[International Lawyer](https://scholar.smu.edu/til)

Volume 9 | Number 2 Article 3

1975

Planning Investments from Abroad in United States Real Estate

John I. Forry

JOHN I. FORRY*

Planning Investments from Abroad in United States Real Estate

Foreign corporations and nonresident aliens have substantially increased their direct investments in the United States in the last decade, including investments in United States real estate. The pace of such investments has quickened recently, facilitated by concentrations of available funds abroad, by United States dollar devaluations and by the continuing relative economic strength and political stability of the United States.

This paper outlines certain basic structures for such foreign investments in United States income producing real property, property acquired for development, and property held for appreciation. The objective is to highlight significant income tax, estate planning and tax treaty considerations affecting such investments.

Fact Situation

The following hypothetical situation will serve as the framework for our discussion of the problem:

International Real Estate, Ltd. ("IRE"), a corporation organized in the fictional Eurasian country of Franjapan, is contemplating a number of real estate investments in the United States. IRE's principal investment criteria include well established present property value, likely substantial appreciation over the next 3-5 years and, in most cases, current income from the property sufficient to meet interest and operating expenses together with a return of 6-10 percent per annum on invested capital. Franjapan and the United States have recently entered into an income tax treaty.

In addition, a group of individuals who are citizens and residents of the fictional Latin American country of Costazuela propose to engage in several United States real estate investments jointly with IRE. None of these individuals is or ever has been a citizen or resident of the United States. There are no tax treaties between Costazuela and the United States.

---

*John I. Forry, a graduate of Harvard Law School, is a partner in the Los Angeles, California law firm of Forry & Golbert, as well as an author, lecturer and professor of international business law and taxation.

Investments in Unimproved Property Held for Appreciation

A. *Direct Ownership*

Perhaps the simplest structure for a proposed investment in unimproved property to be held for appreciation is the direct ownership of such property by IRE and the Costazuelan individuals. Such property may be held by the joint venturers as tenants in common, so that in the event of an individual investor's death, his interest should not pass to the other investors but to his own heirs.

If after a holding period the investors sell the property and realize a long-term or short-term capital gain upon the sale, what will be the United States federal income tax consequences to them?[1] First, capital gain realized by each of the Constazuelan individuals will be taxfree if (i) the gain is not effectively connected with the conduct of a trade or business within the United States by the individual (effectively connected income) *and* if (ii) the individual is not present in the United States for at least 183 days during his taxable year in which the sale occurs. In connection with the first of these two requirements, it is important that the unimproved property be segregated from any United States improved property or property acquired for development by the same investors, since these latter investments generally will entail the conduct of a United States trade or business either directly or through resident agents of the owners.

Second, capital gain realized by IRE upon sale of the property will likewise be taxfree, if the gain is not effectively connected income. In the case of a foreign corporation such as IRE, there is no supplementary test based upon more than 183 days' presence in the United States. It should be noted that, although there is assumed to be an income tax treaty between the United States and IRE's home country, under most such treaties the income from direct real estate investments in the United States continues to be taxed by the United States in accordance with many of the basic statutory provisions applicable to non-treaty investors.

A corollary of the taxfree treatment accorded such capital gain is that no deductions for real estate taxes, interest or other carrying charges are permitted to the investors, since such deductions generally are permitted to them only to the extent allocable to "effectively connected income."

B. *Partnership*

Alternatively, IRE and the Costazuelan individuals may wish to form a United States or foreign partnership to use their unimproved property. Since for United States income tax purposes such a partnership is not a separate taxable

[1] *See generally* Internal Revenue Code of 1954, as amended ("IRC"), §§ 871-74, 881-84.

entity, the overall tax treatment of the investors does not differ substantially from that in the case of direct ownership described above.

