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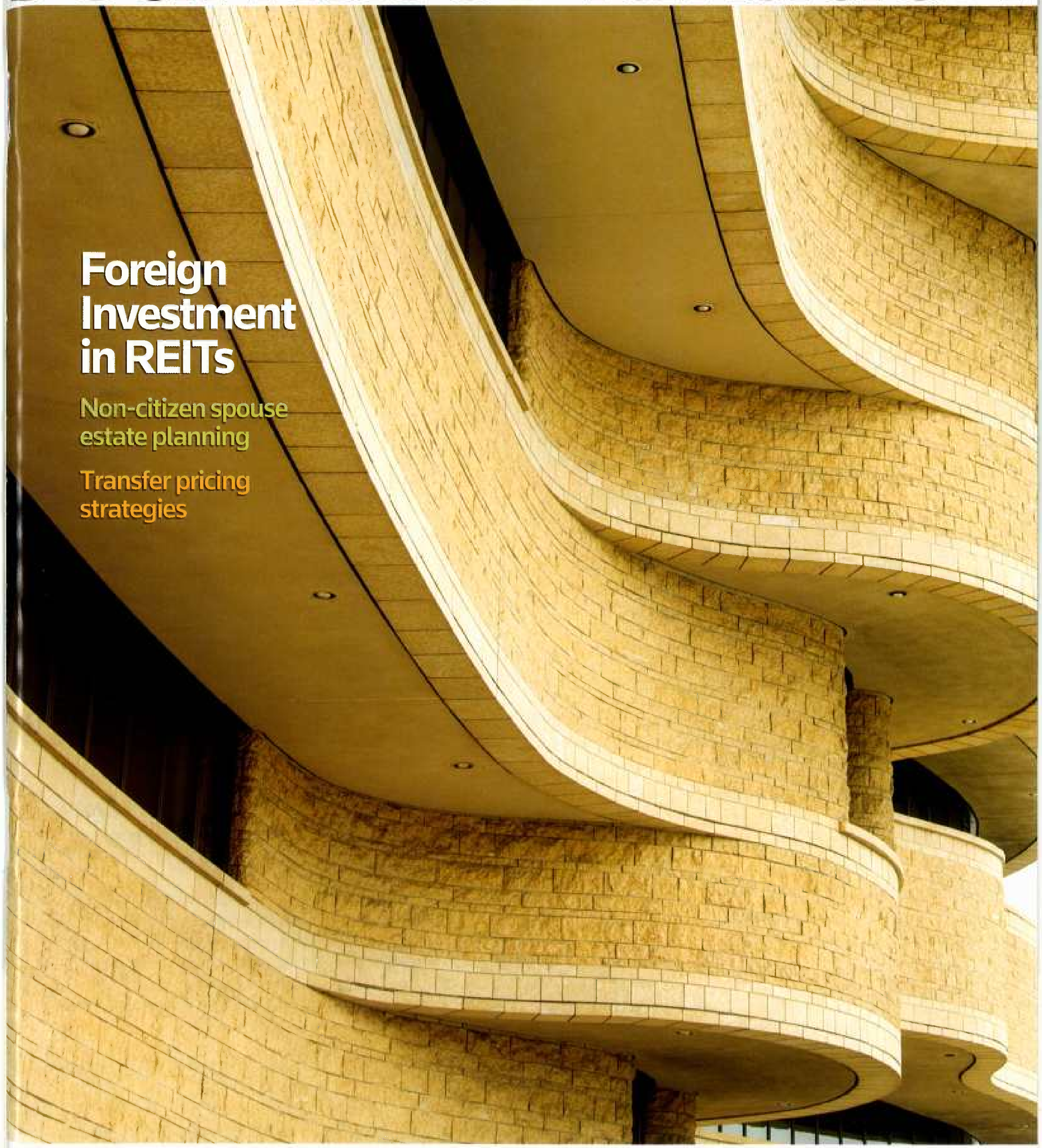

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PATH Act Improves Rules for Foreign Investment in U.S. Real Estate

BY RICHARD M. LIPTON, PATRICIA McDONALD, STEVEN R. SCHNEIDER, LEAH GRUEN, SAMUEL P. GRILLI, AND DIANA MYERS

Although changes made by the PATH Act to FIRPTA make REITs more attractive to foreign investors, there are ambiguities in the Act's statutory language that require clarification.

On 12/18/15, President Obama signed the Consolidated Appropriations Act, 2016[1] (the Appropriations Act) into law, which includes the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act).

This article focuses on the provisions in the PATH Act that change the application of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), found in Sections 897, 1445, and 6039C of the Code. These amendments to FIRPTA alter the investment landscape for many non-U.S. investors buying and selling U.S. real estate and making real estate-related investments.

BACKGROUND AND PRIOR LAW

In this section, we lay the foundation for this article by summarizing the FITPTA rules as they stood under pre-PATH Act law. The later sections then examine the PATH Act changes to those FIRPTA rules and the impact of those changes on foreign persons who invest in U.S. real estate.

