STRUCTURING FOREIGN INVESTMENT IN U.S. REAL ESTATE

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1.	**GENERAL U.S. INCOME TAX BACKGROUND**	**2**
1.1	Types of Income	2
1.2	Taxation of Real Estate-Related Income	2
1.3	Taxation of Real Estate Gains (FIRPTA)	3
1.4	Payment of Tax	4
2.	**BEFORE PLANNING BEGINS**	**6**
2.1	Non-Tax Issues	6
2.2	Tax Issues	7
2.3	Withholding.	8
3.	**POSSIBLE INVESTMENT STRUCTURES**	**9**
3.1	Ownership Without Interposing a Corporation	9
3.2	U.S. Corporation.	10
3.3	Foreign Corporation	11
3.4	Foreign Corporation Owning a U.S. Corporation	13
3.5	Non-Grantor Foreign Trust	14
4.	**MULTIPLE PROPERTY ISSUES**	**14**
5.	**REAL PROPERTY FOR PERSONAL USE**	**15**
5.1	Big-Picture Issues	15
5.2	Acquisition	16
5.3	Ownership and Occupation	17
5.4	Disposition	18
5.5	Privacy	21
6.	**SOME ADDITIONAL ISSUES**	**23**
6.1	Trap for the Unwary - Holding Additional Assets in the Real Estate Entity	23
6.2	Use of Debt	23
6.3	Foreign Tax Considerations	23

Foreign investors in U.S. real estate must weigh a number of variables when deciding which structure will accomplish their objectives. Inevitably, no one structure will achieve the perfect result. One structure may result in the lowest income tax burden, while potentially subjecting the investor to U.S. transfer taxes. Another structure may insulate the investor from U.S. transfer taxes but result in multiple levels of income tax. This paper describes some of the possible structuring alternatives a foreign investor may use to limit U.S. tax exposure with respect to the ownership and subsequent disposition of U.S. real estate.

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1. GENERAL U.S. INCOME TAX BACKGROUND

1.1 Types of Income

Real property may yield various types of income for a foreign investor.

In the case of real property held directly, income can be derived from ownership and operation of the property, primarily in the form of rental and license income but also ancillary income such as fees for services performed on real property, income from advertising displays, and severance of natural resources. Gains can be derived from sale or exchange of the whole property or separate parts of the property.

If the real property is held through an entity, income can also be derived from the entity in the form of profit distributions and gains from sale or exchange of interests in the entity. The entity may also be foreign or domestic and it may be classified as a corporation, a partnership or an entity disregarded as separate from its owner.

Income may also be derived from interest on loans secured by real property and such interest may be charged at fixed or variable rates; payments may also be received by a lender measured reference to gross or net income or gains derived from the property or from an entity that owns the property.

1.2 Taxation of Real Estate-Related Income

In the case of foreign persons (whether nonresident alien individuals or foreign corporations) the United States makes a fundamental distinction between income that is effectively connected with the conduct of a trade or business within the United States (often referred to as "ECI") and income that is not effectively connected.

Foreign persons are taxed on the amount of ECI net of deductions properly allocable to such income at, broadly speaking, the same graduated rates that apply to U.S. persons.[2] Nonresident aliens are therefore entitled to preferential rates of tax on long-term capital gains. This regime is referred to in this paper as the "net basis" regime. Foreign persons subject to tax under the net basis regime are also subject to the alternative minimum tax. In addition, a foreign corporation engaged in a U.S. trade or business may be subject to the branch level taxes at 30% on the "dividend equivalent amount" and on interest paid by or allocable to a U.S. branch.[3] The branch level taxes represent an effort to put foreign corporations on the same footing as a foreign persons investing in domestic corporations.

The determination as to whether an activity rises to the level of the conduct of a U.S. trade or business is a highly factual question without hard and fast rules. In general, a triple net lease of a single property to a single tenant where the investor has no activity other than collection of the rent (and payment of any interest and amortization on any mortgage) would not rise to the level of a U.S. trade or business. As the investor's activities and number of holdings increase, it becomes more likely that the investor is engaged

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[2] Sections 872 and 882 of the Internal Revenue Code of 1986, as amended ("Code"). All unprefixed references to sections are to sections of the Code. Pursuant to an extremely punitive rule designed to discourage noncompliance by foreign taxpayers, a nonresident alien or foreign corporation that fails to file a federal income tax return will lose the ability to claim otherwise allowable deductions with respect to effectively connected income. See sections 874(a) and 882(c)(2). The applicable regulations specify certain "drop-dead" dates by which returns must be filed in order to avoid such loss of deductions, and the validity of those regulations has been the subject of some litigation. See *Swallows Holding, Ltd. v. Commissioner*, 126 TC 96 (2006), vacated and remanded, 515 F. 3d 162 (3d Cir. 2008).

[3] Section 884.

in the conduct of a U.S. trade or business, although it is difficult to determine exactly when this line is crossed.

If a foreign person receives income that (i) has a U.S. source; (ii) constitutes interest, dividends, rents, royalties or other fixed or determinable annual or periodical income ("FDAP income") but (iii) is not effectively connected with a U.S. trade or business, the foreign person will be taxed at a flat rate of 30% on the gross amount of the income, with no deductions.[4] We will refer to this regime is referred to as the "gross basis" regime. There are various statutory exceptions to the 30% tax in the case of interest and income tax treaties may reduce or eliminate the tax in the case of dividends and royalties, but there are no statutory or treaty exceptions or rate reductions for real property rental income.

In the absence of a special rule, dealing with rental income may be challenging for foreign investors. First, the authorities regarding the level of activity needed to be considered engaged in the conduct of a trade or business in the United States ("ETBUS") are unclear at best. Depending on the particular facts and circumstances, it may be difficult to determine whether rent should be considered ECI, subject to tax on a net basis, or FDAP income, subject to tax on a gross basis. Second, the taxation of rent that constitutes FDAP income is typically quite burdensome, as the foreign owner may have substantial expenses for which no deduction is permitted.

Congress therefore provided foreign investors with a special "net income election" pursuant to which all of their income from real property located in the United States, including gains from disposition, is treated as effectively connected income. The effect of that election is that rental income is taxable on a net basis, whether or not the level of rental activity is sufficient to result in ETBUS status. Once made, though, the election may not be revoked without the consent of the Internal Revenue Service ("IRS"). Even if rental income is not effectively connected with a U.S. trade or business, the investor may elect the net basis regime.[5] This may be advantageous if, for example, the investor could offset the income with expenses, such as interest, property taxes, insurance, repairs, or property management expenses, that are only deductible under the net basis regime.

1.3 Taxation of Real Estate Gains (FIRPTA)

Under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), principally set forth in section 897, generally provide, among other things, that nonresident aliens and foreign corporations are subject to U.S. tax on gain recognized in connection with a sale or other disposition of a United States real property interest (USRPI) as if such gain were ECI, so that such gains are always subject to the net basis regime.[6] In summary, a USRPI includes:

(1) Direct interests in real property, which includes land, buildings, "inherently permanent structures" and other improvements;[7]

(2) Interests in growing crops and timber, and mines, wells and other natural deposits – but once extracted or severed, crops, timber, ores, minerals, etc. cease to be USRPIs;

(3) "Associated personal property", a broadly defined term that includes, for example, property used in the living quarters of a lodging facility, such as beds and other furniture, refrigerators, ranges and other equipment, as well as property used in common areas, such as lobby furniture and

[4] Sections 871(a) and 881(a).

[5] Sections 871(d) and 882(d). Certain of our income tax treaties also permit such an election and usually these may be made on annual basis.

[6] Section 897(a).

[7] Treas. Reg. §§ 1.897-1(b)(2) and (3).

laundry equipment.[8]

(4) A direct or indirect right to share in appreciation in value, gross or net proceeds or profits from real property;

(5) An interest in domestic corporation that was a "U.S. real property holding corporation" (USRPHC) at any time during the shorter of five years ending on the date of disposition and the taxpayer's holding period (even if the corporation has been in existence longer).[9]

A USRPHC is defined as a corporation where the sum of fair market values of USRPIs held on any "applicable determination date" equals or exceeds 50% of sum of the fair market values of (i) USRPIs; (ii) non-U.S. real property interests; and (iii) other trade or business assets.[10] A look-through rule applies for assets held through entities; in the case of corporations, the look-through rule applies only if a 50% control requirement is satisfied.

