



Structuring Foreign Investment in US Real Property

The purpose of this article is to set forth some of the most important legal and tax issues affecting foreign⁽¹⁾ investors in the United States. The rules of the game are quite different in every aspect of involvement with real property from determining what individual or entity should be listed as the purchaser on the contract, to how a rental property must be managed, to the procedures to be followed when the real property is sold.

The purchase Stage

Before the foreign investor signs a contract to purchase real property, consideration should be given to the form in which title to the property is to be held so as to consider the United States income tax issues⁽²⁾ and to take advantage of possible United States estate and gift tax savings. When dealing with a domestic client purchasing residential property, real estate professionals generally use a form purchase and sale contract in which they insert the client's name individually or jointly with a spouse as the buyer of property without giving any further thought to possible tax consequences. Such neglect to how title to property is taken when dealing with a foreign client, however, can prove to be disastrous.

Because nonresident aliens are subject to United States estate and gift tax rules different than those applied to United States citizens and residents, proper planning can achieve significant benefits for a foreign investor who acquires United States real property directly or indirectly through a foreign corporation - one incorporated in a jurisdiction outside the United States. Absent an applicable estate tax treaty, a nonresident alien is subject to United States estate tax if he dies while holding title to United States real property in either his own name, jointly with someone else, or through a domestic corporation (one incorporated in a jurisdiction within the United States) of which he is a shareholder. The federal estate tax provides an exemption equivalent of only US\$60,000.00 ⁽³⁾ for nonresident aliens (cf. currently US\$1,000,000.00 for residents and citizens), and a marital deduction is available only if the surviving spouse is a United States citizen or if the property is transferred to a "qualified domestic trust" ⁽⁴⁾. Moreover, if the real property was held in the foreign investor's individual name, a probate proceeding may be required in order to convey proper title from his or her estate to the proper beneficiaries.

In contrast, stock in a foreign corporation (which, for example, directly or indirectly owns United States real property) owned by a nonresident alien at the time of his death is exempt from United States estate tax and is considered as property located outside the jurisdiction of United States probate courts. Gifts of



United States real property by nonresident aliens are subject to United States gift tax, while gifts of intangible personal property, such as stock in a foreign corporation, are generally exempt from United States gift tax.

Real estate professionals should seek the advice of qualified legal counsel prior to the execution of the purchase contract, or if that is not possible, then to at least make the purchase contract assignable by adding the words "and/or assigns" after the name of the foreign purchaser. In making the contract assignable, qualified legal counsel can then consider a range of options available in structuring the purchase in the most tax-efficient manner. The cost of the real property and the foreign investor's objectives are important factors in structuring any transaction. Obviously, the tax planning involved in the purchase of a US \$10,000,000.00 office building is much different than that for a US\$200,000.00 condominium apartment. Many financial institutions are reluctant to provide mortgage financing for real property owned directly by a foreign corporation in spite of the foreign investor's personal guarantee of the mortgage note. Many condominium association bylaws limit unit ownership directly by a foreign corporation, despite affidavits regarding the personal use of the unit by the foreign investor and his family.

If a foreign investor has already purchased United States real property in his own name or jointly with another person, correcting the problem may prove too costly to consider. Changing title to the property creates income tax consequences under the Foreign Investment in Real Property Tax Act ("FIRPTA") which is discussed below, not to mention additional transfer and documentary stamp taxes and approvals from the mortgagee and the condominium association. Unfortunately, sometimes the only economical answer may be the purchase of term life insurance to cover the future estate tax liability -- an additional cost for which the foreign investor may not have bargained.

Income Tax Issues

Many foreign investors are concerned with the income tax considerations involved in their ownership of United States real property. Such questions include whether rental income is subject to income tax in their country as well as in the United States, whether certain expenses will be deductible, and whether the gain on the sale of the property will be taxed in more than one country. While a thorough discussion of all the income tax issues involved is beyond the scope of this article, the informed real estate professional should be aware of some critical issues.

