

CALIFORNIA CONTINUING EDUCATION, INC
PRESENTS

REAL ESTATE NRA RETURN OF TAX FREE INTEREST

by

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Premise: Path to tax free interest return for nonresident aliens including real estate.

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I. Warm-Ups

Business generally generates value from equity participation, royalty or loan interest. For domestic businesses, payors deduct payment expenses and payees have income. The generated value exchange attracts taxation. Payments can cross borders and ultimate profits can accrue anywhere. The portfolio interest exception enables nonresident, non-U.S. payees to avoid the tax on interest income.

Other governments may have jurisdiction over the payee, but not all foreign jurisdictions tax interest income. Payees that receive untaxed income provide advantage either to the recipient or in the ability of the recipient to provide a lesser interest rate to U.S. businesses. In the U.S., there are a number of restrictions placed upon the provision of tax-free interest to nonresident aliens, including the FDAP tax IRC §871(a) and the tax payment withholding mechanism IRC §1441-1464.

There are three types of U.S. source interest related income that qualifies for statutory exceptions from tax and withholding:

- (1) obligations (debts) which are payable 183 days or less from the date of original issue.
- (2) bank deposit interest, and
- (3) portfolio interest, providing all of the conditions for portfolio interest exceptions are met.

Without the portfolio interest exception, the base FDAP is supposed to have 30% withheld by the payor. If the payor doesn't withhold the FDAP amount, the payor is liable for the amount that should have been withheld. Further, the withholding agent uses form 1042-S to report the withholding, and if done improperly a penalty of \$50 for each information return may apply under Reg. §301.6721-1 & IRC §6724(d)(1). An information reporting must be done even if there was no withholding and no amount of money was required to be paid. This rule is due to an information exchange treaty for a number of countries listed in Rev. Proc. 2018-36.

Real estate businesses potentially face another snag in the form of FIRPTA (Foreign Investment in Real Property Tax Act of 1980). FIRPTA was meant to stop the tax free gains for foreign persons "disposing" of interests in United State real property. Disposing includes sale, exchange, liquidation, redemption, gift, transfers, etc. The current withholding percentage is 15% which has increased from the 10% rate in force prior to February 17, 2016.to curb the preferential treatment and imposing income tax

on foreign persons disposing of United State real property interests.

Usually the seller disposing of a U.S. real property interest, the business entity itself is the withholding agent. IRS states “A U.S. real property interest is an interest, other than as a creditor, in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the U.S. Virgin Islands, as well as certain personal property that is associated with the use of real property (such as farming machinery). It also means any interest, other than as a creditor, in any domestic corporation unless it is established that the corporation was at no time a U.S. real property holding corporation during the shorter of the period during which the interest was held, or the 5-year period ending on the date of disposition (applicable periods).”

II. Portfolio Exception Contours

In general, the portfolio exception is for payments of interest on principal, meaning that the payee is not “participating,” owning, or contracting with the project or business other than as a money creditor. §871(h) and §881(c)

(A) The relationship must be such that tax would have been owed by the interest recipient “but for” the exemption under IRC § 871(h)(1), with the otherwise interest having been owed under First, IRC § 871(a)(1)(A) for interest, original issue discount, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other FDAP gains, profits and income; and Second, sale or exchange of original issue discount obligation, payment on an original issue discount obligation. IRC § 871(a)(2) emphasizes that capital gains measured as if they were effectively connected income, and from sales is to have a 30% tax with gains and losses determined without regard to IRC § 1202 and without the benefits of a capital loss carryover for losses under IRC § 1212.

(Comment: This provision sets up the universe of relationships that create monetary transfers and taxation, those relationships which are not interest and those which are interest, before recitation of the exception)

(B) Portfolio interest is paid on an obligation that is in “Registered Form.” 26 CFR §5f.103-1

(c)(i) the obligation is registered as to both stated principal and stated interest with the issuer (or its agent) and any transfer of the obligation may be effected only by

surrender of the old obligation and reissuance to the new holder;

(c)(ii) the right to principal and stated interest with respect to the obligation may be transferred only through a book entry system maintained by the issuer or its agent;
or

(c)(iii) the obligation is registered as to both principal and stated interest with the issuer or its agent and can be transferred through both of the methods of (i) and (ii).

(Comment: This provision requires the obligation to be bond-like or formal-type so that unambiguous records are kept, and so that any ancillary obligations, deals, contracts and the like will be recorded formally, at least as to the debt. In essence, transfers require a formal writing as in (c)(i) and (c)(ii).)

(Historical Note: that any non-registered form debt WAS considered portfolio if made prior to 2012 if the non-registered form debt was targeted to foreigners.)

(C) Other reinforcing provisions relating to registration. In circumstances where registration is required, further penalizing consequences appear in the code:
IRC § 163(f) denies the payor an interest deduction if the obligation if registration is required and the obligation nevertheless remains in not in registered form.
IRC § 4701 imposes an excise tax on the payor of 1% per anum for non-registered obligations where there was an obligation to register.
IRC § 165(j) denies a payor deduction for losses for non-registered obligations where there was an obligation to register.
IRC § 1287 denies holders capital gain treatment for gains on sale where non-registered obligations where there was an obligation to register.
IRC § 312(m) denies ability to reduce earnings and profits by the amount of interest where IRC § 163(f) is not complied with
IRC § 149(a) requires registration in order to obtain interest exemption where there was an obligation to register.

