

Regulation of Foreign Ownership in U.S. Property and 1031 Exchanges

United States real estate has long been an attractive investment opportunity to foreign investors. When investing in real estate, the question of whether foreign investors can utilize 1031 Exchanges comes to the forefront. This blog will explore if and how 1031 Exchanges can be utilized by foreign investors, why foreign investors choose to invest in US real estate, and the regulatory framework governing foreign real estate investments.

How 1031 Exchanges are Utilized in Real Estate Transactions Involving Foreign Investors

The Seller of U.S. property to a foreign investor can utilize a 1031 Exchange in the exact same way they would if they were selling property to a domestic investor that is a citizen of the United States. As the Seller they must abide by the standard 1031 Exchange rules and regulations to complete a valid 1031 Exchange for tax deferral.

But can a foreign investor use a 1031 Exchange when investing in U.S. Real Estate? The short answer is yes; foreign investors can use 1031 Exchanges for U.S. real estate investments. The longer answer includes added complexities that foreign investors must abide by to achieve tax deferral status.

Some key considerations for foreign investors regarding 1031 Exchanges include:

- 1. U.S. Property Requirement:** Both the property being sold, and the Replacement Property must be in the continental United States, with some exceptions. Learn more about the designation between foreign and domestic property.
- 2. Tax Identification Number:** Foreign investors must obtain a U.S. Tax Identification Number (TIN) to complete a 1031 Exchange.
- 3. Withholding Requirements:** Under FIRPTA, 15% of the gross sale price must be withheld for foreign Sellers of U.S. real estate. However, foreign investors can potentially avoid this withholding if their 1031 Exchange is properly structured.
- 4. Compliance with 1031 Exchange Rules:** Foreign investors must follow the same rules as domestic investors, including the 45-day identification period and the 180-day completion period.

Foreign Investment in Real Property Tax Act (FIRPTA)

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) was enacted by Congress to impose tax on foreign investors selling real estate assets in the United States. FIRPTA mandates that anyone purchasing real estate assets from foreign individuals or entities must withhold a specified portion of the purchase price, which would ordinarily be paid to the foreign Seller. Buyers are required to withhold up to 15% of the gross sale price when purchasing from individual Sellers. This mandate ensures the foreign Seller pays the required capital gains taxes. Withholding can be avoided if a property becomes the purchaser's personal residence and the sales price is no more than \$300,000, if the 1031 Exchange is simultaneous i.e. The Seller and Buyer are exchanging properties with one another, or if the IRS has issued a withholding certificate to the foreign Seller.

While foreign investors can utilize a 1031 Exchange it requires advance planning. For a foreign investor to achieve tax deferral with a 1031 Exchange they file a Form 8288-B and successfully obtain a withholding certificate prior to the sale of their property. It is strongly encouraged that foreign investors consult with a professional tax advisor to determine if FIRPTA applies, help them obtain a U.S. Taxpayer Identification Number (TIN), and apply for a withholding certificate. In a 1031 Exchange, the Buyer must be informed in writing that a withholding certificate has been requested.

It is important to contact a reputable 1031 Exchange Qualified Intermediary well before the closing date to prepare all necessary exchange documentation, which must then be sent to the closing agent. Once the sale is finalized, the 45-day and 180-day identification deadlines commence.

Why are Foreign Investors Investing in US Real Estate?

Foreign Investors, and even countries, are drawn to investing in U.S. Real Estate for a multitude of reasons. Many of the reasons don't differ from why U.S. citizens choose to invest in real estate. Reasons for foreign investment in U.S. real estate include:

- 1. Stable Economic Environment:** The U.S. economy is perceived as stable and resilient with strong legal protections for property rights, making it an attractive investment destination.
- 2. Diversification:** Investing in U.S. real estate allows foreign investors to diversify their portfolios, reducing risk by spreading investments across different geographic regions.
- 3. High Returns:** Historically, U.S. real estate markets, especially in major cities, have provided strong returns on investment through both rental income and property value appreciation.
- 4. Political Stability:** The political stability and transparency in the U.S. attract investors seeking safe and secure investment environments compared to their home countries.
- 5. Investment Opportunities:** The U.S. offers a wide range of real estate investment opportunities, from residential property to commercial real estate, catering to various investment strategies and goals.
- 6. Legal and Tax Advantages:** The U.S. provides certain legal and tax benefits for real estate investors, such as the ability to use 1031 Exchanges to defer capital gains taxes.

Foreign Investments in U.S. Real Estate

As of March 2023, U.S. property sales to foreign Buyers totaled \$53 billion. Across the country, 79% of the counties have at least one foreign investor present.

