

STRUCTURING INBOUND INVESTMENTS IN U.S. REAL ESTATE

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Principal Topics

1. Building Blocks
2. Planning
3. Questions

BUILDING BLOCKS:
OWNERSHIP AND DISPOSITION OF U.S. REAL ESTATE

Two U.S. Tax Regimes May Apply

- **Passive Income:** Fixed and determinable, annual or periodical (FDAP) income from U.S. sources
 - 30% tax on “gross income”
 - U.S. payor withholds tax
 - Subject to reduction or elimination by (i) Tax Treaty or (ii) Code exemption (e.g., portfolio interest)
- **Active Income: ECI Income**
 - If engaged in U.S. trade or business (ETB), then income effectively connected (ECI) with that business is subject to U.S. income tax
 - Must file U.S. tax return
 - Tax imposed at graduated rates (NRA is eligible for long-term capital gains rates)
 - Tax imposed on “net income” so get deductions to lower tax liability
 - Branch profits tax may apply to non-U.S. corporations

Rental Income

- Rental income: FDAP income subject to 30% withholding tax
- Tax can be very harsh

Example:

- Lessee pays \$100 rent to owner and \$100 expenses to third parties related to the property (e.g., real property taxes, insurance)
- Gross rental income = \$200
- Withholding tax = \$60
- Net cash owner gets \$40 ($\$100 - \60)
- Effective tax rate of 60%

Rental Income (cont'd)

- If leasing or other activity in relation to property makes foreign owner ETB, then rental income becomes ECI
- Tax *only* on "net income" from property, which usually produces lower tax for owner

Example:

- Lessee pays \$100 rent to owner and \$100 expenses related to the property
 - Gross rental income = \$200
 - Net rental income (before depreciation and interest deductions) = \$100
 - Maximum tax (assuming no depreciation or interest) = \$35 (corporate)/\$39.6 (individual)
 - Effective tax rate = 35% and lower if get depreciation, interest, and other deductions
- Owner must file tax return

Rental Income (cont'd)

- When does leasing make foreign owner ETB?
 - General Rules:
 - Rental of one property to one tenant under a “net” lease is not ETB
 - See Rev. Rul. 73-522; Neill
 - Rental to many tenants is ETB
 - See Pinchot (11 real estate properties)
 - Election to be ETB: §871(d), 882(d)
 - Often recommended since lower tax burden (due to deductions)
- If rental income is ECI, give Form W-8ECI to lessee to eliminate withholding tax

Sale of Real Estate

- Gain is taxable: Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) – §897
 - Gain from sale of “United States real property interest” (USRPI) taxed as if:
 - Foreign seller is engaged in a trade or business in the U.S. and the gain is effectively connected with that trade or business
 - Foreign sellers are taxed on gains at the same rates as those applicable to U.S. sellers
 - Gain can qualify for long-term capital gains treatment
 - Like-kind exchange treatment does not apply unless the seller receives U.S. property in the exchange – §1031(h)

Sale of Real Estate (cont'd)

- Definition of USRPI (Treas. Reg. § 1.897-1)
 - Interest in real property:
 - Real property includes land, buildings, and other improvements
 - Includes growing crops and timber, and mines, wells, and other natural deposits – but once extracted or severed, crops, timber, ores, minerals, etc. are no longer USRPIs
 - Includes “associated personal property”
 - Includes direct or indirect right to share in appreciation in value, gross or net proceeds or profits from real property
 - Does not include mortgage loan at fixed rate of interest (or variable rate such as prime, LIBOR, etc.)
 - Interest in domestic corporation that was a U.S. real property holding corporation (USRPHC – see later slide) at any time during the 5-year period preceding sale

Sale of Real Estate (cont'd)

- Withholding Requirement: §1445
 - Buyer must withhold 15% of “Amount Realized” on Sale (was 10% from enactment of §1445 in 1985 but increased by PATH Act to 15% effective February 16, 2016)
- Problem: Overwithholding
 - Example:
 - Sell real estate with a tax basis of \$900 for \$1,000
 - Buyer must withhold \$150 tax (15% of \$1,000) even though gain is only \$100 & tax will be less than that
 - Solution: Get exemption or reduced rate certificate by filing Form 8288-B before the sale
- Rev. Proc. 2000-35 explains how to do this
- Recommended in example above to lower the withholding tax

Sale of Real Estate (cont'd)

- Other Exemptions to Withholding:
 - Seller gives buyer a:
 - Non-foreign affidavit or
 - Non-USRPHC affidavit if you are buying a company (as defined below)
 - Sales price < \$300,000 on property, and buyer will use this for their residence
 - Amount not indexed for inflation in 30 years
 - Situations where withholding required under partnership withholding rules

Interest Income from U.S. Mortgage

- Interest income is FDAP income subject to 30% withholding tax
- Elimination under:
 - Portfolio Interest Exemption: §§ 871(h), 881(c) applies to all interest if debt is in registered form, except:
 - Loan by foreign bank in the ordinary course of business
 - Loan from 10% or greater shareholder or partner
 - Contingent interest
 - HIRE Act of 2010 eliminated exception for post-3/18/2010 instruments in bearer form
 - Tax Treaties
 - Almost all treaties provide for exemption or reduced rate

Interest Income (cont'd)

- Issue: Can a foreign lender be ETB?
 - **“Buy” outstanding mortgages:** No
 - **“Originate” or make new loans:** Yes, if lender makes many loans in the U.S. and is therefore conducting a lending business in the U.S. (looks like a bank)
 - Note: Controversial General Legal Advice Memorandum (GLAM) 2009-10, where origination activities were conducted by U.S. agent
- If ownership of mortgages makes lender ETB, then portfolio interest exemption will not apply
 - Must file U.S. tax return and pay tax on net income from lending business
- Issue: How is interest from foreign seller financing of real estate sale taxed?
 - Not taxable under FIRPTA
 - Either FDAP income or (less commonly) ECI, whether or not sale that generated the note is taxed under FIRPTA

Sale of U.S. Mortgage

- General rule: Gain from sale is not U.S. source FDAP and not ECI
- Exception:
 - If in U.S. lending business, then gain from sale would be ECI and therefore taxable
 - If mortgage loan has contingent interest, then the loan is a USRPI and gain from its sale will be taxable under FIRPTA
- Example: Loan has 5% fixed interest and contingent interest = 25% of cash flow from the property

Dividend from U.S. Corporation

- Dividend income:
 - FDAP income subject to 30% withholding tax
 - Subject to reduction or elimination: Tax Treaties
- Non-dividend distributions:
 - If corporation is a USRPHC, as discussed below, withhold 15% of the distribution - §1445(e)(3)
 - Subject to reduction if exemption or reduced rate certificate is obtained from the IRS

Sale of Stock of U.S. Corporation

- Normal rule: Gain from sale is not U.S. source FDAP income and does not make investor ETB
- FIRPTA: Taxable if sell stock of a U.S. Real Property Holding Corporation (USRPHC)
 - Treats the gain as ECI income
 - Corporate sellers may also have branch profits tax

Sale of Stock (cont'd)

- USRPHC definition (§897(c)(2)):
 - FMV of USRPIs held on any “applicable determination date” equals or exceeds
 - 50% of sum of FMVs of (i) USRPIs; (ii) non-U.S. real property interests; and (iii) other trade or business assets
 - Look-through rule for assets held through entities
 - For corporations, only look-through if they own more than 50%
- Exemption:
 - Regularly traded class of stock if taxpayer owns 5% or less
 - Does not include stock in a corporation that has sold all of its USRPIs in taxable transactions

