

Is Direct Investment in US Real Estate an Effective Planning Strategy?

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Why would anyone want to invest in US real estate today - particularly a foreign investor? Seasoned foreign and domestic investors have long been aware of the benefits of direct investment in US real estate. Despite what have sometimes been described as draconian real estate investment laws that impose unfair tax consequences on foreign investors, their effects are actually quite negligible when one considers how tax treaties and good tax planning strategies provide substantial advantages to the astute investor.

While the typical advantages available to the domestic US real estate investor are readily evident, there is a common thread among all investment approaches, both domestic and foreign, that is, leveraging. One additional factor favouring the foreign investor was not, however, present at the beginning of the millennium. The precipitous decline of the dollar vis-à-vis the Euro and other currencies, has presented an extraordinary opportunity for the foreign investor. We like to think of it as a kind of super leveraging opportunity.

Super leveraging is an opportunity made possible by purchasing a leveraged investment in an economy supported by a weaker currency. For example, if an American investor purchases real property in the United States for USD 100,000 with 30% down payment and sells for USD 115,000 he earns a 50% return on investment. If that same investor was, let's say, an EU based investor, he may effectively compound that already handsome return on investment owing to the favorable currency differential. That's super leveraging. As of this writing the Euro is 1.3489 to the US Dollar.¹

Ironically, the economic health of any given country's market is not necessarily

reflective of its currency value, at least in the short run. Moreover, the practice of diversification in investment is of particular importance in real estate. Cross-border investment in real estate in the United States makes sense now more than ever and gives deference to the proverbial warning of not putting all of one's eggs in one basket. Spreading investments across several countries or regions is good risk management, period. Cross border real estate investment has increased threefold from 2001 to 2006 with the bulk of that activity being in the US market.²

Further, notwithstanding the recent weakening in regional sales and sometimes dramatic declines in property prices, the US real estate market still enjoys a noteworthy ease in terms of property acquisition and exit options for investors of all classes, from the individual to the institutional investor. Low interest rate financing programs are readily available to both foreign and domestic investors and, these low rates are paradoxically attributable to a large degree to foreign investment activity in the US. In terms of creating a hedge against inflation, US real estate, as a whole, outperforms other traditional investment vehicles. In fact, over the past ten years, residential real estate prices increased 6.5% as compared to a 2.5 inflation rate.³ Just as Mark Twain would have cajoled, rumours of his death were greatly exaggerated, the death of US real estate investment opportunity, it seems, has been greatly exaggerated.

Who can Invest in US Real Estate?

The United States welcomes, if not, depends upon foreign investment. Despite a history peppered with occasional nationalistic fervour and apprehension over loss of economic sovereignty, the door remains wide open to inbound investment. As such, there are few if any

real barriers to direct investment in American real estate. With the constant wave of visitors, both tourists and those for business purposes, it is often unclear just who is a domestic and who is a foreign investor. This ambiguity is the result of the applicable tax law concerning US citizens and the hazier category of "resident/US person." The latter being a term of art created to extend the reach of US taxation to lawful permanent residents (green card holders) and other residents who subject themselves to this category.

For example, non-residents who reside in the US for at least 183 days are deemed subject to US taxation. Similarly, though less well known is the Substantial Presence Test which is applied to non-residents who have remained in the United States for at least 31 days and then factors in the number of days the individual has been present during the preceding two years. If the application of the test results in an aggregate total of 183 days, the individual is deemed to be a US resident for tax purposes, subject to certain exceptions.⁴

Note that even where the investor is an entity such as a foreign corporation, they may nonetheless, elect to be treated as being resident in the US for tax purposes by electing to do so under the Internal Revenue Service's "check-the-box" scheme.⁵ Unless you fall into one of the categories described above, you are a foreign investor for purposes of the US real estate and tax law.

Foreign Investment in Real Property Tax Act

Under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), all gains and losses realised by non-residents and foreign entities from the sale, exchange or disposition of real property interests are taxed in the same manner as

a US person or business. For foreign individuals this would mean a tax rate of 10-35% and for foreign corporations, 15-35%. A built in collection component of FIRPTA imposes a 10% withholding tax on all disposition by foreign real property sellers—collected by the purchaser on behalf the Internal Revenue Service.⁶

Many foreign investors derive income from their US real property investments such as where income results from their active management of their investments, for instance, a commercial property. In such cases this income will again be taxable under the same rate scheme discussed above, that is, 10-35% or 15-35% for foreign individuals and corporations respectively.⁷

For income derived from more passively earned income from real property holdings, such income may be subject to a 30% withholding tax. But again, tax treaties would certainly minimise the effect of this withholding tax and the foreign investor may elect to have this passive investment income treated as business income thereby opening up the opportunity to offset this burden through the use of allowable tax deductions and depreciation.⁸

At first blush this may seem to be overly burdensome, however, it should be pointed out that ample relief is provided for under most dual tax treaties, though tax treaties alone will not likely reduce the burden below the 10% withholding level. Still, the foreign investor, with proper planning, will have similar tax reduction strategies available to domestic investors such as allowable deductions and depreciation. The fact is US real estate investment law actually favours the foreign inbound investor.

