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Inside Section 897: Investments and Dispositions of U.S. Real Property Interests by Nonresidents

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Foreign investment in U.S. real property has increased in recent years, driven, in part, by the weakness of the U.S. dollar in relation to, most notably, the euro, British pound, and Canadian dollar. Despite the recent worldwide economic downturn, declining property values and comparatively low interest rates continue to make U.S. real estate an attractive long-term investment for foreign investors. Before making a substantial investment in U.S. real property, however, foreign persons should fully consider the U.S. tax consequences of their investment, including those that arise when property is sold and the proceeds are repatriated. Individual investors should also consider the transfer tax implications of investments in the U.S., whether by direct ownership, or through a trust, partnership, or corporation, and the transfer tax impacts at death.

For many individual foreign individual investors, the desired ownership structure is to employ the use of a foreign corporation, generally one that is organized in a low-tax or tax haven jurisdiction, to hold title to the U.S. real property. While this strategy may provide estate tax benefits for nondomiciliary individuals who would otherwise be subject to U.S. estate tax if they directly owned U.S. real property at death, a closer evaluation should be made weighing the income tax benefits of various ownership structures versus potential adverse estate tax consequences. Of course, an applicable income or estate tax treaty may have substantial influence on the ultimate form of ownership selected.

In contrast to nonresident aliens investing in U.S. real property, foreign business organizations frequently evaluate whether to make an investment through the formation of a wholly owned U.S. corporate subsidiary or through a U.S. partnership, the interests of which are held through a wholly owned U.S. subsidiary of the foreign entity. The use of a U.S. corporate subsidiary, even if the subsidiary is owned through a U.S. partnership, prevents a foreign investor from being deemed as engaged in a U.S. trade or business. The use of a U.S. corporation also avoids the imposition of the branch profits tax under Section 884 on U.S. sourced income (subject to treaty override). This article presents an overview of the U.S. federal income tax considerations that foreign investors in U.S. real property and their advisors must consider before they make an investment.