CONSIDERATIONS FOR FOREIGN BUYERS AND SELLERS OF US PROPERTY

Foreign Buyer Considerations

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- Taxes
- Non-Resident Spouse
- Rental Activity
- Form of Ownership
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Foreign Seller Considerations

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    - FIRPTA
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BUYER CONSIDERATION – DAYS IN UNITED STATES

How many days in the US before subject to US income tax on worldwide income?

183 days per year with three year look back

100%	of 2011	120
One-Third	of 2010	40
One-Sixth	of 2009	20

No more than 120 days per year consistently OR risk exposure to US Income Tax on GLOBAL INCOME

BUYER CONSIDERATION – TAXES

Income Tax (Rental Activity)
Capital Gains Tax
Estate Tax

Typically the largest tax concern that a foreign individual might have would be estate tax consequences. In 2011, the federal estate tax rate is progressive from 26 to 35 percent. NYS estate tax is also progressive and can go as high as 16 percent. U.S. citizen are eligible in 2011 to a $5 million dollar exemption where as a non-resident alien is only eligible to a $60,000 exemption.

It is very common for an individual to be regarded as resident for income tax purposes (based on days physically present in the United States, for example) although still considered non-resident (aka "non-domiciled") for estate and gift tax purposes. The domicile notion is indicative not of physical presence but where one intends one's permanent home to be (i.e., in this case, outside the United States).

It is important to note is that there are less than twenty such Estate and Gift Tax Treaties (unlike the 65 plus Income Tax Treaties) and despite such Treaties, U.S. real estate investments often remain exposed to U.S. estate tax. Tax Treaties may help but require disclosure of worldwide assets.

As if to compound the problem, recourse mortgages on such real estate are also generally not fully deductible against the value of the asset in determining the net taxable estate. Estates of non-residents are allowed a deduction for recourse debts only to the extent of the ratio of U.S. assets to worldwide assets (which, in turn, requires disclosure of worldwide assets to the IRS for such determination). A non-recourse mortgage (one in which the mortgage liability attaches only to the asset) may, if available, avoid this issue of apportionment and be fully offset against the value of the property.

BUYER CONSIDERATION – NON-RESIDENT SPOUSE

Holding real estate jointly with a nonresident spouse can generate further issues. The general rule that property owned jointly with a right of survivorship between spouses will be included at one-half its value in the estate of the first spouse to die does not apply if the surviving spouse of the decedent is not a U.S. citizen.

Instead, the taxable value of such property is includable in the first decedent's estate in full except to the extent the executor can substantiate the contributions of the non-citizen surviving spouse to the acquisition of the property. Thus, jointly owned U.S. situs property will be fully included in the gross estate of a nonresident who provided the funds to acquire the property. Attention should also be paid to the presumptive rules applicable to individual States as to whether jointly held property is deemed to be held jointly versus as tenancy-in-common (absent express indication to the contrary).

There is typically no escape from estate taxation via a transfer between spouses as there is no marital deduction for transfers to a non-U.S. citizen spouse. In fact, these rules apply whether the decedent spouse bequeathing the assets is a foreign national or a U.S. citizen. The rationale for the tax authorities is that, absent these rules, the estate tax deferred assets transferred to a non-U.S. citizen will leave the U.S. tax net, never to be recaptured.

U.S. citizens and residents are eligible for a $1m lifetime exclusion that does not apply to nonresidents. Both residents and non-residents are also limited to an annual exclusion amount of approximately $13,000 on gifts to non-U.S. citizen spouses before tax applies, unlike the unlimited spousal transfer exemption that applies to transfers to U.S. Citizens.

BUYER CONSIDERATION – RENTAL ACTIVITY

How the property will be used (personal use/investment) is important as well. Rental income earned on U.S. real property is subject to different rules depending on how it is owned. Structure and use will have different tax consequences and may be governed by different regulations. Which structure is best can only be based on an individual's unique situation.

Taxpayer is taxed at a flat rate of 30% on gross income (i.e. with no deduction for expenses) unless the amount considered taxable, or the rate of tax, are eligible for reduction by any applicable Income Tax Treaty.

However, provided a **timely** election is made on a U.S. income tax return filing, the Internal Revenue Code permits nonresidents for income taxpayers to elect to treat rental income as **derived from a U.S. trade or business** and, therefore, not subject to flat rate withholding.

The two key points to understand in this context are that, firstly, particular procedures need to be followed in order to avoid the tax withholding, and secondly, - although no less importantly - that only by filing a U.S. tax return may the nonresident taxpayer make the appropriate tax election to be taxed on a net basis.

