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Options to Consider for Non-US Investors in US Real Estate

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INTRODUCTION

Foreign individuals investing in US real estate typically do so through foreign[1] corporations. This classic corporate structure avoids imposition of the estate tax, but may be very costly from an income tax perspective. Unfortunately, many foreign investors—and their US tax advisers—simply "follow the herd," without adequately considering other options that may permit a substantial reduction of US income tax. This article describes several alternative structures that merit careful consideration in appropriate circumstances.

BACKGROUND: BASIC US TAX RULES FOR NONRESIDENTS

Income Tax

Non-resident aliens of the United States generally are taxable

1. on a net basis, at the same rates applicable to US citizens and resident aliens, on any income that is considered to be effectively connected with the conduct of a trade or business in the United States ("effectively connected income");[2] and

2. on a gross basis, at a 30 percent rate (unless a lower treaty rate or treaty exemption is available) on any fixed or determinable annual or periodical income that has a US source and does not constitute effectively connected income ("FDAP income").[3]

For this purpose, gain from the disposition of a "United States real property interest" (USRPI) is treated as effectively connected income. A USRPI generally includes not only US real estate but also stock (and certain other interests) in a domestic corporation if the corporation is (or, during a specified lookback period, was) a "United States real property holding corporation" (USRPHC).[4]

Under current law, ordinary income is taxed at a maximum rate of 39.6 percent, and long-term capital gains are taxed at a maximum rate of 20 percent;[5] state and local taxes may apply as well. The 3.8 percent Medicare tax that recently came into effect for certain investment income earned by non-corporate domestic taxpayers does not apply to nonresident aliens.[6]

In the case of income earned through a domestic corporation, two levels of tax may apply. First, the income is subject to corporate income tax at a maximum rate of 35 percent (plus state and local tax if applicable).[7] Second, any dividends paid by the corporation to the foreign shareholder are subject to withholding tax at a 30 percent rate (unless a lower treaty rate or treaty exemption is available).[8] Liquidating distributions to foreign shareholders generally can be made tax-free with proper planning. In the case of a domestic corporation that was a USRPHC at any time during the applicable lookback period, this generally requires, among other things, that such distributions be deferred until all USRPIs have been sold.[9]

If effectively connected income is earned by a foreign corporation, the corporate tax burden generally should be comparable, but in lieu of a dividend withholding tax, a branch profits tax (imposed at a 30 percent rate unless a lower treaty rate or treaty exemption is available) applies to the "dividend equivalent amount" when "effectively connected earnings and profits" are deemed to have been repatriated to the home office.[10]

Estate Tax

A nonresident alien[11] who dies while owning US real property or other property with a US situs is subject to US estate tax.[12] If the US real property is owned through a domestic corporation, and the nonresident alien directly owns the stock of the domestic corporation, US estate tax still applies, because stock of a domestic corporation is considered a US-situs asset.[13] Under current law, the maximum US federal estate tax rate is 40 percent (plus state estate taxes if applicable). The $5 million unified exemption that applies to US citizens and residents generally does not apply to nonresident aliens. However, a prorated portion of the exemption (based on the ratio of US-situs assets to worldwide assets) may be available under a tax treaty, such as the 1980 Canada-US income tax treaty.[14]

Stock of a foreign corporation has a foreign situs and is therefore not subject to US federal estate tax. This holds true even if the sole asset of the foreign corporation is US real property or stock of a USRPHC.[15]

THE CLASSIC CORPORATE STRUCTURE

In the vast majority of cases, nonresident aliens invest in US real estate through foreign corporations. In some instances, the foreign corporation owns the US real estate directly; in others, the foreign corporation owns the US real estate through a domestic corporation.[16] In either event, the foreign corporation serves as a "blocker" to protect the foreign investor from any risk of liability for estate tax. That is certainly desirable, but the cost of such protection may be exceedingly high. Let's consider an example.

