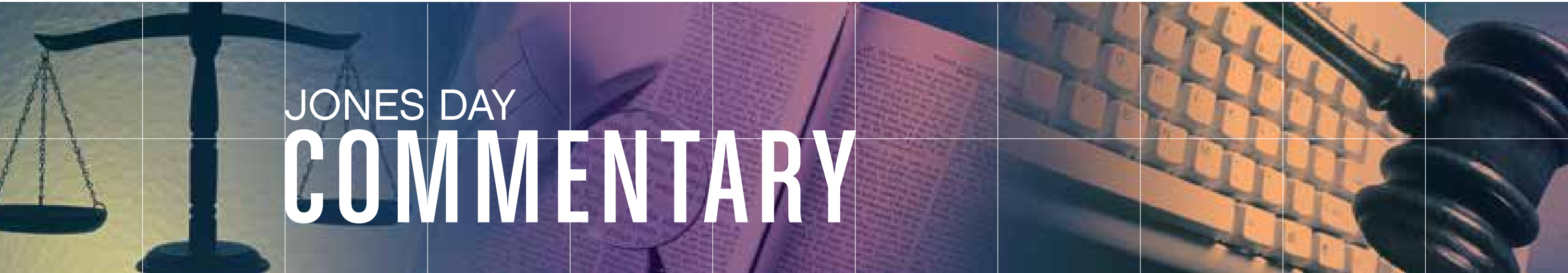
JONES DAY

SEPTEMBER 2013



CONGRESSIONAL PROPOSALS SEEK TO PROMOTE FOREIGN INVESTMENT IN U.S. REAL ESTATE

On July 31, Representative Kevin Brady (R-TX) introduced H.R. 2870 to amend the Foreign Investment in Real Property Tax Act ("FIRPTA"), the tax regime governing foreign investment in U.S. real estate. The proposal is a companion bill to S. 1181, introduced by Senator Robert Menendez (D-NJ) on June 18, and both Congressional bills are reprisals of legislation proposed in 2010 and 2011.

The Congressional proposals—each titled *Real Estate Investment and Jobs Act of 2013*—are backed in both chambers on a bipartisan basis and are intended to promote greater foreign investment in real estate investment trusts ("REITs"). The proposals follow on the heels of an announcement by the White House earlier this year, which outlined the Obama administration's goal of promoting greater foreign investment in U.S. real estate by changing the application of FIRPTA with respect to foreign pension fund investors.

BACKGROUND

As discussed in a prior *Commentary (available upon request)* on the competing White House proposal, commentators have been critical of FIRPTA since its inception in 1980. FIRPTA made gains from the disposition of U.S. real property interests taxable in the hands of foreign investors and, in the view of many, creates a barrier to foreign investment. According to Senator Robert Menendez (D-NJ), FIRPTA imposes

> significant penalties on foreign investments in domestic real estate that do not exist on other types of U.S. investments such as corporate stocks and bonds. These rules ... freeze out foreign investment in our real estate markets by imposing an arbitrary withholding tax on the gains realized by overseas capital invested in domestic properties.

Legislation has been periodically introduced that would abolish or significantly reduce the effects

© 2013 Jones Day. All rights reserved. Printed in the U.S.A.

of FIRPTA. Although attempts at legislative change have thus far been unsuccessful, many believe that the time for change may finally be ripe, spurred principally by economic circumstances. By 2018, it is expected that more than $2 trillion in loans, including commercial mortgage-backed securities, will mature. Without increased foreign investment in these items, significant amounts of debt may go into default, triggering foreclosures and decreased property values. The threat of impending default and foreclosure, combined with continued economic stagnation, may prompt legislators to focus more intently on proposals that are expected to bring capital into the United States.

THE PROPOSALS

The Congressional proposals focus exclusively on promoting foreign investment in the stock of REITs and do four things:

- Reverse part of IRS Notice 2007-55 (the "Notice") such that liquidating distributions from a REIT to a foreign shareholder are tax-free;
- Increase the ownership ceiling for the publicly traded FIRPTA exception from 5 percent to 10 percent with respect to REIT investments by foreign persons;
- Create a new FIRPTA exception for certain foreign investors who are 10 percent or less holders of REIT stock, regardless of whether the REIT is publicly traded; and
- Add helpful presumption rules to ease the determination of whether a REIT is "domestically controlled."

These proposals, if enacted into law in their current form, would encourage increased participation in U.S. real estate markets by foreign investors through REIT structures, and they would potentially apply to such investments made through privately held REITs, REITs whose shares are publicly traded, as well as so-called "non-traded" REITs whose shares, though publicly offered, are not listed on a securities exchange.

