taxnotes® international

Volume 99, Number 7 ■ August 17, 2020

Home Thoughts From Abroad: When Foreigners Purchase U.S. Homes

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

Reprinted from *Tax Notes International*, August 17, 2020, p. 857

Home Thoughts From Abroad: When Foreigners Purchase U.S. Homes

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

Michael J.A. Karlin is with Karlin & Peebles LLP in Los Angeles, and Stanley C. Ruchelman is with the Ruchelman Law Firm in New York.

In this article, the authors update their 2007 examination of the issues faced by foreign owners of U.S. homes held primarily for personal use by the owners and their families.

Table of Contents

I. 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; allow his wife and children (some of whom are U.S. residents) to use the house; 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?

II. 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 United States for a nonresident alien client.[1]

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 homeownership, this investment benefits from extraordinary tax advantages. We are not required to report as income the economic benefit derived from

[1]This article is a comprehensive update of Michael J.A. Karlin and Stanley C. Ruchelman, "Home Thoughts From Abroad: Foreign Purchases of U.S. Homes," *Tax Notes Int'l*, Nov. 26, 2007, p. 877, whose genesis was a panel presentation at the 2006 autumn meeting of the American Bar Association Section of Taxation in Denver. The title of this article is taken from the title of a poem by Robert Browning. *See* Daniel Karlin (ed.), *Robert Browning: Selected Poems* (1989).

occupation of the property rent free, nor, as a practical matter, do we report as a gift the rent-free use of our property by friends and family members, even those whom we are not obligated to support.[2] We are allowed to deduct interest on mortgage loans (up to $1 million in some circumstances, but capped at $750,000 through 2025 in many instances).[3] We can deduct the cost of state and local property taxes.[4] If the home qualifies, deductions are available for home offices. We can exempt up to $250,000 (or $500,000 if filing jointly) of gain from the sale of our principal residence.[5] Until 2022, tax credits subsidize the installation of energy-efficient devices.[6] 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[7] — as well as 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.[8] For most Americans, the estate tax is not an issue, and their mortgage is deductible in full from the value of their estate.[9] In short, homeownership is a deal that fewer and fewer adult Americans can resist, and there are no obvious fiscal drawbacks — indeed, no real drawbacks at all.

Foreign persons buy homes in the United States 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 United States, 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 NRAs (such as students), U.S. residents, or even U.S. citizens. They may also buy permanent homes for their own use in preparation for moving to the United States, or they may remain the owners of homes they lived in before leaving the United States and ceasing to be U.S. residents. In some cases, a home 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 article, 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.

III. 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

[2] *See infra* note 45 and accompanying text.

[3] Section 163(h)(3). For tax years beginning after December 31, 2017, and before January 1, 2026, section 163(h)(3)(F), enacted by the so-called Tax Cuts and Jobs Act (hereinafter "the 2017 act"), provides that (1) the limitation is $750,000 instead of $1 million unless the indebtedness was incurred on or before December 15, 2017, or before April 1, 2018, if there was a binding contract to purchase the residence in existence on or before December 15, 2017, that closed before April 1, 2018; and (2) eliminates any deduction for interest on home equity indebtedness that existed in tax years before 2018. The caps on the deduction were offset to some extent by expanding the amounts in each tax bracket and thus subjecting additional income to lower rates of tax.

[4] Section 164 (regular income tax) taxes are not deductible in computing income subject to the alternative minimum tax. Section 56(b)(1)(A)(ii). In tax years beginning after December 31, 2017, and before January 1, 2026, the aggregate deduction for state income and property taxes is capped at $10,000 ($5,000 for a married individual filing separately) under section 164(b)(6).

[5] Section 121.

[6] Section 25D. The 2017 act reduced the rate of subsidy for property placed in service from 2016 on and eliminates it altogether for property placed in service after 2021.

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

[8] Under section 280A(g), if a home is used during the tax year by the taxpayer as a residence and the dwelling unit is actually rented for less than 15 days during the tax year, the income derived from that 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 that 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.

[9] Congress has made changes to exemption levels over the years. The exemption level is now $10 million per person, adjusted for inflation, so for individuals dying in 2020, the level is $11.58 million. For individuals dying after 2026, the exemption level is scheduled to revert to $5 million per person adjusted for inflation since 2010 — the amount that has been in effect since 2010. And if the first spouse to die cannot use the full exemption, the unused portion inures to the benefit of the estate of the surviving spouse as a deceased spousal unused exclusion amount. *See* section 2010(c).

by sale or exchange or by gift or bequest. In this section, we provide an overview of these issues as well as privacy considerations.

A. Big-Picture Issues

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

1. 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;[10]
2. avoiding paying 30 percent withholding tax on the use value of the property (or on actual rent paid to avoid uncertainties concerning imputed rent and the bona fides of a cross-border structure);
3. avoiding the federal estate tax (and state taxes on inheritance) should the owner die while still owning the property, and still allowing the heir to obtain a step-up in basis; and
4. minimizing compliance and contact with the U.S. tax system — many foreigners have a deep-rooted aversion to having to file personal income tax returns in the United States or having an individual taxpayer identification number.

Other issues may also arise, such as a desire to maintain privacy; the need to take account of the income, capital gains, gift, and succession taxes in the home country; and the need to coordinate succession planning for the home with the planning for other assets. The client's particular situation also must be considered, such as whether family members and presumptive heirs are U.S. citizens or residents, and whether the client may wish to move to the United States permanently or temporarily.

It will be readily apparent that accomplishing all these objectives is extremely difficult. Every structure, from direct ownership to a multitiered 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 concerns and offer a plan principally addressing them. In this context, the prioritization of goals is critical.

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

As with 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 15 percent of the purchase price (or some lesser amount if the seller produces a withholding certificate from the IRS).[11] 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, one or more attorneys, a lender, or other real estate professionals, these requirements, enacted in 1984, will likely be known and implemented. However, the parties have to be concerned about marginally competent real estate industry participants when both the seller and the purchaser are not U.S. persons.

For example, one of us has more than once encountered an escrow company that withholds tax and then sends the tax to the government without the FIRPTA withholding tax forms or without properly completing them. This makes it difficult to ensure that the IRS associates the seller with the amount withheld. The problem is compounded if the buyer does not have a U.S. TIN to affix to Form 8288, "U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests."[12] Without a proper TIN, the IRS may be unable to track collection of the withholding tax, which can be problematic at the time of a future sale, as discussed later.

[10] The corporate tax rate cuts enacted by the 2017 act have scrambled planning for this tax.

[11] Section 1445(a).

[12] *See* instructions to line 1 of Form 8288 for 2019; *see also* IRS, "ITIN Guidance for Foreign Property Buyers/Sellers" (Mar. 16, 2020).

The buyer, too, should be concerned because she is the person legally responsible for compliance with the withholding rules. That responsibility cannot be avoided by leaving everything to an escrow agent or attorney. Thus, the buyer will be liable for late payment (or, in an extreme case, complete nonpayment) of the withheld tax and will be the party that must deal with an angry seller who is unable to get credit for withheld tax.

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. This is particularly true since 2015, when the withholding rate increased to 15 percent of the gross proceeds.[13] This calculation requires the seller not only to compute FIRPTA gain but also to establish that he has no unsatisfied withholding liability based on compliance with section 1445 when he purchased the property.[14] All too often, we have been asked to assist foreign sellers who couldn't locate their records concerning the purchase of the real estate or locate the attorney who represented them in that transaction, and therefore could not readily 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 must also be alert to the financing of the price of a home being acquired in anticipation of a move to the United States. 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 $750,000 of their loan amount as qualified residence indebtedness.[15] However, the buyers will not be able to do so unless the loan was obtained by them and secured by the home within 90 days of the date of purchase (or was obtained to refinance such a loan).[16]

3. Tax Residence

The ownership or availability of a home in the United States does not alone make a foreign person a U.S. resident for tax purposes. Nevertheless, that ownership can affect application of the rules for determining whether an alien is a resident alien — that is, under the closer connection test or a treaty's tiebreaker provision for dual-resident individuals.[17]

First, regardless of whether 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.[18] This test applies to individuals present in the United States 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 United States 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.

Second, 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 United States and another country under the respective internal laws of the two countries.[19]

---

[13] Protecting Americans From Tax Hikes (PATH) Act of 2015, Division Q, section 324. For 15 percent of the proceeds to be large enough to be less than a 20 percent tax on capital gains, a property would had to have quadrupled in value. For example, a property sold for $1 million would have to be generating a $750,000 gain. The level of appreciation required for gain taxed at the corporate rate of 21 percent would be similar.

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

[15] *See supra* note 3 regarding changes in section 163(h) made by the 2017 act.

[16] For the 90-day rule, see Notice 88-74, 1988-2 C.B. 385, applying the tracing rules of reg. section 1.163-8T. Interest on a secured home equity loan of up to $100,000 may also be deducted by a U.S. resident irrespective of when the loan was obtained.

[17] Section 7701(b)(3)(B).

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

[19] In most U.S. income tax treaties, the dual-residence tiebreaker is set out in article 4. *See* 2006 U.S. Model Tax Convention on Income, article 4(3).

