

Foreigners Investing In U.S. Real Estate Pay Capital Gain Taxes Too

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In recent weeks, several authorities have noted and commented on the increase of foreign investors owning United States real estate. Some commentators believe this is cause for concern and others feel that the investment is favorable to the U.S. and its economy for a variety of reasons (See “Commentary-Support for Foreign Investment in our Real Estate Market,”

Bob Knakal, September 8, 2008). Noted in the Commentary was the fact that no foreign investor has ever been able to “pick up a building and move it to their country.”

In fact, once invested in the U.S. the likelihood of a foreigner liquidating its investment and taking the profits out of this country tax free are very unlikely. This is obviously a consequence of our tax system. Thus, most foreign investors selling real estate will incur capital gain taxes similar to the taxes incurred by any U.S. citizen. In order to defer such capital gain tax liability and preserve profits resulting from a foreigner owning U.S. real estate, it would be necessary to perform a §1031 exchange. Luckily, foreign investors are able to take advantage of the tax benefits of performing a tax deferred exchange in much the same way as a U.S. citizen. However, to avail oneself of the benefits of §1031, a foreign investor must reinvest in replacement property located in the U.S. or, in some limited instances, a U.S. territory. Thus, a foreign investor would not only be unable to move a building to their country but would also be unable to take its profits out of the U.S. without leaving tax dollars behind. This means that even if a foreign investor sells U.S. real estate, it is likely that the profits of such sale will be reinvested in additional U.S. real estate, thus resulting in such profits further benefiting our economy.

Obviously, any foreign investor seeking to capitalize on the appreciation of their U.S. investments must consider the tax implications of doing so. For U.S. tax purposes, a foreign person includes a nonresident alien or foreign partnership, trust, estate, or corporation that has not elected to be treated as a domestic corporation under IRC §897(i). Sales of U.S. real estate by a foreign person are subject to certain withholding rules under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA). Under FIRPTA, the transferee (or purchaser) is required to withhold and remit to the IRS 10% of the sales price in order to ensure that any taxable gain realized by such foreign person is actually recognized and paid. The purchaser must file IRS Forms 8288 and 8288-A to report and pay the amount withheld to the IRS by the 20th day after the date of a transfer.

Thus, a foreign investor seeking to fully defer all capital gain taxes in a §1031 tax deferred exchange must address this withholding requirement well in advance of closing. Failure to do so will likely result in 10% of the proceeds being ineligible for tax deferral. The only way to ensure that the buyer does not withhold 10% of the proceeds from the sale is to obtain a withholding certificate issued by the IRS (“Withholding Certificate”). The transferee, the transferee’s agent or the transferor may request a Withholding Certificate. The IRS will generally grant or deny an application for a Withholding Certificate within 90 days after its receipt of a completed Form 8288-B application.

While formerly, a buyer was not required to withhold if the seller provided notice that no recognition of any gain or loss on the transfer is required because of a non-recognition provision in the Internal Revenue Code or a provision in a U.S. tax treaty, a “Declaration and Notice to Complete an Exchange” (“1031 Declaration and Notice”), the law was amended in 2003 in a manner which severely limited the usefulness of such 1031 Declaration and Notice.*

As a result, foreign persons desiring to engage in a delayed 1031 exchange should consult a tax adviser and apply for a 1031 Withholding Certificate well in advance of the anticipated disposition of U.S. property holdings.

* Under rules effective as of November 3, 2003, however, a transferee can rely on a 1031 Declaration and Notice only if: (1) the foreign person completes a simultaneous exchange (i.e., the same day), and (2) the foreign person receives no cash or mortgage boot. Under these rules, a buyer of U.S. property from a foreign person can rely on a 1031 Declaration and Notice only if the foreign person exchanges U.S. property for other U.S. property in a swap in which the foreign person receives no cash or mortgage boot. Since many exchanges can involve payment of some cash or debt reduction and very few exchanges are simultaneous exchanges, the utility of a 1031 Withholding Certificate has been substantially reduced.

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