

Foreign Investment in U.S. Real Property

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Summary

- Estate & Gift Taxation
- Disposition rules under §897
- Elections
- Withholding Taxes

Definition of Nonresident

- Income Tax: §7701(b)(1)(a)
 - Substantial presences
 - Lawful permanent residence
 - Income Tax Treaty may override
 - §877(g) for former citizens and long-term residents
- Estate Tax – Treas. Reg. 20.0-1(b)(1)
- Gift Tax – Treas. Reg. 25.2501-1(b)
 - An alien is a resident if his domicile is in the U.S.
 - §877 applies to estate §2107 & gift §2501(a)(3)
- Note potential planning opportunities by changing taxpayer's status

Gift & Estate Tax Rates

- Unified Rates

2006	18% - 46% (over \$2 million)
2007 - 2009	18% - 45% (over \$2 million)

- Estate Tax Credit

Residents:	2006 - 2008	\$2 million
	2009	\$3.5 million
	2010	\$0
Nonresidents:	Unchanged	\$60,000

- Gift Tax Exclusions

Residents:	Annual	\$12,000
	Lifetime	\$1 million
Nonresidents:		\$12,000

Estate & Gift Tax Comparison

- (1) An NRA descendant's gross estate includes property which at the time of death is situated in the United States. §2103.

- (2) A nonresident alien is subject to gift tax when he makes a gift of real or tangible personal property situated in the United States. §2501(a)(1); §2511(a); Treas. Reg. §25-2511-1(b).