Under an exception informally known as the "cleansing exception", an interest in a domestic corporation is not a USRPI if (i) as of the date of the disposition of such interest, the corporation did not own any USRPIs, and (ii) all of the USRPIs held by the corporation during such period (a) were disposed of in transactions in which the full amount of gain (if any) was recognized, or (b) themselves ceased to be USRPIs by reason of prior application of the cleansing exception.[11] Moreover, an interest in a regularly traded class of stock is a USRPI only if taxpayer owned 5% or more of the class.

As a general rule, nonrecognition provisions of the Code apply to sales or exchanges of USRPIs only if the transferor remains taxable on the property received in the sale or exchange and certain notifications requirements are satisfied.[12]

1.4 Payment of Tax

Withholding. In several cases, tax on foreign persons is collected through requiring the withholding of tax.

First, if the foreign person is subject to gross basis taxation, the payor of the income is required to withhold tax, usually at 30% but sometimes at a lower rate provided by treaty.[13] Withholding therefore applies to payments of rent, dividends and interest. If the foreign person treats the income as effectively connected with a U.S. trade or business, it can avoid withholding by providing Form W-8ECI to the payor.[14]

Second, tax on gain subject to FIRPTA is generally enforced by requiring withholding at 15% on the gross amount realized in any sale or exchange of a USRPI; in some cases, however, the Code instead

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[8] Treas. Reg. § 1.897-1(b)(4).
[9] Section 897(c)(1); Treas. Reg. § 1.897-1.
[10] Section 897(c)(2); Treas. Reg. §§ 1.897-2.
[11] Section 897(c)(1)(B). The exception does not apply so long as gain remains unrecognized, e.g., in the case of an installment sale where the corporation has not elected out of installment sale treatment under section 453(d).
[12] Section 897(e). See also section 897(d) with regard to taxation of corporate distribution of USRPIs.
[13] Sections 1441 (nonresident alien) and 1442 (foreign corporation).
[14] The 30% withholding requirement also applies to payments to a nonresident alien individual for independent personal services, even though such income is generally subject to net basis taxation. Such an individual cannot avoid withholding by providing Form W-8ECI but can provide Form 8233 if he or she is a resident of a treaty country entitled to treaty benefits or the amount is expected to be exempt under the $3,000 exception in section 864.

requires withholding at the maximum applicable rate on realized gains.[15] The transferee is required to deduct and withhold a tax equal to 15% of the amount realized on the disposition – not simply the gain from the sale. The result is that a sale at a loss potentially triggers withholding responsibilities. The transferee also is required to report the transfer to the IRS and remit the amount withheld within 20 days of the date of the transfer. A return reporting the sale must be filed by the foreign person and the withheld tax is applied as a credit on the return against the foreign person's tax liability. If the 15% withholding would be greater than the tax liability, there are procedures pursuant to which the foreign person may demonstrate this to the IRS, using Form 8288-B, in which case the IRS will issue a "withholding certificate" authorizing the transferee to reduce or eliminate the withholding.

Withholding is also required on corporate distributions of U.S. real property interests, on sales and distributions by domestic partnerships, trusts and estates and, as described below, can also apply to distributions of any property by domestic corporations.[16] Withholding is generally not required in transactions that satisfy requirements relating to nonrecognition transactions.

Third, a nonresident alien may be subject to wage withholding on income from services as an employee if the services are performed in the United States.[17]

Fourth, where a foreign person is a partner in a partnership, domestic or foreign, that is engaged in a U.S. trade or business, the partnership is required to pay a tax at the highest rate of tax on the partner's share of "effectively connected taxable income".[18] The tax is computed in a manner similar to estimated taxes for corporations. For various reasons, but in particular limitations on the use of partner level deductions in computing effectively taxable income, the amount of tax withheld is very likely to exceed the tax due and this can affect structuring.

The various withholding requirements can overlap and the Code provides various rules to deal with these. As between sections 1445 and 1446, in the case of a domestic partnership, section 1446 applies and section 1445 generally does not.[19] In the case of a foreign partnership, amount withheld under section 1445 that is allocable to foreign partner is treated as satisfying the section 1446 withholding requirement with respect to such partner.

Sections 1441 and 1446 generally do not overlap because section 1441 applies mostly to income subject to gross basis taxation and section 1446 only applies to income subject to net basis taxation.[20]

Section 1441 and 1445 can overlap when a domestic corporation makes a distribution that under section 301(b) might be treated as a dividend, a return of capital or a capital gain. The corporation has a choice: It can withhold under section 1441 and not under section 1445 or it can withhold under section 1441 on the portion estimated to be dividend and section 1445 on remainder of distribution.[21]

In 2017, Congress enacted a provision imposing tax on a foreign person from sale or exchange of a partnership interest where the partnership is ETBUS.[22] Tax is collected by requiring the transferee to

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[15] Section 1445(a).
[16] Section 1445(e).
[17] Sections 3401 and 3402.
[18] Section 1446.
[19] See Treas. Reg. § 1.1446-3(c)(2).
[20] There is an exception: In the case of U.S.-source independent personal services, section 1441 trumps section 1446. Treas. Reg. § 1.1446-3(c).
[21] Treas. Reg. §§ 1.1445-5(b)(1) and 1.1441-3(b)(4).
[22] Section 864(c)(8).

withhold 10% of the amount realized by the foreign person.[23] We do not propose to describe these provisions in detail, but we note that provision is made for these rules to be coordinated with FIRPTA tax and withholding. A transferee that is otherwise required to withhold under section 1445[24] with respect to the amount realized, as well as under section 1446(f)(1), will be subject to the payment and reporting requirements of section 1445 only, and not section 1446(f)(1), with respect to that amount.[25] However, if the transferor has applied for a withholding certificate, the transferee must withhold the greater of the amounts required under section 1445(e)(5) or 1446(f)(1). A transferee that has complied with the withholding requirements under either section 1445(e)(5) or 1446(f)(1) is deemed to satisfy the withholding requirement.

Finally, under the Foreign Account Tax Compliance Act (FATCA) can require withholding of tax at 30% in the case of any "withholdable payment" to a foreign financial institution which does not meet extensive reporting and related requirements or to a non-financial foreign entity that does not either certify that the beneficial owner of the payment does not have any substantial U.S. owners or provides to the payor the name, address, and TIN of each substantial U.S. owner.[26] Withholdable payments include any payment of U.S. source FDAP income. While the FATCA legislation permits withholding to be applied to the gross proceeds from the sale or other disposition of any property of a type which can produce U.S. source interest or dividends, the government has proposed to exercise its authority not to require such withholding and such withholding is not currently required even though the proposed regulations have not been finalize.[27] FATCA withholding is to be applied before withholding under any other withholding provision.

Tax compliance. Whether or not tax is withheld, foreign taxpayers generally have to file tax returns with respect to income related to U.S. real estate. [28] They are also required to pay estimated tax on income and gains although they are entitled to take credit for taxes withheld. In all cases, even where the tax withheld equals or exceeds the tax due, a foreign person subject to FIRPTA must file an income tax return.[29]

There is an exception for taxpayers subject to the gross basis regime where all of their tax is satisfied by withholding or they are exempt from tax because of a statutory or treaty exception. But such taxpayers must still file returns if they wish to recover overwithheld tax or insufficient tax is withheld. Moreover, a foreign taxpayer claiming a treaty exemption or rate reduction on payments of interest or dividends must make a claim to the payor using IRS Form W-8BEN, which must include a taxpayer identification number.

2. BEFORE PLANNING BEGINS

The authors are often asked what they recommend as a structure for investment by a foreign person in U.S. real estate. There is no single answer to this question. Numerous factors will drive structuring recommendations, and some of the most important of these are not tax issues at all. The following is an abbreviated listing of these issues. How they affect planning will be evident from the discussion of the various structures in the remaining parts of this paper.

2.1 Non-Tax Issues

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[23] Section 1446(f).
[24] Specifically, section 1445(e)(5) or Treas. Reg. §1.1445-11T(d)(1).
[25] Treas. Reg § 1.1446(f)-1(d).
[26] Sections 1471 and 1472.
[27] Section 1473. Reg. section 1.1471-2(a), as proposed to be amended on December 18, 2018, 83 FR 64757.
[28] See Treas. Reg. § 1.6012-1(b)(1)(i) (nonresident alien); Treas. Reg. § 1.6012-2(g)(1)(i).
[29] Treas. Reg. § 1.1445-1(f)(1).

