

# BUYING U.S. REAL ESTATE

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ITSG WORLD CONFERENCE  
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# Rental income

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- Rental income: **FDAP** income subject to 30% withholding tax
- Tax can be very harsh
  - Example:
    - Lessee pays \$100 rent to owner and lessee pays expenses to 3rd parties related to the property of \$100 (e.g., real property taxes, insurance)
    - Gross rental income = \$200
    - Withholding tax = \$60
    - Net cash owner gets = \$40 (\$100 - \$60)
    - Effective tax rate of 60%

# Rental income (cont'd)

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- If leasing or other activity in relation to property makes foreign owner **ETB**, then rental income becomes **ECI**
- Tax only on “net income” from property, which usually produces lower tax for owner
  - Example:
    - Lessee pays \$100 rent to owner and lessee pays expenses related to the property of \$100
    - Gross rental income = \$200
    - Net rental income (before depreciation & interest deductions) = \$100
    - Maximum Tax (assuming no depreciation or interest) = \$35
    - Effective tax rate = 35% and lower if get depreciation, interest & other deductions
  - Owner must file tax return

# Rental income (cont'd)

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- When does leasing make foreign owner **ETB**?
  - General Rules:
    - Rental of one property to one tenant under a “net” lease is not ETB  
See Rev. Rul. 73-522; *Neill*
    - Rental to many tenants is ETB  
See *Pinchot v. Comm’r* (11 real estate properties)
  - Election to be ETB: §871(d), 882(d) or treaty equivalent
    - Often recommended since lower tax burden (due to reductions)
- If rental income is ECI, give Form W-8ECI to lessee to eliminate withholding tax.

# Sale of real estate

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- Gain is Taxable: Foreign Investment in Real Property Tax Act of 1980 (**FIRPTA**) – §897
- Gain from sale of “United States real property interest” (“USRPI”) taxed as if:
  - Foreign seller is engaged in a trade or business in the U.S. & the gain is effectively connected with that trade or business
  - Foreign sellers are taxed on gains at the same rates applicable to U.S. sellers
  - Gain can qualify for long-term capital gains treatment
- Includes Interest in domestic corporation that was a U.S. real property holding corporation at any time during the 5-year period preceding sale

# Sale of real estate (cont'd)

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- Withholding Requirement: §1445
  - Buyer must withhold 10% of “Amount Realized” on Sale
  - Other Withholding Rules (e.g., 35% at disposition of real property by a partnership)
- Problem: Over withholding
  - Example:
    - Sell real estate with a tax basis of \$900 for \$1,000
    - Buyer must withhold \$100 tax (10% of \$1,000) even though gain is only \$100 & tax will be less than that
  - Solution: Get Exemption or reduced rate certificate by filing Form 8288-B before the sale
- Rev. Proc. 2000-35 describes procedures for applying –  
Recommended in example above to lower the withholding tax

# Gift tax

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- Nonresident alien (NRA) is taxed on gifts of tangible (but not intangible) property located in the United States
  - Gift of U.S. real property is subject to gift tax
  - Gift of stock (whether domestic or foreign corporation) is not subject to gift tax
  - Gift of partnership interest probably not subject to gift tax
  - Points to note:
    - No step-up in basis on *inter vivos* gift
    - No unified credit
    - “Substance over form” risk, for example:
      - Donee or trust is funded with cash and purchases real property from grantor (*Davies v. Commissioner*, 40 T.C. 525 (1963))
      - Foreign owner contributes property to partnership, then makes gift of partnership interest

# Estate tax

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- Estate of NRA is subject to estate tax on property located in the United States, includes:
  - U.S. real property and tangible property located on it
  - Stock in U.S. corporation (publicly traded or not)
  - But not stock in foreign corporation
  - Top rate (2015) 40%; unified credit equivalent to \$60,000 exemption (unchanged for decades)
- Uncertain treatment of partnership interests
  - IRS position: interest is located in the U.S. if partnership is engaged in U.S. trade or business.
  - What if:
    - Partnership not ETB but decedent elected under §871(d)?
    - Partnership owns only residence for NRA's personal use?
  - Other theories: place of organization or partner domicile



# Options – 1

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- 20% tax or 39.6% tax
- Privacy Concerns
- Estate Tax at 40%
- but - only one level of tax
  - may exempt up to \$250k of gain if principal residence

Foreign  
Individual

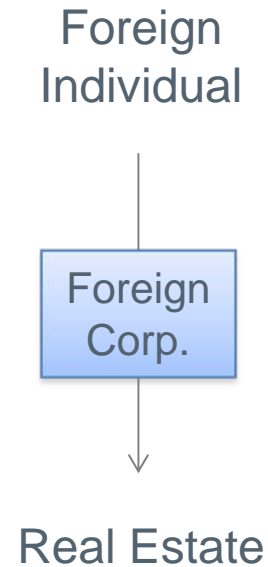


Real Estate

# Options – 2

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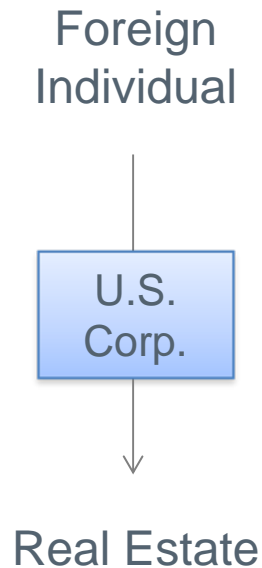
- No Estate Tax
- Branch Profits Tax
- Privacy Concerns
- Sale of Stock - Tax Free BUT!  
Discounted price
- Tax-Free Refinancing Distributions



# Options – 3

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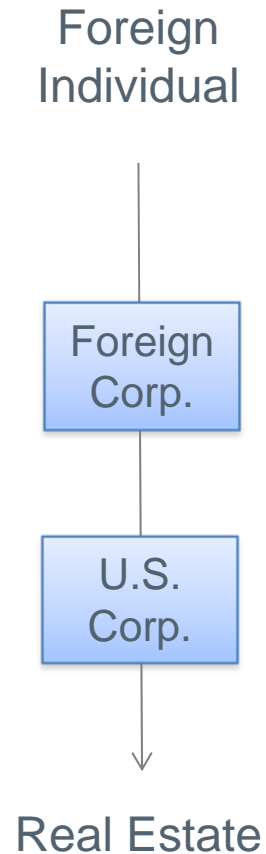
- No Branch Profits Tax
- Dividend Withholding Tax
- Estate Tax
- Privacy Concerns
- Sale of Stock – Taxable
- Taxable Refinancing Distributions



# Options – 4

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- No Branch Profits Tax
- No Estate Tax
- No Disclosure
- Sale of Stock
- Taxable Refinancing Distributions



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**NEW YORK**

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