

**TAX STRUCTURING OF FOREIGN INVESTMENT IN U.S. REAL ESTATE  
WITH A N.Y. TWIST**

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This paper describes some of the possible structuring alternatives a foreign investor may use to limit his or her U.S. tax exposure with respect to the ownership and subsequent disposition of U.S. real estate. In explaining the structures, this paper also describes some of the relevant U.S. federal tax consequences as well as the New York tax consequences of such ownership and disposition.

## **I. GENERAL U.S. INCOME TAX BACKGROUND**

### **A. Types of Income**

Real property may yield numerous types of tax issues 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.

In either case, income may 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.

### **B. Taxation of Real Estate-Related Income**

In the case of foreign persons (whether nonresident alien individuals or foreign entities) the United States makes a fundamental distinction between income that is effectively connected with the conduct of a trade or business and income that is not effectively connected.

Foreign persons are taxed on the amount of effectively connected U.S. trade or business income net of deductions allocable to such income at, broadly speaking, the same graduated rates that apply to U.S. persons.<sup>1</sup> 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.<sup>2</sup> The branch level taxes represent an effort to put foreign corporations on the same footing as a foreign persons investing in domestic corporations.

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<sup>1</sup> Sections 872 and 882 of the Internal Revenue Code of 1986, as amended (“Code”). All unprefix references to sections are to sections of the Code.

<sup>2</sup> Section 884.

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 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, (subject to reductions by applicable treaty, if any), with no deductions.<sup>3</sup> We will refer to this regime 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.

Even if rental income is not effectively connected with a U.S. trade or business, the investor may elect the net basis regime.<sup>4</sup> This may be advantageous if, for example, the investor could offset the income with expenses, such as interest, taxes, insurance, repairs or property management expenses, that would only be deductible under the net basis regime.

### **C. Taxation of Real Estate Gains**

Under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), gain from sale by a foreign person from sale or exchange of a "United States real property interest" (USRPI) is subject to the net basis regime.<sup>5</sup> In summary, a USRPI includes:

1. Direct interests in real property, which includes land, buildings, "inherently permanent structures" and other improvements;<sup>6</sup>
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 laundry equipment.<sup>7</sup>
4. A direct or indirect right to share in appreciation in value, gross or net proceeds or profits from real property;

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<sup>3</sup> Sections 871(a) and 881(a).

<sup>4</sup> Sections 871(d) and 882(d).

<sup>5</sup> Section 897(a).

<sup>6</sup> Treas. Reg. §§ 1.897-1(b)(2) and (3).

<sup>7</sup> Treas. Reg. § 1.897-1(b)(4).

5. An interest in domestic corporation that was a “U.S. real property holding corporation” (USRPHC) at any time during the 5-year period preceding sale.<sup>8</sup>

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.<sup>9</sup> 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.

A USRPI does not include interest in a USRPHC that has sold all of its USRPIs in taxable transactions. 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.<sup>10</sup>

We do not propose to describe FIRPTA taxation (or withholding) in detail. These topics have been covered extensively in numerous articles and treatises.<sup>11</sup> We refer below as necessary to various relevant provisions of FIRPTA.

#### **D. Payment of Tax**

1. 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 an applicable by treaty.<sup>12</sup> 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.<sup>13</sup>

Second, tax on gain subject to FIRPTA is generally enforced by requiring withholding at 10% on the gross amount realized in any sale or exchange of a USRPI; in some cases, however, the Code

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<sup>8</sup> Section 897(c)(1); Treas. Reg. § 1.897-1.

<sup>9</sup> Section 897(c)(2); Treas. Reg. §§ 1.897-2.

<sup>10</sup> Section 897(e). See also section 897(d) with regard to taxation on corporate distribution of USRPIs.

<sup>11</sup> E.g., IRS Publication 515; Caballero, Feese and Plowgian, 912-2nd T.M., U.S. Taxation of Foreign Investment in U.S. Real Estate (BNA); Rhoades & Langer, U.S. International Taxation & Tax Treaties (Matthew Bender, looseleaf 2011), ch. 31

<sup>12</sup> Sections 1441 (nonresident alien) and 1442 (foreign corporation).

