



# Basic Tax Aspects of U.S. Inbound Real Estate Investment

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# BASIC DEFINITIONS

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- The Foreign Investment in Real Property Tax Act (FIRPTA), enacted in 1980, treats income and capital gains from U.S. real estate investments as “effectively connected” with a U.S. trade or business
- United States Real Property Interest (USRPI) – broad definition
- United States Real Property Holding Corporation
  - FMV of USRPIs > 50% of (USRPI + foreign RPI + other assets)
  - Look through partnerships to underlying assets
  - Look through from controlling corporations (50% or more)

# APPLICABLE U.S. TAXES

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- Corporate income tax – 35%
- Personal income tax – up to 39.6%
- Net Investment Income tax – 3.8%
- Withholding tax on interest or dividends – 30% unless reduced/eliminated by treaty or law
- Branch Profits tax – 30% unless reduced/eliminated by treaty
- Capital gains tax – 35% for corporations, up to 20% for individuals (plus NII where applicable.)

# TYPICAL STRUCTURING CONCERNS

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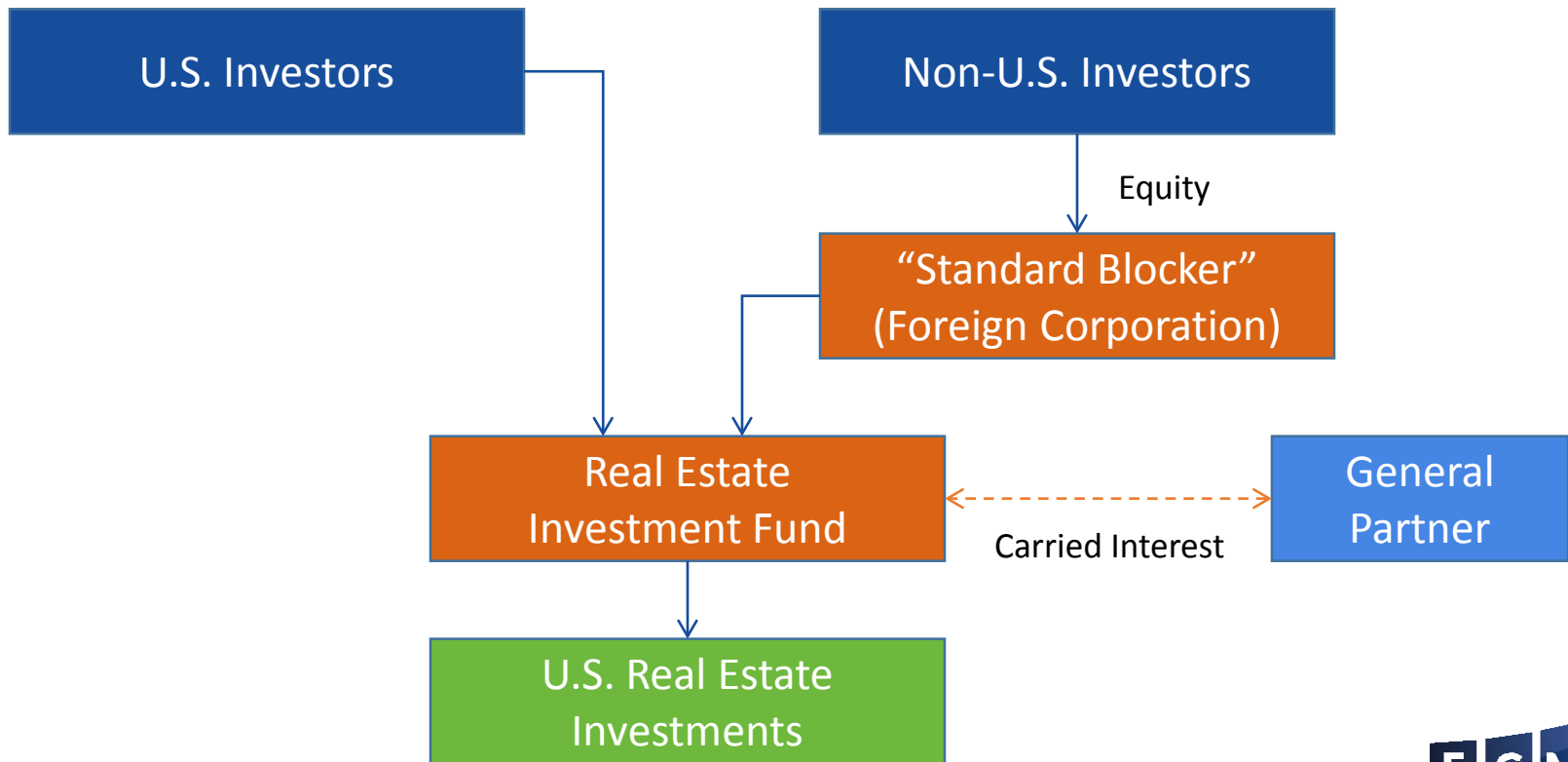
- Maximize leverage/minimize interest withholding tax
- Minimize tax on profit distributions
- Avoid double taxation of income or capital gains
- Achieve legal liability protection
- Minimize IRS view of overall tax posture
- Avoid adverse estate/inheritance tax aspects
- Manage cash flows from investments