Effectively Connected Income

Under the U.S. federal income tax laws, foreign persons typically are not subject to U.S. federal income tax payment and U.S. federal income tax filing requirements with respect to U.S.-source capital gains, unless such capital gains are treated as (or deemed to be) income that is effectively connected with the conduct of a trade or business in the United States (ECI). FIRPTA deems the following to be ECI: (1) gains from the disposition of a "United States real property interest" (USRPI),[2] which includes shares in a "United States real property holding corporation" (USRPHC),[3] and (2) distributions attributable to the disposition of a USRPI (e.g., REIT capital gain dividend distributions), because the character of the income that gave rise to such distributions is generally retained or traced.

Federal Income Tax Payment, Return Filing Requirements, and Withholding Tax

If a foreign person disposes of a USRPI, FIRPTA requires that foreign person to pay federal income tax on the gain from the disposition, if any, and the foreign person must file a federal income tax return to report the disposition.[4] To enforce the collection of tax, FIRPTA required the transferee to withhold 10% of the amount realized on the disposition and remit it to the IRS.[5] This amount is credited against the foreign transferor's federal income tax liability on the disposition. Accordingly, to the extent the foreign transferor's tax liability is actually less than the amount withheld, the tax withheld from the foreign transferor is entitled to a refund of the difference. To the extent the foreign transferor's income tax liability on the disposition is actually greater than the amount withheld, the foreign transferor owes additional taxes and may need to make estimated tax payments.[6]

The 5% Public Shareholder Exception

FIRPTA has always contained an exception for shareholders of a publicly-traded corporation. Specifically, if any class of stock of a corporation is regularly traded on an established securities market, that class of stock is treated as a USRPI only with respect to a person who, at some time during the relevant testing period, held more than 5% of that class of stock (the Public Stock Exception).[7] To determine whether a shareholder owns more than 5% of a class of stock, the shareholder must apply the constructive ownership rules of Section 318(a), except that 5% is substituted for 50% in Sections 318(a)(2)(C) and (a)(3)(C).[8]

Real Estate Investment Trusts

A real estate investment trust (REIT) is generally a USRPHC by virtue of the assets it holds, and thus, shares of the REIT are USRPIs (subject to the exceptions discussed below). A foreign person that invests in a REIT derives ECI with respect to the REIT investment in the form of (1) distributions attributable to the REIT's disposition of a USRPI (a Capital Gain Dividend), and (2) capital gains from the disposition of shares in the REIT, unless certain exceptions apply.[9]

The Domestically-Controlled Exception for REITs

Special FIRPTA rules apply to an investment in USRPIs through a "qualified investment entity" (QIE) that is domestically controlled. In order to be "domestically controlled," 50% or more of the value of the QIE's shares must be held, directly or indirectly, by U.S. persons during the relevant testing period (generally the shorter of the five-year period ending on the date of disposition or the period during which the QIE was in existence).[10] A QIE is defined as any REIT and any regulated investment company (RIC) that is a USRPHC or that would be a USRPHC if the Public Stock Exception or the domestically-controlled exception did not apply.[11] The stock of a "domestically controlled" QIE is deemed not to be a USRPI, and thus, a foreign shareholder can dispose of the stock of such an entity without being subject to federal income tax, withholding, or tax return filing requirements under FIRPTA (even though the stock would otherwise be a USRPI if not for this exemption).[12]

Foreign investors often choose to invest through domestically controlled REITs so that they can avoid FIRPTA on disposition of REIT shares. Capital Gain Dividends from a domestically-controlled REIT are treated as ECI, however (i.e., the domestically controlled exception discussed above applies only to dispositions), and therefore a foreign person investing in a domestically-controlled REIT may still have U.S. income tax payment and filing exposure, subject to the exception below.

The 5% Public Shareholder Exception for REITs

Similar to the Public Stock Exception for publicly traded corporations, FIRPTA contains an exception for shareholders of QIEs. If a shareholder has owned no more than 5% of a class of stock of a QIE that is regularly traded on an established securities market located in the United States during the one-year period ending on the date of a distribution by the QIE, such distributions with respect to such class of stock attributable to gain from sales or exchanges of USRPIs are not treated as Capital Gain Dividends taxable as ECI under FIRPTA;[13] instead, they are treated as ordinary dividends (the Public QIE Distribution Exception).[14] These ordinary dividends are however subject to Chapter 3 U.S. withholding tax of 30% (subject to reduction under an applicable income tax treaty), as well as Chapter 4 withholding under the Foreign Account Tax Compliance Act.[15]

THE FIRPTA EXEMPTION FOR REGULARLY TRADED REITS

Section 322 of the PATH Act amended FIRPTA by adding a new Section 897(k)(1) to the Code. Under pre-PATH Act law, the Public Stock Exception and the Public QIE Distribution Exception provided that FIRPTA generally does not apply to a foreign shareholder of a regularly traded REIT, as long as the shareholder has owned 5% or less of the REIT stock during the relevant testing period. In other words, FIRPTA does not apply to the foreign shareholder's gain from the sale of REIT stock or to REIT Capital Gain Dividends. New Section

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897(k)(1) raises this ownership percentage from 5% to 10%, which means that a foreign shareholder can own a greater percentage of a regularly traded REIT without being subject to FIRPTA on dispositions of REIT stock or on Capital Gain Dividends. For purposes of determining whether a person constructively holds more than 10% of a REIT's stock, the shareholder must apply the constructive ownership rules of Section 318(a), except that 10% is substituted for 50% in Sections 318(a)(2)(c) and (a)(3)(c).[16]

The foregoing amendments apply to dispositions and distributions occurring on or after 12/18/15.

