

Planning for Foreign Persons Investing in U.S. Real Estate

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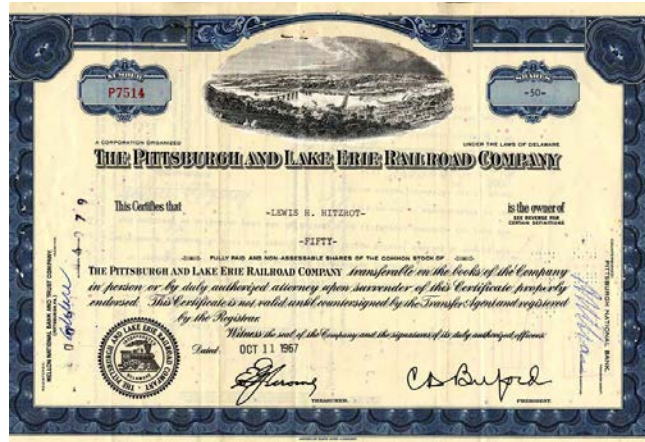
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Principal Topics

- **Building Blocks**
- **Planning**
- **Tax Planning with Debt**
- **Real Estate Investment Trusts**
- **Questions**



BUILDING BLOCKS: OWNERSHIP OF REAL ESTATE, STOCK & NOTE

LOAN NUMBER
51555-1065

Mortgage Note

\$ 24,000.00 Donora Pennsylvania
April 30th 19 65

For Value Received, SOCELDIA BENEFICIA ESPANOLA DE DONORA, P.A., a non-profit corporation, promises to pay to the order of MELLON NATIONAL BANK AND TRUST COMPANY, its successors or assigns, in lawful money of the United States of America, the sum of TWENTY-FOUR THOUSAND AND NO/100----- Dollars (\$ 24,000.00) and any additional moneys loaned or advanced hereunder by any holder hereof as hereinafter provided, as follows: Two Hundred Sixty and 47/100 Dollars (\$260.47) on July 1, 1965, and on the same day of each succeeding month thereafter, to be applied first to interest at the rate of five and a half per cent. (5-1/2%) per annum on the unpaid balance of principal, with the remainder to be applied to reduction of the principal debt, with the privilege of paying all or any additional part of the principal debt on any installment payment date, no such prepayment, however, to alter the amount of the aforesaid monthly payments. In addition to and concurrent with the aforesaid monthly payments, the undersigned will pay one-twelfth of all annual taxes, insurance premiums and other charges and assessments, as estimated by the holder hereof and as required by the accompanying mortgage;

and any balance of principal or interest remaining unpaid on June 1, 1975 shall become due and payable on said date, and in addition thereto, in the event any payment provided for herein shall become overdue, the Undersigned agrees to pay a late charge in an amount not exceeding six per cent (6%) of any such overdue payment as compensation for the additional service resulting from the default; all payments to be made at Donora Office.

Donora Pennsylvania or elsewhere as shall be directed by any holder hereof.

This Note shall evidence and the Mortgage given to secure its payment shall cover and be security for any future loans or advances that may be made to or on behalf of the Undersigned by any holder hereof at any time or times hereafter and intended by the Undersigned and the then holder to be so evidenced and secured, as well as any sums paid by any holder hereof pursuant to the terms of said Mortgage, and any such loans, advances or payments shall be added to and shall bear interest at the same rate as the principal debt.

In case default be made for the space of thirty (30) days to the payment of any installment of principal or interest, or in the performance of any of the other obligations of this Note or said Mortgage, the entire unpaid balance of the principal debt, additional loans or advances and all other sums paid by any holder hereof to or on behalf of the Undersigned pursuant to the terms of this Note or said Mortgage, together with unpaid interest thereon, shall at the option of the holder and without notice become immediately due and payable, and one or more executions may forthwith issue on any judgment or judgments obtained by virtue hereof; and no failure on the part of any holder hereof to exercise any of the rights hereunder shall be deemed a waiver of any such rights or of any default hereunder.

The Undersigned hereby empowers any attorney of any court of record within the United States of America or elsewhere to appear for the Undersigned and, with or without complaint filed, confer judgment, or a writ of judgment, against the Undersigned in favor of any holder hereof, as of any term, for the unpaid balance of the principal debt, additional loans or advances and all other sums paid by the holder hereof to or on behalf of the Undersigned pursuant to the terms of this Note or said Mortgage, together with unpaid interest thereon, costs of suit and an attorney's commission for collection of five per cent (5%) of the total indebtedness or \$50, whichever is the larger amount, on which judgment or judgments one or more executions may issue forthwith upon failure to comply with any of the terms and conditions of this Note or said Mortgage. The Undersigned hereby forever waives and releases all errors in said proceedings, waive stay of execution, the right of laches and extension of time of payment, agrees to condemnation of any property levied upon by virtue of any such execution, and waives all exemptions from levy and sale of any property that now is or hereafter may be exempted by law.

