INBOUND INVESTMENTS INTO U.S. MARKETS

Estate Planning Council of Norther New Jersey

Morristown, NJ
March 27, 2024

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TOPICS

- Introduction & Fundamentals
- Investment in U.S. Financial Markets
- Investment in U.S. Real Property
- Investment in U.S. Tangible Property
- Additional Considerations
- Question & Answer

INTRODUCTION & FUNDAMENTALS

Introduction

Jurisdiction for Taxation

Estate Tax Blockers

Basis Step Up

Anti-Deferral Regimes

INTRODUCTION

- Residency
  - Residency is the Code's basis for taxation from an income tax perspective.
    - Substantial Presence Test
    - Lawful Permanent Residence Test
  - A nonresident is taxed on "passive" US source income and income effectively connected income with a US trade or business.
- Domicile
  - Domicile is the Code's basis for taxation from a transfer tax perspective.
    - Physical presence plus intention to remain indefinitely.
  - A nondomiciliary is taxed on US situs property.

JURISDICTION FOR TAXATION

Substantial Presence Test

- The substantial presence test looks at the amount of time an individual is physically present in the US.
- Individual will be a resident if:
  - 31 or more US days during a calendar year; and
  - Sum of all US days during calendar year, one-third of US days during first preceding calendar year, and one-sixth of US days during second preceding calendar year is at least 183 days.
- Generally, any day of physical presence counts as a US day regardless of how much time during that day the individual is in the US.
- Exempt individuals.
- Closer connection or US income tax treaty exception may be available.

JURISDICTION FOR TAXATION

Permanent Residence Test

- Under the permanent residence test, an individual is a US resident if the individual is a "lawful permanent resident" of the US.
- This means the individual holds a US green card.
- An individual that is a resident under this test is considered to be a resident until such time as he or she surrenders the green card or it is revoked. Physical presence in the US is irrelevant (other than for determining residency start date and residency end date in first and last year of residency).

JURISDICTION FOR TAXATION

Domicile

- A person whose primary residence or "domicile" is in the United States. An individual is a U.S. domiciliary if he or she lives in the United States and has no definite present intent to leave, as shown by the surrounding facts and circumstances. See Treas. Reg. Sections 20.0-1(b)(1) and (2).
- Unhelpful facts and circumstances test which does not dovetail with income tax residency. Nonresident can be US domiciled and resident can be nondomiciliary.
- Absent treaty, only $60,000 estate tax exemption and no gift tax exemption. Likely same GST exemption as US domiciliaries.
- Estate tax situs rules are broader than gift tax situs rules insofar as they cover intangibles; treaties can alter result.
- Unsettled are:
  - Partnerships as estate tax "blockers."
  - Foreign disregarded entities as estate tax "blockers."
  - Application of Section 2104(b) to trusts where settlor retains strings.
- Treaties can help with double taxation.

JURISDICTION FOR TAXATION

Trusts

- Trust residency.
  - A trust is a foreign trust if it fails either “court” or “control” test. Treas. Reg. §301.7701-7.
- Grantor trusts.
  - Section 672(f)(1) override to sections 673-677.
  - Exceptions in section 672(f)(2).
  - “Economic grantor” under Treas. Reg. §1.672(e)-1.
- Foreign nongrantor trusts.
  - Taxed like nonresidents on FDAPI and ECI.
  - Foreign source income and capital gains are part of DNI though not taxable to the trust.
  - Throwback rules apply to distributions of UNI to US beneficiaries.
  - US beneficiaries can be attributed an interest in the underlying foreign corporations held by the trust or the underlying foreign funds for purposes of CFC and PFIC rules.

JURISDICTION FOR TAXATION

Types of Income

- Fixed Determinable Annual Periodical Income (“FDAPI”)
  - Gross basis at 30% withholding.
  - Exceptions for portfolio interest, bank deposit interest.
  - Capital gains not taxed except if nonresident is present in the US for 183 days and has US tax home.
- Effectively Connected Income (“ECI”)
  - Net basis at graduated rates up to 37%.
  - Pass through investments and FIRPTA can subject nonresident to ECI.
  - Trading safe harbor.
- Treaties can provide reduced rates and exemptions.