Observations and Implications

New Section 897(k)(1) creates a peculiar dichotomy in the Public Stock Exception. Before the PATH Act, a foreign investor could own up to 5% of a traded corporation, regardless of whether the corporation was a REIT or a regular C corporation. Now, a foreign investor can own up to 5% of a traded C corporation, but up to 10% of a traded REIT. Furthermore, the new 10% threshold applies to REITs, but not to RICs, even though Congress often affords REITs and RICs similar treatment.

THE FIRPTA EXEMPTION FOR QUALIFIED FOREIGN PENSION FUNDS

Section 323 of the PATH Act provides that FIRPTA does not apply to USRPIs held directly (or indirectly through one or more partnerships) by a "qualified foreign pension fund" (QFPF) and any entity, all of the interests of which are held by a QFPF. This exemption from FIRPTA also applies to Capital Gain Dividends received from a REIT. Because a QFPF is now exempt from FIRPTA tax on these dispositions and distributions, a QFPF is now exempt from FIRPTA withholding tax.[17] This provision is intended to make it easier for QFPFs to invest in U.S. real estate.

The Definition of a Qualified Foreign Pension Fund

A "qualified foreign pension fund" means any trust, corporation, or other organization or arrangement (1) which is created or organized under the law of a country other than the United States, (2) which is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered, (3) which does not have a single participant or beneficiary with a right to more than 5% of its assets or income, (4) which is 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 (5) with respect to which, under the laws of the country in which it is established or operates, either (a) contributions to such trust, corporation, organization, or arrangement which would otherwise be subject to tax under such laws are deductible or excluded from the gross income of such entity or taxed at a reduced rate, or (b) taxation of any investment income of such trust, corporation, organization or arrangement is deferred or such income is taxed at a reduced rate.

The FIRPTA exemption for QFPFs is effective for dispositions and distributions occurring after 12/18/15.

The Pension Fund FIRPTA Exemption is a Dramatic Change in Law

Although all of the FIRPTA amendments made by the PATH Act are notable, the authors believe that the most important change is section 323, which adds new Section 897(l) to the Code, a game changer that calls off FIRPTA altogether for QFPFs and entities wholly owned by a QFPF. Traditionally, foreign investors, including pension funds, have made U.S. real estate investments through a combination of REITs and/or non-REIT corporations. As a result of section 323 of the PATH Act, QFPFs will have more options and flexibility with respect to investments in U.S. real estate. For example, a QFPF may consider investing in U.S. real estate through a partnership that allocates capital gain from a sale of the real estate directly to the QFPF, and ordinary rental income from holding the real estate to a blocker corporation owned by the QFPF. Such structure takes advantage of the QFPF's FIRPTA exemption on gains while shielding the QFPF from direct federal income tax payment obligations on the ordinary income.[18] The tax drag at the blocker corporation level could be reduced by capitalizing the blocker in part with debt if the U.S. withholding tax on interest payments from the blocker to the QFPF can be reduced under an applicable income tax treaty or under the portfolio interest exception to U.S. withholding tax. Another option may be for a QFPF to simply invest

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1 P.L. 114-113.

2 "Disposition" means any transfer that would constitute a disposition by the transferor for any purpose of the Code and the Treasury Regulations thereunder. Reg. 1.897-1(g).

3 "USRPHC" means any corporation if the fair market value of its USRPIs equals or exceeds 50% of the fair market value of (1) its USRPIs, (2) its interests in real property located outside the United States, plus (3) any other of its assets which are used or held for use in a trade or business. Section 897(c)(2).

4 Sections 897(a)(1) and 6039C.

5 Section 1445(a).

6 Reg. 1.1445-1(f)(2).

7 Section 897(c)(3) and Reg. 1.897-1(m). Reg. 1.897-9T(b) also applies the Public Stock Exception to certain equity interests in the traded corporation that are non-regularly traded.

8 Section 897(c)(6)(C).

9 Section 897(h)(1).

10 Section 897(h)(4).

11 Section 897(h)(4)(A).

12 Section 897(h)(2).

13 Section 897(h)(1); Reg. 1.897-1(m).

14 Sections 852(b)(3)(E) and 857(b)(3)(F).

15 Sections 871(a)(1), 1441, and 1471 through 1474.

16 Section 897(k)(1)(A).

17 Reg. 1.1445-2 has been updated to reflect the fact that QFPFs are not subject to withholding. T.D. 9751, 2/19/16 (as corrected on 4/26/16). New Section 897(l)(3) provides that the Secretary shall prescribe regulations as may be necessary or appropriate to carry out the purposes of the QFPF exemption. These regulations have not been issued yet, and T.D. 9751 requests comments on what regulations should be issued.

18 The QFPF would still be treated as engaged in a U.S. trade or business through its direct investment in the partnership and thus would still need to file a federal income tax return, despite not owing any federal income tax with respect to such investment.

through a REIT, with the ordinary REIT dividends subject to normal 30% dividend withholding (absent reduction by treaty) and REIT capital gain dividends now being exempt from FIRPTA.