This obligation shall bind the Undersigned and its successors and assigns, and the benefits hereof

Two U.S. Tax Regimes May Apply

- **Passive Income:** FDAP Income from U.S. Sources
 - 30% tax on “gross income”
 - U.S. payor withholds tax
 - Subject to reduction or elimination by (i) Tax Treaty or (ii) Code exemption (e.g., portfolio interest)
- **Active Income:** ECI Income
 - If engaged in U.S. trade or business (ETB) then income effectively connected (ECI) with that business is subject to U.S. income tax
 - Must file U.S. tax return
 - Tax imposed at graduated rates (NRA is eligible for long-term capital gains rates)
 - Tax imposed on “net income” so get deductions to lower tax liability
 - Branch profits tax may apply to non-US corporations

Rental Income

- Rental income: **FDAP** income subject to 30% withholding tax
- Tax can be very harsh
 - Example:
 - Lessee pays \$100 rent to owner and lessee pays expenses to 3rd parties related to the property of \$100 (e.g., real property taxes, insurance)
 - Gross rental income = \$200
 - Withholding tax = \$60
 - Net cash owner gets = \$40 (\$100 - \$60)
 - Effective tax rate of 60%

Rental Income (cont'd)

- If leasing or other activity in relation to property makes foreign owner **ETB**, then rental income becomes **ECI**
- Tax only on “net income” from property, which is usually produces lower tax for owner
 - Example:
 - Lessee pays \$100 rent to owner and lessee pays expenses related to the property of \$100
 - Gross rental income = \$200
 - Net rental income (before depreciation & interest deductions) = \$100
 - Maximum Tax (assuming no depreciation or interest) = \$35
 - Effective tax rate = 35% and lower if get depreciation, interest & other deductions
 - Owner must file tax return

Rental Income (cont'd)

- When does leasing make foreign owner **ETB**?
 - General Rules:
 - Rental of one property to one tenant under a “net” lease is not ETB
See Rev. Rul. 73-522; *Neill*
 - Rental to many tenants is ETB
See *Pinchot* (11 real estate properties)
 - Election to be ETB: §871(d), 882(d)
 - Often recommended since lower tax burden (due to deductions)
- If rental income is ECI, give Form W-8ECI to lessee to eliminate withholding tax

Sale of Real Estate

- Gain is Taxable: Foreign Investment in Real Property Tax Act of 1980 (**FIRPTA**) – §897
 - Gain from sale of “United States real property interest” (“USRPI”) taxed as if:
 - Foreign seller is engaged in a trade or business in the U.S. & the gain is effectively connected with that trade or business
 - Foreign sellers are taxed on gains at the same rates applicable to U.S. sellers
 - Gain can qualify for long-term capital gains treatment
 - Like kind exchange treatment does not apply *unless* the seller receives U.S. property in the exchange – §1031(h)

Sale of Real Estate (cont'd)

- Definition of USRPI (Treas. Reg. § 1.897-1)
 - Interest in real property:
 - Real property includes land, buildings, and other improvements
 - Includes growing crops and timber, and mines, wells and other natural deposits – but once extracted or severed, crops, timber, ores, minerals, etc. are no longer USRPIs
 - Includes “associated personal property”
 - Includes direct or indirect right to share in appreciation in value, gross or net proceeds or profits from real property
 - Does not include mortgage loan at fixed rate of interest (or variable rate such as prime, LIBOR, etc.)
 - Interest in domestic corporation that was a U.S. real property holding corporation (USRPHC – see later slide) at any time during the 5-year period preceding sale

Sale of Real Estate (cont'd)

- Withholding Requirement: §1445
 - Buyer must withhold 10% of “Amount Realized” on Sale
- Problem: Overwithholding
 - Example:
 - Sell real estate with a tax basis of \$900 for \$1,000
 - Buyer must withhold \$100 tax (10% of \$1,000) even though gain is only \$100 & tax will be less than that
 - Solution: Get Exemption or reduced rate certificate by filing Form 8288-B before the sale
- Rev. Proc. 2000-35 explains this
- Recommended in example above to lower the withholding tax

Sale of Real Estate (cont'd)

- Other Exemptions to Withholding:
 - Non-recognition rules can apply
 - Domestication of a foreign corporation that owns US real estate under §897(e)
 - Contribution of US real estate to a newly formed US company under §897(e)
 - §1031 Like kind exchange of US real estate for other US real estate under §897(e)
 - §355 spin-offs may work under §897(d)

Dividend from U.S. Corporation

- **Dividend income:**
 - FDAP income subject to 30% withholding tax
 - Subject to reduction or elimination: Tax Treaties
- **Non-dividend distributions:**
 - If corporation is a USRPHC, as discussed below, withhold 10% of the distribution - §1445(e)(3)
 - Subject to reduction if go to IRS to obtain exemption or reduced rate certificate
- **REIT Dividends:**
 - Special rules discussed later

Sale of Stock of U.S. Corporation

- Normal rule: Gain from sale is not U.S. source FDAP income and does not make investor ETB
- FIRPTA: Taxable if sell stock of a U.S. Real Property Holding Corporations (USRPHC)
 - Treats the gain as ECI income
 - Corporate sellers also have branch profits tax

Sale of Stock (cont'd)

- USRPHC definition (§897(c)(2)):
 - FMV of USRPIs held on any “applicable determination date” equals or exceeds
 - 50% of sum of FMVs of (i) USRPIs; (ii) non-U.S. real property interests; and (iii) other trade or business assets
 - Look-through rule for assets held through entities
 - For corporations, only look-through if own more than 50%
- Exemption:
 - Regularly traded class of stock if taxpayer owns 5% or less
 - Does not include stock in a corporation that has sold all of its USRPIs in taxable transactions

