1997

Advising Foreign Investment in U.S. Real Estate, or How to Be a Modern Renaissance Attorney

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Advising Foreign Investment in U.S. Real Estate, or How To Be a Modern Renaissance Attorney

Martin L. Camp and María Lusia Cánovas

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I. Introduction.

This article is intended to serve as a practical guide for U.S. real estate counsel representing non-U.S. persons or entities acquiring U.S. real estate. It should help counsel remain alert to many of the pitfalls involved in this type of transaction and the assumptions often made by the non-U.S. client. In sum, it should provide counsel with an awareness of the considerations and skills that are required in order to successfully represent a foreign person investing in U.S. real estate.

II. Know Your Client.

"Know your client" is a good adage that becomes indispensable when representing a foreign person.1 Real estate counsel will want to avoid problems with among others, the U.S. Internal Revenue Service (IRS), the Immigration and Naturalization Service, the Drug Enforcement Administration, and foreign governments. Much of these organization's requirements regarding foreign investors in the United States are spurred by the possibility of U.S. individual involvement behind foreign entities shielding tax evasion or money laundering activities. The consequences of overlooking these requirements may result in the seizure of the U.S. real property acquired by the foreign person.2

In addition, real estate counsel will want to check the solvency of the new client and ask for a retainer fee. As discussed in greater detail later, the attorney needs to be certain that he has adequately communicated to the foreign client the basis upon which the attorney's fees will be calculated as well as a general understanding of all transaction costs, that the client should expect to bear.

III. Tell Your Client.

Providing your client with some general information on the different elements that will come to play in the U.S. transaction will help prevent some of the common flaws in communication that affect international deals. Real estate counsel should adjust information regarding the following issues to meet the client's concerns and needs.

1. Reference in this article to a foreign person or a foreign investor means, depending on the context:
   a. an individual who is neither a resident of the United States for income tax purposes, see I.R.C. § 7701(b) (1996), nor engaged in the conduct of a trade or business in the United States see I.R.C. § 864(b) (1996);
   b. an estate or trust which is "foreign," within the meaning of I.R.C. § 7701(a)(31) (1996), and is not engaged in the conduct of a trade or business in the United States see I.R.C. § 864(b) (1996);
   c. a corporation, association, company, or partnership which is neither organized under the laws of the United States or one of the states, see I.R.C. § 7701(a)(4) (1996), nor engaged in the conduct of a trade or business in the United States see I.R.C. § 864(b) (1996).

2. For example, the federal Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1963(a)(3), (b)(1) (1988), permits the U.S. Government to seize real property acquired as a result of racketeering activities. Also, many states allow a lien to be placed upon property acquired as a result of racketeering activities.
A. Costs.

Present your client with an estimate of the total costs and expenses that might result from the transaction. Be sure your client understands that estimates are not quotes or caps and keep him informed along the way if cost increases appear necessary. Also, try to stay ahead with regard to any retainer arrangement.

Legal fees in the United States are generally higher than in most other countries.\(^3\) Also, the client may not expect to be charged on an hourly basis, nor understand that every time you place or receive a telephone call on his behalf, he will be billed.\(^4\) Additionally, if applicable, alert your client if you anticipate that you will need the assistance of other professionals, such as tax, immigration, and/or environmental counsel, or the services of a surveyor and a title company, and provide your client with an estimate of their fees.

To many foreign persons, the various land registration systems used in the fifty states are initially deceptive because, as opposed to the civil law systems, the U.S. governmental entity providing the archive guarantees neither the accuracy nor the adequacy of the information stored there. If the client is from a civil law jurisdiction, their jurisdiction generally has a centrally planned system of recordation and title verification. Prior to registration, a thorough investigation is conducted by the government official in charge of the registry, and the registration of the transaction will warranty the transaction’s good standing, making title insurance unnecessary in most cases. Therefore, a foreign investor may not anticipate the cost, nor understand the need, of purchasing title insurance or performing a review of the physical condition of the property.

Another costly and time-consuming task that is not anticipated by most first-time foreign investors is environmental due diligence. Real estate counsel must sensitize the foreign client to the potential environmental liabilities that may result from the purchase of U.S. real property under the environmental laws such as the Superfund statute.\(^5\) For example, it should be explained to the client that under the Superfund statute, even parties wholly innocent of wrongdoing may be liable, strictly, jointly, severally, retroactively, and almost unlimitedly for the costs of mitigating or remediating pollution. The impact of other federal laws, such as those protecting wetlands and endangered species, also need to be explained. State and local laws affecting land use and development laws, such as zoning and subdivision requirements, also need to be explained. The goal here is obviously not to scare the investor or make him believe he should not invest in U.S. real estate. Rather, it is to avoid surprises in the process which can lead to suspicion and misunderstanding. The investor may or may not be sophisticated in his own country’s laws and regulations regarding real estate and development. Often, investors are motivated to invest in the United States

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3. Emily Couric, Foreign Clients Find U.S. Legal System "Bizarre": Hurdles for Lawyers, 1986 NAT'L L.J.

4. One of the authors had an Italian client who called constantly to discuss not only the transaction they were working on, but also his numerous businesses. When she explained to him that she was charging him also for the advice that she was providing to him regarding the unrelated transactions, the client was not favorably impressed. However, the client thanked the author for her straightforwardness, and soon after they signed a new letter of engagement that framed the new scope of their representation.

States because of a desire to have assets in a safe country. They need to understand the risks of real property acquisition and ownership. An early discussion of this matter is suggested. It will provide the client with a realistic approach to the costs and time involved in the transaction. 6

B. FEDERAL AND STATE LAWS ON FOREIGN OWNERSHIP.

Notify your client that you will need to research whether there are state or federal restrictions on foreign ownership of the land that will affect his transaction.

