



FLORES GROUP

INTERNATIONAL ATTORNEYS & ADVISORS

FIRPTA ALERT

FOREIGN INVESTORS IN U.S. REAL ESTATE PARTNERSHIPS

I. Introduction

Many foreign investors invest in US partnerships and joint ventures for their real estate investments. This Alert summarizes the principal U.S. federal tax implications where a U.S. partnership, including a U.S. limited liability company classified as a partnership for federal income tax purposes, owns U.S. real estate and admits one or more foreign partners.

II. Partnership Classification and General U.S. Tax Treatment

A partnership generally is not itself subject to federal income tax. Instead, it files an annual information return on Form 1065, and its income, gain, loss, deduction, and credit items flow through to its partners under Subchapter K of the Internal Revenue Code. See IRC sections 701, 702, 703, and 6031.

The allocation of partnership tax items is generally governed by IRC section 704, subject to the substantial economic effect rules and other partnership tax limitations. See Treas. Reg. section 1.704-1(b).

Where a partnership has foreign partners or items of international tax relevance, it may also be required to file Schedules K-2 and K-3. Schedule K-2 is an extension of Form 1065 Schedule K used to report items of international tax relevance, and Schedule K-3 is the partner-level extension of Schedule K-1 for such items.

III. Foreign Partner Treated as Engaged in U.S. Trade or Business

Under IRC section 875, a nonresident alien individual or foreign corporation that is a partner in a partnership engaged in a U.S. trade or business is generally treated as engaged in such U.S. trade or business. Accordingly, if the U.S. partnership's real estate activity constitutes a U.S. trade or business, the foreign partner's allocable share of income may be treated as effectively connected income ("ECI").

A foreign partner with ECI may be required to file a U.S. federal income tax return and pay U.S. tax on a net basis. A foreign individual generally files Form 1040-NR, while a foreign corporation generally files Form 1120-F. A foreign partnership, trust, or estate may have additional owner-level, beneficiary-level, or withholding reporting obligations.

IV. Rental Income from U.S. Real Estate

U.S. real estate rental income received by a foreign person may be taxed under different regimes depending on the facts. If the income is effectively connected with a U.S. trade or business, it is generally taxed on a net basis, allowing deductions such as depreciation, interest, real property taxes, repairs, insurance, management fees, and other properly allocable expenses.

If the income is not treated as effectively connected income, it may be treated as U.S.-source fixed or determinable annual or periodic income ("FDAP"), potentially subject to gross-basis withholding, generally at 30% unless reduced by an applicable treaty or statutory rule. See IRC sections 871(a), 881(a), 1441, and 1442.

In many real estate structures, foreign investors prefer net-basis taxation because net-basis treatment allows deductions. Proper structuring, elections, and documentation are essential.

V. Section 1446 Withholding on Foreign Partner's Share of ECTI

A. General Rule

The principal partnership-level compliance obligation is withholding under IRC section 1446. Under IRC section 1446(a), if a partnership has taxable income effectively connected with

the conduct of a U.S. trade or business, and any portion of that income is allocable under IRC section 704 to a foreign partner, the partnership must withhold and pay tax. Treasury Regulation section 1.1446-1 provides implementing rules for partnership withholding on ECTI allocable to foreign partners.

B. Withholding Applies Even Without Distributions

Section 1446 withholding may apply even if the partnership does not distribute cash to the foreign partner. This can create a cash-flow issue because withholding is based on allocable ECTI rather than actual cash distributions.

The partnership agreement should therefore authorize the partnership to withhold from distributions, make tax distributions, treat withholding as a partner-specific distribution or advance, require indemnification from foreign partners, and restrict transfers that would create withholding or compliance problems.

C. Forms 8804, 8805, and 8813

The partnership generally reports and pays section 1446 withholding using Form 8813 for quarterly payment vouchers, Form 8804 for the annual partnership withholding tax return, and Form 8805 for the foreign partner's information statement. Form 8805 reports the foreign partner's allocable share of ECTI and the corresponding withholding tax credit.

