FOREIGN INVESTMENT – US REAL PROPERTY

Mark Chaves
October 2023

MARCUM UNIVERSITY

FIRPTA and Definitions

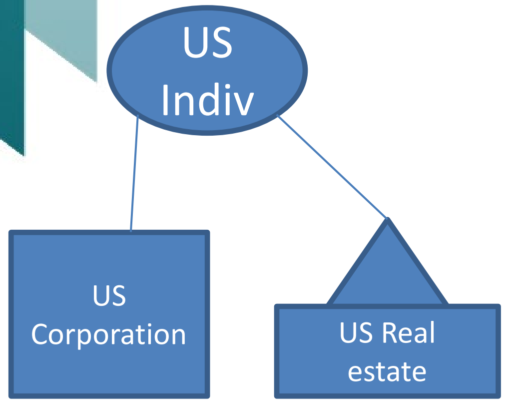
- The US Foreign Investment in Real Property Tax Act (FIRPTA) governs the taxation of non-resident individuals or entities disposing of US real estate or US real estate entities
- Gain on disposition is treated as sale of an asset effectively connected with a US trade or business.
- In order to ensure collection of tax on the disposition, the US imposes a withholding tax on the sale = to 15% of the amount realized.
- ***Real property -*** The term "real property" includes the following three categories of property: Land and unserved natural products of the land, improvements, and personal property associated with the use of real property.
  - ***Improvements***— The term "real property" includes improvements on land. An improvement is a building, any other inherently permanent structure, or the structural components of either
  - ***Structural components of buildings and other inherently permanent structures -*** Structural components include walls, partitions, floors, ceilings, windows, doors, wiring, plumbing, central heating and central air conditioning systems, lighting fixtures, pipes, ducts, elevators, escalators, sprinkler systems, fire escapes and other components relating to the operation or maintenance of a building. However, the term "structural components" does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs.

FIRPTA and Definitions

- ***Personal property associated with the use of the real property***—The term "real property" includes movable walls, furnishings, and other personal property associated with the use of the real property. "Personal property" means any property that constitutes "tangible personal property"

- **Stock of a US Real Property Holding Corporation**
  - Domestic corporation that holds more than 50% US real property interests during the 5 year period ending on date of disposition (Based on FMV)
  - Look through rule for partnerships
- Look through rule for controlling interests in tiered corporations

Sale of US Real Estate - Withholding



- Sale or disposition of US real property by a non-resident individual or entity results in the application of the US FIRPTA Provisions
- FIRPTA = Foreign Investment in US Real Property Tax Act
  - Requires a withholding tax of 15% of the amount realized on the sale of a US real property interest
- Exceptions to withholding apply if:
  - The domestic corporation being sold does not qualify as a US Real Property Holding Corporation
  - Purchaser is acquiring the property for use as a residency and the amount realized does not exceed $300,000
  - Stock disposed of is regularly traded
  - Reduced withholding may apply if:
    - Withholding exceeds the maximum tax liability that may apply on the sale
    - Apply for a withholding certificate on Form 8288-B
    - Purchased for use as a residence and amount realized does not exceed $1M. Withholding reduced to 10%

MARCUM UNIVERSITY

Withholding Certificate Procedure

- Used to reduced withholding tax if the maximum tax liability on disposition is less than the required withholding amount
- Form 8288-B is the applicable form
- Form 8288-B must be sent to the Internal Revenue Service on or before the date of sale
- Application contains penalties of perjury statements attesting to the fact that the calculation of tax liability is correct, and that no money is owed to the IRS by the seller on the seller's purchase of the property

	Example (Individual seller)	Example (Corporate seller)
Sales Price =	$2,000,000	$2,000,000
Closing costs =	($80,000)	($80,000)
Tax basis =	($1,000,000)	($1,000,000)
Gain on Sale =	$920,000	$920,000
Tax on gain =	$184,000	$193,200 (21%)
Required withholding =	$300,000	$300,000
Reduction in withholding =	$116,000	$106,800

