Properly Structuring the Purchase of Real Estate in the U.S.: Death May Not Be Unavoidable, but Taxes Are

Introduction

There is a saying that two things in life are unavoidable: death and taxes. In the case of foreign real estate investors in the United States, this saying is not merely an anecdote but can be a serious problem for those who do not properly plan for these two “unavoidable” occurrences.

There are a number of good business reasons to invest in U.S. real estate: prices are the lowest in a generation; price appreciation is promising compared to other international markets; and property rights are very clearly defined and protected. For foreign investors the challenge is not at all in purchasing real estate: there are really no limitations and the process is the same as for Americans. However, the one major difference that most foreign buyers do not think about is what happens when the buyer dies. In this respect tax laws are significantly harsher on foreign owners if proper planning is not done in advance.

Investors often focus on income tax and capital gains taxes but tend to forget about the heavy estate tax (a tax which is levied upon an individual’s estate upon his or her death), which can deplete the value of their assets, especially in the case of foreign investors. The best ways to limit liability and to avoid paying estate taxes is to use both a foreign and domestic corporate structure to protect the individual foreign investor. It is better to protect yourself now than to ignore the issue. A prudent foreign investor should set up the proper legal structure prior to making a purchase to avoid paying estate taxes.

How Estate Taxes Effect Your Investment

Generally, the estate tax is a tax on the assets of an estate of a deceased person prior to any transfers to heirs or beneficiaries. Although U.S. residents do not have to pay federal estate taxes at all in 2010 due to a strange quirk in the tax code (if Congress takes no actions, the estate tax will return to previous levels under which the first $3.5 million if exempt from estate tax), non-residents have to pay estate taxes for any estate valued at $60,000 or more in U.S. gross assets. As a result, foreign investors who own U.S. real estate may have to pay up to 45% of the value of their estate over $60,000 of the property at the time of death. Additionally there are state estate taxes which vary from state to state.

Limiting Legal Liability

If a foreign investor is willing to take title in their own name but wants some protection against liability, the non-resident can take title in the name of a United State's limited liability company ("LLC"). A reason why a foreign investor is concerned with owning property directly is because of the risk of lawsuits against them individually and the possibility that a Court could enter a judgment against them. Moreover, some non-resident investors want to protect their privacy when they purchase real estate. Purchasing in an investors own name will require disclosure of certain personal information. By purchasing real estate through an LLC, a non-resident can limit

legal liability and have some anonymity.
There may be situations where an investor should purchase real estate directly. One situation is if the non-resident plans on using his U.S. property as a primary residence. If so, the foreign investor owning the property directly may be able to take certain tax deductions on the real estate. In addition, when the property is sold, the foreign investor may be able to claim that the home is a principal residence and possibly exclude some of the gross proceeds from tax. This article does not cover detailed transfer or income tax issues. However, with regard to estate taxes, the foreign investor should consider purchasing life insurance to cover estate taxes that may occur upon death.

Another situation is if the foreign investor is buying an apartment for a child attending school in the United States. The foreign investor should consider purchasing the property in the child's name if eligible. When the child finishes school, the child may be able to sell the property at a lower capital gains tax rate. Upon receipt of the proceeds, the child could make a gift of the proceeds to the non-resident parents.

A foreign investor who plans on purchasing several properties in the U.S. should consider purchasing each property through separate LLCs, to limit the liability of each property. This protects the foreign investors against lawsuits or judgments based on one piece of property but not on the other property. Also, there could be adverse tax consequences upon the sale of some properties all held in the same LLC.

How to Use a Corporate Structure to Avoid Estate Taxes

A foreign corporation does not have to pay estate tax. Therefore, by forming a foreign corporation in conjunction with a U.S. LLC, you limit your liability through the use of the LLC and obtain the tax advantages of a foreign company. In effect, the foreign corporation would own the share of the LLC and the LLC would purchase the real estate. The foreign investor therefore would only own shares in the foreign corporation and not the LLC. Neither would the foreign investor own directly the real estate. Upon the foreign investor's death, there would be no estate taxes because the foreign investor does not own U.S. domestic stock; nor would the foreign investor pay estate taxes on the real property. Any transfer of stock can occur without any U.S. estate taxation. If the foreign investor owned shares of the LLC or the real property directly, these U.S. assets would be subject to U.S. estate taxes and/or probate at the time of death.

The foreign investor could also hold the shares of the foreign corporation in an off shore revocable trust, depending on the laws of the country of residency. The terms of the trust could set forth how the trustee should distribute the shares of the foreign corporation and in turn, distribute the ownership of the real estate to named beneficiaries. An off shore trust provides the foreign investor additional flexibility in distributing assets upon death.

Estate Tax Treaties

Prior to forming the foreign corporation, it is important for foreign investors or their legal counsel to review any tax treaty the U.S. may have with the foreign investors' country of residency. The United States has estate tax treaties with 17 countries: Australia, Austria, Canada,

Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, Norway, the Republic of South Africa, Sweden, Switzerland and the United Kingdom. If the tax treaty does not look favorable to the foreign investor, the non-resident could form the foreign corporation in another jurisdiction that may have more favorable tax rules such as the Cayman Islands, the Bahamas, the British Virgin Islands or Bermuda. These jurisdictions do not impose taxes on transactions related to the corporations. The foreign investor must carefully consider income taxes when contemplating the acquisition of U.S. real property through a foreign corporation.

If the foreign investor plans on purchasing real estate directly or through an LLC, the non-resident could purchase life insurance to offset estate taxes. The foreign investor could form a irrevocable trust to purchase life insurance, most likely term insurance in an amount equal to what is the estimated estate taxes that may occur upon death. Because the insurance proceeds would be in an irrevocable trust, there could be no estate taxes on the proceeds.

For estate tax purposes, generally, the government assesses an estate tax based on the real estate's fair market value at either the time of death, or within six months after death if the value of the estate. One way a foreign investors want to reduce the value of their U.S. property for estate tax purposes prior to their demise, is to obtain a non-recourse mortgage on the property.

Conclusion

The foreign investor in real estate in the U.S. must take into consideration all taxation issues, including estate tax issues in particular. AmLaw Group (www.amlawpro.com) advises foreign buyers on the entire process of real estate acquisition: from property selection to financing and tax structuring. AmLaw Group was founded by Charles Raether, an American attorney with almost two decades of experience with CIS markets as an attorney, executive with an international real estate consultancy, and business consultant. Mr. Raether’s extensive experience with the realities of business in the CIS and fluency in Russian allow him to effectively support cross-border transactions between the U.S. and overseas investors. Contact us with any further questions concerning real estate investments, business immigration, and commercial matters involving the U.S.