Why an LLC or a Corporation is Not a Suitable Vehicle for a Personal-Use Property for Non-U.S. Buyers

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March 2018

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.

(The current federal estate tax exemption amount of $11.8 million is only for U.S. citizens and U.S.-domiciled individuals.)

The U.S. estate tax is a completely separate tax from the capital gains tax upon the sale of the real property. Therefore, if the non-U.S. owner dies the next day after closing on the purchase of the apartment, the estate tax is still due even though there is no appreciation on the real property and therefore, no capital gains tax would be due.

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

Cautionary Tale

Oftentimes when a non-U.S. client buys U.S. real property for personal use by the buyer's family members, he or she somehow is under the impression that a limited liability company ("LLC") or a U.S. corporation is the right vehicle. However, either of these vehicles produces highly undesirable tax results as discussed in this article.

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.

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%. In addition, there is generally an automatic 30% branch profits tax on the after-tax earnings (the dividend equivalent amount).

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 can be time-consuming and costly to do so.

What About Using a Corporation to Hold the Apartment?

A corporation (that is not a non-profit corporation that satisfied specific requirements of the U.S. tax law) is a business entity whose purpose is to engage in profit-making activities. Therefore, a corporation is by definition not in the business of providing free use of its corporate assets to its shareholder or to the family members of the shareholder. For example, a shareholder who owns 100 shares of the stock of General Electric Company would not expect to be able to use GE's corporate jet for free. The same logic also applies to the use of the corporate assets of a closely-held corporation. There is no such thing as a personal

holding corporation under U.S. tax concepts.

FMV Rental Payments Required for Use of Corporate Assets

For the IRS to respect the corporate structure for tax purposes, the shareholder must first respect the corporate structure. Otherwise, the IRS is free to pierce the corporate veil and to disregard the entire corporate structure completely, in which case, the shareholder is treated as owning the underlying real estate directly for U.S. tax purposes (even though the apartment is titled under the corporation).

Because a corporation is not in the business of providing free use of its assets to its shareholder or to the family members/friends of the shareholder, a fair market value rental payment must be paid for the use of the apartment by the shareholder or by any other person. The corporation is treated as being in the business of real estate rental. The rental payments, minus expenses and depreciation, are subject to federal income tax at a flat rate of 21%.

Since a personal-use apartment does not actually generate a real cash flow, using the corporate structure creates the situation of a tax liability without the corresponding cash flow.

Real Property Tax Depreciation Reduces the Apartment's Tax Basis and Increases Capital Gains at Sale

Because the apartment is a corporate business asset, it is required to be depreciated over 27.5 years. The tax depreciation has nothing to do with whether the apartment is actually increasing in value as the tax depreciation is a tax concept. In addition, the tax depreciation is mandatory.

For example, a $5 million apartment depreciated over 27.5 years has approximately $181,818 of depreciation a year. The depreciation, together with other expenses related to the apartment (*e.g.*, condo common charges, real property taxes, etc.) may be used to reduce the corporate income subject to tax. If the depreciation and other expenses exceed the rental income for that year, the excess is a net operating loss (the "NOL") for that year. The NOL may be carried forward indefinitely to reduce future corporate income (up to 80%). However, a corporate tax return must be timely filed with the IRS to preserve the NOLs.

The apartment's tax basis (for future capital gains calculations) is reduced by the amount of depreciation every year. When the apartment is finally sold, the gain portion subject to tax is increased because the tax basis has been reduced all these years by the depreciation.

Foreign Corporation vs. U.S. Corporation

A foreign corporation is taxed exactly the same way as a U.S. corporation – it is also required to file a tax return to report the rental income with the IRS in this situation. In addition, unlike a U.S. corporation, it is subject to an additional tax called the branch profits tax, generally at 30% of the after-tax earnings of the corporation (unless reduced by an applicable income tax treaty). British Virgin Islands, a popular choice for foreign corporations, does not have

an income tax treaty with the U.S. so the full 30% branch profits tax will apply.

The branch profits tax is automatically due if the corporation has taxable income (no distributions to the shareholder is required). It is possible to eliminate the branch profits tax if the foreign corporation is liquidated or if certain stringent IRS requirements are met after the termination of its U.S. business.

In addition, because a foreign corporation is a non-U.S. person, it is also subject to the 15% FIRPTA withholding on the sale proceeds of the apartment (not just on the gain portion). Even if the FIRPTA tax can be refunded after the filing of a tax return if the withheld amount exceeds its final tax liability, the corporation will lose use of this funds for many months or more than one year if the apartment sale takes place at the beginning of a calendar year.

The shares of a foreign corporation is not subject to U.S. estate tax while the shares of a U.S. corporation is fully subject to U.S. estate tax at about 40% of the fair market value of the shares. So a U.S. corporate holding structure not only incurs a high income tax, it also exposes the apartment to the U.S. estate tax at the death of the shareholder.

Corporation vs. U.S. Trust

Compared with a properly structured U.S. trust as a personal-use property holding vehicle, a corporation is simply not tax efficient as a holding vehicle for a personal-use property.

Proper Terms for U.S. Trust

If using a U.S. trust structure, the client must make sure that the drafting attorney is well versed in the international aspect of the settlor and/or beneficiaries. Tax rules differ for a non-U.S. settlor vs. a U.S. settlor and a trust that is appropriate for a U.S. settlor may not be for a non-U.S. settlor.

Final Thoughts

After the above analysis, it is clear that the a corporate/LLC structure is not a suitable choice for a personal-use property. A U.S. trust structure is a preferable choice for non-U.S. purchasers of personal-use U.S. real property.

While the initial cost of the trust set-up will be higher, the on-going tax benefit and the reduced IRS compliance burden from the trust structure still make it a preferred option in this case.

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