

FIRPTA Pitfalls

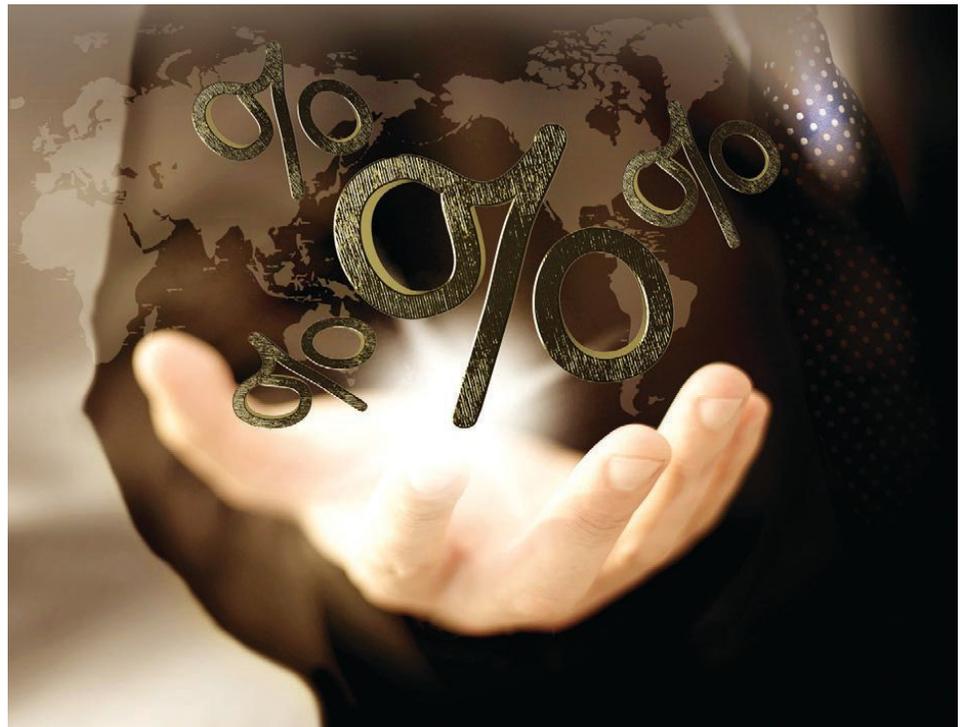
BY THAD D. KIRKPATRICK, ESQ., BOARD CERTIFIED REAL ESTATE ATTORNEY, COHEN & GRIGSBY, P.C., NAPLES, FLORIDA, AND LEGAL RESOURCES COMMITTEE MEMBER.

I. BACKGROUND

The Foreign Investment in Real Property Tax Act ("FIRPTA") is applicable to all transactions involving interests in real property where the seller is a "foreign person" (this includes entities). A disposition means "disposition" for any purpose described in the Internal Revenue Code. This includes, but is not limited to, a sale or exchange, liquidation, redemption, gift, transfers, etc. FIRPTA requires withholding of a portion of the amount realized (typically, the purchase price) by foreign persons at the time of disposition. FIRPTA requires that buyers of U.S. real property interests (transferees) from foreign persons, as well as certain buyers' agents, and settlement providers, are required to correctly withhold from the amount realized on the disposition. Sellers are able to provide certification to the buyer that the seller is not a foreign person subject to withholding (commonly referred to as a "Seller FIRPTA Certification"), and in those instances where the certification correctly provides certain information, the transaction will be exempt from withholding.

II. RECENT AMENDMENT

By now you may have heard that FIRPTA was recently amended, effective



as of February 16, 2016 (applying to all real estate transactions governed by FIRPTA that close on or after that date). Previously, the withholding requirement in connection with transfers of U.S. real property interests was generally 10%. The amendment: (i) changed the default withholding amount

for such transactions, which is now 15% of the amount realized (typically, the purchase price) and (ii) established a new category for a reduced withholding amount of 10% - in certain limited circumstances (where an exception applies).

III. CERTIFICATES

A Seller who cannot provide a Seller FIRPTA Certification may apply to the IRS for a reduced withholding certificate, which may be issued due to:

1. **A determination by the IRS that reduced withholding is appropriate because either:**
 - a. The amount that must be withheld

A Seller who cannot provide a Seller FIRPTA Certification may apply to the IRS for a reduced withholding certificate.

would be more than the transferor's maximum tax liability, or

b. Withholding of the reduced amount would not jeopardize collection of the tax,

2. **The exemption from U.S. tax of all gain realized by the transferor, or**
3. **An agreement for the payment of tax providing security for the tax liability, entered into by the transferee or transferor.**

A seller who will be subject to withholding, and for whom withholding presents a serious burden, is well advised to seek advice and assistance from lawyers and/or tax practitioners (CPAs) so that the available options can be evaluated and preparation of filings can be expedited. Tax specialists who regularly deal with these sorts of applications should be consulted with early on – even before there is a contract for sale, in order to prepare for the consequences that a transaction might bring. The period for review and issuance of such certificates by the IRS is generally 90 days after receipt of a complete application; therefore, considering the timeline that many transactions often take – diligence in preparing for this in advance is key.

