Foreign Investment in U.S. Real Property: Tax and Reporting Challenges
Anticipating Tax Issues When a Foreign Investor or Entity Acquires or Disposes of Interests

TUESDAY, JULY 21, 2015, 1:00-2:50 pm Eastern

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Foreign Investment in U.S. Real Property: Tax and Reporting Challenges

Anticipating Tax Issues When a Foreign Investor or Entity Acquires or Disposes of Interests

July 21, 2015
General Issues to Consider for Inbound Real Estate Investment

• Choice of Investment Entity
• Confidentiality, Reporting Obligations and Disclosures
• Withholding on Rent, Interest & Dividends
• FIRPTA Withholding Upon Sale
• Portfolio Interest Exemption
• Branch Profits Tax
• Earnings Stripping Limitations
• Estate and Gift Tax Consequences
Principal Topics

• Basic income tax rules
  – Capital gains
  – Operating income
  – Interest and dividends

• Withholding
  – FIRPTA
  – Rent, interest and dividends
  – Partnership withholding

• Estate and gift taxes

• Structuring
  – Foreign business entities
  – U.S. business entities
  – Trusts
Basic Income Tax Rules
Tax Residency

• Income Tax Purposes: Objective Test
  – U.S. Taxpayer:
    • Citizenship
    • “Lawful Permanent Resident” (Green Card holder) (Regardless of U.S. Presence)
    • Substantial Presence Test
      – Non-U.S. individual is considered a U.S. tax resident if present in the U.S. for:
        » 31 days or more during current calendar year, and
        » 183 or more, taking into account all days in the U.S. during the current year, 1/3 of all days in the U.S. during first preceding year and 1/6 of all days in the U.S. during second preceding year
Tax Residency

• Exceptions to Substantial Presence Test
  – If in the U.S. less than 183 days during current year and either:
    • (i) have “tax home” (regular or principal place of business or regular place of abode) and “closer connection” (maintain more significant contacts with the other country than the U.S., as determined by taking into account various facts and circumstances) with another country for entire current year or
    • (ii) maintain a “tax home” on first day of current year in one country, change tax home to second country for remainder of year and have “closer connection” to the other country than to the U.S. and are subject to tax as resident of either country for entire year or of both countries for a period during which tax home is maintained there.
Tax Residency

• **Exceptions to Substantial Presence Test**
  – Special rules apply on timing of residency in beginning and ending years
  – Exempt Individuals
  – Tax treaties can impact U.S. statutory rules on tax residency.
    - If individual is a U.S. resident and also a resident of a treaty partner country under its law, “tie breaker” rules apply to classify the individual as a resident of one or the other of the jurisdictions. These rules look to various, alternatives, sets of factors.
    - Must affirmatively claim treaty benefits.

• **Consequences:**
  – Worldwide Income Taxation
  – Informational Reporting Requirements
Basic Income Tax Rules – Gains

• Foreign Investment in Real Property Tax Act of 1980 (FIRPTA)
  – § 897
  – Gain from sale or exchange of “United States real property interest” (“USRPI”) taxed as if foreign seller were engaged in the conduct of a trade or business in the United States and the gain were effectively connected with such trade or business
  – Therefore, foreign sellers are taxed on gains at the same rates applicable to U.S. sellers – gain can qualify for long-term capital gains treatment in the hands of a foreign seller
  – Non-recognition provisions do not apply unless in the exchange the seller receives property that would itself be taxable in sale or exchange
Basic Income Tax Rules – Gains

• 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 next slide) at any time during the 5-year period preceding sale
U.S. Real Property Holding Corporation

- Basic definition (§ 897(c)(2)):
  - Fair market value 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; in the case of
  corporations, more than 50% control requirement
- USRPI does not include interest in corporation that has sold all of its
  USRPIs in taxable transactions
- Interest in regularly trade class of stock is a USRPI only if taxpayer
  owned 5% or more of class
Basic Income Tax Rules – Operating Income

• If income is effectively connected with a U.S. trade or business, tax is imposed on foreign taxpayer at regular U.S. rates (individual or corporate)
• Foreign taxpayers may elect to treat real estate income as effectively connected (e.g., income from triple net leased property) – § 871(d)
• Tax base is the gross income net of allocable deductions, including operating costs, management fees and interest expense
• Normal expense limitation rules apply, e.g., at-risk, passive activity loss rules, capitalization of expenses, earnings stripping, AHYDO, etc.
Basic Income Tax Rules – Interest and Dividends

