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Inbound Taxation Changes Under the 2017 Tax Cuts and Jobs Act

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The TCJA has changed the tax rules that apply to the taxation of foreigners investing in the U.S.

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The 2017 Tax Cuts and Jobs Act [1](#) (TCJA) has introduced the most sweeping changes to the U.S. tax system since 1986. Included in the TCJA are changes to the taxation of international transactions—both cross-border business transactions and cross-border personal investments. Most of the changes apply to the taxation of outbound transactions—U.S. taxpayers operating a business or investing overseas. While the tax community is well familiar with what the new rules are, it is still exploring the practical implications of these rules and exploring the best structures. A discussion of outbound taxation under the TCJA will appear in a future article.

This article explores how the TCJA has changed the tax rules that apply to the taxation of foreigners investing in the U.S. It provides an overview of the rules and proposes a practical roadmap to structuring inbound transactions for nonresident aliens (NRAs).

The first section discusses the various ownership structures generally available for foreign investors engaged in U.S. businesses. The second section analyzes the TCJA tax law changes under two

hypothetical structures:

- (1) The LLC Structure. NRA spouses form a California limited liability company (LLC), which in turn acquires an apartment building.
- (2) The Foreign Corporation-U.S. Corporation Structure. NRA spouses form a foreign corporation which in turn forms a California corporation (or LLC taxed as a corporation) to acquire an apartment building.

Ownership Structures for Foreign Investors Engaged in U.S. Businesses

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NRAs acquire U.S. assets using several alternative domestic ownership structures depending on their goals and priorities. There is no perfect structure. Each alternative has its own advantages and disadvantages.

For example, corporations, limited partnerships (LPs), and LLCs all afford their NRA owners a liability shield for any liability arising from the assets or the business of the entity. **2** However, LPs and LLCs are not required to maintain certain corporate formalities (like holding annual meetings of shareholders and maintaining annual minutes) affording creditors fewer bases for piercing the corporate veil to hold partners and members personally liable.

Moreover, interests in LPs and LLCs are not attachable by creditors, making them a more effective asset protection vehicle than corporations. **3** For example, when a creditor obtains a judgment against an individual who owns an apartment building through a corporation, the creditor can force the debtor to turn over the stock of the corporation, resulting in the loss of all corporate assets. **4** However, if the debtor owns the apartment building through an LLC or LP, the creditor's remedy is limited to a charging order—a court order that places a lien on distributions actually made from the LLC or LP. **5** Take note, however, that the manager or general partner still controls whether and when a distribution is made. Thus, if a charging order is in place, distributions can be delayed.

Ownership Structures

Direct Investment.

Direct investment (assets owned by the NRA) is simple and is subject to only one level of tax on the disposition. If the asset is held for one year, the sale is taxed at a 15% or 20% capital gains rate. **6** NRAs are not subject to the 3.8% net investment tax. **7** The disadvantages of the direct investment are: no privacy; no liability protection; the obligation to file U.S. income tax returns; and the U.S. asset is subject to U.S. estate and gift tax for transfers at death and during life.

LLC or LP Structure.

An NRA may acquire U.S. business assets through an LLC or an LP. The LLC may be a disregarded entity or taxed as a partnership for U.S. income tax purposes.

This structure is better than direct ownership because it provides NRAs with privacy and liability protection and allows for lifetime transfers of the membership or partnership interests with no gift tax. **8** However, there are disadvantages. For an LP, the general partner's name will be disclosed in the public record. Further, an LLC must file a statement of information with the appropriate state agency to disclose the manager's name in the public record. An option to avoid disclosure of an individual manager's name is to use one LLC to act as the manager of the operating LLC. The authors frequently use Delaware LLCs, as the name of the LLC manager is not required to be disclosed.

U.S. and state income tax returns will have to be filed by NRA members and the entity, if other than a single member LLC. A single member LLC owned by an NRA has to file an IRS Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in U.S. Trade or Business, but no tax return. Moreover, if the NRA member or partner dies, the value of his interest in the entity will be subject to U.S. estate tax. However, transfers of interests in a partnership or LLC should be exempt from U.S. gift tax. NRAs are subject to gift tax only on gifts of U.S. situs real and tangible personal property, but not for U.S. situs intangible property. **9** U.S. situs intangible property includes: (1) shares of stock issued by a U.S. or foreign corporation, and (2) debt obligations, including a bank deposit, the primary obligor of which is a U.S. person. **10** Shares in U.S. corporations and interests in partnerships or LLCs are considered intangible property. **11** Therefore, shares or partnership/LLC interests may be gifted without incurring U.S. gift tax even if the underlying asset of the entity is U.S. real property.

For gifts, the donor's tax basis of the property carries over to the donee. **12** Generally, the tax basis of property in the hands of a person acquiring property from a decedent is "stepped-up" to a tax basis equal to its fair market value (FMV) at the date of the decedent's passing. **13**

Domestic Corporation.