JURISDICTION FOR TAXATION

Estate Tax Situs

- The estate tax is imposed on the worldwide assets of a US citizen or domiciliary and on the US situated assets of a non-citizen non-domciliary.
- Accordingly, planning around US situs rules is critical. However, structure must still account for US income tax sensitivities.
  - Compare corporate, partnership or trust structures, especially for investment in US real estate.
  - Basis step-up considerations discussed further below.
- De minimis credit ($60,000 exclusion)

JURISDICTION FOR TAXATION

Estate Tax Situs

US Estate Tax Situs	Non-US Estate Tax Situs
Stock in a US corporation (IRC § 2104(a))	Proceeds of life insurance on nonresident (IRC § 2105(a))
Transfers with retained interests if US situs at time of transfer or at death (IRC § 2104(b))	Works of art on loan for exhibition (IRC § 2105(c))
Debts of US persons (other than certain bank deposits and debts paying portfolio interest) (IRC § 2104(c))	Certain bank deposits and debts paying portfolio interest (IRC § 2105(b))
Real property and tangible personal property located in US	Look through rule on stock in regulated investment company (i.e., mutual funds) (IRC § 2105(d))
Partnership interest???	Partnership interest???

JURISDICTION FOR TAXATION

Gift Tax "Situs"

- The gift tax is imposed on the worldwide assets of a US citizen or domiciliary and on the US situated real and tangible personal property of non-citizen non-domiciliaries (not imposed on the transfer of intangibles, such as share of stock in a US corporation). IRC § 2501(a)(2).
- Accordingly, lifetime planning transferring intangibles may significantly reduce US estate taxation if such intangibles were otherwise held until death. Issues on restructuring:
  - Triggering income tax (especially FIRPTA)
  - Step transaction doctrine
  - Special situs rule (IRC § 2104(b))
- Cash???
- No credit for gift taxes.

JURISDICTION FOR TAXATION

GST Tax

- The GST tax is a “backstop” to the US estate and gift taxes, intended to supplement the US estate and gift tax regime on multi-generational wealth transfers.
- The fundamental premise of the GST tax is that there must be (have been) a predicate transfer subject to the US estate or gift tax.
- Accordingly, if there is no predicate transfer subject to the US estate or gift tax, there can be no GST tax. See Reg. § 26.2663-2.
- The creation of multi-generational GST exempt “dynasty trusts” is the single most powerful technique in international estate planning for multi-national families.

ESTATE TAX BLOCKERS

- Notwithstanding this acceptance by the professional community, the efficacy of an estate tax blocker may be more nuanced than merely assessing the situs of the foreign entity itself. The reason lies in the language of section 2104(b).
- By its terms, section 2104(b) treats as U.S. situs property any property of which the decedent has made a transfer, by trust or otherwise, within the meaning of sections 2035 to 2038, inclusive, if the transferred property were U.S. situated either at the time of transfer or at the time of the decedent's death

ESTATE TAX BLOCKERS

- The authority under section 2036 is now well settled that for an entity to be respected within the section 2036 context, there must have been a significant and legitimate non-tax reason for the creation of the entity.
- Therefore, as a matter of best practice, a practitioner advising around the creation of an estate tax blocker may wish to follow some of the practices that have developed when planning with domestic family limited partnerships in terms of considering (and documenting) the non-tax reasons for the creation of an entity.
- In the cross-border context, consideration around non-U.S. succession laws (such as forced heirship or Sharia), post-mortem administration and avoidance of multi-jurisdictional probate, and other governance objectives are often highly significant issues.

BASIS STEP UP

- As applied to a non-U.S. transfer tax resident, however, § 1014(b)(9) has limited application in the context of a properly designed plan.
- It is therefore necessary to find an alternative provision on which to rely on a step-up in basis, and one finds this § 1014(b)(2) and § 1014(b)(3).
- It is critical to bear in mind that § 1014(a) merely provides a step-up in basis in assets held directly by the decedent or the foreign grantor trust. If U.S. situated assets are owned through an entity, this will produce new outside basis but will be insufficient to provide new inside basis.

ANTI-DEFERRAL REGIMES

Entity Classification

- Threshold question is whether the “arrangement” rises to the level of being an entity for US tax purposes, and, if so, whether the entity is a trust or a business association.
- If a foreign business association, classification defaults to:
  - partnership if it has two or more members and at least one member does not have limited liability;
  - a corporation if all members have limited liability; or,
  - a disregarded entity if it has a single owner that does not have limited liability.
- The above classifications can be changed using a check the box election, except for per se corporations.

