

TAX

Foreign Investment in U.S. Real Property

By Louis Vlahos

Nonresident aliens (or NRAs) are buying residences on the east end of Long Island. While many of them will seek out local real estate counsel to assist them with their purchase, they may not be familiar with the potential tax consequences of acquiring and owning U.S. real property.

In most cases, the NRA will be purchasing a single residence for personal use or for rental to a third party. Alternatively, he may be purchasing vacant land for investment or for later personal use. Each scenario presents its own U.S. income, estate and gift tax implications, which should be considered in advance of the acquisition.

Choice of entity

The NRA who plans to lease his property to third parties, or otherwise hold it for investment, must consider how to insulate himself from liabilities that may arise from such activities. A corporation that is properly operated and capitalized can protect the NRA shareholder from such liabilities. An LLC (treated as a pass-through for tax purposes) can likewise protect its foreign members. However, the form of entity selected, and its capitalization, can have significant U.S. tax consequences.

Income taxes

For purposes of the U.S. income tax, an NRA is a noncitizen who is not a lawful permanent resident, and who does not have a "substantial presence" in the U.S. (based on the number of days of physical presence).

The nature of the income tax to be imposed upon an NRA who owns U.S. real property will depend upon whether or not his U.S. real estate activities rise to the level of a trade or business. This requires an examination of the facts and circumstances of the NRA's particular situation; for example, do those activities go beyond mere ownership of property or receipt of rental income? If they do, are they sporadic or irregular (as opposed to continuous or considerable)?

Assume for the moment that the NRA's U.S. real estate activity does not rise to the level of a trade or business. In general, the rental income received by an NRA who directly owns U.S. real property is subject to a flat 30 percent withholding tax on the gross rental income, without deduction for depreciation, property taxes or other expenses associated with the ownership and rental of the property. (A treaty may provide for a lower rate.) However, the NRA may elect to treat this rental activity as a U.S. trade or business. In that case, the NRA will

treat his rental income as effectively connected to a U.S. trade or business and, in determining his U.S. income tax liability, will be allowed the deductions related to the real property. He will then be taxed on a net income basis, at graduated income tax rates.

If the real property is held by a U.S. corporation, the corporation's profits will be subject to corporate-level income taxes. The NRA shareholder will then be subject to income tax when the corporation distributes its after-tax rental profits to the shareholder as a dividend. A dividend distribution to the shareholder is generally subject to a flat 30 percent withholding tax, or lower treaty rate. (However, beware of the personal holding company tax.) If the corporation was capitalized, in part, with a loan from the NRA shareholder, the interest payment would be taxable to the shareholder, but it would also be deductible by the corporation.

If the real property is owned by a foreign corporation that is not engaged in a U.S. trade or business, its profits will be subject to U.S. corporate-level income tax (at a flat 30 percent, or lower treaty rate), and its dividend distributions to the foreign shareholder should not be taxable in the U.S. However, if the corporation is so engaged, its dividend distributions may be taxable to the shareholder. If it fails to pay dividends, its after-tax income may be subject to the so-called "branch profits" tax; in general, an additional 30 percent tax on its net income (after U.S. corporate taxes), which is intended to mimic the tax that would have been imposed upon the distribution of such net income to the corporation's foreign shareholder.

If the NRA holds the U.S. real property through an LLC, he will be taxed on his share of the rental income generated as if he held the property directly. The LLC, itself, will not be taxable, but it will be required to withhold tax in respect of the income allocable to the foreign member.

Sale

When an NRA sells U.S. real property or an interest in U.S. real property, the gain recognized on the sale is treated and taxed as having been derived from a U.S. trade or business (the so-called "FIRPTA" tax), even if such property was not, in fact, connected to a trade or business. Thus, the NRA will be taxed in the same manner as a U.S. taxpayer. In addition, the purchaser generally must withhold 10 percent of the purchase price toward satisfaction of the tax.