1. State Restrictions.

State law, being more concerned with the nature of land ownership than federal law, has been more directly focused on foreign control. Proceeding from the initial law of England that recognized no right of foreign ownership, the states have intermittently and unevenly relaxed their restrictions over a period of years. The development has been characterized for different approaches that may be roughly grouped into identifiable categories. 7

Approximately eighteen states have removed common law disabilities on foreign ownership land. In six states, 8 no express restriction in ownership of land other than agricultural exists, and therefore, by implication none exists. The remaining states have not followed a uniform method of approach and the variety of provisions is somewhat startling. However, the striking element is that in a number of jurisdictions which limit foreign rights, the restriction applies primarily to individuals. Foreign corporations are often not restricted as long as they qualify to do business in the state. In addition, most states do not restrict the rights of foreign investors to hold shares in business corporations. More frequently, states restrict corporations with foreign shareholders from engaging in certain activities. For example, in Iowa, a corporation formed under the laws of a foreign country, and any other corporation or business entity in which a majority interest is owned directly or indirectly by nonresident aliens, is a "foreign business" entitled to deal with real property, except agricultural land. 9

At least five states have limitations on foreign ownership in terms of acreage or the length of the investment. Pennsylvania limits foreign ownership to 5,000 acres, 10 Wisconsin allows only 640 acres of foreign ownership, 11 and South Carolina sets a

6. For further analysis, see Johnine J. Brown, Counseling Foreign Clients: The Environmental Attorney as Chicken Little, 1991 ILL. LEGAL TIMES 21.
11. WIS. STAT. ANN. § 710.02 (West Supp. 1996).
500,000-acre ceiling. Indiana requires foreign individuals to dispose of their property in excess of 320 acres within five years from the date of acquisition or from arriving at the age of eighteen years. Finally, Nebraska prohibits foreign individuals from acquiring title or holding a leasehold interest to land beyond five years.

Other states apply controls based on the type of land involved, particularly agricultural land, or on the type of the investor. Thus, Minnesota and North Dakota prohibit foreign individuals from purchasing agricultural land, Iowa allows foreign ownership of only 320 acres of agricultural land, and South Dakota limits individual ownership to 160 acres. Missouri, South Dakota, Oklahoma, and Wisconsin legislate against corporate ownership of real property for agricultural uses. There is also a grouping of states, such as Maryland, New Jersey, and Virginia, which have statutes directed toward validating the right of "friendly" foreigners. Normally, this is defined to mean citizens of any country with which the United States is not presently engaged in hostilities, but each state's law must be checked on this point.

Finally, state laws applicable to private ownership by foreign individuals or by private companies do not necessarily apply to foreign governments and the laws of each state must be separately examined if that particular question is involved. Also, it is important to remember that the federal government's treaty-making power preempts state law. Therefore, any state law that is contrary to a current federal treaty should be disregarded.

2. Federal Restrictions.

Current federal regulation of foreign ownership takes a variety of forms. Approximately 2,600 federal statutes affect federally owned public lands and energy resources. Half of such public lands are located in Alaska and most remaining lands are located in Western states. These statutes regulate, among other topics, homesteading, graz-

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ing, mineral leasing, and inheritance by foreign persons. In addition, they generally restrict issuance, use, or transfer of licenses or leases to foreign persons. Other federal regulations are designed to govern land ownership by foreigners from countries hostile to the United States.28

C. REPORTING AND DISCLOSURE REQUIREMENTS.

A concern for individual foreign investors may be the anonymity of their investments. This is especially frequent in the case of individual investors concerned about threats of extortion or kidnapping in their home countries, or in the case of flight capital. Real estate counsel should ascertain the legitimacy of such concern and inform the client of the limitations in maintaining anonymity imposed by tax considerations and governmental reporting procedures.

Prior to 1976, anonymity of foreign investors could be virtually assured simply by the use of a tax haven jurisdiction corporate entity having bearer shares as the investment vehicle. Passage of the International Survey Act of 1976 and the Agricultural Foreign Investment Disclosure Act of 1978 commenced a chain of legislative enactments placing reporting requirements on foreign investors. A few states, most particularly those with agricultural economy followed suit.


a. Basic Reporting Requirements.

The basic reporting requirements are set forth in the following regulations: the International Investment and Trade in Services Survey Act of 1976 (IISA), the Agricultural Foreign Investment Disclosure Act of 1978 (AFIDA), the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).29

Each of the above regulations has a different definition of the terms "foreign person", "control", or both, which determines its scope of application. Also, the exemptions available, the forms to be filed, the degree of confidentiality of the information provided, and the penalties imposed for failure to file the respective reports are different for each of the regulations.

IISA requires reports to be filed with respect to the direct or indirect acquisition by a "foreign person" (either as an individual, or an affiliate in a chair of ownership, or by merger) of a voting interest of 10 percent or more in a U.S. business enterprise including real estate.30 This includes an interest held by a U.S. intermediary, such as a trust or agent, for a foreign beneficial owner.31 Exemptions from filing under IISA are available for (i) residential real estate

held exclusively for personal use and not profitmaking purposes,\(^{32}\) (ii) personal residences owned by a corporation whose shareholder occupies the property,\(^{33}\) (iii) acquisitions under $1,000,000 in value and under 200 acres,\(^{34}\) and (iv) investments as a limited partner.\(^{35}\) In some cases, exemptions require the filing of a form (such as Form BE-13) with the Commerce Department. Sample Forms BE-13, BE-13 Supplement C, BE-14, BE-15 Supplement C, BE-15 (LF), BE-15 (SF), BE-605 and BE-605 Bank are included in Appendix A.\(^{36}\) 

AFIDA requires "any foreign person"\(^{37}\) (including U.S. corporations having foreign shareholders holding a 10 percent or greater ownership) who "acquires or transfers" any interest (other than a security interest)\(^{38}\) in "United States agricultural land" (including ranchlands and timberlands)\(^{39}\) to file a report of such ownership with the Agricultural Stabilization and Conservation Service ("FSA") county office where the land is located (or, upon receiving permission from the FSA office in Washington, with that office) within 90 days after such acquisition or disposition.\(^{40}\) Under the present AFIDA reporting regime, ownership is disclosed up to the third level. Thus, entity "C" which owns entity "B" (which in turn owns entity "A") is not required to reveal the identity of the "foreign persons" which own or control entity "C". An exemption is available if the tract of land acquired is less than ten acres in the aggregate and the annual gross receipts from sale of the produce is not more than $1,000.\(^{41}\) Sample Form FSA-153 is included in Appendix B.\(^{42}\)

