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# **An Overview of Foreign (Non-U.S.) Investment in U.S. Real Estate**

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The following outline provides a general discussion of a number of the different planning alternatives for foreign investors in U.S. real estate. Please note that this outline is intended to review only those circumstances where the structure in question is the original owner of any such U.S. real estate, as numerous complex rules (a discussion of which is outside the scope of this presentation) apply to transfers of U.S. real estate.

**THIS OUTLINE IS NOT INTENDED AS A COMPLETE ANALYSIS OF ALL POSSIBLE TAX CONSIDERATIONS IN ACQUIRING, HOLDING AND DISPOSING OF ONE OR MORE USRPIs. EACH INVESTOR IS RESPONSIBLE FOR HIS, HER, OR ITS OWN TAX PLANNING DECISIONS, PARTICULARLY SINCE THE POTENTIAL RELATED FEDERAL, STATE, LOCAL AND POSSIBLY THIRD COUNTRY TAX ISSUES AND CONSEQUENCES MAY NOT BE THE SAME FOR ALL INVESTORS. INVESTORS SHOULD THEREFORE CONSULT THEIR OWN U.S. AND THIRD COUNTRY TAX ADVISORS FOR SPECIFIC GUIDANCE REGARDING THE MATTERS DISCUSSED HEREIN.**

- There are at least seven different types of potential investment structures for foreign investment in U.S. real estate.
- Each has potentially different U.S. income, gift and estate tax consequences.
- Consider the need for asset protection / limited liability. Foreign investors often are unaware of our litigious society.

-Each different type of investment structure has its own advantages and disadvantages.

-Planning opportunities may be different based upon the age and health of the person(s) in question.

# Investment Alternative 1: Direct Ownership of U.S. Real Property Interest

NRA



USRPI

## Investment Alternative 1: Advantages

- Long-term capital gains generally available.
- Single level of taxation.
- Simple structure.
- No BPT / No BPIT.

## Investment Alternative 1: Disadvantages

-No anonymity. Planning should never be solely based upon a desire for anonymity, as it cannot be guaranteed (consider FATCA or where there is a tax treaty between the U.S. and the country of the investor's residence).

-NRA must file Form 1040NR. The filing of Form 1040NR will occur upon property disposition or sooner if the USRPI is a USTB property or a "net election" is made to treat it as a USTB property.

## Investment Alternative 1: Disadvantages

-FIRPTA withholding applies to the NRA's sale of the USRPI (generally, 10% of purchase price, credited against actual tax due). If the foreign seller knows that the seller's U.S. income tax liability will be less than the gross 10% withholding tax, the seller can utilize certain procedures to request the reduction of the withholding tax.

-No U.S. estate and gift tax protection.

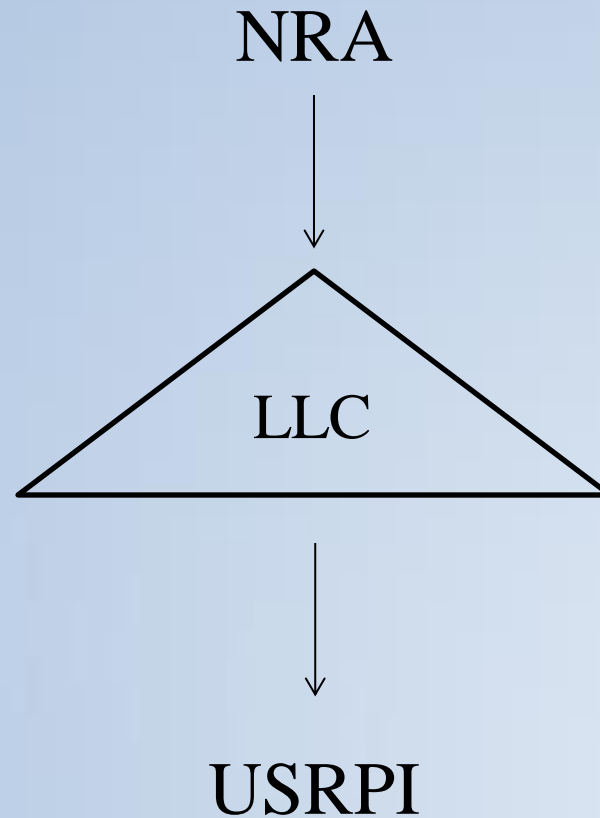
-No deduction or capitalization of expenses permitted if there is never any income generated by the U.S. real estate.



