This memorandum is intended to provide summary information and should not be construed as legal advice. Readers should seek specific legal advice before taking action with respect to the matters discussed herein.
Introduction

Advising the nonresident alien client on buying and selling real estate requires more than knowing the tax rules. The advisor must understand not only what is in the client’s mind, but the misinformation and false assumptions that the client may bring from his home country. The advisor must understand the client’s legal and business culture and expectations in order to explain the options, alternatives, and their consequences. The advisor must counsel the client about planning options and consequences that the advisor might not think about when advising an American client.

Nonresident aliens planning to purchase real estate in the United States, whether a single family home, a condominium apartment, shares of stock in a cooperative apartment corporation, vacant land, or a limited partnership interest in a real estate investment partnership, should understand certain basic rules of planning and taxation relating to real property ownership. Proper planning before the purchase is essential. It can be difficult and expensive to change the form of real estate ownership after title closes. Changing the form of ownership after title closes may subject the owner to significant extra taxes and transfer fees. Therefore, the foreigner considering the purchase of U.S. real estate should understand the planning options before signing a contract to purchase.

Since every transaction is different, no single solution fits every case. A structure appropriate for a thirty-year old nonresident alien buying a house to live in while on assignment in the U.S. for five years is probably unacceptable for a sixty-year old person who wants to invest several million dollars in vacant land for long-term capital appreciation.

There is no ideal solution to foreign ownership of U.S. real estate. The interplay of Federal and state income taxes, estate and gift taxes and the desire of many clients for anonymity requires the foreign investor and his or her advisor to weigh the advantages and disadvantages of multiple options. The U.S. advisor must ensure that the client has all the necessary facts so that he or she can make an informed decision. There is no single solution, only choices.

The advisor must inform the nonresident alien (NRA) client about local real estate customs and practices because if the advisor does not, no one else will. Structuring real estate investment involves choices and trade-offs. Because almost all investments in U.S. real estate are potentially subject to estate tax at very high rates, much tax planning for the NRA client involves structures designed to avoid estate taxes. If the advisor simply structures the investment to avoid estate taxes without fully explaining the pros and the cons of the proposed structure, the advisor will not be doing what is best for the client.

1 “Foreigners” and “nonresident aliens” for income tax purposes mean individuals who are neither U.S. citizens, green card holders, nor U.S. tax residents by virtue of the number of days they are present in the United States under the substantial presence test. For estate and gift tax purposes the terms mean persons who are not domiciled in the United States at time of death or at the time of making a gift. The definition of U.S. resident for income tax purposes is based on measurable standards. The definition of “domicile” is a facts and circumstances test. It is quite possible to be a U.S tax resident for income tax purposes and a non-domiciliary for estate tax purposes. A foreign corporation is a corporation not organized under the laws of any U.S state. The terms “foreigner,” “nonresident alien” and “NRA” are used interchangeably.
Similarly, because all rental income and gain on sale are potentially subject to income tax, the advisor must explain the income tax consequences of different ownership structures. There is a conflict between structures that avoid estate taxes and structures that minimize income taxes on rental income and gains taxes on sale. The corporate structure that avoids estate taxes will be more costly to set up and operate, and may have income tax consequences that do not exist when title is in individual name.

**What the Advisor Needs to Know About the Client’s Home Country Rules and Practices**

Foreign clients, although not from another planet, are certainly from another country. The rules and practices in the client’s home country may be very different from the rules and practices in the U.S. Understanding the rules, practices, and costs associated with the purchase or sale of real estate is an important part of the overall planning. Real estate planning for foreigners is not simple.

In many countries lawyers are not involved in real estate transactions. A Notary Public handles real estate. This is not the American notary with a rubber stamp in the desk. The foreign Notary Public is a trained lawyer. The Notary draws the deed, verifies title, and collects the transfer taxes and fees. The deed is then recorded in the public registry. A lawyer is not an essential part of the transaction.

In many Civil Law countries, clients do not make wills because their Civil Code dictates how property must pass to a surviving spouse and children. Typically a surviving spouse receives part of the property as community property (usually one-half) and most, if not all, of the remainder passes to the children. Community property may come into play when determining the U.S. estate tax.

Some countries have no estate tax or impose an estate tax only on the appreciation since the purchase. Also, many countries adjust prices for inflation. Our tax code has no adjustment for inflation for estate taxes or gains taxes. This comes as a surprise to many NRAs.

**New York City Real Estate: Co-op or Condominium**

The advisor must understand the practical and legal differences between a co-operative apartment and a condominium. New York is one of the few cities that have co-operative apartments.

With a co-op apartment, a corporation owns the building and the land on which it sits. Co-op ownership is evidenced by shares of stock in the co-operative housing corporation, and the apartment is occupied under a proprietary lease.

