A PIECE OF PARADISE:

Advising US Owners of Foreign Real Estate

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World travelers are always looking for keepsakes to stay connected to foreign lands. A prized memento such as a local handicraft or a cap from a favorite destination can bring joy with no government involvement beyond a sales tax. However, travelers sometimes want something more permanent, such as a home in their foreign paradise. In contrast to a trinket, a beach condo in Mexico or a farm in New Zealand remains in that country, governed by local law even when it is owned by a foreign person. The mix of laws that regulate how foreigners can own and use real property may surprise purchasers. To ensure that their purchase does not become a cautionary tale, purchasers should coordinate with US and foreign advisors before and after the transaction.

The legal issues surrounding foreign real estate ownership may vary significantly. In this article, we focus on US laws because they apply to every US purchaser. In addition, we mention some common trends and issues that may arise under the laws of other countries.

Advisors working with US purchasers of non-US real estate should guide clients in four spheres: 1) identifying local counsel where the real estate is located, 2) considering tax and reporting implications in the US and abroad, 3) deciding how to take title, and 4) considering how the property will pass upon death.

LOCAL LAW

Purchasers should keep in mind that real estate will always remain governed by local law, no matter who owns it. A key step in any transaction is to retain local counsel: Every jurisdiction is unique, and there may be unexpected issues and opportunities associated with the property. Here are some reasons clients should coordinate early with appropriate local counsel:

- The country may restrict or even prohibit foreign land ownership.
- Land may be governed by local or regional rules and national law. A restriction in one area of the country may not apply in another area.
- Local laws may determine the ways that real estate can be passed to heirs.
- A traditional US estate plan may be ineffective or tax-inefficient in the local country.
- Some forms of ownership that are common in the non-US country may generate significant tax or reporting burdens in the US. Similarly, some forms of ownership that are common in the US may generate significant tax or reporting burdens in the foreign country.
- Living in non-US real estate may have local immigration consequences.
- Working remotely from non-US real estate may create significant tax and immigration consequences.

Depending on the arrangement, a US purchaser may work with one local advisor or a team of attorneys in the foreign jurisdiction. Local transactional counsel can coordinate the real estate purchase. The transactional work may include forming a local entity or receiving permission from local government agencies for the purchase. Immigration counsel can address questions of visa status, property use, and working remotely in the foreign country. Estate planning counsel can plan for the smooth succession of the property. Tax counsel can plan for tax efficiency and may prepare any local tax filings.

The members of the local counsel team may be located in different firms and different parts of the world. For example, a transactional attorney may be located near the property. Tax, estate planning, and immigration counsel may be located in the national capital, another country, or even the US. Purchasers may postpone the estate planning and immigration reviews, but local transactional and tax counsel will be essential.

It is important to find advisors who have previously worked with foreign purchasers. Even if they do not have US-specific expertise, advisors who frequently handle international matters will understand how to coordinate transactions across jurisdictions. They also are more likely to have a network of helpful resources with similar expertise. Last, as with any human interaction, it is important for the purchasers and local counsel to speak the same language, both figuratively and literally, so they can communicate effectively.

TAX AND REPORTING IMPLICATIONS

Every US purchaser should step back and consider tax implications early and often when purchasing property abroad. Foreign and US taxes can significantly impact the cost of owning foreign property, so the tax calculation should be part of the purchase price calculation.

US tax considerations include income tax, gift and estate taxes, and information reporting requirements. Taxes in the local jurisdiction may vary depending on how the purchaser intends to use the property. In addition to property and income taxes, foreign jurisdictions may have a wealth tax, inheritance tax, and unexpected information reporting obligations. If the foreign jurisdiction applies taxes to its residents, be sure to learn how that jurisdiction defines residence and how to avoid accidental resident status. Tax treaties and US foreign tax credits may provide some relief from double taxation. Some nations also offer a period of favorable tax treatment for new residents.

Retaining tax professionals licensed in both the US and the foreign jurisdiction is important. All of these tax professionals should be seasoned in international tax planning. Their knowledge and experience will help the purchaser avoid penalties by staying fully compliant with tax filings. Professional guidance may also save the purchaser money through deductions and tax credits.

In addition to foreign taxes, every US purchaser should consider the US income tax, information reporting associated with the purchase of foreign real estate, and estate and gift taxes.

US Income Tax Considerations

US persons, including citizens and residents, must report their worldwide income on annual individual income tax returns. If a US citizen resides abroad, US taxation and reporting still apply. US green card holders are permanent residents of the US. If a US green card holder resides abroad, all US taxation and reporting will likely apply, although treaties may provide some relief in some cases.

If foreign real property is rented and earns income, the income will likely be taxed in both the local jurisdiction and the US. If a US person owns real property individually, applying foreign tax credits and treaty relief may be comparatively easy to reduce double taxation on rental income. Deductions and tax years

may not always line up perfectly, so some amount of double taxation may be unavoidable.

