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US SENATE FINANCE COMMITTEE UNANIMOUSLY APPROVES FIRPTA REFORMS

On February 11, 2015, the Senate Finance Committee approved a bill that would make significant changes to the Foreign Investment Real Property Tax Act (FIRPTA), encouraging investment in US real estate in several ways, but increasing FIRPTA withholding tax and changing other requirements with respect to foreign investment in Real Estate Investment Trusts (REITs) and Regulated Investment Companies (RICs). The bill would:

- Increase the maximum stock ownership that a shareholder may hold without the stock being treated as US real property interest (USRPI), as well as increase the percentage ownership threshold that results in treating a distribution to holders of publicly traded REIT stock, attributable to gain from sales of exchanges of USRPI, as a dividend.
- Update the definition of "domestically controlled."
- Increase the tax rate on withholding under FIRPTA from 10% to 15%.
- Require corporations to disclose their US real property holding company (USRPHC) status under certain circumstances, implement a presumption that qualified investment entities are under control, and impose a penalty on corporations failing to disclose their USRPHC status.
- Generally require FIRPTA withholding by brokers.
- Provide that the cleansing rule is not applicable to RICs or REITs.
- Indicate that, for purposes of determining whether dividends from a foreign corporation are eligible to receive a dividends-received deduction, dividends derived from RICs and REITs are not treated as dividends from domestic corporations.

The bill does not provide special relief for foreign investors as some had hoped. Senator Robert Menendez (D-NJ), one of the bill's proponents, indicated that because the bill only addressed one element of FIRPTA reform, he plans to seek more comprehensive reforms moving forward. He suggested that FIRPTA should be amended to encourage foreign pension plans to invest in US real estate.

The bill was one of 17 tax bills marked up by the Finance Committee on February 11. According to Senate Finance Committee Chairman Orrin Hatch, the markup was "in many ways a continuation of the process" the Committee began last Congress and additional markups are likely to be held in the coming months.

With regard to the 17 bills before the Committee at the markup, Chairman Hatch noted that all bills were required to: (1) "fall squarely" within the Committee's jurisdiction; (2) be bipartisan and noncontroversial; (3) have little or no budgetary impact, with those bills scored as costs required to be offset; (4) address a subject matter that has been thoroughly reviewed; (5) not be actively opposed by Senate leadership or the White House; and (6) be considered a limited tax benefit under Senate Rule 44. Additionally, Chairman Hatch and Ranking Member Ron Wyden (D-OR) emphasized that they are committed to ensuring that all seventeen bills be considered on the Senate floor in a way that is "balanced and bipartisan." The Senate has not set a timeframe for consideration of the bills.

Below, we have outlined the components of the FIRPTA reform bill.

Maximum Stock Ownership

Under the bill, a shareholder may hold, during the testing period, up to 10% (up from 5%) stock ownership in a publicly traded REIT without the stock being treated as USRPI upon disposition. The bill also increases from 5% to 10% the threshold that, if not exceeded, results in a distribution to holders of publicly traded REIT stock that is attributable to gain from sales or exchanges of USRPI being treated as a dividend rather than FIRPTA gain. Any such distributions that are not dividends would be exempt from US tax.

The attribution rules of section 897(c)(6)(C) of the Internal Revenue Code (Code) would be modified to refer to the determination of whether a person holds more than 5% of a class of stock that is publicly traded (in the case of a non-REIT shareholder) or more than 10% (in the case of a REIT shareholder), as applicable. The bill would not change the present law attribution rules that trigger attribution between a shareholder and a corporation if the shareholder owns more than 5% of a class of stock of the corporation.

The bill also provides that REIT stock held by a qualified shareholder[1] is not USRPI, except to the extent that an investor in the qualified shareholder (other than an investor that is a qualified shareholder) holds more than 10% of that class of stock of the REIT.

[1] A qualified shareholder is defined as an entity that is (i) eligible for the benefits of a comprehensive income tax treaty which includes an exchange of information program, (ii) a qualified collective investment vehicle (as defined below), (iii) whose principal class of interests is listed and regularly traded on one or more recognized stock exchanges (as defined in such comprehensive income tax treaty), and (iv) that maintains records on the identity of each person who, at any time during the qualified shareholder's taxable year, is the direct owner of more than 10% of that principal class of interests.

A qualified collective investment vehicle is defined as an entity that (i) would be eligible for a reduced rate of withholding under the comprehensive income tax treaty described above, even if such entity holds more than 10% of the stock of such REIT (ii) would be classified as a US real property holding corporation (determined without regard to the proposal's rules that exempt REIT stock held by the entity from treatment as a US real property interest), or (iii) is designated as such by the Secretary of the Treasury and is either (a) fiscally transparent within the meaning of section 894, or (b) required to include dividends in its gross income, but is entitled to a deduction for distributions to its investors.

