

WHITE PAPER

*Foreigner's Tax Guide to  
Buying U.S. Real Estate*



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## Structuring and Tax Considerations for Foreign Investors Acquiring U.S. Real Estate

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For a foreign investor, seizing the moment and identifying a U.S. property to purchase is generally the easy part of the acquisition process. Choosing the right structure for the acquisition from a legal, tax and risk standpoint, isn't quite as easy (or enjoyable). As such, the first step in making a decision to buy a United States Real Property Interest (USRPI) is to meet with a U.S. tax professional and/or real estate attorney.

The predominant question tax professionals are asked when meeting with foreigners who are acquiring or have acquired USRPI is "what is the optimal structure for acquiring it?" The answer is always the same: it depends.

The structure depends on the foreigner's unique facts and circumstances as every foreign investor is different in terms of needs, goals, and timelines. For instance, a younger individual may be more concerned with limiting his or her income tax liability rather than estate taxes as it relates to the purchase. An older individual may be focusing on estate tax issues and on efficient ways to transfer the property to his or her loved ones. Thus, there is no way to recommend an optimal structure without interviewing the foreigner and considering all the facts and circumstances.

From a U.S. tax perspective, several factors will help determine the optimal structure for acquiring a USRPI. Some of these factors include:

- The amount of the investment
- The purpose for buying the property (e.g., personal usage vs. rental property)
- The expected holding period
- The investor's country of origin
- The investor's budget
- The investor's short-term and long-term needs
- The investor's goals

In addition to these factors, a foreign investor must weigh several tax considerations that will likely impact the acquisition in one way or another. The following represents three significant U.S. tax considerations that should be addressed when purchasing a USRPI, followed by the most common investment structures used in acquiring a USRPI.

## *Three Significant Tax Considerations*

### **FIRPTA**

The Foreign Investment in Real Property Tax Act of 1980, otherwise known as FIRPTA, was enacted to ensure collection of U.S. withholding tax from foreign investors disposing of a USRPI a U.S. trade or business. As such, the foreign person transferor of the USRPI will generally be taxed on the transfer.

For 2013 real estate sales, the applicable income tax rate ranges from 15% to 20% if the property is owned by an individual or flow-through entity for more than a year or 35% if owned through a foreign corporate entity. The United States collects that tax by requiring a withholding agent, generally the broker, to withhold either 10% of the gross consideration from the sale of the USRPI or 35% of the gains of the sale of the USRPI. The withheld amount is then transmitted to the Internal Revenue Service (IRS) as prepayment of the income tax on behalf of the foreign seller and acts as a credit against the foreign seller's U.S. income tax obligations (if any). It's a major inconvenience when the foreign individual does not have an income tax liability, but in order to comply with FIRPTA, he/she must go through the time-consuming process of submitting several tax forms and waiting to request/process a refund of the overpayment of the income tax that has been withheld.

Both the transferor and the transferee must have a U.S. Tax Identification Number (ITIN) for the reduced withholding (or early refund) process to take place. It should be noted that through proper planning, a reduced withholding or an early refund may be obtained upon a timely application to the IRS.

FIRPTA's rules and regulations are onerous, not only from a financial standpoint, but from a compliance standpoint as well. As such, it is in a foreign investor's best interest to choose a structure that is not subject to FIRPTA, if possible.

It provides that gains derived from the disposition of a USRPI by a foreign person will be deemed to be income effectively connected with

### **U.S. Branch Profits Tax**

Some foreign persons choose to acquire USRPIs through a Foreign Corporation. An adverse consequence of acquiring U.S. real estate through a Foreign Corporation is the Branch Profits Tax. The Branch Profits Tax is a 30% tax imposed on a Foreign Corporation's annual after-tax net profit. The Foreign Corporation pays regular corporate income tax on its effectively connected taxable income, and after that corporate income tax has been paid, the Foreign Corporation pays the Branch Profits Tax of 30% on the remaining amount that is not deemed to be reinvested in the United States.