<sup>13</sup> 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.

instead requires withholding at the maximum applicable rate on realized gains.<sup>14</sup> The transferee is required to deduct and withhold a tax equal to ten percent (10%) 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 10% 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.<sup>15</sup> 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.<sup>16</sup>

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".<sup>17</sup> 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.<sup>18</sup> 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.<sup>19</sup>

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

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<sup>14</sup> Section 1445(a).

<sup>15</sup> Section 1445(e).

<sup>16</sup> Sections 3401 and 3402.

<sup>17</sup> Section 1446.

<sup>18</sup> See Treas. Reg. § 1.1446-3(c)(2).

<sup>19</sup> 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).

under section 1441 on portion estimated to be dividend and section 1445 on remainder of distribution.<sup>20</sup>

Finally, we can look forward to FATCA, which 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.<sup>21</sup> Withholdable payments include any payment of U.S. source FDAP income as well as gross proceeds from the sale or other disposition of any property of a type which can produce U.S. source interest or dividends.<sup>22</sup> FATCA withholding is being phased in over a period of years beginning in 2014.<sup>23</sup>

FATCA withholding, once it is in effect, will have to be applied before withholding is applied under any other withholding provision.

2. 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.<sup>24</sup> 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.<sup>25</sup>

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.

## **II. 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.

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<sup>20</sup> Treas. Reg. §§ 1.1445-5(b)(1) and 1.1441-3(b)(4).

<sup>21</sup> Sections 1471 and 1472.

<sup>22</sup> Section 1473.

<sup>23</sup> See Notice 2011-53, 2011-32 I.R.B. 124. Note that U.S. taxpayer reporting of foreign financial accounts, a separate provision of FATCA, will be required for 2011. § 1.6038D-1T, T.D. 9757 (released Dec. 19, 2011).

<sup>24</sup> See Treas. Reg. § 1.6012-1(b)(1)(i) (nonresident alien); Treas. Reg. § 1.6012-2(g)(1)(i).

<sup>25</sup> Treas. Reg. § 1.1445-1(f)(1).

## **A. Non-Tax Issues**

1. An understanding of investor characteristics, including type (individual, corporate, partnership or LLC, pension plan, collective investment vehicle (e.g., a REIT or a foreign analog), or a foreign government) and location of the investor;
2. Number of properties to be acquired;
3. 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

4. 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;
5. Whether the investment will be wholly-owned or held jointly with others.

## **B. 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 currently pays tax at corporate rates on its income and any dividend paid to foreign persons 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 (currently 15%).

3. The investor's concerns about U.S. estate and gift taxes. 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.<sup>26</sup>

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 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.

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<sup>26</sup> Section 2101.

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).<sup>27</sup> 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. 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.<sup>28</sup>

### **III. 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.

#### **A. Ownership Without Interposing 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.<sup>29</sup> Nevertheless, as will be described below, in spite of the income tax efficiency of this structure, it is relatively uncommon.

##### 1. 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<sup>30</sup>, and (iii) the investor is not eligible to take

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<sup>27</sup> Treas. Reg. §§ 301.7701-2 and -3.

<sup>28</sup> 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 (Nov. 15, 2006), available at <http://www.irs.gov/pub/irs-trty/model006.pdf> (viewed Dec. 29, 2011)

<sup>29</sup> Home country considerations can come into play here. Many countries treat an LLC as a corporation. Moreover, some countries treat U.S. tax paid by the investor as corporate tax. See, e.g., the decision of the U.K. Upper Tax Tribunal in *Anson v HMRC*, FTC/39/2010 (Aug. 11, 2011), holding that the U.S. tax paid by an individual U.K. resident is not creditable because the U.S. and the U.K. taxes were not paid in respect to the same profits, as required by the U.K.-U.S. income tax treaty, art. 24. A good discussion of this decision, by Sullivan & Cromwell LLP, is available at [www.sullcrom.com/Recent-Developments-Regarding-Entity-Classification-for-UK-Tax-Purposes-08-24-2011/](http://www.sullcrom.com/Recent-Developments-Regarding-Entity-Classification-for-UK-Tax-Purposes-08-24-2011/) (viewed Dec. 30, 2011). A U.K. investor seeking limited liability without loss of tax credits needs to seek U.K. advice on what form of entity to use that would not result in loss of U.K. double tax relief.