The corporation will always be a "C" corporation because an NRA may not be a shareholder of an S corporation. **14** A corporation will afford privacy and liability protection, allows lifetime gift tax-free transfers of the shares, and does not require the foreign shareholder to file a U.S. income tax return. **15** Engaging in a U.S. trade or business requires a U.S. tax return. However, ownership of U.S. stock by an NRA does not, by itself, trigger a return filing obligation. **16**

There are three disadvantages to the ownership of U.S. assets through a

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domestic corporation: (1) federal and state corporate income tax at the corporate level will add a second layer of tax; (2) dividends from the domestic corporation to its foreign shareholder will be subject to 30%

withholding; **17** and (3) the shares of the domestic corporation will be included in the U.S. estate of the foreign shareholder. **18**

The U.S. corporation may own the U.S. assets directly, or through a U.S. partnership or disregarded entity owned by the corporation. The corporation may even be an LLC that elects to be taxed as a corporation. In turn, the ownership of the U.S. corporation by the NRA may be direct, or through a foreign corporation, a foreign partnership, a foreign trust, or a foreign disregarded entity.

Foreign Corporation.

Foreign corporation ownership offers the following advantages: (1) liability protection; (2) no U.S. income tax or filing requirement for the foreign shareholder; (3) shares in the foreign corporation are non-U.S. assets not included in the U.S. estate of NRA shareholders; (4) dividends are not subject to U.S. withholding; (5) no tax or filing requirement on the disposition of the stock; and (6) no gift tax on the transfer of shares of stock.

The disadvantages of using the foreign corporation are: (1) corporate level taxes (just like with the domestic corporation), because the foreign corporation may be deemed engaged in a U.S. trade or business; and (2) the foreign corporation will be subject to the branch profits tax, **19** the largest disadvantage of ownership of U.S. business assets through a foreign corporation.

Because the branch profits tax is often not reduced or eliminated by a treaty, the most advantageous structure for ownership of U.S. assets by NRAs is through the foreign corporation-U.S. corporation structure (discussed below).

Foreign Corporation-U.S. Corporation (or U.S. LLC Taxed as a Corporation).

The authors' preferred structure is a foreign corporation (or a foreign irrevocable trust) holding shares of a U.S. corporation or an LLC taxed as a corporation. For an NRA shareholder, this structure affords privacy and liability protection; escapes U.S. income tax filing requirements; avoids U.S. estate taxes; allows for gift tax-free lifetime transfers; and avoids the branch profits tax. However, the structure will be subject to two levels of taxation, once at the U.S. corporate level and again at the foreign shareholder's level on receipt of dividends. Further, distributions from the U.S. subsidiary to the foreign shareholder are subject to the 30% FDAP withholding (possibly reduced by a tax treaty), but the timing and the amount of the dividend is within the NRA's control.

However, if the U.S. subsidiary owns U.S. real property, the foreign parent may be subject to taxation on disposition of its shareholder interest under the Foreign Investment in Real Property Tax Act of 1980 discussed immediately below.

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).

Rules applicable to dispositions of U.S. real estate by NRAs or foreign corporations are found in a separate regime known as FIRPTA which is codified in **Sections 897** , 1445, and 6039C.

Generally, FIRPTA taxes the disposition of U.S. real property interests (USRPI) as if the NRA or foreign corporation were engaged in a U.S. trade or business. **20** This means that the traditional income tax rules that apply to U.S. taxpayers will also apply to the NRA. Purchasers who acquire a USRPI from a NRA are obligated to withhold 15% of the amount realized on the disposition. **21**

FIRPTA applies to the disposition of U.S. real property owned directly by foreign persons as well as the disposition of interests in entities that own USRPIs.

A foreign partner in a U.S. partnership is deemed as a proportionate owner of the partnership assets, including real estate. **22** The disposition of such partnership interest will be subject to FIRPTA to the extent such partnership owns USRPIs and will be subject to withholding.

A USRPI includes stock in a U.S. real property holding company (USRPHC). **23** A domestic corporation will be treated as a USRPHC if its USRPIs equal or exceed 50% of the FMV of its USRPIs, its foreign real property, and any other of its assets which are used or held for use in a trade or business. **24**

A USRPI does not include an interest in a corporation if on the date of the disposition of the interest, the corporation did not hold any USRPI and all of its USRPI at any time during the five-year period ending on the date of the disposition were disposed of in transactions in which the full amount of the gain (if any) was recognized. **25** This rule is referred to as the "cleansing" rule because the taxable disposition of a corporation's USRPIs removes its "taint" as a USRPHC. **26** As such, the corporation will pay federal (21%) corporate tax on the net gain on the sale of the property.

