U.S. TAX IMPLICATIONS OF FOREIGN INVESTMENT IN U.S. REAL ESTATE

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There are several different reasons why non-U.S. citizens (e.g., Mexican citizens or Mexican companies) might want to "own" real estate in the U.S.

First, an individual may want to own real property in the U.S. for personal and/or recreational purposes. Many non-U.S. citizens own homes in California and throughout the U.S. (either directly as individuals or indirectly through domestic or foreign entities).

Second, ownership[1] in U.S. real estate may satisfy specific business objectives of a foreign company. For instance, a Mexican company that exports goods to the U.S. may want to develop a distribution and/or warehousing network in the U.S. Also, a company may want to open a sales office (or offices) in the U.S. to help market its goods or services in the U.S. or other parts of North America.

If a non-U.S. citizen owns U.S. real estate, the method by which the real estate is owned is very important. For instance, a non-U.S. citizen (whether he or she resides in the U.S.) probably wants to avoid paying any U.S. estate tax upon his or her death to the extent possible. The U.S. has a tax known as the estate tax imposed upon the entire "taxable estate"[2] of an individual upon his or her death. This type of tax, which is a type of "death" tax like an inheritance tax, does not exist in many countries such as Mexico. The estate tax is discussed in more detail in another presentation, but it should be noted that a Mexican citizen who owns real estate directly as an individual (as opposed to a foreign corporation owning the real estate) will be subject to the U.S. estate tax upon his or her death. The current estate tax rates range from 18 percent to *50 percent.[3] These highest rates were modestly reduced from 55 percent beginning in 2002. The "taxable estate" of nonresidents who are not domiciled in the U.S. includes property situated within the United States. Property situated in the U.S. includes, among other things, U.S. real estate, most personal property physically located in the U.S., certain debt obligations, and stock in a U.S. corporation.[4]

*In 2001, a new federal tax law (the "Act") modified estate and gift tax rates as follows:

Death in Year	*Estate Tax Life Time Exemption Equivalent for Non-U.S. Citizens with Foreign Domicile*	*Estate Tax Exemption Equivalent For U.S. Citizens or U.S. Domicile*	*Highest estate and gift tax Rate*
2002	US$ 60,000	US$ 1 million	50%
2003	US$ 60,000	US$ 1 million	49%
2004	US$ 60,000	US$ 1.5 million	48%
2005	US$ 60,000	US$ 1.5 million	47%
2006	US$ 60,000	US$ 2 million	46%
2007	US$ 60,000	US$ 2 million	45%
2008	US$ 60,000	US$ 2 million	45%
2009	US$ 60,000	US$ 3.5 million	45%
2010	Estate Tax – Repealed Gift Tax Rate	Estate Tax – Repealed Gift Tax Rate – Maximum Rate	N/A 35%
2011	US$ 60,000	US$ 1 million	55% + 5% (surtax in higher estates)

A foreign investor should carefully plan for the tax consequences of U.S. real estate investments because of the complex legal framework of foreign real estate investments. Foreign investors should consider several important factors before investing, acquiring, or selling U.S. real estate. The following is a list of some of these considerations:

- Will the real estate generate income?
- Does the investor want only a debt interest in the real estate, an equity interest, or some combination of both?
- Should a corporation, partnership, trust, **or** an individual acquire the real estate?
- Should the entity be domestic, foreign, or some combination of both?
- Should the real estate be leveraged significantly, through medium-term or long-term financing to obtain the tax benefits of interest expense paid? If so, should the financing come from the U.S. or outside the U.S.?
- If a foreign corporation owns U.S. real estate, should it make an election to be taxed like a domestic U.S. corporation in relation to its U.S. real estate investment?
- What U.S. tax returns must be filed, and what information must be disclosed to the IRS regarding the foreign investors? Can the investment be restructured to avoid some of these reporting requirements?

These questions cannot be adequately answered until the economic and business objectives of a particular foreign investor are carefully examined. Why invest in U.S. real estate? Does the foreign investor want to lease real estate or purchase real estate? Does the foreign investor want capital appreciation or annual income from the real estate investment? Does the foreign investor need initial "income tax losses" to offset against other sources of U.S. income? How long does the foreign investor want to own an interest in real estate?

