PART OF THE LEHMAN TAX LAW
KNOWLEDGE BASE SERIES
"United States Taxation Of Investors"

TAX PLANNING

Foreign Investment In United States Real Estate

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Over 38 years of Florida real estate experience with foreign investors that purchase:

- ✓ shopping centers
- ✓ rental apartments
- ✓ rental apartment houses
- ✓ warehouses
- ✓ land acquisitions
- ✓ real estate development deals of all types

Define The Investor

- **Foreign Corporations**
  A Foreign Corporation is any corporation that is not formed in the United States or under the laws of the United States or any state.

- **Non Resident Alien Individual**
  A non U.S. citizen individual who is not a Resident Alien

- **Resident Alien**
  (Resident for U.S. Income Tax Purposes)

TAXATION PATTERN

U.S. **Resident Alien** ("Tax Resident") - Subject to Taxation

1. Income Taxation - Worldwide Income
2. Estate Taxation - Worldwide Assets
3. Gift Taxation - Worldwide Assets

THE FOREIGN INVESTOR

1. Non-Resident Alien
2. Foreign Corporation

Any corporation not organized in the U.S.

STATUS FOR TAX PURPOSES

A. Non-Resident Alien - Not a "Resident Alien"

B. Resident for Income Tax Purposes

1. Green Card
2. Substantial Presence Test
3. Voluntary Election

Exceptions:

4. The Closer Connection
5. Treaties: Tie Breaker

C. Foreign Corporations

Substantial Presence Test

NON RESIDENT ALIEN				RESIDENT ALIEN	
Residency "Days"	Days in US	Year	Formula	Days in US	Residency "Days"
120	120	2010	100%	120	120
40	120	2009	33.33%	150	50
20	120	2008	16.67%	120	20
180	Total			Total	**190**

EXCEPTIONAL CIRCUMSTANCES & SPECIAL BENEFITS

Students

- A foreign student who has obtained the proper immigration status will be **exempt** from being treated as a U.S. resident for U.S. tax purposes even if he or she is here for a substantial time period that would originally result in the student being taxed as a U.S. resident.
- This student visa not only permits the student to study in the United States, but to pay taxes only on income from U.S. sources not worldwide income.
- The visa also permits the student's direct relatives to accompany the student to the United States and receive the same tax benefits.

THE FOREIGN INVESTOR

1. Non-Resident Alien
2. Foreign Corporation

Any corporation not organized in the U.S.

Non Resident Alien
<u>Individual Investor</u> – Subject to Taxation

1. **Income Taxation** - United States source income, limited type of foreign <u>Source</u> income

2. **Estate Tax** - United States <u>Situs</u> assets only (includes real estate)

3. **Gift Tax** - real and tangible personal property with a United States <u>Situs</u>

Branch Tax - Corporations only

THE BRANCH PROFITS TAX

A tax on Foreign Corporations (generally not treaty corporations) that taxes the annual un-invested cash of a foreign corporation that represents earnings and profits.

Foreign Corporation	
Net profit Before U.S. Taxes	$1,000,000
3% City Income Tax	(30,000)
5% State Income Tax	(48,500)
34% Federal Income Tax	(321,500)
30% U.S. Branch Tax	(180,000)
NET PROFITS	**$ 420,000**

(CORPORATE EXAMPLE)

Investing in U.S. Real Estate

Because the way in which Non Resident Aliens of Foreign Corporations passive income is treated by the U.S., the U.S. has had to devise a system to be able to assert its taxation on U.S. source income where they had no jurisdiction to tax the recipient.

Generally, in the case of passive capital gains caused by a Non Resident Alien or Foreign Corporation, there is no taxation. Therefore, there was no need to devise a taxing structure.[1]

1. this is not the case for Foreign Investors that invest in U.S. real estate or Foreign Investors that are not governed by "gains income" tax treaty and have "effectively connected capital gains income".

Practical Advice

1. Excellent time because dollar borrowing is cheap for strong investors. ***There is cheap money if you are strong***.
2. Investment from Russia, China, Brazil, India, Israel, South Korea, Canada investment is strong because people are making money.
3. Investment is strong from Venezuela, Spain, and Latin America in general. These people are some of the people investing in America because they are afraid.
4. England, France, Germany, Netherlands, Belgium, Italy have always been investors in America and now investing in real estate in Europe where the shaky Euro prevails is certainly not the place to be.