BUILDING BLOCKS: FATCA AND REAL ESTATE

FATCA: Basics

- FFI: 30% withholding on withholdable payments under §1471 will be imposed unless FFI:
 - Signs agreement with IRS (“PFFI Agreement”);
 - Is resident of country that has signed a FATCA IGA; or
 - Is exempt from FATCA under existing IRS guidance
- NFFE: 30% withholding on withholdable payments under §1472 will be imposed unless NFFE:
 - Certifies that it has no substantial U.S. owner; or
 - Provides the name, address, and TIN of each substantial U.S. owner; and
 - In either case, withholding agent (a) neither knows nor has reason to know certification is incorrect and (b) provides the substantial U.S. owner to IRS

FATCA: Application to Real Estate

Withholdable payments from real estate-related income:

- FDAP:
 - U.S.-source interest (e.g., interest from mortgage loan)
 - Dividends (e.g., dividend from USRPHC)
 - Rents and other types of payments from the U.S. (e.g., rent on U.S. real estate)
- U.S. Securities:
 - Gross proceeds from the sale of any property that could produce U.S.-source dividends or interest
 - This includes USRPHC stock and debt
- Exception: Withholdable payments do not include payments of ECI
 - This means that disposition gains subject to U.S. tax under FIRPTA should not be subject to FATCA withholding
 - E.g., gain from the sale of a domestic corporation that is a USRPHC

BUILDING BLOCKS: ESTATE AND GIFT TAXES

Gift Tax

- Nonresident alien is taxed on gifts of tangible (but not intangible) property located in the United States
 - Gift of U.S. real property is subject to gift tax
 - Gift of stock (whether domestic or foreign corporation) is *not* subject to tax
 - Gift of partnership interest probably *not* subject to tax
 - Points to note:
 - No step-up in basis on inter vivos gift
 - No unified credit
 - Substance over form risk. For example:
 - Donee or trust is funded with cash and purchases real property from grantor – e.g., *Davies v. Commissioner*, 40 T.C. 525 (1963)
 - Foreign owner contributes property to partnership and then makes gift of partnership interest

Estate Tax

- Estate of nonresident alien is subject to estate tax on property located in the United States. Includes:
 - U.S. real property and tangible property located on it
 - Stock in U.S. corporation (publicly traded or not)
 - But not stock in foreign corporation
 - Top rate = 40%; unified credit equivalent to \$60,000 exemption (unchanged for decades)
- Uncertain treatment of partnership interests
 - IRS position: Interest is located in the U.S. if partnership is engaged in U.S. trade or business. What if:
 - Partnership not ETB but decedent elected under §871(d)?
 - Partnership owns only residence for NRA's personal use?
 - Other theories: Place of organization or partner domicile

PLANNING:
DILIGENCE; IDENTIFYING OBJECTIVES

Before Planning Begins

- Understand investor characteristics – type, location
- Ascertain investment characteristics and objectives:
 - Use: personal use, business, investment
 - Types of income generated from real estate: rent, interest, dividends, capital gains, services, and others
 - Capital: equity, debt (many different flavors and sources)
 - Exit: anticipated timing, method
- Consider choice of entity – wholly owned, joint ventures, passive investment vehicles
- Withholding and compliance
- Estate and gift taxes

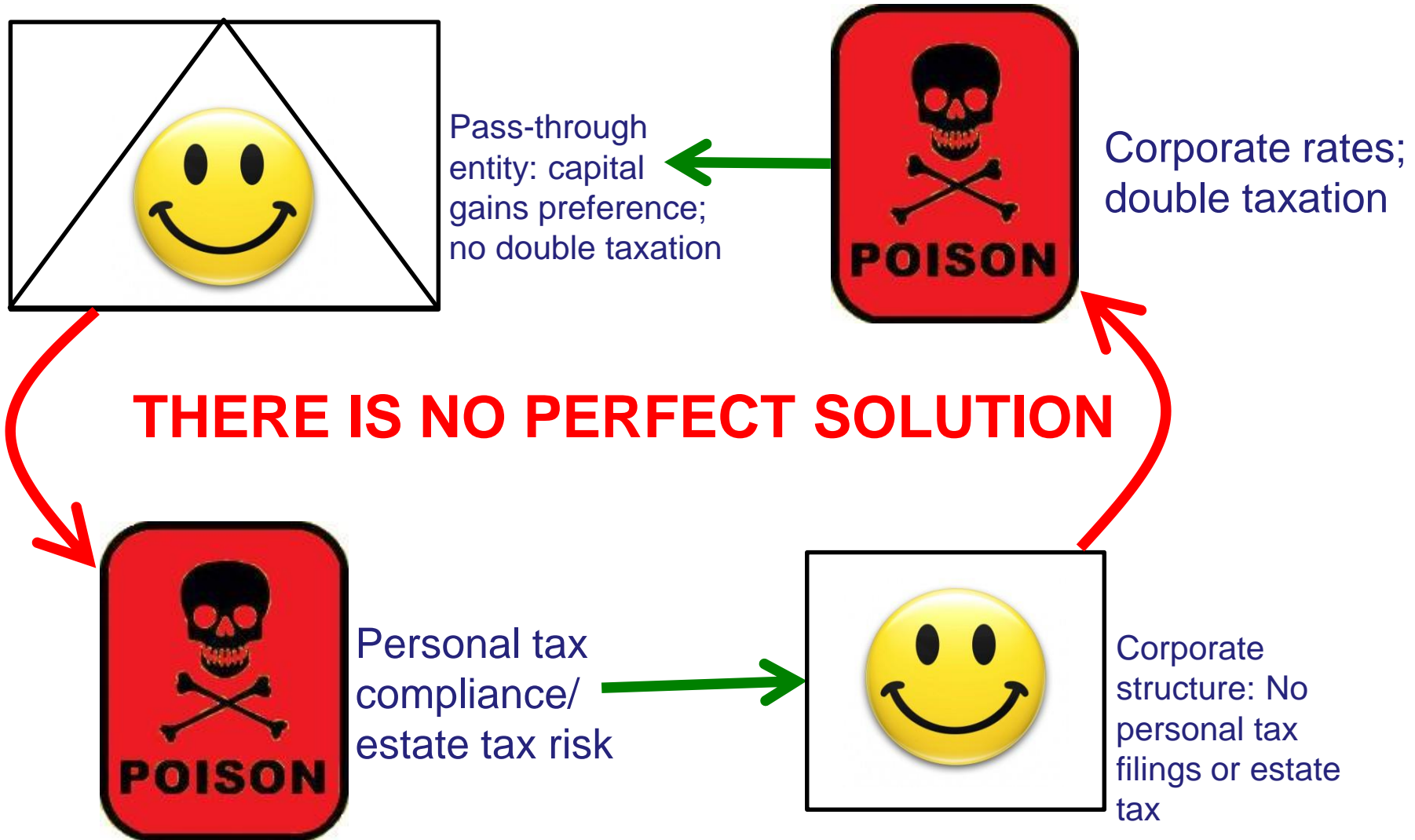
Home Country Taxation

- No planning should be undertaken before considering whether home country taxation is relevant
- U.S. taxation of foreign investors may be modified by treaty
 - No exception from U.S. taxation of gain from real estate, but treaties can reduce or eliminate tax on interest and dividends
 - Almost all treaties contain “limitation on benefits” provisions to counteract abusive use of treaties

Objectives Drive Structure

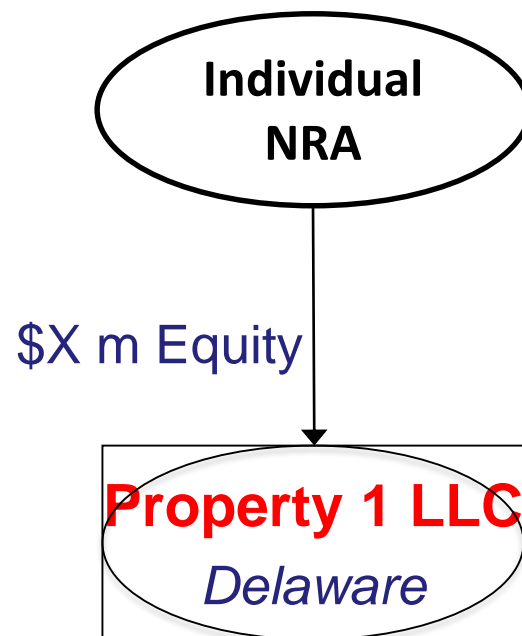
- Tax objectives:
 - Avoid cross-border double taxation (U.S./foreign)
 - Mitigate taxation of operating income
 - Avoid double taxation of corporate earnings
 - Obtain long-term capital gains treatment on sale
 - Avoid gift and estate taxes
 - Limit overwithholding
 - Limit contact with U.S. tax system
- Nontax objectives
 - Preserve confidentiality
 - Facilitate inter-family transfers
 - Limited liability

