TAX 101:

UNDERSTANDING U.S. TAXATION OF FOREIGN INVESTMENT IN REAL PROPERTY – PART III

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Disposition
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INTRODUCTION

This is the final article in a three-part series that explains U.S. taxation under the Foreign Investment in Real Property Tax Act of 1980 ("F.I.R.P.T.A."). This article looks at certain planning options available to taxpayers and the tax consequences of each.

These planning structures aim to mitigate taxation by addressing several different taxable areas of the transaction. They work to avoid gift and estate taxes, and double taxation of cross-border events and corporate earnings, while simultaneously striving for preferential treatment (*e.g.*, long-term capital gains treatment), as well as limiting over-withholding, contact with the U.S. tax system, and liability. Often, such structures are helpful in facilitating inter-family transfers and preserving the confidentiality of the persons involved.

PRE-PLANNING

As with everything else, planning can go a long way when it comes to maximizing U.S. real estate investments. Here are a few questions to ask:

Investor Background

1. Where is the investor located?
2. Where is the investment located?
3. What kind of business is the investor engaged in?

No planning can take place without asking these questions. Not only is it important to determine whether the investor's home country is relevant and whether treaties that eliminate taxes or limit benefits are applicable but also whether the investor has ties to the U.S. that could change applicable tax status. In addition, the investor's background can affect withholding and compliance requirements as well as estate and gift taxes that may be incurred.

Investment Objectives

1. What is the investment being held for?

Whether an investment is held for personal use, such as real estate being used as a residence, or for business use affects the tax treatment of the income derived from the investment.

A foreign person may decide to purchase a home in the U.S. for a number of reasons, *e.g.*, temporary stays, short-term vacation homes, job postings or for their children who may be U.S. citizens, residents or students. The tax implications that apply to a purchase of a U.S. property for personal use by a foreign person are complex in their own manner.[1]

If an investment is because held for business or investment purposes, it will, or will have the potential to, produce some sort of income. As we saw in the first article of this series, different types of income are taxed differently.[2] Income must be identified as rent, interest, dividends, capital gains, or portfolio interests. The investment objective will determine whether the capital invested is held as equity or debt, as well as the type of entity that should hold the investment. Finally, the duration and method of exit should to be determined before an investment terminates.

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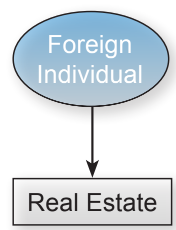
STRUCTURED INVESTMENT OPTIONS

This section will look at a few of the planning options available to foreign persons when considering investing in U.S. real property.[3]

Option 1



Although directly owning U.S. real estate may seem like a simpler transaction than a structured holding, the tax consequences can be severe for a foreign person.

If the foreign person's ownership of U.S. real estate is part of a U.S. trade or business, current net rental income will be taxed at ordinary income tax rates.3 If the foreign person is not involved in a U.S. trade or business (and does not elect to be so treated), a 30% withholding tax on the gross rental income will apply.

A 10% F.I.R.P.T.A. withholding tax applies to a transfer of U.S. real estate by a foreign person. While the withholding tax is calculated based on the amount realized on the sale, the actual tax on disposition can be higher or lower depending on the amount of gain realized upon the transfer.

The potential U.S. estate tax consequences are the key disadvantage. On the death of the foreign person, U.S. estate tax of approximately 40% can apply.

U.S. tax laws provide for only a $60,000 exemption from said tax, although an estate tax treaty may provide a different result. Consequently, a foreign person may want to consider planning the investment through an entity or procure life insurance to provide liquidity upon death for any U.S. estate tax.

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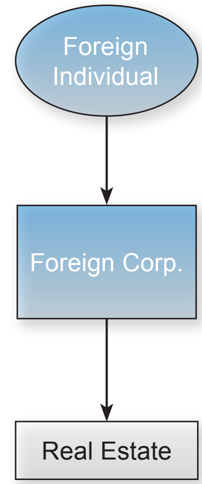
1 See *TAX NOTES*, Sept. 3, 2007, p. 863, "Home Thoughts From Abroad: Foreign Purchases of U.S. Homes."

