Foreign investments in U.S. real estate, particularly in New York and Miami, have dramatically increased over the past several years and are expected to grow. The foreign interest in real estate holdings has been driven by various factors, including the ever rising prices of real estate in New York, the demise of the Swiss banking system, and unstable economic and political situation in home countries. While foreigners flock to New York and Florida to acquire real estate, very few realize the dire tax and legal consequences of investing into US real estate without proper advance planning.

Frequently, problems arise after the property is sold, or after the property has passed through the estate, and the owner/beneficiary is left with a hefty tax bill. Three major considerations must be taken into account when acquiring U.S. property and devising real estate holding structure – taxation upon disposition of property and repatriation of profits, taxation upon death, and privacy and reporting requirements. The appropriate real estate holding structure heavily depends on the client’s goals, future plans and the underlying reasons for investing in the U.S. real estate. With proper advance planning and advice, many concerns over ownership of U.S. real estate can be reduced or even eliminated altogether.

**INDIVIDUAL DIRECT OWNERSHIP**

A foreign investor may own U.S. real estate directly in his or her own individual name. This is the most primitive and cost-effective form of ownership, yet provides the least long-term benefits and exposes the owner to liability, tax reporting requirements, estate taxes and Foreign Investment in Real Property Tax Act (“FIRPTA”) withholding tax.

- **Privacy:** None
- **Liability:** Personal and Unlimited
- **Estate Taxes:** Federal Estate Tax 35% + State Tax (New York 15-16%); no exemption over $60,000
- **Sales Taxes:** 15 - 20% on gain (10% of sales price FIRPTA withholding tax)
- **Income Taxes:** 30% withholding tax on gross passive income
Individual direct form of ownership is only chosen by a small percentage of foreign investors. If the property is rented out, the owner will have to file a U.S. income tax return reporting the U.S. income. The owner will also be personally liable for any damages that result from that real estate. In addition, investors might be fearful revealing their wealth for security reasons. An investor's individual name as an owner of real property will appear in the public records where that real property is located.

Upon sale of real property, the foreign investor will be subject to FIRPTA withholding tax at the rate of 10% of the total sale price (not on gain realized from sale). FIRPTA tax must be withheld from the purchase price by the buyer and is treated as an advance payment of U.S. taxes. A foreign person must then file the applicable U.S. income tax return to calculate the amount of tax due. The amount withheld is then credited against the total income tax liability. If the property was held for at least one year, preferential capital gains rate of 15% or 20% is applied depending on income, otherwise the sale is be taxed at ordinary income rates (currently up to 40%).

Things become more complicated if the property is rented out and, thus, produces income. Generally, such income is treated as passive investment income and the foreign person is be subject to a flat 30% tax, no deductions are permitted. The worst part is that the payor of the rent is obligated to withhold the 30% tax. If the foreign person owns several properties and performs substantial and regular management activities, the rental income might be treated as income effectively connected to U.S. trade or business and, thus, will be taxes at ordinary income rates (up to 40%), but the foreign person is allowed certain deductions. In certain circumstances, it might be advisable to elect taxation at ordinary income rate to benefit from deductions. The harsh 30% withholding tax may also be mitigated through applicable tax treaties.

Foreign persons are also subject to Federal estate tax on property owned in the U.S. when they die. Thus, if one does choose to own U.S. real estate individually, the foreign individual investor will be subject to an estate tax in the event that investor passes away while owning the U.S. real estate. The current federal estate tax for foreigners is 35% plus the applicable state tax rate, which is now 15-16% in New York. U.S. citizens are given an individual exemption from the tax up to $5 million dollars. However, non-U.S. citizens are not granted the exemption, unless a treaty exists with their country. As a result, property valued above $60,000 is subject to estate tax. With a little careful advance planning, however, it is relatively easy to avoid U.S. estate taxes as discussed in the following sections.

CORPORATE INDIRECT OWNERSHIP

Limited Liability Company

Foreign investors may acquire property in the name of a limited liability company. Limited liability companies are pass-through entities and, thus, the tax consequences are similar to the ones described above. However, the big difference is that the limited liability company provides the investor with limited personal liability for losses related to the real estate investment - individual foreign investor's personal assets are not exposed to the liabilities of the investment. This is often the best vehicle for a smaller investor in U.S. real estate.
Investment in U.S. Real Estate by Foreign Persons

Privacy: Limited; owner’s name does not show up in public records but must file taxes with IRS

Liability: No Personal Liability + Limited (limited to value of property)

Estate Taxes: Federal Estate Tax 35% + State Tax (New York 15–16%), no exemption over $60,000

Sales Taxes: 15 - 20% on gain (10% of sales price FIRPTA withholding tax)

Income Taxes: 30% withholding tax on gross passive income

The limited liability company provides for the best income tax treatment and limited liability for the investor’s wealth. It can also provide the foreign investor with additional privacy protections, as purchasers of property in the U.S. are required to register their ownership with the city and state, and these registries are accessible to the public in online databases. However, the limited liability form of ownership also does not protect the foreign investor from U.S. Federal and State estates taxes upon death.

Since a limited liability company is a pass-through entity, the sales and income tax consequences are essentially the same as if the foreign person owned the property directly.

