What Foreign Persons Need to Know

Before Buying U.S. Real Estate

by Gideon Rothschild, Esq.¹

There have been recent reports of an influx of foreign buyers of US real estate due to the weakened dollar and lower interest rates. Although there are no restrictions placed on foreigners regarding the purchase of U.S. real estate, there are numerous tax implications that could result in significant loss if not planned for in advance. There are also various reporting requirements for foreign sellers and investors accompanied by significant penalties for failure to comply. When planning is done in advance of the closing, however, many of these tax consequences may be avoided.

Perhaps the largest tax concern for the individual buyer is the U.S. estate tax. Although U.S. persons are entitled to a $5 million exemption from estate tax, a non U.S domiciliary is only entitled to a $60,000 exemption. Furthermore, if the property is mortgaged on a recourse basis, the mortgage balance is not fully deductible in calculating the taxable estate. The federal estate tax rates are graduated up to 35% and if the property is situated in New York or New Jersey, there is also a state estate tax imposed. The tax is imposed on all U.S. situs property owned by the non U.S. person at his/her death. U.S. situs property includes U.S. real estate as well as shares of stock issued by corporations formed in the U.S. and tangible personal property located in the U.S. (e.g., artwork located in the condominium). Yet all of these taxes can be avoided by careful structuring of the transaction.

Where the foreigner already owns the property in his individual name, one uncomplicated technique is to purchase enough life insurance to cover the potential estate tax liability. However, with potential appreciation in values difficult to project, the amount of insurance needed may have to be based on a value significantly higher than current value.

Where the purchase has not been consummated yet, a fail safe and common technique is to form a foreign corporation to acquire the property. Where the foreign person owns the shares of the foreign corporation which in turn owns the U.S. property, such property would not be subject to US estate tax as the foreign shares are not considered U.S. situs property.

Typically, the foreign corporation is formed in a “tax-haven” jurisdiction such as the British Virgin Islands or Bahamas since such countries do not impose a tax on corporate transactions. If the property is income producing, a separate branch profits tax would be due if the property is owned directly by such foreign corporation. To avoid this tax, the property may be owned by a U.S. corporation in the first instance, whose shares are then owned by the foreign corporation. Unfortunately, this subjects the net income to U.S. corporate taxation (in lieu of the branch profits tax). But such taxes can be reduced by depreciation, mortgage interest, and other deductions.

Another approach is to place the property in an irrevocable trust. This approach must be carefully structured since the trust would also be subject to U.S. estate tax if the grantor transfers property to the trust and retains the income or use and enjoyment therefrom. One way to avoid this result is for the grantor to pay fair market rent to the trust. Although under certain trust structures the rental income may be reportable for U.S. income tax purposes, even then it will likely be better than being exposed to the potential estate tax liability.

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The use of a corporate structure also imposes corporate income tax liability on the subsequent sale of the property. If an individual anticipates selling the property during his lifetime and wishes to avoid the corporate tax rate (between federal, state and city this can be as high as 53%) he can purchase the property in his own name and buy sufficient term insurance to cover the possibility of death prior to a sale event.

Where a foreign corporation or individual receives rental income, the taxation of such income depends on whether the owner is engaged in a U.S. trade or business. Generally, the ownership of real estate is not considered a trade or business if it consists of merely passive activity such as a net lease. In such situations, the gross income is subject to a 30% withholding tax (unless a lower treaty rate applies) and no deductions from gross income are allowed.

If the owner elects to treat the income as effectively connected to a trade or business and files a timely return there is no obligation to withhold from the rental income. Instead, the owner may deduct all expenses associated with the property in determining his taxable income which is then taxed at progressive rates.

In addition to the estate tax and income tax, the real estate professional must be familiar with the Foreign Investment in Real Property Tax Act (FIRPTA) which affects sales by foreigners of U.S. real property interests ("USRPI") as well as the income taxation of rental income earned by a foreign investor.

As the above limited discussion demonstrates, the purchase and sale of real estate by a foreign person may potentially result in significant tax consequences if not planned for properly in advance. Referring the investor to a competent tax professional is a valued added service the real estate professional can offer their clients.

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