

# Chapter 26

## IMPACT OF STATE AND LOCAL TAXES ON FOREIGN INVESTMENT IN US REAL ESTATE

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A foreign investor considering the tax implications of an investment in US real estate typically focuses on US federal income taxes and ignores state and local taxes. There are a number of reasons for this, first and foremost of which is that federal tax rates are substantially higher than those charged by states and localities. The maximum federal income tax rate applicable to corporate and individual investors is 35 percent. Moreover, corporations face a second level of tax applicable to distributions (or deemed distributions) to shareholders imposed at the rate of 30 percent unless reduced by tax treaty.

Most state and local income tax rates, on the other hand, are less than one-quarter of the federal rates. State taxes are also deductible in computing federal taxable income, making the effective rate lower still. However, taxes on net income are not the only taxes levied by state and local governments. Some states tax gross income and others tax a corporation's capital employed in the state.

While almost all states have sales and use taxes (the latter apply to the sale or use of tangible personal property in the state), some also tax various services. Some jurisdictions also impose a tax on rents paid with respect to real estate located within their boundaries. Another type of tax imposed by many states and some cities and counties is a real estate transfer or recording tax. This type of tax is typically expressed as a percentage of the consideration received in connection with a transfer of real estate. Finally, *ad valorem* real estate taxes are imposed against the value of real estate located within the jurisdictional limits of many state and local taxing authorities.

The overall burden of state and local taxes within the context of foreign investment in US real estate can be significant. Perhaps more importantly, many of them are payable regardless of whether the taxpayer is making a profit. Foreign investors in real estate should also be aware that income tax treaties to which the US is a party (many of which reduce taxation of certain types of income and attempt to eliminate double taxation) do not typically apply to state and local taxes.

Finally, except for certain limitations in the US Constitution, no uniformity of taxation is required of US states and localities. This variation can create both pitfalls and opportunities. Attention to state and local tax planning will usually be rewarded.

### US CONSTITUTION

The power of states and their political subdivisions to levy taxes is derived from the US Constitution, which confers specific powers on the federal government and permits powers not so conferred to be exercised by the states. The Constitution also limits the powers of both federal and state governments. These limitations include the right to equal protection under the law and the right not to be deprived of life, liberty or property without due process of law. The due process clause is the principal protection against unlimited state taxation in that it requires a certain minimum level of contact between a person and a state seeking to impose a tax on that person and also requires that a state tax only that portion of a person's activities that are fairly attributable to that state. The courts have also cited the federal government's exclusive authority to regulate interstate and foreign commerce in limiting the exercise of state taxing power.

### STATE INCOME TAXES

Just about every state imposes some type of corporate and individual income tax. The principal focus of this discussion will be upon corporate income taxes, since most foreign investors do their investing through corporations. The highest state corporate tax rates generally range between 5 and 10 percent. While income taxes are for the most part imposed at the state level, some larger cities, like New York, impose them as well.

In order to be subjected to a state's corporate income tax, a corporation must typically be deemed to be doing business in the state or to own income-producing tangible property located there. Ownership of a direct interest in

income-producing real estate within a particular state will almost always provide sufficient nexus for that state to tax the owning corporation. The indirect ownership of such real estate, however, such as through another corporation, will not usually result in taxation of the shareholder corporation. While the corporation that actually owns the real estate will be subject to tax, it may be possible to reduce that corporation's taxable income by making tax-deductible payments (such as interest) to the shareholder corporation.

Ownership of real estate through non-corporate entities such as partnerships, limited liability companies (LLCs) and trusts presents more complicated issues. Some states impose a tax on the income of the entity itself. Others tax the owners of the entity on their share of its income attributable to the in-state real estate. Still others differentiate between forms of ownership of the entity. For example, some states tax general partners' partnership income but not that of limited partners. Taxation of income of LLC interests is also not uniform across the states, although most states now follow the federal income tax classification rules for such entities.

As noted earlier, the variations between states' tax rules can present some tax-saving opportunities, among them the use of related-party debt.

