# FOREIGN PERSONS BUYING US REAL ESTATE

## QUICK REFERENCE GUIDE

KAUFMAN ROSSIN & CO. PROFESSIONAL ASSOCIATION
CERTIFIED PUBLIC ACCOUNTANTS

# Structuring and Tax Considerations for Foreign Investors Acquiring U.S. Real Estate

The real estate development boon that took place at the latter part of the last decade left South Florida with an inventory surplus, especially in the condominium market. Such an abundance coupled with foreign investors wanting to move money out of their home countries for political or economic reasons, has created a subsequent boon in the South Florida real estate market. According to a study by Florida Realtors, foreign buyers spent $10.71 billion during the year ended June 30, 2012, accounting for 19% of total residential sales volume. Buyers from Latin America and the Caribbean together made up 35% of all foreign purchases of South Florida real estate.

For a foreign investor, seizing the moment and identifying a property is generally the easy part of the acquisition process. Choosing the right structure for the acquisition from a legal, tax and risk standpoint, isn't quite as easy (or enjoyable). As such, the first step in making a decision to buy a United States Real Property Interest (USRPI) is to meet with a U.S. tax professional and/or real estate attorney.

The predominant question tax professionals are asked when meeting with foreigners who are acquiring or have acquired USRPI is "what is the optimal structure for acquiring it?" The answer is always the same: it depends. The structure depends on the foreigner's unique facts and circumstances as every foreign investor is different in terms of needs, goals, and timelines. For instance, a younger individual may be more concerned with limiting his or her income tax liability rather than estate taxes as it relates to the purchase. An older individual may be focusing on estate tax issues and on efficient ways to transfer the property to his or her loved ones. Thus, there is no way to recommend an optimal structure without interviewing the foreigner and considering all the facts and circumstances.

From a U.S. tax perspective, several factors will help determine the optimal structure for acquiring a USRPI. Some of these factors include:

- The amount of the investment
- The purpose for buying the property (e.g., personal usage vs. rental property)
- The expected holding period
- The investor's country of origin
- The investor's budget
- The investor's short-term and long-term needs
- The investor’s goals

In addition to these factors, a foreign investor must weigh several tax considerations that will likely impact the acquisition in one way or another. The following represents three significant U.S. tax considerations that should be addressed when purchasing a USRPI, followed by the most common investment structures used in acquiring a USRPI:

## Three Significant Tax Considerations

**FIRPTA**

The Foreign Investment in Real Property Tax Act of 1980, otherwise known as FIRPTA, was enacted to ensure collection of U.S. withholding tax from foreign investors disposing of a USRPI. It provides that gains derived from the disposition of a USRPI by a foreign person will be deemed to be income effectively connected with a U.S. trade or business. As such, the foreign person transferor of the USRPI will generally be taxed on the transfer.

For 2012 real estate sales, the applicable income tax rate is 15% if the property is owned by an individual or flow-through entity or 35% if owned through a foreign corporate entity. Depending on the individual's income threshold, the 15% rate that applies to individual and pass-through sellers has increased in 2013. The United States collects that tax by requiring a withholding agent, generally the broker, to withhold either 10% of the gross consideration from the sale of the USRPI or 35% of the gains of the sale of the USRPI. The withheld amount is then transmitted to the Internal Revenue Service (IRS) as prepayment of the income tax on behalf of the foreign seller and acts as a credit against the foreign seller's U.S. income tax obligations (if any). It's a major inconvenience when the foreign individual does not have an income tax liability, but in order to comply with FIRPTA, must go through the time-consuming process of submitting several tax forms and waiting to request/process a refund of the overpayment of income tax.

Both the transferor and the transferee must have a U.S. Tax Identification Number (ITIN) for the reduced withholding (or early refund) process to take place. It should be noted that through proper planning, a reduced withholding or an early refund may be obtained upon a timely application to the IRS.

FIRPTA's rules and regulations are onerous, not only from a financial standpoint, but from a compliance standpoint as well. As such, it is in a foreign investor's best interest to choose a structure that is not subject to FIRPTA, if possible.

**U.S. Branch Profits Tax**

Some foreign persons choose to acquire USRPIs through a Foreign Corporation. An adverse consequence of acquiring U.S. real estate through a Foreign Corporation is the Branch Profits Tax. The Branch Profits Tax is a 30% tax imposed on a Foreign Corporation's annual after-tax net profit. The Foreign Corporation pays regular corporate income tax on its effectively connected taxable income, and after that corporate income tax has been paid, the Foreign Corporation pays the Branch Profits Tax of 30% on the remaining amount that is not deemed to be reinvested in the United States.

