

FOREIGN PENSION PLANS INVESTING IN SHARES OF A U.S. REIT

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Foreign money is again pouring into the United States real estate market. A 1996 survey conducted by the Association of Foreign Investors in US Real Estate (AFIRE) estimates that foreign investor confidence in the United States real estate market is the highest it has been since annual AFIRE surveys began in 1992: drawn by the combination of strong and sustainable economic growth, limited supply expansion, and complete political stability, 81 percent of respondents ranked United States real estate ahead of European real estate, and 77 percent of respondents ranked United States real estate ahead of Southeast Asian real estate.¹ Foreign pension plans, which account for a sizeable portion of this investment inflow, are making their United States realty investments through real estate investment trusts (REITs), with one huge Dutch pension plan slated to invest an additional \$3 to \$4 billion in REITs by 2000.²

A REIT is a special-purpose entity for federal income tax purposes: though subject to tax at the rates generally applicable to corporations, a REIT is entitled to a deduction for dividends paid to its shareholders; a REIT thus pays little or no corporate-level tax and its shareholders pay tax on their dividend income, the net effect being a single level of tax on the REIT's earnings.³ Offering investors diversified parcels of realty, economies of scale, quality property management teams, a single-level-of-tax regime, and in the case of publicly traded REITs liquidity, REITs have rapidly become the vehicle of choice for foreign pension plans to invest in U.S. real estate. This article describes a foreign pension plan's tax treatment on the three potential forms of return on an investment in REIT shares:⁴ (1) ordinary income REIT distributions;⁵ (2) capital gain REIT distributions;⁶ and (3) gain on sale of the REIT shares.⁷

Sections 401(a) and 501(a) exempt a pension trust from taxation only if, among other requirements, the trust is created or organized in the United States, and thus foreign pension plans are ineligible for this exemption.⁸ Additionally, Treasury regulations with a proposed effective date of December 21, 1995, have staked out the position that pension plans, even if closely affiliated with a labor union, are generally ineligible for exemption as section 501(a) and 501(c)(5) "labor organizations."⁹ Thus, as summarized in the chart below and as discussed in this article, foreign pension plans are generally taxed like other foreign investors unless a treaty provides otherwise:¹⁰ (I) they are potentially eligible for the section 892 exemption on ordinary income REIT distributions and gain on the sale of REIT shares; (II) they are eligible for any applicable treaty reduction in tax and withholding rates on ordinary income REIT distributions; (III) they are subject to special FIRPTA gain rules on capital gain REIT distributions; and (IV) they are possibly subject to tax on gain from the sale of their REIT shares.

Type of Foreign Pension Plan	Ordinary Distributions	Capital Gain Distributions	Gain on Sale of REIT Shares
Exempt under section 892	Exempt	Taxable	Exempt

Other pension plans	Taxable	Taxable	Likely exempt, but possibly taxable
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1. Section 892 Exemption

Section 892(a)(1) generally exempts from U.S. income taxation investment income from "stocks, bonds, or other domestic securities" earned by foreign governments. For section 892 purposes, "foreign government" includes not only the foreign sovereign itself, but also integral parts, controlled entities, and political subdivisions thereof.¹¹ The section 892 exemption does not, however, apply to investment income earned by or from a "controlled commercial entity":¹² e.g., a wholly owned state airline, though possibly a foreign government for section 892 purposes,¹³ would be a controlled commercial entity ineligible for section 892 exemption.¹⁴

A. Ordinary Income REIT Distributions

The section 892(a)(1) exemption should extend to ordinary income REIT distributions, notwithstanding the following two caveats. First, temp. Treas. reg. section 1.892-3T(a)(3) (1988) provides that for purposes of the section 892(a)(1) exemption on investment income from stocks, bonds, or other securities, "the term 'other securities' does not include . . . trust interests." While by definition all REITs are associations taxable as corporations for federal income tax purposes, many REITs are organized as trusts (rather than as corporations) under local law. One strained reading of temp. Treas. reg. section 1.892-3T(a)(3) (1988) might be that the exclusion of "trust interests" applies to all REITs organized under local law as trusts, and thus equity interests in such REITs cannot qualify for section 892 exemption. Alternatively, and more likely, the exclusion of trust interests from "other securities" is simply limited to entities that are taxed as trusts, whereas for federal tax purposes all REITs (even those organized locally as trusts) are corporations whose equity interests are "stock" qualifying for section 892 exemption.¹⁵

The second caveat is also easily resolved. Temp. Treas. reg. section 1.892-3T(a)(1) (flush language) (1988) provides that the section 892 exemption does not extend to income earned from, or gain upon the disposition of, a U.S. real property interest within the meaning of section 897(c)(1)(A)(i). Section 897(c)(1)(A)(i) describes U.S. real estate, but not stock in a corporation holding U.S. real estate, as a U.S. real property interest. Although a REIT would likely be a corporation holding U.S. real estate, it is definitely not itself U.S. real estate. Thus, a REIT does not violate the limitation in temp. Treas. reg. section 1.892-3T(a)(1) (flush language) (1988).¹⁶

In sum, the section 892 exemption should extend to ordinary income REIT distributions.¹⁷ However, the section 892 exemption generally will not extend to capital gain REIT distributions: special rules in section 897(h) supersede any exemption under

section 892 with respect to this form of return on an investment in REIT shares, as discussed more fully below in Part III.¹⁸

B. Foreign Government Pension Plans

Given that ordinary income REIT distributions are the type of investment income potentially exempt under section 892, the next issue is whether a pension plan for a foreign government (including integral parts, controlled entities, and political subdivisions thereof) is the type of investor eligible for the section 892 exemption. Pursuant to regulations under section 892, guidelines have been developed for two kinds of foreign government pension plans: (1) a "pension fund," which is not a separate juridical entity but merely a "set-aside" account of a foreign government, and is therefore eligible for the section 892 exemption to the same extent as such foreign government; and (2) a "pension trust," which is a separate juridical entity and must therefore be a "controlled entity" (but not a "controlled commercial entity") of a foreign sovereign to qualify for the section 892 exemption.¹⁹ As illustrated below, the section 892 exemption may be more readily available to pension trusts than to pension funds:²⁰ only the commercial activities of a pension trust, and not also those of its sponsor, are relevant to the determination of whether the pension trust is a controlled commercial entity ineligible for the section 892 exemption; in contrast, the commercial activities of a foreign government that is itself a controlled commercial entity will generally taint any pension fund it establishes and thus render such pension fund ineligible for the section 892 exemption.

