Foreign-Owned U.S. Real Estate: To Rent Or Not To Rent

By Dina Kapur Sanna and Stephen Ziobrowski[1]

I. Introduction

Nonresident aliens frequently purchase U.S. real property for personal use. To avoid U.S. estate tax, the most common structure to hold the U.S. real property is through a foreign corporation organized and owned by the nonresident. Because the property is owned by the foreign corporation rather than the nonresident, for purposes of U.S. estate tax the nonresident is treated as owning the stock of the foreign corporation rather than the underlying U.S. real property, and stock in a foreign corporation is not a U.S. situs asset and therefore not subject to estate tax.

Although the foreign corporation structure addresses U.S. estate tax issues, it is not without its complications. Sections II through IV of this article will describe the more standard issues implicated by the structure. The balance addresses an issue that has not previously received much attention but plagued practitioners nonetheless: namely, whether rent should be charged to the nonresident or his family members for their personal use of U.S. real property when the property is owned through a foreign corporation to avoid adverse U.S. tax consequences..

II. U.S. Taxation of Nonresident Individuals

(A) Estate Tax

For U.S. estate tax purposes, a nonresident is a noncitizen who is not domiciled in the U.S. (U.S. domicile is acquired by living in the U.S. with no definite present intention of later moving from the U.S.).[2] The gross estate of a nonresident consists only of property that has, or is deemed to have, a "U.S.-situs" at the time of his death or at the time of certain lifetime transfers that come under the so-called "retained string provisions" of Code sections 2035-2038.[3] Under these Code sections, a decedent is subject to estate tax on property he has transferred during his life, by trust or otherwise, where he has retained the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or

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[2] Treas. Reg. § 20.0-1(b). "Section" or "§" references are to the Internal Revenue Code of 1986, as amended (the "Code") and Treasury Regulations promulgated under the Code.

[3] Code §§ 2101-2104. Under Code Section 2104(b), any property subject to the string provisions of Code Sections 2035 through 2038 is included in the gross estate of a nonresident, if it had or was deemed to have a U.S. situs at the time of the transfer or death.

the income therefrom or where the enjoyment is subject at the date of his death to any change exercisable by the decedent alone or in conjunction with another person to alter, amend, revoke, or terminate (or such power was relinquished within 3 years of death).[4]

A nonresident's gross estate is determined in the same manner as the gross estate of a U.S. resident or citizen, except that (i) property outside the U.S. is excluded; (ii) special rules apply to joint property where the surviving spouse is not a U.S. citizen; and (iii) the deductions and credits available to a nonresident's gross estate are limited. Although a nonresident is subject to estate tax on U.S.-situs assets at marginal rates of up to 40%, the applicable estate tax exemption is only $60,000, unless a bilateral estate tax treaty provides otherwise, compared to $5 million for a U.S. citizen or resident.[5]

The situs rules are found in Code Sections 2104 and 2105, as amplified by Treasury Regulations, unless modified by a bilateral estate tax treaty. With few exceptions (e.g., works of art on loan, personal property accompanying a nonresident who dies while in the U.S.), tangible personal property located in the U.S. is a U.S.-situs asset. Real property located in the U.S. has a U.S. situs.[6] If the real property is subject to a non-recourse mortgage, the real property is included in the gross estate at its net equity value.[7] In contrast, where the real property is subject to a recourse mortgage, the real property is included at its full value, but only a pro-rated deduction for the mortgage is allowed, based on the proportion that the nonresident's U.S. assets bear to his worldwide assets.[8] Intangible personal property, the written evidence of which is not treated as the property itself, is deemed to have a U.S. situs if it is issued by, or enforceable against, a U.S. resident.[9] This includes debt obligations of a U.S. person or a U.S. governmental entity, the written evidence of which is not treated as the property itself.[10] There are exceptions for portfolio debt, certain short-term original issue discount obligations, and bank deposits. Also, stock of a corporation organized under U.S. law (or the law of a U.S. state) is deemed to have a U.S. situs, regardless of where the share certificates are physically located.[11] Notably, there is no mention in the situs rules of partnership interests, nor is there any case law applying the relevant provisions to partnership interests. A partnership that does not terminate on the death of a partner can be viewed as a separate and distinct entity from its owners or as an aggregate of their interests. Case law and commentary support entity theory more than aggregate theory in this context. When applying the entity theory however, there are two possible outcomes for determining situs: (i) situs is determined based on the location where the

