

New Beginnings – New US Tax Regime: Time to Re-Think Real Estate Planning Paradigms

Michael J. Legamaro

Michael@legamaro.com

Ruby Banipal

Ruby@legamaro.com

Relevant US Tax Principles Post-TCJA

New International Tax Paradigm: Upends Planning of Past 50 or more years

- ▶ Large Margin of rates between C corporation and Flow-through Entities (21% v. 37%)
 - ▶ No AMT!
 - ▶ Corporations king!
- ▶ Limitations of Deductibility for State/Local Tax Payments, Business Interest and Payments Involving Related Hybrid Entities or Hybrid Transactions
 - ▶ Techniques to Avoid

New Tax Law incentivizes move to C Corporation

- ▶ Flow-through structures no longer as economically efficient for Non-US Investors when compared to “Days of Old”
 - ▶ For real estate income, rental subject to tax at 37% and gain at 20%
 - ▶ Formerly 39.6% and 20%
 - ▶ State and local tax imposed at individual level; now non-deductible above \$10,000/year
 - ▶ Formerly deductible in full
- ▶ C corporations taxed at 21%
 - ▶ State and local taxes fully deductible
 - ▶ “Shareholder Level” dividend taxed at 20%
 - ▶ “Combined” rate approximately 38.8%, assuming regular distribution
 - ▶ Ways Around Shareholder Tax = Liquidation at End of Investment

C Corporation Benefits for Investment Income

- ▶ Flow-Through Effective Rates on Investment Income range from 20% to 37%, Without State Tax Deductibility
- ▶ Corporate Rate = 21% Plus State Tax Deductibility
 - ▶ No more corporate Alternative Minimum Tax (AMT)
- ▶ Keeping “assets in corporate solution” viable strategy again
 - ▶ Personal Holding Company Excise Tax Generally Manageable
 - ▶ Accumulated Earnings Excise Tax Generally Manageable

State and Local Tax

- ▶ State Tax Rates range from 0% to 13.3% of net income
 - ▶ California = 13.3%
 - ▶ New York = 8.81%
 - ▶ New Jersey = 8.97%
 - ▶ Florida, Texas, elsewhere = 0%
- ▶ Deduction for state and local property (and income and sales) taxes is limited to \$10,000 per year
- ▶ Limitation does not apply to taxes incurred in connection with a trade or business
- ▶ Limitation does not apply to taxes incurred by C corporation

Interest Deductibility Limitation

- ▶ Deduction for business interest expense limited to 30% of “adjusted taxable income”
- ▶ Adjusted taxable income based on EBITDA until 2022, then EBIT
- ▶ Disallowed deduction may be carried forward indefinitely
 - ▶ Utilization in future years subject to applicable interest deductibility limitations
 - ▶ Complicated mechanics for partnerships and S-corporations – limitation applies at entity level

Planning Exceptions & Exemptions to Business Interest Limits

- ▶ Exception from 30% limitation:
 - ▶ Small Business Exception: revenues of less than \$25M
 - ▶ Electing Real Property Trade or Business Exception (RPTB Exception)
- ▶ Repayment of principal permits repatriation to shareholder on tax-free basis
- ▶ Investment Interest \neq Business Interest

Exception for Real Property Businesses

- ▶ Real property trade or businesses (RPTB) may elect exclusion from interest deductibility limitation
 - ▶ Election irrevocable once made
- ▶ RPTB includes, *inter alia*, real property development, re-development, construction, rental, management, leasing trade or business.
- ▶ Election requires using straight line method depreciation and longer recovery periods than usual depreciation method
 - ▶ Recovery periods for nonresidential depreciable real property, residential depreciable real property and qualified improvements are extended to 40, 30 and 20 years, respectively

Deductibility of Investment Interest

- ▶ Unlike “business interest” which is now subject to limitations under IRC Section 163(j), “investment interest” remains deductible
- ▶ Limitation on deductibility = aggregate amount of “investment income”; carryforward for any excess
- ▶ Where dividends/gains on sale of US corporation shares considered “investment income”, interest is deductible against net
 - ▶ Special election [IRS Form 4952] required to treat dividend income/gains as investment income
 - ▶ May apply to all or any portion of dividends or gains
 - ▶ Election, once made, revocable solely with consent of IRS

Juicy New Deductions Apart from Interest

- ▶ ***100% deduction for cost basis of qualifying property placed in service*** from September 2017 through 2022
 - ▶ After 2022, percentage phases down to 80% (2023 service date), 60% (2024), 40% (2025), 20% (2026)
- ▶ No “original use” requirement – applies to purchases of used and new equipment
 - ▶ Excludes property acquired from affiliate or in a tax free transaction (i.e., like kind exchange)
- ▶ Qualified property generally includes assets with recovery periods of 20 years or less
 - ▶ Real estate related property eligible for 100% expensing likely includes heating, lighting, plumbing, cooling, fire protection, and alarm systems

New Anti-Hybrid Rules Limit Deductions

- ▶ No deduction for interest paid to related party (RP) (50% connection) if the amount:
 - ▶ is not included in RP's taxable income, or
 - ▶ generates a RP deduction
- ▶ **AND** the amount is:
 - ▶ paid pursuant to a hybrid transaction (*i.e.*, treated as interest under U.S. tax law but not under the RP's tax law), or
 - ▶ paid to, or by, a hybrid entity (*i.e.*, transparent for U.S. tax law but not under RP's tax law, or vice versa)

