



# FIRPTA: Impact on Structuring Foreign Investment in U.S. Real Estate

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# Classification of U.S. and Foreign Persons

- “U.S. PERSON” (IRC §7701(a)(30)):
  - A. a citizen or resident of the United States
  - B. a domestic partnership
  - C. a domestic corporation
  - D. any estate (other than a foreign estate)
  - E. any trust if –
    - i. a U.S. court is able to exercise primary supervision over the trust; and
    - ii. one or more U.S. persons have the authority to control all substantial decisions of the trust

# Classification of U.S. and Foreign Persons

- U.S. CITIZENS AND RESIDENTS (for income tax purposes):
  - ☐ U.S. Citizen
  - ☐ U.S. Resident Alien (§7701(b))
    - A. “green card” test (§7701(b)(1)(A)(i))
    - B. “substantial presence” test (§7701(b)(3)) (year-by-year basis)
      - i. Physically present in U.S. for at least 183 days in current year; or
      - ii. Physically present in U.S. for at least 31 days in current year and
      - iii. Weighted average of 183 days during current and two preceding years
      - iv. Weighted Average:     Current year x 100%  
                                  Preceding year x 1/3  
                                  Second preceding year x 1/6

# Classification of U.S. and Foreign Persons

- NON-RESIDENT ALIEN (“NRA”)
  - An individual who is not a U.S. citizen or resident (7701(b)(1)(B))
- DOMESTIC AND FOREIGN CORPORATIONS AND PARTNERSHIPS
  - Domestic Corporations and Partnerships:
    - Organized under U.S. federal or state law (7701(a)(4))
  - Foreign Corporations and Partnerships:
    - Organized under foreign (non-U.S.) law (7701(a)(5))
  - Foreign Trusts
    - Foreign court supervision over trust; OR
    - Foreign persons has authority to control one substantial decision
- “FOREIGN PERSONS” - as used in this presentation includes NRAs, foreign corporations and foreign estates and trusts

# Classification of U.S. and Foreign Persons

- DOMESTIC AND FOREIGN TRUSTS
  - Domestic Trust (§7701(a)(30)(E))
    - A U.S. court is able to exercise primary supervision over the administration of the trust; and
    - One or more U.S. persons control of all “substantial decisions” of the trust
    - Regulations spell out “substantial decisions” (Treas. Reg. §301.7701-7(d))
  - Foreign Trust
    - Any trust that is not a domestic trust (§7701(a)(31))

# U.S. Taxation of Foreign Persons

- U.S. INCOME TAXATION IMPOSED ON U.S. SOURCE INCOME OF FOREIGN PERSONS
  - U.S. Source Income includes:
    - Rents derived from U.S. real and U.S. personal property
    - Royalties derived from use or privilege of using intangible property in the U.S.
    - Dividends from U.S. domestic corporations
    - Interest paid by U.S. payor except:
      - Interest on U.S. bank deposits (IRC §871(i))
      - “portfolio interest” (IRC §871(h))
    - Under FIRPTA and §861(a)(5), gain on sale of U.S. real estate or stock in a U.S. real property holding corporation (but generally no other capital gain)

# U.S. Taxation of Foreign Persons

- U.S. INCOME TAXATION
  - Fixed and Determinable Periodic (“FDAP”) Income such as rent, royalties, dividends, interest, wages and other remuneration (IRC §871(a)(1) for NRAs and §881(a)(1) for foreign corporations)
    - A foreign person is subject to a U.S. tax at a 30% flat rate on the gross amount of FDAP that is not ECI (i.e., not effectively connected with a U.S. trade or business).
    - The tax is withheld at the source by the payor. Foreign person is not required to file a U.S. income tax return to report and pay the tax.
    - The withholding tax may be reduced or varied by treaty with the country where the foreign person is a resident.
    - Note: “Dividends” (defined in IRC §316) paid by a U.S. corporation to a foreign shareholder are subject to 30% U.S. withholding tax (rate may be lower if a treaty applies). Distributions to a foreign shareholder in partial or complete redemption or liquidation of stock are not subject to U.S. tax or withholding if there is a “sale or exchange” of the shares under IRC §§302 and 331 (unless corporation is a USRPHC).

# U.S. Taxation of Foreign Persons

- U.S. INCOME TAXATION

- U.S. Trade or Business Income

- U.S. source income that is “effectively connected” with the conduct of a U.S. trade or business (“ECI”) is taxed on a net basis under the same graduated income tax rates applicable to U.S. citizens and residents (§871(b)) and to U.S. corporations (§882(a))
    - Rental income may be classified as FDAP or ECI, depending on the taxpayer’s level of business activity.
    - Rents from “triple net” leases are generally FDAP; rents from property requiring active management by the taxpayer are usually considered as connected with a trade or business.
    - “Net election” under §871(d) or §882(d) allows NRAs and foreign corporations, respectively, to treat real estate activities as a trade or business (usually a beneficial because it allows the foreign person to deduct property related expenses from rental income, but requires foreign person to file a U.S. income tax return)
    - Under FIRPTA (§897(a)(1)), gain or loss on disposition of a U.S. real property interest (USRPI) is ECI.

# U.S. Taxation of Foreign Persons

- Foreign Corporations
  - ❑ Like domestic corporations, taxed at 21% on ECI (net income).
  - ❑ Additional 30% “branch profits” tax on foreign corporation’s “effectively connected earnings and profits” (IRC §884(a)). Rate is often reduced by tax treaty.

