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Location, Location And Tax Implications

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Foreign Investors Need To Consider FIRPTA When Purchasing US Real Estate

With the recent global economic slowdown and weakness in the European and Asian equity markets, foreign investors from such countries as China, Russia, Germany and other parts of Europe are increasingly looking to real estate as a safe haven investment. One of the investment choices favored by jittery foreign investors is US residential and commercial real estate. Many foreign investors view US real estate as having stability and value retention, especially in international cities, such as New York, San Francisco, Los Angeles and Boston. Among foreign investors, Chinese investors represent the largest group of foreign investors in US real estate in 2015.

Prior to making purchases in US real estate, foreign investors should talk with a qualified tax advisor and exercise caution as they carefully consider tax implications, including evaluating different ownership structures and exit strategies. For the unprepared foreign investor making these real estate investments, failure to consider the tax consequences could be a costly mistake.

The foremost hurdle for the foreign investor to overcome is a law colloquially named FIRPTA. Codified under Section 897 of the Internal Revenue Code, the Foreign Investment in Real Property Act (FIRPTA) of 1980 was designed to prevent foreign investors in US real property from selling their holdings and taking their proceeds outside the US without paying tax on the gain recognized. Prior to FIRPTA, foreign investors often were exempt from US tax on the sale of US real estate.

Under FIRPTA, any gains recognized by a foreign investor on the disposition of a US real property interest (USRPI) are treated as if the gains are effectively connected to a US trade or business, thereby making them subject to US federal income tax at graduated rates. The current maximum

capital gain rate for individuals is 20 percent (for 39.6 percent bracket taxpayers) and a flat 35 percent for corporations.

Under the PATH (Protecting Americans from Tax Hikes) Act of 2015, recently signed into law and effective February 17, 2016 the buyer of a USRPI from a non-resident of the US is required to withhold 15 percent (previously 10 percent) of the purchase price and pay this to the IRS when the property's selling price is USD1m or greater. Withholding remains at 10 percent when the property's selling price is greater than USD300,000 but does not exceed USD1m and certain residency requirements are met.

Since the seller owes the tax, the IRS places the burden on the buyer to ensure collection, as there is little to stop a foreign seller from exiting the US immediately after the sale. In effect, FIRPTA requires the buyer to act as a withholding agent who is fully liable for any amount withheld.

Obtaining A Withholding Certificate

The 15 percent withholding obligation on the gross sale price of the real estate may be reduced or eliminated if a withholding certificate is obtained from the IRS. When an adjustment to amounts withheld is sought, typically a seller or the seller's agent must request a withholding certificate by submitting a Form 8288-B application to the IRS.

Generally included in the Form 8288-B application are a calculation of the maximum tax imposed, a copy of the signed contract of transfer, the adjusted basis of the property and other supporting documents.

A foreign investor's tax advisor can assist the foreign seller in preparing a FIRPTA application to the IRS. The goal of the IRS application is to obtain a reduced withholding by asserting that the maximum tax liability is lower than the 15 percent withholding of the sales price.

As a general rule, foreign sellers find it preferable to obtain an immediate refund from an escrow-withheld amount, *versus* having the full 15 percent withholding and then applying for a refund upon filing a tax return. In addition to the obvious cash flow advantages, most foreign investors prefer to have cash amounts remain in their own pockets (or, more accurately, held in escrow) rather than relinquishing control to the IRS.

However, there are certain procedural and documentary compliance requirements for submitting the application to the IRS, which are summarized below:

- The buyer is required to remit the withheld tax to the IRS within 20 days following the closing, along with a completed Form 8288 and Form 8288-A;
- The IRS stamps the Form 8288-A to show receipt and then mails a stamped copy to the foreign investor;
- The foreign investor must attach the stamped copy of the Form 8288-A to the investor's US federal income tax return in order to claim a credit for the withheld amount against any income tax liability.

There is a certain exception to this rule:

- When the seller properly notifies the buyer at or before closing that the seller has applied for a withholding certificate, then the buyer should not send the withheld tax but hold the 15 percent in escrow until the withholding certificate is received.

Gift Tax, Estate Tax And FIRPTA

While a gift of US real estate may have a legitimate, non-tax-motivated purpose, many foreign sellers may be tempted to avoid the FIRPTA withholding through the use of a gift. Foreign investors should generally be advised to avoid direct gifts of US real estate.

A direct gift of US real estate generally produces an unfavorable overall tax result due to the gift tax. Unlike an intangible gift, any gift of US real estate or tangible personal property is subject to the gift tax. Additionally, a foreign donor making a gift to a spouse does not benefit from an unlimited marital deduction to reduce the gift tax unless the spouse is a US citizen.

A popular alternative structure for foreign investors is the use of a foreign corporation (either directly or through a US subsidiary) to purchase US real estate. This structure can be utilized to avoid both the gift and estate tax. However, the disadvantages of using a foreign corporation (either directly or through a US subsidiary) subjects any gain from the investment upon sale to a maximum federal income tax rate of 35 percent, as compared to a 20 percent capital gains rate if sold by an individual investor. Additionally, a foreign corporation that directly purchases US real estate is liable for branch profits tax, which is a tax designed to replicate the dividend withholding tax when paid from a US corporation to a foreign person.

Good Tax Planning Is Crucial

The FIRPTA withholding provisions are very complex, and the pitfalls are numerous for the unprepared foreign investor. The good news is that thoughtful advanced planning can result in the following positive outcomes:

- Reducing or eliminating withholding tax through the use of withholding certificates or tax-planning techniques;
- Entitling a foreign transferor to receive an immediate reduction of withholding tax paid where the ultimate tax liability is less than the amount withheld;
- Ensuring all compliance and reporting requirements imposed by FIRPTA are met.