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Alan Appel
New York Law School, alan.appel@nyls.edu

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Author: ALAN I. APPEL - Alan I. Appel is a member of the Tax Advice and Controversy Client Service Group in the New York office of Bryan Cave LLP. He focuses his practice in international and domestic tax planning involving taxation of mergers and acquisitions, partnerships, joint ventures, limited liability companies, and tax controversy matters. He is a member of the tax faculty at New York Law School and of the Journal's Board of Advisors, and is Chair of the U.S. Activities of Foreigners and Tax Treaties Committee of the American Bar Association Section of Taxation. Mr Appel may be contacted by email at *aiappel@bryancave.com*.

Text

This article describes the basic principles of U.S. federal income tax liability under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) and the withholding mechanism that ensures collection of the tax. In addition, it sets forth some structuring alternatives to limit a foreign investor's tax exposure with respect to the ownership and subsequent disposition of U.S. real estate.

FIRPTA BASICS

Taxation. FIRPTA [1] was enacted to ensure that foreign persons are subject to at least one level of U.S. federal income tax when they dispose of U.S. real estate investments. In general, any gain or loss realized by a non-resident alien or a foreign corporation on the sale of U.S. real property interests (USRPIs) will be recognized and subject to U.S. tax. A USRPI is an interest in U.S. real property held directly or through certain entities when specified requirements are met. In addition to direct ownership of U.S. real estate, interests in entities that hold USRPIs, such as stock of a U.S. corporation or a partnership interest, are treated as if they themselves are USRPIs. [2]

Withholding. While FIRPTA tax liability applies only to sales of USRPIs by non-resident aliens or foreign corporations, the withholding mechanism is much broader in scope. FIRPTA withholding applies to any disposition of a USRPI by a foreign person. [3] In the case of any disposition of a USRPI by a foreign person, the transferee is required to deduct and withhold a tax equal to 10 percent of the amount realized on the disposition--not simply the gain from the sale. The result is that a sale at a loss potentially triggers withholding responsibilities. The transferee also is required to report the transfer to the IRS and remit the amount withheld within 20 days of the date of the transfer. The amount withheld is counted as a credit against the transferor's tax liability. [4]

POSSIBLE INVESTMENT STRUCTURES

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[1] Enacted as Subtitle C of Title XI (the "Revenue Adjustments Act of 1980") of the Omnibus Reconciliation Act of 1980, P. L. 96-499,94 Stat. 2599, 2682 (Dec. 5, 1980); IRC §§ 897, 1445. All references to the Sections in this article refer to the Internal Revenue Code of 1986 (the "IRC"), as amended.

[2] IRC § 897(c).

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[3] IRC § 1445.

[4] Treas. Reg. § 1.1445-1(c).

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There are several possible ways to structure transactions involving foreign shareholders, each with its own advantages and disadvantages.

U.S. Corporation. One option is for the foreign individual to own the U.S. real estate investment through a U.S. corporation, as illustrated in Figure 1. A U.S. corporation owned by a non-resident alien individual gives that person a liability shield. In addition, the corporation becomes a separate taxpayer, which eliminates the need for the individual to file annual U.S. federal (as well as state and local) tax returns. If the U.S. corporation sells the real estate in a fully taxable transaction, FIRPTA would not apply. [5] On the plus side, the U.S. corporation could use a portion of the sales proceeds to pay down any debt, then adopt a plan of liquidation and distribute the remaining proceeds to its non-resident alien individual shareholder as a liquidating distribution, which can be paid free of any U.S. withholding tax. [6] This structure, however, has some disadvantages:

[SEE Figure 1: U.S. Corporation IN ORIGINAL]

1. Two levels of taxation: Two levels of tax may be imposed on the corporation's operating income (assuming it will be repatriated back to the individual). A corporate-level tax will be imposed, [7] as will a 30 percent withholding tax on any dividends paid to the investor. [8] This withholding rate, however, could be reduced by a tax treaty. If available cash flow is used in whole, or in substantial part, for debt service, dividends from operations may not be anticipated.

2. Limited anonymity: The corporation provides the individual investor only limited anonymity. The U.S. tax return filed by the corporation requires the corporation to disclose the name, address, and taxpayer identification number of any person who owns 50 percent or more of the company's stock.

3. Federal estate tax liability: The individual investor will have U.S. federal estate tax liability. [9] No U.S. federal gift tax liability should result from a lifetime gift of the stock in the U.S. corporation, however. [10]

Foreign Corporation. A foreign corporation used to own the U.S. real estate investment (see Figure 2) similarly provides the non-resident alien investor a liability shield. Moreover, the individual does not have to file a U.S. tax return; the foreign corporation will do so if it is engaged in a U.S. trade or business or sells the real estate investment. [11] If the foreign corporation sells the real estate in a fully taxable transaction, such disposition will be subject to FIRPTA. A sale of the stock of 3. the foreign corporation, however, is not taxed by FIRPTA. But the purchaser of the stock of the foreign corporation will inherit any built-in gain at the foreign corporation level.

