From Russia, with money

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On May 6, 2012, the French elected Socialist FranÃ§ois Hollande as president. One campaign goal was a 75 percent tax rate on those earning more than 1,000,000 ($1,300,000) per year, a marked increase from the previous rate of 48 Percent. This resulted in the much publicized departure of actor Gerard Depardieu to Russia. Less publicized was the move of France's richest man, Bernard Arnault (worth $42 billion) to Belgium.

Due to the French upheaval, we bought a NespressoÂ® machine, and the flood of inbound French clients has praised the quality of our espressos, cappuccinos and lattes. What we did not expect is the number of in-bound clients from Russia. They too love the espresso. However, they are not fleeing high tax rates. They seek California's stability, culture and economics, along with the 600,000 friendly faces of the existing 600,000 greater-L.A. Russian-speaking community. (No estimates for San Francisco or other cities were easily available.)

Some of these investors intend to become U.S. residents or citizens. Others simply want to invest. Many who intend to become residents or citizens are investing on behalf of relatives who will remain in Russia. These folks are sophisticated. They want to know, in advance, how to structure their acquisition of U.S. real property. Although the following discussion was prompted by this particular influx, the alternatives are equally applicable to the continuing flow of in-bound investors from China, Korea, Canada, India, Germany and Egypt, to name the ones we have seen most recently.

There are three main approaches for a noncitizen, nonresident (NCNR) to acquire U.S. real property. (We will assume that the property does not put the NCNR in the position of engaging in a trade or business, e.g., the property is not a hotel.) None is perfect. So there is no substitute for meeting with the client and discussing all of the client's goals and objectives to determine which might be best for that particular client.

The first alternative is the simplest: direct ownership as an individual of the real property. KISS. In addition to the advantage of no complications, there is only one level of tax in the event of a later sale, and the sale will result in capital gain, assuming the usage and holding period rules are met. However, one group of disadvantages is that the individual must file U.S. and possibly state and local tax returns, and NCNRs prefer to avoid being caught in the U.S. filing web. Also, on the NCNR's death, that U.S. situs property will create a U.S. taxable estate. In contrast to the $5,250,000 lifetime exclusion for U.S. citizens and residents, the NCNR has only a $60,000 exclusion, making it more likely that a federal estate tax return (IRS Form 706) must be filed and a federal estate tax (currently 40 percent) will have to be paid. Note that this alternative - direct investment - includes investment through a pass-through entity, such as a partnership, or through a disregarded entity such as a single-member LLC. These are preferable to achieve privacy (if a fictitious name is used) and liability protection for the NCNR.

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The second alternative is for the NCNR to invest in a U.S. corporation which owns the U.S. real estate. (The corporation will be a "C" corporation; an NCNR cannot own stock in an "S" corporation.) There at least four advantages: (i) liability protection from problems occurring at the property; (ii) privacy; (iii) the NCNR need not file a U.S. return; and (iv) no U.S. gift tax return is due on gifts of stock in the U.S. corporation. There are several disadvantages: (i) stock in a U.S. corporation creates a taxable estate for the NCNR; (ii) two levels of income tax (state and federal at the corporate level and a "branch profits tax" on dividends to the shareholder); (iii) sale of stock in a U.S. real property holding corporation will require a return and 10 percent withholding; and (iv) long-term capital gains rates are unavailable to the corporation when it sells the real estate.

A variation on this second alternative is for the NCNR to own stock in a foreign corporation which, in turn, owns the stock in the U.S. corporation. That improves the results because the U.S. stock will not create a taxable estate at the NCNR's death. As a result, many clients prefer this alternative.

The final alternative is for the NCNR to own the stock of a foreign corporation which owns the U.S. real property. This is an attractive approach: (i) liability protection and privacy for the NCNR; (ii) no U.S. income tax or filing requirements for the NCNR for on-going operations or on disposition of the stock; (iii) dividends are not subject to U.S. withholding; (iv) refinancing distributions are tax free; and (v) transfers of the stock during lifetime or at death are not subject to U.S. gift or estate tax. The disadvantages are: (i) profits and gains from the property are subject to the branch profits tax; (ii) there are two levels of income tax (the regular corporate tax and the branch profits tax); and (iii) the corporation will have to file a U.S. return.

One problem with tax planning involving other countries is that the U.S. has 67 income and 18 estate and gift tax treaties. A treaty pre-empts the otherwise applicable Internal Revenue Code provision. So we must review the treaty or treaties applicable to each particular client.

If we wish to welcome the incoming money "From Russia With Love" (1963, the second Bond film starring Sean Connery), we must be able to explain the alternative ways to structure the investment, and customize it for each particular client.

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