Confidential Executive Summary

Initial inquiry

For U.S. tax purposes, the result will depend on whether the SCPI is deemed to be a partnership or a corporation. There are **4 factors** used to make this determination; continuity of life, centralization of management, limited liability & free transferability of interest.

SCPI as partnership analysis

If the SCPI is a partnership, then rental income and expenses will be **effectively connected** with a U.S. trade or business, or in any case, the individual partners should make a **protective "net basis" election** under section 871 (d) of the Internal Revenue Code for such treatment. In addition, any interest earned from excess funds should also receive effectively connected treatment, provided that such amounts are retained or reinvested in the business for its present anticipated needs. Thus, there will be **no withholding obligations** by the U.S. partnership.

However, the partnership will be required to compute **"estimated**" income taxes for each of the foreign partners at the highest individual rate **(39.6%),** per section 1446 of the IRC, and pre-pay these amounts quarterly with the Internal Revenue Service. These rules differ from normal U.S. partnership rules in that the partnership's only reporting obligation is to supply the annual Form 1065 K-1's , which the individual partners use to compute estimates at the end of the year.

The individual foreign partners will receive, from the partnership, an annual Form 1065 K-1's providing the partner's annual share of the partnership income.
The partnership will also provide an annual summary of the quarterly estimated tax payments. The individual partners in the KG's must file Form 1040 NR with the IRS which will include, as income, the amount from the K-1, and as prepayments, the summary provided by the partnership.

Going forward, if the partnership refinances its debt obligations, the partnership can distribute the excess funds to the partners without withholding obligations, provided that the partners **have a tax basis** for this distribution. A tax basis will be determined at the time of the distribution and it includes the initial contribution, any gain or loss from the partnership, and the partner's share of partnership debts.

Furthermore, if the real estate is sold there will be **withholding on the sale proceeds by the transferee**. Estimated income calculations for the quarter will include the **net gain** realized on sales of such real estate. However, if the U.S. partnership interest is disposed of in its entirety, before the real estate is sold, then there may be withholding, by the partnership, under the **FIRPTA** rules provided by section 897 of the Internal Revenue Code.

SCPI as corporation analysis

If the SCPI is deemed to be a corporation, then the corporation should also "elect" for **net basis treatment**. The corporation will be taxed up to **35%,** which is **lower** then the maximum individual rate of **39.6%.** Furthermore, the **only filing obligation** will lie with the corporation, which will file an annual Form 1120F along with quarterly estimates.

If the property is sold, there will be similar results as with a partnership (**10%** withholding on proceeds by **transferee**) **except** that the corporation must also withhold **28%** of the net gain.

However, the corporation will also be subject to the branch profits tax of **5%** of the effectively connected earnings & profits not distributed or reinvested in the U.S. Furthermore, the corporation will have filing obligations under **5472** for transactions with affiliated entities .

French taxation

For French tax purposes, the income tax paid will be credited and thus there will be **no double taxation**.

I. Background

A French entity called a SCPI ("Société Civile de Placements Immobiliers") will be formed with the objective of raising equity from European based investors for the purpose of investing in U.S. Real estate. The type of real estate will be primarily credit net lease property. The SCPI will be formed under French laws and is subject to the regulatory rules of the COB, which is equivalent to the SEC. It must be the **direct owner** of the real estate and will be **wholly owned by its shareholders**.

In this deal, the SCPI must have at least $850,000 of capital which is to be raised from principals initially (15% of this capital must be raised from French investors within 1 year). There must be a bank guarantee to reimburse the investors for this 15%. Each investor is **liable for up to two times his** investment. The SCPI can raise money with either fixed or floating capital, and if floating capital is used, then new capital can be raised with less formal filing requirements.

The SCPI will be managed by a SCPIMC ("Société de Gérance de SCPI"), which will in turn, be managed and owned by Tibor Pivko & Company ("TPC"). TPC will be responsible for the following:

❶ Analyzing the investments & acquiring properties in the U.S.
❷ Financing the properties through first mortgages.
❸ Asset management of the properties including periodic inspections, collecting rents, paying property expenses, preparing property financial statements, and coordination of U.S. tax & reporting issues.
❹ Selling the properties when appropriate.

