Foreign Investment in U.S. Real Property – An Introduction

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GLOBAL REAL ESTATE SUMMIT 2020 - NOVEMBER 5 2020

US Tax Ramifications of Foreign Investment in U.S. Real Property

Agenda:

- Types of U.S. taxes a nonresident alien (“NRA”) is exposed to when purchasing U.S. Real Property
- Sample structures to mitigate these taxes
- Foreign Investment in Real Property Tax Act (“FIRPTA”)
  - Withholding Requirements
  - Withholding Certificates
- Foreign Person’s Tax Filing Requirement
  - Taxpayer Identification Number
- Other
  - LB&I IRS division – FIRPTA Reporting Compliance for NRAs Campaign
  - FinCEN Geography Targeting Orders

Imposition of U.S. Taxes

Real Estate Taxes

Estate & Gift Tax

- Transfer Taxes
  - Gift – During life
  - Estate – At death
- NRA individuals are subject to income, gift, estate, and generation-skipping tax (GST) on their U.S.-situated assets
- IRC § § § § § 2104, 2105, 2501(a)(1) and (2), 2663(2) and Treas. Reg. 26.2663-2(a)

Mansion Tax (NYC 1%-3.9% PP > $1M)

Income Tax

- NRA persons (individuals and entities) are subject to income tax on their U.S. – source income and disposition of U.S. real property
- IRC § § § § 871, 872, 881, 882 and 897

U.S. Estate & Gift Taxes

Imposition

- Based on value of property less debts on date of death or at time of gift
- $15,000 gift tax exemption
- $60,000 lifetime estate tax exemption
- Tax Rate – is 40% in 2020

Example

- Value of real and other tangible property located on premises - $10mm
- Debts - $0
- NRA taxable estate - $10mm
- NRA estate tax ~ $4mm

U.S. Income taxes

Rental Income

- Federal Tax
  - 10% to 37%
  - State taxes deducted on federal return
- State Tax
  - Varies by state
  - No personal income tax (individuals and trusts) in AK, FL, NV, SD, TX, WA and WY (TN and NH tax only interest and dividends)

Gain on Sale

- Federal Tax
- Income tax rates
- 20% for individuals and trusts
- Generally 21% for corporations
- Withholding (FIRPTA)

credited towards tax liability

- State Tax
  - Varies by state

U.S. Income taxes

Net Investment Income Tax (“NIIT”)

- NRAs are not subject to this tax.

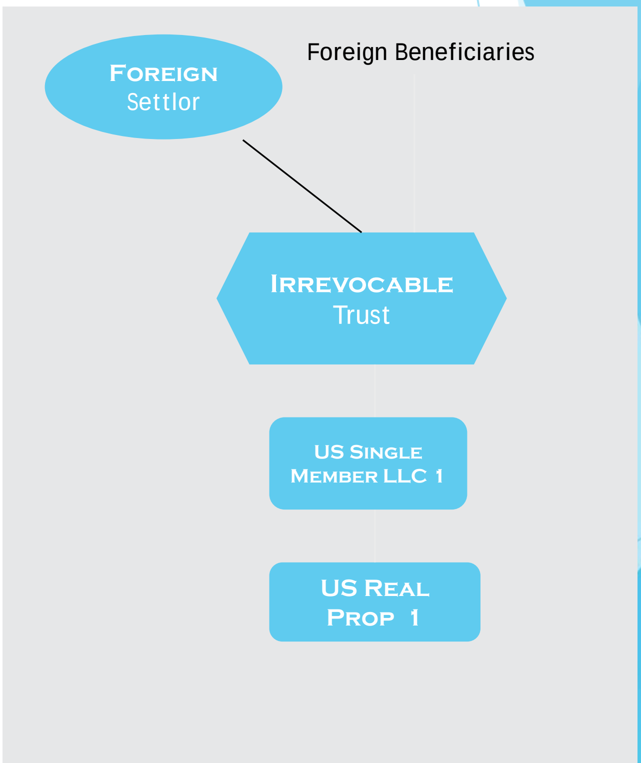
Simple Trust Structure

Benefits

- Single level of income tax
  - Trust will file and pay tax
- Individual income tax rates apply
- No estate or gift tax
- U.S. or foreign trust allowed

Disadvantages

- ITINs may be required
- Foreign settlor / beneficiaries may be required to file U.S. tax returns