Structuring May Mean Picking Your Poison



PLANNING:
SELECTED STRUCTURING OPTIONS

Individual Ownership



U.S. Federal Tax Classifications



Corporation/Trust



Hybrid Entity



U.S. Partnership

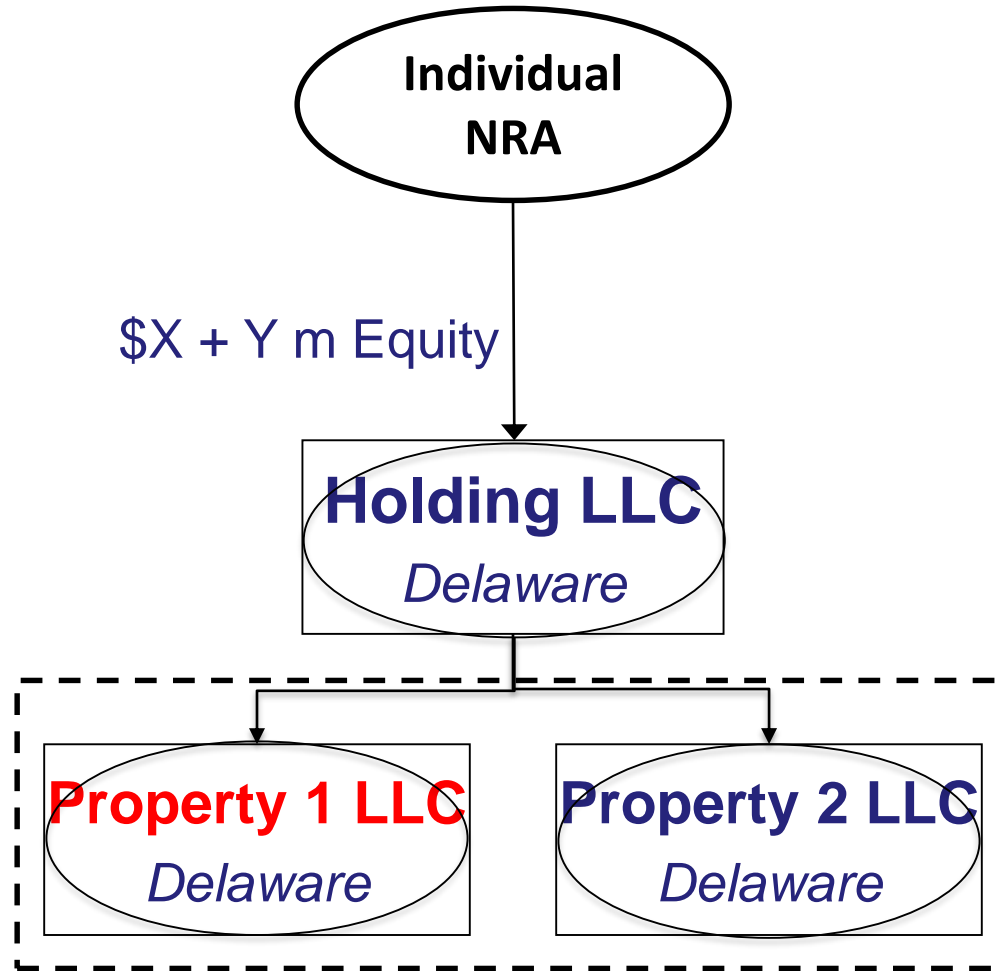


Branch








Disregarded Entity "DRE"

Individual Ownership



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Individual Ownership

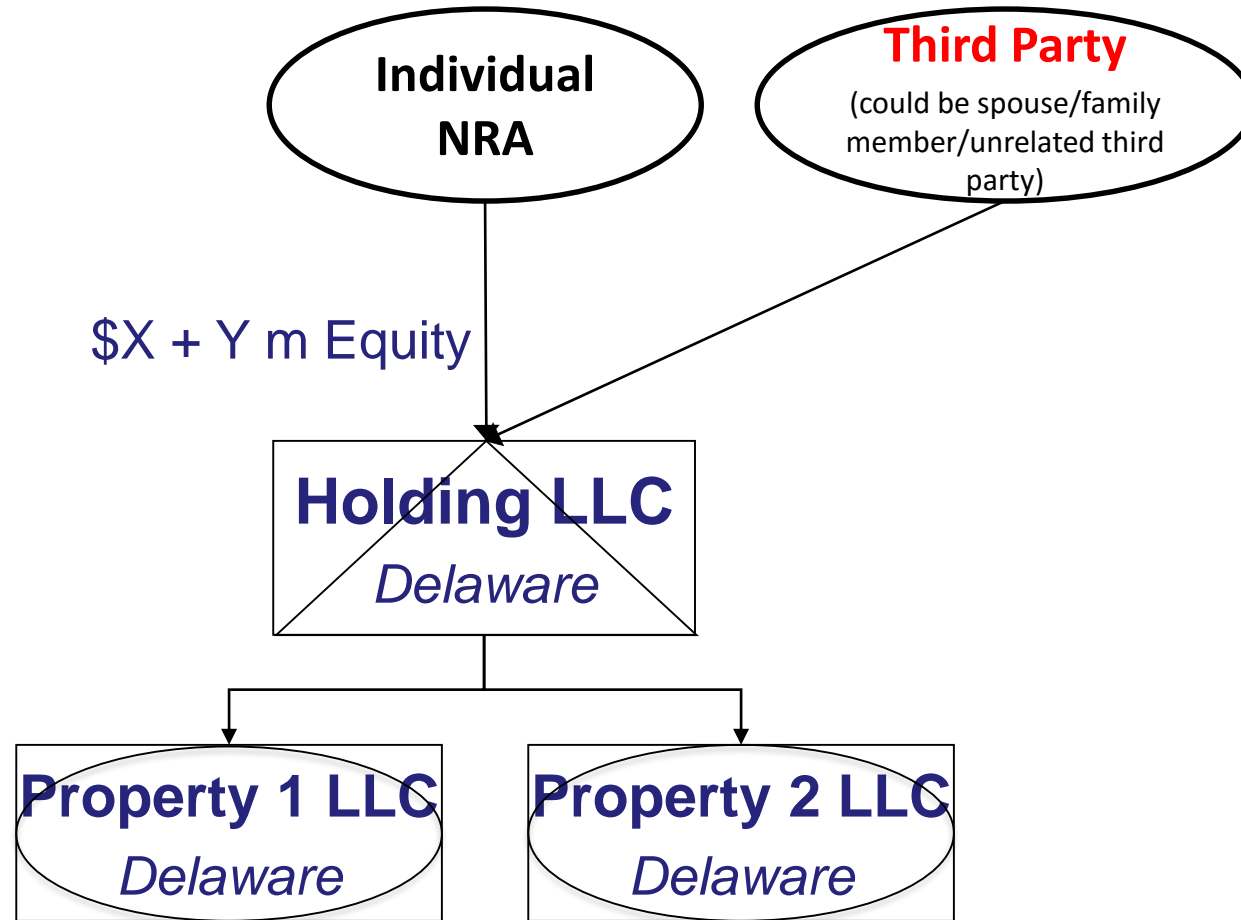
Advantages

- Long-term capital gains treatment available
- Single level of tax
- Profits and losses offset
- No imputed income for personal-use property
- LLCs provide limited liability; holding LLC can provide "presence"






