Buying USA

Michael W Galligan offers ways of minimizing US transfer taxes on US property interests of non-US persons

I sometimes wish that we could compel US immigration officers to give a notice to every person who enters the United States who is neither a US citizen nor a US domiciliary, saying: 'Warning: do not acquire any property within the US without consulting an attorney or accountant!' Why? Almost every week of practice brings to light some situation in which non-US people, enthused about owning a home in the US, or purchasing art here, or investing in our equity markets, blissfully make investments and commit to contracts of purchase without the remotest idea of the US legal or tax consequences of such investments or purchases.

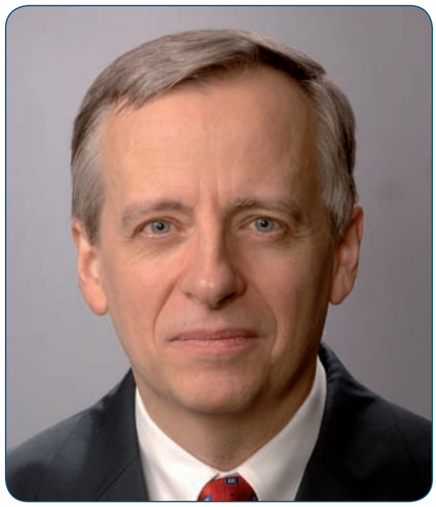
While my comments here will focus primarily on tax issues, the sometimes vexatious nature of dealing with the inheritance and disposition of US property owned by non-US persons (i.e., non-US citizens who are not domiciled in the United States) should not be minimized. The US custodians of the property may not be comfortable with transferring the property to non-US heirs without US court proceedings; there may well be no will or other dispositive instrument (or no such instrument that a US court can understand without expert advice); and, under choice of law rules in the relevant US jurisdiction, non-US law might in the end govern issues about the disposition of the property rather than the law of the US jurisdiction where the property is located.

The US transfer tax burden

But the tax issue for non-US persons is especially noteworthy because there are many jurisdictions in the world that have no inheritance, estate or death-related income tax. These jurisdictions for the most part have no gift taxes (India and Russia impose income tax on some gifts). Gifts of some types of US property by non-US persons are subject to US gift tax and, more significantly, many forms of US property are subject to US estate tax even though the owner was never a US citizen and was never domiciled here.

Thus, if property of a person from one of these countries eventually becomes subject to US transfer tax, there is no credit that the owner's estate or the owner's heirs can claim for the US tax against any death-related tax in their own countries. To them, the US tax payment is a complete loss. Even when the owner comes from a country that does have a death-related tax, the heirs may well be put in a position of paying much more tax than they would if no US tax was due because many countries with gift and inheritance taxes have much lower tax rates, especially when there is a close family relationship between the donor or decedent and the donees or heirs. Thus, even if countries that do have gift or estate taxes give a credit for US gift or tax estate tax, the addition of the US tax would create an extra layer of tax that would otherwise not apply.

Exempt assets



The good news for non-US persons who want to acquire US property is that, with proper advice and planning, most non-US persons and their heirs should be able to legitimately and legally avoid any US gift, estate or generation-skipping transfer tax on the disposition of their US property and investments. A non-US person who is strongly averse to consulting tax attorneys and accountants could avoid all risk of US transfer taxes by limiting their US acquisitions to a relatively narrow but not insignificant range of US property (although not necessarily avoiding some of the non-tax problems mentioned above).

For example, bank deposits with US branches of US banks engaged in the banking business are not subject to US estate tax. Some commentators believe that gifts of deposits from a US bank may be subject to gift tax, but this is widely disputed and highly questionable. It is undisputed that most bonds and notes issued after 18 July 1984 that are held by non-US persons and eligible for the income tax exemption under the *Internal Revenue Code (IRC)* s871(h) will be subject neither to US estate nor US gift tax as long as the owner does not become a US resident for US income tax purposes.