As far as specific sectors within the real estate market, Industrial and Multifamily real estate account for the largest portion of foreign commercial real estate investment. From Quarter 2 in 2020 to 2022, industrial real estate investment grew from 15% to 30% of all foreign capital invested. Multifamily properties are second to industrial property at just under 30% of all foreign investment. A growing sector of real estate in recent years is agricultural land. Foreign ownership and investment in U.S. agricultural land, which includes farmland, forest land, and pastures, has also seen a significant increase over the last few years. Since 2017, this sector has grown almost 50%. According to the latest AFIDA report from 2021, more than 40 million acres of U.S. agricultural land is owned by foreign investors and companies. This equates to just under 2% of all U.S. land and over 3% of all privately held agricultural land.

While residential real estate remains a popular real estate sector of foreign investment, commercial property investment has grown in recent years. As of 2023, the leading countries in commercial property acquisitions include:

- Canada – \$15.98 billion
- Singapore – \$10.85 billion
- Japan – \$2.91 billion

Regulations on Foreign Investment in U.S. Real Estate

Various governmental entities and numerous laws are utilized to regulate foreign investment in U.S. real estate. While there has been increased foreign investment in commercial and residential properties over the past few years, agricultural land has seen a significant rise, which has heightened national security concerns including foreign control over food supply and proximity to sensitive U.S. military and government bases. Congress has several committees tasked with addressing these concerns.

The Committee on Foreign Investment in the United States (CFIUS):

The CFIUS is an interagency committee authorized to review certain transactions involving foreign investment in the United States, as well as specific real estate transactions by foreign entities, to determine their impact on U.S. national security.

Members of CFIUS include:

- Department of the Treasury (chair)
- Department of Justice
- Department of Agriculture
- Department of Defense
- Department of State
- Department of Energy

White House Offices that Observe and Participate in CFIUS Activities:

- Office of Management & Budget
- Council of Economic Advisors
- National Security Council
- National Economic Council
- Homeland Security Council

Non-Voting, Ex-Officio Members:

- Director of National Intelligence
- Secretary of Labor

These roles are defined by statute and regulation.

CFIUS operates under Section 721 of the Defense Production Act of 1950, as amended, and follows Executive Orders and the Code of Federal Regulations. The latest amendment was the Foreign Investment Risk Review Modernization Act (FIRRMA) in August 2018. Pursuant to these provisions, CFIUS allows the President to suspend or block certain foreign transactions. There are specific rules for how investigations and self-reporting can lead to these actions or exemptions for some foreign entities.

Agricultural Foreign Investment Disclosure Act (AFIDA)

AFIDA provides the framework for the collection and dissemination of information on foreign transactions and ownership of agricultural land in the U.S. Since its enactment in 1978, the law and regulations have been administered by the USDA Farm Service Agency which requires foreign investors who acquire, transfer, or hold interest in U.S. agriculture land to report their holdings and transactions to the Secretary of Agriculture. FSA uses the info to compile and file an annual report with Congress and the data is also included in searchable spreadsheets on a county-by-county basis throughout the United States.

Current Congressional Measures

In addition to the long-standing CFIUS and AFIDA regulations, there are measures pending in Congress to improve the current system.

- The AFIDA Improvements Act of 2024 will use the results from the Government Accountability Office (GAO) study of the AFIDA process to codify the AFIDA requirements and provide more robust data reporting and review.
- The Promoting Agricultural Safeguards & Security Act of 2023 (PASS) prohibits persons who are acting on behalf of China, Russia, Iran, or North Korea from purchasing or investing in U.S. agricultural land and companies. The President may waive this prohibition on a case-by-case basis if the President determines that the waiver is vital to U.S. national security interests. The bill also places the Secretary of Agriculture on CFIUS and requires CFIUS to review certain transactions involving investments by foreign persons in the U.S. agricultural sector. The Bill also requires the Department of Agriculture to report to Congress on the risks that foreign purchases of U.S. businesses engaged in agriculture pose to the agricultural sector of the United States.
- The Farmland Act of 2023 (Foreign Agricultural Restrictions to Maintain Local Agriculture and National Defense) was introduced to amend AFIDA to strengthen the oversight and transparency of AFIDA. Notably, the Act amends AFIDA by imposing a requirement that any entity (including a Buyer, Seller, real estate agent, broker, and title company) involved in the purchase or transfer of agricultural land in the United States shall (1) conduct due diligence relating to the agriculture land being purchased or transferred; and (2) certify to the Secretary of Agriculture that, to the best of the knowledge and belief of the entity, the entity is in compliance with all applicable provisions of AFIDA. It also would allow for review of any purchase or lease of U.S. ag land by a foreign entity which exceeds \$5,000,000 in value or more than 320 acres that has taken place in the past 3 years.

The above measures regulated by legislation and executed by various committees help ensure our country remains diligent and aware of the potential risks that foreign investment in U.S. real estate could post on national security, as well as the US economy.

Foreign investors will continue to find U.S. real estate as an attractive investment opportunity and 1031 Exchanges continue to provide qualifying foreign investors the same tax deferral opportunities as U.S. citizens.