Foreign Nationals and The New FIRPTA Compliance

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Course Objectives

At the end of the course, the student will be able to:

- List the categories of a 'foreign person.'
- Define 'Personal Residence' according to the IRS.
- Explain what FIRPTA is to their customer.
- Describe when the 10% tax applies.
- Explain when the 15% tax applies.
- State how many days before the proceeds are due to the IRS.
- Describe a 'Withholding Certificate'.

Timeline

Introduction of FIRPTA	15 min.
Foreign Person definition	10 min.
Personal Residence according to the IRS	20 min.
Withholding Certificate	15 min.
Withholding Thresholds	15 min.
What about Short Sales?	10 min.
FIRPTA compliance chart	15 min.
Case Studies	60 min
Total	**180 min.**

(3 hours CE credit)

What is FIRPTA?

The Foreign Investment in Real Property Tax Act is the Federal law governing the taxation & withholding by foreign persons selling U.S. real estate. Real estate sales associates, brokers, and attorneys should advise foreign buyers of the Foreign Investment in Real Property Tax Act (FIRPTA) prior to closing. When foreign buyers are aware of the tax upon purchase, they are less likely to be surprised about the tax upon selling.

Under the old FIRPTA Rules, the buyer was required to withhold 10% of the gross sales price, although certain exceptions apply.

Under the new FIRPTA, effective in February 2016, the withholding was increased to 15% of the gross sales price. In addition, there is a distinction for Buyers using the property as a "Personal Residence" with varying treatment at different sales prices. (Certain exceptions apply here as well.)

This withholding is remitted to the Internal Revenue Service as a deposit on the income tax liability generated from the sale. When the actual income tax resulting from the sale is reported on the seller's tax return, the withholding will be applied and the seller will either remit a sum to satisfy the outstanding balance or will receive a refund of any excessive withholding.

An exception to the withholding requirement applies to sales of real property where the sales price does not exceed $300,000 if the purchaser intends to make personal use of the property as a residence for at least fifty percent of the time the property is in use, for at least two consecutive 12-month periods following the date of purchase. This exception is not available to business entities, trusts, or the sale of vacant land.

Foreign Person:

A "foreign person" is defined under FIRPTA as a nonresident alien individual, foreign corporation, partnership, trust or foreign estate.

- ✓ This is completely separate from Immigration Status.
- ✓ Green Card Holders are not automatically exempt.
- ✓ The key question to ask **Seller** is what type of U.S. Tax Return they file. 1040 or 1040NR?

What is a "Personal Residence" according to IRS?

- Buyer or members of Buyer's family (ancestors, siblings, spouse and lineal descendants) INTEND to use the property as a residence for at least ½ the time the property will be used by anyone as a residence during the first two 12-month periods following the purchase.
- If the Buyer is acquiring the property to use as a rental 100% of the time this is NOT a Personal Residence.

In other words….

- The buyer or family intends to use the property at least ½ of the time of the first two 12-month periods. (IT IS NOT CORRECT TO SAY FIRST 2 YEARS! *The 12 month periods are examined separately*.)

- The time when property is vacant does not count against the personal use.

  - ✓ **Example**: Buyer intends to use the property for 3 months. They can rent it out for a maximum of 3 months and it can sit vacant for 6 months.

- If the total price of the property is more than $1,000,000, then 15% of the gross sale should be paid to the IRS.

- The 10% or 15% withholding from the gross proceeds are due to IRS within 20 days after closing when purchasing from a foreign seller.

- A "Withholding Certificate" may be applied for to allow a lesser amount to be withheld at closing. Remit amount within 20 days of date of Certificate.

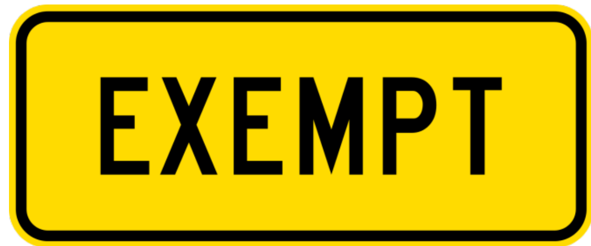
Exemptions

Withholding Certificate

A Seller may apply for a withholding certificate (IRS Form 8288-B) allowing less than 10% or 15% withholding if the tax due from the sale will be less than the withholding AND the calculation is properly documented.