1. Pension funds. Some foreign government pension plans are not organized as separate juridical entities, but are instead part of a "set-aside" account of a foreign government. Not legally distinct from the foreign government, such pension funds are subject to the same restrictions as the foreign government in obtaining the section 892 exemption for interest and dividend income:²¹ viz., (i) such income cannot inure "to the benefit of any private person,"²² and (ii) such income cannot be received by or from a "controlled commercial entity."²³

Most foreign government pension funds, though organized ultimately to benefit employees, will not fail the above private inurement test;²⁴ however, a pension fund permitting unlimited or clearly excessive employee contributions may be deemed to be an investment conduit in part, thereby failing the private inurement test and destroying the pension fund's eligibility for section 892 exemption.²⁵ In Rev. Rul. 88-7, 1988-1 C.B. 269, the Service examined pension plans that were not separate juridical entities, but were instead set-aside funds of United Kingdom local government councils. These pension funds provided retirement benefits to government employees and also to nongovernment employees of social welfare organizations (e.g., library systems, community social centers, and schools for the deaf), but the pension funds did not provide benefits to employees of for-profit enterprises. The Service concluded that the pension funds could provide benefits to nongovernment employees of social welfare organizations as well as to government employees without failing the private inurement test; thus, the pension funds were exempt from U.S. taxation on their interest and dividend income pursuant to section 892. Although there is no explicit holding that a government pension fund for employees

of *for-profit* private enterprises will fail the private inurement test and therefore be ineligible for section 892 exemption, the analysis in Rev. Rul. 88-7 strongly suggests that outcome.²⁶

The second requirement for a pension fund to qualify for section 892 exemption is that the juridical entity owning the set-aside account must be a foreign government, but not a controlled commercial entity. By way of example, consider the application of section 892 to the pension fund of a separately incorporated, state airline that is wholly owned by a foreign sovereign. Assuming the state airline qualifies as a controlled entity of such foreign sovereign,²⁷ the state airline will itself constitute a foreign government for section 892 purposes.²⁸ However, the state airline's business activities would render it a "controlled commercial entity" (as distinguished from an entity engaged in governmental or nonprofit activities),²⁹ and thus the state airline (including its set-aside pension fund) would be ineligible for the section 892 exemption.³⁰ In contrast, the section 892 exemption is available to the pension fund of a national health service that is an integral part of, but not a juridical entity separate from, a foreign sovereign: as an integral part of its foreign sovereign, the national health service would itself be a foreign government for section 892 purposes;³¹ furthermore, regardless of whether any activities of such foreign sovereign (including those of its national health service) were considered commercial in nature, the foreign sovereign itself (including the national health service's pension fund) is never a controlled commercial entity ineligible for section 892 exemption.³²

2. Pension trusts. In contrast to pension funds, some foreign government pension plans are organized as legally separate trusts, i.e., as separate juridical entities. To qualify for exemption under section 892, such pension trusts must first constitute a controlled entity of a foreign government (including integral parts, controlled entities, and political subdivisions thereof),³³ which requires satisfying the four requirements of temp. Treas. reg. section 1.892-2T(c) (1988):

(i) The trust is established exclusively for the benefit of (A) employees or former employees of a foreign government, or (B) employees or former employees of a foreign government and nongovernmental employees or former employees that perform or performed governmental or social services;³⁴

(ii) The funds that comprise the trust are managed by trustees who are employees of, or persons appointed by, the foreign government;

(iii) The trust forming a part of the pension plan provides for retirement, disability, or death benefits in consideration for prior services rendered; and

(iv) Income of the trust satisfies the obligations of the foreign government to participants under the plan, rather than inuring to the benefit of a private person.³⁵

Assuming the above four requirements are satisfied, and the pension trust is therefore a controlled entity, the pension trust must then avoid being a controlled commercial entity to qualify for the section 892 exemption. For this purpose, the pension trust will avoid

controlled commercial entity status if it earns only income that would not be unrelated business taxable income (UBTI), as defined in section 512(a)(1), if such pension trust were a section 401(a) trust.³⁶ To alleviate the harshness of this rule, Notice 89-50, 1989-1 C.B. 690, provides that in applying the UBTI exception when some (but not all) of the income of the pension trust consists of UBTI, the determination of whether or not the trust is a controlled commercial entity will take into account all facts and circumstances. Under this standard then, a *de minimis* amount of UBTI is presumably compatible with a pension trust's exemption under section 892.

Consider, for example, the application of section 892 to a pension trust set up by a separately incorporated, state airline that is wholly owned by a foreign sovereign. Assuming that the state airline qualifies as a controlled entity of such foreign sovereign,³⁷ for section 892 purposes the state airline would itself be a foreign government and further the state airline's employees would be foreign government employees.³⁸ Accordingly, the state airline's pension trust could potentially satisfy the above described four requirements of temp. Treas. reg. section 1.892-2T(c) (1988) and thereby qualify for section 892 exemption, provided that such pension trust *itself* did not earn (more than *de minimis*) UBTI.³⁹ That is, the state airline's commercial activities and UBTI are not imputed to the state airline's pension trust - a juridical entity separate and apart from the state airline - to render such pension trust a controlled commercial entity ineligible for the section 892 exemption. As explained above, however, a state airline and its set-aside pension fund would be ineligible for the section 892 exemption.