Disadvantages

- Gift tax probably imposed on gift of LLC interest if LLC is disregarded entity (query effect of *Suzanne Pierre* case)
- Estate tax exposure
- Must file individual income tax returns and partnership returns

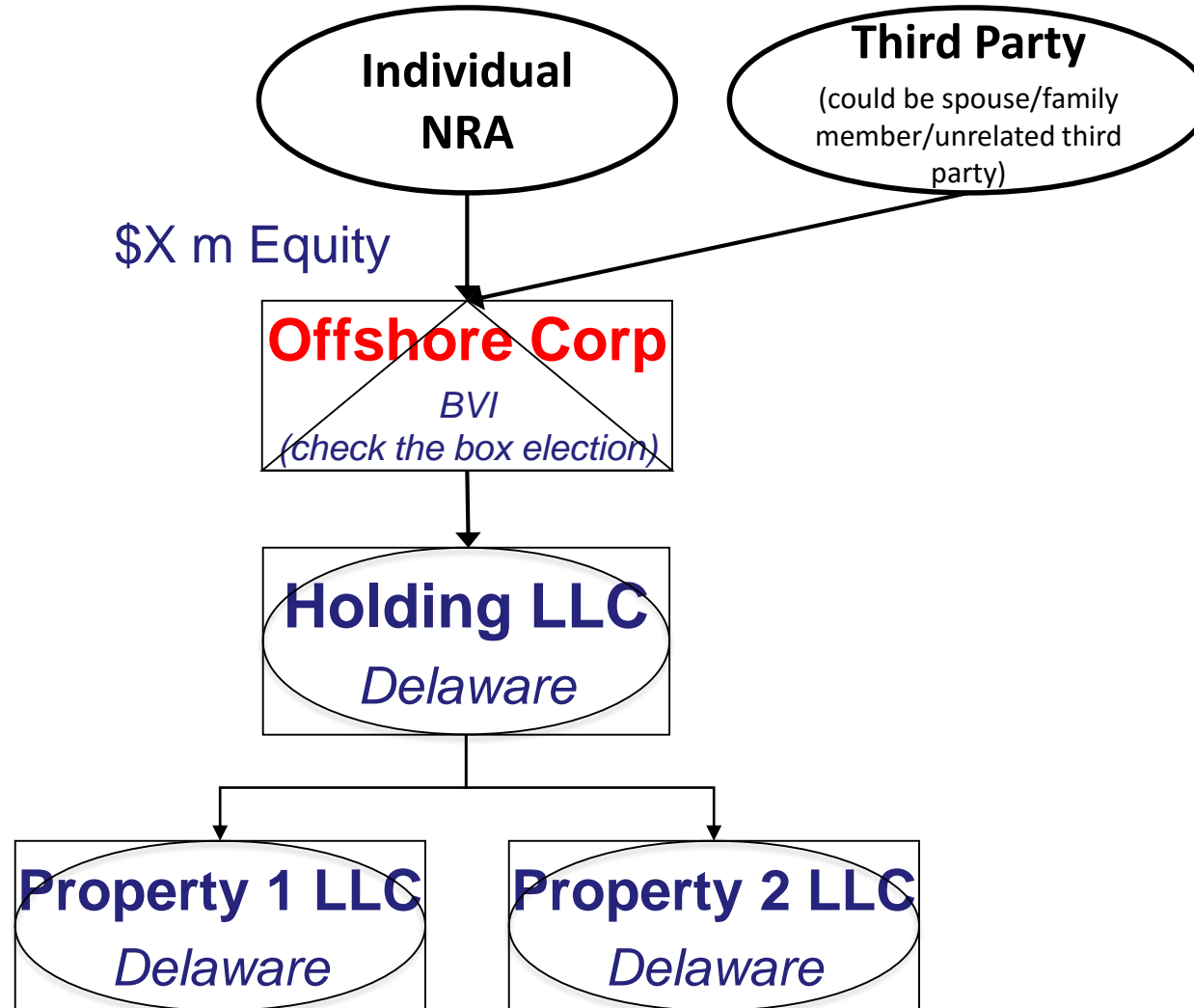
Individual Ownership (with partnership)








U.S. Federal Tax Classifications

-  Corporation/Trust
-  Hybrid Entity
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Individual Ownership (with partnership)



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Individual Ownership (with partnership)

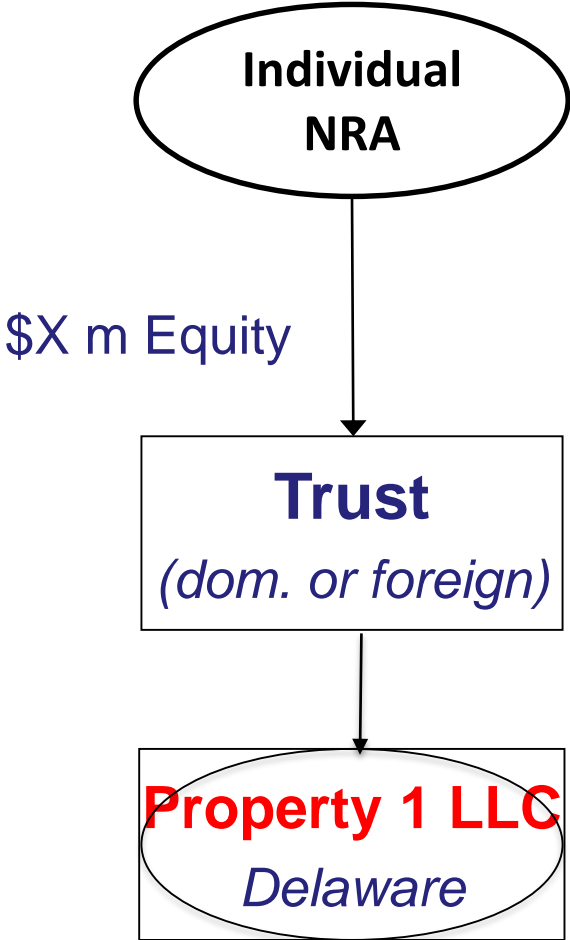
Advantages

- Long-term capital gains treatment available
- Single level of tax
- Should not have imputed income for personal use property, but less certain than with direct ownership
- Gift tax probably does not apply to gift of interest in LLC treated as partnership
- LLCs provide limited liability; holding LLC can provide "presence"






Disadvantages

- Estate tax exposure, but may have counterargument, especially if LLCs not engaged in trade or business; additional argument if offshore holding company is classified as partnership inserted in structure
- Must file individual income tax returns and partnership returns
- § 1446 (over)withholding
- Treaty issues raised by LLC and foreign corp