(1) An understanding of investor characteristics, including type (individual, corporate, pension plan, collective investment vehicle (e.g., a REIT or a foreign analog), or a foreign government) and location of the investor;

(2) Ascertaining investment characteristics and investor objectives, including:

- The intended use of the real estate– whether for personal or business use or for short- or long-term investment;
- The types of income that may be generated from operating the real estate: Rent, interest, dividends, capital gains, services and other types of income (e.g., advertising revenue);
- How the investment will be funded, whether by equity or debt or a combination (all of which can come in many different flavors and from many different sources);
- The anticipated exit, including timing and method;

(3) Whether a nonresident alien is considering moving to the United States at any time while he owns the investment or is a beneficiary of a trust that owns the investment;

(4) Whether the investment will be wholly-owned or held jointly with others.

2.2 Tax Issues

(1) The classic system of corporate taxation results in double taxation of income by taxing earnings at the corporate level when earned and at the shareholder level when distributed. Double taxation applies to investment through domestic and foreign corporations alike. A domestic corporation pays tax at corporate rates on its income and any dividend is then subject to withholding at 30% or lower treaty rates. A foreign corporation pays tax at corporate rates on its U.S. trade or business income and then pays the branch level tax on any portion of its profits it does not reinvest in the United States. Counteracting such double taxation is a key element of any planning.

(2) Individual investors will seek the preferential rate of tax available on long-term capital gains.

(3) The investor's concerns about U.S. estate and gift taxes.[30] For some nonresident alien individual investors, a combination of relative youth and short-term holding expectation may cause such taxes to be of little concern; for others, it is the primary concern. One of the most straightforward ways to avoid exposure to estate and gift tax is to have real property held directly or indirectly through a foreign corporation, creating potential tension between planning for estate taxes on the one hand and income taxes on the other. U.S. estate and gift taxes are charged at high effective rates in the case of nonresident alien decedents, because the unified credit provides an exemption amount equivalent to just $60,000, an amount that has not increased in decades.[31]

(4) The investor's concerns about U.S. tax withholding. An investor in a partnership engaged in real estate activities that will be subject to net basis taxation, as well as the partnership itself, have to be concerned with overwithholding under section 1446, which effectively operates like a loan to the U.S. government for the life of the investment, indeed a loan that increases each year as income from the investment rises. Section 1446 can operate with extraordinary severity in the case of insolvent

[30] Some additional discussion of U.S. gift and estate taxes is set out in paragraphs 5.2 and 5.4 below.
[31] Section 2101.

investments.

(5) The investor's concerns about compliance requirements as well as more general requirements concerning confidentiality. Many foreign investors are deeply reluctant to file U.S. income tax returns, because of concerns about the perceived heavy-handedness of U.S. tax and reporting requirements. This tends to drive taxpayers to use corporate vehicles, despite having to deal with double taxation and loss of capital gains treatment.

(6) The tax requirements of any U.S. partner. For example, because a foreign person cannot be a member of an S corporation, a joint venture with a U.S. S corporation has to be structured as a partnership (or LLC) between the foreign investor and the S corporation. Another example would be the requirement of U.S. non-profits and pension plans to structure investments that do not give rise to unrelated business taxable income.

(7) All of these issues will require consideration of the U.S. rules for classifying business, entities, both domestic and foreign, as corporations or partnerships (or disregarded entities).[32] The classification rules have to be applied both to existing entities that the foreign investor brings to the table as well as to entities that may be formed for the purposes of the investment.

(8) Special rules apply to certain forms of investment in U.S. real estate, including the rules relating to real estate investment trusts (REITs), foreign pension funds, and certain investments in U.S. public companies. We do not discuss these special rules in this article.

(9) No planning should be undertaken before considering whether home country taxation is relevant. U.S. taxation of foreign investors may be modified by treaty. As we have seen, there is no exception from U.S. taxation of FIRPTA gain or rental income but treaties can reduce or eliminate tax on interest and dividends. Almost all treaties contain "limitation on benefits" provisions to counteract inappropriate use of treaties, particularly by residents of third countries seeking treaty benefits for entities they control that are located in treaty countries.[33]

2.3 Withholding

Every buyer is a withholding agent for FIRPTA purposes and must therefore either obtain a certification of nonforeign status from the seller or withhold 15% of the purchase price (or some lesser amount if the seller produces a withholding certificate from the IRS).[34] Buyers must also be alert to state withholding tax requirements.

In almost any transaction handled with the participation of a title company, an escrow company, one or more attorneys, a lender, or other real estate professionals, these requirements, enacted in 1984, will likely be known and implemented. However, in the present day, the parties also have to be concerned with the under-staffed IRS Ogden, Utah FIRPTA unit, where it has become routine for withholding certificate applications to languish for months unattended and for the IRS to be unable to associate withheld tax with the foreign taxpayer from whom the tax was withheld. At the time of the writing, the unit does not appear to be returning phone messages.

Any buyer should be concerned because he or she is the person legally responsible for compliance with

[32] Treas. Reg. §§ 301.7701-2 and -3.

[33] Limitation on benefits provisions vary from treaty to treaty. For a general view of the U.S. position on limitation on benefits, see United States Model Income Tax Convention, art. 22 (2016), available at https://home.treasury.gov/system/files/131/Treaty-US-Model-2016_1.pdf (viewed Feb. 4, 2024).

[34] Section 1445(a).

the withholding rules. That responsibility cannot be avoided by leaving everything to an escrow agent or attorney. Thus, the buyer will be liable for penalties for late payment (or, in an extreme case of non-payment by the withholding agent, for the entire amount of the tax required to be withheld) and will be the party that must deal with an angry seller who is unable to get credit for withheld tax that was not properly remitted to the government. The buyer also risks a claim by the seller if the withholding agent fails to release funds to the seller once a withholding certificate has been issued (as could happen if the withholding agent became insolvent or, again in an extreme case, absconded with the funds.

Foreign buyers have a special need to maintain good records following their purchase. When the foreign buyer later seeks to sell the property, the buyer-turned-seller may wish to obtain a FIRPTA withholding certificate to reduce the amount of tax withheld based on a calculation of the seller's maximum tax liability. This is particularly true since 2015, when the withholding rate increased from 10% to 15% of the gross proceeds.[35] This calculation requires the seller not only to compute FIRPTA gain but also to establish that the seller has no unsatisfied withholding liability based on compliance with section 1445 when the property was purchased.[36] Failure to keep good records can make it difficult to obtain a FIRPTA withholding certificate at the time of sale.

3. POSSIBLE INVESTMENT STRUCTURES

Having concluded this introduction to the many considerations that can affect the structure of foreign investment in U.S. real estate, the remainder of this paper describes a series of structures commonly used for such investments.

3.1 Ownership Without Interposing a Corporation

Perhaps the most cost-efficient structure from a pure income tax standpoint is for an individual foreign investor to own a real estate investment (either real estate itself or an investment in a U.S. LLC or partnership) without any interposing any corporation. If the investment is real estate itself or there is any other liability concern, the investor will in most cases own the investment through an LLC.[37]

Taxation of Current Income. Assuming for simplicity that (i) the investor uses a single member LLC to own the real estate, (ii) the LLC does not elect to be taxed as a corporation[38], and (iii) the investor is not eligible to take advantage of any treaty, the investor could be subject in relation to current rental income from the property either to the gross basis or net basis tax regime, as described above.[39]

Although the maximum rate under the net basis regime is higher than the rate under the gross basis regime, if there are sufficient expenses to partially or fully offset the income, the tax under the net basis regime may be lower than tax under the gross basis regime. In fact, even assuming the taxpayer is paying the maximum Federal rate, a ratio of expenses to gross income of as low as 15% would result in a lower tax under the net basis regime compared with the gross basis regime. A typical real estate

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[35] Protecting Americans From Tax Hikes (PATH) Act of 2015, Division Q, section 324. For 15% of the proceeds to be large enough to be less than a 20 percent tax on capital gains, a property would had to have quadrupled in value. For example, a property sold for $1 million would have to be generating a $750,000 gain. The level of appreciation required for gain taxed at the corporate rate of 21 percent would be similar.

[36] Reg. section 1.1445-3(c)(1)(ii) and (3).

