ANDERSEN TAX

Purchasing U.S. Real Estate

Tax Considerations for the Non-U.S. Investor

By David Roberts and
Len Schneidman

Andersen Tax LLC, U.S.

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As a non-U.S. person, how you invest in U.S. residential real estate can have a significant impact on your tax situation.

Introduction

For a non-U.S. person considering an investment in U.S. residential real estate, how you structure the ownership can have a significant effect on your tax situation. It can impact income tax during the period of ownership; capital gains tax when later selling the property, and even gift and estate taxes when transferring the property to an heir by gift or inheritance.

When deciding how best to structure the purchase it is important to consider the purpose and intent behind the decision. This should include:

- Will it be for personal use and, if so, by whom?
- If purchasing as an investment, will it generate rental income?
- If purchasing with a view to resell, what is the potential holding period?
- Is the intent to pass to future generations?

It is also important to recognize that subsequent restructuring can be costly, so it is critical to get proper independent tax and legal advice prior to the purchase. This advice should consider not only the implications in the U.S. where the property will be located, but also, in the purchaser's home country.

When considering how to purchase the property, there are several approaches that a non-U.S. person (hereafter referred to as a non-resident alien or *NRA*) might use; the most common ways include:

- Ownership in personal name
- Ownership through a foreign corporation (*FC*), typically in a tax neutral jurisdiction
- Ownership through a U.S. corporation that is owned by the FC; and/or combined with a trust

This is not an exhaustive list of the options available, but does cover the most common approaches. Each has its advantages and disadvantages. Unfortunately, in most cases there is no perfect solution, hence the need to first identify the reasons behind the purchase and then choose the best available option.

Some of the advantages and disadvantages of these potential ownership methods are covered below. Each is considered in the context of property for personal versus investment use.

Ownership in Personal Name

Purchasing in personal name is an obvious choice; there are advantages, but one significant disadvantage to the uninformed buyer.

Buying for Personal Use

The biggest disadvantage is that the U.S. real estate owned by an NRA is exposed to U.S. estate tax. The U.S. will tax the estate of an NRA where certain assets are located in the U.S. including real estate and shares in U.S. companies. This means that U.S. assets with a value in excess of the $60,000 exemption will be taxed at rates up to 40%. For example, the estate of an NRA who dies owning a $5,000,000 New York City apartment in his or her personal name would face a tax bill of almost $2,000,000.

Relief from the estate tax may be provided through an estate tax treaty, but there are only 16 such treaties in place and often the relief provided is not comprehensive. Relief from the estate tax is also available where the NRA is survived by a U.S. citizen spouse due to the unlimited marital deduction. If the property has debt against it, the debt can only reduce the value of the U.S. taxable estate if it is non-recourse debt, otherwise the amount of reduction is limited to the ratio of the U.S. assets to worldwide assets, undesirably requiring disclosure of the NRAs worldwide estate in order to claim the reduction.

If the NRA owner wishes to transfer the property during lifetime as a gift, then U.S. gift tax will apply at 40%. There is no allowable exclusion other than the annual exclusion in the amount of $14,000 per recipient.

Other than the simplicity of purchasing in one's own name, a big advantage of personal ownership is the tax treatment upon sale. Currently capital gains are taxed at a federal tax rate of 20% (plus applicable state taxes) versus a federal rate of 35% if sold through a corporation. State and local taxes can increase this rate differential further depending on where the property is located. Withholding tax will apply to the sale of the property. The Foreign Investment in Real Property Tax Act (*FIRPTA*), subject to certain exceptions, requires the buyer to withhold 15% of the sale's proceeds and remit this to the taxing authorities. The NRA must then file a tax return to report the actual gain or loss and pay additional tax or claim a refund of any overpaid tax as appropriate.

Buying for Income Production

Where an NRA receives rent from a property, he or she can choose to be taxed in one of two ways: a flat rate of 30% (or lower if a treaty applies) or, by election, at graduated income tax rates on income that is net of allowable deductions. Depreciation is an allowable expense, but any prior tax benefit is recaptured (that is, taxed as ordinary income) upon sale. The same capital gains tax treatment as above will apply.

Personal ownership does not provide any liability protection. Where a property is rented out, especially to a third party, this can be a significant risk. Another consideration is that, upon death, the property may be subject to costly and time consuming probate proceedings as legal title is determined, estate taxes are paid and ultimately title is transferred.

Purchasing Through a Foreign Corporation

For Personal Use

There are several benefits to owning real estate through a foreign corporation (*FC*) but probably the biggest advantage is that the FC provides protection from U.S. estate tax. While the U.S. property is a U.S. asset subject to U.S. estate tax, the FC shares are not a U.S. asset and consequently fall outside the scope of the U.S. estate tax net. Furthermore, the shares of the FC can be gifted by the NRA without incurring gift tax. However, when the recipient decides to sell, the original cost basis of the property will be used to determine the gain or loss to the FC.