## “STANDARD BLOCKER”

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- “Standard Blocker” pays effective rate of tax at 54.5% (up to 35% on realized gains, plus “branch profits” tax of 30% ), unless the blocker resides within a treaty jurisdiction
- Standard Blocker files U.S. income tax return. Non-U.S. investors are thus not subject to tax return filing requirements, or investigatory and subpoena powers of the IRS
- Structure is less complex than Leveraged Blocker structure, but less tax efficient
- Blocker corporation can be formed in low-tax offshore jurisdiction to avoid local tax on dividends

# “STANDARD BLOCKER”

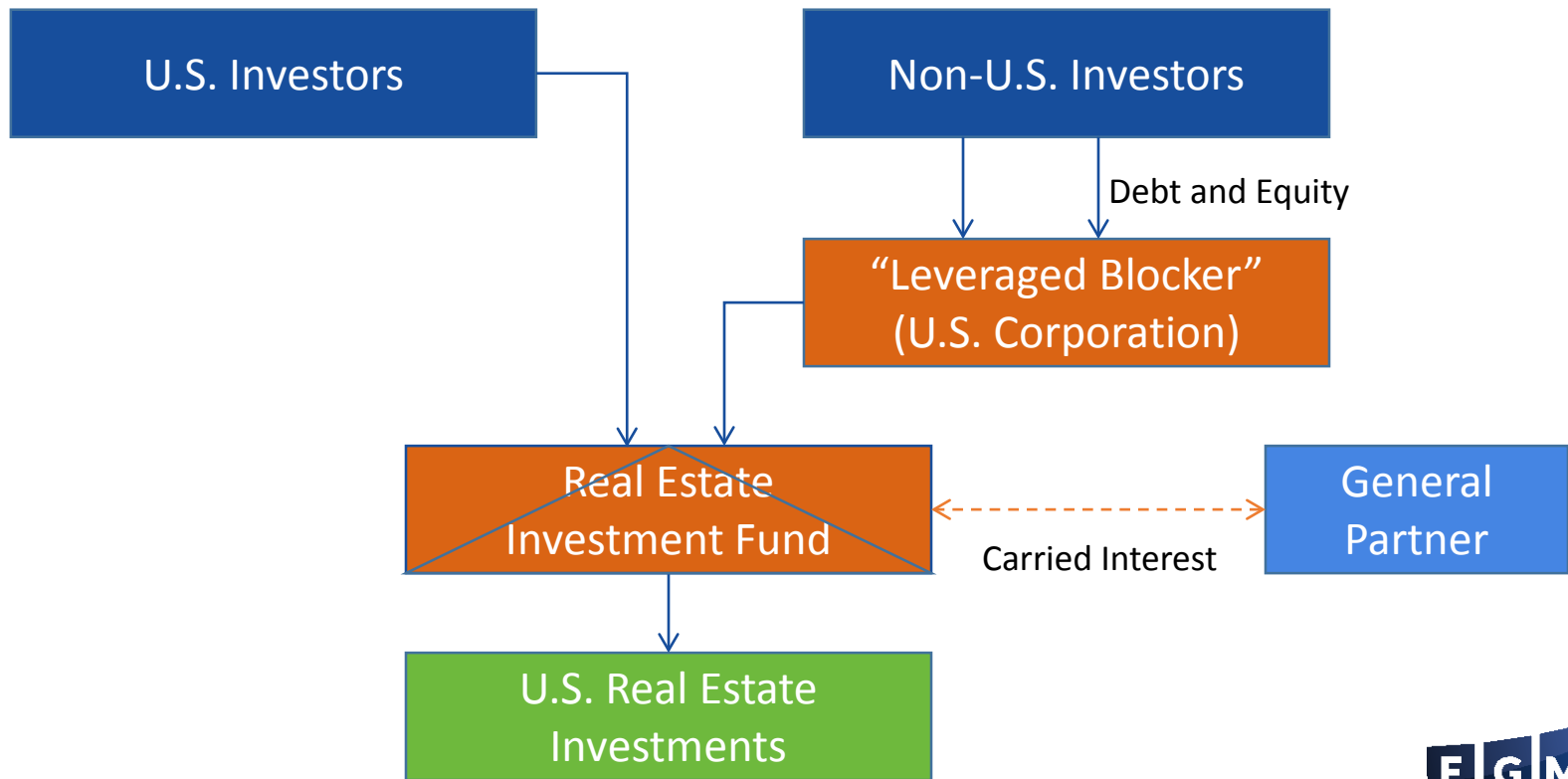


## “LEVERAGED BLOCKER”

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- Leveraged Blocker pays U.S. tax on realized gains
- NRA investors capitalize blocker with debt and equity
- Interest payments on debt reduce net taxable income of leveraged blocker
- Interest payments may escape withholding tax, depending on treaty and/or portfolio interest exception
- Dividend payments on profit may have low withholding tax, depending on treaty terms

