School of Continuing and Professional Studies
70th Institute on Federal Taxation

Foreign Investment in U.S. Real Estate

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Principal Topics

- Basic income tax rules
  - Capital gains
  - Operating income
  - Interest and dividends
- Withholding
  - FIRPTA
  - Rent, interest and dividends
  - Partnership withholding
- Estate and gift taxes
- Structuring
  - Foreign business entities
  - U.S. business entities
  - Trusts

Basic Income Tax Rules

Basic Income Tax Rules – Gains

- Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) – § 897
  - Gain from sale or exchange of "United States real property interest" ("USRPI") taxed as if foreign seller were engaged in the conduct of a trade or business in the United States and the gain were effectively connected with such trade or business
  - Therefore, foreign sellers are taxed on gains at the same rates applicable to U.S. sellers – gain can qualify for long-term capital gains treatment in the hands of a foreign seller
  - Nonrecognition provisions do not apply unless in the exchange the seller receives property that would itself be taxable in sale or exchange

Basic Income Tax Rules – Gains

- 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 next slide) at any time during the 5-year period preceding sale

U.S. Real Property Holding Corporation

- Basic definition (§ 897(c)(2)):
  - Fair market value 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; in the case of corporations, more than 50% control requirement
- USRPI does not include interest in corporation that has sold all of its USRPIs in taxable transactions
- Interest in regularly traded class of stock is a USRPI only if taxpayer owned 5% or more of class

Basic Income Tax Rules – Operating Income

- If income is effectively connected with a U.S. trade or business, tax is imposed on foreign taxpayer at regular U.S. rates (individual or corporate)
- Foreign taxpayers may elect to treat real estate income as effectively connected (e.g., income from triple net leased property) – § 871(d)
- Tax base is the gross income net of allocable deductions, including operating costs, management fees and interest expense
- Normal expense limitation rules apply, e.g., at-risk, passive activity loss rules, capitalization of expenses, earnings stripping, AHYDO, etc.

Basic Income Tax Rules – Interest and Dividends

- Interest
  - U.S. source interest paid to a foreign person, taxed at 30% of gross
  - Numerous exceptions if interest is not ECI
    - Short-term OID
    - Bank interest
    - Portfolio interest exemption (exceptions where loan made by foreign bank, “10-percent shareholder” or “10-percent partner”; also not applicable if interest is contingent)
    - Many treaties eliminate or reduce rate of tax
- Dividends
  - Dividend paid by U.S. corporation to foreign person, taxed at 30% of gross
  - Treaties typically reduce rate to 5% or 15%

Taxation of Foreign Corporations

- If foreign corporation is engaged in a U.S. trade or business, including through ownership or sale of U.S. real property, taxed at regular U.S. corporate rates (34% or 35%)
- In addition, subject to branch level taxes (§ 884). Branch taxes intended to treat U.S. trade or business as if it were a separate U.S. corporation:
  - Dividend tax rate x "dividend equivalent amount"
  - Interest tax rate x interest allocated to U.S. branch
  - Treaties often reduce or even eliminate branch taxes
- Dividend equivalent does not apply to liquidation proceeds, if formalities met

Withholding

- 10% of gross amount realized from sale of USRPI (some states also require withholding on sale by nonresident)
- Exemptions:
  - Non-foreign affidavit
  - Non-USRPHC affidavit
  - Excess withholding can be avoided based on maximum tax - see IRS Form 8288-B and Rev. Proc. 2000-35
  - Sales price <$300,000 on property that will be transferee's residence (amount not indexed for inflation in >30 years)
  - Regularly traded stock
  - Situations where withholding required under partnership withholding rules (§ 1446)

Withholding – Rent, Interest, Dividends (§ 1441)

- Payor must withhold 30% of gross amount of U.S. source "fixed or determinable annual or periodic" income paid to foreign person
- Applies to rent, interest, dividends and services income (except income subject to wage with-holding)
- Treaties can reduce or exempt payments from withholding, if foreign person certifies its entitlement to treaty benefits (typically on Form W-8BEN)
- See slide on interactions with § 1445 regarding corporate distributions

Withholding – Partnerships (§ 1446)

- A partnership must withhold on its foreign partner's "effective connected taxable income" (ECTI)
- Rate is highest rate under § 1 or § 11
  - Long-term capital gains rate can apply to individual partner
- Estimated tax payments are due on 15th day of the 4th, 6th, 9th & 12th (sic) months of partnership's tax year; true up on 15th day of 4th month of next year
- Publicly traded partnerships (Treas. Reg. §1.1446-4)
  - Withholding based on distributions not income allocations
  - Preferential rates may not be used
  - Rules not extended to other types of large partnerships
- Overwithholding is pervasive problem

