BY JACOB STEIN

# Tax Planning for Foreign Investment in California Real Estate

**THE RECENT CONFLUENCE** of falling U.S. real estate prices and a weaker dollar, together with the flight of capital from Russia and China, has produced a significant demand for real estate in California, Florida, and Manhattan among foreign investors. This demand is fueled by the global perception that the United States is politically and economically stable (or at least more stable than the alternatives), has a transparent legal system that makes it easy for foreigners to invest in real estate,[1] and imposes no currency controls, making it easy to divest.

A foreigner desiring to invest in U.S. real estate typically has many goals. First, the foreigner may seek privacy. For example, a member of the Vietnamese Politburo who may be concerned about political exposure, a South African who may have violated local currency controls may seek to hide his or her identity, and a Mexican national who may be concerned for his or her physical safety were his or her wealth to become known may all feel a need to keep their real estate investments secret. Second, to the same extent as U.S. nationals, foreigners usually desire to shield their U.S. holdings from creditor claims. Third, unlike U.S. investors who invest in U.S. properties, foreign investors need to minimize their worldwide tax liability. Additional important considerations include whether the real estate is income-producing, and if so, whether the income is passive income or income from a trade or business. Another concern, especially for older investors, is whether the investor is a U.S. resident for estate tax purposes.

## Privacy and Liability

Most foreign investors are concerned about privacy. To safeguard it, the real estate should be acquired either by a trust or a legal entity, preferably an LLC. LLCs are generally preferred over corporations because they offer greater structuring flexibility and better creditor protection than corporations, and, unlike a limited partnership, LLCs do not require the formation of a second entity that will act as the general partner. If using a trust, the name of the trustee and the name of the trust must appear on the recorded deed. The investor should not be the trustee, and the trust should not include the investor's name.

A generic name should be used for an entity. However, if the entity will own California real estate, it will have to register with the California secretary of state, unless the real estate is vacant land or personal use property.[2] Either the initial articles of incorporation or the statement of information will reveal to the world the identity of the corporate officers or the LLC manager. A possible alternative is to use a two-tier structure—a California LLC to own the real estate, and a Delaware LLC to act as the manager of the California LLC. In Delaware, the name of the LLC manager is not required to be disclosed, and all that will appear on California form is the name of the Delaware LLC as the manager. Care should be exercised so that the Delaware LLC is not deemed to be doing business in California, otherwise it will also have to register.[3]

If the real estate is encumbered by debt, the borrower's name will appear on the recorded deed of trust, even if title is taken in the name of a trust or an LLC. The borrower's name may be kept private by having the trust entity act as the borrower, with the investor personally guaranteeing the loan. This ensures that the investor's name does not appear on any recorded documents.

Corporations, limited partnerships, and LLCs will afford owners a shield for any liability arising from the assets or the business of the entity.[4] However, limited partnerships and LLCs are not required to maintain certain corporate formalities (like holding annual meetings of shareholders and maintaining annual minutes), affording creditors fewer bases for piercing the corporate veil. Interests in limited partnerships and LLCs are not attachable by creditors, making them a more effective asset protection vehicle than corporations.[5] Thus, for example, when a creditor obtains a judgment against an individual who owns an apartment building through a corporation, the creditor can force the debtor to turn over the stock of the corporation, resulting in the loss of corporate assets.[6] If the debtor owns the apartment building through an LLC or a limited partnership, the creditor's remedy is limited to a charging order, which places a lien on distributions from the LLC or limited partnership.[7]

## Income Taxation of Real Estate

A person colloquially referred to as a foreigner is known as a nonresident alien (NRA) for federal income tax purposes. An NRA is defined as a either a foreign corporation or a person who is 1) physically present in the United States for less than 183 days in any given year, 2) less than 31 days in the current year, 3) physically present for less than 183 total days for a three-year period (using a weighing formula), and 4) does not hold a green card.[8]

Income tax rules applicable to NRAs can be quite complex. As a general rule, an NRA pays a flat 30 percent tax on U.S.-source "fixed or determinable, annual or periodical" (FDAP) income that is not effectively connected to a U.S. trade or business[9] and that is subject to withholding.[10] The rate of tax may be reduced by an applicable treaty. The income is taxed on a gross basis, with almost no offsetting deductions.