Reverse IRS Notice 2007-55 as to REIT Liquidating Distributions. Perhaps the most significant aspect of these Congressional proposals is the proposal to reverse part of the Notice. The Notice was released by the Internal Revenue Service (the "IRS") in 2007 and contained two rulings relating to foreign investments in REITs. The proposals would reverse the second of the Notice's two rulings, which provided that liquidating distributions paid by a REIT should be treated as sales of the REIT's underlying real estate rather than a sale of stock. The IRS's position in the Notice greatly disturbed investor expectations about their REIT investments by creating an inconsistency between the tax treatment of a sale of REIT shares and liquidating distributions received from a REIT. The Notice's release in 2007 was particularly ill-timed as it coincided with the economic recession and considerably chilled foreign investment in U.S. real estate.

By way of background, a foreign shareholder selling REIT shares can avoid tax in several ways:

- Where the REIT does not primarily own assets that are considered to be "U.S. real property interests" (such as in the case of a "mortgage REIT");
- Where the REIT is majority-owned by U.S. persons (i.e., where it is "domestically controlled");
- Where the REIT is publicly traded and the shareholder can rely upon the 5 percent publicly traded exception;
- Where the shareholder sells its shares after the REIT has disposed of all of its real property in a transaction in which gain or loss is recognized; or
- Where the shareholder is a "foreign government" eligible for the section 892 exemption and does not control the REIT.

Under general income tax principles, a redemption or liquidation of shares of a corporation generally is treated as a sale or exchange of stock. Thus, it was believed by many tax practitioners that liquidating distributions from a REIT—a corporation—should be treated similarly, such that foreign shareholders whose REIT investments fit the above-described profiles could avoid U.S. tax on a liquidating distribution.

Despite the widely held view, the Notice instead took the position that, specifically for REIT investments, a liquidating distribution would not be treated as gain from the sale of stock but rather as gain attributable to a sale of the REIT's underlying real estate, with the resulting gain therefore subject to income tax and (in the case of foreign corporate shareholders) the branch profits tax. The Congressional proposals

would reverse the first part of the Notice by harmonizing the tax treatment of REIT stock sales and liquidating distributions, effectively restoring what many believed to be the IRS's original position on REIT liquidating distributions.

Prior to the Notice, the use of private REIT structures that were majority owned by U.S. persons was a popular technique for foreign investors to participate in private U.S. real estate projects, as it represented what many believed was one of the only methods of permitting such foreign investors to invest in such projects without significant U.S. tax burdens (thus putting such investments on par with investments by foreign persons in U.S. stock and bond funds). As noted, the Notice has had a chilling effect on participation by foreign investors in private U.S. real estate transactions, because it very clearly signaled the IRS's intention to challenge this intended tax-favored treatment for foreign investors upon liquidation of the investment. Thus, this particular proposal in Congress, if enacted in its current form, would be significant in encouraging these types of investments once again.

However, the Congressional proposals would leave undisturbed the first part of the Notice, which "clarified" the IRS's view that REIT capital gain distributions paid during the life of a REIT (rather than at liquidation) were not eligible for exemption to a foreign government shareholder under section 892 of the Internal Revenue Code. Subject to exceptions, section 892 exempts from federal income tax income of foreign governments from certain investments in the U.S., including stock investments. The Notice presented the IRS's view that the section 892 exemption did not extend to REIT distributions stemming from an underlying sale by a REIT of U.S. real property interests. This portion of the Notice has attracted far less attention, and outcry, than the second part dealing with liquidating distributions, and legislative proposals to date have altogether ignored this aspect of the Notice.

Expand FIRPTA Exception for Publicly Traded REIT Stock. The proposals also increase the amount of stock minority shareholders in a REIT may own without triggering tax under FIRPTA. Currently, a foreign shareholder can own up to five percent of certain publicly traded entities that hold primarily U.S. real property assets and still escape tax under FIRPTA. Where the publicly traded entity is a REIT, the five percent exception extends to capital gain dividends as well.

The proposals increase the ownership ceiling to 10 percent with respect to publicly traded REIT investments, allowing foreign investors to boost their ownership stake in public REITs without being subjected to FIRPTA. It should be noted, however, that the general income tax and withholding tax rules will continue to apply to capital gain distributions even if FIRPTA does not.

Create New FIRPTA Exception for REIT Ownership by "Qualified Shareholders." The proposals also create a new FIRPTA exception for "Qualified Shareholders." Under this proposal, gain from the sale of stock of a REIT (whether or not publicly traded) by a Qualified Shareholder will not be subject to FIRPTA, except to the extent that an investor in the Qualified Shareholder (other than an investor who is also a Qualified Shareholder) holds (either directly or indirectly through the Qualified Shareholder) more than 10 percent of the stock of the REIT.

