212; *Joyce Ann Cirelli et al., v. Commissioner*, 82 T.C. 335 (1984), in which the court held that a yacht owned by a partnership was in reality owned by a corporation whose shareholders used it for personal purposes; the court applied the traditional approach and pointed out (with several citations) that ''a distribution need not be to a shareholder to be taxable as a constructive dividend; the distribution need only be for the shareholder's benefit''; *but see Sparks Farm, Inc. v. Commissioner*, T.C. Memo. 1988-492.

[55]Reg. section 1.897-2(f)(2) and (h).

attack based on the imputation of rental income to the corporation based on the transfer pricing rules of section 482. Section 482 provides, in pertinent part:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the U.S., and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary [that is, the Commissioner of Internal Revenue] may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Section 482 is not so felicitously worded that it is immediately clear that it would apply to a transaction between a corporation and its shareholder that involves the use of corporate property for personal use rent-free or at below-market rents.[56]

If, however, section 482 were applied to the use of corporate property by a shareholder, the result would be the imputation of rental income to the corporation. The law is clear that section 482 can create a payment of income between the parties and is not limited to allocating actual income.[57] In those circumstances, the income would be taxable and it would seem inappropriate to use the traditional approach to disallow expenses incurred by the corporation.[58] However, if the corporation failed to file a tax return in a timely fashion, as defined, income tax regulations would disallow deductions as a matter of course.[59]

3. Structuring alternatives. Assuming the taxpayer avoids the hazards of the entity classification regulations, there are two principal ways of structuring the acquisition of a home by using a corporation. These are:

- direct ownership of the home through a foreign corporation; and
- ownership of the home through a domestic corporation, which in turn may be owned by a foreign corporation, a trust, or an individual.

a. Ownership through a foreign corporation. As noted earlier, ownership of a home through a foreign corporation eliminates any exposure to the estate tax. Moreover, from a compliance point of view, it enables the foreign individual to avoid almost all contact with the U.S. tax system, not an insignificant concern in the case of many high-net-worth individuals. As previously mentioned, there will be some identification of the individual in the corporation's tax return on Form 1120F, ''U.S. Income Tax Return of a Foreign Corporation,'' as a more than 50 percent owner[60] and as an ultimate 25 percent foreign shareholder on Form 5472, ''Information Return of a 25 Percent Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Under Section 6038A and 6038C of the Internal Revenue Code).''[61] However, that identification does not mandate the issuance of a TIN for the individual.

In doing so, however, the foreign owner incurs a long list of other tax disadvantages. Those include loss of the long-term capital gains preference, which applies only to individuals and nongrantor trusts; possible double taxation[62] of income and gains of the corporation, to the extent the income and gains are, or are treated as, effectively connected with a U.S. trade or business; having to deal with the imputed rental income issue; and loss of step-up in basis of the real property on death of the foreign owner. Also, any U.S. heirs of the foreign owner will inherit shares in an entity that will either become a controlled foreign corporation, if one or more U.S. heirs own 10 percent or more of the voting shares and those 10-percent-plus owners together are in the majority, or a passive foreign investment company, if either such condition is not met for some or all of the beneficiaries.[63] As we will see, this can be a cursed inheritance.

As noted earlier, foreign taxpayers are occasionally advised that they do not have to pay U.S. tax on the sale of their stock in a foreign corporation. While that is technically true because stock in a foreign corporation is not a U.S. real property interest,[64] the use of a foreign corporation rarely achieves the goal of avoiding the cost of taxation on sale of U.S. real property. The issues here are generic for foreign investors in U.S. real property but they are particularly acute when the property is a home, given the nature of the potential buyers of residential property. Even if one could find a buyer of a home willing to risk dealing with the unknown, and in some cases the unknowable, risk of liabilities of a privately held foreign corporation, a well-advised buyer will realize that purchase of the foreign corporate stock will not result in a step-up in basis in the underlying real property. That typically results in a requested discount to cover the assumption of the tax cost of the seller that arises from a carryover inside basis for the property. Moreover, it is hard to imagine a U.S. buyer interested in acquiring a home by acquiring stock in a foreign corporation, for reasons explained later in this report.

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[56]*See, e.g., Sparks Farm, Inc. v. Commissioner*, T.C. Memo. 1988-492, in which the unique facts of the case apparently precluded section 482 from applying. The breadth of the holding, however, is open to debate.

[57]*See* reg. section 1.482-1(f)(2)(i).

[58]Section 482 cannot, in general, be invoked by the taxpayer. However, reg. section 1.482-1(a)(3) provides that ''if necessary to reflect an arm's length result, a controlled taxpayer may report on a timely filed U.S. income tax return (including extensions) the results of its controlled transactions based upon prices different from those actually charged.''

[59]Reg. section 1.882-4(a)(3). These regulations were held invalid in *Swallows Holding Limited v. Commissioner*, 126 T.C. No. 6, *Doc 2006-1541, 2006 TNT 18-10* (2006).

[60]Question S on Form 1120F.

[61]Line 4a of Form 5472.

[62]Corporate income tax under section 882 and BPT under section 884.

[63]Section 957(a) (definition of CFC); section 1297 (definition of PFIC).

[64]Section 897(c).

The cost of losing the CGT preference available to individuals can be made worse by the branch profits tax. The branch profits tax is imposed on a foreign corporation on the ''dividend equivalent amount,'' which is defined as the E&P arising from effectively connected taxable income for the year, which would include gain from the sale of any U.S. real property, increased by any reduction (or reduced by any increase) in the corporation's U.S. net equity. U.S. net equity in turn is a function of U.S. assets and liabilities.[65] The rate of tax is 30 percent, the same as the rate of withholding tax on dividends paid by a domestic corporation, and it is subject to reduction by treaty.[66]

As a practical matter, the foreign corporation will not be subject to the branch profits tax if, following sale of a home, all of the proceeds are reinvested in ''U.S. assets.'' That might not include the purchase of a new home, unless the home somehow produces ECI. U.S. assets are defined as ''the money and aggregate adjusted bases of property of the foreign corporation treated as connected with the conduct of a trade or business in the U.S.'' under applicable regulations. The regulations provide that property would be treated as a U.S. asset if income from the asset is ECI (or would be if the asset produced income on the date for determining the amount of U.S. assets) *and* gain on sale would be treated as effectively connected. The problem is the first part of this requirement because rental income may or may not be trade or business income that is effectively connected.[67] The second part is not a problem because section 897(a) treats all gains from sale or exchange of U.S. real property interests as effectively connected.

If less than all of the proceeds are reinvested, either because the foreign corporation trades down or because it finances its next purchase with more debt, branch profits tax will be payable. In any event, if sales proceeds are used to pay taxes, the nonresident alien shareholder of the foreign corporation will be required to invest additional amounts in the corporation to cover the corporate income taxes — otherwise, there will be a shortfall in the amount that is reinvested.

A foreign corporation will not be subject to the BPT for the tax year in which it completely terminates all of its U.S. trade or business.[68] The foreign corporation must meet several conditions, including either having no U.S. assets or having adopted an ''irrevocable resolution'' by the shareholders to completely liquidate and dissolve, in which case the corporation's U.S. assets must have been distributed, used to pay liabilities, or ceased to be U.S. assets. There is also a prohibition on reinvesting the former U.S. assets in new U.S. assets, directly or indirectly, for three years following the close of the year of the sale. This rule is the equivalent to a liquidation-reincorporation rule and is exceptionally harsh (as well as bad policy that discourages investment in the U.S.). It requires a taxpayer to ring-fence the sales proceeds and to keep them in an identified investment outside the U.S. The statute of limitations is extended to six years to allow the IRS to monitor reinvestment.

The consequences appear less severe for a foreign shareholder when the foreign shareholder makes personal use of a home owned by a corporation when the corporation is foreign. As noted earlier, the double tax exposure is captured at the level of the foreign corporation in the form of corporate income taxes and BPTs. The real tax risk comes when the foreign corporation wishes to sell the property and is faced with a potential basis reduction because the property is depreciable from its inception yet the corporation may not have filed tax returns over the years in which losses have been established. As a result, a maximum tax determination letter from the IRS may not be realistically available and a full 10 percent withholding tax may be due at the time of sale.

b. Ownership through a domestic corporation. When a domestic corporation is used to acquire the home, several of the big-picture issues we have described will play out differently.

