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Tax Challenges for Foreign Investors in U.S. Real Estate

Structuring Investments That Minimize Taxable Income and Capital Gains

TUESDAY, OCTOBER 2, 2012

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Tax Challenges for Foreign Investors in U.S. Real Estate: Structuring Investments That Minimize Overall Income and Transfer Tax Burden

October 2, 2012

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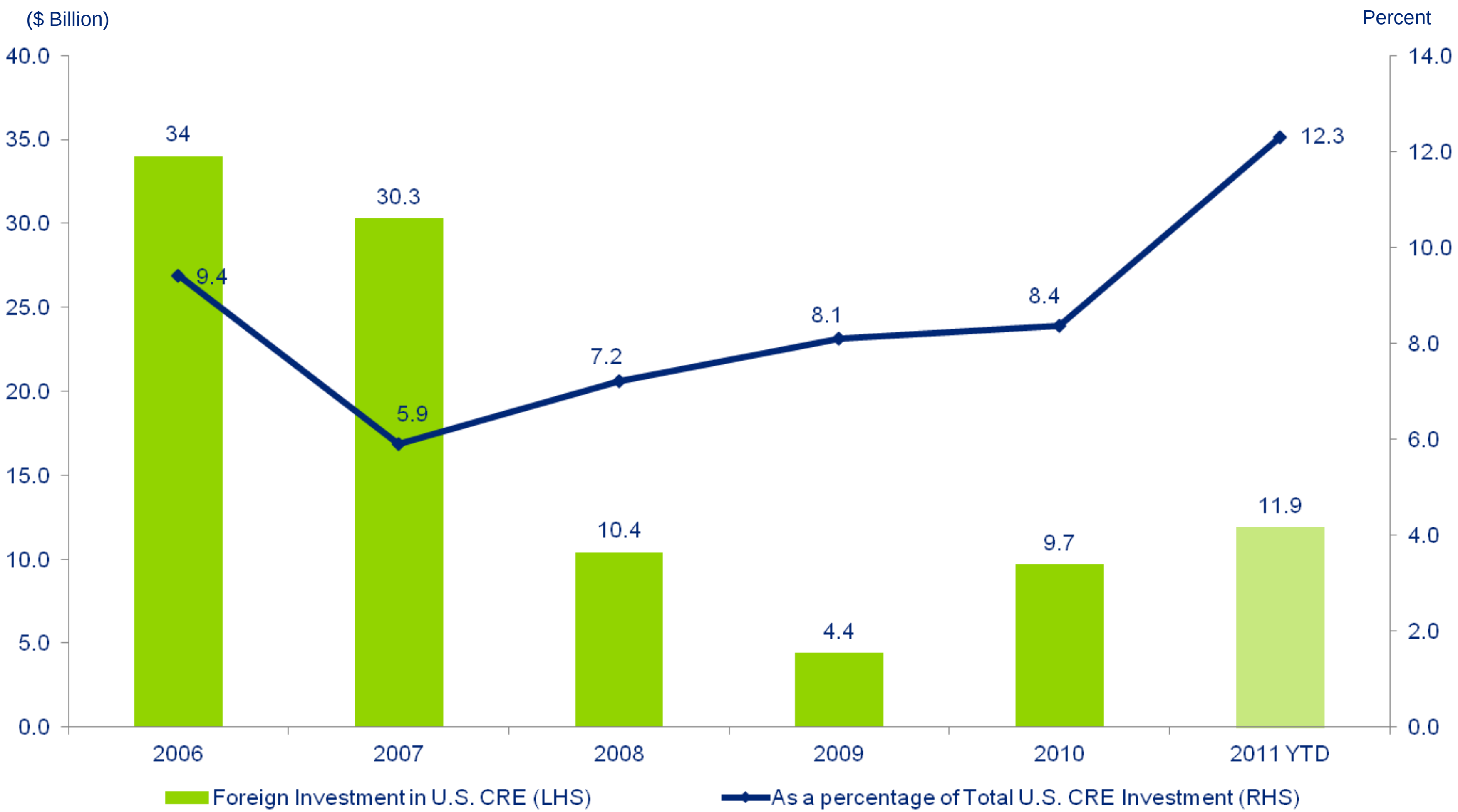
General Issues to Consider on Inbound Real Estate Investment

- Choice of Investment Entity
- Withholding on Rent, Interest & Dividends
- FIRPTA Withholding Upon Sale
- Portfolio Interest Exemption
- Branch Profits Tax
- Earnings Stripping Limitations
- Estate and Gift Tax Consequences

Foreign Investors Gain Share in U.S. CRE

Foreign Investment in U.S. CRE

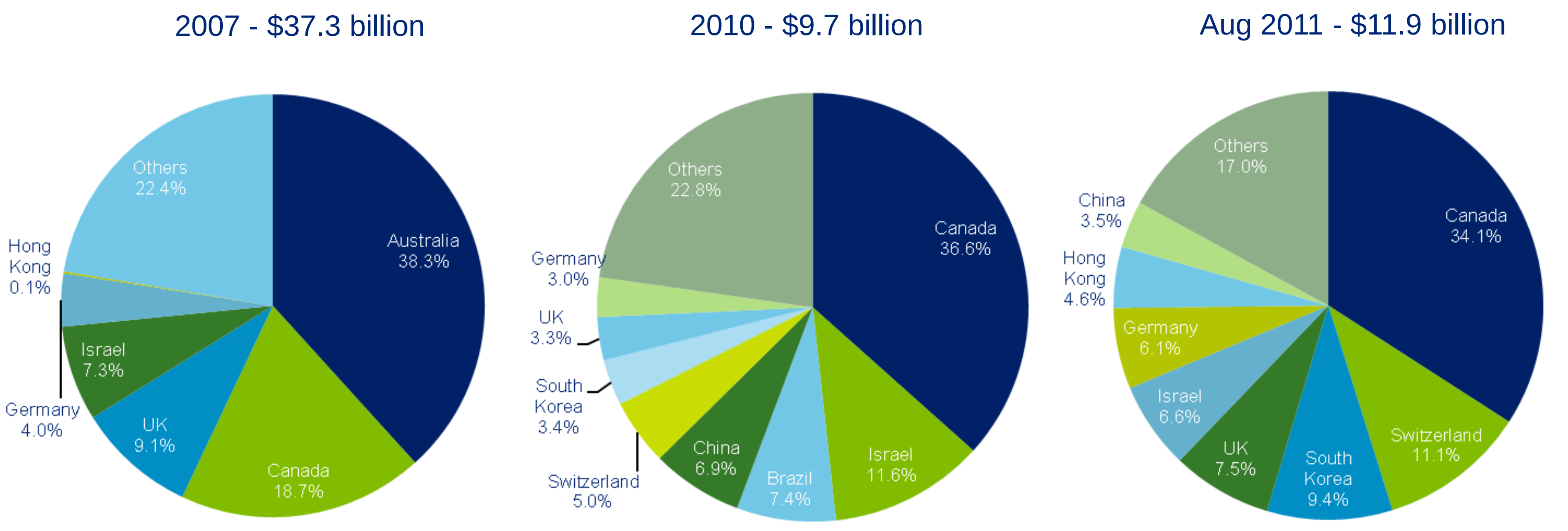


YTD represents through July 2011

Source: Real Capital Analytics, as of August 2011

Composition of Foreign Investment in U.S. CRE

Foreign Investment in U.S. CRE by Region



Source: RCA, May 2010 (for 2007 data), August 2011 (for 2010, 2011 data)

