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Court decisions on FATCA reporting and corporate ownership of real estate

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Introduction

Transparency and attention to detail are the hallmarks of modern succession planning for international families. The Internal Revenue Service (IRS) chief recently said that implementation of the withholding tax under the Foreign Account Tax Compliance Act (FATCA) designed to penalise offshore tax evasion by Americans will not be delayed again beyond its July 1 effective date. As advisers to international families review succession planning structures to determine each foreign entity's FATCA classification, in order to avoid the 30% withholding tax, consideration should be given to whether each entity has been maintained in a manner consistent with the hoped-for income and estate tax results. Non-US individuals should also be prepared for information about their US bank accounts to be reported to their home country's tax authorities.

Court upholds reporting of US accounts held by non-resident aliens

On January 13 2014 the US District Court in the District of Colombia dismissed a case filed by two state bankers' associations challenging 2012 amendments to the Treasury Department's interest-reporting regulations. The court upheld the amendments, finding that the IRS:

> *"reasonably concluded that the regulations will improve US tax compliance, deter foreign and domestic tax evasion, impose a minimal reporting burden on banks, and not cause any rational actor – other than a tax evader – to withdraw his funds from U.S. accounts."*

The regulations support reciprocal reporting between countries under FATCA. US banks are now required to report to the IRS any information about accounts earning more than $10 of interest that are held by non-resident aliens from all countries which the United States has a tax treaty or other information exchange agreement. These new reporting requirements allow the United States to respond to requests from its treaty and exchange partners and to implement the reciprocal FATCA intergovernmental agreements being entered into with countries such as Costa Rica, Ireland, the Isle of Man, Jersey, Malta, Mexico, the Netherlands and the United Kingdom (for further details please see "FATCA update: planning for compliance within structures for international families").

Tax Court disallows deductions

Estates of individuals who were not US citizens and who were not residents in the United States at the time of their deaths are subject to US estate tax only on assets deemed situated in the United States (for further details please see the "Overview (May 2013)"). US situs assets for estate tax purposes include US real estate, but not the stock of non-US corporations. Thus, to avoid US estate tax when buying a US home, a non-resident alien will often capitalise an offshore corporation, which will then purchase the US real property, either directly or through a US corporate subsidiary. A US Tax Court case, *Parker v Commissioner* (TC Memo 2012-327), illustrates the importance of understanding the US income tax effects of such a structure, and serves as a reminder that corporate formalities should be respected and business purpose not be disregarded.

Facts

Mr Parker, a citizen of Peru, owned Vicmar, a foreign corporation. Vicmar owned 100% of Vilanova, SA, a Panama corporation. Vilanova owned 100% of GD Parker, Inc, a Florida corporation. GD Parker owned shares of several other corporations formed in the United States. One of the corporations was M Vanini Investments, Inc, a Florida corporation. Vanini owned a 23-room single-family personal residence in Florida. Parker and his family used the residence and did not pay rent to Vanini. Vanini also owned a personal residence in Spain that Parker and his family used rent-free. The administrative assistant for the GD Parker Administrative Group used an office in the Florida residence for her work. Vanini took deductions for repair and maintenance expenses and depreciation.

Decision

The court held that holding property in a corporation does not automatically create deductions for residence expenses and depreciation. Trade or business activity is needed for deductions to be allowed. The Tax Court denied the corporate deductions to the extent that they were not attributable to the office. The court explained that the properties were held for the personal use of the shareholder, and not for the profit-motive of the corporation. As such, the expenses were not ordinary and necessary trade or business expenses.

In addition, the court held that a shareholder's personal use of the property rent free would constitute a deemed distribution from the US corporation to its foreign parent corporation, with additional deemed distributions through the entire ownership chain down to the individual shareholder. The amount of the deemed distribution was the fair rental value of the personal use. The Tax Court determined that the personal use of the corporation's property by Parker and his family constituted a corporate distribution to Parker. The court also found that a withholding tax was due on the distribution from the US corporation (ie, GD Parker) to its foreign parent (ie, Vilanova), since the distribution did not constitute income effectively connected to a US trade or business and was paid to a non-US person.

