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An Investment Structuring of U.S. Real Properties by Korean Families and Cross-border Tax Implications*

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Abstract

What would be the ideal solution if our Korean tax resident, Ms. Kim, is considering buying a condominium in New Jersey for her use and to possibly rent it out? She may or may not buy it in her name. She would prefer ways to allow her family to use the house without paying rent because some of them are United States ("U.S.") residents. She does not want to be subject to U.S. gift tax, not even an estate tax-proof structure should she die. She does not know how to file a U.S. tax return on her own; not to mention, she has a preference for minimizing U.S. capital gains tax when she sells the condominium. Is there any cross-border advisor who might be able to assist with all her needs, including U.S./Korean income, estate/inheritance, and gift tax considerations related to the acquisition of this condominium with a view of Manhattan? The problem of determining tax consequences based on the underlying legal situation is aggravated in this cross-border context because Korean tax consequences often must be determined based on U.S. legal concepts and the limitation on treaty benefits. While exploring the reasons behind and implications of the different outcomes in tax administration where cross-border real estate acquisition is concerned, the author explores the relevance and application of both U.S. and Korean rules and regulations intended to optimize income and transfer taxes between the two jurisdictions. This article further considers the utility of U.S. grantor trust rules in the context of Korean individuals as non-citizen, non-domicile grantors of the trust in terms of U.S. income and estate tax purposes.

KEYWORDS: cross-border succession planning, estate tax, tax treaty

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I. Introduction

Korean pension funds, securities companies, and insurance firms possess considerable experience investing[1] in overseas real estate. Typical institutional deals have relative scales of economy to afford expensive lawyers and accountants specialized in cross-border investment structuring with optimal tax efficiency in both the home and target jurisdictions. From the retail side, as regulations on holding real estate in Korea have become more stringent, there is a growing demand for foreign investment. Unlike Korea, the U.S. does not have a real estate acquisition tax and comprehensive real estate wealth tax and does not penalize with additional taxation, even on multifamily dwellings. The fact that the condominiums in New Jersey and Manhattan are relatively cheap compared with the price of apartments in the Seoul metropolitan area, the prices of which have risen sharply in a short period, can provide a higher rate of collateral than in Korea. Naturally, Korean individuals' interest in and demand for U.S. real

1) Konrad Putzier, *Korean Appetite for U.S. Commercial Real Estate Heats Up During Pandemic,* Wall St. J. (Nov. 17, 2020, 8:00 AM), https://www.wsj.com/articles/korean-appetite-for-u-s-commercial-real-estate-heats-up-during-pandemic-11605618010 ("South Korean investors are emerging as some of the most aggressive buyers of U.S. commercial real estate during the Covid-19 period. The East Asian country's pension funds, life insurers, and other investors have been targeting warehouses and office buildings with long-term tenants. They are also drawn by ultra-low U.S. interest rates, which make currency hedging cheaper. South Korean investors swarmed some recent hot property sales. They accounted for nine of the 18 bids for a warehouse near Los Angeles that has been leased to Amazon.com Inc ... While Chinese investors have been pulling back from the U.S. in recent years due to local capital controls, and other foreign firms are shying away amid fears over the pandemic, South Korean interest has been rising. In the first nine months of the year, Korean investors accounted for 8.6% of all overseas investment in U.S. commercial real estate, up from 3.7% a year earlier, according to Real Capital Analytics. South Koreans invested $1.56 billion, up from $1.24 billion a year earlier, during that time, trailing only Canadian and German investors. A year ago, South Koreans ranked 10th among foreign investors in U.S. real estate, according to Real Capital Analytics.").

estate acquisition has been steadily increasing. Korean families may buy homes in the U.S. for children who go to school as nonresident aliens (NRAs), U.S. residents, or U.S. citizens by birth. They may also buy permanent homes for their use in preparation for moving to the U.S. or may diversify their real estate portfolio, generating both cashflows of rental income and capital gains after an eventual sale.

Korean families with assets located in more than one country may have concerns about the transfer taxes that may be imposed at the time of death by the foreign jurisdictions where their assets are located. If a family holds a portfolio of U.S. and Korean assets, it will be important to determine which assets the U.S. will consider located in its jurisdiction for estate and gift tax purposes. Both countries tax their residents on a worldwide basis and provide their residents with a foreign tax credit for withholding taxes paid regarding foreign source income. Then, the typical protocols and tests would be followed to determine how the resident or domicile country will treat these assets. Should the Korean family consider a U.S.-based wealth transfer plan, even without the current presence of beneficiaries in the U.S.? How can we structure the acquisition, ownership, and disposition of U.S. residential and commercial real estate properties for them?

Korean families must be familiar with the differences in gift, inheritance, and estate taxation systems in both countries to be prepared for the worst outcomes. Unlike the U.S. federal estate tax,[2)] the donee individuals and nonprofit legal entities in Korea, here through inheritance[3)] or bequest, are

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2) I.R.C. §§ 2031, 2101(a); Sangsokse mit jeungyeosebeop [Inheritance Tax and Gift Tax Act], art. 2 (S. Kor.). While § 2031 of the Internal Revenue Code defines a U.S. domiciled individual's gross estate for U.S. estate tax purposes, the U.S. will impose its transfer tax on the worldwide assets wherever located of a U.S. citizen or the U.S. domiciled individual; or on the U.S.-situs assets of a non-citizen non-resident individual under § 2101(a). Article 2 of the Inheritance Tax and Gift Tax Act of Korea defines the concept of a legatee, resident, and donee for Korean inheritance and gift tax purposes.

3) Mee-hyon Lee, Individual Tax and Private Client Committee: South Korea International Estate Planning Guide (2012) ("The inheritance tax in Korea is imposed on the recipient of the transferred wealth when received, imposed on the increase of wealth occurring to the beneficiary of a property transfer. Inheritance tax is assessed on: (a) all world-wide property bequeathed by a resident, and (b) all situs-property bequeathed by a non-resident. The tax base of inheritance tax is the amount derived by subtracting certain deductions such as public imposts, funeral expenses, claims against the estate, certain charitable contributions, itemized deductions (deductions for the surviving spouse, dependents, minors, the elderly, the

subject to domestic inheritance tax. Although it is the domicile[4] of the beneficiary who is relevant in the U.S., the residence of the person transferring property at death is critical in Korea. A Korean resident donee is subject to a tax on gifted assets, while a nonresident donee is subject to tax on the gifted situs assets only. Gift and inheritance taxes share the same applicable tax rates but with slight distinctions[5] in gift tax deductions.

Trusts are legal relationships under which the legal ownership and management of a property are separated from its ownership. Trusts originated under English common law and are recognized under the laws of most common law countries. Interestingly, East Asian civil law countries, including Japan,[6] China,[7] Taiwan,[8] and Korea,[9] have adopted legislation to allow for the establishment of trusts or trust-like contractual relationships.[10]

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disabled, etc.) from the value of the inherited property. Any of the following is added to the value of the inherited property: (a) the value of property donated within 10 years before the commencement of succession to the successor; or (b) the value of property donated within 5 years before the commencement of succession to a non-successor person. Where one designates a direct lineal descendant, who is not one's own (grand)child as a beneficiary of a bequest, a 30% or 40% sur-charge of generation-skipping transfer (GST) tax is levied in addition to the normal amount of inheritance tax.").

4) I.R.C. § 2209. Under § 2209, domicile is defined as living within a country with no definite present intent of leaving. In English common law, domicile refers to the country to which an individual belongs, the country which is her natural home in which she intends to remain permanently or indefinitely, or if absent, the country to which she intends ultimately to return. While a short-term physical presence might cause residency status for income tax purposes, in the estate and gift tax context, the applicable concept is "domicile," a longer-term relationship with the jurisdiction rather than residence. The country may exercise taxing rights on either worldwide or the situs assets of the domiciled person and the personal use properties will be deemed to have their status at the domicile location.

5) For instance, while a gift tax is not imposed on for-profit companies and non-profit organizations established for the public interest, a non-profit corporation is liable to pay gift tax for any donation it has received. The tax is payable on gifts of more than 5% of the voting shares of a specially-related corporation or 10% for a public interest corporation with certain requirements.

6) Masayuki Tamaruya, *The Transformation of Japanese Trust Law and Practice: Historical Contexts and Future Challenges* 1 (U. Tokyo Bus. L., Working Paper No. 2021-E-02, 2021).

7) Lusina Ho, *Family Trusts for Chinese Clients*, 20 Trusts & Trustees 93 (2014).

8) Chih-Cheng Wang, *The Main Features of Trust Law and Practical Issues of Offshore Trust in Taiwan*, 20 Trusts & Trustees 391 (2014).

9) Ying Khai Liew, *Trusts and Choice Law in South Korea: The Case for Adopting the Hague Trusts Convention*, 20(1) J. Kor. L. 57 (2021)

10) Ying-Chieh Wu, *Trusts Reimagined: The Transplantation and Evolution of Trust Law in*

A trust involves a settlor who settles property to the trust and a trustee who has legal ownership and management of the property for the beneficial owners of the property. The interests of the beneficiaries are mostly fixed and can only be altered by amending the trust instrument in a nondiscretionary trust. In contrast, the trustee retains a wide range of discretion concerning the amount and timing of income or corpus payable to any particular beneficiary under a discretionary trust, where its beneficiary often ends up with 'a mere expectation' of the benefits.

A will substitute trust is inter vivos revocable. Under the Trust Laws[11] of Korea, a settlor has the right to change the structure of a trust, including beneficiaries, during their lifetime because the beneficiary will receive the rights to the trust at the time of the settlor's death or receive trust payments upon the death of the settlor. The assets held in the trust are subject to the inheritance and gift taxes of the decedent. For example, a trust structured as a grantor trust in the U.S. can be tax transparent, whose principal benefit is to avoid[12] probate on the death of the settlor. Although the law allows for

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Northeast Asia, 68 Am. J. Compar. L. 441 (2020).

11) Korea is a country based in civil law, didn't adopt the Hague Convention on the Recognition of Trust of 1985 but does recognize the legal concept of a trust. *See* Mee-Hyon Lee, *supra* note 3 ("Under the Act, trust property does not form part of the inheritance of the trustee, and is not subject to property division following the trustee's divorce. The trust property can't be subject to any compulsory enforcement, auction for exercise of security rights, preservative measure, disposition on default of national taxes, and so on, unless they are grounded on rights created by a cause before the trust, or on rights created while handling the trust business. The trust property does not form part of the bankruptcy foundation of the trustee, the property of the debtors (of which the administrator of rehabilitation proceedings has the authority to manage and dispose), or the individual rehabilitation foundation. If the debtor has established the trust knowingly to the detriment of the creditor, the creditor may claim for cancellation of the fraudulent act and restoration against the trustee or beneficiary even if the trustee acted in good faith…").

12) Funding a trust during a grantor's lifetime requires reregistering real, tangible and intangible properties in the name of the trust(ee), which may avoid the necessity of probate on the death of the grantor. Since the settlors of the trust are the owners of the trusts, items of trust's income, deductions, and tax credits are included when computing the settlor's taxable income and credits, regardless of the actual distribution of the income. Therefore, trusts and the beneficiaries are relieved of any tax obligation. From the cross-border context, because grantor trusts satisfy (1) the residence state laws separately take into account on a current basis the interest holder's respective share of the item of income paid to the entity, whether or not distributed to the interest holder; and (2) the character and source of the item in the hands of the interest holder are determined as if such item were realized directly from the source

the creation of a testamentary trust, will substitute trust, and trust with successive beneficiaries, these are rarely used as a means for property succession. The most relevant reasons for this may be a lack of significant tax benefits versus forced heirship-based legal inheritance and the right to receive some portion of the deceased's estate, notwithstanding contrary instructions in the decedent's will called the elective share, which means heirs are not entitled to inherit the assets with testamentary capacity and the added uncertainties of tax application. Although common U.S. trust planning strategies may be of little use to ordinary Korean families, there might be some potential benefits for those vested individuals under their particular asset situs and planning situations.

Taxation on income derived from the trust depends on whether the trust is opaque or transparent. If the trust is treated as a conduit—therefore not being subject to taxation—any income generated from the trust will vest in the beneficiary, and the tax liability will be assessed according to the beneficiary's residency. Because there is no clear legal distinction between a revocable and irrevocable grantor trust under the income and corporate tax laws of Korea, any income generated from the trust vests in the beneficiary, who is liable to pay taxes on any trust income of interest, dividends, or gains on transfer. The beneficiaries would recognize the profits of the trust assets as their income on the trustee's reception as if the beneficiaries hold the assets directly, but inheritance or gift is subject to tax at the time of distribution to the beneficiaries. An exception for individual and corporate income tax purposes exists for an investment fund that satisfies certain requirements, such as the qualifying investment trust (QIT),[13] when it is established in the form of a collective investment vehicle according to the Financial Investment Services and Capital Markets Act. The profits of the QIT constitute the beneficiaries' dividend income to be withheld at distribution. For tax purposes, foreign investment trusts are always treated as a QIT and taxed as if they have satisfied the requirements of such.

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from which realized by the entity under the U.S. tax laws, they are considered fiscally transparent entities.

13) Sodeuksebeob [Income Tax Act], art. 127 para. 4 (S. Kor.); Beobinsebeob [Corporate Tax Act], art. 73 (S. Kor.).

Cho[14] elaborated on the potential utility of offshore tax blockers[15] for structuring qualified Korean equity investors of U.S. collateralized loan obligations (CLOs) and applied to the investment in publicly-traded partnerships[16] such as U.S. master limited partnerships. The capitalized manager vehicle, which is either a corporation or partnership formatted as the upper-tier of the CLO, is expected to carry both U.S. domestic and Cayman offshore blockers to facilitate two different characteristics of the cash flows of the income[17] from the underlying loan origination activities, which are effectively connected income from U.S. trade or business and the original returns from holding risk-retention notes, which are portfolio interests. Prebble[18] studied New Zealand or Australian trusts[19] with resident trustees with non-citizen and non-domicile (NCND) settlors with foreign source income. The work elaborated on the use and abuse of tax treaty networks of the host countries as well. Kim[20] considered both the general legal issues derived from the different conflict rules on successions in Japan, Korea, and China from a comparative conflict of laws perspective and various succession issues involving special permanent residents in Japan.

The current paper extends Kim's study in several dimensions. First, the present paper tests an application of the U.S. grantor trust rules in the

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14) Joung Keun Cho, *Cross-border Tax Implications in the U.S. CLO Equity Investing by the Qualified Korean Investors,* 6(2) Asset Mgmt. Rev. 17 (Dec. 2018).

15) Tax blockers are the U.S. or foreign entities that are classified as corporations for U.S. income tax purposes. Offshore blockers may check the box under Treasury Regulation § 301.7701-3 to elect their classification for federal tax purposes, or they may be classified as corporations under the default rules. The blocker structure eliminates both the risk of filing a U.S. tax return and the risk that a foreign investor may be deemed to be engaged in a U.S. trade or business by blocking potential U.S.-source ECI and the character of income at the blocker level.

16) Joung Keun Cho, *Cross-border Tax Implications in the U.S. Pass-through Taxation in Master Limited Partnership Interests and Lending*, 28 Asia Life Sci. 503 (2019).