Principal Topics

- Basic income tax rules
  - Capital gains
  - Operating income
  - Interest and dividends
- Withholding
  - FIRPTA
  - Rent, interest and dividends
  - Partnership withholding
- Estate and gift taxes
- Structuring
  - Foreign business entities
  - U.S. business entities
  - Trusts

Basic Income Tax Rules

Tax Residency

- **Income Tax Purposes: Objective Test**
  - **U.S. Taxpayer:**
    - Citizenship
    - Green Card (Regardless of U.S. Presence)
    - Substantial Presence Test
  - **Exceptions:**
    - Closer Connection
    - Treaty Based Position
    - Certain Exempt Individuals
  - **Consequences:**
    - Worldwide Income Taxation
    - Informational Reporting Requirements

Basic Income Tax Rules – Gains

- Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) – § 897
  - Gain from sale or exchange of “United States real property interest” (“USRPI”) taxed as if foreign seller were engaged in the conduct of a trade or business in the United States and the gain were effectively connected with such trade or business
  - Therefore, foreign sellers are taxed on gains at the same rates applicable to U.S. sellers – gain can qualify for long-term capital gains treatment in the hands of a foreign seller
  - Nonrecognition provisions do not apply unless in the exchange the seller receives property that would itself be taxable in sale or exchange

Basic Income Tax Rules – Gains

- Definition of USRPI (Treas. Reg. § 1.897-1)
  - Interest in real property:
    - Real property includes land, buildings, and other improvements
    - Includes growing crops and timber, and mines, wells and other natural deposits – but once extracted or severed, crops, timber, ores, minerals, etc. are no longer USRPIs
    - Includes "associated personal property"
    - Includes direct or indirect right to share in appreciation in value, gross or net proceeds or profits from real property
    - Does not include mortgage loan at fixed rate of interest (or variable rate such as prime, LIBOR, etc.)
  - Interest in domestic corporation that was a U.S. real property holding corporation (USRPHC – see next slide) at any time during the 5-year period preceding sale

U.S. Real Property Holding Corporation

- Basic definition (§ 897(c)(2)):
  - Fair market value of USRPIs held on any "applicable determination date" equals or exceeds
  - 50% of sum of FMVs of (i) USRPIs; (ii) non-U.S. real property interests; and (iii) other trade or business assets
- Look-through rule for assets held through entities; in the case of corporations, more than 50% control requirement
- USRPI does not include interest in corporation that has sold all of its USRPIs in taxable transactions
- Interest in regularly trade class of stock is a USRPI only if taxpayer owned 5% or more of class

Basic Income Tax Rules – Operating Income

- If income is effectively connected with a U.S. trade or business, tax is imposed on foreign taxpayer at regular U.S. rates (individual or corporate)
- Foreign taxpayers may elect to treat real estate income as effectively connected (e.g., income from triple net leased property) – § 871(d)
- Tax base is the gross income net of allocable deductions, including operating costs, management fees and interest expense
- Normal expense limitation rules apply, e.g., at-risk, passive activity loss rules, capitalization of expenses, earnings stripping, AHYDO, etc.

Basic Income Tax Rules – Interest and Dividends

- Interest
  - U.S. source interest paid to a foreign person, taxed at 30% of gross
  - Numerous exceptions if interest is not ECI
    - Short-term OID
    - Bank interest
    - Portfolio interest exemption (exceptions where loan made by foreign bank, "10-percent shareholder" or "10-percent partner"; also not applicable if interest is contingent)
    - Many treaties eliminate or reduce rate of tax
- Dividends
  - Dividend paid by U.S. corporation to foreign person, taxed at 30% of gross
  - Treaties typically reduce rate to 5% or 15%

Taxation of Foreign Corporations

- If foreign corporation is engaged in a U.S. trade or business, including through ownership or sale of U.S. real property, taxed at regular U.S. corporate rates (34% or 35%)
- In addition, subject to branch level taxes (§ 884). Branch taxes intended to treat U.S. trade or business as if it were a separate U.S. corporation:
  – Dividend tax rate x "dividend equivalent amount"
  – Interest tax rate x interest allocated to U.S. branch
  – Treaties often reduce or even eliminate branch taxes
- Dividend equivalent does not apply to liquidation proceeds, if formalities met

Withholding

Withholding – FIRPTA (§ 1445)

- 10% of gross amount realized from sale of USRPI (some states also require withholding on sale by nonresident)
- Exemptions:
  - Non-foreign affidavit
  - Non-USRPHC affidavit
  - Excess withholding can be avoided based on maximum tax - see IRS Form 8288-B and Rev. Proc. 2000-35
  - Sales price <$300,000 on property that will be transferee’s residence (amount not indexed for inflation in >30 years)
  - Regularly traded stock
  - Situations where withholding required under partnership withholding rules (§ 1446)

Withholding – Rent, Interest, Dividends (§ 1441)

- Payor must withhold 30% of gross amount of U.S. source “fixed or determinable annual or periodic” income paid to foreign person
- Applies to rent, interest, dividends and services income (except income subject to wage with-holding)
- Treaties can reduce or exempt payments from withholding, if foreign person certifies its entitlement to treaty benefits (typically on Form W-8BEN)
- See slide on interactions with § 1445 regarding corporate distributions

Withholding – Partnerships (§ 1446)

- A partnership must withhold on its foreign partner's "effective connected taxable income" (ECTI)
- Rate is highest rate under § 1 or § 11
  - Long-term capital gains rate can apply to individual partner
- Estimated tax payments are due on 15th day of the 4th, 6th, 9th & 12th (sic) months of partnership's tax year; true up on 15th day of 4th month of next year
- Publicly traded partnerships (Treas. Reg. §1.1446-4)
  - Withholding based on distributions not income allocations
  - Preferential rates may not be used
  - Rules not extended to other types of large partnerships
- Overwithholding is pervasive problem

Withholding - Interactions

- Section 1445/1446
  - Domestic partnership – § 1446 trumps § 1445
  - Foreign partnership – § 1445 amount withheld allocable to foreign partner treated as satisfying § 1446 withholding requirement with respect to such partner
- Section 1441/1446 – generally no overlap
  - Exception: US-source independent personal services - § 1441 trumps 1446. Treas. Reg. § 1.1446-3(c)
- Section 1441/1445 – corporation has choice
  - Withhold under § 1441 and not under § 1445
  - Withhold under § 1441 on portion estimated to be dividend and § 1445 on remainder of distribution

Withholding – FATCA (§§ 1471-1474)

- Foreign Accounts Tax Compliance Act (FATCA) generally beyond the scope of this presentation
- FATCA can require withholding on payments of U.S. source income to foreign financial institutions and non-financial foreign entities
- Note that FATCA withholding can apply to proceeds of sale of USRPI consisting of stock in USRPHC

Estate and Gift Taxes

Residence for Estate and Gift Tax Purposes

- A U.S. resident for transfer-tax purposes is a person who is "domiciled" in the U.S. at the time of death or at the time of the gift – subjective test
  - A person acquires domicile in a place by **living there**, for even a brief period of time, with no definite present **intention** to leave

- An individual can be a resident for income-tax purposes and not for transfer-tax purposes, and vice-versa
  - There is no "perfect" holding structure for real estate, but it's even more challenging for a client who is income-tax resident and transfer-tax nonresident

Gift Tax

- Nonresident aliens are taxed **only** on gifts of:
  - U.S.-situsED tangible property
  - U.S.-sitused real estate

