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## Representing Foreign Investors

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Pierre E. Debbas, Esq.  
Romer Debbas, LLP  
275 Madison Avenue, Suite 801  
New York, NY 10016  
212-888-3100  
[pdebbas@romerdebbas.com](mailto:pdebbas@romerdebbas.com)

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### I.

### **INTRODUCTION**

During the real estate boom, we experienced an influx of foreign investors investing in New York City. There were several factors that attracted foreigners to purchase real estate in New York. The exchange rate during the beginning of the 21<sup>st</sup> century through present day is largely in favor of countries overseas and made purchasing here more attractive and more affordable. The new development boom that took place was a large allure for foreign investors which resulted in about 30% of all new development purchases coming from overseas. However, representing foreign investors is drastically different than representing domestic investors or people purchasing for their personal residence. In this seminar, we will discuss the different types of properties which foreign investors should focus on, the tax ramifications for them when they sell or derive income, the creation of companies in which foreigners typically take title, as well as several different aspects of a real estate transaction that we only see with investors from overseas.

## II.

### CO-OPS v. CONDOMINIUMS

One of the most important aspects in representing a foreign investor is identifying the type of property that they can qualify for or that meets their investment objectives.

#### 1. CO-OPS

*a. Board Approval:* As you are aware, all buyers in a co-op building are subject to board approval which can be denied for any or no reason whatsoever. Several co-op boards frown upon investors (whether domestic or international) and are more concerned with seeing a buyer have other assets in the United States.

i. If a buyer of a co-op is rejected by a board, they have no recourse unless they were unjustly discriminated due to:

1. Sexual orientation,
2. Gender,
3. Age,
4. Race, or
5. Creed

*b. Lease Restrictions:* Several co-ops do not permit shareholders to lease their units and those that do permit this impose several restrictions including, but not limited to the following:

- i. Annual lease fee due to the co-op of a fixed percentage of the run (i.e. 10% of the annual rent),
- ii. A monthly lease fee equal to 20% of the monthly maintenance fees,
- iii. The tenant must be approved by the board and approval is conducted in the same manner as described in subparagraph a above.
- iv. The term of the lease must be for a minimum of 1 year and a shareholder can only rent out the unit for a fixed number of years during the course of their ownership (i.e. a shareholder can only rent their apartment for a total of 3 years, regardless of how long they have owned the unit).

*c. Board Application:* As you are aware, co-op board applications require an extensive amount of financial information about a prospective purchaser. Foreign investors are not accustomed to such intrusive requests and as a result are often reluctant to purchase co-ops. Additionally, the board can ask for the following in an application which foreigners typically will not consent to:

- i. Personal guarantees,
- ii. Maintenance held in escrow, and/or
- iii. Recommendation letters.

## 2. CONDOMINIUMS

- a. Real Property:* a condominium unit is treated as real property (i.e. not shares in a corporation like a co-op).
- b. Transferability:* condominium units can be bought or sold without the approval of the board (with the exception of the board's right of first refusal). The lack of restrictions in buying and selling a condominium unit and the lack of having a board arbitrarily approve/reject a purchaser makes an investment in a condominium much more attractive and a safer investment.
- c. Leasing The Units:* a condominium unit owner can freely lease their unit to whomever they want. The only restrictions typically imposed by the condominium are:
  - i. Right of first refusal,
  - ii. Application fee,
  - iii. Lease must be at least 1 year,
  - iv. Lease cannot be more than 1 year, and
  - v. No transient occupancy (i.e. short term rentals such as 5 days, 2 months, etc.).
- d. Sponsor Units:* Foreign investors are frequently drawn to new development buildings due to their amenities, tax abatements and the ability to charge higher rents.

## 3. CLOSING COSTS

- a.* One item to be specifically aware of is the drastic difference in closing costs between, co-ops, resale condominiums and new developments. Below is a breakdown in the different closing costs associated with each type of property.

