U.S. Tax Structures Utilized In Connection With Foreign Investment In U.S. Real Estate

Jack Miles
Kelley Drye & Warren LLP

KELLEY DRYE

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Topics

I. Structuring Objectives

- Maximize After-Tax Net Economic Return of Foreign Investor
- Minimize U.S. Income and Withholding Tax
- Avoid U.S. Estate and Gift Tax
- Minimize Foreign Tax
- Insulate Liability by Investing through a Limited Liability Entity
- Preserve Anonymity of Foreign Investors

II. Underlying U.S. Tax Rules – ECI vs. FDAP

Effectively Connected Income (ECI)

- If a nonresident alien individual (NRA) or a foreign corporation is "engaged in a U.S. trade or business" (ETB), then income "effectively connected" (ECI) with the U.S. trade or business is subject to U.S. tax, on a <u>net income</u> basis.

- A U.S. tax return must be filed.

- A foreign corporation ETB is also subject to the U.S. branch profits tax rules, discussed below, in the absence of a treaty exemption.

II. Underlying U.S. Tax Rules – ECI vs. FDAP

FDAP Income

- If the NRA or foreign corporation is not ETB and it derives passive income, such as rentals, interest, dividends, and other so-called “fixed or determinable annual or periodical” income (collectively, FDAP Income), from U.S. sources, then the U.S.-source FDAP Income will generally be subject to a 30% U.S. <u>gross</u> <u>income</u> <u>tax</u>, unless the tax is reduced or eliminated by an applicable tax treaty or a statutory provision in the Internal Revenue Code (e.g., portfolio interest).
  - There are no statutory or treaty exemptions with respect to real property rentals.

II. Underlying U.S. Tax Rules – ECI vs. FDAP

- The question whether a foreign person is ETB is factual and has generated significant case law. In making this determination, courts have considered the following factors, among others:
  - The extent and continuity of U.S. activities;
  - The nature of U.S. activities; and
  - The amount of income derived from U.S. activities.

II. Underlying U.S. Tax Rules – ECI vs. FDAP

- A triple net lease of a single property to a single tenant would generally not give rise to a U.S. trade or business.

- Even if a foreign owner of U.S. real property is not ETB, it may make an election to be ETB. See Code Sections 871(d) and 882(d). This election is often beneficial because it enables the foreign owner of the U.S. real property to be taxable on a net income, rather than on a gross income, basis.

III. Taxation of Real Estate Gains

- Under the "Foreign Investment in Real Property Tax Act of 1980" (FIRPTA), gain derived by a foreign person from the sale of a "United States real property interest" (USRPI) is taxable in the U.S. on a net income basis, regardless of whether the seller is actually engaged in a U.S. trade or business.
- USRPIs include:
  - A direct interest in real property and "associated personal property."
  - A right to share in appreciation in value or profits with respect to real property.
  - An interest in a U.S. corporation that was a "U.S. real property holding corporation" (USRPHC) at any time during the five-year period preceding the sale.
    - A U.S. corporation generally constitutes a USRPHC if, on any "applicable determination date," the fair market value of its USRPIs equals or exceeds 50% of the fair market value of (i) its USRPIs, (ii) its real property interests located outside the U.S., and (iii) any other of its assets which are used in its trade or business.
  - The FIRPTA tax is generally collected through a 15% withholding with respect to the total amount realized by the foreign person on the disposition. (The rate is 10% for dispositions before February 17, 2016.)

IV. Investment Structures

Structure 1: **Direct Investment**

- Foreign investors invest through a limited liability company (LLC), which would generally be treated as a transparent entity for U.S. tax purposes.
- Foreign investors would be taxable on a net income basis with respect to the rental income, assuming the income is ECI.
  - Note: An election under Sections 871(d) and 882(d) may be required to assure ECI classification.
- Individual investors would be taxable at a maximum 39.6% U.S. federal tax rate with respect to ordinary income, but long-term capital gains would be eligible for a reduced 20% federal tax rate. State and local taxes could also be imposed.
- Corporate investors would be subject to a maximum 35% federal tax with respect to ordinary income and capital gain. (Note the absence of a capital gain preference at the corporate level.) State and local income taxes could also be imposed.
- The branch profits tax, discussed below, would also be imposed in the absence of a treaty exemption.