- Gifts of U.S. stock are **not** subject to tax

- Gifts of partnership interests **may not** be subject to tax, but this result is less certain
  - Uncertainty should lead to conservative planning

Gift Tax

- Annual exclusion is available to nonresident aliens. In 2012, annual exclusion amounts are:
  - $13,000 for gifts to non-spouses
  - $139,000 for gifts to non-citizen spouses
    - QDOT not available for *inter vivos* gifts (only at death)

- No unified credit; all gifts above annual exclusion to non-spouses or to non-citizen spouses are taxable

- Unlimited marital deduction for gifts to citizen spouses

Estate Tax

- Nonresident aliens are subject to estate tax on property located in the United States. Includes:
  - U.S. real property
  - Tangible personal property located in the U.S.
  - Debt obligations of U.S. persons, unless portfolio exemption applies
    - FATCA removed ability to structure private loans to qualify for portfolio exemption
  - Stock in U.S. corporations (whether or not publicly traded)
  - Uncertain treatment of foreign partnership interests
    - No bright line rule
      - Some authorities use “aggregate” approach, and some use the “entity” approach
    - If partnership is engaged in U.S. trade or business, clearly a U.S. asset
    - Uncertainty on this issue should lead to conservative planning

Estate Tax

- Trusts
  - Revocable trusts or trusts in which the decedent retained an interest under which a transferred asset could be "clawed back" under Code Sections 2033 through 2038
    - Look to situs of assets
    - Ensure that only foreign assets are transferred to the trust
      - If the nonresident alien transfers a U.S. asset to the trust, and then the trust later sells the U.S. asset and buys a foreign asset, there will be estate inclusion (Code Section 2104)
  - Irrevocable trusts
    - Structure like a typical completed-gift trust to ensure no estate inclusion

Estate Tax

- Limited to $60,000 estate-tax exemption ($13,000 tax credit)
- Unlimited marital deduction if assets left to a spouse who is a U.S. citizen
  - QDOT must be used to defer estate tax if surviving spouse is a non-citizen
- Charitable deduction and deduction for estate administration expenses
  - Ratio of U.S. assets to worldwide assets
- Nonrecourse debt on U.S. property results in only net value included in U.S. estate

Covered Expatriates: New “Inheritance Tax”

- **Gifts** or **bequests** from “covered expatriates” to a U.S. citizen or resident (including a domestic trust) are subject to an inheritance-type tax instead of a transfer tax
  - Meaning that the tax is **payable by the U.S. recipient**
  - Covered **gifts** taxed only to the extent exceed annual exclusion
- Covered gift/bequest to foreign trust taxed only when distribution attributable to the gift/bequest made to U.S. beneficiary
  - How to administer?
- Exception for transfers that are otherwise subject to U.S. transfer tax and reported on a gift- or estate-tax return
- Tax is reduced by foreign gift tax or estate tax

Planning

Before Planning Begins

- Understand investor characteristics - type, location
- Ascertain investment characteristics and objectives:
  - Use: personal, business, investment
  - Types of income generated from real estate: rent, interest, dividends, capital gains, service, and others
  - Capital: equity, debt (many different flavors and sources)
  - Exit: anticipated timing, method
- Consider choice of entity – wholly-owned, joint ventures, passive investment vehicles
- Withholding and compliance
- Estate and gift taxes

Home Country Taxation

- No planning should be undertaken before considering whether home country taxation is relevant
  - Typical planning vehicles for U.S. persons can be disastrous to a nonresident alien (for example a revocable trust established by a U.K. resident will trigger immediate IHT)
- U.S. taxation of foreign investors may be modified by treaty
  - No exception from U.S. taxation of gain from real estate but treaties can reduce or eliminate tax on interest and dividends
  - Almost all treaties contain “limitation on benefits” provision to counteract abuse

Income Treaties & Estate and Gift Tax Treaties

- The U.S. is party to more than 50 income tax treaties, but only 16 estate and gift tax treaties (because many countries do not have an estate, inheritance, or gift tax)

- Below are the countries with which the U.S. is party to estate and gift tax treaties:
  - Australia
  - Austria
  - Canada
  - Denmark
  - Finland
  - France
  - Germany
  - Greece
  - Ireland
  - Italy
  - Japan
  - Netherlands
  - Norway
  - South Africa
  - Switzerland
  - United Kingdom

Treaty Analysis

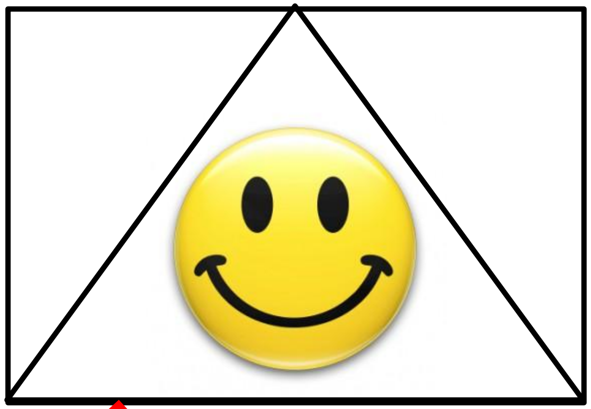
- Treaty analysis first requires an understanding of whether each country considers the client to be resident in that country under its internal rules

- Tax counsel in the other jurisdiction is required

Objectives Drive Structure

- Tax objectives
  - Avoid cross-border double taxation (U.S./foreign)
  - Mitigate taxation of operating income
  - Avoid double taxation of corporate earnings
  - Obtain long-term capital gains treatment on sale
  - Avoid gift and estate taxes
  - Limit overwithholding
  - Limit contact with U.S. tax system
- Nontax objectives
  - Preserve confidentiality
  - Facilitate inter-family transfers
  - Limited liability

Structuring May Mean Picking Your Poison



Pass-through entity: capital gains preference; no double taxation

Corporate rates; double taxation

THERE IS NO PERFECT SOLUTION

Personal tax compliance/ estate tax risk

Corporate structure: No personal tax filings or estate tax

Options - 1

Foreign Individual

↓

real estate

- 15% tax or 35% tax
- Privacy Concerns
- Estate Tax
- but - only one level of tax!

Options -2

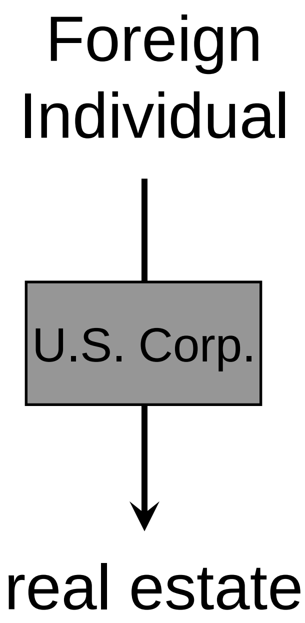
Foreign Individual

Foreign Corp.

real estate

- No Estate Tax
- Branch Profits Tax
- Privacy Concerns
- Sale of Stock - Tax Free BUT!
- Tax-Free Refinancing Distributions

