Foreign investment involving U.S. real property.

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Abstract- The Foreign Investment in US Real Property Tax Act of 1980 (FIRPTA) and the tax Reform Act of 1986 closed tax loopholes available to foreign investors. The laws also changed the tax climate and structure of foreign real estate investment. FIRPTA effectively makes ownership of US real estate a trade or business. The law requires recognition of gains or losses as if they were connected with a trade or business, and requires US taxation in the year of disposition. The ideal tax planning strategy is to structure real estate holdings producing income and cash flow as a foreign treaty country corporate owner of a heavily indebted US subsidiary to avoid or reduce US withholding taxes. To withstand an IRS challenge, the investor should: establish a valid business purpose for using the host country; ensure profit to the host country corporation; and respect local tax and disclosure rules.

* The branch Profits Tax. The combination of this tax and the regular corporate income tax can subject the U.S. business profits of a foreign corporation to a tax of approximately 54%.

* Lower Tax Rates. Changes have resulted in the reduction of the individual income tax rate to 28% and the corporate tax rate to 34%. This creates an environment where it is more economical, from a tax standpoint, for the foreign investor to operate under a sturcture where U.S. profits are subject to tax at the individual level.

* Repeal of the General Utilities Doctrine. This doctrine previously allowed for the liquidation of a corporate entity at little or no corporate level tax. With the repeal, the cost of operating in corporate form has increased.

* Higher Estate Tax Rates. The estate tax rates on U.S. situs assets of nonresident aliens has nearly doubled. Thus, the avoidance of U.S. estate taxes has taken on even greater importance

Before examining the effects of these changes on foreign investment in U.S. real property, the goals and motivations of the typical foreign investor should be analyzed.

Goals of the Foreign Investor

The prospect of significant economic gain is perhaps the strongest lure of the foreign investor to U.S. real property. Historically, U.S. real property has been recognized as a strong investment, which has demonstrated steady appreciation without the fluctuations that are characteristic of the financial markets. The political and economic stability of the U.S., the absence of threat of government appropriation or nationalization, and the soundness of the currency system have no doubt lured investors. Satisfied with the safety and security of a U.S. real property investment, the foreign investor focuses attention on the impact of taxes, and desires:

* Minimization of U.S. taxes on income from operating the property and on the gain from eventual disposition.

* Avoidance of U.S. estate taxes on the U.S. assets of the foreign investor.

* Minimization of foreign taxes on the U.S. business, including taxes associted with any current return on the foreign investor's debt/equity investment in the U.S.

From a non-tax perspective, the foreign investor wishes to shield his or her other assets from liabilities arising from U.S. investments. Additionally, foreign investors often desire anonymity both in the U.S. and in their home countries.

The investment structure needed to achieve one particular goal may conflict with the objectives of another. For example, direct ownership of U.S. real property would result in lower individual income tax rates, but would sacrifice anonymity and create the imposition of U.S. estate taxes. Accordingly, the proper structure for a particular situation will depend on the weight the foreign investors place on each of their goals.

U.S. Taxation on the Foreign Investor

The IRC's scheme for taxation of nonresident aliens and foreign corporations is dependent on the level of activity of the investor's business in the U.S. and on the nature of the income generated.

Withholding of U.S. taxes on a gross income basis is required with respect to fixed or determinable annual or periodical gains, profits and income received by a foreign investor from U.S. sources to the extent this income is not effectively connected with the conduct of a trade or business in the U.S. Interest, dividends, and rents are examples of this type of income. The statutory rate of withholding is 30%, but this rate is often reduced by U.S. income tax treaties.

Capital gains which are not effectively connected with the conduct of a trade or business in the U.S. are exempt from U.S. taxation when earned by a foreign corporation. Nonresident alien individuals are similarly treated if they are not present in the U.S. for 183 days or more in the year the gains is recognized. Otherwise, the statutory 30% withholding tax is imposed, unless reduced by a treaty.

Where the foreign investor is engaged in a U.S. trade or business, all items of income which are effectively connected with such trade or business, less deductions attributable to such income, are subject to U.S. taxation at established graduated tax brackets.