FDAP includes interest, dividends, royalties, and rents. For example, NRAs that receive interest income from U.S. sources are subject to a 30 percent tax. Other miscellaneous categories of income included within FDAP are certain insurance premiums, annuity payments, gambling winnings, and alimony. NRAs, however, are generally not taxable on their capital gains from U.S. sources unless 1) the NRA is present in the United States for more than 183 days, 2) the gains are effectively connected to a U.S. trade or business, or 3) gains are from the sale of certain timber, coal, or domestic iron ore assets. When these exceptions apply, the NRA is taxed on U.S. source capital gains at the rate of 30 percent.[11]

An NRA is taxed on income effectively connected to a U.S. trade

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or business under the same rules as all other U.S. taxpayers. Income may be reduced by appropriate deductions (connected to the U.S. trade or business) and standard tax rates apply.[12] Because traditional tax rules apply, this is necessarily limited to what constitutes a U.S. trade or business and to what "effectively connected" means.

There is no code definition for the term "U.S. trade or business." However, it has been held to include providing personal services in the United States, selling products in the United States directly or through an agent, soliciting orders from the United States and then exporting merchandise outside the United States, manufacturing, maintaining a retail store, and maintaining corporate offices in the United States. The meaning of "effectively connected" is highly specific and complex and involves the "force of attraction" rule and "asset-use" and "business-activities" tests.[13]

In general, however, an NRA will be engaged in a U.S. trade or business if the NRA is a general or limited partner in a U.S. partnership engaged in a trade or business.[14] Similarly, a beneficiary of a U.S. estate or trust will be engaged in trade or business if the estate or trust is so engaged.[15]

For real estate, the critical inquiry concerns the nature of the rental income. It is passive if it is generated by a triple-net lease or from lease of unimproved land. If rental income is passive, it is taxed on a gross basis, with no deductions, at a flat rate of 30 percent, with the applicable withholding.[16]

The loss of deductions is often tax-prohibitive, and investors should consider electing to treat their passive real property income as income from a U.S. trade or business.[17] However, the election can only be made if the property is generating income.[18] Consequently, if an NRA owns unimproved land that will be developed in the future, he or she should consider leasing the land for some purpose in an attempt to generate income. This will give the NRA the ability to claim deductions from the property and possibly generate a loss carry-forward that will offset income in future years.

A popular planning tool to avoid taxation of real estate income is portfolio interest, which is payable on a debt instrument and is not subject to taxation or withholding.[19] NRAs often try to fit into the portfolio interest rules by lending through equity participation loans or loans with equity kickers. An equity kicker is an addition to a fixed-income security (like a loan) that allows the lender to participate in equity appreciation. This may be accomplished in the form of a conversion option, allowing the lender to convert debt into equity. These provisions usually increase interest rates on a contingent basis to mimic equity participation. NRAs should be aware, however, that in two cases the IRS has successfully argued that portfolio interest "loan" structures were in reality equity investments that produced income subject to taxation and withholding.[20]

If a foreign individual or a foreign corporation owns a U.S. corporation, there are two levels of tax. The U.S. corporation will be subject to the regular income tax on its profits, and there will be a tax on dividends paid to the foreign shareholders, subject to 30 percent withholding.

The so-called branch profits tax replicates this double tax when the U.S. business is owned by a foreign corporation, whether directly, through a disregarded entity, or through a pass-through entity. Under the branch profits tax, the foreign corporation is taxed on its effectively connected income and on any deemed dividends, which are any profits not reinvested in the United States.[21] The branch profits tax applies at the rate of 30 percent but may be reduced by an applicable treaty.[22] The U.S. has treaties covering the branch profits tax with most of the European nations, reducing the tax to between 5 and 10 percent.

