Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I Concept Unit

Unit Name	Taxation on the Disposition of USRPI by Foreign Persons	
Primary UIL Code	9424.04-04	Foreign Seller Issues

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Knowledge Base	International
Shelf	Inbound
Book	Withholding Business
Chapter	Investment in Real Property Tax Act (FIRPTA)

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General Overview

Taxation on the Disposition of USRPI by Foreign Persons

Note: This Unit is updated to clarify the point on slide 7 that publicly traded stock of a corporation continues to not be a U.S. Real Property Interest (USRPI) if held by a 5% or less shareholder. Only for Real Estate Investment Trusts (REITs), was the 5% threshold increased to 10% or less under the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act") passed on December 18, 2015.

Under the Foreign Investment in U.S. Real Property Tax Act of 1980 (FIRPTA), gains or losses from the disposition of a USRPI by certain foreign persons are treated as gains or losses effectively connected with a trade or business within the United States. Foreign persons subject to FIRPTA includes foreign corporations and nonresident aliens (NRAs). The three components necessary for FIRPTA (IRC 897) to apply to a transaction are that (1) there is a gain or loss on the disposition of (2) a USRPI and (3) such gain or loss is realized by an NRA or a foreign corporation.

IRC 1445, enacted in 1984, requires withholding on the disposition of USRPI by foreign persons. Foreign persons include foreign corporations, foreign partnerships, foreign trusts and estates, NRAs and other foreign entities.

The PATH Act was signed into law on December 18, 2015. Dispositions of REIT stock, REIT distributions and dispositions of any other U.S. Real Property Interests by a foreign person had FIRPTA withholding rate increased from 10% to 15% of the gross purchase price realized on these dispositions with limited exceptions. This rate increase is effective for the aforementioned dispositions occurring 60 days after December 18, 2015. This 15% is required to be withheld by the withholding agent, generally the buyer/transferee, regardless of whether it is a U.S. or foreign person, and be remitted to the IRS by the 20th day after the date of transfer together with the filing of Form 8288, *U.S. Withholding Tax Return for Disposition by Foreign Persons of U.S. Real Property Interests,* and Form 8288-A, *Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests*. The NRA or foreign corporation making the disposition is required to file a U.S. income tax return (Forms 1040NR, 1120-F, etc.) to report its income effectively connected with a trade or business within the United States (ECI). The foreign corporation or NRA can claim the amount withheld as a credit against any U.S. income tax due.

! **CAUTION:** As mentioned above, the rate of withholding on FIRPTA transactions increased from 10% to 15% under the 2015 Path Act. Please be aware of the proper rate that should be applied in individual cases.

General Overview (cont'd)

Taxation on the Disposition of USRPI by Foreign Persons

A foreign person may request a reduced withholding if proper conditions exist and a Form 8288-B, *Application for Withholding Certificate for Dispositions*, by Foreign Persons of U.S. Real Property Interests) is submitted and accepted by the IRS. There are basically six different categories that qualify for a reduced amount of, or, exemption from, withholding. These categories are:

1. Non recognition or Exemption
2. Maximum Tax Liability
3. Installment Sales
4. Security Agreements
5. Blanket Applications
6. Nonstandard Applications

The Form 8288-B applications are processed at the Campus by Tax Examiners and are compared with a check list to determine if proper and all required documentation is submitted. Please see Rev. Proc. 2000-35 for explanation of each withholding certificate application category and Treas. Reg. 1.1445-3(b) for additional information.

! **CAUTION:** Since 2006, all FIRPTA related forms and documents are processed at the Ogden Service Center. The mailing address is: Internal Revenue Service Center, P.O. Box 409101, Ogden, UT 84409 per the current Form 8288 instructions. The regulations, however, have not been updated to reflect such change in address.

This Concept Unit is meant to give general information about FIRPTA. Income Tax Treaties permit the United States to tax gains resulting from the disposition of USRPIs under IRC 897. Paragraph 1 of Article 13 of the U.S. Model Treaty permits the taxation of gains of a foreign resident from the disposition of real property located in the United States.

CONSULTATION: Consultation with the Withholding Business Practice Network (PN) or your local counsel may be useful.