<sup>30</sup> See Treas. Reg. § 301.7701-3(b). Absent such an election to the contrary, the LLC would be ignored for U.S. federal and New York income tax purposes, and the investor would be treated for such purposes as owning the real estate directly.

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.

The two general tax regimes are described in more detail below.

a. No U.S. Trade or Business - Gross Basis Regime. A foreign individual receiving rental income from U.S. real property that is not effectively connected with a U.S. trade or business would be subject to a 30% withholding tax on the gross rental income paid by the tenant.<sup>31</sup> The tax is applied to all rent paid by the tenant, including any landlord expenses paid by the tenant on behalf of the landlord, without any deductions. The tenant withholds the tax from the rent he pays to the landlord and remits it to the U.S. Treasury.<sup>32</sup> Although not entirely clear, it would appear that there would be no New York State income tax on the rent, even if the property is located in New York.<sup>33</sup>

b. U.S. Trade or Business - Net Basis Regime. If the income of the foreign individual is effectively connected with a U.S. trade or business (or if the foreign individual elects to be so treated), the income is taxed under the net basis regime<sup>34</sup>. In general, the individual would pay a federal income tax at graduated rates up to 35%. In addition, if the property is located in New York State, there would be an additional New York State income tax of close to 9%. Taking account of the deductibility of state taxes for federal income tax purposes, the combined effective rate would be approximately 40%.

Thus, 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 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.

## 2. Taxation of Gain on Sale

A key advantage of the noncorporate ownership is that individuals, unlike corporations, are eligible for U.S. federal capital gains rates of 15% (25% to the extent of prior depreciation). Even including an additional New York State tax of approximately 9%, the tax rate on sale for the individual is significantly lower than the tax rate under a corporate structure. FIRPTA withholding<sup>35</sup> and

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<sup>31</sup> Section 1441.

<sup>32</sup> The authors' experiences is that many tenants are unaware of their withholding responsibilities. Should the tenant fail to withhold, the foreign investor must file a tax return and pay the tax. See footnote 24 *supra* and accompanying text.

<sup>33</sup> The reason is that computation of New York tax starts with federal income on the federal tax return, of which there is none in this case. New York City income tax would not be payable even if the property is located in New York City because the city does not generally impose an income tax on nonresident individuals.

<sup>34</sup> Section 873.

<sup>35</sup> Section 1445

possible New York State withholding (discussed below following the discussion of the various structures) will apply.

### 3. 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.

### 4. 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<sup>36</sup>. Similarly, a gift of all or any portion of the real estate would be subject to U.S. gift tax<sup>37</sup>. 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.

### 5. 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. and New York State 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.

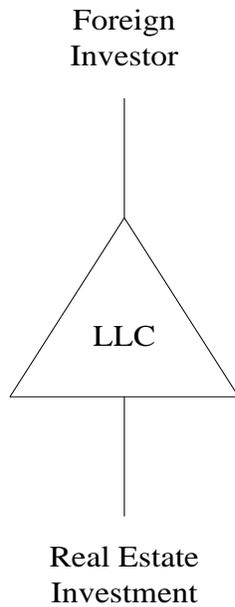
### 6. Summary

This structure has some important disadvantages, primarily the imposition of U.S. estate tax and the requirement to file returns and the resulting lack of anonymity. However, given the (i) lower income tax rates, especially (x) the capital gains rates on sale and (y) the lack of a New York City tax for a New York City property (which is not true if a corporation is interposed), and (ii) 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.