Practical Advice

One client leads to another.

If you do the right job as a professional, it works.
If you do not, it does not work.

- Real Estate Attorney
- Tax Attorney
- Accountant
- Real Estate Broker(s)
- Appraisers

Taxation of Real Estate

History

Historical discussion until the mid 80's, N.V. corporations. Real Estate has its own Code Section separate apart from income and gains and losses from other kinds of income.

Basically, U.S. wants to have at least one tax.

- However, if you do not know what you are doing you can pay three taxes.
- If you really know what you are doing and the circumstances are right you can cut the normal tax an American would pay in half.

Potential Taxes

What are the taxes a foreign investor can be subject to?

- Tax planning for foreign investors' real estate requires a look at both the U.S. income tax consequences and U.S. estate and gift tax consequences and in the case of the foreign corporate investor, potential dividend taxes and a United States "branch tax".
- Often it means looking at the taxes in the Investor's home country to avoid double taxation.

Income Tax - Annual Income

There is a U.S. income tax that is applied on annual net income which starts at 15% and can be as high as 35% for both corporations and individuals.

There is a tax on capital gains from the sale of assets which is only 15% to an individual taxpayer, but may be as high as 35% to a corporate taxpayer.

- Please note: For individual tax payers over $400,000 capital gains rate is now 20% and ordinary income is now 39.6%

U.S. Situs Assets

- Any tangible and intangible property located in the United States at death
- Real estate located in the United States
- Generally shares of stock owned in United States corporations
- Generally partnership interests in U.S. assets
- Generally debt obligations of United States persons, states and governmental authorities

  ** debt exceptions - do not include:*

  - bank deposits
  - life insurance proceeds
  - portfolio debt

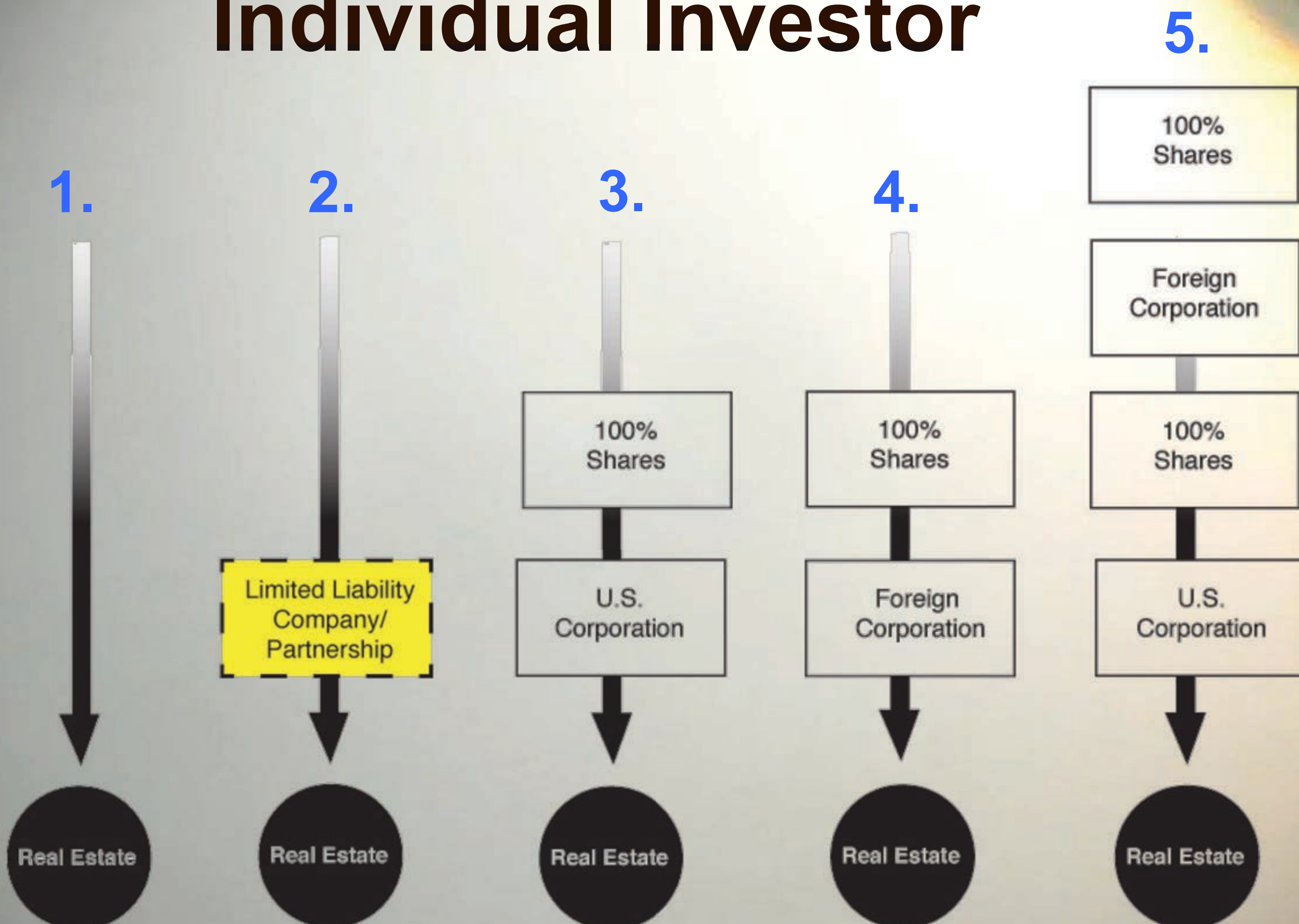
The Individual Foreign Investor – The Problem of the Estate Tax