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 with nonimmigrant student (F or J) status. Buyers should be warned that making a gift of real property located in the United States may subject them to gift tax (regardless of whether 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.[20] How the funds transfers are handled can make a significant difference.

5. Estate Tax Planning

Planning before the acquisition of the home also often provides the best opportunity to avoid a future estate tax on the home, as described later.[21]

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.

NRAs 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. This 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 (DNI). 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 raise actual or imputed rental income 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 rent should be charged comes into play. For a home owned by a corporation, personal use by a director or officer will likely attract imputed rental income for the corporation if actual rent is not paid at a fair market rate. It is less certain that rental income would be imputed to a shareholder who did not have an executive role when the corporation conducted an ongoing business unrelated to the real estate. When the home is owned by a partnership, the picture is cloudier, but there is definitely 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 a domestic trust does not give rise to imputed income to the trust, nor is it even treated as a distribution to the beneficiaries.[22] The same is true for a foreign grantor trust and even a foreign non-grantor trust, as long as the user is not a U.S. person.[23]

3. Tax Compliance

If a home produces no income, there is no need for an NRA owner to file a tax return, except for the year of sale. Because the deductions (mortgage interest, property taxes, and so forth) associated with a home held by an individual for personal or family use are not available to the NRA, there is no reason to file a return just to

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

[21] *See infra* Section IV.A.3.

[22] *Plant v. Commissioner*, 30 B.T.A. 133 (1934), *aff'd*, 76 F.2d 8 (2d Cir. 1935), *acq.*, 1976-2 C.B. 2; and *Alfred I. duPont Testamentary Trust v. Commissioner*, 66 T.C. 761 (1976), *aff'd*, 574 F.2d 1332 (5th Cir. 1978). *See* dicta in *Dickman v. Commissioner*, 465 U.S. 330 (1984).

[23] *See* the table in Section IV.D.1 and the discussion in Section V.B.

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 is required to file a U.S. return unless it is 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 rental income issue may also cause compliance requirements.

Finally, U.S. users of a foreign-owned home may have various compliance issues.[24]

D. Disposition

1. Income Tax

Under FIRPTA, foreign persons are subject to tax on gains from the sale or exchange of a U.S. real property interest (USRPI), which fairly obviously includes real property used as a home, as well as associated personal property.[25]

An NRA can qualify for the exclusion under section 121 for $250,000 on the sale of a principal residence, assuming the alien meets the general requirements for the exclusion. The IRS appears to have accepted this.[26] Of course, if the alien is using the home as a principal residence, he is often likely to be a resident alien under the substantial presence test, but this is not invariably the case. For example, an alien may be a former resident who sold the home after ceasing to be a resident.[27] 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 require 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 NRAs generally cannot file joint returns.[28] Therefore, a couple seeking to maximize the exclusion would need to be joint owners of the house, and each spouse would need to qualify separately for the $250,000 exclusion — that is, each would had to have owned their joint interest in the home for at least two years and have lived there as their primary residence for at least two years. If these requirements could not be met, the couple should sell the home in a year when both are still resident aliens.

Withholding at 15 percent of the amount realized will be required on the sale if the seller's interest is held directly or by a foreign corporation or foreign partnership.[29] If the buyer will use the property as a principal residence, withholding is not required if the price is $300,000 or less. If the seller is a domestic partnership or trust, the purchaser has no withholding obligation under FIRPTA; instead, the domestic partnership or trust must withhold U.S. tax at 15 percent or 35 percent of the foreign partner's or beneficiary's share of the gain.[30]

[24] *See infra* Section V.

[25] Section 897(a).

[26] *See* IRS Publication 519, "U.S. Tax Guide for Aliens, 2019," ch. 3 (Mar. 4, 2020). 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.

[27] Section 7701(b)(2)(B). Bear in mind that a former resident who was a long-term permanent resident for purposes of the expatriation rules of section 877A may be treated as having sold the home for fair market value on the day before the date of expatriation, and there is some doubt whether the section 121 exemption applies to the resulting gain. However, section 121 could apply to gain on post-expatriation appreciation, assuming the former resident sells the property no more than three years after it ceased to be the principal residence (which, depending on the facts, is not automatically the date tax residence ended). If the home was acquired before the establishment of tax residence in the United States, the cost basis in the property is not less than its FMV on the residency starting date. *See* section 877A(h)(2).

[28] *But see* section 6013(g), which permits the filing of a joint return by a couple when one of the spouses is a U.S. citizen or resident alien and the other is an NRA, if the NRA agrees to be treated as a resident alien for all purposes and to waive treaty benefits.

[29] Section 1445(a).

[30] Section 1445(e)(1) and reg. section 1.1445-5(c). *See infra* text accompanying notes 129 and 130.

States may also require withholding when a nonresident individual or entity sells real property situated in the state.[31]

A section 1031 exchange generally is not an option for property held for personal use. But one can 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. Remember, however, that the property would have to be exchanged for other real property situated in the United States because foreign and U.S. real property are not considered to be of like kind.[32]

2. Gift Tax

The gift by an NRA[33] of real estate located in the United States is subject to gift tax at the same rates as apply to a gift by a U.S. citizen or resident alien, but without the unified credit that would shelter up to $11.58 million in lifetime gifts.[34] 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 it to a domestic corporation in a section 351 tax-free incorporation or in a section 721 transfer to a partnership. If at a future point the original transfer is "old and cold," a gift of the stock or partnership interest could be made without triggering gift tax. In comparison, a transfer to a foreign corporation would require the recognition of any appreciation in the value of the property, unless the corporation is eligible to make an election under section 897(i) to be treated as a domestic corporation for FIRPTA purposes.

We describe later the effect of a gift of property subject to a debt secured by a mortgage on the property.

3. Estate Tax

The taxable estate of an NRA is subject to the estate tax.[35] The rates again are the same as for residents but, subject to some limited exceptions for decedents who were domiciled in treaty countries, the unified credit (which in 2020 will reach an exemption equivalent of $11.58 million) is also unavailable.[36] Instead, the credit available to NRAs is equivalent to an exemption of just $60,000, an amount that has not increased for decades.

The taxable estate of an NRA is limited to property situated in the United States.[37] Real property held directly is situated in the United States, as is stock of a domestic corporation.[38] Tangible property located at the home is also part of the taxable estate; however, there is a limited exception for artwork, which applies only to works on loan for purposes of exhibition at a public gallery or museum or in transit to or from the exhibition in accordance with the loan.[39] Stock of a foreign corporation is situated outside the United States even if its only asset is U.S. real property. The position with partnership interests is unclear, and is discussed in more detail later in the 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

---

[31] *E.g.*, Cal. Rev. & Tax Code sections 18662 and 18668 (California even requires withholding on sales by California-resident individuals); Colo. Rev. Stat. section 39-22-604.5; Md. Code Ann. Tax-Gen. section 10-912; N.Y. Tax Law section 663; and S.C. Code Ann. section 12-8-580. The scope of withholding, rates, filing procedures, and the availability of refunds varies considerably.

[32] Section 1031(h)(1), enacted by the Revenue Reconciliation Act of 1989. 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 United States.

[33] Note that the definition of an NRA for purposes of subtitle B of the code, dealing with estate, gift, and generation-skipping transfer 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 United States. Reg. section 20.0-1(b)(1) provides: "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."

[34] Interspousal gifts to an NRA 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). The $100,000 has been inflation-adjusted since 1997, and for 2020 is $157,000. Rev. Proc. 2019-44, 2019-47 IRB 1093, section 3.43(2).

[35] Sections 2101 and 2102.

[36] Rev. Proc. 2019-44, section 3.41.

[37] Section 2106.

[38] Section 2104(a).

[39] Section 2105(c).

multiplying the worldwide liabilities by a ratio in which U.S.-situated assets comprise the numerator and the worldwide assets comprise the denominator.[40] Under this fungibility rule, this treatment applies even to a note secured by a mortgage or deed of trust on U.S. real property.[41] For a nonrecourse debt, however, the Tax Court has held, with IRS acquiescence, that only the value of the equity of redemption is includable. For this reason, if an NRA purchases a home with a mortgage, it is desirable that the mortgage be nonrecourse.[42] The Tax Court has held that a loan will be treated as recourse despite state procedural rules that have the practical (even quasi-universal) effect of making the loan nonrecourse.[43]

E. Privacy

1. Ownership of Property

Legal title to real estate is generally a matter of public record in the United States. 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 three sets of rules that may be relevant to homebuyers. The first is the International Investment and Trade in Services Survey Act, administered by the Commerce Department's Bureau of Economic Analysis.[44] The foreign direct investment rules do not require disclosure to the government of the ultimate beneficial owners of "business enterprises" engaged in foreign investment, and in any event the information is not public and may be used by the government only for statistical purposes. The Bureau of Economic Analysis requires a survey to be completed for any investment if the total assets of a newly acquired or newly established entity are more than $3 million, or the transaction involves the acquisition of 200 or more acres of U.S. land. The bureau 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 second set of rules is under the Agricultural Foreign Investment Disclosure Act, administered by the Agriculture Department's Farm Services Agency.[45] The agricultural foreign investment rules would be relevant to a foreign homebuyer who purchased a farm or ranch. These 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.

