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INSIGHTS

HOME THOUGHTS FROM ABROAD: WHEN FOREIGNERS PURCHASE U.S. HOMES

FINAL G.I.L.T.I. HIGH-TAX REGULATIONS AND THE TESTED UNIT: WOULD A ROSE BY ANY OTHER NAME SMELL AS SWEET?

AND MORE

Insights Vol. 7 No. 5

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EDITORS' NOTE

In this month's edition of *Insights*, our articles address the following:

- **Home Thoughts From Abroad: When Foreigners Purchase U.S. Homes.** Remember when tax planning was an exercise in solving two or three potential issues for a client? Memorandums ran eight pages or so. Those days are long gone, especially when planning for a non-U.S. individual's purchase of a personal use residence in the U.S. A myriad of issues pop up once the property is identified, so that planning which begins at that time often misses significant tax issues encountered over the period of ownership and beyond. Michael J.A. Karlin, a partner of Karlin & Peebles, L.L.P., Los Angeles, and Stanley C. Ruchelman, address the big-picture issues in an article that exceeds 50 pages. Included are issues that arise leading up to the acquisition, during ownership and occupancy, the time of disposition, and at the conclusion of life. The article is the "go-to" document for tax planners.

- **Final G.I.L.T.I. High-Tax Regulations and the Tested Unit: Would a Rose By Any Other Name Smell As Sweet?** A precursor to a global minimum tax for multinational enterprises, the G.I.L.T.I. rules under Subpart F ensure that tax is imposed on cross-border income. The tax rate on G.I.L.T.I. reported by U.S. corporations is relatively low, currently 10.5% and a foreign tax credit is allowed for 80% of the foreign taxes imposed on tested income taxed under the G.I.L.T.I. provisions. In the summer, the I.R.S. issued proposed and final regulations allowing taxpayers to avoid the tax by claiming an exclusion for highly taxed income of tested units. Are the regulations a true benefit or is the benefit illusory? Andreas Apostolides and Neha Rastogi explain all.

- **New Partnership International Information Return Schedules.** The I.R.S. recently released drafts of two new partnership return schedules and accompanying instructions to address the reporting of income from international transactions. The new forms are required because of tax law changes enacted as part of the Tax Cuts & Jobs Act in 2017 and recent changes in I.R.S. policy regarding partnerships as aggregates rather than entities. Schedule K-2 and Schedule K-3 each contain nine parts, generally covering the information required with respect to the most common international tax provisions of U.S. tax law. Schedule K-3 contains a tenth part applicable only to the distributive share of a partner in relation to a sale of a partnership interest. Galia Antebi and Nina Krauthamer explain all.

- **When an Exchange of Vows is Followed by Separate Ownership of Shares Should Either Spouse Feel G.I.L.T.I.?** Cross border tax planners are expected to know all there is about various provisions of Subchapter N of the Internal Revenue Code. An example might be the G.I.L.T.I. provisions adopted in the Tax Cuts & Jobs Act of 2017. They are not expected to know more mundane provisions of tax law such as rules that apply to married persons filing a joint tax return. In their article, Andreas Apostolides and Stanley C. Ruchelman examine a recent hiccup in G.I.L.T.I. provisions that focus computations in a top-down way. What happens when the marital property regime adopted by the married couple is that of separate property (or they are domiciled in a common law jurisdictions), one spouse separately owns

C.F.C.'s with losses, the other spouse separately owns C.F.C.'s with positive earnings, and none of the C.F.C.'s generates Subpart F income? Is the married couple treated as one unit or simply an aggregate of two separate taxpayers? The answer may be troubling.

- **The Do's And Don'ts of I.R.S. Transfer Pricing Storytime**. Earlier this year, the I.R.S. updated its Transfer Pricing Documentation Best Practices F.A.Q. list with a response to Q. 4. What are some areas the I.R.S. has identified in transfer pricing documentation reports that could benefit from improvement? It seemed to be a reaction to two events on the global tax stage. First, the I.R.S. regularly encounters too many suboptimal reports that provide unreliable data leading to a prolonged examination. Second, recent activity in the European Union and the O.E.C.D. suggest that U.S. taxpayers face claims of local value-creation by foreign tax authorities, resulting in increased foreign income allocations. Such allocations reduce the U.S. tax base. Michael Peggs discusses do's and don'ts explained by the I.R.S., and the benefits that are obtained from a robust transfer pricing report, both within budget-related considerations of a global company.

Enjoy the read!

- The Editors

HOME THOUGHTS FROM ABROAD: WHEN FOREIGNERS PURCHASE U.S. HOMES

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PROLOGUE

Your real estate partner comes into your office, saying:

> We have a new client, Mr. N.R.A., who is buying the most expensive house in town. Here is what he wants to do: not buy it in his own name; not pay rent; allow his wife and children (some of whom are U.S. residents) to use the house; not pay estate tax, should he die; not pay gift tax, should he give it away; not file a tax return; and not pay tax when he sells the property.

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

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

INTRODUCTION

This report is concerned with a seemingly simple subject: how to plan the acquisition, ownership, and disposition — by sale, exchange, gift, or bequest — of residential real property in the United States for a nonresident alien client.[1]

For many Americans, as we are regularly reminded, the purchase of a home is the single largest financial transaction of our lives and, because it is the policy of the federal and state governments to encourage homeownership, this investment benefits from extraordinary tax advantages. We are not required to report as income the economic benefit derived from occupation of the property rent free, nor, as a practical matter, do we report as a gift the rent-free use of our property by friends and family members, even those whom we are not obligated to support.[2] We are allowed to deduct interest on mortgage loans (up to $1 million in some circumstances,

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1 This report is a comprehensive update of Michael J.A. Karlin and Stanley C. Ruchelman, "Home Thoughts From Abroad: Foreign Purchases of U.S. Homes," *Tax Notes*, Sept. 3, 2007, p. 863, whose genesis was a panel presentation at the 2006 autumn meeting of the American Bar Association Section of Taxation in Denver. The title of this report is taken from the title of a poem by Robert Browning. See Daniel Karlin (ed.), Robert Browning: *Selected Poems* (1989).

2 See *infra* note 45 and accompanying text.

but capped at $750,000 through 2025 in many instances).[3] We can deduct the cost of state and local property taxes.[4] If the home qualifies, deductions are available for home offices. We can exempt up to $250,000 (or $500,000 if filing jointly) of gain from the sale of our principal residence.[5] Until 2022, tax credits subsidize the installation of energy-efficient devices.[6] We have established the most sophisticated market in the world to securitize our home loans, offer those mortgage-backed securities loans tax free to foreigners[7] — as well as many domestic financial institutions and investment funds — and, out of an essentially illiquid financial asset, create the liquidity needed to drive down the cost of our mortgages. We can even rent the home out a few days a year without paying tax on the rental income.[8] For most Americans, the estate tax is not an issue, and their mortgage is deductible in full from the value of their estate.[9] In short, homeownership is a deal that fewer and fewer adult Americans can resist, and there are no obvious fiscal drawbacks — indeed, no real drawbacks at all.

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

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

[5] Section 121.

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

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

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

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

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

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

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

"Foreign persons must juggle exposure to capital gains taxes, estate and gift taxes, and, in many cases, imputed rental income, without the benefit of many of the tax exemptions and deductions and other favorable treatment bestowed on U.S. residents."

OVERVIEW

Foreign buyers of U.S. homes face tax issues on acquisition of the property, during the ownership of it, and on disposition of it, whether by sale or exchange or by gift or bequest. In this section, we provide an overview of these issues as well as privacy considerations.

Big-Picture Issues

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

1. Minimizing tax on sale of the property so as to pay, if possible, no more than the preferential rate of tax on long-term capital gains of individuals[10]

2. Avoiding paying 30% withholding tax on the use value of the property (or on actual rent paid to avoid uncertainties concerning imputed rent and the *bona fide*s of a cross-border structure)

3. Avoiding the federal estate tax (and state taxes on inheritance) should the owner die while still owning the property, and still allowing the heir to obtain a step-up in basis

4. Minimizing compliance and contact with the U.S. tax system — many foreigners have a deep-rooted aversion to having to file personal income tax returns in the United States or having an individual taxpayer identification number.

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

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

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

Acquisition

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

F.I.R.P.T.A. Withholding

As with any buyer, the foreign buyer is a withholding agent for purposes of the 1980 Foreign Investment in Real Property Tax Act and must therefore either obtain a certification of nonforeign status or withhold 15% of the purchase price (or some lesser amount if the seller produces a withholding certificate from the I.R.S.).[11] Buyers must also be alert to state withholding tax requirements.

In almost any transaction handled with the participation of a title company, an escrow company, one or more attorneys, a lender, or other real estate professionals, these requirements, enacted in 1984, will likely be known and implemented. However, the parties have to be concerned about marginally competent real estate industry participants when both the seller and the purchaser are not U.S. persons.

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

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

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11 Section 1445(a).

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

However, foreign buyers have a special need to maintain good records following their purchase. When the foreign buyer later seeks to sell the property, the buyer-turned-seller may wish to obtain a F.I.R.P.T.A. withholding certificate to reduce the amount of tax withheld based on a calculation of the seller's maximum tax liability. This is particularly true since 2015, when the withholding rate increased to 15% of the gross proceeds.[13] This calculation requires the seller not only to compute F.I.R.P.T.A. gain but also to establish that he has no unsatisfied withholding liability based on compliance with §1445 when he purchased the property.[14] All too often, we have been asked to assist foreign sellers who couldn't locate their records concerning the purchase of the real estate or locate the attorney who represented them in that transaction, and therefore could not readily demonstrate compliance with F.I.R.P.T.A. withholding at the time of an earlier purchase. As a result, it was difficult to obtain a F.I.R.P.T.A. withholding certificate at the time of sale.

Financing

Foreign buyers must also be alert to the financing of the price of a home being acquired in anticipation of a move to the United States. Not infrequently, those buyers pay all cash or at least they don't obtain a mortgage loan at the time of the purchase. Once they become resident, they might wish to deduct interest on the first $750,000 of their loan amount as qualified residence indebtedness.[15] However, the buyers will not be able to do so unless the loan was obtained by them and secured by the home within 90 days of the date of purchase (or was obtained to refinance such a loan).[16]

Tax Residence

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

First, regardless of whether a foreign individual resides in a treaty country, he may seek to apply the foreign-tax-home/closer-connection test to avoid being treated as a resident alien.[18] This test applies to individuals present in the United States between 31 and 182 days during the calendar year when the addition of one-third of the days in the preceding calendar year and one-sixth of the days in the second

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

14 Reg. §1.1445-3(c)(1)(ii) and (3).

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

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

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

18 Section 7701(b)(3)(B) and reg. §301.7701(b)-2.

preceding calendar year takes the total days of presence in that period to 183 or more. The closer-connection portion of the test looks at the individual's personal and family ties to the United States and compares them with his ties to the foreign country. Plainly, the ownership of a home that is regularly used for personal purposes is a factor to be considered in the application of the test — there being an obvious difference between a vacation home used just a few days a year and a home used for longer or more frequent stays.

Second, the ownership or availability of a permanent home is the first tiebreaker in virtually all tax treaty provisions dealing with individuals who are resident both in the United States and another country under the respective internal laws of the two countries.[19]

Gift Tax

Foreign buyers sometimes buy homes for U.S. relatives. The relative might be a U.S. resident, but frequently the relative will be a child who is a student with non-immigrant student (F or J) status. Buyers should be warned that making a gift of real property located in the United States may subject them to gift tax (regardless of whether the relative is resident for U.S. income tax purposes), whereas a gift of cash funds through an interbank transfer that is used to purchase the home can readily be structured to avoid gift tax, as long as the cash is not used to purchase a property owned by the donor.[20] How the funds transfers are handled can make a significant difference.

Estate Tax Planning

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

Ownership and Occupation

Deductions

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

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

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

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

21 See *infra* "Estate Tax" under **Structuring Alternatives**.

Imputed Rental Income

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

However, the moment the home is owned by an entity, the possibility that rent should be charged comes into play. For a home owned by a corporation, personal use by a director or officer will likely attract imputed rental income for the corporation if actual rent is not paid at a fair market rate. It is less certain that rental income would be imputed to a shareholder who did not have an executive role when the corporation conducted an ongoing business unrelated to the real estate. When the home is owned by a partnership, the picture is cloudier, but there is definitely some risk that rent-free use will result in the imputation of rental income. The $250,000 or $500,000 exemption for gain derived from the sale of a principal residence may be jeopardized if the owner of the property is a partnership. By contrast, it appears that personal use of property held in a domestic trust does not give rise to imputed income to the trust, nor is it even treated as a distribution to the beneficiaries.[22] The same is true for a foreign grantor trust and even a foreign non-grantor trust, as long as the user is not a U.S. person.[23]

Tax Compliance

If a home produces no income, there is no need for an N.R.A. owner to file a tax return, except for the year of sale. Because the deductions (mortgage interest, property taxes, etc.) associated with a home held by an individual for personal or family use are not available to the N.R.A., there is no reason to file a return just to preserve the benefit of those deductions. Nonetheless, a mortgage lender may insist on receipt of an individual T.I.N. from the owner.

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

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

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

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

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

23 See the table in "Ownership Through a Trust" under **Structuring Alternatives** and the discussion in "Care in Planning with Trusts" under **Foreign Owner's Family Includes U.S. Persons**.

24 See *infra* **Foreign Owner's Family Includes U.S. Persons**.

Disposition

Income Tax

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

"An N.R.A. can qualify for the exclusion under §121 for $250,000 on the sale of a principal residence, assuming the alien meets the general requirements for the exclusion. The I.R.S. appears to have accepted this."

An N.R.A. can qualify for the exclusion under §121 for $250,000 on the sale of a principal residence, assuming the alien meets the general requirements for the exclusion. The I.R.S. appears to have accepted this.[26] Of course, if the alien is using the home as a principal residence, he is often likely to be a resident alien under the substantial presence test, but this is not invariably the case. For example, an alien may be a former resident who sold the home after ceasing to be a resident.[27] Less commonly, the exemption may be available to a peripatetic alien whose U.S. home is the principal residence even though he does not meet the substantial presence test or, in a case that would require a combination of unusual facts, is nonresident by virtue of a treaty tiebreaker.

The $500,000 exclusion for married couples is not available because it requires the filing of a joint return, and N.R.A.'s generally cannot file joint returns.[28] Therefore, a couple seeking to maximize the exclusion would need to be joint owners of the house, and each spouse would need to qualify separately for the $250,000 exclusion — that is, each would had to have owned their joint interest in the home for at least two years and have lived there as their primary residence for at least two years. If these requirements could not be met, the couple should sell the home in a year when both are still resident aliens.

Withholding at 15% of the amount realized will be required on the sale if the seller's interest is held directly or by a foreign corporation or foreign partnership.[29] If the buyer will use the property as a principal residence, withholding is not required if the price is $300,000 or less. If the seller is a domestic partnership or trust, the purchaser has no withholding obligation under F.I.R.P.T.A.; instead, the domestic

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25 Section 897(a).

26 See I.R.S. Publication 519, "U.S. Tax Guide for Aliens, 2019," ch. 3 (Mar. 4, 2020). Section 897(e) bars the application of nonrecognition provisions, but §121 provides for exclusion of gain from gross income rather than for nonrecognition. It does not appear that §897(e) overrides a provision for an exclusion from gross income.

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

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

29 Section 1445(a).

partnership or trust must withhold U.S. tax at 15% or 35% of the foreign partner's or beneficiary's share of the gain.[30]

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

A §1031 exchange generally is not an option for property held for personal use. But one can imagine circumstances in which a property originally held as a residence for the foreign investor is converted to a rental property. In those circumstances, a §1031 exchange should be possible. Remember, however, that the property would have to be exchanged for other real property situated in the United States because foreign and U.S. real property are not considered to be of like kind.[32]

Gift Tax

The gift by an N.R.A.[33] of real estate located in the United States is subject to gift tax at the same rates as apply to a gift by a U.S. citizen or resident alien, but without the unified credit that would shelter up to $11.58 million in lifetime gifts.[34] By contrast, a gift of an intangible asset, such as shares of stock or of a partnership interest, is not subject to gift tax. An alien contemplating the gift of U.S. real property should consider transferring it to a domestic corporation in a §351 tax-free incorporation or in a §721 transfer to a partnership. If at a future point the original transfer is "old and cold," a gift of the stock or partnership interest could be made without triggering gift tax. In comparison, a transfer to a foreign corporation would require the recognition of any appreciation in the value of the property, unless the corporation is eligible to make an election under §897(i) to be treated as a domestic corporation for F.I.R.P.T.A. purposes.

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

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

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

32 Section 1031(h)(1), enacted by the Revenue Reconciliation Act of 1989. Before 1989, it was possible for an alien to rent out the home and resume status as a nonresident (in either order) and later exchange the property for property outside the United States.

33 Note that the definition of an N.R.A. for purposes of subtitle B of the Code, dealing with estate, gift, and generation-skipping transfer taxes, is not governed by §7701(b). Rather, whether an alien is a resident is determined by the more subjective test of whether the alien is domiciled in the United States. Reg. §20.0-1(b)(1) provides:

> A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.

34 Interspousal gifts to an N.R.A. are not subject to the unlimited marital deduction. However, the annual exclusion is increased to $100,000 for an interspousal gift. See §2523(i). The $100,000 has been inflation-adjusted since 1997, and for 2020 is $157,000. Rev. Proc. 2019-44, 2019-47 IRB 1093, §3.43(2).

Estate Tax

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

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

It should not be assumed that the value of a home or other real property is reduced by any debt secured by a mortgage. In fact, under a fungibility concept long espoused by the I.R.S., debt may be deducted only to the extent the estate establishes the worldwide assets and liabilities of the decedent and deducts the U.S. proportion of the liabilities. That proportion is determined by multiplying the worldwide liabilities by a ratio in which U.S.-situated assets comprise the numerator and the worldwide assets comprise the denominator.[40] Under this fungibility rule, this treatment applies even to a note secured by a mortgage or deed of trust on U.S. real property.[41] For a nonrecourse debt, however, the Tax Court has held, with I.R.S. acquiescence, that only the value of the equity of redemption is includable. For this reason, if an N.R.A. purchases a home with a mortgage, it is desirable that the mortgage be nonrecourse.[42] The Tax Court has held that a loan will be treated as recourse despite state procedural rules that have the practical (even quasi-universal) effect of making the loan nonrecourse.[43]

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35 Sections 2101 and 2102.

36 Rev. Proc. 2019-44, §3.41.

37 Section 2106.

38 Section 2104(a).

39 Section 2105(c).

40 See also §2601(b).

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

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

43 A few state laws provide that a mortgage secured by an owner-occupied residence is nonrecourse. See Cal. Civ. Proc. Code §580b. See *Estate of Fung v. Commissioner*, 117 T.C. 247 (2001). Another provision found in many state laws is a bar on deficiencies when the buyer's obligation is seller-financed and such an obligation will be treated as nonrecourse. Many states also have rules that bar deficiencies after a foreclosure proceeding under the power of sale given by statute or the mortgage or deed of trust, but if state law permits an election of alternative remedies, the loan will not be treated as nonrecourse for estate tax purposes even if the lender would be most likely to elect power of sale foreclosure.

Privacy

Ownership of Property

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

"The agricultural foreign investment rules would be relevant to a foreign homebuyer who purchased a farm or ranch. These rules pose a more serious obstacle to privacy because the reports are a matter of public record."

Foreign investment nontax reporting rules may require some level of disclosure of ownership to the government. There are three sets of rules that may be relevant to homebuyers. The first is the International Investment and Trade in Services Survey Act, administered by the Commerce Department's Bureau of Economic Analysis.[44] The foreign direct investment rules do not require disclosure to the government of the ultimate beneficial owners of "business enterprises" engaged in foreign investment, and in any event the information is not public and may be used by the government only for statistical purposes. The Bureau of Economic Analysis requires a survey to be completed for any investment if the total assets of a newly acquired or newly established entity are more than $3 million, or the transaction involves the acquisition of 200 or more acres of U.S. land. The bureau also requires quarterly and annual reports if the amount of investment exceeds $30 million and a survey every five years when the minimum drops to $10 million.

The second set of rules is under the Agricultural Foreign Investment Disclosure Act, administered by the Agriculture Department's Farm Services Agency.[45] The agricultural foreign investment rules would be relevant to a foreign homebuyer who purchased a farm or ranch. These rules pose a more serious obstacle to privacy because the reports are a matter of public record. Disclosure of beneficial ownership can be avoided only by having at least three tiers of entities between the ultimate owner and the property.

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

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

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

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

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

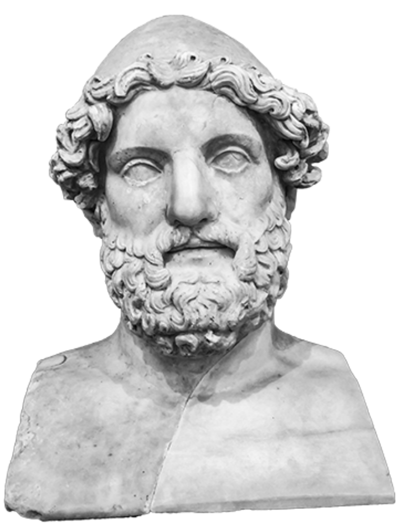
Finally, as a general matter, law enforcement authorities concerned with criminal investigations can usually determine the ownership of property or compel its disclosure.

Filing Tax Returns

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

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

Our system of taxing real estate transfers, whether by sale or exchange or by gift or bequest, does not facilitate anonymity vis-à-vis the tax authorities. Anonymity will come at a cost, most notably by requiring the use of some form of entity that cannot be fiscally transparent — and therefore prevents the availability of preferential rates of capital gains tax — or may require planning to avoid or mitigate double taxation.



The tax authorities — federal, and to some extent state — have the power in some circumstances to require disclosure of the identities of the ultimate owners of real property. The scope of this power depends on the chosen structure; however, anyone who has completed a Form 5472, "Information Return of a 25 Percent Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business," or answered question 5 of Schedule K of Form 1120 or question V of Form 1120-F likely has come across some disclosure requirements.

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

STRUCTURING ALTERNATIVES

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

Direct Ownership

Fairly obviously, the simplest way for a foreign individual to acquire real property in the United States is to purchase it outright. This approach has the virtue of (comparative) simplicity. It is easy to understand. It avoids the cost of establishing and maintaining a foreign blocker corporation. It eliminates imputed rental income issues.[47] It assures long-term capital gains treatment on a sale more than one year after the purchase, and in some cases it even permits the use of the principal residence exclusion under §121. Gain for heirs who take the property upon the owner's death may be eliminated because the successors will obtain a step-up in basis.

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

Privacy

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

Single-Member L.L.C.

A single-member domestic L.L.C. would be disregarded as an entity separate from its owner for federal and state income tax purposes but would offer some limited liability protection and a significant level of privacy in most states. One notable exception is New York, where the names of the stakeholders in an L.L.C. must be published for limited liability to exist.[48] Also, the funding of the L.L.C. by the member is a reportable event on a pro forma Form 1120, "U.S. Corporation Income Tax Return," that includes Form 5472.[49] To file the Form 5472, a T.I.N. must be obtained from the I.R.S., and to obtain the number, information concerning the responsible person must be provided. The responsible party is the person who ultimately owns

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47 There is no dispute that the owner of a residence derives no income from his enjoyment of the residence. Moreover, regarding the use of the residence by family members, the I.R.S. was warned off this area by the Supreme Court in *Dickman*, 465 U.S. at 341: "It is not uncommon for parents to provide their adult children with such things as the use of cars or vacation cottages, simply on the basis of the family relationship. We assume that the focus of the Internal Revenue Service is not on such traditional familial matters."

48 N.Y. Tax Law §1409; N.Y. City Admin. Code §11-2105.

49 Reg. §§301.7701-2(c)(2) and 301.6038A-1(c)(1).

or controls the entity or who exercises ultimate effective control over it. The person should have a level of control over, or entitlement to, the funds or assets in the entity that, as a practical matter, enables the person, directly or indirectly, to control, manage, or direct the entity and the disposition of its funds and assets.[50]

L.L.C.'s are not cost free, however. Apart from annual fees, some states, like California, have special taxes on L.L.C.'s. Moreover, they may create income tax and estate planning issues in the foreign owner's home country. Countries are split between those like the United Kingdom that for the purposes of their own tax treat U.S. L.L.C.'s as corporate bodies,[51] and those like France that will conform their treatment of the L.L.C. to the U.S. treatment.[52] Further, an interest in an L.L.C. is personal property,[53] which means that its devolution may be governed primarily by the laws of the foreign owner's domicile, whereas devolution of real estate directly held would be governed by the law of the state in which it was located.