A U.S. real property interest includes not only a direct interest in



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such property, but also an interest in a U.S. corporation if at least 50 percent of the corporation's fair market value is attributable to U.S. real property. An interest in a U.S. LLC may also be a U.S. real property interest. The sale of such stock or LLC interest would be subject to the FIRPTA tax.

If an LLC sells the U.S. real property, the foreign member's share of the gain recognized will be treated and taxed as if it were effectively connected to a U.S. trade or business.

If the real property is held by a U.S. or foreign corporation, the gain recognized by the corporation on the sale of the property will be subject to corporate-level U.S. income tax, although the foreign shareholder should not be subject to additional U.S. tax on the corporation's liquidating distribution.

Estate and gift tax transfers

If a foreigner (a noncitizen who is not "domiciled" in the United States; "domicile" differs from income tax "residence") owns a direct interest in U.S. real property at the time of his death, the fair market value of such real property will be subject to U.S. estate tax. If the foreigner owns the real property indirectly through a U.S. corporation, the value of his shares shall be subject to U.S. estate tax. If a foreign corporation holds the U.S. real property, the shares owned by the foreigner at his death shall not be included in his U.S. gross estate, unless the corporation is properly disregarded for U.S. tax purposes. Surprisingly, it is unclear whether a foreigner's interest in an LLC that holds U.S. real property will be subject to the estate tax, though the risk of taxation likely increases where the LLC is engaged in a U.S. trade or business.

If a foreigner makes a gift of a direct interest in U.S. real property, the transfer will be subject to U.S. gift tax. (If the property is subject to a mortgage, the transfer will be treated, in part, as a sale.) On the other hand, a gift transfer of stock in a foreign corporation that owns U.S. real property will not be subject to gift tax (provided the corporation is not disregarded for tax purposes). Similarly, a transfer of an interest in an LLC that owns U.S. real property should not be subject to U.S. gift tax.

Reporting

A foreigner who makes a gift of a direct interest in U.S. real property must report the value of the gift to the IRS on Form 709. The value of the gift is subject to gift tax, up to a marginal rate of 40 percent.

The estate of a foreigner who dies

owning U.S. real property (or shares of stock in a U.S. corporation owning such property) must file an estate tax return on Form 706-NA, and is subject to U.S. estate tax, up to a marginal rate of 40% of the value thereof, though the estate is allowed a \$13,000 credit. (No similar credit is provided for purposes of the gift tax.)

In the case of an NRA whose ownership of U.S. real property does not rise to the level of a U.S. trade or business, the rental income from such property must be reported to the IRS on an income tax return, Form 1040NR, only if the income tax liability with respect to such income was not fully satisfied by the withholding of tax; even if it had been, it may behoove the NRA to file a "protective" return nonetheless, in order to start the running of the limitations period on assessment of additional tax and to preserve his ability to claim deductions in the event it is later determined that he was engaged in a U.S. trade or business.

If the NRA's real estate ownership and related activities rise to the level of a U.S. trade or business, or if the taxpayer has elected to treat such real estate activity as a trade or business, then the NRA must file Form 1040NR to report the rental income and the related expenses.

Any gain realized on the NRA's sale of U.S. real property must also be reported on Form 1040NR.

If the foreigner is relying upon a treaty to reduce his U.S. tax liability, he must also file Form 8833.

Other reporting requirements may also apply, depending upon the entity, if any, through which the NRA owns the U.S. real property. For example, if a U.S. corporation is used, it will have to file its own income tax return, on Form 1120. In addition, if the corporation will be at least 25% foreign-owned, it will have to file Form 5472 to disclose certain information regarding its foreign shareholder.

A foreigner individual seeking to acquire U.S. real property should not be dissuaded from doing so by the various tax implications and reporting requirements described above. Indeed, the foreigner considering such a purchase probably has good personal or investment reasons for the acquisition, and taxes should be secondary. However, he must be informed and mindful of the U.S. tax consequences. If he plans accordingly for taxes, his ownership of the property will prove less costly.

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