2 See *Insights* Vol. 1 No. 10, "Tax 101: Understanding U.S. Taxation Of Foreign Investment In Real Property – Part I."

3 See "Foreign Ownership of U.S. Real Estate."

4 See *Institutional Investment Real Estate Magazine*, "Tax Structuring of Foreign Investment in U.S. Real Estate."

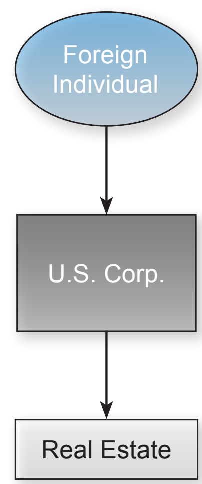
Option 2



Although the corporate level taxes on current income may be slightly lower than the maximum rates applicable to individuals, taxes on the sale of real estate and repatriation of funds may be higher for a corporation owning U.S. real property. In addition, current income and income from the disposition may be subject to an additional branch profits tax of up to 30%, and even when branch profits tax does not apply at the sale and wind-up of the U.S. investment, the sales proceeds must be kept out of the U.S. for three years and the statute of limitations must be extended to six years. If this is not done, branch profits tax can be imposed on the gains and deferred branch profits tax can be triggered.

However, owning U.S. real estate through a foreign corporation also has its advantages. The sale of stock in the foreign corporation will be tax-free to a nonresident alien individual or foreign corporate holder, and U.S. estate tax will not apply where the real property owner is a foreign corporation rather than an individual. The nonresident alien individual decedent holds an interest only in non-U.S. situs property, and therefore, the asset is not subject to U.S. estate tax.

Option 3



Although owning U.S. real estate through a U.S. corporation will eliminate the branch profits tax, the holding will incur tax on all other fronts and is ordinarily not recommended.

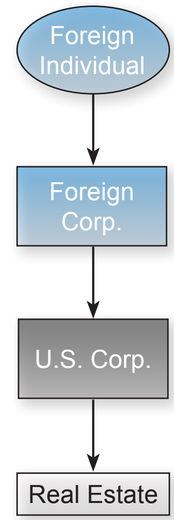
The sale of stock in a U.S. corporation owning exclusively U.S. real estate is taxable since it would constitute the sale of a F.I.R.P.T.A. asset. Distributions by the U.S. corporation may be subject to a 30% withholding tax. The withholding tax may be reduced by treaty.

Shares of a domestic corporation are U.S.-situs property for U.S. estate tax purposes. The single level corporation does not shield the real property from being subject to estate tax in the absence of an estate tax treaty. Regrettably, relatively few estate tax treaties exist in comparison to income tax treaties and fewer still are in the process of being negotiated.

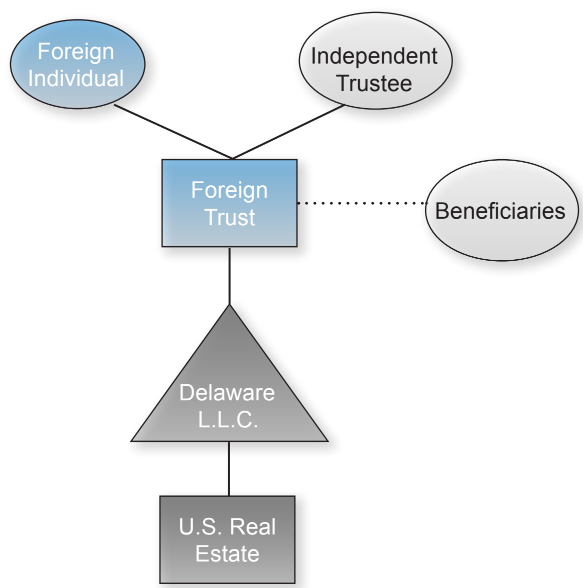
Option 4

A triple tiered investment (where a foreign individual owns stock in a foreign corporation that, in turn, owns a U.S. corporation holding real estate) is a commonly recommended structure, with significant tax advantages.

Branch profits tax will not be applicable, although dividend distributions may attract a withholding tax. However, liquidating distributions after the sale of all U.S. real property interests by the U.S. corporation will not attract U.S. withholding tax. In addition, U.S. estate or gift tax will not apply. However, cash distributions to shareholders funded by the proceeds of a refinancing will probably be taxed.[5]



Option 5

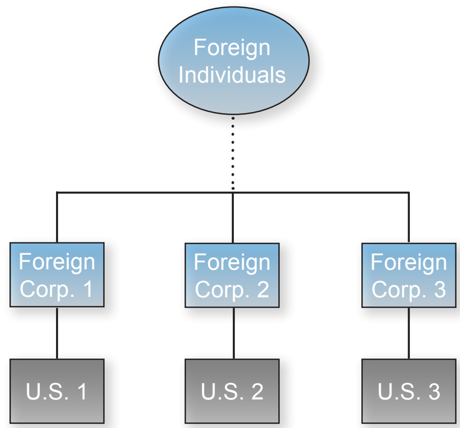


In this structure, a foreign trust is used to own U.S. real estate through a Delaware L.L.C. The trust will be treated like an individual for tax purposes (subject to the individual, not corporate, rates), and the transfer of cash is not subject to a gift tax, if properly structured. Assets in the trust are not subject to estate tax at the time of demise provided that the taxpayer did not retain the right to income during lifetime, the trust is not revocable or amendable, and the individual does not retain any dominion or control over the trust or its assets. A foreign trust is not subject to net investment income tax.

