U.S. Tax Considerations of Foreign Investment in U.S. Real Estate

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In today's real estate market, many foreign investors are interested in purchasing condominiums or other personal residences in the U.S. ("U.S. real estate"). Often, such investors will purchase U.S. real estate in their individual names, without fully exploring the potential U.S. income, estate and gift tax consequences associated with such ownership, or any other potential structures available through which to own such U.S. real estate. Preliminarily, for purposes of this discussion, assume that the "foreign" investor is both a U.S. income tax nonresident alien and a U.S. estate and gift tax nonresident domiciliary (an "NRAD"). Residence for such purposes is defined extremely differently under the Internal Revenue Code, applicable regulations, and case law; however, analysis of such definitions is beyond the scope of this article.

The major difficulty that arises in the context of advising the foreign investor is that the U.S. income and estate and gift tax consequences of various ownership structures are oftentimes at odds. Investment decisions must be tailored to the needs of the particular investor, as certain compromises might have to be made depending on which tax the investor chooses to minimize.

Specifically, individual ownership of U.S. real estate by a foreign investor currently provides the major income tax advantage of the potential for a current maximum long-term capital gain rate of 15% upon any eventual sale of the real estate. It should be noted, however, that such sale by a foreign investor (whether individual, corporation, partnership or trust) would also be subject to U.S. income tax pursuant to the Foreign Investment in Real Property Tax Act of 1980, and to withholding under the relevant withholding rules enacted in 1984. The withholding tax responsibility is that of the transferee and is generally 10% of the amount realized on the sale of a U.S. real property interest, notwithstanding the actual tax liability due. Such withholding can be eliminated or reduced under certain circumstances, by filing an Application for Reduced Withholding with the Internal Revenue Service (the "Service"), or can otherwise potentially be wholly or partially refunded following the filing of a U.S. income tax return for the tax year of the sale.

Individual ownership of U.S. real estate by a foreign investor is not preferred, however, from a U.S. estate and gift tax perspective. Generally, subject to the current allowable credit against estate tax for the estate of an NRAD (which is equivalent to a $60,000 exemption), the entire value of the U.S. real estate (along with any other "U.S. situs" property) would be includible in the estate of an NRAD and could be subject to tax at the maximum estate tax rate, which is currently 46%. Furthermore, any gift made by an NRAD of the U.S. real estate during his lifetime would be subject to U.S. gift tax at the same 46% rate, subject to an annual per donee exclusion, which for 2006 is $12,000.

Some options to potentially avoid the U.S. estate tax with respect to U.S. real estate would be the holding of the real estate through: (1) a foreign corporation (an "FC"), (2) a foreign partnership, or (3) a foreign or domestic (i.e., U.S.) irrevocable trust.

Subject to certain potential arguments by the Service, the FC option could provide protection from U.S. estate tax, as the shares of an FC are generally not includible in the estate of an NRAD. Any sale of the property by the FC, however, would be subject to U.S. income tax at ordinary income tax rates of up to 35% (as corporations are not eligible to receive preferential long-term capital gain treatment), and could also be subject to an additional level of tax, known as the Branch Profits Tax. Furthermore, if instead of purchasing the real estate through the FC initially, the investor transfers appreciated real estate owned individually to the FC, such transfer would subject the investor to immediate gain recognition and, consequently, to U.S. income tax and withholding as discussed above.

The partnership option, on the other hand, could retain the major benefit of individual ownership, i.e., preferential long-term capital gain treatment. However, the situs of a foreign partnership and whether the transfer of a foreign partnership interest is subject to gift tax, or to estate tax if held at the time of death, is unclear under current law. In the event that appreciated real estate is first owned individually and then transferred to a partnership, U.S. income tax could be avoided with the filing of appropriate documentation with the Service, as the transferor would remain subject to U.S. income tax with respect to the appreciated real estate subsequent to its transfer to the partnership.

An additional option is ownership through either a foreign or domestic irrevocable trust. The trust structure should also maintain the benefit of the preferential long-term capital gain rate. With respect to estate and gift tax, the trust could be structured to avoid inclusion in the settlor's gross estate, provided the settlor is comfortable with giving up certain controls over the trust. It should be noted that in the case of real estate initially owned individually, any transfer to an irrevocable trust could potentially be considered a taxable gift, unless carefully structured.

In conclusion, because of the various U.S. tax issues associated with foreign investment in U.S. real estate, a foreign investor contemplating such should consult with a U.S. tax advisor prior to such investment.

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