

TAX 101: UNDERSTANDING U.S. TAXATION OF FOREIGN INVESTMENT IN REAL PROPERTY – PART I

Authors

Sheryl Shah
Nina Krauthamer

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INTRODUCTION

U.S. real estate has been a popular choice for foreign investors, whether the property is held for personal use, rental or sale, or long-term investment. Since the passage of the Foreign Investment in Real Property Tax Act of 1980 (“F.I.R.P.T.A.”), the governing tax rules have developed and evolved, but have not succeeded in discouraging foreign investment. F.I.R.P.T.A. can be a potential minefield for those unfamiliar with U.S. income, estate, and gift taxation – all of which come into play. This article is the first of a series on understanding U.S. taxation of foreign investment in real property.

TAXATION OF A FOREIGN PERSON

“A foreign person is subject to U.S. income tax only on income that is characterized as U.S. source income.”³⁰

As simple as the concept sounds, there are applicable nuances, caveats, exemptions, and exceptions. Therefore, several questions must first be answered to determine the U.S. income tax consequences for a foreign person engaged in U.S. economic activities, including ownership of real property:

1. Is the income derived from a U.S. source and therefore potentially taxable?
2. Is the income taxable or exempt from tax?
3. Is the income passive or active, subject to a flat withholding tax on gross income or, alternatively, to graduated rates on net income?
4. Is the income earned by an individual or corporation or other entity, each of which may have different rules and applicable tax rates?

³⁰ For regulations regarding source of income, see I.R.C. §§861–865. These rules are discussed at length in BNA 905 T.M., Source of Income Rules.

For a foreign investment in U.S. real estate, income may be derived through several means:

1. Rental income from leased property;
2. Interest on a debt investment secured by real estate;
3. Dividends received from a corporation owning U.S. real estate;
4. Sale or disposition of a real estate asset or an entity owning a real estate asset.

RENTAL INCOME

Rent continues to be a significant source of income from ownership of U.S. real estate. Generally, rental income is U.S. sourced if the property is located in the United States.³¹

Rental income can be “passive” or “active,” and the character of the income as such will dictate the tax regime applied. The difference in the tax levied can be dramatic.

Passive Income

For all U.S.-source “fixed or determinable, annual or periodical” (“F.D.A.P.”) income,³² a flat 30% withholding tax is levied on the *gross* amount at source.

I.R.S. literature states that:

Income is fixed if it is paid in amounts known ahead of time. Income is determinable whenever there is a basis for figuring the amount to be paid. Income can be periodic if it is paid from time to time. It does not have to be paid annually or at regular intervals. Income can be determinable or periodic, even if the length of time during which the payments are made is increased or decreased.

Rental income generally falls under this category because it is typically agreed upon in advance and paid by a specified date. Should the income be treated as F.D.A.P., the tax can equate to a large percentage of net income since it is levied on the gross amount. This concept is illustrated in the following example.

Ex: A tenant pays \$100 in rent to the owner and \$100 in property-related expenses to third parties (taxes, insurance, etc.).

- Gross rental income = \$200

³¹ See Code §861(a)(4).

³² F.D.A.P. income is described in Code §§871 and 881.

- Withholding tax = 30% of \$200 = \$60
- Net cash to owner = \$100 - \$60 = \$60
- Effective tax rate = 60%

Active Income

If the foreign individual or corporation is engaged in a U.S. trade or business ("E.T.B."), the income effectively connected with that business ("E.C.I.") is subject to U.S. income tax on a net basis using a graduated rate, which requires the filing of a U.S. tax return. Whether or not an entity is considered to be E.T.B. is determined by the nature, extent, continuity, time devoted, and income derived from its activities in the U.S.

Simply leasing out a property does not suffice.³³ In *Neill*, the petitioner was a nonresident alien that rented out her apartment in Philadelphia. The court found that owning and leasing the property constituted no more of a business than her ownership of stocks or bonds held in U.S. companies by her U.S. agent. It was held that the mere ownership of property from which income is drawn does not constitute the carrying on of trade or business.