5 *Id.*

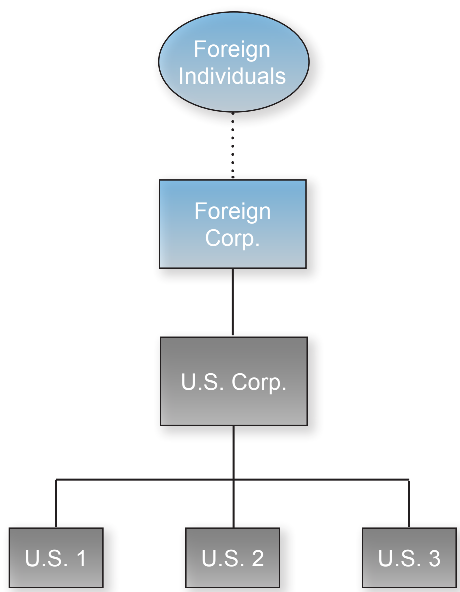
Multiple Property Structures

Option 1



The advantage of brother-sister corporations owned by separate foreign corporations is the ability to sell one property and distribute the proceeds free of further U.S. withholding tax. Gains and losses from one U.S. property cannot be offset against gains and losses of another U.S. property.

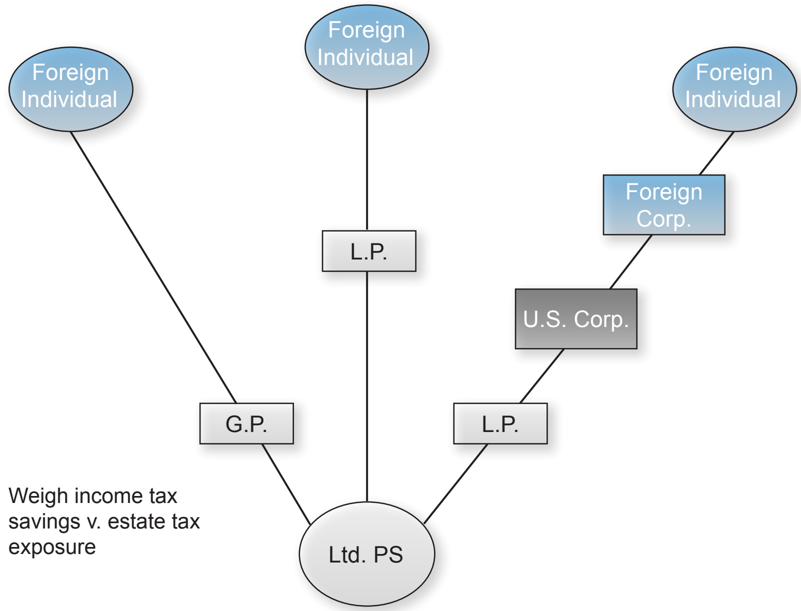
Option 2



The advantage of creating a U.S. consolidated group permits gains and losses of each property to offset each other, potentially saving tax dollars on a current basis. However, a distribution of sales proceeds may be subject to U.S. withholding tax if the group continues to own U.S. real property.

> ***"The advantage of creating a U.S. consolidated group permits gains and losses of each property to offset each other."***

Traditional Partnership Structure



Note that in this structure, there is an investment in a U.S. flow-through entity (a partnership) owned indirectly by an individual using the structure in Option 4.

FINANCING CONSIDERATIONS

Debt Equity

Being financed through debt gives an entity the opportunity to deduct some of the interest payment and reduce the overall tax obligation.[6] The I.R.S. will look at debt-or-creditor relationships carefully where the parties are related to make sure these loans are not equity disguised as debt.

To ensure financing of real estate is not classified as equity, certain guidelines must be followed. All of the loans should be documents, and the overall terms should be at arm's length. The payment terms must be achievable, and the interest rates reasonable. The terms should be observed and lender must take steps an unrelated lender would take to monitor and enforce the loan. It is generally prudent to pay interest at least annually and to amortize some portion of the loan balance.

Earnings Stripping – "Disqualified Interest"[7]

Earnings stripping reduces the amount of taxable income by paying excess interest to related third parties, known as Disqualified Interest. Section 163(j) aims to limit deductions for Disqualified Interest but may only do so if the debt/equity ratio exceeds 1.5 to 1.

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6 See *Insights* Vol. 1 No. 3, "Tax 101: Financing a U.S. Subsidiary – Debt vs. Equity."

7 §163(j).

