TAX 101:

UNDERSTANDING U.S. TAXATION OF FOREIGN INVESTMENT IN REAL PROPERTY – PART II

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This article examines the U.S. income, gift, and estate tax consequences to a foreign owner upon a sale or other disposition of U.S. real property, including a sale of real estate, sale of stock of a U.S. corporation, or a sale of a mortgage secured by U.S. real property.

In addition to (or sometimes in lieu of) rental income, many foreign investors hope to realize gain upon a disposition of U.S. real property. The Foreign Investment in Real Property Tax Act of 1980 ("F.I.R.P.T.A.") dictates how gains are taxed from the disposition of United States Real Property Interests ("U.S.R.P.I.'s"). The law has a fairly extensive definition of U.S. real property for this purpose. Most significantly, the law provides for a withholding mechanism in most cases.

WHAT IS A U.S.R.P.I.?

A U.S.R.P.I. includes the following:

- Land, buildings, and other improvements;
- Growing crops and timber, mines, wells, and other natural deposits (but not severed or extracted products of the land);
- Tangible personal property associated with the use, improvement, and operation of real property such as:[1]
  - Mining equipment used to extract deposits from the ground,
  - Farm machinery and draft animals on a farm,
  - Equipment used in the growing and cutting of timber,
  - Equipment used to prepare land and carry out construction, and
  - Furniture in lodging facilities and offices.
- Direct or indirect rights to share in appreciation in value, gross or net proceeds, or profits from real property;
- Ownership interests other than an interest solely as a creditor, including:[2]
  - Fee ownership;
  - Co-ownership;

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1 Treas. Regs. §1.897-1(b)(4)(i)

2 Treas. Regs. §1.897-1(d)(2)

- Leasehold interest in real property;
- Time-sharing interest;
- Life estate, remainder, or reversionary interest; and
- Options, contracts, or rights of first refusal.

- Certain partnership interests, if 50% or more of the value of the gross assets consists of U.S.R.P.I.'s and 90% or more of the value of the gross assets consists of U.S.R.P.I.'s plus any cash or cash equivalents (the "50/90 Test");
- With certain exceptions, a corporation characterized as a U.S. Real Property Holding Corporation ("U.S.R.P.H.C.") at any time during the five-year period preceding the sale. A corporation will be so characterized if the fair market value of U.S.R.P.I.'s held by it on any determination date equals or exceeds 50% of the sum of the fair market values of:
  - U.S.R.P.I.'s,
  - Non-U.S. real property interests, and
  - Other trade or business assets.

  This can be expressed as a formula:

$$\textbf{U.S.R.P.H.C.\%} = \frac{\textbf{F.M.V. of U.S.R.P.I.}}{\textbf{F.M.V. of U.S.P.R.I.} + \textbf{F.M.V. of Foreign Real Property} + \textbf{F.M.V. of trade/business assets}}$$

  However, an exception is provided for regularly traded classes of stock if the taxpayer owns 5% or less. In addition, and significantly, a corporation that has disposed of all of its U.S.R.P.I.'s in taxable transactions is also excluded from meeting the definition of a U.S.R.P.H.C.

SALE OF REAL ESTATE

When a foreign person disposes of a U.S.R.P.I., the gain from the sale of that U.S.R.P.I. is taxed as if the foreign seller is engaged in a trade or business in the U.S. and the gain is effectively connected income ("E.C.I."), meaning that the foreign seller is taxed on gains at the same rates as a U.S. seller.

This treatment has its advantages as well as disadvantages. One of the biggest benefits is that the gain can qualify for reduced tax rates as a long-term capital gain or like-kind exchange under Code §1031, if exchanged for another U.S.R.P.I.

However, this also means that the seller is therefore required to file U.S. tax returns to determine the amount of tax owed on the gain. Generally, to ensure satisfaction of the seller's U.S. tax obligations, a portion of the gain is withheld by the buyer and remitted to the I.R.S. (as explained in detail below). A foreign seller is taxed in the same way and at the same rate as a U.S. seller, without regard to rules that may be applicable in the seller's home country. To complete this process, a foreign seller will need a tax identification number.

WITHHOLDING REQUIREMENT

The law provides for a withholding requirement to make sure that the tax owed on the gain of the disposition of real property will be paid. This withholding amount has to be retained by the "Withholding Agent," which is often the buyer, and remitted to the I.R.S. Any tax withheld in excess of what is owned will be refunded to the seller when the appropriate tax returns are filed.

Generally speaking, 10% of the amount realized must be withheld by the buyer. Distribution by a domestic entity requires 10% to be withheld unless the entity has a foreign partner or beneficiary. If a partner or beneficiary of that domestic entity is a foreign person, 35% of the gain realized has to be withheld to the extent allocable to such foreign person.

However, since this can often be more than the tax owed on the gain, an exemption or reduced rate certificate ("Withholding Certificate") can be obtained by filing Form 8288-B before or at the same time as the property transfer to reduce the required withholding.

