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Tax Implications for Non-Resident Aliens Investing in U.S. Real Estate

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While the real estate market in the U.S. has recently shown signs of slow recovery, there are still plenty of opportunities for foreign investors wishing to acquire U.S. properties for intermediate and long-term investment. The question I am often asked is how foreign investors should structure this transaction in a way that minimizes their tax and reporting exposure. In this article, I will try to examine the tax implications of investing in U.S. real property and some of the strategies that may be followed.

The United States taxes non-resident aliens only on U.S.-source income (aside from a few exceptions that are beyond the scope of this article). Foreign investors are therefore subject to U.S. income tax (and in some cases state income tax) on both their rental income and capital gain on the sale of the property. Depending on the investment structure, foreign investors may also be subject to estate tax if they die before selling the property or gift tax if the property is gifted away.

There are four basic structures that are normally used for foreign investment in U.S. real estate: investing through a U.S. LLC, a foreign corporation, a U.S. corporation wholly owned by a foreign corporation, or a U.S. LLC wholly owned by a foreign pass-through entity. Each of these strategies has its own advantages and disadvantages and require advanced planning by a tax professional (alternative structures may be considered if necessary).

Investing through a U.S. LLC is one of the simplest and least costly ways of investing in U.S. real estate. The main advantage of an LLC is that it allows for pass-through taxation at the individual level. In 2013, the maximum long-term capital gains tax on individuals in the U.S. is 15 percent (20 percent for taxpayers with taxable income in excess of \$400,000). Rental income (after allocable deductions) is treated as ordinary income subject to marginal tax rates which range from 10 percent to 39.6 percent in 2013. The main problem with this form of investment is that it may subject the foreign investor to estate tax if he/she dies before selling the property. The United States imposes estate taxes on property held by non-resident aliens which is located within the U.S. (U.S. situs property) and investing through an LLC does not eliminate this tax. Another disadvantage of investing through an LLC is that it requires each individual foreign investors to file a U.S. tax return (Form 1040NR) thereby losing anonymity and adding to the cost of the investment.

Using a foreign corporation is usually not recommended, as it may expose foreign investors to the branch profits tax. After-tax earnings of a U.S. branch that are not reinvested in the business by the end of the tax year or that are repatriated in a later tax year may be subject to an additional 30 percent branch level tax. Conversely, there are certain tax planning strategies that can help avoid the branch profits tax. While foreign corporations are normally subject to the same federal corporate tax rates as local corporations (ranging from 15 percent to 35 percent in 2013), a check-the-box election may be made to have the company taxed as a partnership. Estate and gift taxes are avoided when investing through a foreign corporation. This strategy is sometimes used by investors in non-income producing real property whose only source of income is from the sale of the property.

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Non-resident aliens investing in income-producing real property may be advised to use a U.S. corporation as the holding company for their foreign corporation. This allows the foreign investors to avoid estate tax liability and the branch profits tax, but may subject them to corporate tax rates that are significantly higher and double taxation on both the rental income and the capital gain. U.S. Corporations are not entitled to reduced tax rates on long-term capital gains. A tax professional should be consulted before using a foreign corporation, as the rules are complex.

One additional option is for foreign investors to form a foreign pass-through entity and have it invest in a U.S. LLC. This form of investment may be more effective than all previously discussed strategies, as it allows for pass-through taxation at the individual level as well as avoidance of estate and gift taxes and the branch profits tax. However, careful tax planning is required for this structure, with an emphasis on the entity classification for U.S. income and estate tax purposes.

Another issue that foreign investors must take into account is the withholding requirements. Rental income paid to an individual non-resident alien is subject to 30 percent withholding. Taxpayers can make an election to treat all the income as effectively connected to a U.S. trade or business, thereby exempting these payments from withholding. When an individual non-resident alien sells a real estate property, he/she is subject to 10 percent withholding. In addition, foreign investors (whether corporate or individual) in a U.S. partnership or LLC must be withheld 35 percent of their share in the company's distributable profits. This amount can be credited against the total tax liability in the taxpayer's personal tax return for the year. Careful consideration should also be given to the local tax laws in the foreign investor's country of residence and the relevant tax treaties, which may reduce or eliminate many of the taxes discussed above.

If you have any questions concerning this matter, feel free to contact us at your convenience. Aside from compliance and tax preparation, our firm can help you design a tax strategy that is right for your investment needs. We are also available for on-going consulting as your investment needs change.

ABOUT THE FIRM

Savransky Partners LLC is an international tax consulting firm which specializes on the tax needs of U.S. taxpayers with offshore investments and foreign taxpayers investing in the U.S. The firm offers a wide range of services, including tax preparation, US & International tax planning, negotiations with the IRS and state tax agencies, comptrollership services, and FIN48.

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