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Foreign Clients Purchasing US Real Property: Plan Carefully

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When foreign clients (nonresident aliens for US tax purposes) purchase real property in the United States for personal use, they often purchase the property through a foreign corporation to limit their liability and to escape United States income and estate taxation when the property is ultimately transferred. While considerable US tax benefits can be achieved by using a foreign corporation, such benefits must be weighed carefully against the potentially adverse US income tax consequences that might arise as a result of a transfer before death.

Holding US real estate through a foreign corporation can be advantageous for US tax purposes, especially in cases where the US real estate is expected to be owned by successive generations of the same family. Holding the real estate through a foreign corporation insulates the nonresident alien shareholder from the imposition of the US estate tax because, unlike shares of a US corporation, shares of a foreign corporation are deemed to be located in the jurisdiction where the corporation is organized and, therefore, are not US-situs property for US estate and gift taxation of a nonresident alien. Moreover, since a nonresident alien can sell shares in a foreign corporation without any US tax consequence, it is possible to transfer the underlying real estate without triggering a US tax.

FOREIGN CORPORATIONS, NOT QUITE THE ALL WEATHER SUIT

If certain corporate formalities are not observed, however, the IRS may take the position that the corporation is a sham and the nonresident alien decedent is the beneficial owner of the US real estate. Thus, if a foreign corporation is illusory or is determined to be the alter ego of the nonresident alien, it may be ignored for federal estate tax purposes, with the result that the nonresident alien shareholder will be deemed to own directly the property of the foreign entity that is situated in the United States. In addition, if the nonresident alien sells the US real estate, the gain will be subject to the special income tax rules of the Foreign Investment in Real Property Tax Act of 1980, also known as FIRPTA. Prior to the enactment of FIRPTA, a nonresident alien could acquire, hold and dispose of US real property without paying federal income taxes on either operational or disposition income. After FIRPTA, any gain recognized by a nonresident alien or entity from the disposition of a US real property interest is subject to US income tax as if the nonresident alien or entity was engaged in a US trade or business and as if such gain was effectively connected with such trade or business. Corporations are not eligible for the preferential long-term capital gains

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rate of 15 percent, and so any gain to the corporation from the sale of US real estate is taxable at corporate tax rates of up to 35 percent. Moreover, if the sale is not planned properly, the corporation may be subject to an additional Branch Profits Tax, at rates of up to 30 percent.

While it is true that the US taxes can be avoided by selling the shares of the foreign corporation instead of the underlying real estate, the owner may have difficulty in finding a willing buyer. After all, in addition to buying the real estate with a US built-in gain, the buyer will be acquiring any additional liabilities of the foreign corporation. Most likely, such a buyer will demand a discount for purchasing the foreign corporation, thereby reducing or perhaps even eliminating any tax benefit received by selling the corporation rather than the real estate.

One may think that an obvious alternative is to hold the US real estate directly, but individual ownership generally is undesirable due to the unquestionable exposure to US estate and gift taxes, as well as the prospect of unlimited personal liability and the lack of confidentiality regarding ownership. Many nonresident aliens also will be reluctant to use the trust form because of the tax risk of a trust with business activities being characterized as an "association taxable as a corporation" and the degree to which the investor typically must give up beneficial ownership and control in favor of heirs to achieve the desired protection against US estate tax. Thus, a partnership (and specifically a limited partnership or limited liability company taxed as a partnership) may be the most desirable form of non-corporate ownership.

FOREIGN PARTNERSHIPS, THE NONRESIDENT ALIEN'S BEST FRIEND?

The partnership has the very significant advantage of enabling the nonresident alien to obtain the benefits of the lower income tax rates applicable to individuals. In addition, the partnership also provides a vehicle for making US tax-exempt gifts of the partnership's underlying US real estate through transfers of the partnership interest itself because US gift tax on nonresident aliens is not applicable to gifts of intangible interests, such as a partnership interest. In contrast, if a nonresident alien were to own US real estate and business assets directly in his or her own name, then a gift of all or any portion of those assets would be subject to the US gift tax.

A potential US tax negative to the partnership form of ownership is the question of whether it creates any exposure to US estate taxation, a question of considerable debate that is beyond the scope of this article.

Obviously, no one structure is appropriate for all situations. A thorough examination of the client's particular facts, including the client's desire for anonymity and sensitivity to tax filing obligations, the type of real estate to be acquired, and the expected holding period will determine how best to proceed. In addition, the US tax rules will always have to be considered in conjunction with the nonresident alien's income tax situation in the client's home country.

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