ANTI-DEFERRAL REGIMES

CFC Definition

- A CFC is any non-US corporation in which US shareholders own more than 50% of the total voting stock or value.
- A US shareholder is any US person who owns 10% or more of the total voting stock or value.
- Special rules apply for determining the ownership of stock to treat a shareholder as owning stock directly, indirectly, and constructively.
  - Stock owned by or for a corporation, partnership, trust or estate is considered to be owned proportionately by its shareholders, partners, or beneficiaries.
  - Stock is treated as owned constructively through IRC § 318 attribution rules, subject to certain modifications.

ANTI-DEFERRAL REGIMES

CFC Taxation

- If a US person owns stock in a CFC on the last day of any taxable year, the US person will be required to include in gross income the pro rata share of the CFC's "subpart F income" and "GILTI".
- This includes passive income such as interest, dividends, rents, royalties, and net gains on the sale or exchange of property producing such income.
- Inclusion of subpart F income results regardless of an actual distribution from the CFC to the shareholder.
- This "phantom" income may leave the shareholder with a large tax liability, but no cash with which to satisfy the liability.
- The income is essentially taxed as a non-qualified dividend at the shareholder's effective tax rate.
- No more "30 day" rule following 2017 tax act.

ANTI-DEFERRAL REGIMES

PFIC Definition

- A PFIC is any non-US corporation if 75% or more of the gross income is passive, or if 50% or more of the assets produce passive income.
- Once classified as a PFIC during the shareholder’s holding period, it will remain a PFIC for that shareholder in all subsequent tax years.
- The CFC rules trump the PFIC rules.
- Direct and indirect ownership rules apply; constructive ownership rules do not.

ANTI-DEFERRAL REGIMES

PFIC Taxation

- A shareholder in a PFIC is subject to special tax on PFIC “excess distributions.”
- An excess distribution occurs to the extent that the shareholder receives a distribution that exceeds 125% of the average distributions within the 3 preceding taxable years. Any gain recognized on the disposition of stock in a PFIC is treated as an excess distribution.
- Excess distributions are treated as ordinary income.
- An excess distribution is allocated ratably over the shareholder’s holding period. Portions allocated to prior taxable years are subject to an interest charge. The interest charge is a function of the deferred tax multiplied by the IRC § 6621 rate (short-term AFR plus three percentage points).
- Avoid excess distribution regime by “qualified electing fund” (“QEF”) election or by “market to market” election.

INVESTMENT IN U.S. FINANCIAL MARKETS

Single Foreign Corporation

Triple Blocker

Asset Protection Trust with Single Foreign Corporation

SINGLE FOREIGN CORPORATION

Generally

- From an income tax perspective, the structure obtains the same benefits as a non-U.S. resident individual having invested directly, which is to say, the exclusion of capital gains and portfolio and depository interest from U.S. tax and the imposition of a 30 percent withholding tax on other FDAPI.
- From an estate tax perspective, the efficacy of the foreign corporation as an estate tax blocker may be conditioned by whether there exists a significant or legitimate non-tax purpose for having created the entity and whether corporate formalities are observed.

SINGLE FOREIGN CORPORATION

Post-Mortem

- On a post-mortem basis in the hands of a U.S. beneficiary, the choice of the single foreign corporation confronts the inside basis and CFC dilemma
- Two solutions:
  - "churn" the underlying investment portfolio
  - one can confront the CFC rules head on, and hope that the non-U.S. investor dies "at the right time."

SINGLE FOREIGN CORPORATION

Example

- Assume for example, that the non-U.S. investor dies on January 1 and a check the box election is made effective January 2. The U.S. beneficiary will be forced to include one-half of the Subpart F and GILTI income, multiplied by the U.S. beneficiary's percentage ownership in the CFC. If, however, the non-U.S. investor had died on October 27, the 300th day of the year, the U.S. beneficiary would include only 1/300th of the Subpart F and GILTI income, multiplied by the U.S. beneficiary's percentage ownership in the CFC. If the portfolio were to be regularly "churned" and the non-U.S. investor were to live beyond the first few days or weeks of January, the potential underlying gain could prove to be quite manageable.

TRIPLE BLOCKER

Generally

- First, the non-U.S. investor forms two new corporations and owns 100% of the stock of each foreign corporation (“FC1” and “FC2,” respectively).
- Second, FC1 and FC2 are structured such that each owsn 50% of the stock of a subsidiary corporation (FC-Sub). FC-Sub, in turn, owns U.S. situs investments. When the non-U.S. investor dies, the shares of FC1 and FC2 receive a fair market value basis upon the death of the grantor (assuming direct ownership or a properly structured foreign grantor trust).
- Third, FC-Sub files a check-the-box election, effective before the grantor’s death.

