INCOME TAXATION OF REAL ESTATE SALES
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1 **Introduction**

Those who engage in buying and selling real property are often asked by real estate agents and escrow companies to fill out tax withholding and reporting paperwork relating to their transactions. Those who are non-taxpayers often have a difficult time deciding how to complete this paperwork in a way that accurately describes and protects their status. This memorandum of law will describe:

1. The state and federal laws applicable to income tax withholding and reporting of real estate sales.
2. The forms used for state and federal tax withholding and reporting of real estate sales.
3. Tactics for filling out real estate withholding and reporting forms useful to those who are “nontaxpayers” not subject to the Internal Revenue Code Subtitle A.
4. Tools and techniques for educating title companies, escrow companies, and buyers so that they will cooperate with you in lawfully avoiding income tax withholding and reporting of real estate sales.

2 **I.R.C. 121 Exclusion of Proceeds from Sale of Principal Residence**

I.R.C. 121 allows for an exclusion from gross income of the sale of a principal residence if the taxpayer has used the residence as his principal residence for 2 of the last five years. The amount of gain excluded is up to $250,000 for a single individual and $500,000 for a married couple. This exclusion, like every other “benefit” of the I.R.C., only applies to “taxpayers”. Many of the real estate withholding forms you will encounter during the sale of a property will mention this exclusion. The provision of law permitting this is as follows:

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TITLE 26 > Subtitle A > CHAPTER 1 > Subchapter B > PART III > § 121
§ 121. Exclusion of gain from sale of principal residence

(a) Exclusion

Gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer’s principal residence for periods aggregating 2 years or more.

(b) Limitations

(1) In general

The amount of gain excluded from gross income under subsection (a) with respect to any sale or exchange shall not exceed $250,000.

(2) Special rules for joint returns

In the case of a husband and wife who make a joint return for the taxable year of the sale or exchange of the property—

(A) $500,000 Limitation for certain joint returns

Paragraph (1) shall be applied by substituting “$500,000” for “$250,000” if—

(i) either spouse meets the ownership requirements of subsection (a) with respect to such property;

(ii) both spouses meet the use requirements of subsection (a) with respect to such property; and

(iii) neither spouse is ineligible for the benefits of subsection (a) with respect to such property by reason of paragraph (3).

(B) Other joint returns

If such spouses do not meet the requirements of subparagraph (A), the limitation under paragraph (1) shall be the sum of the limitations under paragraph (1) to which each spouse would be entitled if
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such spouses had not been married. For purposes of the preceding sentence, each spouse shall be
treated as owning the property during the period that either spouse owned the property.

3 FIRPTA Requirements

The Federal Investment in Real Property Transfer Act (FIRPTA) is found at 26 U.S.C. §897, which says the following:

The Federal Investment in Real Property Transfer Act (FIRPTA) is found at 26 U.S.C. §897, which says the following:

3 TITLE 26 > Subtitle A > CHAPTER 1 > Subchapter N > PART II > Subpart D > § 897

§ 897. Disposition of investment in United States real property

(a) General rule

(1) Treatment as effectively connected with United States trade or business

For purposes of this title, gain or loss of a nonresident alien individual or a foreign corporation from the
disposition of a United States real property interest shall be taken into account—

(A) in the case of a nonresident alien individual, under section 871 (B)(1), or

(B) in the case of a foreign corporation, under section 882 (a)(1), as if the taxpayer were engaged in a
trade or business within the United States during the taxable year and as if such gain or loss were
effectively connected with such trade or business.

(2) Minimum tax on nonresident alien individuals

(A) In general

In the case of any nonresident alien individual, the taxable excess for purposes of section 55 (b)(1)(A)
shall not be less than the lesser of—

(i) the individual’s alternative minimum taxable income (as defined in section 55 (b)(2)) for the
taxable year, or

(ii) the individual’s net United States real property gain for the taxable year.

(B) Net United States real property gain

For purposes of subparagraph (A), the term “net United States real property gain” means the excess of—

(i) the aggregate of the gains for the taxable year from dispositions of United States real property
interests, over

(ii) the aggregate of the losses for the taxable year from dispositions of such interests.

(b) Limitation on losses of individuals

In the case of an individual, a loss shall be taken into account under subsection (a) only to the extent such
loss would be taken into account under section 165 (c) (determined without regard to subsection (a) of
this section).

