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Taxation Agreement Between Turkey and the USA*

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I. USA/ Turkey Taxation Agreement

Whenever an individual or business invests in a foreign country, the question of which jurisdiction should tax the investor's earnings may arise. Given the growth in globalization, this issue is increasingly relevant. To save the taxpayer from this jurisdictional conflict of interest, countries form treaties designed to avoid double taxation, which arises when income from the same source is taxed in two countries. Additionally, these treaties aim to prevent tax evasion and encourage cross-border trade efficiency between the countries. Moreover, the agreements tend to reduce taxes imposed by the U.S. Internal Revenue Code (IRC) on international investors. This memo will explore the tax agreement between the United States and Turkey and address the options available to Turkish investors regarding the taxation of income generated from ownership of U.S. property.

The Turkey/United States tax agreement is not unlike other tax treaties. The first ten articles of the treaty guide foreign companies and investors to determine their tax liability and to whom they are liable. The first two articles identify whose tax obligations are affected and what taxes are covered by the treaty. Article 3 defines general terms used in the treaty, while Articles 4 and 5 define and provide rules for determining where an investor is a **"resident"** and if there exists a **"permanent establishment"** respectively.

Articles 6 - 21 calculate which, or whether both, of the States, can tax income. The relevant types of income for foreign investors in U.S. property include profits from immovable property **(Article 6),** business profits **(Article 7),** shipping and air transport **(Article 8),** associated enterprises **(Article 9),** and dividends **(Article 10).** Finally, article 23 lays out the method for eliminating double taxation. Under this provision, the State entitled by the rules in Articles 6 -12 to tax income must provide taxpayer relief from double taxation. Both the U.S. and Turkey adopt the credit method under which the residence country taxes the income but provides a deduction from that tax paid to the source country on tax liability in the resident country.

II. Tax Implications for Foreign Owners of U.S Real Property

Article 6 of the tax treaty provides that income derived from immovable property is subject to taxation by the State in which it is located. Accordingly, the United States is entitled to tax income from U.S. properties owned by Turkish investors. However, Turkey's tax regulations also warrant the taxation of rental income from foreign property. Thus, with both countries entitled to tax the same income, Turkish investors face a possible double taxation issue.

A. Residency for Taxation Purposes

Residency status will affect how Turkish investors are taxed in the United States. For U.S. tax purposes, foreign nationals are either nonresidents or resident aliens. The latter, resident aliens, are treated as U.S. citizens regarding taxation. Where nonresidents are taxed only for their U.S. source income, the United States tax resident aliens on their worldwide income.

Article 4 of the treaty determines residency for tax purposes. The provision outlines the criterion for residency and provides "tie-breakers" in situations where it may be less clear. Since the focus of this memo is on U.S. property ownership, the assessment of options for Turkish investors will assume nonresident for U.S. taxation. However, foreign investors need to assess their own residency status as it will influence the tax paid to the United States.

B. U.S. Taxation of Nonresident Aliens

The taxation of U.S. rental income of a nonresident depends on whether the foreign owner of the property engaged in a **"U.S. trade or business"**. The United States taxes any income received by a foreign investor efficiently connected with their U.S. trade or business on a net basis. While there is no formal definition of **"trade or business,"** previous I.R.S. rulings demonstrate that it is met by **"considerable, continuous, and regular"** economic activities within the United States. Rental income generated by U.S. property fails to rise to this classification for foreign investors. Generally, this form of income is typically deemed **passive income** and is subject to a flat 30 percent gross income. However, investors can make an election under I.R.C. § 871(d) to treat rental income as efficiently connected income.

The election allows the Turkish investor to be taxed at graduated rates and take business deductions before paying the tax.

Expenses including mortgage interests, real property taxes, maintenance, repairs, and deprecation may be deducted in determining net taxable income.

The Turkey Tax Agreement does not contain a specific provision allowing for the net election like similar tax treaty agreements. Despite the absence of this disclosure, Turkish investors mustn't forget this option is available to them. In making this election, the investor agrees to prepare a U.S. tax return to report rental income earned. The taxpayer will need to apply for an Individual Taxpayer Identification Number (ITIN)using Form W-7 and submit the document with the tax return. In addition, the investor must complete and submit Form W-8ECI to the withholding agent. Although the net election requires additional work, it is more advantageous to the investor as it allows the deduction of necessary expenses incurred while operating the property and for the remainder to be taxed at likely lower ordinary income tax rates.

C. Turkish Tax Liability and Double Taxation Relief

Article 23 of the treaty details the methods each country must employ to prevent double taxation. According to the provision, a resident of Turkey who derives income subject to taxation in both the United States and Turkey receives an equal amount deduction from the Turkish tax on that individual's income. However, the deductions may not exceed the amount of the tax assessed on such income in Turkey. In addition, the foreign tax paid must be documented by foreign tax office receipts approved by the Turkish consulate in the United States.