Relevant Key Factors

Taxation on the Disposition of USRPI by Foreign Persons
Key Factors
▪ This Unit analyzes the dispositions of USRPI by a foreign person. The gain or loss from transactions involving dispositions of USRPIs by NRAs or foreign corporations is treated as effectively connected with a U.S. trade or business and such foreign persons were engaged in such U.S. trade or business. The withholding requirements on dispositions of USRPI are specified under IRC 1445. A detailed discussion of all of these concepts are included in the Detailed Explanation of the Concept section of this Unit.

Detailed Explanation of the Concept

Taxation on the Disposition of USRPI by Foreign Persons	
Analysis	**Resources**
Reasons for FIRPTA Law Prior to 1980, foreign persons could dispose USRPIs without paying taxes on the gain unless the gain was effectively connected with a U.S. trade or business. In 1980, Congress passed the Foreign Investment in U.S. Real Property Tax Act which added IRC 897 and treated gain or loss on the disposition of USRPI as ECI. This law also added IRC 6039(C) which required foreign property owners to disclose their ownership of U.S. real property. The goal of IRC 6039(C) was to allow the IRS to monitor the ownership of USRPI by foreign persons in an effort to determine when there was a disposition. For various reasons, this effort was not effective and in 1984, under the Deficit Reduction Act, Congress enacted IRC 1445. Temporary regulations under IRC 1445 were issued on December 31, 1984, and final regulations were issued on December 24, 2006. IRC 1445 requires the buyer/transferee to withhold 15% (10% prior to the PATH Act of 2015) of the amount realized from the disposition of a USRPI by a foreign person, or 35% of the gain on certain distributions of USRPIs.	▪ T.D. 8000, 1985-1 C.B. 296 ▪ T.D. 8113, 1987-1 C.B. 259

Detailed Explanation of the Concept (cont'd)

Taxation on the Disposition of USRPI by Foreign Persons	
Analysis	**Resources**
<u>USRPI</u> ▪ USRPI includes more than a direct interest in real estate. A USRPI includes an interest in real property (including an interest in a mine, well, or other nature deposit) located in the United States or the Virgin Islands, and any interest (other than solely as a creditor) in any domestic corporation unless the corporation establishes that it is not a U.S. Real Property Holding Corporation (USRPHC) at any time during the specified period (generally 5 years preceding disposition).	▪ IRC 897(c)(1)(A)
▪ A corporation is a USRPHC if: $$\frac{\text{Fair Market Value (FMV) of Its USRPI}}{\text{(FMV of Its USRPI + Interests in Real Property Located Outside the U.S. + All Other Assets Used or Held for Use in Its Trade or Business)}} \geq 50\%$$	▪ IRC 897(c)(2)
▪ Publicly traded stock of a corporation is not USRPI if held by a 5% or less shareholder. For Real Estate Investment Trusts, the 5% threshold was increased to 10% or less under the PATH legislation passed on December 18, 2015.	▪ IRC 897(c)(3)

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Detailed Explanation of the Concept (cont'd)

Taxation on the Disposition of USRPI by Foreign Persons	
Analysis	**Resources**
<u>Rule for Sales of Interest in Partnerships, Trusts, and Estates</u> ▪ The amount of any money, and the Fair Market Value (FMV) of any property, received by an NRA or foreign corporation in exchange for all or part of its interest in a partnership, trust, or estate shall, to the extent attributable to USRPI, be considered as an amount received from the sale or exchange in the United States of such property. ▪ For purposes withholding under IRC 1445, an interest in a partnership is treated as a USRPI if 50% or more of the value of gross partnership assets consists of USRPIs and 90% or more of the value of the gross partnership assets consists of USRPIs and cash and cash equivalents.	▪ IRC 897(g) ▪ Treas. Reg. 1.1445-11T(d)(1)

Detailed Explanation of the Concept (cont'd)

Taxation on the Disposition of USRPI by Foreign Persons	
Analysis	**Resources**
Real Property	
▪ Local law definitions of real estate are not controlling.	▪ Treas. Reg. 1.897-1(b)(1)
▪ Land and unsevered products of the land - This includes land, growing crops and timber, mines, wells, and other natural deposits. When crops and timber are severed from the land or ores, minerals and other natural deposits are extracted from the land they are no longer considered to be real property.	▪ Treas. Reg. 1.897-1(b)(2)
▪ Improvements - This category includes building, any other inherently permanent structure, or the structural components of either. − Building means any structure enclosing a space within its walls, and usually covered by a roof. Examples include apartment houses, factory and office buildings, barns, warehouses, railway and bus stations, and stores. − Inherently permanent structure is any property that is affixed to real property and that will ordinarily remain affixed to the property for an indefinite period of time. Examples include swimming pools, bridges, fences, etc. − Structural components (defined in Treas. Reg. 1.48-1(e)(2)), include for example walls, partitions, floors, ceilings, windows, doors, wiring, plumbing, HVAC systems, lighting fixtures, pipes, elevators, sprinkler systems, fire escapes and other components relating to the operation or maintenance of a building.	▪ Treas. Reg. 1.897-1(b)(3)(iii)

