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Foreign Person Investing in U.S. Real Estate

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Foreign Purchases of U.S. Homes

Foreign Home Buyers want to:

Minimize tax on sale of the property

Avoid paying 30% withholding tax on imputed rent

Avoid Estate Tax on death of owner

Minimize compliance and contact with U.S. tax system

Foreign Purchases of U.S. Homes

Acquisition:

No immediate tax consequences to buyer

But:

Although ownership does not make foreign person U.S. tax resident it may be a factor

Mortgage interest deduction only available for loan within 90 days of purchase

FIRPTA Withholding Agent Issues

Gift Tax Issues

Foreign Purchases of U.S. Homes

Ownership and Occupation

When a home is owned directly by an individual there are no Income Tax consequences

However, if a home is owned by an entity, imputed rental issues can arise

If the home produces no income, no tax return needs to be filed

Foreign Purchases of U.S. Homes

Sale

The Foreign Investment in Real Property Tax Cut

Under (“FIRPTA”) foreign persons are subject to tax on capital gains from U.S.
real property

A non-resident can qualify for the $250,000 per individual owner tax exclusion on the sale of a principal residence

Foreign Purchases of U.S. Homes

Transfers

Gifts by non-residents of U.S. real estate are subject to U.S. Gift Tax

If a non-resident individual dies owning U.S. real estate, U.S. Estate Tax is payable on the value of the real estate.

No $5M exemption from Gift and Estate Tax is available to non-residents

Foreign Purchases of U.S. Homes

Structuring

Direct Ownership

Advantages

- Simple Structure
- Low Cost
- No Imputed Rental Issues
- Qualifies for Long Term Capital Gain
- Qualifies for Principal Residence Tax Exclusion

Disadvantages

- Subject to U.S. Estate Tax
- No Privacy

Foreign Purchases of U.S. Homes

Single Member LLC

Advantages
- Offers Limited Liability Protection
- Privacy
- Disregarded for Federal Income Tax
- No Imputed Rental issues

Disadvantages
- Cost of Formation and Registration
- LLC's are often treated as Corporations outside the U.S. – Tax Mismatch
- Subject to U.S. Estate Tax

Foreign Purchases of U.S. Homes

Grantor Trust:

Advantages

- Grantor treated as owner for U.S. income tax purposes
- Privacy if grantor not trustee

Disadvantages

- Cost of formation and professional trustee
- Some complexity
- Subject to U.S. Estate Tax
- Trusts not recognized in some countries

Foreign Purchases of U.S. Homes

Non Grantor Trust:

Advantages

- Long Term Capital Gain Rate Available
- Avoids U.S. Estate Tax on death if grantor does not have a retained interest
- Privacy

Disadvantages

- U.S. Gifts Taxes arises if property transferred into a Non Grantor Trust
- Non Grantor Trust pays income tax at top rate applicable to individuals (currently 39.6%)
- Imputed rental income if foreign Non Grantor Trust
- Expensive and tax complex

Foreign Purchases of U.S. Homes

Domestic Corporation

Advantages

- Privacy
- Shares exempt from U.S. Gifts Tax
- Exempt from U.S. Estate Tax if corporation owned by foreign entity

Disadvantages

- Subject to U.S. Estates Tax if corporation owned by foreign individual
- Imputed rental income if shareholder lives rent free in property
- Gain on sale taxed at 34%
- No Principal Residence Tax Exclusion
- Higher costs than direct ownership
- Taxation of dividend distribution upon sale of property

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Foreign Purchases of U.S. Homes

Foreign Corporation:

Advantages

- Privacy
- Exempt from U.S. Estate Tax
- Exempt from U.S. Gifts Tax
- Avoids almost all contact with U.S. tax system

Disadvantages

- Gain on sale taxed at 34%
- No Principal Residence Tax Exclusion
- Higher cost of ownership
- Imputed rental income

Two Alternative Tax Regimes For Rental Investments

1. Passive Income Regime

2. Active Income Regime

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U.S. Taxation of Rental Income

Passive Income also known as FDAP

Subject to 30% Withholding Tax

No expenses are tax deductible
Rent includes landlords expenses paid by tenant-Rev. Rul. 73-522

No tax return filed by foreign owner

U.S. Taxation of Rental Income

Leasing can mean foreign lessor is engaged in a U.S. Trade or Business

Rent becomes U.S. Effectively Connected Income (ECI)

ECI taxed as net income at scale rates after expenses

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U.S. Taxation of Rental Income

If foreign lessor is engaged in a U.S. Trade or Business

Foreign lessor must file U.S. tax return

Foreign corporate lessor may be subject to U.S. Branch Profits Tax

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U.S. Taxation of Rental income

If U.S. rental income is to be taxed as ECI, foreign investors management of their property must be:

Considerable, Continuous and Regular

Pinchot v. Commissioner (1940)

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U.S Investment in Rental Income

U.S. Internal Revenue Code Permits -

Foreign Investor to elect ECI tax treatment

IRC Section 871(d)

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Sale of U.S. Real Estate

U.S. tax rules contained in:

Foreign Investment in Real Property Tax Act 1980 (FIRPTA)

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Sale of U.S. Real Estate

Gain from the sales of U.S. real property Interest ("USRPI") owned By non-U.S. persons are taxed as if:

Foreign seller is engaged in a U.S. trade or business

Resulting in U.S. taxation of any gain on sale

Sale of U.S. Real Property

What is a USRPI?

- Land and Building
- Growing crops and timber, mines, wells and natural deposits in the ground
- Includes “Associated Personal Property”
- Includes direct or indirect rights to share in appreciation in value or net proceeds of profits from real property
- U.S. Real Property Holding Company (“USRPHC”)

Sale of U.S. Real Property

When A non-U.S. person sells a USRPI -

Buyer – domestic or foreign – must withhold 10% of gross sale proceeds and pass it on to the IRS

This leads to over withholding

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Sale of U.S. Real Property

To avoid over withholding seller can obtain a FIRPTA Withholding Certificate

Seller must calculate FIRPTA gain

IRS will issue certificate instructing buyer to withhold the FIRPTA gain amount only

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Sale of U.S. Real Property

Normal Rule: Sale of shares in a U.S. corporation by non-U.S. person not subject to U.S. income tax

FIRPTA Rule: Sale of shares in a USRPHC are subject to U.S. tax

Sale of U.S. Real Property

The term USRPHC means

Any Corporation if:

The Fair Market Value of it’s USRPI equals or exceeds 50% of:

- Its USRPI
- Its interest in real property outside U.S.
- Any other assets used in trade or business

Sale of U.S. Real Property

Rules permit look through of USRPHC to its 50% subsidiaries

Corporation will not be a USRPHC if stock its regularly is traded and taxpayer owns 5% or less