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# Tax Planning for Chinese Investment in U.S. Real Estate

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Taxes Without Borders

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According to recent estimates, Chinese investors represented the largest group of foreign investors in U.S. real estate in the second quarter of 2015 with $1.9 billion in acquisitions. In the last 12 months, Chinese investors acquired $5.9 billion in commercial U.S. real estate, and Asia was second overall to Europe for foreign investment in U.S. real estate during this period.

Chinese investors have been focused largely on acquiring office, hotel, and condominium properties, and more recently, industrial and retail properties. Wealthy Chinese investors already represent the largest group of foreign purchasers of single family homes and condominiums accounting for 16% of the overall foreign investors of these types of properties last year.

There appears to be several reasons for this growing trend, including:

- The strength of the U.S. economy
- The devaluation of the yuan
- A low-interest rate environment in the United States
- The liquidity and transparency that the United States offers relative to other

global markets.

**U.S. Tax Consequences of Direct Investment**

From a U.S. federal income tax perspective, the main obstacle facing Chinese persons who invest in U.S. real estate is the Foreign Investment in U.S. Real Property Tax Act (FIRPTA), more specifically Section 897. Under this provision, any gain recognized by a foreign person on the disposition of a "United States real property interest" (USRPI) will be treated as if such gain were effectively connected to a U.S. trade or business and, therefore, subject to U.S. federal income tax at the graduated rates that apply to U.S. persons. Additionally, when Section 897 applies, the purchaser of a USRPI typically is required to withhold and remit to the IRS 10% of the purchase price in accordance with Section 1445.

When non-U.S. persons invest in U.S. real estate, it is common for the investment to be made through a two-tier corporate structure, in which the foreign purchaser owns a non-U.S. corporation (Foreign Blocker), which in turn owns a U.S. corporation (U.S. Blocker). U.S. Blocker then purchases the interests in the U.S. real estate. Most often, where there are multiple purchasers, the real estate is directly purchased by a U.S. limited liability company. In such cases, U.S. Blocker then invests in that U.S. LLC.

The reasons for this approach are:

1. The estate tax protection offered by Foreign Blocker
2. The insulation from branch profits tax and FIRPTA withholding provided by U.S. Blocker; and
3. The elimination of a requirement of Foreign Blocker to file a U.S. tax return (U.S. Blocker files instead)

The situation is different for a Chinese investor, however. The U.S. branch profits tax is intended to replicate the second level U.S. withholding tax that would apply when a dividend is paid by a U.S. corporation to its foreign corporate parent. The branch profits tax provisions became effective in 1987. Jurisdictions that had an income tax treaty with the United States in effect on January 1, 1987 which have not since been modified are provided with a complete exemption from the branch profits tax.[1] The U.S.-China income tax treaty is one of those treaties.

Consequently, Chinese investors can avoid the branch profits tax altogether by investing in U.S. real estate directly through a Chinese corporation, or through a U.S. branch of such a Chinese corporation. In fact, the overall tax results are more favorable when such Chinese investors invest in this manner. If a Chinese investor instead invests in a two-tier structure like the one explained above, the U.S. Blocker will first pay up to 35% U.S. federal income tax. Dividend distributions from that U.S. Blocker to the Chinese Blocker will then be subject to a further 10% U.S. withholding tax pursuant to the U.S.-China treaty. Given that the corporate income tax rate in China (25%) is already lower than the corporate tax rate in the United States (35%), the investor gets no current foreign tax credit benefit from paying the additional 10% U.S. withholding tax.

It should be noted that one downside of investing in U.S. real estate through a Chinese corporation, rather than through a pass-through structure, is that the investor loses the ability to claim capital gains rates of 20% on any gain from an eventual sale of the U.S. property. Corporations are not eligible for such preferential rates on long-term capital gains, and therefore are subject to the same maximum U.S. federal income tax rate of 35% on such gains. Therefore, consideration may be given to filing a check-the-box election in the United States, electing to treat the Chinese company as a partnership (if there are multiple owners) or a disregarded entity (if the Chinese company is wholly-owned by one investor) for U.S. tax purposes. When U.S. property is sold by an investor who owns his or her interests through such a transparent structure, any resulting gain can generally qualify for the lower 20% long-term capital gains rate. Note that if the Chinese entity is a GYG (Gufen Youxian Gongsi), this election will not be available, as such entities are “per se corporations” that are not eligible to elect alternative classification.