The disposition provisions in the bill would apply to dispositions on and after the date of enactment, while the attribution rule change would be effective on the date of enactment and the distribution provision would apply to any distribution by a REIT on or after the date of enactment which is treated as a deduction for a taxable year of such REIT ending after such date.

Definition of Domestically Controlled

The bill provides several new rules and presumptions for purposes of determining whether a qualified investment entity is domestically controlled.

A qualified investment entity would be permitted to presume that stock held by a holder of less than 5% of a class of stock regularly traded on an established securities market in the United States is held by US persons throughout the testing period, except to the extent that the qualified investment entity has actual knowledge regarding stock ownership.

Any stock in the qualified investment held by another qualified investment entity (i) any class of stock of which is regularly traded on an established stock exchange, or (ii) which is a regulated investment company which issues redeemable securities, would be treated as held by a foreign person unless such other qualified investment entity is domestically controlled, in which case such stock shall be treated as held by a US person. Any stock in a qualified investment entity held by any other qualified investment entity not described in (i) or (ii) of the preceding sentence would only be treated as held by a US person to the extent that the stock of such other qualified investment entity is (or is treated under the new provision as) held by a US person.

Tax Rate on FIRPTA Withholding

The bill would increase the withholding rate from 10% to 15% on dispositions and certain distributions of URSPIs. This higher rate of withholding would not apply to sales of residences intended for personal use by the acquirer if the purchase price is not in excess of $1 million. The tax increase would apply to disposition occurring more than 60 days following the date of enactment.

Disclosure and Notification

The bill would require disclosures of USRPHC status by any corporation that is or was a US real property holding corporation at any time during the five-year period ending on the date on which disclosure is made. Such a corporation would be required to: (1) attach a statement regarding its status as a USRPHC within the past five years to its annual tax return; and (2) disclose such status on Form 1099s sent to shareholders, in annual reports, on websites and, for privately-held corporations, on stock certificates. Any qualified investment entity will be presumed to be foreign controlled in the absence of disclosure to the contrary.

A penalty would be imposed for failure to comply with the USRPHC notification requirements.

For a corporation with gross receipts of less than $5 million, the penalty for failing to comply with USRPHC notification requirements would be $500,000, with the penalty increasing to $1.5 million for corporations with gross receipts of $5 million or more. For corporations with USRPI of $1 billion or more, the penalty would $5 million, and increased to $10 million in the case of intentional failure to disclose or report. Publicly traded partnerships would also be subject to the rules.

The disclosure and notification provisions would be effective January 1, 2016.

FIRPTA Withholding by Brokers

The bill would amend the FIRPTA withholding rules to require that a broker deduct and withhold tax equal to 15% of the amount realized on a disposition of stock of a USRPHC. Withholding would not be required for the sale of stock of a domestically controlled qualified investment entity or for stock of a REIT that is not treated as USRPI because it was being sold by a qualified shareholder. A broker would be exempt from the withholding requirement in instances involving the disposition of any class of stock of a USRPHC that is regularly traded on an established securities market, provided that immediately prior to the disposition the transferor holds 5% or less of such stock (or 10% or less in the case of REIT stock). Broker withholding would only be required in instances where the broker had actual knowledge or reasonably should have known that the disposition was of stock of a USRPHC. Similar withholding rules would also apply to brokers in the case of a disposition of publicly traded partnership interest if the partnership would be a USRPHC if it were a US corporation.

The withholding rules would apply to dispositions after December 31, 2015.

Cleansing Rule

The bill would modify the "cleansing rule" so that it would apply to stock of a corporation only if neither the corporation nor of the corporation's predecessors was a RIC or a REIT at any time during the shorter of the period that the taxpayer held such stock since June 18, 1980, or the five-year period ending on the date of the disposition of such stock.

The proposal would be effective for dispositions on or after the date of enactment.

Dividends Received Deductions

For purposes of determining whether dividends from a foreign corporation (attributable to dividends from an 80% owned domestic corporation) are eligible for a dividends-received deduction under section 245 of the Code, the proposal would treat dividends from RICs and REITs as if they were not dividends from domestic corporations.

The proposal would apply to dividends received from RICs and REITs on or after the date of enactment.

Revenue Cost

The Joint Committee on Taxation (JCT) estimates that the proposal would cost approximately $38 million over the next 10 years.

What is Next?

In discussing the bill during the markup, Senator Robert Menendez (D-NJ) noted that he plans to seek more comprehensive reforms moving forward. Specifically, he suggested that FIRPTA should be amended to encourage foreign pension plans to invest in US real estate. In addition to support from Senators Johnny Isakson (R-GA) and Chuck Schumer (D-NY), Ranking Member Wyden also advocated for further reforming FIRPTA and indicated that there is "still much more to do." Chairman Hatch indicated that pursuing such reforms would require identifying "pay-fors" that would impact the industries benefited by the reforms, but Senator Menendez assured him that the Committee would be able to come together on the issue.

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