Generally, the mere ownership by a foreign investor of U.S. real property will not constitute the conduct of a trade or business in the U.S. 1 However, there have been cases where, because of the number of properties being leased or because of the level of activity in management of the property, trade or business activity has been held to exist. 2 The traditional net lease of a single piece of U.S. real property, or the net lease of property to an intermediary, such as an unrelated management company, would probably avoid trade or business classification. 3

Avoiding trade or business classification may not be advisable for the typical real estate activity, since U.S. taxation would then take the form of a 30% withholding tax on the gross rents received, unreduced by related expenses. A real estate investment will often, at least at the outset, operate at a net loss generated by deductible cash expenditures or non-cash depreciation. Accordingly, the imposition of a tax on gross receipts could be devastating. In this connection, the IRC allows the foreign corporation or individual to make an election (irrevocable without IRS consent) to treat its U.S. income as effectively connected, thereby subjecting it to the tax based on net income. 4 Certain U.S. income tax treaties provide for the ability to make a similar election on an annual basis, with basically the same result.

Changes Encted by FIRPTA

Before enctment of FIRPTA, tax planning strategies were available to avoid U.S. taxation on the disposition of U.S. real property. These loopholes were closed by FIRPTA through its blanket categorization of dispositions of U.S. Real Property Interest ("USRPI") as if the taxpayer was engaged in a trade or business within the U.S. and as if the gain or loss on disposition was

effectively connected with such trade or business. Thus, regardless of the categorization of the taxpayer's activities in the U.S. during the operation phase, vis-a-vis effectively connected or not, FIRPTA required U.S. taxation in the year of disposition. A USRPI is not only represented by direct ownership of U.S. real property, but also by an interest in a domestic corporation that is or has been a U.S. real property holding corporation ("USRPHC"). A USRPHC is a corporation whose fair market value of its USRPIs equals or exceeds 50% of the aggregate fair market value of its USRPIs, plus its interests in real property outside the U.S. and any other assets which are used or held for use in a trade or business. Certain exceptions to USRPHC classification exist if the corporation had previously disposed, in a taxable transaction, of its USRPI.

To track the foreign party ownership of a disposition, FIRPTA originally enacted a reporting system buttressed by proposed and temporary regulations, none of which became effective. TRA 84 replaced the reporting requirements with new withholding requirements. The general withholding rule is that, unless an exemption applies, whenever a foreign person disposes of a USRPI, the transferee of that interest must deduct and withhold a tax equal to 10% of the amount realized on the disposition. One of the exceptions permits a foreign corporation which disposes of a USRPI to make an election to be treated as a domestic corporation for withholding tax pu rposes. This special election is found in Sec. 897(i) and is available only if the foreign corporation is entitled to non-discriminatory treatment under a U.S. treaty.

Though originally enacted to ensure that residents of a treaty jurisdiction engaged in business activities within the U.S. will be treated no less favorably than a U.S. resident carrying on the same activities (mainly for General Utilities doctrine purposes), any electing foreign corporation can also avoid the 10% FIRPTA withholding on disposition. Although the foreign corporation would still be liable for corporte income tax on the disposition of the USRPI, the regular corporate tax may be less than the 10 withholding, and, furthermore, payment of any tax liability would be delayed until the due date of a regular estimated corporate income tax payment.

Estate Tax Consequences

For U.S. estate tax purposes, the gross estate of a nonresident alien consists of all U.S. situs property in which the decedent had an interest at death. Direct ownership of U.S. real property would therefore subject the nonresident owner to U.S. estate taxes. Stock in a corporation is deemed to have a situs in the jurisdiction in which the corporation is formed or organized. Thus, shares of a U.S. corporation are U.S. assets, while shares in a foreign corporation are not. 5 Stock in a foreign corporation that has made a Sec. 897(i) election to be taxed as a U.S. corporation will nevertheless be considered foreign source. Regarding the situs of a partnership interest, the IRS has ruled that the situs of a partner's interest is where the business of the partnership is carried on. 6 Thus, an interest in a partnership owning U.S. real property would most likely be considered a U.S. situs asset.

