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Federal Withholding: The Foreign Investment In Real Property Tax Act (FIRPTA)

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I. Introduction

This memorandum discusses the requirement under federal law that a buyer withhold funds equal to 10 percent of the sales price in certain types of sales, and send the amount withheld to the Internal Revenue Service (IRS) at the close of escrow. The federal law is titled the Foreign Investment in Real Property Tax Act (FIRPTA).

The questions and answers that follow are based mainly on Internal Revenue Code §§ 1445 and 879, and on "final" regulations issued by the Treasury Department in December 1986.

The questions and answers are necessarily general in nature, and are not intended to cover every fact situation. Slightly different facts may produce different results. Accordingly, parties should consult a professional tax advisor to determine whether (and how much) withholding is required in a particular transaction.

As used in this memorandum, "seller" means any transferor, and "buyer" means any transferee, except as specified in either FIRPTA or the regulations issued under it.

"Sales" refers to any transactions in which a "U.S. Real Property Interest" is transferred, including installment sales, exchanges, foreclosures and other types of transactions, except as specified in either FIRPTA or the regulations issued under it.

FIRPTA refers to "date of transfer," while this memorandum refers to date of "close of escrow." In most transactions, these two dates are the same; if there is a conflict, however, it is the date of transfer that controls.

II. FEDERAL RULE

A. THE "BASICS"

Q 1. What is FIRPTA?

A It is the Foreign Investment in Real Property Tax Act. Since January 1, 1985 the Act has required that a buyer withhold 10 percent of the gross sales price and send it to the Internal Revenue Service if the seller is a "foreign person." The term "foreign person" has a very specific meaning, and can be misleading. (See Question 4.) There are a number of exemptions and special rules.

Q 2. What sales are covered by FIRPTA?

A All sales, including installment sales, exchanges, foreclosures, deeds in lieu of foreclosure and other transactions by a "foreign person" (see Question 4, and the reverse side of C.A.R. Standard Form AS for definition); of

- a U.S. real property interest (real property, or an interest, such as shares, in corporation that owns real property -- see Question 32);
- that close on or after January 1, 1985;
- unless an exemption applies (see Question 3).

Q 3. What are the exemptions to FIRPTA?

A No withholding is required if any one of the following exemptions applies to all sellers or to the entire property:

- The seller furnishes a "nonforeign affidavit" stating under penalty of perjury that the seller is not a foreign person. The affidavit must also contain the seller's taxpayer identification number. This exemption is not available if the buyer has actual knowledge that the affidavit is false, or if an agent in the transaction informs the buyer that it is false, or if the IRS requests the buyer to furnish a copy of the affidavit and the buyer fails to comply. (Parties may use C.A.R. Standard Form AS. See Questions 5 through 12.) or
- The buyer receives a "withholding certificate" (also called a "qualifying statement") from the IRS, stating that no withholding is required. (A withholding certificate may also be issued calling for a reduced amount of withholding. See Questions 27 through 31.) or
- The property is acquired for use by the buyer as the buyer's residence and sells for no more than \$300,000. (See Questions 20 through 22 for discussion of the requirements for this exemption. C.A.R. Standard Form AB may be used for this purpose.) or
- The transaction is a "nonrecognition transaction" for the seller and the seller furnishes a notice of nonrecognition transaction. (See Question 18.)
- Additional exemptions apply to certain sales of shares of stock, and to dispositions of interests in a domestic corporation.

Q 4. Who or what is a "foreign person"?

A A foreign person is a nonresident alien individual, or a foreign corporation that has not properly made an election to be treated as a domestic corporation, or a foreign partnership, trust, estate or other entity. As a rough guideline an individual is not a foreign person if he/she:

- is a United States citizen, or
- is a resident alien (holder of a "green card" that has not been revoked), or
- meets the "substantial presence" test.

Some other individuals may be U.S. persons (i.e., not foreign persons) as well. A more technical definition of "foreign person" (including the substantial presence test) appears on the reverse side of C.A.R. Standard Form AS.

B. NONFOREIGN AFFIDAVIT

Q 5. Is it necessary for a seller to sign a nonforeign affidavit if the seller tells the agent he/she is not a foreign person?

A Yes, if the buyer wants protection from potential personal liability for tax that should be withheld. Having the seller complete and sign an affidavit of nonforeign status insulates the buyer from liability to the IRS if the seller is an individual (or multiple sellers are all individuals), unless the buyer has knowledge that the affidavit is false. (See Question 15 and 16.)

