

Foreign Investment in U.S. Real Estate: Tax Concerns When Acquiring or Disposing of Ownership Interests

Entity Selection, FIRPTA, Blocker Corporations, and the BEAT Tax

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Foreign Investment in U.S. Real Estate: Impact of Tax Reform

August 3, 2021

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Topics

1. What are the U.S. income tax implications of purchasing U.S. real estate by foreign parties?
2. Compare and contrast U.S. income tax consequences if the purchaser is a foreign individual, a single member or multi-member domestic limited liability company, or blocker corporation.
3. How does the use of a foreign trust affect the U.S. income tax consequences?
4. Understanding the U.S. income tax reporting obligations if foreign investors acquire direct or indirect interests in U.S. real property.
5. FIRPTA compliance issues for sellers.
6. Summary of various investment structure alternatives.

Overview of the U.S. tax rules that apply to foreign investors in U.S. real estate

1. Income Tax Costs
2. Applicability of Withholding Tax
3. FIRPTA
4. Estate and Gift Tax Exposure for the Foreign Owner

Possible objectives in representing owners of U.S. real estate

- Minimize or eliminate U.S. income tax costs on rental income
- Minimize or eliminate U.S. income tax costs on sale
- Limit U.S. estate tax exposure
- Limit U.S. gift tax exposure
- Limit tax return obligations (information disclosure)

Summary of U.S. taxes

U.S. corporate rate	21%
U.S. regular rate	Top marginal rate of 37%*
U.S. capital gain rate (corporation)	21%
U.S. capital gain rate (individual)	20%**
FIRPTA Withholding Rate	15%***
FDAP Withholding Rate (No treaty)	30%
Medicare Tax	3.8%
State Taxes	Various

*In some circumstances, a lower rate may be available with the pass-through deduction rate

**A lower capital gain rate is applicable for lower bracket taxpayers

***A 10% FIRPTA withholding rate is applicable to distributions by certain REITs.

Overview of U.S. Taxation of Foreign Investors

1. Rental Income
2. Interest Income
3. Dividend Income
4. Gain or Loss of Disposition

FDAP withholding

- FDAP – fixed, determinable, annual or periodic
- In general, a 30% withholding rate on payments of FDAP income to foreign persons or entities
- In general, FDAP does not include income arising from a trade or business
- FDAP withholding can apply to rent (in certain circumstances) and will apply to dividends paid by U.S. corporations to foreign shareholders

Tax treaties and FDAP withholding

- Many U.S. income tax treaties call for a reduced rate of withholding on FDAP income
- The availability of treaty benefits can be subject to limitation

U.S. Tax Filings

1. If FDAP income, U.S. payor is required to withhold U.S. tax and payee is not obligated to file a U.S. income tax return.
2. If income is derived from a U.S. trade or business and the income is not FDAP, the income is subject to U.S. Income tax on a net basis. In these circumstances, the foreign investor will be under obligation to file a U.S. income tax return and be subject to U.S. tax at the regular rates.

FDAP Example - Dividends

Louis and Estrella plan to invest in a commercial office property located in Florida. They form a U.S. corporation to acquire the property. In 2020, the property generates \$2.0 million of net rental proceeds. The corporation will distribute this cash to Louis and Estella as a dividend.

Because there is no income tax treaty between Columbia and the United States, the 30% FDAP withholding rate applies to the planned \$2 million dividend distribution. The amount withheld is \$600,000, leaving a net amount of \$1.4 million to be remitted to Louis and Estella.

When is a Rental Activity a U.S. Trade or Business?

- Rev. Rul. 73-522 – rental to a single tenant under a net lease does not rise to the level of a U.S. trade or business.
- Election to treat rental activities as a U.S. trade or business is set forth in Code Section 871(d) and 882(d).
- If the election is made, the non-U.S. owner will have an obligation to file a U.S. federal income tax return each year to report net taxable income from the real estate (and other U.S. source income).