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<sup>36</sup> Section 2101.

<sup>37</sup> Section 2501.



### **B. 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.

#### 1. 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 up to 35%. If, however, the property is located in New York City, for example, there would be additional New York State and New York City corporate tax at combined rates approaching 20%.<sup>38</sup> Taking account of the deductibility of state and local taxes in computing federal tax, the marginal rate could approach 48%. The tax is based on income net of expenses.

#### 2. 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.

#### 3. 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 shareholder's basis in the stock, there would be a FIRPTA tax to the shareholder. However, if

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<sup>38</sup> New York State and New York City impose tax on capital if higher than the tax on net income.

there are no assets remaining in the corporation other than sale proceeds or other non-USRPI assets, 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.<sup>39</sup>

#### 4. Estate and Gift Taxation

A gift of the stock should not be subject to U.S. gift tax<sup>40</sup>. 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<sup>41</sup> 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.

#### 5. Filing of Returns; Lack of Anonymity

The corporation, but not the individual, will be required to file U.S. and New York 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 50% or more of the stock of the corporation.

#### 6. 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 there would be no FIRPTA withholding, but the sale would be subject to tax.<sup>42</sup> 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:

- a. There may be a second level of tax on operating income and refinance proceeds that are be repatriated back to the individual. If available cash flow is used in

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<sup>39</sup> 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.

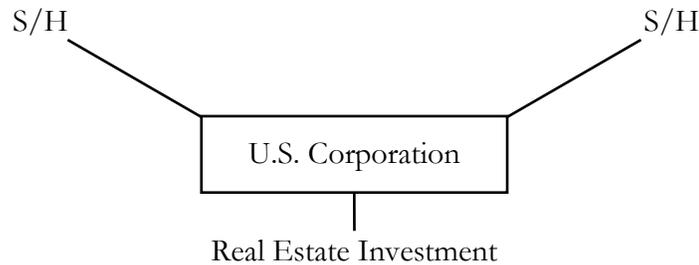
<sup>40</sup> Section 2501(a)(2)

<sup>41</sup> Section 2104(a).

<sup>42</sup> 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).

whole, or substantial part, for debt service, dividends from operations may not be anticipated.

- b. The corporation provides the individual investor only limited anonymity because of the disclosures on the U.S. tax return filed by the corporation.
- c. 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.



### C. Foreign Corporation

#### 1. 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. On the other hand, if the corporation is engaged in a U.S. trade or business or elects to be so treated, it will be subject to the net basis regime. However, in this case, the marginal tax rate of the net basis regime is significantly higher than for an individual. In general, the corporation would pay a federal income tax at graduated rates up to 35%, and if the property is located in, for example New York City, New York State and New York City taxes at a combined rate approaching 20%.<sup>43</sup> Moreover, the corporation would be subject to the branch profits tax<sup>44</sup> 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.

Because some of these taxes are deductible in determining the other taxes, a useful short hand would be to assume that the overall effective tax rate of all of these taxes combined for New York City property is approximately a maximum of 64%. However, this tax is based on income after deduction for expenses, including interest (subject to certain limitations) and depreciation. Thus, although the rate under the net basis regime is much higher than the rate under the gross basis regime, if there are sufficient expenses to reduce or eliminate the income, it is possible that tax under the net basis regime may be lower than tax under the gross basis regime.

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<sup>43</sup> The tax on capital may apply instead, if higher.

<sup>44</sup> Section 884.

## 2. 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. However, sale of the stock of the foreign corporation should be free of U.S. federal and New York State and New York City income tax.<sup>45</sup> It should be noted that the purchaser of the stock of the foreign corporation will inherit any built in gain at the foreign corporation level.

## 3. Repatriation of Funds

There is no dividend withholding tax, but repatriation may be a factor in computing the branch profits tax.

## 4. 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.<sup>46</sup>

## 5. 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.<sup>47</sup>

## 6. Summary

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

- a. 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

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<sup>45</sup> However, New York State and New York City transfer tax should still be applicable. See Section III-C below for a discussion of the discount the buyer is likely to insist upon because of the low basis of the underlying real estate and other factors.