The domestic corporation will be subject to federal income tax on any future capital gain at up to 34 percent or, in truly unusual circumstances, 35 percent, as well as any state income tax. Because the corporation will be presumed to be engaged in business, it can usually deduct its expenses, including interest, taxes, and the costs of maintenance, repair, and insurance, as well as other corporate costs such as accounting and tax preparation fees. However, if the shareholders make personal use of the home without paying a reasonable rent, those expenses may be disallowed in accordance with the case law described above.[69]

On sale of the property, the foreign owner will presumably want to have access to the proceeds of the sale. Any distribution of the proceeds other than in liquidation of the corporation will be a dividend to the extent of the

[65]Section 884(a).

[66]Section 884(e); reg. section 1.884-1(g). The U.S. has renegotiated many of its treaties to allow imposition of the BPT at the direct investment dividend rate. That rate was usually 5 percent or 10 percent; the 5 percent rate remains the official starting point in the current version of the U.S. model income tax treaty (U.S. Treasury Department, U.S. model income tax convention of Nov. 15, 2006, art. 10, para. 2) but several recent U.S. treaties now provide for a 0 percent rate, beginning with the United Kingdom (2001 treaty) and Australia (2001 protocol). Note that the zero rate may not apply if the shares of the corporation have been recently acquired. Each treaty must be checked for this point.

[67]*See* reg. section 1.884-1(d)(1), discussed in Isenbergh, *Foundations of U.S. International Taxation*, Tax Management Portfolio 900-1st, II.F.2.c.(1), which refers to the conjunctive requirement of the regulation. Presumably, if the home were rented out (including to the owner of the foreign corporation), the foreign corporation made an election under section 882(d) (election to treat real property income as effectively connected).

[68]This concession has no basis in the language of the statute but is provided by temp. reg. section 1.884-2T, apparently to provide equivalent treatment to the tax-free treatment of a foreign shareholder on liquidation of a domestic corporation the shares in which are not U.S. real property interests. It is authorized by section 884(g), a general grant of authority to issue regulations that carry out the purpose of the statutory provision.

[69]*See* note 56, *supra*.

corporation's E&P and therefore subject to tax at a flat rate of 30 percent or a lower treaty rate. Moreover, the entire amount of the distribution will be subject to withholding, even if less than all of the distribution is a dividend, although the corporation would have the right to withhold less based on a reasonable projection of its E&P at the end of the tax year.[70]

To avoid dividend treatment, the foreign shareholder can cause the domestic corporation to be liquidated. However, the shareholder should not do this unless the corporation has purged itself of all U.S. real property interests; otherwise, the shareholder may have to recognize gain inherent in the shares of stock of the corporation.[71] Generally that is not a problem if the corporation is a single-asset vehicle for the ownership of just one house and the house has been sold. However, if the corporation holds an installment note from the buyer, the note will be a U.S. real property interest (USRPI). The corporation must therefore either dispose of the note by collection or sale or it will have to make an election out of installment sale under section 453(d), thereby accelerating gain recognition by the corporation but also removing the USRPI status of the note. As mentioned earlier, those planning opportunities exist only if the corporation notifies the IRS of the early termination of its status as a U.S. real property holding corporation.[72]

A gift of stock in a domestic corporation is not subject to gift tax because of the rule that only gifts of tangible personal property and real property located in the U.S. are taxable to a nonresident alien donor.[73]

The consequences of the death of the foreign owner depend on the structure of the ownership of the domestic corporation. If the corporation is owned directly by the foreign owner, the taxable estate will include the shares and the estate will be subject to estate tax regarding those shares on the owner's death. That's because stock in a domestic corporation has a U.S. situs for estate tax purposes.[74] If the domestic corporation is owned by a trust, the consequences will depend on whether any of section 2036 ("Transfers With Retained Life Estate"), section 2038 ("Revocable Transfers"), or section 2041 ("Powers of Appointment") applies to the foreign decedent.[75] If any of those sections applies, the value of the stock in the domestic corporation will be includable in the estate of the foreign owner; otherwise, there will be no estate tax, except in unusual circumstances, possibly when the foreign corporation is treated during the individual's lifetime as an alter ego. These three provisions that cause property owned by a trust to be included in a taxable estate may be thought of as the estate tax counterpart to the grantor trust rules and we refer to them collectively as the "retained interest" rules.

Stock in the domestic corporation will be stepped up on death of a foreign owner who held the stock directly or through a trust governed by the retained interest rules, but the basis in the underlying property will not be stepped up.[76] If the trust is not governed by any of the retained interest rules, there will be no step-up in the basis of the shares at the time of death of the settlor.

If the domestic corporation is owned by a foreign corporation, no estate tax will be due. Any step-up will occur only at the level of the stock in the foreign corporation but not at any lower tier. Once again, if the stock was held by a trust governed by any of the retained interest rules, no step-up will occur at any level.

C. Ownership Through a Partnership

The foreign individual could form a partnership or an entity classified for federal tax purposes as a partnership to acquire and hold the home. The check-the-box regulations[77] have changed the rules of the game here. The traditional definition of a partnership was set out in the regulations under section 761 and included "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on. The term 'partnership' is broader in scope than the common law meaning of partnership, and may include groups not commonly called partnerships. . . . A joint undertaking merely to share expenses is not a partnership."[78]

However, beginning in 1997, the definition of a partnership for all purposes of the Internal Revenue Code has been set out in the check-the-box regulations. Those regulations provide that a partnership is a business entity that is not treated as an association (corporation) or a trust, and a business entity is any entity recognized for federal tax purposes (including a disregarded entity) that is not properly classified as a trust or otherwise subject to

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[70]Reg. section 1.1441-3(c)(2)(i)(C).

[71]*See* section 897(c).

[72]*See* note 57.

[73]Section 2511(a). Note that the tax would apply if the donor was subject to section 877(b) during the year the gift was made. *See* section 2501(a)(2). Section 877(b) applies to both citizens and long-term green card holders who gave up their citizenship and met specific financial and filing tests.

[74]Section 2104(a).

[75]These provisions are the estate tax counterparts to the grantor trust provisions of subchapter J, Part E (sections 671-679).

[76]There is a tendency on the part of taxpayers and the IRS (depending on whose interest it serves) to value stock in a single-asset corporation as being identical to the value of the underlying real property. That is not the case in many ways. Among the differences is the fact that the value of the stock will be reduced by any liabilities — the full amount of any mortgage, whether recourse or nonrecourse. The courts and, grudgingly, the IRS may accept discount for some or all of the capital gains tax that would be payable on the sale of the property. A discount will also be appropriate for marketability, which will reflect both the fact that the stock is not listed and the natural concern of any buyer about buying stock in a privately held corporation rather than the underlying asset. Minority or reduced interest discounts may also apply if, for example, a decedent held less than all of the shares, as will occur if a husband and wife each owns exactly 50 percent of the shares of the corporation.

[77]T.D. 8697, 61 *Fed. Reg.* 66584-66593, *Doc 96-32369, 96 TNT 245-1* (Dec. 18, 1996).

[78]Reg. section 1.761-1, T.D. 6500, 25 *Fed. Reg.* 11814, Nov. 26, 1960, *amended by* T.D. 7208, 37 *Fed. Reg.* 20686, Oct. 3, 1972, before amendment by T.D. 8697, *supra* note 76, in 1996.

special treatment under the code. There no longer appears to be a requirement that the partnership be formed for profit.

So what are the consequences to our foreign home buyer of using a partnership, or an entity classified as a partnership, to purchase the property?

1. Income tax.

a. Contribution. If the nonresident alien acquires the property and transfers it to the partnership in exchange for a partnership interest or as a contribution to the partnership, the transfer is a realization event but entitled to nonrecognition under the domestic tax law,[79] and that treatment is not overridden by FIRPTA rules relating to nonrecognition. However, to avoid FIRPTA withholding, the alien or the partnership must provide notice to the IRS of the transaction afforded nonrecognition treatment.

b. Imputed rental income. If a partner, foreign or domestic, is permitted to use the home free of rent or at a below-market rental, the question arises whether the partnership will have imputed rental income.

It's easier to see how rental income might be imputed between a corporation and its shareholders rather than between a partnership and its partners. As discussed elsewhere in this report, corporations and shareholders are separate taxpayers and a corporation is assumed to be engaged in business. But there is something intuitively odd about treating a partner as paying rent to a partnership for use of partnership property when that same income will be allocated right back to the partner. And that oddity is reinforced in the post-check-the-box world by the fact that a partnership formed solely to hold property for the personal use of its partners cannot really be said to be engaged in a business. When, however, a second partner holds more than a de minimis interest in the partnership, the oddity is diminished.

