by Vanja Habekovic

HOMES away from HOME

Foreign buyers of California residential real estate must consider how best to address concerns of privacy, liability exposure, and taxation

MANY WEALTHY NON-AMERICANS see U.S. real estate as an attractive and secure investment opportunity and a safe vehicle by which they may expatriate cash from their home countries. Foreign investment in U.S. real estate reached $54 billion for the year ending March 2015.[1] Not surprisingly, the Golden State has topped the charts in market share, second only to Florida.[2] The majority of these sales are for single-family residences intended to be used as vacation homes or investment property.[3] Sometimes foreign buyers acquire a home for their U.S. college-bound children.

Whatever the reason for purchasing a home in California, foreign investors typically have a number of competing objectives. A common one is privacy. Since title to real estate in the United States is usually public record, wealthy foreign investors, particularly those that are public figures, are rightfully concerned about the public availability of the locations of their personal residences. As a corollary to this concern, many foreign investors do not want to file income tax returns in their individual names. Lawsuits are another common fear of foreign investors. While liability exposure for the ownership of a personal residence is arguably less than for a property that is being rented to unrelated third parties, foreign buyers often have concerns about America's notoriously litigious society. Finally, foreign investors want to minimize income and estate taxes on their real estate investment. What many investors neglect to consider when investing in California is property tax, which can be significant, and the property tax impact of subsequent transfers of real property to their children by gift or inheritance.

When advising foreign purchasers of U.S. real estate, it is advisable to mention that under the U.S. tax system, U.S. residents are taxed on all the income they earn, whether it was earned in the United States or abroad. Most other developed countries employ a territorial tax system, which does not tax income from a foreign source. Many foreign investors are shocked to hear that their visits to the United States could cause them to become U.S. residents for tax purposes, subjecting them to U.S. tax on their worldwide income.

A foreign individual is treated as a U.S. tax resident if either 1) the lawful permanent resident test or 2) substantial presence test is met.[4] Under the lawful permanent resident test, those who hold green cards owe the U.S. tax on their worldwide income. Under the substantial presence test, foreign individuals are treated as U.S. tax residents if they are physically present in the U.S. for 1) at least 31 days in the current year, and 2) 183 days or more in the current and previous two calendar years, with a weighting formula used for the previous two calendar years.[5] In order to avoid passing the substantial presence test and to maintain status as nonresident aliens (NRAs), foreign individuals must keep track of the time they spend here, especially if they are getting close to the 183-day threshold. There are some noteworthy exceptions under the substantial presence test, including time

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spent here on a student visa. Also, tax treaty residence rules trump the Internal Revenue Code and therefore need to be reviewed in analyzing a foreigner's U.S. tax status.

Under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), NRAs and foreign corporations are taxed on dispositions of U.S. real property interests.[6] A real property interest in the United States includes not only a direct interest in real property but also interests in certain corporations that own real property, known as U.S. real property holding corporations.[7] The FIRPTA tax is enforced through a withholding mechanism in which buyers are required to withhold 10 percent of the gross proceeds from the sale of a U.S. real property interest for federal purposes, and 3⅓ percent for California purposes.[8] Since the withholding tax is on the total proceeds from the sale and not just the gain on sale, the amount of withholding may far exceed the NRA's U.S. federal and California state tax liability. The withheld tax can be applied against the actual tax liability on the NRA's income tax return, and the NRA can obtain a refund if there was overwithholding.

The estate tax is only imposed on an NRA's U.S. situs assets.[9] U.S. real estate and stock in a U.S. corporation are treated as U.S. situs assets, while stock in a foreign corporation is not, even when the corporation's sole asset is U.S. real property or all the stock of a U.S. corporation whose sole asset is U.S. real property.[10] Whether interest in partnerships or LLCs holding real property are treated as U.S. situs assets is not entirely clear under current IRS guidance. The large exemption from estate tax for U.S. residents is unavailable for nonresidents; their exemption is only $60,000.[11]

California property tax is based on the fair market value of the property at the time of purchase.[12] The tax rate is 1 percent annually plus any special or direct assessments, which vary from city to city. The fair market base value of a property is adjusted for inflation but only up to 2 percent per year. Thus, once real property is acquired, the property tax increases are relatively modest. Attorneys should advise foreign purchasers that their property taxes may be significantly higher than those of the current owners of a property. This cost needs to be taken into account when evaluating the investment.