Considerations for tax planning

Parker v Commissioner highlights the importance of respecting the substance of this commonly used corporate structure to own US real estate and understanding its income tax consequences. The owner of the property is the corporation, not the individual, and the individual should not treat the property as though he or she is the owner.

The corporation should collect fair market rent for use of the property. Careful determination of market rent and an actual rent payment are key, rather than a book entry inclusion of rental income on the tax return of the US corporation (which occurred in *Parker*). The corporation will have income from its rental business, which may be offset by ordinary and necessary deductions for depreciation and expenses. The net income is subject to US income tax. If the owner is a foreign corporation, there could be an additional branch profits tax on the income.

Failure to collect rent can result in a deemed distribution equal to the fair rental value of the personal use. A distribution is classified as a dividend for US tax purposes if the corporation has earnings and profits. Absent an applicable tax treaty, if a non-US shareholder is to be paid a dividend, that dividend is subject to a 30% withholding tax. Thus, if the US subsidiary is deemed to pay a dividend to its foreign parent, it will be required to pay the US withholding tax. Even if the corporation has no earnings and profits, the deemed distribution will be treated as either a return of capital or capital gain. The foreign parent's basis in the subsidiary stock will be reduced on receipt of the distribution. If the basis is eventually reduced to zero, further distributions will be taxed as dispositions of stock. While a non-resident alien's disposition of US stock generally does not give rise to tax in the United States, disposition of stock of a US corporation that owns US real estate is subject to US income tax under the Foreign Investment in Real Property Tax Act rules (for further details please see "Foreign investment in US real property: buyers beware").

It is also important to keep in mind that a corporation is not entitled to the lower long-term capital gains tax rate. If the corporation disposes of the property, it will be subject to US income tax at ordinary income tax rates. Moreover, if a foreign corporation owns the real estate directly, the disposition will be subject to withholding under the Foreign Investment in Real Property Tax Act, which is generally equal to 10% of the proceeds from the sale.

FATCA's impact on investments in US real property through holding companies

When a non-resident alien invests in US real property through a structure that includes one or more non-US entities, the family adviser must now consider two possible FATCA implications:

- whether an entity in the structure is a foreign financial institution subject to FATCA compliance; and
- whether a distribution from an entity is a FATCA withholdable payment.

An offshore entity that owns a single US home directly will most likely not be classified as a foreign financial institution unless, in addition to the real estate, the entity holds financial investments that amount to 50% or more of the total assets. Likewise, an investment fund where the assets consist solely of non-debt, direct interests in real property located in and outside of the United States is not a foreign financial institution for FATCA purposes, even if it is managed by a professional investment manager, because less than 50% of its gross income is attributable to investing, reinvesting or trading in financial assets. On the other hand, an offshore entity that owns real estate investments through other entities (eg, through a partnership) may be considered to hold financial assets, rather than direct investments in real estate and, therefore may be classified as a foreign financial institution. Such entities will have to consider their FATCA classification for purposes of complying with the FATCA intergovernmental agreement between the country where the entity is organised and the IRS.

In addition, the FATCA final regulations provide that a distribution from a US real property holding corporation with respect to its stock that is a US real property interest may be a payment subject to FATCA withholding. The family adviser should ensure that each non-US entity in the structure can complete a certificate of status for purposes of FATCA and other withholding.

Comment

Parker v Commissioner illustrates that the lifetime management of estate planning structures is critical. If the structure is disregarded by the IRS, the individual will be considered to own the real estate directly and, at death, the value of the real estate will be includable in the decedent's US estate, notwithstanding that it was owned through a foreign corporation. If the individual pays fair market rent to the corporation, the likelihood of the form being disregarded is minimised. To reduce the risk that the corporate form will be disregarded, it is important that all corporations in the structure maintain corporate formalities and be managed as independent corporate entities apart from the shareholder. The corporation boards should include third-party directors and not act as mere nominees for the shareholder. The directors should keep a minute book and record decisions made with respect to the company's rental property. Knowing the FATCA classification of each non-US entity, and complying with registration and due diligence requirements under an intergovernmental agreement or the FATCA final regulations, also supports the corporate formalities and prevents the imposition of the FATCA withholding tax.

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