Year-end Tax Bill Increases FIRPTA Withholding Rate to 15%

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Starting Feb. 16, title settlement agents will need to start holding back more proceeds from the sale of property by foreign nationals due to recent changes to the Foreign Investment in Real Property Tax Act (FIRPTA). The changes were part of the year-end tax extension legislation signed into law by President Obama on Dec. 18, 2015. (Reference: The legislation is H.R. R. 2029, now known as Public Law 114-113. See Section 324 for text of changes.)

FIRPTA is a tax law passed in 1981 requiring foreign persons to pay U.S. income tax on the gains they make from selling U.S. real estate. The duty is on the U.S. national buyer (and not the settlement agent) to deduct and withhold a portion of the sales price and report the sale to the IRS. Buyers can withhold less than the statutory amount if they obtain a determination of the specific amount of tax owed by the foreign national using IRS Form 8288-B. In most cases, the settlement agent is the party that actually remits the funds to the IRS, but the buyer is held legally responsible. Additionally, until the tax is paid in full, the government obtains a security interest in the real property.

Under the changes, the withholding rate for sales by foreign nationals will increase to 15% of the total sales price (up from the current 10%). The changes do not impact the current FIRPTA exemptions including the exemptions for sales under $300,000 for the sale of primary residence or vacant land. Additionally the current 10% withholding amount still applies to sales of primary residences where the sales price is less than $1 million.

So here is your new cheat-sheet:

- If the amount realized (generally the sales price) is **$300,000 or less**, AND the property will be used by the buyer as a **primary residence**, the withholding rate is **0%**.
- If the amount realized **exceeds $300,000 but does not exceed $1 million**, AND the property will be used by the buyer as a **primary residence**, the withholding rate is **10% on the full amount realized**.
- If the amount realized **exceeds $1 million**, then the withholding rate is **15% on the entire amount**, regardless of use by the buyer.

Title and settlement companies will want to review their FIRPTA procedures before the effective date to ensure they will assist the company in compliance with the law. It is a good assumption that the risks associated with using the $300,000 exemption will continue and expand to the new rate for transactions under $1 million.

Buyers (and their settlement agents) looking to take advantage of the exemption should document (under the penalty of perjury) the buyer's intent to use the property as a residence. Settlement agents should consider providing a disclosure to the buyer of the legal and tax risk they face for misapplying the exemption. It is also a good idea to be on the lookout for red flags related foreign sellers forcing the buyer to agree to claim residence status merely to lower the withholding rate. A buyer that fails to comply appropriately with FIRPTA could be liable for any additional withholding tax, penalty and interest.

Many state and local real estate form contracts contains language specifically referring to a 10% withholding and will likely need to be updated.

Liability of Agents

According to the IRS, an agent is any person who represents the transferor or transferee in any negotiation with another person (or another person's agent) relating to the transaction, or in settling the transaction. A person is not treated as an agent if the person only performs one or more of the following acts related to the transaction:

- receipt and disbursement of any part of the consideration
- recording of any document
- typing, copying and other clerical tasks
- obtaining title insurance reports and reports concerning the condition of the property
- transmitting documents between the parties

A withholding agent is personally liable for the full amount of FIRPTA withholding tax required to be withheld, plus penalties and interest. A withholding agent is any person having the control, receipt, custody, disposal or payment of income that is subject to withholding. Generally, the person who pays an amount to the foreign person subject to withholding must do FIRPTA withholding.

Along with the increased withholding rate, the law made a number of changes that impact real estate investment trusts (or REITS). The new REIT provisions have varying effective dates.

Qualified Pension Plans

One of the biggest REIT changes is a new exemption for distributions from the REIT to qualified foreign pension plans. The exemption applies to distributions made after Dec. 18. Prior to the changes, U.S. pension funds were generally exempt from U.S. taxation on capital gains distributions while foreign pension plans were not. To avoid the tax liability, many foreign pension plans relied on sophisticated structuring to minimize U.S. tax liability.

Tax-free Spinoffs

The act also makes important changes to the law related to tax-free spinoffs under Section 355 of the internal revenue code. In recent years, businesses with significant real estate assets have used Section 355 to tax-efficiently separate real estate from the operating business. To prevent potential abuse, the changes require that both entities in a spinoff will have to satisfy an active business test meaning that neither the distributed or distributing entity is a REIT.

There are a few exceptions to this new rule including when

1. both the distributing and distributed entities must qualify for REIT status immediately after the spin, or
2. a REIT spins-off a taxable REIT subsidiary. Additionally, the act prohibits a corporation from making a REIT election within 10 years from the date of the tax-free spinoff.

These new limits for distributions (or requests for a private letter ruling from the IRS) became effective after Dec. 7.

Safe Harbor

The act increased the safe harbor threshold to sales of up to 20% of the fair market value of the REIT's assets before it faces a prohibited transaction tax of 100% of the gain from the sale. This is an increase from the current 10% threshold. This change goes into effect for tax year 2016 and could help encourage more sales activity from REITS.

Personal Property

The changes confirm the situations in which rental income from the lease of personal property can be considered in the calculations to determine whether an entity qualifies as a REIT. To qualify for REIT status and tax treatment, 75% of an entity's income and assets in a given year must come from the rent of real estate, interest on a real estate secured debt, capital gains from the sale of real property and other real property related sources. Before the act, rents related to the leasing of personal property could be considered real estate rent for purposes of the asset test but not the income test. This provision kicks in for the 2016 tax year.

While these are the main provisions that will impact a REIT's purchase and sale of real estate, a number of other changes were made to the rules surrounding REIT ownership and investments in a REIT.

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