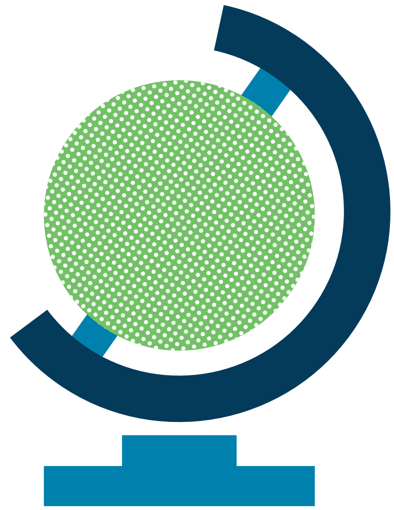
INTERNATIONAL TIDBIT:

Still the *Real* Thing After Three Decades – U.S. Taxation of Foreign Investment in Real Property



As foreign investors chase higher yields in commercial real estate and foreign players increase their stakes in U.S. oil and gas properties, a fundamental aspect of U.S. tax law since 1980 comes into play. The Foreign Investment in Real Property Tax Act or FIRPTA was enacted to prevent foreign investors in U.S. real property from escaping taxation on its appreciation under the general rule that exempts nonresidents from U.S. tax on capital gains. FIRPTA included enactment of IRC section 897, which taxes the disposition of a U.S. real property interest as income "effectively connected with a U.S. trade or business." Teeth, on the enforcement side, are provided by IRC section 1445, requiring a transferee to withhold 10% of the amount realized by the foreign person. The foreign person must also file a U.S. federal income tax return to report the disposition and pay the tax due, after considering the amount withheld.

WHY REAL IS SPECIAL?

Countries all over the world treat investment in their *terra firma* differently from other forms of cross-border investment and some prohibit foreign investment entirely. After all, it's not portable and ownership in the hands of nonresidents may be viewed as undermining or competing with interests of residents. The model double taxation treaties promulgated by the Organization for Economic Cooperation and Development, the United Nations, and the U.S. Treasury all include an article covering real property and giving the country in which it is located first dibs on taxation.

WHAT PROPERTY IS REAL?

In the case of the U.S., a U.S. Real Property Interest ("USRPI") under FIRPTA includes items such as the following:

- Real property (land and buildings, whether residential or commercial);
- An interest in the form of a right to share in the appreciation of, or profits generated by, real property;
- An interest in a mine, well, or other natural deposit;

- Shares of a U.S. corporation that is a U.S. Real Property Holding Corporation (generally, more than 50% of fair market value of its assets is comprised of USRPIs).
- Interests in foreign or U.S. partnerships (if at least 50% of the value of the partnership's gross assets is comprised of USRPIs and at least 90% is comprised of USRPIs plus cash and cash equivalents).

A common approach to structuring investment in USRPIs is for foreign investors to set up a non-U.S. holding company to own a U.S. subsidiary (a corporation or limited liability company electing to be treated as a corporation for U.S. federal income tax purposes). Because the non-U.S. holding company would not be a U.S. real property holding corporation, transfer of its shares would not attract FIRPTA tax. However, any transferee would need to consider the future tax if the U.S. corporation is ever transferred.

One of the few exceptions to FIRPTA is if the U.S. corporation disposes of its USRPIs and pays tax on the gains. Then the U.S. corporation can liquidate and distribute its assets without the foreign investor incurring FIRPTA tax since gain has already been taxed at the level of the U.S. corporation. For this reason, foreign investors may prefer to house each U.S. real property investment in a separate U.S. corporation and liquidate it after the property is sold.

ONGOING INCOME/LOSSES FROM REAL PROPERTY

While FIRPTA is designed to tax the disposition of USRPIs that have appreciated in value, tax on income generated by real property is covered by other sections of the Code. For example, a nonresident earning income effectively connected with the conduct of a U.S. trade or business will be subject to tax at graduated rates on that income but would have the opportunity to deduct related expenses. If, instead, income such as rent is not effectively connected with a U.S. trade or business, the lessee will be required to withhold U.S. tax at the rate of 30% on payments to the non-U.S. owner. This rate is not reduced by double taxation treaties, which give priority to the article covering real property over the exception that might otherwise apply to business profits not attributable to a permanent establishment. The nonresident owner could end up with a smaller U.S. tax bill by electing to treat the income as effectively connected with a U.S. trade or business so that expenses are considered in determining taxable income and might result in less U.S. tax when compared to 30% on gross income.

OIL & GAS

As indicated above, the definition of USRPI includes an interest in a natural resource deposit and the right to share in appreciation of such a deposit or the profits it generates. This would include, for example, the land on which an oil well is drilled and the improvements or structural components affixed to it as well as the oil still in the ground below it. Also included are such typical arrangements as a royalty, an overriding royalty, a participating interest, a production payment based on volume, and a net profits interest. Therefore, nonresident investors need to consider not only the current taxation of income, and whether it is connected with a U.S. trade or business, but also how the disposition of such interests would be taxed.

OTHER TAXING MATTERS

For foreign persons contemplating investments in U.S. real property, federal income tax is just the beginning. States and municipalities may also impose taxes on income as well as ad valorem taxes on the property itself, transfer taxes, and taxes on the separation of natural resources. For foreign individuals, U.S. estate tax should also be considered and is perhaps the chief reason that foreign investors prefer not to own directly any USRPIs. Items such as real property and shares of a U.S. corporation that owns real property are included in a nonresident alien's U.S. estate. Less clear-cut is whether an interest in a partnership (U.S. or foreign) that owns U.S. real property, or in a U.S. limited liability company, is also included in a U.S. estate. This has led foreign individuals to invest through foreign corporations whose shares would not be subject to U.S. estate tax and whose transfer would generally not be subject to FIRPTA.

Before acquiring property, the key for foreign investors is to determine how income and transfers of the property are taxed and to select an investment structure meeting objectives for current income and future appreciation.
