

Client Alert

Tax Practice Group

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PATH Act Provides Favorable New Rules for Foreign Real Estate Investment Through REITs

On Friday, December 18, 2015, President Obama signed into law the Protecting Americans from Tax Hikes Act of 2015 (the “PATH Act”). The PATH Act includes a number of important changes relating to the tax treatment of foreign investment in U.S. real estate, particularly investments made through REITs. These changes are expected to make REITs an even more attractive vehicle for non-U.S. investors, especially foreign pension funds and certain “qualified shareholders,” to invest in U.S. real estate.

Background and Current Law

Under section 897, introduced by the Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”), gain from the sale of a U.S. real property interest (“USRPI”) is taxed as effectively connected income, on a net basis at the graduated rates generally applicable to domestic taxpayers.¹ USRPIs include direct interests in U.S. real estate as well as stock of current and former “U.S. real property holding corporations.”² A U.S. real property holding corporation generally includes any domestic corporation if the value of the corporation’s USRPIs equals or exceeds the combined value of its interests in non-U.S. real property and its trade or business assets.³ Stock of a class that is publicly traded on an established securities market is only treated as a USRPI with respect to shareholders who actually or by attribution own more than 5% of the stock of that class.⁴ Under a special rule, stock of a former U.S. real property holding corporation ceases to be a USRPI if the corporation disposes of all of its USRPIs in taxable transactions (the “cleansing rule”).⁵

Special rules apply to REITs under FIRPTA. First, stock of a REIT is not a USRPI, even if the REIT qualifies as a U.S. real property holding corporation, so long as the REIT is “domestically controlled.”⁶ A REIT is domestically controlled if less than 50% of the value of its stock is held, directly or indirectly, by foreign persons throughout a prescribed testing period.⁷

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Under section 897(h)(1), distributions from a REIT that are received by a non-U.S. taxpayer or another REIT and that are “attributable” to the REIT’s gain from the disposition of a USRPI are treated as gain from the disposition of a USRPI by the non-U.S. taxpayer or REIT receiving the distribution. In Notice 2007-55, the IRS announced its intention to promulgate regulations providing that section 897(h)(1) applies not only to capital gain dividends, but also to redemptions and liquidating distributions.⁸ Section 897(h)(1) does not apply to distributions made with respect to a class of stock that is regularly traded on an established securities market to a holder of not more than 5% of that class. A dividend that is excluded from the operation of section 897(h)(1) because of this rule is treated as an ordinary dividend subject to withholding tax and not as a capital gain dividend.⁹ The exemption from U.S. tax afforded to foreign government investors by section 892 does not apply to distributions covered by section 897(h)(1).

Buyers of USRPIs from non-U.S. persons and U.S. real property holding corporations that make non-dividend distributions to non-U.S. persons are generally required to withhold 10% of the sales proceeds or distribution amount.¹⁰

Key PATH Act Changes

1. FIRPTA exemption for qualified foreign pension funds. The most sweeping change made by the PATH Act is that “qualified foreign pension funds” (“QFPs”) (including entities wholly owned by a QFP) are entirely excluded from the application of FIRPTA.¹¹ A QFP’s income from the ownership and operation of improved real estate directly or through a partnership was, and continues to be, generally taxed as effectively connected income even with the new FIRPTA exemption. Investing through a REIT is still important for a QFP to avoid recognizing this effectively connected income. With the new exemption, however, gain from a QFP’s sale of stock in a REIT will be exempt from tax even if the REIT is not domestically controlled, and capital gain dividends and liquidating distributions will also be tax-free. Regular REIT dividends will be subject to the regular 30% withholding tax, subject to reduction by applicable treaties.

A qualified foreign pension fund is a trust, corporation, or other “organization or arrangement” that satisfies the following criteria:¹²

- a. Created or organized under non-U.S. law;
- b. Established to provide retirement or pension benefits to current or former employees (or their beneficiaries) of one or more employers “in consideration for services rendered”;
- c. Does not have a single participant or beneficiary entitled to more than 5% of its assets or income;
- d. Subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates; and

- e. Under the law of its country of establishment or operation, either: (i) contributions to the organization which would otherwise be subject to tax under such laws are deductible, excludable, or otherwise subject to a reduced rate of tax, or (ii) tax on the investment income of the organization is deferred or imposed at a reduced rate.

The new exemption does not expressly address foreign government pension plans that qualify for the section 892 exemption. Where the QFP exemption does not apply, section 892 investors will continue to be subject to full U.S. tax on REIT distributions that are treated as ECI under section 897(h)(1).

2. **FIRPTA exemption for REIT investments of certain publicly traded investment vehicles.** The PATH Act also provides that REIT stock held by a “qualified shareholder” (“QS”) is not a USRPI and that section 897(h)(1) does not apply to distributions from such a REIT.¹³ The QS rules, which are quite complex, are intended to benefit foreign public REIT equivalents like Australian listed property trusts. To qualify as a QS, an entity must:¹⁴
 - a. Either: (i) be eligible for treaty benefits under a comprehensive tax treaty and have its principal class of interests traded on a recognized stock exchange, or (ii) be a foreign limited partnership that is organized in a jurisdiction that has a tax information exchange agreement and have at least 50% of the value of its interests traded on the NYSE or NASDAQ;
 - b. Meet the requirements of a “qualified collective investment vehicle” (“QCIV”), as described below; and
 - c. Maintain records regarding the identity of any 5% and greater holders.

