

University of Miami Law Review

Volume 50
Number 3 *International Tax Symposium*

Article 6

4-1-1996

Structuring Foreign Investment in United States Real Estate

William H. Newton III

Follow this and additional works at: <https://repository.law.miami.edu/umlr>



Part of the [Taxation-Transnational Commons](#)

Recommended Citation

William H. Newton III, *Structuring Foreign Investment in United States Real Estate*, 50 U. Miami L. Rev. 517 (1996)

Available at: <https://repository.law.miami.edu/umlr/vol50/iss3/6>

This Article is brought to you for free and open access by the Journals at University of Miami School of Law Institutional Repository. It has been accepted for inclusion in University of Miami Law Review by an authorized editor of University of Miami School of Law Institutional Repository. For more information, please contact library@law.miami.edu.

Structuring Foreign Investment in United States Real Estate

WILLIAM H. NEWTON III*

I. INTRODUCTION	517
II. OVERVIEW OF UNITED STATES TAXATION OF FOREIGN INVESTMENT IN REAL ESTATE	518
A. <i>Disposition of United States Real Estate</i>	518
1. TAXATION OF EFFECTIVELY CONNECTED INCOME	519
2. SECOND TIER TAXATION WITH RESPECT TO CORPORATIONS	519
B. <i>Retained Ownership or Holding of United States Real Estate</i>	520
1. THE NET BASIS ELECTION	520
2. ESTATE TAX CONSIDERATIONS	521
3. GIFT TAX CONSIDERATIONS	522
III. APPLICATION OF UNITED STATES TAX PRINCIPLES TO SPECIFIC REAL ESTATE INVESTMENT STRUCTURES FOR FOREIGN PERSONS	523
A. <i>Outright Individual Ownership</i>	523
B. <i>Corporate Investment Structures</i>	524
1. TRANSFERS OF USRPIs TO FOREIGN CORPORATIONS	526
C. <i>Conduit Investment Structures</i>	527
1. PARTNERSHIPS	528
2. TRUSTS	528
IV. CLASSIFICATION OF ENTITIES IN REAL ESTATE INVESTMENT STRUCTURES FOR FOREIGN PERSONS	531
A. <i>Criteria for Distinguishing Corporations and Partnerships From Trusts</i>	532
B. <i>Criteria for Distinguishing Between Corporations and Partnerships</i>	533
C. <i>Trusts Defined</i>	534
V. CONCLUSION	535

I. INTRODUCTION

Structuring foreign investment in United States real estate requires collective consideration of United States income, estate, and gift tax consequences. In analyzing appropriate foreign investment structures in this context, the ultimate beneficial owner is by definition a foreign individual—one who is neither a citizen, resident, nor domiciliary of the United States.

A foreign individual investing in United States real estate may utilize any one of a series of alternative investment structures components of which may be organized either in or outside the United States. These components may include corporations, partnerships, or trusts. Selection of the appropriate components and their classification as foreign or domestic may have a significant impact on the overall level of taxation.

* J.D. Southern Methodist University. Attorney at Law, Miami, Florida; Adjunct Professor of Law University of Miami; Author of *International Income Tax and Estate Planning* (2nd ed Shepard's/McGraw Hill 1993).

II. OVERVIEW OF UNITED STATES TAXATION OF FOREIGN INVESTMENT IN REAL ESTATE

Choosing the appropriate structure for foreign investment in United States real estate initially requires an analysis of United States taxation, as it impacts both on disposition and retained ownership or holding of realty. Disposition principally involves issues relating to income taxation, while retention or holding of realty may also involve estate and gift tax considerations as well.

A. *Disposition of United States Real Estate*

Gain derived by foreign investors from disposition of United States real estate is subject to income taxation.¹ The approach treats gain from disposition of a United States real property interest as effectively connected with a United States trade or business, and correspondingly subjects that gain to taxation.

A United States real property interest ("USRPI") for this purpose includes interests in: (1) United States situs real property and (2) domestic corporations classified as United States real property holding corporations ("USRPHCs"). A USRPHC is any corporation in which the fair market value of USRPIs equals or exceeds that of foreign situs realty and assets used or held for use in trade or business.²

In contrast with domestic corporations, disposition of an interest in a foreign corporation is not subject to this same treatment. Gain from disposition is not defined as effectively connected, even if the foreign corporation's only assets consist of USRPIs.³ Accordingly, gain from disposition of foreign corporate stock may escape income taxation.

Even so, disposition of a USRPI by a foreign corporation results in taxation at the foreign corporate level.⁴ Disposition of a USRPI by a foreign corporation, as opposed to disposition of an interest in a foreign corporation, is typically necessary for a prospective purchaser: (1) to avoid unknown or contingent corporate liabilities and (2) to obtain a step-up in the basis of underlying, including depreciable, corporate assets.

Partnerships and trusts are treated as conduits for taxation of gain from disposition of a USRPI. This means that USRPIs are considered to be owned proportionately by the partners and beneficiaries, who correspondingly are subjected to income taxation.

1. I.R.C. § 861(a)(5), 897(a)(1), 882(a)(1) (1994).

2. *Id.* § 897(c)(2).

3. *Id.* § 897(c)(1)(A)(ii).

4. *Id.* § 897(a)(1).