FIRPTA sought to enforce tax payment by requiring comprehensive reporting of foreign ownership of U.S. real property by means of annual information returns identifying the ultimate beneficial owners by name and address. Since U.S. tax treaties require broad exchange of information between partners, provision of this information to Washington could have had dramatic effect in the investor's home country. However, the IRS has not yet exercised this authority, granted to it under the Internal Revenue Code (the Code) Section 6039C. Thus, at the present time, except as may be required in connection with applying for a withholding certificate in order to reduce withholding at the time of sale, there are no reporting or disclosure obligations under FIRPTA.\(^{43}\)

\(^{33}\) 15 C.F.R. § 806.8 (1989).
\(^{34}\) 15 C.F.R. § 806.15 (j)(3)(ii)(b),(c) and (j)(4)(ii)(b) (1989).
\(^{36}\) Forms are available from the U.S. Department of Commerce, Bureau of Economic Analysis, 1441 L.St., N.W., Washington, D.C. 20230, Associate Director for International Economics, International Investment Division, Direct Investment in the U.S. Branch. Forms may also be ordered by telephone (and form completion may be discussed) at (202) 606-9809. E-Mail: james.bomkamp@bea.doc.gov.
\(^{37}\) 7 C.F.R. § 781.2(c),(g), (k) (1989).
\(^{38}\) 7 C.F.R. § 781.2(c)(1), (j) (1989).
\(^{39}\) 7 C.F.R. § 781.2(b) (1989).
\(^{40}\) 7 C.F.R. § 781.3(a)-(b) (1989).
\(^{41}\) 7 C.F.R. § 781.2(b) (1984). The original exemption size was one acre but was changed to ten acres by 49 Fed. Reg. 35,072, 35,073 (1984).
\(^{42}\) Forms are available from the U.S. Department of Agriculture at FSA, DAPFDO-OAS-FIDB, 1400 Independence Avenue, S.W., Washington, D.C. 20250-0531. Forms may also be ordered by telephone (and form completion may be discussed) at (202) 720-6833.
\(^{43}\) Indeed, the IRS has indicated that it will implement these rules only if it determines that the § 1445 withholding tax mechanism is being abused, see T.D. 8000, 1985-1 C.B. 296, 301.
TEFRA, through introduction of Code section 6038A, requires, for taxable years beginning after December 31, 1982, every domestic corporation and every foreign corporation engaged in a trade or business within the United States to file an annual information return with the IRS if such corporation is "controlled by a foreign person." Foreign person is defined to include any nonresident alien or foreign corporation, partnership, estate, or trust. Control is generally defined to mean ownership of stock possessing 50 percent or more of the total combined voting power of all classes of stock entitled to vote, or ownership of 50 percent or more of the total value of shares of all classes of stock of a corporation. Constructive ownership rules apply. Thus, the reporting requirement would appear to be triggered for any wholly owned U.S. subsidiary of a foreign corporate parent, even if the foreign parent is publicly held.

b. Special Problems.

In addition to the basic reporting requirements described above, real estate counsel may have to address certain additional reporting or disclosure requirements. Some requirements may arise because of the size of the transaction (see the Hart-Scott-Rodino Antitrust Improvements Act of 1976), others may arise because of the governmental nature of the investor (see the Foreign Agents Registration Act of 1938), and some may be inadvertently triggered by the movement of money or bearer shares (see the Currency and Foreign Transactions Reporting Act of 1970).

Finally, when real estate is acquired in the context of the acquisition of an ongoing business, regulations pursuant to the so-called Exxon Florio Amendment to the Omnibus Trade and Competitiveness Act ("Section 721"), amending Title VII of the Defense Production Act of 1950, will apply. Acquisition of U.S. real estate per se is, however, not subject to Section 721. Also, under the Publicly Traded Companies, Domestic and Foreign Investment Improved Disclosure Act of 1977, acquisitions of foreign beneficial interests in U.S. corporations in excess of 5 percent need to be reported on Schedule 13D to the Securities and Exchange Commission.

44. The purpose of the reporting requirement, passed at the urging of Congress' General Accounting Office, is to aid the federal government in the administration of § 482 of the Internal Revenue Code and to curb tax avoidance through international transactions between related companies which, through pricing maneuvers, might allow for manipulation of U.S. taxable income.
48. For further discussion, see Cecelia M. Waldeck, Note, Proposals for Limiting Foreign Investment Risk Under the Exxon-Florio Amendment, 42 HASTINGS L.J. 1175 (1991).

Real estate counsel must closely scrutinize particularly in the farm states, passed or pending local legislation which affects the transaction. Many of the statutes requiring disclosure are patterned largely after IISA and AFIDA; they are designed to alert officials of the magnitude of foreign ownership of state lands.

D. Taxation.

The client should be aware of the type of taxes it might have to deal with if it decides to invest in U.S. real estate. Roughly, it should understand that three basic kinds of taxes exist that affect ownership of real estate: state and local property taxes; federal and state income taxes, including capital gains taxes on the sale of the property; and federal and state gift and death or estate taxes. On the other hand, real estate counsel should be aware of the tax planning objectives of the client, if any, and pursue such goals diligently. The following is a brief discussion of this area of the law. A real estate practitioner should be certain that his client has adequate tax advice from either a tax attorney or a CPA.

1. Who Can Be Taxed?

Foreign investors are subject to a special set of rules of the U.S. Internal Revenue Code (the Code). Such rules apply to (a) "nonresident alien" individuals, and (b) corporations that are treated as foreign corporations for U.S. tax purposes.

a. "Nonresident Alien" Individuals.

For U.S. federal income tax purposes, while a U.S. resident alien will be treated like a citizen and be taxed on the basis of his worldwide income, a nonresident alien individual will be taxed only on income derived from sources within the United States. Therefore, for tax purposes, it will generally not benefit your client to become a U.S. resident. Accordingly, the client cannot be a green card holder, or meet the substantial presence test of § 7701(b)(3) of the Code.

The substantial presence test is satisfied if the nonresident alien individual is in the United States for a certain number of days either in the current calendar year or over a three-year lookback period. A nonresident alien individual qualifies as a resident alien, in spite of not being a green card holder, if he is physically present in the United States for: (1) 183 days or more during the calendar year; or (2) at least 31 days during the calendar year and satisfies the physical presence test under the three year lookback rule. A nonresident alien individual satisfies the physical presence test under the three-year lookback rule if the sum of the number of days of his physical presence in the United States in the current calendar year, one-third the number of days of his physical presence in the first preceding calendar year, and one sixth the number of days of his physical presence in the second preceding calendar year equals 183 days or more.

