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FIRPTA Provisions Under Protecting Americans From Tax Hikes Act of 2015

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FIRPTA Reform

The Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act") was signed into law on December 18, 2015

– The PATH Act contains a number of important revisions to the FIRPTA rules under section 897 relating to non-U.S. taxpayers investing in U.S. real estate

- For publicly-traded REITs, raise FIRPTA exemption from 5% shareholders to 10% shareholders
- Exemption from FIRPTA for qualified foreign pension plans
- Revisions to rules determining "domestically controlled REIT" status
- Narrowly targeted provision exempting qualified shareholders from FIRPTA
- "Cleansing" rule would not apply to REITs
- FIRPTA withholding increased from 10% to 15% of gross purchase price
- Deduction under section 245 for U.S. source portion of dividends from certain CFCs (to the extent attributable to dividends from an 80%-owned domestic corporation) would not include dividends derived by CFC from REITs or RICs

Exception for Persons Holding Publicly-Traded REIT Stock

For REIT stock that is regularly traded on an established securities market, the exemption from FIRPTA would increase from 5% or less shareholders to 10% or less shareholders.

- Neither sale of REIT stock nor sale of assets by REIT and distribution of proceeds is subject to FIRPTA for such shareholders.
- Distributions that otherwise could be treated as capital gain dividends are treated as ordinary dividends subject to tax under rules related to ordinary dividends.
  - Distributions not subject to branch profits tax.
  - Ordinary dividend withholding tax (subject to treaty reduction) would apply to amounts treated as dividends.
  - Joint Committee Report confirms result in AM 2008-003 (other than in a narrow context relating to certain "qualified shareholders" – discussed at 14-17) providing that no withholding should apply with respect to distributions that are not dividends (e.g., redemption or liquidating distributions).
- Provision is important to certain large non-U.S. investors who have expressed interest in taking larger stakes in publicly-offered REITs.
- Effective for dispositions of REIT stock or REIT distributions on or after December 18, 2015.

Exception for Qualified Foreign Pension Funds

Under newly-enacted section 897(l), USRPIs held by a "qualified foreign pension fund" (a "QFP") or any entity all of the interests of which are held by a QFP would not be subject to the FIRPTA rules section 897.

- A QFP is defined as any trust, corporation, or other organization or arrangement
  - Which is organized under the laws of a country other than the U.S.;
  - Which is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees of one or more employers in consideration for services rendered;
  - Which does not have a single participant or beneficiary with a right to more than 5% of the QFP's assets or income;
  - Which is subject to government regulation and provides annual information reporting about beneficiaries to the foreign country's tax authorities; and
  - With respect to which, under the laws of the country in which it is established or operated, either:
    - contributions to the entity that otherwise would be subject to tax under local law are "deductible or excluded from the gross income of such entity or taxed at a reduced rate," or
    - taxation of investment income of the entity is deferred or taxed at a reduced rate.
- Compare definition of QFP to definition of a "broad participation retirement fund" under FATCA rules at Reg. §1.1471-6(f)(2).
- JCT Blue Book states: "Foreign pension funds may be structured in a variety of ways, and may comprise one or more separate entities. The word 'arrangement' encompasses such alternative structures."

Exception for Qualified Foreign Pension Funds

Under the new rule, a QFP is exempt from FIRPTA with respect to a direct sale of FIRPTA assets as well as with respect to a REIT distribution that otherwise would result in FIRPTA tax under section 897(h)(1).

PATH Act also amends section 1445 withholding rules so that a QFP is not treated as a "foreign person" for purposes of section 1445.

- As a result, a QFP should not be subject to FIRPTA withholding with respect to section 897(h)(1) distributions so long as the distribution is part of an exchange under section 302 or 331 or the dividend is designated as a capital gain dividend.
- Regulations issued on February 18, 2016, clarify that a qualified foreign pension fund is not a foreign person for purposes of the withholding certification rules under section 1445 and thus a qualified foreign pension fund should be able to certify to non-foreign status under those rules. Reg. §1.1445-2(b)(2).
- Regulations have not been issued under section 1446, so there still is no sanctioned certification process where FIRPTA gain is recognized by partnership.

This amendment is effective for dispositions and distributions after December 18, 2015.

Exception for Qualified Foreign Pension Funds

It appears that a foreign governmental pension plan can qualify as a QFP if it meets the relevant tests. There are, however, certain requirements that make it uncertain as to whether some foreign governmental pension plans will qualify.

