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Foreign Investment in Real Property Tax Act of 1980 and Section 1031 Exchanges

A foreign person that sells or exchanges a U.S. real property interest is subject to a required withholding under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA). A U.S. real property interest includes sales of interests in parcels of real property. FIRPTA requires that 10 percent of the gross sales price be withheld and remitted to the IRS within 20 days after the date of transfer.

Additionally, Treasury Decision 9082 (effective November 4, 2003) requires all foreign sellers of U.S. real property to have a Taxpayer Identification Number (TIN) to pay the required withholding or to request a reduced tax withholding. Individuals who do not qualify for Social Security Numbers (SSN) may – by filing form W-7 – obtain Individual Taxpayer Identification Numbers (ITINs) to meet the requirement to supply a TIN.

What is the definition of “foreign person” under FIRPTA?

FIRPTA defines a “foreign person” as a non-resident alien individual, a foreign corporation that has not made an election under section 897(i) of the Internal Revenue Code to be treated as a domestic corporation, a foreign partnership, a foreign trust, or a foreign estate. The term “foreign person” does not include a resident alien individual.

Who is required to withhold and remit the 10% to the IRS?

The buyer/transferee and certain agents of the buyer are responsible for withholding the 10 percent.

How and when is the withholding paid?

The tax must be reported and paid using IRS Form 8288, which must be filed with the IRS by the 20th day after the date of the transfer.

Are there any exceptions to the withholding requirement?

Yes, there are numerous exceptions to the withholding requirement. The most common exceptions are as follows:

1. Buyer acquires the property for use as a home and the sales price is not more than \$300,000;
2. Seller provides a certification stating under penalty of perjury that they are not a foreign person;
3. Seller obtains a withholding certificate from the IRS that excuses the withholding;
4. Seller provides the buyer a notice of non-recognition stating that no recognition of gain or loss on the transfer is required because of a provisions in the IRC Code or U.S. tax treaty; or
5. Amount the seller realizes from the disposition is zero.

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How does the seller obtain a Withholding Certificate?

A transferor looking to reduce or eliminate the FIRPTA withholding amount must file a Form 8288-B, Application for Withholding Certificate for Disposition by Foreign Persons of U.S. Real Property Interests. Form 8288-B requires a TIN. Thus, a transferor who does not qualify for an SSN may attach Form W-7 (application for TIN) with Form 8288-B. Foreign sellers should be aware that it takes the IRS 90 days to respond to an Application.

What is a notice of non-recognition?

A notice of non-recognition is a written notice given by the seller to the buyer stating that no recognition of any gain or loss on the transfer is required because of a non-recognition provision in the Internal Revenue Code – e.g. IRS section 1031 – or a provision in a U.S. tax treaty. The buyer is required to file a copy of the notice with the IRS by the 20th day after the date of transfer. The notice must contain the seller's TIN. There is no promulgated form for this notice.

A buyer is personally liable under FIRPTA if there is ultimately any actual tax liability to the seller resulting from the sale. The IRS can assess the full 10 percent of the sales price that should have been withheld or the seller's actual tax liability on the sale, whichever is less, plus interest and penalties. Thus, a buyer should never close a sale in reliance on a notice of non-recognition transaction except on the advice of a CPA, attorney, or other tax advisor because personal liability can result from reliance on an improper notice of non-recognition.

What if the seller applies for a Withholding Certificate to excuse withholding and the application is still pending at the time of the disposition?

If an application for a Withholding Certificate is submitted to the IRS on or before the date of a transfer and the application is still pending on the date of transfer, the withholding tax must be withheld, but it does not have to be paid and reported until 20 days after the withholding certificate or notice of denial is mailed by the IRS. It is important to note that if the seller's principal purpose in applying for a withholding certificate is to delay paying the withholding, the buyer/transferee will be subject to interest and penalties.

How does withholding of 10% of the proceeds affect a seller's 1031 exchange?

A seller in a 1031 exchange may use proceeds only to pay necessary expenses of sale or for the purchase of replacement property. Amounts expended for other items will be taxable. Thus, it is important for foreign sellers to recognize that using proceeds to pay the FIRPTA has a taxable consequence because FIRPTA is not considered a necessary expense of sale. To avoid this result, sellers should bring in cash to the closing agent to pay for the FIRPTA withholding, thus allowing all proceeds generated by the sale to be used in the exchange.