Generally, if a foreign person spends an average of 122 days in the United States over a three-year period, he will be treated as a resident alien for tax purposes. However, there

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50. A relatively current list of state reporting and disclosure requirements can be found in David Alan Richards' article, see Richards, supra note 29, at 136-55.
are a variety of rules that govern the numerical daycount as well as a good number of exceptions and exemptions that should be taken into account before advising the client on this issue.51

b. "Foreign Corporations".

A "foreign corporation" is a corporation that has not been created or organized in the United States or under the laws of the United States or any state.52 On December 18, 1996, the IRS published the commonly called "check the box" regulations addressing the classification of domestic and foreign entities for tax purposes.53

In the foreign entity area, the regulations contain a list of specified entities in eighty-two countries whose tax status will per se be that of a corporation. For all other entities, absent taking any affirmative action, the so-called "default rules" apply. Those rules provide that a foreign entity will be classified as a corporation if none of its members has unlimited liability for debts of the entity. If at least one member has unlimited liability, then the default status will be that of a partnership. If the entity has only one member, corporate status will be applicable if that member does not have unlimited liability for the debts of the entity. If this is the case, then the entity will be disregarded for tax purposes.

If the entity and its members desire a different tax status than that provided by the default rules, then such entity can generally achieve that status by making an affirmative election with the I.R.S. The choice of entity by the foreign investor and the I.R.S. classification of the foreign entity for tax purposes are key in the development of the foreign investment strategy.54

2. Kinds of Taxes.

a. State and Local Property Taxes.

Real estate counsel should explain to her client that property taxes are levied every year based upon the appraised value of the property located within the United States and should be regarded as an ancillary cost of ownership, like utilities and maintenance.


In general, the United States taxes foreign investors only with respect to certain specified forms of income.55 Foreign investors are taxed on a net income basis, at the same graduated income tax rates imposed on U.S. corporations or U.S. citizens or residents, and on income (whether from U.S. or other foreign sources) that is considered effectively connected with the conduct of a trade or business in the United States ("effectively connected income"). Effectively connected income includes gain or loss on the disposition of U.S.

real property interests. The maximum tax rate for U.S. citizens or residents is 39.6 percent on ordinary income and 28 percent on capital gain. The maximum rate for corporations is identical both for ordinary income and capital gain: 34 percent for most corporations and 35 percent for those with taxable income in excess of $10,000,000. Applicable state income taxes are added to these. For example, Florida has no individual income tax but does have a corporate tax of 5.5 percent.

The United States also taxes foreign investors on a gross income basis, at a flat 30 percent rate (unless reduced or exempted by a treaty), on certain types of fixed or determinable annual or periodical noneffectively connected income, such as interest, dividends, royalties, and rents. The 30 percent tax is collected by a withholding tax imposed on the payor.

If a foreign corporation is engaged in U.S. trade or business or is deemed to be so engaged as a result of a Code § 882(d) election, it will be subject to regular U.S. corporate income tax on its net income. In addition, and in the absence of treaty relief, it will also be subject to a 30 percent branch profits tax on both its effectively connected earnings and profits and on its interest deductions allocable thereto. As a result, if a foreign corporation pays 34 percent tax on its income, and the remaining profits are subject to the 30 percent tax, the effective tax rate upon remittance to the shareholders will be about 54 percent (without taking any applicable state income taxes into account).

Branch level taxes may be reduced or eliminated by treaty provided the foreign corporation is a qualified resident of the treaty jurisdiction. In general, this requires that treaty beneficiaries own more than 50 percent (by value) of the stock.

c. Estate and Gift Taxes.

The regulations provide, and the courts agree, that for estate and gift purposes, a resident is one who, at the time of his death (or at the time of making the gift) has his domicile in the United States. The estate tax rates for nonresident aliens are the same as those applied to U.S. citizens. Accordingly, they range between 18 percent on the first $10,000 of taxable U.S. assets to 55 percent on taxable U.S. assets over $3,000,000.

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62. The concept of "domicile" requires more permanence than "residence." For the purpose of determining the issue of domicile, "[i]t is not fleeting or casual or sporadic intention which controls, but a serious conception of home." Rodiek v. Commissioner, 33 B.T.A. 1020, 1033 (1936), aff’d, 87 F.2d 328 (2d Cir. 1931). It is also important to note that U.S. estate tax treaties may affect the determination of whether an alien is domiciled in the United States for U.S. estate tax purposes. See, for example, The United States-Netherlands Estate Tax Treaty, which provides that a person domiciled in the Netherlands is presumed not to be domiciled in the United States unless he is in the United States for at least seven years.
63. Treas. Reg. §§ 20.0-1(b), 25.2501-1(b) (1996); Farmers Loan & Trust Co. v. United States, 60 F.2d 618 (S.D.N.Y. 1932); Rodiek v. Comr.; 33 B.T.A. 1020, aff’d, 87 F.2d 328 (2d Cir. 1937). (1936), aff’d, 87 F.2d 328 (2d Cir. 1937).
64. I.R.C. §§ 2101(b), 2001 (c) (1996).
Avoiding or minimizing U.S. estate taxes is important because, although a nonresident's estate is taxable at the same rates as a U.S. resident's estate, a nonresident's estate is not entitled to the $600,000 exemption of § 6018(a)(1) of the Code. Instead, a nonresident is only entitled to a $60,000 exemption (assuming no U.S. estate tax treaty is applicable). Also, while the unified credit for residents is $192,800, the unified credit for nonresidents is only $13,000. Finally, many states also impose their own inheritance (estate) taxes.

Gifts of realty made by a nonresident are taxable at the same rates as gifts made by U.S. citizens, but without the benefit of the unified credit to offset the gift tax payable. In addition, the IRS reserves the right to redetermine the value of such gifts if it ascertains that the value was under reported for gift tax purposes.

3. Tax Planning Objectives.

The transaction should be structured to achieve the foreign investor's business objectives. A list of the most common primary objectives of tax planning for U.S. real property investments by foreign persons is provided below, with a short discussion on how to achieve them.


