



FIRPTA, Section 892 and REITS

ABA Tax Section: Real Estate Committee

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Principal Topics

- Overview of Taxation of Foreign Persons
- Taxation of Income/Gains from Investment in U.S. Real Estate
- Planning Considerations and Alternative Structures

Overview of Taxation of Foreign Persons

Income Taxation of Nonresident Aliens and Foreign Corporations

- Only Certain Income Taxed
 - Income Effectively Connected with a U.S. Business (“ECI”)
 - Net basis at regular rates
 - FC subject to BPT at 30% or lower treaty rate
 - Fixed, Determinable, Annual or Periodical Income (“FDAP”) from U.S. Sources
 - Gross basis at 30% or lower treaty rate
 - Includes interest, dividends, rents, royalties
 - Exception for portfolio interest, described below
 - Capital Gains not FDAP, but taxable at 30% rate if NRA in U.S. for 183 Days or More
 - Rare
 - Gain from disposition of U.S. real property interests (“FIRPTA”)
 - Treated as ECI
 - Partnership look-through rules apply
- Section 1411 NII tax not applicable

Estate and Gift Taxation of NRAs

- Only U.S. Situs Assets Subject to Tax
- Intangibles Exempt from Gift Tax
 - Stock of US corporation
 - Probably a partnership interest
 - IRS does not concede; may argue for aggregate approach
 - Cf. Rev. Rul. 91-32
 - U.S. Situs Assets Include:
 - Real Property Located in the U.S.
 - Shares of Stock in a U.S. Corporation
 - Tangible Personal Property Located in the U.S.
 - Certain Debt Obligations of U.S. Persons and the U.S. Government (and its subdivisions, including states)
 - Intangible Property Used in the U.S.

Taxation of Income/Gains from Investments in U.S. Real Estate

FIRPTA - Overview

- Foreign persons taxed on gain from disposition of United States real property interest (“USRPI”) as ECI
 - Same tax rates as applicable to US persons
- Buyer required to withhold 10% of amount realized from foreign seller
 - Arbitrary and may exceed tax due
 - May request withholding certificate by filing Form 8288-B
- USRPI generally includes
 - Land, buildings, improvements, etc.
 - Any other interest, other than solely as a creditor, in real property
 - Does not necessarily include debt secured by real property
 - Is there a kicker?
 - stock of US corporation that is (or, during 5-year or shorter look-back period, was) a US real property holding corporation (“USRPHC”)
- Corporation is a USRPHC if USRPIs represent 50% or more of USRPIs, plus foreign real property, plus assets used in a trade or business

The USRPHC Trap

- Per section 897(c)(1)(A)(ii) a USRPI includes any interest in a domestic corporation (other than solely as a creditor) “unless the taxpayer establishes (at such time and in such manner as the Secretary by regulations prescribes) ...” that the corporation was not a USRPHC at any time during the applicable lookback period.
- Per Treas. Reg. sec. 1.897-2(g), a foreign person disposing of an interest in a domestic corporation (other than solely as a creditor) “must” establish that the interest was not a USRPI either by obtaining (A) a statement from the corporation, or (B) a determination from the IRS.
- If the foreign person does not do so, then “the interest shall be presumed to have been a U.S. real property interest the disposition of which is subject to section 897(a).”
 - The IRS views this presumption as not rebuttable.
 - Thus, even where domestic corporation clearly never USRPHC, a paperwork failure (!) results in substantive tax.
- Rev. Proc. 2008-27 provides limited relief if, among other requirements, the taxpayer has reasonable cause.

FIRPTA - Exceptions

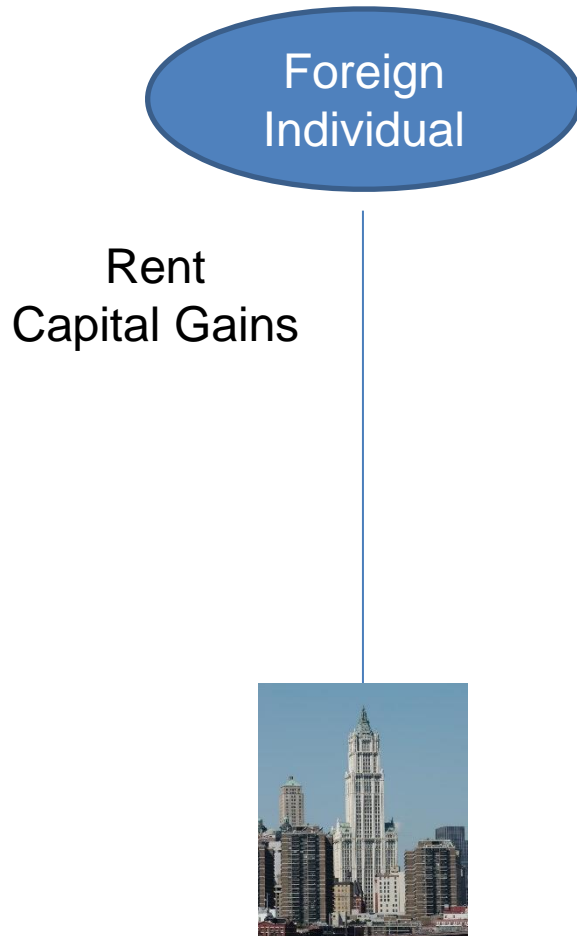
- Like-kind exchanges (section 1031)
 - Careful that US and non-US cannot be like kind
- Regularly traded stock
 - Interest must not exceed 5% during 5-year or shorter look-back period
- Stock of domestically controlled REIT (described below)
- Stock owned by foreign government
 - Special exemption under section 892
 - N/A to “dirt” (other than certain embassy properties)
- Cleansing exception:
 - Stock of former USRPHC that
 - Sold all USRPIs
 - Recognized all gain

Planning Considerations and Alternative Structures

Before Planning Begins

- Understand investor characteristics - type, location
- Ascertain investment characteristics and objectives:
 - Use – personal, development, investment
 - Types of income generated from real estate: Rent, interest, dividends, capital gains, services and others
 - Exit – anticipated timing, method
 - Donative intent?
 - Confidentiality paramount?
 - Willing to file personal returns?
- Consider choice of entity – wholly-owned, joint ventures, passive investment vehicles (e.g., REITs)
- Withholding and compliance
- Estate and gift taxes
- Foreign tax considerations

Structure 1: Direct Investment by a Foreign Individual



US Tax Consequences:

Must File Personal Return: Possible deal breaker!

Rental Income:

- Gross rental income taxable at 30%; or
- Net rental income taxable at graduated rates up to 39.6%*

Long Term Capital Gains:

- LTCG taxable at 20%*
- FIRPTA withholding at 10% of amount realized unless reduced by withholding certificate

Gift/Estate Tax:

- Applies at 40%*
- May purchase term insurance to ameliorate risk

*plus state and local tax, where applicable ¹²

Structure 1a: Direct Investment by Foreign Individual Nonrecourse Debt Variation



Rent
Capital Gains



Property acquired for \$2,000,000 with \$1,500,000 of NR debt; value increases to \$8,000,000 and NR Debt increased to \$6,000,000; foreign individual dies

US Tax Consequences:

Gift/Estate Tax:

