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Structuring a Foreign Investment in the United States

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From a U.S. standpoint, no issue drives the structure of a Mergers and acquisitions (M&A) deal more so than taxation. The parties can negotiate and agree to all the other terms, but tax will determine how the transaction is structured, what is possible and what is not. This article will examine in detail the U.S. tax consequences of inbound investments and how to properly structure them.

Income Taxation

A person we in the U.S. colloquially refer to as a "foreigner" is often referred to as a "non-resident alien" ("NRA") for U.S. federal income tax purposes. An NRA is defined as a either a foreign corporation or a person who is (1) physically present in the U.S. for less than 183 days in any given year, (2) less than 31 days in the current year, (3) physically present for less than 183 total days for a three year period (using a weighing formula), and (4) does not hold a permanent resident status (a green card or an EB-5 visa) (Code Section 7701(b)(1)(A). All Code references are to the Internal Revenue Code of 1986, as amended).

A foreigner may be deemed a U.S. resident (based on one of the above tests) and also a resident of his home country. To avoid double taxation, most income tax treaties incorporate a tie-break provision for residency. For example, Article 4, Section 4 of the U.S.-U.K. Income Tax Treaty provides that if an individual is deemed to be a resident of both the U.S. and the U.K., he will be the tax resident of the country where he has a permanent home, and if there is a home in both countries, the country where he has habitual abode, and if there is habitual abode in both, the country where he holds citizenship, and if in both, the tax authorities of both nations will have to reach a mutual agreement.

Withholding on FDAP Income

As a general rule, an NRA pays a flat 30% tax on U.S.-source “fixed or determinable, annual or periodical" (“FDAP”) income that is not effectively connected to a U.S. trade or business, (Code Sections 871(a) and 881. Rental income is sourced to where the property is located. Code Section 861(a)(4).), and which is subject to tax withholding by the payor (Code Section 1441(a)). The rate of tax may be reduced by an applicable treaty to anywhere between zero and 15%. The income is taxed on a gross basis, with almost no offsetting deductions.

FDAP income includes interest, dividends, royalties, rents annuity payments, and alimony. Note that the NRA is subject to this tax but does not pay it. The 30% FDAP tax is withheld by the payor at the time of payment and remitted to the U.S. Treasury. The NRA receives the remaining 70%. The obligation to withhold is imposed on the person or entity making the payment to the NRA, and if such payor fails to withhold, it is liable to the IRS for the tax, applicable penalties and interest.

Capital Gains

NRAs are generally not taxable on their capital gains from U.S. sources unless (i) the NRA is present in the U.S. for more than 183 days, (ii) the gains are effectively connected to a U.S. trade or business, or (iii) gains are from the sale of certain timber, coal or domestic iron ore assets. When these exceptions apply, the NRA is taxed on U.S. source capital gains at the rate of 30% (Code Section 871(a)(2)).

Business Income

An NRA is taxed on income effectively connected to a U.S. trade or business under the same rules as all other U.S. taxpayers. Income may be reduced by appropriate deductions (connected to the U.S. trade or business) and standard tax rates apply (Code Sections 871(b) and 882).

There is no tax code definition for the term "U.S. trade or business." However, U.S. trade or business has been held to include providing personal services in the U.S., selling products in the U.S. directly or through an agent (see below), soliciting orders from the U.S. and then exporting merchandise outside the U.S., manufacturing, maintaining a retail store, and maintaining corporate offices in the U.S. The amount of the commercial activity is not as important as the fact that the NRA was active in the U.S. and its level of activity was “considerable, continuous, and regular” (Linen Thread Co. Ltd at 734). The U.S. business must be of an active nature, and not a mere passive investment or ownership of property (Continental Trading, Inc. v. Comm'r., 265 F.2d 40, 43 (9th Cir. 1959), cert. denied, 361 U.S. 827 (1959); Neill v. Comm'r, 46 B.T.A. 197 (1942) (building leased on a net basis not a business); Aktiebolaget Separator v. Comm'r., 45 B.T.A. 243, 249–50 (1941), aff'd per curiam by unpub. op., 128 F.2d 739 (2d Cir. 1942), cert. denied, 317 U.S. 661 (1942) (mere collection of dividend income does not constitute a trade or business).

Income is divided into two categories to test whether it is "effectively connected." The first category, under Code Section 864(c)(2), covers FDAP income, portfolio interest and capital gains from assets located in the U.S. This income will be deemed effectively connected to a U.S. trade or business if it meets either the "asset-use" test or the "business-activities" test.