Since the buyer generally has no independent way of knowing whether the seller is a foreign person, it is suggested that the seller's affidavit of nonforeign status, or buyer's affidavit that the property will be used by the buyer as the buyer's residence for the required amount of time or other appropriate documentation that no withholding is required be obtained in every transaction.

The agent should also comply with the above for protection from potential personal liability.

Q 6. What information must be included in the seller's affidavit?

A Internal Revenue Code § 1445(b)(2) provides that in order for the buyer (transferee) to be exempt from the withholding requirement, the seller (transferor) must provide "to the transferee an affidavit by the transferor stating, under penalty of perjury, the transferor's United States taxpayer identification number and that the transferor is not a foreign person."

Q 7. Must the seller provide his or her social security number to the buyer in order to be exempt from withholding?

A Yes. If no other exemption applies (see Question 3) and the seller does not provide his or her social security number to the buyer, the buyer is obligated by Internal Revenue Code § 1445(a) to withhold 10% of the purchase price. The Code does not require that the seller give the buyer his or her social security number in order to sell the property, only to be exempt from withholding. Therefore, the seller could refuse to provide a social security number to the buyer and not be in violation of the Code or in breach of contract. However, the buyer would be obligated to withhold. Accordingly, if the seller wants to avoid withholding by the buyer, the seller will have to provide the buyer with a social security number.

Q 8. Can the buyer and seller agree that the seller will provide his or her social security number to escrow (or title) only and not to the buyer?

A The answer is not clear. Neither the Internal Revenue Code nor the regulations address this question. Accordingly, there is no authority specifically permitting escrow to act as the buyer's agent for receipt of the seller's social security number, nor is there any authority specifically prohibiting such conduct.

Understandably, and particularly in light of recent privacy law issues and concerns for identity theft, sellers are reluctant to release their social security numbers to buyers. Sellers may well feel more comfortable with providing such information to escrow only. So long as escrow retains the seller's affidavit and is ready to provide it to the buyer should the buyer ever be required to produce the affidavit to the IRS, having escrow hold the seller's affidavit containing the social security number seems like a reasonable and justifiable alternative. However, since there is no specific authority for escrow to do this, the buyer is assuming some risk. Should there ever be a question about the seller's tax status, the IRS could rule that the buyer had not complied with the letter of the law and was, therefore, subject to the 10 percent withholding that would have otherwise been required. The only thing that is clear is that the buyer can avoid withholding liability by complying with Section 1445(b)'s strict language and getting a seller's affidavit complete with the seller's social security number.

Q 9. What form of affidavit may be used by a nonforeign seller?

A C.A.R. Standard Form AS is available for this purpose.

Q 10. How long should the seller's nonforeign affidavit be retained by the buyer?

A The affidavit should be retained for five years after the end of the year of sale, and must be furnished to the IRS on request. It may be good practice to have the buyer sign a receipt for the original nonforeign affidavit.

Q 11. What if the seller is a foreign corporation?

A The sale will normally require withholding, unless one of the exemptions applies (see Question 3), or unless the corporation has made an election under Internal Revenue Code § 897(i) to be treated as a domestic corporation. If

the corporate seller has made that election, a copy of the IRS acknowledgment of the election must be attached to the seller's nonforeign affidavit to provide full protection to the buyer (and agents, see Question 14 and 16).

Q 12. *Must the seller's affidavit of nonforeign status (or the buyer's affidavit of intent to use property as buyer's residence) be signed before a notary public?*

A No.

C. POTENTIAL LIABILITY

Q 13. *What is the potential liability of the buyer for failure to withhold when required?*

A The IRS can assess the full 10 percent of the sales price that should have been withheld, or the seller's actual tax liability in the sale, whichever is less, plus interest and penalties, against the buyer. This can occur if the buyer does not obtain the seller's affidavit of nonforeign status and the seller fails to pay taxes due on the sale. Even if the seller eventually pays taxes on the sale, the buyer can be liable for interest and penalties if the seller is a foreign person and no nonforeign affidavit was furnished.

Q 14. *What potential liability to the IRS is faced by the agents of the buyer and seller?*

A An agent of the buyer or seller is potentially liable to the IRS for the 10 percent of the sales price that should have been withheld, or for the seller's actual tax liability in the sale, or for the amount of commission or other compensation received by the agent, whichever is less, plus interest and penalties, but only if:

- the seller provides a nonforeign affidavit and the agent knows the affidavit is false, or
- the interest being sold is shares of stock or some other interest in a U.S. Real Property Holding Corporation and the corporation furnishes a statement that the transfer of the interest is not a transfer of a U.S. real property interest and the agent knows the statement is false.