Real estate funds, sponsors, and managers may very well see an uptick in interest from foreign pension plan investors and may need to consider potential changes to their fund structures, or additional structural alternatives, to accommodate such investors in light of the PATH Act.

Ambiguities in the Definition of a Qualified Foreign Pension Fund

Notwithstanding the FIRPTA call-off for QFPFs, there are certain ambiguities that need to be clarified and resolved, particularly ambiguities surrounding the requirements to satisfy QFPF status. The second prong of the QFPF definition states that a QFPF must be "established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered." Based on this language, foreign superannuation funds and foreign sovereign pension funds created as part of a sovereign social security system arguably may not qualify as QFPFs, because such funds may cover self-employed individuals and, in some countries, unemployed individuals who make voluntary contributions. Another ambiguity is whether a QFPF is required to be specifically established by an employer instead of a governmental unit. A literal reading of this requirement suggests that this is not necessary, but the language is not at all clear. Foreign government-established funds that have made or are interested in making investments in U.S. real estate are well advised to consult with their tax advisors to determine if they may be treated as QFPFs.

The fourth prong of the QFPF definition states that a QFPF "is 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." It is not entirely clear what constitutes information reporting, or what kind or degree of reporting is sufficient. For instance, does "beneficiary" mean all persons that may at any point in the future receive distributions from the pension fund, or only those persons that received a distribution from the pension fund in a reporting year? If a pension fund provides annual information reporting to the relevant tax authorities for those persons that received distributions from the fund in a particular year, but not for persons that have not yet vested or otherwise did not receive distributions from the fund in such year, it would seem that this should be sufficient to qualify the fund as a QFPF. This conclusion is not without doubt however, given the ambiguity in the statutory language.

Moreover, if a pension fund issues reports to a non-tax regulatory/governmental authority in its country, does that satisfy the reporting requirement? A literal reading of the statute suggests the pension funding in such instance would not satisfy the requirement to be a QFPF. What if the annual information reporting by the pension fund is not a requirement of local law in the foreign country? There is nothing in the fourth prong of the QFPF definition indicating that information reporting must otherwise be required by applicable law. Therefore, a pension fund should be able to satisfy this criterion with voluntary annual information reporting about its beneficiaries to the relevant tax authorities.

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It also is questionable whether foreign governmental investors that rely on the Section 892 exemption but that are not pension or retirement funds may rely on the FIRPTA exemption, which would lead to the odd result that a foreign pension plan could receive more favorable tax consequences than a foreign government. This in turn means that different U.S. tax structuring alternatives may need to be assessed and implemented for QFPFs and for Section 892 investors that are not pension funds. For example, certain foreign government funds may need to continue to use a domestically-controlled REIT for tax-efficient investment in U.S. real estate, whereas pension funds constituting QFPFs *from the same foreign country* may not need to use a REIT in order to make a tax-efficient investment in U.S. real estate. With the right tax planning, such a QFPF may receive more favorable federal income tax consequences than a governmental non-pension fund from the same foreign country.

Structuring Considerations Generally

Assuming a foreign pension fund is comfortable that it qualifies as a QFPF, the fund should structure its U.S. real estate investments in a way that allows it to take advantage of the pension fund FIRPTA exemption.

The first structuring consideration pertains to QFPFs that hold U.S. real estate indirectly through other entities. Section 323 of the PATH Act exempts a QFPF or "any entity all of the interests of which are held by a QFPF" from FIRPTA tax. If a QFPF were to make an investment in U.S. real property via a corporation in the QFPF's jurisdiction that is a wholly-owned subsidiary of a wholly-owned subsidiary of the QFPF, would such lower-level subsidiary qualify for the pension fund FIRPTA exemption? There appears to be no rationale or logic for excluding such a wholly-owned subsidiary from the benefits accorded to a QFPF. However, the statutory language of section 323 does not say "directly or indirectly" prior to "held by a QFPF," so there is an argument that the literal language of section 323 does not exempt an entity that is indirectly wholly-owned by a QFPF. Congress did use such language in other places in the PATH Act; in fact, Congress used such language in the same paragraph in section 323–providing that such section applied to any USRPI "held directly (or indirectly through 1 or more partnerships)." Although it does not appear that Congress intended to exclude lower-tier, wholly-owned subsidiaries of QFPFs from the benefit of the pension fund FIRPTA exemption, the statutory language on its face could be interpreted to exclude lower-tier wholly-owned entities, which in turn will have an impact on tax structuring. Absent clarifying guidelines, QFPFs structuring new in-bound real estate investments or reevaluating their existing structures may consider minimizing the number of layers in their structure, to the extent possible.

Additionally, there is the question as to whether an entity qualifies for the FIRPTA exemption if its interests are held by multiple QFPFs, rather than a single QFPF. Technically, section 323 of the PATH Act covers only an entity "all of the interests of which are held by a QFPF." It could be argued that a literal reading of the language seems to exclude an entity completely owned by multiple QFPFs; however, in the authors' view, that is not the correct answer given there is no rationale or logic for excluding an entity completely owned by more than one QFPF.