A third requirement arises under the Bank Secrecy Act. Under the act, Treasury's Financial Crimes Enforcement Network — the same agency that together with the IRS enforces foreign financial account reporting — has issued a series of geographic targeting orders under which U.S. title insurance companies must identify the natural persons behind shell companies used to pay for high-end residential real estate in seven metropolitan areas, when no bank financing or similar form of external financing is involved. The latest geographic targeting order does not include a minimum purchase price, as had previously been the case, with amounts varying according to

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

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

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

[43] A few state laws provide that a mortgage secured by an owner-occupied residence is nonrecourse. *See* Cal. Civ. Proc. Code section 580b. *See Estate of Fung v. Commissioner*, 117 T.C. 247 (2001). 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 be treated as nonrecourse for estate tax purposes even if the lender would be most likely to elect power of sale foreclosure.

[44] International Investment and Trade in Services Survey Act, 22 U.S.C. ch. 46, sections 3101-3108; and regulations at 15 C.F.R. pt. 801.

[45] Agricultural Foreign Investment Disclosure Act, 7 U.S.C. ch. 66, sections 3501-3508; and regulations at 7 C.F.R. pt. 781.

location.[46] FinCEN generally does not share this information with other government agencies, but there are law enforcement circumstances in which it could do so.

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 United States. The names of trustees may appear on real estate records, and 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. For 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. For limited partnerships, public registration is required, but only the name of the general partner needs to appear in the public records. By contrast, for a general partnership, registration is not technically required but may be necessary as a practical matter, in which case at least one of the partners' names 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 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 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 vis-à-vis the tax authorities. 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 — or may require planning to avoid or mitigate double taxation.

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 completed 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," or answered question 5 of Schedule K of Form 1120 or question V of Form 1120-F likely has come across some disclosure requirements.

IV. Structuring Alternatives

In this section, we consider 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 article is not intended to be a detailed review of issues common to all foreign investment in U.S. real estate. We mention 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 United States is to purchase it outright. This approach has the virtue of (comparative) simplicity. It is easy to understand. It avoids the cost of establishing and maintaining a foreign blocker corporation. It eliminates imputed rental

[46] FinCEN, "Geographic Targeting Order" (Nov. 8, 2019). The areas covered are (1) the Texas counties of Bexar (San Antonio), Dallas, and Tarrant (Fort Worth); (2) the Florida counties of Broward, Miami-Dade, and Palm Beach; (3) the New York City boroughs of the Bronx, Brooklyn, Manhattan, Queens, and Staten Island; (4) the California counties of Los Angeles, San Diego, San Francisco, San Mateo, and Santa Clara; (5) the city and county of Honolulu in Hawaii; (6) the Nevada county of Clark (Las Vegas); (7) the Washington county of King (Seattle); (8) the Massachusetts counties of Suffolk and Middlesex (Boston); and (9) the Illinois county of Cook (Chicago).

income issues.[47] 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 upon the owner's death may be eliminated because 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 results of direct ownership but not necessarily the nontax results. 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.[48] Also, the funding of the LLC by the member is a reportable event on a pro forma Form 1120, "U.S. Corporation Income Tax Return," that includes Form 5472.[49] To file the Form 5472, a TIN must be obtained from the IRS, and to obtain the number, information concerning the responsible person must be provided. The responsible party is the person who ultimately owns or controls the entity or who exercises ultimate effective control over it. The person should have a level of control over, or entitlement to, the funds or assets in the entity that, as a practical matter, enables the person, directly or indirectly, to control, manage, or direct the entity and the disposition of its funds and assets.[50]

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,[51] and those like France that will conform their treatment of the LLC to the U.S. treatment.[52] Further, an interest in an LLC is personal property,[53] 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. Although there are advantages and disadvantages to partnership classification, as discussed later, these should not 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 for couples married under community property laws; in that case, the IRS

[47] 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 was warned off this area by the Supreme Court in *Dickman*, 465 U.S. at 341: "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."

[48] N.Y. Tax Law section 1409; and N.Y. City Admin. Code section 11-2105.

[49] Reg. sections 301.7701-2(c)(2) and 301.6038A-1(c)(1).

[50] Instructions for Form SS-4, "Application for Employer Identification Number (EIN)," line 7a-7b (Dec. 2019).

[51] *See* HM Revenue & Customs, "Double Taxation Relief Manual," DT 19853 (May 18, 2020). HMRC does not willingly give credit to a U.K. resident individual who is a member of an LLC for U.S. tax paid. This issue was successfully litigated by the taxpayer in *Anson v. HMRC*, [2015] UKSC 44. However, HMRC responded by stating that it "has after careful consideration concluded that the decision is specific to the facts found in the case." One has to wonder how the U.K. Supreme Court, which like the U.S. Supreme Court generally only takes on cases of broad interest, will respond to this peremptory statement, which is completely unreasoned. It is also somewhat mysterious why HMRC insists on its hard line, which forces unwilling taxpayers to treat U.S. LLCs as hybrid entities, to which tax authorities are normally quite hostile.

[52] Before its elimination by the January 2009 protocol, paragraph 2(b)(iv) of article 4 (Resident) of the France-U.S. income tax treaty treated 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. Treasury's 1994 technical explanation expressly stated that an LLC is an entity that is similar to a partnership.

[53] *Pierre v. Commissioner*, 133 T.C. 24 (2010).

allows the couple to choose whether the LLC should be treated as having more than one owner.[54]

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 an NRA.[55] 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 and/or the grantor's spouse. However, this 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 United States. Both types of trusts lose their status as grantor trusts upon the death of the grantor, even if a surviving spouse exists, although if the survivor is a grantor, the trust will remain a grantor trust for the survivor's share.

Normally, the trust will be formed under the law of the state where the property is located, but this 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 the ability to form a private trust company. The trust can also be formed offshore, where trustee fees are typically lower than in the United States, 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 such combination. If the foreign owners start out as trustees, these same considerations will still 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 USRPIs as effectively connected with a U.S. trade or business, it also provides that for 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.[56] 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 this type of owner does not have effectively connected income against which the loss can be claimed to reduce tax.

3. Estate Tax

The biggest single tax issue with 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. Leaving aside taking a chance on survival, which may actually be reasonable if the home is being purchased only for

---

[54] *See* Rev. Proc. 2002-69, 2002-2 C.B. 831. The revenue 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, but it does not exist in many other countries where English common law is the basis of jurisprudence.

[55] 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); and reg. section 1.672(a)-1, (b)-1, and (c)-1.

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

a short term and the buyer is in reasonably good health, perhaps the simplest way to address this liability is through life insurance, whose proceeds will not be includable in the estate of an NRA.[57] 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 United States. 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. Proceeds from the sale of real property that was held for personal use will not be includable in an NRA's gross estate for estate tax purposes if they are held in a bank account (even a U.S. bank account) at the time of death. How easy or difficult this alternative may prove to be will depend on practical factors, such as the desires of an aging homeowner and the ability to anticipate death. Clearly, death from a lingering illness allows for this type of planning if the individual is physically residing in other property and is competent enough to sign a deed or execute a power of attorney. Death from an accident or a virulent illness does not allow this. Further, it comes at a cost of recognizing gain on any sale, although the tax will almost certainly be less than the estate tax.[58]

A third planning device is to ensure that any loan is nonrecourse to the foreign owner, so that the full amount of the loan is effectively deductible.[59]

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.[60] This can be avoided if the interest on the debt is structured as portfolio interest, which means that the debt should not be indicated 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 to the buyer an IRS Form W-8BEN, "Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)."[61] The problem disappears if the obligor is not a U.S. resident.[62]

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 similar or higher marginal rates than in the United States 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 United States.

B. Use of Corporate Structure

In many cases, foreign homebuyers 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. This advice is not only simple but simplistic. Whether it is actually right depends on the client's principal concerns.

If we look at structuring the acquisition of a home in light of the big-picture issues described earlier, the use of a structure with a foreign corporation has only one clear, albeit important, advantage, which is that shares of that corporation are indubitably not located in the United States for purposes of the estate tax.[63] But the use of a corporation raises concerns about all

[57]Section 2105(a).

[58]Some estate tax treaties allow a partial unified exemption to treaty country domiciliaries.

[59]*See supra* note 41 and accompanying text.

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

[61]Section 871(h) and reg. section 1.871-14. Form W-8BEN is required for the portfolio interest exemption but not for the estate tax exemption. Section 2105(b)(3).

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

[63]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, U.S. tax law's prejudice against disregarding the corporate form voluntarily chosen by the taxpayer is 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.

the other issues, including the imputation of rental income, the potential for double taxation of income 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. It can also create tax problems in the owner's home country.

1. Entity Classification

The U.S. entity classification rules must be applied to any foreign entity through which a home is acquired. This article does not review the entity classification regulations, but any adviser must be thoroughly acquainted with them, especially in relation to foreign entities.[64] Those entities will have a default classification, and nearly 90 of them are classified as corporations per se.[65] 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.

