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Journal of Taxation of Investments
Vol. 32, No. 3, Spring 2015
Authorized Reprint

Foreign Investment in U.S. Real Estate—Think About Taxes Before Investing

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Foreign investors in U.S. real estate or mortgage debt face the specter of U.S. income taxes, as well as estate and gift tax exposure, not to mention state and local taxes. Even after the Foreign Investment in Real Property Tax Act, however, with careful planning foreign investors can limit—or possibly avoid—U.S. tax liability. This article provides an overview of the applicable tax law and then outlines a number of acquisition structures that may materially improve a foreign investor's post-tax return from investment in the U.S.

Introduction

A foreign investor's decision to invest in U.S. real estate may sometimes be made without full consideration of all potential U.S. taxes. An advisor may be aware of the landmark 1980 legislation called the Foreign Investment in Real Property Tax Act (FIRPTA)[1] and advise clients that U.S. tax is inevitable if they are to acquire and dispose of U.S. real estate. However, that view overlooks the current complexity of U.S. federal, state, and local income, estate, and gift taxes and how they apply to income from operating the real estate and its sale as well as to mortgage debt. With proper planning, foreign investors can structure how they will own, operate, and ultimately sell their investments in a way that can materially reduce or eliminate U.S. taxes. However, the path to achieve such goals is complex. After first exploring this complex structure and describing situations where there is flexibility that can be a trap for the unwary or an opportunity for the well informed, this article suggests multiple acquisition structures that may materially improve an investor's post-tax return from investment in the U.S.

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[1] IRC § 897. See also infra note 57 and accompanying text.

Who Is a Foreign Investor?

The U.S. tax system treats its tax residents very differently from, and more harshly than, non-residents. U.S. tax treatment is different from that of many foreign countries, and may be a trap for foreign investors who spend considerable time in the U.S. making and monitoring investments or residing at homes they may purchase. Individuals who are U.S. citizens or resident aliens are subject to U.S. taxation of their worldwide income.[2] For these investors, the U.S. will tax income from a real estate investment in California or in Costa Rica or wherever else the investor may own property. By contrast, if the individual investor can avoid being a resident alien or citizen, U.S. taxation is limited to that income having a nexus with the U.S., as discussed below.[3]

A "nonresident alien" is an individual who is neither a U.S. citizen nor a U.S. resident.[4] A U.S. resident includes a person who is a U.S. permanent resident (a green card holder under U.S. immigration law) or an individual who spends a substantial amount of time in the U.S., determined under a test known as the "substantial presence" test.[5] This test has two components. The test's first prong creates an irrebuttable presumption that a foreign individual is a resident if that person spends more than 183 days in the U.S. in a given year. The second prong creates a rebuttable presumption that a foreign individual is a U.S. resident if he or she spends "too much time" in the U.S. over a three-year period, determined by applying a complicated test based on days spent in the U.S. over the three-year period.[6] Tax treaties, if applicable, can sometimes override residency status.[7] Any foreign individual who comes to the U.S. (other than on sporadic, temporary occasions)

[2] Treas. Reg. § 1.1(h)-1(b). Worldwide taxation also applies to U.S. corporations. IRC § 11(a); Treas. Reg. § 1.11-1(a).

[3] See infra notes 8–31 and accompanying text.

[4] IRC § 7701(b)(1)(B).

[5] IRC § § 7701(b)(1)(A)(i), (ii), (b)(3). Certain individuals who satisfy neither of the tests but who will satisfy the substantial presence test in the following tax year as well as a complex set of other rules may elect to be treated as residents. IRC §§ 7701(b)(1)(A)(iii), (b)(4).

[6] In particular, an individual is presumed to be a U.S. resident if the aggregate number of days spent in the U.S. in a three-year span is 183 days or more. For this purpose, each day in the current year is counted but only one-third of the days in the first preceding year and one-sixth of the days in the second preceding year. Take, for example, a person who spends 122 days annually in the U.S. in 2015, 2014, and 2013. Under this test, the person is treated as spending 122 days in the U.S. in 2015, 41 days in 2014, and 21 days in 2013, or an aggregate of 184 days. Thus, the person will be presumed to be a resident for 2015. The presumption can be rebutted, however, by a showing that the person has both a "tax home" and a "closer connection" to a foreign country than to the U.S., provided that in no event did he or she spend more than 183 days in the U.S. in the year in question. IRC § 7701(b)(3)(B).

[7] E.g., U.S.-Australia Treaty art. 4(2)(the "tie breaker" rule).

should keep track of the days spent in the U.S. and document that time in a written diary or calendar, and keep other records to substantiate the time spent in and outside the U.S. This record keeping can help the investor substantiate that he or she is not a U.S. resident, which would be useful in the event of an IRS inquiry and request for support to show why residency does not exist.

U.S. Income Taxation of the Foreign Investor

The U.S. taxes foreign investors under one of two basic income tax regimes, described below.

Passive Income. If a foreign investor receives income of a type that is referred to as fixed or determinable annual or periodic (FDAP) income, such as dividends, interest, rents, and royalties,[8] and the income has a U.S. source (such as dividends paid by a U.S. corporation, interest paid by a U.S. person, and rent for property located in the U.S.),[9] the U.S. imposes a 30 percent tax on the gross amount of such income.[10] This class of income can be viewed as passive income, although that term is not used in the Internal Revenue Code. In order to insure that this tax is paid, the U.S. imposes on the U.S. payor, who is referred to as the withholding agent, the obligation to withhold this 30 percent tax from the payment made to the non-U.S. investor and remit it to the IRS.[11]

Exceptions to Tax. There are three main exceptions to this withholding tax:

1. *U.S. tax treaties can reduce or eliminate this withholding tax.*[12] Reliance on a tax treaty must be claimed by delivering to the

[8] The scope of affected income includes "interest (other than original issue discount as defined in [S]ection 1273), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income." IRC § 871(a)(1)(A).

[9] See IRC § 861.

[10] IRC §§ 871(a), 881(a). Where a debt instrument has original issue discount (e.g., interest is not paid currently but accrues and is paid at maturity of the loan), then the 30 percent tax may also apply to a sale of the debt obligation or a payment of principal on the debt. IRC § 871(a)(1)(C).

[11] IRC §§ 1441, 1442.

[12] IRC § 894. For example, Article 11(1) of the U.S.-U.K. Treaty provides for an exemption from U.S. withholding tax on interest while Article 10 of the Treaty can lower the withholding tax on dividends to 15 percent or 5 percent, or even exclude the dividends from tax. The U.S. has several dozen other income tax treaties that can provide similar benefits. However, each treaty contains its own limitations on use that need to be met in order to get treaty benefits.

withholding agent an appropriate Form W-8.[13] In addition, reliance on a treaty to reduce or eliminate the tax on interest paid to related parties could trigger the "earnings stripping" rules, which can reduce or eliminate the tax deduction that otherwise would be available to the borrower.[14]

2. *This tax is eliminated if the income is taxed under the active income category* (discussed below).[15] Reliance on this exception must be claimed by delivery to the withholding agent of Form W-8ECI.

3. *This tax is eliminated for interest income that is classified as "portfolio interest."*[16] The portfolio interest exemption is a broad exclusion applicable to debt that is in registered form, provided that the lender is not (1) a bank lending in the ordinary course of its business, (2) a 10 percent or more shareholder in the borrower, or (3) a controlled foreign corporation that receives interest from a related person. The 10 percent or more shareholder prohibition[17] (which also applies to partnerships) can be an obstacle but one that may be surmounted.[18] The portfolio interest exclusion does not, however, apply to contingent interest.[19] Reliance on this exception must be claimed by delivery of a Form W-8 and a statement that all the applicable conditions for its use are met. In addition, use

[13] A foreign individual would give a Form W-8BEN; a foreign entity (that is not an intermediary) would give a Form W-8BEN-E; a foreign entity that is an intermediary (such as a partnership or trust) would give a Form W-8IMY; and a foreign government and certain other foreign organizations would give a Form W-8EXP. Reliance on a treaty is subject to various conditions (e.g., every treaty has a limitations on benefits clause that must be met) and the appropriate Form W-8 requires certification that the treaty, the relevant article allowing for reduced taxation, and all other conditions for use of the treaty are met.

[14] IRC § 163(j) applies if (1) the corporation has either (a) interest expense paid or accrued to a related person for which a tax treaty reduces the applicable withholding tax or (b) interest owed to an unrelated person for which there is a guarantee by a related person, and such guarantor is eligible for treaty relief if interest were paid to it directly; (2) the corporation has "excess interest"; and (3) the corporation's debt-to-equity ratio exceeds 1.5 to 1. Excess interest is defined to be the excess of (1) the corporation's net interest expense over (2) the sum of the corporation's "adjusted taxable income" plus any excess interest carryforward from preceding years. Adjusted taxable income is defined to be taxable income with certain adjustments (such as an add-back for depreciation taken).

[15] IRC §§ 1441(c)(1), 1442(b).

[16] IRC §§ 871(h), 881(c).

[17] IRC §§ 871(h)(3), 881(c)(3)(B).

[18] See infra notes 146–147 and accompanying text.

[19] IRC §§ 871(h)(4), 881(c)(4).

of this exemption could trigger the "earnings stripping" rules discussed above.[20]

Liquidating Distributions vs. Dividends. A distribution paid by a corporation after it has adopted a plan of liquidation is *not* a dividend subject to 30 percent withholding tax.[21] Such a distribution also is not subject to FIRPTA withholding *unless* the corporation is a U.S. real property holding company.[22] As will be discussed later,[23] liquidating distributions can escape FIRPTA tax with proper planning.