In any event, section 707(a)(1) explicitly recognizes the idea of partnerships entering into transactions with partners not acting in their capacity as partners. This concept is frequently encountered in transactions in which a partner lends money or leases or licenses property to a partnership for which the partnership pays interest, rent, or royalties. But there is nothing in section 707 that makes it a one-way street in which partners provide assets to the partnership. It could arguably be interpreted as applying to a transaction in which a partnership as owner of property allows the property to be used by a partner as tenant or licensee.

The question is then directed to the authority for imputing income in those circumstances. The most obvious possibility is section 482.

Whether section 482 covers a partner's rent-free use of partnership property requires us to consider whether the transaction involves ''organizations, trades, or businesses'' on both sides of the transaction. Fairly obviously, a partnership is an organization. But is the partner an ''organization, trade, or business''? Section 482 is often thought of as having a very broad reach, but it seems doubtful that it reaches quite as far as an individual not actually engaged in a trade or business who does no more than make personal rent-free use of partnership property.

We have been unable to find any direct authority on this point in the partnership context. Some courts have given a broad meaning to the term ''organization, trade or business'' so that, for example, it includes employees.[80] Others have adopted a more limited approach.[81]

The closest case would seem to be *Dolese*, a case involving an individual, his wholly owned corporation, and a partnership in which the individual and the corporation were partners. To facilitate a subsequent tax-efficient sale and charitable gift of the property, the partnership made a distribution of partnership property to the partners that was not proportionate to their partnership interests. The taxpayer argued that section 482 could not apply to a partnership and one of its partners because they are not separate taxpaying entities. The Tenth Circuit ruled that the taxpayer did have a trade or business as a corporate executive and that the transaction was related to that trade or business.

It has to be said that the court's reasoning is a little strained. Moreover, somewhat gratuitously, the court added:

> The fact that no prior case has addressed the application of § 482 to the distribution of income and deductions from a partnership to an individual and the individual's wholly-owned corporation does not persuade us that application of the section is precluded. Cases addressing the dual business requirement have held that the terms ''trade,'' ''business,'' and ''organization'' are to be broadly construed. *Wilson v. United States*, 530 F.2d 772, 777 (8th Cir. 1976). See also *Keller*, 77 T.C. at 1022. Furthermore, § 482 gives the Commissioner broad discretion to place a controlled taxpayer in the same position as an uncontrolled taxpayer. *Foster*, 756 F.2d at 1432; *Peck*, 752 F.2d at 472. Expansive construction of the terms comports with the Commissioner's broad discretionary power. We therefore conclude the tax court's application of the dual business requirement was not contrary to law.

The authors have not reached a consensus on what would happen in a case, more straightforward than the facts of *Dolese*, of a partner making personal use of partnership property such as a residence. If the tax adviser making the determination deals with a broad spectrum of cross-border tax issues facing individuals, there may be a greater likelihood to argue that section 482 should not be applicable in the absence of two businesses. These advisers may find section 7872 instructive as it relates to loans that bear rates of interest that are

[79]Section 721.

[80]*See, e.g., Ach v. Commissioner,* 42 T.C. 114 (1964), *aff'd,* 358 F.2d 342 (6th Cir. 1965), *cert. denied*, 385 U.S. 899 (1966); *Dolese v. Commissioner*, 811 F.2d 543 (10th Cir. 1987). *See also Powers v. Commissioner.*, T.C. Memo. 1982-567, *aff'd,* 724 F.2d 64, 66 (7th Cir. 1983), involving the lease of property.

[81]*See, e.g., Foglesong v. Commissioner*, 35 T.C.M. 1303 (1976), *rev'd and remanded*, 621 F.2d 865 (7th Cir. 1980), *on remand*, 77 T.C. 1102 (1981), *rev'd*, 691 F.2d 848 (7th Cir. 1982).

below market. The transfer pricing regulations contain rules for an arm's-length interest rate. Presumably, those rules should apply under the theory that a loan between related parties should be subject to section 482 as much as a rental. Presumably, too, section 482 is inapplicable, which is the reason that section 7872 was enacted. Reasoning by analogy, it certainly can be argued that below-market rentals between related parties in the nonbusiness context should be removed from section 482 and in the absence of a provision comparable to section 7872 should be immune from adjustment. The validity of that argument awaits the next case.

On the other hand, if the tax adviser's practice concentrates on transfer pricing issues, the likelihood is that he — as well as the IRS — will argue that section 482 permeates every nook and cranny of tax law. These advisers would look to *B. Forman Co. Inc v. Commissioner*,[82] involving a joint undertaking of operating corporations. There, the Second Circuit had no difficulty applying section 482 in a partnership context. They may also look to *Procacci v. Commissioner*,[83] in which a partnership leased a golf course to a related party and charged no rent under the circumstances involved in the case. The issue revolved around a prior version of the transfer pricing rules (reg. section 1.482-2(c)(2)) that contained a method to determine an arm's-length charge for the use of tangible property when neither party to the lease was engaged in the trade or business of leasing tangible property.

In any event, the foreign taxpayer that uses a partnership to acquire a home must be willing to respond to a challenge by the IRS under which the partnership is assessed with imputed income under section 482 without any offsetting deduction for the partner.

Is there any other basis for imputing income between the partnership and the partner? We haven't found any statutory or case law that would provide or allow for this. As we have already seen in the somewhat analogous position of a corporation that allows personal use of property to its shareholder, the traditional approach has been to disallow deductions to the corporation and impute a constructive dividend to the shareholder. That would usually be an adequate way to counteract whatever tax avoidance was thought to occur when a shareholder uses corporate property because in most cases the deductions would be valuable and the constructive dividend would be income as long as the corporation had E&P.

But the traditional approach is not much of a threat to a partnership or the partners when the only asset of the partnership is a personal-use residence. Absent imputed income, the partnership has no income and therefore no immediate use for the deductions, and the partnership distributions are generally not taxable to partners.[84]

c. Actual rental income. The partnership might in fact have rental income. A cautious planner might choose to have the partnership charge the partners for use of the property. Alternatively, the property might be vacation property that was placed in a rental pool or otherwise made available for lease when not in use by the owner.

How the income is taxed requires first that we determine whether the partnership, and therefore by imputation under section 875 the partner, is engaged in a U.S. trade or business with which the rental income is effectively connected. Under one view, that may seem unlikely when the property is primarily a personal use residence (and if it is not, then the situation is outside the scope of this report). But other views may be possible as well.

Assuming there is no actual trade or business, rental income may be taxed to foreign partners either as FDAP income, at a flat rate of 30 percent of the gross income, or the foreign partner can affirmatively elect under section 871(d) to be taxed on the income as if he, she, or it were engaged in a trade or business within the U.S. and as if the income is effectively connected to that business. The section 871(d) election is made at the partner level on the partner's tax return. If the election is made, graduated rates would apply to the net income.

As noted below, the treatment of the income in turn has withholding consequences for the partnership.

d. Gain on sale. There is no real doubt that if the partnership held residential real property for more than a year, any gain on the sale of the property would be long-term capital gain.

The question arises whether the partnership should have taken depreciation deductions on the portion of the basis attributable to the building. If so, the deductions would have been allocated to the partner and should be deductible at the partner level.

That question answers itself rather easily in the case of property held for investment or use in a trade or business. But the position is not so clear when the property is held for personal use as a residence by the partners. Any excess deductions could contribute to a net operating loss and result in a carryover for up to 20 years under current law. However, use of the loss would be limited under the alternative minimum tax rules.[85]

e. Withholding. One consequence of holding property through a partnership with one or more foreign partners is that the collection of withholding tax may be required for some income items of the partnership. Specifically, if the partnership is domestic, the partnership will have to withhold tax under Chapter 3 and, specifically, sections 1441, 1445, and 1446; and if the partnership is foreign, sections 1445 and 1446 would apply.

The final regulations confirm the IRS's position that a payment is considered made to the extent income subject to withholding is allocated under section 482. Further, income arising as a result of a secondary adjustment made in conjunction with a reallocation of income under

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[82]453 F.2d 1144 (2d Cir. 1972), *cert. denied* 407 U.S. 934 (1972).

[83]94 T.C. 397 (1990).

[84]As we have seen, however, a corporation that owns only a personal use residence may not care about the deductions, and

(Footnote continued in next column.)

the constructive distribution may only cause a reduction in the shareholder's shares. *See* text accompanying and following *supra* note 54.