1. TAXATION OF EFFECTIVELY CONNECTED INCOME

Foreign persons deriving effectively connected income from disposition of a USRPI are taxed at regular progressive rates applicable to United States persons. Moreover, deductions connected with effectively connected income are available provided the foreign person files a true and accurate return.⁵ To be true and accurate, the regulations require the return to be filed within specific time constraints.

The current maximum individual rate is 39.6% on ordinary income and 28% on capital gain.⁶ Pending budget proposals drop the effective capital gain rate further. The maximum corporate rate both for ordinary income and capital gain is identical: 34% for most corporations and 35% for those with taxable income in excess of \$10,000,000.⁷ Added to these are applicable state income taxes—Florida has no individual income tax but does have a corporate tax of 5.5%.⁸

2. SECOND TIER TAXATION WITH RESPECT TO CORPORATIONS

Under United States tax principles, a corporation is considered a separate taxpaying entity apart from its shareholders. This creates the potential for double taxation—once at the corporate level and a second time at the shareholder level with distribution of dividends.

The approach to imposition of the second tier tax varies depending on whether the corporation effecting distribution is domestic or foreign. A domestic corporation is defined as one organized in the United States, while a foreign corporation is one organized outside the United States. Even so, regardless of approach, the impact in either event may drive the overall effective rate of taxation (assuming, as in Florida, a state corporate income tax of 5.5%) up to approximately 57%.

In the case of a domestic corporation, United States source dividend distributions are subject to withholding as fixed or determinable, annual or periodic income at a rate of 30%, absent applicable treaty. If the domestic corporation is a USRPHC (which sold all of its USRPIs in taxable transactions), the corporation can, under current law, liquidate tax free thereby avoiding the second level tax.⁹

In contrast, a foreign corporation engaged in United States business activity is subject to the complexities of the second level branch profits tax.¹⁰ This tax is imposed in lieu of the withholding tax on dividends

5. *Id.* § 882(c).

6. *Id.* § 1.

7. *Id.* § 11(b).

8. FLA. STAT. § 220.11(2) (1995).

9. I.R.C. § 897(c)(1)(B) (1994).

10. *Id.* § 884; Treas. Reg. § 1.884-1 (1992).

applicable to domestic corporations. Once again, absent treaty, a 30% rate applies to the dividend equivalent amount—effectively connected earnings and profits. As a further parallel to domestic corporate taxation, current branch profits tax regulations provide a termination exception, under which the tax is inapplicable, thereby avoiding second tier taxation so long as the foreign corporation completely terminates its United States trade or business. The foreign corporation can do this by retaining no United States assets or completely liquidating and dissolving.

For a number of years, Congress has considered legislation that, if adopted, would eliminate the ability of a domestic corporation, cleansed of its USRPI taint, to liquidate tax free. Indeed, such legislation was proposed in 1995 but was dropped from the Revenue Reconciliation Bill of 1995 that was ultimately adopted by Congress. The rejected legislation would have imposed a second tier tax when a foreign person owning stock of 10% or more in a domestic corporation disposed of its shares. A disposition for this purpose would include liquidation of the domestic corporation even if all USRPIs had previously been disposed of in taxable transactions. The rate of this tax would be 30%.

The legislative history underlying this proposal states that upon adoption, the Internal Revenue Service ("Service") will concurrently amend its branch profits tax regulations to eliminate the termination exception such that the 30% branch profits tax rate would be fully effective. The overall result would be to drive the effective rate of taxation up to approximately 57%.

B. Retained Ownership or Holding of United States Real Estate

Retained ownership or holding of United States real estate may give rise to additional income and estate and gift tax considerations.

1. THE NET BASIS ELECTION

During the holding period the realty may be leased and thereby generate rental income. Deductions are available to reduce the level of taxation provided that the rental income is effectively connected with a United States trade or business or considered to be so. Otherwise, the rental income would be taxed at the 30% rate applicable to fixed or determinable, annual or periodic income without benefit of deductions.

To ensure the existence of a trade or business, exercise of the Code net basis election is typically prudent.¹¹ This election is not available merely for capitalizing carrying charges if, as in the case of unimproved

11. I.R.C. § 882(d) (1994); Treas. Reg. § 1.882-2 (1992).

realty, income is not produced. By contrast, ownership of non-income producing realty by a domestic corporation allows capitalization thus serving to reduce the level of gain on ultimate disposition.

2. ESTATE TAX CONSIDERATIONS

Real property located in the United States is United States situs property, and subject to federal estate taxation if individually owned by a foreign investor. By contrast, the stock of a foreign corporation is foreign situs property, and avoids estate tax even if the underlying corporate property has a United States situs.¹² This does not apply to domestic corporate stock individually owned by a foreign investor. Instead, domestic stock is defined as United States situs regardless of the location of the certificates.¹³ Accordingly, ownership of United States situs realty by a foreign, rather than a domestic, corporation provides the potential for avoiding imposition of estate tax.

For foreign situs treatment in this context, the following criteria should all coexist:

1. The entity must be classified as a corporation in fact rather than some other arrangement or undertaking;
2. corporate formalities must be observed; and
3. the corporation must be the real owner of the realty in substance, rather than a mere custodian.

