



Foreign Persons Investing in U.S. Real Estate

ABA Section of Taxation

Committee on U.S. Activities of Foreigners and Tax Treaties

**Orlando Florida
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Panel

Chair

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Principal Topics

- **Building Blocks**
- **Planning**
- **Real Estate Investment Trusts**
- **Questions**



BUILDING BLOCKS: OWNERSHIP OF REAL ESTATE, STOCK & NOTE

Two U.S. Tax Regimes May Apply

- **Passive Income:** FDAP Income from U.S. Sources
 - 30% tax on “gross income”
 - U.S. payor withholds tax
 - Subject to reduction or elimination by (i) Tax Treaty or (ii) Code exemption (e.g., portfolio interest)
- **Active Income:** ECI Income
 - If engaged in U.S. trade or business (ETB) then income effectively connected (ECI) with that business is subject to U.S. income tax
 - Must file U.S. tax return
 - Tax imposed at graduated rates (NRA is eligible for long-term capital gains rates)
 - Tax imposed on “net income” so get deductions to lower tax liability
 - Branch profits tax may apply to non-US corporations

Rental Income

- Rental income: **FDAP** income subject to 30% withholding tax
- Tax can be very harsh
 - Example:
 - Lessee pays \$100 rent to owner and lessee pays expenses to 3rd parties related to the property of \$100 (e.g., real property taxes, insurance)
 - Gross rental income = \$200
 - Withholding tax = \$60
 - Net cash owner gets = \$40 (\$100 - \$60)
 - Effective tax rate of 60%

Rental Income (cont'd)

- If leasing or other activity in relation to property makes foreign owner **ETB**, then rental income becomes **ECI**
- Tax only on “net income” from property, which is usually produces lower tax for owner
 - Example:
 - Lessee pays \$100 rent to owner and lessee pays expenses related to the property of \$100
 - Gross rental income = \$200
 - Net rental income (before depreciation & interest deductions) = \$100
 - Maximum Tax (assuming no depreciation or interest) = \$35
 - Effective tax rate = 35% and lower if get depreciation, interest & other deductions
 - Owner must file tax return

Rental Income (cont'd)

- When does leasing make foreign owner **ETB**?
 - General Rules:
 - Rental of one property to one tenant under a “net” lease is not ETB
 - See Rev. Rul. 73-522; *Neill*
 - Rental to many tenants is ETB
 - See *Pinchot* (11 real estate properties)
 - Election to be ETB: §871(d), 882(d)
 - Often recommended since lower tax burden (due to deductions)
- If rental income is ECI, give Form W-8ECI to lessee to eliminate withholding tax

Sale of Real Estate

- Gain is Taxable: Foreign Investment in Real Property Tax Act of 1980 (**FIRPTA**) – §897
 - Gain from sale of “United States real property interest” (“USRPI”) taxed as if:
 - Foreign seller is engaged in a trade or business in the U.S. & the gain is effectively connected with that trade or business
 - Foreign sellers are taxed on gains at the same rates applicable to U.S. sellers
 - Gain can qualify for long-term capital gains treatment
 - Like kind exchange treatment does not apply *unless* the seller receives U.S. property in the exchange – §1031(h)

Sale of Real Estate (cont'd)

- Definition of USRPI (Treas. Reg. § 1.897-1)
 - Interest in real property:
 - Real property includes land, buildings, and other improvements
 - Includes growing crops and timber, and mines, wells and other natural deposits – but once extracted or severed, crops, timber, ores, minerals, etc. are no longer USRPIs
 - Includes “associated personal property”
 - Includes direct or indirect right to share in appreciation in value, gross or net proceeds or profits from real property
 - Does not include mortgage loan at fixed rate of interest (or variable rate such as prime, LIBOR, etc.)
 - Interest in domestic corporation that was a U.S. real property holding corporation (USRPHC – see later slide) at any time during the 5-year period preceding sale

Sale of Real Estate (cont'd)

- Withholding Requirement: §1445
 - Buyer must withhold 10% of “Amount Realized” on Sale
- Problem: Overwithholding
 - Example:
 - Sell real estate with a tax basis of \$900 for \$1,000
 - Buyer must withhold \$100 tax (10% of \$1,000) even though gain is only \$100 & tax will be less than that
 - Solution: Get Exemption or reduced rate certificate by filing Form 8288-B before the sale
- Rev. Proc. 2000-35 explains this
- Recommended in example above to lower the withholding tax

Sale of Real Estate (cont'd)

- Other Exemptions to Withholding:
 - Seller gives buyer a:
 - Non-foreign affidavit or
 - Non-USRPHC affidavit if you are buying a company (as defined below)
 - Sales price < \$300,000 on property & buyer will use this for their residence
 - Amount not indexed for inflation in 30 years
 - Situations where withholding required under partnership withholding rules

Dividend from U.S. Corporation

- **Dividend income:**

- FDAP income subject to 30% withholding tax
 - Subject to reduction or elimination: Tax Treaties

- **Non-dividend distributions:**

- If corporation is a USRPHC, as discussed below, withhold 10% of the distribution - §1445(e)(3)
 - Subject to reduction if go to IRS to obtain exemption or reduced rate certificate

- **REIT Dividends:**

- Special rules discussed below

Sale of Stock of U.S. Corporation

- Normal rule: Gain from sale is not U.S. source FDAP income and does not make investor ETB
- FIRPTA: Taxable if sell stock of a U.S. Real Property Holding Corporations (USRPHC)
 - Treats the gain as ECI income
 - Corporate sellers also have branch profits tax

Sale of Stock (cont'd)

- USRPHC definition (§897(c)(2)):
 - FMV of USRPIs held on any “applicable determination date” equals or exceeds
 - 50% of sum of FMVs of (i) USRPIs; (ii) non-U.S. real property interests; and (iii) other trade or business assets
 - Look-through rule for assets held through entities
 - For corporations, only look-through if own more than 50%
- Exemption:
 - Regularly traded class of stock if taxpayer owns 5% or less
 - Does not include stock in a corporation that has sold all of its USRPIs in taxable transactions

Interest Income from U.S. Mortgage

- Interest income is **FDAP** income subject to 30% withholding tax
- Elimination under:
 - Portfolio Interest Exemption- §§ 871(h), 881(c) applies to all interest if debt is in registered form except:
 - Loan by foreign bank in the ordinary course of business
 - Loan from 10% or greater shareholder or partner
 - Contingent interest
 - HIRE Act of 2010 eliminated exception for post-3/18/2010 instruments in bearer form
 - Tax Treaties
 - Almost all treaties provide for exemption or reduced rate

Interest Income (cont'd)

- Issue: Can a foreign lender be ETB?
 - **“Buy” outstanding mortgages**: No
 - **“Originate” or make new loans**: Yes, if lender makes many loans in the U.S. and are therefore conducting a lending business in the U.S. (looks like a bank)
- If ownership of mortgages makes lender ETB, then portfolio interest exemption will not apply
 - Must file U.S. tax return and pay tax on net income from lending business
- Issue: How is interest from foreign seller financing of real estate sale taxed?
 - Not taxable under FIRPTA
 - Either FDAP income or (less commonly) ECI, whether or not sale that generated the note is taxed under FIRPTA

Sale of U.S. Mortgage

- General rule: Gain from sale is not U.S. source FDAP & not ECI
- Exception:
 - If in U.S. lending business then gain from sale would be ECI and therefore taxable
 - If mortgage loan has contingent interest then the loan is a USRPI and gain from its sale will be taxable under FIRPTA
- Example: Loan has 5% fixed interest and contingent interest = 25% of cash flow from the property



FATCA & REAL ESTATE

FATCA: Application to Real Estate

- FFI: 30% withholding on withholdable payments under §1471 will be imposed unless FFI:
 - Signs agreement with IRS (“PFFI Agreement”);
 - Is resident of country that has signed a FATCA IGA;
 - Is exempt from FATCA under existing IRS guidance
- NFFE: 30% withholding on withholdable payments under §1472 will be imposed unless NFFE:
 - Certifies that it has no substantial U.S. owner”; or
 - Provides the name, address, and TIN of each substantial U.S. owner; and
 - In either case, withholding agent (a) neither knows nor has reason to know certification is incorrect and (b) provides the substantial U.S. owner to IRS

FATCA: Application to Real Estate (cont'd)

Withholdable payments – real estate-related income:

- FDAP:

- U.S.-source interest (e.g., interest from mortgage loan),
- Dividends (e.g., dividend from USRPHC),
- Rents and other types of payments from the U.S. (e.g., rent on U.S. real estate)

- U.S. Securities:

- Gross proceeds from the sale of any property that could produce U.S.—source dividends or interest
- This includes USRPHC stock and loan principal repayments from a U.S. borrower



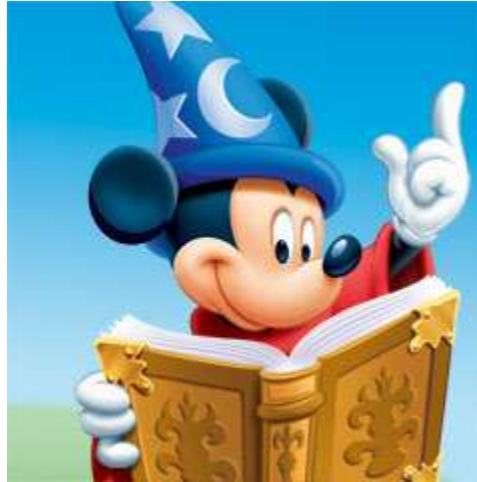
ESTATE AND GIFT TAXES

Gift Tax

- Nonresident alien is taxed on gifts of tangible (but not intangible) property located in the United States
 - Gift of U.S. real property is subject to gift tax
 - Gift of stock (whether domestic or foreign corporation) is not subject to tax
 - Gift of partnership interest probably not subject to tax
 - Points to note:
 - No step-up in basis on *inter vivos* gift
 - No unified credit
 - Substance over form risk. For example:
 - Donee or trust is funded with cash and purchases real property from grantor – e.g., *Davies v. Commissioner*, 40 T.C. 525 (1963)
 - Foreign owner contributes property to partnership and then makes gift of partnership interest