Don't Forget that Tax/Withholding Applies to Interest Paid Foreign Persons

- ▶ IRC Section 871 generally imposes tax on interest paid to a foreign person
 - ▶ Withholding by US payor required under IRC Section 1441
- ▶ Foreign persons must compare benefits of reducing net income via interest subject to withholding (30% of interest paid) where net income is subject to tax
 - ▶ @ 37% or 20% for “flow-through” structures
 - ▶ ***But Watch Out for Branch Profits Tax*** (when Flow-through owned by Foreign Corporation)
 - ▶ @ 21% for corporate structures, where no Dividend Withholding Tax applies [or 44.7% with 30% WHT]

Portfolio Interest Exempt from Tax/Withholding

- ▶ **Interest rate must be fixed**
 - ▶ No equity kicker allowed
- ▶ **Lender may not be “10% shareholder” of borrower**
 - ▶ For corporate borrower, based on voting power
 - ▶ For partnership borrower, based on capital or profits interests
 - ▶ Limitation N/A to trusts
- ▶ **Lender may not be a bank making loan in ordinary course or a CFC related to borrower**
 - ▶ Income cannot be ECI
 - ▶ Must certify foreign status to benefit from exemption (Form W-8)

Door Opens for Foreign Beneficiary of US S Corporation

- ▶ S Corporation is a “flow-through” for US tax purposes
 - ▶ Corporation in form but partnership (more or less) in substance
 - ▶ Corporation reports taxable income to shareholders who are subject to tax (or not) depending upon net income
 - ▶ Certain trusts – so-called “electing small business trusts” (ESBTs) – are qualified shareholders
- ▶ Until 2018, no foreign person could be “current income beneficiary” of an ESBT [or other trust qualified to be S shareholder]
- ▶ Distinction removed for foreign persons commencing 2018

Post-TJCA Law to “FIRPTA Assets”

FIRPTA Largely Unchanged

- ▶ **Foreign Investment in Real Property Tax Act (FIRPTA) – taxes foreign persons selling U.S. real estate**
 - ▶ Generally retained as is
- ▶ **NRAs and FCs taxed on gain from disposition of U.S. real property interest (USRPI) as Effectively Connected Income (ECI)**
 - ▶ Generally, same tax rates apply as to U.S. persons
 - ▶ Branch profits Tax may also apply to FC income
 - ▶ Look-through rules apply for USRPIs held through a partnership
 - ▶ Must file return to report FIRPTA liability!

What is a USRPI?

- ▶ **An interest, other than solely as a creditor, in real property located in the United States, including:**
 - ▶ Land, building, improvements; leasehold, life estates, remainder interests in U.S. real property; options to acquire U.S. real property
- ▶ **An interest, other than solely as a creditor, in any U.S. corporation that is (or, during 5-year or shorter look-back period, was) a U.S. real property holding corporation (USRPHC)**
 - ▶ A USRPHC is a corporation for which the FMV of its USRPIs is 50% or more of the total FMV of its USRPIs + its foreign real property + any other trade or business assets.
 - ▶ “Cleansing Exception:” stock of former USRPHC is “cleansed” if all USRPIs have been sold, and corporation recognized all gain
- ▶ **USRPI does not include debt secured by real property, BUT**
 - ▶ Caution! Equity kickers can transform a debt interest into a USRPI

USRPI & Partnerships

▶ Partnership Interests

- ▶ Partnership interest treated as USRPI only to extent gain on disposition is attributable to USRPIs
- ▶ Thus, disposition of partnership owning USRPIs triggers ECI and withholding under FIRPTA with respect to partner's allocable share of the ECI

▶ FIRPTA Withholding only applies to “50/90” partnerships

- ▶ If $\geq 50\%$ of partnership assets are USRPI and $\geq 90\%$ of partnership assets are USRPI, cash, and cash equivalents, entire partnership interest classified as USRPI for FIRPTA Withholding purposes (but not Section 897 purposes).
- ▶ On sale of a 50/90 partnership interest, FIRPTA withholding applies to entire amount realized unless reduced by FIRPTA Certificate

FIRPTA Exceptions

- ▶ **Like-kind exchanges (Section 1031)**
 - ▶ U.S. and foreign property cannot be like-kind
- ▶ **Certain publicly traded USRPHC stock**
 - ▶ If do not own interest of greater than 5% (including during look back period)
 - ▶ Subject to REIT-related revision under the PATH Act
- ▶ **Purchase of a residence under \$300k**

Tax Paid via Withholding

- ▶ **Buyer of USRPI required to withhold 15% on amount realized (FIRPTA Withholding)(Section 1445)**
 - ▶ Amount realized = cash + FMV of transferred property + assumed liabilities
 - ▶ Arbitrary and may exceed tax due, requiring refund application
 - ▶ Withholding base includes value of assumed debt
 - ▶ Application of FIRPTA to partnerships is complex
 - ▶ Parties may request withholding certificate from IRS prior to sale to reduce or eliminate FIRPTA Withholding (FIRPTA Certificate, Form 8288-B)