Moreover, the corporation should be created for a business purpose or actually engaged in business activity. Otherwise, it may be disregarded as a sham and the apparent shareholder treated as the direct individual owner of the realty.

In contrast with the relative certitude of foreign situs treatment for United States situs realty owned by a foreign corporation, the conservative view is that a partnership engaged in a United States trade or business gives rise to United States situs treatment. Indeed, this is the position of the Internal Revenue Service. Even so, what legal authority exists on this point, including that reflecting the Service's position, is relatively obscure and remote in time.

Other alternative and inconsistent positions include: (1) if a partnership is engaged in a United States trade or business such that it is classified as a United States resident, then a claim enforceable against the partnership as an intangible could be classified as United States situs property; (2) if the partnership terminates at the decedent's death, situs is that of underlying partnership assets; and (3) as intangible personal property, situs is the domicile of the decedent partner. While certain

12. I.R.C. § 2104(a) (1994).

13. *Id.*

negative implications of these positions can be avoided—termination of the partnership at death can be precluded by appropriate drafting of the partnership agreement—there is, nevertheless, a substantial risk for purposes of estate taxation in terms of utilizing a partnership as a foreign investment vehicle.

The situs of property interests held in trust depends at the outset on whether taxation of the decedent grantor or trust beneficiaries is at issue. A foreign grantor retaining incidents of ownership over trust property is subject to estate tax on underlying trust assets otherwise having a United States situs. Correspondingly, a foreign beneficiary holding a vested right over trust assets is also taxed on United States situs assets subject to that right.

A foreign investor is allowed only a \$60,000 credit equivalent exemption against the estate tax rather than the \$600,000 amount available to United States citizens or domiciliaries. Moreover, the marginal rates for foreign persons have increased such that they are now identical to those for United States persons. In this regard, the rate for taxable estates in excess of \$60,000 begins at 26% and proceeds progressively upward to the 55% maximum rate.

3. GIFT TAX CONSIDERATIONS

Interrelated with estate tax is the gift tax impact on foreign donors. As with the estate tax, for purposes of the gift tax, realty is considered situated at its physical location. Thus, gifted realty individually owned and located in the United States is subject to gift taxation.¹⁴

By contrast, all intangible personal property is excluded from gift tax and is defined as foreign situs property.¹⁵ Included in this exclusion is stock in domestic as well as foreign corporations. Accordingly, while domestic corporate stock held at death results in estate tax, a completed, inter vivos transfer avoids imposition of gift tax. As with estate tax, the corporation, whether foreign or domestic, must be real both in form and substance.

A partnership interest is typically classified as intangible personal property. As a result, its gratuitous transfer generally escapes gift taxation. Nevertheless, the partnership agreement should be carefully drafted to ensure that a transfer may be made without termination of the partnership since in this latter event the situs of underlying assets may control. Moreover, local law should also be carefully considered to verify intangible personal property classification, because certain jurisdic-

14. *Id.* § 2511(a).

15. *Id.* § 2501(a)(2).

tions may treat a partnership as a conduit such that the situs of underlying assets controls.

Transfers of interests held in trust may also result in gift taxation. In the case of a trust grantor, taxation may arise on transfer of assets in trust or release of a retained power over trust assets. The same is also true of a transfer of a vested trust interest by a beneficiary. In each instance, the situs of underlying trust assets generally controls, although in appropriate circumstances other alternative theories may conceivably apply.

In contrast with estate taxation, a foreign investor is allowed no credit against the gift tax. Even so, the \$10,000 annual exclusion per donee remains available. In addition, the marginal gift tax rates for foreign persons remain identical to those for United States persons.

III. APPLICATION OF UNITED STATES TAX PRINCIPLES TO SPECIFIC REAL ESTATE INVESTMENT STRUCTURES FOR FOREIGN PERSONS

The appropriate structure for foreign investment in United States real estate varies with the facts and circumstances presented—what is suitable for one foreign investor may not be for another. Even so, there are a number of basic foreign investment structures that may be modified or refined depending on the overall tax consequences and objectives of the particular investor. These basic foreign investment structures include: (1) outright individual ownership, (2) corporate investment structures, and (3) conduit investment structures involving partnerships or trusts.

A. *Outright Individual Ownership*

Outright individual ownership in this context means direct ownership of United States real estate by one or more foreign investors in individual names. Because United States situs realty individually owned is subject to estate tax, at first blush, using this approach as a planning technique would appear a non sequitur. However, this is not invariably so. While estate taxation will result if the taxable estate exceeds the \$60,000 credit equivalent exemption, the value of property included in the gross estate may be directly reduced by nonrecourse debt. That is, with nonrecourse debt only the equity of redemption, the value of the realty less the debt, need be reported for estate tax return purposes. Furthermore, in contrast to claiming a deduction for recourse indebtedness, no need exists for allocation between United States and foreign situs property.

This approach is typically viable only for more modestly priced

realty, and even then only if public disclosure of record ownership is not a concern. It may also be helpful for foreign investors who have taken title to realty individually without proper planning, particularly where there has been subsequent appreciation. At a minimum, bona fide debt reflecting arm's-length interest and actual payment is required. As the owner-obligor is by definition foreign, interest paid will be foreign source and not subject to United States income taxation; although conceivably the interest could be taxed in the obligee's home jurisdiction. In terms of avoiding imposition of estate tax, this technique requires careful monitoring of the fair market value of the realty and modification of the obligation where appropriate to maintain equity at \$60,000 or less.

