

— ADVANCED COURSE —

# Foreign Real Estate Investor Tax Planning Techniques

*By Richard S. Lehman Esq.*

# Richard S. Lehman

*Lehman has been practicing in South Florida for nearly 40 years.*

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Mr. Lehman began his career in tax law with a law degree from Georgetown University, a Master's Degree in tax law from New York University, and two years of clerking for the Honorable William M. Fay, a Judge on the United States Tax Court in Washington, D.C. Mr. Lehman spent several years as the senior attorney of the Interpretive Division of the Chief Counsel's office at the Internal Revenue Service, the IRS's internal law firm.

Mr. Lehman has had extensive experience with all areas of the Internal Revenue code that apply to **American taxpayers** and **non-resident aliens** and **foreign corporations** investing or conducting business in the United States, as well as U.S. citizens and domestic corporations investing abroad.

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**Richard works with other lawyers, accountants, business leaders and individuals who are struggling to find their way through the complexities of United States Tax Law.**

# SEMINAR OUTLINE

— ADVANCED COURSE —

CLE Credits: 2.5

## Foreign Real Estate Investor Tax Planning Techniques

BY RICHARD S. LEHMAN, ESQ.

### I. Principle Objectives

- Limited Personal and Asset Liability
- Single U.S. Tax
- Avoid Double Taxation – U.S. and Country of Investor
- Confidentiality
- Tax Planning
  - Eliminate U.S. Taxation of Real Estate Income and Gains
  - Eliminate U.S. Estate and Gift Tax
  - Eliminate U.S. Branch Tax on Foreign Corporations
  - Single Tax
  - Deferral of Payment of Tax
  - Reduce Tax Rates

### II. Basics

- Tax Rates
- Taxable Persons and Entities
  - Foreign Individual Investor
  - Limited Liability Company of Partnership
  - The U.S. Corporation
  - Foreign Corporation
  - Foreign Trusts

### III. Planning Techniques

- Avoidance of the Double Tax - Gains
- Elimination of the U.S. Estate and Gift Tax and the Branch Tax
- The Foreign Trust – U.S. Estate Tax Avoidance and Income Tax Benefits
- Tax Bracket Advantages and Individual Planning
- Avoidance of the Double Tax
- Tax Free Income
- Partially Tax Free Income
- Tax Treaties

# OUTLINE: Principle Objectives

- Limited Personal and Asset Liability
- Single U.S. Tax
- Avoid Double Taxation – U.S. and Country of Investor
- Confidentiality
- Tax Planning
  - Eliminate U.S. Taxation of Real Estate Income and Gains
  - Eliminate U.S. Estate and Gift Tax
  - Eliminate U.S. Branch Tax on Foreign Corporations
  - Single Tax
  - Deferral of Payment of Tax
  - Reduce Tax Rates

# OUTLINE: Basics

- Tax Rates
- Taxable Persons and Entities
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  - Limited Liability Company of Partnership
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# OUTLINE: Planning Techniques

- Avoidance of the Double Tax on Gains
- Elimination of the U.S. Estate and Gift Tax and the Branch Tax
- The Foreign Trust – U.S. Estate Tax Avoidance and Income Tax Benefits
- Tax Bracket Advantages and Individual Planning
- Avoidance of the Double Tax – Other Countries.
- Tax Free Income
- Partially Tax Free Income
- Tax Treaties

# Foreign Investors – Income Tax

- Non Resident Alien Individuals and Foreign Corporations (“Foreign Investors”) that invest in U.S. real estate are taxed similar to U.S. Individual Taxpayers and U.S. Corporations on their U.S. real estate income.

The term “Foreign Investors” is used for:  
foreign individual(s) and foreign entities

# Foreign Investors – Income Tax

## *Similarities*

- Foreign Investors in U.S. real estate will be taxed on their ordinary income, whether it is from operating income such as rentals or inventory sales or other income producing transaction from U.S. real estate.
- Foreign Individual Investors, like American individuals will be taxed on their capital gains from the sale of investment real estate at lower tax rates than ordinary income.
- Foreign Corporations, like U.S. Corporations, have the same rate of tax imposed on capital gains and operating income



# Foreign Investors – Estate & Gift Tax

1. A drastic difference between the U.S. estate and gift tax laws that govern U.S. persons and Non Resident Individuals who may die owning U.S. real estate, or foreign individual investors who give gifts of U.S. real estate to third parties.
2. The U.S. gift taxes and estate taxes on Foreign Investor(s) are prohibitive and can be as high as 40% of the net value of the real property gifted or demised.
3. Only a small amount of the value of the real estate, (\$60,000), may be a gift or left as an inheritance during the Foreign Investor's life without paying U.S. estate or gift taxes.
4. The U.S. estate and gift taxes can be avoided.

## Foreign Investors – Branch Tax

- There is also a unique tax on Foreign Corporations that build cash reserves from earnings and profits in the U.S.
- They must either reinvest cash in U.S. assets, or distribute the cash as dividends or suffer a tax known as “Branch Tax”.
- This can be an additional 30% tax on profits in addition to the foreign corporate income tax.
- This is another tax that can be planned around.

## Foreign Investors – Tax Benefits

Because of the laws that favor foreign investments in the United States; and because of certain advantages that a Foreign Investor may find if a U.S. Tax Treaty governs the Foreign Investors, there can be significant differences and benefits for Foreign Investors in U.S. real estate; many of which are not enjoyed by American Investors.

# History of the Real Estate Taxation

- In the 1980s a new section was added to the Internal Revenue laws: **Code Section 897**
- A unique set of tax rules that apply only to real estate income. An attempt to make sure that a Foreign Investor paid at least one U.S. tax on operating income and one tax on capital gain.
- It is often possible for a Foreign Investor to pay no tax on income that is essentially derived from real estate profits.

# Investment and Tax Objectives

Principal objectives that affect the  
Foreign Investor in U.S. real estate

# Limited Personal and Asset Liability

## Insurance

The first solution for the protection of the asset and the owner is providing for the proper liability insurance for the investment. Insurance policies covering liability for the typical injuries or damages that may occur on a real estate property are readily available in the U.S. from designated Insurance Brokers.

## Entity Choice

The second solution for the asset is the proper entity choice so the real estate asset is not exposed to liabilities of other assets owned by the Foreign Investor and *vice versa* and more importantly so that the Foreign Investor is not personally liable for any damages that may result from the real estate investment.

# Investment and Tax Objectives

## Single U.S. Tax.

- The Foreign Investor will want an entity that will facilitate the paying of only a single tax on U.S. operating profits and a single U.S. tax on gains from sale.

# Investment and Tax Objectives

## Avoid Double Taxation – United States and Country of Investor.

- Between the two countries, a single tax should be paid to the U.S. on real estate income and the U.S. tax or the other countries' tax may be appropriately credited among the income taxes of each country. It is important to maximize the tax credits to avoid double taxation between the two countries.



# Investment and Tax Objectives

## Confidentiality

- The Foreign Investor often is concerned with the preservation of confidentiality for fears of kidnapping in their own country and a number of other reasons. Therefore, generally the Foreign Investor would prefer an entity that requires as little disclosure of their personal information as possible on U.S. tax returns and U.S. information returns.

# Investment and Tax Objectives

## Tax Planning

- The proper use of entity choices can take advantage of the following:
  1. Tax deductions for expenses
  2. Tax exclusions of certain types of income
  3. The ability to defer the payment of taxes to a later date that is provided to Foreign Investors under the U.S. tax system.

# Tax Planning tools will allow Foreign Investor to:

1. Eliminate U.S Taxation of Real Estate Income and Gains. Totally and/or partially eliminate U.S. taxes on certain real estate income and gains.
2. Eliminate U.S. Estate and Gift Tax. The U.S. Estate and Gift tax can be completely eliminated with the proper entity choice.
3. Eliminate U.S. Branch Tax on Foreign Corporations. Eliminate U.S. Branch taxes with the proper entity choice.
4. Single Tax. Insure that only a single U.S. tax will be paid on real estate profits.
5. Deferral of Payment of Tax. Defer taxation of gains on real estate profits that are realized for payment at a later date than the realization of these gains.
6. Reduce Tax Rates. Proper planning can assure that income is reported in the lower tax brackets among groups of investors.

A dark wood desk with a blue pen and a brass object.

**Individual Tax Payer  
U.S. Corporations  
Foreign Corporations**

**Operating Income  
& Gains from Sale**

## Minimum and Maximum Individual Tax Rate TAX RATES

- Operating Income 10% to 39.6%
- Capital Gains Tax 15% to 20%

## Minimum and Maximum Corporate Tax Rate for U.S. and Foreign Corporations

### TAX RATES

- Operating Income First \$75,000 Average 20%
- Capital Gain Maximum of 35% plus deductible State Corporate Income Tax  
(Corporate Income Tax not in all states)

# Passive Income

## TAX RATES

Maximum U.S. Tax Rate – Interest Income Payable to Foreign Creditor	30% 15% or less, Treaty
Maximum U.S. Tax Rate – Dividends Payable to Foreign Shareholders	30% 15% or less, Treaty Corporations

# Maximum Use of Investment Entity INDIVIDUAL

- Personal Liability YES
- Personal Disclosure (Tax Returns) YES
- U.S. Estate Gift Tax YES 20 -40%  
(Value in excess of \$60,000)
- U.S. Income Tax YES
- Operating Income Tax Rate 10-40%
- Passive Income (no tax treaty country)
- Interest Tax Rate 30%
- Dividends Tax Rate 30%
- U.S. Capital Gains Tax Tax Rate 15-20%
- Tax Planning Techniques **Moderate**
- Branch Tax NO

# Maximum Use of Investment Entity LIMITED LIABILITY COMPANY

- Personal Liability NO
- Personal Disclosure YES  
(Tax Returns)
- U.S. Estate Gift Tax YES 20 -40%  
(Value in excess of \$60,000)
- U.S. Income Tax YES
- Operating Income Tax Rate 10-40%
- Passive Income (no tax treaty country)
- Interest Tax Rate 30%
- Dividends Tax Rate 30%
- U.S. Capital Gains Tax Tax Rate 15-20%
- Tax Planning Techniques **Moderate**
- Branch Tax NO



# Maximum Use of Investment Entity U.S. CORPORATION

- Personal Liability NO
- Personal Disclosure (Tax Returns) NO
- U.S. Estate Gift Tax YES 20-40%  
\* Value in excess of \$60,000 NO GIFT TAX
- U.S. Income Tax YES
- Operating Income (plus state income tax) Tax Rate 15-35%
- Passive Income (no tax treaty country)
- Interest Tax Rate 30%
- Dividends Tax Rate 30%
- U.S. Capital Gains Tax (plus state income tax) Tax Rate 15-35%
- Tax Planning Techniques **Moderately better than Indv.**
- Branch Tax NO