Detailed Explanation of the Concept (cont'd)

Taxation on the Disposition of USRPI by Foreign Persons	
Analysis	**Resources**
▪ Personal property associated with the use of real property - This includes movable walls, furnishings, and other personal property associated with the use of real property only in (A) mining, farming, and forestry, (B) the improvement of real property, (C) the operation of a lodging facility, or (D) the rental of furnished office and other work space.	▪ Treas. Reg. 1.897-1(b)(4)

Detailed Explanation of the Concept (cont'd)

Taxation on the Disposition of USRPI by Foreign Persons	
Analysis	**Resources**
Interest in Real Property ▪ USRPI also includes interest other than solely as a creditor with respect to real property interest. These would include a fee ownership, co-ownership, or leasehold interest in real property, a time sharing interest in real property, and a life estate, remainder, or reversionary interest in such property. ▪ It also includes any direct or indirect right to share in the appreciation in the value, or in the gross or net proceeds or profits generated by, the real property, for example, an equity kicker.	▪ Treas. Reg. 1.897-1(d)(2)(i)

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">Taxation on the Disposition of USRPI by Foreign Persons</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td><u>Disposition</u>

▪ For purposes of FIRPTA, “disposition” means any transfer that would constitute a disposition under the Internal Revenue Code and regulations. This includes but is not limited to:
– Sale or exchange
– Capital contribution, distribution, liquidation and redemptions
– IRC 1031 Like-kind exchanges (consider non-recognition rules of IRC 897(e))
– Involuntary conversions
– Gifts</td><td>▪ Treas. Reg. 1.897-1(g)</td></tr>
<tr><td><u>Foreign Person</u>

▪ A foreign person includes a NRA, foreign corporation, foreign partnership, foreign trust, a foreign estate, and any other person that is not a U.S. person.</td><td>▪ Treas. Reg. 1.1441-1(c)(2)</td></tr>
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Detailed Explanation of the Concept (cont'd)

Taxation on the Disposition of USRPI by Foreign Persons	
Analysis	**Resources**
Taxing the Gain ▪ Gain from the sale of USRPIs by a NRA or foreign corporation is subject to tax under IRC 897. The NRA or foreign corporation may claim deductions that are attributable to income that is treated as effectively connected with a trade or business. However, the NRA or foreign corporation may not make an election under IRC 871(d) or IRC 882(d) for a taxable year in which the foreign person derives no income from the U.S. real property other than gain from the sale of USRPI.	▪ CCA 200504029

Detailed Explanation of the Concept (cont'd)

Taxation on the Disposition of USRPI by Foreign Persons	
Analysis	**Resources**
<u>Taxing the Gain</u> ▪ Some taxpayers that transfer options to acquire a USRPI may not have properly complied with IRC 897 or IRC 1445, usually because they improperly claim that such options are not USRPIs. Options to acquire any interest in real property (other than an interest solely as a creditor) are included in the definition of USRPIs. The transferee of an option to acquire a USRPI must deduct and withhold a tax equal to 15% of the amount realized by the transferor upon the disposition. This withholding requirement does not apply when the option is granted or when it expires.	▪ Treas. Reg. 1.897-1(d)(2)(ii)(B). ▪ Treas. Reg. 1.1445-1(b)(3). See also, CCA 200522020.

