

An Introduction to the Taxation of U.S. Real Estate Held by Foreign Investors

A primer on the principal planning alternatives and basic U.S. tax considerations of foreign investment in U.S. real estate.

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Foreign investors actively invest in U.S. real estate by speculating on land and developing homes, condominiums, and commercial buildings. Many foreign investors own recreational property in popular U.S. beach and ski destinations. This article summarizes the U.S. tax consequences associated with a foreign investor's acquisition of different U.S. property interests. This article also provides a number of tax planning options that should be considered by foreign investors when acquiring U.S. real estate.

TYPES OF U.S. TAXES FOR INVESTORS SHOULD CONSIDER WHEN INVESTING IN U.S. REAL PROPERTY

The acquisition of U.S. real property has no immediate U.S. tax consequences to the foreign investor. Although the acquisition of U.S. real property by a foreign investor will have no immediate U.S. tax consequences, there are a number of future tax consequences that should be carefully considered by a foreign investor prior to acquisition of U.S. real estate.

U.S. Income Taxes.

The United States taxes its citizens, residents, and domestic corporations and trusts on a worldwide basis. Foreign persons physically present in the U.S. for at least 183 days during any year, or a greater number of days over a three-year period.

Foreign persons (principally nonresident aliens and foreign corporations) are subject to two different U.S. taxing regimes. One regime applies to income that is connected with the conduct of a trade or business in the United States. The other regime applies to certain specified types of nonbusiness income from U.S. sources. If a foreign person conducts a trade or business in the United States, the net income effectively connected with the U.S. business activity will be taxed at the usual U.S. rates.¹

If a foreign person receives U.S.-source income in respect of investments not effectively connected with the conduct of a trade or business within the United States (such as dividends, interest, rents, or royalties), the gross amount of the payment generally will be subject to a tax of 30%.² This enumeration is sometimes referred to as "FDAP income." The collection of such taxes is effected primarily through the imposition of an obligation on the person or entity primarily through the imposition of an obligation on the person or entity making the payment to the foreign person to withhold the tax and pay it over to the Internal Revenue Service ("IRS").

If a foreign investor is acquiring rental property in the United States, the foreign investor must make an initial determination as to whether the ownership or the property will be viewed as a U.S. trade or business. If it is, all U.S.-source income effectively connected with the trade or business would be subject to U.S. income tax at regular rates. If the leasing of U.S. real estate by a foreign investor does not give rise to a U.S. trade or business, the rental income derived from the property is subject to U.S. withholding tax at the rate of 30% (unless an election is made under Sections 871(d) or 882(d) of the Internal Revenue Code). In some cases, the withholding rate could potentially be reduced under an income tax treaty.

FIRPTA.

The Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") is designed to ensure that a foreign investor is taxed on the disposition of a U.S. property interest. The term "disposition" means transfer. To

ensure collection of FIRPTA, any transferred acquiring a U.S. real property interest must deduct and withhold a tax on the amount realized on the disposition. A transferee is any person, foreign or domestic, that acquires a U.S. real property interest by purchase, exchange, gift, or any other type of transfer.³ The amount subject to withholding is the sum of cash paid, the market value of the property transferred, or the amount of liabilities to which the transferred property is subject.⁴ The withholding rate is generally 15% of the sales price of the real property.

If the real property being sold or transferred is commercial property, the foreign seller or transferor is subject to a 15% withholding tax. If the real property being sold or transferred is residential real estate is \$300,000 or less, then the withholding tax is not required. If the sales price is equal to or greater than \$300,001, but equal to or less than \$1 million then the seller may qualify for a reduced withholding in the amount of 10%. If the sales price for the residential real estate is greater than \$1 million, then the withholding rate is 15%. To qualify under the personal residence exemption, the transferee or certain members of the transferor's family (lineal descendants) must intend to reside at the real property at issue for more than 50% of the number of days that the property is used by any person for residential purposes during each of the two years following the purchase.⁵

If the sales price of U.S. real estate is equal to or greater than \$300,001, but equal to or less than \$1 million then the seller would qualify for reduced withholding

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in the amount of 10% (instead of 15%). If the sales price is greater than \$1 million, then no exception applies, and the buyer is responsible for withholding 15% of the amount realized by the seller.

The purchaser of a U.S. real property from a non-U.S. person or entity is, in general, required to withhold 15% of the purchase price, which can be claimed by the foreign investor as a credit against U.S. tax liability associated with the disposition of the property. In some cases, a foreign investor can apply to the IRS for a certificate authorizing a reduced amount of withholding tax (for example, if the 15% withholding tax exceeds the maximum amount of tax payable on the disposition of the property).

Branch Profits Tax.

If a foreign investor establishes a foreign blocker corporation to hold U.S. real estate,

profits or ("ECEP") that are not reinvested in the United States and are deemed to have been distributed.⁷ The dividend equivalent amount" includes the gain from the sale of U.S. real property. In other words, gains on U.S. assets held by foreign corporations are not taxed at favorable capital gains rates. Instead, gains on U.S. assets such as real estate are typically taxed at the 30% branch profits tax rate. In some limited cases, the branch profits tax will be reduced if the foreign investor is from a favorable U.S. treaty jurisdiction and the foreign investor utilizes a home-country/treaty company.

A foreign corporation's dividend equivalent amount for a taxable year is computed using the following two-step procedure:

Step 1:

Compute the foreign corporation's ECEP for the taxable year. ECEP equals the

not below zero), and is increased by the amount of any reduction in U.S. net equity for the year. In other words, an increase in U.S. net equity during the year is treated as a reinvestment of earnings and profits in the U.S. branch operation, whereas a reduction in U.S. net equity during the year is treated as a repatriation of earnings and profits.

See [Illustration 1](#) below for an example of the calculation of the branch profits tax.

Illustration 1.

Shony, a foreign corporation, operates a branch sales office in the United States. During its first year of operations, Shony's ECEP is \$250,000 and its U.S. net equity is \$500,000 at the beginning of the year and \$750,000 at the end of the year. Therefore, Shony's DEA for year 1 is \$0, computed as illustrated in Exhibit 1.

Exhibit 1:	
(A) ECEP	\$250,000
(B) Increase in U.S. net equity	
End of the year U.S. net equity	\$750,000
Beginning of the year U.S. net equity	<u>-\$500,000</u>
Increase in U.S. net equity	<u>\$250,000</u>
Dividend equivalent amount [A-B]	None

that entity could be subject to the U.S. branch profits tax.⁶ The branch profits tax specifically treats the deemed repatriation of already taxed profits from the U.S. by a foreign corporation as an occasion to impose a second tax under Section 884. Section 884 describes this second tax as the "dividend equivalent amount" or ("DEA") of the "effectively connected earnings and profits" with certain adjustments. The branch profits tax a tax equal to 30% of a foreign corporation's imposed on DEA, which are the after-tax effectively connected earnings and

earnings and profits attributable to income effectively connected with the foreign corporation's U.S. trade or business, before any reductions for dividend distributions, the branch profits tax, or the tax on excess interest.

Step 2:

Adjust the ECEP amount for any changes in the foreign corporation's U.S. net equity during the year. The ECEP amount from Step 1 is reduced by the amount of any increase in U.S. net equity for the year (but

During year 2, Shony has no ECEP, and its U.S. net equity is \$750,000 at the beginning of the year and \$600,000 at the end of the year. Therefore, Shony's DEA for year 2 is \$150,000, computed as illustrated in Exhibit 2.

The determination of U.S. net equity is made as of the last day of the foreign corporation's taxable year. U.S. net equity equals the aggregate amount of money and the adjusted basis of the property of the foreign corporation connected with the U.S. trade

Exhibit 2:	
(A) ECEP	\$0
(B) Decrease in U.S. net equity:	
Beginning of the year U.S. net equity	\$750,000
End of the year U.S. net equity	<u>\$600,000</u>
Decrease in U.S. net equity	<u>\$150,000</u>
DEA [A-B]	\$150,000

or business reduced (including below zero) by the amount of liabilities connected with the U.S. trade or business. The amount of U.S. connected liabilities is determined by applying the same formula used to determine a foreign corporation's interest expense deduction, except that the assets value and liability amounts are based on end of year totals rather than annual averages. Generally speaking, an asset is considered to be "connected" with a U.S. trade or business to the extent the income produced by the asset or a gain from the disposition of the asset is effectively connected income. Various special rules are provided for applying this principle to specific types of assets, such as depreciable property, inventory, installment obligations, accounts receivable, bank deposits, and debt instruments.

