FOREIGN OWNERSHIP OF REAL PROPERTY IN KENTUCKY

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In 1997, United States affiliates of foreign persons owned approximately $1.1 billion of commercial property in Kentucky,[1] and foreign persons owned almost 120,000 acres of Kentucky agricultural land.[2] Clearly, there is substantial foreign investment in Kentucky real property and, consequently, a need for Kentucky real estate practitioners to know the issues surrounding the acquisition, ownership and disposition of real property in Kentucky by foreign persons.

This article by no means describes all the legal issues involved in representing foreign persons who purchase, own or sell real estate in Kentucky (e.g., minimizing tax consequences, estate planning, etc.), but provides a broad overview of the principal issues specifically surrounding foreign acquisition, ownership and disposition of real property in Kentucky.

1. Kentucky Escheat Statutes

Absent a treaty to the contrary, each state may prohibit aliens from owning real property within its borders.[3] A state may also forbid indirect ownership of real property by a corporation where a majority of the shareholders are aliens.[4]

Under the common law, an alien could only take real property by the act of a party (i.e., purchase or devise), but could not take real property by an act of law (i.e., descent).[5] The alien's title acquired by purchase or devise was good against all persons but the state.[6] Such title could be held until the alien was divested of title by inquest of office or an escheat action brought by the state,[7] and no one had the right to complain if the state did not enforce its escheat rights.[8] However, because there could be no inheritance by descent from an alien, on the death of an alien or upon the death of a citizen who left only alien heirs, the real property of the decedent escheated to the state without an escheat action.[9]

K.R.S. Â§ 381.290 - Â§ 381.340 (the "Escheat Statutes"), which modify but do not replace the relevant common law, expressly provide for the escheat of Kentucky real property held by certain aliens. However, the Escheat Statutes confer upon a non-resident alien the right to hold real property in Kentucky for a given period,[10] and allow a non-resident alien to acquire and pass real property by both devise and descent.[11]

Under the Escheat Statutes, the real property of a non-resident alien may be escheated to the Commonwealth at any time after the expiration of eight years from the time the non-resident alien[12] acquires title to the realty.[13] Upon the expiration of the eight-year period, the real property does not automatically escheat to the Commonwealth. The Commonwealth must bring an escheat action,[14] and if the alien becomes a U.S. citizen or transfers the property to a citizen before the property is escheated, the Commonwealth has no further escheat claim.[15]

Under exceptions to the Escheat Statutes, the following aliens may acquire, hold and dispose of real property, free from the threat of escheat:

1. An alien, not an enemy,[16] may recover, inherit, hold and pass by descent, devise or otherwise, any real property, if such alien declares his or her intention to become a citizen of the U.S., according to the forms required by law. [17]

2. The spouse of a U.S. citizen and the children of a U.S. citizen, although born out of the U.S., may also take and hold real property by devise, purchase, descent or distribution.[18]

3. Any alien, not an enemy, who resides within Kentucky may, as long as he or she remains a resident of Kentucky as if he or she was a citizen of the U.S., take and hold residential real property, real property which

is occupied by the alien or his or her servants, and real property held for any business, trade or manufacture.[19] This exception would not likely apply to vacant or idle land.

The escheat provisions do not apply to a domestic corporation, the shares of which are partially or wholly-owned by non-resident aliens.[20] The rationale for this exception is that a domestic entity, distinct from its foreign shareholders, owns the real property, and the foreign shareholders merely hold a personal property interest (i.e., stock of the corporation), which is expressly permitted by the Escheat Statutes.[21] While real property held by a foreign corporation appears to be subject to escheat,[22] K.R.S. Â§ 271B.15-050(2) provides that if a foreign corporation qualifies to transact business in Kentucky, it is entitled to the same rights and privileges as a domestic corporation. Therefore, real property held by a qualified foreign corporation would presumably not be subject to escheat.

2. Foreign Investment in Real Property Tax Act, I.R.C. Â§ 897 and I.R.C. Â§ 1445 ("FIRPTA")

U.S. tax laws attempt to subject income that a foreign person realizes from U.S. real property interests to two levels of tax: (i) regular tax on operating income and gain from the disposition of U.S. real property interests; and (ii) withholding tax on the repatriation of operating income and gain on any disposition.[23] While advising a foreign client regarding minimization or avoidance of these taxes requires a detailed review of FIRPTA and the applicable regulations, a Kentucky real estate lawyer more commonly needs to be aware of the withholding obligations FIRPTA places on purchasers of real property interests sold by foreign persons.

