FIRPTA: Impacts of Entity Choice and Structure

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OCTOBER 23, 2019

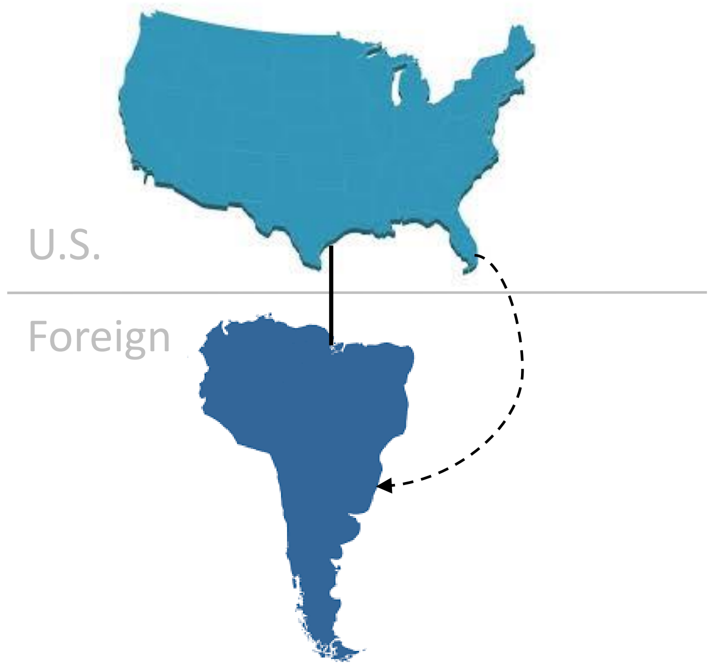
Introduction

International Tax Advisors, Inc. – Drew R. Edwards, CPA - Managing Owner

- Focused on tax strategy and planning
- Approaches include:
  - Structuring (e.g., choice of entity, funding, deferral, FIRPTA mitigation);
  - Incentives and credits (e.g., sec. 199A deduction, IC-DISC); and
  - Penalty reduction (e.g., correct compliance deficiencies, work with the IRS to request abatements)
- Assist attorneys, CPAs, and financial advisors with international tax planning for their clients
- Support entrepreneurs, small and mid-sized businesses
- Outdoor enthusiast

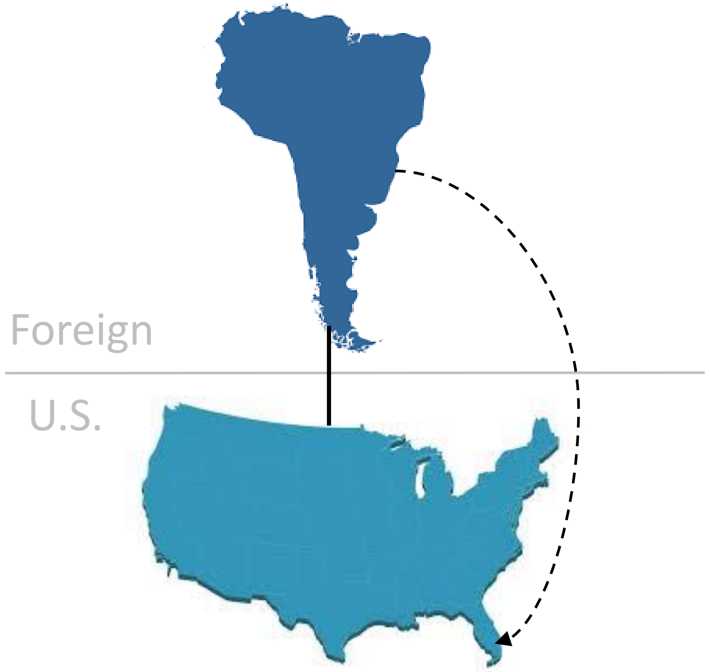
International

Structuring: Outbound vs. Inbound



<u>Outbound Taxation</u>

U.S.-based business or individual with operations aboard



<u>Inbound Taxation</u>

Foreign-based business or individual with U.S. operations

Structuring, Inbound: U.S. Taxation

Foreign individuals, nonresident aliens (“NRAs”), are generally subject to U.S. income tax only on their U.S. source income. 2 tax rates can apply:

