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Tax Structuring of Foreign Investment in U.S. Real Estate with a N.Y. Twist

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This paper describes some of the possible structuring alternatives a foreign investor may use to limit his or her U.S. tax exposure with respect to the ownership and subsequent disposition of U.S. real estate. In explaining the structures, this paper also describes some of the relevant U.S. federal tax consequences as well as the New York tax consequences of such ownership and disposition.

POSSIBLE INVESTMENT STRUCTURES

Ownership Without Interposing Corporation

Perhaps the most cost-efficient structure from a pure income tax standpoint would be for the foreign investor to own his or her real estate investment (either real estate itself or an investment in a U.S. LLC or partnership) without any interposing corporation. If the investment is real estate itself or there is any other liability concern, the investor will in most cases own the investment through an LLC. Nevertheless, as will be described below, in spite of the income tax efficiency of this structure, it is relatively uncommon.

Taxation of Current Income

Assuming for simplicity that (i) the investor uses a single member LLC to own the real estate, (ii) the LLC does not elect to be taxed as a corporation,\(^1\) and (iii) the investor is not eligible to take advantage of any treaty, there are two general tax regimes that may apply to the taxation of current rental income from the property. The first regime is a 30% withholding tax on gross rents, referred to herein as the “gross regime,” which generally applies where the rental income from the property is not effectively connected with a U.S. trade or business.\(^2\) The second regime is a tax at a higher rate but generally applying to net income (i.e., after deduction for expenses), referred to herein as the “net regime,” which generally applies where the rental income is effectively connected with a U.S. trade or business.\(^3\) However, even if such rental income is not effectively connected with a U.S. trade or business, the investor may elect the net regime.\(^4\) This may be advantageous if, for example, the investor has expenses to offset much of the income.

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1 See Regs. § 301.7701-3(b). Absent such an election to the contrary, the LLC would be ignored for U.S. federal and New York income tax purposes, and the investor would be treated for such purposes as owning the real estate directly.

2 § § 871(a), 881(a). Unless otherwise provided herein, section references refer to the Internal Revenue
The determination as to whether an activity rises to the level of the conduct of a U.S. trade or business is a highly factual question without hard and fast rules. In general, a triple net lease of a single property to a single tenant where the investor has no activity other than collection of the rent (and payment of any interest and amortization on any mortgage) should not rise to the level of a U.S. trade or business. As the activities or holdings of the investor increase, it becomes more likely that the investor is engaged in the conduct of a U.S. trade or business, although it is difficult to determine exactly when this line is crossed.

The two general tax regimes are described in more detail below.

**No U.S. Trade or Business — Gross Regime**

A foreign individual receiving rental income from U.S. real property that is not effectively connected with a U.S. trade or business (absent an election to be subject to the net regime described below) would be subject to a 30% withholding tax on the gross rental income paid by the tenant. The tax is applied to all rent paid by the tenant, including any landlord expenses paid by the tenant on behalf of the landlord, without any deductions. The tenant withholds the tax from the rent he pays to the landlord and remits it to the Internal Revenue Service. Although not entirely clear, it would appear that there would be no New York State income tax on the rent, even if the property is located in New York.

**U.S. Trade or Business — Net Regime**

If the income of the foreign individual is effectively connected with a U.S. trade or business (or if the foreign individual elects to be so treated), the income is taxed based on the net regime. In general, the individual would pay a federal income tax at graduated rates up to 35%. In addition, if the property is located in New York State, there would be an additional New York State income tax of close to 9%. Taking account of the deductibility of state taxes for federal income tax purposes, the combined effective rate would be approximately 40%. Thus, although the rate under the net regime is higher than the rate under the gross regime, if there are sufficient expenses to reduce or eliminate the income, the tax under the net regime may be lower than tax under the gross regime.
Taxation of Gain on Sale

A key advantage of the noncorporate ownership is that individuals, unlike corporations, are eligible for U.S. federal capital gains rates of 15% (25% to the extent of prior depreciation). Even including an additional New York State tax of approximately 9%, the tax rate on sale for the individual is significantly lower than the tax rate under a corporate structure. FIRPTA withholding \(^8\) and possible New York State withholding (discussed below following the discussion of the various structures) will apply.

\(^8\) § 1445.

