

U.S. Tax Treatment of Foreign Investment in U.S. Real Estate

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Two Tax Regimes May Apply

1. Passive Income (Fixed or Determinable Annual or Periodical, or “**FDAP**”) Taxation
2. Active Income (Effectively Connected Income, or “**ECI**”) Taxation



Passive Income (FDAP)

Passive income (FDAP) from U.S. sources

- 30% tax on “gross income”
- U.S. payor withholds the tax
- Tax rate subject to reduction or tax eliminated by (i) tax treaty or (ii) Code exemption (e.g. portfolio interest)
- Foreign recipient is not required to file a U.S. income tax return

Internal Revenue Code (IRC) §§ 871(a); 1441.



Active Income (ECI)

If engaged in a U.S. trade or business (“**ETB**”), then income effectively connected with that business (ECI) is subject to U.S. income tax. *IRC § 871(b)*.

Foreign recipient must file a U.S. tax return.

Tax is imposed at graduated rates (Nonresident Alien, or “**NRA**”, is eligible for long-term capital gains rates).

Tax is imposed on “net income,” so deductions are available to lower tax liability.

Branch profits tax applies to non-U.S. corporations, subject to a possible tax treaty override.



Rental Income

Passive income (FDAP): Rental Income is subject to 30% withholding on gross income.

- Tax can be harsh
- Example: Lessee pays \$100 rent to owner and lessee pays expenses to third party related to the property of \$100 (real property taxes, insurance)
 - ❖ Gross rental income = \$200
 - ❖ Withholding tax = \$60
 - ❖ Net cash owner gets = \$40 (\$100-60)
 - ❖ Effective tax rate of 60% on \$100



Rental Income

Active Income (ECI): If leasing or other activity in relation to property causes the foreign owner to be engaged in a U.S. trade or business (ETB), then rental income becomes ECI.

- Tax is only on net income
- Example: Lessee pays \$100 rental to owner and lessee pays expenses related to property of \$100
 - ❖ Gross rental income = \$200
 - ❖ Net rental income (before depreciation) = \$100
 - ❖ Maximum tax (assuming no depreciation) = \$35
 - ❖ Effective tax rate = 35%
 - ❖ Foreign owner must file U.S. tax return



Rental Income

When does leasing make a foreign owner ETB?

- Rental of one property to one tenant under a net lease is not ETB. *Rev. Rul. 73-522*.
- Rental to many tenants is ETB. *Pinchot v. CIR*, 113 F.2d 718 (2d Cir. 1940). In this case, taxpayer owned a partial interest in 11 buildings in New York City.
- Election to be ETB: *IRC §§ 871(d), 882 (d)*.
- If rental income is ECI, then foreign owner needs to give Form W-8ECI to lessee to eliminate withholding tax.



IRC §§ 871(d)/882(d) Election

By making an IRC §§ 871(d) or 882(d) “net election,” a foreign person can assure itself ETB status.

A key prerequisite to the election is that the foreign person must have gross income from U.S. real property in the year of election.

Income from U.S. real property for purposes of the net income election does not include:

- Interest on a mortgage,
- Corporate dividends, including REIT dividends.

Once an election is made, it remains in effect (unless revoked with IRS consent) in subsequent years even if there is no income from the properties in those years.



IRC §§ 871(d)/882(d) Problem for Undeveloped Real Estate

A foreign person owning undeveloped U.S. real estate that does not produce income may not make the net election.

A foreign person owning nonproductive U.S. real estate can neither deduct carrying charges nor capitalize them under IRC § 266.

Foreign persons may seek to have some gross receipts in order to make the net election.



Net Operating Losses and the Net Election

Reg. § 1.871-10(c)(2) says that any real property for which a net election is made shall be treated as a capital asset, not as an asset used in a trade or business, for net operating loss purposes.

In PLR 9103010, a widely-held foreign corporation acquired an interest in a partnership that owned and operated real estate in the U.S. The corporation made an election under IRC § 882(d). The IRS held that if the corporation had an operating loss from the partnership, it could offset the loss against other ECI. To the extent such loss was not fully utilized, it could be used in computing the corporation's net operating loss. However, a loss realized on the sale of the property would be a capital loss and not taken into account in calculating a net operating loss.