17) Joung Keun Cho, *FATCA and Foreign Pass-through Payment Issues in the U.S. Collateralized Loan Obligations Equity Investing by the Accredited Korean Investors*, 18 Asia Life Sci. 359 (2019).

18) John Prebble, *Trusts and Double Taxation Agreements*, 2 eJ. Tax Rsch. 192 (2004).

19) Jeremy Beckham & Craig Elliffe, *New Zealand's Foreign Trust Regime and the Use of Tax Treaties*, 18 Trusts & Trustees 833 (2012).

20) Eon-Suk Kim, *Cross-border Succession in Japan, Korea, and China and Related Legal Issues*, 35 Chonnam L. Rev. 27 (2015).

context of Korean individuals as NCND grantors of a trust from U.S. estate and income tax purposes. Second, although Prebble[21] approached a comparative treatment of trustees in the host countries between the common law jurisdictions and among the civil law countries as in Kim,[22] the current paper explores the specific relevance of the U.S. and Korean rules and income tax convention to garner income and transfer tax planning possibilities concerning U.S. real estate investment by Korean families. Various alternative investment structures will be reviewed from different investor perspectives. Therefore, the current paper revolves around the following goals: (1) eligibility regarding the preferential long-term capital gains rate of individuals upon disposition of the property; (2) minimum exposure to 30% withholding tax on the imputed fair market rent of the property because of a chosen cross-border real estate holding structure; (3) minimum exposure to federal estate and state inheritance taxes and the heirs' eligibility to a step-up in basis should the owner die; and (4) minimum required individual compliance with the U.S. Internal Revenue Service (IRS), such as filing personal income tax returns. An assured level of privacy in both jurisdictions, as well as coordination in the foreign tax credit regime in Korea, might be sought.

It is readily apparent that addressing all particular objectives is not viable: although the ownership of a U.S. home may trigger an NCND Korean investor, who would be a likely U.S. tax resident, the ownership would affect the application of the rules for determining this individual's residency under the closer-connection test or a tie-breaker provision for dual residency under the Korea–U.S. Income Tax Convention ("Treaty"). Thus, an item-by-item income approach may be more eligible when it comes to working within the Treaty. Furthermore, anonymity in tax compliance will come at a cost through the use of fiscally nontransparent tax blockers because it prevents the availability of preferential rates of capital gains tax or may require further structuring to mitigate the outcomes of double taxation. Because every structure—ranging from multilayered tax partnerships to common law trusts—in cross-border settings may involve more than simply compromise on one or more pros

21) Prebble, *supra* note 18.

22) Kim, *supra* note 20.

and cons, identifying and prioritizing the most important concerns of each particular case may provide better opportunities for achieving the desired outcomes.

The current article proceeds as follows: Section 2 discusses U.S. estate and gift tax frameworks applicable to resident Korean individuals. Section 3 formulates a set of investment structuring solutions applicable to Korean cross-border families. After advanced structuring exercises adopting foreign grantor trust, foreign non-grantor trust, and U.S. discretionary trusts in Section 4, Section 5 considers the eligibility issues of treaty benefits, including foreign tax credits. Section 6 concludes the paper.

II. U.S. Income, Estate, and Gift Taxation Rules Applicable to Korea Resident Family

1. General Approach

Korean families buying U.S. homes would face inevitable tax issues at each stage of the acquisition, duration of ownership, and disposition of the property in the forms of sale, exchange, gift, or bequest. For instance, they are taxed on U.S.-source non-ECI[23] FDAP[24] income on a gross basis and are

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23) When a foreign person engages in a trade or business in the U.S., all income from sources within the U.S. connected with the conduct of that trade or business is considered to be effectively connected income (ECI), whether or not any connection between the income, and the trade or business being carried on in the U.S., during the tax year.

24) I.R.S. I.R.M. 4.10.21.2(11) (Sept. 20. 2018); FDAP income is Fixed or otherwise Determinable and Annually or Periodically is paid in non-regular frequencies such as alimony, annuities/wages/salary, interest, dividends, lottery/slot machine winnings, premiums, rent, remunerations, and intellectual property sales income where compensation is contingent upon the use, productivity, or disposition of the property. Capital gains from personal property sale may be considered FDAP if the non-U.S. person stays in the U.S. over 183 days during the tax year. Treasury Regulation § 1.1441-2(a) defines FDAP income as all income included in gross income under IRC § 61 (i.e., all income unless it is specifically excluded by the IRC). One important exception to this all-inclusive rule is for gains. There is no withholding required for gains derived from the sale of property (including market discount and option premiums) except for gains described in IRC § 631(b) or (c) (relating to the treatment of gains on the disposition of timber, coal or domestic iron or with a retained economic interest) and gains subject to the 30% tax under IRC § 871(a) (1)(D) or IRC § 881(a)

not entitled to the itemized deductions available to average U.S. taxpayers, such as qualified residence interest and property taxes in their U.S. personal income tax returns. Any expense related to personal use property[25] remains nondeductible when the property is held through a trust or partnership, while the expenses of maintaining trust assets may reduce the distributable net income (DNI). Whenever a home is structured to be acquired through a corporation, deductions of these maintenance costs may be allowed; however, any personal use of the corporate property will result in an imputed fair market rental income to be included in the NCND Korean shareholder's Form 1040 filings. When the home is owned through a partnership, not only will any rent-free use result in the imputation of rental income, but the maximum $500,000 exemption under the Internal Revenue Code (IRC) § 121 for gain from the sale of a principal residence may not be available. If the home is held in a U.S. domestic trust, foreign[26] grantor trust (FGT), or foreign non-grantor trust (FNGT) after the death of the NCND Korean settlor, any personal use of the home by U.S. beneficiaries would give rise to imputed income[27] to the trust and be treated as a distribution to those U.S. beneficiaries.

It is reasonable for NCND Korean families to intend to minimize U.S.

(4) (relating to contingent payments received from the sale or exchange of patents, copyrights and similar intangible property). Other items of income which are excluded from the withholding requirements are: (1) non-U.S. source income; (2) portfolio interest paid on a debt obligation; (3) bank deposit interest; (4) interest or OID on a short-term OID obligation; and (5) insurance premiums paid on a contract subject to IRC § 4271 excise tax or paid to a foreign insurer.

25) Personal use property is not purchased with the primary intent of making a profit, nor do use it for business or rental purposes including vehicles, furniture, boats, etc. and generally does not increase in value overtime. On the other hand, listed personal property may increase in value over time such as jewelry, art works, coins, etc. While capital losses for personal use property are denied, capital losses for listed personal property can only be applied against the same type of gains.

26) The term 'foreign' in FGT and FNGT in this article means non-U.S. All statutory references are to the U.S. Internal Revenue Code of 1986 and related U.S. Federal Regulations, as amended.

27) Neither FGT nor FNGT needs to file a U.S. return if it holds a U.S. home producing no income at all and is used exclusively by their non-U.S. beneficiaries and related family members. On the other hand, if the home is held through a U.S. domestic corporation, the corporation must file a return even if it has no income because imputed rental income issue always attracts further compliance requirements.

situs assets to avoid estate taxes by holding U.S. real property, U.S. situs tangible personal property, and U.S. corporation shares through Korean entities that have elected to be treated as non-U.S. corporations. However, any U.S. source income payable to a Korean entity is subject to withholding tax and immediate income tax consequences if a U.S. real estate would transfer to a Korean entity. Because bond interest income is preferred to stock dividends and rental income, Exhibit 1 summarizes the general income tax treatment of the NCND Korean families' U.S. source income.

Exhibit 1. U.S. Source Income and General Tax Treatment

U.S. Source Income	General U.S. Income Tax with Treaty Treatment
Capital Gains Other than U.S. Real Property Gains	Generally excluded from U.S. income tax. However, if an NCND Korean was present in the U.S. > 183 days during the year, the net gains are taxed at 30%. Capital gains are also subject to U.S. taxes if they are ECIs. FDAP income is taxed on a gross basis at 30% for NCND Korean individuals and corporate entities.
Capital Gains from the Sale of U.S. Real Property	Under the Foreign Investment in Real Property Tax Act (FIRPTA) of 1980, capital gains from the sale of U.S. real property are taxed on a net basis. A 15% withholding tax is required based on the gross sale price. For capital gains from the disposition of a residence < $1 million, withholdings are required at a reduced rate of 10% in IRS Forms 8288 and 8288-A.
Dividends	Dividends from U.S. corporations are generally included as U.S.-source taxable income and subject to 30% gross withholding tax. Reduced rates may apply under the Treaty: (a) 15% of gross dividend or (b) 10% of gross dividends if the corporate recipient owns (i) at least 10% of the voting stock of the paying corporation and (ii) not more than 25% of the gross income of the paying corporation for the prior taxable year consists of interest or dividends.
Interest Income from Bank Deposits[28]	Excluded from 30% gross withholding tax unless ECI.
Interest Income from Bonds or other Debts	Subject to 30% gross withholding tax, unless the portfolio interest exception applies. A reduced Treaty rate not to exceed 12% of the gross amount of interest may apply.

Portfolio Interest Exemptions	Excludes interest paid to NCND Koreans on bonds and other debt securities if: (1) the registered-form obligation; (2) an NCND Korean individual or entity is the beneficial owner of income; and (3) the recipient provides the payer IRS Forms W-8, W-8BEN, 1042, and 1042-S.
Rental Income	Rental income is subject to 30% gross withholding tax. A special election by NCND Korean individual owners enables treating U.S. real property interests as ECI for net income taxation, with some allowed deductions.
U.S. Mutual Funds	Certain interest-related dividends[29] and long-term capital gain dividends from U.S. issuers are excluded from U.S. income tax. U.S. mutual funds may designate both interest-related and capital gain dividends.

Under the 1996 law,[30] "Every trust is a foreign trust[31] unless (1) the U.S. court can exercise primary jurisdiction over the administration of the trust; and (2) at least one U.S. persons have the power to control all substantial decisions of the trust." Failure to meet the demands of either test makes a foreign trust for U.S. federal income tax purposes, even if the trust is created and governed by the U.S. law of a state and administered in the U.S. by a U.S. trustee. If the trust fails to qualify for these exceptions in any particular year, it may not qualify in any subsequent year, even if the requirements are otherwise satisfied. A safe harbor[32] is created whereby the

28) I.R.C. §§ 2105(b)(1), 871(i)(3). U.S. bank deposits include money in a checking, savings or unrestricted agency account and certificates of deposit. Cash in a bank's safe deposit box is not a U.S. bank deposit and the funds held by a bank in a fiduciary capacity where the beneficiary's access is restricted do not constitute U.S. bank deposits. A brokerage firm is not in the banking business, and cash held by a U.S. brokerage firm will still have a U.S. situs.

29) Andrew Haave et al., *Welcome to the (Regulatory) Jungle: Tax and Securities Law Considerations in Private Inbound Structures*, 94 TAX NOTE INT'L. 975 (2019).

30) I.R.C. § 7701(a)(30)(E), (31)(B). Under the Fed. Reg. § 301.7701-7, "the "U.S." refers only to the fifty states and the District of Columbia."

31) For clarity, a person is foreign if she is non-U.S. citizen/resident. A settlor creates a trust and the grantor is treated as the owner of the trust under the U.S. income tax rules. A non-grantor trust is treated as a separate (i.e., opaque) taxpayer for U.S. income tax purposes, while a grantor trust is still very transparent.

32) DORSEY & WHITNEY, LLP. ("A safe harbor exemption is not the exclusive means that must be employed to fall within a more general exemption or jurisdictional limitation. By

trust is a domestic trust if it is (a) administered[33] exclusively in the U.S.; (b) no provision of directing administration outside the U.S.; and (c) no automatic change of situs clause,[34] except for some force majeure situations. Any person who can control substantial decisions will be treated as a fiduciary for the purposes of the control test. Therefore, a grantor or beneficiary who can revoke and/or appoint will also be considered in determining "substantial control."

Treasury regulations provide a nonexclusive list of "substantial decisions," including (1) whether and when to distribute income/corpus and the amount of any distribution; (2) the selection of a beneficiary and power to make investment decisions;[35] (3) whether an incoming cash flow is allocated to income or corpus; (4) whether to compromise, arbitrate, abandon claims of the trust, or terminate the trust; (5) whether to sue/defend on behalf of the trust; (6) whether to remove, add, or appoint a successor to a trustee. If any vacancy by a trustee's death/resignation would shift control of a substantial decision out of the U.S. (an "inadvertent change"), the trust can reinstate U.S. control within 12 months by a change of (or residence of) fiduciaries to remain a U.S. trust. Otherwise, it will become a foreign trust on the date of the vacancy. For instance, a discretionary will trust can be formed with an institutional U.S. trustee, and the trust can be governed by South Dakota law. When one of the NCND Korean family members is appointed to act as a co-trustee with sole or shared investment discretion, it is a foreign trust because a U.S. fiduciary

promulgating a safe harbor, the IRS is affirming that someone complying with its requirements will definitely have the benefit of the broader exemption or limitation.").

33) Administration of trust means either substantial or ministerial such as, but not limited to, "carrying out the operational and fiduciary duties such as maintaining books/records, filing tax returns, managing/investing assets, defending from creditors' suits, and determination of timing and amount of distributions under the trust instrument and applicable laws."

34) A provision requires an automatic migration from the U.S. in response to any attempts of asserting jurisdiction by a U.S. court.

35) If a U.S. trustee or protector appoints/removes a foreign investment advisor, this appointment alone will not make the trust foreign. Likewise, the power solely to name a successor will not be considered a substantial decision if it is limited to change the situs of the trust from one jurisdiction to another.

cannot control[36] substantial decisions.

2. Estate and Gift Taxes to NCND Korean Families

The estates of NCND Korean individuals are subject to estate tax on U.S. situs assets. The same rates of up to 40% for U.S. citizens are assessed as the U.S. estate tax, with a $60,000 exemption versus a 2022 lifetime exemption[37] of $12.06 million available for a U.S. person. Worldwide debts and administration expenses may be deductible in proportion with the decedent's U.S. to worldwide assets. Nonrecourse liabilities are allocated to the properties they secure, while most third-party loans are considered recourse debts for this purpose. An unlimited marital deduction is available for the property left to a qualified domestic trust (QDOT) for a non-U.S. citizen's surviving spouse. U.S. situs assets for estate tax purposes include (1) U.S. situs real property;[38] (2) U.S. situs tangible personal property, unless in transit or an exhibition; (3) U.S. corporate shares;[39] (4) U.S. incorporated mutual funds[40] and money market funds organized in corporate form; (5) U.S. brokerages cash deposits[41] and personal properties

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36) I.R.C. § 7701(a)(30)(E). While a U.S. trustee confirms the trust might pass the court test for the status of U.S. domestic trust, having a non-U.S. person as trust protector with substantial power to replace the trustee can be an intentional failure of the control test and the trust is still foreign for U.S. income tax purposes.

37) I.R.C. § 2106(b).

38) Treas. Reg. § 20.2104-1(a)(2); *id.* § 20.2105-1(a)(2).

39) I.R.C. § 2104(a), including shares of a U.S. co-operative corporation such as co-op apartment. However, the shares of non-U.S. corporation are not treated as U.S. situs and the location of the certificate and the custody account are irrelevant.