Interest Income from U.S. Mortgage

- Interest income is **FDAP** income subject to 30% withholding tax
- Elimination under:
 - Portfolio Interest Exemption- §§ 871(h), 881(c) applies to all interest if debt is in registered form except:
 - Loan by foreign bank in the ordinary course of business
 - Loan from 10% or greater shareholder or partner
 - Contingent interest
 - HIRE Act of 2010 eliminated exception for post-3/18/2010 instruments in bearer form
 - Tax Treaties
 - Almost all treaties provide for exemption or reduced rate

Interest Income (cont'd)

- Issue: Can a foreign lender be ETB?
 - **“Buy” outstanding mortgages**: No
 - **“Originate” or make new loans**: Yes, if lender makes many loans in the U.S. and are therefore conducting a lending business in the U.S. (looks like a bank)
- If ownership of mortgages makes lender ETB, then portfolio interest exemption will not apply
 - Must file U.S. tax return and pay tax on net income from lending business
- Issue: How is interest from foreign seller financing of real estate sale taxed?
 - Not taxable under FIRPTA
 - Either FDAP income or (less commonly) ECI, whether or not sale that generated the note is taxed under FIRPTA

Sale of U.S. Mortgage

- General rule: Gain from sale is not U.S. source FDAP & not ECI
- Exception:
 - If in U.S. lending business then gain from sale would be ECI and therefore taxable
 - If mortgage loan has contingent interest then the loan is a USRPI and gain from its sale will be taxable under FIRPTA
- Example: Loan has 5% fixed interest and contingent interest = 25% of cash flow from the property

FATCA & REAL ESTATE



FATCA: Application to Real Estate

- FFI: 30% withholding on withholdable payments under §1471 will be imposed unless FFI:
 - Signs agreement with IRS (“PFFI Agreement”);
 - Is resident of country that has signed a FATCA IGA;
 - Is exempt from FATCA under existing IRS guidance
- NFFE: 30% withholding on withholdable payments under §1472 will be imposed unless NFFE:
 - Certifies that it has no substantial U.S. owner”; or
 - Provides the name, address, and TIN of each substantial U.S. owner; and
 - In either case, withholding agent (a) neither knows nor has reason to know certification is incorrect and (b) provides the substantial U.S. owner to IRS

FATCA: Application to Real Estate (cont'd)

Withholdable payments – real estate-related income:

- FDAP:

- U.S.-source interest (e.g., interest from mortgage loan),
- Dividends (e.g., dividend from USRPHC),
- Rents and other types of payments from the U.S. (e.g., rent on U.S. real estate)

- U.S. Securities:

- Gross proceeds from the sale of any property that could produce U.S.—source dividends or interest
- This includes USRPHC stock and loan principal repayments from a U.S. borrower



ESTATE AND GIFT TAXES



Gift Tax

- Nonresident aliens are taxed on gifts of tangible (but not intangible) property located in the United States
 - Gift of U.S. real property is subject to gift tax
 - Gift of stock (whether domestic or foreign corporation) is not subject to tax
 - Gift of partnership interest probably not subject to tax
 - Points to note:
 - No step-up in basis on *inter vivos* gift
 - No unified credit
 - Substance over form risk. For example:
 - Donee or trust is funded with cash and purchases real property from grantor – e.g., *Davies v. Commissioner*, 40 T.C. 525 (1963)
 - Foreign owner contributes property to partnership and then makes gift of partnership interest

Estate Tax

- Estate of nonresident alien is subject to estate tax on property located in the United States. Includes:
 - U.S. real property and tangible property located on it
 - Stock in U.S. corporation (publicly traded or not)
 - But not stock in foreign corporation
 - Top rate (2013) 40%; unified credit equivalent to \$60,000 exemption (unchanged for decades)
- Uncertain treatment of partnership interests
 - IRS position: Interest is located in the U.S. if partnership is engaged in U.S. trade or business. What if:
 - Partnership not ETB but decedent elected under §871(d)?
 - Partnership owns only residence for NRA's personal use?
 - Other theories: Place of organization or partner domicile



PLANNING



Before Planning Begins

- Understand investor characteristics - type, location
- Ascertain investment characteristics and objectives:
 - Use – personal use, business, investment
 - Types of income generated from real estate: Rent, interest, dividends, capital gains, services and others
 - Capital – equity, debt (many different flavors and sources)
 - Exit – anticipated timing, method
- Consider choice of entity – wholly-owned, joint ventures, passive investment vehicles (e.g., REITs)
- Withholding and compliance
- Estate and gift taxes

Home Country Taxation

- No planning should be undertaken before considering whether home country taxation is relevant
- U.S. taxation of foreign investors may be modified by treaty
 - No exception from U.S. taxation of gain from real estate but treaties can reduce or eliminate tax on interest and dividends
 - Almost all treaties contain “limitation on benefits” provisions to counteract abusive use of treaties

Objectives Drive Structure

- Tax objectives:
 - Avoid cross-border double taxation (U.S./foreign)
 - Mitigate taxation of operating income
 - Avoid double taxation of corporate earnings
 - Obtain long-term capital gains treatment on sale
 - Avoid gift and estate taxes
 - Limit overwithholding
 - Limit contact with U.S. tax system
- Nontax objectives
 - Preserve confidentiality
 - Facilitate inter-family transfers
 - Limited liability

Structuring May Mean Picking Your Poison



Options - 1

Foreign
Individual



real estate

- 20% tax or 39.6% tax
- Privacy Concerns
- Estate Tax at 40%
- but - only one level of tax!