# U.S. Taxation of Foreign Persons

- GIFT AND ESTATE TAXATION

- THE IMPORTANCE OF DOMICILE

- Whether a person is a “U.S. resident” for estate and gift tax purposes is subject to a different test than that for income tax purposes.
    - “A resident decedent is [one] who, at the time of his death had his domicile in the United States ... A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom.” (Treas. Reg. §20.0-1(b)(1))
    - U.S. residents are subject to gift taxes and estate taxes on a worldwide basis, with an exemption of \$11.4 million plus a marital deduction.
    - A “nonresident not a citizen” (“NRNC”) (§§2101(a), 2501(a)(2)) is subject to gift taxation only on gifts of U.S. real estate, and tangible personal property and cash located in the U.S., and to estate taxation only on U.S. real estate and tangible and intangible property located in the U.S.

# U.S. Taxation of Foreign Persons

- U.S. GIFT TAX
  - An NRNC is not subject to U.S. gift tax on U.S. intangible property, (e.g., stock in a U.S. corporation).
  - U.S. gift tax rates apply, and an annual exclusion of \$15,000 for gifts of “present interests” (adjusted annually for inflation) is allowed (\$30,000 for “split gifts”)
  - An annual exclusion of \$155,000 (adjusted annually for inflation) is allowed for gifts of “present interests” to a spouse who is a non-U.S. citizen (§2523(i)(2)); gifts to a spouse that is a U.S. citizen are allowed an unlimited marital deduction.
  - No unified credit is allowed to an NRNC for gift taxes (§2102(c)(3)(B)).
  - Since gifts of “intangible property” by an NRNC are not subject to the gift tax, that tax may be avoided by gifting of stock in corporations owning U.S. real estate.

# U.S. Taxation of Foreign Persons

- U.S. ESTATE TAX
  - ❑ The gross estate of an NRNC includes all tangible and intangible property in the United States owned or controlled by the decedent.
  - ❑ Unlike U.S. citizens and residents, who have an \$11.4 million estate tax exemption, NRNC's have only a mere \$60,000 exemption (§2102(c)(1)), with  
no marital deduction for a non-U.S. citizen spouse (§2056(d)).
  - ❑ The current 2019 estate tax rates for estates in excess of \$60,000 range from 26% to 40%.
  - ❑ U.S. property included in an NRNC's estate includes U.S. real estate, stock in a U.S. corporation, debt obligations of a U.S. person (with exemptions for bank deposits and "portfolio interest obligations") (§§2105(b)(1), 2105(b)(2)). Life insurance proceeds are not included in a decedent NRNC's gross estate (§2105(a)).

# U.S. Taxation of Foreign Persons

## Foreign Investment in Real Property Tax Act (“FIRPTA”)

- FIRPTA TAXATION AND WITHHOLDING
  - Sales and other dispositions of “U.S. real property interests” (USRPIs) by foreign persons are subject to U.S. income tax under §897 and U.S. tax withholding under §1445.
  - The withholding rate is a percentage of the gross amount realized on the disposition and the type of property disposed of:
    - 0% for the disposition of property with a purchase price of \$300,000 or less if property will be used by the transferee as a residence;
    - 10% for amounts realized in excess of \$300,000 but not in excess of \$1 million if property will be used by the transferee as a residence;
    - 15% for all other dispositions and types of property.
  - The buyer/transferee must file IRS Forms 8288 and 8288-A to report the amount withheld and transmit the amount withheld to the IRS within 20 days after the disposition.

# U.S. Taxation and Foreign Persons

- FIRPTA TAXATION AND WITHHOLDING (Definition of “U.S. real property interest” (“USRPI”))
  - §897(c)(1)(A)(i): An interest in real property located in the United States.
  - §897(c)(1)(A)(ii): Any interest (other than an interest solely as a creditor) in a U.S. domestic corporation that was a U.S. real property holding corporation (“USRPHC”) at any time during the shorter of: (1) the period during which the seller held such interest, or (2) the 5-year period ending on the disposition of such interest.
  - §897(c)(1)(B): However, a corporation is not a USRPHC if (1) as of the date an interest in the corporation is disposed of, it did not own any USRPIs, (2) all USRPIs owned by the corporation at any time during the shorter of the above two periods were disposed of in fully taxable transactions, and (3) neither the corporation nor any predecessor was a RIC or a REIT at any time during those periods (sometimes called the FIRPTA “cleansing rule”).
  - §897(c)(2): Definition of USRPHC - FMV of domestic corporation’s USRPIs  $\geq$  50% of: the FMV of the sum of the corporation’s USRPIs, plus the corporation’s real property interests outside the U.S., plus any other trade or business assets of the corporation.

- What is a USRPI? (IRC §897, Treas. Reg. §1.897-1)
  - A direct “interest in real property” (other than as a creditor) located in the United States or the Virgin Islands
    - Interests include
      - Fee interests;
      - Leaseholds;
      - Options; and
      - Appreciation rights
    - Real property includes
      - Land;
      - Unsevered natural products of the land (e.g., growing crops and timber, mines, wells and other natural deposits);
      - Improvements (e.g., buildings); and
      - Personal property “associated with the use” of real property (e.g., fixtures)

# U.S. Taxation of Foreign Persons

- FIRPTA TAXATION AND WITHHOLDING
  - Since FIRPTA withholding is based upon the gross purchase price of the real property, it may in some cases exceed the seller's tax due on the transaction. The taxpayer may apply to the IRS on Form 8288-B to reduce the withholding amount to the taxpayer's maximum tax liability with respect to the transaction.
  - Unlike FDAP withholding (for which no U.S. return is required by the foreign recipient of the income), FIRPTA withholding amounts are available as credits against the taxpayer's income tax liability for the year of sale and the foreign person must file a U.S. income tax return to report the sale.
  - Taxable dispositions of USRPIs include some capital contributions, entity distributions, merger transfers. Gifts of USRPIs are not taxable unless liabilities assumed (e.g., mortgages) exceed donor's tax basis.