1. U.S. trade or business exists – any effectively connected income (“ECI”) associated with the U.S. trade or business is taxed for a NRA at the same graduated tax rates as U.S. citizens; or
2. No U.S. trade or business exists – any fixed or determinable, annual, or periodic (“FDAP”) income (i.e., passive income such as interest, dividends, rents or royalties) is taxed at a flat 30% rate, unless a tax treaty specifies a lower rate

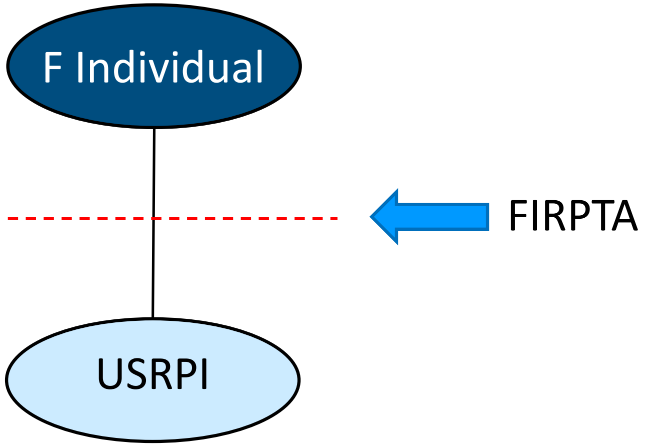
Exceptions: regardless of whether a NRA conducts a trade or business in the U.S., he/she may be deemed to have ECI under certain provisions:

- Section 897 – Disposition of U.S. real estate
- Section 996(g) – IC-DISC distributions

FIRPTA, Inbound

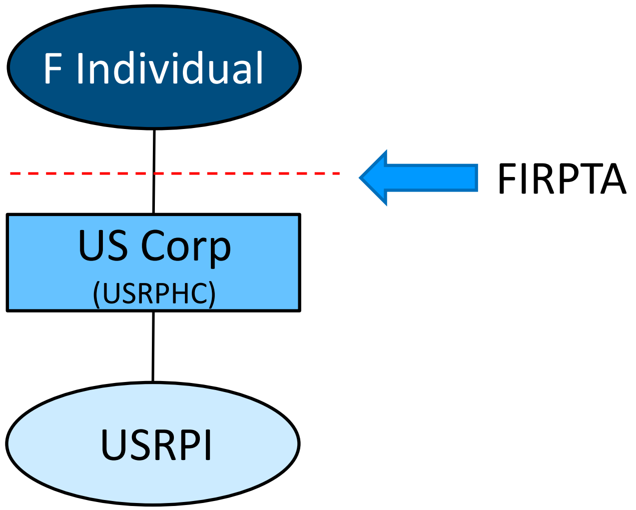
PLANNING APPROACHES -> INTERNATIONAL -> STRUCTURING -> FIRPTA, INBOUND

FIRPTA, Inbound: General



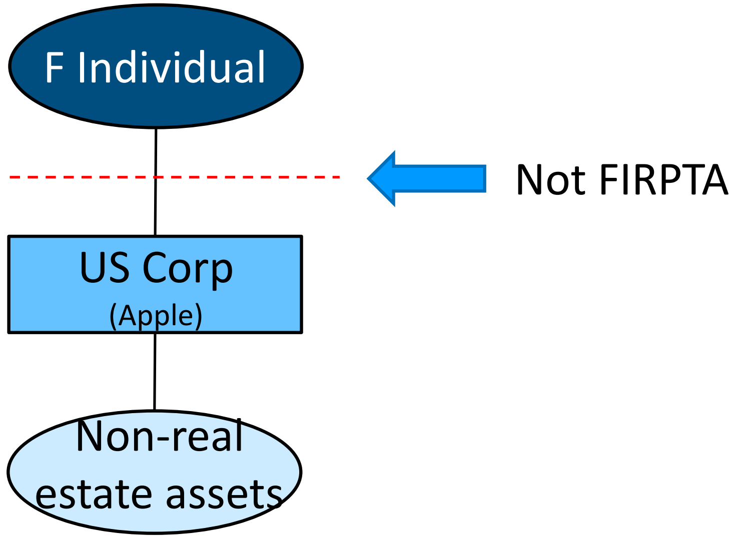
- The Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”), established section 897 to ensure foreign investors in U.S. real estate were not tax advantaged over domestic investors
- Section 897 – the gain/loss of a NRA or foreign corporation from the disposition of a U.S. real property interest (“USRPI”) shall be taxed as if the foreign person were engaged in a U.S. trade or business and the gain/loss treated as effectively connected income (“ECI”)
- Section 1445 – 15% gross withholding tax applies to section 897 dispositions