Estate Tax

- Estate of nonresident alien is subject to estate tax on property located in the United States. Includes:
 - U.S. real property and tangible property located on it
 - Stock in U.S. corporation (publicly traded or not)
 - But not stock in foreign corporation
 - Top rate (2013) 40%; unified credit equivalent to \$60,000 exemption (unchanged for decades)
- Uncertain treatment of partnership interests
 - IRS position: Interest is located in the U.S. if partnership is engaged in U.S. trade or business. What if:
 - Partnership not ETB but decedent elected under §871(d)?
 - Partnership owns only residence for NRA's personal use?
 - Other theories: Place of organization or partner domicile



PLANNING

Before Planning Begins

- Understand investor characteristics - type, location
- Ascertain investment characteristics and objectives:
 - Use – personal use, business, investment
 - Types of income generated from real estate: Rent, interest, dividends, capital gains, services and others
 - Capital – equity, debt (many different flavors and sources)
 - Exit – anticipated timing, method
- Consider choice of entity – wholly-owned, joint ventures, passive investment vehicles (e.g., REITs)
- Withholding and compliance
- Estate and gift taxes

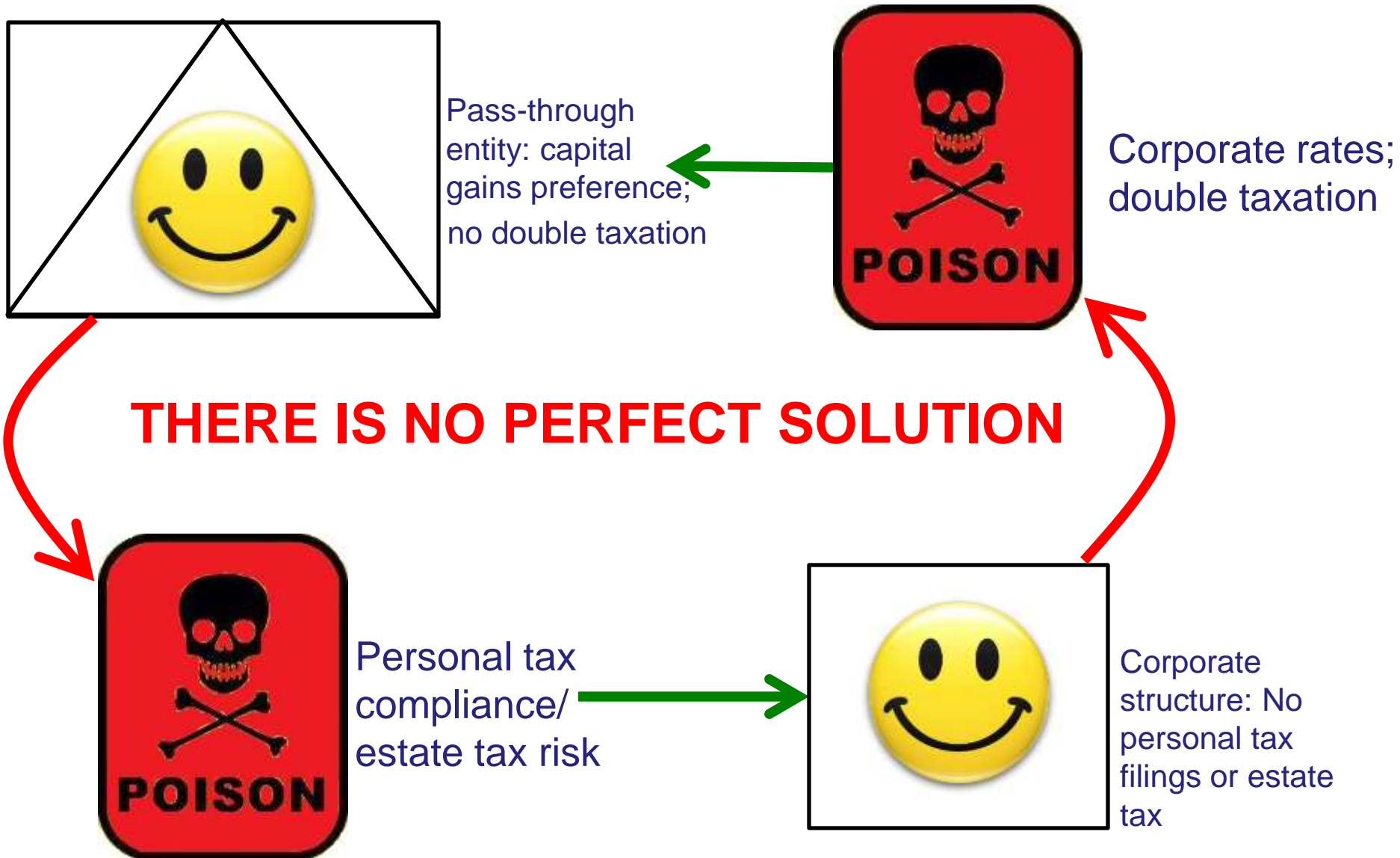
Home Country Taxation

- No planning should be undertaken before considering whether home country taxation is relevant
- U.S. taxation of foreign investors may be modified by treaty
 - No exception from U.S. taxation of gain from real estate but treaties can reduce or eliminate tax on interest and dividends
 - Almost all treaties contain “limitation on benefits” provisions to counteract abusive use of treaties

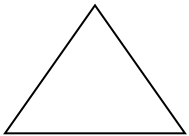
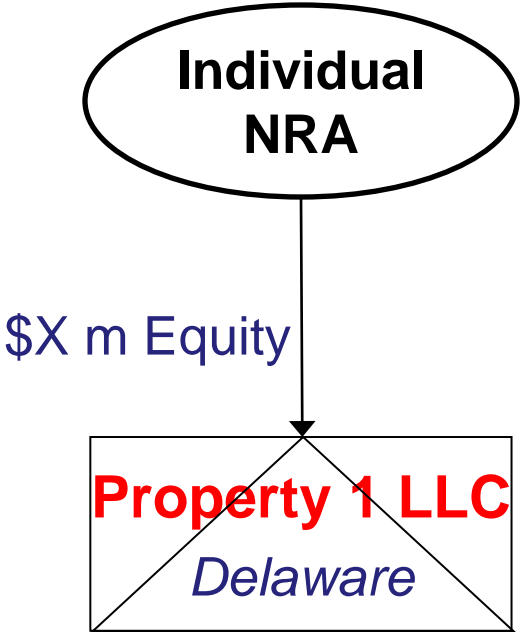
Objectives Drive Structure

- Tax objectives:
 - Avoid cross-border double taxation (U.S./foreign)
 - Mitigate taxation of operating income
 - Avoid double taxation of corporate earnings
 - Obtain long-term capital gains treatment on sale
 - Avoid gift and estate taxes
 - Limit overwithholding
 - Limit contact with U.S. tax system
- Nontax objectives
 - Preserve confidentiality
 - Facilitate inter-family transfers
 - Limited liability

