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PREVENTIVE PLANNING

An Estate Tax Trap for Foreign Real Estate Investors

Foreign Irrevocable Trusts Can Reduce Tax Burden

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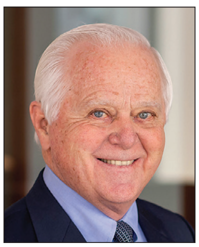
SPECIAL TO BANKER & TRADESMAN



The Internal Revenue Code contains numerous traps for the unwary foreigner who invests in U.S. real estate. The tax law provisions applicable to nonresident foreign investors are often quite different – and more onerous – than the tax rules applicable to U.S. citizens and foreign residents. One area where nonresident foreign investors may need specialized tax advice to avoid costly mistakes is federal estate tax.

A U.S. citizen's or resident's estate is subject to an estate tax based upon the value of the worldwide property, tangible and intangible, owned by the decedent on the date of death or over which he or she has certain rights or powers. The estate tax rate for 2019 is 40 percent for taxable estates over an $11.18 million exemption, which is adjusted annually for inflation (the exemption reverts to its 2017 level in 2026). A U.S. estate may also claim a marital deduction equal to the property value left to a surviving spouse. Most American families will never pay a federal estate tax.

The gross estate of a nonresident foreign investor includes all U.S. tangible and intangible property in which the decedent had an interest at the time of death, or over which he or she has certain rights or powers. A foreign estate, however, is provided a mere $60,000 exemption. A nonresident foreigner's estate is generally not allowed a marital deduction unless the surviving spouse is a U.S. citizen. Unlike U.S. citizens, a foreign investor faces potential ruinous taxation by taking title to valuable U.S. real estate individually or through U.S. entities.

Avoiding the Tax

In most cases, the severity of these tax rules can be mitigated by competent, pre-investment tax planning. For estate tax purposes, it is important for a foreign investor to avoid ownership of U.S. tangible and intangible property.

Direct individual real estate ownership, ownership or indirect ownership through a single-member LLC or a U.S. domestic corporation is not sufficient; the real estate, the LLC interest and the corporate stock are all U.S. tangible or intangible assets. Ownership through a partnership is also highly risky.

Many years ago, I attended a Practicing Law Institute seminar in New York City to learn something about U.S. taxation of foreign investors in U.S. real estate. The seminar leader – a well-known expert – began his presentation with, "If you let your foreign clients purchase U.S. real estate in their own names, you are committing malpractice." I have never forgotten this advice, even though there are rare occasions when it does not apply, such as when a foreign investor plans a short-term property "flip."

Estate tax protection for a foreign investor is afforded by investing through a foreign corporation because its shares are not considered U.S. property. However, foreign corporations are subject to a 30 percent "branch profits tax" on their accumulated U.S. profits, in addition to the 21 percent corporate income tax. For this reason, investors often use a two-tier corporate structure consisting of a U.S. real property corporation owned by a foreign holding company owned by a foreign investor.

Foreign irrevocable trusts are often used as an investment vehicle. They are easy to create and can provide for transfers of beneficial ownership between family members free of the estate tax. Although U.S. tax rates applicable to trusts in general are quite steep, a well-designed foreign irrevocable trust can also provide for a pass-through of income to beneficiaries at the lower U.S. individual tax rates. However, there are special tax rules applicable to transfers to foreign trusts, such as a tax imposed on the appreciated value of property transferred by a U.S. grantor to a foreign trust with no U.S. beneficiaries.

U.S. estate taxes can be harsh for foreign investors who have not planned properly. Professionals who advise these individuals should educate their clients and encourage them to seek proper counsel to avoid falling into this tax trap.

Image courtesy of Oxford Properties Group

International investors have acquired an interest in many of Boston's trophy office towers in recent years, including Toronto-based Oxford Properties Group's 125 Summer St.

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