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Foreign Investment in US Real Property: Buyers Beware

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US real estate brokers are seeing more sales to foreign buyers than ever before. The Manhattan real estate market is particularly benefiting as buyers with strong currencies against the dollar see New York properties as a relative bargain. However, regardless of where the property is located, foreign purchasers of US land, homes and rental properties need to be aware of the resulting tax consequences of their investment. This update highlights the relevant tax considerations of owning US real property. For a detailed discussion of the gift, estate and income tax rules applicable to non-US individuals, please see the Overview (March 2006).

Condo Versus Coop

Manhattan apartments are often owned through a housing cooperative (coop) or a condominium (condo). New York law defines a 'cooperative apartment house' as a multi-unit dwelling in which each resident has (i) an interest in the entity owning the building, and (ii) a lease entitling the

resident to occupy a particular apartment within the building (this lease may be referred to as a proprietary lease). Coop boards reserve the right to approve any and all potential investors. Foreign buyers without US credit histories or who do not intend to use the apartment as a primary residence are often rejected by coop boards. Condo investments, on the other hand, generally do not pose such problems. A condo consists of multi-unit dwellings where each unit is individually owned and the common areas, such as hallways and recreational facilities, are jointly owned (usually as tenants in common) by all the unit owners in the building.

A foreign buyer's purchase of a condo means that he or she owns US real property. However, the characterization of a coop ownership is not as clear and may be characterized as either real property or intangible personal property, depending on the property or tax law (state or federal) to be applied. For example, the Taxpayer Services Division Technical Services Bureau of the New York State Department of Taxation and Finance released a technical memorandum which provided substantiating information as to the distinguishing characteristics of ownership of a condominium and cooperative apartment. The memorandum concluded with the statement that in auditing New York estate and gift tax returns, a condominium is real property and a cooperative is intangible personal property.⁽¹⁾

The purchase of US real property, whether condo, house, building or undeveloped land (and, in certain circumstances, coop apartments), pulls the foreign investor into the US tax net.

Date of Death Value of Real Property Is Subject to Estate Tax

Where a foreign investor owns US real property at death, the value of that property will be subject to US estate tax. This is the case even when the United States and the country of the decedent's domicile have entered into an estate and gift tax treaty. The estate of a decedent who was neither a citizen of nor resident in the United States is permitted a credit that shelters only \$60,000 from estate tax. The excess value will be subject to estate tax at graduated rates ranging from 26% to 45%. The estate will be required to file a US estate tax return. It may also be necessary to undergo a court proceeding in the jurisdiction where the real property is located in order to pass title to the person who inherits the property.

With careful planning it may be possible to purchase US real property through a structure where the decedent owns stock at death and not the underlying property. However, the US estate tax rules are far reaching; retained interests in transferred properties can cause estate tax inclusion and stock in a US corporation is treated as a US *situs* asset for estate tax purposes (in the absence of an overriding treaty provision). Such a corporate structure will not eliminate (and may even complicate) the income tax consequences discussed below. For properties of significant value, the foreign investor should seek competent legal advice before purchasing US real property.

Gratuitous Transfer of Real Property Is Subject to Gift Tax

Where a foreign investor transfers US real property by gift, he or she will be subject to US gift tax. Again, this is the case even where an estate and gift tax treaty applies. There is no gift tax credit available to a transferor who is neither a citizen of nor resident in the United States (other than a limited annual exclusion); the fair market value of the property at the date of the gift is subject to tax at the same graduated rates that apply to the estate tax.

Rent from Real Property Is Subject to Income Tax

Non-resident aliens are subject to US income tax on US source income that is fixed or determinable, annual or periodic (eg, dividends, interest, rents and royalties) and on net income that is effectively connected to a US trade or business. Real property holdings may warrant a special election by the non-resident alien owner, because such property may or may not be considered a trade or business for US income tax purposes. If rent is considered fixed or determinable income it will be subject to US income tax at a flat 30% withholding rate rather than as effectively connected income. On the other hand, net taxation on income effectively connected with a US trade or business will often result in lower tax due to the benefit of deductions and graduated tax rates. A foreign owner of income-producing US real property may make an election (irrevocable without Internal Revenue Service (IRS) consent) to treat the income as effectively connected, thereby subjecting it to the tax based on net income.

Real Property Owner May Become US Income Tax Resident

Owning a US home or vacation property, even a rental property, will result in the foreign owner spending time in the United States. It is possible to become resident in the United States for income tax purposes without any deliberate decision to acquire that status. Under the substantial presence test, which counts the number of days a person is physically present in the United States, income tax residency will be acquired by an individual who regularly conducts business or otherwise maintains a physical presence in the United States and who does not engage in very deliberate planning to avoid exceeding the limit on days spent in the United States, even if that person's permanent home is outside the United States. Once the foreign real property owner is considered to be US resident, his or her worldwide income is subject to US income tax.

Sale of Real Property Is Subject to Capital Gains Tax

Non-resident aliens are generally not subject to US income tax on capital gains, with the exception of capital gains realized on the sale or exchange of US real property interests. The Foreign Investment in Real Property Tax Act 1980 (FIRPTA) added to the income tax rules provisions that gain or loss from the disposition by a non-resident alien or foreign corporation of a US real property interest is to be treated as effectively connected with a US trade or business and is thus subject to US net income taxation. The tax is enforced by means of a special withholding tax regime. A US real property interest includes not only condominiums and parcels of land, but also shares of US real property holding corporations (ie, any corporation, including a cooperative housing corporation, which holds US real property interests with a fair market value that equals or exceeds 50% of the fair market value of its specified assets). A disposition includes not only a sale, but also:

- capital contributions, redemptions, distributions, like-kind exchanges and gifts where liabilities exceed the adjusted basis;
- changes in interests in a partnership, trust or estate;
- corporate reorganizations, mergers or liquidations; and
- foreclosures or inventory conversions.

To ensure collection of the FIRPTA tax, the purchaser or transferee of a US real property interest from a foreign person is required, as withholding agent, to withhold 10% of the total amount realized by the foreign person, which is generally more than the tax owed on any gain. The seller or transferor may obtain from the IRS a withholding certificate adjusting the amount that must be withheld. The exceptions to FIRPTA withholding generally apply when the disposition is not subject to the FIRPTA tax. Even so, regulations require substantiation that FIRPTA withholding tax is inapplicable before withholding can be avoided (for a detailed discussion of income tax rules applicable to sale of US real property by non-US individuals please see "Dispositions of US Real Property Interests by Foreign Persons").

Comment

With many attractive properties on the market throughout the United States and the dollar remaining weak against many foreign currencies, foreign investors are finding good deals on ski condos, beach houses and even Manhattan *pieds-à-terre*. However, before buying that dream home or investing in a rental apartment, the resulting exposure to US taxes should be carefully considered.

For further information on this topic please contact Jennie Cherry or Tina Albright at Kozusko Harris Vetter Wareh LLP by telephone (+1 212 980 0010) or by fax (+1 212 751 0084) or by email (jcherry@kozlaw.com or talbright@kozlaw.com).

Endnotes

(1) TSB-M-81 (1), Estate and Gift Tax, February 20 1981, available at www.tax.state.ny.us/pdf/memos/estate_&_gift/m81_1e.pdf

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