US Corporation

The use of a U.S. corporation by an individual foreign investor is very limited and, in most cases, not advisable. That is because ownership of a U.S. corporation that owns real estate does not solve any U.S. estate tax problems and shares of stock in a U.S. corporation are also included in the foreign investor’s estate. This structure also creates an extra tax burden for the foreign investor with increased capital gain rates and a second layer of taxation upon repatriation of profits. It does provide the investor with the liability shield and eliminates the need for the individual to file annual U.S. tax return (any person owning more than 50% of the corporation must be disclosed to the U.S. Internal Revenue Service (“IRS”)).

Privacy: Limited; name does not show up in public records but 50% + owner is disclosed to IRS

Liability: No Personal Liability + Limited (limited to value of property)

Estate Taxes: Shares are included in the estate and taxed.

Sales Taxes: No FIRPTA, corporate capital gains rate of 35% + 30% tax rate on dividend distribution

Income Taxes: up to 40% corporate rate + 30% tax rate on repatriation of profits to foreign shareholder

In terms of income taxes, two levels of tax will be imposed on corporation’s operating income – the regular corporate rate of up to 40% and a flat withholding tax of 30% when the profits are repatriated to the foreign shareholder (unless reduced by applicable treaty).

If the property is used as a personal residence, it is not likely to generate income until the property is sold at a gain. Unlike the tax on an individual, which is limited to 15–20%, this tax can be as high as 35% when earned by a corporation. The second level of taxation upon sale can be eliminated when the
property is sold in a fully taxable transaction and the sales proceeds are distributed to the shareholder as a liquidating distribution.

**Foreign Corporation**

As a general rule, it is not a good idea for a foreign investor to use a foreign corporation that will then directly invest in U.S. real estate. This is because foreign corporations that invest in U.S. real estate can be subject not only to U.S. corporate income taxes but also to the branch profits tax of 30% — a second tax on the “deemed” distributions of the corporation’s U.S. income to its shareholders even if the dividend was not distributed.

| Privacy: | Yes |
| Liability: | No personal liability |
| Estate Taxes: | None |
| Sales Taxes: | FIRPTA, unless stock in a foreign corporation is sold instead of the actual asset |
| Income Taxes: | corporate tax rate + 30% branch profit tax (combined effective rate up to 55% or more) |

The branch-profits tax is essentially a double tax on the corporation’s effectively connected income and is aimed at mimicking the double taxation of dividends from U.S. corporations. Thus, the branch-profits tax is an additional tax of 30% (on top of the regular income tax) imposed on the effectively connected earnings and profits of a foreign corporation that are not reinvested in the corporation’s business.

There are no estate taxes because when the foreign investor dies, the foreign investor has only transferred to his or her heirs’ shares in the foreign corporation and there is no direct interest in U.S. real estate. However, the double taxation and branch profit tax, application of FIRPTA withholding rules and high capital gain normally outweigh any advantages this structure.

**US Blocker Structure**

US Blocker structure allows to completely eliminate estate taxes and has the potential to eliminate FIRPTA withholding requirements with proper planning and execution. This structure affords the owner with both asset protection and privacy.

| Privacy: | Yes |
| Liability: | No Personal Liability |
| Estate Taxes: | None |
| Sales Taxes: | corporate capital gains rate of 35%; FIRPTA depends on structuring and holding period |
| Income Taxes: | 34% corporate rate + taxation on shareholder’s level at distribution |
If the foreign investor establishes a foreign corporation that in turn owns 100% of U.S. corporation that owns real estate, the foreign investor will be able to avoid any U.S. estate tax completely since nothing in the U.S. is transferred in the event of the death. FIRPTA withholding requirements can also be avoided when the real estate is sold because the seller of real estate is a domestic entity. If the U.S. corporation is willing to wait a statutorily-required 5-year period after the sale of property, the U.S. corporation can distribute the cash realized from the sale to its foreign shareholder as liquidation proceeds with no tax consequences at all.

The U.S. corporation will, however, be required to pay tax at the regular corporate rates, and repatriation of profits to the foreign shareholder will be subject to flat tax of 30% (unless reduced by an applicable tax treaty). The U.S. corporation will also be subject to high corporate capital gains tax rate when the property of sold.

**Leveraged Blocker**

Leveraged Blocker is the most complex and expensive structure and is only recommended for huge investments in U.S. real estate, involving several investors or a fund. The structure is very similar to US Blocker structure, but, in addition, the foreign person loans part of the investment to the U.S. Corporation, which generates U.S. tax deductions to the corporation. Because the U.S. Corporation can deduct the interest, this lowers the effective U.S. tax rate. This structure requires extensive planning and involves several complex tax provisions dealing with portfolio interest exemption and income stripping rules.

Before making a substantial investment in U.S. real property foreign investors should fully consider the U.S. tax consequences of their investment, including those that arise when the property is sold and proceeds are repatriated. At Feinstein & Partners, we will be glad to consult with you upon request on tax planning and real estate matters, including the topics addressed in this articles.

**ABOUT FEINSTEIN & PARTNERS:**

For over 15 years, we have been providing full legal support to domestic and international clients in connection with their business activities, real estate investments, wealth management and tax planning. Feinstein & Partners was built to serve clients quickly, efficiently and with genuine knowledge of both local and international considerations.

Among our clients are individuals, families, start-ups and established businesses, real estate investors and developers, private funds. With over a decade of experience and a strong professional network, we can get the job done quickly and efficiently, be it devising and implementing a strategy for your business or vigorously defending your rights in any dispute.

Visit us at [www.feinsteinpartners.com](http://www.feinsteinpartners.com)

*This article is provided for your convenience and does not constitute legal advice. The information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.*