

U.S. Tax Considerations – Foreign Investment in U.S. Real Estate

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Doris S. Hsu, Esq.
The Ruchelman Law Firm
150 East 58th St. FL 14
New York, NY 10155
(212) 755-3333
Hsu@ruchelaw.com

Introduction

- Foreign persons buy homes in the United States
 - Personal use during temporary stays which may be:
 - Long-term
 - Short term or vacation
 - Permanent home in preparation for moving to the United States
 - Homes for children who may be or become
 - Nonresident aliens (e.g., students)
 - Resident aliens or U.S. citizens
- In some cases, the home may be rented out
 - E.g., a resort home or condominium in a rental pool

Moments of Importance

□ Issues arise –

- During ownership
- Upon sale or taxable exchange
- Upon gift
- Upon death

Possible Issues

- Effect on U.S. residence status
- Income tax/withholding tax on rental income, actual and imputed
- Capital gains
- FIRPTA and state income tax withholding
- Gift tax and estate tax
- Consequences to U.S. heirs

During Ownership

- Residence status of alien in most cases not directly affected by ownership of U.S. home
- However, ownership and occupancy of home (and size/value of home compared to foreign home) may affect:
 - Foreign tax home – closer connection test
 - Tax treaty tiebreaker
 - Determination of domicile for estate and gift tax
 - Residency for state tax purposes
 - Loss of residence for purposes of foreign country's tax

During Ownership

- If corporation holds property, must shareholders or related users pay FMV rent?

- If personal use of corporate property and for less than FMV rent

- **Consequences:**
 - Deemed dividend equal to excess of FMV over rent paid

 - If corporation is domestic and has E&P, withholding tax on deemed dividend

Upon Sale

- Mandatory gain recognition and taxation (FIRPTA Tax - IRC Sec. 897)
 - 15% tax rate for individuals, 25% for recapture income
 - 34%/35% tax rate for corporations on net income after reduction for net operating loss carryovers
 - Branch profits tax if foreign corporation owned property
 - Credit allowed for FIRPTA tax withheld under section 1445

Upon Sale

- Branch level taxes if owner is foreign corporation
 - Branch profits tax of 30% on effectively connected earnings, without reduction for net operating loss carryovers
 - Opportunity to reduce branch profits tax through termination of trade or business
 - Three-year non-reinvestment rule and three-year extension of statute of limitations
- FIRPTA withholding if owner is foreign
 - 10% withholding imposed on gross amount realized
 - \$300,000 exemption when buyer will use property as principal residence – (exemption is only from FIRPTA withholding, not from taxation on gain)
 - Excess withholding can be avoided by requesting reduced withholding certificate from the IRS
 - Some states require withholding on sale by nonresidents

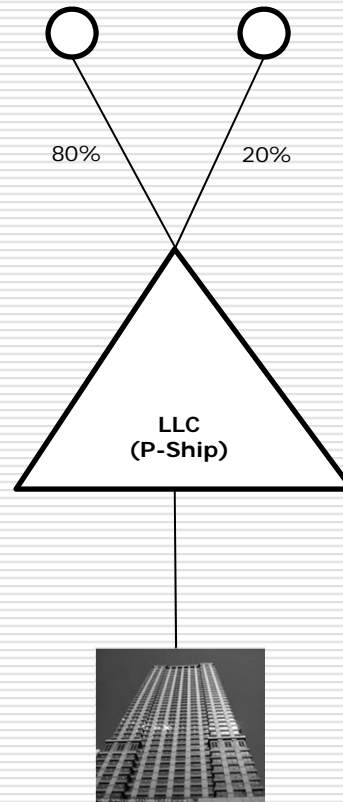
Upon Gift

- Gift tax applies to gifts of real property located in the United States, but not to gifts of interest in entities holding U.S. real estate.
- Gifts by NRA of intangible property are not subject to gift tax – IRC Sec. 2501(a)(2)
- No unlimited marital deduction for gifts to noncitizen spouse – IRC Sec. 2523(i)(1)
- Annual exclusion for gift to noncitizen spouse is \$139,000 for 2012 – IRC Sec. 2523(i)(2)

Upon Death

- U.S. real property and shares of U.S. corporations are subject to estate tax
- \$60,000 exemption not very helpful
- Deductions are allowed in computing taxable estate only if worldwide estate of noncitizen nonresident decedent is included in U.S. estate tax return
- Deductions against taxable estate must be prorated based on the ratio that U.S. situs assets bears to worldwide assets
 - Treatment of recourse v. nonrecourse mortgages

Case Study



Current Structure – Tax Consequences

- U.S. LLC's are partnerships (fiscally transparent) for U.S. federal income tax purposes and the condominiums are U.S. real property interests ("USRPI's").