Investment Funds—Partnerships/LLCs. Many foreign persons invest in investment funds (e.g., private equity funds) that hold U.S. stock and debt investments. Funds formed as partnerships (or limited liability companies (LLCs) that are treated as partnerships for tax purposes[24]) are tax transparent; income is not taxed at the partnership level, but is allocated to each of its partners who then must pay U.S. tax, if applicable, on his or her share of the income.[25] Where the fund is a U.S. partnership/LLC that has U.S.-source passive income (such as dividends from a U.S. corporation), the partnership would become the withholding agent that is required to collect the 30 percent tax with respect to the investor's share of the partnership's investment income.[26]

Many investment funds are created using a master-feeder structure. The master fund is structured as a partnership; it holds all the investments and has two investors, each of which is a feeder fund. One feeder fund is a U.S. partnership/LLC; U.S. persons invest their money in this partnership. The second

[20] See supra note 14 and accompanying text.

[21] Treas. Reg. § 1.1441-3(c)(2)(b).

[22] Treas. Reg. § 1.1445-5(e)(2). See infra notes 74–84 and accompanying text.

[23] See infra notes 142–143 and accompanying text.

[24] Under the check-the-box regulations dealing with the characterization of an entity as either a corporation, partnership, or disregarded entity, (1) a domestic LLC (e.g., a Delaware LLC) with more than one member is treated as a partnership unless it files an election to be treated as a corporation, and (2) a foreign LLC with more than one member is treated as a corporation unless it files an election to be treated as a partnership. Treas. Reg. §§ 301.7701-3(b)(1)(i), (2)(i)(A). However, if the partnership has more than 100 members, then it may be reclassified as a corporation under the publicly traded partnership rules of IRC § 7704. Many real estate partnerships that have interest, dividend, or rental income can be structured to fall within the "qualifying income" exemption to these rules under IRC § 7704(c).

[25] IRC §§ 701–703. The rules require separately stating various items of income, gain, deduction, and loss, preserving the character of such items when they are passed through to the partners.

[26] The three exceptions to this tax discussed above (e.g., treaty, active income, or portfolio debt) can also apply here. See supra notes 12–18 and accompanying text.

feeder fund is often an offshore corporation; non-U.S. persons invest their money in this offshore feeder fund. The two feeder funds then contribute the cash that they got from their investors to the master fund, which acquires investments. In this case, the offshore feeder fund is a "blocker" corporation; it prevents the non-U.S. person from having to deal with U.S. taxes. In this case, the foreign investor is not directly confronted with the 30 percent withholding tax, which is now an issue between the master partnership and the offshore corporate feeder fund.

Active Income. If the investor conducts business in the U.S., either directly or through (1) employees or agents or (2) ownership of U.S. rental property, that activity may cause the investor to be engaged in a U.S. trade or business (ETB). If the investor is ETB, any income that is effectively connected with that trade or business (ECI) is subject to regular U.S. tax.[27] The term active income is not used in the Code, but is rather used in a descriptive sense for this type of income.

Tax Base and Rates. ECI is taxed at the regular graduated tax rate structure applicable to U.S. investors (maximum rate of 39.6 percent for individual investors and 35 percent for corporate investors), and the tax is imposed on taxable income rather than gross income so the investor can claim applicable deductions to lower the U.S. tax burden (such as business expenses, depreciation, and interest).

Imposition of this tax requires the foreign investor to file an annual income tax return and to make regular and estimated tax payments. Tax treaties can reduce or eliminate the passive income tax, but generally do not eliminate tax on income from U.S. real property or gain from its sale.[28]

Investment Funds—Partnerships/LLCs. If a foreign investor is a partner in a partnership (or member of an LLC that is treated as a partnership for tax purposes) that has ECI (e.g., the partnership owns several parcels of income-producing U.S. real estate), the investor's share of that income is also ECI.[29] While investors who have ECI are not usually subject to any U.S. withholding taxes, if a partnership has a foreign investor and ECI, the partnership is required to withhold tax on the foreign investor's share of that ECI.[30] This withholding is done at the maximum tax rate so it can exceed the

[27] IRC §§ 871(b), 882(a).

[28] E.g., U.S.-U.K. Treaty arts. 6 (income from real property), 13 (gains).

[29] IRC § 875; Treas. Reg. § 1.875-1.

[30] IRC § 1446.

investor's actual tax liability, and this withholding is required even if no cash distributions are made to the investor. This withholding does not excuse the foreign investor from filing an annual tax return and paying any added tax that may be due.[31]

Making the Active vs. Passive Income Distinction

The first question to be addressed is whether the foreign investor has active or passive U.S.-source income from the U.S. investment. In more technical terms, do the U.S. activities rise to the ETB level so as to make the U.S.-source income ECI, or is the income caught by the FDAP category subject to potential 30 percent U.S. withholding tax? Where the investor holds stock of a U.S. corporation, that status will not make the investor ETB, and the dividend generally falls under the passive income category. However, rent, interest, and certain other cases pose potential concerns since the line between passive income and active income can be blurry.

Rental Income. Rental income is listed as an FDAP income item subject to the 30 percent withholding tax. However, if the investor's ownership of the real estate rises to the level of a trade or business, the rental income moves from the passive income basket to the active income basket.[32] In this case, an investor would want to be in the active income basket, because the tax on active income will generally be much lower, as illustrated in Example 1.

> ***Example 1:*** Assume that under a net lease, the tenant pays $1,000 of rent to the non-U.S. landlord, and in addition pays $1,000 of expenses related to the property (e.g., real estate taxes and insurance). The 30 percent passive income tax is imposed on the $2,000 gross rental income, so the 30 percent tax is $600. Thus, the foreign investor ultimately gets net cash of only $400 ($1,000 rent paid minus $600 withholding tax), and is paying a net 60 percent tax rate ($600 ÷ $1,000).
>
> By contrast, if this is active income, the $2,000 gross income is reduced by the $1,000 of tax-deductible expenses the tenant paid. In addition, the landlord can claim depreciation deductions and interest deductions if the landlord borrowed to buy the property, so the net tax imposed is far lower.

[31] A foreign corporate investor in the fund has to also pay the branch profits tax. See discussion infra at notes 96-99 and accompanying text.

[32] IRC §§ 1441(c)(1), 1442(b). In this case, the owner should furnish IRS Form W-8ECI to the lessee so as to eliminate 30 percent withholding tax on FDAP income.

In drawing the line between active and passive income, ownership of a commercial office building or large residential complex with numerous tenants would make the investor ETB.[33] By contrast, a triple net lease of a single property to a single tenant is not enough to make the investor ETB.[34] Apart from these easier cases, how many tenants must the investor lease to so as to rise to the level of being ETB? The IRS has not said how many are enough, but, as a practical matter, there is help on this issue. The Code allows an investor who has gross income from real estate rental property to make an election to treat the income as ETB.[35] In any case of uncertainty, this election should be made to preserve ETB treatment.

Interest Income. Unlike the case of rent, the investor generally does *not* want to be ETB for interest income and have ECI income since that status will lead to U.S. taxation of the interest. If the interest income remains in the passive category, it may escape U.S. tax under the portfolio interest exemption or a treaty. ETB status should not arise if the non-U.S. investor "buys" outstanding debt as an investment. However, if the investor sets up an office in the U.S. and uses it to "originate" or make new loans, that activity can make the investor ETB, which is damaging. In this case, the investor is starting to resemble a U.S. bank that lends money in the ordinary course of its business; therefore the rules can push the investor into the ETB category. Making one loan in a year should not make the investor ETB, but there is no clear line as to how many originated loans will make the investor ETB. This issue is the subject of a recent Chief Counsel Memorandum as well as one issued in 2009, which discussed when certain lending activities conducted by a foreign corporation can make the corporation ETB and have ECI.[36] Bottom line: The foreign investor (or a partnership in which the investor is a member) should not originate loans and should take care in buying any originated loans that are "old and cold" in order to prevent ECI treatment of the interest income.

Service Fees Paid to Related Persons. A fee paid for services rendered (such as a management fee) is treated as active income.[37] The source of the

[33] E.g., Pinchot v. Comm'r, 113 F2d 718 (2d Cir. 1940) (ownership of 11 properties that were actively managed by an agent). De Amodio v. Comm'r, 34 TC 894 (1960), aff'd on another issue, 299 F2d 623 (3d Cir. 1962), held that two actively managed properties were enough.

[34] Neill v. U.S., 46 BTA 197 (1942); GCM 18835, 1937-2 CB 141.

[35] IRC §§ 871(d), 882(d). The election can be made only in a year in which the investor has income from U.S. real estate, and applies to all properties (i.e., it cannot be made on a property-by-property basis). Once made, the election is effective for all subsequent years and can be revoked only with IRS consent.

[36] See ILM 2015-01-013 (Sept. 5, 2014), available at 2009 TNT 182-13; AM2009-010 (Sept. 22, 2009), available at http://www.irs.gov/pub/irs-utl/am2009010.pdf.

[37] See § IRC 864(b)(1).

income is based on the place where the services are performed.[38] If the work is done outside the U.S., the fee is foreign-source income and should not be subject to U.S. tax. If the foreign investor performs work outside the U.S. for a related U.S. company (such as a wholly owned U.S. corporation), the fee (1) is not subject to U.S. tax, and (2) is also an ordinary and necessary business deduction for the U.S. company that reduces its own U.S. tax liability.[39]

Careful planning is needed when making such service arrangements; the fee charged must reflect an arm's length charge comparable to what an unrelated third party would pay pursuant to Section 482's transfer pricing rules. If the fee exceeds an arm's length charge, the IRS can recharacterize the excess amount as a deemed dividend, which (1) is not deductible to the corporation and (2) is subject to the 30 percent withholding tax on passive income.[40] Reporting of these related party arrangements on Form 5472 is generally required so that IRS review may occur.[41]

Other Income Characterization Issues

Apart from active versus passive income characterization issues, several other characterization issues have a major effect on the foreign investor.

