U. S. TAX CONSIDERATIONS FOR FOREIGN HORSE OWNERS

By:

Douglas P. Romaine, Esq.
STOLL KEENON OGDEN, PLLC
300 W. Vine Street, Suite 2100
Lexington, KY 40507
Tel. 859.231.3000
Fax. 859.253.1093
E-mail: douglas.romaine@skofirm.com

The U. S. horse industry and in particular the thoroughbred horse business attracts participants from around the world. Tax practitioners are called upon to advise foreign persons of the U. S. tax consequences of their horse activities in the United States. This article is intended to address some of the typical tax issues that are presented by a foreign person's conduct of horse operations in the U. S. Such issues are presented as specific fact patterns requiring analysis by a tax professional intending to illustrate the operative tax rules. These fact patterns present a life cycle of a foreign person's U. S. activities that progress from limited racing activity, to syndication of a successful racing colt, to maintenance of a racing and breeding operation in the U. S. and ultimately to a liquidation of the entire business operations in the U. S.

Fact Scenario #1

A trainer friend, Tom Terrific, who maintains a public racing stable, calls and explains that he has a new client, Lucky Owner, who just won the Bluegrass Stakes race at Keeneland setting a new track record with an athletic 3-year old colt, Runaway Trick, that was recently shipped to the U.S. to test the waters for a possible entry in the Kentucky Derby. The racetrack has indicated that the purse is subject to 30% withholding. Lucky Owner is a foreign national who made millions by providing outsourcing services in India to U. S. companies. He calls France his home. Lucky Owner is new to the horse business and has never raced in the U. S. before. The trainer wants to know whether there is anything the client can do to avoid the proposed withholding.

Discussion

The campaigning of a race horse in the U. S. by a foreign person brings into play both income tax and withholding considerations.[1] As a general rule, a nonresident alien engaged in a trade or business within the U. S. is taxed on the income effectively connected with such U. S.

[1] In addition to these tax concerns, most states impose excise taxes known as sales and use taxes which advisors also need to be cognizant of. Their application is not susceptible to generalization because each state imposes its own laws. In the fact pattern presented, no use tax is applicable as Kentucky provides an exception for temporary racing within the Commonwealth by a nonresident. *See*, KRS 139.541(2)(f).

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trade or business in the same self assessing manner as the federal income tax on a U. S. citizen who files a Form 1040.[2] The IRS has ruled that the entry of a horse in a race in the U. S. constitutes being engaged in a trade or business within the U. S. and is therefore subject to U. S. tax unless exempted by some other provision of law.[3]

In that regard, France, the domiciliary country of Lucky Owner, and the United States have entered into an income tax treaty which provides that the "industrial and commercial profits" of a French national will not be taxed in the U. S. unless such profits are attributable to a "permanent establishment" in the U. S.[4] A nonresident alien is not considered to have established a permanent establishment in the U. S. merely by entering a race horse in a single race during the year in the U. S.[5] Accordingly, the race winnings of Lucky Owner are exempt from tax by the U. S.

Even though the race winnings are exempt from tax, the tax withholding rules, which are designed to enforce payment of a nonresident's U. S. tax liability, require the racetrack to withhold on race purses paid to nonresidents at the rate of 30%[6] *unless* the foreign owner can certify to the track that the winnings are either (i) exempt from taxation pursuant to a treaty with the U. S., or (ii) effectively connected with a U. S. trade or business.

To claim exemption from withholding pursuant to a treaty, a nonresident owner must file Form W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States, with the race track *and* must certify that the he has not raced and does not intend to enter a horse in another race during the year. The entering of a horse in more than one race, which may constitute a permanent establishment, is a rule designed to prevent a misapplication of treaty benefits. The substantive application of this rule is governed by the principal that the entering of a horse in more than one race does not in and of itself constitute a fixed place of business, but because of the underlying activities conducted in respect to the racing of the horse, a permanent establishment could arise. The Service will consider, in part, activities such as an owner or agent, with general contracting authority, concluding contracts within the United States with respect to the entry of the horse in a race, the stabling or training of the horse and his length of stay within the United States, as factors that may constitute the nonresident alien owners having a permanent establishment in the United States. [7]

If the nonresident owner is not otherwise entitled to treaty benefits, in order to be exempt from withholding, he must file Form W-8ECI, Certificate of Foreign Person's Claim for Exemption from Withholding on Income Effectively Connected With the Conduct of a Trade or Business in the United States, with the race track indicating that the purse income is effectively connected with the conduct of a U. S. trade or business, that such income is includible in the

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[2] IRC § 871(b).
[3] Rev. Rul. 58-63, 1958-1 C.B. 624.
[4] Fr. Treaty, Art 7. The provisions in the French treaty for business profits are similar to those in the '81 U.S. model income tax treaty.
[5] Rev. Rul. 85-4, 1985-1 C.B. 294.
[6] IRC § 1441 provides for withholding at the source of U. S. income tax at the rate of 30% on items of "fixed or determinable annual or periodical income", affectionately known in tax circles as "FDAP", at a flat rate of 30% without any deductions or personal exemptions. FDAP includes horse race winnings.
[7] *See*, Private Letter Ruling 8138020 (June 18, 1981). *See also*, GCM 39323 (01/15/85).