FIRPTA, Inbound: USRPHC



- Section 897(c)(2) - USRPI includes entities comprised 50% or more of real estate based on FMV (defined as a U.S. Real Property Holding Company, “USRPHC”)
- USRPHC is considered a USRPI for 5yrs after the disposition of real estate interest - §897(c)(1)(A)(ii)(II)

FIRPTA, Inbound: Non-USRPHC



- Section 865 – income from the sale of personal property by a foreign person shall be foreign source (personal property includes stock)
- Section 864(b)(2)(A) – Stock Trading Safe Harbor

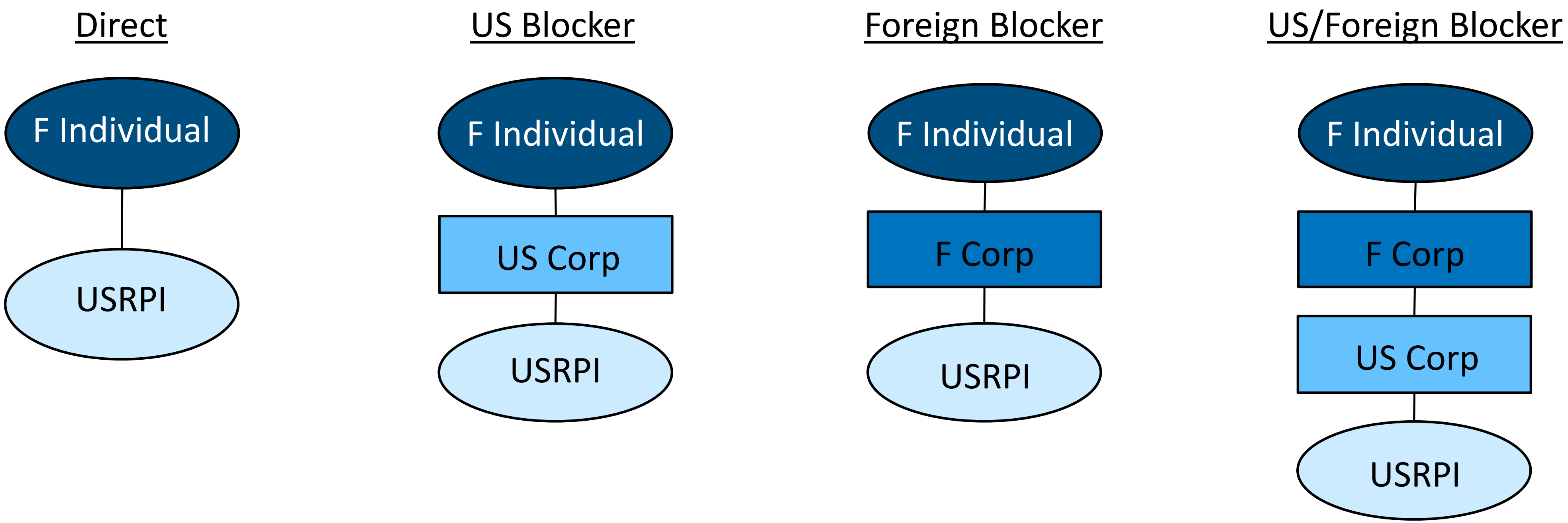
FIRPTA, Inbound: Exceptions

- Under $300k sales price to buyer using as a residence – §1445(b)(5)
- Transferee receives a qualifying statement – §1445(b)(4)
- Non-recognition transaction – Treas. Reg. §1.897-6T(a) and (b)
- Cleansing exception for USRPHC – §897(c)(1)(B)