> *Example 1*
>
> Luke, a nonresident alien individual, organizes a foreign parent corporation ("FP") with a US corporate subsidiary ("US Sub"), and US Sub purchases a US property ("Blackacre"), to be held for investment, for $5,000,000.[17] Luke is hopeful that Blackacre will be sold within three to five years for $10,000,000—

that is, at a $5,000,000 gain. For the sake of simplicity, assume no current income, no depreciation (or depreciation recapture), no state or local taxes, and that maximum federal rates apply. If all goes as planned and Blackacre is sold at a gain of $5,000,000, US Sub will pay corporate income tax in the amount of $1,750,000.[18] Assuming proper planning, no further tax will be paid when US Sub makes liquidating distributions to FP.

OTHER OPTIONS

Suppose Luke is unenthused about the idea of paying $1,750,000 of corporate income tax, and he asks what other structures should be considered. A number of alternatives are described below.

Direct Ownership Structure

Example 2

The facts are the same as in example 1 except that Luke holds Blackacre in his own name.[19] If all goes as planned and Blackacre is sold at a gain of $5,000,000, the 20 percent long-term capital gains rate will apply, so Luke will pay personal income tax in the amount of $1,000,000, for a tax savings of $750,000 in comparison with the corporate structure illustrated in example 1.[20]

There are two key downsides to this structure. First, Luke must file US income tax returns in his own name. For many nonresidents, this is a deal breaker. Let's assume that Luke is not so squeamish.

Second, Luke takes the risk that he may die prior to the sale of Blackacre, in which case his estate will be liable for a federal estate tax in the amount of $4,000,000.[21] This concern ought not be minimized, but it is not self-evident that it makes the direct ownership structure a non-starter. Note that if Luke were to die owning Blackacre, his heirs would receive a stepped-up tax basis, so in the absence of any further appreciation, they could sell the property tax-free. Luke might rationally conclude that the substantial possibility of a $750,000 income tax savings justifies some risk of paying $2,250,000 more than in the baseline scenario in example 1.[22]

Furthermore, as shown below, there are various steps that may be taken to reduce or eliminate the burden of the estate tax.

Example 3

The facts are the same as in example 2 except that Luke organizes a British Virgin Islands (BVI) corporation ("Lenderco"), and uses $3,000,000 of funds borrowed from Lenderco, along with $2,000,000 of other funds, to purchase Blackacre. When Blackacre increases in value to $10,000,000, Lenderco lends an additional $3,000,000 to Luke, increasing the loan to $6,000,000. Both loans are made on a nonrecourse basis, meaning that Lenderco may not seek repayment from any of

Luke's assets other than Blackacre. It is assumed that the advances by Lenderco constitute indebtedness for federal tax purposes.

If we disregard any interest paid or received on the nonrecourse debt, the income tax consequences are the same as in example 2.[23] The potential estate tax, however, is substantially reduced. Under the applicable estate tax regulations, the value of property that is subject to nonrecourse debt is limited to the net value above the amount of the debt.[24] Thus, for estate tax purposes, Blackacre has a value of $4,000,000, with the result that the estate tax is reduced to $1,600,000. As it turns out, this is less than the corporate income tax imposed in example 1. Luke's heirs receive a stepped-up tax basis in Blackacre, so in the absence of any further appreciation, they can sell the property tax-free.

So, even though Luke dies owning Blackacre, the structure is still tax-efficient. Indeed, since the $1,600,000 estate tax is accompanied by an income tax savings of $1,750,000, the modified direct ownership structure results in a net tax savings of $150,000.

And we're not done yet. Depending on the circumstances, it may in effect be possible to further reduce or eliminate the estate tax entirely through certain offsets. For example, if Luke is 45 years old and in good health, he may be able to purchase sufficient term insurance to fully fund the estate tax due. The amount required to pay the insurance premiums may represent only a small portion of the anticipated income tax savings.

