# Tax Guide For Foreign Investors In U.S. Residential Real Estate

2019 EDITION

DAVIS MALM

ATTORNEYS

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# I. INTRODUCTION

The U.S. income tax code contains numerous traps for the unwary foreign investor. This guide is intended to assist the foreign investor in U.S. real estate in understanding how the U.S. estate, gift and income tax rules affect his or her investment and the planning opportunities available to minimize U.S. taxes.

With proper legal advice, a foreign investor should be able to:

- avoid U.S. estate and gift taxation on his or her investment;
- avoid the 30% withholding tax on the gross income generated by his or her investment;
- minimize the annual U.S. income tax liability on the net income generated by his or her investment; and
- minimize the potential capital gain on the profitable sale of his or her investment.

This edition reflects the changes in U.S. income tax law made by the Tax Cuts and Jobs Act of 2017, enacted on December 22, 2017, and generally effective for 2018 and subsequent tax years.

# II. THE U.S. TAX SYSTEM

## A. U.S. PERSONS

### 1. Basic Rules

U.S. persons are subject to U.S. income taxation on their worldwide income; individuals who are U.S. residents are subject to U.S. estate, gift and generation-skipping transfer ("GST") taxation on their worldwide assets.

Non-U.S. persons are subject to income tax only on their U.S. source income; individuals who are non-U.S. residents are subject to U.S. estate, gift and GST taxation only on U.S. situs assets.

### 2. U.S. Persons

U.S. persons include U.S. citizens (including persons with dual citizenship in the U.S. and a foreign country) and U.S. residents, regardless of citizenship.

*For U.S. income tax purposes*, a U.S. resident includes a "green card" holder (or other lawful permanent resident) who is present in the U.S. A person is also a U.S. resident if he has a "substantial presence" in the U.S. One is deemed to have a substantial presence if he or she is (a) present in the U.S. for 183 days in a calendar year; (b) present in the U.S. for at least 31 days in a calendar year and has been present in the U.S. for an average of more than 121 days per year during that year and the two prior years; or (c) elects to be classified as a U.S. resident in certain circumstances. The tax code contains numerous exceptions for persons temporarily in the U.S.

*For U.S. estate tax purposes*, a different test is used: Whether the person resides in and has "domicile" in the U.S. A person has domicile in a country by living there indefinitely, with no intention of relocating to another country.

### 3. U.S. Domestic Corporations

A corporation organized in the U.S. (usually under state law) is a U.S. person.

### 4. U.S. Domestic Trusts

A trust is a U.S. person if (a) it is subject to the primary jurisdiction of a U.S. court over its administration *and* (b) one or more U.S. persons have the power to control all substantial decisions of the trust.

## B. NON-RESIDENT ALIENS ("NRAS")

A person is an NRA if he, she or it is not a U.S. person. NRAs include foreign individuals, foreign corporations, and foreign estates and trusts.

# III. ESTATE TAXATION

## A. U.S. PERSONS

An estate of a U.S. citizen or resident is subject to an estate tax based upon the value of the worldwide property, tangible and intangible, owned by the decedent on the date of death or over which he has certain rights or powers. The current estate tax rate for 2018 is 40% for taxable estates in excess of an $11.2 million exemption, which is adjusted annually for inflation. A U.S. estate may also deduct from the taxable estate a marital deduction equal to the value of property left to a surviving spouse. The amount of lifetime taxable gifts during the decedent's life is also included in calculating the gross estate. *See* Section VI below.

## B. NON-RESIDENT ALIENS

The gross estate of an NRA includes all tangible and intangible property situated in the U.S. ("U.S. property"), in which the decedent has an interest at the time of his death, or over which he has certain rights or powers.

The taxable estate of an NRA is taxed at rates ranging from 26% to 40% of the value of estates in excess of a $60,000 exemption (the 40% rate applies to taxable estates over $1 million in value). Moreover, the estate of an NRA is generally not allowed a marital deduction unless the surviving spouse is a U.S. citizen. Taxable gifts are not included in the gross estate, but are separately taxed. *See* Section VI below.

