TOP 10 QUESTIONS ABOUT FIRPTA

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1. WHAT IS FIRPTA?

United States tax law requires that all persons, whether foreign or domestic, pay income tax on the disposition of U.S. real property interests. Domestic persons or entities typically are subject to this tax as part of their regular income tax; however, the U.S. needed a way to collect taxes from foreign persons on the sale of U.S. real property interests. The Foreign Investor in Real Property Act ("FIRPTA") was enacted to provide such a mechanism and requires that a buyer withhold and remit to the IRS a certain percentage of the sales price in anticipation of the taxes that will be due from the foreign seller on such transaction.[i] FIRPTA applies in nearly all transactions, residential and commercial, in which a foreign owner of a U.S. real property interest sells such interest. The amount withheld is not the tax itself, but is payment on account of the taxes that ultimately will be due from the seller.

2. WHAT ARE THE WITHHOLDING REQUIREMENTS?

Unless an exemption or reduced rate applies, FIRPTA requires that the *buyer* withhold fifteen percent (15%) of the sales price in all transactions in which the seller of a U.S. real property interest is a "Foreign Person."

3. WHO IS A "FOREIGN PERSON"?

FIRPTA defines a "Foreign Person" by defining who is *not* a Foreign Person, so it is important to understand the following definitions:

a. A "Foreign Person" is defined as any person other than a "United States Person."

b. A "United States Person" is any of the following: (i) a U.S. Citizen; (ii) a resident alien who has a Green Card; (iii) a resident alien who meets the Substantial Presence Test; (iv) a domestic (U.S.) corporation, partnership or other legal entity (except a "Disregarded Entity" as defined by IRS Regulations), trustee or other fiduciary; (v) a Disregarded Entity, the owner of which qualifies as a "United States Person" under (i), (ii), (iii), or (iv), above; or (vi) a foreign entity which has elected to be treated as a domestic corporation (as evidenced by acknowledgement copy of election furnished by IRS).

c. The Substantial Presence Test: Under FIRPTA, a Foreign Person is considered a U.S. Person for the calendar year of sale if they are present in the United States for at least:

   i. 31 days during year of sale AND
   ii. 183 days during the 3 year period that includes year of sale and the 2 years preceding year of sale, but only counting:
      a. All days during year of sale;
      b. 1/3rd of the days during the first preceding year; and
      c. 1/6th of days during the second preceding year.

   When counting days, you may not include the days that a Foreign Person is present in the U.S. as a representative of a foreign government (e.g. foreign diplomat), as a teacher or student under a "J", "Q", "F" or "M" Visa, or as a professional athlete in a charitable sports event.

d. A "Disregarded Entity" is any single-owner domestic business entity (such as a single-member limited liability company) other than a corporation, unless it has elected to be treated as a domestic association for tax purposes.

4. WHAT IF THE SELLER IS A DOMESTIC LLC?

Single-Member LLC: A single-member domestic limited liability company, while a recognized legal entity, is considered a "Disregarded Entity" for tax purposes. Accordingly, if the seller is a single-member limited liability company, then you have to look to the identity of the sole member of the limited liability company. If the sole member is

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a "Foreign Person," then the FIRPTA withholding rules apply in the same manner as if the foreign sole member was the seller.

Multi-Member LLC: A domestic limited liability company with more than one owner is not considered a "Disregarded Entity" and is taxed differently than single-member limited liability companies. Accordingly, the FIRPTA rules regarding withholding do not apply to multi-member domestic limited liability companies.

