



Foreign Persons Receiving Rental Income From U.S. Real Property

U.S. real estate professionals and rental agents/property managers are encountering an increasing number of situations that involve foreign persons' acquiring U.S. real estate as a part-time residence, for investment or in some cases to conduct a U.S. business. The U.S. tax rules that apply to ownership and dispositions of U.S. real estate by [foreign persons](#) are different in some important respects from the rules that apply to U.S. persons.

U.S. real estate professionals must know how to properly deal with foreign investors in U.S. real estate in order to be in compliance with the federal tax laws affecting real estate transactions. They must be familiar with the rules that determine whether an individual or entity is to be treated as a U.S. person or a foreign person. In addition, they must also be familiar with the fundamentals of U.S. federal income taxation of foreign investors with U.S. rental income. Under U.S. tax law, a taxpayer can depreciate the property. There are different depreciation rates for residential and commercial properties. This annual depreciation is deducted from income as an expense on an income tax return. However, it may be recaptured if the property is sold.

Foreign Property Owner's Tax Return Responsibility During Ownership and Rental of Real Property Interest

Before agreeing to manage U.S. real property for a foreign taxpayer, a real estate professional or rental agent should discuss with the foreign client whether the rental income will be taxed as investment income through withholding, or on a net income basis as "[effectively connected with a U.S. trade or business](#)," without withholding (although the owner may have to file estimated tax returns). Rental income from real property located in the United States and the gain from its sale will always be U.S. source income subject to tax in the United States regardless of the foreign investor's personal tax status and regardless of whether the United States has an income treaty with the foreign investor's home country.

The method by which rental income will be taxed depends on whether or not the foreign person who owns the property is considered "engaged in a U.S. trade or business." Ownership of real property is not considered a U.S. trade or business if it consists of merely passive activity such as a net lease in which the lessee pays rent, as well as all taxes, operating expenses, repairs, and interest in principal on existing mortgages and insurance in connection with the property. Such passive rental income is subject to a flat 30 percent withholding tax (unless reduced by an applicable income [tax treaty](#)) applied to the gross income rather than the "net rent" received. Thus, the real estate taxes, operating expenses, ground rent, repairs, interest and principal on any existing mortgages, and insurance premiums paid by the lessee on behalf of the foreign owner-lessor, must be included in gross income subject to the 30 percent withholding tax. The gross income and withheld taxes must be reported on [Form 1042-S, Foreign Persons U.S. Source Income Subject to Withholding](#) to the IRS and the payee by March 15 of the following calendar year. The payor must also submit [Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons](#), by March 15.

If, on the other hand, the foreign investor is engaged in a U.S. trade or business such as the developing, managing and operating a major shopping center, the rental income will not be subject to withholding and will be taxed at ordinary progressive rates. Expenses such as mortgage interest, real property taxes, maintenance, repairs and depreciation (accelerated cost recovery) may then be deducted in determining net taxable income. The nonresident must make estimated tax payments for the tax due on the net rental income, if any. The only way these expenses can be deducted, however, is if an income tax return Form 1040NR for nonresident alien individuals and Form 1120-F for foreign corporations is timely filed by the foreign investor.

Foreign individuals and foreign corporations may elect to have their passive rental income taxed as if it were effectively connected with the U.S. trade or business. Once such an election is made by attaching a declaration to a timely filed income tax return, there is no obligation to withhold even in a net-lease situation. Once made, the election may not be revoked without the consent of the IRS. Unless the foreign investor has properly informed the property manager that the rental income is to be treated as "effectively connected income" by submitting to the property manager with a fully completed Internal Revenue Service [Forms W-8ECI, Certificate of Foreign Person's Claim for Exemption From Withholding on Income Effectively Connected With the Conduct of a Trade or Business in the United States](#) (PDF), the property manager should withhold thirty percent (30 percent) of the gross rental receipts so as to avoid personal liability. A fully completed Form W-8ECI must include a valid U.S. tax identification number for the foreign landlord (in other words, the rental agent must withhold and remit the 30 percent tax to the IRS until this requirement is satisfied). A real property manager who collects rent on behalf of a foreign owner of real property is considered a withholding agent and is personally and primarily liable for any tax that must be withheld. The liability of the withholding agent includes amounts that should have been paid plus interest, penalties, and where applicable, criminal sanctions. Property managers who do not comply with these rules will be held liable (either individually or through their company) for 30 percent of gross rents, plus penalties and interest. Also, property managers need to report annual rents collected on behalf of foreign landlords on Forms 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, and 1042-S, Foreign Person's U.S. Source Income Subject to Withholding. These are the equivalent of Forms 1096 and 1099-MISC but are for foreign owners.

To enforce the system of withholding, the Internal Revenue Code defines a "withholding agent" to be any person in whatever capacity (including lessees and managers of U.S. real property) having the control, receipt, custody, disposal or payment of income that is subject to withholding. Thus, a real

property manager who collects rent on behalf of a foreign owner of real property is clearly considered a withholding agent. A withholding agent is personally and primarily liable for any tax that must be withheld. The liability of the withholding agent includes amounts that should have been paid plus interest, penalties and, where applicable, criminal sanctions. The statute of limitations does not start until a withholding return is filed by the withholding agent. Once the return has been filed, the statute of limitations begins to run at the later of two dates: the date of actual filing of the correct return or April 15 of the calendar year in which the return should have been filed. The withholding agent will remain liable if he actually knows that the foreign owner's statements are false. The withholding agent's duty of inquiry seems to be a "reasonably prudent test," measured by all facts and circumstances.

A nonresident who fails to submit a timely filed income tax return loses the ability to claim deductions against the rental income, causing the gross rents to be subject to the 30 percent tax. Generally, the nonresident will need to retroactively file at least six years of delinquent income tax returns, or all prior year tax returns, if they have held the rental property for less than six years. However, the ability to elect to treat the rental income as effectively connected with a U.S. trade or business will be lost after 16 months from the original due date of the return, and the remaining back years may be subject to tax under the gross income method. Rental income from real property located in the United States and the gain from its sale will always be U.S. source income subject to tax in the United States regardless of the foreign investor's status and regardless of whether the United States has an income treaty with the foreign investor's home country.

For tax treatment of disposition of U.S. real property interest see [FIRPTA Withholding](#).

References/Related Topics

- [Determining Alien Tax Status](#)
- [FIRPTA Withholding](#)
- [Real Estate](#)
- [Taxation of Nonresident Aliens](#)

Note: This page contains one or more references to the Internal Revenue Code (IRC), Treasury Regulations, court cases, or other official tax guidance. References to these legal authorities are included for the convenience of those who would like to read the technical reference material. To access the applicable IRC sections, Treasury Regulations, or other official tax guidance, visit the [Tax Code, Regulations, and Official Guidance](#) page. To access any Tax Court case opinions issued after September 24, 1995, visit the [Opinions Search](#) page of the United States Tax Court.

Page Last Reviewed or Updated: 10-Feb-2014