Sheldrick & Co. PLLC

Cross-Border News

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Cross-Border Investment

Investing in U.S. Real Estate

Planning Tips for Brazilian Investors

Faced with economic uncertainty and a depreciating currency at home, high net worth Brazilians increasingly view the U.S. real property market, in particular cities such as Miami and New York, as a safe investment haven. Based on recent estimates, foreign investment accounted for 36 percent – over $6 billion – of all real estate investment in the Miami area in 2015, with Brazilian investors now the major players in the market for luxury accommodation.

Investment in U.S. real estate is attractive for several reasons: there are no restrictions or special taxes on the ownership of real property by foreign nationals; dollar-based investments are viewed as relatively safe; and the returns on real estate investments in cities such as New York and Miami, both residential and commercial, continue to be robust. However, by investing in U.S. real estate, foreign nationals face exposure to a variety of Federal, state and local taxes, as well as associated compliance and reporting requirements, the nature of which depends in part upon how the investment is structured.

This article summarizes the principal U.S. tax implications of acquiring, owning and disposing of U.S. real estate. It also highlights the advantages and disadvantages of some potential investment structures. However, because the rules are complex and their application depends upon individual circumstances, any Brazilian national planning such an investment should consult a qualified tax adviser or accountant prior to buying property.

Tax Implications in General

Investors may buy real property either for their personal use (for example, as a vacation or retirement home), as a source of rental income, for capital appreciation, as a hedge against currency fluctuation or any combination of these. Some investors prefer to retain some degree of anonymity; for others, this is not a concern. Some wish to acquire a single property; others wish to create a substantial portfolio of properties. Each of these factors, and others, may affect how the investment should be structured, but even in the simplest scenario a lack of planning can lead to unintended tax consequences.

Merely owning property in the U.S. does not affect a foreign national's tax status. However, Brazilian nationals, especially those owning vacation homes in the U.S., should bear in mind that they may become residents of the U.S. for Federal income tax purposes if they make extended visits to the U.S. for business or on vacation, even if they do not have a "Green Card". Generally, a person is a resident for tax purposes for any year in which he or she either is present in the country on 183 days or more, or is present on 31 days or more and also meets a "substantial presence" test measured over a three-year period.

Tax residents are subject to U.S. income tax on their worldwide income (subject to available foreign tax credit relief) and must also comply with extensive tax reporting and disclosure requirements relating to their overseas accounts and other foreign assets. And although there is no double taxation treaty between the U.S. and Brazil, the countries are party to an agreement providing for the sharing of tax information.

It is therefore important that frequent visitors to the U.S. carefully track the days they spend in the country, to avoid inadvertently attaining tax residence.

Acquisition and Ownership of Real Estate

There is no Federal tax on the transfer or ownership of real property, but taxes may apply at the state and local levels. Transfer taxes are generally the seller's responsibility, though a seller may, as a matter of contract, require the buyer to absorb the cost of the tax.

All states impose a tax on the ownership of property, generally based on its assessed valuation (which may not necessarily reflect current market value). However, rates vary considerably from state to state, and from one locality to another. A prospective purchaser should therefore examine the impact of state and local property taxes, especially when acquiring property for investment purposes.

Rental Income

Non-resident individuals and foreign entities are subject to Federal income tax on income derived from the rental of real property in the United States. State and local income taxes may also apply.

At the Federal level, the way in which rental income is taxed depends upon whether the property-owner is engaged in the business of renting property. If the property-owner is *not* engaged in business, rental income is subject to tax at the rate of 30 percent of the gross amount – *i.e.*, with no deduction for depreciation and carrying costs. If the property owner *is* engaged in a business, tax is charged at standard graduated rates on the net income derived from the business. Federal income tax rates range from 10 percent to 39.6 percent for individuals and from 15 percent to 35.0 percent for corporations.

Whether the ownership of real property constitutes a business is a factual question and the U.S. Internal Revenue Service has issued an interpretive ruling laying out the factors to be taken into account. Property owners should review these criteria with their U.S. advisers to ensure that rental income is correctly reported.

Since a tax of 30 percent of the gross income may result is a higher tax burden than a graduated tax on the net amount, property-owners may also wish to consider taking advantage of the option available to foreign nationals to treat rental income as being derived from a business, even if the general criteria are not met. This election must be made in writing to the tax authorities in the specified form and manner.