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2 There are a few co-op apartments in Manhattan that do not own the land. The co-op corporation holds a long-term lease on the building. At the expiration of the lease a new lease must be executed or the property would revert to the lessor. Prices for apartments in co-ops that do not own the land are generally lower than prices for the traditional co-op apartment. Caution is in order when advising a client considering purchasing shares in a co-op that does not own the land.
The shares of stock in a co-op are, as are shares of stock in any U.S. corporation, considered to be intangible or movable property. A condominium (called in some countries horizontal property) is real property or immovable property.

The distinction between intangible shares and property such as real estate has significant tax planning consequences. While shares of a corporation (including shares in a co-op) and a condominium apartment are both U.S. situs assets for estate tax purposes, they are treated differently for gift tax purposes. Shares may be gifted (in the case of shares of a co-op subject to consent of the board of directors) without incurring a gift tax. The gift of a condominium is subject to Federal gift tax and in many states at the state level as well.

The distinction between movable and immovable property is also important in the case of intestate succession. If a foreigner dies without a will in the United States or in the home country, the law of the domicile will govern the inheritance of the shares. The law of the situs of the property (i.e. the state where the property is located) will govern the inheritance of the real property. Thus, it is theoretically possible for an NRA to die owning a co-op apartment in Manhattan and a beach house in Malibu and for the two properties to pass to different heirs.

A co-op is managed by a board of directors elected by the tenant shareholders. The board has the right to approve or reject a buyer, and it has an almost unlimited right to ask for information about the prospective buyer, his or her family, and the intended use. Foreigners rarely purchase co-ops because they do not want to provide detailed personal and financial information. Also, most co-ops will not allow corporate ownership or rental, which may be an important tax planning consideration for the foreign buyer.

Condominiums also have an approval process, but it differs from the approval process of a co-op purchase. The condominium has a right of first refusal. The owner seeking to sell or rent must give notice to the board of managers of his intention to sell or rent the unit. The board of managers, in accordance with the rules of the condominium association, has either to approve the sale or rental or to exercise its right of first refusal and purchase or lease the unit.

The approval process for condominiums is generally less rigorous than that of a co-op, and a condominium cannot prohibit corporate ownership. Nonetheless, some condominium boards are imposing increasingly burdensome requirements for financial and personal information before approving a sale or rental.

A condominium has a separate tax lot, and the owner may mortgage the unit without notifying or obtaining the consent of the board of managers. If a co-op owner wants to finance the purchase of the co-op, the bank will require a recognition agreement from the co-op indicating that the bank has a lien on the shares. The bank’s lien on the co-op shares is subordinated to the co-op’s claim for unpaid maintenance charges. A co-op can refuse to consent to a loan secured by the shares and assignment of the proprietary lease.

Some NRAs are reluctant to provide any information when buying U.S. real estate. If an NRA wants to buy an apartment in New York and does not want to provide any personal information, the purchase would have to be a condominium or co-op from a sponsor (developer). The sponsor does not normally ask for any information about the buyer. Generally the NRA has to indicate only who will occupy the apartment. No tax
returns, no letters of reference, and no financial statements are required.

**Reporting Requirements**

Although a sponsor may not require much information from a prospective purchaser, there are now new reporting requirements for New York City when the purchaser is a single member limited liability company (LLC) and new US Treasury Department reporting requirements for all-cash purchases that exceed $3 million.

**New York City**

If the purchaser is a single member limited liability company, when the ACRIS transfer tax documents are presented for recording in New York City, the name of the sole member of the limited liability company must be disclosed. If the sole member is a corporation (domestic or foreign) or a trust, the name of the ultimate beneficial owner does not have to be disclosed. If a limited liability company has two or more members, then no disclosure is required. The purchasing entity as well as the sole member if an LLC is the purchaser must have an Employment Identification Number (EIN) for ACRIS purposes.

**Internal Revenue Service**

The Internal Revenue Service has issued new regulations referred to as a Geographic Target Order, which now mandate the disclosure of the beneficial owners of companies buying real estate in Manhattan and Miami-Dade County when such purchases are all-cash and in excess of $3 million in Manhattan and in excess of $1 million in Miami-Dade. The order will be in place from March 1, 2016 through August 27, 2016. After this period, the IRS will determine if the Order was worthwhile and whether it will be cancelled, continued or expanded.

If all payments are by wire transfer the Order should not apply. The Order does not apply to deals that have already closed.

At or prior to closings, title insurance companies will be required to obtain copies of licenses and/or passports from any beneficial owner who owns at least a 25% interest in the relevant entity, as well as a copy of a license and/or passport from the attorney who is representing the purchasing entity. Further, all members of an LLC taking title must be disclosed, regardless of the percent interest they each hold. The use of the attorney-client privilege will not be accepted under this ruling as a means of avoiding the provision of the required identification information. IRS Form 8300 will be used by title companies to send the information to the IRS.

Failure to comply by the title insurance companies or attorneys could lead to substantial fines and the potential for criminal liability.