There are a few ways to avoid or lower the Branch Profits Tax, such as reinvesting the Foreign Corporation's profits in the United States, having certain exemptions in the income tax treaty between the country in which the Foreign Corporation was formed and the U.S., or terminating all business operations in the U.S. upon the sale of all USRPIs and not reinvesting for a number of years. The Branch Profits Tax also doesn't affect Foreign Corporations that own U.S. property that is not producing income (i.e., non-rental

properties), such as vacant investment properties. Personal use of corporate assets requires income recognition at the corporate level.

As stated above, a Foreign Corporation that ceases all operations in the U.S. may avoid the Branch Profits Tax. However, that could prove difficult for a Foreign Corporation that owns several rental properties (i.e., income-producing properties) because all properties would have to be sold in order for operations to cease, thereby avoiding the Branch Profits Tax.

### **U.S. Estate Tax**

A foreign individual will be subject to the U.S. estate tax on the portion of his or her gross estate (assets controlled by taxpayer) situated in the United States. Thus, if a foreigner dies owning real estate in the United States, his or her taxable estate would include the USPRI's value, and the estate would be subject to the U.S. estate tax. For 2013, there is a \$60,000 value exemption (netted against the gross estate), and the estate tax rate ranges from 18 to 40%.

It should be noted that some investors who purchase real estate as individuals choose to minimize the risk of estate taxes by purchasing term life insurance. The settlement from the insurance policy would offset some or all of the estate tax. The insurance policy is then placed in an Irrevocable Life Insurance Trust in which the owner of the USPRI names someone other than himself as the trustee and beneficiary. The inclusion of a life insurance trust facilitates administrative and legal matters in the event of a foreign individual's passing. While the life insurance alternative is intriguing in theory, it can prove to be quite expensive if the policyholder outlives expectations.

## ***Most Common Structures Used to Acquire U.S. Real Estate***

Foreign investors can acquire U.S. real estate in a number of different ways through a number of different structures. Some elect to make the acquisition through simple structures using just one entity (single-tiered structure), while others choose more complex structures involving several entities (multi-tiered structure).

### **Single-Tiered Structures**

#### **Direct Ownership by Foreign Individual**

The most common way for a foreign person to acquire U.S. real estate is as an individual. The advantages of such a structure are its simplicity, an assumed (more) favorable long-term capital gains tax rate at the date of sale, and affordability (from a structuring standpoint). However, there are some disadvantages.

First, the foreign person's estate will be subject to the estate tax upon his or her death, or gift tax upon gifting the property. As stated above, the estate tax rate is significant as it can range from 18% to 40%. Second, the foreign investor would be subject to FIRPTA and its onerous withholding rules upon the disposition of the property. Third, owning the property as an individual leaves the investor vulnerable from a liability standpoint if the investment is a rental property as any accident at the property may result in litigation against the individual owner.

Many foreigners value their anonymity and prefer to stay off of the U.S. government's radar. Foreigners who directly own real estate would be required to file an annual tax return, which means such anonymity would not be possible. Furthermore, the local counties of U.S. states list the owners of U.S. real estate on their property appraisers' records, which are available for review by the public (via the internet).

In many cases, foreigners approach tax professionals already owning U.S. real estate individually and it results in after-the-fact structuring, such as transferring the property to another entity like an LLC or corporation. The resulting transfer of property to a legal entity may result in a U.S. income tax liability (via FIRPTA), local transfer taxes, additional U.S. tax filing requirements, and additional administrative and filing costs.

### **Ownership by U.S. Corporation**

One of the least common ways that foreign persons own U.S. real estate is through U.S. Corporations. Though ownership via a US Corporation provides the foreign investor/shareholder the shield of limited liability, it comes with significant disadvantages. For example, the sale or disposition of the property or company stock is subject to the FIRPTA tax provisions, higher federal and state corporate tax rates (as opposed to lower long-term capital gain rates), and estate taxes (based on the value of the USRPI) upon the shareholder's death. Some anonymity is achieved when acquiring USRPI under this structure, however it is not total as the company will be required to disclose shareholder information on their tax return (Form 1120) if the foreign person owns more than 50%.