U.S. property included in an NRA's estate include (i) U.S. real estate owned or under his control; (ii) corporate stock in a U.S. corporation; (iii) debt obligations of a U.S. person (with exceptions for certain bank deposits and "portfolio interest obligations"); (iv) interests in U.S. partnerships; and (v) interests in U.S. trusts (discussed below). Life insurance proceeds, even if paid by a U.S. insurer, are *not* included in an NRA's estate. A credit against the estate tax is allowed for gift taxes paid.

The U.S. has tax treaties with several foreign countries which may limit the amount of U.S. estate tax on an NRA's estate.*

Massachusetts has an estate tax applicable to real estate and tangible personal property located in Massachusetts. Rates range from 0.8% to 16%; estate tax returns need not be filed if the gross estate is $1 million or less. Other U.S. states also impose estate or inheritance taxes (so-called "death taxes") on NRA estates. These tax rates are lower than the U.S. estate tax rate, but these taxes should not be ignored when planning an investment in U.S. real estate.

* The U.S. has estate tax treaties with the following countries: Australia, Austria, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, South Africa, Norway, Switzerland, and the U.K.

# IV. U.S. ESTATE TAX CONSEQUENCES OF REAL ESTATE OWNERSHIP STRUCTURES

## A. DIRECT OWNERSHIP BY NRA

U.S. real property directly owned by an NRA on his death is subject to U.S. estate taxes (and any applicable state death taxes).

## B. DOMESTIC (U.S.) CORPORATION

Shares of a U.S. corporation owned by an NRA on his death are subject to U.S. estate taxes (and any applicable state death taxes).

## C. FOREIGN CORPORATION

Shares of a foreign corporation owned by an NRA on his death are *not* subject to U.S. estate taxes (and many state death taxes).

## D. U.S. DOMESTIC TRUSTS

The interest of a beneficiary in a U.S. trust owned by an NRA is subject to U.S. estate taxes (or any applicable state death taxes).

## E. IRREVOCABLE FOREIGN TRUST

Any U.S. property owned by a foreign trust is *not* subject to U.S. estate taxes (or many state death taxes) on the death of the settlor of the trust *unless* (a) the trust is a "grantor trust," or (b) the settlor of the trust had certain retained powers over or interests in the trust on the date of death.

## F. REVOCABLE OR GRANTOR FOREIGN TRUSTS

If an NRA possesses the right to revoke the trust, or possesses any of the proscribed powers or interests in any U.S. property held by the trust on the date of his death, he will be subject to U.S. estate taxes (and any applicable state death taxes).

## G. PARTNERSHIP INTERESTS

An investment in a partnership may be considered to be U.S. property if the partnership is engaged in business in the U.S. or holds U.S. assets; the tax law is unsettled on this issue.

# V. U.S. ESTATE TAX PLANNING

In most cases, it is better for a foreign person to be classified as an NRA than a U.S. resident, since the estate tax applies only to the NRA's U.S. property, and not to his worldwide property. However, some foreign investors may seek U.S. resident status and the generous $11.2 million exemption from worldwide taxation, as they do for U.S. residents. If the bulk of a foreign individual's wealth is located in the U.S., it may be good estate tax planning for him or her to seek U.S. resident status.

It is clear that an NRA planning to invest in U.S. real estate will want to avoid direct ownership as an individual, or indirect investment through a U.S. corporation, U.S. trust, revocable foreign trust or U.S. partnership, since in each case, he would own U.S. property that would be subject to the U.S. estate tax on his death. Investment through a foreign corporation or a foreign irrevocable trust would not have that result.

## A. FOREIGN CORPORATION

Foreign investors who invest through a foreign corporation should avoid the U.S. estate tax (and most state death taxes). However, the imposition of *income* taxes via withholding taxes or the "branch profits tax" (discussed in Section IX(B)(4) below) may preclude the foreign corporation as a viable alternative, unless a favorable tax treaty exists.

## B. U.S. CORPORATION WITH FOREIGN CORPORATION PARENT

Favorable U.S. income and estate tax treatment may be found through a structure where a U.S. corporation owned by a foreign corporation purchases income-producing real estate. This structure avoids both the estate tax and the branch profits tax.