When a country has a form of entity that is primarily used for publicly traded companies, the per se corporation list includes that form of entity, so that all other entities used as privately held entities are eligible. Examples include the public limited company in Hong Kong, India, Pakistan, Singapore, Sweden, and the United Kingdom. As a result, a limited company in those countries other than a public limited company is an eligible entity. In other countries, the same kind of entity is used for both public and private companies. Examples include many of the continental European countries, such as France, Germany, Italy, Spain, and Switzerland, where the "anonymous company" is used. As a result, in those countries care must be taken to use some other form of company if an eligible entity is desired. In Canada, the only form of corporate entity that can be classified as a partnership is an unlimited liability company formed under the laws of specific provinces (Alberta, British Columbia, or Nova Scotia) — in fact, because its shareholders all have unlimited liability, an unlimited liability company is classified as a partnership by default.

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. Therefore, essentially every entity in those jurisdictions is an eligible entity that can elect out of its default classification. For example, all entities in the Bahamas, the British Virgin Islands, the Cayman Islands, the Channel Islands, and Malta can make an election to change status. In Cyprus, Gibraltar, and Malta, 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 it 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 whether it was classified as a partnership or as a 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.[66]

On the other hand, the regulations provide for deemed relevance in the following terms: "The classification for Federal tax purposes of a foreign eligible entity that files Form 8832, 'Entity Classification Election,' shall be deemed to be relevant only on the date the entity classification election is effective."[67]

This suggests that the filing of Form 8832 alone makes the election relevant. Were this viewed not to be the case, a minor investment in

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

[65] The list is set out in reg. section 301.7701-2(b)(8).

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

[67] Reg. section 301.7701-3(d)(1)(ii)(A).

the United States could force relevance as a factual matter.

It's interesting to consider whether the enactment of the Foreign Account Tax Compliance Act in 2010 has effectively gutted the relevance rule.[68] FATCA requires just about any foreign entity to explain its FATCA status to any financial institution in the world with which it seeks to do business, even if the foreign entity has absolutely no other connection with the United States. Many such institutions require Form W-8BEN-E from their non-U.S. entity customers. Completing Form W-8BEN-E is not a trivial exercise. The easy part is stating that the entity is foreign by giving its country of incorporation. But question 5 asks for FATCA status, with 28 possible choices, which cannot be answered without understanding how the various terms are defined.[69] And that's before we get to issues of how to deal with tax transparency.

Making an election to treat the entity as having a non-default classification would affect the date of the election, but unless the point about FATCA is answered in favor of indefinite relevance, 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.[70] It's not clear how all this works if classification was 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 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 cause it to be treated as always having been a partnership? We pose those 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.

a. Denial of Deductions

The IRS's 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.[71]

This treatment may not be much of a deterrent to foreign owners of a special purpose vehicle that owns the home in the United States. 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 this too may have no adverse effect if the corporation owned a single asset and was intended to be liquidated following the ultimate sale of the property. In that case, the liquidation that would be tax free under section 897(c), as long as 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 (USRPHC).[72]

b. Transfer Pricing

Therefore, one might wonder whether the IRS would forgo the traditional approach or combine it with an attack based on the imputation of rental

[68] FATCA was enacted as part of the Hiring Incentives to Restore Employment (HIRE) Act of 2010 and codified at sections 1471 through 1474.

[69] One of us well remembers an executive at a reputable offshore trust company a few years ago who thought that the company was an "international organization." For the true definition, see section 7701(a)(18) and the International Organization Immunities Act.

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

[71] *E.g.*, *Transport Manufacturing & Equipment Co. v. Commissioner*, 434 F.2d 373 (8th Cir. 1970), *aff'g* T.C. Memo. 1964-190; *Yarbrough Oldsmobile Cadillac Inc. v. Commissioner*, T.C. Memo. 1995-538; *Nicholls, North, Buse Co. v. Commissioner*, 56 T.C. 1225 (1971); *Offshore Operations Trust v. Commissioner*, T.C. Memo. 1973-212; and *Cirelli v. Commissioner*, 82 T.C. 335 (1984); *but see Sparks Farm Inc. v. Commissioner*, T.C. Memo. 1988-492.

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

income to the corporation under the transfer pricing rules of section 482. Section 482 provides:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, 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.[73]

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.[74] 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.[75] 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.[76]

c. Deemed Distribution

The 2012 Tax Court decision in *G.D. Parker*[77] may indicate how this issue will be addressed in the future, although the case is not without unanswered questions. It involved an NRA who owned 80 percent of the shares of a Panamanian corporation that owned all the shares of a Florida corporation (the taxpayer in the case). A Florida subsidiary of the taxpayer corporation owned a couple of homes and a yacht, which were used for personal purposes by the NRA and his family. The IRS argued that the value of the rent-free use was a distribution up the corporate chain from the subsidiary to the taxpayer, to the Panamanian corporation, and on up to the NRA. The court held that the taxpayer's distribution to the Panamanian corporation was subject to withholding tax at 30 percent[78] to the extent it constituted a dividend, and the parties were ordered to determine the amount of the top-level Florida corporation's E&P.[79]

The court would have allowed a deduction from the amount of the distribution for rent paid by the NRA, but under the particular circumstances it rejected on various factual grounds the taxpayer's claim that the NRA had paid rent.

Two other notable points: For one of the homes — a vacation home in Spain — the court treated only one month's usage a year as subject to tax and withholding. It did not address why the full annual rental value of the vacation home was not subject to tax and withholding when, as the

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

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

[75] 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."

[76] Reg. section 1.882-4(a)(3). These regulations were held invalid by the Tax Court, but that decision was overruled by the Third Circuit in *Swallows Holding Ltd. v. Commissioner*, 515 F.3d 162 (3d Cir. 2008), *rev'g* 126 T.C. 96 (2006).

[77] *G.D. Parker Inc. v. Commissioner*, T.C. Memo. 2012-327.

[78] Sections 881(a) (imposition of tax on foreign shareholder) and 1442(a) (imposition of withholding tax).

[79] Although the court's holding necessarily meant that the Panamanian corporation was treated as having made a distribution to the NRA shareholder, such a distribution would not have been taxable or subject to withholding because neither tax nor withholding applies to a dividend from a foreign corporation to an NRA. Also, although this was not mentioned, the deemed distribution from the Florida subsidiary to the taxpayer would not have been subject to tax because the subsidiary and the taxpayer filed a consolidated return (and even if they had not, the taxpayer would have been entitled to a 100 percent dividends received deduction).

court had found, the taxpayer did not rent, or offer to rent, the vacation home at any time during the three tax years at issue. The IRS conceded the value of one month's rent for the vacation home, but there seems to have been no deeper analysis of this question. (Without explanation, the court also did not require any tax or withholding for use of the yacht.)

We believe that if the home is constantly available for use by the shareholder or family members, the amount of the distribution would be the full annual rental value (less any rent paid). However, if the home were regularly available for rent (or, as in one case we have dealt with, as a shooting location for movies and television shows), it would be appropriate to include only the fair rental value of the time the property was being used for personal purposes.

Another notable feature of *G.D. Parker* is why the court believed that withholding was limited to the amount found to be a dividend. Although the tax on the shareholder is so limited, the amount of withholding is not, at least not when the corporation is a USRPHC.

In fact, the court in *G.D. Parker* did not consider in detail the withholding regulations. Had it done so, it would have found that when a domestic corporation makes a distribution, it is required to withhold 30 percent of the full amount of the distribution, regardless of whether the corporation has E&P, and not just the amount of the distribution that is treated as a dividend.[80] There is an exception when the corporation is willing to project that it will have no E&P, but this exception effectively does not apply when the corporation is a USRPHC.

Instead, under the regulations, the corporation must choose between (1) applying withholding on the full amount of the distribution (the rate being 30 percent, subject to reduction by a tax treaty) or (2) applying 30 percent tax on the amount estimated by the corporation to be a dividend from E&P and then applying FIRPTA withholding at 15 percent of the remaining amount of the distribution, subject to reduction of this latter amount under a withholding certificate obtained from the IRS.[81]

So, what have we learned from *G.D. Parker*? Most important, that personal use of corporate property can result in (1) corporate distributions that can in turn expose a domestic corporation to withholding liability, and (2) if there is E&P, dividend income that is FDAP income to the immediate foreign shareholder. Even more alarming, as discussed later, is the outcome if, at the top of the corporate chain, there is a foreign non-grantor trust with a U.S. beneficiary.

3. Rental Income

The *G.D. Parker* analysis, combined with the requirements of the withholding regulations, makes any corporate structure in which there will be personal use of residential property quite challenging. However, if the individual users of the property pay rent, some of the complexities are reduced or eliminated, while other complexities perhaps take their place.