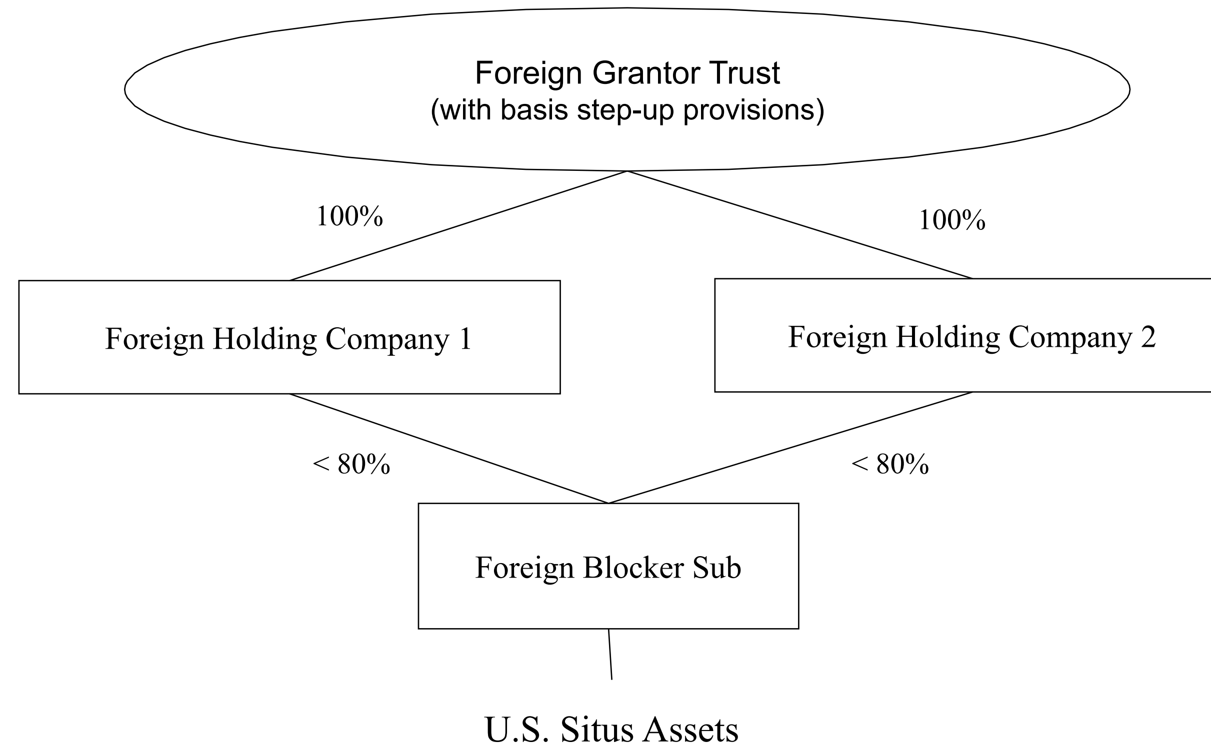
TRIPLE BLOCKER

Generally

- Because the check-the-box election is a deemed liquidation for U.S. tax purposes, and FC1 and FC 2 will recognize gain in an amount equal to the difference between the fair market value of FC-Sub's assets received in the liquidation and the basis of the FC-Sub stock surrendered.
- As a result, each of FC1 and FC2 will receive a stepped-up basis in the assets of FC-Sub.
- Fourth, FC1 and FC2 each file a CTB election, effective two days after the grantor's death, so that FC1 and FC2 may shield the U.S. situs assets deemed to be owned by FC1 and FC2 from U.S. estate tax.

TRIPLE BLOCKER

Generally



TRIPLE BLOCKER

Post-Mortem

- If the decedent dies in the first 75 days of the calendar year (i.e., on or before March 16), it may be possible to make the deemed liquidation of FC-Sub as a result of the check-the-box election occur in the prior taxable year, thereby avoiding any allocation of gain realized by FC1 and FC2 to the U.S. Shareholder who acquires the shares in the following year (i.e., the year of the decedent's death).
- If the decedent dies more than 75 days into the calendar year so that the deemed liquidations of FC1, FC2, and FC-Sub occur in the same taxable year, and FC1 and FC2 are liquidated promptly after death, then a fraction of the gain will be apportioned to the U.S. Shareholders. However, this fraction is likely to be 1/77 or less.