II. Nonexempt Ordinary Income REIT Distributions

Foreign pension plans not qualifying under section 892 (e.g., a pension trust for employees in the private sector) are taxed on ordinary income REIT distributions like other foreign investors:⁴⁰ a REIT's distributions of operating income out of its earnings and profits are "dividends," and are therefore taxed at a 30 percent rate (less if reduced by treaty), with the REIT required to withhold the taxes imposed on such distributions.⁴¹ Distributions in excess of the REIT's earnings and profits are treated first as a nontaxable return of capital to the extent of the foreign investor's basis in its REIT shares (which nontaxable return is unfortunately subject to withholding under the rules discussed below in Part IV, regarding gain from the sale of REIT shares), and then as amounts received in exchange for the foreign investor's REIT shares (which amounts are subject to tax and withholding as discussed below in Part IV).⁴²

Pursuant to older U.S. income tax treaties, such as the U.S.-United Kingdom treaty, the tax rate and withholding rate on dividends from U.S. sources to United Kingdom pension plans⁴³ are reduced from 30 to 15 percent, and no exception to this 15 percent rate is made for REIT dividends.⁴⁴ In contrast, recent U.S. income tax treaties, such as the U.S.-Germany treaty, eliminate this reduced rate on ordinary income REIT distributions to foreign investors, except that foreign "individuals" (but not corporations, and apparently not trusts or other juridical entities) owning less than 10 percent of the REIT are accorded a reduction from the 30 percent statutory tax and withholding rates.⁴⁵

Under these recent U.S. treaties then, the full 30 percent tax and withholding rates generally apply to ordinary REIT dividends received by foreign pension plans.⁴⁶

III. Capital Gain REIT Distributions

Whether or not a foreign pension plan might otherwise qualify for the section 892 exemption or for reduced treaty rates on dividends, REIT distributions "attributable to" a REIT's recognized capital gain arising from dispositions of U.S. realty (or stock in certain corporations holding U.S. realty)⁴⁷ are subject to tax under FIRPTA, the Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499.⁴⁸ Foreign investors are therefore taxed on such gain at graduated U.S. tax rates,⁴⁹ and a REIT must at the time of payment generally withhold 35 percent of all distributions designated by the REIT as capital gain REIT distributions.⁵⁰ For those foreign pension plans subject to tax under sections 882 or 892(a)(3) as corporate investors (as opposed to subject to tax under section 871(b) and Treas. reg. sections 1.871-2(a) (as amended in 1992) and 301.7701-5 (as amended in 1960) as nonresident alien individuals), these amounts subject to FIRPTA tax will in addition be subject to the section 884 branch profits tax of 30 percent, unless an applicable treaty reduces or eliminates such branch profits tax liability.⁵¹

Unfortunately, the foregoing FIRPTA tax liability and withholding rules are unclear in their application. First, section 897(h)(1) imposes FIRPTA tax on REIT distributions to a foreign shareholder "to the extent attributable to gain from sales or exchanges by the REIT of" U.S. realty or stock in certain corporations holding U.S. realty. Because a REIT may in its discretion designate what portion of its distributed corporate-level net capital gain is characterized as a capital gain REIT distribution (rather than as an ordinary income REIT distribution),⁵² and because a REIT's designated capital gain REIT distribution may reflect corporate-level gains and losses from capital assets other than U.S. realty or stock in a corporation holding U.S. realty (e.g., capital gains and losses from government bonds), capital gain REIT distributions and the gains taxed under section 897(h)(1) are not necessarily synonymous concepts. A foreign shareholder of a REIT might thus be subject to FIRPTA tax on amounts less than or in excess of the capital gain REIT distributions on his REIT shares. However, a sensible, administrable rule here would be for the gains taxed under section 897(h)(1) to be synonymous with capital gain REIT distributions, and a regulation to that effect should be issued.⁵³

Second, on a distribution to a foreign shareholder, a REIT is obligated to withhold 35 percent of the maximum amount that it can designate as a capital gain REIT distribution, even if it has not yet made or will never make such a designation.⁵⁴ However, a REIT can generally determine such amount only after the close of its taxable year - often well after the distribution has occurred.⁵⁵ Anticipating this possibility, regulations provide that no FIRPTA withholding is required on a distribution that is subsequently determined to be a withholdable distribution, but in lieu thereof, the foregone FIRPTA withholding from the earlier distribution is to be withheld from future REIT distributions on those shares.⁵⁶ For example, if \$100 is distributed to a foreign shareholder on his REIT shares and subsequently determined by the REIT to be a withholdable distribution, there is no FIRPTA withholding on that first \$100 distribution, but the next \$100 distributed by the

REIT on those shares is subjected to 35 percent withholding, regardless of whether that next \$100 is an ordinary income REIT distribution or a capital gain REIT distribution. In some instances, this withholding lag can result in mismatches. For example, a foreign investor that receives a large distribution subsequently determined to be withholdable might sell his shares to another investor (either domestic or foreign) before the foregone FIRPTA withholding has been fully recouped. In that event, the selling foreigner has received withholdable distributions free of FIRPTA withholding, and the buying investor may be subjected to excessive FIRPTA withholding. However, since for both parties the FIRPTA tax liability on distributions is properly determined under section 897(h), as opposed to the lagged withholding rules of the regulations, the selling foreigner would presumably owe additional FIRPTA tax and the buying investor would be entitled to a refund for FIRPTA overwithholding.⁵⁷

IV. Gain on Sale of REIT Shares

A foreign pension plan qualifying for exemption under section 892 will be exempt from U.S. income tax on the gain from the sale of its REIT shares.⁵⁸

As for other pension plans (e.g., pension plans for private enterprises), their sale gain on REIT shares may be subject to FIRPTA tax, depending in part on whether the REIT is "domestically controlled" or "foreign controlled."⁵⁹ A domestically controlled REIT is a REIT in which, at all times during the preceding five years, "less than 50 percent in value of the stock was held directly or indirectly by foreign persons."⁶⁰ Sale gain on an interest in a domestically controlled REIT is not subject to FIRPTA tax and withholding.⁶¹ Assuming further that such gain is not effectively connected with a U.S. trade or business, the gain will be free of U.S. income tax.⁶²

If instead the REIT is foreign controlled, the sale gain is potentially subject to FIRPTA tax. Assuming the REIT owns sufficient U.S. real property, the foreign controlled REIT will be a U.S. real property holding corporation,⁶³ sale gain on its shares will be subject to U.S. taxation at graduated rates,⁶⁴ and withholding of 10 percent of the amount realized on disposition may be required.⁶⁵ However, gain from the sale or disposition of shares of a foreign controlled REIT by a foreign shareholder is not subject to FIRPTA tax and withholding if: (1) the stock of the REIT is regularly traded on an established securities market, and (2) the shareholder did not own more than 5 percent of the stock of the REIT at any time during the preceding five years.⁶⁶ Assuming further that such gain is not effectively connected with a U.S. trade or business, the gain will be free of U.S. income tax.⁶⁷