# Maximum Use of Investment Entity FOREIGN CORPORATION

- Personal Liability NO
- Personal Disclosure (Tax Returns) NO
- U.S. Estate Gift Tax (Value in excess of \$60,000) NO
- U.S. Income Tax YES
- Operating Income (plus state income tax) Tax Rate 15-35%
- Passive Income (no tax treaty country)
- Interest Tax Rate 30%
- Dividends Tax Rate 30%
- U.S. Capital Gains Tax (plus state income tax) Tax Rate 15-35%
- Tax Planning Techniques **Improved**
- Branch Tax YES

# The Tax Planning Techniques

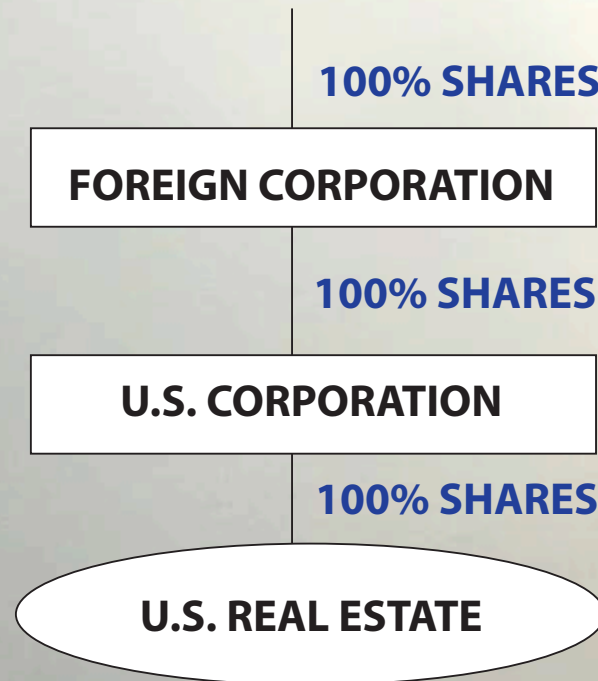
## Elimination of the U.S. Estate and Gift Tax and the Branch Tax

- Tiered Corporations and Multiple Corporations; Flexibility, and Use of Losses

# Tiered Corporate Structure

NON RESIDENT  
**INVESTOR**

ALIEN FOREIGN CORPORATE INVESTOR



# Maximum Use of Investment Entity

## TIERED ENTITY

- Personal Liability NO
- Personal Disclosure (Tax Returns) NO
- U.S. Estate Gift Tax (Value in excess of \$60,000) NO
- Operating Income YES
  - on U.S. Operating corporation only
- Passive Income (no tax treaty country)
- Interest Tax Rate 30%
- Dividends Tax Rate 30%
- U.S. Capital Gains Tax YES (Income from sale)
  - If Foreign Corp sells shares of U.S. Corp to third parties.
- Tax Planning Techniques **Significant**
- Branch Tax NO

# The Tax Planning Techniques

## Avoidance of the Double Tax

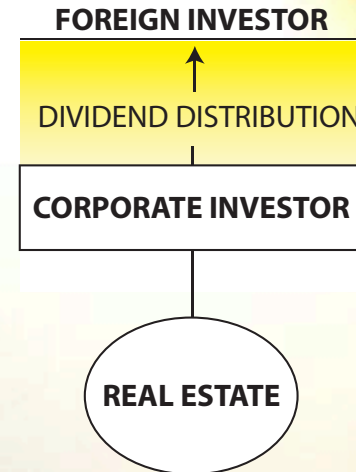
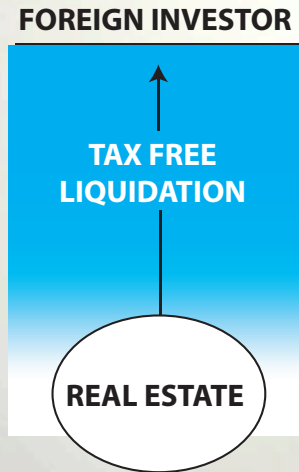
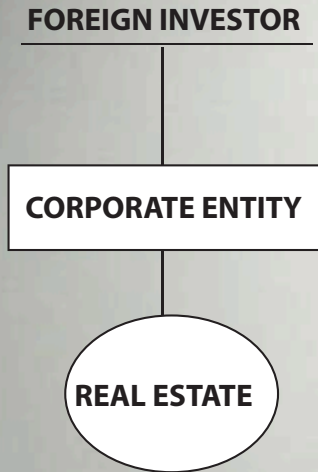
- The Liquidation of the Operating Company

## Tax Planning Tool No.1

A Foreign Investor that owns U.S. Real Estate through a corporation and not as an Individual can pay a single tax on the gain of the sale of that Real Estate by Liquidating the Corporation and Distributing the Cash Proceeds

A Foreign Investor that does not liquidate the Corporation and Distributes those proceeds will have a double tax since the Cash Distribution will be considered a Taxable Dividend

# Complete Liquidation



## LIQUIDATION

\$1,000,000 X 34%  
NET PROCEEDS \$1,660,000.

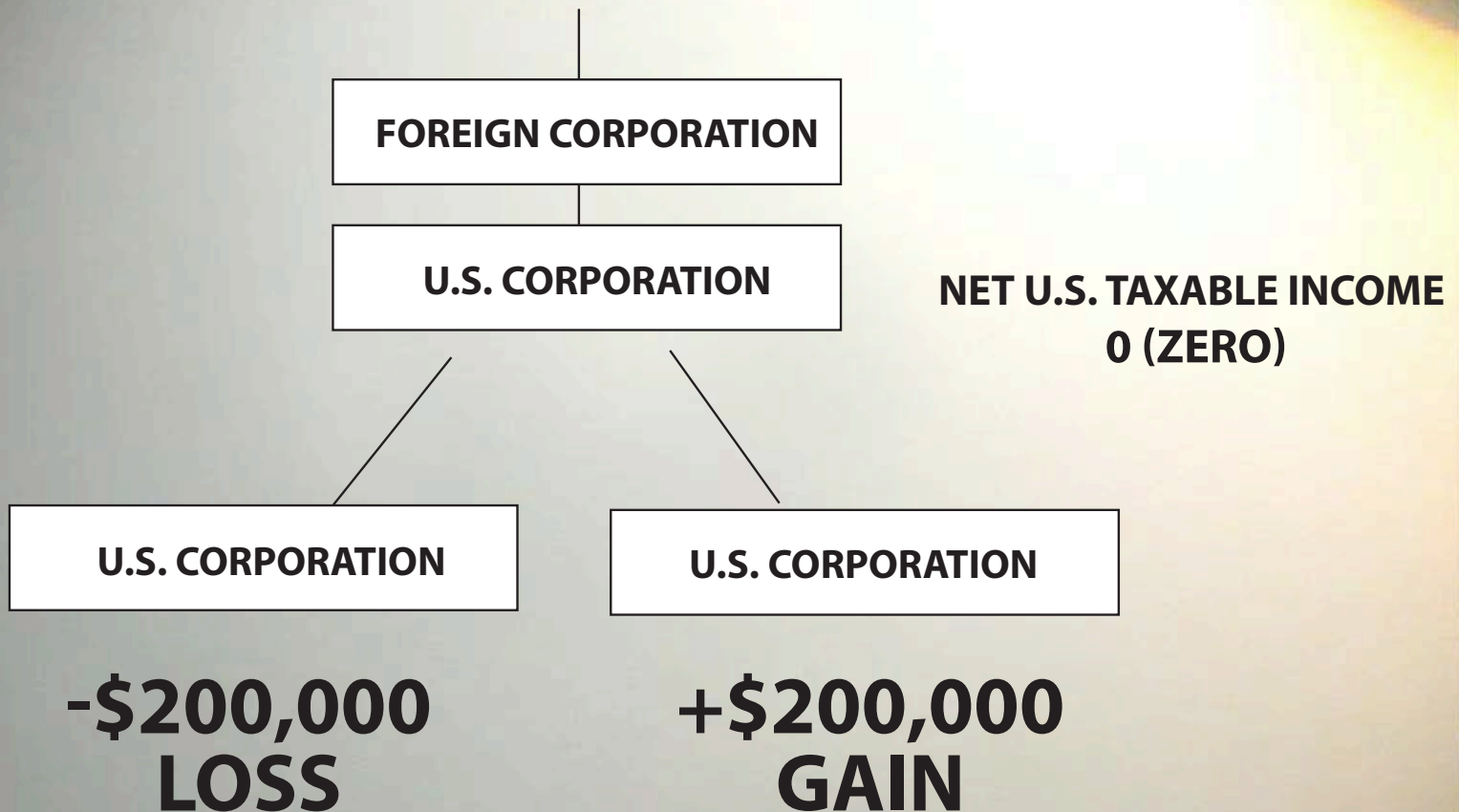
## DIVIDEND DISTRIBUTION

\$1,000,000 X 34%  
NET PROCEEDS \$1,660,000

PURCHASE PRICE	\$1,000,000	DIVIDEND \$660,000.
SALES PRICE	\$2,000,000	x 30% TAX
TAXABLE GAIN	\$1,000,000	\$198,000.
	<b>TOTAL \$1,660,000. NET PROCEEDS</b>	<b>TOTAL \$1,462,000 NET PROCEEDS</b>