A QCIV is any foreign person that satisfies one of the following tests:¹⁵

- a. Is eligible for a reduced withholding rate on REIT dividends under an applicable tax treaty, even if it owns more than 10% of the REIT’s stock;
- b. Is publicly traded, is classified as a partnership for U.S. federal income tax purposes, is a withholding foreign partnership, and would qualify as a U.S. real property holding corporation if it were a domestic corporation; or
- c. Is another entity designated as a QCIV by the Secretary of the Treasury that is either “fiscally transparent” within the meaning of section 894 or includes dividends in its gross income but is entitled to a deduction for dividends paid.

A QS’s FIRPTA exemption is limited by a set of highly technical rules to the extent that the QS has an “applicable investor,” which is an investor that owns (indirectly through the QS or otherwise) more than 10% of a REIT in which the QS owns an interest.¹⁶

3. **Increase in ownership cap for publicly traded REITs to 10%.** The PATH Act also expands the exclusion of publicly traded stock from the definition of USRPI. Under the expanded exclusion, stock of a publicly traded REIT will not be treated as a USRPI unless the holder owns more than 10% of the

traded class.¹⁷ Distributions received by a shareholder who owns 10% or less of a publicly traded class of a REIT will also be exempt from the application of section 897(h)(1).¹⁸ The increased ownership ceiling only applies to publicly traded REITs, not to other U.S. real property holding corporations or privately held REITs. The ordinary dividend withholding tax (subject to any reduced rates provided by treaty) applies to any dividends that are exempted from section 897(h)(1) under this rule.

- 4. Changes to domestically controlled REIT definition.** Under current law, publicly traded REITs may have difficulty determining whether or not they are domestically controlled. The PATH Act provides that any shareholder owning less than 5% of a publicly traded REIT will be treated as a U.S. shareholder unless the REIT has actual knowledge to the contrary.¹⁹

Under current law, it is not clear how domestic control of a REIT is measured when the REIT in question has a REIT as a shareholder. The PATH Act provides two special rules for evaluating domestic control.²⁰ The first rule provides that a publicly traded REIT that owns an interest in a subsidiary REIT is treated as a domestic shareholder of the subsidiary REIT if the parent REIT is itself domestically controlled (and as a foreign shareholder if it is not). The second rule provides that a private REIT is treated as a foreign shareholder to the extent of the parent REIT's foreign ownership—in other words, a look-through rule.

- 5. Repeal of the cleansing rule for REITs.** The PATH Act eliminates the cleansing rule for REITs.²¹ Because section 897(h)(1) (as interpreted by Notice 2007-55) already causes distributions of USRPI gain to be treated as ECI, one effect of the cleansing rule in the REIT context was to create a concern that a shareholder could not claim a stock loss resulting from a liquidation of an unprofitable investment in a foreign-controlled private REIT as an ECI loss. The repeal of the cleansing rule in this context should eliminate this technical concern.
- 6. Increased FIRPTA withholding rate.** The PATH Act provides for an increase in the rate of FIRPTA withholding from 10% to 15%.²²

The new FIRPTA rules contained in the PATH Act will make REITs a more attractive vehicle for non-U.S. investors, especially foreign pension funds and qualified shareholders, to invest in U.S. real estate. The PATH Act also contains a number of “quality of life” improvements to the REIT rules (not discussed here) that will generally make it easier for REITs to maintain compliance with the applicable technical requirements.

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¹ All section references are to the Internal Revenue Code of 1986, as amended.

² I.R.C. § 897(c)(1)(A)(ii).

³ I.R.C. § 897(c)(2).

⁴ I.R.C. § 897(c)(3).

⁵ I.R.C. § 897(c)(1)(B).

⁶ I.R.C. § 897(h)(2).

⁷ I.R.C. § 897(h)(4)(B).

⁸ 2007-2 C.B. 13.

⁹ I.R.C. § 857(b)(3)(F).

¹⁰ I.R.C. § 1445.

¹¹ I.R.C. § 897(l)(1).

¹² I.R.C. § 897(l)(2).

¹³ I.R.C. § 897(k)(2).

¹⁴ I.R.C. § 897(k)(3)(A).

¹⁵ I.R.C. § 897(k)(3)(B).

¹⁶ I.R.C. § 897(k)(2)(B).

¹⁷ I.R.C. § 897(k)(1).

¹⁸ *Id.*

¹⁹ I.R.C. § 897(h)(4)(E)(i).

²⁰ I.R.C. § 897(h)(4)(E).

²¹ I.R.C. § 897(c)(1)(B)(iii).

²² I.R.C. § 1445.