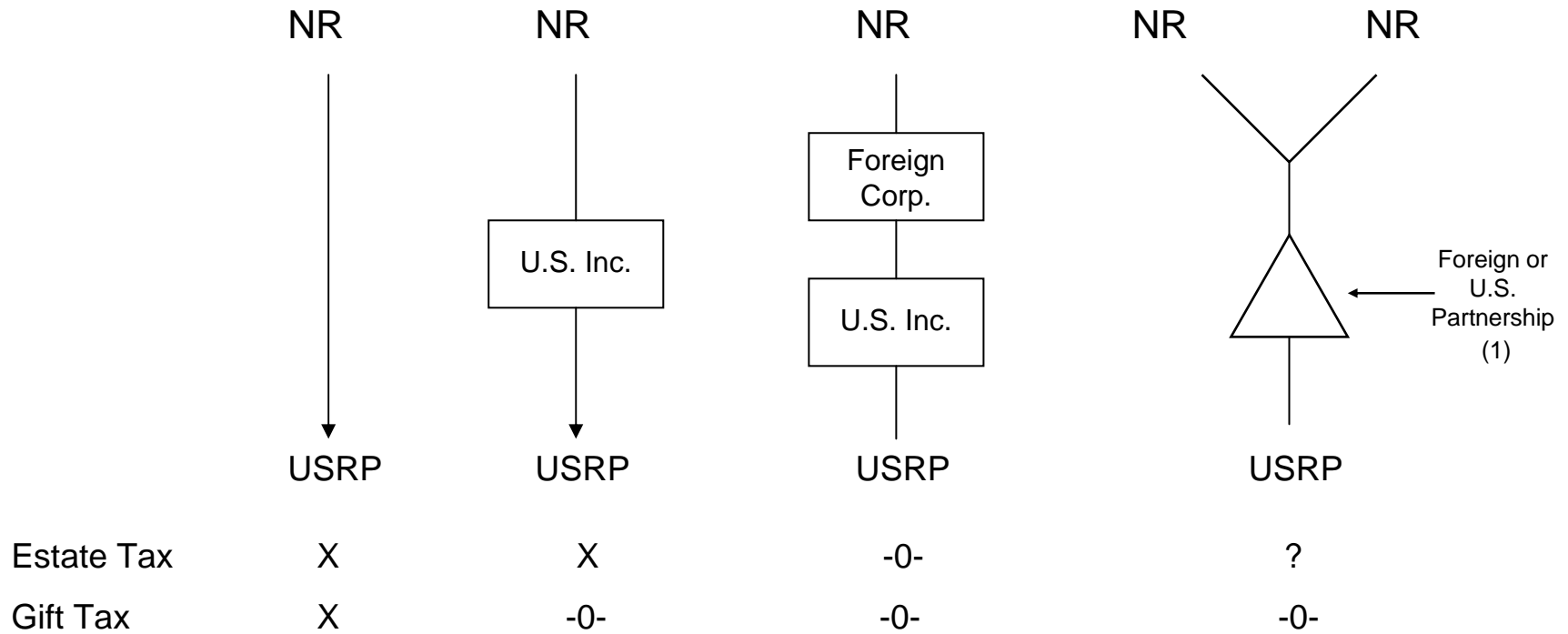
Property Subject to Gift & Estate Tax

	Estate Tax	Gift Tax
Real Property	X	X
Tangible Personal Property in U.S.	X	X
Cash in U.S. Banks	-0- ⁽¹⁾	X
Life Insurance	-0-	-0-
Intangible Property “situated” in U.S.	X ⁽²⁾	-0-
U.S. Stocks	X	-0-
U.S. Debts	X	-0-

(1) If interest from institution qualifies for portfolio interest exemption. §871(h).

(2) Shares of stock owned and held by a nonresident not a citizen of the United States shall be deemed property within the United States only if issued by a domestic corporation. §2104(a).

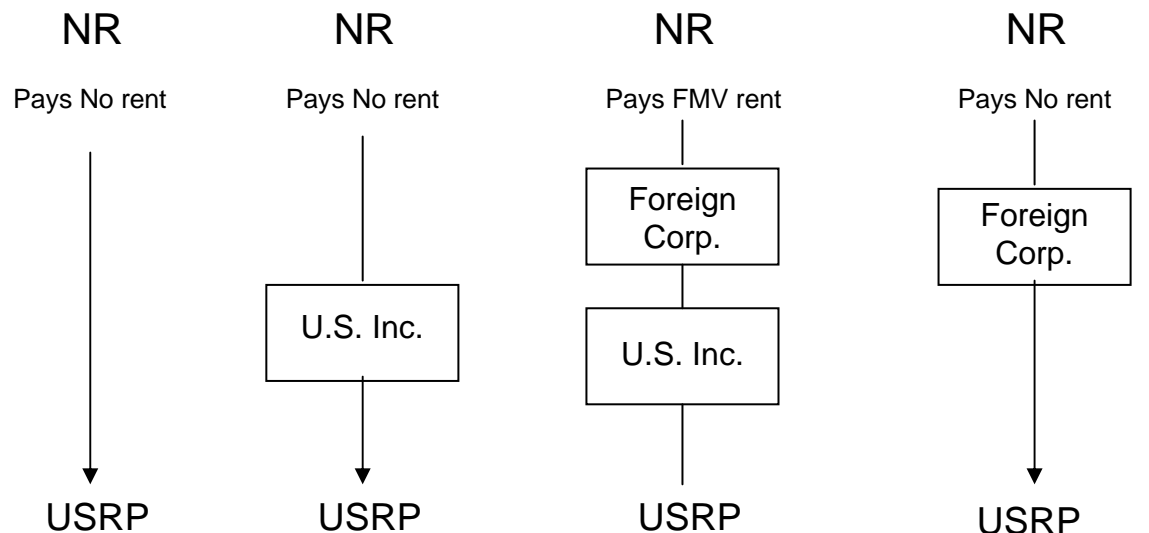
Estate & Gift Tax on USRP Interests



(1) Partnerships

- See *Blodgett v. Silberman*, 277 U.S.1 (1928).
 - Rev Rule 55-701, 1955-2 C.B. 836
- Estate taxation of partnership based upon situs:
 - location of partnership's trade on business
 - owner's domicile
 - where assets located

Florida Beach House



See ILM 200504029

Estate Tax

Direct ownership - taxed
 Indirect ownership
 Risk under §2036(a)(1)

X	----	----	----
----	X	----	----
----	X	----	X

Income Tax Risk

Imputed Income §482
 30% Dividend taxation §871
 Rental income taxed §§1 & 55
 Branch profits tax §884

----	X	----	X
----	X	----	----
----	----	X	X (no deductions)
----	----	----	X

Branch Profit Tax

1. 30% tax on dividend equivalent – changes in net equity from year to year
 - Exceptions: May be eliminated under treaty. 1.884-4(a).
 - Is zero in the year of a complete termination

2. Branch level interest withholding taxes
 - Puts foreign company in a U.S. company position
 - 30% on interest paid to foreign person
 - Exceptions:
 - Portfolio interest 871(h)
 - Treaties 1.884-4(a)