Options - 2

Foreign
Individual



real estate

- No Estate Tax
- Branch Profits Tax
- Privacy Concerns
- Sale of Stock - Tax Free BUT!
- Tax-Free Refinancing Distributions

Options - 3

Foreign
Individual

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graph TD; A[Foreign Individual] --> B[U.S. Corp.]; B --> C[real estate];
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U.S. Corp.

real estate

- No Branch Profits Tax
- Dividend Withholding Tax
- Estate Tax
- Privacy Concerns
- Sale of Stock – Taxable
- Taxable Refinancing Distributions

Options - 4

Foreign Individual



Foreign Corp.



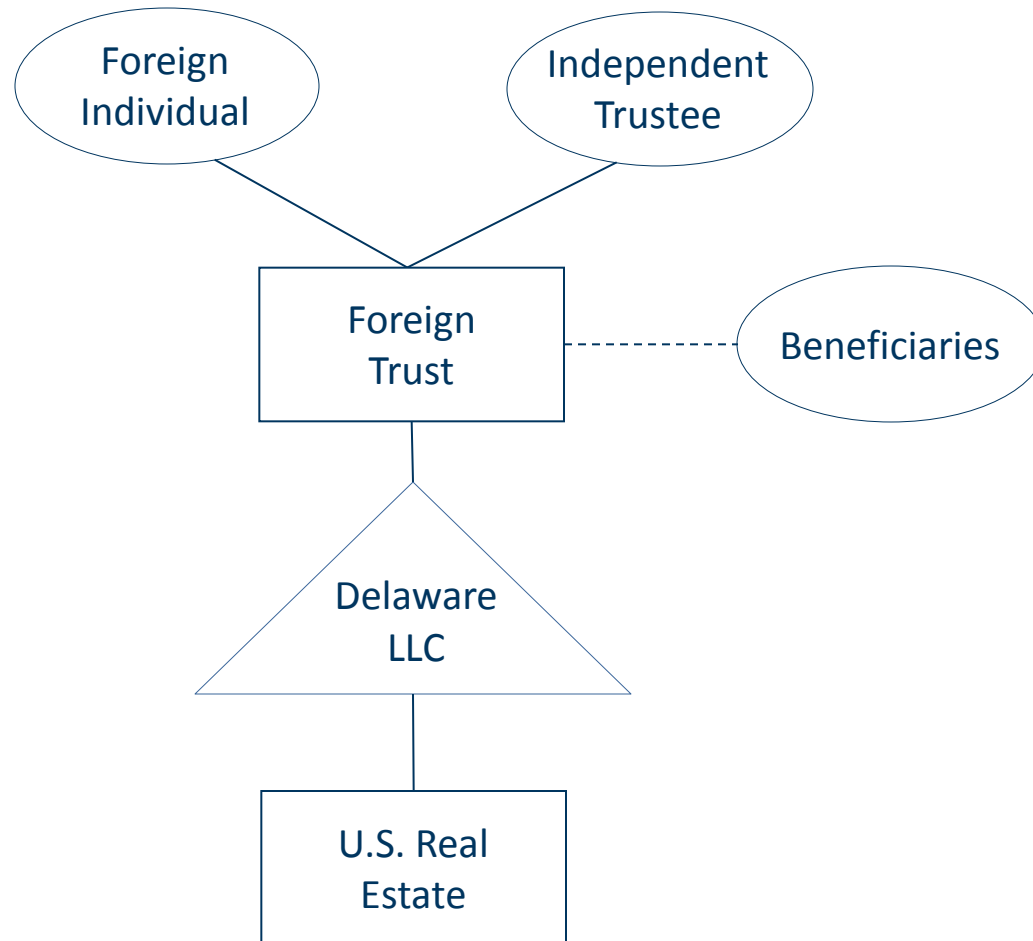
U.S. Corp.



Real Estate

- No Branch Profits Tax
- No Estate Tax
- No Disclosure
- Sale of Stock
- Taxable Refinancing Distributions