### **Based on a \$1,500,000 Purchase Price and a \$750,000 Loan**

	Co-ops	Condos	New Developments
<i>Purchase Price</i>	<i>1,500,000</i>	<i>1,500,000</i>	<i>1,500,000</i>
<i>Mortgage/Loan</i>	<i>750,000</i>	<i>750,000</i>	<i>750,000</i>
<i>Loan Application</i>	<i>\$750</i>	<i>\$750</i>	<i>\$750</i>

<b>Board Application</b>	<b>\$500</b>	<b>\$500</b>	<b>N/A</b>
<b>Title Insurance</b>	<b>N/A</b>	<b>\$6,350</b>	<b>\$4,450</b>
<b>Mortgage Premium</b>	<b>N/A</b>	<b>\$890.00</b>	<b>\$740.00</b>
<b>Misc. Title Insurance Expenses</b>	<b>N/A</b>	<b>\$1,200</b>	<b>\$1,200</b>
<b>Mortgage Recording Tax</b>	<b>N/A</b>	<b>\$14,450</b>	<b>\$14,450</b>
<b>Mansion Tax</b>	<b>\$15,000</b>	<b>\$15,000</b>	<b>\$15,280</b>
<b>NYC Transfer Tax</b>	<b>N/A</b>	<b>N/A</b>	<b>21,800</b>
<b>NYS Transfer Tax</b>	<b>N/A</b>	<b>N/A</b>	<b>6,120</b>
<b>Sponsor's Legal Fee</b>	<b>N/A</b>	<b>N/A</b>	<b>\$1,500</b>
<b>Managing Agent Fees</b>	<b>\$750</b>	<b>N/A</b>	<b>N/A</b>
<b>Bank's Closing Fees</b>	<b>\$1,250</b>	<b>\$1,250</b>	<b>\$1,250</b>
<b>Misc. Fees (i.e. Legal Fees, adjustment, etc.)</b>	<b>\$5,000</b>	<b>\$5,000</b>	<b>\$8,000</b>
<b>TOTAL</b>	<b>\$23,250</b>	<b>\$45,390</b>	<b>\$75,540</b>

### III.

### FINANCING

Financing for foreign investors is significantly different than that of first time home buyers and domestic investors. Banks are more concerned with their ability to go after a borrower from overseas in the event of default of the mortgage. Typically, most foreign investors do not have income or other assets in the States. This poses a serious business risk to the lending institutions.

#### 1. UNDERWRITING REGULATIONS

##### *a. Requirements for Borrower:*

- i. 50% down (i.e. 50% loan to value ratio).
- ii. Maximum loan amount \$1,500,000.
- iii. \$100,000 minimum deposit balance in the bank post-closing.
- iv. 12-24 month reserve
- v. Full documentation from the borrower with respect to a CPA letter, employment letter which must reference the last 3 years of income for the borrower.

##### *b. Requirements for the Building:*

- i. New Development: requirement for 70% (in some cases 50%) of the units to be closed or in contract.
- ii. Resale: no bulk investors owning more than 10% of the units.

### IV.

### LIMITED LIABILITY COMPANIES & OFF-SHORE COMPANIES

When representing a foreign investor, it is prudent to advise them to purchase the property in the name of a limited liability company.

#### 1. LIMITED LIABILITY COMPANY (“LLC”)

- a. A LLC will take title to a property and the member(s) of the LLC would be your individual clients.
- b. The LLC is a shield of protection for any purchaser with respect liability stemming from their ownership of a property.
- c. The LLC limits any liability or claims stemming from the ownership of a property to just the value of that property. The person making a claim against the owner cannot make it against them individually or go after any other assets which the owner has in the States (or overseas).
- d. The steps to creating an LLC are:
  - i. Operating Agreement: one must be created for the LLC which lists the members and states how the LLC is to be operated and managed.