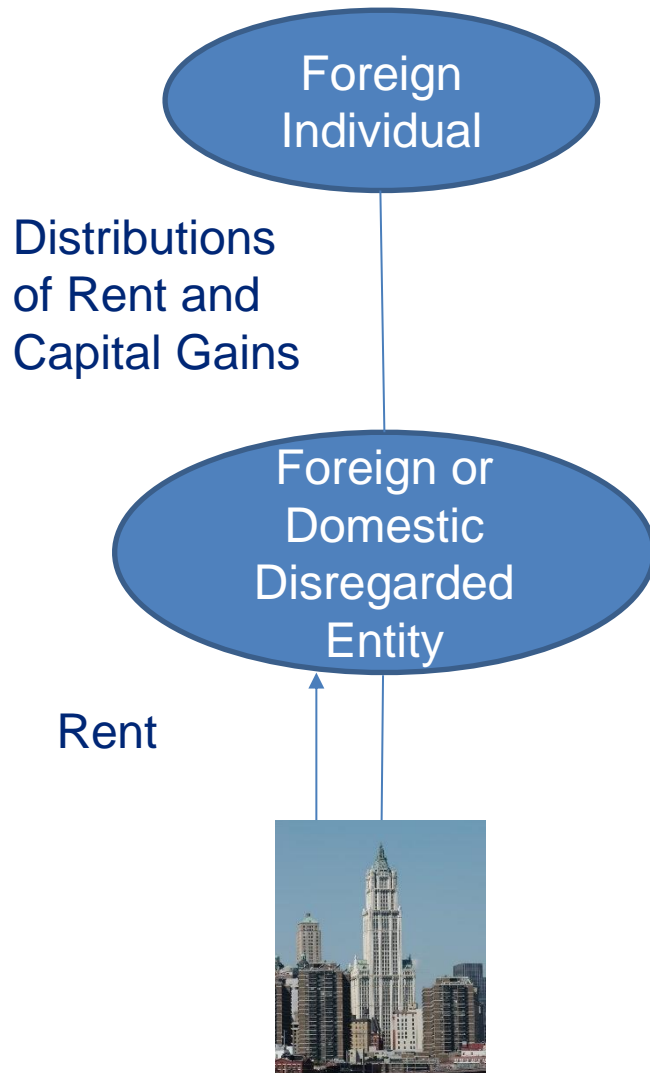
- Applies at 40%*
- Value for estate tax purposes is \$2,000,000, so federal estate tax is \$800,000.

Long Term Capital Gains:

- Basis is stepped-up at death, so property may be sold tax-free thereafter if no further appreciation.
- Disregarding state/local, step-up has value of \$1,200,000.
- Even with imposition of estate tax, direct ownership structure favorable on these facts.

*plus state and local tax, where applicable ¹³

Structure 2: Investment by Foreign Individual Through Disregarded Entity

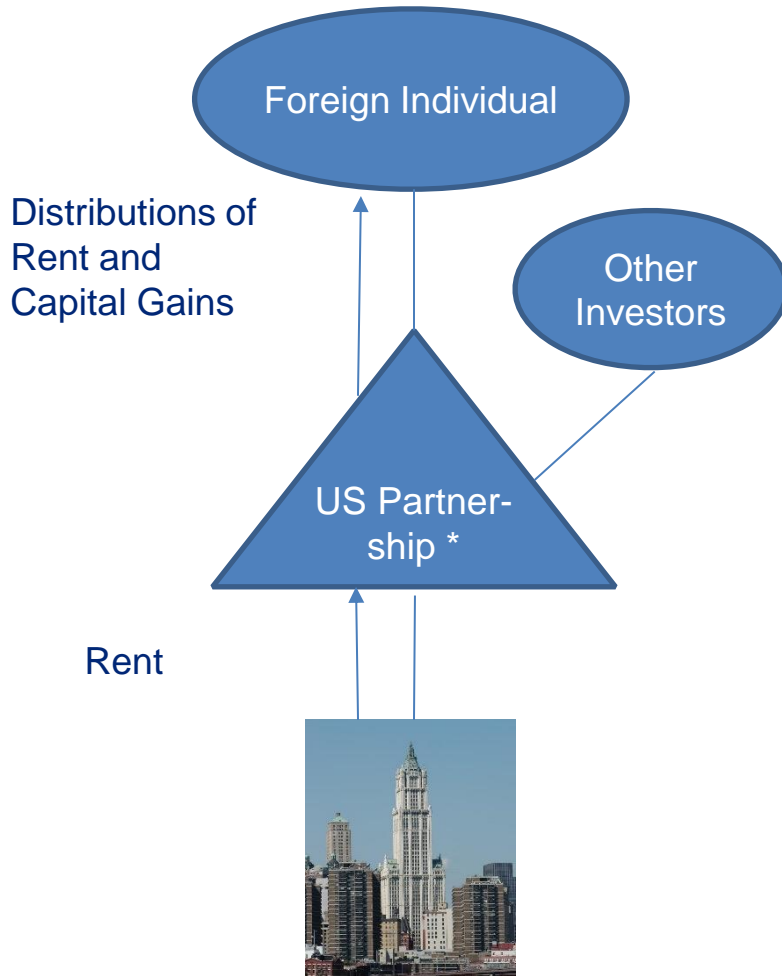


US Tax Consequences:

Generally identical to direct investment in Structure 1.

Gift of the DRE may conceivably be exempt pursuant to intangibles exception.

Structure 3: Investment by Foreign Individual Through Domestic Partnership



* or LLC taxed as a partnership

US Tax Consequences:

Rental Income:

- Same as direct investment in Structure 1, except no withholding on rent by lessee, and partnership withholding on ECI rent required under section 1446.

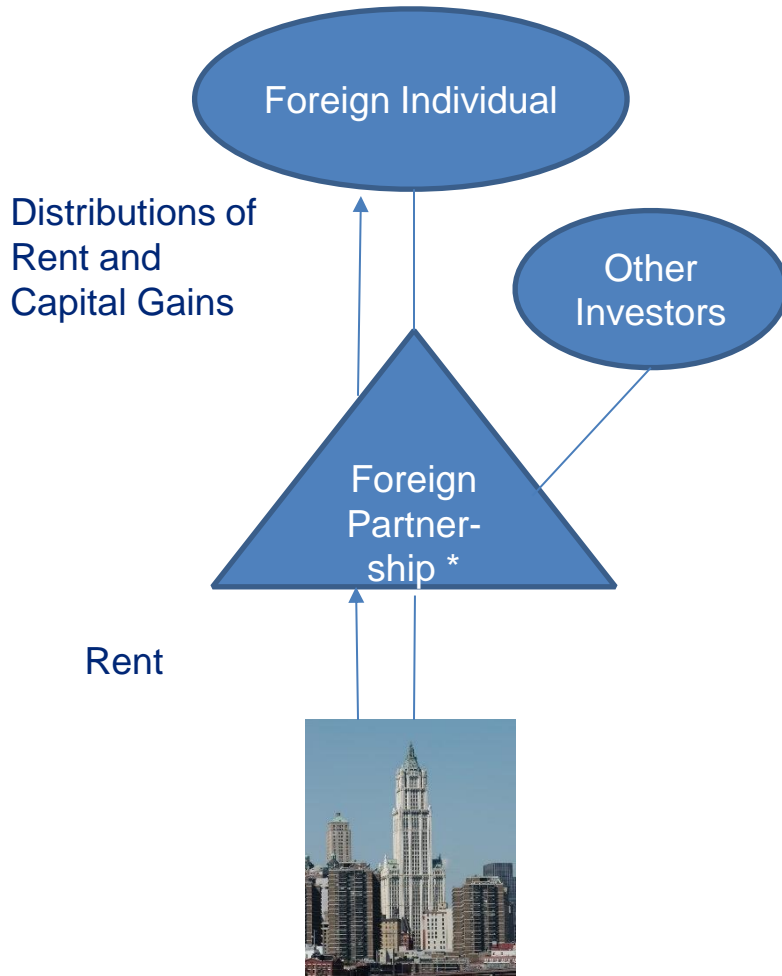
Long Term Capital Gains:

- Same as direct investment in Structure 1, except no FIRPTA withholding imposed on property sale by partnership, and partnership must withhold on gain under section 1446.

Gift/Estate Tax:

- Tax-free gifts should be possible, pursuant to intangible exception.
- Unclear whether estate tax would apply.

Structure 4: Investment by Foreign Individual Through Foreign Partnership



* or LLC taxed as a partnership

US Tax Consequences:

Rental Income:

- Same as with domestic partnership, except lessee should withhold on non-ECI rent.