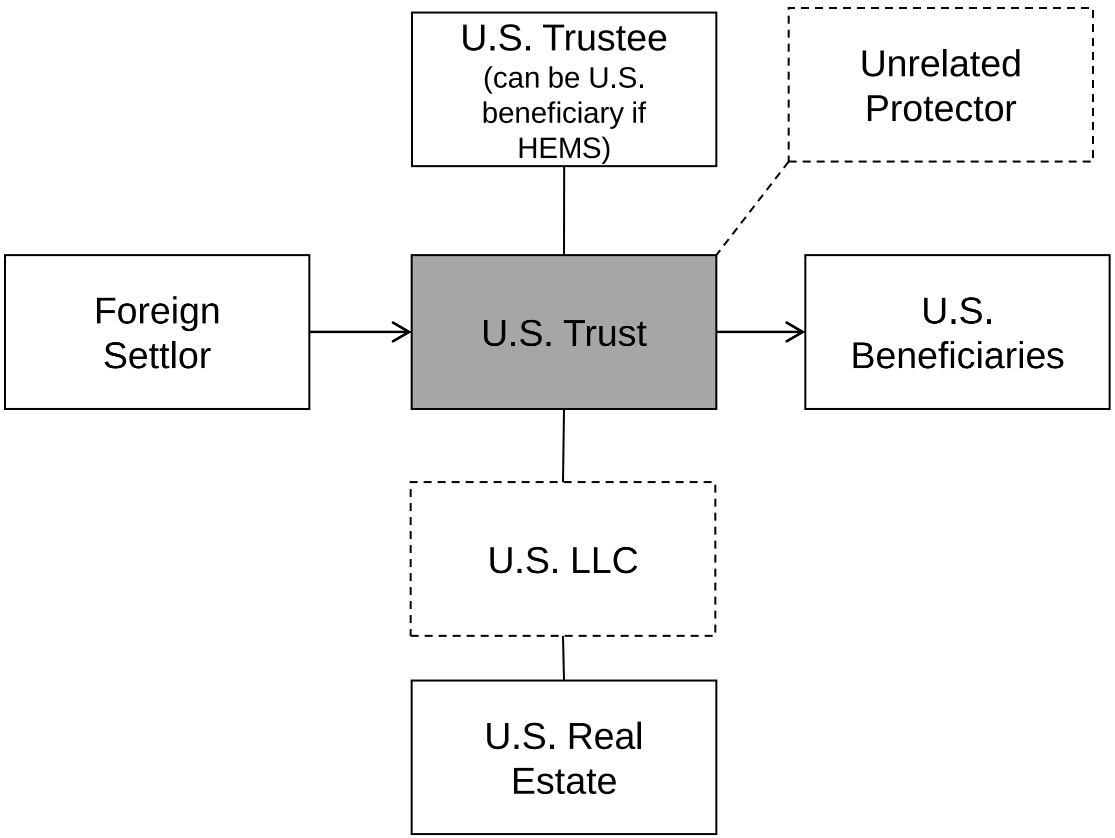
Options - 3



- No Branch Profits Tax
- Dividend Withholding Tax
- Estate Tax
- Privacy Concerns
- Sale of Stock – Taxable
- Taxable Refinancing Distributions

Options – 4

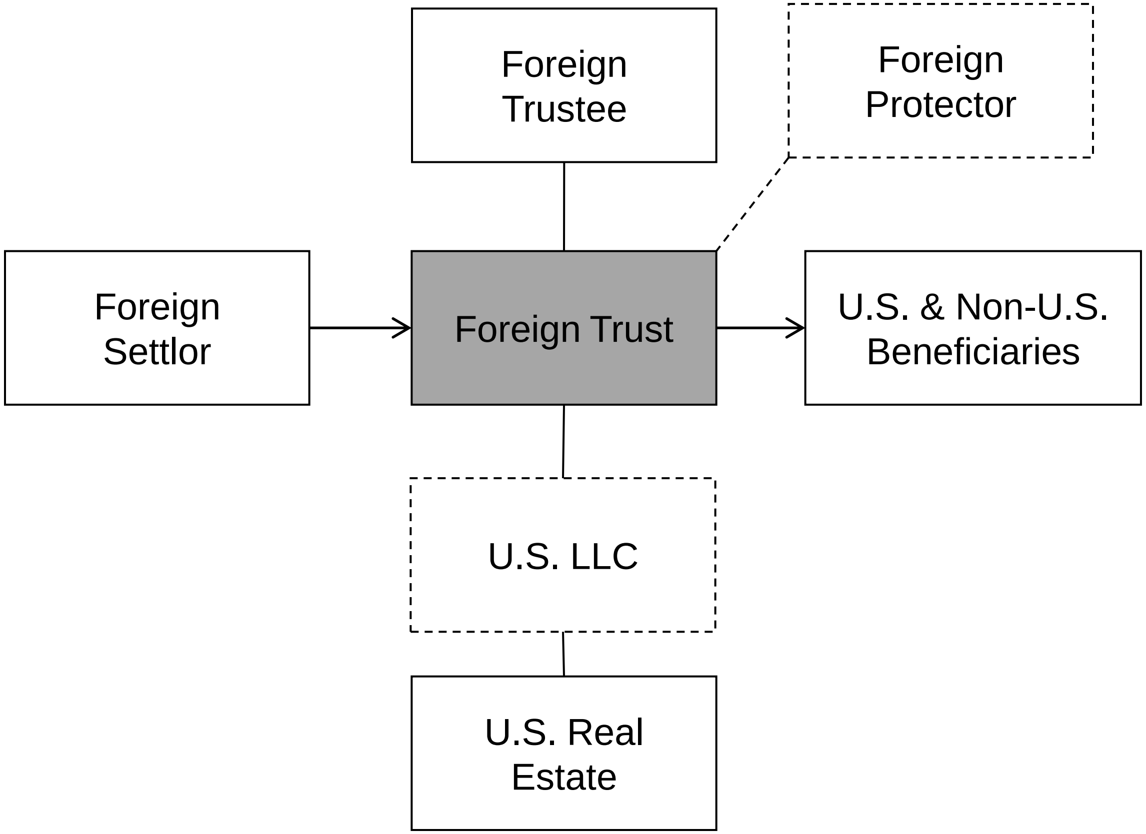
Trust Planning



- Foreign person must sell (FIRPTA), or gift in increments
- Non-grantor trust
- No U.S. estate tax
- No GST tax
- Regular U.S. tax on subsequent sale
- Include redomiciliation provision

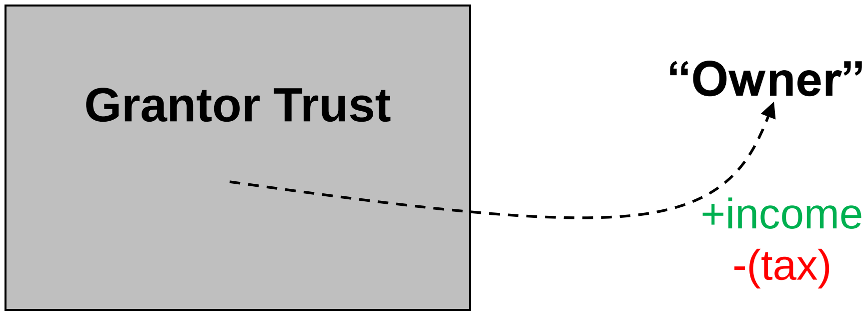
Options – 5

Trust Planning



- Foreign person must sell (FIRPTA), or gift in increments
- Non-grantor trust
- No U.S. estate tax
- No GST tax
- Subsequent sale (FIRPTA)
- Include redomiciliation provision