Withholding - Interactions

- Section 1445/1446
  - Domestic partnership – § 1446 trumps § 1445
  - Foreign partnership – § 1445 amount withheld allocable to foreign partner treated as satisfying § 1446 withholding requirement with respect to such partner
- Section 1441/1446 – generally no overlap
  - Exception: US-source independent personal services - § 1441 trumps 1446. Treas. Reg. § 1.1446-3(c)
- Section 1441/1445 – corporation has choice
  - Withhold under § 1441 and not under § 1445
  - Withhold under § 1441 on portion estimated to be dividend and § 1445 on remainder of distribution

Withholding – FATCA (§§ 1471-1474)

- Foreign Accounts Tax Compliance Act (FATCA) generally beyond the scope of this presentation
- FATCA can require withholding on payments of U.S. source income to foreign financial institutions and non-financial foreign entities
- Note that FATCA withholding can apply to proceeds of sale of USRPI consisting of stock in USRPHC

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 corporation domestic or foreign) not subject to tax
- Less certain but gift of partnership interest probably not subject to tax
- Points to note:
  - No unified credit
  - No step-up in basis on *inter vivos* gift
  - QDOT required for taxable gifts to spouse who is not a U.S. citizen

Estate Tax

- Estate of nonresident alien is subject to estate tax on property located in the United States. Includes:
  - U.S. real property and property located on it
  - Stock in U.S. corporation (whether or not publicly traded)
  - Uncertain treatment of partnership interests
    - No real authority
    - IRS position is that interest is located in the United States if partnership is engaged in U.S. trade or business
    - But various other respectable theories (place of organization of partnership, domicile of partner)

Planning

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 (e.g., REITs)
- Withholding and compliance
- Estate and gift taxes

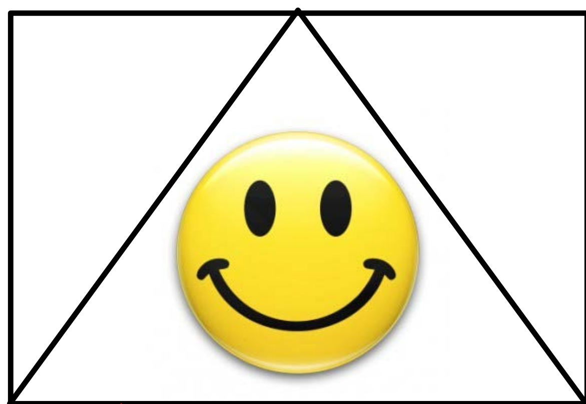
Home Country Taxation

- 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

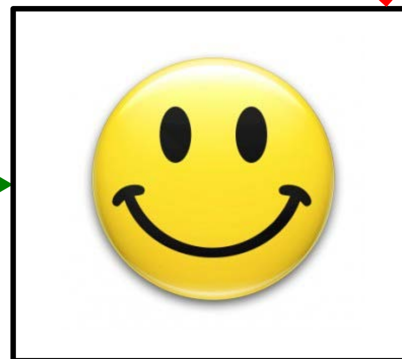


Pass-through entity: capital gains preference; no double taxation

Corporate rates; double taxation

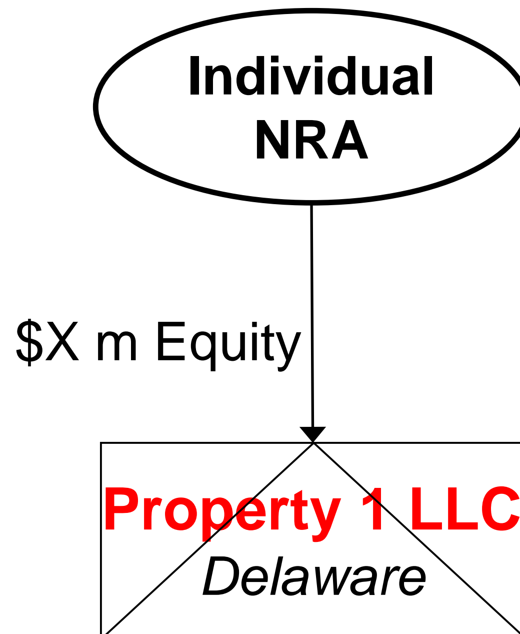
THERE IS NO PERFECT SOLUTION

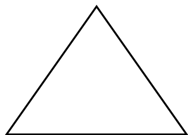
Personal tax compliance/ estate tax risk