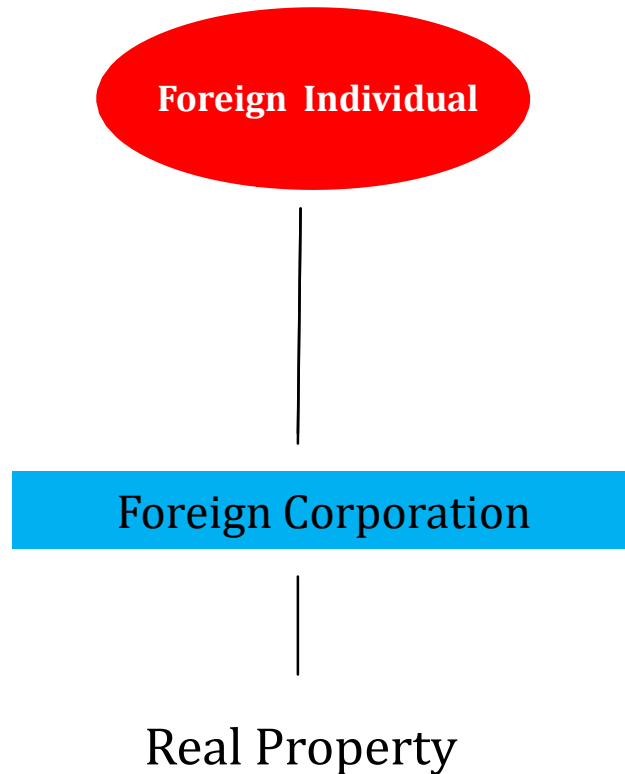
Direct Investment by NRA

Foreign Individual

Real Property

- ▶ **Must File Personal 1040 Return**
 - ▶ Possible deal breaker!
- ▶ **Rental Income:**
 - ▶ Gross rent subject to 30% withholding by lessee; or
 - ▶ Net rental income subject to tax up to 37% (+SALT)
- ▶ **Long Term Capital Gains:**
 - ▶ Taxable at 20%(+SALT)
 - ▶ FIRPTA Withholding on sales proceeds (subject to any FIRPTA Certificate)
- ▶ **Estate Tax Result:**
 - ▶ Applies at 40% (+ state estate tax) on the USRPI value
 - ▶ Purchase term insurance to mitigate risk
 - ▶ May use non-recourse debt to reduce value

NRA Investment Through Foreign Corp



▶ To Foreign Corporation

- ▶ 1120F filing will require disclosure of owners
- ▶ Gross rental incomes subject to 30% withholding by lessee; or
- ▶ Net rental income subject to tax up to 21% (+SALT)
- ▶ BPT may apply at 30% or lower treaty rate

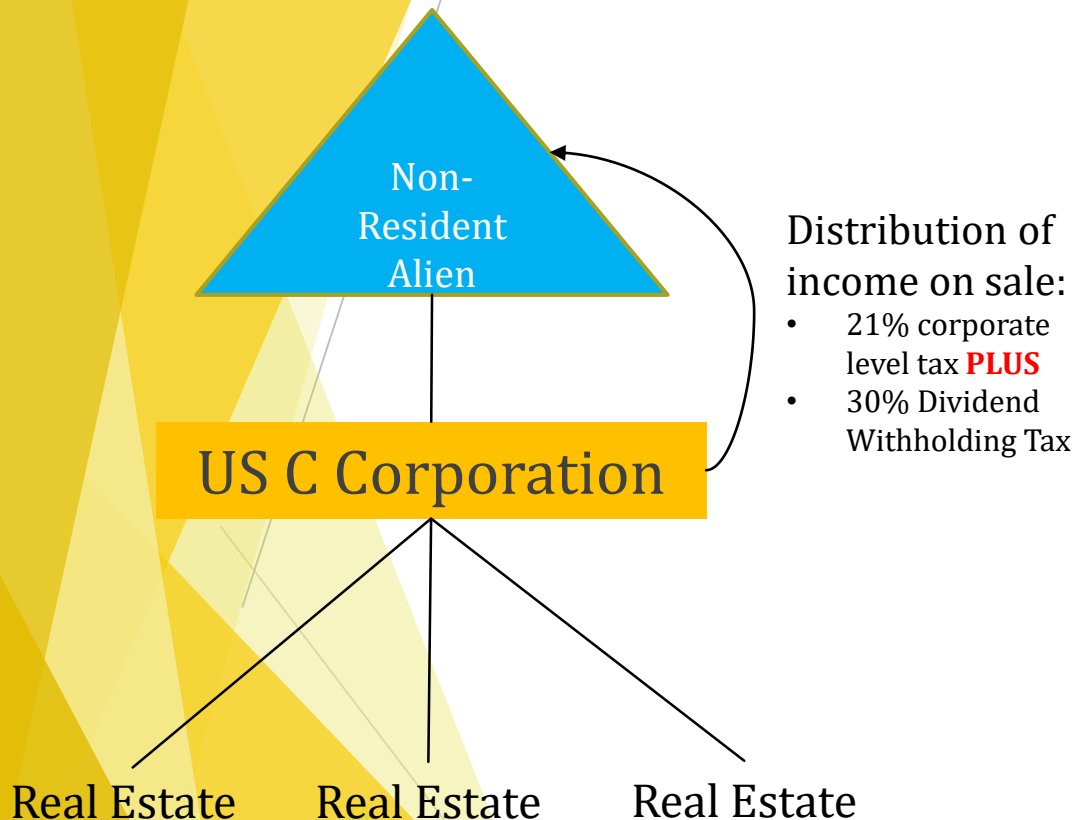
▶ Gain from Sale of USPRI:

- ▶ Taxable at up to 21%(+SALT)
- ▶ FIRPTA Withholding on sales proceeds (subject to any FIRPTA Certificate)
- ▶ BPT may apply at 30% or lower treaty rate

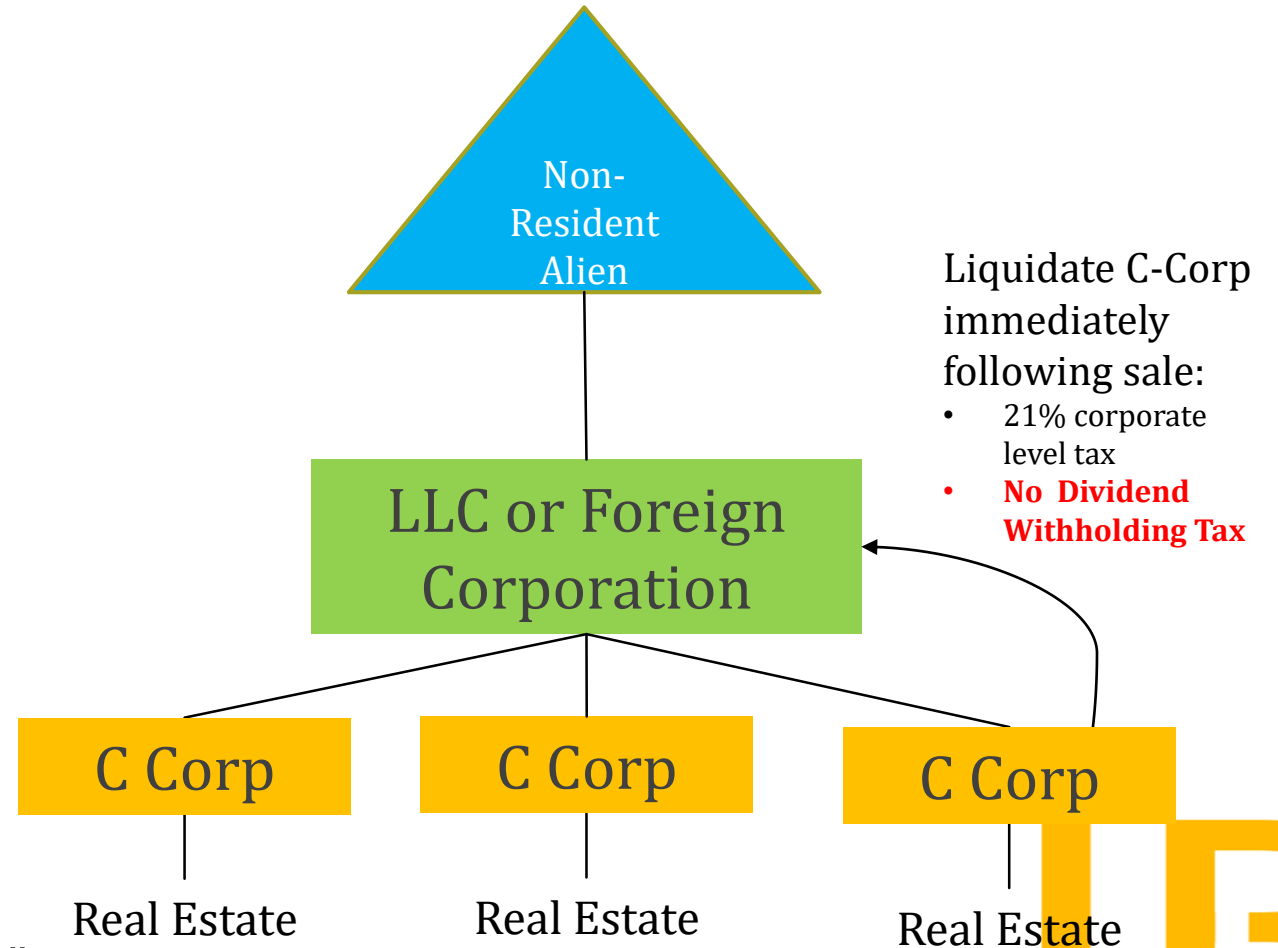
▶ To NRA Shareholder

- ▶ No tax on dividends or §301(c)(3) amounts
- ▶ No tax, including FIRPTA, on sale of FC stock