TRIPLE BLOCKER

Post-Mortem

- For example, if the decedent died on March 17, and the check-the-box elections for FC1 and FC2 are effective on March 19, the deemed liquidation occurs on March 18.
- Here, the fraction is 1/77 because (i) the decedent's holding period should include the date of death, (ii) the U.S. Shareholder's holding period does not include the date the U.S. shareholder acquired the stock, (iii) the U.S. Shareholder's holding period includes the date of disposition, which should be the date of the deemed liquidation of FC1 and FC2 (i.e., March 18); and (iv) there are only 77 days in the taxable years of FC1 and FC2 as corporations (i.e., January 1 to March 18).

ASSET PROTECTION TRUST WITH SINGLE FOREIGN CORPORATION

Generally

- The use of an asset protection trust as the owner of a single foreign corporation presents a potential solution to make the check the box election effective the day before the non-U.S. investor's death, and still insulate the underlying U.S. situated assets from U.S. estate taxation.
- The technique relies on the premise that because the assets of the trust are not subject to the claim's of the settlor's creditors, then, if other offending powers are absent from the terms of the trust instrument and there is no implied agreement that the assets will be available to the settlor at the settlor's direction, then, the assets held by the asset protection trust should not be estate tax includible to the settlor under either § 2036 or § 2038.
- By simple application, the same should thus be true in the context of § 2104(b).

ASSET PROTECTION TRUST WITH SINGLE FOREIGN CORPORATION

Qualification as a Grantor Trust

- For the technique to work, the asset protection trust must therefore be a foreign grantor trust, such that by causing the check the box election to be effective on the day before the non-U.S. investor's death, all of the income is purged during the foreign grantor trust period and therefore attributable to the non-U.S. investor.
- To achieve this, the asset protection must be circumscribed in a way that would be uncommon in the more traditional domestic context. This is to say in that in order to qualify as a grantor trust with respect to the non-U.S. investor, only the non-U.S. investor and the non-U.S. investor's spouse may be beneficiary's during the non-U.S. investor's lifetime

INVESTMENT IN U.S. REAL PROPERTY

Two-Tiered Corporation

Two-Tiered Partnership

Irrevocable Trust

TWO-TIERED CORPORATION

Generally

- If properly structured to manage branch profits tax exposure, a foreign corporation can offer income tax efficiency comparable to direct ownership or ownership through a partnership without the estate tax exposure.
- Historically, there were two main drawbacks to a foreign corporation: (1) corporations were taxed at higher rates than individuals on long-term capital gains (up to 35%), and (2) if the corporation was inherited by U.S. persons it would be a very tax-inefficient structure, exposing the U.S. owners to double taxation.
- The reduction in corporate tax rates to 21% has eliminated the first issue, making foreign corporations much more attractive estate tax blockers to foreign owners who do not plan to gift or bequest their interests in the property to U.S. persons.

TWO-TIERED CORPORATION

Further Considerations

- Net Rent Election
  - A non-U.S. owner can make a “net rent” election under § 871(d) to treat the rent as ECI. A higher marginal rate may apply, but the owner could deduct property taxes and other expenses and claim depreciation deductions against the rental income. The owner would have to file a federal and possibly state income tax return to report the income.
- Personal Use of the Property
  - Both IRS guidance and case law suggest that uncompensated use of property held in a corporation by its shareholder or the shareholder’s family members will generally be treated as a constructive distribution to the shareholder and thus as a taxable dividend to the extent of the corporation’s earnings and profits.

TWO-TIERED CORPORATION

Further Considerations (cont.)

- Branch Profits Tax
  - If a foreign corporation owns U.S. real property directly or through a pass-through entity, net gains and other earnings may be subject to a 30 percent “branch profits” tax on top of any federal or state corporate income tax due.
  - The tax, which is intended to approximate the 30 percent tax that would apply to dividends from a domestic corporation, generally can be avoided if the foreign corporation is liquidated in the year of sale and certain other procedural requirements (including a three-year prohibition on effectively connected income and use of the property by certain related parties) are satisfied.

TWO-TIERED CORPORATION

Post-Mortem

- If the stock of the foreign corporation will be distributed to the U.S. beneficiaries, including a U.S. trust for their benefit, a monetization event is not contemplated in the near term and the property is expected to further appreciate, then a check-the-box election may make sense to avoid double taxation (i.e., at the foreign corporate and U.S. shareholder levels) on the pre- and post-death appreciation when the non-U.S. shareholder passes away
- If a check-the-box election is made shortly after death, then there should be no post-death appreciation and only corporate-level tax at 21% at the federal level should apply (plus state and local taxes if applicable)

TWO-TIERED CORPORATION

Post-Mortem (cont.)