When the user of the property, whether a shareholder or a family member, pays rent to use the property, the corporation will have income. That income is taxable, but it can be reduced by an allocable share of expenses, as well as by deductions for depreciation. Depreciation for residential rental property is favorable, being straight line over a useful life of 27.5 years.[82] If the corporation is foreign, expenses treated as rent to the corporation are FDAP income subject to withholding by the user, unless the foreign corporation provides Form W-8ECI, "Certificate of Foreign Person's Claim That Income Is Effectively Connected With the Conduct of a Trade or Business in the United States," to the user and then files a tax return either taking the position that it is engaged in a trade or business or actually electing that treatment under section 882(d) or a treaty provision. Many foreign corporations and their shareholders in this position are unlikely to have received advice on this point.

One issue regularly encountered with entity structures is how to fund expenses. Expenses can

[80] Without diving into yet further technicalities, a distribution is taxable as a dividend to the extent the distributing corporation has E&P accumulated from prior years or current-year E&P, regardless of whether deficits were accumulated in prior years. A distribution not treated as made out of E&P is treated as a return of the shareholder's basis in the shares and then as a capital gain. Section 301(c).

[81] Reg. section 1.1441-3(c)(4).

[82] Section 168(c).

include property taxes, insurance, utilities, repairs, maintenance, and — particularly at the higher end — security and staffing. It is not uncommon for the user to pay these expenses directly. Those payments should be treated constructively as if they were rent paid by the user to the owner of the property and then by the owner. Like any other rent, it is taxable to the owner.[83] If the owner of the property is foreign (for example, a foreign corporation or a foreign trust), the gross amount of rent is subject to tax and withholding at 30 percent — again, unless the owner provides a Form W-8ECI.

4. Structuring Alternatives

Assuming the taxpayer avoids the hazards of the entity classification regulations, there are two principal ways to structure the acquisition of a home using a corporation:

- direct ownership of the home through a foreign corporation; or
- 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 — a not insignificant concern for many high-net-worth individuals. As previously mentioned, there will be some identification 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[84] and as an ultimate 25 percent foreign shareholder on Form 5472.[85] However, that identification does not mandate the issuance of a TIN for the individual, although the responsible person must be identified when the foreign corporation applies for a U.S. TIN.

In doing so, however, the foreign owner incurs a long list of other tax disadvantages. These include loss of the long-term capital gains preference, which applies only to individuals and non-grantor trusts (although with the corporate income tax rate reduced to 21 percent since 2018, this may not be a significant disadvantage — until, that is, a future round of tax reforms);[86] possible double taxation[87] 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 and related issues described earlier; and loss of step-up in basis of the real property on death of the foreign owner. Moreover, any U.S. heirs of the foreign owner will inherit shares in an entity that will either become (1) 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 (2) a passive foreign investment company, if either such condition is not met for some or all of the beneficiaries.[88] 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. Although this is technically true because stock in a foreign corporation is not a USRPI,[89] the use of a foreign corporation rarely achieves the goal of avoiding the cost of taxation on the 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, unknowable — risk of liabilities of a privately held foreign corporation, a well-advised buyer will realize that the purchase of the foreign corporate stock will not result in a step-up in basis

[83] Reg. section 1.61-8(c) (as a general rule, if a lessee pays any of the expenses of his lessor, those payments are additional rental income of the lessor); *see also* reg. section 1.162-11(a) (taxes paid by a tenant to or for a landlord for business property are additional rent and taxable income to the landlord); and Rev. Rul. 76-474, 1976-2 C.B. 135.

[84] Question S on Form 1120F.

[85] Line 4a of Form 5472.

[86] In California, it is actually not a disadvantage at all when the top personal income tax rate is 13.3 percent and the tax rate on corporate income is 8.84 percent.

[87] Corporate income tax under section 882 and branch profits tax under section 884.

[88] Sections 957(a) (definition of CFC) and 1297 (definition of PFIC).

[89] Section 897(c).

in the underlying real property. This typically results in a requested discount to cover the assumption of the tax cost of the seller that arises from a carryover of inside basis for the property. Moreover, it is hard to imagine a U.S. buyer being interested in acquiring a home by acquiring stock in a foreign corporation, for reasons explained later.

The cost of losing the capital gains tax 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.[90] 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.[91]

A foreign corporation will not be subject to the branch profits tax if, following the sale of a home, all the proceeds are reinvested in U.S. assets. However, in comparison with a sale of business property, U.S. assets might not include the purchase of a new home, unless the home 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 United States" under applicable regulations. The regulations provide that property will 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 leg of this requirement if there is no rental income or the rental income is not treated as effectively connected trade or business income.[92] The second leg is not a problem because section 897(a) treats all gains from sale or exchange of USRPIs as ECI.

If less than all 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 NRA 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 branch profits tax for the tax year in which it completely terminates all of its U.S. trades or businesses.[93] 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 equivalent to a liquidation-reincorporation rule and is exceptionally harsh (as well as bad policy that discourages investment in the United States). It requires a taxpayer to ring-fence the sales proceeds and keep them in an identified investment outside the United States. 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 he makes personal use

[90] Section 884(a).

[91] Section 884(e); and reg. section 1.884-1(g). The United States has renegotiated many of its treaties to allow imposition of the branch profits tax 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 (article 10, para. 10(b)), but several recent U.S. treaties now provide for a 0 percent rate, beginning with the 2002 U.K.-U.S. treaty and the 2001 protocol to the Australia-U.S. treaty. 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.

[92] *See* reg. section 1.884-1(d)(1), discussed in Joseph Isenbergh, *Foundations of U.S. International Taxation*, Tax Management Portfolio No. 900-2nd, at Section II.H.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).

[93] This concession has no basis in the language of the statute but is provided by reg. section 1.8842T, apparently to provide treatment equivalent to the tax-free treatment of a foreign shareholder on liquidation of a domestic corporation whose shares are not USRPIs. It is authorized by section 884(g), a general grant of authority to issue regulations that carry out the purpose of the statutory provision.

of a home owned by a corporation — if 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 and branch profits taxes. The real tax risk comes when the foreign corporation wishes to sell the property. It may be 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 15 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 21 percent, as well as any state and local income taxes that may be applicable. 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 return preparation fees. On the other hand, if the shareholders make personal use of the home without paying a reasonable rent, these expenses may be disallowed in accordance with the case law described earlier.[94]

On sale of the property, the foreign owner will presumably want to have access to the sale proceeds. Any distribution of the proceeds other than in liquidation of the corporation will be a dividend to the extent of the 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.[95]

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 USRPIs in taxable transactions in which gain is fully recognized; otherwise, the shareholder may have to recognize gain inherent in the shares of stock of the corporation without liquidity to satisfy tax.[96] Generally, this 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 USRPI. The corporation must therefore either dispose of the note by collection or sale, or else 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, these planning opportunities exist only if the corporation notifies the IRS of the early termination of its status as a USRPHC.[97]

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 United States are taxable to an NRA donor.[98]

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 on those shares upon the owner's death. This is because stock in a domestic corporation has a U.S. situs for estate tax

[94] *See supra* note 65.

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

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

[97] *See supra* note 66.

[98] Section 2511(a). Note that the tax would apply if the donor were 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.

purposes.[99] In a few cases, the stock could be exempt under a treaty.[100]

If the domestic corporation is owned by a trust, the consequences will depend on whether any of sections 2036 (transfers with retained life estate), 2038 (revocable transfers), and 2041 (powers of appointment) apply to the foreign decedent.[101] If so, 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 as an alter ego during the individual's lifetime. This trio of 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. We refer to them collectively as the retained interest rules.

Stock in the domestic corporation will be stepped up upon 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.[102] 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 the settlor's death.

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[103] 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.[104]

However, beginning in 1997, the definition of a partnership for all purposes of the IRC was set out in the entity classification regulations (more commonly known as 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 that 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 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 NRA acquires the property and transfers it to the partnership in exchange for a partnership interest or as a contribution to the partnership, the

[99] Section 2104(a).

[100] The United States has entered into a relatively small number of treaties that address estate tax (15 plus the Canada income tax treaty, which deals with some estate tax issues), and the older treaties do not provide an exemption from the estate tax. Newer treaties (with Austria, Denmark, France, Germany, the Netherlands, and the United Kingdom) do provide such an exemption. Notably, the Swiss treaty does not.

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

[102] Taxpayers and the IRS (depending on whose interest it serves) tend to value stock in a single-asset corporation as being identical to the value of the underlying real property. But there are many differences, including 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 the shares, as will occur if a husband and wife each own exactly 50 percent of the shares of the corporation.

[103] T.D. 8697.

[104] Former reg. section 1.761-1, added by T.D. 6500 and amended by T.D. 7208 and T.D. 8697.

transfer is a realization event but entitled to nonrecognition under the domestic tax law,[105] and that treatment is not overridden by FIRPTA rules regarding nonrecognition. However, to avoid FIRPTA withholding, the alien or the partnership must notify the IRS of the transaction that is 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 rate, 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 than between a partnership and its partners. As discussed elsewhere in this article, 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 the 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 the owner of property allows the property to be used by a partner as a tenant or licensee.

