taxnotes® international

Volume 92, Number 13 ■ December 24, 2018

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Reprinted from *Tax Notes International*, December 24, 2018, p. 1299

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by Diego Embón, Steffen Kranz, and James A. Schmidt

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In this article, the authors discuss the taxation of foreign real estate investors in the United States, Argentina, and Germany with a focus on tax-efficient investment structures and the impact of recent tax reform measures on those structures.

For an individual or entity looking to make an effective real estate investment, understanding the specific, unique tax landscape of a target jurisdiction is critical. Major new tax regulations and reforms can have a serious impact on existing or planned investments, and tax law consequences can heavily influence decisions regarding the structures used to make them.

This article offers a multijurisdictional perspective on these issues, with tax experts from Argentina, Germany, and the United States discussing the tax landscape in their respective jurisdictions from the perspective of a real estate investor.

I. Major Tax Rules and Recent Reforms

A. The United States

It has been barely a year since the United States enacted the Tax Cuts and Jobs Act (P.L. 115-97). The TCJA resulted in the most significant changes to the U.S. tax law system in several decades, affecting nearly every aspect of the country's tax system, including its treatment of foreign investment in U.S. real estate. All told, the changes are generally beneficial to inbound investment.

As the name suggests, tax cuts are at the heart of this legislation. The act reduces the corporate tax rate to a flat 21 percent, reduces individual income tax rates, and creates a deduction equal to 20 percent of qualifying income for passthrough businesses, such as many real estate management entities.

The law also modifies some rules on interest expenses, although it did not change the deduction for interest paid to foreign corporations — commonly called a blocker structure — by a U.S. corporation that owns real estate. Capital gains tax rates as well as estate and gift tax rates remain unchanged.

The TCJA also modified the treatment of like-kind exchanges — that is, when investors reinvest sale proceeds and defer the gain — to exclude gains attributable to personal property from the tax-deferral regime. This means that sales of hotels and restaurants, which typically include a significant personal property component, can now trigger additional taxable gain. A new element in the law is the Opportunity Zone. This regime allows investors to increase their basis in the reinvested gains and avoid tax on further appreciation of that gain if an eligible property is held for at least 10 years. The government of each U.S. state has designated the geographic area in its state that qualifies for treatment.

Before conducting any tax planning for inbound U.S. investments, it is essential to determine whether the foreign investor is a nonresident alien or a U.S. person. Nonresident aliens are only taxed on their U.S.-source income, but they face more exposure to U.S. estate taxes. In contrast, the United States taxes U.S. persons on their worldwide income, but they have less exposure to U.S. estate tax.

The test for the nonresident alien status varies depending on whether the determination is being made for the income or estate tax regimes. For

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income tax purposes, an investor will be treated as a U.S. person if it meets the substantial presence test, is a lawful resident, or elects that treatment. For estate tax purposes, the determination is driven by a factual analysis of where the investor intends to establish its domicile and the intent to indefinitely reside there.

The TCJA did not modify these tests, but it did change some of the outcomes that follow from the determination. For example, in the estate tax arena, U.S. persons may exclude $11 million in assets from estate tax, while nonresident aliens may exclude only $60,000.

B. Germany

Forthcoming changes in German legislation include limiting the use of so-called RETT blocker structures and taxing the profits that foreign investors realize on the sale of shares in real estate companies.

1. RETT Blockers

The transfer and acquisition of real estate located in Germany is subject to German real estate transfer tax (RETT). The tax rates for RETT vary between 3.5 and 6.5 percent, depending on the law of the relevant federal state. One structuring option for avoiding RETT involves the interposition of partnerships or corporations through which the real estate is then acquired or sold.

When contemplating the applicability of RETT, an investor must consider two regulations. For partnerships that hold properties located in Germany, RETT applies if at least 95 percent of the shares in the partnership are transferred to new shareholders within five years. This is known as the share transfer regulation. Further, RETT applies to partnerships and corporations if a shareholder acquires control of 95 percent of the shares in the relevant company. This is the share pooling regulation. The share pooling regulation also applies if someone concludes a contract whose execution leads to 95 percent control. Traditionally, as long as the aforementioned limits were not exceeded, the use of intermediate companies could provide structuring opportunities that avoided RETT.