This mechanism has traditionally been used to reduce federal income taxes when the lender is a foreign entity resident in a country whose tax treaty with the US provides for a reduced rate of withholding tax on interest payments. This technique was curtailed somewhat by "earnings stripping" legislation enacted in the late 1980s but is still widely used. A variation is to establish a US corporation in a state (like Delaware) that does not tax passive income as long as the recipient corporation is not conducting an active business there, and then to have that company lend money to the company that owns the real estate. Some states (Ohio is an example) have

enacted laws to limit the deductibility of interest on related-party debt. Others have tried to deal with the issue through unitary tax or combined reporting concepts or by treating the loans as sham transactions that should be ignored. Most states, however, have not been as aggressive as they could be in dealing with the issue. A foreign investor that owns real estate in jurisdictions in which related-party debt can generate state tax savings will, in most cases, need to use a separate corporation, rather than a tax-transparent entity like a partnership or an LLC, to own the real estate. While from a federal income tax standpoint this creates a more complicated structure, the ability to include the fiscal results of related domestic companies in a consolidated federal income tax return minimizes the complication.

If a corporation owns real estate in more than one state, its tax liability to each state is determined through allocation and apportionment rules. Allocation involves attributing all of the income from a particular activity, such as the ownership of real estate, to the state in which that activity occurs. Apportionment involves applying the percentage of the corporation's overall sales, payroll and property attributable to a particular state to its entire taxable income. Some states count each factor equally, some double count certain factors (typically sales), and some use fewer than three factors. Some factors, like payroll, can be manipulated, for example by hiring a management company to perform building services rather than using direct employees. The property factor is usually averaged in some way throughout the year, which can present tax-planning opportunities if a company plans to dispose of more than one property during a particular year. Disposition of property in a high-tax state early in the year and disposition of property in a lower-tax state later in the year will likely yield a lower overall state tax burden than if the order of sale were reversed.

A very simple example of the difference between allocation and apportionment would be that of a taxpayer who owns property in two different states, X and Y. Assume that both states tax income at 5 percent, but that State X allocates all income from real estate to the state in which the real estate is located and State Y uses a three-factor apportionment method. Finally, assume that the taxpayer has equal amounts of sales, payroll and property attributable to each state. If the property in State X is sold for a \$100 gain and the property in State Y for a \$200 gain in the same year, the tax payable in State X would be \$5 (5 percent of the \$100 of gain allocable to that state), and the tax in State Y would be \$7.50 (5 percent of the 50 percent of the taxpayer's \$300 taxable income apportionable to that state). In this example, the overall tax rate is 4.167 percent, even though the tax rates in both states are 5 percent.

By contrast, an effective tax rate higher than 5 percent would result if the locations of the gains were reversed. The tax payable in State X would be \$10 (5 percent of the \$200 gain allocable to that state), and the State Y tax liability would still be \$7.50 (5 percent times 50 percent of the \$300 taxpayer's total taxable income), for an overall effective tax rate of 5.833 percent.

Tax losses carried forward are usually determined differently at the state and local levels than at the federal level. Some jurisdictions have shorter carry-forward periods than those permitted for federal tax losses. In addition, most jurisdictions permit only losses attributable to activities in the state against income allocated or apportioned to the state. This can lead an investor with activities in more than one state to bear a much higher overall state income tax liability in proportion to its federal income tax liability than might be expected. An investor with properties in Illinois and New York, disposing of the property in Illinois in 2000 at a \$100 loss and disposing of the property in New York in 2001 at a \$100 gain,

will have its federal taxable income in 2001 fully offset by the \$100 loss carried forward from 2000. Its New York income tax liability, however, will be only partially offset because not all of the loss carried forward will have been attributable to New York activities.

Another issue that can arise is whether income from the sale of an interest in real estate constitutes “business” or “non-business” income. Many state and local tax systems differentiate between the two, taxing business income on an apportionment basis and non-business income on an allocation basis. If allocation is used, the income from the sale of a direct interest in real estate typically will be attributed in its entirety to the state in which the real estate is located, but income from the sale of an indirect interest, such as an interest in a partnership or an LLC, may be taxed in the owner’s state of “commercial domicile,” usually where its management is located.