Ownership Through Trust



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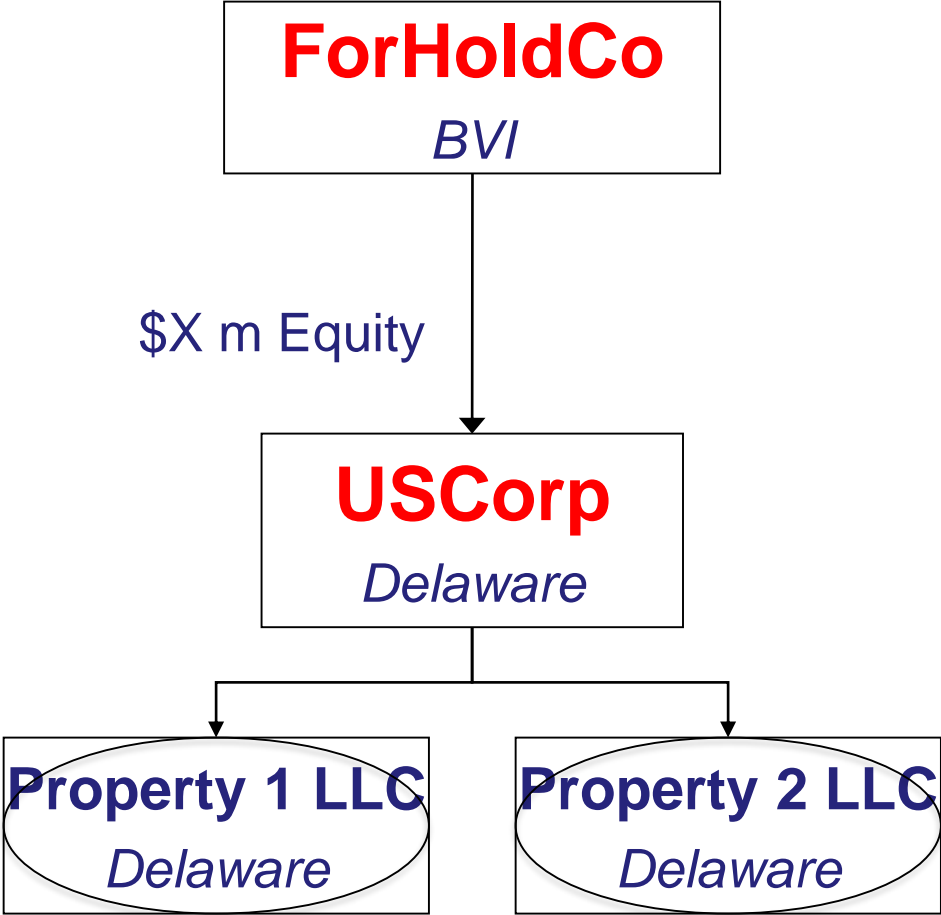
Ownership Through Trust

- Vehicle for newly acquired residential property
 - Irrevocable trust (domestic or foreign) formed with cash
 - Cash transfer should not be subject to gift tax
 - Nongrantor trust taxed as individual (entitled to LTCG rates)
- Trust uses cash to acquire U.S. real property
 - Acquisition of property from unrelated seller does not affect corpus of gift
 - Different result if settlor sells U.S. real property to trust; see *Davies v. Commr.*, 40 T.C. 525 (1963), and *De Goldschmidt-Rothschild v. Commr.*, 168 F.2d 975 (2d Cir. 1948)
- If trust is domestic, personal use not treated as distribution to beneficiary; cf. §643(i) if trust is foreign – beneficiary deemed to receive distribution of fair value of right to use the property






Ownership Through Trust (cont'd)

- At settlor's death, no transfer of property, so no estate tax, even though trust corpus consists of U.S. real property
- No basis step-up because property is not included in estate
- Settlor can use property in certain circumstances without subjecting estate to estate tax under §2036(a):
 - Settlor must not have a right to trust income
 - Right should not exist where trust has an independent trustee and trustee has complete discretion over use of trust assets
- The benefit may be forfeited where
 - Informal agreement allows settlor to control the income
 - Creditors of the settlor can reach trust assets (precludes formation of trust in many U.S. jurisdictions because of "self-settled trust" issues)
 - The settlor is the trustee
 - Trustee's discretion is subject to an enforceable standard

Corporate Structure



U.S. Federal Tax Classifications

-  Corporation/Trust
-  Hybrid Entity
-  U.S. Partnership
-  Branch
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Corporate Structure

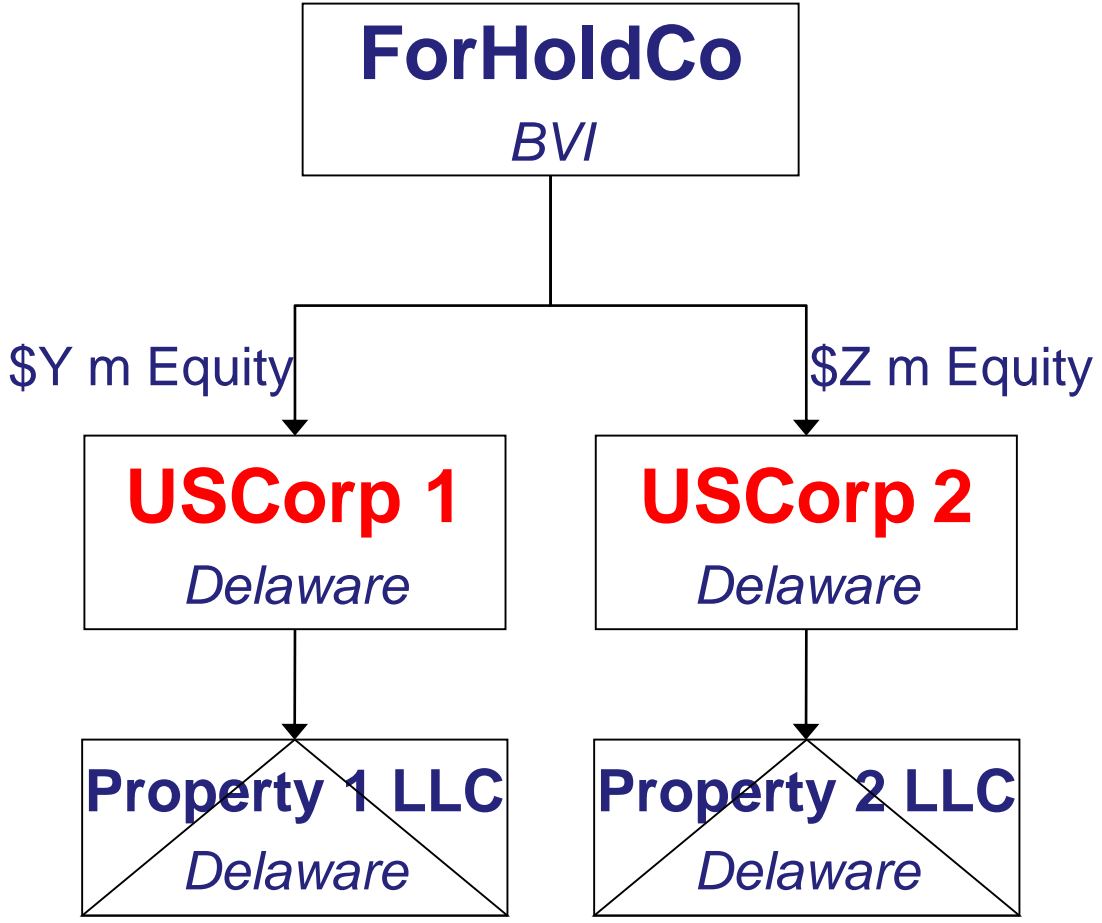
Advantages

- No estate or gift tax on transfers of foreign stock
- No branch profits tax
- Consolidation of U.S. profits and losses
- No individual income tax filings (Note: This does not provide anonymity for ultimate beneficial owner.)






