Representing Foreign Buyers and Sellers in United States Real Estate Transactions

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Today, many parts of the world are unsettled due to a variety of economic, political and/or environmental issues. Such unrest can lead to rapid inflation which can devalue local currencies. Certain nations restrict the amount of local currency a citizen may take out of her country. Where does international money consistently find a safe home? Foreign investors have historically considered United States real estate to be an attractive and stable investment.

According to the National Association of Realtors Report on 2017 International Investment in U.S. Residential Real Estate, between April 2016 and March 2017 foreign buyers and recent immigrants purchased $153 billion in U.S. residential property. This represented about 284,455 homes, an increase from 214,885 homes in the previous twelve-month period, or five percent of all existing residential home sales in that twelve-month period.[1] Furthermore, international investors have purchased over $365 billion in U.S. commercial real estate since 2010, with the majority of capital flowing to the largest metropolitan regions. Manhattan alone represented nearly a fifth of all foreign investment in commercial real estate.[2] In fact, the National Association of Realtors in its study on Commercial Real Estate International Business Trends 2018 reported that during 2017, 18 percent of its surveyed commercial real estate brokers closed transactions with international clients.[3] Because so much U.S. real estate is being bought and sold by foreign investors, it is ever more likely that you, as an attorney, will represent either a foreign purchaser or seller of U.S. real estate or a domestic client buying U.S. real estate from a foreign person. This article will discuss issues you may encounter in such circumstances.

Customs and Expectations.

In the U.S., local real estate laws and customs vary, sometimes greatly, from state to state. For example, certain states levy a tax on mortgage recording, other states levy a tax on real property transfers but, not on transfers of the entity that

[1] National Association of Realtors, 2017 Profile of International Activity In U.S. Residential Real Estate, 2018.
[2] Evan Gentry, *Why Foreign Investors Love U.S. Commercial Real Estate and Why More Will Follow*, Forbes Real Estate Council. May 30, 2018.
[3] National Association of Realtors, Commercial Real Estate International Business Trends 2018.

owns the real property. In the U.S., title insurance is commonplace, but in most foreign countries, title insurance is rarely used.

Certain customs and practices can make for unpleasant surprises (which are devoutly to be avoided). For example, a foreigner (or anyone else) buying a New York City condominium should be advised that there is a 1 percent or more "mansion tax" that a purchaser must pay on residential conveyances over $1,000,000. Similarly, when the purchase is based on a floorplan in a glossy brochure that is marketing a building yet to be constructed, the buyer should expect to pay the *seller's* New York State and New York City transfer taxes. Because the buyer is now paying the seller's tax obligation, that cost is deemed additional consideration and is added to the purchase price to reach the *grossed-up* purchase price upon which the buyer will pay the computed transfer taxes. A purchaser's expectation for the availability of services and amenities on the move-in date should also be tempered. Contracts often provide for a closing as soon as a temporary certificate of occupancy is obtained (so that occupancy is legal), but, despite the developer's good faith efforts, certain construction may be ongoing and full services, such as a health club or screening room, might not be available until a later date (which can be *much* later).

You should ascertain your client's expectations as to immigration and U.S. citizenship. Property ownership is not sufficient to entitle a person to reside in the U.S. and does not create a pathway to citizenship, except pursuant to a specific program, such as the EB-5 program.

Once you understand your foreign client's proposed transaction, you should walk her through the steps necessary to consummate it and explain what the expectations of the parties to the transaction will be (and listen to hers).

<u>Complexities.</u>

Certain complexities that might not arise with a U.S. party may slow down or complicate a transaction for a foreign party. If a transaction is to be financed, for example, a foreign party may have more hoops to jump through in getting a mortgage than a domestic buyer might. There could be additional documentation requirements to prove creditworthiness and confirm international assets. Currency conversion issues can impact transaction timing due to either (or both) requirements of the U.S. banking system or of the home country. An international wire transfer will likely not move as quickly or smoothly as a domestic one.