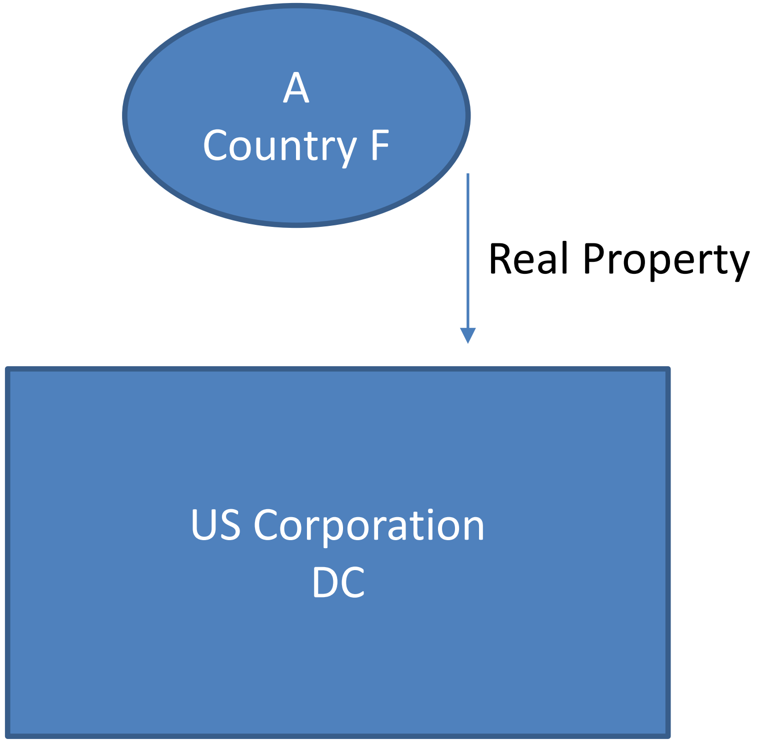
- The reduced withholding of $116,000 or $106,800 may be held by the closing agent until the IRS authorizes the refund seller
- Gain generally treated as capital gain

MARCUM UNIVERSITY

Non-Recognition Transactions

- Withholding is generally not required in the case of dispositions of US Real Property Interests that qualify as non recognition transactions
- Non recognition transactions include the following:
- Section 332 – Corporate liquidations
- Section 351 – Transfers to a corporation
- Section 354/361 – Corporate Reorganizations
- Section 355 – Corporate spinoffs/split-ups/split-offs
- Section 721 – Contributions to partnerships
- Section 731 – Partnership distributions
- Section 1031 – Like Kind exchanges
- Section 1033 – Involuntary conversions
- Section 1036 – common stock exchanges or preferred stock exchanges
- In order for a non recognition provision to apply, a US Real Property Interest must be received in exchange for a US Real Property Interest

SECTION 351 Example



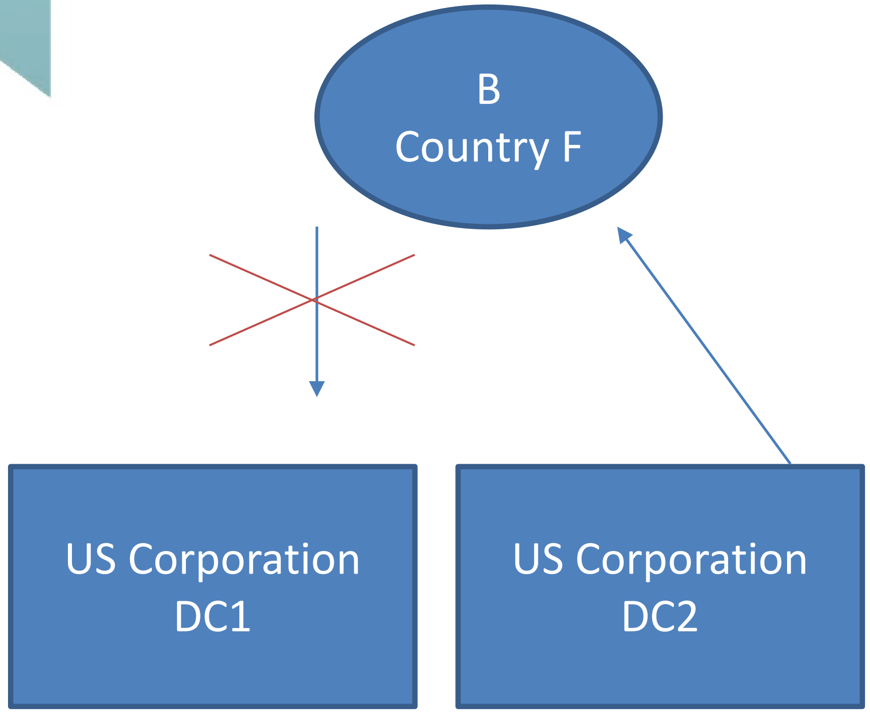
- A is a citizen and resident of Country F with which the U.S. does not have an income tax treaty. A owns Parcel P, a U.S. real property interest, with a fair market value of $500,000 and an adjusted basis of $300,000. A transfers Parcel P to DC, a newly formed U.S. real property holding corporation wholly owned by A, in exchange for DC stock.

