FOREIGN INVESTMENT AN U.S. REAL ESTATE – A F.I.R.P.T.A. INTRODUCTION

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INTRODUCTION

Whether in an up or down economy, the U.S. is attractive for foreign investors. U.S. economic and legal transparency, as supported by appropriate legal protection and a predictable regulatory environment, further enhances the attraction for foreign investment. According to Henley & Partners,[1] a key concern for high net worth individuals ("H.N.W.I.") is unease over political and economic uncertainty, which continues to drive key investment decisions such as owning wealth in offshore structures. As a result, real estate has now become the third-largest asset class – with residential property being more sought-after than commercial property for those over 40.

Like anyone else who invests in real estate, foreign investors buying real estate in the U.S. must evaluate the terms and conditions of the purchase to determine if it makes sense in a particular set of circumstances. However, non-U.S. investors must evaluate an additional factor that will come into play when they dispose of the property, the Foreign Investment in Real Property Tax Act ("F.I.R.P.T.A.").

STARTING WITH THE BASICS

F.I.R.P.T.A. allows the U.S. to withhold income tax when a foreign person disposes of a U.S. real property interest ("U.S.R.P.I."). The disposition of a U.S.R.P.I. by a foreign person is treated as if the person were engaged in a U.S. trade or business, and gain or loss must generally be recognized on the transaction.[2] The disposition by the foreign person is subject to tax,[3] and the transferee (buyer or his agent) must withhold tax in the absence of certain exceptions and submit the appropriate tax returns.[4] The withholding tax is 15% of the net proceeds, typically the sales price less any sales commissions (10% for dispositions before February 17, 2016, and in limited cases involving lower cost residential properties). However, treaty exceptions may apply. The withholding obligation rests on the buyer or its agent and not on the foreign seller. This is because it is easier for the I.R.S. to collect tax from someone with a U.S. connection.

For purposes of this law, a "foreign person" includes a nonresident alien ("N.R.A."), foreign partnership, foreign trusts, foreign estate, or foreign corporation that has not

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[1] Henley & Partners, "How Citizenship Planning is Providing Millions in Revenue and Increased Freedom for the Wealthy," (presentation, STEP New York 15th Annual International Estate Planning Institute Conference, New York, NY, March 15, 2019).

[2] Code §§897(a), 87(b) and 882(a).

[3] Code §§1, 11, and 55.

[4] Code §1445 and related regulations.

made an election to be treated as a domestic corporation for F.I.R.P.T.A. purposes (*i.e.*, a Code §897(i) election).

As explained in Code §§897(c)(1) through (c)(4), a U.S.R.P.I. is any interest in real property and associated property located in the U.S. or the Virgin Islands and any interest in a domestic or foreign corporation defined as a U.S. real property holding company ("U.S.R.P.H.C."). A U.S.R.P.H.C. is defined as a domestic or foreign corporation that has U.S.R.P.I.'s that equal or exceed 50% of the total fair market value of its U.S. and foreign real property and any other assets used in a trade or business. There is an exception for stock regularly traded on an established securities market. Assets held by a partnership, trust, or estate are treated as being held proportionately by its partners or beneficiaries.

Withholding Requirements

The 15% withholding rule noted above, and explained in Code §1445(a), generally applies regardless of the amount of gain or loss attributed to the foreign seller. The net proceeds realized for withholding purposes include cash, fair market value of other property, and liabilities assumed by the buyer or to which the U.S.R.P.I. is subject.

Several exceptions to the general rule are provided under Code §1445(b). These include the following situations:

- The property is acquired by the buyer for use as a residence, and the purchase price is less than $300,000.
- The corporate stock of the seller is regularly traded on an established securities market.
- A non-publicly traded corporation furnishes an affidavit that the interest being disposed is not a U.S.R.P.I., and the transferee has no knowledge that the statement is false.
- An N.R.A. transferor furnishes the transferee with an affidavit stating, under penalty of perjury, that the seller is not a foreign person, and provides a U.S. Taxpayer Identification Number on such an affidavit (the transferee can accept such an affidavit as long as no knowledge exists that the statement is false.
- The transferor applies for and receives a qualifying statement from the I.R.S. that exempts the transaction from withholding. The I.R.S. has 90 days from the date of receipt of the application to process a response.

The transferee has 20 days after the transfer date to file Form 8288, *U.S. Withholding Tax Return for Dispositions 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*, and submit the tax withheld. The I.R.S. will return stamped copies of the forms to the transferor (and withholding agent) to be attached to the tax return at filing.[5] If the transferor was not able to obtain a Taxpayer Identification Number by the transfer date, the transferee is still obligated to file Forms 8288 and 8288-A and submit the tax withheld by the prescribed due date.