– As general rule, the individual foreign investor that invest in United States real estate in equity amounts of $1,000,000 or more is going to be forced to use a corporation formed outside of the United States (Foreign Corporations) somewhere in their investment structure if they are going to avoid the U.S. estate tax.

There are many exceptions to this general rule but it is still the general rule.

– The United States Estate tax is so onerous that the individual Foreign Investor will generally not want to assume the risk of his or her estate having to pay the United States a large tax on the death of the individual foreign owner.

Non-Resident Alien Individual Investor



Individual Ownership Entities

Entity	Advantage	Disadvantage
Individual Ownership	• Graduated Individual Income	✓ Estate Tax Applies
	• Tax only on U.S. source income	✓ Gift Tax Applies
	• Capital Gains Tax Rates @ 15%	✓ Unlimited Personal Liability
	• No Branch Tax Concern	✓ Disclosure of Ownership (Real Estate Records)

Limited Liability Company Entities

Entity	Advantage	Disadvantage
Limited Liability Co.	• Graduated Individual Income	✓ Estate Tax Applies
	• Tax only on U.S. source income	✓ Gift Tax Applies to Transfer of Interest
	• Capital Gains Tax Rate at 15%	
	• No Branch Tax	
	• Limited Personal Liability	
	• No Disclosure of Ownership	

Partnership Entities

Entity	Advantage	Disadvantage
Partnership	• Graduated Individual Income • Tax only on U.S. source income • Capital Gains Tax Rate at 15% • Limited Personal Liability • No Branch Tax • No Disclosure of Ownership	✓ Estate Tax Applies ✓ Gift Tax Applies To Transfer of Interest

U.S. Corporation Entities

Entity	Advantage	Disadvantage
U.S. Corporation	• Graduated Corporate Tax Rates • No Branch Tax • No Gift Tax on Transfer of Shares • Limited Personal Liability • No Disclosure of Ownership • Inexpensive Separate Tax Entity	✓ Capital Gains Taxed as Ordinary Income ✓ Dividend and/or Interest Tax (Double Tax) ✓ Estate Tax

Foreign Corporation Entities

- Not w/Treaty Country

Entity	Advantage	Disadvantage
Foreign Corporation (Not w/Tax Treaty Country)	• Graduated Corporate Rates • No Estate Tax on Death • No Gift Tax on Transfer of Shares	✓ Capital Gains ✓ Taxed as Ordinary Income ✓ Dividend/Interest Tax (Double Tax) ✓ Branch Tax ✓ Expensive Separate Tax Entity

Tiered Entities

Entity	Advantage	Disadvantage
Tiered Corporate Entities	• Graduated Corporate Tax Rates • No Estate Tax • Flexibility for Income Tax Planning • No Gift Tax on Transfer of Shares • No Branch Tax • No Disclosure of Interests	✓ Expensive Separate Entity ✓ Capital Gains Taxed as Ordinary Income ✓ Dividend/Interest Tax (Double Tax)

