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CONSIDERATIONS FOR FOREIGN INVESTORS OF U.S. PROPERTY

Foreign nationals can freely buy U.S. real estate for their own personal use as a residence, either in their own names or through corporations or other entities, without having to report to any government agency. Things get more complicated, however, when foreign nationals or entities go to sell U.S. real estate or co-op assets.

The purchase of U.S. assets by foreign investors warrants estate planning in advance of the intended acquisition.

- Foreign investors do not have the benefit of U.S. estate tax exclusions, which is $3,500,000 for 2009.
- U.S. estate taxes are based on the value of the property at death not the gain in value from the acquisition date.

Absent estate planning, a foreign investor's estate can owe up to 46% of the value of the property in Federal tax upon his or her death. State and local tax obligations can increase the tax obligation to over 50% of the value of the property.

Foreign investors can structure their acquisitions through off-shore entities to avoid U.S. estate and gift taxes. Income tax on the rental income or gain from a sale can also be avoided, depending on the country of residence, by proper planning.

Foreign investors can establish a holding corporation that is outside the U.S. either (i) in the country of residency or (ii) in a country with favorable tax rules such as Bermuda or the Bahamas. The holding company then establishes a U.S. subsidiary which then acquires and holds the U.S. asset. The foreign investor then owns stock in the foreign holding corporation. Upon death of the foreign investor, there are no estate taxes due as the transfer of shares of a foreign corporation are not subject to U.S. estate taxes.

There are two forms of apartment ownership in New York City, co-operative and condominium. Co-op apartments require board approval. Such boards are generally very unreceptive to holding corporations purchasing into the co-op association. Condos are therefore better suited to foreign investors.

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RENTALS, THE NON-RESIDENT ALIEN OWNER, & U.S. TAXES

Non-resident alien (NRA) rental property owners need to be aware of the US tax laws concerning reporting rental activity.

1. *Each* owner is required to file a US income tax return *each* year to report their share of rental income, whether it nets to a profit or a loss. There is no statute of limitation for unfilled tax returns. There are two allowable options to reporting:

A. Report only the GROSS rental income and pay a 30% tax on it. No operating expense deductions are allowed. This is very simple, and the default. The IRS can impose it on unfiled, missed, years.

B. Elect, by filing for the FIRST year of the rental activity to claim expenses and depreciation against the gross income. Tax is due on only the NET INCOME – at the graduated tax rate. If there is a loss for any year, the "passive loss" is carried forward to another year, to either offset subsequent income, or taxable gain, income, from a sale of the property.

While Option "B", appears to be a rather easy decision, many NRA landlords seem to ignore U.S. filing until forced to file, usually when they sell or exchange the property.

Worse yet, miss the filing deadline and the IRS is *allowed* to DENY the Option B election to offset income with expenses.

2. For any year with taxable net income, there will be assessment of late-filing and late-paying penalties, and interest, compounded daily. Under Option A, these additions will be substantial.

3. DEPRECIATION IS MANDATORY in the US. Use it or lose it! When the rental property is sold, the "tax basis", (original cost with some additions) of the property will be reduced for the depreciation that should have been taken. There is an allowable "catch-up" but it is complicated. If expenses and depreciation in any year create a loss, then normally the losses, categorized as "passive", can be carried forward to offset future passive income, or the profit on a sale. Normally only buildings and land improvements are depreciable. Note that when sold there will be a recapture ("claw-back") of the depreciation allowed.

The requirement to file has been around for a long time. However since third party (sales escrow) reporting became mandatory a few years ago, the IRS can more easily enforce the law. A US Tax Court case, Espinosa v. Commissioner, 107 T.C. No. 9 (9/24/96) is a good illustration. The NRA owner did not file timely returns as requested by the IRS; subsequently the IRS calculated the taxes based on the gross rents, Option A. The NRA taxpayer later prepared "Option B" tax returns and challenged the IRS on grounds of fairness. He lost, all operating deductions were denied. Therefore gross rent was taxed at 30%, plus penalties and interest. Espinosa was simply foolish, however that case gave the IRS a court determination on which to base future actions. It is my experience that you can voluntarily file past returns with little or no problem.

This is simplified and general information presented to alert you to a potential problem. Consult with a competent U.S. tax advisor or tax attorney.

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CONSIDERATIONS FOR FOREIGN INVESTORS SELLING REAL ESTATE ASSETS

Foreign nationals should be aware of crucial tax issues and suitability concerns associated with residential real estate. This memo highlights such concerns and issues.

Taxes – Upon Sale

The Foreign Investor Real Property Transfer Act (FIRPTA) requires a withholding of 10% of the sales price, regardless of the amount of the profit from the transaction.

FIRPTA applies to individuals as well foreign corporations and partnerships. It applies to the transfer of all U.S. real property interests, both residential and investment, including the sale of cooperative apartments.

The required payment of ten percent is a deposit on any tax liability owed by the property owner. The payment is not lost; it is merely a deposit on the tax owed. If too much was withheld, the seller can wait until the end of the calendar year and file for a refund of the overpayment.

An exemption from the full withholding tax (ten percent of the sales price) is available if the seller's true tax can be proven to be less than the withholding amount. This requires IRS approval prior to the closing of the transaction. The appropriate forms can be completed by the seller's attorney or his or her accountant. Within 90 days of request, the IRS is required to determine if a smaller withholding amount is appropriate.

NYS – Non Resident Capital Gains

At closing, non-resident sellers are required to file estimated income taxes of 6.85% on capital gains to NYS under forms IT-2664 or IT-2663.