40) *Id.* § 2104(a). Mutual fund here refers to non-listed, liquid publicly offered collective investment vehicles. For partnership or grantor trust-type of fund, the situs of the underlying assets will decide the situs of the fund. However, the situs rules are less clear for partnerships, which are not addressed in the IRC or Treasury Regulations. One may generally assume that interests in limited or general partnerships will probably be considered U.S. situs assets if either do business in the U.S. or own assets in the U.S. Some authorities suggest one would look to the underlying assets or where the partnership conducts its business (if any), while others suggest one might look to where the partnership is organized.

41) *Id.* § 2104(c). Since the elimination by the Taxpayer Relief Act of 1997, bonds would qualify for the portfolio debt exemption without considering the stated maturity. NCND decedent Korean-owned publicly traded bonds and registered private debt would qualify as "portfolio debt" and not be subject to U.S. estate taxation, provided the decedent was also an

in safe deposit boxes; (6) U.S. obligor debts; and (7) cash surrender value of U.S. insurer-issued life insurance[42] owned by an NCND Korean on the life of another person.

Non-U.S. situs property held by NCND Korean individuals at death is eligible for a basis adjustment[43] under IRC § 1014(a)—"The basis of property acquired by bequest, devise, or inheritance or by the decedent's estate is stepped up or down to fair market value (FMV) at the time of death"—even though it is not subject to the U.S. estate tax. Property that is otherwise includable in the decedent's taxable estate[44] is eligible for a basis adjustment at death, even if such property does not pass by bequest, devise, or inheritance. Property transferred in a trust that is not includable in the decedent's taxable estate[45] is eligible for a basis adjustment at death but only if certain the delineated powers are retained by the decedent during their lifetime.

Gifts include bequests[46] from the estates of non-U.S. persons. Transfers of non-U.S. situs properties to a U.S. donee by an NCND Korean are not subject to U.S. income, estate, gift, or generation-skipping transfer (GST)[47] tax, unless the donor is a covered expatriate.[48] Naturally, NCND Koreans

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NCND for income tax purposes (*id.* § 2105(b)(3)). In addition, U.S. bank accounts including checking, savings, time deposits and certificates of deposits are not U.S. situs property. Under *id.* §§ 2105(b)(3), 871(h), the types of obligations that can qualify as portfolio debt obligations include U.S. government obligations; obligations issued by agencies of the U.S.; obligations issued by states, counties, cities and public authorities; and obligations of U.S. corporations and partnerships. However, it is unlikely that debt obligations issued by a U.S. individual would qualify. In TAM 9748004, the IRS held that a unit investment trust which held portfolio debt obligations was treated as non-U.S. situs property under *id.* § 2105(b)(3).

42) Treas. Reg. § 20.2105-1(g). Life insurance proceeds paid by a U.S. insurer on the life of an NCND are not U.S. situs property.

43) Rev. Rul. 84-139, 1984-2 C.B. 168.

44) I.R.C. § 1014(b)(9). For instance, the U.S. situs assets held in a trust settled by an NCND with certain "retained strings".

45) *Id.* § 1014(b)(2)-(3). For instance, non-U.S. situs assets held in a trust settled by an NCND grantor without any "retained strings."

46) *Id.* § 6039F(b). While a devise is a testamentary gift of real property, a bequest is a testamentary gift of personal property other than cash.

47) Treas. Reg. § 26.2663-2.

48) I.R.C. § 877A(g)(1). The average annual net income tax of more than $171,000 that must be imposed for the 5 tax years ending before the date of the cessation of the citizenship or long-term permanent residency for an individual to be considered a covered expatriate.

are subject to gift tax only on gifts of U.S. situs real property and tangible personal property. Annual exclusion of $16,000 (in 2022) for gifts of a present interest may apply, but the $60,000 credit afforded for estate tax purposes may not be applied to gifts. Although gift tax would not apply to U.S. corporate shares, gifts of cash and checks that take place within the U.S. may be subject to the gift tax; therefore, cash gifts[49] to a U.S. person by an NCND Korean individual should not be made in the U.S. Any U.S. person who receives over $100,000 of "large gifts" from non-U.S. persons at any time must report[50] the gifts with their income tax return by the following April 15 tax deadline. Although qualified medical or educational payments[51] are not considered to be gifts—thus carrying no need for reporting—the U.S. donee is required to report the receipt of purported[52] gifts from Korean corporations and/or partnerships if the aggregate amount of purported gifts from all such entities exceeds $17,339 (in 2022) in any year.

IRS Form 3520, "Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts," is used by U.S. persons to report certain transactions with foreign trusts, ownership of foreign trusts under the grantor trust rules, and receipt of certain large gifts or bequests from foreign persons. Although the recipient must be a U.S. person, for income tax purposes, the non-U.S. person may be a Korean individual, entity, corporation, partnership, trust, or estate. The reporting is to ensure that the purported gift is not a disguised distribution of income from an FGT or FNGT. Although there is no tax on gifts from NCND Korean persons, there will be severe tax consequences[53] if the gift is not reported on

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49) *Id.* § 2501(a)(3); *id.* § 2511(b).

50) *Id.* § 6039F; Form 3520 ("The U.S. donee must aggregate gifts from NCND individuals that she knows or has reason to know are related, within the meaning of *id.* § 643(i)(2)(B). If an NCND mother and father each give their U.S. person $60,000, the gifts are aggregated, breaching the $100,000 reporting threshold, and the U.S. recipient must report both gifts. Once the $100,000 threshold has been breached, the U.S. recipient must separately identify each gift in excess of $5,000.").

51) *Id.* § 2503(e).

52) *Id.* § 672(f)(4). "Purported" implies the IRS may recharacterize those gifts from entities as taxable income to the U.S. recipient.

53) *Id.* § 6039F(c)(1)(A), (B) ("The form does not ask for the identity of a foreign individual donor, although the IRS could request this information."). Form 3520 is required to be filed

Form 3520. The U.S. recipient is subject to a penalty greater than $10,000 and 5% per month of the gift value (up to 25%). Penalties can be waived very selectively only upon reasonable cause, but ignorance of the law is not reasonable cause.

A revocable FGT by an NCND Korean individual to hold assets will not in and of itself reduce taxes payable in Korea, and the U.S. source trust income is still subject to U.S. withholding tax. Furthermore, if the NCND Korean grantor has a retained interest in the trust, such as its power to revoke the trust structure, it will not be able to shield its U.S. situs assets from U.S. estate taxation. An FGT or FNGT might hold the shares of an appropriately administered Korean corporation that, in turn, holds the financial assets that will shield U.S. stocks from U.S. estate tax. On the other hand, the FGT or FNGT might offer substantial nontax benefits, such as preservation of wealth for future generations with discretionary cash flows, which is a rare platform in high inheritance tax jurisdictions such as Korea,

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under a number of circumstances. A U.S. person is required to file Form 3520 for a calendar year if during the year: (1) she is the "responsible party" for reporting a "reportable event" or held an outstanding obligation of a foreign trust (or of a person related to the trust) that they treated as a "qualified obligation;" (2) she is a U.S. person who is treated as the owner of any part of the assets of a foreign trust under the grantor trust rules; (3) she is a U.S. person who received a distribution from a foreign trust, either (in)directly, or a related foreign trust held an outstanding obligation they issued (or an obligation of a person related to them) that they treated as a qualified obligation; (4) she is a U.S. person who received more than a $100,000 gift or bequest from a NRA or a foreign estate or received gifts of more than $17,339 (for 2022) from foreign corporations or foreign partnerships, or (5) she is a U.S. person who received a gift (or bequest) of more than the annual gift tax exclusion amount ($16,000 in 2022) from a "covered expatriate." There are limited exceptions to filing with respect to tax-exempt trusts, transactions for FMV, compensation for services and similar transactions. Form 3520 is due when the income tax return is due, including extensions (or when Form 706 is due in the case of a U.S. decedent). A maximum 6-month extension is available for tax years beginning after Dec 31, 2015. The penalties for failure to file Form 3520 are significant. The initial penalty is the greater of (i) $10,000 or (ii) 35% of the gross value of any property transferred to a foreign trust that is required to be reported, 35% of the gross value of distributions from a foreign trust that is required to be reported, or 5% of the gross value of the portion of a trust's assets treated as owned by a U.S. person that is required to be reported. In the case of the failure to report large gifts or bequests from foreign persons, the penalty is 5% of the amount such foreign gifts apply for each month in which the failure to report continues, but not to exceed a total of 25%. These penalties may be waived if the failure to file was for reasonable cause and not willful neglect. An additional accuracy-related penalty of 20% may be imposed for undisclosed foreign financial asset understatements.

and additional protection from foreign taxes, creditors, forced heirship, selective shares, and potential marital claims, including blackmail from a (previous) spouse(s).

A sophisticated irrevocable structure settled in a trust-friendly jurisdiction protects U.S. assets and serves to save estate and GST taxes for future generations. Transfers by an NCND Korean grantor to a U.S. beneficiary and any U.S. domestic trust are not subject to U.S. estate, gift, or GST tax on non-U.S. situs assets, which is a significant benefit in the scope of estate planning discussions for NCND Korean families. Exhibit 2 shows an application of the U.S. transfer tax rules to NCND Korean donors and donees.

Exhibit 2. Application of U.S. Transfer Tax Rules

	Non-U.S. Citizen/Non-U.S. Domiciled	U.S. Citizen or U.S. Domiciliary
U.S. Estate Tax	Taxable on U.S. situs assets (real, tangible, and intangibles)	Taxable on worldwide assets
Applicable Exclusion	$60,000, available for estate tax purposes but not for lifetime gifts	$12,060,000 (in 2022) available for estate, gift, and GST tax purposes
U.S. Gift Tax	Taxable on gratuitous* transfers of U.S. situs tangible assets (real and personal)	Taxable on all gratuitous transfers
Annual Gift Tax Exclusion	$16,000 (in 2022), but gift splitting with a spouse is not allowed	$16,000 and gift splitting with U.S. citizen/domiciliary spouse is allowed
Transfers to a Non-U.S. Citizen Spouse	- No unlimited marital deduction for transfers to a non-U.S. citizen spouse - Lifetime gift to non-U.S. citizen spouse, annual exclusion of $164,000 (in 2022)	

* A gratuitous transfer is any transfer not for FMV. Anyone who creates a trust without making gratuitous transfers to it is not treated as a grantor of any portion of the trust.

Although NCND Korean individuals can gift certain intangible assets, such as the securities of U.S. corporations, to others during their lives free of U.S. gift tax, their estate is fully subject to tax if the same person dies

holding these assets. For both gift and estate tax purposes, real property and tangible personal property physically located in the U.S. have a U.S. situs. For gift tax purposes, the intangible personal property does not have a U.S. situs, regardless of its source or location. For estate tax purposes, intangible personal property has a U.S. situs if it is derived from a U.S. person or entity. Stock issued by a U.S. corporation and debt obligations issued by or enforceable against any U.S. person or entity has a U.S. situs for estate tax purposes. For deposits with U.S. banks and savings and loans, life insurance proceeds paid by U.S. life insurance companies if the insured is an NCND Korean individual, portfolio debt obligations, and works of art on loan for the exhibition are treated as non-U.S. situs. An NCND Korean individual may make a transfer of an American Depository Receipts of a Korean corporation or a Puerto Rico Bond to a U.S. beneficiary either during life or death and can do so free of the U.S. transfer taxes, whereas a transfer of the stock of a U.S. corporation or a non-qualified U.S. municipal obligation at death would be subject to U.S. estate tax. Exhibit 3 summarizes the treatment of the assets of NCND Korean individuals for U.S. transfer tax purposes.

Exhibit 3. General Treatment of Assets of NCND Koreans for U.S. Transfer Tax Purposes

<table>
<tr><th>Asset Classes</th><th>U.S. Situs for Estate Tax Purposes</th><th>U.S. Situs for Gift Tax Purposes</th></tr>
<tr><td>Korea situs Assets</td><td colspan="2" rowspan="2">Nontaxable</td></tr>
<tr><td>Real Property – Korea situs</td></tr>
<tr><td>Real Property – U.S. situs</td><td colspan="2" rowspan="4">Taxable</td></tr>
<tr><td>U.S. Real Property Held by a Korean Corporation*</td></tr>
<tr><td>Tangible Personal Property – U.S. situs</td></tr>
<tr><td>Currency/Cash – U.S. situs</td></tr>
<tr><td>U.S. Bank Deposits (checking, certificates of deposits)</td><td>Nontaxable</td><td>Taxable</td></tr>
</table>

U.S. Brokerage Deposits	Taxable	Nontaxable
U.S. Mutual Funds**		
U.S. Corporation Stocks		

* Despite Article 16 of the Treaty, the U.S. and Korean tax authorities signed a mutual agreement in June 1999 and listed it as an IRS Notice; this notice confirms Korea's taxation rights on the disposal of stocks of excessive real estate corporations. According to Korean law, the proceeds from the corporate stock transfer that meet certain requirements are regarded as real estate transfer income to be treated as domestic source income. Based on reciprocity, the U.S. would retain taxation rights on the disposal of Korean corporate stocks with more than 50% of the balance sheet assets of U.S. real property interests.
** U.S. mutual funds structured as regulated investment companies are U.S. corporations and treated as U.S.-situated assets for estate tax purposes.

3. *Foreign Trust Planning*

There are advantages for NCND Koreans in creating a multi-generational trust for the benefit of U.S. heirs because U.S. estate, gift, or GST tax will not be imposed on the trust assets. Once the NCND Korean creates an inter-vivos FGT for the U.S. beneficiary, the structure may provide a significant advantage in U.S. income taxes. An NCND Korean can also create a long-term U.S. domestic or nonresident trust for U.S. beneficiaries without transfer tax consequences for the life of the trust. If the trust would be created in a jurisdiction not bound by a legal doctrine of the Rule Against Perpetuities,[54] the longer-term benefit of transfer tax avoidance may be achieved in both jurisdictions.

The U.S. trust will be subject to U.S. income taxes, while an NCND Korean grantor will be subject to U.S. income taxes for their FGT. If all the beneficiaries would be expected to remain in the U.S. for the longer term and the structuring trust to qualify as an FGT is difficult, it can be designed as a U.S. trust. If the FGT is irrevocable, the Korean grantor and the grantor's spouse should be the sole beneficiaries during their lives for receiving trust distributions and can be designated to be taxed as either a

54) Trust must terminate and distribute assets no later than 21 years after the death of the last surviving individual who is alive at the time the trust was created.

foreign or U.S. trust. The sole beneficiaries can make gifts to the U.S. beneficiaries at any time, but the U.S. recipient must report the nontaxable gifts over the threshold of $100,000. On the other hand, if it is a fully revocable FGT, the trust can be directly transferred to a U.S. recipient without U.S. income tax consequences. The U.S. beneficiary would be required to file Form 3520 and appoint a U.S. agent or else have the trustee represent to the IRS that it will allow access to the trust's books and records to prove that it is a grantor trust. If the NCND Korean grantor wishes the trust to continue for the U.S. beneficiary and the beneficiary's descendants for the longest term possible, even after the spouse of the grantor's death, it can be designed to grant the beneficiaries in each generation only a limited power of appointment.