THE ESTATE AND GIFT TAX

U.S. Federal law imposes a transfer tax upon the privilege of transferring property by gift, bequest, or inheritance. During an individual's lifetime, this transfer tax takes the form of a gift tax. For gift tax purposes, a gift is defined as the transfer of property for less than adequate and full consideration in money or money's worth, other than a transfer in the "ordinary course of business." No U.S. gift tax would be owed on a gift to a beneficiary until the gifts made to the beneficiary in a calendar year exceed an applicable exclusion amount for that year (\$18,000 for calendar year 2024). Upon an individual's death, the tax takes the form of an estate tax. The tax is measured against a tax base that includes all the assets owned at death.

The U.S. estate and gift tax is assessed at a rate of 18 to 40% of the value of an estate or gift. A unified credit is available to minimize the impact of the transfer tax. The unified credit gives a set dollar amount that an individual can gift during their lifetime and pass on to beneficiaries before a gift or estate taxes apply. U.S. citizens and resident individuals are permitted a unified credit that exempts \$13.61 million (for the 2024 calendar year) from the estate tax. This means that U.S. citizens and residents can pass \$13.61 million to their heirs without being assessed a gift or estate tax. The unified credit is significantly smaller for foreign individuals that are not domiciled in the U.S. The current unified credit for non-domiciliaries is equivalent to a \$60,000 exemption, unless an applicable treaty allows a greater

credit. In addition to its smaller size, the unified credit available to non-U.S. citizens and non-U.S. domiciliaries cannot be used to reduce their U.S. gift tax. The credit can only be used by their estates upon their deaths to reduce U.S. estate tax.⁸

Since the gift tax is not assessed on the transfer of securities, non-domiciliaries often transfer securities to heirs prior to death for planning purposes.

There are also significant differences as to how the estate and gift tax is calculated for individuals domiciled in the U.S. compared to individuals not domiciled in the U.S. The worldwide estate of a decedent is subject to U.S. estate tax only if the individual was either a U.S. citizen or resident at the time of death.⁹ In contrast, the estate of a non-U.S. citizen individual not domiciled in the U.S. is subject to estate tax solely on his or her U.S. situs assets. Similarly, all property gifted by a U.S. citizen or domiciliary is subject to U.S. gift tax regardless of where the property is situated. However, in the case of a donor who is neither a U.S. person nor a U.S. domiciliary, only gifts of real property or tangible personal property situated in the U.S. are subject to U.S. gift tax.

Because individuals domiciled in the U.S. are permitted a unified credit of \$13.61 million, for most U.S. domiciliaries the estate and gift tax is not an issue. This situation is different for foreign persons who are not domiciled in the U.S. Instead of a unified credit that would shelter up to \$13.61 million in lifetime gifts, individuals not domiciled in the U.S. are only provided a credit equivalent to an exemption of just \$60,000 against the estate tax. Given the differences in the way the U.S. estate and gift tax are calculated, it is crucial to understand when an individual can be classified as being domiciled in the United States. An individual is presumed to have a foreign domicile until such domicile is shown to have changed to the United States. A person acquires a U.S. domicile by living here, potentially even for a brief period of time, with no definite present intention of leaving. To be domiciled in the U.S. for

estate and gift tax purposes, an individual must physically present in the U.S., coupled with the intent to remain in the U.S. indefinitely or permanently.¹⁰ For U.S. estate and gift tax purposes, an individual can only be domiciled in one country.¹¹ The term "domicile" for estate and gift tax purposes should not be confused with the terms "resident" or "residence" used in the income tax context. A foreign investor may be characterized as a resident of the U.S. for income tax purposes through either the green card test¹² or substantial presence test.¹³ Just because a foreign person is classified as a U.S. resident for U.S. federal income tax purposes, does not mean the individual is domiciled in the U.S. for estate and gift tax purposes.

The estate tax for a decedent that was not domiciled in the U.S. is only assessed on its gross estate. The gross estate is made up of property or assets situated in one of the U.S. states or the District of Columbia at the time of death. This is often referred to as U.S. situs assets or property. The gross estate is composed of revocable transfers, transfers taking effect on death, transfers, with a retained life interest or (to a limited extent) transfers within three years of death are includible in the U.S. gross estate if the subject property was U.S. situs property at either the time of the transfer or the time of death. In the case of corporate stock, the stock of a U.S. corporation is U.S. situs and stock of a foreign corporation is foreign situs, regardless of place of management or location of stock certificates.

The rules for determining gift tax for an individual not domiciled in the U.S. differ from the estate tax. As a general rule, the gift tax applies only if transfers of tangible property (real property and tangible personal property, including currency) are physically located in the United States at the time of the gift. The gift tax does not apply to intangible property such as stock in U.S. or foreign corporations even though such property is includible in the U.S. gross estate for federal estate tax purposes. Since the gift tax is not assessed on the transfer of securities, non-domiciliaries often transfer securities to heirs prior to death for planning purposes.

METHODS FOREIGN INVESTORS CAN HOLD REAL ESTATE IN THE U.S.

The next subsections of this article will explore the various ways a foreign investor may hold U.S. real property.

Direct Investment in U.S. Real Estate.

Fairly obviously, the simplest way for a foreign individual to acquire real property in the U.S. is to purchase it outright. That approach has the virtue of simplicity. It avoids the cost of establishing and maintaining a foreign blocker corporation. It eliminates imputed rental issues, 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 121.¹⁴ Gain for heirs who take the property on the owner's death may be eliminated, as the successors will obtain a step-up in basis.

If a foreign investor holds real estate that will be rented, the foreign investor must make a decision how to treat the rental income for U.S. income tax purposes. As a general rule, the leasing of U.S. real estate will not give rise to a U.S. trade or business. If the leasing of real estate is not treated as income arising from a U.S. trade or business, the rental income will be subject to a 30% withholding tax without the benefit of any deductions to reduce the withholding tax. Foreign investors may consider making a "net basis election" under Section 871(d) to be taxed at graduated rates. Upon making the net basis election, the foreign investor is not subject to the 30% withholding tax and is permitted to deduct expenses associated with real estate, such as depreciation and property taxes. These expenses often exceed the taxable rental income.

The biggest tax issue relating to direct ownership is the exposure to the U.S. estate tax should the foreign investor die before selling the property. Some foreign investors believe they can sell their U.S. property before death. The problem is this type of planning depends on one's ability to predict his or her own death. The simplest way of addressing this risk is through life insurance. The proceeds of life insurance are not included in the estate of the foreign investor for purposes of the estate tax.¹⁵ Another method to potentially mitigate or eliminate a foreign investor's exposure to the U.S. estate tax is to utilize a self-canceling installment note or ("SCIN"). A SCIN is a technique that is sometimes used to avoid the inclusion of a note receivable in the holder's estate.

For example, Mom sells Blueacre to Son for a note. Son's note is for a period of ten

years or Mom's life, whichever is shorter. If Mom dies before the note is fully paid, the note is not technically canceled—rather, it has been satisfied, because all payments required pursuant to its terms have been made. Therefore, there is nothing to include in Mom's estate. However, in order for Mom not to have made a gift to Son at the outset, the consideration for Blueacre would have had to be more than would have received under a straight 10-year note, to reflect the fact that Son would not have had to pay the whole price if Mom died during the period.

Sometimes foreign investors can plan for the estate and gift tax by utilizing a gift and estate tax treaty.

A SCIN is an installment obligation that terminates on the occurrence of a certain event (often the seller's death) before it is otherwise due. Through proper planning, a foreign investor may sell his or her real property to designated beneficiaries in exchange for a SCIN and avoid the U.S. estate and gift tax.

Finally, sometimes foreign investors can plan for the estate and gift tax by utilizing a gift and estate tax treaty. The U.S. currently has treaties with 15 countries regarding estate, gift, or generation-skipping transfer tax. The U.S. has entered into treaties with Finland, Greece, Ireland, Italy, the Netherlands, South Africa, and Switzerland that cover only estate taxes. The U.S. has treaties with Australia and Japan that cover estate and gift taxes. The U.S. has treaties with Austria, Denmark, France, Germany, and the United Kingdom ("U.K.") that cover estate, gift, and generation-skipping transfer taxes. The U.S.-Canada income tax treaty substantially modifies the U.S. estate tax for Canadian citizens and residents.