# U.S. Taxation and Foreign Persons

- FIRPTA TAXATION AND WITHHOLDING

- §897(g): Under Treas. Reg. § 1.897-7T(a), assets (including USRPIs) held by a partnership shall be treated as property held proportionately by its partners for purposes of tax liability under FIRPTA on a sale of an interest in the partnership.
- §1445(e)(5): Under Treas. Reg. §1.1445-11T(d), FIRPTA withholding is required on a foreign partner's disposition of an interest in a domestic or foreign partnership in which  $\geq 50\%$  of its gross assets (by value) and  $\geq 90\%$  of its gross assets (by value) consists of USRPIs, and USRPIs plus any cash and cash equivalents, respectively. Withholding is not required below those thresholds.
- No withholding is required under §1.1445-11T(d) if the transferee of a partnership interest receives a written certification from the partnership signed no earlier than 30 days before the disposition that the 50% and/or 90% thresholds are not satisfied, unless the transferee has actual knowledge that the certification is false.
- Under §1446, if a partnership has ECI, including taxable income or gain from USRPIs (other U.S. business assets), the partnership must withhold U.S. tax on a foreign partner's allocable share of such U.S. income and gain.

# U.S. Taxation of Foreign Persons

- FIRPTA TAXATION AND WITHHOLDING

- FIRPTA Tax liability imposed on gain on sale of publicly traded stock in a USRPHC only if the seller held > 5% of such class of stock (10% limit for publicly-traded REITs) any time during the shorter of the periods described in §897(c)(1)(A)(ii); but no FIRPTA withholding on sale of a publicly-traded stock (§1445(b)(6)). Constructive ownership rules apply. (see §§897(c)(3) and 897(c)(6)(C))
- §897(h)(2): USRPI does not include any interest in a domestically controlled REIT defined as a REIT whose stock at all times during a specified “testing period” was less than 50% owned (directly or indirectly) by foreign persons.
- §897(l): FIRPTA does not apply to “qualified foreign pension funds.”
- §897(k)(3): Stock in a REIT which is held (directly or indirectly through one or more partnerships by a “qualified shareholder” is not a USRPI. “Qualified shareholder” includes certain foreign partnerships, certain publicly-traded entities that are residents of treaty countries and certain publicly-traded foreign limited partnerships. Definition is very complex. Does not apply if an “applicable investor” actually or constructively owns more than 10% of the REIT’s stock.

# Application of U.S. Nonrecognition Provisions Under FIRPTA

- Generally, a USRPI may be exchanged by a foreign person in a tax-free exchange (e.g., IRC §§351, 368, 721, 1031) only if the foreign person receives a USRPI in exchange (see §897(e)).
- Section 332 Liquidations: A domestic liquidating corporation that is a USRPHC and distributes a USRPI to a foreign parent corporation under IRC §332 will not recognize U.S. taxable gain nor will the foreign parent. (Treas. Reg. §1.897-5T(b)(3)(iv)(A) and 1.367(e)-2(b)(2)(ii). Exception: Domestic corporation must recognize gain on distribution of stock in a “former USRPHC” which is treated as a USRPI.
- If a foreign corporation distributes a USRPI in a §332 liquidation to its 80% or greater foreign parent, neither the distributee foreign corporation nor the distributing foreign corporation recognizes gain if: (1) distributee would be subject to U.S. income tax on subsequent disposition of the USRPI, (2) basis of the distributed USRPI to the distributee is no greater than distributor’s basis plus any U.S. gain recognized, and (3) any applicable IRS filing requirements are satisfied (see Treas. Reg. §1.897-5T(c)(2)(i) and Notice 89-57).

# Application of U.S. Nonrecognition Provisions Under FIRPTA

- Section 351: Foreign person transfers a USRPI to a foreign corporation in exchange for stock or as a capital contribution: foreign person generally is not entitled to nonrecognition because stock in a foreign corporation is not a USRPI (Treas. Reg. §1.897-6T(b)(5))
  - Exception (Treas. Reg. §1.897-6T(b)(1)): Nonrecognition under §351 applies if (1) contributed property is stock in a USRPHC, (2) transferee corporation's disposition of contributed stock would be subject to U.S. taxation and certain other requirements are satisfied, (3) certain filing requirements are satisfied (see Treas. Reg. §1.897-5T(d)(1)), (4) substantially all of the stock of the transferee corporation is owned in the same proportions by the same foreign persons who owned the stock of the USRPHC immediately before the transfer, and (5) if any of the stock in the foreign corporation received in the exchange is disposed of within one year, the transferor must recognize the previously realized gain proportionately. The exception does not apply if the transferred USRPI is not stock in a USRPHC. However, this transaction may be an "inversion" under IRC §7874.
  - Example: F is an NRA who owns 100% of the stock of DC which owns U.S. real estate and is a USRPHC. F contributes all of F's stock in DC to FC, a foreign corporation in exchange for all of FC's stock in a §351 exchange. Under Treas. Reg. §1.897-6T(b)(1)(iii), if certain filing requirements are satisfied, this is a nontaxable exchange under §351 even though the FC stock received by F is not a USRPI - because FC's subsequent disposition of the DC stock would be subject to U.S. taxation (DC is a USRPHC).