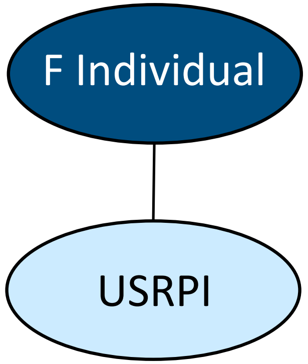
Entity Choice, Inbound

PLANNING APPROACHES -> INTERNATIONAL -> STRUCTURING ->ENTITY CHOICE, INBOUND

Entity Choice, Inbound: Options

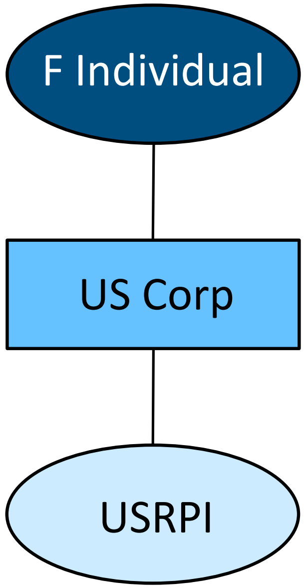


Entity Choice, Inbound: Direct Purchase



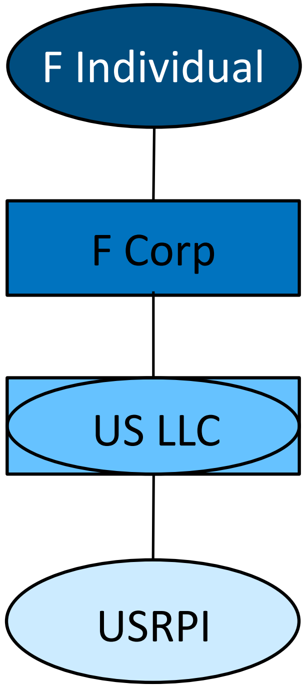
- *Scenario- Purchase of U.S. real estate directly. Suggestion is for F Individual to hold in his/her name*
- **Pros:**
  - One level of tax
  - Reduced administrative burden
  - No state business income tax
- **Cons:**
  - U.S. tax filing requirement on income effectively connected with a U.S. trade or business (Rental real estate? Triple net lease?)
  - FDAP (gross rental income and dividends) 30% withholding tax applies upfront; subsequently taxed on net income at graduated rates when activities arise to the level of a U.S. trade or business (top 37% rate for F Individual)
  - Upon sale, FIRPTA withholding at 15% of amount realized unless reduced by withholding certificate
  - 40% Estate tax applies
  - No legal liability protection

Entity Choice, Inbound: US Blocker



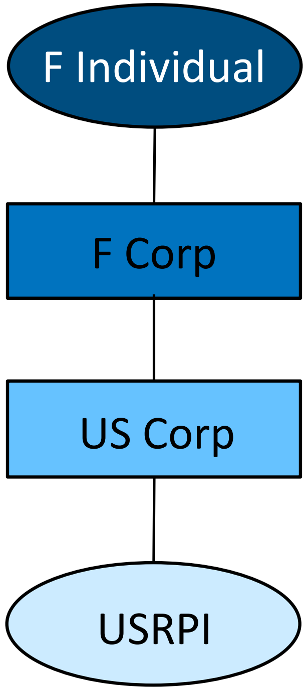
- *Scenario- F Individual wishes to block the attribution of a U.S. trade or business which gives rise to U.S. tax filing requirements. Suggestion is for F Individual to hold the investment through a U.S. corporation*
- **Pros:**
  - F Individual should have no U.S. tax filing or reporting requirements
  - Legal liability protection
  - Flexibility in triggering 2nd layer of tax, potential for deferral (rate arbitrage, 37% -> 21%)
  - Upon sale, potential to mitigate FIRPTA withholding with only one layer of U.S. tax resulting -> cleansing exception
- **Cons:**
  - 2 layers of tax, U.S. corporate tax (21%) and FDAP withholding (30% on gross)
  - Plus state corporate taxes (5.5% FL), effective tax rate ("ETR") = 49%
  - U.S. tax filings are still required; but for US Corp rather than F Individual
  - 40% Estate tax applies

