A CONCISE GUIDE TO ACQUISITION VEHICLES FOR THE PURCHASE OF U.S. REAL ESTATE BY FOREIGN INDIVIDUALS[1]

Author
Nina Krauthamer

Tags
Estate and Gift Tax
Foreign Corporation
Foreign Investment
Foreign Trusts
Real Estate
Partnership

Purchases by foreign individuals of U.S. real estate for personal use, investment, or development continue to boom. Those individuals will face particular U.S. income, estate, and gift tax issues. Choice of a proper investment vehicle is critical.

Direct ownership by the foreign individual is generally discouraged, as it may create the need for an ancillary probate proceeding in the state where the property is located as a condition of a transfer in the event of the death of the individual. Ownership of the real estate at death or ownership through a disregarded entity, such as a single-member L.L.C., could result in onerous U.S. estate taxes of roughly 40%, plus possible state estate taxes, as well. In this regard, it is imperative to analyze (i) the income, estate, and gift taxes of the individual's country of residency (with the help of local counsel) and (ii) the possible application of an estate tax treaty between the U.S. and the individual's country of residence. U.S. estate tax treaties may change the situs rules for the imposition of the estate tax (althought not ordinarily in the case of real property), may offer an enhanced exemption from tax or a marital deduction, and, of equal importance, may require that the home country permit a credit against the estate tax imposed by the other taxing jurisdiction. Extensive U.S. tax planning may not prove to be necessary if the home country's estate tax is comparable to the U.S. estate tax and a credit for U.S. tax is available in the home country.

It is important to consider whether the individual will be using his or her own funds to make the acquisition, or whether the acquisition will be financed by borrowing. If the individual can procure nonrecourse financing to purchase the property (ordinarily difficult in a personal context), the amount subject to U.S. estate taxes would be limited to the fair market value of the property net of the amount of the nonrecourse financing.

Several structures are potentially available to hold a U.S. real estate investment. They include the following.

TWO-TIER STRUCTURE

In the case of development property, where it is likely that the income to be realized is ordinary income, a two-tier corporate structure is quite popular. Typically, the foreign individual (or a foreign trust) owns a foreign holding corporation (sometimes referred to as a "foreign blocker"), which in turn owns a U.S. real estate corporation. (Use of a U.S. L.L.C. is not desirable, as a single-member L.L.C. would be disregarded, and therefore, the foreign corporation would be treated as owning the property for U.S. tax purposes.) Stock of a foreign corporation is treated as a

---

[1] This article was originally published in the November 2015 edition of the ABA Section of Real Property, Trust and Estate Law's *RPTE eReport* and has been altered for this publication.

non-U.S. situs asset and therefore not subject to U.S. estate tax. The corporate formalities imposed under the laws of the jurisdiction of the foreign corporation (and consistent with U.S. tax principles) associated with ownership by a corporation must be carefully observed.

This two-tier corporate structure may be used for other types of acquisitions if estate tax certainty is an important goal. If the U.S. real estate is personal use property, some practitioners recommend that the property be rented for fair market value, supported by a broker's market analysis, and that the rent be used to pay all operating costs and carrying charges. Other practitioners believe that for personal use property, rent could be limited to the operating costs and carrying charges; some practitioners believe that rent need not be charged at all.

"Foreign trusts are often desirable in the case of personal use property or long-term passive real estate investments where it is desirable to capture the lower capital gains rates applicable to individuals (and trusts)."

Gain on the sale of the property would be subject to tax at the corporate rates of tax (35% Federal and, *e.g.*, approximately 12% N.Y.S. and N.Y.C. after consideration of the Federal deduction), which are higher than the rates applicable to sales of U.S. property by nonresident, non-citizen individuals, and foreign trusts (20%, or 25% on depreciation recapture, Federal and, *e.g.*, approximately 9% N.Y.S.). After a sale, cash can be distributed without further tax if the U.S. real estate corporation is liquidated; cash distributions in a non-liquidation context could be taxed as dividends, subject to U.S. withholding tax. This structure provides for a high level of U.S. estate tax certainty but at a cost of higher income tax rates in certain circumstances.

ONE-TIER STRUCTURE: FOREIGN CORPORATION

For personal use property, some practitioners recommend a one-tier foreign corporate structure whereby a foreign corporation purchases personal use property directly (or through a single-member L.L.C.) for use by shareholders of the corporation, with rental at less than full fair market rent. Those practitioners believe that, at worst, the foregone rent would be treated as a disguised dividend to the shareholder – generally with no adverse U.S. tax consequences, as a dividend by a foreign corporation is not subject to U.S. withholding tax. Other practitioners believe that there could be a risk that under these circumstances the I.R.S. may impose both a corporate tax and an additional branch profits tax on imputed rental income. A sale of the property would give rise to tax on gain at the corporate rates above, although the additional branch profits would not apply if the corporation terminates its U.S. business (and certain other conditions are met).

