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Proper Planning is Key to Minimizing Tax Exposure For Foreigners Investing in U.S. Real Estate

By: Andrew Berger, Attorney at Law,
Corporate, Tax & Securities Law Group

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, absent proper planning, U.S. real estate purchased by a foreign investor could create significant U.S. federal income and estate and gift tax exposure that might otherwise be avoidable, thereby potentially costing the foreign investor millions of dollars more than anticipated.

In particular, before any decisions are made to invest in U.S. real estate, the following issues need to be understood:

- **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.[1]

Understanding the differences between these tax regimes and when each applies is critical to properly structuring any investment in U.S. real property.

- **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**. With a maximum current rate of 45%, 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.

[1] Applicable tax treaties can reduce or eliminate this tax liability.

As seen above, foreign persons investing in U.S. real estate will need to navigate a complex web of tax rules that, without proper planning, can impose a heavy and unanticipated income and estate and gift tax burden on the foreign person. Fortunately, a number of planning opportunities are available for foreign investors that can be used to minimize these taxes.

For additional information on this or any other tax and estate planning issue, please contact Andrew Berger, 954-364-6074 or aberger@becker-poliakoff.com.

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