Corporate structure: No personal tax filings or estate tax

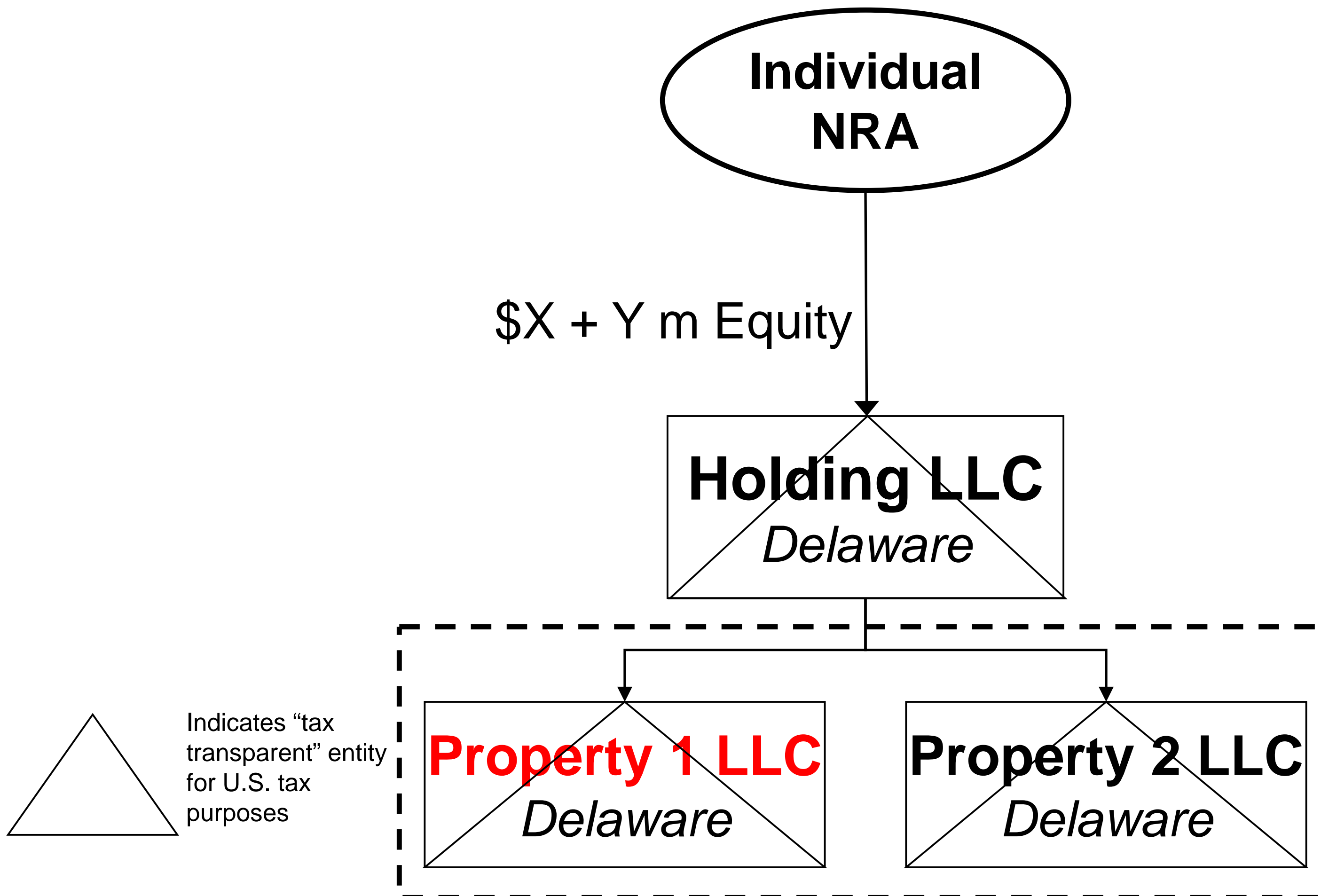
Individual Ownership





Indicates "tax transparent" entity for U.S. tax purposes

Individual Ownership



Individual Ownership

Advantages

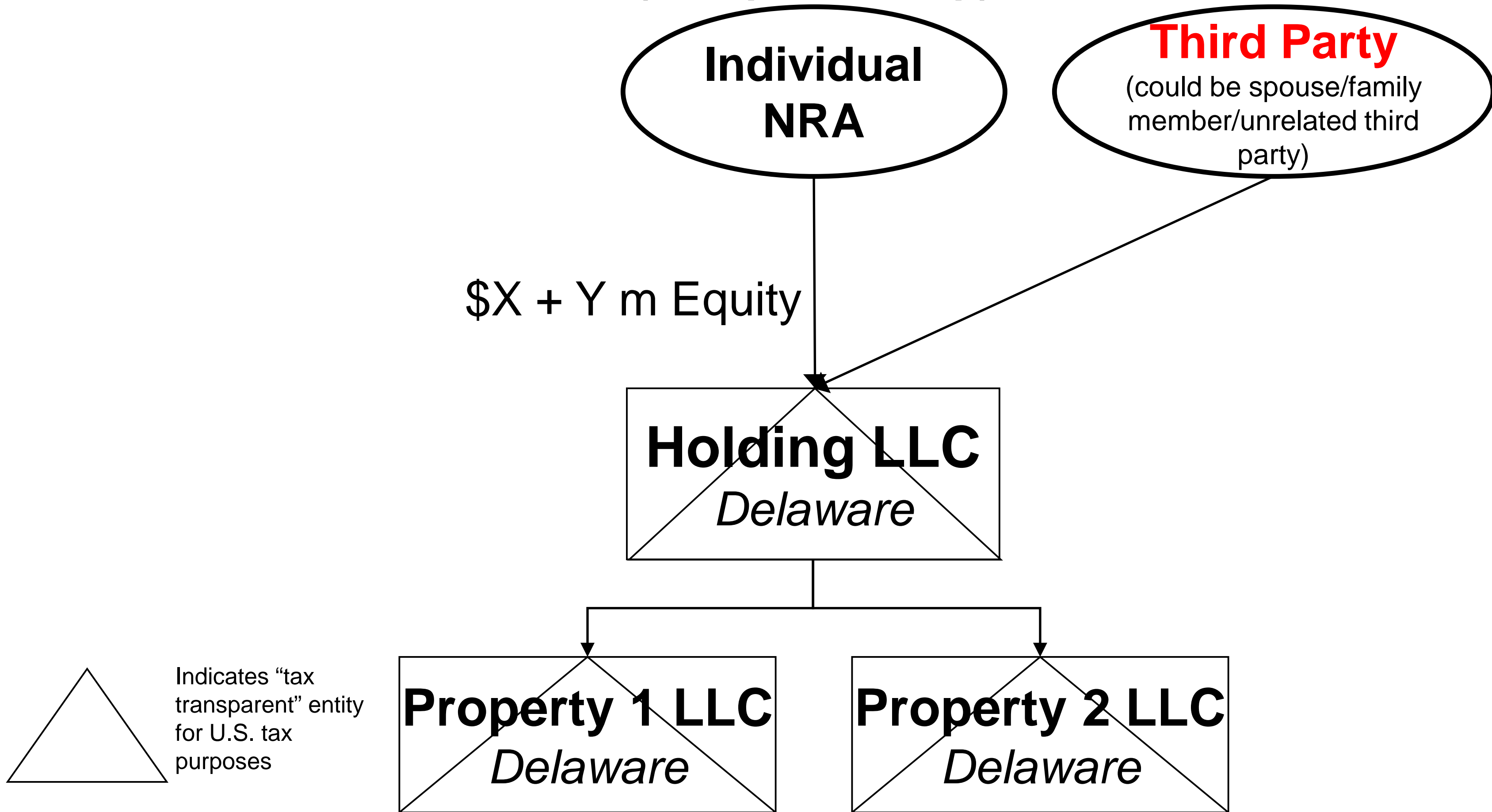
- Long-term capital gains treatment available
- Single level of tax
- Profits and losses offset
- No imputed income for personal use property
- LLCs provide limited liability; holding LLC can provide “presence”

Disadvantages

- Gift tax probably imposed on gift of LLC interest if LLC is disregarded entity
- Estate tax exposure
- Must file individual income tax returns and partnership returns

