PRESENTATION TO THE MIAMI BOARD OF REALTORS

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REPRESENTATION OF FOREIGN INVESTORS IN FLORIDA REAL ESTATE; PRE-CONTRACT TO PURCHASE AND SALE, AND IRS COMPLIANCE

1. Introduction

This presentation and accompanying materials provides an overview of the practical, legal and tax considerations that the real property professional needs to know when representing foreign investors.[1]

The handout begins with this overview, followed by (1) outline of US tax, worldwide tax and other important considerations, (2) memoranda on reporting requirements and subjective factors leading to a determination of residency, (3) Firpta affidavits and forms 8288, 8288-A and 8288-B, (4) forms W-7 and SS-4 to apply for identification numbers, (5) diagram with structuring options, (6) documentation for British Virgin Islands (BVI) corporation, and (7) form 3520 to report certain foreign gifts and transactions with foreign trusts, and (8) IRS comparison with form 8938 statement of specified foreign assets, and form TD F90-22.1 report of foreign and financial accounts (FBAR).

2. Let the games begin - Pre-Contract to Contract

When representing a foreign buyer it's important to determine the best form in which to title the property for US income tax, estate tax, gift tax, and other purposes. Real estate professionals should seek the advice of qualified legal counsel prior to the execution of the purchase contract – and at the least – should provide that the contract is assignable by adding the words "and/or assigns" after the name of the foreign buyer.

[1] I'm using the term foreign investors and foreigners as it is most familiar to real estate professionals, though we generally prefer use of the terms "offshore investor" or "international investor" as these terms may be deemed to be less discriminatory.

I've been frequently asked if we can effectively re-title properties that are held by foreign individuals by way of transfer to a foreign or domestic entity - generally for estate tax, limited liability, confidentiality and other reasons. Unfortunately, however, this is generally not practicable because of the Firpta requirements that apply solely to foreigners, and the potential closing costs for documentary stamp taxes, title insurance, and required approvals from the condominium association and/or the mortgagee. When presented with the options, individual foreign owners will generally forego the transfer, and may consider the purchase of life insurance to pay for contingent future estate taxes.

When purchasing a condominium unit it's also important to review the bylaws to make sure that ownership directly by a foreign entity is permitted, and it's important to consider the time and informational requirements for condominium approval as condominium associations often need a longer period of time to approve foreign investors.

3. Who is foreign?

a. Federal Tax; US residency =

(i) Green card or citizenship, or
(ii) ***183 or more days in any calendar year***, or
(iii) Present for at least 31 days but less than 183 days and meet the "substantial presence test" whereby weighted formula is applied to number of days present in current and past two years (current year + 1/3 or prior year and 1/6 of year before that), and if 183 or more, then residence is presumed unless foreign investor timely files form 8840 showing that he has "closer connections" to his/her "tax home" and IRS approves (tough to get).

b. Upon becoming a US Resident - You're in the Soup

Worldwide income is subject to US income tax, worldwide assets are subject to US estate tax, and U.S. residents are subject to strict and extensive (and

becoming more strict and punitive) federal reporting requirements with the IRS.[2]

c. Why do we use foreign entities – because the estate tax on foreign ownership of real property is punitive

For example, if an individual dies owning US real property valued at $1 Million:

(a)US Resident Decedent	**(b)Foreign Decedent[3]**
$5 Million Exemption	**$60,000** Exemption

(a) the estate of the US decedent would have the benefit of the $5 Million uniform gift and estate tax exemption and assuming that the gift exemption was not already used would ***not have to pay any estate tax*** on the $1 Million property,[4]

(b) the foreign investor, however, would only have a $60,000 exemption, and would then pay on a graduated scale which currently provides for a top rate of 35% (graduated rates of 18%-35%),[5] and thus, the ***estate of the foreign decedent would incur a federal tax liability of approximately $300,000***.

This estate tax applies to foreign ownership of US situs real and personal property. It does not apply, however, to foreign ownership of shares in an offshore entity as that is not considered to be US property. ***The proper use of a foreign entity will result in no estate tax upon the death of a***

[2] Nonresidents generally are subject to federal income tax only on their US source income. Rental income from real property in the US and gain from the sale of real property are both US source income subject to federal income tax regardless of the immigration status of the foreign investor and regardless of whether the US has an income treaty with the home country of the investor.

[3] This is absent an applicable tax treaty; and the US currently has estate tax treaties in force with Australia, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, Norway, South Africa, Switzerland and the UK.

[4] The $5 Million uniform gift/estate tax exemption is scheduled to expire this December 31, 2012. It is impossible to predict the amount that will be in effect for 2013 and thereafter, though many practitioners, myself included, believe that it is likely to be substantially less than $5 Million, and assuming that the Congress is unable to agree to a new amount the amount may be $1 Million on January 1, 2013 upon the expiration of Bush tax cuts.

