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Taxes Across Borders

A Guide to Foreign Investment in California Real Estate

While a non-resident alien (NRA) desiring to invest in U.S. real estate property typically has many goals, such as liability protection and privacy, the main concern is to minimize worldwide income and estate tax liability.

Privacy and Liability

Privacy is attainable by acquiring real estate through a trust or a legal entity—preferably an LLC. A generic name should be used and, for a trust, a third-party trustee.

Corporations, limited partnerships and LLCs will afford their individual owners a shield for any liability arising from the assets or the business of the entity. 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.

Income Taxation of Real Estate

For federal income tax purposes, an NRA is defined as either a foreign corporation or person who is:

1. Physically present in the U.S. for less than 183 days in any given year;
2. Physically present in the U.S. for 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.

Income tax rules applicable to NRAs can be quite complex. Generally, 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, and which is subject to tax withholding by the payor. FDAP includes interest, dividends, royalties and rents, insurance premiums, annuity payments, gambling winnings and alimony. An applicable treaty may reduce the rate of tax. The income is taxed on a gross basis, with almost no offsetting deductions.

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NRAs, however, are generally not taxable on their capital gains from U.S. sources.

An NRA is taxed on income effectively connected to a U.S. trade or business under the same rules as all U.S. taxpayers. U.S. trade or business 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; and manufacturing, maintaining a retail store, and maintaining corporate offices, in the United States.

NRAs will be engaged in a U.S. trade or business if they are a general or limited partner in a U.S. partnership engaged in a trade or business, or if they have a dependent agent in the United States engaged in business on their behalf.

For real estate, the critical inquiry concerns the nature of the rental income: Is it passive or from a trade or business? Rental income is passive if it is generated by a triple-net lease or from lease of unimproved land. The rental income is then taxed on a gross basis (no deductions) at a flat rate of 30 percent, with the applicable withholding.

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. However, the election can only be made if the property is generating income.

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 not incorporated and is owned by a foreign corporation. The foreign corporation is taxed on its effectively connected income and is also taxed on a deemed dividend, which is a tax on any profits not reinvested in the United States. The branch profits tax applies at the rate of 30 percent, but may be reduced by an applicable treaty.

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). Generally, the act taxes the disposition of an interest in U.S. real property as if the NRA was engaged in a U.S. trade or business. This means that the traditional income tax rules that apply to U.S. taxpayers will also apply to the NRA.

Purchasers who acquire a United States real property interest from an NRA are obligated to withhold 10 percent of the amount realized on the disposition, even if the property is sold at a loss (but certain exceptions may apply). 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. The withheld taxes are later credited against the total tax liability of the foreigner.

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Estate and Gift Tax

For estate tax purposes, the test to determine who is an NRA centers on the decedent's domicile. This is a more subjective test, which looks primarily at intent. The test will also consider factors such as the length of stay in the United States and 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 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 NRA's gross estate that, at the time of death, is situated in the U.S. The rate of an 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). However, these rules may be ameliorated by an estate tax treaty.

Advance planning can eliminate or reduce the U.S. estate tax obligations of NRAs. For example, U.S. real property 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. An NRA donor is not subject to U.S. gift taxes on any gifts of non-U.S. situs property made to any person, including U.S. citizens and residents. U.S. citizens and residents must report gifts from an NRA that are in excess of $100,000 on Form 3520.

Gifts of U.S.-situs assets are subject to gift taxes—with the exception of intangibles, which are not taxable. Tangible personal property and real property is sited within the United States if it's physically located in the United States. NRA donors are allowed the annual gift tax exclusion but not the lifetime unified credit.

The primary thrust of estate tax planning for NRAs is through the use of:

- Foreign corporations to own U.S. assets; or
- The gift tax exemption for intangibles to remove assets from the U.S.

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. Consequently, real estate owned by the NRA through a U.S. corporation, partnership or an LLC may be removed from the NRA's U.S. estate by gifting entity interests to foreign relatives gift tax-free.

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; there is no perfect structure.

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. The disadvantages of the direct investment include no privacy, no liability protection, the obligation to file U.S. income tax returns, and—if owned at death—real estate is subject to U.S. estate taxes.

Under an LLC/limited partnership structure, the NRA acquires the real estate through an LLC or a limited partnership. The LLC may be a disregarded entity or tax partnership for U.S. income tax purposes. This is an improvement over direct ownership, because it provides the NRA with privacy and liability protection *and* 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.

Ownership of real estate through a domestic corporation 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 owning real estate through a domestic corporation:

1. Federal and state corporate income tax at the corporate level will add a second layer of tax;
2. Dividends from the domestic corporation to its foreign shareholder will be subject to 30 percent withholding; and
3. 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.

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

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direct, or through a foreign partnership or disregarded entity.

Advantages of foreign corporation ownership include:

- Liability protection;
- No U.S. income tax or filing requirement for the foreign shareholder;
- Shares in the foreign corporation are non-U.S. assets not included in the U.S. estate;
- Dividends are not subject to U.S. withholding;
- No tax or filing requirement on the disposition of the stock; and
- No gift tax on the transfer of shares of stock.

Disadvantages include:

- 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
- 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 often not reduced or eliminated by a treaty, the most advantageous structure for ownership of U.S. real estate by NRAs is through the hybrid foreign corporation-U.S. corporation structure. Here, the NRA owns a foreign corporation, which 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 fixed or determinable, annual or periodical income withholding, but the timing and the amount of such 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, which require analysis in light of the client's objectives and priorities. CPA

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