[85]*See* section 56(d), which limits the benefit of a NOL when computing alternative minimum taxable income.

section 482 from a foreign person to a related U.S. person is considered paid to a foreign person unless the taxpayer to whom the income is reallocated has entered into a repatriation agreement with the IRS and the agreement eliminates the liability for withholding. The secondary adjustment accounts for the absence of cash in the U.S. entity once taxable income has been increased. The IRS's position is that the cash that should have been charged was actually received and distributed to the owner. While a deemed distribution of profits has a taxable effect in the corporate context, the effect in the partnership context should be negligible in most contexts.

Section 1441 applies to income that is not effectively connected with a U.S. trade or business. It would therefore apply to rental income, including rental income imputed under section 482.[86] If the partnership is domestic, the tenant of the property would not be required to withhold tax on the rent; rather, it is the partnership that would have to withhold the tax on distributions to the partner or, if no distribution is made, on the date Form K-1 is due or is actually mailed to the partner, whichever is earlier.[87]

If the partnership takes the view that the rental income is effectively connected with a U.S. trade or business, or if the foreign partner elects to treat it as ECI, then withholding under section 1441 on rental payments can be avoided. If the partnership is domestic, the tenant does not have to withhold and the partnership can rely on a Form W-8ECI from a foreign partner.[88] If the partnership is foreign, and if, as will normally be the case, the partnership is a ''nonwithholding foreign partnership,'' the partnership can provide a Form W-8ECI to the tenant.[89]

Section 1446 will apply to any income or gain allocated to the foreign partners to the extent the income or gain is effectively connected with a U.S. trade or business. Section 1446 requires the partnership to withhold tax on the ''effectively connected taxable income'' of the partnership allocable to foreign partners at the highest rate applicable to that partner, which in the case of an individual, is currently 35 percent. However, the section 1446 regulations allow the use of preferential rates for long-term capital gains and depreciation recapture, currently 15 percent and 25 percent, if the partnership has documentation that allows it to determine that the partner is an individual (or, presumably, a trust taxed as an individual). A full discussion of section 1446 is far beyond the scope of this report.[90]

2. Gifts of partnership interests. A foreign partner in a partnership may wish to make a gift of the partnership interest or may bequeath the partnership interest to his heirs.

A gift by a nonresident alien of a partnership interest generally will not be subject to the U.S. gift tax. That tax does not apply to gifts by nonresident aliens of intangible assets, with an exception in cases involving expatriates subject to section 877.[91]

Two income tax issues nevertheless have to be taken into consideration in connection with the gift by a nonresident alien of a partnership interest.

First, the recipient of the gift takes a basis in the partnership interest that is the lower of the donor's basis and fair market value. A gift can therefore result in a decrease but not an increase in the basis of the interest. A transfer of a partnership interest by gift does not result in a basis adjustment to the partnership's assets under section 743, even though the partnership may previously have made the optional basis adjustment election under section 754, an election that remains in effect for future years unless revoked with IRS consent.

Also, a gift of a partnership interest may be treated as a sale or exchange if the partnership has liabilities and any portion of those liabilities is allocable to the donor partner. That is quite likely to be an issue if the home owned by the partnership is mortgaged. There are two schools of thought on that.

The IRS takes the position that any transfer of a partnership interest is a sale or exchange when the partnership has any liabilities that are transferred to the successor partner, based on the classic case of *Crane v. Commissioner* and an expansive but plausible reading of section 752(d).[92] The *Crane* argument is that any transfer of property that is subject to a liability results in an amount realized by the transferor and is part of the

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[86]Reg. section 1.1441-2(e)(2) confirms the IRS's position that a payment is considered made to the extent income subject to withholding is allocated under section 482. Further, income arising as a result of a secondary adjustment made in conjunction with a reallocation of income under section 482 from a foreign person to a related U.S. person is considered paid to a foreign person unless the taxpayer to whom the income is reallocated has entered into a repatriation agreement with the IRS and the agreement eliminates the liability for withholding. *See also Central de Gas de Chihuahua v. Commissioner*, 102 T.C. 515, *Doc 94-3638, 94 TNT 65-12* (1994); FSA 199922034, *Doc 1999-19684, 1999 TNT 108-20* (Mar. 3, 1999).

[87]Reg. section 1.1441-5(b)(2).

[88]Reg. section 1.1441-5(b)(2) says that a foreign partner is not required to furnish a withholding certificate to claim an exemption from withholding under section 1441 on the grounds that income is effectively connected. However, reg. section 1.1446-2(b)(2)(ii) requires a foreign partner that makes an election under section 871(d) or 882(d) to furnish to the partnership a statement that indicates that such election has been made and if a partnership receives a valid Form W-8ECI from a partner, the partner is deemed, for purposes of section 1446, to have ECI subject to withholding under section 1446 to the extent of the items identified on the form. *See also* reg. section 1.871-10(d)(3).

[89]Reg. section 1.1441-5(c)(1)(ii)(B). Because a withholding foreign partnership is one that has entered into an agreement with the IRS concerning guaranteed payments to partners, we can reasonably assume that in most cases involving a private

(Footnote continued in next column.)

use residence, the partnership will be a nonwithholding foreign partnership. *See* reg. section 1.1441-5(c)(2).

[90]For a more detailed discussion, see Appel and Karlin, ''At Long Last . . . Final Regulations on Foreign Partner Withholding,'' *JOIT* (Oct. 2005), and ''Uncle Sam Meets Uncle Scrooge — the Temporary Regulations on Foreign Partner Withholding,'' *JOIT* (Dec. 2005).

[91]Section 2501(a)(2).

[92]331 U.S. 1 (1947); *see also Tufts v. Commissioner*, 461 U.S. 300 (1983).

transferee's basis. Section 752(d) provides that in the case of any sale or exchange of a partnership interest, liabilities shall be treated in the same manner as liabilities in connection with a sale or exchange of property not associated with partnerships.[93]

The consequences of the IRS position are as follows: A transaction in which the donee takes the partnership, subject to liabilities of which the donor is thereby relieved, is bifurcated into (1) a sale to the extent of the liabilities in question and (2) a gift of the value of the partnership interest net of those liabilities. If the liabilities exceed the basis, the donor may actually realize a gain, which would normally be a capital gain. The donee also has to be concerned with possible consequences under the FIRPTA withholding tax rules.[94]

The other possible position is that section 752(d) applies only to transfers of partnership interests that actually are sales or exchanges. The basis for this position is, not surprisingly, the literal language of the section 752(d) — the notion that section 752(d) explains what to do when there is a sale or exchange but says nothing about converting a transaction such as a gift into a sale or exchange.

If this interpretation is correct, the transferor is still not out of the woods because then section 752(b) comes into play. Section 752(b) says that any decrease in a partner's share of partnership liabilities is treated as a distribution of money by the partnership to the partner. That will not result in a gain, however, unless the deemed distribution exceeds the transferor's basis in the partnership.[95]

Readers are invited to do their own analysis of this issue, which does not appear to have been definitively resolved by any court.

3. Death of a partner.

a. Estate tax. When the partnership interests pass to the heirs of a deceased nonresident alien partner, the estate tax position is less than clear.[96] The IRS's position is that a partnership interest has U.S. situs if the partnership is engaged in a U.S. trade or business. In the estate tax area, the IRS has given no consideration to the relative sizes of the U.S. business and other activities and assets, which can lead to the bizarre results in an atypical fact pattern involving a partnership that has a tiny U.S. business and very substantial assets in other places around the world that are not related to the U.S. business. This approach should be contrasted with the position of the IRS in the income tax area, in which it states that the taxable status of the gain is controlled by the assets in the partnership.[97]

The approach in the estate tax area likely helps the estates of some deceased nonresident aliens and harms the estates of others. In particular, the IRS position is rather favorable to the estates of nonresident aliens when the sole asset of the partnership is a residence held exclusively for private use. That's because a partnership does not appear to be engaged in a U.S. trade or business if it simply holds the residence for use by the partners and, arguably, their family members, provided that section 482 is inapplicable.[98]

Nonetheless, several issues remain unaddressed by the IRS. It is not clear if the Service would try to apply its position to a partnership that was not engaged in a U.S. trade or business but had income or gain that was deemed to be effectively connected with a U.S. trade or business for purposes of imposing tax under section 871(b), 882, or 897(a). Also unclear is the case of a partnership that has income that is not actually effectively connected to an ongoing trade or business, but that, as a result of a section 871(d) election or because of a FIRPTA gain under section 897(a), is deemed to be ECI. It is also unclear when the partnership must be engaged in a trade or business. Is it the date of death? Any time during the year of death? Any time whatsoever before death?

There are other theories that may be applicable. Those include treating residence of the deceased partner as the situs of the partnership interest (*mobilia sequuntur personam*) or the place of organization of the partnership as the situs, similar to the rule for corporations.