FDAP Withholding Example – Rental Income

Louis and Estrella are citizens of Columbia. In 2018, they purchased a condominium in Boston. (No entity is used) The condominium is initially used by their son while he attends college. In 2020, after the son graduates, Louis and Estrella engage a rental company to lease the condominium. The monthly rental payment is \$3,000. Because there is no income tax treaty between Columbia and the United States, the 30% FDAP withholding rate applies. The amount to be withheld on each rental payment is \$900, leaving a net payment of \$2,100 to be remitted to Louis and Estrella.

FDAP Withholding Example – Rental Income

(continued)

The condominium generates approximately \$30,000 in depreciation deductions each year. If the election to treat the condominium as a U.S. trade or business is made the net income from the property (\$36,000 less \$30,000) of \$6,000 would be subject to income tax at regular U.S. rate. Assuming an effective tax rate of 18%, the tax cost would be \$1,080 per year.

Making the Election

- The election is attached to the return for the first taxable year in which the election is to apply.
- Once made, the election can be revoked only with the consent of the commissioner. However, revocation prior to the expiration of the statute of limitations is permitted (without the consent of the commissioner) by filing an amended return.

Disposition of U.S. Real Property

- In general, U.S. source capital gains recognized by a non-U.S. person or non-U.S. entity are not subject to U.S. income tax unless the gain arises from a U.S. trade or business.
- Code Section 897 changes this treatment and characterizes “U.S. real property interest” gains (and losses) as gain (or loss) from a U.S. trade or business.
- The U.S. Income Tax Treatment under Code Section 897 is generally referred to as the Foreign Investment in Real Property Tax Act or FIRPTA.

FIRPTA applies to a "United States Real Property Interest"

- The FIRPTA rules require the seller to withhold this tax at a rate of 15% for dispositions occurring after February 17, 2016
- The FIRPTA rule are in Code Section 897 and the withholding obligations are set forth in Code Section 1445

What is a United States Real Property Interest (USRPI)?

- An interest in real property (other than an interest solely as a creditor) located in the United States or the Virgin Islands. See 897(c).
- Interest in a domestic corporation unless taxpayer establishes not a USRPHC in past 5 years
 - United States Real Property Holding Corporation (USRPHC). See 897(c)(2)
 - USRPHC is defined as any corporation if the FMV of its USRPIs equals or exceeds 50% of the FMV of (1) its USRPIs, (2) its interest in real property located outside the United States, plus (3) any other of its assets which are used or held for use in a trade or business

What is a United States Real Property Interest (USRPI)? *(continued)*

- What about partnership interests?
 - Code Section 897(g) provides that an interest in a partnership is treated as a USRPI only to the extent that the gain on its disposition would be attributable to USRPIs
 - For purposes of Code Section 1445, an interest in a partnership is treated as a USRPI in its entirety if 50% or more of the value of gross partnership assets consist of USRPIs and 90% or more of the value of the gross partnership assets consists of USRPIs plus cash and cash equivalents

What can be a USRPI?

- Land, buildings, and other related permanent structures located in the United States
- Unsevered minerals and natural deposits
- Co-ownership interests in real property located in the United States
- Leasehold interests in real property located in the United States
- Life estates in real property located in the United States
- Remainder interests in real property located in the United States
- Options to acquire interests in real property located in the United States
- Stock in U.S. real property holding corporations

U.S. Real Property Holding Company

USRPHC is a U.S. corporation that holds USRPIs having a fair market value that is 50% or more of the sum of the fair market values of the following:

- USRPIs owned by the U.S. corporation,
- interests in real property located outside of the United States, and
- Other assets used in the U.S. corporation's trade or business

The testing period to determine if a U.S. corporation is a USRPHC is generally five years. See Code Section 897(c).