When compared to a U.S. corporation, there are advantages and disadvantages to using a foreign corporation to hold U.S. real estate:

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[5] The non-resident alien individual shareholder's sale of the stock in the U.S. corporation, which would be treated as a USRPI, would be subject to FIRPTA.

[6] Treas. Reg. § 1.897-2 (h)(4)(ii).

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[7] IRC § 336.

[8] IRC SS 871(a), 881(a).

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[9] IRC § 2104(a).

[10] IRC § 2501(a)(2).

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[11] Ownership of a single parcel of U.S. real estate that is triple net leased out to a single tenant would not constitute the conduct of a trade or business. While leasing a project to a significant number of tenants (such as 15 tenants) will constitute the conduct of a U.S. trade or business, the exact line where an investor passes from being passive to active is not clear. In order to assure that the foreign corporation is engaged in a U.S. trade or business the foreign corporation can file an election under IRC § 882(d).

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1. No U.S. withholding tax on foreign shareholder's dividends: There is no U.S. withholding tax imposed on dividends paid by a foreign corporation to its shareholder even where the corporation's only activities are in the U.S. In its place, however, the 30 percent branch profits tax on the foreign corporation's dividend equivalent amount is imposed, which operates as if "phantom dividends" were distributed to shareholders and subjects such dividends to a 30 percent tax. [12]
2. Limited investor anonymity: The foreign corporation also provides the individual investor only limited anonymity. The U.S. tax return filed by the corporation requires the corporation to disclose the name, address, and taxpayer identification number of any person who owns 50 percent or more of the company's stock.
3. Favorable treatment of distributed refinancing proceeds: If the property were to be refinanced, a distribution of the refinancing proceeds to the shareholder would not attract either a dividend withholding tax or the branch profits tax. This may be an advantage over a U.S. corporation, which likely would have to withhold a 30 percent passive income tax from a similar distribution to its shareholder (to the extent that the company has accumulated or current E&P).
4. Possible avoidance of U.S. estate or gift taxes: It is possible that neither U.S. estate nor gift tax will apply to a lifetime gift or testamentary transfer of the stock in the foreign corporation. Generally, it is not possible to advise with certainty that this common approach of using a non-U.S. holding company to protect U.S. situate assets from U.S. estate tax at the death of a foreign grantor will be successful. [13]

[SEE Figure 2 Foreign Corporation IN ORIGINAL]

[SEE Figure 3 Foreign Corporation Owing U.S. Corporation IN ORIGINAL]

Foreign Corporation Owning a U.S. Corporation. A non-resident alien individual could set up a foreign corporation whose sole asset is all the stock of a U.S. corporation (see Figure 3). The U.S. corporation, in turn, acquires the real estate investment. This structure again gives the individual a liability shield and eliminates the need for the investor to file a U.S. tax return.

While this two-tiered structure is more intricate than the other structures discussed above, it has many advantages that make its usefulness worthwhile despite the added complexity and cost to administer:

1. Branch profits tax not applicable: The complex branch profits tax will not be applicable since the operating asset--i.e., the real estate investment--and the income generated therefrom reside in the U.S. corporation.

2. Individual foreign shareholder's identity hidden: While the U.S. corporation must disclose the identity of its 100 percent shareholder by name that will identify only the foreign corporation. The foreign corporation is under no such obligation, since it is not engaged in a U.S. trade or business.

3. U.S. withholding tax avoidable: Assuming no operating income is to be distributed out of the U.S., once the property is sold by the U.S. corporation in a fully taxable transaction and one level of U.S. tax has been paid on the resulting gain, the U.S. corporation can be liquidated, with the cash coming out to the foreign corporation free of any U.S. withholding

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[12] IRC § 884.

[13] This is because a number of recent U.S. tax cases and rulings have focused on the issue of whether a structure, such as a foreign corporation, has sufficient reason for its existence other than a U.S. tax advantage to be respected for U.S. estate tax purposes at the death of its ultimate owner. There are several technical issues in a purely U.S. domestic context that have been (and still are being) decided by various U.S. courts over recent years as the IRS has attacked the use within the United States of "family limited partnerships" and taxpayers have resisted. The arguments and rationales are quite muddy, and different courts are taking widely diverging views. None of these cases relate directly to the issue of shifting situs of assets in the hands of a non-resident alien, but the primary U.S. tax rule under debate is equally relevant to a non-resident alien. This is because of a statutory provision that states that if assets would be included in the estate of a non-resident alien under that rule then those assets will be subject to U.S. estate tax if they were U.S. situate assets either at the date of death or at the time of the transfer into the holding company or trust. These cases reinforce the need for the exchange between the grantor and the corporation to be accepted as a bona fide exchange and for the corporation to be operated as a proper corporation that has non-tax purposes.

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tax. [14] The foreign corporation is then free to distribute the cash to the ultimate shareholder, at any time, with no U.S. tax impact.