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[5] Treas. Reg. §1.1445-1(c).

The transferor may still receive credit for the amount of tax withheld by attaching substantial evidence of withholding to the return. The 15% withholding is not the amount of tax but merely a mechanism for the U.S. to ensure the collection of tax. This withholding does not relieve the seller from filing a U.S. tax return (*i.e.*, Forms 1040NR, 1120, or 1120F).

"Form 8288-B must include Taxpayer Identification Numbers for all parties involved, otherwise it will be rejected."

The rules are different if the seller is a domestic partnership, trust, or estate with foreign partners or beneficiaries. Code §1446 withholding tax applies to the effectively connected income ("E.C.I.") of a domestic partnership to the extent that it is allocable to foreign partners. Non-grantor trusts and estates have a withholding obligation upon the distribution of cash or property to a foreign beneficiary. The fiduciary must maintain a special U.S.R.P.I. account to withhold 37% of any distributions to a foreign beneficiary up to the balance of the U.S.R.P.I. account. If a grantor trust has a foreign owner, the fiduciary must withhold 37% of the gain realized by the trust on the disposition of a U.S.R.P.I., to the extent the gain is allocated to the foreign person. If a domestic trust or estate has an N.R.A. as beneficiary and disposes of a U.S.R.P.I., the fiduciary may be required to withhold tax on the share allocable to the N.R.A. beneficiary.[6]

Withholding Certificates: Rules and Exceptions

Withholding certificates are commonly called reduced withholding or exemption certificates. Application for such certificate is made on Form 8288-B, *Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests*. This form is filed when sellers claim to be entitled to nonrecognition treatment or exemption from tax. It is also filed when sellers are certain that they have a loss or that the 15% withholding obligation is greater than their maximum tax liability on the gain from the sale. Another filing instance that is less common occurs when the seller claims that the special installment sale rules described in Section 7 of Rev. Proc. 2000-35 allows for reduced withholding. This form can be filed by an N.R.A. or foreign corporation.

The most common reason for requesting an exemption is a withholding obligation in excess of maximum tax liability, described above. For this claim, the filer must attach the following information:

- A calculation of the maximum tax liability showing that the applicable tax on the sale of the property is less than the 15% withholding obligation
- Sales contracts showing the amount of sale (or an appraisal, if there is no contract)
- Either a closing statement, *H.U.D. Settlement Statement*, or sales contract showing the original cost of property, along with any receipts showing improvements made to the property[7]

Form 8288-B must include Taxpayer Identification Numbers for all parties involved, otherwise it will be rejected. However, if the transferor is applying for an individual Taxpayer Identification Number ("I.T.I.N."), the phrase "Applied for I.T.I.N." may be used in lieu of an identification number. Form 8288-B should be attached to a complete I.T.I.N. application and sent to the I.T.I.N. Operation in Austin, Texas.

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[6] Treas. Reg. §1.1445.5(c)(1)(iii)(A).

[7] Code §897(j).

Although either the buyer or seller can file this form, it is typically filed by the seller or the seller's agent. The withholding agent identified on Line 4a of the form should be the buyer or the buyer's agent. A U.S. mailing address is recommended for the withholding certificate for ease of delivery and tracking. This address does not need to be the same as the transferor's (Line 1) or transferee's (Line 2) address. If an interest in a U.S.R.P.H.C. is being transferred, the submission must include a share certificate showing the ownership percentage of the foreign seller of the U.S.R.P.H.C.

Foreign Person's Tax Filing Requirements

N.R.A.'s who have a direct investment in a U.S.R.P.I. must generally file income tax returns, except where they are engaged in a U.S. trade or business and the fair market value of the U.S.R.P.I. does not exceed $50,000. In addition, any person subject to Code §897(a), as noted above, or Code §1445 (regarding withholding tax on dispositions of U.S.R.P.I.'s) must pay the required tax and file a return.[8]

Dispositions that are taxable events are broadly defined and include the following:

- Sales, exchanges, distributions, tax-free exchanges, certain gifts, and so forth of U.S.R.P.I.'s
- Sales of interests in partnerships, trusts, and estates that have U.S.R.P.I.'s[9]
- Contributions to capital of a foreign corporation[10]

The following transactions generally are not taxable since U.S. tax is only deferred and not avoided:

- A distribution of a U.S.R.P.I. by a foreign corporation in liquidation or otherwise, if the distributee would be subject to U.S. tax on a subsequent disposition of the U.S.R.P.I. and there has been no tax-free increase in the tax basis of the U.S.R.P.I.[11]
- An exchange of a U.S.R.P.I. in a nonrecognition transaction for another ownership interest if the subsequent sale of such interest would be subject to U.S. tax and there has been no tax-free increase in the tax basis of such ownership interest[12]

The 15% F.I.R.P.T.A. withholding will be credited toward the ultimate tax liability and the excess, if any, will be refunded to the foreign person, unless the withholding was not sufficient to satisfy the tax. Early refunds of excess withholding tax can also be obtained by filing a tax return as soon as possible, if the taxpayer has no other income to report on the U.S. tax return. If this is desired, prior year tax return forms can be used to file a return for the current year as long as the prior year is crossed out and marked as the current year. If filing a final corporate return, taxpayers should include the words "Final Tax Return" at the top of the return.

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[8] Code §§6039C(a), (b), and (d).

[9] Code §897(g).

[10] Code §897(j).

[11] Code §897(d).

[12] Code §897(e).

The gain derived from the sale of a U.S.R.P.I. under Code §897 is considered to be E.C.I. In general, the 30% branch profits tax applies to a foreign corporation's effectively connected earnings and profits. This tax is in addition to income tax.

However, there is an exception under Treas. Reg. §1.884-2T if the foreign corporation "completely terminates" all of its U.S. trade or business. In order to be considered to have completely terminated the U.S. trade or business for purposes of this exception, the following three prongs must be satisfied:

- The foreign corporation has no assets used in a U.S. trade or business as of the close of the year.
- Neither the foreign corporation nor a related corporation uses any of the assets of the terminated U.S. trade or business nor earnings and profits of the foreign corporation in the year of the termination in the conduct of a different U.S. trade or business for a period of three years following the close of the taxable year in which the termination took place.
- The foreign corporation has no E.C.I. during the period of three years following the close of the taxable year in which the termination took place.

This last item is especially relevant if foreign investors have plans to purchase a U.S.R.P.I. at a future date and do not intend to dissolve the foreign corporation. However, if corporate dissolution is chosen, in addition to filing the corporate return (*i.e.*, Form 1120-F), Form 966, *Corporate Dissolution or Liquidation*, must be filed as required under Code §6043(a). A certified copy of the resolution or plan of liquidation and dissolution and all amendments or supplements not previously filed should be attached to the Form 966.

A second exception from branch profits tax exists when the gain relates to the sale of shares of a domestic corporation that is a U.S.R.P.H.C.

I.T.I.N.

N.R.A.'s who have never filed a U.S. tax return or are unable to obtain a social security number must obtain an I.T.I.N. by filing Form W-7, *Application for IRS Individual Taxpayer Identification Number*, with the I.R.S. An I.T.I.N. will be needed in order to file for a reduced withholding certificate on Form 8288-B and to file the required return if they are to receive a credit for overpayment of taxes.

If an I.T.I.N. application is filed for the purpose of reporting the sale of a U.S.R.P.I. on Form 1040NR, then Box "b" (Nonresident alien filing a U.S. tax return) should be checked off. When filing Form W-7, it should be the first form attached, followed by the certified (in English) passport copy, and the Form 1040NR, including Copy B of Form 8288-A stamped (typically in red) by the I.R.S. Copy B of Form 8288-A is proof of withholding.

If an I.T.I.N. application is filed for the purpose of applying for a reduced withholding certificate on Form 8288-B, then Box "h" (Other, Exception 4 – Disposition by a foreign person of U.S. real property interest – third-party withholding) should be checked off. Again, when filing Form W-7, it should be attached first, followed by the Form 8288-B, including any schedules (discussed above). It takes the I.R.S. approximately six to ten weeks to process an I.T.I.N. application.

If one or more parties involved are foreign corporations and do not have an E.I.N., they can simply apply for one by filing Form SS-4, *Application for Employer Identification Number*.[13]

CONCLUSION

This paper has covered the basic procedures for complying with Federal tax withholding requirements under F.I.R.P.T.A. Any non-U.S. person planning to purchase a U.S.R.P.I. should consult with an experienced tax advisor to learn more about how the Federal rules and applicable state laws may apply to a particular transaction.

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[13] Certain procedures for obtaining an E.I.N. have changed as of May 13, 2019. See "The Responsible Party – Changes Effective May 2019" in this edition of *Insights*.

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