# Foreign Nationals in the U.S. Real Estate Market – Know Your Ground

**R. Scott Jones, Esq.***

The luster of the real estate market in the United States shines even more brightly for investors in current market conditions. While the appeal for foreign investors may have leveled off somewhat with the strengthening of the U.S. dollar in the last year against a number of currencies, some brave investors believe that certain markets still look historically attractive.

Indeed, foreign nationals present in the U.S. temporarily may also be attracted by the capital gain exclusion available on real estate eligible to be treated as one's principal residence, that permit owner-occupiers to exclude up to US$500,000 on a married filing joint basis. Even on a revenue basis, the deductibility of mortgage interest and real estate taxes (subject to Alternative Minimum Tax restrictions) is a further compelling reason for some.

It is important for foreign national investors in U.S. real estate to plan carefully, however, in order to avoid a series of tax and legal traps. This article seeks to outline the key planning issues and junctures that the sensible investor should consider depending upon a number of factors. These include the type of asset, who it is intended for, the period of planned ownership, the financing arrangements, the intent of the investor himself as to his own residence position, and the intended usage of the real estate.

There is a lot to think about!

## The Purchase

The process for the foreign investor starts early and is informed by a number of estate and gift tax considerations that do not apply to domestic purchasers. The standard form approach of real estate purchase contracts for individual and joint purchase of real estate can be a trap-in-waiting. Ideally, professional advice should be sought well in advance of any transaction. In the real world, however, this often does not happen!

At minimum, at the initial contract stage, it is important to modify the language to build maximum flexibility as to the ultimate owner and the form of title at closing, as this may have an impact on various tax considerations.

So, what are the issues?

### ***Definitions***

First, there is an important distinction to be made.

The tax traps associated with the purchase of U.S. real estate may impact nonresidents for estate and gift tax purposes and/or those nonresident for income tax purposes. These are not the same. It is very common for an individual to be regarded as resident for income tax purposes (based on days physically present in the United States, for example) although still considered non-resident (aka "non-domiciled") for estate and gift tax purposes. The domicile notion is indicative not of physical presence but where one intends one's permanent home to be (i.e., in this case, outside the United States).

***Taxable Value***

Now for the sticker-shock, since there is really no other way to describe it in certain instances.

The taxable value of assets held by an estate tax non-resident at death can seem surprisingly high to the ill-informed. Such a non-resident is subject to tax on all U.S. "situs" assets, absent any exclusions that may be available under a relevant Estate Tax Treaty that the deceased taxpayer's home country may have with the United States.

The exemption amount available to such a taxpayer for estate tax purposes is a mere $60,000 at the federal level, with no legislative plans to increase the amount. Compare this to the $3.5m available to the U.S. Citizen or other resident for estate tax purposes!

The issue is compounded by the tax rates applicable to taxable assets. The excess over $60,000 in taxable assets (i.e. after the exclusion) is taxed on a progressive scale from 26-45%. This is in addition to any State taxes that may be applicable.

Real estate investments are not the only U.S. assets subject to U.S. estate taxes. Equity investments in U.S. corporations and U.S. mutual and pension funds are also typically included. In some cases, Estate & Gift Tax Treaties can assist in reducing or eliminating exposure to tax on such investments. However, important to note is that there are less than twenty such Estate and Gift Tax Treaties (unlike the 65 plus Income Tax Treaties) and despite such Treaties, U.S. real estate investments often remain exposed to U.S. estate tax.

As if to compound the problem, recourse mortgages on such real estate are also generally not fully deductible against the value of the asset in determining the net taxable estate. Estates of non-residents are allowed a deduction for recourse debts only to the extent of the ratio of U.S. assets to worldwide assets (which, in turn, requires disclosure of worldwide assets to the IRS for such determination). A non-recourse mortgage (one in which the mortgage liability attaches only to the asset) may, if available, avoid this issue of apportionment and be fully offset against the value of the property.

***Exemptions – Or Not***

Holding real estate jointly with a nonresident spouse can generate further issues. The general rule that property owned jointly with a right of survivorship between spouses will be included at one-half its value in the estate of the first spouse to die does not apply if the surviving spouse of the decedent is not a U.S. citizen.

Instead, the taxable value of such property is includable in the first decedent's estate in full except to the extent the executor can substantiate the contributions of the non-citizen surviving spouse to the acquisition of the property. Thus, jointly owned U.S. situs property will be fully included in the gross estate of a nonresident who provided the funds to acquire the property. Attention should also be paid to the presumptive rules applicable to individual States as to whether jointly held property is deemed to be held jointly versus as tenancy-in-common (absent express indication to the contrary).

There is typically no escape from estate taxation via a transfer between spouses as there is no marital deduction for transfers to a non-U.S. citizen spouse. In fact, these rules apply whether the decedent spouse bequeathing the assets is a foreign national or a U.S. citizen. The rationale for the tax authorities is that, absent these rules, the estate tax deferred assets transferred to a non-U.S. citizen will leave the U.S. tax net, never to be recaptured. This rule can be alleviated with the inter-vivos or posthumous creation of a Qualified Domestic Trust (QDOT), but unlike a "standard" marital trust, may only serve to achieve deferral of tax due on the death of the first spouse.

