



FLORES GROUP

INTERNATIONAL ATTORNEYS & ADVISORS

FIRPTA ALERT

USING LEGAL ENTITIES TO REDUCE FIRPTA TAXATION IN U.S. REAL ESTATE

1. Overview of FIRPTA

The Foreign Investment in Real Property Tax Act of 1980, commonly referred to as **FIRPTA**, is principally contained in Internal Revenue Code §§ 897 and 1445. FIRPTA is intended to ensure that foreign persons pay U.S. federal income tax on gains arising from investments in U.S. real property.

FIRPTA does not impose a separate or additional tax. Instead, IRC § 897 treats gain realized by a foreign person from the disposition of a **United States real property interest**, or USRPI, as income effectively connected with a U.S. trade or business. As a result, the foreign investor must generally file a U.S. income tax return and pay U.S. federal income tax on the actual taxable gain.

FIRPTA is supported by a separate withholding system under IRC § 1445. In most direct sales of U.S. real property by a foreign seller, the purchaser must withhold **15% of the total amount realized**. The amount realized generally includes cash paid, the value of other property transferred, and liabilities assumed by the purchaser or to which the property remains subject.

The withholding is not the final tax. It is a collection mechanism and is credited against the foreign seller's actual U.S. tax liability. If the amount withheld exceeds the final tax, the seller generally claims a refund by filing the applicable U.S. income tax return.

2. Property Subject to FIRPTA

FIRPTA applies to the disposition of a USRPI. A USRPI generally includes:

- Land and buildings located in the United States;
- Leasehold interests;
- Options to acquire U.S. real property;
- Mines, wells, and natural deposits;
- Certain personal property associated with the use of U.S. real estate; and
- Stock in certain domestic corporations that hold substantial U.S. real property.

A domestic corporation is generally treated as a **United States real property holding corporation**, or USRPHC, when the fair market value of its U.S. real property interests equals or exceeds 50% of the combined value of its U.S. real property, foreign real property, and other business assets.

Consequently, a foreign shareholder's sale of stock in a domestic corporation can be subject to FIRPTA even though the shareholder is selling stock rather than the real estate itself.

Certain exceptions may apply. These include the publicly traded stock exception for qualifying minority shareholders, the domestically controlled REIT exception, the qualified foreign pension fund exemption, and the cleansing rule for certain former USRPHCs that have disposed of all U.S. real property in fully taxable transactions.

An interest held solely as a creditor generally is not a USRPI. Therefore, genuine debt secured by U.S. real property is normally treated differently from an equity ownership interest.

However, purported debt may be recharacterized as equity where the terms and economic substance do not support true debtor-creditor treatment.

3. Foreign Persons Subject to FIRPTA

A foreign person generally includes:

- A nonresident alien individual;
- A foreign corporation;
- A foreign partnership;
- A foreign trust; and
- A foreign estate.

A nonresident alien is generally an individual who is neither a U.S. citizen nor a U.S. resident under the green-card test, substantial-presence test, or another applicable residency rule.

A corporation formed outside the United States is generally a foreign corporation. A partnership formed under foreign law is ordinarily treated as a foreign partnership.

A trust is considered foreign unless it satisfies both the U.S. court test and the U.S. control test. The court test requires a U.S. court to be able to exercise primary supervision over the trust's administration. The control test requires U.S. persons to control all substantial trust decisions.

The classification of a trust as domestic or foreign is separate from its classification as a grantor or nongrantor trust. A foreign grantor trust generally attributes ownership and income to the foreign grantor. A nongrantor trust is generally treated as a separate taxpayer.

A domestic single-member LLC owned by a foreign person generally does not eliminate FIRPTA. If the LLC is disregarded for federal income tax purposes, the foreign owner is treated as the actual owner and seller of the real property.

U.S. citizens, resident aliens, domestic corporations, domestic partnerships, domestic trusts, and domestic estates generally are not foreign persons for FIRPTA purposes, although they may have separate withholding and reporting obligations when foreign owners or beneficiaries are involved.

4. Taxation and Withholding Rules

The foreign seller's taxable gain is generally calculated by subtracting adjusted tax basis and allowable selling expenses from the amount realized. Adjusted basis includes acquisition costs and capital improvements and is reduced by depreciation allowed or allowable.

The gain may consist of long-term capital gain, short-term capital gain, depreciation recapture, unrecaptured IRC § 1250 gain, or ordinary income components.

A nonresident alien individual generally reports FIRPTA gain on Form 1040-NR. Long-term capital gain rates may apply, while depreciation recapture and other ordinary-income components may be taxed at higher individual rates.

A foreign corporation generally reports FIRPTA gain on Form 1120-F and is subject to the federal corporate income tax rate. A foreign corporation may also be subject to the branch profits tax under IRC § 884.

The general FIRPTA withholding rate is 15% of the amount realized. For example, if a foreign seller receives \$3 million in cash and the buyer assumes a \$2 million mortgage, the amount realized is generally \$5 million. The required withholding would normally be \$750,000, even if the seller's actual taxable gain is substantially less.

