



FLORES GROUP

INTERNATIONAL ATTORNEYS & ADVISORS

FIRPTA ALERT

FOREIGN INVESTMENT IN U.S. REAL PROPERTY THROUGH TRUSTS

I. Introduction

The Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”), principally Internal Revenue Code Sections 897 and 1445, generally subjects a foreign person’s gain from the disposition of a United States real property interest (“USRPI”) to U.S. federal income tax. Section 1445 supports collection of that tax through withholding.

FIRPTA is not merely a 15% tax. The commonly cited 15% amount is generally a withholding payment based on the gross amount realized, including cash, other property, and assumed liabilities. The foreign transferor’s actual federal income-tax liability is calculated separately on the applicable return. Withholding may be more or less than the final tax.

A trust does not, merely by holding title, eliminate FIRPTA. The result depends on four separate classifications:

1. Whether the trust is domestic or foreign.
2. Whether it is a grantor or nongrantor trust.
3. Whether the relevant owner, beneficiary, or transferor is a U.S. or foreign person.

4. Whether the trust holds real estate directly or through an LLC, partnership, corporation, REIT, or other entity.

II. FIRPTA Applies to USRPI

A. U.S. real property interests (USRPI)

In general, FIRPTA applies to dispositions of USRPI which includes:

- Direct ownership of land, buildings, and improvements located in the United States or U.S. Virgin Islands.
- Certain personal property associated with the use of real property.
- An option or contractual right to acquire a USRPI.
- Stock of a domestic corporation that is or was a U.S. real property holding corporation during the relevant testing period, unless an exception applies.
- Certain interests in partnerships, trusts, estates, REITs, and other entities whose value is attributable to U.S. real property.

A mortgage held solely as a creditor is generally not a USRPI, although participating debt, equity-like rights, conversion rights, or profit interests may produce a different result.

B. Tax and FIRPTA withholding

Section 897 treats a foreign person's gain from disposing of a USRPI as income effectively connected with a U.S. trade or business. The foreign person generally must file a U.S. return and compute tax on net taxable gain after allowable basis and deductions.

Section 1445 generally requires the transferee to withhold 15% of the amount realized, not 15% of the gain. The amount realized includes:

- Cash paid or payable.
- Fair market value of other property transferred.

- Liabilities assumed by the buyer.
- Liabilities to which the property remains subject.

The buyer is normally the withholding agent and may be personally liable for a failure to withhold. Different withholding computations apply to certain trusts, estates, partnerships, corporations, and REITs.

III. FIRPTA and Trusts Rules

In order to determine if and how FIRPTA applies to a trust the first thing to determine if the trust is domestic or foreign and then if the trust is revocable or irrevocable.

A. Domestic versus foreign trust

A trust is a domestic trust for U.S. federal tax purposes only if:

1. A U.S. court can exercise primary supervision over its administration; and
2. One or more U.S. persons control all substantial trust decisions.

Failure of either requirement generally makes the trust a foreign trust.

The trust's governing-law clause, place of signing, situs designation, or use of a U.S. bank account does not alone determine the result. Trustee powers, protector powers, removal and replacement rights, migration clauses, distribution powers, investment authority, and actual administration must be reviewed.

B. Grantor versus nongrantor trust

Grantor-trust status is a separate determination under Sections 671 through 679.

A revocable trust is usually a grantor trust because the settlor retains the power to re-vest title in himself or herself. An irrevocable trust can also be a grantor trust if the settlor or another person retains specified powers, interests, borrowing rights, substitution rights, reversionary interests, or control.

Where the trust is a grantor trust, the deemed owner generally reports the trust's income and dispositions as though the owner held the assets directly.

IV. Revocable Trust Investing in U.S. Real Estate

A. Foreign settlor's revocable trust

Assume a nonresident alien creates a revocable trust and contributes U.S. real property to it. The settlor retains the right to revoke the trust and is treated as the owner for federal income-tax purposes.

The trust generally does not protect the settlor from FIRPTA. When the property is sold:

- The foreign settlor is treated as the relevant owner or foreign transferor.
- FIRPTA applies to the foreign-owned portion.
- The applicable fiduciary and closing parties must comply with the grantor-trust withholding rules.
- The settlor generally reports the gain on Form 1040-NR.
- Basis, depreciation, recapture, capital-gain rules, and transaction expenses are calculated at the owner level.

The IRS has specifically indicated that FIRPTA withholding applies when a USRPI is held in a grantor trust and a foreign person is treated as a grantor or owner of all or part of the property.

B. Mixed U.S. and foreign grantors

Where spouses or other persons are treated as separate owners of portions of the grantor trust, FIRPTA generally applies to the foreign-owned portion.

The parties cannot simply assign all proceeds or gain to a U.S. spouse to eliminate withholding. Ownership, capital contributions, local property law, the trust instrument, and the grantor-trust rules control the allocation. IRS FIRPTA guidance generally allocates the amount realized among co-transferors according to their capital

contributions and treats a husband and wife as having contributed 50% each for this purpose. The title documents, trust instrument, grantor-trust treatment, and underlying facts should be reviewed to confirm the persons treated as owners and transferors

C. Domestic revocable trust does not solve the issue

A revocable trust may satisfy the domestic trust court and control tests, but that does not necessarily cause the foreign grantor to become a U.S. person. The grantor-trust rules look through the trust.