Withholding under Code Section 1445

- Except as otherwise provided in Code Section 1445, under Code Section 1445(a), if a foreign person disposes of a USRPI (as defined in Code Section 897(c)), then the transferee is required to deduct and withhold a tax equal to 15% of the amount realized on the disposition
- Exceptions to Code Section 1445(a)
 - Transferor provides non-foreign affidavit
 - Property acquired by transferee used as a residence, and does not exceed \$300,000
- Code Section 1445(e) – Certain distributions and other dispositions
 - In some cases withholding applies on the basis of gain realized

Application of FIRPTA to Non-Recognition Transactions

Treas. Reg. 1.1445-3 – Amount of FIRPTA withholding may be reduced or eliminated pursuant to a withholding certificate issued by the IRS.

- Transferor must obtain and use a tax identification number (“ITIN”).
- Application must disclose the parties to the transaction (including names, addresses and tax identification numbers).

The IRS has adopted Form 8288-B to make a request for reduced withholding.

Treas. Reg §1.1445-3(b)(6) sets forth additional rules for tax deferred like kind exchanges under Code Section 1031.

FIRPTA Withholding Example

Tomas Broadview, Gabriella Rossi and Gerte Hausmann formed a U.S. corporation (“Holdco”). Holdco’s sole asset is a commercial office building in Chicago.

- If Holdco sells the property, no FIRPTA withholding is required because Holdco is a U.S. Person. On the sale, Holdco will be liable for U.S. income tax on the excess of the amount realized on the sale and Holdco’s tax basis in the property. (U.S. corporate income tax is imposed at a flat rate of 21%).

Coordination with the Partnership Withholding Rules

- Code Section 1446 imposes a withholding obligation on partnership with non-U.S. partners.
- The Code Section 1446 withholding rate is the highest rate imposed under Code Sections 1 and 11, as applicable depending on whether the foreign partner is an individual or corporation.
- The withholding amount is equal to the product of the partnership's effectively connected taxable income allocated to the foreign partner in the relevant taxable year multiplied by the applicable withholding rate.

Coordination with the Partnership Withholding Rules

In the case of a U.S. partnership with foreign partners:

- The payment and reporting requirements of Code Section 1446 will apply and not section 1445 with respect to the gain from the disposition of a U.S. real property interest.
- In the event amounts are withheld under Code Section 1445 at the time of the disposition of the U.S. real property interest, such amounts are credited against the partnerships 1446 withholding obligation.

See Treasury Regulation Section 1.1446-3(c).

Partnership Withholding Rule - Example

Same facts as the prior example except Holdco is a U.S. limited liability company that is treated as a partnership for federal income tax purposes.

- If Holdco sells the property, no FIRPTA withholding is required because Holdco is a U.S. Person (notwithstanding that all of its members are non-U.S. Persons).
- However, Holdco has a withholding obligation under Code Section 1446 on the allocation of gain from the sale to its non-U.S. Members (even if no distribution is made).
- The withholding tax is 37%, which is the highest tax rate applicable to individuals. However, unlike FIRPTA withholding, the amount subject to withholding under Code Section 1446 is determined on a net gain basis.

Summary of the Partnership Withholding Rules

Code Section 1446 – Withholding tax applies at partnership level

- Applies to a partnership that has effectively connected taxable income (ECTI) for year, and
- Any portion of such income is allocable to a foreign partner

Effectively connected income (ECI)

- Non-resident aliens are taxed in the United States on a net basis on their ECI. See Code Section 871(b)(1)
- Foreign corporations are taxed in the United States on a net basis on their ECI. See Code Section 882(a)(1)

Code Section 1446(f) Withholding

- Code Section 1446(f) imposes a withholding obligation on the buyers of an interest in an entity that is treated as a partnership for U.S. income tax purposes that is owned by a non-U.S. Person.
- The rate of this withholding tax is 10% on the amount realized on the disposition.
- If the transferee fails to withhold, a secondary withholding obligation is imposed on the partnership.
- Treasury Regulations issued in November 2020 provide additional guidance on how these withholding rules apply and sets forth details on various exceptions.

FIRPTA/Partnership Withholding Tax Example

Gensola Limited is an Irish entity and holds an equity interest in Real Property Holdings. Real Property Holdings owns several commercial properties in the United States.