Moreover, the traps-in-waiting may begin earlier still. Initial funding of a U.S. real estate purchase may be a gift tax issue in certain circumstances. For example, take the case where a non-resident parent funds the purchase of U.S. real estate for a similarly estate tax non-resident child at college in the United States. Not only is there (albeit slight) estate tax exposure if the child owns the property, but the initial gift itself, if from U.S. sources and not planned properly, may also trigger gift tax beforehand.

While certain classes of assets, such as U.S. equities, are exempt from gift tax per se if given by nonresident donors, U.S. citizens and residents are eligible for a $1m lifetime exclusion that does not apply to nonresidents. Nonresidents are eligible for the "standard" annual exclusion amount of $13,000 per donee, but a nonresident for estate tax purposes cannot split gifts with a spouse in order to effectively double this exclusion. Both residents and non-residents are also limited to an annual exclusion amount of $133,000 on gifts to non-U.S. citizen spouses before tax applies, unlike the unlimited spousal transfer exemption that applies to transfers to U.S. Citizens. Gift tax rates are the same as those applicable to estate taxes.

***Probate Issues***

Real estate held directly by the decedent foreign national also raises the prospect of requiring a probate proceeding in order to convey title to beneficiaries upon death. Such

an ancillary proceeding in the United States aside from original probate in the home country may also be undesirable to the non-resident on a number of counts.

***Strategies***

Gift tax and estate tax rules do not completely coincide and, indeed, can present certain planning opportunities as a result. The key, however, is to develop a program, if possible that reflects both gift and estate tax concerns and which is consistent with the immediate and longer term objectives of the nonresident taxpayer.

While an in-depth review is beyond the scope of this article, certain strategies to eliminate non-resident estate tax and probate concerns, such as the purchase of U.S. assets through an offshore corporation or trust structure, may be possible. However, nothing is ever that straightforward! Such techniques can also carry the disadvantage of higher establishment and maintenance fees in addition to the loss of certain income tax benefits (such as the long term capital gains rate of 15%) available if the property is held personally. As such, in order to plan effectively, a trade-off analysis is invariably required.

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In summary, the estate and gift tax regime applicable to non-residents and other non-U.S. Citizens is fraught with potential traps and decision-points.

As the acting attorney handling nonresident estates, I can attest to the fact that the combination of high taxable values and the considerable rates of tax come as a very unpleasant surprise to beneficiaries of a nonresident estate with U.S. assets.

Understanding these issues is a salutary reminder of the need for effective advance planning in order to avoid their effects.

**The Income-Producer**

Clearly, investors purchasing U.S. real estate with a view to generating rental income need to understand the income tax landscape also.

If such an asset generates income, it is considered U.S. source under U.S. tax principles based upon the location of the asset. If the owner-recipient is non-resident for *income tax* purposes (i.e. a non-immigrant visa holder spending less time in the U.S. than required to be considered income tax resident), such U.S. source rental income is subject to U.S. income tax.

The question as to how this income is taxed, however, is dependent upon whether the income is to be considered generated in a U.S. trade or business.

Net lease arrangements wherein a tenant pays rent plus handles all expenses on the property and mortgage interest and real estate expenses is not trade or business income. As such, the taxpayer is taxed at a flat rate of 30% on gross income (i.e. with no deduction for expenses) unless the amount considered taxable, or the rate of tax, are eligible for reduction by any applicable Income Tax Treaty.

If the taxpayer is significantly more actively involved in managing the property as a business concern, possibly with multiple properties, such income may be properly regarded as trade or business income not subject to this flat rate of withholding and also eligible for offset of expenses associated with the production of this income.

However, provided a timely election is made on a U.S. income tax return filing, the Internal Revenue Code permits nonresidents for income taxpayers to elect to treat rental income as derived from a U.S. trade or business and, therefore, not subject to flat rate withholding. This applies even in a net lease situation.

The two key points to understand in this context are that, firstly, particular procedures need to be followed in order to avoid the tax withholding, and secondly, – although no less importantly – that only by filing a U.S. tax return may the nonresident taxpayer make the appropriate tax election to be taxed on a net basis.

## The Exit

So, what else do we need to know?

As is true for many things in life, getting in seems much more straightforward than getting out!

And so it is true for U.S. real estate being sold by foreign nationals who are subject to an automatic withholding of 10% federal tax on gross proceeds at closing.**

Such sellers must complete certain IRS Forms at the time of the sale and also require a Taxpayer Identification Number in order to file the Forms. An application may be made for the tax to be reduced or eliminated, but often this can present a timing issue and, on occasion, even a cash-flow problem. Specialist guidance should be sought well in advance of a contemplated sale in order to avoid, or at least alleviate these issues.

## Conclusion

The life cycle of real estate for the foreign investor is fraught with potential traps that need to be carefully navigated. Proper advance planning from a qualified professional familiar with these issues could be the best investment you make to avoid a series of problems down the line.

** Refer to my article "Foreign Investment in Real Property Tax Act 1980 – Buyer AND Seller Beware" at www.goldsteinjones.com

* R. Scott Jones, Esq. is a partner with New York law firm Goldstein Jones LLP.
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