

#L-1046

ns11  
08/27/86

First Supplement to Memorandum 86-61

Subject: Study L-1046 - Estate and Trust Code (Nonresident Decedent--  
comments of San Francisco Public Administrator)

Attached are comments of the San Francisco Public Administrator  
relating to problems in handling estates of nonresident decedents.

Respectfully submitted,

Nathaniel Sterling  
Assistant Executive Secretary

# City and County of San Francisco



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August 26, 1986.

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IN REPLY REFER  
TO OUR FILE NO

Re: Memorandum 86-61

I believe the Probate Code, as presently written, is the best method of handling estates of foreign domiciled decedents.

Practically speaking, I believe it would be virtually impossible for someone in a foreign country to mail a legal document, in a foreign language, to any but a major financial institution and expect them to close an account and forward funds to a foreign address. We often experience difficulty when dealing with a bank just a 100 miles away.

I am certain that problems such as Safe Deposit Boxes, sale of securities, and such would be relegated to the local Public Administrators.

It seems likely that many savings/checking accounts would be used for direct deposits by foreign residents. Whether the account holder or their heirs is due the last deposits in the account depends on the day of the month that the person died. It is impossible to stop these electronic deposits in less than 90 days and if any funds are incorrectly distributed by the holding agency, they are liable for the funds. We regularly return funds to financial institutions that have overpaid any estate.

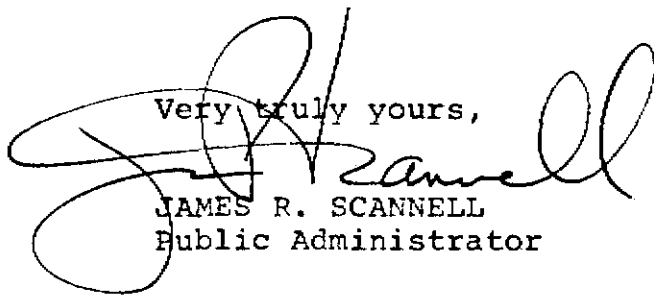
I doubt very much if any financial institution would close any account without verification of authenticity of any document from the nearest Consulate, whom I do not believe would have information or knowledge on the matter.

In January of 1985 the IRS-FERPTA Act became law which could hold the buyer or even the escrow holder in the sale of real property liable for 10% of the purchase

price if a foreign resident seller does not deposit that amount with the IRS. The funds remain on deposit until a tax clearance is obtained.

There is certainly very little comity with other nations on this subject and in fact many U.S. citizens have great difficulties with foreign inheritances.

Very truly yours,



JAMES R. SCANNELL  
Public Administrator

# Tax withholding in real property purchases from foreigners

New rules pose serious risks  
for U.S. buyers and their attorneys

by Brad J. Sherman

A person who purchases U.S. real property from a foreign individual or entity must now withhold 10 percent of the amount realized by the seller. IRC §1455(a). This amount includes not only the cash paid to the seller, but also cash paid to the seller's creditors and encumbrances that the buyer assumes or takes the property subject to. See Temp Reg §1.1445-1T(g)(5). Similar withholding rules apply to purchases of corporate stock (in companies not publicly traded) and partnership interests from foreigners.

The withholding requirements have their genesis in the Foreign Investment in Real Property Tax Act (FIRPTA) passed by Congress in 1980 to force foreign investors in U.S. real property to pay taxes on disposition of that property at the same rate as U.S. investors. FIRPTA also encompasses sales by foreigners of interests in certain entities that own U.S. real property.

The original FIRPTA provided for the imposition of complex reporting requirements on foreign investors in U.S. real estate. However, the reporting requirements proposed by the IRS were considered too burdensome and were withdrawn before taking effect.

As part of the 1984 Tax Reform Act, Congress enacted a revised

FIRPTA (FIRPTA II), which applies to transfers of U.S. real property interests after December 31, 1984. See IRC §§897, 1445, 6039C. FIRPTA II gives the IRS a powerful weapon for collecting tax from foreigners selling U.S. real property. It is also a dangerous trap for unsuspecting American investors.