Additionally, the agent of the seller can be liable to IRS for the lesser of those same three amounts, if:

- the seller is a corporation, and
- furnishes a false nonforeign affidavit,
- even if the agent does not know that the affidavit is false!

It is not clear whether an agent of the seller by subagency would be considered the "agent of the seller" for purposes of this liability.

Q 15. *Is the buyer protected from personal liability if the seller's nonforeign affidavit is false?*

A The buyer will be protected from personal liability for the tax that should have been withheld, if the buyer relies in good faith on the seller's nonforeign affidavit. The buyer will not be protected if:

- the buyer has actual knowledge that the affidavit is false, or
- the buyer receives notice from an agent in the transaction that the affidavit is false.

Q 16. *What if the buyer receives notice after a sale closes that the seller's affidavit was false?*

A Under Treasury regulations, the buyer will only be protected for consideration already paid. The regulations provide that the buyer should withhold tax from the consideration that remains to be paid, such as payments on a trust deed and note carried by the seller, up to the 10 percent that would have been withheld if not for the false affidavit.

HOWEVER, the buyer's failure to make payments on the financing will expose the buyer to the possibility that the seller will commence default proceedings on the trust deed, or take other action based on nonpayment. The buyer in this circumstance should consult legal counsel immediately.

Q 17. Are the agents protected from liability if the seller's nonforeign affidavit is false?

A The agents will be protected from liability to the IRS if no withholding was done in reliance on an individual seller's nonforeign affidavit. However, if the seller is a foreign corporation which provides a false nonforeign affidavit, only the buyer and the buyer's agent will be fully protected for good faith reliance. The seller's agent can be liable for the withholding that should have been done, even if the agent does not have knowledge that the affidavit is false. Again, it is not clear from the statute and regulations whether an agent of the seller by subagency would be considered the seller's agent for purposes of this liability.

D. NOTICE OF NONRECOGNITION TRANSACTION**Q 18. What is a "notice of nonrecognition transaction"?**

A It is a notice given by a seller to inform the buyer that no withholding is necessary because of a "nonrecognition" provision in the tax law. Examples include a like-kind exchange under Internal Revenue Code § 1031 or a seller who is covered by a U.S. tax treaty that results in nonrecognition of gain on the sale. A buyer should not close a sale in reliance on a notice of nonrecognition transaction except on the advice of a certified public accountant, attorney or other professional tax advisor. Personal liability can result from reliance on an improper notice of nonrecognition transaction.

In addition, a buyer who relies on a notice of nonrecognition transaction must send a copy of the notice to the IRS by the 20th day after the transfer of the property. The address for this purpose is the same as the address shown in Question 25.

E. THE DEPOSIT RECEIPT**Q 19. What provision should be made in the sales agreement for compliance with FIRPTA?**

A The deposit receipt or other sales agreement should reflect the agreement of the buyer and seller to comply with the requirements of FIRPTA by either having the proper amount of tax withheld and deducted by the buyer through escrow, or obtaining/providing appropriate documentation that no withholding or reduced withholding, is required.

C.A.R.'s Real Estate Purchase Contract and Receipt for Deposit, Standard Form RPA-CA, covers compliance with FIRPTA under the paragraph entitled "Withholding Taxes." Parties to transactions who use other contract forms should include an appropriate provision in each agreement.

F. RESIDENCE OF BUYER**Q 20. When does the exemption for residential property selling for no more than \$300,000 apply?**

A The exemption applies to any sale in which both of the following requirements are met:

- the total consideration (sales price) is no more than \$300,000, and
- on the date of transfer the buyer "has definite plans to reside in the property for at least 50 percent of the number of days that the property is used by any person during each of the first two 12-month periods following the date of transfer." Days that the property will be vacant are not taken into account for this purpose. The buyer is considered to reside in the property on any day the buyer or his/her brothers, sisters, ancestors, defendants or spouse reside in it.

C.A.R. Standard Form AB may be used for this purpose.

Q 21. What if the buyer does not plan to reside in the property?

A The exemption discussed in Question 20 will not be available. Withholding will be required if the seller is a foreign person unless another exemption applies.