Structuring the U.S. Investment

Direct Ownership by a Foreign Corporation

In recent years, the most popular vehicle utilized by foreign investors for holding their U.S. real property has been the foreign corporation. Foreign corporate ownership provided some degree of anonymity, limited the foreign owner's personal liability, shielded the property from U.S. estate taxation, and allowed for the use of the then lower corporate tax rates. TRA 86 introduced the branch profits tax which may make direct U.S. real property ownership by a foreign corporation inadvisable.

The rationale for enactment of the branch profits tax was to eliminate the disparity of U.S. tax treatment between foreign corporations doing business in the U.S. through branch operations and

foreign corporations doing business in the U.S. through wholly owned U.S. subsidiries. While both entities are subject to corporate level taxes on income effectively connected with a U.S. trade or business, dividend distributions and interest payments to shareholders of a U.S. corporation are subject to a shareholder level tax as well. The effect of U.S. withholding on similar payments by foreign corporations to its shareholders, however, culd be mitigated if the foreign corporation also operated abroad extensively and derived substantial income from foreign sources. On the other hand, distributions from the U.S. branch of the foreign corporation to its home office were not subject to U.S. withholding at all.

Branch Profits Tax

The branch profits tax attempts to correct this inequity by taxing the "dividend equivalent amount" of the U.S. branch. The dividend equivalent amount is a measurement of the branch's effectively connected earnings and profits for the taxable year. The branch's effectively connected earnings and profits for the taxable year are adjusted by the increase or decrease in U.S. net equity during the year. Thus, if the branch's earnings and profits were not reinvested in U.S. business assets, it could be subject to the branch profits tax even if the earnings and profits had not been remitted to the home office. The regular corporate tax serves to reduce the base for the applicatioin of the 30% branc profits tax. Thus, foreign corporations having effectively connected U.S. earnings and profits can be subject to corporate level taxes of approximately 54%. Sec. 897(i) elections will not absolve the forign corporation from this tax.

An additional element of branch taxation is the 30% withholding (subject to treaty modifications) on interet paid by the U.S. branch. The purpose of the branch level interest tax is to prevent taxpayers from avoiding the braach profits tax by overloading a corporation with interest deductions. The branch level interest tax treats the U.S. branch as a U.S. subsidiry and acts to replace the former second level withholding tax on interest.

Foreign corporations subject to the branch profits tax will no longer be subject to the second level withholding tax on dividend payments. This is true even if there is no branch profits tax for a particular year due to the earnings and profits limitations.

TAx Treaties May Help

An important exception to the branch tax rules is the elimination (or reduction, dependent upon the treaty) of the application of this tax to a foreign corporation if the foreign corporation is a qualified resident of a foreign country with which the U.S. has an income tax treaty. Thus, if the foreign investor is a resident of a treaty country and utilizes a corporation formed in that country to hold the U.S. real property investment, the branch tax rules may not apply. In this case, the pre-branch tax rules become applicable, as modified by TRA 86:

* No branch profits tax;

* Interest payments by the foreign corporation will not be subject to the 30% (subject to treaty modifications) withholding regardless of the extent of the foreign corporation's income from its U.S. business in relation to the amount of its worldwide income; and

* Dividend distributions are subject to the 30% (subject to treaty modifications) withholding if the effectively connected U.S. source income of the foreign corporation is equal to or greater than 25% of its gross income from all sources for a three year period.

In the latter case, the amount of the dividend subject to withholding is in proportion to the ratio of its effectively connected gross income to total gross income.

Can Be Costly Unles Treaty Exists

From this brief review of the branch tax rules, it is clear that if the holding of U.S. real property will generate effectively connected earnings and profits, the use of a foreign corporation can be extremely costly tax-wise, unless the foreign investor happens to reside in a treaty country and uses a home country corporation. The IRS has published a list of countries with whom the U.S. has income tax treaties which serve to override or modify the branch tax rules. 7 Residents of those countries will find that foreign corporate ownership of U.S. real property will, usually, be the most effective vehicle for their U.S. investment.