# Non Resident Investor



# NON-RESIDENT INVESTOR

FOREIGN CORPORATION

U.S. CORPORATION

U.S. Property  
No. 1

U.S. Property  
No. 2

U.S. Property  
No. 3

**Value:**     **\$30,000**

**\$10,000**

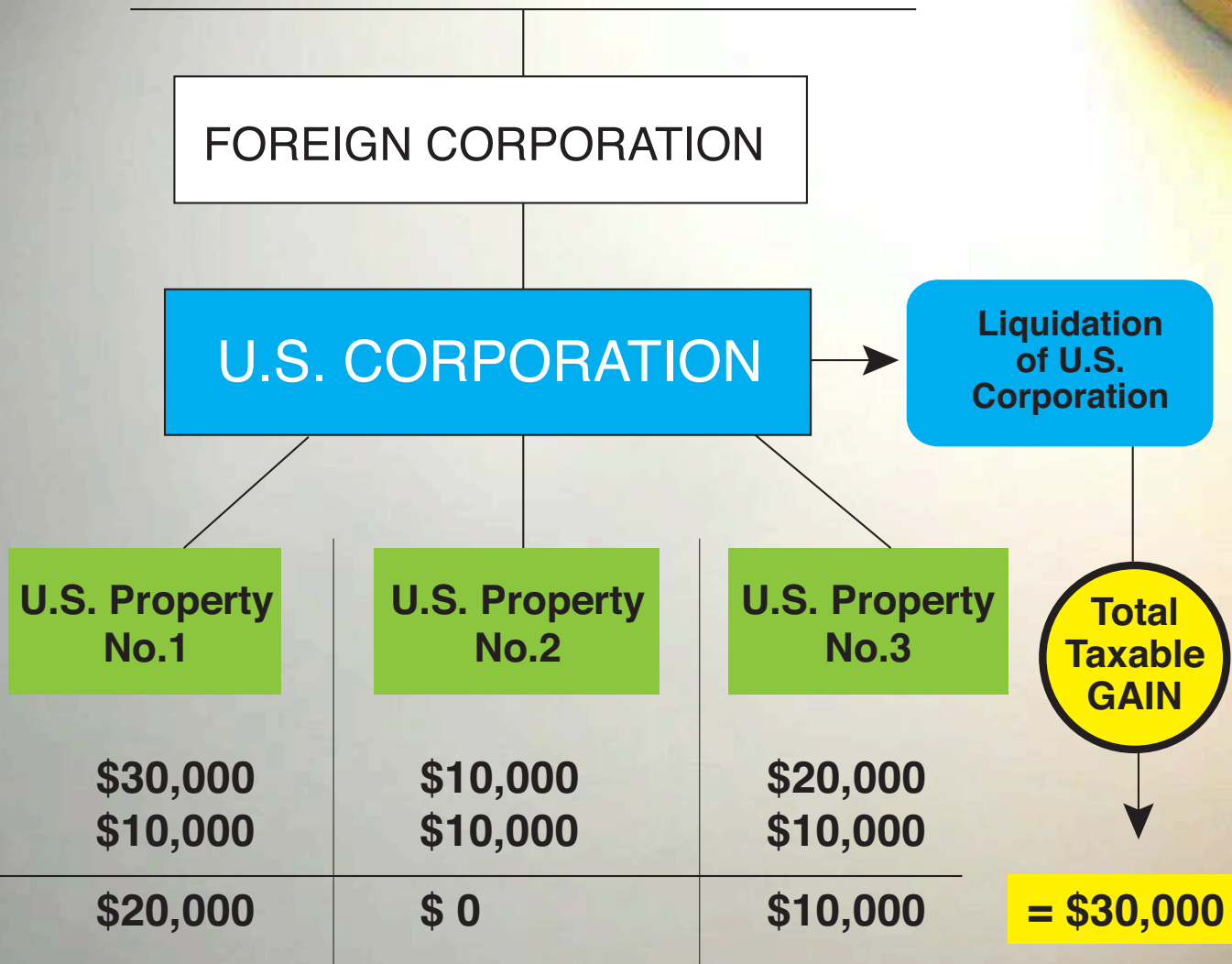
**\$20,000**

**Cost:**      **\$10,000**

**\$10,000**

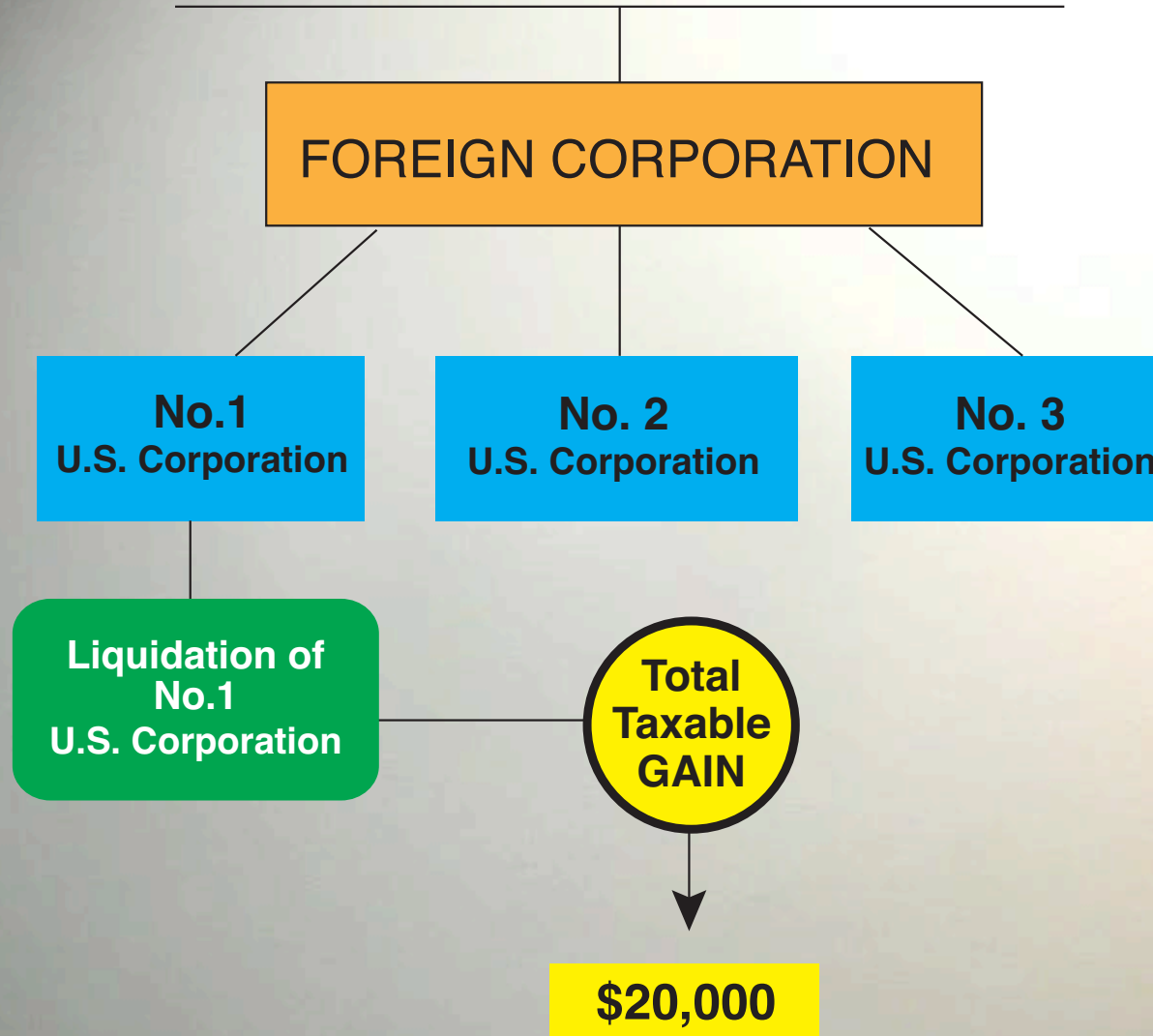
**\$10,000**

# NON-RESIDENT INVESTOR



= \$30,000

# NON-RESIDENT INVESTOR

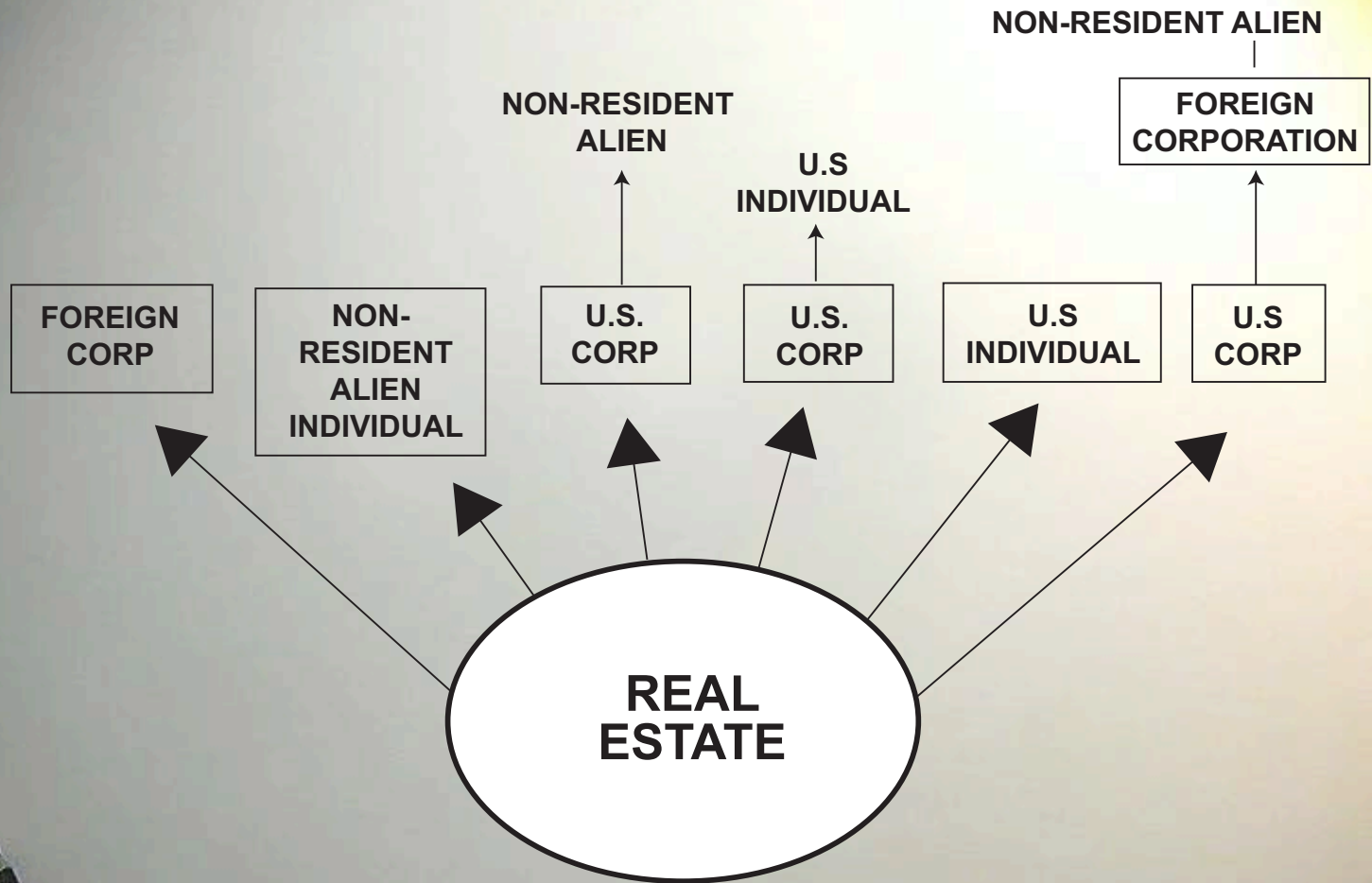


# The Tax Planning Techniques

## Tax Bracket Advantages and Individual Planning

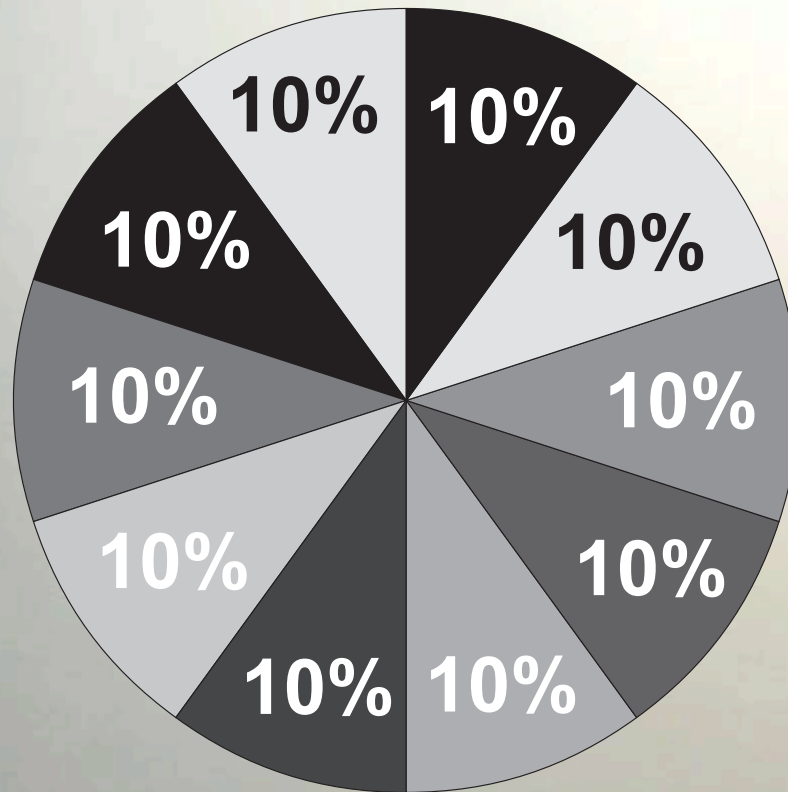
- Use of the Limited Liability Company or Partnership – Multiple Taxpayers

# Non-Resident Alien



# Exhibit A

Limited Liability Company (Members) or  
Partnership (Partners)



# Separate Tax Brackets

	<b>Income</b>	<b>Depreciation</b>	<b>Rate</b>	<b>Tax</b>
U.S. Corporation	\$20,000	\$6,400	15%	\$2,040
Foreign Corporation	20,000	6,400	15%	2,040
Foreign Individual	20,000	6,400	10%	1,360
US Individual (Other U.S. Income \$400,000)	20,000	6,400	40%	5,940



# The Tax Planning Techniques

## Avoidance of the Double Tax

- Deductible Interest Income & Real Estate Profits

# Assumptions

## U.S. COMMERCIAL PROPERTY

ALL CASH – TOTAL COST (CASH) \$2,000,000.

A. LAND \$400,000.  
B. BUILDING \$1,600,000.

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**5 YR DEPRECIATION FACTOR** (4% X \$1.6 MILLION) \$64,000 PER YEAR

NET RETURN ON CASH INVESTMENT (10%) \$200,000.

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## (CASH FLOW)

EVENTUAL SALE OF PROPERTY – 5 YEARS \$4,000,000.  
Individual and U.S. State and Corporate Tax Rate

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**SALE OF PROPERTY** \$4,000,000 - \$1,680,000 = \$2,320,000. GAIN