Structuring Considerations Related to REITs

It is also not completely without doubt whether a REIT Capital Gain Dividend that a QFPF receives through a partnership is covered under the pension fund FIRPTA exemption. This is because the exemption applies to "any distribution received from a real estate investment trust by" a QFPF or any entity all of the interests of which are held by a QFPF, but does not expressly include a REIT distribution received via a partnership. The statutory language of Section 323 does provide that it applies to any USRPI "held directly (or indirectly through 1 or more partnerships)," but it is not entirely clear whether these two provisions work together.

On the one hand, Congress did not expressly specify that REIT distributions must be received "directly" by a QFPF. However, Congress did not include a parenthetical that sanctions receipt of REIT distributions indirectly through one or more partnerships, whereas it did expressly cover REIT distributions received by an entity wholly-owned by a QFPF. As a result, it could be argued that a REIT Capital Gain Dividend received through one or more partnerships is not covered because, by definition, a partnership cannot be directly wholly-owned by a QFPF.

The authors believe this is not the correct interpretation of the statutory provision because there is no logic or rationale for drawing such an arbitrary distinction with respect to partnerships. It is hard to believe Congress intended for the stock of a REIT held through a partnership to be exempt from FIRPTA under this provision, but that any distributions through the partnership would remain subject to FIRPTA. However, a similar dichotomy exists with respect to the domestically-controlled REIT exception. Nonetheless, such an interpretation seems absurd in light of the fact that under section 322 of the PATH Act (discussed below), a REIT distribution to a "qualified shareholder" is exempt from FIRPTA to the extent REIT stock proceeds are exempt, and the REIT stock exemption includes the same parenthetical for ownership through one or more partnerships. Logic would dictate exempting a QFPF from FIRPTA on a REIT Capital Gain Dividend received through a partnership in accordance with the exemption granted to the underlying REIT stock, but this position is not without doubt.

As discussed above, a QFPF investing in U.S. real estate through a REIT structure obtains the benefit of the FIRPTA exemption on (1) Capital Gain Dividends arising from a sale of the underlying real estate by the REIT, and (2) gains from the disposition of REIT shares, without regard to whether the REIT is domestically controlled. However, such a QFPF investor still has to make sure that the underlying real estate investment is appropriate for a REIT, and there are significant costs associated with the establishment and maintenance of REIT structures.

A QFPF investor can now avoid the due diligence headache and costs required to confirm and ensure that the REIT is domestically controlled, and does not need to negotiate assurances from the REIT manager or real estate fund sponsor that the REIT will continue to be domestically controlled. A QFPF also no longer needs to negotiate and bargain for the protection that a disposition of the property by a fund sponsor will involve a sale of REIT shares only, as opposed to a sale of the underlying real estate. However, a QFPF investor still must consider that, notwithstanding the exemption in the PATH Act, ordinary dividends from a REIT arising from the operating income of the REIT still remain subject to 30% U.S. withholding tax (subject to reduction under an applicable income tax treaty). A QFPF investor must appropriately structure its investment to take into account this

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treatment of ordinary dividends in order to make a tax-efficient investment.

U.S. Withholding Agents Should Request a Certification from Qualified Foreign Pension Funds

All U.S. withholding agents (i.e., persons such as REITs, partnerships, limited liability companies, corporations, etc. having the control, receipt, custody, disposal, or payment of income subject to U.S. withholding tax.)[19] that expect to make any payments to a foreign person claiming to be a QFPF should ask the purported QFPF to certify, under penalties of perjury, that it satisfies the QFPF requirements. A withholding agent should also consider requesting that the payee indemnify the withholding agent and its affiliates for any taxes, interest, and penalties that may be imposed on such persons if the withholding agent should have withheld but did not because it relied on such certification. The QFPF certification and any indemnity should be in addition to the applicable IRS Form W-8 that a withholding agent is required to receive from a foreign person.

THE FIRPTA EXEMPTION FOR CERTAIN QUALIFIED SHAREHOLDERS OF REITS

Section 322 of the PATH Act adds a new subsection (k) to Section 897 of the Code. Under the new subsection, (1) REIT stock held by a "qualified shareholder," including stock held indirectly through one or more partnerships, is not a USRPI in the hands of such qualified shareholder, and (2) any distribution to a qualified shareholder is not treated as gain recognized from the sale or exchange of a USRPI to the extent the stock of the REIT held by the qualified shareholder is not treated as a USRPI. The changes in section 322 of the PATH Act apply to dispositions of REIT stock and REIT distributions occurring on or after 12/18/15.

A "qualified shareholder" is defined as a foreign person that meets *all* of the following three requirements:

1. Such person either (a) is eligible for the benefits of a comprehensive income tax treaty with the United States which includes an exchange of information program (a Comprehensive Treaty) and whose principal class of interests is listed and regularly traded on one or more recognized stock exchanges (as defined in the Comprehensive Treaty), or (b) is a foreign partnership created or organized under foreign law as a limited partnership in a jurisdiction that has an agreement for the exchange of information with respect to taxes with the United States and has a class of limited partnership units that is regularly traded on the NYSE or NASDAQ markets, and such class of limited partnership units value is greater than 50% of the value of all the partnership units.
2. Such person is a "qualified collective investment vehicle" (defined below).
3. Such person maintains records on the identity of each person who, at any time during the foreign person's tax year, is the direct owner of 5% or more of the class of interests or units (as applicable) described in (1), above.

