Tax Planning For Foreigners Purchasing Property in Florida

~ Michael J. Wilson

Foreigners have long been active in Florida real estate. Whether owning a vacation home or an investment property, foreigners make up a significant number of purchasers of Florida real property. Regrettably, many foreigners enter the Florida market without sufficiently considering the tax ramifications arising from the ownership of United States real property. Differences between the US and foreign tax systems necessitate careful planning prior to entering the market to ensure that the best tax planning strategies are used for each purchaser's particular circumstances. For persons already in the Florida market, it may not be too late to restructure ownership plans to avoid a surprise tax bill. But the window for planning may get smaller as property values continue to increase. This article discusses the US tax issues and planning techniques that can help minimize tax headaches for foreign owners of Florida real property.

Ultimately, the appropriate tax planning will depend on the needs of each investor: whether the property will be held for personal use versus income production; whether it will be held for short or long term; whether the investor intends to sell the property or pass the property on to heirs; and on the investor's tolerance for increasingly complex and administratively burdensome multi-tiered structures.

The content of this article is aimed at foreign individuals and does not apply to US citizens, "Green Card" holders (i.e., permanent residents), or others who are taxed as US residents. This article is also not aimed at individuals who are US domiciliaries for US estate and gift tax purposes. A discussion of US estate and gift tax considerations for individuals who are US domiciled, including a summary of the analysis for determining whether an individual is a US domiciliary, can be found in the article by Douglas J. Elmore entitled Not a US Citizen? How to Minimize Liability for US Transfer Taxes on Worldwide Assets, *beginning on page 36. This article only briefly touches on foreign tax planning considerations, and any tax planning should be reviewed by a tax advisor in the relevant foreign jurisdiction. Accordingly, this article is not intended to provide advice regarding foreign tax law.*

Overview

If you are a foreigner entering the Florida real estate market, there are several important tax issues you should consider. The first half of this article outlines these issues alongside the general structure of the US tax system. In the second half of the article, we describe these issues' significance under various real property holding structures.

General Structure of the US Tax Regime

US tax residents are taxed on their worldwide income. Non-US tax residents are only required to report and pay tax on their income sourced to the United States. Income of US individuals may be ordinary (taxed at graduated rates up to 39.6 percent) or capital (taxed at rates up to 20 percent).

A foreign individual can become a US tax resident if he or she obtains US citizenship, becomes a lawful permanent resident (i.e., "Green Card" holder), or satisfies the "substantial presence" test, which looks at the number of days spent in the United States. The substantial presence test can be a trap for the unwary who spend too much time in the United States. If a foreign person becomes a US tax resident, he or she will have the same tax obligations as any US person (including the requirement to file an annual tax return with the IRS, reporting all worldwide income). Therefore, foreigners generally want to ensure that they do not become US tax residents. The discussion in this article does not apply to foreign individuals who have become US residents. But if you are a foreigner who does not qualify as a US tax resident, there are many tax consequences of owning real property in the United States about which you should be aware.

The US income tax regime taxes non-resident persons under two prongs. First, if income is from a "US trade or business," the net income from such trade or business is taxed at the US regular graduated tax rates (currently, up to 39.6 percent). Whether an activity rises to the level of a trade or business is a factual determination, but a single transaction rarely meets the threshold. The trade or business tax applies to the net income of the foreign investor from the US trade or business, after applying any available deductions. Second, if income is passive (that is, not from a US trade or business) and sourced to the United States, such income is subject to a 30 percent flat withholding tax. The 30 percent tax is generally withheld by the payor. No deductions are available to offset the 30 percent flat withholding tax. Capital gains are taxed to individuals at rates up to 20 percent where certain holding requirements are met. Corporations are taxed at graduated rates up to 35 percent and enjoy no reduced capital gains tax rate.