III. Ownership Structure Options for Tax Mitigation

Before investing, foreign individuals need to consider the tax consequences and benefits of different ownership structures. The most advantageous approach will vary depending on an investor's circumstances and objectives. Finding the proper form can mitigate taxes paid to the U.S. and their home countries.

A. A Note on Direct Ownership

Observing the structure options purely from an income tax standpoint, direct ownership of U.S. property by a foreign national is the most cost-effective structure. Foreign investors are subject to one of the two taxation regimes expressed previously. The controlling regime will depend on the property's connection to trade and business activities or the investor's decision to be taxed on a net basis. These regimes present lower income tax than that faced by a corporation. Individual owners also have the advantage of lower federal capital gains rates and ease of repatriation of funds without additional taxation. Despite the benefits this approach provides, it is relatively uncommon given several disadvantages.

Direct ownership exposes the property to U.S. estate tax when the foreign owner dies. Additionally, a gift of some or all the property is also subject to U.S. gift tax. If the Turkish investor elects to be taxed on a net basis, they must file federal and state tax returns, surrendering their anonymity. A foreign investor who does not expect to hold the property for an extended period and is not concerned about anonymity may find this structure best suited for their investment.

When the investment is real estate itself, or any liability concerns exist, investors will benefit from owning the asset through a limited liability company (LLC). Direct ownership is particularly risky because lawsuits can be brought against the owner directly, leaving the investor's personal assets exposed. An LLC offers liability protection by creating a division between business activities and the owner. Although an LLC may be appealing for its business characteristics, from a tax standpoint, it has minimal benefits. LLCs are often treated as disregarded entities for tax purposes, meaning they are treated as if they were directly held by a foreign investor.

B. Corporations

Foreign investment in U.S. real property through corporate ownership is the favored method of holding title to U.S. real estate. Once the decision to use a corporation has been made, the question arises as to whether the entity should be domestic or foreign. Each method carries with it its own consequences and benefits.

i. Domestic Corporation

One of the key advantages of ownership through a corporation, which distinguishes it from direct ownerships, is the liability shield it provides its nonresident owner while offering potential tax benefits. Additionally, the corporation acts as its taxpayer, eliminating the responsibility of the foreign owner to file federal and state tax returns. However, this structure only offers partial anonymity because of disclosures on tax returns filed by the corporation.

U.S. corporations are subject to federal income tax on current income (net of deductions) at graduated rates exceeding those faced by individual owners, and a flat withholding tax when the profits are repatriated to the foreign shareholder. This structure also creates an extra tax burden for the foreign investor with increased capital gain rates and the second layer of taxation upon repatriation of profits. Another disadvantage of this structure is that the value of the stock in the domestic corporation is subject to U.S. estate tax upon the death of the foreign individual. However, the gift of stock in a domestic corporation is not subject to U.S. gift tax. While an option to the investor, the use of a U.S. corporation by foreign investors is very limited and often, not advisable.

ii. Foreign Corporation

A foreign corporation, like a foreign individual, is subject to one of the two tax regimes. If it is not engaged in U.S. trade or business, it will face a gross withholding tax of 30%. If engaged in these activities or if there is an election to be treated as such, the corporation income will be taxed on a net basis. However, compared to the foreign individual, the marginal net basis regime is significantly higher. Moreover, the corporation would be subject to a branch profit tax of 30% on the earnings that were not reinvested in the property or some other U.S. trade or business. If there is a gain on sale of the property, it would be taxed at the same rates as income. However, if there are no other U.S. assets in the corporation, the company may avoid branch profit tax. The stock of the foreign corporations is not subject to estate tax upon the death of an individual. Similarly, a gift of stock is not subject to U.S. gift tax.

C. Non-Grantor Foreign Trust

A trust offers several advantages for foreign buyers of U.S. real estate. Not only can it reduce U.S. taxes, but it can also protect the buyer's privacy and non-trust assets.

A non-grantor trust is taxed as if it was an independent taxpayer. For foreign trusts, this means that trust is taxed like a nonresident alien. Income is taxed at accelerated marginal rates, but the trust is entitled to a deduction to the extent it distributes income during the year it is earned. Such income is taxed to the beneficiaries who receive the disruptions. Property held in a non-grantor trust will not be included in the settlor's estate. This structure is beneficial to foreign investors as it limits U.S. income tax on profits and gains to rates applicable to individuals without exposing them to U.S. estate tax. It is imperative to note that this structure imposes important reporting requirements, which can result in significant penalties if not satisfied.

IV. Conclusion

Tax treaties between countries create opportunities for foreign investors to mitigate their tax liability and avoid taxation of income in both States. Knowledge of the ownership structure options available and the implication they play on tax liabilities in both Turkey and the United States will help investors make decisions that best suit their circumstances and objectives in owning U.S. real property.