Pursuant to the asset-use test an asset is deemed "used" in a trade or business if the asset is needed in that trade or business. For example, a business maintains a large cash reserve to cover payroll. Because the cash reserve is needed to operate the business, the cash reserved is deemed used in the business, and the interest income on that reserve will be FDAP and effectively connected. That results in the interest income on the cash reserve being taxed at regular U.S. tax rates.

The business-activities test looks to whether the activity that generated income was a material factor in the realization of income of that trade or business. The business activities test is primarily used for passive assets, because such assets are not themselves often critical to the operation of a business. For example, a foreigner carries on an active trade or business in the U.S., and then invests the profits in deeds of trust. The interest income from the deeds of trust is not related to the U.S. trade or business and is not effectively connected.

All other categories of income (i.e., not FDAP, portfolio interest or capital gains) are automatically "effectively connected" under the "force of attraction" rule set forth in Code Section 864(c)(3). Under this rule if a nonresident alien has a U.S. trade or business, all U.S.-source income (other than FDAP, portfolio interest or capital gain) is deemed effectively connected to a U.S. trade or business. This result is true even if the U.S.-source income has absolutely no connection to the U.S. trade or business. The NRA will be deemed engaging in a U.S. trade or business for the year if it was engaged in such a business at any time during that year.

Branch Profits Tax

If a foreign corporation owns a U.S. corporation, there are two levels of tax. The U.S. corporation will be subject to the regular income tax on its profits, and there will be a 30% withholding tax on dividends paid to the foreign parent (subject to possible treaty reduction). If the same business is operated with just a foreign corporation (the U.S. operation is an unincorporated branch), there is no dividend originating in the U.S. and no withholding tax. To eliminate this disparity and to subject foreign corporations operating through a U.S. branch to a double tax (tax on earnings and tax on dividends), Congress enacted Code Section 884, which imposes a branch profits tax.

The branch profits tax applies at the rate of 30% (same as the withholding tax on dividends),(Id.) but may be reduced by an applicable treaty. The U.S. has treaties covering the branch profits tax with most of the European nations, reducing the tax to between 0-10% (usually to the same rate that a dividend would be subject to under the same treaty).

Qualifying for treaty benefits is difficult, as the foreign corporation must establish that it is not "treaty shopping" – meaning it is organized in the treaty country for a purpose other than tax avoidance (shareholders are resident in the treaty country, it does not distribute most of its income out of the treaty country, or it is engaging in an active trade or business in the treaty country).

The 30% tax applies to a "dividend equivalent amount" (Code Section 884(a)) which is the foreign corporation's effectively connected earnings and profits for the year, less investments the corporation makes in its U.S. assets (money and adjusted bases of property connected with the conduct of a U.S. trade or business). Money is only counted to the extent that it is necessary to meet the operating expenses of the U.S. business.

If a foreign corporation completely terminates its U.S. business, it is not subject to the branch profits tax for that year (Treas. Reg. Section 1.884-2T(a)(1)). As a planning note, if a foreign investor is planning on operating several U.S. businesses that will generate little or no earnings and profits (like depreciable real estate), it would make sense to form several foreign corporations, with each foreign corporation operating a separate branch. For example, if a foreign investor acquires two U.S. apartment buildings through a foreign corporation, on the sale of one building there may be a branch profits tax (as the resulting cash will not be necessary for the continued operation of the U.S. trade or business). If two separate corporations owned two buildings, then on the sale of one building the foreign corporation that is the seller would terminate its U.S. business and will not be subject to the branch profits tax.

FIRPTA

Rules applicable to the tax on the disposition of real estate are found in a separate regime known as FIRPTA (the Foreign Investment in Real Property Tax Act of 1980) (FIRPTA is codified in Code Sections 897, 1445 and 6039C). Generally, FIRTPA taxes the disposition of an interest in U.S. real property ("USRPI") (A USRPI is defined as any interest in (i) real property located in the U.S., or (ii) a domestic corporation that is a "United States real property holding corporation." Code Section 897(c)(1)) as if the NRA were engaged in a U.S. trade or business (Code Section 897). This means that the traditional income tax rules that apply to U.S. taxpayers will also apply to the NRA. Purchasers who acquire a USRPI from a NRA are obligated to withhold 15% of the amount realized on the disposition.