Options - 5

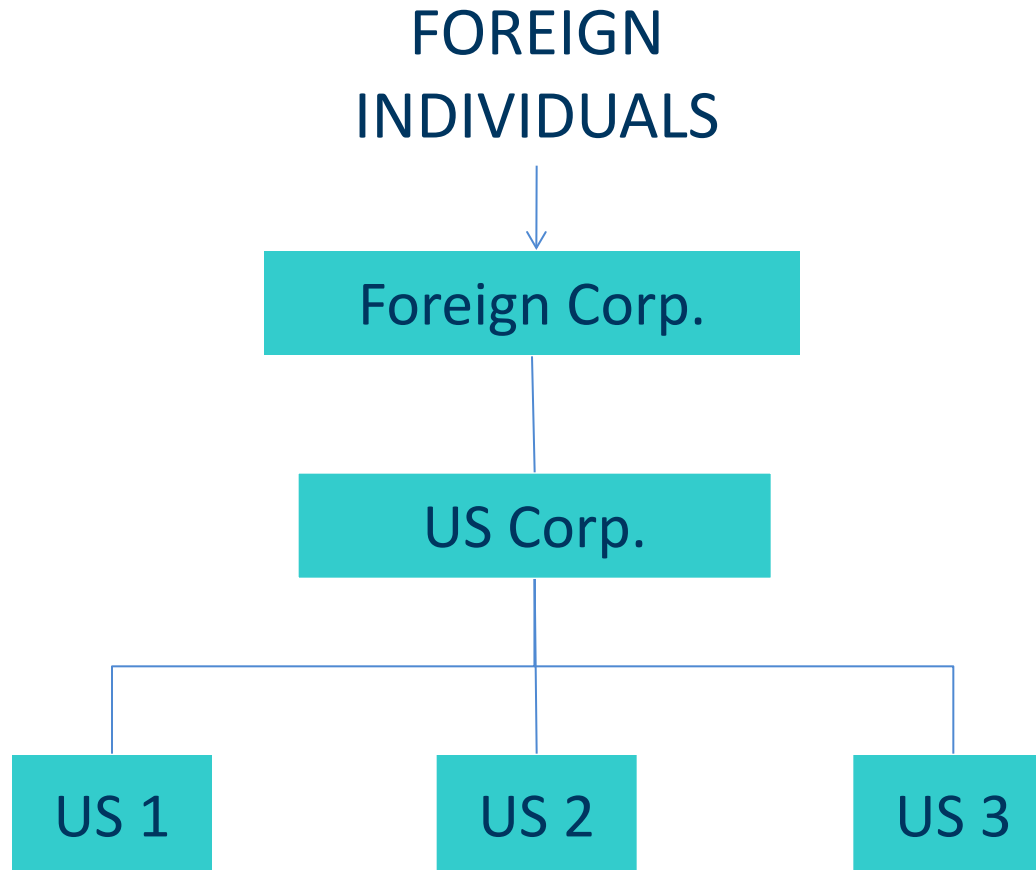


Non-Grantor Foreign Trust

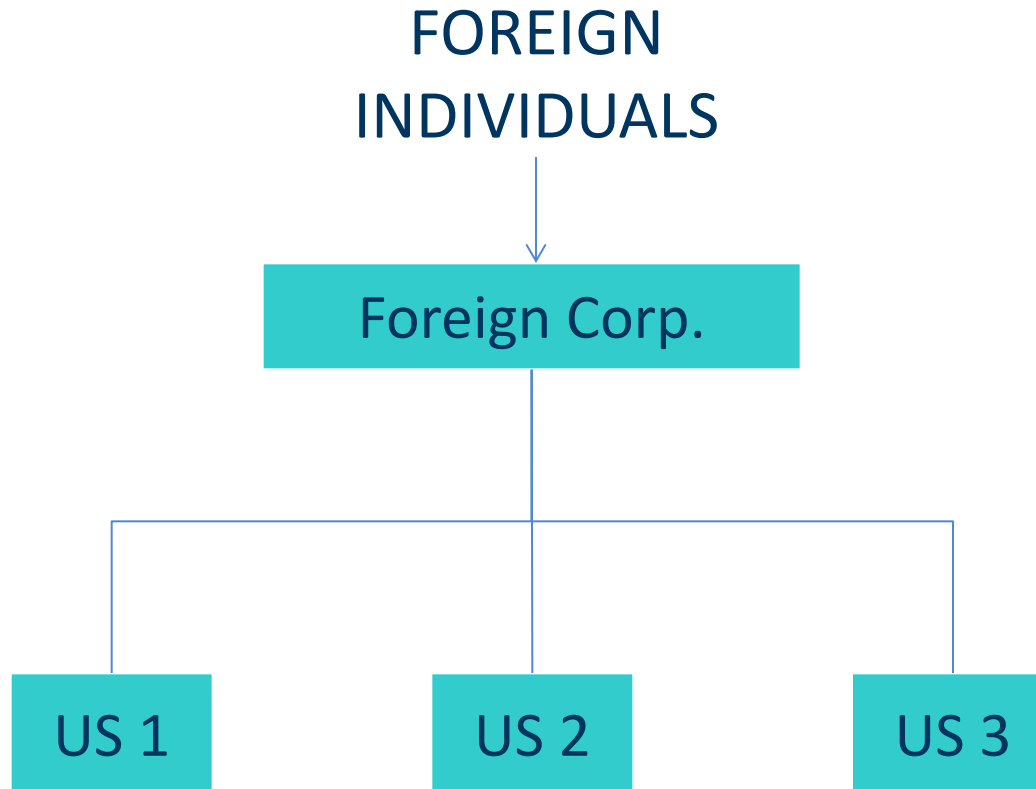
The tax consequences that may be anticipated under the foregoing structure are as follows:

- The transfer of cash to the Trust is not subject to U.S. gift tax.
- Under U.S. tax law, the Trust will be treated as if it were an individual. It will be entitled to the benefits of the 20% tax applicable to capital gains, the 25% tax applicable to depreciation recapture, and 39.6% tax on operating profits.
- There will be no further tax as funds are distributed to the beneficiaries.
- The assets in the Trust should not be subject to U.S. estate tax at the time of the individual's demise provided that (i) the individual does not retain the right to the income of the Trust during his lifetime -- although he may receive discretionary distributions along with other beneficiaries, (ii) the Trust is not revocable or amendable by the individual, and (iii) the individual does not retain any dominion or control over the Trust or its assets.
- Query whether IRS will treat foreign trust as a foreign corporation if the asset is non-personal use real estate.