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foreign owner's gross income, and that such income will be reported on a U. S. income tax return.[8]

In the case at hand, Lucky Owner has had only one start in the U. S. and thus should be entitled to the presumption that no permanent establishment exists in the U. S. Lucky Owner may choose to file Form W-8BEN to avoid withholding. However, the question becomes whether he can certify on Form W-8BEN that he does not intend to enter any other races during the year. If at the time of certification, Runaway Trick has not been entered into another race and if at that time there is uncertainty as to his plans, for instance, if the trainer advises the owner that he needs time to observe the horse to determine its fitness to race further, there would appear to be a reasonable basis that even though Lucky Owner would like to run the horse in the Kentucky Derby, there is not a definite plan or intent to do so. If on the other hand, Lucky Owner is not able to so certify because he is certain of his plans to so enter the horse in another race, then the 30% withholding may only be avoided by the filing of Form W-8ECI which thereby treats such income as effectively connected with a U. S. trade or business. Such a filing requires that the foreign person obtain a U. S. taxpayer identification number and file a U. S. income tax return reporting. Can a foreign person avoid withholding by filing Form W-8ECI with the withholding agent and subsequently file a U. S. return claiming such income is exempt from tax under a treaty because no permanent establishment exists? Implicit in the instructions to Form W-8ECI are that it may not be used if the foreign person is going to claim entitlement to a treaty benefit and that such income is not effectively connected with a U. S. trade or business.[9]

Fact Scenario #2

> Runaway Trick, fresh off his victory in the Bluegrass Stakes is entered into the Kentucky Derby. He draws an unfavorable outside post position and when the race is run, is never in contention. After the race it is determined that he has bowed a tendon and his racing career is over. Nevertheless, Lucky Owner has been approached by a prominent Kentucky stud farm to syndicate the colt whereby shares in Runaway Trick will be sold to others with Lucky Owner retaining a specified number of shares. Lucky Owner anticipates that he will make millions on his initial investment. Lucky Owner wants to know how much he will have to pay to the IRS with respect to the syndication transaction.

Discussion

Gains from the disposition of movable property forming part of the business property of a permanent establishment in the U. S. are subject to tax by the U. S.[10] A permanent establishment includes not only a fixed place of business through which the business is conducted but also includes the presence of an agent (other than an independent agent[11]) of the nonresident who acts

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[8] In order to use this exemption, the foreign person must be assigned a U. S. taxpayer identification number. Moreover, this income must be reported on an appropriate U. S. income tax return.

[9] Instructions for Form W-8ECI (Rev. February 2006), pg 1.

[10] Fr. Treaty, Art. 13(3)(a).

[11] An enterprise would not have a permanent establishment merely because it carries on business through a broker, general commission agent, or any other agent "of an independent status," provided that that person acts in the ordinary course of its business as an independent agent. *See*, U.S. Model Treaty (11/15/06), Art. 5(6).

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on behalf of the foreign principal by concluding contracts on behalf of the principal. A horse trainer who has a public stable and clients is generally regarded as an independent agent whose activities will not constitute a permanent establishment.[12] Further a stud farm which "syndicates" a stallion prospect is acting on its own account rather than in a representative capacity of the owner. Accordingly, since Lucky Owner has not established a permanent establishment in the U.S. at the time of the syndication, the profits accruing to Lucky Owner from the syndication of the colt as a stallion prospect should not be subject to tax in the U. S.[13]