<sup>46</sup> 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 foreigner 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.

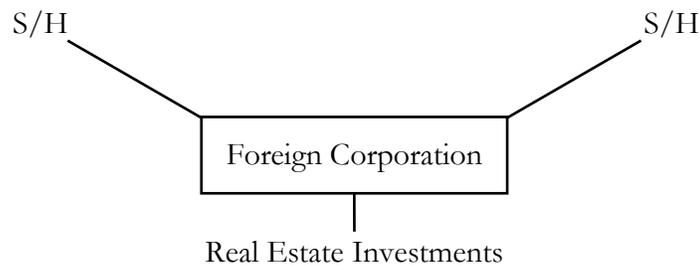
<sup>47</sup> Section 6038C.

corporation's dividend equivalent amount. Both taxes are on top of the regular corporate tax. However, it may be easier to avoid 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.

- b. If the property were to be refinanced, a distribution of the refinancing proceeds by the 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).
- c. The conventional wisdom is that there should be no estate tax in the case of the foreign corporation<sup>48</sup>.

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. In addition, it may also be used by foreigners who are able to take advantages of treaties that reduce the branch profits tax.



#### **D. 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.

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<sup>48</sup> Treas. Reg. § 1.897-2(h)(4)(ii).

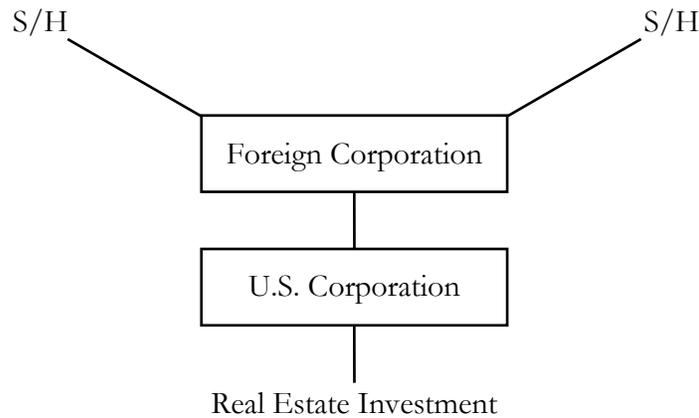
- While the U.S. corporation must disclose the identity of its 100% shareholder by name, that will identify only the foreign corporation. The foreign corporation is under no such obligation to disclose its shareholder since it is not engaged in a U.S. trade or business. However, if there is any “reportable 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<sup>49</sup> and New York State and New York City income tax.<sup>50</sup>

- 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.<sup>51</sup>

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).



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<sup>49</sup> 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.

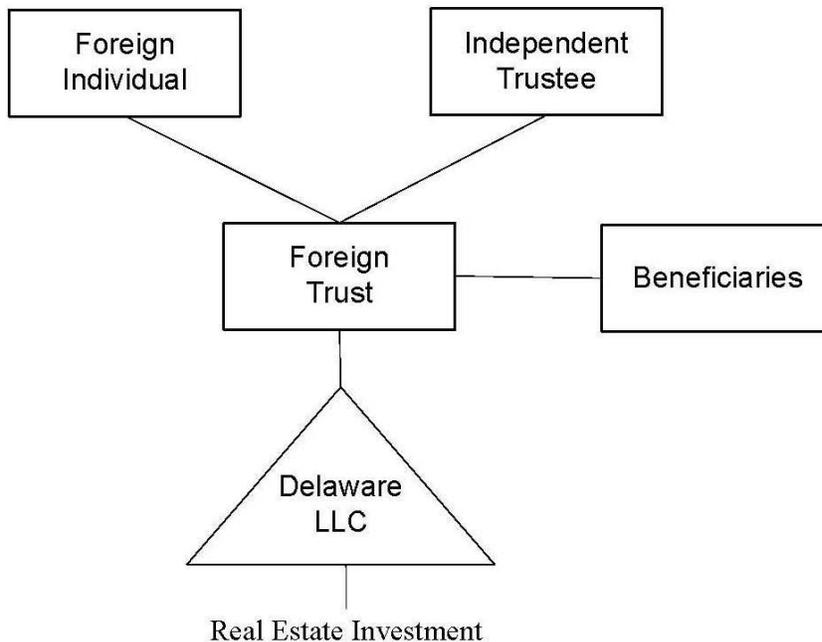
<sup>50</sup> However, New York State and New York City transfer tax should still be applicable. See Section III-C below for a discussion of the discount the buyer is likely to insist upon because of the low basis of the underlying real estate and other factors.