Finally, Luke may reside in a country that has an estate tax. If, for example, the US estate tax imposed with respect to Blackacre were fully creditable against an estate tax imposed by Luke's home country, the net cost of the US estate tax would be zero.[25]

Partnership Structure

It may also be possible to block imposition of the estate tax through the use of a partnership structure, as described below.

Example 4

The facts are the same as in example 1, except that Luke organizes a BVI limited partnership ("Partnership") to purchase Blackacre. Luke directly owns a 99 percent limited partnership interest (the "LP interest"), and his wholly owned BVI corporation ("GPco") owns a 1 percent general partnership interest. If all goes as planned and Blackacre is sold at a gain of $5,000,000, the 20 percent long-term capital gains rate will apply to Luke's 99 percent share of the gain, and GPco's 1 percent of the gain should be taxed at a 35 percent rate, for a total income tax cost of $1,007,500 (not materially higher than the $1,000,000 payable in example 2).[26]

As in example 2, there is the risk that Luke may die prior to the sale of Blackacre. In that event, US estate tax may be imposed, but the operative word here is "may."

There is no authority directly addressing how, or whether, the US estate tax rules apply in the case of a non-US person who owns an indirect interest in US-situs property through a partnership. While a lookthrough is certainly possible, it is also possible that the situs of the partnership interest would be determined by reference to the place where the partnership was organized, the partnership's place of management, the domicile of the decedent, or some combination of these factors.

If Luke were to die unexpectedly before selling Blackacre, it would be perfectly permissible (and reasonable) for his executors to take the position that no US estate tax is due, on the ground that the LP interest is not a US-situs asset. It should be assumed that the Internal Revenue Service would disagree if there were an audit, but the risk of an audit is uncertain.[27] And it is unclear who would prevail if the issue were litigated.

There are also additional steps that may be taken to minimize the risk of US estate tax in this scenario. For example, if advance warning is available that Luke's death may be near, he could give away the LP interest to family members or other loved ones on a tax-free basis. The gift tax does not apply to gifts of intangibles by nonresident aliens,[28]and the LP interest is an intangible. Even if the LP interest is determined to be a US-situs asset, the IRS ought not to be empowered to disregard the gift tax exemption for intangibles.[29]

Alternatively, if Luke should die unexpectedly while owning Blackacre, Partnership may elect to be classified as a corporation for US federal tax purposes as of the date of Luke's death, provided that the necessary action can be taken within 75 days.[30] Due to the retroactive effect of such election, Luke would be considered to have died while owning stock of a BVI corporation (undeniably a foreign-situs asset), and thus US estate tax would not apply.

As a consequence of the entity-classification election, Luke would be considered to have transferred a USRPI to a BVI corporation as of the close of business on the day preceding the date of death. This would trigger tax (and withholding obligations) as if Luke had sold the USRPI, so the costs (and cash flow burden) of the deemed sale would need to be carefully weighed against the benefit of avoiding the estate tax. If, for example, Blackacre had not materially appreciated in value since the date of purchase, the income tax cost would be low, and a retroactive election may be highly desirable.

Note also that certain techniques described above with respect to the direct ownership structure (such as nonrecourse funding and the purchase of term insurance) may also be used in connection with the partnership structure, in the event that an entity-classification election is not made and Luke dies owning an interest that may be considered to have a US situs.

Trust Structure

If a nonresident is willing to make a substantial gift and give up control of the property, the trust structure described below may be ideal.

Example 5

> Anakin, a nonresident alien individual, contributes $5,000,000 to an irrevocable, discretionary foreign trust of which his wife, Padme, is the trustee. Their future children and other descendants are the principal beneficiaries. Neither Anakin nor Padme may receive any distributions or other benefits under any circumstances. Assuming that Padme approves of the investment, the trust purchases Blackacre for $5,000,000, and it is hoped that Blackacre will be sold in a few years for $10,000,000—that is, at a gain of $5,000,000. As in the prior examples, assume no current income, no depreciation (or depreciation recapture), no state or local taxes, and that maximum federal rates apply. If all goes as planned and Blackacre is sold at a gain of $5,000,000, the trust will pay income tax in the amount of $1,000,000.[31]

If Anakin (or Padme) unexpectedly dies before Blackacre is sold, there should still be no estate tax, since Anakin's cash contribution to the trust should be a completed gift.[32] Thus, the trust structure provides all of the income tax benefits of the direct ownership structure without the estate tax risk. The fact that it is not used more often is quite remarkable.