The question is then directed to the authority for imputing income in these 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 broad reach, but it seems doubtful that it reaches quite as far as an individual who is not actually engaged in a trade or business and 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 broad meaning to the term "organization, trade or business" so that, for example, it includes employees.[106] Others have adopted a more limited approach.[107]

The closest case would seem to be *Dolese*,[108] which involved an individual, his wholly owned corporation, and a partnership in which the individual and the corporation were partners. The partnership made a distribution of partnership property to the partners that was not proportionate to their partnership interests in order to facilitate a subsequent tax-efficient sale and charitable gift of the property. 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 held that the taxpayer did have a trade or business as a corporate executive and that the transaction was related to that trade or business.

The court's reasoning was a little strained. Moreover, somewhat gratuitously, it added:

> The fact that no prior case has addressed the application of section 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.

[105] Section 721.

[106] *See, e.g.*, *Ach v. Commissioner*, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir. 1965); and *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).

[107] *See, e.g.*, *Foglesong v. Commissioner*, T.C. Memo. 1976-294, *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).

[108] *Dolese*, 811 F.2d 543.

> 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, section 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.

It is not certain what would happen in a case, one more straightforward than the facts of *Dolese*, in which a partner makes 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, it may be more persuasively contended that section 482 should not be applicable in the absence of two businesses. These advisers may find section 7872 instructive because it relates to loans that bear rates of interest that are 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. Section 482 is likely 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 this 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.*,[109] 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*,[110] 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)), which contained a method of determining 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 who 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 statute 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 its shareholder personal use of corporate property, the traditional approach has been to disallow deductions to the corporation and impute a constructive dividend to the shareholder. This 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.[111] Might the holding in *G.D. Parker* apply so that the partnership is treated as

[109] *B. Forman Co. Inc. v. Commissioner*, 453 F.2d 1144 (2d Cir. 1972).

[110] *Procacci v. Commissioner*, 94 T.C. 397 (1990).

[111] As we have seen, however, a corporation that owns only a personal use residence may not care about the deductions, and the constructive distribution may only cause a reduction in the shareholder's shares. *See supra* text accompanying and following note 65.

making a distribution of the fair use value of the home? Perhaps it might, but unlike in the corporate case, a partnership distribution is not taxable unless it consists of cash that exceeds the partner's basis in the partnership. This might reduce the incentive for the IRS to delve too deeply into this argument.

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. As a practical matter, the partners may be paying the partnership's expenses for the home, which, as we have seen, is a form of rent.[112] 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, this may seem unlikely when the property is primarily a personal use residence (and if it is not, the situation is outside the scope of this article). 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 United States 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 later, 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, those deductions would have been allocated to the partner and should be deductible at the partner level.

This 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 an indefinite period under current law.[113] However, use of the loss would be limited under the alternative minimum tax rules.[114]

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. If the partnership is domestic, the partnership will have to withhold tax under chapter 3 (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 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

---

[112] *See supra* note 76 and accompanying text.

[113] Section 172(b)(1)(A)(ii)(II), as amended by the 2017 act and the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136). For NOLs arising in tax years beginning before January 1, 2018, the carryover period is limited to 20 years.

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

that should have been charged was actually received and distributed to the owner. Although a deemed distribution of profits has a taxable effect in the corporate context, the effect in the partnership context should be negligible in most situations.

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.[115] 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, then on the date Form K-1 is due or is actually mailed to the partner, whichever is earlier.[116]

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, 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.[117] 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.[118]

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 for an individual is now 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 beyond the scope of this article.[119]

2. Gifts of Partnership Interests

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

An NRA's gift of a partnership interest generally will not be subject to U.S. gift tax. That tax does not apply to gifts by NRAs of intangible assets, with an exception in cases involving expatriates subject to section 877.[120]

Two income tax issues nevertheless must be considered in connection with an NRA's gift 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 it is revoked with the IRS's consent.

Further, 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

[115] 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 (1994); and FSA 199922034.

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

[117] 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 ECI. However, reg. section 1.1446-2(b)(2)(ii) provides that (1) a foreign partner that makes an election under section 871(d) or 882(d) must furnish the partnership with a statement indicating that the election has been made; and (2) 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).

[118] 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 use residence, the partnership will be a non-withholding foreign partnership. *See* reg. section 1.1441-5(c)(2).

[119] For a more detailed discussion, see Alan Appel and Karlin, "At Long Last . . . Final Regulations on Foreign Partner Withholding," 16 *J. Int'l Tax'n* 20 (2005); and Appel and Karlin, "Uncle Sam Meets Uncle Scrooge — The Temporary Regulations on Foreign Partner Withholding," 16 *J. Int'l Tax'n* 32 (2005).

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

allocable to the donor partner. This is likely to be an issue if the home owned by the partnership is mortgaged. There are two schools of thought on this.

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*[121] and an expansive but plausible reading of section 752(d). 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 transferee's basis. Section 752(d) provides that in any sale or exchange of a partnership interest, liabilities will be treated in the same manner as liabilities in connection with a sale or exchange of property not associated with partnerships.[122]

The consequence of the IRS's position is 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 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.[123]

The other possible position is that section 752(d) applies only to transfers of partnership interests that are actually 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. This will not result in a gain, however, unless the deemed distribution exceeds the transferor's basis in the partnership.[124]

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 interest passes to the heirs of a deceased NRA partner, the estate tax position is less than clear.[125] 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 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 substantial assets in other places around the world that are not related to the U.S. business. This approach should be contrasted with the IRS's position in the income tax area, which was that the taxable status of the gain is controlled by the assets in the partnership.[126] (That position was discredited by a 2017 Tax Court decision[127] but was later enacted by Congress in the so-called Tax Cuts and Jobs Act.[128])

The approach in the estate tax area likely helps the estates of some deceased NRAs and harms the

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

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

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

[124] Section 731(a). For a more detailed discussion on these conflicting theories, see William S. McKee, William F. Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, para. 15.05 (2020).

[125] *See* M. Annette Glod, "United States Estate and Gift Taxation of Nonresident Aliens: Troublesome Situs Issues," 51 *Tax Law*. 110 (1997); Robert F. Hudson Jr., "Tax Effects of Choice of Entities for Foreign Investment in US Real Estate and US Businesses," 4 *Bus. Ent.* 4 (2002); Patrick W. Martin et al., "Why Section 2104 Must Address When Partnership Interests Owned by Foreign Investors Are (and Are Not) Subject to United States Estate Tax," State Bar of California, Taxation Section, International Committee (2003); and Richard A. Cassell et al., "U.S. Estate Planning for Nonresident Aliens Who Own Partnership Interests," *Tax Notes Int'l*, Aug. 11, 2003, p. 563.

[126] *See* Rev. Rul. 91-32, 1991-1 C.B. 107. This ruling concluded 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.

[127] The IRS's position was wholly unsupported by authority except when the underlying asset is a USRPI, and no USRPI is mentioned in the ruling. In fact, had the IRS's position been correct, there would have been no need for section 897(g) (enacted in 1980). The IRS's arguments were dismantled by the Tax Court in *Grecian Magnesite v. Commissioner*, 149 T.C. 63 (2017), *aff'd*, 926 F.3d 819 (2019).

[128] Section 864(c)(8).

estates of others. In particular, the IRS's position is rather favorable to the estates of NRAs when the sole asset of the partnership is a residence held exclusively for private use. This is 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.[129]

Nonetheless, several issues remain unaddressed by the IRS. It is not clear if the IRS 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 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?

One interesting point: Section 875 provides that "for the purposes of this subtitle" a foreign person is considered to be engaged in a U.S. trade or business in which a partnership in which that foreign person is a member is so engaged. But section 875 does not apply for purposes of the estate tax. The subtitle referred to in section 875 is subtitle A (income taxes). Estate taxes are the subject of subtitle B. Whatever else the IRS may argue, it cannot use section 875 as support for the argument that a partnership of which a deceased foreign partner was a member was engaged in a U.S. trade or business for purposes of the estate tax.

Other theories may apply. These include treating the residence of the deceased partner as the situs of the partnership interest (*mobilia sequuntur personam*) or treating the partnership's place of organization 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 an NRA contributes residential property to a partnership but retains the right to live there, section 2036 may apply.[130] This can be avoided by having the partnership enter into a lease with its foreign partner that provides for an FMV rental. But again, this approach has adverse income tax consequences and 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 to 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 whose principal benefit is to avoid probate on the death of the settlor.[131] In this section, we discuss the application of the non-grantor trust rules.

1. Summary of Non-Grantor Trust Rules

The non-grantor 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 because the transfer of the property to the trust may be a gift[132] — or cash used to purchase the property. As a general rule, a trust is treated as if it were an individual, so a foreign non-grantor trust is treated as an NRA individual.

The table summarizes the effects of these alternatives.

[129] *See supra* discussion accompanying notes 103 and 104.

[130] *See Estate of Disbrow v. Commissioner*, T.C. Memo. 2006-34.

[131] *See supra* note 50 and accompanying discussion.

[132] A transfer to a grantor trust can also be a gift if it is structured as a completed gift, but this is practically impossible when the grantor is foreign.

