



What Foreign Persons Need to Know When Investing in U.S. Real Estate

Andrew M. Berger

3111 Stirling Road
Ft. Lauderdale, Florida 33312-6525
Tel: 954.364.6074
Fax: 954.985.4176
aberger@becker-poliakoff.com

For a variety of reasons, including the weakened U.S. dollar and the current economic situation, many foreign investors view U.S. real estate as an extremely attractive investment. However, foreign investors acquiring U.S. real estate will need to navigate a complex web of tax rules that, without proper planning, can result in a heavy and unanticipated tax burden, as well as personal liability exposure.

In particular, foreign investors need to understand the following issues:

- **Who is a Resident Alien**

Foreign investors who spend considerable time in the U.S. are often surprised to learn how easily they can become resident aliens and therefore subject to U.S. tax on their worldwide income. In order to avoid resident alien status, which is determined under what is known as the “substantial presence test,” foreign investors must carefully monitor the number of days they spend in the U.S. and properly document such time spent in a written diary or calendar.

- **The Tax Regime Applicable to Nonresident Aliens**

The U.S. tax system taxes foreign investors investing in the U.S. under one of two possible tax regimes:

(1) If the investor is engaged in a U.S. “trade or business,” any income that is “effectively connected” with such trade or business will be taxed on a net basis at the regular graduated tax rates applicable to a U.S. citizen or resident (the “trade or business tax”); or

(2) If the U.S. activity of the investor does not rise to the level of a U.S. trade or business, any passive U.S. source income paid to that foreign investor generally will be subject to a 30% tax on the gross amount of such income (the “passive income tax”). The passive income tax is generally paralleled by a withholding obligation imposed on the U.S. payor.

Generally, the ownership of real estate is not considered a trade or business if it consists of merely passive activity such as a net lease. In such situations, the gross income is subject to a 30% withholding tax (unless a lower treaty rate applies) and no deductions from gross income are allowed. However, an election is available to treat the income as effectively connected to a trade or business, thus avoiding withholding tax from being imposed on the rental income. If the election is made, the owner may deduct all expenses associated with the property in determining his or her taxable income, which is then taxed at progressive rates.

- **The Branch Profits Tax**

The branch profits tax generally imposes a 30% tax on the after-tax business income of foreign corporations engaged in a U.S. trade or business and operates as if “phantom dividends” were distributed to shareholders. Foreigners who acquire U.S. real estate through a foreign corporation need to be mindful of this tax, which is a major trap for the unwary that, fortunately, can be avoided through proper planning.

- **The Estate and Gift Tax Ramifications of U.S. Investments**

The potential impact of the U.S. estate tax should not be overlooked when foreign individuals invest in U.S. real estate. In addition to the high estate tax rate, several exemptions and deductions available to a U.S. domiciliary are either not available or severely limited to a non-U.S. domiciliary. Avoidance of the U.S. estate and gift tax through the use of certain acquisition structures should, therefore, be a primary consideration in structuring any investment in U.S. real property.

- **The Foreign Investment in Real Property Tax**

Act of 1980 (“FIRPTA”). FIRPTA imposes an income tax on the gains made by foreign persons upon a disposition of real property situated in the U.S. Collection of this tax is ensured through a withholding mechanism under which the transferee of any U.S. property purchased from a foreign person must withhold 10% of the purchase price at closing and remit it to the IRS within 20 days, instead of paying the full amount to the foreign seller. Because the transferee is required to deduct and withhold 10% of the purchase price on the transfer and not simply the gain, even a sale at a loss potentially triggers withholding responsibilities. Certain exceptions and ways to eliminate or reduce this withholding tax may be available and should be carefully scrutinized.

Fortunately, a number of planning opportunities, including the use of trusts and certain entity structures, are available for foreign investors that can be used to minimize the U.S. income and estate taxes, while providing asset protection. Unfortunately, many foreign investors fail to take advantage these planning opportunities and often make the mistake of acquiring

U.S. real estate in their individual names. While individual direct ownership is simple and involves the least initial expense, this ownership structure has several disadvantages that typically outweigh its benefits. Such disadvantages include:

- Lack of limited liability protection afforded by entity structures, which prevent judgment creditors from reaching your personal assets.
- U.S. estate and gift tax exposure, which can lead to a very significant tax bill at death or on making a gift.
- The investor’s presence in the U.S. will be known in that the investor will not have the cloak of anonymity that many foreign investors prefer.
- The investor will have to file annual income tax returns with respect to income-producing property. Even if the property does not produce income, an ultimate sale of the property will necessitate the need to file a tax return. This factor may discourage many foreign investors due to the complexity of the filing, the fear of possible added tax burdens, and the concern that U.S. tax authorities may be too invasive in their inquiries into private matters.

I would welcome the opportunity to discuss ways you may be able to structure your real estate investment to minimize U.S. income and wealth transfer taxes, while protecting your personal assets from the claims of creditors. If you would like to schedule a complimentary consultation, please contact my assistant, Tina Fritz, at (954)364-6074 or tfritz@becker-poliakoff.com, and she will arrange a mutually convenient date and time for the consultation. ■

Andrew Berger is a tax and estate planning attorney with Becker & Poliakoff, P.A. He received his LL.M. in Taxation from New York University School of Law, his J.D. from Fordham University School of Law, and his B.A. from Emory University. He is admitted to practice law in Florida, New York and New Jersey. He may be contacted by email at aberger@becker-poliakoff.com

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