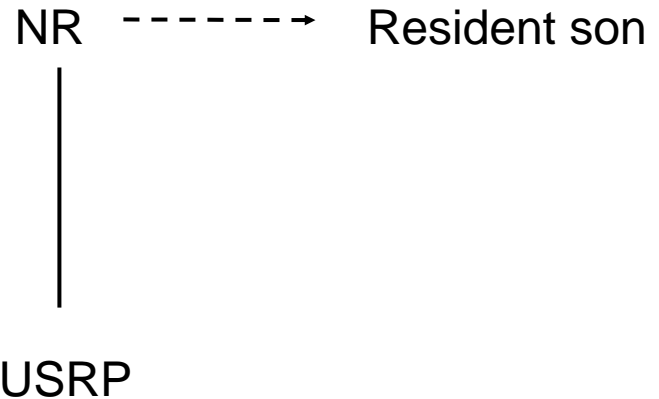
Gift vs. Sale by Foreign Parents

Option 1

- Cash gift to son, then
- Sell to son at fair market value

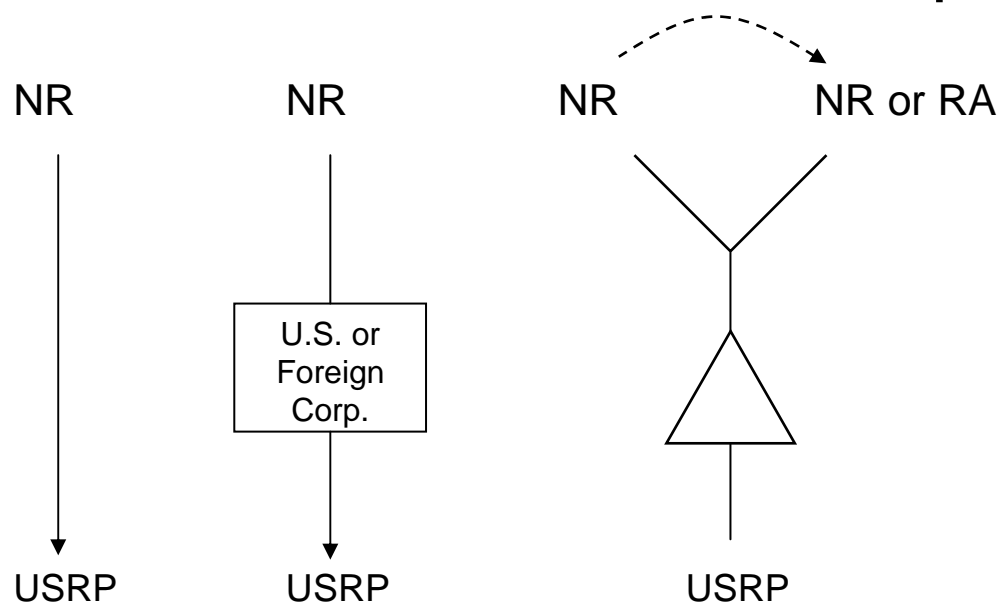
Option 2

- Sell property in exchange for debt
- Forgive debt on property



In *Geoffrey C. Davies*, 40 T.C. 525 (1963), acq. 1966-1 C.B.2, son received cash which he understood would be used to acquire property. Mortgage to parents paid exclusively from gifts from parents. Cash gifts repaid within short period of time. Cash gifts treated as a gift of an interest in real estate.

Direct vs. Indirect transfer of Income Property



Income Tax vs. Estate & Gift Tax

- Direct gifts – taxable
- Gifts of intangible property are nontaxable
 - In corporate form – income taxes are higher
 - In partnership form – preserves single level of tax ⁽¹⁾
 - Forward planning required

(1) Intangible property includes partnership interests. PLR 77 37063.

Nonresident Income Taxation

- General Rule:

Nonresident aliens are generally not subject to tax on U.S. capital gains. §871 and §865(a)(2) (source rules)

- USRPIs are generally capital assets, Consequently, absent FIRPTA, the dispositions of USRPIs would generally not be subject to tax.

