Structuring United States Investments by Foreign Taxpayers

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Introduction

Nonresident noncitizens face United States tax exposure only on income/assets directly associated with the United States

- Special tax rules/regimes apply to nonresidents; familiarity with these rules is increasingly a necessity

The United States is an increasingly appealing jurisdiction for foreign investment

- Political stability/managerial infrastructure provide advantages, as do beneficial United States tax rules on income beneficially owned by foreigners
  - Careful evaluation of both investment type and client needs/background are needed to optimize tax benefits

Background Considerations

Under default U.S. rules, nonresident aliens/foreign business entities are subject to United States tax on:

- (1) income effectively connected with a United States trade or business, and
- (2) fixed or determinable annual or periodic income

Non-U.S. taxpayers are subject to U.S. tax primarily on income items sourced to the United States

- Detailed sourcing rules for income items exist; for example, interest/dividend income is sourced to the payor's location
  - Rent/royalties sourced to the place of use of the asset
  - Personal services sourced to where services performed

Nonresidents – Effectively Connected Income and Branch Profits Tax

Income effectively connected to a United States trade or business is subject to tax

- "Trade or business" undefined in the Code/regulations – but profit-oriented activities carried on in the United States which are regular, substantial, and continuous are properly classified as a trade or business for these purposes
  - Macro-level – relatively light requirements to be considered engaged in a U.S. trade or business
- Effectively connected income taxed by the United States at graduated rates, with deductions/credits available

Branch profits tax – second layer of tax on direct U.S. investments by foreign corporations

- 30% tax on effectively connected E&P not reinvested into the United States – disincentives U.S. branch operations

Background – Effectively Connected Income

Special rules regarding ECI:

- Generally, the performance of personal services within the United States constitutes a United States trade or business
  - Treaties can modify implementation
- Partnerships – foreign partners of a partnership are classified as engaged in any U.S. trade or business carried on by the partnership
  - Treated as deriving gain or loss which is effectively connected upon sale/exchange of the partnership interest

Macro-level: relatively light requirements for a United States trade or business; where such trade or business exists, taxpayer subject to United States taxes on income effectively connected with the trade or business

Nonresidents – FIRPTA

Under the Foreign Investment in Real Property Tax Act of 1980, gain from disposition of United States real property interest by a foreign taxpayer is subject to tax

- *Gains are automatically classified as ECI!*
- United States real property interest: any interest in United States real property or an interest in a domestic corporation unless such corporation was not a United States real property holding corporation for the prior five years
  - United States real property holding corporation: corporation where more than 50% of the corporation's assets are United States real property interests
- Transferee must withhold on disposition at a rate of 15% of the amount realized

Vitally, nonresident aliens generally not subject to capital gains tax on non-ECI U.S.-sourced gains

Effectively Connected Income

- Foreign corporations engaged in a United States trade or business are generally subject to regular United States tax at normal graduated rates
  - Withholding unrequired for effectively connected income
    - Recipient should provide Form W-8ECI to substantiate the income is ECI
  - Foreign corporations engaged in a United States trade or business are allowed deductions; however, must timely file a “true and accurate return” to obtain them
    - 18-month grace period is applicable for these purposes, generally requiring the return to be filed within 18 months of the due date
      - Filing a protective return can be beneficial where questions exist as to whether there is a United States trade or business

POLL QUESTION #2

True or False: Nonresidents are taxed by the United States on income effectively connected to a United States trade or business in similar fashion to how United States taxpayers are taxed.