Planning should also take into account the case law developed in the family limited partnership area. The risk here is that if a nonresident alien contributes residential property to a partnership but retains the right to live there, section 2036 may apply.[99] That can be avoided by having the partnership enter into a lease with its foreign partner that provides for a FMV rental, but again, this approach has adverse income tax consequences and

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[93]*See* Rev. Rul. 77-402, 1977-2 C.B. 222 (grantor of a trust treated as realizing gain from reduction in his share of liabilities on deemed transfer of a partnership interest when trust ceased to be a grantor trust). *See also* T.D. 7741, 1981-1 C.B. 430, which states that the regulations promulgated under section 1001 make this clear when in fact they do not.

[94]Section 1445(e)(5).

[95]Section 731(a). For a more detailed discussion on these conflicting theories, see McKee, Nelson, and Whitmire, *Federal Taxation of Partnerships and Partners*, 3d ed. (Warren, Gorham & Lamont 1996, loose-leaf supplemented through 2006), para. 15.05.

[96]*See* Glod, ''United States Estate and Gift Taxation of Nonresident Aliens: Troublesome Situs Issues,'' 51 *Tax Law*. 110 (1997); Hudson, ''Tax Effects of Choice of Entities for Foreign Investment in U.S. Real Estate and U.S. Businesses,'' 4 *BET* (Mar. 4, 2002); State Bar of California, Taxation Section, International Committee, ''Why Section 2104 Must Address When Partnership Interests Owned by Foreign Investors Are (and Are Not) Subject to U.S. Estate Tax'' (2003) (Patrick W. Martin, principal author); Cassell, Karlin, McCaffrey, and Streng, ''U.S. Estate Planning for Nonresident Aliens Who Own Partnership Interests,'' *Tax Notes*, June 16, 2003, p. 1683, *Doc 2003-14517, 2003 TNT 116-36*; additional resources in this area can be found at http://law.karlinks.com/ABA.

[97]*See* Rev. Rul. 91-32, which concludes that a foreign person recognizes taxable gain on the sale of a partnership interest to the extent the gain is attributable to assets used or held for use in a U.S. trade or business. That position, it should be said, is wholly unsupported by authority except when the underlying asset is a U.S. real property interest, and no such authority is cited in the ruling. In fact, if the IRS's position were correct, there would be no need for section 897(g) (enacted in 1980).

[98]*See* discussion accompanying *supra* notes 76 and 77.

[99]*See Estate of Lorraine C. Disbrow v. Commissioner*, T.C. Memo. 2006-34, *Doc 2006-3898, 2006 TNT 40-7*.

may not resolve the underlying estate tax problem because the partnership will have the appearance of being engaged in a trade or business.

b. Step-up. On death of the foreign partner, the basis of any partnership interest held by the decedent will be adjusted to FMV — usually, but not invariably, upward. To achieve a step-up at the partnership level, the partnership should make an election under section 754 to provide a special allocation of basis to the estate and ultimately the successors.

D. Ownership Through a Trust

The trust is a vehicle that can serve a variety of purposes for the purchase of a home. At its simplest, as we have already discussed, a trust structured as a grantor trust can be a tax transparent method of ownership, the principal benefit of which is to avoid probate on the death of the settlor.[100] In this part of the report, we discuss the application of the non-grantor-trust rules.

1. Summary of nongrantor trust rules. The nongrantor trust is another way for a foreign person to hold property. The trust may be foreign or domestic and may be simple or complex. The property originally settled may be the property — generally not preferable — or cash used to purchase the property. As a general rule, a trust is treated as if it were an individual, and therefore a foreign nongrantor trust is treated as a nonresident alien individual.

The table on the following page summarizes the effects of those alternatives.

2. Planning with trusts. A foreign trust is potentially an attractive vehicle for newly acquired residential property. The trust would have to be an irrevocable domestic or foreign trust. To avoid gift tax, the trust should be funded with cash, preferably cash transferred from outside the U.S.[101] As the table indicates, a gift of real property into trust will be subject to gift tax, and the IRS may take the position that a gift of cash that is conditioned on its being used to purchase property already owned by the settlor will be treated as a gift of real property.[102]

Once the property is owned by the trust, the beneficiary who lives in the house rent free or for below-market rent should not have imputed income, nor, in general, will expenditures by the trustees on taxes, insurance, and repairs be treated as distributions to the beneficiary.[103]

Trusts are taxed at rates applicable to individuals, albeit with no progression through the brackets, and are therefore entitled to the preferential rate of 15 percent currently applicable to long-term capital gains.[104] However, if the trust is foreign, a trap lurks for amounts distributed to U.S. beneficiaries from the trust in a year following the year of sale.

The problem may be stated thus: The throwback rules, which were repealed in 1997 for domestic trusts, continue to apply to foreign trusts.[105] Moreover, capital gain of a foreign trust is treated as distributable net income, whether or not the trust distributes it in the year of sale. As a result, any undistributed gain becomes undistributed net income. When a distribution is made out of a foreign trust, the distribution does not retain the character of the gain from which it was derived and is therefore ordinary income to a U.S. beneficiary. It follows that a U.S. beneficiary who receives a distribution made out of gain accumulated from an earlier year may have to pay tax at ordinary income tax rates, comforted only by being allowed to take credit for the long-term capital gains tax previously paid by the trust for the year of sale.[106] Fortunately, this character rule does not apply if the beneficiary is a nonresident alien.[107]

In short, if the beneficiaries of a foreign nongrantor trust are or become U.S. persons, it would generally be advisable for a distribution representing proceeds of sale of the residence to be made to the beneficiaries in the year of sale. That might entail a distribution to all beneficiaries, only to foreign beneficiaries, or to what is commonly referred to as a decanter trust, which is a second trust

(Text continues on p. 881.)

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[100]*See supra* note 42 and accompanying discussion.

[101]Cash in the form of currency notes is treated as tangible personal property; no authority exists on whether cash credited to a bank account should be treated as tangible because it is the equivalent of currency or as intangible because technically an amount credited to a bank account is an (intangible) claim against the bank. The conservative view is that gifts of cash should be structured by wire transfer from, or draft drawn on, a foreign bank account. The ultraconservative view is that the donee (the trust in this case) should receive the transfer or deposit the draft in a non-U.S. account. Whether the ultraconservative view can be easily implemented is open to debate.

[102]The IRS's view is supported by *De Goldschmidt-Rothschild v. Commissioner*, 168 F.2d 975 (2d Cir. 1948) (conversion of domestic stocks and bonds into Treasury notes under a prearranged program or understanding and solely for the purpose of making a tax-exempt gift in trust; held, ineffectual for gift tax purposes). *Compare Davies v. Commissioner*, 40 T.C. 525 (1963) (intrafamily transfer cast in the form of a sale by a nonresident alien of real property situated in the U.S. in return for a note secured by a mortgage, the face amount of which was less than the fair market value of the property with the difference being

(Footnote continued in next column.)

attributable to a gift of cash that was to be used as part of the consideration given at purchase, held, on the facts, the nonresident alien did not make a gift of cash; instead he made a gift of an interest in real property situated in the U.S.; subsequent gifts of cash abroad sufficient to retire the note, made without prearrangement in a later year, were not gifts of property situated in the U.S.).

[103]*H.B. Plant v. Commissioner*, 30 B.T.A. 133 (1934), *aff'd,* 76 F.2d 8 (2d Cir. 1935) (mere right or privilege under the terms of will to occupy the former home of the testator is not income; expenditures on maintenance of the premises, including payment of taxes, also do not represent income distributed or distributable to the beneficiary); *see also Alfred I. duPont Testamentary Trust v. Commissioner*, 66 T.C. 1976, *aff'd per curiam,* 574 F.2d 1332 (5th Cir. 1978).

[104]Section 1(h).

[105]Section 665(c).

[106]*See* sections 665 through 668. For discussion of the throwback rules, see Bittker, *Federal Taxation of Income, Estates and Gifts*, Chapter 83.4, (3d Ed. 2003); Knickerbocker, *Subchapter J — Throwback Rules,* Tax Management Portfolio 856-2d.

[107]This is the effect of section 667(a), even if it does not explicitly so state. The character is preserved in the hands of a foreign beneficiary by section 667(e).

