# Inbound Investments

## Use these tax strategies when advising international clients.

by Richard S. Lehman, JD

In the midst of an unprecedented commercial real estate boom, some investors, particularly those from outside the United States, believe assets currently on the market reflect bargain-basement prices. As these opportunities spring up throughout the country, international investors are eyeing these properties and purchasing at a record pace. To better serve this rapidly growing market, U.S. commercial real estate professionals should become familiar with the tax benefits available to inbound international real estate investors.

### Tax Differences

The U.S. taxes corporations that own U.S. real estate differently depending upon whether the real estate's owner is an international or domestic corporation. There also are tax similarities and differences between individual international investors and U.S. investors. Noncorporate U.S. and international investors who are not considered real estate dealers or developers both generally pay capital gains tax on profit from the sale of U.S. investment real estate. These taxes can be as low as 15 percent on long-term capital gains. Domestic and international corporations also pay tax on the sale of capital assets, as much as 35 percent federal income tax, along with state corporate income taxes that range between 5 percent and 10 percent.

The major negative difference in taxes applies only to international corporations that may earn profits in U.S. real estate. Unlike domestic corporations, these international corporations may be required to pay 30 percent branch profits tax on undistributed and reinvested U.S. profits in addition to federal and state taxes.

The remaining differences favor international investors in both the interest of tax fairness and to promote inbound investment in the U.S. These differences include:

- tax-free interest income generated from U.S. real estate-related cash flow through the use of portfolio interest loans, which are loans from an international investor to U.S. individuals, corporations, partnerships, or trusts, so long as the international investor creditor does not directly or indirectly own 10 percent or more of the U.S. debtor;
- stock in an international corporation that owns U.S. real estate is not taxable on the sale of shares in that corporation; and
- international investors that form a corporation to own U.S. real estate can avoid a second tax on distributions of corporate profits by liquidating the corporation after it has paid U.S. corporate taxes prior to distributing dividends.

### Planning Is Important

These tax differences can result in lower taxes for international investors if careful plans are made or significantly higher taxes if mistakes are made. The following example illustrates effective tax planning that makes use of a portfolio interest loan.

Assume a nonresident alien individual, or a citizen of a foreign country that is considered a nonresident for U.S. income tax purposes, establishes an international corporation (international investor) that organizes a Florida-based corporation (domestic corporation) that owns real estate in Florida that was purchased 20 years ago for $1 million. The investment's current value is $11 million.

If the international investor sells the real estate, a $10 million gain will result in total corporate taxes of 38 percent, or $3.8 million. This would leave a net distribution of $7.2 million to the international investor after sale and liquidation of the Florida company. No additional shareholder-level tax is due upon liquidation.

Now assume that instead of selling the real estate the international investor sells a U.S. investor 3 percent of the shares of the domestic corporation for a price of approximately $200,000, or 3 percent of $7.2 million. Instead of selling the real estate to a third party and liquidating the corporation, the corporation enters into a 1031 exchange to acquire $11 million of replacement real estate in the form of a triple-net-lease building with an annual return of approximately 6.5 percent for a cash flow of $700,000 per year.

Assume further that sometime after the sale of the shares to the U.S. investor, all of the international investor's shares in the

corporation, 97 percent, are repurchased by the domestic corporation in exchange for the domestic corporation's portfolio interest installment note equal to a value of $7 million with interest of 10 percent for 10 years.

After the redemption, the U.S. investor's ownership of 3 percent of the domestic corporation represents 100 percent of all issued shares and total ownership of the domestic corporation. The international investor owns the note representing an indebtedness of the domestic corporation for $7 million.

The 1031 replacement property is held by the domestic corporation for 10 years and appreciates in value by 3 percent per year resulting in a fair-market value of $14.3 million after 10 years. The U.S. investor then elects S-corporation tax status once he or she owns 100 percent of the domestic corporation. At the end of the 10-year period, this allows the S-corporation's shareholder to sell the replacement property as a long-term capital gain asset paying a 15 percent tax rate for total taxes of approximately $2 million.

What can commercial real estate advisers glean from this example? Over the 10-year period the international investor receives $7 million in tax-free interest. The corporation pays little in income tax since the interest is generally deductible, subject to certain special rules, turning the investment into a tax-free 10 percent return in U.S. real estate with a large cash payment on the due date of the note.

As a result of the replacement property's sale, the international investor's loan is paid at a tax cost of approximately $2.5 million (35 percent of $7 million), resulting in an additional net distribution of approximately $4.5 million to the international investor for a total of $11.5 million.

Also, there is an additional profit of $5.3 million ($14.3 million sales price minus $2 million in U.S. taxes minus $2.5 international investor taxes minus $4.5 million distribution to the international investor) that is left to be distributed to the U.S. investor, the international investor, or both.

Finally, during the 10-year period, the corporation will produce net after-tax cash flow totaling approximately $16.8 million for the two investors.

## Use Caution

While these general tax rules affect inbound international investors, there are many requirements and specifications that must be considered in each transaction. In addition, some international investors may be citizens of countries that have tax treaties with the U.S., which may provide a similar, though better, tax environment for the international investor. Consult a qualified tax professional to ensure inbound investment transactions are structured properly to maximize the tax advantages.

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