At their meetings on June 21, 2018, and November 29, 2018, the finance ministers of Germany's 16 federal states decided to initiate a legislative process aimed at restricting the use of RETT blockers by using several routes.

The first extends the share transfer regulation — previously only applicable to partnerships — to include changes in shareholdings in corporations. Thus, several independent investors would be unable to acquire all of the shares in a real estate holding corporation at once (by way of a club deal) without triggering RETT.

The second rule will reduce the relevant thresholds for both the share transfer regulation and the share control regulation from 95 percent to 90 percent. The new rules also extend the five-year period for share transfer and holding to 10 years.

To avoid RETT in the future, investors will need to be more cautious and plan for long-term structuring. It will be possible to avoid RETT when acquiring or selling shares in real estate holding companies, but it is not yet clear exactly how the changes in the law will affect existing RETT blocker structures, so there is some degree of planning uncertainty in this respect.

2. Profits Realized by Foreign Investors

Many of Germany's double taxation agreements contain a provision corresponding to article 13, paragraph 4 of the 2014 OECD model income tax treaty, which states that capital gains realized from the sale of shares in corporations that directly or indirectly derive more than 50 percent of their value from immovable assets (real estate companies) can be taxed in the country where the immovable assets are located.

However, in the absence of corresponding domestic tax provisions, Germany can only exercise this right of taxation if the shares in question are shares in corporations with their registered office or place of management in Germany and the shareholder has held an interest of at least 1 percent in the corporation within the last five years. This means that profits that a foreign investor generates when selling shares in a foreign corporation may not be subject to German income tax — even if the corporation primarily holds real estate located in Germany.

Under a new regulation in the German Income Tax Act, a (limited) tax liability will arise on the sale of shares in a corporation if, at any time

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during the 365 days before the sale, more than 50 percent of the corporation's share value was based directly or indirectly on domestic immovable assets and the shares were attributable to the seller at that time. Also, in the future, a (limited) tax liability will arise on the sale of shares in those real-estate-rich companies even if the minimum participation requirements are not fulfilled.

In the future, foreign investors will also be subject to (limited) tax liability in Germany if they sell shares in a foreign company and more than half of the company's share value is based on real estate located in Germany. The new regulation will only affect share disposals made and profits if they are based on changes in value occurring after December 31, 2018.

C. Argentina

Argentina published a major tax reform measure on December 29, 2017, that generally took effect January 1, 2018. Like the TCJA in the United States, the package — known as Law 27,430 — created some of the most comprehensive changes to the nation's tax system in decades. Law 27,430 introduces material tax reforms, including several key changes to income tax (both at corporate and individual levels), VAT, tax procedural law, criminal tax law, social security contributions, excise tax, tax on fuels, and tax on the transfer of real estate. It also provides for a special regime comprising an optional revaluation of assets for income tax purposes.

1. Dividend Tax

Dividends paid to Argentine resident individuals and foreigners out of income that companies generate during the fiscal years beginning between January 1, 2018, and December 31, 2019, are subject to a 7 percent withholding tax. If, however, dividends are distributed to Argentine companies, then no dividend tax applies. No Argentine withholding tax applies on dividend distributions stemming from income generated in fiscal years beginning before January 1, 2018.

Dividends paid to Argentine individuals and foreigners stemming from income generated during fiscal years starting on or after January 1, 2020, are subject to a 13 percent withholding rate on the amount of the dividends. For foreigners, applicable treaties can help prevent double taxation if specified conditions are met. Again, if dividends are distributed to Argentine companies, then no dividend tax applies.

The combined effective rate for shareholders on distributed income — that is, the corporate income tax rates plus dividend withholding rates on the after-tax profit — is close to the 35 percent income tax rate in force before the tax reform. The government made the change to promote the reinvestment of profits.

As for real estate transactions involving foreigners, the tax reform means that property transfer tax (Impuesto a la Transferencia de Inmuebles, or ITI) will coexist with the income tax — one or the other tax will be applied depending on the time of acquisition and the nature of the seller.

2. Income Tax

The recent tax reform measures affect nonresident companies and individuals who invest in Argentine real estate.

According to the tax reform, Argentine corporate entities — that is, entities organized or incorporated under Argentine law — must pay income tax on their net income at the rate of 30 percent for fiscal years that begin after January 1, 2018, and on or before December 31, 2019. The rate becomes 25 percent for tax periods initiated after January 1, 2020.