Q 22. EXAMPLE: Seller is a nonresident alien, a foreign person. Property is a single-family residence. Selling price is \$225,000. Sale is scheduled to close escrow September 1, 1991. Buyer intends to use the property as a residence for three months between September 1, 1991, and August 31, 1992 and for three months between September 1, 1992 and August 31, 1993. Assuming none of the other exemptions apply, is the buyer required to withhold and deduct 10 percent of the sales price?

A It depends on what the buyer intends to do for the remainder of those two 12-month periods. Suppose the buyer has definite plans that the property will be vacant for nine months and used by the buyer as a residence for three months, out of each of those 12-month periods. Based on those plans, the buyer will be using the property as a residence for at least 50 percent of the number of days the property will be in use during each of the two 12-month periods following close of escrow. As a result, no withholding will be required.

However, suppose the buyer instead plans to use the property as a residence three months, and has agreed to rent the property to a friend for the remaining nine months out of each of those two 12-month periods. In this case the buyer does not plan to use the property for at least 50 percent of the number of days the property will be in use in each of the two 12-month periods. Accordingly, withholding will be required. It is the buyer's plans on the date of transfer (normally, date of close of escrow) that will govern.

G. HANDLING OF FUNDS AND REPORTING

Q 23. When withholding is required, how should the funds be handled?

A Withholding should normally be accomplished by having the escrow agent (title company, escrow corporation, financial institution, etc.) withhold the funds required. The funds collected will normally be sent to the IRS at close of escrow and while the law does not specify that the withholding must be done through escrow, this procedure eliminates the possibility that a buyer might withhold funds at close of escrow and then not send them to the IRS as required. Withholding and transmittal of funds will, of course, require agreement between the buyer and seller in the deposit receipt or other sales agreement, or in the escrow instructions. (See Questions 24 and 25 relating to how and when funds are then transmitted to the IRS.)

Q 24. When must the withheld funds be sent to the IRS?

A Withholding must be reported and paid to the IRS by the 20th day after the close of escrow. However, the transmittal of funds should normally be made simultaneously with the close of escrow, as in the case of other disbursements of the seller's proceeds.

Q 25. How are the withheld amounts reported and transmitted?

A They are reported and transmitted to the IRS on IRS Forms 8288 and 8288-A. IRS Form 8288-A will be stamped by the IRS to show receipt, and a stamped copy will be returned to the seller. (See Question 35 for how to obtain copies of these forms.)

IRS Forms 8288 and 8288-A should be sent to:
INTERNAL REVENUE SERVICE CENTER
d.p. 543 East Bldg./FIRPTA-x
P.O. Box 21086
Philadelphia, Pennsylvania 19114-0586

Q 26. If there is more than one buyer, must each buyer withhold the amount required?

A It is only necessary that the total proper amount be withheld once. Multiple buyers will not increase the total amount to be withheld. For a multiple seller transaction, withholding will be required only on the interest attributable to a seller who is a foreign person. However, the reporting form discussed in Question 25 must be filed for each seller who is subject to the withholding if there are multiple sellers.

H. WITHHOLDING CERTIFICATE

Q 27. What is a "withholding certificate"?

A It is a form issued by the IRS specifying that no withholding, or a reduced amount of withholding, is necessary. A withholding certificate will normally be available when, for example, taxes due on the seller's gain will be less than 10 percent of the sales price. A withholding certificate will also be available when the seller has made other arrangements with the IRS to ensure payment of the taxes due.

Q 28. How can the parties obtain a withholding certificate?

A Either the buyer or the seller may apply for a withholding certificate. Normally, however, it will be the seller's responsibility to obtain the withholding certificate and provide it to the buyer, to avoid withholding. The agreement between the buyer and seller should make it clear whose responsibility it is to obtain a withholding certificate, if applicable.

The IRS will generally act on a withholding certificate request within 90 days after receipt of a completed request.

Q 29. Are there different categories of withholding certificate applications?

A Yes, there are six basic categories. This categorizing provides for specific information that is needed to process the applications. The six categories are:

- 1) Applications based on a claim that the transfer is entitled to nonrecognition treatment or is exempt from tax.
- 2) Applications based solely on a calculation of the transferor's maximum tax liability.
- 3) Applications under special installment sale rules.
- 4) Applications based on an agreement for the payment of tax with conforming security.
- 5) Applications for blanket withholding certificates.
- 6) Applications on any other basis.

