

Foreign Investment in Real Property Tax Act 1980 – Buyer AND Seller Beware

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This article summarizes the tax withholding rules imposed on a buyer and his/her agent when purchasing U.S. real estate from a nonresident alien for U.S. tax purposes.

Nonresident alien individuals and foreign corporations are subject to tax on realized gain from the disposition of an interest in U.S. real property, held directly or indirectly. The gain is taxed as if it were effectively connected with the conduct of a U.S. trade or business, whether or not the foreign person is in fact engaged in a U.S. trade or business during the taxable year.

When Tax Withholding is Required

Furthermore, pursuant to the Foreign Investment in Real Property Tax Act 1980 (FIRPTA), the Internal Revenue Code generally requires any transferee (buyer) of a U.S. Real Property Interest (USRPI) buyer to withhold from the purchase price an amount which constitutes a tax on the foreign transferor (seller). The normal withholding rate under Internal Revenue Code (IRC) section 1445 is 10% of the **amount realized by the seller** on the disposition. The amount realized by the seller is the sum of the following:

- 1) The cash paid, or to be paid (principal only),
- 2) The fair market value of other property transferred, or to be transferred, and
- 3) The outstanding amount of any liability assumed by the buyer or to which the property is subject immediately before and after the transfer.

There is no deduction for any expenses of sale.

This creates a problem where the sales price exceeds the amount of cash in the transaction (for instance, where the nonresident seller carries a note on the property). Owning real property through corporations also provides no escape from FIRPTA.

IRC section 1445 also states that a foreign corporation that distributes a U.S. real property interest must withhold a tax equal to 35% of the gain it recognizes on the distribution to its shareholders. This withholding requirement does not apply if the foreign corporation has elected under IRC section 897(i) to be treated as a domestic corporation.

However, a domestic corporation must withhold a tax equal to 10% of the fair market value of the property distributed to a foreign person if:

1. The shareholder's interest in the corporation is a U.S. real property interest, and
2. The property distributed is either in redemption of stock or in liquidation of the corporation.

Reporting and Payment to the IRS

The buyer must report and pay to the IRS any tax withheld by the 20th day after the date of the sale. In reporting and paying the withheld amount the following forms are to be used: **Form 8288, U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests by Foreign Persons of U.S. Real Property Interests;** and **Form 8288-A, Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests.**

Forms 8288, 8288-A and the withholding tax must be filed (mailed) to the IRS by the 20th day after the date of transfer **unless the seller is waiting for a response from the IRS to an application for a withholding certificate filed before closing occurs (see below).**

In this case, upon receipt of an approved withholding certificate or rejection letter, the taxpayer has 20 days from the date on the certificate/letter to file Forms 8288 and 8288-A and remit the required amount. Penalties and interest will be charged on late filed Forms 8288 (filed after the 20th day from the date of transfer or the response from the IRS to the withholding certificate). There is a penalty of up to \$10,000 in addition to the tax for a willful failure to collect and pay.

The withholding agent must prepare a Form 8288-A for each person from whom tax has been withheld. Attach copies A and B of Form 8288-A to Form 8288. Keep Copy C for your records.

IRS will stamp Copy B and send it to the person subject to withholding. That person must file a U.S. income tax return and attach the stamped Form 8288-A to receive credit for any tax withheld. FIRPTA forms are sent to the following address:

Director, Philadelphia Service
Center FIRPTA Unit
P.O. Box 21086
Philadelphia, PA 19114-0586.

Note: A real estate broker or salesperson ("broker") for either party can be held liable for the tax that should have been withheld (up to the amount of compensation received), if the broker has actual knowledge that the non-foreign affidavit is false and fails to notify the buyer and the Internal Revenue Code (IRC) section 1445. Under certain circumstances, the broker may also be liable for civil or criminal penalties.

Tax Resident Or Not?