Comparison of Trusts as Ownership Vehicles

	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 NRA is not subject to U.S. gift tax if funded from outside the United States. Note the IRS's position that a cash gift is treated as a gift of the underlying property if cash must be used to purchase the settlor's property. For this purpose, cash means dollar bills, not necessarily funds in an account; nevertheless, the most cautious planning involves transferring funds outside the United States or transferring value in the form of Treasury bills or other highly liquid intangible assets.[a]			
Creation of trust with gift of tangible property located in the United States	Taxable gift; there is no income tax consequence unless the amount of debt assumed or taken subject to the trust exceeds the grantor's adjusted basis.			
Reporting	No Form 3520 reporting.		Form 3520 reporting required.	
Use of property by grantor	No tax consequences to the grantor — but note the possible effect on the application of section 2036 when the grantor dies.			
Use of property by other beneficiaries	No tax consequences to the foreign beneficiaries — they should not have imputed rent if the trust instrument permits free use of the property. But if there is a U.S. beneficiary, the trust will be deemed to make a distribution to the beneficiary of the fair use value of the property.[b] Whether this is taxable presumably depends on whether the trust has DNI or undistributed net income, but note that the use of the property does not appear to create income for the trust.		No tax consequences to the grantor or other beneficiaries — they should not have imputed rent if the trust instrument permits free use of the property.	
Sale of property — FIRPTA withholding	Yes — by the buyer.[c]		Yes — by the trust on distributions out of "U.S. real property interest account."[d]	Yes — by the trust on distributions out of "U.S. real property interest account"; note that this account is reset to zero at the end of each year, so there is no withholding on gain accumulated by the trust.[e]
Sale of property — rate of taxation of gain.	Capital gains rates.	Capital gains rates, but if distributed to a U.S. beneficiary in a later year, the gain is ordinary (for a foreign beneficiary, the character is preserved).[f]	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 the beneficiary.[g]	Gain and credit pass through to the beneficiary if distributed in the year of sale; otherwise, the trust is taxable on gain in the year of sale; the beneficiary is taxable in the year of the 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.	Gain passes through to the beneficiary.[h]	Gain and credit pass through to the beneficiary if distributed in the year of sale; otherwise, the trust is taxable in the year of sale; no further tax on the beneficiary on distribution in a later year.[i]

Comparison of Trusts as Ownership Vehicles *(Continued)*

	Foreign Trust		Domestic Trust	
	Simple Trust	Complex Trust	Simple Trust	Complex Trust
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.[j]			
Estate tax on death of grantor	Depends on the application of section 2036.			
Generation-skipping transfer tax	Not applicable if the property given or bequeathed to the trust by the NRA 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 1040 NR.	Form 1040NR if proceeds distributed in the year of sale; no reporting if proceeds are distributed in a later year in which the trust has no DNI.
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 a later year in which the trust has no DNI.

[a]Rev. Rul. 55-143, 1955-1 C.B. 465.

[b]Section 643(i), as amended by section 533 of the Hiring Incentives to Restore Employment (HIRE) Act of 2010.

[c]Section 1445(a).

[d]*See* reg. section 1.1445-5(c)(1)(iii)(A).

[e]*See id.*, especially the seventh and eighth sentences.

[f]Section 667(e).

[g]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 DNI; the gain is treated as DNI to the extent distributed; and the beneficiary includes in income the amount distributed up to the amount of the DNI.

[h]Same as explained *supra* note g.

[i]This assumes that the distribution in the later year does not carry out DNI from some other source earned during the year of distribution.

[j]Section 165(c), confirmed for NRA individuals by section 897(b).

2. Planning With Trusts

a. In General

A trust is potentially an attractive vehicle for newly acquired residential property. To avoid gift tax, the trust should be funded with cash, preferably cash transferred from outside the United States.[133] 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.[134]

Once the property is owned by the trust, a 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

[133]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 instead treated 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.

[134]The IRS's view is supported by *De Goldschmidt-Rothschild*, 168 F.2d 975 (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 was held ineffectual for gift tax purposes). *Cf. Davies*, 40 T.C. 525.

treated as distributions to the beneficiary.[135] There is, however, a significant exception, introduced in 2010, when the trust is foreign and the beneficiary is a U.S. person. We discuss this later.[136]

Trusts are taxed at rates applicable to individuals, albeit with essentially no progression through the brackets, and are therefore entitled to the preferential rate of 20 percent now applicable to long-term capital gains.[137]

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 is this: The throwback rules, which were repealed in 1997 for domestic trusts, continue to apply to foreign trusts.[138] Moreover, capital gain of a foreign trust is treated as DNI, regardless of whether the trust distributes it in the year of sale. As a result, any undistributed gain becomes undistributed net income (UNI). 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 it 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.[139] Fortunately, this character rule does not apply if the beneficiary is an NRA, which is why the problem is confined to distributions to U.S. beneficiaries.[140]

In short, if the beneficiaries of a foreign non-grantor 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. This 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 (with different terms and a nonidentical group of beneficiaries) that receives distributions in an amount sufficient to zero out UNI. 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 time of 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 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 the 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. This section applies if the grantor retained an interest in the trust because of any right to use the residence during her 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.[141] This means that the trustee's exercise of 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 similar persons.

Another requirement is that creditors of the settlor should not be able to reach trust assets, at least in theory. This may require the trust to be

[135] *Plant*, 30 B.T.A. 133, *aff'd*, 76 F.2d 8, *acq.*, 1976-2 C.B. 2 (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*, 66 T.C. 1976.

[136] Section 643(i).

[137] Section 1(h).

[138] Section 665(c).

[139] *See* sections 665 through 668. For a discussion of the throwback rules, see Boris Bittker, *Federal Taxation of Income, Estates and Gifts*, ch. 83.4, (2003); and Daniel C. Knickerbocker, *Subchapter J — Throwback Rules,* Tax Management Portfolio No. 856-2nd.

[140] 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).

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

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).[142] Some U.S. states, including Alaska, Delaware, Nevada, South Dakota, and Wyoming, also provide for such trusts,[143] although the practical efficacy of spendthrift provisions to protect a settlor-beneficiary has been questioned in light of federal bankruptcy reforms enacted in 2005.[144]

The message for planners is therefore that the non-grantor trust must be implemented with considerable care, and once in place, it must be respected by all concerned, especially the settlor and the trustees.

b. Section 643(i)

We discuss in the following section the issues created by section 643(i) for the U.S. beneficiary of a foreign non-grantor trust who makes use of a home owned by the trust.

V. Foreign Owner's Family Includes U.S. Persons

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

- A foreign owner buys a home for use by one or more children who are students in the United States and who typically are not considered residents for income tax purposes during that period. After college, the students remain in the United States and become residents for income tax purposes.
- A foreign executive on a medium-term stay in the United States has a child born in the United States or marries an American and moves back to his 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 United States for personal or business reasons.
- A beneficiary of a foreign trust moves to the United States, and the trustees are asked to assist with the purchase of a home for the beneficiary.

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

A. Reconsider Use of Corporations

One situation we have encountered is when the foreign owner heeds 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 own 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.

[142] 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, among others.

[143] Alaska Stat. section 34.40.110; Del. Code Ann. tit. 12, section 3570 et seq.; Nev. Rev. Stat. ch. 166; S.D. Codified Laws sections 55-1-24 et seq.; and Wyo. Stat. Ann. sections 4-10-506 and 4-10-510 et seq.

[144] 11 U.S.C. section 548(e), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, permits the bankruptcy 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 bankruptcy petition if (1) the transfer was made to a self-settled trust or similar device; (2) the transfer was by the debtor; (3) the debtor is a beneficiary of the trust or similar device; and (4) the debtor made the transfer with the actual intent to hinder, delay, or defraud any entity to which the debtor was or became indebted on or after the date that the transfer.

shareholders and their U.S. relatives than for foreign shareholders.

Third, the basis in the stock of the corporation may have been adjusted to FMV but the basis in the home itself is not adjusted. Therefore, if the home has increased in value, gain on the sale will include both pre- and post-mortem 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.[145]

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, this 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 catalogue 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. Care in Planning With Trusts

On the grantor's death, 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 non-grantor trust on death of the grantor. This will potentially affect the U.S. beneficiaries of the trust in several 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.[146] 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 UNI, which clearly also applies to distributions made by domestic trusts that are former foreign trusts.

Second, the conversion to non-grantor trust status will require the U.S. beneficiaries to deal with the compliance requirements of section 6048(a) — including the filing of Form 3520, "Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts" — in any year that the beneficiaries receive a distribution from the trust, and they will need to obtain information from the foreign trust in the form of a foreign non-grantor trust beneficiary statement.[147]

Third, and perhaps most important, is an amendment to the distribution rules. Section 643(i), which was first enacted in 1996, originally provided that the amount of a loan of cash or marketable securities by a foreign trust to a grantor or beneficiary who is a U.S. person is to be treated as a distribution by the trust. In 2010 section 643(i) was amended so that if a foreign trust permits a U.S. grantor or beneficiary to use any other trust property, the FMV of the use of the property is to be treated as a distribution by the trust.[148] The rule does not apply to the extent the

[145]The gain should not be subpart F income. Section 952(b) excludes from the definition of subpart F income any income 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 ECI under section 897(a). *See* reg. section 1.952-1(b)(2).