Last December, the Treasury Department issued temporary regulations under FIRPTA II and proposed that they be made permanent. The withholding requirements apply whenever there is a transfer of a "U.S. real property interest," which includes:

- Any interest in U.S. real property (Reg §1.897-1(b)).
- Any interest in various types of personal property associated with the use of U.S. real property, including, for example, mining and farm equipment, furniture leased to tenants along with real property, movable walls, and fixtures (Reg §1.897-1(b)(4)).
- Stock in a U.S. corporation, if over one-half of the corporation's business and real estate assets constitute a U.S. real property interest. Stock in a corporation that has a class of stock traded on an established securities market is generally excluded (IRC §397(c)).
- Interests in partnerships, trusts, and estates, to the extent provided in regulations that are expected to be issued (IRC §897(c)(4)(B), §897(g), and §1445(e)(5)).

The penalties for failing to with-

hold are heavy and include liability for the full amount that should have been withheld. IRC §1461. Also, certain obligations are imposed on both the buyer's and seller's attorneys, real estate brokers and escrow agents. These obligations are discussed below.

In addition to withholding requirements for purchases, FIRPTA II also requires withholding of tax from certain amounts distributed by corporations, partnerships, trusts, and estates to foreign shareholders, partners or beneficiaries. IRC §1445(e).

The transferee of a U.S. real property interest must assume that the transferor is foreign, until it is established that the transferor is a "U.S. person." See IRC §1445(f)(3). This term includes an individual who is a citizen or resident of the United States, as well as a corporation, partnership, trust or estate established and governed by U.S. law. Thus, a corporation or partnership may be a U.S. person even if all of its owners are foreign.

A purchaser of a U.S. real property interest need not withhold if he obtains a "Certificate of Non-Foreign Status" indicating that the transferor is a U.S. person. Temp Reg §1.1445-2T(b). A purchaser acts at his peril if he simply assumes that the transferor is a U.S. person and therefore fails to obtain an appropriate certificate.

Two forms of a Certificate of Non-Foreign Status designed to

Brad J. Sherman, a Los Angeles sole practitioner and licensed CPA, specializes in tax law.

# Form 1

DO NOT RECORD.  
DO NOT SEND  
TO IRS.

TRANSFEE (BUYER)  
MUST RETAIN FOR  
SIX YEARS AFTER  
THE TRANSACTION.

## CERTIFICATION OF NON-FOREIGN STATUS BY INDIVIDUAL TRANSFEROR

1. Section 1445 of the Internal Revenue Code provides that a transferee (buyer) of a U.S. real property interest must withhold tax if the transferor (seller) is a foreign person.
2. In order to inform each transferee that withholding of tax is not required upon my (our) disposition of a U.S. real property interest, the undersigned transferor(s) certifies and declares by means of this certification, the following:
  - A. I (we) am (are) not non-resident alien(s) for purposes of United States income taxation and,
  - B. Each transferor has accurately indicated his or her United States taxpayer identifying number (Social Security number) below:
 

NAME	SOCIAL SECURITY NUMBER
_____	_____
_____	_____
_____	_____

(Attach additional page if necessary.)
  - C. My (our) home address (or addresses) is \_\_\_\_\_  

(Attach additional page if necessary.)
3. I (we) understand that this certificate may be disclosed to the Internal Revenue Service by the transferee and that any false statement contained in this certification may be punished by fine or imprisonment (or both).
4. Each of the undersigned transferors understands that each transferee is relying on this certificate in determining whether withholding is required and each transferee may face liabilities if any statement in this certificate is false.
5. Each of the undersigned transferors hereby indemnifies each transferee, and agrees to hold each transferee harmless, from any liability or cost which such transferee may incur as a result of: (i) the transferor's failure to pay any U.S. Federal income tax which such transferor is required to pay under applicable U.S. law, or (ii) any false or misleading statement contained herein.

Under penalties of perjury, each of the undersigned declares that he or she has examined this certification and that to the best of his or her knowledge and belief it is true, correct, and complete.

EXECUTED in \_\_\_\_\_ County, State of \_\_\_\_\_  
on the date indicated below.