### **Ownership by Foreign Corporation**

A foreign investor's ownership of U.S. real estate via a Foreign Corporation has many similarities to owning U.S. real estate via a U.S. Corporation, such as the annual filing of a federal and state tax return (Form 1120F), the shield of limited liability, and some level of anonymity. It also shares one of its main disadvantages: corporate tax rates, which are likely to be greater than long-term capital gain tax rates found in other structures (e.g., individual, pass-through entities). One significant difference is that this structure usually eliminates the estate and gift tax, which can be substantial. Another difference is the inclusion of the Branch Profits Tax, which would be a factor if the corporation has income and/or distributes earnings via a dividend.

### **Ownership by Limited Liability Company (LLC)**

One of the most common ways that foreign investors choose to acquire U.S. real estate is through a Limited Liability Company, usually as a single-member LLC. Such a structure may have some of the ownership benefits of a corporation and of an individual (lower capital gain rates; low cost of structuring). However, as with the individual ownership structure, acquiring USRPI via an LLC leaves a foreign individual vulnerable to estate & gift taxes and FIRPTA withholding regulations. Additionally, as a single-member LLC, the foreign individual would be required to record all rental activity (assuming the property is income-producing) on an annual individual tax return (Form 1040NR), thus eliminating any form of anonymity the investor may seek.

## Multi-Tiered Structures

### Foreign Corporation Owning a U.S. Corporation

A foreign person can invest in U.S. real estate through a two-tier structure that includes a Foreign Corporation and U.S. Corporation. Under such a structure, the Foreign Corporation would own the stock of the U.S. Corporation as its sole asset, and the U.S. Corporation would own the USRPI directly. If more than one USRPI is owned, then forming a U.S. Holding Corporation that owns multiple U.S. subsidiaries (to own each individual USRPI) would be prudent. While more complex and costly from an administrative perspective, this two-tier structure may provide the foreign individual with certain advantages, such as the avoidance of estate tax and Branch Profits Tax, which should outweigh the aforementioned complexity and costs.

### Foreign Corporation Owning a US Corporation That Owns Several LLCs

A foreign investor's acquisition of several income-producing properties generally results in a more complex structure. Such a structure may include a Foreign Corporation that wholly owns a U.S. Corporation, which in turn owns several LLCs, one for each property acquired. An individual LLC is organized for each property to provide limited liability and limit potential legal risks to each individual property. From a U.S. income tax perspective, the income and/or losses of each property/LLC then flows up to the U.S. corporate owner and is recorded on the income tax return (Form 1120) of the U.S. Corporation, which serves as the Holding Company. Such a structure carries many of the attributes of the structure above, such as being subject to FIRPTA rules and regulations, avoidance of estate taxes and the Branch Profits Tax, the same income tax rate, and anonymity. From an administrative standpoint, costs would be dictated by the number of properties within the structure.

## Other Multi-Tiered Structures

### Trusts

A foreign investor may structure a U.S. Investment interest in real estate utilizing either a domestic or a foreign trust (revocable or irrevocable). FIRPTA rules will generally apply, however trusts generally create favorable opportunities for estate planning. Because of the complexity in various trust instruments, consulting a legal and/or tax professional is strongly advised.

## Summary

Foreign persons interested in acquiring property interests in U.S. real estate have a slew of options available from a structuring standpoint. The option a foreign person ultimately pursues will have a material impact from a tax, risk and legal standpoint. The eventual structure should be determined based on a foreign investor's unique facts and circumstances. In determining the optimal structure, a foreign investor should consider several factors, including: his or her potential U.S. income tax liability, other related tax issues (U.S. estate and gift tax, FIRPTA, Branch Profits Tax), the importance of anonymity, liability exposure, and the administrative costs associated with each structure.

In the end, the key for any foreign investor is to properly plan before acquiring USRPI by consulting a real estate attorney and/or U.S. tax professional. Without proper planning, a foreign investor runs the risk of after-the-fact structuring, which may result in higher administrative and legal costs, potential tax liabilities and needless tax filings.

## Contact us to learn more



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