Argentina's income tax law covers all income that Argentine residents receive, whether from Argentine or foreign sources. However, nonresidents are only taxed on their Argentine-source income. Generally speaking, local-source income is income stemming from assets situated in or activities carried out in Argentina.

Argentina taxes nonresidents using a 35 percent withholding on a specified percentage of deemed net income as a single and final payment. Nonresident companies that sell real estate located in Argentina are subject to a 35 percent income tax rate on 50 percent of the presumed income, ultimately leading to a 17.5 percent effective withholding rate.

Nonresident individuals are subject to lower rates, as explained below.

3. Stamp Tax (Provincial Tax)

Most Argentine provinces and the city of Buenos Aires levy a stamp tax (Impuesto de

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Sellos) on documents that outline transactions for a consideration. This includes, *inter alia*, contracts, acknowledgments of debts, incorporations, promissory notes, and transfers of real estate. In general, the rate is between 1 and 1.5 percent on the economic value of the instrument. Usually, however, the rate is higher for transfers of real estate — for example, 3.6 percent in the city of Buenos Aires.

II. Planning for Tax-Efficient Investment

Foreign investors can use various structures to maximize the tax efficiency of their real estate investments. Investors should reconsider their traditional approaches in light of the tax reform movements around the world.

A. The United States

One structure that foreign investors use to generate tax efficiency in the U.S. is owning real property through a foreign corporation. U.S. law does not consider the foreign stock to be a U.S.-situs asset. Therefore, the transfer of the stock as a gift or at death would avoid U.S. estate tax. However, the foreign corporation would be subject to U.S. income tax. Historically, investors did not favor this structure. The downside to this arrangement was the excessive rate of income tax in case of a sale — corporations do not enjoy favorable long-term capital gain rates — but with the reduction in the U.S. corporate tax rate, this structure is likely to become more prevalent.

Another popular option is owning U.S. real property through a partnership, in part because partnerships enjoy special long-term capital gain rates. However, an interest in a U.S. partnership is subject to U.S. estate tax. The small income tax benefit of owning the property through a partnership — which enjoys a 20 percent long-term capital gain rate — versus a foreign corporation — which now pays a 21 percent rate — might not justify the exposure to U.S. estate tax.

Some tax planners employ a two-tier partnership to achieve both preferable income and estate tax outcomes. Under this plan, the property is owned by a U.S. partnership, which is in turn owned by a foreign partnership. The proceeds from the property will be taxed at capital gain rates when sold by the lower partnership, and the gift or transfer at death of an in interest in the foreign partnership will avoid estate tax.

Passthrough structures now enjoy the added benefit of the new 20 percent deduction. Nonresident aliens with U.S.-source income from property management, brokerage, or other real estate services will experience a lower overall income tax rate after taking this deduction.

B. Germany

A foreign investor can still avoid the accrual of German RETT by acquiring German real estate indirectly rather than directly. For example, the acquisition of 94.9 percent of the shares in a GmbH, a private German company, does not trigger RETT if the remaining shares (5.1 percent) are held or acquired by another person with whom the purchaser is not associated — a RETT blocker. In particular, this increases the attractiveness of club deals.

As discussed above, German legislators are increasingly restricting the use of RETT blocker models. However, in the future, a well-planned structure will still make it possible to indirectly acquire or dispose of real estate located in Germany without triggering RETT.

If carefully structured, indirect real estate investment by a foreign investor using a company located abroad can be an effective way to realize tax-free capital gains in real property assets upon the sale of shares in the foreign company in Germany. However, as discussed above, forthcoming German legislation will soon significantly restrict the ability of foreign investors to sell shares in foreign real estate companies without incurring tax obligations.

About 10 years ago, Germany passed the Real Estate Investment Trust Act, creating an investment vehicle now known in many countries around the world.[1] However, the initial expectation that foreign investors would view German REITs as a tax-attractive tool for indirect real estate investments has since been crushed. In contrast to other countries, the special legal form of the REIT has gained almost no significance in Germany. There are only a handful of REITs in Germany to date.

[1] For coverage of the act's passage, see Darryl Tait, "Upper House Approves REIT Act," *Tax Notes Int'l*, Apr. 9, 2007, p. 155.

