This document was recently prepared by an IRS task force, with input from Thomas C. Roberge of Thomas C. Roberge & Company, Certified Public Accountants headquartered in St. Petersburg, Florida and Jonathan H. (Jason) Warner, a tax attorney with offices in Miami.

International Taxpayer

Tax Information For Realtors, Rental Agents and Foreign Owners of U.S. Real Estate

Foreign Persons Involved in U.S. Real Estate Transactions

With the increasing globalization of trade and investments, foreign ownership of U.S. real estate continues to grow. Consequently, U.S. realtors and rental agents/property managers are encountering an increasing number of situations that involve foreign persons acquiring U.S. real estate as a part-time residence, for investment or in some cases to conduct a U.S. business. The U.S. tax rules that apply to ownership and dispositions of U.S. real estate by foreign persons are different in some important respects from the rules that apply to U.S. persons.

This article discusses the U.S. federal income tax rules that U.S. real estate professionals must know to properly deal with foreign investors in U.S. real estate, and to avoid certain personal liabilities for improper U.S. federal income tax compliance. The first part of this article covers the rules that determine whether an individual or entity is to be treated as U.S. or foreign. The second part discusses compliance with the Foreign Investment in Real Property Tax Act (FIRPTA) for sales by foreign persons of U.S. real property interests ("USRPI"). The third part provides the fundamentals of U.S. federal income taxation of foreign investors with U.S. rental income.

Definition of Foreign Persons

Because a number of U.S. federal tax rules differ when a foreign person is involved or apply only to foreign persons, it is important for a U.S. real estate professional to understand when an individual or entity is considered foreign for U.S. federal income or estate tax purposes.

A nonresident alien is defined for federal income tax purposes as an individual who is neither a U.S. citizen nor a resident of the United States within the meaning of section 7701(b) of the Internal Revenue Code (the "Code"). An alien individual is a resident of the U.S. for federal income tax purposes if he or she meets either of the two tests under section 7701(b):

The first test is the "green card" test. If an alien has been admitted for U.S. permanent residence (i.e., has a green card) at any time during the calendar year, the alien is a resident of the United States and is taxed on his or her worldwide income, the same as a U.S. citizen. Otherwise, U.S. immigration status generally is not controlling or relevant for U.S. federal tax purposes. In this respect, the U.S. differs from many foreign countries, in which immigration and tax status are integrated, a difference that frequently causes confusion.

The second test is the substantial presence test. Under the substantial presence test, an alien individual is a resident for U.S. federal tax purposes if the alien is physically present in the U.S. for 183 days or more during the current calendar year. Alternatively, if the alien is physically present for at least 31 days during the current year, the alien may be treated as a U.S. tax resident ***in the current year*** under a three-year look-back test in which each day of presence in the current year is counted as a full day, each day of presence in the first preceding year is counted as one-third of a day, and each day of presence in the second preceding year is counted as one-sixth of a day. If the total of such days is 183 days or more, the alien ***may*** be a U.S. tax resident ***for the current year*** unless certain exceptions apply and the alien files certain required information with the IRS to claim the benefit of any relevant exception. As with the green card test, if an alien is a U.S. tax resident under either version of the substantial presence test, the alien is taxed on his or her worldwide income, the same as

Just because there has been withholding with regard to the sale by the foreign seller, or the transaction was exempt from withholding, does not mean the foreign seller is excused from filing a U.S. income tax return and reporting any gain with respect to the sale. The sale of a U.S. real property interest by a foreign investor is a taxable event calling for the filing of a U.S. federal income tax return for the year of the sale. The amount of tax withheld may be credited against the seller's federal income tax liability, which will reduce the amount of tax owed or may entitle the seller to a refund.