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Thereafter, the foreign parent corporation may repatriate the proceeds of the sale as part of a tax-free liquidating distribution from the U.S. corporation. **27**

First Hypothetical-LLC Structure Taxed as a Pass-Through Entity

The first hypothetical uses an LLC structure that is disregarded for U.S. tax purposes. In 2010, NRA spouses form a two-member California LLC which in turn acquires an apartment building in California. The LLC's manager lives in California and manages the property with the assistance of a property management firm. The manager is authorized to negotiate and sign leases, collect rents, pay taxes and insurance premiums, and negotiate terms and agreements with contractors for repairs to the property. Wife and Husband hold 70% and 30% membership interests, respectively. The purchase price of the property was \$2.75 million in 2010 and its current market value is \$5 million. For simplicity, the purchase price is the tax basis and adjustments for depreciation and past allocations of gains or losses to the members are ignored. Thus, if the LLC sells the property in 2018, the gain is \$2.25 million: \$5,000,000 (FMV) - \$2,750,000 (tax basis (cost)) = \$2,250,000 (gain). Rental income for tax year 2018 is \$400,000.

In 2016, the apartment building was updated at a cost of \$1.3 million, which included a new HVAC system, elevator, and electrical system.

Thirty Percent Flat Withholding Tax vs. Net Basis Taxation

Thirty Percent Flat Withholding Tax

Generally, NRAs pay a flat withholding tax of 30% on fixed, determinable, annual, or periodical (FDAP) income. FDAP income is generally passive income. **28** Rents are treated as FDAP income under **Section 871(a)(1)(A)** . Thus, NRAs are taxed on their gross rents, without offsetting deductions (including depreciation). However, NRAs may elect net basis taxation to treat their real property income as if it was effectively connected to a U.S. trade or business. **29**

Net Basis Election Sections 871(d) and 882(d) .

Sections 871(d) and **882(d)** allow a foreign corporation or an NRA investor that earns income from real property to elect to be taxed on a net basis at graduated rates as if the income was effectively connected income with a U.S. trade or business. After making the election, the NRA investor is no longer subject to the 30% withholding tax on gross rents. Instead, he is allowed to deduct expenses attributable to rental of the real property, such as interest paid on a mortgage, property taxes, insurance, and depreciation.

The net basis election may be revoked only with consent of the Secretary of the Treasury and applies to all U.S. real estate held at the time of the election, as well as to property that may be acquired in the future.

The NRA spouses have elected to treat their rental income as effectively connected to a U.S. trade or business to qualify for net basis taxation.

Taxable Income.

For federal tax purposes, an LLC taxed as a partnership is not required to pay federal income tax. However, the LLC is required to file an information return-Form 1065, U.S. Return of Partnership Income. All items of income and deductions are computed at the entity level. The LLC then issues Schedules K-1 to each spouse stating the amount of income or loss attributed to him or her. Thereafter, each spouse includes his or her distributive share of LLC income or loss on his or her separate Form 1040NR. Each spouse must file a separate Form 1040NR because NRAs who are married are generally not allowed to file jointly. **30** Further, they must use the tax rate schedule for married filing separate returns for calculating their income tax liability. **31**

The LLC's gross income consists of \$400,000 of annual rents received. Annual expenses are \$30,000 for California real property taxes, \$80,000 for mortgage interest, and \$45,000 for depreciation. Depreciation is based on the straight-line method and the applicable recovery period for residential real estate is 27.5 years. There are no W-2 wages paid. Thus, taxable income attributable to each spouse is \$171,500 for Wife and \$73,500 for Husband (see Exhibit 1).

Exhibit 1. Taxable Income Example

	LLC	Wife	Husband
	100%	70%	30%
Rental Income	400,000	280,000	120,000
Deductions:			
Wages	-	-	-
Property Taxes	(30,000)	(21,000)	(9,000)
Interest	(80,000)	(56,000)	(24,000)
Depreciation	(45,000)	(31,500)	(13,500)
Taxable Income	245,000	171,500	73,500

Deductions

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Qualified Business Income Deduction-20% Deduction for Taxpayers (other than corporations) under [Section 199A](#) .

The TCJA gives individual taxpayers a 20% deduction of the qualified business income (QBI) from a partnership, S corporation, or sole proprietorship (collectively, "pass-through entities"). **32** The deduction is taken at the entity level and is subject to several convoluted limitations.

Issue: Do NRAs Qualify for the QBI Deduction?

The TCJA does not address whether the QBI deduction applies to NRAs. However, QBI provisions require qualifying items of income, gain, deduction, and loss to be effectively connected with the conduct of a U.S. trade or business. [33](#) Because our NRA spouses have elected to treat their rental income as effectively connected with a U.S. trade or business to qualify for net basis taxation, it should likewise qualify for the QBI deduction. [34](#)

QBI Deduction Mechanics

QBI deduction is equal to the lesser of-

- (1) The taxpayer's *combined QBI amount*, OR
- (2) An amount equal to 20% of the excess (if any) of -
 - (a) the taxpayer's taxable income, over
 - (b) the taxpayer's net capital gains. [35](#)
- (3) The **combined QBI amount** for the tax year is -
 - (a) the sum of the *deductible QBI amount* for each qualified trade or business, plus
 - (b) 20% of the aggregate amount of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income ("QPTPI"). [36](#)
- (4) The **deductible QBI amount** for each qualified trade or business is equal to the lesser of -
 - (a) 20% of the taxpayer's QBI with respect to the trade or business, or
 - (b) the *W-2 wage limitation*. [37](#)
- (5) The **W-2 wage limitation** is equal to the greater of -

