Know the Law: April '06

Protecting Foreign Customers from Exposure to U.S. Estate Taxes

Are you working with a foreign investor who wants to buy property in the United States? If so, you must encourage that investor to do proper planning because the way in which title is held will determine whether the assets of nonresident aliens are subject to federal estate tax upon the owner's death.

Such assets include, but are not limited to, real property, stock in corporations and other entities formed in the United States and interests in assets previously transferred if the foreign transferor has retained a right to beneficial enjoyment or income. U.S. assets left to the surviving spouse of a non-U.S. citizen won't qualify for the unlimited marital deduction unless the assets have been transferred to a qualified domestic trust (QDOT) before the death.

This applies whether the title is taken solely in an individual's name or jointly with another person, including a spouse.

While minimizing or avoiding exposure to estate tax is extremely important, it's also important to consider current and future income tax consequences of the alternatives to assure the proper solution is chosen. With federal individual long-term capital gains tax rates at only 15 percent compared to substantially higher federal corporate income tax rates (preferential capital gains tax rates don't apply to corporations), the knee-jerk reaction of placing title to all foreign-owned U.S. real property in the name of an offshore corporation may not always be the best approach.

State income taxes must also be considered. It's important to determine whether it's better to (1) be subject to preferential personal long-term capital gains tax rates on a possible resale while being exposed to an estate tax if the person dies while owning the property, (2) be subject to higher corporate income tax rates while taking advantage of the possible U.S. estate and gift tax savings or (3) explore alternatives in an attempt to achieve the best of the aforementioned situations.

If the real estate professional does not have access to legal counsel prior to the execution of the purchase contract, the purchase contract should at least be made assignable by adding the words "and/or assigns" after the name of the foreign investor. In making the contract assignable, qualified legal counsel can then consider a range of options available in structuring the purchase in the most tax-efficient manner.

If the foreign investor has already purchased U.S. real property either in his or her own name or jointly, changing the title to an entity may prove too costly to consider, as it may create income tax consequences under the Foreign Investment in Real Property Tax Act ("FIRPTA"), and additional transfer costs, documentary stamp taxes and the need to obtain approval from the mortgagee.

Checklist for Working with Foreign Investors

If your foreign customer has already purchased real property in the United States and now wishes to consider his or her tax exposure and estate plan, the customer needs to consult with an attorney and consider the following:

1 Obtain an appraisal to determine the property's current fair market value. If the property hasn't substantially appreciated, then a sale (with consideration changing hands and conventional closing costs paid) to a foreign corporation controlled by the foreign owner ("FO") or his or her family may avoid estate tax without a large current income tax. Merely transferring title to the foreign corporation without consideration will be deemed a taxable disposition and will fail to avoid inclusion of the property for estate tax.

2 Advise the FO to purchase life insurance. The proceeds of life insurance on the life of a nonresident alien aren't sub-ject to estate tax and can provide liquidity to pay the estate tax.

3 If there is a surviving spouse, the FO should have a qualified attorney draft a qualified domestic trust ("QDOT") —either during the lifetime of the FO or upon his or her demise — in order to at least avoid estate tax upon the death of the first spouse.

4 Determine if there are U.S. taxpayer family members (such as adult children) who may more properly be the owners, perhaps subject to a mortgage in favor of the foreign parents.

Steven L. Cantor (steve@cantorwebb.com), managing partner of Cantor & Webb PA, and Daniel Bensimon, law clerk, wrote this article. Cantor's Miami-based practice focuses on the representation of international private clientele and international businesses in the areas of tax and estate planning, international and domestic real estate and probate.