Repatriation of Funds

Because there is no corporate entity involved, there is no cost or impediment to the repatriation of current income, refinance proceeds or sales proceeds.

Estate and Gift Taxation

A key disadvantage to this structure is that the real estate will be subject to U.S. estate tax on the death of the foreign individual. \(^9\) Similarly, a gift of all or any portion of the real estate would be subject to U.S. gift tax. \(^10\) If the real estate is held in a partnership or multi-member LLC treated as a partnership for tax purposes, it may still be subject to U.S. estate tax but may not be subject to U.S. gift tax.

\(^9\) § 2101.

\(^10\) § 2501.

Filing of Returns; Lack of Anonymity

If the individual is engaged in a trade or business with respect to the real estate, or elects to be treated as so engaged, the individual is taxed under the net regime, thereby obligating the individual to file U.S. and New York State income tax returns reporting the income from the property. Similarly, under either regime, the individual will be obligated to file returns reporting the sale of the property. In addition to the administrative burden, the filing obligation will mean that the individual will not have anonymity from the government with respect to this investment.

Summary

This structure has some important disadvantages, primarily the imposition of U.S. estate tax and the requirement to file returns and the resulting lack of anonymity. However, given the (i) lower income tax rates, especially (x) the capital gains rates on sale and (y) the lack of a New York City tax for a New York City property (which is not true if a corporation is interposed), and (ii) the ease of repatriation of funds without additional tax, this structure should not be overlooked in appropriate circumstances. A foreign individual who is both relatively young and not particularly concerned about anonymity may find this structure to be the best.

Ex. 1
U.S. Corporation

Another possible structure would be for the individual to own the U.S. real estate investment through a U.S. corporation. A U.S. corporation owned by a non-resident alien individual gives that person a liability shield, although that could be accomplished with an LLC. 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.

Taxation of Current Income

The U.S. corporation will be subject to federal income tax on current income (net of deductions) at graduated rates generally up to 35%. If, however, the property is located in New York City, for example, there would be additional New York State and New York City corporate tax at combined rates approaching 20%. Taking into account the deductibility of state and local taxes in computing federal tax, the marginal rate could approach 48%. The tax is based on income net of expenses.

Taxation of Gain on Sale

Gain on sale would be taxed at the same rates as current income. Corporations do not have special capital gains rates.

Repatriation of Funds

A significant disadvantage over direct individual ownership is that there may be a 30% withholding tax (subject to reduction by many treaties) on the repatriation of current income or refinance proceeds. In addition, to the extent that the distribution exceeds earnings and profits and the shareholder's basis in the stock, there would be a FIRPTA tax to the shareholder. However, if there are no assets remaining in the corporation other than sale proceeds, the corporation can generally be liquidated and the proceeds (after payment of any indebtedness on the real property) repatriated free of a second level of tax. Thus, subject to certain restrictions, it may be possible for the corporation to retain earnings until the property is sold and avoid a second level of tax on repatriation.

Estate and Gift Taxation

Another important disadvantage to this structure is that the value of the real estate will be subject to U.S. estate tax on the death of the foreign individual. However, a gift of the stock should not be subject to U.S. gift tax.
Filing of Returns; Lack of Anonymity

The corporation, but not the individual, will be required to file U.S. and New York tax returns. However, this provides only limited anonymity because the tax return requires disclosure of the name, address and taxpayer identification number of any person owning 50% or more of the stock of the corporation.

Summary

This structure has some advantages. The corporation provides liability protection. In addition, the corporation becomes a separate taxpayer, which eliminates the need for the individual to file annual U.S. federal and state and local tax returns. If the U.S. corporation sells the real estate in a fully taxable transaction there would be no FIRPTA withholding, but the sale would be subject to tax. The U.S. corporation could use a portion of the sales proceeds to repay 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. This structure, however, has some important disadvantages:

a. There may be a second level of tax on operating income and refinance proceeds that are being repatriated back to the individual. If available cash flow is used in whole, or substantial part, for debt service, dividends from operations may not be anticipated.

b. The corporation provides the individual investor only limited anonymity because of the disclosures on the U.S. tax return filed by the corporation.

c. The individual investor will be subject to U.S. estate tax.