An interest in real property includes any ownership of land, buildings, mineral deposits, crops, fixtures, personal property used to (1) exploit natural resources, (2) construct improvements, (3) operate a lodging facility, or (4) to provide a furnished office to a tenant (like movable walls or furnishings), improvements, leaseholds, or options to acquire any of the above (Code Section 897(c) and Treas. Reg. Section 1.897-1(b)). Ownership interests include fee ownership, co-ownership, leasehold, time-share, a life estate, a remainder, a reversion or a right to participate in the appreciation of real property or in the profits from real property (Treas. Reg. Section 1.897-1(d)(2)(i)).

A partnership interest is treated as a USRPI if (1) 50% or more of the value of partnership gross assets consists of USRPIs, and (2) 90% or more of the value of partnership gross assets consist of USRPIs plus cash and cash equivalents (Treas. Reg. Section 1.897-1(d)(2)(i)). The disposition of such partnership interest will be subject to FIRPTA to the extent such partnership owns USRPIs and will be subject to withholding.

A domestic corporation will be treated as a United States Real Property Holding Corporation ("USRPHC") if USRPIs equal or exceed 50% of the sum of such corporation's USRPIs, foreign real estate and trade and business assets (Code Section 897(c)(2)). Disposition of an interest in a USRPHC is subject to the FIRPTA tax and withholding, but is not subject to state income tax (Code Section 897(a)(1). There are no state law equivalents to FIRPTA and under state law a sale of an interest in a domestic corporation (even if it is a USRPHC for federal income tax purposes) by a foreigner is not taxable, following the general rule of Code Section 892).

Contrast that with the disposition of a USRPI owned directly, which is subject to the lower federal capital gains rate, but is also subject to the state income tax. The disposition of an interest in a domestic corporation will not be subject to these rules if on the date of the disposition the corporation had no USRPIs and all of the gain was fully recognized (no installment sales or exchanges) on the sale of any USRPIs sold within the past five years (Code Section 897(c)(1)(B) and Treas. Reg. Section 1.897-2(c)).

Any NRA (individual or corporation) selling a USRPI is subject to withholding of 10% of the amount realized; withholding applies even if the property is sold at a loss (Code Section 1445). The withholding obligation is imposed on the purchaser, who must report the withholding and pay over the tax using Form 8288 within 20 days of the purchase. If the purchaser fails to collect the withholding tax from the foreigner, the purchaser will be liable for the tax, plus any applicable penalties and interest. The withheld taxes are later credited against the total tax liability of the foreigner.

Withholding is not required if: (1) the seller provides a certificate of non-foreign status, (2) property acquired by the purchaser is not a USRPI, (3) the transferred property is stock of a domestic corporation and the corporation provides a certificate that it is not a USRPHC, (4) the USRPI acquired will be used by the purchaser as a residence and the amount realized by the foreigner on the disposition is $300,000 or less, (5) the disposition is not subject tax (a tax-free exchange), or (6) the amount realized by the foreigner on the disposition is zero (Id. and Treas. Reg. Section 1.1445-2(d)(2)(i)).

Estate and Gift Tax

For estate tax purposes, the test is completely different in determining who is an NRA – the inquiry centers around the decedent's domicile (Treas. Reg. Sections 20.0-1(b)(1), 25.2501-1(b)). This is a more subjective test, that looks primarily at intent, (Treas. Reg. Sections 20.0-1(b)(1), 25.2501-1(b)) and will also consider factors such as the length of stay in the U.S. and frequency of travel, size and cost of home in the U.S., location of family, participation in community activities, participation in a U.S. business, and ownership of assets in the U.S. and voting.

A foreigner can be a U.S. resident for income tax purposes, but not be domiciled for estate tax purposes. For simplicity in explaining the estate and gift tax considerations, this article will refer to foreigners who are both non-resident aliens and not domiciled in the U.S. as NRAs.

An NRA is subject to a different transfer tax (estate and gift taxes) regime than a U.S. taxpayer. The estate tax is imposed only on the part of the NRA's gross estate that at the time of death is situated in the U.S. (Code Section 2103). The rate of NRA's estate tax is the same as that imposed on U.S. citizens and resident aliens, but the unified credit is only $13,000 (equivalent to about $60,000 of property value) (Code Section 2102(b)(1)). These harsh rules may be ameliorated by an estate tax treaty. The U.S. does not maintain as many estate tax treaties as income tax treaties, but there are estate tax treaties in place with most Western

European countries, Australia and Japan

The following assets are specifically included by the Code in the definition of property situated in the U.S.: (1) shares of stock of a U.S. corporation, (2) revocable transfers or transfers within three years of death of U.S. property or transfers with a retained interest (described in Code Sections 2035 to 2038), and (3) debt issued by a U.S. person or a governmental entity within the U.S. (e.g. municipal bonds) (Code Section 2104).