Documents executed in a foreign country with a notarial attestation which are to be recorded in a U.S. jurisdiction must be authenticated. Many countries, including the U.S., have joined a treaty called the *Hague Convention of 5 October*

1961 Abolishing the Requirement of Legalisation for Foreign Public Documents. This treaty reduces the authentication process to the issuance of a certificate called an apostille by an authority designated by the country where the document was issued. If your client plans to execute a document in a foreign country where attestation is required in the U.S., she must obtain an apostille, generally from a U.S. consulate or embassy. This process should be initiated well in advance of closing.

Note that it is generally more difficult to serve and sue a foreign person than a domestic one. For this reason, sellers have been known to require a larger down payment, rather than to rely solely on their ability to take a foreign person to court. Likewise, any judgment obtained against a foreign person might be difficult to enforce, if all or most of their assets are located abroad. Nonetheless, many successful transactions today involve foreign persons and these complexities need not deter or derail a mutually satisfactory closing.

Cooperative and Condominium Ownership.

Although there are many cooperative apartments available in locales like New York City, a foreign purchaser should consider carefully before seeking to purchase one. It is generally accepted that a cooperative's board of directors has the right to accept or reject a purchaser for any reason, or no reason, as long as it does not violate anti-discrimination laws. Cooperative boards can and do ask for detailed financial and social information that a foreign buyer may not want to produce. Compared to ownership of a condominium, cooperative ownership is more restrictive: limited or no subleasing permitted; occupancy and use requirements etc. Although there is a board approval process for a condominium purchase, it is generally less rigorous than for a cooperative, and condominium boards rarely prohibit corporate or other types of ownerships often favored by foreign investors. Rather than a purchaser approval right, a condominium board has merely a right of first refusal to purchase the unit. Where a board does not wish the transaction to go through, it can refuse to waive its first refusal right. The resulting cloud on title can (and often will) discourage a commercial lender from granting a mortgage. Such refusals to waive are rare, but not unheard of. Where a foreign buyer is determined to purchase a cooperative (and not a condominium), she might consider buying a sponsor cooperative unit, where board approval is not required.

Foreign Investors' Tax and Structural Considerations.

This article is not intended to give tax advice, and readers should encourage foreign buyers or sellers in real estate transactions to consult tax advisors. That

said, a foreign person buying or selling U.S. property should be aware of potential tax issues: there are income taxes, gains tax, and state and local transfer taxes, as well as estate tax issues to be concerned with. In addition to federal, state and local tax considerations, deciding how to structure the transaction can be a multilayered and fact-specific process. Considerations include: the nature of the property; the intended holding period; [i]the buyer/seller's situation and the totality of its/their U.S. connections; tax treaties between the foreign investor's home jurisdiction and the U.S.; the treatment of income repatriated to the foreign investor's home jurisdiction; and the organizational structure of the foreign investor. The answers also depend on the size of the investment and whether it is for personal use or part of a business. Should an individual or a U.S. or a foreign entity purchase? And, if an entity, what kind of entity? A common structure for holding U.S. property is a limited liability company, a pass-through tax entity, which offers certain privacy and other benefits. However, as of 2017, IRS regulations mandate that a single member foreign-owned limited liability company comply with specific complex requirements established under Section 6038 A of the Internal Revenue Code, which can include: designating a responsible party, complying with reporting requirements, and retaining permanent records regarding related-party transactions.[4] Will this be acceptable to your client? There can be large penalties for non-compliance.

Income Tax Issues.