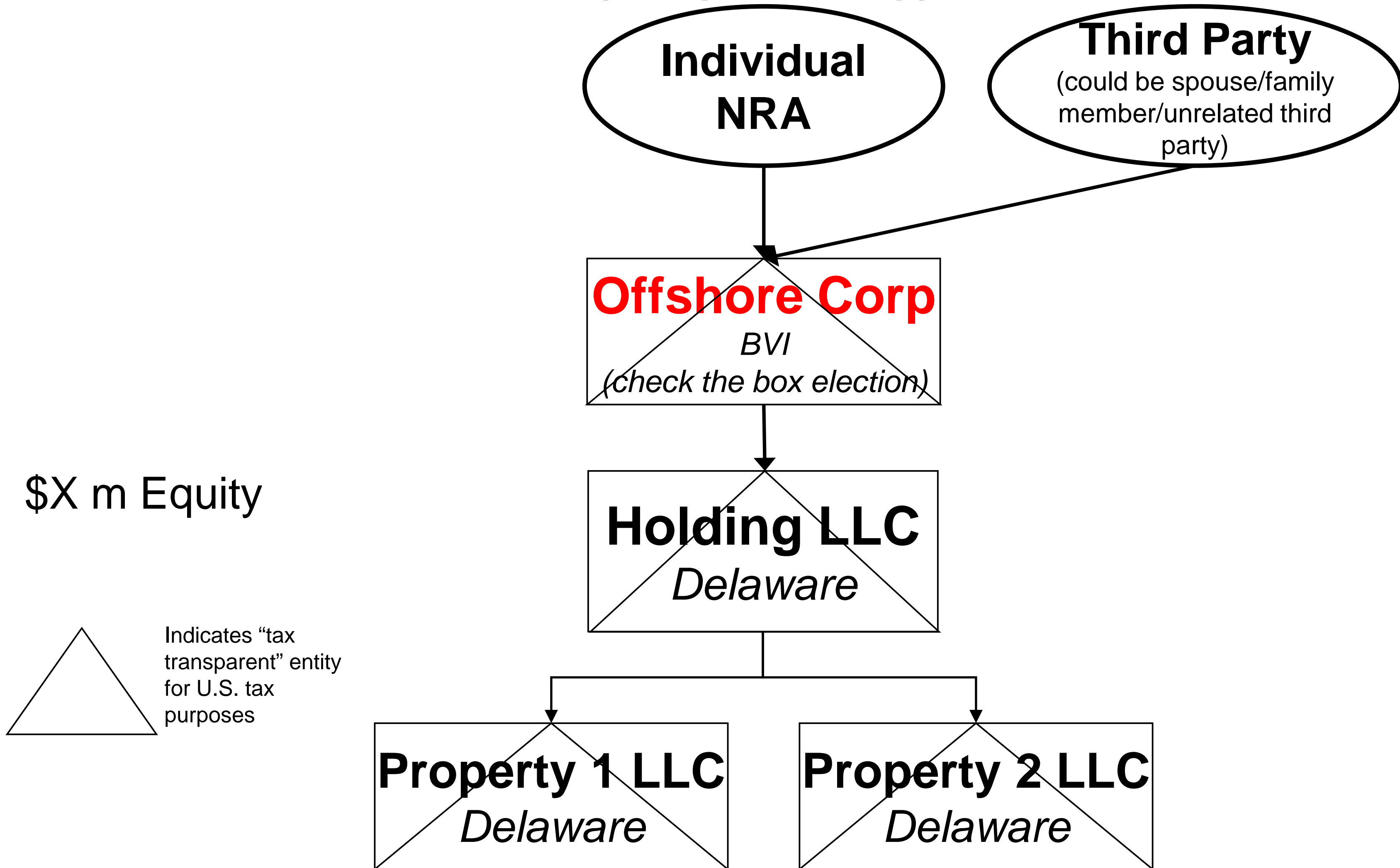
Individual Ownership

(with partnership)



Individual Ownership

(with partnership)



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 counter argument, especially if LLCs not engaged in trade or business; additional argument if offshore holding company classified as partnership inserted in structure
- Must file individual income tax returns and partnership returns
- § 1446 (over)withholding

