How foreign investors can avoid hidden traps of U.S. taxation on U.S. investments

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Asians love the U.S. as a place to live, buy homes, invest, go to school, and run their businesses. Over the past five years, we have seen an unprecedented increase in foreign investment in the US — particularly as a new flood of Chinese investors joins the tide of Japanese, Korean, Malaysian and other Asian investors.

My partner Scott Harshman counsels foreign investor clients from all over the world. He tells them that it is urgent to get an early grip on potential U.S. tax consequences and structures when first contemplating their investment in the U.S. The key is doing the analysis BEFORE making the investment. The earlier, the better. Otherwise, the unfortunate foreign investor may become ensnared in a messy tangle of tax and regulatory issues never imagined.

Here is what Scott says . . .

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**Tax Alert for foreign investors looking at U.S. investments**

By Scott Harshman, Partner JMBM

**Pre-immigration and Non-U.S. Resident Planning**

It does not matter whether foreign individuals are investing in U.S. property and hoping to become residents in the U.S., or are planning to invest in U.S property without U.S. residence: the investment is particularly complex for these individuals.

The definition of “U.S. property” for international tax purposes is a term of art, and the details are complex. That is why – to avoid potential problems and minimize U.S. tax exposure – planning for the ownership of U.S. property should be done **before** the investment is made.

If this planning is well thought-out and structured properly, the foreign individual – and the business entities owned by such individual – can avoid many pitfalls associated with the U.S. tax and legal systems.

A qualified legal and tax advisor will take into account a host of factors to properly advise the investor, including country of origin, visa status, residency status, the willingness to disclose world-wide assets and income, and family and business partner dynamics. The advisor will ascertain the current ownership of assets in trust or business entities and their U.S. tax classification, as well as relevant tax treaties that affect the specific situation.

**International Income Tax Planning**

Prior to becoming a U.S. permanent resident, it is wise for foreign individuals to consult competent legal and tax counsel
on U.S. tax and reporting requirements. Foreign individuals may not be aware that they are currently U.S. income tax residents under various residency tests, resulting in the taxation of their world-wide income and disclosure of their world-wide assets and bank accounts.

Failure to properly report activities of a foreign entity by a U.S. resident may result in substantial penalties. Likewise, foreign ownership of U.S. entities may result in strict tax withholding requirements, special tax rules, and potentially the branch profits tax.

Banking advisors and accountants should be aware that foreign individuals who become U.S. residents (or U.S. citizens who are resident in a foreign country) and own foreign mutual funds will need to report the investment as a passive foreign investment company (PFIC). Generally, PFIC treatment should be avoided due to unfavorable tax treatment and reporting obligations.

Income tax treaties can help alleviate these issues, but the analysis and planning should occur as soon as possible prior to becoming a U.S. resident.

International Estate Planning

Generally, multinational families that own property in the U.S. need a U.S. estate plan. In California and many other states, assets held by individuals can be subject to lengthy and expensive probate court proceedings. This is easily avoided with proper planning. More importantly, the U.S. estate plan can direct who should inherit the U.S. assets – and when – after a death.

Non-U.S. residents may be subject to the U.S. estate and gift tax with respect to U.S. property at a tax rate of 40%. Foreign persons are entitled to a $60,000 exemption from estate tax (compared to U.S. permanent residents or U.S. citizens who receive a $5,450,000 exemption in 2016).

Foreign persons can generally transfer an unlimited amount of non-U.S. property to U.S. persons, or trusts, and can plan for the ownership of assets in the U.S. that may completely avoid U.S. estate and gift tax. However, the rules can be complex. U.S. persons must report gifts (above a certain threshold) from foreign persons or entities to avoid penalties. Unlike a gift of assets between U.S. citizen spouses, a gift of assets to a non-U.S. citizen is subject to U.S. gift tax (above a certain threshold).