CONCLUSION

As shown above, there are a number of possible structures to be considered by foreign individuals who wish to invest in US real estate. Each structure has pros and cons, and a structure that works for one investor may not work for another. All investors, however, would benefit from a careful analysis of the available options.

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[1] With apologies to Canadian readers, in the context of this article, the term "foreign" means non-U.S.

[2] However, pursuant to an extremely punitive rule designed to discourage noncompliance by foreign taxpayers, a nonresident alien or foreign corporation that fails to file a federal income tax return will lose the ability to claim otherwise allowable deductions with respect to effectively connected income. See sections 874(a) and 882(c)(2) of the Internal Revenue Code of 1986, as amended (herein referred to as "IRC"). (Unless otherwise stated, section references in this article are to the IRC.) The applicable regulations specify certain "drop-dead" dates by which returns must be filed in order to avoid such loss of deductions, and the validity of those regulations has been the subject of some litigation. See *Swallows Holding, Ltd.*, 126 TC 96 (2006), vacated and remanded, 515 F. 3d 162 (3d Cir. 2008).

[3] Non-resident aliens and foreign corporations may elect to treat rent that otherwise constitutes FDAP income as effectively connected income (so as to be taxed on a net basis), and when well advised, they typically make this election. IRC sections 871(d) and 882(d).

[4] There are certain limited circumstances in which stock of a domestic corporation that is (or, during the applicable lookback period, was) a USRPHC is not considered a USRPI. This exclusion applies, for example, to certain interests in publicly traded corporations and stock of a domestically controlled real estate investment trust. IRC sections 897(c)(3) and (h)(2). A corporation is a USRPHC if the value of its USRPIs represents 50 percent or more of the total value of its USRPIs, interests in foreign real property, and other assets used in a trade or business. IRC section 897(c)(2).

[5] See IRC section 1. Depreciation recapture is taxed at a maximum rate of 25 percent. IRC section 1250.

[6] IRC section 1411(e)(1).

[7] IRC section 11.

[8] IRC sections 871, 881, 1441, and 1442.

[9] IRC section 897(c)(1)(B).

[10] IRC section 884.

[11] For US federal gift and estate tax purposes, a nonresident is an individual whose domicile is not within the United States. Treas. reg. sections 20.0-1(b)(1) and 25.2501-1(b).

[12] IRC section 2103.

[13] IRC section 2104(a).

[14] Article XXIX B(2) of the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 (herein referred to as "the Canada-US tax treaty"). Thus, for example, if a Canadian resident dies and 10 percent of her worldwide assets consist of US-situs property, a $500,000 exclusion should be available.

[15] The answer may be different in certain circumstances if the decedent was at one time a citizen or permanent resident of the United States. See IRC section 2107.

[16] In the case of multiple properties, multiple foreign corporations and/or multiple US corporations may be used.

[17] FP and US Sub are capitalized entirely with equity.

[18] $5,000,000 x 35% = $1,750,000. A portion of US Sub's capital could be provided through related-party debt, permitting deductible interest to be paid by US Sub, but the tax savings would not typically be very dramatic, since interest on the related-party debt would typically be subject to a 30 percent US withholding tax (unless treaty benefits were available). An exemption from the 30 percent US withholding tax applies in the case of certain "portfolio interest," but the exemption is not available if the lender is considered to be a "10 percent shareholder" of the borrower, and certain constructive ownership rules apply for purposes of applying this 10 percent shareholder test. IRC section 871(h)(3). In certain circumstances, it may be possible to avoid the impact of the 10 percent shareholder limitation through creative structuring.