Sale of Stock—FIRPTA. Gain from the sale of stock by a foreign investor is generally treated as non-U.S.-source income and is not subject to U.S. tax.[42] However, FIRPTA can change that analysis in the case of a sale of stock of a U.S. corporation the predominant asset of which is U.S. real estate. In that case, the selling shareholder is usually treated as ETB and the gain on the sale of stock is ECI.[43]

Debt to Related Persons. A foreign shareholder can reap several tax advantages from lending money to his or her U.S. corporation rather than making an added capital contribution:

- Principal payments on the loan by the U.S. corporation are not FDAP income and are not subject to U.S. withholding tax.

[38] IRC §§ 861(a)(3), 862(a)(3).

[39] IRC § 162(a) (assuming the fee is "reasonable" compensation for the work done).

[40] Treas. Reg. § 1.482-9.

[41] E.g., Part IV, line 7 of Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business, requires disclosure of "Consideration received for technical, managerial, engineering, construction, scientific, or like services."

[42] IRC § 865(a)(2).

[43] See discussion infra at notes 74–84 and accompanying text.

- Interest oftentimes is treated more favorably under tax treaties by being exempted from the 30 percent withholding tax (dividends rarely get a complete exemption from such tax),[44] and sometimes the interest can be eligible for the portfolio interest exemption.[45]
- The corporation may be able to deduct interest, which will lower its U.S. tax liability, although the earnings stripping rules may limit that deduction where the 30 percent withholding tax is reduced or eliminated.[46] By contrast, no tax deduction is allowed for a dividend paid to a shareholder.

While these factors support maximizing the amount of shareholder debt, care must be taken in structuring the debt since the IRS could assert that the debt be recharacterized as equity (such as preferred stock in the company). Similarly, if a corporation makes a loan to a shareholder, the IRS could treat the loan as a disguised dividend. Case law indicates the following relevant factors in making this determination:

1. The debt to equity ratio of the corporation;[47]
2. The presence of a written loan agreement that establishes an absolute and unconditional duty to repay the loan;
3. The corporation's ability to repay the loan;
4. Whether there is a set maturity date (such as payable in five years), which is preferable to support true debt status, or the loan is payable on demand;
5. The magnitude of the loan;
6. Whether a ceiling limits the amount of the loan;
7. Whether security is given for the advance;
8. Whether interest is charged, the rate of the interest, and whether interest is paid currently;
9. The extent to which the shareholder controls the corporation; and
10. Whether the advances are proportionate to the shareholder's stock ownership.[48]

[44] E.g., U.S.-U.K. Tax Treaty art. 11 (interest generally exempt from 30 percent withholding tax), 10 (dividends are subject to a 15 percent or 5 percent rate or exemption, which exemption is not readily available to most U.K. shareholders).

[45] See supra note 16 and accompanying text.

[46] See supra note 14 and accompanying text.

[47] A 3 to 1 debt to equity ratio may be a sensible planning goal, but ultimately the ratio used, whether higher or lower, must be reasonable for the type of business being conducted.

[48] E.g., Alterman Foods, Inc. v. U.S., 505 F2d 873 (5th Cir. 1974), aff'g 73-2 USTC ¶9792 (N.D. Ga. 1973); Livernois Trust v. Comm'r, 433 F2d 879 (6th Cir. 1970), aff'g TC Memo. 1969-111; Chism Est. v. Comm'r, 322 F2d 956 (9th Cir. 1963), aff'g TC Memo. 1962-6; Oyster Shell Prods. Corp. v. Comm'r, 313 F2d 449 (2d Cir. 1963), aff'g TC Memo. 1961-323. IRC § 385 also sets forth certain relevant factors in determining whether related party debt can be recharacterized, although no regulations have been promulgated under this section.

No one factor is dispositive. If the IRS is successful in recharacterizing the debt as equity (such as by treating the loan as deemed preferred stock), (1) the interest deduction will be lost to the U.S. corporation, and (2) any repayment of the loan can then become a taxable dividend subject to dividend withholding tax.

REITs. Investments in real estate investment trusts (REITs)[49] are another option for the foreign investor. A REIT is a corporation (1) the assets of which consist substantially of real estate or mortgage debt, and (2) which satisfies several tests relating to its income, assets, and share ownership.[50] Unlike regular corporations, a REIT that pays dividends to its shareholders can avoid being subject to tax since the REIT gets a deduction for those dividends.[51] The tax treatment of the dividends is, however, more complex, and they can be treated as either passive income or active income.

REITs can pay to their shareholders either (1) regular dividends arising from the receipt of rent or interest by the REIT or (2) capital gain dividends arising from the sale of real property. A regular dividend paid by a REIT is treated like any dividend from a U.S. corporation and is subject to the 30 percent withholding tax on passive income.[52] While treaties can lower this tax burden, many treaties now treat REIT ordinary dividends less favorably than dividends from other corporations.[53] By contrast, capital gain dividends attributable to the sale of U.S. real estate are subject to FIRPTA and are treated as ECI and subject to 35 percent withholding tax.[54] The investor is also then required to file a U.S. tax return. However, if the REIT's stock is publicly traded on a U.S. exchange and the investor owns 5 percent or less of

[49] IRC § 856. A REIT is treated like a tax transparent entity and is not subject to tax if it meets certain eligibility requirements. However, the shareholders are then subject to U.S. tax on their share of the REIT's income. IRC § 857(b).

[50] See IRC § 856.

[51] IRC § 857(b)(2)(B).

[52] If a REIT believes that a distribution may not be a dividend in its entirety, then the REIT may be able to elect to have the withholding tax imposed on only that portion of the distribution that is taxable as a dividend. Treas. Reg. § 1.1441-3(c)(2).

[53] Several treaties provide that the lower (15 percent) rate applies to dividends paid by a REIT only if the recipient is the beneficial owner of a less than 10 percent interest (or, in some cases, 10 percent or less interest) in the REIT and certain other conditions are met. See, e.g., U.S.-Austria Treaty art. 10(2); U.S.-U.K. Treaty art. 10(4); U.S.-Denmark Treaty art. 10(3); U.S.-Italy Treaty art. 10(9). These treaties do not allow reliance on a lower withholding rate (such as 5 percent) that may apply to dividends paid by a regular corporation.

[54] IRC §§ 897(h), 1445(e)(6); Treas. Reg. § 1.1445-8(c)(2)(i). The regulations provide that any amount that could be designated as a capital gain dividend is deemed to have been designated as such regardless of the amount actually designated. Treas. Reg. § 1.1445-8(c)(2)(ii)(A).

the REIT's stock, the capital gain dividend is treated like a regular dividend, which avoids the ECI complexities.[55]

FIRPTA Tax Liability and Withholding Obligations

Pursuant to FIRPTA, gain or loss realized by a nonresident alien or a foreign corporation from the sale of a U.S. real property interest (USRPI), as defined below, will make the investor ETB and the resulting income ECI.[56] As a result, the investor will have to file a U.S. tax return and pay all required taxes on the sale, and a non-U.S. corporate investor may also then be liable for the branch profits tax (BPT).

A USRPI is any interest in U.S. real property held not solely as a creditor, and held directly or through certain entities when specified requirements are met.[57] Real property includes land and unsevered natural deposits such as mines, wells, and timber.[58] The real property must be located in the U.S. or the U.S. Virgin Islands. Options to acquire land or improvements thereon (including a right of first refusal) are also included, even if not currently exercisable.[59] Certain personal property that is "associated with the use of real property," such as some construction equipment, is included as well.[60]

Withholding. To insure that the FIRPTA tax is paid, withholding is imposed on those who purchase a USRPI from a foreign person.[61] A "foreign person"[62] is not limited to nonresident aliens and foreign corporations, but can also include a foreign partnership or trust.[63] A purchaser of a USRPI is required

[55] IRC § 897(h)(1). This treatment also avoids the branch profits tax discussed later. See discussion infra at notes 96-99 and accompanying text.

[56] IRC § 897(a)(1).

[57] IRC § 897(c). Treas. Reg. § 1.897-1(d)(1) provides that fee ownership, co-ownership, and leasehold ownership interests are all USRPIs. The same is true for time-sharing interests, life estates, remainders, and reversionary interests. Treas. Reg. § 1.897-1(b)(3) provides that improvements to land, such as buildings or other permanent structures, are usually considered real property.

[58] IRC § 897(c)(1)(A)(i); Treas. Reg. § 1.897-1(b)(2). These deposits, however, cease to be real property once they are severed or extracted from the land.

[59] Treas. Reg. § 1.897-1(d)(2)(ii)(B). Compare the similar definition in Treas. Reg. § 1.897-1(d)(3)(i)(E) of options to acquire an interest in entities that hold USRPIs, discussed later in the text.

[60] Treas. Reg. § 1.897-1(b)(4) provides special rules to determine when such property should be considered to be "associated with the use of real property."

[61] IRC § 1445. In non-sale situations such as a corporation distributing real estate to its shareholders, FIRPTA can also apply with special withholding rules. IRC § 1445(e).

[62] IRC § 1445(f)(3).