Probate is a court procedure by which a will is determined to be valid or invalid. Generally, the probate process involves collecting a decedent's assets, liquidating liabilities, and distributing property to heirs. It requires the filing of information returns with U.S. authorities disclosing the identity of the deceased and the heirs, and may require that ancillary information be obtained from officials of the home country of the deceased, such as birth and death certificates, resulting in the disclosure of the existence of the U.S. property to officials of that country. Furthermore, it is often a time-consuming and costly process.

A U.S. real property investment can be properly structured so that no U.S. estate tax nor probate costs will result upon the foreign person's death. For example, a trust can be

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67. See David M. Daly, Plan Ahead to Avoid Multi-State Death Taxes, 3 INSTITUTIONAL INVESTOR, INC. 4, 10 (1996); Kenneth P. Brewer, A Rose by Any Other Name, 10 STATE TAX NOTES 799 (1996).
68. By contrast, all intangible personal property is excluded from gift tax and is defined as foreign situs property. I.R.C. § 2501(a)(2) (1996). Included in this exclusion is stock in domestic and foreign corporations, as well as partnership interests. Accordingly, while domestic corporate stock held at death results in estate tax, a completed, inter vivos corporate stock transfer avoids imposition of gift tax. The transfer of a partnership interest also escapes gift taxation.
71. See Daly, supra note 67.
used to avoid probate or an offshore corporation can be set up in a jurisdiction with favorable tax treatment in order to avoid probate and U.S. estate taxes altogether.  


Depending on the type and number of U.S. real properties held by the foreign person and how those properties are used (rental, development and sales, and/or held for appreciation), certain choices will have to be made that can postpone or accelerate the reporting of the profits or gains for U.S. income tax purposes and, hence, the payment of income taxes. These choices include the accounting methods for preparing the U.S. tax returns, whether to hold the property directly, indirectly through a U.S. or foreign corporation or through a combination, and whether to form and file as a U.S. consolidated return group.

c. Repatriation of Earnings as Deductible Interest.

Repatriation of earnings as deductible interest is one of the more difficult features to qualify for in a structure for foreign investors, particularly for those foreign investors from nontreaty countries. Generally, if a U.S. corporation holds the U.S. real property, then a payment of interest by the corporation to a nontreaty investor will generally be subject to a 30 percent withholding tax. This withholding tax applies even if a nontreaty foreign investor uses a foreign corporation to hold the U.S. real property. Pursuant to the branch level interest tax, the greater of the interest allowable as a deduction or the interest paid by the foreign corporation will generally be subject to a 30 percent tax.

There are several ways to address this problem. If the foreign investor has a favorable treaty, he may be able to take deductions for interest paid to shareholders while reducing or eliminating the 30 percent tax. Also, interest qualifying as "portfolio interest" paid and deducted by the U.S. real property business is exempt from the 30 percent U.S. tax. Furthermore, the portfolio debt instruments owned by the foreign investor receiving the interest will also be exempt from the U.S. estate and gift taxes. However, to qualify for the portfolio interest exemption, the interest cannot be paid by a corporation to a person or entity that owns, directly or indirectly, 10 percent or more of the corporation issuing the debt. This requirement limits significantly the situations in which the portfolio interest exemption can be used. Other requirements must also be met for interest to qualify for the exemption.

d. Repatriation of Earnings and Distributions.

The ability to repatriate earnings as distributions from a corporation holding the U.S. real property without incurring the 30 percent U.S. withholding or branch profits tax is important because, when imposed, the tax can materially reduce the profits to the foreign

72. The stock of a foreign corporation is foreign situs property and avoids estate tax even if the underlying corporate property has a U.S. situs. This does not apply to domestic corporate stock individually owned by a foreign investor since domestic stock has a U.S. situs regardless of the location of the certificates. I.R.C. § 2104(c)(2) (1996).


A treaty can reduce or eliminate the branch profits tax or the withholding tax on dividends (whichever applies). If that is not the client’s case, for foreign investors from nontreaty countries, there are only a few ways to avoid the 30 percent tax on the repatriation of earnings. Use of tax counsel in order to design the optimal tax structure is strongly recommended.

e. Minimization of Worldwide Tax Liability.

When structuring any U.S. investment by a foreign person, consideration must be given to the tax structure’s effect upon the investor’s non-U.S. tax liabilities. The foreign investor has to be aware of the importance of maintaining his nonresident status in the United States. Some foreign nationals may have children who were born in the United States and may have dual citizenship. Other foreign clients may be planning to have children in the United States to preserve the option of U.S. citizenship for their offspring. While there are obvious benefits to obtaining U.S. citizenship, the potential taxation on worldwide assets and income is one caution which needs to be communicated to foreign clients intending to give U.S. property to their American born children or to secure U.S. citizenship themselves.

f. Additional Desirable Features for Investors with Various Properties.

Where a foreign investor or a group of investors invests in two or more properties, it is often desirable to do the following:

1. limit legal liability solely to the property involved;
2. offset operating income or gains from one or more properties with the losses generated by others;
3. transfer funds belonging to one corporation to another corporation without triggering taxable income or gain to either corporation.

A means of obtaining these features is to form a U.S. consolidated return group. This entails placing each property in a separate U.S. corporation, each owned by a U.S. holding company. However, there are no "canned solutions" which work well for all investors. Real estate counsel, advised by a competent tax attorney, needs to consider each investor’s unique situation in the context of developing the optimal investment strategy.

E. THE IMPACT OF TAX TREATIES.

Before structuring the investment, real estate counsel should determine if there is treaty relief applicable to the transaction. The U.S. bilateral tax treaty system is designed to achieve two parallel objectives: 1) to prevent double taxation of income generated in international transactions; and 2) as a corollary, to prevent evasion of taxation on the same type of income.

76. As mentioned previously, if the corporation pays income tax on its earnings and these earnings are subject to the 30% tax upon distribution, the effective tax rate is about 54%.
The United States has entered into numerous tax and tax-related treaties that affect the planning of foreign investment in U.S. real estate. These are, among others, income tax treaties, estate and gift tax treaties, excise tax treaties, exchange of information treaties, tax implementation agreements with U.S. possessions, and mutual assistance treaties. A complete list of all U.S. tax-related treaties and their current status can be found in each monthly edition of *Tax Management International Journal*.