If the United States and your home country have entered into an income tax treaty, the treaty may help to mitigate double taxation by the two countries. A tax treaty is a written agreement providing tax rules intended to avoid the same income being taxed in both countries. If there is no relief available under any treaty, many countries (including the United States) offer relief in the form of tax credits for foreign taxes paid.

Rental Income

Some foreign owners of US property rent out their property for part or all of the year. Rental income from US property is generally sourced to the United States, and the income must be reported to the IRS by the recipient. Assuming the rental property is held passively (that is, the foreign owner is not actively involved in managing the property), rental income paid to a foreign owner is subject to a 30 percent flat withholding tax, unless the foreign

owner makes an election to be engaged in a US trade or business regarding its rental real estate. If the owner manages the property, the rental income may be deemed to arise from a US trade or business, and graduated tax rates would apply, subject to expense deductions. A tax treaty may provide relief against double taxation of rental income. This means that the rental income may be taxable by the foreigner's home country, even if tax was already paid on the income in the United States (although the other country's law may provide a tax credit for foreign taxes paid in the United States).

If ownership of the property is by a legal entity, such as a corporation, partnership, or limited liability company, and the property is used personally by the owner of that entity, then the entity may be required to charge a fair market rent to the owner. If the entity does not charge such rent, the IRS may impute a fair market rent that will be taxable.

Taxation of Gain from Selling the Property

Like rental income, income from the disposition of US real property by a foreign person is sourced to the US and must be reported to the IRS by the recipient. Unlike rental income, disposition income is treated as though from a US trade or business and may qualify for the lower capital gains tax (currently, up to 20 percent) if held for more than one year. Additional tax may apply on recapture income if depreciated property is sold at a gain. A tax treaty may provide relief against double taxation of income from selling the property. This means that the income on disposition may be taxable in the foreign person's country, even if tax was paid on the income in the United States (although the other country's law may provide a tax credit for foreign taxes paid in the United States).

Income from the disposition of real property by a foreign owner is subject to the "Foreign Investment in Real Property Tax Act" (FIRPTA), which requires tax withholding by the buyer at the time of sale. The FIRPTA rules may also apply when foreign owners sell their interests in a property-holding entity—even if the real property is not directly sold. Under the FIRPTA rules, the buyer is generally required to withhold 10 percent of the sale price at the time of the sale. The IRS then requires that the foreign seller file an annual tax return with the IRS and calculate the actual tax due on the gain (calculated using the applicable graduated tax rates). The foreign person must pay any additional tax due or may be eligible for a tax refund to the extent the withheld amount is more than the tax due. There are several exceptions and modifications to the FIRPTA rules that may apply in the case of foreign investors.

Estate Tax

At a rate of 40 percent, the US estate tax regime should be a significant consideration for foreign investors. This regime differs considerably from many foreign tax systems and often catches foreigners by surprise. The discussion below of US estate tax matters is only applicable to foreign individuals who are not US domiciles.

The US estate tax is an entirely separate tax from the US income tax and applies to the worldwide estates of US tax residents (subject to certain exemptions). Foreign persons are subject to the US estate tax only to the extent of ownership of property physically in the United States (so-called "US situs assets").

The estate tax applies to foreigners much the same as it does to US persons, but with some detrimental modifications. The most significant difference is that a US person is

currently entitled to a $5.43 million unified estate and gift tax exemption (meaning US persons can make up to $5.43 million in lifetime gifts plus estate transfers before triggering tax) and an unlimited marital deduction for transfers to a US spouse (meaning US persons can make unlimited gifts and estate transfers to their US spouses without triggering taxes). The unified tax exemption is adjusted annually for inflation.

Foreign persons do not enjoy these same considerable benefits. Instead, they are limited to a $13,000 unified tax credit and no marital exemption for transfers to spouses. This means that (absent proper planning) if foreign persons own US real estate at the time of their death, the sting of the estate tax may apply to most of the value of their US properties. Compare this with US persons owning real property who may escape the estate tax entirely (if their estate and previous gifts total less than $5.43 million).