Opportunities for the Foreign Inbound Investor

You may have erroneously concluded that the United States real estate investment laws have been drafted to create disincentives to foreign investment, but in reality the exact opposite is true. With proper planning, astonishing opportunities for profits are not only available, but encouraged. The so called draconian provisions of the law are primarily applicable to purely foreign corporations and even then may be avoided by layering in sub-entities. For instance, a foreign corporation might form a domestic corporation to acquire American real property holdings. Even in circumstances where suitable tax treaties are in place, proper planning can achieve impressive results.

This is particularly important in today's market where we see bargain-basement prices in many regional US real estate markets. Today's low price real property opportunities will not remain for

long and those who properly plan for the next upswing may find their profits well sheltered - or squandered solely dependent upon their level of planning.

An increasing number of overseas investors are continuing to buy a wide range of properties in America. Two examples are second homes and condos. An estimated USD41 billion worth of residential real estate purchases were made in the United States since 2005.⁹ German buyers top the list of such investors, accounting for 13% of the total purchases from overseas, but Australia, Japan and the United Kingdom account for much of the total investment. Buyers interested in second homes tend to purchase property in resort areas, such as properties along the coastlines or in ski resorts.¹⁰

Money is pouring into condos as well. In Las Vegas, 12% of a twin 48 story tower has been purchased by foreign investors; in New York City, up to 33% of new condos sold in the city are being sold to overseas investors, and real estate agents are soliciting buyers from Asia.¹¹

US Immigration as a Source of Investors

Interest in immigration to the US continued to increase. Naturally, many foreign investors have an interest in living in the US, either short-term or long-term, to monitor and manage their investments. There are three visas of particular importance to foreign nationals who want to invest in US real estate, the E-2 treaty investor visa; the L-1 intracompany transferee visa, and the EB-5 investment visa.

The E-2 visa is a temporary visa which may be renewed indefinitely as long as the investor is actively engaged in managing the investment. It is available to citizens of countries which have a treaty with the US. <12> To qualify for this visa, a "substantial" investment must be made in an enterprise that the investor will develop and direct. No minimum amount of capital qualifies as "substantial". Rather, a "sliding scale" compares an investment's overall value and the amount of capital actually invested.

The L-1 intracompany transferee visa is for foreign nationals who work for multinational companies doing business both in the US and abroad. Managers, executives and employees with "specialised knowledge" may qualify for this visa as long as they have worked for the foreign employer for at least one year out of the last three years. A major advantage to the L-1 visa is that certain investors/applicants qualifying for this visa may also qualify as lawful permanent residents (ie, a green card).¹³

For investors who have larger amounts of capital (generally at least

USD1 million dollars, although USD500,000 is sufficient in certain rural or high unemployment areas), an EB-5 visa may be available. In order to qualify, the investment must benefit the US economy and create full time employment for at least ten US workers. The law does not specify who may be a qualified applicant, but it appears that corporate or non-individual investors are precluded. However, two or more individuals may join to make an EB-5 investment. And yes, real estate investments can qualify.¹⁴

In summary, despite parochial reservations and intermittent warnings of economic threats, US real estate investment laws and policy continue to promote both domestic and foreign direct investment. Safeguards are performed in place to ensure tax compliance and engender transparency, but these provide for generous returns to the savvy investor and are not overly burdensome.

ENDNOTES:

- 1 *The Wall Street Journal Online*, at www.wsj.com (17 May 2007).
- 2 Henry Chin, Ermina Topintzi, and Peter Hobbs, *Global Real Estate Investment and Performance 2006 and 2007* RREEF Research (March 2007).
- 3 *Foreign Investment in US Real Estate, Current Trends and Historical Perspective*, National Association of Realtors® (November 2006).
- 4 *US Tax Guide for Aliens - Publication 519*, Internal Revenue Service (2006).
- 5 *US Treasury Decision 8697 and IRS Reg. §301.7701-3(g)(1)*.
- 6 IRC 897.
- 7 *Id.*
- 8 *Id.*
- 9 Les Christie, *Real Estate: Who's Buying Now?* at (http://money.cnn.com/2007/01/23/real_estate/new_real_estate_buyers/index.htm) (26 January 2007).
- 10 Ron Scherer, *House Not Home: Foreigners Buy Up American Real Estate* *The Christian Science Monitor* at: <http://www.csmonitor.com/2005/0715/p01s03-ussc.html> (15 July 2005).
- 11 *Id.*
- 12 Thomas W. Goldman and Peter J Loughlin, *E-2 Visa* at www.ImmigrationWizards.com/e2visa.htm (January 2007).
- 13 Thomas W. Goldman and Peter J Loughlin, *L-1 Visas* at www.ImmigrationWizards.com/visas11.htm (May 2007).
- 14 *Immigration and Naturalization Act §203(b)(5)*.



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