When dealing with a foreign investor, the real property professional should be



are aware that the United States immigration status of the foreign investor and the number of days the foreign investor spends in the United States during the year will have a significant impact on the income tax consequences of the investment in United States real property, even if such property is owned directly by a corporation, trust or other type of entity. The status of a foreign individual (i.e., a person who is not a citizen of the United States) as either a resident or nonresident for federal income tax purposes is fundamental in determining how such person will be taxed. Residence for United States income tax purposes is different than residence for immigration purposes (i.e., the type of visa the foreign person has) and residence for United States estate and gift tax purposes (which is based upon domicile, meaning being physically present in a jurisdiction and intending to remain there). Residents are taxed like United States citizens on their worldwide income and are subject to rigorous information reporting requirements, while nonresidents generally are subject to federal income tax on only their United States source income and they enjoy exclusions from federal income tax on certain interest income and non-real estate capital gains. When a foreign investor changes from being a nonresident to being a resident of the United States for income tax purposes, not only does his worldwide income become subject to United States taxation, but he must then also comply with numerous reporting requirements. For federal income tax purposes, foreign individuals are considered residents of the United States for the year in question if they fall into any of the following three categories:

1. They are lawfully admitted residents for immigration purposes (i.e., have a "green card").
2. They are physically present in the United States for 183 or more days during the current calendar year, regardless of their immigration status.
3. They are present in the United States for at least 31 days but less than 183 days during the current calendar year and meet the "substantial presence test" whereby a weighted formula is applied for the number of days they have spent in the United States during the current and two preceding calendar years with certain exceptions. If applying the weighted formula to the number of days the foreign investor has been in the United States over the current and past two years results in 183 days or more, he will be presumed to be a resident in the current year unless he can substantiate that he has "closer connections" to and a "tax home" in the same foreign jurisdiction and he timely files IRS Form 8840 (and a nonresident alien income tax return if such return is required to be filed as well).

There are other exceptions which may be applicable, including, but not limited to, one for foreign individuals in the United States on a student visa or a valid diplomatic visa and one based upon the application of a United States income tax treaty then in force.

Other United States income tax considerations include an analysis of the difference between income tax rates for individuals and corporations, and



whether a corporate owner should be incorporated in a foreign or domestic jurisdiction ⁽⁵⁾. A more detailed discussion of the income tax advantages and disadvantages with regard to the various ways in which real property may be titled is beyond the scope of this article.

What should be clear is that there are many tax issues which must be considered prior to determining how real property should be titled, and if a foreign investor actually has a "green card" or spends a substantial part of the year in the United States, he or she most likely will be considered a resident of the United States for federal income tax purposes.

Management of Foreign-owned rental property

The source of rental income (whether from the United States or from foreign sources) is dependent on place of use of the item being rented. The source of income from the sale or exchange of an item is dependent on physical location of the item. Thus, both rental income from real property situated within the United States and the gain from the sale of such real property will always be United States source income subject to federal income tax regardless of the immigration status of the foreign investor and regardless of whether the United States has an income treaty with the home country of the foreign investor.

The method by which the rental income will be taxed depends on whether or not the foreign owner ⁽⁶⁾ is considered "engaged in the United States trade of business." Ownership of real property is not considered "a United States trade or business" if it consists of merely passive activity such as a net lease in which the lessee pays rent, as well as all taxes, operating expenses, repairs, interest and principal on existing mortgages and/or insurance in connection with the property. Such passive rental income is subject to a flat thirty percent (30%) withholding tax (unless reduced by applicable income tax treaty) applied to the gross income rather than the "net rent" received. Thus, the real estate taxes, operating expenses, ground rent, repairs, interest and principal on any existing mortgages and insurance premiums paid by the lessee on behalf of the foreign owner-lessor must be included in gross income subject to the thirty percent (30%) withholding tax.

If the foreign owner is engaged in a "United States trade or business" such as the developing, managing and operating of a major shopping center, on the other hand, the rental income will not be subject to withholding and will be taxed at ordinary progressive rates and may be subject to "branch profits tax" (see footnote 5). Expenses such as mortgage interest, real property taxes, maintenance, repairs and depreciation ("accelerated cost recovery") may then be deducted in



determining net taxable income. The only way these expenses can be deducted, however, is if an income tax return (Internal Revenue Service Form 1040NR for nonresident alien individuals and Internal Revenue Service Form 1120F for foreign corporations) is timely filed by the foreign owner.

Foreign individuals and foreign corporations may elect to have their passive rental income taxed as if such income were effectively connected with the United States trade and business. Once such an election is made by attaching a declaration to a timely filed income tax return, there is no obligation to withhold even in a net-lease situation. Once made, the election may not be revoked without the consent of the Internal Revenue Service ("IRS"), except that it may be revoked without the consent of the IRS before the statute of limitation for filing a claim for refund expires with regard to the year in which the election was initially made.