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[4] Code §§ 2036 and 2038.
[5] Code § 2102(b). This figure is indexed for inflation and for decedents dying in 2013, is $5,250,000.
[6] Treas. Reg. § 20.2104-1(a)(1).
[7] Treas. Reg. § 20.2053-7.
[8] Id.
[9] Treas. Reg. § 20.2104-1(a)(4).
[10] Code § 2104(c),Treas. Reg. § 20.2104-1(a)(7).
[11] Code § 2104(a), Treas. Reg. § 20.2104-1(a)(5).

partnership conducts its business,[12] or (ii) situs is determined based on the residency of the partnership for income tax purposes (i.e., its place of organization).[13] No clear rule has emerged.

(B) Income Tax

For U.S. income tax purposes, a nonresident is a noncitizen who does not hold a green card or satisfy the substantial presence test.[14] To satisfy the substantial presence test, an individual must be physically present in the United States for 31 days in the current calendar year and for a weighted total at least 183 days during the current year and the two preceding calendar years. For this purpose, the number of days of presence in the current year is counted in full, the number of days of presence for the first preceding year is multiplied by a factor of 1/3, and the number of days of presence for the second preceding year is multiplied by a factor of 1/6. There are exceptions for, among others, students, teachers, foreign diplomats, and those who can claim a closer connection to another country. In addition, a bilateral income tax treaty can provide relief for dual-resident taxpayers who can claim residence in the treaty country, if they satisfy the provisions of the treaty tie-breaker.

A nonresident is subject to U.S. income tax on his (i) U.S. source fixed or determinable annual or periodical ("FDAP") income, the tax on which is collected by withholding at a 30% rate (or lower treaty rate) on gross FDAP income; and (ii) income which is effectively connected with a U.S. trade or business ("ECI"), which is taxed at graduated rates of up to 39.6% on a net basis.[15]

(1) FDAP

FDAP income includes, among other items, interest, dividends and rents from U.S. sources.[16] However, FDAP income generally does not include capital gains recognized on sales or exchanges of assets held for investment.[17] Also, FDAP income does not include gain recognized on the disposition of a "U.S. real property interest," which, as discussed in detail below, is taxed as if it were ECI.[18] A nonresident taxpayer whose only income is FDAP income on which tax has been withheld is not required to file a U.S. tax return.

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[12] See, e.g., Revenue Ruling 55-701, 1955-2 C.B. 836.
[13] See, e.g., Treas. Reg. § 301.7701-5; which is consistent with the rules applied to corporations under Code § 2104(a) and Treas. Reg. § 20.2104-1(a)(5).
[14] Code § 7701(b)(1)(A).
[15] Code §§ 871(a), (b). Nonresident alien individuals are not subject to the 3.8% Medicare tax that may apply to the net investment income of U.S. taxpayers. Code § 1411(e)(1).
[16] Code § 871(a)(1)(A). Exceptions exist for interest earned on portfolio debt instruments and bank deposits. Code §§ 871(h) and 871(i)(3).
[17] Code § 871(a)(1)(A) (listing types of income other than capital gains). Despite the general exemption from U.S. tax for capital gains that are not treated as ECI, Code Section 871(a)(2) provides that net U.S. source capital gains are taxable at 30% in the hands of nonresident alien individuals physically present in the United States for 183 days or more during the taxable year.
[18] Code § 897.