IV. Investment Structures

Structure 1: **Direct Investment**

- Foreign investors would be subject to U.S. tax filing obligations:
  - Form 1040NR would be filed by individual investors and Form 1120-F would be filed by corporate investors. Foreign investors would not preserve their right to anonymity.
  - U.S. taxes could be creditable in certain foreign jurisdictions.
- U.S. Estate and Gift Tax: A major disadvantage of this structure is that, upon the death of the NRA, the U.S. real estate would be subject to U.S. estate tax. The estate tax exemption with respect to an NRA is only $60,000.
- Repatriation of Funds: No U.S. withholding tax would be imposed in connection with the distribution offshore of sales or refinancing proceeds.

IV. Investment Structures

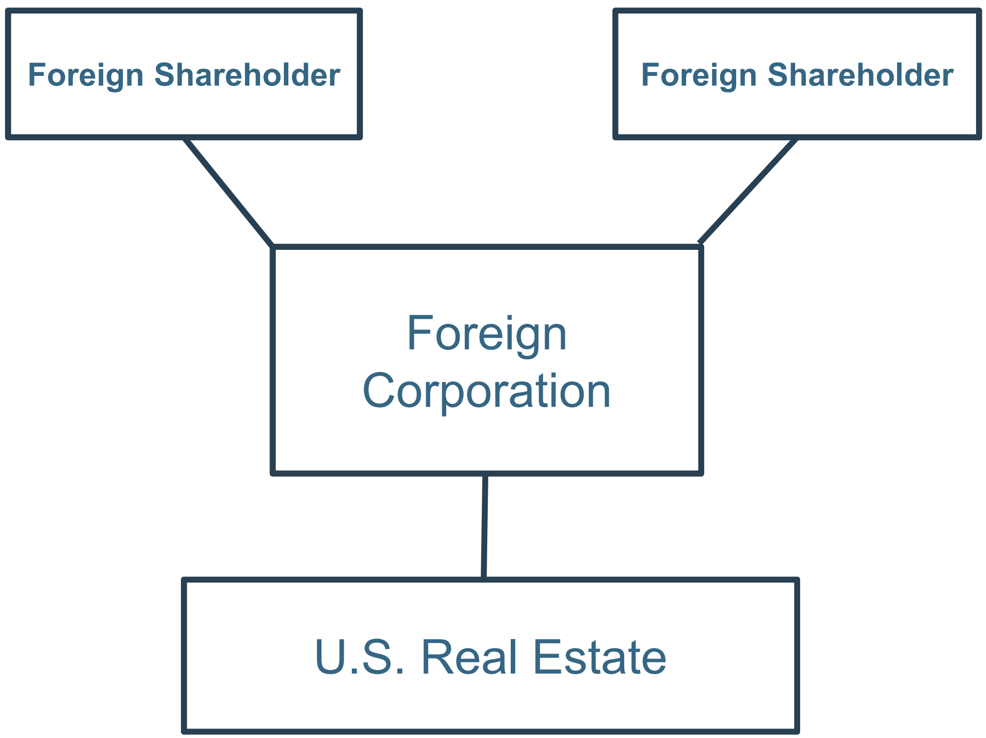
Structure 1: **Direct Investment**

Summary:

- The most significant drawbacks are:
  i. Potential U.S. estate tax;
  ii. U.S. tax filing obligations; and
  iii. Loss of anonymity.
- The most significant advantages are:
  i. Long-term capital gain opportunity;
  ii. Avoidance of a U.S. withholding tax; and
  iii. Opportunity to avoid New York City tax with respect to New York City property.