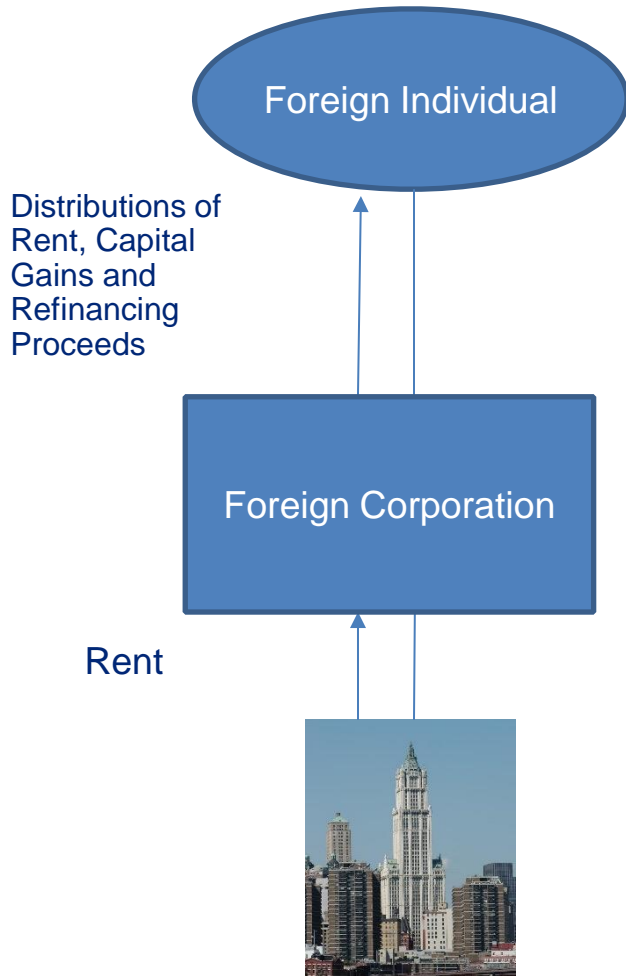
Long Term Capital Gains:

- Same as with domestic partnership, except purchaser should withhold on sale of property by the partnership.

Gift/Estate Tax:

- Same as with domestic partnership, except that somewhat better argument for avoiding estate tax.

Structure 5: Investment by Foreign Individual Through Foreign Corporation



US Tax Consequences:

To Corporation

Rental Income:

- Gross rental income taxable at 30% via withholding by Lessee; or
- Net rental income taxable at graduated rates up to 35%*
 - Branch Profits Tax applies at 30% or lower treaty rate

Gain from Sale:

- Gain on sale of US real property taxable at 35%*
- FIRPTA withholding on sale of Real Property by Foreign Corporation

To Shareholder

Income Tax:

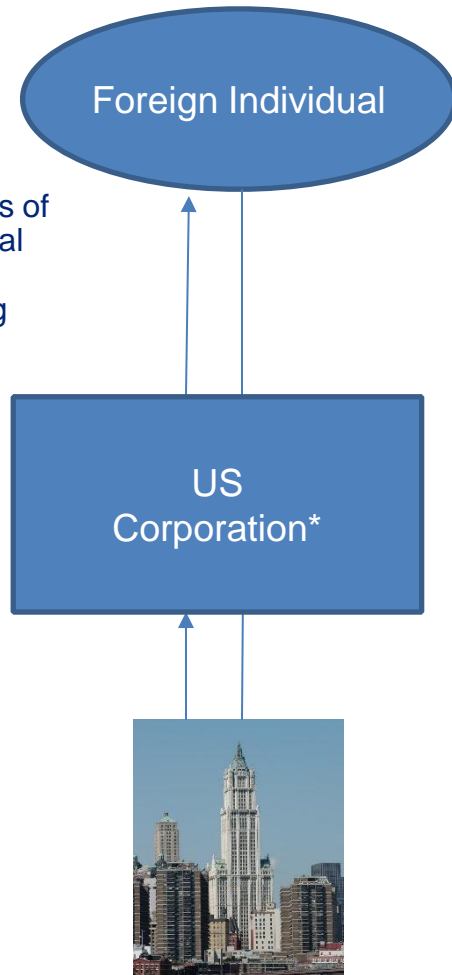
- No tax on distributions of dividends or §301(c)(3) amounts

Estate Tax:

- No U.S. estate tax

*plus state and local tax, where applicable

Structure 6: Investment by Foreign Individual Through Domestic Corporation



* or LLC taxed as a corporation

US Tax Consequences:

To Corporation

Rental Income:

- Net rental income taxable at graduated rates up to 35%*

Gain from Sale:

- Gain on sale of US real property taxable at 35%*
- No FIRPTA withholding on sale of the property by Corporation

To Shareholder

Income Tax:

- Dividends (distributions to extent of e&p) subject to 30% withholding tax, unless reduced by treaty
- Capital gain distributions (§301(c)(3)) amounts subject to FIRPTA taxation if USRPHC
- No shareholder tax on liquidating distributions after sale of all US real property and other requirements met

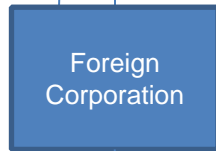
Gift/Estate Tax:

- Tax-free gifts possible
- U.S. estate tax applies at 40%*

*plus state and local tax, where applicable

A very poor combination of income/estate tax!

Structure 7: Investment by Foreign Individual Through Foreign and Domestic Corporation



Distributions of Rent,
Capital Gains and
Refinancing
Proceeds

Distributions of Rent,
Capital Gains and
Refinancing
Proceeds

Rent

* or LLC taxed as a corporation

US Tax Consequences:

To US Corporation

Same as in prior structure.

To Foreign Corporation

Same as consequences to individual in prior structure, except that favorable LTCGs rates will not apply, and dividend WHT may qualify for a lower corporate treaty rate if treaty benefits are available.

To Foreign Individual

Income Tax:

- No consequences.

Gift/Estate Tax:

- Not applicable

Structure 8: Use of Trust

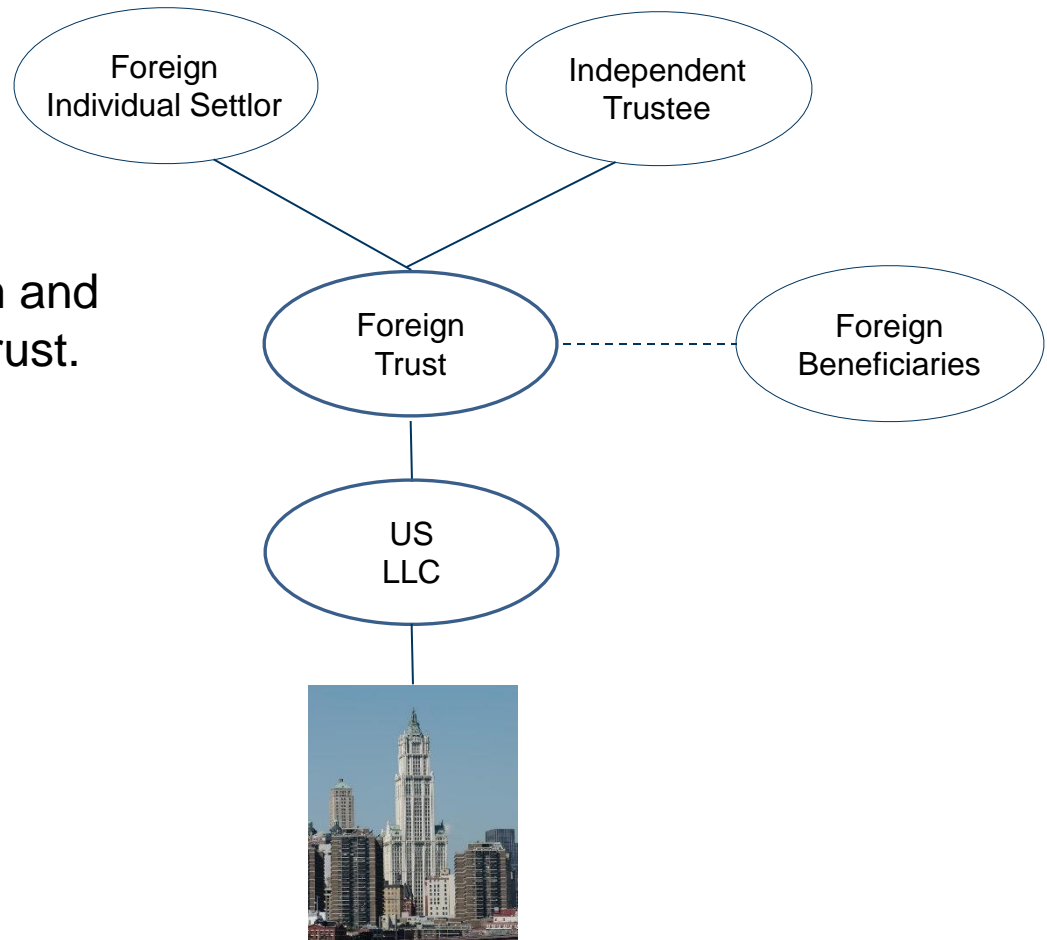
Settlor transfers cash to FT; then trustee buys the property.

