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Foreign Investment in Real Property Act (FIRPTA)

In general, a foreign person or corporation is not taxed on U.S.-source capital gains income unless it is associated with operating a trade or business. However, under the Foreign Investment in Real Property Tax Act (FIRPTA), gain on the sale of U.S. real property is taxed at the same rates that apply to U.S. sellers. To ensure collection of this tax, the buyer is required to withhold part of the purchase price and submit a payment to the Internal Revenue Service, unless the sale falls under one of several exceptions. The foreign investor then files a U.S. tax return which can be used to refund part of the withholding tax if it exceeds the tax on the gain.

The FIRPTA rules were adopted in 1980, as part of the Omnibus Reconciliation Act of 1980 (P.L. 96-499). The general rationale was to equalize the tax treatment of foreign and domestic investors, although it was also partly in response to concerns about purchases of U.S. farm land by foreign investors.

FIRPTA Tax Rules

FIRPTA rules treat the gain from the sale of real property as effectively connected income associated with a U.S. business and thus subject to the same tax as a U.S. seller (Section 897 of the Internal Revenue Code). Individuals are taxed at capital gains tax rates (generally 15% and 20%) and corporations at the corporate rate of 21%.

The tax applies to real property located in the United States and the Virgin Islands. The inclusion of the Virgin Islands was to avoid, under the Virgin Island mirror tax code (which effectively applies U.S. tax rules to Virgin Islands residents), the use of a Virgin Islands corporation to avoid the tax on gains on U.S. real property.

The tax applies to direct holdings of real property and to major holdings in certain U.S. real property holding corporations (USRPHC). A USRPHC is a corporation that has 50% or more of its assets (real property plus assets used in the trade or business) in U.S. real property. The most common example of this type of corporation is a real estate investment trust (REIT). REITs are corporations that issue shares of stock, are largely invested in real property, and do not generally pay corporate tax. REITs distribute and deduct most income as dividends to shareholders. Individual shareholders pay tax at ordinary individual income tax rates on those dividends (rather than the lower rates normally applied to dividends on corporate stock). REITs also distribute capital gains, which are taxed under the capital gains tax, similarly to a partnership.

The FIRPTA tax does not apply to USRPHCs that are REITs or regulated investment companies that are domestically controlled, in that they are less than 50% owned by foreign investors. As a result, domestic REITs can be used for foreign investors to hold an interest in U.S. real property without being taxed.

Exemptions

Foreign governments and pension funds are exempt from the FIRPTA tax.

FIRPTA does not apply if (1) the investment is made through a qualified investment entity; (2) the U.S. real property is regularly traded on an established U.S. securities market; and (3) the recipient foreign person or corporation did not hold more than 5% of that class of stock or beneficial interest within the one-year period ending on the date of distribution. (The American Jobs Creation Act of 2004 [P.L. 108-357] extended the exception to cover capital gains distributions as well as stock sales.) A special rule adopted in the Protecting Americans from Tax Hikes (PATH) Act of 2015, enacted as part of the Consolidated Appropriations Act, 2016 (P.L. 114-113), increased the foreign ownership requirement to 10% for REITs.

Sales that are eligible for nonrecognition under other rules, such as corporate reorganizations and like-kind exchanges (Section 1031), are generally treated the same under FIRPTA. Taxes on gain are deferred until the property acquired in the exchange is sold. Section 1031 does not, however, apply to the exchange of a U.S. property for a foreign property.

FIRPTA Withholding Taxes

FIRPTA withholding taxes were enacted in the Deficit Reduction Act of 1984 (P.L. 98-369). These rules require the purchaser of real property or interests in real property from a foreign person to withhold taxes (Section 1445 Internal Revenue Code). The PATH Act increased the general FIRPTA withholding rate from 10% to 15% of the price of the property. This withholding is transmitted on IRS Form 8288 along with a withholding statement 8288-A. The rules also require partnerships, estates, trusts, foreign corporations, and in some cases domestic corporations to withhold tax on distributions of gain subject to FIRPTA at the highest tax rate that would apply under the income tax.