- **Interest**
  - U.S. source interest paid to a foreign person, taxed at 30% of gross
  - Numerous exceptions if interest is not ECI
    - Short-term OID
    - Bank interest
    - Portfolio interest exemption (exceptions where loan made by foreign bank, “10-percent shareholder” or “10-percent partner”; also not applicable if interest is contingent)
    - Many treaties eliminate or reduce rate of tax

- **Dividends**
  - Dividend paid by U.S. corporation to foreign person, taxed at 30% of gross
  - Treaties typically reduce rate to 5% or 15%
Taxation of Foreign Corporations

• If foreign corporation is engaged in a U.S. trade or business, including through ownership or sale of U.S. real property, taxed at regular U.S. corporate rates (34% or 35%)

• In addition, subject to branch level taxes (§ 884). Branch taxes intended to treat U.S. trade or business as if it were a separate U.S. corporation:
  – Dividend tax rate x “dividend equivalent amount”
  – Interest tax rate x interest allocated to U.S. branch
  – Treaties often reduce or even eliminate branch taxes

• Dividend equivalent does not apply to liquidation proceeds, if formalities met
Withholding
Withholding – FIRPTA (§ 1445)

• 10% of gross amount realized from sale of USRPI (some states also require withholding on sale by nonresident)

• Exemptions:
  – Non-foreign affidavit
  – Non-USRPHC affidavit
  – Excess withholding can be avoided based on maximum tax - see IRS Form 8288-B and Rev. Proc. 2000-35
  – Sales price <$300,000 on property that will be transferee’s residence (amount not indexed for inflation in >30 years)
  – Regularly traded stock
  – Situations where withholding required under partnership withholding rules (§ 1446)
Withholding – Rent, Interest, Dividends
(§ 1441)

• Payor must withhold 30% of gross amount of U.S. source “fixed or determinable annual or periodic” income paid to foreign person
• Applies to rent, interest, dividends and services income (except income subject to wage withholding)
• Treaties can reduce or exempt payments from withholding, if foreign person certifies its entitlement to treaty benefits (typically on Form W-8BEN/W8-BEN-E)
• See slide on interactions with §1445 regarding corporate distributions
Withholding – Partnerships (§ 1446)

• A partnership must withhold on its foreign partner’s “effective connected taxable income” (ECTI)
• Rate is highest rate under § 1 or § 11
  – Long-term capital gains rate can apply to individual partner
• Estimated tax payments are due on 15th day of the 4th, 6th, 9th & 12th (sic) months of partnership’s tax year; true up on 15th day of 4th month of next year
• Publicly traded partnerships (Treas. Reg. §1.1446-4)
  – Withholding based on distributions not income allocations
  – Preferential rates may not be used
  – Rules not extended to other types of large partnerships
• Over-withholding is pervasive problem
Withholding - Interactions

- Section 1445/1446
  - Domestic partnership – § 1446 trumps § 1445
  - Foreign partnership – § 1445 amount withheld allocable to foreign partner treated as satisfying § 1446 withholding requirement with respect to such partner

- Section 1441/1446 – generally no overlap
  - Exception: US-source independent personal services - § 1441 trumps 1446. Treas. Reg. § 1.1446-3(c)

- Section 1441/1445 – corporation has choice
  - Withhold under §1441 and not under § 1445
  - Withhold under §1441 on portion estimated to be dividend and § 1445 on remainder of distribution
Withholding – FATCA (§§ 1471-1474)

- Foreign Accounts Tax Compliance Act (FATCA) can require withholding on payments of U.S. source income to foreign financial institutions and non-financial foreign entities
- Note that FATCA withholding can apply to proceeds of sale of USRPI consisting of stock in USRPHC
Estate and Gift Taxes
Residence for Estate and Gift Tax Purposes

- A U.S. resident for transfer-tax purposes is a person who is "domiciled" in the U.S. at the time of death or at the time of the gift – subjective test
  - A person acquires domicile in a place by living there, for even a brief period of time, with no definite present intention to leave

- An individual can be a resident for income-tax purposes and not for transfer-tax purposes, and vice-versa
  - There is no "perfect" holding structure for real estate, but it’s even more challenging for a client who is income-tax resident and transfer-tax nonresident
Estate Tax