A "qualified collective investment vehicle" is defined as a foreign person that meets *one* of the following three conditions:

1. Under a Comprehensive Treaty, such person is eligible for a reduced rate of withholding with respect to ordinary dividends paid by a REIT, even if such person holds more than 10% of the stock of the REIT.
2. Such person is a publicly traded partnership treated as a partnership for U.S. tax purposes, a withholding foreign partnership, or a foreign partnership that at any time during the five-year period ending on the date of disposition of, or distribution with respect to, such partnership's interest in the REIT, would have been a USRPHC if it were a corporation.
3. Such person is designated as a qualified collective investment vehicle by Treasury and is either fiscally transparent within the meaning of Section 894 of the Code, or is required to include dividends in its gross income but is entitled to a deduction for distributions to equity holders.

Notwithstanding the foregoing, however, the FIRPTA exemption for a qualified shareholder is not available with respect to any "applicable investor' of the qualified shareholder. In general, an applicable investor is a person (other than a qualified shareholder itself) that directly, indirectly, or constructively holds more than 10% of the REIT. In the case of an applicable investor, a portion of the REIT stock will be treated as a USRPI to the extent of the applicable investor's investment in the qualified shareholder. For example, if a Qualified Shareholder owns 50% of a REIT and Fco owns 40% of the Qualified Shareholdert (and no other direct or indirect ownership in the REIT), Fco's indirect interest in the REIT is 20%, such that Fco is an applicable investor of the Qualified Shareholder. Thus, 40% of the REIT stock held by the Qualified Shareholder will be treated as a USRPI, and 40% of the amounts realized by the Qualified Shareholder with respect to any disposition of stock in the REIT or with respect to any Capital Gain Dividends from the REIT will be treated as amounts realized from the disposition of USRPIs.

These rules also apply if a distribution by a REIT is treated as a sale or exchange of stock under Section 301(c)(3) (distributions in excess of basis), Section 302 (distributions in redemption of stock), or Section 331 (distributions in complete liquidation) with respect to a qualified shareholder, but only in the case of an applicable investor; in the case of any other person, such distribution is treated under Section 857(b)(3)(F) as a dividend from a REIT.[20]

As described in the Joint Committee Report, this provision of section 322 of the PATH Act is intended to override one of the conclusions of AM 2008-003 in certain cases. AM 2008-003 had concluded that a dis-

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19 Section 1441(a).

20 Section 897(k)(2)(C).

tribution in complete liquidation from a domestically-controlled, publicly traded REIT to a foreign corporation is not subject to FIRPTA as long as the foreign corporation never owned more than 5% of the REIT stock. New Section 897(k)(2)(C) restricts this conclusion with respect to an applicable investor of the qualified shareholder.[21]

Partnership Allocations

New Section 897(k)(4) contains rules with respect to partnership allocations of USRPI gains to applicable investors who are nonresident alien individuals or foreign corporations and partners in a foreign partnership that is a qualified shareholder. For each tax year, if an applicable investor's proportionate share of "USRPI gain" exceeds its distributive share of "USRPI gain," the applicable investor's distributive share of non-USRPI income or gain is recharacterized as USRPI gain in an amount equal to such excess and the applicable investor's distributive share of income or gain for the tax year that is not subject to FIRPTA is decreased by an amount equal to such excess. "USRPI gain" equals the excess (if any) of (1) the sum of (a) any gain recognized from the disposition of a USRPI and (b) any Capital Gain Dividends, over (2) any loss recognized from the disposition of a USRPI.[22]

Observations and Implications

An investor in a qualified shareholder holding stock in a REIT is an applicable investor if the investor holds more than 10% of the stock of the REIT, whether or not by reason of the investor's ownership interest in the qualified shareholder. This means that a person who owns only 0.01% of a REIT through a qualified shareholder will be an applicable investor if the person separately owns 10% or more of the REIT. Administratively, a qualified shareholder may be hard pressed to determine which of its investors are applicable investors, and it is unclear how much due diligence a qualified shareholder must do in order to understand whether its investors hold REIT shares outside of the shares held indirectly through the qualified shareholder entity. Fund sponsors and REIT managers may wish to consider adding language to offering documents that requires an investor to covenant as to whether such investor has owners that are "applicable investors," and to notify a sponsor or manager if the investor becomes aware of any change in its ownership structure such that it has owners that are applicable investors.