[63] Under IRC § 7701(a)(30)(E), a trust is a U.S. trust if a U.S. court is able to exercise primary supervision over its administration, and one or more U.S. persons have the authority to control all substantial decisions of the trust. Otherwise, the trust is a foreign trust.

to (1) withhold 10 percent of the amount realized by the seller on the sale,[64] (2) report the transfer to the IRS on Form 8288, and (3) remit the amount withheld within 20 days of the date of the transfer.[65] Failure to withhold will result in the purchaser being liable for the withholding tax, including interest and penalties.[66]

A common problem is that the tax to be withheld can exceed the seller's actual tax liability, as shown in Example 2.

> ***Example 2:*** Assume a foreign investor owns raw land that has a tax basis of $9 million and a fair market value (FMV) of $10 million. Although the seller's taxable gain is only $1 million, and his actual tax liability is far less than that, the purchaser is required to withhold $1 million (that is, 10 percent of $10 million). The $1 million must be withheld even if the seller has a loss on the sale.

In such over-withholding situations, the seller is eligible for a refund of any tax withheld that exceeds its actual tax liability, but not until the time the seller files an income tax return for the year that includes the taxable sale.[67] However, a better option is available: Either the seller or the buyer can file Form 8288-B with the IRS *before* the sale and request a withholding certificate that allows for the tax withheld to match the actual tax liability (including providing that no tax be withheld if there is a loss on sale).[68] Filing Form 8288-B delays the buyer's obligation to remit the withholding tax to the IRS until 20 days after the day the IRS mails a copy of the withholding certificate or denies the request. Where this option is chosen, the buyer should make sure that all cash is not paid immediately to the seller. Instead, the buyer should hold back an amount equal to the statutory 10 percent withholding amount, thus insuring that the buyer will have the cash to pay any possible final IRS determination. The seller should provide in the sales contract that any cash held back at closing for potential withholding taxes is to be placed into an escrow account beyond the reach of the buyer's creditors, and any escrowed amount that exceeds the IRS determination of the tax due will be paid promptly to the seller.

[64] IRC § 1445(a).

[65] Treas. Reg. § 1.1445-1(c)(1).

[66] IRC § 1461; Treas. Reg. § 1.1445-1(e).

[67] The taxpayer gets a credit on its return for the withholding tax. Treas. Reg. § 1.1445-1(f).

[68] See also Rev. Proc. 2000-35, 2000-2 CB 211. A withholding certificate may also be issued if there is an IRS determination that there is an exemption from U.S. tax of all gain realized by the transferor or an agreement for the payment of tax providing security for the tax liability, entered into by the transferee or transferor.

Treatment of Entities. Apart from direct interests in real estate, interests in entities that hold USRPIs are treated as if they are USRPIs provided that the interests are held "not solely as a creditor."[69] The basic types of non-creditor interests in an entity that holds USRPIs are generally (1) stock of a corporation,[70] (2) a partnership interest,[71] (3) a beneficiary's interest in a trust or other ownership interest in a trust (such as the grantor of a grantor trust),[72] and (4) rights to share in the appreciation of the interests in the above entities or in the appreciation in value of the assets of those entities.[73]

A USRPI includes any interest in a domestic corporation that qualifies as a U.S. real property holding corporation (USRPHC).[74] A U.S. corporation generally is a USRPHC if the FMV of the USRPIs held by such corporation is at least 50 percent of the FMV of the sum of the corporation's assets that are USRPIs, foreign real property interests, and trade or business assets of the corporation at any time during the five-year period preceding the sale of its stock.[75] The regulations allow use of book value rather than FMV in determining USRPHC status, which is easier to monitor.[76] USRPHC status does not apply to a foreign corporation even if all its assets are USRPIs. A sale of the stock of a foreign corporation is never taxed by FIRPTA.[77]

[69] IRC § 897(c)(1)(A)(ii). The regulations provide separate rules for determining non-creditor interests in USRPIs (in Treas. Reg. § 1.897-1(d)(2)) and in entities that hold USRPIs (in Treas. Reg. § 1.897-1(d)(3)), even though the principles are similar.

[70] Treas. Reg. § 1.897-1(d)(3)(i)(A).

[71] Treas. Reg. § 1.897-1(d)(3)(i)(B).

[72] Treas. Reg. § 1.897-1(d)(3)(i)(C). In the grantor trust setting, a grantor may be treated as the owner of a portion of a trust under IRC § 671. Persons other than the grantor also may be treated as holders of ownership interests (see, e.g., IRC § 678), and they too are considered holders of interests other than solely as creditors in the trust.

[73] These rights include contingent interests such as stock appreciation rights (even if the holder owns no stock in the corporation). Treas. Reg. § 1.897-1(d)(3)(ii)(B).

[74] IRC § 897(c)(1)(A)(ii); Treas. Reg. § 1.897-1(d)(3)(i)(E).

[75] IRC § 897(c)(2); Treas. Reg. § 1.897-2(b). Rules as to how FMV is determined generally look to an asset's net (rather than gross) market value. Treas. Reg. § 1.897-1(o)(2)(i).

[76] Treas. Reg. § 1.897-2(b)(2) allows corporations to determine their status based on an alternative "book value." The book value is determined by the value at which an item is carried on the financial accounting records of the corporation, if such value is determined in accordance with generally accepted accounting principles applied in Treas. Reg. § 1.897-2(b)(2)(ii).

[77] While foreign corporations are generally not USRPHCs, in determining whether a U.S. corporation is a USRPHC, the IRC "looks through" foreign corporations to determine whether a U.S. corporate holder of stock in the foreign corporation is a USRPHC. If the foreign corporation would be a USRPHC had it been a U.S. corporation, the interest in the foreign corporation will be a USRPI for purposes of determining whether the U.S. corporate holder of the interest may be a USRPHC. IRC § 897(c)(4).

Planning to avoid FIRPTA is made more difficult by a rebuttable presumption that treats any interest in a U.S. corporation as an interest in a USRPHC *unless* the taxpayer establishes that the corporation was not a USRPHC during the shorter of the taxpayer's holding period for the interest or the five-year period ending at the date of the disposition of the interest.[78] As a result, a corporation cannot avoid being a USRPHC by, for example, having its shareholders contribute more cash to the company that is used to buy foreign real estate or trade or business assets prior to its sale. Even if the FMV of non-U.S. real estate assets grows to exceed the value of the U.S. real estate, this five-year look-back period means that FIRPTA may still apply to a sale of stock.[79] This can pose a problem for a fast-growing start-up operating company.[80] Initially, the company's real estate may have been its prime asset; while that can quickly change, the five-year look back means the USRPHC taint stays with the company for five years.

A foreign person selling stock of a U.S. corporation may advise the buyer that the corporation is not a USRPHC and no withholding is required. However, in order to be fully protected, the buyer, as a closing condition, should obtain a certificate from the corporation stating that the corporation is not a USRPHC.[81]

[78] IRC § 897(c)(1)(A)(ii). The procedure for establishing that the corporation is not and was not a USRPHC in the testing period is normally accomplished by obtaining a statement from the corporation. Treas. Reg. § 1.897-2(g)(1)(i)(A). Such statement generally may be used to obtain exemption from withholding under IRC § 1445. Treas. Reg. § 1.897-2(g)(1)(ii)(B). The corporation must comply with certain notice requirements in Treas. Reg. § 1.897-2(g)(1)(ii)(A) for such statement to be valid. What happens, however, if the corporation fails to file such a notice with the IRS? While the corporation that believes it is not a USRPHC also may believe that it can then establish that it was not a USRPHC on audit or in litigation, the regulations do not offer any such clear path. Furthermore, if the corporation's non-USRPHC certification is later found to be false, the shareholder is excused from penalties and interest, but the shareholder is not excused from liability for the tax. Treas. Reg. § 1.897-2(g)(1)(ii)(A). While some taxpayers may feel such risk is warranted given the likely inability of the IRS to be able to follow the shareholder back to his home country to seek collection of the tax, it would nonetheless appear prudent to have the corporation file the notice with the IRS, especially given the cursory amount of information required to be filed.

[79] Treas. Reg. § 1.897-2(f)(1).

[80] Leasing real estate rather than buying the real estate may alleviate this concern. While a leasehold is a USRPI, its FMV and book value are oftentimes quite small, especially when the rent being paid reflects a fair market rental for the property. See Treas. Reg. § 1.897-1(o)(3).

[81] Treas. Reg. § 1.1445-2(c)(3). Testing to determine USRPHC status need only be made on the following dates in the five-year period: (1) the last date of the corporation's tax year; (2) the date on which the corporation acquires any USRPIs; (3) the date on which the corporation disposes of any foreign real estate or any assets used or held for use in its trade or business; and (4) the date an entity (if ownership of USRPIs is attributed to the USRPHC) acquires any USRPIs or disposes of any foreign real estate or any assets used or held for use in its trade or business. Treas. Reg. § 1.897-2(c)(1).

There is an important exclusion from USRPHC status for stock in a publicly held company where the selling stockholder owns no more than 5 percent of the stock.[82] This exclusion is useful for foreign investors holding stock in publicly traded REITs. In addition, even if a REIT's stock is not publicly traded, stock of a REIT owned by a foreign investor is not a USRPHC if the REIT is "domestically controlled."[83] A REIT is domestically controlled if less than 50 percent in value of its stock is held directly or indirectly by foreign persons. REITs that desire to take advantage of this exception should add to their corporate documents restrictions on who can own the stock to prevent foreign persons from acquiring 50 percent or more of the stock.