This presentation cannot answer all these questions. However, it is designed to provide a framework of some of the more significant tax issues that should be considered before a foreign individual or company invests in U.S. real estate.

SPECIAL TAX RULES APPLICABLE TO FOREIGN INVESTORS WHO INVEST IN U.S. REAL ESTATE

There are several unique rules applicable to non-U.S. citizens, non-U.S. residents[5] and foreign companies that own real estate situated in the U.S. Congress passed most of this legislation nearly 20 years ago known as the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA").

Generally, a non-U.S. citizen (e.g., a Mexican citizen who resides in Mexico or outside the U.S.) who does not have (1) U.S. source income or U.S. source income "effectively connected" with a trade or business,[6] and (2) does not stay in the U.S. for the "183" days test per year, does not have to pay taxes to the U.S. government. Consequently, prior to the enactment of FIRPTA, a foreign investor could purchase real estate in the U.S. (e.g., a bare tract of land that had development potential) for USD$ 100,000 and sell it for USD$ 300,000. The U.S. would generally not tax the Mexican citizen on the USD$ 200,000 gain. If a U.S. citizen were to have that same USD$ 200,000 gain, it would have to pay income tax on the gain. Congress passed FIRPTA because it thought foreign investors were receiving more favorable tax treatment on some of their U.S. real estate investments than U.S. residents.

FIRPTA created a completely different tax method by which non-U.S. residents are taxed upon their gains derived from ownership in U.S. real estate. FIRPTA also imposes a mandatory withholding mechanism by which part of the tax must be withheld by the buyer (or third party withholding agent) immediately upon the sale or disposition of the U.S. real property interest.

IMPOSITION OF TAXES UNDER FIRPTA

A tax cannot be imposed unless there is a sale or other disposition of a *U.S. Real Property Interest* ("USRPI") under FIRPTA. Any direct ownership interest in real property located in the U.S. or the U.S. Virgin Islands (as well as certain ownership interests in corporations,[7] partnerships,[8] and estates which own real property that is located in the U.S. or the U.S. Virgin Islands)[9] is a USRPI. "Real property" is defined by IRS Regulations (and not by local laws such as California or New York law), and includes the following items:[10]

- Undeveloped land;[11]
- Crops and minerals that are not severed or extracted from the ground;
- Permanent structures such as improvements and buildings that are inherently permanent;[12] and
- Personal property that is particularly associated with real property (e.g., mining equipment, timbering equipment, construction equipment used predominantly for developing real property, hotels, motels, apartments, and equipment predominantly used in the rental of furnished office and other work space).[13]

Although the definition of "real property" for purposes of a USRPI is expansive, a so-called "pure creditors' interest" is not deemed a USRPI. A pure debt interest in U.S. real estate such as a mortgage (which is an example of a debt interest) does not create a USRPI. Instead, the foreign lender who takes a mortgage against the U.S. real estate would be subject to a withholding tax on the interest income received unless the loan is structured as portfolio interest.[14] Therefore, debt "investments" in real estate might provide a more desirable means by which a foreign investor can invest in U.S. real estate to avoid any FIRPTA taxes. A pure creditor also has significantly fewer reporting obligations to the IRS. Also, the FIRPTA tax may be avoided by creatively structuring other types of debtor/creditor relationships.

The exact investment arrangement should be carefully planned. If a foreign investor were to take a disguised "equity" ownership interest (as opposed to a pure creditor's interest or other non-USRPI), then the IRS might take the position that the gains derived by the foreign investor should be subject to the FIRPTA tax.

For example, assume MEXICOMPANY, S.A., lends Mr. Martinez USD$ 500,000 pursuant to a promissory note to purchase undeveloped real estate in San Diego, and MEXICOMPANY, S.A. takes back a security interest in the real estate (i.e., a mortgage). Assume, further, that the terms of the promissory note require Mr. Martinez to pay MEXICOMPANY, S.A. 50 percent of the appreciation of the real estate based upon annual appraisals of the undeveloped property. This type of loan arrangement would likely be deemed an "equity kicker" and thus would likely require MEXICOMPANY, S.A. to pay FIRPTA tax upon the sale or exchange of the promissory note.