# Elimination or Reduction of FIRPTA Withholding Obligation

- Transferor delivers a certificate of non-foreign status to transferee
- Transferor has an amount realized of zero (e.g., a gift)
- Transferred property is not a USRPI:
  - Corporate stock: Transferred interest in a corporation is not a USRPI if the corporation has not been a USRPHC within the shorter of the two periods set forth in §897(c)(1)(A)(ii). Transferor can request the corporation to certify that fact to the transferor, who will provide a copy of the certification to the transferee before closing. The corporation must file notice with IRS pursuant to Treas. Reg. §1.897-2(h)(2) within 30 days after sending certification to transferor (Treas. Reg. §1.1445-5(b)(4))
  - Partnership interest: if general partner signs a statement on behalf of the partnership certifying  $\geq 50\%$  of value of partnership's gross assets does not consist of USRPIs or that  $\geq 90\%$  of value does not consist of USRPIs plus cash and cash equivalents and provides statement to transferee before closing, no withholding required
  - Estates or Trusts: disposition of an interest in an estate or trust is not presently subject to FIRPTA withholding (see Treas. Reg. §1.1445-11T(c))

# Elimination or Reduction of FIRPTA Withholding Obligation

- Nonrecognition Provisions

- Withholding can be avoided if (1) transferor notifies transferee in writing that under a nonrecognition provision (e.g., IRC §§351, 721, 1031) or under a U.S. tax treaty, transferor has no U.S. taxable gain or loss and (2) transferee must send a copy of such notice to IRS within 20 days after the transfer date (see Treas. Reg. §1.1445-2(d)(2)(i))
- Notice of nonrecognition transfer cannot be relied on if (1) only partial nonrecognition (e.g., boot received), or (2) transferee knows or has reason to know that transferor is not entitled to claim nonrecognition treatment
- Under Treas. Reg. §1.1445-2(d)(iv), notice of nonrecognition may not be relied on for a deferred 1031 exchange (i.e., transferor has 45 days after transfer to identify replacement property and 180 days after transfer to close on purchase of replacement property). Transferee may only rely on a withholding certificate in such situations (see below)

# Elimination or Reduction of FIRPTA Withholding Obligation

- Withholding Certificate (Treas. Reg. §1.1445-3)
  - Available when (1) transferor is exempt from U.S. income tax on the transfer, (2) transferor enters into an agreement with IRS to pay tax at a later date, or (3) tax due on the transaction is less than amount required to be withheld and IRS determines that reduced withholding will not jeopardize collection of tax
  - Application for the certificate must be filed on or before transfer of USRPI
  - If withholding certificate obtained before transfer, withholding may be reduced or eliminated at closing as provided in the withholding certificate; if received later and FIRPTA tax has already been withheld, certificate can authorize early or normal refund of excess tax withheld
  - Application for withholding certificate can be filed with IRS on Form 8288-B for certain categories of transactions, or on forms provided in Rev. Proc. 2000-35
  - All parties to the transaction must have a U.S. TIN, which must be provided in the application

# Elimination or Reduction of FIRPTA Withholding Obligation (cont.)

- Withholding Certificate (cont.)
  - If application is based on actual tax liability being less than required withholding amount (including under a nonrecognition provision) must provide proof that transferor has no unsatisfied FIRPTA withholding liability as a result of transferor's acquisition of subject property; any such unsatisfied liability will be included in the transferor's tax liability
  - Can be used to allow transferee to withhold on each payment in a deferred installment sale
  - Generally either the transferor or the transferee may apply for a withholding certificate
  - IRS ordinarily acts on an application within 90 days, but sometimes takes longer, in which case IRS is supposed to notify applicant within 45 days after submission of application
  - If application submitted to IRS on or before transfer date but still pending at closing, withholding still required at closing but transferee can defer payment of withheld amount to IRS until 20 days after IRS approval or denial of application
  - In a deferred 1031 exchange, a withholding certificate cannot be obtained before closing because replacement property will not be acquired until after closing; thus, FIRPTA withholding required at closing; withholding from sale proceeds will be taxable "boot" to seller; so seller should fund withholding out of other funds if possible

# Section 897(i) Election

- Effect of election is to treat a foreign corporation (FC) as a U.S. domestic corporation, solely for purposes of FIRPTA
- Remains a foreign corporation for all other U.S. tax purposes (e.g., other U.S. income tax provisions and U.S. estate and gift tax)
- Requirements for a valid election:
  - FC must hold a USRPI;
  - FC must be entitled to nondiscriminatory treatment with respect to that USRPI under an applicable U.S. tax treaty;
  - Upon making the election, FC must qualify as a USRPHC; and
  - FC must file election with the IRS in proper form and in a timely manner.