Settlor must have no benefit from and no dominion or control over the trust. This is often a deal-breaker.

If properly structured, no gift tax when trust funded and no estate tax when settlor dies.

Income tax consequences same as for individual investor, e.g., LTCG rates apply.

Can also use domestic trust, but 3.8% NII tax applies.

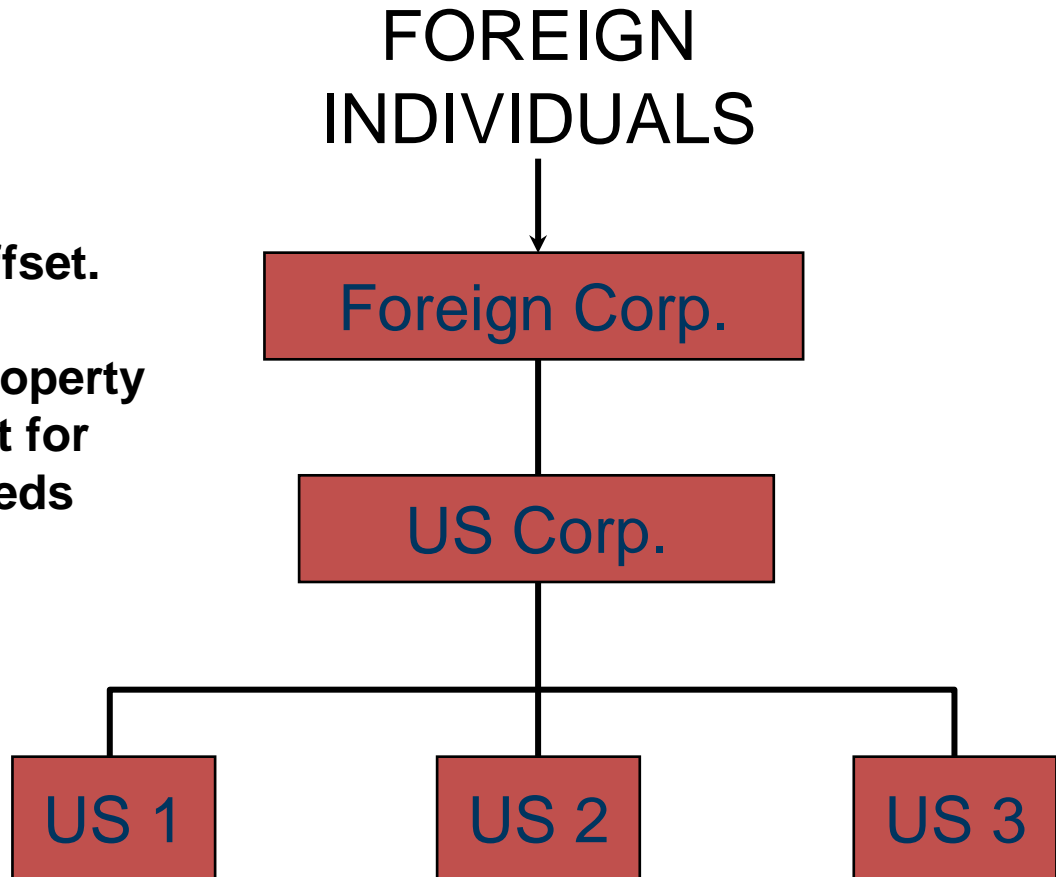


A Few More Structures

Structure 9: Multiple Properties - Consolidation Priority

Profits and losses may be offset.

However, when US 1 sells property at a substantial gain, difficult for US Corp. to repatriate proceeds without dividend WHT.

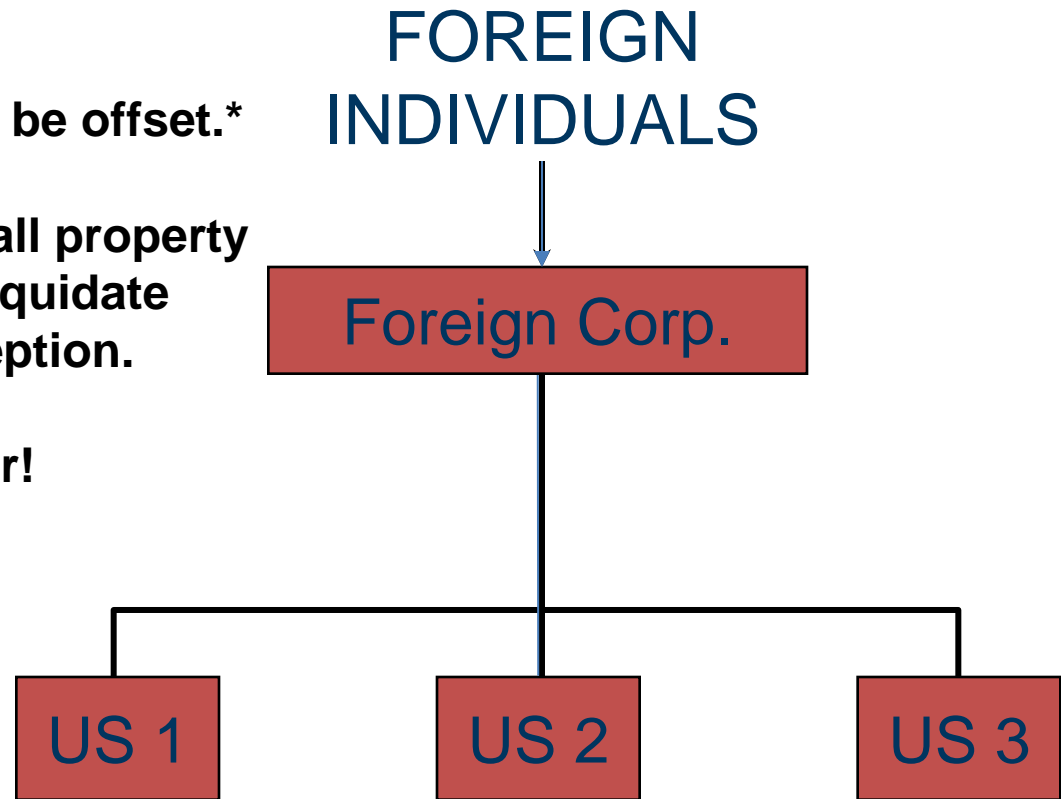


Structure 10: Multiple Properties — Distribution of Sale Proceeds Priority

Profits and losses may not be offset.*

However, when US 1 sells all property at a substantial gain, can liquidate tax-free per cleansing exception.