Grantor Trusts



- The trust's "owner" is deemed to own the trust's income for U.S. tax purposes
- Income is currently taxable to the owner (whether or not it is distributed); therefore, beneficiaries not taxable on distributions
- If the owner is a foreign person, subject to U.S. tax only on certain U.S.-sourced income
  - A trust properly characterized as having a foreign owner can provide complete avoidance of U.S. tax on trust income, even when it is distributed to U.S. beneficiaries
  - Grantor-trust status as to a foreign person will not solve estate-tax problem on U.S. assets in the trust because trust must be revocable or grantor & spouse must be the only beneficiaries

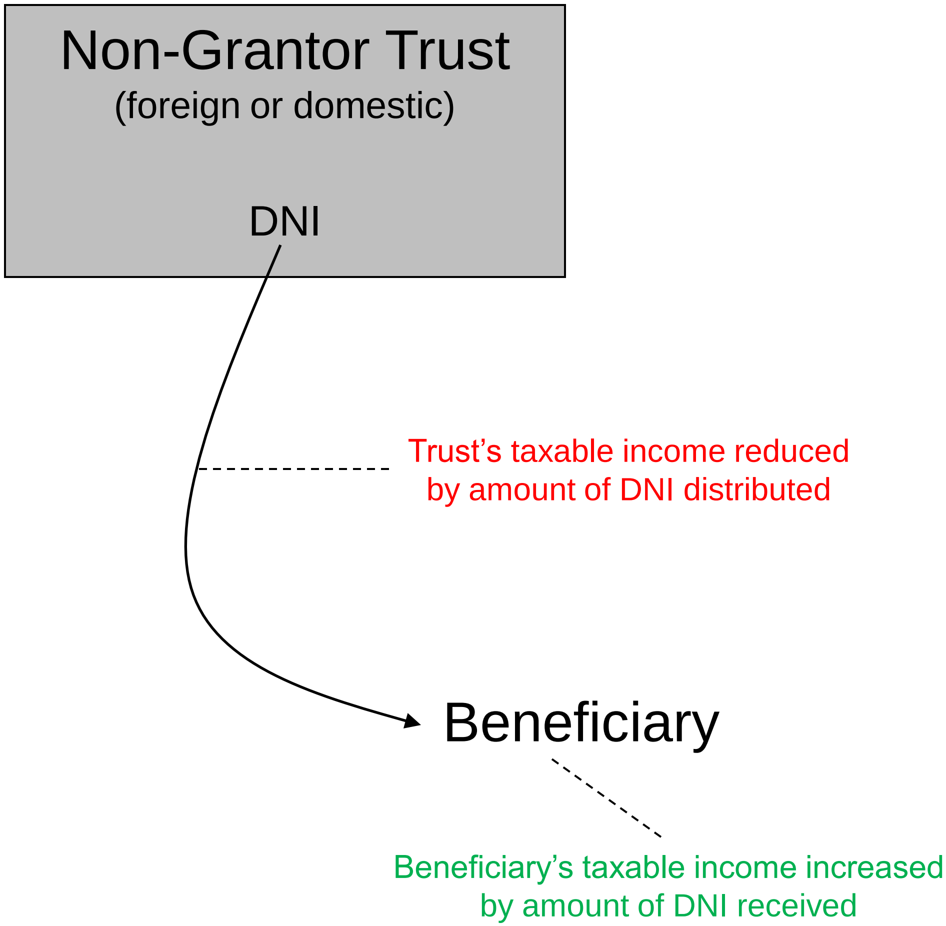
Non-Grantor Trusts

Non-Grantor Trust

+income
-(tax)

- Income is considered to be "owned" by the trust itself
- If it's a U.S. trust, it pays tax on worldwide income (to the extent not distributed)
- If it's a foreign trust, it pays tax only on certain U.S.-source income (to the extent not distributed)
  - This could provide an opportunity for deferral of U.S. tax until distributed to U.S. beneficiaries
  - To preclude this deferral, "throwback" rules apply to income accumulated within a foreign non-grantor trust and later distributed to U.S. beneficiaries

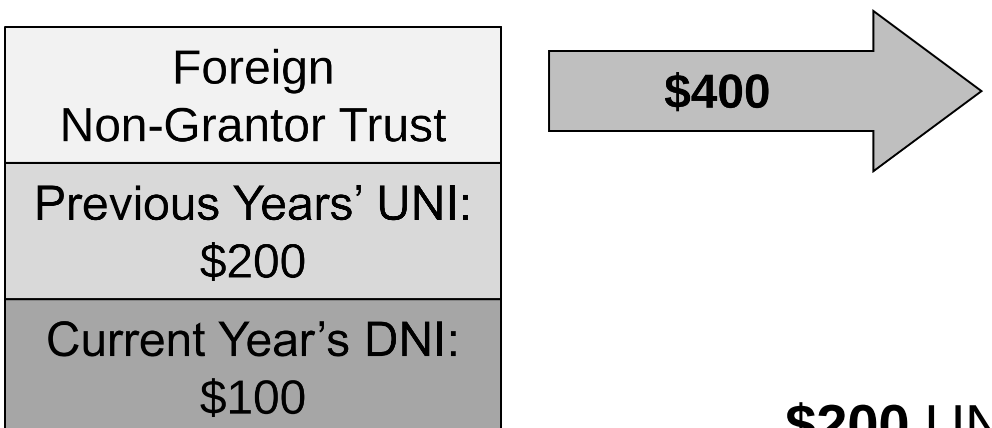
Non-Grantor Trusts: Taxation of Distributions



- In computing taxable income, the trust receives a deduction equal to DNI distributed
- The beneficiaries must include in income their pro-rata share of DNI
- Foreign non-grantor trusts with U.S. beneficiaries must account for all income as though it were a U.S. trust, even though the trust itself is generally not subject to U.S. taxation

Foreign Non-Grantor Trusts

- An “accumulation distribution” is one that exceeds current-year DNI
- After all DNI is distributed, distribution is deemed to consist of UNI until no UNI remains
- After all UNI is distributed, the distribution will be considered non-taxable principal



U.S. Beneficiary’s income includes:

$100 DNI
$200 UNI (subject to throwback tax)
$0 (principal)

Foreign Non-Grantor Trusts

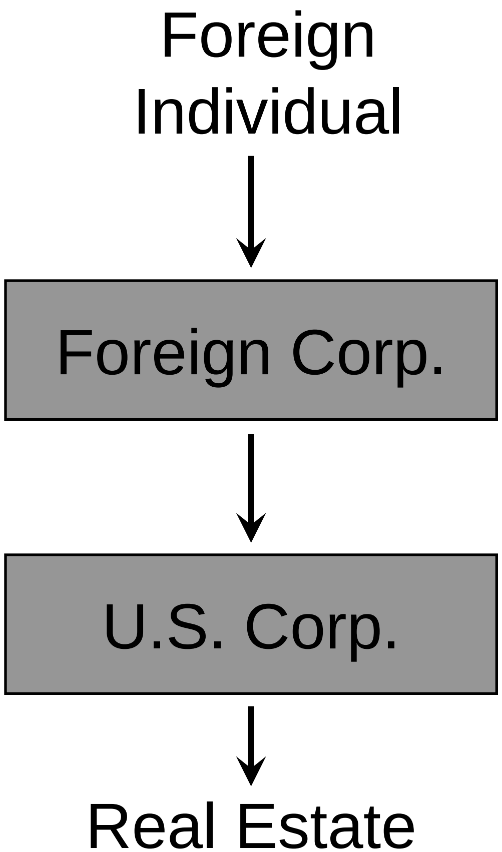
- Once a foreign non-grantor trust has UNI, it remains in the trust until it is distributed
  - UNI can be distributed to a foreign beneficiary without triggering the throwback tax (but beware of loopholes below)