(a) 50% of *W-2 wages* for the trade or business, or

(b) the sum of

(i) 25% of the *W-2 wages* for the trade or business, plus

(ii) 2.5% of the unadjusted basis immediately after acquisition of all *qualified property*. **38**

(6) The *W-2 wage* limitation does not apply if taxable income does not exceed the applicable threshold amount. The **threshold amounts** are -

(a) \$315,000 for married taxpayers filing jointly, and

(b) \$157,500 for all other taxpayers. **39**

(7) **Phase-In Reduction.** Finally, the *W-2* limitation phases in for taxpayers whose taxable income exceeds the applicable threshold amount but does not exceed the sum of the applicable threshold plus \$100,000 for joint filing and \$50,000 for all others.

Definitions

QBI.

QBI is the net amount of *qualified items of income, gain, deduction, and loss* of any *qualified trade or business* of the taxpayer. **40** QBI does not include any qualified REIT dividends, qualified cooperative dividends, or QPTPI.

Qualified Items of Income, Gain, Deduction, and Loss.

Qualified items of income, gain, deduction, and loss are qualified items only to the extent (1) they are included or allowed in determining the taxpayer's taxable income for the tax year, and (2) they are effectively connected with the conduct of a trade or business within the United States or Puerto Rico. **41** They do not include investment items, including:

- short-term capital gain or loss,
- dividends or any payment equivalent to a dividend,
- interest income other than interest that is properly allocable to a trade or business,
- the taxpayer's reasonable compensation paid by a qualified trade or business,
- a partnership's guaranteed payment, and

- any amount paid by a partnership to the taxpayer acting other than in his or her capacity as a partner for services. [42](#)

Qualified Trade or Business.

A qualified trade or business is any trade or business other than a specified service trade or business ("SSTB") or the trade or business of performing services as an employee. [43](#) However, there is an exception for SSTBs based on a taxpayer's income that phases out on a

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proportionate basis between \$157,500 and \$207,500 for a single taxpayer and \$315,000 and \$415,000 for joint taxpayers. [44](#)

W-2 Wages.

W-2 wages are the "total wages subject to wage withholding, elective deferrals, and deferred compensation paid by the qualified trade or business" for employment of its employees. [45](#) Amounts paid to an independent contractor are not W-2 wages.

Qualified Property.

Generally, qualified property is tangible property that qualifies for depreciation under [Section 167](#) . Thus, the qualified property limitation does not apply to residential rental property. However, it will likely apply to the HVAC system, elevator, and electrical system purchased in 2016 at a cost of \$1,300,000.

First Hypothetical-NRAs Invest in U.S. Rental Property through an LLC

Preliminary Issue: Is residential rental property a qualified trade or business?

[Section 199A](#) does not define "qualified trade or business." However, SSTBs and the trade or business of being an employee were explicitly omitted from the definition of "qualified trade or business" for purposes of the QBI deduction. [46](#) By negative implication, residential rental property should be a qualified trade or business.

Additionally, [Section 199A](#) requires qualifying items of income, gain, deduction, and loss to be effectively connected with the conduct of a U.S. trade or business. [47](#) In defining qualifying items of income, gain, deduction, and loss, [Section 199A](#) uses the international tax concept of *effectively connected income* under [Section 864\(c\)](#) (Definition and Special Rules) of Part I (Determination of Sources of Income) of Subchapter N (Tax Based on Income From Sources Within or Without the United

States). **48**

In the international tax context, "a prerequisite for a foreign person to derive effectively connected income is that such person must be engaged in a U.S. trade or business." **49**

Step 1-Are the NRA Members Engaged in a U.S. Trade or Business?

At issue is whether the rental activities of NRA members give rise to a trade or business for purposes of **Section 199A** . To determine if a foreign person is engaged in a U.S. trade or business (USTB) not only are his activities considered but also the activities of dependent agents. **50**

An agency relationship is deemed to exist when the U.S. agent is "dependent" and has the authority, which he regularly exercises, to conclude contracts in the name of the foreign principal. **51** Further, in the foreign context, where an agency relationship exists, the Code and Treasury Regulations provide that -

- To constitute a trade or business, a group of activities must ordinarily include the collection of income and the payment of expenses. **52**
- The agent's office or fixed place of business may be deemed an office or fixed place of business of the foreign investor. **53**
- A foreign partner of a U.S. or foreign partnership that is engaged in a U.S. trade or business is deemed to also be engaged in a U.S. trade or business. **54**

Finally, "[i]n the real estate context, the appointment of an agent with discretionary authority to negotiate and sign leases on behalf of the foreign principal will give rise to a trade or business status for the principal." **55**

As applied to the NRA members, the LLC's operating agreement is a legal and dependent relationship between the NRA members and the U.S. manager. Second, the manager's duties include signing leases and agreements with contractors for repairs, and arranging for liability insurance. Third, the manager is authorized to collect rents and to pay taxes and insurance premiums, and expenses and repairs to the property. Therefore, the manager's activities should be deemed imputed to the NRA members and his office should be deemed a fixed place of business for the NRA members. Further, the NRA member's activities, as attributed from the LLC manager, should be sufficient to qualify as a USTB not only in the foreign context but also for purposes of **Section 199A** .