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">Taxation on the Disposition of USRPI by Foreign Persons</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td><u>Foreclosures</u>

▪ A NRA or foreign corporation owning a USRPI that was foreclosed is subject to FIRPTA taxes on any gain resulting from the foreclosure. The transferee is the withholding agent and is required to deduct and remit the withholding.
▪ The FIRPTA rules for foreclosures differ from the rules for other dispositions in the following manner:
– If the transferee (or transferor) notifies the court or trustee having jurisdiction on the date of transfer, and notifies the IRS regarding the transaction, then the withholding would be the lesser of:
▪ The net proceeds if any, determined by the court or trustee, or
▪ The amount otherwise required to be withheld under IRC 1445(a), which is 15% of the amount realized (Treas. Reg. 1.1445-2(d)(3)). This means that if the notification requirements are met, the withholding would work out to be zero if the foreign person is having a loss (which is usually the case).</td><td>▪ Treas. Reg. 1.1445-2(d)(3)(i)(A)</td></tr>
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Detailed Explanation of the Concept (cont'd)

Taxation on the Disposition of USRPI by Foreign Persons	
Analysis	**Resources**
<u>Deed in Lieu of Foreclosure</u> ▪ In some cases a debtor will simply deed over the title of the USRPI serving as the security to the creditor. This transaction is also subject to FIRPTA if the debtor is a foreign person. The amount realized will be the amount encumbering the USRPI, plus any additional amounts paid to the debtor. If the following three conditions are met, however, there will be no withholding requirement under IRC 1445: – The transferee is the only person with a security interest in the USRPI; – No cash or other property (excluding incidental fees) is paid to any person with respect to the transfer; and – The notice requirements are met (as stated under Foreclosures above).	▪ Treas. Reg. 1.1445-2(d)(3)(i)(B).
<u>Gifts</u> ▪ Gifts of USRPI by foreign persons may give rise to FIRPTA. For example, if the transferor is relieved of the mortgage or other liabilities secured by the property gifted and such liabilities are in excess of the transferor's basis in the property gifted, the gain recognized could be subject to IRC 897 and IRC 1445.	▪ See Rev. Rul. 70-626, 1970-2 C. B. 158

Detailed Explanation of the Concept (cont'd)

Taxation on the Disposition of USRPI by Foreign Persons	
Analysis	**Resources**
<u>Refunds to Foreign Person</u> ▪ Any tax withheld and submitted to the IRS on a FIRPTA transaction must be credited to the foreign transferor's tax return. The foreign transferor is to include Form 8288-A which has been stamped by the IRS, with its tax return to establish the amount withheld which is available as a credit. The IRS sometimes runs into situations where the foreign seller does not have a Form 8288-A. For example, the withholding agent does not submit the withholding to the IRS, meaning that the IRS cannot provide the seller with a stamped copy of Form 8288-A. In situations such as this, the foreign transferor may establish the amount of tax withheld by the buyer by attaching substantial evidence to its tax return (e.g., closing documents) showing the withholding amount.	▪ Treas. Reg. 1.1445-1(f)(1) ▪ Treas. Reg. 1.1445-1(f)(3)(i)) See also, CCA 201028040