Although most publicly traded REITs are doubtless domestically controlled (and sale gain on such REITs' shares thus not subject to FIRPTA), foreign shareholders may find it difficult to establish domestically controlled status.⁶⁸ Accordingly, many foreign shareholders as a practical matter rely on the FIRPTA exemption for owning during the preceding five years 5 percent or less of the stock of a REIT regularly traded on an established securities market.⁶⁹

V. Conclusion

Spurred by diversified realty portfolios, economies of scale, quality property management teams, a single-level-of-tax regime, and in the case of publicly traded REITs liquidity, foreign pension plans opt for REITs as the vehicle of choice for investing in United States real estate. The tax rules applicable to such an investment are often favorable but highly technical, and rules that would bring some certainty and simplicity to the area should therefore be adopted: e.g., clarifying by regulation that FIRPTA gains taxed under section 897(h)(1) are synonymous with capital gain REIT distributions.

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¹ See AFIRE, "Foreign Investors Choose US Real Estate" (1996 Press Release).

² See M. Pacelle, "Dutch Fund Makes Splash in U.S. REITs," *Wall Street Journal*, p. C1 (June 14, 1996); R. Burgess, "Dutch Pension Fund ABP, Rodamco Forming \$700 Mln U.S. REIT," *Bloomberg* (October 29, 1996).

³ See section 857(b). This single-level-of-tax regime for REITs parallels that for regulated investment companies, and REITs are often described as mutual funds for real estate investing. Compare sections 851-855 and 860 with sections 856-860. To qualify as a REIT, an organization must satisfy several income-mix, asset-mix, shareholder-diversification, and distribution requirements. These requirements are set forth in sections 856 *et seq.* and include, *inter alia*: (i) at least 75 percent of a REIT's gross income must be derived from real estate assets (generally, rents from realty or interest from mortgages secured by realty) (see section 856(c)(3)); (ii) at least 95 percent of its gross income must be derived from such real estate assets, or from other dividends and interest (see section 856(c)(2)); (iii) less than 30 percent of its gross income must be from the disposition of assets held for specified short periods of time (see section 856(c)(4)); (iv) at least 75 percent of its total assets by value must be comprised of real estate assets, cash items, or government securities (see section 856(c)(5)(A)); (v) not more than 25 percent of its assets by value may be comprised of securities (other than government securities or shares in other REITs), and such securities of any one issuer must not comprise more than 5 percent by value of the REIT's total assets or more than 10 percent of the outstanding voting securities of such issuer (see sections 856(c)(5)(B) and 856(c)(6)(B); Treas. reg. section 1.856-2(d)(2) (as amended in 1981)); (vi) after its first taxable year as a REIT, no five or fewer individuals may own, directly or indirectly (and after applying certain attribution rules), more than 50 percent in value of the outstanding shares of the REIT at any time during the last half of any taxable year, and beneficial ownership of the REIT must be held by 100 or more persons (see sections 542(a)(2), 856(a)(5), 856(a)(6),

and 856(h)); and (vii) 95 percent of the REIT's ordinary income must be distributed to its shareholders (see section 857(a)). Statutory references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder, except as otherwise noted. Electronic references are to the LEXIS-NEXIS Tax Notes Today file.

⁴ Foreign investors also have an appetite for REIT debt (including convertible REIT debt), and interest income on such debt can generally qualify for exemption from U.S. income taxation as portfolio interest. See *generally* sections 871(h) and 881(c). This article, however, focuses exclusively on an equity investment in REIT shares.

⁵ A REIT's distribution to shareholders out of its earning and profits is generally dividend income to the shareholders. See *generally* sections 301 and 856(a)(3); Treas. reg. section 1.856-1(e) (as amended in 1981).

⁶ To the extent of its corporate-level net capital gain, a REIT may designate a portion of its distributions to shareholders as long-term capital gain. See section 857(b)(3)(B)-(C).

⁷ This article focuses on "Equity REITs," which are REITs that primarily acquire ownership interests in real property. REITs are also permitted to invest in mortgages secured by real property (Mortgage REITs) or in a combination of both real property and mortgages secured by real property (Hybrid REITs). For federal income tax purposes, however, a foreign pension plan would do better by investing in mortgages directly rather than through a Mortgage REIT or a Hybrid REIT: a REIT that earns interest income on mortgages pays out its earnings to shareholders in the form of dividend income, which under U.S. statutes and treaties is generally subject to more onerous tax burdens than interest income. Compare sections 871(a) and 881(a) with sections 871(h) and 881(c); see also Treasury Department, U.S. Model Income Tax Convention, Arts. 10 and 11 (September 20, 1996).

⁸ See Treas. reg. section 1.401-1(a)(3)(i) (as amended in 1976).

⁹ See prop. Treas. reg. section 1.501(c)(5)-1(b) (1995); Notice of Proposed Rulemaking EE-53-95, 1996-5 IRB 23 (December 21, 1995) (proposed effective date of December 21, 1995). For periods prior to December 21, 1995, courts have reached opposite conclusions regarding a union-affiliated pension plan's eligibility for exemption as a section 501(a) and 501(c)(5) labor organization. Compare *Morganbesser v. United States*, 984 F.2d 560 (2d Cir.1993) (exemption available for union-affiliated pension plan), *nonacq.* 1995-52 IRB 4, with *Stichting Pensioenfonds Voor De Gezondheid, Geestelijke En Maatschappelijke Belangen v. United States*, (D.D.C. 1996) (exemption unavailable for union-affiliated pension plan). See also AFL-CIO Comments, "Attorneys Say Labor Organization Regs Are Illegal and Should Be Withdrawn," *Doc 96-11214* (79 pages) (proposed regulation is contrary to statute and legislative history); Memorandum of Michael McNulty and Robert Borkenhagen, "Attorneys Say Regs Should Be Clarified So That Foreign Pension Funds Aren't Disqualified," *Doc 96-9643* (18 pages) (certain foreign union-affiliated pension plans do, and should continue to, qualify for exemption); Nolan, "Can A Pension Plan Be a Labor Organization?," 47 *The Tax Lawyer* 501 (1994) (discussing scope of statutory exemption).