According to a recently released Treasury Regulation, Forms 8288, 8288-A and 8288-B must contain the foreign seller's U.S. taxpayer tax identification number (and the buyer's tax identification number as well). The seller's tax identification number also is required for reporting the transaction on Form 1099-MISC, as the sale generally is not eligible for the "no information" reporting exception for sale of a taxpayer's principal residence. Nonresident aliens generally obtain an Individual Taxpayer Identification Number (ITIN) for this purpose), but ITINs are no longer issued unless the applicant is filing a U.S. federal income tax return with the application or other specific exceptions apply. Under guidelines published by the IRS in February, 2004 (see "ITIN Guidance for Foreign Property Buyers/Sellers") the application for the ITIN (Form W-7) can be done at the time of closing the transaction, with the Form W-7, proper supporting documents, and the FIRPTA withholding documents (either Form 8288-B, or Form 8288, 8288-A and the remittance of the amount withheld) being filed with the IRS ITIN Unit rather than filed directly with the IRS FIRPTA Unit. The instructions for filing are on current Form W-7, as modified by the above ITIN Guidelines.

Transferor's Tax Return Responsibility Upon Selling Real Property Interest

The individual transferor of the U.S. real property interest is required to file a Form 1040NR along with Schedule D, and if required, Form 4797, Sale of Business Property, and/or Form 6251, Alternative Minimum Tax, in order to meet its tax obligation. If the transferor is a corporation, then a Form 1120F with appropriate schedules will have to be filed. In order for a foreign individual or corporate transferor to claim a credit against its tax liability for the amount of tax withheld by the purchaser under Code section 1445 or obtain a refund of excess withholding, the transferor should attach to its tax return the receipted copy of Form 8288-A that the IRS returns to the transferor.

Under U.S. tax law, a taxpayer can depreciate the property; there are different rates for residential and commercial properties. This annual depreciation is deducted from income as an expense on an income tax return. However, it will be recaptured when the property is sold.

The reporting of real property interests either on Form 8288, Form 1040NR or Form 1120-F may trigger an IRS inquiry regarding taxes for rental income in situations where the nonresident has failed to submit timely tax returns relating to the property.

U.S. Income Taxation of Foreign Persons

The U.S. federal income tax differentiates two principal types of U.S. source income of foreign persons: business income and investment income. If a foreign person conducts a business in the United States, the net income is taxed at the same graduated rates applicable to U.S. citizens and residents. For example, if a foreign person is an operator of U.S. commercial real estate, the foreign person is conducting a business in the United States and must pay federal income tax at graduated rates. The foreign person will file either a Form 1120F (for foreign corporations) or a Form 1040NR (for nonresident aliens). If a foreign person receives investment income not connected with a U.S. business, the gross amount is taxed through withholding by the party paying the rent proceeds to the owner at a flat rate of 30 percent (without any deductions) unless a U.S. income tax treaty provides a lower rate or an exemption and proper documentation if provided. The policy behind withholding on investment income is that a foreign person earning only investment income in the United States typically does not have enough U.S. contacts for the IRS to collect tax due through the self-assessment process. Unlike the FIRPTA requirements, a foreign person whose entire U.S. tax liability for investment income is satisfied by withholding is not required to file a U.S. federal income tax return, although the party paying the income will have to file certain tax information returns in connection with the withholding, as discussed below.

Foreign Property Owner's Tax Return Responsibility During Ownership and Rental of Real Property Interest

a U.S. citizen.

If the alien is from a country that has an income tax treaty with the United States, the treaty may act to change these results, subject to certain required filings with the IRS to claim the treaty benefit. Also, in the first year that an alien might be subject to the substantial presence rule, it may be difficult to tell if the alien actually will become treated as a U.S. tax resident for that year.

A foreign corporation is a corporation that is not incorporated in the United States. The rules for other types of entities are more complex. Also, if an eligible foreign entity has filed a “check-the-box” election for U.S. federal tax purposes, its U.S. federal income tax treatment will differ from the norm for that type of entity; for example, a foreign corporation with a single owner may (if eligible) elect to be disregarded for U.S. federal tax purposes, or to be treated as a partnership if it has more than one owner. In either case, the resulting U.S. taxpayer is the owner or owners, who themselves may be foreign or domestic for U.S. federal tax purposes. Similarly, a foreign unincorporated entity might elect to be taxed as a foreign corporation for U.S. federal tax purposes.