*** However, consider merger!**



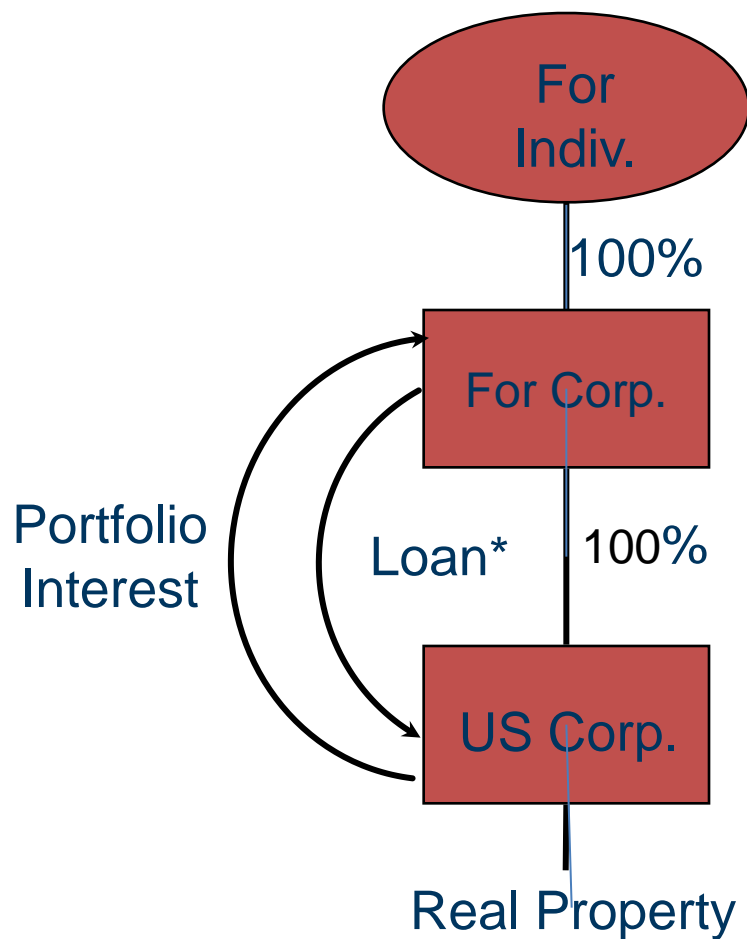
Using Debt to Reduce Inefficiency of Corporate Structure

- Interest deduction reduces corporate tax base
 - Earnings-stripping and other limitations apply
- Repayment of principal allows repatriation to shareholder on tax-free basis
- If possible, desirable to avoid or reduce WHT
 - Treaty
 - Portfolio interest exemption
- Need to ensure debt respected for tax purposes, e.g.,
 - Documentation
 - Interest rate cannot be excessive
 - Cannot be thinly capitalized
 - Reasonable term

Portfolio Interest Exemption (for non-ECI)

- Interest must be fixed
 - No kicker allowed
- Lender may not be “10% shareholder” of borrower
 - For corporate borrower, based on voting power
 - For partnership borrower, based on capital or profits interests
- Lender may not be a bank making loan in ordinary course or a CFC related to borrower
- Must certify foreign status

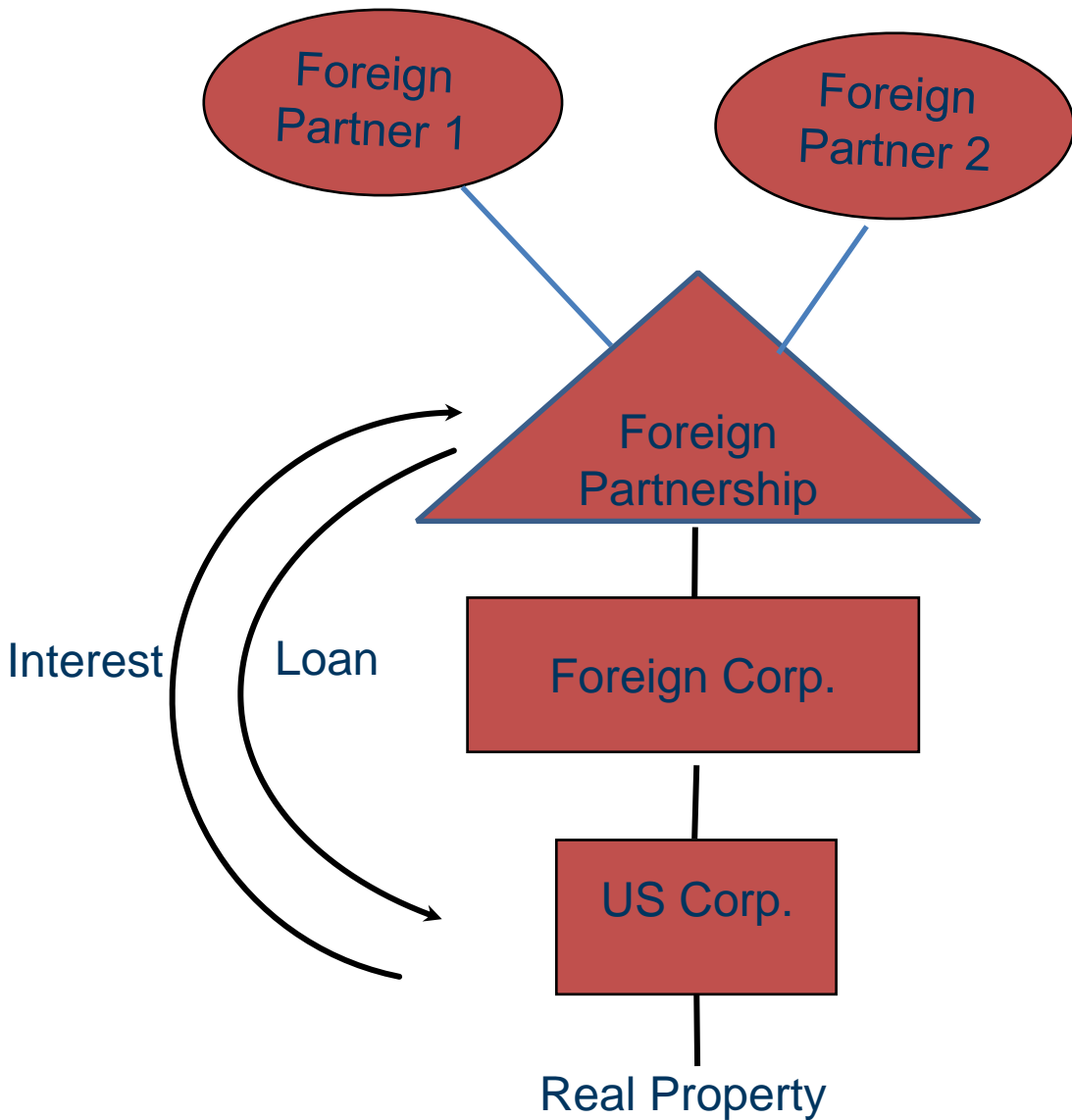
Structure 11: Treaty Loan Structure



For. Corp. resides in a treaty country and qualifies for zero WHT on interest.

