

FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT

PREFACE: *This is brief and very general. Each transaction and individuals' tax situation is unique, and there may be other problems or options. Nonresident alien owned corporations, both foreign and domestic are treated differently. Consult with a competent tax professional for a definitive analysis.*

WHAT IS "FIRPTA"?

The *Foreign Investment in Real Property Tax Act* of 1980 (FIRPTA) specifically imposes an income tax withholding on the sale of US real property interests by *NonResident Alien* (NRA) individuals, partnerships and corporations. The tax withholding is a refundable credit against any federal tax due on the property sale. When a NRA sells US real property they are required to report the sale by filing a US tax return after the end of the sale year, and pay any income tax due on the *capital gain (net profit)*, if any. The 10% withholding may or may not be enough to cover the tax due. If there is US tax on the sale then it may also become a foreign tax credit against your home country taxes, avoiding "double taxation" -- consult your tax professional.

For a NRA, with some exceptions, the sale is reported on Form 1040NR, "U.S. Nonresident Alien Income Tax Return". If there are multiple NRA owners, such as husband and wife, or a joint venture or partnership, then each NRA files a separate tax return reporting their portion of the sale and also any other US source income in the year of sale.

HOW DOES FIRPTA AFFECT THE SALE?

The FIRPTA regulations mandate withholding 10% of the GROSS SALES PRICE for Federal income tax at the time of title transfer to the buyer. It is paid directly to the Internal Revenue Service (IRS). Actual profit or loss does not change the 10% withholding requirement. Some states may also impose a tax withholding. The 10% withholding may not always cover the actual tax due, so tax planning is important.

Reduction or elimination of the required withholding, based on showing it as over withholding, may be possible if Form 8288-B, "Application for Withholding Certificate For Dispositions by Foreign Persons of U.S. Real Property Interests", is filed. It can be filed before or after the sale closes, before the end of the sale year. Processing time varies from possibly 6 weeks to 5 or more months. When the application is sent to the IRS *before* title transfer then the 10% withholding can be kept in the escrow trust account until a *Withholding Certificate* is received from the IRS. This speeds the release of the refund considerably. *It is necessary that both sellers and buyers have either a US Social Security Number (SSN) or Individual Taxpayer Identification Number (ITIN) to file the Form 8288-B – if not then Form W-7's must accompany the application (see my paper on the ITIN application).* Properly done, the W-7 applications should be submitted through escrow if the withholding is submitted to the IRS, accompanying Forms 8288 and 8288-A. That will avoid needless IRS correspondence and delays, in requesting ITIN's and matching sellers to the withholdings.

The legal responsibility for withholding is the buyer's. Withholding is required even if the amount exceeds the down payment on an installment sale. If it is an installment sale, with payments spread over 2 tax years or more, then Form 8288-B should be submitted as soon as the sale contingencies are satisfied. On an installment sale the IRS determines the withholding requirement based on the actual down payment plus payments to be received that year. For property owned over 1 year the IRS generally uses 15%, of the net capital gain (profit) to determine the necessary withholding – unless it was rental property (see below).

Failure to withhold can create substantial penalties for the buyer and his agents. An infrequent problem occurs when NRA sellers learn that there was no withholding from the prior NRA seller when they purchased the property and the prior owners did not file a tax return and pay any tax due. The IRS will then recharacterize the withholding on the current sale as belonging to the prior sale: blocking the current withholding as a credit towards tax on the current sale until the prior owner's file a return and pay the tax.

CERTIFICATE of RESIDENCY

Withholding can be eliminated on a sale of \$300,000 or less if there is a Certification of Residency by the buyer stating that it will be used as a residence by the buyer or his/her immediate family for 50% of the total number of days it is used by any person (that is, buyer, family and renters) during the two 12-month periods following the sale. Vacant days do not count. It also must be legally possible for the buyer to live there. There is a liability for the buyer and seller if the residency requirements are not met. *This option does not eliminate the need for the seller to file a tax return and any tax due on the sale.*

TAX-DEFERRED EXCHANGES

Investment, income producing, and rental properties may qualify under Internal Revenue Code Section 1031 for an exchange of "like kind" properties that avoids some or all U.S. taxes on the transfer from your old property into a new property. Known as "1031 Exchanges" or "Tax-free Exchanges", be aware that the exchanging of properties may not

defer taxation as a sale in your home country. Rules are complex and beyond the scope of this article and you must consult with tax professionals.

CALCULATING TAXABLE PROFIT – aka “CAPITAL GAINS”

Real estate for investment or personal use is classified as a “capital asset”. If the property is owned over one year then tax is assessed at a lower long term capital gain rate, on the difference between the “tax basis” and the sales price. The tax basis is the original purchase price and acquisition costs, plus any major improvements, outside of normal repairs, any utility service district (LID) assessments paid, and the selling costs. Property taxes, mortgage interest, association dues are not allowable in the basis calculation on non-income producing property.

Other tax basis adjustments are possible if the property was owned before September 27, 1980, or if it was jointly owned with a now deceased spouse or if it was inherited. If the property is, or was, a rental, then the tax basis will be lowered for the depreciation allowable, and the tax calculation will become more complex.

If there is a capital gain “profit” on the real property sale, then the income tax will be calculated on that gain as adjusted for allowable personal exemptions, and possibly some other deductions.

If the property was legally the principal residence of the sellers for at least 2 out of the last 5 years then the capital gain may be reduced or even escape taxation. This is a more complex situation determined in part by residency rules and tax filing issues. Another basis complication occurs if the property was originally acquired in a Section 1031 tax-deferred exchange.

THE TAX

After determining the taxable gain, the actual tax depends on several factors: date of sale, if the property was owned a year or more, creating “long-term capital gain”, and if it was income property. The tax rate on long-term capital gain depends on the taxpayer’s marginal tax rate imposed on the total of all other US income before adding in the capital gain. If the marginal tax rate is 15% or less then the capital gain will be taxed at the lowest allowable capital gain rate up to the taxable income break point where the marginal rate on the tax schedule changes to a higher rate. At that point the capital gain tax will go to its upper rate, currently not to exceed 15%. Yes, a bit complex.

If the property was owned less than 12 months then the gain is short-term and will be taxed at the graduated ordinary marginal rates. If it was held 12 months or more then the long-term rates, based on the individual marginal rates as mentioned above, are as follows:

May 6th 2003 to December 31, 2007, the capital gain tax rate is 5% for tax brackets of 10% and 15%, and for all higher tax brackets have a maximum of 15%.

From 2008 through 2010, for taxpayers in the 10% and 15% tax brackets, the rate is reduced to 0%. All higher tax brackets have the 15% maximum capital gains rate.

RENTAL PROPERTY

There is a capital gain tax rate exception for rental property. If part of the gain is wholly or partly due to depreciation then that portion is “recaptured” (“clawed back”) and taxed at 25%. Depreciation of an asset is mandatory in the US tax code and the tax basis is always adjusted for it -- however there is catch-up relief available for “missed” depreciation. See my paper on rental property for other concerns.

Contact my office for a list of the documentation needed for FIRPTA tax preparation. Again, always consult with a competent US tax advisor when considering a real estate transaction.

© Donald L. Starr, CPA
www.dstarr.com

11/16/07