The Order does not apply to transactions where the funds are sent by wire transfer. Clients should be sure to speak with their advisor to determine whether they are subject to the new regulations and required reporting.
The Costs of Buying and Selling New York State and City Real Estate

There are substantial costs associated with the purchase and sale of New York real estate. If the client only learns about these costs three days before closing when his advisor asks him to wire the funds for the purchase, this does not reflect well on the advisor. The advisor does not want to hear “why didn’t you tell me sooner?” In New York State there are state transfer taxes and a state “Mansion Tax” of 1% of the contract price paid by the buyer when the contract price is $1,000,000 or greater. If the property is in New York City, there are additional transfer taxes.

The general custom in New York City is for the seller to pay the state and city transfer taxes, but the custom is different for sales by a developer ("sponsor sales"). The sponsors try to (and usually do) pass the state and city transfer taxes to the buyer. This means that when the NRA sells the real estate, he will pay the transfer taxes on sale, and will have paid the transfer taxes on acquisition.

If a client is buying from a sponsor, the advisor must read the offering plan and financials for both co-ops and condominiums, and inform the prospective buyer of the costs associated therewith. The advisor should not assume that the real estate broker has informed the buyer of these charges.

These costs typically are:

- A “Mansion” Tax of 1% of the total contract price if the price is $1,000,000 or above.
- New York State Real Estate Transfer Tax of $4 per thousand (.4%)
- New York City Real Property Transfer Tax of 1% on transfers less than or equal to $500,000, or
  New York City Real Property Transfer Tax of 1.425% on transfers over $500,000.
- Mortgage Recording Tax (if the buyer is obtaining a mortgage loan):
  Under $500,000: 2.05%, of which .25% is paid by the lender.
  Equal to or greater than $500,000: 2.175% of which .25% is paid by the lender.
- Title insurance: $14,280

The following is an example of the costs of purchasing a New York City condominium apartment from a sponsor. Assume a $5,000,000 purchase price and a $2,500,000 mortgage.

The buyer will pay, in addition to the contract price, approximately $204,982³ consisting of the following:

- “Mansion Tax”: $50,912 (payable by all buyers)
- New York City Real Property Transfer Tax: $72,550
- New York State Real Estate Transfer Tax: $20,365
- Mortgage recording tax: $46,875
- Title insurance: $14,280

³ Because the buyer is paying the transfer taxes, the amount on which the tax is calculated is grossed up. The total amount of the transfer taxes is added to the contract price and then the actual mansion tax and transfer taxes are calculated.
The buyer may also be required to pay a contribution to a working capital fund equal to one or two month’s common charges and the sponsor’s attorney’s fees for attending the closing.

A client willing to spend several million dollars for a New York City apartment would not walk away from the deal because of these costs, but the advisor must inform the client of these expenses. This information is part of the planning process.

**What the Buyer Needs to Know when Buying from a Sponsor in a Building Under Construction**

Foreigners often sign contracts to purchase an apartment before the building is half completed or earlier. They buy from glossy sales brochures, and sometimes after a visit to a model apartment. Clients as a general matter do not read the offering plan. Advisors must read the offering plan and inform their clients that title will close on their apartment as soon as the building has a temporary certificate of occupancy for the unit. This means that occupancy is legal, but that full service may not be available for many months following closing. Sponsors now routinely include in the offering plan a drastic warning that full service may not be available for an extended period of time.

Below is an extract from the two-page section entitled the “Interim Service Period” from the offering plan of one of New York City’s new super luxury towers.

“Prospective Purchasers are advised that until move-ins are finished and construction work…on the Residential Section and the Building overall is completed, certain of the services anticipated to be provided…as part of the normal operation…and certain of the Residential Common Elements may not be available in whole or in part. For example, and without limitation: (i) during periods of time in which move-ins are occurring in other Residential Units certain passenger and/or service elevators may be taken out of service and dedicated to such uses; (ii) …construction in general is a complicated process which requires the coordination of numerous concurrent tasks, contractors and suppliers and the balancing of complex mechanical and architectural systems, all of which is subject to unanticipated delays and difficulties and necessarily involves disruption and inconvenience… all such dates and timetables, to the extent provided, being only good faith estimates.

Why is this warning important to the advisor? The client may expect to find everything just right the day of the move in. If the client is buying for investment and plans to rent the unit as soon as possible after closing of title, prospective tenants may not want to move into a construction zone. The client decides if he wants to buy, but the client cannot make an informed decision unless the client’s advisor provides the necessary information.
Estate and Gift Taxes

Much of the tax planning for foreigners relates to estate taxes. Foreigners are subject to Federal estate taxes on all United States situs assets on the date of death fair market value. U.S. situs assets include real estate, shares in U.S. companies, whether public or private (including shares in a co-op apartment), and tangible property such as works of art located in the United States. Also real property and tangible property, but not shares of stock, are subject to state estate taxes.

The estate tax is based on the date of death fair market value. Unlike the exclusion amount for U.S. taxpayer, which is adjusted for inflation, there is no adjustment for inflation when determining the date of death fair market value. Even if the fair market value at date of death is less than the purchase price, there is an estate tax on the date of death value.