Income tax consequences will vary depending on the use of the property. If a property is for personal benefit, such as a vacation home and no income will be generated, this analysis may not apply. However, where rental income will be generated, the Internal Revenue Service (the "IRS") has two divergent approaches to taxing income of foreign persons. On the one hand, where income can be effectively connected with the conduct of a U.S. trade or business, foreign persons are taxed on the amount of effectively connected income net of deductions allocable to such income, which may consist of such items as mortgage costs, taxes, insurance and brokerage fees. The net is then taxed using the regular rate that applies to U.S. persons. Alternatively, income can be characterized as Fixed, Determinable, Annual or Periodic ("FDAP"). Generally, income from U.S. sources that constitutes interest, dividends, rents or royalties are FDAP income, and are taxed at a flat rate of 30 percent of the gross income with no deductions. That being said, where there is rental income, even if it is not considered effectively

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4 See Brian Hayes, C.P.A., ***New Reporting Requirements for Foreign-Owned U.S. Disregarded Entities,*** **The Tax Adviser, Chicago** April 1, 2017

connected, the investor may be able to make a special election to have it taxed on a net basis. To further complicate the analysis, under certain circumstances where a foreign person is present in the U.S. over a specified period of time, that person might be deemed a U.S. resident for U.S. income tax purpose and consequently required to file a U.S. income tax return and pay taxes on their *worldwide* income. Clearly, your client should consult with an experienced tax advisor to identify and work through any such issues.

Taxes on Disposition.

What taxes will be due on the disposition of the property?

Where the estate of a deceased foreigner sells property that foreigner owned individually, U.S. estate tax (if applicable) will apply to the fair market value of the property on his date of death, without adjustment for inflation and with limited credits. Additionally, there will be U.S. capital gains taxes on the gain.

FIRPTA Liability for U.S. Purchaser.

The Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") [5] creates a procedure for the payment of U.S. capital gains tax by a foreign seller. With some exceptions, 15 percent of the purchase price must be remitted to the IRS. Note that a buyer of real property from a foreign seller must be concerned with FIRPTA compliance because the buyer will be liable for the applicable gains taxes, if the foreign seller fails to pay them.

At a typical closing, the buyer receives a seller's affidavit certifying that the seller is not a foreign person in which event there are no issues, unless the buyer has reason to doubt the certification. However, where the seller is a foreign person and cannot legitimately deliver a FIRPTA affidavit, the FIRPTA statute imposes secondary liability for the foreign seller's unpaid capital gains taxes on the buyer. In this way, the law makes the buyer a party to a seller's non-compliance and buyer must assure that there is proper compliance or will be left with an unwanted liability. Since the seller's gains tax liability can be a large amount, the seller will often file for a determination that a lesser amount is due. Under this scenario, the seller files for a Notice of Determination and the 15 percent tax, rather than being paid to the IRS at the time of the closing, is held in escrow. Once the IRS determination letter is received, the escrow agent will remit the indicated tax amount to the IRS and refund any balance to the foreign seller. The buyer may

[5] The **Foreign Investment in Real Property Tax Act of 1980** (FIRPTA), enacted as Subtitle C of Title XI (the "Revenue Adjustments Act of 1980") of the **Omnibus Reconciliation Act of 1980**, Pub. L. No. 96-499, 94 Stat. 2599, 2682 (Dec. 5, 1980). Internal Revenue Code sections 897 and 6039C were enacted in FIRPTA;[3] the Act also made conforming amendments to other various provisions of the Internal Revenue Code.

want evidence that a Notice of Determination has been applied for as a condition to closing and withholding. Further, the buyer may want to know the foreign seller's basis in the property in order to calculate the estimated liability amount. For example, if the foreigner sold at a loss, the capital gains tax due will be less than the 15 percent, so the buyer's transferee liability will be accordingly reduced.

Other Restrictions and Reporting Requirements.

There is no blanket prohibition on foreigners owning real estate in the U.S. However, there are a number of U.S. reporting requirements and restrictions which may apply in certain circumstances:

BEA Reporting Requirements.

