Tax Planning Considerations for the Purchase of a Residence in the U.S. by Foreign Buyers

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Many foreigners purchase a personal residence as an investment and/or a safe haven from their own countries. In the past, such purchasers assumed they would not be liable for U.S. income taxes. That is not a safe assumption in light of the Tax Court's 2012 ruling in Parker. *The author reviews the tax planning considerations and suggests that the common thinking about how to structure the purchase of a home in the U.S. needs to be reviewed and reconsidered.*

Introduction

Many factors influence a foreign buyer's decision to purchase residential real estate in the United States. Generally, most of these decisions tend to be driven by concerns over political and economic uncertainty in the buyer's home country. Most foreigners do not leave their home country, family, and friends for trivial reasons.

The combination of economic and political stability, along with a stable currency and low inflation, continue to make the United States a desirable destination. Numerous non-Americans discovered this truth a long time ago. In many large metropolitan areas of the U.S., wealthy individuals and their families can live without personal scrutiny and threat to their personal freedom and security. Thus, many foreigners purchase a personal residence as an investment and a safe haven from their own countries in the pursuit of their own version of life, liberty, and the pursuit of happiness on American soil. On a different level, the major metropolitan areas in the U.S. are frequently more affordable than are other large cities around the world. A dollar denominated investment in a "hard asset" such as real estate provides an excellent hedge against inflation (as many South American, European,

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and Asian buyers know all too well). Also, frequently, foreigners send their children to college in the U.S., and the children frequently remain in the U.S. for a number of years after graduation. As home financing options are less available in many countries than in the U.S., many foreigners purchase the U.S. residence outright. As a result and by definition, these foreigners have substantial assets in the U.S. for tax purposes.

Level of Foreign Investment in U.S. Residential Real Estate

The level of foreign investment in U.S. real estate is significant. The total amount of foreign purchases of residential real estate was $68 billion in 2013.[1] This number is down from 2012 when the total amount of purchases was $82 billion,[2] but it is still substantial.

On a national level, Chinese investors accounted for 12 percent of the home purchases by foreign buyers in 2013, or $8.16 billion in U.S. residential real estate in 2013, according to the U.S. National Association of Realtors.[3] Canadians were purchasers in 23 percent of the transactions, Mexicans 8 percent, and citizens of three European countries (the United Kingdom, Germany, and France) 10 percent. South American buyers made 7 percent of the purchases.[4]

Florida has always been a popular market for foreign home buyers. Foreign purchases accounted for 23 percent of all of the residential real estate transactions in Florida in 2013. Latin American buyers accounted for 29 percent of these transactions while European buyers accounted for 23 percent. Canadians made 39 percent of all of the foreign acquisitions in Florida.[5]

Tax Planning Considerations

Traditionally, the tax structuring for wealthy foreigners in regard to the purchase of a U.S. personal residence has focused on federal estate tax considerations and not on federal income taxation. As a practical matter, one might ask, why would the foreign homeowner worry about income taxation if there is no rental income associated with principal residence? In fact, however, there are reasons to consider the income tax as well.

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[1] National Association of Realtors, "2013 Profile of International Home Buying Activity," at 2, available at http://www.realtor.org/sites/default/files/2013-profile-of-international-home-buying-activity-2013-06.pdf.

[2] Id. at 4-5.

[3] Id. at 2.

[4] Id. at 15.

[5] National Association of Realtors, "Profile of International Home Buyers in Florida 2013 Report," at 20, available at http://osceolarealtors.org/wp-content/uploads/downloads/2013/10/2013-Florida-International-Buyers-report.pdf.

Income Tax Issues. The tax code provides for taxation on worldwide income for any non-citizen who has a green card (i.e., a permanent residence visa), meets the substantial presence test, or makes an election under Section 7701(b)(1)(A) to be treated as a permanent resident in the first year of residency.[6] For the nonresident alien (NRA), U.S. tax planning is a delicate balance of income and estate tax considerations. An NRA would normally be taxed for income tax purposes exclusively on U.S. source income. The tests for residency for income tax purposes are described below. If an individual satisfies one of these tests, he or she is no longer a nonresident.

The Green Card Test. Under the green card test, a person holding a green card is considered a U.S. resident for income tax purposes. The green card holder continues to be treated as a U.S. taxpayer unless the taxpayer proactively makes an effort to relinquish or revoke green card status.

The Substantial Presence Test. The substantial presence test of Section 7701(b)(3) looks at the number of days over a three-year period that an individual is physically present in the U.S. An individual is substantially present if he or she is present for at least 31 days during the current year *and* at least 183 days, calculated using a weighted formula, for the three-year period ending on the last day of the current year (December 31).[7]

The formula weights days in the current year more heavily than days in prior years—using a multiplier of one for the days in the current year, one-third for the first preceding year, and one-sixth for the second preceding year. (Regardless of the formula, the substantial presence test is not satisfied if the taxpayer is not in the U.S. for at least 31 days in the current tax year. Furthermore, the taxpayer does not have to prove a "closer connection" to the home jurisdiction than the U.S.)