¹⁰ See Rev. Rul. 83-144, 1983-2 C.B. 295 (Philippine pension trust taxable in the U.S.); LTR 8030005 (foreign pension trusts, which would be exempt under sections 401(a) and 501(a) if organized in the U.S., are not entitled to exemption from U.S. income taxation notwithstanding nondiscrimination clause in tax treaty). Some treaties accord U.S. tax-exempt status to foreign pension plans on interest and dividend income comparable to that enjoyed by United States pension plans. See, e.g., U.S.-Canada Income Tax Treaty, Art. 21; U.S.-Netherlands Income Tax Treaty, Art. 35; see *also* section 514 (interest and dividend income from leveraged investments subject to tax). However, even where a treaty accords such U.S. tax-exempt status to a foreign pension plan, the exemption will not extend to the section 897 FIRPTA gain tax that can sometimes be imposed on the return from an investment in REIT shares, as discussed below in Parts III and IV. See, e.g., Protocol Amending the U.S.-Netherlands Income Tax Treaty, Art. 6; Treasury Department, Technical Explanation of the U.S.-Netherlands Treaty (in explanation of Article 35, section 897(h) is said to supersede the tax exemption accorded foreign pension plans); see *also* Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499, section 1125(c), *reprinted in* 1980-2 C.B. at 528 (section 897 FIRPTA gain tax generally supersedes treaty obligations).

¹¹ See temp. Treas. reg. sections 1.892-2T(a)(1)-(3) (1988) and 1.892-2T(d) (1988). A separate juridical entity must satisfy four requirements to qualify as a controlled entity (and therefore a foreign government) for section 892 purposes: (i) it must be wholly owned and controlled by the foreign sovereign directly or indirectly through one or more controlled entities; (ii) it must be organized under the laws of the foreign sovereign that owns it; (iii) its net earnings must be credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and (iv) its assets must vest in the foreign sovereign upon dissolution. See temp. Treas. reg. section 1.892-2T(a)(3) (1988); LTR 9224034, 92 *TNT* 124-46 (fund boards of Swedish national pension system eligible for section 892 exemption). Thus, a state-owned enterprise ceases to qualify for section 892 exemption if such enterprise ceases to be wholly owned by the foreign sovereign within the meaning of temp. Treas. reg. sections 1.892-2T(a)(1)-(3) (1988) and 1.892-2T(d) (1988), e.g., upon partial privatization of such enterprise.

¹² In general, a controlled commercial entity is an entity engaged in commercial activities (whether within or without the United States) that is 50 percent or more owned by the foreign government. See *generally* section 892(a)(2); temp. Treas. reg. section 1.892-5T (1988); LTR 9224034, note 11 *supra* (corporation managing rental real estate and 50 percent owned by Sweden is a controlled commercial entity, and so dividends from such corporation are not exempt under section 892).

¹³ See temp. Treas. reg. section 1.892-2T(a)(3) (1988) (controlled entities are foreign governments for section 892 purposes).

¹⁴ See temp. Treas. reg. sections 1.892-4T(b) (1988) and 1.892-5T(a) (1988); *cf. Qantas Airways Ltd. v. United States*, 62 F.3d 385 (Fed.Cir. 1995), *cert. den.* __ U.S. __ (1996) (sustaining as reasonable a regulation that denied an exemption under former section 892

to controlled entities engaged in commercial activities, such as Australia's wholly owned airline Qantas); Rev. Proc. 97-7, section 4.01(7), *Doc 97-1162 (3 pages)* 1997-1 IRB at 186 (Service will not ordinarily rule on whether a foreign government is engaged in commercial activities for section 892 purposes).

¹⁵ See sections 856(a)(3), 7701(a)(3), and 7701(a)(7); Treas. reg. sections 1.856-1(e) (as amended in 1981) (REITs organized as trusts under local law are treated as corporations for Internal Revenue Code purposes generally), 301.7701-2(b) (as amended in 1996) and 301.7701-3(c)(1)(v)(B) (as amended in 1996) (all REITs taxable as corporations), and 301.7701-4(a) (as amended in 1996) (for purposes of the Internal Revenue Code, the definition of "trust" is generally limited to those entities taxable as trusts).

¹⁶ Section 897(c)(1)(A)(ii) describes stock in a corporation holding U.S. real estate as a U.S. real property interest, but that section is not referred to in temp. Treas. reg. section 1.892-3T(a)(1) (1988) as giving rise to nonexempt income. See also temp. Treas. reg. section 1.892-3T(b) (Example 1(ix)) (1988) (stock in a corporation described in sections 897(c)(1)(A)(ii) and 897(c)(2) gives rise to income exempt under section 892).

¹⁷ Ordinary income REIT distributions out of a REIT's earnings and profits are dividends exempt from tax under section 892; ordinary income REIT distributions in excess of the REIT's earnings and profits are treated first as a nontaxable return of capital to the extent of the foreign investor's basis in its REIT shares, and then as amounts received in exchange for its REIT shares, both such amounts exempt from tax under section 892 as more fully described below in Part IV. See sections 301 and 892(a)(1)(A)(i); temp. Treas. reg. sections 1.892-3T(a)(1)-(2) (1988), 1.892-3T(b) (Example 1(ix)) (1988), and 1.897-9T(e) (1988). Cf. LTR 9643031, *Doc 96-28731 (6 pages)* (no ruling on the issue of whether ordinary income REIT distributions or gain on the sale of REIT shares qualify for section 892 exemption).

¹⁸ See temp. Treas. reg. sections 1.897-9T(e) (1988) (except as specifically provided in regulations pursuant to section 892, foreign governments are subject to the rules of section 897) and 1.1445-10T(b)(1) (1988) (same as to applicability of withholding rules). As described more fully below in Part III, capital gain REIT distributions are subject to special rules under section 897(h), and section 892 does not provide any exception for foreign governments with respect to the application of these special rules. See generally temp. Treas. reg. section 1.892-3T (1988).