Nonresident Taxation on Sale of USRPI

- The code treats any gain from disposition as income effectively connected with a U.S. trade or business. §897(a).
- §897 broadly defines the term “U.S. real property interest” (USRPI) to include the following
 1. An interest in real property located in the United States or the Virgin Islands, and
 2. Any interest in a domestic corporation unless the taxpayer establishes that the domestic corporation was not a U.S. real property holding corporation (USRPHC) for a certain period. §897(c)(1).
- USRPI includes any interest, except an interest solely as a creditor.
- USRPI includes associated personal property.

USRPI

A USRPI includes an interest in:

- Land and unsevered natural products of the land
- Improvements and personal property associated with the use of real property
- Standing timber
- Growing crops
- Mines
- Wells and other natural deposits before extraction
- Buildings
- Swimming pools
- Fences
- Advertising displays
- Oil and gas pipelines
- Permanently installed telephone and television cables
- Leaseholds
- Options

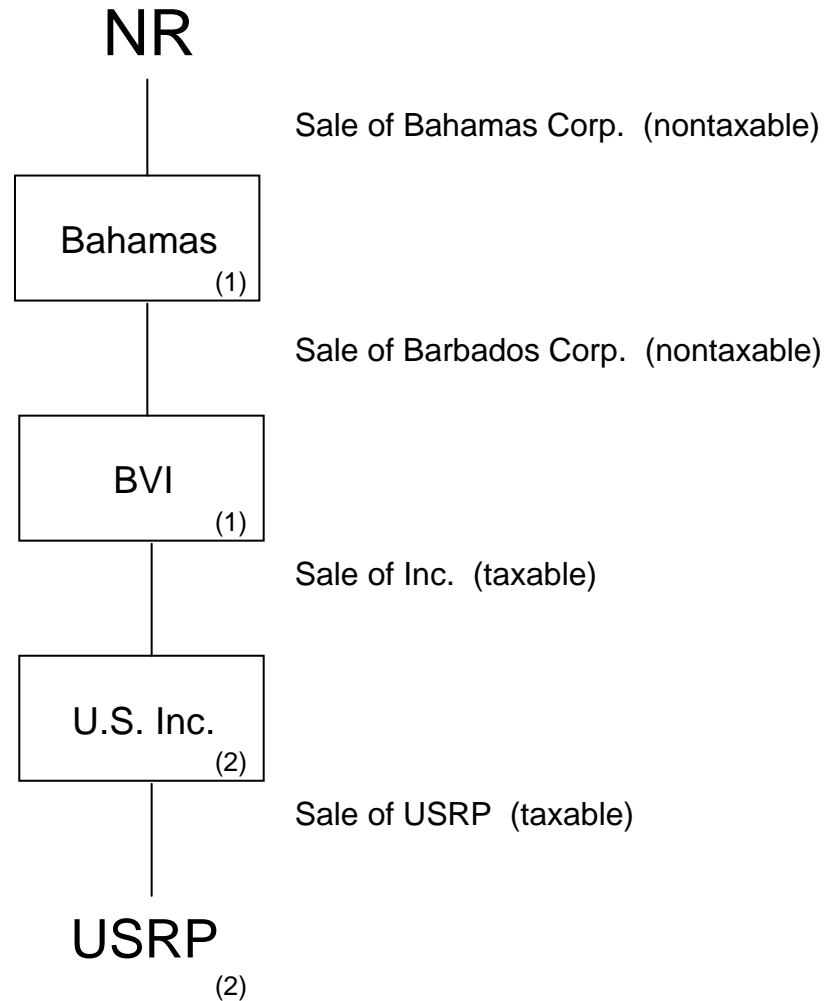
USRPHC Holding Corporation

A USRPHC is a domestic corporation whose USRPI percentage equaled 50 percent or more anytime within the preceding five year period. §897(c)(2).

$$\text{USRPHC Percentage} = \frac{\text{Fair market value (FMV) of USRPI}}{\text{FMV of USRPI} + \text{FMV of Foreign Real Property} + \text{FMV of Trade Business Assets}}$$