[37] Home country considerations can come into play here. Many countries treat an LLC as a corporation. In these cases, we often see a limited partnership with a limited liability entity with a modest interest in the partnership serving as the sole general partner.

[38] See Treas. Reg. § 301.7701-3(b). Absent such an election to the contrary, the LLC would be ignored for U.S. federal income tax purposes, and the investor would be treated for such purposes as owning the real estate directly.

[39] See paragraph 1.2 above.

investment will have a significantly higher expense ratio, due to expenses for interest, property taxes, repairs and management expenses, as well as depreciation of buildings and improvements, although the last of these comes at the cost of a reduction in the investor's basis.

Taxation of Gain on Sale. A key advantage of the noncorporate ownership is that individuals, unlike corporations, are eligible for U.S. federal long-term capital gains rate of 20%. While the corporate rate of 21% is similar, noncorporate ownership makes it unnecessary for the investor to be concerned with planning for shareholder level tax.

Repatriation of Funds. Because there is no corporate entity involved, there is no cost or impediment to the repatriation of current income, refinance proceeds or sales proceeds.

Estate and Gift Taxation. A key disadvantage to this structure is that the real estate will be subject to U.S. estate tax on the death of the foreign individual[40] . Similarly, a gift of all or any portion of the real estate would be subject to U.S. gift tax[41] . If the real estate is held in a partnership or multi-member LLC treated as a partnership for tax purposes, it may still be subject to U.S. estate tax but may not be subject to U.S. gift tax.

Filing of Returns; Lack of Anonymity. If the individual is engaged in a trade or business with respect to the real estate, or elects to be treated as so engaged, the individual is taxed under the net basis regime, thereby obligating the individual to file U.S. income tax returns reporting the income from the property. Similarly, under either regime, the individual will be obligated to file returns reporting the sale of the property. In addition to the administrative burden, the filing obligation will mean that the individual will not have anonymity from the government with respect to this investment.

Summary. This structure has some important disadvantages, primarily the potential imposition of U.S. estate tax and the requirement to file returns and the resulting lack of anonymity. However, given the ease of repatriation of funds without additional tax, this structure should not be overlooked in appropriate circumstances. A foreign individual who is both relatively young (or does not expect to hold the property for an extended period of time) and not particularly concerned about anonymity may find this structure to be the best.

U.S. Corporation. Another possible structure would be for the individual to own the U.S. real estate investment through a U.S. corporation. A U.S. corporation owned by a nonresident alien individual gives that person a liability shield, although that could be accomplished with an LLC. In addition, the corporation becomes a separate taxpayer, which eliminates the need for the individual to file annual U.S. federal as well as state and local tax returns.

Taxation of Current Income. The U.S. corporation will be subject to federal income tax on current income (net of deductions) at graduated rates generally at 21%. The tax is based on income net of expenses.

Taxation of Gain on Sale. Gain on sale would be taxed at the same rates as current income. Corporations do not have special capital gains rates.

Repatriation of Funds. A significant disadvantage over direct individual ownership is that there may be a 30% withholding tax (subject to reduction by many treaties) on the repatriation of current income or refinance proceeds. In addition, to the extent that the distribution exceeds earnings and profits and the

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[40] Section 2101.
[41] Section 2501.

shareholder's basis in the stock, there would be a FIRPTA tax to the shareholder. However, if there are no assets remaining in the corporation other than sale proceeds or other non-USRPI assets, as a result of the cleansing exception the corporation can generally be liquidated and the proceeds (after payment of any indebtedness on the real property) repatriated free of a second level of tax. Thus, subject to certain restrictions, it may be possible for the corporation to retain earnings until the property is sold and avoid a second level of tax on repatriation.[42]

Estate and Gift Taxation. A gift of the stock should not be subject to U.S. gift tax[43]. An important potential disadvantage to this structure is that the value of the stock in the domestic corporation, itself a function of the value of the underlying real estate, will be subject to U.S. estate tax[44] on the death of the foreign individual. If the foreign individual is domiciled in one of the relatively small number of countries with which the United States maintains an estate tax treaty concluded since about 1970, the treaty will likely exempt the stock of a domestic corporation from estate tax.

Filing of Returns; Lack of Anonymity. The corporation, but not the individual, will be required to file tax returns. However, this provides only limited anonymity because the tax return requires disclosure of the name, address and taxpayer identification number of any person owning 25% or more of the stock of the corporation.

Summary. This structure has some advantages. The corporation provides liability protection. In addition, the corporation becomes a separate taxpayer, which eliminates the need for the individual to file annual U.S. federal and state and local tax returns. If the U.S. corporation sells the real estate in a fully taxable transaction, tax would be due but there would be no FIRPTA withholding.[45] The U.S. corporation could use a portion of the sales proceeds to repay debt, then adopt a plan of liquidation and distribute the remaining proceeds to its nonresident alien individual shareholder as a liquidating distribution, which can be paid free of any U.S. withholding tax.

This structure, however, has some important disadvantages:

(1) There may be a second level of tax on operating income and refinancing proceeds that are repatriated back to the individual. If available cash flow is used in whole, or substantial part, for debt service, dividends from operations may not be anticipated.

(2) The corporation provides the individual investor only limited anonymity because of the disclosures on the U.S. tax return filed by the corporation.

(3) The estate of an individual investor will be subject to U.S. estate tax if he or she dies before disposing of the investment, unless an estate tax treaty applies.

3.3 Foreign Corporation

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[42] FIRPTA was enacted to ensure that foreign persons are subject to at least one level of U.S. federal income tax when they dispose of U.S. real estate investments. In general, any gain or loss realized by a nonresident alien or a foreign corporation on the sale of U.S. real property interests ("USRPIs") will be recognized and subject to U.S. tax. A USRPI is an interest in U.S. real property held directly or through certain entities when specified requirements are met. In addition to direct ownership of U.S. real estate, interests in entities that hold USRPIs, such as stock of a corporation or a partnership interest, are treated as if they themselves are USRPIs. Sections 897 and 1445.

[43] Section 2501(a)(2)

[44] Section 2104(a).

[45] The nonresident alien individual shareholder's sale of the stock in the U.S. corporation would be subject to tax (and FIRPTA withholding to enforce the tax).

Taxation of Current Income. As was the case with the foreign individual, the foreign corporation will be subject to one of two tax regimes. It will be subject to the gross basis regime, with a gross withholding tax of 30% (subject to treaty reduction) if it is not engaged in a U.S. trade or business and does not elect to be so treated. If the ECI regime applies (or is elected), the corporation would be subject to the branch profits tax[46] of 30% on the "dividend equivalent amount" meaning, in general, its annual earnings and profits, to the extent these earnings and profits were not reinvested in the property or some other U.S. trade or business.

Taxation of Gain on Sale. Gain on sale of the real estate would be taxed at the same rates as current income, except that if there are no other U.S. assets in the corporation, it should be possible to avoid the branch profits tax. Sale of the stock of the foreign corporation would be free of income tax but the purchaser of the stock of the foreign corporation will inherit any built in gain at the foreign corporation level. This makes most buyers reluctant to buy stock in a foreign corporation in order to acquire its real property.

Repatriation of Funds. There is no dividend withholding tax, but repatriation may be a factor in computing the branch profits tax, except where the foreign corporation is liquidating or completely terminating its U.S. trade or business.

Estate and Gift Taxation. An important advantage to this structure is that the stock of the foreign corporation is generally thought not to be subject to U.S. estate tax on the death of the individual. Similarly, a gift of the stock should not be subject to U.S. gift tax.[47]

Filing of Returns; Anonymity. The corporation, but not the individual, will be required to file tax returns. However, this provides only limited anonymity because the foreign corporation will have to include Form 5472 in its return, in which it must identify direct 25% shareholders and ultimate indirect 25% foreign shareholder.[48]

Summary. When compared to a U.S. corporation, there are advantages and disadvantages to using a foreign corporation to hold U.S. real estate:

(1) Instead of the 30% withholding tax that is generally imposed on dividends paid by a U.S. corporation, in the case of a foreign corporation engaged in a trade or business in the U.S. a 30% branch profits tax is generally imposed on the foreign corporation's dividend equivalent amount. Both taxes are on top of the regular corporate tax. However, it may be easier to avoids the second level of tax in the case of the U.S. corporation by retaining funds in the corporation until liquidation than it is to avoid the branch profits tax in the case of the foreign corporation.