IV. Investment Structures

Structure 2: Investment Through A Foreign Corporation



IV. Investment Structures

Structure 2: **Investment Through A Foreign Corporation**

- U.S. Taxation of Shareholders of Foreign Corporation:
  - No U.S. estate tax
  - No U.S. tax payments or filing obligations
  - No U.S. withholding tax with respect to dividend distributions
  - Gain recognized in connection with sale of stock of foreign corporation would not be subject to FIRPTA tax. (Note, however, that a buyer presumably would discount the purchase price to reflect the built-in U.S. tax liability.)
- U.S. Taxation of Foreign Corporation:
  - Foreign corporation would be subject to federal income tax at a rate of 35%. State and local taxes may also be imposed.
  - Foreign corporation would also be subject to the branch profits tax in the absence of a treaty exemption. The branch profits tax is generally imposed at a 30% rate on the foreign corporation's "dividend equivalent amount," which is the foreign corporation's "effectively connected" earnings and profits for the taxable year, to the extent not reinvested in the U.S. trade or business.

IV. Investment Structures

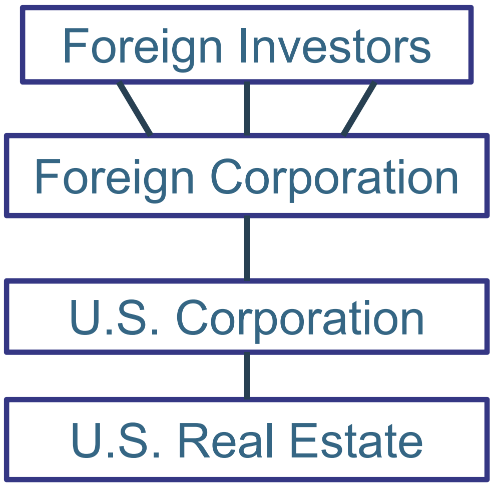
Structure 2: **Investment Through A Foreign Corporation**

- U.S. taxes paid may be creditable in the foreign corporation's home jurisdiction.

- **Summary**: The major disadvantage of this structure is the branch profits tax. Note also that the foreign corporation would be required to disclose the identity of its ultimate indirect 25% foreign shareholders.

IV. Investment Structures

Structure 3: **Foreign Corporation Owning A U.S. Corporation**



- U.S. Taxation of Foreign Investors:
  - No U.S. estate or gift tax
  - No U.S. income tax or filing obligations
  - No U.S. withholding tax on dividend distributions from foreign corporation
  - No FIRPTA tax on gain from sale of stock in foreign corporation (Note, likely discount to purchase price, reflecting built-in U.S. tax liability)

IV. Investment Structures

Structure 3: **Foreign Corporation Owning A U.S. Corporation**

- U.S. Taxation of Foreign Corporation:
  - No U.S. income tax payment or filing obligations
  - No branch profits tax obligation
  - Dividends received from U.S. corporation subject to 30% U.S. withholding tax unless reduced or eliminated by an applicable tax treaty.
  - Gain recognized in connection with sale of stock in U.S. subsidiary would be subject to FIRPTA tax if the U.S. subsidiary constitutes a USRPHC.
- U.S. Taxation of U.S. Subsidiary:
  - U.S. tax payment and filing obligations
  - Dividend distributions to foreign parent subject to 30% U.S. withholding tax unless reduced or eliminated by an applicable tax treaty