Structuring May Mean Picking Your Poison

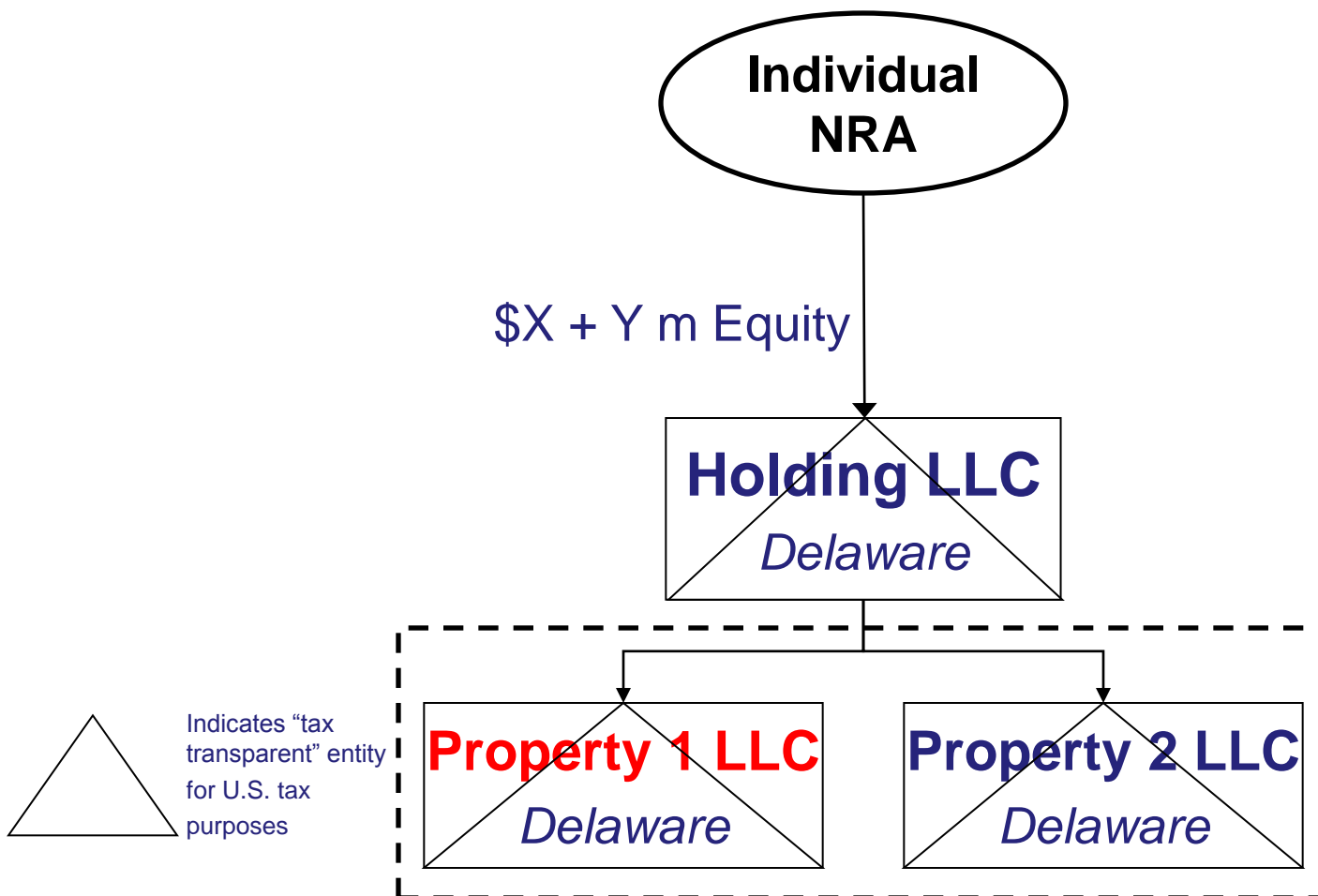


Individual Ownership



Indicates "tax transparent" entity for U.S. tax purposes

Individual Ownership



Individual Ownership

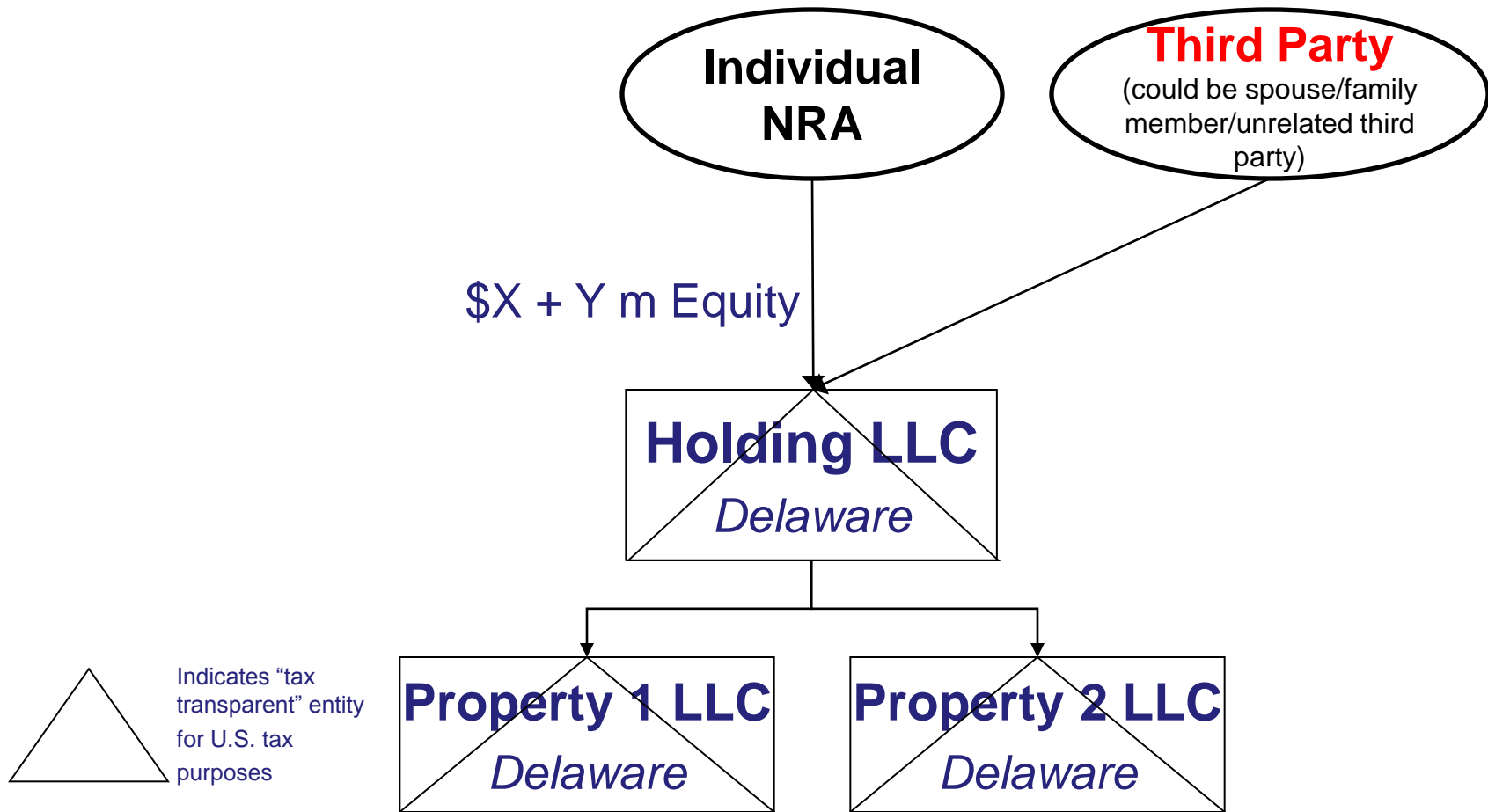
Advantages

- Long-term capital gains treatment available
- Single level of tax
- Profits and losses offset
- No imputed income for personal use property
- LLCs provide limited liability; holding LLC can provide “presence”

Disadvantages

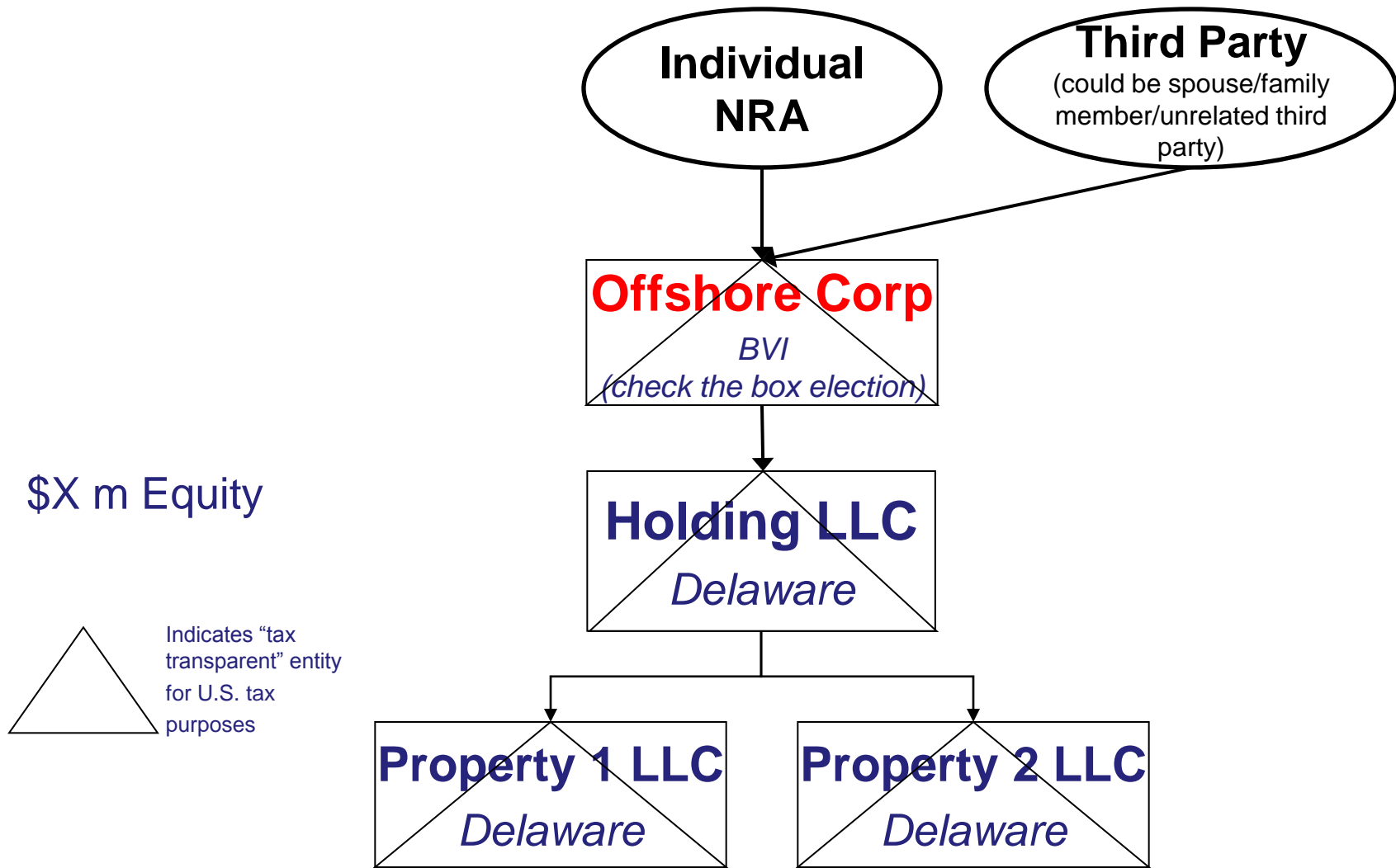
- Gift tax probably imposed on gift of LLC interest if LLC is disregarded entity (query effect of *Suzanne Pierre* case)
- Estate tax exposure
- Must file individual income tax returns and partnership returns

