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FREQUENTLY ASKED QUESTIONS REGARDING WITHHOLDING REQUIREMENTS UNDER THE FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT

Previous to the enactment of the Foreign Investment in Real Property Tax Act (FIRPTA) in 1980, foreign sellers of U.S. real estate were not taxed on the capital gains realized on the sale of real estate situated in the U.S., unless such real estate was used in a U.S. trade or business. Under FIRPTA, foreign sellers of U.S. real estate were subjected to U.S. capital gains tax on the profit realized on the sale effective for dispositions after June 18, 1980. The withholding requirements under FIRPTA became effective for dispositions after December 31, 1984.

The withholding rules under FIRPTA can be very confusing and have changed over the years. The questions and answers below attempt to address some of the most common situations encountered in complying with the requirements under FIRPTA.

What is the definition of a "foreign person" with regards to FIRPTA?

For purposes of applying the withholding rules under FIRPTA, a "foreign person" is defined as a nonresident alien individual, a foreign corporation, a foreign partnership, a foreign trust or a foreign estate. A resident alien individual, including a nonresident alien electing to be treated as a U.S. resident, is not a foreign person.

Under FIRPTA, a foreign person disposing of a U.S. real property interest must have 10 percent of the amount realized withheld. What constitutes "amount realized?"

An "amount realized" means the sum of the cash paid, or to be paid (not including interest), the fair market value of other property transferred or to be transferred and the amount of any liability assumed by the transferee or to which the U.S. real property interest is subject immediately before and after the transfer. Generally, the amount realized, for purposes of FIRPTA withholding, is the sales or contract price.

Is there any exception to the 10 percent withholding requirement under FIRPTA when U.S. real property is sold by a foreign person?

Yes, there is no withholding required if the sales price is \$300,000 or less **and** the buyer (including family members) intends to use the property for personal purposes as a residence for more than 50 percent of the time the property is in use for the first two 12-month periods following the transfer. The days the property is vacant are excluded in the 50 percent calculation. Vacant land is specifically excluded, even if the buyer intends to build a residence on the property. In order for this exemption to apply, the buyer must be an individual, as opposed to a partnership, corporation, estate or trust. The buyer must also sign an affidavit, under penalties of perjury, that they meet the requirements for the exemption. Even though the seller may be exempt from the 10 percent withholding, the seller is still required to file a U.S. income tax return to report the sale and pay any applicable income taxes on the profit on sale.

What is a withholding certificate and who may apply for one?

Technically, the amount of tax required to be withheld under the provisions of FIRPTA cannot exceed the maximum tax liability of the transferor. Many times, the maximum tax liability is significantly less than the 10 percent required withholding. Under these circumstances, the regulations provide a procedure by which the Internal Revenue Service (IRS) can agree to an amount which is less than the required 10 percent withholding. The agreement of a reduced amount can be obtained by applying for a withholding certificate. This procedure is generally done by submitting a properly completed IRS Form 8288-B. Either the transferor (seller) or transferee (buyer) may apply for the withholding certificate.

A nonresident has a contract to sell U.S. real estate for \$500,000, with a closing date of July 1. There will be a tax loss on the transaction. What is the latest date an application for reduced withholding can be submitted?

The application for a reduction in the 10 percent withholding must be submitted to the IRS no later than July 1, the date of closing. If the application is not submitted by the date of closing, the full 10 percent withholding must be remitted to the IRS.

How long does it take the IRS to process an application for a reduced withholding?

Although there is no set time period, most applications for a reduced withholding are processed within 90 - 120 days after submission.

When must the 10 percent withholding or reduced withholding, if applicable, be remitted to the IRS?

At closing, the 10 percent withholding is deducted from the proceeds due to the seller. If no reduction is applied for, then the 10 percent withholding must be remitted to the IRS within 20 days after closing. If an application has been filed to reduce the withholding, the 10 percent is withheld, but the funds are held in escrow, awaiting receipt of the withholding certificate from the IRS. The reduced withholding must be remitted to the IRS within 20 days after the date of the withholding certificate. The withholding amount is remitted to the IRS using Forms 8288 and 8288-A.

Who is responsible for the proper remittance to the IRS of the 10 percent withholding or reduced amount, if applicable?

Generally, the transferee (buyer) is the party responsible for seeing that the proper amount of withholding is remitted to the IRS on a timely basis. The IRS will not hold the closing agent (attorney, title company, etc.) responsible for remitting the withholding as long as their connection with the transaction is limited to a) receiving and disbursing any part of the consideration, b) recording any document, c) typing, copying, and other clerical tasks, d) obtaining title insurance reports and reports concerning the condition of the property, or e) transmitting documents between the parties. In most cases, the closing agent is the party that actually remits the funds to the IRS, but the buyer is held responsible for seeing that it is done.

Is there an exemption from the 10 percent withholding when a foreign person is the seller in a short sale?

There is no exemption from the 10 percent withholding on account of a short sale. However, in most cases, it would be advisable to apply for a reduction in the withholding from the IRS. A withholding certificate, stating that the withholding had been reduced to zero, must be obtained before closing can take place or the 10 percent must be held by the closing agent until a withholding certificate can be obtained or remitted to the IRS within 20 days after closing. Even though the IRS is not obligated to expedite the processing of reduced withholding applications in the case of a short sale, it is sometimes possible to obtain expedited processing due to a hardship.

If a nonresident sells U.S. real estate at a loss and receives a zero withholding certificate, must they still file a U.S. income tax return to report the sale?

Yes, without exception. The granting of a withholding certificate does not eliminate any requirements to file a U.S. tax return to report the transaction.

Is a foreign person required to have an Individual Taxpayer Identification Number (ITIN) before selling U.S. real estate?

A foreign person is **not** required to possess an ITIN in order to sell U.S. real estate. However, if they do not possess an ITIN at the time of sale, it is to their advantage to apply for one shortly after the sale.

How does a foreign person apply for an ITIN?

The ITIN is applied for by completing a Form W-7 and remitting the form, along with proper documentation, to the IRS. In order to apply for an ITIN, the foreign person must show that they have a valid reason for requesting the number. The sale of U.S. real estate constitutes a valid reason for obtaining the ITIN.

A husband and wife hold joint title to U.S. real estate. The husband is a foreign person and the wife is a U.S. citizen. They are selling U.S. real estate for \$500,000. How is the amount of withholding determined?

If the U.S. real estate is owned jointly by foreign and nonforeign spouses, the withholding is 10 percent of the amount realized that is allocable to the foreign seller. In the absence of evidence to the contrary, a husband and wife are each deemed to own 50% of the property for purposes of the 10 percent withholding. In the above example, the withholding would be \$25,000 (\$500,000 sales price X 50% attributable to foreign spouse X 10% withholding rate).

While it is impossible to address every conceivable situation which may be encountered, hopefully this article has provided useful information pertaining to some of the most frequently asked questions regarding the application of the Foreign Investment in Real Property Tax Act.

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