## Investment Alternative 1: Planning Notes

- As a hedge against the U.S. estate tax, consider obtaining U.S. life insurance, which is a foreign situs asset exempt from U.S. estate tax where the insured is a nonresident alien decedent.
- Check applicable U.S. tax treaties.

# Investment Alternative 2: Ownership of U.S. Real Property Interest Through a Domestic Limited Liability Company



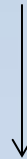
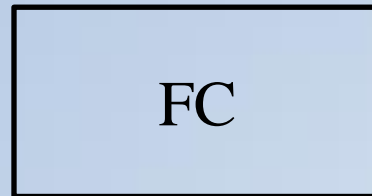
## Investment Alternative 2: Additional Advantage

-Limited legal liability depending on State law (see Olmstead case).

## Investment Alternative 2: Disadvantages

-Same as in Investment Alternative 1 (a wholly owned LLC is disregarded for U.S. tax purposes). Consider modification to the structure where there are more than one members of the LLC – See Investment Alternative 6.

# Investment Alternative 3: Ownership of U.S. Real Property Interest Through a Foreign Corporation



USRPI

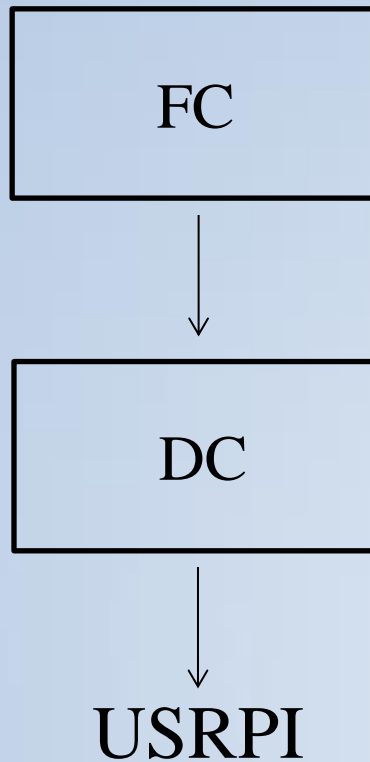
## Investment Alternative 3: Advantages

- No U.S. estate or gift tax if FC is respected.
- Limited legal liability.
- Some anonymity.
- Ordinary corporate income tax (plus state), but only one tax if BPT termination rules are satisfied.

## Investment Alternative 3: Disadvantages

- Possibility of BPT or BLIT.
- No favorable capital gains rate.
- FIRPTA Withholding.
- Expense of the FC.
- Section 163(j) interest-stripping limitation.

# Investment Alternative 4: Ownership of U.S. Real Property Interest Through a Domestic Corporation / Foreign Corporation





## Investment Alternative 4: Advantages

- No U.S. estate or gift tax if FC is respected.
- Limited legal liability.
- Extra level of anonymity.
- Ordinary corporate income tax (plus state), but only one tax unless non-liquidating distribution.
- No BPT or BLIT.
- No FIRPTA withholding on sale by DC of USRPI.

## Investment Alternative 4: Disadvantages

- Non-liquidating dividend by DC subject to FDAPI withholding tax.
- No favorable capital gains rate.
- Expensive structure.
- Section 163(j) interest-stripping limitation.