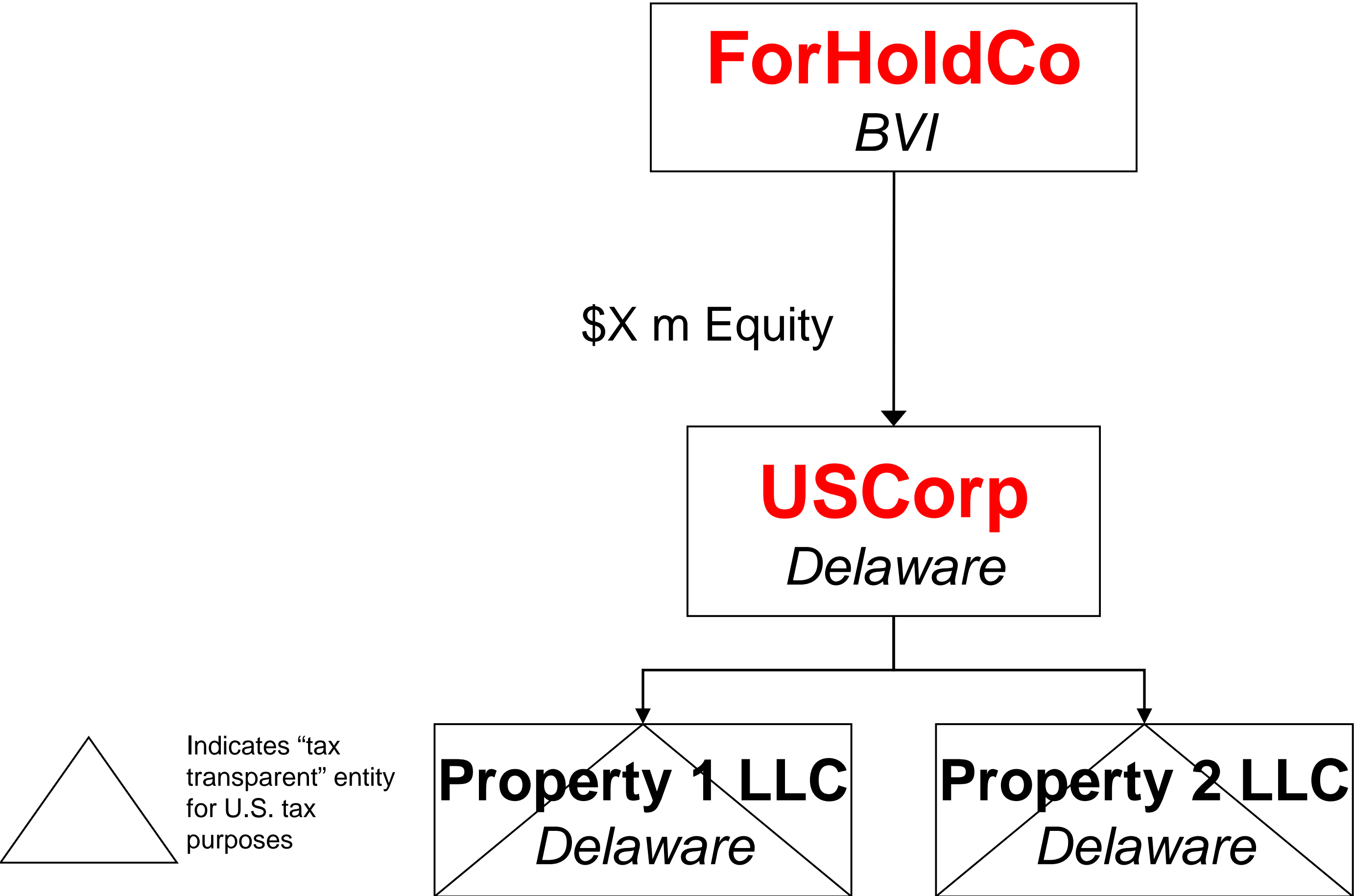
Ownership Through Trust

- Vehicle for newly acquired residential property
  - Irrevocable trust (domestic or foreign) formed with cash
    - Cash transfer not subject to gift tax – cash is intangible property
    - Trust is nongrantor trust taxed as individual (entitled to 15% LTCG rates)
  - Trust uses cash to acquire U.S. real property
    - Acquisition of property from unrelated seller does not affect corpus of gift
    - N.B. – different result if settlor sells the U.S. real property to the 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, beneficiary who lives in the house rent-free or for below-market rent does not have imputed income (see § 643(i) if trust is foreign – beneficiary deemed to receive distribution of fair value of right to use the property)
    - See *dicta* in *Dickman v. Commissioner*, 465 U.S. 330 (1984): "It is not uncommon for parents to provide their adult children with such things as the use of cars or vacation cottages, simply on the basis of the family relationship. We assume that the focus of the Internal Revenue Service is not on such traditional familial matters."

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 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 the trust has an independent trustee and the trustee has complete discretion over the use of trust assets
    - *Commr. v. Irving Trust Co.*, 147 F.2d 946(2d Cir. 1945), and *Sherman v. Commr.*, 9 T.C. 594 (1947)
- The benefit may be forfeited where –
  - An 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 due to "self-settled trust" issues)
  - The settlor is the trustee
  - The trustee's discretion is subject to an enforceable standard

Corporate Structure



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

Disadvantages

- Corporate tax rates on sale of properties (no capital gains preference)
- Taxfree 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 structure following sale of all properties

Corporate Structure

(with multiple corporations)

ForHoldCo
BVI

$Y m Equity

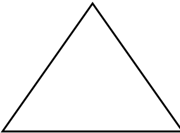
$Z m Equity

USCorp 1
Delaware

USCorp 2
Delaware

Property 1 LLC
Delaware

Property 2 LLC
Delaware



Indicates “tax transparent” entity for U.S. tax purposes

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 taxfree

Disadvantages

- Corporate tax rates on sale of properties (no capital gains preference)
- Taxfree 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)

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)

ForHoldCo
BVI

Finance Company
BVI

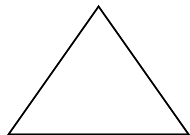
$Y/4 m Equity

$Z/4 m Equity

USCorp 1
Delaware

USCorp 2
Delaware

$Y x ¾ m Loan to USCorp 2
$Z x ¾ m Loan to USCorp 2



Indicates "tax transparent" entity for U.S. tax purposes

Property 1 LLC
Delaware

Property 2 LLC
Delaware

Foreign Corporate Structure (with financing)

Advantages

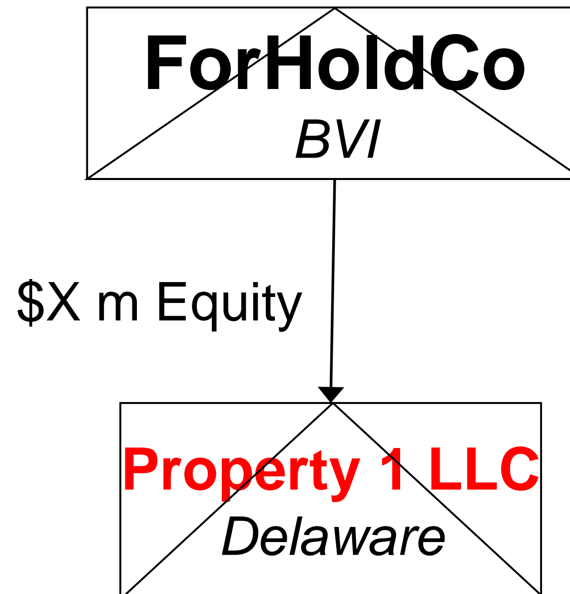
- Deduction for interest (including contingent interest)
- Can avoid withholding on non-contingent interest if qualified for portfolio interest exemption
- No withholding on repayment of loan principal