U.S.-situs property also includes real estate in the U.S. (if debt is recourse it is ignored – gross value is included, not just equity) and tangible personal property, like works of art, furniture, cars (and even currency in a safety deposit box) (Treas. Reg. Section 20.2104-1(a)). A beneficial interest in a trust holding U.S. property is also U.S.-situs property (Rev. Rul. 55-163, 1955-1 C.B. 674). U.S.-situs property does not include life insurance proceeds paid on the life of the NRA, bank accounts (unless connected with a U.S. business), portfolio interest loans (Code Section 2105) and shares of stock in a foreign corporation (Treas. Reg. Section 20.2105-1(f)).

Advance planning can eliminate or reduce the U.S. estate tax obligations of NRAs. For example, U.S. real estate owned by the NRA through a foreign corporation is not included in an NRA's estate. This effectively converts U.S. real property into a non-U.S. intangible asset. Even if the real property was not initially acquired through a foreign corporation, it may be beneficial to pay an income tax today on the transfer of the real estate to a foreign corporation (usually treated as a sale) to avoid the estate tax in the future.

Gift taxes are imposed on the donor. A NRA donor is not subject to U.S. gift taxes on any gifts of non-U.S. situs property gift to any person, including U.S. citizens and residents. U.S. citizens and residents must report gifts from a NRA, in excess of $100,000 on Form 3520 (IRS Notice 97-34, 1997-1 CB 422).

Gifts of U.S.-situs assets are subject to gift taxes, with the exception of intangibles, which are not taxable (Code Section 2501(a)(2)). Tangible personal property and real property is sited within the U.S. if it is physically located in the U.S. (Treas. Reg. Section 25.2511-3(b)). NRA donors are allowed the same annual gift tax exclusion as other taxpayers and are subject to the same rate schedule for gift taxes. However, the lifetime unified credit is not available to NRA donors (Code Section 2505(a)).

The primary thrust of estate tax planning for NRAs is through the use of (i) foreign corporations to own U.S. assets, or (ii) the gift tax exemption for intangibles to remove assets from the U.S.

If the NRA dies owning shares of stock in a foreign corporation, the shares are not included in the NRA's estate, regardless of the situs of the corporation's assets. It is important that the corporation have a business purpose and activity, lest it be deemed a sham designed to avoid U.S. estate taxes (See, e.g., Jackson v. Comm'r, 233 F. 2d 289 (2d Cir. 1956)).

The gift of an intangible, wherever situated, by an NRA is not subject to gift tax. Shares in U.S. corporations and interests in partnerships or LLCs are intangibles (See, e.g., Jackson v. Comm'r, 233 F. 2d 289 (2d Cir. 1956)). Consequently, real estate owned by the NRA through a U.S. corporation, partnership or an LLC may be removed from the NRA's U.S. estate by gifting entity interests to foreign relatives, gift tax free.

Ownership Structures for Foreign Investors

An NRA can acquire U.S. assets using several alternative ownership structures. The NRA's goals and priorities dictate the type of structure that is used. Each alternative has its own advantages and disadvantages – there is no perfect structure.

Direct investment (assets owned by the NRA) is simple and is subject to only one level of tax on the disposition. If the asset is held for one year, the sale is taxed at a 15% rate (Code Section 1(h)). The disadvantages of the direct investment are: no privacy, no liability protection, the obligation to file U.S. income tax returns, and if owned at death, the U.S. asset is subject to U.S. estate taxes.

Under an LLC/LP structure, the NRA acquires the U.S. asset through an LLC or a limited partnership. The LLC may be a disregarded entity or a tax partnership for U.S. income tax purposes. This is an improvement over the direct ownership alternative, because this structure provides the NRA with privacy and liability protection and allows for lifetime transfers that escape the gift tax. The obligation to file U.S. income tax returns and the possibility for a U.S. estate tax on death remain. Ownership of U.S. assets through a domestic corporation (the corporation will always be a "C" corporation; a foreign shareholder precludes an "S" corporation) (Code Section 1361(b)(1)(C)) will afford privacy and liability protection, allow lifetime gift tax-free transfers, and obviate the foreigner's need to file U.S. income tax returns. Engaging in a U.S. trade or business requires a U.S. tax return; ownership of stock will not trigger a return filing obligation.