Some practitioners believe that limited partnership interests are not U.S. situs assets for estate tax purposes. The issue of the situs of partnership interests is not clear. It would not be prudent to assume that a partnership interest in a foreign or domestic partnership owning U.S. real estate is not a U.S. situs asset. If estate taxes are of concern, the corporate structure or the use of an irrevocable trust (discussed below) should be considered.

U.S. estate taxes are very high. For American taxpayers the estate tax exclusion amount is $5,450,000 for 2016 with annual adjustments for inflation. The maximum estate tax rate is 40%. There is an unlimited marital deduction for property passing to a U.S. citizen spouse.

NRAs are subject to U.S. estate taxes at the same rates as American taxpayers, but have only a $13,000 unified credit against the federal estate tax, which translates to an exemption of only $60,000. The maximum estate tax rate is 40% on the amount in excess $1,000,000.

An NRA is not entitled to the unlimited marital deduction unless the surviving spouse is an American citizen or the U.S. situs assets are left in a Qualified Domestic Trust (QDOT) for the benefit of the NRA spouse.

An NRA is allowed a marital deduction for property passing to a surviving spouse in a QDOT but the QDOT does not avoid the estate tax. The QDOT defers the estate tax until the death of the surviving spouse or earlier in some circumstances. A QDOT must meet several conditions, including:

- The trust must have at least one U.S. individual or corporate trustee.
- The income must be distributed solely to the surviving spouse.
- There must be an irrevocable election on the estate tax return to treat the Trust as a QDOT.
- The trust assets must be subject to estate tax on the death of the surviving spouse.

Therefore, all real estate investments by NRAs may be subject to very high estate taxes if title is taken in individual or joint name. The advisor must tell the NRA that the estate tax is based on the date of death fair market value, without adjustment for inflation. Furthermore, the
advisor must tell the NRA that there is an estate tax even if the property is worth less than its original cost.

Structures that Avoid the Estate Tax Are Not Always the Best Structures

The question then arises: why not structure every real estate investment in order to avoid estate taxes? The answer is that avoiding estate taxes may not be the prime concern for every client, and the cost of the structure in terms of higher taxes on rental income and higher taxes on sale may cause the client to opt for personal ownership. What is important is that the advisor makes sure that the client has all the information about the options and attendant costs before deciding on a structure that avoids the estate tax. Changing title to real estate after purchase can be expensive.

There are situations where personal ownership may be preferable. For example, if a foreigner is coming to work in the United States and is planning to purchase a home, corporate ownership would not be desirable. If he owns the property in personal name he will be able to take a tax deduction for real estate taxes and mortgage interest. In addition, when the property is sold, the seller may be able to claim that the home is a principal residence and exclude $500,000 of the gain from tax if married, or $250,000 if the owner is single.

If the foreigner is buying an apartment for a child attending college or graduate school in the United States or working in the United States, it may make more sense to take title in the child’s name. When the child finishes school or his employment, the property could be sold at the lowest possible capital gains tax rate, and the child could possibly claim the exclusion for sale of a principal residence.

Some NRAs are leery of personal ownership because of the risk of lawsuits against them individually and the possibility of a judgment enforceable against their property. If an NRA is willing to take title in personal name but wants some protection against liability, title can be taken in the name of a limited liability company (“LLC”). Taking title in the name of an LLC does not change the income and estate tax rules for individual ownership.

All owners, whether individuals or corporations, should have both property and third party liability insurance coverage.

If an NRA owns a life insurance policy issued by an American company, the proceeds payable on the property owner’s death to a spouse or child are generally not taxable. Thus, life insurance may offer a possible solution to the estate tax problem.

Community property rights may result in substantial saving on estate taxes. The general U.S. rule provides that, with respect to property jointly owned by husband and wife, only one half the value is included in the estate of the first to die. The situation is different if the surviving spouse is not a U.S. citizen. In that case, the entire date of death value is included in the estate of the first to die, subject to proving the amount of contribution by each spouse.

Notwithstanding the contribution rule, if the matrimonial regime of the country of domicile recognizes community property it may be possible to exclude one half the value. If community property rules apply, then at death only one half of the property can properly be deemed owned by the decedent, and one half would be deemed owned by the surviving spouse.
If the surviving spouse is a U.S. citizen there is no estate tax as there is a full marital
deduction for property passing to a U.S. citizen. In addition, the property would receive a step
up in basis to the date of death fair market value.

Gift Taxes

Just as there is no estate tax on property passing to a U.S. citizen spouse there is no gift
tax on gifts to a U.S. citizen spouse. Unlike the estate tax rules, which subject all U.S. situs
property to estate taxes, not all U.S. situs property is subject to the gift tax. Intangible property,
which in the case of real estate investments would be shares of stock in American corporations
(including co-ops) or interests in limited liability companies, is not subject to the gift tax. Thus,
a gift by an NRA of real property is subject to gift tax, but the gift of shares of a U.S.
corporation that owns real estate is not subject to the gift tax.