There are a few ways to avoid or lower the Branch Profits Tax, such as reinvesting the Foreign Corporation's profits in the United States, having certain exemptions in the income tax treaty between the country in which the Foreign Corporation was formed and the U.S., or terminating all business operations in the U.S. upon the sale of all USRPIs and not reinvesting for a number of years. The Branch Profits Tax also doesn't affect Foreign Corporations that own U.S. property that is not producing income (i.e., non-rental properties), such as vacant investment properties. Personal use of corporate assets requires income recognition at the corporate level.

As stated above, a Foreign Corporation that ceases all operations in the U.S. may avoid the Branch Profits Tax. However, that could prove difficult for a Foreign Corporation that

owns several rental properties (i.e., income-producing properties) because all properties would have to be sold in order for operations to cease, thereby avoiding the Branch Profits Tax.

**U.S. Estate Tax**

A foreign individual will be subject to the U.S. estate tax on the portion of his or her gross estate (assets controlled by taxpayer) situated in the United States. Thus, if a foreigner dies owning real estate in the United States, his or her taxable estate would include the USPRI's value, and the estate would be subject to the U.S. estate tax. For 2012, there is a $60,000 value exemption (netted against the gross estate), and the estate tax rate ranges from 18 to 35%. As of January 1, 2013, the maximum rate on estate taxes increased to 40% (from 35%).

It should be noted that some investors who purchase real estate as individuals choose to minimize the risk of estate taxes by purchasing term life insurance. The settlement from the insurance policy would offset some or all of the estate tax. The insurance policy is then placed in an Irrevocable Life Insurance Trust in which the owner of the USRPI names someone other than himself as the trustee and beneficiary. The inclusion of a life insurance trust facilitates administrative and legal matters in the event of a foreign individual's passing. While the life insurance alternative is intriguing in theory, it can prove to be quite expensive if the policyholder outlives expectations.

# Most Common Structures Used to Acquire USRPI

Foreign investors can acquire U.S. real estate in a number of different ways through a number of different structures. Some elect to make the acquisition through simple structures using just one entity (single-tiered structure), while others choose more complex structures involving several entities (multi-tiered structure).

## Single-Tiered Structures

**Direct Ownership by Foreign Individual**

The most common way for a foreign person to acquire U.S. real estate is as an individual. The advantages of such a structure are its simplicity, an assumed (more) favorable long-term capital gains tax rate at the date of sale, and affordability (from a structuring standpoint). However, there are some disadvantages.

First, the foreign person's estate will be subject to the estate tax upon his or her death, or gift tax upon gifting the property. As stated above, the estate tax rate is significant as it can range from 18% to 40%. Second, the foreign investor would be subject to FIRPTA and its onerous withholding rules upon the disposition of the property. Third, owning the property as an individual leaves the investor vulnerable from a liability standpoint if the investment is a rental property as any accident at the property may result in litigation against the individual owner.

Many foreigners value their anonymity and prefer to stay off of the U.S. government's radar. Foreigners who directly own real estate would be required to file an annual tax return, which means such anonymity would not be possible. Furthermore, the local counties of U.S. states list the owners of U.S. real estate on their property appraisers' records, which are available for review by the public (via the internet).

In many cases, foreigners approach tax professionals already owning U.S. real estate individually and it results in after-the-fact structuring, such as transferring the property to another entity like an LLC or corporation. The resulting transfer of property to a legal entity may result in a U.S. income tax liability (via FIRPTA), local transfer taxes, additional U.S. tax filing requirements, and additional administrative and filing costs.

**Ownership by U.S. Corporation**

One of the least common ways that foreign persons own U.S. real estate is through U.S. Corporations. Though ownership via a U.S. Corporation provides the foreign investor/shareholder the shield of limited liability, it comes with significant disadvantages. For example, the sale or disposition of the property or company stock is subject to the FIRPTA tax provisions, higher federal and state corporate tax rates (as opposed to lower long-term capital gain rates), and estate taxes (based on the value of the USRPI) upon the shareholder's death. Some anonymity is achieved when acquiring USRPI under this structure, however it is not total as the company will be required to disclose shareholder information on its tax return (Form 1120) if the foreign person owns more than 50%.

**Ownership by Foreign Corporation**

A foreign investor's ownership of U.S. real estate via a Foreign Corporation has many similarities to owning U.S. real estate via a U.S. Corporation, such as the annual filing of a federal and state tax return (Form 1120F), the shield of limited liability, and some level of anonymity. It also shares one of its main disadvantages: corporate tax rates, which are likely to be greater than long-term capital gain tax rates found in other structures (e.g., individual, pass-through entities). One significant difference is that this structure usually eliminates the estate and gift tax, which can be substantial. Another difference is the inclusion of the Branch Profits Tax, which would be a factor if the corporation has income and/or distributes earnings via a dividend.