Another important exclusion from USRPI status is that a corporation that was a USRPHC will cease to be a USRPHC if it holds no USRPIs on the date of its sale and all dispositions of USRPIs in the previous five years were in taxable transactions.[84] If a U.S. corporation owns only one parcel of U.S. real estate that it sells for cash, adopts a plan of liquidation, and liquidates, USRPHC status is lost and the liquidating distribution is not subject to U.S. tax under FIRPTA and is not a dividend subject to 30 percent withholding tax. This tax result leads to an important investment strategy: a separate U.S. corporation should be used to hold each U.S. real estate investment to allow for getting the cash out of the U.S. with only a corporate-level tax.

A partnership interest is a USRPI if 50 percent or more of the value of the partnership's gross assets is USRPIs and 90 percent or more of the value of partnership's gross assets consists of USRPIs plus cash or cash equivalents. A sale of an interest in a partnership that satisfies the 50/90 test is treated differently for tax and withholding purposes. Only the gain attributable to USRPIs held by the partnership is taxed under the substantive FIRPTA tax regime.[85] However, *all* of the gain from the disposition of the partnership interest is subject to withholding.[86]

Disposition of interests in trusts and estates that hold USRPIs is taxed under Section 897(g). Only the gain attributable to the USRPIs held is taxed. The interests themselves, however, apparently are not USRPIs.[87]

[82] IRC § 897(c)(3); Treas. Reg. § 1.897-1(c)(2)(iii).

[83] IRC § 1445(e)(1).

[84] Treas. Reg. § 1.897-2(f)(2). The corporation may continue to hold a leasehold interest that has an FMV of zero, even if there is a renewal option (so long as the renewal is at FMV), and interests in corporations that ceased to be USRPHCs. Treas. Reg. § 1.897-2(f)(2).

[85] IRC § 897(g); Temp. Treas. Reg. § 1.897-7T(a).

[86] Treas. Reg. § 1.897-7(a); Temp. Treas. Reg. § 1.1445-11T(d).

[87] Unlike partnerships, the IRC and the Regulations do not provide special rules defining interests in trusts and estates as USRPIs.

Interests in partnerships or trusts that are regularly traded on an established securities market are generally treated as interests in publicly traded corporations and are not governed under these partnership rules.[88] As discussed above, only foreign persons who own a greater than 5 percent interest in publicly traded corporations (that also are USRPHCs) are taxed on dispositions of those interests. The same rules generally are applicable to publicly traded partnerships and trusts.

Loans With Contingent Interest. An interest in real property solely as a creditor is not a USRPI.[89] An issue can arise as to whether a mortgage loan comes within this "solely as a creditor" category if the interest rate has both a fixed component (e.g., 9 percent per year) and a contingent component dependent upon some benchmark. An interest rate tied to an index (such as LIBOR) is permissible so long as the index does not have the principal purpose of reflecting changes in real property values.[90] However, contingent interest based on the value of the property or a share of its cash flow, which is sometimes called an equity kicker, would cause the loan to become a USRPI.

A loan classified as a USRPI has a tax effect only if the loan is sold. Any gain from the sale will be taxed as ECI under FIRPTA. Interest paid on the loan is still subject to 30 percent withholding tax unless reduced or eliminated by either the portfolio interest exemption that applies only to fixed interest or a treaty that can apply to both fixed and contingent interest. However, if debt instruments with contingent interest are to be used, that factor may support an IRS effort to recharacterize the debt as equity.[91]

Impact on Nonrecognition Rules. If a foreign investor purchased a parcel of U.S. real estate directly, and now wants to move the property into an entity such as a foreign or U.S. corporation or exchange it for other property, Section 351 or other nonrecognition rules may allow for tax-free movement of the property.[92] However, FIRPTA can override these rules where an interest in a USRPI may be exchanged for an interest that is not a USRPI (such as stock of a foreign corporation).[93] Nonetheless, the IRS has been generous

[88] Treas. Reg. § 1.897-1(c)(2)(iv).

[89] Treas. Reg. § 1.897-1(d)(1). Whether an interest is not solely as a creditor is important for two reasons—not only whether the disposition of the interest itself is subject to FIRPTA taxation but also whether the interest will be taken into account in determining whether a corporate holder of that interest is a USRPHC.

[90] Treas. Reg. § 1.897-1(d)(2)(ii)(D).

[91] See supra notes 44–46 and accompanying text.

[92] E.g., IRC §§ 332, 354, 355, 361, 721, 731, 1031, 1033, 1036. See Temp. Treas. Reg. § 1.897-6T(a)(2).

[93] IRC § 897(e); Temp. Treas. Reg. § 1.897-6T.

in allowing certain transfers to be made tax free despite FIRPTA.[94] Careful planning is needed to navigate these rules, a subject beyond the scope of this article.

Using Foreign Corporations: The Branch-Level Taxes

Corporations are often used to own real estate. A U.S. corporation that owns U.S. real estate may face two levels of tax: (1) the basic corporate income tax imposed on the corporation's worldwide income, and (2) the 30 percent withholding tax imposed on dividends paid by that corporation to its foreign shareholders.[95] If a foreign investor uses a foreign corporation to hold its real estate, however, that investment is subject to a more complicated system of taxation.

The Branch Profits Tax. Where the U.S. real estate activity makes the company ETB (or an election is made to be treated as ETB), the foreign corporation will be subject to U.S. corporate income tax on its ECI in a manner similar to that applicable to a U.S. corporation holding the real estate. Unlike a U.S. corporation, no 30 percent U.S. withholding tax applies when the foreign corporation pays a dividend to its shareholder. Instead, as a substitute for this withholding tax, all or part of the foreign corporation's ECI is likely to be subject to a second level of tax known as the branch profits tax (BPT).[96] For this purpose, the U.S. real estate is treated as a branch of the foreign corporation that invokes the BPT.

The BPT is a 30 percent tax imposed on the corporation's "dividend equivalent amount," which is the corporation's ECI with certain adjustments including a deduction for the corporate income tax paid on the ECI. One way to eliminate the BPT is to invest the money in U.S. trade or business assets (such as building an improvement on the real estate), but merely depositing the money in a bank account is not treated as an investment in the U.S. trade or business even if the money is held for future U.S. investment.[97] Most important, the BPT is imposed on a current basis even if the foreign corporation does not distribute any money to its shareholder—this is a principal reason why the BPT is worse than the 30 percent withholding tax on dividends,

[94] Treas. Reg. § 1.897-6T(b)(1).

[95] This passive income tax on dividends may be reduced by a tax treaty. In addition, liquidating distributions paid by that corporation are generally not subject to tax except where FIRPTA, as discussed below, overrides the general rule. See supra note 22 and accompanying text.

[96] IRC § 884(a).

[97] IRC § 884(b), (d); Treas. Reg. § 1.884-1(b), (f).

which applies only if there is a distribution to the shareholder.[98] Tax treaties can reduce or eliminate the BPT,[99] but that does not help companies formed in tax haven countries (such as the Cayman Islands) that do not have a tax treaty with the U.S.

The Branch Interest Tax. In addition to the BPT, a foreign corporation that has ECI faces the complementary branch interest tax (BIT).[100] The BIT treats the foreign corporation's U.S. branch as if it were a U.S. corporation, and any interest paid by the foreign branch to foreign lenders is U.S.-source income subject to the 30 percent withholding tax on interest income.[101] The BIT is broader in scope, however, as it applies even if no interest is actually paid by the foreign branch.

The BIT allocates a certain percentage of the foreign corporation's global interest expense to the U.S. branch and treats that interest as paid by a U.S. corporation, even if that interest was not deductible in the computation of ECI.[102] The BIT has two components:

1. Any interest "paid" by the U.S. branch is treated as paid by a U.S. corporation to the foreign lender and is subject to the 30 percent withholding tax on interest.[103]
2. Any "excess interest" (the amount by which the foreign corporation's interest allocable to the branch exceeds any interest paid by

[98] Treatment of liquidations can also produce another detriment to those subject to the BPT. The 30 percent withholding tax on dividends does not generally apply to a liquidating distribution by a U.S. corporation to a foreign shareholder. Treas. Reg. § 1.1441-3(c)(2)(b). Such a distribution also is not subject to FIRPTA withholding unless the corporation is a U.S. real property holding company (discussed later in this article). Treas. Reg. § 1.1445-5(e)(2). In the case of a liquidating distribution by a non-U.S. corporation, there is no similar exception for the BPT in the Code. However, Temp. Treas. Reg. § 1.884-2T(a) provides an exception, but it requires satisfaction of four conditions that sometimes can be hard to meet (such as the requirement that none of the assets of the liquidated foreign corporation be used by the shareholder or any related person in a U.S. trade or business until the lapse of a three-year period that starts at the end of the year of termination).

[99] There are limits on the use of treaties to reduce or eliminate the BPT as set forth in the treaty (such as the limitation on benefits (LOB) provision of the treaty) and also in IRC § 884(e). Treas. Reg. § 1.884-5 generally provides that a foreign corporation that is a resident of a tax treaty jurisdiction can obtain a BPT exemption under a treaty only if it meets the LOB provision of the treaty and (1) the foreign corporation is a qualified resident of that foreign country or (2) the LOB provision came into force after 1986. As a practical matter, this limit does not adversely affect many treaties since most treaties have been renegotiated since 1986.

[100] IRC § 884(f).

[101] IRC § 884(f)(1); Treas. Reg. § 1.884-4(a)(1).

[102] IRC § 884(f)(1). See generally H. Rep. No. 104-586, 104th Cong., 2d Sess. 173 (1996).