# Investment Alternative 5: Ownership of U.S. Real Property Interest Through a Domestic Corporation



USRPI

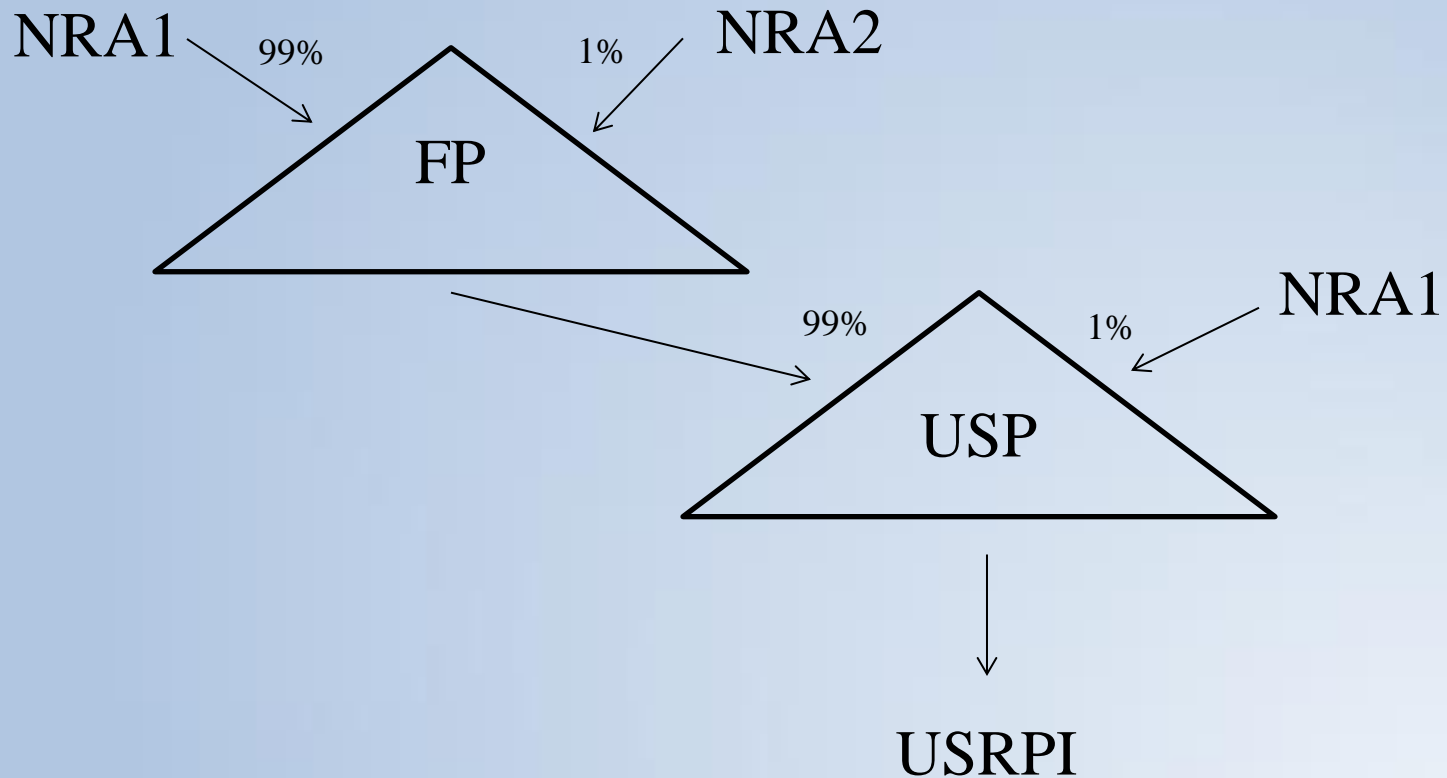
## Investment Alternative 5: Advantages

- No U.S. gift tax.
- Limited legal liability.
- Some anonymity.
- Ordinary corporate income tax (plus state), but only one tax unless non-liquidating distribution.
- No BPT or BLIT.
- No FIRPTA withholding on sale by DC of USRPI.

## Investment Alternative 5: Disadvantages

- U.S. estate tax.
- Non-liquidating dividend by DC subject to FDAPI withholding tax.
- No favorable capital gains.
- Section 163(j) interest-stripping limitation.

# Investment Alternative 6: Ownership of U.S. Real Property Interest Through a Partnership Structure



## Investment Alternative 6: Advantages

- Pass-through income tax rate.
- Possibility for long-term capital gains rate.
- Limited legal liability depending on state law.
- No BPT or BLIT.

## Investment Alternative 6: Disadvantages

- Trade or business status, or permanent establishment of partnership causes such status at NRA partner level.
- No real anonymity.
- U.S. tax return filings.
- No limited legal liability if a general partner unless provided by state law.
- Section 1446 withholding on ECTI of any foreign partner but the Regulations allow for a reduction based on a foreign partner's deductions and losses reasonably expected to be available.

