

1031 Exchange

Foreign Investors & 1031 Exchanges

Internal Revenue Code Section 1031 allows deferment of capital gains taxes on real property used in trade or business or held for investment

In 1980, the United States government implemented the Foreign Investment In Real Property Tax Act, known as FIRPTA. FIRPTA requires investors who own real estate inside the United States but who reside elsewhere to pay taxes on any gains realized from the sale of a US property.

The tax rates imposed under FIRPTA are the same rates applicable to U.S. citizens. For example, if an investor is a nonresident and the real estate qualifies for long term capital gains treatment (the property was owned for more than one year), the gain will generally be taxed at a rate of 15% at the federal level.

To ensure collection of taxes, FIRPTA requires 15% withholding based on the sale price of the property. Instead of paying the full amount to the foreign seller, the buyer of the property is obligated to withhold 15% of the purchase price of the property and send it directly to the IRS.

For example, the sale of a \$1,000,000 apartment building by a foreign seller will result in a \$150,000 withholding. The amount of the seller's gain is irrelevant. The withholding is treated as an advance payment against the actual taxes owed. In some cases, the withholding may be more or less than the actual taxes owed. The foreign seller will need to file a US tax return for the year the sale occurred and the final tax obligation, or refund, will be determined by crediting the withholding amount against the tax shown on the return.

Foreign sellers can defer the payment of taxes and avoid with holding on the sale of an investment property by conducting a 1031 exchange. However, FIRPTA rules impose additional requirements in order to avoid the 15% withholding: The escrow company must receive from the foreign seller a withholding certificate issued by the IRS that sanctions the particular exchange and allows the transferee to avoid withholding tax. Without a certificate, the escrow company normally must make the withholding payment within 20 days. However, if the withholding certificate has been submitted but no response is yet received from the IRS, the foreign seller should provide the escrow officer written notice that the application for withholding certificate has been made. Once given such written notice, the escrow officer can wait until the IRS certificate has been received and does not need to submit payment within 20 days of closing.

The foreign seller will generally use IRS form 8288-B to file an application for a withholding certificate. To apply for a withholding certificate, the foreign seller must have an individual taxpayer identification number (ITIN). The application for an ITIN is done with IRS form W-7 for individuals and SS-4 for entities and can take four to six weeks to be processed by the IRS. Foreign investors considering selling and conducting a 1031 Exchange should plan to obtain an ITIN well before selling their property (8-10 weeks) and apply for a withholding certificate as soon as a buyer is found for the property.

Given the legalities of Form 8288-B, Asset Exchange Company can not assist with the preparation of form 8288-B and the foreign seller should therefore consult with their personal tax advisor well in advance of their transaction.