Each treaty's terms are different. Some estate tax treaties such as the U.S.-South Africa estate tax treaty only permit credits to offset an estate tax.¹⁶ Other treaties, such as the ones with the United Kingdom, Canada, and Germany, permit non-U.S. domiciliaries the benefit of a larger unified credit available to domiciliaries.

The three illustrations below show how each of the U.S.-U.K., U.S.-Canada, and U.S.-Germany treaties may be utilized to eliminate the U.S. estate tax.

Illustration 2.

Let's assume a U.K. domiciliary dies while owning U.S. real estate valued at \$125,000. Since the U.K. domiciliary died owning U.S. situs property worth more than \$60,000, the U.K. domiciliary's estate would typically be subject to U.S. estate tax. However, Article 8, paragraph 5 of the U.S.-U.K. estate, gift, and generation-skipping tax treaty states:

Where property may be taxed in the United States on the death of a United Kingdom national who was neither domiciled in nor a national of the United States and a claim is made under this paragraph, the tax imposed in the United States shall be limited to the amount of tax which would have been imposed had the decedent become domiciled in the United States immediately before his death, on the property which would in that event have been taxable.

In order to determine if the estate of a U.K. domiciliary owes U.S. estate tax, it will be necessary review the decedent's worldwide assets at the date of death and calculate a hypothetical estate tax on the decedent's worldwide assets as if the decedent were domiciled in the U.S. In this example, assume that the U.K. domiciliary owed U.K. assets valued at \$1,356,939 when she died in 2023. Since she owed U.S. situs assets valued at \$125,000, the U.K. domiciliary's total worldwide estate was valued at \$1,481,939. The estate tax exemption in 2023 is \$12.92 million. The U.S. assets comprised 16% of the total worldwide assets (\$125,000/\$1,356,939). Under the estate tax treaty between the U.S. and the U.K., the estate is able to take a pro rata credit of \$2,007,520. The estate tax on \$1,481,939 is approximately \$592,775 ($\$1,481,939 \times 40\% = \$592,775$) which is offset in full by the unified credit, leaving a U.S. estate tax of zero.

Illustration 3.

Assume a Canadian domiciliary dies owning U.S. real estate valued in excess of \$60,000. Similar to [Illustration 2](#), the executor may file a U.S. estate tax return with an attached Form 8833 "Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)" citing Article XXIX B of the United States-Canada Income Tax Treaty. The purpose of Article XXIX B is to better coordinate

the operation of the death tax regimes of the two countries. Such coordination is necessary because the U.S. imposes an estate tax, while Canada applies income tax on gains realized at death rather than an estate tax.

As with the U.S.-U.K. estate, gift, and generation skipping tax treaty, the U.S.-Canada income tax treaty permits a deceased Canadian domiciliary a pro rata percentage of the same unified credit available to U.S. domiciliaries. The resulting percentage is applied to the unified credit for the year of death. This amount is the maximum unified credit allowed, which is limited to the actual amount of tax.

Illustration 4.

For this example, assume a husband and wife were domiciled in Germany. They decided to acquire U.S. real estate in the resort town of Park City, Utah. Husband died when the U.S. real property had a fair market value of \$5,000,000. Assume that the Park City real estate was the only asset the couple held on the date of the husband's death.

The executor of the deceased German domiciliary husband may utilize the U.S.-German estate, gift, and generation skipping tax treaty reduce the estate's exposure to the U.S. estate tax. Under the U.S.-German estate, gift, and generation-skipping tax treaty, for purposes of determining the estate tax, "the taxable base is to the extent by its value (after taking into consideration any applicable deductions) exceeds 50% of the value of all property."

Under Article 10, Paragraph 4, for purposes of determining the U.S. estate tax for the estate of the deceased German husband, 50% of the value of the property passed to the surviving spouse is not subject to the U.S. estate tax. In determining the estate tax imposed by the United States, Article 10, Paragraph 5 provides that if a decedent was domiciled in Germany at the time of the decedent's death, the estate tax shall be allowed a unified credit equal to the greater of: a) the amount that bears the same ratio to the credit allowed to the estate of the citizen of the United States as to the value of the part of the decedent's gross estate that at the time of the decedent's death is situated in the United States bears to the value of the decedent's entire gross estate wherever situated; or b) the unified credit

allowed to the estate of a nonresident not a citizen of the United States. Under Article 10, Paragraph 5 of the treaty, the estate of the husband is allowed a unified credit of \$12.92 million against the estate tax.

The U.S. estates of individuals domiciled in Australia, Finland, France, Greece, Japan, and Switzerland are also entitled to utilize a proportion of the applicable unified credit amount otherwise available only to the estates of U.S. citizens and U.S. domiciliaries.

In addition to the estate and gift tax, the

Historically, foreign investors have made their direct investments in the U.S. principally through corporate ownership structures.

primary obstacle facing foreign persons who invest in U.S. real estate is FIRPTA, more specifically Section 897. Section 897 treats any gain recognized by a foreign person on the disposition of a United States real property interest or ("USRPI") as if it were effectively connected to a U.S. trade or business. A potential strategy to avoid FIRPTA or reduce FIRPTA is the use of a shared appreciation mortgage.

In a typical shared appreciation mortgage, a foreign lender may provide a foreign real estate investor with a loan at a fixed rate of interest, plus a share of any profit realized on the sale or disposition of the real property. For purposes of FIRPTA, the lender receives, as "contingent deferred" interest, a predetermined share of the property's appreciation between the time the loan is made and the time the property is sold or the loan otherwise is paid. Shared mortgage appreciation agreements offer a tax planning opportunity for foreign investors investing in U.S. real estate. For example, a foreign corporation lends \$1 million to a domestic individual, secured by a mortgage on residential real property purchased with the loan proceeds. Under the loan agreement, the foreign corporate lender will receive fixed monthly payments from the domestic borrower, constituting repayment of principal plus interest at a fixed rate, and a percentage of the appreciation in the

value of the real property at the time the loan is retired. Section 897 will not apply to the foreign lender on the receipt of either the monthly or the final payments, because these payments are considered to consist solely of principal and interest for U.S. federal income tax purposes. The receipt of the final appreciation payment that is tied to the gain from the sale of the U.S. real property does not result in a disposition of a USRPI for purposes of Section 897, because the amount is considered to be interest rather than gain under Section 1001.

In order for the contingent interest of a shared appreciation mortgage to be recognized, at a minimum, the debt instrument must contain the following terms:

1. a definite maturity date as well as a cap on interest participation;
2. explicitly not be convertible into an equity interest for the borrower;
3. the lender should not have effective control over the borrower or the borrower's assets exceeding that which a lender ordinarily would have;
4. there should be sufficient security for the debt;
5. the loan should be recourse under in nature, rather than nonrecourse;
6. there should not be a provision in the loan under which the purported lender is obligated to subordinate to some or all the borrower's gross receipts rather than on its net income.

Foreign investors may attempt to use debt instruments with contingent interest features to avoid the FIRPTA tax discussed in Section 897. This does not mean that using a shared appreciation mortgage avoids U.S. tax. Instead, a shared appreciation mortgage requires the lender to treat the receipt of contingent deferred interest as interest rather than capital gain. In other words, the contingent interest received by the foreign investor through a shared appreciation mortgage is generally subject to 30% withholding tax. However, unlike FIRPTA, this type of withholding tax is often eliminated or reduced by an income tax treaty. Income tax treaties generally provide for a reduction or elimination of withholding tax on interest income. The ability of a foreign investor to utilize an income tax treaty will largely depend on

the residence of the investor.

OVERVIEW OF STRUCTURING ALTERNATIVES TO HOLD U.S. REAL PROPERTY OR U.S. BUSINESSES FOR ESTATE AND GIFT TAX PLANNING

Holding U.S. Assets through a Foreign Corporation.