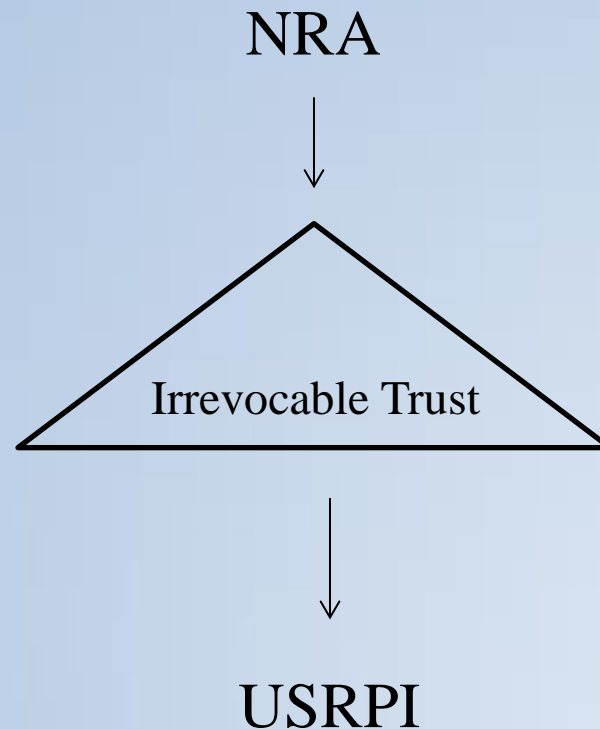


## Investment Alternative 6: Uncertainties

-Difficult to avoid U.S. estate tax, if at all. Will the IRS assert the entity or aggregate theory, and if the entity theory applies, does the entity merit foreign situs status? Does having the two-tier partnership structure help?

-Possibly U.S. gift tax.

# Investment Alternative 7: Ownership of U.S. Real Property Interest Through an Irrevocable Trust



## Investment Alternative 7: Advantages

- Single level of taxation.
- Possibility for favorable long-term capital gains rate.
- No BPT or BLIT.
- If a foreign trust, can pay out U.S. tax-free foreign source interest on U.S. business related debt and obtain deduction where such business assets secure such debt of where debt is “booked” to a U.S. trade or business subject to percentage limitation.
- No U.S. gift and estate tax if trust properly structured.

## Investment Alternative 7: Disadvantages

- Trade or business status, or permanent establishment of trust causes such status at NRA beneficiary level.
- No real anonymity.
- U.S. tax return filings.
- No limited liability if no entity between trust and USRPI.

## Investment Alternative 7: U.S. Transfer Tax Considerations

-If no tainted rights, powers, benefits, interests etc. are retained, may avoid U.S. estate tax (otherwise U.S. estate tax and possibly gift tax). However, if the NRA settlor is in the class of beneficiaries and there is no implied agreement, some state and foreign country laws may combine to provide estate tax protection.

## LEGEND OF SELECTED ABBREVIATIONS

BLIT—the U.S. branch level interest tax (see, e.g. IRC § 884). In circumstances where a borrower is a foreign corporation engaged in a USTB, which status can result through, for instance, an LLC which has a USRPI-related trade or business or gains treated as such, the interest paid may be subject to the U.S. 30% flat tax subject to certain exemptions (for example, the PIE) and/or U.S. income tax treaty benefits.

BPT—the U.S. branch profits tax (see, e.g. IRC § 884). If a foreign corporation does not reinvest its annual U.S. trade or business earnings and profits (i.e., its effectively connected earnings and profits) in accordance with certain specific IRS regulations, those earnings and profits not so reinvested will be treated as if they had been distributed as a dividend to the foreign corporation's shareholders, and subject to a 30% flat tax with payment responsibility placed on the foreign corporation.

## LEGEND OF SELECTED ABBREVIATIONS

ECI—effectively-connected income, generally income derived from a USTB, or income from the sale of a USRPI which is treated as ECI

E&P—earnings and profits

ECE&P—effectively-connected earnings and profits (for BPT purposes)

FC—foreign (non-U.S.) corporation. The corporation could be established in any non-U.S. jurisdiction, with the most desirable place of formation to be determined in part depending upon each person's individual situation

FIRPTA—Foreign Investment in Real Property Tax Act of 1980, as amended (see, e.g., 897 and 1445). This complex law and the Treasury Regulations interpreting these statutes have governed the U.S. income tax law relating to transfers of USRPIs since it became law.

## LEGEND OF SELECTED ABBREVIATIONS

IRC—Internal Revenue Code of 1986, as amended (the U.S. tax law)

IRS—Internal Revenue Service (the federal tax authority)

LLC—limited liability company (a recently created type of legal entity that, among other uses, is commonly formed to hold USRPIs—depending upon various factors, it can be treated as either a pass-through entity or as a corporation for U.S. tax purposes)

NOL—net operating loss

NRA—nonresident alien individual for U.S. income tax purposes



## LEGEND OF SELECTED ABBREVIATIONS

PIE—portfolio interest exemption, which enables interest to be paid free of U.S. tax to a foreign lender under certain circumstances

USCO—domestic (for example, Florida) corporation

USRPI—United States real property interest (throughout this outline, it is presumed that the Florida LLC in which each foreign investor may invest holds only USRPIs and that an interest in the Florida LLC is itself a USRPI)

USTB—United States trade or business