_____ (Signature)	_____ (Date)
_____ (Signature)	_____ (Date)
_____ (Signature)	_____ (Date)

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## CEB Forum

comply with the requirements of Temp Reg §1.1445-2T are reproduced here. Form 1, on page 60, is designed for use when the transferor is one or more individuals. Form 2, on page 61, is designed for use when the transferor is a corporation, partnership, trust or estate.

A Certificate of Non-Foreign Status may be executed by a foreign corporation if it has elected to be treated as a domestic corporation under IRC §897(i). The electing foreign corporation must attach a copy of the Acknowledgment of Section 897(i) Election, an IRS form. The Certificate of Non-Foreign Status should neither be recorded nor filed with the IRS. Instead, it should be retained in the purchaser's files for at least six years after the date the property is transferred. Temp Reg §1.1445-2T(b)(3).

A purchaser may not rely on a Certificate of Non-Foreign Status if he has personal knowledge that the certificate is false, or if he has received a notice that the transaction is false from an "agent" as defined below. However, a purchaser is not liable merely because he negligently, though in good faith, accepts a false certificate. Temp Reg §1.1445-2T(b)(4).

When the transferor fails to execute a Certificate of Non-Foreign Status, the transferee should generally withhold 10 percent of the amount realized and transmit it to the IRS along with IRS Forms 8288 and 8288-A. The IRS will stamp one copy of Form 8288-A and send it to the transferor. The transferor should attach a copy of the stamped Form 8288-A to his U.S. income tax return to claim credit for the amount withheld. Whether or not amounts are withheld, the transferor remains obligated to file a U.S. income tax return and to pay any additional amount due.

The amount withheld and the appropriate IRS forms must be mailed within 10 days of the date the U.S. real property interest is transferred. Certified or registered U.S. mail should be employed. For all FIRPTA II purposes, the date the property is transferred is the

first date on which consideration is paid, rather than the date on which title to the asset vests in the purchaser. This is important when a land sale contract is used. The payment of a good faith deposit is not considered in determining the date a real property interest is transferred. Temp Reg §1.1445-1T(g)(8).

If any "agent" of the transferor or transferee knows that a Certificate of Non-Foreign Status is false, he has an obligation to notify both the purchaser and the IRS promptly. Temp Reg §1.1445-4T. Agents include persons involved in negotiating or settling the transaction (for example, attorneys, real estate brokers and escrow agents). Temp Reg §1.1445-4(T). Agents who fail to meet these obligations are liable for the amount that should have been withheld or the full amount of compensation they earned on the transaction, whichever is less. Temp Reg §1.1445-4T(e).

If a foreign corporation fraudulently executes a Certificate of Non-Foreign Status, its agents will be held liable as if they actually knew that their client was a foreign corporation. Temp Reg §1.1445-4T(1)(2). Careful agents will assure themselves that their seller-clients are incorporated under the laws of a U.S. jurisdiction.

#### Lessening the burden

Several provisions allow withholding to be avoided or reduced. A foreign investor's counsel should review these provisions as soon as the sale of a U.S. real property interest is considered. Early in the transaction, the purchaser should indicate that he expects to receive a Certificate of Non-Foreign Status at closing. This notice will alert both parties to any problems and give them time to use any of the following exemptions or methods to reduce their tax burdens.

- **Residence under \$300,000.** Generally, no withholding is required if the purchaser or a family member will use the purchased property as a residence. This exemption applies only if the seller realizes \$300,000 or less and is subject to a number of technical requirements. Temp Reg §1.1445-

## Form 2

DO NOT RECORD.  
DO NOT SEND  
TO IRS.

TRANSFEEE (BUYER)  
MUST RETAIN FOR  
SIX YEARS AFTER  
THE TRANSACTION.

