Bloomberg Tax

Tax Management
Real Estate Journal™

The 2017 Tax Act and U.S. Real Estate: The Foreign Investor and Unusually Low Tax Rates

By Richard S. Lehman, Esq.[*]

INTRODUCTION

The boom in U.S. real estate caused by foreign investors is about to get bigger as a result of greatly reduced U.S. income taxes for nonresident aliens and foreign corporations.[1]

Because of the new 2017 tax act,[2] foreign investors could receive a 40% reduction in the U.S. income tax of their gains and income from their real estate investments. For those foreign investors who already were invested in U.S. real estate, their after-tax returns could now be 40% more valuable without their raising a finger.[3]

Tax rates on U.S. real estate income were lowered to 21% for corporations, both foreign and domestic.[4] With U.S. home inventories low, a world in turmoil, and many countries around the world continuing to charge high tax rates, the flow of foreign investment to real estate in the United States will only increase as a result of the 2017 tax act.

Furthermore, not only has the after-tax income of real estate investments gone up for the foreign investor, the investment structure has become simpler.

This article will focus on:

- investment structures that will be helpful to large, medium, and small investors;
- the simplicity of the new requirements; and
- the extraordinary tools available to the foreign investor that can reduce the foreign investor's tax burden to an even lower rate than those enjoyed by the American taxpayer.

The 2017 tax act not only reduces the tax rate on real estate profits, it decreases the amount of income that will be taxed annually in the early years by decreasing the time in which deductions can be taken in calculating taxable income. The long and the short of this is that with a little tax planning, the foreign investor should be able to earn ordinary annual income from the rental of U.S. real estate at a tax cost of approximately 15% and from the sale of U.S. real estate at a tax cost in the 21% range.

DEPRECIATION DEDUCTIONS AND INTEREST DEDUCTIONS

Depreciation Deductions

The tax deductions that allow investors to reduce their current taxable income on real estate, such as de-

---

[*] Mr. Lehman founded Lehman Tax Law in Boca Raton, Florida, after spending several years as the senior attorney of the Interpretive Division of the Chief Counsel's office at the Internal Revenue Service. Mr. Lehman has been in the private practice of law in South Florida for more than 40 years, with extensive experience with all areas of the Internal Revenue Code that apply to American taxpayers and non-resident aliens and foreign corporations investing or conducting business in the United States, as well as U.S. citizens and domestic corporations investing abroad.

[1] Like American investors, prior to the 2017 tax act, foreign investors paid a tax on real estate profits of 35% for profits in excess of $75,000 when investing through a corporation. Foreign individual investors were forced to pay even higher rates prior to the 2017 tax act, with individual income tax rates as high as 39.6%.

[2] Pub. L. No. 115-97.

[3] This boom in real estate may lead to a scarcity of available property in states that have a low state income tax. U.S. citizens and tax residents in cities and states with high property taxes and high state and city income taxes starting in 2018 will not be able to deduct more than $10,000 in calculating their U.S. tax. In essence, there will be a "double tax" on state and city income tax and property taxes. This may start a mini-migration of the wealthy to states like Florida, Texas, Nevada, and other states with low city, state, and property taxes.

[4] §1(j)(2), as added by the 2017 tax act, §11001(a)(1); §11(b), as amended by the 2017 tax act, §13001(a). All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise specified.

preciation, have been accelerated so that certain components of the tangible personal property related to the building structure may be deducted at a more accelerated pace than under prior law.[5]

Interest Expense Deductions

Generally, under the new law, business interest expenses are limited to 30% of the adjusted taxable income of the taxpayer as an annual deduction, for businesses with annual gross receipts in excess of $25 million.

The amount of business interest not allowed as a deduction for any taxable year may be carried forward indefinitely and utilized in future years, subject to this and other applicable interest deductibility limitations and restrictions.[6]

Taxpayers investing in real property may elect to avoid this limitation on deductible interest.