Entity Choice, Inbound: Foreign Blocker



- *Scenario- Estate lawyer recommends a foreign blocker to prevent U.S. Estate tax application*
- **Pros:**
  - Successfully blocks 40% Estate tax
  - Legal liability protection
  - F Individual should have no U.S. tax filing or reporting requirements
  - US LLC, as a disregarded entity has no direct US tax filing (passes on to F Corp)
  - Upon sale, potential to mitigate FIRPTA withholding with only one layer of US tax resulting – complete termination exemption (Treas. Reg. §1.884-2T(a))
- **Cons:**
  - 2 layers of tax, U.S. corporate tax (21%) and branch profits tax ("BPT") (30% on net)
  - F Corp likely has a U.S. filing req

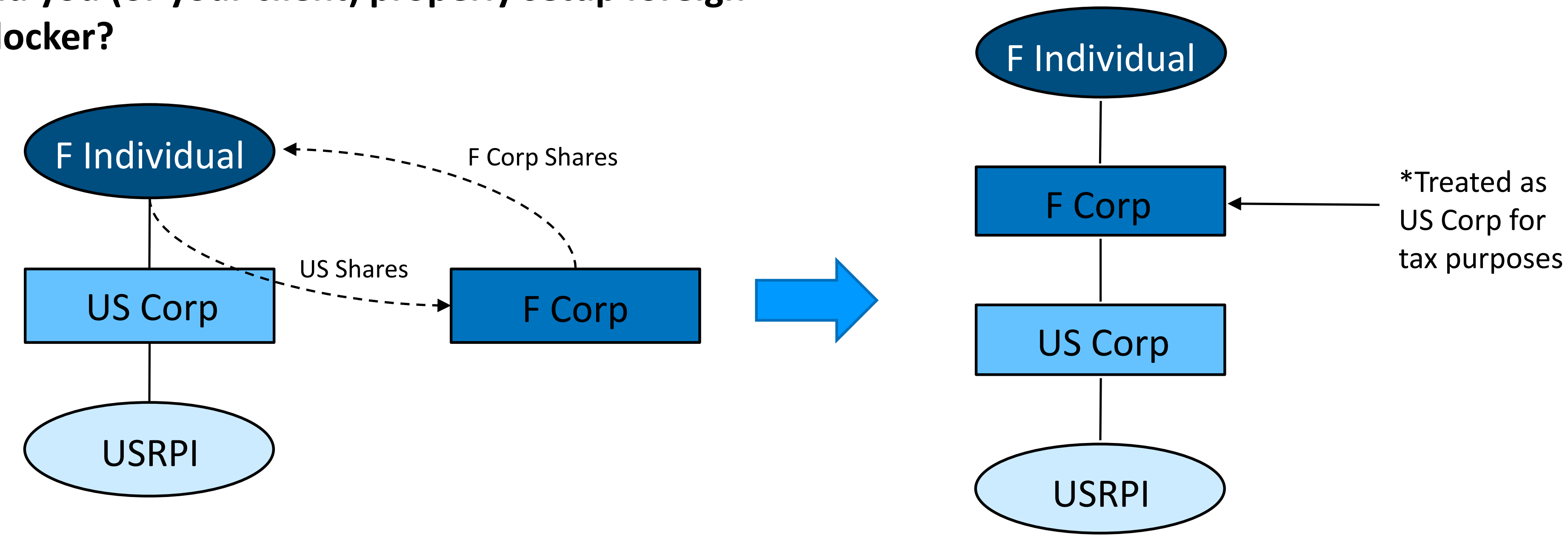
Entity Choice, Inbound:
US and Foreign Blockers



- *Scenario- A foreign individual purchases property through US and Foreign corporate blockers*
- **Pros:**
  - Successfully blocks 40% estate tax
  - Legal liability protection
  - No U.S. tax consequences to F Individual
  - Flexibility in triggering 2nd layer of tax, potential for deferral
  - Upon sale, potential to mitigate FIRPTA withholding with only one layer of US tax resulting -> cleansing exception
- **Cons:**
  - 2 layers of tax, U.S. corporate tax (21%) and FDAP withholding (30%* on gross)
    - Plus state corporate tax
    - * Treaty could lower 30% withholding rate
  - U.S. tax filings are still required; but for US Corp rather than F Individual
  - **BEWARE!** → Inadvertent Inversion
    - How did you set up the F Corp blocker?
    - Was the US Corp preexisting?
    - If yes, estate tax may still apply

Entity Choice, Inbound: Inadvertent Inversion

Did you (or your client) properly setup foreign blocker?