# Section 897(i) Election (cont.)

- Election must be made before first disposition of an interest in FC that would have been subject to tax under §897(a)
  - If election made after that date, the election can still be made if (i) there is payment of prior U.S. tax (plus interest) that would have been paid on prior dispositions of interests in FC by foreign persons under §897(a) during the 10 years before the date of the election (longer look-back in some cases), or (ii) a transferee acquiring an interest in FC from a foreign person during the above periods took a basis in the interest equal to the foreign transferor's basis (increased by any U.S. gain recognized by the transferor and any U.S. tax paid by the transferee)
- Election can be revoked only with consent of IRS; election remains effective for corporation's entire remaining period of existence
- There must be a binding waiver of any U.S. treaty benefits with respect to any gain or loss from the disposition of a USRPI during the period in which the "i" election is in effect (other treaty benefits should remain available)
- Each shareholder (both foreign and domestic shareholders) must consent to the "i" election and waiver of treaty benefits and, subject to an exception, the consents and waivers must be filed with IRS

# Section 897(i) Election (cont.)

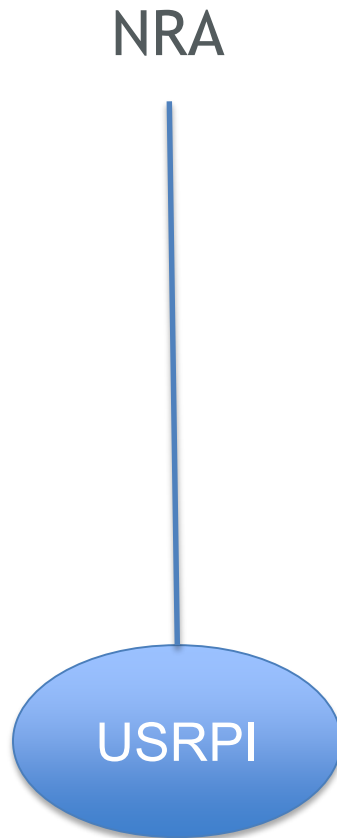
- Advantages:
  - FC can benefit from certain U.S. nonrecognition provisions that would otherwise be unavailable by virtue of §§897(d) and (e) without becoming a U.S. corporation for non-FIRPTA purposes
  - FC avoids FIRPTA withholding on its disposition of a USRPI (including a deferred 1031 exchange)
- Disadvantages:
  - Disclosure of foreign shareholders to IRS upon filing election
  - Election exposes any gain inherent in FC's non-USRPI assets (if any) to U.S. tax on sale of stock in FC by a foreign shareholder (all gain on sale of stock is subject to U.S. tax, but if FC did not make an “i” election and sold only its USRPIs, only the gain on the USRPIs would be subject to U.S. tax, or if foreign shareholder sold stock in FC without an “i” election, there would generally be no U.S. tax)

# Real Property Ownership Structuring

Common objectives include one or more of the following:

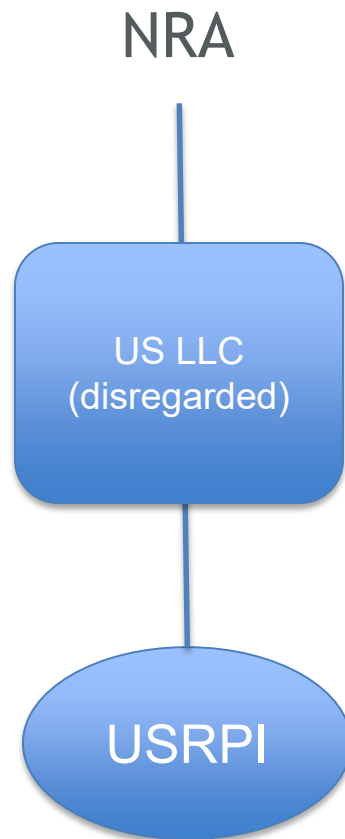
- Preserve anonymity (not buy in own name)
- Consider personal use (not pay rent)
- Insulate against US estate tax
- Insulate against US gift tax
- Minimize or eliminate US income tax on rental income
- Minimize or eliminate US income tax on sale of the property
- Minimize US tax filings

# Ownership Individually



- FIRPTA Taxation
  - Gain subject to U.S. taxation. Amount realized subject to FIRPTA withholding.
- Advantages
  - Simplicity.
  - No additional entity tax return.
  - Total control and ownership in NRA.
  - Long-term capital gain tax rate of 20% applies if held for over 12 months, subject to depreciation recapture and §1250 gain.
- Disadvantages
  - No privacy.
  - All income (annual rental or capital gain at exit) is taxed to the NRA.
  - Rental income subject to tax at rate up to 37% - but interest and depreciation deductions often reduce or eliminate net income.
  - No estate tax protection.
  - No gift tax protection.
  - U.S. tax filings by the NRA individually.

# Ownership Through Disregarded US LLC



- FIRPTA Taxation
  - Same as previous slide.
- Advantages
  - SMLLC provides property liability protection.
  - SMLLC is disregarded for US tax purposes, so single level of income tax.
  - Long-term capital gain tax rate of 20% applies if held for over 12 months, subject to depreciation recapture and §1250 gain.
- Disadvantages
  - All income (annual rental or capital gain at exit) is taxed to the NRA.
  - Rental income subject to tax at rate up to 37% - but interest and depreciation deductions often reduce or eliminate net income.
  - No estate tax protection.
  - No gift tax protection.
  - U.S. tax filings by NRA individually.
  - Foreign tax law treatment of the LLC should be confirmed (whether characterized as a corporation or a flow-through entity).
  - Form 5472 filing required, which requires LLC to obtain an EIN and NRA to obtain an ITIN.