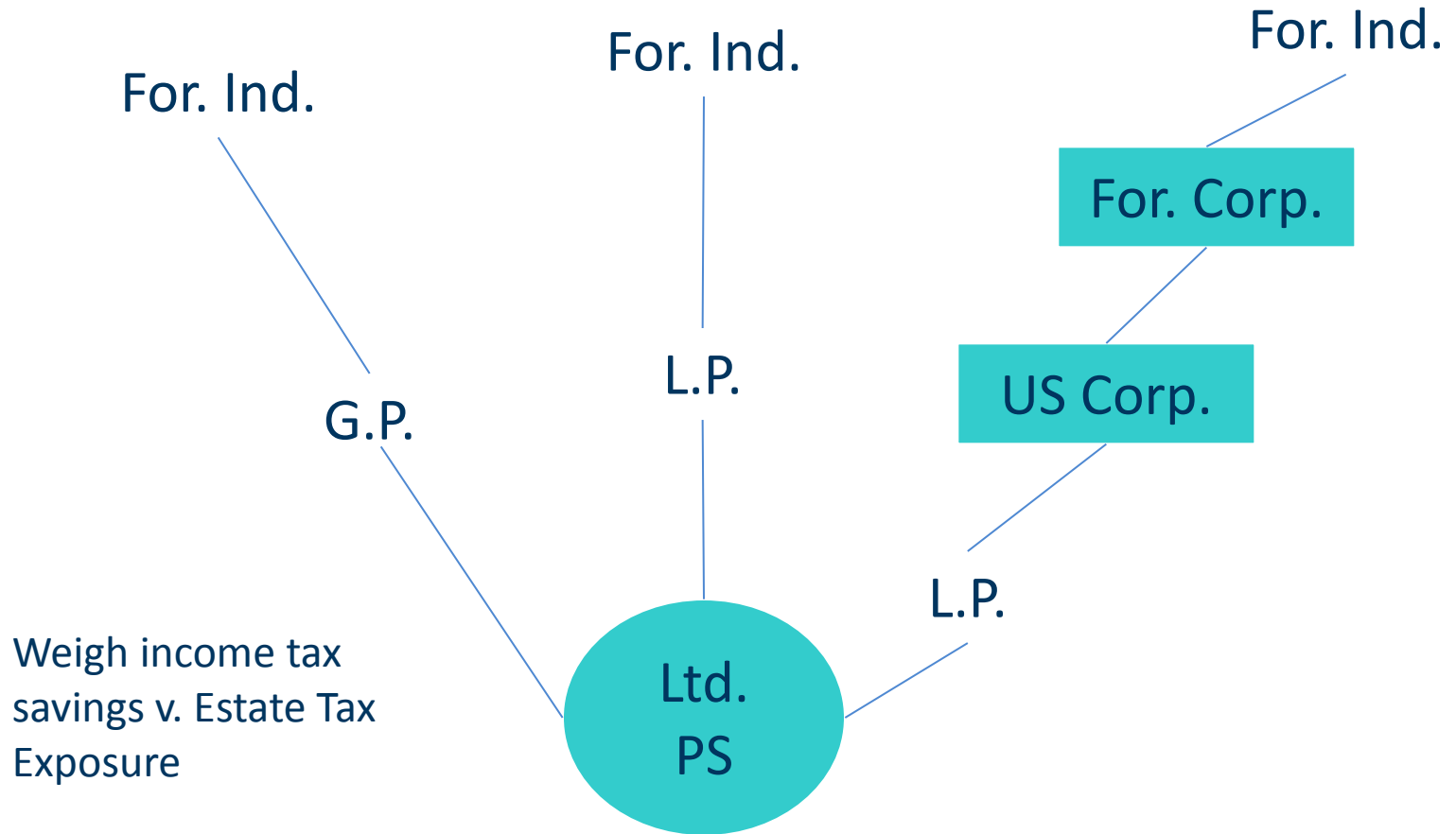
Multiple Properties



Multiple Properties (cont'd)



Traditional Partnership





Tax Planning with Debt

Debt:Equity

- Any use of a mixture of equity capital and loans provided by the equity investors requires the usual attention to detail to avoid reclassification by IRS
- In particular:
 - Loans must be documented
 - Overall terms should be at arm's length
 - Payment terms must be achievable; use OID/deferral options if there will be predictable delays in payment (e.g. development loan)
 - Internal and overall ratios must be reasonable
 - Terms should be observed and lender must take steps an unrelated lender would take to monitor and enforce loan

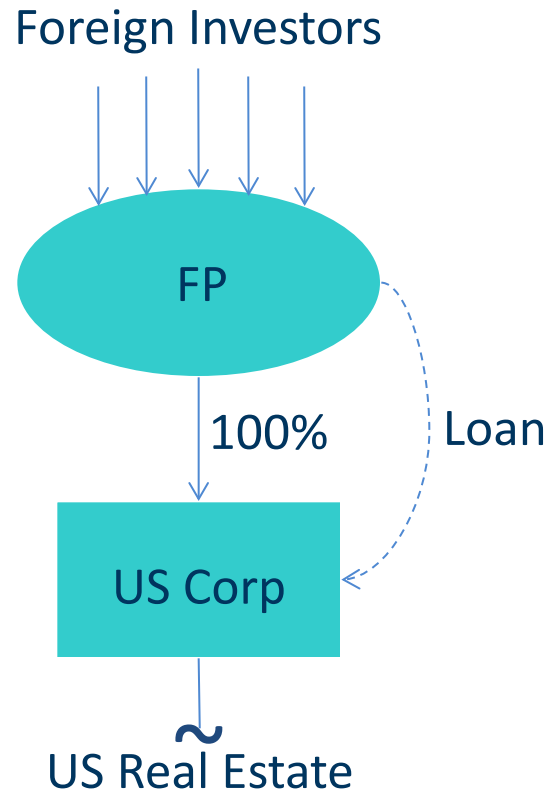
Earnings Stripping, AHYDO, 267(a)