¹⁹ See Treas. reg. section 301.7701-1(a) (as amended in 1996) and temp. Treas. reg. sections 1.892-2T(a)(2) (1988) and 1.892-2T(c) (1988). Of course, the concept of a trust as a juridical entity separate and apart from its settlor is an Anglo-Saxon legal concept, but one that is slowly finding greater acceptance in other legal traditions. See generally N. Bradbury et al., *International Trust Precedents* (1996).

²⁰ Whether it is a pension fund or a pension trust, a pension plan entitled to the section 892 exemption must annually file a Form 8709 (1994) to relieve the REIT from its withholding obligation on dividend payments to foreigners. See temp. Treas. reg. sections 1.892-7T(e) (1988) and 1.1441-8T (1988); Notice 89-50, 1989-1 C.B. 690; prop. Treas. reg. sections 1.1441-1(e) (1996) and 1.1441-8T (1996) (extant Forms 8709 to be grandfathered and ultimately replaced by Form W-8).

²¹ See temp. Treas. reg. sections 1.892-2T(c)(1) (flush language) (1988) and 1.892-2T(c)(2) (Example (4)) (1988).

²² Temp. Treas. reg. sections 1.892-2T(a)(2) (1988) and 1.892-2T(b) (1988).

²³ See temp. Treas. reg. section 1.892-5T (1988).

²⁴ See temp. Treas. reg. section 1.892-2T(c)(2) (Example (4)(a)) (1988).

²⁵ See temp. Treas. reg. section 1.892-2T(c)(2) (Example (3)) (1988) (unlimited employee contributions to a pension trust).

²⁶ However, a national pension system comparable to the U.S. social security system can qualify for section 892 exemption. See LTR 9224034, note 11 *supra*; see also temp. Treas. reg. section 1.892-2T(c)(1) (final sentence) (1988) (exempt pension funds may also benefit nongovernmental employees or former employees that perform or performed governmental or social services); Rev. Proc. 97-7, section 4.01(6), 1997-1 IRB at 186 (Service will not ordinarily rule on "[w]hether income received by local governmental authorities of the United Kingdom from certain United States investments of money allocable to their superannuation funds is exempt from federal income taxation").

²⁷ See *supra* note 11.

²⁸ See temp. Treas. reg. section 1.892-2T(a)(1) (1988).

²⁹ See temp. Treas. reg. section 1.892-4T (1988). The line between commercial activities versus governmental and nonprofit activities is determined under general U.S. standards and norms. See temp. Treas. reg. section 1.892-4T(c)(3)-(4) (1988). For example, libraries, toll bridges, local transportation services, and postal services are not commercial activities, but railroads (even though operated at times by the U.S. government) are a commercial activity. See *id.*

³⁰ See temp. Treas. reg. sections 1.892-2T(c)(2) (Example (4)(b)) (1988) and 1.892-5T(a) (1988).

³¹ See temp. Treas. reg. section 1.892-2T(a)(2) (1988).

³² See temp. Treas. reg. sections 1.892-2T(c)(2) (Example (4)) (1988), 1.892-5T(a) (1988), and 1.892-5T(d)(4) (Example 1) (1988).

³³ See temp. Treas. reg. section 1.892-2T(a)(1) (1988).

³⁴ Again, the line between commercial activities versus governmental and nonprofit activities is determined under U.S. standards and norms. See *supra* note 29.

³⁵ Temp. Treas. reg. section 1.892-2T(c) (1988).

³⁶ See temp. Treas. reg. section 1.892-5T(b)(3) (1988); see also Rev. Rul. 66-106, 1966-1 C.B. 151 (REIT dividends are not UBTI) and section 514 (income from leveraged investments is UBTI). Under section 856(h)(3), REIT dividends to a section 401(a) pension trust can in certain circumstances be UBTI. However, section 401(a) generally does not apply to foreign pension trusts, and therefore the section 856(h)(3) UBTI rule would not apply to foreign pension trusts to jeopardize their section 892 exemption. If an applicable treaty afforded to a pension trust section 401(a) and 501(a) exemption (subject to the UBTI rules of section 511 *et seq.*), such trust would not need to rely on the narrower tax exemption afforded by section 892. See *generally supra* text accompanying notes 8-10. Also, it is possible for a pension trust to earn income which, even though other than UBTI, is nevertheless not exempted by section 892. For example, real estate rental income may not be UBTI, but neither is it exempted under section 892. See temp. Treas. reg. section 1.892-5T(d)(4) (Example (2)(a)) (1988).

³⁷ See *supra* note 11.

³⁸ See temp. Treas. reg. section 1.892-2T(a)(1) (1988).

³⁹ See temp. Treas. reg. section 1.892-5T(d)(4) (Example 2(c)) (1988); Notice 89-50, 1989-1 C.B. 690.

⁴⁰ If the pension plan is a separate juridical entity, it is taxed as a nonresident alien individual. See Treas. reg. sections 1.871-2(a) (as amended in 1992) and 301.7701-5 (1960). If the pension plan is not a separate juridical entity, but is instead a set-aside fund of its sponsor, it will be taxed like its sponsor (either a corporation or an entity to which the nonresident alien individual rules apply). In either event, although technically governed by different statutes and regulations, the tax treatment (including treaty benefits) will generally be identical. See *generally* sections 871, 881, 892(a)(3), 894, 897, 1441, 1442, 1445, and 7852(d); but see *infra* text accompanying notes 45-46, and 51.

⁴¹ See *generally* sections 301, 856, 857, 871, 881, 894, 1441, and 1442; Treas. reg. sections 1.1441-3(b)(1) (as amended in 1995) and 1.1442-1 (as amended in 1966); prop. Treas. reg. sections 1.1441-3(a) (1996), 1.1441-3(c) (1996), and 1.1442-1 (1996).