Some care needs to be exercised to avoid having the L.L.C. be treated as a partnership. Although there are advantages and disadvantages to partnership classification, as discussed later, these should not come about through inadvertence. In particular, if the home is owned by more than one person, the owners should do so as joint owners, each choosing whether to do so through his own L.L.C. There is an exception for couples married under community property laws; in that case, the I.R.S. allows the couple to choose whether the L.L.C. should be treated as having more than one owner.[54]

Grantor Trust

Another privacy alternative is the grantor trust. The simplest form of grantor trust would be a revocable living trust. The enactment of §672(f) in 1996 narrowed the application of the grantor trust rules when the grantor is a foreign person. Nevertheless,

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

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

52 Before its elimination by the January 2009 protocol, paragraph 2(b)(iv) of article 4 (Resident) of the France-U.S. income tax treaty treated partnerships and similar entities as passthrough entities qualifying for treaty benefits to the extent owned by a resident of one of the two treaty jurisdictions. Treasury's 1994 technical explanation expressly stated that an L.L.C. is an entity that is similar to a partnership.

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

54 See Rev. Proc. 2002-69, 2002-2 C.B. 831. The revenue procedure applies to marriages governed by the community property laws not only of states but also of U.S. possessions and foreign countries. The concept of community property is recognized principally in continental Europe and in Latin America, but it does not exist in many other countries where English common law is the basis of jurisprudence.

a revocable trust will be a grantor trust during the owner's lifetime, even if the owner is an N.R.A.[55] An irrevocable trust can also qualify as a grantor trust under §672(f) if the only beneficiaries that may receive distributions during the grantor's lifetime are the grantor and/or the grantor's spouse. However, this would limit the flexibility of the trustees to allow the use of the property to nondependent members of the grantor's family, as often occurs when the foreign owner has acquired the property for the use of adult children, particularly children attending college in the United States. Both types of trusts lose their status as grantor trusts upon the death of the grantor, even if a surviving spouse exists, although if the survivor is a grantor, the trust will remain a grantor trust for the survivor's share.

Normally, the trust will be formed under the law of the state where the property is located, but this will not always be the case. The foreign individual may own homes in more than one state but may wish to form only one trust. The choice of trust jurisdiction may also be influenced by regulatory considerations. Some foreign owners may wish to form the trust in a state that offers superior asset protection, longer perpetuity periods, or the ability to form a private trust company. The trust can also be formed offshore, where trustee fees are typically lower than in the United States, or in the foreign owner's home country. Consideration should also be given to the interaction of the trust with the overall estate plan and to the potential location of successor beneficiaries.

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

Treatment of Losses

Although F.I.R.P.T.A. treats gain or loss from the sale of U.S.R.P.I.'s as effectively connected with a U.S. trade or business, it also provides that for an individual, the loss will be taken into account only to the extent it is incurred in a trade or business or in a transaction entered into for profit, or if it qualifies as a casualty or theft loss.[56] A home acquired for occupation by a foreign owner or members of his family will generally not qualify for deduction by an individual (or a trust), whereas losses may be available if property is held through a corporation. Even if the loss is allowed, typically this type of owner does not have effectively connected income against which the loss can be claimed to reduce tax.

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

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

Estate Tax

The biggest single tax issue with direct ownership — including ownership through one of the transparent vehicles described in the preceding paragraphs — is the exposure to the U.S. estate tax should the foreign owner die before selling the property. Leaving aside taking a chance on survival, which may actually be reasonable if the home is being purchased only for a short term and the buyer is in reasonably good health, perhaps the simplest way to address this liability is through life insurance, whose proceeds will not be includable in the estate of an N.R.A.[57] Term life insurance, in particular, is relatively inexpensive, especially compared with the costs of establishing and maintaining offshore corporate structures. Insurance may not always be available. Some U.S. life insurance companies do not offer competitive rates for nonresidents, but there is no requirement that the insurance company be based in the United States. The amount of the insurance may have to be adjusted if property values increase. But in many cases, this may be the easiest way to fund the payment of the estate tax.

A second way of dealing with the tax is to sell the property before death. Proceeds from the sale of real property that was held for personal use will not be includable in an N.R.A.'s gross estate for estate tax purposes if they are held in a bank account (even a U.S. bank account) at the time of death. How easy or difficult this alternative may prove to be will depend on practical factors, such as the desires of an aging homeowner and the ability to anticipate death. Clearly, death from a lingering illness allows for this type of planning if the individual is physically residing in other property and is competent enough to sign a deed or execute a power of attorney. Death from an accident or a virulent illness does not allow this. Further, it comes at a cost of recognizing gain on any sale, although the tax will almost certainly be less than the estate tax.[58]

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

Some care needs to be exercised with installment sales. If the buyer is a U.S. person, the installment debt owed by the buyer will have a U.S. situs for estate tax purposes.[60] This can be avoided if the interest on the debt is structured as portfolio interest, which means that the debt should not be indicated by a promissory note that is in negotiable form. Rather, the note should be in registered form within the meaning of the portfolio debt rules. Thus, it should not be payable "to order," and the foreign holder of the note should deliver to the buyer an I.R.S. Form W-8BEN, "Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)."[61] The problem disappears if the obligor is not a U.S. resident.[62]

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57 Section 2105(a).

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

59 See *supra* note 41 and accompanying text.

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

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

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

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

Use of Corporate Structure

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

If we look at structuring the acquisition of a home in light of the big-picture issues described earlier, the use of a structure with a foreign corporation has only one clear, albeit important, advantage, which is that shares of that corporation are indubitably not located in the United States for purposes of the estate tax.[63] But the use of a corporation raises concerns about all the other issues, including the imputation of rental income, the potential for double taxation of income and gain at corporate and perhaps shareholder levels, the loss of preferential rates on long-term capital gains, and the lack of a step-up in basis on death for the inside basis in the U.S. asset. It can also create tax problems in the owner's home country.

Entity Classification

The U.S. entity classification rules must be applied to any foreign entity through which a home is acquired. This report does not review the entity classification regulations, but any adviser must be thoroughly acquainted with them, especially in relation to foreign entities.[64] Those entities will have a default classification, and nearly 90 of them are classified as corporations *per se*.[65] In most cases, a foreign entity with limited liability for its members has a default classification as a corporation but is often an eligible entity that can elect to change its default classification.

When a country has a form of entity that is primarily used for publicly traded companies, the *per se* corporation list includes that form of entity, so that all other entities used as privately held entities are eligible. Examples include the public limited company in Hong Kong, India, Pakistan, Singapore, Sweden, and the United Kingdom. As a result, a limited company in those countries other than a public limited company is an eligible entity. In other countries, the same kind of entity is used for both public and private companies. Examples include many of the continental European countries, such as France, Germany, Italy, Spain, and Switzerland, where the "anonymous company" is used. As a result, in those countries care must be taken to use some other form of company if an eligible entity is desired. In Canada, the only

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

[64] Reg. §§301.7701-2 and -3.

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

form of corporate entity that can be classified as a partnership is an unlimited liability company formed under the laws of specific provinces (Alberta, British Columbia, or Nova Scotia) — in fact, because its shareholders all have unlimited liability, an unlimited liability company is classified as a partnership by default.

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

One other point on classification: The check-the-box regulations have a relevance rule that might act as a trap for the unwary. According to the regulations, a foreign eligible entity's classification is relevant when it affects the liability of any person for federal tax or information purposes. One can imagine circumstances in which it might be desirable to change the default classification of a foreign entity, only to discover that no person's liability for tax or information reporting would be affected by the classification. For example, suppose a foreign company holds title to a home. The payment of rent to the foreign company would be subject to withholding at a rate of 30% whether it was classified as a partnership or as a corporation, so the liability would not be affected. Nor would there be any requirement for the entity or any foreign owner to file a tax return.[66]

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

This suggests that the filing of Form 8832 alone makes the election relevant. Were this viewed not to be the case, a minor investment in the United States could force relevance as a factual matter.

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

66 However, an election to treat the entity as a partnership would be required if the foreign owner decided she wanted to elect to treat the rent as E.C.I. under §871(d).

67 Reg. §301.7701-3(d)(1)(ii)(A).

68 F.A.T.C.A. was enacted as part of the Hiring Incentives to Restore Employment (HIRE) Act of 2010 and codified at §§1471 through 1474.

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

And that's before we get to issues of how to deal with tax transparency.

Making an election to treat the entity as having a non-default classification would affect the date of the election, but unless the point about F.A.T.C.A. is answered in favor of indefinite relevance, the election would cease to have effect five years later (that is, 60 months after relevance ceases), and classification would be determined either by default or by election on the first day classification again became relevant.[70] It's not clear how all this works if classification was not relevant until a particular event takes place, at which point classification becomes relevant going back before — in some cases, long before — the event took place. For example, the death of a foreign owner with U.S. heirs may cause the classification to become relevant not just going forward but looking backward as well. Suppose the entity would be classified by default as a corporation. Would a check-the-box election to treat the entity as a partnership result in a deemed corporate liquidation, or cause it to be treated as always having been a partnership? We pose those questions without answering them, but they have obvious practical consequences for planners.

Imputed Income

Whether a corporation is domestic or foreign, we need to consider the possibility that the use of the home by the owner or his family will give rise to imputed income.

Denial of Deductions

The I.R.S.'s historic approach to a situation in which a corporation allows its controlling shareholder or his family to make personal use of corporate property has been to deny deductions to the corporation and to treat the excess of fair rental value over any actual rent as a constructive dividend.[71]

This treatment may not be much of a deterrent to foreign owners of a special purpose vehicle that owns the home in the United States. A foreign owner may not be seeking deductions for expenses, which might only generate a loss that could not be used. A constructive distribution by a foreign corporation would not be taxed to the foreign owner. A constructive distribution by a domestic corporation would be taxed only if the corporation had earnings and profits — which it might well not. Otherwise, the distribution would simply result in a reduction in the foreign owner's basis in the shares in the domestic corporation — and this too may have no adverse effect if the corporation owned a single asset and was intended to be liquidated following the ultimate sale of the property. In that case, the liquidation that would be tax free under §897(c), as long as sufficient notice is filed with the I.R.S. so that an early termination will occur regarding its status as a U.S. real property holding corporation ("U.S.R.P.H.C.").[72]

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70 Reg. §301.7701-3(d)(3).

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

72 Reg. §§1.897-2(f)(2) and (h).

Transfer Pricing

Therefore, one might wonder whether the I.R.S. would forgo the traditional approach or combine it with an attack based on the imputation of rental income to the corporation under the transfer pricing rules of §482. Section 482 provides:

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

Section 482 is not so felicitously worded that it is immediately clear that it would apply to a transaction between a corporation and its shareholder that involves the use of corporate property for personal use rent free or at below-market rents.[73]

If, however, §482 were applied to the use of corporate property by a shareholder, the result would be the imputation of rental income to the corporation. The law is clear that §482 can create a payment of income between the parties and is not limited to allocating actual income.[74] In those circumstances, the income would be taxable, and it would seem inappropriate to use the traditional approach to disallow expenses incurred by the corporation.[75] However, if the corporation failed to file a tax return in a timely fashion, as defined, income tax regulations would disallow deductions as a matter of course.[76]

Deemed Distribution

The 2012 Tax Court decision in *G.D. Parker*[77] may indicate how this issue will be addressed in the future, although the case is not without unanswered questions. It involved an N.R.A. who owned 80% of the shares of a Panamanian corporation that owned all the shares of a Florida corporation (the taxpayer in the case). A Florida subsidiary of the taxpayer corporation owned a couple of homes and a yacht, which were used for personal purposes by the N.R.A. and his family. The I.R.S. argued that the value of the rent-free use was a distribution up the corporate chain from the subsidiary

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

[74] See reg. §1.482-1(f)(2)(i).

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

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

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

to the taxpayer, to the Panamanian corporation, and on up to the N.R.A. The court held that the taxpayer's distribution to the Panamanian corporation was subject to withholding tax at 30%[78] to the extent it constituted a dividend, and the parties were ordered to determine the amount of the top-level Florida corporation's E&P.[79]

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

Two other notable points: For one of the homes — a vacation home in Spain — the court treated only one month's usage a year as subject to tax and withholding. It did not address why the full annual rental value of the vacation home was not subject to tax and withholding when, as the court had found, the taxpayer did not rent, or offer to rent, the vacation home at any time during the three tax years at issue. The I.R.S. conceded the value of one month's rent for the vacation home, but there seems to have been no deeper analysis of this question. (Without explanation, the court also did not require any tax or withholding for use of the yacht.)

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

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

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

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

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

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

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

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

Rental Income

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

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

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

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81 Reg. §1.1441-3(c)(4).

82 Section 168(c).

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

Structuring Alternatives

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

- Direct ownership of the home through a foreign corporation
- Ownership of the home through a domestic corporation, which in turn may be owned by a foreign corporation, a trust, or an individual

Ownership Through a Foreign Corporation

As noted earlier, ownership of a home through a foreign corporation eliminates any exposure to the estate tax. Moreover, from a compliance point of view, it enables the foreign individual to avoid almost all contact with the U.S. tax system — a not insignificant concern for many high-net-worth individuals. As previously mentioned, there will be some identification in the corporation's tax return on Form 1120F, "U.S. Income Tax Return of a Foreign Corporation," as a more than 50% owner[84] and as an ultimate 25% foreign shareholder on Form 5472.[85] However, that identification does not mandate the issuance of a T.I.N. for the individual, although the responsible person must be identified when the foreign corporation applies for a U.S. T.I.N.

"As noted earlier, ownership of a home through a foreign corporation eliminates any exposure to the estate tax. Moreover, from a compliance point of view, it enables the foreign individual to avoid almost all contact with the U.S. tax system. . ."

In doing so, however, the foreign owner incurs a long list of other tax disadvantages. These include loss of the long-term capital gains preference, which applies only to individuals and non-grantor trusts (although with the corporate income tax rate reduced to 21% since 2018, this may not be a significant disadvantage — until, that is, a future round of tax reforms);[86] possible double taxation[87] of income and gains of the corporation to the extent the income and gains are, or are treated as, effectively connected with a U.S. trade or business; having to deal with the imputed rental income and related issues described earlier; and loss of step-up in basis of the real property on death of the foreign owner. Moreover, any U.S. heirs of the foreign owner will inherit shares in an entity that will either become (1) a controlled foreign corporation if one or more U.S. heirs own 10% or more of the voting shares and those 10%-plus owners together are in the majority or (2) a passive foreign investment company, if either such condition is not met for some or all of the beneficiaries.[88] As we will see, this can be a cursed inheritance.

As noted earlier, foreign taxpayers are occasionally advised that they do not have to pay U.S. tax on the sale of their stock in a foreign corporation. Although this is technically true because stock in a foreign corporation is not a U.S.R.P.I.,[89] the use of a foreign corporation rarely achieves the goal of avoiding the cost of taxation on the sale of U.S. real property. The issues here are generic for foreign investors in U.S. real property, but they are particularly acute when the property is a home, given the nature of the potential buyers of residential property. Even if one could find a buyer of a home willing to risk dealing with the unknown — and in some cases,

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84 Question S on Form 1120F.

85 Line 4a of Form 5472.

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

87 Corporate income tax under §882 and branch profits tax under §884

88 Sections 957(a) (definition of C.F.C.) and 1297 (definition of P.F.I.C.).

89 Section 897(c).

unknowable — risk of liabilities of a privately held foreign corporation, a well-advised buyer will realize that the purchase of the foreign corporate stock will not result in a step-up in basis in the underlying real property. This typically results in a requested discount to cover the assumption of the tax cost of the seller that arises from a carryover of inside basis for the property. Moreover, it is hard to imagine a U.S. buyer being interested in acquiring a home by acquiring stock in a foreign corporation, for reasons explained later.

The cost of losing the capital gains tax preference available to individuals can be made worse by the branch profits tax. The branch profits tax is imposed on a foreign corporation on the "dividend equivalent amount," which is defined as the E&P arising from effectively connected taxable income for the year, which would include gain from the sale of any U.S. real property, increased by any reduction (or reduced by any increase) in the corporation's U.S. net equity. U.S. net equity in turn is a function of U.S. assets and liabilities.[90] The rate of tax is 30%, the same as the rate of withholding tax on dividends paid by a domestic corporation, and it is subject to reduction by treaty.[91]

A foreign corporation will not be subject to the branch profits tax if, following the sale of a home, all the proceeds are reinvested in U.S. assets. However, in comparison with a sale of business property, U.S. assets might not include the purchase of a new home, unless the home produces E.C.I. U.S. assets are defined as "the money and aggregate adjusted bases of property of the foreign corporation treated as connected with the conduct of a trade or business in the United States" under applicable regulations. The regulations provide that property will be treated as a U.S. asset if income from the asset is E.C.I. (or would be if the asset produced income on the date for determining the amount of U.S. assets) *and* gain on sale would be treated as effectively connected. The problem is the first leg of this requirement if there is no rental income or the rental income is not treated as effectively connected trade or business income.[92] The second leg is not a problem because §897(a) treats all gains from sale or exchange of U.S.R.P.I.'s as E.C.I.

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

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[90] Section 884(a).

[91] Section 884(e); reg. §1.884-1(g). The United States has renegotiated many of its treaties to allow imposition of the branch profits tax at the direct investment dividend rate. That rate was usually 5% or 10%. The 5% rate remains the official starting point in the current version of the U.S. model income tax treaty (article 10, para. 10(b)), but several recent U.S. treaties now provide for a 0% rate, beginning with the 2002 U.K.-U.S. treaty and the 2001 protocol to the Australia-U.S. treaty. Note that the zero rate may not apply if the shares of the corporation have been recently acquired. Each treaty must be checked for this point.

[92] See reg. §1.884-1(d)(1), discussed in Joseph Isenbergh, *Foundations of U.S. International Taxation*, Tax Management Portfolio No. 900-2nd, at Section II.H.2.c.(1), which refers to the conjunctive requirement of the regulation. Presumably, if the home were rented out (including to the owner of the foreign corporation), the foreign corporation made an election under §882(d) (election to treat real property income as effectively connected).

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

A foreign corporation will not be subject to the branch profits tax for the tax year in which it completely terminates all of its U.S. trades or businesses.[93] The foreign corporation must meet several conditions, including either having no U.S. assets or having adopted an irrevocable resolution by the shareholders to completely liquidate and dissolve, in which case the corporation's U.S. assets must have been distributed, used to pay liabilities, or ceased to be U.S. assets. There is also a prohibition on reinvesting the former U.S. assets in new U.S. assets, directly or indirectly, for three years following the close of the year of the sale. This rule is equivalent to a liquidation-reincorporation rule and is exceptionally harsh (as well as bad policy that discourages investment in the United States). It requires a taxpayer to ring-fence the sales proceeds and keep them in an identified investment outside the United States. The statute of limitations is extended to six years to allow the I.R.S. to monitor reinvestment.

The consequences appear less severe for a foreign shareholder when he makes personal use of a home owned by a corporation — if the corporation is foreign. As noted earlier, the double tax exposure is captured at the level of the foreign corporation in the form of corporate income and branch profits taxes. The real tax risk comes when the foreign corporation wishes to sell the property. It may be faced with a potential basis reduction because the property is depreciable from its inception yet the corporation may not have filed tax returns over the years in which losses have been established. As a result, a maximum tax determination letter from the I.R.S. may not be realistically available, and a full 15% withholding tax may be due at the time of sale.

Ownership Through a Domestic Corporation

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

The domestic corporation will be subject to federal income tax on any future capital gain at up to 21%, as well as any state and local income taxes that may be applicable. Because the corporation will be presumed to be engaged in business, it can usually deduct its expenses — including interest; taxes; and the costs of maintenance, repair, and insurance — as well as other corporate costs such as accounting and tax return preparation fees. On the other hand, if the shareholders make personal use of the home without paying a reasonable rent, these expenses may be disallowed in accordance with the case law described earlier.[94]

On sale of the property, the foreign owner will presumably want to have access to the sale proceeds. Any distribution of the proceeds other than in liquidation of the corporation will be a dividend to the extent of the corporation's E&P and therefore subject to tax at a flat rate of 30% or a lower treaty rate. Moreover, the entire amount of the distribution will be subject to withholding, even if less than all of the distribution is a dividend, although the corporation would have the right to withhold less based on a reasonable projection of its E&P at the end of the tax year.[95]

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

94 See *supra* note 65.

95 Reg. §1.1441-3(c)(2)(i)(C).

To avoid dividend treatment, the foreign shareholder can cause the domestic corporation to be liquidated. However, the shareholder should not do this unless the corporation has purged itself of all U.S.R.P.I.'s in taxable transactions in which gain is fully recognized; otherwise, the shareholder may have to recognize gain inherent in the shares of stock of the corporation without liquidity to satisfy tax.[96] Generally, this is not a problem if the corporation is a single-asset vehicle for the ownership of just one house and the house has been sold. However, if the corporation holds an installment note from the buyer, the note will be a U.S.R.P.I. The corporation must therefore either dispose of the note by collection or sale, or else it will have to make an election out of installment sale under §453(d), thereby accelerating gain recognition by the corporation but also removing the U.S.R.P.I. status of the note. As mentioned earlier, these planning opportunities exist only if the corporation notifies the I.R.S. of the early termination of its status as a U.S.R.P.H.C.[97]

A gift of stock in a domestic corporation is not subject to gift tax because of the rule that only gifts of tangible personal property and real property located in the United States are taxable to an N.R.A. donor.[98]

The consequences of the death of the foreign owner depend on the structure of the ownership of the domestic corporation. If the corporation is owned directly by the foreign owner, the taxable estate will include the shares, and the estate will be subject to estate tax on those shares upon the owner's death. This is because stock in a domestic corporation has a U.S. situs for estate tax purposes.[99] In a few cases, the stock could be exempt under a treaty.[100]

If the domestic corporation is owned by a trust, the consequences will depend on whether any of §§2036 (transfers with retained life estate), 2038 (revocable transfers), and 2041 (powers of appointment) apply to the foreign decedent.[101] If so, the value of the stock in the domestic corporation will be includable in the estate of the foreign owner; otherwise, there will be no estate tax, except in unusual circumstances, possibly when the foreign corporation is treated as an alter ego during the individual's lifetime. This trio of provisions that cause property owned by a trust to be included in a taxable estate may be thought of as the estate tax counterpart to the grantor trust rules. We refer to them collectively as the retained interest rules.

Stock in the domestic corporation will be stepped up upon death of a foreign owner who held the stock directly or through a trust governed by the retained interest rules,

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96 See §897(c).

97 See *supra* note 66.

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

99 Section 2104(a).

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

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

but the basis in the underlying property will not be stepped up.[102] If the trust is not governed by any of the retained interest rules, there will be no step-up in the basis of the shares at the time of the settlor's death.

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

Ownership Through a Partnership

The foreign individual could form a partnership or an entity classified for federal tax purposes as a partnership to acquire and hold the home. The check-the-box regulations[103] changed the rules of the game here. The traditional definition of a partnership was set out in the regulations under §761 and included:

> a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on. The term "partnership" is broader in scope than the common law meaning of partnership, and may include groups not commonly called partnerships. . . . A joint undertaking merely to share expenses is not a partnership.[104]

However, beginning in 1997, the definition of a partnership for all purposes of the IRC was set out in the entity classification regulations (more commonly known as the check-the-box regulations). Those regulations provide that a partnership is a business entity that is not treated as an association (corporation) or a trust, and that a business entity is any entity recognized for federal tax purposes (including a disregarded entity) that is not properly classified as a trust or otherwise subject to special treatment under the code. There no longer appears to be a requirement that the partnership be formed for profit.

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

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102 Taxpayers and the I.R.S. (depending on whose interest it serves) tend to value stock in a single-asset corporation as being identical to the value of the underlying real property. But there are many differences, including that the value of the stock will be reduced by any liabilities — the full amount of any mortgage, whether recourse or nonrecourse. The courts and, grudgingly, the I.R.S. may accept discount for some or all of the capital gains tax that would be payable on the sale of the property. A discount will also be appropriate for marketability, which will reflect both the fact that the stock is not listed and the natural concern of any buyer about buying stock in a privately held corporation rather than the underlying asset. Minority or reduced interest discounts may also apply if, for example, a decedent held less than all the shares, as will occur if a husband and wife each own exactly 50% of the shares of the corporation.

103 T.D. 8697.

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

Income Tax

Contribution

If the N.R.A. acquires the property and transfers it to the partnership in exchange for a partnership interest or as a contribution to the partnership, the transfer is a realization event but entitled to nonrecognition under the domestic tax law,[105] and that treatment is not overridden by F.I.R.P.T.A. rules regarding nonrecognition. However, to avoid F.I.R.P.T.A. withholding, the alien or the partnership must notify the I.R.S. of the transaction that is afforded nonrecognition treatment.