(2) ECI

A nonresident who has ECI must file a U.S. tax return and may deduct expenses that are directly connected with the ECI. ECI is generally not subject to withholding in the U.S. except where it is derived through a partnership.

Rental income from U.S. real property can be FDAP or ECI, depending on the facts. To eliminate uncertainty, there is an election available which allows a nonresident to treat income from U.S. real property as ECI.[19] Despite the fact that ECI may be subject to a higher marginal tax rate than FDAP, this election is often favorable because it results in tax on net income, not gross income, and net rental income may be modest due to depreciation and deductible expenses such as insurance and real estate taxes.

(3) FIRPTA

Under the Foreign Investment in Real Property Tax Act ("FIRPTA"), gains from the disposition of a "U.S. real property interest" are taxed as ECI to a nonresident.[20] In general, a U.S. real property interest ("USRPI") is (i) a direct interest in U.S. real property (other than an interest solely as a creditor) and (ii) an interest in stock of a domestic corporation that is a U.S. real property holding company ("USRPHC").[21] A USRPHC is a corporation more than 50% the value of which is attributable to U.S. real property (with an exception for publicly-traded corporate stock, if the nonresident owns 5% or less of such stock).[22] FIRPTA applies a look-through rule to partnerships and trusts. Under this look-through rule, a disposition of an interest in a USRPI by a partnership is treated as a disposition of each partner's ratable share of the USRPI held by the partnership.[23] Under Treasury Regulations, an interest in a partnership is a USRPI if 50% or more of the value of the partnership's gross assets are USRPIs and 90% or more of the value of the gross assets of the partnership consists of USRPIs plus cash or cash equivalents (but only to the extent that the gain on disposition is attributable to USRPIs). FIRPTA withholding (discussed below) may be imposed on the entire proceeds of disposition of a partnership interest that is a USRPI.[24]

FIRPTA is enforced through withholding obligations imposed on the transferee, who must generally withhold 10% of the "amount realized."[25] Relief from FIRPTA withholding may be available for non-recognition transactions under the Code, provided certain filing requirements are met.[26] In other cases, withholding may be reduced or eliminated pursuant to a withholding certificate issued by the Internal Revenue Service ("IRS"). The IRS may issue

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[19] Code § 871(d)(1).
[20] Code § 897(a).
[21] Code § 897(c)(1).
[22] Code § 897(c)(2)-(3).
[23] Code § 897(g).
[24] Treas. Reg. § 1.897-7T(a). Despite the limitations of the regulations, the Internal Revenue Service has indicated that the applicability of the Code section is not contingent on the issuance of regulations. Notice 88-72, 1988-2 C.B. 383.
[25] Code § 1445.
[26] Code § 897(e), Treas. Reg. § 1.897-6T(a).

such a certificate where it determines that reduced withholding is appropriate, the transferor is exempt from U.S. tax, or the IRS enters into an agreement for the payment of tax.[27] A withholding certificate that is obtained prior to the transfer relieves the transferee from withholding obligations.[28]

A nonresident taxpayer who has FIRPTA gain must file a U.S. tax return and apply the taxes withheld against the tax liability shown on the return. The lower long-term capital gains rate (currently 20%) is available to a nonresident individual on a sale of a USRPI, if the sale otherwise qualifies.

III. U.S. Taxation of Corporations

(A) Entity Classification

The U.S. tax classification of a business entity is not always consistent with its form of organization. Under the so-called "check-the-box" rules found in Treasury Regulations Section 301.7701-3, many types of business entities are permitted to elect their classification for U.S. tax purposes. In particular, most partnerships or limited liability companies (whether U.S. or foreign) can elect to be taxed as corporations; other types of foreign entities are "per se" corporations for U.S. tax purposes and are not eligible to elect their classification. This article presumes that the entity holding U.S. real property is taxed as a corporation in the U.S.