The gift tax rates, like the estate tax rates, are the same for NRAs and American
taxpayers, but the NRA does not get the $13,000 estate tax credit for gifts. A foreigner who
comes to the United States for a limited time, may become a U.S. tax resident for income tax
purposes but retain his foreign domicile. Since the gift tax rules for intangible property apply
only to U.S. citizens and those non-citizens who are U.S. domiciliaries, a NRA who is resident
for income tax purposes may be able to make tax-free gifts while living and working in the
United States.

An American taxpayer who receives gifts from an NRA aggregating more than
$100,000 in any one year must report the gifts on Form 3520. This form must be filed even if
no gift tax is payable because the gift is an intangible or because the donee spouse is an
American citizen.

Structures that Avoid Estate Taxes

There are several structures that will avoid the estate tax:

- The property can be held in the name of a foreign corporation, which typically
  will be formed in an offshore jurisdiction.
- The property can be held in an irrevocable trust or a trust whose assets would
  not be included in the settlor's gross estate for U.S. estate tax purposes.
- Title can be taken in a two-tier structure with the property in the name of an
  American company (A “U.S. real property holding corporation”) whose shares
  are held by an offshore company.

While the above structures should avoid the estate tax, the typical corporate structure
results in higher taxes on sale, on rental income, and in New York and some other states the
obligation to pay franchise taxes, which are discussed below.

If a corporate structure is chosen, it is essential that the corporation be operated as a
corporation. For example, the company should have its own bank account to pay its bills and to
receive rental income. If the corporate formalities are not properly observed, the IRS might
take the position that the corporation is a sham, and that in the event of death the real property
should be included in the beneficial owner’s U.S. estate.
Taxes on Sale of Real Estate or Sale of Shares of a Real Property Holding Company

The advisor must explain to the client not only the risk of estate tax, but also the costs and possible negatives from the corporate structures that avoid the estate tax. One negative of the corporate structure is the possibility of significantly higher taxes on sale. If real property, shares of a co-op or shares of a real property holding corporation are held individually, jointly, or in a partnership for more than a year, the gain on sale is taxed at the long-term Federal capital gains tax rate of 20%. The personal capital gains tax rate is significantly lower than the corporate rates.

There is no special corporate capital gains tax rate. If property or shares are held in corporate name, the corporate tax rate on the gain may be much higher than the individual long-term capital gains tax rate. A corporation pays tax on any gain at the ordinary graduated corporate tax rates. In New York, there are also State and City corporate taxes to be paid. There is no New York City capital gains tax on sales by individual nonresidents of New York City.

The following example will show the disparity between corporate and personal tax rates. Assume a Manhattan condominium that was never rented is sold after being held for at least one year for a net gain of $1,000,000. If the property were owned in sole name or joint personal name the total taxes would be $240,000 for the combined Federal and New York State taxes. There is no New York City tax on sale by individual sellers.

If a corporation (whether domestic or foreign) owned the property, the total Federal, New York State and New York City taxes would be approximately $450,000.

In addition to the higher taxes, the corporate owner will have been paying annual franchise taxes (discussed in the next section).

When a corporation sells all of its real property interests, the corporation ceases to be a real property holding corporation. The corporation can then be dissolved and there should be no tax on the liquidating distributions. It is almost always preferable to have only one property for one owning corporation. If more than one property is held by one company there could be adverse tax consequences when some, but not all the properties are sold.

The corporation will pay tax on the net gain from the sale of the property, but the distribution of the net sales proceeds to the foreign parent corporation might be subject to withholding tax if the owner is a domestic company or the branch profits tax if the owner is a foreign corporation. If the company only owns one property after payment of the tax on the sale, there is no further withholding tax on the liquidating distribution.

New York Franchise Taxes

Another negative of corporate ownership, especially in New York, is the franchise tax that all corporations (domestic or foreign) have to pay, whether or not the property is rented. New York State and New York City impose a franchise tax for “employing” capital in the State and City. Franchise taxes are typically assessed on the current fair market value of the
property. The amount subject to the franchise tax is reduced by the amount of any mortgage on the property or unsecured indebtedness of the owner. Franchise taxes are also payable if a corporation owns shares in a co-op.

These franchise taxes should be paid because they are a lien on the property, and will be raised as an exception to title on the title report when the property is sold.

The New York State franchise tax rate for property within the Metropolitan Area is; approximately $1,600 per $1,000,000 of value. The franchise tax is being reduced every year and is being phased out over five years.

The New York City franchise tax rate is: .0015 (.15%). Effective in 2007 this tax rate applies only if the gross rent exceeds $250,000 a year. If the property is not rented or the gross annual rent is less than $250,000 the franchise tax is less than $200 a year.