Nonetheless, owning and renting multiple properties, and managing them or hiring an agent to do so may constitute E.T.B.³⁴ Using agents who negotiate, renew leases, arrange for repairs, collect rents, pay taxes and assessments, and remit net proceeds will be E.T.B. since the activities of these agents extend beyond the scope of mere ownership and the receipt of income.³⁵

Once E.T.B. is established (or deemed present), the following income will be treated as E.C.I.:

- All U.S.-source income derived from a U.S. trade or business;
- U.S.-source capital gains, F.D.A.P., or similar income that is derived from assets held or used for a U.S. trade or business;
- Income for which a U.S. trade or business is material to its realization;
- Income derived under a net election (as discussed below); and
- Gain derived by a foreign person from the disposition of a U.S. real property interest.

³³ *Neill v. Comr.*, 46 B.T.A. 197 (1942).

³⁴ *Pinchot v. Comr.*, 113 F.2d 718 (2d Cir. 1940) (taxpayer owned 11 properties that were actively managed by an agent); *de Amodio v. Comr.*, 34 T.C. 894 (1960), aff'd on another issue, 299 F.2d 623 (3d Cir. 1962); *Lewenhaupt v. Comr.*, 20 T.C.

³⁵ See <http://www.andrewmitchel.com/charts/amodio.pdf>; Andrew Mitchel is of counsel to Ruchelman P.L.L.C.

"Rental income can be 'passive' or 'active,' and the character of the income as such will dictate the tax regime applied. The difference in the tax levied can be dramatic."

The tax consequences of this regime are significantly different from those for passive income simply because the rate is applied on a net income rather than a gross income basis.

Ex: A tenant pays \$100 in rent to the owner (a corporation) and \$100 in property-related expenses to third parties (taxes, insurance, etc.).

- Gross rental income = \$200
- Net rental income before deductions = \$200 - \$100 = \$100
- Maximum tax applicable = 35%
- Effective tax rate = 35%

Each situation plays out differently depending on whether the income is considered passive or active. A foreign owner may choose to be E.T.B., and therefore subject to a lower effective tax rate, through a net election.

Net Election

As indicated above, it is often difficult to say with certainty whether rental income is considered to be active or passive. When a foreign person's activities do not amount to E.T.B., an option exists for the election of income to be treated as E.C.I.³⁶ The net election treats the foreign person as though they were engaged in U.S. trade or business, and rental income is therefore effectively connected with that trade or business. In turn, the net election allows the deduction of depreciation, taxes, and other expenses before applying a graduated tax rate.

A foreign corporation or individual is eligible for the net election if:

- Income is derived from ownership of or an interest in U.S. real property during the taxable year in which the election is made; and
- The foreign individual's interest in or holding of that property is for the purpose of producing income.

The net election only applies to income that would not otherwise be considered E.C.I.

A net election for also exists in tax treaties between the U.S. and other countries. The *2006 U.S. Model Income Tax Convention* provides that a resident of a Contracting State (who is liable for tax in the other country) may make a net election for income from real property in any taxable year. This election provides for tax on income from real property located in that other country to be calculated on a net basis, as if it were business profits attributable to a permanent establishment that country.³⁷

³⁶

26 C.F.R. §1.871-10, 26 U.S.C. §882(d).

³⁷

2006 U.S. Model Income Tax Convention, Article 6(5).



INTEREST

Interest income may be earned on real estate, such as through mortgages and other debts secured by real estate. This income from interest is considered to be passive (*i.e.*, F.D.A.P. income subject to 30% withholding tax). The source of that interest is usually determined by the place the obligor is a resident.³⁸

However, there are several exceptions:

- Interest paid after December 31, 2003 by a foreign partnership predominantly engaged in a foreign trade or business is considered U.S. sourced if it is effectively connected with a U.S. trade or business;³⁹
- Interest paid by a foreign corporation engaged in a U.S. trade or business, which is effectively connected with that U.S. trade or business, is considered U.S.-source income.

On the flipside, the following interest payments made from U.S. debtors to foreign persons are exempt from U.S. income tax:

- Portfolio interest⁴⁰ – The interest on specified debt obligations paid to certain foreign persons is tax free if in registered form:
 - Issuer of investment must be a U.S. person;
 - Holder must be a foreign person providing proof of foreign status;
 - Holder is not a bank extending credit while E.T.B.;
 - Holder that is a “controlled foreign corporation” is not related to the issuer;
 - Holder is not a 10% or greater shareholder of the issuer;⁴¹
 - Interest must not be contingent interest;⁴²
 - Foreign person cannot be from a country that the Secretary of the Treasury has determined to have inadequate exchange of information with the U.S.;
 - Income cannot be E.C.I. and must be F.D.A.P.;⁴³

³⁸ §§861(a)(1) and 862(a)(1).