(B) General Rules of Corporate Taxation

In the U.S., a corporation is generally a separate and distinct taxable entity. The character of a corporation's income is not "passed through" to its shareholders.[29] A corporation is subject to tax on its net income, at tax rates currently ranging from 15-35%. A corporation does not pay a lower rate of tax on capital gains. A shareholder who receives a distribution in respect of his stock realizes taxable income to the extent of the corporation's current or accumulated earnings and profits.[30] These amounts are treated as dividends. The amount of a distribution in excess of the corporation's current or accumulated earnings and profits is treated as a non-taxable return of stock basis. To the extent amounts distributed exceed the corporation's current or accumulated earnings and profits and the shareholder's basis in his stock, the distribution is treated as gain from the sale or exchange of property (which may qualify as capital gain).[31]

A foreign corporation may hold U.S. real property directly (including through a disregarded entity). Assuming that the property produces rental income and the corporation has

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[27] Treas. Reg. § 1.1445-3(a).
[28] Id.
[29] There are several exceptions to this general statement. For example, under certain circumstances corporations can make an election to be treated as "S corporations," which are generally taxed as "pass throughs." An "S corporation" cannot have a nonresident alien shareholder, however.
[30] Code §§ 301(a), (c), 316.
[31] Code § 301(c).

made an election to treat the rental income as ECI, the corporation will be required to file a U.S. tax return and pay tax on its net income at rates of up to 35%. Gain on the sale of the property will be subject to tax under FIRPTA as ECI, and, absent an exception, FIRPTA withholding will apply to the sale proceeds. In addition, a 30% tax may be imposed on the after-tax earnings that are not reinvested in the U.S. business (the "branch profits tax"). Although the branch profits tax is intended to parallel the 30% withholding tax imposed on dividends paid by U.S. corporations to foreign shareholders (discussed below), the branch profits tax often results in a higher effective tax because the tax is imposed regardless of whether a dividend has been paid. There is, however, an exception from the branch profits tax when property is sold if the corporation terminates its U.S. trades or businesses and does not reinvest the sales proceeds in the U.S. for at least three years.[32]

Alternatively, a foreign corporation could set up a U.S. corporate subsidiary, which in turn would own the U.S. real property. If the property produces net rental income, the U.S. corporation will file a U.S. tax return and pay tax at regular corporate rates. A dividend paid by the U.S. subsidiary to its foreign parent will be subject to 30% withholding (or lower treaty rate, if applicable), because it constitutes FDAP income. However, if no dividends are paid during the life of the U.S. corporation, the 30% withholding tax can be avoided. If the U.S. corporation is liquidated following the sale of its property, the corporation can avoid FIRPTA withholding tax if (i) the distributing corporation did not hold any USRPIs at the date of distribution and (ii) all of its USRPIs were disposed of in transactions in which the full amount of gain was recognized.[33]

IV. Corporate Ownership: Benefits and Downsides

Because U.S. real property is a U.S.-situs asset for estate tax purposes, nonresidents often hold U.S. real property through a blocker foreign corporation. This approach has the advantages of low cost and simplicity. The downside is loss of the lower capital gains tax rate on a sale of property and potential for a second entity-level tax (i.e., the branch profits tax).

Conduit structures, such as foreign partnerships or foreign nongrantor trusts, can preserve qualification for the lower capital gains rate, but those alternatives present their own downsides. In the case of a foreign partnership holding U.S. real property, the nonresident must be willing to accept a risk of estate tax exposure because of the lack of clear guidance on the situs of partnership interests.[34] In the case of a foreign nongrantor trust holding U.S. real property,

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[32] Treas. Reg. § 1.884-2T(a)(1). In order for the foreign corporation to be treated as completely terminating all of its U.S. trade or business activities it must (i) cease to have any U.S. assets, (ii) not reinvest in a U.S. trade or business within three years (nor can any related corporation make such an investment), (iii) have no ECI for three years from the end of the termination year, and (iv) comply with certain procedural requirements. <u>See generally</u> Treas. Reg. § 1.884-2T(a)(2)(i).