The possible dramatic tax increase resulting from a change in ownership of real property includes transfers by gift or inheritance. A transfer of real property to a spouse, however, does not result in a reassessment of real property.[13] In addition, a transfer of a primary residence to a child on death does not result in a reassessment, and transfers of up to $1 million of other than a primary residence is also excluded from reassessment.[14] With respect to transfers of interests in entities that own California real property, if a person obtains more than 50 percent of the voting stock of a corporation or more than 50 percent of the total interest in partnership or LLC capital and profits, the transfer constitutes a change of ownership of the real property owned by that corporation or partnership.[15] However, transfers of interests in entities that result in a spouse's obtaining a greater than 50 percent interest do not result in a change of ownership.[16]

Structuring Alternatives

There are a number of ways to hold title to the real property to address these issues. No one solution meets all objectives, and thus the pros and cons of each structure need to be weighed in light of the foreign investor's concerns.

The simplest and most straightforward structure is direct investment by the individual. The key advantage of direct ownership is the favorable long-term federal capital gain rate (currently at a maximum of 20 percent[17]) on the sale of the property if it is held for over a year. California, however, does not have a preferential capital gain rate, and the gain would be taxed at a current maximum rate of 13.3 percent. Direct investment also leaves open the possibility of being able to utilize the exemption for gain on the sale of a principal residence ($250,000 for singles and $500,000 for couples).[18] If a person has more than one residence, determination of which residence is the principal one is made by an analysis of facts and circumstances. Ordinarily, the property that the taxpayer uses the majority of the time is treated as the principal residence.[19] This creates a tension between obtaining principal residence treatment for a U.S. home

The Rental Predicament

When a shareholder uses corporate property for personal purposes, the fair rental value of the property is includible in income as a constructive dividend to the extent of the earnings and profits of the corporation.[1] In the context of a U.S. corporation holding real property, the question is whether the foreign individual shareholder should pay rent to the U.S. corporation for the shareholder's free use of the property.

In a relatively recent case, *G.D Parker Inc. v. Commissioner*,[2] the Tax Court held that a foreign individual's free use of residential real property held by a U.S. corporation was a constructive dividend to its foreign parent corporation and ultimately to the foreign individual shareholder at the top of the structure. The result was that the U.S. corporation was liable for a 30 percent withholding tax on the constructive dividend to the foreign corporation. The Tax Court also denied expenses associated with the property on the grounds that the acquisition and maintenance of the property were primarily motivated by personal rather than profit-motivated purposes.

While the idea of a constructive dividend may seem alarming, such a distribution is not taxable as a dividend if the corporation has no earnings and profits. For example, a U.S. corporation that owns a single residential property that is not rented to third parties and has no other income or assets should not have any earnings and profits. Whether free use of corporate property by a shareholder could result in deemed rental income to a corporation that would generate earnings and profits, however, is a question that remains unanswered.

In the case of a U.S. corporation with no earnings and profits, a constructive distribution does not result in a taxable dividend to the foreign parent corporation. The distribution is first treated as a return of capital and, after basis is exhausted, capital gain. Where the shareholder is only using the real property occasionally, it would likely take many years before basis is exhausted as the deemed distributions would be small.

In light of *G.D Parker* and the risk of imputed rent, rental agreements at fair value should be considered when a U.S. corporation owns real property that the ultimate foreign shareholders are using primarily for personal purposes. The rental income can be offset by maintenance, depreciation, insurance, and other expenses so that there is no income tax liability resulting from the deemed rental payments, and potentially even losses that could be used in the future. In any event, the foreign shareholders would have to fund the property expenses in some manner, whether by capital contribution or loan to the U.S. corporation.

If actual rental payments are made to the U.S. corporation, questions of local business tax must be evaluated. Many cities in California impose taxes and registration requirements on doing business in their city. Rental real estate is a business activity subject to tax in many cities. Each city has its own tax rates and municipal code, so the rules of the particular city where the real property is located must be reviewed to determine whether and how much business tax might be owed on rental payments to the U.S. corporation. Notably, it is unwise to claim that no city business tax is owed because the activity of renting to the ultimate sole shareholder is not a business activity. Such a contention would undermine the position that maintenance, depreciation, insurance and other expenses of owning the residential property is a business expense for income tax purposes.**—V.H.**

[1] Ireland v. United States, 621 F. 2d 731 (5th Cir. 1980).

[2] G.D Parker Inc. v. Comm'r, T.C.M. 2012-327.

MCLE Test No. 253

The Los Angeles County Bar Association certifies that this activity has been approved for Minimum Continuing Legal Education credit by the State Bar of California in the amount of 1 hour.

1. U.S. residents are taxed only on income they earn in the United States.
True.
False.

2. Green card holders are U.S. tax residents.
True.
False.

3. It is possible to be treated as a U.S. tax resident by being physically present in the United States.
True.
False.

4. Withholding under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) is 10 percent of the gain on the sale of a U.S. real property interest.
True.
False.

5. There is no estate tax imposed on nonresident aliens.
True.
False.

6. A transfer of real property to a spouse does not result in a reassessment of real property for California property tax purposes.
True.
False.