(c) United States real property interest

For purposes of this section—

(1) United States real property interest

(A) In general

Except as provided in subparagraph (B), the term “United States real property interest” means—

(i) an interest in real property (including an interest in a mine, well, or other natural deposit)
located in the United States or the Virgin Islands, and
(ii) any interest (other than an interest solely as a creditor) in any domestic corporation unless the
taxpayer establishes (at such time and in such manner as the Secretary by regulations prescribes)
that such corporation was at no time a United States real property holding corporation during the
shorter of—

(I) the period after June 18, 1980, during which the taxpayer held such interest, or

(II) the 5-year period ending on the date of the disposition of such interest.

(B) Exclusion for interest in certain corporations

The term “United States real property interest” does not include any interest in a corporation if—

(i) as of the date of the disposition of such interest, such corporation did not hold any United
States real property interests, and

(ii) all of the United States real property interests held by such corporation at any time during the
shorter of the periods described in subparagraph (A)(ii)—

(I) were disposed of in transactions in which the full amount of the gain (if any) was recognized, or

(II) ceased to be United States real property interests by reason of the application of this
subparagraph to 1 or more other corporations.

(2) United States real property holding corporation

The term “United States real property holding corporation” means any corporation if—

(A) the fair market value of its United States real property interests equals or exceeds 50 percent of
(B) the fair market value of—

(i) its United States real property interests,

(ii) its interests in real property located outside the United States, plus

(iii) any other of its assets which are used or held for use in a trade or business.

(3) Exception for stock regularly traded on established securities markets

If any class of stock of a corporation is regularly traded on an established securities market, stock of
such class shall be treated as a United States real property interest only in the case of a person who,
at some time during the shorter of the periods described in paragraph (1)(A)(ii), held more than 5
percent of such class of stock.

(4) Interests held by foreign corporations and by partnerships, trusts, and estates

For purposes of determining whether any corporation is a United States real property holding
corporation—

(A) Foreign corporations

Paragraph (1)(A)(ii) shall be applied by substituting “any corporation (whether foreign or domestic)”
for “any domestic corporation”.

(B) Interests held by partnerships, etc.

Under regulations prescribed by the Secretary, assets held by a partnership, trust, or estate shall be
treated as held proportionately by its partners or beneficiaries. Any asset treated as held by a partner
or beneficiary by reason of this subparagraph which is used or held for use by the partnership, trust,
or estate in a trade or business shall be treated as so used or held by the partner or beneficiary. Any
asset treated as held by a partner or beneficiary by reason of this subparagraph shall be so treated for
purposes of applying this subparagraph successively to partnerships, trusts, or estates which are
above the first partnership, trust, or estate in a chain thereof.
(5) Treatment of controlling interests

(A) In general

Under regulations, for purposes of determining whether any corporation is a United States real property holding corporation, if any corporation thereinafter in this paragraph referred to as the “first corporation”) holds a controlling interest in a second corporation—

(i) the stock which the first corporation holds in the second corporation shall not be taken into account,

(ii) the first corporation shall be treated as holding a portion of each asset of the second corporation equal to the percentage of the fair market value of the stock of the second corporation represented by the stock held by the first corporation, and

(iii) any asset treated as held by the first corporation by reason of clause (ii) which is used or held for use by the second corporation in a trade or business shall be treated as so used or held by the first corporation.

Any asset treated as held by the first corporation by reason of the preceding sentence shall be so treated for purposes of applying the preceding sentence successively to corporations which are above the first corporation in a chain of corporations.

(B) Controlling interest

For purposes of subparagraph (A), the term “controlling interest” means 50 percent or more of the fair market value of all classes of stock of a corporation.

(6) Other special rules

(A) Interest in real property

The term “interest in real property” includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.

(B) Real property includes associated personal property

The term “real property” includes movable walls, furnishings, and other personal property associated with the use of the real property.

(C) Constructive ownership rules

For purposes of determining under paragraph (3) whether any person holds more than 5 percent of any class of stock and of determining under paragraph (5) whether a person holds a controlling interest in any corporation, section 318 (a) shall apply (except that paragraphs (2)(C) and (3)(C) of section 318 (a) shall be applied by substituting “5 percent” for “50 percent”).