Scenario #1: Real Property Holdings is a non-U.S. corporation and sells one of the properties for \$10 million and distributes the net sale proceeds to Gensola.

- FIRPTA withholding of 15% of the amount received on the sale must be withheld by the buyer.
- No FDAP withholding on the distribution on the net proceeds because Real Property Holdings is not a U.S. Person.

FIRPTA/Partnership Withholding Tax Example *(continued)*

Scenario #2: Same facts as #1 above except that Real Property Holdings is a U.S. corporation

- No FIRPTA withholding is required because Real Property Holdings is a U.S. Person.
- Because the distribution is not being made in connection with the liquidation of Real Property Holdings, FDAP withholding on the distribution of the net proceeds by Red Property Holdings will be required.
- Rate of FDAP withholding will be 30% unless lower rate is allowed under an applicable tax treaty.

FIRPTA/Partnership Withholding Tax Example *(continued)*

Scenario #3: Same facts as #1 above except that Real Property Holdings is a U.S. entity that is treated as a partnership for U.S. tax purposes.

- No FIRPTA withholding because Real Property Holdings is a U.S. Person.
- The Partnership Withholding rules will apply on the amount of gain allocated to Gensola for U.S. income tax purposes (net of deductions). The rate of withholding will be the highest applicable income tax rate (37% or 21%).
- No U.S. Withholding tax is imposed on the actual distribution of the net proceeds.

Summary of Application of Code Section 897

Dispositions of USRPIs generate ECI

- Gain or loss from the disposition of a USRPI is taken into account as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with such trade or business

Income from USRPIs other than dispositions (e.g., rental income)

- Determine whether US trade or business exists
- If US trade or business exists, is the income effectively connected? If yes, and a U.S. income tax return is required and U.S. tax is imposed on “net income”
- If US trade or business does not exist, then general rules for US source income apply and payment may be subject to 30% U.S. tax withholding

Consider withholding certificates

- File Form 8288-B (application, with supporting documents)
- If satisfied, certificate is issued by the IRS
- Allows reduction or elimination of withholding
- Certificate of non-foreign status
- Escrow arrangement?

Additional FIRPTA Issues

The Non Recognition Rules

Considering a disposition? *Non-recognition provisions*

- "Dispositions" – not defined in Code Section 897
- Broadly defined to include:
 - Sales and exchanges
 - Capital contributions
 - Entity distributions
 - Transfers in connection with mergers
 - Gifts ... But only if there is boot or liabilities in excess of basis

Dispositions/non-recognition

- Dispositions generally include non-recognition transactions **unless**:
 - Non-US person receives USRPI in exchange for USRPI (hot for hot)
 - USRPI received in exchange would be subject to US tax upon disposition **and**
 - Reporting requirements satisfied
- Certain foreign corporations eligible for treaty benefits may elect to be treated as a US corporation for these purposes (Code Section 897(i))

Overview of the FIRPTA non-recognition rules

- Code Section 897(d) and (e) restrict a foreign person's ability to rely on a non-recognition provision in connection with a transfer of a USRPI
- Code Section 897(d) applies to distributions of USRPIs by foreign corporations
- Code Section 897(e) applies to transactions in which a foreign person exchanges a USRPI for another asset
- Confusingly, when a foreign corporation that is a party to a reorganization transfers a USRPHC interest to another corporation that is a party to the reorganization, the rules of Code Section 897(e) and Treas. Reg. § 1.897-6T apply before the rules of Code Section 897(d) and Treas. Reg. § 1.897-5T

Overview of the FIRPTA non-recognition rules

Applicable regulations (Treas. Reg. §§ 1.897-5T and 1.897-6T) have been modified or supplemented by seven different notices (some of which modify other notices in the series):

1. Notice 2006-46 (providing rules relating to inbound merger transactions, foreign-to-foreign non-recognition transactions, and the FIRPTA toll charge);
2. Notice 99-43 (providing rules relating to single-entity reorganization transactions involving a "former" USRPHC);
3. Notice 89-85 (providing rules relating to certain distributions of USRPHC interests by foreign corporations and Code Section 897(i) elections);