Cabinet Francis PERTAIN ("CFP") will be solely responsible for the legal formation, coordination, marketing , and administration of the European entities.

The specific responsibilities of CFPshall include:

❶ Setting up the European entities (SCPI & SCPIMC), drafting statutes & by-laws, registering the two companies, finding premises, preparing legal advertisements, and taking care of registration taxes & stamp duties.

❷ Drafting prospectus and translating from French into English.

❸ Obtaining the 2 COB agreements.

❹ Organizing the distribution of SCPI shares.

II. <u>French Taxation</u>

Under French laws, the SCPI is a **tax transparent entity** and is taxed only upon the receipt of income. France taxes residents (***appendix A***), generally, on their worldwide income (unlimited liability). The tax rate increases progressively up to a maximum of **56.8%.** In addition, there is an added tax CSG (Contribution SocialeGénéralisée) of **2.4%.** Interest on acquisition loans, and management fees paid by the SCPI are deductible. If the investment is sold, there is a 4.8% duty on proceeds, **<u>except</u>** if the SCPI has floating capital, which will be used in the current deal as structured.

Capital gains from real estate **located in France are tax exempt** if they derive from the sale of the taxpayer's main residence or from the sale of a qualified second residence. Other capital gains from real estate are taxed as ordinary income, if sold before 2 years. Otherwise, there is a <u>decreasing scale of capital gains tax over **21 years**</u>. Gains from the disposal of shares are not taxable if below FF325,800 & above this at a **19.4% rate**.

Pursuant to the France-U.S.A. treaty (***appendix B***), U.S. income tax paid from capital situated in the U.S. is allowed as a **credit**, limited to the French tax attributable to such income.

III. U.S. Taxation

A. Will the SCPI be taxed as a Corporation or a Partnership?

An entity is first tested to determine if it is a trust, estate or corporation. It is a partnership, only if it does not satisfy the requirements for one of these entities. While **local law** (state or foreign country) **does not control** an organization's classification, it is pertinent. Also, federal tax rules are applied in light of the legal relationships existing under local law.

Pursuant to IRS regulations, there are six major characteristics found in "pure" corporations. These are:

1) Associates.
2) Business objective.
3) Continuity of life.
4) Centralization of Management.
5) Limited liability.
6) Free transferability of interest.

An organization is treated as a corporation if its characteristics are such that it more nearly resembles a corporation than a partnership. Thus, the entity must have at **least 3 corporate** factors, to be taxed as a corporation. However, in practice, organizations incorporated under U.S. law virtually always are treated as corporations.

In determining if an entity is a partnership or a corporation the first 2 characteristics are disregarded (Associates & Business objective), and the **remaining 4 are analyzed**.

1) Continuity of Life

The regulations link continuity of life to the legal concept of dissolution under local law. Thus, continuity of life **does not exist** if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member will cause a dissolution of the organization. Continuity of life also **does not exist** if dissolution may be avoided by the remaining partners "agreeing" to continue the partnership.

2) Centralization of Management

An organization is centrally managed if it is managed in "representative capacity". Thus, in limited partnerships, if the general partners have a substantial economic interest in the partnership, they are regarded as *managing for their* ***own interests*** & thus there is **no centralized management**.

3) Limited Liability

Limited liability exists where no member is personally liable for the debts of the organization. In the case of limited partnerships, **personal liability does not exist** with respect to a general partner when he has **no substantial assets**.

4) Free Transferability of Interests

Free transferability of interests is present only if each member of the organization has the power, without the consent of other members, to name another partner in

substitution of his interest. However, free transferability does exist if other members of the partnership have the right of first refusal.

The entities commonly used in France and their characteristics are as follows:

Entity	***Min. Capital***	***Freely Transferable***	***Centralized Mgmt.***	***Tax Category***
Société anonyme (SA)	F250,000	Yes	Yes	Corp.
Société à responsabilité limiteé (SARL)	F50,000	No	Yes	Corp.
Société en nom collectif (SNC)	N/A	No	No	Partnership

B. Partnership Taxation (3 Mechanisms of Taxation)

(1) Foreign Partners distributive share of Partnership EC Income

Code section 1446(a) imposes an obligation on a domestic or foreign partnership that has Effectively Connected income (hereafter "EC") for any taxable year to make estimated tax payments for its foreign partners. This quarterly estimate is computed by multiplying each partner's EC taxable income by the **highest individual rate** for non-corporate taxpayers.