The 30 percent tax is onerous, as it applies to a "dividend equivalent amount," which is the corporation's effectively connected earnings and profits for the year, less investments the corporation makes in its U.S. assets (money and adjusted bases of property connected with the conduct of a U.S. trade or business). The tax is imposed even if there is no distribution.

The rules applicable to the tax on the disposition of real estate are found in a separate regime known as the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).[23] Generally, FIRTPA taxes the disposition of a U.S. real property interest (USRPI)[24] as if the NRA were engaged in a U.S. trade or business.[25] This means that the traditional income tax rules that apply to U.S. taxpayers will also apply to the NRA. Purchasers who acquire a USRPI from a NRA are obligated to withhold 10 percent of the amount realized on the disposition.

An interest in real property includes any ownership of land, buildings, mineral deposits, crops, fixtures, personal property used to 1) exploit natural resources, 2) construct improvements, 3) operate a lodging facility, or 4) provide a furnished office to a tenant (including movable walls or furnishings), improvements, leaseholds, or options to acquire any of the above.[26] Ownership interests include fee ownership, co-ownership, leasehold, timeshare, a life estate, a remainder, a reversion or a right to participate in the appreciation of real property or in the profits from real property.[27]

A partnership interest is treated as a USRPI if 1) 50 percent or more of the value of partnership gross assets consists of USRPIs, and 2) 90 percent or more of the value of partnership gross assets consist of USRPIs plus cash and cash equivalents.[28] The disposition of partnership interest will be subject to FIRPTA to the extent such partnership owns USRPIs and will be subject to withholding.

A domestic corporation will be treated as a U.S. real property holding corporation (USRPHC) if USRPIs equal or exceed 50 percent of the sum of the corporation's assets.[29] Disposition of an interest in a USRPHC is subject to the FIRPTA tax and withholding but is not subject to state income tax.[30] This may be compared with the disposition of a USRPI owned directly, which is subject to the lower federal capital gains rate but is also subject to the state income tax.

The disposition of an interest in a domestic corporation will not be subject to these rules if on the date of the disposition the corporation had no USRPIs and all of the gain was fully recognized (no installment sales or exchanges) on the sale of any USRPIs sold within the past five years.[31]

Any NRA (individual or corporation) selling a USRPI is subject to withholding of 10 percent of the amount realized. Withholding applies even if the property is sold at a loss.[32] The withholding obligation is imposed on the purchaser, who must report the withholding and pay over the tax, using Form 8288 within 20 days of the purchase. If the purchaser fails to collect the withholding tax from the foreigner, the purchaser will be liable for the tax plus any applicable penalties and interest. The withheld taxes are later credited against the total tax liability of the foreigner.

Withholding is not required if 1) the seller provides a certificate of non-foreign status, 2) property acquired by the purchaser is not a USRPI, 3) the transferred property is stock of a domestic corporation and the corporation provides a certificate that it is not a USRPHC, 4) the USRPI acquired will be used by the purchaser as a residence and the amount realized by the foreigner on the disposition is $300,000 or less, 5) the disposition is not subject to tax, or 6) the amount realized by the foreigner on the disposition is zero.[33]

## Estate and Gift Tax

For estate tax purposes, the test is completely different in determining who is an NRA—the inquiry centers around the decedent's domicile.[34] This is a subjective test that looks primarily at intent. The test considers factors such as the length of stay in the United States; frequency of travel, size, and cost of home in the United States; location of family; participation in community activities; participation in U.S. business and ownership of assets in the United States; and voting.

