Unreported US Rental Income for Foreign Property Owners: Four Pathways to Tax Compliance and Associated Risks

Tax Compliance Options for Foreign Property Owners With Unreported US Rental Income

If you're a non-US resident who has been collecting rent without meeting your tax obligations, you have options. None of them are simple, and all carry risks. This guide explains what you should have been doing and what you can do now to become compliant.

The Two Tax Options for Foreign Rental Property Owners

When you rent US real estate as a foreign person, federal tax law gives you two ways to handle the tax obligation.

Option One: Pay 30% Tax on Gross Rental Income

Income from US real property owned by a nonresident alien is subject to a 30% tax rate if it is not effectively connected with a U.S. trade or business.

This tax applies to your gross rental income. That means the full amount you collect before any expenses.

How it works: If your property rents for $2,000 per month, you owe $600 to the IRS each month. That's $7,200 per year on $24,000 in rental income.

The responsibility for paying this tax falls on you, your property manager, or even your tenant. The IRS doesn't send you a bill. You must calculate and remit the payment yourself.

The trade-off: You don't have to file a US tax return if you pay the 30% tax. However, you cannot deduct any expenses. No mortgage interest, no property taxes, no repairs, no depreciation. Nothing.

For most rental properties, this option results in a much higher tax bill than you would actually owe if expenses were considered and an income tax return is timely filed.

Option Two: Elect to Treat Rental Income as Effectively Connected With a US Trade or Business

The IRS allows foreign property owners to make an election under Internal Revenue Code Section 871(d). This election changes how your rental income is taxed and is done through inclusion in your income tax filing.

Instead of paying 30% of gross income, you file annual US tax returns reporting your net rental income. You can deduct all ordinary and necessary rental expenses against your rental income.

Common deductible expenses include:

- Mortgage interest
- Property taxes
- Insurance premiums
- Property management fees
- Repairs and maintenance
- Utilities you pay
- Legal and professional fees
- Depreciation on the building

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After deductions, many foreign rental property owners owe little or no tax. Some even show a loss that can offset future rental income.

Making the Election: Form W-8ECI

To make the election and avoid the 30% withholding, you must complete Form W-8 series forms and provide them to the relevant party(ies). The Form W-8BEN (foreign individuals) or W-8BEN-E (foreign entities) certifies your are foreign. Form W-8ECI certifies that your US rental income is effectively connected with a US trade or business.

You give these completed forms to whoever collects your rent. This could be your property manager, tenant, or agent. They are not sent to the IRS. They keep it on file to document why they're not withholding and sending 30% of your rent to the IRS.

Important requirement: Once you make this election, you must file a US tax return every year reporting your rental income and expenses. The election remains in effect for all future years unless you revoke it through proper procedures.

The Discovery Problem

Many foreign property owners learn about these requirements only when preparing to sell their rental property. At that point, they realize they haven't:

- Paid the 30% tax, or
- Filed annual tax returns with the election

Years of non-compliance create serious problems. All those years remain open for IRS assessment of taxes, penalties, and interest.

There is no perfect solution once you're in this situation. However, you have four paths forward.

While a taxpayer may have been also required to report the activity in their home country (or did so even if not required) this would not relieve them of the U.S. tax filing requirements.

Path One: File Late Returns Making the Election

You can file US tax returns for all prior years when the property was rented. In these returns, you make the Section 871(d) election to treat the rental activity as effectively connected with a US trade or business.

What this means: You report your rental income and claim all allowable deductions on Form 1040-NR for each year. If your expenses are high enough, you may owe little or no tax.

The risk: The IRS could disallow your election because you're making it late. If they do this, they can assess the 30% tax on your gross rental income for all those years. They would also add penalties and interest for late payment.

This risk is real but difficult to quantify. The IRS has discretion in these matters. Some taxpayers successfully make late elections. Others face assessments.

When this might work best: If your rental expenses significantly reduce your net income, this approach could save substantial money if the IRS accepts the late election.