**Ex. 2**

**Foreign Corporation**

**Taxation of Current Income**

As was the case with the foreign individual, the foreign corporation will be subject to one of two tax regimes. It will be subject to the gross regime, with a gross withholding tax of 30% (subject to treaty reduction) if it is not engaged in a U.S. trade or business and does not elect to be so treated. On the other hand, if the corporation is engaged in a U.S. trade or business or elects to be so treated, it will be subject to the net regime. However, in this case, the marginal tax rate of the net regime is significantly higher than for an individual. In general, the corporation would pay a federal income tax at graduated rates up to 35%, and if the property is located in, for example New York City, New York State and New York City taxes at a combined rate approaching 20%.
a “branch profits tax” of 30% on, in general, its annual earnings and profits. Because some of these taxes are deductible in determining the other taxes, a useful short hand would be to assume that the overall effective tax rate of all of these taxes combined for New York City property is approximately a maximum of 64%. However, this tax is based on income after deduction for expenses, including interest (subject to certain limitations) and depreciation. Thus, although the rate under the net regime is much higher than the rate under the gross regime, if there are sufficient expenses to reduce or eliminate the income, it is possible that tax under the net regime may be lower than tax under the gross regime.

16 The tax on capital may apply instead, if higher.

17 § 884.

Taxation of Gain on Sale

Gain on sale of the real estate would be taxed at the same rates as current income, except that if there are no other U.S. assets in the corporation, it should be possible to avoid the branch profits tax. However, sale of the stock of the foreign corporation should be free of U.S. federal and New York State and New York City income tax. It should be noted that the purchaser of the stock of the foreign corporation will inherit any built-in gain at the foreign corporation level.

18 However, New York State and New York City transfer tax should still be applicable. See, below, a discussion of the discount the buyer is likely to insist upon because of the low basis of the underlying real estate and other factors.

Repatriation of Funds

There is no dividend withholding tax, but repatriation may be a factor in computing the branch profits tax.

Estate and Gift Taxation

An important advantage to this structure is that the stock of the foreign corporation is generally thought not to be subject to U.S. estate tax on the death of the individual. Similarly, a gift of the stock should not be subject to U.S. gift tax.

19 Some have argued that recent successful IRS attacks in other areas, such as the family limited partnership area, ignoring the existence of entities set up for certain tax planning purposes, could be applied to ignore the foreign corporation and include the real estate in the foreign individual's estate. It remains to be seen to what extent such attacks will be forthcoming or successful. Certainly, the foreigner would be well advised at the very least to carefully adhere to all corporate formalities. Having a business purpose for the foreign corporation would be very helpful.

Filing of Returns; Anonymity

The corporation, but not the individual, will be required to file tax returns. However, this provides only
limited anonymity because the tax return requires disclosure of the name, address and taxpayer identification number of any person owning 50% or more of the stock of the corporation. A second foreign corporation could be interposed if greater anonymity is desired.

Summary

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

a. Instead of the 30% withholding tax that is generally imposed on dividends paid by a U.S. corporation, in the case of a foreign corporation engaged in a trade or business in the U.S., a 30% branch profits tax is generally imposed on the foreign corporation’s “dividend equivalent amount,” which operates as if “phantom dividends” were distributed to shareholders and subjects such dividends to a 30% tax. Both taxes are on top of the regular corporate tax. However, it may be easier to avoid the second level of tax in the case of the U.S. corporation by retaining funds in the corporation until liquidation than it is to avoid the branch profits tax in the case of the foreign corporation.

b. If the property were to be refinanced, a distribution of the refinancing proceeds by the foreign corporation to the shareholder would frequently not be taxable in the U.S. In the case of a U.S. corporation, there would in most cases be a 30% tax (to the extent of earnings and profits) and/or a FIRPTA tax (to the extent the distribution exceeds earnings and profits and the shareholder's basis in the stock).

c. The conventional wisdom is that there should be no estate tax in the case of the foreign corporation.

Both structures generally provide the individual investor with 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% or more of the company's stock.

The foreign corporation structure is frequently used by foreign individuals seeking to purchase an apartment for occasional personal use, although it does raise some issues. In addition, it may also be used by foreigners who are able to take advantages of treaties that reduce the branch profits tax.

Ex. 3

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

3. Assuming no operating income is to be distributed out of the United States, 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 tax. The foreign corporation is then free to distribute the cash to the ultimate shareholder, at any time, with no U.S. tax impact.