- ii. Articles of Organization: this document must be filed with the State and is then returned to the members evidencing that it has been filed.
- iii. Publication: under New York law the LLC must be published with two newspapers for six consecutive weeks.
  - 1. The City/State filing fees and publication fees amount to approximately \$1,100.00 (excluding legal fees).

## **2. TAX BENEFITS FOR AN LLC**

- a.* An LLC is generally taxed like a partnership or a corporation. In the structure of a partnership, the members of the LLC will pay income tax at their individual rates and not at the corporate rate.
- b.* It is treated as a pass-through tax structure where the income passes directly through the LLC and to its individual members.
- c.* The net rent roll for the unit ends up being taxed at the individual rate for your client.

## **3. OFF-SHORE COMPANIES**

- a.* Several foreign investors purchase a property in the name of an LLC with a non-US entity (i.e. British Virgin Island Company) being the sole member of the LLC.
- b.* Your individual clients will then be the members of the off-shore company which owns the LLC outright and the LLC owns the property.

## **4. TAX BENEFITS FOR USING AN OFF-SHORE ENTITY**

- a.* Your client's income tax liability for the rent roll will not change if the off-shore company is the sole member or your client individually is.
- b.* The purpose of the off-shore company is to potentially avoid having your client pay estate tax in the U.S.
- c.* We would confer with estate counsel to see what the size of the estate would be and if it is beyond any exemptions offered and also with the foreigner's local counsel with respect to any tax implications or required structures in their country of residence.
- d.* The reason an off-shore company helps avoid paying estate tax is that the company's only asset is the LLC and the LLC (not the off-shore company) actually owns the apartment. Therefore, the off-shore company does not own any specific asset in the States, rather shares in an LLC and the members of the off-shore company do not directly own anything in the States.

## V. GAINS TAX & WITHHOLDING TAX FOR FOREIGN INVESTORS

Whether the property is owned in an individual's name, the name of an LLC or an LLC with an off-shore company as the sole member, the foreign seller must pay New York State Non-Resident Gains Tax and Federal Capital Gains Tax.

### 1. **GAINS TAX CALCULATION – Based on \$1,800,000 Sales Price (\$300,000 Gross Gain)**

#### a. Closing Costs on Sale

1. NYC Transfer Tax:	\$ 25,650
2. NYS Transfer Tax:	\$ 7,200
3. Brokers Commission	\$108,000
4. Misc. Expenses	<u>\$ 4,000</u>

b. Total Closing Costs on Sale \$144,850

#### c. Calculating of Taxable Basis

##### 1. Closing Costs from Purchase (\$1,500,000) and Sale of Property

a. Purchase Price:	\$1,500,000
b. Closing Costs from Purchase (resale):	\$ 45,390
c. Closings Cost from Sale (average):	\$ 144,850
d. Capital Improvements (if any):	<u>\$ 20,000</u>

d. Total Combined Closing Costs \$1,710,240

#### e. Net Capital Gain

a. Sales Price of	\$1,800,000
b. Total expenses	<u>(\$1,710,240)</u>

f. Total Capital Gain \$ 89,760

### 2. **NEW YORK STATE NON-RESIDENT GAINS TAX**

a. 8.82% of \$89,760 = \$ 7,917

### **3. FIRPTA WITHHOLDING TAX AND FEDERAL CAPITAL GAINS TAX**

- a. Federal Capital Gains Tax of 20% of \$89,760                      \$ 17,952  
(depending on what the Federal Gains Tax is  
at the time of sale)
  
- b. FIRPTA Withholding Tax of 15% of the Gross Sales Price of \$1,800,000  
which equals \$270,000. If you are current on all of your other taxes owed  
to the IRS (i.e. income taxes, capital gains tax, etc.) then you should receive  
the sum of \$252,048.00 as a refund of the 10% that was withheld at the  
sale.

### **VI. CONCLUSION**

When representing a foreign investor you should be mindful of the various liability and tax ramifications involved. It is important to align yourselves with attorneys and accountants that are experienced in this particular area.

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