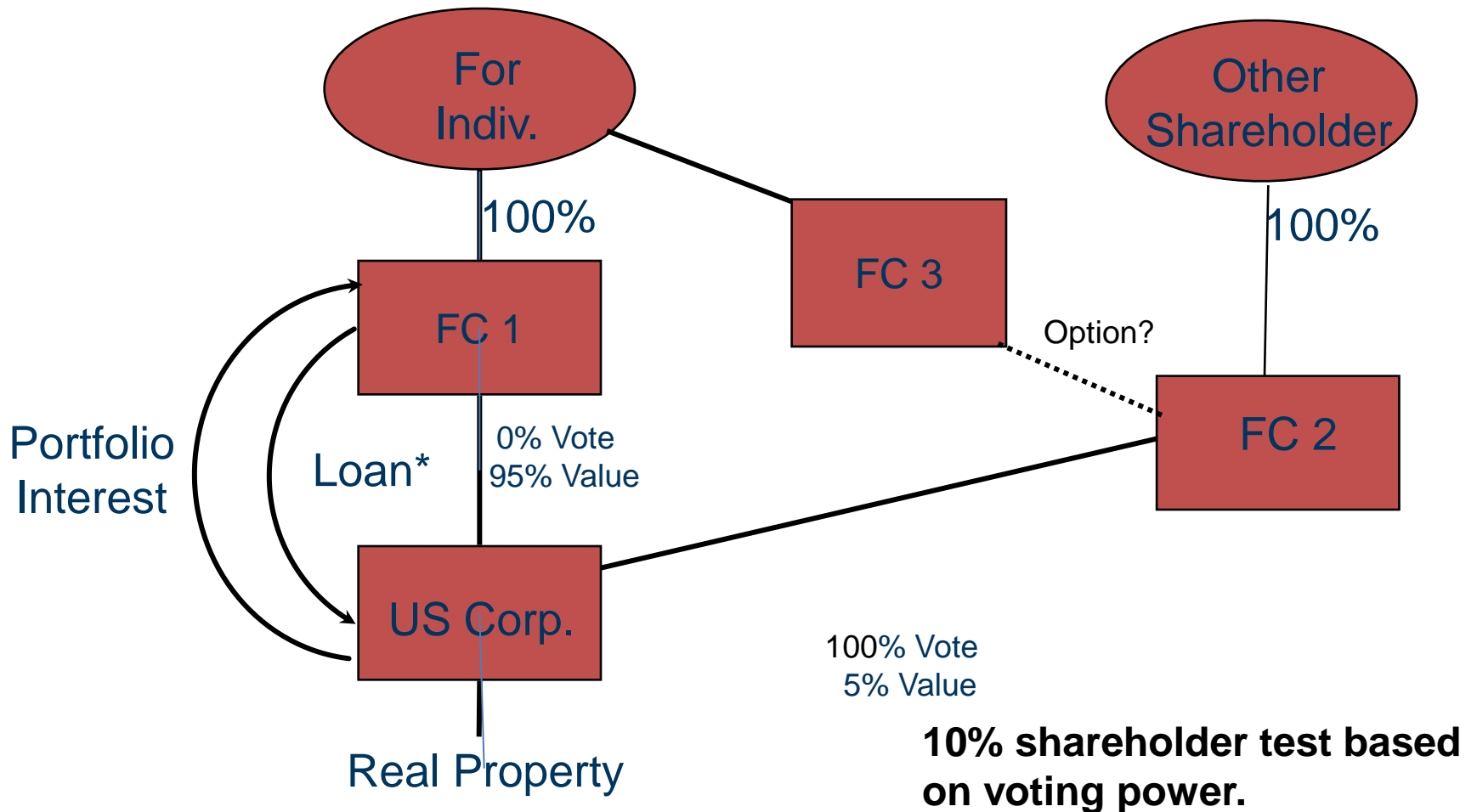
* It may be desirable for Loan to constitute equity for non-US tax purposes.

Structure 12: Portfolio Interest Partnership Lender Structure For Investor Group



All foreign partners have less than 10% of FP.

Structure 13: Portfolio Interest Split Vote/Value Structure

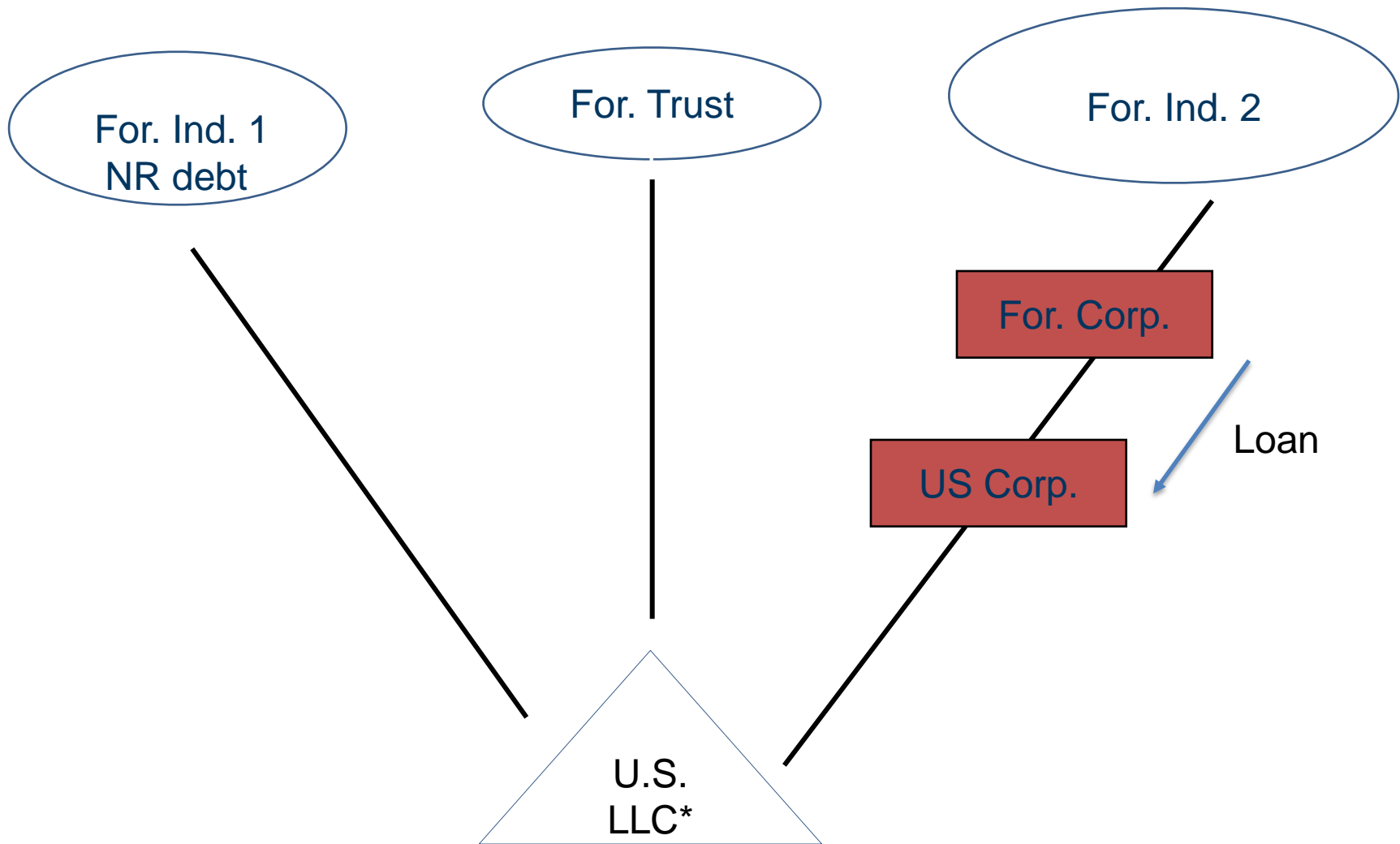


* It may be desirable for Loan to constitute equity for non-US tax purposes.

Split must be real!

IRS will examine closely.

Structure 14: Partnership to Accommodate Multiple Investors With Disparate Tax Objectives



*taxed as a partnership

Shared Appreciation Mortgage

Sample SAM

- Loan \$1,000,000 to purchaser of property for \$1,500,000 purchase price.
- Lender receives 4% interest per year plus 20% of appreciation after five years (or gain on earlier sale).
- Lender has some aspects of a real estate investment.
- Critical that SAM be respected as debt for tax purposes.

Tax Treatment of SAM

- FIRPTA
 - SAM is a USRPI
 - Sale of SAM would be taxed under FIRPTA
 - However, if SAM respected as debt, “kicker” payment at maturity not treated as USRPI gain
- Kicker interest may nevertheless be subject to WHT
 - Portfolio interest exemption clearly n/a.
 - Treaty may apply, if covers contingent interest.