A real property trade or business that elects to be excluded from the interest deductibility limitations will utilize an alternative depreciation system with respect to its depreciable real property. Under the alternative depreciation system, the recovery periods for nonresidential depreciable real property, residential depreciable real property, and qualified improvements are 40 years, 30 years, and 20 years, respectively.[7]

THE LARGE INVESTOR

The large foreign investor's investments may often be more complicated either because of the size and value of a single investment or because many separate investments are made.

For complex or multiple acquisitions, the suggested structure requires the foreign investor to establish a foreign corporation in a jurisdiction outside of the United States. The foreign corporation can be established as a ''holding company.''

This ''holding company'' can establish several U.S. corporations as 100%-owned subsidiaries of the holding company. Each U.S. corporate subsidiary may then invest directly and separately in one or more separate real estate transactions. The U.S. corporate subsidiary will be the only entity that pays a 21% tax. While this structure is complex, it permits the foreign investor the best of all worlds, ensuring that there are no U.S. estate taxes and also allowing for lower income tax rates.[8] The foreign investor will own only shares in a foreign corporation; the transfer of such shares are not subject to the U.S. estate and gift taxes.

U.S. Estate Taxes

Foreign investors in the United States must focus not only on the U.S. income tax; they must also be aware of the U.S. estate tax, which is imposed if a nonresident alien individual dies while owning U.S. real estate. There is also a gift tax imposed on the nonresident alien individual who transfers U.S. real estate as a gift.

The United States charges an estate tax on a foreign investor who owns real estate in the United States directly or through a U.S. corporation, partnership, and certain U.S. trusts. The gift tax will also be assessed on individuals in limited liability companies. This estate and/or gift tax is particularly onerous for foreign investors. While Americans may die owning $11 million worth of assets without paying this tax, this is not the case for nonresident alien individuals who will be subject to the estate tax on real estate owned directly by the individual.

This estate tax imposed at death will tax the nonresident alien on any real estate that is individually owned or if the real estate is owned by a U.S. corporation that is owned directly by the foreign investor.

This is an expensive tax that increases in percentage as the value of the real estate increases. This tax can quickly expand to a tax of 40% on the value of all real estate valued at more than $60,000.[9]

The Sale of the U.S. Real Estate — Liquidation of the Corporate Entity

Ultimately, in a successful real estate venture in the United States, there will be a certain amount of U.S. taxes that must be paid on the taxable profits from the sale of the venture. However, when the time for sale comes, the tax payment should not be onerous. The foreign (or U.S.) corporation that will own the U.S. real estate will be subject to a U.S. tax of 21% of the gain resulting from the sale.[10]

A nonresident alien individual, or corporate shareholders in a U.S. or foreign corporation that has prof-

[5] §179(b), §179(f), as amended by the 2017 tax act, §13101, §168(e)(2), §467.

[6] §163(j), as amended by the 2017 tax act, §13301(a).

[7] §163.

[8] §2103, §2106.

[9] §2102.

[10] Dividends distributed to a foreign shareholder are taxable to the extent of earnings and profits. Care must be taken to prevent unnecessary cash distributions that fit this situation. Gain on the sale of real estate is calculated by subtracting from the ultimate sale price the cost or the ''basis'' of the owner in the property being sold. This basis is calculated by subtracting the depreciation deductions claimed over the years from the cost of the assets increased by any improvements. §871(a)(1)(A), §881(a)(1).

ISSN 8755-0628

ited from real estate and paid all of the taxes due to the United States on gain from the sale, will not pay any additional corporate or individual tax on gain as a result of a technique of liquidating the U.S. corporation after it has paid the income taxes or capital gains taxes under the U.S. tax laws. Put simply, a foreign real estate investor will not be subject to an individual tax on the gain from the sale of the U.S. corporate shares that result from the liquidation of the corporation.[11]

The U.S. Capital Gains Tax on Sale

U.S. corporations may be liquidated upon the sale of the U.S. real estate asset and there will be a single tax on the gain earned by the liquidating U.S. corporation at only 21%, with no additional U.S. taxes.

In addition to ensuring a single U.S. income tax at lower rates and no estate and gift taxes, there will be no exposure whatsoever to the U.S. ''branch tax,'' discussed below.