A tax treaty may provide some relief from the US estate tax rules that otherwise apply to foreigners. But any relief depends entirely on whether a tax treaty exists between the United States and the investor's home country, and such treaty's estate tax provisions. For instance, many treaties provide that the foreign investor is entitled to a pro-rata portion of the estate tax exemption available to US tax residents. The pro rata portion is based on the value of the deceased foreign person's US estate relative to the value of the individual's worldwide estate. In addition, many treaties permit tax-free transfers to a surviving spouse. Therefore, all foreign investors must take special care in planning to avoid the US estate tax.

The estate tax has been the target of much legislative activity, and the threat of major changes always looms. There is no telling what exemption amount or tax rate will apply in the unknown future. In the last 15 years, the rate applicable to US persons has been as high as 55 percent and as low as 35 percent (and prior to retroactive legislation, it was reduced to 0 percent in 2010!), with exemption amounts dipping as low as around $675,000. Foreign persons are in the lucky position that, with proper planning, they can structure their assets so they fall outside the US estate tax. This means they need not be worried about future fluctuations in the tax rate or exclusion amount (at least for so long as the estate tax system exists in its current form).

Tax and Other Filing Requirements

Foreign purchasers should also consider the administrative requirements related to owning US property. Not only will complex holding structures lead to more complicated tax filing requirements, but these complex structures will involve more non-tax administrative requirements, such as corporate maintenance filings and annual registration fees.

Florida State and Local Taxes

Florida has no state individual income tax, but there is a state corporate income tax (which is levied in addition to the federal corporate income tax). The Florida corporate income tax rate is 5.5 percent. Sales tax applies to rental income from commercial leases and residential property leased for six months or fewer per year. The sales tax rate is 6 percent plus applicable county-level taxes (the combined rate in Sarasota County, for example, is 7 percent). Some counties apply additional tourist development and similar taxes on rental income. Because of the combined state and local sales taxes plus tourist development taxes, rental income may be subject to tax of 12 percent or greater in some counties. Other non-federal taxes may apply in Florida to foreign owners of real property, including local property taxes.

Choice of Holding Structure

There are various structures for investing in US real estate, and each structure has its own advantages and disadvantages. Below is a summary of the most common structures and their respective advantages and disadvantages.

1. *Direct Ownership*

This is the simplest ownership structure and requires the least planning. Direct ownership is when one or more individuals owns title to the property in his or her own name (as opposed to through an entity). The income from real property flows directly to the owner under this structure. Individual foreign owners are directly taxable on the rental income at a flat rate of 30 percent. This amount is nonrefundable. Alternatively, the foreign owner could elect to be taxed on a net basis, in which case graduated income tax rates will apply (up to 39.6 percent). Foreign direct owners are also directly taxable on income from any gain on sale, at graduated ordinary income tax rates (up to 39.6 percent) or possibly at the lower capital gains rate (up to 20 percent). FIRPTA also applies on the disposition of the real property, which requires the buyer to withhold and remit to the IRS 10 percent of the sale price (which may be refundable, depending on the tax due on the gain, if any).

The foreign owner may be required to file an individual income tax return with the IRS, reporting income from the property. For a variety of privacy reasons, many people prefer to report this income on the tax return of a separate entity rather than on an individual tax return, which makes direct ownership less desirable.

Most significantly, direct ownership has considerable adverse US estate tax consequences since the property will be captured by the estate tax regime upon the investor's death. The property will be subject to the 40 percent estate tax (unless a tax treaty between the United States and the investor's home country provides some relief). Even if estate tax liability is mitigated under a treaty, the investor's heirs may still have burdensome administrative filing requirements at the time of the investor's death. The upside is that the property's tax basis will be stepped up upon the investor's death, so his or her heirs will have a higher tax basis in the property for income tax purposes going forward.

Direct ownership of the property also means that the individual owner will have personal liability for liabilities and claims associated with the property. These claims could include claims by persons injured while on the property.