IRS Treatment Non-Resident Alien of Rental Income
Without Election to Treat Income as Effectively Connected with US Trade or Business

- If a USRPI interest is used by a foreign person or entity for the production of income, IRC section 871 imposes a 30 percent tax rate (or Tax Treaty rate if lower)
- The income is to be treated as, "income not effectively connected with a U.S. trade or business" (Non-ECI)
- Mechanism is used to assure the IRS receives tax due at source since NRAs with just non-ECI generally not required to file US tax returns
- Nonresidents must file Form1040NR nonresident income tax return on a timely basis

IRS Treatment Non-Resident Alien of Rental Income
Without Election to Treat Income as Effectively Connected with US Trade or Business

- The foreign person or entity can make an Election under IRC section 871(d) to treat the real property income as income effectively connected with a U.S. trade or business (ECI)
- This election allows deductions and subjects net amount to tax at graduated tax rates. NRA must file a US tax return
- In addition to the election, the foreign person needs to file W-8ECI with the payor of the income to identify it as ECI to relieve withholding obligation

BUYER CONSIDERATION – FORM OF OWNERSHIP

A foreign investor can use several structures to purchase real property such as:

a. Directly –
    i. Direct investment usually yields the lowest income tax rate, but can subject someone to estate taxes down the road. Direct ownership of U.S. real property by a non-resident alien is probably the least complex structure and has some advantages. A principle advantage is the long term income tax treatment currently at 15 percent.
    ii. Direct exposure to Estate Tax if death while in ownership of property.
    iii. US Dollar denominated term life insurance is likely most efficient risk management of estate tax exposure. More expensive as insured party ages and may not be available.
    iv. Property transfer at some future date, for zero consideration to an entity to limit estate tax exposure if term life insurance is cost prohibitive.
b. Domestic or Foreign Trust -
    i. Many nonresident aliens choose not to invest in real estate through a trust for fear that the trust maybe recharacterized as an "association taxable as a corporation." Trusts can be taxable for both income and estate tax purposes if some measure of ownership is retained by the grantor or they are not properly established.

ii. Domestic Trusts
    1. If a trust is determined to be a U.S. trust, it will be treated as a U.S. resident for federal income tax purposes, and will therefore be subject to the federal income tax on U.S. resident trusts. In addition, it is likely that the trust will be considered a resident of a particular state of the United States, and therefore be subject to that state's income tax as well.
    2. U.S. resident trusts are generally subject to U.S. income tax on their worldwide income, including the tax on capital gains. Trust will receive a distribution deduction for the income payable or paid to the income beneficiary and the income beneficiary rather than the trust will be subject to the tax on that income.
    3. United States persons must exercise control over all major decisions affecting the trust. United States citizens and United States residents qualify as United States persons for purpose of this requirement. Delegation of investment decisions by a trustee to a foreign investment advisor would not cause the trust to fail the "control test" as long as a U.S. person can terminate the investment advisor's power to make investment decisions at will. It is difficult to conceive of any form of limited power of appointment that would not lead to a failure of the "control test."
    4. If the trustees are permitted to accumulate the income and do not pay all income on a current basis, the trust is subject to income tax on the accumulated income as well as capital gains. The key factor to be noted here is that the marginal income tax rates for trusts accelerate faster than those for individual taxpayers.
    5. Whether a U.S. trust is simple (all income must be paid annually) or complex (income may be accumulated), a U.S. trust is subject to the U.S. tax on capital gains regardless of whether the assets sold are domestic or foreign. As with capital gains on which an individual U.S. taxpayer is taxed, the rate of tax depends on the length the asset has been held.

iii. Foreign Trust
    1. Foreign trusts are completely exempt from the U.S. tax on capital gains on **intangible** assets. Even if a foreign trust maintains some form of active presence in the United States for 183 days or more in a given year, which would ordinarily subject a foreign individual to the U.S. tax on capital gains, the foreign trust will not be subject to such tax. Thus, gains on the sale of U.S. stocks as well as bonds and other debt instruments will ordinarily be completely exempt from U.S. tax. **This exemption, however, does not apply to holdings of U.S. real property.**
    2. There is, however, one trap for the unwary foreign person who uses a foreign trust to conduct investments in the United States. This concerns the U.S. estate tax. The fact that the U.S. assets are held by a foreign trust will not immunize the foreign person's

estate from U.S. estate tax on the U.S. assets if the foreign person was the creator of the trust and, at the time of his death, retained certain interests in or authority over the trust. Thus, if a foreign person creates a trust and retains an enforceable right to receive distributions from the trust or to direct the beneficial enjoyment of the trust assets, U.S. estate tax law "looks through" the trust to the foreign grantor. A similar situation develops if the foreign person retains the right to revoke the trust or has more than a de minimis reversionary right in the trust. To avoid this potential exposure to U.S. estate tax, it is important that the trust assets be held by a foreign corporation owned by the trust rather than directly by the trust.