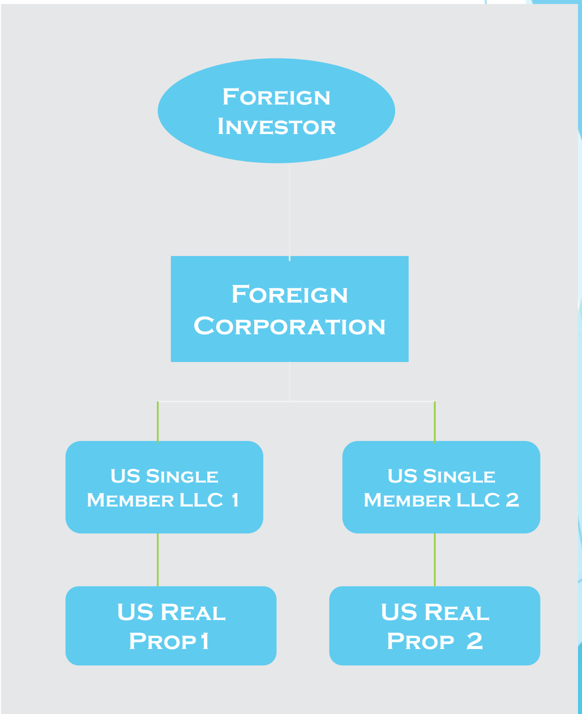
Foreign Corporate Structure

Benefits

- No estate and gift tax
- No ITIN or foreign investor tax filings
- No withholding tax

Disadvantages

- Double taxation
    - Corporate tax of 21%
    - Branch profits tax/withholding tax of 30% on corporate distributions
        - Treaty rates may apply
    - Double taxation at state and some local levels



Foreign Investment in Real Property Tax Act ("FIRPTA")

US seller signs affidavit affirming they are US persons not subject to FIRPTA.

- A foreign person will be subject to FIRPTA upon the disposition of a U.S. real property interest ("USRPI").
- FIRPTA is a process put in place to ensure the collection of tax from a foreign person upon the disposition of a USRPI.
- The disposition of an interest in U.S. real property by a foreign person is treated as if the person was engaged in a U.S. trade or business, and gain or loss must generally be recognized on the transaction (IRC 897(a), 871(b) and 882(a)).
- The disposition by the foreign person is subject to tax under IRC § § § 1, 11, and 55, and the transferee (buyer or his agent) must usually withhold tax and submit the appropriate tax returns (IRC 1445 and related regulations).

Foreign Investment in Real Property Tax Act ("FIRPTA")

- The withholding tax is 15 percent of the net proceeds, typically the sales price less any sales commissions.
  - **EXCEPT:** Sales over $300,000 and under $1,000,000 are 10% if used as a residence.
- Treaty exceptions may apply.
- Note that the withholding obligation is on the buyer or his agent and not on the foreign seller.
- It is easier for the IRS to collect from someone with a U.S. connection.

FIRPTA Definitions: Foreign Person

A foreign person includes:

- Nonresident aliens (“NRA”);
- Foreign corporations that have not made an election to be treated as a domestic corporation for FIRPTA purposes (i.e., IRC 897(i) election);
- Foreign partnerships;
- Foreign trusts; and
- Foreign estates.

FIRPTA Definitions: U.S. Real Property Interest

- U.S. real property interest under IRC 897(c)(1); (c)(2); (c)(3); (c)(4) is:
- Any interest in real property and associated property located in the U.S. or the Virgin Islands; and
- Any interest in a domestic or foreign corporation defined as a U.S. real property holding company.

FIRPTA Definitions: U.S. real property holding company (“USPHC”)

A U.S. real property holding company (“USPHC”) is defined as:

- A domestic or foreign corporation that has U.S. real property interests that equal or exceed 50 percent of the total fair market value of its U.S. and foreign real property and any other assets used in a trade or business.
- There is an exception for stock regularly traded on an established securities market.
- Assets held by a partnership, trust, or estate are treated as being held proportionately by its partners or beneficiaries.

Withholding Requirements

- Generally the transferee, and/or his or her agent, must withhold a tax equal to 15% of the net proceeds on the disposition of U.S. real property by an NRA.
- The 15 percent withholding is not the amount of tax, but merely a mechanism for the U.S. to ensure the collection of tax.
- This withholding does not relieve the seller from filing a U.S. tax return (i.e., Forms 1040NR, 1120 or 1120F).
- The rules are different if the seller is a domestic partnership, trust, or estate with foreign partners or beneficiaries.
- IRC § 1446 withholding tax applies to the effectively connected income of a domestic partnership to the extent that it is allocable to foreign partners.

Withholding Requirements - Continued

- Non-grantor trusts and estates have a withholding obligation upon the distribution of cash or property to a foreign beneficiary.
- The fiduciary must maintain a special USRPI account to withhold 37 percent of any distributions to a foreign beneficiary up to the balance of the USRPI account.
- If a grantor trust has a foreign owner, the fiduciary must withhold a tax of 37% of the gain the trust realizes on the disposition of a USRPI, to the extent the gain is allocated to the foreign person.
- If a domestic trust or estate has a foreign beneficiary and disposes of a USRPI, the fiduciary may be required to withhold. (See Treas. Reg. 1.1445.5(c)(1)(iii)(A).)