Foreign Corporations and the Net Election (Rev. Rul. 92-74)

The IRS has ruled that for a foreign corporation:

- The excess of current allowable deductions over income attributable to the U.S. real property subject to the net election may offset net income from other U.S. sources.
- The excess of current allowable deductions over income attributable to U.S. real property subject to net election may be used to offset effectively connected income from U.S. business other than real estate.
- The Ruling specifically noted that IRC § 469 (passive activity losses) did not apply under the facts of the Ruling. IRC § 469 would result in different conclusions for individuals and closely-held corporations.



Passive Loss Rules and the Net Election

Under IRC § 469, the excess of deductions over income attributable to real property subject to the net election will be characterized as a passive loss.

Any loss will be carried forward as a passive loss and not as a net operating loss.



Making the Net Election

The Net Election may be made on an original or amended return.

The taxpayer makes the net election by including a statement with the following information:

- A schedule of U.S. real property in which the taxpayer owns an interest;
- The extent of the taxpayer's interest;
- The location of each item of U.S. real property;
- A description of any substantial improvement.

In the case a partnership, the net election is made at the partner level.

Some of the older U.S. tax treaties permit an annual net election.

See *Reg. § 1.871-10(d)*.



Foreign Corporations and Branch Profits Tax

A foreign corporation that is engaged in a U.S. trade or business is not only subject to U.S. income tax but also a branch profits tax pursuant to IRC § 884.

A foreign corporation is subject to the U.S. branch profits tax if:

- It is a partner in a partnership that is engaged in a U.S. trade or business;
- It realizes gain from the sale of U.S. real property; or
- It owns U.S. real property for which it has made a net election.

See IRC § 875(1), Reg. §§ 1.884-0(a) and 1.884-1(f)(i); Rev. Rul. 85-60; IRC § 897(a); Reg. §§ 1.884-1(f)(1), 2(ii); IRC §§ 863(c) and 887(b).



Branch Profits Tax and Dividend Equivalent Amount

Tax base for the branch profits tax is the dividend equivalent amount (“**DEA**”)

DEA = the corporation’s effectively connected earnings and profits (“**ECEP**”) adjusted downward for increases in U.S. net equity and upward for decreases in U.S. net equity.

Branch profits tax = DEA, as adjusted, times 30%.

Since ECEP is reduced by federal income, the effective top rate of tax for a corporation moves from 35% to 54.5%. (i.e., 35% of 100 + 30% of 65).

Tax rate may be lower as a result of tax treaties. However, most tax treaties permit the U.S. to impose the branch profits tax.

IRC § 884(b)



Planning for Branch Profits Tax

Most foreign corporations avoid the branch profits tax by forming a U.S. subsidiary corporation.

Dividends from a U.S. subsidiary corporation may be subject to withholding tax, but the tax is more manageable. The taxpayer can time the tax liability by timing when the U.S. subsidiary corporation pays dividends.



U.S. Real Property and Estate Tax

A non-resident alien's (NRA's) estate typically is subject to estate tax on U.S. real property and U.S. corporate stock that the NRA owned. The tax treatment of U.S. partnership interests is uncertain. *Reg. §§ 20.2104-1(a) and 20.2105-1(a).*

There is a \$13,000 unified credit that shelters approximately \$60,000 of taxable estate from tax. *IRC §§ 2101 and 2102.*

There are a limited number of estate tax treaties that can change this result.



U.S. Real Property and Gift Tax

An NRA's gift of tangible personal property and real estate that are located in the U.S. is subject to gift tax. *Reg. § 25.2511-3(b)(1)*.

An NRA's gifts of intangible property are not subject to gift tax. *IRC § 2501*.



Sale of U.S. Real Estate

Gain on the sale of U.S. real property:

- Foreign Investment in Real Property Tax Act of 1980 (“**FIRPTA**”), codified as IRC § 897
- Gain from sale of a United States real property interest (a “**USRPI**”) is taxed as if foreign seller is engaged in a trade or business in the United States and the gain is effectively connected with that trade or business.
- Foreign sellers are taxed on gains at the same rate applicable to U.S. sellers.
- Gain can qualify for long-term capital gains treatment.
- Like-kind exchange treatment does not apply unless the seller receives U.S. real property in the exchange. *IRC § 1031(h)(1)*.