(2) If the property were to be refinanced, a distribution of the refinancing proceeds by the

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[46] Section 884.

[47] Some have argued that recent successful IRS attacks in other areas, such as the family limited partnership area, ignoring the existence of entities set up for certain tax planning purposes, could be applied to ignore the foreign corporation and include the real estate in the foreign individual's estate. It remains to be seen to what extent such attacks will be forthcoming or successful. Certainly, the foreign person would be well advised at the very least to carefully adhere to all corporate formalities. Having a business purpose for the foreign corporation would be very helpful. It should also be noted that the risks will increase if the real property is acquired by the foreign individual and then transferred to a foreign corporation. Apart from the fact that gain will apply to such a transfer, notwithstanding section 351 (see section 897(e)), a government argument to impose estate tax analogous to its arguments in the FLP cases would be strengthened, especially if the property is used for personal purposes by the foreign corporation's ultimate owners or their family.

[48] Section 6038C.

foreign corporation to the shareholder would frequently not be taxable in the U.S. In the case of a U.S. corporation, there would in most cases be a 30% tax (to the extent of earnings and profits) and/or a FIRPTA tax (to the extent the distribution exceeds earnings and profits and the shareholder's basis in the stock).

(3) The conventional wisdom is that there should be no estate tax in the case of the stock of a foreign corporation.

Both structures generally provide the individual investor with only limited anonymity. 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.

The foreign corporation structure is frequently used by foreign individuals seeking to purchase an apartment for occasional personal use, although it does raise some issues described below. In addition, it may also be used by foreigners who are able to take advantages of treaties that reduce the branch profits tax.

3.4 Foreign Corporation Owning a U.S. Corporation

A nonresident alien 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, acquires the real estate investment. This structure again gives the individual a liability shield and eliminates the need for the investor to file a U.S. tax return. While this two-tiered structure is more intricate than the other structures discussed above, it has many advantages that make its usefulness worthwhile despite the added complexity and cost to administer. This is perhaps the most common structure for foreign investors investing in U.S. real estate.

The complex branch profits tax will not be applicable since the operating asset, i.e., the real estate investment, and the income generated therefrom reside in the U.S. corporation.

● 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 to disclose its shareholder since it is not engaged in a U.S. trade or business. However, if there is any "reportable transaction" between the U.S. corporation and any foreign related party, the U.S. corporation will have to include Form 5472 in its return, in which it must identify direct 25% shareholders and ultimate indirect 25% foreign shareholder (as well as the related party).

● Assuming no operating income is to be distributed out of the U.S., once the property is sold by the U.S. corporation in a fully taxable transaction and one level of U.S. tax has been paid on the resulting gain, the U.S. corporation can be liquidated, with the net proceeds being distributed to the foreign corporation free of any U.S. withholding tax. The foreign corporation is then free to distribute the cash to the ultimate shareholder, at any time, with no U.S. tax impact.

● The stock of the foreign corporation could be sold free of U.S. federal tax.[49]

● The conventional wisdom is that neither U.S. estate nor gift tax will apply to a lifetime gift or testamentary transfer of the stock in the foreign corporation.

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[49] A sale by the foreign corporation of the stock of the U.S. corporation, which would be treated as a USRPI, would be subject to FIRPTA and would not provide the purchaser of the stock with a step up in the basis of the real estate. Thus, such a sale is rarely advisable.

On the other hand, one disadvantage to this structure as opposed to a structure of holding the real estate in a foreign corporation is that in the latter case it is more likely that it will be possible to distribute refinance proceeds free of U.S. tax. If the case of the U.S. corporation owned by a foreign corporation, there is likely to be a 30% withholding tax (to the extent of earnings and profits) and/or a FIRPTA tax to the shareholder (to the extent that the distribution exceeds earnings and profits and basis).

One important point to note: The structure should generally not be created by one or more individuals forming a domestic corporation and then contributing the stock to a foreign corporation owned by the individual(s). Such a transaction may be treated as an inversion under the rules enacted in 2004.[50]

3.5 Non-Grantor Foreign Trust

In the past decade, the tax rates for individuals in the U.S. have been reduced. Capital gains are generally subject to a 15% tax,[51] the maximum rate of income tax is capped at 35%[52], and recapture income when depreciated real property is sold at a gain is taxed at 25%.[53]

For newly acquired U.S. real property, a trust structure can limit U.S. income tax on profits and gains to the rates applicable to individuals without exposing them to U.S. estate tax in the event U.S. real estate is owned at the time of an individual beneficiary's demise. The suggested structure is as follows: A foreign individual would fund an irrevocable trust in an offshore low-tax jurisdiction, transferring cash or other assets, but not U.S. real property, to the trust. The trust would be a regular trust for U.S. income tax purposes -- not a grantor trust -- and the beneficiaries would be the individual and his heirs and family members. An independent trustee would be appointed who would have complete discretion over distributions to beneficiaries. The trust would hold 100% of the ownership interest in a limited liability company which would then invest in real estate.

The tax consequences that may be anticipated under the foregoing structure are as follows:

- The transfer of cash to the trust is not subject to U.S. gift tax.

- Under U.S. tax law, the trust will be treated as if it were an individual. It will be entitled to the benefits of the 20% tax applicable to capital gains, the 25% tax applicable to depreciation recapture, and 37.1% tax on operating profits. (Nonresident aliens are not subject to the net investment income tax.)

- There will be no further tax as funds are distributed to the beneficiaries.

- The assets in the trust should not be subject to U.S. estate tax at the time of the individual's demise provided that (i) the individual does not retain the right to the income of the trust during his lifetime -- although he may receive discretionary distributions along with other beneficiaries, (ii) the trust is not revocable or amendable by the individual, and (iii) the individual does not retain any dominion or control over the trust or its assets.

4. MULTIPLE PROPERTY ISSUES

Where the foreign investor wishes to acquire more than one property, then it is generally advisable from a liability perspective to put each property into a separate entity. In most cases these separate entities will

[50] Section 7874.
[51] Section 1(h)(1)(C).
[52] Section 1(i)(2).
[53] Section 1(h)(1)(D).

be separate U.S. corporations.[54]

The use of a foreign holding company to hold all of the stock of each U.S. real estate holding corporation may provide the benefits noted above. A negative factor is that the losses of one property cannot be used to offset the income of another property. If, however, the goal is to repatriate the sale proceeds to the nonresident alien individual, this structure is very helpful. If a plan of liquidation is adopted for the specific U.S. corporation whose property is sold, any remaining sales proceeds (after servicing debt and paying transaction costs) paid out to the holding company would be a non-taxable liquidating distribution.

An improvement in the structure at the cost of additional complication would be to have each U.S. corporation held by a separate foreign corporation. In addition to the advantages discussed above, this will permit the sale of a particular real estate investment free of income tax through the sale of the stock of the foreign corporation.

An alternative structure may be used if the intention is to hold the real estate for long term investment, and there is no expectation of repatriating funds. In that case, a U.S. corporation (rather than a foreign company) could be used as the holding company, which would permit a consolidated tax return to be filed for the U.S. corporations. A consolidated return generally allows the use of one property's losses to offset the income (including gain on sale) of another. If a particular property is sold, the consolidated group will stay in existence. The disadvantage to this structure is that if the ultimate shareholder wishes to repatriate the sale proceeds from a sale of less than all of the properties, a dividend paid by the U.S. operating company to the U.S. holding company generally can be paid free of U.S. tax, but any dividend then paid by the U.S. holding company out of the U.S. will attract a 30% withholding tax (subject to treaty reduction).

If the foreign investor owns the U.S. holding company directly, then U.S. estate tax exposure exists. To protect against this estate tax exposure, at the cost of additional complexity, a foreign holding company may be inserted between the ultimate shareholder and the U.S. corporate holding company (again bearing in mind the need to avoid application of the inversion rules).

5. REAL PROPERTY FOR PERSONAL USE

Various issues arise where a foreign person purchases U.S. real property for personal use, either by the foreign person or for a family member, who may or may not be a U.S. resident. In this section of the article, we list commonly encountered issues. Some of these issues are common to any purchase of U.S. real property, but quite a few are specific to residential property.

