Using a U.S. Trust for Your U.S. Real Property Investments and for Your U.S.-Based Family

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U.S. Estate Tax

An individual who is not a U.S. citizen or domiciled in the U.S. is subject to U.S. estate tax only on U.S.-situs assets. The estate tax is imposed on U.S.-situs assets that are held at death, gratuitously transferred within 3 years of death, or gratuitously transferred during lifetime, where the individual retained certain interests or powers over the transferred assets. Examples of U.S.-situs assets generally include shares of stock of a U.S. corporation, tangible personal property located in the U.S. (jewelry, furniture, paintings, etc.) and U.S. real property.

For such a non-U.S. individual, the federal estate tax is generally at 40% of the fair market value of the U.S.-situs assets (after the application of a $60,000 exemption). Therefore, even for a relatively modest real estate investment of $2 million, the estate tax is close to $800,000, making the U.S. tax authority, the IRS, a significant beneficiary of the client's U.S.-situs assets.

LLC Holding Real Property

An LLC that is 100% owned by one owner (be it an individual, a corporation or a trust) is a disregarded entity for U.S. tax purposes – this means that the LLC is simply treated as an extension of its sole owner and is not a separate taxable entity.

Therefore, if a non-U.S. individual holds U.S. real property through a wholly-owned LLC, for U.S. income tax and estate tax purposes, it is treated as if the individual holds the real property directly. As a result, the use of an LLC in this case offers no U.S. estate tax protection whatsoever.

Cautionary Tale

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Oftentimes when a non-U.S. client buys U.S. real property either to rent out for income or for personal use by the U.S.-based family members, a U.S. limited liability company ("LLC") would be mentioned as a possible holding vehicle. However, holding U.S. real estate directly through an LLC is exactly what not to do for a non-U.S. client, as discussed in this article.

U.S. Income Taxation on U.S. Real Property Sold by Foreigners

As a result of the Foreign Investment in Real Property Tax Act from 1986 (the "FIRPTA"), when a non-U.S. person sells or otherwise exchanges his U.S. real property interest, the gain is

treated as income that is effectively connected with a U.S. trade or business.

Basically, this means that the non-U.S. person is required to file a U.S. income tax return (and therefore, the need to apply and obtain a taxpayer identification number from the IRS) and the gain is fully subject to tax in the U.S. If the non-U.S. person is an individual or a trust, and if the real property is held for more than one year, the gains are eligible for the long-term capital gains rate, currently tops out at 20%. If the non-U.S. person is a corporation, then the capital gains are taxed at a flat rate of 21% at the federal level (plus possible branch profits tax at 30%).

While most non-U.S. clients intuitively understand and accept the capital gains tax when they sell the real property, what they do not realize is that the client is now required under the FIRPTA to file an income tax return with the IRS and obtain an IRS-issued taxpayer identification number (which many non-U.S. clients would prefer not to do).

In addition to the requirement to file an income tax return with the IRS, the FIRPTA also requires a 15% withholding on the gross sale proceeds of the real property, as a pre-payment for their capital gains tax, if the seller is not a U.S. person. The FIRPTA withholding is required even if the non-U.S. client has little gain or even a loss from the sale of the real property. However, the excess FIRPTA withholding tax can be recovered by the filing of an income tax return the following year. Because the U.S. income tax return is filed in the following year while the FIRPTA withholding tax is taken out at the time of the sale, there could easily be several months or more than one year of delay on the receipt of the excess-withheld tax. It is possible to apply to the IRS for a reduced withholding certificate prior to the sale, however it is time-consuming and costly to do so.

What is a Trust?

A trust is a legal arrangement whereby the person that creates and funds the trust (the "settlor" or the "grantor") transfers money or property to the trustee in trust for the beneficiaries. A settlor can be the sole trustee or a co-trustee. In addition, the settlor may also be a beneficiary. The rights and obligations of the settlor, the trustee(s) and the beneficiaries are spelled out in a document called the trust agreement or the trust deed.

U.S. Trust or Foreign Trust?

A trust is a treated as a U.S. trust if: (i) a court within the U.S. is able to exercise primary supervision over the administration of the trust (the "court test"). This effectively means that the trust must be formed in the U.S.; and (ii) only one or more U.S. persons have authority to control all substantial decisions of the trust (the "control test"). Substantial decisions mean those decisions governing the trust if they are not ministerial. Under the control test, as long as one foreign person has the right to make a substantial decision, a trust will fail the control test, thus becoming a foreign trust for U.S. income tax purposes even if the trust is formed in the U.S.