	Foreign Trust		Domestic Trust	
	Simple Trust	**Complex Trust**	**Simple Trust**	**Complex Trust**
Creation of trust with gift of cash used to buy property	Gift of cash by nonresident alien not subject to U.S. gift tax if funded from outside United States — note Service position that cash gift is treated as gift of underlying property if cash required to be used to purchase settlor's property; for this purpose, cash means dollar bills, not necessarily funds in an account[a]			
Creation of trust with gift of tangible property located in the U.S.	Taxable gift; no income tax consequence unless amount of debt assumed or taken subject to trust exceeds grantor's adjusted basis			
Use of property by grantor	No tax consequences to grantor — but note possible effect on application of section 2036 when grantor dies			
Use of property by other beneficiaries	No tax consequences to grantor or other beneficiaries — should not have imputed rent if trust instrument permits free use of property			
Sale of property — FIRPTA withholding	Yes — by buyer[b]		Yes — by trust on distributions out of "U.S. real property interest account"[c]	Yes — by trust on distributions out of "U.S. real property interest account"; note that account is reset to zero at the end of each year, so no withholding on gain accumulated by trust[d]
Sale of property — rate of taxation of gain	Capital gains rates	Capital gains rates, but if distributed to U.S. beneficiary in later year, gain is ordinary (for foreign beneficiary, the character is preserved)[e]	Capital gains rates	Capital gains rates
Sale of property — incidence of taxation of gain	Gain (and credit for tax withheld or paid under FIRPTA) passes through to beneficiary[f]	Gain and credit pass through to beneficiary if distributed in year of sale; otherwise, trust is taxable on gain in year of sale; beneficiary is taxable in year of distribution as ordinary income (U.S. beneficiary) or capital gain (foreign beneficiary) with credit for tax paid; U.S. beneficiary may also pay interest under section 668 to the extent the tax exceeds credit (see discussion below)	Gain passes through to beneficiary[g]	Gain and credit pass through to beneficiary if distributed in year of sale; otherwise, trust is taxable in year of sale; no further tax on beneficiary on distribution in later year[h]
Loss on sale	The trust is treated as an individual, and loss will be allowed only if it is incurred in a trade or business or in a transaction entered into for profit, or if it qualifies as a casualty or theft loss[i]			
Estate tax on death of grantor	Depends on application of section 2036, discussed below			
Generation-skipping tax	Not applicable if the property given or bequeathed to the trust by nonresident alien settlor was not subject to U.S. gift tax or estate tax at the time of the gift or bequest			
Reporting — Trust	Form 1041			
Reporting — Foreign beneficiary	In year of sale, Form 1040NR	In year of required or actual distribution, Form 1040NR	In year of sale, Form 1040NR	Form 1040NR if proceeds distributed in year of sale; no reporting if proceeds distributed in later year in which trust has no DNI

	Foreign Trust		Domestic Trust	
	Simple Trust	**Complex Trust**	**Simple Trust**	**Complex Trust**
Reporting — U.S. beneficiary	In year of sale, Form 1040 and Form 3520	In year of required or actual distribution Form 1040 and Form 3520	Form 1040	Form 1040 if proceeds distributed in year of sale; no reporting if proceeds distributed in later year in which trust has no DNI

[a]Rev. Rul. 55-143.
[b]Section 1445(a).
[c]*See* reg. section 1.1445-5(c)(1)(iii)(A).
[d]Ditto, especially seventh and eighth sentences.
[e]Section 667(e).
[f]Technically, under sections 641, 643, 661, and 662, the gain is taxable to the trust but the trust can deduct the amount distributed, up to the amount of the trust's distributable net income; the gain is treated as distributable net income to the extent distributed; and the beneficiary includes in income the amount distributed up to the amount of the distributable net income.
[g]Ditto.
[h]This assumes that the distribution in the later year does not carry out distributable net income from some other source earned during the year of distribution.
[i]Section 165(c), confirmed, in the case of nonresident alien individuals, by section 897(b).

with different terms and a nonidentical group of beneficiaries that receives distributions in an amount sufficient to zero out undistributed net income. U.S. beneficiaries generally will not participate in the decanter trust while the principal trust has assets. As a result, U.S. beneficiaries will receive either current distributions without an interest charge under the throwback rules or capital distributions.

At the time of the settlor's death, as long as one of the retained interest rules does not apply, there is no transfer of property. Therefore, there should be no estate tax even though trust corpus at the time of death consists of U.S. real property. However, as is always the case when property is held in a trust (other than a retained interest trust), there is no basis step-up because property is not included in the estate.

The question does arise whether the retained interest rule of section 2036(a) might apply to the trust. That section applies if the grantor retained an interest in the trust because of any right to use the residence during his lifetime. To avoid the application of the rule, the settlor must not have a right to trust income or gains and the trust must have an independent trustee with complete discretion over the use of trust assets.[108] This means that the trustee's discretion cannot be subject to any standard that would be enforceable by the settlor and there cannot be a ''wink and a nod'' understanding or other informal arrangement.

Section 2036(a) may come back into play if an informal agreement allows the settlor to control the income. The U.S. tax authorities have become more sophisticated in their understanding of the role played by trust protectors, appointors, and other similar persons.

Another requirement is that creditors of the settlor should not be able to reach trust assets, at least in theory. That may require the trust to be formed in a foreign jurisdiction that allows spendthrift provisions that will protect the settlor or a settlor-beneficiary of a discretionary trust from creditors that arose after the trust was funded (no jurisdiction to our knowledge will protect a trust from the application of fraudulent conveyance or fraudulent transfer laws that can be used to void a gratuitous transfer of assets of the trust as against the claims of creditors in existence at the time of the transfer).[109] Some U.S. states, including Alaska, Delaware, and Nevada, also provide for such trusts,[110] although the practical efficacy of spendthrift provisions to protect a settlor-beneficiary has been questioned in light of federal bankruptcy reforms enacted in 2005.[111]

The message for planners is therefore that the nongrantor trust must be implemented with considerable

[108]*Commissioner v. Irving Trust Co.*, 147 F.2d 946 (2d Cir. 1945), and *Sherman v. Commissioner*, 9 T.C. 594 (1947).

[109]Not all of the traditional offshore jurisdictions have provisions in their laws that protect settlors (as opposed to other beneficiaries). For example, Jersey and Guernsey in the Channel Islands do not, whereas such provisions can be found in the laws of the Bahamas, Barbados, Bermuda, the Cayman Islands, the Cook Islands, and Gibraltar.

[110]Alaska Statutes section 34.40.110; 12 Delaware Laws c. 35, section 3570 et seq.; Nevada Revised Statutes Chapter 166.

[111]Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S. 1402, which added new section 548(e) of Chapter 11 of the U.S. Code. Section 548(e) permits the trustee to avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition if:

> (A) such transfer was made to a self-settled trust or similar device;
> (B) such transfer was by the debtor;
> (C) the debtor is a beneficiary of such trust or similar device; and
> (D) the debtor made such transfer with the actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.

care, and once in place, it must be respected by all concerned, especially the settlor and the trustees.

IV. Foreign Family With U.S. Family Members

Any structure must take account of the possibility that ownership will find its way into the hands of U.S. persons. That happens quite often. Some typical fact patterns include the following:

- A foreign owner buys a home for use by one or more children who are students in the U.S. and who typically are not considered to be residents for income tax purposes during that period. Following college, the students remain in the U.S. and become residents for income tax purposes.
- A foreign executive on a medium-term stay in the U.S. has a child born in the U.S. or marries an American and moves back to his or her home country. The couple has children, who are automatically U.S. citizens even if they are born abroad.
- A foreign individual has children who move to the U.S. for personal or business reasons.
- A beneficiary of a foreign trust moves to the U.S., and the trustees are asked to assist with the purchase of a home for the beneficiary.

In all of those situations, planning has to be reviewed to take account of the use of the home by U.S. citizens or residents and the possibility that such persons might inherit or otherwise acquire an interest in the house.

A. Reconsider Use of Corporations in Planning

A situation the authors have encountered is one in which the foreign owner heeded the all too frequent advice, often given by foreign banks or financial advisers, to purchase the home using an offshore corporation. If by the time of the owner's death one or more of the heirs is a U.S. person, this is the fiscal equivalent of jumping off the Empire State Building and claiming, as one passes the 34th floor, that everything is fine so far. When the owner dies, shares of the corporation indeed pass to his heirs free of estate tax. Unfortunately, the landing is not so soft. The heirs now face a string of tax disadvantages.

First, they are now the owners of a corporation that, so far as the U.S. heirs are concerned, is either a CFC if they are in the majority or a PFIC if they are not or if they are among a class of persons that owns less than a 10 percent interest in the foreign corporation.