(d) Treatment of distributions by foreign corporations

(1) In general

Except to the extent otherwise provided in regulations, notwithstanding any other provision of this chapter, gain shall be recognized by a foreign corporation on the distribution (including a distribution in liquidation or redemption) of a United States real property interest in an amount equal to the excess of the fair market value of such interest (as of the time of the distribution) over its adjusted basis.

(2) Exceptions

Gain shall not be recognized under paragraph (1)—

(A) if—

(i) at the time of the receipt of the distributed property, the distributee would be subject to taxation under this chapter on a subsequent disposition of the distributed property, and
(ii) the basis of the distributed property in the hands of the distributee is no greater than the adjusted basis of such property before the distribution, increased by the amount of gain (if any) recognized by the distributing corporation, or

(B) if such nonrecognition is provided in regulations prescribed by the Secretary under subsection (c)(2).

(e) Coordination with nonrecognition provisions

(1) In general

Except to the extent otherwise provided in subsection (d) and paragraph (2) of this subsection, any nonrecognition provision shall apply for purposes of this section to a transaction only in the case of an exchange of a United States real property interest for an interest the sale of which would be subject to taxation under this chapter.

(2) Regulations

The Secretary shall prescribe regulations (which are necessary or appropriate to prevent the avoidance of Federal income taxes) providing—

(A) the extent to which nonrecognition provisions shall, and shall not, apply for purposes of this section, and

(B) the extent to which—

(i) transfers of property in reorganization, and

(ii) changes in interests in, or distributions from, a partnership, trust, or estate, shall be treated as sales of property at fair market value.

(3) Nonrecognition provision defined

For purposes of this subsection, the term “nonrecognition provision” means any provision of this title for not recognizing gain or loss.


(g) Special rule for sales of interest in partnerships, trusts, and estates

Under regulations prescribed by the Secretary, the amount of any money, and the fair market value of any property, received by a nonresident alien individual or foreign corporation in exchange for all or part of its interest in a partnership, trust, or estate shall, to the extent attributable to United States real property interests, be considered as an amount received from the sale or exchange in the United States of such property.

(h) Special rules for certain investment entities

For purposes of this section—

(1) Look-through of distributions

Any distribution by a qualified investment entity to a nonresident alien individual or foreign corporation shall, to the extent attributable to gain from sales or exchanges by the qualified investment entity of United States real property interests, be treated as gain recognized by such nonresident alien individual or foreign corporation from the sale or exchange of a United States real property interest. Notwithstanding the preceding sentence, any distribution by a real estate investment trust with respect to any class of stock which is regularly traded on an established securities market located in the United States shall not be treated as gain recognized from the sale or exchange of a United States real property interest if the shareholder did not own more than 5 percent of such class of stock at any time during the 1-year period ending on the date of the distribution.

(2) Sale of stock in domestically controlled entity not taxed

The term “United States real property interest” does not include any interest in a domestically controlled qualified investment entity.
(3) Distributions by domestically controlled qualified investment entities

In the case of a domestically controlled qualified investment entity, rules similar to the rules of subsection (d) shall apply to the foreign ownership percentage of any gain.

(4) Definitions

(A) Qualified investment entity

(i) In general The term “qualified investment entity” means—

(I) any real estate investment trust, and

(II) any regulated investment company.

(ii) Termination Clause (i)(II) shall not apply after December 31, 2007.

(B) Domestically controlled

The term “domestically controlled qualified investment entity” means any qualified investment entity in which at all times during the testing period less than 50 percent in value of the stock was held directly or indirectly by foreign persons.

(C) Foreign ownership percentage

The term “foreign ownership percentage” means that percentage of the stock of the qualified investment entity which was held (directly or indirectly) by foreign persons at the time during the testing period during which the direct and indirect ownership of stock by foreign persons was greatest.

(D) Testing period

The term “testing period” means whichever of the following periods is the shortest:

(i) the period beginning on June 19, 1980, and ending on the date of the disposition or of the distribution, as the case may be,

(ii) the 5-year period ending on the date of the disposition or of the distribution, as the case may be, or

(iii) the period during which the qualified investment entity was in existence.

(i) Election by foreign corporation to be treated as domestic corporation

(1) In general

If—

(A) a foreign corporation holds a United States real property interest, and

(B) under any treaty obligation of the United States the foreign corporation is entitled to nondiscriminatory treatment with respect to that interest, then such foreign corporation may make an election to be treated as a domestic corporation for purposes of this section, section 1445, and section 6039C.