VI. FIRPTA: Sale of U.S. Real Property

A. General Rule Under IRC Section 897

The sale of U.S. real property by a foreign person is governed by FIRPTA. Under IRC section 897(a), gain or loss of a nonresident alien individual or foreign corporation from the disposition of a United States real property interest ("USRPI") is generally treated as effectively connected with a U.S. trade or business.

A USRPI generally includes direct interests in U.S. real property and certain equity interests in U.S. real property holding corporations. See IRC section 897(c).

B. FIRPTA Withholding Under IRC Section 1445

Under IRC section 1445, a transferee generally must withhold tax when acquiring a U.S. real property interest from a foreign transferor. Where the direct seller is a domestic

partnership, the seller itself is not a foreign transferor; however, if the domestic partnership sells U.S. real property and has a foreign partner, the foreign partner's allocable share of gain generally remains subject to U.S. tax, and the partnership must analyze its section 1446 withholding obligations.

In practice, for a domestic partnership selling U.S. real estate, the analysis often shifts from buyer-side FIRPTA withholding under section 1445 to partnership-level withholding under section 1446 with respect to the foreign partner's share of ECTI.

VII. Sale or Transfer of the Foreign Partner's Partnership Interest

A. Taxation Under IRC Section 864(c)(8)

A separate issue arises if the foreign partner sells or transfers its partnership interest rather than waiting for the partnership to sell the underlying real estate. Under IRC section 864(c)(8), if a nonresident alien individual or foreign corporation owns, directly or indirectly, an interest in a partnership engaged in a U.S. trade or business, gain or loss from the sale or exchange of all or part of that partnership interest is treated as effectively connected with such U.S. trade or business to the extent provided by the statute. Treasury Regulation section 1.864(c)(8)-1 provides rules for determining the portion of gain or loss treated as effectively connected gain or loss.

B. Withholding Under IRC Section 1446(f)

Under IRC section 1446(f), the transferee of a partnership interest from a foreign transferor may be required to withhold tax, generally equal to 10% of the amount realized, unless an exception applies. This rule is particularly important because withholding may be based on the amount realized, not merely the foreign partner's taxable gain. Amount realized may include cash, property, and the partner's share of partnership liabilities.

VIII. Treaty Considerations

An applicable U.S. income tax treaty may affect the taxation of the foreign partner, particularly where the foreign partner is resident in a treaty jurisdiction. However, treaty relief is limited in the U.S. real estate context. Most U.S. tax treaties preserve U.S. taxing rights over income and gains from U.S. real property.

Treaty positions generally require proper documentation and disclosure, including appropriate withholding certificates and, where applicable, Form 8833 treaty-based return position disclosure. The partnership should not assume treaty relief applies unless the foreign partner provides appropriate documentation and the tax advisors confirm the position.

IX. Conclusion

A U.S. partnership that owns U.S. real estate may admit a foreign partner, but doing so creates significant U.S. federal tax and withholding obligations. The most important federal tax rules include IRC section 875, section 1446, section 897, section 1445, section 864(c)(8), and section 1446(f).

The partnership should implement withholding procedures, obtain appropriate IRS documentation, review the partnership agreement, and analyze the foreign partner's status before admission. The structure is workable, but it requires careful coordination among partnership tax, international tax, real estate, state tax, and estate planning advisors.

X. Disclaimer

This Alert is for general informational and planning purposes only and does not constitute legal, tax, accounting, or investment advice. Application of the rules discussed above depends on the specific facts and should be reviewed by qualified U.S. tax counsel before implementation.

We are International Attorneys and Advisors and we strive to provide our clients the highest quality of legal and tax representation in the complex area of tax law.

This alert has provided only general information and specific factual scenarios may change any conclusions that would apply.

We strongly recommend you consult a corporate and tax attorney regarding your particular case. Should you need additional information it will be our pleasure to assist you.

Sincerely,

Ruben Flores, Attorney & CPA