Step 2-Are the Items of Income, Gain, Deduction, and Loss Effectively Connected with the USBT?

Since the NRA members should be deemed to be engaged in a U.S. trade or business, the next step is to determine whether items of income, gain, deduction, and loss are *effectively connected with the USBT*.

Under **Section 864(c)** , the concept *effectively connected income* is applied on an annual basis." **56**
Section 864(c)(1)(B) states,

Except as provided in . . . **IRC Sec. 871(d)** . . . in the case of a nonresident alien individual or a foreign corporation not engaged in trade or business within the United States during the taxable year, no income, gain, or loss shall be treated as effectively connected with the conduct of a trade or business within the United States. **57**

Significantly, there are two exceptions to the general rule of 864(c)(1)(B) that support the position that items of income, deduction, and loss from the NRA member's rental activities are effectively connected with the conduct of a *USBT*.

First, the NRA spouses have elected to treat their rental income as effectively connected income under **Section 871(d)** , the exception to 846(c). **58**

Second, the general rule of **Section 897(a)** provides that an NRA's gain or

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loss from the disposition of a USRPI shall be treated as effectively connected with the conduct of a U.S. trade or business. **59**

Therefore, the NRA's residential rental property business should qualify as a *qualified trade or business* and the items of income, gain, and loss should qualify as *effectively connected* thereto.

QBI Deduction-Threshold Amount

Before calculating the QBI deduction, it is helpful to first determine whether the NRA spouses' taxable income exceeds the threshold amount. If so, then the W-2 wage limitation does not apply, thereby simplifying the QBI calculation.

The threshold amount is \$315,000 for joint filers and \$157,500 for all other taxpayers. Recall, that NRA spouses are treated as single taxpayers because they are not permitted to file jointly. Therefore, the applicable threshold is \$157,500 and the determination is applied separately to each spouse.

The LLC's 2018 income attributable to Husband's 30% membership interest is \$73,500. Since Husband has no other U.S. source income, his 2018 taxable income is \$73,500, which does not exceed the applicable threshold amount of \$157,500. **60** Therefore, he is exempt from the W-2 wage limitation. **61** Further, the business of residential real property is not listed as excluded from the definition of a qualified trade or business for QBI deduction purposes. Finally, there were no W-2 wages paid or capital gains, qualified REIT dividends, or QPTPI received during the 2018 tax year.

Husband's QBI for the 2018 tax year is \$73,500, the net amount of qualified items of income, gain, deduction, and loss and his QBI deduction is \$14,700 (20% of \$73,500).

Wife's 2018 taxable income of \$171,500 exceeds the \$157,500 applicable threshold amount by \$14,000.

As such, the W-2 wage limitation applies as discussed below.

W-2 Wage Limitation

The LLC's 2018 income attributable to Wife's 70% membership interest is \$171,500. Since she has no other U.S. source income, her 2018 taxable income is \$171,500, which exceeds the \$157,500 threshold amount by \$14,000. **62** Therefore, her QBI deduction is subject to the W-2 wage limitation. **63** Since she has only one qualified trade or business, 20% of her QBI is \$34,300 (20% of 171,500).

Like Husband, she has no capital gains, qualified REIT dividends, or QPTPI and the LLC paid no W-2 wages for the 2018 tax year. Finally, the unadjusted basis immediately after acquisition of all qualified property (i.e., cost basis) of the HVAC system, elevator, and electrical system purchased in 2016 is 1,300,000 of which 70% is allocable to Wife - \$910,000. Thus, her so-called *W-2 wage limitation* is \$22,750 (2.5% of \$910,000). **64**

W-2 Wage Phase-In Reduction.

The phase-in reduction applies because Wife's \$171,500 taxable income falls in between her applicable threshold amount of \$157,500 and \$207,500 (\$157,500 + 50,000 for taxpayers other than joint filers). The reduction amount is \$3,234 calculated as shown in Exhibit 2. Therefore, Wife's QBI deduction is \$31,066 (\$34,300 - \$3,234).

Exhibit 2. The Reduction Amount Calculation

$$\left[\frac{\text{Taxable Income} - \text{Threshold Amt.}}{\$50,000} \right] \times \left[\begin{array}{l} \text{(20\% of QBI) - (2.5\% of Qualified Ppty)} \\ \$34,300 - \$22,750 \end{array} \right] = \text{Reduction Amt. } \$3,234$$

Interest Expense Limitation under Section 163(j) .

Section 163(j) limits business interest expense deduction to the sum of (i) business interest income, (ii) 30% of the adjusted taxable income, and (iii) floor plan financing interest. **65** Disallowed deductions can be carried forward indefinitely. **66** However, small businesses with average annual gross receipts of \$25 million or less are exempt. **67**

The NRA couple has mortgage interest expense of \$80,000 for 2018. However, because their gross receipts from rents are well under \$25 million (i.e., \$400,000), they are exempt from this limitation.

