

Planning Guide For Foreign Acquisition Of U.S. Real Property

WHY SHOULD A FOREIGNER INVEST IN U.S. REAL ESTATE?

Foreign investors view the U.S. as a stable and secure place to invest in real estate. The prospect of significant economic gain, both through rental income and capital growth, is the strongest lure. U.S. real property is generally characterized by steady appreciation and less volatility than financial markets.

There is relative political and economic stability in the U.S., with little threat of government takeover of an acquired real property asset. Moreover, there is a stable currency system. In short, there are limited domestic barriers to the purchase of U.S. real property by foreigners. Further, the recent relative weakness of the U.S. dollar and surplus of property due to significant foreclosure has enhanced the attractiveness of the domestic real estate marketplace for foreign investors.

While the mechanics of a foreigner's purchase of domestic real property are relatively simplistic, there are potentially confusing and complicated reporting requirements and tax consequences that must be considered. The purpose of this discussion is to address the basic concepts surrounding the United States' jurisdiction over foreign investors for U.S. income, gift and estate tax purposes and certain tax planning strategies for such investments.

WHO IS CONSIDERED A "FOREIGNER" OR AN "NRA"

For income tax purposes, Section 7701(b) of the Internal Revenue Code (the "Code") defines foreigners and non-resident aliens ("NRAs") as individuals who are neither U.S. Citizens, green card holders or U.S. tax residents. Unless an NRA possesses a green card, the test to determine if an NRA qualifies for the same status as a U.S. citizen or resident individual is based on "substantial presence." This is defined by the number of days that an individual must reside in the U.S. to achieve such status. An NRA is considered to have a substantial presence in the United States for a particular calendar year in which the alien is both physically present in the U.S. for at least thirty-one (31) days, and, in that same calendar year, is considered to have been in the U.S. for a combined total of one hundred and eighty-three (183) days or more over the past three (3) years pursuant to a complicated look back formula. It must be noted that there are tax treaties in place between the U.S. and various countries that may expand these limitations for the benefit of the foreigner.

For gift and estate purposes, NRAs are individuals who are not domiciled in the U.S. at the time of making of a gift for gift tax purposes and at the time of death for estate tax purposes. For these purposes, the test to determine domicile is a subjective test based on one's intent of permanency in a particular country. Therefore, an NRA will be considered a U.S. "estate and gift tax resident" if the U.S. is found to be the permanent home to which that individual ultimately intends to return. In such case, the U.S. estate tax would apply to the worldwide estate of such individual consistent with the treatment of a U.S. resident. Importantly, NRAs are nevertheless subject to estate and gift taxes on any assets that are actually situated in the U.S.

PITFALLS: WHAT MAY SEEM “FOREIGN” TO THE FOREIGN INVESTOR

The purchase of property in the U.S. has its own set of customs. Foreign investors should be aware of these customs and practices. For example, in many countries attorneys are not involved in real estate transactions. In some countries the entire real estate transaction is handled by one notary public whom is often actually a trained lawyer responsible to prepare the deed, go over title issues and collect transfer fees and taxes. Furthermore, wills are not necessarily a common part of estate planning. In civil law countries people are guided by a civil law code that dictates how property passes to spouses and to children. Some countries adjust estate taxes and transfer or gains taxes based on inflation. The U.S. system does not do this and can present a huge shock to these individuals when they learn what they could be exposed to in the U.S.

Specific to Manhattan real estate, where approximately seventy five percent (75%) of the residential property is cooperative property, a foreigner must come to terms with the concept of owning shares of stock in a corporation rather than bricks and mortar. In addition, cooperatives are free to reject sales and rentals of units based on the cooperative board's review of the purchaser's financial and personal application (although cooperative boards may not discriminate against a purchaser on the bases of certain categories protected under law, including race, color, gender, religion, etc.). The cooperative form of ownership also bears important tax consequences to the foreigner. While estate tax issues are the same for condominiums and cooperatives, the transfer of cooperative shares is not subject to a gift tax. Succession of ownership is relevant to understand as well. For example, a foreigner owning a cooperative unit who dies without a will would be subject to the succession laws of such individual's home country or domicile. In the case of a condominium, the law of the situs of the property controls for inheritance purposes.

THERE IS NO IDEAL SOLUTION: ONLY CHOICES

There are numerous traps for unsuspecting foreign investors when purchasing U.S. real property. To meet the needs of each individual, it is important to consider how any purchase is structured. For example, the direct ownership of real property may reduce the rate of income tax paid but cause the individual to be subject to estate taxes and may cause that individual to lose some of the jurisdictional exceptions that might avoid income tax altogether. In making such decisions, foreign investors must consider and weigh the interplay of federal and state income taxes, estate and gift taxes, and any desire for tax anonymity.

Therefore, it is extremely important for foreign investors to work with a qualified team of legal, accounting and brokerage/valuation professionals who as a team understand the interplay of the relevant tax laws of the foreigner's home country as those of the United States. The goal of the professional team should be to assist the purchaser in facilitating the most efficient investment, accounting and tax structure in the purchase transaction.

PLANNING CONSIDERATIONS

A foreign investor planning to purchase U.S. real property has many considerations to make prior to consummating an acquisition transaction. One of the most important decisions will be deciding

which of the different structure options to select in which to purchase the asset. For example, the foreign investor will need to decide whether to conduct the real estate business in the U.S. as an individual owner, as a member of a limited liability company (“LLC”) or as a shareholder of a domestic or foreign corporation. A foreigner may also acquire property in a trust, as part of an inheritance or as a gift, or might own fractional pieces of property through a partnership (but these types of ownership are not discussed further in this informational guide).

