Tax Structuring for Chinese Investment in U.S. Real Estate

From the Law Office of Gerald R Nowotny

Overview

Unless you have been traveling the galaxies for the last twenty years, you haven’t missed the “Chinese Miracle”. Its enormous impact is felt globally. When you see the skyline of Shanghai, the new meaning of Mao’s Cultural Revolution seems to be the introduction of a new line of Chanel purses and shoes, or a sale of Chanel #5.

Great fortunes have been made in China by Chinese nationals and foreigners. Over time, Chinese high net worth individuals have been able to invest their personal wealth outside of China. Increasingly, you hear stories of large scale Chinese investment in U.S. real estate.

The trend in Chinese investment in the U.S. has been increasing each year. In 2012 the level of investment was $6.5 billion and does not represent the $2 trillion of investment in U.S. treasuries by the Chinese government. Actual Chinese individual investment is quite small compared to other countries.

Since the economic crisis, U.S. investment by the Middle East, Europe and Canada is off dramatically. During the same time, Chinese investment has grown by more than 1300 percent. Much of this investment is in U.S. real estate where great buying opportunities still exist.

This article discusses the use of private placement variable deferred annuity contracts as a tax structuring vehicle for Chinese investors that make investments that generate effectively connected income in a U.S. trade or business (ECI).

These investments generally include direct investment in U.S. residential and commercial real estate as well as investments in funds structured as partnerships and limited liability companies.

Taxation of Chinese High Net Worth Investors.

The Chinese tax code imposes taxation on individuals on worldwide income. The top marginal tax rate is 45 percent.

China is a party to a double tax treaty with United States that entered into legal effect in January 1987. Interest, dividends and royalties are all taxed at 10 percent. Real estate income and gains are taxed in the jurisdiction where the real estate is located.
Taxation of U.S Real Estate Investments for Chinese Investors

IRC Sec 871(d) gives a non-resident alien the right to treat U.S. real estate investment as effectively connected income (ECI) with respect to a trade or business in the United States. Without this election, real estate income and gains would be subject to the 30 percent withholding tax under IRC Sec 871(a) without the benefit of any tax deductions. IRC Sec 882(d) provides a similar deduction for foreign corporations with investments in U.S. real estate.

When a foreign person engages in a trade or business in the United States, all income from sources within the United States connected with the conduct of that trade or business is considered to be ECI. This applies whether or not there is any connection between the income, and the trade or business being carried on in the United States, during the tax year. Taxes are withheld at a 35 percent rate. The foreign taxpayer is taxed according to the graduated rate structure. State taxation would also apply when applicable.

Foreign Investors Real Property Taxes Act (FIRPTA) introduced a federal withholding tax system which requires the buyer of the real property to deduct and withhold ten-percent of the gross sales price and remit to the federal government within twenty days of the transaction.

The application of FIRPTA provides a few exceptions for the withholding requirement. One exception applies to the sale of a principal residence and the amount of gain not exceeding $300,000. Another key exception applies with respect to publicly traded stock owning U.S. real estate with the selling shareholder owning less than five percent of the outstanding shares for the five year period preceding the sale.

Another exception applies if the transferor (such as a life insurance company separate account) provides a certification stating, under penalties of perjury, that the transferor is not a foreign person. A life insurer is not taxable on the investment account of its separate account investments. The life insurer receives a reserves deduction equal to its investment income.

Also, an exception under FIRPTA applies if the transferor provides written notice that no recognition of any gain or loss on the transfer is required because of a non-recognition provision in the Internal Revenue Code or a provision in a U.S. tax treaty.
The Tax Treatment of Annuity Income under the U.S. – Chinese Income Tax Treaty

IRC Sec. 871 subjects “fixed and determinable” income including annuities to a thirty percent withholding tax. The provision would ordinarily subject annuity income to a 30 percent withholding tax. Article 17(1) of the U.S.-People’s Republic of China Income Tax Treaty dealing with pensions and annuities overrides the tax imposed under IRC Sec. 871.

Article 17 of the Treaty essentially provides that the annuity is not subject to U.S. income and withholding tax. The annuity income is only taxed in the foreign jurisdiction.

IRC Sec 72 provides for non-recognition to the policyholder (investor) and insurance company. Private Placement Variable Deferred Annuity Contracts (PPVA) are institutionally priced variable annuity contracts that provide for customized annuity contracts. PPVA is intended to meet the tax law requirements of IRC Sec 72 and IRC Sec 817(h) making it a tax-qualified annuity contract.

**PPVA converts real estate investment income that would otherwise be subject to FIRPTA and U.S. income taxes into annuity income which is exempt either under the provisions of a tax treaty.**

**Private Placement Group Variable Deferred Annuities (PPVA)**

The PPVA is a private placement variable deferred annuity contract issued by a U.S. life insurance company or an offshore life insurer that has made an IRC Sec. 953(d) election to be treated as a U.S. taxpayer. The PPVA contract is institutionally priced and transparent allowing for complete customization of the investment menu to include multiple real estate investments. The policy may be issued on either a group or individual policy form.

Under state insurance law, separate account investments are expressly authorized on a non-guaranteed or variable basis. The separate account assets belong to and are titled in the name of the insurance company.