Potential foreign investors in U.S. real property are, however, scattered all over the globe and the use of a treaty country corporation by a nonresident of that country will not override the branch tax rules. Additionally, the desire for home country anonymity by a treaty country resident may outweigh tax considerations. For these foreign investors, alternatives must be explored.

Foreign Corporation with a U.S. Subsidiary

This alternative would have the foreign investor form a foreign corporation which will own a U.S subsidiary, which will hold the U.S. real property. Interposing a U.S. corporation between the foreign corporation and the U.S. real property will continue to shield the U.S. situs assets from U.S. estate taxes, and since the activity will be contained in the U.S. entity, the branch tax rules will not apply either. Anonymity and limited liability will continue to exist. The issue to consider is the appropriate foreign country to utilize.

The home country of the foreign investor is the obvious choice, unless the owner is desirous of home country anonymity. The choice of another country should be based on a review of the country's corporate tax structure, and the terms of that country's treaties, if any, with the U.S. and the home country. Specifically, the goal is to choose the country that exempts from taxation (or has a minimal tax on) income from business conducted outside the country by corporation with foreign owners. Additionally, the treaty between the U.S. and that country should exempt from U.S. withholding (or have a reduced withholding rate) on interest and dividend payments received from the U.S. subsidiary. A further advantage would be a country that does not require withholding or some other form of tax on payments from the corporation to its nonresident foreign owner. The objective in the search for countries with these special laws is to minimize the tax on the return the foreign investor receives on his or her investment.

Cash Flow Situations

If available, the foreign investor is desirous of receiving cash flow on a current basis. Cash flow can take the form of a dividend from the U.S. subsidiary or interest payments on owner provided debt. A significant factor in minimizing the U.S. taxes of the U.S. corporation is establishing a proper mix of debt and equity. To the extent the corporation is capitalized with debt, interest payments to the foreign owner would be deductible against U.S. income. Dividend payments to the foreign owner on his or her equity investment are not deductible. Thus, it is preferable for the foreign owner to receive the return on his or her investment in deductible interest payments. Naturally, the IRS can argue that purported debt is actually equity. Guidance in the form of regulations in this area were issued and withdrawn. Nevertheless, the IRS rationale in this area can be gleaned from an analysis of these regulations and relevant court cases. 8 Some of the criteria cited as supportive of debt classification are:

* The corporation's debt to equity ratio does not exceed 3:1;

* The debt instrument has a fixed maturity date, an appropriate interest rate, and requires annual payments of such interest;

* All principal and interest payments are made when due;

* The debt is not subordinated to other debt and is not convertible into stock; and

* The intent of the parties.

It should be noted that the 3:1 debt/equity ratio is simply a safe harbor ratio cited in the retracted regulations. The courts have in numerous cases blessed significantly higher ratios.

Ideal Structure

Thus, the ideal structure for income and cash flow producing U.S. real property (where a home country U.S. treaty does not exist or cannot be availed of) is a foreign treaty country corporate owner of a heavily indebted (to its parent) U.S. subsidiary, where the treaty provides for reduced or no withholding on interest payments to the foreign treaty country corporate owner. That treaty country should also exempt or provide a low rate of corporate taxation on these interest income receipts. Barbados may serve as an appropriate country since its treaty with the U.S. reduces the interest withholding rate to 12.5% and its corporate tax rate is only 2.5%. The use of a treaty country will also be beneficial at the time of disposition of the stock of the U.S. subsidiary, since a Sec. 897(i) election can be made to avoid FIRPTA withholding.