<sup>51</sup> See footnote 19 above.

### **E. 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,<sup>52</sup> the maximum rate of income tax is capped at 35%<sup>53</sup>, and recapture income when depreciated real property is sold at a gain is taxed at 25%.<sup>54</sup>

For newly acquired U.S. real property, there is a structure available that will 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 the individual's demise. The suggested structure is as follows: A foreign individual would fund an irrevocable trust in an offshore low-tax jurisdiction, transferring cash, not 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 Delaware limited liability company which would then invest in real estate. The suggested structure is illustrated by the following diagram:



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.

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<sup>52</sup> Section 1(h)(1)(C).

<sup>53</sup> Section 1(i)(2).

<sup>54</sup> Section 1(h)(1)(D).

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 15% tax applicable to capital gains, the 25% tax applicable to depreciation recapture, and 35% tax on operating profits.

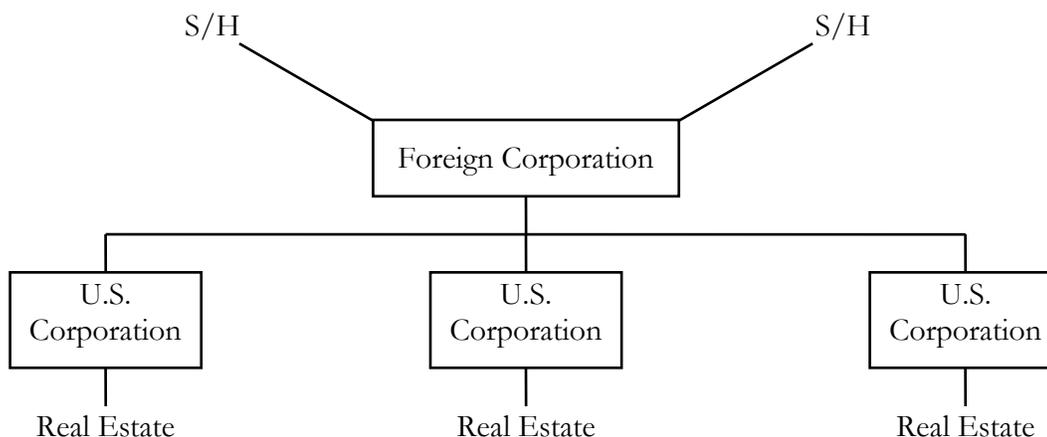
There will be no further tax as funds are distributed to the beneficiaries.

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.