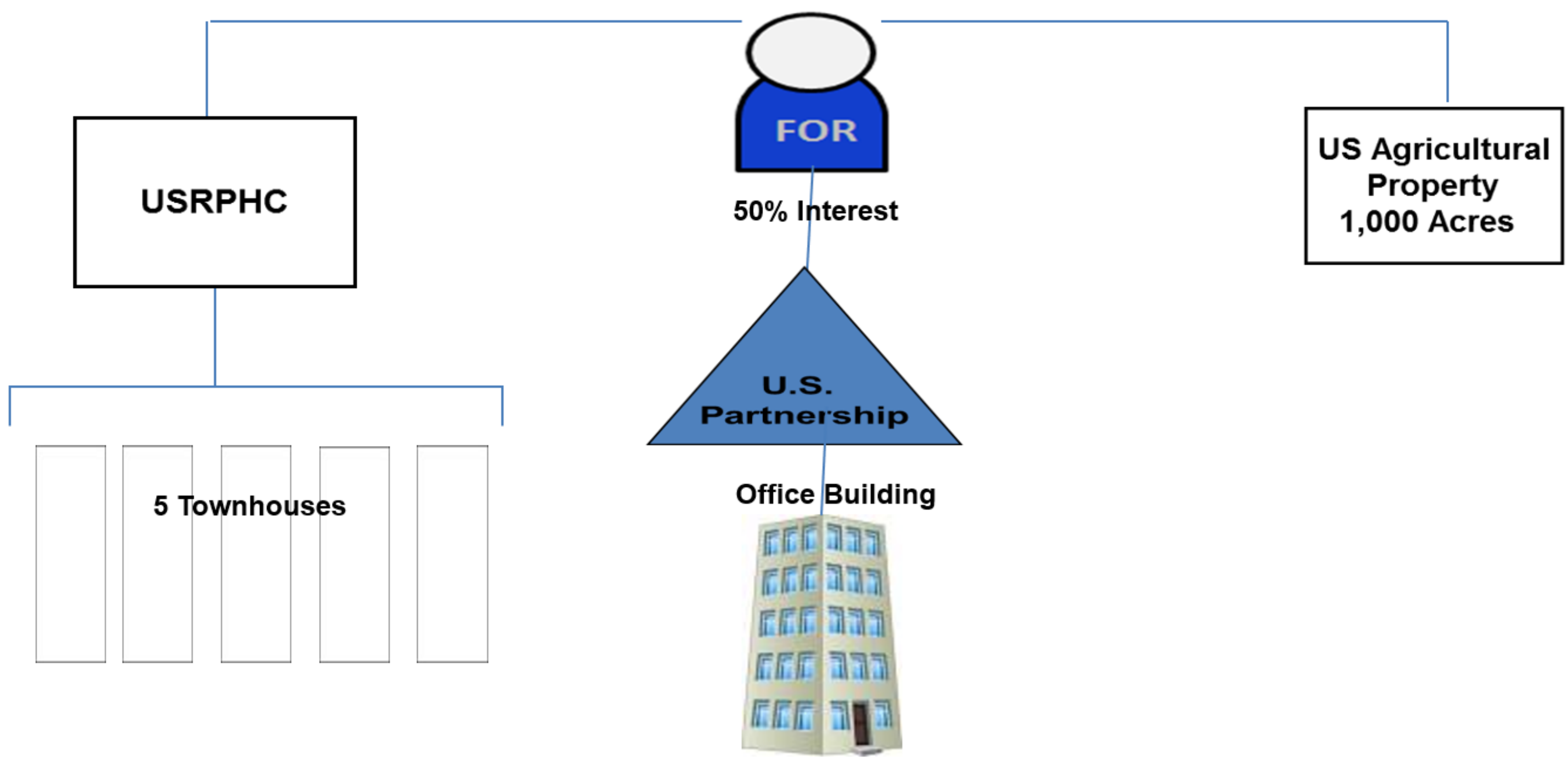
Detailed Explanation of the Concept (cont'd)

Taxation on the Disposition of USRPI by Foreign Persons	
Analysis	**Resources**
<u>Treaty Application</u> ▪ Generally, income tax treaties generally allow the United States to tax gain attributable to the alienation of real property situated in the United States.	▪ See, Article 13, Paragraph 1 of the 2006 U.S. Model Income Tax Convention
<u>Disregarded Entities</u> ▪ The IRS is aware that some transferees of USRPIs are not withholding 15 percent of the amount realized because the foreign transferor elected, by filing a Form 8832, *Entity Classification Election*, to be disregarded as an entity separate from its owner (disregarded entity). This is not proper since a disregarded entity may not certify that it is the transferor of a USRPI for purposes of IRC 897 and 1445. Rather, the owner of the disregarded entity is treated as the transferor of property. **CONSULTATION:** Consultation with Withholding Business PN or your local counsel may be useful.	▪ Treas. Reg. 1.1445-2(b)(2)(iii)

Examples of the Concept

Taxation on the Disposition of USRPI by Foreign Persons

Examples



Examples of the Concept (cont’d)

Taxation on the Disposition of USRPI by Foreign Persons
Examples
▪ This Unit analyzes the dispositions of USRPI by an NRA as depicted in the diagram supra. Each of the three transactions would require the application of the FIRPTA rules (i.e., IRC 897 and 1445). The diagram reflects that NRA is the sole shareholder of a U.S. Corporation that owns 5 townhouses which it uses as rental property in the United States. NRA also owns a separate 50% interest in a U.S. partnership that owns an office building in a city in the United States and individually owns 1,000 acres of agriculture property as well.