Historically, foreign investors have made their direct investments in the U.S. principally through corporate ownership structures. Frequently, a foreign corporation was used as either the direct investment owner or as a holding company for a U.S. subsidiary (which, in turn, owned the direct U.S. real property). Individual foreign investors have frequently preferred use of foreign corporate structures to avoid the U.S. estate and gift tax. Holding U.S. property through a foreign corporation will typically enable the foreign investor to avoid U.S. estate and gift tax because shares in a foreign corporation are not U.S. situs assets. Even though holding U.S. real property through a foreign corporation is typically an effective way to plan for the U.S. gift and estate tax, there are other significant tax consequences that should be carefully considered.

Foreign corporations holding U.S. real estate are generally taxed under the Internal Revenue Code on a gross basis on their U.S. effectively connected income. Foreign corporations are also subject to the branch profits on their effectively connected earnings and profits that are not reinvested in a U.S. trade or business. The branch profits tax may be imposed on rental income and on gain derived from the disposition of real estate. In some limited cases, the branch profits tax can be reduced through an income tax treaty.

If a foreign investor holds real estate through a foreign corporation that will be rented, the foreign investor must make a decision how to treat the rental income for U.S. income tax purposes. As a general rule, the leasing of U.S. real estate will not give rise to a U.S. trade or business. If the leasing of real estate is not treated as income arising from a U.S. trade or business, the rental income will be subject to a 30% withholding tax without the benefit of any deductions to reduce the withholding tax. Foreign investors may consider making a "net basis election" under Section 882(d) to

be taxed at graduated rates. Upon making the net basis election, the foreign investor is not subject to the 30% withholding tax and is permitted to deduct expenses associated with real estate, such as depreciation and property taxes.

Ordinarily, the sale or other disposition of shares in a foreign corporation that owns a U.S. real property interest is not subject to U.S. taxation. Instead, the foreign corporation must recognize gain and pay U.S. tax when it distributes a U.S. real property interest to any of its shareholders, whether by the way of dividend, liquidation, or redemption of stock. The foreign corporation is generally obligated to pay tax on the amount equal to the excess of the fair market value of the U.S. real property interest at the time it is distributed over its adjusted basis.¹⁷ Such a gain will be taxed as if it were effectively connected with the conduct of a U.S. trade or business. The foreign corporation will also be subject

If a foreign investor is a shareholder of a domestic corporation and makes use of the real property held by the domestic corporation for personal reasons, the Internal Revenue Code may impute taxable rental income from the domestic corporation to the foreign investor.

to the branch profits tax on the real estate gains. A foreign corporation may obtain relief from the branch profits tax in the year in which the foreign corporation terminates pursuant to Temp. Reg. 1.884-2T. According to this regulation, an exemption from the branch profits tax may take place when the following elements are satisfied:

1. At the close of the tax year at issue, the foreign corporation has no U.S. assets or the foreign corporation's shareholders have adopted an irrevocable resolution to completely liquidate and dissolve the corporation. All of the foreign corporation's U.S. assets must be liquidated and dissolved or used to satisfy liabilities.
2. For a period of three years

post-termination, the foreign corporation directly or indirectly conducts a U.S. trade or business with any of the assets of the terminated U.S. trade or business or property attributed to the U.S. assets attributable to the foreign corporation.

3. The foreign corporation may not have income treated as effectively connected income during a period of three years from the close of the year of complete termination; and
4. The foreign corporation attaches a waiver of the period of limitations (Form 8848, *Consent to Extend the Time to Assess the Branch Profits Tax Under Regulation Sections 1.884-2(a) and (c)*, or substitute form) to its income tax return for year of complete termination to Treas. Reg. 1.884-2(a)(2)(ii).

If all of the requirements discussed above are satisfied, the foreign corporation will not be subject to the branch profits tax in the year of its termination and its U.S. real property interest is distributed.

As discussed above, anytime a foreign corporation acquires an interest in U.S. real property, the FIRPTA tax regime must be considered. A foreign corporation is required to withhold tax on a distribution of a U.S. real property interest when gain on the distribution is recognized by the corporation under the FIRPTA provisions of Section 897. For example, withholding by a foreign corporation is required when the corporation distributes a U.S. real property interest to shareholders in a liquidating distribution. The amount of tax to be withheld is 35% of the foreign corporation's gain.

Foreign investors holding real property through a foreign corporation may consider making an election under Section 897(i) to minimize the impact of the FIRPTA withholding tax. For example, if a foreign corporation owns U.S. property, it may be advantageous to sell the property and pay associated U.S. federal income taxes. Once the corporation has no real estate and has recognized all taxable real estate gains, it may be possible to liquidate the corporation with no FIRPTA tax consequences to the shareholders. In certain cases, this strategy potentially allows foreign corporate shareholders to avoid U.S. tax on a distribution from the U.S. corporation. This is particularly the case when real property held by

the foreign corporation does not appreciated over its tax basis. In such a case, there should be no FIRPTA withholding. However, it will be necessary to apply for a FIRPTA withholding certificate to avoid FIRPTA withholding. It may be possible to overcome this obstacle, by having the foreign corporation elect to be treated as a U.S. corporation for FIRPTA purposes under Section 897(i).

A foreign corporation that makes a Section 897(i) election is also eligible to transfer real estate to the corporation under the nonrecognition provisions of Sections 351 and 897(e). This may avoid triggering FIRPTA withholding when U.S. real property is contributed to a foreign corporation. A Section 897(i) election only causes the foreign corporation to be treated as a domestic corporation for FIRPTA purposes, not for estate tax purposes. Making a Section 897(i) election should always be considered when utilizing a foreign corporation to hold U.S. real estate. In order to qualify for the Section 897(i) election, the corporation must be entitled to nondiscriminatory treatment under a U.S. income tax treaty.

A foreign corporate structure should probably never be utilized as part of an estate plan in any case where there are U.S. beneficiaries. This is because a U.S. beneficiary may receive shares of a foreign corporation that could be classified as a controlled foreign corporation ("CFC"). To be considered a CFC, more than 50% of the vote or value must be owned by U.S. shareholders, who must also own at least 10% of the corporation. U.S. shareholders of CFCs are subject to specified anti-deferral rules under the global low-tax income ("GILTI") or Subpart F tax regimes, which may require a U.S. shareholder of a CFC to report and pay U.S. tax on undistributed earnings of the foreign corporation. There are other U.S. tax consequences that must be considered before placing U.S. real estate into a foreign corporation. If the foreign investor makes use of a home for personal reasons, any increases in value of the home will not qualify for an exclusion of gains under Section 121. In addition, gain for U.S. heirs who take property on the shareholder's death will not obtain a step-up in basis.

Holding U.S. Assets through a Domestic Corporation.

Given some disadvantages of placing U.S. real property in a foreign corporation,

foreign investors may consider contributing U.S. assets to a domestic corporation. U.S. corporations are taxable on their worldwide income on a net basis with deductions for operating expenses. From a U.S. income tax point of view, a U.S. corporation may potentially avoid some of the harsh tax consequences discussed above. For example, as long as a domestic corporation is not held by a foreign corporation, the branch profits tax regime may potentially be avoided.

Many foreign investors investing in U.S. real property are advised to hold property through multi-tiered structures. These multi-tiered corporate blocker structures typically consist of U.S. corporations which in turn are owned by foreign corporations. Individuals not domiciled in the U.S. are sometimes led to believe that multi-tiered corporate structures can be utilized to avoid the U.S. estate and gift tax. Prior to 2004, multi-tiered corporate structures could be utilized to protect foreign investors from the U.S. federal estate and gift tax. This is no longer the case.

However, unless reduced treaty rates are applicable, foreign investors holding real estate through a domestic corporation may be subject to 30% FDAP withholding on any dividend distribution from the domestic corporation.¹⁸ There are a number of other income tax consequences that must be considered before placing a U.S. asset into a domestic corporation. If a foreign investor is a shareholder of a domestic corporation and makes use of the real property held by the domestic corporation for personal reasons, the Internal Revenue Code may impute taxable rental income from the domestic corporation to the foreign investor. If the real

property placed into the domestic corporation is a primary residence, and if the real property increases in value, the appreciation will not qualify for a Section 121 exemption. As a result, any increase in the value of real property held as a primary residence will be taxed at the corporate level. A second layer of tax will be assessed at the shareholder level as FDAP income potentially subject to the 30% flat tax.