[103] IRC § 884(f)(1).

> the branch) is treated as if it were "deemed paid" by a U.S. corporation to the foreign corporation itself and is subject to 30 percent withholding tax.[104]

The withholding tax on the interest "paid" can be reduced or eliminated by a treaty that the third-party lender can use. The withholding tax on the excess interest can be reduced or eliminated by a treaty that the foreign corporation itself can use. However, only the withholding tax on the interest "paid" can be eliminated by the portfolio interest exception if the other requirements of that exception are met.[105]

FATCA Withholding and Obligations Imposed on Foreign Investment Funds

In order to stop U.S. investors from investing outside the U.S. and not reporting or paying U.S. tax on the resultant income, Congress enacted the Foreign Account Tax Compliance Act (FATCA).[106] FATCA seeks to obtain the assistance of foreign financial institutions (FFIs) in disclosing to the IRS the identity of any of their account holders who are U.S. persons or U.S. controlled foreign entities.[107] FFIs include foreign investment funds, banks, custodians, and insurance companies issuing whole life insurance policies.[108] FATCA

[104] The interest allocable to the U.S. branch is determined under a complex formula in Treas. Reg. § 1.882-5.

[105] Treas. Reg. § 1.884-4(a)(1).

[106] IRC §§ 1471–1474. (FATCA was enacted as part of the Hiring Incentives to Restore Employment (HIRE) Act, P.L. 111-147, 124 Stat. 71 (2010).) For fuller discussion of FATCA, see, e.g., Marnin Michaels, Michael Parets, Tom O'Donnell & Alyssa Varley, "The Unintended Consequences of the HIRE Act: Impact on Offshore Financial Transactions," 23(6) J. Tax'n & Reg. Fin. Insts. 29 (July/Aug. 2010); Marnin Michaels, Tom O'Donnell & Rodney Read, "FATCA Compliance: Preparing for 2013—Notice 2010-60 and Practical Steps to Take Now," 24(4) J. Tax'n & Reg. Fin. Insts. 5 (Mar./Apr. 2011); Susan Nevas, "The Second FATCA Notice: A Sharper Enforcement Tilt," 24(6) J. Tax'n & Reg. Fin. Insts. 13 (July/Aug. 2011); James N. Calvin, Kenneth M. Kess & Pascal Noel, "Non-U.S. Financial Institutions and Investment Funds to Function as Tax Intermediaries Under FATCA," 25(6) J. Tax'n & Reg. Fin. Insts. 35 (July/Aug. 2012); Ehab Farah, "FATCA: Recent Developments and the Intergovernmental Model I Agreement," 26(3) J. Tax'n & Reg. Fin. Insts. 5 (Jan./Feb. 2013); Paul M. Schmidt & Michael W. Nydegger, "FATCA Intergovernmental Agreements—The Model 2 Agreement and Final Regulations," 30(3) J. Tax'n Invs. 19 (Spring 2013); Ian M. Comisky & Matthew D. Lee, "The Foreign Account Tax Compliance Act: An End to Bank Secrecy?," 26 (6) J. Tax'n & Reg. Fin. Insts. 5 (July/Aug. 2013); Jay R. Nanavati, "The 2013 U.S. Department of Justice Program for Swiss Banks—No Easy Choices," 27(3) J. Tax'n & Reg. Fin. Insts. 53 (Jan./Feb. 2014); Philip R. Hirschfeld, "FATCA 2013 Overview: Getting Down to the Wire," 27(4) J. Tax'n & Reg. Fin. Insts. 59 (Mar./Apr. 2014); Daniel Mulcahy & Mark Howe, "FATCA in 2015—Now the Fun Really Begins," 32(2) J. Tax'n Invs. 11 (Winter 2015).

[107] IRC § 1471(b).

[108] IRC § 1471(d)(4), (5); Treas. Reg. § 1.1471-5(d).

imposes a 30 percent withholding tax on U.S. withholdable payments made to FFIs that refuse to participate in the FATCA disclosure program and are not otherwise exempt.[109] Withholdable payments cover many of the same items included in FDAP income (such as U.S.-source interest and dividend income), and the FATCA withholding tax is offset by any amount of FDAP withholding tax already imposed on the payment.[110]

FATCA enforcement has been enhanced by over 100 Inter-Governmental Agreements (IGAs) that have been signed or agreed to by countries (such as the U.K., France, Germany, and the Cayman Islands). An IGA makes FATCA a part of the country's laws to ensure cooperation of local FFIs in the FATCA disclosure program.[111] For those IGAs that are structured as Model 1 IGAs, the FFI discloses the identities of the U.S. account holders to their local countries, which then pass that information on to the IRS.[112] The IRS can then check to make sure U.S. tax has been paid on the income from those offshore investments. A cooperating FFI needs to obtain an IRS number called the Global Intermediary Information Number (GIIN) to confirm its cooperation in the program,[113] and the FFI then furnishes any U.S. withholding agent with the GIIN and other relevant data on an appropriate IRS Form W-8 to prevent FATCA withholding.

FATCA specifically excludes non-financial income (i.e., active business income) from its withholding tax[114] and also provides that an offshore fund that directly owns only real estate is not treated as an FFI subject to FATCA.[115] However, rather than being held directly by an offshore fund, U.S. real estate frequently is owned through subsidiary entities, as discussed later in this article. As a result, FATCA can apply to offshore funds that invest in U.S. real estate, which adds another complication.

State Taxation

U.S. federal withholding tax is generally imposed only on passive income, which usually is *not* subject to state or local tax. However, the presence of

[109] IRC § 1471(a).

[110] Starting on January 1, 2017, withholdable payments will also generally include proceeds received from the sale of U.S. stocks and securities. IRC § 1473(1)(a)(ii); Treas. Reg. § 1.1473-1(a)(1)(ii).

[111] Treasury FATCA Resource Center, FATCA Archive, List of Countries that have signed IGAs or reached agreement to sign, available at http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA-Archive.aspx.

[112] E.g., Article 2(1), Treasury Model 1A IGA Reciprocal, Preexisting TIEA or DTC, June 6, 2014.

[113] E.g., Article 4(1)(c), Treasury Model 1A IGA Reciprocal.

[114] Treas. Reg. § 1.1473-1(a)(4)(iii).

[115] See Treas. Reg. § 1. 1471-5(e)(4)(i), (ii), (v), Ex. 4.

active income can subject the investor to federal tax as well as tax imposed by a state or city in which the business is conducted. For example, if an investor owns a commercial office building in New York City, federal, New York State,[116] and New York City tax will apply to the rental income and gain from sale, and the investor will need to file multiple tax returns. These added taxes reduce the economic yield from the investment.

U.S. Estate and Gift Taxes

Individual investors may also be affected by the U.S. estate and gift tax (maximum rate of 40 percent[117]). The U.S. federal estate and gift tax, which applies to the worldwide estate of U.S. residents,[118] uses a definition of residency that differs from that used for the income tax. A person is a resident for estate and gift tax purposes if the person has a U.S. domicile, which is defined to mean that the U.S. is viewed as the permanent home to which that person ultimately intends to return.[119] With proper planning, one may avoid being caught by this subjective test.

A non-U.S. resident is, however, subject to U.S. estate or gift tax on property transferred at death or by gift if the property is U.S. situs property.[120] The gift tax definition of U.S. situs property includes only U.S. real estate (or tangible personal property in the U.S.),[121] whereas the estate tax definition is broader and also includes stock in a U.S. corporation and debt obligations of a U.S. person.[122] A non-U.S. resident cannot use the marital deduction[123] to

[116] New York's state corporate tax is imposed at the highest of four different bases with one computation based on N.Y. state-source income having a maximum tax rate of 6.5 percent. See New York State Corporate Tax Reform Outline, NYS Dept. of Taxation and Finance (April 2014), available at http://www.tax.ny.gov/pdf/publications/corporation/ctref_outline_4-14.pdf.

[117] IRC § 2001(c).

[118] IRC §§ 2001(a), 2031(a). Some states (such as New York) also have their own estate and gift tax that can apply where local real estate is owned by any individual, U.S. or foreign.

[119] IRC §§ 2001(a), 2031(a); Treas. Reg. §§ 25.2501-1(b), 26.2663-2(a). Factors that relate to domicile include: (1) length of time spent in the U.S and abroad; (2) size, cost, and nature of the decedent's houses or other residences and cars (including rental property); (3) location of the decedent's family and close friends; (4) visa status; (5) location of the decedent's business interests, voting records, and car and driver's license registration; and (6) declaration of residence in decedent's will, trusts, deeds, credit card statements, bank accounts, etc. E.g., Paquette Est. v. Comm'r, TC Memo. 1983-571; Fokker Est. v. Comm'r, 10 TC 1225 (1948); Nienhuys Est. v. Comm'r, 17 TC 1149 (1952).

[120] IRC §§ 2103, 2104, 2501(a). Estates of nonresidents are entitled to deduct a portion of the expenses, losses, indebtedness, and taxes set forth in IRC §§ 2053 and 2054, which include funeral and administration expenses; claims against the estate; mortgages on, and indebtedness with respect to, property included in the gross estate; and uninsured casualty losses suffered by the estate. IRC § 2106.

[121] IRC § 2501(a)(2).

[122] IRC §§ 2103, 2104.

