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## Dispositions of US Real Property Interests by Foreign Persons

**Kozusko Harris Duncan | Private Client & Offshore Services - USA**

JENNIE CHERRY, STEPHEN  
K VETTER



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The Foreign Investment in Real Property Tax Act 1980 (commonly known as 'FIRPTA') introduced tax and reporting requirements designed to ensure the imposition and collection of tax on gain recognized upon a foreign owner's disposition of US real property. These rules, further complicated by detailed regulations, can apply regardless of whether the foreign person owns US real property interests outright, through a corporate structure or in trust. The Internal Revenue Service (IRS) recently announced that it will issue regulations revising rules for inbound and foreign-to-foreign asset reorganizations that involve the transfer of US real property interests.

### **Basic Income Tax Rules**

US persons (individual citizens and domestic corporations) and non-citizens resident in the United States for income tax purposes are subject to US income tax on worldwide income, including gain on the sale of real property. Foreign corporations and non-resident aliens who are not engaged in a US trade or business are generally subject to US income tax only on US source income. Special exemptions for certain types of US source income earned by non-US persons have been enacted to promote

investment in the United States, to facilitate enforcement or to avoid enacting rules that cannot be enforced. One such exemption is that US source capital gains earned by a foreign corporation or non-resident alien are generally exempt from US income tax. (For a detailed discussion of income tax rules applicable to US and non-US individuals, please see the Overview (March 2006).)

### **Foreign Investment in Real Property Tax Act 1980**

Since 1980 the capital gain exemption has not applied to capital gains realized on the sale or exchange of US real property interests. FIRPTA added to the income tax rules provisions that gain or loss from the disposition by a non-resident alien or foreign corporation of a US real property interest is to be treated as effectively connected with a US trade or business and is thus subject to US net income taxation. The tax is enforced by means of a special withholding tax regime.

#### ***US real property interest***

A 'US real property interest' includes not only parcels of land, but also shares of US real property holding corporations. A US domestic corporation is a US real property holding corporation if the fair market value of its US real property interests equals or exceeds 50% of the sum of its:

- US real property interests;
- interests in foreign real property; and
- other assets used or held for use in its trade or business.

Before acquiring stock of a domestic corporation from a foreign person, a transferee/buyer will want to obtain a statement that the stock is not a US real property interest.

#### ***Disposition***

The tax imposed under FIRPTA applies if there is a disposition of a US real property interest for any purpose under the Internal Revenue Code. Thus, in addition to an outright sale, the term 'disposition' can also include:

- capital contributions, redemptions, distributions, like-kind exchanges and gifts where liabilities exceed adjusted basis;
- changes in interests in a partnership, trust or estate;
- corporate reorganizations, mergers or liquidations; and
- even foreclosures or inventory conversions.

### **Withholding and Reporting**

To ensure collection of the FIRPTA tax, the transferee/buyer of a US real property interest from a foreign person is required, as withholding agent, to withhold 10% of the total amount realized by the foreign person. The 10% withholding requirement is generally more than the tax owed on any gain. The transferor/seller may obtain from the IRS a withholding certificate adjusting the amount that must be withheld.

The transferee/buyer must report and pay over the withheld tax to the IRS by the 20th day following the transfer date. A transferee/buyer that fails to withhold may be held liable for the tax. With the payment of tax, the transferee/buyer must file Form 8288, US Withholding Tax Return for Dispositions by Foreign Persons of US Real Property Interests, and Form 8288-A, Statement of Withholding on Dispositions by Foreign Persons of US Real Property Interests.

### **Exceptions to Withholding**

Exceptions to FIRPTA withholding generally apply when a transferor/seller is not subject to FIRPTA tax on the disposition. Even so, regulations require substantiation that FIRPTA withholding tax is not applicable before withholding can be avoided. Complying with the regulations can protect a transferee/buyer from liability for interest, tax and penalties in the event the transferor/seller makes an incorrect determination that no FIRPTA tax was due. Prudent family advisers will therefore recommend completing all substantiation requirements in the manner prescribed in the regulations.