A further planning technique that may be independently utilized or combined with nonrecourse debt is to incur estate tax but to plan for payment through insurance on the life of the foreign owner. That is, proceeds from a foreign decedent's life insurance policy are foreign situs for estate taxation purposes, even if the insurer is a United States person.¹⁶

While outright individual ownership raises the potential of unlimited personal liability, insurance for this purpose may be obtained. Moreover, on disposition, the typical foreign investor is entitled to be taxed at the reduced capital gains rate rather than the higher ordinary income rates applicable to corporations. Even under current law, the potential savings, taking into account the Florida corporate tax, can approximate 10% of the total gain realized. If the proposed legislation that taxes foreign shareholders on disposition of an interest of 10% or greater in a domestic corporation were adopted, and the extant branch profits tax regulations concurrently amended, the rate differential could approach 30%.

B. *Corporate Investment Structures*

A corporate investment structure provides the individual foreign investor with the potential for avoiding imposition of estate tax, regardless of the value of the underlying United States real estate. In the basic approach, the foreign investor forms a foreign corporation in a tax haven where no income, wealth, or transfer taxes exist. To avoid probate and forced share provisions otherwise applicable, shares of the corporation should typically be held in a revocable foreign trust also formed in an appropriate tax haven with the foreign investor as grantor.

The foreign corporation in turn may invest directly in United States

16. *Id.* § 2105(a).

real estate, or form a subsidiary to make such direct investments. Direct investment in active, ongoing real estate operations, in the absence of a treaty, where distributions are either made or considered to be made to the foreign shareholder is typically inappropriate because it raises complexities involving the branch profits tax. Avoiding imposition of this tax requires continuous monitoring of United States assets and liabilities of the foreign corporation because a decrease in United States net equity could activate the tax.

Computation of the amount deemed distributed and the interest deductible by the branch both involve rather arcane calculations. To illustrate, computation of the interest deduction requires a three-step process that allocates a portion of interest paid or accrued by the foreign corporation to the United States real estate activity. The amount of interest actually paid by the branch is United States source and under the Code is subject to 30% withholding.¹⁷ Any amount allocated to the branch in excess of interest actually paid is treated as received by the foreign corporation from a wholly-owned domestic subsidiary and is subject to 30% withholding as well.

Branch level taxes may be reduced or eliminated by treaty provided the foreign corporation is a qualified resident of the treaty jurisdiction. In general, this requires that residents of the jurisdiction or United States persons own more than 50% of the stock. Thus, treaty shopping is effectively precluded absent satisfaction of these criteria.

Apart from treaty, a domestic subsidiary of a foreign corporation typically owns the ongoing real estate operations, especially where distributions are contemplated. This avoids intricacies of the branch level taxes applicable to foreign, but not domestic, corporations. Application of the Code's 30% withholding rate for domestic corporate subsidiary distributions to its foreign corporate parent is much more straightforward and may be even further reduced if the foreign parent is entitled to treaty protection.

In either event, the overall tax rate under the Code, during the operational phase, assuming a 5.5% state rate, can rise to approximately 57%. Absent distributions, the effective rate would approximate 38%. Parenthetically, accumulation rather than distribution of income could raise an issue concerning applicability of the accumulated earnings tax.¹⁸ Since current law allows gain on ultimate disposition of realty to be taxed only once rather than twice, the maximum rate for most corporate structures is also about 38%. Even so, if the proposed legislation eliminating the ability of a domestic corporation to liquidate tax free were

17. *Id.* § 884(f).

18. *Id.* § 535 (1994); see also *id.* § 532.

adopted and the branch profits tax regulations concurrently amended, the overall rate could rise to the approximate 57% level applicable to ongoing corporate operations.

1. TRANSFERS OF USRPIs TO FOREIGN CORPORATIONS

A foreign investor who initially acquires ownership of a USRPI individually may, intending to avoid imposition of estate tax, subsequently transfer that property to a wholly-owned foreign corporation. Although this practice is expressly sanctioned in the legislative history of the Foreign Investors Tax Act of 1966, *Swan v. Commissioner*¹⁹ raises a potentially troubling issue. That is, whether a foreign investor in transferring United States situs assets to a foreign corporation may have transferred property "by trust or otherwise" for purposes of the Internal Revenue Code ("I.R.C.") §§ 2104(b) and 2038(a)(1), thus giving rise to estate taxation. Though a legitimate concern, it would seem for a number of reasons that the answer should be negative.

First, imposition of estate tax in this scenario is contrary to the legislative history.²⁰ Second, *Swan* is inapposite since the arrangements at issue were not held to be corporations. Third, an exchange of stock for assets may be treated as full and adequate consideration so as to render I.R.C. § 2038 inapplicable.²¹

If the property to be transferred to the foreign corporations is a USRPI, the impact of I.R.C. § 897 must be considered.²² It may cut off nonrecognition on transfer of a USRPI to a foreign corporation. An exception arises if the foreign corporation is entitled to and does exercise the I.R.C. § 897(i) election.²³ In this event, the foreign corporation is treated as domestic for purposes of I.R.C. §§ 897, 1445, and 6039C so that nonrecognition is available.²⁴ Exercise of the election does not cause the corporation to be treated as domestic for estate taxation.