Under Section 1445 of the Internal Revenue Code of 1986 (the "Code"),[24] a withholding requirement is triggered if: (i) the transferor is a foreign person, and (ii) the transferee is acquiring a United States real property interest ("USRPI"),[25] as defined by Section 897 of the Code.[26] If both of the forgoing are true, the transferee is required to withhold 10% of the amount realized by the transferor upon the sale of real property.[27]

In general, a "foreign person" under Section 1445 is a non-resident alien individual, foreign corporation, foreign partnership, foreign trust or foreign estate, but not a resident alien individual.[28] A domestic corporation will not be considered a foreign corporation, even if its shareholders are foreign persons. Additionally, a foreign corporation which has made a valid election under Section 897(i) of the Code will generally not be treated as a foreign person.[29]

There are several specific exceptions to the withholding requirement under Section 1445 of the Code. However, the most common exception is when the transferee obtains an affidavit or certificate stating that the transferor is not a foreign person. In determining whether the transferor is a foreign person, the transferee is permitted, by a safe harbor set forth in the regulations, to rely upon a certificate from the transferor certifying that the transferor is not a foreign person.[30] For this purpose, a disregarded entity (i.e., an entity that is disregarded as a separate entity from its owner by applicable Treasury Regulations, such as most single-member limited liability companies) may not make the certification; instead, the owner of the disregarded entity is considered the transferor.[31] No particular form is required for the certificate;[32] however, the certificate must (i) state that the transferor is not a foreign person, (ii) set forth the transferor's name, identification number and home address (in the case of an individual) or office address (in the case of an entity), (iii) be signed under the penalty of perjury and (iv) where the transferor is an entity, state that the transferor is not a disregarded entity.[33] The certificate must be retained by the transferee until the fifth taxable year following the year in which the transfer takes place.[34] A transferee will not be entitled to rely on the certificate if the transferee has knowledge that the certificate is false.[35] A transferee may rely on other means to determine the non-foreign status of a person, but unless the above-described safe harbor certificate is used, the transferee will be liable under FIRPTA if the transferor is, in fact, foreign.[36]

Additionally, transferees need not obtain such a certificate where the real property is residential real property acquired by the transferee for use by the transferee as a residence, and the amount realized does not exceed $300,000.00. This residential purchase exemption is another exception to the withholding requirement.[37]

A transferee who is required to deduct and withhold the tax under Section 1445 of the Code but fails to do so will be liable for the tax, penalties and interest. Corporate officers of the transferee may be subject to a civil penalty equal to the amount that should have been withheld.[38]

3. Federal Reporting Requirements

Perhaps the most surprising legal obligations for foreign persons owning real property in the United States are the broad reporting requirements under Federal law, including the International Investment and Trade in Services Survey Act (the "International Survey Act") [39] and the Agricultural Foreign Investment Disclosure Act. [40]

A. The International Survey Act

The International Survey Act requires certain real estate transactions and ownership to be reported to the Bureau of Economic Analysis ("BEA"). The purpose of the International Survey Act is to provide comprehensive and reliable information pertaining to international investment. The International Survey Act applies to an array of investments in the United States by foreign persons, including investments in real estate.[41]

If the International Survey Act applies, an Initial Report on Form BE-13 must be filed within 45 days of an acquisition where a "foreign person" establishes or acquires directly, or indirectly through a U.S. affiliate (a U.S. business enterprise in which a foreign person owns or controls, directly or indirectly, 10% or more of the voting stock of a corporation or the equivalent if not a corporation), a 10% or more interest in a U.S. "business enterprise" (which includes any real estate).[42] Under the International Survey Act, a "foreign person" generally means a person residing outside of the U.S.[43]

Acquisitions of residential real estate held exclusively for personal use[44] and U.S. business enterprises, including realty, which have assets of $3,000,000 or less and do not own 200 or more acres[45] are exempt from the requirement of filing an Initial Report. If an exemption is claimed (other than an exemption for residential real estate held exclusively for personal use), an Exemption Claim on Form BE-13 must be filed with the BEA.

