

**US Taxation of Foreign Investment in US Real Estate**

Investment in US real estate by foreign investors requires careful planning to avoid tax and legal surprises upon the sale or operation of the property. A good tax and legal plan can not only avoid these surprises but also protect the investment and improve the return on investment.

This paper explains the U.S. tax laws and regulations applicable to a foreign person who is considering investing in U.S. real estate.

*I. INDIVIDUALS AND US TAXATION*

First, a foreign investor will only be taxed in the US if he/she is classified as a US tax resident or has US source income. Generally, the U.S. the classifies individuals in the following categories; (1) citizens, (2) residents, and (3) non residents. IRC section 61 provides that U.S. citizens and residents pay taxes on their worldwide income, i.e., income is taxable regardless of the source or country of origin. In the case of nonresidents the U.S. taxes income that is U.S. sourced or effectively connected to a U.S. trade or business. IRC section 871, 872, & 877. Thus, a foreign investor will only be taxable in the U.S. if he/she is 1) classified a U.S. Tax resident or 2) has U.S. source income in the U.S..

*II. U.S. TAX RESIDENT -DEFINED*

A foreign investor will be considered to be a tax resident of the United States if the individual meets any one of three tests: (1) lawful permanent admission to the United States (i.e., "green card" test); (2) "substantial presence" in the United States, or; (3) a first year election to be treated as a resident. I.R.C. 7701(b)(1)(A).

An individual becomes a lawful permanent resident of the United States in accordance with U.S. immigration laws. Once permanent resident is obtained, an individual remains a lawful permanent resident until the status is revoked or abandoned.

*III. SUBSTANTIAL PRESENCE TEST*

A foreign investor will have substantial presence if he satisfies the criteria of I.R.C. 7701 (b). An individual meets this test if the individual is present in the United States for at least 31 days during the current year and at least 183 days for the three-year period ending on the last day of the current year using a weighted average. I.R.C. 7701(b)(3). The weighted average formula works as follows: days present in the current year are multiplied by 1; days in the immediate preceding year are multiplied by 1/3; days in the next preceding year are multiplied by 1/6 For example, suppose an individual is present in the United States for 120 days in the current year and in each of the two preceding years. The individual does not satisfy the substantial presence test because the weighted average is only 180 days ((120 x 1) + (120 x 1/3)+ (120 x 1/6)). If the individual were present in the United States 122 days each year, the individual would exactly meet the 183 day weighted average ((122 x 1) + (122 x 1/3) + (122x1/6)) and would be considered a U.S. resident.

Even if a foreign individual satisfies the substantial presence test, the foreign individual is not a resident if the individual is present in the United States for fewer than 183 days during the current year and has a tax home in a foreign country to which the individual has a closer connection than to the United States . I.R.C. 7701(b)(3)(B). For this purpose, a tax home is considered to be located at a taxpayer's regular or principal place of business or if the taxpayer has no regular or principal place of business at his regular place of abode, or a treaty exception applies, discussed below. I.R.C. 911 (d)(3); Reg. 1.911-2(b).

*IV. ENTITIES AND US TAXATION*

The residency test for entities is much simpler than the test for individuals. An entity is deemed to be a U.S. taxpayer if it was formed or organized in the U.S. regardless of its place of business or location of its capital or property. A U.S. entity is always taxable on its worldwide income if it is created or organized in the United States. I.R.C. 7701 (a)(3),(4). A foreign entity (i.e., a corporation not created or organized in the United States) is taxable in the U.S. under I.R.C. 881 and 882 only if it has income effectively connected with the conduct of a trade or business in the United States or on specified U.S. investment income. I.R.C. 7701 (a)(5). Thus, the foreign corporation will not be deemed to be US residents or regular taxpayer, unless they have US source income or a permanent establishment, discussed below.

*V. CHECK THE BOX RULES*

Generally, there are three types of entities for U.S. purposes, 1) C corporations which are taxable entities, 2) partnership and S corporations which are flow through entities., the income, expenses, and losses flow through to the owners and they report the income and pay the tax due, and 3) transparent entities which simply do not exist for U.S. tax purposes and have no reporting requirements, instead the owner of the entity reports and pays the taxes on the income. Certain types of entities may elect their classification for U.S. tax purposes under the check the box rules, see discussion below.

Generally, the check the box rules provide for two tax regimes in the U.S. (1) taxable entities which report and pay taxes on their income and (2) flow through or transparent entities, which do not pay taxes on their income instead it flows through to the owners/shareholders/members. These rules are known as the “check-the-box" regulations and they govern the classification of an entity for U.S. tax purposes.

*VI. TAX TREATY EXCEPTIONS*

If a foreign investor is treated as a U.S. resident under Section 7701(b) and is also treated, pursuant to a U.S. treaty with a foreign country, as a resident of that foreign country, the rules on residency provided in the treaty apply for treaty purposes. If an alien individual is determined to be a resident of the foreign country for treaty purposes, and an the individual claims a treaty benefit (as a nonresident of the United States) so as to reduce U.S. income tax liability with respect to any income item covered by the treaty, the individual is treated as a nonresident alien of the United States for purposes of computing U.S. income tax liability under the code and the regulations with respect to the taxable year. This treatment applies, however, only to an alien individual who is treated as a resident of a treaty country pursuant to provision of a treaty that provides for resolution of conflicting claims of residence by the United States and the foreign treaty country (a so-called tie breaker provision). Such an individual is treated as a U.S. resident for all purposes of the code other than the computation of such individual's U.S. income tax liability.