- For some foreign governmental pension plans (e.g., plans created in connection with a government's social security system), participation may be broad such that the plan cannot establish that it provides retirement or pension benefits to participants or beneficiaries that are current or former employees of one or more employers in consideration for services rendered.
- There also may be questions as to whether a foreign government pension plan is subject to government regulation and provides annual information reporting about beneficiaries to the foreign country's tax authorities.
  - The plan may report, instead, to a non-tax authority like the Department of Labor, and some government pension plans may not report to a government authority at all, as the plan is already part of the government (and may not be required to, in effect, report to itself).
- Finally, some middle eastern countries have no tax system at all. In such a country, it may be impossible to satisfy the last requirement – that is, contributions to the entity that otherwise would be subject to tax under local law must be "deductible or excluded from the gross income of such entity or taxed at a reduced rate," or taxation of investment income of the entity must deferred or taxed at a reduced rate.
- The JCT Blue Book states: "Multi-employer and government-sponsored public pension funds that provide pension and pension-related benefits may satisfy this prong of the definition. For example, such pension funds may be established for one or more companies or professions, or for the general working public of a foreign country."

Exception for Qualified Foreign Pension Funds

Although a QFP is exempt from FIRPTA under section 897(l), it still will be important that the QFP invest through a REIT in most situations.

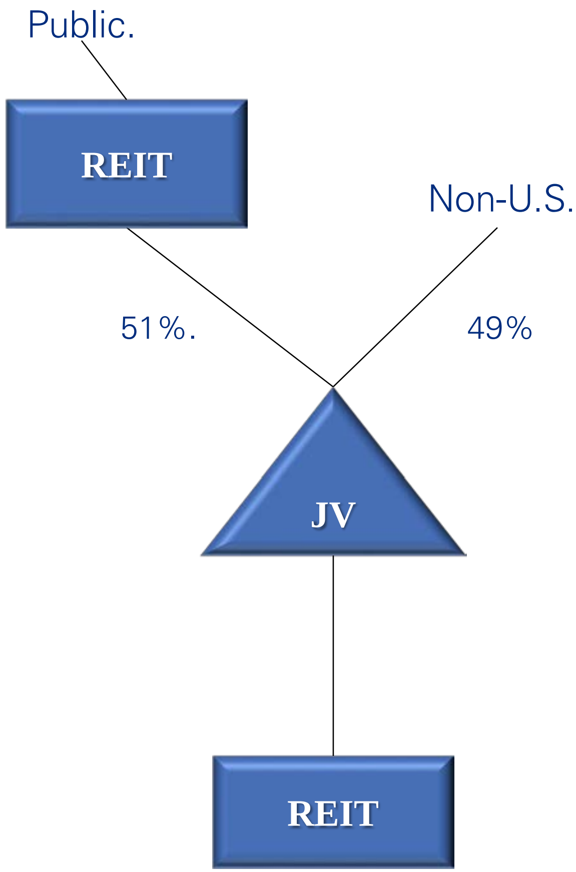
- In general, gain from the sale of real estate held in connection with the conduct of a trade or business in the U.S. will be treated as U.S. effectively connected income ("ECI").
- Most domestic real estate owned in the investment fund context will be held in connection with the conduct of a U.S. trade or business.
  - Gain with respect to such property, if held directly through a partnership, would give rise to ECI without regard to application of the FIRPTA rules.
- By investing through a REIT, the ECI with respect to the property is blocked, and FIRPTA is the only avenue for taxing the gain.
  - Because section 897(l) eliminates application of FIRPTA for QFPs both with respect to the sale of REIT stock and REIT distributions relating to USRPI gain at the REIT level, a QFP can avoid U.S. tax with respect to gain on the U.S. real estate held through a REIT.

Domestically Controlled REIT Determination

The PATH Act modifies the rules for determining when a REIT will be treated as "domestically controlled" for purposes of the FIRPTA exception under section 897(h)(2).