Domestic partnerships (one formed in a jurisdiction within the United States) must withhold tax on income items subject to withholding tax which are included in the distributive share of a foreign partner. Therefore, if partnership profits are derived from net-leased real property, the withholding burden shifts from the lessee to the domestic partnership.

Before agreeing to manage real property for a foreign owner, care should be taken to document whether the foreign owner will consider the rental income as effectively connected with a United States trade or business. As noted below, unless the foreign owner has properly informed the property manager that the rental income is to be treated as "effectively connected income" by submitting to the property manager an original executed IRS Form W-8ECI, the property manager should withhold thirty percent (30%) of the gross rental receipts so as to avoid personal liability. To enforce the system of withholding, the Internal Revenue Service may require payment from a "withholding agent", defined as any person in whatever capacity (including lessees and managers of United States real property) having the control, receipt, custody, disposal or payment of income that is subject to withholding. Thus, a real property manager who collects rent on behalf of a foreign owner is clearly considered a withholding agent. A withholding agent is personally and primarily liable for any tax that must be withheld. The liability of the withholding agent includes amounts that should have been paid plus interest, penalties and, where applicable, criminal sanctions.

The statute of limitations does not begin to run if no withholding return is filed by the withholding agent. When a withholding return is filed by the withholding agent, the statute of limitations begins to run at the later of the date of actual filing of the correct return or the due date for the return. A withholding agent will



remain liable if he has actual knowledge of the falsity of the statements from the foreign property owner. The withholding agent's duty of inquiry seems to be a "reasonably prudent test" measured by all facts and circumstances.

The withholding agent may have a remedy against the foreign owner, although there is very little authority on this point. Public policy arguments as well as international law considerations, however, often preclude the enforcement of one country's tax laws through civil suits in another county. There may be a possibility of a set-off from other funds of the taxpayer in the withholding agent's control, because taxes are primarily the obligation of the income recipient.

Once the tax is paid by the foreign owner, the withholding agent is not automatically absolved from liability as the failure of the foreign owner to file a timely return (if required) may still result in penalties assessed against him. If the withholding agent pays the taxes from personal funds rather than withholding from rental payments, however, the actual amount due is more than thirty percent (30%) of the gross rental receipts because payment of taxes for a third party is further income to that third party and is not deductible by the withholding agent.

If one is managing rental property owned by a foreign owner and one is in doubt as to what one should do, then one should withhold; and, if there is uncertainty, let the foreign owner pursue his or her own claim for refund directly from the IRS. See the "Checklist for Managing Foreign Owned United States Property" at the end of this article.

Foreign Investment In Real Property Tax Act of 1980 ("FIRPTA") and The Sale of Real Property

Every real property transaction in the United States is now affected by the FIRPTA withholding requirements, including the foreclosure on mortgages of property owned by nonresident aliens and foreign corporations. The FIRPTA withholding provisions create a presumption that every seller is a foreign person subject to the withholding unless proof is provided to the buyer to the contrary. Any buyer of a United States real property interest from a foreign owner, and anyone who is required to withhold tax pursuant to such transaction, must file IRS Forms 8288 and 8288-A to report and transmit the amount withheld. If more than one person is required to file IRS Forms 8288 and 8288-A, the obligation of each such person will be met if only one of them withholds the tax and transmits it to the IRS. The purchaser or other withholding agent must report and transmit to the IRS the tax withheld by the twentieth (20th) day after the date of transfer. There is a penalty of up to US\$10,000.00 over the tax for the willful failure to collect and pay.



FIRPTA requires that a transferee (i.e., the purchaser) of a United States real property interest from a foreign seller withhold 10% of the "total amount realized", defined as the full sales or contract price, unless one of several exemptions apply. Some of these exemptions include: (1) if the purchaser is to use the real property as a residence and the purchase price is not more than US\$300,000; (2) if the transferor (i.e., the seller) obtains a qualifying statement from the IRS that he is either exempt from tax or entitled to a reduced withholding amount, or has provided adequate security for payment of the tax, or has made arrangement with the IRS to pay the tax; and (3) if the seller has furnished a "nonforeign affidavit", certifying that he is not a foreign person. The purchaser is directly responsible for withholding the tax, although any attorney or real property professional involved in the transaction, as agents of either the purchaser or the seller, can be held liable for an amount equal to their compensation earned from the transaction if they know that the purchaser has been given a false certification or a statement claiming an exemption from withholding and they fail to so notify the purchaser and the IRS about the same.