In a typical stallion syndicate, each owner of a share of the horse is entitled to a certain number of annual breedings or "seasons" to the stallion, which may either be used by the share owner by breeding the owner's mares to the stallion without payment of stud fees or may be sold by the share owner to third parties entitling such third parties to breed their mares to the stallion for the breeding season to which the seasons relate. The stud farm is engaged by the share owners of the horse as the syndicate manager whose responsibility is to provide for the day to day care of the animal as well as oversee the breedings of the mares to the animal. As consideration for these services, the syndicate manager is awarded a specified number of annual breeding rights to the horse. The syndicate manger is typically authorized on behalf of the share owners to contract for the care of the horse, *i.e.*, veterinarian and farrier services, and to advertise and market the services of the stallion. Further, a typical modern day syndicate agreement provides for a "pooling" of seasons whereby breedings in excess of the number of seasons allocated to the share owners may be sold by the syndicate manager to third parties and the net proceeds then divided among the share owners in proportion to their share ownership. There are no specific rulings issued by the IRS as to whether a stallion syndicate creates the existence of a permanent establishment. It is generally thought that as long as the syndicate manager maintains the status of an independent agent, that a permanent establishment does not exist with respect to the foreign owner of the share in the stallion. The determinants of such an inquiry are the level of comprehensive control which are exercised over the syndicate manager and the level of entrepreneurial risk which the syndicate manager bears.[14] A syndicate manager typically has complete discretion over the details of its work. Further assuming that the foreign owner has no external control over the syndicate manager by means of being a shareholder or officer, director or employee of the syndicate manager, legal independence is assured. With respect to economic independence, a relevant factor is the extent to which the agent bears business risk, primarily risk of loss.[15] An independent agent typically bears risk of loss from its own activities. In the

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[12] A permanent establishment wouldn't exist if the activities of the person are limited to those which, if carried on by a fixed place of business, would not be a permanent establishment. Activities carried on by a fixed place of business that would not create a permanent establishment include: (1) facilities used solely to store, display, or deliver goods or merchandise of the enterprise; (2) the maintenance of inventory or merchandise belonging to the enterprise solely for storage, display, or delivery purposes; (3) the maintenance of inventory or merchandise belonging to the enterprise solely to be processed by another enterprise; (4) the maintenance of a fixed place of business to purchase goods or merchandise or collect information for the enterprise; (5) the maintenance of a fixed place of business to carry on preparatory or auxiliary activities for the enterprise; (6) the maintenance of a fixed place of business to carry on the activities described in (1) through (5) above. *See*, U.S. Model Treaty (11/15/06), Art. 5(5).

[13] It should also be noted that the syndication of the horse will be exempt from Kentucky sales and use taxes pursuant to the breeding stock exception as provided in KRS 139.531(2)(a). The sales of seasons to the stallion, however, will be subject to Kentucky sales tax at the rate of 6% of the amount paid. KRS 139.531(1)(a).

[14] *See*, *Taisei Fire & Marine Insurance Company, Ltd. et al v. Commissioner*, 104 T.C 535 (1995); *See also,* U.S. Model Treaty (11/15/06), Art. 5(6).

[15] Treas. Tech Expl. to Model Treaty (11/15/06), Article 5, Paragraph 6.

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absence of other factors that would establish dependence, an agent that shares business risk with the enterprise, or has its own business risk, is economically independent because its business activities are not integrated with those of the principal. A syndicate manager as indicated is typically compensated on the basis of the value of the seasons of the stallion which is managed. Such a relationship is indicative of entrepreneurial risk typical of an independent agent. Accordingly in such instances no permanent establishment should be created.

Fact Scenario #3

> Lucky Owner is now taken with the horse business and wants to expand his operations in the U. S. by purchasing a farm in central Kentucky and building up a broodmare band to breed to Runaway Trick and other stallions located in the area. He plans to race his best prospects and sell the culls each year as yearlings. Lucky Owner wants to be the sole owner of the operations. He also informs you that he most likely will use an offshore tax haven, such as the Bahamas or the Caymen Islands to control his investment so as to minimize exposure to tax liability in France. Lucky Owner wants to know what is the best way to structure ownership of the farm and horse operations.

Discussion

A foreign individual could choose to own the U. S. operations individually or through a single member LLC so as to attain liability insulation while maintaining direct ownership for tax purposes. While such a structure has appeal for its simplicity, it has several disadvantages. First, there may be an impediment under local law for the direct ownership of real property by nonresident aliens.[16] Second, direct ownership subjects the U. S. based assets to U. S. estate and gift tax exposure.[17] Third, such an ownership structure does not provide for anonymity which many foreign investors may desire since it necessitates the filing of U. S. income tax returns by the foreign investor.[18]

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[16] For instance under Kentucky law, if a nonresident alien purchases real estate and then does not become a citizen within eight (8) years, the property escheats to the state. KRS 381.300.

[17] A nonresident alien's gross estate which is situated in the U. S. at the time of his death is subject to estate tax. IRC § 2103. Correspondingly, U. S. gift tax applies to gifts by nonresident aliens of property situated in the U. S. IRC § 2511(a). Real property and tangible personal property are taxable if physically located in the U. S. Treas. Reg. § 20.2104-1(a)(1) and (2). Further, stock in a U. S. corporation is considered to be a U. S. situs asset. IRC § 2104(a).