**Ownership by Limited Liability Company (LLC)**

One of the most common ways that foreign investors choose to acquire U.S. real estate is through a Limited Liability Company, usually as a single-member LLC. Such a structure may have some of the ownership benefits of a corporation and of an individual (lower capital gain rates; low cost of structuring). However, as with the individual ownership structure, acquiring USRPI via an LLC leaves a foreign individual vulnerable to estate & gift taxes and FIRPTA withholding regulations. Additionally, as a single-member LLC, the foreign individual would be required to record all rental activity (assuming the property is income-producing) on an annual individual tax return (Form 1040NR), thus eliminating any form of anonymity the investor may seek.

## Multi-Tiered Structures

**Foreign Corporation Owning a U.S. Corporation**

A foreign person can invest in U.S. real estate through a two-tier structure that includes a Foreign Corporation and U.S. Corporation. Under such a structure, the Foreign Corporation would own the stock of the U.S. Corporation as its sole asset, and the U.S. Corporation would own the USRPI directly. If more than one USPRI is owned, then forming a U.S. Holding Corporation that owns multiple U.S. subsidiaries (to own each individual USRPI) would be prudent. While more complex and costly from an administrative perspective, this two-tier structure may provide the foreign individual with certain advantages, such as the avoidance of estate tax and Branch Profits Tax, which should outweigh the aforementioned complexity and costs.

**Foreign Corporation Owning a U.S. Corporation That Owns Several LLCs**

A foreign investor's acquisition of several income-producing properties generally results in a more complex structure. Such a structure may include a Foreign Corporation that wholly owns a U.S. Corporation, which in turn owns several LLCs, one for each property acquired. An individual LLC is organized for each property to provide limited liability and limit potential legal risks to each individual property. From a U.S. income tax perspective, the income and/or losses of each property/LLC then flows up to the U.S. corporate owner and is recorded on the income tax return (Form 1120) of the U.S. Corporation, which serves as the Holding Company. Such a structure carries many of the attributes of the previous structure, such as avoidance of estate taxes and the Branch Profits Tax, the same income tax rate, and anonymity. From an administrative standpoint, costs would be dictated by the number of properties within the structure.

## Other Multi-Tiered Structures

**Trusts**

A foreign investor may structure a U.S. Investment interest in real estate utilizing either a domestic or a foreign trust (revocable or irrevocable). FIRPTA rules will generally apply, however trusts generally create favorable opportunities for estate planning. Because of the complexity in various trust instruments, consulting a legal and/or tax professional is strongly advised.

# Summary

Foreign persons interested in acquiring property interests in U.S. real estate have a slew of options available from a structuring standpoint. The option a foreign person ultimately pursues will have a material impact from a tax, risk and legal standpoint. The eventual structure should be determined based on a foreign investor's unique facts and circumstances. In determining the optimal structure, a foreign investor should consider several factors, including: his or her potential U.S. income tax liability, other related tax issues (U.S. estate & gift tax, FIRPTA, Branch Profits Tax), the importance of anonymity, liability exposure, and the administrative costs associated with each structure.

In the end, the key for any foreign investor is to properly plan before acquiring USRPI by consulting a real estate attorney and/or U.S. tax professional. Without proper planning, a foreign investor runs the risk of after-the-fact structuring, which may result in higher administrative and legal costs, potential tax liabilities and needless tax filings.

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# FAQs

## Foreign Persons Buying U.S. Real Estate

1. **What is FIRPTA and how does it affect a foreign individual buying U.S. real estate?**

   FIRPTA stands for "Foreign Investment in Real Property Tax Act." Enacted in 1980, the law allows the United States to impose withholding income tax on foreign persons disposing of U.S. Real Property Interests. Per the Internal Revenue Service, a U.S. Real Property Interest (USRPI) is defined as "any interest, other than solely as a creditor, in real property located in the United States or the U.S. Virgin Islands, including leases and stock in U.S. Real Property Holding Corporations (US RPHC) as well as certain personal property that is associated with the use of real property (such as farming machinery or hotel furniture)." In general, FIRPTA imposes a tax of 10% of the property's gross consideration on any foreign person disposing of a USRPI. This tax is required to be withheld by the buyer of the property through the closing agent, who is generally the withholding agent, and sent to the Internal Revenue Service. The withheld tax is required to be paid within 20 days of the disposition.