The U.S. beneficiaries receiving distributions from an FNGT will be subject to U.S. income tax plus daily-compounded interest charges on the tax from the previous years' undistributed net income[55)] (UNI) and additional reporting[56)] requirements. For income tax purposes, if the FNGT delivers all current income and capital gains to the U.S. recipients, there will be no accumulation problem because the relevant U.S. income tax returns were already filed and paid by the U.S. beneficiary. If an "NCND U.S. resident beneficiary" is planning to leave the U.S. in the near term and will not be liable to U.S. income tax, the trustee may leave the FNGT offshore.[57)] The trust can accumulate income without U.S. income tax concerns because any meantime cash flow to the U.S. beneficiary can be met through a qualified loan. A detailed discussion of cross-border succession planning by NCND Korean individuals through FGT and FNGT will appear in a future article. Once the beneficiary ends their U.S. residency, the FNGT can be freely distributed, irrespective of current and accumulated income, with no U.S. income tax consequences. However, this may not be a wise approach once the beneficiary is a covered expatriate.

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55) Under IRC § 665(a), UNI for any taxable year is defined as the amount by which the trust's DNI exceeds (1) the amount distributed to the beneficiary and (2) the amount of tax imposed on the trust for the DNI.

56) Glenn G. Fox & Paul DePasquale, *U.S. International Trust Reporting and Planning*, 29 Int'l L. Prac. 33 (2016).

57) In this case, the trust is in the form of a "foreign irrevocable, discretionary, dynasty trust."

Because distributions from nonmodified[58)] endowment life insurance contracts might be useful to the beneficiaries without U.S. income tax concerns up to the premium limits, investing the trust assets in an annuity or variable life insurance policies qualified for tax purposes would build up income without interest charges on UNIs. However, a full discussion of private placement annuity or variable life insurance planning is beyond the scope of the current paper.

4. Underlying Entities

The trust may carry assets through underlying Korean and/or U.S. entities to avoid U.S. estate tax during the lifetime of the grantor. If NCND Korean individuals hold their domestic and U.S. securities outright, both the U.S. and Korea may impose death taxes, while a nonresident corporate tax shield against such taxes might be recognized. The underlying entity may be useful, even if the assets are U.S. and/or Korea situs. However, upon the death of the NCND Korean grantor, the underlying entity may be transformed into a controlled foreign corporation (CFC) or a passive foreign investment corporation (PFIC), with negative tax consequences in both jurisdictions to the U.S. heirs. Because even a day of CFC status[59)] can expose U.S. shareholders to fractional phantom income inclusions, this can present potential complications with the unwinding of an offshore tax blocker structure after the death of an NCND Korean settlor. The underlying entity should elect to be disregarded for U.S. tax purposes or liquidated outright, and the assets should be held directly by the trust because the aim of a U.S. estate tax shield is no longer present after death or could be replaced with another limited liability company (LLC).

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58) A modified endowment contract (MEC) is a cash value life insurance contracts that have exceeded federal tax limits and there are no tax benefits of cash withdrawals from the policy.

59) Until the Tax Act of 2017 (formerly known as the "Tax Cuts and Jobs Act of 2017") went into effect, a foreign corporation had to be a CFC for at least 30 consecutive days for the CFC rules to apply. However, this 30-day rule was repealed by the Tax Act of 2017. *See* I.R.C. § 1226 ("To qualify as a foreign investment company (FIC), a foreign corporation must have more than 50% U.S. ownership and operate or be registered as a mutual fund. Income on the sale of an FIC is taxed as ordinary income, and there is no step-up in basis at death.").

Under the U.S. "check-the-box" regulations,[60] it is possible to elect simply for most offshore entities to be treated as transparent for U.S. tax purposes. Because not all entities are eligible to make this election, an entity type has not been designated as a "per se" corporation[61] by the IRS to choose when setting it up. For instance, Korean "Chusik Hoesa" is a per se business entity under TR § 301.7701-2(b)(8)(i) and, thus, not eligible for the election. During the Korean grantor's life, the election is not necessary if the Korean entity holds U.S. situs assets because the treatment of transparency would be applicable for estate tax purposes as well, and the election could voluntarily eliminate the existing estate tax shield for U.S. situs assets that the entity is intended to serve.

This Korean corporate entity may constitute a PFIC that is determinable by a passive income and assets test, but the shares can be publicly held.[62] A Korean corporation is a PFIC if the passive income is more than 75% of its gross income or if more than 50% of the average value of its assets is passive. Most non-U.S. mutual funds[63] would be considered PFICs. U.S. shareholders may choose the qualified electing fund (QEF) or mark-to-market elections to include the PFIC's pro-rata shares of ordinary income and capital gains in her current income. A full check-the-box election of deemed liquidation analysis is beyond the scope of the current article, but briefly, without either election and upon the sale of PFIC shares, U.S. shareholders should recognize ordinary income on the gain and interest charges on the deferred taxes under IRC § 1291.

A CFC is generally a foreign corporation with over 50% ownership in value or voting shares by U.S. shareholders who hold at least 10% of voting[64] control or value. The coverage of a CFC is wider than PFIC for

60) Treas. Reg. §§ 301.7701-1 to -3. Election *post mortem* may result in some phantom income inclusions for the U.S. beneficiaries due to changes in the rules governing CFCs introduced by the Tax Act of 2017. However, the phantom income inclusion can usually be minimized with proper planning vs. the estate tax inclusion from a *pre-mortem* election.

61) Treas. Reg. § 301.7701-2(b)(8).

62) I.R.C. § 1296.

63) To make and maintain a QEF election, the U.S. shareholder must report certain financial information regarding the PFIC, which the offshore fund managers may not be willing to provide.

64) I.R.C. § 957.

entities with the majority of their revenue as passive income. Under IRC § 951(a) and Global Intangible Low-taxed Income (GILTI),[65] if the entity is a CFC during any part of the taxable year, each U.S. shareholder on the closing day of the fiscal and/or calendar year may be taxed on the pro-rata share of its subpart-F income.[66] Under the GILTI regime, a U.S. shareholder

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65) As an additional tax on active business earnings of CFCs. For individual U.S. shareholders of CFCs, GILTI is computed as the excess of CFC net income over a 10% return (reduced by interest expense) on the cost base of tangible assets used for the production of income. There are several classes of income that are excluded from the GILTI computation, including ECI and foreign income that has incurred an effective foreign tax rate greater than 90% of the applicable U.S. corporate tax rate. Given that Biden Administration would probably increase the U.S. corporate tax rate to 28%, a CFC paying an effective tax of greater than 25.2% will not be subject to GILTI. While most Korean companies will be paying more than 25.2% in Korean tax, the actual computation will be complicated by exchange rate fluctuations, and differences in accounting periods and methods.

66) Subpart-F refers to a section of the IRC to prevent deferral of passive income inside a PFIC closely held by U.S. persons. The essential idea is that passive income earned inside a CFC is taxed directly to the shareholders as a "subpart F inclusion", while active business income is taxed to the shareholders only when distributed as a dividend. Any income taxed directly to an individual shareholder under the subpart F rules is considered Previously Taxed Income (PTI), which increases the taxpayer's cost base in CFC shares, and future distributions from the CFC will be treated as tax-free return of capital to the extent of PTI. Alternatively, individual shareholders of CFCs have the option under IRC § 962 to elect to be taxed at corporate rates on their subpart F inclusion. This election has the advantage of allowing foreign tax credit for the income tax paid at the corporate level, and the disadvantage that any subpart F inclusion taxed under IRC § 962 is not added to PTI and does not increase the cost base of the shares. Only the shareholders who (in)directly own 10% or more of the corporation's voting power are considered U.S. shareholders and are subject to tax on certain kinds of the PFIC income, whether or not the PFIC makes a distribution to the U.S. shareholder. Subpart-F income includes Foreign Personal Holding Company Income which is passive income such as dividends, interest, royalties, rent, annuities, gain on dispositions of property generating other types of foreign income, "net gains from certain commodities transactions, net foreign currency gains, income equivalent to interest, income from notional contracts, payment in lieu of dividends, and income from certain personal service contracts." Subpart-F income also includes Foreign Base Company Income under IRC § 954, which includes most passive investment income, as well as certain related party sales and services income with carve-outs for *de minimis* amounts and high taxed income. Subpart-F income additionally includes: (1) insurance income under IRC § 953; (2) income derived from illegal international boycotts; (3) "illegal bribes, kickbacks, or other payments which would be unlawful under the Foreign Corrupt Practices Act of 1977; and (4) income of such corporation derived from any foreign country that the U.S. does not recognize, or with which the U.S. has severed diplomatic relations, or which repeatedly provides support for acts of international terrorism."

of one or more CFCs is taxed on their share of the excess of the CFCs' modified gross income over the benchmark return of 10% of the CFCs' adjusted bases in depreciable tangible property placed in service with certain adjustments for interest income and expense. The GILTI regime eliminated a long-standing distinction under the CFC rules between the operating income of a bona fide overseas business and passive income. Although this will have a limited impact on a typical offshore tax blocker structure that holds mostly marketable securities because such income would already have constituted the subpart-F regime, trusts that hold stocks in closely held operating companies may be affected by this law.

III. U.S. Real Estate Ownership Structures Available to NCND Korean Families

Based on Section 2, we discuss the purchases[67] by our NCND Korean individual, Ms. Kim, regarding her U.S. real estate for personal use, investment, or development, which would face particular U.S. income, estate, and gift tax issues. The problem of determining tax consequences on the underlying legal situation is usually aggravated in the cross-border context because Korean tax consequences often must be determined based on the legal concepts of the U.S. and vice versa. Therefore, it is imperative to understand the income, inheritance, and gift tax rules of Korea and the possible applications in U.S. transfer taxations. Extensive cross-border tax planning may prove worthwhile because the nominal inheritance tax burdens in Korea are heavier than the U.S. estate tax and a credit for U.S. taxes paid is available in Korea, at least in theory.

Once Ms. Kim becomes a U.S. tax resident, she might wish to deduct interest on the first $750,000 loan as qualified residence indebtedness. The loan should be obtained and secured by the home within 90 days of the date of purchase or refinancing. In addition, if the corporation can procure

67) The TAMRA of 1988 introduced a dramatic increase in estate taxes for NCNDs on their U.S. property. A real property located in the U.S. is considered a U.S. situs asset as is stock issued by a corporation organized in the U.S. The value of NCND Korean individual's taxable estate in excess of $60,000 is taxed at a maximum rate of 40%.

nonrecourse financing to purchase the property, the amount subject to U.S. estate taxes would be limited to the FMV of the property, here net of the amount of the nonrecourse leverages. Then, the choice of an investment vehicle may have different tax consequences if the different type of income is earned by an individual, a trust, a partnership, or a corporation—either Korea or the U.S. This section discusses the various ownership structures available to Korean families engaged in U.S. real estate investments.

1. Overview

Direct ownership under Ms. Kim's name is simple, and if the asset is held for over a year, the sale is subject to 20% capital gains tax but is not subject to the 3.8% net investment income tax. However, there is no privacy or anonymity, there is no liability protection, and there is a compliance obligation to file U.S. income tax returns, and the U.S. home is subject to U.S. estate and gift taxes for both pre- and postmortem transfers.

Ms. Kim may acquire a U.S. home through an LLC or a limited partnership (LP). The LLC may be taxed as a disregarded entity, a partnership, or a corporation ("LLC corporation") for U.S. income tax purposes. Using these structures provides a better outcome in privacy and liability protection, and the lifetime transfers of her membership or partnership interests are not subject to the federal gift tax. However, the name of a general partner of the LP and the manager's name[68] of LLC will be disclosed in the public record or in a statement of information filing with the relevant state agency. Federal and state income tax returns will be filed by the members, as well as the entity, if the LLC elects to be taxed as a partnership. A single-member LLC owned by Ms. Kim should file an IRS Form 5472, but no tax return is required if elected disregarded. Moreover, the value of the decedent NCND Korean member or partner's interest in the entity will be subject to U.S. estate tax but not to gift tax on the lifetime transfers of interests in an LLC or partnership or because the shares in U.S. corporations and interests in partnerships or LLCs are considered

68) The name of the LLC manager of Delaware LLC is not required to be disclosed. Otherwise, by using another LLC to act as the manager of the operating LLC, an NCND Korean family might avoid disclosure of an individual manager's name.

intangible, even though the underlying asset of the entity is U.S. real property interests.

The common domestic C corporation ownership does afford privacy and liability protection and gift tax-free transfers of the shares but requires Ms. Kim as a shareholder to file a U.S. income tax return whenever engaging in a U.S. trade or business. C corporation or an LLC that elects to be taxed as a corporation has a double taxation issue since federal and state corporate income tax will add an additional layer of tax. Dividends from the C corporation to Ms. Kim will be subject to 30% withholding, and the shares of the domestic corporation will be included in the U.S. estate of Ms. Kim upon her death.

Korean corporation ownership of a U.S. home offers liability protection and no U.S. income tax or filing requirement for Ms. Kim, the shareholder. The shares in the Korean corporation are non-U.S. assets; thus, they are not included in her U.S. estate, the dividends are not subject to U.S. withholding, no tax or filing requirement is needed on the disposition of shares of stock in general, and no gift tax on the transfer of the stock is required. However, federal and state corporate income tax is due whenever the Korean corporation may be deemed engaged in a U.S. trade or business, and the FIRPTA treats the gains or losses from the sale of a U.S. real property interests (USRPI) as effectively connected with a U.S. trade or business. In addition, the Korean corporation will be subject to the U.S. branch profits tax on its retained earnings and profits. Because the branch profit tax is not reduced or eliminated by the Treaty, further structuring might be necessary.

Tiering a Korean corporation with a U.S. corporation, including an LLC corporation or irrevocable FGT holding shares of a U.S. corporation, affords privacy and liability protection, escapes the U.S. income tax filing compliances of Ms. Kim, leaves her not subject to U.S. estate taxes, allows for gift tax-free lifetime transfers, and avoids the branch profits tax. The timing and amount of the dividend might be under the control of Ms. Kim. However, this type of tiering would induce corporate triple taxation issues: one would be at the U.S. corporate level, second would be on distributions from the U.S. corporation to the Korean holding corporation at 30% FDAP, with the withholding possibly reduced by the Treaty, and third at Ms. Kim's level on the receipt of dividends as the ultimate shareholder. Again,

the Korean holding corporation may be subject to taxation on the disposition of its shareholder interest under the FIRPTA, as codified in IRC §§ 897, 1445, and 6039C, if the U.S. subsidiary corporation holds USRPI, including stocks in a U.S. real property holding company (USRPHC[69]). As a partner in a U.S. partnership, Ms. Kim is deemed a proportionate owner of partnership assets such as U.S. homes. The disposition of such partnership interest will be subject to the FIRPTA to the extent that such partnership owns USRPI and will be subject to withholding. Because 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 years ending on the date of the disposition were disposed of in transactions in which the full amount of the gain was recognized, the Korean holding corporation may repatriate the proceeds of the sale as part of a tax-free liquidation distribution from the U.S. corporation.