- Earnings stripping (§ 163(j))
 - Applies if debt-equity ratio exceeds 1.5
 - Limits deduction for net interest expense to 50% of “adjusted taxable income” (analogous to EBITDA)
 - Excess interest is carried forward to future years
 - Excess limitation carried over against excess interest for 5 years
- Applicable High Yield Debt Obligation (§ 163(e)(5) & (i))
 - Applies if borrower is a corporation, term exceeds 5 years and OID at rate greater than AFR + 5%
 - Excess non-deductible (but interest in hands of lender)
 - If lender related, non-excess not deducted until paid
- If lender related, §§ 267(a)(3) (interest) and 163(e)(3) (OID) defer deduction until interest paid



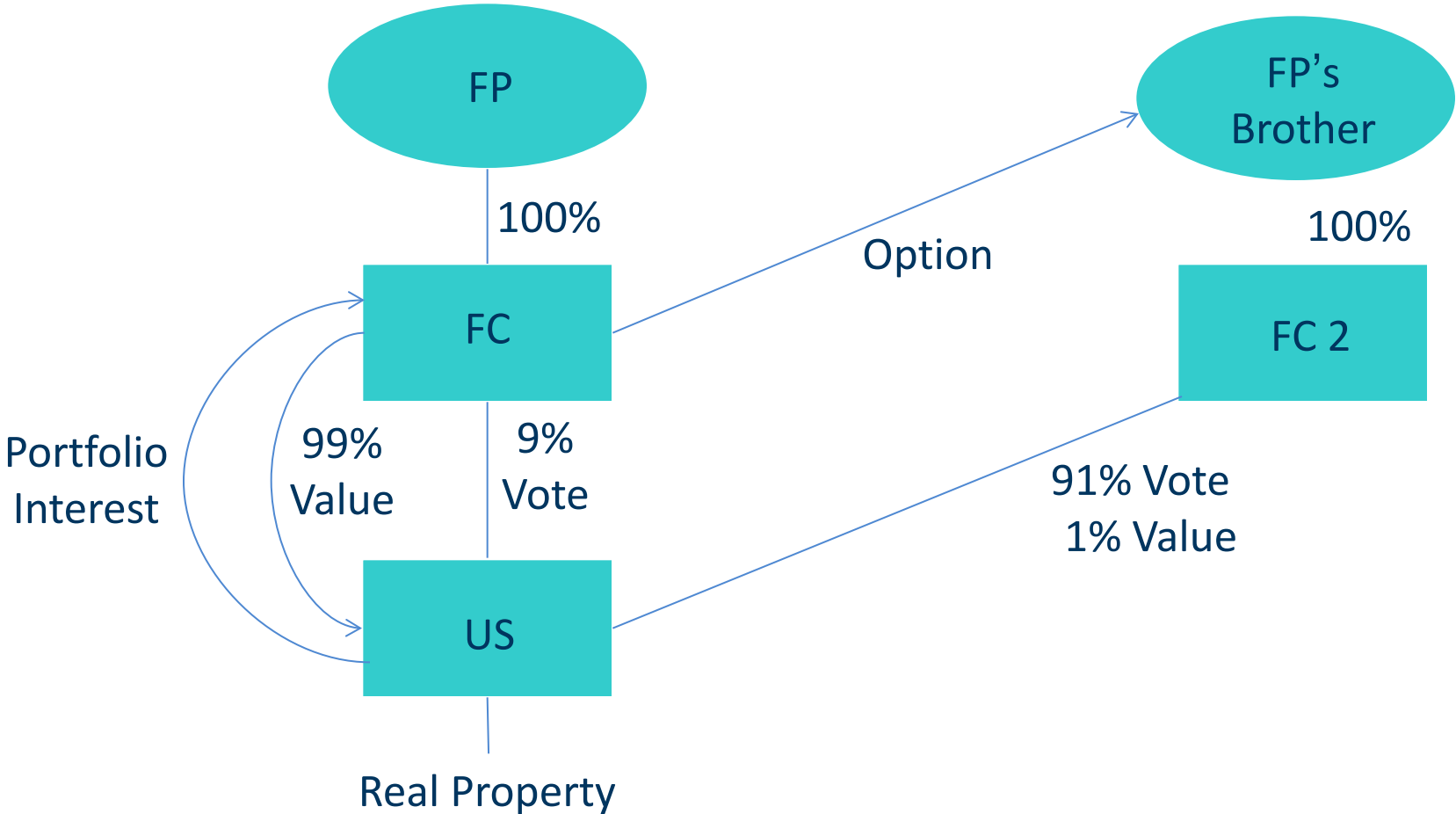
Portfolio Interest Friendly Structures

Portfolio Interest Friendly Structure



- If each foreign investor owns less than 10% of FP, then portfolio interest exception applies to the entire interest payment

Portfolio Interest Friendly Structure (cont.)





Tax Planning with Shared Appreciation Mortgages

Tax Planning with Shared Appreciation Mortgages

- Concern: If non-U.S. taxpayers invests directly in U.S. real estate or through entity, gain from the disposition of the real property or the interest in the entity would be subject to U.S. federal income tax at graduated rates.
- Solution: One possible option to avoid FIRPTA is for foreign investor to use shared appreciation mortgage to invest synthetically in U.S. real estate.
 - Shared appreciation mortgage is loan that provides for interest that is contingent on the gain from the sale of the property.