- Loopholes for improperly eliminating UNI have been closed
  - Distributing funds to a foreign beneficiary who then “gifts” it to a U.S. beneficiary is an accumulation distribution to the U.S. beneficiary
  - Transferring funds from one trust to another trust can be considered an accumulation distribution in some cases

Foreign Non-Grantor Trusts

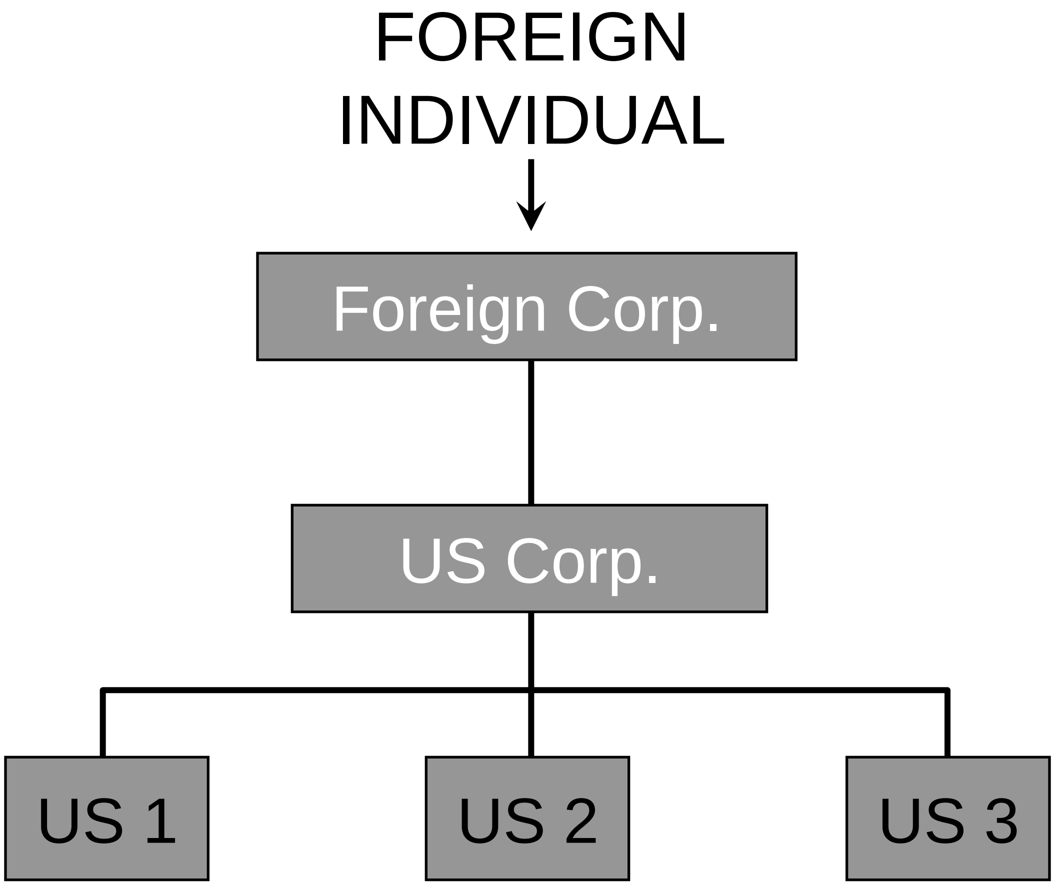
- Foreign non-grantor trusts can provide some good planning opportunities for foreign investment in U.S. real estate, but throwback-tax complications for U.S. beneficiaries can lean in favor of using a U.S. trust instead

Best Option*!?*

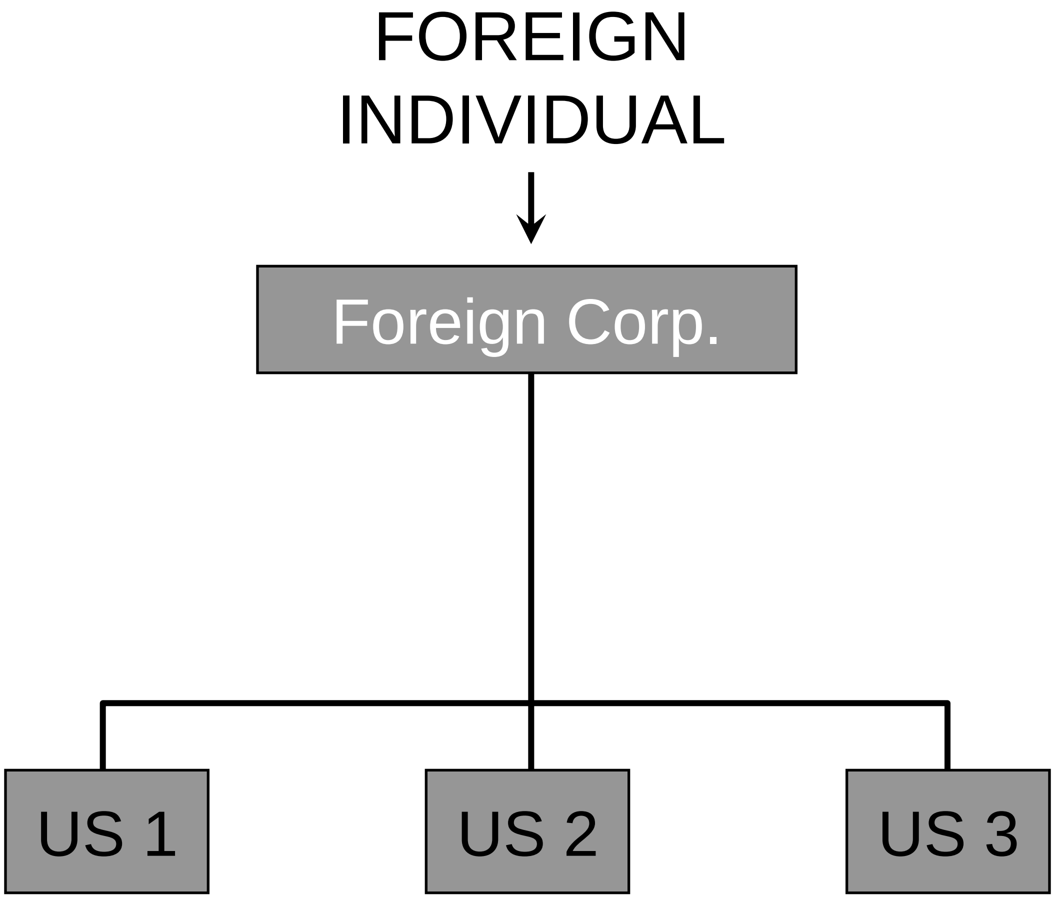


- No Branch Profits Tax
- No Estate Tax
- No Disclosure
- Sale of Stock
- Taxable Refinancing Distributions