5.3 Big-Picture Issues

Although in any given case, a specific issue may prove to be of particular importance, in many cases, planning will revolve around four key objectives:

1. Minimizing tax on sale of the property so as to pay, if possible, no more than the preferential rate

[54] Generally, if the parent will be a foreign corporation, it would be better to use separate U.S. corporations than separate LLCs for this purpose because the separate U.S. corporations will more clearly permit the imposition of only a single level of tax on sale of one of the real estate investments. If the foreign corporation owns several parcels each through a separate LLC, a branch profits tax may be imposed if one parcel is sold while the others are retained. However, if the U.S. consolidated group structure described below is used, then the investor could instead have the U.S. corporation own the separate properties in a series of LLCs since in any event it will be difficult to repatriate the proceeds of a sale of less than all of the properties.

of tax on long-term capital gains of individuals;[55]

2. Avoiding paying 30% withholding tax on the use value of the property (or on actual rent paid to avoid uncertainties concerning imputed rent and the bona fides of a cross-border structure);

3. Avoiding the federal estate tax (and state taxes on inheritance) should the owner die while still owning the property, and still allowing the heir to obtain a step-up in basis; and

4. Minimizing compliance and contact with the U.S. tax system — many foreigners have a deep-rooted aversion to having to file personal income tax returns in the United States or having an individual taxpayer identification number.

Other issues may also arise, such as a desire to maintain privacy; the ability to make taxfree lifetime gifts of the property; the need to take account of the income, capital gains, gift, and succession taxes in the home country; and the need to coordinate succession planning for the home with planning for other assets. The client's particular situation also must be considered, such as whether family members and presumptive heirs are U.S. citizens or residents, and whether the client may wish to move to the United States permanently or temporarily.

Accomplishing every possible objective is extremely difficult. Every structure, from direct ownership to a multitiered corporate structure, may involve compromise on one or more of the objectives, and the adviser's role may be to identify each particular client's most important concerns and offer a plan principally addressing them. Prioritization of the client's goals is critical.

5.4 Acquisition

Acquisition of real property, as with any asset, has no immediate consequences to the buyer. A purchase from an unrelated seller is not a taxable event for the buyer. Nevertheless, several tax issues associated with the acquisition of a home by a foreign person deserve attention.

FIRPTA withholding. All buyers, but foreign buyers in particular, should pay attention to the FIRPTA withholding issues discussed in paragraph 2.3 above.

Financing. Foreign buyers must also be alert to the financing of the price of a home being acquired in anticipation of a move to the United States. Not infrequently, those buyers pay all cash or at least they do not obtain a mortgage loan at the time of the purchase. Once they become resident, they might wish to deduct interest on the first $750,000 of their loan amount as qualified residence indebtedness.[56] However, the buyers will not be able to do so unless the loan was obtained by them and secured by the home within 90 days of the date of purchase (or was obtained to refinance such a loan).[57]

Tax residence. The ownership or availability of a home in the United States does not alone make a foreign person a U.S. resident for tax purposes. Nevertheless, that ownership can affect application of the rules for determining whether an alien is a resident alien — that is, under the closer connection test or a treaty's tiebreaker provision for dual-resident individuals.[58]

[55] The corporate tax rate cuts enacted by the 2017 Act have scrambled planning for this tax.

[56] This amount used to be $1,000,000 before 2018 and it is scheduled to revert to $1 million in 2026

[57] For the 90-day rule, see Notice 88-74, 1988-2 C.B. 385, applying the tracing rules of reg. section 1.163-8T. Interest on a secured home equity loan of up to $100,000 may also be deducted by a U.S. resident irrespective of when the loan was obtained.

[58] Section 7701(b)(3)(B).

First, regardless of whether a foreign individual resides in a treaty country, the individual may seek to apply the foreign-tax-home/closer-connection test to avoid being treated as a resident alien.[59] This test applies to individuals present in the United States between 31 and 182 days during the calendar year when the addition of one-third of the days in the preceding calendar year and one-sixth of the days in the second preceding calendar year takes the total days of presence in that period to 183 or more. The closer-connection portion of the test looks at the individual's personal and family ties to the United States and compares them with his ties to the foreign country. Plainly, the ownership of a home that is regularly used for personal purposes is a factor to be considered in the application of the test — there being an obvious difference between a vacation home used just a few days a year and a home used for longer or more frequent stays.

Second, the ownership or availability of a permanent home is the first tiebreaker in virtually all tax treaty provisions dealing with individuals who are resident both in the United States and another country under the respective internal laws of the two countries.[60]

Gift tax. Foreign buyers sometimes buy homes for or for use by U.S. relatives. The relative might be a U.S. resident, but frequently the relative will be a child who is a student with nonimmigrant student (F or J) status. Buyers should be warned that making a gift of real property located in the United States may subject them to gift tax (regardless of whether the relative is resident for U.S. income tax purposes), whereas a gift of cash to be used to purchase the home can readily be structured to avoid gift tax, as long as the cash is not used to purchase a property owned by the donor.[61] How the funds transfers are handled can make a significant difference.

Estate tax planning. Planning before the acquisition of the home also often provides the best opportunity to avoid a future estate tax on the home, as described later.

5.3 Ownership and Occupation

Deductions. As a general matter, an individual cannot deduct expenditures associated with a home that is used for personal purposes. The principal exceptions are for qualified residence interest and property taxes, which are both itemized deductions.

Nonresident aliens are not entitled to itemized deductions because they are taxed on a gross basis on U.S.-source income not effectively connected with a U.S. trade or business. This nondeductibility will also apply when the property is held through a trust or partnership, although in the case of a trust, expenses to maintain trust assets may reduce distributable net income (DNI). However, if the acquisition is structured through a corporation, as we will see, expenses related to maintaining the property may be allowed, but personal use of the property will raise actual or imputed rental income issues.

Imputed rental income. When a home is owned directly by an individual, there is no income tax consequence to its occupation by the owner. Nor does it appear that, as a practical matter, the IRS seeks to impose income tax or gift tax consequences when property is used by relatives, even adult children to whom parents no longer owe a duty of support.

However, if the home is owned by an entity, the possibility that rent should be charged comes into play. For a home owned by a corporation, personal use by a director or officer will likely attract imputed rental

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[59] Section 7701(b)(3)(B) and reg. section 301.7701(b)-2.

[60] In most U.S. income tax treaties, the dual-residence tiebreaker is set out in article 4. *See* 2006 U.S. Model Tax Convention on Income, art. 4(3).

[61] *Davies v. Commissioner*, 40 T.C. 525 (1963), *acq*., 1966-1 C.B. 2.; and *De Goldschmidt-Rothschild v. Commissioner*, 168 F.2d 975 (2d Cir. 1948).

income for the corporation if actual rent is not paid at a fair market rate. It is less certain that rental income would be imputed to a shareholder who did not have an executive role when the corporation conducted an ongoing business unrelated to the real estate (or if the corporation conducts no business at all beyond ownership of the how). When the home is owned by a partnership, the picture is cloudier, but there is a risk that rent-free use will result in the imputation of rental income. The $250,000 or $500,000 exemption for gain derived from the sale of a principal residence, assuming a nonresident alien could show that a U.S. home was a principal residence, may be jeopardized if the owner of the property is a partnership. By contrast, it appears that personal use of property held in a domestic trust does not give rise to imputed income to the trust, nor is it even treated as a distribution to the beneficiaries.[62] The same is true for a foreign grantor trust and even a foreign non-grantor trust, so long as the user is not a U.S. person.

Tax compliance. If a home produces no income, there is no need for a nonresident alien owner to file a tax return, except for the year of sale. Because the deductions (mortgage interest, property taxes, etc.) associated with a home held by an individual for personal or family use are not available to the nonresident alien, there is no reason to file a return just to preserve the benefit of those deductions. Nonetheless, a mortgage lender may insist on receipt of an individual TIN from the owner.

Similarly, a foreign trust does not need to file a U.S. return simply because it holds a U.S. home that is used exclusively by beneficiaries and related family members.

Neither a foreign or a domestic partnership nor a foreign corporation is required to file a U.S. return unless it is engaged in a U.S. trade or business or receive fixed or determinable annual or periodic income, such as rent, from U.S. sources. Imputed rental income would trigger an obligation to file a return.

If the home is held through a domestic corporation, the corporation must file a return even if it has no income. The imputed rental income issue may also cause compliance requirements.

Finally, U.S. users of a foreign-owned home may have various compliance issues.

5.4 Disposition

Income tax. FIRPTA applies to gains from sale of real property used as a home, as well as associated personal property.