To exercise the election, the foreign corporation must hold a USRPI and be entitled to protection under a treaty nondiscrimination clause.²⁵ The requirement that the foreign corporation hold a USRPI is

19. 247 F.2d 144 (2d Cir. 1957), *rev'g in part & aff'g in part* 24 T.C. 829 (1955).

20. S. Rep. No. 1707, 89th Cong., 2d Sess. 54 (1966).

21. See I.R.C. §§ 351, 367(c)(2) (1994); see also Priv. Ltr. Rul. 6706301590A (June 30, 1967) (concluding in discussing *Swan* that phrase *by trust or otherwise* includes transfers to corporations but receipt of consideration in form of stock renders pertinent Code provision inapplicable).

22. I.R.C. § 897(e) (1994).

23. *Id.* § 897(i).

24. *Id.* §§ 897, 1445, 6039C.

25. *Id.* § 897(i)(1).

satisfied if the USRPI is acquired simultaneously with the effective date of the election.

All income tax treaties to which the United States is a party contain nondiscrimination provisions. Yet, claiming protection to exercise the I.R.C. § 897(i) election requires satisfaction of the terms of the specific treaty at issue. Such provisions in the treaty with Malta should allow exercise of the election without regard to treaty shopping limitations applicable to other provisions. Indeed, because the "treaty benefits" article of the Malta treaty does not preclude, and the internal tax laws of Malta are said to encourage, treaty shopping, the Treasury has announced plans to terminate the treaty effective January 1, 1997. While other treaties may also allow exercise of the election without regard to treaty shopping, caution is warranted since the Treasury may also seek to limit their application. In any event, the internal tax impact in each potential treaty jurisdiction must be carefully considered before moving forward.

Important advantages may result from exercising the election. First, the election allows a corporation to be treated as domestic so that nonrecognition provisions required in connection with tax free transfers and reorganizations continue to be available.²⁶ Second, on exercise, disposition of a USRPI by the deemed domestic corporation may avoid withholding under I.R.C. § 1445.

The election should not be exercised in all circumstances. To illustrate, if a foreign corporation making the I.R.C. § 897(i) election is a USRPHC, its shares are characterized as USRPIs and any gain derived from disposition is subject to taxation. In contrast, the shares of a nonelecting foreign corporation do not constitute a USRPI and, as a result, are not subject to I.R.C. § 897.

An alternative, apart from the I.R.C. § 897(i) election, is for the nondomiciliary to transfer the USRPI to a wholly-owned domestic corporation. The domestic corporate stock is then gifted to those who would otherwise be the ultimate intended beneficiaries of the donor's estate. Where the underlying USRPI is to be used personally by the donor subsequent to the gift, an arm's-length lease would seem required.

C. *Conduit Investment Structures*

A partnership or trust that owns United States real estate may be able to attain significantly reduced income tax rates from that of typical corporate ownership by way of conduit treatment arising from individual investment. Specifically, in the case of active, ongoing real estate opera-

26. *Id.* § 897(d), (e).

tions with distributions to the foreign investor, the ordinary rate differential for Florida realty can approximate 57% for corporate structures versus a maximum of 39.6% for conduit structures. In the case of capital gain the tax savings differential under current law can approach 10%. If the proposed legislation that would place a 10% tax on domestic corporate dispositions for foreign shareholders were adopted, the differential could reach 30%.

1. PARTNERSHIPS

In addition to conduit treatment, a limited partnership may be utilized by an individual foreign investor to limit liability to invested capital. Even so, United States trade or business activity conducted by a partnership, whether domestic or foreign, is imputed to its partners. As a result, individual partners must file income tax returns. This substantially diminishes the level of confidentiality from what it would be if a foreign corporation, rather than a partnership, were the investment vehicle. For this reason alone foreign investors may well prefer a corporate structure regardless of attendant income tax consequences.

Correspondingly, a foreign corporate arrangement properly structured affords virtual certainty in avoiding the imposition of the estate tax while a partnership structure gives rise to a substantial risk of liability for this same tax purpose. It is only with respect to gift taxation that partnerships and corporations are afforded essentially analogous treatment, in that as intangibles both are generally classified as foreign situs property, and excluded from the gift tax. Once again, in the case of a partnership, termination must be avoided and the impact of local law carefully considered.

2. TRUSTS

As in the case of partnerships, each beneficiary of a trust engaged in a United States trade or business is also deemed so engaged. This again requires the filing of an income tax return, thus diminishing the overall level of confidentiality for an individual beneficiary.

Moreover, the foreign grantor must necessarily relinquish all dominion and control over the trust. If the grantor retains any of the incidents of ownership over United States situs property held in trust, upon the grantor's demise, this interest would be included in the gross estate and subjected to estate taxation. In effect, the trust must be irrevocable with no retained rights or powers held by the grantor. A typical foreign investor is not prepared to relinquish control over assets to this degree even where intended beneficiaries are descendants or other objects of the grantor's bounty but, instead, prefers to retain control

through a corporate or partnership approach to United States real estate investment.

