Bloomberg BNA

Daily Tax Report®



John C. Dworkin of John C. Dworkin P.C. looks at how proposed regulations under Section 6038A affect common ownership structures for foreign investment in U.S. real property, including ''all-cash'' foreign buyers of residential real estate. ''From a practice perspective, the proposed regulations will also likely effectively end the recent rise of non-tax practitioners, such as real estate closing attorneys, routinely providing U.S. tax structuring advice to foreign buyers of U.S. residential real property,'' he writes.

# How the Proposed Section 6038A Regulations Would Change Foreign Investment in U.S. Real Property

BY JOHN C. DWORKIN

Proposed regulations (REG-127199-15) issued by the Treasury Department May 6 under Internal Revenue Code Section 6038A affect many common ownership structures relating to foreign investment in U.S. real property, including ''all-cash'' foreign buyers of U.S. residential real property like New York or Miami condominiums and California homes.

From a practice perspective, the proposed regulations will also likely effectively end the recent rise of non-tax practitioners, such as real estate closing attorneys, routinely providing U.S. tax structuring advice to foreign buyers of U.S. residential real property.

A typical investment structure (the ''DRE Corporate Structure'') affected by the proposed regulations would operate as follows.

A foreign buyer purchases a residential condominium unit for all cash through a domestic limited liability company (LLC). The LLC is solely owned by a foreign corporation organized in a tax-favorable jurisdiction, which in turn is owned by the ultimate foreign individual beneficial owner. The condominium unit is generally held for investment (not rental).

No election is made on Internal Revenue Service Form 8832, Entity Classification Election, to treat the LLC as a corporation, and hence the LLC is treated as disregarded from the foreign corporation for tax purposes.

Upon sale of the real property, the buyer would withhold 15 percent of the amount realized on the disposition under Section 1445(a).

*John C. Dworkin, Esq., is with John C. Dworkin P.C., New York. Dworkin's core tax practice includes structuring and corporate implementation of foreign institutional and individual investment in U.S. real property in compliance with the Foreign Investment in Real Property Tax Act (FIRPTA), with particular emphasis on clients from the Gulf Cooperation Council (GCC) Region and Germany.*

## PATH Act Changes

Prior to passage of the Protecting Americans from Tax Hikes Act of 2015 (PATH Act; Division Q of Pub. L. No. 114-113), the Foreign Investment in Real Property Tax Act withholding rate was 10 percent. Under the PATH Act, the 10 percent FIRPTA withholding tax rate was increased to 15 percent.

Historically, in many cases using the DRE Corporate Structure, the foreign corporation wouldn't comply with its obligation to obtain a U.S. taxpayer identification number and wouldn't file a U.S. corporate income tax return reporting the gain on the sale, as it is required to do under Treasury Regulations Section 1.1445-1(f)(1). In such a case, the foreign seller would be making a decision to suffer the FIRPTA withholding tax on sale and not comply any further.

Under Proposed Regulations Sections 1.6038A-1(c)(1) and 301.7701-2(c)(2)(vi), the LLC would now be required to obtain a U.S. taxpayer identification number and disclose its foreign owner on IRS Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business.

Presumably, on sale of the property, the buyer would now be required to transmit the 15 percent withholding tax proceeds to the U.S. Treasury along with the seller's U.S. taxpayer identification number, thus making noncompliance by the foreign corporation with respect to its corporate tax return filing obligation on sale much more difficult.

## 'U.S. Corporation Structure' Not Affected

The DRE Corporate Structure should be compared to another investment structure for foreign buyers of U.S. residential real property that isn't affected by the proposed regulations. Under this structure (the ''U.S. Corporation Structure''), the foreign buyer purchases a residential condominium unit for all cash through an LLC that makes an election on IRS Form 8832 to be treated as a corporation or simply through a domestic corporation (in each case, the ''U.S. Corporation'').

The U.S. Corporation is solely owned by a foreign corporation organized in a tax-favorable jurisdiction, which in turn is owned by the ultimate foreign individual beneficial owner.

**The non-tax practitioner can no longer simply advise the foreign buyer that the DRE Corporate Structure will indefinitely postpone the time in which the foreign corporation is required to obtain a U.S. taxpayer identification number and file corporate tax returns.**

The proposed regulations don't apply to the U.S. Corporation Structure because in this case the LLC would already be subject to information reporting under Section 6038A as a domestic corporation with foreign ownership.

As a result of the proposed regulations, there should now be little or no benefit to the DRE Corporate Structure as opposed to the U.S. Corporation Structure.

Historically, the principal advantage of the DRE Corporate Structure in comparison to the U.S. Corporation Structure was that it indefinitely postponed the time in which the foreign corporation was required to obtain a U.S. taxpayer identification number and file corporate tax returns. Under the proposed regulations, with this advantage essentially nullified by the reporting requirements imposed on the domestic LLC subsidiary, there is no apparent advantage to retaining the DRE Corporate Structure.

The principal disadvantages of the DRE Corporate Structure are twofold, namely:

- in the event the property were rented out, the rental income would be subject to the second-level branch profits tax under Section 884; and
- assuming the property isn't rented out, under Revenue Ruling 91-7 operating expenses such as condominium association fees, property taxes, insurance and other carrying charges aren't deductible or capitalized and thus provide no tax benefit against capital gains on sale.

Note, as the U.S. Corporation Structure includes a foreign corporation interposed between the ultimate foreign individual beneficial owner and the U.S. situs real property, the U.S. estate and gift tax on U.S. situs real property imposed on nonresident alien individuals is successfully avoided in the U.S. Corporation Structure.

## Change for Non-Tax Advisers

From a practice perspective, it is interesting to note that non-tax practitioners such as real estate closing attorneys have become comfortable enough with the DRE Corporate Structure in the last several years to routinely provide this structure to their clients without engaging tax legal counsel.

The practice has evolved to the level where on the assumed facts (represented by the client) that the property wasn't to be rented out, the non-tax practitioner would then advise the client that the DRE Corporate Structure would avoid the U.S. estate and gift tax on U.S. situs real property and indefinitely postpone the time in which the foreign corporation was required to obtain a U.S. taxpayer identification number and file corporate tax returns.

In most if not all cases, the non-tax practitioner wouldn't provide any advice on the applicability of Rev. Rul. 91-7 providing for no capitalization of carrying costs incurred by the foreign corporation under the DRE Corporate Structure, and wouldn't provide any advice on many other FIRPTA issues (including the complex interaction between Section 1031 and the FIRPTA withholding tax) arising from direct foreign ownership of U.S. real property.

As a result, the foreign buyer would often receive and be relying on incomplete tax advice in choosing not to implement the U.S. Corporation Structure with little or no recourse to the non-tax practitioner as a result of the assumed facts and legal disclaimers.

As a result of the proposed regulations, the non-tax practitioner would now presumably be required to provide tax advice to the client regarding the reporting requirements on the Form 5472 to be filed by the domestic LLC, which the non-tax practitioner would likely not be comfortable to provide to the client given the technical complexity of the information reporting required under Section 6038A.

The non-tax practitioner can no longer simply advise the foreign buyer that the DRE Corporate Structure will indefinitely postpone the time in which the foreign corporation is required to obtain a U.S. taxpayer identification number and file corporate tax returns.

Thus, one should expect non-tax practitioners to now limit their scope of work and to not advise on the DRE Corporate Structure without engaging qualified tax professionals.

The proposed regulations, if implemented, apply to taxable years ending on or after the date that is 12 months after the date in which the proposed regulations are published as final regulations.




ISSN 0092-6884