<u>Result</u>

- A has exchanged a U.S. real property interest (Parcel P) for another U.S. real property interest (DC stock) which is subject to U.S. taxation upon its disposition. The nonrecognition provisions of section 351(a) apply to A's transfer of Parcel P.

- The basis of the DC stock received by A is determined in accordance with the rules generally applicable to the transfer. A takes a $300,000 adjusted basis in the DC stock under the rules of section 358(a)(1).

SECTION 354 Example

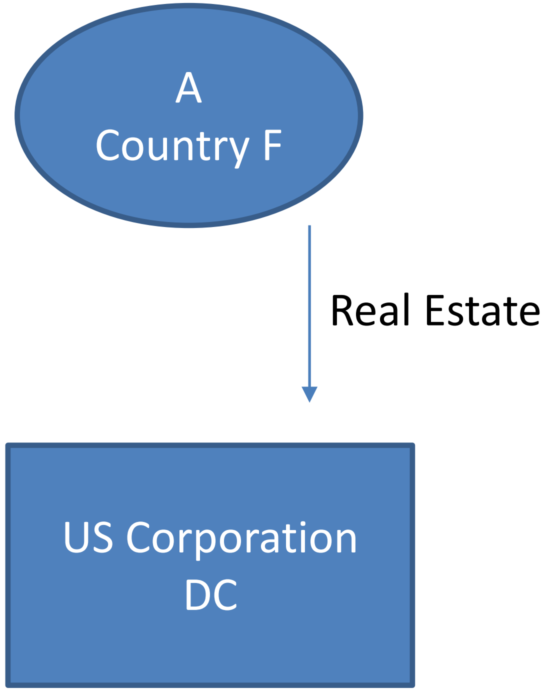


- B is a citizen and resident of Country F with which the U.S. does not have an income tax treaty. B owns stock in DC1, a U.S. real property holding corporation. In a reorganization qualifying for nonrecognition under section 368(a)(1)(B), B exchanges the DC1 stock under section 354(a) for stock in DC2, a U.S. real property holding corporation.

Result

- A does not recognize any gain on the exchange of the DC1 stock for DC2 stock because there is an exchange of a U.S. real property interest(the DC1 stock) for another U.S. real property interest (the DC2 stock) which is subject to U.S. taxation upon its disposition.

SECTION 351 Example – Treaty Country

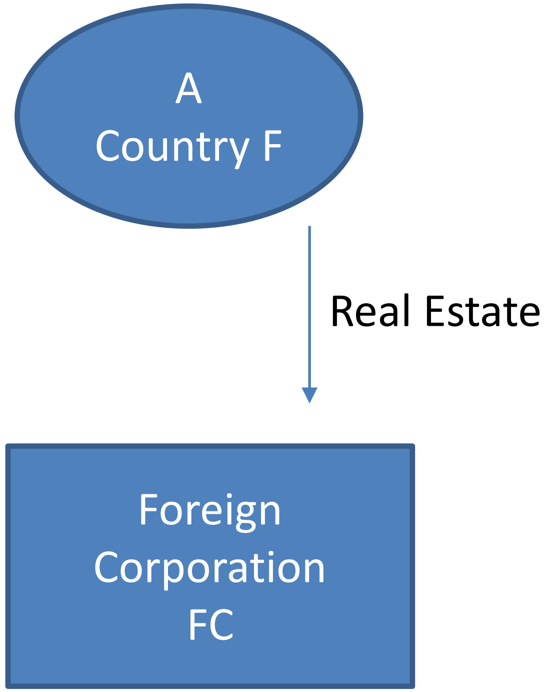


- A is an individual citizen and resident of Country F. F has an income tax treaty with the United States that exempts gain from the sale of stock, but not real property, by a resident of F from U.S. taxation. A transferred Parcel P, an appreciated U.S. real property interest, to DC, a U.S. real property holding corporation, in exchange for DC stock. A owned all of the stock of DC.