Disadvantages

- Corporate tax rates on sale of properties (no capital gains preference)
- Tax-free sale of stock of ForHoldCo, but may be impractical and buyer will discount because no step-up at USCorp level
- Double taxation of profits at corporate and shareholder level, except on liquidation of USCorp following sale of all properties

Corporate Structure (with multiple corporations)



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Corporate Structure (with multiple corporations)

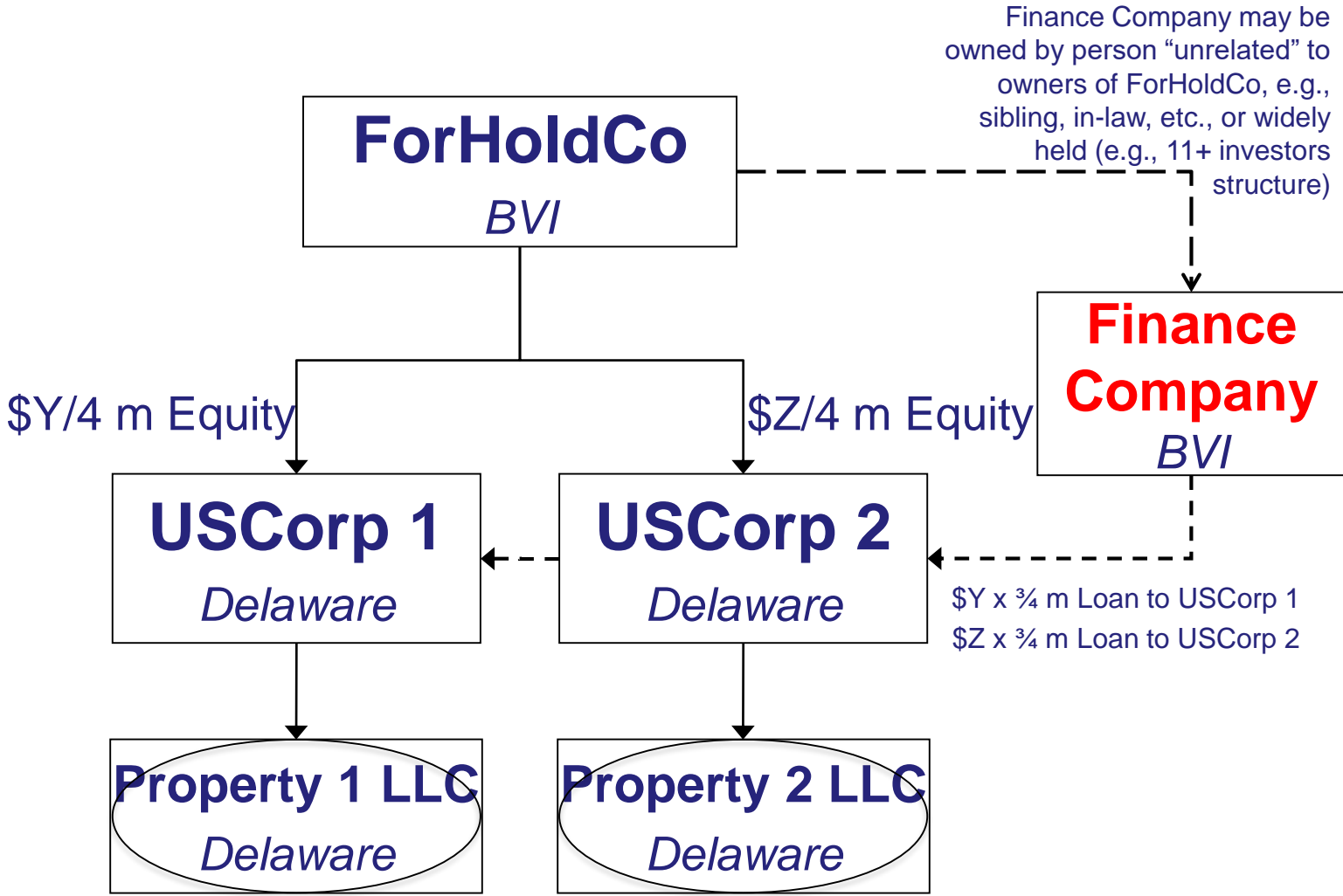
Advantages

- No estate or gift tax on transfers of foreign stock
- No branch profits tax
- Can sell property of one U.S. corporation and pay corporate-level tax, but liquidation is then tax-free






Disadvantages

- Corporate tax rates on sale of properties (no capital gains preference)
- Tax-free sale of stock of ForHoldCo, but may be impractical and buyer will discount because no step-up at USCorp level
- No consolidation of U.S. profits and losses
- Double taxation of operating profits at corporate and shareholder level

Corporate Structure (with financing)



U.S. Federal Tax Classifications

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Foreign Corporate Structure (with financing)

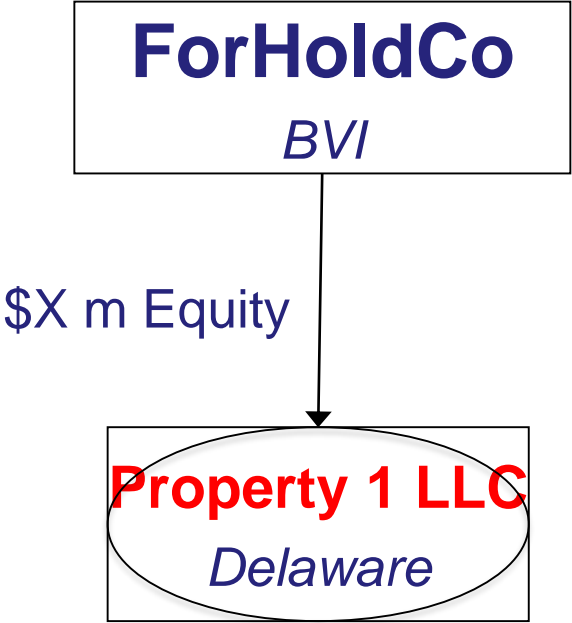
Advantages

- Deduction for interest (including contingent interest)
- Can avoid withholding on non-contingent interest if qualified for portfolio interest exemption
- No withholding on repayment of loan principal






Disadvantages

- Withholding on interest if lender is a "10 percent shareholder" or "10 percent partner" of borrower
- Debt-equity issues must be properly managed, and arm's-length interest rate must be established
- Potential earnings stripping limitations

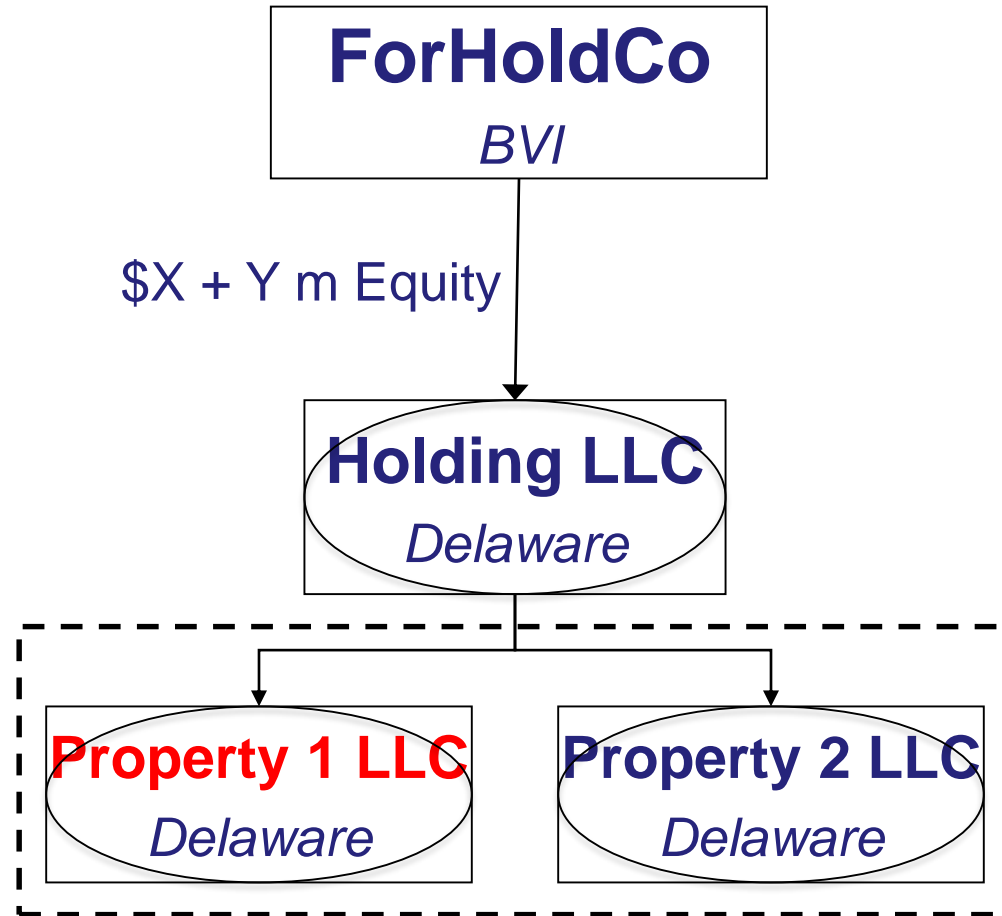
Foreign Corporate Structure (initial property)