In addition to requiring the foreign investor's U.S. affiliate or the business enterprise to file a report, a person who (i) assists or intervenes in the sale to or purchase by a foreign person or a U.S. affiliate of a foreign person of a U.S. business enterprise, including real estate, or (ii) enters into a joint venture with a foreign person or a U.S. affiliate of a foreign person to create a U.S. business enterprise, is required to file a Form BE-14 with the BEA.[46] However, it is not incumbent upon the person assisting or the joint venturer to ascertain the foreign status of the acquiring party, unless the person has reason to believe the acquiring party may be a foreign person.[47]

U.S. affiliates of foreign persons that meet certain parent ownership and size criteria (based on total assets, gross revenues and net income) are also required to file a Benchmark Survey every five years (the next one to be conducted in 2007) which is basically a census of foreign investment in the U.S.[48] The regulations relating to the 2007 Benchmark Survey have not been released; however, they will presumably be similar to the 2002 Benchmark Survey Regulations.[49] Similarly, U.S. affiliates of foreign persons of a certain size (i.e., with any of its total assets, gross revenues or net income (positive or negative) in excess of $30,000,000) are required, depending on their activities, to file annual or quarterly reports with the BEA.[50]

While information contained in the international surveys is confidential,[51] failure to file the surveys as required can have severe penalties. Simply failing to file a survey can result in a civil penalty from $2,500 to $25,000, while willful violations carry fines of up to $10,000 and one year's imprisonment.[52]

B. Agricultural Foreign Investment Disclosure Act ("AFIDA")

The AFIDA requires certain persons to file a Form FSA-153 (a "Report")[53] with the Farm Services Agency (the "FSA"). The purpose of the AFIDA is to determine the effect of foreign investment in agricultural land on family farms and in rural communities.[54]

A Report is required to be filed with the FSA when any foreign person acquires or transfers any interest in "agricultural land",[55] defined as land used for agricultural, forestry or timber production, or idle land that was used for such within the last five years.[56] The Report must be filed each time such a transaction occurs. The

Report must also be filed (i) if a person who holds or acquires an interest in agricultural land becomes a foreign person or (ii) if land held or acquired by a foreign person is converted to agricultural use.[57]

An individual is considered a "foreign person" under AFIDA if he or she is not a citizen of the U.S., is not a citizen of the northern Marianna Islands or the trust territory of the Pacific Islands or is not lawfully admitted to the U.S. for permanent residence or paroled in the U.S. under the Immigration and Nationality Act.[58] Entities which are created or organized under the laws of a foreign government, or which have their principal place of business located outside the U.S., and foreign governments are considered "foreign persons."[59] A domestic entity will also be considered a foreign person if (i) an interest of 10% or more in the entity is held by a single foreign person, (ii) an interest of 10% or more is held by a group of foreign persons who act in concert with respect to the interest or (iii) an interest of 50% or more in the aggregate is held by foreign persons, even though they may not be acting in concert.[60]

If the AFIDA applies, the Report must be filed within 90 days of the acquisition, disposition or other circumstance that triggered the AFIDA's application.[61] The Report must be filed with the FSA County office in the county where the land is located (or in some cases may be filed in the District of Columbia).[62] The Report requires disclosure of detailed information regarding the foreign person and the transaction which invoked the AFIDA. Unlike the International Survey Act, the AFIDA Report is available for public inspection.[63]

If a foreign person fails to submit the Report or knowingly submits a Report which is incomplete, misleading or false, the foreign person is subject to civil penalties.[64] The penalty for filing a Report late is 1/10 of 1% of the fair market value of the foreign person's interest in the agricultural land for each week the violation continues (capped at 25%).[65] The penalty for submitting an incomplete Report, a Report containing misleading or false information, failing to submit a Report or failing to maintain a submitted Report with accurate information is 25% of the fair market value of the foreign person's interest in the agricultural land.[66]

4. Conclusion

It is incumbent upon the real estate practitioner to know his or her client and to inquire about the status of the other parties to a real estate transaction. If a real property transaction involves single family, owner-occupied residential real property, the above Acts will generally be of little or no consequence. However, all the above-discussed Acts will have some relevance to commercial real property transactions.

An established practice is for a foreign person to hold commercial real property in a domestic corporation. If a domestic corporation is utilized, the Escheat Statutes and FIRPTA will have no bearing on the real property transaction. However, regardless of the form in which commercial real property is held, the parties must comply with federal reporting requirements, which cannot be avoided by utilizing a domestic corporation.