[18] In addition to tax reporting requirements, other governmental agencies require reporting with respect to foreign investment in U. S. real estate. For instance, the Agricultural Foreign Investment Disclosure Act of 1978 requires a foreign person to submit a report on Form ASCS-153 to the Secretary of Agriculture any time he holds, acquires or transfers any interest, other than a security interest, in agricultural land. The report requires rather detailed information concerning such matters as the identity and country of organization of the owning person, the nature of the interest held, the details of a purchase or transfer and the agricultural purposes for which the foreign person intends to use the land. In addition, the Secretary of Agriculture may require the identification of each foreign person holding more than a 5% interest in the ownership entity up to three tiers of ownership. Further, the International Investment and Trade in Services Act requires disclosure of a foreign investor's direct or indirect ownership in U.S. real estate by filing of Form BE-13 with the Department of Commerce within 45 days of the date of acquisition. Certain exemptions from reporting are provided for, i.e., the total assets are less than $1 million, the farmland consists of less than 200 acres, or the real estate is used exclusively for personal purposes. The form collects certain financial and operating data about the investment, the identity of the acquiring entity and certain information about the ultimate beneficial owner.

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Another alternative may be for the foreign individual to form a U. S. corporation to own the U. S. operations. Such a structure would provide the shield of liability protection and would eliminate the foreign owner from having to file individual U. S. income tax returns. However, this structure has several disadvantages, namely, (1) it does not eliminate U. S. estate tax exposure (although no U. S. gift tax liability should result from a gift of such stock by a nonresident alien[19]); (2) it raises the possibility of double tax on repatriated earnings[20]; and (3) does not provide the owner with the shield of anonymity.[21]

Instead of a U. S. corporation, the foreign individual may choose to use a foreign corporation to conduct the U. S. operations. Such a vehicle provides a shield of limited liability for its owner and it has the advantages of eliminating the exposure to U. S. estate and gift taxes and there is no U.S. withholding tax imposed on dividends paid by a foreign corporation to its shareholder even where the corporation's only activities are in the U.S. Its principal disadvantage, however, is that it exposes the foreign corporation to the branch profits tax[22], unless exempted by treaty benefits.

Lastly, a foreign individual could set up a foreign corporation whose sole asset is all the stock of a U.S. corporation. The U. S. corporation, in turn, would own the U.S. operations. This structure again gives the foreign investor a liability shield while also eliminating the need for the individual to file a U.S. tax return, the U. S. corporation does. While this two-tiered structure is somewhat more intricate than the other approaches discussed above, this option does have many benefits that make its usefulness worthwhile notwithstanding the added complexity and cost to administer. First, neither U.S. federal estate and gift tax will apply if stock in the foreign corporation is the subject of a gift during the foreign investors lifetime or is transferred at his death. Second, the complex branch profits tax will not be applicable since the operating asset and the income generated therefrom reside in a U.S. corporation. Third, while the U. S. corporation must disclose the identity of its 100% shareholder by name, that will identify only the foreign corporation. The foreign corporation is under no such obligation since it is not engaged in a U.S. trade or business.

In the case at hand Lucky Owner has informed you that he desires to use an investment vehicle based in an offshore tax haven country to control his U. S. investment. Accordingly, based on the above, you recommend that it would be advisable (subject to the input of his foreign

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[19] IRC § 2501(a)(2) provides that gifts by nonresident aliens of intangible personal property are not subject to U. S . gift tax.

[20] A corporate level tax will be imposed on profits as well as a 30% withholding tax on dividends which may be reduced by applicable treaty. This potential disadvantage needs to be tenured with the expectation of "profits" from operations of the horse business.

[21] The U.S. tax return filed by the corporation requires the corporation to disclose the name, address, and taxpayer identification number of any person who owns 50% or more of the company's stock.

[22] A foreign corporation is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the effectively connected earnings and profits of the corporation that are removed in any year from the conduct of its U.S. trade or business. In addition, a foreign corporation is subject to a flat 30-percent branch-level excess interest tax on the excess of the amount of interest that is deducted by the foreign corporation in computing its effectively connected income over the amount of interest that is paid by its U.S. trade or business.

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counsel in the tax haven) for a foreign corporation located in the tax haven to own the stock of a U. S. corporation which will conduct the U. S. operations.

