Foreign Investors: How to Mitigate Their Tax Implications in the U.S.

By Pierre E. Debbas, Esq.

The biggest concern for foreign nationals in investing in the U.S. has been the tax implications of owning or selling a property. The fiscal cliff negotiations that took place at the end of 2012 and into 2013 highlighted several concerns for overseas investors. Chief among these are an increase in capital gains tax from 15% to 20%, changes to the estate tax and the 3.8% Obamacare tax. The most important question to ask is whether an investor is more concerned with the possibility of death during their ownership of the property (and any other U.S. assets) or whether they are more interested in preserving the preferential individual tax rates for capital gains and ordinary income.

The first item to take into consideration is estate tax. Any tangible or personal property located in the U.S. and valued over approximately $60,000, requires the filing of an estate tax return when the foreign person dies. Currently, New York estate tax has a rate of 16% and the federal estate tax rate can be as high as 40%. In 2015, U.S. citizens are given an individual exemption from the federal estate tax up to $5,430,000.00 and for married couples, $10,860,000.00. These exemption levels typically increase annually to adjust for inflation.

However, non-U.S. citizens are not granted the exemption unless a treaty exists with their country. Thus, if a foreign national invests in the U.S., the total net value of their assets over $60,000 are subject to this tax at the time of death which can even tax their initial capital investment and not just the appreciation. Before determining the estate tax liability the foreign person should be aware of the treaty between their country and the U.S. or lack thereof. The US has tax treaties with many foreign countries. Under these treaties, foreign residents are taxed at reduced rates, or are exempt from U.S. taxes on certain items of income.

The most common mechanism that we structure in order to avoid the estate tax is the utilization of a New York limited liability company ("LLC"), which will own the asset and then the formation of an off-shore company (a British Virgin Island company is the most common – "BVI") which acts as the sole member of the LLC. Under this structure, the foreign person can avoid estate tax on U.S. owned property. The reason is that at the time of death of the foreign national, their heirs overseas will be inheriting shares in a foreign corporation, not the actual asset in the U.S. As a result, the IRS views the ownership of the property as an intangible asset, which is not subject to estate tax.

The negative aspect of utilizing the LLC/BVI structure is that an LLC is treated as a disregarded entity for tax purposes and the tax liability passes through the LLC to whoever is the member(s) of the LLC. If a corporation, such as a BVI, is the member, then corporate tax rates for gains tax and income tax apply as opposed to individual tax rates if an individual(s) was to be the member of the LLC. Individual capital gains tax rates on the federal level are 20% and for NYS non-residents are 8.82%. Additionally, ordinary income tax on the individual level is tiered based on the actual income that one earns. In comparison, the corporate tax rates for capital gains and ordinary income are as high as approximately 40% on the federal level and approximately 16% for NYS and NYC combined. There is no structure that you can implement to avoid these taxes, however, foreign nationals are entitled to utilize a 1031 tax deferred exchange in the same manner that U.S. citizens are in order to defer gains taxes.

A foreign person needs to pay the Foreign Investment in Real Property withholding tax ("FIRPTA") when they sell a property and which is 10%of the gross sales price. If the seller is current on all of their other taxes owed to the IRS (i.e. income taxes, capital gains tax, etc.) then they should receive a refund of the 10% that was withheld at the sale; thus there is no additional tax on a foreign investor when selling a property in the U.S.

If a foreign seller is selling at a loss, pre-paying their taxes or partaking in a 1031 exchange, they may be eligible to apply for a "certificate of withholding" which would eliminate the requirement to remit the 10% withholding at the closing, as the certificate of withholding confirms there are no taxes due. It is imperative that the proper structure for a foreign national be determined at the inception of a transaction and that any foreign investor consult with an attorney and accountant before proceeding with a transaction.

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