Withholding Requirements - Continued

Exceptions to the general rule are as follows (under 1445(b)):

- The property is acquired by the buyer for use as a residence, and the purchase price is less than $300,000;
- The corporate stock of the seller is regularly traded on an established securities market;
- A non-publicly traded corporation furnishes an affidavit that the interest being disposed is not an interest in U.S. real property, and the transferee has no knowledge that the statement is false;
- An NRA (individual or entity) transferor furnishes the transferee with an affidavit stating, under penalty of perjury, that he or she is not a foreign person, and provides his or her U.S. taxpayer identification number on such an affidavit. The transferee can accept such an affidavit as long as they do not have knowledge that such a statement is false; and
- The transferor applies for and receives a "qualifying statement" from the IRS that he or she is exempt from withholding. The IRS has 90 days from the date of receipt of the application to process a response.

Withholding Requirements - Continued

- The transferee has 20 days after the transfer date to file Form 8288, *U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests* and Form 8288-A, *Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests,* and submit the tax withheld.
- The IRS will return stamped copies to the transferor (and withholding agent) for attaching to the tax return at filing (Treas. Reg. 1.1445-1(c)).
- If the transferor was not able to obtain a taxpayer identification number by the transfer date, the transferee is still obligated to file Forms 8288 and 8288-A and submit the tax withheld by the prescribed due date.
- The transferor may still receive credit for the amount of tax withheld by attaching substantial evidence of such withholding to his or her return.

Withholding Certificates

- Form 8288-B, *Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests*
  1. This form is filed when sellers claim to be entitled to a nonrecognition treatment or exemption from tax.
  2. A second reason is when sellers are certain that they have a loss or that the 15 percent withholding obligation is greater than their maximum tax liability on the gain of the sale.
  3. There is also a third instance: when the seller claims that the special installment sales rules described in section 7 of Rev. Proc. 2000-35 allowed reduced withholding.
- This form can be filed by an NRA or foreign corporation.

Foreign Person's Tax Filing Requirement

- NRAs who have a direct investment in U.S. real property must generally file income tax returns, except where they are engaged in a U.S. trade or business and the fair market value of the U.S. real property does not exceed $50,000.
- In addition, any person subject to IRC § 897(a) or IRC § 1445 (withholding of tax on dispositions of U.S. real property interest) must pay the required tax and file a return (IRC 6039C(a), (b) and (d)).
- The 10 or 15 percent FIRPTA withholding will be credited toward the ultimate tax liability and the difference will be refunded to the foreign person, unless the withholding was not sufficient to satisfy the tax. Early refunds of excessive withholding tax can also be obtained by filing a tax return as soon as possible, if the taxpayer has no other income to report on the U.S. tax returns. If this is desired, prior year tax return forms can be used to file a return for the current year as long as the prior year is crossed out and marked as the current year. If filing a final corporate return, taxpayers should include the words "Final Tax Return" at the top of the return.

Foreign Person's Tax Filing Requirement - Continued

- No branch profits tax in the year a foreign corporation "terminates" all of its U.S. trade or business - 1.884-2T exception if:

1. The foreign corporation has no assets used in a U.S. trade or business as of the close of the year;
2. Neither the foreign corporation or a related corporation uses any of the assets of the terminated U.S. trade or business or earnings and profits earned by the foreign corporation in the year of the termination in the conduct of a different U.S. trade or business for a period of three years past the close of the taxable year in which the termination took place; and
3. The foreign corporation has no ECI during the period of three years past the close of the taxable year in which the termination took place.

Taxpayer Identification Number

- Form W-7 *Application for IRS Individual Taxpayer Identification Number ("ITIN")*
- Check off box "b"—Nonresident alien filing a U.S. tax return if W-7 filed for the purpose of reporting the sale of a USRPI on Form 1040NR.
- When filing Form W-7, it should be the first form, followed by the certified passport copy, and then attach the Form 1040NR, including Copy B of Form 8288-A which was stamped by the IRS. Copy B of Form 8288-A is proof of withholding.
- Check off box "h" Other - Exception 4 – Disposition by a foreign person of U.S. real property interest – third-party withholding, if W-7 filed for the purpose of applying for a reduced withholding certificate on Form 8288-B.
- When filing Form W-7, it should be first, followed by the Form 8288-B, including any schedules attached to it.