4. The stock of the foreign corporation could be sold free of U.S. federal \(^{21}\) and New York State and New York City income tax. \(^{22}\)

5. The conventional wisdom is that neither U.S. estate nor gift tax will apply to a lifetime gift or testamentary transfer of the stock in the foreign corporation. \(^{23}\)

\(^{21}\) 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 and would not provide the purchaser of the stock with a step up in the basis of the real estate. Thus, such a sale is rarely advisable.

\(^{22}\) However, New York State and New York City transfer tax should still be applicable. See, below, a discussion of the discount the buyer is likely to insist upon because of the low basis of the underlying real estate and other factors.

\(^{23}\) See footnote 19, above.

On the other hand, one disadvantage to this structure as opposed to a structure of holding the real estate in a foreign corporation is that in the latter case it is more likely that it will be possible to distribute refinance proceeds free of U.S. tax. If the case of the U.S. corporation owned by a foreign corporation, there is likely to be a 30% withholding tax (to the extent of earnings and profits) and/or a FIRPTA tax to the shareholder (to the extent that the distribution exceeds earnings and profits and basis).

This is perhaps the most common structure for foreign investors investing in U.S. real estate.

Ex. 4

Non-Grantor Foreign Trust

In recent years, the tax rates for individuals in the United States have been reduced. Capital gains are generally subject to a 15% tax, \(^{24}\) the maximum rate of income tax is capped at 35%, \(^{25}\) and recapture income when depreciated real property is sold at a gain is taxed at 25%. \(^{26}\)

\(^{24}\) § 1(h)(1)(C).

\(^{25}\) § 1(h)(2).

\(^{26}\) § 1(h)(1)(D).
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 of the individual's demise. The suggested structure is as follows: The 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 — not a grantor trust — and the beneficiaries would be the 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% 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 by the following diagram:

Ex. 5

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. law, the Trust will be treated as if it were an individual. It will be entitled to the benefits of the 15% tax applicable to capital gains, the 25% tax applicable to depreciation recapture, and 35% 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 (i) 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, (ii) the Trust is not revocable or amendable by the individual, and (iii) the individual does not retain any dominion or control over the Trust or its assets.

**MULTIPLE PROPERTY ISSUES**

Where the foreign investor wishes to acquire more than one property, then it is generally advisable from a liability perspective to put each property into a separate entity. In most cases these separate entities will be separate U.S. corporations.

28 Generally, if the parent will be a foreign corporation, it would be better to use separate U.S. corporations than separate LLCs for this purpose because the separate U.S. corporations will more clearly permit the imposition of only a single level of tax on sale of one of the real estate investments. If the foreign corporation owns several parcels each through a separate LLC, a branch profits tax may be imposed if one parcel is sold while the others are retained. However, if the U.S. consolidated group structure described below is used, then the investor could instead have the U.S. corporation own the separate properties in a series of LLCs since in any event it will be difficult to repatriate the proceeds of a sale of less than all of the properties.
The use of a foreign holding company to hold all of the stock of each U.S. real estate holding corporation may provide the benefits noted above. 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.

Ex. 6

An improvement in the structure at the cost of additional complication would be to have each U.S. corporation held by a separate foreign corporation. In addition to the advantages discussed above, this will permit the sale of a particular real estate investment free of U.S. and New York State and New York City income tax through the sale of the stock of the foreign corporation, subject to the issues discussed below.

Ex. 7

An alternative structure may be used if the intention is to hold the real estate for long-term investment, and there is no expectation of repatriating funds. In that case, a U.S. corporation (rather than a foreign company) could be used as the holding company, which would permit a consolidated tax return to be filed for the U.S. corporations. A consolidated return generally allows the use of one property's losses to offset the income (including gain on sale) of another. If a particular property is sold, the consolidated group will stay in existence. The disadvantage to this structure is that if the ultimate shareholder wishes to repatriate the sale proceeds from a sale of less than all of the properties, 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% withholding tax (subject to treaty reduction).

Ex. 8

If the foreign investor owns the U.S. holding company directly, then U.S. estate tax exposure exists. To protect against this estate tax exposure, at the cost of additional complexity, a foreign holding company may be inserted between the ultimate shareholder and the U.S. corporate holding company. 29

29 See footnote 7, above. In addition, a liquidation of the U.S. parent of the consolidated group within five years of formation may be taxable. § 332(d).