2. *Direct Ownership*

In general, direct ownership is free from imputed rental income issues and assures long-term capital gains treatment on a sale over a year after the purchase; Ms. Kim's additional feasibility to IRC § 121 principal residence exclusion of up to $250,000. Her U.S. heirs will obtain a step-up in basis. The key disadvantages are Ms. Kim's privacy and her exposure to U.S. estate and gift taxations. Although the FIRPTA treats the gain or loss from the sale of a U.S. home as effectively connected to a U.S. trade or business, a home acquired for nonrental purposes and exclusively occupied by Ms. Kim's family will not qualify for a deduction by the individual.

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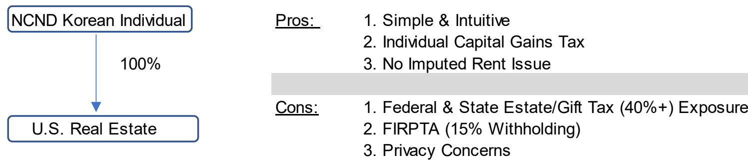
69) A domestic corporation will be treated as a USRPHC if its USRPIs equal or exceed 50% of the FMV of its USRPIs, its foreign real property, and any other of its business assets which are used or held for use in a trade or business. Despite Article 16 of the Treaty, U.S. and Korean tax authorities signed a mutual agreement in June 1999 and listed it as an IRS Notice confirming Korea's taxation rights on the disposal of stocks of excessive real estate corporations. According to Korean law, the proceeds from the corporate stock transfer that meet certain requirements are regarded as real estate transfer income to be treated as domestic source income. Based on reciprocity in international law, U.S. would retain the taxation rights on the disposal of Korean corporate stocks with more than 50% of the balance sheet assets of USRPIs.

Exhibit 4. Individual Ownership



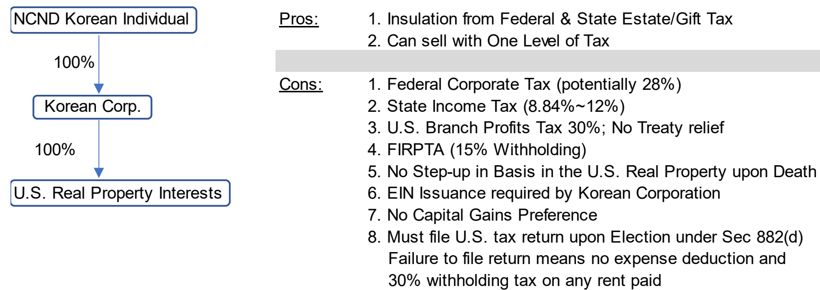
Any direct ownership of a U.S. home by Ms. Kim is tax-inefficient for her heirs because it may create the need for an ancillary probate proceeding[70)] in the county court of the U.S. state where the property is located as a condition of a transfer upon the death of Ms. Kim as the title owner. Homeownership through a single-member U.S. LLC could result in onerous U.S. estate taxes of 40% and subsequent state inheritance taxes.

3. One-tier Corporation Structure

A one-tier corporation structure serves personal use property, whereby a Korean corporation purchases a U.S. home directly or through another layer of a single-member LLC for use by Ms. Kim's family at less than the fair market rents. Having to deal with the imputed rental income, the foregone rent would be treated as a disguised dividend to Ms. Kim as the shareholder but generally will not impose adverse U.S. tax consequences because a dividend to Ms. Kim by a Korean corporation is not subject to U.S. withholding tax. However, under these circumstances, the IRS may attempt to impose both a corporate tax and a 30% branch profits tax on the amounts deemed extracted plus relevant state and local taxes as imputed rental income. A sale of a U.S. home would mean one level of tax on the gain at the corporate rates, and the additional branch profits tax would be

70) As a court of limited jurisdiction, the probate or surrogate court handles the administration of wills and estate settlement problems. As in any civil law jurisdictions, the concept of probate is not familiar in Korea where a forced heirship rules with an immediate inheritance by the heirs of selective share is more common. A will prepared under the Korean laws, at worst, might be completely invalid under the laws in the U.S. state jurisdictions, or even if the state jurisdiction recognizes the Korean will, certain aspects of it might be unenforceable. This could lead the heirs and family incurring substantial legal costs in trying to sort out the complexities in the U.S.

Exhibit 5. One-tier Structure



avoidable if the Korean corporation terminates its U.S. business and certain other conditions are met.

In case the shares in a Korean corporation are disposed of as opposed to the U.S. real estate asset itself, the source of the gain is not in the U.S., despite its U.S. situs, but rather in Korea, where Ms. Kim is resident as the beneficial owner. However, a transfer of the stocks of a Korean real estate holding corporation[71)] may require reporting to the tax authorities in both countries, depending on the asset structure of the entity. For the real estate stocks of more than 50% of the USRPI in their balance sheets, it might be suboptimal to adopt a Korean domestic corporation as an interposed structure. Because an ultimate 25% Korean shareholder would file on Form 5472, Ms. Kim, an over 50% shareholder, would be identified personally in the Korean corporation's tax return on Form 1120F without mandating her taxpayer identification number (TIN) issuance.

The branch profits tax is imposed on a Korean corporation on the dividend equivalent amount (DEA), which is the earnings and profits arising from the ECI for the taxable year. The DEA would include gains from the sale of U.S. real estate to be increased by any reduction in the Korean corporation's net equity in the U.S., which is a function of assets and liabilities in the U.S. The tax rate is 30% and is not subject to beneficial treatment by the Treaty. A Korean corporation might be able to avoid the

71) Beobinsebeob [Corporate Tax Act], art. 93 para. 7 (S. Kor.) ("... once a stock falls within the real estate stocks, the transfer of the stock shall be subject to taxation in Korea as a source country just like the transfer of the real estate itself with the 3-pronged 50% or more tests of (i) asset, (ii) equity and (iii) transferred stocks.").

branch profits tax if all the proceeds from the sales of U.S. real estate are reinvested in "ECI-producing" U.S. assets. However, if there is no rental income or if the rental income is not treated as an ECI, the branch profits tax will still be payable. The Korean corporation will not be subject to the branch profits tax for the year in which it completely terminates all of its U.S. trades or businesses and distributes all its U.S. assets and pays off all its liabilities. There should not be any reinvesting of the former U.S. assets within three years following the sale, and the statute of limitations is extended to six years to allow the IRS to monitor any reinvestments going forward.

It may be prudent to interpose a disregarded U.S. entity, such as an LLC, between the Korean holding corporation and the U.S. real estate assets to facilitate a potential future sale of the property. If Ms. Kim already owns the U.S. estate in her name, it might be transferred to a Korean corporation, but the transfer could be subject to U.S. income tax by recognizing a marking-to-market capital gain. The consequences appear less severe to the IRS but more serious to the Korea National Tax Service (NTS) for Ms. Kim when she makes personal use of a home ultimately owned by a Korean corporation. Here, double taxation exposure is found at the level of the Korean corporation in the form of corporate income and U.S. branch profits taxes. When the Korean corporation is about to sell the property, real tax risks, such as a potential basis reduction because of the depreciable property from its inception, are probable. However, if the corporation has not filed tax returns over the years of built-in losses, a FIRPTA withholding letter will not be available, and a full 15% withholding tax at the time of sale may be due.

Upon Ms. Kim's death, her U.S. heirs become the owners of the Korean corporation that is either a CFC if they are the majority shareholders or a PFIC if they are among a class of persons owning less than a 10% interest in the Korean corporation. Whenever the U.S. heirs make personal use of the U.S. real estate, they have to deal with imputed rental income issues. By the time the U.S. home has increased in value, gains on the sale will include both pre- and postmortem appreciation because the basis in the stock of the corporation may have been adjusted to FMV, but the basis in the home itself did not. The gains recognized by the Korean corporation will be taxed at U.S. corporate rates to its U.S. shareholders, and there will be no IRC §

121 exemption, even if the home becomes the principal residence of one of the U.S. heirs. Therefore, any increase in the value of the property, here as reflected as an incremental gain of the shares of the Korean corporation, will be taxed twice. If the Korean corporation is deemed a PFIC for U.S. income tax purposes, this gain may be largely converted to ordinary income. Whenever the sale takes place after Ms. Kim's death, the U.S. heirs should try to get the Korean corporation liquidated as soon as possible after the sale, which is a taxable transaction for both the Korean corporation and the U.S. heirs, but the gain at the level of the U.S. heirs should be insignificant because of the available step-up.

If the U.S. persons are Ms. Kim's only surviving heirs, one method is to consider domesticating the Korean corporation for U.S. tax purposes. Domestication[72] can be accomplished by dropping either the U.S. home or the Korean corporation into a new U.S. corporation and having the Korean corporation liquidated. All these methods are essentially treated by the IRS as "Type C or D Tax-Free Reorganizations," except for any IRC § 367(b) toll charge. Even if the Korean corporation has earnings and profits, inclusion at the time of repatriation is keyed to the earnings accumulated during the U.S. heir's holding period, which begins at Ms. Kim's death.

Following domestication, a subchapter S election can be made if the corporation has no non-U.S. shareholders, no corporate shareholders, only one class of shares, and is held by no more than 100 shareholders. Because a S election freezes the amount of gain that is potentially taxable for both the corporation and shareholders, the corporate-level tax would be eliminated if the U.S. shareholders could hold out for 10 years. IRC § 1031 exchanges may defer taxation of the gain until the expiration of the 10 years if the U.S. home should be held for investment or as part of a trade or business before the exchange is undertaken. Although this S election following the domestication sequence addresses double taxation and secures the benefit of individual capital gains taxation, it does not work if any Korean resident heir continues to have an interest in the corporation, and it does not solve the imputed rental income problem.

72) Alternatively, Delaware's continuation statute may allow Korean corporations to domesticate into Delaware relatively easily as long as Korean laws permit re- domiciliation.

4. Two-tier Corporation Structure

The probable double-reporting obligations derived from a one-tier corporate structure create a need for a two-tier corporate structure, which is practical for development property with major cash flows of ordinary income. Ownership of U.S. real estate through a U.S. corporation will lead to estate tax on the death of Ms. Kim, corporate-level capital gains tax, and shareholder-level tax on liquidation, though the shareholder gain realized to Ms. Kim may be limited if the sale occurs soon after the death, here thanks to step-up in the corporation shares.

Ms. Kim—or through her FGT—owns a Korean corporation as a U.S. tax blocker, which in turn owns a USRPHC.[73] The stock of a Korean corporation is treated as a non-U.S. situs asset and is not subject to U.S. estate tax, but it is subject to Korean inheritance tax. The corporate formalities imposed under Korea's laws should be consistent with those U.S. tax principles associated with corporate ownership. Because the U.S. real estate is a personal use property, the property may be rented for FMV to fulfill all operating costs and carrying charges from rental income. The structure supposes no U.S. estate tax, no FIRPTA[74] engaged, and no direct reporting obligation for Ms. Kim.

A USRPHC will be subject to federal income tax on any future capital gain at a potential rate of 28%, as well as any state and local income taxes. Because the corporation will be engaged in U.S. business, it can deduct its expenses of interest, taxes, and the costs of maintenance, repair, and insurance as long as Ms. Kim pays reasonable rent on personal use of the home. Capital gains would be subject to the corporate tax rates,[75] which would be higher than the rates[76] applicable to the sales of U.S. property by

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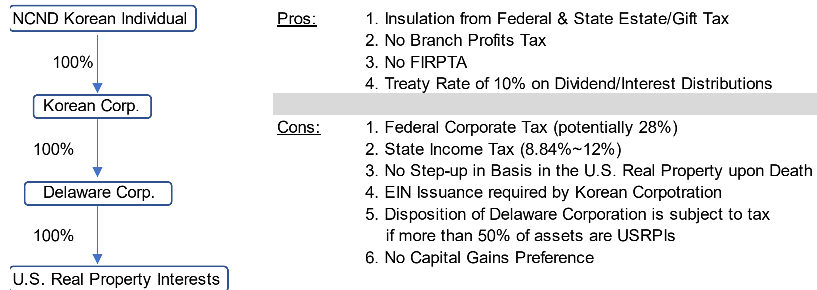
73) Use of a U.S. LLC is not suitable for this purpose since a single-member LLC is a disregarded entity under the default U.S. entity classification rules and Korean corporation would be treated as owning the property for U.S. tax purposes, which is basically the one-tier corporate structure in the end.

74) The sale of USRPHC generates ECI under the FIRPTA of 1980.

75) For example, 28% for federal (as proposed by President Biden) and 12% for New York state/city, considering the available federal deductions.

76) For instance, 20% for federal, 25% on depreciation recapture, and 9% for New York

Exhibit 6. Two-tier Structure



Ms. Kim or her FGT. After a sale, the cash distributions without liquidating the intermediate USRPHC[77] could be taxed as dividends and subject to U.S. withholding tax. Therefore, it can sell U.S. homes with one level of tax by liquidating an interposed USRPHC with a high level of U.S. estate tax certainty, but the Korean corporation must file a U.S. federal income tax return, reporting its ECI and paying taxes.

Seeking expense deductions for rent-free personal use or below fair market rents on a corporate property only generates unusable losses. The value of rent-free use is a distribution up to the corporate chain from the USRPHC to Ms. Kim as the ultimate shareholder and is subject to a 30% withholding tax to the extent of the deemed distributions, regardless of whether the USRPHC has earnings and profits. Although a constructive distribution by a Korean corporation would be taxed to Ms. Kim as the shareholder, a constructive distribution by a U.S. corporation would be

states.

77) Once an interposing USRPHC is adopted, there is a regime of accumulated earnings tax rules, which impose a 20% penalty tax on a USRPHC's accumulated taxable income in addition to regular corporate income tax and shareholder-level tax on distributions. Those rules apply if a corporation is formed to avoid shareholder-level tax and it cannot prove to the IRS that amounts accumulated in the company were for the reasonable needs of the business; that evidentiary burden is higher if the USRPHC is an investment company rather than an operating business. Additionally, under the personal holding company regime, a company with 5 or fewer shareholders is assessed a 20% penalty tax in addition to regular corporate income tax and shareholder-level tax on its personal holding company income, which includes passive income such as dividends, interest, rents, and royalties. Good news is that these two 20% penalty regimes should not apply simultaneously.

taxed based on its earnings and profits, ultimately reducing Ms. Kim's basis in the shares of the USRPHC. If the corporation is scheduled to be liquidated under IRC § 897(c) upon the sale of the property, the liquidation would be tax-free with sufficient notice of an early termination filing for its USRPHC status. Therefore, personal use of corporate property may result in deemed corporate distributions by a USRPHC to incur withholding liability, and the dividend is the FDAP income to the immediate Korean holding corporation, if it has earnings and profits.

When any member of Ms. Kim's family pays rent to use the U.S. real estate, the USRPHC will have taxable income to be reduced by an allocable share of expenses, such as property taxes, insurance, utilities, repairs, and maintenance, and the 27.5 years of straight-line depreciation deductions. If the U.S. home is held by a Korean corporation, expenses treated as rent to the corporation are FDAP income subject to withholding by the using family member, unless the Korean corporation provides Form W-8ECI to the using member and then files a tax return by either taking the position that it is engaged in a trade or business or electing that treatment under IRC § 882(d) or under the provision of the Treaty.

