Legal 1031 Exchange Services, LLC
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1031 Exchanges and the Foreign Investment in Real Property Tax Act

A 1031 exchange is available to foreign sellers of real property held for productive use in a trade or business, or held for investment purposes, however, the foreign status of the person or entity selling the real property can cause some extra complications which must be addressed.

The Foreign Investment in Real Property Act (FIRPTA) was enacted in 1980 by Congress to impose a tax on foreign individuals and corporations when they sell real property within the United States. The Act applies to non-residents aliens, foreign partnerships, corporations, trusts and estates which have not elected to be treated as domestic entities under IRC §897(i). FIRPTA requires the buyer to withhold fifteen percent (15%) from the proceeds of the sale of real property if the seller is a foreign individual and is required to send the withholding directly to the Internal Revenue Service (IRS) within 20 days of the transaction closing to ensure any taxable gain realized by the foreign seller is paid, unless a withholding certificate has been applied for. If the entity selling the real property is a foreign corporation or a trust, then a withholding of twenty-one percent (21%) is required by the act which has been reduced from thirty-five percent (35%) due to a change in the corporate tax rate set out under the Tax Cut and Jobs Act of 2017 for tax years that begin after December 31, 2017. In both cases, this withholding is not a final determination as to the amount of tax owed but is merely an advance payment toward any possible amount owed by the foreign entity, which could include additional income generated besides the sale of the real property. Any foreign entity selling real property must file a U.S. tax return for the year in which the sale took place which determines the actual amount of tax due.

In order to take full advantage of the 1031 exchange a foreign seller should plan in advance of their sale, and consult with their tax, legal, and financial advisors to qualify for an exception to the withholding requirement. If the foreign seller waits until their sale is imminent, they run the risk of not being able to defer the tax on the FIRPTA escrow amount. All of the rules of a typical 1031 exchanges apply to executing a tax deferred exchange for a foreign seller (i.e. use of a qualified intermediary, 45 day identification rule, closing on the replacement property within 180 days, apply all proceeds from the sale to the purchase of the replacement property, etc.).

FIRPTA has some exceptions to avoid the withholding requirement. The first exception to the withholding requirement for a 1031 exchange is if the foreign seller is executing a simultaneous exchange (i.e. executing the exchange of properties within one day). The foreign seller must file a "Declaration and Notice to Complete an Exchange" (1031 Declaration and Notice) which puts the buyer on notice that no withholding will be required. This exception also requires the exchange to be a complete deferral meaning the foreign entity would receive like-kind property, reinvest all proceeds from the sale, and obtain a mortgage of equal or greater value as to the amount which was paid off on the sale property.

Another exception to the withholding requirement is to apply for a withholding certificate from the IRS. This exception requires planning ahead and obtaining an individual tax identification number (ITIN) for an individual or an employer identification number (EIN) for a business. Once the foreign seller has obtained a tax identification number, they can apply for the withholding certificate which can take the IRS approximately ninety (90) days to process. Once the foreign seller has obtained the withholding certificate the funds being held in escrow can be released allowing them to proceed with the delayed 1031 exchange. If the foreign buyer has not planned far enough in advance but would still like to execute a fully deferred exchange, they can replace the escrowed FIRPTA funds with cash from outside of the transaction and have the exchange proceed without any tax ramifications.

A foreign investor interested in executing a 1031 exchange of real property should consult with their tax, legal, and financial advisors, along with a qualified intermediary, as soon as possible prior to the sale of the property, to ensure that all the requirements/exceptions of FIRPTA are met before beginning the exchange process.

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