Direct Ownership Planning Highlights:

- Simplest structure
- Rental income: 30 percent flat withholding tax unless net basis election
- Disposition income: may be eligible for 20 percent capital gains tax; otherwise, taxed up to 39.6 percent
- FIRPTA withholding applies on disposition
- Foreign owner must file US tax return, reporting any income
- Estate tax applies
- No limited liability

2. *Ownership Through US Partnership*

Partnerships are treated as pass-through entities for US tax purposes. As such, the US tax consequences of owning property through a partnership are generally the same as if the

property were owned directly by the foreign individual. Rental income is subject to the 30 percent flat nonrefundable tax (unless a net basis election is made), and income from the sale of the property may enjoy the lower capital gains tax rate (up to 20 percent). The sale of the property will also be subject to FIRPTA withholding, at a rate of 35 percent of the foreign partner's share of the gain. FIRPTA withholding may also apply at a rate of 10 percent if the owner sells the interests in the partnership, rather than selling the real property directly.

Both the individual and the partnership must file annual income tax returns in any year there is income to the partnership. There are also Florida annual filing requirements.

The estate tax implications of ownership through a partnership are somewhat uncertain. US tax law fails to address whether certain forms of intangible property—including interests in partnerships—are included in the US estate of foreign persons to calculate the estate tax. If partnership interests are included in the foreign person's estate, then the value of the real property would be subject to the estate tax regime at the time of the owner's death. Where the property is personal use and not used as a rental, most practitioners believe that it would be an overreach to include partnership interests in the US estate of foreign persons. But there is no certainty on the issue. Accordingly, there is risk to owning property through a partnership vis-a-vis avoiding the US estate tax.

Despite the risks, for foreign investors looking for a simple entity ownership strategy, a partnership is usually the most favorable planning structure because it avoids the double-taxation pitfalls of corporate structures and may also avoid US estate tax. If properly structured and maintained, a partnership will insulate its partners from liabilities and claims associated with the property (discussed below).

US Partnership Planning Highlights:

- More administrative requirements than direct ownership
- Rental income: 30 percent flat withholding tax
- Disposition income: may be eligible for 20 percent capital gains tax; otherwise, taxed up to 39.6 percent
- FIRPTA withholding applies on sale of property or on sale of partnership interests
- Foreign owner and US partnership have annual tax filing obligations
- Estate tax likely does not apply

3. *Ownership Through US Limited Liability Company*

Under US tax law, a limited liability company (LLC) can elect to be taxed as either a corporation or a partnership, unless the LLC has one owner, in which case, it can elect to be taxed as a corporation or is treated as a disregarded entity. If an LLC is treated as a disregarded entity, then the owner of the LLC is treated as directly owning the real property held by the LLC for US income tax purposes.

An LLC taxed as a partnership or treated as a disregarded entity will cause the same US income tax results as direct ownership or a partnership. In other words, rental income is subject to the 30 percent flat tax, and income from selling the property may enjoy the lower capital gains tax rate (up to 20 percent) but will be subject to FIRPTA withholding. FIRPTA withholding may also apply if the owner sells the interests in the LLC, rather than selling the real property directly.

The estate tax may also apply, either (i) because the LLC has only one owner and is disregarded for tax purposes (see discussion above regarding direct ownership) or (ii) because partnership interests may be treated as US situs property (see discussion above regarding partnership ownership).

Both the individual and the LLC (unless it's treated as a disregarded entity) may be required to file an annual income tax return in any year where the entity earned income, and the LLC has Florida annual filing requirements (regardless of whether it's treated as a disregarded entity). This structure, therefore, results in the same tax consequences as direct ownership but with additional administrative layers. However, a disregarded LLC is superior to direct ownership, because the LLC, if properly structured and maintained, will insulate its owners from liabilities and claims associated with the property.