### CERTIFICATION OF NON-FOREIGN STATUS BY ENTITY TRANSFEROR

1. Section 1445 of the Internal Revenue Code provides that a transferee (buyer) of a U.S. real property interest must withhold tax if the transferor (seller) is a foreign person.
2. In order to inform each transferee that withholding of tax is not required upon disposition of a U.S. real property interest by \_\_\_\_\_ (hereinafter referred to as "the Transferor"), the undersigned hereby certifies, and declares by means of this certification, the following on behalf of the Transferor:
  - A. The one item marked below is true and correct:
    - (i) The Transferor is not a foreign corporation, foreign partnership, foreign trust, or foreign estate (as these terms are defined in the Internal Revenue Code and Income Tax Regulations).
    - (ii) The Transferor is a corporation incorporated under the laws of a foreign jurisdiction but has elected to be treated as a U.S. corporation under Section 897(i) of the Internal Revenue Code, AND HAS ATTACHED TO THIS CERTIFICATE A TRUE AND GENUINE COPY OF THE ACKNOWLEDGMENT OF SUCH ELECTION ISSUED BY THE IRS.
  - B. The Transferor's employer identification number is \_\_\_\_\_.
  - C. The Transferor's office address is \_\_\_\_\_.
3. The Transferor understands that this certificate may be disclosed to the Internal Revenue Service by the transferee and that any false statement contained in this certification may be punished by fine or imprisonment (or both).
4. The Transferor understands that each transferee is relying on this certificate in determining whether withholding is required and each transferee may face liabilities if any statement in this certificate is false.
5. The Transferor hereby indemnifies each transferee, and agrees to hold each transferee harmless, from any liability or cost which such transferee may incur as a result of: (i) the Transferor's failure to pay any U.S. Federal income tax which the Transferor is required to pay under applicable U.S. law, or (ii) any false or misleading statement contained herein.

Under penalties of perjury, I declare that I have examined this certification and to the best of my knowledge and belief it is true, correct, and complete; I further declare that I have authority to sign this document on behalf of the Transferor.

EXECUTED in \_\_\_\_\_ County, State of \_\_\_\_\_  
on \_\_\_\_\_, 198\_\_\_\_\_.

Transferor: \_\_\_\_\_  
By: \_\_\_\_\_  
Title: \_\_\_\_\_

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2T(d). Therefore, this provision should be used carefully and relied on only when the transferor is unable to sign a Certificate of Non-Foreign Status.

- **Corporate stock.** Two special exemptions are available when the purchaser is acquiring stock in a corporation rather than a direct interest in U.S. real property. First, no withholding is required if any class of the corporation's stock is regularly traded on an established securities market. However, if the transaction involves a substantial interest (generally 5 percent) in the corporation, this exemption may not apply. Temp Reg §1.1445-2T(c)(2), Reg §1.897-1(c)(2)(iii)(B). Similar rules apply to interests in publicly traded partnerships and trusts.

Second, a purchaser of stock in a corporation may rely on a statement issued by the corporation, in compliance with Reg §1.897-2(h), certifying that the corporation has not been a U.S. real property holding company at any time during the previous five years. Such a holding company is generally a U.S. corporation that owns U.S. real property interests with a fair market value equal to or exceeding 50 percent of the value of all the corporation's real property and business assets. IRC §897(c)(2).

Such statements are subject to the same anti-fraud rules as Certificates of Non-Foreign Status, and a purchaser may not rely on either statement if he knows it is false. The seller's agents may be held liable if they know that a false statement has been issued and fail to inform both the purchaser and the IRS.

- **Foreclosure.** When a lender forecloses, the amount of withholding is generally limited to the cash the debtor receives, which is normally zero. To be entitled to such special treatment, the transferee (lender) must notify the IRS within 10 days after acquiring the property. Also, the transferee is not entitled to use this limited withholding provision if the debt arose from an effort to avoid the withholding re-

quirements. Such intent is presumed when the creditor's security interest did not arise out of the debtor's acquisition or improvement of the property and the total amount of all debts secured by the property exceeds 90 percent of its fair market value. Temp Reg §1.1445-2T(d)(3). Because of these limitations, a non-purchase-money lender should seek a Certificate of Non-Foreign Status at the time of foreclosure or before making the loan.

### Special exemptions are available when the purchaser is acquiring stock in a corporation.

The special withholding rules for foreclosures do not apply to a lender who receives a deed in lieu of foreclosure. Temp Reg §1.1445-2T(3)(i). Consequently, a lender should not accept a deed in lieu of foreclosure unless it is accompanied by either a Certificate of Non-Foreign Status or a withholding certificate.