## C. FOREIGN IRREVOCABLE TRUST

Another favorable estate tax structure is the ownership of U.S. real estate by an irrevocable foreign trust, especially where the property is not income-producing. In such cases, care must be taken (a) to establish the trust in a non-U.S. jurisdiction or to avoid designating a U.S. fiduciary with control over substantial decisions of the trust (to avoid classification as a U.S. trust), and (b) to limit the powers of the settlor over the U.S. real property in the trust.

## D. LIMITED LIABILITY COMPANY WITH FOREIGN IRREVOCABLE TRUST PARENT

One drawback to the use of a foreign irrevocable trust is that, unlike a corporation, the trustee does not have limited liability for all of the trust's debts. One way to avoid this problem is for the trust to create a wholly-owned U.S. limited liability company ("LLC") to own the real estate.

The LLC is a common form of U.S. ownership entity permitted in nearly all U.S. states. It combines the attractive attributes of limited liability for the owners ("members") and management by the members or designated "managers." An irrevocable foreign trust may thus establish a wholly-owned LLC as the owner of U.S. real estate, thus affording the trustee and beneficiaries with limited liability protection and allowing them to use a familiar U.S. entity in dealing with U.S. contract parties.

One tax attribute of an LLC may be quite advantageous: LLCs with a *single owner* are treated as "disregarded entities," which are treated by the IRS as if they did not exist for U.S. income tax purposes. Ownership of real estate by an LLC wholly owned by a foreign irrevocable trust should not result in estate or gift taxation.

Ownership of real estate through a single member LLC is also a good way of preserving the confidentiality of the identities of the trust's owners and limiting the liability of the trust for obligations of the LLC.

# VI. U.S. GIFT TAXES

## A. U.S. PERSONS

U.S. persons are subject to a U.S. federal gift tax on gifts made of their worldwide assets. The gift tax is imposed on the *donor;* donees are not subject to gift or income tax on the receipt of the gift. Taxable gifts are taxed at rates ranging from 18% (for taxable gifts not in excess of $10,000) to 40% (for taxable gifts in excess of $1 million) on the fair market value of gifts made worldwide. An annual exclusion of $14,000 per donee (for 2018) is allowed for gifts of non-trust present interests; spouses may elect to make joint gifts (split 50/50 between spouses). A lifetime exemption of $11.2 million, combined with the estate tax exception, is allowed. Gifts include "bargain sales" at less than fair market value; the excess over fair market value is treated as a taxable gift. Gifts to revocable or grantor trusts are *not* taxable gifts, but such assets remain subject to estate and income taxation of the settlor of the trust. Gifts to irrevocable trusts are taxable, and do not qualify for the $14,000 annual present interest exclusion. Gifts to spouses are free of tax.

## B. NON-RESIDENT ALIENS

A foreign national who is not a U.S. resident is subject to a U.S. federal gift tax on gifts of U.S. *tangible* personal property and cash; U.S. real estate is subject to the gift tax; corporate stock and partnership interests are not. An annual exclusion of $14,000, adjusted for inflation, is allowed per donee; joint gifts with spouses are not allowed unless the spouse is a U.S. person. Gifts to spouses are not entitled to the marital deduction unless the spouse is a U.S. citizen, but an inflation-adjusted annual exclusion is allowed for gifts to a non-citizen spouse (for 2018, the exclusion is $140,000). No other exemption is allowed for lifetime gifts, although gift taxes paid may be credited against the estate tax.

Since the gift tax only applies to *tangible* U.S. property, it does not apply to gifts of stock of foreign corporations or other intangible property. Only a few U.S. states impose a gift tax; U.S. tax treaties may limit the amount of U.S. gift taxation.

# VII. U.S. GIFT TAX PLANNING

Gifts of directly-owned U.S. real estate should be avoided. Gifts of stock, bonds, bank deposits, and partnership interests are "intangible property" not subject to the gift tax. The gift tax can often be avoided by holding real estate (or other tangible assets) in a corporation or other entity and making gifts of the corporation's stock or interests in the other entity.

A recent U.S. Tax Court case suggests that a single-member limited liability company is treated as a separate U.S. entity for estate and gift tax purposes. A gift of a membership interest in an LLC which owns real estate would be a gift of intangible property not subject to the gift tax.