RATE OF TAX ON DISPOSITION OF USRPI

If a Mexican resident individual disposes of a USRPI, then he or she probably would be subject to a 15 percent tax rate (assuming the property was a capital asset in the hands of the Mexican resident). This lower tax rate applies pursuant to the Jobs and Growth Tax Relief Reconciliation Act of 2003, by which the highest long term capital gains rate was reduced from 20 percent to 15 percent. If the real estate was not a "capital asset," then the tax rate could be between 12 percent and **35 percent.[15] A USRPHC that disposes of a USRPI will be subject to graduated tax rates upon the disposition, which may include tax rates at the highest marginal corporate rate of 35 percent.

**The Act as well as the 2003 tax reforms modified income tax rates from the year 2000 forward as follows:

Year	*Marginal Tax Rates*	*Marginal Tax Rates*	*Marginal Tax Rates*	*Marginal Tax Rates*	*Marginal Tax Rates*	*Marginal Tax Rates*
2000	N/A	15%	28%	31%	36%	39.6%
2001	Rebate	Unchanged	27.5%	30.5%	35.5%	39.1%
2002	10%	Unchanged	27%	30%	35%	38.6%
2003-2010	10%	Unchanged	25%	28%	33%	35%

There are other business forms which should be considered before acquiring real estate in the U.S. For instance, there are some benefits that can be obtained if a limited liability company owns the real estate, depending upon the type of real estate and the objectives of the investors. Also, a foreign investor may structure a U.S. investment interest by using certain grantor trusts, grantor option contracts, security interests, commission arrangements, administrative fees, and indexed rates to limit or avoid any FIRPTA tax.

Additionally, a foreign investor may avail himself or herself of certain tax-free transfers of USRPI to avoid or defer the payment of any FIRPTA taxes as follows:

- Like-kind exchanges;
- Exchanges of stock for stock in the same corporation;
- Liquidations of a subsidiary into a parent corporation;
- Transfers to a controlled corporation;
- Exchanges of stock in certain reorganizations, corporate spin-offs, split-offs, and split-ups; and
- Certain distributions of property by a partnership.
- **Election by Foreign Corporation to be Taxed as Domestic Corporation**

A qualifying foreign corporation can elect to be treated like a domestic corporation regarding any disposition or sale of a

USRPI. Only certain foreign corporations (e.g., a *Sociedad Anónima de Capital Variable*) are eligible to make this election.[16] The foreign corporation must also obtain consents from all of its shareholders to make such an election.

WITHHOLDING REQUIREMENTS UNDER FIRPTA

Upon the sale or other disposition of a USRPI by a foreign person, the transferee (e.g., the buyer) generally must withhold 10 percent of the total amount realized[17] from the sale and not just from the taxable gain. Also, if there is an installment sale over a period of time, the 10 percent withholding requirement is imposed upon the total amount realized at the time of the sale (and not over the term of the payments).[18] A U.S. partnership, estate, or trust that disposes of a USRPI is generally subject to a **35 percent withholding tax to the extent such gain is allocable to a foreign partner or beneficial owner of the entity.[19]

This **35 percent rate applies to non-corporate foreign partners. Foreign corporate partners are also subject to a 35 percent rate. The 2003 Tax Act reduces the current **35 percent withholding tax rates applicable to foreign persons (formerly 38.6 percent in the year 2002).

Foreign corporations must withhold 35 percent of the gain recognized with respect to any distributions of a USRPI to the corporations' shareholders.[20] A qualifying foreign corporation can make an election under Section 897(i) to be taxed as a USRPHC and not be subject to any withholding tax requirement, and instead, be taxed like a domestic corporation.

SPECIAL TAX TREATY PROVISIONS (E.G., U.S./MEXICO TAX TREATY)

Most tax treaties have special provisions relating to the ownership of "immovable property"[21] in the U.S. by a resident of the other treaty country (and vice-a-versa). For instance, the U.S./Mexico Tax Treaty allows the U.S. to tax Mexican residents on their income, profits and gains from U.S. real estate (and vice-a-versa). There is usually no maximum tax rate restriction imposed by a treaty with regard to FIRPTA taxes and tax treaty residents will normally continue to be subject to gains from the sale or disposition of any U.S. real property interests under FIRPTA in the same manner as persons that cannot utilize a U.S. tax treaty. Therefore tax treaties usually have little impact upon the application of FIRPTA, other than defining "immovable property."