FOREIGN IRREVOCABLE DISCRETIONARY TRUST

Foreign trusts are often desirable in the case of personal use property or long-term passive real estate investments where it is desirable to capture the lower capital gains rates applicable to individuals (and trusts). Generally, a purchase of U.S. real property by a trust with cash contributed to the foreign trust by a foreign individual would not trigger adverse U.S. estate or gift tax consequences where the individual retains no rights to the income or assets of the trust. A foreign trust is defined by the U.S. tax laws to mean any trust that is not a "domestic" trust. A trust will be considered domestic if (i) a U.S. court can exercise primary supervision over trust administration (the "Court Test") and (ii) U.S. persons control all substantial trust decisions (the "Control Test").

It is ordinarily not necessary to rent personal use property at full fair market rental, unless the intended user is a U.S. person. In that case, a failure to charge rent would be treated as a distribution to the U.S. person in the amount of the fair market value of the use of such property.

It is possible for the settlor (grantor) of the trust to be a potential beneficiary of the trust without causing a U.S. estate tax inclusion upon the death of the settlor (grantor). This generally requires an institutional trustee and no "understanding" as to the settlor's entitlement to discretionary distributions of income or capital. The settlor cannot be a trustee or trust protector. Essentially, the grantor loses control over the property and proceeds from its sale. Any use of the property by the settlor would require the payment of rent at full fair market value.

Tax on the sale of the property is calculated using the rates applicable to individuals (the 3.8% "net investment income tax" does not apply to foreign individuals and foreign trusts). Withholding under the Foreign Investment in Real Property Tax Act of 1980, or "F.I.R.P.T.A.," (generally under recent law changes a 15% withholding tax upon the sale of U.S. real estate by a foreign person) would be applicable in the event of a sale or distribution of the U.S. property. Generally, the cost of establishing and maintaining a foreign trust may prove to be higher than the cost of establishing and maintaining a foreign corporation.

A U.S. trust may also be a suitable vehicle, although in that case, capital gain income would attract the additional "net investment income tax" unless distributed to a foreign individual. F.I.R.P.T.A. withholding would not apply.

FOREIGN GRANTOR TRUST

A foreign individual will be treated as the owner of U.S. real property, subject to the favorable income tax rates applicable to individuals, if the property is owned by a grantor trust. In the case of a foreign individual grantor, a trust will be so treated if either the grantor reserves the right to revoke the trust solely or with the consent of a related or subordinate party (and revest title to the assets to himself), or the amounts distributable during the life of the grantor are distributable only to the grantor and/or the spouse of the grantor. The individual is treated as the owner of the property for U.S. income tax purposes and there is no need to rent the property.

This structure does not afford protection against U.S. estate tax. It is recommended for those individuals who can procure life insurance (generally term insurance) at a reasonable cost to provide for estate taxes upon the death of the individual. While the U.S. real estate is subject to U.S. estate tax, life insurance proceeds with respect to nonresident, non-citizen individuals are not subject to U.S. estate tax.

If a residuary beneficiary of the trust is a U.S. person, it is important that the grantor retain the right to direct the income of the trust to achieve a step-up in basis upon the death of the grantor, reducing the tax on a future actual sale of the property.

PARTNERSHIPS AND MULTI-MEMBER L.L.C.'S

A partnership, or a multi-member L.L.C. taxed as a partnership, is a flow-through entity for U.S. tax purposes. Investment in U.S. real estate through such a vehicle would afford the individual member or partner the lower capital gains rates

applicable to individuals if the real estate is a capital asset. However, ownership of U.S. real property through a U.S. or foreign partnership is generally discouraged because of the uncertainties concerning the situs of a partnership interest for U.S. estate tax purposes, as well as a potential withholding tax applicable to foreign partners. Some practitioners believe that a case can be made for the non-U.S. situs of an interest in a foreign partnership. If the underlying assets of the partnership are situated in the U.S., while there is no specific statutory authority, an interest in a foreign partnership may be subject to U.S. estate tax if the death of a partner causes dissolution of the partnership under local law, or even if it does not, if the partnership carries out business in the U.S. Certain estate tax treaties with the U.S. may offer relief from taxation.

Investment in U.S. real property by a foreign individual requires a careful examination of an appropriate acquisition vehicle. It is often challenging to structure an acquisition that can minimize exposure to both income and estate taxes. However, a failure to consider U.S. taxes could result in an onerous tax burden for the foreign investor.

"Ownership of U.S. real property through a U.S. or foreign partnership is generally discouraged because of the uncertainties concerning the situs of a partnership interest for U.S. estate tax purposes."

Disclaimer: *This newsletter has been prepared for informational purposes only and is not intended to constitute advertising or solicitation and should not be relied upon, used, or taken as legal advice. Reading these materials does not create an attorney-client relationship.*