Furthermore, in those instances where a U.S. subsidiary of a foreign corporation may hold assets that have not appreciated, the same tax-free liquidation permitted to the foreign corporate holding company will be available. So long as a foreign corporate holding company (by virtue of liquidating its domestic subsidiary) is not receiving an appreciated asset, the liquidation will not result in taxation on the foreign corporation because there is no gain to be realized or recognized as a result of the domestic corporation's liquidation.

THE MIDDLE-SIZED INVESTOR

The middle-sized investor may very well wish to structure his or her investment like the large investor. That is, by using both a foreign corporate holding company and a U.S. subsidiary corporation to own the U.S. real estate.[12]

The individual foreign investor who owns a foreign corporation, which directly owns the real estate investment, will pay no estate tax whatsoever upon his or her death. This is because ownership of shares in a foreign corporation is not direct ownership of the real estate asset. A nonresident alien investor who owns shares in a foreign corporation has no direct interest in the U.S. asset and consequently no exposure to the estate or gift tax. There is, however, an unusual tax that is applied to a foreign corporation that directly owns U.S. real estate and does not distribute profits to its investors. This tax is known as the ''branch tax.'' However, by liquidating a foreign corporation once all of the real estate assets have either been sold, or in the event the real estate assets are not subject to any gain, the branch tax can be avoided.

Beware of the Branch Tax: Investment in U.S. real estate through a foreign corporation that does not use a U.S. subsidiary corporation can be problematic because of the ''branch tax.''[13] Unknowing investors may be subject to this tax when they invest in the United States directly through a foreign corporation. However, there are multiple solutions to avoid the branch tax and few, if any, taxpayers in the real estate field have paid this additional tax. This tax is asserted when a foreign corporation accumulates undistributed cash that is not being used for reinvestment in U.S. assets.

A branch tax can often be eliminated by the appropriate capital structure of a foreign corporation that is conducting business in the United States. So long as accumulated cash earnings are paid in the form of interest on a loan to the foreign corporation, or a repayment of the principal of the loan, accumulated cash can be distributed. The payment of interest income to third-party lenders or the actual investor will drain the cash profits and earnings of a foreign corporation and reduce cash in the foreign corporation that may be subject to the branch tax. However, care must be taken to ensure that such loans meet a certain standard.

THE SMALL INVESTOR

In the event the foreign investor is investing cash in a smaller piece of real estate that requires an investment of less than $250,000, there typically is no need for a more complicated structure than the limited liability company structure. This $250,000 number is arbitrary. There is a $60,000 exclusion for the estate tax and the balance of the estate taxes on the remaining amount is paid at a relatively low rate.[14] These companies will be advantageous because the 2017 tax act permits these types of holdings to reduce their ac-

[11] §897.

[12] The United States has numerous tax treaties with jurisdictions around the world. These tax treaties will continue to have effect, though there will undoubtedly need to be changes based upon the 2017 tax act. Investors from treaty countries will typically have an income tax treaty. However, there are very few estate tax treaties between the United States and foreign jurisdictions. The income tax treaties, at times, may produce even better tax results for the foreign investor, depending upon circumstances.

There are also several jurisdictions around the world that lend themselves and their corporate entities to this form of tax planning even without a tax treaty with the United States. Nonresident alien individuals may form a corporation in any one of many countries. These countries typically will not tax corporations formed in that country unless the income being earned or the assets being held have a situs in that country of incorporation.

[13] §884.

[14] §2101.

ISSN 8755-0628

tual taxable income. Instead of charging a 21% tax rate that is available for corporations, the 2017 tax act permits the limited liability company or the individual foreign investor a deduction equal to 20% of the amount of taxable income in calculating taxes.[15] Thus, the tax on U.S. taxable income for purposes of the U.S. income tax on real estate owned by an LLC is a tax on only 80% of the actual earnings. This deduction is subject to certain maximum amounts of income.

There may be a minimum benefit by individuals investing in U.S. real estate or through limited liability companies from an income tax standpoint if the income earned is not significant. There may be the benefit of a lower tax rate and the 20% deduction from earnings. However, this benefit may be far outweighed by the use of the foreign corporate structure, which does not expose a nonresident alien investor to U.S. estate taxes and gift taxes at all.