The formation of a U.S. or foreign corporation owned by the grantor to acquire U.S. real estate is not subject to the gift tax. The creation of a foreign trust to own real estate may require careful planning. If the trust is funded by cash donated by an NRA to the trust in the U.S., this could be deemed a taxable gift.

# VIII. U.S. INCOME TAXATION OF U.S. RESIDENTS

## A. INDIVIDUAL INCOME TAX RATES

For 2018, individual Federal income tax rates are graduated by tax brackets at 10%, 12%, 22%, 24%, 32%, 35% and 37%. Tax brackets vary depending on the status of the individual taxpayer as a single taxpayer, married taxpayer filing joint return or surviving spouse, head of household, or married taxpayer filing separately. The highest rate of 37% (for 2018) is applied as follows:

**Maximum Individual Income Tax Rates (2018))**

| Status | Taxable Income |
|---|---|
| Single Taxpayer | Over $500,000 |
| Married Filing Jointly | Over $600,000 |
| Surviving Spouse | Over $600,000 |
| Head of Household | Over $600,000 |
| Married Filing Separately | Over $300,000 |

A “net investment income tax” is imposed at the rate of 3.8% on the lesser of (i) net investment income or (ii) modified adjusted gross income in excess of a threshold amount ($250,000 for joint returns; $125,000 for single returns). “Investment income” includes (i) gross income from interest, dividends, annuities, royalties, and rents, except to the extent derived in a trade or business; (ii) passive activity income; and (iii) net gain from the disposition of property, other than property used in a trade or business that is not passive activity income.

## B. CORPORATE INCOME TAX RATES

The Tax Cuts and Jobs Act imposes a flat 21% income tax on corporations, effective for tax years beginning **after** December 31, 2017. This is a significant reduction from the previous 35% maximum income tax rate.

## C. QUALIFIED BUSINESS INCOME DEDUCTION FOR PASS-THROUGH INCOME

Non-corporate taxpayers may deduct up to 20% of domestic qualified business income from partnerships, S corporations, or sole proprietorships, effectively reducing the maximum income tax rate from 37% to 29.6%. A limitation on this deduction, based on wages paid (or on wages paid plus a capital element) is phased in for taxpayers with taxable income above a certain threshold amount. This deduction is disallowed for certain service businesses, but this disallowance is phased out for lower income taxpayers. The deduction applies to tax years 2018 through 2025.

## D. INCOME TAX RATES FOR TRUSTS AND ESTATES

Trusts are considered as separate taxable entities, but are entitled to a deduction for income actually distributed to beneficiaries. Beneficiaries are taxable on distributed income at ordinary individual income tax rates described in Section VIII(A) above. These rates are significantly less graduated than individual tax rates, reaching the maximum 37% rate at $12,501 of taxable income.

Undistributed income of a trust is subject to U.S. income tax at a graduated rate schedule as follows:

**Trust Income Tax Rates (2018))**

| Taxable Income | Tax Rate |
|---|---|
| $0 to $2,550 | 10% |
| $2,551 to $9,150 | 24% |
| $9,151 to $12,500 | 35% |
| $12,501 and over | 37% |

# IX. U.S. INCOME TAXATION OF NRAS

NRAs acquiring U.S. real estate exclusively used as a personal residence and not used full or part time for rental or production of income need not be overly concerned with the U.S. income tax consequences of their investment. Property owned by an NRA that is rented or used for the generation of income will be subject to income taxation.

The U.S. imposes a special income tax regime upon NRAs receiving "U.S. source income." Rents are the principal form of U.S. source income applicable to NRAs investing in U.S. real estate. An NRA real estate investor will often receive dividends or interest from the reinvestment of funds in the U.S., which are subject to U.S. income taxation.

## A. U.S. SOURCE INCOME

### 1. Rents

Rent and other income received from real property located in the U.S. are U.S. source income. Rent and other income derived by an NRA from foreign real property are foreign income not subject to U.S. income tax.

### 2. Dividends

Dividend income derived by an NRA from a corporation incorporated in the U.S. is U.S. source income, with a few exceptions. Dividend income derived from a corporation incorporated in a foreign country is foreign source income (with a few exceptions) not subject to U.S. income tax.