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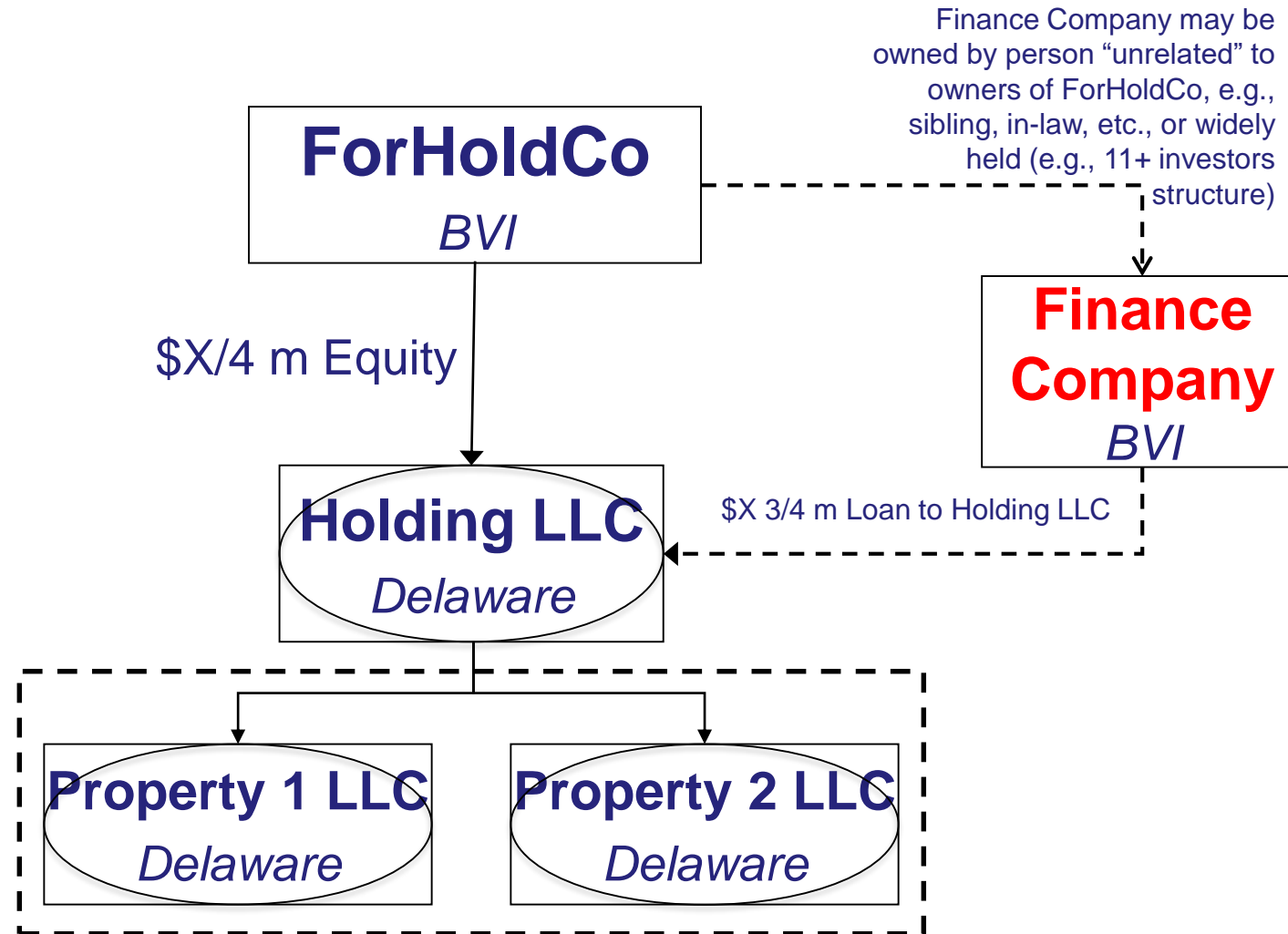
Foreign Corporate Structure (additional properties)



U.S. Federal Tax Classifications






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Foreign Corporate Structure (with financing)



Finance Company may be owned by person "unrelated" to owners of ForHoldCo, e.g., sibling, in-law, etc., or widely held (e.g., 11+ investors structure)

U.S. Federal Tax Classifications

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Foreign Corporate Structure (with financing)

Advantages

- No gift or estate tax
- No capital gains tax on sale of stock (but as practical matter may need to have one corporation per property)
- Consolidation of U.S. profits and losses
- No individual income tax filings

Disadvantages

- Corporate rates
- Branch-level taxes on “dividend equivalent amount” and branch interest – very difficult to manage

PLANNING: FINANCING STRUCTURES

Financing Structures

- Objectives
 - Receive deduction for interest payment
 - Obtain federal and state tax exemption on interest
 - Avoid estate tax on loan
- Opportunities
 - Portfolio interest exemption
 - Treaty rate reduction or exemption
 - Use of participation loans with equity kickers
- Obstacles
 - Debt-equity considerations
 - Earnings stripping § 163(j); AHYDO § 163(e)(3); § 267(a)(3)
 - Estate tax exposure for participation loans and withholding tax on participation interest