It may be possible under certain circumstances to locate a corporation’s management in one of the few states that does not impose any corporate income tax or in a state in which certain types of management activities do not cause a corporation to be subject to tax. Still another possibility is to locate the corporation’s management in a state that taxes on an apportionment basis only, so that the only factor attributable to that state will be payroll.

Many foreign investors invest in US real estate through REITs. Although a REIT is subject to federal income tax, it is entitled to deduct from its federal taxable income distributions to its shareholders. The shareholders are subject to tax on the distributions. State tax treatment of REITs and their shareholders is not uniform, but most states permit deductions for distributions to shareholders regardless of whether the shareholders are subject to state tax on the distributions.

## STATE CAPITAL TAXES

A number of states impose a tax based upon the capital a corporation is deemed to have employed in the states. Some of these impose the capital tax only when it results in a higher tax than the income tax. Capital is typically determined by subtracting the corporation’s liabilities from its assets, but there are a multitude of methods for valuing assets, including book value and fair market value. Some states use a multiple of the value assessed for *ad valorem* taxes and others use a multiple of earnings over a specified period of time. A few states use a combination of these methods.

The definition of deductible liabilities is less varied, but some states exclude liabilities to related persons. Some treat deficits in retained earnings as liabilities. Like corporate income taxes, taxes on capital are subject to apportionment based on the corporation’s activities in a state.

## STATE TAXES ON GROSS INCOME

The most prevalent state tax on gross income is the sales tax, traditionally imposed on receipts from sales of tangible personal property to the ultimate user. The concept of sales tax has been expanded in some states to include fees received for the provision of services. It can also take the form of a tax on rents or on the provision of utilities to tenants. In most cases, taxes on sales are the responsibility of the purchaser.

A few states and some cities and other local taxing authorities impose gross-receipts taxes on certain types of businesses carried on within their boundaries. These taxes are borne by the seller and are sometimes called license or privilege taxes.

One gross-receipts tax of particular relevance to real estate investors is that imposed on the consideration received in connection with transfers of real estate. These taxes are usually referred to as real estate transfer taxes, recording fees or deed stamps and vary from less than 1 percent of the sales price to as much as 3 percent. The obligation

typically falls on the seller, but in some jurisdictions is split between seller and purchaser.

States or cities with higher transfer-tax rates often have a parallel regime under which consideration received for transfers of controlling interests in entities owning in-state real estate will also be subject to transfer tax. Since these indirect taxes are not collected by the officials who record deeds, as are direct transfers of real estate, they are not as easy to enforce, especially when the change of control takes place several steps removed from the entity which owns the real estate.

Finally, some states impose recording taxes on various real estate-related documents (such as long-term leases and mortgages).

#### **AD VALOREM PROPERTY TAXES**

Owners of real estate located just about anywhere in the US must deal with *ad valorem* property taxes levied by local taxing jurisdictions such as counties, cities and special-purpose districts to finance services of a local nature, such as schools and fire and police protection. The rates tend to fluctuate depending upon budgetary requirements and are applied to the value of real property (and

sometimes personal property) located within the taxing jurisdiction.

While all property taxes are based upon the value of the subject property, the manner in which that value is determined varies widely. Since the valuation of real estate is a somewhat subjective exercise, taxpayers often initiate legal proceedings to challenge valuations.

It is a fairly uniform practice across the country for tenants in leases of commercial real estate to bear the expense of property taxes. This can be accomplished by having the tenant pay the taxes directly, either into an escrow account or to the taxing authority, or by having the tenant pay additional rent when property taxes increase.

#### **CONCLUSION**

While often overlooked, state and local taxes can have a real impact on the overall return of US real estate investments. However, the lack of uniformity in the rules governing the states' taxation of multi-state activities creates opportunities, not available at the federal income tax level, to manage the tax components of an investment.



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