[33] Code § 897(c)(1)(B); Code § 1445(e)(3).

[34] Some practitioners have suggested that an interest in a partnership that survives the death of a partner is intangible property which should be subject to estate tax only if it represents an obligation enforceable against a U.S. partnership. Carlyn S. McCaffrey, <u>Tax Planning for Foreign Ownership of United States Homes</u> ACTEC Fall Meeting (Oct. 2012). The IRS has refused to rule on whether a partnership interest is intangible property for purposes of Code

because of the retained string provisions, the nonresident settlor must part with all dominion and control over the trust to avoid U.S. estate tax. A nonresident settlor of a foreign nongrantor trust ideally should not be a beneficiary of the trust and should not use the trust property unless he pays fair market rent to the trust. Despite these downsides, conduit structures may still make sense for some nonresidents. For example, if a nonresident wishes to use property held by an irrevocable trust without payment of rent, he may wish to make his spouse a beneficiary and rely on precedent that indicates that rent-free use of such property contemporaneously with a spouse beneficiary is not a retained interest.[35] **Although the balance of this article is dedicated to the corporate holding structures, Appendix A includes a chart of various real property holding structures, including their advantages and potential disadvantages.**

V. Payment of Rent to Corporation

When property held through a foreign corporation is used for personal purposes by a nonresident shareholder or his family members, the question of imputed rent and/or constructive distribution becomes relevant.

(A) Imputed Rent

Some commentators have suggested that the IRS might attempt to impute rental income to the corporation based on the transfer pricing rules of Section 482.[36] The imputed rent would be U.S. source income, taxable as FDAP or ECI. However, there do not appear to be any cases, rulings, or other guidance that take this approach. In addition, Section 482 by its terms only applies to allocations of income between or among commonly controlled entities, not to allocations between individual shareholders and corporations. Thus, it would seem that Section 482 would not be likely to apply in this situation.

(B) Constructive Distributions

In a 2012 case,[37] the Tax Court considered a situation where U.S. real property was owned by a U.S. subsidiary of a foreign corporation owned by a nonresident shareholder. The U.S. subsidiary was the common parent of an affiliated group of corporations filing a consolidated tax return in the U.S. The Tax Court held that the rent-free use of the corporate property by family members of the nonresident shareholder was a deemed distribution from the U.S. corporation to its foreign parent and then to the nonresident shareholder. Because the U.S. corporation had earnings and profits from the business activities of its U.S. subsidiaries, the deemed dividend from the U.S corporation was subject to U.S. withholding tax of 30%. The Tax Court stated that "[w]hen a shareholder or his family is permitted to use corporate property for personal purposes, the fair rental value of the property is includable in his or her income as a

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Section 2501(a)(2) (dealing with transfers of intangible property by a nonresident for purposes of the U.S. federal gift tax). Rev. Proc. 2013-7, I.R.B. 2013-1, § 4.01(28).

[35] Gutchess Est. v. Comm'r, 46 T.C. 554 (1966), acq. 1967-1 C.B. 2; Rev. Rule 70-155, 1970-1 C.B. 189.

[36] Michael J.A. Karlin & Stanley C. Ruchelman, Home Thoughts from Abroad: Foreign Purchases of U.S. Homes, 116 Tax Notes 863 (2007).

[37] G.D. Parker, Inc. v. Comm'r, T.C. Memo 2012-327 (2012).

constructive dividend to the extent of the corporation's earnings and profits…[and]…[f]or a corporate benefit to be treated as a constructive dividend, the item must primarily benefit the taxpayer's personal interests as opposed to the business interests of the corporation" (citations omitted).[38]

The Tax Court's holding seems to be consistent with the weight of authority in this area. From a review of the existing law, it seems well established that uncompensated use of corporate property by a shareholder may be treated as a constructive distribution from the corporation to the shareholder. While a few cases have characterized such use as gifts from the corporation to the shareholder, these cases are dated and seem to be outliers.[39]

In determining the nature of the constructive distribution, some courts have treated the corporation's depreciation charges and maintenance expenses as a constructive distribution, to the extent that they exceeded the rent paid by the shareholder.[40] The more typical result, however, is that the constructive distribution is the difference between the property's fair rental value and the amount paid by the shareholder for its use.