### 3. Interest

Interest on debt is U.S. source income if the payor is resident in the U.S., with a few exceptions. Interest on debt paid by a non-resident entity (such as a corporation or partnership) is (again, with a few exceptions) foreign income not subject to U.S. income taxation.

There are three major exceptions to this rule. The following types of interest are not considered U.S. source income:

- interest on U.S. bank deposits;
- interest on short-term debt maturing in 183 days or less; and
- so-called "portfolio interest," which includes interest on most publicly traded bonds.

### 4. Gains on Sale of U.S. Real Estate

Gains on the sale or other disposition of U.S. real estate by an NRA are U.S. source income and are subject to U.S. income tax under the FIRPTA rules discussed below in Section XI. Generally speaking, capital gains on sale or disposition of other U.S. property by an NRA are *not* subject to U.S. income tax.

## B. CHARACTER OF U.S. INCOME

The U.S. tax code provides for different methods and levels of income taxation for:

- fixed and determinable periodic income (FDAP);
- income from the conduct of a U.S. business; and
- gains from the disposition of U.S. real estate.

### 1. FDAP Income

FDAP income includes a broad category of income that is fixed in amount and paid from time to time in regular or irregular intervals. FDAP income includes *rent*, dividends, interest, wages, and other remuneration.

An NRA is subject to U.S. tax at a 30% flat rate on the *gross* amount of all U.S. source FDAP income that is *not* effectively connected with the NRA's U.S. trade or business. This tax is withheld at the source by the payor and is paid over to the IRS. For this reason, the tax on FDAP is often referred to as the "withholding tax."

The withholding tax may be limited or eliminated by a U.S. tax treaty with the foreign country where the NRA is domiciled.

### 2. U.S. Trade or Business Income

U.S. source income which is "effectively connected" with a U.S. trade on business is taxed (unlike FDAP income) on a net basis under the graduated income tax rates applicable to U.S. resident individuals or U.S. corporations. The individual income tax rates are highly graduated, ranging from 10% to 37%. In contrast, corporate income is taxed at a flat 21% rate.

Rentals of U.S. real estate on a "net lease" basis (where the tenant pays most or all of the costs of ownership of the property, such as taxes, insurance and repairs) are not considered produced by a U.S. trade or business and are therefore FDAP. Where an NRA owns U.S. real estate and rents it on an occasional, rather than regular, basis, there is some risk that rentals will be considered FDAP. However, the U.S. tax code provides for a special election allowing the taxpayer to be taxed on a net basis rather than a gross basis on its real property income. The election does not apply to other sources of income, which may be FDAP. This is a planning opportunity which can avoid the threat of FDAP treatment of real estate income.

### 3. Deductions from Rental Income

The principal deductions allowed in computing net income from real estate rentals are:

- local real estate taxes;
- state income taxes;
- insurance;
- depreciation;
- condominium fees; and
- interest (subject to the "earnings stripping" rules described below).

Where real estate is used as a residence by the owner and is also rented, taxes and interest (subject to the earnings stripping rules) will be deductible in full, but the other deductions will be limited to the proportion of the time the property is rented.

If a residence is rented for less than 15 days in a calendar year, there is no tax on the rental income.

## 4. Special Rules for Corporations

*Earnings Stripping*. The pre-2018 earnings stripping rules limited the amount of deductible interest of corporations, where the recipient is not subject to U.S. tax on the interest received or to the extent the interest is reduced or eliminated under a tax treaty.

These rules applied only to U.S. domestic or foreign corporations with effectively-connected U.S. income if its debt-to-equity ratio is more than 1.5 to 1.

Disqualified interest included interest paid or accrued by the taxpayer directly or indirectly to a related person (such as a parent or controlling shareholder) and who was exempt from U.S. withholding.

The amount of interest deduction disallowed was the excess of disqualified interest over 50% of the corporation's adjusted taxable income.

**The 2017 tax act eliminated the earnings stripping provisions described above. A new limitation on deductibility of business interest (generally, 30% of the adjusted taxable income of the business) is now imposed. However, the act provides a generous exception for taxpayers with average gross receipts of less than $25 million, adjusted for inflation, which should cover all but the largest companies.**

*Branch Profits Tax*. The U.S. tax code imposes a special "branch profits" tax on *foreign corporations* engaged in a U.S. trade or business. This tax is a second tax (in addition to the basic U.S. corporate income tax) and is equal to 30% of the corporation's "dividend equivalent amount" (*i.e.*, the amount of the corporation's accumulated net profits not reinvested in its U.S. business). The purpose of this rule is to effectively impose a 30% withholding tax on the amount of the corporation's net earnings that it *could*, but did not in fact, distribute to its shareholders.