Imputed Rental Income

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

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

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

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

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

We have been unable to find any direct authority on this point in the partnership context. Some courts have given broad meaning to the term "organization, trade

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[105] Section 721.

or business" so that, for example, it includes employees.[106] Others have adopted a more limited approach.[107]

The closest case would seem to be *Dolese*,[108] which involved an individual, his wholly owned corporation, and a partnership in which the individual and the corporation were partners. The partnership made a distribution of partnership property to the partners that was not proportionate to their partnership interests in order to facilitate a subsequent tax-efficient sale and charitable gift of the property. The taxpayer argued that §482 could not apply to a partnership and one of its partners because they are not separate taxpaying entities. The Tenth Circuit held that the taxpayer did have a trade or business as a corporate executive and that the transaction was related to that trade or business.

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

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

It is not certain what would happen in a case, one more straightforward than the facts of *Dolese*, in which a partner makes personal use of partnership property such as a residence. If the tax adviser making the determination deals with a broad spectrum of cross-border tax issues facing individuals, it may be more persuasively contended that §482 should not be applicable in the absence of two businesses. These advisers may find §7872 instructive because it relates to loans that bear rates of interest that are below market. The transfer pricing regulations contain rules for an arm's-length interest rate. Presumably, those rules should apply under the theory that a loan between related parties should be subject to §482 as much as a rental. Section 482 is likely inapplicable, which is the reason that §7872 was enacted. Reasoning by analogy, it certainly can be argued that below-market rentals between related parties in the nonbusiness context should be removed from §482, and in the absence of a provision comparable to §7872, should be immune from adjustment. The validity of this argument awaits the next case.

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

107 See, *e.g.*, *Foglesong v. Commissioner*, T.C. Memo. 1976-294, *rev'd and remanded*, 621 F.2d 865 (7th Cir. 1980), *on remand*, 77 T.C. 1102 (1981), *rev'd*, 691 F.2d 848 (7th Cir. 1982).

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

On the other hand, if the tax adviser's practice concentrates on transfer pricing issues, the likelihood is that he — as well as the I.R.S. — will argue that §482 permeates every nook and cranny of tax law. These advisers would look to *B. Forman Co.*,[109] involving a joint undertaking of operating corporations. There, the Second Circuit had no difficulty applying §482 in a partnership context. They may also look to *Procacci*,[110] in which a partnership leased a golf course to a related party and charged no rent under the circumstances involved in the case. The issue revolved around a prior version of the transfer pricing rules (reg. §1.482-2(c)(2)), which contained a method of determining an arm's-length charge for the use of tangible property when neither party to the lease was engaged in the trade or business of leasing tangible property.

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

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

But the traditional approach is not much of a threat to a partnership or the partners when the only asset of the partnership is a personal use residence. Absent imputed income, the partnership has no income and therefore no immediate use for the deductions, and the partnership distributions are generally not taxable to partners.[111] Might the holding in *G.D. Parker* apply so that the partnership is treated as making a distribution of the fair use value of the home? Perhaps it might, but unlike in the corporate case, a partnership distribution is not taxable unless it consists of cash that exceeds the partner's basis in the partnership. This might reduce the incentive for the I.R.S. to delve too deeply into this argument.

Actual Rental Income

The partnership might in fact have rental income. A cautious planner might choose to have the partnership charge the partners for use of the property. As a practical matter, the partners may be paying the partnership's expenses for the home, which, as we have seen, is a form of rent.[112] Alternatively, the property might be vacation property that was placed in a rental pool or otherwise made available for lease when not in use by the owner.

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

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

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

112 See *supra* note 76 and accompanying text.

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

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

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

Gain on Sale

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

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

This question answers itself rather easily in the case of property held for investment or use in a trade or business. But the position is not so clear when the property is held for personal use as a residence by the partners. Any excess deductions could contribute to a net operating loss and result in a carryover for an indefinite period under current law.[113] However, use of the loss would be limited under the alternative minimum tax rules.[114]

Withholding

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

The final regulations confirm the I.R.S.'s position that a payment is considered made to the extent income subject to withholding is allocated under §482. Further, income arising as a result of a secondary adjustment made in conjunction with a reallocation of income under §482 from a foreign person to a related U.S. person

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

114 See §56(d), which limits the benefit of an N.O.L. when computing alternative minimum taxable income.

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

Section 1441 applies to income that is not effectively connected with a U.S. trade or business. It would therefore apply to rental income, including rental income imputed under §482.[115] If the partnership is domestic, the tenant of the property would not be required to withhold tax on the rent; rather, it is the partnership that would have to withhold the tax on distributions to the partner or, if no distribution is made, then on the date Form K-1 is due or is actually mailed to the partner, whichever is earlier.[116]

If the partnership takes the view that the rental income is effectively connected with a U.S. trade or business, or if the foreign partner elects to treat it as E.C.I., withholding under §1441 on rental payments can be avoided. If the partnership is domestic, the tenant does not have to withhold, and the partnership can rely on a Form W-8ECI from a foreign partner.[117] If the partnership is foreign, and if, as will normally be the case, the partnership is a "nonwithholding foreign partnership," the partnership can provide a Form W-8ECI to the tenant.[118]

Section 1446 will apply to any income or gain allocated to the foreign partners, to the extent the income or gain is effectively connected with a U.S. trade or business. Section 1446 requires the partnership to withhold tax on the "effectively connected taxable income" of the partnership allocable to foreign partners at the highest rate applicable to that partner, which for an individual is now 35%. However, the §1446 regulations allow the use of preferential rates for long-term capital gains and

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

[116] Reg. §1.1441-5(b)(2).

[117] Reg. §1.1441-5(b)(2) says that a foreign partner is not required to furnish a withholding certificate to claim an exemption from withholding under §1441 on the grounds that income is E.C.I.. However, reg. §1.1446-2(b)(2)(ii) provides that (1) a foreign partner that makes an election under §871(d) or 882(d) must furnish the partnership with a statement indicating that the election has been made; and (2) if a partnership receives a valid Form W-8ECI from a partner, the partner is deemed, for purposes of §1446, to have E.C.I. subject to withholding under §1446 to the extent of the items identified on the form. See also reg. §1.871-10(d)(3).

[118] Reg. §1.1441-5(c)(1)(ii)(B). Because a withholding foreign partnership is one that has entered into an agreement with the I.R.S. concerning guaranteed payments to partners, we can reasonably assume that in most cases involving a private use residence, the partnership will be a non-withholding foreign partnership. See reg. §1.1441-5(c)(2).

depreciation recapture, currently 15% and 25%, if the partnership has documentation that allows it to determine that the partner is an individual (or presumably, a trust taxed as an individual). A full discussion of §1446 is beyond the scope of this report.[119]

Gifts of Partnership Interests

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

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

Two income tax issues nevertheless must be considered in connection with an N.R.A.'s gift of a partnership interest.

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

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

The I.R.S. takes the position that any transfer of a partnership interest is a sale or exchange when the partnership has any liabilities that are transferred to the successor partner, based on the classic case of *Crane*[121] and an expansive but plausible reading of §752(d). The *Crane* argument is that any transfer of property that is subject to a liability results in an amount realized by the transferor and is part of the transferee's basis. Section 752(d) provides that in any sale or exchange of a partnership interest, liabilities will be treated in the same manner as liabilities in connection with a sale or exchange of property not associated with partnerships.[122]

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

120 Section 2501(a)(2).

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

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

The consequence of the I.R.S.'s position is as follows: A transaction in which the donee takes the partnership subject to liabilities of which the donor is thereby relieved is bifurcated into (1) a sale to the extent of the liabilities in question and (2) a gift of the value of the partnership interest net of those liabilities. If the liabilities exceed the basis, the donor may realize a gain, which would normally be a capital gain. The donee also has to be concerned with possible consequences under the F.I.R.P.T.A. withholding tax rules.[123]

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

If this interpretation is correct, the transferor is still not out of the woods because then §752(b) comes into play. Section 752(b) says that any decrease in a partner's share of partnership liabilities is treated as a distribution of money by the partnership to the partner. This will not result in a gain, however, unless the deemed distribution exceeds the transferor's basis in the partnership.[124]

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

Death of a Partner

Estate Tax

When the partnership interest passes to the heirs of a deceased N.R.A. partner, the estate tax position is less than clear.[125] The I.R.S.'s position is that a partnership interest has U.S. situs if the partnership is engaged in a U.S. trade or business. In the estate tax area, the I.R.S. has given no consideration to the relative sizes of U.S. business and other activities and assets, which can lead to the bizarre results in an atypical fact pattern involving a partnership that has a tiny U.S. business and substantial assets in other places around the world that are not related to the U.S. business. This approach should be contrasted with the I.R.S.'s position in the income tax area, which was that the taxable status of the gain is controlled by the assets in

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123 Section 1445(e)(5).

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

125 See M. Annette Glod, "United States Estate and Gift Taxation of Nonresident Aliens: Troublesome Situs Issues," 51 *Tax Law*. 110 (1997); Robert F. Hudson Jr., "Tax Effects of Choice of Entities for Foreign Investment in US Real Estate and US Businesses," 4 *Bus. Ent*. 4 (Mar. 2002); Patrick W. Martin et al., "Why Section 2104 Must Address When Partnership Interests Owned by Foreign Investors Are (and Are Not) Subject to United States Estate Tax," State Bar of California, Taxation Section, International Committee (2003); and Richard A. Cassell et al., "U.S. Estate Planning for Nonresident Aliens Who Own Partnership Interests," *Tax Notes*, June 16, 2003, p. 1683.

the partnership.[126] (That position was discredited by a 2017 Tax Court decision[127] but was later enacted by Congress in the so-called Tax Cuts and Jobs Act.)[128]

The approach in the estate tax area likely helps the estates of some deceased N.R.A.'s and harms the estates of others. In particular, the I.R.S.'s position is rather favorable to the estates of N.R.A.'s when the sole asset of the partnership is a residence held exclusively for private use. This is because a partnership does not appear to be engaged in a U.S. trade or business if it simply holds the residence for use by the partners and, arguably, their family members, provided that §482 is inapplicable.[129]

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

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

Other theories may apply. These include treating the residence of the deceased partner as the situs of the partnership interest (*mobilia sequuntur personam*) or treating the partnership's place of organization as the situs, similar to the rule for corporations.

Planning should also take into account the case law developed in the family limited partnership area. The risk here is that if an N.R.A. contributes residential property to a partnership but retains the right to live there, §2036 may apply.[130] This can be

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126 See Rev. Rul. 91-32, 1991-1 C.B. 107. This ruling concluded that a foreign person recognizes taxable gain on the sale of a partnership interest to the extent the gain is attributable to assets used or held for use in a U.S. trade or business.

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

128 Section 864(c)(8).

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

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

avoided by having the partnership enter into a lease with its foreign partner that provides for an F.M.V. rental. But again, this approach has adverse income tax consequences and may not resolve the underlying estate tax problem because the partnership will have the appearance of being engaged in a trade or business.

Step-Up

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

Ownership Through a Trust

The trust is a vehicle that can serve a variety of purposes for the purchase of a home. At its simplest, as we have already discussed, a trust structured as a grantor trust can be a tax-transparent method of ownership whose principal benefit is to avoid probate on the death of the settlor.[131] In this section, we discuss the application of the non-grantor trust rules.

Summary of Non-Grantor Trust Rules

The non-grantor trust is another way for a foreign person to hold property. The trust may be foreign or domestic and may be simple or complex. The property originally settled may be the property — generally not preferable because the transfer of the property to the trust may be a gift[132] — or cash used to purchase the property. As a general rule, a trust is treated as if it were an individual, so a foreign non-grantor trust is treated as an N.R.A. individual.

The table summarizes the effects of these alternatives.

Planning with Trusts

In General

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

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131 See *supra* note 50 and accompanying discussion.

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

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

will be subject to gift tax, and the I.R.S. may take the position that a gift of cash that is conditioned on its being used to purchase property already owned by the settlor will be treated as a gift of real property.[134]

"The throwback rules, which were repealed in 1997 for domestic trusts, continue to apply to foreign trusts."

Once the property is owned by the trust, a beneficiary who lives in the house rent free or for below-market rent should not have imputed income, nor, in general, will expenditures by the trustees on taxes, insurance, and repairs be treated as distributions to the beneficiary.[135] There is, however, a significant exception, introduced in 2010, when the trust is foreign and the beneficiary is a U.S. person. We discuss this later.[136]

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

However, if the trust is foreign, a trap lurks for amounts distributed to U.S. beneficiaries from the trust in a year following the year of sale.

The problem is this: The throwback rules, which were repealed in 1997 for domestic trusts, continue to apply to foreign trusts.[138] Moreover, capital gain of a foreign trust is treated as D.N.I., regardless of whether the trust distributes it in the year of sale. As a result, any undistributed gain becomes undistributed net income ("U.N.I."). When a distribution is made out of a foreign trust, the distribution does not retain the character of the gain from which it was derived, and it is therefore ordinary income to a U.S. beneficiary. It follows that a U.S. beneficiary who receives a distribution made out of gain accumulated from an earlier year may have to pay tax at ordinary income tax rates, comforted only by being allowed to take credit for the long-term capital gains tax previously paid by the trust for the year of sale.[139] Fortunately, this character rule does not apply if the beneficiary is an N.R.A., which is why the problem is confined to distributions to U.S. beneficiaries.[140]

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134 The I.R.S.'s view is supported by *De Goldschmidt-Rothschild*, 168 F.2d 975 (conversion of domestic stocks and bonds into Treasury notes under a pre-arranged program or understanding and solely for the purpose of making a tax-exempt gift in trust was held ineffectual for gift tax purposes). *Cf. Davies*, 40 T.C. 525.

135 *Plant*, 30 B.T.A. 133, aff'd, 76 F.2d 8, acq., 1976-2 C.B. 2 (mere right or privilege under the terms of will to occupy the former home of the testator is not income; expenditures on maintenance of the premises, including payment of taxes, also do not represent income distributed or distributable to the beneficiary); see also *Alfred I. duPont Testamentary Trust*, 66 T.C. 1976.

136 Section 643(i).

137 Section 1(h).

138 Section 665(c).

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

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

Table 1. Comparison of Trusts as Ownership Vehicles

	Foreign Trust	Domestic Trust
Creation of Trust with Gift of Cash Used to Buy Property	Gift of cash by N.R.A. is not subject to U.S. gift tax if funded from outside the U.S. Note the I.R.S.'s position that a cash gift is treated as a gift of the underlying property if cash must be used to purchase the settlor's property. For this purpose, cash means dollar bills, not necessarily funds in an account; nevertheless, the most cautious planning involves transferring funds outside the U.S. or transferring value in the form of Treasury bills or other highly liquid intangible assets.[a]	
Creation of Trust with Gift of Tangible Property Located in the U.S.	Taxable gift; there is no income tax consequence unless the amount of debt assumed or taken subject to the trust exceeds the grantor's adjusted basis.	
Reporting	No Form 3520 reporting.	Form 3520 reporting required.
Use of Property by Grantor	No tax consequences to the grantor — but note the possible effect on the application of §2036 when the grantor dies.	
Use of Property by Other Beneficiaries	No tax consequences to the foreign beneficiaries — they should not have imputed rent if the trust instrument permits free use of the property. But if there is a U.S. beneficiary, the trust will be deemed to make a distribution to the beneficiary of the fair use value of the property.[b] Whether this is taxable presumably depends on whether the trust has distributed net income ("D.N.I.") or undistributed net income, but note that the use of the property does not appear to create income for the trust.	No tax consequences to the grantor or other beneficiaries — they should not have imputed rent if the trust instrument permits free use of the property.
Sale of Property — F.I.R.P.T.A. Withholding	Yes — by the buyer.[c]	**Simple Trust.** Yes — by the trust on distributions out of "U.S. real property interest account."[d] **Complex Trust.** Yes — by the trust on distributions out of "U.S. real property interest account"; note that this account is reset to zero at the end of each year, so there is no withholding on gain accumulated by the trust.[e]
Sale of Property — Rate of Taxation of Gain	**Simple Trust.** Capital gains rates. **Complex Trust.** Capital gains rates, but if distributed to a U.S. beneficiary in a later year, the gain is ordinary (for a foreign beneficiary, the character is preserved).[f]	Capital gains rates.

	Foreign Trust	Domestic Trust
Sale of Property — Incidence of Taxation of Gain	**Simple Trust.** Gain (and credit for tax withheld or paid under F.I.R.P.T.A.) passes through to the beneficiary.[g] **Complex Trust.** Gain and credit pass through to the beneficiary if distributed in the year of sale; otherwise, the trust is taxable on gain in the year of sale; the beneficiary is taxable in the year of the distribution as ordinary income (U.S. beneficiary) or capital gain (foreign beneficiary) with credit for tax paid; U.S. beneficiary may also pay interest under §668 to the extent the tax exceeds credit.	**Simple Trust.** Gain passes through to the beneficiary.[h] **Complex Trust.** Gain and credit pass through to the beneficiary if distributed in the year of sale; otherwise, the trust is taxable in the year of sale; no further tax on the beneficiary on distribution in a later year.[i]
Loss on Sale	The trust is treated as an individual, and loss will be allowed only if it is incurred in a trade or business or in a transaction entered into for profit, or if it qualifies as a casualty or theft loss.[j]	
Estate Tax on Death of Grantor	Depends on the application of §2036.	
Generation-Skipping Transfer Tax	Not applicable if the property given or bequeathed to the trust by the N.R.A. settlor was not subject to U.S. gift tax or estate tax at the time of the gift or bequest.	
Reporting — Trust	Form 1041.	
Reporting — Foreign Beneficiary	**Simple Trust.** In year of sale; Form 1040NR. **Complex Trust.** In year of required or actual distribution; Form 1040NR.	**Simple Trust.** In year of sale; Form 1040NR. **Complex Trust.** Form 1040NR if proceeds distributed in the year of sale; no reporting if proceeds are distributed in a later year in which the trust has no D.N.I.
Reporting — U.S. Beneficiary	**Simple Trust.** In year of sale; Form 1040 and Form 3520. **Complex Trust.** In year of required or actual distribution; Form 1040 and Form 3520.	**Simple Trust.** Form 1040. **Complex Trust.** Form 1040 if proceeds distributed in year of sale; no reporting if proceeds distributed in a later year in which the trust has no D.N.I.

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

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

[c] Section 1445(a).

[d] See reg. §1.1445-5(c)(1)(iii)(A).

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

[f] Section 667(e).

[g] Technically, under §§641, 643, 661, and 662, the gain is taxable to the trust, but the trust can deduct the amount distributed, up to the amount of the trust's D.N.I.; the gain is treated as D.N.I. to the extent distributed; and the beneficiary includes in income the amount distributed up to the amount of the D.N.I.

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

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

[j] Section 165(c), confirmed for N.R.A. individuals by §897(b).

In short, if the beneficiaries of a foreign non-grantor trust are or become U.S. persons, it would generally be advisable for a distribution representing proceeds of sale of the residence to be made to the beneficiaries in the year of sale. This might entail a distribution to all beneficiaries, only to foreign beneficiaries, or to what is commonly referred to as a decanter trust, which is a second trust (with different terms and a nonidentical group of beneficiaries) that receives distributions in an amount sufficient to zero out U.N.I. U.S. beneficiaries generally will not participate in the decanter trust while the principal trust has assets. As a result, U.S. beneficiaries will receive either current distributions without an interest charge under the throwback rules or capital distributions.

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

The question does arise whether the retained interest rule of §2036(a) might apply to the trust. This section applies if the grantor retained an interest in the trust because of any right to use the residence during her lifetime. To avoid the application of the rule, the settlor must not have a right to trust income or gains, and the trust must have an independent trustee with complete discretion over the use of trust assets.[141] This means that the trustee's exercise of discretion cannot be subject to any standard that would be enforceable by the settlor, and there cannot be a "wink and a nod" understanding or other informal arrangement.

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

Another requirement is that creditors of the settlor should not be able to reach trust assets, at least in theory. This may require the trust to be formed in a foreign jurisdiction that allows spendthrift provisions that will protect the settlor or a settlor-beneficiary of a discretionary trust from creditors that arose after the trust was funded (no jurisdiction to our knowledge will protect a trust from the application of fraudulent conveyance or fraudulent transfer laws that can be used to void a gratuitous transfer of assets of the trust as against the claims of creditors in existence at the time of the transfer).[142] Some U.S. states, including Alaska, Delaware, Nevada, South Dakota, and Wyoming, also provide for such trusts,[143] although the practical efficacy of

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

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

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

spendthrift provisions to protect a settlor-beneficiary has been questioned in light of federal bankruptcy reforms enacted in 2005.[144]

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

Section 643(i)

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

FOREIGN OWNER'S FAMILY INCLUDES U.S. PERSONS

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

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

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

Reconsider Use of Corporations

One situation we have encountered is when the foreign owner heeds the all-too-frequent advice — often given by foreign banks or financial advisers — to purchase the home using an offshore corporation. If by the time of the owner's death, one or more of the heirs is a U.S. person, this is the fiscal equivalent of jumping off the

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144 11 U.S.C. §548(e), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, permits the bankruptcy trustee to avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the bankruptcy petition if (1) the transfer was made to a self-settled trust or similar device; (2) the transfer was by the debtor; (3) the debtor is a beneficiary of the trust or similar device; and (4) the debtor made the transfer with the actual intent to hinder, delay, or defraud any entity to which the debtor was or became indebted on or after the date that the transfer.

Empire State Building and claiming, as one passes the 34th floor, that everything is fine so far. When the owner dies, shares of the corporation indeed pass to his heirs free of estate tax. Unfortunately, the landing is not so soft: The heirs now face a string of tax disadvantages.

First, they are now the owners of a corporation that, so far as the U.S. heirs are concerned, is either a C.F.C. if they are in the majority, or a P.F.I.C. if they are not or if they are among a class of persons that own less than a 10% interest in the foreign corporation.

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

Third, the basis in the stock of the corporation may have been adjusted to F.M.V. but the basis in the home itself is not adjusted. Therefore, if the home has increased in value, gain on the sale will include both pre- and post-mortem appreciation. Moreover, the gain will be taxed at corporate rates, and there will be no §121 exemption, even if the home becomes the principal residence of the U.S. heir.[145]

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

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

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

Care in Planning With Trusts

On the grantor's death, the retained interest rules can apply to the trust, and if they do, the estate tax will apply to any assets held by the trust.

Moreover, the trust will become a non-grantor trust on death of the grantor. This will potentially affect the U.S. beneficiaries of the trust in several ways.

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[145] The gain should not be subpart F income. Section 952(b) excludes from the definition of subpart F income any income that is effectively connected with a U.S. trade or business. It would be helpful if the regulations under §952(b) clarified that this includes income deemed to be E.C.I. under §897(a). See reg. §1.952-1(b)(2).

First, the simplification of the treatment of complex trusts brought about by the 1997 amendments does not apply to foreign trusts with U.S. beneficiaries.[146] Those beneficiaries remain subject to the throwback rules, which may also apply to domestic trusts that were formerly foreign, and to the interest charge on distributions made out of U.N.I., which clearly also applies to distributions made by domestic trusts that are former foreign trusts.

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

Third, and perhaps most important, is an amendment to the distribution rules. Section 643(i), which was first enacted in 1996, originally provided that the amount of a loan of cash or marketable securities by a foreign trust to a grantor or beneficiary who is a U.S. person is to be treated as a distribution by the trust. In 2010 §643(i) was amended so that if a foreign trust permits a U.S. grantor or beneficiary to use any other trust property, the F.M.V. of the use of the property is to be treated as a distribution by the trust.[148] The rule does not apply to the extent the trust is paid the F.M.V. of the use within a reasonable time of that use.[149]

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

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

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146 See §665(c).

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

148 HIRE Act §533.

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

150 See §6048(c)(2).

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

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

What if the N.R.A. Has Already Died?

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

Foreign Corporation Structure

As we have seen, the foreign corporation, whether owned directly or through a trust, may, depending on the percentage of U.S. ownership, have become a C.F.C. or a P.F.I.C.

If U.S. persons are the only beneficiaries, one step would be to consider domesticating the corporation. There are various ways to domesticate the foreign corporation, all of which are treated similarly for U.S. tax purposes. Domestication can be accomplished, if permitted by foreign law, through the use of a continuation statute in the country of incorporation and a U.S. state.[151] Alternatively, domestication can be accomplished by dropping the property into a new domestic corporation or dropping the foreign corporation into a new domestic corporation and, in either case, having the foreign corporation liquidate. All these methods are essentially treated by the I.R.S. as C or D reorganizations.

