US
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Real estate swaps

Generally, under US federal income tax law, a foreign person's gain from the disposition of an interest in US real property is deemed to be effectively connected with a US trade or business. As a result, any such gain is subject to income tax at rates up to a maximum of 35% in the same manner as a US taxpayer. For this purpose, an interest in US real property includes any direct or indirect right to share in the appreciation in the value of real property. In addition, US source income received by a foreign person and not effectively connected with a US trade or business is generally subject to a flat 30% tax, although this rate may be decreased or eliminated by an applicable tax treaty or an exception under domestic US tax law. In contrast, non-US-source income received by a foreign person (such as income derived in respect of most swaps) is generally exempt from US federal income tax. Until recently, it was unclear whether income derived in respect of a swap on US real estate interests should be exempt from US tax.

In a recent ruling (Revenue Ruling 2008-31), the Internal Revenue Service (IRS) held that an interest in a swap contract, the return on which is calculated by reference to a broad-based US real estate index, does not constitute an interest in US real property. The ruling involves a foreign corporation that enters into a swap with a US counterparty based on a widely published index calculated by reference to sales prices, appraisals, reported income, or other objective financial information gathered from a given US geographical area. The index measures real estate values in geographic areas with populations exceeding one million people that contain a broad range of real property holdings of unrelated owners during a relevant testing period. Pursuant to the terms of the swap, the foreign corporation receives the value of any index appreciation and suffers a loss on any index depreciation. The IRS ruled that the broad-based nature of the index does not represent a direct or indirect right to share in the appreciation in the value of real property. As a consequence, income derived under such a swap contract is not deemed to be effectively connected with a US trade or business and therefore not subject to tax at full graduated rates. Further, income derived in respect of a swap is generally sourced to the residence of the payee. Thus, under these rules, a foreign person's income from a swap is generally treated as foreign source income and therefore not subject to a flat 30% US tax, which, as discussed above, is only levied with respect to US source income. As a result, a foreign person that enters into a swap payments which are determined by reference to a broad-based US real estate index should not be subject to any US taxes.

It is important to note, however, that the ruling draws several boundaries. The foreign corporation and the US counterparty must not be related and must not otherwise have an interest in the underlying real property. Moreover, neither the foreign corporation nor the US swap provider may be related to the entity that maintains the index, and the index must be based on a broad range of unrelated real-estate owners over a large geographic area. An example of such an index is the NCREIF Property Index, published by the National Counsel of Real Estate Investment Fiduciaries. This index measures the performance of a very large pool or individual commercial real estate properties acquired in the private market for investment purposes only.

It is unclear whether and to what extent the IRS would be willing to diverge from the facts of the ruling and still hold that income derived from a swap would not constitute gain from an interest in US real property. That said, foreign investors who have the stomach to invest in the US real estate market may now do so without incurring any US taxes by entering into a properly structured swap.

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