

Client Bulletin

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Foreign Airlines and Ownership of Real Property in the United States: Sell or Swap

Many foreign airlines own real property in the United States. While they are exempt from income tax for airline based operations in the United States, foreign airlines may face a significant tax burden when selling property in the United States unless they explore the availability of all possible exemptions or exceptions that U.S. tax law provides with respect to the sale of real property.

Like Kind Exchanges

One primary vehicle to address tax liability created by the sale of real property is known as the "like-kind exchange." Under Section 1031 of the Internal Revenue Code, there is an exception to the general rule that a gain or loss is recognized in the year the property is sold or exchanged. Under the like-kind exchange provision, no gain or loss is recognized when property held for productive use in a trade or business or for investment is exchanged solely for "like-kind" property. The term "like-kind" refers to the nature or character of property and not to its quality. Properties exchanged must be compared to determine whether their nature and character are substantially alike. Certain properties are ineligible for like-kind treatment under Section 1031, including stock in trade, inventory and other property held primarily for sale.

There are two time limitations under Section 1031. To be entitled to non-recognition treatment, the replacement property must be identified in writing within 45 days after the date on which the taxpayer transfers the property

relinquished in the exchange. Second, the replacement property must be received by the earlier of 180 days after the date on which the taxpayer transfers the property relinquished in the exchange or the due date for the taxpayer's return for the taxable year in which the transfer of the relinquished property occurs.

Section 1031 exchanges can reduce or eliminate a significant part of a corporation's tax liability. In the event that the purchase price of the replacement property is equal to or greater than the subject property that is being sold, most income tax liability can be eliminated. A proportional Section 1031 exchange is available as well. Purchasing a replacement property at a price less than the price of the property being sold results in a partial proportional reduction of income tax liability.

One of the benefits of like-kind exchange is that there is no requirement that the new property be occupied by the corporation as a tenant. The property could be purely a rental investment (i.e., office building, retail center or industrial building). Replacement property already (1) should be tenant occupied and (2) should have professional management in place. This eliminates the "headaches" associated with being a landlord. Of course, if the seller so desires, it could occupy a portion of the replacement property. The most significant impact of the like-kind exchange is that in the event the corporation wants or needs cash for its core operations, it would have unencumbered cash available for its use as collateral. Commercial lenders may make revolving credit available to a corporation utilizing the replacement property as collateral. This course of action offers the corporation the greatest return on investment without sacrificing financial safety and flexibility. Another alternative is for the corporation to take out a new mortgage at closing on the replacement property and have cash immediately available.

Under the like-kind exchange provision, a foreign airline willing to invest in real estate will be able to defer the gain recognized from the sale of real property. This offers the foreign airline a superior option to paying state and federal taxes on that income or gain.

Branch Profit Tax

When real property is sold in the United States by a foreign corporation, a Branch Profit Tax (BPT) is imposed. BPT is imposed in addition to income tax or a gain from the sale of property.

The objective of BPT is to treat U.S. branches of foreign corporations identically to a U.S. subsidiary of a foreign corporation with respect to remittance of earnings (dividends). U.S. subsidiaries of foreign corporations are subject to U.S. withholding taxes when they remit dividends to their foreign parents. The BPT tax applies to foreign corporations, to the extent after tax earnings are effectively connected with a U.S. trade or business, when those earnings are not reinvested in a U.S. trade or business by the close of the taxable year or are disinvested in a later taxable year. The rate of tax imposed is a statutory rate of 30% which is reduced, in some cases, by a U.S. income tax treaty.

Exceptions – Reinvestment and Branch Termination

BPT is not triggered if the U.S. branch of a foreign corporation reinvests all of its accumulated effectively connected earnings and profits back in the U.S..

As a general rule, the BPT does not apply if a foreign corporation completely terminates all of its U.S. trade or business activities. The following requirements must be met:

- (1) The foreign corporation must cease to have any U.S. assets;
- (2) Neither the foreign corporation nor any related corporation may reinvest in a U.S. trade or business within three years;
- (3) The foreign corporation must have no Effectively Connected Income for three years from the end of the termination year; and

- (4) Procedural requirements must be met.

There are procedural requirements for electing the branch termination exception. The foreign corporation must attach to its income tax return a waiver of the statute of limitations on assessment of the branch profit tax. The waiver must extend the period of assessment until the end of the sixth year following the termination year. The waiver permits the IRS to assess branch profits tax for the termination year if the three-year prohibition is violated. The waiver must be signed by the person authorized to sign the foreign corporation's income tax returns, and filed on or before the due date (including extensions) of the foreign corporation's income tax return for the year of complete termination.

A limited exception to BPT applies to foreign governments (pre-9/11/92 after tax earnings exempt) while a full BPT exception applies to an international organization which is defined as a public international organization entitled to enjoy privileges, exemptions, and immunities as an international organization under the International Organizations Immunities Act.

Conclusion

When selling real property in the United States, foreign airlines and foreign companies should consider implementing a like kind exchange and addressing the branch profit tax in order to ensure they are maximizing their real property sales, tax and legal strategies.



If you have any questions regarding this Client Bulletin or would like to be added or removed from this electronic mailing list, please contact:

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