LEGISLATION TO RELAX F.I.R.P.T.A. GETS BIPARTISAN SUPPORT

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Tax legislation to encourage foreign investment in U.S. real estate made through real estate investment trusts ("R.E.I.T.'s") was recently introduced in both the House and the Senate. Representatives Kevin Brady (R-T.X.) and Joe Crowley (D-N.Y.), introduced H.R. 2128, the "Real Estate Investment and Jobs Act of 2015." The measure, backed by 22 bipartisan members of the U.S. House of Representatives, would make significant changes to the Foreign Investment in Real Property Tax Act ("F.I.R.P.T.A."). The bill is similar to legislation Representatives Brady and Crowley introduced in the last session of Congress, as well as a companion version introduced in the U.S. Senate this year, co-authored by Senators Mike Enzi (R-W.Y.) and Bob Menendez (D-N.J.), S. 915. The Senate version would adopt additional changes including a proposed increase in F.I.R.P.T.A. withholding tax rates that would complicate investing by those not benefitting from the proposals. Enactment of the significant provisions in H.R. 2128 and S. 915 would signify an important step toward achieving F.I.R.P.T.A. reforms that have been advocated for by a number of real estate organizations for many years.

R.E.I.T. QUALIFICATION

A R.E.I.T. is a creation of the tax law. Any corporation, trust, or unincorporated entity may qualify as a R.E.I.T. if it meets the requirements of Code §856. A benefit of R.E.I.T. status is that it is a conduit for tax purposes, provided distributions are made to shareholders. No tax is imposed on the R.E.I.T. if it distributes all its income to its owners. The R.E.I.T. claims a deduction for dividends that it pays to its shareholders. In addition, a shareholder of the R.E.I.T. may be able to treat a dividend from the R.E.I.T. as taxable at capital gains rates if the underlying income of the R.E.I.T. that generates the dividend arises from the sale of an asset.

Qualifying as a R.E.I.T. requires compliance with many rules. Some of the primary requirements are the following:

1. Income Tests. For each taxable year of the R.E.I.T., the R.E.I.T. must meet two income tests: a 75% test and a 90% test. The purpose of these tests is to ensure that the primary source of the R.E.I.T.'s income is real estate rentals, interest on real estate mortgage loans, gains from the sale of real estate, and certain other passive income.

2. Asset Tests. On the last day of each quarter of the R.E.I.T.'s taxable year, 75% or more of its assets must be real estate assets, cash and cash items, or governmental securities.

3. Distribution Requirement. A R.E.I.T. must annually distribute 90% or more of its income to its shareholders. However, because the R.E.I.T. remains taxable on its retained income, most R.E.I.T.'s will distribute 100% of income

to shareholders in order to eliminate all corporate level tax on the R.E.I.T.

4. Non-Closely Held Requirement. Ownership of more than 50% of the value of the R.E.I.T.'s shares cannot be held by five or fewer individuals. Sometimes, all the common stock of a R.E.I.T. may be owned by a corporation or mutual fund. In that case, a "look-through" rule applies so that a single corporate shareholder is permissible as long as five or fewer individuals do not own more than half of the R.E.I.T. as determined under attribution rules for determining the R.E.I.T.'s shareholders.

5. 100-Shareholder Requirement. The R.E.I.T. must have 100 or more shareholders. This rule is usually satisfied by the R.E.I.T. issuing preferred stock to 100 or more persons. To illustrate: each person buys preferred stock for $1,000, which entitles them to an annual dividend equal to a specified percentage of the $1,000 (such as 12% of $1,000) and a return of their $1,000 upon liquidation of the R.E.I.T.

6. Election Requirement. The corporation must elect to be treated as a R.E.I.T.

7. Domestic Corporation Requirement. A non-U.S. entity cannot elect R.E.I.T. status. If the R.E.I.T. election is not made, the entity must be taxed as a domestic corporation. This means that it must be formed under the laws of one of the 50 states or the District of Columbia.

TAXATION OF R.E.I.T.'S AND THEIR FOREIGN SHAREHOLDERS

F.I.R.P.T.A. imposes U.S. Federal income tax on the gain realized by a foreign investor on the sale of stock of any U.S. corporation that is a U.S. real property holding corporation ("U.S.R.P.H.C."). Investments in R.E.I.T.'s are one way a foreign investor can choose to invest in U.S. real estate. Some R.E.I.T.'s are held by an appropriately sized private group, while others have shares that are publicly traded. In either case, the sale of R.E.I.T.'s stock can subject the foreign investor to U.S. tax under F.I.R.P.T.A., subject to certain exceptions. The proposals seek to expand the list of exceptions.

In addition, a R.E.I.T. can make two types of distributions to its shareholders: (i) ordinary dividends that can come from real estate rental income or interest on real estate mortgages and (ii) capital gains dividends that can come from the sale of real estate owned by the R.E.I.T. Ordinary dividends are not subject to U.S. tax under F.I.R.P.T.A. but are subject to the regular 30% U.S. withholding tax imposed on passive income. The rate of tax may be subject to reduction by operation of a tax treaty, although typically the rate is not reduced below 15% and applies to persons holding a limited interest in the R.E.I.T. By contrast, capital gains dividends are subject to tax under F.I.R.P.T.A. The R.E.I.T. is required to withhold tax from the dividend at the highest relevant tax rate on capital gains and the investor is required to file a U.S. tax return and to pay 30% branch profits if the investor is a corporation.