Individual Ownership (with partnership)

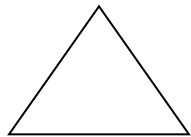


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Individual Ownership (with partnership)



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Indicates "tax transparent" entity for U.S. tax purposes

Individual Ownership (with partnership)

Advantages

- Long-term capital gains treatment available
- Single level of tax
- Should not have imputed income for personal use property, but less certain than with direct ownership
- Gift tax probably does not apply to gift of interest in LLC treated as partnership
- LLCs provide limited liability; holding LLC can provide “presence”

Disadvantages

- Estate tax exposure, but may have counter argument, especially if LLCs not engaged in trade or business; additional argument if offshore holding company classified as partnership inserted in structure
- Must file individual income tax returns and partnership returns
- § 1446 (over)withholding

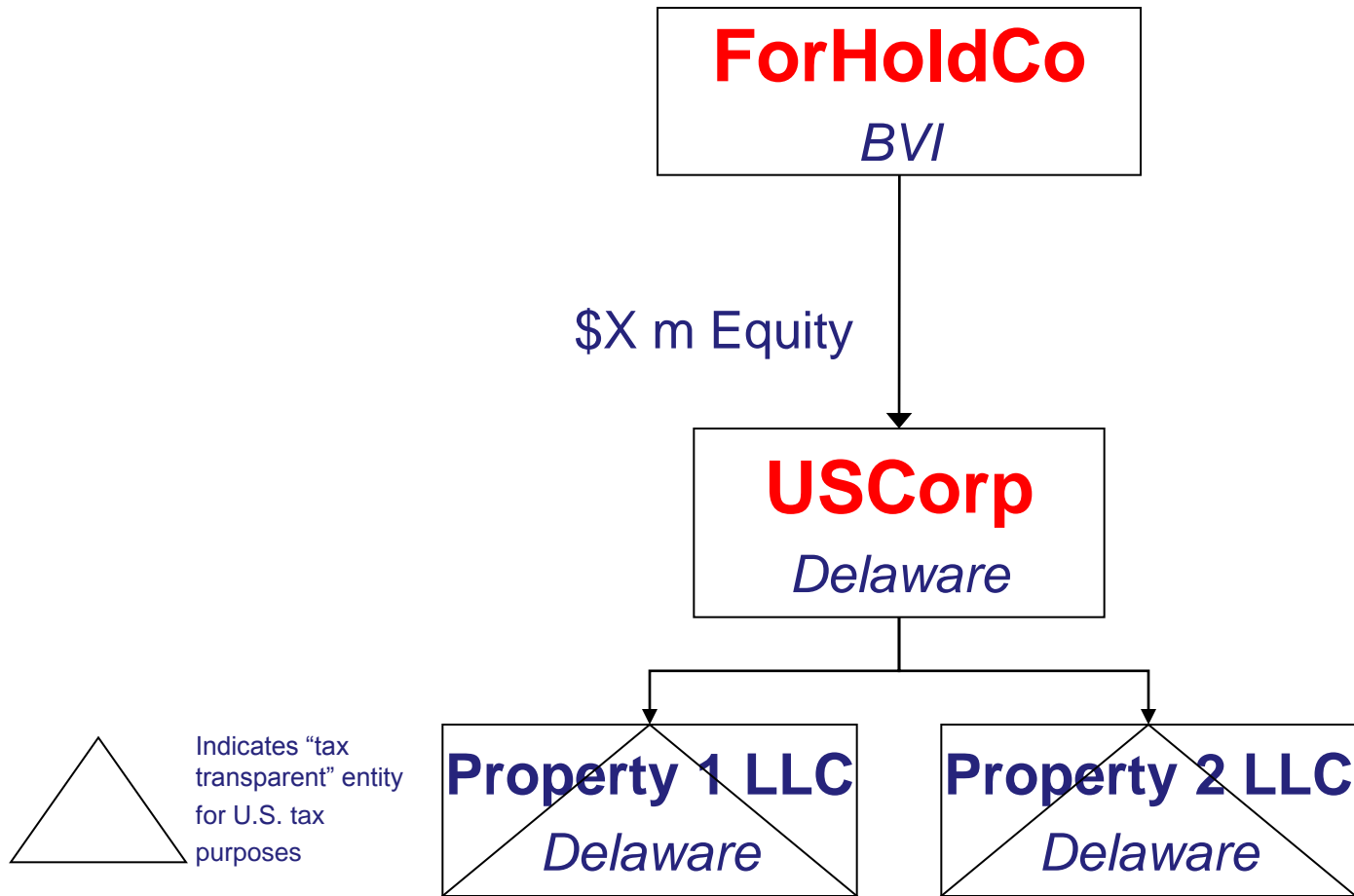
Ownership Through Trust

- Vehicle for newly acquired residential property
 - Irrevocable trust (domestic or foreign) formed with cash
 - Cash transfer should not be subject to gift tax
 - Nongrantor trust taxed as individual (entitled to LTCG rates)
- Trust uses cash to acquire U.S. real property
 - Acquisition of property from unrelated seller does not affect corpus of gift
 - Different result if settlor sells U.S. real property to trust; see *Davies v. Commr.*, 40 T.C. 525 (1963), and *De Goldschmidt-Rothschild v. Commr.*, 168 F.2d 975 (2d Cir. 1948)
- If trust is domestic, personal use not treated as distribution to beneficiary; cf. §643(i) if trust is foreign – beneficiary deemed to receive distribution of fair value of right to use the property

Ownership Through Trust (cont'd)

- At settlor's death, no transfer of property so no estate tax even though trust corpus consists of U.S. real property
- No basis step-up because property not included in estate
- Settlor can use property in certain circumstances without subjecting estate to estate tax under §2036(a):
 - Settlor must not have a right to trust income
 - Right should not exist where trust has an independent trustee and trustee has complete discretion over use of trust assets
- The benefit may be forfeited where –
 - Informal agreement allows settlor to control the income
 - Creditors of the settlor can reach trust assets (precludes formation of trust in many U.S. jurisdictions due to “self-settled trust” issues)
 - The settlor is the trustee
 - Trustee's discretion subject to an enforceable standard

Corporate Structure



Corporate Structure

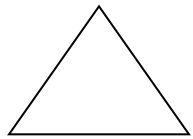
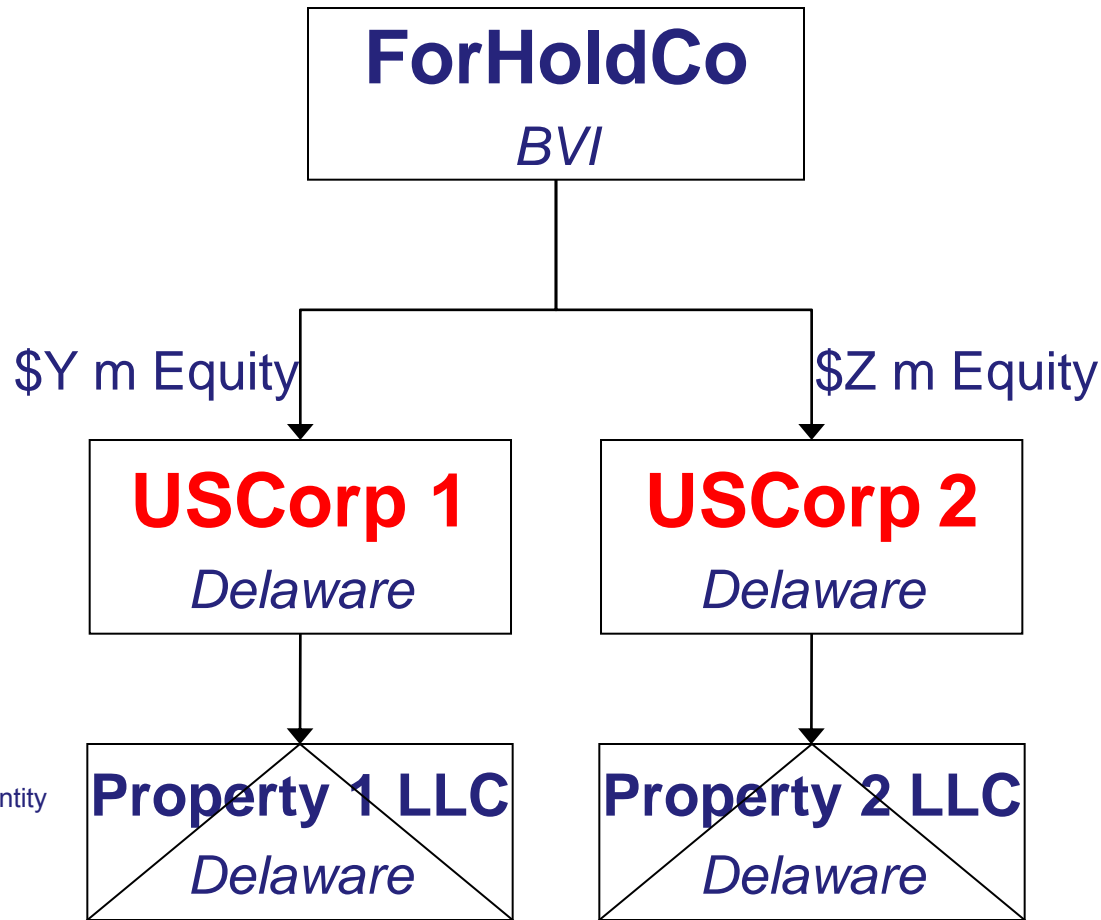
Advantages