Limitation on State and Local Income and Property Taxes [Section 164\(b\)\(6\)](#)

NRAAs can deduct certain itemized deductions if they receive income effectively connected with their U.S. trade or business. Prior to 2018, these deductions

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included: state and local income and property taxes (SALT), charitable contributions to U.S. non-profit organizations, casualty and theft losses, miscellaneous itemized deductions, and ordinary and necessary expenses related to a U.S. trade or business.

For individuals, the TCJA suspended the deduction for miscellaneous itemized deduction, restricts personal casualty loss deduction to losses from presidentially declared disaster (except for investment losses), and limits state and local income and property taxes to \$10,000. [68](#) Significantly, the limit for NRA spouses will be \$5,000 each because their filing status is married filing separate. [69](#) However, foreign income, real property, and personal property taxes paid in carrying on a U.S. trade or business are not subject to the \$5,000 limitation. [70](#)

The LLC paid \$30,000 in state real property taxes. Thus, the entire amount should be allowed as a deduction because the NRA members are engaged in a real estate partnership entered into for profit. Significantly, this exemption does not apply to state income taxes. Thus, it appears that any California income tax deduction attributable to each spouse will be subject to the \$5,000 limitation, even though state income tax is generated in whole by their rental activities.

Limitation on Losses for Noncorporate Taxpayers- [Section 461\(l\)](#) .

For taxpayers other than C corporations, new [Section 461\(l\)](#) disallows a deduction for excess business losses and treats the losses as an NOL carryover to the following year.

An excess business loss is the excess of the aggregate deductions attributable to the taxpayer's trades or businesses over the sum of the taxpayer's aggregate gross income or gain from those business, to the extent that the loss exceeds \$250,000 (for single filers) or \$500,000 (for joint filers).

Thus, the NRA couple can no longer deduct excess business losses over \$250,000. Instead, the excess is carried forward indefinitely as an NOL under [Section 172](#) (which, under new rules, are limited to 80% of taxable income). Carry backs are no longer permitted.

Net Taxable Income and Tax Liability

The NRA couple must use the tax rate schedule for married filing separate returns when determining the tax on income effectively connected with a U.S. trade or business. [71](#) The applicable tax rates are as shown in Exhibit 3.

Exhibit 3. 2018 Individual Tax Rate Schedule for Married Filing Separate

If the taxable income is:	The tax is:
Not over \$9,525	10% of taxable income,
Over \$ 9,525 but not over \$38,700	\$ 952.50, plus 12% of the excess over \$9,525
Over \$ 38,700 but not over \$82,500	\$ 4,453.50, plus 22% of the excess over \$38,700
Over \$ 82,500 but not over \$157,500	\$ 14,089.50, plus 24% of the excess over \$82,500
Over \$ 157,500 but not over \$200,000	\$ 32,089.50, plus 32% of the excess over \$157,500
Over \$ 200,000 but not over \$300,000	\$ 45,689.50, plus 35% of the excess over \$200,000
Over \$ 300,000	\$ 80,689.50, plus 37% of excess over \$300,000

Capital Gain Tax Rates.

For the married filing separate filing status, the maximum zero capital gain rate amount is \$38,600 and the maximum 15% rate amount is \$425,800. [72](#) Thereafter, the 20% rate applies.

Standard Deduction.

For U.S. citizens and residents the standard deduction has increased to \$24,000 for joint filers and \$12,000 for single filers. [73](#) NRAs and married persons filing separate returns cannot claim the standard deduction. [74](#) Therefore, the NRA spouses may not claim the standard deduction on their separate Forms 1040NR.

Personal Exemptions.

TCJA repeals personal exemptions for all taxpayers, their spouses (if married), and their dependents.

Alternative Minimum Tax (AMT).

AMT has been retained for individuals with modifications. The exemption is raised to \$70,300 for single filers or \$109,400 for joint filers. The exemption phaseout threshold has been increase to \$500,000 for single filers and \$1 million for joint filers.

The LLC does not pay AMT because it is not a taxable entity. Instead the LLC's tax attributes flow through to each

spouse. Thus, each NRA spouse will take his distributed share of the LLC's tax preference items and adjustments. [75](#)

Sales Transaction if Property is Sold in 2018.

If the NRA couple sells the apartment building for \$5 million on 12/31/18, the couple's tax liability would increase by each spouse's applicable gain multiplied by the capital gains tax rate. Note that the QBI deduction does not change because the [Section 199A\(a\)\(1\)](#) calculation prevents application of the deduction against gains that have already been taxed at 20% (see Exhibit 4).

Exhibit 4. Sales Transaction if Property Sold in 2018

	LLC	Wife	Husband
	100%	70%	30%
Capital Gain	2,250,000	1,575,000	675,000
Tax liability:			
Tax on Ordinary Income	36,870	27,994	8,876
Capital Gain 20%	450,000	315,000	135,000
Total	486,870	342,994	143,876
Effective Tax Rate	19.51%	19.63%	19.61%

Second Hypothetical-Foreign Corporation-U.S. LLC Taxed as a Corporation

The second hypothetical uses the same property value, cost basis, rental income, and deductions. However, the NRA spouses instead have formed a foreign corporation (Forco), which in turn formed a California LLC to purchase the apartment building.