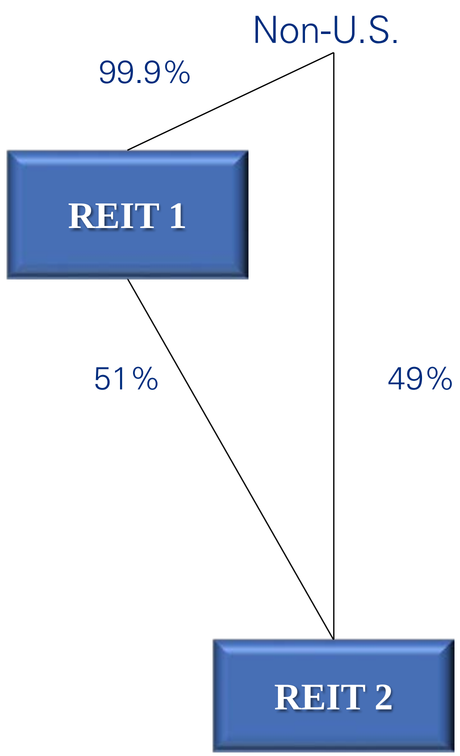
- For purposes of determining whether a REIT is domestically controlled:
  - A less than 5% shareholder in a public REIT is presumed to be domestic unless the REIT has actual knowledge to the contrary.
  - A regularly traded REIT or RIC (including RIC issuing redeemable securities) that is domestically controlled will be treated as a U.S. person in analyzing subsidiary REITs.
    - If a regularly traded REIT or RIC is not domestically controlled, it will be treated as a foreign shareholder.
  - A shareholder that is a non-traded U.S. REIT will be treated as a U.S. shareholder only to the extent that stock of such REIT is held by U.S. shareholders.
- Joint Committee Explanation states: "Treasury regulations provide that for purposes of determining whether a REIT is domestically controlled, the actual owner of REIT shares is the 'person who is required to include in his return the dividends received on the stock.' The IRS has issued a private letter ruling concluding that the term 'directly or indirectly' for this purpose does not require looking through corporate entities that, in the facts of the ruling, were represented to be fully taxable domestic corporations for U.S. federal income tax purposes 'and not otherwise a REIT, RIC, hybrid entity, conduit, disregarded entity, or other flow-through or look-through entity.'"

Domestically Controlled REIT Determination



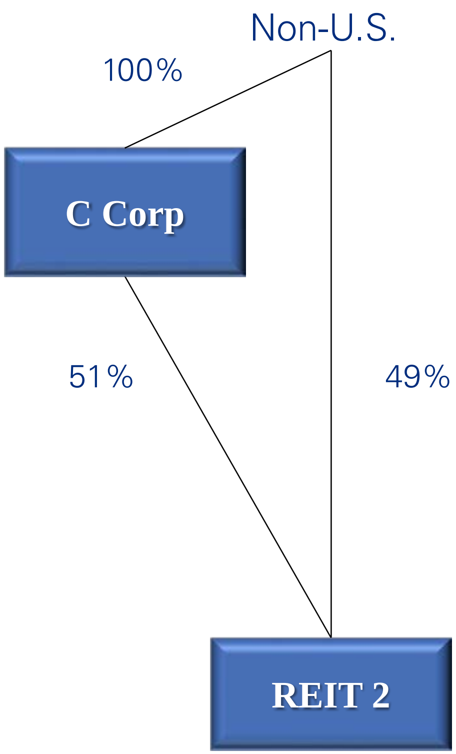
- Public REITs often look for JV partners to off-load exposure on significant property investments.
- Under prior law, treatment of public REIT as a U.S. shareholder was uncertain, as "domestic control" was determined solely by reference to "direct or indirect" shareholders.
- Under new law, a public U.S. REIT generally will be a U.S. shareholder for purposes of determining "domestically controlled" status.

Domestically Controlled REIT Determination



- New law confirms that the "domestically controlled". determination is made by looking through a non-traded REIT to its ultimate shareholders.
- Although REIT 1 is formed in the U.S., REIT 2 would not be treated as "domestically controlled" because REIT 1 would be treated as a non-U.S. shareholder by reference to its Non-U.S. owner.

Domestically Controlled REIT Determination



- Query the impact of the new law (providing look-thru treatment for REITs, but not mentioning C corporations) and the Joint Committee Explanation language referencing the 2009 PLR on a “C corporation blocker” structure.

Domestically Controlled REIT Determination

The provisions relating to the determination of domestic control are effective as of December 18, 2015.

Qualified Shareholder Exemption

A new rule of very limited applicability provides that stock of a REIT held by a “qualified shareholder” is not a USRPI.

– The rule applies regardless of whether the REIT stock is held directly or indirectly through a partnership.

Distributions to a qualified shareholder also would not be subject to FIRPTA under section 897(h)(1) to the extent that the REIT stock is not treated as a USRPI with respect to the qualified shareholder.

– As is the case for section 897(h)(1) dividends that are exempt from FIRPTA tax with respect to 10% or less shareholders of a publicly-traded REIT, dividends paid to a qualified shareholder that are exempt from section 897(h)(1) also will be treated as ordinary dividends paid by the REIT, subject to withholding as applicable to ordinary dividends (possibly reduced by treaty).

