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U.S. Taxation of Foreign Investment in Real Estate Related Income

Real estate is a tax-driven industry. Foreign investors, nonresident alien, who have purchased real estate property in the U.S. are subject to several tax and filing requirements. You are a nonresident alien, including foreign individuals or foreign business entities, if not meet the resident alien definition.

According to the resident alien definition, you are a resident alien of the United States for tax purposes if you meet either the green card test or the substantial presence test for the calendar year (January 1-December 31). To meet substantial presence test, you must be physically present in the U.S. on at least 183 days during the current year, or 183 days during the 3-year period that includes the current year (at least 31 days) and the 2 years immediately before that.

This following content focus on U.S. taxation of real estate held directly by non-resident aliens, especially individuals.

1. Real Estate Tax

The real estate tax is a tax based on the value of real property. The real estate tax is levied by states with various tax rates. Depending on local laws, home or property values are assessed periodically based on estimated sale prices or the sale price at the last acquisition of the property. Foreign investors needs to pay US real estate taxes for owning real estates in U.S.

2. Tax on Rental Income

Rent and other income received from real property located in the U.S. are U.S. source income, which subject to U.S. income tax. Based on the management involvement of the investor, the rental income sourced from the U.S. real estate are distinguished between the income that is not effectively connected with U.S. trade of business and income that is effectively connected.

In general, if the real property is held as a passive investment in U.S. and the investor does not involve the daily management of property, then the rental income is not effectively connected with a U.S. trade or business, taxed at a 30% (or lower rates based on tax treaty) rate on the gross amount of rental income. The withholding agent or tenant must withhold the 30% of gross rent amount, and remit the withheld amount to IRS periodically. In this case, the foreign investor does not need to file tax return each year as long as the withholding amount is adequate.

However, if the property, owned by a foreign investor, is rented or used for the generation of income, and the owner manages the real property as operating a business, then the rental income will effectively be connected to U.S. business and trade. The 30% withholding tax will be removed. The investor will be subject to income taxation on net basis of rental income at graduated tax rates (10%-37%). The net basis of rental income means the owner can take deductions related to the property, such as mortgage interest expense and advertising cost. In this scenario, the foreign investor must obtain a U.S. ITIN from IRS, and file a U.S. tax return for each period even the net basis is a loss. Please note, the foreign investor must submit the Form W-8ECI to the tenant or withholding agent to waive the 30% tax withholding.

3. Tax on sale or other disposition of U.S. Real Estate

Gains on the sale or other disposition of U.S. real estate by a foreign individual are U.S. source income and treated as effectively connected with a U.S. trade or business. Foreign investors are required to pay a capital gains tax and FIRTPA withholding tax.

(1) Capital Gains Tax

Gains on sales of real property held more than one year (“long-term capital gains”) in the US are generally taxed at 15% or 20% (depending on the amount of taxable income) for individual taxpayers.

(2) FIRTPA withholding tax

The disposition of a U.S. real estate held by foreign investor is subject to FIRTPA tax withholding. It is the buyer’s responsibility to withhold tax. Therefore, if you are the seller, there is no need to withhold and remit tax to IRS. If you are the buyer, you need to find out if the seller is a foreign person at first. If the seller is a foreign person, then the buyer of the real property is required to withhold adequate tax amount in 20 days after the transfer, then report and remit the withholding amount to IRS with filing of Form 8828 and Form 8828-A.

As a buyer, FIRPTA requires withholding of up to 15% of the gross purchase price of the real estate (or its fair market value, if greater) for properties other than the buyer's personal residence, and for personal residences sold for more than \$1 million. For personal residences with a purchase price not in excess of \$300,000, no withholding is required; for other personal residences, a 10% withholding rate will apply unless the purchase price exceeds \$1 million.

The FIRPTA withholding tax is not the actual U.S. tax due amount for the seller. If the withheld amount exceeds the actual tax due including the income tax and capital gain tax, then the foreign investor who dispose the real estate should receive a refund when file tax return.

According to IRS, the FIRPTA withholding tax amount from the disposition of a U.S. real property interest can be reduced pursuant to a withholding certificate issued by the IRS. Some situations are exempt to FIRPTA withholding if meeting notification requirements, such as purchasing the personal residences with a price not in excess of \$300,000 etc.

4. Estate Tax

U.S. real property directly owned by a foreign individual on his death is subject to U.S. estate taxes (and any applicable state estate taxes). The taxable estate of a foreign individual is taxed at 40% of the value of estates in excess of a \$60,000 exemption.

If you wish to obtain more information or assistance, please visit our official website at www.kaizencpa.com or contact us through the following means:

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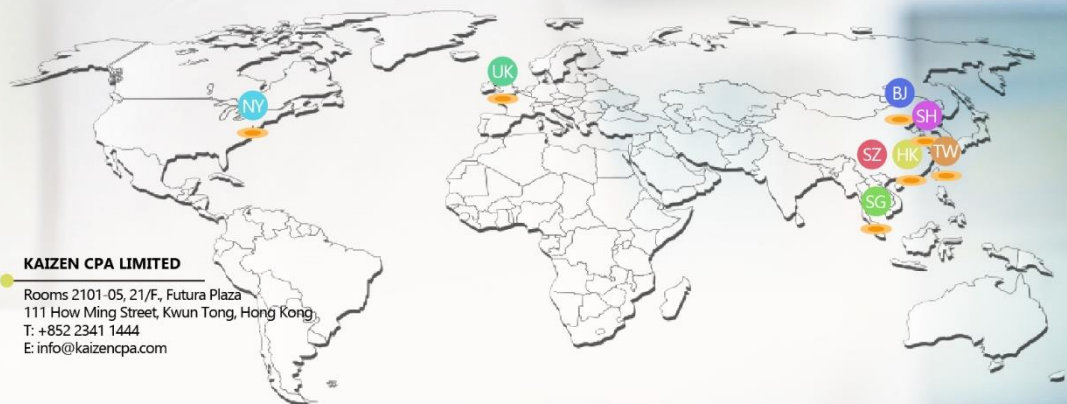
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