Second, if they make personal use of the home, they must continue to deal with imputed rental income issues, which may be worse for U.S. shareholders and their U.S. relatives than for foreign shareholders.

Third, the basis in the stock of the corporation may have been adjusted to fair market value but the basis in the home itself is not adjusted. If the home has increased in value, therefore, gain on sale will include both pre- and postmortem appreciation. Moreover, the gain will be taxed at corporate rates and there will be no section 121 exemption, even if the home becomes the principal residence of the U.S. heir.[112]

It is not in the interest of the U.S. taxpayer for the property to be held by the foreign corporation for any significant length of time following the death of the foreign decedent. Any increase in the value of the property that is reflected in an increase in the value of the shares of the corporation will ultimately be double taxed. If the corporation is a PFIC, that gain may be largely converted to ordinary income.

Assuming the sale takes place soon after death or at least before additional appreciation has occurred in the property, the U.S. shareholder should try to get the foreign corporation liquidated as soon as possible after the sale. There is no benefit to the shareholder having the proceeds locked up in a foreign corporation. Prompt liquidation following the sale will result in a taxable transaction for the corporation and the U.S. shareholder, but the gain at the shareholder level should be low because of the step-up.

The prospect of this catalog of issues should persuade those advising foreign purchasers to think carefully before recommending use of a foreign corporation as the vehicle for purchase. Unfortunately, we have frequently found that advisers don't seriously press their clients to obtain U.S. tax advice in these situations.

B. Trusts Also Require Careful Planning

If a trust is a nongrantor trust during the foreign grantor's life, the retained interest rules can apply to the trust, and if they do, the estate tax will apply to any assets held by the trust. Moreover, the trust will become a nongrantor trust on death of the grantor. That will potentially affect the U.S. beneficiaries of the trust in a number of ways.

First, the simplification of the treatment of complex trusts brought about by the 1997 amendments does not apply to foreign trusts with U.S. beneficiaries.[113] Those beneficiaries remain subject to the throwback rules, which may also apply to domestic trusts that were formerly foreign, and to the interest charge on distributions made out of undistributed net income, which clearly also applies to distributions made by domestic trusts that are former foreign trusts.

Second, the conversion to nongrantor trust status will require the U.S. beneficiaries to deal with the compliance requirements of section 6048(a), including the filing of Form 3520 in any year that the beneficiaries receive a distribution from the trust and the need to obtain information from the foreign trust in the form of a foreign nongrantor trust beneficiary statement.[114]

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[112]The gain should not be subpart F income. Section 952(b) excludes from the definition of subpart F income any income

(Footnote continued in next column.)

that is effectively connected with a U.S. trade or business. It would be helpful if the regulations under section 952(b) clarified that this includes income deemed to be effectively connected under section 897(a). *See* reg. section 1.952-1(b)(2).

[113]*See* section 665(c).

[114]If the U.S. beneficiaries receive a distribution during the lifetime of the grantor while the trust is a grantor trust, compliance requirements regarding Form 3520 apply, but the information reporting is generally viewed as significantly less because no portion of the distribution is taxable to the beneficiary.

A trust cannot, by definition, have distributable net income or undistributed net income before it becomes a nongrantor trust. Because the death of the foreign grantor will definitively cause the trust to become a nongrantor trust, a decision on whether to maintain the trust as a foreign trust is required shortly after the grantor's death.

C. What If the NRA Has Already Died?

Suppose that the adviser is consulted in a situation in which the nonresident alien owner of the home has already died and the heirs include U.S. individuals. What can be done?

1. Foreign corporation structure. As we have seen, the foreign corporation, whether owned directly or through a trust, may, depending on the percentage of U.S. ownership, have become a CFC or a PFIC.

If U.S. persons are the only beneficiaries, one step would be to consider domestication of the corporation. There are a variety of ways to domesticate a foreign corporation, all of which are treated, for U.S. tax purposes in a similar fashion and should be tax free[115] except for any section 367(b) toll charge. Even if the foreign corporation has E&P, the inclusion at the time of repatriation is keyed to the earnings accumulated during the taxpayer's holding period.[116] That period begins at the time of death of the grantor.

The first step in the plan is for the trust to distribute the shares of the corporation to the U.S. beneficiaries. The second step is to take advantage of Delaware's favorable continuation statute allowing foreign corporations to domesticate into Delaware relatively easily.[117] Following the domestication, the next step would be the making of an S election. The S election can be made only if the corporation has no foreign shareholders, no corporate shareholders,[118] only one class of shares, and is held by not more than 100 shareholders.[119] Assuming that to be the case as a result of the distribution in step 1, the S election offers the U.S. beneficiaries the ability to freeze the amount of gain that is potentially taxable at both the corporate and shareholder levels. If the shareholders can hold out for 10 years, the corporate-level tax would be eliminated altogether.[120] If they wish to cause the S corporation to sell the house, it may be possible to use one or more section 1031 exchanges to defer taxation of the gain until the expiration of the 10 years. The property must be held for investment or as part of a trade or business before the exchange is undertaken.

The domestication/S election strategy addresses double taxation and securing the benefit of individual rates of tax on capital gains. It does not work if any foreign persons continue to have an interest in the corporation, and it does not solve the imputed rental income problem. In other words, the potential to domesticate the foreign corporation and make an S election is a partial escape route from an unfavorable structure and not a justification for using a foreign corporation structure to begin with.

As an alternative to the domestication/S election strategy, it is worth considering the liquidation of the foreign corporation if not much taxable appreciation has occurred since the property was acquired.

2. Domestic corporation structure. Ownership through a domestic corporation will lead to estate tax on the death of the foreign shareholder, corporate-level capital gains tax to extract property, and shareholder-level tax on liquidation, although because of a step-up in the corporate stock, the shareholder gain may be limited if the sale occurs soon after the death.

As in the case of a newly domesticated foreign corporation, it is worth considering the making of an S election, followed by a 10-year delay before sale to avoid two levels of tax and, in the meantime, the use of a section 1031 exchange.

V. Potential Impact of Stop Tax Haven Abuse Act

Earlier this year a bill titled the Stop Tax Haven Abuse Act (STHAA) was introduced in the Senate and is now under consideration by the Senate Finance Committee.[121] We cannot be sure if the STHAA will become law, and we do not propose to provide a full description or detailed analysis of the impact of the STHAA. But the prospects for enactment are not negligible and some of the provisions of the STHAA should be considered in planning for the acquisition of a home.

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[115]Reg. section 1.897-5(c)(4) and Notice 2006-46, 2006-24 IRB 1044, *Doc 2006-9901, 2006 TNT 100-9*. Domestication can be accomplished, if permitted by foreign law, through the use of a continuation statute in the country of incorporation and a U.S. state, for example, Delaware General Corporation Law, § 388. Alternatively, domestication can be accomplished by dropping the property into a new domestic corporation or dropping the foreign corporation into a new domestic corporation and, in either case, having the foreign corporation liquidate. All of those methods are essentially treated by the IRS as C or D reorganizations. It should be noted that the domestication would not be adversely affected by the antiavoidance rule of reg. section 1.897-5(c)(4), as amended by Notice 89-85, 1989-2 C.B. 403, and Notice 2006-46, *supra*, because Notice 89-85 requires only that the foreign corporation pay an amount equal to any taxes that section 897 would have imposed on all persons who had disposed of interests in the foreign corporation. No tax would have been imposed on the transfer of the shares of the foreign corporation on the death of the nonresident alien, even though the transfer results in a step-up in basis.

[116]Reg. section 1.367(b)-2(d)(3).

[117]Delaware General Corporation Law, 8 Del. Code § 388. Other states permit domestication or continuation, but the Delaware procedure is the authors' preferred jurisdiction for this exercise.

[118]If the sole shareholder of a corporation is itself an S corporation, the lower-tier corporation can make an election to be a qualified S corporation subsidiary.

[119]Section 1361(b).

[120]*See* section 1374.

[121]The Stop Tax Haven Abuse Act, S. 681, was introduced in the Senate on Feb. 17, 2007, by Sens. Carl Levin, D-Mich., Norm Coleman, R-Minn., and Barack Obama, D-Ill. Identical legislation was introduced in the House on May 2, 2007, by Reps. Lloyd Doggett, D-Texas, Rahm Emanuel, D-Ill., Sander Levin, D-Mich., and Rosa DeLauro, D-Conn. It may be noted that Sen. Levin and Rep. Levin are brothers.