The Foreign Investment in Real Property Tax Act

Section 897 of the Code (enacted under the 1980 FIRPTA legislation) provides rules for the taxation of nonresident alien individuals and foreign corporations on sales or other dispositions of U.S. real property interests (including installment sales, exchanges, foreclosures, and deeds in lieu of foreclosure of a U.S. real property interest).

FIRPTA applies to what it defines as a U.S. real property interest, which includes not only interests in land, but interests in buildings, mines, wells, crops and timber as well. Because Congress was concerned that foreign persons would try to avoid FIRPTA by incorporating their U.S. real estate holdings, a U.S. real property interest is defined to also include any interest in a U.S. corporation if that U.S. corporation is a “U.S. real property holding company,” with the result that a disposition of its stock by a foreign investor may be subject to federal income tax under FIRPTA. A U.S. corporation is a U.S. real property holding company if the fair market value of its U.S. real property interests equals 50 percent or more of the sum of the fair market value of its U.S. real property interests, interests in real property located outside of the United States, and trade or business assets. A foreign corporation may also be classified as a U.S. real property holding company, but the sale of stock in a foreign corporation by a foreign person generally is not subject to U.S. federal income tax (although other important U.S. federal income tax consequences may result).

Since 1985, a disposition of a U.S. real property interest by a foreign corporation or nonresident alien individual generally is subject to a withholding tax regime under section 1445 of the Code. Under the withholding tax regime, any purchaser of a U.S. real property interest from a foreign seller must withhold ten percent (10%) of the gross purchase price and remit such amount to the IRS within 20 days of the closing. The purchase price includes cash plus the fair market value of any other property transferred to acquire the real estate. A purchaser failing to withhold is liable for any uncollected withholding tax, as well as penalties and interest charges.

There are several total or partial exceptions to the Code section 1445 withholding requirement. The more commonly encountered are:

1. ***If the seller is not a foreign person.*** Under Code section 1445, there is a presumption that every seller is a foreign person subject to the withholding tax unless proof to the contrary is provided to the purchaser. Usually, this proof is furnished in the form of a "non-foreign certification," signed by the (U.S. citizen, resident or entity) seller under penalties of perjury, certifying that the seller is not a foreign person and setting forth the seller’s name, address and taxpayer identification number. The purchaser can rely on the certificate unless the purchaser has actual knowledge that it is false or receives a notice from an agent involved in the transaction stating that the certification is false (and an agent involved in a closing who knows that a non-foreign certificate is false is subject to a penalty if he or she fails to give the purchaser a written notice that the certificate is false). In the case of multiple sellers, including spouses holding property jointly, the regulations contain rules for allocating the purchase price among the sellers for purposes of withholding and tax liability. Where

multiple sellers include U.S. and foreign parties, withholding applies (subject to receiving the non-foreign certification from the U.S. parties) only to the amounts allocated to the foreign parties under rules set forth in the regulations under Code section 1445. The purchaser should retain the non-foreign certification for at least five years.

2. ***If the seller or the purchaser obtains a qualifying statement (a withholding certificate) from the IRS providing that the seller is entitled to a reduced (or zero) withholding amount or has provided adequate security or made other arrangements with the IRS for payment of the tax.*** The application for the withholding certificate has to be filed before closing, and (if the seller applies for the certificate) the seller must give the purchaser a written notice at closing stating that the application has been filed with the IRS. The purchaser still must withhold the full ten percent at closing, but the withheld amount may be held by the purchaser and not remitted to the IRS until the IRS sends the purchaser its determination on the amount required to be withheld and paid over. The purchaser has 20 days from receipt of the notice from the IRS to pay over the amount required by the IRS.
3. ***If the purchaser intends to use the real property as a residence and the purchase price is not more than $300,000.*** In order to qualify for this residential use exception, at the time of sale the purchaser (or any member of his immediate family) must have definite plans to reside at the property for at least 50 percent of the number of days that the property is to be used during each of the first two twelve-month periods following the date of sale. So long as the foregoing requirement is met, the property does not need to be the purchaser's primary or principal residence. However, purchasers are cautioned that they will be liable for the tax not withheld if their intention does not materialize in fact and they cannot prove that the failure to so use the property was due to a change of circumstances that they could not reasonably have anticipated at the time of the purchase. Also, this exemption is available to individual purchasers only, and is not allowed for purchases by corporations, partnerships or trusts, or if the seller is a foreign partnership. A purchase of raw land or of an existing dwelling that is to be demolished and replaced, does not qualify for the exemption even if the purchaser intends to construct an otherwise qualifying residence on the property.