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DETERMINATION OF DOMESTIC CONTROL

Another important change in section 322 of the PATH Act involves the determination of whether a REIT is domestically controlled. Generally, a REIT is domestically controlled if at all times during the testing period (generally, five years) less than 50% in value of the stock was held directly or indirectly by foreign persons. Under prior law, there was uncertainty about whether the ownership by an upper-tier REIT (a domestic entity) of a majority interest in a lower-tier REIT caused the lower-tier REIT to be treated as domestically controlled, even if the upper tier REIT was majority owned by non-U.S. persons. This potential interpretation could lead to arguably inappropriate results if the ultimate owners of the upper-tier domestic REIT were not subject to U.S. taxation because of the dividends-paid deduction; the income from the sale of the lower-tier REIT would fully escape U.S. taxation if the lower-tier REIT were treated as domestically controlled in this situation. The PATH Act addressed this situation by adding a new Section 897(h)(4)(E)(iii), which provides that any stock in a qualified investment entity (i.e., a REIT) held in another qualified investment entity shall be treated as held by a U.S. person only in proportion to the stock of such other qualified investment entity that is held by a U.S. person.

This revision clarifies that the potential abuse involving foreign ownership of tiered REITs in which there was a sale of an interest in a lower-tier REIT is no longer possible. More important, however, is the implication in this revision that ownership of a REIT through a taxable U.S. entity such as a C corporation (which is not a qualified investment entity) is not disregarded in making the determination whether a REIT is domestically controlled. This interpretation seems correct, because Congress basically provided in Section 897(h) that if 51% of the gain on the sale of REIT shares is taxable, Congress accepted that the remaining 49% of such gain escapes taxation. This is also consistent with the construct in Ltr. Rul. 200923001, which is specifically acknowledged in the legislative history to the PATH Act. Therefore, if a foreign investor wants to make an investment in U.S. real estate, the foreign investor (assuming it is widely held for REIT share ownership purposes, such as a foreign in-

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21 JCX-144-15, p. 188, 12/17/15.

22 An applicable investor's proportionate share of USRPI gain is determined on the basis of the investor's share of partnership items of income or gain (excluding gain allocated under Section 704(c)), whichever results in the largest proportionate share. If such share may vary during the period the applicable investor is a partner in the partnership, the highest share is used.

vestment fund) could in theory form a taxable U.S. corporation to own 51% of a REIT, while the foreign investor could directly own the remaining 49% of such REIT. The revision in the PATH Act that prohibits this planning if the upper-tier entity is a REIT implies that in this scenario, the sale of shares of the REIT would result in taxable gain to the U.S. corporation but not to the foreign investor.

INCREASE IN THE WITHHOLDING RATE ON DISPOSITIONS OF U.S. REAL ESTATE

Before the PATH Act, the transferee of a USRPI was required to deduct and withhold 10% of the amount realized on the disposition of the USRPI by a foreign person. Section 324 of the PATH Act increased the rate of FIRPTA withholding to 15%, effective for dispositions after 2/16/16 (i.e., 60 days after the enactment of the PATH Act).[23]

The new 15% rate applies not only to straight sales of U.S. real estate, but also to distributions, liquidations, and other transactions specified in Section 1445. Specifically, under amended Section 1445(e)(3), if a domestic corporation that is or has recently been a USRPHC distributes property to a foreign shareholder in a transaction to which Section 301 (distributions not out of earnings and profits), Section 302 (distributions in redemption of stock), or Sections 331-346 (corporation liquidations) applies, then the corporation is required to deduct and withhold 15% of the amount realized by the foreign shareholder.

Further, amended Section 1445(e)(4) provides that a partnership, the trustee of a trust, or the executor of an estate is required to deduct and withhold 15% of the fair market value of any USRPI distributed to a foreign partner or beneficiary in a transaction that would constitute a taxable distribution under regulations, although Treasury has not issued implementing regulations for this provision. Lastly, amended Section 1445(e)(5) provides that the transferee of a partnership interest or of a beneficial interest in a trust or estate must deduct and withhold 15% of the amount realized on the disposition to the extent provided in regulations. Temp Reg. 1.1445-11T currently provides that withholding is required only under Section 1445(e)(5) with respect to the disposition by a foreign partner of an interest in a domestic or foreign partnership when 50% or more of the value of the partnership's gross assets consist of USRPIs, and 90% or more of the value of the partnership's gross assets consist of USRPIs plus any cash or cash equivalents.

Observations and Implications

The Joint Committee on Taxation estimates that the new 15% withholding rate will raise $21 million of revenue in 2016 and $20 million in 2017.[24] Cumulatively, for fiscal years 2016 through 2025, the new withholding rate is expected to raise $209 million.

The Joint Committee's revenue estimate is curious because a change in the withholding rate does not actually increase a taxpayer's income tax obligation on the income arising from any of the transactions covered by subsections (a), (e)(3), (e)(4), or (e)(5) of Section 1445. Instead, any tax withheld under Section 1445(a) is credited against the amount of federal income tax that the foreign transferor ultimately owes on the transfer of the USRPI, as calculated on its U.S. income tax return.[25] If the amount withheld under Section 1445(a) exceeds the transferor's maximum tax liability on the disposition, the transferor may seek an early refund of the excess or may seek a normal refund in filing a federal income tax return.[26] The same principles apply in the context of Section 1445(e) withholding.[27]

Notwithstanding this, the Joint Committee seems to think that increasing the withholding tax rate from 10% to 15% on these dispositions will raise revenue. The Joint Committee may be thinking that in cases in which the 10% withholding was less than the true net taxable gain, some foreign transferors were simply not filing tax returns to report that additional net taxable gain. Alternatively, perhaps the Joint Committee believes that foreign transferors generally will not claim any refunds of the 15% withholding tax, because the only way to get a refund is to file a federal income tax return, which many foreign investors may be reluctant to do. It remains to be seen whether the increased amount (i.e., 15%, rather than 10%) will incentivize a greater number of foreign transferors to file for any refunds to which they are entitled.