Form 1120, U.S. Corporation Income Tax Return

An eligible entity with a single owner can elect to be classified as a corporation or to be disregarded as an entity separate from its owner. [76](#) Eligible entities include LLCs and partnerships. [77](#) Here, the LLC has elected to be classified as a corporation (LLC-Corporation). Therefore, the LLC-Corporation must file Form 1120 U.S. Corporation Income Tax Return.

Taxable Income

The LLC's gross income consists of \$400,000 of rents received. Deductions were \$30,000 California property taxes, \$80,000 mortgage interest, and \$45,000 depreciation. Thus, taxable income is \$245,000.

Deductions

Limitation on Business Interest Expense Deduction ([Section 163\(j\)](#))

The business interest expense deduction of corporations with an average annual income of greater than \$25 million is limited to the sum of business interest income, 30% of the business's adjusted taxable income, and floor plan financing interest. The LLC-Corporation should be able to deduct the entire interest expense of \$80,000 because the limitation does not apply to corporations with gross receipts of \$25 million.

Unlimited Deduction of State and Local Income and Property Taxes million or less.

The limitation on deduction of state and local income and property taxes does not apply to corporations. Thus, the LLC-Corporation should be able to deduct all of its property taxes and state income taxes.

Limitation of Business Losses under [Section 461\(l\)](#) .

The limitation of business losses under [Section 461\(l\)](#) does not apply to corporations. Thus, any losses may be deducted by the LLC-Corporation.

Net Operating Losses (NOLs)

NOLs for the LLC-Corporation are limited to 80% of taxable income, with the remainder carried forward indefinitely. [78](#)

Net Taxable Income and Tax Liability

The TCJA replaced the graduated corporate tax structure with a flat 21% corporate tax rate and repealed the corporate AMT, effective for tax years beginning after 12/31/17. Therefore, the LLC-Corporation's tax liability is \$51,450 (\$245,000 taxable income multiplied by 21%).

Sales Transaction if Property is Sold

The maximum capital gains rate was repealed as obsolete by the TCJA. Thus, capital gains realized by corporations are subject to the flat 21% corporate rate. Tax on the gain on the sale of the

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apartment building is \$471,450 (\$2,245,000 gain multiplied by 21%).

After the sale and payment of the total tax liability, the LLC-Corporation will liquidate pursuant to a liquidation plan and repatriate the net proceeds from the sale of the apartment building to Forco. This liquidating distribution will be tax free to the Forco under the cleansing rule of [Section 897\(c\)\(1\)\(B\)](#). The result is single level of taxation on the sale of the apartment building.

In the hypotheticals above there is no significant difference in the effective capital gain tax rates or the total tax liability on the sale of the property. The LLC structures result in a somewhat lower overall effective tax rate and tax liability for rental income. It is notable, that due to the continued availability of the SALT deduction for corporations, this difference either disappears or flips in favor of the corporate structure when income is much higher, and the property is located in a high-income tax state. While the hypotheticals dealt with rental income, the analysis and the conclusions would be the same for other types of income that an NRA may have in the United States.

Conclusion

Tax planning for inbound investments has always been complex-liability protection, privacy and anonymity, tax filing requirements, withholding obligations, withholding rates, treaty application, availability of deductions, tax exempt income and tax rates, are some of the factors we consider in this analysis. The TCJA has preserved the complexity of this analysis and added another layer-the QBI deduction.

1 P.L. 115-97, 12/22/17.

2 *Erkenbrecher v. Grant*, 187 Cal. 7 9 (1921); *Hollywood Cleaning & Pressing Co. v. Hollywood Laundry Service*, 217 Cal. 124 129 (1932); Reg. 17703.04(a)(2).

3 Uniform Limited Partnership Act (2001) (ULPA), sections 701-703; Uniform Limited Liability Company Act (2006) (ULLCA) sections 501-503; Uniform Partnership Act (1997) (UPA), sections 501-504; Cal. Corp. Code sections 15907.03(a) and 17704.07(f). See, Stein, "A Practical Take on Charging Orders," *Bus. Ent. Mag.*, Sept. 2006, for a general discussion of the charging order

limitation.

4 Cal. Unif. Com. Code section 8112.

5 ULPA, section 703(e) & Comments; ULLCA section 503(g); UPA, section 504(g); Cal. Corp. Code section 17705.03(f).

6 [Section 1\(h\)](#) .

7 [Section 1411\(e\)](#) .

8 [Sections 2501](#) and [2503](#) .

9 [Section 2501\(a\)\(2\)](#) .

10 Reg. 25.251-3(b)(3).

11 See, e.g., *Jackson*, 233 F.2d 289 (CA-2, 1956). The IRS refuses to provide guidance on whether partnership or membership interests qualify as intangible property for U.S. gift tax purposes. See, Rev. Proc. 2018-03, section 4, .01, (29). However, most U.S. international tax practitioners, including these authors, agree that partnership and membership interests are intangible property.

