TAX CONSIDERATIONS OF
FOREIGN INVESTMENT IN U.S. REAL ESTATE

U.S. Taxes

Foreign investors need to be concerned with three separate U.S. taxes; income tax, estate tax and gift tax.

US income tax is levied on individuals at rates ranging from 10% to 35%. US income tax is levied on corporations at rates ranging from 15% to 39%. There is a special capital gains tax rate of 15% for the gain on the sale of assets – including real estate – which have been owned for more than one year. This special capital gains tax rate only applies to individuals, however, and not corporations. Capital gains of corporations are taxed as ordinary income and can be taxed as high as 39%.

The U.S. also has an estate tax which is based on the fair market value of the decedent's estate. A nonresident's U.S. assets – including real estate – will be subject to U.S. estate tax. For nonresident individuals the first $60,000 of value is excluded. Thereafter, the U.S. estate tax rates apply. U.S. estate tax rates go up to 35% through 2012 and up to 55% thereafter.

There is also a gift tax if a nonresident alien individual gifts U.S. real estate to a third party. The gift tax can be as high as the estate tax, depending upon the value of the gift.

Individual Ownership

This is the simplest form of ownership but does not offer any liability, privacy or estate tax protection. It is important to have liability protection when owning real estate in the U.S. so that the owner will not be personally liable for any damages that result from the ownership of the real estate. The foreign investor's name will appear in public records as the owner of the real estate which is usually not desirable from a privacy perspective. Finally, with individual ownership the estate tax rules described above will apply. For the foregoing reasons this form of ownership is not recommended in most cases.

If the property is rented out the foreign investor has two taxation possibilities. The first option is that a withholding tax will apply on a gross basis to the rents received; without taking deductions in to consideration. The default withholding tax rate is 30%; however, this rate is often reduced by a tax treaty with the foreign investor's home country. Most countries offer a foreign tax credit for any withholding tax paid in the U.S. This option does not require the foreign investor to file a U.S. tax return. The second option is to make an election to treat the activity on a net basis. This option allows the foreign investor to deduct expenses, including depreciation, from the rents received and pay tax in the U.S. on the net profit from the rental activity. This option often results in less tax but requires the foreign investor to file a U.S. tax return.

Gain from the sale of the property will be taxed at the lower capital gains tax rate of 15%; provided the real estate was owned for more than one year.

Limited Liability Company

Limited liability companies exist in every state in the U.S. For U.S. tax purposes LLCs are taxed as disregarded entities (nonexistent for tax purposes), partnerships or corporations. The default classification of an LLC with one owner is that of a disregarded entity so the taxation is the same as for individuals as discussed in the previous section.

There is one big advantage to owning real estate through an LLC though, asset protection. LLCs provide limited liability for investors. Limited liability means that only the foreign investor's investment in the LLC is at risk. If the LLC is sued the claimant will not be able to get at the foreign investor's personal assets; that is, assets not in the LLC.

This is often a desirable ownership structure for foreign investors not concerned with the estate tax because it offers the preferential income taxation of an individual with the added benefit of limited liability.

Foreign Corporation

If the property is rented out the foreign corporation has two taxation possibilities. The first option is that a withholding tax will apply on a gross basis to the rents received; without taking deductions in to consideration. The default withholding tax rate is 30%; however, this rate is often reduced by a tax treaty with the foreign corporation's home country. This option does not require the foreign corporation to file a U.S. tax return. The second option is to make an election to treat the activity on a net basis. This option allows the foreign corporation to deduct expenses, including depreciation, from the rents received and pay tax in the U.S. on the net profit from the rental activity. Owning real estate through a foreign corporation generally provides limited liability.

One disadvantage of the net election as it applies to foreign corporations is the branch profits tax. If the net election is made the profits from the rental activity will be considered U.S. effectively connected income (ECI). The branch profits tax is 30% - unless a lower treaty amount is available – of the foreign corporation's "dividend equivalent amount". This tax is in addition to the tax on the net profit. The combination of tax on the net profit and branch profits tax can result in an effective income tax rate of more than 50%.

The primary advantage to owning U.S. real estate through a foreign corporation is that this ownership structure can completely avoid the U.S. estate tax because the shares of the foreign corporation are not considered U.S. property and, therefore, are not subject to the U.S. estate tax. Since the foreign investor is only transferring the shares of the foreign corporation to his or her heirs there is no direct ownership of U.S. property.

This ownership structure is not often recommended because of the branch profits tax.

U.S. Domestic Corporation

U.S. corporations pay tax on their net income at tax rates of up to 39%. Additionally, the 15% long-term capital gains tax rate available to individuals is not available to U.S. corporations. Thus, a corporation would pay tax on a long-term capital gain at ordinary income tax rates of up to 39%. Dividends distributed to foreign shareholders are subject to U.S. withholding tax at a rate of 30%; unless reduced by an applicable tax treaty. Most countries offer a foreign tax credit for any withholding tax paid in the U.S.

Direct ownership by a foreign investor of a U.S. Corporation does not offer any estate tax protection because the shares of the U.S. Corporation are considered U.S. property and would be included in the foreign investors U.S. estate.