#### IV. 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 be separate U.S. corporations.<sup>55</sup>

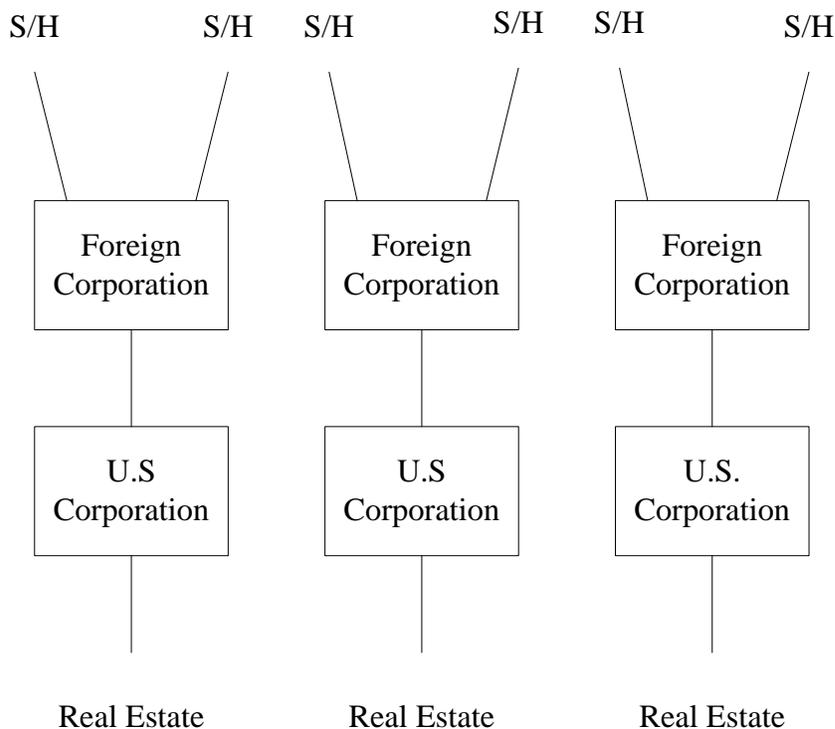
The use of a foreign holding company to hold all of the stock of each U.S. real estate holding corporation may provide the benefits noted above. A negative factor is that the losses of one property cannot be used to offset the income of another property. If, however, the goal is to repatriate the sale 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.



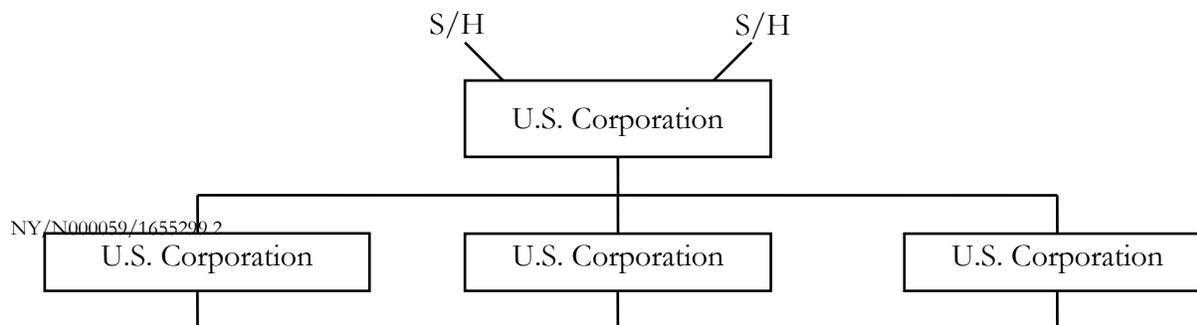
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<sup>55</sup> Generally, if the parent will be a foreign corporation, it would be better to use separate U.S. corporations than separate LLCs for this purpose because the separate U.S. corporations will more clearly permit the imposition of only a 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.