Definition of USRPI

(Reg. § 1.897-1)

A USRPI includes land, buildings and other improvements:

- Includes growing crops and timber, mines, oil and gas wells and natural deposits, but once extracted or severed, crops, timbers, ores and minerals 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 a fixed rate of interest (or variable rate such as prime or LIBOR)
- Generally includes interest in a domestic corporation that was a United States real property holding company (a “**USRPHC**”) at any time during the 5-year period preceding the sale.



Withholding Requirement on Sale

Buyer must withhold 10% of amount realized on sale of a USRPI. *IRC § 1445.*

- Problem: Withholding more than required
- Example: A sells real estate with a tax basis of \$900 for \$1,100. Buyer must withhold \$110 (10% of \$1,100) even though gain is only \$200 and tax will be less than withholding.
- Solution: Get exemption or reduced rate certificate by filing Form 8288-B.



Other Withholding Exemptions

- Seller gives buyer a non-foreign affidavit
 - *IRC § 1445(b)(2)*
- If a sale of stock in a corporation, seller gives buyer a certificate that the corporation is not a USRPHC.
 - *IRC § 1445(b)(3)*
- Sale price < \$300,000 and buyer will use for residence.
 - *IRC § 1445 (b)(5)*
- Sale of principal residence to extent of IRC § 121 exclusion if a withholding certificate is obtained.
 - *Reg. § 1.1445-3(b)(5)*



U.S. Real Property Holding Company (USRPHC)

Withholding tax applies on the transfer of stock in a USRPHC. A USRPHC is a domestic corporation where the fair market value of its U.S. real property interests (“**USRPIs**”) equals or exceeds 50% of the fair market value of its real property assets (U.S. and foreign) and assets used in a trade or business.

A corporation is a USRPHC if 50% or more (by value) of its assets are USRPIs at any time within 5 years prior to the stock disposition.

There is an exception to the 5 year taint. A corporation can purge itself of the USRPHC taint if it disposes of all of its USRPIs in taxable transactions.

IRC § 897(c)(2).



USRPHC Exceptions

A U.S. corporation is excepted from USRPHC status if:

1. The stock of the corporation is publicly traded; and
2. The shareholder transferring the stock owns less than 5% of the outstanding shares of the corporation.

IRC § 897(c)(3).



Nonrecognition Provisions

Gain realized by a foreign corporation on distribution of a USRPI is recognized unless (1) distributee would be taxable on a subsequent disposition and (2) distributee's basis not greater than distributor's basis (increased for any gain recognized). *IRC § 897(d)*.

Nonrecognition provisions apply to a disposition of a USRPI only to the extent the interest is exchanged for an interest that would be subject to tax. *IRC § 897(e)*.

IRC § 897(d) and (e) are elaborated on by Treas. Reg. § 1.897-5T and -6T, respectively.



Nonrecognition Provisions

(Reg. § 1.897-6T)

General rule: Nonrecognition provisions apply only to the extent the transfer of a USRPI is for an interest subject to tax and certain filing requirements are met.

Nonrecognition provisions include IRC §§ 332, 351, 354, 361, 721, 1031, 1033 and 1036.

Thus, the transfer of a USRPI for stock in a foreign corporation generally would not be eligible for nonrecognition treatment (even though the foreign corporation has a carryover basis).



Nonrecognition Provisions

(Reg. § 1.897-6T) continued

A merger of two USRPHCs generally would be eligible for nonrecognition treatment, unless interests in the survivor are not USRPIs (e.g., stock in the survivor meets the regularly traded test).

Where a non-USRPHC and a USRPHC are combined, final USRPI percentage and (if the combined entity is not a USRPHC) direction matter.

Regulations provide an exception for foreign-to-foreign exchanges in which (i) subsequent disposition would be taxable, (ii) filing requirements are met, and (iii) the transaction is in a form specifically described in the Regulations.



Withholding and Amount Realized

On sale of a USRPI, the buyer must withhold 10% of the amount realized by the seller.

The amount realized is the sum of:

1. Cash paid; plus
2. Fair market value of property transferred; plus
3. Outstanding amount of any liability assumed by the buyer or to which the USRPI is subject immediately before or after the transfer.

Reg. § 1.1445-1(g)(5).