[123] IRC § 2056(d).

lower estate tax obligations unless (1) the non-resident's spouse is a U.S. citizen, or (2) the property is transferred to a qualified domestic trust (QDOT). A QDOT is created for the surviving spouse's benefit and insures that, at the foreign spouse's death, estate tax will be paid.[124] The lifetime exclusion (for 2015, $5,430,000) does not apply to the non-resident's estate.[125] The non-resident has an estate tax credit of only $13,000,[126] which equates to an exclusion for $60,000 of property passing at death.[127] As a result, the estate tax can become a large liability for the next generation.

Because the estate tax does not apply to stock of a non-U.S. corporation even if the corporation owns only U.S. real estate, the use of a non-U.S. corporation in the ownership structure can prevent estate tax liability. Debt of a U.S. person is not U.S. situs property if the debt qualifies for the portfolio interest exemption created for the income tax.[128] A few countries have estate tax treaties with the U.S. that can reduce or eliminate U.S. tax.[129] These treaties, if applicable, need to be reviewed for possible benefits.

The application of the estate tax to a non-U.S. partnership that holds U.S. real estate is not firmly established. An argument can be made that an interest in a Cayman Islands partnership managed outside the U.S., the sole asset of which is income-producing U.S. real estate, is an intangible with situs outside the U.S. and is not subject to estate tax. However, it can also be asserted that the situs of the intangible investment in the partnership should be the U.S., where the real estate lies, and U.S. estate tax should apply. This is the position that the IRS takes, supported by some courts.[130]

Pros and Cons of Possible Investment Structures

The foreign investor choosing to acquire income-producing property, a vacation home, or raw land as an investment has several options to choose from. For purposes of simplification, these options are discussed below in the context of an individual investor.

[124] IRC § 2056A.

[125] IRC § 2010.

[126] IRC § 2102(b).

[127] See IRC § 2001(c).

[128] IRC § 2105(b)(3).

[129] The U.S. has estate and gift tax treaties with the following countries: Australia, Austria, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, Norway, South Africa, Sweden, Switzerland, and the United Kingdom.

[130] Rev. Rul. 55-701, 1955-2 CB 836. See also Sanchez v. Bowers, 70 F2d 715 (2d Cir. 1934). The IRS generally refuses to rule on whether partnership interests are intangible assets, unless unique or compelling circumstances exist. Rev. Proc. 2000-7, 2000-1 CB 227.

Individual Direct Investment in U.S. Real Estate. An individual could choose to own the U.S. real estate investment in his or her own name or, alternatively, to own such property through a single-member Delaware (or other state) LLC in order to obtain protection against potential liabilities. Any domestic single member LLC would be treated as a disregarded entity and thus the individual would be treated as owning the real estate for tax purposes.[131]

This structure is simple and avoids adding taxable entities that attract a second level of tax (that is, a corporate-level tax and a tax on dividends paid to the shareholder or a BPT). On a disposition of the property, the investor can also take advantage of favorable individual capital gains tax rates (maximum 20 percent rate for long-term capital gains) that can lower U.S. income tax exposure (maximum regular tax rate of 39.6 percent).

This structure does, however, have some disadvantages. First, U.S. estate and gift tax exposure exists, which can lead to a very significant tax bill at death or on making a gift. Second, the investor's identity will be disclosed on tax returns and in all dealings involving the real estate, which can raise security or other concerns. Third, the investor will have to file annual income tax returns for income-producing property. (A vacation home or property held for investment may not generate the need to file an annual tax return except in the year the property is sold.) These adverse factors may discourage direct investment.

U.S. Corporation as the Real Estate Owner. A U.S. corporation owned by a nonresident alien individual would provide personal liability protection[132] and also shield the individual from being identified to the world as the owner.[133] In addition, since the corporation would now be the taxpayer, the individual would not have to file annual U.S. tax returns.

However, there are some disadvantages that may not make this the best option. U.S. federal estate tax liability will still exist[134] (although no U.S. federal gift tax liability will apply to a lifetime gift of the stock), and two levels of income tax will apply: (1) a corporate-level tax (federal maximum rate of

[131] Treas. Reg. § 301.7701-3(b)(1)(ii), (2)(i)(c). A check-the-box election to achieve corporate tax classification of the LLC could be filed to change the tax structure.

[132] The use of a single-member LLC, however, also can accomplish limited liability while not creating a separate taxpayer.

[133] The corporation must disclose on Schedule K, line 4, of its annual Form 1120 the identity of any shareholder owning 20 percent or more of the company, but this information is not publicly available.

[134] U.S. estate tax treaties can, if applicable, eliminate such tax liability (the U.S.-Netherlands Estate Tax Treaty, for example, would eliminate such tax on intangible property for a Dutch domiciliary).

35 percent, plus possible state and local tax); and (2) a 30 percent withholding tax on dividends paid to the investor (subject to reduction by tax treaty if applicable). Where the property is financed with debt from a third party (such as a bank), however, annual cash flow from the property may be used to pay debt service rather than to pay dividends, reducing any income tax owed. And the potential double tax burden can be eliminated when the property is sold for cash if the corporation then adopts a plan of liquidation and distributes the remaining proceeds as a liquidating distribution, which can be paid without imposition of any U.S. withholding tax.

Foreign Corporation as the Real Estate Owner. As with the use of a U.S. corporation, the use of a foreign corporation to hold the real estate would give the investor the shield of limited liability and anonymity.[135] The investor would not have to file a U.S. tax return; the corporation would have to do so if it is ETB or sells the realty. Nevertheless, there are some differences between the U.S. and foreign corporation.

As an advantage, neither U.S. gift nor estate tax will apply to a lifetime gift or testamentary transfer of the stock in the foreign corporation.[136] However, as a possible detriment, U.S. persons who are used to dealing with U.S. business entities may require extra assurances in dealing with this foreign entity. Rent paid to the foreign corporation is subject to a 30 percent withholding tax unless the foreign corporation supplies Form W-8ECI to the lessee that assures the lessee that the foreign corporation is subject to tax on its rental income.

While there is no U.S. withholding tax imposed on dividends paid by a foreign corporation to its shareholders, the 30 percent BPT will apply to the foreign corporation.[137] The BPT can be more complex and onerous than the 30 percent withholding tax on dividends.[138] The impact of the BPT and the branch-level interest taxes can make the use of a foreign corporation more

[135] However, Item V on the Form 1120F filed by the foreign corporation requires the foreign corporation to disclose the identity of any person who owns 50 percent or more of the corporation.

[136] Also, if the property were to be refinanced, a distribution of the refinancing proceeds to the shareholder would not be subject to a dividend withholding tax or the BPT. This may be an advantage over a U.S. corporation, which may have to withhold a 30 percent tax on such distribution if it is a dividend; dividend treatment would apply if the U.S. corporation has accumulated or current E&P.

[137] IRC § 884(a). Tax treaties also can reduce or eliminate the BPT. IRC § 884(e).

[138] For example, the 30 percent passive income tax does not generally apply to a liquidating distribution paid by a U.S. corporation to a foreign shareholder. Temp. Treas. Reg. § 1.884-2T(a) provides a similar rule for the BPT, but requires satisfaction of four conditions that can sometimes be hard to meet (e.g., none of the assets can be used in a U.S. trade or business until lapse of a three-year period that starts at the end of the year of termination).

complicated and more costly than use of a U.S. corporation if no tax treaty exists that can lessen their impact.

Foreign Corporation Owning a U.S. Corporation That Owns the Real Estate. A foreign investor could form a wholly owned foreign corporation the sole asset of which is all the stock of a U.S. corporation. The U.S. corporation then acquires the U.S. real estate. This structure gives the investor protection from liabilities relating to the real estate while also eliminating the need for the investor to file a U.S. tax return. While this two-tiered structure is more complex than the other structures discussed above, this option has many benefits:

- Neither U.S. federal estate tax nor gift tax will apply if stock in the foreign corporation is the subject of a gift or is transferred at death.
- Neither the BPT nor the branch-level interest taxes will be applicable, because the operating asset and the income generated therefrom reside in a U.S. corporation.
- While the U.S. corporation must disclose on its Form 1120 the identity of its 100 percent shareholder, that disclosure will identify only the foreign corporation. The foreign corporation is under no disclosure obligation since it is not ETB and does not have to file a Form 1120-F. Thus, a better shield of anonymity is created for the foreign investor.
- Once the property is sold in a fully taxable transaction and one level of U.S. tax has been paid on the resulting gain, the U.S. company can be liquidated, with the cash going to the foreign corporation without being subject to any U.S. dividend withholding tax or tax under FIRPTA (because the company is no longer a USRPHC). The foreign corporation, which is not ETB, is then free to distribute the cash to the ultimate shareholder at any time, with no U.S. tax impact.

Given these benefits, the plusses of this structure may often outweigh any difficulties caused by its complexity.[139]

Use of Separate Entities to Acquire Multiple Properties. Where multiple properties are to be acquired, each property is usually owned by a separate entity to limit liability exposure. A separate corporation or a series of single-member LLCs could be used. In this situation, three important planning questions would need to be answered: What type of entity should be

[139] The advantages discussed in the text consider merely the U.S. tax considerations. The structure may become disadvantageous if the use of the foreign corporation creates another level of tax to the foreign individual investor in her own country.

used to hold each property? Should a common holding company be formed to own each property-owning entity? Should the different entities be U.S. entities or foreign entities—and, if foreign, should they be formed in the investor's home country or elsewhere, such as a tax haven country (e.g., the Cayman Islands)?