³⁹ §861(a)(1)(B), as redesignated by P.L. 111-226.

⁴⁰ §§871(h) and 881(c), <http://www.lexisnexis.com/legalnewsroom/tax-law/b/federaltaxation/archive/2013/10/08/portfolio-interest-free-money.aspx>.

⁴¹ The holder does not own (i) 10% or more of the total combined voting power of all classes of stock of the corporation or (ii) 10% or more of the capital or profits interest in a partnership, at the time the interest is received.

⁴² Interest is not treated as contingent if the timing (rather than the amount) of the payment is subject to a contingency. See I.R.C. §871(h)(4)(C).

“U.S.-source dividends are considered to be F.D.A.P. income subject to 30% withholding tax.”

- Underlying debt cannot be treated like equity in the hands of the Holder.
- Interest subject to tax treaties⁴⁴ – Almost all treaties provide for exemption or a reduced rate, which can be claimed by filing a Form W-8BEN with the withholding agent. Among other things, the foreign person must provide:
 - A U.S. Taxpayer Identification Number;
 - Certification that it is the resident of a treaty country;
 - Certification that it is the beneficial owner of the income; and
 - Certification that it meets any applicable limitation on benefits provision contained in the treaty.
- Bank deposit interest;
- Interest paid on a debt instrument that matures in 183 days or less from the date of issue.

Other types of debt instruments, while not providing for tax-free interest, are beneficial because the adverse tax consequences under F.I.R.P.T.A. may not be induced. Principal payments on straight debt instruments investments (interests solely as a creditor) are exempt from F.I.R.P.T.A. rules. A Shared Appreciation Mortgage (“S.A.M.”) requires the borrower to pay a portion of the gain in value of the property in the form of interest. While such instruments are subject to F.I.R.P.T.A., if held to maturity, there is no gain upon repayment of the loan balance or interest.

DISTRIBUTIONS

Dividends

If real estate is owned by a corporation, excess cash flow may be paid in the form of dividends. The source of dividend income is generally determined by the country or state of incorporation⁴⁵ unless certain exceptions apply. Dividends paid by domestic corporations are generally U.S. source; dividends paid by foreign corporations are generally foreign source. Dividends from a foreign corporation, however, may be treated as U.S. source if the corporation is engaged in a U.S.

⁴³ A foreign lender is not considered to be E.T.B. if it buys outstanding mortgages but is E.T.B. if it originates or makes new loans in the U.S. (or is treated as if it does).

⁴⁴ <http://www.irs.gov/Individuals/International-Taxpayers/Claiming-Tax-Treaty-Benefits>.

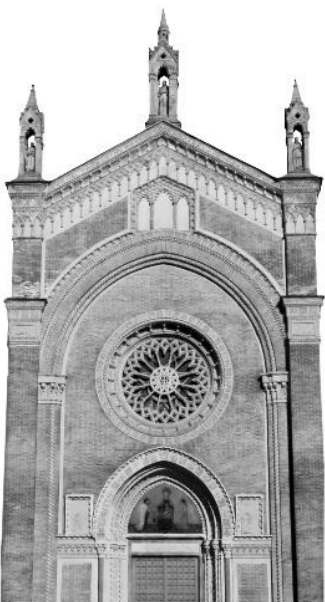
⁴⁵ §§861(a)(2) and 862(a)(2).

trade or business and 25% or more of its worldwide gross income over a three-year period is connected to such U.S. trade or business.⁴⁶

U.S.-source dividends are considered to be F.D.A.P. income subject to 30% withholding tax, which may be reduced or eliminated through applicable tax treaties. Note that a dividend is defined in §316 of the United States Code (the “U.S. Code”) as a payment out of current or accumulated earnings and profits.

A non-dividend distribution by a U.S. Real Property Holding Corporation (“U.S.R.P.H.C.”), discussed more in the next article, will attract a 10% withholding tax (subject to possible reduction if a withholding certificate can be obtained from the I.R.S.) pursuant to §1445(e)(3) of the U.S. Code. Special rules apply to Real Estate Investment Trust (“R.E.I.T.’s”).

The next article will look at tax consequences that arise during disposition.



⁴⁶

§861(a)(2)(B).