There are at least two common misconceptions concerning FIRPTA which must be dispelled. First, just because either there has been withholding from the foreign investor or the transaction was exempt from withholding does not mean the foreign investor has satisfied his income tax liability with respect to the sale. Quite on the contrary, the sale of a United States real property interest by a foreign investor is a taxable event calling for the filing of an income tax return for the tax year in which the property was sold. The amount of tax withheld may be insufficient to pay his actual income tax liability; or, because withholding was avoided he must still pay an income tax on any gains actually realized on the sale of the property.

Second, in order to qualify for the "residential use under US\$300,000.00" FIRPTA withholding exemption, at the time of sale the purchaser (or any member of his immediate family) must have definite plans to reside at the property for at least 50% of the number of days that the property is to be used during each of the first two twelve-month periods following the date of sale. So long as the foregoing requirement is met, the property does not need to be the purchaser's primary or principal residence. In our law office we generally require the purchaser to sign an affidavit under penalties of perjury which contains the language in the relevant Treasury Regulation in order to substantiate qualifying for this FIRPTA withholding exemption.



Conclusions

Successful real property professionals representing foreign investors in the United States must remain informed of the critical issues affecting their clients, particularly in the areas of legal and tax matters.

Checklist for Managing Foreign-Owned United States Real Property:

1. Is the foreign owner of the South Carolina or Georgia property either a foreign corporation, foreign partnership, foreign trust, foreign estate or a nonresident alien individual for income tax purposes? If yes, continue to question No. 2. If no, then there is no problem.
2. Is the owner considering rental income as effectively connected with business income?
3. If the answer to question No. 2 is yes:
 - a. Do you have a valid executed IRS Form W-8ECI on file; and has IRS Form 1042S been filed? IRS Form W-8ECI will remain in effect for a period starting on the date the form is signed and ending on the last day of the third succeeding calendar year, unless a change in circumstances makes any information on the form incorrect. Upon the expiration of the 3-year period, you must obtain a new IRS Form W-8ECI.
 - b. Has the foreign property owner been advised that an income tax return (IRS Form 1040-NR, in the case of a nonresident alien individual or 1120F, in the case of a foreign corporation) must be filed in order to be able to take appropriate deductions?
4. If the answer to question No. 2 is no, has 30 percent of gross rentals been withheld and paid to the IRS?

Endnotes

1. For the purposes of this article, the term "foreign investor" is used to mean a purchaser, owner or seller of United States real estate who is neither a citizen of the United States nor a resident of the United States for United States income, estate and gift tax purposes. While many may consider the term "international investor" less offensive or discriminatory against those from outside the United States, the authors have chosen to use the term most familiar to the real estate professional.
2. The United States currently has seventeen estate tax treaties in force. They are with Australia, Austria, Canada (through the Canada-United States Income Tax Protocol entered into November 9, 1995), Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, Norway, South Africa, Sweden, Switzerland and the United Kingdom.
3. Pursuant to recent changes in United States tax law, the unified credit "applicable credit amount" will increase each year from \$1,000,000.00 in 2002 to \$3,500,000.00 in the year 2009 and then be repealed in 2010 and revert to \$1,000,000 in 2011 and thereafter.
4. A complete discussion as to the legal and tax requirements of a "qualified domestic trust" (commonly referred to as a "QDOT") is beyond the scope of this article. Moreover, there are several estate and gift tax treaties which have been interpreted to allow for a marital deduction even if the surviving spouse is



not a United States citizen.

5. Federal capital gain tax rates are different for corporations (maximum capital gains tax rate of 35%) than they are for individuals (maximum capital gains tax rate of 20%). Florida does not impose State income tax on individuals, but it does impose a income tax of 5% and an intangible tax on corporations. In addition, an additional income tax, the branch profits tax, will be imposed on the dividend equivalent amount to the extent a foreign corporation has earnings and profits which are effectively connected to a United States trade or business. The branch profits tax rate is a flat thirty percent (30%).

6. For the purposes of this article, the term "foreign owner" is used to mean a owner of United States real estate who is neither (a) a citizen of the United States nor a resident of the United States for United States income, estate and gift tax purposes or (b) a corporation or other entity formed in a jurisdiction within the United States.

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