All of these should be tax free,[152] except for any §367(b) toll charge. Even if the foreign corporation has E&P, the inclusion at the time of repatriation is keyed to the earnings accumulated during the taxpayer's holding period.[153] That period begins at the time of the grantor's death.

The first step in the plan is for the trust to distribute the shares of the corporation to the U.S. beneficiaries. The second step is to take advantage of Delaware's favorable continuation statute allowing foreign corporations to domesticate into Delaware

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151 *E.g.*, Del. Code Ann. tit. 8, §388.

152 Reg. §1.897-5(c)(4); and Notice 2006-46, 2006-1 C.B. 1044. The domestication would not be adversely affected by the antiavoidance rule of reg. §1.897-5(c)(4) — as amended by Notice 89-85, 1989-2 C.B. 403, and Notice 2006-46 — because Notice 89-85 only requires the foreign corporation to pay an amount equal to any taxes that §897 would have imposed on all persons who had disposed of interests in the foreign corporation. No tax would have been imposed on the transfer of the shares of the foreign corporation upon the death of the N.R.A., even though the transfer results in a step-up in basis.

153 Reg. §1.367(b)-2(d)(3).

relatively easily.[154] (If foreign law does not permit re-domiciliation, the desired result can also be achieved transactionally with a new Delaware corporation and combining the foreign corporation and the Delaware corporation in one of several ways.)

Following the domestication, the next step would be to make a subchapter S election. The S election can be made only if the corporation has no foreign shareholders, no corporate shareholders,[155] only one class of shares, and is held by no more than 100 shareholders.[156] Assuming this is the case as a result of the distribution in step 1, the S election offers the U.S. beneficiaries the ability to freeze the amount of gain that is potentially taxable at both the corporate and shareholder levels. If the shareholders can hold out for 10 years, the corporate-level tax would be eliminated altogether.[157] If they wish to cause the S corporation to sell the house, it may be possible to use one or a series of §1031 exchanges to defer taxation of the gain until the expiration of the 10 years. The property must be held for investment or as part of a trade or business before the exchange is undertaken.

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

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

Domestic Corporation Structure

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

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

Foreign Trust Structure

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

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

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

156 Section 1361(b).

157 See §1374.

Tiered Structure

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

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

A LITANY OF PRACTICAL ISSUES

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

Tax Compliance

Obtaining T.I.N.'s.

Whatever structure is used, at some point the taxpayers involved will have to acquire T.I.N.'s. The I.R.S. makes this relatively easy for corporate and partnership entities but miserably difficult for individuals. Armed with no more than a properly completed Form SS-4, "Application for Employer Identification Number," and a fax machine, the representatives of corporations and partnerships can obtain employer identification numbers over the telephone and, for domestic entities, online.[158]

Applying for an E.I.N. for a trust can be more difficult because of Form SS-4's requirement to list a grantor, owner, or trustor as the responsible party and to provide a T.I.N. for that person — something that may be impossible if the grantor is no longer alive or unwilling to obtain the number, as can occur for a non-grantor trust. Our experience is that I.R.S. representatives will accept that no such number will be available in those circumstances.

Applications for I.T.I.N.'s are a much different matter. In general, an application for an I.T.I.N. requires the applicant's tax return and identification documents as well as a completed Form W-7, "Application for I.R.S. Individual Taxpayer Identification Number." The identification documents must be originals or certified copies. This means that the individual has to either mail the original documents (such as passports) to the I.R.S. or visit a U.S. embassy or consulate. Starting October 1, 2016, the I.R.S. no longer accepts notarized identification documents.

Recognizing the challenges of these requirements and as envisaged by the Protecting Americans From Tax Hikes ("PATH") Act of 2015, the I.R.S. launched a certified

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

acceptance agent ("C.A.A.") program. A C.A.A. is a person or an entity (usually a professional services firm) that is authorized by the I.R.S. to authenticate the applicant's identification documents and certify copies thereof to the agency. The I.R.S. has recruited C.A.A.'s worldwide and publishes a list of them on its website.[159]

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

Recordkeeping and Tax Returns

If not enamored of extensive recordkeeping requirements, U.S. taxpayers are at least accustomed to them. Foreign taxpayers need to become familiar with the records they should maintain, especially long-term records concerning basis in property and the accumulations of corporations and trusts. The preparation of a pro forma tax return is often a prudent exercise as part of the recordkeeping function. The records need to be maintained in such a way that any required foreign currency translations can be accounted for. As noted earlier, it is important for any potential foreign taxpayer to keep records to show that it has no unsatisfied withholding liability.

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

Establishing and Managing Entities

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

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

Banks often want the entities to qualify to do business in the state where the entity owns the residence. That qualification may be necessary,[161] but in a check-the-box world, the entity that must qualify may not be the entity that needs the bank account. For example, if a trust owns a property through an entity that is disregarded under the check-the-box regulations, the trust is the taxpayer, but the disregarded entity may need to qualify.

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159 I.R.S., "Acceptance Agent Program" (viewed Apr. 20, 2020).

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

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

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

Finally, the home itself must be maintained. Taxes must be paid, the property must be insured, repairs must be made, the house must be cleaned, and the surrounding grounds must be tended. Neighbors may have to be accommodated, and homeowners' and condominium associations must be heeded and their dues paid. Fire prevention measures are desirable and may in fact be required, especially in many western states, and flood control rules may also apply. The usual difficulties for any owner in maintaining a vacation home in the United States are magnified by the distance usually involved for foreign owners, and occupation of the home by members of the younger generation adds a whole new layer of risk and worry unrelated to the tax and other issues discussed in this report. Foreign persons should not purchase homes without making a plan for all these considerations.

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

Home-Country Taxation

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

CONCLUSION

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

FINAL G.I.L.T.I. HIGH-TAX REGULATIONS AND THE TESTED UNIT: WOULD A ROSE BY ANY OTHER NAME SMELL AS SWEET?

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§951A(c)(2)(A)(i)(III)
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Notice 2020-69
Pub. L. No. 115-97
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REG-101828-19
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Rev. Proc. 2019-40
Tax Reform Act of 2014
T.D. 9902
Treas. Reg. §1.951A-2(c)(7)(viii)
Treas. Reg. §1.964-1(c)(5)

INTRODUCTION

> "What's in a name? That which we call a rose
> By any other word would smell as sweet."
>
> – Juliet to Romeo, in *Romeo and Juliet*, Act 2, Scene 2

In the Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97 ("T.C.J.A."), the U.S. Congress enacted the most dramatic change to the U.S. Tax Code since 1986, adding among other provisions G.I.L.T.I.'s quasi-territorial tax under Code §951A. The conceptual underpinnings were inspired by the muse of Dave Camp, Chairman of the House Ways and Means Committee's 2014 blueprint for tax reform, in which he recommended a territorial system including a D.R.D., repeal of indirect foreign tax credits, and enactment of a new category of Subpart F income referred to as "foreign base company intangible income", startlingly similar to G.I.L.T.I.[1] G.I.L.T.I. requires U.S. shareholders owning at least 10% of a controlled foreign corporation, by vote or value ("U.S. Shareholders"), in which U.S. Shareholders collectively own more than 50% by vote or value ("C.F.C.") to compute for each year the "tested income" for each C.F.C., which includes all gross income over the deductions allocable to such income, excepting certain enumerated categories completely excluded from G.I.L.T.I., including high-taxed foreign income excluded from Subpart F income by reason of Code §954(b)(4) (the "High-Tax Exception").

While Chairman Camp's proposal sought to remove all electivity and make the High-Tax Exception automatic (upon being taxed at a rate of between 50-100% of the U.S. corporate tax rate) for both Subpart F and G.I.L.T.I., the T.C.J.A.'s High- Tax Exception is not automatic. While taxpayers previously had no clear guidance to apply the Exception (which is not self-executing), on July 23, 2020 – nearly a full six years after Chairman Camp dropped his tax reform blueprint and three years since Congress enacted a significant number of his proposals into law – the I.R.S. provided one of the last missing pieces of the puzzle in T.D. 9902 ("Final Regulations"), providing rules for when the High-Tax Exception applies to foreign income and containing detailed guidance on how to make the election. These regulations finalize one of the largest remaining pieces in regulations previously proposed on June 21, 2019 (REG-101828-19) ("2019 Proposed Regulations"); though rules relating to treatment of domestic partnerships, including special rules for S corporations,[2] are still pending.

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[1] Tax Reform Act of 2014 Discussion Draft, §4211, full text available here.

[2] See Notice 2020-69, providing an irrevocable election for S corporations with C period accumulated earnings and profits to be treated as the U.S. Shareholder recognizing G.I.L.T.I. income for purposes of adjusting the S corporation's accumulated adjustments account ("A.A.A."), extending the hybrid approach for domestic passthroughs feature of the 2018 proposed G.I.L.T.I. regulations under Code §951A (REG-104390-18), abandoned for an aggregate approach in T.D. 9866, solely for A.A.A. determination purposes.

The Final Regulations, characterized by some as a "gymnastic" exercise to coax workable rules for the G.I.L.T.I. area in an exception that originated in the alien Subpart F context,[3] provide that the Election is an affirmative annual election and may only be made when a taxable rate condition is met: foreign-taxed income is taxed at an effective rate higher than 90% of the U.S. corporate tax rate, which currently being 21%, means the foreign income must be taxed at an effective rate higher than 18.9%, after factoring in allocable deductions. For this purpose, all deductions at the C.F.C. level allocable to G.I.L.T.I. are relevant to its effective tax rate, including depreciation, amortization, and interest expense.[4] The Final Regulations both enable the U.S. Shareholder to determine whether tentative tested net income is high-taxed and provide a mechanism for electing the benefit of the High-Tax Exception ("Election") – based on a novel concept, the "Tested Unit."

Given a strong anti-blending legislative purpose it derived from the legislative history of the Tax Reform Act of 1986, Pub. L. No. 99-514, which also indicated the I.R.S.'s authority to provide for "reasonable groupings of . . . income", the I.R.S. designed the Tested Unit to ensure low-taxed foreign income is not camouflaged amid high-taxed income, escaping U.S. tax. The Final Regulations rely on Tested Units as (i) the level at which to test whether foreign tax exceeds 18.9%, and (ii) the basis on which to exclude high-taxed income from G.I.L.T.I. computations, once the Election is made.

Until simultaneously-issued proposed regulations in REG-127732-19 ("2020 Proposed Regulations") are finalized, extending the Tested Unit concept to Subpart F, Subpart F's high-tax exception continues to apply on an item-of-income basis under preexisting law (instead of Tested Units); the proposal appears a bold move for such a young concept but elegant insofar as it contemplates a unitary election applicable for both high-taxed G.I.L.T.I. and Subpart F income across all C.F.C.'s owned in a C.F.C. group. This reduces planning.

This article introduces the Tested Unit, summarizes the mechanics for making the annual Election, which is made with respect to either a C.F.C. or a C.F.C. Group, and highlights certain issues and concerns, as well as challenges and opportunities for taxpayers contemplating making an Election.

TESTED UNIT – WHAT IS IT?

Prior to the enactment of G.I.L.T.I, Subpart F's High Tax Exception was always applied on an item of income basis. The Tested Unit may appear doggedly alien to anyone used to Subpart F, for under those rules the process is slightly different: a U.S. Shareholder identifies each C.F.C.'s Subpart F income, as defined in Code §952(a) (including foreign personal holding company income, and certain other categories of income), excluding any U.S. effectively-connected income; under the *de minimis* rule, if less than 5% of gross income is Subpart F, then none of the C.F.C.'s

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[3] Mindy Herzfeld, "GILTI High-Tax Exception: Who Benefits?", Tax Notes, Aug. 24, 2020 (observing that "expanding the Subpart F high-tax exception to exclude [income] from the GILTI regime . . . requires a gymnastic reading of the statutory language," suggesting aggressive corporate lobbying was involved).

[4] The last item, interest expense is subject to Code §163(j) based on a recently-issued Notice of Proposed Rulemaking; see T.D. 9905, Preamble discussion of Treas. Reg. §1.163(j)-7 and REG-107911-18, Notice of Proposed Rulemaking.

income is treated as Subpart F, whereas if more than 70% qualifies as Subpart F, then 100% is treated as Subpart F under the full inclusion rule. Unless some other exception applies, each item of Subpart F income is then separately evaluated under the High-Tax Exception.

Based on the 1985 legislative history to Code §954(b)(4), which directed Treasury and the I.R.S. to permit reasonable groupings of income, the I.R.S. found that a purpose of the High-Tax Exception in the G.I.L.T.I. context includes preventing blending of income subject to substantially different rates of tax. This meant that a grouping principle unlike what was used in the Subpart F context was required. The 2019 Proposed Regulations required the taxpayer's effective tax rate be determined for G.I.L.T.I. purposes at the level of a qualified business unit as defined in Code §989(a) ("Q.B.U."), which refers to a "separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records". The trade or business concept lives in case law.[5] Applying the concept requires inherent factual determinations, making the I.R.S.'s call to scuttle that idea in the Final Regulations a very good one.

2020 Final Regulations – the Tested Unit

After considering alternatives, the I.R.S. settled upon something new and seemingly better. Consistent with Congress's purpose to prevent blending of income taxed by different jurisdictions at different rates, the Final Regulations introduce the Tested Unit. At first it may be somewhat confusing that the term "Tested Unit" sometimes refers to a C.F.C., whereas on other occasions, a C.F.C. may include multiple Tested Units. Generally speaking, the former situation arises if the C.F.C. maintains operations in a single country and owns no passthrough interests or branches in another country. In short, in contrast with the Subpart F historic regime, the drafters' selection of the Tested Unit for G.I.L.T.I. high-tax purposes reflects a move to transcend the entity concept.

According to the definition of Treas. Reg. §1.951A-2(c)(7)(iv)(A) a Tested Unit includes

- a C.F.C.;
- an interest in a pass-through entity held, directly or indirectly, by a C.F.C., that is
  - tax resident of a third country, or
  - treated as a corporation or other non-fiscally transparent entity under the tax law of the C.F.C.'s country of incorporation; or
- a branch, or portion of a branch, the activities of which are carried on directly or indirectly by the C.F.C. provided that the branch

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[5] Treas. Reg. §1.989(a)-1(c) defines a trade or business obliquely, by reference to whether a group of activities constitutes an independent economic enterprise carried on for a profit the expenses of which are deductible for tax purposes, and ordinarily includes every operation that's a part of or step in such activities. The trade or business concept appears in some shape or form in each of the following sections, among others: Code §§162(a), 166(d)(2)(A), 167(a)(1), 172(d)(4), 355(b), 864(b), and 954(c)(2)(A).

- gives rise to a taxable presence in the third country where it is located; or
- if it does not give rise to a taxable presence under the third country's tax law, it gives rise to a taxable presence under the owner's tax law and the owner's tax law provides an exclusion, exemption, a preferential rate or other similar relief for income attributable to the branch.

Additional Mechanics

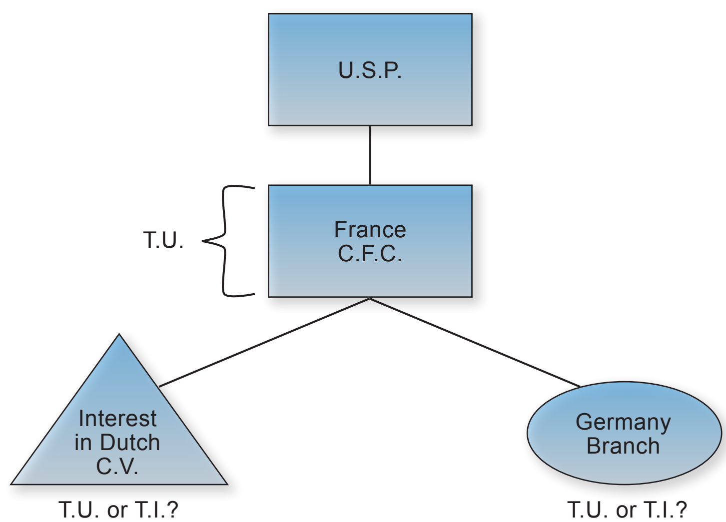
If a passthrough entity/branch fails to qualify as a separate unit under the above definition, it is referred to as a transparent interest and all its items of income and deduction, including foreign taxes, are rolled up into the Tested Unit that directly owns it, both for purposes of the calculation and Election. Tested Units owned by the same C.F.C. and located in the same foreign country are aggregated together.

When items are reported in more than one Tested Unit's books, the rules assign the income item, together with allocable deductions, to the lowest Tested Unit in the vertical tree – preventing double-counting. Adjustments may be required to the higher Tested Units' books.

Similar to a Q.B.U. each Tested Unit is required to maintain separate books and records, but they're not the same thing: a rose by any other name may smell equally sweet, but this is a wholly different flower. The Tested Unit concept corresponds closely to grouping of items reported on a single local-country income tax return, adjusted to eliminate items so they are not double counted.

The foregoing principles are illustrated by examples below.

Fig. 1 – Identifying the Tested Units



Above United States Parent ("U.S.P.") owns France C.F.C., which in turn owns an interest in a Dutch *Commanditaire venootschap*, referred to typically as a "C.V.", and separately, a German branch. Unless 100% of the relevant income below U.S.P. is Subpart F income excluded from G.I.L.T.I., U.S.P.'s first task in determining if the Election is applicable will be to identify the relevant Tested Units:

- France C.F.C. is a Tested Unit.

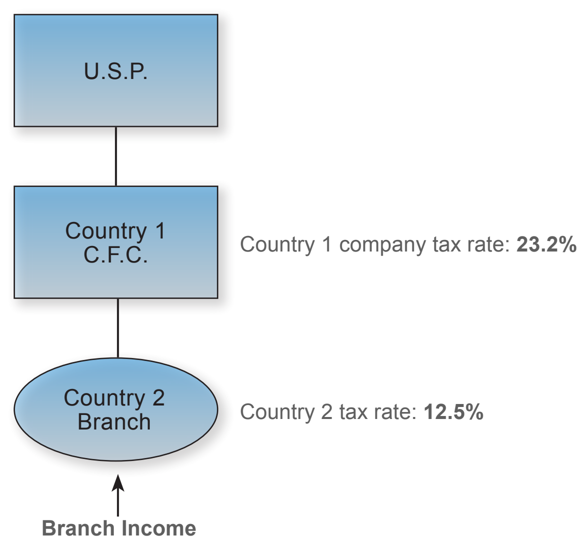
- Germany Branch, assuming it gives rise to a taxable presence in Germany, appears to be a Tested Unit too.

- As for the interest in the Dutch C.V., under Dutch tax rules if all general and limited partners are all required to consent to the addition of a new partner, a C.V. is not treated as a separate taxable entity (in such case, the partners are treated as owning their share of the assets and undertaking their share of activities). However, for U.S. tax purposes the real question may be whether France C.F.C. has a Dutch taxable presence on account of the C.V.'s activities and assets? U.S.P.'s tax team may be pleased to discover that the matter has already been carefully thought through in advance by the France C.F.C. finance team, who have prepared all Dutch tax filings.

In Figure 2, assuming that each Tested Unit's effective tax rate is approximately equal to the statutory rates shown at right, then Country 2 Branch would not qualify for the High-Tax Exception, whereas Country 1 C.F.C. would.

However, in reality the statutory headline rate's is of limited significance.

Fig. 2 – Computing the Effective Rate



Provided Country 2 Branch results in a taxable presence in Country 2 and separate books are maintained for each unit, they are separate Tested Units and the effective rate should be determined separately for each. For example, if Country 1 C.F.C. engaged in borrowing but expense was all allocated to the branch reducing its net tested income, the branch might qualify for the High-Tax Exception even while C.F.C. failed to qualify.

The move in the Tested Unit rules toward use of local financial statements – rather than earnings and profits computations that were the hallmark of Subpart F and centered on U.S. tax principles – has been compared to similar features currently under discussion as part of the O.E.C.D.'s pillar 2 initiative; with one observer critiquing what was referred to as the Final Regulations' nauseating whipsawing approach, requiring on the one hand use of foreign financial statements of the Tested Unit as the starting point for the high-tax computation, but mandating on the other that allocation of expenses and deductions is done based on U.S. tax principles. Such complexity may not serve clear policy objectives, while leaving open the door to new tax planning opportunities.[6]

WHO MAKES THE ELECTION (AND FOR WHOM)?

The Election, which is an annual election,[7] must be made on a unitary basis for all C.F.C.'s in a C.F.C. group, by the group's Controlling Domestic Shareholder(s). If G.I.L.T.I. transcended legal entities by focusing on Tested Units, why do we keep returning to C.F.C.'s? The simple answer may be that the Election must be made for C.F.C.'s because U.S. Shareholders know their percentage interests in C.F.C.'s, but not in T.U.'s; at the end of the day, every Tested Unit is owned, directly or indirectly, by a C.F.C.

"The Election, which is an annual election, must be made on a unitary basis for all C.F.C.'s in a C.F.C. group, by the group's Controlling Domestic Shareholder(s)."

The determination of whether a C.F.C. is included in a C.F.C. group is made as of the close of the relevant C.F.C. inclusion year of the C.F.C. that ends with or within the Controlling Domestic Shareholder(s)' taxable year. The term Controlling Domestic Shareholder(s) refers to U.S. Shareholders who own, in the aggregate, more than 50% of the total combined vote (not value) of the C.F.C.'s stock and who undertake to act on its behalf and make the Election. The 50% voting test is determined under the direct and indirect ownership rules under Code section 958(a). Treas. Reg. §1.964-1(c)(5) provides mechanisms whereby such shareholders may make accounting method elections or determine a C.F.C.'s taxable year.

Where there is no Controlling U.S. Shareholder owning greater than 50% of voting interests in the C.F.C.'s stock within the meaning of Code §958(a), then Controlling Domestic Shareholders refers to all U.S. Shareholders who own stock in the C.F.C. group within the meaning of Code §958(a). A C.F.C. can belong to no more than one C.F.C. group.

A C.F.C. group is specially defined for this purpose to include an affiliated group of corporations owned through one or more chains with a common parent corporation, in which the parent owns directly stock in at least one other corporation, and group members own, in the aggregate, more than 50% of the vote or the value of the outstanding stock of each member affiliate.[8] The definition is modified from the U.S. domestic context to include all corporations in which the ownership criterion is satisfied including foreign corporations. For this purpose, modified Code §318(a) ownership attribution applies;[9] in particular, "50%" ownership in paragraph (a)(2)(C) of Code §318 relating to upward attribution from corporations is replaced with "5%", meaning that where an individual, partnership, corporation or trust owns 5% or more of the value of a corporation's outstanding stock it is attributed stock owned directly or indirectly by such corporation;[10] downward attribution to partnerships, estates,

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6 Mindy Herzfeld, "GILTI High-Tax Exception: Who Benefits?", *supra*.

7 This is different from the approach of the 2019 Proposed Regulations, which included a 60-month cooling-off period.

8 Treas. Reg. Section 1.951A-2(c)(7)(viii)(E)(2)(i).

9 This includes option attribution but does not include downward attribution to partnerships, estates, and trusts.

10 This appears to override the modified attribution rule of Code §958(b)(3) generally applicable to C.F.C.'s based on "10%" in the Election context.

and trusts under paragraphs (a)(3)(A) and (B) is turned off. Option attribution rules apply.

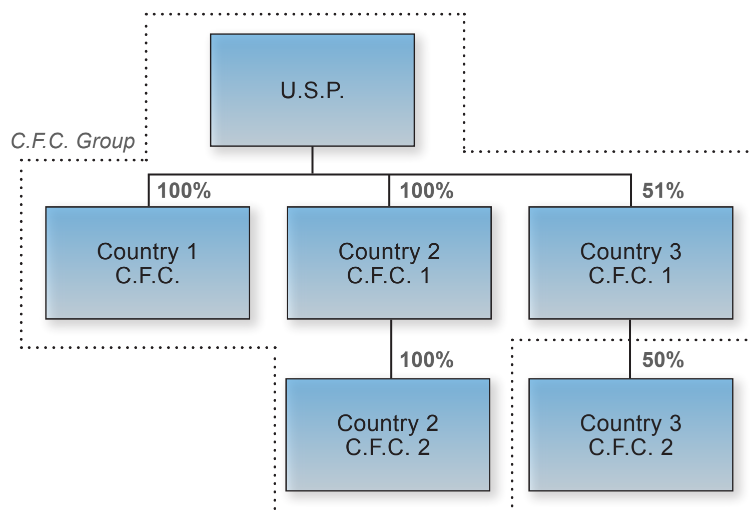
Two noteworthy differences emerge from the above definitions of terms "Controlled Domestic Shareholder(s)" and "C.F.C. Group":

1. While the status of a Controlled Domestic Shareholder is determined solely on the basis of the voting rights owned by a U.S. Shareholder in the C.F.C., a foreign corporation is treated as a member of a C.F.C. Group if the parent corporation owns more than 50% of its total voting rights ***or*** value.