7. California real property held directly by a nonresident alien is subject to the U.S. estate tax.
True.
False.

8. A California LLC that is treated as a disregarded entity for federal tax purposes does not have to pay the $800 minimum tax on LLCs in California.
True.
False.

9. The parent-child exclusion from property tax change in ownership is not available for transfers of interests in LLCs disregarded for income tax purposes.
True.
False.

10. The interspousal exclusion from property tax change in ownership is not available for transfers of entity interests.
True.
False.

11. Stock in a foreign corporation is not a U.S. situs asset for purposes of the U.S. estate tax.
True.
False.

12. FIRPTA withholding does not apply to any sale of stock of a U.S. corporation.
True.
False.

13. The estate tax applies to the stock in a foreign corporation that is owned by a nonresident alien (NRA) if the foreign corporation owns U.S. real property.
True.
False.

14. Married couples can elect to treat an LLC as a disregarded entity for federal income tax purposes.
True.
False.

15. California real estate owned by a foreign individual directly is not subject to the estate tax.
True.
False.

16. California does not impose a withholding tax on the sale of California real property by an NRA.
True.
False.

17. Dividends from a U.S. corporation to a foreign corporation are generally subject to a 30 percent withholding tax.
True.
False.

18. California property tax is based on the fair market value of the real property at the time of purchase.
True.
False.

19. NRAs are eligible for preferential long-term federal capital gain rates on the sale of U.S. real estate.
True.
False.

20. NRAs are not subject to federal income tax on the sale of U.S. real estate.
True.
False.

MCLE Answer Sheet #253

HOMES AWAY FROM HOME

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Mark your answers to the test by checking the appropriate boxes below. Each question has only one answer.

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2.	☐ True	☐ False
3.	☐ True	☐ False
4.	☐ True	☐ False
5.	☐ True	☐ False
6.	☐ True	☐ False
7.	☐ True	☐ False
8.	☐ True	☐ False
9.	☐ True	☐ False
10.	☐ True	☐ False
11.	☐ True	☐ False
12.	☐ True	☐ False
13.	☐ True	☐ False
14.	☐ True	☐ False
15.	☐ True	☐ False
16.	☐ True	☐ False
17.	☐ True	☐ False
18.	☐ True	☐ False
19.	☐ True	☐ False
20.	☐ True	☐ False

while not spending so much time in it that the resident is treated as a U.S. tax resident. There will be FIRPTA withholding on the gross proceeds from the sale.

The main drawback of direct investment is that if the foreign owner dies while holding the real property, the property will be subject to the U.S. estate tax, which has a current maximum rate of 40 percent. For a young buyer with a relatively short investment time frame, the estate tax may be of little concern. For those who are older and wiser, a structure involving a foreign corporation should be considered. An intermediate solution for the young and invincible is to obtain life insurance for an amount equal to 40 percent of the net equity of the real estate value. Under California tax law, a transfer of a primary residence to a spouse or to a child on death does not result in a reassessment of the property.[20] Another disadvantage of direct investment is lack of privacy. The name of the individual NRA owner is a matter of public record, the NRA is required to file U.S. tax returns in her or his name on the sale of the property, and there is no liability protection.

A solution to the privacy and liability concerns is taking title in the name of a single-member LLC—which is disregarded for federal and California income tax purposes. Married couples owning the LLC as community property (even under the laws of a foreign country) can elect to treat the LLC as having only one owner, with the result that it is a disregarded entity.[21] Although the income tax treatment is the same as if the NRA directly owned the property, California imposes an $800 annual minimum tax on LLCs that are disregarded entities, plus a gross receipts tax. The gross receipts tax, which would apply in the year of sale to the gross sales proceeds, ranges from $900 if the total gross receipts are between $250,000 and $500,000 and up to $11,790 if the gross receipts exceed $5 million.

Upon the death of the NRA investor, the LLC membership interests are subject to the estate tax. Addition, the parent-child exclusion from property tax change in ownership is not available for transfers of entity interests, although the interpsousal exclusion is available.[22] However, unless a child of the NRA inherits more than 50 percent of the total interest in LLC capital and profits, the transfer of the LLC interests does not constitute a change in ownership for property tax purposes.[23] Thus, if an NRA dies with only one child as an heir, the real property held in the LLC is reassessed at current fair market value. On the other hand, real property held in an LLC owned by an NRA who dies with two children as equal heirs does not undergo a reassessment, as no child would obtain more than a 50 percent interest in the LLC.