Importantly, there may be differences between how an LLC is treated under US tax law versus how it is treated under foreign tax law. This can lead to a mismatch of how the income is treated in the foreign country compared with how it is treated in the United States, resulting in possible adverse tax consequences in the investor's home country. Consequently, any tax planning using an LLC should be reviewed by a foreign tax advisor.

LLC Planning Highlights:

- More administrative requirements than direct ownership
- Limited liability for owners
- Rental income: 30 percent flat withholding tax
- Disposition income: may be eligible for 20 percent capital gains tax; otherwise, taxed up to 39.6 percent
- FIRPTA withholding applies on sale of property or on sale of LLC interests
- Estate tax may apply
- Foreign tax planning concerns

4. *Ownership Through US Corporation*

If a US corporation (including an LLC that elects to be taxed as a corporation for US income tax purposes) holds real property, the corporation will be taxed as a US person. In other words, it is subject to tax on all of its worldwide income, including from the rental and sale of any real property it holds. The corporate tax rate applies at rates up to 35 percent, and there is no lower rate for capital gains. The corporation must also file an annual income tax return with the IRS, regardless of whether it earned any income in a particular year. The annual return requires information about the foreign owner(s). Besides the federal corporate tax, the Florida corporate tax will also apply at a rate of 5.5 percent.

The corporation will also be subject to state-level non-tax filing corporate maintenance obligations (such as annual reports). The corporation's shareholders will enjoy limited liability and be insulated from liabilities and claims associated with the property.

The biggest disadvantage with ownership through a corporation is that it leads to "double-taxation," that is, income is taxed when earned by the corporation (subject to federal and Florida income tax) and then taxed a second time when distributed to the foreign shareholders. A distribution to a foreign shareholder is generally subject to a 30 percent nonrefundable flat withholding tax (subject to possible reduction under a tax treaty between the United States and the investor's home country). This double-taxation is a significant disadvantage for most investors, so most foreigners look for another planning strategy.

Although a sale of the property is not directly subject to FIRPTA (because the corporation is not a foreign person), the subsequent distribution to the foreign shareholders is subject to 10 percent FIRPTA withholding where it represents the sale of underlying real property. A sale of the interests in the corporation will also trigger FIRPTA withholding.

Finally, the value of the shares of the US corporation will be included in the foreign investor's US estate tax calculation, which is another serious detriment to holding property through a corporate structure.

US Corporation Planning Highlights:

- More administrative requirements than direct ownership
- All income subject to corporate income tax (up to 35 percent) plus Florida corporate income tax (5.5 percent)
- Income is "double-taxed" (corporate income tax plus tax upon distribution to shareholders)
- FIRPTA withholding applies on sale of property (but only when proceeds are distributed to foreign shareholders) or on sale of corporation, but not on direct sale of property
- Corporate tax return required every year
- Estate tax applies

5. *Ownership Through Foreign Corporation*

If the real property is owned through a foreign corporation, the corporation must file a US annual tax return with the IRS, reporting and paying tax on any rental income (30 percent flat tax withholding unless a net basis election is made) or sale income from the property (at corporate income tax rates, up to 35 percent) plus Florida corporate income tax (5.5 percent). Alternatively, the corporation could elect to treat all its income as connected with a US trade or business, in which case the corporate income tax will apply to both disposition income and rental income (up to 35 percent). A major disadvantage with holding property through a corporation is that a corporation does not enjoy the same lower capital gains rate as individuals on proceeds from a sale of the property.

FIRPTA withholding applies to the sale of the property but does not apply to a sale of the foreign corporate stock. The corporation must file an annual tax return, but its foreign owners will not have a separate filing obligation.

In addition, the repatriated income of a foreign corporation is subject to a US branch profits tax (normally 30 percent, but subject to possible reduction under a tax treaty). The branch profits tax intends to replicate the double-taxation that hits domestic corporations when making distributions to their shareholders. At least regarding income from selling the property, this tax can be avoided with proper planning by terminating the corporation's US trade or business at the time of the disposition. The tax cannot generally be avoided on rental income.