- Formula excludes portfolio investments

Sale of USRPI



- (1) Not considered a USRPHC
- (2) USRPI

Dispositions

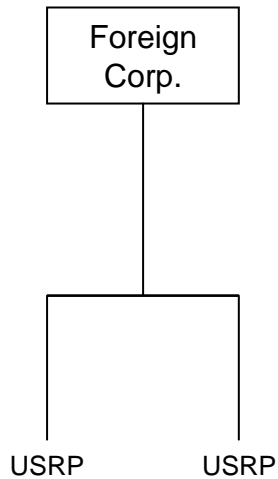
- Any transfer considered “a disposition” under any section of the Code and Regulations is considered a disposition under §897.
- Transfers otherwise qualifying for nonrecognition treatment may be taxed in the following:
 - Gifts in which the adjusted basis of property transfer is less than the liabilities transferred
 - Like-kind exchanges
 - Changes in an interest in a partnership, trust, or estate
 - Foreclosures
 - Involuntary conversions

Corporate Nonrecognition Transactions

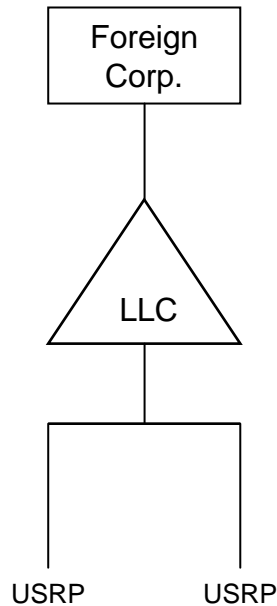
- Nonrecognition provisions are allowed only in exchanges where the interest received in an exchange would be subject to taxation. § 897(e)(1).
- The following are corporate provisions of the Code that provide exceptions from gain recognition:
 - IRC section 368 (reorganizations)
 - IRC section 351 (incorporations)
 - IRC section 332 (liquidation of subsidiary)
 - IRC section 355 (spin-offs, split-offs and split-ups)

Corporate Ownership

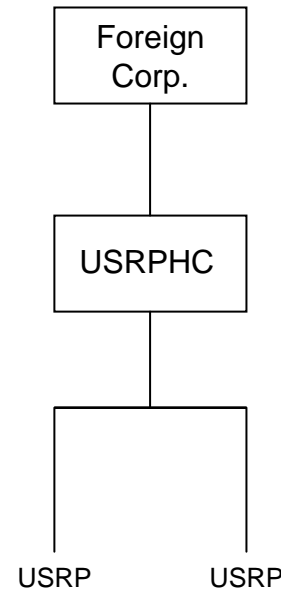
Direct Ownership



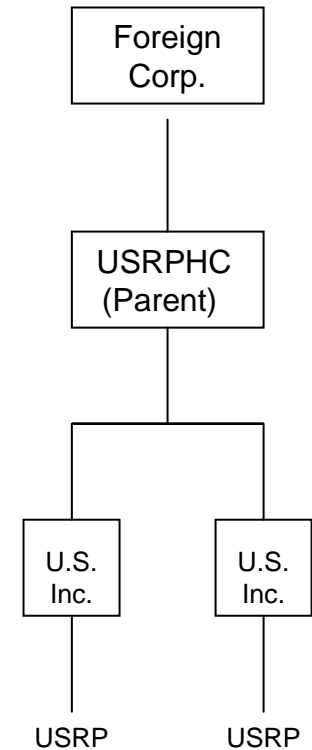
Direct Ownership



Separate USHCs.



Consolidated Group



Tax Issues:

- Distributing funds to foreign parent (§301; §311; §331)
- Offsetting profitable and nonprofitable activities
- Branch profits tax on dividend equivalent (§884)

Nontax Issues:

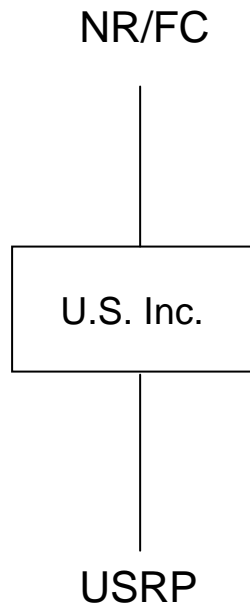
- Segregating liabilities and risks
- Intercompany debt
- Cost and ease of administration

“Cleansing” Transaction

USRPHC status may be terminated by either of two ways.

1. If a determination date, the USRPHC formula falls below 50 percent. However, the interests in the corporation remain tainted for five years.
2. The following conditions are met:
 - No USRPI's are owned; and
 - All USRPIs owned directly or indirectly within the preceding five years were disposed of in transactions in which the full amount of the gain was recognized or ceased to be a USRPI. §897(c)(1)(B)(ii).