The trust itself should be formed in a jurisdiction based on common rather than civil law. This is because the trust is not indigenous to civil law jurisdictions. In fact, civil law jurisdictions ordinarily either do not authorize or expressly prohibit trust creation. Examples of civil law jurisdictions include a large part of continental Europe as well as South and Central American countries whose law is derived from that of Continental jurisdictions. Attempts to create a trust in one of these jurisdictions may result in invalidity.

Even civil law jurisdictions that have modified internal law to accommodate the trust should be avoided at least where a viable alternative exists. These jurisdictions may not have a well-developed body of law on many important issues touching trust validity, such as the rules against perpetuities and accumulations, as well as restraints on trust alienation. The result may give rise to substantial uncertainty both in drafting and trust administration.²⁷

Unexpected results arise even in civil law jurisdictions adopting the trust. In *Estate of Oei Tjong Swan*,²⁸ foreign *Stiftungs* were organized in Liechtenstein and Switzerland. The court treated these arrangements as if they were revocable trusts despite case authority in the same circuit defining *Stiftungs* as separate juridical entities similar to corporations.²⁹

To illustrate further, the court in *Rahman v. Chase Bank & Trust Co (CI) Limited*,³⁰ relying in part on the maxim *donner et retenir ne vaut* derived from Norman French law, held that the degree of the grantor's control and powers over a Channel Islands trust rendered the trust invalid. While application of this maxim to trusts is now limited, previously it had caused considerable difficulties—difficulties that would not have been so accentuated in a strictly common law jurisdiction.³¹

In contrast, common law jurisdictions not only expressly authorize the trust but have developed well-defined legal principles that provide

27. Panama is an example of a jurisdiction that approaches the trust from the perspective of the civil rather than the common law. See generally Roberto Goldschmidt, *The Trust in the Countries of Latin America*, 3 REV. JUR. U.I. 29, 32 (1961).

28. 24 T.C. 829 (1955), *rev'd in part & aff'd in part*, 247 F.2d 144 (2d Cir. 1957).

29. Compare *Swan v. Commissioner*, 247 F.2d 144 (2d Cir. 1957) (holding that where owner retains beneficial ownership rights over property in a trust, the value of the property is included in owner's taxable estate), *rev'g in part & aff'g in part* 24 T.C. 829 (1955) with *Aramo-Stiftung v. Commissioner*, 172 F.2d 896 (2d Cir. 1949) (holding Liechtenstein foundation had constructively received taxable dividends since there was no restriction of the foundation's right to possession of dividends), *aff'g as modified* 9 T.C. 947 (1947).

30. 1987/88 JAM. L. REP. 81.

31. See *Trusts (Amendment) (Jersey) Law*, 1989, art. 1. See generally *Capital Taxes and Estate Planning in Europe* 2801-28 (TJ Lyons ed. F.T. Law & Tax 1995).

interpretative guideposts. In terms of foreign trusts and matters of taxation, the jurisdiction selected should typically be a tax haven with a low or no rate of taxation. Such jurisdictions include the Bahamas, Bermuda, the British Virgin Islands, the Cayman Islands, and Gibraltar.

Furthermore, the situs of the trust must be foreign for purposes of United States income taxation. Interestingly, the jurisdiction of trust formation is not controlling in determining trust situs. Rather, under current law, the division between domestic and foreign trusts is based on the underlying facts and circumstances. In examining the facts and circumstances, though no one factor or grouping of factors is in all events controlling, three specific aspects have been highlighted. These are: (1) the residence of the trustee, (2) location of trust assets, and (3) place of administration.³²

As a general rule, for a foreign trust to exist, a United States person should not serve as trustee. The other two primary factors—location of trust assets and place of administration—are interrelated with the trustee's residence. This interrelationship stems from the nature of the trustees' fiduciary duties. Proper discharge of these duties may, but does not necessarily, require coexistence of all three factors.³³

Should all three coexist, other factors are largely secondary and immaterial. This is supported by the Court's decision in *Maximov v. United States*.³⁴ The trust in *Maximov* was administered in the United States by a United States resident trustee.³⁵ The location of trust assets was not expressly addressed.³⁶ The grantor and all beneficiaries were United Kingdom citizens and residents.³⁷ The trust was held to have a domestic, not a foreign, situs.³⁸

Even so, the Revenue Reconciliation Bill of 1995 contains a provision that would replace these criteria for determining situs. Specifically, a trust would automatically be defined as foreign unless a court in the United States is able to exercise primary supervision over trust administration, and one or more United States fiduciaries have authority to control all substantial decisions of the trust. The effective date is for taxable years beginning after December 31, 1996, unless the trustee elects to

32. See, e.g., Priv. Ltr. Rul. 7917037 (Jan. 24, 1979).

33. See, e.g., Priv. Ltr. Ruls. 7917037 (Jan. 24, 1979) and 7917063 (Jan. 29, 1979) (taxation of foreign trusts prior to domestication maintained, as part of corpus, real property situated in the United States).

34. 373 U.S. 49 (1963).

35. *Id.* at 50.

36. *Id.*

37. *Id.* at 50.

38. *Id.* at 56.

apply the provision to earlier taxable years ending after the date of enactment of the legislation. The election, once made, is irrevocable.