The purchaser is generally responsible for withholding and can be held personally liable for failing to withhold. The purchaser ordinarily files Forms 8288 and 8288-A and remits the withholding by the twentieth day after the transfer.

Limited exceptions apply. For example, withholding may be reduced or eliminated when:

- The seller provides a valid nonforeign affidavit;
- The property is acquired as the buyer's residence and the purchase price falls within the statutory thresholds;
- The property transferred is stock properly certified as not being a USRPI;
- A qualifying nonrecognition transaction applies; or
- The IRS issues a withholding certificate.

A foreign seller may file Form 8288-B to request reduced or eliminated withholding where the anticipated tax is less than 15% of the gross proceeds. This is particularly important when the seller has a high basis, a small gain, or a loss.

Special withholding rules apply to partnerships, corporations, trusts, estates, and REITs. A foreign partner's share of partnership effectively connected income may be subject to withholding under IRC § 1446(a). A foreign partner's sale of a partnership interest may be subject to 10% withholding under IRC § 1446(f).

A trust or estate that recognizes FIRPTA gain may be required to maintain a USRPI account. Distributions attributable to that account and made to a foreign beneficiary may be subject to 21% withholding.

5. Use of Corporate Structures

Corporate structures may manage or reduce certain FIRPTA consequences, but they do not automatically eliminate U.S. tax.

Direct ownership by a foreign individual generally results in one level of federal income tax and may allow favorable individual capital-gain rates. However, it creates direct FIRPTA withholding and may expose the investor to U.S. estate tax.

A domestic LLC that is disregarded provides liability protection but generally produces the same federal income-tax and FIRPTA result as direct ownership.

A domestic partnership or LLC taxed as a partnership generally provides single-level taxation and flexible allocations. However, gain passes through to foreign partners, and both partnership-level withholding and partnership-interest transfer withholding may apply.

A domestic C corporation can act as a blocker and may reduce the need for the foreign shareholder to file annual personal U.S. tax returns. It may also provide U.S. estate-tax planning benefits because domestic corporate stock is generally treated differently from direct real-property ownership for estate-tax purposes. Nevertheless, the corporation pays tax on its income and gain, dividends to foreign shareholders may be subject to withholding, and the corporation's stock may itself be subject to FIRPTA if the corporation is a USRPHC.

A foreign corporation may permit the investor to own foreign corporate stock rather than U.S. real property directly. The sale of foreign corporation stock is generally not itself subject to FIRPTA. However, the foreign corporation remains subject to U.S. tax when it sells the U.S. real property and may also be subject to branch profits tax. A purchaser of the foreign corporate stock may discount the purchase price because the corporation retains the built-in U.S. tax liability.

A commonly used structure consists of a foreign holding corporation owning a U.S. corporate subsidiary that owns the real property. This structure may provide estate-tax protection, centralized U.S. compliance, and possible treaty benefits on dividends. However, it may also create corporate tax, dividend withholding, and FIRPTA exposure upon the sale of the U.S. subsidiary's stock.

6. Use of Trusts

Trusts are commonly used for succession planning, governance, asset protection, and estate planning. However, a trust generally does not eliminate FIRPTA merely by holding title to U.S. real estate.

In a foreign grantor trust, the foreign grantor is generally treated as owning the property. FIRPTA therefore applies as though the grantor owned and sold the property directly.

A domestic grantor trust may also be treated as owned by a foreign grantor. The fact that the trust is domestic does not by itself convert the foreign owner into a U.S. person.

A domestic nongrantor trust is a separate U.S. taxpayer. It may centralize U.S. reporting and provide succession and estate-planning benefits. Nevertheless, it may be taxed at compressed trust tax rates, may be subject to the net investment income tax, and may have withholding obligations when distributions attributable to FIRPTA gain are made to foreign beneficiaries.

A foreign nongrantor trust is a foreign person and is directly subject to FIRPTA when it disposes of U.S. real property. It also introduces substantial foreign-trust reporting, beneficiary reporting, and accumulation-distribution complications.

Trusts may own corporate or partnership entities that hold the real estate. Such structures can improve governance, succession, and liability separation, but all levels of income tax, withholding tax, estate tax, and trust taxation must be analyzed.

7. Conclusion

FIRPTA ensures that foreign investors are taxed on gains arising from U.S. real property. The substantive tax is imposed on actual taxable gain, while the withholding system generally requires collection of 15% of gross proceeds.

Corporate entities and trusts can materially affect the timing, rate, reporting, estate-tax exposure, withholding obligations, and exit alternatives associated with U.S. real estate investments. However, each structure involves tradeoffs. The proper structure should be selected before acquisition after comparing annual operating income, sale alternatives, repatriation, estate tax, treaty eligibility, state tax, home-country tax, and the investor's intended exit strategy.

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.

The Flores group

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This alert has provided only general information and specific factual scenarios may change any conclusions that would apply.^[1]_{SEP}

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