- One further option to consider if most of the beneficiaries will be U.S. individuals is to domesticate the foreign corporation and then elect “S corporation” status by filing IRS Form 2553.
- If there is a trust owning the stock of the corporation, it should be domesticated too and in order to be an eligible shareholder, the trust would have to elect to be treated as an electing small business trust (“ESBT”).

TWO-TIERED PARTNERSHIP

Generally

- Foreign partnerships offer a degree of income tax efficiency because the income is taxed at the partner-level where it may be eligible for long-term capital gain rates.
- It may also be possible to achieve the equivalent of a basis step-up at death by making a Section 754 election after the death of one of the partners.
- However, the relative income tax advantages over a foreign corporation have been greatly reduced now that corporate tax rates have come down to 21% and are likely overshadowed by the potential estate tax exposure

TWO-TIERED PARTNERSHIP

Estate Tax Treatment

- Interests in a foreign partnership arguably are not subject to estate tax in the hands of a non-U.S. decedent, but the law is not well developed in this area.
- There is a risk that the IRS could take an “aggregate” or “look-through” approach and look to the situs of the underlying assets, particularly after Congress adopted an explicitly aggregate approach to the treatment of sales and exchanges of partnership interests in Sections 864(c)(8) and 1446(f).
- Characterization of a partnership interest for estate tax situs purposes may hinge on how the partnership is treated under local law.

IRREVOCABLE TRUST

Generally

- If the property will be acquired for the benefit of a U.S. person, then a U.S. irrevocable trust may be the most tax-efficient structure, as it balances income tax efficiency with estate tax protection for the settlor.
- A trust that will invest in U.S. real estate holdings can be structured to provide the same estate tax protections as a foreign corporation (assuming the settlor will not retain any "impermissible strings" under Section 2036 and 2038), while preserving long-term capital gain treatment (if applicable).

IRREVOCABLE TRUST

Domestic or Foreign?

- If the trust has or is ultimately likely to have U.S. beneficiaries, it generally should be structured as a U.S. trust.
- If a foreign nongrantor trust has U.S. beneficiaries and income is not distributed currently, punitive tax rules apply to distributions of income earned in prior years while the trust was a nongrantor trust.
- No FIRPTA withholding when the property is sold by a U.S. trust.
- Uncompensated use of property of a foreign nongrantor trust by a U.S. beneficiary is reportable on IRS Form 3520 as a constructive distribution and can carry out income. However, U.S. beneficiaries can use property owned by a U.S. trust rent-free without triggering an income inclusion or filing obligation.

INVESTMENT IN U.S. TANGIBLE PROPERTY

STRUCTURES

ADDITIONAL CONSIDERATIONS

STRUCTURES

Generally

- Like stock in a U.S. corporation and U.S. real property, tangible personal property located in the United States is U.S. situated property for estate tax purposes
- Planning for a U.S. beneficiary who will inherit an interest in the tangible personal property requires structuring into a basis step-up solution, particularly given that tangible personal property will overwhelmingly be subject to tax at the higher 28% collectibles rates
- Inter vivos planning to eliminate the asset from the investor's eventual estate thus necessitates the creation of a holding vehicle that has sufficient substance to avoid a step-transaction argument, or, the investor must confront the practical challenges of taking the tangible personal property physically outside of the U.S. borders

STRUCTURES

Step Up in Basis

- Assuming that the tangible personal property is not inventory, any gain from the sale or exchange of tangible personal property is sourced to the seller's place of residency, as determined by tax home.
- This means that unlike an interest in U.S. real property, post-mortem planning around a step up in basis may be available for U.S. tangible personal property in the same way that it may be available for investment in U.S. financial assets.
- At first glance, this would indicate that the structuring choices for U.S. tangible personal property should more closely resemble those available for investment into U.S. financial assets.

STRUCTURES

Step Up in Basis (cont.)

- Corporate Blockers
  - Inability to churn
  - Inability to recycle cash
  - Engage in related party sales?
- Trust Blockers
  - Irrevocable trust (no retained benefit)
  - Asset protection trust (risk of weakening efficacy)
- Are we left with two-tiered partnership?

ADDITIONAL CONSIDERATIONS

Exhibition Exception

- Section 2105 provides that a non-domiciliary’s works of art located in the United States will not be considered U.S. situated for U.S. estate tax purposes if the exhibition exception is satisfied.
- The exhibition exception requires that the works of art are:
  - imported into the United States solely for exhibition purposes
  - loaned for such purposes to a public gallery or museum (no part of the net earnings of which inures to the benefit of any private stockholder or individual) and
  - at the time of the investor’s death are on exhibition or en route to or from exhibition at such public gallery or museum.