- If 80% of the value of the F Corp shares received came from the contribution of US shares = **§7874(b) INVERSION!**
  - F Corp taxed as a domestic corporation – subject to ww taxation
  - F Corp shares considered US situs asset – subject to estate tax 40%

- If 60% of the value came from the US shares
  - Surrogate Foreign Corp
  - Lose U.S. tax attributes: tax credits, net operating losses

Inversions

Section 7874

- American Jobs Creation Act of 2004 added Section 7874 – effectively negating the tax benefits of inversions into tax haven parent corporations (the first step in avoiding the worldwide tax imposed by the U.S.)
- On July 11, 2018, the IRS released final regulations addressing "inversions"—the generic term for a domestic corporation's adoption of a foreign-parented corporate structure
- The Final Regulations primarily adopt temporary regulations issued on April 4, 2016

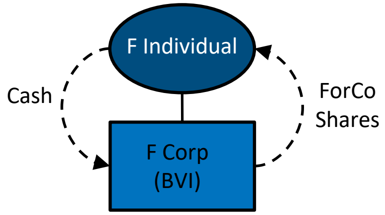
Rules

- Expatriated entities are disallowed certain losses and credits, plus any pre-inversion gains can be subject to pre-2018 tax rates or worse the new foreign parent is treated as a U.S. corporation for all purposes of the IRC (including estate tax)
- Expatriated entity = domestic corporation or domestic partnership with a surrogate foreign corporation
- Surrogate foreign corporation = the entity acquires substantially all of the properties held by the domestic corp/pship
- If after the acquisition, former shareholders own at least:
  - 60% of the surrogate foreign corporation – denied losses, lose credits
  - 80% of the surrogate foreign corporation – the foreign entity is treated as a domestic corporation
- A lack of substantial business activities in the foreign country must exist to be considered a surrogate foreign corporation
  - Substantial when compared to the total business activities of the expanded affiliated group

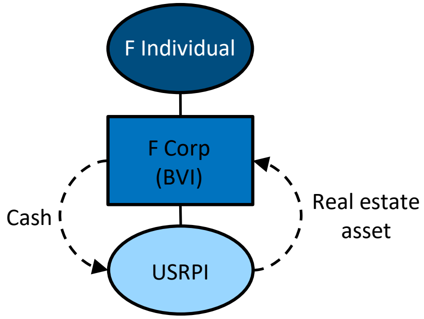
Mitigating Inversions, Pre-Acquisition

Prior to Acquiring U.S. Property

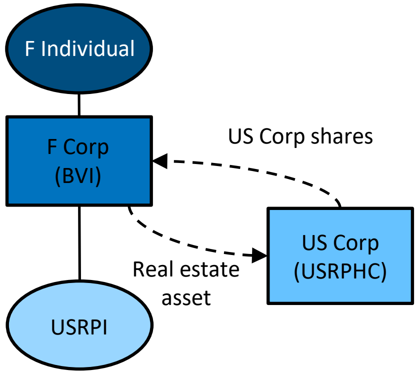
- Sequence is important



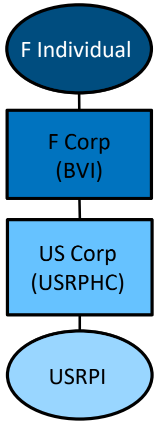
1. Foreign Individual establishes a new foreign corporation (F Corp) by contributing cash in return for shares in F Corp



2. Foreign corporation uses cash to purchase U.S. assets



3. Foreign corporation establishes a new U.S. corporation (US Corp) by contributing U.S. real estate assets in return for shares in US Corp