Ex. 9

SOME OTHER ISSUES TO CONSIDER

Withholding on Operating Income

Section 1446 requires withholding on income allocated to a foreign partner in a partnership (or foreign member of an LLC). Similarly, New York State requires withholding on income allocated to non-New York State resident partners or members. In each case, a return must be filed by the partner or member and the withheld tax is applied as a credit on the return against the foreign person's tax liability.
Withholding on Sale

Federal FIRPTA Withholding

The Internal Revenue Code requires FIRPTA withholding on any sale of a “United States real property interest” (very generally, real estate and interests in entities that primarily own real estate) by non-resident aliens or foreign corporations. The transferee is required to deduct and withhold a tax equal to 10% 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. A return reporting the sale must be filed by the foreign person and the withheld tax is applied as a credit on the return against the foreign person's tax liability. If the 10% withholding would be greater than the tax liability, there are procedures pursuant to which the foreign person may demonstrate this to the IRS, using Form 8288-B, in which case the IRS will issue a “withholding certificate” authorizing the transferee to reduce or eliminate the withholding.

30 §§ 897 and 1445.

NYS Payment of Estimated Tax at Time of Sale

Upon the sale of a fee interest in real property by an individual, estate or trust that in each case is not a resident of New York State, the nonresident must generally file a Form IT-2663 and pay an estimated tax on the sale. Exemption from this requirement is claimed on an attachment to the New York State real estate transfer tax form. The recorder is not permitted to record the deed without either the payment of the estimated tax or a claim for exemption from the requirement to pay. A return must be filed by the nonresident person reporting the sale and the withheld tax is applied as a credit on the return against the nonresident person's tax liability.

Sale of Stock of Foreign Corporation

As has been noted above, the foreign investor may avoid U.S. federal and New York State income tax by selling the stock of the foreign corporation. However, insisting on a stock sale will frequently limit the market of potential buyers, as in most cases only certain foreign buyers will be willing to structure the transaction in that manner. In addition, the buyer will insist on a discount to take account of the risk of purchasing an entity, with the inherent liability potential, and to take account of the fact that the buyer will not have an increase in basis to the underlying real estate asset, so that he will effectively inherit the seller's tax.

New York State and New York City take the position that the sale of the foreign stock will still be subject to New York State and New York City real estate transfer taxes. This position has been the subject of constitutional challenge, which the State and City have to date successfully repelled. See In re Cafcor Trust Reg. Vaduz, Tax Appeals Tribunal, DTA Nos. 812682 and 812683 (4/17/97) (New York State gains tax), and In re Corwood Enterprises, Inc., NYC Tax Appeals Tribunal, TAT(E)00-39(RP) (6/2/06) (New York City transfer tax).

Trap for the Unwary — Holding Additional Assets in the Real Estate Entity

A common mistake foreign investors sometimes make is to hold more assets than the single piece of real estate in the same entity or under a single umbrella U.S. parent. They may hold more than one piece of real estate in one entity, or hold non-real estate assets in the same entity as the real estate. Unless the foreign investor is doing this intentionally to take advantage of the ability to offset losses from one
property against income from another (as was the case with the U.S. consolidated group structure discussed above), such a structure can frequently interfere with the tax planning. As has been discussed above, it is frequently important to liquidate the entity selling the real estate to be able to repatriate the sales proceeds free of a second level of tax. If there are other assets in the entity, it can impede such a liquidation. In addition, having additional assets in the entity can impede a sale of the foreign stock as a planning technique to avoid U.S. income tax on the gain on sale.

Use of Debt

While beyond the scope of this article, it should be noted that taxable income can sometimes be reduced and it can be easier to repatriate funds with proper funding of the entity with some amount of debt.

Foreign Tax Considerations

This article discusses only U.S. tax consequences. A foreign person making an investment in U.S. real estate must also consider the foreign tax consequences of the investment. For example, the investor may wish to consider to what extent taxes paid in the U.S. will be creditable against taxes in the investor's home county. Many treaties provide that real estate income is taxed only in the country where the real estate is located, so that the investor may not have foreign tax on this income.