[5] This rate is in effect from January 1, 2010 to December 21, 2012, and if Congress is unable to agree to a new rate the rate will go back to 55% on January 1, 2013 upon the expiration of the Bush tax cuts.

foreign investor, and thus, clients are well advised to properly employ the use of a foreign entity (and perhaps one or more foreign or domestic entities) for most transactions, and certainly for purchases of luxury residential or commercial properties.

In almost all instances, the amount of the ***mortgage should <u>not</u> be considered*** in the calculation of value. That is, do not reduce the amount of the mortgage in determining the value of US property unless the mortgage note is non-recourse.

But we're real estate attorneys. What about Tenancy by Entirety (TBE Property)? For example, if Florida real property is titled in the name of married foreign individuals (H and W), and H dies – the estate tax will be determined for foreign ownership as set forth above except that the value will be assessed at half the value of the property as there are two owners.[6] But what if the surviving spouse is a US Citizen? In that case, an unlimited marital deduction will be available to the surviving spouse and the foreign decedent's estate will not have to pay an estate tax.[7]

d. ***Florida homestead*** uses a different standard. US residency is not enough. To be eligible must have a ***green card or US citizenship.***

4. Foreign Investment In Real Property Act of 1980 ("Firpta")

The Firpta provisions start with a presumption that ***every seller is a foreign person*** subject to withholding unless proof is proved to buyer to the contrary. Any buyer of a US real property interest from a foreign owner, or anyone who is required to withhold tax pursuant to such transaction (ie, the closing agent), must file Forms 8288 or 8288-A to report and transmit the amount withheld – which is 10% of the gross sales price. The buyer or other withholding agent must report and transmit to the IRS the tax withheld by the ***twentieth (20th) day after the date of transfer***. Forms 8288 and 8288-A, and instructions, are included in the

[6] Same estate tax result if the property is held jointly with right of survivorship or tenancy in common.

[7] Real property left to a non-US citizen surviving spouse will not qualify for the unlimited marital deduction available to US citizens unless transferred to a qualified domestic trust ("QDOT"), which must have a US trustee and will essentially serve as an intermediary until the spouse becomes a US citizen.

attached materials, but it's important to note that an FEI number will be required for the IRS to properly allocate and keep track of these funds.

If it is anticipated that the actual tax will be less than the withholding amount or zero, an ***application for reduced withholding certificate*** may be filed with IRS on form 8288-B. By contrast to the above referenced 20 day provision, this must be filed ***on or before the date of transfer*** – and our experience has confirmed that it's extremely important for all parties involved in a real estate transaction to keep written proof of the date of mailing and content sent to the IRS.

There is an exemption from Firpta requirements (though not from Federal income tax filing requirements) if the sale is for less than $300,000 and buyer executes an affidavit under oath confirming that buyer intends to occupy the property for more than half of the number of days that the property will be occupied for the next two years. This would not apply if the buyer is purchasing property with an existing tenant, or if buyer intends to lease the property.

5. ***Basic Review – Advantages and Disadvantages of foreign investor status***

Disadvantages	**Advantages**
- ***No FL homestead status***	***- Worldwide Income not subject to US tax***
- ***Punitive estate tax***	***- Not subject to US reporting requirements***
- ***Need to comply with Firpta***	

6. ***Structures – Options, Options***

Proper planning can result in significant advantages for a foreign investor who acquires US real property directly or indirectly through a foreign corporation.

Some options – including individual ownership - are:

a. ***Individual, Tenanty by Entirety, Joint Tenancy with Right of Survivorship, Tenancy in Common***

This option is at least initially the ***least costly*** alternative and ***the estate tax exposure can be reduced by having a greater number of beneficial owners***. It also offers the reduced individual capital gains rates, which are

currently 15% but scheduled to increase to an effective rate of approximately 23% at the end of this year. The main disadvantages to this are exposure to estate tax liability, personal liability, lack of privacy and the Firpta withholding requirements at the time of sale. As noted elsewhere, there is a Firpta exemption that may apply in certain transactions that are $300,000 or less. It's important to note, however, that foreign sellers have the requirement to file a tax return for the year of sale separate and apart from the Firpta requirements. Foreign buyers that opt for individual ownership, or that are not represented and take title as individual owners, may wish to consider the purchase of term life insurance to cover the exposure to future estate tax liability.