Obligation to Withhold

Transferees of USRPIs are required to withhold 10% of the amount realized.

If the amount realized is zero, as in the case of a gift, withholding is zero.

If a foreign seller accepts a deferred payment for the entire purchase price, the buyer must still pay 10% of the amount realized.

IRC § 1445; Reg. § 1.1445-1(b)(1), (g)(5).



Withholding Tax Not Final Obligation

The 10% withholding tax is an advance payment of the transferor's final U.S. tax obligation.

The foreign taxpayer must file a U.S. tax return for the year of the sale.

Reg. § 1.1445-1(f)(1); IRC § 897(a).



Withholding: IRC §§ 1441/1445

A USRPHC may choose to satisfy the IRC §§ 1441 and 1445 withholding obligation with respect to USRPHC distributions by either:

- a) Withholding solely under IRC § 1441 on both the IRC §§ 1441 and 1445 portions of the dividend; or
- b) Withholding under IRC § 1441 on the dividend portion and withholding under IRC § 1445 on the non-dividend portion at a reduced rate.

The tax rate on withholding usually cannot be less than 10% unless an applicable treaty specifically provides for a lower rate for USRPHC distributions.



Withholding: IRC §§ 1445/1446 Partnerships

IRC § 1445 imposes withholding tax against all of a partnership's ECI.

IRC §§ 1445 and 1446 overlap.

Reg. § 1.1446-3(c)(2)(i) says that IRC § 1446 supersedes IRC § 1445.

Special rules apply in the case of publicly-traded partnerships.



Withholding: Domestic Trusts/Estates

If a domestic trust or estate disposes of a USRPI, the trustee or executor may be required to withhold.

Withholding obligation arises for a non-grantor trusts and estates on the distribution of cash or property to the beneficiaries.

Fiduciary must maintain a USRPI account and post all gains and losses from USRPI dispositions to the account. Fiduciary must withhold 35% of any distribution to a foreign beneficiary, up to the balance of the USRPI account.

Distributions to U.S. and foreign beneficiaries are treated as coming first from the USRPI account.

The USRPI account is zeroed out at the end of the year.

There is no withholding if the USRPI account is zero at the time of distribution.

Reg. § 1.1445-5(c)(1)(iii)(A).



Alternate Withholding for Large Trusts

A trustee of a trust having more than 100 beneficiaries may elect special withholding rules.

Reg. § 1.1145-5(c)(3)(i).



Disposition of Interests in Entities

Gain from the sale of an interest in a partnership is considered gain subject to IRC § 1446 withholding tax to the extent attributable to USRPIs held by the partnership.

If (1) 50% or more of the value of the partnership's gross assets consists of USRPIs and (2) 90% or more of the value consists of USRPIs, cash and cash equivalents, then the entire interest is a USRPI.

A foreign person that disposes of an interest in a trust or estate that owns a USRPI is not subject to IRC § 1445 withholding unless the interests are traded on an exchange.

IRC § 897(g); Reg. §§ 1.1445-11T(d), 1.1445-11T(b), 1.897-1(c)(2)(iv).



Distributions by a Domestic Corporation

Withholding under IRC § 1445 only applies to domestic corporations distributing property to a shareholder if:

1. The property is distributed to the foreign shareholder;
2. The foreign shareholder's interest in the domestic corporation is a USRPI; and
3. The distribution is pursuant to an IRC § 302 redemption, a liquidation of the domestic corporation, or an IRC § 301 distribution that is not made out of earnings and profits.

The distributed property can be of any type; it does not have to be a USRPI.

IRC § 1445(e)(3); Reg. § 1.1445-5(e)(1)(ii).



Distributions by a Domestic Corporation (continued)

A domestic corporation's stock is a USRPI if the corporation has been a USRPHC during the preceding five years or the shorter period that the shareholder may have held the stock.

Withholding does not apply if the corporation has eliminated its USRPHC status by disposing of all of its USRPIs in fully taxable transactions.

IRC § 1445 (e)(3); Reg. § 1.1445-5(e)(3).



Distributions by a Foreign Corporation

IRC § 1445 withholding applies on a foreign corporation's distribution of a USRPI to its shareholders.

The foreign corporation must withhold a tax equal to 35% of the gain that it realizes.