Tax Planning with Shared Appreciation Mortgages

- Regulation Section 1.897-1(h), Example 2
 - Foreign corporation makes \$1 million loan to domestic individual which is secured by mortgage on real property purchased with loan proceeds.
 - Loan agreement entitles lender to fixed monthly payments, constituting repayment of principal plus fixed interest rate.
 - Lender also entitled to receive certain percentage of the appreciation in value of real property at the time that the loan is retired.
 - Shared appreciation loan treated as U.S. real property interest (USRPI), but receipt of final payments do not constitute “disposition” of USRPI for purposes of Section 897.

Tax Planning with Shared Appreciation Mortgages

- Example 2 concludes that Section 897 is not triggered on receipt of final loan payment because payment constitutes principal and interest, not gain for tax purposes.
- Thus, appreciation payment is treated as interest for tax purposes.
- Cannot qualify for exemption from withholding under portfolio interest rules because payment is “contingent interest.” Section 871(h)(4).
- However, taxpayer could rely on treaty with zero percent withholding on contingent interest.
- Strategy requires a hold to maturity, as sale of the investment would be subject to FIRPTA tax.



REAL ESTATE INVESTMENT TRUSTS (REITS)

REITs – Dividends

- **Ordinary Dividend** - §§1441 & 1442
 - FDAP income subject to 30% withholding tax or lower treaty rate
- **Capital Gains Dividend** – §897(h)(1):
 - **General Rule** if relates to sale of real estate
 - Taxable under FIRPTA
 - REIT withholds 35% tax and shareholder must file tax return
 - **Publicly traded REIT Rule:** If foreign person owns 5% or less of stock for at least one year then
 - Treated like ordinary dividend subject to 30% withholding tax or lower treaty rate
 - Benefit: Less tax than general rule, no requirement to file tax return and no branch profits tax on foreign corporate shareholder

REITs – Dividends (cont'd)

- Section 857(b)(3)(F) provides that shareholder who gets “ordinary income” benefits of §897(h)(1) with respect to capital gain dividend:
 - Dividend not taxed under §897(b)(3)(B) or (D)
 - Dividend is treated as ordinary REIT dividend
- Recharacterized capital gain distribution is taxed as ordinary dividend, i.e., withholding at 30%, subject to reduced rate or exemption under treaty or §892
- Foreign investor using these rules:
 - Does not have to file a U.S. tax return because of the capital gain distribution
 - Branch profits tax is no longer applicable to such distribution to a non-U.S. corporate investor

REITs – Sale of REIT Stock

- **General Rule**
 - Gain is taxable under FIRPTA
 - Exceptions:
 - Publicly Traded REIT: No tax on shareholder owning 5% or less since not USRPHC – §897(c)(3)
- **Domestically controlled REIT**
 - Domestically controlled if 50% or more of the REIT is owned by U.S. persons during last 5 years or if less, time REIT has been in existence
- **No tax since not USRPI – §897(h)(2)**

REITs – Tax Treaties

The 2006 U.S. Model Treaty provides:

- 5% dividend rate does not apply to REIT dividends,
- 15% rate on REIT ordinary dividends (0% if paid to a pension fund) if:
 - Beneficial owner is an individual or pension fund, in either case holding not more than 10% interest in REIT;
 - Dividends is paid with respect to publicly traded class of stock and beneficial owner holds an interest of not more than 5% of any class of the REIT's stock; or
 - Beneficial owner holds an interest of not more than 10% in the REIT and the REIT is diversified.

REITs – Tax Treaties

- Under the 2006 Model Treaty, a REIT shall be "diversified" if the value of no single interest in real property exceeds 10% of its total interests in real property. For the purposes of this rule, foreclosure property is not considered an interest in real property
- The 2006 U.S. Model Technical Explanation states that distributions of gains “attributable to the alienation of a U.S. real property interest” from a REIT will not be a dividend, but rather will be taxable as gain from real property

REITs – Tax Treaties

- Recent treaties are identical, e.g., Japan and Belgium, or substantially similar, e.g., U.K. and new Canadian protocol.
- No ownership limit for dividend exemption for pension funds in Canadian and Swiss treaties. Note an 80% of class of shares limit in Dutch treaty MOU.
- Explicit statement in protocol to Dutch treaty that pension fund dividend exemption inapplicable to REIT dividends of gains from dispositions of USRPIs.
- Special rule allowing Australia listed property trusts to get 15% rate except to the extent 5% holders would not qualify for 15% rate if they received the REIT dividend directly.
- Older treaties do not distinguish between REIT and C corporation dividends, allowing some foreign investors to get dividend withholding rates below that of 2006 Model Treaty (e.g., Hungary and Poland treaties provide for withholding rates as low as 5% in some circumstances for REIT dividends)

REITs – Withholding

- FIRPTA Withholding – Treas. Reg. § 1.1445-8
 - 35% withholding with respect to capital gain dividends or, if larger, largest amount that could have been designated as capital gain dividends.
 - Catch-up withholding for designations of prior distributions as capital gain dividends.
- IRC § 1445(e)(3) – 10% withholding tax on non-dividend distributions by USRPHCs.
- As noted previously, to the extent a distribution from a REIT is from gain on the disposition of a USRPI under §897(h)(1), the distributing entity must generally withhold 35% under §1445(e)(6).