LEGISLATIVE PROPOSALS

Certain exceptions to F.I.R.P.T.A. can apply to capital gains dividends; the proposals seek to expand those exceptions in order to encourage greater equity investment into U.S. real estate. The legislative proposals would increase the amount of stock in a publicly-traded R.E.I.T. that a foreign investor may hold without becoming subject to tax under F.I.R.P.T.A. on the disposition of that R.E.I.T. stock. The goal is to encourage foreign ownership of R.E.I.T. stock, which may enhance foreign investment in U.S. real property.

“The bills would increase the level of ownership that may be held without taxing gain on the sale of those shares. The 5% threshold under current law would be increased to 10% for investment in a publicly traded R.E.I.T.”

The proposals may be summarized as follows:

- Current law allows for a F.I.R.P.T.A. exception when a foreign shareholder sells stock in a publicly traded corporation in which the investor holds 5% or less of the outstanding stock during the relevant stock ownership period. Publicly traded R.E.I.T.'s tend to take advantage of this exception. The bills would increase the level of ownership that may be held without taxing gain on the sale of those shares. The 5% threshold under current law would be increased to 10% for investment in a publicly traded R.E.I.T. If the threshold is not exceeded, the sale of stock in the publicly traded R.E.I.T. will not be subject to U.S. tax. However, the 5% threshold would continue for investment in a publicly traded corporation that is a U.S.R.P.H.C. but not a R.E.I.T.
- Current law allows for a publicly traded R.E.I.T. to classify a capital gains dividend as an ordinary dividend if paid to a shareholder owning 5% or less of its stock. Ordinary dividend treatment eliminates application of F.I.R.P.T.A. and the requirement to file U.S. tax returns and possibly pay branch profits tax. The proposed bills would increase the 5% threshold to 10%.
- A new exemption from tax under F.I.R.P.T.A. is proposed for any R.E.I.T. stock held by a qualified shareholder owning not more than 10% of the R.E.I.T. directly or through attribution from others. If an investor holds more than 10% of the R.E.I.T. stock and the shareholder is a qualified shareholder, only a portion of the shares will be considered to be a U.S.R.P.I. A qualified shareholder is defined as a foreign person that:
    - Is eligible for the benefits of a comprehensive income tax treaty that includes an exchange of information program;
    - Is a qualified collective investment vehicle;
    - Has its principal class of interests listed and regularly traded on one or more recognized stock exchanges (as defined in the applicable treaty); and
    - Maintains records on the identity of each person who, at any time during the qualified shareholder's taxable year, is the direct owner of more than 10% of that principal class of interests.
- A new exemption from F.I.R.P.T.A. is provided for foreign pension funds investing in any U.S.R.P.I., which includes an investment in a R.E.I.T. or a direct investment in U.S. real estate or an investment in a partnership holding U.S. real estate. Proposed §897(i) adds this new exemption and defines a foreign pension plan to be a non-U.S. entity that is formed to provide retirement or pension benefits to beneficiaries who are current or former employees of one or more employers. Other conditions for foreign pension fund status are also required. The House and Senate proposals differ on this point, as the Senate

bill does not contain this new exemption.

- Current law provides that an investment in a domestically controlled R.E.I.T. is not a U.S. real property interest subject to F.I.R.P.T.A. This exemption applies to an investment in a publicly traded R.E.I.T. or a private R.E.I.T. There is no restriction on how much stock can be held to take advantage of this exemption. A foreign investor can own 1%, 5%, or 25% of the R.E.I.T. and still get the exemption. A R.E.I.T. is domestically controlled if less than 50% of the value of the R.E.I.T. shares is held by non U.S. persons at all times within the five-year period ending on the date of disposition of the R.E.I.T. stock. In PLR 200923001, the I.R.S. ruled that a U.S. corporation is a U.S. person and not a foreign person even if the U.S. corporation is controlled by foreign persons. However, determination of whether a R.E.I.T. is domestically controlled can be very difficult. The provision contains several new presumptions for purposes of determining if a R.E.I.T. is domestically controlled. Again, the House and Senate proposals differ, as only the Senate bill contains this provision.

- As a mechanism for enforcement, F.I.R.P.T.A. imposes a withholding tax on the buyer of the U.S. real estate. This compliance provision currently imposes a 10% withholding tax on the amount realized on the sale. The Senate Finance Committee is concerned that some foreign persons may fail to file the required U.S. tax returns under F.I.R.P.T.A. since the tax they owe may be more than the tax withheld. Those persons may escape paying the full U.S. tax on their gain from the disposition of the U.S.R.P.I. Therefore, the Senate bill (but not the House bill) has proposed to increase the 10% F.I.R.P.T.A. withholding obligation to 15%. There is an exception to the increased rate of withholding for sales of residences intended for personal use by the acquirer, with respect to which the purchase price does not exceed $1,000,000. No matter what the rate, relief from over-withholding exists if, prior to a sale, a Form 8288-B was filed requesting reduced withholding tax or its elimination in order to match the amount withheld with actual tax liability.

- Additional changes are contained in the Senate bill. Of these, an important change is a disclosure requirement of U.S.R.P.H.C. status for any U.S. corporation.

CONCLUSION

While proposals to liberalize F.I.R.P.T.A. have been made many times before, they have never been enacted. Now, these bipartisan efforts signal the chance that new legislation may finally be on the horizon.