## 5. Capital Gains

As mentioned above, gains on the sale or disposition of U.S. real estate by an NRA are subject to U.S. income tax under the FIRPTA rules discussed in Section XI below.

## 6. U.S. Income Tax Returns

An NRA who is not engaged in a U.S. trade or business during a taxable year need not file a U.S. income tax return if the U.S. tax liability is fully satisfied by withholding taxes on FDAP.

An NRA engaged in a U.S. trade or business during a taxable year must file a U.S. income tax return on Form 1120-F (for foreign corporations) or Form 1040NR (for NRA individuals).

NRA taxpayers must obtain a taxpayer identification number. Individual NRA taxpayers who do not have Social Security numbers should apply for individual taxpayer identification numbers ("ITINs") on IRS Form W-7, together with their original income tax returns and supporting documents.

# X. U.S. INCOME TAX CONSEQUENCES OF REAL ESTATE OWNERSHIP STRUCTURES

In this Section, we describe the U.S. income tax on the four forms of ownership deemed suitable for estate tax planning. *See* Section VI above.

## A. FOREIGN CORPORATION

Foreign corporations are subject to income tax on their U.S. income. A foreign real estate corporation may be subject to the 30% withholding tax on its gross rental income unless it elects to be taxed on a net basis. Significantly, a foreign corporation is subject to the branch profits tax, which may make it an unsatisfactory choice as an investment vehicle.

## B. U.S. CORPORATION WITH FOREIGN CORPORATION PARENT

U.S. corporations are subject to income tax at a net basis at a flat rate of 21% on all of its income, including capital gains. A U.S. corporation may also be subject to the earnings stripping provisions, which limits its deduction of "disqualified interest" in certain cases. A foreign parent corporation is also subject to the 30% withholding tax on dividends and interest from a controlled U.S. corporation, which may be modified by a tax treaty. A U.S. corporation owning real estate may be a "U.S. real property holding company," or "USRPHC," resulting in tax on the sale of its stock. *See* Section XI below.

## C. FOREIGN IRREVOCABLE TRUST

A foreign irrevocable trust is taxed on its *undistributed* income in the same manner as a U.S. trust. Trusts are subject to tax at individual rates, but with much narrower tax brackets; the maximum tax rate of 37% applies to trust income in excess of $12,500 per year. *See* Section VIII(D) above. It is not taxed on income *distributed* to its beneficiaries; rather, the beneficiaries are taxed on the distributed income in the same manner as U.S. resident individuals.

## D. LIMITED LIABILITY COMPANY

An LLC with more than one member is ordinarily treated as a partnership (but can elect to be treated as a U.S. corporation). A partnership is a "pass-through" entity; all of its income is allocated among its partners, who are, in turn, subject to personal U.S. income tax on that income.

An LLC with a single member is treated as a "disregarded entity" which is ignored for U.S. income tax purposes. As a result, the single member (be it a corporation, trust, partnership, or individual) is taxed directly on the LLC's income; the LLC does not even file an income tax return.

# XI. FIRPTA TAX ON CAPITAL GAINS

## A. FIRPTA

In general, the Foreign Investment in Real Property Tax Act ("FIRPTA") treats the gain or loss from the sale or other disposition of U.S. real estate as effectively connected with a U.S. trade or business. Thus, NRAs selling real estate are subject to U.S. income tax, usually at capital gains rates.

The current maximum capital gains rate for individuals is 20% (for taxpayers in the 37% bracket) and a flat 21% rate for corporations. This provides a slight advantage to the use of a foreign irrevocable trust (taxed at the 20% rate) over a U.S. corporation (taxed at the 21% rate) as an owner of U.S. realty.