Accordingly, changing the trust's situs, naming a U.S. trustee, or using a U.S. revocable living trust generally does not by itself eliminate FIRPTA when a foreign person remains the deemed owner.

D. Transfer into the trust

A transfer of property into a revocable trust often does not produce immediate income-tax gain because the transfer is disregarded as a transfer to the grantor's own grantor trust. Nevertheless:

- The deed and title structure must be coordinated with local law.
- Existing financing may create due-on-sale or lender-consent issues.
- A transfer involving liabilities, multiple grantors, changes in beneficial ownership, or a previously nongrantor trust may be taxable.
- Gift and estate tax consequences remain separate from FIRPTA.
- A transfer that is tax-free does not erase the property's FIRPTA character.

V. Irrevocable Trust Investing in U.S. Real Estate

An irrevocable trust is divided into at least four categories.

A. Foreign irrevocable grantor trust

An irrevocable trust may remain a grantor trust. For example, a foreign settlor may retain powers or interests that cause the settlor to be treated as owner.

If the foreign settlor is treated as owner:

- The trust is generally transparent for U.S. income-tax purposes.
- A sale of U.S. real estate remains a foreign owner's disposition of a USRPI.
- FIRPTA withholding applies under the grantor-trust rules.
- The foreign owner generally reports the gain.
- Irrevocability alone provides no FIRPTA exemption.

This structure may offer succession, probate, confidentiality, governance, or non-tax benefits, but it normally does not eliminate FIRPTA.

B. Foreign irrevocable nongrantor trust

A foreign nongrantor trust is generally a separate foreign taxpayer. If it directly holds and sells U.S. real estate:

- The trust is a foreign person disposing of a USRPI.
- FIRPTA generally applies.
- The trust generally files Form 1040-NR if treated as a foreign trust taxable in the manner of a nonresident alien.
- Income accumulated in or distributed from the trust must also be analyzed under the foreign-trust DNI and UNI rules.

- U.S. beneficiaries may have Forms 3520, 3520-A, Form 8938, or related reporting issues depending on the facts.
- State fiduciary-income-tax and property-tax consequences may apply.

Using a foreign nongrantor trust can therefore add complexity without removing FIRPTA.

C. Domestic irrevocable grantor trust

A trust may be domestic while the foreign settlor or another foreign person remains its deemed owner under the grantor-trust rules.

Treasury regulations provide that the fiduciary withholding rules can apply even when the grantor or another person is treated as the owner. In a grantor-trust disposition, the fiduciary generally withholds by reference to the gain allocable to the foreign deemed owner.

D. Domestic irrevocable nongrantor trust

A domestic nongrantor trust is generally a U.S. person and a separate U.S. taxpayer. Accordingly, its direct sale of a USRPI ordinarily is not subject to the purchaser-withholding rule under Section 1445(a), because the transferor is not a foreign person. The trust nevertheless remains subject to U.S. federal income tax on any recognized gain. If the trust has one or more foreign beneficiaries, special fiduciary-withholding rules under Section 1445(e)(1) may apply.

When a domestic nongrantor trust with foreign beneficiaries disposes of a USRPI, the fiduciary must generally establish a USRPI account for the taxable year. Gains and losses from USRPI dispositions are entered into that account.

The fiduciary generally must withhold at the applicable Section 1445(e)(1) rate—currently 21%—on a distribution to a foreign beneficiary that is attributable to the balance in the USRPI account. For this purpose, distributions during the year are treated as coming first from the USRPI account.

Important consequences include:

- The trust's U.S. status does not automatically remove all FIRPTA-related withholding.
- Withholding depends partly on whether the trust has foreign beneficiaries and whether distributions are made during the disposition year.
- The USRPI account generally starts at zero each year, and an undistributed year-end balance is not carried forward under the regulation.
- Accumulating sale proceeds in the trust through the end of the disposition year may change the Section 1445(e) withholding result, but it does not necessarily eliminate the trust's U.S. income tax or later Chapter 3 withholding.
- The governing instrument, fiduciary accounting income, DNI, capital-gain allocation, distribution deductions, and state law must be coordinated.

A domestic nongrantor trust may therefore be useful for controlled accumulation and multigenerational planning, but it should not be represented as a general FIRPTA exemption.

VI. Conclusion

A trust can be an important vehicle for foreign investment in U.S. real estate. Depending on its classification, ownership, beneficiaries, and investment structure, it may change which FIRPTA withholding provisions apply and, in limited circumstances, may avoid purchaser withholding under Section 1445(a). It does not necessarily eliminate U.S. income tax or all FIRPTA-related withholding obligations.

A foreign person's revocable trust usually remains transparent, and FIRPTA applies as though the foreign settlor owned the property directly. An irrevocable trust must be separately classified: a foreign or domestic grantor trust generally remains subject to

look-through treatment, while a foreign nongrantor trust is itself a foreign taxpayer. A domestic nongrantor trust may change the withholding mechanics and permit controlled accumulation, but special Section 1445(e) rules apply to distributions associated with USRPI gain.

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.^[1]

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,

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