If the Chinese entity is treated as a foreign partnership for U.S. tax purposes after making such an election, there may be some risk that the Chinese investor could be exposed to U.S. estate tax on the underlying U.S. real estate, although there is certainly an argument that the foreign partnership should be viewed as a non-taxable foreign-situs asset for U.S. estate tax purposes. If the Chinese entity is a single-member entity that is classified as a disregarded entity for U.S. tax purposes, on the other hand, the Chinese investor is almost certainly exposed to such estate tax risk. In either case, the ultimate beneficial owners of the Chinese entity will be obligated to file U.S. federal income tax returns. In contrast, where the foreign corporation is classified as a corporation for U.S. tax purposes (i.e., a check-the-box election is not made), the foreign company itself, rather than the individual investors, must file an annual U.S. federal income tax return.

**Norway-Barbados Structure**

An alternative structure that optimizes both income and estate tax benefits from the U.S. perspective, involves the use of a Norwegian blocker company with a Barbados finance branch. In this structure, a U.S. blocker corporation, owned by the Norwegian blocker, would be a member in the U.S. LLC and such corporation would be capitalized with debt from the Barbados branch. The debt instrument would provide for both fixed and contingent interest that is tied to the gain from the sale of the U.S. real estate. The U.S-Norway treaty provides for a complete exemption from U.S. withholding tax on U.S.-source interest (both fixed and contingent), even though the interest is being paid to the Barbados branch. As a result, a Chinese (or other foreign) investor can extract a substantial portion of U.S. real estate-related income and gains with minimal U.S. and foreign tax. The U.S.-Norway treaty does not currently contain a limitation of benefits provision, which is why it is possible for investors from China (or other countries) to utilize such a structure and still qualify for treaty benefits. Additionally, the Norway-Barbados treaty allows the income of a “permanent establishment” in Barbados to be exempt from tax in Norway. Depending upon the facts of a particular case, Barbados will typically either exempt the income from tax in Barbados if it is considered foreign-source income or impose a maximum rate of 1% to 2.5% under the IBC regime.

Another benefit of this structure is that it also eliminates FIRPTA issues. This is because even though the debt instrument, which provides for an “equity kicker,” is considered a USRPI under the FIRPTA rules, FIRPTA itself is never triggered so long as the note is held to maturity.[2] Therefore, the foreign investor is still able to share in the profits from the sale of the U.S. real estate (in the form of contingent interest) without being subject to U.S. federal income tax under FIRPTA.

China also has controlled foreign corporation (CFC) rules, much like the U.S. CFC rules. These Chinese CFC rules generally would apply where a foreign company is “controlled” by Chinese residents and is subject to an effective tax rate that is lower than 50% of the Chinese tax rate (i.e., a rate of less than 12.5%). When these rules apply, all income of the CFC is taxed currently in China at regular Chinese tax rates. There are certain exceptions to these CFC rules in China. For example, unlike the United States, China has a “white list” of countries, corporate residents of which are never subject to the Chinese CFC rules. Norway is on this list. This means that use of the Norway-Barbados structure by a Chinese investor can allow profits to be deferred from Chinese tax indefinitely by leaving such profits in the Norwegian company.

Profits eventually can be repatriated to the Chinese investors without incurring Norwegian withholding tax by liquidating the Norwegian blocker corporation and distributing all proceeds in liquidation. Unlike regular dividend payments, which generally are subject to Norwegian withholding tax, liquidating distributions are exempt from withholding tax in Norway.

## Foreign Investment by Chinese Sovereign Wealth Funds

A principal benefit of the Norway-Barbados structure described above is the ability to “strip” large portions of the income and gain associated with the U.S. real estate investment to be out of the United States in the form of fixed and contingent interest that is exempt from U.S. withholding tax under the U.S.-Norway income tax treaty. Foreign governmental entities, including Chinese sovereign wealth funds, can achieve the same benefits without the use of such a structure either under Section 892 of the Internal Revenue Code or under Article 10(3) of the U.S.-China income tax treaty. Both of these provisions permit contingent interest payments to be made to such types of entities without incurring U.S. withholding tax. In addition, Section 892 provides the added benefit of a complete exemption from FIRPTA if the foreign governmental entity disposes of a non-controlling interest in a U.S. real property holding corporation.

## Conclusion

As illustrated above, there are some unique opportunities available for Chinese investors because of the existence of the U.S-China income tax treaty, as well as the exemption from the Chinese CFC rules for entities formed in jurisdictions that are included on the Chinese “white list.” Chinese investors who take advantage of these opportunities through careful planning and structuring will pay substantially lower effective tax rates worldwide.

[1] *Treas. Reg. Section 1.884-1(g)(3).*

[2] *Treas. Reg. Section 1.897-1(h), example 2.*