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Many investors use special purpose vehicles (SPVs) to acquire, hold, and later sell properties located in Germany. Investors can use partnerships or corporations as SPVs, and they can choose to locate the entity in Germany or abroad. The tax advantages and disadvantages of an indirect real estate transaction compared to a direct one depend on the intended use type — that is, leasing versus sale.

When real estate investments involve SPVs located in Germany, there will usually be a permanent establishment created in Germany. In this case, the SPV will generally owe trade tax on its profits, which real estate companies can only avoid if they meet very strict requirements. SPVs can also be used to avoid RETT.

A particular disadvantage of using commercial SPVs in Germany is that any capital gains are generally subject to income tax. If the entity only acquires a few properties that are held for a longer period, it may make sense to hold them as private assets since capital gains can then be achieved tax-free.

C. Argentina

1. Income Tax

If a nonresident individual sold real estate in Argentina and the seller acquired the property before January 1, 2018, the transaction would have been subject to ITI at a rate of 1.5 percent on the sales price. If the seller acquires the property on or after January 1, 2018, and the seller does not use it for dwelling purposes, the net income would be subject to income tax at a rate of 15 percent.

Nonresidents can use the rules to mitigate taxes since the sale of real property faces a significantly lower income tax rate when it is sold by nonresident individuals — 15 percent — compared with sales performed by nonresident companies — 35 percent — or Argentine companies — 30 percent or 25 percent, depending on when the sale occurs.

2. Stamp Tax

Agreements made by means of offers or proposals with implicit or explicit acceptance — also known as mail contracts or contracts executed in an offer letter format — are a widespread practice used to avoid stamp tax between companies. This practice is valid and binding under the Argentine Civil and Commercial Code.

In this type of transaction, one party sends a letter duly signed by an appropriate representative and proposes entering into an agreement with the other party. The terms and conditions of the agreement can be located in the offer letter itself or in an annex to the offer letter. In case of proposals with explicit acceptance — which are the ones that give more certainty to the parties to the contract and, for this reason, the kind of proposals most commonly used by companies, especially if they are not related — the offer letter states that if the parties agree, their consent and the agreement to enter into the contract will be deemed evidenced when the recipient sends an acceptance letter.

In general, Argentina's provinces and the city of Buenos Aires subject mail contracts to stamp tax when the respective offer letter is accepted exclusively: a) in writing through a reproduction of the proposal or its essential statements or elements that enable to determine the subject matter of the contract; or b) by signing the same. Therefore, as long as the acceptance letter does not fall under cases previously mentioned in items a) or b), in principle mail contracts should not be subject to stamp tax. Nevertheless, in some provinces of Argentina, local regulations state that a taxable event does occur in other situations involving mail contracts. Thus, the application of said general rule depends on the pertinent jurisdiction involved.

Parties to an agreement to purchase real estate may choose to directly execute the title deed or opt to sign a bill of sale first. Choosing to sign a bill of sale before executing the title deed is common practice when foreigners are purchasing real estate because these transactions usually take more time than those in which no foreigners are involved. Nonresidents might choose to structure the bill of sale as an offer letter to avoid stamp tax if, ultimately, the title deed is never executed.

3. Housing Developments

On May 11, 2018, Argentina published Law No. 27,440 in the official gazette, and it modified the tax treatment of several financial instruments.

With the goal of fostering construction of low- and middle-income housing, it states that if financial trusts and closed-end mutual funds that

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have as their objectives (i) real estate developments for social housing of middle- and low-income population, (ii) mortgage loans, or (iii) mortgage securities, then distributions from the rental or sale of those assets will be taxed at a rate of 15 percent, if the following conditions are met:

- the beneficiaries are humans, undivided estates, or nonresidents;
- the fund or financial trust was placed by public offering with the authorization of the Argentine Securities and Exchange Commission (ASEC) for a term of at least five years and distributed among at least 20 investors;
- no investor or shareholder holds more than 25 percent of the offered securities;
- any sales are made through markets duly authorized by the ASEC;
- a minimum of five years passed before the redemption or liquidation of the financial instrument; and
- from the time of the offering and throughout its term, the fund or financial trust complies with the requirements demanded by the ASEC to access to this tax treatment. ■

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