IV. AN EXCEPTION PROVIDING FOR AN EXEMPTION OR REDUCED WITHHOLDING WHERE A CERTIFICATE IS NOT REQUIRED BY THE RULES.

In instances where there is a seller who might otherwise be subject to withholding, IRS rules permit the buyer to treat the transaction as one for which: (i) there is an exemption, or (ii) a reduced withholding amount is permitted, as follows:

1. **0% withholding (EXEMPT)**—the transaction would be exempt if the amount realized is not more than \$300,000.00 and the buyer or a member of the buyer's family has definite plans to reside on the Property in accordance with the Internal Revenue Code and all applicable regulations, or
2. **10% withholding (REDUCED AMOUNT)**—the transaction is eligible for a reduced withholding amount of 10% if the amount realized is greater

than \$300,000.00, but not more than \$1,000,000.00 and the buyer or a member of the buyer's family has definite plans to reside on the Property in accordance with the Internal Revenue Code and all applicable regulations.

Note that the exception permits the buyer to treat the transaction in the foregoing manner if the proper conditions exist; however, the rules do not compel the buyer to do so – even when the buyer believes that the proper conditions may exist. As a practical matter in the vast majority of transactions, the buyer will not be conducting its own settlement; therefore, closing agents and buyer's agents involved should request that the buyer provide a certificate that confirms that the buyer or a member of buyer's family has definite plans to reside on the Property in accordance with the Internal Revenue Code and all applicable regulations. In the absence of the buyer

FIRPTA applies to all real estate transactions unless there is an exemption, and if there is an exemption, there should be a certification that confirms that the exemption applies.

providing such a certificate, withholding should be made; and this is because FIRPTA imposes liability upon not only the buyer (to withhold), but also upon certain buyers' agents, and settlement providers as well.

What follows is a discussion of various pitfalls that one must be aware of when dealing with real property transfers. This is not intended to be an exhaustive list, but rather an effort to touch upon several scenarios that often arise in today's markets. A great resource that you might find helpful in this discussion, is IRS Publication 515: "Withholding of Tax on Nonresident Aliens and Foreign Entities." (see: <https://www.irs.gov/pub/irs-pdf/p515.pdf>)

V. PITFALLS

1. **One of the first and often overlooked pitfalls is that FIRPTA places the burden of withholding upon the buyer (as well as certain buyers' agents, and settlement providers).** Many people believe that if the withholding (and possible ultimate tax) is a burden upon sellers, then FIRPTA is a seller problem. This is not so, since properly documenting compliance with FIRPTA is a buyer obligation, and in instances where withholding is required, but fails to occur, the buyer (as well as certain buyers' agents, and settlement providers) can be held accountable for the withholding amount, penalties and interest.
2. **FIRPTA applies to all real estate transactions unless there is an exemption, and if there is an**

exemption, there should be a certification that confirms that the exemption applies. In some instances (as noted above in Section I) the exemption certification may come from the seller (certificate of non-foreign status). In others, the exemption certification may come from the IRS. If an exception applies (as discussed in Section IV, above), it should be requested from the buyer.

3. **An exception can only apply (as discussed in Section IV, above), where the buyer is an individual.** The exception does not apply in any case where the transferee is other than an individual even if the property is



acquired for or on behalf of an individual who will use the property as a residence.

4. If a buyer (as well as certain buyers' agents, and settlement providers) has actual knowledge of the falsity of a seller's certification (or have notice of the falsity of the certification) prior to closing, then there can be no "reliance" upon the certification and liability for failing to withhold can attach.

5. Where there is a seller who might otherwise be subject to withholding, a buyer might want to carefully consider whether the buyer should provide a certificate that: (i) confirms an exemption, or (ii) permits a reduced withholding amount (as discussed in Section IV, above). This is because a buyer who fails to withhold in reliance upon the exception, but who does not in fact reside at the property for the minimum number of days set forth above, shall be liable for the failure to withhold (if the transferor was a foreign person and did not pay the full U.S. tax due on any gain recognized upon the transfer). The liability will not attach, however, if there is a change in circumstances that the buyer could not have reasonably anticipated at the time of the transfer. But here is the catch: the buyer will have to demonstrate (prove) to the IRS that there was a valid "change in circumstances" and that the buyer could not have reasonably anticipated at the time of the transfer.