Individual ownership is more common for Florida domestic residents than for foreign investors as domestic residents may obtain the benefits of Florida 'homestead' status.[8]

As an aside, if the foreign investor has family members that are US residents, such as adult children, consideration should be given to their taking title subject to a mortgage in favor of their foreign parents.

b. Florida Limited Liability Company

A Florida limited liability company (LLC) offers the advantage of limited liability and confidentiality, and can be owned by foreign investors (whereas an s corporation cannot). If the company is owned directly by foreign investors, the entity will be deemed to be a disregarded entity for purposes of application of the estate taxes for a decedent foreign investor and for purposes of determining applicability of Firpta (that is, Firpta will apply). If this option is considered, practitioners are advised to consider and inform clients of the distinction and asset protection benefits of having more than one member of the LLC (ie, a ***multi-member LLC*** rather than a single member LLC.).[9]

[8] There are two distinct advantages of owning homestead property: (a) constitutional protections against forced sale and restrictions on encumbrances, and (b) statutory exemption and increase limitations to ad valorem taxes.

[9] If you are not up to date on the recent case law and statutory changes in this area I suggest a review of the Florida Supreme Court Olmstead case and Florida Statute § 608.433.

c. ***Offshore Entity – ie, BVI Corporation***

As explained elsewhere in the presentation, proper use of a foreign corporation offers the advantage of ***no estate tax in the event of the death of an individual beneficial owner***. If the beneficial owner further makes an election to be taxed as a US corporation, there will be no Firpta withholding upon the subsequent sale of the property. Use of an offshore entity also offers the advantage of enabling the owner to take losses for depreciation and other expenses while owning the property which can be offset against gains at the time of sale. This generally more than compensates for the fact that the offshore entity will be taxed at the corporate capital gains tax rate (which is greater than the rate for individuals) at the time of sale.

d. ***Offshore and Florida Entity***

We generally recommend that foreign buyers ***own real property through a domestic (Florida) subsidiary corporation or limited liability company to be formed and owned by the offshore corporation***. It is often advantageous for the Florida entity to then enter into a lease with a third party or with the beneficial owner, and file all required income tax returns.

7. Financing

It is certainly more difficult for foreign investors to obtain mortgage financing, although some financial institutions have lending programs targeted to foreign investors. While these programs vary, they often require a US bank account, proof of additional liquidity for additional reserves in a US bank account, bank statements and reference letters, and personal financial statements. Because some of these documents are not always available, and because of foreign investor's concerns for confidentiality, real estate professionals can play an important role in assisting foreign investors with these considerations. It's also important to note that these loans generally require a larger down payment and are typically adjusted rate mortgages.

8. Gift tax considerations – How to give the gift that doesn't keep giving

Most practitioners in Florida are unaware of little known yet important provisions in the Internal Revenue Code and Federal Income Tax authorities that may result

in an unexpected gift tax to a foreign investor. Let's start with perhaps the most basic rule affecting foreign investors: Those foreign investors who become US residents – typically by choice or actual residency – will thereupon have all of their worldwide income and assets subject to U.S. income, gift and estate taxation. The natural thought, by negative implication, is that foreign investors who do not become US residents will not be subject to US gift taxes on their gifts to family members. Not necessarily so!

Though the IRS hasn't as yet devoted significant resources to enforcement in this area, the Internal Revenue Code provides that ***a gift of US situs tangible property (which includes real estate) as well as cash earmarked for the purpose of purchasing US tangible property, are indeed subject to U.S. gift tax***; which is currently as high as 35% of the gift amount. These taxes do not apply, however, to funds used to lease a property or to cash gifts that are given for a purpose other than for the purchase of tangible real or personal property located in the US.[10] There will also be no gift tax on a gift of stock in a foreign corporation that owns US real property (either directly or indirectly) as the stock is considered to be located outside the jurisdiction of the US probate courts.

9. Property Management

Foreign owners of rental properties need to consider whether they will consider their rental income to be effectively connected with a US trade or business, and if so, the foreign owner should provide the property manager with an original executed IRS Form W-8ECI. ***If this is not provided, the property manager will be responsible to withhold thirty percent (30%) of the gross rental receipts to avoid personal and primary liability*** for taxes that should have been paid, plus interest and penalties.

10.Reporting requirements (FBAR, FATCA)

When a foreign investor changes his status from nonresident to resident it's well known that his worldwide income will be subject to US taxation. Generally more problematic, is that he will ***be subject to extensive IRS reporting requirements***.

[10] US Resident recipients of cash gifts (including those from foreign individuals) that are greater than $100,000 are required to file a simple informational return reporting this to the IRS – and this is important as failure to file can result in significant penalties to the recipient. This is a common consideration in the case of gifts from nonresident parents to their resident children.

These requirements are also generally more problematic for foreign investors than US citizens as foreign investors are more likely to have accounts outside of the US that are subject to the IRS' extensive requirements. For more information on these requirements, please see the attached Memoranda and forms which follows this outline.

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