THE $300,000 RESIDENCY EXCEPTION TO THE FIRPTA 10% WITHHOLDING RULE

There is a general income tax rule that any person (whether U.S. or foreign) who purchases U.S. real estate from a foreign person must withhold 10% of the gross purchase price and pay it to the IRS as an estimated income tax payment on behalf of the foreign seller. If the buyer fails to withhold the 10% and pay it to the IRS, the IRS can assess the 10% against the buyer. However, there are exceptions to this general rule.

One exception is that an “individual” buyer does not have to withhold the 10% when the purchase price does not exceed $300,000 and he or she has definite plans to use the property as a “residence” during each of the first two 12-month periods immediately after acquisition. The term “residence” is a technical term. The IRS provides that an individual purchaser satisfies the “residency” test if the buyer or members of his or her family reside at the property at least 50% of the number of days that it is used by any person during each of the first two 12-month periods immediately after the purchase.

A major potential problem in relying on this exception is that the IRS has never defined what constitutes “definite” plans to use the property as a “residence” or what constitutes “a change in circumstances that could not have been reasonably anticipated at the time of purchase”.

Caution!!!

Please be advised that the below description of tax planning concepts are by no means complete from a technical, legal or tax viewpoint. The memorandum is being provided for preliminary discussion purposes only and should in no way be treated as the provision of tax advice to be acted upon in any way. The efficacy of the described tax plan concepts will be largely dependent not only upon the soundness of the underlying tax planning concept but as well upon the proper implementation of the plan including the order of the transactional steps, timely filing of certain compliance documents with tax authorities and compliance with the applicable laws.
The regulations provide that if the buyer establishes that the failure to meet the residency test was caused by a change in circumstances that could not have been reasonably anticipated at the time of the transfer, then the buyer will not be held liable for the failure to withhold. The problem in relying on this is that the IRS has never defined what circumstances are that could not have been reasonably anticipated at the time of the purchase. We do not know what the term “reasonable” means in the eyes of the IRS. Until these terms are defined, they are open for interpretation. We do not want any of our clients to become the first test case.

The following example illustrates when a buyer meets the “residency” test. Suppose Simon Smith purchases a beach house on November 27, 2010 from Sarah Charlesworth, a foreign seller. The two 12 month test periods are from November 28, 2010 to November 27, 2011 and from November 28, 2011 to November 27, 2012. Also assume that in each test period the property is vacant for 180 days and used for 185 days. In Period One, Simon and his family reside at the property for 93 days and rent it for 92 days. In Period Two, he and his family reside at the property 92 days and rent it for 93 days. Let’s look at the results.

<table>
<thead>
<tr>
<th></th>
<th>Period One</th>
<th>Period Two</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total number of days in each test period</td>
<td>365</td>
<td>365</td>
</tr>
<tr>
<td>Less number of days property is vacant</td>
<td>(180)</td>
<td>(180)</td>
</tr>
<tr>
<td>Number of days property is used</td>
<td>185</td>
<td>185</td>
</tr>
<tr>
<td>Number of days used for personal purposes</td>
<td>93</td>
<td>92</td>
</tr>
<tr>
<td>Number of days rented</td>
<td>92</td>
<td>93</td>
</tr>
<tr>
<td>Number of days property is used</td>
<td>185</td>
<td>185</td>
</tr>
</tbody>
</table>

Simon does not satisfy the time-use requirement to use the “residency” exception since only Period One meets the one-half personal use requirement. Therefore, he must withhold 10% of the gross purchase price. Remember, both 12-month periods must be used for personal use at least 50% of the time that the property is used. In Period One, Simon meets the residency requirement since at least 50% of the use (93/185) is personal use and less than half (92/185) is rental use. In Period Two, he does not meet the residency requirement since less than half the use (92/185) is personal use and more than half (93/185) is rental use, thereby subjecting him to the 10% penalty for relying on the residency exception and failing to withhold.

An individual buyer (whether U.S. or foreign) should not rely on the “residency” exception when purchasing from a foreign seller unless they are absolutely sure that they are not going to rent the property for more than an insignificant amount of time during the first two years that they own the property. The buyer is taking on all the risk and getting nothing in return when he or she relies on this exception.

By relying on the residency exception, the buyer is giving up their right to change their mind and rent the property for the majority of time during these two 12-month periods. If the buyer is not sure, he or she should consider withholding the 10% from the purchase price and paying it to the IRS or, have the foreign seller apply for relief from the 10% withholding tax from the IRS. It is in the buyer’s best interest to seek professional advice when dealing with these rules.

Finally, the non-U.S. seller is still required to file a U.S. income tax return for the year of sale to report the transaction and pay the correct amount of taxes even when the 10% is not withheld. Another problem to the seller is that by not having the buyer withhold, the seller could be subject to underpayment of estimated tax penalties when they file their tax return and pay their tax the following year. This is usually an unpleasant surprise to the unsuspecting seller who thought that they were getting a good deal because the buyer did not withhold.
HOLD HARMLESS STATEMENT TO
“STATEMENT OF INTENT TO RESIDE”

I hereby declare that I have read and understand the attached memorandum “The $300,000 Residency Exception to the FIRPTA 10% Withholding Rule” and “Statement of Intent to Reside”. I further declare that my (our) decision to rely on this exception to the 10% FIRPTA withholding rule is solely my (our) own decision, and agree to hold harmless all other parties for any and all taxes, penalties and interest for my (our) failure to meet the requirements of this exception.

________________________________    ________________________
Buyer’s Signature                      Date

________________________________
Printed Name of Buyer

________________________________    ________________________
Buyer’s Signature                      Date

________________________________
Printed Name of Buyer
STATEMENT OF INTENT TO RESIDE

1. I am the transferee (Buyer) of real property located at _____________________________________
   ___________________________________________________________________________________

2. The sales price (amount realized by Seller on the sale) does not exceed $300,000.

3. I am purchasing the real property to use as a residence. I have definite plans that a member of my family, to include brother(s), sister(s), ancestor(s), or spouse, or I will reside in the property for at least 50% of the number of days that the property is used by any person during the two 12 month periods following the date the property is transferred to me.

4. I am making this affidavit in order to establish an exemption from withholding a portion of the sales price of the property under Internal Revenue Code Section 1445.

5. I understand that if the information in this affidavit is incorrect or unforeseen circumstances within the 24-month period disqualify me, I may be liable to the Internal Revenue Service for up to 10% of the sales price of the property, plus interest and penalties.

Under penalties of perjury, I declare that the statements above are true, correct and complete.

_________________________________________ __________________________
Buyer’s Signature Date

_________________________________________
Printed Name of Buyer

STATE OF FLORIDA
COUNTY OF

The foregoing instrument was acknowledged before me this __________ by _______________________, (date)
who is personally known to me or who has produced ______________________ as identification.

Signature of Notary

My commission expires: _______________________

NOTICE: THIS FORM IS INTENDED FOR USE ONLY BY INDIVIDUAL BUYERS (AND CANNOT BE USED BY CORPORATIONS, PARTNERSHIPS, TRUSTS, ETC.). THIS FORM DOES NOT NEED TO BE SUBMITTED TO THE INTERNAL REVENUE SERVICE, BUT SHOULD BE RETAINED BY THE PARTIES FOR THEIR RECORDS. THE $300,000 EXCEPTION ALSO CANNOT BE USED FOR A PURCHASE OF RAW LAND.