

CHAPTER 9 REAL ESTATE

By Sara P. Sandford, Mark Rowley and Ada Ko

1. INTRODUCTION

In the United States, real estate or real property generally includes land and buildings. U.S. real property law is mostly a combination of ancient rules derived from English common law and modern statutes. The law is complicated and varies from state to state. Foreign investors wishing to conduct businesses in the United States are advised to consult their counsel well in advance, whether the foreign investors are real estate developers or other types of enterprises engaged in a business which will acquire or lease real estate. Foreign investors conducting business in the United States can either acquire U.S. real property or lease property for their U.S. operations. Although alien ownership of U.S. real property is regulated by both federal and state governments, control over alien land ownership is primarily vested in the states. Therefore, laws governing land ownership in the United States have not developed in a uniform fashion.

Regulation of alien land ownership finds its genesis in the feudal laws of medieval England, under which the King was the owner of all land and alien land ownership was prohibited. This same common law approach was adopted by the colonies in North America, but soon proved to be problematic. After the United States gained independence, the states began a gradual movement toward the removal of common law restrictions on alien land ownership, though not breaking completely with the common law heritage. Over the years, the United States has significantly eased restrictions on foreign ownership of U.S. real property, but retains reporting requirements for foreign investors.

2. FEDERAL REGULATION OF ALIEN LAND OWNERSHIP

Federal regulation of alien land ownership takes various forms. This section briefly describes the key federal laws and regulations governing alien land ownership.

A. Controlling Exploitation of Federally Owned Lands

Federal laws and regulations in this area are designed to protect natural resources of the United States. They generally restrict alien exploitation of natural resources on public lands to aliens who intend to become U.S. citizens, and affect different types of lands, including lands containing mineral deposits and off-shore oil tracts.

B. The International Investment and Trade in Services Survey Act

The U.S. government requires U.S. businesses to report all direct and indirect foreign ownership of such business enterprise, if a foreign person (or foreign entity) owns

10% or more of the voting interest in the U.S. business, with limited exceptions. The information filed is confidential and not subject to Freedom of

Information Act disclosure. Any U.S. entity that fails to furnish the required information is subject to a civil penalty ranging from \$2,500 to \$25,000. Any willful violation may be subject to a criminal fine up to \$10,000 assessed against the U.S. entity, or in the case of an individual (including officers, directors, employees or agents), they may be imprisoned for not more than one year, fined, or both.

C. The Agricultural Foreign Investment Disclosure Act

This Act imposes certain reporting requirements for acquisitions or transfers of agricultural land interests by foreign persons. Under the Act, any foreign person who acquires or transfers any interest in agricultural land, with certain limited exceptions, must submit a report to the Secretary of Agriculture no later than 90 days after the date of such acquisition or transfer. The report must include such information as the legal name and address of such foreign person, his or her citizenship (if an individual instead of a legal entity), the purchase price paid for the property, and other information the Secretary may require. Failure to report will subject the foreign person to civil penalties.

D. The Foreign Investment in Real Property Tax Act (“FIRPTA”)

Under FIRPTA, a foreign investor who holds U.S. real estate as a passive investment (i.e., with any type of net lease), such passive rental income is subject to a flat 30 percent withholding tax (unless reduced by an applicable income tax treaty) applied to the gross income rather than the "net rent" received. Thus, the real estate taxes, operating expenses, ground rent, repairs, interest and principal on any existing mortgages, and insurance premiums paid by the lessee on behalf of the foreign owner-lessor, must be included in gross income subject to the 30 percent withholding tax. If, on the other hand, the foreign investor is engaged in a U.S. trade or business such as the developing, managing and operating a major shopping center, the rental income will not be subject to withholding and will be taxed at ordinary progressive rates. Expenses such as mortgage interest, real property taxes, maintenance, repairs and depreciation (accelerated cost recovery) may then be deducted in determining net taxable income.

FIRPTA also imposes on foreign sellers of U.S. real estate, a 15% withholding tax (on the gross sales price) unless the transaction is exempt from FIRPTA withholding.

3. STATE REGULATION OF ALIEN LAND OWNERSHIP

The rights of aliens, including foreign investors, with respect to real property are primarily a matter of state regulation, and depend upon the constitutional and statutory provisions of

the state in which the property is situated. Some states have statutory or constitutional provisions granting aliens the same rights as citizens. Some states have enacted statutes restricting the rights of aliens ineligible for citizenship from acquiring real property. The tendency of most state legislation, however, has been to enable aliens to purchase and own real estate.

4. ACQUIRING REAL PROPERTY

A foreign investor may acquire U.S. real property for development or investment, or as a location for its U.S. operations. Purchasing real property requires assistance of skilled U.S. advisers, including attorneys. Such a transaction may have many traps for the unwary. Due diligence is absolutely necessary. Careful consideration must be given to such issues as whether the property is free of encumbrances or other title defects, and whether environmental or zoning regulation limits the use of the property. Local tax authorities also impose annual real estate taxes, with such taxes adjusted based on the value of the property. In addition, disposition of real property may be subject to tax on capital gains. Negotiating a real property transaction requires the allocation of legal and economic risks, and assistance of skilled U.S. legal counsel is highly recommended.

5. LEASING REAL PROPERTY

A foreign investor may lease property for its U.S. operations. The parties to the lease are free to negotiate almost any terms, including the duration of the lease, rent, maintenance and repair obligations, early termination and penalties, financing arrangements, assignment and subleases, and remedies. Assistance of skilled U.S. counsel is essential to avoid surprises, especially since most lease agreements tend to favor the landlord.

6. INSURANCE

Foreign investors that own or lease property should be aware that insurance against risks in connection with owning or using the property is available. Generally, a foreign investor should consider purchasing three kinds of insurances: (a) title insurance, (b) property insurance, and (c) liability insurance. A foreign investor may purchase title insurance from a title insurance company. Title insurance protects the foreign investor as a purchaser or as a tenant against the risk that its ownership or leasehold rights are subject to third-party security interests or other title defects. Property insurance is intended to protect against damage to property caused by such events as fire or flooding. Liability insurance helps protect the foreign investor against claims that arise on account of the property and which may be asserted against the investor.

For any questions, please feel free to contact Mark Rowley at mrowley@gsblaw.com or at 206.816.1408, or Sara Sandford at ssandford@gsblaw.com or at 206.816.1464.