A major potential benefit to holding U.S. real property in a domestic corporation is the ability to utilize financing. Foreign investors may consider utilizing portfolio debt to acquire U.S. real estate through a U.S. corporation as an alternative over repatriation by dividend distributions. Portfolio debt has two advantages. First, the corporation may realize an interest deduction for the amount paid to its shareholders. Second, interest on portfolio debt may be exempt from U.S. withholding taxes. This can be a very useful tax planning tool for foreign investors that do not qualify for tax treaty benefits. Portfolio debt eliminates U.S. withholding tax with the need to utilize any particular provision of a tax treaty. In order to avoid U.S. withholding taxes on portfolio interest, the two following requirements must be satisfied.

The first requirement of the portfolio debt rules is the interest paid must not be paid to a so-called "10% shareholder." A 10% shareholder is a domestic corporation holding U.S. real property which owns 10% or more of the combined voting power of all classes of the stock of the lending corporation.

The second requirement provides that the portfolio exemption does not apply to payments of interest to CFCs that are considered related persons with respect to the borrower domestic corporation. Section 267(b) applies to determine if a domestic corporation is related to a foreign corporation. Section 267(b) considers two corporations to be related where a parent corporation owns more than 50% of the vote or its total voting power or value is owned by U.S. persons (i.e., U.S. individuals, U.S. trusts, U.S. corporations, or U.S. partnerships) who each own at least 10% of the combined voting power of all classes of stock, or at least 10% of the total value of all classes of stock.¹⁹ It should be noted that the attribution rules of Section 318 can apply to attribute stock ownership of a foreign corporation to U.S. persons such as a U.S. corporation holding real estate owned by foreign investors.

For example, consider the situation of a foreign company ("Foreign Parent Company") that owns 100% of the shares in another foreign company ("Foreign Subsidiary Company"). Foreign Subsidiary Company owns 51% of a U.S. company ("U.S. Finance Subsidiary"), but only holds non-voting shares -with the voting shares being held by a completely unrelated and independent third party. If Foreign Subsidiary Company makes loans to U.S. Company that were to directly or indirectly own a U.S. corporation that was not a subsidiary of Foreign Subsidiary Company, it is possible that Foreign Subsidiary Company could be considered a CFC since Foreign Subsidiary Company's stock would be attributed from Foreign Parent Company down to the U.S. corporation directly or indirectly owned by Foreign Parent Company.²⁰

In order for a domestic corporation to deduct portfolio interest payments for U.S. tax purposes, the provisions of Section 163(j) must be satisfied. Section 163(j) can potentially apply to limit deductions for interest, including deductions for interest payments on portfolio debt loans. The general rule of Section 163(j) limits the deductibility of interest expenses paid or accrued on debt properly allocable to a trade or business to the sum of business interest income, and 30% of "adjusted taxable income." For these purposes, adjusted taxable income is determined without regard to certain deductions such as depreciation, amortization, and depletion.

Care must also be exercised in capitalizing a U.S. corporation that holds U.S. real estate to ensure that the company does not offend the U.S. thin capitalization rules. The U.S. thin capitalization rules contain no fixed debt-equity ratio; thus, a loan's recharacterization as capital can result in the disallowance of interest deductions and the interest payments being treated as dividends subject to U.S. withholding. These rules apply not only to an investment in a U.S. corporation but also to an investment in a foreign corporation that owns U.S. real estate.

In certain cases, a domestic corporation can be an effective tool for estate and gift tax planning. Recall that the U.S. federal gift tax applies to non-domiciliaries when they make transfers of tangible property physically located in the U.S. at the time of the gift. Thus, the gift tax may not apply

when domestic stocks are transferred through a gift.

Although domestic corporate stocks are typically subject to the U.S. estate tax because these assets are considered U.S. situs property, U.S.-estate and gift tax treaties may abrogate this general rule. For example, Article 9 of the U.S.- German Estate and Gift Tax Treaty, Article 5 of the U.S.- United Kingdom Estate and Gift Tax treaty, and Article 7 of the U.S.- Austria Estate and Gift Tax Treaty exclude U.S. corporate stock from the estate tax. Depending on the domiciliary of the foreign investor and the ability of a foreign investor to utilize an estate and gift tax treaty, holding real estate through a domestic corporation can be an effective method to avoid both the U.S. estate and gift tax.

Since U.S. corporate stock is treated as U.S. situs property for purposes of the estate tax, utilizing a multi-tiered corporate structure to hold U.S. real estate will not likely provide any meaningful estate tax protection for foreign investors.

The FIRPTA provisions contained in Section 897 imposes a tax on gain realized upon the disposition of a "U.S. real property interest." U.S. real property interest is also defined to include any interest (other than an interest solely as a creditor) in a U.S. corporation unless the foreign person holding such interest establishes that the U.S. corporation was at no time during the five years ending on the date of the disposition a U.S. real property holding corporation.²¹ A "U.S. real property holding corporation" is defined to include any corporation (whether domestic or foreign), the fair market value of whose U.S. real estate interests equals or exceeds 50% of the sum of the fair market value of:

1. its U.S. real property interests,
2. its interests in real property located outside the United States, and
3. any other of its assets that are used or held for the use in a trade or business.²²

Since the test depends on comparative asset values, a corporation could become a U.S. real property holding corporation even if it did not modify its asset holdings.

Gains realized from the disposition of an interest in a U.S. corporation that constitute a U.S. real property holding corporation is generally taxed at the same rate and under the same rules as the disposition of direct holdings in real estate. The entire amount of gain realized from the sale of stock in a domestic U.S. real property holding corporation is subject to tax, regardless of the portion attributable to the U.S. real property interest that it holds. However, Section 897 will not apply to the sale or other disposition of the stock if the corporation holds no U.S. real property interest at the time of the disposition and if all U.S. real property interests held by the corporation during the five years prior to the disposition have been transferred in which the full amount of gain has been recognized.

If a U.S. corporation owns U.S. real property, it may be advantageous to sell the property and pay any associated U.S. taxes. Once the corporation has no real estate and has recognized all real estate gains, it would no longer constitute a real property holding corporation and it would be possible to liquidate the corporation with no FIRPTA tax consequences to the shareholders. This would potentially allow a corporate shareholder to avoid U.S. tax on a distribution from the U.S. corporation. If the property is not appreciated over its tax basis, there would be no FIRPTA withholding, although it will be necessary to apply for a FIRPTA withholding certificate to avoid FIRPTA withholding.

Holding U.S. Real Property through a Multi-Tiered Blocker Structure.

Many foreign investors investing in U.S. real property are advised to hold property through multi-tiered structures. These multi-tiered corporate blocker structures typically consist of U.S. corporations which in turn are owned by foreign corporations. Individuals not domiciled in the U.S. are sometimes led to believe that multi-tiered corporate structures can be utilized to avoid the U.S. estate and gift tax. Prior to 2004, multi-tiered corporate structures could be utilized to protect foreign investors from the U.S. federal estate and gift tax. This is no longer the case.

All this was possible because prior to 2004, a U.S. corporation was able to reincorporate in a foreign jurisdiction and thereby replace the U.S. parent corporation with a foreign parent corporation. These transactions were commonly referred to as asset inversion transactions. In asset inversions, a U.S. corporation generally recognized gain (but not loss) under Section 367(a) as though it had sold all of its assets, but the shareholders generally did not recognize gain or loss, assuming the transaction met the requirements of a reorganization under Section 368. To remove the incentive to engage in corporate inversion transactions, Congress included several provisions in the 2004 JOBS Act aimed at corporate inversions. One of these provisions was Section 7874.

The anti-inversion rules are designed to prevent corporate inversions by providing different methods of taxation depending on whether the former U.S. shareholders own at least 80% of the new foreign corporation or at least 60% (but less than 80%) of the shares of a new foreign corporation.

The anti-inversion rules apply if pursuant to a plan or series of related transactions:

1. a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction;
2. the former shareholder of the U.S. corporation holds (by reason of holding stock in the U.S. corporation) 80% or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and
3. the foreign incorporated entity, considered together with all companies connected to it by a chain of greater than 50% ownership (i.e., the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group.

The provision denies the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Internal Revenue Code.