2. The 50% voting test for determining the Controlled Domestic Shareholder status of a U.S. Shareholder is determined under the direct and indirect ownership rules provided under Code section 958(a). In other words, the constructive ownership rules of Code section 958(b) read with Code section 318 is ignored for the purpose of this test. However, whether a foreign corporation is a member of a C.F.C. Group is determined under the constructive ownership rules provided under Code section 318 subject to certain modifications.

Examples of the C.F.C. group, together with certain questions not fully answered by the Regulations, are explored in relation to Figures 3 through 7 below.

Fig. 3 – C.F.C. Group (Ex. 1)



In Ex. 1 (Figure 3), to identify the C.F.C.s that are the members of a C.F.C. Group for purposes of making the Election, we need to ascertain which C.F.C.'s can be said to be owned more than 50% (by vote or value) by U.S.P. under the attribution rules of Code section 318. The C.F.C. group (apparently) includes each of U.S.P, Country 1 C.F.C., Country 2 C.F.C. 1, Country 2 C.F.C. 2, and Country 3 C.F.C. 1, because U.S.P. meets the greater-than-50% ownership by vote or value with respect to each of the entities. In addition, while Code §1504 is modified to include foreign corporations, domestic corporations are not excluded.

Under Code §318(a) attribution, without considering application of Code §958(b)(2), because U.S.P. owns 51% (or more than 5%) of Country 3 C.F.C. 1 as measured by value, U.S.P. is attributed a *pro-rata* share of ownership in whatever legal entities

Country 3 C.F.C. 1 owns, including its 50% ownership interest in Country 3 C.F.C. 2. Therefore, U.S.P. is treated as actually owning interests in Country 3 C.F.C. 2 based on its indirect *pro rata* ownership. However, U.S.P.'s ownership in Country 3 C.F.C. 2 is insufficient to include it in the U.S.P. C.F.C. group, because 51% * 50% = 25.5%, which falls below the greater-than 50% of vote or value threshold.

Now, the question is who is the Controlling Domestic Shareholder? Of course, here, USP is the only U.S. Shareholder that directly or indirectly owns more than 50% of the total voting rights in Country 1 C.F.C., Country 1 C.F.C. 2, Country 1 C.F.C. 3, and Country 2 C.F.C. 2.[11] Therefore, USP is the Controlling Domestic Shareholder that can make the Election for all the members of the C.F.C. Group, as explained above. It may be noted that U.S.P.'s ownership in Country 3 C.F.C. 2 is insufficient to treat U.S.P. as its Controlled Domestic Shareholder because it indirectly owns only 51% * 50% = 25.5%, which falls below the greater-than 50% of vote threshold.[12]

No matter how tangled attribution rules work themselves out, the ultimate problem for U.S.P. with respect to Country 3 C.F.C. 2 is still unresolved, as U.S.P. does not own more than 50%. Under the alternative rule of Treas. Reg. §1.964-5(c)(1)(i) (third sentence), should U.S.P. desire to make an Election for Country 3 C.F.C. 2, it will be necessary first to locate at least one other Code §958(a) U.S. Shareholder.

In addition, Code §964 requires the Controlling Domestic Shareholder(s) to provide notice of the Election to the non-controlling Code §958(a) U.S. Shareholders, on or before the due date of their U.S. tax return (or information return) for the taxable year in which or with which the C.F.C.'s taxable year ends and for which the Election is made. In addition to finding another U.S. Shareholder with whom to make the election, U.S.P. may have to separately identify other Code §958(a) U.S. Shareholders, if they exist, and provide the requisite notices (though as discussed below, the Regulations are ambiguous and conflicting as to whether a failure to do so is fatal).

A more practical challenge is that, even if another U.S. Shareholder is located, U.S.P. and one or more other U.S. Shareholders may be unable to agree as to the desirability of an Election for any given inclusion year. Because a decision to make the Election should be based on careful computations that take into account each U.S. Shareholder's tax attributes for any given year, different U.S. Shareholders can be expected to disagree as a matter of course. As a result, U.S. persons acquiring a 10% or greater stake in a foreign joint venture are strongly recommended to agree up front with their fellow U.S. investors in the J.V.A. as to who has final decision-making power regarding U.S. tax elections.

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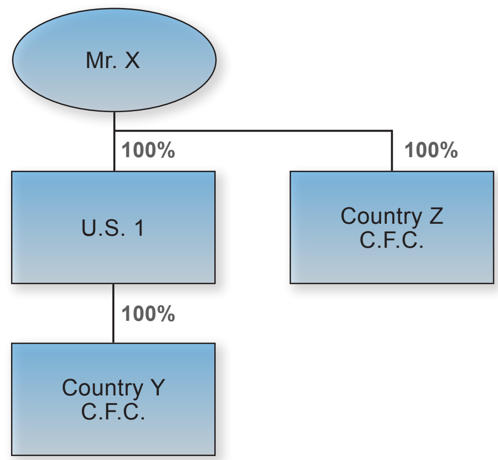
11 For C.F.C. determination purposes, under mega-attribution of Code §958(b)(2), U.S.P. is considered as owning 100% of Country 3 C.F.C.1, and in turn 50% of Country 3 C.F.C. 2, which by is still not enough to make Country 3 C.F.C. 2 a C.F.C.; the hypothetical's facts assume additional U.S. Shareholders at either at the first- or second-tier C.F.C level.

12 Code §958(a)(2).

A different set of challenges – arising from application of attribution principles – is illustrated by the following Ex. 2 (Figure 4):

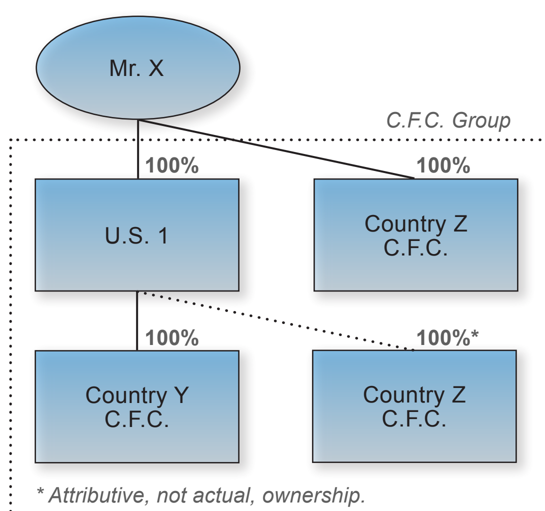
Fig. 4 – C.F.C. Group (Ex. 2)



In the above structure, two C.F.C.'s are owned in parallel chains by the same U.S. individual, Mr. X.; the first corporation, Country Z C.F.C., is owned directly by Mr. X, whereas the second, Country Y C.F.C., is owned indirectly via U.S. 1, a U.S. corporation.

Under attribution, because Mr. X owns 100% of U.S. 1, his ownership in Country Z C.F.C. is attributed (downward) to U.S. 1 under attribution; in consequence, as Code §318 appears relevant for C.F.C. group determinations, the preliminary conclusion is that U.S. 1 together with Country Y C.F.C. and Country Z C.F.C. jointly comprise a C.F.C. group, as shown in Fig. 5:

Fig. 5 – C.F.C. Group (Ex. 2 – Presumed C.F.C. Group via Attribution)



Through an oddity of how the C.F.C. group is defined, corporate U.S. Shareholders (such as U.S. 1, above) are technically included as members of a C.F.C. group, even though domestic corporations never earn tested gross income. In addition, the

Controlling Domestic Shareholder of this constructive C.F.C. group initially appears to be U.S. 1, since under attribution it owns more than 50% in two other C.F.C.'s, and therefore is the party the regulation appears to contemplate as making an election (similar to U.S.P. in Ex. 1, above). The only difficulty is that U.S. 1 does not actually own more than 50% of Country Z C.F.C.'s stock within the meaning of Code §958(a), as required by Treas. Reg. §1.964-1(c)(5). Although Code §318 provides that stock constructively owned is treated as actually owned to create the group, the Controlling Domestic Shareholder rules do not appear to have contemplated U.S. Shareholders of a C.F.C. group, but only particular C.F.C.'s viewed in isolation; separately, Treas. Reg. §1.964-1(c)(5) omits reference to Code §958(b), which is the short-hand reference in the international tax provisions signifying constructive ownership, referencing only Code §958(a) in defining Controlling Domestic Shareholders.

If U.S. 1 is not the appropriate Controlling Domestic Shareholder to file the Election for the constructive C.F.C. group, then perhaps might Mr. X be the appropriate Controlling Domestic Shareholder? The Controlling Domestic Shareholder rules are clear that only Code §958(a) ownership is considered. What makes Mr. X a better candidate to be the Controlling Domestic Shareholder for all of these related C.F.C.'s is that he directly or indirectly owns 100% of all the affected C.F.C.'s stock.

"In short, Mr. X cannot be the Controlling Domestic Shareholder vis-à-vis all the entities in this constructive group.

There are at least two ways out of this impasse. . ."

Is there a C.F.C. group? If so, who is the Controlling Domestic Shareholder? While the proffered solution of a constructive C.F.C. group including 3 entities, with Mr. X as the Controlling Domestic Shareholder seems to make initial sense, Code §958(a) indirect ownership stops with the first U.S. person in the chain,[13] so unless Code §318 can be imported into either Code §958(a), or Treas. Reg. §1.964-1(c)(5) through the back door of Treas. Reg. §1.951A-2(c)(7)(viii)(E)(2)(i), this approach doesn't work. The Final Regulations are quite clear that Code §318 only applies to determine members of the C.F.C. group, not to alter application of the Controlling Domestic Shareholder rule. It appears this is simply a remaining area of latent ambiguity and unreconciled regulatory constructs. In short, Mr. X cannot be the Controlling Domestic Shareholder *vis-à-vis* all the entities in this constructive group.

There are at least two ways out of this impasse:

1. The definition of a C.F.C. group in Treas. Reg. §1.951A-2(c)(7)(viii)(E)(2)(i) may be intended to be applied on the basis that individuals are included in the C.F.C. group as though they were corporations; if so, the difficulty with this approach is that Code §1504 only refers to includible corporations. This doesn't really work satisfactorily and requires us to apply Code §318 selectively, in a way that both considers Mr. X to be a member of the group, and not to be a member of the group to avoid including an ineligible person.

2. A more natural approach which eliminates most of the problems is to read Code §318 out of the C.F.C. group definition entirely whenever the effect would be to pull individuals like Mr. X or their separate stockholdings into a C.F.C. group; under such approach, the individual owner, like Mr. X., is the sole person entitled to make an Election under Treas. Reg. §1.951A-2(c)(7)(viii)(A) for any stock he or she owns directly, including Country Z C.F.C. The

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13 Treas. Reg. §1.958-1 (attribution under this paragraph stops with the first U.S. person in the chain of ownership running from the foreign entity).

same would hold true in any fact patterns where Mr. X owned 51% or more in a C.F.C. directly; and if he owned 50% or less, he would be required to locate additional Code §958(a) Shareholders, similar to U.S.P. in Ex. 1.

- Under this approach, if Country Z C.F.C. owned 100% of another controlled foreign corporation (*e.g.*, "Country Z C.F.C. 2"), then the two Country Z C.F.C.'s would form a second C.F.C. group parallel to the first, with respect to which Mr. X would be the Controlling Domestic Shareholder entitled to make the Election; as for U.S. 1's C.F.C. group, U.S. 1 would be the Controlling Domestic Shareholder entitled to make the Election. The groups never overlap and Code §318 would be ignored.
- If this is the proper reading of the C.F.C. group rules, then attribution principles should only be applied in a manner that does not combine otherwise unaffiliated entities or groups – including for determining who is a U.S. Shareholder or a Controlling Domestic Shareholder, or obviously and as illustrated in Ex. 3, below, whether a foreign corporation is a C.F.C. – though this selective application chafes against the explicit language of the Regulation to the effect that Code §318 is applicable for determining membership in a C.F.C. group.[14]

While the Final Regulations leave some ambiguity, particularly in pockets of discontinuity between the High-Tax Exception rules and pre-G.I.L.T.I. Treas. Reg. §1.964-1(c) (which, as previously noted, does not appear to have contemplated C.F.C. groups), the second reading proffered above feels more natural and harmonizes the dueling provisions better than the alternatives. In addition, these conflicts do not appear to be resolved by special tie-breaker rules applicable to situations where a C.F.C. may fall under more than one C.F.C. group.

The Preamble also suggests that the above may be what the drafters had in mind, stating that the "if a CFC is not a member of a CFC group, a high-tax election is made . . . only with respect to the CFC[.]" (citing Treas. Reg. §1.951A-2(c)(7)(viii)(A)). Unfortunately the statement flies in face of the explicit language of Treas. Reg. §1.951A-2(c)(7)(viii)(E)(2), which provides that "for purposes of this paragraph [defining the C.F.C. group], stock ownership is determined by applying the constructive ownership rules of section 318(a)," without excluding individuals. The Final Regulations would benefit from a subsequent clarification in this regard.

Based on this reading, Ex. 2 should be modified to reflect the presence of just one C.F.C. group, which includes U.S. 1 and Country Y C.F.C. Attribution via Mr. X, an individual, is ignored, and Country Z C.F.C. would be treated as a standalone entity for purposes of the Election, as depicted in Figure 6.

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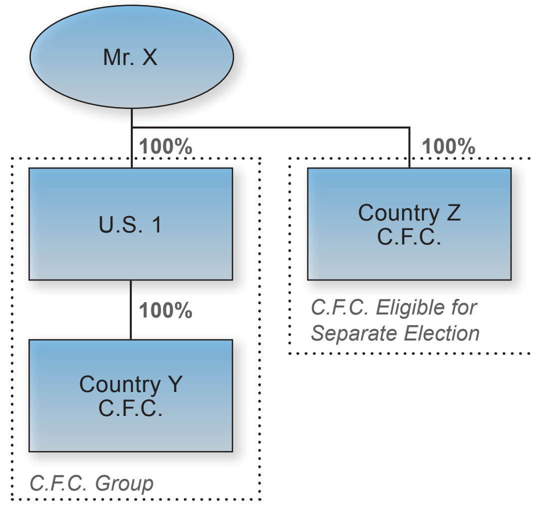
[14] The difficulty with this proposed approach to resolving some of the inconsistencies is that Code §318(a) principles must be selectively read in or out of the provision's language depending on circumstances not contemplated by rule's explicit language. In short, failure to state that Code §318 should not aggregate pre-existing corporate groups into larger affiliated groups appears to be an oversight.

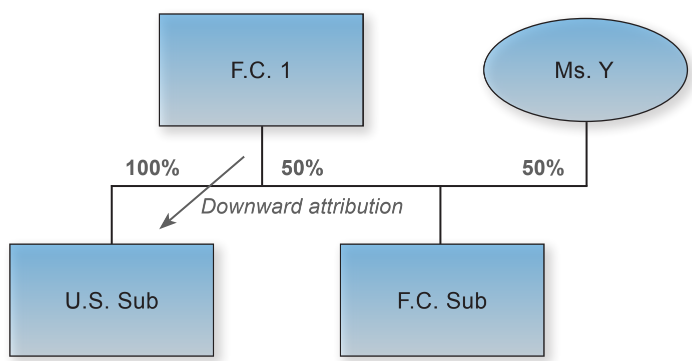
Fig. 6 – C.F.C. Group (Ex. 2 – as Modified)



A positive takeaway from the above interpretation is that U.S. Shareholders who own C.F.C. stock directly, rather than indirectly through vertical chains of foreign corporations, enjoy complete latitude to decide on a standalone basis whether or not to make an Election with respect to each entity they own, each year.

While the I.R.S. has mentioned it intends to revisit "faux C.F.C.'s" created by downward attribution,[15] after the T.C.J.A. Code §§318 and 958(b) apply in determining whether a foreign corporation is a C.F.C. as exemplified in the following hypothetical.

Fig. 7 – Constructive Attribution Scenario (Ex. 3)



F.C. Sub is treated as a C.F.C. solely as a result of downward attribution. This is because Ms. Y, a U.S. person, owns 50% of F.C. Sub's outstanding equity and in addition, F.C. 1's 50% ownership in F.C. Sub is attributed to U.S. Sub under Code §958(b), meaning that U.S. Shareholders collectively own, directly or constructively, 100% of F.C. Sub. However, unlike Ms. Y, U.S. Sub is not a Code §958(a) Shareholder to be considered as part of a Controlling Domestic Shareholder group,

15 Andrew Velarde, "IRS May Refine Tested Unit Rule in GILTI High-Tax Exclusion Regs", Tax Notes, Aug. 5, 2020 (attributing quote regarding faux C.F.C. issues to John Merrick, senior-level counsel to I.R.S. Associate Chief Counsel (International)).

within the meaning of Treas. Reg. §1.964-1(c)(5),and for purposes of making an Election for high-tax purposes. Under the regulation's alternative approach, Ms. Y is treated as the Controlling Domestic Shareholder if she undertakes to act as such, because there are no other Code §958(a) U.S. Shareholders; this presupposes Ms. Y knows about the existence of U.S. Sub, and while she may have a duty to inquire about the matter with F.C. Sub, as the I.R.S. indicated in Rev. Proc. 2019-40,[16] in practice she may fail to do so, or she may only hear back from F.C. 1 group after it's already too late.

If F.C. Sub owns 100% of a second corporation ("F.C. Sub 2"), downward attribution also results in creation of a C.F.C. group, though, similar to the sound of a proverbial tree falling in the forest, no one may perceive its existence.

WHAT IS REQUIRED TO BE INCLUDED IN THE ELECTION?

The Controlling Domestic Shareholder makes the Election via the following steps:

1. File a statement under Treas. Reg. §1.964-1(c)(3)(ii), which includes identifying information for both the C.F.C. and each Controlling Domestic Shareholder approving the Election, identifying other U.S. domestic shareholders notified of action taken, and other required details; unless there is one sole 100% U.S. owner, the Controlling Domestic Shareholders all are required to attach a statement describing the action taken to their U.S. tax or information returns.

2. Provide notice to other U.S. domestic shareholders in the C.F.C., though failure to do so (apparently) will not invalidate the Election.

3. Provide any additional information required by applicable administrative pronouncements.

4. Additional requirements apply if the Election is made with retroactive effect on an amended return, filed within 24 months of the unextended due date.

Under item (2) above, Controlling Domestic Shareholders are required provide "any notices required under [Treas. Reg.] §1.964-1(c)(3)(iii)" to minority U.S. Shareholders upon making the Election. This is because there is a consistency requirement, making the Election binding on all U.S. Shareholders, even if they did not participate in the Election, or potentially are opposed to it.

In another example of discontinuities between the Final Regulations and Treas. Reg. §1.964-1(c)(5), despite the requirement to give the remaining U.S. Shareholders notice,[17] Treas. Reg. §1.964-1(c)(5) states that failure to do so shall not invalidate an election.[18] A less jarring inconsistency between the rules, old and new, may

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[16] 2019-43 I.R.B. 982.

[17] *Cf.* Treas. Reg. §§1.951A-2(c)(7)(viii)(A)(1)(ii) & -2(c)(7)(viii)(D).

[18] Treas. Reg. §1.964-1(c)(3)(iii) (Notice) (see last sentence, appearing to make a dead letter of the requirement to provide "required" notices).

be seen in the fact that Treas. Reg. §1.964-1(c) generally contemplates elections that remain valid until revoked, whereas the Election is an annual election valid only for the inclusion year. While this regulation was designed to address elections relating to accounting methods and tax years rather than annual elections, it would be helpful to have certain clarifications relating to the G.I.L.T.I. context.

HOW DOES ONE DECIDE WHETHER TO MAKE THE ELECTION?

An Election may not always yield positive tax consequences. If the Controlling Domestic Shareholder is eligible to make it vis-à-vis one or more Tested Units exceeding the requisite effective rate of tax, it may be tempting to make the election without giving any further thought, however, several factors should be kept in mind before making the Election, which are discussed below and illustrated with numerical examples.

1. **The Election may Interfere with the Taxpayer's Eligibility to Cross-Credit Foreign Taxes between High-tax and Low-tax Jurisdictions.**

A U.S. Shareholder of more than one C.F.C. that are organized in both high-taxed and low-taxed jurisdictions may lose its eligibility to claim a credit of the foreign taxes paid in the high tax jurisdiction for which a high tax exception election is made against its G.I.L.T.I. tax liability arising from the operations of the C.F.C. located in the low-tax jurisdiction.

Example A

X Co., a U.S. corporation is the sole shareholder of C.F.C. 1 (Tested Unit 1) organized in Jurisdiction 1 and C.F.C. 2 (Tested Unit 2) organized in Jurisdiction 2. The effective tax rate of C.F.C. 1 and C.F.C. 2 for the purpose of determining whether they meet the requirements of the G.I.L.T.I high tax exception is 25% (*i.e.*, greater than 18.9%) and 8.5% (*i.e.*, less than 18.9%). Accordingly, C.F.C. 1 qualifies under the G.I.L.T.I. high tax exception whereas C.F.C. 2 does not.

Alternative 1 explains the total U.S. Federal income tax liability on the G.I.L.T.I. income of X Co. if it makes the Election with respect to Tested Unit 1. Under Alternative 2, X Co. does not make the Election for Tested Unit 1. The example indicates that X Co. is better off (with a lower overall U.S. Federal income tax liability) under Alternative 2 since the taxes paid by Tested Unit 1 in Jurisdiction 1 not only fully offset U.S. tax on its G.I.L.T.I. inclusion but also fully offsets the U.S. tax on the G.I.L.T.I. inclusion of Tested Unit 2.

As a result, the net G.I.L.T.I. tax liability of X Co. from the operations of both Tested Units is $0. Unlike Alternative 2, the application of the high tax exception (via the Election) for Tested Unit 1 under Alternative 1 disallows X Co. to claim a credit of the taxes paid in Jurisdiction 1 against the G.I.L.T.I. tax arising from the operations of Tested Unit 2. As a result, X Co. is liable to pay $3.49 in incremental G.I.L.T.I. tax with respect to Tested Unit 2.

Example 1	Alternative 1		Alternative 2	
	HTE Election is made		HTE Election is not made	
	Tested Unit 1 (High Tax)	Tested Unit 2 (Low Tax)	Tested Unit 1 (High Tax)	Tested Unit 2 (Low Tax)
Gross Tentative Tested Income	100	100	100	100
U.S. $ Amount of Foreign Taxes Paid or Accrued	25	8.5	21	8.5
Net Tentative Tested Income	75	91.5	75	91.5
Effective Foreign Tax Rate	25%	8.5%	20%	7.83%
Eligible for HTE Election?	Yes *(the election is made)*	No	Yes *(the election is not made)*	No
Tested Income for G.I.L.T.I. Computation	N/A	100	100	100
Q.B.A.I.	N/A	20	20	20
Deemed Tangible Income Return – 10%	N/A	2	2	2
G.I.L.T.I. Inclusion before §250 Deduction	N/A	98	98	98
G.I.L.T.I. Deduction – 50%	N/A	49	49	49
Net Income Subject to G.I.L.T.I. Tax	0	49	49	49
G.I.L.T.I. Tax – 21%	0	10.29	10.29	10.29
F.T.C. Available – 80%	0	6.8	20	6.8
Net U.S. Tax Liability – Additional Tax Outflow	0	3.49	0	3.49
Excess F.T.C. Available			9.71	
Cross Credit of foreign taxes paid on the high-taxed income against the G.I.L.T.I. tax liability on the low-taxed tested income – up to $9.71				3.49
Net U.S. Tax Liability – Additional Tax Outflow	**0**	**3.49**	**0**	**0**
Unused F.T.C. (cannot be c/f)	$20.00	0	$6.22	

2. **Whether Subsequent Distributions of Earnings and Profits will be Received Tax-Free in the Hands of a Corporate U.S. Shareholder Depends on Whether the Distribution is Made out of P.T.I. or Subject to Code §245A.**

In case of a corporate shareholder owning 10% or more of the total voting rights or value of a C.F.C, a subsequent distribution of the income previously subject to the G.I.L.T.I. tax is treated as “Previously Taxed Income” (“P.T.I.”) and not subject to further U.S. tax under Code §959. However, dividends not previously taxed in the U.S. are not subject to U.S. Federal income tax only if they satisfy the requirements of Code §245A. Therefore, if a corporate U.S. Shareholder makes an Election, an actual dividend distribution is not P.T.I. and therefore must satisfy the requirements of Code §245A to receive a tax-free treatment in the U.S.

