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Repeal of FIRPTA: New Opportunity Zone Proposed Regulations Clear Procedural Hurdle for Foreign Investors to Sell Real Property Without Paying Tax on Gain

Tax Reform Legal Update

UPDATE: The article below is based, in part, on the position that gain not subject to Federal income tax nonetheless is “recognized” for U.S. tax purposes and thus can be “eligible gain” for opportunity zone purposes. On December 19, 2019, the IRS issued final Opportunity Zone regulations. The IRS rejected the suggestion that eligible gain include gain not subject to Federal income tax, effectively rejecting a key basis for this article.

The new opportunity zone regime essentially repeals the U.S. capital gains tax for investments made through a qualified opportunity fund (QOF) in any of the 8,700 qualified opportunity zones (QOZs) throughout the country. In January, we published a [Legal Update](#) about how non-U.S. taxpayers can receive the same benefit, even if the QOF investment is made with capital gains that the U.S. would not have taxed in the first place. Given the predominance of real estate investments by QOFs, the

result is the effective repeal of the Foreign Investment in Real Property Tax Act (FIRPTA), which is the special tax regime that otherwise ensures that non-U.S. investors pay U.S. capital gains tax on gains from the sale of U.S. real estate.

In that Legal Update, we also described how the procedural mechanics of FIRPTA complicate a non-U.S. investor's ability to achieve the tax-free result. That is, Congress enacted FIRPTA with two key elements. First, Congress imposed U.S. income tax on a non-U.S. investor's gain from the sale of real property. Second, Congress created a withholding regime pursuant to which the buyer must withhold and remit to the IRS a portion of the purchase price. Although the opportunity zone regime effectively nullifies the imposition of tax, it has no direct impact on the withholding rules.

It initially appeared that the no tax on appreciation benefit only applied to a taxpayer's gain from a sale of an interest in a QOF. Because these transactions generally would be sales to third parties, the FIRPTA withholding rules created an obstacle. After all, buyers that fail to withhold become liable for the tax owed by the seller. With the no tax on appreciation benefit, the non-U.S. investor has no FIRPTA tax liability. Although the Treasury Regulations provide guidance for when a buyer has no liability or other penalties where no tax is owed by the seller, unrelated buyers generally will not assume the risk of failing to withhold and remit tax. Instead, the seller would have to file a refund claim for all of the remitted tax or obtain an IRS certificate that no FIRPTA withholding is required.

In April, the [IRS issued](#) its second round of QOZ proposed regulations, which expanded the no tax on appreciation benefit to a QOF's flow-through gain from its sale of assets. It appears that this may provide the procedural link for dealing with FIRPTA withholding.

If the QOF is a U.S. partnership or LLC taxed as a partnership, it can sell the U.S. real property interest and provide the buyer with the necessary certificate of non-foreign status. This ensures that the buyer does not have a FIRPTA withholding obligation and shifts the FIRPTA withholding obligation from the buyer of the U.S. real property interest to the QOF. The withholding obligation now applies when the QOF allocates gain from the sale to its non-U.S. partners. Unlike the buyer, however, the QOF has more

information about its non-U.S. partners and can ensure satisfaction of the regulatory requirements so that it has no liability or penalty for not withholding.

In expanding the no tax on appreciation benefit to include the QOF's flow-through gain, the IRS provided U.S. taxpayers with important relief to make the QOZ regime more workable. (As noted in our prior alert, there is still a potential issue because QOF investments generally will be two-tier structures, and it appears that the no tax on appreciation benefit **does not apply** to flow through gain from the asset sale by the lower-tier entity.) This provision also provides an avenue for addressing FIRPTA withholding in a manner that comports with the regulatory requirements for no penalty to apply. This appears to allow non-U.S. taxpayers to clear a procedural hurdle that otherwise complicated the substantive repeal of FIRPTA effect by the QOZ regime. However, other procedural issues remain for non-U.S. investors. Please contact us to learn more about QOZ investments.