One of the most significant concerns raised by the STHAA is its continuation of the assumption that permeates the U.S. treatment of foreign trusts and corporations in which a U.S. person has an interest that such entities are essentially tax avoidance vehicles. The promoters of the legislation never acknowledge that foreign corporations and trusts may come into existence long before there was any actual or anticipated contact between the individual shareholders and beneficiaries and the U.S. As a result, the STHAA, if enacted, will reinforce the hostile and inflexible treatment of immigrants by the U.S. tax system.

A. Trust Loans Treated as Distributions

The STHAA would amend section 643(i), which was first enacted in 1996. With exceptions, section 643(i) treats a loan by a foreign trust of cash or marketable securities to a U.S. beneficiary as a distribution of the amount of the loan. Section 643(i) went well beyond the most aggressive possible IRS argument that could be made without legislation, which would be that the loan of property gives rise to income equal to the value of the temporary use of the property between the time of the loan and the time the loan is repaid (or the property is returned). Unless a regulatory exception applies, section 643(i) treats the entire amount of the loan as a distribution and disregards the obligation to repay the loan.

It is reasonably clear that the current reach of section 643(i) is limited to cash and marketable securities, and the drafters of the STHAA more or less acknowledged this in the proposed amendment to that section. Section 105(c) of the STHAA would expand the reach of the section by applying it to ''other property, including real estate, marketable securities, artwork, jewelry, and other personal property.'' Section 105(c) does not have a stated effective date, which means that it would take effect on the date of enactment.

B. U.S. Transferees Treated as Beneficiaries

Another notable feature of the STHAA that might be of concern is the insertion by section 105(b) of a new section 679(c) that would treat as a beneficiary any U.S. person who receives a transfer of property from a foreign trust, or the use of that property, whether or not such person is named in the trust as a beneficiary. An exception is made for property transferred in exchange for payment of FMV by the U.S. person.

C. Other Notable Provisions

Other features of the STHAA include proposed intensified reporting of transactions involving a long list of ''offshore secrecy jurisdictions,'' draconian presumptions that anything of value received in transactions between U.S. persons and non-publicly-traded entities in those jurisdictions is income and that any payment by U.S. persons to those jurisdictions represents previously unreported income, as well as presumptions concerning control by U.S. persons of entities in offshore secrecy jurisdictions with whom they enter into transactions.

VI. A Litany of Practical Issues

While the big four tax issues — capital gains treatment, planning for gift and estate taxes, imputation of rental income, and basis step-up on death — dominate tax planning, the purchase of a home by a foreign person potentially involves a number of practical tax compliance and nontax issues. This part of the report surveys these issues.

A. Tax Compliance

1. Obtaining TINs. Whatever structure is used, at some point the taxpayers involved will have to acquire TINs. The IRS makes this relatively easy for corporate and partnership entities but miserably difficult for individuals. Armed with no more than a properly completed Form SS-4, the representatives of corporations and partnerships can obtain employer identification numbers over the telephone and, in the case of domestic entities, online.[122]

For some reason, applying for an EIN for a trust can be more difficult because of Form SS-4's requirement to provide a TIN for the grantor, something that may be impossible if the grantor is no longer alive or unwilling to obtain the number, as can occur in the case of a nongrantor trust. Not all IRS representatives will accept that no such number will be available for a foreign grantor, even a deceased one.

Applying for individual individual taxpayer numbers (ITINs) is a much different matter. The IRS appears to require the originals of identification documents or notarized copies. That means either that the individual has to come to the U.S. to have the copies notarized by a U.S. notary public or visit a U.S. embassy or consulate. In countries that are members of the Hague Convention on the Abolition of the Legalization of Foreign Public Documents, a local notary can be used, provided an apostille is attached to the document. The apostille in effect certifies that the notary is a true notary or commissioner of oaths under the law of the jurisdiction that granted the power. Nonetheless, not all revenue representatives will easily accept a foreign notary, even when an apostille is attached. If the individual does not live near a U.S. consulate or in a Hague Convention country, the process can be a challenge.

If it can wait, there is another practical method of obtaining an ITIN, which is to file a tax return or information without a number. In its desire to process the return, the IRS will generally assign a number to the individual in question without all of the formalities.

2. Record keeping and tax returns. If not enamored of extensive record-keeping requirements, U.S. taxpayers are at least accustomed to them. Foreign taxpayers need to become familiar with the records they must maintain, especially long-term records relating to basis in property and the accumulations of corporations and trusts. The preparation of a pro forma tax return is often a prudent exercise as part of the record-keeping function. The records need to be maintained in such a way that any

[122]Applicants can call (800) 829-4933 for domestic corporations and (215) 516-6999 for foreign corporations. Online applications can be made at https://sa2.www4.irs.gov/sa_vign/newFormSS4.do (reviewed July 7, 2007). The form can also be faxed to the appropriate fax number currently listed at http://www.irs.gov/file/report/0,,id=111138,00.html (reviewed July 7, 2007).

required foreign currency translations can be accounted for. As noted earlier, it is important for any potential foreign taxpayer to keep records to show that it has no unsatisfied withholding liability.

Foreign taxpayers then have to make arrangements to file all necessary tax returns. That routine, if not necessarily a welcome chore for U.S. taxpayers, can be quite burdensome for foreign persons.

B. Establishing and Managing Entities

The average U.S. home buyer does not have to establish an entity to buy a house. At most, the buyer will establish a living trust. For foreign home buyers, the establishment of trusts, partnerships, LLCs, or corporations involves a significant and sometimes unanticipated level of expense and complexity.

One of the most significant of these complexities involves opening bank accounts. In the wake of the so-called USA PATRIOT Act, that has become a real challenge. That's because in many cases, local banks will not open accounts for nonresident individuals and they do not want to open accounts for business entities, especially foreign entities that are not actually engaged in business, as will be the case when the only activity is acquiring and maintaining a residence.

Banks often want the entities to qualify to do business in the state where the entity owns the residence. That qualification may be necessary,[123] but in a check-the-box world, the entity that must qualify may not be the entity that needs the bank account. For example, if a trust owns a property through an entity that is disregarded under the check-the-box regulations, the trust is the taxpayer but the disregarded entity may need to qualify.

Entities must be respected if they are to serve their intended purpose. That is true of all structures, but the fact that the underlying asset is dedicated to personal use tends to increase the likelihood that the foreign owner will pay less than the full measure of attention required to behave in accordance with the chosen structure. For example, if a corporation is used, a lease should be entered into; a fair rent should be determined; the rent should be paid on time and in accordance with the lease and expenses, such as property taxes, insurance, and repairs; and maintenance costs should be paid by the persons legally responsible under the terms of the lease. When possible, checks drawn on corporate bank accounts should be used to pay operating expenses. That is over and above the usual requirements to maintain the corporation in good standing.

Finally, the home itself must be maintained. Taxes must be paid, the property must be insured, repairs must be made, and the house must be cleaned and the surrounding grounds tended. Neighbors may have to be accommodated, and homeowners and condominium associations must be heeded and have their dues paid. The usual difficulties for any owner in maintaining a vacation home in the U.S. are magnified by the distance usually involved for foreign owners; and occupation of the home by members of the younger generation adds a whole new layer of risk and worry unrelated to the tax and other issues discussed in this report. Foreign persons should not purchase homes without making a plan for all of these considerations.

If real compliance requirements are not enough, scams have been reported for companies that are apparently owned by persons having Islamic names. Bogus USA PATRIOT Act bank reporting forms are now being faxed to these companies with officious cover letters printed on apparent Treasury Department letterhead. The form seeks bank account information and statements signed under penalties of perjury by all parties with signatory authority over the account. Presumably, the scam artist will use scanned copies of the signatures to sign bogus checks drawn on real accounts.

C. Home Country Taxation

Planning needs to take account of home country tax considerations and the potential application of U.S. income treaties and estate and gift tax treaties. The interaction of foreign and U.S. taxation adds a significant additional layer of complexity that requires coordination with the foreign owner's home country advisers.

Conclusion

We began this report with a visit from our real estate partner, the lawyer with unverified faith in our magical powers to accomplish a simple set of objectives for a foreign client interested in buying a home in the U.S. As we have made clear from the beginning, there is no single plan that meets all of the major objectives — our wand can make many, but not all, of the obstacles disappear, and the challenge is to inform our clients of those obstacles and help them choose which they are prepared to live with and which must be made to go away. We have had clients who told us not to worry about capital gains because they anticipated that the property would never be sold and clients who were completely unconcerned about the estate tax and very anxious to avoid tax on sale. For some clients, privacy trumps all tax concerns. There is, in short, no preeminent plan.

[123]California, for example, considers a corporation or LLC to be doing business in California merely by virtue of owning California real property.