A foreigner can be a U.S. resident for income tax purposes but not be domiciled for estate tax purposes. An NRA, whether a nonresident alien or nondomicilary, is subject to a different transfer tax (estate and gift taxes) regime than a U.S. taxpayer. The estate tax is imposed only on the part of the gross NRA's estate that at the time of death is situated in the United States.[35] The rate of NRA's estate tax is the same as that imposed on U.S. citizens and resident aliens, but the unified credit is only $13,000 (equivalent to about $60,000 of property value).[36] These harsh rules may be ameliorated by an estate tax treaty. The U.S. does not maintain as many estate tax treaties as income tax treaties, but there are estate tax treaties in place with many of the major European countries, Australia, and Japan.[37]

The following assets are specifically included by the IRC in the definition of property situated in the United States: 1) shares of stock of a U.S. corporation, 2) revocable transfers or transfers within three years of death of U.S. property or transfers with a retained interest (described in IRC Sections 2035 to 2038), and 3) debt issued by a U.S. person or a governmental entity within the United States (e.g., municipal bonds).[38]

U.S. property also includes real estate in the United States (if debt is recourse it is ignored—gross value is included, not just equity) and tangible personal property such as works of art, furniture, cars, and currency.[39] A beneficial interest in a trust holding U.S. property is also U.S.-situs property.[40] U.S.-situs property does not include life insurance proceeds paid on the life of the NRA, bank accounts (unless connected with a U.S. business), portfolio interest loans,[41] and shares of stock in a foreign corporation.[42]

The gross estate is reduced by various deductions relating to the U.S.-situs property. The estate tax returns must disclose all of the NRA's worldwide assets, in order to determine the ratio that the U.S. assets bear to non-U.S. assets. This ratio determines the percentage of allowable deductions that may be claimed against the gross estate.[43] When real estate is subject to a recourse mortgage, the gross value of the real estate is included, offset by the mortgage debt.[44] This distinction is irrelevant for U.S. taxpayers filing estate tax returns but is very relevant for NRAs for whom debts are subject to apportionment between U.S. and non-U.S. assets and therefore not fully deductible.[45]

Advance planning can eliminate or reduce the U.S. estate tax obligations of NRAs. For example, U.S. real estate owned by the NRA through a foreign corporation is not included in an NRA's estate. This effectively converts U.S. real property into a non-U.S. intangible asset. Even if the real estate were not initially acquired through a foreign corporation, it may be beneficial to pay an income tax today on the transfer of the real estate to a foreign corporation (usually treated as a sale) to avoid the estate tax in the future.

Gift taxes are imposed on the donor. A NRA donor is not subject to U.S. gift taxes on any gifts of non-U.S. situs property gifted to any person, including U.S. citizens and residents. Citizens and residents, however, must report on Form 3520 gifts from a NRA that are in excess of $100,000.[46] Gifts of U.S.-situs assets are subject to gift taxes, with the exception of intangibles, which are not taxable.[47] Tangible personal property and real property is sited within the United States if it is physically located in the United States.[48] NRA donors are allowed the same annual gift tax exclusion as other taxpayers and are subject to the same rate schedule for gift taxes. However, the lifetime unified credit is not available to NRA donors.[49]

The primary thrust of estate tax planning for NRAs is through the use of 1) foreign corporations to own U.S. assets, or 2) the gift tax exemption for intangibles to remove assets from the United States. If the NRA dies owning shares of stock in a foreign corporation, the shares are not included in the NRA's estate, regardless of the situs of the corporation's assets. It is important that the corporation have a business purpose and activity, lest it be deemed a sham designed to avoid U.S. estate taxes.[50]

The gift of an intangible, wherever situated, by an NRA is not subject to gift tax. Shares in U.S. corporations and interests in partnerships or LLCs are intangibles.[51] Consequently, real estate owned by the NRA through a U.S. corporation, partnership, or LLC may be removed from the NRA's U.S. estate by gifting entity interests to foreign relatives.