Taxpayer Identification Number - Continued

- Power of Attorneys are recommended.
- It is also recommended that the applicant’s mailing address on Line 2 be a U.S. address for ease of delivery and tracking of the ITIN assignment letter.
- Passport certifications of the issuing agency need to be in English.
- IRS processing time: about 6 to 10 weeks.
- ITINs now expire if not used on a federal income tax return for 5 consecutive years.
- ITIN deactivation began in 2016.
- If one or more parties involved are foreign corporations and do not have an EIN, they can apply for one by filing Form SS-4.

LB&I division – FIRPTA Reporting Compliance for NRAs Campaign

- Announced September 14, 2020
- FIRPTA taxes foreign persons on the disposition of their U.S. real property interests.
- Generally the buyer/transferee is the withholding agent and is required to withhold 15% of the amount realized on the sale, file the required forms, and remit the tax to IRS.
- This campaign is intended to increase FIRPTA voluntary compliance through issue based examinations and external education and outreach.

Geographic Targeting Orders (“GTOs”)

- GTOs issued by the Financial Crimes Enforcement Network (“FinCEN”) since 2016
- The stated purpose of the GTOs is to try to close loopholes in the current Anti-Money Laundering regime, and identify bad actors who may be laundering money and concealing their identities through the use of legal entities, such as shell companies, and avoiding the Bank Secrecy Act BSA/AML systems of banks by conducting all-cash real estate deals with no loans.
- These GTOs require U.S. title insurance companies to identify the natural persons behind legal entities used in purchases of residential real estate performed without a bank loan or similar form of external financing. The current monetary reporting threshold is $300,000.
- The GTOs now broadly cover purchases involving virtual currency as well as “fiat” currency, wires, personal or business checks, cashier’s checks, certified checks, traveler’s checks, a money order in any form, or a funds transfer.

Geographic Targeting Orders ("GTOs") - Continued

- 9 jurisdictions are currently covered by the GTOs.
  - New York: Boroughs of Brooklyn, Queens, Bronx, Staten Island, and Manhattan
  - Massachusetts: Suffolk and Middlesex Counties
  - Illinois: Cook County
  - Washington: King County
  - California: San Diego, Los Angeles, San Francisco, San Mateo, and Santa Clara Counties
  - Nevada: Clark County
  - Texas: Bexar, Tarrant, and Dallas counties
  - Hawaii: City and County of Honolulu
  - Florida: Miami-Dade, Broward, and Palm Beach Counties

Executive Summary

1. Each situation is different and there are various options foreign real estate investors have to mitigate their U.S. income & estate tax exposure.

2. Even if you do not know details about the tax impact of your client's investment, recommend that they seek someone who can explain the tax ramifications of their investment and assist your client with tax planning before the purchase.

3. Many foreign buyers who do not plan ahead, leave their problems to their heirs and this becomes a big burden at the worse time for them.

Disclaimer

Please note:

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Consult your own accounting, tax, and legal professionals for advice related to your individual situation.

Any names or situations have been made up for illustrative purposes — any similarities found in real life are purely coincidental.


Global Taxes

Gratitude

Our most sincere thanks to:

Emilce Cacace
TRC, CIPS, e-Pro,
ABR, SRS, CBR, RSPS
Real Estate Instructor, CDEI.

NAR Global Ambassador to Argentina-Uruguay-Paraguay
Chair Global Business Council HGAR
Vice-President of the World Council of Brokers for FIABCI-International.

Faculty member for Fordham, HGAR & CAME
Co-Chair Fair Housing and Cultural Diversity Committee HGAR (2017)
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Thank You! Gracias! Obrigada! 谢谢!

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Alicea Castellanos is the CEO and Founder of Global Taxes LLC. Alicea provides personalized U.S. tax advisory and compliance services to high net worth families and their advisors. Alicea has more than 17 years of experience. Prior to forming Global Taxes, Alicea founded and oversaw operations at IWTAs, a boutique tax firm, worked at a prestigious global law firm and CPA firm.

Alicea specializes in U.S. tax planning and compliance for non-U.S. families with global wealth and asset protection structures which include non-U.S. trusts, estates and foundations that have a U.S. connection.

Alicea also specializes in foreign investment in U.S. real estate property, and other U.S. assets, pre-immigration tax planning, U.S. expatriation matters, U.S. persons in receipt of foreign gifts and inheritances, foreign accounts and assets compliance, offshore voluntary disclosures/tax amnesties, FATCA registration, and foreign companies wanting to do business in the U.S.

Alicea is fluent in Spanish and has a working knowledge of Portuguese.

Alicea is an active member of the Society of Trusts & Estates Practitioners (STEP), the New York City Bar, the New York State Society of Certified Public Accountants (NYSSCPAs), and the American Institute of Certified Public Accountants (AICPA).

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