The domestic or foreign status of the shareholder is irrelevant.

The withholding obligation applies even if the foreign corporation is not a USRPI.

There are exceptions to withholding for non-recognition transfers and situations where withholding certificates are obtained.

IRC § 1445(e)(2); Reg. § 1.1445-5(d)(1).



Withholding Certificates

A withholding certificate can reduce or eliminate an IRC § 1445 withholding obligation.

The IRS designates 6 categories for withholding certificates:

Category 1: application based on a claim of non-recognition treatment or exemption

Category 2: application based on seller's maximum tax liability

Category 3: application based on deferred payment sales or for dispositions described in IRC § 1445(c)

Category 4: application based on a tax payment agreement where the certificate refers to one disposition

Category 5: application based on tax payment agreement, where a seller seeks a blanket withholding exemption.

Category 6: application based on nonstandard situation.

Rev. Proc. 2000-35 section 4.05.



Withholding Certificate Category 1 Application

Based on a claim of non-recognition treatment or exemption, such as for:

- Gifts

- Foreign Government Sellers

- Treaty Exemptions (Note to Omnibus Reconciliation Act of 1980 overrides treaty benefits in general).
 - *Reg. § 1.1445-3(d)(2)(ii).*



Withholding Certificate Category 2 Application

Based on seller's maximum tax liability

Seeks no withholding or reduced withholding on the grounds that there is no gain realized or the maximum amount of tax is less than the withholding.

Maximum tax is defined for purposes of this section.



Withholding Certificate Category 3 Application

Based on deferred payment sales or dispositions described in IRC § 1445(c)

Normally, the purchaser must pay the withholding amount within 20 days of sale.

A withholding certificate allows a purchaser to meet its withholding obligation from each payment made.



Withholding Certificate Categories 4 and 5 Applications

The IRS will issue a withholding certificate for reduced or no withholding if the seller or buyer enters into a qualified agreement to pay the tax at a later date.

The withholding certificate may cover one sale (Category 4) or several sales within a 12-month period (Category 5).

Types of surety: bond, letter of credit, certain guarantees.



Withholding Certificate Category 6 Application

Based on non-standard situations.

Applies to applications for reduced or no withholding not in Categories 1 to 5.



Withholding Certificate Application Mechanics

If a party submits a withholding certificate application before the transfer date, the buyer must still withhold if the certificate is not yet received.

Withholding need not be paid until 20 days after IRS determination.

Except for the blanket withholding certificate, either the buyer or the seller may request the withholding certificate.

Reg. § 1.1445-1(c)(2)(i)(A).



Potential Ownership Structures of U.S. Real Property

1. Individual Ownership
2. Foreign Corporation Ownership
3. Foreign/Domestic Corporation Ownership
4. Trust Ownership



Individual (NRA) Ownership of U.S. Real Property

Capital gain treatment on sale.

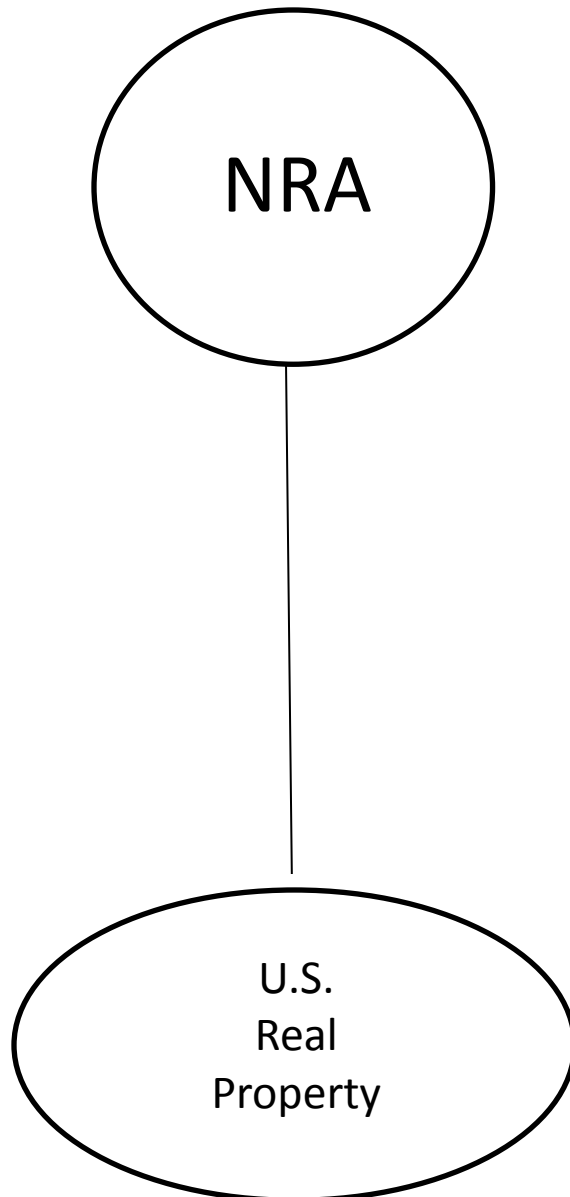
Branch profits tax does not apply.