A foreign investor may be able to avoid the US taxation by invoking a U.S. Tax Treaty, if he qualifies for the treaty. The treaty usually provides that a foreign person that is considered a tax resident of both countries pursuant to the internal laws of each country may invoke the benefits of the treaty and choose to be treated as a nonresident. Specifically, the treaty provides that the residency of the person shall be determined as follows:

a). He shall be deemed to be resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both contracting States, he shall be deemed to be a resident of the States with which his personal and economic relations are closer (center of vital interest);

b). If the State in which he has his center of vital interests cannot be determined, or if he does not have a permanent home available to him in either State, he shall be deemed to be resident of the State in which he has an habitual abode;

c). If he has an habitual abode in both States or in neither, he shall be deemed to be resident of which he is a national;

d). In any other case, the competent authorities of the Contracting States shall settle the question by mutual agreement.

In the case of a foreign entity it is taxable in the US only if it has 1) US source that income that is specifically taxed according to the tax treaty, usually passive type income ( dividends, interests, royalties, etc.) and 2) business or commercial type income if the foreign entity has a permanent establishment in that State. A permanent establishment is defined in Article 5 as follows:

*Permanent Establishment*

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on

2. The term "permanent establishment" includes, especially a) a place of management

b) a branch c) an office d) a Factory

e) a workshop; and

f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources

g) The term "permanent establishment" shall also include a building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, or supervisory activity in connection therewith, but only if such building site, construction or activity lasts more than six months

*VIII. REAL ESTATE AND US TAXATION*

The US taxation of real estate owned by foreign investors is governed by a special set of rules known as FIRPTA provided under IRC section 897. Generally, the gains from the sale of US real estate are taxed under the regular US tax rules and there are no exceptions under the tax treaty or the Internal Revenue Code for foreign investors. On the contrary they are subject to stricter withholding rules and taxation. Furthermore, US real estate is defined not only as real estate property but also interest/stock in entities that own substantial amounts of real estate, i.e. more than 50%.

In accordance with Article 6 of the US Tax Treaty real estate is taxable in the State in which the real estate is located as follows:

*Income from Immovable Property (Real Property)*

1. Income derived by a resident of a Contracting State from immovable property (real property), including income from agriculture or forestry, situated in the other Contracting State may be taxed in that other State.

2. The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Ships, boats, aircraft, and containers shall not be regarded as immovable property

3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of immovable property

4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services

5. A resident of a Contracting State who is liable to tax in the other Contracting State on income from real property situated in the other Contracting State may elect for any taxable year to compute the tax on such income on a net basis as if such income were attributable to a permanent establishment in such other State. Any such election shall be binding for the taxable year of the election and all subsequent taxable years unless the competent authority of the Contracting State in which the immovable property is situated agrees to terminate the election.

In general, FIRPTA requires that upon the sale of US real estate by a foreign person that a withholding of 15% of the gross proceeds be imposed at the time of sale, regardless if any gain or loss. The withholding is provisional and it is credited against the final tax liability. The final tax liability is determined at the end of the year with the tax return and the regular tax rates are applied depending if the seller is an individual or corporation. In the case of an individual the rates depend if the gain is regular gains or capital gains. The regular rates for individuals are progressive and start at 10% to 37 %, if the gains qualify for long term capital gains the rate is between 20 to 25%. In the case of a corporation there are no capital gains rates and rates is a flat 21%. An important decision to be made is whether to invest as an individual or a corporation for tax purposes because of the rate differential.

*IX. REAL ESTATE AND THE ESTATE TAX*

Another potential tax the foreign investors may be subject to is the US estate or inheritance tax. The U.S. estate tax applies to the transfer of property at death of an individual, whether he/she is a US citizen, resident or nonresident. In general, the U.S. estate tax applies to the amount of property that the decedent owned or was deemed to own at death, regardless of any relationship between the decedent and those who are entitled to the property by virtue of decedent’s death.

To ascertain the applicable estate tax, it is necessary first to determine which property is subject to the tax (the “gross estate”). For U.S. citizens and resident aliens, all property wherever located is included in the gross estate. I.R.C. § 2031. A non-resident alien is subject to U.S. estate tax only with respect to property deemed situated in the United States at death I.R.C. § 2103. Once a decedent’s gross estate is determined, a variety of deductions are allowed in arriving at a decedent’s taxable estate. I.R.C. § 2051. Next, the applicable tax rate is applied to a decedent’s taxable estate. I.R.C. § 2001. Finally, any applicable tax credits offset a decedent’s U.S. estate tax liability dollar-for-dollar.

An individual can be a resident for income tax purposes and not for estate and gift tax purposes and vice versa. The definition of residency for estate tax purposes depends heavily on an individual’s subjective intent. One important factor is the nature of an alien’s U.S. home.

The nature and type of accommodations offers a good indication of an individual’s attitude towards the area. Among the factors considered important are: whether the location of the home is in a residential or resort area; the size and value of the home; whether the home is owned or rented; other personal ties including club membership, location of important personal possessions, and a chosen burial site. Residency listed on passports and other sworn statements of intent made on visa applications or similar documents has a presumptive value in determining residency for estate and gift tax purposes. An individual’s business connections to a particular location are a factor to be considered. Because an individual’s subjective intent determines residency, mere absence from a fixed home, however long, does not cause a change of domicile.

In general, the US estate tax is imposed on individuals and not entities, thus a common way for individuals to avoid or defer the tax is to invest through legal entities such as trust, corporations or other legal entities.

*Please let me know if you have any questions on these matters.*

*Sincerely,*

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