However, the determination whether gain upon sale of the property is "effectively connected income" generally depends upon whether the partnership is engaged in a United States trade or business, since each of the partners will then be considered so engaged.[2]

In addition, the taxable character of a foreign entity as a partnership for United States tax purposes will depend upon United States standards. This may often be an issue where a foreign entity has attributes similar to those of a United States corporation.[3]

C. *Foreign Corporation*

A major additional factor in planning foreign investments in United States real estate is the impact of United States federal gift and estate taxes upon the individual investors. A gift by one of the Costazuelan individuals of his interest in United States real estate, whether owned directly or through a partnership, will be taxable by the United States at the substantial gift tax rates applicable to United States citizens and residents. Likewise, upon the death of such an individual foreign investor, the United States estate tax will apply to his interest in United States real estate owned directly or through a partnership.

Accordingly, it may be wise for the Costazuelan individuals to form a foreign corporation to hold their interests in unimproved United States real estate. This should be a corporation organized in a jurisdiction which imposes little or no taxes on the individual shareholders or the corporation itself, *i.e.*, a tax haven. In this situation, no United States federal gift tax will apply to transfers of the foreign corporation's stock by the Costazuelan individuals to, for example, other members of their families. Nor will the United States estate tax apply to the foreign corporation's stock upon the death of any of the individuals.[4]

Separate corporations also help segregate unimproved property from any improved United States property of the same investor, whether the investor is an individual, a corporation or other entity.

The tax haven's own income, gift and estate taxes must also be examined and minimized, of course. In addition, any tax treaties between the United States and the tax haven, or between the tax haven and the individual investors' home country, must be examined carefully for their impact upon the use of such a foreign corporation.

D. *Additional Issues*

The structure of the joint venturers' United States real estate investments will

[2]IRC § 875(a).
[3]Treas. Regs. § 301.7701-2.
[4]*See generally* IRC §§ 2101-8, 2501-24.

also depend on state income, gift, estate and inheritance taxes applicable to IRE and the Costazuelan individuals. These taxes will vary with the state in which the real estate is located or other activities of the investors are carried on. In many states, foreign investors are treated approximately the same as out-of-state United States investors. However, it is important to ascertain whether any limitations exist upon foreign ownership of real estate.

Taxes in Franjapan and Costazuela will also influence the structure of the proposed investments in United States real estate. For example, in the case of capital gain on the sale of unimproved United States real estate, no home country tax may be imposed. Or such gain generated abroad may not be subject to tax until remitted to the home country.

On the other hand, substantial home country taxation of such gain may be an additional factor favoring use of a foreign corporation organized in a tax haven by the Costazuelan individuals or even by IRE, in order to stopgap the sales proceeds outside the home country's tax jurisdiction and permit their reinvestment abroad without current tax costs. Other factors such as foreign exchange or investment limitations in Franjapan or Costazuela may, of course, affect the availability or value to the investors of using such a foreign corporation.

Investments in Income-Producing Property and Property Acquired for Development

A. *Direct Ownership or Partnership*

Rental income from an office building, apartment building, shopping center or similar income-producing property, which is received by IRE or the Costazuelan individuals either directly or through a partnership, will usually be "effectively connected income." The same is true of sales proceeds from United States property developed and held for sale by the investors, such as from sales of condominiums or other subdivided property.[5] Such "effectively connected income" will be taxable by the United States to the Costazuelan individuals on a net basis at the ordinary rates paid by a United States citizen or resident. That income will be similarly taxed to IRE on a net basis at the ordinary rates paid by a United States corporation—22 percent of the first $25,000 of taxable income and 48 percent of the balance.

In some cases, where little or no business activity is carried on in the United States by the foreign investors or their resident agents, the income may not constitute "effectively connected income." This is particularly likely where net lease arrangements for the property provide that all maintenance and other activities and costs are to be undertaken by the tenants rather than the foreign owners. In the case of rental income, such treatment is usually extremely

[5]IRC § 864(c).

undesirable because the income will be subject to a withholding tax of up to 30 percent of the gross amount without any deductions, which tax may not be reduced even under a treaty, so that the tax will often equal or exceed the net income from the property.[6]

Where such taxation appears likely, either IRE or any of the Costazuelan individuals may make a special election to have his share of the income taxed on a net basis as "effectively connected income."[7] The principal difficulty here is that such an election must apply to all United States real property interests of an electing foreign corporation, and to all such interests held for the production of income by an electing individual. This may cause capital gain upon the sale of other unimproved property to be taxable, where no tax would apply if the election were not made.