As part of the formation process, the grantor may fund the trust with a combination of outright gifts and loans. A written loan instrument reflecting an arm's length interest rate as well as other indicia of a bona fide debt is necessary. Interest paid on the debt should typically be deductible both from operational income and gain from ultimate sale and disposition of the United States real estate activity. However, the grantor should bear in mind potential allocation and apportionment requirements, mismatching principles, and investment interest limitations.

Assuming the existence of a foreign situs trust, interest paid will be foreign source not subject to United States income taxation. Also the obligation itself, because it arises from a foreign person, will be treated as foreign situs for the purposes of United States estate taxation. If the trust is domestic, while it then may be feasible to avoid allocation and apportionment limitations, for income taxation to be avoided and foreign situs treatment to arise, the obligation must be structured to comply with the requirements of the portfolio interest exemption.³⁹ For domestic trusts, the related-party limitations applicable to corporations and partnerships do not apply. Moreover, the trust should be structured so that trust beneficiaries are extended a vested trust interest only when the grantor intends to exercise direct dominion and control over trust principal. Otherwise estate taxation may arise.

IV. CLASSIFICATION OF ENTITIES IN REAL ESTATE INVESTMENT STRUCTURES FOR FOREIGN PERSONS

Once the foreign investor selects an appropriate real estate investment structure, whether involving foreign corporations, partnerships, or trusts, it is important that entities intended to be included in the structure exist in fact. That is, they must indeed be classified as corporations, partnerships, or trusts for purposes of United States taxation. Otherwise, the contemplated tax treatment may not arise, with attendant income, estate, and gift taxation all being negatively affected.

While the Code sets forth certain criteria in gauging classification of entities, the regulations and rulings expand on these and provide principal guidance. Even so, it is foreign law that determines whether the necessary legal relationships have been established and whether these various criteria exist.

Because of the complexities involved in classifying entities particularly in the foreign context, the Service and the Treasury are considering

39. I.R.C. § 881(c) (1994).

simplifying the classification rules governing both domestic and foreign organizations by allowing taxpayers to make affirmative elections to treat an organization as a partnership or an association taxable as a corporation for federal tax purposes. Yet, until such simplification occurs, the criteria of the Code, regulations, and rulings continue to control.

A. *Criteria for Distinguishing Corporations and Partnerships From Trusts*

Focusing on the pertinent criteria, the starting point for classification is whether the entity possesses associates, and an objective to carry on a business and divide its gains. Both criteria must be present for either a corporation or partnership to exist.⁴⁰

A trust, on the other hand, is an entity whose primary purpose is to protect and conserve property, rather than to engage as associates in a joint business for profit.⁴¹ Indeed, the regulations, in discussing the distinctions between trusts and associations, provide:

Some of the major characteristics of a corporation are common to trusts and corporations, and others are common to partnerships and corporations. Characteristics common to trusts and corporations are not material in attempting to distinguish between a trust and an association, and characteristics common to partnerships and corporations are not material in attempting to distinguish between an association and a partnership. For example, since centralization of management, continuity of life, free transferability of interests, and limited liability are generally common to trusts and corporations, the determination of whether a trust which has such characteristics is to be treated for tax purposes as a trust or as an association depends on whether there are associates and an objective to carry on business and divide the gains therefrom. On the other hand, since associates and an objective to carry on business and divide the gains therefrom are generally common to both corporations and partnerships, the determination of whether an organization which has such characteristics is to be treated for tax purposes as a partnership or as an association depends on whether there exists centralization of management, continuity of life, free transferability of interests, and limited liability.⁴²

Although not specifically addressed in the regulations, an arrangement denominated as a trust that reflects both a joint business for profit and associates can, in fact, be classified as a partnership rather than an association.⁴³

40. Treas. Reg. § 301.7701-2 (1995); see also Marvin Lyons, *Comments on the New Regulations on Associations*, 16 TAX L. REV. 441, 444-47 (1961).

41. See Treas. Reg. § 301.7701-4(a) (1995).

42. See *id.* § 301.7701-2(a)(2).

43. See, e.g., Rev. Rul. 64-220, 1964-2 C.B. 335 (Illinois land trust exhibited associates and

*B. Criteria for Distinguishing Between Corporations
and Partnerships*

Given existence of associates and a profit motive, four additional criteria distinguish between corporations and partnerships. They are:

1. continuity of life;
2. centralized management;
3. limited liability; and
4. free transferability of interests.

For a corporation to exist at least three of the four criteria must be present, and for a partnership no more than two may exist.

Example: A organizes an arrangement that under foreign law is denominated as a partnership. It possesses associates and an objective is to carry on a business and divide its gains. In addition, it reflects continuity of life, centralization of management, and limited liability. Because the arrangement possesses three of the criteria for distinguishing partnerships and corporations, it cannot be a partnership and is classified as a corporation.

This is in contrast with the result in Priv. Ltr. Rul. 7904103⁴⁴ involving a Brazilian limitada. Again, both associates and an objective to carry on a business and divide its gains were present.⁴⁵ However, the limitada lacked both continuity of life and free transferability of interests. Accordingly, it was classified as a partnership, not a corporation.⁴⁶

In *MCA, Inc. v. United States*⁴⁷ arrangements were cast in partnership form. Yet, the Service contended that the substance of the arrangements dictated classification as corporations instead.⁴⁸ The court rejected this contention and concluded that both the substance and form of the arrangements created partnerships given the lack of continuity of lives and free transferability of interests.⁴⁹ The decision precluded characterization of accumulated amounts as subpart F income.⁵⁰ It did authorize deferral of accumulated income within an acknowledge controlled foreign corporation. Parenthetically, the Tax Reform Act of 1986 amended I.R.C. § 954(d)(3)(B) to define a related person as including a partnership, trust, or estate, as well as a corporation.⁵¹ Inclusion of part-

joint business for profit, but because centralized management and limited liability were absent, arrangement classified as partnership and not as association).