A Qualified Shareholder is an entity: (i) that is eligible for benefits under an income tax treaty that includes an exchange of information provision; (ii) whose principal class of interests is regularly traded on a recognized stock exchange, as defined by such treaty; (iii) that maintains records on the identity of each person who is the direct owner of 10 percent or more of the principal class of interests that are traded; and (iv) that is a "qualified collective investment vehicle." A "qualified collective investment vehicle" can take any of three guises: (x) an entity that is eligible for a reduced rate of withholding under an income tax treaty with respect to ordinary dividends paid by a REIT, even if it owns more than 10 percent of the REIT stock; (y) a corporation engaged primarily in the trade or business of operating or managing real estate entities or assets either directly or indirectly through entities under common control; or (z) an entity that is designated by the Secretary of the Treasury as a qualified collective investment vehicle and is either fiscally transparent or required to include dividends in gross income (but entitled to a deduction for distributions paid).

With respect to (x), *above*—i.e., entities eligible for a reduced treaty rate of withholding on REIT ordinary dividends—treaties generally restrict the types of investors eligible for such benefits. For instance, the United States Model Income Tax

Convention allows a reduced rate of withholding on REIT dividends where the beneficial owner of the dividends is (a) an individual or pension fund holding an interest of not more than 10 percent of the REIT; (b) a person holding no more than 5 percent of the REIT's stock and the REIT is publicly traded; or (c) a person holding an interest of no more than 10 percent of a REIT that is "diversified" (i.e., a REIT that has no single interest in real property that exceeds 10 percent of its total interests in real property). However, since a Qualified Shareholder must be publicly traded, and since a publicly traded shareholder of a REIT would likely be treated as the beneficial owner of REIT dividends, option (a), *above*, does not seem a likely avenue for qualification. Thus, the pool of investors potentially eligible for this new FIRPTA exception may be quite restricted.

Ease Determination of "Domestically Controlled" REIT Status. The proposals modify the determination of whether an entity is a "domestically controlled REIT" by adding helpful presumption rules regarding a REIT's ownership. As interests in a domestically controlled REIT are not subject to FIRPTA, knowing whether a particular REIT is primarily held by domestic or foreign shareholders is critically important to foreign investors.

Historically, however, it has been challenging for publicly traded REITs to identify their ownership with precision given that they often lack information about certain of their smaller shareholders and due to uncertainties in the application of the rules. The proposals clarify that, for purposes of determining whether a REIT is domestically controlled, interests in such REIT held by a publicly traded upper tier REIT will be treated as owned by a foreign person unless the upper tier REIT is domestically controlled. For purposes of determining whether a publicly traded REIT is domestically controlled, moreover, the proposals permit the REIT to presume that its smaller shareholders (i.e., persons holding less than 5 percent of a regularly traded class of stock) are U.S. persons absent actual knowledge to the contrary. By simplifying a REIT's determination of whether it is domestically controlled, these rules provide foreign investors with increased certainty regarding the tax treatment of their REIT investments.

PROSPECTS FOR PASSAGE

Congressional reception to the proposals has been very positive. Both Senate and House proposals have enjoyed bipartisan sponsorship and support. Indeed, a similar proposal in 2010 passed the House by a vote of 402 to 11.

Despite what appears to be building momentum, legislative changes to FIRPTA could, as they have before, stall in Congress. Several years ago, the Joint Committee on Taxation estimated that an outright repeal of FIRPTA would cost less than $1 billion per year. Although selective FIRPTA reform will likely cost the government even less, any reduction in tax revenue could be a hard sell in a time of budget deficits. Yet the biggest obstacle to reform may not be one of cost but rather one of process. Some legislators are of the opinion that piecemeal tax reform will not be an option in the current Congress and that amendments to FIRPTA will only materialize as part of larger overall tax reform. This is a view that many seasoned Congressional observers share.

Nonetheless, alternative routes to FIRPTA reform may be pursued if legislation cannot be passed. For example, as discussed in our prior *Commentary*, the Notice could be withdrawn without the approval or agreement of Congress. Although this change would provide only a limited benefit, it would nonetheless remove an important barrier to foreign investment in U.S. real estate.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Babak E. Nikravesh
San Francisco
+1.415.875.5703
bnikravesh@jonesday.com

Teresa A. Maloney
San Francisco
+1.415.875.5789
tmaloney@jonesday.com

Peter J. Elias
San Diego
+1.858.314.1123
pelias@jonesday.com

Jones Day publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our "Contact Us" form, which can be found on our web site at www.jonesday.com. The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the Firm.