Non Grantor Trust Entities

Entity	Advantage	Disadvantage
Non Grantor Trust	• No Estate Tax • Income Tax Rate at Individual Personal Rates • Capital Gains Tax - 15% • No Branch Tax • No Personal Liability	✓ Give Up Ownership And Control of Asset

Real Estate Tax Planning Tools

1) Liquidation of corporation after sale
2) The portfolio loan
3) Like kind exchanges
4) Sale of stock in foreign corporation

Corporate Liquidation

Step 2 on chart below reflects the tax effects of liquidation. Step 3 reflects the tax effects of continuing the company's business.

Purchase Price and Basis =\$1,000,000
Sales Price =\$2,000,000
Taxable Gain = \$1,000,000

STEP 1	STEP 2	STEP 3
Foreign Investor	\$1,680,000 Cash to Shareholder	\$1,472,000 Cash to Shareholder
Corporate Entity U.S. or Foreign		Corporate Entity
Real Estate	Cash net of Taxes \$1,680,000 \$1,000,000 Investment - 320,000 Corporate Tax ________ \$1,680,000	Cash net of Taxes \$1,680,000 \$1,000,000 Investment - 320,000 Corporate Tax ***plus*** - 194,000 Dividend Tax ________ \$1,472,000

Another often used tax planning tool is known as the "Portfolio Loan"

– As a general rule a Foreign Corporation or a U.S. Corporation that owns U.S. real estate will be able to deduct as a business deduction all of the expenses of that ownership, which include the payment of interest on loans made to acquire the real estate.

– As a general rule, loans made by a Foreign Investor to his or her own Foreign Company, U.S. Company or Limited Liability Company will be deductible by the company.

Portfolio Loans

There is, however a major exception to this general rule provided in the Internal Revenue Code.

That is that a Foreign Investor who owns less than 10% of the real estate investment will be able to receive the interest that is deductible by the Foreign Company free of any U.S. tax whatsoever.

1. This rule does not work in the event the investor owns 10% or more of the real estate investment or the entity that owns that real estate investment.
2. This less than 10% requirement includes interest in the deal owned by certain relatives or related companies of the Taxpayer

Like Kind Exchanges

- Another method used by both Foreigners and American alike to grow their U.S. real estate portfolios free of U.S. tax is to make use of the "Like Kind Exchange Rules".
  - Essentially these rules hold that an investor in U.S. real estate may exchange the U.S. real estate project that they own for a different U.S. real estate project without paying any immediate tax on any gain or profit that may be accrued in the first investment.

Seller is Non Resident Alien

STEP 1.	**Non Resident Alien is the Seller**	**United States**
	Foreign Corporation	
	$10,000,000 Purchase Price and Adjustments	
	$20,000,000 Sales Price	
	$10,000,000 Gain	$3,350,000 U.S. Taxes
	Cash to Seller	**$16,650,000**

ALTERNATIVE STEP 1.
Non resident Alien individual sells stock of foreign corporation to U.S. buyer for **[$18,000,000]**

United States Buyer

STEP 2. **U.S. Buyer**

Acquires $20,000,000 Replacement Property with Corporations

$10,000,000 Cash Purchase Price

Borrows $18. Million for payment to Foreign Seller

• Cash	$ 2,000,000
• Mortgage	$18,000,000

United States

Conversion of Foreign Corporation To SubChapter S

Like Kind Exchange with Pre-Arranged Property - No Tax Paid

TEN YEARS LATER

STEP 3. **10 years Later**

Buyer Sells the property $20,000,000
Replacement Property for $25,000,000

Simplicity Assume Interest only
Mortgage for 10 years

Taxes paid equal
purchase price ($25,000,000)
minus original basis ($10,000,000)
multiplied by 15%

United States

SubChapter S
Corporate Seller

Sales Price	$25,000,000.
1st Mortgage	$18,000,000.
Net Cash	$ 7,000,000.
Taxable @	15%
Taxes paid	$2,250,000.
Net to Buyer	$ 4,750,000.
Investment by Buyer	$ - 0 -
Profit due Buyer	[$ 4,750,000.]

United States Taxation of Foreign Investors

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