A Form 8288, U.S. Withholding Return for Disposition by Foreign Persons of U.S. Real Property Interests, is required to be filed by the transferee (buyer or designated agent) of the U.S. real property interest. In addition, Form 8288-A, U.S. Withholding Statement on Disposition by Foreign Persons of U.S. Real Property Interest, must be attached to Form 8288 and submitted with the required withholding. The amount of tax required to be withheld and paid to the IRS by the transferee is ten percent of the amount realized on the disposition of the USRPI by the foreign transferor. Forms 8288, 8288-A and the withholding tax must be filed (mailed) to the IRS by the 20th day after the date of transfer unless the seller is waiting for a response from the IRS to an application for a withholding certificate (see next paragraph) filed before closing. In such case, upon receipt of an approved withholding certificate or rejection letter, the taxpayer has 20 days from the date on the certificate/letter to file Forms 8288 and 8288-A and remit the required amount. Penalties and interest will be charged on late filed Forms 8288 (filed after the 20th day from the date of transfer or the response from the IRS to the withholding certificate). There is a penalty of up to $10,000 over the tax for a willful failure to collect and pay.

In certain situations, such as when the tax due on the transferor's gain from the sale is less than the withholding, the foreign transferor or the transferee can submit a Form 8288-B, Application for Withholding Certificate for Disposition by Foreign Persons of U.S. Real Property Interests, to request a reduction or elimination of withholding on a transfer of a USRPI. Refer to IRC Regulation 1.1445-3 or -6 for the different categories of withholding certificates.

The IRS generally will act on a completed withholding certificate application within 90 days of the request. Alternatively, the regulations permit the transferor to request an early refund of amounts already withheld if the request for an early refund is combined with an application for a withholding certificate.

If the seller of a U.S. real property interest is a domestic partnership, trust, or estate with foreign partnerships or beneficiaries, withholding by the buyer is not required, but the domestic partnership, trust, or estate should withhold 35 percent of the gain allocable to the foreign partnership or beneficiary. See Code section 1445(e).

Before agreeing to manage U.S. real property for a foreign taxpayer, a realtor or rental agent should discuss with the foreign client whether the rental income will be taxed as investment income through withholding, or on a net income basis as “effectively connected with a U.S. trade or business,” without withholding (although the owner may have to file estimated tax returns). Rental income from real property located in the United States and the gain from its sale will always be U.S. source income subject to tax in the United States regardless of the foreign investor's personal tax status and regardless of whether the United States has an income treaty with the foreign investor's home country.

The method by which rental income will be taxed depends on whether or not the foreign person who owns the property is considered "engaged in the U.S. trade or business." Ownership of real property is not considered a U.S. trade or business if it consists of merely passive activity such as a net lease in which the lessee pays rent, as well as all taxes, operating expenses, repairs, and interest in principal on existing mortgages and insurance in connection with the property. Such passive rental income is subject to a flat 30 percent withholding tax (unless reduced by an applicable income tax treaty) applied to the gross income rather than the "net rent" received. Thus, the real estate taxes, operating expenses, ground rent, repairs, interest and principal on any existing mortgages, and insurance premiums paid by the lessee on behalf of the foreign owner-lessor, must be included in gross income subject to the 30 percent withholding tax. The gross income and withheld taxes must be reported on Form 1042-S, Foreign Persons U.S. Source Income Subject to Withholding to the IRS and the payee by March 15 of the following calendar year. The payor must also submit Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, by March 15.