The main benefit of the LLC structure compared to direct ownership is limited liability protection. As compared to a corporation, the remedies for a creditor's claims against an LLC are more limited. LLCs do not require compliance with corporate formalities such as shareholder meetings and keeping minutes in order to maintain protection against creditors. LLCs also offer increased privacy, as the name of the LLC, not the person, is listed in the public records as the owner of the home. However, the California LLC-12 Statement of Information lists the names of the managers or members of the LLC, and this form can be obtained by anyone from the California Secretary of State. Moreover, the tax filing requirement in the name of the individual NRA remains.

A foreign corporation structure is commonly recommended to hold U.S. real property, as stock in a foreign corporation is not subject to the U.S. estate tax. This could be structured either as direct ownership by the foreign corporation or ownership of the real estate by a U.S. corporation that is held by a foreign corporation. In either case, the ultimate owner would be the NRA. While avoidance of estate tax is a clear advantage to this structure, the income tax result is not ideal. Corporations, domestic or foreign, are not eligible for long-term capital gain rates. Thus, gain on sale of the real property in either case would be subject to tax at a maximum rate of 35 percent rather than the long-term capital gain rate of 20 percent. In addition, California imposes an $800 annual minimum tax on corporations organized in or doing business in California, plus a net income tax of 8.84 percent.

Another consideration for a corporate structure in which a foreign corporation owns the U.S. corporation that owns the property, in addition to the income tax at the U.S. corporate level, a dividend distribution from the U.S. corporation to the foreign corporation would be subject to a 30 percent withholding tax.[24] In other words, this structure creates a double tax. However, if there is a liquidating distribution (e.g., the real property is sold and the U.S. corporation is liquidated) the 30 percent withholding tax does not apply. The direct foreign corporation ownership structure also has this double layer of tax as a result of the imposition of the branch profits tax. It is possible to avoid the branch profits tax, however, by terminating the foreign corporation's U.S. business. From a California property tax perspective, the transfer of the shares of stock to a spouse on death would not result in a property tax reassessment. However, a transfer of the shares to another heir would result in a property tax reassessment if an heir acquired more than 50 percent of the foreign corporation.

Like an LLC, a corporate structure provides privacy in that the corporation's name is listed as the owner of the real property on the public records. Nonetheless, Form 1120-F, the U.S. income tax return of a foreign corporation, requires listing shareholders who own 50 percent or more of the corporation. Therefore, NRA majority shareholders of a foreign corporation owning real estate in the United States are required to put their names on the tax returns, although the NRA is not required to obtain a taxpayer identification number.

In structuring an NRA's purchase of a home in California, one has to keep the California-specific income and property tax implications in mind while also balancing the federal income and estate tax consequences, privacy concerns, and liability protection issues. Even if everyone wants to live to California, not every investment structure works for everyone. ■

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1 National Association of Realtors, 2015 Profile of Home Buying Activity of International Clients For the Twelve Month Period Ending March 2015 (June 2015), *available at* http://www.realtor.org. While the number of units sold declined, the dollar value of the sales increased.

2 *Id.* Sixteen percent of all international unit sales for April 2014 through March 2015 took place in California; 21% in Florida.

3 *Id.*

4 I.R.C. §7701(b).

5 I.R.C. §7701(b)(3).

6 I.R.C. §897(a).

7 I.R.C. §897(c).

8 I.R.C. §1445; Rev. & Tax. Code §18662(e). A California real property interest only includes direct interests in real property, not interests in corporations owning real property. Rev. & Tax Code §18662 (e)(5).

9 I.R.C. §2101, 2103.

10 I.R.C. §2104; Treas. Reg. §§20.2104-1(a)(1), 20.2105-1(f).

11 H.R. Rep. No. 100-1104, at 116 (1988) (Conf. Rep.).

12 Rev. & Tax. Code §110.

13 Rev. & Tax. Code §63.

14 Rev. & Tax. Code §63.1. The parent-child exclusion requires an actual conveyance by deed. Transfers of interests in legal entities do not qualify.

15 Rev. & Tax Code §64(c); *see also* Jacob Stein, *Tax Planning for Foreign Investment in California Real Estate,* Los Angeles Lawyer 13 (Jan. 2013); Gregory R. Broege, Christopher J. Matarese, & Richard J. Ayoob, *What Determines Change in Ownership of Real Property in California?,* Los Angeles Lawyer 14 (Feb. 2015).

16 Prop. Tax R. 462.220(b).

17 Nonresident aliens are not subject to the 3.8% net investment income tax imposed by I.R.C. §1411.

18 I.R.C. §121.

19 Treas. Reg. §1.121-1(b).

20 Rev. & Tax. Code §63.

21 Rev. Proc. 2002-69.

22 LLCs that are disregarded for California income tax purposes are not disregarded for property tax purposes and their separate existence is respected. Cal. Prop. Tax Ann. 220.0375.015.

23 Rev. & Tax. Code §64(c).

24 I.R.C. §881.

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