Because a number of U.S. federal tax rules differ when a foreign person is involved or apply only to foreign persons, it is important for a U.S. real estate professional and a buyer's attorney to understand when an individual or entity selling the real estate is considered foreign for U.S. federal income tax purposes.

A nonresident alien is defined for federal income tax purposes as an individual who is neither a U.S. citizen nor a resident of the United States within the meaning of IRC section 7701(b). An alien individual is a resident of the U.S. for federal income tax purposes if he or she meets either of the two tests under section 7701(b):

1) The first test is the “**green card**” test. If an alien has been admitted for U.S. permanent residence (i.e., has a green card) at any time during the calendar year, the alien is a resident of the United States and is taxed on his or her worldwide income, in the same way as a U.S. citizen. Otherwise, U.S. immigration status generally is not controlling or relevant for U.S. federal tax purposes.

2) The second test is the **substantial presence** test. Under the substantial presence test, an alien individual is a resident for U.S. federal tax purposes if the alien is physically present in the U.S. for 183 days or more during the current calendar year. Alternatively, if the alien is physically present for at least 31 days during the current year, the alien may be treated as a U.S. tax resident **in the current year** under a three-year look-back test in which each day of presence in the current year is counted as a full day, each day of presence in the first preceding year is counted as one-third of a day, and each day of presence in the second preceding year is counted as one-sixth of a day. If the total of such days is 183 days or more, the alien **maybe** a U.S. tax resident **forthe current year** unless certain exceptions apply and the alien files certain required information with the IRS to claim the benefit of any relevant exception. As with the green card test, if an alien is a U.S. tax resident under either version of the substantial presence test, the alien is taxed on his or her worldwide income, the same as a U.S. citizen.

If the alien is from a country that has an income tax treaty with the United States, the treaty may act to **change these results**, subject to certain required filings with the IRS to claim the treaty benefit.

Also, in the **first and last** years that an alien might be subject to the substantial presence rule, it may be even more difficult to tell if the alien actually will be treated as a U.S. tax resident for that year due to timing issues and other elections that may have been made or tax treaty provisions that may be available.

Taxpayer Identification Numbers

It is noted above that once tax is withheld by the buyer, the foreign seller obtains credit for having paid this amount by receiving a stamped copy of Form 8288-A

from the IRS. However, this will not be provided to the seller if the seller's Taxpayer Identification number (TIN) is not included on that form.

The forms and other notices and elections relevant to FIRPTA withholding have always requested the TIN of the seller and buyer. However, if the seller or a foreign buyer did not already have a TIN, the prior regulations and forms accepted "Applied For" in lieu of the TIN and the seller's TIN was not required to be provided until the seller filed its U.S. federal income tax return reporting the disposition of the real property interest.

However, Treasury Decision 9082 effective November, 2003 changed this position by requiring that all foreign buyers and foreign sellers of U.S. real property interests provide their TIN's, names and addresses when disposing of a U.S. real property interest on withholding tax returns, applications for withholding certificates, notice of non-recognition, or elections to be treated as a domestic corporation under IRC section 897(i). It is well documented that for a number of tax and non-tax related reasons, the subject of identity has come under far greater scrutiny in recent years.

If the seller sends Forms 8288 and 8288-A to the IRS for processing but does not list an Individual taxpayer Identification Number (ITIN) on the forms and does not attach a Form W-7 ITIN application (for individuals), the IRS will process the forms, but will not date stamp Form 8288-A "Copy B Mailed" or forward it to the foreign seller. Instead, the IRS will mail Letter 3794 SC/CG to the foreign seller, instructing the seller to apply for an ITIN by filing Form W-7.

