SECTION REVIEW
MASSACHUSETTS BAR ASSOCIATION

Taxation Law

Six tax traps for foreign investors

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The Internal Revenue Code contains numerous traps for the unwary foreign investor in U.S. real estate or businesses. The tax law provisions applicable to nonresident foreign investors are very often quite different — and more onerous — than the familiar tax rules applicable to U.S. citizens and foreign residents in the United States. This article identifies a few of the most common areas where nonresident foreign investors may need specialized tax advice to avoid costly mistakes.

Estate Tax

Nonresident foreign investors are subject to estate tax rules that are far less favorable than those applicable to U.S. citizens and residents.

An estate of a U.S. citizen or resident is subject to an estate tax based upon the value of the worldwide property, tangible and intangible, owned by the decedent on the date of death or over which he or she has certain rights or powers. The current estate tax rate for 2015 is 40 percent for taxable estates in excess of a $5.34 million exemption, which is adjusted annually for inflation. A U.S. estate may also deduct from the taxable estate a marital deduction equal to the value of property left to a surviving spouse. The amount of lifetime taxable gifts during the decedent's life is also included in calculating the gross estate.

The gross estate of a nonresident foreign investor includes all tangible and intangible property situated in the U.S. (U.S. property), in which the decedent has an interest at the time of his death, or over which he has certain rights or powers. The estate is taxed at rates ranging from 26 percent to 40 percent of the value of estates in excess of a $60,000 exemption (the 40 percent rate applies to taxable estates over $1 million in value). Moreover, the estate of a nonresident foreigner is generally not allowed a marital deduction unless the surviving spouse is a U.S. citizen. Taxable gifts are not included in the gross estate, but are separately taxed.

Gift Tax

Similarly, nonresident foreign investors are subject to gift tax rules that are far less favorable than those applicable to U.S. citizens and residents.

U.S. persons are subject to a federal gift tax on gifts made of their worldwide assets, tangible and intangible. The gift tax is imposed on the *donor*; donees are not subject to gift or income tax on the receipt of the gift. Taxable gifts are taxed at rates ranging from 18 percent (for taxable gifts not in excess of $10,000) to 40 percent (for taxable gifts in excess of $1 million) on the fair market value of gifts made worldwide. An annual exclusion of $14,000 per donee (for 2014) is allowed for gifts of non-trust present interests; spouses may elect to make joint gifts (split 50/50 between spouses). A lifetime exemption of $5.43 million, combined with the estate tax exception, is allowed.

A nonresident foreign national is subject to a federal gift tax on gifts of real estate and *tangible* personal property and cash located in the United States. Intangible assets such as corporate stock and partnership interests are not subject to tax. An annual exclusion of $14,000, adjusted for inflation, is allowed per donee. Joint gifts with spouses are *not* allowed unless the spouse is a U.S. person. Gifts to spouses are not entitled to the marital deduction unless the spouse is a U.S. citizen, but an inflation-adjusted annual $140,000 exclusion is allowed for gifts to a non-citizen spouse. No other exemption is allowed for lifetime gifts, although gift taxes paid may be credited against the estate tax.

Withholding Taxes

The tax code imposes a number of special withholding taxes on U.S. source income received by nonresident foreign nationals.

Rents, dividends, interest, royalties and other "fixed or determinable annual or periodic income" (FDAP) received by nonresident foreign nationals are taxed at a flat rate of 30 percent on the *gross* amount received determined without deductions, unless these amounts "effectively connected" with a U.S. trade or business conducted by the taxpayer. This tax must be withheld at the source by the payor, and — although referred to as the "withholding tax" — is a true tax, not a credit against income taxes. In some cases, tax treaties reduce or eliminate the withholding rates for certain classes of income.

Net income "effectively connected" with a U.S. business conducted by a nonresident foreign national is taxed at customary U.S. personal and corporate income tax rates. A special election permits income from real estate activities to be classified as "effectively connected" and thus taxed on a net — rather than a gross — basis.

Income of a nonresident foreign investor in a U.S. partnership is subject to withholding at a 39.6 percent rate for individuals (35 percent for corporations). Unlike the 30 percent tax on FDAP, amounts withheld by the partnership are credited against the income tax payable by the foreign partner and are potentially refundable, in a manner similar to the familiar withholding from U.S. employee income.

Income of a nonresident foreign investor from the sale or disposition of U.S. real property interests is subject to "FIRPTA" withholding at the rate of 10 percent of the gross proceeds of sale. An amendment to the tax code, effective Feb. 16, 2016, increases this rate to 15 percent for properties other than a principal residence, and for principal residences sold for more than $1 million. This amount is withheld at the source by the buyer and is creditable and potentially deductible like the partnership withholding discussed above. The amount withheld may be greater than the capital gain tax imposed on the seller and sometimes greater than the net cash received by the investor.

No S Corporation Election

Nonresident foreign investors cannot take advantage of the benefits provided by the S corporation classification, since stock ownership by a nonresident foreign investor will terminate the corporation's S corporation election.

Branch Profits Tax

Foreign corporations engaged in business in the U.S. are subject to a "branch profits tax," a second tax in addition to the regular U.S. corporate income tax. This tax is equal to 30 percent of the corporation's "dividend equivalent amount," and effectively imposes a 30 percent tax on corporate income *deemed* distributed as a dividend to its foreign shareholders.

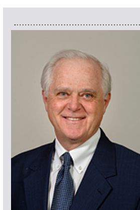
Earnings Stripping

U.S. and foreign corporations which pay interest to foreign lenders may not deduct the interest payments if the interest income is not taxable to the recipient or to the extent it is reduced by a tax treaty.

Conclusion

The foregoing discussion is only a general summary of a complex topic, and is subject to numerous qualifications and exceptions. In many cases, the severity of the tax rules applicable to foreign investors can be mitigated by competent pre-investment tax advice and proper structuring of the investment transaction.

For a more complete discussion of this topic, please see the publication "Tax Guide for Foreign Investors in U.S. Residential Real Estate" available on the Davis Malm & D'Agostine, P.C. website (www.davismalm.com) or upon request. ■



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