• The decedent’s estate is responsible for paying the 40% tax
• $5,000,000 lifetime exemption indexed for inflation, less Gift Tax exemption used (currently $5,430,000)
• Basis step-up for property held by decedent at death
• Unlimited Marital Deduction is used to exempt property from the Estate Tax until the surviving spouse’s death
Estate Tax

- Nonresident aliens are subject to estate tax on property situated in the United States.
  - U.S. real property
  - Tangible personal property located in the U.S.
  - Debt obligations of U.S. persons, unless portfolio exemption applies
  - Stock in U.S. corporations (whether or not publicly traded)
  - Uncertain treatment of foreign partnership interests
    - No bright line rule
      - Some authorities use “aggregate” approach, and some use the “entity” approach
    - Uncertainty on this issue should lead to conservative planning
Estate Tax

• Trusts
  – Revocable trusts or trusts in which the decedent retained an interest under which a transferred asset could be “clawed back” under Code Sections 2033 through 2038
    • Look to situs of assets
    • Ensure that only foreign assets are transferred to the trust
      – If the nonresident alien transfers a U.S. asset to the trust, and then the trust later sells the U.S. asset and buys a foreign asset, there will be estate inclusion (Code Section 2104)
  – Irrevocable trusts
    • Structure like a typical completed-gift trust to ensure no estate inclusion
Estate Tax

• Limited to $60,000 estate-tax exemption ($13,000 tax credit)

• Unlimited marital deduction if assets left to a spouse who is a U.S. citizen
  – Qualified Domestic Trust ("QDOT") must be used to obtain the marital deduction from the estate tax if surviving spouse is a non-citizen

• Charitable deduction and deduction for estate administration expenses
  – Ratio of U.S. assets to worldwide assets

• Nonrecourse debt on U.S. property results in only net value included in U.S. estate
Gift Tax

• The donor is taxed on gratuitous transfers at a 40% rate
• $5,000,000 lifetime exemption equivalent, indexed for inflation (currently $5,430,000)
• $10,000 annual exclusion, indexed for inflation (currently $14,000)
• $147,000 Annual Exclusion for gifts to non-citizen spouses
• Unlimited Exclusions for educational and medical payments
• Donees take a carryover basis in transferred property
Gift Tax

• Nonresident aliens are taxed only on gifts of:
  – U.S.-sitused tangible property
  – U.S.-sitused real estate

• Gifts of U.S. stock are not subject to tax

• Gifts of partnership interests may not be subject to tax, but this result is less certain
  – Uncertainty should lead to conservative planning
Gift Tax

- Annual exclusion is available to nonresident aliens. In 2015, annual exclusion amounts are:
  - $14,000 for gifts to non-spouses
  - $147,000 Annual Exclusion for gifts to non-citizen spouses
    - QDOT not available for *inter vivos* gifts (only at death)

- No unified credit; all gifts above annual exclusion to non-spouses or to non-citizen spouses are taxable

- Unlimited marital deduction for gifts to citizen spouses
Generation-Skipping Transfer Tax

- 40% tax imposed on a transferee who is two or more generations below the generation of the transferor
- Serves as the backstop to Gift and Estate Taxes
- $5,000,000 lifetime exemption, indexed for inflation (currently $5,430,000)
Generation-Skipping Transfer Tax

- Transfers subject to GST tax only if subject to either Estate Tax or Gift Tax.
Covered Expatriates: New “Inheritance Tax”

- **Gifts** or **bequests** from “covered expatriates” to a U.S. citizen or resident (including a domestic trust) are subject to an inheritance-type tax instead of a transfer tax
  - Meaning that the tax is **payable by the U.S. recipient**
  - Covered **gifts** taxed only to the extent exceed annual exclusion

- Covered gift/bequest to foreign trust taxed only when distribution attributable to the gift/bequest made to U.S. beneficiary

- Exception for transfers that are otherwise subject to U.S. transfer tax and reported on a gift- or estate-tax return

- Tax is reduced by foreign gift tax or estate tax
Before Planning Begins

• Understand investor characteristics - type, location

• Ascertain investment characteristics and objectives:
  – Use: personal, business, investment
  – Types of income generated from real estate: rent, interest, dividends, capital gains, service, 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

• Withholding and compliance

• Estate and gift taxes
Home Country Taxation

• No planning should be undertaken before considering whether home country taxation is relevant
  – Typical planning vehicles for U.S. persons can be disastrous to a nonresident alien (for example a revocable trust established by a U.K. resident will trigger immediate IHT)

• U.S. taxation of foreign investors may be modified by treaty
Treaty Analysis

- Treaties typically allocate the jurisdiction where the real property the primary taxing right in relation to real property.