# “LEVERAGED BLOCKER”



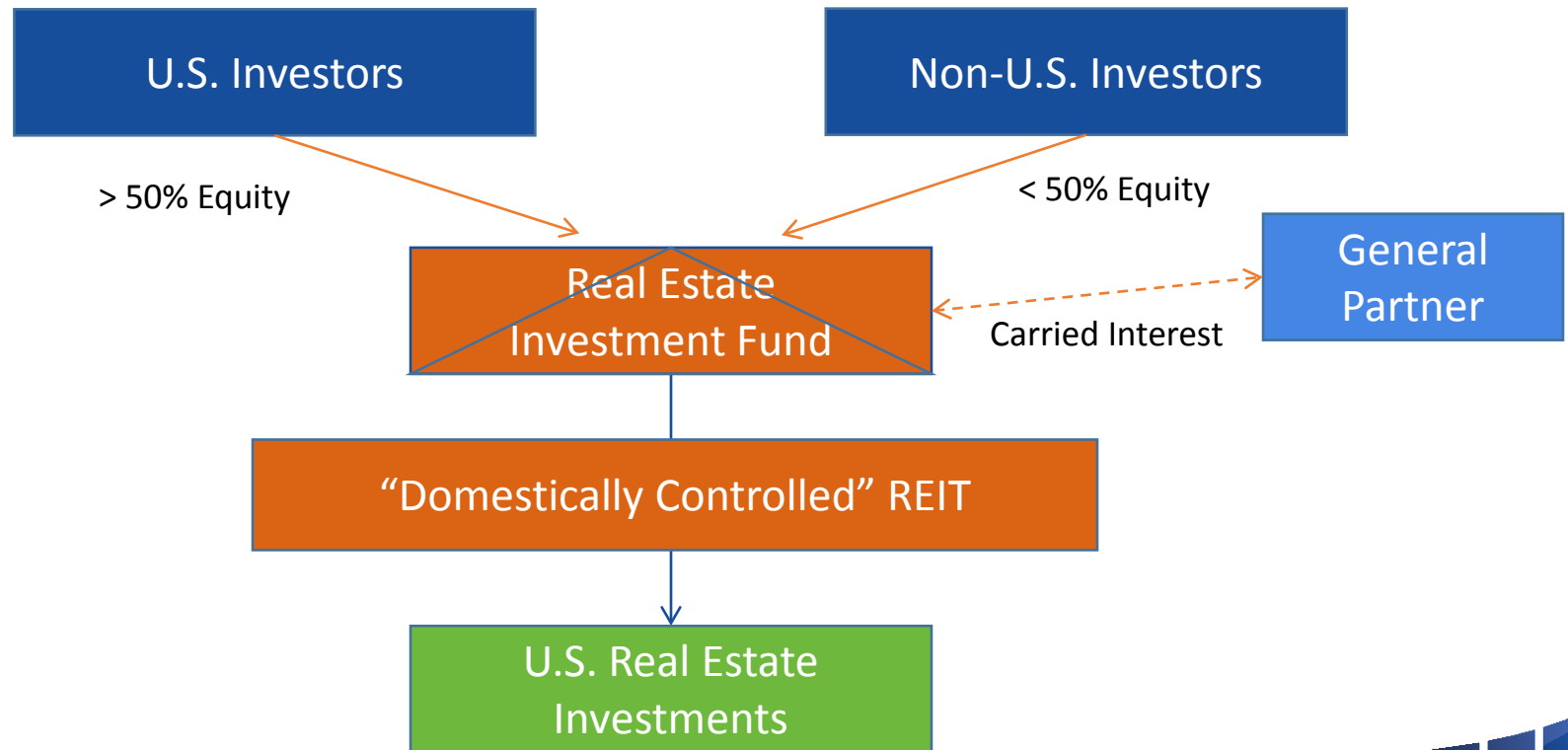


# DOMESTICALLY CONTROLLED REIT

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- REIT must be more than 50% held by U.S. persons in order to be “domestically controlled”
- Sales of underlying real estate can still trigger FIRPTA tax and U.S. tax return filing requirement to non- U.S. investors
- Benefit to non-U.S. investors may be limited to reduced U.S. tax withholding rates on dividends paid by REIT
- REIT structure may also be favorable for funds that invest in non-capital gain producing assets, or public or other domestically-controlled REITs