Ownership of U.S. Real Estate

There has been an influx of foreign investment in U.S. commercial real property and luxury personal residences. Potential issues involve the ownership structure, purchase, financing, leasing, development, management, and operation of these real estate investments. Investors/purchasers and their advisors must understand the Foreign Investment in Real Property Tax Act (FIRPTA) in order to meet all tax withholding obligations and will need advice and solutions to mitigate the burdens imposed by FIRPTA.

In addition to tax filings, foreign persons that invest in U.S. commercial property (whether directly or through an entity) may
also be subject to disclosure obligations to the U.S. Department of Commerce. This filing requirement is often overlooked.

Foreign Asset and Bank Account Reporting

Foreign individuals who become permanent residents of the U.S. must report their foreign accounts and assets (including interests in foreign entities) under the Foreign Account Tax Compliance Act. If there was a failure to report in any year, there may be solutions to avoid or minimize civil and criminal penalties, and alternatives and options to preserve wealth and begin complying with U.S. reporting requirements. An experienced advisor is essential in these matters, since the IRS frequently publishes new rules. Foreign investors are often sensitive to preserving the attorney-client privilege in these matters, and we often assist accountants and other advisors in preparing and filing documents, and negotiating with the applicable government agencies.

Potential Pitfalls and Planning

The following are a few of the issues and considerations that frequently arise in tax planning for foreigners making investments in U.S. property:

- Foreign investors may be able to accelerate taxable events or transactions to step up income tax basis in assets prior to becoming a U.S. resident, thereby avoiding substantial U.S. income tax.
- Foreign investors may be able to convert foreign entities from one U.S. tax classification to another (e.g. corporation to partnership) and achieve substantial income tax savings and avoid complex reporting.
- The formation of “drop off trusts” – where the foreign individual forms a trust to avoid U.S. taxation prior to becoming a U.S. resident – is subject to special grantor trust rules, making all the income taxable to the individual.
- Foreign trusts (either formed in a foreign country or formed in the U.S. and controlled by foreign persons) can be subject to special “throwback rules” that tax all accumulated income for prior years, with an interest charge, when distributions are made to a U.S. beneficiary.
- The U.S. estate tax rules can be significantly different than the U.S. gift tax rules for non-U.S residents. For example, the gratuitous transfer of U.S. stock is not a gift, but that same stock would be included in the estate of the foreign individual for estate tax purposes.
- U.S. real property owned by a foreign person will be subject to U.S. estate tax, while (if structured properly) the foreign person’s ownership of stock in a foreign corporation that owns U.S. real property can escape U.S. estate tax entirely.
- After obtaining U.S. citizenship or a Green Card, an individual may later be subject to a U.S. “exit” tax upon renouncing his or her U.S. citizenship or permanent residence status.
- A permanent resident will have filing requirements for foreign bank accounts when they control such accounts individually or through an entity, even if they do not own the account or the entity.

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How JMBM helps foreign investors in the U.S.
Over the years, JMBM’s Global Hospitality Group® has represented many non-US residents investing in US properties, including hotels, offices, retail, multifamily and other commercial real estate, as well as luxury homes.

We start with the tax planning and business strategies and help with everything involving U.S. business transactions, including the purchase, sale and financing of US real estate.

This is Jim Butler, author of www.HotelLawBlog.com and hotel lawyer, signing off. Why don’t you give us a call (or send an email) and let us know what you working on? We would like to see if our experience might help you create value or avoid unnecessary pitfalls. Who’s your hotel lawyer?

Our Perspective. We represent hotel owners, developers and investors. We have helped our clients find business and legal solutions for more than $87 billion of hotel transactions. We have closed more than 1.5 billion of EB-5 financing and sourced more than half of that for our clients.

As a client, our unparalleled experience means that you get:

- better, faster, more cost-effective results
- greater certainty of execution while avoiding costly missteps or missed opportunities
- added credibility from our experience and reputation
- greater confidence that you will get the best deal possible

If you would like chat about how we might help you achieve your hotel goals—with EB-5 financing or otherwise— please contact Jim Butler. And of course, there is no charge for our initial discussion.

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