FDAP Income

United States-sourced fixed or determinable annual or periodic income (“FDAP income”) is also subject to United States tax if from sources within the United States

- Can include interest, dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, etc.
- FDAP income functionally is an overarching income inclusion of all U.S. sourced items other than capital gains and certain other limited exceptions

FDAP Income

Tax generally not imposed on interest – narrow scope where it is subject to tax

- Portfolio interest/interest on bank accounts exempted
- Rents – look to whether the management of the relevant property constitutes a trade or business
- If so, treated as ECI rather than FDAP
  - Election is available to treat income from real property as effectively connected when it would not be if no election was made
- Salaries/wages - usually subject to ECI rules rather than FDAP
- Capital gains and losses generally exempted from withholding tax

FDAP Income

Interplay exists between ECI and FDAP income

- US-sourced income is classified as effectively connected to a U.S. trade or business rather than FDAP if it satisfies an asset use test or a business activities test
  - Asset use test: income derived from assets used in the conduct of a United States trade or business is ECI
  - Business activities test: income is treated as ECI if activities of a United States trade or business were a material factor in creation of the income
- Goal of asset use test and business activities test is to determine whether income is actually connected with a U.S. trade or business

FDAP Income

Withholding requirement generally applies to FDAP income items

- Persons having control, receipt, custody, disposal or payment of certain income items for foreign persons are normally required to withhold and deduct a tax equal to 30%
  - Withholding amounts/rate can be reduced by treaty provisions – however, generally need to be provided a beneficial owner withholding certificate prior to payment to rely on treaty provisions
- If source of an item cannot be determined at time of payment it is treated as from U.S. sources for these purposes
- Amount on which withholding is determined is typically the amount of gross income without deductions
  - Generally the entire amount of a distribution from a corporation is subject to withholding (even amounts which ultimately would not be treated as a dividend), though exceptions can apply

ECI v. FDAP Income

Effectively connected income vs. FDAP income

- United States views income effectively connected with a United States trade or business as normally creating enough United States contacts to justify tax imposition similar to that of United States persons
  - i.e. normally will find a physical presence in the country, though this rationale is historical/antiquated
    - Less concern about ultimate tax collection given the extent of contact usually required
- FDAP income does not necessarily require such contacts with/presence in the United States
  - Withholding system thus utilized to ensure payment of tax
    - Under a withholding approach, factoring in deductions is infeasible

POLL QUESTION #3

Nonresident aliens are often not subject to United States tax on which of the following items?

- Income connected to a United States trade or business
- Dividend income from the United States
- Rental income from the United States
- Capital gains from the United States

Nonresidents – Income Tax Treaties

Tax treaties function to reduce a country's taxing authority in situations covered by treaty terms

- Income tax treaties – if income is earned in country A by a (qualified) resident of country B, country A agrees to modify its default tax rules for the income item
  - Goal with treaties is to not disincentivize transactions between residents of treaty party countries based on double taxation
- Under treaties, residents of a treaty country can be taxed at a reduced rate, or even exempted from tax, on specified items of income from the other country
  - i.e. withholding taxes on United States-sourced income
- Treaties either provide an increased standard for tax by the U.S. (i.e. look for a "permanent establishment" rather than U.S. trade or business) or reduce the rate of tax (i.e. FDAP income items)

Income Tax Treaties – Who Can Obtain Benefits?

Tax treaties provide benefits to qualified residents of a treaty party country (normally for income sourced to the other treaty jurisdiction)

- Threshold question regarding treaty benefits: can residence in a treaty country be established?
  - United States Model Treaty Art. 4(1): taxpayer is a resident of a country for treaty purposes if it "is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature"

Tax Treaties – Common Provisions

Benefits depend on specific treaty terms; however, some terms are commonly utilized in treaties

- Treaties usually provide that business profits of a resident of one country may be taxed by the other country only where a permanent establishment exists in that country and the profits are attributable to such a permanent establishment
  - Can be compared/contrasted to U.S. trade or business requirements – higher threshold of activity/connection required
  - Where no permanent establishment exists, nonresident only subject to U.S. tax on U.S. sourced income (rather than all income attributed to the permanent establishment, irrespective of source)