[19] If liability is a concern, assume that Luke holds the property through a wholly owned US limited liability company (LLC). The LLC would be disregarded for US tax purposes and thus would not affect the tax analysis herein.

[20] $5,000,000 x 20% = $1,000,000. Note that since Luke is a nonresident alien, certain withholding rules applicable to sales of USRPIs by foreign persons generally will require the purchaser to withhold 10 percent of the total purchase price. See IRC section 1445(a). The amount withheld can be claimed as a credit against the tax due (and, to the extent that such amount is in excess of the tax due, will be refunded). If the amount withheld would exceed the tax due and certain other requirements are satisfied, a withholding certificate may be obtained that authorizes the purchaser to withhold a reduced amount (or to not withhold at all). The 10 percent withholding requirement can be eliminated if a US LLC classified as a partnership is interposed to hold the property. A second owner would be needed for the LLC to be considered a partnership and not a disregarded entity.

[21] $10,000,000 x 40% = $4,000,000. Assume that Luke is not entitled to the benefits of a tax treaty that would allow him a prorated portion of the $5,000,000 exemption and that state estate taxes do not apply.

[22] $4,000,000 – $1,750,000 = $2,250,000.

[23] A 30 percent withholding tax may be imposed on the interest, depending on whether the requirements for the portfolio interest exemption are considered to be satisfied. The exemption does not apply to interest that is determined by reference to certain contingencies, such as "income or profits of the debtor or a related person," or "any change in value of any property of the debtor or a related person." IRC section 871(h)(4). The Internal Revenue Service might argue that the nonrecourse nature of the loan causes payment of the interest to be subject to such a contingency, but this appears to be an extremely weak argument.

[24] Treas. reg. section 20.2053-7.

[25] Canada does not have an estate tax, but article XXIX B(6) of the Canada-US tax treaty nevertheless allows a credit against Canadian income tax for a Canadian resident who dies owning US-situs property subject to US estate tax.

[26] ($5,000,000 x 99% x 20%) + ($5,000,000 x 1% x 35%) = $990,000 + 17,500 = $1,007,500. (It is assumed that imposition of the branch profits tax can be avoided.) Note that since Partnership is a foreign partnership, the same withholding rules applicable to a sale of Blackacre by Luke would apply to the sale by Partnership.

[27] The author is not aware of any US estate tax audits in this type of scenario. This may be due in large part to the fact that in such situations estate tax returns are (justifiably) not filed.

[28] IRC section 2501(a)(2). There are limited exceptions, which are not relevant to this discussion. This exception does not apply for estate tax purposes.

[29] The analysis would be different if the Internal Revenue Service successfully applied the partnership anti-abuse rule to disregard Partnership for US federal tax purposes. See Treas. reg. section 1.701-2. It would be prudent to take certain steps to minimize the risk that the partnership anti-abuse rule applies. The author has conveniently deemed a discussion of such steps to be beyond the scope of this article.

[30] Under the applicable entity-classification regulations, such an election may be made effective on a retroactive basis up to 75 days prior to the date of filing. Luke's consent would be required for the election to be effective as of the date of death, but it appears that the executor should be permitted to provide the necessary consent on Luke's behalf.

[31] $5,000,000 x 20% = $1,000,000. For "extra credit," the trust can be organized as a domestic trust (requiring, among other things, that the trustee be a US person), and Anakin or Padme can lend funds to the trust. Interest paid on the loan generally should be deductible, and with proper structuring, interest on the loan would be paid free of withholding tax, pursuant to the portfolio interest exemption. IRC section 871(h). As noted above, the exemption is not available where the lender is considered to be a 10 percent shareholder of the borrower, but this limitation has no application where the borrower is a trust.

[32] The discretionary nature of the trust is not necessary to this conclusion. It is assumed that Anakin would wish Padme to have control over the dispensation of funds in the trust (and, depending on the particulars of their relationship, she may or may not consider any suggestions he might wish to make).