(D) Contingent / Convertible Interest

Contingent interest cannot be portfolio interest. Contingent Interest is (unrelated to performance, such as sales, cash flow, profits of debtor or an related person, changes in value of property, or any dividend or partner distribution whether related to a payor or not.)

(Note: Contingent interest does not include contingencies that existed prior to April 7, 1993.) (Note: commentators have stated that other provisions and agreements between a lender and the debtor may include options and other provisions, so long as the note and registered debt and interest has no contingencies)

(Comment: The idea is to not only exclude participatory interests, but also those that might be convertible to a participatory interest. Thus the ability to convert a registered debt can eliminate the ability to except an interest payment from income by the nonresident alien.)

(E) Ownership Relationship: Loans from >10% owners of the borrower. IRC § 871(h)(3)

Ownership of greater than 10% is considered too strong of a participation relationship to enable exception of interest income from the nonresident alien.

(F) The nonresident alien must not be in an exchange or training program (under 8 U.S.C. § 1101(a)(15)(F), (J), (M), or (Q) or else the interest will be treated as being effectively connected income.

(G) The lender is not in the business of banking, or else the loan is ineligible for the portfolio interest exception §881(c)(3)(A), § 1441(a), § 1461.

(H) Related controlled foreign corporation (CFC) is receiving the interest payments from a related U.S. payor / debtor. If the foreign payee of interest is related, then the portfolio interest exception does not apply. §957, §864, §881(c)(3)(C)

III. The FIRPTA Problem

In cases where a more direct participation in real estate is established, the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) (IRC § 897) comes into play. Before FIRPTA, gains would be sourced to the foreign investor's country of residence if no withholding were imposed since the U.S. would have no real way to measure and tax gain advantage upon sale. Currently money gains made from rental of real property and current cash income would be subject to taxation of "United States real property interest" ("USRPI") income generated. FIRPTA forces generated income related to sales as if foreign seller were engaged in the conduct of a trade or business in the United States and the gain were effectively connected with such trade or business. The FDAP sent overseas captures rental income gains in taxable income that would otherwise

disappear by being sent overseas.

Because FIRPTA effectively forces the sale of real estate to be effectively connected income, foreign sellers are taxed on gains at the same rates applicable to U.S. sellers. The real estate withholding rate of 15% of the gross amount of the sale will force so much of the sale amount to be left in the United States that it will force the seller to file a tax return in the U.S. to obtain release from the money withheld.

Nonresident Alien (no tax treaty) Combined Example:

Real estate purchased 01/01/00 for \$100,000

Rental income as of 12/01/01 (2yrs) \$100,000

Operating expenses as of 12/01/01 (2yrs) \$50,000

Property Sold 12/01/01 (held 2yrs) for \$200,000

Operating Result excluding depreciation: Even if a US company managed the property and accounted for expenses, \$50,000 of net income would generate a 30% withholding of \$15,000. So, only \$35,000 would be repatriated

If a return were prepared for a U.S. corporate entity the 21% tax would result in an after-tax gain of \$39,500 for use in other U.S. operations, followed by the 30% FDAP tax would leave a repatriation of \$27,650.

A sole proprietor filing a 1040-NR (without standard deduction) would pay \$9,285.00 tax on \$100,000 of rental income.

Sale result: 30% of \$200,000 (\$60,000) would be withheld. The net \$140,000 would be repatriated to the owner. The owner only made \$40,000 profit.

If a U.S. return were filed so that the property could be taxed as an effectively connected business, a \$100,000 long term capital gain would be generated. A corporation would suffer 21% tax on the \$100,000 gain and the individual investor would suffer a 9.3% blended dividend rate on what was left over, as a total 28.34% tax. A single taxpayer with no other income or investments would pay a 9.3% blended capital gain rate (\$9,300).

The 30% withholding on a \$50,000 operating gain and 15% withholding on a \$200,000 sale proceed totals \$45,000 in the hands of government. Filing the 1040 tax returns on the above resulted in a total tax of \$18,585 (\$9,300 + \$9285) thus freeing \$26,415 (\$45,000 - \$18,585) which would otherwise be lost. The system is set to penalize those not filing.

What is US Real Property Interest is broad. Definition of USRPI (Treas. Reg. § 1.897-1), Interests in real property includes:

- (a) Real property includes land, buildings, & improvements
- (b) pre-harvest pre-extraction crops & timber, & mines, wells & deposits
- (c) can expand to include personal property that is associated with extraction

IV. ECI Election Possibility Gross 30% or Net 21% (or Net 37%) IRC § 871(d)(1) election

Generally, the point of using the exclusion for portfolio income is to avoid tax and withholding. A requirement is made to avoid an actual interest in real estate or a business. Real estate gains in value can occur through generation of income or successive sales of property in a manner to increase the value of holdings for the real estate holder. Holdings can also be increased using the 1031 exchange.

Its also known that when payments and cash flow stop, that the remedy for real estate interest holders is to bring in a new tenant, or to sell the property and move on to the next one. A portfolio interest note holder can also foreclose and either end up with first time ownership of the property (if the forecloser makes a bid) or end up with cash from a foreclosure sale to the public.

The election gives the taxpayer an ability to choose between FDAP or ECI, either foreign individuals or foreign corporations. Election opens the gateway to further tax advantage via depreciation. Election is made by submitting for W-8ECI before the expiration of the period prescribed by §6511(a) or (c) expires (relating to the period of limitation for filing a claim for credit or refund).

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