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

[147]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 to be significantly less because no portion of the distribution is taxable to the beneficiary.

[148]HIRE Act section 533.

trust is paid the FMV of the use within a reasonable time of that use.[149]

For a trust that holds only real property for personal use by the grantor and beneficiaries, a distribution by the trust might not be taxable because such a trust likely would have neither DNI nor UNI. But there is a trap here: Form 3520 must be filed by any U.S. beneficiary each year to report distributions from a foreign trust. The form requires the beneficiary to choose between reporting under the so-called default method or the actual method. And once the beneficiary has ever been subject to the default method, he cannot use the actual method in any future year, except the final year of the trust.[150]

To be able to use the actual method, the beneficiary must also receive from the trust a foreign non-grantor trust beneficiary statement. If the beneficiary uses the actual method, the distribution may indeed be tax free if the trust had no DNI or UNI. However, if instead the default method applies, whether by choice or by failure to file Form 3520, the full amount of the distribution is treated as ordinary income and is taxable, even if it would not have been taxable had the beneficiary been able to use the actual method. Moreover, the tax distribution will attract interest based on how long the trust has been a non-grantor trust.

An early failure to recognize the need to file Form 3520 using the actual method can therefore result in the fair market rental value of a residence being taxed at quite unfavorable rates.

All these problems result from the trust being a non-grantor trust. A trust cannot, by definition, have DNI or UNI before it becomes a non-grantor trust. Because the death of the foreign grantor will definitively cause a trust that may previously have been a grantor trust to become a non-grantor trust, a decision on whether to maintain the trust as a foreign trust should be made shortly after the grantor's death. Consideration should be given to terminating the trust (or at least distributing out the residence). Another possibility would be to domesticate the trust, a strategy that may make it possible to keep the property out of the estate of the successor beneficiaries, as well as eliminate issues under section 643(i).

C. What if the NRA Has Already Died?

Suppose the adviser is consulted in a situation in which the NRA 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 domesticating the corporation. There are various ways to domesticate the foreign corporation, all of which are treated similarly for U.S. tax purposes. 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.[151] 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 these methods are essentially treated by the IRS as C or D reorganizations.

All of these should be tax free,[152] 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.[153] That period begins at the time of the grantor's death.

The first step in the plan is for the trust to distribute the shares of the corporation to the U.S.

[149] There is no guidance on what is reasonable. We would generally recommend that rent be paid at least yearly, although we can envision cases in which delay might reasonably be permitted if a trust became a non-grantor trust following the death of the grantor.

[150] *See* section 6048(c)(2).

[151] *E.g.*, Del. Code Ann. tit. 8, section 388.

[152] Reg. section 1.897-5(c)(4); and Notice 2006-46, 2006-1 C.B. 1044. 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 — because Notice 89-85 only requires the foreign corporation to 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 upon the death of the NRA, even though the transfer results in a step-up in basis.

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

beneficiaries. The second step is to take advantage of Delaware's favorable continuation statute allowing foreign corporations to domesticate into Delaware relatively easily.[154] (If foreign law does not permit re-domiciliation, the desired result can also be achieved transactionally with a new Delaware corporation and combining the foreign corporation and the Delaware corporation in one of several ways.)

Following the domestication, the next step would be to make a subchapter S election. The S election can be made only if the corporation has no foreign shareholders, no corporate shareholders,[155] only one class of shares, and is held by no more than 100 shareholders.[156] Assuming this is 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.[157] If they wish to cause the S corporation to sell the house, it may be possible to use one or a series of 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 secures 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 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 making an S election, followed by a 10-year delay before sale to avoid two levels of tax, and in the meantime using a section 1031 exchange.

3. Foreign Trust Structure

As noted earlier, following the death of the foreign grantor of a foreign grantor trust, consideration should be given to domesticating the foreign trust or at least the portion that owns the U.S. real property.

4. Tiered Structure

If the property was held by a tiered structure, the techniques described above may have to be combined. Consider, for example, the structure of a revocable foreign trust that owned a foreign corporation that in turn owned the domestic corporation that owned the property. One approach would be to domesticate the foreign corporation; merge the domesticated corporation with the existing domestic corporation (the latter should be the survivor to avoid the need to change title to the property); domesticate the trust, with a modification permitting the trust to hold the merged corporation as an S corporation; and finally, make the S election. The domestication of the foreign trust after the domestication of the foreign corporation would prevent the trust from holding stock in a foreign corporation for even a short time, when it would be a CFC.

VI. A Litany of Practical Issues

While the big four tax issues — capital gains treatment, planning for gift and estate taxes,

[154] Del. Code Ann. tit. 8, section 388. Other states permit domestication or continuation, but the Delaware procedure is our preferred jurisdiction for this exercise.

[155] 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.

[156] Section 1361(b).

[157] *See* section 1374.

imputation of rental income, and basis step-up on death — dominate tax planning, the purchase of a home by a foreign person potentially involves several practical tax compliance and nontax issues. This section surveys those 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, "Application for Employer Identification Number," and a fax machine, the representatives of corporations and partnerships can obtain employer identification numbers over the telephone and, for domestic entities, online.[158]

Applying for an EIN for a trust can be more difficult because of Form SS-4's requirement to list a grantor, owner, or trustor as the responsible party and to provide a TIN for that person — something that may be impossible if the grantor is no longer alive or unwilling to obtain the number, as can occur for a non-grantor trust. Our experience is that IRS representatives will accept that no such number will be available in those circumstances.

Applications for ITINs are a much different matter. In general, an application for an ITIN requires the applicant's tax return and identification documents as well as a completed Form W-7, "Application for IRS Individual Taxpayer Identification Number." The identification documents must be originals or certified copies. This means that the individual has to either mail the original documents (such as passports) to the IRS or visit a U.S. embassy or consulate. Starting October 1, 2016, the IRS no longer accepts notarized identification documents.

Recognizing the challenges of these requirements and as envisaged by the Protecting Americans From Tax Hikes (PATH) Act of 2015, the IRS launched a certified acceptance agent (CAA) program. A CAA is a person or an entity (usually a professional services firm) that is authorized by the IRS to authenticate the applicant's identification documents and certify copies thereof to the agency. The IRS has recruited CAAs worldwide and publishes a list of them on its website.[159]

It is no longer possible to obtain an ITIN by filing a tax return or information return without a number. In its desire to process the return, the IRS used to assign a number to the individual in question without all the formalities. However, in 2015 Congress provided that the IRS is authorized to issue a TIN to an individual "only if the applicant submits an application," using an IRS-prescribed form and documentation.[160]

2. Recordkeeping and Tax Returns

If not enamored of extensive recordkeeping requirements, U.S. taxpayers are at least accustomed to them. Foreign taxpayers need to become familiar with the records they should maintain, especially long-term records concerning 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 recordkeeping function. The records need to be maintained in such a way that any 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 must make arrangements to file all necessary tax returns. This routine, if not a necessarily welcome chore for U.S. taxpayers, can be quite burdensome for foreign persons.

[158] IRS, "How to Apply for an EIN" (viewed Apr. 20, 2020). Amazingly, it can still be done by fax. International applicants can call 267-941-1099. Since May 21, 2012, the IRS limits EIN issuance to one per responsible party per day.

[159] IRS, "Acceptance Agent Program" (viewed Apr. 20, 2020).

[160] Section 6109(i), added by section 203(a) of the PATH Act.

B. Establishing and Managing Entities

The average U.S. homebuyer does not have to establish an entity to buy a house. At most, the buyer will establish a living trust. For foreign homebuyers, 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 USA PATRIOT Act, this has become a real challenge. This is 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,[161] 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. This is true of all structures, but the fact that the underlying asset is dedicated to personal use will tend 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, repairs, and maintenance costs — should be paid by the persons on whom the legal responsibility falls under the terms of the lease. When possible, checks drawn on corporate bank accounts should be used to pay operating expenses. This 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, the house must be cleaned, and the surrounding grounds must be tended. Neighbors may have to be accommodated, and homeowners' and condominium associations must be heeded and their dues paid. Fire prevention measures are desirable and may in fact be required, especially in many western states, and flood control rules may also apply. The usual difficulties for any owner in maintaining a vacation home in the United States 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 article. Foreign persons should not purchase homes without making a plan for all these considerations.

If real compliance requirements were not enough, scams have been reported for companies that are apparently owned by persons having Islamic names. Bogus 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 must 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.

VII. Conclusion

We began this article 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

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

a home in the United States. As we have made clear from the beginning, there is no single plan that meets all the major objectives — our wand can make many but not all the obstacles disappear. The challenge is to inform our clients of these obstacles and help them choose which ones they are prepared to live with and which ones must be made to go away. We have had clients tell us not to worry about capital gains because they anticipated that the property would never be sold, and we have had clients who were completely unconcerned about the estate tax and very anxious to avoid tax on the sale. For some clients, privacy trumps all tax concerns. There is, in short, no one preeminent plan. ■