Once made and not modified within the three-year period for amending the original year's tax return, the election remains in force for all subsequent years unless revoked by the taxpayer with the tax authorities' permission. In case of such revocation, a re-election generally may not be made for another five years without further permission.

However, the election may be made from year to year under some United States income tax treaties.[8] Accordingly, in the hypothetical situation here, the treaty between the United States and Franjapan may permit IRE simply to avoid the election in a year in which taxfree capital gain from other property is expected. Alternatively, property requiring the election should be segregated in a separate corporation. The easiest approach, of course, is to structure investments in income producing property which are clearly subject to tax on a net basis, rather than having to rely on the election.

If IRE or the Costazuelan individuals eventually realize long-term or short-term capital gain upon sale of the income producing property developed by them, the capital gain will also be "effectively connected income," because it is derived from assets which have been used in a United States trade or business. Such gain will be taxed to IRE by the U.S. approximately as capital gain derived by a U.S. corporation, and will be taxed to the Costazuelan individuals approximately as capital gain derived by United States citizens or residents. Any long-term capital gain will be further subject to the 10 percent minimum tax on tax preferences.[9] The taxable character of such gain is in contrast to the generally taxfree capital gain—as described above—upon the sale of unimproved property which has not been used in a United States trade or business by the foreign investors.

---

[6] *Cf. Evelyn M. L. Neill*, 46 B.T.A. 197 (1942); Rev. Rul. 73-522, 1973-2 Cum. Bull. 226.
[7] IRC §§ 871(d), 882(d).
[8] *Cf.* France-U.S. Income Tax treaty of 1967, as amended, Article 5(3).
[9] IRC §§ 56-58.

As an alternative, the foreign investors may be able to exchange the property wholly or partly for other property of like kind. In that case, the currently taxable gain will be limited to the sum of the money and the fair market value of other property not of like kind—if any—which is received by the investors in the exchange.[10]

B. *Foreign Corporation*

As in the case of unimproved real property, the interest of each of the Costazuelan individuals in United States income-producing property or property acquired for development, if owned either directly or through a partnership, will be subject to United States federal gift tax upon a gift by the individual. His interest will also be subject to United States federal estate tax upon his death. In order to avoid such taxes, the individual investors may wish to organize a foreign corporation in a tax haven to own their interests in the property, since no United States gift or estate taxes will apply to their transfers of stock in the corporation itself.

However, the use of such a foreign corporation by the individual investors is somewhat more difficult in the case of income-producing or development property than in the case of unimproved property. First, the income of the foreign corporation from the property will usually be "effectively connected income," subject to United States taxation on a net basis at the ordinary 22 percent or 48 percent rate paid by a United States corporation, which may be higher than the rates which would be payable by the individuals if they received the income directly.

Second, and more important, the individual foreign shareholders of the corporation will ordinarily wish to receive personally—either immediately or eventually—the proceeds from operation or sale of the property. If this is accomplished by way of dividends from the foreign corporation, the profits will often be subject twice to United States federal income tax—once at the corporate level, and once by a withholding tax at the payment of dividends. If the United States profits are instead accumulated in excess of the reasonable business needs of the foreign corporation, a substantial accumulated earnings tax may be imposed on the corporation.[11]

Alternatively, the shareholders may receive some income by way of interest charges on loans they make to provide part of the corporation's operating funds, if the corporation maintains an adequate debt-to-equity ratio and the interest charges are at arm's length rates.[12] Such interest will be deductible by the corporation, if attributable to its United States income, but the interest pay-

[10]IRC § 1031.
[11]IRC § 531.
[12]IRC § 482.

ments to the shareholders often will still be subject in turn to a large withholding tax.

