FOREIGN NATIONALS AND FIRPTA

By:
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About the Author:
Ms. Glendinning joined the firm in 1987 and has headed the International Tax Department since 1996. She has authored articles regarding various international tax issues and frequently gives presentations on U.S. income and estate taxation of foreign nationals doing business in the U.S.

When a foreign person sells U.S. real estate, he or she is subject to having ten percent of the gross sales price withheld from the proceeds received at closing. This is a requirement under the Foreign Investment in Real Property Tax Act, known as FIRPTA. This ten percent withholding must be remitted to the Internal Revenue Service (IRS) no later than 20 days after closing.

The ten percent withholding has no relation to the amount of tax actually owed on the sale. It is merely a deposit that is applied against the actual tax. The actual tax is calculated on the U.S. income tax return required to be filed to report the sale. The amount of withholding is compared to the actual tax on the sale. If the tax is less than the withholding, the difference is refunded to the seller. If the tax is more than the withholding, the seller must pay the difference to the IRS.

There is one exception to this general rule. No withholding is 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 at least 50 percent of the time the property is in use for the next two 12-month periods following the transfer. The days the property is unoccupied are excluded in the 50 percent calculation. Vacant land is specifically not eligible for this treatment, even if the buyer intends to build a residence on the property. In order for the exemption to apply, the buyer must be an individual, as opposed to a partnership, corporation, estate or trust.

For example, a foreign person sells U.S. real estate for $250,000. The buyer intends to rent out the property for three months of the year and use it personally for four months of the year. The property will be vacant for the remaining five months of the year. In this example, the property is in use for seven months of the year. Since the buyer intends to use the property for personal purposes for four months out of the seven months that the property is in use, this meets the 50 percent test. If this is the intent of the buyer for at least two years following the purchase of the property, the seller will be exempt from the ten percent withholding requirement, as long as the buyer signs an affidavit, under penalties of perjury, that he or she meets the conditions for the exemption. Even though the seller is exempt from the ten percent withholding, he or she must still file a U.S. income tax return to report the sale and pay any income taxes that apply.

If the sales price exceeds $300,000, no exemption from withholding is available regardless of the intended use of the property by the buyer. Withholding is mandatory on any sale in excess of $300,000, whether the sale results in a profit or a loss.

If the actual tax on the transaction is significantly less than the ten percent withholding, the seller may apply for a withholding certificate from the IRS. This withholding certificate allows for an amount of less than ten percent of the gross sales price to be withheld from the closing proceeds. Let's take the example where a property is being sold for $500,000, but the seller had previously purchased the property for $600,000. The seller will incur a loss on the sale and, therefore, no tax will be payable on the transaction. The seller is still subject to a withholding of $50,000 on the sale. The seller may submit an application to the IRS showing evidence that the transaction will result in a loss. This application must be submitted to the IRS no later than the date of closing. Otherwise, the ten percent will have to be sent to the IRS no later than 20 days after closing. Once the application has been submitted, it generally takes the IRS 90 days to issue the withholding certificate. The withholding certificate will state that withholding on the sale has been reduced to zero. Therefore, closing can take place without withholding.

Due to the 90 day time lag between the filing of the application and the issuance of the withholding certificate, many times the closing will take place before the withholding certificate is issued. In this case, the closing takes place and the ten percent withholding is deducted from the closing proceeds. Instead of remitting the ten percent withholding to the IRS no later than 20 days after closing, the closing agent is authorized to hold the funds in escrow until receipt of the withholding certificate. Once the withholding certificate is received, the closing agent will remit the lower withholding amount, if any, and release the balance of the funds directly to the seller.

The decision of whether or not to apply for a withholding certificate to reduce the withholding depends on the particular circumstances of the sale. Factors to consider are the amount of actual tax compared to the amount of withholding and the timing of the sale. Individuals are on a calendar year reporting for income tax purposes. If the sale takes place in January, the seller must wait until the following January to apply for the refund via the filing of an income tax return. By the time the refund is received, this could be at least 14 months after the sale. Depending on the amount of the overpayment, it could be advisable to apply for the reduced withholding through the filing of the withholding certificate application. If the same sale took place in December, the tax return could be filed shortly thereafter and the refund obtained within a few months after closing. In this case, there would be less reason to apply for the reduced withholding.

In the case of a short sale, where the sales proceeds are insufficient to pay the mortgage balance, the ten percent withholding rules still apply. The only exception is if the sales price is $300,000 or less and the buyer meets the criteria for the exception as explained above. The only other alternative is to request a withholding certificate from the IRS. Otherwise, it is doubtful that the lender would approve the sale as any withholding would reduce the amount paid to the lender at closing.

Since every situation is unique, we are happy to advise you on the options available to you in complying with this requirement on the sale of your property.

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I would be happy to assist you with any of your questions. Please call 941-365-4617 or email me at rglendinning@kbgrp.com.