THE FIRPTA "CLEANSING EXCEPTION" NO LONGER APPLIES TO RICS AND REITS

The "cleansing exception" in Section 897(c)(1)(B) provides that shares in a U.S. or non-U.S. corporation are not considered USRPIs, and therefore are not subject to FIRPTA when disposed, if (1) as of the date of the disposition of such shares, the corporation did not hold any USRPIs, and (2) all of the USRPIs held by the corporation at any time during the five years before the sale of the shares (or the shareholder's holding period, if shorter) were disposed of in transactions in which the full amount of the gain (if any) was recognized (the Cleansing Exception).

If the corporation at issue owns shares in another corporation, and the Cleansing Exception applies to that subsidiary corporation, shares in that subsidiary corporation will not be considered USRPIs. This means that the parent corporation at issue also qualifies for the Cleansing Exception because it will not be considered to hold any USRPIs (i.e., the parent

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23 The regulations under Section 1445 have also been updated to reflect the increased withholding tax rate. TD 9751 (as corrected on 4/26/16). Notwithstanding, FIRPTA withholding remains at 10% in the case of a buyer who purchases U.S. real property for use as a residence and the amount realized is between $300,000 and $1 million; no withholding is required if the amount realized for the property in such transaction does not exceed $300,000. Sections 1445(c)(4), (b)(5).

24 Joint Committee on Taxation, Estimated Budget Effects for the PATH Act for Fiscal Years 2016 - 2025 (12/16/15).

25 Reg. 1.1445-1(f)(1).

26 Reg. 1.1445-1(f)(2).

27 Reg. 1.1445-5(b)(7).

corporation can meet prong (1) of the test above).[28]

The Cleansing Exception appears to be premised on the notion that once the income on the disposition of a USRPI by a corporation has been captured for federal income tax purposes, the imperative under FIRPTA to treat such a corporation as a USRPI is no longer compelling, presumably because federal income tax on the U.S. real estate investment has not been completely avoided. RICs and REITs (which are corporations) were previously eligible for the Cleansing Exception.

Section 325 of the PATH Act added a new clause (iii) to Section 897(c)(1)(B) of the Code, which provides that the Cleansing Exception applies to a corporation only if neither that corporation nor any predecessor of that corporation was a RIC or a REIT at any time during the testing period. This new rule took effect on 12/18/15 when the PATH Act became law.[29]

Observations and Implications

The legislative history does not explain the purpose behind section 325 of the PATH Act, but presumably Congress did not approve of the position that certain foreign shareholders investing in U.S. real estate through RICs and/or REITs were taking the position that the Cleansing Exception, in combination with a corporate liquidation, avoided federal income tax on the disposition of the U.S. real estate investment at both the RIC/REIT level and at the foreign shareholder level.

In such a transaction, foreign investors would hold U.S. real estate through a U.S. corporation that had elected to be treated as a RIC or REIT (USCO), and which would sell the property in a taxable transaction that was covered by the Cleansing Exception. Then, the USCO would undertake a complete corporate liquidation under Section 331 in which it would distribute the cash proceeds of the disposition of the U.S. real estate to the foreign shareholders. USCO would take the position that under Section 562(b) such distribution should be treated as a dividend for purposes of computing the dividends paid deduction, which would offset USCO's entity-level tax on the disposition of the U.S. real estate. The foreign shareholders would take the position that because (1) Section 331 treats the amounts received in liquidation of USCO as payment in exchange for stock, and (2) USCO was no longer a USRPI as a result of the Cleansing Exception, they should be treated as having sold shares in a U.S. corporation that was not a USRPI (which is not subject to federal income tax under FIRPTA). Accordingly, little or no federal income tax would be collected in connection with a disposition of the underlying property (directly by a REIT/RIC, and indirectly by foreign investors in the REIT/RIC).

Section 325 of the PATH Act presumably was enacted to make taking the position described above unavailable. The provision appears to have been overly broad, however. Under section 325, not only are RICs and REITs not eligible for the Cleansing Exception, but this exclusion from the Cleansing Exception also covers C corporations that have previously been treated as RICs or REITs.

CONCLUSION

The PATH Act made several notable changes to the provisions of FIRPTA. Many of these changes make REITs more attractive investment vehicles for foreign investors. One of the more significant changes is that certain foreign pension and retirement funds are now exempt from FIRPTA, with the result that there may be an increased deployment of foreign pension capital into the U.S. real estate market. There are ambiguities in the PATH Act's statutory language that need clarification, however, and as a result foreign pension and retirement funds are well advised to discuss the PATH Act changes with their advisors, in order to achieve maximum U.S. tax efficiency on inbound real estate investments.

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28 Section 897(c)(1)(B)(ii)(II).

29 Reg. 1.897-2(f) has also been updated to reflect that RICs and REITs cannot benefit from the Cleansing Exception. TD 9751.