Overview of the FIRPTA non-recognition rules (continued)

4. Notice 89-64 (providing rules relating to the application of Article XIII(9) of the Canada-U.S. Income Tax Convention to certain non-recognition exchanges involving USRPIs);
5. Notice 89-57 (providing rules relating to the filing requirements that must be satisfied by a foreign person that transfers a USRPI in a non-recognition transaction);
6. Notice 88-72 (providing rules applicable to the disposition of interests in partnerships that own USRPIs);
7. Notice 88-50 (announcing the IRS's intention to treat a domestication of a foreign corporation as an inbound F reorganization that involves a deemed transfer of assets (including USRPIs) owned by the foreign corporation).

Structures to Minimize U.S.
Withholding Taxes on the Ownership
and Sale of U.S. Real Property

Threshold Issue – What Entity Should Be Used?

Choice of entity

- No entity (personal use property)
- Single member limited liability company
 - Disregarded entity for U.S. income tax purposes
- Foreign corporation
- Multi-member limited liability company
 - Treated as a U.S. partnership for U.S. income tax purposes
- U.S. corporation

Review of the U.S. Tax Consequences of Choosing the Wrong Entity

1. Ownership of U.S. real property directly by a foreign individual

- Rental income will be subject to U.S. income tax at regular rates or at FDAP withholding rates
- FIRPTA withholding on sale proceeds
- U.S. individual tax returns (IRS Form 1040) to be filed by the foreign individual

[Same consequences in U.S. real property owned by a single member LLC that is treated as a disregarded entity for U.S. federal income tax purposes]

2. Ownership of U.S. real property by a foreign corporation

- Rental income subject to U.S. income tax at corporate rates if U.S. income tax return filed. Branch profits tax may also apply
- FIRPTA withholding on sale proceeds and the gain on sale of the property subject to U.S. income tax at corporate rates
- No U.S. tax imposed on sale of stock of foreign corporation
- No FIRPTA withholding on sale of stock of foreign corporation
- Filing of U.S. income tax return for foreign corporation (IRS Form 1120F) will require disclosure of owners