If, on the other hand, the foreign investor is engaged in a U.S. trade or business such as the developing, managing and operating a major shopping center, the rental income will not be subject to withholding and will be taxed at ordinary progressive rates. Expenses such as mortgage interest, real property taxes, maintenance, repairs and depreciation (accelerated cost recovery) may then be deducted in determining net taxable income. The nonresident must make estimated tax payments for the tax due on the net rental income, if any. The only way these expenses can be deducted, however, is if an income tax return Form 1040NR for nonresident alien individuals and Form 1120-F for foreign corporations is timely filed by the foreign investor.

Foreign individuals and foreign corporations may elect to have their passive rental income taxed as if it were effectively connected with the U.S. trade and business. Once such an election is made by attaching a declaration to a timely filed income tax return, there is no obligation to withhold even in a net-lease situation. Once made, the election may not be revoked without the consent of the IRS. Unless the foreign investor has properly informed the property manager that the rental income is to be treated as "effectively connected income" by submitting to the property manager with a fully completed Internal Revenue Service Forms W-8ECI, Certificate of Foreign Person’s Claim for Exemption From Withholding on Income Effectively Connected With the Conduct of a Trade or Business in the United States, the property manager should withhold thirty percent (30%) of the gross rental receipts so as to avoid personal liability. A fully completed Form W-8ECI must include a valid U.S. tax identification number for the foreign landlord (in other words, the rental agent must withhold and remit the 30% tax to the IRS until this requirement is satisfied). A real property manager who collects rent on behalf of a foreign owner of real property is considered a withholding agent and is personally and primarily liable for any tax that must be withheld. The liability of the withholding agent includes amounts that should have been paid plus interest, penalties, and where applicable, criminal sanctions. Property managers who do not comply with these rules will be held liable (either individually or through their company) for 30% of gross rents, plus penalties and interest.

Also, property managers need to report annual rents collected on behalf of foreign landlords on Forms 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, and 1042-S, Foreign Person’s U.S. Source Income Subject to Withholding. These are the equivalent of Forms 1096 and 1099-MISC but are for foreign owners.

To enforce the system of withholding, the Internal Revenue Code defines a "withholding agent" to be any person in whatever capacity (including lessees and managers of U.S. real property) having the control, receipt, custody, disposal or payment of income that is subject to withholding. Thus, a real property manager who collects rent on behalf of a foreign owner of real property is clearly considered a withholding agent. A withholding agent is personally and primarily liable for any tax that must be withheld. The liability of the withholding agent includes amounts that should have been paid plus interest, penalties and, where applicable, criminal sanctions. The statute of limitations does not start until a withholding return is filed by the withholding agent. Once the return has been filed, the statute of limitations begins to run at the later of two dates: the date of actual filing of the correct return or April 15 of the calendar year in which the return should have been filed. The withholding agent will remain liable if he actually knows that the foreign owner's statements are false. The withholding agent's duty of inquiry seems to be a "reasonably prudent test," measured by all facts and circumstances.

A nonresident who fails to submit a timely filed income tax return loses the ability to claim deductions against the rental income, causing the gross rents to be subject to the 30 percent tax. Generally, the nonresident will need to retroactively file at least six years of delinquent income tax returns, or all prior year tax returns, if they have held the rental property for less than six years. However, the ability to elect to treat the rental income as effectively connected with a U.S. trade or business will be lost after 16 months from the original due date of the return, and the remaining back years may be subject to tax under the gross income method. Rental income from real property located in the United States and the gain from its sale will always be U.S. source income subject to tax in the United States regardless of the foreign investor's status and regardless of whether the United States has an income treaty with the foreign investor's home country.

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Thomas C. Roberge, CPA may be contacted at (727) 822-9393.

Jonathan H. (Jason) Warner may be contacted at (305) 670-0007.