In IRS Field Service Advice (the "FSA") 199945017, the majority shareholder of an S corporation used a corporate asset on a rent-free basis after previously paying the corporation for use of the asset.[41] The IRS advised that this could be treated as a constructive dividend to the majority shareholder, as he personally benefited from the use of the asset. The amount of the constructive dividend was the fair rental value of the asset. This constructive dividend would be taxed the same as a dividend actually paid to the shareholder.[42]

The FSA is consistent with other rulings. The IRS's position is set forth most succinctly in Revenue Ruling 58-1.[43] In that ruling, the IRS stated that where shareholders are allowed to use an apartment owned by a corporation for below-market rent, the excess of the fair

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[38] Id. The personal use of corporate property also resulted in disallowance to the U.S. corporation of tax benefits generated by the property, such as depreciation or the investment tax credit, because the corporation was not using the leased property for business purposes.
[39] Moreover, the IRS has indicated that corporations generally do not make gifts. See IRS Field Service Advice 199945017 (August 11, 1999, re-released on April 29, 2005, with additional information) (see below discussion of this guidance).
[40] Riss & Company, Inc. v. Comm'r, T.C. Memo 1964-190 (finding that disallowed deductions for maintenance costs and depreciation on three residential properties occupied by the corporation's shareholder and members of the family were instead taxable distributions from the corporation to its shareholder to the extent the disallowed deductions exceeded rents paid), aff'd sub nom. Transport Mfg. & Equipment Co. v. Comm'r, 434 F.2d 373 (8th Cir. 1970) (affirming that deductions were properly denied on one of the three properties; holdings with respect to other two properties not appealed).
[41] IRS Field Service Advice Memoranda are nonbinding, taxpayer-specific rulings furnished by the IRS National Office issued in response to requests made by IRS officials in the field.
[42] The FSA also noted that if it was determined that the use of the asset was compensation to the majority shareholder, that the entire amount would be taxable as ordinary income and subject to applicable employment taxes and income tax withholding.
[43] 1958-1 C.B. 173.

market rent over the amount paid by the shareholder is treated as a distribution by the corporation and is includible in the shareholder's income, to the extent that it constitutes a dividend. The ruling goes on to confirm that the amount constituting a dividend is that part of the constructive distribution derived from the corporation's earnings and profits.[44] Although one commentator has suggested that rent-free use of corporate property by shareholders should *always* be treated as income to the shareholders,[45] case law is generally consistent in holding that shareholders must report the value of use of the property as a constructive distribution,[46] which could result in no tax liability to the shareholder (*e.g.*, if the corporation has no earnings and profits).

VI. Conclusions

If a nonresident shareholder of a foreign corporation uses real property held by the corporation without paying a fair market rent, the uncompensated use of the property may be treated as a constructive distribution by the corporation to the shareholder. This may or may not have adverse U.S. tax consequences.

Where the foreign corporation holds U.S. real property directly, a constructive distribution should generally have no U.S. tax consequence to the foreign corporation or the nonresident shareholder because neither are U.S. taxpayers and the distribution is not FDAP or ECI. In contrast, if the real property is held indirectly, through a U.S. subsidiary, as was the case in G.D. Parker, the constructive distribution could be subject to a 30% withholding tax if the U.S. corporation has earnings and profits. However, if the U.S. corporation holds no other income producing property, and if the U.S. real property is not rented, then the constructive distribution would generally not be taxable because the U.S. corporation would have no current or accumulated earnings and profits. This suggests that a U.S. corporation used for this purpose

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[44] See 58th St. Plaza Theatre, Inc. v. CIR, 195 F. 2d 724 (2d Cir.) cert. denied, 344 US 820 (1952) (lease to shareholder's wife); Nicholls, North, Buse Co. v. Comm'r, 56 T.C. 1225, 1238 (1971) ("It is well established that any expenditure made by a corporation for the personal benefit of its stockholders, or the making available of corporate-owned facilities to stockholders for their personal benefit, may result in the receipt of a constructive dividend.").

