# Purchasing U.S. Real Estate

## Tax Considerations for the Non-U.S. Investor

By Michael Hirschfeld, David Roberts and Len Schneidman

Andersen Tax LLC, U.S.

June 2018

## Table of Contents

# Purchasing U.S. Real Estate:
# Tax Considerations for the Non-U.S. Investor

**As a non-U.S. person, how you invest in U.S. residential real estate can have a significant impact on your tax situation. Recent tax law changes have now made the choice of how you invest even more important.**

## Introduction

A non-U.S. person considering an investment in U.S. residential real estate must carefully consider how the ownership of the real estate is structured, which can have a significant effect on his or her tax situation. It can impact income tax during the period of ownership, tax when later selling the property, and even gift and estate taxes when transferring the property to an heir by gift or inheritance.

When deciding how best to structure the purchase, it is important to consider the purpose and intent behind the decision. This should include:

- Will it be for personal use and, if so, by whom?
- If purchasing as an investment, will it generate rental income?
- If purchasing with a view to resell, what is the potential holding period?
- Is the intent to pass to future generations?

It is important to recognize that subsequent restructuring can be costly, so it is critical to get proper independent tax and legal advice prior to the purchase. This advice should consider not only the implications in the U.S. where the property will be located, but also, in the purchaser's home country.

When considering how to purchase the property, there are several approaches that a non-U.S. person (referred to as a non-resident alien or NRA) might use; the most common ways include:

- Ownership in personal name
- Ownership through a foreign corporation (FC), typically in a tax neutral jurisdiction
- Ownership through a U.S. corporation
- Ownership through a U.S. corporation that is owned by the FC; and/or combined with a trust

The last option, while more complex, is often the most tax efficient option and recent U.S. tax law changes that lowered the U.S. corporate tax rate to 21% make it often the more beneficial choice. This is not an exhaustive list of the options available, but does cover the most common approaches. Each has its advantages and disadvantages. Unfortunately, in most cases there is no perfect solution, hence the need to first identify the reasons behind the purchase and then choose the best available option.

Some of the advantages and disadvantages of these potential ownership methods are covered below. Each is considered in the context of property for personal versus investment use.

## Ownership in Personal Name

Purchasing in personal name is an obvious choice; there are advantages, but one significant disadvantage to the uninformed buyer.

### The Estate/Gift Tax Trap

The biggest disadvantage is that the U.S. real estate owned by an NRA is exposed to U.S. estate tax. The U.S. will tax the estate of an NRA where certain assets are located in the U.S. including real estate and shares in U.S. companies that predominately own U.S. real estate. The exclusion from U.S. estate tax for bequests to a spouse is not available to a surviving NRA spouse unless the property passes to a qualified domestic trust, which will result in estate tax when the surviving spouse dies. Also, the NRA gets a very nominal exemption from the estate tax; U.S. assets with a value in excess of the $60,000 exemption will be taxed at rates up to 40%. For example, the estate of an NRA who dies owning a $5,000,000 New York City apartment in his or her personal name would face a tax bill of almost $2,000,000. Several states (such as New York and California) also impose an estate tax, which increases the financial burden suffered by your heirs.

Relief from the estate tax may be provided through an estate tax treaty, but there are only 15 such treaties in place and often the relief provided is not comprehensive and does not extend to U.S. real estate owned at death. Relief from the estate tax is also available where the NRA is survived by a U.S. citizen spouse due to the unlimited marital deduction, but that is all too often not applicable. If the property has debt against it, the debt can only reduce the value of the U.S. taxable estate if it is non-recourse debt, otherwise the amount of reduction is limited to the ratio of the U.S. assets to worldwide assets, undesirably requiring disclosure of the NRA's worldwide estate in order to claim the reduction.

If the NRA owner wishes to transfer the U.S. real estate during lifetime as a gift, then U.S. gift tax will apply at 40%. There is no allowable exclusion other than the annual exclusion in the amount of $14,000 per recipient. However, no U.S. gift tax applies to a gift of stock even if it is stock of a U.S. company that only owns U.S. real estate.