If Ms. Kim owns the Korean corporation, using a U.S. C corporation instead of a U.S. LLC may be preferable to avoid the potential double tax on the distribution of the sales proceeds to her as the ultimate beneficial owner of the Korean holding corporation. Though the stock of a Korean corporation is not subject to U.S. estate tax, holding a U.S. home through a Korean corporation that does not engage in legitimate business activities or operate in an arm's-length fashion, there is a risk that it will not be respected as an effective shield from U.S. estate tax. Furthermore, a Korean entity that may not be considered the equivalent of a U.S. corporation may instead be treated as a trust or association for the purpose of determining whether Ms. Kim died owning a U.S. real estate asset.

After the sale and payment of the tax liability, the LLC corporation will liquidate according to a liquidation plan and repatriate the net proceeds from the sale of the U.S. home to a Korean holding corporation. This liquidating distribution will be tax-free to the Korean corporation under the cleansing rule of IRC § 897(c)(1)(B). The result is a single level of taxation on the sale of U.S. homes. Interposing a U.S. LLC subsidiary would result in a somewhat lower overall effective tax rate and tax liability for rental income,

if any. However, because the state and local property tax deduction for corporations is still available, this difference either disappears or flips in favor of the corporate structure when the rental income is much higher and when the property is located in a high corporate income tax state such as New Jersey (11.5%), Pennsylvania (9.99%), or California (8.84%).

IV. Further Structuring Using Trust and Partnership

In addition to continued creditor protection and generation-skipping planning benefits on the passing of Ms. Kim, structuring tax partnerships and non-grantor trusts would provide favorable capital gains treatment on a future sale of the U.S. home while allowing Ms. Kim to retain control over the underlying assets as the owner of the general partner interest. With more sophistication in U.S. real property ownership, how this may play out is evaluated in this section.

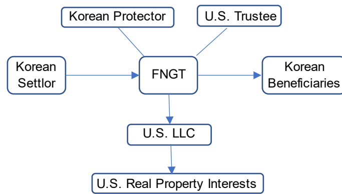
1. Foreign Irrevocable Discretionary Trust Structure

A U.S. trust may be organized under the laws of a state but will be considered foreign for U.S. tax purposes if the Korean protector has sufficient powers, such as the power to terminate the trust and control distributions. An FNGT[78] is often desirable in investing in personal-use property or long-term passive real property because it benefits from the lower capital gains rates of individuals. An FNGT's purchase of U.S. real property would not trigger adverse U.S. estate, gift, or GST tax consequences, where Ms. Kim is just the grantor but is not a trustee or trust protector,[79] and it retains no rights to the income or assets of the trust. Essentially, she effectively loses control over the property, and the proceeds

78) A foreign trust in the U.S. tax purpose is to mean any trust that is not a domestic trust. Again, a trust will be considered domestic trust if a U.S. court have primary supervision authority over the administration of the trust (the "Court Test") and U.S. persons control all substantial trust decisions (the "Control Test").

79) A trust protector supervises the trustee and can be an individual or a group of individuals that is not the settlor, beneficiary, or trustee. A trust protector may be appointed by the settlor with the trust instrument.

Exhibit 7. Foreign Discretionary Trust Structure



Pros:
1. Assured Insulation from Federal & State Estate/Gift Tax
2. No Branch Profits Tax
3. Single Level of U.S. Tax
4. No Federal Corporate Tax at LLC/LP Level
5. Preferential Capital Gains Tax
6. Sec 1446 Self-determined Withholding from U.S. LLC

Cons:
1. Complicated and High Structuring/Maintenance Costs
2. FIRPTA on Subsequent Sale
3. No Step-up in Basis in the U.S. Real Property upon Death

from the use of the property would require the payment of fair market rents. It is normally not necessary to rent a personal use property at FMV unless the intended user is a U.S. beneficiary, where failure to charge rent would be treated as a constructive distribution to the U.S. person. With requirements such as an institutional trustee and no understanding as to the grantor's entitlement to discretionary distributions[80)] of income or capital, it is also possible to be a limited potential beneficiary of the FNGT without U.S. estate tax consequences upon her death.

From the structure in Exhibit 7, tax on the sale of the property is calculated using the capital gains rates for individuals, but a 3.8% net investment income tax (NIIT) does not apply to Ms. Kim and the FNGT. Upon the sale of U.S. real estate, a 15% withholding tax under FIRPTA would be applicable. An FNGT reports transactions with Ms. Kim and related parties on Form 5472 "Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business" if it wholly owns a U.S. LLC. A single-member LLC is a disregarded entity for U.S. tax purposes, but whenever it is owned by a non-U.S. person like Ms. Kim or by an FNGT, it is treated as a corporation for the filing purposes of Form 5472. The LLC is then required to obtain a U.S. tax identification number. Furthermore, U.S. beneficiaries may be subject to U.S. tax on the earnings of any FNGT-owned CFCs or PFICs, as discussed in Section 2.4.

If Ms. Kim wishes to retain discretionary interest permitting the trustee to make distributions from the trust to her, avoiding U.S. transfer taxes may become more difficult because any discretionary interest in the trust will

80) A discretionary distribution means a distribution that is made to a person at the discretion of the trustee or a person with a limited power of appointment.

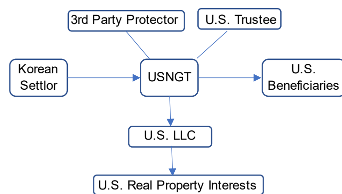
cause the trust assets to be included in her estate, especially if there was an implied understanding that she would have continued enjoyment of the assets transferred in the trust or their income, including a circumstance where her creditors, such as the Korean government, may attempt to attach the trust assets. At the time of Ms. Kim's death, with no retained interest in the trust because of any right to use the U.S. home during her lifetime and right to income or gains, with no "wink and nod" type of informal arrangement with an institutional U.S. trustee, there should be no estate tax, even though the trust corpus at the time of death consists of a U.S. real property and there is no basis step-up because the property is not included in her U.S. estate. A historical pattern of distributions or continued use may prove such an implied understanding. For instance, if Ms. Kim receives distributions or uses the asset only rarely—or only in the event of unforeseen circumstances—a stronger case of "no implied understanding" may be made.

For a trust that holds only real property for personal use by the grantor and beneficiaries, distribution by the trust might not be taxable because such a trust would likely have neither a DNI nor UNI. Form 3520 must be filed by any U.S. beneficiary each year to report distributions from an FNGT. The form requires the beneficiary to choose between reporting under the so-called default method and the actual method. Once the U.S. beneficiary has ever been subject to the default method, this person cannot use the actual method in any subsequent year, save for the final year of the trust. To be able to use the actual method, the beneficiary must also receive an FNGT beneficiary statement from the trust. If the beneficiary uses the actual method and the FNGT has no DNI or UNI, the distribution may be tax-free. If the default method applies—either by choice or by failure to file Form 3520—the full amount of the distribution is treated as this person's taxable ordinary income, even if it would have been a mere nontaxable gift had the beneficiary been able to use the actual method. This taxable distribution will accrue interest charges based on how long the trust has been an FNGT. Failure to file Form 3520 using the actual method may result in the fair market rental value of a U.S. real estate asset being heavily taxed.

2. U.S. Irrevocable Discretionary Trust Structure

Although the general cost of establishing and maintaining an FNGT with a U.S. institutional trustee may prove to be higher than that of a U.S. corporation, a U.S. trust might be a viable alternative because there is no U.S. estate, GST tax, and FIRPTA withholding that are usually applicable to an FNGT. However, regular U.S. capital gain tax and the additional NIIT would apply. Exhibit 8 shows one of the structuring possibilities of a U.S. non-grantor trust by a Korean settlor exclusive for the settlor's U.S. beneficiaries.

Exhibit 8. U.S. Discretionary Trust Structure



Pros:
1. Assured Insulation from Federal & State Estate/Gift Tax
2. U.S. Regular Trust Taxation & N.I.I.T. (3.8%)
3. No Branch Profits Tax
4. No FIRPTA
5. Single Level of U.S. Tax
6. No Federal Corporate Tax at LLC/LP Level
7. Preferential Capital Gains Tax
8. Sec 1446 Self-determined Withholding from U.S. LLC

Cons:
1. Complicated and High Structuring/Maintenance Costs
2. No Step-up in Basis in the U.S. Real Property upon Death

If the U.S. corporation is owned by a trust with any of the retained interest rules that apply to Ms. Kim, the value of the stock in the U.S. corporation will be included in her U.S. estate. Interests in the LLC corporation, here called outside basis,[81)] will be stepped up upon her death to who held the stock directly or retained interest through a trust, but the basis in the underlying U.S. estate, which is called inside basis, will not be adjusted. If the U.S. trust is free from retained interest rules such as IRC § 2036 "Transfers with Retained Life Estate," IRC § 2038 "Revocable Transfers," and IRC § 2041 "Powers of Appointment," there will be no step-

81) Inside basis is to the adjusted basis of each trust asset, as determined from the trust's earnings and profits and determines the beneficiary's tax basis according to the respective individual assets transferred. Outside basis is each beneficiary's basis in the beneficial interest. Each beneficiary owns a proportionate share of the trust's inside basis for all of its assets, and all beneficiaries should maintain a record of their respective outside bases.

up in the basis of LLC interests at the time of Ms. Kim's death. Although no estate tax will be due as long as the U.S. LLC is owned by a U.S. discretionary trust, any step-up will occur only at the level of the interests in the U.S. non-grantor trust, but not at any lower chain of corporate tiering.

3. Foreign Grantor Trust Structure

If a U.S. real property is owned by an FGT,[82] Ms. Kim will be treated as the owner of the trust property; thus, there is no need to consider fair market rents and subject to the favorable income tax treatment applicable to individuals versus trusts. Because the FGT structure does not afford protection against U.S. transfer taxes, it might be feasible for Ms. Kim to procure reasonable term life insurance for U.S. estate taxes upon her death. If the residuary beneficiary is a U.S. person, Ms. Kim may retain the right to direct the income of the trust to achieve a step-up in basis upon her death to reduce the capital gains tax for the U.S. heir. In the case where no qualified executor, personal representative, or administrator is appointed upon her death, anyone, including the trustee of an FGT in actual or constructive possession of the decedent's U.S. situs assets, must file an estate tax return using Form 706-NA "U.S. Estate and Generation-Skipping Transfer Tax Return" within nine months following the date of death. If an FGT holds the U.S. blocker corporation directly, the structure could benefit from a reduced withholding tax on dividends from the U.S. tax blocker.

Elaborating one step further on the structure in Exhibit 9, if a revocable FGT that owned a Korean entity that in turn owned USRPHC domesticates the Korean entity by merging with the existing U.S. corporation, which should be the survivor, this would avoid the need to change the title to the U.S. real estate. Otherwise, the FGT would need to be domesticated, here with a modification permitting the trust to hold the merged corporation as an S corporation and make the S election. The domestication of the FGT after the S election of the Korean entity would prevent the trust from

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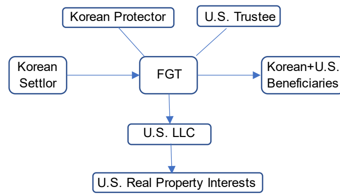
82) Once more, for an NCND individual grantor, a trust will be so treated if either the grantor reserves the right to revoke the trust solely "or with the consent of a related or subordinate party" and revest title to the assets to herself, or the amounts distributable during the life of the grantor are distributable only to the grantor and/or the spouse of the grantor.

Exhibit 9. Foreign Grantor Trust Structure



Pros:
1. No Branch Profits Tax
2. Single Level of U.S. Tax
3. No Federal Corporate Tax at LLC/LP Level
4. Preferential Capital Gains Tax
5. Sec 1446 Self-determined Withholding from U.S. LLC
6. Step-up in Basis in the U.S. Real Property upon Death

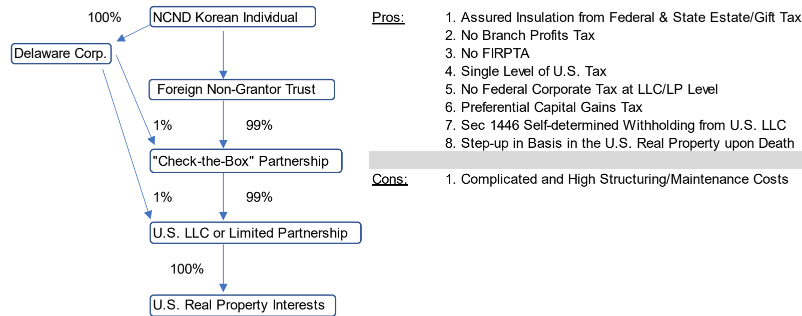
Cons:
1. No Insulation from Federal & State Estate/Gift Tax
2. Complicated and High Structuring/Maintenance Costs
3. Exposure to Federal & State Estate/Gift Tax
4. FIRPTA on Subsequent Sale

holding stock in a Korean entity for even a short time, during which it would be a CFC.

4. Partnership and Multimember LLC Structure

Investment in U.S. real estate through a pass-through entity for U.S. tax purposes, such as a partnership or a multimember LLC taxed as a partnership, would afford the individual member or partner the lower capital gains rates applicable to individuals if the real estate is a capital asset. Then, it is a matter of weighing between immediate income tax savings and the potential exposure to U.S. estate tax burdens. In general, any ownership of U.S. real property through the U.S. or Korean partnership is suboptimal because of the uncertainties concerning the situs of a partnership interest for U.S. estate tax purposes, as well as a potential withholding tax applicable to Ms. Kim as an NCND partner for U.S. income tax purposes. Another case of inference can be made for the non-U.S. situs of interest in a Korean LP. Because the underlying asset of the partnership is a U.S. home, interest in a Korean LP may be subject to U.S. estate tax if the death of Ms. Kim causes dissolution of the LP under the Korean law; even if it does not, if the LP carries out business in the U.S., Exhibit 10 elaborates on the structure by tiering tax partnerships under the FNGT to achieve enhanced assurance from U.S. transfer taxation while benefiting from favorable capital gains taxation at individual rates (20%).

Exhibit 10. Partnership Structure



5. Evaluation

Direct ownership of a U.S. real estate asset exposes U.S. transfer taxes but is not subject to branch profits tax. There is no withholding obligation on the repatriation from selling proceeds back to Korea, and U.S. tax-free disposition of the property is not available because the FIRPTA applies. This structure effectively exposes the Korean family to U.S. tax compliance, but the disposition of the underlying property attracts favorable capital gains taxation at individual rates (20%). Ownership through Korean corporations shields any exposure to U.S. transfer taxes, but is subject to branch profits tax. There are no withholding obligations on the repatriation of selling proceeds from the Korean corporation, and the U.S. tax-free nature of the corporation is also allowed but is still subject to the FIRPTA. This structure exposes the Korean corporation to U.S. tax compliance, and the disposition of underlying property attracts corporate income taxation.

Ownership through a U.S. LLC, either as a disregarded entity or as a tiered tax partnership structure, does not effectively shield the sales of the asset from U.S. transfer taxes, but it is not subject to branch profits tax. There is no withholding obligation on the repatriation of selling proceeds from the LLC, but the U.S. tax-free disposition of the LLC is not available. This structure exposes the Korean family to U.S. tax compliances, and the disposition of underlying property attracts favorable capital gains taxation at individual rates (20%). The use of a U.S. partnership may require withholding under IRC § 1446. Ownership through USRPHC shields any exposure to U.S. gift and branch profit taxes but is subject to estate tax.

