

IRS Issues Warning About FIRPTA Abuses

The release is a part of an ongoing campaign by the IRS to identify patterns of noncompliance or abusive transactions involving foreign investment in U.S. real estate and to warn taxpayers and real estate professionals about such issues. The IRS previously released and published on its website "Tax Information For Realtors, Rental Agents and Foreign Owners of U.S. Real Estate," covering federal income tax and withholding obligations on U.S. real estate rentals by foreign owners in additions to basic FIRPTA requirements.

Flipping Contracts—Since a contract to acquire "U.S. Real Property Interest" (USRPI), gain on the sale or the disposition of the contract is subject to federal income tax under 26 U.S.C., Sec. 897 with the transferee being required to withhold and remit 10 percent of the gross amount paid to the foreign assignor. If there is no gain, or if the potential tax on the gain (at ordinary income rates if the contract has not been held for over a year) is less than the required withholding, the transferor may apply for a withholding certificate to authorize lesser or zero withholding. The IRS believes that in some instances, whether intentionally or through lack of knowledge on the part of foreign investors and U.S. real estate professionals, transfer of real estate purchase contracts have been effected by foreign investors without FIRPTA withholding or filing of federal income tax returns to report the gain and pay any additional tax due. The release also covers FIRPTA taxation and withholding on sale or dispositions of an opinion, a more complex subject.

Disposition of an Option or Contract to Acquire a United States Real Property Interest Under U.S. tax law, a foreign person that sells or exchanges a U.S. real property interest must report the gain on a U.S. tax return, and the buyer of the U.S. real property interest must withhold and pay to the IRS 10 percent of the gross amount paid to the foreign person. A U.S. real property interest includes options or contracts to acquire land or land improvements and leaseholds of land or land improvements. The disposition of such an option or contract by a foreign seller is reportable on the foreign seller's U.S. tax return and is subject to a 10 percent withholding tax payable by the buyer to the IRS. Under U.S. tax law, the buyer must determine if the seller is a foreign person. If the seller is a foreign person and the buyer fails to withhold, the buyer can be held liable for the withholding tax.

The IRS has become aware of instances in which foreign persons have acquired options or entered into contracts to purchase U.S. real property interests and sold the options or assigned the contracts before such instruments are exercised or executed and title to the underlying property is taken. Buyers of the options or contracts are failing to withhold and remit to the IRS the required 10 percent from the proceeds of the sale.

Other Abuse Areas. While not covered by this release, the IRS is known to be looking at other areas indicating possible FIRPTA withholding abuse and federal income tax evasion. Some of these include:

- 1) Transactions involving the \$300,000 personal residence "exemption." Besides the view of this writer and other FIRPTA commentators that it is foolhardy for a buyer to agree to this so-called exemption (since it confers no benefit on the buyer, yet exposes the buyer to substantial risk), the IRS has been looking into reports that real estate professionals may be encouraging or aiding their seller clients to claim this exemption to avoid withholding, as a predicate to not filing the required federal income tax return.
- 2) Transfers to avoid or reduce withholding. Reportedly, some foreign individual or corporate sellers are seeking to avoid FIRPTA withholding by contributing the U.S. real estate to a U.S. corporation just before a sale to a third party. While the contribution to the corporation may be effected free of federal income tax, compliance with the FIRPTA non-recognition transaction rules is required and other federal income tax issues may arise. The more significant issue, however, is the implication that the seller may be trying to avoid federal income tax on the sale.

Another example is a gift to a spouse or child of an interest in the U.S. real estate preceding a sale to a third party. While there might be a legitimate non-tax motivation involved, such a transfer may be a noncompliance signal if it results in reduction or avoidance of FIRPTA withholding tax on the subsequent sale, such as when the donee is a U.S. tax resident. In addition, such transfers (whether or not in contemplation of a sale) generally cause a federal gift tax exposure, without benefit of the unlimited marital deduction or unified credit that U.S. donors use to (legally) avoid or reduce gift tax. Regardless of FIRPTA, real estate counsel should caution their clients against making any gift of a U.S. real estate interest. In the early days of FIRPTA withholding, the depressed U.S. real estate market often caused a sale by a foreigner to yield insufficient cash to cover FIRPTA withholding after mortgage payoffs, commissions and other sale expenses. In today's market that is rare, and inordinate opposition to the withholding tax may be a signal that the seller is seeking to evade the federal income tax on the sale. Buyers and their representatives would be well-advised to tread carefully so as to avoid any implication of aiding and abetting the seller in such cases.

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Thank you for your continued loyalty and friendship.

Regards,
Scott and Amy

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1. Santa Claus (or Father Christmas) was a bishop named Nicholas. Where did he come from?

- A. Germany
- B. France
- C. Turkey
- D. Russia

2. Chanukah is known as:

- A. The Festival of Lights
- B. The Holiday of Rededication
- C. The Jewish Christmas
- D. The Yiddish Ramadan

3. Where did the Christmas tree tradition originate

- A. Germany
- B. Israel
- C. New England
- D. Scandinavia

4. What does the word Hanukkah mean?

- A. The Festival of Lights
- B. The Holiday of Rededication
- C. The Jewish Christmas
- D. The Yiddish Ramadan

5. What is the most popular tree topper?

- A. Star
- B. Angel
- C. Light
- D. None of the Above



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*"No act of kindness,
however small,
is ever wasted."*

Aesop

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