Many clients, who have not been properly advised will, when questioned about franchise taxes, state that they have been paying their taxes every year. They have been paying taxes: real estate taxes. The local tax authorities send real estate tax bills. No one sends out franchise tax bills. The franchise tax is easily forgotten. If it is not timely paid the corporate taxpayer must pay interest and possibly penalties.

Sale of Shares of a Foreign Corporation Owning U.S. Real Property

Shares of a foreign corporation are not U.S. situs property. Therefore, the sale by a foreigner of shares of a foreign company is not subject to U.S. tax. Sometimes it is possible to sell the shares of the offshore company, which is either the direct owner of the property or the owner of the U.S. real property holding corporation. The sale of shares of a foreign corporation frequently occurs in resort communities such as Aspen or Vail where NRAs own vacation properties. The transaction is not a sale of real property, but a sale of shares pursuant to a stock purchase agreement.

While the sale by an NRA of the shares of an offshore company is not subject to tax or the withholding tax requirements of the Foreign Investment in Real Property Tax Act (FIRPTA) discussed below, the buyer will want to discount the price of the shares from the fair market value of the underlying property to reflect the adjusted cost basis of the property. The price for the shares of the offshore company has to be discounted because the buyer is inheriting the historic cost basis of the property, and the next sale may be of the property itself. The sale of the property would generate a tax at the corporate level based on the difference between the cost basis of the property and the net sales price.

Rental Income

In all cases of rental income, the NRA owner (whether an individual or a corporation) would want to be taxed on a net income basis because the rent is either effectively connected income with a U.S. trade or business or the owner makes a net election to be taxed on net income. This status permits the owner to deduct maintenance, real estate taxes, operating expenses, and depreciation, which cannot be deducted if the rental income is taxed at 30% of the gross rents.
A major negative of corporate ownership is the possibility of a second tax on the payment of dividends by a domestic company or the branch profits tax on a foreign corporation.

If the property is rental property, any distribution by way of dividends, to the extent that company has earning and profits, may be subject to a 30% withholding tax, unless a lower treaty rate applies. Many foreigners from a treaty country do not want to take advantage of their treaty and use a tax haven company either to own their real estate or as the parent corporation of the U.S. real property holding corporation.

If the owning corporation is a foreign corporation, the company may be subject to the branch profits tax, which is essentially equivalent to the 30% withholding tax, when funds are remitted abroad or not appropriately reinvested in the company’s U.S. operations. As discussed above, when a corporation sells all its real estate and pays tax on the gain, any distribution in liquidation should not be subject to withholding tax.

Rental property held in personal name is not subject to withholding tax. The owner or owners can do whatever they wish with the free cash flow and remit the money to a foreign account at any time.

**Portfolio Interest**

One way to take money out of a corporation is for the corporation to borrow money from an unrelated person or entity and have the interest on the loan qualify as portfolio interest. Interest on a portfolio interest loan is not subject to withholding tax.

**Restructuring Ownership**

Clients frequently come to their advisor long after acquiring real estate in individual or joint name or in corporate name. They will have heard about the estate tax and want to do something about it or have heard about the higher corporate tax rates and want to transfer title to individual name. There are strategies to rearrange ownership that may reduce or avoid estate taxes. Below are some examples.

**Case 1: Sell the Property**

The client is 65 years old. She purchased the property several years ago for $400,000. There is a $250,000 mortgage on the property. The current fair market value is $750,000. If the owner dies the property will be subject to a Federal estate tax of approximately $235,000, on the entire date of death fair market value. There is no adjustment for inflation, and at best only a partial deduction for the mortgage. If the estate wants to deduct the mortgage the estate must disclose the decedent’s worldwide assets. Even then only a percentage of the mortgage debt is deductible. The amount of the mortgage deduction is the percentage that the decedent’s U.S. assets bear to the decedent’s worldwide assets. Generally the heirs of a deceased foreigner do not want to disclose the decedent’s worldwide assets in the Federal estate tax return.

If the property were sold rather than held until death the Federal long-term capital gains tax would be approximately $70,000 at the rate of 20% of the net gain, far less than the estate tax. The preferred solution may be the simplest. To avoid the estate tax, sell the property.
Case 2: Sell the Co-op Shares

The NRA owns a co-op apartment. The shares are subject to estate tax. If she sells the apartment and pays tax at the personal capital gains tax rate of 20%, she can buy a condominium using a corporate structure. She will pay a tax on the gain and a higher tax when the corporation sells, but the structure avoids estate tax.

Case 3: Gift of Co-op Shares

An NRA owns shares in a co-op. If the co-op board consents, the shares can be gifted to the owner’s children without paying a gift tax. The family would continue to occupy the apartment, but the risk of estate tax has been passed to a younger generation.