The IRS is obviously not keen on the use of a treaty country to avoid or reduce U.S. withholding where such withholding would have existed in full were a home country foreign corporation used. The IRS has been aggressive in its attacks on treaty country shopping. Recent treaties contain clauses limiting third country residents from using the favorable terms of their provisions. Where treaty provisions or U.S. law (e.g., the unavailability of the exception to the branch tax rules to nontreaty residents) do not adequately protect treaty country shopping, the IRS will administratively dispense with the perceived abuse, as it did in two 1984 Revenue Rulings. 9

Those rulings dealt with the then-popular use of a foreign financing subsidiary (e.g., the Netherlands Antilles) to provide access to foreign financing without U.S. withholding requirements. The IRS held that interest paid to the Antilles corporation was not exempt from U.S. withholding tax, if the corporation was a mere conduit for the passage of interest payments and a sufficient business and economic purpose for involving the Antilles subsidiary in the transaction did not exist.

These rulings and the general IRS aversion towards treaty country shopping should warrant the exercise of extreme caution when considering a treaty country to achieve withholding reductions that would not otherwise be available. This caution should include establishing a valid business purpose for the use of the treaty country (perhaps some stock ownership by a treaty resident), ensuring that there be some element of profit inuring to the treaty country corporation, and respecting the existence of the corporation in terms of administration, bookkeeping, and local filings. Notwithstanding, there can be no guarantee that the corporation will withstand IRS scrutiny.

For non-income or cash flow producing U.S. real property (i.e., during the operation phase as opposed to disposition gains), or where foreign investor debt is not significant, or where the foreign investor does not desire to test the dangerous waters of treaty country shopping, the use of the traditional tax haven foreign country as the foreign corporate parent is appropriate. The Netherlands Antilles or Aruba can serve this purpose well since there is no local taxation on a foreign parent's foreign income. As mentioned, the existence and terms of any treaties between the foreign parent and the foreign investor's home country must be reviewed to determine the cost of repatriating the investment. Direct ownership by the foreign corporation of the non-income producing U.S. real estate should also be consider since the dreaded branch profits tax is not

applicable if the foreign corporation liquidates in the same year that it sells the U.S. real property. Caution is again advised since the base for applying the branch profits tax is earnings and profits.

Other Alternatives

Investment in U.S. real property can be made directly by a foreign person. This may not be the preferred route insofar as the foreign owner may be required to file a U.S. income tax return (assuming the real property is effectively connected, treated as effectively connected under IRC election, or subject to tax on a net income basis under a treaty election). In addition, the property would be subject to U.S. estate taxation. Similar consequences would result from an investment in U.S. real property through a partnership. Other, more exotic, mechanisms have been developed, such as split-interest ownerships, certain trust arrangements, and other noncorporate structures which, for home country purposes, are pass-through entities but are treated as corporations in the U.S. Generally, the desire to accomplish every goal of the foreign investor by complicating the form of the structure only raises the risks inherent therein and may result in the eventual toppling of the entire scheme.

Conclusion

Foreign investor interest in U.S. real property will probably not wane. Structuring the foreign investment is a challenging and evolving discipline as astute tax planners struggle with ever altering U.S. and foreign laws and treaties. The key to a particular situation is to recognize and weigh the importance of each goal of the foreign investor, determine the long-term interest of the foreign investor in U.S. real property, and choose the structure that best accomplishes these objectives with some degree of simplicity.

1 See Herbert v. Comr., 30 T.C. 26 (1958). See also Neill v. Comr., 46 B.T.A. 197 (1942).

2 See de Amodio v. Comr., 34 T.C. 894 (1960). See also Pinchot v. Comr., 113 F2d 718 (2d Cir. 1940).

3 See LTR 7731043.

4 See Secs. 871(d) and 882(d).

5 See Sec. 2104(a) and Regs. 20.2105-1(f).

6 See Rev. Rul. 55-701, 1955-2 C.B. 836.

7 See Notice 87-58, 1987-35 I.R.B. 2 (Aug. 18, 1987).

8 See R.A. Hardman, 827 Fid 1409 (9th Cir. 1987). See also Rev. Rul. 83-98, 1983-2 C.B. 383.

9 See Rev. Ruls. 84-152, 1984-2 C.B. 381 and 84-153, 1984-2 C.B. 383.

10 For example, the German Stille Gesellschaft."

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