A trust that fails to meet either the court test or the control test is classified as a foreign trust for U.S. income tax purposes. A foreign trust is treated as a non-U.S.

individual for U.S. income tax purposes, and therefore, is subject to FIRPTA. A U.S. trust, on the other hand, is not subject to FIRPTA because FIRPTA only applies to non-U.S. persons.

What Should the Trust Agreement Say?

Basically, the settlor and the trustees may have whatever terms they can agree on to govern the proposed trust as long as the proposed terms do not violate the state law under which the trust is created.

However, if the trust is to be effective to block the U.S. estate tax for the non-U.S. settlor, the trust must be an irrevocable trust. In addition, the settlor may not be a beneficiary and generally must give up all control over the beneficial enjoyment of the trust's income and principal. This means that the settlor may not serve as the trustee or the protector (discussed later).

A typical arrangement is that the settlor would choose either a good personal friend (unrelated) who resides in the state where the desired real property is located or would use an independent trust company as the trustee. The children and the grandchildren (*i.e.*, the descendants) of the settlor will be the beneficiaries.

In addition to the trustee, generally the role of a protector is also provided in the trust agreement. The most important power of a protector is the power to remove and replace the trustee. Due to the irrevocable nature of the trust, the protector is there to change and replace the trustee if and when the need arises. The traditional choice of a protector is a U.S.-based trusted friend or advisor. The settlor may not serve as the protector.

While the conditions on the trust for the settlor may seem highly restrictive, these restrictions are not material if the trust is to acquire a real property to serve as the primary home for the U.S.-based children/grandchildren. While not officially beneficiaries of the trust, the settlor and the settlor's spouse may stay at the real property as guests of the beneficiaries when they come to the U.S. to visit the U.S.-based family.

The Beauty of a U.S. Trust in this Case

A properly drafted trust agreement eliminates the U.S. estate tax for the settlor and the beneficiaries for assets held by the trust – this means that no estate tax is triggered upon the death of the settlor or any of the beneficiaries.

Because the trust is a U.S. trust, the FIRPTA does not apply. When the trust sells the real property, there is no 15% withholding tax on the gross sale proceeds (though the trust is still required to file a tax return and pay the applicable tax on the capital gains).

In addition, because the trust is a U.S. trust, the U.S.-based beneficiaries are not required to pay rent to the trust to live in the real property and the trust is not required to file an income tax return with the IRS until it either sells the real property of has other sources of income.

From an asset protection point of view, because generally the spouses of the children are not beneficiaries, the assets inside the trust are also protected against spousal claims in case of a divorce (the spouse will

be permitted to reside in the real property as long as the spouse is married to a beneficiary and not legally separated). The trust is also generally effective in blocking the creditors' claims against the beneficiaries. This is especially desirable if a beneficiary is in a profession that is prone to law suits.

Using an LLC to Preserve Privacy and to Segregate Liabilities

In New York City, where many non-U.S. persons choose to buy their U.S. real property, the real property sales are recorded in a public data base on the internet. All relevant parties to a sale and its purchase price are easily searchable. A U.S. trust may form a wholly-owned LLC to acquire and hold the real property, so that only the LLC is shown in the public database as the owner (and not the trust or the beneficiaries).

In addition, if the trust plans to acquire multiple properties, it is advisable to hold each property in a separate LLC. This way, liabilities from one property are contained within that particular LLC and are not "spread" to the other LLCs of the trust.

An LLC that is 100% owned by the trust is a disregarded entity for U.S. income tax purposes, so the LLC is tax-neutral and there is no additional IRS tax filing requirement from the use of the LLC.

Importance of Funding the U.S. Trust with Cash

As a compliment to the U.S. estate tax, a U.S. gift tax is imposed on a non-U.S. individual if the gift is tangible personal property located in the U.S. at the time of the gift (jewelry, furniture, paintings, etc.) or U.S. real property. The gift tax rate is also 40% and there is no exemption amount for a non-U.S. individual.

Therefore, it is imperative that the non-U.S. settlor creates the trust and the LLC (if using) first. The settlor then funds the trust/LLC with cash (*i.e.*, a wire transfer). The trust/LLC is the one purchasing the real property. A wire transfer of cash is not considered to be a transfer of tangible property and therefore, the funding by the settlor this way does not trigger U.S. gift tax.

If the settlor buys the real property first, the transfer of the real property to the trust (in the absence of a sale at fair market value) will cause the transfer to be subject to U.S. gift tax.

As a trust typically takes one to two months to create, it is important to plan in advance.

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