## Ownership Structures

An NRA can acquire U.S. real estate using several alternative ownership structures. The NRA's goals and priorities dictate the type of structure that is used. Each alternative has its own advantages and disadvantages. For example, direct investment (real estate owned by the NRA) is simple and is subject to only one level of tax on the disposition. If the real estate is held for one year, the sale is taxed at a 15 percent rate.[52] The disadvantages of the direct investment are: no privacy, no liability protection, the obligation to file U.S. income tax returns, and if the NRA dies while owning the property, it is subject to U.S. estate taxes.

Under an LLC or a limited partnership structure, the NRA acquires the real estate through an LLC or an LP. The LLC may be a disregarded entity or a tax partnership for U.S. income tax purposes. This is an improvement over the direct ownership alternative, because this structure provides the NRA with privacy and liability protection and allows for lifetime transfers that escape the gift tax. The obligation to file U.S. income tax returns and the possibility for U.S. estate tax on death remain, however.

Ownership of real estate through a domestic corporation (a C corporation, since a foreign shareholder precludes an S corporation)[53] will afford privacy and liability protection, allow lifetime gift tax-free transfers, and obviate the foreigner's need to file U.S. income tax returns. Engaging in a U.S. trade or business requires a U.S. tax return; ownership of stock will not trigger a return filing obligation.

There are three disadvantages to the ownership of real estate through a domestic corporation. One is that federal and state corporate income tax at the corporate level will add a second layer of tax. The second is that dividends from the domestic corporation to its foreign shareholder will be subject to 30 percent withholding. The third is that the shares of the domestic corporation will be included in the U.S. estate of the foreign shareholder. Further, on the disposition of the stock in the corporation, the foreign shareholder will be subject to FIRPTA, because the corporation will be treated as a USRPHC. This will require the filing of a U.S. income tax return and 10 percent tax withholding by the purchaser of the shares.

Ownership of the real estate may be by the U.S. corporation directly, or through a U.S. partnership or disregarded entity owned by the corporation. The corporation may even be an LLC that chooses to be taxed as a corporation. In turn, the ownership of the U.S. corporation by the NRA may be direct, or through a foreign partnership or disregarded entity.

Foreign corporation ownership offers the following advantages: 1) liability protection, 2) no U.S. income tax or filing requirement for the foreign shareholder, 3) shares in the foreign corporation are non-U.S. assets not included in the U.S. estate, 4) dividends are not subject to U.S. withholding, 5) no tax or filing requirement on the disposition of the stock, and 6) no gift tax on the transfer of shares of stock.

The disadvantages of using the foreign corporation are 1) corporate level taxes (just like with the domestic corporation), because the foreign corporation will be deemed engaged in a U.S. trade or business, and 2) the foreign corporation will be subject to the branch profits tax, the largest disadvantage of ownership of U.S. real estate through a foreign corporation.

Because the branch profits tax is not always reduced or eliminated by a treaty, the most advantageous structure for ownership of U.S. real estate by NRAs is a hybrid foreign and U.S. corporation. The NRA owns a foreign corporation that in turn owns a U.S. LLC taxed as a corporation. This structure affords privacy and liability protection, escapes U.S. income tax filing requirements, avoids U.S. estate taxes, allows for gift tax-free lifetime transfers, and avoids the branch profits tax. Distributions from the U.S. subsidiary to the foreign parent are subject to the 30 percent FDAP withholding, but the timing and the amount of this dividend is within the NRA's control.

There are multiple considerations and structures available to foreign investors in U.S. real estate, and no structure is perfect. Each structure presents its own advantages and disadvantages that require analysis in light of the objectives and priorities of each client. ■