Although there are many variations of inversions, as a general rule, when a

domestic corporation holding U.S. real estate merges into a foreign corporation to avoid U.S. estate and gift taxes, the transaction can be classified as inversion. This is because the U.S. corporation holding the real estate becomes a subsidiary of a foreign corporation and the former shareholders of the U.S. corporation will ultimately hold at least 80% (by vote or value) of a foreign corporation by reason of holding stock in the U.S. corporation. This type of a structure will not likely trigger the recognition of the inversion gain. However, it will deny the intended tax benefit by treating the foreign corporation as a domestic corporation for all purposes of the Internal Revenue Code.

For income tax purposes, a foreign grantor trust treats the foreign investors as if he or she directly held the real property held in trust. A foreign grantor trust does not offer protection from the U.S. estate and gift tax.

Section 7874 will result in adverse U.S. federal estate and gift tax consequences because the transfer of shares of a domestic corporation to a foreign corporation is an inversion. The foreign investor who directly owned the shares in the U.S. corporation now owns all of the shares of the foreign corporation, which holds the stock of the U.S. corporation. This means, a foreign investor (who is not a U.S. domiciliary) is treated as holding shares in a U.S. corporation rather than stock in a foreign corporation. Since U.S. corporate stock is treated as U.S. situs property for purposes of the estate tax, utilizing a multi-tiered corporate structure to hold U.S. real estate will not likely provide any meaningful estate tax protection for foreign investors.

Holding U.S. Assets through a Partnership.

The use of a traditional partnership (regardless of whether it is domestic or foreign) has the advantage of enabling the foreign investor to obtain the benefits to avoid the two layers of tax associated with corporate structures. A partnership, whether domestic or foreign can be classified as a conduit through which the partners are attributed their shares of partnership items

of income and expenses. The partnership is not subject to income tax. Instead, the partners are taxed directly on their share of the partnership's income annually, regardless of whether the income is distributed to the partners. Partnerships are required to withhold on a foreign partner's share of U.S. effectively connected income. When a foreign investor sells a partnership interest, the gain from the sale is treated as effectively connected income subject to U.S. tax to the extent it is attributable to the partnership's ownership of U.S. real property.

The main benefit of holding U.S. real estate in a partnership is that it provides a vehicle for making U.S. tax-exempt gifts of the partnership's underlying U.S. real estate through transfer of the partnership interest itself.²³ In contrast, if a foreign investor were to own U.S. real estate directly in his or her own name, then a gift of the real property would be subject to a U.S. gift tax. Even though a gift of a partnership is not subject to a U.S. gift tax, there is some risk that the IRS might assert that a partnership engaged in a U.S. trade or business will be classified as a U.S. situs asset for purposes of the U.S. estate tax.²⁴ The IRS may claim that a traditional partnership interest should be classified as "U.S. situs property" (and, thus, subject to the U.S. estate tax on nonresident aliens) when the partnership is engaged in a U.S. trade or business such as the leasing of U.S. real estate. This is the conclusion one may seemingly extract from an analysis of Treas. Reg. 20.2104-1(a), which provides what appears to be, in broad conceptual terms, a comprehensive list of the assets that may constitute "property within the United States."²⁵ Under that regulation, both real property and tangible property located in the United States are U.S. situs assets, as are shares in U.S. corporations and debts issued by U.S. persons.

There is a strong argument that can be made that residence of a deceased partner is the situs of the partnership interest (*mobilia sequuntur personam*) is the situs of the partnership for purposes of the estate tax. This theory is discussed in *Blodgett v. Siberman*.²⁶ In *Blodgett v. Siberman*, the United States Supreme Court addressed the basic question of whether the State of Connecticut had the right to impose its state inheritance tax on a Connecticut decedent who had owned an interest in a New York partnership whose assets were

principally in, the State of New York. In reaching the conclusion that Connecticut did have authority to tax the Connecticut decedent on his New York partnership interest, the U.S. Supreme Court essentially decided two subsidiary issues.²⁷ First, it concluded that the common law maxim of "mobilia sequuntur personam" applied, in that "intangible personalty has such a situs at the domicile of its owner that its transfer on his death may be taxed there." Having concluded that Connecticut would have the authority to tax the New York partnership interest if it constituted intangible personalty, the Court goes on to analyze whether the partnership interest was "a chose in action and intangible personalty." After analyzing the applicable New York partnership law and finding that a partner does not have a direct ownership right in the underlying assets of the partnership, but rather the partner has "simply a right to share in what would remain of the partnership assets after its liabilities were satisfied," the Court concluded "it was merely an interest in the surplus, a chose in action." The New York partnership interest was, therefore, an intangible personalty subject to the mobilia sequuntur personam rule. Consequently, *Blodgett v. Silberman*, can be read as standing for the proposition that a partnership interest is a separate intangible asset, and the location of its assets or the place where the partnership carries on its business is immaterial in determining the situs of the intangible interest.²⁸

Because there is no explicit Internal Revenue Code section or regulation discussing the situs of partnership interests, the principle of mobilia sequuntur personam potentially may control the situs of a partnership interest. Nonetheless, notwithstanding this logic, foreign investors wanting to utilize a partnership as a vehicle to avoid the estate tax to hold U.S. real estate should utilize a foreign partnership. Utilizing a foreign partnership would not only preserve the mobilia sequuntur personam discussed above, investors holding real property in a foreign partnership could also take the position such an entity avoids the estate tax under a "foreign entity exemption theory." Foreign investors may consider holding U.S. real property through a Nevis LP. A Nevis LP is not treated as a Per Se Corporation²⁹ for U.S. tax purposes. A Nevis LP is also not treated as a corporation

under the laws of Nevis because the general partners of such an entity own unlimited legal liability. A Nevis LP can be treated as a partnership for U.S. tax purposes under the so-called "check-the-box" rules.

Ownership of U.S. Property through a Foreign Trust.

A foreign investor can hold U.S. real property through a foreign grantor trust. A grantor is a type of trust in which the grantor retains ownership of the trust's assets for income tax purposes. A "grantor" for purposes of Section 679 is defined in Prop. Treas. Reg. 1.671-2(e) to include any person to the extent such person either creates the trust or acquires an interest in a trust in a non-gratuitous transfer from a person who is a grantor of the trust. A foreign grantor trust will be recognized under U.S. tax law if a foreign person is regarded as the owner of a foreign trust property. A foreign person is considered the owner of a foreign trust if either the foreign trust is revocable solely by the grantor without the approval or consent of any person other than a related or subordinate party who is subservient to the grantor, or where, during the lifetime of the grantor, the amounts distributable (whether income or corpus) from the foreign trust are distributable only to the grantor or the grantor's spouse. For income tax purposes, a foreign grantor trust treats the foreign investors as if he or she directly held the real property held in trust. A foreign grantor trust does not offer protection from the U.S. estate and gift tax.

A foreign trust can also be established as a non-grantor trust. A non-grantor trust is any trust that is not a grantor trust. This kind of trust affords no control or powers to the grantor. This means that the grantor is unable to revoke or change the terms of the trust or make changes to the trust beneficiaries. A foreign non-grantor trust is potentially an attractive vehicle for foreign investors to hold U.S. real property. If the trust is regarded as such for U.S. tax purposes, the trust would not be subject to the branch profits tax. A foreign non-grantor trust can potentially avoid the gift tax, and estate tax. A non-grantor trust is generally taxed in the same manner as individuals, with certain modifications. Thus, like a U.S. citizen or resident, a domestic trust will pay U.S. tax on its worldwide income and capital gains. Items of ordinary income are taxed at graduated rates after the

allowance of certain deductions and credits. Gains from the sale of capital assets are taxed at capital gains rates. Similar to a nonresident alien, a foreign non-grantor trust will pay U.S. income tax only on its income and certain gains from U.S. sources and on income or gain that is "effectively connected" to a U.S. trade or business. However, distributions from a foreign non-grantor trust to U.S. beneficiaries are subject to a complex set of rules.

In calculating its taxable income for U.S. beneficiaries, a trust will receive a deduction for distributions to its beneficiaries to the extent that these distributions carry out the trust's "distributable net income" or "DNI" for the taxable year. Generally, the DNI of a domestic non-grantor trust for a particular year is equal to its taxable income for that year adjusted:

1. by adding to taxable income the amount deducted as a personal exemption, the amount of its tax exempt income, and the amount of the trust's deduction for distributions to beneficiaries and
2. by subtracting from taxable income the trust's capital gains except to the extent such capital gains are "paid, credited or required to be distributed to any beneficiary during the taxable year."³⁰

Any DNI so distributed will retain its character in the hands of the recipient beneficiaries and will be taxed to them.