5. WHAT ARE SOME EXCEPTIONS TO THE WITHHOLDING REQUIREMENTS?

While there are several exceptions to FIRPTA withholding requirements that eliminate or reduce the required withholding, the most common exceptions are discussed below.

a. *Seller not a "Foreign Person."* One of the most common and clear exceptions under FIRPTA is when the seller is not a Foreign Person. In this case, the seller must provide the buyer with an affidavit that certifies the seller is not a Foreign Person and provides the seller's name, U.S. social security number or taxpayer identification number ("TIN"), and address.

b. *Personal Residence Exemption.* Under the Personal Residence Exemption, no withholding is due when (1) the buyer is acquiring property that will be used as the buyer's residence, (2) the sales price is $300,000 or less, and (3) the buyer elects to waive withholding. See additional requirements set forth, below, under "Reduced Rate of Withholding."

c. *Reduced Rate of Withholding:* This new exception, which goes into February 16, 2016, is similar to the Personal Residence Exemption, but provides for a reduced rate instead of a full exemption.[ii] Under this exception, a reduced withholding equal to ten percent (10%) of the sales price is due when (1) the buyer is acquiring property that will be used as the buyer's residence, (2) the sales price is more than $300,000 but not more than $1,000,000, and (3) the buyer elects to waive withholding.

   In order to qualify for, either, the Personal Residence Exemption or the Reduced Rate of Withholding, the buyer or a member of the buyer's family must have definite plans to reside at the property for at least 50% of the number of days the property is occupied by any person during each of the two 12-month periods following the date of closing. If the buyer fails to meet the occupancy requirements, the buyer may become liable to the IRS for the difference between the amount that was actually withheld, if any, and the amount that should have been withheld, plus interest and penalties. Under this exception, *the buyer is not required to make this election, even if the facts may support the exemption or reduced rate* and the settlement agent should advise the buyer that, neither, the exemption nor the reduced rate automatically applies. Instead, if the buyer opts to invoke the exemption or the reduced rate, the buyer must make an affirmative election to do so. This election should be in the form of an affidavit from the buyer setting forth the buyer's decision and, if applicable, the facts that entitle the buyer to the exemption or reduced rate.

d. *Seller Obtains Withholding Certificate.* In some cases, the seller has applied for and received a withholding certificate from the IRS that reduces or eliminates the withholding requirement. A buyer relying on this exception must obtain a copy of the Withholding Certificate and retain a copy in buyer's records for five (5) years.

e. *Foreign Corporation or Single-Member LLC has "checked the box."* There is an exception for foreign corporations or single-member limited liability companies that are subject to FIRPTA withholding that have "checked the box" on the applicable IRS form to be taxed as a domestic corporation. Domestic corporations are not subject to the withholding rules under FIRPTA, so withholding will not be required in cases where entities otherwise subject to withholding have elected to be taxed as a domestic corporation. Importantly, to take advantage of this exemption from withholding, the entity must file Form 8832 with the IRS, obtain IRS approval, and provide evidence of this status to the buyer. The buyer will need to retain a copy of this approval in buyer's records for five (5) years.

6. ARE TINs REQUIRED FOR ALL PARTIES?

IRS regulations require all buyers and foreign sellers of U.S. real property interests to provide their TINs, names, and addresses on withholding tax returns, applications for withholding certificates, notice of non-recognition, and other related IRS documents when disposing of a U.S. real property interest. While it is best practice to have the TINs for all parties at the time of closing, it is possible to close without the TINs under the following guidelines:

1. If the buyer does not have a TIN, the buyer must remit the proper withholding forms within 20 days after closing; however, the buyer will also need to remit, *to a separate address in a separate package*, a properly completed application (Form W-7) for a TIN simultaneously with remitting the withholding forms. Please refer to the instructions for each form for further instructions and mailing addresses.

2. If the seller does not have a TIN, the buyer must remit the proper withholding forms within 20 days after closing,

but the seller's TIN information will be left blank. While the TIN is not necessary for closing, it should be noted that the seller will have to obtain a TIN in order for the IRS to process the funds and, in fact, upon receipt of the withholding documentation, the IRS will follow up with the seller instructing the seller to apply for a TIN. For this reason, many settlement agents provide the friendly advice that the seller submit its separate application for a TIN by the time of closing.