Example 1 illustrates how the formula works.

Example 1: Assume Chico Da Silva spends 120 days in the U.S. in 2014 as well as 2013 and 2012. The weighted total of days is calculated as follows:

Year	***Application of Formula***
2014	120 days x 1 = 120 days
2013	120 days x 1/3 = 40 days
2012	120 days x 1/6 = 20 days
	Weighted Total = 180 days

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[6] See IRC § 7701(b)(1)(A).

[7] See IRC § 7701(b)(3).

> Since the weighted total is less than 183 days, Da Silva would not satisfy the substantial presence test and thus would not be subject to U.S. federal income taxation on his worldwide income.

The Closer Connection Test. The closer connection test, an important exception to the substantial presence test, provides that if the NRA is able to demonstrate to the IRS (using Form 8840) that he or she has a tax home in a foreign jurisdiction and has a closer connection to that foreign jurisdiction than to the United States, the individual will not be treated as a U.S. taxpayer, so long as the individual is present in the U.S. on fewer than 183 days during the current taxable year.[8]

The "tax home" is the taxpayer's home for determining deductible business travel expenses while away from home. The closer connection test requires a more subjective analysis, based on intent, than is required under the substantial presence test. The analysis focuses on (1) the amount of time spent in the U.S. versus in the foreign jurisdiction, (2) the value and locations of homes, and (3) whether the homes are owned or rented.[9] In addition, the analysis considers the following factors:

- Time spent in the U.S. due to health problems or political problems in the home jurisdiction;
- Location where the taxpayer's family and friends are situated;
- Location of valuable personal property;
- Visa status;
- Jurisdiction where the individual is registered to vote;
- Jurisdiction of driver's license;
- Location of business interests; and
- Location of religious and social affiliations.

Election to Be Treated as U.S. Taxpayer. There are times when a foreign buyer might want to take advantage of U.S. tax benefits and treatment. Or, in some cases, a foreign buyer might want to be treated as a U.S. taxpayer in order to take advantage of treaty benefits from a third country that is not the taxpayer's residence. The first-year election allows an individual to make an affirmative election to be treated as a U.S. taxpayer providing the individual is present in the U.S. at least 31 consecutive days in the current tax year and is present for at least 75 percent of the days in the testing period. The testing period starts on the first day of the consecutive 31-day

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[8] See IRC § 7701(b)(3)(B).

[9] See IRC § 7701(b)(3)(A).

period and December 31 in the year of election. In addition, the individual must meet the substantial presence test in the next tax year.[10]

Federal Estate and Gift Taxation. The U.S. gift tax regime applies to gratuitous transfers of property made during the donor's lifetime. For NRAs, the gift tax only applies to a gratuitous transfer of U.S. situs real and tangible property.[11] The IRS position on this is ambiguous. Commentators have suggested that a look-through to the situs of the underlying assets seems to be a more cautious approach.[12]

NRAs are permitted to make tax-free transfers of U.S. situs real estate and tangible personal property up to the annual exclusion limit (in 2014 and 2015, $14,000 per donee). NRAs also may make (1) unlimited charitable gifts to a public charity and (2) gifts on behalf of donees directly to educational and medical institutions.[13]

The unified credit for federal gift and estate taxes for NRAs is dramatically lower than for U.S. citizens and residents. The unified credit for the NRA, which has not had the benefit of indexing since inception, is only $60,000. However, the U.S. has estate tax treaties with 16 different countries.[14] These tax treaties generally provide three benefits for the taxpayer:

1. They provide a restriction to limit taxation at situs;
2. They provide additional deductions and exemptions that would otherwise be unavailable under internal law; and
3. They provide specific methods for relieving double taxation.

Determining Situs of Partnerships and LLCs. There is uncertainty as to the situs of a partnership or LLC for federal estate tax purposes. The IRS will generally not rule on the issue. The taxation of an NRA's LLC or partnership interest depends on which of two approaches is applied—the aggregate theory or the entity theory:

- *Aggregate Theory:* Under the aggregate theory, the partnership interest is viewed as a pro rata interest in each of the underlying assets.

[10] See IRC § 7701(b)(4).

[11] See IRC § 2502(a)(2).

[12] Richard A. Cassell et al. "U.S. Estate Planning for Nonresident Aliens Who Own Partnership Interests," 31 Tax Notes Int'l 563 (2003).

[13] See IRC §§ 2503(b), 2503(c), 2522(b).

[14] The U.S. has estate and gift tax treaties with Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, South Africa, Sweden, Switzerland, and the United Kingdom.