### ***Use as personal residence***

In the case of a personal residence the seller may be subject to tax, but the buyer may not be required to withhold. This exception applies only when one or more individuals acquire the US real property interest for use as a residence and the amount realized is \$300,000 or less. Whether the seller is an entity or individual is irrelevant, as is the seller's use of the property. No detailed substantiation is required to be filed to obtain this exception, although it applies only to the buyer's withholding of tax. The seller must pay any tax incurred on the gain when it files its income tax return.

### ***'i-election'***

Foreign corporations eligible under Section 897(i) of the Internal Revenue Code may elect to be treated as domestic corporations for purposes of FIRPTA (commonly referred to as an 'i-election'). When disposing of a US real property interest, the electing foreign corporation can then provide the purchaser with certification of its non-foreign status and avoid withholding, provided information and documentation requirements are complete.

FIRPTA can still apply upon the disposition of the electing corporation's own stock. Stock of a foreign corporation is not a US real property interest under FIRPTA so that neither the tax nor withholding rules apply to the disposition of its stock. However, once that foreign corporation has made an i-election, its stock is considered stock in a domestic corporation and upon a disposition is subject to FIRPTA withholding as a US real property interest. Thus, a transferee/buyer of stock of a foreign corporation may be required to withhold under FIRPTA if the transferor/seller is foreign and the foreign corporation has made an i-election.

### **Corporate Ownership Structures**

A non-resident alien owning a US real property interest outright is subject to FIRPTA withholding upon disposition of the property. The estate of the non-resident alien is subject to US estate tax on the value of any interest in the real property owned at death. Rather than outright ownership, corporate structures are often utilized and, in many cases, owned by foreign trusts. (For a detailed discussion of gift and estate tax rules applicable to US and non-US individuals, please see the Overview (March 2006).)

A common structure used to acquire US real property has been for the non-

resident alien (or a trust settled by the non-resident alien) to organize and capitalize a foreign corporation, with the foreign corporation then purchasing the US real property. This structure arguably shields the non-resident alien from US estate tax as he or she owns shares of a foreign corporation at death which are not deemed situated in the United States, although there are potential corporate income tax issues. For purposes of FIRPTA, the foreign corporation's distribution of a US real property interest to its shareholders (including a liquidation or redemption) is considered a disposition.

Another common structure is for the foreign corporation to organize a US corporation, which in turn acquires and holds the US real estate. The use of a US company for rental real estate avoids the potential application of the branch profits tax. In addition, a US company may sell the property without the buyer having to comply with the FIRPTA withholding requirements. However, in addition to two levels of US taxation on corporate income, liquidating distributions and even certain non-liquidating distributions of a US real property holding company may be considered dispositions subject to FIRPTA.

### **Changes Affecting Compliance**

General corporate tax rules often do not tax gain realized in the course of a statutory merger or consolidation, but these transactions may be considered dispositions under FIRPTA when US real property interests are involved. In 1988 the IRS issued regulations to address the overlay of the FIRPTA rules with the corporate non-recognition rules. These regulations, as modified by subsequent notices, generally provide that certain corporate transactions involving the transfer of US real property interests are not taxable as long as the ability to tax the transferred gain is preserved and specified conditions and limitations are met. These rules are extremely complex and include detailed procedural requirements, often a trap for the unwary.

In January 2006 the IRS modified the definition of a 'statutory merger or consolidation' to include those carried out under the laws of foreign jurisdictions. It subsequently announced in May that it will revise the

FIRPTA rules so that foreign corporations holding US real property interests are not required to recognize gain when participating in an otherwise tax-free merger or consolidation, whether foreign to foreign or an inbound reorganization. The proposed changes are helpful to the extent that they eliminate or modify some of the more complicated FIRPTA regulations, but further revisions are needed.

*For further information on this topic please contact Jennie Cherry at Kozusko Harris Vetter Wareh LLP's New York office by telephone (+1 212 980 0010) or by fax (+1 212 202 4484) or by email (jcherry@kozlaw.com). Alternatively, contact Stephen Vetter at Kozusko Harris Vetter Wareh LLP's Washington, DC office by telephone (+1 202 457 7200) or by fax (+1 202 457 7201) or by email (svetter@kozlaw.com).*

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