In 1976, Congress passed the International Investment and Trade in Services Survey Act (the "Survey Act'), requiring the Bureau of Economic Analysis (the "BEA") to regularly collect data on international capital flows and investments in the U.S. However, in 2009, the BEA's filing requirement for the acquisition of a direct or indirect interest in U.S. real estate by a foreign investor was discontinued for budgetary reasons. It wasn't until 2014 that the BEA reinstated such mandatory reporting requirements. The BEA rules even apply to a U.S. business investing in U.S. real estate if any foreign person has a 10 percent or more direct or indirect interest in that business. There are many rules and exceptions relating to the BEA reporting requirements, as well as a form to file for exemption from reporting. [6]

Agricultural Foreign Investment Disclosure Act of 1978.

This Act mandates filing requirements in connection with the acquisition or transfer of any agricultural land to a foreign person. Hefty fines will be levied for a failure to report. The statute's goal is to prevent purchaser anonymity for acquisitions of agricultural land in the U.S.[7]

Foreign Asset Control Rules.

The U.S. federal government imposes economic sanctions against, and prohibits certain transactions with, specified countries, entities, individuals and organizations. The Office of Foreign Asset Control at the U.S. Department of Treasury ("OFAC") oversees and enforces these sanctions. All U.S. persons as

[6] See Bureau of Economic Analysis, U.S. Department of Commerce Website and BEA: A Guide to BEA'S A Guide to BEA's Direct Investment Surveys.

[7] https://www.farmlandinfo.org/agricultural-foreign-investment-disclosure-act-regulations

defined by OFAC must comply with these restrictions. According to applicable rules, the term "United States person" or "U.S. person" means "any United States citizen, permanent resident alien, entity organized under the laws of the United States or any jurisdiction within the United States (including foreign branches), or any person in the United States."[8]

Patriot Act Compliance.

The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (commonly known as the "Patriot Act") was passed after September 11, 2001, primarily to deter and punish terrorist acts in the U.S, and around the world, as well as to enhance law enforcement's investigatory tools. No U.S. citizen or company may do business with any Specially Designated Global Terrorist, which is a designation authorized under U.S. Executive Order 13224 (among other executive orders), and Title 31, Parts 595, 596, and 597 of the U.S. Code of Federal Regulations (among other U.S. laws and regulations). People or entities are designated as "Specially Designated Global Terrorists (SDGTs)" under Executive Order 13224 by the U.S. Department of State or the U.S. Department of the Treasury.[9]

The penalties for failure to comply with the Patriot Act are up to $500,000 for companies or up to $250,000 and/or 10 years' imprisonment for individuals. Most purchase and sale agreements for real estate today contain representations to establish the parties' compliance with the Patriot Act. Accordingly, it is critical to know the background of each counterparty all the way down to its individual constituents. Patriot Act representations should be thoroughly evaluated. Section 352 of the Patriot Act imposes requirements on every financial institution and all persons involved in real estate settlements and closings. Patriot Act issues can have a significant impact on a transaction and its ability to close.

Miscellaneous Issues.

There are other federal requirements, which may apply to specialized situations (such as antidumping, antitrust, traffic in arms, etc.) yet probably would not apply to an everyday real estate transaction. There also may be local and/or state filing requirements that must be complied with.

Absentee Ownership.

[8] 31 CFR § 560.314

[9] See Executive Order13224.

Where a foreign purchaser intends to own, but not occupy her property, maintenance and management processes should be put in place.

Diplomatic Immunity.

From a foreigner's perspective, diplomatic immunity is a good thing but, from a counterparty's perspective, it is troubling. Many will hesitate to enter into a contract with someone who is not subject to the same rules as they are. There are a number of potential ways to address this concern: a deep-pocketed domestic guarantor, a designated U.S. agent for service of process and/or a larger contract deposit than usual to be held in escrow in the event the foreign purchaser decides to default.

Conclusion.

This article is intended to illuminate issues that may arise in real estate transactions involving foreign persons. Although each situation is unique and nuanced, an attorney who is sensitive to potential concerns can guide her client to a positive outcome.