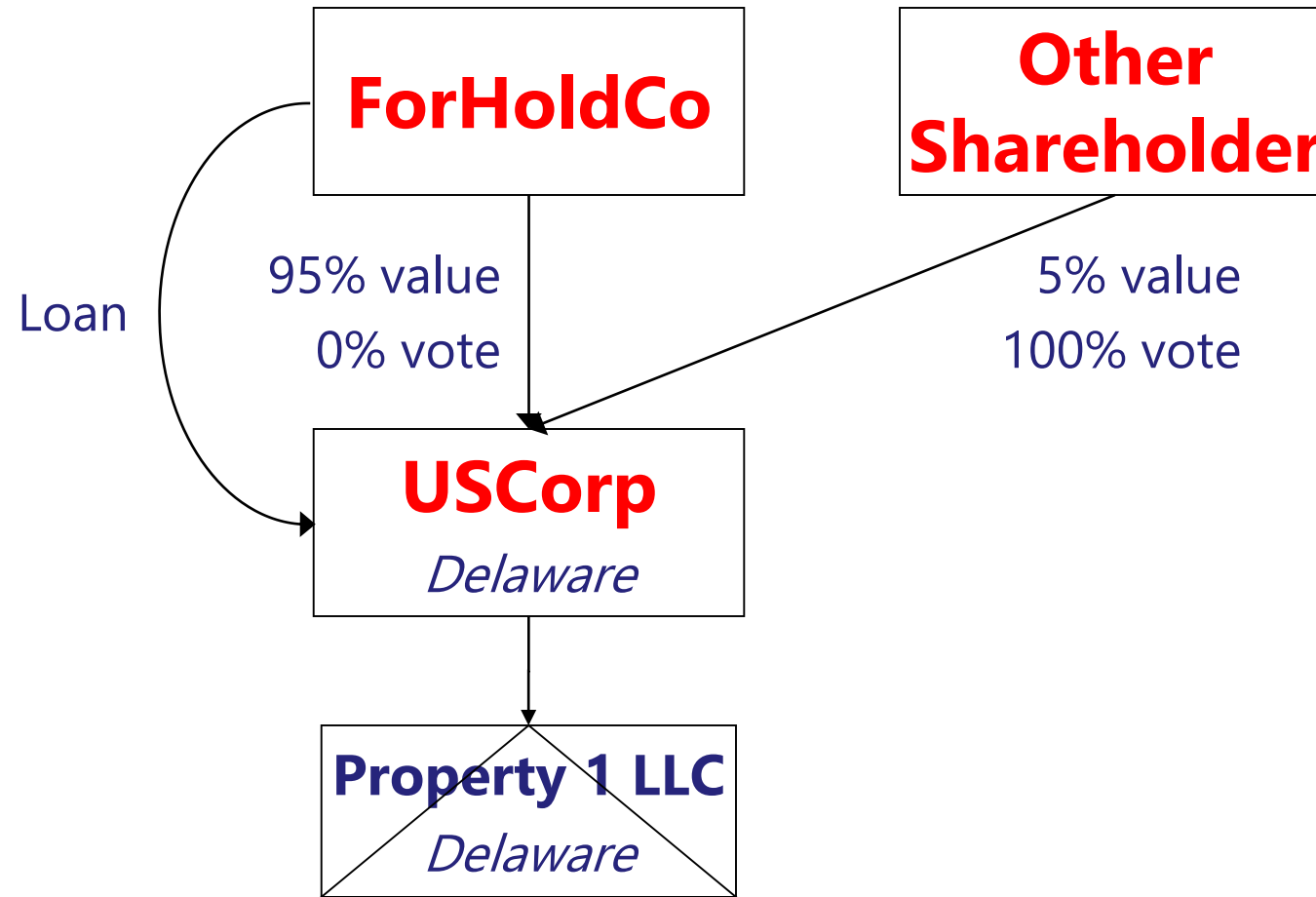
Portfolio Interest Exemption

- Documentation requirements
 - Registered form (exemption for bearer form loans repealed for loans issued on or after March 18, 2012)
 - Form W-8BEN/W-8BEN-E
 - Cannot be payable to bearer at any time prior to maturity
- Ineligible recipients
 - Bank on extension of credit made under loan agreement entered into in ordinary course of its trade or business
 - 10-percent shareholder, meaning holder of 10% of voting power of corporation using §318(a) attribution, or 10% profits or capital interest in partnership
 - Attribution rules offer planning opportunities
- Exception does not apply to contingent interest






Portfolio Interest Exemption (cont'd)

- Contingent interest includes interest determined by reference to:
 - receipts, sales, or other cash flow of debtor or related person
 - income or profits of the debtor or a related person
 - change in value of property of debtor or related person
 - any dividend, partnership distributions, or similar payments made by debtor or related person
- Estate tax exposure:
 - Fixed or indexed interest loan – exempt from estate tax
 - Participation loan – subject to estate tax (but treaty may eliminate tax)

Portfolio Interest Financing Structure



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Financing Structure

Advantages

- No gift or estate tax
- No capital gains tax on sale of stock (but as practical matter may need to have one corporation per property)
- No individual income tax filings
- Portfolio interest exemption, if IRS accepts voting rights disproportionate to economic percentages – business purpose almost certainly required

Disadvantages

- Corporate rates – no capital gains preference

Debt-Equity

- Any use of a mixture of equity capital and loans provided by the equity investors requires the usual attention to detail to avoid reclassification by IRS
- In particular:
 - Loans must be documented
 - Overall terms should be at arm's length
 - Payment terms must be achievable at the time the arrangement is entered into; use OID/deferral options if there will be predictable delays in payment (e.g., development loan)
 - Internal and overall ratios must be reasonable
 - Terms should be observed and lender must take steps an unrelated lender would take to monitor and enforce loan

Earnings Stripping, AHYDO, 267(a)

- Earnings stripping (§ 163(j))
 - Applies if debt-equity ratio exceeds 1.5
 - Limits deduction for net interest expense to 50% of “adjusted taxable income” (analogous to EBITDA)
 - Excess interest is carried forward to future years
 - Excess limitation carried over against excess interest for 5 years
- Applicable High Yield Discount Obligation (§ 163(e)(5) & (i))
 - Applies if borrower is a corporation, term exceeds 5 years and OID at rate greater than AFR + 5%
 - Excess non-deductible (but interest in hands of lender)
 - If lender related, non-excess not deducted until paid
 - Include “AHYDO savings” language in instrument
- If lender related, §§ 267(a)(3) (interest) and 163(e)(3) (OID) defer deduction until interest paid

Participation Loans

- Portfolio interest exemption remains available on fixed interest portion
- Loan is a USRPI, so gain on sale is taxable and subject to § 1445 withholding
- But repayment of loan is not disposition of USRPI – treated as payment of interest and principal (Treas. Reg. § 1.897-1(h), Example 2)
- Treaty may exempt interest, but modern treaties now treat contingent interest as dividend (see U.S. Model Income Tax Treaty of 2006, art. 11(2))
- Certain treaties still permit reduced withholding rates on contingent interest (e.g., U.S. income tax treaties with Greece, Hungary, Norway, and Poland)

PLANNING: SWAPS AND FIRPTA

Swaps and FIRPTA

- Treas. Reg. §1.897-1(d)(3)(i)(D) (FIRPTA interest includes direct or indirect to share in the appreciation in the value of, or in the gross or net proceeds or profits generated by, the real property)
- Preamble to NPC regulations issued in 1993 indicates that “[T]he IRS is considering whether notional principal contracts involving...[certain] specified indices (e.g., United States real property) are subject to Section 897.”
- For 15 years, no guidance was issued

Swaps and FIRPTA

- Rev Rul. 2008-31 considered whether interest in NPC, where return is calculated by reference to index based on data from geographically and numerically broad range of U.S. real estate, is a USRPI

Swaps and FIRPTA

- Facts of Rev. Rul. 2008-31
 - X maintains and widely publishes index that seeks to measure changes in residential or commercial real estate values within metropolitan statistical area (MSA), combined statistical area (CSA), or similar U.S. geographic area
 - Area has population exceeding 1,000,000 and is calculated by reference to (1) sales prices (obtained from various public records), (2) appraisals and reported income, or (3) similar objective financial information, each with respect to a broad range of real property holdings of unrelated owners within the relevant geographic area during a relevant testing period.
 - Because of the broad-based nature of the index, an investor cannot, as a practical matter, directly or indirectly, own or lease a material percentage of the real estate, the values of which are reflected by index

Swaps and FIRPTA

- Facts of Rev. Rul. 2008-31 (cont'd)
 - On January 1, Year 1, FC, a foreign corporation, enters into NPC, with unrelated counterparty DC, a domestic corporation. Neither FC nor DC is related to X.
 - Pursuant to NPC, FC profits if index appreciates (i.e., to the extent the underlying U.S. real property in the particular geographic region appreciates in value) over certain levels. Conversely, FC suffers a loss if the index depreciates (or fails to appreciate at more than a specified rate).
 - During NPC term NPC, DC does not, directly or indirectly, own or lease a material percentage of the real property, the values of which are reflected by the index

Swaps and FIRPTA

- Swaps and FIRPTA – Holding of Rev. Rul. 2008-31
 - Because of the broad-based nature of the index, the NPC does not represent a "direct or indirect right to share in the appreciation in the value . . . [of] the real property" within the meaning of Treas. Reg. §1.897-1(d)(2).
 - Accordingly, FC's interest in the NPC calculated by reference to the index is not a USRPI under §897(c)(1)

Swaps and FIRPTA

- Questions not answered by ruling:
 - How broadly based does the index need to be?
 - Is the maturity of a swap a “disposition” for purposes of §897(a)?
 - TAM 9730007 and PLR 9824026 seem to indicate not
- See also Treas. Reg. §1.897-1(h), example 2 (shared appreciation mortgage is USRPI, but payments at maturity not a “disposition” for purposes of §897(a))
- Rationale of example is that final loan payments do not constitute “gain” for tax purposes
- Query whether same rationale should apply to final payments received pursuant to swap

Questions?

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