Clarifications to Foreign Investment in Real Property Tax Act to Encourage Equity Investment in U.S. Commercial Real Estate

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Executive Summary

The United States is in the midst of the greatest financial crisis in 75 years, a crisis largely caused by the virtual collapse of the debt marketplace. This debt capital crisis poses a tremendous threat to U.S. commercial real estate markets.[1] Today, commercial real estate properties in most areas of the nation are relatively healthy as vacancy rates remain low, cash flows remain positive and real estate supply is roughly in line with demand for rental space. But that will be of no consequence if the market for commercial debt remains dead as it is today. If commercial real estate companies are not able to rollover their existing debt as it comes due, bankruptcies will occur, property values will plummet, and this important economic sector (6% of the gross domestic product) will become a drag on the economy. The result will be job losses at real estate companies, and in the construction trades as new developments are unable to move forward. In addition, the fall in commercial real estate values will sharply erode local property taxes undermining funds for public safety and schools and financial institutions will be further weakened (as they were in the 1980s and 1990s). The broad economic effects of the commercial real estate debt crisis merits that this issue be addressed in the economic stimulus package that Congress will consider next year.

The industry is working with the Treasury Department and the Federal Reserve Board on strategies that can restore the real estate debt markets, but it is also necessary to remove artificial barriers to equity capital as well. Congress should make changes to the Foreign Investment in Real Property Tax Act (FIRPTA) to remove unnecessary and inappropriate impediments to investment in U.S. real estate by equity capital providers outside the U.S.

The following changes to FIRPTA would make it easier for U.S. real estate companies to access foreign equity capital which could be crucial in the months ahead if widespread bankruptcy and dislocation in the commercial real estate markets are to be avoided: 1) a recent decision by the Treasury Department that changed the treatment of REIT liquidating distributions should be reversed so that such distributions are treated as a sale of stock rather than a capital gain distribution ; 2) there should be clarification that SEC-registered REITs may meet the definition of a "domestically controlled qualified investment entity" by disregarding shareholders of less than 5% of stock (the SEC filing threshold); and, 3) the exemption for foreign portfolio investors (*i.e.*, 5% or less shareholders) for SEC-registered REITs should be made consistent with the Model U.S. Tax Convention and the Portfolio Investor interest rules (*i.e.*, 10% or less shareholders).

By enacting these three modifications, Congress would be updating FIRPTA rules, both to reduce the current tax bias in favor of debt financing and to assist U.S. real property owners who need to access equity capital from around the world at a time of great distress in the debt and broader financial markets.

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[1] * For example, see: *Crisis Hits Values of Commercial Mortgages*, *Investors Leery of Real Estate Bonds*, Washington Post, November 21, 2008; *Meltdown Far From Over, New Mortgage Crisis Looms*, Associated Press, November 28, 2008

Background on FIRPTA

In general, developed nations around the world do not impose an income tax on the sale of capital assets by foreign investors, including a foreign investor in real estate corporations, so long as the investor is not conducting a trade or business. However, in the U.S. since the 1980s FIRPTA imposes a significant withholding tax on foreigners in conjunction with the sale of U.S. real estate equity. Notably, the U.S. imposes no U.S. tax on most interest payments on most debt paid to debt holders who own less than 10% of the issuer, whether or not the debt is real estate related. As a result, foreign investment in U.S. real estate is often structured as debt rather than as equity.

This unduly harsh treatment of real estate equity investment arose in the 1980s when Congress enacted FIRPTA after a wave of foreign investment engendered concern that farmland and other U.S. real estate would come under foreign control. (The primary FIRPTA sponsor in the Senate unsuccessfully attempted to repeal the entire law a few years after it went into effect).

FIRPTA treats any gain from a non-U.S. person's sale of U.S. real property as if the non-U.S. person was doing business in the United States, and therefore subjects it to full U.S. income tax. To enforce the FIRPTA regime, the tax code requires U.S. persons who sell to non-U.S. investors to collect a significant tax (usually 10% of the gross proceeds, or 35% of the net amount in the case of REITs) and remit it to the IRS. The FIRPTA rules do not apply to sales of debt secured by real estate such as mortgages.

The FIRPTA rules apply both to sales of direct U.S. real estate as well as to the sale of shares of corporations the assets of which primarily consist of U.S. real estate (United States Real Property Holding Corporation, or USRPHC). However, recognizing that "portfolio" investors of listed real estate companies, such as REITs, are more akin to securities owners than to direct real estate investors, FIRPTA exempts sales of stock in a USRPHC that is regularly traded on an established securities market (so long as the seller owns 5% or less of that company).

In addition, FIRPTA exempts stock sales of REITs and mutual funds that are USRPHCs if they are primarily owned by U.S. persons (domestically controlled qualified investment entities).