Certifying Acceptance Agency

A certifying acceptance agent is a person that is authorized under an agreement with the IRS to submit a Form W-7 to the IRS on behalf of an ITIN applicant without furnishing supporting documentary evidence. Instead, when a certifying acceptance agent submits a Form W-7 to the IRS, it certifies to the IRS that it has reviewed the appropriate documentation evidencing the ITIN applicant's identity and alien status, and that it is maintaining a record of such documentation. In addition, the certifying acceptance agent must certify that, to the best of its knowledge and belief, the documentation is authentic, complete, and accurate. As part of the certification, the certifying acceptance agent must describe the documentation upon which it is relying. The certification is not binding on the IRS, and, in appropriate cases, the IRS may request to see appropriate documentation before issuing an ITIN.

Real Estate Closing Issues

Foreign owners of U.S. real property interests often are unaware until immediately before closing of the FIRPTA withholding requirement or the requirement to provide a TIN. They should be informed as a matter of routine at the time of contract of these issues at which point there is sufficient time in which to act to mitigate their effects. The buyer's attorney should consider incorporating appropriate language in the contract well before closing occurs in order to

provide the seller with adequate notice.

While the regulations are not clear, It appears the IRS Form W8-BEN should be used to provide their TIN to the other party. Both buyer and seller should be required to provide this information at the time of contract.

Exceptions to the Requirement of Withholding

No withholding is required if the buyer can establish either that:

- 1) the seller is not a 'foreign person',
- 2) the interest transferred is not a U.S. Real Property Interest (USRPI)
- 3) the seller is not subject to taxation on the transaction (for a variety of reasons),
- 4) the seller qualifies for reduced withholding (e.g. under certain tax treaties) or has qualified for a withholding certificate.

Non-Foreign Person

There is an exception to withholding if the seller furnishes to the buyer an affidavit stating, under penalty of perjury, that the seller is not a foreign person and containing the seller's TIN. Form W-9 is used for this purpose. A buyer (and agent thereof) may rely on this statement and will be relieved of the withholding obligation unless he/she has notice or knowledge that the non-foreign affidavit is false.

Exception to the General Rule

Probably the most important exception is that a person who acquires property for use by him as a residence is not required to withhold tax if the **total purchase price for the property does not exceed \$300,000**. In order to claim this exemption, the buyer must have definite (and carried out) plans to reside at the residence for at least 50% of the number of days the property is in use during each of the first two 12-month periods following the date of the sale.

Withholding Certificates

The amount required to be withheld in a transaction cannot exceed the amount that the IRS determines to be the seller's maximum tax liability. **Either the buyer or the seller may request a determination of the seller's maximum tax liability from the IRS.** The seller may seek an early refund of any amount withheld in excess of the seller's maximum tax liability. The buyer may also be motivated by a concern to determine its withholding requirement or to shorten period during which any withholding tax is held in escrow.

The amount required to be withheld can be adjusted pursuant to a withholding certificate issued by the IRS. A withholding certificate may be issued as a result of:

- 1) A determination by the IRS that reduced withholding is appropriate because either:
 - a. The amount required to be withheld would be more than the seller's maximum tax liability, or
 - b. Withholding of the reduced amount would not jeopardize collection of tax
- 2) The exemption from U.S. tax of all gain realized by the seller, or
- 3) An agreement for the payment of tax providing security for the tax liability, entered into by the buyer or the seller.

A withholding certificate is applied for using **Form 8288-B, Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests**. This form requires the description of the U.S. real property interest being sold, the sales price, a calculation of the maximum tax owed, and evidence that the seller has no unsatisfied FIRPTA withholding obligations with respect to the purchase of the U.S. real property interest. Even if a withholding certificate is obtained, the nonresident alien must file a U.S. tax return for the year of sale and pay any appropriate amount of tax due at that time or evidence entitlement to non-recognition or exclusion.

The IRS generally will act on a completed withholding certificate application within **90 days** of the request (although this can depend). Alternatively, the regulations permit the seller to request an early refund of amounts already withheld if the request for an early refund is combined with an application for a withholding certificate.

A seller that applies for a withholding certificate must notify the seller in writing that the certificate has been applied for on the day of or the day prior to the closing.