As part of its tax treaty negotiating process, the U.S. Treasury Department relies upon a prototype known as the "U.S. Model Draft". However, because of the bilateral nature of treaty negotiations, modifications to the U.S. Model Draft are common and, accordingly, each treaty has developed particularities of its own.

The Model Treaty applies to all federal income taxes, including excise taxes imposed in insurance premiums. Accumulated earnings tax, personal holding company tax, and social security tax are, however, typically excepted from treaty application. Some of the benefits provided by current tax treaties are: elimination of the U.S. withholding tax on interests; exemption of transfers of U.S. real property from U.S. estate or gift tax; and, with regard to income derived from U.S. realty, exemption of such income from tax in the home country or allowance of a tax credit for U.S. tax imposed on such income.

### IV. The Purchasing Entity.

Once counsel has interviewed the client and taken into consideration the above concerns, counsel should be ready to develop the optimal investment strategy. No exhaustive treatment of this topic is intended in this article. However, an overview of the more common alternative investment structures is provided below.

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A. **INDIVIDUAL OWNERSHIP.**

Direct ownership of U.S. real estate by one or more foreign investors in individual name presents three problems. First, the property is subject to U.S. estate tax. Second, there is unlimited liability in the individual ownership of U.S. real property. Finally, probate of a foreign estate to clear title to U.S. real estate is, as previously discussed, a time-consuming, costly, and often difficult process.

The above concerns can, however, be tempered by adequate planning when the realty is modestly priced. While estate taxation will result if the taxable estate exceeds the $60,000 credit equivalent exemption, the value of property included in the gross estate may be directly reduced by nonrecourse debt. A further planning technique that can be used cumulatively with nonrecourse debt, is to incur estate tax but to plan for payment of that tax through life insurance of the foreign owner. This is possible since proceeds from a foreign decedent's life insurance are foreign situs for estate taxation purposes even if the insurer is a U.S. person.79

B. **BASIC CORPORATE INVESTMENT STRUCTURES.**

A corporate investment structure provides the individual foreign investor with the potential for avoiding imposition of estate tax, regardless of the value of the underlying U.S. real estate.

The primary U.S. income tax advantages of holding U.S. real estate through a U.S. corporation are that (i) the branch profits tax is not applicable and, (ii) unlike the case of branch tax provisions, there are no statutory anti-treaty-shopping rules that will preclude foreign investors recipients of interest or dividends from the U.S. corporation from asserting treaty benefits. An important drawback, however, is that if the foreign investor dies while holding shares of a U.S. corporation, the shares will be includable in the foreign investor’s estate for U.S. estate tax purposes.80 For that reason, it might be advisable for the foreign investor to hold the shares of the U.S. corporation through an intermediate foreign holding corporation.81

A carefully established foreign corporation will avoid estate tax. On the other hand, it will be subject to the branch profits tax. In the basic approach, the foreign investor forms a foreign corporation in a tax haven where no income, wealth, or transfer taxes exist. To avoid probate and share provisions otherwise applicable, shares of the corporation are typically held in a revocable foreign trust82 also formed in an appropriate tax haven with the foreign investor as grantor.83

Once incorporated, the former corporation may invest in U.S. real estate directly or form a subsidiary. Direct investment is advisable in real property that will not produce

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81. See Knight & Doernberg, supra note 78, at 292-94.
82. The form of trust usually recommended for use by a nonresident alien grantor is a revocable trust. The grantor of a revocable trust retains broad powers over the trust during his lifetime. The trust may be drafted to provide the grantor with rights to remove assets from the trust, terminate the trust, or remove the trustee and appoint a successor.
83. See Newton, supra note 55, at 530.
rental income or be subdivided or sold as "dealer" property since it will not trigger the branch profits tax. Investment through a subsidiary will be generally preferable, however, if the foreign investment is in active, ongoing real estate operations where distributions are made or considered to be made to the foreign shareholder, therefore, raising complexities involving the branch profits tax.

The choice of the country in which to incorporate the foreign corporation will depend on the type and amount of the U.S. investments. The selection process involves comparison of general factors, such as the absence of local taxation, the availability and enforcement of bank secrecy, the costs of organization, the amount of annual franchise and registered agent fees, the availability of reliable and experienced management, and political and economic stability. Among the countries commonly used are Aruba, the Bahamas, Barbados, the British Cayman Islands, and the Channel Islands.

C. PASS THROUGH INVESTMENT STRUCTURES.

A partnership or trust that owns U.S. real estate may be able to attain significantly reduced income tax rates from that of typical corporate ownership by way of pass through treatment arising from individual investment.

1. Partnerships.

An entity that is classified as a partnership for U.S. federal income tax purposes will not be separately taxed on its net income. All items of income, gain, losses, and deductions are passed through to the partners without payment of a corporate-level tax.84

Other federal income tax advantages which compel the election of a partnership as the preferred vehicle are simplicity of formation, flexibility in allocating items of partnership income and loss among the partners, and flexibility upon disposition (the partnership is capable of "electing out" under I.R.S. § 761 and the partners may be able to make separate decisions regarding whether to sell their proportionate interest in the partnership or enter into a like-kind exchange under I.R.S. § 1031). In addition, partnerships can benefit from several state tax advantages, such as having the taxable income taxed at the lower personal income rate rather than at the higher corporate income tax rate.

There are certain drawbacks, however, in structuring the investment as a partnership. First, in a partnership, individual partners must file income tax returns. This substantially diminishes the level of confidentiality from what it would be if a foreign corporation, rather than a partnership, were the investment vehicle. Second, although partnerships are excluded from the gift tax, they have a substantial risk of liability for the estate tax.85 Third, in the case of general partnerships and general partners of limited partnerships, it is necessary to set up an incorporated entity that effectively insulates the partners from personal liability.86 Finally, the pass through structure also affects the foreign partner's ability

85. For U.S. estate tax purposes, the estate of a decedent nonresident alien is taxed only on the value of the property located in the United States, see I.R.C. § 2103 (1996). The IRS has ruled that a partnership interest will have a situs where the business is carried on, see Rev. Rul. 55-701, 1955-2 C.B. 836.
86. See GALLAGHER, supra note 78, at 1-71.
to claim an exemption from U.S. taxation pursuant to an income tax treaty between the United States and the country of which the foreign partner is a resident. Although many income tax treaties with the United States include a provision that prohibits the United States from taxing business profits of a foreign person in the United States unless the foreign person has a "permanent establishment" (as defined by the applicable treaty) in the United States, the courts and the I.R.S. generally have applied I.R.C. § 875(1) to impute the permanent establishment of the partnership to the foreign partner.  

