

***Foreign Investment in U.S. Real Estate
And
1031 Exchanges***

What Is FIRPTA?

In 1980, the U.S. Government implemented the Foreign Investment In Real Property Tax Act (or “FIRPTA”). The purpose of this law is to impose an income tax on the gains derived by foreign persons from the sale of their U.S. property.

FIRPTA imposes an income tax on the sale of any U.S. real property interest . This includes U.S. real estate owned directly by a foreign investor, as well as shares owned by a foreign person in a U.S. corporation that owns substantial real estate.

To ensure collection of U.S. taxes that are due on the sale by a foreign investor, FIRPTA also provides a withholding mechanism under which the buyer, who is the “transferee” of the U.S. property, is obligated to withhold 10% of the purchase price at closing and send it directly to the Internal Revenue Service (the “IRS”), instead of paying the full amount to the foreign seller. In addition, a number of states, such as Hawaii, California and Colorado, also have a withholding tax on sales of real estate located within their borders.

Who is subject to FIRPTA?

FIRPTA tax is imposed on nonresident alien individuals and foreign corporations.

FIRPTA Tax Rates:

A foreign person's gains from dispositions of their U.S. property are subject to income tax under FIRPTA at the same graduated rates applicable to U.S. persons.

Individual Capital Gain Tax Rates: If the investor is a nonresident individual and the real estate qualifies for capital gain treatment, the net capital gain income will generally be subject to a tax rate of approximately 15%.

Corporate Capital Gain Tax Rates: If the investor is a foreign corporation and the real estate qualifies for capital gain treatment, the net capital gain income is currently subject to a possible tax rate in excess of 35%.

Ten Percent Withholding Tax: When FIRPTA applies, the transferee of the U.S. property must deduct and withhold 10% of the "amount realized" by the foreign seller. The amount of the seller's gain actual gain on the sale is irrelevant. The "amount realized" is usually the sales price for the property and includes the cash paid to the seller, the fair market value of any other property transferred by the buyer to the seller, and the outstanding amount of any liabilities paid off. This withholding tax is treated as an advance payment against the actual Individual or Corporate capital gains tax discussed above.

Withholding Tax Not Final Obligation: The 10% withholding tax imposed on the foreign seller of a U.S. property is not the amount of tax actually due. It is merely an advance payment toward the foreign seller's U.S. income tax obligation arising from the sale of the property. The foreign seller must file a U.S. income tax return for the year of the sale by the applicable filing deadline. Such return will show the amount of gain derived from the disposition of the sale of the property and the amount of U.S. income tax due on the gain. The amount of the foreign seller's final U.S. tax obligation, or refund, is determined by crediting the withholding tax against the amount of income tax shown on the return.

1031 Exchanges:

Section 1031 of the U.S. Internal Revenue Code makes it possible for a foreign seller to avoid recognizing gain on the sale of its property by "exchanging" it for another investment property. If the exchange qualifies under U.S. law, recognition of gain for the foreign seller will be deferred and no FIRPTA income or withholding tax will be due on the transaction.

U.S. law requires that the foreign seller use an independent third party, or "Qualified Intermediary" to handle the exchange. All of the proceeds from the sale, including non-cash proceeds (such as a boat that you receive in trade), must go to the Intermediary to be used for the purchase of the new property. Any thing received directly, or indirectly, by the seller (no matter how insignificant) will disqualify the entire transaction resulting in imposition of the FIRPTA withholding and recognition of the entire gain.

To qualify for the 1031 exchange exemption, several requirements must be met: (1) the new property must be located within the U.S.; (2) From the date the foreign seller closes the sale of the old property to the buyer, the foreign seller has 45 calendar days to provide the Intermediary with a list of properties they want to buy, (this list is called "the 45 day list" and there are typically 3 properties or less on this list); (3) From the date the foreign seller closes the sale of

the old property to the buyer, the foreign seller has 180 calendar days to purchase one or more of the properties on the 45 day list; (4) The foreign seller of the old property must take title to the new property in the same legal name in which they owned the old property; (5) The foreign seller must buy new property for an amount equal to, or greater than, the sale price of the old property; (6) All cash from the sale of the old property, after paying closing costs and liabilities, must go the Intermediary and be used for the purchase of the new property.

FIRPTA rules impose additional requirements into 1031 exchange rules in order to avoid the 10% withholding. One of these is that the person responsible for transferring of the old property from the foreign seller to the buyer/transferee (such as a title or escrow company) must receive from the foreign seller either: (1) a Withholding Certificate issued by the IRS that sanctions the particular exchange and allows the transferee to avoid withholding any tax, or (2) notice from the foreign seller that certifies that the seller has applied for a Withholding Certificate. A seller will generally use IRS Form 8288-B to file an application for Withholding Certificate.

The foreign seller must provide an “individual taxpayer identification number” (“ITIN”) when applying for a Withholding Certificate. The ITIN cannot just be ‘applied for’. The ITIN must be assigned by the IRS and received by the seller before a Withholding Certificate application can be filed. The instructions to the application form for an ITIN (IRS Form W-7) state that it takes four to six weeks for the IRS to assign an ITIN. However, many tax professionals say it often takes more than three months for the ITIN to be assigned. If the foreign seller is an entity, then the person signing the entity’s ITIN application must also have a tax identification number. If that person is also a foreign person, they must apply for and receive an ITIN so that they can apply for the entity’s ITIN, which must be received before the entity can apply for a Withholding Certificate. All of this can take considerable time.

In any event, a few general guidelines should help ensure that foreign investors are not unwittingly tripped up by the FIRPTA restrictions. First, any foreign property owner should plan ahead to obtain an ITIN well before transferring any property, and to apply for a withholding certificate as soon as any property transfer has been arranged. Second, it is critical that any foreign seller wishing to complete a 1031 exchange consult with a knowledgeable, professional, qualified intermediary early in the sale process. Finally, any foreign seller should seek independent legal, tax, or financial counsel from experienced advisors to assist them with the closing and U.S. tax filing process.

A copy of the IRS forms necessary to apply for the ITIN, as well as the forms necessary to obtain a Withholding Certificate can be downloaded from our web site.