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Tax Implications of Purchasing Real Estate from a Foreign Person—What You Need to Know

By: Linda M. Bruckner, CPA

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Many tax clients think that the tax withholding rules apply only to those in business. They are familiar with withholding on employee wages and may have even needed to withhold tax on income allocated or paid to a foreign investor in their company; however, most clients do not expect a federal tax withholding requirement when making payments for personal purposes—which is why the rules surrounding the purchase of a home may come as a surprise.

Here are the basics of what tax professionals and real estate attorneys need to know about sales of property involving foreign transferors:

- IRC section 1445 requires tax withholding on the disposition of a U.S. real property interest by a foreign person. The purchaser of the property is responsible for withholding and remitting the tax to the IRS. Failure to properly withhold taxes can make the purchaser liable for the tax. IRC section 1445 applies to transfers of personal use property as well as trade or business property.

- The term “foreign person” includes nonresident alien individuals and foreign corporations, foreign partnerships, foreign trusts, and foreign estates. It does not include resident aliens or foreign corporations that have elected to be taxed as domestic corporations.

- A U.S. real property interest can include certain personal property associated with the use of the real property. It can also include an interest in a corporation if the corporation holds—or has held during a prescribed period—a U.S. real property interest.

- The required withholding is based on the “amount realized,” which is essentially the gross sales price. The amount realized includes the amount of cash paid, the fair market value of any property transferred or to be transferred, and the amount of any liability assumed (and to which the property is subject either immediately before or after the transfer).

- As of Feb. 17, 2016, the withholding rate is 15%, up from the previous rate of 10%. There are exceptions to the 15% withholding rate if the buyer is acquiring the property as his or her personal residence. In that case, no withholding is required if the amount realized is $300,000 or less, and a 10% withholding rate applies if the amount realized is in excess of $300,000 but not in excess of $1,000,000. Note that there are specific rules as to what constitutes use as a personal residence.

- In advance of the sale, the transferor (or transferee) may request a reduced withholding rate or an exemption from the withholding requirement by requesting a Withholding Certificate from the IRS and stating the reasons why a 0 or reduced rate of withholding is appropriate. If the certificate is obtained and furnished to the purchaser prior to closing, the purchaser can withhold as permitted by the certificate.

- If the transferor has requested but not yet received the Withholding Certificate by the date of closing, the purchaser must withhold at the prescribed rate. If, however, the transferor gives proper notice to the purchaser that a Withholding Certificate has been requested, the purchaser can delay remitting the withholding to the IRS until the transferor receives the approved certificate or is notified that the request for reduced withholding was denied. Once the certificate (or notice of denial) is received, the portion of the withheld funds that constitutes required withholding must be remitted to the IRS, but the portion not required by the certificate can be immediately released to the transferor.

- The request for a Withholding Certificate is usually made by filing Form 8288-B with the IRS, Application for Withholding Certificate for Dispositions by Foreign Persons of US Real Property Interests, but this form is not used for all requests. IRS Publication 515 describes the procedures for requesting a Withholding Certificate, depending on the basis for the request.

- Form 8288, U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests, is used to report and transmit the amount withheld. Form 8288-A must be completed for each person subject to the withholding and attached to Form 8288.

- Note that withholding may also be required in connection with transactions involving U.S. real property interests that are not actual sales or sales by a foreign person. Examples include corporate distributions of U.S. real property interests, dispositions of U.S. real property interests by partnerships with foreign partners, and dispositions of U.S. real property interests by trusts and estates with foreign beneficiaries. The specific rules and withholding rates vary.
  In the case of a straightforward sale of U.S. real estate, the benefits of applying for a Withholding Certificate can be illustrated by the following example:

  A Canadian citizen who had moved to the United States to work for an American university was returning home to Canada. During the six years the taxpayer worked in the United States, he and his spouse lived near the university in a house they purchased shortly after their arrival. When the taxpayers returned to Canada in December 2015, they abandoned their U.S. residency status. In February 2016, they closed on the sale of their home with a sales price of $650,000. Because the sale of the home met the requirements of IRC section 121, the taxpayers were eligible to exclude up to $500,000 of gain on the sale of the residence and would have owed no tax. However, absent a Withholding Certificate, $65,000 of tax would have been withheld and remitted to the IRS, and the taxpayers would have had to wait until they filed their 2016 tax return—a full year later—to request a refund of the withheld funds. By obtaining a Withholding Certificate in advance of closing, the taxpayers were able to receive all of their proceeds at closing.

  It is becoming more common for foreign individuals and entities to invest in U.S. real estate. Thus, we are seeing more sales of property by foreigners. It is important that we, as professional advisors, understand the rules so that we can properly counsel our clients—whether they are purchasing a real property interest from a foreign person or are themselves the foreign person selling that real property interest.

Linda M. Bruckner, CPA, *is a partner at Sciarabba Walker & Co., LLP in Ithaca, NY. She is head of the firm's international tax group and provides tax consulting services to individual and business clients. Linda also assists clients with business mergers, sales, and acquisitions; IRS audits; financial and estate planning; and litigation support. She received her BS from Cornell University and is a member of the NYSSCPA and the AICPA. Linda can be reached at lbruckner@swcllp.com.*

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