Finally, REIT capital gains distributions are subject to a 35% FIRPTA withholding tax unless they are paid to 5% or less shareholders of a listed REIT, in which case the distributions are subject to the same withholding rates as ordinary dividends (30% or a lower tax treaty rate --often 15% or 0% in certain limited cases, such as for a foreign pension fund).

Proposed Changes

<u>REIT Liquidating Distributions</u>

Current law is unclear whether payments from a REIT made as part of its liquidation should be considered a sale of its stock (which is exempt from FIRPTA under several circumstances) or a capital gain distribution (which is subject to FIRPTA in several circumstances). The IRS issued a private letter ruling in 1990 concluding that liquidating distributions should be treated as a sale of stock, but that ruling was revoked in 2004. In 2007, the IRS issued Notice 2007-55 in which it concluded that liquidating distributions should be treated as capital gain liquidations that are subject to FIRPTA if paid to foreign shareholders.[2]

The IRS change in position has caused considerable consternation in the foreign investor community and has severely constrained continued foreign investment in U.S. real estate. In June 2008, the Tax Section of the American Bar Association submitted a detailed discussion of this issue and recommended several changes to the 2007 policy. Although the REIT liquidating distribution issue has been placed on the Treasury Department's Business plan, this barrier to foreign investment could best be alleviated by a legislative change clarifying that such distributions are treated as sales of stock for FIRPTA purposes.

<u>Domestically Controlled Qualified Investment Entity</u>. Current law appropriately does not apply the FIRPTA regime to sales of stock in a "domestically controlled qualified investment entity" because it is primarily owned by U.S. persons, i.e., at least 50% U.S. ownership.[3] This rule works well for private REITs and private mutual funds since they know the identity of their shareholders and can monitor whether foreign owners collectively cross the 50% threshold disqualifying the REIT or mutual fund as a "domestically controlled qualified investment entity". For listed REITs and mutual funds, however, it is difficult if not impossible to track each and every owner because a number of shares that are traded on an established securities market are in "street name".

The tax code has recognized the problem of identifying public shareholders in both the net operating loss limitation section and in the REIT subchapter.[4] The Securities Exchange Act of 1934 requires shareholders owning 5% or more of an SEC-registered company to timely file ownership notices with the SEC that are publicly available. Both of these tax sections allow an SEC-registered company to rely on the filings in measuring stock ownership in their particular circumstance.

Similarly, for purposes of determination of whether a regularly traded REIT or mutual fund is a "domestically controlled qualified investment entity," the law should be clarified so that only persons who own more than 5% of a U.S.-listed REIT's or mutual fund's stock are to be taken into account in calculating whether foreign shareholders own more than 50% of the stock.

<u>Portfolio Investors</u>. Since its inception, FIRPTA has exempted "portfolio investors" (5% or less) in listed USRPHCs because U.S. policy has long regarded them as investors in securities rather than in real estate directly. This policy parallels the portfolio interest exemption under which foreigners pay no U.S. tax on interest payments made to them connected to U.S. debt so long as they own less than 10% of the debt issuer's stock or partnership interest. In 2004, Congress extened this policy to REIT capital gain distributions in that distributions to 5% or less shareholders of a listed REIT are treated as ordinary dividends rather than distributions subject to FIRPTA.

For purposes of FIRPTA, the 5% "portfolio" investor limit has become badly outdated. In addition to the 10% ceiling used for portfolio interest mentioned above, the Model U.S. Tax Convention in use by the Treasury Department for negotiation with foreign governments utilizes a 10% ceiling (rather than

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[2] In a 2008 Chief Counsel Memorandum, the IRS concluded that FIRPTA does not apply to distributions to a foreign shareholder of a listed REIT who owns 5% or less of that REIT's shares. *See* AM2008-003.

[3] The qualified investment entity rules had long applied to "domestically controlled REITs" and were extended to mutual funds in 2004 for three years. The Emergency Economic Stabilization Act enacted in October 2008 extended these rules for mutual funds through December 31, 2009.

[4] *See* I.R.C. §§ 382(g)(4), 856(d)(3)(flush language); *see also* Treas. Reg. § 1.382-2T(k)(1)(i).

5%) for applying a lower tax rate for individual investors generally as well as for the lower tax rate employed for U.S. REIT dividends paid to foreign “portfolio” investors.

To encourage further foreign equity investment in U.S. REITs (which generates substantial U.S. taxes because of the high dividend payments required under the REIT rules), the 5% FIRPTA “portfolio” investor ceiling should be modified to conform to the modern 10% standard both for the FIRPTA sales rule and the REIT capital gains rule modified in 2004. Further, the “portfolio” investor exemption for listed REIT shares should be extended to all non-traded REITs that are required to register with the SEC. These REITs are widely held, completely transparent because of their SEC-required filings, and their investors have substantially the same governance rights as their listed company counterparts.