- During the current ownership phase, the Clients are required to file non-resident tax returns with the IRS on Form 1040NR because they are treated as engaged in a trade or business in the U.S. through the LLC's. Filing of Form 1040NR also preserves the net operating losses from the rental business.

- Upon disposition of the USRPI:
 - Partnership recognizes capital gain or loss.
 - Capital gain or loss is allocated to the Clients.
 - Preferential tax rate of 15% if held long-term.
 - Filing obligations: 1040NR.

- The value of a Client's interest in the LLC's is subject to U.S. estate tax (death duty) currently at 35%. Rate is likely to go up in the future.

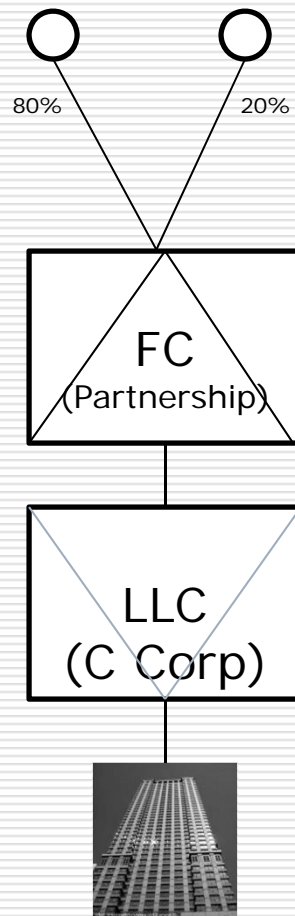
Clients' Wish List

- Do not want to file tax returns with the IRS on Form 1040NR
 - OK with higher corporate income tax rate on gains (operating income currently taxed at same rate for both corporate and individuals)
 - Ok with not complete anonymity

- Want flexibility of tax free gifts of the U.S. real property interests

- No U.S. estate tax (death duty) upon death

Fix – Foreign Partnership



Fix – Foreign Partnership

□ U.S. Tax Consequences

- U.S. LLC converting to U.S. corporation through a check-the-box election on Form 8832
 - The C corporation is the taxpayer that files with the IRS and it will be subject to U.S. corporate income taxation, currently a maximum tax rate of 35%.
 - There is no preferential capital gains treatment for corporate holders of capital assets. Sale of a capital asset will be taxed at regular corporate rates.
 - After tax proceeds from the sale of a condominium can be distributed free of U.S. tax if the LLC (as a corporation for U.S. tax) liquidates.

Fix – Foreign Partnership

- Transfer of shares of U.S. corporation to a foreign corporation that has made a check-the-box election to be treated as a partnership for U.S. tax purposes.

- The transfer of shares qualifies as a tax-free 721 capital contribution though timing of transfer must be managed.

- The Clients must file Form 1040NR's with the IRS to report the transfer to preserve the tax-free treatment.

- To avoid the 10% FIRPTA withholding tax, the IRS must be notified of the transfer within 20 days after the transfer.

Fix – Foreign Partnership

- Post Transfer
 - The Clients
 - There is U.S. income tax on the sales or taxable exchanges of the interest of the foreign partnership to the extent attributable to the U.S. real estate holding company.
 - The Clients' interest in the foreign partnership is not subject to U.S. estate tax (death duty).
 - Gifts of the interest of the foreign partnership are not subject to U.S. gift tax. (U.S. gift tax is imposed on the person making the gift).
 - No U.S. estate tax upon clients' death because the foreign partnership does not do business in the U.S.

Fix – Foreign Partnership

- U.S. Tax Return Obligations

- U.S. Corporation

- Form 1120.

- Must disclose 20% direct owners and 50% ultimate beneficial owners on Schedule G of Form 1120

- Form 5472 if there are reportable transactions.

- Foreign Partnership

- No IRS filing or reporting obligations unless it sells the shares of the U.S. corporation.

Fix – Foreign Partnership

- ❑ U.S. Tax Return Obligations
 - ❑ The Clients
 - No further IRS filing or reporting obligations.
- ❑ Fix is not ideal as the sale of foreign partnership interest is still subject to U.S. income tax.
 - ❑ Rollover to a foreign corporation is most likely caught in the corporate inversion net and thus the foreign corporation will be treated as a U.S. corporation → U.S. estate tax exposure.
 - ❑ Cannot contribute U.S. real estate (hard assets) to a foreign corporation tax-free, so cannot contribute the real estate to a foreign corporation and then drop the real estate into a U.S. corporation.
 - ❑ Importance of getting the structure right upon acquisition!

Thank You!



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