However, for foreign corporate owners, the tax treaties (as well as the nondiscriminatory treatment under the Section 897(i) election explained above) sometimes impact the U.S. branch profits tax. For example, the U.S./Mexico Tax Treaty limits the amount of the branch profits tax that can be imposed by the U.S. government on the U.S. profits of a Mexican corporation (e.g., from its U.S. real estate investment enterprises) to a 10 percent (and sometimes as low as 5 percent) tax on the "dividend equivalent amount." This U.S./Mexico Tax Treaty rate is significantly less than the non-treaty branch profits tax rate equal to 30 percent of the dividend equivalent amount of the foreign corporation for the taxable year.

STATE AND LOCAL TAXATION APPLICABLE TO FOREIGN INVESTORS WHO INVEST IN U.S. REAL ESTATE

This overview focuses upon U.S. federal income taxes applicable to foreign investors of U.S. real estate. In addition, States (e.g., California, Arizona, Texas and Florida) commonly impose income taxation along with local (e.g., County and City of San Diego) property taxes that should also be considered. For instance, California tax law requires buyers to withhold 3 1/3 of the total sales price of California real estate owned by non-California persons (including non-U.S. sellers of real estate).[22] California escrow agents also have a duty to inform buyers of this California withholding tax obligation.[23] The withholding tax, like FIRPTA (see below) is not a final tax, but merely a collection mechanism to be used against the final income tax. California individual and corporate tax rates, that may apply, range to as much as 9.4 percent. See the FIRPTA discussion below for a comparative analysis of federal income tax treatment and withholding taxes.

In addition to State income taxation (and the withholding tax mechanisms that may apply), there are typically local property taxes that will apply to a transfer or sale of real estate. In California, for instance, the California Constitution and tax code provides that all property in California that is not free from tax under federal or California law is subject to taxation "in proportion to its value." The maximum *ad valorem* real property tax rate in California is one percent of the "full cash value."[24] Finally, California counties and cities may also apply a local documentary transfer tax on the transfer of real property.[25]

In summary, all foreign investors that are contemplating investing in U.S. real estate should carefully consider and plan the legal structure utilized for this investment. If not carefully planned, a foreign investor can unwittingly expose himself, herself or itself to unnecessary U.S. income tax, gift tax and/or estate tax, especially in light of the complicated U.S. real estate taxation regime of FIRPTA.

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ENDNOTES

1 *For purposes of this discussion, "ownership" will usually refer to most types of real estate interests (e.g., leasehold interests in real estate, direct ownership, corporate ownership, etc.).*

2 *Internal Revenue Code ("I.R.C.") §§ 2103 and 2106.*

3 *I.R.C. § 2001(c).*

4 *I.R.C. § 2104.*

5 *There are special "residency" rules for individuals that apply for income tax purposes. A U.S. resident for tax purposes might not be a U.S. resident for immigration or other legal purposes. Whenever the word U.S. "resident" or "non-resident" or "foreign investor" is used in this presentation, it is only referring to the applicability of the U.S. tax laws - and not immigration laws, or any other legal purposes. The U.S. tax laws define a U.S. tax resident based upon the number of days spent in the U.S., the lawful permanent residency of the individual in the U.S. (i.e., whether they have a "green card"), or based upon an election made by the taxpayer.*

6 *The tax rules relating to U.S. source and effectively connected income from a U.S. trade or business are impacted significantly by tax treaties between the U.S. and other countries. For example, the U.S./Mexico Tax Treaty requires that a Mexican resident usually have a "permanent establishment" in the U.S. before being taxed in the U.S. on its business activities. The U.S./Mexico Tax Treaty, however, does not significantly alter the way Mexican citizens are taxed on their gains from the sale of U.S. real estate (other than the application of the branch profits tax). Not all U.S. Tax Treaties are the same, and therefore each foreign investor should exercise whether there exists an applicable tax treaty within the U.S.*