Consideration should be given to using (1) a separate Delaware LLC to own each property, (2) a U.S. holding corporation to own each LLC,[140] (3) a foreign corporation to own the U.S. holding, and (4) the foreign investor to own the foreign holding company. This structure eliminates estate and gift tax exposure, preserves the investor's anonymity, gives the investor liability protection, and avoids the branch-level taxes. In addition, tax losses generated by one property can offset the income from other properties.[141] However, one must also consider how cash from a sale of one of the properties can be distributed to the foreign investor in a tax-efficient manner. The sale of one of the properties for cash will generate a corporate-level tax. Then, when the remaining cash is distributed to the shareholder, the distribution will be treated as a taxable dividend to the extent of the company's current and accumulated earnings and profits. The dividend will be subject to a 30 percent withholding tax.

An investor who is an eligible resident of a country that has a tax treaty with the U.S. may be able to reduce that tax. Absent a treaty, however, the 30 percent withholding tax can significantly reduce the after-tax cash the investor receives from the investment. In this situation, consideration should also be given to (1) use of a separate U.S. corporation to own each property, (2) use of a foreign holding corporation to own all the stock of each real estate holding company,[142] and (3) having the foreign investor own the foreign holding company. This gives

[140] If a U.S. corporation owns only single-member LLCs, then the LLCs are disregarded entities and the U.S. corporation is the only U.S. taxpayer. If a separate U.S. corporation is used to own each property and a U.S. corporation serves as the parent of the U.S. group, then the U.S. parent corporation would file a consolidated income tax return with all its corporate subsidiaries. IRC § 1501. Some states (e.g., New York) allow a parent corporation to file a combined tax return for state tax purposes (in New York, NYS Form CT-3-C is used to file a combined return). However, other states (such as New Jersey) do not permit filing a combined state tax return. NJ Dep't of the Treasury, Division of Taxation, Corporation Business Tax-Rates and Accounting Periods (no combined return allowed), available at http://www.state.nj.us/treasury/taxation/ot4.shtml.

[141] If separate corporations (rather than LLCs) are used to own each property, and state tax returns are required to be filed in states that do not allow a combined return to be filed by a parent corporation and its subsidiary corporations, then for state tax purposes use of separate corporations may restrict the use of the losses of one company to offset the income of another company.

[142] In some cases, foreign investors may want to use multiple foreign corporations, one for each U.S. corporation or group of U.S. corporations. Use of multiple offshore holding companies can be useful if the investor wishes to transfer properties to different beneficiaries without having to dissolve the group structure that may trigger tax liability.

the same benefits as are available where there is a U.S. holding corporation, except that losses from one property may not offset income from another property. However, this structure is more advantageous when consideration is given to sales of properties. If a single property is sold by one of the U.S. companies in a fully taxable transaction and a plan of liquidation is adopted by that company, the sales proceeds remaining after paying corporate-level taxes and all expenses and liabilities can be paid without imposition of U.S. tax.[143]

Use of Shareholder Debt When Acquiring U.S. Real Estate. If a U.S. or foreign corporation is used to acquire the real estate, the investor will have to transfer cash to the company to allow it to buy the property. Lending some of the needed cash to the company may be more tax favorable than making a shareholder capital contribution. Since this is related-party debt, the IRS could seek to recharacterize the loan as deemed equity in the company, but proper planning can minimize this risk (e.g., by transferring only part of the needed cash as an equity capital contribution and maintaining a reasonable debt to equity ratio for the company).[144]

For the corporation, interest paid on the debt can produce tax deductions (whereas dividends are never tax deductible). For the shareholder, principal payments are not subject to U.S. tax, while the interest is subject to a 30 percent withholding tax.[145] A tax treaty may lower or eliminate that withholding tax, but then the earnings-stripping rules may limit the tax deduction available to the corporation.

Qualifying for the Portfolio Interest Exemption by Using Two Classes of Stock. In the absence of a tax treaty, the portfolio interest exemption is not available if the interest is paid to the corporation's sole shareholder. The portfolio interest exemption also is not available for interest paid to a shareholder who owns 10 percent or more of the corporation's voting stock,[146] but non-voting stock does not count regardless of how large an equity ownership in the company it may represent. As a result, if the corporation is formed with two classes of stock, one class of voting stock and a second class of non-voting stock, and there are two shareholders, one owning only the voting stock and the other only the non-voting stock, the portfolio interest exemption may be applicable for interest paid to the shareholder who owns only non-voting stock.

[143] The liquidating distribution would not be treated as a dividend subject to 30 percent withholding tax or a distribution subject to FIRPTA.

[144] See supra notes 47–49 and accompanying text.

[145] See supra notes 9–11 and accompanying text.

[146] Treas. Reg. § 1.871-14(g)(2)(i)(A).

Caution: In structuring a corporation with two classes of stock, the two shareholders must not be related to one another (except for their common ownership of the company), and one cannot act as the nominee for the other. In addition, if the voting stockholder has too small an equity ownership in the company (such as 1 percent equity), an IRS challenge may be expected and a court may be receptive to the argument that the two classes of stock should be disregarded.

Qualifying for the Portfolio Interest Exemption by Using an Offshore Fund. Sometimes, an offshore investment fund with many investors may be created to buy U.S. real estate. This offshore fund may create separate U.S. corporations, with each U.S. corporation being used to buy a single real estate parcel. The offshore fund can lend some of the money to each U.S. corporation and make an equity capital contribution of the rest of the cash needed to buy the property. If the offshore fund is characterized as a corporation, the portfolio interest exemption will not apply since the foreign corporation is a related party that owns 100 percent of the stock of each U.S. corporation. However, if the offshore fund is characterized as a partnership for U.S. tax purposes, the portfolio interest regulations are applied at the partner level, not at the partnership level; the regulations apply a "look-through" approach to determine if interest is paid to a related person and not eligible for the exemption.[147]

If no investor owns 10 percent or more of the offshore fund, the portfolio interest exemption applies to "all" the interest paid. If some but not all of the investors own less than 10 percent of the offshore fund, "part" of the interest paid is eligible for the exemption. The portion of the interest eligible for exemption is based on the percentage of the offshore fund owned by less than 10 percent investors. For example, if one investor owns 20 percent of the fund, but each of the other investors owns less than 10 percent of the fund (and is not related to the others), 80 percent of the interest is eligible for the exemption.

Use of Loan With Contingent Interest Rather Than Becoming a Partner in the Real Estate Project. A foreign investor may be asked to contribute money to a partnership or LLC that then acquires income producing U.S. real estate. In that case, the foreign investor will be ETB and subject to U.S. tax on both the taxable income of the partnership allocated to it and its share of gain on the sale of the property. With a maximum regular tax rate of 39.6 percent and a maximum long-term capital gains rate of 20 percent, a foreign individual may owe significant U.S. tax on the return from this investment and will have to file an annual federal tax return as well as state and local tax returns in the places where the property is situated.

[147] Treas. Reg. § 1.871-14(g)(3)(i).

A foreign investor who wants to make an investment without the hassle of annual tax filings and the related tax liability may instead consider lending money to the partnership, rather than becoming an equity participant. If a tax treaty applies, all interest on the debt could be paid without imposition of the 30 percent withholding tax.[148] If no treaty is applicable, the portfolio interest exemption can apply to fixed interest paid on the loan but not contingent interest.[149]

It is possible for debt as an alternative to equity to replicate the terms of an equity investment in a partnership with a loan made to the partnership, as illustrated in Example 3.

> ***Example 3:*** Consider a foreign investor who contributes $10 million to buy a 10 percent interest in a partnership and is thereby entitled to (1) get a preferred annual distribution from the partnership equal to 6 percent of the investor's invested capital, (2) receive a return of the investment on sale of the property (to the extent that funds are available), and (3) share in 10 percent of all excess cash distributions. As a practical matter, the right to 10 percent of all excess cash distributions is expected to apply only on a sale of the property and the parties expect the property will be sold within 10 years.
>
> As an alternative, the investor could be offered the opportunity to make a $10 million loan to the partnership on the following terms: (1) a maturity date of 10 years; (2) the partnership would pay fixed interest on the loan of 6 percent per year, and (3) at the maturity, the partnership would pay the investor as contingent interest 10 percent of any appreciation in value of the real estate since the property was first purchased by the partnership. Assuming the status of the loan as debt for tax purposes is respected, the fixed annual interest would be exempt from withholding tax under the portfolio interest exemption; only the contingent interest on the property's appreciation in value would be subject to the 30 percent withholding tax (assuming no treaty applies to lower or eliminate that tax). In this case, the aggregate U.S. tax burden on the foreign investor as a lender to the partnership may be much lower than the tax the investor would owe if the investor were an equity participant.

Caution: Any such rearrangement of equity into debt must deal with many business issues since debt and equity are not truly interchangeable, but the possible tax benefits may make it a worthwhile option to consider.

[148] See supra notes 12–13 and accompanying text.

[149] See supra notes 16–20 and accompanying text.

Conclusion

Notwithstanding FIRPTA, planning opportunities exist for foreign investors seeking to invest in U.S. real estate or mortgage debt. There are potentially two levels of income tax that can apply when the property is held by an entity. However, with careful structuring, those making equity investments can limit their income tax exposure to only one level of tax on sale—and possibly avoid U.S. taxation altogether. U.S. income tax exposure may also be significantly reduced or eliminated if an investor makes both an equity contribution to the entity buying the property and a loan to that entity, or if the investor decides only to be a lender to the company that is buying the real estate. It is also important to take into account estate and gift tax exposure, as well as state and local taxes, all of which can add a significant financial burden. A foreign investor should explore all options before investing in the U.S. so as to ensure that the maximum financial return can be attained without incurring excessive tax payments and filing obligations.

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Journal of Taxation of Investments
Vol. 32, No. 3, Spring 2015
Authorized Reprint

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