The buyer will have to demonstrate (prove) to the IRS that there was a valid "change in circumstances" and that the buyer could not have reasonably anticipated at the time of the transfer.

6. A seller who might otherwise be subject to withholding might want the buyer to provide a certification to the seller of buyer's definite plans to reside upon the property (as discussed in Section II, above) and there are addenda available that would make that certification to the seller part of

the contract (and require that it be confirmed by the buyer at closing). Failing to use these addenda such as NABOR®'s "ADDENDUM TO SALES CONTRACT-FIRPTA BUYER RESIDENTIAL USE EXEMPTION," could possibly place the seller in a position of requesting it from a buyer at closing (and having that request refused because the buyer is not contractually obligated to provide it). When that happens, a settlement provider (and other parties involved) will demand withholding from the seller.

7. The exemption and reduced withholding avenues stated previously (in Section IV) are not the only sources of relief from the requirements of withholding and a buyer may not be willing to certify or sign an addendum that the buyer will certify that an exception applies. Failing to be very proactive in directing a seller to make proper application to the IRS, in order to receive a certificate from the IRS that authorizes specified reduced withholding or even no withholding, can result in a frustrated closing, or no closing if the seller is unable to properly fund the withholding amount.
8. When one applies to the IRS for a reduced withholding certificate they must now provide proof/documentation to the IRS that when they purchased the property there was no FIRPTA withholding due at that time, or that if FIRPTA withholding was due, that it was withheld and submitted to the IRS. This is even more reason that FIRPTA is a buyer issue, because some day they may need proof (if they are foreign) that FIRPTA was complied with at the time of their purchase of the U.S. real property interest.
9. There are misconceptions, including the notion that FIRPTA withholding may not apply to real property transfers by U.S. entities such as corporations, limited partnerships or limited liability companies, or even trusts. ALL forms of ownership can involve FIRPTA withholding—upon sale or other disposition. Seller certification

of non-foreign status in these instances must also confirm that the entity is not a disregarded entity, and if it is a disregarded entity, that the taxpayer involved is not a foreign person.

10. The requirements for certificates that can be provided by buyers regarding the use of the property as a residence are often misunderstood. First, the buyers must be individuals (not entities). Second, the statements regarding use of the property (statement regarding 50% occupancy) are not as stringent as one might think, because there are qualifiers that govern how that percentage is to be calculated. Here are the qualifiers: 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 used by any person during each of the first two 12-month periods following the date of transfer. When counting the number of days the property is used, you don't count the days the property will be vacant.

Lawyers and tax professionals who regularly deal with these matters should be consulted, and it is best to do so before there is a contract.

11. What about US entities that are owned by foreign persons? In some instances (such as when such entities have a tax identification number and regularly file and pay US taxes), these entities may qualify to provide a certificate that will allow the transaction to be exempt from withholding upon disposition of the real property interest, but the nuances regarding what qualifies and what does not are not easily understood and it is advisable that an attorney or tax professional be consulted when this is the circumstance. It is important to note that where the

withholding in such instances is exempt, upon distribution (such as a dividend payment) by the entity to foreign owners (or shareholders), withholding of up to 35% may be applicable.

There are many details regarding the exemption from withholding and qualification for reduced withholding, and in particular regarding applications to the IRS for a certificate (permitting exemption or reduced withholding). Lawyers and tax professionals who regularly deal with these matters should be consulted, and it is best to do so before there is a contract.

NAPLES CONFERENCE CENTER

Making business a pleasure



CLASSROOM FACILITIES



BANQUET FACILITIES



CONFERENCE FACILITIES



- ◆ **EXCEPTIONAL FACILITIES**
Flexible space for groups up to 250
- ◆ **OUTSTANDING VALUE**
Affordable rates with free Wi-Fi
- ◆ **CONVENIENT LOCATION**
Centrally located for easy access

See for yourself how simple we can make your business meeting. You'll find the value you receive as attractive as the many amenities you'll discover when you book your next business event at the Naples Conference Center. Call today for member rates.

NAPLES CONFERENCE CENTER

Corie Chase (239) 597-1666 x 224
 1455 Pine Ridge Road, Naples, FL 34109
www.NaplesConferenceCenter.com

provided by



NABOR
Naples Area Board of REALTORS®