- No estate or gift tax on transfers of foreign stock
- No branch profits tax
- Consolidation of U.S. profits and losses
- No individual income tax filings (Note: This does not provide anonymity for ultimate beneficial owner)

Disadvantages

- Corporate tax rates on sale of properties (no capital gains preference)
- Taxfree sale of stock of ForHoldCo but may be impractical and buyer will discount because no step-up at USCorp level
- Double taxation of profits at corporate and shareholder level except on liquidation of structure following sale of all properties

Corporate Structure (with multiple corporations)



Indicates "tax transparent" entity for U.S. tax purposes

Corporate Structure (with multiple corporations)

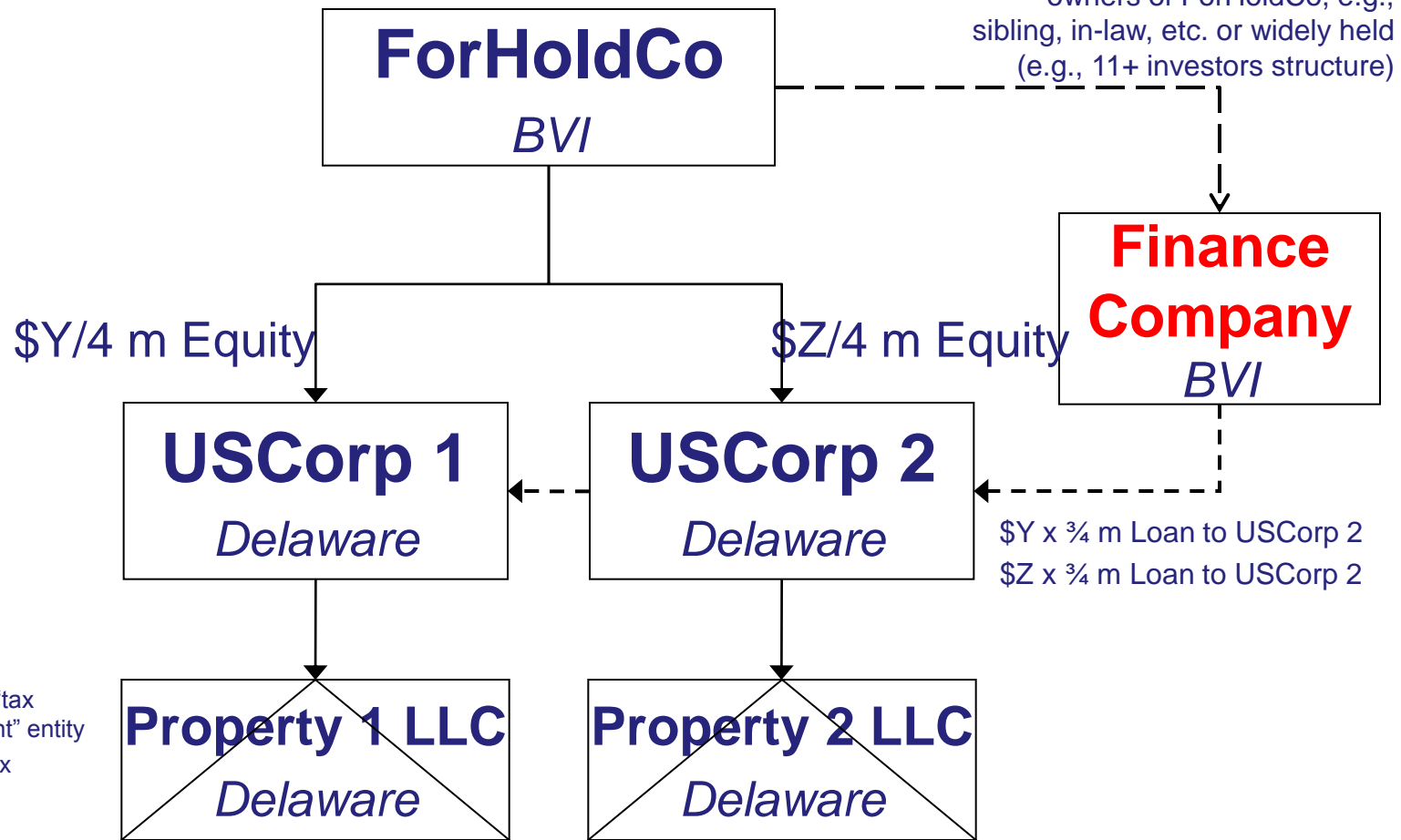
Advantages

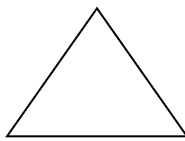
- No estate or gift tax on transfers of foreign stock
- No branch profits tax
- Can sell property of one U.S. corporation and pay corporate level tax but liquidation is then taxfree

Disadvantages

- Corporate tax rates on sale of properties (no capital gains preference)
- Taxfree sale of stock of ForHoldCo but may be impractical and buyer will discount because no step-up at USCorp level
- No consolidation of U.S. profits and losses
- Double taxation of operating profits at corporate and shareholder level

Corporate Structure (with financing)




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Foreign Corporate Structure (with financing)

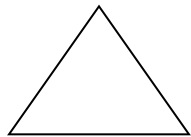
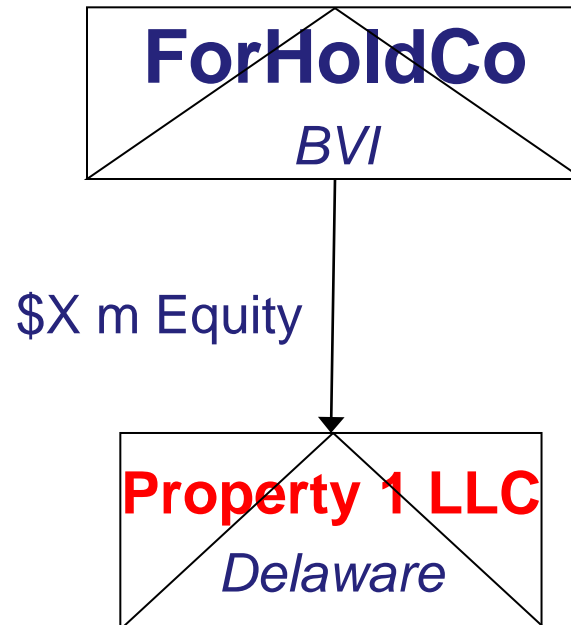
Advantages

- Deduction for interest (including contingent interest)
- Can avoid withholding on non-contingent interest if qualified for portfolio interest exemption
- No withholding on repayment of loan principal

Disadvantages

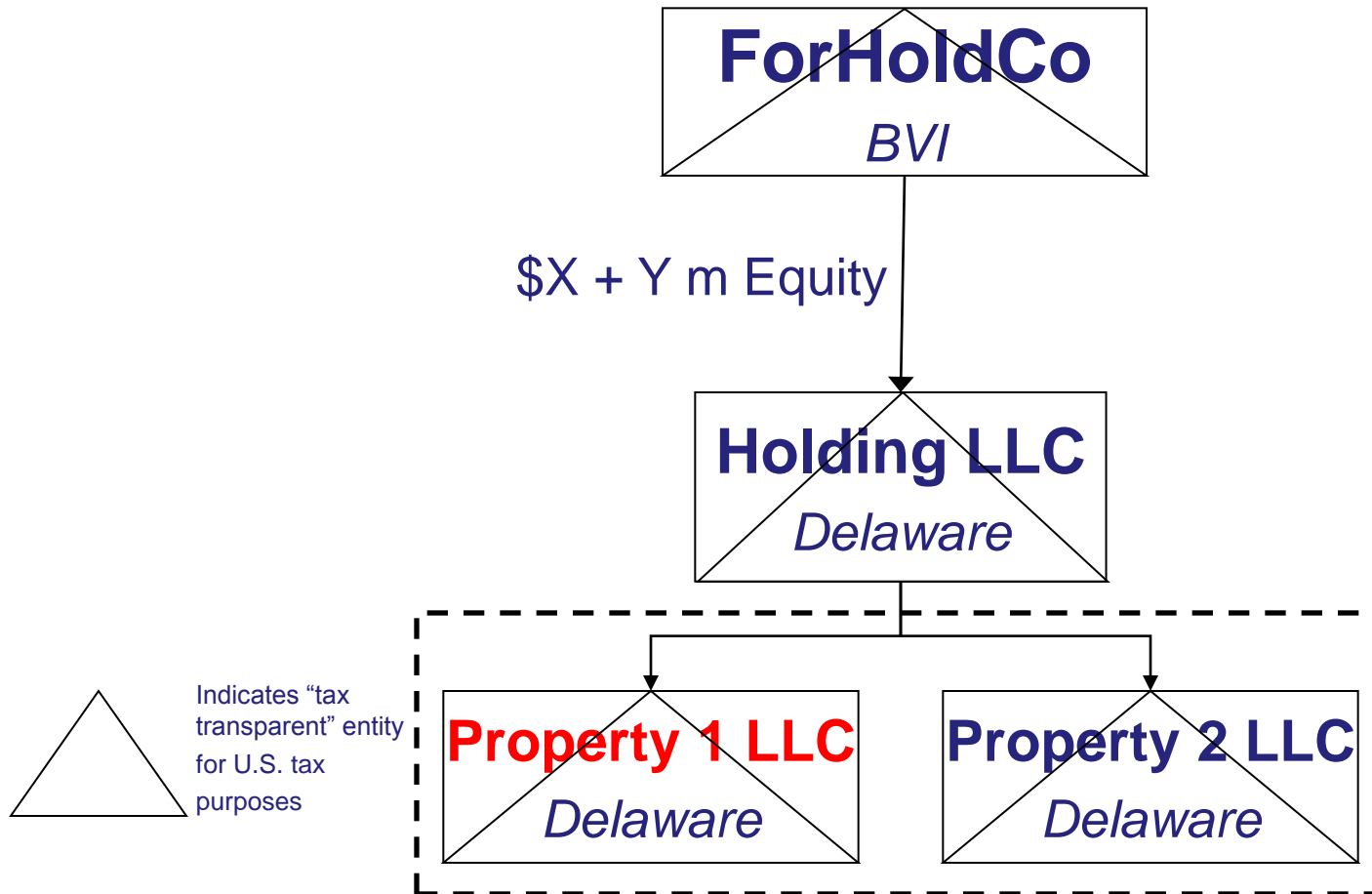
- Withholding on interest if lender is a “10 percent shareholder” or “10 percent partner” of borrower
- Debt:equity issues must be properly managed
- Potential earnings stripping limitations