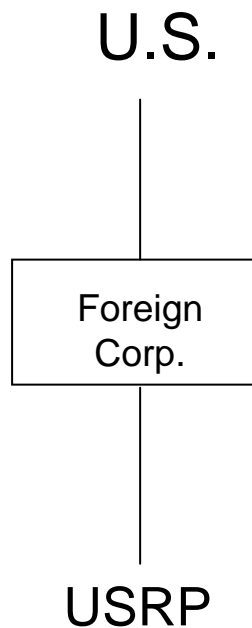
“Cleansing” Transaction



Proceeds

1. U.S. Inc. sells property (taxable).
2. U.S. Inc. adopts plan of liquidation.
3. Cash distributed to foreign owner.
 - Dividends: §301 – 30% withholding. §§871, 881.
 - Sale or exchange (liquidation) §331.
 - Liquidation is not a “disposition”. §897(c)(1)(B)(ii).
4. Problems keeping company active. §301.

Problem for the Inbound Nonresident



- CFC Status under §§951, 954
- PFIC status under §1297(a)
- Ownership through foreign trusts (§679)
- Reporting

The “i” Election

- IRC section 897(i) allows foreign corporations to be taxed as domestic corporations for FIRPTA purposes only. To make an IRC section 897(i) election, a foreign corporation must:
 - Own a USRPI;
 - Qualify as a USRPHC upon making the election;
 - Be entitled to nondiscriminatory treatment of its USRPI under an income tax treaty; and
 - Submit the election in proper form
- The electing foreign corporation is treated as a USRPHC. Its stock is therefore a USRPI and subject to FIRPTA on its disposition.
- §897(i) election will nullify
 - §897 Dispositions rules
 - §1445 Withholding
 - §6039 C Reporting
- §897(i) does not apply to estate & gift tax treatment

Election to Treat Real Property as Effectively Connected Income

Nonresident: §871(d)

Foreign Corporation: §882(d)

- Election applies to all future years
- Eliminates risk that income is fixed and determinable period income (§871 and 881) subject to 30% withholding

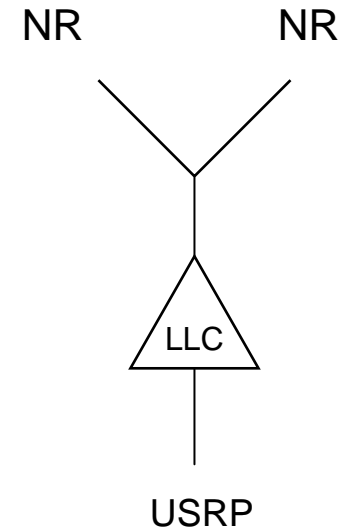
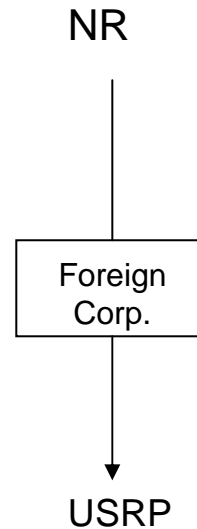
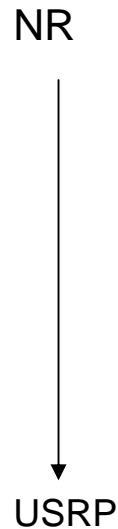
Withholding Tax on Disposition

- Effective January 1, 1985 §1445 imposes a withholding obligation for disposition of a USRPI
- §1445(d) makes the transferee liable for the tax.
- Withholding rates: federal 10% (3.3% for California) times the amount realized in sale
- Exemptions
 - Personal residence
 - Federal – Sale for less than \$300,000 §1445(a)(5)
 - California – Sale for less than \$100,000

Withholding Certificates

- Withholding must be paid by the 20th day after the Service mails a copy of the withholding certificate
- IRC section 1445 authorizes the Service to reduce or eliminate the withholding amount. See Rev. Proc. 88-23 for withholding certificate procedures
- A withholding certificate only adjusts a withholding obligation to correspond with the probable tax liability arising from a transfer
- If the application is pending the transferee need not pay over the amount required to be withheld immediately
- See Forms 8288 and 8288A, Treas. Reg. 1.445-1(c)(1).