4. From inception, US Corp is owned by F Corp, no transfer by “former shareholders”

Mitigating Inversions, Post-Acquisition

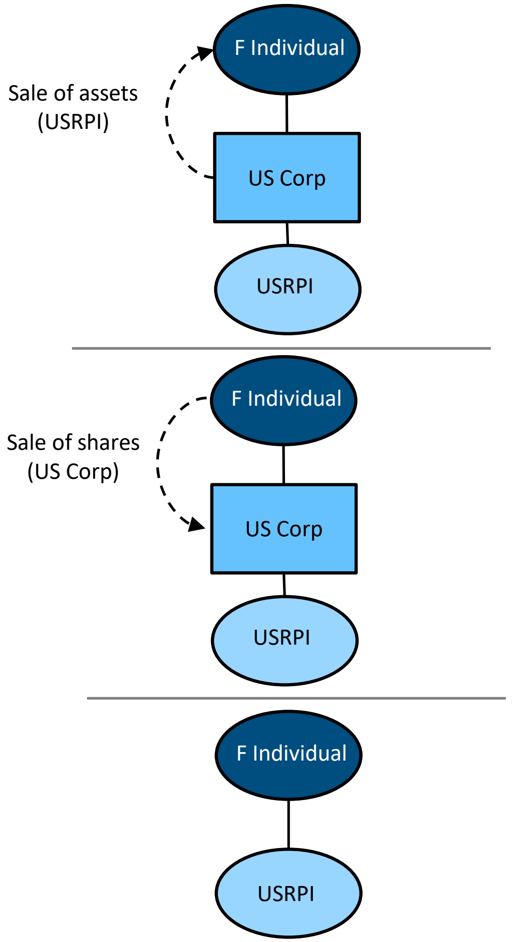
Post Acquisition of U.S. Property

- Reduce the former shareholders interest in the potential surrogate foreign corporation below 60%
  - Introduce new shareholders, vote vs. value rights
- Reduce the proportionate value of U.S. property contributed to the potential surrogate foreign corporation by including non-cash, non-U.S. property held elsewhere by the former shareholders
  - Cash-box and "anti-stuffing" rules are included in the Regulations to prevent diluting the value of U.S. assets with cash and similar assets
- Liquidate the U.S. corporation or partnership and execute the structure using proper sequence
  - Gains/losses and other tax consequences can be triggered upon liquidation

Liquidation

Non-corporate shareholder liquidation

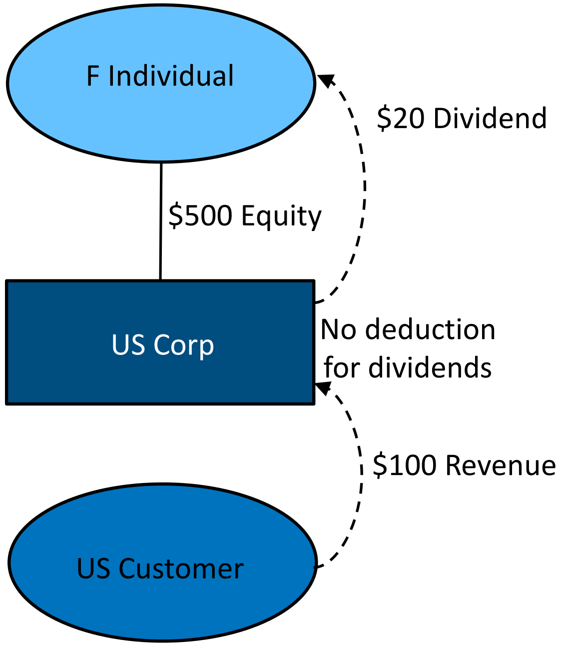
- Step 1 – US Corp deemed to sell all of its assets at FMV (section 336)
  - Gain/loss recognized by US Corp
- Step 2 – Shareholders (F Individual) deemed to sell their interest in US Corp (section 331)
  - Gain/loss recognized by shareholders (section 1001)
- Result – F Individual holds U.S. assets (real estate) directly