A nonresident alien can qualify for the exclusion under section 121 for $250,000 on the sale of a principal residence, assuming the alien meets the general requirements for the exclusion. The IRS appears to have accepted this.[63] Of course, if the alien is using the home as a principal residence, he is often likely to be a resident alien under the substantial presence test, but this is not invariably the case. For example, an alien may be a former resident who sold the home after ceasing to be a resident.[64] Less

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[62] *Plant v. Commissioner*, 30 B.T.A. 133 (1934), *aff'd*, 76 F.2d 8 (2d Cir. 1935), *acq.*, 1976-2 C.B. 2; and *Alfred I. duPont Testamentary Trust v. Commissioner*, 66 T.C. 761 (1976), *aff'd*, 574 F.2d 1332 (5th Cir. 1978). *See* dicta in *Dickman v. Commissioner*, 465 U.S. 330 (1984).

[63] *See* IRS Publication 519 for 2023 (still in draft) available at https://www.irs.gov/pub/irs-dft/p519--dft.pdf (viewed Feb. 4, 2024). Section 897(e) bars the application of nonrecognition provisions, but section 121 provides for exclusion of gain from gross income rather than for nonrecognition. It does not appear that section 897(e) overrides a provision for an exclusion from gross income.

[64] Section 7701(b)(2)(B). Bear in mind that a former resident who was a long-term permanent resident for purposes of the expatriation rules of section 877A may be treated as having sold the home for fair market value on the day before the date of expatriation, and there is some doubt whether the section 121 exemption applies to the

commonly, the exemption may be available to a peripatetic alien whose U.S. home is the principal residence even though he does not meet the substantial presence test or, in a case that would require a combination of unusual facts, is nonresident by virtue of a treaty tiebreaker.

The $500,000 exclusion for married couples is not available because it requires the filing of a joint return, and NONRESIDENT ALIENs generally cannot file joint returns.[65] Therefore, a couple seeking to maximize the exclusion would need to be joint owners of the house, and each spouse would need to qualify separately for the $250,000 exclusion — that is, each would had to have owned their joint interest in the home for at least two years and have lived there as their primary residence for at least two years. If these requirements could not be met, the couple should sell the home in a year when both are still resident aliens.

Withholding at 15% of the amount realized will be required on the sale if the seller's interest is held directly or by a foreign corporation or foreign partnership.[66] If the buyer will use the property as a principal residence, withholding is not required if the price is $300,000 or less. The $300,000 limit has not changed since 1985 and is of increasingly limited relevance. If the seller is a domestic partnership or trust, the purchaser has no withholding obligation under FIRPTA; instead, the domestic partnership or trust must withhold U.S. tax at 15% or 35% of the foreign partner's or beneficiary's share of the gain.[67]

States may also require withholding when a nonresident individual or entity sells real property situated in the state.[68]

A section 1031 exchange generally is not an option for property held for personal use. But one can imagine circumstances in which a property originally held as a residence for the foreign investor is converted to a rental property. In those circumstances, a section 1031 exchange should be possible. Remember, however, that the property would have to be exchanged for other real property situated in the United States because foreign and U.S. real property are not considered to be of like kind.[69]

Gift tax. The gift by a nonresident alien[70] of real estate located in the United States is subject to gift tax

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resulting gain. However, section 121 could apply to gain on post-expatriation appreciation, assuming the former resident sells the property no more than three years after it ceased to be the principal residence (which, depending on the facts, is not automatically the date tax residence ended). If the home was acquired before the establishment of tax residence in the United States, the cost basis in the property is not less than its FMV on the residency starting date. *See* section 877A(h)(2).

[65] *But see* section 6013(g), which permits the filing of a joint return by a couple when one of the spouses is a U.S. citizen or resident alien and the other is a nonresident alien, if the nonresident alien agrees to be treated as a resident alien for all purposes and to waive treaty benefits.

[66] Section 1445(a).

[67] Section 1445(e)(1) and reg. section 1.1445-5(c).

[68] *E.g.*, Cal. Rev. & Tax Code sections 18662 and 18668 (California even requires withholding on sales by California-resident individuals); Colo. Rev. Stat. section 39-22-604.5; Md. Code Ann. Tax-Gen. section 10-912; N.Y. Tax Law section 663; and S.C. Code Ann. section 12-8-580. The scope of withholding, rates, filing procedures, and the availability of refunds varies considerably.

[69] Section 1031(h)(1), enacted by the Revenue Reconciliation Act of 1989. Before 1989, it was possible for an alien to rent out the home and resume status as a nonresident (in either order) and later exchange the property for property outside the United States.

[70] Note that the definition of a nonresident alien for purposes of subtitle B of the code, dealing with estate, gift, and generation-skipping transfer taxes, is not governed by section 7701(b). Rather, whether an alien is a resident is determined by the more subjective test of whether the alien is domiciled in the United States. Reg. section 20.0-1(b)(1) provides: "A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless

at the same rates as apply to a gift by a U.S. citizen or resident alien, but without the unified credit that would shelter up to $11.58 million in lifetime gifts.[71] By contrast, a gift of an intangible asset, such as shares of stock or of a partnership interest, is not subject to gift tax. An alien contemplating the gift of U.S. real property should consider transferring it to a domestic corporation in a section 351 tax-free incorporation or in a section 721 transfer to a partnership. If at a future point the original transfer is "old and cold," a gift of the stock or partnership interest could be made without triggering gift tax. In comparison, a transfer to a foreign corporation would require the recognition of any appreciation in the value of the property, unless the corporation is eligible to make an election under section 897(i) to be treated as a domestic corporation for FIRPTA purposes.

Consideration should also be given to the effect of a gift of property subject to a debt secured by a mortgage on the property.

Estate tax. The taxable estate of a nonresident alien is subject to the estate tax.[72] The rates again are the same as for residents but, subject to some limited exceptions for decedents who were domiciled in treaty countries, the unified credit (which in 2024 has reached an exemption equivalent of $13.61 million) is also unavailable.[73] Instead, the credit available to NONRESIDENT ALIENs is equivalent to an exemption of just $60,000, an amount that has not increased for decades.

The taxable estate of a nonresident alien is limited to property situated in the United States.[74] Real property held directly is situated in the United States, as is stock of a domestic corporation.[75] Tangible property located at the home is also part of the taxable estate; however, there is a limited exception for artwork, which applies only to works on loan for purposes of exhibition at a public gallery or museum or in transit to or from the exhibition in accordance with the loan.[76] Stock of a foreign corporation is situated outside the United States even if its only asset is U.S. real property. The position with partnership interests is unclear, and is discussed in more detail later in the context of a partnership that owns a property held for personal use by the partners.

It should not be assumed that the value of a home or other real property is reduced by any debt secured by a mortgage. In fact, under a fungibility concept long espoused by the IRS, debt may be deducted only to the extent the estate establishes the worldwide assets and liabilities of the decedent and deducts the U.S. proportion of the liabilities. That proportion is determined by multiplying the worldwide liabilities by a ratio in which U.S.-situated assets comprise the numerator and the worldwide assets comprise the denominator.[77] Under this fungibility rule, this treatment applies even to a note secured by a mortgage or deed of trust on U.S. real property.[78] For a nonrecourse debt, however, the Tax Court has held, with IRS acquiescence, that only the value of the equity of redemption is includable. For this reason, if a nonresident alien purchases a home with a mortgage, it is desirable that the mortgage be nonrecourse.[79] The Tax Court has held that a loan will be treated as recourse despite state procedural rules that have the

accompanied by actual removal."

[71] Interspousal gifts to a non-citizen spouse are not entitled to the unlimited marital deduction. However, the annual exclusion is increased to $100,000 for an interspousal gift. *See* section 2523(i). The $100,000 has been inflation-adjusted since 1997, and for 2024 is $185,000. : Rev. Proc. 2023-34; 2023-48 IRB 1287, section 3.43(2).

[72] Sections 2101 and 2102.

[73] Rev. Proc. 2019-44, section 3.41.

[74] Section 2106.

[75] Section 2104(a).

[76] Section 2105(c).

[77] *See* also section 2601(b).

[78] *Rodiek v. Commissioner*, 33 B.T.A. 1020 (1936), *aff'd*, 87 F.2d 328 (2d Cir. 1937).