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**TAXABLE GAIN** \$2,320,000 X 40% = \$928,000. TAX

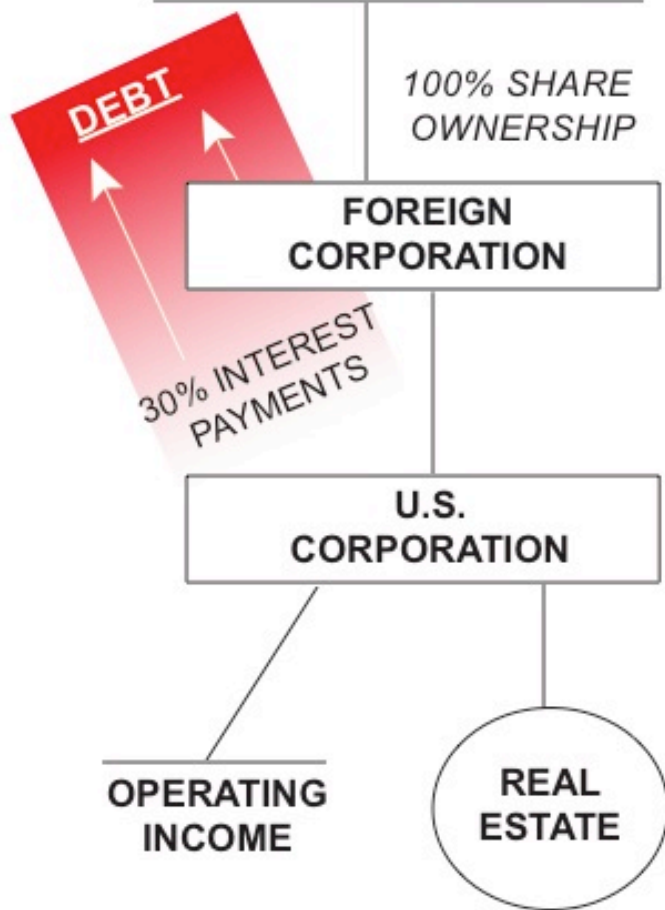
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# Interest Payments to Non Resident Aliens

- If a foreign investor receives interest income from a United States corporation OR a United States person, OR any United States entity investing in real estate, the general rule will be a 15% (Treaty Rate) to 30% withholding tax on that interest.
- If a Foreign Investor lends money to a U.S. person or entity invested in U.S. real estate, and receives interest income, the U.S. person or entity has an interest cost and will reduce its taxable income with a deduction for a cost of doing business

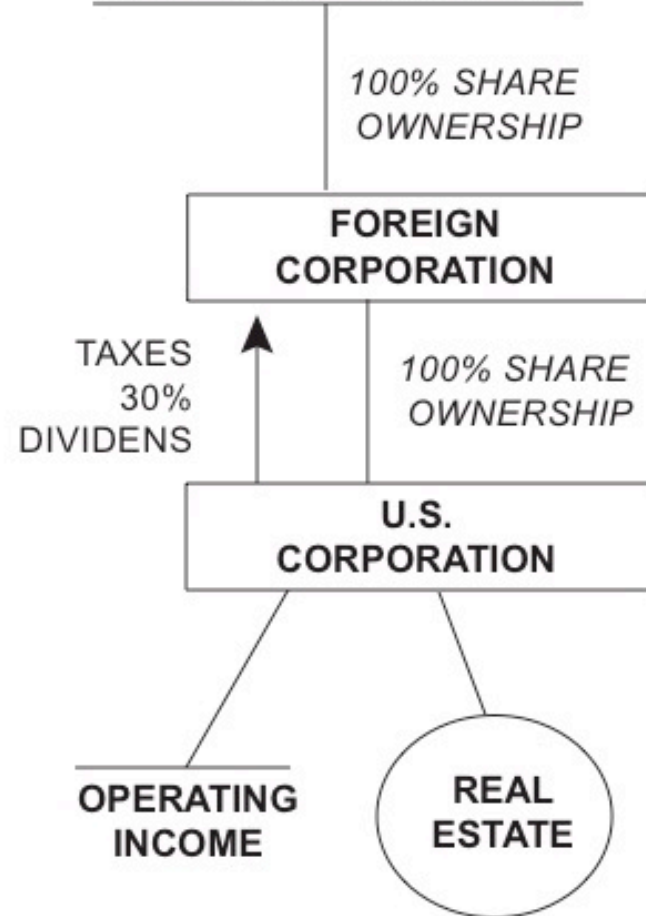
**As a general rule interest payments made by an American payor to a Foreign Investor are subject to one of two types of U.S. taxes.**

## NON-RESIDENT ALIEN INDIVIDUAL



TAXES 35% PROFITS  
TAXES 30% INTEREST

## NON-RESIDENT ALIEN INDIVIDUAL



TAXES 35% PROFITS  
TAXES 30% DIVIDEND

## **Example No. 1.**

- Represents a \$2,000,000 Investment
- \$1,000,000 Equity and \$1,000,000 Debt

## **Example No. 2**

- Represents a \$2,000,000 Investment
- Equity Investment \$2,000,000

Debt Investment - \$ 0 -

## EXAMPLE 1

Gross Income	\$200,000.
Depreciation	(\$64,000.)
Interest Payments	(\$40,000.)
	<hr/>
Taxable Income	= \$96,000.
Corporate Tax Assumed 40%	\$38,400.
Add back tax on interest paid (30%)	\$12,000.
	<hr/>
<b>TOTAL TAX.....</b>	<b>= \$50,400.</b>

## EXAMPLE 2

Gross Income	\$200,000.
Depreciation	\$64,000.
	<hr/>
Taxable Income	= \$136,000.
Corporate Tax (40%)	\$54,400.
PLUS Tax on Dividends Distributed (30%)	\$12,000.
	<hr/>
<b>TOTAL TAX.....</b>	<b>= \$66,400.</b>