The net result of the provision is that there generally is no U.S. tax by virtue of FIRPTA on the sale of REIT shares by a qualified shareholder or on section 897(h)(1) distributions received by such a shareholder.

– Under a special rule, a distribution under section 301(c)(3), 302, or 331 with respect to a qualified shareholder (other than an “applicable investor”) will be treated as a REIT dividend notwithstanding any other provision.

Qualified Shareholder Exemption

A qualified shareholder is defined as a foreign person that meets three requirements:

- Under the first requirement, the foreign person must be
  - Eligible for benefits under a treaty which has an exchange of information program and the principal class of interests of which is listed and regularly traded on one or more recognized stock exchanges (as defined under the treaty), or
  - A foreign limited partnership organized in a jurisdiction that has an agreement for the exchange of information with respect to taxes with the U.S. and has a class of limited partnership units which is regularly traded on the NYSE or NASDAQ exchange, and the value of such class of limited partnership units is greater than 50% of the value of all partnership units.
- Under the second requirement, the foreign person must be a “qualified collective investment vehicle”.
- Under the third requirement, the foreign person must maintain records on the identity of each person who, at any time during the foreign person’s taxable year, holds directly 5% or more of the class of interest described in the first requirement.

Qualified Shareholder Exemption

A "qualified collective investment vehicle" means a foreign person:

- Which is eligible for reduced treaty rate withholding with respect to ordinary REIT dividends even if such person holds more than 10% of the stock of such REIT – treaty must specifically contemplate application to REIT dividends; <u>or</u>
- Which
  - Is a publicly-traded partnership (as defined under section 7704(b)) which is not taxable under section 7704(a);
  - Is a withholding foreign partnership for purposes of chapters 3, 4, and 61;
  - If the foreign partnership were a U.S. corporation, would be a USRPHC (determined without regard to the qualified shareholder exemption) at any time during the five-year period ending on the date of disposition of, or distribution with respect to, the partnership's interests in a REIT; <u>or</u>
- Which is designated as a qualified collective investment vehicle by the Secretary and is either
  - Fiscally transparent under section 894; or
  - Required to include dividends in its gross income, but is entitled to a deduction for distributions to persons holding interests in such foreign person (other than those holding interests solely as a creditor).

Qualified Shareholder Exemption

If a qualified shareholder has one or more "applicable investors", a "benefit reduction" rule would provide that the exemption will not apply with respect to the qualified shareholder to the extent of the applicable investors' collective percentage ownership interest in the qualified shareholder.

- An applicable investor is any person (other than another qualified shareholder) that (i) owns an interest in the qualified shareholder, and (ii) holds more than 10% of the REIT's stock (whether or not by reason of the person's ownership interest in the qualified shareholder).
  - It appears that the constructive ownership rules under section 897(c)(6)(C) are intended to apply for purposes of determining ownership of REIT stock, although the statute cross references to the wrong provision. Section 897(k)(2)(E) cross references section 897(k)(2)(C) rather than section 897(k)(2)(D). Presumably this mistake will be the subject of a technical correction.

Qualified Shareholder Exemption

The qualified shareholder provision has very narrow application and could primarily benefit foreign public REITs in a limited number of jurisdictions.

- Examples of potential beneficiaries include Australian property trusts and Dutch beleggingsinstelling.

The qualified shareholder provision applies to dispositions of REIT stock and distributions by a REIT after December 18, 2015.

Repeal of Cleansing Exception

The PATH Act repeals the "cleansing exception" under section 897(c)(1)(B) for REITs and RICs.

- Prior to this change, if a Fund purchased REIT stock and took a basis in the stock that was higher than basis of assets held by the REIT, a subsequent sale of all USRPI held by the REIT (subject to tax under section 897(h)(1) for non-U.S. shareholders) could "cleanse" the USRPI taint of the REIT stock.
- The cleansing of the REIT stock as a USRPI prevented recognition of FIRPTA loss by non-U.S. shareholders on liquidation of the REIT, with the result that the non-U.S. shareholders were subject to tax on noneconomic gain.

Other Amendments

Other amendments affecting FIRPTA and non-U.S. investment in real estate

- FIRPTA withholding would be increased from 10% of gross sales proceeds to 15% of gross sales proceeds
- Deduction under section 245 for U.S. source portion of dividends from certain CFCs (to the extent attributable to dividends from an 80%-owned domestic corporation) would not include dividends derived by CFC from REITs or RICs

Thank you