# DOMESTICALLY CONTROLLED REIT

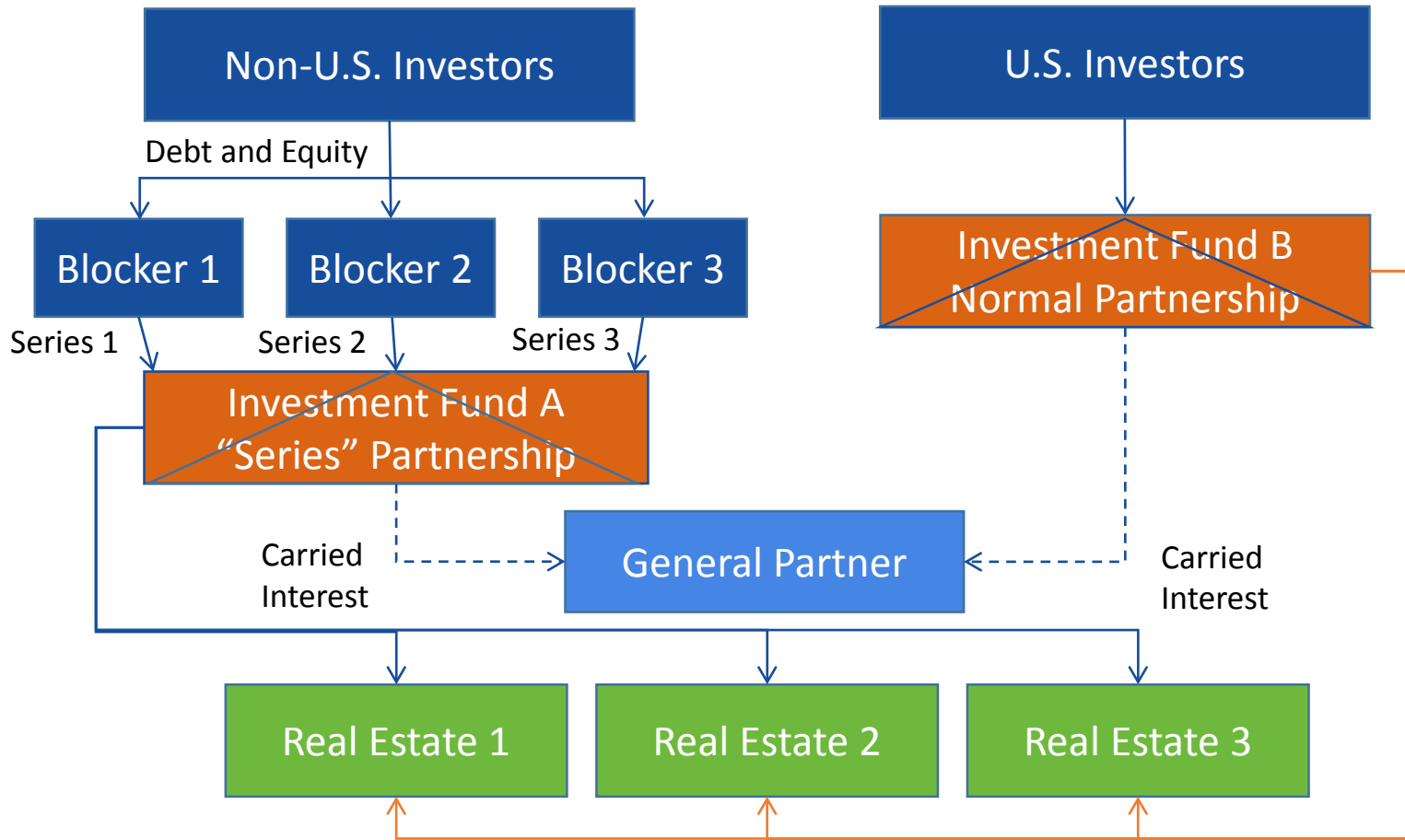


# SERIES PARTNERSHIP

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- Investment Fund A requires a separate “series” for every real estate investment
- Each real estate investment has a corresponding “leveraged blocker”
- With respect to each real estate investment, NRA investors receive repayment of debt, and proceeds from the liquidation of the corresponding “leveraged blocker”
- Involves many entities and can be costly to implement and manage
- Some uncertainty regarding IRS’ level of comfort with proposed carried interest arrangement

# SERIES PARTNERSHIP



# TRANSFER TAX PLANNING – 1

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- Issue 1: What are the estate, inheritance, gift, and income tax implications of non-resident aliens holding inbound U.S. real property?
  - Treaty protection (there are only 17 U.S. transfer tax treaties)
  - Without regard to the investor's citizenship or domicile, the U.S. will tax certain U.S. situs assets, such as real property (Treas. Reg. § 20.2104-1(a){1})
  - Absent treaty protection, the U.S. transfer tax repercussions can be very problematic
    - Modest \$60,000 estate tax exclusion
    - No marital deduction without special planning
    - Possible death tax double taxation
    - Possible offshore capital gain recognition

# TRANSFER TAX PLANNING – 2

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- Issue 2: What can be done to eliminate the U.S. tax nexus
  - Re-characterize the asset as an intangible, specifically a foreign entity, such as a corporation
    - Place U.S. real property interest into a foreign corporation
    - Foreign corporation needs a bona fide business purpose
      - Establish a rebuttal to the possible form over substance argument
      - A generic business purpose can undermine
  - Best planning would include comingling the U.S. situs real property with other assets that help establish the “business purpose” related to the entity

# TRANSFER TAX PLANNING – 3

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- Issue 3: Use of partnerships and LLCs
  - Two competing theories related to U.S. tax nexus
    - Aggregate Theory: views a partnership interest as pro-rata ownership of the partnership's underlying assets,
      - the place of organization of the partnership is irrelevant
      - U.S. nexus determined by the situs of the partnership's property.
    - Entity Theory: the partnership is an entity separate from its partners. To determine the situs of a partner's interest in the entity you look to
      - the location where the partnership conducts its business, or
      - the residency of the partnership for income tax purposes (i.e., its place of organization)
  - If partnership either has its assets in the U.S. or does business in the U.S. it will likely have a U.S. nexus



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