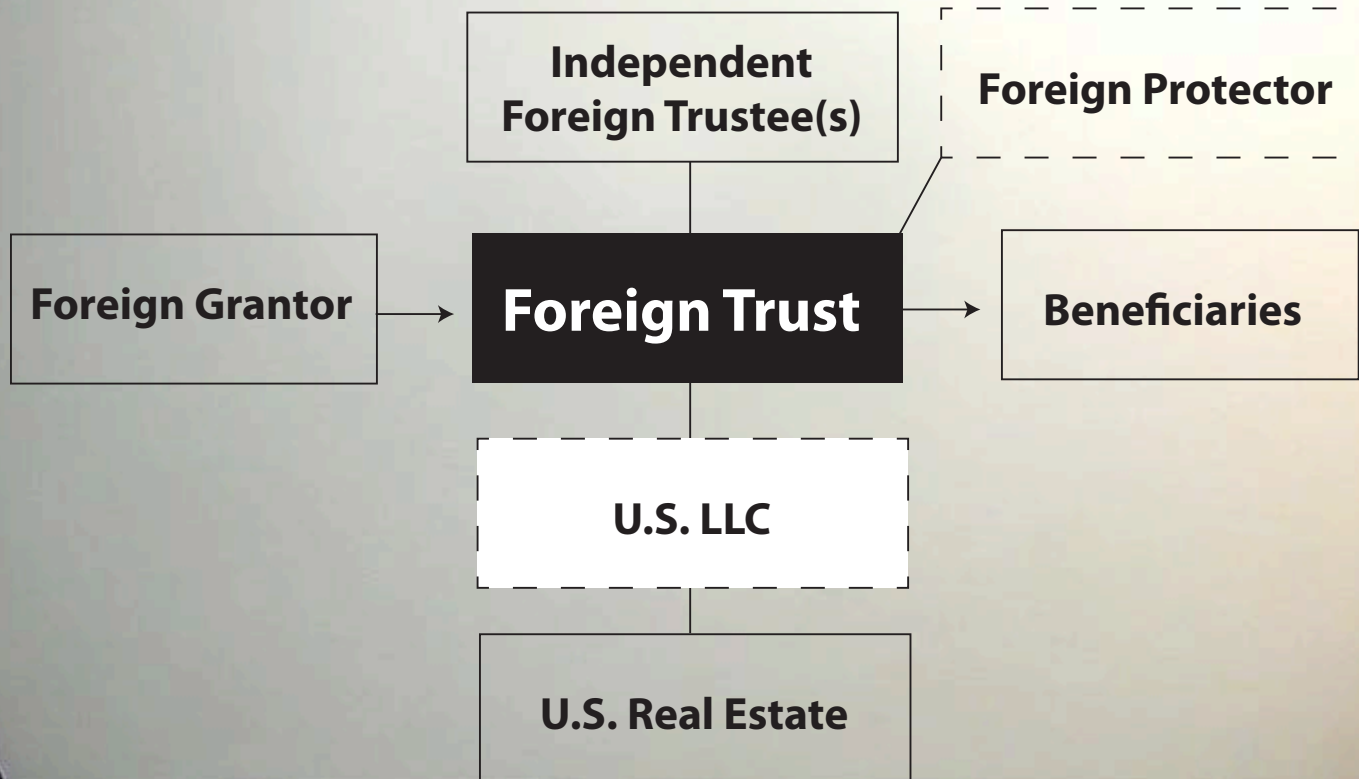
# The Tax Planning Techniques

## The Foreign Trust – U.S. Estate Tax Avoidance and Income Tax Benefits

- The Non Grantor Trust

# Non Grantor TRUST PLANNING

- Foreign person invests funds for U.S. real estate investment
- Non-grantor trust
- No U.S. estate taxes





# The Tax Planning Techniques

## Tax Deferral

- Delayed Tax Payment on Gains

# Like Kind Exchange

Real Estate Investors whose property increased in value may **change their investment** from one real estate investment to a different real estate investment of a higher value **without paying tax on the gain** in their original asset until a later point in time.

# Like Kind Exchange

A taxpayer may invest in a real estate property, (Property), and not sell but may exchange that real estate Property; which has increased in value for a completely different type of real estate Property, equal to the increased value of the second Property, without paying tax on the gain represented by the increased value of the new property until a later date in time when the Property No. 2 is actually sold by the Foreign Investor.

# Like Kind Exchange

- The tax on the gain is deferred until that time the asset is actually sold to a third party.
- This is accomplished by insuring that the new appreciated asset will continue to be owned at the old reduced cost or basis of the Property asset that has been exchanged.

# Like Kind Exchange

## Code Section 1031 governs Like Kind Exchanges

- The exchange property be identified “on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange” is an arbitrary cutoff date which must be strictly complied with.
- The exchange property must be received on or before the earlier of ;
  - the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange or
  - the due date (including extensions) for the transferor’s return for the taxable year in which the transfer of the relinquished property occurs.

# Like Kind Exchange

## Identification of Multiple Properties

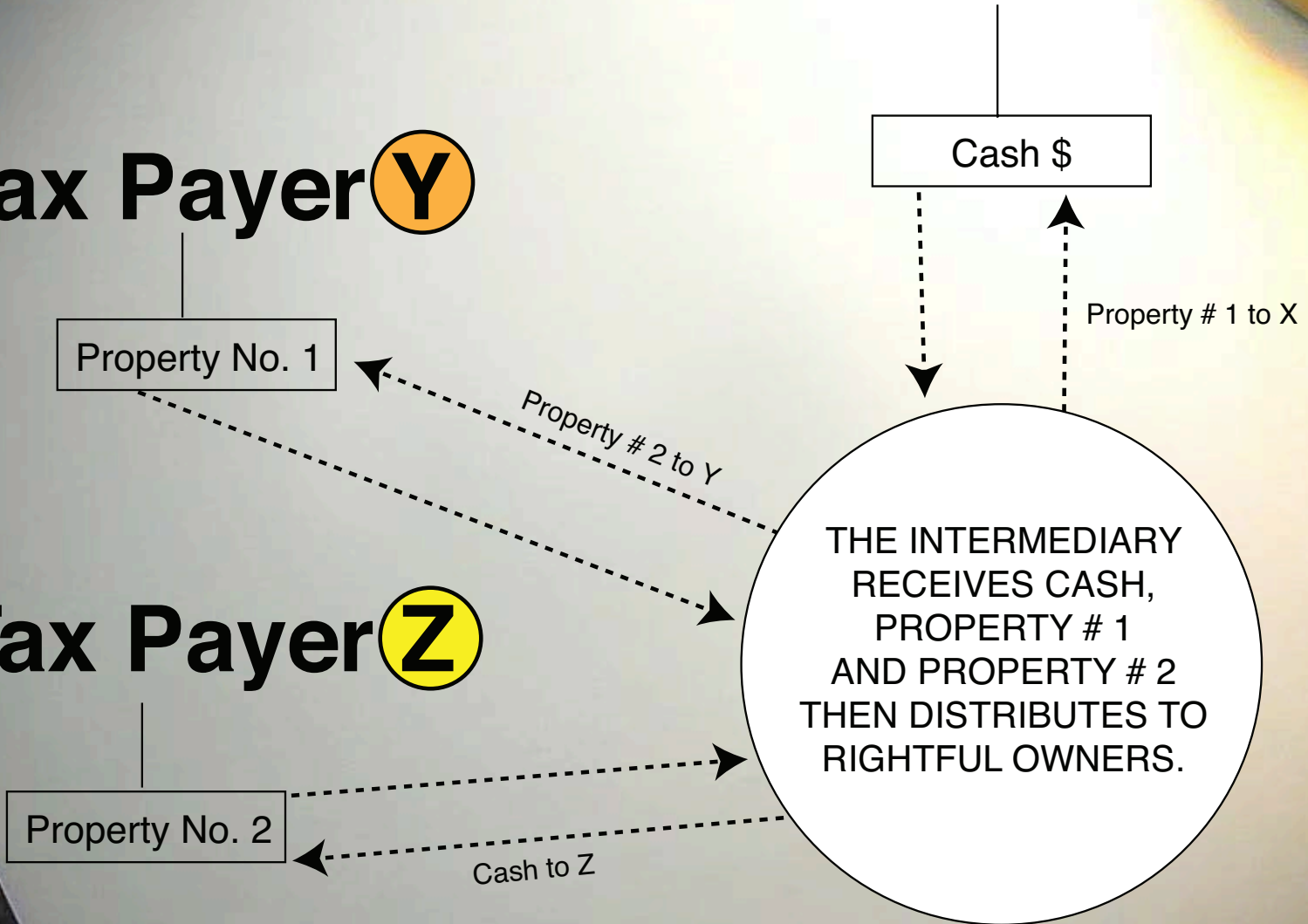
- The maximum number of replacement properties that the taxpayer may identify is
  - three properties without regard to their fair market values or
  - any number of properties as long as their aggregate fair market value as of the end of the identification period does not exceed 200% of the aggregate fair market value of all of the relinquished properties as of the date the relinquished properties were transferred by the taxpayer.

In the case of replacement property that is to be produced, the fair market value for purposes of the 200% rule is its estimated fair market value as of the date it is expected to be received by the taxpayer.

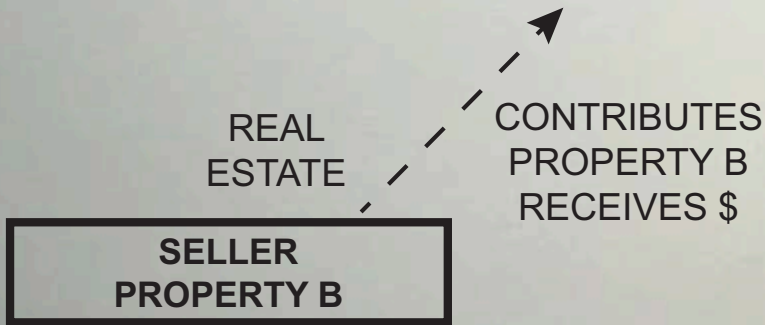
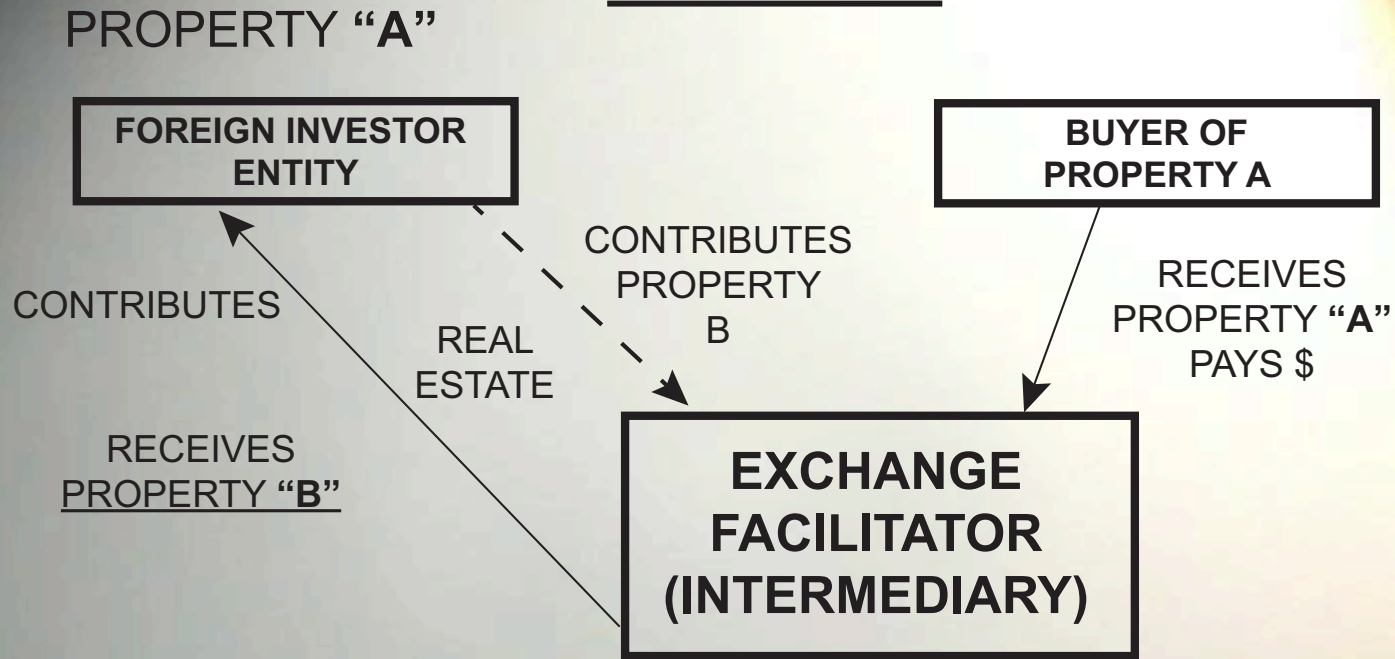
# Tax Payer X