(2) Revocation only with consent

Any election under paragraph (1), once made, may be revoked only with the consent of the Secretary.

(3) Making of election

An election under paragraph (1) may be made only—

(A) if all of the owners of all classes of interests (other than interests solely as a creditor) in the foreign corporation at the time of the election consent to the making of the election and agree that
gain, if any, from the disposition of such interest after June 18, 1980, which would be taken into
account under subsection (a) shall be taxable notwithstanding any provision to the contrary in a treaty
to which the United States is a party, and

(B) subject to such other conditions as the Secretary may prescribe by regulations with respect to the
corporation or its shareholders.

In the case of a class of interest (other than an interest solely as a creditor) which is regularly traded
on an established securities market, the consent described in subparagraph (A) need only be made by
any person if such person held more than 5 percent of such class of interest at some time during the
shorter of the periods described in subsection (c)(1)(A)(i) (i). The constructive ownership rules of
subsection (c)(6)(C) shall apply in determining whether a person held more than 5 percent of a class
of interest.

(4) Exclusive method of claiming nondiscrimination

The election provided by paragraph (1) shall be the exclusive remedy for any person claiming
discriminatory treatment with respect to this section, section 1145, and section 6039C.

(j) Certain contributions to capital

Except to the extent otherwise provided in regulations, gain shall be recognized by a nonresident alien
individual or foreign corporation on the transfer of a United States real property interest to a foreign
corporation if the transfer is made as paid in surplus or as a contribution to capital, in the amount of the
excess of—

(1) the fair market value of such property transferred, over

(2) the sum of—

(A) the adjusted basis of such property in the hands of the transferor, plus

(B) the amount of gain, if any, recognized to the transferor under any other provision at the time of the
transfer.

Note the following about the above FIRPTA act:

1. The act refers only to real property located in the “United States”, which is defined in 26 U.S.C. §7701(a)(9) and
   (a)(10) and includes no part of any state of the Union.

   TITLE 26 > Subtitle F > CHAPTER 79 > Sec. 7701. [Internal Revenue Code]
   Sec. 7701. - Definitions
   (a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent
   thereof—
   (9) United States

   The term "United States" when used in a geographical sense includes only the States and the District of
   Columbia.

   (10) State

   The term "State" shall be construed to include the District of Columbia, where such construction is necessary to
   carry out provisions of this title.

2. The rules of statutory construction forbid adding anything to the definition of “United States” above, or assuming
   anything not expressly spelled out:

   "Expressio unius est exclusio alterius. A maxim of statutory interpretation meaning that the expression of one
   thing is the exclusion of another. Burgin v. Forbes, 293 Ky. 456, 169 S.W.2d 321, 325; Newblock v. Bowles,
   170 Okl. 487, 40 P.2d 1097, 1100. Mention of one thing implies exclusion of another. When certain persons
   or things are specified in a law, contract, or will, an intention to exclude all others from its operation may be
inferred. Under this maxim, if statute specifies one exception to a general rule or assumes to specify the effects of a certain provision, other exceptions or effects are excluded.”

"When a statute includes an explicit definition, we must follow that definition, even if it varies from that term’s ordinary meaning. Meese v. Keene, 481 U.S. 465, 484-485 (1987) ("It is axiomatic that the statutory definition of the term excludes unstated meanings of that term"); Colautti v. Franklin, 439 U.S. at 392-393, n. 10 ("As a rule, a definition which declares what a term "means"... excludes any meaning that is not stated"); Western Union Telegraph Co. v. Lenroot, 323 U.S. 490, 502 (1945); Fox v. Standard Oil Co. of N.J., 294 U.S. 87, 95-96 (1935) (Cardozo, J.); see also 2A N. Singer, Sutherland on Statutes and Statutory Construction § 47.07, p. 152, and n. 10 (5th ed. 1992) (collecting cases). That is to say, the statute, read "as a whole," post at 998 [530 U.S. 943] (THOMAS, J., dissenting), leads the reader to a definition. That definition does not include the Attorney General's restriction -- "the child up to the head." Its words, "substantial portion," indicate the contrary." [Steinberg v. Carhart, 530 U.S. 914 (2000)]

3. The term “domestic” is in reference to the term “United States”, which in turn implies the District of Columbia or the Virgin Islands.