Path Two: File Current Year Return Only, Pay 30% Tax on Current Year

You can file a tax return only for the year you sell the property. This return reports the sale. For the current year's rental income before the sale, you pay the 30% tax.

What this doesn't address: All prior years remain unreported. They stay open for potential IRS assessment of the 30% tax plus penalties and interest on those years.

The risk: The IRS could examine your return for the sale year and discover you owned and rented the property in prior years. This could trigger assessments for those years.

Why someone might choose this: Some foreign sellers take this approach hoping the IRS won't discover or pursue the prior years. This is a gamble.

Path Three: File Current Year Return Making the Election

You file a tax return for the sale year, making the Section 871(d) election. You report your rental income and expenses for that year and deduct them.

The same problem: All prior years remain unreported and open to IRS assessment.

Combined risks: You face both the risk that the IRS will disallow your late election for the current year AND the risk of assessment for prior years.

Marginally better than Path Two: At least for the current year, you're attempting to reduce your tax through deductions rather than paying 30% of gross rent.

Path Four: Pay the 30% Tax for All Prior Years

You can calculate and pay the 30% tax on the gross rental income for each year the property was rented.

How it works: Add up your total rent collected each year. Multiply by 30%. Send that amount to the IRS for each year.

The IRS will assess penalties and interest for late payment. These penalties compound over time, so older years carry higher penalty amounts.

The certainty: This approach provides certainty. You're paying what you should have paid under the 30% rule. The IRS may still assess penalties and interest, but the base tax amount is clear.

When this might work best: If you had minimal expenses or if you want certainty even though it costs more than filing with the election might cost.

Understanding the Penalties

Federal tax law imposes penalties for failure to file returns, failure to pay tax, and accuracy-related issues.

Failure to file penalty: Generally 5% of unpaid tax per month, up to 25% maximum.

Failure to pay penalty: Generally 0.5% of unpaid tax per month. The failure to pay penalty will not exceed 25% of your unpaid taxes

Interest: The IRS charges interest on unpaid tax from the due date until the payment date. Interest rates change quarterly.

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These penalties and interest compound over multiple years. A tax liability from five years ago carries substantially more in penalties and interest than the original tax amount.

Why Property Managers Matter

If you use a property management company, they should be aware of these requirements. A competent property manager will:

- Ask whether you're a US person or foreign person
- Request series W-8 forms as needed if you're foreign and want to avoid withholding
- Withhold and remit 30% of rent to the IRS if you don't provide Form W-8ECI
- Provide you with proper tax documentation

Many foreign property owners never receive this guidance from their property managers. Some managers are unaware of these obligations.

Your property manager's failure to withhold doesn't excuse your failure to comply. The IRS can pursue you, the property manager, or even the tenant for unpaid taxes.

Factors to Consider in Choosing Your Path

How much rental income did you collect? Higher income means higher potential tax liability and penalties.

How many years went unreported? More years mean more potential penalties and interest.

What were your expenses? If expenses nearly equal your income, making the election (even late) might result in minimal tax.

What is your risk tolerance? Some approaches provide more certainty but cost more. Others risk higher penalties but might result in less total payment.

Are you planning to return to or remain in the US? While this article cannot and does not provide legal or immigration advice, immigration consequences can result from tax problems. Having a tax lien or unpaid tax debt can affect visa applications and green card processes.

The Compliance Process

Regardless which path you choose, proper execution matters.

Gather complete records: Assemble rental income records, expense documentation, bank statements, and property management reports for all relevant years.

Calculate correctly: Determine your gross income, allowable deductions, and tax liability for each approach you're considering.

File properly: Use the correct forms (Form 1040-NR for nonresident aliens), complete all required schedules, and follow IRS instructions. It should be noted that all persons listed on title will need to file. It is incorrect for one person to report 100% of the activity.

Document your election: If making the Section 871(d) election, attach the required statement to your tax return.

Track correspondence: Keep copies of everything you send to the IRS and any responses you receive.

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When to Seek Professional Help

These situations are complex. The stakes are high. Most foreign property owners benefit from working with a tax professional who specializes in international tax matters.