ADDITIONAL CONSIDERATIONS

Tangibles in Residence

- If tangibles are associated with a U.S. residence, including the tangibles in the same structure as the U.S. real estate may make sense from a simplicity perspective.
- However, if the value of the tangibles is more significant, this may be a sort-sighted strategy for several reasons.
  - The post-mortem planning around tangibles likely necessitates a different strategy from what would be employed for real property. If a check the box election is made on a holding company post-mortem, this would not cause U.S. source income (other than the proportionate amount of Subpart F income) with respect to the tangible personal property, but it would constitute a FIRPTA disposition and trigger all the gain in the U.S. real estate.
  - Given branch profits tax considerations, it will often make more sense to use a two-tiered corporation structure and hold the U.S. residence in a domestic corporation. If the tangible personal property is held with the U.S. resident in the domestic corporation, it would unnecessarily subject the U.S. tangible to U.S corporate tax on sale.

ADDITIONAL CONSIDERATIONS

Tangibles in Residence (cont.)

- If a third party buyer is open to purchasing the holding company rather than the real property, having the tangibles in the same company will generally require that the tangibles be bundled with the residence in the sale or otherwise distributed out from the entity which may then incur a tax on the distribution.

ADDITIONAL CONSIDERATIONS

Treatment as Inventory

- A non-U.S. investor with significant tangible personal property holdings in the United States may run the risk that the level of the investors activities is material enough to cause the investor to rise to the level of being engaged in a U.S. trade or business.
- The consequence is that the tangible personal property can then be considered inventory, and the general sourcing ruling of sec. 865(a) would cease to apply.
- Instead, any sale or exchange of the tangible personal property as inventory would treated as U.S. source income if the sale or exchange took place within the United States under a passage of title test.

ADDITONAL CONSIDERATIONS

Private Placement Life Insurance

U.S. Activities of Family Offices

Hybrid Residency Issues

Withholding Taxes

PRIVATE PLACEMENT LIFE INSURANCE

- Private placement life insurance is a type of variable universal life insurance, which allows the policy owner to build cash value within the policy.
- The hallmark of private placement is that unlike certain registered products, the inside investments of the private placement product can be bespoke.
- In the hands of a non-U.S. investor, this becomes a potentially powerful tool to solve the myriad inbound investment challenges.
- Most importantly, it solves the problems of estate tax inclusion and basis step-up.

PRIVATE PLACEMENT LIFE INSURANCE

- By definition, amounts receivable as insurance on the life of a nondomiciliary are not deemed U.S. situs property.
- When the policy pays out the death benefit, the beneficiary will receive cash free of income taxation and, naturally, without built in gain.
- Subject to the limitations on the available underlying investments due to diversification requirements and the absence of investor control, there is ample opportunity for the non-U.S. investor to construct an inbound investment portfolio in a highly efficient and flexible manner.

U.S. ACTIVITIES OF FAMILY OFFICES

- At higher levels of wealth, individuals may operate through more complex investment and family office structures.
- If a nonresident invests in a partnership (U.S. or foreign) and that partnership is considered to be engaged in a USTB, the partnership's USTB will be attributed to the nonresident.
- Additionally, in the case of a nonresident who engages in investment activities, ECI includes, in relevant part, gain from the sale of investment assets if the nonresident maintains an office or fixed place of business in the United States that materially participates in generating the gain.

U.S. ACTIVITIES OF FAMILY OFFICES

- If the family office has employees or other “agents” who are physically present in the United States, the activities of those agents adds an additional layer of complexity to the analysis of the U.S. taxation of the inbound investments.
- What this means is that if a nonresident has a USTB by reason of having an agent in the U.S. that negotiates or concludes contracts on its behalf the gain realized from the transactions entered into by the agent will constitute ECI only if the agent is a dependent agent.
- If the nonresident has a USTB by reason of an independent agent relationship, however, the activities of the independent agent that are involved in generating gain will not create an office or fixed place of business and therefore will not give rise to ECI.

HYBRID RESIDENCY ISSUES

- A common fact pattern for an inbound investor may be that the individual exceeds the day counting threshold under the substantial presence test, but has not formed the subjective intent to remain indefinitely in the United States that is required to be U.S. domiciled.
- Such a situation poses a particularly challenging planning scenario.
- This is because, as a nondomiciliary, the investor would be well-advised to try to block underlying U.S. situs assets to insulate from U.S. income tax exposure.
- However, from a U.S. income tax perspective, the inbound investment structure will very likely contain CFCs.