Ownership through a foreign corporation provides one significant advantage in that it will shield the real property from falling into the US estate regime, since the corporate stock is not US situs property. Ownership through a corporation is also advantageous because it provides limited liability for the foreign owner. This structure also provides anonymity for the foreign owner who usually does not need to report it to the IRS.

Foreign Corporation Planning Highlights:

- More administrative requirements than direct ownership
- Rental income: 30 percent flat withholding tax
- Disposition income: subject to corporate income tax (up to 35 percent) plus Florida corporate income tax (5.5 percent)
- Income is "double-taxed" (branch profits tax) at 5 percent
- FIRPTA withholding applies on sale of property but not on sale of stock
- Estate tax does not apply

6. *Ownership Through Foreign Partnership*

The tax consequences of using a foreign partnership are similar to those that arise from holding property through a US partnership (discussed above). The partnership will be treated as a pass-through entity for US tax purposes, and the tax obligations will flow through to the individual partners. Rental income is subject to the 30 percent flat nonrefundable tax, and income from the sale of the property may enjoy the lower capital gains tax rate (up to 20 percent). The sale of the property will also be subject to FIRPTA withholding at a rate of 10 percent on the purchase price. FIRPTA withholding may also apply if the owner sells his or her interests in the partnership, rather than selling the real property directly.

Both the individual and the partnership must file annual income tax returns. There are also Florida annual filing requirements.

As discussed above, the estate tax implications of ownership through a partnership are somewhat uncertain.

Foreign Partnership Planning Highlights:

- More administrative requirements than direct ownership
- Rental income: 30 percent flat withholding tax
- Disposition income: may be eligible for 20 percent capital gains tax; otherwise, taxed up to 39.6 percent
- FIRPTA applies on sale of property or on sale of partnership interests
- Foreign owner and US partnership have annual tax filing obligations
- Estate tax likely does not apply

7. *Ownership Through US Trust*

Some investors use a trust structure for owning US real property. Special rules will determine the taxation of the trust and its owners, many of which are beyond this article. If the trust is a grantor trust (whether foreign or domestic) with a foreign grantor, the tax consequences will generally be identical to direct ownership by a foreign individual. If the trust is a non-grantor irrevocable trust, it is possible to avoid the estate tax upon the grantor's death. There may be increased administrative requirements and added costs associated with a trust structure.

Trust Planning Highlights:

- Increased expenses and administrative complexity
- More options for minimizing tax liabilities

8. *Multi-Tiered Ownership*

For a variety of reasons, foreign buyers may invest in US property through a multi-tiered ownership structure. Using these structures entails increasing complexity but may satisfy the needs of particular investors. For instance, the investor may want to use an entity from his or her home country, which owns a US property holding company. Even more complex structures can involve third-country holding companies. These more complex structures may provide benefits to foreign investors, such as avoidance of the estate tax and the branch profits tax, all while providing greater anonymity for the foreign owners. But these multi-tiered structures come with increased expenses for planning, implementation, and administrative oversight. These structures may not be appealing to persons purchasing a single property for personal use, but they will make more sense for larger investments with a steady income flow.

Multi-Tiered Structure Planning Highlights:

- Increased administration over multiple entities
- Increased expenses associated with multiple entities
- More options for minimizing tax liabilities

Already in the Market? There Are Still Planning Opportunities.

There are myriad US tax issues arising from foreign ownership of Florida property. Foreigners considering entering the US real estate market are strongly urged to enter into careful planning with both a US and foreign tax advisor prior to purchasing any property, lest they get caught in a web of unexpected tax pitfalls. But even if you are a foreign person who failed to plan ahead and are already in the market, do not fear! There are still planning opportunities to be had. However, with property values increasing in much of Florida, the window may be closing for foreign investors to restructure their real property investments with no serious tax hits. But as property values continue to move upward, the time to act is now.

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