7 *USRPI also includes any interests in a "U.S. real property holding corporation" ("USRPHC"). A USRPHC is any domestic U.S. corporation that, if at any time during the past five years during which a foreign person held shares of the corporation, its USRPI's fair market value equaled or exceeded 50 percent of the aggregate value of the corporations' (1) USRPIs, (2) its real property located outside the U.S., and (3) its other trade or business assets.*

8 *If 50 percent of a partnership's assets are U.S. real property, or 90 percent or more of its assets are made up of USRPIs, cash, and cash equivalents, then an interest in the partnership attributable to the partnership's USRPIs will be subject to FIRPTA with certain limitations.*

9 *I.R.C. § 897(c).*

10 *Treas. Reg. § 1.897-1(b).*

11 *Treas. Reg. § 1.897-(b)(2).*

12 *Treas. Reg. § 1.897-(b)(3).*

13 *Treas. Reg. § 1.897-(b)(4).*

14 *Qualifying portfolio interest is not subject to U.S. withholding tax.*

15 *Plus, a foreign individual may be subject to the so-called alternative minimum tax (AMT) upon the disposition of the USRPI.*

16 *The foreign corporation must (1) be a USRPHC, (2) hold a USRPI, and (3) must be entitled to nondiscriminatory treatment under a treaty with the U.S. The Mexico/U.S. Tax Treaty will qualify a Mexican corporation (e.g., a Sociedad Anónima de Capital Variable or a Sociedad Anónima) as a qualifying entity for purposes of the election.*

17 *"Realized" is a technical tax term, and generally refers to all consideration paid or received in a transaction. Assume a Mexican resident owns undeveloped real estate in California with a fair market value of $2 million. Assume further, that the real estate has an outstanding mortgage of $1.75 million. If a buyer is willing to pay the Mexican real estate owner $100,000 in cash, promise to pay $150,000 pursuant to a promissory note, and assume the outstanding mortgage of $1.75 million, the total amount "realized" equals $2 million (and not $100,000, the amount of cash received). The Mexican resident who sold the real estate became $2 million richer, because he received (1) $100,000 of cash, (2) a promise purportedly worth $150,000, and (3) was relieved of an outstanding debt of $1.75 million. Assuming the Mexican resident's tax basis in the property was $1.8 million, there would have been a taxable gain under FIRPTA of $200,000 (the amount realized of $2 million less the tax basis of $1.8 million).*

18 *A buyer of a USRPI should be aware of an installment sale where the total 10 percent withholding requirement exceeds the amount of the initial payment upon closing of escrow. The buyer could actually be in a position of paying a greater amount to the government than is actually received by the foreign seller at the time of the sale.*

19 *Treas. Reg. § 1.1445-5(c)(1).*

20 *I.R.C. § 1445(e)(2).*

21 *Article 6 of the U.S./Mexico Tax Treaty defines real property broadly and in reference to the laws of the country in which the real property is located. Therefore, the laws of the U.S. need to be examined to determine exactly what constitutes real property as set forth in Treas. Reg. 1.897-1(b). As was explained above, the federal tax regulations define "real property" for purposes of FIRPTA and not local laws, such as California State law. Notwithstanding the local laws of each country, "immovable property" is defined by the Tax Treaty as including unharvested agriculture and forestry situated in the U.S. or Mexico, and property which is an accessory to immovable property, including equipment used in agriculture and forestry, and rights to mineral deposits and other such natural resources.*

[22] *California Revenue and Taxation Code (R&TC) Section 18662.*

[23] *Id.*

[24] *Cal. Const. Art XIII A, §1(a) and R&TC Sections 93 and 95-100.*

[25] *The amount of the tax is based on the consideration or value of the real property transferred. The county rate is fifty-five cents ($0.55) for each five hundred dollars ($500) of value, and the noncharter city rate is one-half of the county rate and is credited against the county tax due. R&TC § 11911(c). Charter cities may impose transfer taxes at a rate higher than the county rate. Cal. Const. Art. XI, § 5.*