# Tax Payer Y

# Tax Payer Z



# BEFORE



# AFTER

FOREIGN INVESTOR OWNS PROPERTY "B"

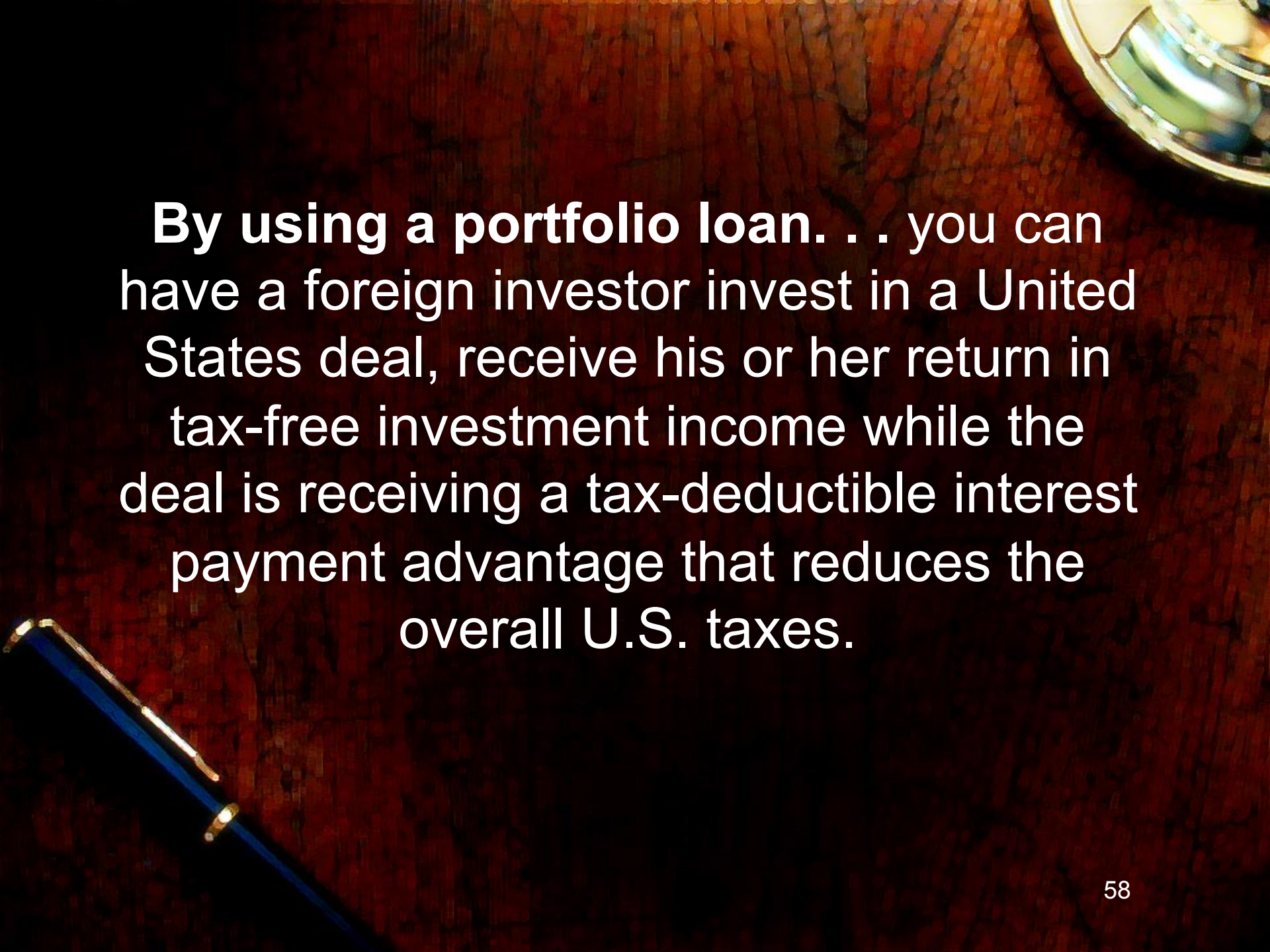
BUYER OF PROPERTY "A" OWNS PROPERTY



# The Tax Planning Techniques

## Tax Free Income

- A. The Portfolio Interest Exclusion – Tax Free Income
- B. Attribution Rules
- C. Eleven (11) Investors
- D. Family Personal Loans
- E. Contingent Interest
- F. Structured Sales

A dark wood desk with a blue pen and a brass object.

**By using a portfolio loan. . . you can have a foreign investor invest in a United States deal, receive his or her return in tax-free investment income while the deal is receiving a tax-deductible interest payment advantage that reduces the overall U.S. taxes.**

# Interest Earned by a Foreign Investor

The second type of interest income is investment interest.

- If interest is earned by a Foreign Individual or Corporation as investment income, it is passive in nature, and the gross interest income (not reduced by expenses) may be subject to a 30% tax on the gross interest income.
- The tax rate is reduced if the Foreign Investor is from a country with a tax treaty with the United States.

# Withholding Agent

A withholding agent is the person responsible for withholding on payments made to a foreign person.

- So long as the Portfolio Interest rules are followed, there is no U.S. tax to be paid and the withholding obligation does not apply to the American payor.

# **Portfolio Interest Exemption (Income Tax)**

This exemption permits interest on U.S. debt instruments to be exempt from the gross basis tax if the interest income is payable to Foreign Persons under certain circumstances.

# Portfolio Interest Exemption (Income Tax)

- This exemption is necessary since many lending transactions earn a net profit from a very narrow spread between borrowing and lending rates.
- The Portfolio Interest Exception was designed to encourage Foreign Persons to engage in U.S. lending transactions.
- The exemption eliminates the 30% tax on interest on these instruments. This exemption from tax has several requirements and restrictions.

# Estate Tax Exception

- The portfolio debt interest payments are not only excluded from the foreign Lenders U.S. taxable income, in addition the Foreign Person that owns the Portfolio Obligation will also not be subject to U.S. estate taxation if they die owning the Obligation.
- Typically, a debt of a U.S. person is subject to the estate tax if the individual foreign owner dies while holding the U.S. debt.
- A Foreign Individual Investor that holds only a Portfolio Interest Obligation in a real estate investment does not need any other estate tax planning, such as the Foreign Non Grantor Trust or the Foreign Corporation.

# Requirements – Registered Form

*Registered form means that:*

- The obligation is registered (on record), with the issuer (or its agent) as to both principal and any stated interest, and the transfer of the obligation can only be accomplished by surrender of the old instrument and either the reissuance (by the issuer) of the old instrument to the new holder or the issuance of a new instrument to the new holder; or
- The right to principal and stated interest may be transferred only through a book entry system maintained by the issuer; or
- The obligation may be registered as to both principal and any stated interest with the issuer (or its agent) and may also be transferred through both of the methods.



# Beneficial Owner Statement

- In order for interest on a registered obligation to fall within the statutory definition of portfolio interest and thus be exempt from that tax in the first instance, the person who would otherwise be required to deduct and withhold tax on payment of the interest (i.e., the payor) must receive a statement that the beneficial owner of the obligation is not a U.S. person.

# Beneficial Owner Statement

The payor obtains a Form W-8BEN directly from the beneficial owner.

- According to the regulations, interest is eligible for the portfolio debt exception if the payor can “reliably associate the payment with documentation upon which it can rely to treat the payment as made to a foreign beneficial owner”.
- All beneficial owners (other than financial institutions or clearing organizations) are required to provide a Form W-8BEN. They must be provided to a withholding agent within 90 days of an interest payment.

# Information Reporting

It is also important that the debtor of a Portfolio Obligation keep records and file an information return only that advises the U.S. of the Portfolio lenders.

- This is not a tax return. It is only for information purposes.

# Information Reporting

If there is a qualified portfolio loan, the interest paid by the U.S. payor that is deductible by the U.S. payor when paid to the foreign investor, **is not going to be subject to that 30% tax.**

# Exceptions from Portfolio Interest Exemption

There are a number of types of loans that cannot qualify for portfolio interest treatment and whose interest payments to a Foreign Investor would be subject to a U.S. tax. If this is the case, the interest payments to the payee from the U.S. payor will be taxable as if they are not considered Portfolio Interest.

# Contingent Interest

The first exception is that interest does not qualify as portfolio interest if the interest is not true interest; but if it is really an equity investment instead of a loan.

# Contingent Interest

Portfolio interest treatment is not available for any interest determined by reference to:

- Profits or any other measure of the business debtor's business success; or
- Nor can the investment be based upon receipts, sales or other cash flow of the debtor or a related person can be used to determine the amount of interest; or
- Portfolio Interest also cannot depend on any income or profits of the debtor or a related person; or
- Any change in value of any property of the debtor or a related person; or
- Any dividend, partnership distributions, or similar payments made by the debtor or a related person.

# Contingent Interest A Planning Tool

- We looked at the fact that contingent interest on a Portfolio Note will not be treated as Portfolio Interest and taxes will be required to be paid on the contingent portion of interest paid on a Foreign Investor's Note.
  - This does not completely diminish the planning techniques that may still be available while using the Portfolio Note. This is because any contingent interest that is paid out to an Investor will be subject to the 30% withholding taxes.



# Contingent Interest

## A Planning Tool

- The use of Contingent Interest can still enhance the promised financial return of the investment and allow the Investor to have Portfolio Interest treatment on the fixed interest portfolio of the loan while also offering the Investor an “equity position” in the borrower’s projects.
  - An example of this would be a Portfolio Loan that seeks a payment of 6% per year interest annually and a percentage of profits in addition to the fixed interest. The foreign investor will pay no tax on the true Portfolio Interest amount and a single fixed tax of 30% on the contingent portion.