REIT Structures

REIT Requirements

- 100 Shareholders
 - Easily dealt with
- Five or fewer test
 - Prevents individual or family (or even a handful of families) from forming private REIT
- REIT Election
- Restrictions as to nature of income and assets
 - In extremely general terms, the intention is for REITs to be passive vehicles
 - Active operations can potentially be placed into taxable REIT subsidiaries

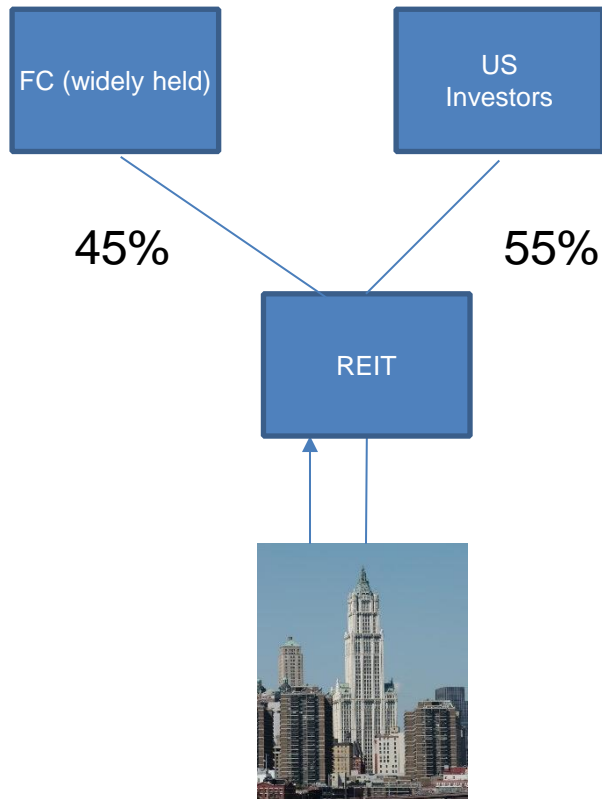
Advantages of REIT Status

- REITs effectively pay no corporate tax
 - Dividend paid deduction
- Favorable for foreign investors, who generally pay federal but may not pay state local tax on REIT dividends
- Tax-free sale of domestically controlled REIT stock
- Tax-free sale of stock of regularly traded REIT (or non-REIT) stock if the foreign investors has not owned more than 5% at any time during a 5-year look-back period.

Taxation of REIT Dividends

- Ordinary REIT Dividend
 - Same treatment as non-REIT dividends, i.e., gross withholding at 30% or lower treaty rate
 - Only difference is that treaty benefits for REIT dividends are typically less favorable, in view of the fact that corporate tax has not been imposed
- “FIRPTA” Dividends
 - When a REIT sells USRPI at a gain and makes distributions to its shareholders that are attributable to such gain, those “FIRPTA” dividends are treated as USRPI gains under section 897(h)(1).
 - Treaty benefits do not apply.
 - Also subject to BPT, in the case of corporate foreign investors.
 - The REIT must withhold on the distribution.
 - Section 897(h) n/a if the REIT stock is regularly traded and the foreign investor did not own more than 5% at any time during a 1-year look-back period.
 - In such case, the ordinary REIT dividend rules apply.
- Section 892 Discussed Below

Structure 15: Domestically Controlled REIT



Ideally, FC would like to sell its interest in REIT to avoid FIRPTA.

Under the right circumstances, a buyer can acquire 100% of the REIT stock and liquidate the REIT tax-free. The REIT (if still a REIT) pays no corporate tax on the liquidation by reason of a dividend paid deduction. The buyer's exchange of REIT stock for the building is taxable, but there should be no gain.

In practice, however, this game plan can prove difficult. Many buyers will be reluctant or potentially unable to safely extract the building from the REIT.

For example, an individual buyer would cause the REIT to flunk the 5 or fewer test. In that event, the REIT would pay corporate tax on the liquidation.

FC may try selling to other shareholders or back to the REIT, but the deal that makes the business people comfortable is likely to make the tax people nervous.

One interesting question under IRS view is what happens if "outside" gain on the stock doesn't match "inside" gain recognized by the REIT. For example, if new foreign investor purchases REIT stock from FC and REIT immediately liquidates. IRS is aware of this phantom gain issue but has not addressed.

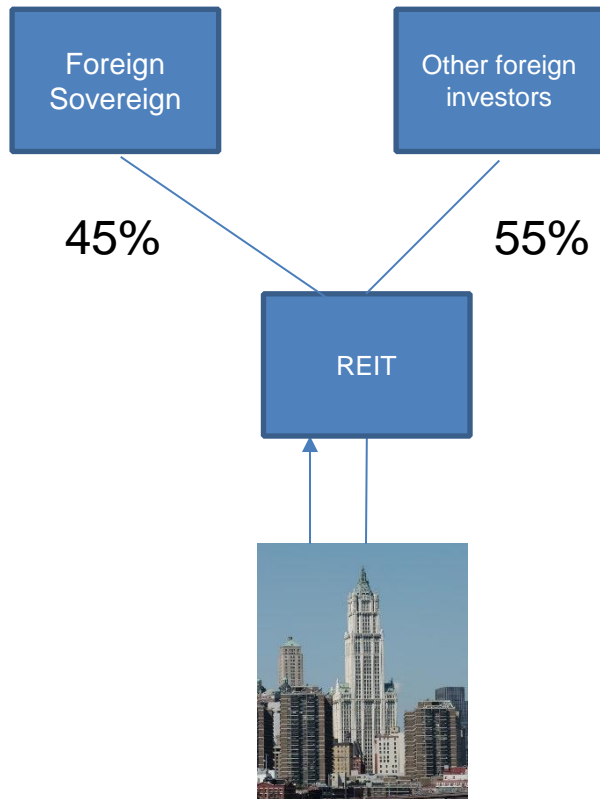
Tiered REIT structures: Some argue no need to look through upper-tier REIT to its shareholders. Clearly unintended. Query what basis for this position.

Foreign Sovereign Exemption (section 892)

Section 892

- Excludes from gross income the income of a foreign government from, among other things, investments in the United States in stocks, bonds, or other US securities.
 - Includes both integral parts and controlled (wholly owned) entities of the foreign sovereign.
- Does not apply to income from commercial activities.
- Overrides FIRPTA with respect to stock of a US corporation that is (or, during the lookback period, was) a USRPHC other than a controlled commercial entity.
- Does not apply to
 - income from commercial activities
 - income earned by or from controlled commercial entities

Structure 16: Foreign Controlled REIT



Foreign Sovereign, FS, would like to exit without paying tax. In this case, the REIT is foreign controlled, so stock in the REIT is a USRPI.

Nevertheless, FS may sell the REIT stock tax-free under section 892.

All the issues pertaining to the ability to sell REIT stock to a buyer still apply.

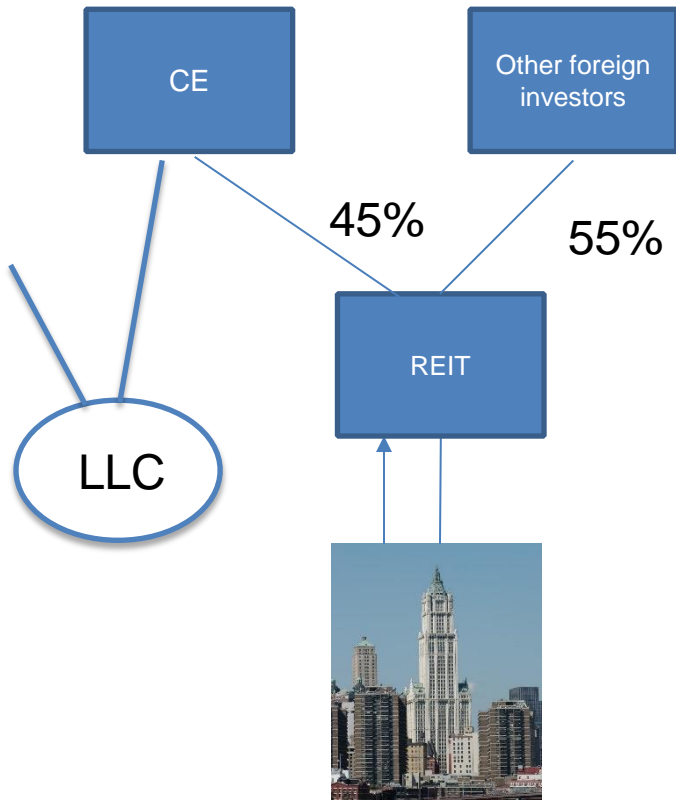
What if REIT sells the building and distributes proceeds in liquidation?