Avoiding Dividend Withholding Tax by Liquidation

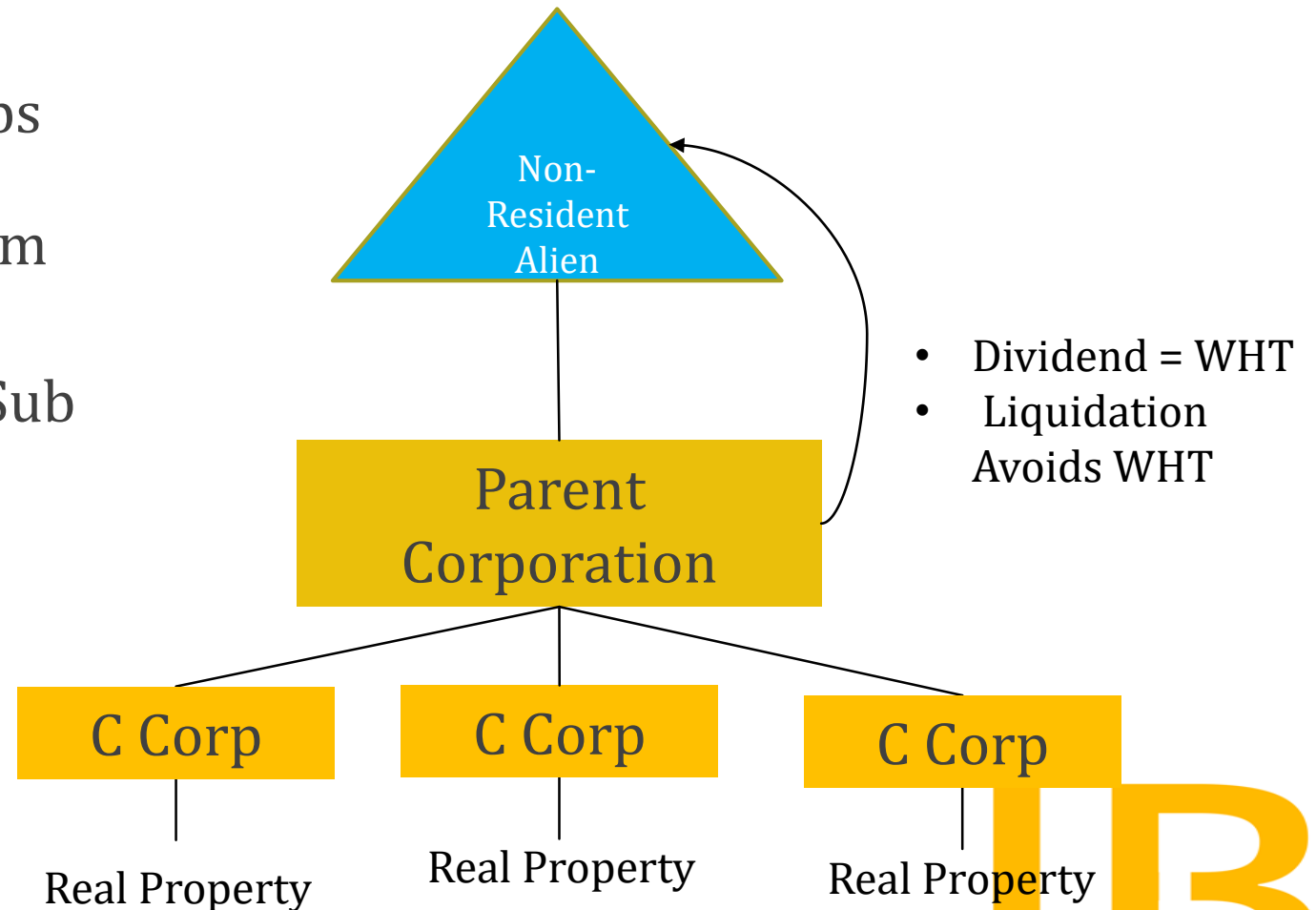


No Branch Profits Tax Since No “Branch”