# Contingent Interest

## A Planning Tool

- If a contingent interest factor was present, the tax benefit of an interest deduction by the U.S. payor of the note does not change.
- The portfolio exclusion from a U.S. tax on the true interest portion of the loan, and the Foreign Investor payee, pays no tax and that portion of the note.
  - With a degree of creativity and reasonable financial projections, there are many ways to structure fixed non contingent loans (covered by assured profits at the operating level); and then a contingent portion of that loan so that the Investor can maximize the portfolio interest portion of the loan while providing investors with significant equity participations.
  - These very sophisticated types of indexes can also be helpful in public offerings.

# Commercial Banking

- Another exception that prevents tax free Portfolio Interest treatment results if the debtor is in the business of banking. Interest treatment on interest paid to a bank on extensions of credit in the ordinary course of the bank's banking business cannot be portfolio interest.

## 10% Equity Participants – The Major Tax Planning Hurdle

- There is another aspect of the portfolio interest loan that prevents foreign investors from earning equity profits disguised as interest restricts the portfolio interest exemption. If the Lender owns 10% or more of the control of the borrowing entity which may be a corporation or a partnership.

## **LESS THAN 10% Equity Holder**

The rules are, all of this works so long as the foreign investor does not own 10% or more of the deal that he is investing in.

- Be careful, the moment any investor has more than 10% in the deal and that investor is lending money to the deal, the 30% tax is going to be back on, and it might be more expensive than it's worth.

# Planning Tool

- Portfolio Interest income is one of the best planning tools available and is only infrequently used by the smaller real estate investors. It has been a successful financing tool for decades of other industries.
  - If the foreign owner of a U.S. corporation was paid interest income on his or her debt in that corporation, the corporation can deduct the interest as an expense of the corporation while the investors pay themselves tax free interest with the same money; there will be no U.S. taxes paid on U.S. real estate income.

# Inter-Personal Loans

- One of the simplest methods of using the portfolio loan is when an individual nonresident alien loans funds to a related individual U.S. Taxpayer and there are no entities involved.
- A loan from father in any country in the world directly to daughter, a U.S. tax resident, who will pay reasonable interest for the loan and use the loan for a U.S. real estate acquisition, is a portfolio loan in spite of the close relationship.
- The interest on this loan, like any business loan, is deductible as an expense of carrying the real estate and since there is no personal attribution, the father's interest is portfolio interest and is tax free.

## **Structured Sale Of A Foreign Interest**

The Portfolio loan can be used effectively to buy out a foreign partner or a foreign shareholder to the advantage of the U.S. payor and the Foreign Payee.



Assume that U.S. partner pays the foreign partner with a Portfolio Note of \$1,100,000 in the form of a Portfolio Interest Note. Assume the U.S. Partner pays 13% Portfolio Interest on the Note for three years.

Total Paid to Foreign Investor	\$1,100,000.
Minus U.S. Tax (\$100,000 gain)	- 40,000.
Return on Sale	= \$1,060,000.
Interest Paid (Portfolio Note)	
13% x \$1,060,000 x 3 years	\$430,000.
<b>NET TOTAL PAID TO FOREIGN INVESTOR</b>	<b>= \$1,490,000.</b>
<b>INTEREST <u>DEDUCTIBLE</u> BY U.S. PAYOR</b>	<b>\$ 430,000.</b>

- Assume a U.S. 50% partner has invested with a foreign corporate partner in one acre of U.S. raw land on a 50/50 basis.
  - Cost of the property is \$2,000,000 cash, shared equally by the partners.
- A few years later the American wishes to buy out the foreign partner's 50% share for \$1,500,000 with a profit of \$500,000 to the foreign partner that is taxable by the U.S. at 40%.
  - The net proceeds to the foreign partner is \$500,000 profit x 40% tax, plus principal of \$1,000,000 returned. [Total return \$1,300,000].
  - Assume the Foreign Investor then invested the funds in a U.S. Bank at a 3% return for three years. Total return over the sale and three year period equals \$1,000,000 principal, \$300,000 net profits plus interest at 3% X \$1,300,000 X 3 years = \$120,000 Interest on Profits.
  - Total Cash Paid to the Foreign Partner over the three year period is \$1,500,000 plus \$120,000 paid by a bank.

**THE NET CASH TO THE PARTNER IS \$1,420,000.**

*There is no interest deductible by the U.S. Partner who purchased the shares of the Foreign Partner.*

# The Tax Planning Techniques

## Partially Tax Free Income

- Sale of Shares – Foreign Corporation

## Sale Of Shares Of Foreign Corporation

- If a foreign corporation invests directly in United States real estate and if the foreign shareholder can sell the shares of his or her foreign corporate stock to a U.S. buyer **instead of the real estate**, the shares of that Foreign Corporation that owns U.S. real estate directly or through a U.S. corporation stock, can be **sold by the Foreign Investor for no tax whatsoever**.

# STEP 1

Foreign Investor

**Foreign Corporation**

U.S. Real Estate

If U.S. Real Estate is sold, the tax will be more than **40%** on Foreign Corporation

# STEP 2

*The Foreign Investor sells shares to U.S. Investor*

**U.S. Investor**

**Foreign Corporation**

**U.S. Real Estate**

# STEP 3

*U.S. Investor "Domesticates" the Foreign Corporation thus the Foreign Corporation becomes a U.S. Corporation*

**U.S. Investor**

**U.S. Corporation**

**U.S. Real Estate**

# STEP 4

*U.S. Investor elects for U.S. Corporation to NOT EXIST for U.S. tax purposes*

**U.S. Investor**

**U.S. Real Estate**

The U.S. Investor now sells real estate at U.S. capital gains rate at **20%**

# Sale Of Shares Of Foreign Corporation

- A \$45,000,000 purchase price is paid for the real estate and assume the depreciation over the years has reduced the owner's basis in the asset to \$1,000,000.
- Leaving a profit to the U.S. corporation of \$44,000,000.
- If the corporate tax is paid and it is assumed there is a state corporate tax on 6% on the profit the total tax on the sale is approximately \$17,600,000, leaving net cash to the seller of \$27,400,000.

# Sale Of Shares Of Foreign Corporation

- Assume the Purchaser is a U.S. Taxpayer.
- Assume the U.S. purchaser has already identified a Triple-A piece of U.S. real estate and the U.S. investor knows that it can be purchased for \$45,000,000 and 80% of this purchase price can be financed. (\$36,000,000).
- Assume the Purchaser will pay the Foreign Investor Seller \$32,000,000 to buy the shares of the Foreign Corporation. The Foreign Investor is satisfied to be paid \$32,000,000 instead of \$27,400,000 net.
- There is an additional cash profit of \$4.6 million to the Foreign Investor.

# Sale Of Shares Of Foreign Corporation

- The owner of the foreign corporation has sold the shares in the foreign holding company for \$4,600,000 more than the foreign investor would have received after taxes from the sale of the property.
- The American investor that buys the foreign corporation shares will then undertake several corporate steps.
  - Change the corporation from a foreign corporation to an American corporation by a transaction in most states called DOMESTICATION. It does not result in taxation. This is a corporate change of the form of the corporation to that of a U.S. corporation and no longer a Foreign Corporation.



# Sale Of Shares Of Foreign Corporation

- The American borrows the cash necessary to buy the equity in the new property. That equity contribution required by the U.S. purchaser is \$32,000,000.
- The U.S. Buyer agrees only to buy the shares of the Foreign Corporation that owns the U.S. corporation that owns the U.S. real estate.
  - The sale of shares by the Foreign Investor are not taxable at all to the Foreign Investor. The U.S. buyer will have a cash profit from the \$36,000,000 in loan proceeds of \$4,000,000. The Foreign Investors have benefited \$4,600,000.

# Sale Of Shares Of Foreign Corporation

- Then the U.S. investor immediately elects subchapter S because 5 years from now, that U.S. corporation, as a subchapter S corporation that has been cleansed during the 5-year period from taxation of the gain as a corporate gain taxable at the 40% rate.
- Rather, when the U.S. SubChapter S Corporation sells the property at a gain, it will be at an individual tax rate that is taxed at the 23.8% capital gains rate under Code Section 1371, all “built in ordinary corporate gain” becomes individual “capital gains” after a year period.

# Seller is Non Resident Alien

## STEP 1

### Non Resident Alien is the Seller

### United States

Foreign Corporation

1,000,000. Purchase price after adjustments

45,000,000. Sales Price

44,000,000. Gain

\$17,600,000. U.S. Taxes

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**Cash to Seller**

**\$27,400,000.**

## ALTERNATIVE STEP 1

Non resident alien individual sells stock of foreign corporation to U.S. buyers for \$32,000,000.

# Like-Kind Exchange Transaction

VALUE OF REAL ESTATE HAS INCREASED BY \$50,000,000.

Mortgage balance \$30,000,000.

Original mortgage \$ 32,000,000.

Amortization 2,000,000.

Adjusted Basis 0

## NET RESULT TO U.S. INVESTOR

Cash to Close: \$50,000,000.

United States capital gains taxes: 23.8% \$11,900,000.

Profit to U.S. Investor for sale \$34,000,000.  
(subtract mortgage payment)

U.S. Investor investment 0

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4,100,000.

Add Mortgage profit 4,000,000.

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\$8,100,000.

# The Tax Planning Techniques

## Tax Treaties

- A. Interest
- B. Dividends
- C. Estate Tax Treaties
- D. Branch Tax

# **FIRPTA Withholding Rate To Increase To 15%**

Effective February 16, 2016

FIRPTA general withholding rate increases from 10% to 15% effective for closings on or after **February 16, 2016.**

Closing agents should adjust their procedures and forms to reflect this change.

# **FIRPTA Withholding Rate To Increase To 15%**

The 10% rate will still apply for those transactions in which the property is to be used by the Transferee as a residence, provided the amount realized (generally the sales price) does not exceed \$1,000,000, and the existing \$300,000 “exemption” remains unaffected.

## Here are your new guidelines:

1. If the amount realized (generally the sales price) is \$300,000 or less, and the property will be used by the Transferee as a residence (as provided for in the current regulations), no sums need to be withheld or remitted.
2. If the amount realized exceeds \$300,000 but does not exceed \$1,000,000, and the property will be used by the Transferee as a residence (there are no regulations that specifically address these changes but many as assuming you can follow the current regulations for the \$300,000 exception), then the withholding rate is 10% on the full amount realized.
3. If the amount realized exceeds \$1,000,000, then the withholding rate is 15% on the entire amount, regardless of use by the Transferee.