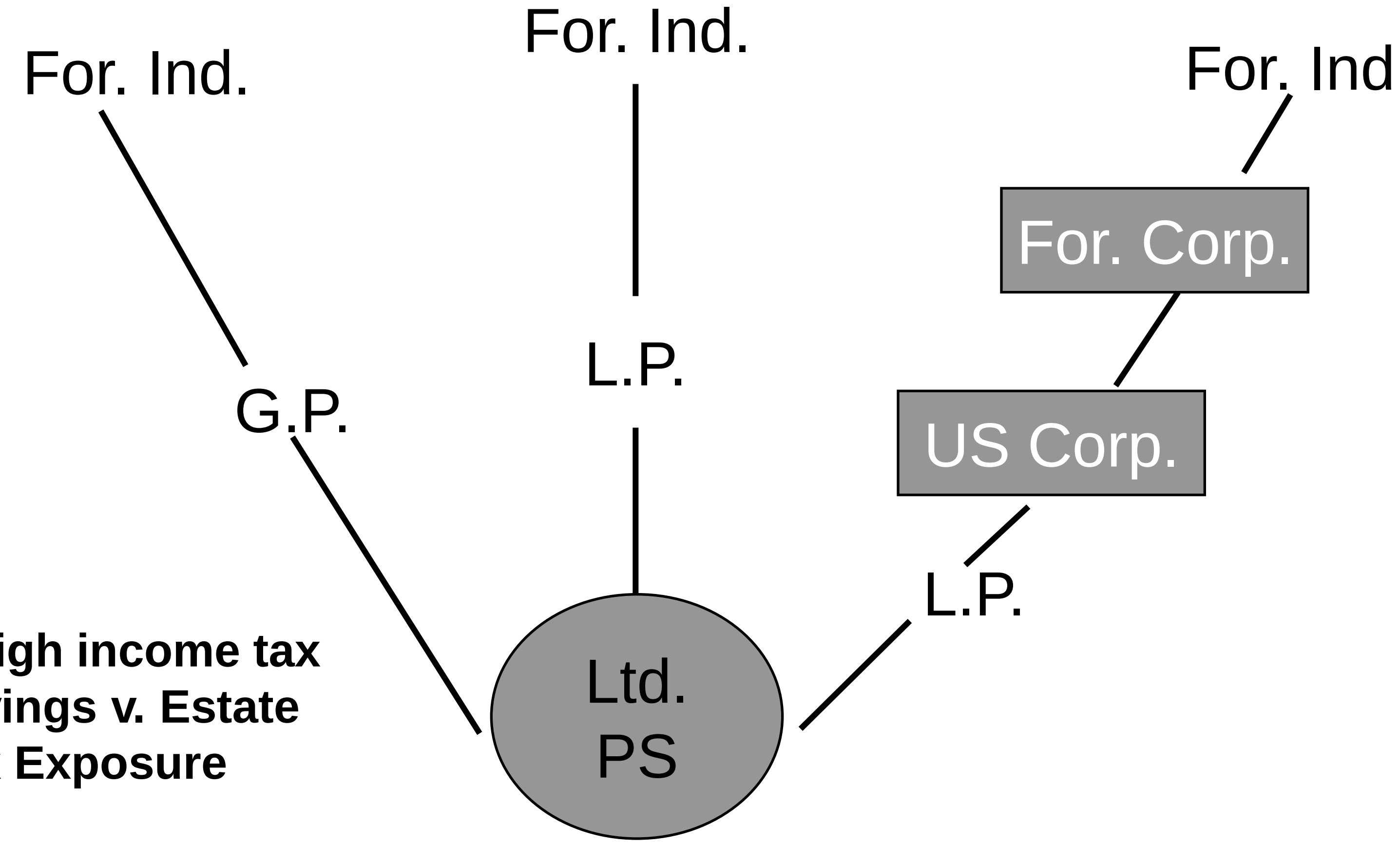
Multiple Properties



Multiple Properties (cont'd)



Traditional Partnership



Weigh income tax savings v. Estate Tax Exposure

Tax Planning with Shared Appreciation Mortgages

Tax Planning with Shared Appreciation Mortgages

- Section 897(a) imposes U.S. tax on “gain from the disposition of a US real property interest” recognized by non-US persons.
- US real property interests include stock (& participating debt) in a U.S. corporation if the FMV of its US real property is equal to or greater than 50% its assets.
- Section 1445(a) requires the transferee of a US real property interest to withhold 10% of the proceeds in respect of the tax due under Section 897.

Tax Planning with Shared Appreciation Mortgages

- Therefore, if non-U.S. taxpayers invests directly in U.S. real estate or through entity, gain from the disposition of the real property or the interest in the entity would be subject to U.S. federal income tax at graduated rates.
- In addition, if non-U.S. taxpayer invests through foreign corporation also likely subject to branch profits tax.
- One possible option to avoid FIRPTA is for foreign investor to use shared appreciation mortgage to invest synthetically in U.S. real estate.
  - Shared appreciation mortgage is loan that provides for interest that is contingent on the gain from the sale of the property.

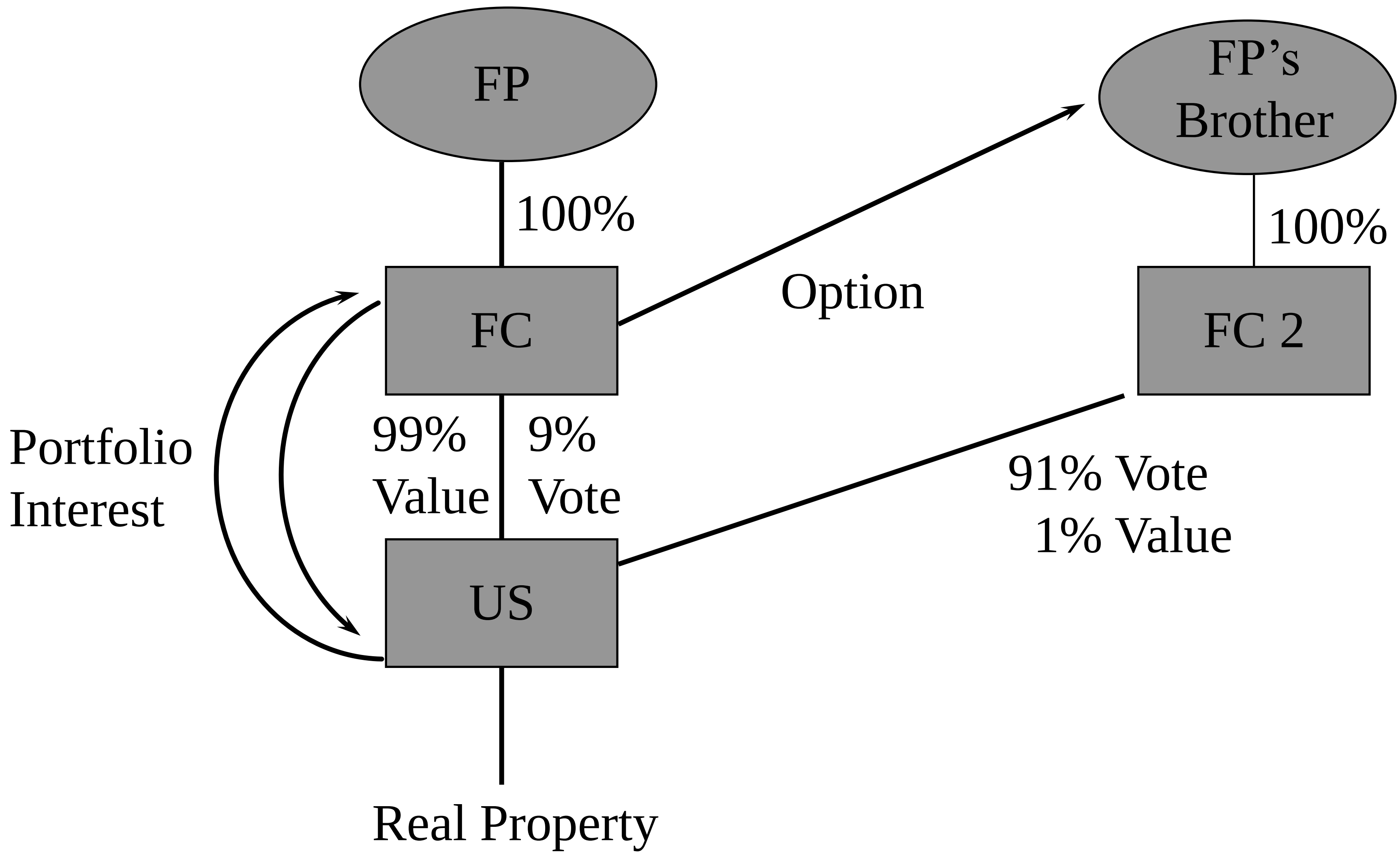
Tax Planning with Shared Appreciation Mortgages

