



Wolters Kluwer



## GLOBAL TAX WEEKLY a closer look

ISSUE 188 | JUNE 16, 2016

**SUBJECTS** TRANSFER PRICING INTELLECTUAL PROPERTY VAT, GST AND SALES TAX CORPORATE TAXATION INDIVIDUAL TAXATION REAL ESTATE AND PROPERTY TAXES INTERNATIONAL FISCAL GOVERNANCE BUDGETS COMPLIANCE OFFSHORE

**SECTORS** MANUFACTURING RETAIL/WHOLESALE INSURANCE BANKS/FINANCIAL INSTITUTIONS RESTAURANTS/FOOD SERVICE CONSTRUCTION AEROSPACE ENERGY AUTOMOTIVE MINING AND MINERALS ENTERTAINMENT AND MEDIA OIL AND GAS

**COUNTRIES AND REGIONS** EUROPE AUSTRIA BELGIUM BULGARIA CYPRUS CZECH REPUBLIC DENMARK ESTONIA FINLAND FRANCE GERMANY GREECE HUNGARY IRELAND ITALY LATVIA LITHUANIA LUXEMBOURG MALTA NETHERLANDS POLAND PORTUGAL ROMANIA SLOVAKIA SLOVENIA SPAIN SWEDEN SWITZERLAND UNITED KINGDOM EMERGING MARKETS ARGENTINA BRAZIL CHILE CHINA INDIA ISRAEL MEXICO RUSSIA SOUTH AFRICA SOUTH KOREA TAIWAN VIETNAM CENTRAL AND EASTERN EUROPE ARMENIA AZERBAIJAN BOSNIA CROATIA FAROE ISLANDS GEORGIA KAZAKHSTAN MONTENEGRO NORWAY SERBIA TURKEY UKRAINE UZBEKISTAN ASIA-PAC AUSTRALIA BANGLADESH BRUNEI HONG KONG INDONESIA JAPAN MALAYSIA NEW ZEALAND PAKISTAN PHILIPPINES SINGAPORE THAILAND AMERICAS BOLIVIA CANADA COLOMBIA COSTA RICA ECUADOR EL SALVADOR GUATEMALA PANAMA PERU PUERTO RICO URUGUAY UNITED STATES VENEZUELA MIDDLE EAST ALGERIA BAHRAIN BOTSWANA DUBAI EGYPT ETHIOPIA EQUATORIAL GUINEA IRAQ KUWAIT MOROCCO NIGERIA OMAN QATAR SAUDI ARABIA TUNISIA LOW-TAX JURISDICTIONS ANDORRA ARUBA BAHAMAS BARBADOS BELIZE BERMUDA BRITISH VIRGIN ISLANDS CAYMAN ISLANDS COOK ISLANDS CURACAO GIBRALTAR GUERNSEY ISLE OF MAN JERSEY LABUAN LIECHTENSTEIN MAURITIUS MONACO TURKS AND CAICOS ISLANDS VANUATU

## A Foreign Trust Investing In The US: 'Ordinary' Or 'Business' Trust?

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- All Section references are to the US Internal Revenue Code, 1986, as amended and the US Department of the Treasury regulations (collectively, "Code") promulgated thereunder unless stated otherwise;
- Unless stated otherwise, the terms "tax" and "taxation" mean income tax;
- Unless stated otherwise, the term "resident" means a resident for tax purposes;
- The term "property" or "properties," as the context may require, mean real property located within the US;
- All references to "treaty" refer to the relevant Convention between the Government of the United States of America and the relevant foreign country for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income.

Foreign investors often acquire US real estate *via* a non-US trust, whether simple, unit or an alternative. While many Australia residents, for example, invest *via* trusts, residents from other jurisdictions as well have preferred a trust structure as the sole member of a US limited liability company ("LLC") with US effectively connected income.

For purposes of this article, assume the trust, settlor, beneficiaries and trustee(s) are all residents of the same jurisdiction and that none of the parties is a US citizen or tax resident. Further assume all LLC income is effectively connected with a US trade or business and, if applicable, attributable to a US permanent establishment.

This article broadly examines the material issues global tax advisors must address. It does not provide an in-depth analysis of the below as that depends on the detailed nature of each set of facts, the jurisdiction of the trust, and the potential application of a treaty and the specific treaty language.

1. The classification of the trust for US tax purposes;
2. The application of the relevant treaty *vis-à-vis* the trust and/or its beneficiaries;
3. Based on the results of 1 and 2 above, determine the trust's/beneficiaries' US filing requirements.

First and foremost, how does the trust's jurisdiction treat the LLC? In many foreign jurisdictions, Australia for example, the LLC is a disregarded entity and Australia taxes the trust on the income earned through the LLC. Other jurisdictions may see the LLC as a corporation while still others see the LLC as a "tax haven" company and may apply a different set of rules. Depending on the jurisdiction, the trust may/may not face home country tax, and whether it distributes the income might impact home country taxation. Additionally, the beneficiaries might face tax upon the distribution and potentially may or may not be able to utilize a foreign tax credit for the taxes paid in the US.

Additionally, classifying the trust for US purposes is of critical importance. An entity which is not classified as an "ordinary" trust for US tax purposes is treated as either a corporation or a partnership (Reg. Section 301.7701-2(a)). Reg. Section 301.7701-1(a)(1) provides that *whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law*. Furthermore, Reg. Section 301.7701-1(a)(2) provides that *joint undertakings or other contractual arrangements may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation or venture and divide the profits therefrom*.

The entity classification rules use the term "ordinary" trust to distinguish such an entity from a "business" trust which would be classified as either a corporation or a partnership. For our purposes, we assume a "business" trust exists for US purposes. In such a case, the trust is normally an association taxable as a corporation for US tax purposes. Query whether a protective entity classification ("check the box") election should be made.

Whether the foreign jurisdiction treats the trust as an "ordinary" *versus* "business" trust determines whether a hybrid scenario exists in the cross-border context. Generally, this raises concerns with tax authorities and, to counter any hybrid mismatches, a treaty may address the issue or a country may have an anti-treaty abuse provision in its domestic law. In the case of the US, the Code contains treaty override provisions, perhaps most notable in Section 894(c).

In this regard, under the treaty take care as to whether the trust is a resident of the foreign jurisdiction, a "qualified person" and also the application of any Code treaty override.

Regarding the treaty override, note the US sees LLC as a disregarded entity with the trust as the single owner/taxpayer with a "branch" in the US. Therefore, consider the branch profits tax as well.

Lastly, since, under Section 897(a)(1), LLC has effectively connected income with a trade or business in the US and is wholly owned by a business trust, the provisions of Section 882 apply. Trust (the owner of the LLC) is required to file Form 1120-F (*US Income Tax Return of a Foreign Corporation*) reporting the income effectively connected with such trade or business. It will also include Form 8833 (*Treaty-Based Return Disclosure Under Section 6114 or 7701(b)*) *vis-à-vis* the branch profits tax (specifically, the dividend equivalent amount) with its Form 1120-F if it meets the limitation on benefits provisions. If there are transactions between the LLC and related parties (other than the trust itself), Form 5472 (*Information Return of a 25 percent Foreign-Owned US Corporation or a Foreign Corporation Engaged in a US Trade or Business*) may be required.

In addition, single owner LLCs are now required to obtain a taxpayer identification number.

Too often we see a misapplication and misunderstanding of the above issues leading to tax exposure for inaccurate reporting/disclosure or overpayment of global tax.