Ownership of real estate by a foreign investor through a U.S. corporation is, however, preferable in the following two scenarios:

Gift of Shares

Tthe foreign investor can gift the shares of the U.S. corporation tax free. Shares can be gifted to family members and others free of U.S. tax. Gifting of the actual real estate would be subject to U.S. gift tax at rates as high as estate tax rates. If the foreign investor gifts the shares prior to death the U.S. estate tax will be avoided.

Foreign Corporation and U.S. Corporation

Another very advantageous use of a U.S. corporation is when the U.S. Corporation is owned by a foreign corporation. In this scenario the foreign investor establishes a foreign corporation that, in turn, establishes a U.S. corporation that will own the U.S. real estate.

In this structure the U.S. Corporation pays tax at graduated rates of up to 39% on its net income. The lower 15% long-term capital gains tax rate available to individuals is not available to corporations so any long-term capital gain will be taxed at ordinary income tax rates up to 39%. When dividends are distributed to the foreign corporation they will be subject to withholding tax; the default withholding rate is 30% but is often reduced by an applicable tax treaty. Most countries offer a foreign tax credit for any withholding tax paid in the U.S.

This structure has the advantages of providing limited liability, avoiding the branch profits tax and avoiding the estate tax. The structure does, however, have the potential for double taxation. Nonetheless, this is often the preferred structure for foreign investment in U.S. real estate due to the limited liability, avoidance of the branch profits tax and estate tax.

U.S. Partnership
Foreign investment in U.S. real estate through a U.S. partnership is taxed much like an individual. In essence the partnership acts only as a conduit through which the income and expenses are divided amongst the partners. The partnership itself does not pay tax; the partners, individually, pay tax on their pro rata share of partnership income. The partnership will be responsible for any withholding a foreign partner is subject to. Partners are generally required to file a U.S. tax return. Additionally, gain on the sale of a partnership interest by a foreign investor could be subject to U.S. tax. A U.S. partnership interest owned by a foreign investor would be subject to U.S. estate tax upon the death of the foreign investor.

Because partners in a U.S. general partnerships have unlimited liability this ownership structure is rare. Usually, partners will elect to establish an LLC and have it taxed as a partnership because it offers limited liability and partnership taxation.

Foreign Partnership
If the property is rented out the foreign partnership has two taxation possibilities. The first option is that a withholding tax will apply on a gross basis to the rents received; without taking deductions in to consideration. The default withholding tax rate is 30%; however, this rate is often reduced by a tax treaty with the foreign partnership's home country. Most countries offer a foreign tax credit for any withholding tax paid in the U.S. This option does not require the foreign partnership to file a U.S. tax return. The second option is to make an election to treat the activity on a net basis. This option allows the foreign partnership to deduct expenses, including depreciation, from the rents received and pay tax in the U.S. on the net profit from the rental activity. This option often results in less tax but requires the foreign partnership to file a U.S. tax return.

Foreign partnerships are becoming an increasingly popular vehicle through which foreign investors invest in U.S. real estate. Some tax advisors believe that foreign partnerships provide limited liability, no branch profits tax, the favorable capital gains tax rate of 15% and avoid the estate tax. These advisors are correct that foreign partnerships usually provide limited liability, no branch profits tax and the favorable capital gains tax rate of 15%; however, whether a foreign partnership avoids the estate tax is debatable.

There are two methodologies of viewing a partnership interest; the entity theory and aggregate theory. The entity theory takes the point of view that a partnership interest is an interest in an entity, much like a share of stock. That is the partnership owns assets and the partners own a share of the partnership. The aggregate theory takes the point of view that a partner in a partnership owns a pro rata share of the partnership's assets. If the entity theory applies it is likely that a partner in a foreign partnership would avoid the estate tax because the partnership interest would not be considered U.S. property. If, however, the aggregate theory applies the partner is treated as owning a pro rata share of the partnership's assets. In the case of a foreign partnership owning U.S. real estate the foreign investor would be treated as owning their pro rata share of the foreign

partnership's U.S. real estate and would be subject to U.S. estate tax. In the past the IRS has taken the position that the aggregate theory applies. It is, however, still not clear which theory controls. Any foreign investor investing in U.S. real estate through a foreign partnership should give careful consideration to the fact that they could be subject to the U.S. estate tax.

Other Ownership Structures
There are several other ownership structures involving cross-border trusts, foreign trusts and various combinations of entities. These structures may provide tax advantages in foreign investor's home country but rarely avoid the estate tax in the U.S.

Like Kind Exchanges
A like-kind exchange is a tax-free exchange of real estate for other real estate. This allows an owner of appreciated U.S. real estate to exchange that real estate for other U.S. real estate without having to pay any immediate tax. This is available to both foreign and U.S. individuals and entities.

Sale of Foreign Corporation
If the foreign investor invested in U.S. real estate through a foreign corporation that either directly or indirectly owned the U.S. real estate, the foreign investor could sell the shares of the foreign corporation without incurring any U.S. tax.

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