Capital gains of a domestic non-grantor trust generally do not enter into the DNI calculation and are usually taxed to the trust. Any distributions by the trust to U.S. beneficiaries in excess of DNI will be a non-taxable distribution of capital. The DNI of a foreign non-grantor trust includes its capital gains. In addition, a foreign non-grantor trust's DNI includes the amount of its income from non-U.S. sources subject to certain reductions. Distributions to beneficiaries are considered first to carry out the DNI of the current year (pro rata as to each item of income or gain) and will be taxed to the recipient beneficiaries. If a foreign trust does not distribute all of its DNI in the current year, the after tax portion of the undistributed DNI will become "undistributed net income" or "UNI."

Distributions of the UNI of a foreign non-grantor trust received by a U.S. beneficiary

are taxed under the "throwback rule," which generally seeks to treat a beneficiary as having received the income in the year in which it was earned by the trust. A foreign non-grantor to UNI for any particular year is equal to the amount by which its DNI for such year exceeds the sum of:

1. The amount of trust accounting required to be distributed in such year;
2. The amount of any other amount properly paid or credited or required to be distributed for such year; and
3. The amount of any taxes imposed on the trust that are attributable to its DNI for the year.³¹

The throwback rule effectively results in federal tax being levied at the recipient's highest marginal income tax rate for the year in which the income tax rate for the year in which the income or gain was earned by the trust. This means any capital gains accumulated by a foreign trust for distribution in a later taxable year will lose its favorable rate and instead be taxed at ordinary income rates. In addition, the throwback rule adds an interest charge to the taxes on a throwback distribution in order to offset the benefits of tax deferral. The interest charge accrues for the period beginning with the year in which the income or gain is recognized and ending with the year that the UNI amount is distributed, and is assessed at the rate applicable to underpayments of tax, as adjusted compounded daily.

If a beneficiary has received an accumulation distribution from a foreign non-grantor trust, the "throwback tax" on the distribution will be calculated by the following nine steps discussed below.

Step 1:

An allocation needs to be made for the accumulated income for the prior years. If the amount of accumulated income exceeds the UNI for the earliest year of the trust, the excess income is allocated to the next year for which there is any remaining UNI. This process continues from year to year until all of the accumulation distribution has been properly allocated. Each allocation of accumulated income is distributed on the last day of the year for trust accounting purposes.

Below, please see [Illustration 5](#), which demonstrates Step 1 to calculating the throwback tax.

Illustration 5.

Tom is a beneficiary of F, a foreign non-grantor trust. F was established in 2017 by Tom's mother who is not a citizen or resident of the United States. F distributed \$100,000 to Tom in 2024, a year in which F's DNI and trust distributed income was \$20,000. Consequently, \$80,000 of the distribution is treated as an accumulation distribution. F's DNI, none of which was distributed, in each of its preceding years was as follows:

2017- \$4,000
2018- \$20,000
2019- \$30,000
2020 - \$40,000

Tom's \$80,000 accumulation distribution is deemed to have been made \$4,000 on the last day of 2007, \$20,000 on the last day of 2018, \$30,000 on the last day of 2019, and \$40,000 on the last day of 2020.

Step 2:

Next, add to the amount deemed, under Step 1, to have been distributed on the last day of a preceding year the taxes that were imposed on such amounts in such a year. Such taxes include U.S. and foreign income taxes.

Below, please see [Illustration 6](#), which demonstrates Step 2 in calculating the throwback tax.

Illustration 6.

Assume that F, the trust discussed in [Illustration 5](#), paid taxes in each of its preceding taxable years equal to 40% of its DNI. The total amount deemed to have been distributed to Tom on the last day of 2017, 2018, 2019, and 2020 will be \$5,600, \$28,000, \$42,000, and \$36,400 for each year respectively. Based on this example, the entire amount deemed to be "Throwback Tax" is \$112,000.³²

Step 3:

Next, determine the number of preceding taxable years in which the distribution is deemed to have been made to the beneficiaries of the trust. For purposes of this calculation, if any year's deemed distribution is less than 25% of the total amount of the accumulation distribution divided by the number of preceding taxable years to which the accumulation distribution is allocated, that year will not be

included for purposes of calculating the throwback tax.

Below, please see [Illustration 7](#), which demonstrates Step 3 in calculating the throwback tax.

Illustration 7.

In [Illustration 5](#) and [Illustration 6](#), the number of preceding taxable years in which a distribution is deemed to have been made is three. The year 2017 is disregarded because the amount of the accumulation distribution allocated to that year (\$4,000) is less than 25% of the total accumulation distribution (\$80,000) divided by the number of years to which the distribution is deemed allocated is four.

Step 4:

Next, it will be necessary to identify the beneficiary's computation years. The computation years are those three of the beneficiary's five immediately preceding taxable years left after eliminating the year in which his or her income was the highest and the year in which his or her income was the lowest.

Below, please see [Illustration 8](#), which demonstrates Step 4 in calculating the throwback tax.

Illustration 8.

Assume that Tom's taxable income for the 2019, 2020, 2021, 2022, and 2023 tax years was \$50,000, \$100,000, \$200,000, \$150,000, and \$175,000 respectively. The year of the highest taxable income was in 2021, and the year of the lowest taxable income received in 2019 are both eliminated for purposes of this calculation. Tom's three computation years are now 2020, 2022, and 2023.

Step 5:

Next, it will be necessary to determine the average annual distribution amount. This is done by dividing the amount of deemed distribution by the number of preceding years in which the distribution is deemed to have been made to the beneficiaries.

Below, please see [Illustration 9](#), which demonstrates Step 5 in the calculation of the throwback tax.

Illustration 9.

In [Illustration 9](#), the amount deemed distributed was \$112,000 and the number of preceding years in which the distribution is deemed to have been made was three.

The average annual distribution amount is \$37,333 ($\$112,000/3 = \$37,333$).

Step 6:

Next, it will be necessary to determine the amount by which the beneficiary's income tax would have increased in each of the three computation years if the annual distribution amount had been added to his or her taxable income for these years. To make this calculation, no differentiation is made among the various types of income that were included in the foreign nongrantor's trust's UNI (other than tax-exempt income). Consequently, if a portion of the trust's UNI was long term capital gain, the beneficiary will not receive the advantage of the lower rate that generally applies to such grants. If any foreign income were added in Step 2 to the amount deemed to have been distributed, the amount of such taxes may be allowed as a credit against the increase in tax calculation in this step.

Step 7:

It will next be necessary to determine the average tax increase by dividing the sum of the three increases by three.

Step 8:

Next, it will be necessary to multiply the average tax increase by the number of preceding taxable years in which the distribution is deemed to have been made as determined under Step 3.

Step 9:

Finally, it will be necessary to subtract from the product obtained in Step 8 by the amount of any U.S. income taxes that were added into the calculation in Step 2. The final result is the amount of the beneficiary's throwback tax.

CALCULATION OF THE INTEREST CHARGE

If a foreign non-grantor trust makes a distribution of UNI to a U.S. beneficiary, the distribution will not only be subject to the throwback tax, the distribution will also be subject to an interest charge as per Section 668. As per the Internal Revenue Code, the interest rate charged on the throwback tax is the rate applied under Section 6621 to underpayments of federal income tax. This interest is also compounded daily. The number of years over which interest is calculated is determined by a process which is

said to produce a "dollar-weighted" number of years.

The interest charge is calculated utilizing a three-step formula. This formula is set forth in Schedule C "Calculation of Interest Charge" on Form 3520. First, the UNI for each year must be multiplied by the number of years between such a year and the year of the distribution. Second, all products calculated in the first step must be added together. Finally, the sum of such products calculated in the second step must be divided by the aggregate amount of the non-grantor foreign trust's undistributed income. The quotient is to be rounded to the nearest half-year. For purposes of this calculation, an accumulation is treated as having come proportionately from each year with respect to which there is UNI.

Investing in U.S. Real Estate Through a REIT

A real estate investment trust or ("REIT") is a common vehicle for earning income from rental property. In general, REITs have fully transferable interests and are widely held, having a minimum of 100 investors. REITs make current distributions out of income derived from U.S. real estate investments. The distributions are taxed in the U.S. as corporate distributions but there is no corporate-level tax. Any distributions in excess of the REIT's earnings and profits are treated as nontaxable returns of capital or, if the distribution exceed basis, as taxable gain, in either case, the distribution is subject to a 15% withholding tax, unless the FIRPTA exceptions for domestically controlled REITs or publicly traded companies apply.