No withholding is required if the property is purchased by an individual for use as a residence and the property is sold for $300,000 or less. A lower withholding rate of 10% applies if the property is purchased for use as a residence and is sold for $1 million or less.

No withholding is required in several other circumstances, including dispositions of stock in a publicly traded corporation and when affidavits are received indicating that a privately traded corporation is not a USPRHC or that other arrangements have been made.

One issue that may be encountered by purchasers of property of a foreign person is when the sale is part of a Section 1031 like-kind exchange. In such cases, the FIRPTA rules allow for the tax to be deferred. While the tax could be recouped on a subsequent tax return, the seller can submit an 8288-B (Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests) in advance of the sale. The foreign purchaser can also deposit the tax with the settlement agent and thereby be able to receive and reinvest the full purchase price (thereby avoiding tax on the withholding amount that would apply if it is not reinvested).

Revenue Effect

In 2008, the Joint Tax Committee estimated the revenue gain from FIRPTA was less than $50 million. This provision was treated as a negative tax expenditure, that is, a gain rather than a loss. FIRPTA has not subsequently been included in tax expenditure lists. Estimates of the revenue effects of revisions in the PATH Act indicate a larger pre-2015 amount, as the provisions increasing the share of stock owned in REITs to 10% were projected to lose about $100 million per year and the provision excluding pension funds was estimated to lose around $120 million. The provision increasing the withholding rate on direct sales of property from 10% to 15% was much smaller, gaining about $20 million.

As noted below, one reason for the limited revenue collected from FIRPTA may be the ability to set up blocker corporations to create an exempt domestically controlled REIT, which is now the subject of proposed regulations.

Proposed Regulations

The Treasury proposed significant regulatory changes (REG-100442-22) on December 29, 2022. These changes are targeted at the use of blocker corporations (intermediate investment entities that are domestic) that foreign persons invest in, which, in turn, are used to create a domestically controlled REIT. The proposed regulations would require taxpayers to take into account indirect foreign ownership through REITs, regulated investment companies (e.g., mutual funds), and non-publicly traded partnerships. It would also include regular U.S. corporations if foreign persons own 25% or more of the fair market value of stock.

Proposals and Issues

In the 116th Congress, Representative Larson introduced a bill, H.R. 2210, to repeal FIRPTA. Also in the 116th Congress, Representative Suozzi introduced a bill, H.R. 4598, to allow foreign insurance companies to be exempt from FIRPTA. In the 117th Congress, Representative Suozzi introduced a bill, H.R. 3123 , to allow nontraded publicly offered REITs the exemptions available to publicly traded REITs.

The primary argument for eliminating FIRPTA, which the real estate industry has long advanced, is that it discourages foreign investments in U.S. property, including infrastructure property. The magnitude of such an effect is not known.

As discussed in detail in a 2013 law review article by Professor Willard B. Taylor, a Treasury study prior to enactment of FIRPTA found that foreign ownership of land was insignificant. Treasury, however, was concerned about the different treatment of investors in business property who were able to avoid tax under the "effectively connected" rule. Taylor points out that investment through partnerships is typically subject to tax because the partnership is involved in a trade or business. If just the FIRPTA rules affecting USRPHCs were eliminated, the tax would still be imposed depending on the form of the investment through a REIT or RIC (regulated investment company) as compared to a partnership, so that some alternative rules (such as treating REITs the same as partnerships) might be considered to address this differential. In that context, and REITs and RICs act effectively as flow-through entities similar to partnerships, while ordinary corporations are subject to a corporate-level tax.

If all of FIRPTA were eliminated, there would be no tax on nonbusiness real property. There would also be a need to incorporate definitions of real property that are currently contained in Section 897.

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