Exceptions to Withholding[3]

There are certain situations when the buyer is not required to withhold:

- The buyer receives a non-foreign affidavit or non-U.S.R.P.H.C. affidavit from the seller, if the purchase is of a U.S. corporation but not a U.S.R.P.H.C. under Treas. Reg. §1.897-2;
- The property is not a U.S.R.P.I. under Treas. Reg. §1.897-1 and §1.897-2, and therefore, the gain from the sale will not be considered U.S.-source income;
- The sales price is less than $300,000 and the buyer or a family member will use the property as a residence for at least 50% of the first two 12-month periods following the sale;[4]
- Withholding is required under partnership withholding rules §1446;
- Non-recognition transactions wherein the sale is afforded non-recognition treatment by an I.R.C. provision or the seller is not required to recognize a gain under the provisions of a tax treaty. This may include §1031 like-kind exchanges, involuntary conversions, and inter-spousal transfers;
- The seller provides a written notice to the buyer stating that the seller is not a foreign person at the time of the transfer and is therefore required to file a U.S. tax return. The notice should be provided at the time of or prior to the transfer, should include the seller's name, tax identification number, and home address, and should be signed under penalties of perjury.

"The law provides for a withholding requirement to make sure that the tax owed on the gain of the disposition of real property will be paid."

[3] Internal Revenue Manual 21.8.5.5.1 (05-20-2008) Exceptions to F.I.R.P.T.A. Withholding

[4] Treas. Reg. §1.1445-2(d)(1)

Partnership Withholding Rules §1446[5]

Any foreign or domestic partnership must pay a withholding tax on its foreign partner's E.C.I. The applicable tax rate is 39.6% under §1 for non-corporate partners or 35% under §11 for corporate partners.

In a publicly traded partnership, withholding is based on distributions rather than income allocations. The Withholding Agent can be either the Publicly Traded Partnership or a nominee who is a domestic person that holds an interest in the Publicly Traded Partnership on behalf of the foreign person.

"Any foreign or domestic partnership must pay a withholding tax on its foreign partner's E.C.I."

If the foreign partner certifies that the partnership investment is the only E.C.I. for that taxable year, the partnership is not required to pay the §1446 withholding tax on the foreign partner's income if the partnership estimates that the actual §1446 tax due is less than $1000.

Section 1446 withholding does not apply to F.D.A.P. income that is not effectively connected to the partnership's U.S. trade or business. Nonetheless, F.D.A.P. income is subject to 30% withholding on U.S. sourced income paid to a foreign person under the N.R.A. withholding tax regime.

Withholding Certificate[6]

To reduce or eliminate the withholding amount required, the seller, buyer, or either party's agent may request a Withholding Certificate on the day of or prior to the transfer by submitting a Form 8288-B, *Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests*, to the I.R.S. If the requesting party is the seller, he/she should notify the buyer before or during the transfer so that the full withholding amount is not remitted prior to I.R.S. notification on the application of the Withholding Certificate. The parties may also agree to place the withholding amount in escrow while the I.R.S. reaches a decision. The I.R.S. will generally notify the requesting party within 90 days after receipt of a complete application, which includes the taxpayer identification numbers of all parties. Once a Withholding Certificate has been received, the buyer or escrow agent must submit the amount specified on the certificate to the I.R.S. within 20 days and remit the remainder to the seller.

Form 8288-B may be used to apply for a Withholding Certificate in the following cases:

1. The transferor claims it is entitled to non-recognition treatment or is exempt from tax,
2. A calculation shows the transferor's maximum tax liability is less than the tax otherwise required to be withheld, or
3. Special installment sales rules described in §7 of Rev. Proc. 2000-35 allow for reduced withholding.

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5 Internal Revenue Service. "Partnership Withholding: Withholding Tax on Foreign Partners' Share of Effectively Connected Income – IRC Section 1446."

6 Internal Revenue Service. "Withholding Certificates."

SALE OF STOCK OF U.S. CORPORATION

Usually, the gain from the sale of stock of a U.S. corporation is not U.S.-source F.D.A.P. income and does not make the investor engaged in U.S. trade or business. Under F.I.R.P.T.A., the gain is taxable if the stock sold is that of a U.S.R.P.H.C. because the gain is treated as E.C.I. Branch profits taxes may be incurred by a foreign corporate holder, as well.

SALE OF A U.S. MORTGAGE

The gain from the sale of a U.S. mortgage generally is not considered F.D.A.P. or E.C.I. unless:

- The taxpayer is in the U.S. lending business making the gain E.C.I. and therefore taxable, or
- The mortgage loan has contingent interest which makes it a U.S.R.P.I. and the gain from its sale taxable under F.I.R.P.T.A.

GIFT TAX

A foreign person is taxed on gifts of tangible property located in the U.S.:

Gift of...	Tax
U.S. Real and Tangible Property	Gift Tax
Stock (domestic or foreign corporation)[7]	No Tax
Partnership Interest[7]	No Tax

ESTATE TAX

The estate of a nonresident alien individual is subject to estate tax on U.S. real property and tangible property and U.S. situs intangibles, such as stock in U.S. public or private corporations. The unified credit is limited to a to a $60,000 exemption.

The estate taxation of foreign partnership interests where the partnership holds U.S. property is not as clear. If the partnership is engaged in a U.S. trade or business, the I.R.S. may argue that the situs may be domestic.

The next installment will address the different ways an investor can structure an investment to minimize tax liability.

[7] Note that a transfer of real property to a corporation or partnership, followed by a gift of the shares or interests in the entity, may be subject to gift tax, if integrated as a "step transaction."