- **Nonrecognition transaction.** Withholding may not be required if the transferor will not have to pay any U.S. income tax on the transfer because of one of the many nonrecognition provisions, for example, if the disposition is part of a tax-free exchange. See Temp Reg §1.1445-2T(d)(2).

- **IRS withholding certificate.** Either the transferor or the transferee may apply for a withholding certificate under Temp Reg §1.1445-3T. The IRS may authorize either reduced withholding or zero withholding and usually responds within 90 days of receiving an application.

The IRS may issue a withholding certificate for any of the following reasons (Temp Reg §1.1445-3T): (1) The transferor is exempt from U.S. tax. (2) The tax the transferor would pay as a result of the transfer (assuming the highest tax bracket) plus any amount the transferor should have withheld when he originally acquired the property is less than 10 percent of the amount realized. Under these circumstances, the IRS

will authorize a reduction in withholding to the transferor's "maximum tax liability." See IRC §1445(c). (3) The transferor and IRS reach an agreement designed to secure payment of the transferor's tax. The IRS will enter into such an agreement only when it receives an acceptable security interest. The IRS generally accepts disposed-to-surety bonds from banks and insurance companies and letters of credit. Only in unusual circumstances will it accept a mortgage or trust deed on real property. Temp Reg §1.1445-3T(e)(v)(B).

If a promptly filed application for a withholding certificate is pending 10 days after the U.S. real property interest is transferred, the transferee must generally withhold the full amount but need not remit it to the IRS. Normally the parties would agree to have the amount held by the escrow agent. If the application is denied, the withheld amount (but not earned interest) must be remitted to the IRS. Penalties may be imposed on those who apply for a withholding certificate for the primary purpose of delaying the remittance of the withheld tax. Temp Reg §1.1445-1T(c)(2)(iii).

- **Early refunds.** If withholding cannot be avoided or sufficiently reduced, the transferor can apply for an early refund. See Temp Reg §1.1445-3T(f).

### Highly encumbered real estate

In many transactions, the amount of cash payable to the transferor is less than 10 percent of the amount realized by the transferor. This is because the amount realized includes amounts payable to the transferor's creditors and liabilities that the transferee assumes (or takes the property subject to). Thus the cash available at closing will often be insufficient to cover tax withholding obligations, real estate commissions and closing costs. Neither the statute nor the regulations is entirely helpful in these situations. In some transactions a foreign seller pays cash at closing.

In many cases, foreign investors in U.S. real estate seek to mortgage and abandon their properties rather

*Continued on page 78*

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## CEB Forum

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than sell them. If the buyer withholds, the foreign seller receives no more than 90 percent of his property's sale price reduced by existing encumbrances. This amount is often further reduced by a 6 percent real estate brokerage commission and closing costs. On the other hand, a foreigner may be able to encumber the property for up to 80 or 90 percent of its appraised value. The foreign investor might then be violating U.S. law if he abandons the property and fails to file his U.S. tax return.

Lenders should be cautious in making high-leverage real estate loans to foreign persons. Any tax withholding required by FIRPTA II on foreclosure will come out of the lender's pocket. As noted above, withholding is required if the IRS can show that evading withholding was a principal purpose of the foreclosure transaction, although it is unclear whether the borrower's or the lender's motives are at issue. Note that a non-purchase-money lender bears the burden of proof on the motivation question if total debts secured by the property exceed 90 percent of its fair market value. The temporary regulations do not indicate when property must be valued or whether debts secured by the property include unpaid interest. See Temp Reg §1.1445-2T (d)(3)(iv).

Whenever your client purchases real property, he should seek a Certificate of Non-Foreign Status from the transferor. The certificate should also be sought by the purchaser of an equity interest in a corporation, partnership or trust (other than through an established securities market).

If the certificate cannot be obtained, both parties to the transaction should work together to eliminate or reduce the withholding burden.

California Lawyer welcomes articles on substantive law topics for the CEB Forum. Proposed outlines are greatly preferred, but completed manuscripts will be considered.

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Counsel to attorneys and bar applicants with ethics inquiries and representation in disciplinary, malpractice and moral fitness matters.

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