Other non-tax advantages are that the FC provides privacy to the NRA since ownership is in the name of the FC rather than his or her personal name. The FC provides limited liability protection so that any claims against the property owner should be limited to only the assets of the FC (i.e., only the property itself rather than the personal assets of the NRA). For this reason it is generally advisable not to mix other assets within the same FC that holds the real estate.

Where the property is used for personal reasons by an officer or shareholder of the FC, the corporation may be required to charge a rent (or rent will be imputed) to the individual using the property. This can be disadvantageous since it will create potentially taxable income to the property user without any corresponding tax deduction.

A major consideration of using corporate ownership is that when the property is sold, any gain will be taxed at corporate tax rates of 35% (plus state tax where applicable). An additional layer of tax known as the branch profits tax (see below) may also apply unless the foreign corporation is liquidated and certain subsequent restrictions on reinvestment are adhered to. Furthermore, similar to individual ownership, the sale will be subject to the FIRPTA withholding tax of 15% of the sales proceeds. FIRPTA can be avoided by selling the FC shares rather than the underlying property, but that can severely limit the market of willing buyers since the purchaser assumes the inherent U.S. tax liability attributable to the appreciated real estate. It may also be possible to avoid the application of FIRPTA withholding in certain circumstances where the FC elects to be treated as a domestic corporation.

For Income Production

Income received by the FC is taxed at the federal corporate tax rate of 35%. In addition to this, branch profits tax (*BPT*) may also apply. The BPT is effectively a deemed dividend tax, which applies an additional 30% tax on the income after the 35% corporate tax has been applied. This can equate to a tax charge of 54% (plus state taxes where applicable). For this reason, direct FC ownership would generally not be advisable where substantial income is expected to be generated.

Finally, if the FC is considered to be doing business in the U.S. then it will be required to file a U.S. tax return regardless of whether it had net income or loss. In certain locations within the U.S., for example New York City, the state taxing authorities will apply an annual capital tax on net asset value in addition to any income taxes.

Purchasing Through a U.S. Corporation

As noted above, direct ownership by the FC may not be the most efficient form of ownership. Similarly, a U.S. corporation as the direct owner may also be unsuitable. The U.S. corporation on its own would not provide estate tax protection and would be subject to the higher corporate tax rate of 35% on income and gains. For the NRA investor a better solution may be to combine the benefits of the FC and U.S. corporation together.

For Personal Use

As above, estate tax does not apply due to FC ownership. Probate will still apply on the FC shares, but in the jurisdiction where the FC shares are registered. Privacy to the beneficial owner is provided as the U.S. corporation must disclose the FC as owner, but the FC is under no obligation to disclose the NRA owner. Upon sale of the property there is only a single level of tax on any gain at the corporate level. If the sale of the real estate is a liquidating event for the U.S. corporation, then the proceeds can be distributed to the FC without further tax.

For Income Production

Net rental income received by the U.S. corporation is taxed at the U.S. corporate tax rate of 35% at the entity level. If dividends are paid by the U.S. corporation to the FC then, subject to any treaty reduction, a 30% withholding tax will apply. However, as long as a dividend is not paid to the FC, no second level of tax will apply and it may ultimately be avoided by making a tax-free liquidating distribution.

The U.S. corporation will have to file U.S tax returns.

Purchasing Through a Trust

A corporate structure in itself is not an estate plan. Dealing with the estate of a person, resident of one country with assets in another, can be a long and expensive process that could tie up the assets and potentially expose them to heirship challenges. A trust can be a useful tool when combined with any of the above structures and provide the benefit of avoiding probate and distributing assets to beneficiaries in a pre-determined and orderly manner.

For NRAs who live in a civil law jurisdiction, a trust is unlikely to be recognized as a legal structure in their home country. Alternative wealth transfer entities commonly used outside of the U.S. such as stiftungs or private foundations are not specifically addressed under U.S. tax law and require additional analysis to determine their classification, typically as either a trust or a corporation. When adding U.S. assets into a trust or equivalent structure, the funding should follow a specific process to avoid a direct contribution that may cause the U.S. assets to be included in the estate of the NRA.

Summary

For the NRA investor, the potential estate tax exposure is so significant it is often the decisive factor in avoiding ownership of U.S. real estate in personal name. Depending on the circumstances, ownership in personal name may make sense where the estate tax exposure can be limited, for example, when the holding period is short enough to warrant risking estate tax exposure or if the property could be purchased by a younger family member. Life insurance can also play a role in managing that risk. The main decision comes down to one of balancing estate tax exposure by owning in personal name versus potentially paying higher taxes on income and gains if held by a corporation. This could be addressed by electing to treat the foreign and U.S. corporations as flow-through entities thereby preserving the lower capital gains tax rates available to individuals. This does however create some uncertainty as to whether it provides sufficient protection from estate taxes.

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