Income Tax Withholding on Income Property



Withholding §1441(a): 30%
 §1441(c): -0-

30%
 -0-

Maximum Rate – 15%, 35%
 §1446

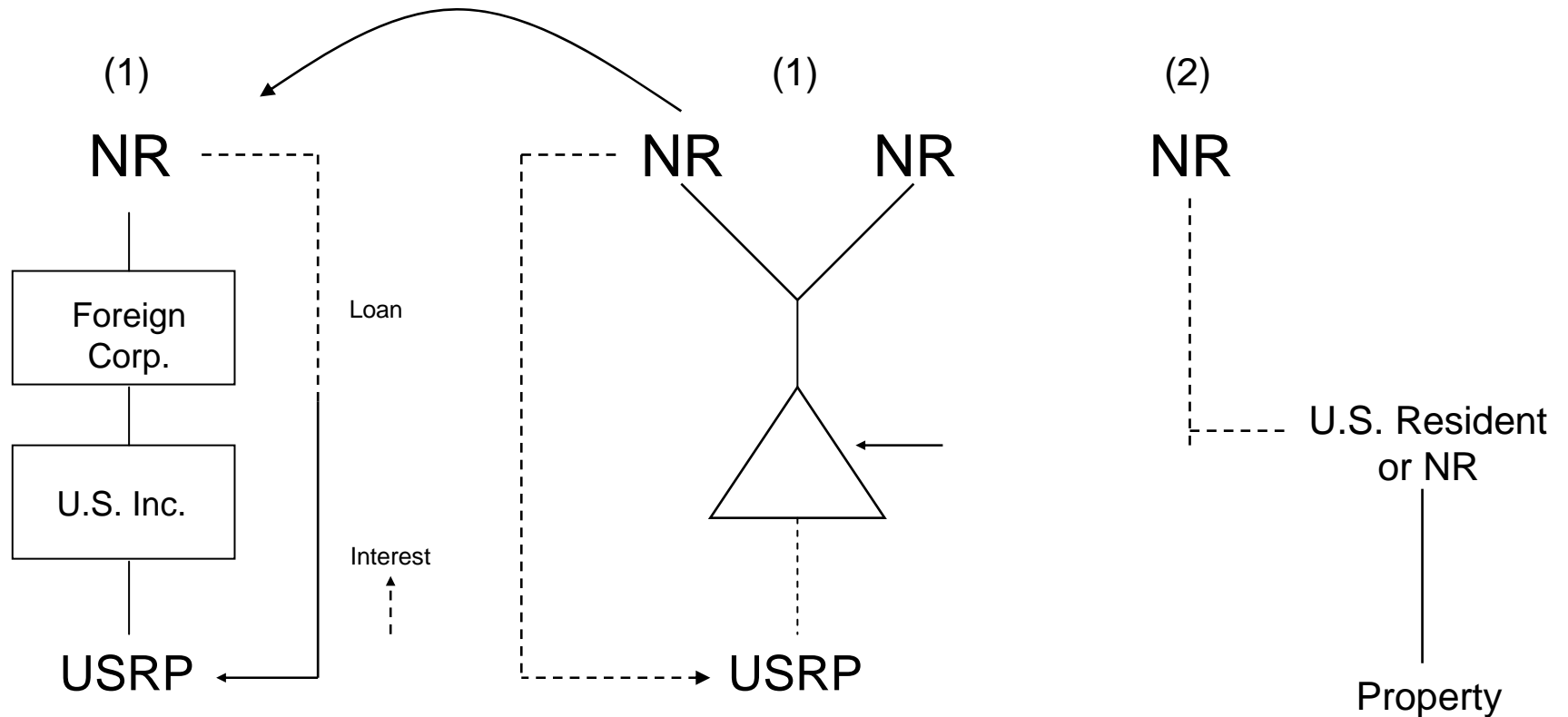
Disposition

- §1446 prevails over §1445
 Treas. Reg. 1.1446-3(c)(2).
- New final & proposed regulations may reduce withholding tax

Planning Summary

- Resident status is crucial
- Use of elections & treaties
- Withholding rules
- What's the taxpayer's long-term game plan
- Consider filing protective returns for foreign investors to preserve deductions

Portfolio Debt



Portfolio Debt

(1)(a) No greater than 10% (Attribution under §267)

(b) Must meet qualifications under §163(f)

(2) No attribution attribution