2. **Are there any exemptions to FIRPTA?**

   Yes, there are exemptions to avoid FIRPTA or to reduce the amount required to be withheld. For instance, if the property being purchased is to be used as a residence and the purchase price is $300,000 or less, FIRPTA would not apply. Another exception is when the purchaser receives a certificate, under the penalty of perjury, from the seller stating that the seller is not a foreign person. Another instance of exemption is when the buyer receives a withholding certificate from the IRS that excuses withholding or reduces the amount of withholding below the required 10% of the purchase price. Such an exemption, procured by the filing of Form 8288-B, must be addressed no later than the closing date of the sale.

3. **Are real estate agents/brokers liable and/or responsible for income tax withholding related to rental income collected on behalf of foreign real estate owners?**

   Real estate agents and/or brokers frequently come across transactions involving foreign persons acquiring or renting U.S. property. Before agreeing to manage U.S. property for foreign investors, agents/brokers should become familiar with U.S. laws regarding the withholding of tax related to disposing of or renting U.S. property (e.g., FIRPTA). Foreign individuals and Foreign Corporations may elect to have their passive rental income taxed as if it were "effectively connected" with the U.S. trade or business. Unless the foreign investor has properly informed the property manager that the rental income is to be treated as effectively connected income (by submitting a completed IRS Form W8-ECI), the property manager should withhold 30% of the gross rental receipts so as to avoid personal liability. Real estate agents and/or brokers should consult their Certified Public Accountant or tax advisor if they have any questions regarding withholding of taxes related to foreign persons investing in U.S. property.

4. **What type of expenses can a foreign person use to offset the rental income earned from investing in U.S. real estate?**

   Expenses directly related to the rental activity will be deductible. For example, real estate taxes, depreciation, mortgage interest paid, condo maintenance fees, repairs, insurance, utilities, etc.  If the property is owned by a foreign individual or foreign entity, the owner may elect to treat the passive rental income as "effectively connected" with a U.S. trade or business. This election must be attached to a timely-filed income tax return. If this election is not made, the investor will lose all current deductions related to the rental activity (unless the owner is actually engaged in a U.S. trade or business with such real estate).

5. **What happens if I use the property partly as a rental property and partly as a vacation home?**

   If the property is used for 14 days or more as a vacation home and the rest of the time rented to others, the foreign investor must prorate expenses incurred and split the activity between personal and rental. The proration should count the number of days the property is used as a rental property separately from the number of days the property is used for personal use. The resulting percentage is then multiplied by the expenses incurred on the property. Expenses related to personal use are either limited or non-deductible.

6. **What is the optimal structure for a foreign person buying a property in South Florida?**

   Unfortunately, there is no "one size fits all" solution that addresses every client or investor's needs. Every investor is different in terms of circumstances, goals, and priorities. For instance, estate taxes, which carry a high tax rate of 40% over an exemption amount of $60,000, are a major consideration for most foreign investors, especially those with children. Treaties may provide a more favorable estate tax exemption. If a foreign individual wants to be shielded from estate tax, he or she may wish to implement a multi-level structure, perhaps anchored by a non-grantor trust or a foundation.

   Some clients who are not overly concerned with estate taxes opt for a much simpler structure whereby the USRPI is owned by a multi-member LLC, which may not provide complete estate tax protection. Foreign persons buying property in the U.S. should consult with a tax professional as an integral part of the purchase process.

7. **Aside from the appropriate structure, are there other ways for foreign persons investing in a USRPI to protect themselves from estate taxes?**

   Yes. Some investors wish to hold the real estate in their individual names (which leaves them liable to estate tax) but offset the tax through the purchase of a term life insurance policy (adjusted annually depending on fair market value fluctuation of all U.S.-based assets. The proceeds from the life insurance policy is used pay some or all of the estate tax.

**8. If a foreign individual has already purchased and titled a real estate investment under his or her personal name, can the individual still create a structure that will transfer the property ownership while protecting him or her from estate taxes?**

Yes. The Internal Revenue Code allows for certain non-recognition transfers of property from an individual to a business structure. However, each situation is different and several factors should be analyzed to determine whether the transfer will result in a favorable tax situation; certain transfers are taxable events. As with every business decision, it is important to consider the costs versus the benefit. If a foreign individual thinks he or she may have improperly structured the purchase of USRPI, he or she should seek the help of a tax professional to discuss the reorganization and the options available.

**9. Is it possible for a foreign person to defer the gain from the sale of a U.S. Real Property Interest (USRPI)?**

Yes. A foreign person who owns investment property may engage in a simultaneous like-kind exchange whereby the gain on the sale of the property is rolled into the purchase of another investment property.