12 [Section 1015](#) .

13 [Sections 1014\(a\)\(1\)](#) and (b)(1).

14 [Section 1361\(b\)\(1\)\(C\)](#) .

15 NRA shareholders do not file income tax returns on dividends received from a U.S. corporation because a flat 30% tax is withheld and remitted to the IRS by the payee corporation. [Sections 871\(a\)\(1\)\(A\)](#) , 1441 (a), and (b).

16 But see "Foreign Investment in Real Property Tax Act" below.

17 [Sections 871\(a\)](#) and [881\(a\)](#) .

18 [Sections 2104\(a\)](#) and [2103](#) .

19 Section 884(a) .

20 Section 897(a)(1) .

21 Section 1445(a) .

22 Reg. 1.897-1(e)(1)(i)(A)

23 Section 897(c)(1)(A)(ii) .

24 Section 897(c)(2) .

25 Section 897(c)(1)(B) .

26 Caballero, Feese, and Plowgian, "U.S. Taxation of Foreign Investment in U.S. Real Estate," BNA Tax Management Portfolio, 912, Note 361.

27 Section 332 .

28 Sections 871(a) and **881(a)** .

29 The election is made under **Sections 871(d)** and **882(d)** .

30 Section 6013(a)(1) .

31 IRS Pub. 519, *U.S. Tax Guide for Aliens*, Ch. 5, Filing Status, Nonresident Aliens, www.irs.gov/publications/p519.

32 Section 199A .

33 Section 199A(c)(3)(A) .

34 Further, the Conference Report to Accompany H.R. 1 does not mention foreign persons or nonresident aliens in Section 11011 Deduction for Qualified Business Income.

35 Section 199A(a)(1) .

36 Section 199A(b)(1) .

37 Section 199A(b)(2) . See also, Streng and Kehl, "Choice of Entity: Operational Issues," BNA Tax Management Portfolio 701, I.B.2.a.(1).

38 Section 199A(b)(2)(b) . See also, Streng and Kehl, Note 37, *supra*.

39 Section 199A(e)(2) .

40 Section 199A(c)(1) .

41 Streng and Kehl, Note 37, *supra*, I.B.2.a.(1)(a), citing **Section 199A(c)(3)(B)** (emphasis added) (hereafter, "701 T.M.")

42 Sections 199A(c)(3)(B) and (4).

43 Section 199A(d)(1) .

44 Section 199A(d)(3) .

45 701 T.M., I.B.2.a.(1)(b), citing **Section 199A(b)(4)(A)** .

46 701 T.M., I.B.2.a.

47 Section 199A(c)(3)(A) .

48 Section 199A(c)(3)(A)(i) .

49 Caballero, Feese, and Plowgian, 912-2nd T.M., U.S. Taxation of Foreign Investment in U.S. Real Estate, II.A (hereafter, "912-2nd T.M."). **Section 864(c)(1)(A)** .

50 912-2nd T.M., I.A.3.a.

51 Reg. 1.864-7(d)(1)(i) .

52 Reg. 1.355-3(b)(2)(ii) . See also, Stoffregan, Harris, and Wirtz, "Partners and Partnerships-International Tax Aspects," BNA Tax Management Portfolio, 910-2nd T.M., Note 276.

53 Reg. 1.864-7(d) .

54 Section 875(1) .

55 See 912-2nd T.M., I.A.3.a., citing *Lewenhaupt*, **20 TC 151** L (1953), *aff'd per curiam*, 221 F.2d 227 **47 AFTR 420** (CA-9, 1955); **Rev. Rul. 80-225, 1980-2 CB 318** , and **Reg. 1.864-7(d)** .

56 Caballero, Feese, and Plowgian, "U.S. Taxation of Foreign Investment in U.S. Real Estate," II.A.3.B (hereafter, "912-2nd T.M.").

57 Section 864(c)(1)(B) (emphasis added).

58 Sections 871(d) .

59 Sections 897(a)(1) and 871(b) .

60 Section 199A(e)(2) .

61 Section 199A(b)(3)(A) .

62 Section 199A(e)(2) .

63 Section 199A(b)(3)(A) .

64 Section 199A(b)(2)(B)(i) .

65 Section 163(j)(1) .

66 Section 163(j)(2) .

67 Sections 163(j)(3) and 448(c) .

68 Sections 67(g) and 164(b) .

69 Section 164(b)(6)(B)

70 Bloomberg Tax Complete Analysis of H.R. 1, Conference Agreement, as passed by Congress (12/20/17).

71 IRS Pub. 519, Note 31, *supra*.

72 Sections 1(j)(5)(B)(i) and (ii).

73 Section 63(c)(7) .

74 Sections 63(c)(6)(A) and (B).

75 See generally, 701 T.M., I.3.b.

76 Reg. 301.7701-3(a) .

77 See Instructions for Form 8832, Entity Classification Election.

78 Section 172 .