Taxation may be more complicated if a US person owns foreign rental property in a trust or other entity. The trust or other entity may not be taxed in the same way in both jurisdictions. For example, the US disregards revocable trusts and single-member limited liability companies (LLCs) and taxes their income and gains to the trust's settlor or to the LLC's owner. A foreign country may not disregard a revocable trust or LLC and, instead, may treat it as a separate taxpayer. Treaties and foreign tax credits are designed to provide relief from double taxation for one taxpayer. If the taxpayers are different, relief may be limited.

Some foreign jurisdictions will not allow US persons to hold real property as individuals. These jurisdictions may require some form of local trust or other entity to hold title. In this case, the US person should review the proposed ownership structure with US tax counsel.

Moving funds into and out of foreign entities may generate US income and capital gains taxes. For example, under 26 U.S.C. § 684, any transfer of property from a US person to a foreign trust is taxed as if there had been a sale on the date of transfer. The deemed sale triggers a tax on any unrealized capital gains. The section 684 tax can apply unexpectedly because foreign trusts are not easy to spot. Some foreign business entities may be taxed as trusts in the US. Careful review by an experienced professional can help prevent unwelcome surprises.

Information Reporting

Foreign assets open up a new world of tax compliance for many US taxpayers: information reporting. The US government requires US taxpayers to report certain information about foreign assets and foreign financial activities every year. This information reporting is designed to help capture every US person's taxable income, but the rules are very broad. Taxpayers must report foreign assets and accounts even if they generate no income.

The Internal Revenue Service (IRS) has been focusing on information reporting for many years. The forms, their instructions, and the IRS's published guidance all change frequently. Penalties for failure to comply are high. Therefore, it is important not to rely exclusively on any single static resource, such as this article or any other, for guidance.

Up to now, personal use of foreign real estate has generally not been reportable on US information returns as long as the property is individually held. However, if real estate is held in an entity, owned by several persons, or generates any income, it may be reportable on one or more IRS forms. That is not the end of the analysis, though.

Even if a US person owns only personal-use real estate and holds title as an individual, some information reporting resulting from ownership of other assets in the foreign jurisdiction will almost certainly be required. Most property owners keep at least one bank account in the local jurisdiction to make paying local bills and taxes easier. The US taxpayer may try to keep the account under $10,000 to prevent unnecessary reporting, but if the account (or any combination of foreign accounts) exceeds $10,000 for even one day, it is reportable. This event may happen in the year of purchase, the year of sale, or in years with large construction projects. Escrow accounts with local counsel associated with a real estate sale may also be reportable on one or more US information returns.

For context, here are a few US reporting requirements to keep in mind:

- Foreign bank and financial accounts (FBAR):[1] A US person must report any interest in or signature authority over any combination of foreign accounts that exceed $10,000 **during the calendar year**. Again, if a US person's foreign bank accounts in the aggregate exceed the threshold due to receipt of sale proceeds or funds for a renovation, even if only for a day, every foreign account becomes reportable.
- Forms 3520[2] and 3520-A[3]: A US person must use these forms to report certain transactions with foreign trusts. If foreign real property is held in an entity that the IRS treats as a foreign trust, Forms 3520 and 3520-A must be filed annually. A US person can also use Form 3520 to report the receipt of particular gifts and inheritances from non-US persons.

1 *See generally* I.R.S., Report of Foreign Bank and Financial Accounts (FBAR), https://www.irs.gov/businesses/small-businesses-self-employed/report-of-foreign-bank-and-financial-accounts-fbar (last visited Nov. 12, 2024).
2 *See generally* I.R.S., About Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, https://www.irs.gov/forms-pubs/about-form-3520 (last visited Nov. 12, 2024).
3 *See generally* I.R.S., About Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner, https://www.irs.gov/forms-pubs/about-form-3520-a (last visited Nov. 12, 2024).

- Forms 8858,[4] 8865,[5] 5471,[6] and 8832:[7] If the non-US real estate is held in an entity that the US considers to be a foreign disregarded entity, partnership, or corporation, these forms may be required. The **check-the-box** rules governing entity classifications[8] apply differently to foreign entities than US entities and should be reviewed carefully when forming a new entity.

Depending on the circumstances, penalties for failure to file these forms can range from $10,000 to 35 percent of the value of the unreported property (50 percent in the case of a willful failure to file). The IRS has aggressively pursued these penalties in recent years. Working with a professional tax preparer can help protect US purchasers of foreign real property.

Gift and Estate Tax

In general, all citizens, green card holders, and US residents should plan for the possibility of worldwide gift and estate tax. US gift and estate taxes apply to all worldwide property transferred upon the death of a US taxpayer, defined as any US citizen or person domiciled in the US. The rule of global gift and estate tax clearly applies to all citizens. Green card holders and income tax residents have room to argue that they are not domiciled in the US because the definition of "domicile" is subjective. However, because the rule is subjective, the IRS may disagree with a taxpayer's reporting position.