Exhibit 11. Comprehensive Evaluation

	Alt 1	Alt 2	Alt 3	Alt 4	Alt 5	Alt 6	Alt 7	Alt 8
U.S. Tax System Exposure for NCNDs/KR/US Entity	Yes	Yes	Yes	Yes	Yes	Yes	No	No
LT Capital Gains Rate on Disposition of USRPIs	Yes	Yes	Yes	Yes	No	No	No	Yes
Withholding Tax on Repatriation of Funds from Entity	Yes	No	No	No	Yes	No	No	No
U.S. Tax-Free Disposition of Entity	No	No	No	No	Yes	No	Yes	Yes
U.S. Branch Profits Tax	No	No	No	No	Yes	No	No	No
Exposure to U.S. Estate Tax	Yes	?	?	?	No	Yes	No	No
Exposure to U.S. Gift Tax	Yes	?	?	?	No	No	No	No

Alt 1. Direct Ownership
Alt 2. Ownership through U.S. LLC (Disregarded Entity)
Alt 3. Ownership through U.S. LLC (Tax Partnership)
Alt 4. Ownership through Two Tiers of Tax Partnerships
Alt 5. Ownership through Korean Corporation
Alt 6. Ownership through USRPHC
Alt 7. Ownership through KR Corporation and USRPHC
Alt 8. Ownership through FGT, Tax Partnership, and U.S. LLC

There is a withholding obligation on the repatriation of selling proceeds from the USRPHC, and U.S. tax-free disposition of the U.S. corporation is not available. This structure exposes both the USRPHC and Korean family to U.S. tax compliance, and the disposition of underlying property attracts corporate income taxation. However, a cleansing exception would apply to allow for a tax-free disposition or liquidation of the USRPHC.

Ownership through Korean corporations and a USRPHC effectively shields any exposure to U.S. transfer and branch profit taxes. There is a withholding obligation on the repatriation of selling proceeds from the USRPHC, and the U.S. tax-free disposition of the Korean corporation is allowed. This structure also shields the Korean family from U.S. tax compliance, and here, the disposition of underlying property attracts corporate income taxation. A cleansing exception also allows tax-free disposition or liquidation of the USRPHC. Exhibit 11 summarizes the pros and cons of the eight different alternative structures discussed in Sections 3 and 4.

V. Trust and the U.S.–Korea Income Tax Convention

Is the trust a person? If it is, is it a resident of the contracting state? Under which circumstances would the trustees of an FNGT or a U.S. discretionary trust be deemed as the beneficial owner of the trust's income and are subject to Treaty benefits? A detailed answer to these questions, with the conclusions tied to statutory provisions and recent Korean case law, is discussed in this section.

1. Is the Trust a Person? Is it a Resident of the Contracting State?

Income and estate tax treaties between countries may alter some domestic rules, particularly regarding the determination of residence, source of income, the situs of assets, and income withholding rates. The U.S. has estate tax treaties with Australia, Austria, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan,[83] the Netherlands, Norway, South Africa, Sweden, Switzerland, and the U.K., as of writing this paper. Estate tax treaties with the U.K., France, Germany, Austria, Denmark, and Sweden are based on the unified system concept, covering taxes on estate, gifts, and GST taxes.

A trust is an arrangement by which legal ownership or title to a property is held by the trustee as a fiduciary, for the benefit of whom may (not) exist. Then, is trust a person?[84] Although not being a common law jurisdiction and, thus, not familiar with the laws of equity, Korean laws "partially" acknowledge the trust concept, even though Korea is not a signatory country to the "Hague Convention on the Recognition of Trusts." Under Article 2 of the U.S.–Korea Income Tax Convention, "The term 'person' includes an individual, a partnership, a corporation, an estate, a trust, or any body of persons. The term 'Korea corporation' or 'corporation of Korea' means a corporation (other than a U.S. corporation) that has its head or main office in Korea or any entity treated as a Korean corporation for Korean tax purposes. The term 'U.S. corporation' or 'corporation of the U.S.' means a corporation that is created or organized under the laws of the U.S. or any state thereof or D.C. or any unincorporated entity treated as a U.S. corporation for U.S. tax purposes."

83) The U.S. has also "gift tax treaties" with Australia and Japan. The estate tax treaty with Sweden is no longer in effect following the repeal of Sweden's inheritance tax in 2004.

84) Org. for Econ. Coop. and Dev. [OECD], *Model Tax Convention on Income and on Capital 1977* art. 3(1)(a), art. 4. Article 3(1)(a) of the 1977 OECD Model Tax Convention defines a "person" as including "an individual, a company and any other body of persons", and even though trust is not expressly defined, it could nonetheless be as a body of persons. The trustees would either be individuals or companies and thus fall within the definition provided for by Article (3)(1), and thus entitled to treaty benefits. From Article 4, "any person who, under the laws of that State, is liable to tax therein because of his domicile, residence, place of management or any other criterion of a similar nature."

Although the 1977 OECD Model Tax Convention and the commentaries are less conclusive, trusts may be entitled to benefit from the Treaty from the first step. For a trust in the Treaty context, the source of income and residence of the trustee matter. The institutional trustees will ordinarily be residents in the jurisdiction from where their day-to-day management of the trust takes place. The next most relevant question is as follows: If the trust is a person, then is it a resident of one of the contracting states? The fact that the U.S. trustees manage the FNGTs from the U.S. in which they are residents might be helpful in establishing a trust or trustee residence as the U.S. for Treaty purposes.

2. Trust Recognized as a "Person" but Fails to Obtain Treaty Benefits[85)]

National Westminster Bank PLC, acting as the trustee of Baring Global Growth Trust, claimed a refund of the Italian imputation credit on certain Italian source dividends under the Italy–U.K. double tax treaty (cases no. 2617–2618). The Supreme Court of Italy argued that Article 3 of the tax treaty lists general definitions applicable to the other provisions of the treaty "unless the context otherwise requires." Although the "OECD Model Tax Convention on Income and Capital" does not define "trust," scholars have demonstrated that an extensive interpretation of the definition of "person"[86)] in Article 3 is only general and non-exhaustive and includes trusts. Furthermore, a trust is a juridical instrument fully recognized following the 1992 ratification of the Hague Convention on the Recognition of Trusts and has been fully regulated in Italy for tax purposes since 2007. Then, the articles of the tax treaty must apply to trusts under the definition of "person."

The Supreme Court has accepted that the structure of a trust varies by

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85) Andrea Manzitti, *Trust recognised as a "person", but fails to get treaty benefits*, Eur. Tax Blog (May 7, 2020), https://www.europeantax.blog/post/102g6ry/trust-recognised-as-a-person-but-fails-to-get-treaty-benefits.

86) Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, It.-U.K., Oct. 21, 1988, 1648 U.N.T.S. art. 3(d). Under Article 3(d) of the U.K.-Italy Double Tax Treaty, "the term "person" comprises an individual, a company, and any other body of persons, but does not include ..." partnerships which are not treated as bodies corporate for tax purposes in either Contracting State.

its settled country, and a case-by-case analysis is always required. For trusts to benefit from the treaty's tax provisions, it is necessary to provide evidence of the trust structure, the powers of the trustees, and the beneficiaries that enable the identification of the ultimate beneficial owner(s) of the dividends. The Supreme Court has also clarified that trustees must provide evidence of the fact that the dividends have not only been taken into account in calculating taxable income, but that they have been taxed effectively in the other jurisdiction, for instance, an ad hoc certificate issued by the tax authorities of the country. Therefore, to obtain Treaty benefits, merely being recognized as a "person" is not enough. The "person" must also be a "resident" in one of the contracting countries and the "beneficial owner" of the income with respect to which treaty benefits are claimed.

A beneficial owner in common law is hardly conclusive but may be summarized as having the right to use and enjoy the income without being constrained by a legal or contractual obligation to pass it on to another person. Hence, only a discretionary trust may qualify as a "beneficial owner" of a foreign source dividend with actual economic activity, as evidenced by the management of the entity, balance sheet, expenditure, staff, premises, and equipment, all of which are not easy criteria for a trust to fulfill. In this case, the trustees of the U.K. trust failed to provide sufficient evidence of its beneficial ownership of the relevant dividends. They also failed to prove that the dividends had effectively suffered from U.K. tax, which was a specific treaty requirement. So, the U.K. trust[87] lost the case.

3. *Trustees and Beneficial Ownership*

Regarding taxation trust income, the income earned by the trust is ultimately distributed to the beneficiaries. Because some income is reserved in the trust property, it is necessary to temporarily tax the trust property

87) The U.K. may prove to be a favorable jurisdiction for the foreign trusts as "either the income can be taxed only on a remittance basis if the trustees are non-domiciled, or if capital gains are outside the scope of domestic taxation where settlors and beneficiaries are non-resident of the U.K."

itself as a calculation unit of income. In typical succession planning, the legal and beneficial ownership of the same property can be separately vested in several different persons, in which the beneficial owner is different from the nominee legal owner. Articles 12, 13, and 14 of the U.S.–Korea Income Tax Convention seek to prevent treaty abuse by limiting the benefit of dividends, interest, and royalties to the beneficial owner rather than the legal owner, who may be a trustee of the recipient trust. The commentary of the 1977 OECD Model Tax Convention confirmed that treaty benefits will not be extended to intermediaries, such as agents or nominees. Even though this limitation on benefits (LOB) would seemingly prevent a trustee from benefiting under the treaty, what if the trustee is required to exercise control over the trust income, as would be the case in a discretionary trust? Because the trustee is not compelled to pay out all the received funds to a specific person, it is the trustee who is the beneficial owner for treaty purposes.

A case law debate in the Netherlands confirms a common law grantor trust rule in a revocable trust such that if a taxpayer can use the property of the trust as their own, the property will be regarded as the taxpayer for income and net wealth tax purposes. The income tax position of the beneficiaries is determined by whether the property and income of the trust can be attributed to them. Although a transfer to an irrevocable nondiscretionary trust, such as a possession trust, will generally constitute a taxable transfer and be subject to Dutch gift or inheritance tax, the creation of an irrevocable discretionary trust[88] will not constitute a taxable acquisition by the beneficiaries from the settlor because they have not yet benefited. As an example of a civil law system recognizing trusts, the Netherlands is clear that named beneficiaries cannot be regarded as holding a beneficial interest if the trustees do not have contractual and/or legal obligations to deliver the income to the beneficiaries. Trustees must have a beneficial interest without alienating a legal interest if the settlor is to

88) Article 29(a) of the Dutch Income Tax Law imposes taxation on certain foreign entities and does not apply to beneficiaries of trusts if they have "no more than a mere expectation" that the trustees will make distributions to them. The above position has been confirmed by the Lower Court of the Hague in 1995 since the Netherlands is a signatory country to the Hague Convention.

have relinquished all rights under an irrevocable arrangement. If the trustee is acting in a nominee capacity without unfettered discretion, the income and gains will be taxed where the beneficiary is a resident, not at the resident jurisdiction of the trustee. However, if the trustee carries out its day-to-day management of the trust without being distracted either by the settlor or beneficiaries, the tax jurisdiction of a trust should be accepted as the residence of the trustee under the terms of the Treaty.[89)]

4. Limitations on Benefits

Although there are no explicit LOB wordings in the Treaty, any corporation deriving from sources within the other country shall not be entitled to the benefits of the dividends in Article 12, interest in Article 13, royalties in Article 14, or capital gains in Article 16 if such income stream is substantially less than the tax generally imposed by a resident country on corporate profits and if 25% or more of the corporate capital is owned (in) directly by one or more persons who are not individual residents of the country or, in the case of a Korean corporation, who are citizens of the U.S. under Article 17 "Investment or Holding Companies" of the Treaty.

Under Article 14 "Actual Taxation of Framework Act on National Taxes" and Article 2-2 "Substance over Form Principle" concerning International Transactions of Adjustment of International Taxes Act, the ultimate owner of a taxable income, profit, property, act, or transaction

89) Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect To Taxes on Income and the Encouragement of International Trade and Investment, U.S.-S. Kor., art. 16, June 4, 1976, 30 U.S.T. 5253 (U.S.-Korea Income Tax Convention) ("A resident of one of the Contracting States shall be exempt from tax by the other Contracting State on gains from the sale, exchange, or other disposition of capital assets unless; (a) The gain is derived by a resident of one of the Contracting States from the sale, exchange, or other disposition of property in Article 15 (Income from Real Property) situated within the other Contracting State; (b) The recipient of the gain, being a resident of one of the Contracting States, has a permanent establishment in the other Contracting State and the property giving rise to the gain is effectively connected with such permanent establishment ; or (c) The recipient of the gain, being an individual who is a resident of one of the Contracting States: (i) Maintains a fixed base in the other Contracting State for a period or periods aggregating 183 days or more during the taxable year and the property giving rise to such gains is effectively connected with such fixed base; or (ii) Is present in the other Contracting State for a period or periods aggregating 183 days or more during the taxable year.").

shall be liable to pay taxes, and the tax-related rules would be applied. For international transactions, tax treaties shall apply to the person in whom the taxable income, earnings, property, act, or transaction is vested. Tax treaties shall apply to the computation of the tax base according to the substance of a transaction, regardless of the name, form, or title of the taxable income, earnings, property, act, or transaction. Under Article 156-4 "Special Cases concerning Procedures for Withholding Taxes from Nonresidents in Specific District" on Income Tax Act and Article 98-5 "Special Case Concerning Withholding Procedures for Foreign Corporations in Specific Places" on Corporate Tax Act, any person or corporation to which the domestic source income is substantially attributed, including their agent, might be able to apply for a tax exemption or reduced tax rate, here according to a tax treaty on such income.

Korean tax law stipulates both general anti-abuse regulations and the principles of beneficial ownership in the Treaty. Then, the meaning of a beneficial owner in the context of international taxation and in domestic actual assessment rules to the interpretation of the Treaty[90] would matter. In some rulings, substantial taxation principles have been applied to identify the ultimate beneficial owners of the income. Two relatively recent cases of the Supreme Court of Korea and Seoul Administrative Court are prominent references. To summarize, the meaning of the beneficial owner under the Treaty can be interpreted in the same manner as the ultimate beneficial owner under the domestic assessment of anti-abuse rules because the common purpose of the rules is to prevent any potential abuse.

A. Seoul Administrative Court 2011Guhap40035 (August 17, 2012)

(1) Case Summary

In this case, the Korea National Tax Service (KNTS) notified the withholding corporate tax at a 15% rate, as in Article 10(2)(b) of the Korea–Germany[91] Tax Treaty, and reported the plaintiff as an oligopolistic

90) Yutaka Kitamura, *The Application of the Japan-U.S. Tax Treaty to Trusts*, TAX NOTE INT'L. 577 (Feb. 13, 2006).