If an application for a withholding certificate is submitted to the IRS before or on the date of a transfer and the application is still pending with the IRS on the date of transfer, **the correct withholding tax must be withheld, but does not have to be reported and paid immediately**. The amount withheld (or lesser amount as determined by the IRS) must be reported and paid within 20 days following the day on which a copy of the withholding certificate or notice of denial is mailed by the IRS.

If the principal purpose of applying for a withholding certificate is to delay paying over the withheld tax to the IRS, the seller will be subject to interest and penalties. The interest and penalties will be assessed beginning on the 21st day after the date of transfer and ending on the day the payment is made.

Sale of a Personal Residence or Like-Kind Exchange

Typical cases in which a withholding certificate may be sought are on the basis of exclusion from tax of any capital gain on real estate that qualifies as the seller's

personal residence (IRC section 121), or for like-kind exchange treatment (IRS section 1031).

For example, the application must include information establishing that the seller, who is a nonresident alien individual at the time of the sale (and is, therefore, subject to FIRPTA) is entitled to claim the benefits of section 121 by showing that the seller occupied the U.S. real property interest as his or her personal residence for the required period of time (i.e., for tax purposes, it is a “home-sale”).

In this instance, Form 8288-B expressly requests the following be attached:

- A brief description of the transfer,
- A summary of the law,
- Facts supporting the claim of non-recognition or exemption from tax
- Evidence that the transferor has no unsatisfied withholding liability, and
- the most recent assessed value for state or local property tax purposes of the interest to be transferred, or other estimate of its fair market value.

A nonresident alien or foreign corporation must also attach a statement of the adjusted basis of the property immediately before the distribution or transfer.

When a seller exchanges a U.S. real property interest, and the exchange qualifies for non-recognition treatment, the seller must draft a notice of non-recognition in accordance with IRC section 1445 and include on the notice the seller’s TIN, name and address. The seller must present this notice to the buyer before the date of sale. The buyer must mail the notice of non-recognition to the IRS no later than 20 days from the date of the exchange. If the notice of non-recognition does not contain the seller’s TIN, name and address, then the seller cannot rely on the notice and is required to withhold tax.

Tax Complications

Understanding the application of exclusion and non-recognition provisions to a seller’s tax treatment is key to understanding the merits of any withholding certificate application and, therefore, the obligation on the buyer to withhold tax.

For example, the home-sale gain exclusion rule generally allows a taxpayer to exclude from income gain realized from the sale or exchange of property if, during the five-year period ending on the date of the sale or exchange, such property was owned and used by the taxpayer as the taxpayer's principal residence for a period aggregating two or more years. The amount of the exclusion from gross income is generally limited to \$250,000 (\$500,000 for certain married taxpayers filing a joint return).

To be eligible for the home-sale gain exclusion, a taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements due to a **change in place of employment**, health, or other unforeseen circumstances may exclude the fraction of the \$250,000 amount (\$500,000 for certain married taxpayers filing a joint return) equal to the shorter of: (1) the aggregate periods during which the ownership and use requirements were met during the five-year period ending on the date of sale or exchange bears to two years; or (2) the period after the date of the most recent sale or exchange to which the home-sale gain exclusion applied bears to two years. In such circumstances, the requirement that the exclusion provision apply no more than once every two years is ignored. The pro-ration is on the basis of either the number of days (using 730 as the denominator) or the number of months (using 24 as the denominator).

Clearly, the normal rules do not apply in the context of cross-border moves and investments and require careful examination.

Lastly, it is important to ensure that the seller's tax return reporting the disposition of the real estate reflects facts and contained in the application for any withholding certificate and/or that procedures are followed for obtaining appropriate credit for any withholding taxes paid at closing.

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In summary, FIRPTA provisions present a host of issues that require early and specialized attention to ensure the real estate closing occurs as smoothly as possible. Lawyers and real estate brokers representing both sellers and buyers need to be aware of these provisions and act accordingly.

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