# Ownership Through Single US Corporation



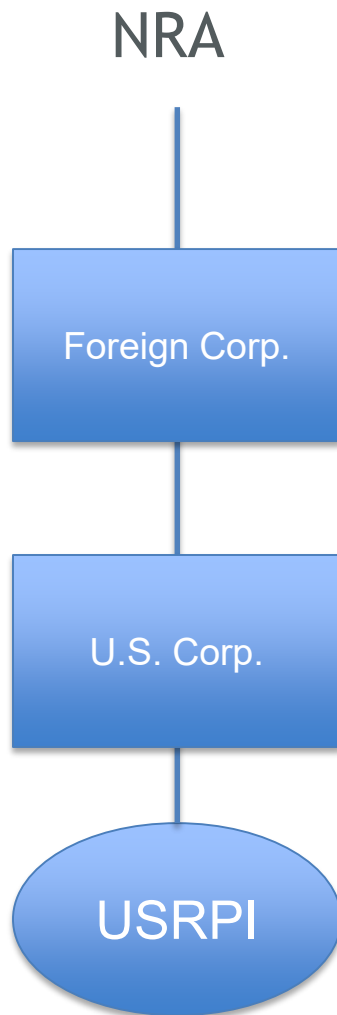
- FIRPTA Taxation
  - Stock is a USRPI. Sale of stock is subject to tax and withholding under FIRPTA.
- Advantages
  - No US gift tax on USCo share transfers.
  - Expenses related to maintaining the property likely allowed if Form 1120 is filed.
  - 21% tax rate (plus state income tax) on both rent and capital gain on property disposition
  - Can liquidate company after real estate is sold and no second level tax.
  - Interest stripping possible with related party loans, but limited.
  - No U.S. branch profits tax.
- Disadvantages
  - U.S. estate tax on death (stock in U.S. corporations included in the U.S. taxable estate).
  - 30% dividend withholding tax (unless reduced by treaty).
  - Filing of Form 1120 requires disclosure of 25% non-U.S. owners and balance sheet .
  - Corporation must obtain an EIN, which requires NRA to have an ITIN.
  - Corporation must file Form 5472.

# Ownership Through Single non-US Corporation



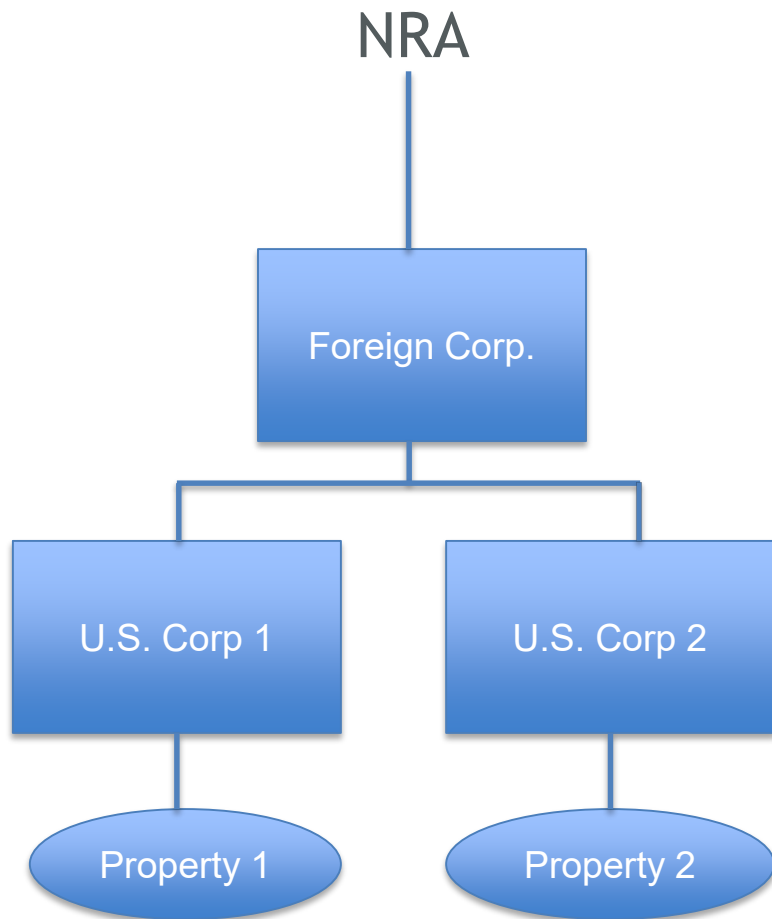
- FIRPTA Taxation
  - Stock not a USRPI; no U.S. taxation under FIRPTA on sale of stock.
- Advantages
  - No U.S. estate tax (foreign corporation shares are not included in the US taxable estate).
  - No U.S. gift tax on foreign corp. share transfers.
  - Expenses related to maintaining the property likely allowed if Form 1120F is filed.
  - 21% tax rate (plus state income tax) on both rent and capital gain on property sale.
- Disadvantages
  - Branch profits tax (30% on 79%) on any net taxable rental income if a trade or business; if not a T or B, gross rent subject to 30% U.S. withholding by lessee.
  - Branch profits tax risk on sale if corporation remains in existence after property sale unless cash is re-invested in a U.S. trade or business.
  - Withholding under §1446 on taxable income at the highest marginal rate if foreign corp. invests via partnership.
  - Filing of Form 1120F requires disclosure of 50% owners and balance sheet.