[45] David Elkins, Tax Consequences of Shareholders' Rent-Free Us of Corporate Property, 5 FIU L. Rev. 41, 78 (2009).

[46] Id. at 44; see also id. at n. 14 (listing numerous cases in which shareholder use of corporate property is found to be a constructive distribution). There are three cases going back to 1934, 1940 and 1958 in which courts held that the rental value was properly treated as a gift from the corporation to the occupying shareholders. As stated above, the IRS has indicated that corporations generally do not make gifts. See supra n. 38. In addition, commentators have indicated that given the subsequent case history and guidance from the IRS, these early gift characterizations were "questionable" and examples of the courts "dabbling" with the idea. See id. at 42-43 (stating that the courts "…dabbled with the idea that where the shareholder did not provide any services to the corporation, the free use of corporate property should be considered a tax-free gift to the shareholders…[but the courts] eventually decided that the rent-free use of corporate property by shareholders is properly classified as a constructive dividend."); Daniel M. Schneider, Characterization and Assignment of Corporate and Shareholder Income, 14 N. Ill. U. L. Rev. 133, n. 128 (1994) (citing the 1958 decision, but calling it "questionable").

should be a single purpose holding entity, with no other assets, and should not be included in any consolidated return with other U.S. corporations that could generate earnings and profits. If the U.S. corporation had no earnings and profits, a constructive distribution would reduce the foreign corporation's basis in the stock of the U.S. corporation. At some point the basis in the stock could be reduced to zero so that future constructive distributions would be gains taxable as ECI and subject to FIRPTA withholding (because the U.S. corporation is a USRPHC). It could be a long time before that would happen, though, and the property might be sold before then. Moreover, if the U.S. corporation were liquidated following a taxable sale of all of its U.S. real property, there is no authority for taxing the foreign corporation on the liquidating distribution, even if the foreign corporation's basis in the stock of its U.S. subsidiary is zero or near zero. This suggests that with the right structure, *i.e.*, a foreign corporation holding the real property directly or through a U.S. subsidiary that has no other income or assets, rent-free use of corporate-owned real property need not have any adverse U.S. income tax consequence.

There may, however, be some risk that the IRS could argue that a shareholder's failure to pay rent for U.S. real property held by a corporation could constitute a retained interest in the property, resulting in inclusion of the property in the taxable estate of a deceased nonresident shareholder. Code Section 2036 provides that the gross estate includes the value of property transferred without adequate consideration by the decedent *by trust or otherwise*, under which he has retained the right to designate the persons who shall possess or enjoy the property or the income therefrom. Code Section 2038 provides for inclusion in the gross estate of the value of property transferred *by trust or otherwise*, where enjoyment thereof was subject at the date of decedent's death to any change through the exercise of a power to alter, amend, revoke or terminate. Some practitioners have raised concerns that the IRS, emboldened by its recent successes in litigating cases involving family limited partnerships, might launch a similar attack against foreign corporations holding U.S.-situs assets used for personal purposes. There are, however, no cases or rulings to date applying either Code Section 2036 or 2038 to that situation.[47] Therefore, this potential concern does not appear at this time to justify the payment of rent, so long as the corporation observes corporate formalities so as not to be treated as the nonresident shareholder's alter ego.[48]

On the other hand, the payment of rent by the shareholder may offer a planning opportunity. A corporation holding U.S. real property will need to fund expenses associated with the property (taxes, insurance etc.). These expenses could be financed by capital contributions or loans by the shareholder, or they could be financed through rental payments. If the corporation collects rent for the property, it can claim deductions for depreciation, insurance, utilities, and other expenses that would not be deductible if the property were used solely for personal purposes. It may be the case that these deductions will result in a net tax loss to the corporation, particularly if the nonresident shareholder uses the property for only portions of the