- Treaties typically allow local law to determine the meaning of real property.

- Treaties may limit taxing rights with respect to income not related to the use of the real property, e.g., interest, royalties, fees.
Treaty Analysis

• Is the client considered a resident of their home country?

• Reporting obligations to claim treaty benefits

• Limitation on benefits article

• New FATCA regime
Income Treaties & Estate and Gift Tax Treaties

• The U.S. is party to more than 50 income tax treaties, but only 16 estate and gift tax treaties (because many countries do not have an estate, inheritance, or gift tax)

• Below are the countries with which the U.S. is party to estate and gift tax treaties:
  – Australia  – Finland  – Ireland  – South Africa
  – Austria  – France  – Italy  – Switzerland
  – Canada  – Germany  – Japan  – United Kingdom
  – Denmark  – Greece  – Netherlands
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

Pass-through entity: capital gains preference; no double taxation

Corporate rates; double taxation

There is no perfect solution

Personal tax compliance/estate tax risk

Corporate structure: No personal tax filings or estate tax
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

FOREIGN CORPORATION

U.S. CORPORATION

U.S. REAL ESTATE
Maximum Use of Investment Entity

TIERED ENTITY

- Personal Liability: NO
- Personal Disclosure: NO (Tax Returns)
- U.S. Estate Gift Tax: NO (Value in excess of $60,000)
- 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

**FOREIGN INVESTOR**

**CORPORATE ENTITY**

**REAL ESTATE**

**FOREIGN INVESTOR**

**TAX FREE LIQUIDATION**

**REAL ESTATE**

**LIQUIDATION**

$1,000,000 \times 34\%$

NET PROCEEDS $1,660,000$

**FOREIGN INVESTOR**

**DIVIDEND DISTRIBUTION**

**CORPORATE INVESTOR**

**REAL ESTATE**

**DIVIDEND DISTRIBUTION**

$1,000,000 \times 34\%$

NET PROCEEDS $1,660,000$

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<th>PURCHASE PRICE</th>
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<th>DIVIDEND $660,000.</th>
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<tr>
<td>SALES PRICE</td>
<td>$2,000,000</td>
<td>x 30% TAX</td>
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<tr>
<td>TAXABLE GAIN</td>
<td>$1,000,000</td>
<td>$198,000.</td>
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**TOTAL**

$1,660,000$

NET PROCEEDS

**TOTAL**

$1,462,000$

NET PROCEEDS
Non Resident Investor

FOREIGN CORPORATION

U.S. CORPORATION

NET U.S. TAXABLE INCOME 0 (ZERO)

U.S. CORPORATION

U.S. CORPORATION

-$200,000 LOSS

$200,000 GAIN

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NON-RESIDENT INVESTOR

FOREIGN CORPORATION

U.S. CORPORATION

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<tr>
<th>U.S. Property</th>
<th>Value</th>
<th>Cost</th>
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<td>No. 3</td>
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NON-RESIDENT INVESTOR

FOREIGN CORPORATION

U.S. CORPORATION

<table>
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<th>U.S. Property No.2</th>
<th>U.S. Property No.3</th>
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</tr>
<tr>
<td>GAIN: $20,000</td>
<td>GAIN: $0</td>
<td>GAIN: $10,000</td>
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</table>

Total Taxable GAIN: $30,000
NON-RESIDENT INVESTOR

FOREIGN CORPORATION

No. 1 U.S. Corporation

No. 2 U.S. Corporation

No. 3 U.S. Corporation

Liquidation of No.1 U.S. Corporation

Total Taxable GAIN

$20,000
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

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

5 YR DEPRECIATION FACTOR (4% X $1.6 MILLION) $64,000 PER YEAR
NET RETURN ON CASH INVESTMENT (10%) $200,000.

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

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

100% SHARE OWNERSHIP

FOREIGN CORPORATION

30% INTEREST PAYMENTS

U.S. CORPORATION

OPERATING INCOME

REAL ESTATE

TAXES 35% PROFITS
TAXES 30% INTEREST

NON-RESIDENT ALIEN INDIVIDUAL

100% SHARE OWNERSHIP

FOREIGN CORPORATION

TAXES 30% DIVIDENDS

U.S. CORPORATION

OPERATING INCOME

REAL ESTATE

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.)