IRS typically takes 90 days to issue from receipt of application.

This application can be made as soon as the Seller goes under contract – a copy of the contract must be attached to the application.



Withholding Thresholds

If Buyer is acquiring for use as a Residence, the following withholding schedule applies:

- 0% withholding - The sales price is $300,000 or less.
- 10% withholding – The sales price is greater than $300,000 but not more than $1,000,000.
- 15% withholding – The sales price is greater than $1,000,000.
- Short Sales – withholding still required! FIRPTA also applies to short sale transactions and may present hurdles in negotiations with the short sale lender. If a sale does not qualify for the above-referenced exception, the seller may take the necessary steps to apply to the IRS for a withholding certificate, which grants a reduction or elimination of the ten percent withholding requirement. Application and processing of a withholding certificate requires additional time and should be considered when negotiating the terms of a contract.

What if…

If Buyer is <u>NOT</u> acquiring for use as a Residence…..15% withholding applies at any price.

The circumstances and outcomes vary widely. For any investor considering a purchase of US real property, it is strongly recommended that the foreign person consult with a US tax advisor experienced in this area of law to assist in structuring any transaction.

Let's review the chart on the following page….

- Case Studies

1. Seller is selling property to Buyer for the purchase price of $250,000. Buyer intends to occupy the property for 6 months and rent it out 2 months for the first two 12 month periods. Buyer is willing to sign the appropriate affidavit at closing. How much is withheld?

   Answer: No withholding is required since the purchase price is $300,000 or less, and Buyer will occupy the property for 6 out of the 8 months that the property is occupied for the first two 12-month periods, thus satisfying the withholding exemption.

2. What if the same set of facts but the Buyer is Eli Manning Development Corporation, Inc., a New York corporation? How much is withheld?

   Answer: 15% of the gross sales price is withheld at closing since the Buyer must be an individual for the withholding exemption to apply.

3. What if the same set of facts as #1, but the Buyer has a change in family circumstances and is unable to occupy the property as intended? What happens?

   Answer: No impact as a result of the change in circumstances. The test is the Buyer's intention at the time of closing. Provided the intent to occupy as described in #1 was there, then there is no issue with signing the affidavit.

4. Seller is selling property to Buyer for the purchase price of $650,000. The Buyer intends to occupy the property as his primary residence and is willing to sign the appropriate affidavit at closing. How much is withheld?

   Answer: 10% of the gross sales price is withheld at closing.

5. What if the same set of facts as #4, but Buyer refuses to sign the affidavit at closing? How much is withheld?

   Answer: 15% of the gross sales price.

6. Seller is selling property for the purchase price of $4,000,000. The Buyer intends to occupy the property as their primary residence and will sign anything that helps the Seller avoid the withholding, as they have become friendly during the pendency of this transaction. How much is withheld?

   Answer: 15% of the gross sales price is withheld for any sales price exceeding $1,000,000 regardless of the Buyers intended use.

7. John Lennon Development, LLC, a single member New Jersey limited liability company (owned solely by a Non-US tax resident) is selling property for the purchase price of $250,000. Buyer intends to use the property as a rental property 100% of the time it is in use, because it is so desirable. How much is withheld?

Answer: 15% of the gross sales price.

8. What if the same set of facts as #7, but the Seller is a Multi Member LLC that is considered a partnership with foreign partners? How much is withheld?
   Answer: FIRPTA doesn't apply at closing. What happens is:
   a. Partnership prepares a tax return and reports capital gain from disposition
   b. Partnership with foreign partners requires to file Forms 8804/8805 and that's where the calculation comes in – anytime there is income in the partnership, the partnership is required to send a check with Form 8804 based on approximate calculation of tax impact on that income. Capital gains are subject to a 40% rate. This essentially becomes the withholding and the partnership remits the 40% x Capital Gain with Form 8804 when filing partnership tax return (Due March 15/ or Sept 15 on extension).
   c. The partners in turn can file their own 1040NRs and show their respective shares of the capital gain and tax calculated on it. Most of the time the tax on capital gain calculated at personal level is much less than 40% tax applied at partnership level, so the partners are then able to get a refund of excess withholding when they file their own 1040NR.

9. What is the same set of facts as #7, but the Seller is a Multi Member LLC or Single Member LLC that has elected to be taxed as a C Corporation?

   Answer: The withholding applies at closing, in the same way as it applies to the individual