Taxation of Gain on the Sale of Real Property

Non-resident individuals and foreign corporations are also subject to Federal and, possibly, state tax on gain realized on the sale of an interest in U.S. real estate. In the case of corporations, capital gains are treated as business income at standard graduated rates. Individuals are also subject to tax, but gain realized on the sale of property owned for a year or more is taxed at preferential rates.

With certain limited exceptions, a person purchasing U.S. real property from a foreign person must withhold and pay to the IRS 10 percent of the total gross sales price, including (1) the cash paid or payable, (2) the fair market value of any property provided in exchange, and (3) the amount of any liability assumed by the transferee in connection with the property. The foreign seller can credit the tax withheld against its actual tax liability when the tax return is filed.

Estate and Gift Tax

An issue frequently overlooked by foreign nationals who invest in U.S. real estate is that transfers of U.S. property either by gift (for example, to a family member) or upon the owner's death are subject to Federal Estate and Gift Tax ("EGT") at graduated rates of up to 40 percent on the value of the decedent's U.S. assets, subject to a combined exemption of $60,000. U.S. real property, shares in U.S. corporations and (in the view of the IRS) interests in domestic partnerships and LLCs owning U.S. real estate, are taxable assets for EGT purposes. In addition to Federal tax, some states also charge inheritance tax. No inheritance tax applies in Florida, but the estates of non-residents owning property in New York are subject to tax at rates of up to 16 percent of the value of the New York assets. Non-residents do not qualify for provisions allowing property to pass to a spouse free of inheritance tax, although in some cases estate taxes can be deferred, though not avoided, through certain trust-based arrangements.

ACQUISITION / OWNERSHIP STRUCTURES

Foreign investors have numerous options in deciding how to acquire and own U.S. real estate, ranging from the very simple to the highly complex. Some structures rely, at least in part, on the utilization of benefits provided by a double taxation treaty. This is generally not possible for Brazilian investors because there is no tax treaty between the two countries, and U.S. rules generally preclude the practice of "treaty shopping".

The most appropriate ownership structure depends on many factors, including the amount of the investment, the number of properties to be acquired, the purpose of the investment, the exit strategy, if any, and the personal tax circumstances of the purchaser. Some more complex structures may create opportunities for reducing or deferring U.S. taxes, but these benefits need to be weighed against the legal, administrative and accounting costs associated with such arrangements, as well as the impact on the investor's tax liability in Brazil. The following examples of ownership structures are therefore intended as general guidance only.

Direct Ownership

The simplest approach, and one appropriate for persons acquiring a single property primarily for personal use, is direct ownership. However, direct ownership has at least three possible drawbacks.

First, some investors prefer to maintain a degree of anonymity with respect to their investment. This is not possible through a direct investment, because ownership of real estate is a matter of public record. Second, direct ownership exposes the owner to personal liability in the case of lawsuits arising from the rental of the property. Though this latter problem can be mitigated by insurance, it is of concern especially to investors acquiring multiple properties for investment purposes rather than their personal use. Third, direct ownership subjects the owner to U.S. inheritance taxes.

Domestic LLC

A second, and popular, option is to acquire property through a domestic limited liability company, or "LLC". An LLC is relatively easy to form (especially if it has only one owner) and offers some measure of anonymity as to ownership.

An LLC is frequently compared to a *sociedade limitada* formed under Chapter IV of the Brazilian Civil Code. The analogy is apt in the sense that both entities are quasi-contractual in nature, but it is misleading in the tax context. A single member LLC is disregarded for U.S. tax purposes and its income or loss is included on the owner's tax return. If the LLC has two or more members, it must file a partnership tax return in its own name, but its income, loss and tax attributes are allocable to the members according to the formula set forth in the LLC Agreement (the equivalent of the *contrato social*) and are not taxed at the LLC level. This means that non-resident members of a U.S. LLC are directly subject to U.S. tax. They must obtain U.S. tax identification numbers, file tax returns and report and pay tax on their *pro rata* share of the LLC's net income.