The place of organization is irrelevant; one looks to the underlying situs of the partnership's property.

- *Entity Theory:* Under the entity theory, the partnership is viewed as being separate from its partners. The approach looks to the location where the partnership is formed or the residency of the partnership for income tax purposes in order to determine the situs of the partner's interest in the property.

Issues for NRAs When Structuring the Purchase of a U.S. Residence

The *Parker* Case. The 2012 Tax Court case of *G.D. Parker, Inc. v. Commissioner*[15] is the proverbial "game changer" for this planning scenario and shifts the focus to income tax considerations with respect to the purchase of a U.S. residence by a nonresident alien. The case is a perfect example of what can go wrong.

Genaro Delgado Parker, a wealthy Peruvian, had a large ocean-front home in Key Biscayne. Parker owned a Florida corporation which had a number of subsidiary companies, including another Florida corporation that actually owned the Key Biscayne home. The shares of the holding company were owned by a Panamanian corporation. In this respect, Parker did what a large number of foreign buyers have done when it comes to purchasing a personal residence.

Parker and his family lived in the Key Biscayne home rent-free for several years (2003-2005). The IRS disallowed deductions for G.D. Parker, Inc. under Section 262 for repairs and maintenance and depreciation on the basis that these deductions were personal and family expenses and not business expenses. These expenses over a three-year period averaged about $125,000–$150,000 per year. Furthermore, the IRS treated the rent-free use of the house as a constructive dividend paid to Parker through the corporate chain up to Parker personally.

When a shareholder or his family is permitted to use corporate property for personal purposes, the fair rental value of the property is includable in his or her income as a constructive dividend to the extent of the corporation's earnings and profits.[16] For a corporate benefit to be treated as a constructive dividend, the item must primarily benefit the taxpayer's personal interests as opposed to the business interests of the corporation.[17]

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[15] TC Memo. 2012-312.

[16] See Comm'r v. Riss, 374 F2d 161, 166-167, 170 (8th Cir. 1967), aff'g in part, rev'g in part TC Memo. 1964-190; Melvin v. Comm'r, 88 TC 63, 80-81 (1987), aff'd, 894 F2d 1072 (9th Cir. 1990); Falsetti v. Comm'r, 85 TC 332, 356 (1985).

[17] Ireland v. U.S., 621 F2d 731 (5th Cir.1980); Palo Alto Town & Country Village, Inc. v. Comm'r, 565 F2d 1388 (9th Cir.1977), remanding TC Memo. 1973-223; Comm'r v. Riss, supra note 16.

The IRS hired a local real estate expert to determine the fair market value rent that should be imputed as a constructive dividend and determined that the fair rental was about $23,000 per month over a three-year period.

Section 881(a) imposes a tax of 30 percent on dividends received from U.S. sources by a foreign corporation except as provided under Section 881(c), to the extent the dividend received is not effectively connected with the conduct of a trade or business within the U.S. A lower rate may apply where the taxpayer has the benefit of a tax treaty. Section 1442(a) generally requires the payor of interest subject to the tax imposed by Section 881(a) to deduct and withhold that tax at the source. If the payor does not do so, it becomes liable for such taxes under Section 1461. The IRS assessed substantial accuracy-related penalties and interest in *Parker*.

The amazing aspect of this case is the fact that the original tax audit was primarily focused on the taxpayer's other corporate transactions. Once you let IRS people into the tent, however, they can look under every stone. The last thing that the foreign taxpayer wants to do is end up on the flip side of the cliché—"su casa es mi casa" (your house is my house)—as a result of poor tax planning.

A New Planning Paradigm. The planning paradigm has shifted to a balance of planning for unexpected estate taxes and income tax considerations for use of the personal residence. A failure to acknowledge these considerations could result in Uncle Sam owning the foreigner's house as a result of tax liens.

The writing was already on the wall for nonresident aliens purchasing a homestead in the U.S prior to the *Parker* case. Some older case law existed which examined the business purpose of the corporation owning the U.S. real estate. If the corporation is disregarded, the shareholder can be treated as the direct owner of the property resulting in an unexpected estate tax. Specifically, raw land or a residence used by the shareholder poses some concern.

The *Bigio* Case. In *Bigio v. Commissioner*,[18] a nonresident owned a condominium as a residence and other properties on Miami Beach through a Panamanian corporation. Absent a lease or loan arrangement, the Tax Court determined that the nonresident was the beneficial owner of the condominiums.

Bigio was principally an income tax case focused on the issue of U.S. residency based upon the taxpayer's substantial presence in Miami during the tax years in question. The Tax Court looked through the ownership by a

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[18] TC Memo. 1991-319.