# Two-Tier Corporate Structure



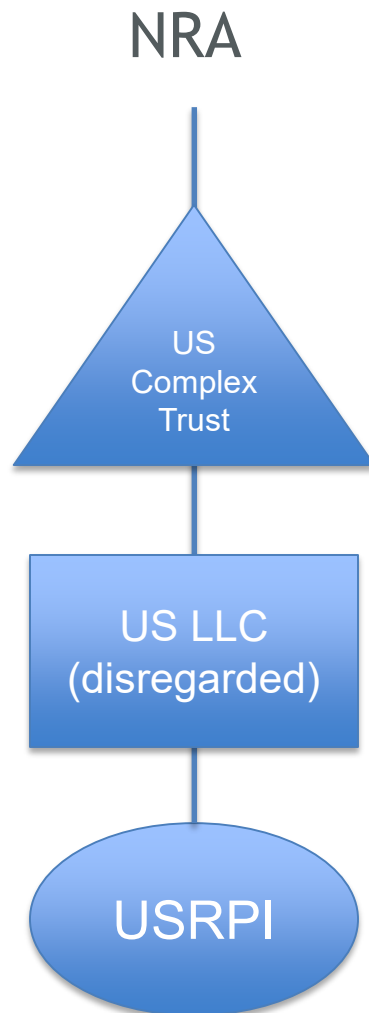
- FIRPTA Taxation
  - Stock of foreign corp. is not a USRPI; no U.S. taxation under FIRPTA on sale of foreign stock.
  - Taxation and withholding if foreign corp. sells U.S. corp. stock.
- Advantages
  - 21% tax rate (plus state income tax) on both rent and capital gain on property disposition.
  - No US gift tax.
  - No US estate tax.
  - No US branch profits tax.
  - Interest stripping possible with related party loans, but limited.
- Disadvantages
  - 30% dividend withholding tax (unless reduced by treaty).
  - Cannot extract free cash from US Co. without dividend withholding tax until time of liquidation (so may not be good for multiple properties).
  - 30% interest withholding tax (unless reduced by tax treaty) on related party loans (10% ownership test - voting stock).
  - Form 1120 US tax compliance requires disclosure of identity of direct and indirect owners and balance sheet.

# Two-Tier Corporate Structure - Multiple Properties



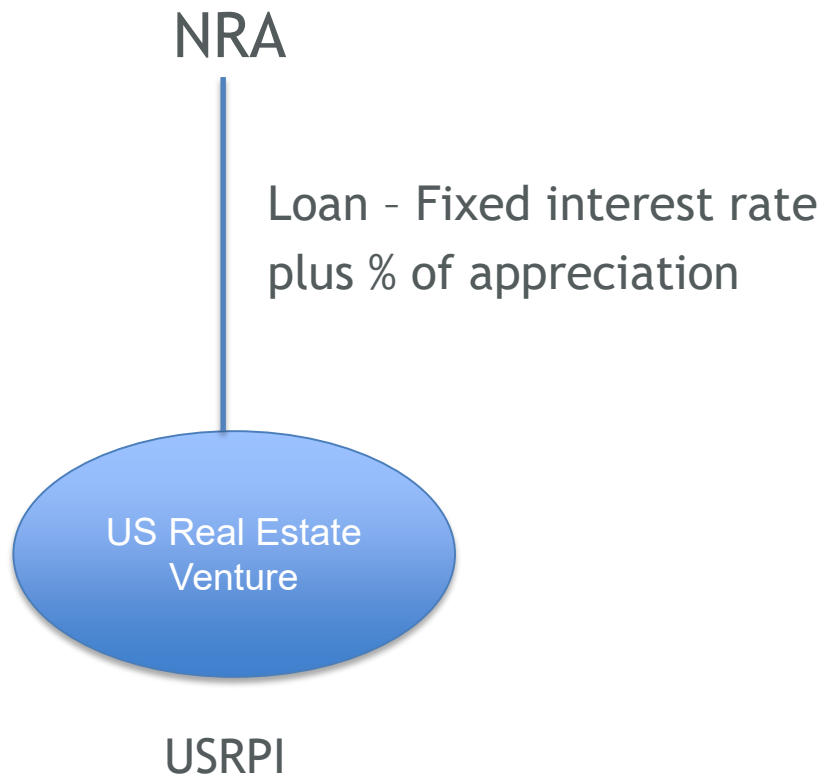
- FIRPTA Taxation
  - Foreign Corp’s sale of stock of U.S. Corp. 1 or U.S. Corp. 2 is subject to FIRPTA tax and withholding if U.S. Corp. is a USRPHC
  - NRA’s sale of stock of Foreign Corp. not subject to FIRPTA taxation or withholding
  - Sale of property by U.S. Corp. 1 or 2 and liquidation of Corp. not subject to FIRPTA if “cleansing rule” applies
- Advantages
  - Can liquidate each U.S. corp. when the relevant property is sold without second level tax.
  - More protection against a claim on one property affecting entire portfolio.
- Disadvantages
  - Complexity.
  - Cost of multiple entities, multiple tax returns, etc.
  - Cannot file consolidated returns under Foreign Corp.

# Non-US Irrevocable Trust that Owns Disregarded Entity



- FIRPTA Taxation
  - FIRPTA withholding obligation arises not on disposition of USRPI but on subsequent distribution of proceeds to a foreign beneficiary
  - Trust is required to maintain a “USRPI account” to track gains and losses from sales of USRPIs
  - Any year-end balance of USRPI account is canceled because trust pays tax on any undistributed gain
  - Withholding rate is highest rate under §11(b) (currently 21%)
- Advantages
  - 20% long-term capital gains rate on gain from sale (plus state tax).
  - Can consolidate income and expenses from multiple projects for efficient offsetting.
  - No withholding required on related party offshore loans to trust. No US tax filing requirement for foreign grantor or beneficiaries (absent distributions).
  - No US estate tax exposure (settlor will not be a beneficiary).
  - No US gift tax.
  - No branch profits tax.
  - A single-member domestic LLC would be disregarded for federal and state income tax purposes but would offer some limited liability protection and a level of privacy.
  - Personal use of property held in trust does not give rise to imputed income to the trust.
- Disadvantages
  - 37% income tax on ordinary income (i.e., business and rental income) (plus state tax).
  - 3.8% Medicare tax will apply to ordinary income (rental) unless trustee actively involved in managing the property.