⁴² See sections 301(c)(2), 301(c)(3), and 1445(e)(3) (final sentence); Treas. reg. sections 1.897-1(c) (as amended in 1996), 1.1445-1(g)(1) (as amended in 1995), and 1.1445-5(e) (as amended in 1995); temp. Treas. reg. section 1.897-5T(b)(2) (1988). Under the Internal Revenue Service's interpretation of current regulations, however, sections 1441 and 1442 withholding of 30 percent (less if reduced by treaty) is apparently required on the gross amount distributed either under section 301(c)(2) as a nontaxable return of capital or under section 301(c)(3) in exchange for the REIT's shares, with the foreign investor

entitled to file a refund for any excess withholding. See sections 1462 and 1464; Treas. reg. sections 1.1441-3(b) (as amended in 1995), 1.1442-1 (as amended in 1966), and 1.1441-3(h) (as amended in 1995); Rev. Rul. 72-87, 1972-1 C.B. 274. This interpretation of the current regulations has been criticized generally, and in the case of REITs apparently has the unintended result of superseding the more specific FIRPTA withholding rules of section 1445 and the regulations thereunder. See Treas. reg. sections 1.1445-1(g)(2) (as amended in 1995) and 1.1445-5(b)(1) (as amended in 1995) (double withholding not required on corporate distributions, and so section 1441 and 1442 withholding supersedes section 1445 withholding). Regulations proposed to be effective for payments after December 31, 1997, would no longer require section 1441 and 1442 withholding on distributions that constitute amounts distributed under section 301(c)(2) as a nontaxable return of capital or under section 301(c)(3) in exchange for a REIT's shares, and these regulations would thus confirm the primacy of section 1445 withholding rules (discussed below in Part IV) in such instances. See prop. Treas. reg. sections 1.1441-3(c) (1996), 1.1441-3(g) (1996), and 1.1442-1 (1996).

⁴³ See *generally* U.S.-U.K. Income Tax Treaty, Arts. 1(1) and 3(1)(c) (treaty benefits extend to U.K. trusts); section 892(a)(3) (treaty benefits extended to U.K. governmental units, if U.K. reciprocates for U.S. governmental units).

⁴⁴ See U.S.-U.K. Income Tax Treaty, Arts. 10(1), 10(2)(b), and 10(3).

⁴⁵ See U.S.-Germany Income Tax Treaty, Art. 10(2) (flush language). Similar limitations on reduced treaty withholding for ordinary income REIT dividends are to be found in recent U.S. treaties with several other nations, reflecting the Treasury Department's contention that foreign investment through U.S. REITs should bear a tax burden at the shareholder level - because the REIT itself is largely free of corporate-level tax - comparable to the tax burden on direct foreign investment in U.S. real estate. See Treasury Department, Technical Explanation of the U.S.-Netherlands Treaty (explanation of Article 10); Treasury Department, Technical Explanation of New Model Income Tax Convention (explanation of Article 10) (September 20, 1996); Letter from Mark Decker to Lawrence Summers, "NAREIT Opposes REIT Withholding Provisions in Tax Treaties," Doc 96-25492 (7 pages) (criticizing Treasury's policy of generally excluding ordinary income REIT dividends from treaty rate reductions, and cogently arguing that sound tax policy is for ordinary income REIT dividends to be afforded the same treaty rate reductions applicable to other corporations' dividends).

⁴⁶ In the absence of a treaty definition or mutual agreement between the U.S. and the foreign country, a U.S. definition of "individual" would control for purposes of determining a foreign party's eligibility under the treaty for reduced tax and withholding on ordinary income REIT dividends. See, e.g., U.S.-Germany Income Tax Treaty, Art. 3(2). Query whether foreign pension trusts (and also certain pension funds) might so qualify as an individual given their tax status as "nonresident alien individuals" for Internal Revenue Code purposes generally? See Treas. reg. sections 1.871-2(a) (as amended in 1992) and 301.7701-5 (as amended in 1960); *but see* Model Income Tax Convention, Arts. 3(1)(h) and 10(3) (September 20, 1996) ("trusts" are apparently a category of legal persons

separate from "individuals," and only individuals are entitled to reduced treaty rates on ordinary income REIT dividends).

⁴⁷ Utilizing section 1031 like-kind exchanges for real estate, many REITs have little or no recognized capital gains.

⁴⁸ See section 897(h)(1). These FIRPTA rules supersede section 892 and thus apply to foreign governments (and sub-units thereof), as well as to private parties. See temp. Treas. reg. sections 1.892-3T (1988), 1.897-9T(e) (1988), and 1.1445-10T(b)(1) (1988). Per section 1125(c) of FIRPTA, 1980-2 C.B. at 528, section 897 generally also supersedes treaty obligations of the United States. Thus, the dividend taxation provisions of treaties will not mitigate the application of section 897 to capital gain REIT distributions. Cf. LTR 9224034, note 11 *supra* (FIRPTA supersedes U.S.-Sweden treaty, which exempted Swedish investors' non-"effectively connected," U.S.-source capital gains from real estate interests). As to those few treaties that exempt foreign pension plans' investment income from U.S. income taxation, such exemption does not extend to section 897 FIRPTA gain. See *supra* note 10.

⁴⁹ See sections 871(b), 882, and 897(a).

⁵⁰ See section 1445(e); Treas. reg. section 1.1445-8(c)(2)(i) (as amended in 1995); Rev. Rul. 69-244, 1969-1 C.B. 215 (capital gain dividends of regulated investment companies, and presumably REITs as well, are not dividends subject to the tax and withholding regimes of sections 871, 881, 1441, and 1442). Any excessive amounts withheld give rise to a claim for refund by the foreign investor. See sections 1462 and 1464; Treas. reg. section 1.1445-8(h) (as amended in 1995).

⁵¹ See *generally* Treas. reg. sections 1.884-0(a) (as amended in 1996) and 1.884-1(d)(2)(xi) (Example 4) (as amended in 1996). Applicable treaties may either eliminate the section 884 branch profits tax entirely, or reduce its 30 percent rate to the same reduced treaty rate applicable to dividends paid by U.S. corporations generally. See *generally* section 884(e). Any treaty exception to reduced treaty dividend rates for ordinary income REIT dividends ought not apply in this context because income subject to section 884 branch profits tax has already been once subject to net income taxation at graduated rates. See *generally* section 884(e)(2) and *supra* note 45.