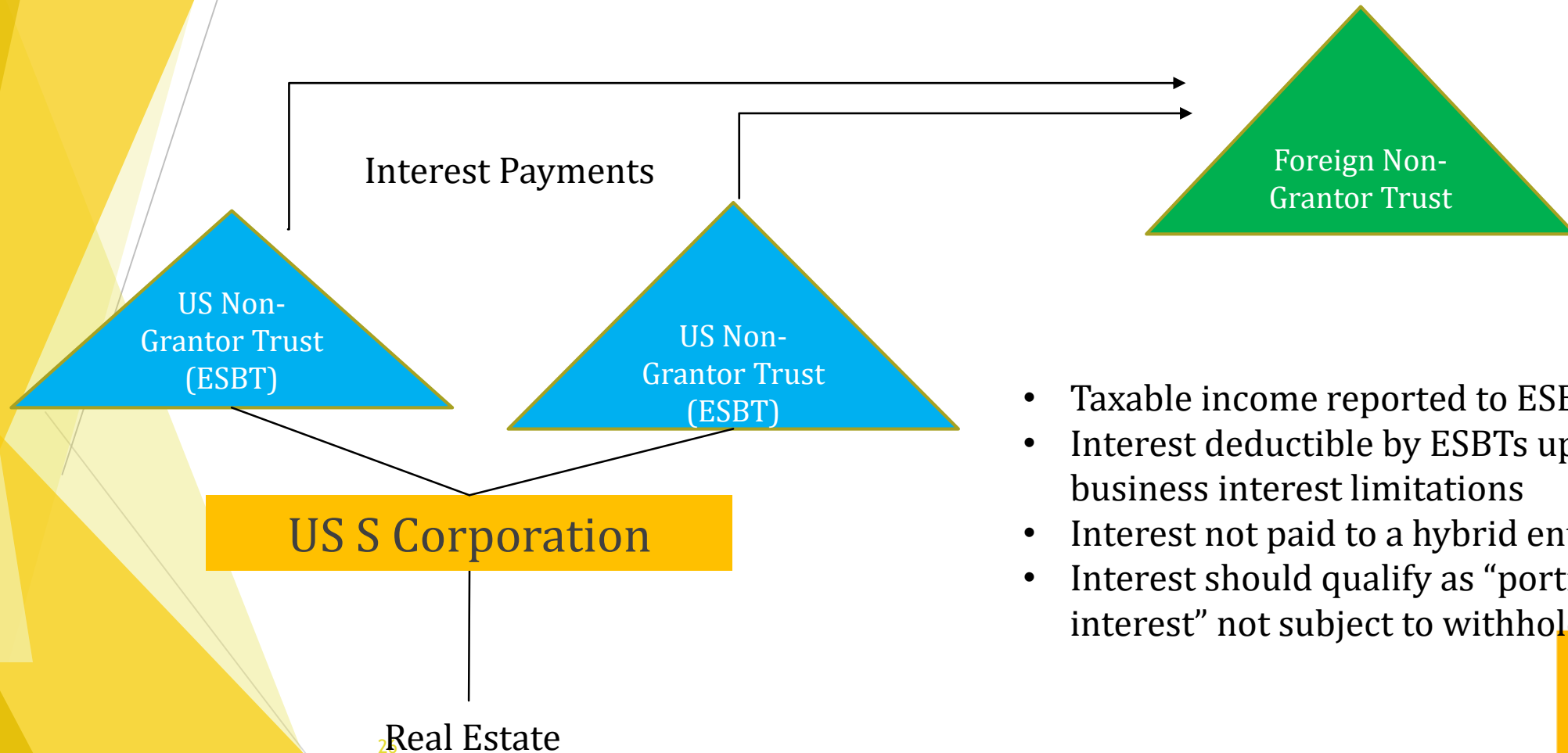


Improve Result with Consolidated Group?

- ▶ Group of Parent and Subs permits use of losses in one to offset income from another
- ▶ Merger/Liquidating of Sub into parent eliminates separate holding entity



S Corporation Owned by Domestic Trusts FBO Non-US Persons



- Taxable income reported to ESBTs
- Interest deductible by ESBTs up to business interest limitations
- Interest not paid to a hybrid entity
- Interest should qualify as “portfolio interest” not subject to withholding

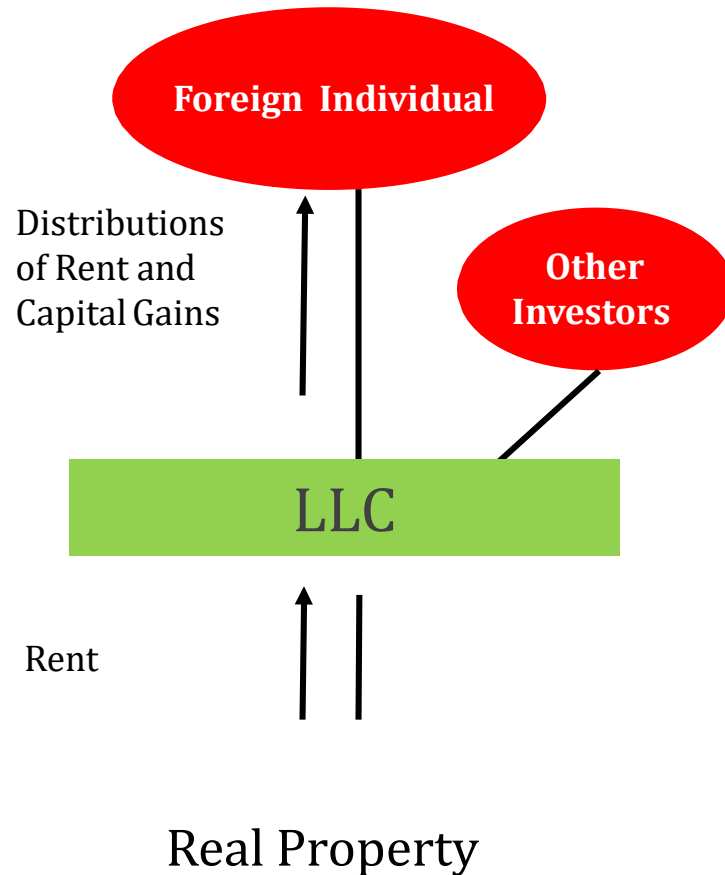
Non-US Beneficiaries Should Find Domestic Trust Structure Efficient

- ▶ Domestic US Non-Grantor Trust is subject to tax on “distributable net income” retained in trust
 - ▶ Where investment interest is deductible against dividends/gains, reduction in DNI to zero is possible
 - ▶ Gains not included in DNI absent language to that effect in trust instrument or “reasonable application” of fiduciary discretion
 - ▶ DNI is deductible if actually paid to beneficiaries – i.e., not retained
- ▶ Distributions to beneficiaries “carry out” character of trust income so that beneficiaries pay tax (or not) depending on what income is included in DNI
 - ▶ If no “net” dividend income in trust but only gains, distribution of cash to non-US beneficiary may carry out gains to beneficiary
 - ▶ Since gains on sale of non-US shares is exempt from income, beneficiary avoids tax

Impact to ESBTs Distributing Income?