US gift and estate taxes currently apply at a rate of 40 percent after the US person makes taxable gifts in excess of the lifetime exemption amount. The exemption amount is $13.99 million in 2025, which covers most lifetime gifting by most taxpayers. In addition to US gift and estate taxes, the local jurisdiction where the foreign real property is located may apply gift, estate, or inheritance tax if the property passes by gift or at the owner's death.

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4 *See generally* I.R.S., About Form 8858, Information Return of U.S. Persons With Respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs), https://www.irs.gov/forms-pubs/about-form-8858 (last visited Nov. 12, 2024).

5 *See generally* I.R.S., About Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, https://www.irs.gov/forms-pubs/about-form-8865 (last visited Nov. 12, 2024).

6 *See generally* I.R.S., About Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations, https://www.irs.gov/forms-pubs/about-form-5471 (last visited Nov. 12, 2024).

7 *See generally* I.R.S., About Form 8832, Entity Classification Election, https://www.irs.gov/forms-pubs/about-form-8832 (Nov. 12, 2024).

8 Classification of certain business entities. *See* Treas. Reg. § 301.7701–3, https://www.govinfo.gov/content/pkg/CFR-1998-title26-vol17/pdf/CFR-1998-title26-vol17-sec301-7701-3.pdf (last visited Nov. 12, 2024).

For US persons with taxable estates, a few gift and estate tax treaties can provide some relief from double taxation. Foreign tax credits may also be available.[9] However, keep in mind that treaty relief generally provides that the taxpayer will pay the higher of the two applicable taxes. For example, for property located in the UK, if inheritance tax applies, the local exemption may be only £345,000 (less than $500,000 at exchange rates at the time of publication). The US-UK estate tax treaty may provide no relief from UK inheritance tax on a £5 million estate because there is no double taxation.

OWNERSHIP OF NON-US REAL ESTATE

Local counsel is also imperative when determining how to best own real estate. It is important not to let what we are used to in the US drive decisions regarding real estate abroad because an obvious choice in the US could have significant negative consequences under local law.

One option often used in the US is to take title to real estate via revocable trust. This allows the owner to have control over the property and avoid being subject to probate upon death. Taking title to non-US real estate via a US revocable trust is often the wrong option. Outside the US, the trust document may not be respected; when it is, the tax and reporting consequences may be punitive.

Another strategy frequently used in the US is the LLC. This option should be used only if local counsel deems it advisable. In addition to enhanced reporting requirements in the US under the Corporate Transparency Act, each country may have its own registration and reporting requirements. In addition, although the LLC may be a disregarded or pass-through entity in the US, it may be a separate taxpayer in the foreign jurisdiction, preventing relief from double taxation.

Even joint ownership may not be what we think it is. In the US, jointly owned property with survivorship rights passes to the surviving owner outside probate. In some non-US jurisdictions, jointly owned property passes through probate at the death of each owner.

Often, the best way to own foreign real estate is the simplest: individual ownership or holding title through a foreign entity that is commonly used in the local jurisdiction. It is important for the US advisor to take a flexible approach, understand the client's goals and risk tolerance, and listen to local counsel regarding the best form of ownership.

If a client proposes a complex or unusual ownership structure that appears designed to avoid taxes in the local jurisdiction, US advisors should respond as they would to a structure designed to evade US taxes. We may not be licensed in foreign jurisdictions, but we are not immune to their laws. Advisors in other jurisdictions may have obligations to report aggressive tax-avoidance schemes to local authorities without informing the client or other advisors. Just as the US has pursued Swiss financial advisors who lure US clients into tax-avoidance schemes, US advisors are vulnerable to claims from foreign jurisdictions if we assist clients with tax evasion.

DEATH AND INHERITANCE

The transfer of foreign real property upon the owner's death will depend on local law. US purchasers may be surprised to learn that a foreign country requires a certain percentage of property to pass to particular family members under a forced inheritance regime. For example, an owner may be required to leave two-thirds of a foreign condo in equal shares to their children. This may be inconsistent with their estate plan if only one of their children uses the foreign condo or if they are disinheriting a child. On the other hand, in some locations, probate is straightforward and clearly the best estate planning option.

To resolve such estate planning questions, work with local counsel first and ask them what is most helpful and effective in their jurisdiction. One common tool for resolving cross-jurisdictional estate planning issues is a local will. However, multiple wills can also create problems and should be thoughtfully drafted.

CONCLUSION

Owning non-US real estate as a US person can bring both great joy and unwelcome surprises. To maximize the joy, clients should work with competent counsel in both the local jurisdiction and in the US to ensure they take title correctly, file and pay taxes properly, and avoid any unintended consequences. Advisors who are well-versed in international planning will be helpful guides in this process.

9 *See* Credit for foreign death taxes, Treas. Reg. § 20.2014-1 (Apr. 1, 2014), https://www.govinfo.gov/app/details/CFR-2014-title26-vol14/CFR-2014-title26-vol14-sec20-2014-1.