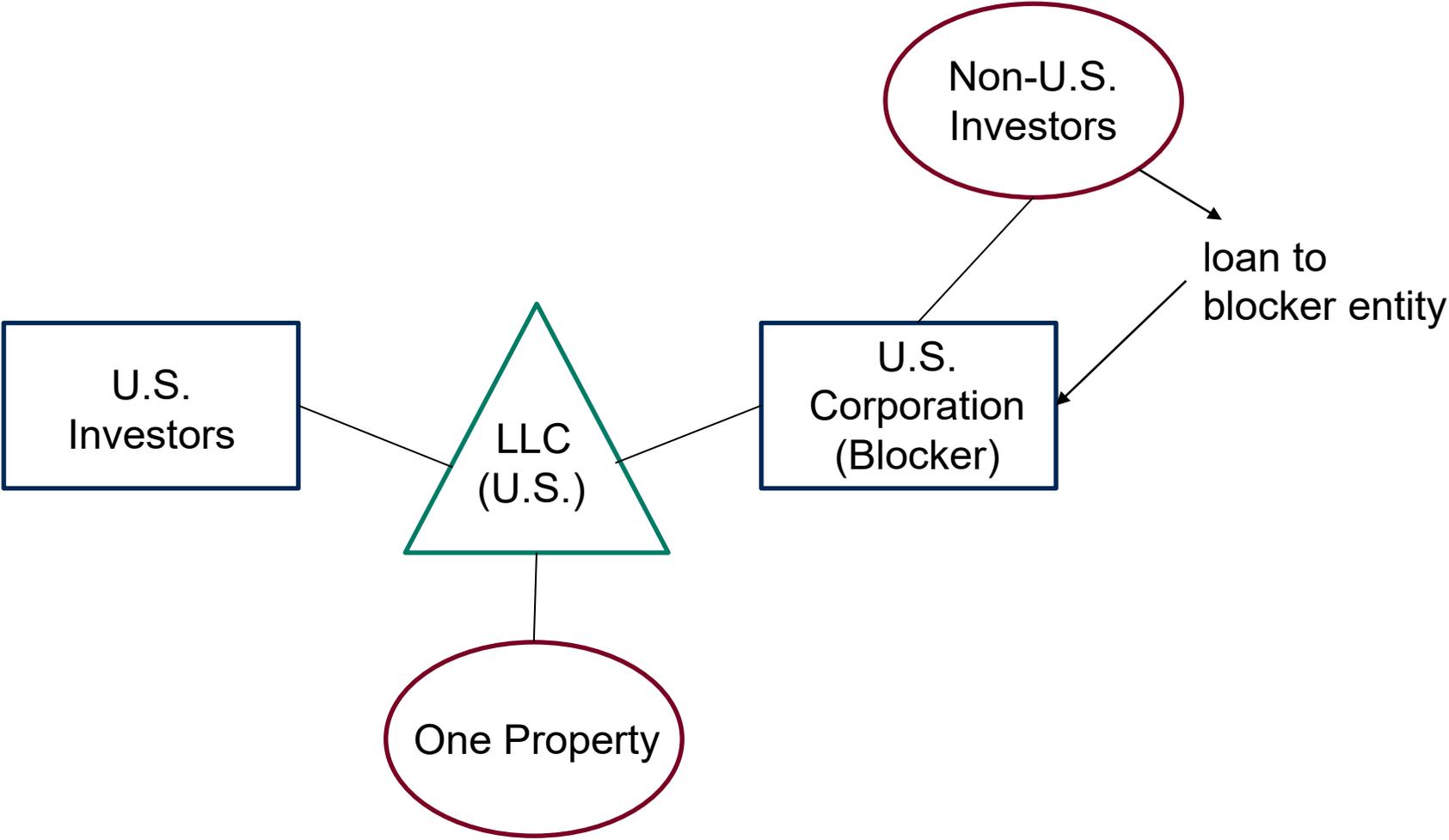
3. Ownership of U.S. real property through an entity that is a U.S. Partnership

- Code Section 1446 withholding on the flow through income net gain allocated to a non-U.S. partner (highest applicable income tax rate)
- No FIRPTA withholding because entity is a U.S. Person

Ownership of U.S. real property through a U.S. corporation

- Rental income subject to U.S. income tax at regular corporate rates
- Gain on sale of U.S. real estate subject to U.S. income tax at regular corporate rates
- Dividend distributions subject to U.S. withholding tax
- FIRPTA withholding on sale of the stock if corporation is a U.S. real property holding company.

The Leveraged Blocker Structure



Operational Period

1. Domestic LLC allocated net income (or net loss) to each member on an annual basis (Schedule K-1). No Code Section 1446 withholding, because U.S. Blocker is a U.S. Person.
2. U.S. Blocker is subject to U.S. corporate income tax on net income, which will include flow through income from Domestic LLC and other entity level expenses paid by the U.S. Blocker (e.g., interest expenses, management fees, etc.)
3. FDAP withholding will apply to payment of fees or interest to non-U.S. Persons.
4. FDAP withholding will also apply to dividend distributions.
5. No FDAP withholding on payments by the U.S. Blocker to repay the principal amounts on the shareholder loan (i.e., tax-free distribution)

Liquidation Period

1. Domestic LLC allocates the gain on the sale of the property to each member (Schedule K-1).
2. No FIRPTA withholding.
3. U.S. Blocker is subject to U.S. tax on the net income/gain that flows through the Domestic LLC
4. No FIRPTA or FDAP withholding on distributions made to the foreign shareholders that are made as part of the liquidation of the U.S. Blocker