Unlike the P.T.I. rules, Code §245A has certain specific and complex requirements that must be satisfied before a corporate U.S. Shareholder can claim the Code §245A dividends received deduction ("D.R.D."). Some of the requirements include a minimum holding period, satisfaction of anti-hybrid rules, and determination of the foreign source portion of dividends.

3. **The Election may Limit Eligibility of a U.S. Shareholder to Claim an Increased Amount of Foreign Tax Credit Under Code section 960(b).**

Code §904 uses a formula to limit a taxpayer's use of allowable foreign tax credits. The main objective of the limitation is to ensure that a taxpayer is not allowed to claim a credit of the foreign taxes against its U.S. tax liability on U.S. source income. However, newly inserted Code §960(b)(1) increases that limit if certain conditions are satisfied. Under Code §960(b), the foreign tax credit limit may be increased in the year in which a U.S. Shareholder in a C.F.C. receives an actual distribution that is excluded from taxable income because the distribution was included in income previously under Code section 959(a) (includes the G.I.L.T.I. income). In other words, a distribution of P.T.I. can generate G.I.L.T.I. foreign tax credits where withholding and other foreign taxes are imposed on distributions of P.T.I. from a C.F.C. to its corporate U.S. Shareholder. However, distributions of earnings and profits that are eligible for the Code §245A D.R.D. are not eligible for such foreign tax credits. As a result, corporate U.S. Shareholder should consider the impact of foreign tax withholding and availability of a foreign tax credit on subsequent distributions of earnings and profits when deciding whether to elect or forego the High Tax Exception.

"Unlike the P.T.I. rules, Code §245A has certain specific and complex requirements that must be satisfied before a corporate U.S. Shareholder can claim the Code §245A dividends received deduction."

4. **Where a Corporate U.S. Shareholder Incurs a Net Operating Loss, an Election may be Beneficial to Ensure Maximum Utilization of the G.I.L.T.I. Deduction.**

A corporate U.S. taxpayer that is subject to the G.I.L.T.I. tax is also entitled to a deduction equal to 50% of its G.I.L.T.I. ("G.I.L.T.I. Deduction"). When a corporate U.S. Shareholder incurs a net operating loss ("N.O.L.") or has carried forward N.O.L.'s and is also eligible for a G.I.L.T.I. Deduction in the same tax year, specific ordering rules require it to use the N.O.L. to first offset the G.I.L.T.I. income before computing the G.I.L.T.I. Deduction. As a result, the N.O.L. is used to offset the G.I.L.T.I. income which would otherwise be taxed at a lower effective tax rate of 10.5%. In the absence of the G.I.L.T.I. income, the N.O.L.s could have been used to offset other income of the shareholder taxed at a higher rate of 21%. This undermines the tax effectiveness of N.O.L.'s since they are used offset the low-taxed G.I.L.T.I. income instead of the high-taxed ordinary income. Therefore, if eligible, a corporate taxpayer is better off making the Election with respect to a C.F.C. in the year it has incurred an N.O.L. or has carried forward N.O.L.'s

Effect of the C.A.R.E.S. Act on G.I.L.T.I. and N.O.L.'s

Prior to the T.C.J.A., a corporate taxpayer could carryback N.O.L.s for two years and carry the N.O.L.'s forward for 20 years. The T.C.J.A., however, eliminated N.O.L. carrybacks and allowed a corporate taxpayer to carry N.O.L.'s forward indefinitely. At the same time, the T.C.J.A. limited a corporate taxpayer's ability to use N.O.L.'s by permitting N.O.L.'s to offset only 80% of its taxable income in a year. The 2020 Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136 ("C.A.R.E.S. Act") allowed taxpayers to carry back N.O.L.'s incurred in Tax years 2018 through 2020 for up to five years. Further, the C.A.R.E.S. Act has eliminated the 80% limitation on use of N.O.L. carryforwards for Years 2018 through 2020. In view of the above new provision, if a corporate taxpayer carries back an N.O.L. to a year in which it was subject to G.I.L.T.I., the taxpayer my partly or fully the lose the benefit of the G.I.L.T.I. Deduction. This is explained with the help of the following example.

Example

X Co. is a U.S. corporation that owns F Co., a C.F.C. In 2018, X Co. has a G.I.L.T.I. inclusion of $100 and $50 of ordinary income. Accordingly, X Co. is entitled to a G.I.L.T.I. Deduction of $50 (50% of G.I.L.T.I. inclusion of $100). Therefore, the taxable income of X Co. in 2018 is $100 ($100 - $50 + $50).

In 2019, however, the taxpayer incurred an N.O.L. of $100 and does not make an election to forgo the carryback. As a result of the C.A.R.E.S. Act, $100 of the N.O.L. is carried back to 2018. In the absence of the ordering rules, X Co. would have $0 of taxable income in 2018. This is because X Co. reported a taxable income of $100 in 2018 and a carryback of the $100 N.O.L. should have resulted in a net income of $0.

However, because of the ordering rules, the N.O.L. will first reduce the ordinary income ($50) and then the G.I.L.T.I. Inclusion amount ($100). The taxable G.I.L.T.I. income will be reduced to $50 ($100 + $50 - $100). As a result, the taxpayer is permitted a G.I.L.T.I. Deduction of $25 (*i.e.*, 50% of $50). Consequently, X Co.'s resulting taxable G.I.L.T.I. income is $25 ($50 - $25), not the expected $0 taxable income.

5. Code §962 Election and or G.I.L.T.I. High Tax Exception Election.

In addition to considering the Election in any given year, a U.S. individual, estate or trust, should also consider an election under Code §962 (the "§962 Election"). By virtue of §962 Election, non-corporate taxpayers receive the benefit of a hypothetically interposed U.S. C corporation, meaning they enjoy a 50% Code §250 deduction with respect to G.I.L.T.I. income and pay tax at a (now) 21% corporate rate, while receiving a benefit for 80% of the associated foreign tax credits. When the underlying earnings (net of tax paid) are repatriated, the individual, estate or trust is taxed on dividend income (at a qualified rate if the paying foreign entity is a qualified entity) in addition to the 3.8% net investment income tax, potentially subject to a credit for foreign withholding taxes arising on the distribution.[19]

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[19] Subpart F and G.I.L.T.I. as well as P.F.I.C. inclusions are all considered other gross income from a trade or business subject to N.I.I.T., though taxpayers may make a special irrevocable election with respect to the C.F.C. or qualified electing fund and pay the N.I.I.T. up front at the time the income is included.

There may be circumstances where the §962 Election may obviate the need for the Election. But it's important to keep in mind that both elections may be made simultaneously; if both are made, the Election will completely remove certain tentative tested gross income from tested income (and thereby, from G.I.L.T.I.), together with associated items such as allocable and apportionable deductions and tested foreign taxes, whereas the Code §962 Election will not remove or eliminate G.I.L.T.I. but merely has consequences for how the G.I.L.T.I. that remains is taxed in the U.S. There is no hard-and-fast answer to whether an Election is appropriate – the ultimate decision must be based on careful modeling, with the answer provided by the numbers.

CONCLUDING REMARKS

This article noted features of the Final Regulations that may be beneficial, certain opportunities, as well as certain challenges to watch out for. For individuals owning significant stakes in foreign corporations' stock, important considerations include holistic assessment of each foreign corporation's tax attributes each year, including an evaluation how G.I.L.T.I. interacts with other aspects of the U.S. Shareholder's domestic tax profile. A final decision about whether to make the Election should be based upon careful numerical analysis, including side-by-side comparison with the Code §962 Election – which may be made in the alternative, or concurrently.

NEW PARTNERSHIP INTERNATIONAL INFORMATION RETURN SCHEDULES

Authors
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Tags
958(a) Attribution
Aggregate Treatment
Base Erosion Payments
B.E.A.T.
Entity Treatment
Foreign Partners
Foreign Tax Credits
G.I.L.T.I.
Partnership
Schedule K-2
Schedule K-3
Sub-Part F Income

INTRODUCTION

The I.R.S. recently released drafts of two new partnership return schedules and accompanying instructions to replace, supplement, and clarify the way partnership income, loss, deductions, credits and other items from international transactions are reported by a partnership to the I.R.S. and to its partners.[1]

Partnerships that have no foreign activities or foreign partners are not expected to be affected by these new forms.

EFFECTIVE DATES AND PURPOSE

Once finalized, partnerships (including limited liability companies ("L.L.C.'s") taxed as partnerships) that file Form 1065, *U.S. Partnership Tax Return*, would use these two new forms for tax years beginning in 2021 (filing season 2022) to report items of international tax relevance.

The proposed forms do not intend to replace existing information reporting requirements, such as Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations* or Form 8865, I*nformation Return of U.S. Persons with Respect to Certain Foreign Partnerships*. The new forms simply intend to standardize the format used in submitting information of international tax relevance to the partners and aims to assist the partners in completing their required information returns. It will replace the use of statements and other narrative information currently used by reporting partnerships. It will also, not surprisingly, allow the I.R.S. to verify taxpayer compliance on international matters with more ease. Penalties may apply for incomplete filing.

New Schedule K-2 (Form 1065), *Partners' Distributive Share Items – International*, would replace the information currently provided on Form 1065, Schedule K, lines 16(a) through 16(r). **New Schedule K-3** (Form 1065), *Partner's – Share of Income, Deductions, Credits, etc. – International* would replace portions of Schedule K-1, Part III, Boxes 16 and 20, and would provide information to the partner generally in the format of the following forms that might be completed by the partner:

- Form 1040, *U.S. Individual Income Tax Return*
- Form 1040-NR, *U.S. Nonresident Alien Income Tax Return*
- Form 1116, *Foreign Tax Credit (Individual, Estate, or Trust)*
- Form 1118, *Foreign Tax Credit – Corporations*

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[1] I.R. News Release 2020-155 (7/14/20).

- Form 1120, *U.S. Corporation Income Tax Return*
- Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*
- Form 4797, *Sales of Business Property*
- Form 8949, *Sales and Other Dispositions of Capital Assets*
- Form 8991, *Tax on Base Erosion Payments of Taxpayers with Substantial Gross Receipts*
- Form 8992, *U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI)*
- Form 8993, *Section 250 Deduction for Foreign Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI)*

INTERNATIONAL TAX RELEVANCE

Schedule K-2 and Schedule K-3 each contain nine parts, generally covering the information required with respect to the most common international tax provisions in the Internal Revenue Code ("Code"). Schedule K-3 contains a tenth part applicable only to the distributive share of a partner in relation to a sale of a partnership interest. A computer-generated Schedule K-2 that deviates from the official form can only be used with prior approval from the I.R.S. and would be subject to annual review.

The Schedules' parts are described below.

<u>Part I: Partnership's Share of Current Year International Transaction Information</u>

This part is used to report information for international tax items not reported elsewhere on the Schedule K-2 or K-3. It indicates whether specified attachments and statements with information not elsewhere identified on a designated part on the form are included.

For example, Part I would indicate whether information regarding Code §267A disallowed interest or royalty payment deduction is included. For each partner that is disallowed a deduction, a statement would be attached to his Schedule K-3, which would identify the amount of interest and/or royalty paid or accrued by the partnership for which the partner is disallowed a deduction, as well as the extent to which information reported elsewhere on Schedule K-3 reflects amounts of interest or royalty for which the partner is disallowed a deduction.

<u>Part II: Foreign Tax Credit Limitation</u>

The part is used to compute the partnership's income or loss by source and separate category of income and to report the partner's distributive share of such income or loss. Partners will use the information to compute and claim a foreign tax credit on Forms 1116 or 1118

A partnership would complete this part if it has foreign source income, deductions, or losses, or has paid or accrued foreign taxes and has at least one, direct or indirect (through a pass-through entity) partner that is eligible to claim a foreign tax credit.

The information provided on Schedule K-2 includes the partnership income and taxes by source and category. The information provided on Schedule K-3 includes a partner's distributive share of the partnership's income and taxes by source and category to be used by the partner together with its other foreign source income and taxes in that category to compute and claim its foreign tax credit.

Part III: Other Information for Preparation of Form 1116, *Foreign Tax Credit (Individual, Estate, or Trust)* or Form 1118, *Foreign Tax Credit – Corporations*

If Part II is completed, this part will also need to be completed to provide additional information for partners to compute and claim a foreign tax credit.

Section 1 includes information that partners need to allocate and apportion their research and experimental (R&E) expenses.

Section 2 includes information that partners need to allocate and apportion their interest expenses.

Section 3 includes information on foreign taxes paid or accrued by the partnership (including on U.S. source income), and the partner's distributive share of such taxes. For each of the amounts listed a statement providing the amount in both foreign currency and U.S. dollars, as well as the exchange rate used, and the dates of payment must be attached. An indication of this attachment is made on Part I, box 4, foreign tax translation.

Part IV: Other Foreign Transaction Information for U.S. Partners

Section 1 includes information necessary for partners to determine the deduction under Code §250 with respect to Foreign-Derived Intangible Income (F.D.I.I.).

Section 2 includes information on income adjustments required under Code §743(b), by source and category.

Section 3 includes information on distributions from foreign corporations to the partnership and the partner's share of such distribution. Partner's will use this information not only to calculate and claim foreign tax credit, but also to

- exclude distributions of previously taxed earnings and profits ("P.T.E.P.") from gross income,
- report foreign currency gain or loss with respect to distributions of P.T.E.P., and
- compute and claim dividend received deduction under Code §245A.

Part V: Information on Partners' Section 951(a)(1) and Section 951A Inclusions (Subpart F Income and G.I.L.T.I.)

This part is used to report the partners' Subpart F income inclusion, Code §956 income inclusion, and their share of controlled foreign corporation ("C.F.C.") items needed to determine their G.I.L.T.I. inclusion (tested income, tested loss, qualified business asset investment ("Q.B.A.I."), tested loss Q.B.A.I., and tested interest income and expense) with respect to C.F.C.'s owned, directly or indirectly, by the partnership. Partners will use this information to complete Form 8992, *U.S. Shareholder*

Calculation of Global Intangible, Low-Taxed Income (G.I.L.T.I.), and report their gross income on their applicable income tax return.

With a goal to conform the treatment of Subpart F income earned through a domestic partnership with the treatment of G.I.L.T.I. earned through a domestic partnership as provided in Treas. Reg. §1.951A-1(e)(1), Proposed Regulations §1.958-1(d)(1) provide that except as otherwise provided, for purposes of Code §951, a domestic partnership is not treated as owning stock in a foreign corporation within the meaning of Code §958(a). However, for purposes of determining whether a U.S. person is a U.S. shareholder (owning 10% or more, directly, indirectly or constructively) and whether a foreign corporation is a C.F.C., a domestic partnership is not disregarded as an owner. As a result, if a U.S. partner is a 5% partner in a domestic partnership that owns 100% of a foreign corporation, the foreign corporation would be treated as a C.F.C.; but the U.S. partner would not be a U.S. shareholder with respect to this C.F.C. Compare that with a domestic upper-tier partnership that is 10% owned by a U.S. person, and that owns 90% of a lower-tier domestic partnership that owns 100% of a foreign corporation. Here, the U.S. person is treated as a U.S. shareholder under the applicable attribution rules as amplified under Code §958(b)(2), according to which the upper-tier partnership that is treated as owning 90% of the foreign corporation under Code §318(a)(2) will be treated as owning 100% of the foreign corporation.[2]

"A partnership may not file a Form 5471, Schedule I-1, for each C.F.C. that it owns."

In completing the relevant part of Schedule K-2, a domestic partnership must assume that the partnership relies on Prop. Reg. §1.958-1(d), discussed above, which treats a domestic partnership as not owning stock of a foreign corporation within the meaning of Code §958(a) for purposes of Code §951 or Code §951A). Each partner is therefore treated as owning shares in the C.F.C. For Schedule K-3, the Schedule K-3 instructions acknowledge that partnerships may not rely on the Proposed Regulations. If it does, the instructions provide that a partner should include in gross income the amounts reported in Part V for any foreign corporation for which it is a U.S. shareholder (within the meaning of Code §951(b), *i.e.*, directly or indirectly under Code §958(a) or constructively under Code §958(b)) and for which he owns shares within the meaning of Code §958(a) and exclude any amounts with respect to foreign corporations with respect to which it is not a U.S. shareholder. If a partnership does not rely on the Proposed Regulation, then any amount of Subpart F income reported on Part V of Schedule K-3 would be included by the partner in gross income as a distributive share, regardless of its status as a U.S. shareholder.

A partnership may not file a Form 5471, Schedule I-1, for each C.F.C. that it owns (within the meaning of Code Section 958(a)). In such case, the partnership will still need to provide amounts with respect to the C.F.C. as if the partnership filed Form 5471, Schedule I-1, for that C.F.C.

Part VI: Information to Complete Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company ("P.F.I.C.") or Qualified Electing Fund ("Q.E.F.")*

Section 1 includes general information on foreign corporations that are P.F.I.C.'s and are held directly or indirectly by the partnership. Such information includes information about elections made by the partnership at the partnership level, for example,

[2] See Prop. Reg. §1.958-1(d)(3) Examples 1 and 2.

a Q.E.F. election or a mark-to-market ("M.T.M.") election. Additionally, this section includes a summary of annual information, including acquisition of P.F.I.C. shares during the year and the value of P.F.I.C. shares held at the end of the year.

Section 2 includes additional information on P.F.I.C. or Q.E.F. The section is broken down by "general information," "Q.E.F. information," "M.T.M. information" and "Code §1291 and other information."

Information provided for "Q.E.F. information," includes the partnership's share of total ordinary earnings and net capital gain of the P.F.I.C. for its tax year in which, or with which, the tax year of the P.F.I.C. ends.

A domestic partnership would provide this information if it made a Q.E.F. election or if any domestic lower-tier partnership made an election.

A foreign partnership should provide this information if it received an annual statement from the P.F.I.C., unless it knows that no direct or indirect partner has made a Q.E.F. election with respect to the P.F.I.C.

Information provided for "Code §1291 and other information" may be relevant for an electing P.F.I.C. as well. Therefore, generally, information provided in this part is provided with respect to all P.F.I.C.'s owned directly or indirectly by the partnership.

This section includes information on distributions received during the tax year, total distributions received in the preceding three tax years, and information relating to disposition of any block of stock in the P.F.I.C. during the partnership's tax year.

Part VII: Partnership's Interest in Foreign Corporation Income (Section 960)

Completed if the partnership is a U.S. shareholder of a C.F.C., or has an inclusion with respect to a P.F.I.C., and the partnership has at least one partner (or is notified by a pass-through entity partner that it has at least one partner) that is eligible to claim a deemed paid foreign tax credit (whether a corporation or an individual, estate or trust that made a Code §962 election).

Part VIII: Partners' Information for Base Erosion and Anti-Abuse Tax (Section 59A)

This part will assist partners in determining if they are subject to the Base Erosion and Anti-Abuse Tax ("B.E.A.T."), and to compute their B.E.A.T. tax, if any.

Part IX: Foreign Partners' Character and Source of Income and Deductions

Partners will use information provided in this part to compute and report any U.S. tax liability. This part must be reported by every partnership that has a foreign partner, or that knows, or has reason to know, a foreign person has a U.S. income tax reporting obligation with respect to all or part of a distributive share of the partnership's income. The part consists of four sections:

- Section 1 identifies gross income from U.S. source that is fixed, determinable, annual or periodic ("F.D.A.P ."), and is not effectively connected with the partnership's conduct of a U.S. trade or business ("Non-E.C.I."), other U.S. source Non-E.C.I., foreign source non-E.C.I., effectively connected income ("E.C.I.") derived from U.S. sources and foreign source E.C.I.

- Section 2 identifies deductions, losses, and net income in computing E.C.I.
- Section 3 provides information a partner may use to apportion deductions to E.C.I. and Non-E.C.I.
- Section 4 is completed for publicly traded partnerships that is a Code §871(m) covered partnership, regardless of whether the partnership's partners are foreign or domestic.

Partners will use the information to compute and report any U.S. tax liability on Forms 1040-NR and 1120-F, or on Forms 1042 and 1042-S.

Part X: Foreign Partner's Distributive Share of Deemed Sale Items on Transfer of Partnership Interest

This part appears in Schedule K-3 only and no corresponding part appears in Schedule K-2.

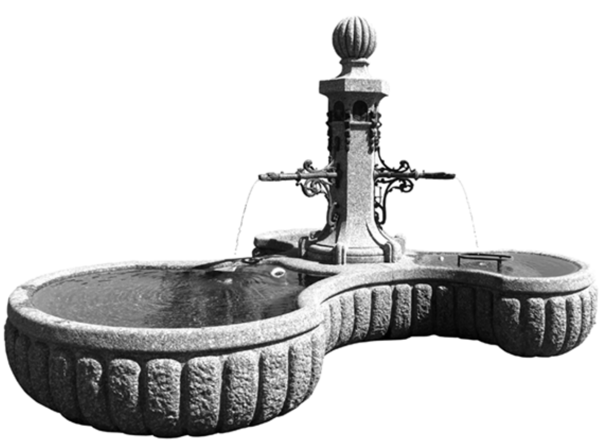
The part provides information for a foreign partner to use to determine the gain or loss it reports on its return from the transfer of an interest in a partnership. This generally applies to a partnership that directly or indirectly is engaged in the conduct of a U.S. trade or business (or from a distribution that results in recognition of gain or loss to a partner) or the gain or loss from a partnership's direct or indirect transfer of an interest in a partnership that is engaged in a U.S. trade or business. Partners will use the information to complete Form 4797, *Sales of Business Property*, and Form 8949, *Sales and Other Dispositions of Capital Assets*.

Gain or loss attributable to the transfer of a partnership interest attributable to U.S. real property interests is also identified on this part.

FURTHER CHANGES

The I.R.S. plans similar revisions, as applicable, to Form 1120-S, U.S. *Income Tax Return for an S Corporation*, and Form 8865, *Return of U.S. Persons with Respect to Certain Foreign Partnerships*.

Comments to the proposed and anticipated forms were accepted until September 14, 2020, and further guidance is expected to follow.



WHEN AN EXCHANGE OF VOWS IS FOLLOWED BY SEPARATE OWNERSHIP OF SHARES SHOULD EITHER SPOUSE FEEL G.I.L.T.I.?

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Tags
Code §951A
Code §951(b)
Code §958
Code §1502
Code §6013
Form 8992
Pub. L. No. 115-97
Poe v. Seaborn, 282 U.S. 101
REG-104464-18
Revenue Act of 1948
Rite Aid Corp., 255 F.3d 1357
Treas. Reg. §1.951A-1
Treas. Reg. §1.1502-51
Treas. Reg. §1.6013-4(b)
Treas. Reg. S1.6038-5
T.D. 9866
T.D. 9902
T.D. 9908

INTRODUCTION

> "Get thee a good husband,
> and use him as he uses thee."
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> – *All's Well That Ends Well*, Act 1, Scene 1
>
> "Marriage is a matter of more worth
> Than to be dealt in by attorneyship."
>
> – *Henry VI*, Part I, Act 5, Scene 5

Today's cross border tax planners are expected to know all there is about various provisions of Subchapter N of the Internal Revenue Code. That is home to several provisions of U.S. tax law that affect taxpayers with foreign income. Examples include (i) the source of income, (ii) the imposition of U.S. tax on nonresident, non-citizen individuals, (iii) the taxation of foreign corporations, (iv) the foreign tax credit, (v) the foreign earned income exclusion, (vi) Subpart F income, (vii) G.I.L.T.I., (viii) the transition tax, (ix) currency transactions, and (x) international boycott income. Cross border tax planners are not expected to know more mundane provisions of tax law such as the rules that apply to married persons filing a joint tax return, with the possible exception of elections that apply when one of the spouses is neither a citizen nor a resident of the U.S.

Yet, as the I.R.S. rolls out regulations on all the provisions in Subchapter N that have been affected by the Tax Cuts & Jobs Act of 2017, strangely enough the highly sophisticated provisions of Subchapter N can be affected by the highly mundane provisions regarding married individuals electing to file joint tax returns with a U.S. spouse.

This article addresses a recent hiccup in the tax law that is brought about under the G.I.L.T.I. provisions of U.S. tax law that focus computations in a top-down way. What happens when one spouse separately owns C.F.C.'s with losses and the other spouse separately owns C.F.C.'s with positive earnings in a fact pattern where none of the C.F.C.'s generates Subpart F income? If a joint tax return is filed, are the tested losses of companies owned by one spouse available to offset tested income of companies owned by the other spouse? The answer should be simple, but is it?