These United States withholding taxes on the dividends and interest paid by the foreign corporation are likely because, if at least one-half of the foreign corporation's gross income for the latest three taxable years is "effectively connected income," a like proportion of any dividends or interest paid by the corporation will be subject to a United States withholding tax of 30 percent of the gross amount paid.[13] Under various United States income tax treaties, this United States withholding tax is in certain circumstances not imposed on dividend or interest payments by a foreign corporation. One such jurisdiction, the Netherlands Antilles, is discussed in greater detail below.

C. *United States Corporation*

IRE or the Costazuelan individuals may wish to organize a United States corporation to own their income-producing property or property acquired for development. Such a corporation may, for example, assist in obtaining additional local financing for the purchase or development of the property, or provide a local organization to manage or develop the property, or simply provide a local identity which is helpful in dealing with federal or state agencies, contractors or other United States businesses.

From a tax planning standpoint, ownership of the property through such a corporation may have certain limited benefits for at least the individual investors, but usually will also have substantial disadvantages. On the positive side, the individual investors will be able to make gifts of their stock in the United States corporation without the imposition of United States federal gift tax. However, such stock will still be subject to United States federal estate tax in the event of an individual investor's death.

On the negative side, the rental or other income generated by the property will be taxed on a net basis at the rates ordinarily applicable to any United States corporation. It should be possible for the corporation to take deductions for reasonable interest charges payable to its foreign shareholders. However, such interest payments will be subject to United States withholding tax of 30 percent of the gross amount paid. In addition, any dividends paid by the United States corporation out of its accumulated profits will be subject to a further withholding tax of 30 percent of the gross amount paid. Excessive accumulation of profits may also result in imposition of the penalty tax alluded to above in the case of a foreign corporation. This contrasts with direct ownership of the property, where the foreign investors pay only one tax at ordinary rates upon the effectively connected income realized directly by them from the property.

---

[13]IRC §§ 861(a)(1)(D), 861(a)(2)(B), 871(a)(1), 881(a).

Under many United States income tax treaties, of course, the United States withholding tax on such interest payments may be eliminated or reduced to 10 percent or less of gross amount, and the withholding tax on such dividends may be reduced to 5-15 percent of gross amount.

In the event of sale of the property, capital gain to the United States corporation will be fully taxable at the usual United States corporate capital gain rate of 30 percent. By contrast, in the event unimproved property is involved, foreign investors owning such property directly will often receive such capital gain taxfree. In addition, regardless of what type of property is involved, distribution of the sale proceeds to the foreign shareholders generally will constitute a dividend to the extent of the corporation's accumulated profits and be subject to an additional United States withholding tax of 30 percent or to a lesser treaty rate.

As one alternative, the United States corporation—as in the case of a foreign owner described earlier—may engage in a like kind exchange of the property. In that case, the currently taxable gain will be limited to any money and the value of any other property not of like kind received by the corporation in the exchange.

Alternatively, the foreign shareholders may be able to sell the shares of their United States corporation for capital gain, which generally will be taxfree because, in itself, it is not effectively connected income to them. Where the United States corporation qualifies as a collapsible corporation, however, such gain may possibly be subject to ordinary income taxation. Such qualification is particularly likely where the corporation has been used to develop the United States property.[14]

A further possibility is sale of the property and liquidation of the United States corporation pursuant to a 12-month plan of liquidation, which will avoid most income tax at the corporate level, except as to the recapture of accelerated depreciation taken by the United States corporation.[15] Again, this alternative is not available where the United States corporation is a collapsible corporation. Nor is it generally possible if a corporation—such as IRE in the situation here—owns at least 80 percent of the United States corporation's common stock.

In order to avoid these income tax difficulties with a United States corporation owning the property, it may be wise to consider organizing such a United States corporation not to own the property, but to perform development or management services for the property. The corporation's income from such services may be kept as low as consistent with arm's length dealings between the corporation and its foreign shareholders or a related foreign corporation owning

---

[14]IRC § 341. *But see* the limitations on taxation of such foreign investors in IRC §§ 871(a)(1), 881(a).