Permanent Establishments

Permanent establishment vs. United States trade or business

- Permanent establishment standard higher, but both look to similar factors
  - A primary differentiation is the “permanence” aspect – historically necessitating more of a physical footprint
    - Standard evolving with digitization of business – less need for physical presence to economically utilize a jurisdiction
- Permanent establishment generally a low threshold: as an example, maintenance of a small office in the United States solely to solicit orders for work done outside the United States has constituted a permanent establishment.
  - See Revenue Ruling 65-263

Tax Treaties – FDAP Income

Tax treatment of FDAP income also modified by treaty terms

- Treaties often reduce/eliminate tax on FDAP income
  - FDAP income attributable to a permanent establishment is governed by the business profits/permanent establishment treaty provision
  - Dividends – can still be taxed, but rates usually reduced
  - Tax of interest/royalties can be removed from source country under treaties

POLL QUESTION #4

The taxation of which of the following income items can be impacted by treaty terms?

- Dividend income
- Personal services income
- Income connected to a U.S. trade or business
- All of the above

Nonresident Individuals – Transfer Taxes

Estate tax: nonresident individuals subject to tax on all property (whether tangible or intangible) sitused within the U.S.

- Subject to some exceptions: (1) bank accounts not used in a U.S. trade or business, (2) debt instruments generating portfolio interest, and (3) life insurance proceeds
- Real property and tangible personal property are sitused in accordance to where the assets are physically located
  - Shares of a corporation are sitused in the country in which the corporation is formed
- Nonresident individuals receive a $60,000 estate tax exclusion with a maximum 40% rate of tax applicable
  - Nonresidents taxed $345,800 on their first $1,060,000 of U.S.-sitused assets, then at a flat 40% rate above that number

Nonresident Individuals – Transfer Taxes

Gift tax: nonresidents normally are subject to gift tax on lifetime gratuitous transfers of tangible property within the United States

- Generally comprising real property situated within the country and tangible personal property within the U.S. at the time of the gift, including hard currency or cash situated within the U.S.
  - Intangible property (i.e. shares of a corporation) is not subject to gift tax for nonresident alien donors

No specific gift tax exclusion for nonresident individuals, though the $15,000 per donee annual exclusion is available

Nonresident Individuals – Transfer Taxes

What isn't subject to transfer tax?

- Non-U.S. sitused assets are not subject to U.S. transfer tax when donor is a NRA
  - Foreign property, foreign holdings are not subject to U.S. transfer taxes
- Intangible assets are not subject to gift tax for NRA donor *regardless of situs*
  - i.e. stock in a U.S. corporation generally will not be subject to gift tax
    - Reliance on ability to gift asset pre-death to remove from taxable estate an option, but carries risk (i.e. sudden death)

POLL QUESTION #5

A nonresident alien is subject to United States estate tax on which of the following assets?

- U.S.-based real estate
- Foreign-based real estate
- Foreign intangible assets
- All of the above

Foreign Trusts

Foreign trusts subject to special tax rules (and potentially punitive rules for U.S. beneficiaries)

- A foreign trust is any trust which is not a domestic trust
  - A trust is considered to be domestic if both of the following conditions are met:
    - A United States court can exercise primary jurisdiction over the trust administration
      - Relatively straightforward
    - United States persons control all substantial trust decisions
      - "Substantial decisions" provided by regulations – includes whether to distribute income/corpus, beneficiary selection, removal/addition of successor trustee, etc.

Where a trustee change causes the control test to be failed – 12 month grace period to re-establish U.S. control

Foreign Trusts

How are foreign trusts taxed?

- Foreign grantor trust – income is taxable to the trust creator (mirroring how domestic grantor trust is classified)
  - NOTE: nonresident aliens cannot establish trusts treated under U.S. rules as foreign grantor trusts except under narrow circumstances
- Foreign nongrantor trust – treated as an entity separate from its creator (mirroring how domestic nongrantor trust is classified)
  - Subject to direct tax only on its U.S. sourced income
  - Special rules apply to foreign nongrantor trusts with U.S. beneficiaries – including the "throwback" rule

Foreign Trusts

United States beneficiaries of foreign nongrantor trust are subject to tax via the "throwback" rule on accumulated distributions