Examples of the Concept (cont'd)

Taxation on the Disposition of USRPI by Foreign Persons

Examples

- Consider the following basic facts:
  1. NRA is the sole shareholder of a U.S. corporation. The only assets of the corporation are 5 townhouses which are located in the United States. The townhouses are rental properties and are leased by the corporation to renters. The FMV of the only class of stock of the corporation is $1 million. NRA has identical adjusted basis in each share of stock and the aggregate basis of the stock is $600,000.
  2. NRA owns a 50% interest in a U.S. partnership. The only asset of the partnership is an office building which is located in the United States. The partnership has no liabilities. The FMV of the office building is $10 million and the partnership's adjusted basis in the office building is $5 million. The FMV of NRA's 50% interest in the partnership is $5 million and the adjusted basis in the interest is $1 million.
  3. NRA individually owns 1,000 acres of agricultural land in the United States which he holds as investment. The land is not subject to any liability. The FMV of the land is $2 million and NRA's adjusted basis in the land is $500,000.

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Examples of the Concept (cont'd)

Taxation on the Disposition of USRPI by Foreign Persons
Examples

- FIRPTA Implications of basic facts and diagram on previous two slides:

1. NRA sells 25% ownership of USRPHC for cash of $250,000 to a U.S. individual. The amount NRA realized on the sale is $250,000. The stock sold has an adjusted basis of $150,000. NRA should recognize $100,000 of gain and such gain should be treated as ECI. U.S. individual buyer/transferee is required to withhold $25,000 ($250,000 amount realized x 15% withholding rate) under IRC 1445.
2. Dispositions of certain interests in a partnership are treated as USRPI whereby IRC 897 and 1445 may apply. Specifically, if 50% or more of the value of gross partnership assets consists of USRPIs and 90% or more of the value of the gross partnership assets consists of USRPIs and cash and cash equivalents, the interest in a partnership is treated as a USRPI and a 15% withholding would apply to any amount realized by NRA. In example 2, NRA gives 5% of his interest in the U.S. partnership to a niece as a college graduation present. The gift of the 5% interest in the partnership is a disposition for purposes of IRC 897 and 1445. If NRA receives any considerations (including relief of liability) in exchange for all or part of an interest in such partnership, gain or loss will be recognized and taxed as ECI to the extent attributable to a USRPI. Since the disposition in the example is a gift and NRA did not have any amount realized (including any relief of liability) on the disposition, NRA would not recognize any gain and the disposition would not be subject to any withholding. The tax results would differ if the office building was subject to a mortgage and there was an amount realized related to a relief of liability subject to 15% FIRPTA withholding.
3. NRA exchanges his 1,000 acres of U.S. agricultural land for 100 acres of undeveloped commercial land located in the United States of equal value in a simultaneous like-kind exchanges under IRC 1031. NRA did not recognize any gain or loss on the exchange. This transaction may not be subject to withholding because it is a "nonrecognition transaction," provided the notice requirements under Treas. Reg. 1.1445-2(d)(2) are satisfied.
   – See Treas. Reg. 1.1445-2(d)(2)(iv) for consequences related to like-kind exchanges that do not qualify for nonrecognition treatment in their entirety and to deferred like-kind exchanges.

Index of Referenced Resources

Taxation on the Disposition of USRPI by Foreign Persons
CCA 200504029
CCA 200522020
CCA 201028040
IRC 897
Rev. Rul. 70-626 1970-2 C.B.158
T.D. 8000, 1985-1 C.B. 296
T.D. 8113, 1987-1 C.B. 259
Treas. Reg. 1.1445-11T
Treas. Reg. 1.897-1
Treas. Reg. 1.1441-1
Treas. Reg. 1.1445-1
Treas. Reg. 1.1445-2
U.S. Model Treaty (2006), Art. 13(1)

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Training and Additional Resources

Taxation on the Disposition of USRPI by Foreign Persons	
Type of Resource	**Description(s) and/or Instructions for Accessing**
Other Training Materials	Overview of Withholding Under FIRPTA for Sales by Individuals (IRC 1445)

Glossary of Terms and Acronyms

Acronym	Definition
ECI	Effectively Connected Income
FIRPTA	Foreign Investment in Real Property Tax Act of 1980
FMV	Fair Market Value
PATH	Protecting Americans from Tax Hikes Act of 2015
PN	Practice Network
NRA	Nonresident Alien
REIT	Real Estate Investment Trust
UIL	Uniform Issue List
USRPI	U.S. Real Property Interest
USRPHC	U.S. Real Property Holding Corporation

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Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
9442.02	*Overview of Withholding under FIRPTA for Sales by Individuals*
9442.02	*U.S. Real Property Holding Corporations -USRPHC Status*