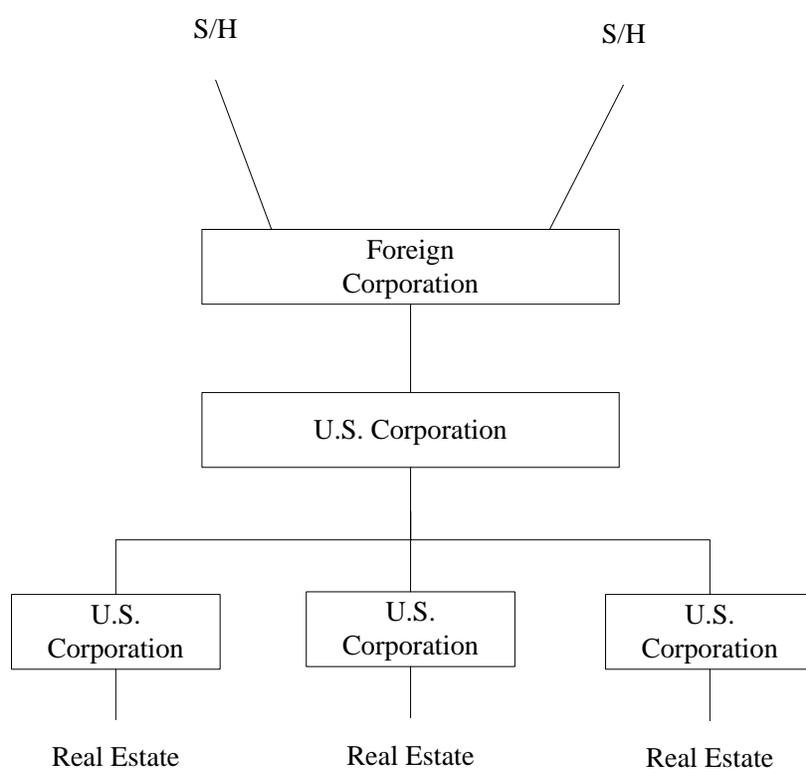
An improvement in the structure at the cost of additional complication would be to have each U.S. corporation held by a separate foreign corporation. In addition to the advantages discussed above, this will permit the sale of a particular real estate investment free of U.S. and New York State and New York City income tax through the sale of the stock of the foreign corporation, subject to the issues discussed in Section III-C below.



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.<sup>56</sup>



## V. SOME ADDITIONAL ISSUES

### A. Withholding on Operating Income

In addition to Federal requirements discussed above, New York State requires withholding on income allocated to non-New York State resident partners or members. In each case, a return must be filed by the partner or member and the withheld tax is applied as a credit on the return against the foreign person's tax liability.

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<sup>56</sup> See footnote 7 above. In addition, under legislation passed in 2004, a liquidation of the U.S. parent of the consolidated group within five years of formation may be taxable. Section 332(d).

## **B. New York Estimated Tax on Sale**

Upon the sale of a fee interest in real property by an individual, estate or trust that in each case is not a resident of New York State, the nonresident must generally file a Form IT-2663 and pay an estimated tax on the sale. Exemption from this requirement is claimed on an attachment to the New York State real estate transfer tax form. The recorder is not permitted to record the deed without either the payment of the estimated tax or a claim for exemption from the requirement to pay. A return must be filed by the nonresident person reporting the sale and the withheld tax is applied as a credit on the return against the nonresident person's tax liability.

## **C. Sale of Stock of Foreign Corporation**

As has been noted above, the foreign investor may avoid U.S. federal and New York State income tax by selling the stock of the foreign corporation. However, insisting on a stock sale will frequently limit the market of potential buyers, as in most cases only certain foreign buyers will be willing to structure the transaction in that manner. In addition, the buyer will insist on a discount to take account of the risk of purchasing an entity, with the inherent liability potential, and to take account of the fact that the buyer will not have an increase in basis to the underlying real estate asset, so that he will effectively inherit the seller's tax.

New York State and New York City take the position that the sale of the foreign stock will still be subject to New York State and New York City real estate transfer taxes. This position has been the subject of constitutional challenge, which the State and City have to date successfully repelled.<sup>57</sup>

## **D. 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.

## **E. Use of Debt**

While beyond the scope of this paper, it should be noted that taxable income can sometimes be reduced and it can be easier to repatriate funds with proper funding of the entity with some amount of debt.

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<sup>57</sup> See *In re Cafcor Trust Reg. Vaduz*, Tax Appeals Tribunal, DTA Nos. 812682 and 812683 (Apr. 17, 1997) (New York State gains tax) and *In re Corwood Enterprises, Inc.*, NYC Tax Appeals Tribunal, TAT(E)00-39(RP) (June 2, 2006) (New York City transfer tax).

## **F. 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 country. While many countries employ a territorial system of taxation for corporations, under which their corporations do not pay tax on foreign income, this system applies less commonly to individuals.

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