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EMAIL: INFO@KLUGTAXLAW.COM
PHONE: 202-661-2179
FAX: 202-661-6119
WEBSITE: WWW.KLUGTAXLAW.COM

TAX CUTS AND JOBS ACT SHOULD PROMPT SECOND LOOK AT FOREIGN INVESTMENT IN US REAL ESTATE

BY CHRISTOPHER KLUG
INTERNATIONAL TAX ATTORNEY

The 2017 Tax Cuts and Jobs Act ("TCJA") made several key changes that impact the investment of non-US persons in US real estate. The TCJA signed into law December 22, 2017, is the most comprehensive tax reform in over thirty years. The Changes to the TCJA that affect US taxation of cross-border investment should prompt non-US persons to take a second look at investments in US real estate. Income tax rate decreases, limitations on deducting interest expenses, and deducting net operating losses will impact foreign persons investment in US real property.

INCOME TAX RATE REDUCTION

The TCJA reduced income tax rates for corporations and passthrough entities; the maximum tax rate for C-corporations was reduced from 35 percent to 21 percent, which could significantly increase the after-tax return on real estate investments held through US corporations.

It is typical for foreigners to structure their investment in US real estate by contributing capital to a foreign corporation that is formed in a low-tax or no-tax jurisdiction. The foreign corporation then contributes capital as debt or equity or a combination of both to a wholly owned US corporation. The US corporation can purchase the US real estate directly, or through a joint venture with other investors. The US corporation shields the foreign individual investor from US tax liability and filing requirements, however, typically information filings will reveal the foreign individual investor in US tax filings. The decrease in the C-corporation tax rate only makes this structure more beneficial for the foreign investor.

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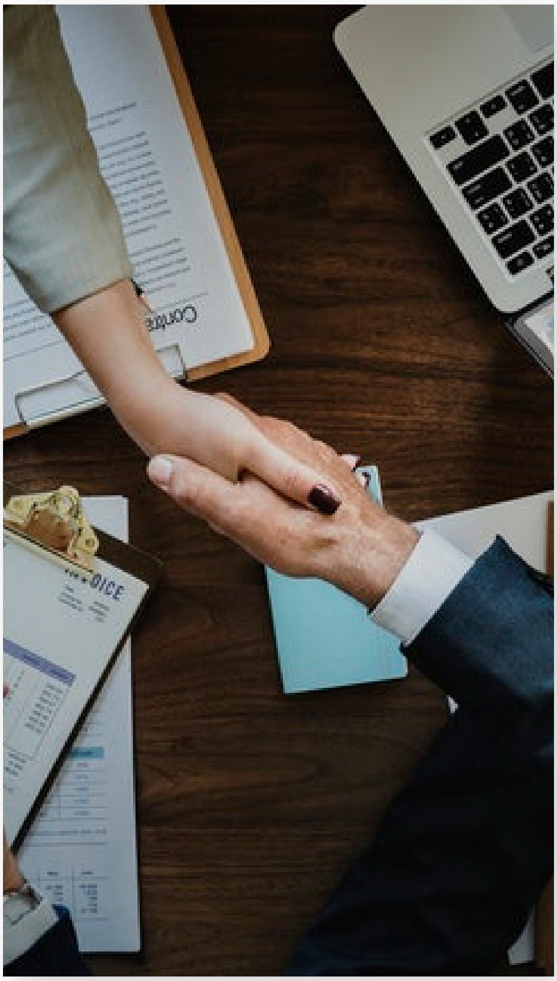

The TCJA does not change the 30 percent US federal withholding rate (lower if a treaty applies) on dividends paid by a US corporation to a foreign person. The effective combined rate on foreign shareholders of a US corporation subject to a 30 percent dividend withholding tax is now 44.7 percent, down from 54.5 percent.

For passthrough entities, Internal Revenue Code ("IRC") § 199A provides that taxpayers other than corporations who earn qualified business income are entitled to deduct as much as 20 percent of that income. The deduction is capped based on certain limitations for Form W-2 wages and the tax basis of depreciable property. An individual investor eligible for the full benefit of the passthrough deduction will have a maximum marginal tax rate of 29.6 percent.

IRC § 871(d) and 882(d) allow non-US individuals and corporations not engaged in a trade or business that derive income from US real property to elect to be taxed on a net basis at graduated rates as if the income were effectively connected to a US trade or business. Under this election, the investor is exempt from the 30 percent withholding tax on rental income and is allowed to deduct expenses such as depreciation and interest.

A foreign corporation investing in US real estate through a US corporation allows the foreign investor to avoid US estate and gift tax. The foreign investor owns shares in a foreign corporation, the transfer of which is not subject to US estate and gift tax. A foreigner is subject to US gift and estate tax (rules different for each) on US situs assets and they have no gift tax exemption and only a $60,000 estate tax exemption, with the balance being subject to tax at rates up to 40%. A foreigner's ownership

US real estate can generate significant US estate tax if not properly structured.

FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT

Non-US investors in US real estate are subject to the Foreign Investment in Real Property Tax Act ("FIRPTA"), which generally taxes non-US individuals and corporations on their gains from the disposition of US real property interests. This includes ownership in US real property or ownership of interest in a US corporation that is a US real property holding corporation.

A corporation is a US real property holding corporation if the value of its US real property interests is at least 50 percent of its assets value. The stock of a domestic corporation is presumed to be a US real property interest unless the taxpayer establishes that the corporation was not a US real property holding corporation at any point during the previous five years.

If FIRPTA applies to the sale of US real estate, the purchaser of the US real estate is required to withhold and remit 15 percent of the gross purchase price to the Internal Revenue Service ("IRS"). In addition, states may have their own withholding tax regime for nonresident sellers of real estate within the state.

If a corporation that is a US real property holding corporation disposes of all its property in a taxable transaction in which the full amount of gain is recognized, the stock ceases to be a US real property interest, and any liquidation gain would not be subject to additional corporate or individual tax. This is a tremendous advantage for foreign investors as compared to US investors, the foreign investor can exit a C-corporation structure with only one level of income tax.

LIMITS ON INTEREST EXPENSES AND NOLS

The TCJA replaced the earnings stripping rules with new limits that apply to all taxpayers, not just corporations and regardless of whether there is a related lender or guarantor, and without any debt-equity ratio requirements. Under the TCJA business interest deductions are limited to the sum of trade or business interest income plus 30 percent of adjusted taxable income. The limit does not eliminate the deductions, but defers the excess deductions to future years. Disallowed interest is carried forward indefinitely.

There is an exception to the interest deduction limitation for taxpayers with average annual gross receipts of $25 million or less for the three preceding tax years, but the exception does not apply to partnerships or LLCs when at least 35%

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of the losses are allocated to limited partners.

The TCJA limits the taxpayer's ability to use NOLs to 80 percent of taxable income, with no carryback to prior years but indefinite carryforwards to future years.

CONCLUSION

The TCJA made significant changes that affect a non-US person's investment in US real estate. The reduction in the corporate tax rate is a favorable result for foreign investors as a typical structure is to invest through a C-corporation. It is important for non-US investors to review the tax rules under the TCJA and the proposed structures to ensure the optimal tax result.

Christopher Klug

/KlugLawOfficePLLC

+KlugLawOfficePLLCWashington

info@klugtaxlaw.com

www.klugtaxlaw.com

202-661-2179