[15]IRC §§ 337, 1250.

the property. The United States corporation can then provide liaison with local agencies and businesses, with the property itself providing all or most of the security required for any additional local financing for the property on behalf of the foreign owners.

D. *Additional Issues*

Whether direct ownership, a partnership or a corporation is used for United States income-producing property or property acquired for development, the applicable state income, gift, estate and inheritance taxes must be examined just as in the case of unimproved real property. In the case of income-producing or development property, it will also generally be necessary to qualify the foreign investors, or the legal entity they employ, to do business in the applicable state jurisdiction.

The Netherlands Antilles Corporation

As described above, the Costazuelan individual investors may often find it advantageous to organize a foreign corporation to own their interests in United States real estate, in order to minimize United States gift and estate taxes on their holdings. In addition, both IRE and the Costazuelan individuals may find such a foreign corporation in a tax haven useful in stopgapping income to minimize home country taxes or other investment regulation. However, as also noted, where such a foreign corporation is used to own income-producing property or property acquired for development which generates effectively connected income, some or all of the dividend or interest payments by the corporation to its foreign corporate or individual shareholders may be subject to additional United States withholding tax of up to 30 percent of the gross amount paid. In addition, of course, the foreign corporation's jurisdiction of organization may impose its own income, gift, estate or inheritance taxes, even though most of such taxes may be low enough to qualify the jurisdiction as a tax haven.

These difficulties often may be avoided by utilizing a Netherlands Antilles corporation to own United States real estate investments, because of the unique benefits under the United States income tax treaty with the Antilles and under local Antilles income tax laws.[16] In this situation, the United States property commonly is owned by an Antilles corporation organized as a *Naamloze Vennootschap* ("N.V."), the stock of which is issued to the foreign corporate or individual investors. The basic tax treatment of such an investment structure may be summarized as follows, in terms of the hypothetical investors described previously:

[16]*See generally* U.S.-Netherlands Income Tax Treaty of 1948, as amended and presently in force between the U.S. and the Netherlands Antilles, Arts. V, X, XII.

(a) Ownership of the United States real estate by the N.V. avoids United States federal gift tax on transfers of the corporate stock by the Costazuelan individuals, and United States federal estate tax on the death of any of the individuals.

(b) Unimproved United States real estate held directly by IRE or the Costazuelan individuals may be sold to the N.V. at an arm's length price, often for taxfree capital gain to them, prior to development.

(c) Interest at arm's length rates may be charged by IRE or the Costazuelan individuals on loans to the N.V. to provide part of the funds to acquire or develop the property, which charges may be deducted by the N.V. from gross income generated by the property for United States tax purposes.

(d) No United States withholding tax is imposed on the interest paid by the N.V., or on dividends to the N.V.'s shareholders, even where one-half or more of the N.V.'s gross income is effectively connected income.

(e) No Antilles income taxes are imposed on the United States real estate income of the N.V., or on dividends or interest paid by the N.V. to IRE or the Costazuelan individuals.

(f) No Antilles gift, estate or inheritance taxes are imposed on transfer or inheritance of the N.V.'s stock by the Costazuelan individuals or their successors.

Upon sale of the United States real estate, the following alternatives are available to IRE and the Costazuelan individuals:

(i) If the N.V. itself sells the property, capital gain upon the sale will be taxfree to the N.V. *if* the property has not been used in a United States trade or business by the N.V. Such gain, of course, is particularly likely where unimproved real estate has been acquired and held for appreciation by the N.V. The election to treat real property gain as effectively connected income may be made or revoked on a yearly basis. As an alternative, the N.V. may engage in a like kind exchange of property, in which event its currently taxable gain will be limited to any money and the value of any other unlike property received in the exchange.