Individual must pay tax on gross income or file individual income tax return.

Estate tax applies on death.



Individual (NRA) Ownership





Foreign Corporation Ownership of U.S. Real Property

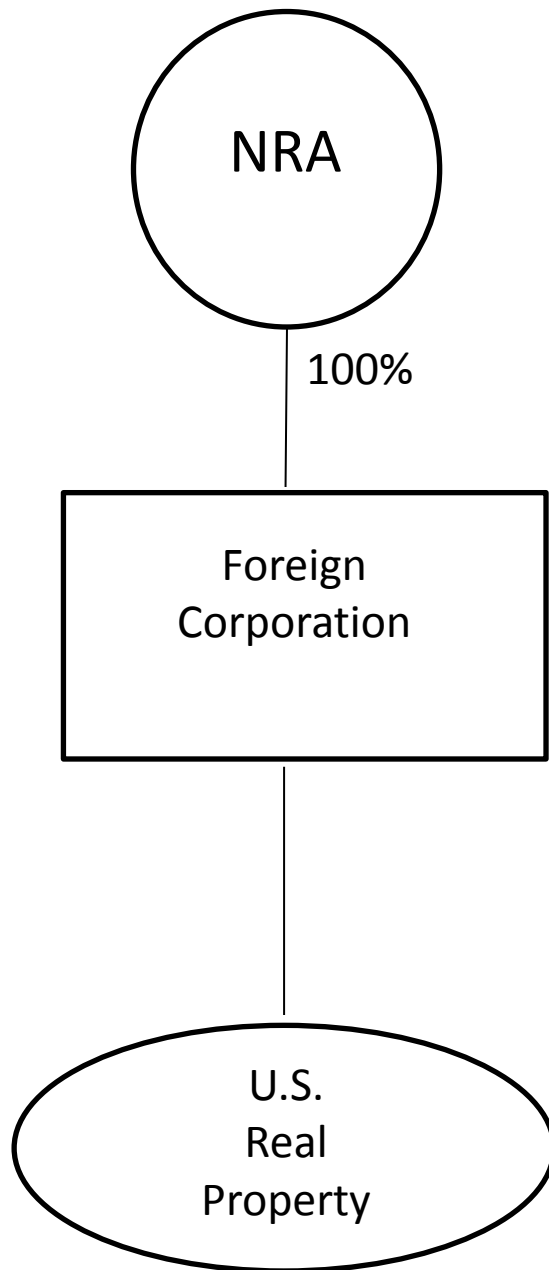
No U.S. estate tax exposure.

Branch profits tax.

No beneficial capital gains tax (in most cases).