Disqualified Interest comes in three forms:

1. Untaxed interest paid to a related person;
2. Interest paid to a third party when no U.S. gross basis tax is imposed and the debt is supported by a foreign related person; and
3. Interest paid by a taxable R.E.I.T. subsidiary to a R.E.I.T.

Earnings stripping limits the deduction for net interest expense to 50% of "adjusted taxable income," which is the functional equivalent of E.B.I.T.D.A. with a limited number of adjustments. Excess interest is carried forward to future years.

Applicable High Yield Debt Obligation ("A.H.Y.D.O.")[8]

A.H.Y.D.O. applies if:

- The borrower is a corporation;
- The term exceeds five years; and
- The original issue discount is at a rate greater than AFR + 5%.

"The branch profits tax generally applies if the foreign corporation directly owns the U.S. property."

Where these factors exist, the excess interest (*viz.*, interest in excess of AFR + 5%) is non-deductible. If the lender is related, the non-excess is not deducted until it is paid. If the lender is related, §267(a)(3) interest and §163(e)(3) original issue discount ("O.I.D.") defer deduction until interest is paid.

Branch Profits Tax Considerations

Branch profits tax is the tax applied to earnings from a foreign corporation's branch entity in the U.S. The branch profits tax generally applies if the foreign corporation directly owns the U.S. property. It is a 30% tax paid in addition to income tax paid by a foreign corporation abroad, unless reduced by treaty.

The tax may not adversely affect foreign investors in U.S. real property if the foreign corporation directly owns U.S. real estate and that property is not income producing. A branch profits tax may apply when that property is eventually sold, unless all U.S. operations are terminated and the conditions mentioned above are met.[9]

Generally, the branch profits tax is eliminated by having a U.S. corporation own all of the U.S. income-producing real property.

Like-Kind Exchanges[10]

Section 1031[11] allows for the deferral of tax if the gain from the disposition of real property is reinvested in similar property that constitutes a "like-kind exchange." Most fee interests in real estate are like-kind to each other, including improved-to-unimproved property and residential-to-commercial property, provided they are used in a trade or business or are held for investment. In addition, a lease of 30 years or more is considered like-kind to a fee interest. While foreign properties can be

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8 §163(e)(5) & (i).

9 See "Branch profits tax for nonresident investors in U.S. real estate."

10 See "Like-Kind Exchanges Under IRC Code Section 1031."

11 §1031.

exchanged for each other, U.S. and non-U.S. property are not treated as like-kind.

Like-kind exchanges are not limited by taxpayer type. Any taxpayers may participate in a like-kind exchange.

There must be an exchange of properties to fall under a like-kind exchange. The different types of exchanges are as follows:

- Swaps: One property is 'swapped' for another, *e.g.*, a building for a building;
- Deferred Exchanges: A disposal of property is followed by the acquisition of one or more other like-kind replacement properties. A disposal and subsequent purchase is usually taxable. However, for a like-kind exchange, the transactions must be mutually dependent parts of an integrated transaction constituting an exchange of property. Qualified intermediaries are generally used to effect a non-simultaneous like-kind exchange; and
- Reverse Exchanges: Replacement property is acquired through an exchange accommodation titleholder with whom it is parked for no more than 180 days, during which the previous property is relinquished.

As mentioned above, the properties involved must be held for use in a trade or business or for investment. Property used for personal use does not qualify. The properties must be of a similar nature, character, or class to qualify as like-kind. Most real estate will usually be considered like-kind to other real estate except for non-U.S. property. Real property is never considered like-kind to personal property.

There is a 45-day limit from the disposition of one property in which to identify potential replacement properties in writing to the seller of the replacement or intermediary. In addition, the replacement property must be received and the exchange completed within the earlier of 180 days of the sale of the exchanged property or the due date of the income tax return of the year.

The gain in a like-kind exchange will be deferred and the taxpayer must keep track of the basis in the new property. The basis will be the same as the basis of the property disposed of, which will preserve the deferred gain for later. On the other hand, the resulting depreciable basis of the replacement property will be calculated as much lower than if the property was acquired in a taxable transaction.

"Like-kind exchanges are not limited by taxpayer type. Any taxpayers may participate in a like-kind exchange."

A like-kind exchange must be reported on a Form 8824; otherwise, the taxpayer may be held liable for taxes, penalties, and interest.

Section 1031 exchanges involving a F.I.R.P.T.A. asset are subject to F.I.R.P.T.A. withholding unless certain exceptions apply. It is not uncommon to obtain a withholding certificate if there is no tax due or if the tax on the exchange is less than the amount required to be withheld.

CONCLUSION

Foreign investment in U.S. real property is fraught with minefields. However, there are a number of options available to individuals and corporations. These structures maximize treaty benefits and limit tax liability when exercised in the proper manner. But they require detailed planning and may affect other corporate or personal transactions.