This quarterly payment is made on FORM 8813. An annual reconciliation is required to also be filed on FORM 8804. Individual detail must also be provided to each partner on FORM 8805.

(2) Fixed or determinable, annual or periodic income (FDAP)

(a) Non-Effectively Connected Income (definition and withholding)

Generally, nonresident aliens are taxed on all income from sources within the United States. The rate of taxation depends on whether the items are deemed to "Effectively Connected with a U.S. Trade or Business" (**EC**) or Non- Effectively Connected Income.

Examples of Non-Effectively Connected Income include passive items such as **interest, dividends, rents, annuities**. "Interest" that is otherwise deemed the be non-effectively connected, may be **EC income** when earned from a real estate entity engaged in a U.S. trade or business. To fall under these rules, the excess funds used to generate the interest must be held to meet the *present needs of the business*, not its anticipated future needs, and must be generated from the business and retained or invested in that business.

A foreign partner is subject to withholding on its distributive share (whether or not distributed) of U.S. source noneffectively connected FDAP and certain other gains or losses. If a partnership withholds on the partner's percentage of FDAP "gross" proceeds, it is not required to withhold when such proceeds are actually distributed to the partners. Withholding is at a **30% flat rate** (this is actually the tax and thus there is **no** filing obligations). The 30 rate may be reduced by treaty with any country. The France-U.S.A. treaty has a reduced dividend rate, but the U.S. **fully taxes income from real property**.

(b) Benefits of EC Income and Rules for such Treatment

The advantage for Effectively Connected Income is that the taxpayer can deduct all *expenses associated with the income* and this can even result in a loss that reduces other Effectively Connected Income. The net income is taxed at the graduated rates under the Tax Code. If however, the items are deemed to be Non-Effectively Connected, then these amounts are taxed at a **flat 30% rate** with *no benefit for the expenses* associated with the activity.

To qualify for this treatment, the taxpayer must meet 2 tests: engaging in a U.S. trade/business **and** the income/expense must be associated with a trade/business.

1. Engaging in a U.S. Trade/Business

Whether an investor is engaged in a U.S. trade or business is a **facts and circumstances test**. Generally, if there is *regular and continuous activity that goes beyond the mere receipt of income and payment of expenses* incident to the collection of rent, then the owner will be considered as engaged in a trade or business. For example, if a foreign investor hired an agent to actively manage the property, then this would be deemed to be trade/business activities because the activities of the agent would be attributed to the investor. However the leasing of property pursuant to a net lease whereby the tenant pays all the expenses, would not be trade/business activity.

The Code also provides that the activities of a partnership are attributed to the partners. Thus, if the partnership is engaged in a trade/business, then so are the partners.

2. Income/Expense associated with a trade/business

This determination is also done on a **facts and circumstances basis** and is applied through a **asset use test**. Thus, if the assets are used in a trade/business, then the income/expenses derived from these assets are also deemed to be associated with a U.S. trade/business.

(c) Election for EC Treatment

Taxpayers who would otherwise not qualify for trade/business activity, can still **elect** to have this treatment if they "own" real property. Individual partners can make the election; they are not required to actually "own" the property. This election is effective until revoked. In our case, in order to protect ourselves, the **individual** partners must make the election.

A taxpayer, however, cannot avail himself of the election for a taxable year in which he derives **no gross income** from U.S. Real Property (the property must be rented for part of year). Thus, the deductions otherwise allowable for these years would be lost. It would be our suggestion that a "protective" election be made by **each individual partner**, to avoid the IRS coming to an adverse position on the trade/business issue.

To claim such exemption, the person entitled to the income must file a FORM 4224 with the withholding agent. The withholding agent must attach a duplicate of this form to any FORM 1042S filed for such year. Form 1042S is required for each recipient of FDAP income, **whether or not** tax is required to be withheld.