# Ownership Through Shared Appreciation Mortgage



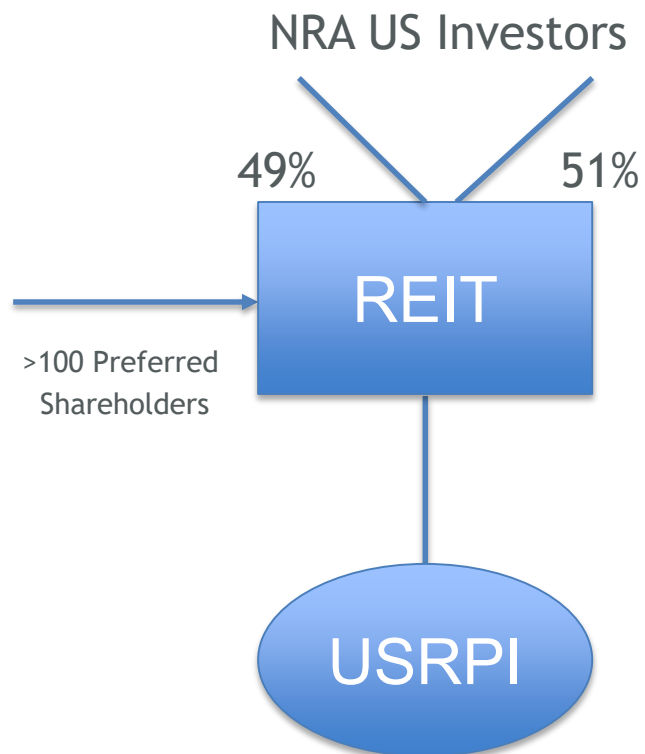
- **FIRPTA Taxation**
  - Right to share in property's appreciation is generally a USRPI
  - Receipt of share of appreciation under the Note is generally not a disposition; thus, no FIRPTA withholding
  - However, if Note is sold or exchanged, any gain (including equity kicker) is subject to FIRPTA tax and withholding
- **Advantages**
  - U.S. property owner/borrower (not the NRA) pays U.S. income tax on rental income from properties
  - No gift tax
  - NRA recipient at loan maturity may pay no income tax on repayment
- **Disadvantages**
  - Cannot control, manage or have greater than 10% ownership interest in venture or interest will be withheld at 30% (absent treaty)
  - Cannot share in contingent appreciation without triggering U.S. withholding tax on interest (absent treaty exemption)
  - Cannot use property personally

# Shared Appreciation Mortgages

## Regulation Section 1.897-1(h), Example 2

- Foreign corporation makes \$1 million loan to domestic individual which is secured by mortgage on real property purchased with loan proceeds.
- Loan agreement entitles lender to fixed monthly payments, constituting repayment of principal plus fixed interest rate.
- Lender also entitled to receive certain percentage of the appreciation in value of real property at the time that the loan is retired.
- Shared appreciation loan treated as U.S. real property interest (USRPI), but receipt of final payments do not constitute “disposition” of USRPI for purposes of Section 897.
- Example 2 concludes that Section 897 is not triggered on receipt of final loan payment because payment constitutes receipt of principal and interest, not gain for tax purposes.

# Ownership Through Domestically Controlled REIT



- FIRPTA Taxation
  - No FIRPTA taxation or withholding on sale of REIT shares by foreign shareholder of a domestically controlled REIT
- Advantages
  - No income tax at REIT level if all income distributed
  - Sale of domestically controlled REIT shares is free of U.S. tax to foreign seller
  - No gift tax on gift of shares
- Disadvantages
  - REIT ownership and operations are complicated with multiple shareholders and investment limitations
  - Dividend tax at 30% (unless rate reduced by treaty)
  - Domestically controlled REIT transfers management and control to U.S. person(s)
  - U.S. estate taxable asset
  - May be limited market for REIT share sale

# Portfolio Interest

- U.S. source interest paid to a foreign person that is not ECI of the foreign person is subject to flat 30% withholding tax (lower rate may apply under an applicable tax treaty).
- Tax collected via withholding at source.
- However, Sections 871(h) and 881(c) provide that interest that qualifies as "portfolio interest" is exempt from U.S. taxation and withholding.
- Debt instrument must be in registered form and must be respected as "real" debt for tax purposes.

# Portfolio Interest

- Does not apply if amount of interest is contingent on sales, cash flow, income, profits or change in value of debtor's property
- Does not apply if lender is 10-percent voting shareholder of issuing corporation (non-voting stock is not counted for this purpose) or 10-percent owner of capital or profits interest in issuing partnership
- For this purpose, Section 318 attribution rules apply to determine ownership, including Section 318(a)(4) option attribution rule

# Portfolio Interest

- However, there is an exception to the contingent interest rule (see §871(h)(4)(C)):
- Any amount of interest determined by reference to
  - (I) changes in the value of property (including stock) that is “actively traded” (within the meaning of section 1092(d)) other than property described in section 897(c)(1) or (g)) (i.e., other than USRPIs and interests in partnerships, trusts, or estates that are considered USRPIs),
  - (II) the yield on property described in subclause (I), or
  - (III) changes in any index of the value of property described in subclause (I) or of the yield on property described in subclause (II).
- Therefore, interest paid to a foreign person that is contingent only on the above factors will be exempt from the 30 percent U.S. withholding tax (regardless of the existence of a treaty).
- Also, foreign lender can avoid U.S. withholding on interest if withholding is eliminated under an applicable tax treaty with the U.S.