4. Possible avoidance of U.S. estate and gift taxes: It is possible that neither U.S. estate nor gift tax will apply to a lifetime gift or testamentary transfer of the stock in the foreign corporation. [15]

Structures Suitable for Multiple Property Ownership. Where more than one property is to be acquired, consideration should be given to having each property owned by a separate entity to limit liability exposure. Separate U.S. corporations or a series of single member limited liability companies could be used.

The use of a foreign holding company to hold all of the stock of each U.S. real estate holding corporation (see Figure 4, next page) may provide the benefits noted above. [16] A negative factor is that the losses of one property cannot be used to offset the income of another property. If, however, the goal is to repatriate the sale proceeds to the non-resident alien individual, this structure is very helpful. If a plan of liquidation is adopted for the specific U.S. corporation whose property is sold, any remaining sales proceeds (after servicing debt and paying transaction costs) paid out to the holding company would be a non-taxable liquidating distribution.

[SEE Figure 4: Foreign Holding Company Owning Multiple U.S. Properties IN ORIGINAL]

[SEE Figure 5: U.S. Holding Company With Foreign Shareholders Owning Multiple U.S. Properties IN ORIGINAL]

If a U.S. corporation (rather than a foreign company) is used as the holding company (see Figure 5), a consolidated tax return can be filed for the U.S. corporation. A consolidated return generally allows the use of one property's losses to offset the income of another. If a certain property is sold, the consolidated group will stay in existence. In that instance, if the ultimate shareholder wishes to repatriate the sale proceeds, a dividend paid by the U.S. operating company to the U.S. holding company generally can be paid free of U.S. tax, but any dividend then paid by the U.S. holding company out of the U.S. will attract a 30 percent withholding tax (subject to treaty reduction).

In addition, if the foreign investor owns the U.S. holding company directly, then U.S. estate tax exposure exists. To eliminate this latter exposure, a foreign holding company may have to be inserted between the ultimate shareholder and the U.S. corporate holding company.

Non-Grantor Foreign Trust. In recent years, the tax rates for individuals in the U.S. have been reduced. Capital gains are generally subject to a 15 percent tax, [17] the maximum rate of income tax is capped at 35 percent, [18] and recapture income when depreciated real property is sold at a gain is taxed at 25 percent. [19]

For newly acquired U.S. real property, there is a structure available that will limit U.S. income tax on profits and gains to the rates applicable to individuals without exposing them to U.S. estate tax in the event U.S. real estate is owned at the time

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[14] Treas. Reg. § 1.897-2(h)(4)(ii). A sale by the foreign corporation of the stock of the U.S. corporation, which would be treated as a USRPI, would be subject to FIRPTA.

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[15] See supra note 13.

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[16] The use of a foreign holding company to hold the real estate investments in a series of single-member limited liability companies would have the same results as a foreign corporation used to own directly the U.S. real estate investment.

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[17] IRC § 1(h)(1)(C).

[18] IRC § 1(i)(2).

[19] IRC § 1(h)(1)(D).

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of the individual's demise. The suggested structure is as follows: Foreign Individual would set up an irrevocable trust in an offshore low-tax jurisdiction (the "Trust"), transferring cash, not real property, to the Trust. The Trust would be a regular trust for U.S. income tax purposes--i.e., not a grantor trust--and the beneficiaries would be the Foreign Individual and his heirs and family members. An independent trustee would be appointed who would have complete discretion over distributions to beneficiaries. The Trust would hold 100 percent of the ownership interest in a Delaware limited liability company (the "Delaware LLC") and the Delaware LLC would then invest in real estate. The suggested structure is illustrated in Figure 6.

The tax consequences that may be anticipated under the foregoing structure are as follows:

. The transfer of cash to the Trust is not subject to U.S. gift tax.
. Under U.S. tax law, the Trust will be treated as if it were an individual. It will be entitled to the benefits of the 15 percent tax applicable to capital gains, the 25 percent tax applicable to depreciation recapture, and 35 percent tax on operating profits.
. There will be no further tax as funds are distributed to the beneficiaries.
. The assets in the Trust should not be subject to U.S. estate tax at the time of the individual's demise provided that (1) the individual does not retain the right to the income of the Trust during his lifetime--although he may receive discretionary distributions along with other beneficiaries, (2) the Trust is not revocable or amendable by the individual, and (3) the individual does not retain any dominion or control over the Trust or its assets.

[SEE Figure 6: Non-Grantor Foreign Trust IN ORIGINAL]

CONCLUSION

The process of deciding upon an appropriate structure for investing in U.S real property may be a function of which investment vehicle will yield the best tax and business results while recognizing that there is no perfect solution. Each of the structures discussed above has both positive and negative features. The investor must decide what is more important, (1) a lower rate of capital gains taxation with no double taxation but at the price of personal U.S. tax compliance, U.S. estate tax exposure, and lack of anonymity; or (2) a corporate structure which ensures no U.S. estate tax, no personal U.S. tax compliance filings, and anonymity, and higher corporate tax rates and potential double taxation. Caveat: Note that the structures described above only take into consideration potential U.S. tax consequences and do not consider the foreign investor's home country tax considerations. No planning should be implemented by a foreign investor without first obtaining competent home country tax advice.

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