There are three disadvantages to the ownership of U.S. assets through a domestic corporation: (1) federal and state corporate income tax at the corporate level will add a second layer of tax, (2) dividends from the domestic corporation to its foreign shareholder will be subject to 30% withholding, and (3) the shares of the domestic corporation will be included in the U.S. estate of the foreign shareholder. If the corporation owns primarily real estate in the U.S., on the disposition of the stock in the corporation the foreign shareholder will be subject to FIRPTA, because the corporation will be treated as a USRPHC (See FIRPTA and USRPHC discussion, above). This will require the filing of a U.S. income tax return and 10% tax withholding by the purchaser of the shares.

Ownership of the U.S. assets may be by the U.S. corporation directly, or through a U.S. partnership or disregarded entity owned by the corporation. The corporation may even be an LLC that checks-the-box to be taxed as a corporation. In turn, the ownership of the U.S. corporation by the NRA may be direct, or through a foreign partnership or disregarded entity.

Foreign corporation ownership offers the following advantages: (1) liability protection, (2) no U.S. income tax or filing requirement for the foreign shareholder, (3) shares in the foreign corporation are non-U.S. assets not included in the U.S. estate, (4) dividends are not subject to U.S. withholding, (5) no tax or filing requirement on the disposition of the stock, and (6) no gift tax on the transfer of shares of stock.

The disadvantages of using the foreign corporation are: (1) corporate level taxes (just like with the domestic corporation), because the foreign corporation may be deemed engaged in a U.S. trade or business; and (2) the foreign corporation will be subject to the branch profits tax, the largest disadvantage of ownership of U.S. real estate through a foreign corporation.

Because the branch profits tax is often not reduced or eliminated by a treaty, the most advantageous structure for ownership of U.S. assets by NRAs is through the foreign corporation-U.S. corporation structure. Here, the NRA owns a foreign corporation, which in turn owns a U.S. LLC taxed as a corporation. This structure affords privacy and liability protection, escapes U.S. income tax filing requirements, avoids U.S. estate taxes, allows for gift tax-free lifetime transfers and avoids the branch profits tax. Distributions from the U.S. subsidiary to the foreign parent are subject to the 30% FDAP withholding, but the timing and the amount of such dividend is within the NRA's control.

About the Author

Jacob Stein, Esq. is the managing partner of Aliant, LLP. He specializes in structuring international business transactions, complex U.S. and international tax planning and asset protection planning. Mr. Stein received his law degree from the University of Southern California, and a Master of Laws in Taxation from Georgetown University. He has been accredited by the State Bar of California as a Certified Tax Law Specialist. He is AV-rated (highest possible rating) by Martindale-Hubbell, has been named "A Super Lawyer" by the Los Angeles Magazine and is one of "America's Most Honored Professionals 2016", by the American Registry.

Over the course of his career Mr. Stein has represented officers and directors of Fortune 500 companies; Forbes 400 families around the world; celebrities; high-profile entrepreneurs; private equity funds; wealthy foreigners doing business in the United States and many more. He is the author of several books, numerous scholarly articles and technical manuals including his most recent article, Pre-Immigration Tax Planning, published in the January 2016 edition of EB-5 Investors Magazine Volume 3, Issue 3.

His other works include his book: A Lawyer's Guide to Asset Protection Planning in California, Second Edition, published in April of 2016, which is the only legal treatise on asset protection specific to California, and International Joint Ventures – A Concise Guide for Attorneys & Business Owners, published in 2014. Mr. Stein is a frequent lecturer to various attorneys, CPA and other professional groups, teaching over 50 seminars per year. His presentation topics include: Tax Planning for Cross-Border Joint Ventures, A Foreigner's Guide to Investing in U.S. Real Estate, Creative Planning with Controlled Foreign Corporations, Advanced Asset Protection Planning, Advanced Estate Tax Planning and various courses on trust law. He is an instructor with the California CPA Education Foundation, National Business Institute, Thomson Reuters, the Rossdale Group, Lorman Education Services and many more. For the past ten years he has been an adjunct professor of taxation at the CSU, Northridge Graduate Tax Program.

Mr. Stein is a member of several international legal networks, including: Union Internationale des Avocats, International Practice Group, IR Global, and the International Bar Association.