Ownership as an Individual or as a Single Member Limited Liability Company

Foreign investors interested in purchasing real property that will become a future residence for their personal use should consider direct ownership. This is the least complex structure and it has some advantages. Alternatively, the foreign investor could acquire the property through a single member LLC. Subject to applicable local law, the typical LLC would provide liability protection and also maintain direct ownership for tax purposes. When the property is sold, the tax structure is simple as there is only one level of tax imposed and gains on the sale of the property may qualify for any preferential capital gains tax rates.

However, there are also a number of disadvantages to direct ownership as well. As explained below, a direct owner may be required to file a U.S. income tax return if the real property acquisition causes the purchaser to be engaged in a trade or business in the United States. In addition, direct ownership will not accomplish any goal of a foreigner to remain anonymous. Property owned directly additionally exposes the owner to estate tax issues, in the event the individual owner dies while still holding the property, which often times involves much higher tax rates; typically, the potential for estate tax in the United States is a significant concern of a foreign buyer. The federal estate tax rate is progressive and can reach excessive and prohibitive limits. Further, certain states impose estate taxes that may increase the aggregate tax burden. A direct owner will also pay income tax at the time real property is disposed of, which may not necessarily be true under other structures. When domestic real property is disposed of by a foreigner Section 897 of the Code treats such disposition as though the foreign individual was engaged in a U.S. trade or business. These are commonly known as the FIRPTA provisions. Once the foreign investor is deemed to be engaged in a U.S. trade or business, any income that is “effectively connected” with such trade or business will be taxed at the same rates applicable to the U.S. citizens or residents.

Ownership Through a Domestic Corporation

A U.S. corporation owned by an NRA does provide a liability shield. In addition, the corporate entity becomes a taxpayer separate for its owner. Such should eliminate the need for the individual to file annual U.S. federal, state and local tax returns based solely on such ownership. However, the corporate entity may have filing requirements. Also, the tax return would require the corporation to disclose the name, address and tax identification number of any person who owns fifty percent (50%) or more of the corporate stock. Therefore, any goal of owner anonymity will not be accomplished.

This structure has an additional disadvantage in that U.S. federal estate tax liability is not avoided. Also, there will actually be two levels of tax imposed on the corporation’s income. The first level is the income tax imposed in the corporation’s net income and the second is the tax imposed upon the distribution of those earnings to the owner via dividends. Unless there is a reduction for an

applicable treaty rate, the Code imposes a thirty percent (30%) withholding tax on dividends paid from domestic corporations to foreign owners. Certain tax treaties do reduce the withholding rate to as low as five percent (5%). Thus, it is important to research the details of any applicable income tax treaty.

Ownership through a Foreign Corporation

The purchase of U.S. real estate through a foreign corporation is another alternative. While often undertaken to limit tax liability, a foreign corporation is mostly used to avoid U.S. income tax and U.S. estate tax consequences. This may result in the ability to pass on U.S. real property to estate beneficiaries without paying U.S. taxes. Furthermore, the individual investor does not have to file a U.S. tax return. The corporation will have U.S. tax compliance requirements if it is determined to engage in a U.S. trade or business or when the entity sells the real property asset.

While there is no U.S. estate or gift tax, or any U.S. withholding tax against the dividends paid by the foreign corporation to a shareholder, the branch profits tax may be applicable. The thirty percent (30%) branch profits tax is imposed on a foreign corporation's "dividend equivalent amount" and applies regardless of any current distributions to the shareholders. The tax is imposed on the corporation's taxable income that is "effectively connected" to a U.S. trade or business. Again, anonymity is not complete in this case either. Any filed tax return would require the corporation to disclose the name, address and tax identification number of any person who owns fifty percent (50%) or more of the corporate stock.

Foreign Corporation Which Owns a U.S. Corporation

This is a more complex structure under which both a foreign corporation and a domestic U.S. corporation are utilized. The single asset of the foreign corporation is the stock of the U.S. corporation, which in turn, owns the real estate asset. This more complicated and costly structure does have several important benefits that make it worthwhile to seriously consider. First, the investor is provided a limited liability shield and does not have to file any U.S. tax return. Furthermore, the federal estate and gift tax would not apply in a situation where the stock of the foreign corporation was transferred as a gift or upon death. Importantly, the branch profits tax would not apply under this structure because the real property asset and any income from its operations would be held by a U.S. corporation and not the domestic branch of a foreign corporation. In addition, and most importantly to some foreign investors, the ultimate investor would be anonymous. Since the U.S. corporation would identify the foreign corporation as its sole shareholder and the foreign corporation would not be under a similar obligation because it is not engaged directly in a U.S. trade or business, the ultimate owners anonymity would be preserved. Finally, any cash directed to the foreign corporation upon the liquidation of the U.S. company (as tax would have been paid at this stage) would be free of any U.S. withholding tax and could be easily distributed to the ultimate investor free of any U.S. tax impact. It should be noted, however, that income tax would be taxed at a less favorable rate when compared to individual ownership.

CONCLUSION

The key for any foreign investor interested in owning U.S. real estate is to do careful planning before acquiring the real property. Once the asset has been acquired there is far less flexibility to

restructure the investment without encountering tax liability. The different approaches summarized above all have their own tax related and non-tax related advantages and disadvantages. The planning structure that a foreign investor should follow will ultimately depend on in-depth dialogue with a team comprised of attorneys, accountants and brokers about the investor's intent for the property, the investor's particular situation abroad, the investor's desire for anonymity and the relative weight the foreign investor places on each of such individual's goals.

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