For FIRPTA tax analysis, this point is the critical point. The life insurer is a domestic life insurer and is the legal and beneficial owner of the investment in U.S. real property. This U.S. real estate investment holding is reported annually as part of the insurer's holdings in the insurance regulator where the insurer is domiciled.
Separate account contract holders have no right to receive in kind distributions, or direct the purchase or sale of separate account assets. Ownership and control of separate account assets legally and contractually rest with the insurer.

In a tax-qualified annuity, the policyholder only has the ability to make a fund selection to allocate premium among one or more variable investment sub-accounts. The policyholder has no management or investment control and only receives a pass-through of any investment gains or losses.

PPVA contracts are taxed as a variable deferred annuity under the appropriate provisions of the Internal Revenue Code (IRC Sec 72 and IRC Sec 817(h)).

**U.S. Tax Qualification for Annuities**

Annuity policies must satisfy the federal tax requirements for investment diversification and investor control.

The separate account is not treated as a separate entity from the insurance company for tax purposes. Since the assets and liabilities of the separate account belong to the insurance company, any income, gains, or losses of the separate account belong to the insurance company. Changes in the value of the separate account assets are treated as an increase or decrease in tax reserves under IRC Sec 807(b).

The life insurer signs the subscription agreement of the investment option available in the PPVA contract. The life insurer maintains direct ownership over the policy’s investment assets including all of the legal rights associated with ownership.

This, the **Investor Control Doctrine** is a significant component in achieving tax qualification of the annuity. The policyholder (aka the investor) has no ownership in the investment asset owned by the insurer’s separate account and only has the right to participate in the investment gains and losses. The Investor Control Doctrine has been developed as a series of rulings and court cases. Under the traditional variable annuity or life contract, the insurer and not the policyholder is considered the owner of the underlying separate account assets.

The policyholder is not taxed on the increase in the contract’s account value. However, if the insurer gives the policyholder a degree of control over investments underlying the contract that is inconsistent with treatment of the insurer’s status as owner of the assets, the tax benefits of the policy will be forfeited. Investor control is determined based upon the facts of a specific situation.
From a federal estate tax perspective, an annuity issued by a U.S. life insurer is considered U.S. sitused property and is subject to federal estate taxation. This tax treatment is different than the treatment of life insurance on the life of the policyholder which under IRC Sec 2015 is considered non-U.S. sitused property.

As a result, the PPVA contract should be issued by an offshore life insurer that has made an IRC Sec 953(d) election to be treated as a U.S. life insurer. Alternatively, the PPVA may be owned within an irrevocable trust.

IRC Sec. 817(h) imposes investment diversification requirements for variable life insurance and annuity policies. IRC Sec. 817(h) stipulates that a single investment may not exceed more than 55% of the account value, two investments more than 70%, three investments more than 80%, and four investments more than 90%. Therefore, an investment account must hold at least five different investments. IRC Sec 818(a) provides an exemption from the investment diversification rules for pension annuities.

The tax regulations, Reg. 1.817-5 specify that all of the interests in the same real property project represent a single issue for diversification purposes. The regulations allow a five-year initial period for real estate accounts in order to comply with the diversification requirements. The same regulations provide for a two-year plan of liquidation provision in which the fund may be non-conforming with the investment diversification requirements.

**Tax Treaties and FIRPTA**

Generally, tax treaties and U.S. statutes (including the Internal Revenue Code) are on a theoretical parity. However, under IRC Sec 7852(d) Code provisions adopted subsequent to the IRC Sec 897 should supersede tax treaty provisions.

As previously stated above, the properly issued and tax compliant, annuity contract should fall squarely between the exceptions dealing with FIRPTA. The life insurance spate account is the direct owner of U.S. real estate and not the foreign policyholder. Additionally, the sale of U.S. real estate within the PPVA separate account results in no taxation to the policyholder or life insurer.
Strategy Example

Facts

Hong Lee is a wealthy Chinese industrialist. The Lee family office maintains an investment office in San Francisco that focuses on U.S. investment opportunities. The family office is looking to make significant investments in multi-family and residential housing. The family uses a real estate investment advisor, Acme Investments, an independent investment specialist, in multi-family housing to manage the investments. Acme will have discretionary authority over all investment decisions.

Solution

Acme will create a new fund that will be exclusively offered through the purchase of a PPVA contract. The PPVA will be a U.S. tax qualified annuity contract issued by a domestic life insurer, Corona Life, to the Lee Family Trust, a New Zealand Trust. Corona is domiciled in Delaware. The funds are transmitted directly to Acme and allocated to the Acme Real Estate Fund.

All of the real estate income and gains within the annuity contract will not be subject to taxation or withholding taxes under Article 17 of the U.S.–People’s Republic of China Income Tax Treaty. The annuity proceeds will not be subject to U.S. estate taxation.

Summary

Private Placement Variable Deferred annuity contracts have been under-utilized as vehicles for investments in U.S. real or funds that generate taxation as ECI. The PPVA should be given serious consideration for proposed investments that might be subject to FIRPTA or any type of investment withholding. The PPVA can convert taxable real estate and effectively connected income into tax-free income for the non-resident alien.

The key requirement for preserving the character of annuity income for tax purposes is satisfaction of the federal tax requirements for variable insurance products, principally the Investor Control Doctrine and investment diversification requirements. If these requirements are met, the character of any investment income within the annuity income is transformed into tax-free annuity income.