THE PORTFOLIO INTEREST DEDUCTION

Generally, the benefits of the 2017 tax act are available to the American investor and the foreign real estate investor. However, there is another tax planning tool that has been in the law for a long time and to which the American real estate investor has no access. It is, however, available under the right circumstances to the foreign investor. This is the tax planning tool known as the ''portfolio interest deduction.''[16]

The foreign investor has the advantage of the new lower tax rate of the 2017 tax act and the new accelerated depreciation tax deductions. In addition, subject to certain limitations, foreign investors will be able to finance their U.S. real estate with their own funds that may be invested in U.S. real estate in the form of a loan so long as the foreign investor owns, directly or indirectly, less than 10% of the real estate project. Under the right circumstances, the foreign investor may enjoy tax-free interest income that will be paid on loans that are made by the investor.[17]

Under the right circumstances, foreign investors may receive tax-free interest from their real estate investment loans that will be deducted from the taxable income of the real estate investment, thereby reducing the taxable income from the real estate venture, overall, while increasing the income of the investor. This is because the interest income from a portfolio loan that is earned by the investor is not considered taxable income.

This technique will further reduce any U.S. taxes that must be paid on the real estate profits. Furthermore, these interest deductions from the current taxable income of the real estate do not reduce the tax basis of the real estate like the deduction for depreciation (which leads to larger taxable profits on the sale of the property). This is a completely tax-free payment.

This is contrary to the deduction for depreciation that may be currently taken to offset current income, but that reduces the cost basis of the real estate asset so that there will be larger taxable profits on the sale.

The portfolio interest loan and the tax deduction that accompanies its payment are not available unless the portfolio loan meets several criteria, the most important of which is that the foreign lender and/or his or her ''immediate relatives'' cannot together own 10% or more of the real estate project in which they have invested.[18]

In calculating whether an investor owns less than 10% of a particular investment, the 2017 tax act rules require that certain relatives of the investor, and certain corporations and partnerships that can indirectly increase the investor's ownership in the real estate, are excluded from ownership.

In addition to this restriction, the portfolio interest deduction is not available under several other unique circumstances. If available, the portfolio loan deduction, coupled with the depreciation deduction and other techniques will often ensure that there is a cash flow from the real estate investment but little or no taxable income whatsoever resulting from the project for a lengthy period of time.

---

[15] §199A, as added by the 2017 tax act, §11011(a); §701, §1366, §6662.

[16] §871(b), §881(c).

[17] §871(h)(3), §881(c)(3).

[18] §871(h)(3)(c), §881(c)(3).

ISSN 8755-0628

Lehman Tax Law

RICHARD S. LEHMAN, ESQ.

TEL: 561-368-1113 • rlehman@lehmantaxlaw.com

2000 Glades Road, Suite 312 • Boca Raton, FL. 33431

Richard S. Lehman, Esq

International Tax Attorney

With nearly 50 years as a tax lawyer in Florida, Lehman has built a tax law firm with a national reputation for being able to handle the toughest tax cases, structure the most sophisticated income tax and estate tax plans, and defend clients before the IRS.

- Georgetown University J.D.
- Masters in Tax Law from New York University Law School
- Law Clerk to the Honorable William M. Fay – U.S. Tax Court in Washington D.C.
- Senior Attorney, Interpretive Division, Chief Counsel's office, Internal Revenue Service
- Author: "Federal Estate Taxation of Non-Resident Aliens," Florida BarJournal
- Contributing Author and Editor: International Business and Investment Opportunities"
- Florida Department of Commerce, Division of Economic Development, Bureau of International Development (translated in German, Spanish, and Japanese)

Mr. Lehman has had extensive experience with all areas of the Internal Revenue code that apply to American taxpayers and non-resident aliens and foreign corporations investing or conducting business in the United States, as well as U.S. citizens and domestic corporations investing abroad.

Richard S. Lehman, Esq.
Located in the Dorot & Bensimon P.L. Domestic & International Tax Law Office
2000 Glades Road, Suite 312, Boca Raton, FL. 33431