2. **Limited Liability Companies.**

Limited liability companies ("LLCs") offer two advantages over limited partnerships and may present one serious disadvantage. The advantages are that LLCs provide a liability shield as well as the benefits of a partnership for U.S. income tax purposes. The disadvantage is that some states impose an entity-level state tax on the net income of an LLC under circumstances in which limited partnerships are not subject to an entity-level tax.  

Almost all of the states have passed LLC statutes. So called "bulletproof" statutes contain mandatory provisions which ensure that the LLC will lack two of the four corporate characteristics (typically, free transferability and continuity of life) and will therefore be treated as a partnership for U.S. income purposes. Other, more flexible statutes, allow the members of the LLC to design the agreement so as to lack any two of the four corporate characteristics.  

From a tax point of view, real estate counsel has to ascertain whether the LLC meets the I.R.S.'s "resemblance test" that will classify the LLC as a partnership for tax purposes.  

3. **Trusts.**

The primary advantage of owning U.S. real property through a trust is to provide for the orderly administration of the assets during an individual's lifetime and their continued management or disposition upon his death. In addition, if the trust is appropriately drafted, both the settlor and beneficiaries of the trust may be exempt from U.S. estate tax upon the death of either party.  

For tax purposes, trusts are classified as either grantor or non-grantor trusts. In a grantor trust, the trust's grantor retains a significant ownership interest over rights to the trusts assets. Grantor trusts, as a general rule, are not subject to U.S. tax; rather, the grantor is treated as owner of the trust and taxed on all or part of its income. On the other  

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87. See, e.g., Johnston v. Commissioner, 24 T.C. 920 (1955); Unger v. Commissioner, 58 T.C.M. 1157, aff'd, 936 F.2d 1316 (D.C. Cir. 1991); Donroy Ltd. v. United States, 301 F.2d 200 (9th Cir. 1962).  

88. 15 PA. CONS. STAT. § 8925 (1995); FLA. STAT. CH. 220.03(1)(e) (1995); FLA. ADMIN. CODE ANN. r. 12C-1.022(1)(b) (1995).  

89. The four corporate characteristics are continuity of life, free transferability of interests, centralization of management, and limited liability.  

90. See Groff & Crouch, supra note 78, at 6-8; GALLAGHER, supra note 78, at 16-18, for an analysis of the I.R.S.'s position on the application of the "corporate resemblance" test to LLC's.  

91. BLACK'S LAW DICTIONARY 700 (6th ed. 1990) defines a grantor as "the person by whom a grant is made. A transferor of property. The creator of a trust is usually designated as the grantor of the trust."
hand, nongrantor trusts are subject to U.S. tax on their taxable income. Trust income tax rates are provided under the Code in a separate tax rate schedule similar to the schedule applying to an individual taxpayer.\footnote{I.R.C. §§ 641(b) and 1(e) (1996).}

Foreign nonresident trusts are taxed in the same way as foreign individuals but are subject to a trust's income tax rules. For purposes of confidentiality and the avoidance of U.S. income and estate tax, the foreign trust is generally created and managed in one of the tax haven countries that recognize the English common law of trusts. These countries include the Bahamas, the Cayman Islands, Gibraltar, the British Virgin Islands, the Isle of Man (near Ireland), and the Cook Islands.\footnote{See JONES, DAY, REAVIS & POGUE, supra note 78, at 3; Azad, supra note 78 at 502.} The Bahamas and the Cayman Islands are especially attractive because they have enacted special laws such as the Trusts Act, 1989, and Fraudulent Conveyances Act, 1991, respectively, which both deal specifically with offshore trusts and offshore companies.

D. POOLLED INVESTMENT VEHICLES.

Poolled investment vehicles are a popular choice between investors who have limited funds but want to invest in U.S. real estate. A key advantage of pool investment vehicles is that they provide instant diversification of the investor's real estate. For example, a real estate investment fund can include equity ownership of varied types of properties in many locations, as well as real estate-related debt interests such as mortgages secured by real property. Another benefit is that investors who lack the resources to go through the due diligence process on their own, can rely on the personnel and experience of the fund to select and screen potential investments and follow up their development.

In most cases pooled investment vehicles are structured as a Real Estate Investment Trust, a partnership, a participating loan, or a foreign fund investing through a U.S. subsidiary. Tax treatment of each structure differs in consideration to the vehicle used and tax counsel should be consulted in order to define the best strategy for the particular client.

V. The Contract.

The contract is the culmination of the investment process and the result, in most transactions, of a team effort.

A. THE ROLE OF THE ATTORNEY.

Early in the process, the foreign investor, with counsel assistance, should assemble a team to negotiate and conclude the transaction. Depending on the complexity of the investment, real estate counsel will work closely with real estate brokers or finders, title companies, accountants, and, if applicable, mortgage and/or investment bankers. In addition, in most cases, assistance of immigration and tax counsel will be required.

Real estate counsel should play a constructive role in structuring and completing the transaction. A competent real estate counsel will consider each of the objectives of the client and develop the optimal legal structure to achieve them. She will address the con-
cerns of the other members of the team and help structure the tax and financial strategies that better suit the interests of the client. Furthermore, real estate counsel should keep the client actively involved in the process. All relevant approaches should be succinctly explained, with ultimate memorialization in writing before proceeding, so that the investor has sufficient knowledge to make an informed decision.

Once the transaction is consummated, contact with the client should be maintained and the investment vehicle monitored in terms of legislative provisions that may affect the investment structure. In this context, because foreign investors often understand the written word better that the spoken, it is suggested that real counsel confirms in writing the substance of her communications with the client.

Depending upon the sophistication of the client and his previous U.S. investment experience, the lawyer should ensure that the client understands the role of all parties in the transaction including who represents whom and how they expect to be compensated. This can avoid misunderstandings which result from differences in conveying in the client's country. Frequent communication, written when possible, can help assure that the client understands the process.