91) With reference to Daebeobwon [S. Ct.], May 24, 2013, 2012Du24573 (S. Kor.) case where the beneficial owner of dividend income, that is an indirect owner, is entitled to the

shareholder who exercises the right to the stock, therefore appointing it as a taxpayer and imposing a corporate tax for each business year. The current lawsuit was filed, claiming that it was illegal to apply a 15% restricted tax rate. Under the German Investment Law, the German asset management company—the plaintiff—set up a listed and publicly offered fund (the "Fund") that divides the profits from the real estate portfolio to its investors. Following the German Investment Law, the company acquires 100% of the shares of a Korean portfolio company (the "Portfolio Company"). In this case, a company holds only real estate as an investment on behalf of the Fund, which cannot possess or exercise the ownership or rights of the equity investment under the name of the Fund. A 100% shareholder made a management decision by holding and exercising the right to dispose of or accrue investment assets and received dividends from the capital during the fiscal years 2008–2010 and 2012. The current dividend was included in the income of the fund and filed a tax return to the German tax authorities. The Fund was exempted from corporate tax and business tax on dividend income under the German Investment Act. While paying dividends to the Fund, the Portfolio Company withheld the corporate tax at a 5% rate under Article 10, Paragraph 2(3)(a) of the Agreement between the Republic of Korea and the Federal Republic of Germany for the Avoidance of Double Taxation Concerning Taxes on Income and Capital (the "Korea–Germany Tax Treaty")[92] and paid to the tax authorities.

(2) Applicability of Person

Article 3(1)(d) and (e) of the Korea–Germany Tax Treaty stipulates that the person as an independent taxable unit is divided into individuals and corporations, being treated as an entity with a legal personality for tax

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lower treaty rate under the Japan-Korea Tax Treaty because the beneficial ownership could not be limited to mean only direct ownership unless the tax treaty explicitly stated that the beneficial owner should own the shares directly. The case under the Korea-Germany Tax Treaty may provide some practical implications if no other facts and circumstances warranted an interpretation of ownership under the U.S.-Korea treaty different from that in the Korea-German tax treaty.

92) 5% of the total dividend amount if the beneficial owner directly owns at least 25% of the corporate capital to which the dividend is paid (excluding associations), and 15% of the total dividend amount in all other cases.

purposes. Because the applicable law for judging the legal entity of an organization has not been established and even though Article 3(2) of the Korea–Germany Tax Treaty does not provide definitions, it follows domestic tax law, unless otherwise interpreted within the context of the Korea–Germany Tax Treaty. In addition to the head or main office locations, there are no specific regulations regarding the specific requirements of a foreign corporation under the Corporate Tax Law as to whether a foreign entity can be regarded as a foreign corporation. In light of the legal content of the established country and substance of the entity, it should be judged according to whether it can be regarded as a subject of independent rights and obligations of the judicial group members in Korea (The Supreme Court 2010Du5950). In this case, a German LLC is itself independent of rights and obligations, can acquire ownership and other real rights to land can be a party to the lawsuit, and bears recourse responsibility to the creditors of the LLC but only with the LLC property. Because the transfer and inheritance of an employee's shares are possible in principle, the LLC can be viewed as a subject of separate rights and obligations, here independent of the members of the Korean judicial system, and as a subject of the Korea–German Tax Treaty and as corresponding to the corporation.

(3) Applicability to Resident

Article 4(1) of the Korea–Germany Tax Treaty and its purposes means that a "resident of a Contracting State" is, according to the laws of that country, stipulated as a person obligated to pay tax in that country. Considering that German LLCs are obligated to pay corporate and business taxes and that the German tax authorities issued a certificate of German residents between 2006 and 2009, when it comes to the dividend income paid by the plaintiff (the "Portfolio Company") in 2011, this would correspond to residents who are subject to the Korea–Germany Tax Treaty.

(4) Applicability to the Beneficial Owner of Dividend Income

In this case, the Fund owns 100% of the shares of the special purpose company it has founded and has the same personal composition, such as location, contact information, and directors. It must be determined whether this is within the category of 'treaty shopping.' The company was legally

established under the German LLC Act, which invests or lends funds to the Portfolio Company in its name, and the LLC concludes an investment management contract and pays fees for acquiring stocks of the Portfolio Company under its name. Under the German Corporate Tax Law, the person liable for corporate tax on dividend income—the LLC—is the subject of independent rights and obligations under the law that some of the dividend income was directly reinvested. As a shareholder of the Portfolio Company, the Fund cannot exercise the right to claim dividend payments; the LLC is the entity that can exercise it. After the dividend resolution process at the general shareholders' meeting, the LLC distributed the dividend income to the mutual fund, and there is no evidence to suggest that the mutual fund or its investors have a contractual and legal obligation to automatically pay out the dividend income.

B. The Supreme Court 2016Du3522 Case and the Supreme Court 2016Du30132 Case on the "Application of the Korea–Germany Tax Treaty to German Public Offering Fund"

The Supreme Court of Korea assumed that the beneficial owner under the Korea–Germany Tax Treaty has the right to use and profit without any legal or contractual obligation to transfer the dividend back to another person. The judgment was made by combining various circumstances, such as the contents and status of related business activities and the actual use and management of the income. Because it enjoys the right to use and profit without any legal or contractual obligations to transfer to another person, such as a general investor and because the Fund is defined as a beneficial owner, the dividend income was paid to a German LLC, that is, the beneficial owner of the stock in this case, so it is reasonable to apply a 5% restricted tax rate and should cancel the application of a 15% restricted tax rate.[93)]

93) The author thanks an anonymous reviewer for the helpful insight quoted herein: "There could be the different view from Daebeobwon [S. Ct.], Dec. 24, 2019, 2016Du30132 (S. Kor.) (Defa Fund case) in that the plaintiff therein, as an asset management company, has a limited power on the dividend from the portfolio investment of the publicly offered fund and the beneficial owner would be the Fund itself, a pass-through entity, rather than the management company in light of CIV regime of OECD MTC Commentaries and substantial

5. Implications to an FNGT

Because the settlor may also be a trustee and beneficiary—even simultaneously—this flexibility of trusts makes them difficult to tax, which is magnified concerning non-resident discretionary trusts, such as FNGTs or U.S. discretionary trusts. In many countries that recognize trusts, they are taxed as entities, at least to the extent that they accumulate their income. Beneficiaries are generally taxable on trust income distributed to them, but not on the returns of the corpus of the trust, which generally include the after-tax income of the trust because the income earned or collected by a trust in a fiscal year is usually added to the trust's capital if not distributed during the year.

U.S. tax on non-U.S. source income might be deferred by establishing a trust to earn the income. Because an FNGT is treated as a separate legal entity for U.S. tax purposes in general and is not a resident in Korea, the Korean beneficiaries, if any, are not taxable when the income is earned by the trust. If any Korean resident can be classified in the class of fixed beneficiaries, they may be taxable when the distributions from the trust are made, so Korean tax is not deferred.[94] To ensure that the KNTS would have full knowledge of foreign trusts to tax income and assets, the reporting duties of any foreign financial accounts with designated account ownership and tax disclosure have been implemented on the tax residents of Korea since 2016. However, assessing taxes has been difficult for the KNTS when dealing with a trust, especially where the settlor does not have full control of the assets, the U.S. trustee is managing assets on behalf of the beneficiary and the beneficiary has an uncertain right to income and capital but "a mere expectation" of it. Once an NCND Korean family establishes a

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taxation doctrine under the Korean tax laws."

94) *See* Sintakbeob [Trust Act] art. 78 (S. Kor.). For a beneficiary certificate issuance trust under Article 78 of the Trust Act of Korea, a limited liability trust under Article 114, and a discretionary trust in which the trustee has the right to dispose of the trust property, reserve profits, and determine the distribution amount, income from the trust property is levied on the trustee. The corporate taxation of dividend income upon distribution to shareholders is permitted. Accordingly, instead of deducting dividends from income, the rule of non-inclusion of dividends in gross income is excluded.

revocable FGT in the U.S. that is funded with non-U.S. situs assets, neither the trust nor the settlor is taxed in the U.S. on non-U.S. source income during the settlor's lifetime. If the trust would not have U.S. situs assets at the death of the grantor, there are no U.S. estate tax consequences, and the decedent remains subject to applicable inheritance tax rules in Korea. Exhibit 12 stipulates an income tax treatment of an FGT in both countries and some brief case examples to follow.

Exhibit 12. U.S. and Korea Source Income of FGT/FNGT and Tax Treatment

	Treatment in Korea		Treatment in the U.S.
	Trustee Beneficial Ownership	'Narrow, Technical' Trustee	
Capital Gains	Nontaxable	Income Tax Bracket	Nontaxable 30% Withholding for ECI/FDAP
Capital Gains from Real Properties	Income Tax Bracket Up to 26.5% for a Corporate Entity	Income Tax Bracket	20% on Net Gains 25% for Depreciation Recapture 15% Withholding (FIRPTA) Up to 28% for a corporation*
Dividends	11% or 16.5% Withholding	15.4% (up to KRW 20mn) Income Tax Bracket (above)	30% Withholding**
Bond Interest	13.2% Withholding	15.4% (up to KRW 20mn) Income Tax Bracket (above)	30% Withholding 0% on Portfolio Exclusion
Rental Income	Income Tax Bracket Up to 26.5% for a Corporate Entity	Income Tax Bracket	30% Withholding Up to 28% for a Corporate Entity*
Passive Investment Income (CIV)	13.2% (Interest Withholding) 16.5% (Dividend Withholding)	20% (up to KRW 300mn) 25% (above the threshold) 3-year Carry-forward for Net Loss	Nontaxable on Long-term Capital Gains Dividends***

* President Biden has proposed amending the federal statutory corporate income tax rate from 21% to 28%.

** If an FGT invests in a Luxembourg or Irish fund for global equity exposure, including the U.S., it generally would not be subject to U.S. federal income tax on dividends for non-U.S. equities, and the 15% dividend withholding rate under either treaty might apply (vs. 30% withholding rate if the FGT held U.S. equities directly or through U.S.

mutual funds).
*** A full exemption analysis is beyond the scope of the current article, but briefly, once an FGT invests in U.S.-regulated investment companies such as mutual funds, the fund's distribution of "net short-term capital gains" is classified as a "dividend," and 30% withholding would apply, unless the fund elects to classify the distributions as "short-term capital gain distributions." Without the fund's affirmative election, the FGT will be subject to a 30% withholding tax on both U.S. and non-U.S. short-term capital gains and dividends. If the FGT invests directly in the underlying securities or indirectly through a non-U.S. collective investment vehicle such as Irish or Luxembourg funds, it would avoid this disadvantage.

The relationship between the tax treaties and CFC rules may be controversial if the FGT earns active business income rather than passive investment income. Article 8 of the Treaty or Article 7 of the OECD and UN Model Treaties provides that a country with CFC rules cannot impose a tax on the business profits of a corporation (or trust) resident in the other country, even if it is controlled by the residents of the first country, except to the extent that the trust has a permanent establishment (PE) in the first country and the profits are attributable to that PE. Most countries' CFC rules do not apply to active business income. Because the tax is imposed on the resident shareholders of the nonresident trust—not the CFC—nothing in a tax treaty prevents Korea from taxing its residents. Article 1 of the Commentary on the OECD Model Treaty was revised in 2003 to clarify that there is no conflict between CFC rules and tax treaties; therefore, tax treaties do not prevent the application of CFC rules. The revisions to the commentary later clarified that countries with CFC rules do not need to put an explicit provision in their treaties, hence allowing the application of CFC rules.

The formerly revocable FGT would become irrevocable, hence becoming a separate taxable entity for U.S. income tax purposes upon the settlor's death. Any realized and accumulated income realized in the trust after the settlor's death will become subject to U.S. federal income tax. It may be domesticated as a U.S. trust to be a separate U.S. domestic trust taxpayer for any U.S. beneficiaries or remain as an FNGT to be a separate foreign trust taxpayer for non-U.S. beneficiaries. Exhibit 13 stipulates the treatment of inheritance, estate, gift, and GST taxes of a U.S. purpose trust in both countries.

Exhibit 13. U.S. and Korea Estate, Gift, GST Tax Treatment of U.S. Purpose Trusts

Asset Classes*	U.S. Tax Purposes		Korean Tax Purposes	
	Estate/ GST Tax	Gift Tax	Inheritance /GST Tax	Gift Tax
Korea situs Assets	Taxable	Taxable	Taxable	Taxable
Real Property – Korea situs	Taxable	Taxable	Taxable	Taxable
Real Property – U.S. situs	Taxable	Taxable	NT	NT
U.S. Real Property Held by Foreign Blocker	NT	NT	NT	NT
Tangible Personal Property – U.S. situs	Taxable	Taxable	NT	NT
Currency/Cash – U.S. situs	Taxable	Taxable	NT	NT
U.S. Bank Deposits (checking, CDs)	NT	Taxable	NT	NT
U.S. Brokerage Deposits	Taxable	NT	NT	NT
U.S. Mutual Funds	Taxable	NT	NT	NT
U.S. Company Stocks	Taxable	NT	NT	NT

* Worldwide assets held by Korean individuals will be subject to Korean inheritance and gift taxes, while foreign death tax credits for the estate/gift taxes paid in the U.S. for the U.S. situs property shall be generally available.

VI. Conclusion

Tax planning for U.S. property investments must consider liability protection, privacy, and anonymity, tax filing requirements, withholding obligations, withholding rates, treaty application, the availability of deductions, tax-exempt income, and tax rates, to name a few. Korean families can acquire U.S. assets using several alternative cross-border ownership structures, depending on their goals and priorities. Because there is no one perfect structure, each alternative has its own pros and cons. Ownership through an FGT, tax partnership, and U.S. LLC effectively shield any exposure to U.S. transfer and branch profits taxes. There are no withholding obligations on the repatriation of selling proceeds from the LLC/partnership, and U.S. tax-free disposition or liquidation of the LLC/partnership is allowed thanks to a cleansing exception. This structure

effectively shields the Korean family from U.S. tax compliance, and the disposition of the underlying property attracts favorable capital gains taxation at individual rates (20%).

From the standpoint of a taxable legal entity, the question of the residence of the trusts becomes meaningful under the current Korean tax system because the system has recently introduced corporate taxation into its trust system, even though conduit theory is the fundamental basis in Korean tax law. The possibility of the current taxation system for trusts conflicting with the taxation of offshore trusts legislated based on common law principles is quite high and may be an irresolvable issue when it comes to the potential utility of trusts in the regimes of gift, inheritance, estate, and GST taxes together with the inherent benefits that a trust can garner.

If the trust is designed as an irrevocable U.S. discretionary trust as a separate U.S. taxpayer for U.S. income tax purposes, it is subject to worldwide taxation on realized and accumulated income in the trust, and the beneficiaries are subject to income tax consequences in each jurisdiction of their residence on any current income distributions. Although the transfers to the trust are completed gifts for U.S. gift tax purposes, NCND Korean individuals are subject to U.S. gift tax on lifetime gifts of U.S. situs of tangible personal and real properties only. Any Korea situs property and U.S. situs intangible personal property, including U.S. securities, are not subject to U.S. gifts or GST taxes. Therefore, NCND Korean individuals may transfer unlimited amounts of both Korean property and U.S. intangible property throughout their lives and can do so free of U.S. gift and GST taxes; however, they are subject to the Korean gift tax rules. Since these assets from the completed gift into an irrevocable U.S. trust are no longer within the settlor's estate, they are not subject to U.S.–Korea estate, inheritance, gift, and GST taxes for subsequent generations if properly structured and administered.