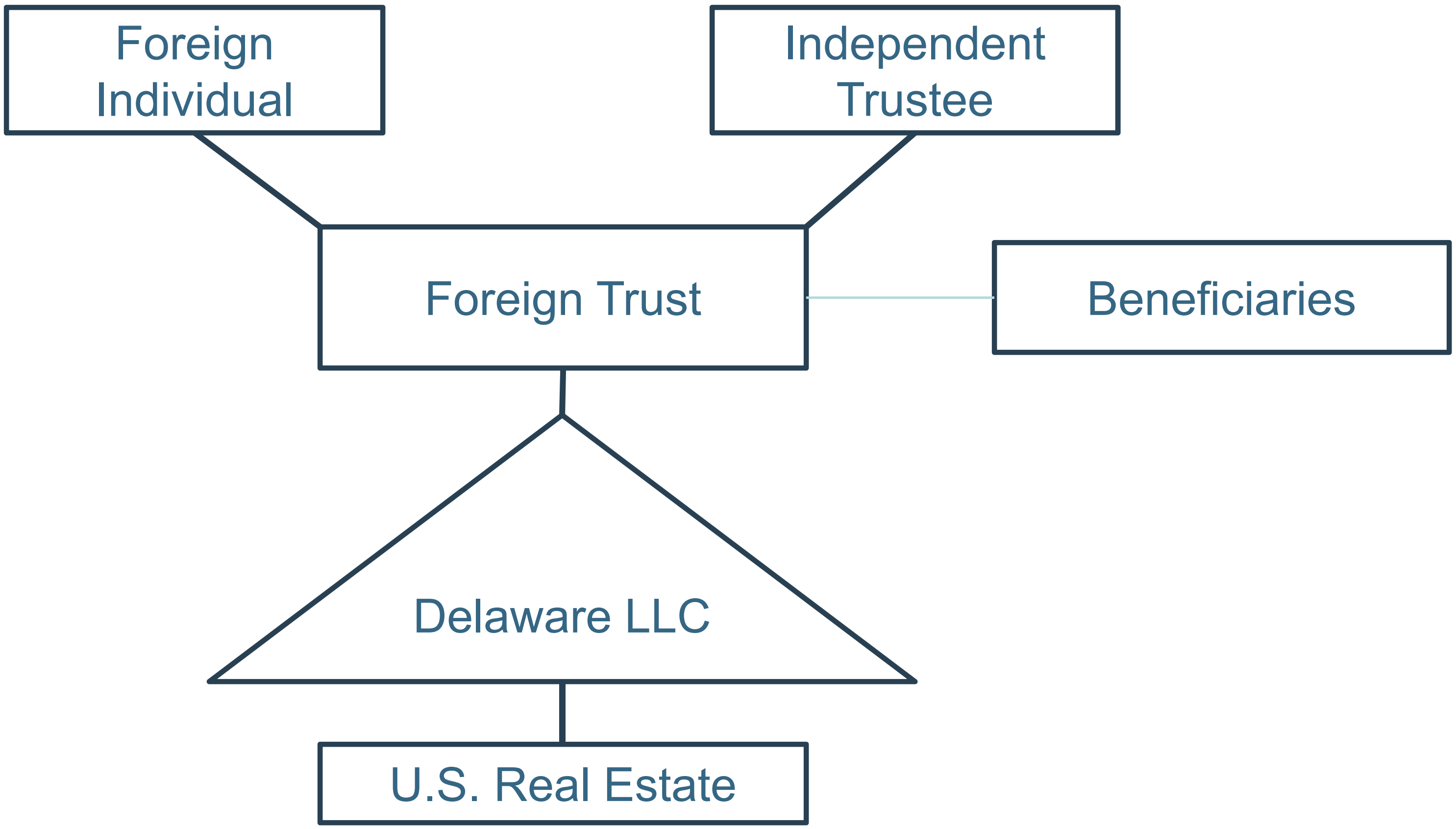
IV. Investment Structures

Structure 3: **Foreign Corporation Owning A U.S. Corporation**

- **Observations**:
  - Common structure
  - Although the U.S. subsidiary must disclose the identity of its foreign parent, there is no requirement that it disclose the identity of its ultimate shareholders, unless there are so-called "reportable transactions" between the U.S. corporation and a foreign-related party, in which case, the U.S. subsidiary must file Form 5472, identifying ultimate indirect 25% shareholders.
  - The foreign shareholders could sell stock in the foreign parent corporation without incurring federal, New York State and New York City income taxes. New York State and City transfer taxes would, however, be imposed. (Note, likely discount to purchase price, reflecting built-in U.S. tax liability.) A potential disadvantage of this structure is that a distribution of refinancing proceeds may give rise to a U.S. withholding tax.

IV. Investment Structures

Structure 4: **Non-Grantor Foreign Trust**



IV. Investment Structures

Structure 4: Non-Grantor Foreign Trust

- A foreign individual would transfer cash, not real estate, to an irrevocable trust in a low-tax foreign jurisdiction.
- The trust would be a regular trust, not a grantor trust. The beneficiaries would be the individual and his family members.