- Regulation Section 1.897-1(h), Example 2
  - Foreign corporation makes $1 million loan to domestic individual which is secured by mortgage on real property purchased with loan proceeds.
  - Loan agreement entitles lender to fixed monthly payments, constituting repayment of principal plus fixed interest rate.
  - Lender also entitled to receive certain percentage of the appreciation in value of real property at the time that the loan is retired.
  - Shared appreciation loan treated as U.S. real property interest (USRPI), but receipt of final payments do not constitute “disposition” of USRPI for purposes of Section 897.

Tax Planning with Shared Appreciation Mortgages

- Example 2 concludes that Section 897 is not triggered on receipt of final loan payment because payment constitutes principal and interest, not gain for tax purposes.
- Thus, appreciation payment is treated as interest for tax purposes.
- Cannot qualify for exemption from withholding under portfolio interest rules because payment is “contingent interest.” Section 871(h)(4).
- However, taxpayer could rely on treaty with zero percent withholding on contingent interest.

Portfolio Interest Friendly Structure



Applications of Section 1031

Section 1031(a)

- “No gain or loss shall be recognized on the exchange of property held for productive use in trade or business or for investment if such property is exchanged solely for property of like- kind which is to be held either for productive use in trade or business or for investment”
  - Mandatory application
  - Not limited by taxpayer type
- Section 1031(a)(2) excludes most entity interests and financial instrument positions from deferral
  - DRE’s are excepted
- Section 1031(a)(3) sanctions deferred exchanges

Like-Kind

- Most Fee Interests in Real Estate are Like Kind to each other:
  - IMPROVED TO UNIMPROVED OK
  - RESIDENTIAL TO COMMERCIAL OK
- Leases of 30+ years are Like Kind to Fee Interests

Section 1031(h)

- U.S. real estate not like kind to non-U.S. real estate
  - Therefore, cannot escape U.S. taxation by exiting through exchange
- Foreign for Foreign is still allowed
  - Would be relevant only for U.S. taxpayer
- Personal Property used outside U.S. isn’t like kind to personal property used in U.S. with “use” defined by reference to periods 2 years before (for relinquished asset) AND 2 years after exchange (for replacement asset)

Planning Principles
Using Like-Kind Exchanges

- Since almost all real estate types are like-kind, shifting from FIRPTA unfriendly to FIRPTA friendly assets can be accomplished tax free
  - Low leverage, high income to high leverage, low income
- For highly appreciated residential property where gain exceeds Section 121 exclusion, conversion to rental can allow deferral on sale through exchange
- Since stock sales may be free of tax, find stock buyer willing to acquire stock, sell assets and defer tax on corporate level built in gain through like-kind exchange

Like-Kind Exchange Transaction

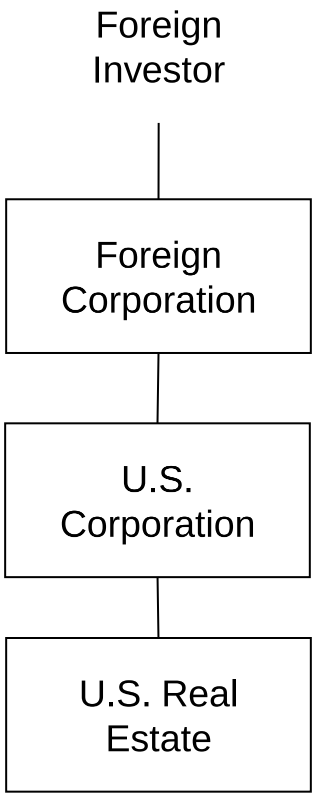
- Foreign Investor owns 100% of Foreign Corporation

- Foreign Corporation owns 100% of U.S. Corporation

- U.S. Corporation owns U.S. Real Estate to be sold

- Real Estate:

  - Sales Price: $45,000,000
  - Basis: $5,000,000
  - State and federal corporate tax rates: 40%
  - Tax payable by Domestic Corporation: $16,000,000
  - Net cash to Foreign Investor: $29,000,000



Like-Kind Exchange Transaction

- U.S. Investor acquires shares of Foreign Corporation for $36,000,000 from Foreign Investor

- Like-kind exchange real property preselected by U.S. Investor

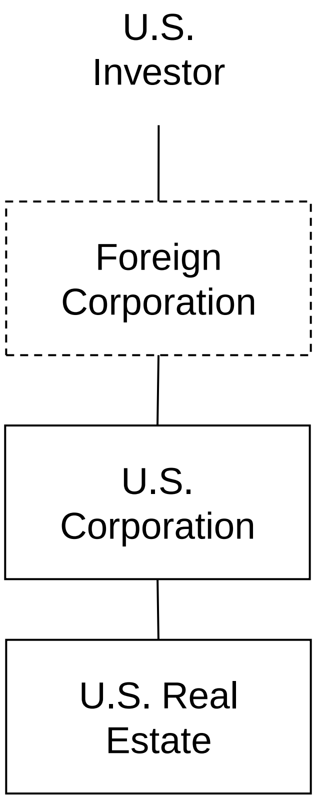
- Description of like-kind property acquired

    - U.S. real estate that can be financed for 80% of Value (80% x $45,000,000) third-party financing: $36,000,000

    - Average annual amortization of mortgage and depreciation: $500,000 per year

- Foreign Corporation is reorganized downstream into U.S. Corporation

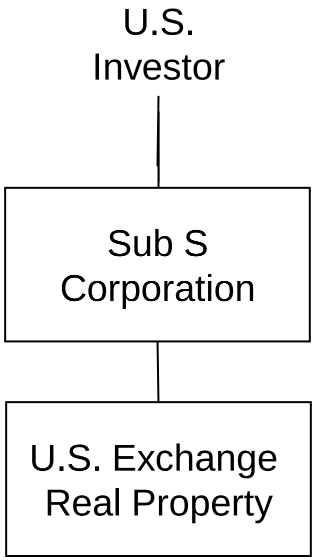
- Investor Elects Subchapter S for U.S. Corporation



Like-Kind Exchange Transaction

Assume 10 Years Later

- Value of real estate has increased by 10%: $49,500,000
- Mortgage balance: $31,000,000
  Original mortgage: $36,000,00
  Amortization: $5,000,000
- Adjusted Basis: $0.00
- Net result to U.S. Investor:
  Cash to Close: $49,500,000
  United States capital gains taxes:
  15% x $49,500,000 = $7,425,000
- Profit to U.S. Investor: $11,075,000
- U.S. Investor investment: $0.00



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