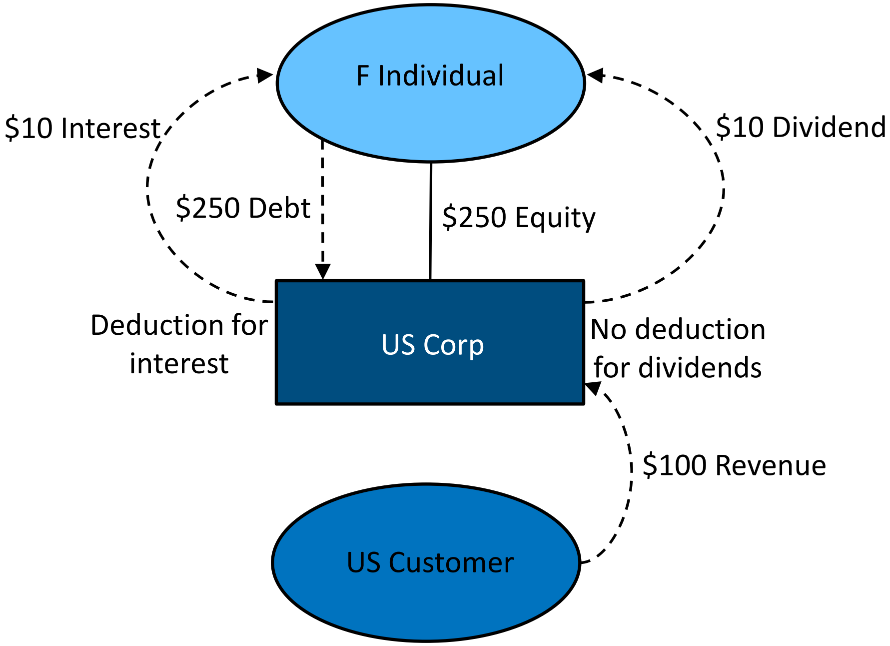
Funding, Inbound

PLANNING APPROACHES -> INTERNATIONAL -> STRUCTURING -> FUNDING, INBOUND

Funding, Inbound: Debt vs. Equity



US Corp, $100 (taxable income) x 21% (corp tax) = $21 US corp level tax



US Corp, $90 (taxable income) x 21% (corp tax) = $18.90 US corp level tax

Interest Expense Limitations

Section 163(j)

- Proposed regulations issued November 26, 2018
- Limits deductions for interest to 30% of ATI
- Only applies if gross receipts >=$25M
- Exceptions for Electing Real Property Trade or Business
  - Section 469(c)(7), active owners who materially participate
  - 11 activities qualify (e.g., development, acquisition, rental, operation, management)
  - Election made on a trade/businesses basis, not necessarily entity basis
- Foreign corporations (Treas. Reg. §1.163(j)-7)
- Foreign persons with ECI (Treas. Reg. §1.163(j)-8)
- Elections for excepted businesses (Treas. Reg. §1.163(j)-9)

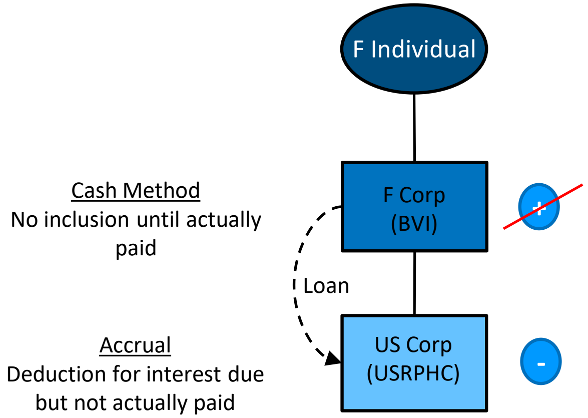
Application to foreign persons

- Unlike U.S. citizens who are taxed on worldwide income, generally, a NRA is taxed only on his/her ECI (section 872)
  - Deductions allowed to the extent they are connected with ECI

Interest Expense Limitations Cont.

Section 267

- Deduction must be matched with payee income – section 267(a)(2)
- Accrual method in U.S., cash method in foreign country = disallowed deductions – section 267(a)(3)



THANK YOU

Questions?

Presenter

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Education, licenses and certifications

- BA, University of Florida - 2003
- Master of Accounting, University of Florida - 2005
- CPA Licensed in Florida
- QuickBooks Certified

Professional Experience

- Drew is a CPA with more than 14 years of international tax consulting experience. Drew spent the majority of his career working within the "Big 4" accounting firms, most recently as a Senior Manager with KPMG
- Drew currently advises clients on a variety of tax matters, such as mergers, acquisitions, joint ventures, reorganizations and real estate specific transactions
- Drew also advises businesses on efficient tax strategies, including entity choice, state and local tax planning, incentives and credits, and estate tax
- Drew focuses on increasing after-tax profits of individuals and businesses through planning and global tax strategy