Case 4: Gift of One Half Interest in a House to U.S. Citizen Spouse

An NRA wife is joint owner with her U.S. citizen husband of a condominium in Aspen valued at $1,000,000. If the wife dies first there is no estate tax on property passing to a U.S. citizen. If the husband dies first he will be entitled to the then current exclusion amount, and there may be little or no estate tax. The couple might decide that it would be simpler if the husband owned the entire property. If the wife gifts her half interest there would be no gift tax. The husband could then take advantage of his exclusion amount to make a gift to their children or create a qualified personal residence trust.

Case 5: Transfer the Property to a U.S. Corporation

The NRA owns property in individual name. The NRA can transfer the real property to a domestic corporation in a tax-free transfer under Internal Revenue Code Section 351. This alone will not avoid the estate tax as the shares of the domestic company are U.S. situs property and subject to estate tax. The owner can, however, make a gift of the shares to a younger member of the family or to a trust whose assets would not be deemed to be part of the transferor’s estate.

Case 6: Transfer the Property to a Foreign Corporation under Internal Revenue Code Section 897(i)

It is also possible to transfer the condominium to a foreign corporation incorporated in a country with which the United States has a tax treaty that allows the foreign corporation to elect under Internal Revenue Code Section 897(i) to be taxed as an American corporation. This transfer to the foreign corporation is not taxable. The result is that the foreign corporation is treated as an American company for all purposes other than for estate taxes. The sale of the shares of the foreign corporation would be taxable but in the event of death the shares are considered foreign situs assets, and not subject to estate tax.

Case 7: Redomicile the Foreign Corporation

Delaware has a very simple redomiciliation statute. A foreign company incorporated in, for example, the British Virgin Islands, can be redomiciled to Delaware. The shares of the Delaware company will be subject to estate tax, but as in Case 5 above the shares can be gifted to a younger generation, without a gift tax. If all the persons receiving the gifted shares are
American taxpayers there may be additional tax strategies that would reduce the gain when the company sells the property.

**Case 8: Sell the Property and Reinvest the Proceeds Using a 1031 Tax Deferred Exchange**

Section 1031 of the Internal Revenue Code allows an owner of “investment property” to sell such property, purchase another “investment property”, and defer tax on the gain from the sale. This allows the owner to leverage 100% of the sales proceeds into more expensive real estate, diversify his assets, or consolidate his investments into one property.

The transaction must be completed within 180 days from the date of the closing of sale on the property sold. The property to be acquired must be identified within 45 days from the date of the closing on the property sold. A 1031 transaction must comply with many technical requirements to qualify for tax free status, including the requirement that the funds for the purchase and the proceeds of sale be held and disbursed by an independent third party “qualified intermediary.”

A foreigner cannot sell U.S. investment property and purchase investment property in another country. The proceeds from the sale can only be invested in U.S. situs property.

A client considering a 1031 transaction must consult with counsel before deciding to buy or sell, and throughout the transaction period, as failure to comply with the rules will result in a taxable transaction.

**Passive Investment in a Real Estate Limited Partnership**

An NRA who invests as a limited partner in a U.S. real estate investment partnership may have to invest through a U.S. corporation. For example, take the case of a U.S. limited partnership that is planning to acquire a rental apartment complex in Florida, and renovate and upgrade the property with the goal of selling the project in three years.

Typically the U.S. investment property will be acquired by a domestic limited liability company or limited partnership. The limited partnership interests would be sold through a privately circulated offering memorandum and subscription documents. Generally, the NRA will have to invest through a two tier corporate structure through an irrevocable trust. The investment would be made by a domestic company all of whose shares would be owned by an offshore company.

Because the U.S. entity that owns and operates the property is a partnership, the partnership would be required to withhold estimated taxes from any net profits allocated to a foreign partner. The withholding must be at the highest tax rate applicable to the foreign partner, whether an individual or a corporation. The U.S. partnership may not want to make withholding tax payments to the IRS as such payments could affect the partnership cash flow. If the LLC or limited partnership has cash flow problems, the foreign partner might be required to reimburse the LLC for any amounts paid to the government.

If the NRA invests in the U.S. partnership through a domestic corporation there will be no withholding on distributions to partners. The U.S. corporation will be required to pay tax on
its share of the partnership profits whether or not distributed.

If the domestic company declares a dividend to its foreign parent, to the extent there are earnings and profits, there will be a 30% withholding tax, unless a lower treaty rate applies. If the NRA investor does not need the cash thrown off by the partnership, the investor should let the income accumulate inside the domestic company until the partnership has sold all its property.

When the investment partnership sells the project and makes a final distribution to its partners, the U.S. corporation will no longer be a U.S. real property holding company. Therefore, after the U.S. corporation pays tax on the final partnership distribution, the U.S. company can be liquidated. The liquidating distribution to the foreign parent company should not be subject to withholding tax as might be the case with a dividend when the domestic corporation owns a U.S. real property interest.

The Use of Trusts For Real Estate Investments

The Revocable Trust

Many NRAs are familiar with trusts to hold investment assets. Typically an offshore company will hold an investment portfolio and the shares of the offshore company would be held by an offshore trust.