One of the exceptions to the applicability of FIRPTA frequently relied on by foreign investors is the sale of stock in a domestically controlled REIT. REIT stands for "Real Estate Investment Trust." A REIT is organized as a partnership, corporation, trust, or association that invests directly in real estate through the purchase of properties or by acquiring mortgages. REITs typically issue shares that trade on stock exchanges and are bought and sold like stocks. To qualify as a REIT, a company must comply with certain provisions of the Internal Revenue Code. These requirements include to primarily own income-generating real estate for the long-term and distribute income to shareholders. A REIT must also:

1. invest at least 75% of total assets in real estate, cash, or U.S. Treasuries;
2. derive at least 75% of gross income from rents, interest on mortgages that finance real property, or real estate sales;
3. pay a minimum of 90% of taxable income in the form of shareholder dividends each year;
4. be an entity that is taxable as a corporation;
5. be managed by a board of directors or trustees;
6. have at least 100 shareholders after its first year of existence; and
7. have no more than 50% of its shares held by five or fewer individuals.

A domestically controlled REIT is an entity in which non-U.S. persons hold directly or indirectly less than 50% of the interests in the REIT. Foreign investors frequently acquire U.S. real estate through a domestically controlled REIT and structure their exit in U.S. real estate as a sale of shares in such domestically controlled REIT instead of a sale of a free simple interest in order to avoid the FIRPTA tax. Therefore, the determination of whether a REIT is domestically controlled is often critical to a foreign investor's investment decision.

Section 897(h)(4)(B) generally provides that a domestically controlled REIT is which less than 50% in value of the stock is held "directly or indirectly" by foreign persons. The Internal Revenue Code does not provide specific guidance interpreting the words "directly or indirectly." In the past, the IRS has considered whether a foreign-owned U.S. corporation should be viewed as a U.S. person for purposes of determining whether a REIT is domestically controlled. According to the fact pattern in Private Letter Ruling 200823001 (June 5, 2009), a REIT was held by two domestic corporations that were owned in part by foreign shareholders. The IRS determined that the REIT was considered to be "domestically controlled" despite the fact that the REIT was indirectly owned by a foreign corporation. The Ruling refers to Treas. Reg. 1.897-1(c)(2)(i), which provides that "the actual owners of stock, as determined under Treas. Reg. 1.857-8, must be taken into account." Treas. Reg. 1.857-8(b) provides that the actual owner of stock of a REIT is the person who is required

to include in gross income any dividends received on the stock. The proposed regulations do not retain the reference to Treas. Reg. 1.857-8 in Treas. Reg. 1.897-1(c)(2)(i).

The proposed regulations introduce a new concept of look-through persons and non-look-through persons that will dramatically impact REIT planning. Under the proposed regulations, in order to determine if a REIT is domestically controlled, it is necessary to review each look-through person until you reach a non-look-through person. A look-through person is any person other than a non-look-through person and includes a regulated investment company, a REIT, an S corporation, a non-publicly traded partnership (domestic or foreign), and a trust (domestic or foreign). A public REIT is treated as a foreign person that is a non-look-through person.

A non-public domestic C corporation is treated as a look-through-person if it is a foreign-owned domestic corporation. A foreign-owned domestic corporation is any non-public domestic C corporation if foreign persons hold directly or indirectly 25% or more of the fair market value of the non-public domestic C corporation's outstanding stock. This means that, contrary to prior guidance, a REIT shareholder that is a private taxable domestic C corporation is a look-through person if 25% or more of the value of its outstanding stock is held by shareholders which are foreign persons. The Treasury Department and the IRS intend this new foreign-owned domestic corporation rule to prevent the use of intermediary domestic C corporations to create domestically controlled REITs. While the proposed regulations import this new concept of look-through persons and non-look-through persons, they continue to rely only on actual chains of ownership and do not import the attribution or constructive stock ownership rules found in other parts of the Internal Revenue Code such as Sections 267 and 318.

CONCLUSION

The foregoing discussion is intended to provide the reader with a basic understanding of the principal planning alternatives and basic U.S. tax considerations of foreign

investment in U.S. real estate. This article does also not discuss state tax consideration involving foreign investment in real property. Any foreign investor considering investing in U.S. real estate should consider the tax laws of the state in which the real property being acquired is located. It should be evident that this is a complex subject. It is also important to note that this area is constantly subject to new developments and changes. As a result, it is crucial that the foreign investor should review his or her particular circumstances with a qualified international tax attorney, both to ensure that the proposed planning option is appropriate for the foreign investor's specific factual circumstances, and to ensure that there has not been new developments or changes which would render the proposed planning approach inadvisable.

End Notes

¹ See I.R.C. Sections 871 and 882.

² See I.R.C. Sections 871(a) and 881(a).

³ See Treas. Reg. 1.1445-1(g)(4).

⁴ See Treas. Reg. 1.1445-1(g)(5).

⁵ See Treas. Reg. 1.1445-2(d)(1).

⁶ See I.R.C. Section 884.

⁷ Generally when a foreign person or foreign corporation engages in a trade or business in the United States, all income sources within the U.S. connected with the trade or business is considered effectively connected.

⁸ See I.R.C. Section 2505(a).

⁹ See I.R.C. Sections 2001(a) and 2031(a).

¹⁰ Treas. Regs. 20.0-1(b)(1) and 25.2501-1(b) provide an overview of the term "domicile" for estate and gift tax purposes by stating as follows: "a person acquires a domicile in a place by living there, even for 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.

¹¹ A number of U.S. estate and gift tax treaties vary the domicile rules and permit dual domicile situations.

¹² Under the green card test, a lawful permanent resident for any part of a calendar year for U.S. immigration purposes is a U.S. resident for U.S. federal income tax purposes.

¹³ Under the substantial presence test of I.R.C.

Section 7701(b)(3), if an individual is present in the U.S. for 183 days or more in a single year, including partial days. An individual may also be considered a U.S. resident for the current calendar year under the substantial presence test if at least 31 days in the testing year and the following formula amounts to 183 days or more: add all of the days present in the year being tested, one-third present in the first preceding year, and one-sixth of the days present in the second preceding year.

¹⁴ I.R.C. Section 121 allows a taxpayer to exclude up to \$250,000 (\$500,000 for certain taxpayers who file a joint return) of the gain from the sale of property owned and used as a principal residence for at least two of the five years before the sale. A taxpayer can claim the full exclusion only once every two years.

¹⁵ See I.R.C. Section 2105(a).

¹⁶ I.R.C. Section 2013 allows a credit against the federal estate tax imposed on the present decedent's estate for the federal estate tax paid on the transfer of property from a transferor who died within ten years before, or within two years after, the present decedent's death.

¹⁷ See I.R.C. Section 897(d)(1).

¹⁸ See I.R.C. Section 897(c)(1)(A)(ii); I.R.C. Section 1445(e)(3).

¹⁹ I.R.C. Section 957(a); 951(b).

²⁰ See Moore and Melrose, *Inbound Structuring For U.S. Real Estate Latest And Greatest Structure And More* (2020).

²¹ See I.R.C. Section 897(c)(1)(A)(ii).

²² See I.R.C. Section 897(c)(2).

²³ See I.R.C. Section 2501(a)(2).

²⁴ See Treas. Reg. 20.2104-1(a)(4).

²⁵ The list of U.S. situs assets at Treas. Reg. 20.2104-1(a) lacks any mention of partnership interests.

²⁶ 277 U.S. 1 (1928).

²⁷ See Hudson Jr., *All The Extra U.S. Tax Issues About Advising Foreign Clients on U.S. Real Estate Investments, But Were Afraid to Ask* (2016).

²⁸ *Id.*

²⁹ Per Se Corporations are entity types specifically identified by the United States Treasury as corporations and are not eligible to elect treatment as a partnership or disregarded entity.

³⁰ See I.R.C. Section 643(a)(3).

³¹ See I.R.C. Section 665(a).

³² See Example in "The Throwback Tax," by Harrison, McCaffrey, Heller, and Kirshner, February 2015.