A qualified advisor can:

- Analyze your specific situation
- Calculate potential tax liability under different scenarios
- Prepare accurate returns
- Communicate with the IRS on your behalf
- Help structure a compliance plan that minimizes your total cost

The cost of professional help is typically far less than the potential penalties for handling these matters incorrectly.

Prevention for Future Compliance

If you become compliant through any of these paths, stay compliant going forward.

File returns annually: Once you make the Section 871(d) election, file a return every year reporting your rental income and expenses.

Keep proper records: Maintain organized records of all rental income and expenses throughout the year.

Provide Form W-8ECI: Give your property manager or tenant an updated Form W-8ECI. Generally, a Form W-8ECI will remain valid for a period starting on the date the form is signed and ending on the last day of the third succeeding calendar year, unless a change in circumstances makes any information on the form incorrect.

For example, a Form W-8ECI signed on September 30, 2022, generally remains valid through December 31, 2025.

Monitor IRS correspondence: Ensure the IRS has your current address. Respond promptly to any IRS notices.

Plan for estimated taxes: If you owe tax after deductions, you may need to make quarterly estimated tax payments to avoid penalties.

Key Takeaways

Foreign nationals who own US rental property have tax obligations whether they know about them or not.

The default rule subjects rental income to 30% tax on gross amounts with no deductions allowed.

Making an election allows you to file returns, claim deductions, and typically owe less tax.

Years of unreported rental income create problems with no perfect solutions.

All four paths forward carry risks and costs. The choice you make depends on your specific situation.

Professional guidance should be considered essential for navigating these matters correctly and minimizing your financial exposure.

The most important step is taking action. Continued non-compliance only makes the problem worse. Each passing year adds more potential liability.

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Whether you're currently in compliance or discovering these requirements for the first time, understanding your obligations protects you from unnecessary penalties and helps you structure your rental activities tax-efficiently going forward.

Author’s Notes:

There are other planning opportunities related to the rental of U.S. real estate. Each situation is unique.

This article is not intended to be tax advice.

Real estate transactions involving foreign sellers present unique complexities. Each situation involves different property values, ownership structures, gain calculations, and timing and fact pattern considerations that affect the strategy that is right for you.

It is important to consult with tax professionals who regularly handle taxpayers with cross border issues or fact patterns that are more complex. The expertise of the professional is more important than where they are physically located. Professionals that have expertise in these matters can help ensure you understand your specific obligations and explore available options. Consulting with tax professionals who regularly handle international property transactions can help you maximize your profits and minimize your U.S. taxes.

I am happy to advise you on the options available to you in complying with determining if you are out of compliance and the requirements to bring yourself into compliance with U.S. tax law.

This information covers U.S. tax rules and regulations only. Your home country may have its own tax requirements for foreign property ownership and rental. These may result in different tax treatment than U.S. rules apply to the ownership. Consult with a tax advisor in your country familiar with cross border activity before finalizing your ownership structure or handling reporting of activity.

About the author:

David A Cumberland, CPA CGMA has presented at the local, state, and national level. David has authored articles intended for both the taxpayer and the tax professional. He is vice chair of the FICPA International tax committee and founder of Cumberland CPA & Co. which serves clients worldwide. He has published in the FICPA's Florida CPA Today magazine and produces client-based tax articles in English and Spanish to educate both current and prospective clients and advisors to those clients. He primarily practices in the area of inbound international tax work covering both individual and business tax preparation and consulting. Fluent in Spanish, his emphasis is working with international clients or clients with international considerations. David brings unique value and perspective to advising clients as a CPA as he has more than two decades of operational management experience in business in addition to a technical tax background. Having retired as lead shareholder of the International Tax Department of one of the largest independent certified public accounting firms in Southwest Florida his focus now is on continuing to serve clients he is passionate about in a boutique setting.

For full bio please click here or go to www.CumberlandCPA.com/about/

Questions or Inquiries can be sent to: ARTICLES@CumberlandCPA.com