Other than the simplicity of purchasing in one's own name, a big advantage of personal ownership used to be the tax treatment upon sale. Long-term capital gains of individuals are taxed at a maximum federal tax rate of 20%. Last year, a corporation that sold the real estate incurred tax at a much higher 35% rate. The Tax Cuts and Jobs Act (TCJA), however, greatly lowered the U.S. corporate income tax to a flat 21% rate, which is almost the same as the 20% individual capital gains rate. State and local taxes must also be considered, which are often imposed by the state or locality in which the property is located.

Withholding tax will apply to the sale of the property by a NRA or a foreign corporation. The Foreign Investment in Real Property Tax Act (FIRPTA), subject to certain exceptions, requires the buyer to withhold 15% of the sale's proceeds and remit this to the taxing authorities. The NRA must then file a tax return to report the actual gain or loss and pay additional tax or claim a refund of any overpaid tax as appropriate, but that tax return can only be filed after the end of the year. If the withholding tax may exceed the actual tax due, then the seller or even the buyer can request relief from Internal Revenue Service (IRS). If an application is made to IRS on or before the closing date to reduce the tax withheld to the actual tax due or not withhold at all since the property is being sold at a loss, then the obligation to withhold and remit tax to IRS is suspended until after IRS makes a determination as to the actual tax due. Once IRS makes that decision, then the tax IRS indicates must be withheld has to be sent to IRS within 20 days to avoid penalties and interest.

### Buying for Income Production

Where an NRA receives rent from a property, he or she can choose to be taxed in one of two ways: a flat rate of 30% on the *gross* amount of rental income (with no offsetting deductions) or, by election, at graduated income tax rates on income that is *net* of allowable deductions. Depreciation is an allowable expense, but any prior tax benefit is recaptured (that is, taxed as ordinary income) upon sale. The same capital gains tax treatment as above will apply. The 30% withholding tax usually results in a much greater U.S. tax exposure and thus, the investor should make any needed elections to be taxable on a net basis even though that means the investor must then file an annual U.S. income tax return. If the investor wants to be taxed at a net basis then the investor must also supply the tenant with IRS Form W-8ECI to insure that the tenant knows not to withhold the 30% tax.

Personal ownership does not provide any liability protection. Where a property is rented out, especially to a third party, this can be a significant risk. Another consideration is that, upon death, the property may be subject to costly and time consuming probate proceedings as legal title is determined, estate taxes are paid and ultimately title is transferred. Often, a single member Delaware (or other state) limited liability company (LLC) is formed to own the real estate so as to give the owner protection against personal liability. While that structure may shield the investor from personal liability, that LLC does not usually act as a shield against tax liability. The LLC is disregarded for tax purposes unless the investor chooses to make a tax election to treat the LLC as regarded.

## Purchasing Through a Foreign Corporation

### General Considerations

There are several benefits to owning real estate through a FC but probably the biggest advantage is that the FC provides protection from U.S. estate tax. While the U.S. property is a U.S. asset subject to U.S. estate tax, the FC shares are not a U.S. asset and consequently fall outside the scope of the U.S. estate tax net. Furthermore, the shares of the FC can be gifted by the NRA without incurring gift tax. However, when the FC decides to sell, the original cost basis of the property will be used to determine the gain or loss to the FC.

Other non-tax advantages are that the FC provides privacy to the NRA since ownership is in the name of the FC rather than his or her personal name. The FC provides limited liability protection so that any claims against the property owner should be limited to only the assets of the FC (i.e., only the property itself rather than the personal assets of the NRA). For this reason, it is generally advisable not to mix other assets within the same FC that holds the real estate.

Where the property is used for personal reasons by an officer or shareholder of the FC, the corporation may be required to charge a rent (or rent will be imputed) to the individual using the property. This can be disadvantageous since it will create potentially taxable income to the property user without any corresponding tax deduction.

As a result of the TCJA, when the property is sold, any gain will be taxed at a flat corporate tax rate of 21% (plus state tax where applicable). An additional layer of tax known as the branch profits tax (see below) may also apply unless the foreign corporation is liquidated and certain subsequent restrictions on reinvestment are adhered to. Furthermore, similar to individual ownership, the sale will be subject to the FIRPTA withholding tax of 15% of the sales proceeds. FIRPTA can be avoided by selling the FC shares rather than the underlying property, but that can severely limit the market of willing buyers since the purchaser assumes the inherent U.S. tax liability attributable to the appreciated real estate. It may also be possible to avoid the application of FIRPTA withholding in certain circumstances where the FC elects to be treated as a domestic corporation.