JOINT TAX RETURNS

In a report to Congress prepared by the U.S. Treasury Department in 1998[1] incident to adoption of Section 401 of the Taxpayer Bill of Rights,[2] requiring the Treasury Department to conduct a study of issues relating to joint income tax returns, the Treasury Department focused on the history of the joint tax return filed by married couples.

> In 1918, married taxpayers were allowed to file joint returns. This earliest form of joint filing permitted spouses to offset deductions and losses against each other's income. There was only one tax rate schedule for taxpayers, however, regardless of whether they filed jointly or separately. If both spouses earned income and did not have offsetting deductions or losses, the result of filing jointly would have been an increase in total tax because of the single tax rate schedule and that schedule's progressivity. * * *
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> * * *
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> In 1938, Congress enacted the predecessor of I.R.C. § 6013(d), which introduced explicit statutory joint and several liability for joint returns. As explained in the legislative history, the provision was enacted to preserve the administrative ease of joint filing for taxpayers and the Government * * *
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> * * *
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> In *Poe v. Seaborn*, 282 U.S. 101 (1930), the Supreme Court held that a husband and wife in a community property state were entitled to file separate returns, each treating one-half of the couple's community income as his or her respective income for Federal income tax purposes. Because of progressive rate structures, the immediate effect of *Poe v. Seaborn* was that many married couples with only one income earner who resided in community property states could pay significantly less tax than their counterparts in common law states by choosing to report their income on separate returns. * * *

The current provision, Code §6013, was added by the Revenue Act of 1948, with the objective of allowing married taxpayers in States without community property laws to obtain similar treatment as those in States that do, *i.e.*, split income equally between two individuals, frequently offering a tax rate benefit.[3] By virtue of checking "married filing jointly" two taxpayers report all their income and deductions together to determine taxable income and pay tax due.

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1 Report to the Congress on Joint Liability and Innocent Spouse Issues, pp. 6-7.

2 2, Pub. L. No. 104-168, 110 Stat. 1453 (July 30, 1996).

3 In consequence of *Poe v. Seaborn*, 282 U.S. 101, *supra*, taxpayers in community property states who do not file joint returns are generally liable for the tax on half of community income regardless of which spouse generated the income.

APPLICATION TO G.I.L.T.I.

The question posed is whether the system adopted to split income of a married couple works well in connection with the computation of G.I.L.T.I. where one spouse owns C.F.C.'s with positive tested income and the other spouse owns C.F.C.'s with tested losses.

The irony is that uncertainty arises here due to Congress's largesse in two, perhaps competing respects — on the one hand, the policy *vis-à-vis* married taxpayers to allow pluses of one to offset minuses of the other; and the architectural feature of the G.I.L.T.I. system on the other hand, allowing U.S. Shareholders in multiple C.F.C.'s, to use negative results of one C.F.C. to offset positive results of another. As noted by one senator in an April 2000 Senate floor discussion of a Republican-backed bill to eliminate certain marriage penalties in the Code, "the ironic thing about the marriage penalty is that it was actually borne out of fairness."[4]

"The irony is that uncertainty arises here due to Congress's largesse in two perhaps competing respects. . ."

Example

Assume Wife ("W") and Husband ("H"), each a U.S. citizen, are newlyweds and each owns a European business.[5] The property regime applicable to H and W is one of separate property. W incorporated her business several years ago as a *société anonyme* ("S.A") under the laws of France. H formed his business as a German *Gesellschaft mit beschränkter Haftung* ("GmbH") prior to 2017. For illustration, assume that S.A.'s business in 2019 has been profitable, netting $100, while GmbH's business has netted losses of $100.

Under Code §951A global intangible low-taxed income provisions ("G.I.L.T.I."), S.A.'s earnings gives rise to $100 tested income for W, and $100 of G.I.L.T.I. each year, assuming no allocable deductions. G.I.L.T.I. applies to tax years beginning after 2017 to a U.S. shareholder owning at least 10% of controlled foreign corporations, by vote or value ("U.S. Shareholder"), in which U.S. Shareholders collectively own more than 50% by vote or value, thereby making the foreign corporation a controlled foreign corporation ("C.F.C."). In 2019 W, as U.S. Shareholder of S.A., a C.F.C., reports $100 of net tested income which results in $100 of G.I.L.T.I. taxable at the highest marginal rate.[6] At the same time, the GmbH owned by H is a C.F.C. In 2019, it generates a net tested loss of $100, and zero G.I.L.T.I. income to H. The

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4 In Senate floor discussion of Republican marriage tax penalty relief in 2000 referred to as the Marriage Tax Penalty Relief Reconciliation Act of 2000, ultimately passed by a slim Republican majority in both houses – who lost control of the Senate that year – but vetoed by President Clinton before leaving office, Arkansas Senator Blanche Lincoln (D) explained that the Republican plan, in her view, addressed only 3 out of 65 marriage penalties in the Code.

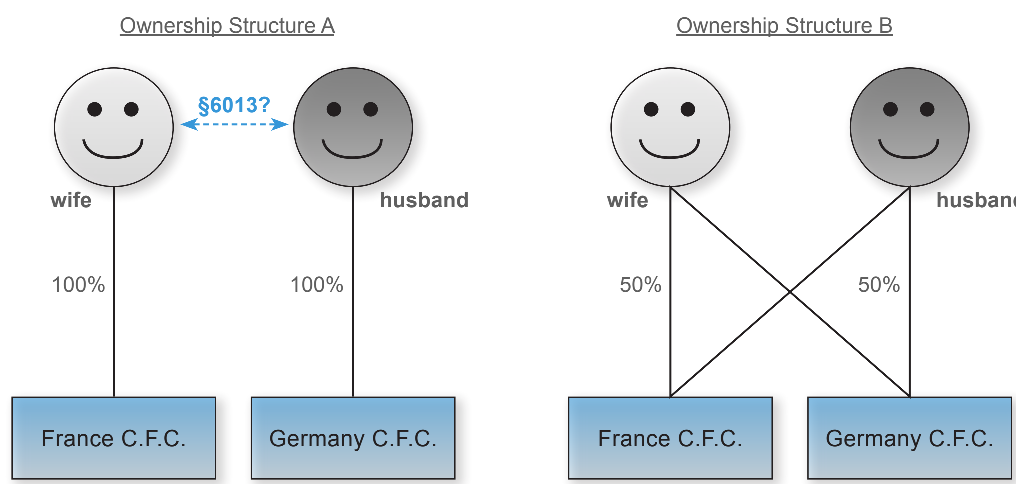
5 Consistent with Treas. Reg. §301.7701-18 wherein the I.R.S. reflected the Supreme Court's decisions in *Obergefell v. Hodges*, 135 S. Ct. 2584 (2015) and *U.S. v. Windsor,* 570 U.S. 12 (2013), the terms spouse, husband, and wife since 2016 refer to lawfully married individuals with a gender neutral signification.

6 If W lives in New York State, 5% of the total G.I.L.T.I. (or in the example above, $5) may also be taxable at the State level at maximal rates for married couples filing jointly of up to 8.82% (declining to 6.57% over a few years). N.Y.C.'s highest tax bracket applicable to married filing jointly returns is 3.876%. Confusingly, N.Y.C. has not updated its rules post 2018, and follows prior N.Y.S. rules which included 100% of G.I.L.T.I. in taxpayer income after any Code §250 deduction.

tested loss cannot be carried forward to any future year of H. The tested loss is not a recognized loss for H in that it does not reduce other income. That being the case, will the filing of a joint income tax return produce a benefit for the couple?

The fact pattern is illustrated in Ownership Structure A of Figure 1, that appears below. The alternative Ownership Structure B reflects actual co-ownership of the two companies or the application of a community property regime between the spouses; under a community property regime, Structure A would potentially be treated as Structure B if the C.F.C.'s were acquired by both spouses after the marriage or a decision was made to convert the C.F.C.'s to community property.[7]

Fig. 1: The Newlyweds' C.F.C.'s



While on H and W's facts, Code §6013 ideally should treat Structure A the same as Structure B, there is no specific guidance on this topic and the conclusion certainly is not addressed in regulations issued by the I.R.S. under the G.I.L.T.I. regime.

Courses of Action Available to H and W:

Faced with this issue, what alternatives are available to support netting H's tested loss against W's tested income for purposes of computing the G.I.L.T.I. tax, assuming that community property laws are not available?

There are several possible courses of action available to H and W:

1. The first course of action is to do nothing, hoping that the I.R.S. will provide guidance based on its grant of authority to provide appropriate rules regarding G.I.L.T.I. Alternatively, H and W may do nothing, hoping for a solution as part of a technical corrections bill to the Tax Cuts & Jobs Act, if ever adopted. An issue with this approach is that no certainty exists that either the I.R.S. or Congress will act before the taxpayer's 2019 tax return is examined. If this course of action is taken, the computation is illustrated in Fig. 2, Ownership Structure A, below.

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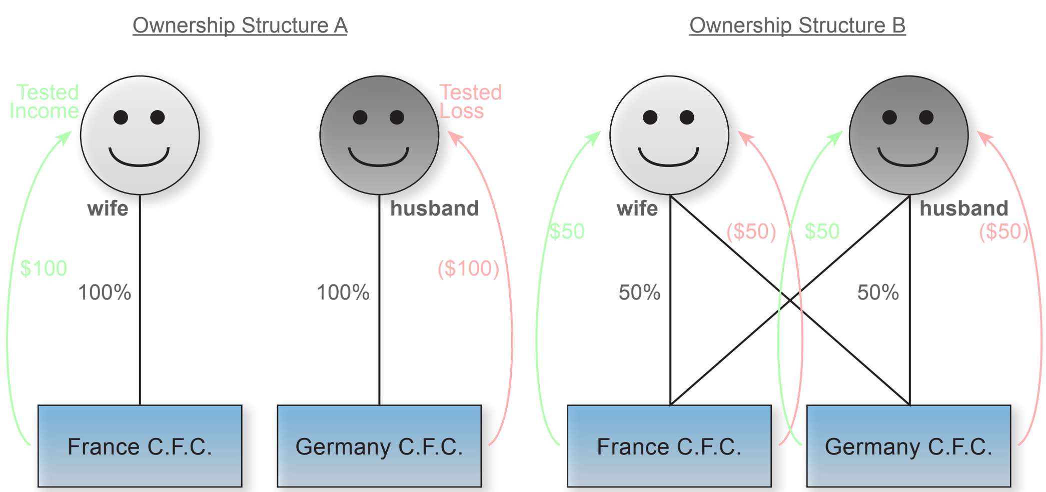
[7] See Pub. 555, *Community Property*.

2. The second course of action is to do nothing based on the legislative history at the time U.S. tax law was amended to provide for joint tax returns with enhanced brackets. As explained above, the purpose was to eliminate disparity in tax treatment between married couples resident in common law states and married couples resident in community property states. An issue with this approach is that case law involving married couples wishing to be treated as a single taxpayer does not reach consistent results. Some courts reach favorable conclusions and others reach unfavorable conclusions. How one identifies whether the favorable or unfavorable cases will control is somewhat of a crapshoot. In any event, it should be remembered that the I.R.S. argued for the unfavorable approach in all the cases. The cases are discussed below in this article. If this course of action is taken, the computation is illustrated in Fig. 2, Ownership Structure A, below.

3. The third course of action is for H and W to gift 50% interests in each of GmbH and S.A., respectively to the other spouse, effectively replicating community property rules. Several issues with this approach are technical and practical. Regarding the technical issues, confirmation must be obtained from both U.S. and European tax advisers that the simultaneous gifts can be effected at no tax cost, taking into account both income and inheritance taxes. In the U.S., cross-gifts might resemble a taxable exchange, especially if cash balancing is involved to eliminate differences in value, though there do not seem to be cases applying this approach to married couples. Regarding practical problems, H and W may wish to retain ownership separately in the event of a termination of the marriage. This may suggest that netting tested income and losses between the spouses should not be permitted because the married couple are not acting as a "single unit" as to all their property. If this course of action is taken, the computation is illustrated in Fig. 2, Ownership Structure B, below.

Fig. 2: Why are "G.I.L.T.I." Couples Punished?



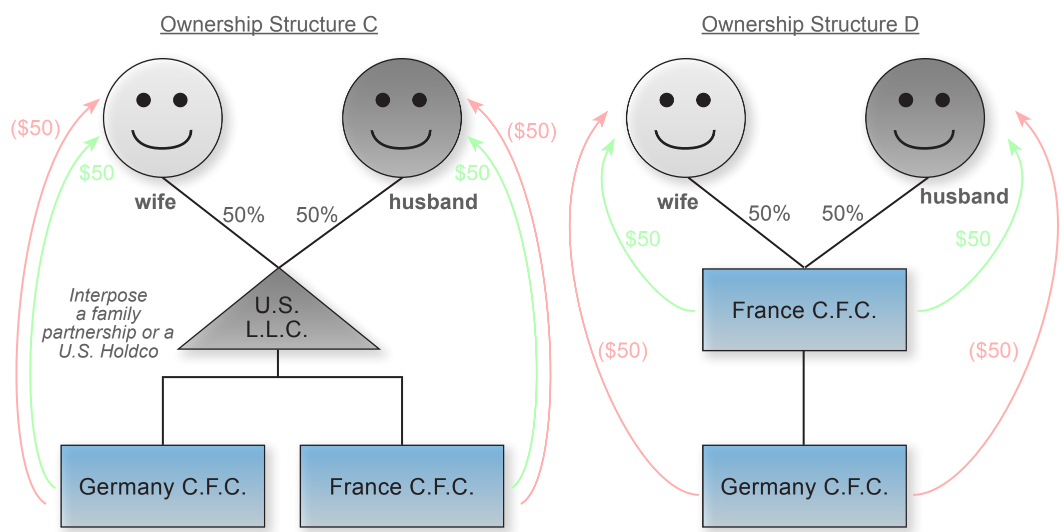
For W, $100 G.I.L.T.I. income on return:	
Tested Income	$100
Tested Loss	($0)
Net Tested Income / G.I.L.T.I. inclusion	$100

For each of W and H:	
Tested Income	$50
Tested Loss	($50)
Net Tested Income / G.I.L.T.I. inclusion on Joint Return	$0

4. The fourth course of action is for H and W to transfer 100% of the interests in each of GmbH and S.A. to a joint holding vehicle, possibly one that is tax transparent for U.S. tax purposes as well as European law purposes. A simple general partnership may be appropriate because of the absence of legal personality and the ease with which it can be disbanded. These features may allow the entity to be transparent in Europe as well as the U.S. Another alternative is an S-corporation, which is tax transparent or a C-corporation that is not tax transparent. S-corporations provide favorable tax benefits in connection with ongoing income and losses. However, S-corporation transfers of assets to shareholders are taxable events in the U.S. C-corporations are not tax transparent, but the tax rates under existing U.S. tax law are low in general – 21% – and even lower for G.I.L.T.I. inclusions, once the 50% deduction is taken into account. If this course of action is taken, and the U.S. L.L.C. is taxed as a partnership, the G.I.L.T.I. computation is illustrated in Fig. 3, Ownership Structure C, below.

5. The fifth course of action is for one spouse to contribute the shares to the corporation owned by the other spouse. In return, shares of the corporation effecting the acquisition would be the only consideration received by the transferor spouse. This course of is attractive only if the transaction can be effected in a tax-free way in the U.S. and in Europe. In the U.S., an outbound transfer may have issues under Code §367(a) but may be treated as a foreign-to-foreign reorganization tax-free under Code§ 368(a)(1)(D), covered by Code § 367(b). To be treated as a transfer of assets treated as a tax-free "D" reorganization, it would also be necessary for Germany C.F.C. to be checked pursuant to the plan to be treated as an entity disregarded as separate from France C.F.C. Advice of European tax advisers would be required as to European taxes, both income and transactional (such as stamp duties). Again, this structure will be problematic and would need to be undone in the event of a termination of the marriage. If this course of action is taken, the computation is illustrated in Fig. 3, Ownership Structure D.

Fig. 3: Two Additional Self-Help Options (Fourth & Fifth Course of Action for H and W)



Additional Tax Considerations

If an election is made to treat U.S. L.L.C. as a C-corporation, U.S. HoldCo can claim a Code §250 deduction reducing the corporation's G.I.L.T.I. by 50%, and is entitled to claim Code §960(d) 80% foreign tax credits.[8] If Structure B, C (assuming the L.L.C. is taxed as a partnership for U.S. purposes) or D are selected, the couple can consider making a Code §962 election to defer tax at their highest marginal tax rate until an actual distribution, or a high-tax election if the foreign effective tax rate for a C.F.C. or its tested unit is greater than 18.9% in any particular year.

WHAT ARE THE STEPS OF THE G.I.L.T.I. COMPUTATION IN A JOINT RETURN CONTEXT?

Determining the G.I.L.T.I. inclusion involves a C.F.C.-level and U.S. Shareholder-level calculation.

C.F.C.-level Calculation

Once all the U.S. Shareholders of each C.F.C. are identified, G.I.L.T.I. requires each to determine the following for each owned C.F.C.:

1. Gross income applying U.S. tax principles

2. Gross tested income, derived by removing Subpart F, U.S. source income, related-party dividends, and certain oil and gas extraction income from gross income

3. Net tested income, derived by offsetting all allocable and apportionable deductions; C.F.C.'s with a net positive amount after this step (tested income) are referred to as a "tested income C.F.C." and those with a net negative amount (tested loss) are referred to as a "tested loss C.F.C."

"Determining the G.I.L.T.I. inclusion involves a C.F.C.-level and U.S. Shareholder-level calculation."

Shareholder-level Calculation

The next steps are all determined at the U.S. Shareholder level:

1. Aggregate of shareholder's *pro rata* share of tested income from all tested income C.F.C.'s, over aggregate tested loss from all tested loss C.F.C.'s ("net C.F.C. tested income" or "loss")

2. Net deemed tangible income return is computed as (i) 10% of *pro rata* share of Q.B.A.I. from all tested income C.F.C.'s, less (ii) specified interest expense ("net D.T.I.R.")

3. Deduct net D.T.I.R. from net C.F.C. tested income. The result is G.I.L.T.I.

Joint Tax Returns — How Are the Joint Calculations Harmonized?

Treas. Reg. §1.6013-4(b) provides in relevant part, that where a couple files a joint return all items are to be aggregated as follows:

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8 The S election may be made for Federal and N.Y.S. purposes, but not N.Y.C. In addition, under Notice 2020-69, S corporations may irrevocably elect to be treated as the U.S. Shareholder recognizing G.I.L.T.I. income for purposes of adjusting the accumulated adjustments account, which makes sense if they have C period accumulated earnings and profits.

> If a joint return is made, the gross income and adjusted gross income of husband and wife on the joint return are computed in an aggregate amount and the deductions allowed and the taxable income are likewise computed on an aggregate basis. Deductions limited to a percentage of the adjusted gross income, such as the deduction for charitable, etc., contributions and gifts, under section 170, will be allowed with reference to such aggregate adjusted gross income. A similar rule is applied in the case of the limitation of section 1211(b) on the allowance of losses resulting from the sale or exchange of capital assets (see §1.1211–1). Although there are two taxpayers on a joint return, there is only one taxable income.

Based on legislative intent of Code §6013 to treat joint filers similar to married couples in community property states, there is a view that simply by the act of filing the joint return Ownership Structure A is recast as Structure B as shown in Fig. 2, previously.

As discussed below, case law does not uniformly apply aggregation principles to married couples filing joint tax returns, but frequently defers to the legislative purpose underlying a specific Code provision. It is unclear what legislative purpose of Code §958 would defeat aggregation of tested income and loss under Code §6013, however outside of the joint return context only subsection (b) of Code §958 applies attribution principles. Courts generally require attribution to be specifically permitted or required by a statute, rather than inferred from the context.[9] In addition, the filing of a joint return does not by itself transmute separate property into marital.[10] Assumptions about Code §6013's legislative purpose notwithstanding, even for couples actually residing in a community property jurisdiction, there remains electivity to treat specific property as separate property. If a harmonizing provision or cross-reference were enacted under Treas. Reg. §1.951A-1(c) or Treas. Reg. §1.6014-4(b), one assumes that it would provide mechanics similar to the following:

- First, the spouses' *pro rata* shares of tested income and tested loss from all C.F.C.'s are aggregated, as if the couple were a single Code §958(a) U.S. Shareholder (step 1 of shareholder-level calculation).
- Next, the couple's *pro rata* shares of Q.B.A.I. and interest expense from all C.F.C.'s are also aggregated, once again treating both spouses as a single Code §958(a) U.S. Shareholder (step 2).
- Finally, G.I.L.T.I. is determined on an aggregate basis and the final result is divided by two.

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9 On occasion, the Tax Court has even refused to apply statutorily-required attribution, as in the case of the former foreign personal holding company provisions under Code §554 at issue in *Nellie Miller v. Commr.*, 43 T.C. 760 (1965), *nonacq*., 1966-1 C.B. 4, where the Court refused to attribute stock owned by a nonresident alien family member to a related U.S. family member despite the statute's plain language.

10 *Holston v. Holston*, 128 So. 3d 736 (Ala. Civ. App. 2013), at 744, citing Hunt v. Hunt, 389 S.W. 3d at 761-62. The consequence in H and W's case is that the couple's C.F.C.'s might default to separate property treatment under state law, even if residing in a community property jurisdiction where no election was made to treat the foreign legal entities as community property.

Nevertheless, Treas. Reg. §1.6014-4(b) only refers to items of income and deduction which includes G.I.L.T.I., but not items such as tested income and loss which do not show up anywhere on the tax return and arguably are tied to each spouse's separate interest in their respective C.F.C. Thus, if H and W were to proceed under the second course of action above (do nothing based on Code §6013's legislative history), assumptions are required to be made along the way.

Because paragraph (4) of Treas. Reg. §1.951A-1(c) in the G.I.L.T.I. rules contains an explicit cross-reference to the special consolidated G.I.L.T.I. mechanics of Treas. Reg. §1.1502-51, while there is no cross-reference to Treas. Reg. §1.6014-4(b) or joint tax returns, nor any statement that either attributive ownership under Code §318 or some kind of implicit aggregation principle under Code §6013 is relevant for married couples who own interests in C.F.C.'s and file joint returns, H and W are left bearing the risk if the I.R.S. should later disagree.

In short, a judgment call seems to be required that Code §958(a) should be applied in deference to a presumed aggregation principle in Code §6013. Based on the Instructions to Form 8992, *U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI)*, which indicate only that each Code §958(a) U.S. Shareholder should file a separate form, it appears the couple must rely on presumptions about the legislative intent of Code §6013 overriding separate ownership under Code §958(a) or imposing attribution despite the separate legal ownership.

In other situations where a different approach is mandated under G.I.L.T.I. or the international tax provisions, the I.R.S. has provided specific rules. For example, the I.R.S. enacted Treas. Reg. §1.1502-51 to modify the U.S. Shareholder-level G.I.L.T.I. calculation in the case of U.S. consolidated subsidiaries that are members of a group — rules which require additional concepts not otherwise needed for an individual's G.I.L.T.I. computation, and unique concepts such as the "G.I.L.T.I. Allocation Ratio."[11] Moreover, joint tax returns are distinguishable from consolidated groups because as at least one court has specifically noted, couples are not treated as a single taxpayer for all purposes unlike consolidated groups.[12] Consolidated groups require additional complex rules pertaining to basis and E&P adjustments, which are irrelevant for a married couple, meaning that H and W would be hard-pressed to concoct some kind of rule by analogy here.

In addition, in one other context in the international tax rules the I.R.S. specifically included a rule addressing married couples filing a joint tax return. In particular, in August 2020 and concurrently with issuance of Code §163(j) final regulations[13] the

11 As the I.R.S. explained in the Preamble to the 2019 final G.I.L.T.I. regulations, the purpose of the special rules for consolidated U.S. affiliates is to ensure single-entity treatment at the level of the group, while preserving the location of tested income within the group for purposes of basis and E&P adjustments. The Instructions to Form 8992 provide that each affiliate preparing a Form 8992 must indicate all the relevant C.F.C's in Schedule A including C.F.C.'s from which the U.S. affiliate is allocated a portion of the consolidated tested loss, in addition to its own C.F.C.'s.

12 *J&S Carburetor Co. v. Commr.,* 93 T.C. 166 (1989) ("Moreover, our decision in *McClamma* [76 T.C. 754 (1981),] was premised on our conclusion in *Barron v. Commr.,* 71 T.C. 1028 (1978) that a husband and wife filing joint returns are to be treated as separate taxpayers rather than as a single taxpayer entity. Here it is appropriate to treat the affiliated group as a single taxpaying entity.")