The assumed tax consequences are as follows:

- The trust would be treated as if it were an individual. Thus, it would be taxable at a 39.6% federal rate with respect to ordinary income (plus the 3.8% Medicare tax), and it could qualify for the preferential 20% rate with respect to long-term capital gains.
- The assets in the trust should not be subject to U.S. estate tax, assuming:

    i. The individual does not retain the right to the income from the trust, but he could receive discretionary distributions;

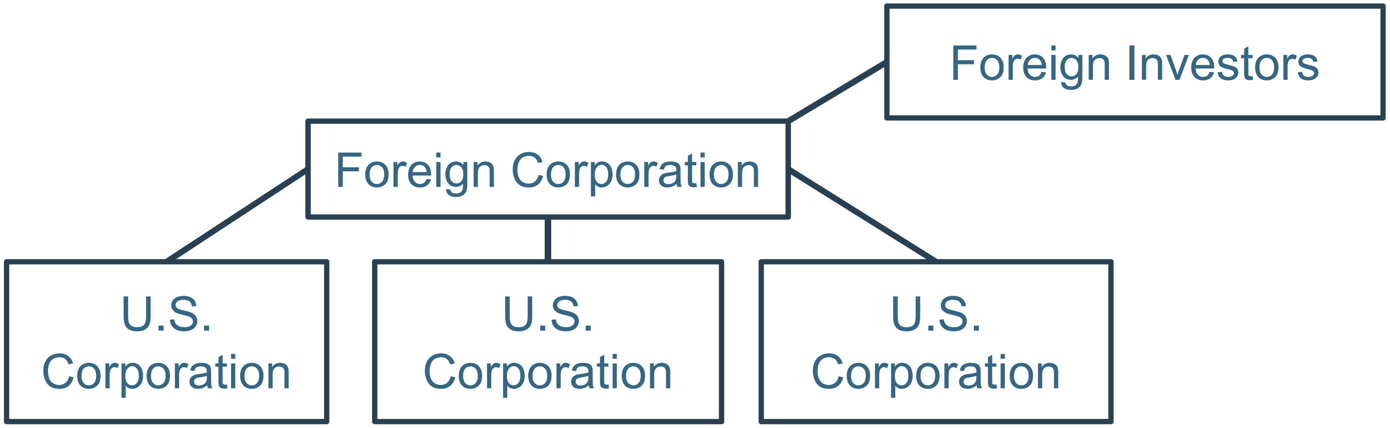
    ii. The trust is not revocable; and

    iii. The individual does not retain any control over the trust or its assets.

- Many foreign investors are unwilling to give up all the rights, powers and interests with respect to the U.S. real estate.
- Query: Could the IRS treat the foreign trust as a foreign corporation?

IV. Investment Structures

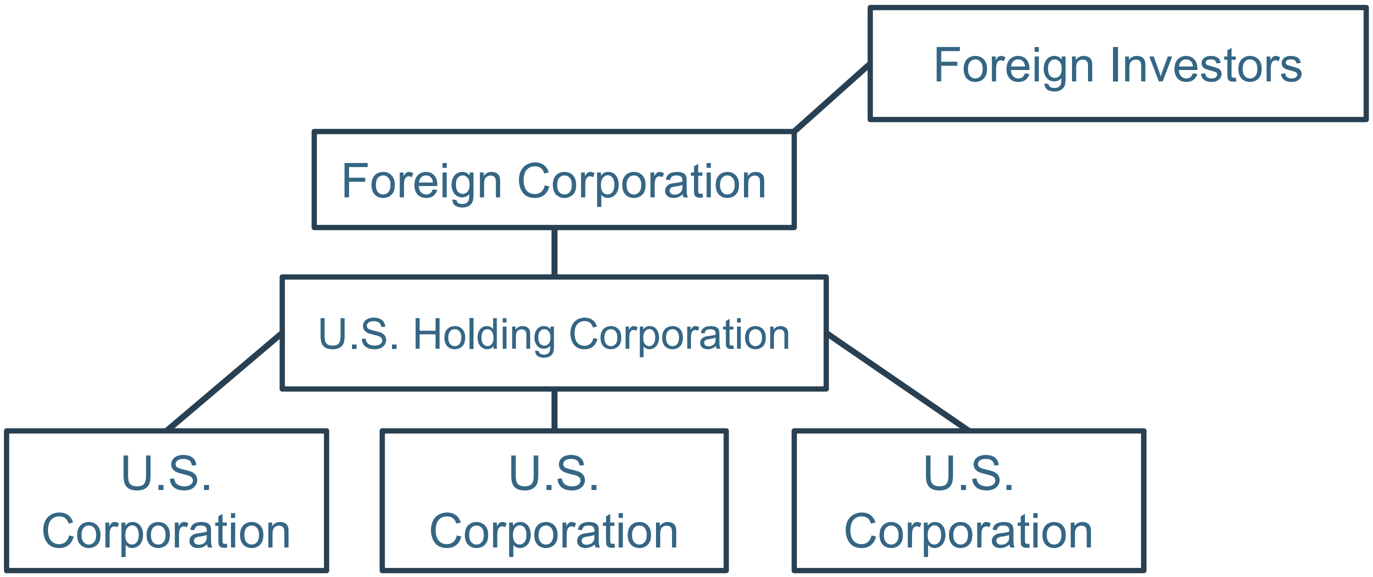
Structure 5: Multiple Properties – Foreign Holding Corporation