B. THE INVESTMENT PROCESS.

Foreign investments in U.S. real property generally follow the same procedure that U.S. investors use. First, the foreign investor learns about the real property and starts communication with the seller. Second, as discussions progress, the investor starts to structure the investment for tax efficiency and develops the financing structure. The foreign investor presumably will want to avoid U.S. tax on its own activities and reduce U.S. tax on capital gain. As the parties approach agreement, the investor and its counsel will need to consider compliance with mandatory legal requirements as well as practical matters that have a bearing on the consummation of the transaction. For example, compliance with state limitations in foreign ownership of land and agreement on a fixed exchange rate for the purchase price, respectively.

When the parties reach agreement on the general terms of the investment, they may enter a non-binding letter of intent or memorandum of understanding providing for further due diligence and, in some occasions, including a no shopping clause, a confidentiality agreement, or both. The letter will state that the parties do not intend to become legally bound to sell or purchase unless and until a formal contract is executed. In addition, the parties will agree to negotiate in good faith to enter into a binding agreement within a period specified in the letter of intent. The purchaser usually will put into escrow a good faith deposit or letter of credit, which will be returnable if a contract is not entered into, and which will be become part of the down payment if a contract is entered into.

Once definitive agreements are signed, the parties will complete due diligence and take the necessary steps to obtain any government or other approvals needed to close (or complete) the deal. Closing will take place once the required approvals are obtained and all contractual conditions are satisfied or waived. At closing, the investor will pay the purchase price and the seller will deliver title to the U.S. real property. Compliance with U.S. disclosure requirements and FIRPTA withholding duty is mandatory.

94. See Jesse B. Heath, Jr., Counseling Foreigners Investing in U.S. Real Estate, 1985 Nat'l L.J. 20; Mazo, supra note 78.
C. Drafting the Contract.

Each contract has its peculiarities. The following considerations are present in most contracts regarding foreign investment in U.S. real estate. Hopefully, counsel will find them illustrative.

1. The Parties to the Agreement.

Parties to the contract will be the foreign investor, acting per se or through an entity, and the seller. The seller's name, including all entities that are known to operate the business if the real estate transaction is part of a larger deal, shall be provided. The states of incorporation of buyer, seller, and any parent to be a party to the agreement shall be stated.

In some occasions, the foreign investor may require the utilization of a power of attorney for contracting the purchase or sale of the property, for closing the transaction, or for both matters. The use of a power of attorney for contracting, although appealing from a practical point of view, may be misleading. If used, it should describe in detail the scope of the authorization and include exculpatory language. In some occasions, attorneys execute a separate indemnity agreement with the client.95 This is, however, of doubtful utility in Texas.96

The use of a power of attorney for closing is rare. It may cause title problems and lenders usually will require the signature of the foreign investor in loan documents. It is preferable to have the foreign client execute the documents before the U.S. Consul or other notary acceptable by the law of the place in which the deed will be recorded. Review of the documents to be executed by U.S. counsel before execution should be assured. This requires advanced planning.

2. Purchase Price and Related Payments.

The purchase price and form of payment should be defined. The most common forms of payment are payment by cash, a certificate of deposit, a letter of credit or by exchange for other assets (i.e., investor's shares). Counsel for the seller usually requires that the certificate of deposit be placed with a U.S. bank or trust company acting as escrow agent. Letters of credit are often irrevocable and conditional solely upon presentation of a certificate of default by the investor. A clause that grants the seller the right to contest any such notice of default should be anticipated, as well as one granting the investor the right to contest any draw by seller.

In addition to the above, if applicable, the contract should anticipate the need to secure indemnification payments or payments of any shortfall amounts payable in connection with a purchase price adjustment or for any other purpose. Common strategies are to escrow or withhold a portion of the purchase price or to require seller to have a letter of credit to secure payment of any indemnification amounts.

95. See Markus, supra note 78, at 57 app. L - Indemnity Agreement.
3. **Representations and Warranties/Organization, Standing and Authority.**

A common concern of sellers dealing with foreign investors is to be assured that the foreign investor, especially if it is a company, has authority to enter into the transaction. Sellers usually require from the buyer a broad representation providing that the foreign corporation is a corporation duly organized, validly existing under the laws of its country of incorporation, and with all requisite power and authority to enter into the transaction and perform its obligations thereunder such as its ability to consummate the transactions as contemplated and conduct its business as is being conducted.

Depending on the magnitude of the transaction, counsel for the foreign investor may decide to require an opinion of counsel for the foreign entity as to the above representation or, instead, engage foreign counsel to that effect. In any case, U.S. counsel should insist that the seller accepts foreign counsel's opinion alone.

4. **Miscellaneous.**

a. **FIRPTA Withholding Requirement.**

The parties should abide themselves to comply with U.S. disclosure and withholding requirements. Under FIRPTA, buyers are required to withhold 10 percent of the amount realized on the disposition (essentially, the gross proceeds of sale), unless: (i) the property is acquired by the foreign investor for use by him as a residence, and the amount realized for the property does not exceed $300,000; (ii) the buyer is presented with a bona fide withholding certificate reducing the obligation; or (iii) the foreign investor furnishes the buyer with a "nonforeign affidavit" in the form required by law.97

b. **Assignability.**

The right to assign the contract at will benefits the client. It simplifies procedures in the event of, for example, a tax driven corporate reorganization of the foreign investor. If a general right to assign the contract is unacceptable to the seller, negotiating a right to assign to affiliates of the investor, or an investment entity, might be an option.

c. **Remedies.**

Counsel should inform her client of any limitations of remedies required by seller and enforceable by local law. She should also address the consequences of a default by seller. In some occasions, including an arbitration provision in the contract benefits both parties. Arbitration proceedings are usually less time-consuming and costly than their judicial counterparts.

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VI. Conclusion.

Structuring foreign investment in U.S. real estate is an involved process with no one easy solution. It requires collective consideration of U.S. tax, business, environmental, and foreign policy regulations. In most cases, a team effort is necessary. A Master's degree in international relations would also be welcomed. It is a challenging and demanding job. On the other hand, it offers counsel the possibility of exploring different areas of knowledge and learning from other professionals and other cultures. It offers the possibility of becoming as near to a Renaissance attorney as is possible in our specialized 20th century world.