### For Income Production

Income received by the FC is taxed at the federal corporate tax rate of 21%. In addition to this, branch profits tax (BPT) may also apply. Income tax treaties can lower or eliminate the BPT, but many countries do not have a treaty with the U.S. The BPT is effectively a deemed dividend tax, which applies an additional 30% tax on the income after the 21% corporate tax has been applied. This can equate to a tax charge of 44.7% (plus state taxes where applicable). For this reason, direct FC ownership would generally not be advisable where substantial income is expected to be generated.

Finally, if the FC is considered to be doing business in the U.S. then it will be required to file a U.S. tax return regardless of whether it had net income or loss as well as state and possibly local tax returns where the property is located. In certain locations within the U.S., for example New York City, the state taxing authorities will apply an annual capital tax on net asset value in addition to any income taxes.

## Purchasing Through a U.S. Corporation

As noted above, direct ownership by the FC may not be the most efficient form of ownership. Similarly, a U.S. corporation as the direct owner may also be unsuitable. The U.S. corporation on its own would not provide estate tax protection, but it would be subject to the recently adopted corporate tax rate of 21% on income and gains.

## Purchasing Through a U.S. Corporation Owned by a Foreign Corporation

For the NRA investor a better solution may be to combine the benefits of the FC and U.S. corporation together.

### General Considerations

As above, estate tax does not apply due to FC ownership. Probate will still apply on the FC shares, but in the jurisdiction where the FC shares are registered. Privacy to the beneficial owner is provided as the U.S. corporation must disclose the FC as owner, but the FC is under no obligation to disclose the NRA owner. Upon sale of the property, there is only a single level of tax on any gain at the corporate level (21% federal tax rate). If the sale of the real estate is a liquidating event for the U.S. corporation, then the proceeds can be distributed to the FC without further tax.

### For Income Production

Net rental income received by the U.S. corporation is taxed at the U.S. corporate tax rate of 21% at the entity level. If dividends are paid by the U.S. corporation to the FC then, subject to any treaty reduction, a 30% withholding tax will apply. However, as long as a dividend is not paid to the FC, no second level of tax will apply and it may ultimately be avoided by making a tax-free liquidating distribution.

The U.S. corporation will have to file U.S tax returns.

## Purchasing Through a Trust

A corporate structure in itself is not an estate plan. Dealing with the estate of a person, resident of one country with assets in another, can be a long and expensive process that could tie up the assets and potentially expose them to heirship challenges. A trust can be a useful tool when combined with any of the above structures and provide the benefit of avoiding probate and distributing assets to beneficiaries in a pre-determined and orderly manner.

For NRAs who live in a civil law jurisdiction, a trust is unlikely to be recognized as a legal structure in their home country. Alternative wealth transfer entities commonly used outside of the U.S. such as stiftungs or private foundations are not specifically addressed under U.S. tax law and require additional analysis to determine their classification, typically as either a trust or a corporation. When adding U.S. assets into a trust or equivalent structure, the funding should follow a specific process to avoid a direct contribution that may cause the U.S. assets to be included in the estate of the NRA.

## Summary

For the NRA investor, the potential estate tax exposure is so significant it is often the decisive factor in avoiding ownership of U.S. real estate in personal name. Depending on the circumstances, ownership in personal name may make sense where the estate tax exposure can be limited, for example, when the holding period is short enough to warrant risking estate tax exposure or if the property could be purchased by a younger family member. Life insurance can also play a role in managing that risk. The main decision comes down to one of balancing estate tax exposure by owning in personal name versus potentially paying higher taxes on income and gains if held by a corporation. However, the TCJA's dramatic reduction of the federal corporate tax rate to 21% now means there may only be marginal added tax by owning the real estate through a corporation. As a result, the scales have now tipped so that use of a U.S. corporation owning the real estate, which is owned by a foreign corporation owned by the NRA, may be the best option to choose.

For more information, visit *International Wealth* on andersentax.com