- The primary benefit of this structure is the ability to repatriate sales proceeds free of the U.S. withholding tax.
- The primary disadvantage of this structure is the inability to file a U.S. consolidated tax return.

IV. Investment Structures

Structure 6: Multiple Properties – U.S. Holding Corporation



- The primary benefit of this structure is the ability to file a U.S. consolidated tax return.
- The primary disadvantage of this structure is that, following a sale of one, but not all, of the properties, sales proceeds could not be distributed offshore without triggering the U.S. dividend withholding tax.

V. Debt

- Funding the operating entity with debt could reduce U.S. tax and create the opportunity to repatriate earnings to the foreign investors with minimal or no U.S. withholding tax.

Debt-Equity Classification:

- Care should be exercised to assure that the purported debt is not reclassified as equity for tax purposes. While a debt-equity discussion is beyond the scope of this outline, to enhance the likelihood that the purported debt is respected as such, the debtor should not be undercapitalized and formal indicia of debt should be maintained, e.g., a written instrument should be executed providing for fixed payments of interest and principal.

Earnings Stripping:

- The debtor's interest deduction could be reduced or eliminated pursuant to the so-called "earnings stripping rules" (Code Section 163(j)) if –
  - The debtor's debt-equity ratio exceeds 1.5 to 1.0;
  - The debtor's net interest expense exceeds 50% of "adjusted taxable income"; and
  - The interest is paid to a related foreign person and either no U.S. withholding tax or a reduced U.S. withholding tax is imposed on the interest.

V. Debt

U.S. Withholding Tax:

- Interest payable by a U.S. debtor to a foreign creditor is generally subject to a 30% U.S. withholding tax, subject to reduction or elimination by an applicable treaty or statutory exception.
- Debt incurred by the operating entity should be structured so that interest payable to the foreign creditor is either not subject to the U.S. withholding tax or is subject to a reduced U.S. withholding tax rate.

Portfolio Interest Exemption: Portfolio interest is exempt from the U.S. withholding tax.

- To qualify as portfolio interest, the following requirements must be satisfied, among others:
  - The creditor must not own, directly, indirectly, or constructively, 10% or more of the equity in the debtor;
  - The interest must not be received by a bank on an extension of credit made pursuant to a loan agreement in the ordinary course of its trade or business;
  - The underlying debt obligation must be in registered form; and
  - The interest generally cannot be contingent in nature.

VI. New Reporting Requirements for New York and Miami Real Estate

- The Financial Crimes Enforcement Network (FinCEN) recently announced two Geographic Targeting Orders (GTOs) imposing new reporting requirements for title insurance companies operating in New York City and Miami, Dade County.
  - The new GTOs require each title insurance company to file a FinCEN Form 8300, commonly known as a Currency Transaction Report, within 30 days of an all-cash purchase of real estate worth over $3 million in Manhattan, or over $1 million in Miami, Dade County.
  - The Currency Transaction Report must not only identify the purchasing entity, but also any individual who beneficially owns 25% or more of the purchasing entity.

QUESTIONS?

Jack Miles
Kelley Drye & Warren LLP
101 Park Avenue
New York, NY 10178
Telephone: (212) 808-7574
jmiles@kelleydrye.com

www.kelleydrye.com