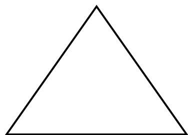
Disadvantages

- Withholding on interest if lender is a “10 percent shareholder” or “10 percent partner” of borrower
- Debt:equity issues must be properly managed
- Potential earnings stripping limitations

Foreign Corporate Structure

(initial property)

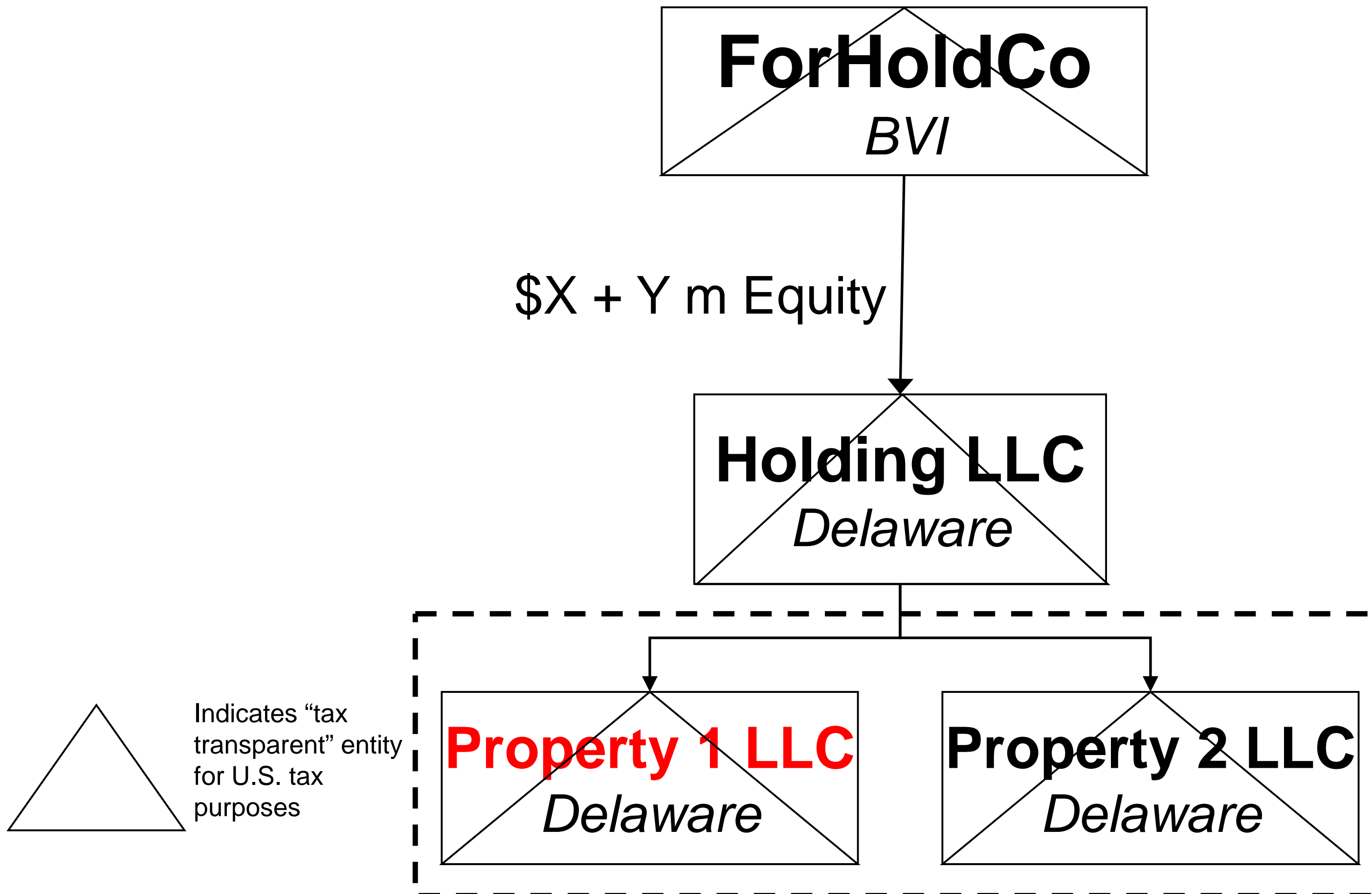




Indicates "tax transparent" entity for U.S. tax purposes

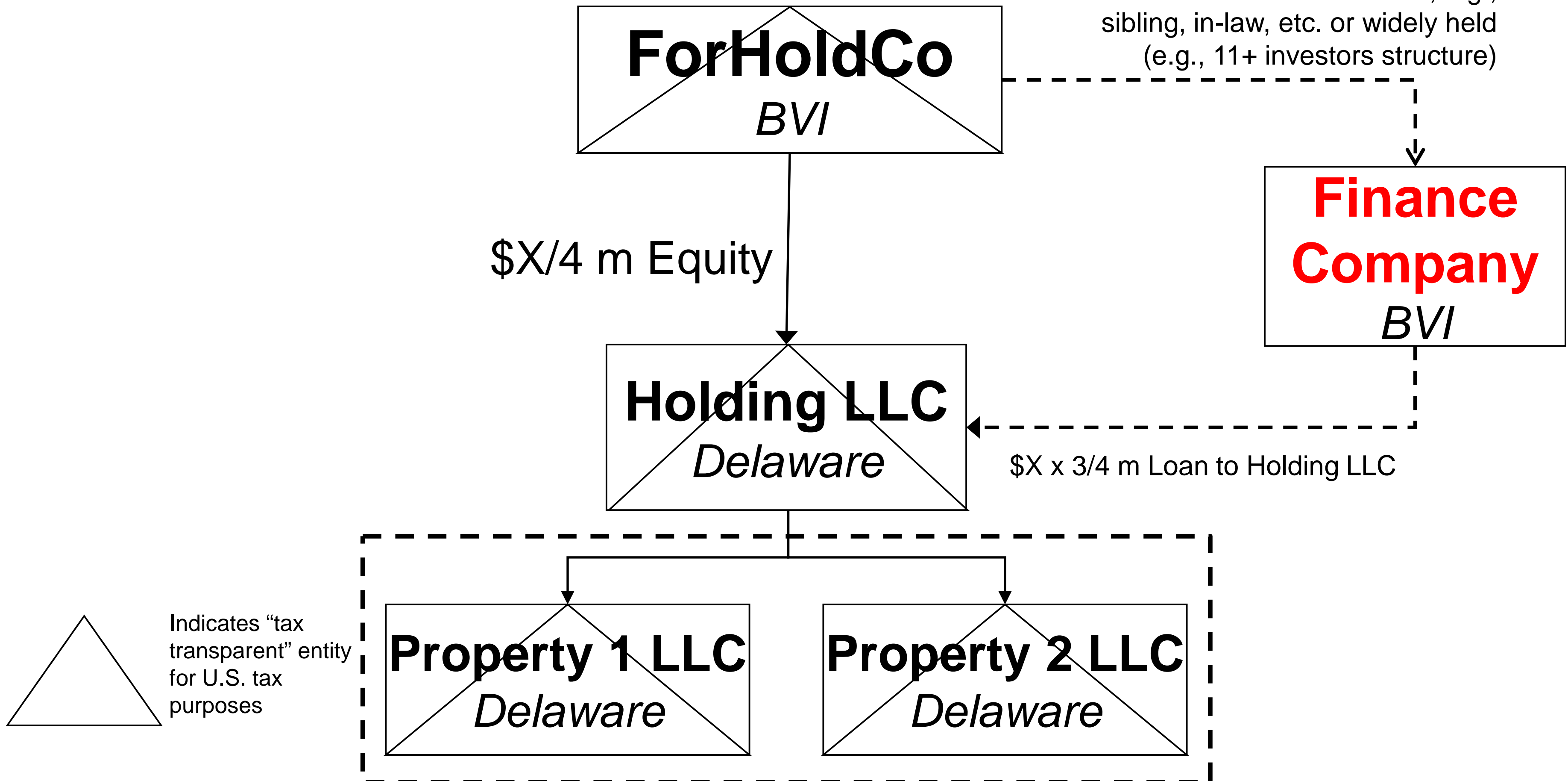
Foreign Corporate Structure

(additional properties)



Foreign Corporate Structure

(with financing)



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

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
  - 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
  - Received by 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
- Does not apply to contingent interest

Portfolio Interest (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)

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))

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; 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 to shelter excess interest for 5 years
- Applicable High Yield Debt Obligation (§ 163(e)(5) and (i))
  - Applies if borrower is a corporation, term exceeds 5 years and OID at rate greater than AFR + 5%
  - Excess non-deductible (but still treated as interest in hands of lender)
  - If lender related, no deduction on non-excess portion until paid
- If lender related, §§ 267(a)(3) (interest) and 163(e)(3) (OID) defer deduction until interest paid

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