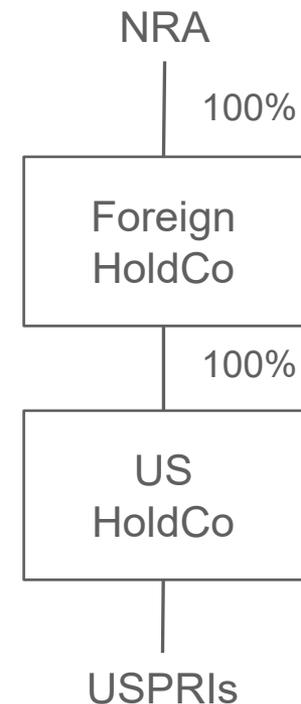
[key is that the structure involves a single U.S. real property]



Other Advanced Planning Structures

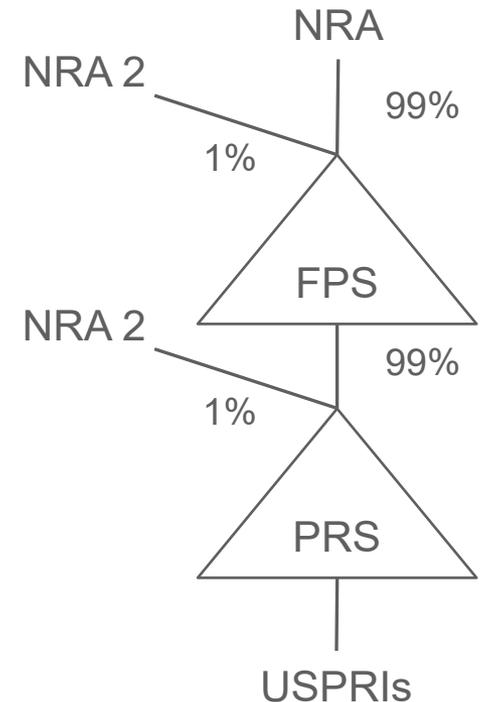
Dual corporate structure

- US HoldCo will be subject to corporate tax on its net income
 - 21% flat US federal rate, 3% to 8% state corporate tax rates
- Foreign HoldCo will be subject to US tax on its gross income
 - Dividends and Interest from US HoldCo (30% withholding)
 - Rates could be lower if US income tax treaty applies
 - Portfolio interest not subject to withholding
- Disposition of US HoldCo
 - Subject to tax if US HoldCo is a USRPHC
 - Not subject to tax if all USRPIs sold and pursuant to liquidation
- Does not apply to stock in Foreign HoldCo



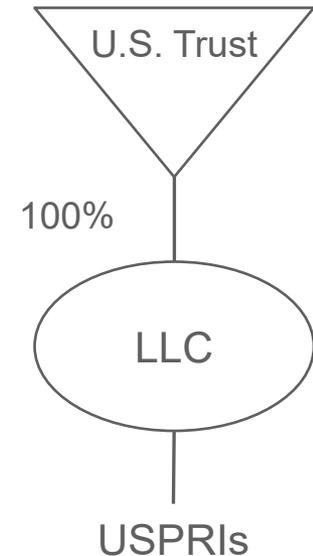
Two-tier partnership structure

- All items of income, gain, loss, deduction, credit "flow-through"
- Single layer applies at the partner level
- Withholding tax on ECI to foreign partners
 - Withholding tax is credited at the partner level
- Long-term capital gains rate 20%
- Ordinary income rates up to 37%
 - With pass-through deduction rate could be 29.6%
- Likely does not apply.
 - *But see Grecian Magnesite case to extent not repealed*



U.S. trust structure

- Structure as nongrantor trust
- Structure as exempt trust (U.S. estate tax)
- Single layer of tax (at either trust or beneficiary level)
- Consider multiple trusts to facilitate distributions
- Long-term capital gains rate of 20%
- Ordinary income tax rates up to 37%



Using the Portfolio Interest Exception

Portfolio Interest Issues Created by the 2017 Tax Act

- One exception to the FDAP withholding rules applies to portfolio interest.
- The requirements for the portfolio interest exception are set forth in Code Section 871(h) for foreign lenders that are individuals and in Code Section 881(c) for foreign lenders that are non- U.S. corporations.
- If the portfolio interest exception applies, there is no U.S. withholding on the U.S. source interest payments.