(3) FIRPTA

Taxpayers used to avoid paying tax on sales through a number of loopholes. The Foreign Investment in Real Property Tax Act of 1980 changed this in that it subjects foreigners to U.S. tax on their capital gains (but not losses) from the sale or exchange of U.S. real property interests, including interests in certain corporations owning U.S. real estate. In effect, these provisions essentially force Effectively Connected treatment on these sales.

A **transferee**, who acquires U.S. real property from a foreign person, is required to withhold **10% of the amount realized** by the transferor. This amount must be paid 20 days after the transfer on FORM 8288.

However, if the "transferor" is a partnership, then the **partnership must withhold 28%** (the individual capital gains rate) of the distributive share of the gain realized on the sale by foreign partners. If the transferor is liable under other provisions of the U.S. Income Tax Code, then the transferor is exempt from further withholding requirements. In our case, we already make estimated prepayments under the 1446 and thus should be **exempt** from **FIRPTA** treatment. However, the withholding provisions still apply to the "transferee".

C. U.S. Taxation Summary (Partnerships)

	FDAP Income (Non EC Income)	**Foreign Partnership EC Income**	**FIRPTA (Forced EC Treatment)**
Withholding/ Estimated Tax Requirements	Flat 30% withholding, with treaty benefit for dividends.	Estimates computed- EC taxable income multiplied by highest individual rate (39.6%).	10% or amount realized- by transferee. 28% of gain- by transferor.
Exemptions	Trade/business or net basis election.	N/A	If estimates paid under 1446, 28% W/H is N/A.
Forms Needed for Exemption	Form 4224 each year for each foreign partner.	N/A	N/A
U.S Return Req.	No	Yes- Form 1040 NR .	N/A
Other Forms Needed	Form 1042S with 4224. Forms W-8, 1001.	Form 8813 Form 8804 & Form 8805	Form 8288
Due Dates	1042S- 3/15	8813- quarterly. 8804- 4/15.	20 days after sale.

D. U.S. Taxation- Corporations

1. Effectively Connected Income (EC)

Income effectively connected (EC) with a U.S. trade/business (less deductions effectively connected) are taxable under U.S. corporate rates, up to **35%**. Corporations, that own real estate, can also "elect" for such treatment. Gains from the sale of U.S. real property are deemed to be effectively connected.

There are special rules under the regulations for determining the interest expense that is effectively connected.

2. Non-Effectively Connected (Fixed or Determinable Annual or Periodical Gains and Income-- "FDAP")

Income received from sources in the U.S. that are not "effectively connected" are taxed at a **flat 30%** rate. This type of income is fixed or determinable annual or periodic income (FDAP) & includes the following:

- Interest.
- Dividends.
- Rents.
- Salaries, wages, compensations, renumerations.
- Premiums & annuities.

FDAP income specifically does **not** include gains from the sale of property.

3. Gains from the sale of U.S. Real Property (FIRPTA)

Dispositions of U.S. real estate by a foreign corporation are deemed to be effectively connected. Furthermore, transferees are **required to withhold 10%** of the sales proceeds. Foreign corporations can, however, to "elect" to be treated as domestic corporations, if it meets certain requirements under the regulations.

4. Branch Profits Tax

Corporations that have effectively connected income have an additional tax equal to **30% of the "dividend equivalent amount"** for the taxable year. This amount is reduced by **treaty** to **5%**.

The "dividend equivalent amount" means the **effectively connected** earnings & profits for the taxable year adjusted as follows:

- **Reduced** for **increases** (ending bal. current yr. less ending bal. prior year) in net equity (U.S. "effectively connected" assets less U.S. "effectively connected" liabilities).
- Increased for decreases in net equity.

The policy behind this tax is to equate operating as a "branch" with operating as a "subsidiary". Thus, the computation of the "dividend equivalent amount" starts with the **earnings & profits** and is **increased** by the ***decrease in net equity*** which are deemed to be dividends paid to the "parent".

5. Branch Level Interest Tax

A foreign corporation engaged in a U.S. trade or business is also potentially liable for this tax **to the extent** that the interest allowable under IRC Section 882 exceeds the actual amount paid.

6. 5472 Filing Obligation

A foreign corporation must file form 5472 to report transactions with a related parties (25% direct/indirect owners or persons relate by 267(b) attribution rules).