Foreign Corporation Ownership





Foreign/Domestic Corporation Ownership of U.S. Real Property

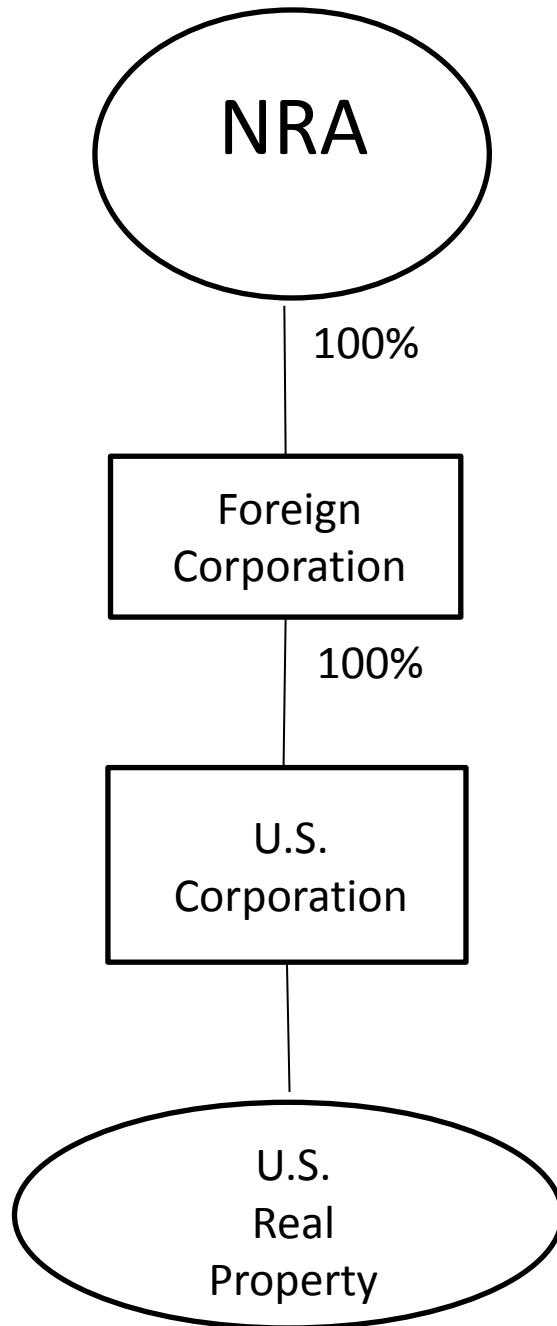
No estate tax exposure.

No branch profits tax.

No beneficial capital gains.



Foreign/Domestic Corporation Ownership





Trust Ownership of U.S. Real Property

Benefit from capital gains rate.

No branch profits tax.

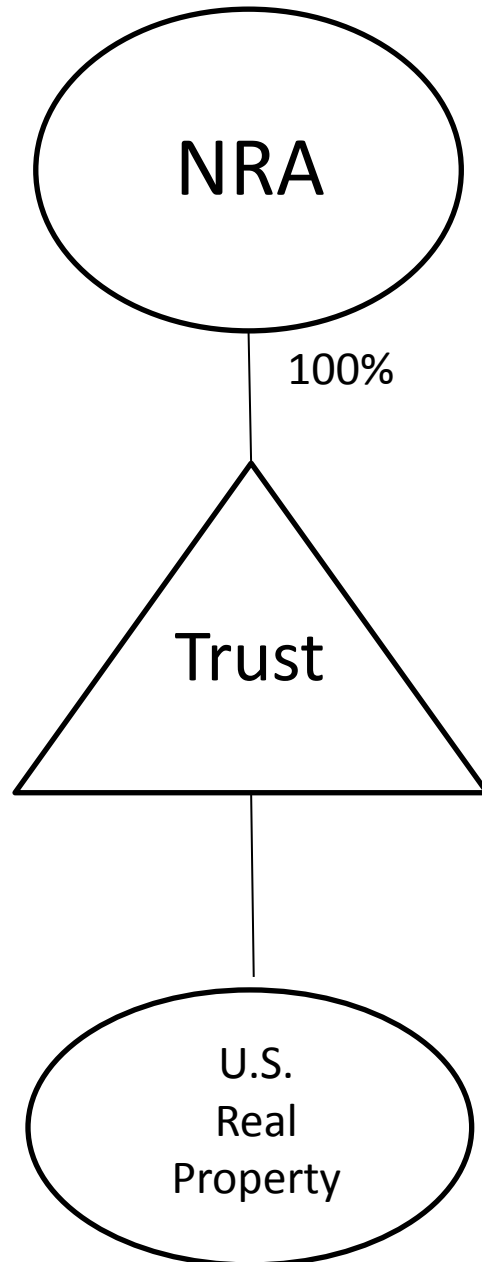
No withholding tax on distribution (if properly structured).

No estate tax exposure.

Difficult for client to understand and administer.



Trust Ownership





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