Foreign investment in US real property

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With an appreciating real estate market, strong currency, and well defined rule of law to protect investments, the US is a top choice for foreign investors in real estate. However, many of these investors may fear the perceived burden from US taxes and aggressive US tax enforcement agencies. Whether those perceptions are correct, investors do not have to have concerns about tapping into the US real estate market if they have proper planning and take precautions to meet tax reporting obligations.

How to own the property?

Property in the US can be owned directly by the investor, or through a separate entity such as a trust, LLC, or corporation. Forming entities in the US is not a long or expensive process, which keeps it as a relevant option. Personal factors and goals for the property will greatly affect the choice of how to own the real estate, but there are a few general principles that can help to guide this choice.

First, ownership usually should not be through a corporation. Corporations will cause two levels of tax for the owners. First the corporation will pay tax on any income or gain, then the shareholders will pay tax when the income or proceeds are ultimately passed out to them from the corporation. For this reason, it is uncommon to own property through a corporation as the tax burden usually outweighs the benefits.

Next, an LLC can avoid the double taxation of a corporation and provide similar tax consequences to the investor as owning the property directly. The benefit of an LLC owning the property is that it may give some legal protection. If the property is going to be rented there can be insurance concerns, finance issues, or liability questions in case of an accident. These are all areas that may be better served by using an LLC. However, if the property will just be held as a passive investment that appreciates over time, the use of an LLC may not be necessary.

Trust ownership is another popular way to enter the US real estate market. Trusts can provide many benefits unrelated to tax. Absent a US will or trust, if a foreign parent were to pass away, the heirs would have to come to US court and prove they should be the rightful owners of the property. By using a trust, this can be avoided so that as a matter of law, the property automatically passes to the designated beneficiaries. Additionally, trusts can be used to accomplish many goals beyond the scope of this article, such as designating ownership, income rights, future benefits, and many other items. Lastly, and often most important to the investor, in certain situations it can be possible for the ownership by a trust to be setup to mitigate income tax and transfer tax consequences.

The first factor in determining how to own property in the US must always be the goals of the investor. This includes plans to move to the US, both for the investor and/or the family, goals for future wealth transfers, and cash flow needs. Once these are clearly defined, choice of ownership can be more clearly designated.

How will it be taxed?

Taxation of US real property is extremely detailed, in fact, there is an entire subset of tax laws known as FIRPTA (Foreign Investment in Real Property Tax Act of 1980). Despite being detailed, these laws are generally well defined. Detailed laws may cause pitfalls for the uniformed, but can also allow for many planning opportunities. There are four main areas of tax to be concerned with when investing in US real property.

Income Taxes
Ordinary income taxes would apply to any income generated from use of the property, ie – rent. In general, under US tax law rent is taxed at 30% on the *gross* rent for foreign investors, which means there is no allowance for any deductions such as maintenance, management fees or depreciation.[1] This can be a very high cost, considering much of the income may be spent on expenses. However, it is possible to file an election to treat the rent as a business, which allows for the use of deductions to offset taxable income.[2] The key to this election is that it must be filed in a timely manner. If tax returns are filed late, the election for deductions will be disallowed.[3] This illustrates a great example of how the US tax system does not have to be feared with proper planning and knowledge, but ignoring these obligations can lead to problems.

Capital Gain Taxes
Capital gain taxes are technically a part of income taxes. However, they generally have a more favorable rate and are on the sale of the investment rather than business income, causing most taxpayers to think of them as their own category. Capital gain tax applies when the property is sold, or if a deemed transfer is triggered. The tax would be on the appreciated value calculated as the current sales price less the “basis”. Basis in the property is the original purchase price plus certain improvements to the property, but lowered for any depreciation taken as an expense. Planning against capital gains tax is more difficult because it is triggered when the property is sold. This leaves no room for the tax laws to defer such taxes until a later event, unless there is an installment sale. The main option to mitigate the capital gains tax is to keep accurate records of improvements to the property, as well as the original purchase price.

Transfer Taxes
Gift and estate taxes in the US can be as high as 40%. For US property, foreign investors only receive an exemption of $60,000 when leaving it as an inheritance. Furthermore, there are situations where a transaction can be treated as a deemed sale of real estate even if it was not sold. The most common example of this is when US property is given as a gift from one foreign person to another foreigner. Due to these rules, it is not always as simple as giving your beneficiaries property through a gift or bequest. Nevertheless, in some cases it can be possible through proper wealth transfer planning to avoid conditions triggering tax. It is thus imperative that if the investor plans to give the property through a gift or bequest, that proper planning is done to mitigate any taxes. If the investor ultimately plans to sell the property to an outside third party, these taxes would not be a cause for concern because that transaction would be subject to capital gain taxes and not transfer tax. A more in depth discussion on this topic can only be done on an individual, case by case basis as wealth transfer planning is unique to the goals and wishes of the individual investor.

Real Estate Taxes
Regardless of the use or the type of property, real estate taxes must be paid. In the US, these

[1] 26 USC. § 871.
[2] An “election” for US tax purposes is a statement to inform the taxing authorities of the use of an available method for determining tax.
[3] 26 C.F.R. § 1.874-1

are generally in the range of 1-2% of the property value per year. The only planning regarding real estate taxes is that if the property is rented, and proper elections are filed as stated above, these taxes can be used as a deduction against income.

Summary

Owning property in the US is a relatively easy process. It does not require citizenship, a green card, or any US status at all. Moreover, the choice of whether or not to own outright or through an entity is solely the choice of the purchaser. While US laws on owning real estate, including tax consequences, can be lengthy, they are also generally well defined and do not have to be intimidating to the informed investor. The important thing is that proper planning is performed to make sure the goals of the investor are met using a tax efficient strategy. Through proper planning, investors can enjoy a successful venture into the US real estate market.