(ii) Alternatively, IRE or the Costazuelan individuals may sell their shares of the N.V., generally for taxfree capital gain, except possibly where the N.V. is a collapsible corporation. As noted earlier, collapsible corporation treatment may be particularly likely where unimproved property has been developed by the N.V. The purchaser may also be hesitant to acquire shares in a foreign corporation rather than the property itself.

(iii) Alternatively, the property may be sold and the N.V. liquidated pursuant to a 12-month plan of liquidation, with no United States income tax on the N.V. itself, except as to recapture of accelerated depreciation taken by the N.V. on its property. This advantageous tax treatment is not available if the N.V. qualifies as a collapsible corporation, or where the N.V. is owned at least 80 percent by IRE or another corporation. Where available, however, such liquidation may provide other substantial tax benefits to the foreign investors. First, although a revenue ruling is usually required to permit taxfree reorganizations involving foreign corporations for United States tax purposes, such a requirement is not applicable to a 12-month liquidation of the N.V.

Second, no United States income tax generally will be imposed at the shareholder level on distributions to IRE or the Costazuelan individuals, since they are deemed to receive the proceeds of sale of the property in exchange for their stock, and therefore receive taxfree capital gain. Third, the N.V.'s gain from sale of the property prior to its liquidation will be free of Antilles tax. In addition, no Antilles tax will be imposed at the shareholder level on income derived by the foreign investors at the N.V.'s liquidation from their ownership or disposition of its shares, if Antilles corporate liquidation requirements are complied with, and if the N.V. has been organized and maintained under Article 14A of the Netherlands Antilles Profits Tax Ordinance.

Additional Approaches

The considerations outlined above often must be applied to more complex arrangements for foreign investments in United States real estate. For example, where one or more foreign corporations or nonresident aliens wish to joint venture a United States real estate project with a domestic developer or other investors, a partnership between the United States party and, for example, a foreign corporation owned by the foreign investors may be an appropriate vehicle. Because the domestic and foreign investors may have different income goals or are subject to different tax treatment, special allocations between them of income and deductions, or of capital gain and ordinary income, or of land and improvements ownership, or of equity and loan participation may be appropriate. Similarly, among the foreign investors themselves—whether they are corporations or individuals—different income goals or overseas tax problems may dictate special allocations or participations in the project.

Additional opportunities for new investment vehicles are also suggested by the difficulties in recent years of offshore funds for foreign investors, including funds involved in United States real estate investments. For example, significant use may be found for adapting limited partnerships to the needs of foreign investors. Such a partnership may be used, for example, for direct investment in improved property by a small group of sophisticated foreign investors (or by one or more foreign corporations organized by them) in a private offering structured by a general partner who will manage the United States investment.

Furthermore, limited partnerships for domestic investors in real estate—as in other types of investments—have been oriented historically to providing investors with initial tax deductions that substantially exceed immediate taxable income of the partnership, which may then be used to offset other taxable income of the investors. However, such excess writeoffs have come under increasing attack by federal tax authorities and have become the subject of numerous proposed amendments to the federal tax laws. For foreign investors, such excess writeoffs may often be unnecessary, since they may have little or no other United States income against which to use them. These investors are more often concerned with spreading available deductions over several years so as to reduce future taxable income from the same property or group of properties.

An alternative United States investment vehicle is the real estate investment trust which, upon compliance with requirements of the Internal Revenue Code, is not itself subject to federal income tax.[17] Although dividends paid by the trust to foreign shareholders are subject to United States withholding tax, capital gains passed through to the foreign holders usually will not be "effectively connected income" to them and so will escape United States tax. This may be particularly advantageous if the income is paid to a tax haven for taxfree reinvestment. Such a trust must have at least 100 shareholders, and the foreign investors may join with United States shareholders in a new or existing trust.

In summary, the structuring of foreign investments in United States real estate requires consideration of special income tax, estate planning and treaty issues. These must be applied carefully in light of the character of each investment, the investment objectives and the specific foreign investors involved.

[17] IRC §§ 856-58.