Taxable Income = $96,000.

Corporate Tax Assumed 40% $38,400.
Add back tax on interest paid (30%) $12,000.

TOTAL TAX .................................................. = $50,400.

EXAMPLE 2

Gross Income $200,000.
Depreciation $64,000.

Taxable Income = $136,000.

Corporate Tax (40%) $54,400.
PLUS Tax on Dividends Distributed (30%) $12,000.

TOTAL TAX .................................................. = $66,400.
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

Like Kind Exchange

• 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.
THE INTERMEDIARY RECEIVES CASH, PROPERTY #1 AND PROPERTY #2 THEN DISTRIBUTES TO RIGHTFUL OWNERS.
FOREIGN INVESTOR ENTITY

CONTRIBUTES
REAL ESTATE

RECEIVES PROPERTY “B”

PROPERTY "A"

FOREIGN INVESTOR OWNS PROPER
TY “B”
BUYER OF PROPERTY “A” 
OWNS PROPERTY

BEFORE

BUYER OF PROPER
TY “A”

CONTRIBUTES PROPERTY B

REAL ESTATE

CONTRIBUTES

EXCHANGE FACILITATOR (INTERMEDIARY)

RECEIVES PROPER
TY “A”
PAY $ 

RECEIVES PROPERTY “B”

SELLER
PROPERTY B

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
• **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 continent 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.
This presentation contains general information only and the presenters are not, by means of this presentation, rendering legal, tax, accounting, business, financial, investment, or other professional advice or services. This presentation is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Neither the presenters nor the firms with which they are affiliated shall be responsible for any loss sustained by any person who relies on this presentation.
Ryan Dudley, Partner and practice leader of the International Tax Services group at Friedman LLP, specializes in developing cross border commercial structures and financing strategies to optimize international operations and transactions. With 20 years of public accounting and investment advisory experience, Ryan’s clients have ranged from Fortune 50 multi-national corporations, to private equity and hedge funds, through to small businesses and start-ups. He has advised clients in industries as diverse as banking and finance, technology, real estate, infrastructure, manufacturing and pharmaceuticals.

Ryan's experience includes:

- Advising on the U.S. tax implications of inbound and outbound transactions
- Planning for inbound and outbound acquisitions, dispositions and reorganizations
- Developing offshore holding, financing and operating structures
- Structuring corporate and partnership arrangements
- Managing intellectual property used in international businesses
- Creating financial instruments and structures
- Tax treaty analysis
- Dealing with various compliance and filing obligations

**Affiliations**

- American Institute of Certified Public Accountants (CPA)
- New York State Society of Certified Public Accountants
- NYSSCPA International Tax Committee member
- Institute of Chartered Accountants of Australia (Chartered Accountant - CA)
- Taxation Institute of Australia (Chartered Tax Advisor - CTA)
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**Education**

Ryan received a Bachelor of Commerce in Accounting & Finance and Legal Studies from the University of New South Wales and a Masters of International Tax from Regent University. He completed the Institute of Chartered Accountants of Australia’s Professional Year Program in Taxation and has qualified under FINRA’s General Securities Representatives Exams (Series 7 & 63).
John Strohmeyer is an associate in the trusts, probate and estate planning section of Porter Hedges. His practice focuses on traditional estate and disability planning, the facilitation of the probate of wills, and the preparation of estate and gift tax returns. Mr. Strohmeyer also has experience in the design, implementation, and administration of foreign trust and related business and investment structures, including taxation and compliance aspects of such structures.

Mr. Strohmeyer's practice involves creating and implementing estate plans for individuals including drafting wills and trust agreements, revocable management trusts, irrevocable gifting trusts, grantor trusts, and supplemental-needs trusts. In addition, he drafts operating agreements for single-member and multi-member entities. Mr. Strohmeyer represents clients in all phases of probate and heirship administrations.

Mr. Strohmeyer was selected for inclusion in Texas Rising Stars for Estate & Probate in 2015. Before joining the firm, Mr. Strohmeyer practiced with a boutique firm in Austin, Texas. His practice focused on estate administration, estate and transfer-tax planning for high-net-worth individuals, ensuring U.S. taxpayers’ compliance with foreign-asset reporting requirements administered by the IRS, and designing, implementing, and administering outbound and inbound foreign trust and entity structures for multi-jurisdictional clients.
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.

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.