[79] *See* reg. section 20.2053-7; and *Johnstone Estate v. Commissioner*, 19 T.C. 44 (1952), *acq*., 1953-1 C.B. 5.

practical (even quasi-universal) effect of making the loan nonrecourse.[80]

5.5 Privacy

Ownership of property. Legal title to real estate is generally a matter of public record in the United States. Foreign investors, often to a greater extent than their domestic counterparts, are concerned about liability and privacy in relation to their ownership of U.S. residential real estate. Privacy is a particular concern for the very wealthy, who do not want to have residential addresses made available through public land records readily accessible on the internet.

Foreign investment nontax reporting rules may require some level of disclosure of ownership to the government. There are four sets of rules that may be relevant to homebuyers. The first is the International Investment and Trade in Services Survey Act, administered by the Commerce Department's Bureau of Economic Analysis.[81] The foreign direct investment rules do not require disclosure to the government of the ultimate beneficial owners of "business enterprises" engaged in foreign investment, and in any event the information is not public and may be used by the government only for statistical purposes. The Bureau of Economic Analysis requires a survey to be completed for any investment if the total assets of a newly acquired or newly established entity are more than \$3 million, or the transaction involves the acquisition of 200 or more acres of U.S. land. The bureau also requires quarterly and annual reports if the amount of investment exceeds \$30 million and a survey every five years when the minimum drops to \$10 million.

The second set of rules is under the Agricultural Foreign Investment Disclosure Act, administered by the Agriculture Department's Farm Services Agency.[82] The agricultural foreign investment rules would be relevant to a foreign homebuyer who purchased a farm or ranch. These rules pose a more serious obstacle to privacy because the reports are a matter of public record. Disclosure of beneficial ownership can be avoided only by having at least three tiers of entities between the ultimate owner and the property.

A third requirement arises under the Bank Secrecy Act. Under the act, Treasury's Financial Crimes Enforcement Network — the same agency that together with the IRS enforces foreign financial account reporting — has issued a series of geographic targeting orders under which U.S. title insurance companies must identify the natural persons behind shell companies used to pay for high-end residential real estate in various mostly metropolitan areas, when no bank financing or similar form of external financing is involved. The latest geographic targeting order applies to sales where the purchase price \$50,000 or more in the City or County of Baltimore, MD, or \$300,000 or more in other areas covered by the order.[83] FinCEN generally does not share this information with other government agencies, but there

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[80] A few state laws provide that a mortgage secured by an owner-occupied residence is nonrecourse. *See* Cal. Civ. Proc. Code section 580b. *See Estate of Fung v. Commissioner*, 117 T.C. 247 (2001). Another provision found in many state laws is a bar on deficiencies when the buyer's obligation is seller-financed and such an obligation will be treated as nonrecourse. Many states also have rules that bar deficiencies after a foreclosure proceeding under the power of sale given by statute or the mortgage or deed of trust, but if state law permits an election of alternative remedies, the loan will not be treated as nonrecourse for estate tax purposes even if the lender would be most likely to elect power of sale foreclosure.

[81] International Investment and Trade in Services Survey Act, 22 U.S.C. ch. 46, sections 3101-3108; regulations at 15 C.F.R. pt. 801.

[82] Agricultural Foreign Investment Disclosure Act, 7 U.S.C. ch. 66, sections 3501-3508; regulations at 7 C.F.R. pt. 781.

[83] The areas covered are listed in FinCEN, "Geographic Targeting Order" (Apr. 21, 2023), available at https://www.fincen.gov/sites/default/files/shared/508_Order_April2023REGTO.pdf. (viewed February 5, 2024).
California
San Diego, Los Angeles, San Francisco, San Mateo, or Santa Clara
Maryland

are law enforcement circumstances in which it could do so.

Fourth, the Corporate Transparency Act, enacted in 2021, is now in operation.[84] Essentially, the Act requires reports to FinCEN of the beneficial owners of millions of business entities formed or registered in the United States. Entities that came into existence before 2024 must file their initial report in 2025; entities formed in 2024 or thereafter must file their initial report within 90 days of formation or registration. The information reported to FinCEN is not public but it is available to numerous Federal and state agencies and, in some cases, foreign government agencies.

For most other purposes, privately held trusts and other entities offer some measure of protection from the inquisitive public. Trusts do not have to be registered in the United States. The names of trustees may appear on real estate records, and beneficial owners concerned about privacy should not act as trustees and should not include their own name as part of the name of their trust. For corporations and limited liability companies, public registration is required. However, the names of the owners are not a matter of public record in most states, with New York being a notable exception. For limited partnerships, public registration is required, but only the name of the general partner needs to appear in the public records. By contrast, for a general partnership, registration or recordation is not technically required but may be necessary as a practical matter, in which case at least one of the partners' names will become a matter of public record.

Finally, as a general matter, law enforcement authorities concerned with criminal investigations can usually determine the ownership of property or compel its disclosure. The CTA will significantly increase the information available to such authorities, although the cynically-minded may feel that criminals and other malefactors might be the least likely to have provided accurate or even any information under the CTA.

Filing tax returns. Many nonresidents would prefer not to have to file U.S. income tax returns or have any contact with the U.S. tax system at the federal or state level. Of these, most do not want to file

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Montgomery, Anne Arundel, Prince George's, or Howard
Connecticut
Fairfield or Litchfield
New York
Boroughs of Brooklyn, Queens, Bronx, Staten Island, or Manhattan in New York City,
District of Columbia

Nevada
Clark
Florida
Miami-Dade, Broward, or Palm Beach
Texas
Bexar, Tarrant, Dallas, Harris, Montgomery, or Webb
Hawaii
Hawaii, Maui, Kauai, or Honolulu, or the City Honolulu
Virginia
Arlington or Fairfax, or the cities Alexandria, Falls Church, or Fairfax
Illinois
Cook

[84] The Act was enacted as part of the William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021, Pub. L. 116–283, section 6403.

returns during the period of ownership, and some object to filing returns even on sale of the property.

This antipathy to the U.S. tax system does not necessarily mean that the nonresidents do not wish to pay tax, but they would more gladly do so if it could be done anonymously or without having to personally file a tax return.

Our system of taxing real estate transfers, whether by sale or exchange or by gift or bequest, does not facilitate anonymity vis-à-vis the tax authorities. Anonymity will come at a cost, most notably by requiring the use of some form of entity that cannot be fiscally transparent and therefore prevents the availability of preferential rates of capital gains tax (although the current Federal corporate rate and the long-term capital gains rate for individuals are almost the same) or may require planning to avoid or mitigate double taxation.

The tax authorities — federal, and to some extent state — have the power in some circumstances to require disclosure of the identities of the ultimate owners of real property. The scope of this power depends on the chosen structure; however, anyone who has completed a Form 5472, "Information Return of a 25 Percent Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business," or answered question 5 of Schedule K of Form 1120 or question V of Form 1120-F likely has come across some disclosure requirements.

6. SOME ADDITIONAL ISSUES

6.1 Trap for the Unwary - Holding Additional Assets in the Real Estate Entity

A common mistake foreign investors sometimes make is to hold more assets than the single piece of real estate in the same entity or under a single umbrella U.S. parent. They may hold more than one piece of real estate in one entity, or hold non - real estate assets in the same entity as the real estate. Unless the foreign investor is doing this intentionally to take advantage of the ability to offset losses from one property against income from another (as was the case with the U.S. consolidated group structure discussed above), such a structure can frequently interfere with the tax planning. As has been discussed above, it is frequently important to liquidate the entity selling the real estate to be able to repatriate the sales proceeds free of a second level of tax. If there are other assets in the entity, it can impede such a liquidation. In addition, having additional assets in the entity can impede a sale of the foreign stock as a planning technique to avoid U.S. income tax on the gain on sale.

6.2 Use of Debt

While beyond the scope of this paper, taxable income can sometimes be reduced by interest deductions and it can be easier to repatriate funds with proper funding of the entity with some amount of debt. In some cases, the debt can be structured so that interest in the hands of a foreign lender can meet the requirements of the portfolio interest exception.[85]

6.3 Foreign Tax Considerations

This paper discusses only U.S. tax consequences. As noted earlier, a foreign person making an investment in U.S. real estate must also consider the foreign tax consequences of the investment. For example, the investor may wish to consider to what extent taxes paid in the United States will be creditable against taxes in the investor's home county. While many countries employ a territorial system of taxation for corporations, under which their corporations do not pay tax on foreign income, this system

[85] Sections 871(h) and 881(c).

applies less commonly to individuals.