13 T.D. 9905.

I.R.S. issued a Notice of Proposed Rulemaking (REG-106089-18) relating to application of Code §163(j) and Treas. Reg. §1.163(j)-7 to C.F.C.'s, which applies for purposes of determining how much interest expense should be taken into account as an offset each C.F.C.'s tested income ("Notice"). The Notice is relevant when the U.S. Shareholder is a single taxpayer, a married couple, or a domestic consolidated group. Under the Notice of Proposed Rulemaking, the I.R.S. would explicitly permit married couples filing a joint tax return to determine their Code §163(j) limitation on a joint basis for all commonly owned C.F.C.'s. The benefit of this elective relief is to reduce compliance costs of computing multiple separate Code §163(j) limitations when there are many C.F.C.'s owned in common.[14] Under the proposed regulation, "related United States shareholders" is defined to include "members of a consolidated group and individuals described in [Code §]318(a)(1)(A)(i) who file a joint tax return are treated as a single person."

In the context of our G.I.L.T.I. issue in H and W's context the Notice is relevant in two respects. First, the approach taken in the Notice may reflect an implicit I.R.S.'s view that married taxpayers filing joint returns are already conducting G.I.L.T.I. computations on a joint basis. However, the Notice also demonstrates that when the I.R.S. means for couples to be treated as a single person, it explicitly provides for that result (though in this case relief is elective rather than mandatory).

"Under the Notice of Proposed Rulemaking, the I.R.S. would explicitly permit married couples filing a joint tax return to determine their Code §163(j) limitation on a joint basis for all commonly owned C.F.C.'s."

As noted above, in the case of H and W even under community property rules, barring any special agreement, H and W's respective interests in their C.F.C.'s would likely be treated as separate property where acquired prior the marriage. Therefore, if the I.R.S. considers rules under either Treas. Reg. §1.6014-4(b) or Treas. Reg. §1.951A-1 (or elsewhere), to provide harmonized spousal G.I.L.T.I. mechanics, the rules should leave room for electivity. It would also be helpful, if the I.R.S. could update the Instructions to Form 8992 to provide that, similar to consolidated U.S. subsidiaries, married couples filing a joint tax return should attach two separate Forms 8992, and report their respective halves of the above computation, with respective G.I.L.T.I. amounts from Part II, line 5 aggregated as a single amount on Form 1040.

Under Rev. Proc. 2002-69, taxpayers living in a community property state may decide whether a limited liability company owned by either spouse is treated as a disregarded entity or as a partnership for U.S. Federal income tax purposes. Thus, should the I.R.S. issue guidance under Code §§951A and 6013 to address H and W's issue, such relief could be elective like the revenue procedure.

INCONSISTENT CASE LAW ON SINGLE UNIT OR AGGREGATE TREATMENT OF MARRIED COUPLE

Part of the difficulty for H and W relates to the fact that — under a profusion of precedents applicable to different contexts and Code provisions — there is no failsafe method for determining when married spouses filing jointly are required to aggregate their computations, and when to perform them separately. This state of affairs is markedly different both from the rules applicable to partnerships, which generally defer to the legislative policy of the underlying tax rule in question, and from the rules for consolidated returns which are supposed to reach a single-entity result. The following cases and rules are instructive, insofar as they reflect the absence of a single, logical approach for joint tax returns.

14 Prop. Treas. Reg. §1.163(j)-7(f)(6)(i).

In addition, it is a matter of frequent discussion by legislators, practitioners and commentators that joint returns sometimes result in a "marriage bonus" and other times in a "marriage penalty,"[15] suggesting that the proper benchmark is the extent to which Code §6013 results mirrors the results that would obtain for individual taxpayers filing separately, but simultaneously recognizing that in practice the rules frequently diverge from that standard and that the actual result depends on the particular Code provisions in question.

Married Couple as a Single Unit

The following cases and rules treat a married couple as a single unit, meaning as though they were one taxpayer.

- In *Taft v. Helvering*[16] the Supreme Court held that I.R.S. Regulations, providing that a 15%-of-net-income limitation on charitable contributions should be determined vis-à-vis each spouse's standalone taxable income, were inconsistent with the concept of a joint return, and overturned them.

- In *Estate of Hooks v. Commr*.[17] the Tax Court ruled that, where two statutory provisions of the Tax Code then in effect granted a surviving spouse a right to deduct interest on a final joint tax return, the I.R.S. could not deny her the deduction based on the argument that the deduction did not belong to her because it was her spouse who took the loan out against his insurance policy before death.

- In *Helvering v. Janney*[18] the I.R.S. enacted Regulations in 1935 which were at odds with prior legislative enactments and its own longstanding practice, and sought in reliance on those Regulations to prevent a husband and wife from offsetting their respective capital gains and losses (clearly, the language in current Treas. Reg. §1.6013-4(b) was added later). The Supreme Court refused to apply the Regulations and allowed the taxpayers to offset their capital gains and losses.

- In *Ross v. Commr*.,[19] the Tax Court considered whether a married couple filing a joint return could claim a duplicate $1,000 (or in all, $2,000) benefit for offsetting capital losses against ordinary income. The statute and regulations were clear that only a single $1,000 offset was available, but the taxpayers challenged this rule based on residence in a community property state. The Court ruled against the couple, citing the B.T.A.'s opinion in *Marvin L. Levy v. Commr*.:[20]

  > It would be a peculiar logic to permit the "joint" return to give the benefit of offset of gains and losses not available to the individual by merging all items, including capital gains and losses

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15 For example, Alan Appel and Joshua Gamboa discuss a marriage penalty relating to high-income taxpayers under the T.C.J.A. in their article in Tax Notes, "The Hidden Marriage Penalty Inside the T.C.J.A.", dated Aug. 3, 2020.

16 311 U.S. 195 (1940).

17 22 T.C. 502 (1954).

18 24 A.F.T.R. 1073, 61 S. Ct. 241 (1940).

19 37 T.C. 445 (1961).

20 46 B.T.A. 1145 (1942).

of the spouses, yet to say that in one very particular respect, the limitation on capital losses, there is no such merger, and that the identity of the taxpayer is preserved so that each can individually take a deduction of $2,000 [the present amount is $1,000] capital losses. . . . The limitation, like the offsetting of gains and losses, is not separate, but a part of the method of computation of the income under the integrated return.

"[S]ome authorities aggregate spouse's interests or implicitly treat them as owning each other's property even where no joint return is filed. . ."

- In *McClure v. U.S.*,[21] the Fourth Circuit ruled that a special provision providing for a lower tax rate where 80% of a payment for services delivered over a long period was paid within a period no longer than 36 calendar months, both the taxpayer who performed the services and his spouse would be eligible for the lower tax rate. The statute (Former Code Section 107(a)) expressly provided that the income earned could be split between the spouses to produce a greater benefit, even if the spouse did not perform any services. The Fourth Circuit ruled that the split could be applied for all of the years over which the services were performed, even if the taxpayers were not married or had not selected to file a joint return in all those years.

- In *Anderson v. Commr.*,[22] the Tax Court considered whether a marital couple's alternative minimum tax exemption amount was doubled under the 1954 Code when they live in a community property State. The Tax Court observed as follows:

  The Code is replete with examples of situations similar to that presented [here] * * * whereby married individuals filing separate returns receive only one-half of a benefit available to single persons and jointly filing individuals,.* * * Where Congress intends to grant married persons filing jointly twice the benefit of single individuals, it has been clear and unambiguous.

- In Rev. Rul. 75-356[23] and P.L.R. 7813073, the I.R.S. concluded that farmers who filed a joint return had to aggregate both spouses' income to determine whether more than two thirds of his income came from farming, which was necessary to discern whether the taxpayer qualified as a farmer under Former Code §6073(b) of the Code. As such, after aggregating the spouses' income the farmer failed the test.

In addition, some authorities aggregate spouse's interests or implicitly treat them as owning each other's property even where no joint return is filed, such as the basis-leaping rule of Code §302[24] or Code §469's active participation requirement.[25]

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21 228 F.2d 322 (4th Cir. 1955). Similar issues involving application of Former Section 107(a)'s benefit by joint-filing spouses to separate filing years seem to be at issue in *Ford v. Commr.*, 217 F.2d 886 (9th Cir. 1954).

22 77 T.C. 1271 (1981).

23 1975-2 C.B. 497.

24 Treas. Reg. §1.302-2(c).

25 In addition, in the case of nonstatutory stock options ("N.S.O.'s") and nonqualified deferred compensation transferred to a former spouse incident to a divorce, the I.R.S. provided in Rev. Rul. 2004-60 that F.I.C.A., F.U.T.A., and income tax withholding, in addition to reporting requirements, are triggered on the nonemployee spouse's exercise of N.S.O.'s and distributions from the nonqualified deferred compensation plan, and are treated as remuneration for Code §3402 purposes. Because the nonemployee spouse includes these amounts in gross income, the spouse is also entitled to a credit for income tax withheld under Treas. Reg. §1.31-1(a).

Married Couple as Aggregate of Two Individuals

An opposing stream of authorities respects spouses' separateness, or requires them to apply or qualify under various provisions independently:

- A seminal case about maintaining distinctions between spouses filing a joint tax return is *Coerver v. Commr.*,[26] where the spouses sought a Code §162 trade or business deduction for the wife's travel between her work in New York City and the couple's home in Wilmington, where her husband resided year-round. The Tax Court rejected the spouses' position that costs of maintaining a N.Y. apartment and traveling to and from Delaware constituted living expenses away from home within Code §162, since it was the wife's choice to work in New York and reside with her husband, not a requirement of her employer:

> It may be true that a joint return is to be treated as the return of a "taxable unit" and as though it were made by a "single individual," but this merely means that the husband and wife are permitted to aggregate their income and deductions in a joint return. * * * This may have the result in instances, of permitting the losses or deductions of one spouse to offset the income of the other spouse * * * but each spouse must first be entitled to a particular deduction before it can be aggregated. The concept of a "taxable unit" under the joint return provision, [Code §]6013, merely means that while there are two taxpayers on a joint return, there is only one taxable income. It does not create a new tax personality which would be entitled, in its own right, to deductions not otherwise available to the individual spouses under the pertinent sections of the statute.

- P.L.R. 8920019 addresses a fact pattern involving the filing of a joint tax return by two spouses, one of whom was insolvent for purposes of Code §108(a)'s insolvency exclusion. Citing *Coerver*, the I.R.S. held that the joint return filing did not convert the assets of both spouses into assets of the insolvent spouse, for determining insolvency, because the bankruptcy statute looked only to that spouse's assets and did not allow the insolvent spouse's creditors to reach assets in the name of the solvent spouse.

- In Rev. Rul. 66-172,[27] the I.R.S. held that where husband (H) and wife (W) jointly owned an S Corporation as tenants by the entirety, and each took income into account under Subchapter S, following which H died, W did not succeed to H's share of previously-taxed income ("P.T.I.") under old law S corporation rules because the I.R.S. explicitly provided – via Regulation – that the shareholder's right to non-dividend distributions was personal and non-transferrable. H and W had been filing joint tax returns for the years in question, and the I.R.S. cited Treas. Reg. §1.6013-4(b) for the principle that joint returns in no way changed the result under Subchapter S because a joint return is the return of two separate taxpayers.

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26 36 T.C. 252 (1961), *aff'd*, 297 F.2d 837 (3d Cir. 1962).

27 1966-1 C.B. 198.

- Code §911's foreign earned income exclusion depends on activities undertaken by either spouse, and each determines their excludable foreign earned income under Treas. Reg. §1.911-3; if they live together, the spouses may elect to compute their housing cost amount jointly or separately. Each completes a separate Form 2555.

- Treas. Reg. §1.6017-1 requires spouses filing a joint return not to compute their self-employment tax on an aggregate basis.

- Dual-status individuals who are not U.S. tax residents at the close of a tax year and who are married to a U.S. citizen or resident may make a joint election with their spouse under Code §6013(g) to be treated as a U.S. resident for certain purposes of the Code (Income Tax and Wage Withholding). Under such an election, income of both spouses is included in modified adjusted gross income as well as in net investment income for Code §1411 net investment income tax; however, whether the U.S. taxpayer is independently subject to tax under Code §1411 is made without regard to the election or the non-resident spouse's income.

- Both Courts and the I.R.S. have consistently ruled that where a husband and wife file a joint return and pay tax, there is no joint interest in overpayments. For example, in Rev. Rul. 74-611, a married couple filed a joint tax return and the wife paid the entire amount of tax liability, subsequently determined to be an overpayment which the husband attempted to apply to his own tax liability from a prior year before the couple were married or filed a joint return. The I.R.S. refused to allow the overpayment to be so applied.[28]

- The case of *McClamma v. Commr.*[29] recognized that the automatic stay under Chapter 11 of the Bankruptcy Code did not extend to the spouse who did not file a petition in bankruptcy.

- Innocent spouse relief provisions under Code §6015.

- For a married couple one or both of whom are nonresident alien individuals who earn community income for a taxable year, Code §879 treats them as each earning the income each earned on a separate basis for some purposes, for example, trade or business income treated as community income under Code §1402(a)(5) is treated as gross income of the spouse carrying on the trade or business, or if jointly operated by both spouses, then on the basis of their respective distributive shares.

CONCLUSION

Filing a joint tax return under Code §6013 and netting tested income of C.F.C.'s owned by one spouse with tested losses of C.F.C.'s owned by the other spouse without more justification sounds like a good idea at first. However, those who have read the cases may have a different view. This approach may be compared to a person jumping into a swimming pool with a blindfold on and without checking the water level in the pool – there may be logic to the act, but it is fraught with danger.

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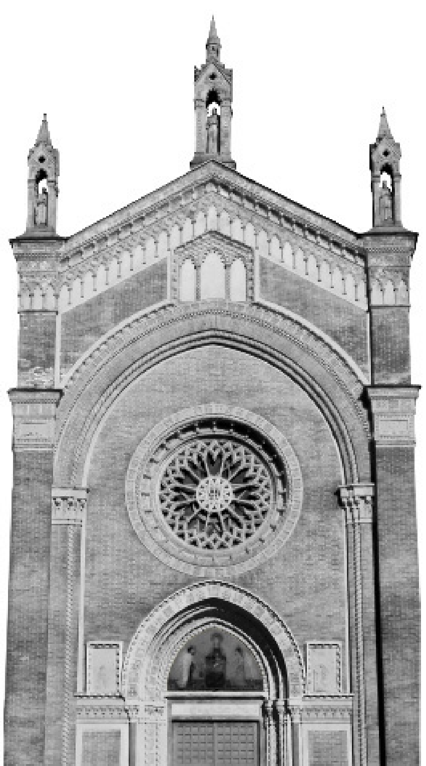
[28] 1974-2 C.B. 399.

[29] 76 T.C. 754 (1981).

The cases applying Code §6013 are not consistent when the issue is the status of the married couple as a single unit or an aggregate of two taxpayers. Hence, a taxpayer who assumes that a couple should be treated as one unit does so on faith, believing that the aggregation principle must cover G.I.L.T.I. calculations. The rational answer is that aggregate treatment may be the answer, but until Congress or the I.R.S. take action, a risk exists that a different view could prevail.

As indicated above, there is a natural and logical way to harmonize the provisions of Code §§951A and 6013 in order for the spouses in H and W's position to offset tested income and tested loss, in a manner that does not require potentially structural changes that are costly.

In short, the I.R.S. should lend greater clarity to this area via guidance in any format it deems appropriate. The guidance could provide that the married couple will be treated as owning C.F.C.'s on a 50/50 basis for G.I.L.T.I. purposes, but could also leave room for couples to elect out of that treatment and compute separate G.I.L.T.I. inclusions while filing a joint return. In a 2000 Senate discussion about proposed legislation to eliminate certain marriage penalties, a Democratic senator cited 65 different provisions that, in context, constituted a penalty for married taxpayers filing jointly. By issuing guidance on this G.I.L.T.I. issue, the I.R.S. would remove one more potential penalty from the Code.



THE DO'S AND DON'TS OF I.R.S. TRANSFER PRICING STORYTIME

Author
Michael Peggs

Tags
Transfer Pricing
Transfer Pricing Agreement
Transfer Pricing Documentation

Earlier this year, the I.R.S. updated its Transfer Pricing Documentation Best Practices F.A.Q. list with a response to Q. 4, What are some areas the I.R.S. has identified in transfer pricing documentation reports that could benefit from improvement?[1]

Given the uncanny resemblance of the I.R.S. list of documentation pet peeves to my many years of review notes written for transfer pricing documentation drafters in the U.S., Canada, and elsewhere, it seemed that this would be a good time of year to recap the state-of-the-art of transfer pricing documentation.

The F.A.Q. also appears at the time when U.S. taxpayers must take clear factual and analytical positions in the face of increasingly frequent claims of foreign tax authorities concerning the purported local "value creation" that gives rise to increased foreign income allocations. Given the I.R.S. may deal with such foreign tax authority claims in Competent Authority negotiations at a later date, companies should consider this F.A.Q. instalment as constructive I.R.S. transfer pricing documentation drafting comments.

SETTING THE SCENE

A description of the company's business and the industry in which it operates provides important context for the understanding of a transfer pricing position. This part of the company's documentation might be thought of as the response to the common I.R.S. international examiner's question, "What is the business, and how does it work?"

A response delivered in the context of the controlled transaction at issue should describe the company's business operations, and then place the business in the appropriate industrial organization context of competitors, suppliers, factor markets, and product or service markets. This is critical information, especially when applying the comparable uncontrolled transaction method and using transactional data. Without information on the factors of comparability, there can be no useful comparability analysis.

The I.R.S. encourages drafters of the industry and company analysis sections of a documentation report to tell the company's story, and to include factual information that informed the company (or its advisor or expert) in their selection and application of a transfer pricing method or methods. The ever-important discussion of expectations-versus-actual outcomes or budget-versus-actual is particularly relevant in the present recession, and can assist in an effective identification and disaggregation of "effects of bad risk realization from the effects of intercompany pricing."

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1 Q 4 available here.

Correctly, the F.A.Q. notes that robust documentation assists with the rapid conclusion of an I.R.S. transfer pricing risk assessment. Effective and thorough drafting can alleviate the need to manage an extensive and lengthy transfer pricing examination.

ROBUST NARRATIVE, PLEASE

The I.R.S. does not favor a functional analysis checklist, and critiques this presentation as a functional analysis without the analysis. The binary responses in a checklist or a subjective percentage of responsibility for a particular function are targets of this I.R.S. comment. This style of documentation does not allow for the connection of the description of a business function to an explanation of the relative merits of specified transfer pricing methods. Those who use it as part of a DYI attempt at transfer pricing have been warned. Critically, a checklist approach cannot explain which functions are relatively important to the success of particular business or line of business, or how certain functions create value in the context of a "value creation" argument likely to be the focus of a foreign transfer pricing examination or a Competent Authority matter.

RISK, AS EXPECTED?

Where they exist – and it is advisable that they do exist – intercompany agreements establish a transactional framework within which counterparties will take certain risks. The presentation of a risk analysis should be consistent with the risks outlined in the intercompany agreement, link company or tested party risks to the comparability analysis presented later in the report, and explain in basic terms the need for a comparability adjustment brought about by a significant difference in risk between the controlled transaction and the selected comparable transaction or transactions.

MORE NARRATIVE, THIS TIME ABOUT METHOD

The requirement to describe and explain the transfer pricing method selected, as well as alternative methods considered, but not selected, is codified in the principal documents requirement of Treas. Reg. §1.6662-6(d)(2)(b). Despite this, the F.A.Q. finds these two elements of documentation lacking. In particular, where internal inquiries about the availability and appropriateness of third-party transactions or pricing data have been made to evaluate the applicability of a particular transfer pricing method, a written summary of this inquiry should be included in the documentation. It informs the I.R.S. that the inquiry has been made in sufficient depth and that the conclusion reached concerning the inapplicability of a transfer pricing method is based on the lack of suitable data, and for that reason, is well-founded.

A description of the company's or tested party's customers or suppliers in advance of the discussion of method selection allows for an orderly rejection of a particular transfer pricing method. In managing a transfer pricing examination of the tax year, the description is preferable to an unsupported concluding statement cited by the F.A.Q. to the effect that "there are no comparable uncontrolled prices (CUPs) so we did not apply the CUP method."

The F.A.Q. alludes to difficulties that arise during an examination upon the discovery of an internal company database of legal agreements with unrelated parties. The existence of internal data that has been shielded from the transfer pricing economist can be problematic. The economist preparing the study must be given access to all sources of information within the company extending beyond the tax department and the accounting department to operations and legal departments.

TELL THE WHOLE STORY OF COMPARABILITY

The F.A.Q. points to the absence of any analysis of the relative profit potential of comparable transactions as the most common shortcoming of comparability factor evaluation, especially in the context of pricing intangible property transactions under the comparable uncontrolled transaction method. This is often a very difficult factor to quantify and more detailed disclosure of the approach applied to evaluate this comparability factor becomes important if a disagreement arises between the examiner and the taxpayer over differing views of future profitability or profit potential. More generally however, it seems the F.A.Q. addresses a broader concern held by the I.R.S. over the lack of explicit evaluation of all factors of comparability.

Again, the requirement to explain how comparability was evaluated is a requirement that is codified in the transfer pricing documentation regulations. It is not uncommon that company or transaction comparability is evaluated in a deductive manner, taking a very large set of data and applying an increasingly refined set of comparability criteria until a robust level of comparability is achieved. The F.A.Q. commentary relates most directly therefore to the later stages of comparability evaluation, raising the question of the compliance value of intensive screening on all elements of an often very large data set.

IMPACTS OF DIFFERENT FUNCTIONS OR RISKS

Evaluating comparability based on many functional and risk factors presents a challenge from the standpoint of documentation. The F.A.Q. calls for more disclosure of the observed levels of comparability for each functional and risk factor, and for a more accurate enumeration of the comparability shortfalls that would require some form of adjustment. This comment appears to reflect closer harmonization of qualitative comparability evaluation with the updated O.E.C.D. standard. The interesting consideration here is the compliance effect of more detailed disclosure. It is not at all clear that additional detailed disclosure will result in a lower likelihood of the examination proceeding past the risk assessment stage. The same may be said with regard to the likelihood of concurrence by the I.R.S. with an income allocation position for the sole reason that the taxpayer's comparability analysis has been meticulously documented.

EXPLAIN COMPARABILITY ADJUSTMENTS

Finally, the F.A.Q. asks that better documentation of comparability adjustments should be included in the report. In particular, the I.R.S. commentary notes that the reasons for an adjustment should be explained, which is a particularly helpful disclosure to make where it is understood that an I.R.S. examiner must understand the logic of the adjustment in order to understand the broader logic of the income allocation.

A great many pointy-headed debates over the theory and practice of comparability adjustments have taken place without making a significant contribution to the resolution of a transfer pricing dispute. The F.A.Q. does not signal that these debates could become more useful or efficient with the disclosure of further information, but only that taxpayers should explain themselves more thoroughly.

"[C]ompanies must search for the point at which a marginal benefit of expenditure to manage examination risk begins to diminish."

EVERY STORY IS UNIQUE

The F.A.Q. states clearly that the items outlined above are not all of the areas which the I.R.S. has identified as suboptimal when evaluating a transfer pricing report. Moreover, additional effort and expense to strengthen or improve the quality of a report prior to the filing of a tax return will not provide a safe harbor against the imposition of penalties. While the F.A.Q. is not binding on the I.R.S., it is not unusual to find in practice that the absence of identified shortcomings set out in the F.A.Q. affects I.R.S. deselection of certain audit issues and leads to a more efficient I.R.S. examination.

The F.A.Q. makes it clear that more complex transactions call for more detailed analysis and documentation. It is obvious in the current business environment that international transactions do not necessarily begin as simple transactions. Understanding that complex transactions lead inevitably to a trade-off between compliance benefit and compliance cost, companies must search for the point at which a marginal benefit of expenditure to manage examination risk begins to diminish. This point is unique to each business at each point in time, and must be located rather un-scientifically by divining the effort level that likely results in penalty protection and the effort level that limits cost and disruption from transfer pricing controversy. In practice, this decision is made by determining how much quality documentation can be bought with a certain budget.

The F.A.Q. list describes many requirements that go beyond the penalty protection threshold. In today's high-controversy environment, the tendency is to over-document to manage the risk of income adjustments, penalties, and reputation risk. Finding the optimal amount and type of documentation is further frustrated by the asymmetric application of transfer pricing principles, and indeed asymmetric transfer pricing principles in many G20 countries. In this context, the FAQ informs the U.S. company of the opening bargaining position of the I.R.S. when intercompany pricing is a material item in the tax return.

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