[47] Fillman v. U.S., 355 F.2nd 632 (Ct. Cl. 1966); Estate of O.T. Swan v. Comm'r, 247 F.2nd 144 (2nd Cir. 1957); Strangi v. Comm'r, 417 F.3rd 468 (5th Cir. 2005) aff'g T.C. Memo 2003-145.

[48] It would also be helpful if the corporation is funded with cash and purchases the U.S. real property rather than the real property being contributed to the corporation, as in the former case, there is no transfer of a U.S. situs asset that could, even in theory, result in estate tax inclusion under Code Section 2036.

year (as opposed to paying a full year's rent). These losses can be carried over into future taxable years and be used against net income arising in those later years, including gain on the sale of the property. As a result, the overall U.S. income tax resulting from the corporation's ownership of U.S. real property could actually be lower if the nonresident shareholder paid rent for the periods of time that he used the property. Payment of rent would also avoid the risk that the IRS could assert that the rent-free use of corporate property was a constructive distribution potentially subject to U.S. income tax or a retained interest in the property potentially subject to U.S. estate tax. It would be prudent to run projections for revenue and expenses of the corporation before having a nonresident shareholder pay rent, but under the right circumstances, payment of rent by the corporation's shareholder could be a tax efficient way to fund the expenses of owning the property.

Nonresident U.S. Real Property Holding Structures For Personal Use Property					
	Directly or Revocable Trust	Foreign Corporation	U.S. Subsidiary (Single Purpose Entity) of Foreign Corporation	Partnership	Irrevocable Foreign Nongrantor Trust
U.S. estate tax	Yes	No	No	Maybe	No, if not a beneficiary and has no “retained strings” over trust
U.S. income tax of rental income	1. 30% withholding tax on gross basis unless NRA elects for income to be ECI taxed at net basis at individual tax rates of 10% - 39.6% 2. NRA files return and discloses all U.S. source income	1. 30% withholding unless foreign corporation elects for income to be ECI taxed at net basis at corporate tax rates of approximately 35% and foreign corporation files return (but NRA does not) 2. If ECI, potential 30% branch profits tax on “dividend equivalent amount” resulting in effective tax rate of 54.5%	1. Taxed at corporate tax rates of approximately 35% and U.S. corporation files return (but foreign corporation and NRA does not) 2. Dividends to foreign corporate parent subject to withholding tax at 30%	1. 30% withholding tax on NRA partner’s share of rental income unless partner elects for income to be ECI and partner must file return; NRA partner’s share of ECI is subject to withholding by partnership at 35% 2. No second-level tax imposed	1. 30% withholding tax unless trust elects for income to be taxed as ECI on a compressed rate schedule of 10%-39.6% and trust files a return disclosing all U.S. source income 2. Distributions of ECI to NRA beneficiary are deductible by trust but taxable to beneficiary; both trust and beneficiary must file returns
U.S. income tax on disposition	20% long-term capital gain rate available and FIRPTA withholding applies	1. No tax on disposition of foreign stock 2. Tax on disposition of U.S. real property at corporate tax rates of approximately 35% and FIRPTA withholding applies 3. Second-level branch profits tax can be avoided if corporation completely terminates its U.S. trades or businesses	1. Tax on disposition of U.S. real property but no FIRPTA withholding 2. Second-level dividend withholding tax can be avoided if U.S. corporation liquidates following sale	20% long-term capital gains rate available and FIRPTA withholding applies to partnership	20% long-term capital gains rate available and FIRPTA withholding applies to trust
Basis adjustment at death	Yes	No, only foreign stock gets basis step-up	No, only foreign stock gets basis step-up	Yes, if Section 754 election is made	No