Requirements of the Portfolio Interest Exception

1. The non-U.S. lender cannot own, either directly or indirectly, 10% or more of the combined voting power of the borrower.
2. The debt obligation must be in registered form.
3. The lender must not be a bank or engaged in the conducts of a U.S. trade or business relating to the loan.
4. The lender cannot be a “controlled foreign corporation”.

The Attribution Issue Coded by the 2017 Tax Act

- Prior to 2018, Code Section 958(b)(4) contained a limitation on in-bound attribution of stock in the context of determining whether a foreign corporation is a controlled foreign corporation.
- The 2017 Tax Act repealed this Code Section. As a result, the attribution rules that apply to determine whether more than 50% of the vote or value of a foreign corporation is owned by U.S. shareholders (i.e. U.S. person that owns more than 10%) are now more expansive.

The Post 2017 Attribution Rules

- The ownership of a U.S. corporation by a shareholder of a foreign corporation through attribution could cause a lender that is a foreign corporation to be treated as a controlled foreign corporation.
- Thus, through these expanded attribution rules, even though a foreign corporation is owned solely by foreign individuals, the foreign corporation could be a controlled foreign corporation and thus ineligible for the portfolio interest exception, in some circumstances.

Example

A owns 100% of FC, a foreign corporation, which makes a loan to a U.S. limited liability company owned by unrelated U.S. entities. B, A's son, owns ABC corporation, a U.S. corporation that owns real property in Georgia.

Through the family attribution rules, B is deemed to own all of the stock of FC. Through entity attribution, ABC corporation is deemed to own FC, causing FC to be a CFC.

Because A's son owns U.S. corporation, FC cannot qualify for the portfolio interest exception.

Additional considerations

Jurisdiction of individuals and entities

- Local country considerations (income tax, withholding tax, foreign tax credits, etc.)
- Consider overall effective rate on operating income and income from dispositions
- Will a US income tax treaty apply?
- FATCA and CRS considerations

Additional considerations *(continued)*

Capital structure

- Debt vs. equity
- Access to cash
- Estate tax considerations

Reporting

- How sensitive is the ultimate beneficial owner to filing a US income tax return?
- Information reporting may apply regardless of structure

U.S. Gift Tax Issues

Gifts of U.S. tangible property located in the United States is subject to U.S. Gift Tax. Example, gift of a parcel of U.S. real estate.

Gifts of intangible property is not subject to U.S. Gift Tax. Example, gifts of shares in a US or foreign corporation are not subject to U.S. gift tax regardless of whether these corporations own U.S. real estate.

Emerging Issues – The Corporate Transparency Act

- On January 1, 2021, Congress passed the Corporate Transparency Act (the “CTA”)
- The CTA was part of the expansion of the Anti-Money Laundering Act of 2020.
- The Anti-Money Laundering Act established the Financial Crimes Enforcement Network (FinCEN) within the U.S. Department of Treasury.
- The CTA requires FinCEN to maintain a federal database of the beneficial owners of certain U.S. entities (and U.S. domiciled entities that are not U.S. entities).
- The CTA requires the U.S. Department of Treasury to establish reporting requirements for certain U.S. entities to report and disclose the identify of their beneficial owners to FinCEN.

Update to the CTA

1. Not in effect until Treasury Regulations are issued
2. Among the entities that are excluded is an entity that (i) employs more than 20 employees on a fulltime basis in the U.S., (ii) filed U.S. federal income tax returns in prior years demonstrating more than \$5 million in gross receipts in the aggregate, and (iii) has an operating presence at a physical office in the U.S.
3. A corporation, limited liability company, or singular entity that is “owned or controlled,” directly or indirectly, by the above reference entity is likewise excluded

Questions?

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