# FIRPTA Guidelines

- The well-documented flaws and risks of the \$300,000 exemption will likely continue although future regulations could change existing procedures.
- The Transferee's intent to use the property as a residence should be documented as best they can and point out to the Transferee the risks of allowing the exemption to apply to their transaction.
- Under the law, the Transferee is the withholding agent and is responsible for withholding and remitting the proper amount to the I.R.S.
- Taxpayers should also be alert for situations where the foreign Transferor forces the Transferee to claim residence status merely to lower the withholding rate, since the Transferee could be liable for any additional withholding tax, penalty, and interest if their intent is ever challenged by the IRS.

## FIRPTA Guidelines

- The current FAR/BAR contract form contains language specifically referring to a 10% withholding.
- An amendment to the contract for closing scheduled on or after February 16, 2016 should be added to change the potential rate of withholding to 15%.

## **Exception for interest held by foreign retirement and pension funds**

- The provision exempts from the tax rules governing Foreign Investors in U.S. real estate that are qualified foreign pension funds or by a foreign entity wholly-owned by a qualified foreign pension fund.

# **A qualified foreign pension fund means any trust, corporation, or other organization or arrangement**

- (A) which is created or organized under the law of a country other than the United States,
- (B) which is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered,
- (C) which does not have a single participant or beneficiary with a right to more than five percent of its assets or income,
- (D) which is subject to government regulation and provides annual information reporting before its beneficiaries to the relevant tax authorities in the country in which it is established or operates, and
- (E) with respect to which, under the laws of the country in which it is established or operates.



***Increase in rate of withholding of  
tax on dispositions of United States  
real property interests***

***(sec. 324 of the bill and sec. 1445 of the Code)***

## Present Law

A purchaser of a USRPI from any person is obligated to withhold 10% of gross purchase price unless certain exceptions apply.

- The Obligation does not apply if the transferor furnished an affidavit that the transferor is not a foreign person. Even absent such an affidavit, the obligation does not apply to the purchase of publicly traded stock.
- Also, the obligation does not apply to the purchase of stock of a nonpublicly trade domestic corporation, if the corporation furnishes the transferee with an affidavit stating the corporation is not and has not been a USRPHC during the applicable period (unless the transferee has actual knowledge or received a notification that the affidavit is false).

## Explanation of Provision

The provision generally increases the rate of withholding of tax on dispositions and certain distributions of URSPIs, from 10 percent to 15 percent.

There is an exception to this higher rate of withholding (retaining the 10 percent withholding rate is retained so long as the purchase price does not exceed \$1,000,000).

## Persons and property subject to tax

- Foreign persons are generally exempt from U.S. tax on capital gains.
- Under FIRPTA, however, foreign persons are subject to tax on gains from disposition of U.S. real property interests (USRPIs).



## Persons and property subject to tax

- An interest in property is any direct equity interest in the property, such as a fee simple ownership, but does not include interests solely as a creditor. Thus, co-owners of property each hold an interest in the property.

## Persons and property subject to tax

- Real property is land, buildings and land improvements. Generally, whether property is or is not real property is determined under U.S. tax law concepts, not state law.
  - Thus, gas pumps and awnings at gas stations are not real property under U.S. Federal tax law, even though they may be realty under state law.

For FIRPTA purposes, real property also includes unsevered natural products of the land (e.g., oil and gas in place in the ground, uncut timber, unharvested crops) and personal property associated with the use of real property.

## Persons and property subject to tax

- A **United States Real Property Interest (USRPI)** includes shares of a **U.S. Real Property Holding Corporation (USRPHC)**. A USRPHC includes any U.S. corporation if more than 50% of such corporation's assets were USRPIs at any testing date. Disposition of an interest in a USRPHC is subject to the FIRPTA tax and withholding but is not subject to state income tax.
- This may be compared with the disposition of a USRPI owned directly, which is subject to the lower federal capital gains rate but is also subject to the state income tax.

Provisions generally do not apply, and gain must be recognized.

## Amount of Gain

- Under general U.S. tax principles applicable to FIRPTA, gain is equal to the excess of the amount of money or fair market value of property received over the amount of adjusted basis of the property exchanged. Where the amount received is subject to a contingency, the amount is not recognized until the contingency is resolved.

## Tax Imposed

- FIRPTA gain is subject to tax as effectively connected income. Nonresident alien individuals are subject to tax on such income at regular graduated tax rates for U.S. individuals. The deduction for personal exemptions, certain adjustments to gross income, and most itemized deductions are not allowed. Foreign corporations are subject to tax on such income at regular corporate income tax rates.

# Withholding

Buyers of U.S. real property interests are required to withhold 10% of the full sales price on ANY purchase of a USRPI, subject to only four exceptions.

## Withholding is not required:

- By a purchaser for use as a residence for a price \$300,000 or less.
- In a real estate corporate transaction, a myriad of persons may be involved as agents of either the transferor or the transferee. The list includes attorneys, accountants, brokers, transfer agents, settlement personnel, title companies, paralegals, secretaries, appraisers, lenders, and support staff for all such people.
- The regulations narrow the potential universe of agents considerably for purposes of the notice requirements.

# General Rule

For purposes of these reporting rules, an agent of the transferor or transferee is a person who represents either the transferor or the transferee, either in negotiating the transaction with another person or in settling the transaction.

# General Rule

In Section 1445 transactions involving a USRPI distribution by a foreign corporation; or a distribution of property by a domestic corporation, the term further includes:

1. Any person that represents or advises an entity or fiduciary with respect to the planning, arrangement, or consummation by the entity of the transaction; or
2. Any persons that represents or advises the holder of an interest in an entity with respect to the planning, arrangement, or consummation by the entity of the transaction.



# Settlement Officers and Clerical Personnel

Regardless of the above definition, a person is not an agent merely because such person performs one or more of the following activities:

- 1.the receipt and disbursement of any portion of the consideration;
- 2.the recording of a document;
- 3.typing, copying and other clerical tasks;
- 4.obtaining reports concerning title insurance and reports concerning the condition of the real property; or
- 5.transmitting and delivering documents between the parties.

# The “Net Election” General Overview

It is often difficult to determine whether the real estate rental activities of a foreign person are continuous, regular, and substantial enough to constitute the conducts of a U.S. trade or business.

- If the foreign person is not engaged in a U.S. trade or business, it will generally be subject to the flat 30% withholding tax on its rental income.
- However, if the rental activities rise to the level of a U.S. trade or business, the rental income will be taxed as effectively connected income on a net basis at graduated rates. This net basis taxation allows the taxpayer to deduct depreciation, real estate taxes and other expenses related to the real estate business from the gross rent to determine the net income subject to tax.
- In most situations, this method of taxation will result in a lower current tax than the flat 30% tax. By making the “net election”, a foreign person can generally assure itself of a U.S. trade or business status with regard to its U.S. real property activities regardless of whether the rental activities in fact constitute a trade or business under the general rules.

## **Eligibility to make the Election; Income to Which the Election Applies**

A foreign corporation or a nonresident alien individual is eligible to make the election provided:

- The foreign corporation or the nonresident alien individual derives gross income during the taxable year from U.S. real property (or from an interest therein); and
- In the case of a nonresident alien individual, the property is held for the production of income.

## **Eligibility to make the Election; Income to Which the Election Applies**

- A key prerequisite to the making of the election is that the foreign person must derive gross income from U.S. real property (or an interest therein) in the year of the election.
- Once an election has properly been made, it remains in effect (unless revoked) in subsequent years even though there is no income from the real property in any subsequent year. Income from real property for this purpose includes gains from the sale or exchange of the real property, rents or royalties from mines, wells, or other natural deposits and gains.
- It also includes such amounts that are included in the gross income of a foreign person as a beneficiary of an estate or trust if the character of such income in the hands of the recipient is that of income from U.S. real property (or from an interest).

# Exceptions from FIRPTA Withholding

1. You (the transferee) acquire the property for use as a home and the amount realized (generally sales price) is not more than \$300,000.
  - You or a member of your family must have definite plans to reside at the property for at least 50% of the number of days the property is used by any person during each of the first two 12-month periods following the date of transfer.
    - When counting the number of days the property is used, do not count the days the property will be vacant.

## Exceptions from FIRPTA Withholding

2. The property disposed of (other than certain dispositions of nonpublicly traded interests) is an interest in a domestic corporation if any class of stock of the corporation is regularly traded on an established securities market.
  - However, if the class of stock had been held by a foreign person who beneficially owned more than 5% of the fair market value of that class at any time during the previous 5-year period, then that interest in a U.S. real property interest if the corporation qualifies as a United States Real Property Holding Corporation (USRPHC), an you must withhold on any disposition.

## Exceptions from FIRPTA Withholding

3. The disposition is of an interest in a domestic corporation and that corporation furnishes you a certification stating, under penalties of perjury, that the interest is not a U.S. real property interest. Generally, the corporation can make this certification only if the corporation was not a USRPHC during the previous 5 years (or, if shorter, the period the interest was held by its present owner), or as of the date of disposition, the interest in the corporation is not a U.S. real property interest by reason of section 897(c)(1)(B) of the Internal Revenue Code.

- The certification must be dated not more than 30 days before the date of transfer.

## Exceptions from FIRPTA Withholding

4. The transferor give you a certification stating, under penalties of perjury, that the transferor is not a foreign person and containing the transferor's name, U.S. taxpayer identification number, and home address (or office address, in the case of an entity)



## Exceptions from FIRPTA Withholding

5. You receive a withholding certificate form the Internal Revenue Service that excuses withholding. Refer to Withholding Certificates.

## Exceptions from FIRPTA Withholding

6. The transferor gives you written notice that no recognition of any gain or loss on the transfer is required because of a Nonrecognition provision in the Internal Revenue Code or a provision in a U.S. tax treaty.

- You must file a copy of the notice by the 20th day after the date of transfer with the Internal Revenue Service Center, P.O. Box 409101, Ogden, UT 84409

## Exceptions from FIRPTA Withholding

7. The amount the transferor realizes on the transfer of a U.S. real property interest is zero.

8. The grantor realizes an amount on the grant or lapse of an option to acquire a U.S. real property interest. However, you must withhold on the sale, exchange or exercise of that option.

# Exceptions from FIRPTA Withholding

9. The disposition (other than certain dispositions of nonpublicly traded interest) is of publicly traded partnerships or trusts.

- However, if an interest in a publicly traded partnership or trust was owned by a foreign person with a greater than 5% interest at any time during the previous 5 year period, then that interest in a U.S. real property interest if the partnership or trust would otherwise qualify as a USRPHC if it were a corporation, and you must withhold on it.