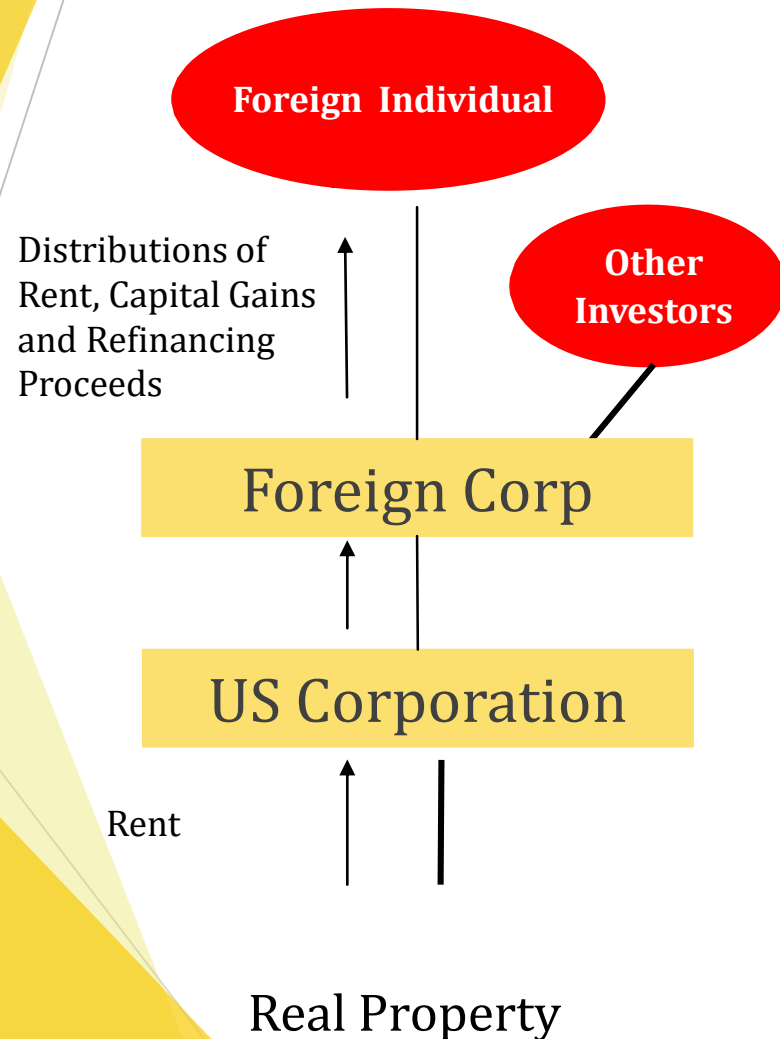
- ▶ Rental income realized at ESBT level may be subject to tax and paid by ESBT [@ 37%] if not distributed
- ▶ Rental income distributed by ESBT to non-US beneficiaries subject to withholding as rental income
- ▶ Capital gains realized by ESBT and not distributed subject to tax [@ 20%]
- ▶ If gains distributed by ESBT (with appropriate drafting), no withholding or tax imposed? IRC Section 1445(e)(3) appears to be limited to C corporation distributions but don't bet on it!!

Investment through Domestic Partnership (LLC)



- ▶ **NRA Partner Must File Personal 1040 Return:**
 - ▶ Possible deal breaker!
- ▶ **Rental Income:**
 - ▶ Partner level taxation
 - ▶ No withholding by lessee on rent
 - ▶ LLC withholds on ECI rent allocable to NRA partner
- ▶ **Long Term Capital Gains:**
 - ▶ 20% - Same as direct investment
 - ▶ instead of FIRPTA withholding on sales proceeds paid to LLC, LLC must withhold on amounts allocable to NRA partner.
- ▶ **Gift Tax/Estate Tax:**
 - ▶ Tax-free gifts should be possible pursuant to intangible exception
 - ▶ No clear authority on whether LLC interest is U.S. situs asset