Distributions by a multi-member LLC to a non-resident member are subject to a 30 percent withholding tax, and although this tax is creditable against taxes due by the member, accounting for the withholding tax creates additional administrative burdens and, consequently, cost. Further, use of an LLC does not avoid payment of EGT because, as noted above, the IRS treats an interest in an LLC as a U.S. *situs* asset, at least to the extent that the LLC owns real estate in the United States. For these reasons, an LLC may not be an attractive structure for ownership of U.S. real estate, unless some intermediary entity is interposed between the LLC and the ultimate owner.

Domestic Corporation

Use of a domestic corporation presents different challenges and opportunities. A domestic corporation is subject to tax on rental income and capital gain at standard rates. Dividend payments to non-resident owners are subject to a 30 percent withholding tax, with the consequence that rental income and capital gain is effectively taxed twice (though the double taxation of gain realized on the sale of property can be avoided through proper planning).

Where property is purchased primarily for capital appreciation rather than current income, a domestic corporation may offer greater flexibility due to its ability to retain and reinvest net income. However, U.S. tax law generally discourages corporations from retaining and accumulating profits, in particular "passive income", and undistributed profits may be subject to additional tax if certain conditions apply.

A non-resident shareholder is subject to tax on the sale of shares in a domestic corporation formed to hold real property. Moreover, as noted above, transfers of shares in a U.S. corporation are subject to EGT.

Foreign Corporation

Direct ownership of U.S. real estate by a foreign corporation addresses issues of limited liability and avoids EGT. It does not, however, assure total anonymity because a foreign corporation must disclose, on its U.S. tax return, the name of any person or entity owning directly or indirectly 50 percent or more of its voting stock. A foreign corporation is subject to income tax on U.S.-source rental income at standard corporate rates, but an additional "Branch Profits Tax" of 30 percent is imposed on its residual profits. The net effect is the same as if the foreign investor had formed a domestic corporation to own the property, and the corporation had distributed all of its after-tax profits, triggering a 30 percent withholding tax.

Use of a foreign corporation in theory also permits a non-resident owner to dispose of appreciated property on a tax-free basis by selling the shares of the corporation rather than the property itself. However, the tax due on the eventual sale of the property the corporation owns will typically be factored into the value of the shares.

More complex strategies involve the use of a foreign corporation to own the shares of a domestic entity, which in turn acquires and holds title to the real property. Such structures are more costly to establish and maintain and their effectiveness often relies on the utilization of tax treaty benefits not available to Brazilian investors.

RECENT DEVELOPMENTS

The economic attributes that make U.S. real estate attractive to legitimate investors, coupled with the degree of anonymity possible by acquiring real estate through LLCs or other entities, have contributed to the increasing use of such investments for money-laundering. The Boards of Directors of some condominium and almost all co-op apartment buildings are disinclined to approve acquisitions by LLCs or other entities unless the identities of the beneficial owners are fully disclosed. In addition, on March 1, 2016, the IRS will commence a pilot program requiring that title insurance companies disclose the identities of the beneficial owners of entities acquiring certain real estate in cash transactions. Initially these disclosure requirements will apply only in Manhattan, for properties worth over $3 million, and in Miami, for properties worth over $1 million. However, it is probable that this program will be expanded in the future, as part of continuing broader efforts to combat tax evasion and money-laundering.

Recommendations

Whatever ownership structure is used, U.S. taxation cannot be avoided, but devising a structure that best fits the personal circumstances and objectives of the investor can mitigate its effect. Persons contemplating U.S. real estate investments should:

✓ *Seek advice from qualified tax advisers or accountants – avoid "one size fits all" solutions;*

✓ *Monitor time spent in the U.S. to avoid inadvertently acquiring residence status;*

✓ *Define the goals of the investment and the timeframe and nature of an exit strategy, if any;*

✓ *Take into account tax implications in Brazil and any relevant third countries, not just the United States;*

✓ *In comparing ownership options, focus on real numbers, not theoretical tax benefits; for smaller investments, the respective tax costs of alternative ownership structures may not be significant in practice; and*

✓ *Weigh the potential tax benefits of any proposed ownership structure against the costs and practicality of creating and maintaining it.*

For additional information, please contact:

Andrew Sheldrick
+1 646.350.0469 x101
asheldrick@sheldricklaw.net

Marilyn Feuer
+1 646.350.0469 x103
mfeuer@sheldricklaw.net