HYBRID RESIDENCY ISSUES

- There are a limited numbers of ways to address this, including:
  - proactively planning around CFC issues to mitigate income tax leakage to the greatest extent possible
  - ensuring there is another owner of the would-be CFC and checking the box before the investor becomes a U.S. resident (and thus relying on the classification of the entity as a partnership to constitute a blocker)
  - moving to an optimal income tax position (most likely through a fully transparent, non-blocked structure) and hedging out the estate tax risk through life insurance.

WITHHOLDING TAXES

FIRPTA

- A buyer purchasing U.S. real property from a non-U.S. seller generally must withhold 15 percent of the gross consideration paid. In the case of property that will be used by the transferee as a personal residence, the withholding rate is reduced to ten percent if the amount realized does not exceed $1,000,000 and no withholding is required if the amount realized is $300,000 or less. Noncash consideration (including the assumption of debt), is subject to withholding.
- The buyer or seller may apply for a withholding certificate from the IRS to reduce the amount required to be withheld if it exceeds the tax owed by filing Form 8288-B. Otherwise, the seller can file a tax return and apply for a refund. Withholding may also be required at the state level in some jurisdictions.

WITHHOLDING TAXES

FIRPTA (cont.)

- Fifteen percent FIRPTA withholding applies under § 1445 to the disposition of an interest in a U.S. or foreign partnership if 50 percent or more of the value of the gross assets consists of U.S. real property interests and 90 percent or more of the value of the gross assets consists of U.S. real property interests plus cash or cash equivalents.
- Even if an interest in a partnership would not be subject to FIRPTA withholding under the 50/90 test, it may nonetheless be subject to ten percent withholding under § 1446(f). Section 864(c)(8) provides that gain or loss from the sale, exchange or other disposition of a partnership interest by a nonresident is ECI to the extent that the seller would have had ECI had the partnership sold all its assets for fair market value. The amount of ECI is limited to what would be allocated to the partner upon a hypothetical liquidation of the partnership at fair market value as the date of disposition. A comparable provision limits the amount of an effectively connect loss.

WITHHOLDING TAXES

ECI Partnerships

- Section 864(c)(8) provides that gain or loss from the sale, exchange or other disposition of a partnership interest by a nonresident is ECI to the extent that the seller would have had effectively connected gain or loss had the partnership sold all its assets for fair market value.
- The amount of ECI is limited to what would be allocated to the partner upon a hypothetical liquidation of the partnership at fair market value as the date of disposition. A comparable provision limits the amount of an effectively connect loss.
- Notably, if there are underlying USRPIs, the § 864(c)(8) gain or loss is reduced to avoid duplication.

WITHHOLDING TAXES

ECI Partnerships (cont.)

- The sourcing rule of § 864(c)(8) it buttressed by a FIRPTA-style withholding tax regime imposed by § 1446(f) and its regulations.
- Section 1446(f) provides that the purchaser or other transferee is required to withhold ten percent of the amount realized on disposition of a partnership interest by a nonresident if any portion of the gain would be treated as ECI under § 864(c)(8)

WITHHOLDING TAXES

FDAPI

- When a foreign taxpayer receives dividends, interests, or other periodic payments from U.S. sources, the withholding mechanism under § 1441 essentially requires the U.S. payor to withhold the tax for the foreign taxpayer.
- By default, the amount withheld is 30 percent on the gross payment amount.
- However, a withholding agent can withhold less if the foreign payee is entitled to a reduced rate under an applicable tax treaty and the payee provides adequate documentation by way of an appropriate Form W-8.

WITHHOLDING TAXES

FDAPI (cont.)

- A withholding agent under § 1441 is any person who has control, receipt, custody, disposal, or payment of an income item subject to withholding. In many cases, financial institutions act as withholding agents when a foreign taxpayer receives FDAPI payments stemming from a bank account at the financial institution, for example.
- However, the identity of the withholding agent depends on the facts and circumstances of each situation where an FDAPI payment is made to a foreign taxpayer.
- For example, in a closely held investment structure, such as where the U.S. payor is a closely held corporation making dividend payments to a foreign shareholder, that corporation is responsible for withholding tax on the dividend payment.
- In essence, the closely held corporation must implement procedures to withhold the tax and deposit any withheld tax in a Federal Reserve or other authorized bank.

QUESTION & ANSWER