Foreign Corporate Structure (initial property)

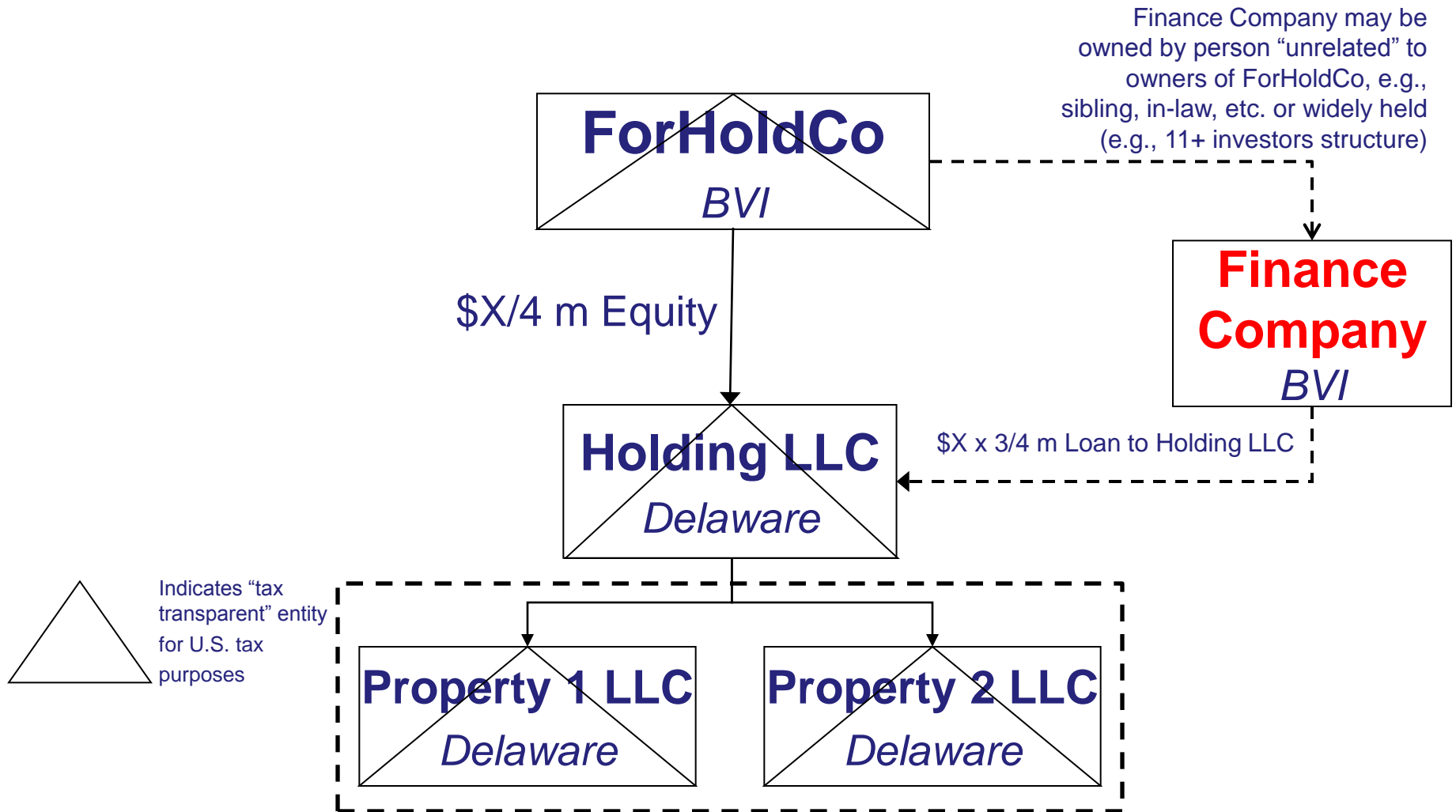


Indicates "tax transparent" entity for U.S. tax purposes

Foreign Corporate Structure (additional properties)



Foreign Corporate Structure (with financing)



Foreign Corporate Structure (with financing)

Advantages

- No gift or estate tax
- No capital gains tax on sale of stock (but as practical matter may need to have one corporation per property)
- Consolidation of U.S. profits and losses
- No individual income tax filings

Disadvantages

- Corporate rates
- Branch level taxes on “dividend equivalent amount” and branch interest – very difficult to manage

Financing Structures

- Objectives:
 - Receive deduction for interest payment
 - Obtain Federal and state tax exemption on interest
 - Avoid estate tax on loan
- Opportunities
 - Portfolio interest exemption
 - Treaty rate reduction or exemption
 - Use of participation loans with equity kickers
- Obstacles
 - Debt:equity considerations
 - Earnings stripping § 163(j); AHYDO § 163(e)(3); § 267(a)(3)
 - Estate tax exposure for participation loans and withholding tax on participation interest

Portfolio Interest Exemption

- Documentation requirements
 - Registered form (exemption for bearer form loans repealed for loans issued on or after March 18, 2012)
 - Form W-8BEN
 - Cannot be payable to bearer at any time prior to maturity
- Ineligible recipients
 - Bank on extension of credit made under loan agreement entered into in ordinary course of its trade or business
 - Received by 10-percent shareholder, meaning holder of 10% of voting power of corporation using § 318(a) attribution, or 10% profits or capital interest in partnership
 - Attribution rules offer planning opportunities
- Does not apply to contingent interest

Portfolio Interest Exemption (cont'd)

- Contingent interest includes interest determined by reference to:
 - receipts, sales or other cash flow of debtor or related person
 - income or profits of the debtor or a related person,
 - change in value of property of debtor or related person
 - any dividend, partnership distributions, or similar payments made by debtor or related person
- Estate tax exposure:
 - Fixed or indexed interest loan – exempt from estate tax
 - Participation loan – subject to estate tax (but treaty may eliminate tax)

Participation Loans

- Portfolio interest exemption remains available on fixed interest portion
- Loan is a USRPI, so gain on sale is taxable and subject to § 1445 withholding
- But repayment of loan is not disposition of USRPI – treated as payment of interest and principal (Treas. Reg. § 1.897-1(h), Example 2)
- Treaty may exempt interest but modern treaties now treat contingent interest as dividend (see U.S. Model Income Tax Treaty of 2006, art. 11(2))

Debt:Equity

- Any use of a mixture of equity capital and loans provided by the equity investors requires the usual attention to detail to avoid reclassification by IRS
- In particular:
 - Loans must be documented
 - Overall terms should be at arm's length
 - Payment terms must be achievable; use OID/deferral options if there will be predictable delays in payment (e.g. development loan)
 - Internal and overall ratios must be reasonable
 - Terms should be observed and lender must take steps an unrelated lender would take to monitor and enforce loan

Earnings Stripping, AHYDO, 267(a)

- Earnings stripping (§ 163(j))
 - Applies if debt-equity ratio exceeds 1.5
 - Limits deduction for net interest expense to 50% of “adjusted taxable income” (analogous to EBITDA)
 - Excess interest is carried forward to future years
 - Excess limitation carried over against excess interest for 5 years
- Applicable High Yield Debt Obligation (§ 163(e)(5) & (i))
 - Applies if borrower is a corporation, term exceeds 5 years and OID at rate greater than AFR + 5%
 - Excess non-deductible (but interest in hands of lender)
 - If lender related, non-excess not deducted until paid
- If lender related, §§ 267(a)(3) (interest) and 163(e)(3) (OID) defer deduction until interest paid



REAL ESTATE INVESTMENT TRUSTS (REITS)

REITs Pre-2004 JOBS Act

- Any distribution, to extent attributable to gain from a sale or exchange by REIT of a USRPI was typically considered a FIRPTA gain to non-U.S. shareholders (“historic” §897(h))
 - Gain taxed at regular rates
 - Tax returns
 - 35% withholding
 - Branch profits tax