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[1] With the exception of a few states that restrict foreign ownership of mineral rights, no restrictions are imposed on foreign ownership of U.S. real estate.
[2] Corp. Code §17451(a).
[3] *See* Jacob Stein, *California Registration Requirements for Foreign LLCs*, Cal. Tax Lawyer 41 (Summer 2008).
[4] Erkenbrecher v. Grant, 187 Cal. 7, 9, 200 P. 641 (1921); Hollywood Cleaning & Pressing Co. v. Hollywood Laundry Serv., 217 C. 124, 129 (1932); rp. Code §§17101(a), 15632(a).
[5] Corp. Code §§15673, 17302. *See* Jacob Stein, *A Practical Take on Charging Orders*, 8 Bus. Ent. Mag. 28 (Sept. 2006).
[6] U.C.C. §8112.
[7] Corp. Code §17302.
[8] I.R.C. §7701(b).
[9] I.R.C. §§871(a), 881. Rental income is sourced to where the property is located. I.R.C. §861(a)(4).
[10] I.R.C. §1441(a).
[11] I.R.C. §871(a)(2).
[12] I.R.C. §§871(b), 882.
[13] *See* I.R.C. §§864(c)(2), (3).
[14] I.R.C. §875(1).
[15] I.R.C. §875(2).
[16] I.R.C. §871(a)(1); Treas. Reg. §1.871-7(a)(3).
[17] I.R.C. §871(d); Rev. Rul. 92-74, 1992-2 CB 156.
[18] Rev. Rul. 91-7, 1991-1 CB 110.
[19] I.R.C. §§871(h), 881(c)(1).
[20] *See, e.g.*, Farley Realty Corp. v. Commissioner, 279 F. 2d 701 (2d Cir. 1960), Portage Plastics Co. v. United States, 470 F. 2d 308 (7th Cir. 1972).
[21] I.R.C. §884(a).
[22] *Id.*
[23] Foreign Investment in Real Property Tax Act of 1980, *codified at* I.R.C. §§897, 1445, 6039C.
[24] A USRPI is defined as any interest in 1) real property located in the United States or 2) a domestic corporation that is a "United States real property holding corporation." I.R.C. §897(c)(1).
[25] I.R.C. §897.
[26] I.R.C. §897(c); Treas. Reg. §1.897-1(b).
[27] Treas. Reg. §1.897-1(d)(2)(i).
[28] Temp. Reg. §1.897-7T.
[29] I.R.C. §897(c)(2).
[30] I.R.C. §897(a)(1). There are no state law equivalents to FIRPTA, and under state law a sale of an interest in a domestic corporation (even if it is a USRPHC for federal income tax purposes) by a foreigner is not taxable, following the general rule of I.R.C. §892.
[31] I.R.C. §897(c)(1)(B); Treas. Reg. §1.897-2(c).
[32] I.R.C. §1445.
[33] *Id.*; Treas. Reg. §1.1445-2(d)(2)(i).
[34] Treas. Reg. §§20.0-1(b)(1), 25.2501-1(b).
[35] I.R.C. §2103.
[36] I.R.C. §2102(b)(1).
[37] This includes tax treaties with Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Norway, Sweden, Switzerland, and the United Kingdom.
[38] I.R.C. §2104.
[39] Treas. Reg. §20.2104-1(a).
[40] Rev. Rul. 55-163, 1955-1 C.B. 674.
[41] I.R.C. §2105.
[42] Treas. Reg. §20.2105-1(f).
[43] I.R.C. §2105(a)(1), (2).
[44] Treas. Reg. §20.2053-7. If the mortgage is nonrecourse, only the net value of the property is included in the estate.
[45] Treas. Reg. §20.2106-2. Apportionment is also possible only if worldwide assets are disclosed on the estate tax return.
[46] I.R.S. Notice 97-34, 1997-1 C.B. 422.
[47] I.R.C. §2501(a)(2).
[48] Treas. Reg. §25.2511-3(b).
[49] I.R.C. §2505(a).
[50] *See, e.g.*, Jackson v. Commissioner, 233 F. 2d 289 (2d Cir. 1956).
[51] Interest is an intangible if the partnership is a distinct legal entity and survives the death of its partners. Sanchez v. Bowers, 70 F. 2d 715 (2d Cir. 1934). For the application of this rule to an LLC, *see* Pierre v. Commissioner, T.C. Memo 2010-106.
[52] I.R.C. §1(h).
[53] I.R.C. §1361(b)(1)(C).