Result

- A must recognize gain on the transfer of Parcel P. Even though there is an exchange of a U.S. real property interest for another U.S. real property interest, there is gain recognition because the U.S. real property interest received (the DC stock) would not have been subject to U.S. taxation upon a disposition immediately following the exchange. A may not convert a U.S. real property interest that was subject to taxation under section 897 into a U.S. real property interest that could be sold without taxation under section 897 due to a treaty exemption.

Transfer to Foreign Corporation

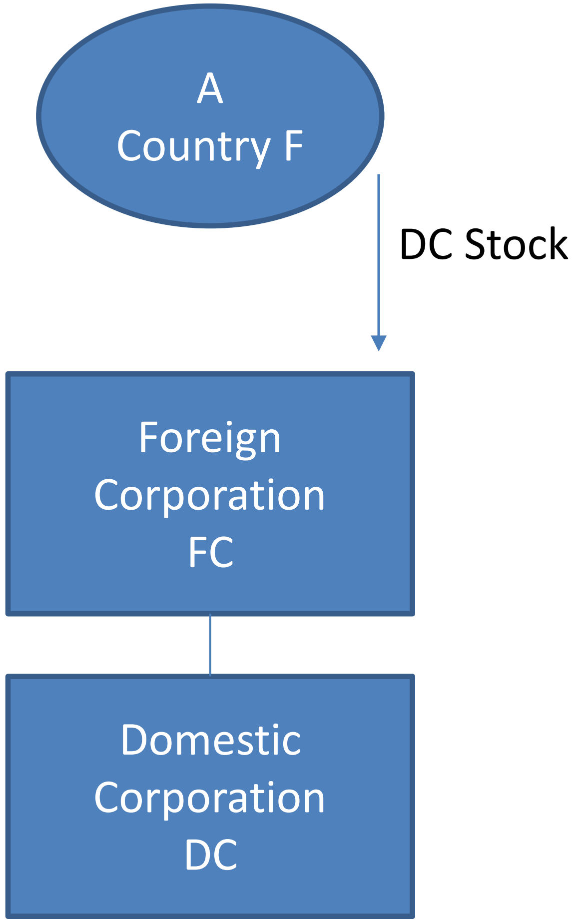


- A is an individual citizen and resident of Country F. F has no income tax treaty with the United States that exempts gain from the sale of stock, but not real property, by a resident of F from U.S. taxation. A transferred Parcel P, an appreciated U.S. real property interest, to FC, a foreign corporation, in exchange for FC stock. A owned all of the stock of FC.

Result

- A must recognize gain on the transfer of Parcel P.
- FC is not a domestic corporation and will not be considered a USRPHC
- Note 897(i) election in the case of treaty countries

IRS Notice 2006-46



- A is an individual citizen and resident of Country F. F has no income tax treaty with the United States that exempts gain from the sale of stock, but not real property, by a resident of F from U.S. taxation. A transferred domestic corporation stock, DC (a USRPHC)to FC, a foreign corporation, in exchange for FC stock. A owned all of the stock of FC.

Result

- Notice 2006-46 provides an exception to gain recognition if:
- FC stock is not disposed of within one year of receipt
- A must own substantially all of FC stock
- Need to consider the US inversion rules

MARCUM UNIVERSITY

Planning Opportunities

- Many foreign investors own US real property through foreign corporations to shelter the asset from US estate tax exposure
- Foreign investors often have children that are US citizens or residents and wish to transfer the US real estate to their children
- Removing the US real property from the foreign corporation will produce US gain under section 301/331 as described previously and under the FIRPTA provisions
- Investors can consider gifting the shares of the foreign corporation to their US children (foreigners are exempt from US gift tax on gifts of intangible property such as shares of stock)
- US children can then domesticate the US corporation (treated as a tax-free reorganization under section 368(a)(1)(F)
- Newly domesticated corporation can elect S status. No corporate level gain on the property sale under section 1374 if the property is not disposed of within 5 years