REITs Pre-2004 JOBS Act

- Non-US investor's sale of stock of a domestically-controlled REIT did not trigger tax or withholding under §897
 - REIT is domestically-controlled if at all times during testing period less than 50% in value of the stock was held directly or indirectly by foreign persons
 - Relevant testing period is (generally) the shorter of the five-year period ending on the date of the disposition or of the distribution or the period during which the REIT was in existence

“New” §897(h) – “Qualified Investment Entities”

- Terminology change: §897(h)(1), as amended by the JOBS Act (and subsequent legislation), now applies to “qualified investment entity”
 - Includes REITs and, until December 31, 2013, RICs (if RIC is a USRPHC without regard to whether any investment is not an USRPI under 5% public shareholder exception and/or the “domestically-controlled” exception)
 - RIC which is a USRPHC is generally no longer treated as a qualified investment entity after December 31, 2013
 - Continues to be required to withhold on certain FIRPTA gains passed through to shareholders after 2013 (i.e., if RIC were to receive a capital gain distribution from a REIT)
 - Otherwise, REIT is now the only kind of qualified investment entity

REITs – Dividends

- **Ordinary Dividend** - §§1441 & 1442
 - FDAP income subject to 30% withholding tax or lower treaty rate
- **Capital Gains Dividend** – §897(h)(1):
 - **General Rule** if relates to sale of real estate
 - Taxable under FIRPTA
 - REIT withholds 35% tax and shareholder must file tax return
 - **Publicly traded REIT Rule:** If foreign person owns 5% or less of stock for at least one year then
 - Treated like ordinary dividend subject to 30% withholding tax or lower treaty rate
 - Benefit: Less tax than general rule, no requirement to file tax return and no branch profits tax on foreign corporate shareholder

REITs – Dividends (cont'd)

- Section 857(b)(3)(F), added by JOBS Act, provides that shareholder who gets “ordinary income” benefits of §897(h)(1) with respect to capital gain dividend:
 - Dividend not taxed under §897(b)(3)(B) or (D)
 - Dividend is treated as ordinary REIT dividend
- Recharacterized capital gain distribution is taxed as ordinary dividend, i.e., withholding at 30%, subject to reduced rate or exemption under treaty or §892
- Foreign investor availing itself of these rules:
 - Does not have to file a U.S. tax return because of the capital gain distribution
 - Branch profits tax is no longer applicable to such distribution to a non-U.S. corporate investor

REITs – Sale of REIT Stock

- General Rule
 - Gain is taxable under FIRPTA
 - Exceptions:
 - Publicly Traded REIT: No tax on shareholder owning 5% or less since not USRPHC – §897(c)(3)
- Domestically controlled REIT
 - Domestically controlled if 50% or more of the REIT is owned by U.S. persons during last 5 years or if less, time REIT has been in existence
- No tax since not USRPI – §897(h)(2)

REITs – Tax Treaties

The 2006 U.S. Model Treaty provides:

- 5% dividend rate does not apply to REIT dividends,
- 15% rate on REIT ordinary dividends (0% if paid to a pension fund) if:
 - Beneficial owner is an individual or pension fund, in either case holding not more than 10% interest in REIT;
 - Dividends is paid with respect to publicly traded class of stock and beneficial owner holds an interest of not more than 5% of any class of the REIT's stock; or
 - Beneficial owner holds an interest of not more than 10% in the REIT and the REIT is diversified.

REITs – Tax Treaties

- Under the 2006 Model Treaty, a REIT shall be "diversified" if the value of no single interest in real property exceeds 10% of its total interests in real property. For the purposes of this rule, foreclosure property is not considered an interest in real property
- The 2006 U.S. Model Technical Explanation states that distributions of gains “attributable to the alienation of a U.S. real property interest” from a REIT will not be a dividend, but rather will be taxable as gain from real property

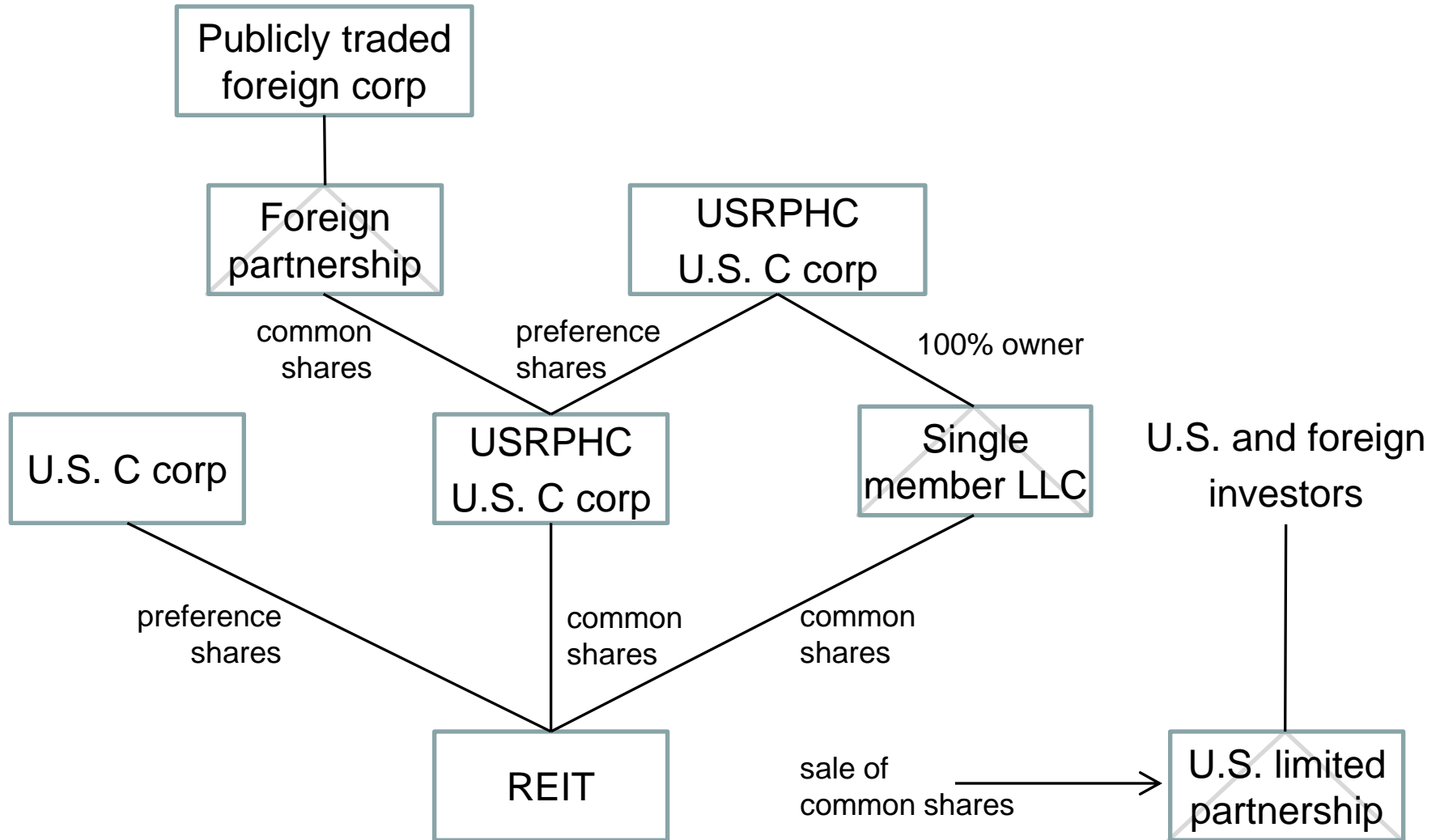
REITs – Tax Treaties

- Recent treaties are identical, e.g., Japan and Belgium, or substantially similar, e.g., U.K. and new Canadian protocol.
- No ownership limit for dividend exemption for pension funds in Canadian and Swiss treaties. Note an 80% of class of shares limit in Dutch treaty MOU.
- Explicit statement in protocol to Dutch treaty that pension fund dividend exemption inapplicable to REIT dividends of gains from dispositions of USRPIs.
- Special rule allowing Australia listed property trusts to get 15% rate except to the extent 5% holders would not qualify for 15% rate if they received the REIT dividend directly.
- Older treaties do not distinguish between REIT and C corporation dividends, allowing some foreign investors to get dividend withholding rates below that of 2006 Model Treaty (e.g., Hungary and Poland treaties provide for withholding rates as low as 5% in some circumstances for REIT dividends)

REITs – Withholding

- FIRPTA Withholding – Treas. Reg. § 1.1445-8
 - 35% withholding with respect to capital gain dividends or, if larger, largest amount that could have been designated as capital gain dividends.
 - Catch-up withholding for designations of prior distributions as capital gain dividends.
- IRC § 1445(e)(3) – 10% withholding tax on non-dividend distributions by USRPHCs.
- As noted previously, to the extent a distribution from a REIT is from gain on the disposition of a USRPI under §897(h)(1), the distributing entity must generally withhold 35% under §1445(e)(6).

Domestically-Controlled REIT Structure – PLR 200923001



Domestically-Controlled REIT Structure – PLR 200923001

- U.S. persons will own all REIT preferred shares and >50% of the REIT's value will continue to be owned by U.S. C corporations
- Issue was whether stock “held directly or indirectly by foreign persons” includes shares held by two U.S. C corporations for purposes of determining whether REIT is domestically-controlled

IRS Ruling in PLR 200923001

- “Based solely on the information and representations submitted, and on the facts and circumstances of this case, including the representation that [the two U.S. C corporations] are each fully taxable domestic Subchapter C corporations for U.S. federal income tax purposes and are not otherwise a REIT, RIC, hybrid entity, conduit, disregarded entity, or other flow-through or look-through entity, we conclude that [the two U.S. C corporations] will be considered domestic holders of their respective [REIT shares] for purposes of determining whether [the REIT] is a domestically controlled QIE within the meaning of Section 897(h)(4)(B).”