- Where foreign trust has United States beneficiaries and accumulates income, distributions in excess of current year income amounts carry severe consequences
  - Income classified as ordinary, interest applies from date income originally earned, can be taxed at prior year rates
- Often better to avoid foreign nongrantor trusts where there will be U.S. beneficiaries, but can mitigate throwback rule ramifications by making current distributions

Structuring Nonresident United States Investments

United States tax rules for nonresidents starkly contrast with those applicable for U.S.-based taxpayers

- United States taxpayers - taxable on income earned worldwide, no matter what type
  - Individuals are taxable on gifts/bequests exceeding a lifetime exclusion amount
- Nonresidents are subject to tax only on certain U.S. sourced-gains, with certain types of gains (non-ECI capital gains) not subject to tax
  - Nonresident alien individuals are subject to estate/gift tax only on U.S. sitused assets, but exemptions are comparatively miniscule

Structuring Nonresident United States Investments

How should nonresident alien investments into the United States be structured?

- Nonresident alien investors typically focus on four United States tax factors: (1) income tax consequences, (2) estate/gift tax consequences, (3) anonymity; and (4) simplicity of structure/minimization of filing requirements
  - Anonymity – nondisclosure of identity to the United States government
    - Assorted provisions (including the Corporate Transparency Act) require some level of ownership disclosure
- Foreign corporations do not face estate/gift tax exposure, but are subject to branch profits tax
  - Branch profits tax avoidance available by having foreign corporation own a separate U.S. corporation

Structuring Nonresident United States Investments

Critically, proper structure will hinge on the specific investment involved, given the variable considerations at issue

- Multitude of questions needs to be asked in order to properly structure the investment's ownership
  - Questions will typically focus on the types of income/gains anticipated from an investment, the type of taxpayer making the investment, treaty application, etc.
- Additional layer of questions – what are the home country tax implications?

POLL QUESTION #6

Which ownership structure for foreign investments permits owner to not reveal identity on tax returns filed?

- Individual ownership
- Ownership by a foreign corporation owned by a foreign person
- Ownership by domestic corp owned by foreign corp and person
- All of the above

Structuring Nonresident United States Investments

Common ownership structures

- Individual ownership of a U.S.-sitused income generating asset (or ownership through a DRE)
  - Benefits: exemption from capital gains tax (*if* gain from asset sale not classified as ECI – real estate gains **not** exempt), long-term assets which are ECI subject to capital gains rates on disposition (though can be subject to FIRPTA withholding)
  - Detriments – estate/gift tax exposure, need to file individual U.S. tax returns if ECI generated

Structuring Nonresident United States Investments

Common ownership structures

- Ownership of a U.S.-sitused income generating asset through a foreign corporation
  - Benefits: same exemption from capital gains tax as for NRA ownership; protection from estate/gift tax exposure (as NRA owns a foreign corporation – non-U.S. sitused asset); subject to corporate tax rates on income
  - Detriments – exposure to branch profits tax on earned income; Form 1120-F requires disclosure of underlying ownership if earning ECI; no differentiated tax rate for LTCG

Structuring Nonresident United States Investments

Common ownership structures

- Ownership of a U.S.-sitused income generating asset through a foreign corporation owned by a domestic corporation
  - Benefits: protection from estate/gift tax exposure; no branch profits tax; no disclosure of ownership required (as Form 1120 filed showing foreign corporation as owner); subject to corporate tax rates on income
  - Detriments – no differentiation for LTCG; no exemption for non-ECI capital gains (as asset owned by domestic corporation)

Structuring Nonresident United States Investments

Common ownership structures

- Ownership of a U.S.-sitused income generating asset through a foreign nongrantor trust
  - Benefits: protection from estate/gift tax exposure; no branch profits tax; subject to LTCG rates
  - Detriments – potential ramifications for U.S. beneficiaries of trust; need disclosure of identity on tax return; subject to individual tax rates on ordinary income

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