A question of situs

Unquestionably, real property directly-owned by a non-US person will be considered US situs property and will be subject to gift, estate and generation-skipping transfer tax. The same holds true for tangible property located in the United States, such as art, gems, manuscripts, furniture, jewelry, vehicles, and boats (except for works of art on loan to US museums for exhibition). In the somewhat convoluted wording of *IRC* s2104(a), the *Code* provides that shares of stock 'owned and held by a nonresident not a citizen of the United States' will be considered US situs property 'only if issued by a domestic [US] corporation' and therefore subject to US estate tax. Lifetime gifts of stock of US corporations, however, are not subject to US gift tax at all under *IRC* s2501(a)(2). Debt obligations not exempt under the rule described earlier are US situs if enforceable against 'a US person,' the United States itself or its political subdivisions.

Things become considerably murkier with many other types of US-connected property not expressly addressed in the *Code* or the regulations. There is an argument of considerable merit that, in the absence of a *Code* or regulatory provision addressing partnership interests, state property law should determine the situs of property and therefore, under the common-law rule that prevails in most US jurisdictions, a non-US decedent's interest in a US partnership should be deemed to have its situs in the decedent's domicile outside the United States and therefore not be taxed.

As with corporate stock, pursuant to *IRC* s2501(a)(2), lifetime gifts of US partnership interests should generally be free from US gift tax, although special care should be taken that gifts of interests in partnerships that own US real estate or tangible property could not be recharacterized as gifts of the underlying property.

Minimizing tax

The generous exemption of gifts of US intangible property owned by non-US persons from US gift tax makes planning relatively straightforward for non-US persons who are happy to give up any ownership interest in US property. They can make gifts of intangible property with no worry about US gift tax, and the donees of such gifts can use those gifts or the proceeds of their sale to purchase US real or tangible property. (Of course, the transfer tax consequences of such gifts in the clients' 'tax homes' must not be overlooked.) There is a splendid opportunity here to leverage the gift tax exemption for the long-term benefit of US persons who are objects of a non-US person's generosity by making those gifts into trusts that can last for many generations because gifts that are not subject to US gift tax are also not subject to US generation-skipping transfer tax.

Naturally, many non-US persons want to acquire US property for their own profit and enjoyment during their lifetime but would like to avoid US estate tax upon their deaths. Here, the key is to indirectly own US property that if owned directly would be subject to US estate tax.

The role of non-US corporations

The favored vehicle of choice over many years for structuring ownership of US situs property has been the non-US or 'offshore' corporation. Despite doubts raised in some quarters, the non-US corporations owned by non-US persons still seem to have the strongest legal support for protecting US assets from US estate tax.

Treas. Reg. 20.2105-1(f), seeking to complement the provisions of *IRC* 2104(a) about stock of US corporations, states unequivocally that 'shares of stock issued by a corporation which is not a domestic corporation,' when owned by a nonresident who was not a citizen of the US at the time of death, is considered to be situated 'outside the United States' and therefore not subject to tax. Under long-standing principles of law in the US, the whole point of a corporation is to have independent legal existence and not to be assimilated to or merged with its shareholders, even if there are only a few or even just one shareholder. Thus, as long as the requisite corporate forms are followed, the US assets of the non-US corporation should be treated as assets of the corporation, not of the shareholders.

Section 2104(b) confers US estate tax situs on property transferred by a non-US person 'by trust or otherwise' where the donor retained certain interests or rights enumerated under ss2035-2038 of the *Code* and the property was US property either when contributed or when the donor died. Section 2104(a), however, should trump s2104(b) because s2104(a) unequivocally provides that shares of stock owned and held by non-US persons are situated in the US 'only' if issued by a domestic corporation and, under long-standing principles of statutory construction, in the event of a conflict between a general provision and a specific rule of law, the specific rule should prevail.

Non-US LLCs and partnerships

There is renewed interest in the viability of partnerships and LLCs to serve as estate planning entities for non-US persons because of the attractive income tax features of partnerships compared with corporations, and possibly also because 'remedial' estate planning may be significantly easier using non-US partnerships and LLCs rather than non-US corporations. This is especially the case when non-US clients hold appreciated real property interests in their own names.

As noted above, there is a good argument to construe current law so that a partnership interest owned by a foreign person does not have US estate tax situs (basically, that Rev. Rul. 55-701, which, in interpreting a now defunct estate tax treaty looks to the place where business is conducted, should be limited to its facts. Treas. Reg. s20.