As far as repatriating any earnings from the U. S. operations, the U. S. corporation may pay deductible management or advisory fees to its foreign parent subject to the caveat that such payments must be fair and reasonable.[23] Such payments are subject to IRS reporting requirements. Further, when capitalizing the U. S. subsidiary the foreign parent may loan the U. S. subsidiary monies and receive interest on such indebtedness. Such interest, while subject to 30% withholding (or lower treaty rate if applicable), would be deductible by the U. S corporation. In 1989, Congress recognized that such interest deductions could be used to eliminate all U. S. taxation of earnings. In response, it enacted Section 163(j), which created what is known now as the earnings stripping rules. Interest deductions are disallowed if the debtor corporation's debt-to-equity ratio exceeds 1.5-to-1 and its interest expense exceeds 50% of its adjusted taxable income. If a corporation meets these criteria, such excess interest expense will not be deductible if (1) it is paid or accrued to a related person and no tax is imposed or (2) it is paid or accrued to an unrelated person and there is either no gross basis tax imposed with respect to such interest, or there is a disqualified guarantee of such indebtedness.

Oftentimes, horse operations do not show profits due to their capital intensive start up costs. In such situations, capital can be returned tax free to the U. S. corporation's foreign owner when the U. S. subsidiary has no earnings and profits.[24] Interestingly, the author was involved in a case where the foreign owner had advanced monies on an interest free basis to its wholly owned U. S. subsidiary which sustained substantial tax losses from its operations. Under Treas. Reg. § 1.7872-5T(c)(2)(ii) loans by a foreign parent to its wholly owned U. S. subsidiary are exempt from the imputed interest rules. Nevertheless, the IRS examining agent attempted to imputed interest under authority of IRC § 482. The incentive was to impose a 30% withholding tax on the imputed interest at a time when the U. S. subsidiary would derive no tax benefit from an imputed deduction since it had net operating losses. Such a "heads we win, tails you lose" position was not sustained by the Appeals Officer.

Fact Scenario #4

Lucky Owner's luck ran out. He had a massive coronary and died. His wife has no interest in continuing to fund the horse operations of her husband. She calls and asks that you advise her how best to liquidate the U. S. horse operations.

Discussion

There are two alternatives means to effect a liquidations of Lucky Owner's U. S. horse operations which were structured as ownership by a U. S. corporation which in turn was owned

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[23] Under IRC § 482, as interpreted by complex regulations, IRS has broad power to reallocate income, deductions and other tax items among commonly controlled businesses, in order to prevent evasion of taxes or clearly to reflect the income of those businesses.

[24] The portion of a distribution that is not paid out of current or accumulated E&P is not includible in the income of a foreign shareholder who has no U.S. business and is only subject to 30% (or lower treaty rate withholding). Treas. Reg. § 1.1441-3(c)(2)(i)(C).

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by a foreign corporation. The first is a sale of the stock in the U. S. corporation by the foreign corporation. Such a disposition is not subject to U. S. tax or withholding obligation *unless* the U. S. corporation were classified as a "U. S. real property holding corporation"[25]. A foreign person who disposes of an interest in a USRPI treats the gain as one coming from the active conduct of a U. S. trade or business. Further, to assure payment of taxes in such situations, the buyer is obligated to withhold a tax and remit to the U. S. treasury in an amount equal to 10% of the gross sales price.

If a buyer cannot be found for the stock of the U. S. corporation or if the U. S. corporation constitutes a USRPHC, another alternative would be for the U. S. corporation to sell its assets and pay tax at the corporate level on any gains recognized. The remaining cash proceeds can then be distributed to the foreign corporation in complete liquidation of the U. S. corporation free of U. S. tax or withholding obligations. The foreign corporation may then distribute the proceeds to the ultimate beneficiary free of U. S. tax considerations.

Conclusions

As is evident, the rules addressing U. S. taxation of foreign investors are complex and broad. Each fact pattern needs to be addressed with an analysis of the general rules and then the effect of any tax treaties needs to be examined as well. As far as structuring U. S. operations of foreign nationals, there is no one size fits all. Each structure needs to be tailored to the specific facts and desires of the investor involved.

[25] In general, a domestic corporation is a U. S. real property holding corporation ("USRPHC") if the fair market value of its U. S. real property interests ("USRPIs"), on any applicable determination date, equals or exceeds 50% of the fair market value of the sum of (1) its USRPIs, (2) its interests in foreign real estate, and (3) any other assets that are used or held for use in a trade or business. IRC § 879(c)(2). If a corporation qualifies as a USRPHC on any applicable determination date after 6/18/80, any interest in such corporation will be tainted as a USRPI for a five-year period from such date. IRC § 879(c)(1)(A)(ii).

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