Additional information can be found in the IRS publication entitled "ITIN Guidance for Foreign Property Buyers/Sellers," which is available at www.irs.gov.

7. WHAT IF THIS IS A SHORT SALE OR THERE ARE OTHERWISE INSUFFICIENT PROCEEDS FOR WITHHOLDING?

There are times, such as short sales, when the proceeds from the sale are insufficient for withholding under FIRPTA. However, FIRPTA withholding requirements are based on the sales price, not the seller's proceeds, so *there is no automatic exemption for transactions in which the seller is receiving zero or insufficient proceeds*. In these cases, the seller will need to apply for an exemption or reduced withholding from the IRS. As with applying for a TIN, this process can take some time, so it is imperative that the settlement agent raise these issues with the foreign seller as early as possible in the process.

8. WHAT IF LESS THAN ALL SELLERS ARE "FOREIGN PERSONS"?

The analysis of whether the buyer must withhold funds under FIRPTA must be undertaken with respect to each seller separately, even if the seller is a married couple. Generally, withholding is required for each Foreign Person based on such person's percentage of ownership. For example, if there are four joint owners, each owning a 25% interest, and one of the sellers is a Foreign Person, then the buyer is required to withhold only 25% of the required withholding. If the seller owns the real property interest as a married couple, the IRS deems each spouse to own 50%. In this case, if only one spouse is a Foreign Person, then withholding only as to such spouse's one-half interest is required.

9. WHO IS RESPONSIBLE FOR COMPLYING WITH FIRPTA?

While the seller is the party subjected to the tax, it is up to the *buyer* to withhold the appropriate percentage of the sales price when purchasing U.S. real property from a "Foreign Person." In the event the buyer does not properly withhold, the buyer may be liable to the IRS in an amount equal to the amount of taxes that should have been withheld, plus interest and penalties.

While the buyer has the ultimate liability to the IRS, the collection and disbursement of funds to the IRS as part of the closing process creates a responsibility and potential liability for the settlement agent if the matter is not properly handled and documented. Accordingly, it is important that your file reflect specific written direction from the buyer if anything other than fifteen 15% is being withheld. For example, if a buyer elects to waive the withholding or withhold a reduced rate, settlement agents should obtain an affidavit from the buyer setting forth the buyer's decision and, if applicable, the facts that entitle the buyer to the exemption or reduced rate along with an acknowledgement that the buyer has been given the opportunity to obtain independent tax or legal advice.

10. HOW IS THE WITHHOLDING SUBMITTED AND REPORTED?

Generally, the funds withheld must be forwarded, together with IRS Forms 8288 and 8288-A, to the IRS within 20 days after the closing date. However, if an application for a withholding certificate is submitted to the IRS before the date of a sale and the application is still pending with the IRS on the closing date, the correct withholding tax must be withheld, but does not have to be reported and paid immediately. The amount withheld (or lesser amount as determined by the IRS) must be reported and paid within 20 days following the day on which a copy of the withholding certificate or notice of denial is mailed by the IRS.

MORE QUESTIONS?

If you have any further questions about FIRPTA withholding, please feel free to contact a First American underwriter; however, please understand that First American cannot provide *legal* advice to any party regarding FIRPTA. This article is intended as informational only and should any party need legal advice, the settlement agent should advise such party to engage legal counsel.

i FIRPTA uses the phrase "amount realized," which *typically* is the sales price; however, if you or any of the parties involved have any questions, the buyer should consult with legal counsel of buyer's choosing to ensure that the proper figure is being used when calculating the withholding amount.

ii This amount recently was increased from 10%. According to the strict reading of the effective date for recent amendments to FIRPTA, the fifteen percent (15%) withholding applies to transactions in which the closing, or disposition of real property, occurs on or after February 17, 2016; however, it has come to our attention that the IRS may be interpreting the language to mean that February 16, 2016, is the effective date. While this is ultimately up to the buyer to decide, we recommend using the date that the IRS will be using.