## B. FIRPTA Withholding

FIRPTA also requires withholding of up to 15% of the *gross* sale price of the real estate (or its fair market value, if greater) for properties other than the buyer's personal residence, and for personal residences sold for more than $1 million. For personal residences with a purchase price not in excess of $300,000, no withholding is required; for other personal residences, a 10% withholding rate will apply unless the purchase price exceeds $1 million. The withholding amount can be well in excess of the capital gains tax on the net selling price (after deducting the cost basis of the property and the costs of sale). In some cases, it can be less than the net cash received by the NRA after payment of the mortgage on the property.

However, unlike the 30% withholding tax on FDAP income described above, the FIRPTA withholding amount is treated as a *credit* against the capital gains tax actually due as reported on the NRA's U.S. income tax return. This means that the NRA will receive a tax refund if the amount withheld exceeds the tax due. Although, the taxpayer will ordinarily have to wait until the end of the year of sale to receive the refund, the correct amount of tax will ultimately be paid.

## C. U.S. Real Property Holding Companies

An NRA that owns, directly or indirectly, a U.S. corporation owning a substantial portion of U.S. real estate cannot escape U.S. taxation by selling the stock of the U.S. corporation or its foreign parent company. FIRPTA provides that U.S. corporations owning U.S. real estate that is more than 50% of its real estate and business assets are treated as USRPHCs. The sale of USRPHC stock (or the stock of a foreign parent company) is treated as the sale of U.S. real estate.

If a U.S. corporation with a foreign parent sells all of its U.S. assets, it must, of course, pay a U.S. capital gains tax, but it ceases to be a USRPHC. This means that the U.S. corporation can be liquidated and the cash proceeds from the sale distributed to its NRA shareholders *without* payment of additional U.S. tax by its foreign parent or its NRA shareholders, since the liquidation of a corporation is ordinarily a capital gains transaction.

# XII. SUMMARY

Exhibit A contains a tabular summary of the U.S. estate and income tax rules affecting the choice of an ownership vehicle for investment in U.S. residential real estate. Exhibit A, and this Guide generally, should not be a substitute for careful and detailed tax advice by an experienced tax advisor.

Exhibit A

**OWNERSHIP OPTIONS FOR FOREIGN INVESTMENT IN U.S. RESIDENTIAL REAL ESTATE**

The following table summarizes the estate and income tax advantages and disadvantages of three common investment strategies for investment by an FNA in U.S. residential real estate. The tax advantages of ownership by a U.S. subsidiary of a foreign corporation seem to be about equal to the tax advantages of ownership by a foreign irrevocable trust.

| | Foreign Corp. | USRPHC Owned by Foreign Corp. | Foreign Irrevocable Trust* |
|---|---|---|---|
| U.S. Estate Tax Exposure | **No** | **No** | **No** |
| U.S. Tax Return by NRA | **Yes** | **No** | **Yes** |
| Branch Profits Tax | **Yes** | **No** | **No** |
| U.S. Withholding Tax on Dividends | **No** | **Yes** (but no tax on liquidation) | **No** |
| Maximum Capital Gains Tax Rate | **21%** (plus branch profits tax) | **21%** (no branch profits tax) | **20%** |
| Conclusion | **Worst** | **Best** | **Best** |

* Includes a foreign irrevocable trust owning real estate through a single member LLC.

# About Davis Malm

Founded in 1979, Davis, Malm & D'Agostine, P.C. is a full-service Boston business firm that provides sophisticated legal representation to local and global businesses, institutions and individuals in a wide spectrum of industries. Clients rely on Davis Malm's attorneys to efficiently deliver successful result through direct partner involvement, responsive client service, and practical and creative problem solving. Davis Malm is the member firm for the International Lawyers Network representing Massachusetts and northern New England.

The firm's interdisciplinary team of real estate and tax attorneys possess years of experience and in-depth knowledge on issues facing foreign investors. We take the time to understand each client's unique needs and objectives. Our team of attorneys works closely to provide coordinated and comprehensive advice and tax-efficient designs to meet each client's goals. If you would like to discuss any of the topics in this guide, please contact its primary author:

William F. Griffin, Jr., Esquire
Managing Director
617.367.2500
wgriffin@davismalm.com

DAVIS MALM
ATTORNEYS

One Boston Place, 37th Floor, Boston, Massachusetts 02108 | 617.367.2500 | davismalm.com

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