3. One may wonder how the I.R.S. would learn that a foreign person has an interest, through a trust, in U.S. securities when or after the grantor dies, assuming that the grantor has no other assets in the United States that would require the filing of an estate tax return. If the trust continues after the grantor's death, there may be little way for the I.R.S. to find out about the decedent's taxable interest. But if the trust terminates and distributions of U.S. securities are made, the transfer agent may inquire about the circumstances once it becomes obvious that the transfer is part of a distribution and not part of a sale.
4. Irrevocable transfers of property made before a donor becomes a U.S. citizen will not be subject to U.S. gift or estate tax as long as the donor does not retain an interest in or power over the property that would cause it to be treated as if the person were the owner under U.S. transfer tax concepts.

c. Business entity
   i. Property held by (i) NYS LLC owned by foreign holding corporation or (ii) a foreign holding corporation **without** pass through tax status
   ii. Cost of NYS LLC is approx. $1,500 to $2,000 (mostly required publishing fee and filing fees)
   iii. Ownership of real property through a foreign corporation will typically mean that 35 percent of any gain at disposition will be withheld from dispositions of real property.

SELLER CONSIDERATION - SECTION 121 EXEMPTION

Foreign investors looking to purchase real property that will become a future residence should consider direct ownership. Section 121 personal residence gain exclusion rules apply to foreign investors, but additional rules must be met (IRS, 2007). A foreign investor currently must live in the residence 50 percent of the time over the course of the two 12 month periods, which exposes him/her to US income tax. A foreign investor is also limited to home purchases of $300,000 or less.

SELLER CONSIDERATION - SECTION 1031 EXCHANGES

Foreign real property is not eligible for a 1031 exchange with U.S. real property under codes section 1031(h)(1). A foreign investor though is eligible to do a 1031 exchange of like-kind property where both properties are within the United States or the Virgin Islands. The same rules apply to foreign investors as apply to US citizens and resident aliens performing a 1031 exchange.

SELLER CONSIDERATION - FIRPTA

In 1980, the Foreign Investment in Real Property Tax Act (FIRPTA) was passed creating code sections 897, 1445 and 6039C making most foreign investments in U.S. real estate taxable (Levy, 2008). The basic idea of the tax act was that foreigners should pay income tax on U.S. real property interests (USRPI).

1. FIRPTA
    - 10% withholding tax on FULL SALES PRICE on sale of U. S Real Property Interests (USRPIs) sold by income tax nonresident individuals
    - Foreign corporations are subject to 35% tax withholding on distributed gains
    - Forms 8288 & 8288-A record FIRPTA tax withholding
    - Tax is due 20th day from date of closing
    - Penalty of $10,000 for failure to collect and pay tax if buying from NRA
    - Buyer and agent can reasonably rely on Form W-9 residency certification to avoid withholding. Agents acting against direct knowledge is considered unreasonable.
    - Nonresident taxpayer must file tax return to claim credit for tax paid or evidence exemption on tax return.
    - In many cases seller remains nonresident but is unaware as to the need for a Taxpayer Identification Number
    - All parties need ITINS for Withholding Certificate Application to be processed. Seller needs the ITIN to file tax return to evidence any exemption from taxation
    - " ITIN Applied For" on any IRS Forms is now unacceptable
    - Early communication of the need for these numbers is critical
    - Suggest incorporating language into the real estate contract
2. Non-Resident State Tax Issues
    - State non-resident withholding issues (NYS IT-2663 & NYS IT 2664)
    - 8.97% of Capital Gain
    - Applies to Non-NYS Residents
    - Unless Section 121 Exempt / Section 1031 Exempt
3. FIRPTA- When is Withholding Not Required?
    - FIRPTA withholding is required unless:
        - Seller is not a 'foreign person',
        - The seller qualifies for reduced withholding (i.e. qualifies for a "Withholding Certificate") 8288-B
            1. Procedure exists for applying for exemption from withholding requirement

2. Seller is asked if income taxes were filed and paid for the last three years
3. IRS Form 8288-B requiring statement of tax law and facts evidencing tax exclusion
4. Buyer relieved of responsibility, seller's cash flow improved
5. Full disclosure on IRS Forms which may take 90 days to process

- "De Minimis" Exception not required to withhold tax if:
    1. 1) the total purchase price for the property does not exceed $300,000, and
    2. 2) the buyer must has definite (and carried out) plans to reside at the residence for at least 50% of the number of days the property is in use during each of the first two 12-month periods following the date of the sale.

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