Swaps and FIRPTA

- Preamble to NPC regulations issued in 1993 indicates that “[T]he IRS is considering whether notional principal contracts involving...[certain] specified indices (e.g., United States real property) are subject to Section 897.”
- No guidance had been issued for 15 years.
- Treas. Reg. §1.897-1(d)(3)(i)(D) (FIRPTA interest includes direct or indirect to share in the appreciation in the value, or in the gross or net proceeds or profits generated by, the real property)

Swaps and FIRPTA

- Rev Rul. 2008-31 considered whether interest in NPC, where return calculated by reference to index based on data from geographically and numerically broad range of U.S. real estate, is a USRPI

Swaps and FIRPTA

- Facts of Rev. Rul. 2008-31
 - X maintains and widely publishes index that seeks to measure changes in residential or commercial real estate values within metropolitan statistical area ("MSA"), combined statistical area ("CSA"), or similar U.S. geographic area
 - Area has population exceeding 1,000,000 and is calculated by reference to (1) sales prices (obtained from various public records), (2) appraisals and reported income, or (3) similar objective financial information, each with respect to a broad range of real property holdings of unrelated owners within the relevant geographic area during a relevant testing period.
 - Because of the broad-based nature of the index, an investor cannot, as a practical matter, directly or indirectly, own or lease a material percentage of the real estate, the values of which are reflected by index

Swaps and FIRPTA

- Facts of Rev. Rul. 2008-31 (cont'd)
 - On January 1, Year 1, FC, a foreign corporation, enters into NPC, with unrelated counterparty DC, a domestic corporation. Neither FC nor DC is related to X
 - Pursuant to NPC, FC profits if index appreciates (i.e., to the extent the underlying U.S. real property in the particular geographic region appreciates in value) over certain levels. Conversely, FC suffers a loss if the Index depreciates (or fails to appreciate more than at a specified rate)
 - During NPC term NPC, DC does not, directly or indirectly, own or lease a material percentage of the real property, the values of which are reflected by the index

Swaps and FIRPTA

- Swaps and FIRPTA – Holding of Rev. Rul. 2008-31
 - Because of the broad-based nature of the Index, the NPC does not represent a "direct or indirect right to share in the appreciation in the value . . . [of] the real property" within the meaning of Treas. Reg. §1.897-1(d)(2).
 - Accordingly, FC's interest in the NPC calculated by reference to the Index is not a USRPI under §897(c)(1).

Swaps and FIRPTA

- Questions not answered by ruling:
 - How broadly based does the index need to be?
 - Is the maturity of a swap a “disposition” for purposes of §897(a)?
 - TAM 9730007 and PLR 9824026 seem to indicate not
- See also Treas. Reg. §1.897-1(h), example 2 (shared appreciation mortgage is USRPI but payments at maturity not a “disposition” for purposes of §897(a))
- Rationale of example is that final loan payments do not constitute “gain” for tax purposes.
- Query whether same rationale should apply to final payments received pursuant to swap.

Planning with Shared Appreciation Mortgage

- Section 897(a) imposes U.S. tax on “gain from the disposition of a U.S. real property interest” recognized by non-US persons.
- U.S. real property interests include stock (& participating debt) in a U.S. corporation if the FMV of its U.S. real property is equal to or greater than 50% its assets.
- Section 1445(a) requires the transferee of a U.S. real property interest to withhold 10% of the proceeds in respect of the tax due under §897.

Planning with Shared Appreciation Mortgage

- Therefore, if non-U.S. taxpayer invests directly in U.S. real estate or through entity, gain from the disposition of real property or the interest in the entity would be subject to U.S. federal income tax at graduated rates
- In addition, if non-U.S. taxpayer invests through foreign corporation also likely subject to branch profits tax
- One possible option to avoid FIRPTA is for foreign investor to use shared appreciation mortgage to invest synthetically in U.S. real estate
 - Shared appreciation mortgage is loan that provides for interest that is contingent on the gain from the sale of the property

Planning with Shared Appreciation Mortgage

- Regulation §1.897-1(h), Example 2
 - Foreign corporation makes \$1 million loan to domestic individual, secured by mortgage on real property purchased with loan proceeds
 - Loan agreement entitles lender to fixed monthly payments, constituting repayment of principal plus fixed interest rate
 - Lender also entitled to receive certain percentage of the appreciation in value of real property at the time that the loan is retired
 - Shared appreciation loan treated as U.S. real property interest (USRPI), but receipt of final payments do not constitute “disposition” of USRPI for purposes of §897

Planning with Shared Appreciation Mortgage

- Example 2 holds that receipt of final loan payment does not trigger §897 because payment constitutes principal and interest, not gain for tax purposes
- Thus, appreciation payment is treated as interest for tax purposes
- Cannot qualify for exemption from withholding under portfolio interest rules because payment is “contingent interest”. §871(h)(4)
- However, taxpayer could rely on treaty with zero percent withholding on contingent interest

Avoiding FIRPTA

- Liquidating Distribution Structuring Technique
 - In PLR 9016021, private REIT with non-U.S. shareholders sold assets and distributed sales proceeds pursuant to plan of liquidation.
 - The IRS ruled that distributions were payments in exchange for stock under §331, as opposed to §897(h) distributions attributable to gains from sales of USRPIs. This result obtained notwithstanding REIT was entitled to dividends paid deduction for distributions under §561
 - Under ruling, shareholders were able to recover basis
 - Taxpayers took the position that liquidating distributions from domestically-controlled REITs and/or “cleansed” REITs were not taxable under FIRPTA.

Avoiding FIRPTA

- PLR 200453008 withdrew PLR 9016021 for reconsideration
 - The IRS did not explicitly note in its revocation that the holding of PLR 9016021 was incorrect
 - However, revocation of PLR 9016021 obviously indicates that the IRS had substantial doubts regarding its original position
- Current proposals to amend FIRPTA would legislate result of PLR 9016021

Foreign Sovereign Fund REIT Investments

- Notice 2007-55
 - In typical pre-Notice transaction, foreign governmental investor (“FGI”) would purchase non-controlling interest in private, domestically-controlled REIT (often with single asset)
 - FGI was expected to receive ordinary dividends from REIT over course of REIT’s remaining life (e.g., 5 to 7 years). Such dividends are exempt from U.S. withholding and income tax
 - When it came time to liquidate the investment, REIT would sell its assets and distribute sales proceeds (and any remaining assets) to shareholders (including FGI) in complete liquidation
 - FGI would then take one or both of the following positions:
 - (i) all distributions from a REIT are exempt from taxation and withholding under §892, and/or
 - (ii) §897(h)(1) is inapplicable to liquidating distributions

Foreign Sovereign Fund REIT Investments

- Notice 2007-55
 - IRS will challenge transactions in which foreign government treats REIT capital gain distributions as (i) not subject to §897(h)(1), and/or (ii) as exempt from tax under §892
- In Notice 2007-55 the IRS concluded
 - Foreign government is a person under Treas. Reg. § 1.897-9T(e) with respect to USRPIs
 - Treas. Reg. §§ 1.897-9T(e) and 1.1445-10T(b) provide that a foreign government is subject to taxation under both §897 and §1445 on the disposition of a USRPI “except to the extent specifically otherwise provided in the regulations issued under section 892”
 - Section 892 regulations have no specific exemption for foreign governments under §897 or §1445

Foreign Sovereign Fund REIT Investments

- In Notice 2007-55, IRS noted:
 - “Income derived from sources other than described in this paragraph (such as income earned from a U.S. real property interest described in section 897(c)(1)(A)(i)) is not exempt from taxation under section 892. Furthermore, any gain derived from the disposition of a U.S. real property interest defined in section 897(c)(1)(A)(i) shall in no event qualify for exemption under section 892.” Treas. Reg. §1.892-3T(a)(1)
 - The IRS believes this language makes it clear that gain from the disposition of a USRPI which is described in §897(c)(1)(A)(i) is not exempt from taxation under §892
 - Under §892, gain derived by a foreign government from disposition of a USRPHC is exempt provided USRPHC is not a controlled commercial entity under §892(a)(2)(B)

Foreign Sovereign Fund REIT Investments

- Notice 2007-55
 - IRS will challenge assertion by any foreign taxpayer that §897(h)(1) does not apply to distributions in complete liquidation under §331 or §332
 - Regulations will clarify that application of §897(h)(1) and withholding under §1445(e) is not limited to §316 distributions by qualified investment entities
 - Regulations will clarify that the term “distribution,” as used in §897(h)(1) and §1445(e)(6) will include any distribution included under §§301, 302, 331, and/or 332, where the distribution is attributable, in whole or in part, to gain from sale or exchange of a USRPI by a qualified investment entity or other pass-through entity

Foreign Sovereign Fund REIT Investments

- Proposed regulations (REG-146537-06) on taxation under §892 published on November 2, 2011 would provide that:
 - A single act of selling a passive investment in U.S. real estate, although fully taxable, could also cause a controlled entity to lose its tax exemption on all other U.S. source income if §897 were interpreted to treat the sale of U.S. real estate as a commercial activity
 - A disposition of a USRPI, including a deemed disposition under §897(h)(1), does not by itself constitute conduct of a commercial activity. No modification made to rule that income derived from disposition of a USRPI (other than interest in a U.S. real property holding company) continues to be ineligible for exemption from tax under §892



QUESTIONS