2104-1(a)(4), which looks to the residence of the issuer of an asset is only supposed to apply to a 'limited' range of circumstances. Thus, state property situs rules that defer to a decedent's domicile, as demonstrated by the US Supreme Court's *Blodgett* v *Silberman* decision, should be determinative. When dealing with the property of non-US persons, one should consider the issues that have arisen in domestic estate planning over the last few years regarding interests in so-called 'family-limited partnerships,' since these issues arise under *IRC* s2036(a), which is incorporated into the federal estate tax rules for non-US decedent estates by *IRC* s2104(b).

New York planning

As I intimated at the outset, comprehensive planning for non-US persons has to consider not only tax issues but many choice-of-law, property law, inheritance law, and personal law issues. Planners should not forget that s3-5.1(h) of New York's *Estates Powers and Trusts Law (EPTL)* enables a non-US person to ensure that New York law's substantive inheritance law (with its lack of forced heirship concepts and its disinclination to allow courts to make post-death amendments to wills) applies to the testamentary disposition of New York situs property, even if the law of that person's domicile might be different.

Section 7-1.10 of New York's *EPTL* provides an analogous rule for transfers to trusts governed by New York law. A non-US person need not be forced to a Hobson's choice between the inheritance advantages of a New York will plan and the estate tax advantages of having US property held by a non-US corporation. It would appear, applying the logic of the often overlooked 1933 NY Court of Appeals decision in *Hutchinson* v *Ross*, that a limited liability company (LLC) organized in New York should have New York situs for purposes of NY *EPTL* ss3-5.1(h) and *EPTL* ss7-1.10. If such a New York LLC owns stock of a non-US corporation that owns US assets, the LLC would not be subject to US estate tax as long as the non-US person or a trust governed by New York law is the LLC's sole member, because the LLC would be disregarded for all US tax purposes (including estate tax) and the owner of the US assets for estate tax purposes would still be the non-US corporation.

Repairing bad situations

All of these planning issues can be approached carefully and effectively if a non-US client takes competent advice before acquiring US property. The situation becomes more complicated when counsel is approached for assistance, long after the US property has been acquired by its non-US owner. In many situations – especially when the assets involved are mainly stock of US corporations or other intangible assets – remedial planning can still be effective and without incidental tax costs. This is because of the broad exemption of non-US persons from gift tax on transfers of intangibles; the general exemption of non-US persons from US capital gains taxes; and the 'non-recognition' rules under the *Code* for transfer of assets to corporations and partnerships.

The situation, however, becomes considerably more complicated when US real property and 'associated' tangible property is involved. Section 897 of the *Code* generally makes all 'dispositions' of US real property interests subject to US capital gains tax. It also suspends, subject to regulation, most of the non-recognition provisions of the *Code* regarding transfers to corporations and partnerships. Therefore, transfers of direct fee interests in US real property to non-US corporations and partnerships will generally be subject to US capital gains tax. Under certain very limited circumstances (primarily related to corporate reorganizations) the *Foreign Investment Real Property Tax Act (FIRPTA)* tax on transfers of interests in US real property holding corporations may be able to be deferred until the sale of company stock. More interestingly, it appears that, subject to special conditions and detailed requirements, transfers to non-US partnerships (including LLCs treated as partnerships for US tax purposes) may not trigger current US capital gains tax as long as the *FIRPTA* tax is merely being deferred and can be collected if and when the partnership interest itself is sold or exchanged. But, of course, as already noted, clients and their advisers have to weigh the merits of deferring capital gains taxes on a transfer of US real property to a foreign entity with the lack of clear authority concerning the efficacy of LLCs and partnerships to eliminate the incidence of US estate tax.

In the meantime, can we not still hope that every non-US visitor to the US would receive an appropriate notice not to rush to acquire US assets without proper counsel or advice? The chances of requiring such a notice may seem even slimmer than the chances of repealing the infamous 'Reed Amendment' denying admission to (supposedly unworthy) tax-motivated US expatriates. Still, such a notice, at least in a policy environment less content with 'trapping' unwary non-US persons motivated to invest in US assets, seems to be eminently reasonable.

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