Investment by NRA Through Foreign and U.S. Corporation

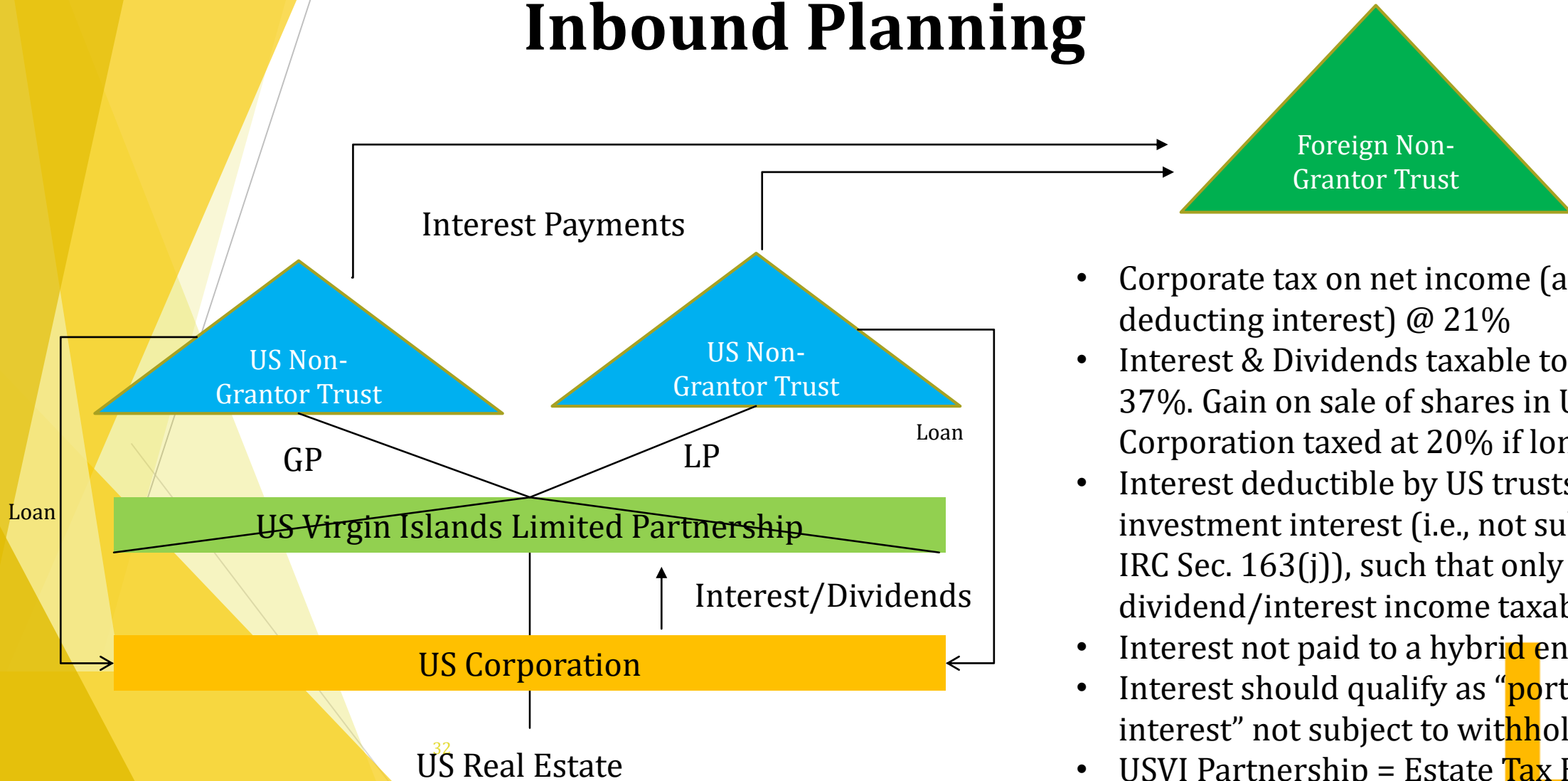


- ▶ **To US Corporation:**
 - ▶ Rental income and gain taxable at up to 21% (+ state and local tax)
- ▶ **To Foreign Corporation:**
 - ▶ Dividends and interest from US Corporation subject to 30% withholding tax (or lower under treaty)
 - ▶ Portfolio interest exemption may be available
 - ▶ Disposition of US Corporation stock subject to up to 21% tax as ECI under FIRPTA if US Corporation is a USRPHC
 - ▶ If US Corporation liquidates after “Cleaning Exception” applies, then the liquidating distribution may be tax-free
- ▶ **To Foreign Individual:**
 - ▶ No U.S. income/gift/estate tax consequences.

Estate Tax Inclusion Problem for Non-US Settlor Benefitting from Trusts

- ▶ Non-US Persons subject to US Estate Tax if “own” at least \$60,000 of “US Situs assets” at death
- ▶ US Situs assets include shares in US Corporations
- ▶ All persons (foreign or domestic) deemed to own assets held in trust for their benefit if they settle those trusts and hold that beneficial entitlement at death (but nuances exist)
- ▶ Absent planning, non-US person settling US nongrantor trust for own benefit considered to own all US situs assets owned by trust – i.e., subject to US estate tax at death
- ▶ Thus need a “non-US blocker” to block out US estate tax – such a foreign partnership (not as ideal as historic planning)

Improving Financing Model for Inbound Planning



- Corporate tax on net income (after deducting interest) @ 21%
- Interest & Dividends taxable to trusts at 37%. Gain on sale of shares in US Corporation taxed at 20% if long-term
- Interest deductible by US trusts as investment interest (i.e., not subject to IRC Sec. 163(j)), such that only “net” dividend/interest income taxable
- Interest not paid to a hybrid entity
- Interest should qualify as “portfolio interest” not subject to withholding
- USVI Partnership = Estate Tax Blocker

TCJA Summary – Impacting Real Estate

- ▶ Corporate income tax rate reduced to 21%; Individual income tax rate reduced to 37%
- ▶ Maximum capital gains rate remains 20% for individuals
- ▶ State and local tax deductions limited
- ▶ Interest deductions limited to 30% of taxable income; real estate election out
- ▶ Anti-hybrid rules introduced limiting deductions where no income inclusion
- ▶ NOLs limited to 80% of taxable income; business loss use for individuals limited
- ▶ 100% expensing for qualifying property - real property improvements
- ▶ Like-kind exchanges preserved for real property with changes
- ▶ Non-resident Aliens (NRAs) subject to 15% withholding on sales proceeds from disposition of partnership that owns a U.S. real property
- ▶ U.S. estate tax exposure for NRAs unchanged – 40% on U.S. situs assets

