considerations when investing in the US

Foreign investors in U.S. real estate projects need to be cognizant of both U.S. income and estate tax rules when structuring their investments. This article highlights some items for foreign investors to consider when making U.S. real property investments.

Income Tax Considerations

Generally, foreign investors that realize capital gains from the sale of U.S. assets are not subject to U.S. income tax on any gain realized, unless the property sold consists of U.S. real estate, or a domestic entity that owns predominantly U.S. real estate. Although the detailed rules surrounding the taxation of real estate-related gains are beyond the scope of this article, it is important to note that gains realized on the sale of U.S. real property interests by foreign sellers are subject to U.S. income tax as though such gains were effectively connected to a U.S. trade or business.

Gains from the sale of investments held for more than one year are subject to a maximum federal capital gains rate of 20 percent, if realized by a non-resident individual. Gains on property held for less than one year can be as high as 37 percent for non-resident individuals.

The federal tax rate for corporate profits has been reduced from 35 percent to 21 percent under the Tax Cut and Jobs act of 2017 (“TCJA”). This is a flat rate and applies to all levels of profit and types of income.

Due to the reduced rate disparity between individual long-term capital gain taxation (20 percent) and corporate taxation (21 percent) enacted by the TCJA, individual investors have become more apt to invest in U.S. real estate using a non-U.S. corporation.

Estate Tax Considerations

Investing through a foreign corporate vehicle provides the foreign investor with U.S. estate tax protection, and the individual is insulated from have to file a U.S. income tax return, for example in the event that the property is rented or income-producing.

U.S. estate tax can be as high as 40 percent and is imposed on non-U.S. decedents that own U.S. situs assets at the time of death. U.S. situs assets generally include property (real and personal) located in the U.S., as well as shares in domestic entities. Non-resident decedents are allowed an exemption of $60,000 against their total U.S. estate tax value in computing their U.S. estate tax liability. This compares to U.S. resident decedents, who are allowed an exemption of $5.4M each. The exemption amount is often modified by treaty. For example, in the case of Canada and Germany, the U.S. estate tax exemption may be greater than $60,000 depending on the decedent’s U.S. situs assets compared with worldwide situs assets.

Due to the U.S. estate tax concerns discussed above, non-U.S. individuals commonly own U.S. property through non-U.S. corporations. In the event that the corporation’s shareholder personally uses the property while in the U.S. (for example, as a vacation home), the shareholder should be careful to maintain a fair market value lease between

himself/herself and the corporation. The absence of a properly executed lease arrangement has caused the U.S. tax administration ("Internal Revenue Service" or "IRS") to impose, on a corporation's shareholder, a deemed dividend equal to the annual fair rental value of the property, to the extent that the property is used by the shareholder personally. This deemed dividend is then subject to U.S. withholding tax.

In a separate case, the absence of a fair value lease arrangement between a corporate property owner and its shareholder (for property used by the shareholder extensively), caused the IRS to ignore the existence of the corporation for purposes of imposing U.S. estate tax on the shareholder upon the shareholder's demise. The existence of a corporation can be ignored for U.S. tax purposes if the corporation simply owns title to the property but no other indicia of ownership exists, or none is properly documented (for example, there is no lease agreement or property expenses are not paid using a corporate bank account), causing the line between corporate and shareholder ownership to become blurred.

Conclusion

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In conclusion, it is important for foreign investors in U.S. real property to be mindful of both income and estate tax considerations when structuring the property's acquisition.

In the event that U.S. property will be used personally and is owned by a separate entity, it is important that a lease agreement be executed and that the lease rate consider the fair rental value of the property to avoid any unwanted income or estate tax consequences. Care should be taken to ensure that lease payments are made to the corporation by its shareholders and that property expenses are borne by the corporation itself. These details are often overlooked by purchasers of U.S. property, but should be "top-of-mind" once the property is acquired.

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