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5x5 series: Insights and actions

FIRPTA Issues and Considerations

Foreign Investment in Real Property Tax Act (FIRPTA) imposes a US tax on the capital gains of foreign persons when they dispose of US real property interests (USRPI). Such gains are not available for reduced treaty rates. The TCJA significantly changed the way foreign investors and multinational businesses approach their structure in the US, often resulting in increases to US investment and restructuring initiatives. The current economic climate is triggering transactions (e.g., conversions of distressed debt to equity, stock sales, etc.) and changing FIRPTA profiles (e.g., significant decreases in going concern value, etc.). These factors combine to heighten the importance of understanding the substantive and withholding tax requirements and other implications of FIRPTA.

5 insights you should know

1. Section 897(a) provides that gain or loss on the disposition of a USRPI is treated as effectively connected income as if such foreign person was engaged in a US trade or business, even if they are not so engaged.
2. USRPI includes (but is not limited to) land, buildings, inherently permanent structures, personal property associated with real property, and interests in domestic corporations, unless the taxpayer establishes otherwise.
3. FIRPTA trumps all nonrecognition provisions, unless the FIRPTA rules themselves provide an exception – If a transaction does not meet one of the FIRPTA exceptions to gain recognition, any realized gain must be recognized, and the transaction likely is also subject to withholding.
4. Withholding is generally 15% of the total amount realized (NOT gain) but can be 21% of gain depending on the facts and which of seven different withholding provisions applies.
5. Analysis to determine the applicability of the FIRPTA rules and possible exceptions generally involves looking back five years and undertaking valuation work, which requires moderate lead time to complete. Failure to perform proper identification and testing may delay or preclude the execution of transactions as well as result in penalties.

5 actions to take now

1. Establish systems and processes. Acquisitive structures must quickly grasp FIRPTA implications and profile throughout the M&A lifecycle; taxpayers should have systems and processes in place to extract or collect the data as part of the M&A and reorganization process.
2. Proactively integrate FIRPTA considerations. Consider income tax consequences related to a planned transaction/reorganization and whether FIRPTA is implicated by actual or deemed transfers. Consider FIRPTA exceptions, availability for nonrecognition, or alternatives.
3. Consult on expected and unexpected business changes. Perform ongoing FIRPTA analysis in real time and monitor company financial data for developments that may require additional testing, as well as market shifts that could materially impact a company's FIRPTA position.
4. Document FIRPTA positions for withholding purposes. Distributions, internal restructuring, and no-cash transactions are generally subject to FIRPTA substantive tax and withholding obligations. Document exceptions and facts, particularly with the disposition of partnership interests and internal distributions.
5. Ensure testing and filings are made timely. FIRPTA analysis and documentation must be done contemporaneously with anticipated transfers. Filings are generally required on or before the date of transfer and notification to the IRS must be done timely. While statements can also be required as part of filing an income tax return, failure to address FIRPTA at the time of transfer can lead to missed withholding, interest, and penalties.

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