Panamanian corporation and ruled that Bigio was the beneficial owner, i.e., the court treated Bigio as if he owned the property personally. The structuring in *Bigio* did not involve the use of a separate U.S. entity to own the real estate coupled with the ownership of the U.S. entity by a foreign corporation. The federal estate tax laws for nonresidents treat shares in a foreign corporation as non-U.S. situs property.

Potential Problems When an LLC Owns the Property. Many existing transactions for nonresident aliens owning homes have used an LLC treated as a disregarded entity to own the U.S. real estate. This structuring poses a potential estate tax risk with respect to an LLC that is treated as a passthrough entity—i.e., treated as a sole proprietorship or partnership. The IRS generally will not issue an advance ruling on whether or not a partnership interest (or LLC interest treated as a partnership interest) is treated as intangible property when owned by an LLC. As a result, an LLC that is treated as a disregarded entity, partnership, or sole proprietorship may be considered a U.S. situs asset for federal estate tax purposes.

In that respect, making an election to be treated as a regular corporation is essential for estate tax planning purposes; otherwise a single-member LLC will be treated as a disregarded entity, potentially subjecting the residence owned by the nonresident alien to federal estate taxes. Under the aggregate theory of partnerships, the owner of a partnership interest may be treated as owning a proportionate interest of the underlying property of the partnership.

How Ugly Can it Get? The revelation that the ownership of the U.S. homestead is improperly structured is likely to surface during an audit and will be a big surprise to the taxpayer. The initial estate tax bracket under the progressive rate structure is 26 percent. The threshold for the nonresident alien is $60,000 of assets in the U.S. estate. Absent an arm's-length lease between the corporation and the nonresident alien, a deemed dividend will be assessed based upon a fair market rental of the property to the taxpayer.

Corporate-level deductions for repairs and maintenance along with depreciation will be disallowed. The U.S. corporation is the withholding agent and is personally liable for the withholding on the dividend deemed payable to the foreign corporation that owns the shares of the U.S. corporation. Based upon the personal use of the residence, the withholding tax rate on the deemed dividend is 30 percent absent a lower rate under a tax treaty.

Federal Tax and Compliance Requirements of Electing to Be Taxed as a Corporation. LLCs are entities created by state statute. A single-member LLC is treated as a disregarded entity for tax purposes absent an election to be treated as a corporation through the filing of Form 8832.

A domestic LLC with two members is treated as a partnership for tax purposes unless it files Form 8832 and elects to be treated as a corporation. A single member LLC is treated as a sole proprietorship absent an election to be treated as a corporation.

An election must be filed within 75 days of the formation of the company. Alternatively, the IRS allows Form 8832 to be filed within the first 75 days of the fiscal year which is the calendar tax year for our foreign buyer. Revenue Procedure 2009-41 permits business entities to file a classification election with an effective date retroactive up to three years and 75 days prior to the date that the request is filed.[19]

Normally an entity may not change its corporate status within a 60-month period unless there is a change of ownership of more than 50 percent. The 60-month rule does not apply to an LLC that was a newly formed entity that made its initial election upon formation. Most entities formed by nonresident aliens should be able to fall under this rule in regard to making an election for the LLC to be treated as a corporation for federal tax purposes.

As previously stated in the discussion of federal estate taxes, the corporate election is critical to avoid U.S. federal estate taxation. The LLC will require a tax identification number and file a Form 1120 each year.

Where Do We Go From Here?

The scale of the potential tax adversity as demonstrated in *Parker* for foreigners purchasing a personal residence is significant. It is always alarming to find out that one may be sleeping in a minefield. In the author's personal experience, and in the absence of additional guidance on the correct theory of taxation of partnerships and LLCs, NRAs are extremely vulnerable on both the federal estate tax and the income tax fronts. Professional advisors never expected an IRS income tax attack such as that in *Parker*.

Moving forward, taxpayers and their advisors would be well advised to revisit their existing structures and make revisions. The *Parker* decision suggests that corporate ownership of personal real estate with the shares being owned by a foreign corporation in order to eliminate U.S. transfer taxes is still a functional solution.

However, taxpayers should structure an arm's-length lease with a fair market rent based on comparable rentals in the jurisdiction where the property is located. Oddly enough, in many instances the tax rate at the corporate level may end up being lower than the marginal tax rate of the individual if the LLC were taxed as a partnership.

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[19] Rev. Proc. 2009-41, 2009-2 CB 439.

Summary

The amount of real estate purchased within the United States by foreigners for either personal or rental purposes is very significant and shows no signs of slowing down. The common thinking about how to restructure the purchase of a home in the U.S. needs to be reviewed and reconsidered. The tax minefield has new land mines based upon the result in *Parker*. My legal instinct suggests that a large majority of foreign owners have not properly structured their U.S. property ownership. As a result, the tax structuring of each and every foreign buyer should be reviewed to avoid any unpleasant surprises.