An application for a withholding certificate under categories 1, 2, and 3 must be submitted to the Director, Internal Revenue Service Center, d.p. 543 East Bldg./FIRPTA-x, P.O. Box 21086, Philadelphia, PA 19114-0586. An application for a withholding certificate under categories 4, 5, and 6 must be submitted to the Assistant Commissioner (International), Director, Office of Taxpayer Service and Compliance, Attention: IN:C:E, 950 L'Enfant Plaza, South, S.W., Comsat Building, Washington, DC 20024.

Q 30. Is there a particular form to be used when applying for the withholding certificate?

A For applications for withholding certificates under categories 1, 2 and 3 in Question 29, IRS Form 8288-B, Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests, must be used.

For applications for withholding certificates under categories 4, 5, and 6 under Question 29, no particular form is required. However, a specific format must be followed. Detailed regulations cover the contents of the application, which are too lengthy to list here. Parties should consult the regulations, IRS Publication 515, Withholding of Tax on Nonresident Alien and Foreign Corporations or their tax advisor to avoid submitting an incomplete or incorrect application.

Q 31. Must the buyer withhold the required percent even if an application for withholding certificate has been filed but not yet acted on by the IRS?

A Yes and No! "Delayed reporting and payment" may apply if the application for withholding certificate was filed with the IRS on or before the date of transfer of the property. Note that withholding must still be done, but that the amount withheld need not be reported and paid to the IRS or the FTB until the 20th day after the IRS rules on the application for a withholding certificate. This procedure should be followed only on the advice of legal counsel.

Following the IRS ruling, the amount withheld should be disbursed according to the ruling. However, the disbursement of funds by real estate licensees and escrow agents must conform to the instructions of the principals in the transaction. Whenever funds are held after close of escrow pending IRS action on an application for withholding certificate, escrow instructions should specify in detail how the funds are to be handled so that little or no clarification by the parties will be required later, after close.

I. TERMS USED

Q 32. What is a "U.S. Real Property Interest" (USRPI)?

A A USRPI is either:

- an interest in real property (generally, land, unsevered natural products, improvements to land and personal property associated with the use of real property) located in the United States or the Virgin Islands (for interests in other U.S. possessions and territories, parties should consult counsel); or
- an interest, such as corporate shares, in a U.S. Real Property Holding Corporation whether the corporation is foreign or domestic. (See Question 33.)

An interest in real property solely as a creditor is not considered a USRPI. For example, the sale of an existing note and deed of trust is ordinarily not a sale of a U.S. Real Property Interest under FIRPTA and does not require withholding. A transfer of an existing leasehold would be a transfer of a U.S. Real Property Interest and does require withholding if the transaction involves a foreign person and none of the exemptions apply.

Q 33. What is a "U.S. Real Property Holding Corporation" (USRPHC)?

A A USRPHC is a corporation that holds U.S. Real Property Interests that equal or exceed 50 percent of the fair market value of all of its:

- U.S. and foreign real property, plus
- other assets that are used or held for use in a trade or business.

J. FORECLOSURE PROPERTIES

Q 34. Does FIRPTA require withholding by a buyer at a foreclosure sale or by a lender who accepts a deed in lieu of foreclosure?

A Yes, in some circumstances. The rules are too technical to summarize here. Parties should consult their own counsel for legal advice. See also Question 35 for sources of additional information.

Transferees through a foreclosure or deed in lieu of foreclosure may also have special reporting requirements under Internal Revenue Regulation § 1.1445-2(d)(3) and Internal Revenue Code § 6050J.

K. IRS TAX FORMS AND PUBLICATIONS

Q 35. Where can I obtain the IRS tax forms and publications referred to in this Q&A?

A You can get the IRS tax forms and publications referred to in this legal memorandum in several ways: 1) through the [IRS's website](#) (click on Forms and Publications); 2) by fax at 703.368.9644; 3) by phone at 1.800.829.3676 ((800)-TAX-FORM); or 4) by mail at IRS Western Distribution Center, Rancho Cordova, CA 95743-0001.

L. ADDITIONAL INFORMATION

Q 36. Where can additional information be obtained?

A Principals should consult their own tax advisor for advice in particular transactions. You can also ask the IRS for tax help at their website at www.irs.ustreas.gov, or by telephone at 800.829.1040 or 800.829.4477 for pre-

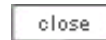
recorded messages covering various topics. For further information refer to IRS Publication 515, Withholding of Tax on Nonresident Aliens and IRS Publication 519, U.S. Tax Guide for Aliens (see Question 35 for how to get a copy of these publications).

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