Most NRAs who establish trusts create revocable trusts that are treated as grantor trusts for U.S. tax purposes. A revocable trust that directly owns real estate does not protect against the estate tax. Similarly, a revocable trust that holds shares of a domestic company would not avoid estate tax as the grantor is deemed to own the assets held by the trust, in this case the shares of the U.S. company.

In order to make maximum use of the trust as part of overall estate planning and to avoid estate taxes, the NRA would take title to the real estate in the name of an offshore corporation or elect a two-tier structure, in which the real estate would be held by a domestic corporation whose shares would be owned by an offshore corporation. The shares of the offshore corporation, whether as the direct owner or as the parent corporation would be held by the trustee as the trust assets.

An NRA should not use an offshore company that holds an investment portfolio to hold real estate. As a general matter one company should own one property.

The Irrevocable Trust

An irrevocable trust may be used to avoid the estate tax. If the trust is properly structured, on the settlor’s death there should be no estate tax and no estate proceedings. The trust may have to be established in a jurisdiction that allows for a self-settled trust to be beyond the reach of the settlor’s creditors. If title is taken in the name of an irrevocable trust, no company is required but it may be prudent to take title in the name of an LLC that is owned by the trust. The LLC would be the owner of record, but would be disregarded for tax purposes.

Care is needed in drafting an irrevocable trust to own real estate to ensure that it
qualifies as a nongrantor trust for U.S. estate tax purposes and that on the death of the settler the trust assets are not included in the settlor’s estate. Therefore, the power of the settlor has to be limited, and there may be a need to limit his use of the property.

A trust is taxed at personal rates, so a sale of the real estate by a trust will be subject to the 20% Federal long-term capital gains tax rate. Neither payment by the trust of real estate taxes, maintenance expenses, nor the use of the trust property by the beneficiaries creates income or gift tax obligations.

Consider the case of parents who want to purchase an apartment for their son and daughter-in-law, and assume that corporate ownership is not an option. If title is in the name of an irrevocable trust, the son and daughter-in-law can be named beneficiaries and can occupy the apartment without adverse tax consequences. The trust can pay the operating expenses and real estate taxes, which in effect is a non-taxable gift to the occupants. When the apartment is sold, the sale will be taxed at personal tax rates.

The 2010 HIRE Act provides that the use of U.S. property owned by a nongrantor trust may be considered a “distribution” to the U.S tax payer. Whether this distribution represents taxable income may depend in part on whether the trust has income. A full discussion of these provisions is beyond the scope of this article, but advisors should be aware of this issue when there are American beneficiaries.

The Foreign Investment in Real Property Tax Act

When a foreign individual or a foreign corporation sells a U.S real property interest, whether shares of stock in a real property holding corporation or the property itself, the sale is subject to the Foreign Investment In Real Property Tax Act (“FIRPTA”).

In 1980 the U.S. Congress enacted the FIRPTA. The purpose of FIRPTA was to tax all sales of real estate by foreigners. Before the enactment of FIRPTA it was sometimes possible for foreigners to avoid income tax on the sale of U.S. real estate, even on the sale of rental property. After FIRPTA was enacted, with very limited exceptions, any foreigner, whether an individual or a corporation, selling real estate or shares in a real property holding corporation is subject to tax at the same rates as American taxpayers. FIRPTA is designed to be a means to collect the tax. All FIRPTA payments are payments on account of any tax due.

FIRPTA established a mechanism to ensure the collection of the income tax. There are two options. Within twenty days of date of sale the buyer can remit 15% of the gross contract price to the IRS. If this 15% amount is more than the tax due, the foreign seller can apply for a refund when he files his income tax return. If the FIRPTA payment is less than the tax due, the balance is paid when the seller files his tax return.

If the tax would be less than 15% of the gross sales price, the second option is for the seller, up to and including the closing date, to file with the IRS an Application for a Withholding Certificate requesting that the IRS issue a determination of the amount (if any) of tax due. If the determination is not received by the sale date, 15% of the gross contract price must be held in escrow by either the seller’s or buyer’s attorney or the title escrow agent until the IRS issues its determination. Once the IRS issues its determination, the person holding the escrowed funds is required to send the amount of the tax to the IRS and to release the balance
to the foreign seller.

For purposes of determining the amount of tax when applying for a withholding certificate, the tax is calculated at the highest personal or corporate rate without certain deductions that can be taken when the tax return is filed.

Notwithstanding any FIRPTA payments, the foreign client is required to file an income tax return. Many foreigners believe that the 15% FIRPTA payment is the total tax payable. This is not correct. All FIRPTA payments are on account of the income tax. A tax return is still required even if no tax is due because of a prior FIRPTA payment. If property is sold at a loss, an income tax return still must be filed.

Each sale of U.S. real estate by a foreigner is different. The best way to comply with FIRPTA can only be decided on a case-to-case basis after review of all the facts.

Some states impose a “FIRPTA”-like withholding tax and the advisor should check with local counsel.

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