4. Federal law may not be enforced within a state of the Union:

"It is no longer open to question that the general government, unlike the states, Hammer v. Dagenhart, 247 U.S. 251, 275, 38 S.Ct. 529, 3 A.L.R. 649, Ann.Cas.1918E 724, possesses no inherent power in respect of the internal affairs of the states; and emphatically not with regard to legislation." [Carter v. Carter Coal Co., 298 U.S. 238, 56 S.Ct. 892 (1936)]

"The difficulties arising out of our dual form of government and the opportunities for differing opinions concerning the relative rights of state and national governments are many; but for a very long time this court has steadfastly adhered to the doctrine that the taxing power of Congress does not extend to the states or their political subdivisions. The same basic reasoning which leads to that conclusion, we think, requires like limitation upon the power which springs from the bankruptcy clause. United States v. Butler, supra." [Ashton v. Cameron County Water Improvement District No. 1, 298 U.S. 513, 56 S.Ct. 892 (1936)]

5. FIRPTA limits itself to only “nonresident alien individuals”. No one else is covered by the act.
6. One can be a “nonresident alien” without also being a “nonresident alien individual”.
7. The terms “individual” and “nonresident alien individual” are defined as follows:

26 CFR 1.1441-1 Requirement for the deduction and withholding of tax on payments to foreign persons

(c) Definitions

(3) Individual.
(i) Alien individual.

The term alien individual means an individual who is not a citizen or a national of the United States. See Sec. 1.1-1(c).

(ii) Nonresident alien individual.

The term nonresident alien individual means a person described in section 7701(b)(1)(B), an alien individual who is a resident of a foreign country under the residence article of an income tax treaty and Sec. 301.7701(b)-7(a)(1) of this chapter, or an alien individual who is a resident of Puerto Rico, Guam, the Commonwealth of Northern Mariana Islands, the U.S. Virgin Islands, or American Samoa as determined under Sec. 301.7701(b)-1(d) of this chapter. An alien individual who has made an election under section 6013 (g) or (h) to be treated as a resident of the United States is nevertheless treated as a nonresident alien individual for purposes of withholding under chapter 3 of the Code and the regulations thereunder.

8. The definition of “nonresident alien individual” above does not include a person born within or domiciled within a state of the Union mentioned in the Constitution. Instead, it only includes people born within or domiciled within federal territories and possessions referred to in the Buck Act as follows:

TITLE 4 > CHAPTER 4 > § 110
§ 110. Same; definitions
As used in sections 105–109 of this title—
(d) The term “State” includes any Territory or possession of the United States.

4 State versions of FIRPTA

States have laws similar to the federal FIRPTA. For instance, the California Revenue and Taxation Code, Section 18662 imposes FIRPTA the same as federal. Below is a copy of that code section:

California Revenue and Taxation Code

18662. (a) The Franchise Tax Board may, by regulation, require any person, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers, and any officer or department of the state or any political subdivision or agency of the state, or any city organized under a freeholder’s charter, or any political body not a subdivision or agency of the state, having the control, receipt, custody, disposal, or payment of items of income specified in subdivision (b), to withhold an amount, determined by the Franchise Tax Board to reasonably represent the amount of tax due when the items of income are included with other income of the taxpayer, and to transmit the amount withheld to the Franchise Tax Board at the time as it may designate.

(b) The items of income referred to in subdivision (a) are interest, dividends, rents, prizes and winnings, premiums, annuities, emoluments, compensation for services, including bonuses, partnership income or gains, and other fixed or determinable annual or periodical gains, profits, and income.

(c) The Franchise Tax Board may authorize the tax under subdivision (a) to be deducted and withheld from the interest upon any securities the owners of which are not known to the withholding agent.

(d) Any person failing to withhold from any payments any amounts required by subdivision (a) to be withheld is liable for the amount withheld or the amount of taxes due from the person to whom the payments are made to an extent not in excess of the amounts required to be withheld, whichever is greater, unless it is shown that the failure to withhold is due to reasonable cause.

(e) (1) This subdivision applies to any disposition of a California real property interest by:

(A) Any person, other than either of the following:

(i) A corporation, including an entity classified for tax purposes as a corporation under Part 11 (commencing with Section 23001).

(ii) A partnership, as determined in accordance with Subchapter K of Chapter 1 of Subtitle A of the Internal Revenue Code, including an entity classified as a partnership for tax purposes under Part 10 (commencing with Section 17001).