A delayed like-kind exchange (as opposed to a simultaneous one) is a detailed process, requiring several tax forms to be filled out (and approved by the IRS). Time constraints are a factor as the new investment property (which the seller is purchasing) must be identified within 45 days of the closing of the original property and acquired within 180 days of the closing date of the original property. FIRPTA withholding is required in a delayed like-kind exchange.

Details on how to enter into an IRC Section 1031 exchange should be discussed with a real estate attorney or tax professional.

**10. Am I required to obtain an ITIN (Tax Identification Number)?**

Generally, a foreign individual or entity will need an ITIN if he sells the USRPI and is required to file a tax return to either obtain a refund or to pay additional taxes owed. An ITIN will also be required for rental property or when the foreign person intends to transfer the property into a structure using a non-recognition provision (discussed in FAQ #8).

# 2013 TAX CALENDAR

## Key Tax Compliance Dates

**January 2013**

| | |
|---|---|
| **15th** | Foreign Investor Withholding tax payment |
| **16th** | Individuals 4th quarter installment of estimated tax payment |
| **31st** | Form NYC IT-204 LL |
| **31st** | Deadline for employers to provide W-2 and Form 1099-MISC |

**March 2013**

| | |
|---|---|
| **1st** | File information returns - Form 1099, W-2/W-3 |
| **15th** | Corporation (Form 1120 /1120S) tax returns, Form 7004 extension |
| **15th** | Form 1042 and 1042-S |
| **31st** | E-deadline for Form 1099-MISC |

**April 2013**

| | |
|---|---|
| **15th** | Individual (Form 1040/1040NR with U.S. wages), partnership tax returns, extensions for both* |
| **16th** | Corporation/Individual 1st installment of estimated tax payment |

**June 2013**

| | |
|---|---|
| **17th** | Corporation/Individual 2nd installment of estimated tax payment |
| **30th** | Form TDF 90-22.1 – Foreign Bank Account Reporting (FBAR) |

**September 2013**

| | |
|---|---|
| **16th** | Extended date for Corporate (Form 1120/1120S) and Partnership (Form 1065) returns |
| **16th** | Corporation/Individual 3rd installment of estimated tax |

**October 2013**

| | |
|---|---|
| **15th** | Extended date for individual (Form 1040 and 1040NR) tax returns |

**December 2013**

| | |
|---|---|
| **1st – 31st** | Tax planning. Compile W-9's for 1099 prep (if requested) |
| **16th** | Extended date for certain Form 1040NR returns |
| **17th** | Corporations 4th installment of estimated tax payment |

** Form 8938 (FATCA) is due with individual and/or partnership's return.*

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# Structure for Holding Real Estate Property
## (for 2012 tax year)

| Compliance Variables | Single Member LLC - Owned by US individual | Single Member LLC - Owned by Foreign Individual | Single Member LLC - Owned by Foreign Corp | U.S. Corporation | Foreign Corporation | Foreign Non Grantor Trust | LLC and Partnerships |
|---|---|---|---|---|---|---|---|
| **Form to File** | 1040 | 1040NR | 1120F | 1120 | 1120F | 1040NR | 1065 |
| **Income Tax - Upon Disposition** | Long-term 15%; Short-term 15-35% | Long-term 15%; Short-term 15-35% | 15-35% | 15- 35% | 15-35% | Long-term 15%; Short-term 15-35% | Passthrough - Capital gains rates |
| **Income Tax - Rental Income** | 10-35% | 10-35% | 15-35% | 10-38% | 15-38% | 15-35% | Passthrough - Ordinary rate |
| **FIRPTA withholding upon disposition** | No | Yes | Yes | No | Yes | Yes | 35% of the allocated gain |
| **Branch Profit Tax** | No | No | 30% | No | 30% or lower treaty rate | No | No |
| **Estate Tax** | 18 - 35% | 18 - 35% | No | 18 - 35% | No | No | 18 - 35% |
| **Anonymity** | No | No | Some | Some | Some | Some | No |
| **State (FL) Tax** | No | No | Yes | Yes | Yes | No | No |

**Note:**
Gift tax may be applicable to certain dispositions.
Property in states other than Florida may be subject to taxes in those states.

Every taxpayer and set of circumstances is different. Any tax advice given in this is chart is an informal opinion based on the general facts and assumptions. As such, the advice is not intended or written to be used for the purpose of avoiding tax penalties and it cannot be used for that purpose. We are available to prepare a more formal, written tax opinion at your request.



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