⁵² See section 857(b)(3)(C).

⁵³ See Estes, "Foreign Investment in U.S. Real Estate Through REITs," 20 *Tax Management International Journal* 143, 148-153 (1991) (arguing that both sound tax policy and administrability dictate that amount subject to tax under section 897(h)(1) be treated as identical to the amount that has been designated by the REIT as a capital gain REIT distribution).

⁵⁴ See Treas. reg. section 1.1445-8(c)(2) (as amended in 1995). However, this "maximum capital gain" construct applies solely for purposes of Treas. reg. section 1.1445-8(c)(2) (as amended in 1995), and not also for section 1441 and 1442 purposes. Apparently, to the

extent that this "maximum capital gain" exceeds the amount actually designated as a capital gain REIT dividend, withholding is required under sections 1441 and 1442 and hence not under section 1445 and the regulations thereunder. See Treas. reg. sections 1.1445-1(g)(2) (as amended in 1995) and 1.1445-5(b)(1) (as amended in 1995) (double withholding not required on corporate distributions, and so sections 1441 and 1442 withholding supersedes section 1445 withholding). Regulations proposed to be effective for payments after December 31, 1997, establish the primacy of section 1445 withholding rules in this instance. See prop. Treas. reg. sections 1.1441-3(c)(1)(v) (1996), 1.1441-3(g) (1996), and 1.1442-1 (1996).

⁵⁵ See section 857(b)(3)(C).

⁵⁶ See Treas. reg. section 1.1445-8(c)(2) (as amended in 1995).

⁵⁷ See sections 1462 and 1464; Treas. reg. sections 1.1445-5(b)(7) (as amended in 1995) and 1.1445-8(h) (as amended in 1995). Also, a buying investor who is not a foreigner may in advance certify his domestic status to the REIT and thereby preclude any FIRPTA withholding. See *generally* Treas. reg. section 1.1445-5(b)(3) (as amended in 1995). Of course, a foreign shareholder's FIRPTA tax liability under section 897(h) is itself subject to uncertainty and difficult for the foreign shareholder to ascertain. See *supra* text accompanying notes 52-53.

⁵⁸ See section 892(a)(1)(A)(i); Treas. reg. sections 1.884-1(a) (as amended in 1996), 1.884-1(b) (as amended in 1996), 1.884-1(f)(2)(v) (as amended in 1996), 1.1445-2(d)(2) (as amended in 1988), and 1.1445-3(d) (1986); temp. Treas. reg. sections 1.892-3T(a)(1)-(2) (1988), 1.892-3T(b) (Example 1(ix)) (1988), 1.897-9T(e) (1988), 1.1445-9T (1988), and 1.1445-10T(b) (1988). Of course, a foreign pension plan qualifying for exemption under section 892 may also rely on the other tax exemptions for sale gain on REIT shares discussed in this Part IV.

⁵⁹ See *supra* notes 10, 18, and 48.

⁶⁰ Section 897(h)(4)(B). See also Treas. reg. section 1.897-1(c)(2)(i) (as amended in 1996); LTR 9630016, *Doc 96-21246* (6 pages) (transfer restrictions designed to maintain "domestically controlled" status compatible with section 856(a)(2) requirement that REIT shares be transferable).

⁶¹ See sections 897(h)(2) and 1445(a); Treas. reg. sections 1.897-1(c)(2)(i) (as amended in 1996) and 1.1445-2(c)(1) (as amended in 1988).

⁶² See *generally* sections 871, 881, and 882.

⁶³ See sections 897(c)(2) and 897(h)(2). A REIT might hold mortgages on realty, a sufficient investment in which would preclude status as a U.S. real property holding corporation. See section 897(c)(1) and Treas. reg. section 1.897-1(c)(1) (as amended in 1996); see also *supra* note 7.

⁶⁴ See sections 897(a) and 897(c)(1). But the section 884 branch profits tax of 30 percent would not apply to this sale gain. See Treas. reg. sections 1.884-1(a) (as amended in 1996), 1.884-1(b) (as amended in 1996), and 1.884-1(f)(2)(iii) (as amended in 1996).

⁶⁵ See section 1445(a); Treas. reg. sections 1.1445-1(a) (as amended in 1995) and 1.1445-2(c)(2) (as amended in 1988) (withholding not applicable on shares regularly traded on an established securities market).

⁶⁶ See sections 897(c)(1)(A)(ii)(I)-(II), 897(c)(3), and 1445(a); Treas. reg. sections 1.897-1(c)(2)(iii) (as amended in 1996) and 1.1445-2(c)(2) (as amended in 1988); and temp. Treas. reg. section 1.897-9T(b) (1988). See also Treas. reg. section 1.897-1(m) (as amended in 1996) ("established securities market" includes domestic national securities exchanges, foreign national securities exchanges, and over-the-counter markets operating interdealer quotation systems); temp. Treas. reg. section 1.897-9T(d) (1988) (definition of regularly traded is straightforward for domestic securities markets but more onerous for foreign securities markets).

⁶⁷ See *supra* note 62.

⁶⁸ See generally Treas. reg. section 1.897-2(g)-(h) (as amended in 1986).

⁶⁹ Given the simple and favorable tax rules for sale gain on REIT shares in comparison to those in place for REIT dividends, a foreign pension plan might consider a "dividend play" to convert impending REIT dividends into gain from the sale of REIT shares: after a dividend has been declared the foreign pension plan sells its REIT shares in the market just before the ex-dividend date (thereby shifting the tax incidence of the declared but unpaid dividend to the purchaser) and then repurchases the same number of REIT shares just when such shares begin trading ex-dividend. See generally Treas. reg. section 1.61-9(c) (as amended in 1964); Rev. Rul. 82-11, 1982-1 C.B. 51. Key criteria to the success of this strategy are: (i) transaction costs; (ii) opportunity to hedge market risk for the (albeit brief) period of time that the foreign pension plan has disposed of its investment in REIT shares, as well as the U.S. tax consequences of entering into such hedges; and (iii) tax consequences in other jurisdictions from periodically disposing of and repurchasing the REIT shares.