Under general tax principles, FS considered to have disposed of REIT stock (and not considered to have received a distribution from the REIT), so section 892 arguably applies.

Per Notice 2007-55, IRS position is (i) a liquidating distribution is still a “distribution” to which section 897(h) applies; and (ii) FS recognizes FIRPTA gain as if had sold interest in the building, and section 892 does not apply.

Again, a foreign purchaser of REIT stock who then liquidates the REIT has a “phantom gain” problem.

Structure 17: Controlled Commercial Entity Problem



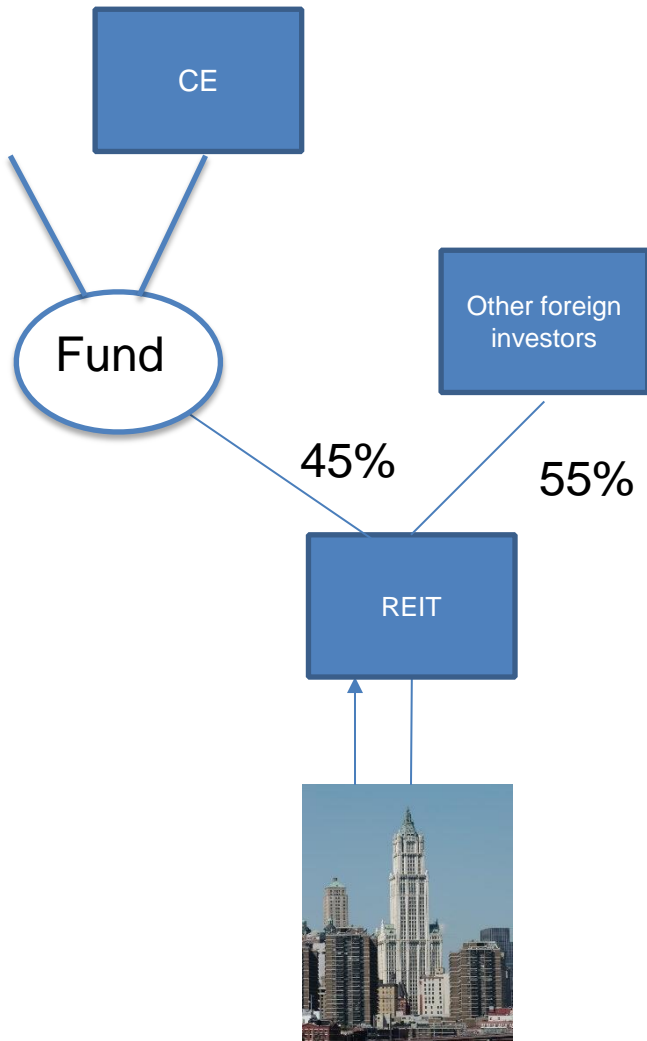
Foreign sovereign invests in REIT through a controlled entity (CE).

However, CE also owns an interest in LLC, which engages in some commercial activity.

This causes CE to be a controlled commercial entity (CCE).

As a CCE, CE is ineligible for section 892. This disqualification applies to all of its income, including the “good” income earned from selling its 45% interest in REIT.

Structure 18: Partnership Issues



CE invests in REIT through Fund (a Delaware LLC).

If Fund is able to sell the REIT stock, CE's gain will be exempt under section 892.

Suppose CE learns that Fund cannot sell its REIT stock and that the REIT plans to sell the building and liquidate. Per Notice 2007-55, this would be taxable to CE, at least in the view of the IRS.

What if CE instead sells its partnership interest in the Fund?

Per the section 892 regulations, section 892 does not apply to dispositions of partnership interests.

Compare with Rev. Rul. 91-32.

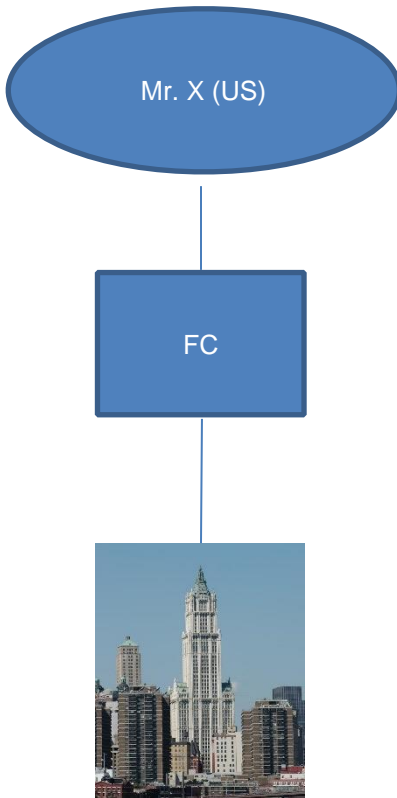
Or, better yet, compare with section 897(g).

Query why look-through applies to impose tax under section 897 but not to permit exemption under section 892.

Heads I win, tails you lose?

Unwinding Corporate Structures

Structure 19: Acquisition of Foreign Corporation with USRPI — Now What? (Part I)



Mr. X, a US citizen, inherits stock of FC from NRA mother, M. M has owned FC at all times and never received any distributions. FC owns US building with zero basis and FMV \$100MM.

Under the current structure, the taxation will be *extremely* inefficient. For example, current income would be subject to regular corporate tax, BPT, and eventually shareholder-level tax as well. On a sale of the building, the existing built-in gain would be subject to regular corporate tax, and further appreciation would be double taxed. BPT may apply as well.

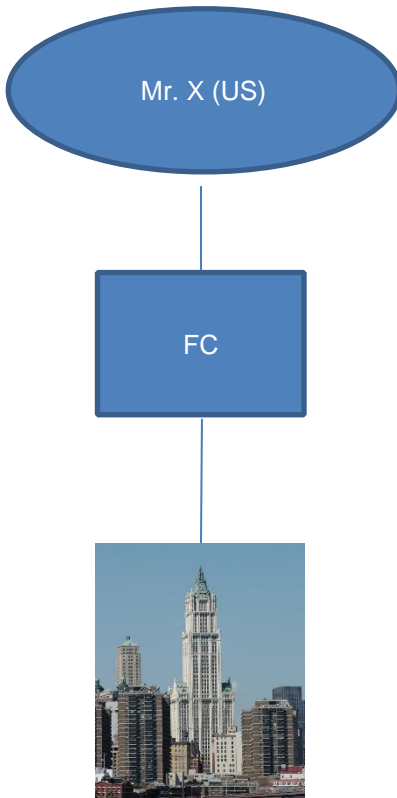
To avoid this horrific tax result, FC domesticates e.g., pursuant to a merger into a newly formed domestic corporation (Newco). Alternatively, Mr. X can contribute FC to Newco and liquidate FC.

Under section 897(e), FC's deemed distribution of Newco stock in connection with the domestication is ordinarily taxable, but this tax may be avoided by paying a toll charge under Notice 2006-46. The toll charge is equal to the tax that would have been paid (with interest) on prior dispositions of FC stock, during a certain lookback period, if FC had been domestic (and thus a USRPHC).

In this case, the toll charge is zero, as there have been no prior dispositions of FC stock.

Newco can elect S corporation status and sell the building (without triggering undue tax) after the built-in gain period.

Structure 19: Acquisition of Foreign Corporation with USRPI — Now What? (Part II)



Mr. X, a US citizen, wants to buy stock of FC from NRA seller, S, for \$100M. FC owns building with zero basis and FMV \$100MM.

Mr. X asks if he can domesticate FC without paying tax, as in Example 17, Part I.

Unfortunately, the toll charge would equal the same tax that S would have paid if FC had been a USRPHC, i.e., \$20M. However, this is less costly than the \$35M that would have been imposed if FC had sold the building. Moreover, there may potentially be a state/local savings.

If Mr. X pays the \$20M he can domesticate FC and elect S status. At the conclusion of the built-in-gain period, he can then sell the building without triggering undue tax.

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