44. Priv. Ltr. Rul. 7904103 (Oct. 26, 1978).

45. *Id.*

46. *Id.*

47. 685 F.2d 1099 (9th Cir. 1982), *rev'g* 502 F. Supp. 838 (C.D. Cal. 1980).

48. *Id.* at 1100.

49. *Id.* at 1104.

50. *Id.*

51. I.R.C. § 954(d)(3)(B) (1994).

nerships in the definition effectively overrules the *MCA* case with respect to the ultimate issue decided.

C. *Trusts Defined*

In gauging existence of a trust, the analysis should initially focus on the underlying instrument governing the arrangement. If powers contained in the instrument indicate the potential to operate a business, this criterion may well be met and this is so even if it is clear it was never contemplated the arrangement would engage in actual business activity.

This approach was addressed in two related revenue rulings. The underlying corpus in each of the arrangements consisted of real property. In Rev. Rul. 78-371⁵² the governing instrument empowered the apparent trustees to acquire contiguous or adjacent property, sell existing property, raze or erect buildings, and borrow money or mortgage and lease the property. The arrangement was held to be an association taxable as a corporation.

In contrast, Rev. Rul. 79-77⁵³ involved an arrangement formed to hold title to land and a building situated thereon. It was further empowered to sign leases and management agreements and to distribute all trust income. The ruling concludes that this arrangement was formed to protect and conserve property, not to engage in business activity. Thus, it was classified as a trust for tax purposes.⁵⁴

Existence of associates—the second of the two criteria for distinguishing between trusts, and associations or partnerships—is not precluded merely because only a single owner, rather than multiple owners, is involved. An association rather than a trust has been held to exist even where the entity consisted of a single owner engaged in a business for profit.⁵⁵ Satisfaction of the associates requirements is based in part on whether the ultimate beneficial owner(s) play a role in the creation of the arrangement. Active participation in establishing the arrangement tends to satisfy the requirement by evidencing a voluntary association for engaging in a joint endeavor, but is not in every instance conclusive.⁵⁶

Moreover, that the ultimate beneficial owners play no role in the creation of the arrangement “is not sufficient reason in itself for classify-

52. 1978-2 C.B. 314.

53. 1979-1 C.B. 448.

54. See also Priv. Ltr. Rul. 8027084 (April 11, 1980) (entity formed by foreign corporation to protect and conserve note secured by wraparound second mortgage classified as grantor trust and is taxable to grantor because grantor had sole discretion to reacquire the trust assets).

55. See, e.g., *Lombard Trustees v. Commissioner*, 136 F.2d 22, 24 (9th Cir. 1943); John B. Hynes, Jr., 74 T.C. 1266, 1280 (1980).

56. See Treas. Reg. § 301.7701-4(a) (1995).

ing the arrangement as an ordinary trust rather than as an association or partnership."⁵⁷ Courts will consider additional criteria in examining whether the associates requirement is met. The primary one is the extent the beneficiaries' interests in the arrangement are transferable. A secondary criterion is the extent the beneficiaries may participate in trust affairs such as management. Where their interests are freely transferable and they may participate fully in trust affairs, the associates requirement should be met. In the alternative, if the beneficiaries' interests are not transferable and their participation is nominal, associates should be precluded.⁵⁸

Although at first blush, application of these criteria may pose some concern in active real estate (business) operations, trust classification remains feasible. That is, the person (the grantor) who creates the arrangement will no longer be the beneficial owner of an irrevocable trust, but, at most, will be deemed a mere creditor. Rather, the ultimate trust beneficiaries, who had no role in trust creation, will hold the beneficial rights. Provided the instrument itself and other pertinent criteria are properly structured it should be possible to create an entity that is a trust in fact for purposes of taxation.

V. CONCLUSION

Structuring foreign investment in United States real estate is an involved process with no one facile solution. Instead, consensus and resolution rests on the facts and circumstances pertinent to each specific foreign investor. What may be appropriate for one investor may be inappropriate for another. What may be an acceptable level of risk for one may be unacceptable for another.

The key factor is that all relevant approaches should be clearly and succinctly explained, with ultimate memorialization in writing before proceeding, so the investor has sufficient knowledge to make an informed decision as to which approach is best for that specific investor. Moreover, once implemented contact with the investor should be maintained and the structure monitored in terms of legislative provisions that may affect the investment structure. Only then will the foreign investor be properly served.

57. Treas. Reg. § 301.7701-4(b).

58. See, e.g., *Bedell Trust v. Commissioner*, 86 T.C. 1207, 1220 (1986) ("[w]e cannot find, where one person has created an entity, unilaterally distributed interests in it to others, and then restricted their ability to transfer their interests that . . ." associates in a joint business for profit are present). See generally Lyons, *supra* note 39, at 454-55.