Bill in 2/11/15 SFC Mark-up to Amend FIRPTA to Encourage Equity Investment in U.S. Commercial Real Estate

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 interests held by foreign investors in real estate corporations, so long as such investors are not conducting a trade or business. However, in the United States, since the 1980s the Foreign Investment in Real Property Act (FIRPTA) has imposed 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 (the "portfolio interest" exception), whether or not the debt is real estate related. As a result of this difference in tax treatment, foreign investment in U.S. real estate is often structured as debt rather than as equity.

This unduly harsh treatment of non-U.S. 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). This tax burden is further increased when the "branch profits tax" is imposed on foreign institutions investing in U.S. real estate.

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 acquire real property from non-U.S. investors to withhold a significant tax (usually 10% of the gross proceeds, or 35% of in the case of REIT capital gain distributions) and remit it to the IRS. The FIRPTA rules do not apply to sales of debt secured by real estate such as mortgages.

FIRPTA taxation applies both to sales of direct interests in U.S. real estate as well as to sales of shares of corporations the assets of which primarily consist of U.S. real estate (United States Real Property Holding Corporations, or USRPHCs). 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 has always exempted 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).

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 Change

Portfolio Investors. The 5% "portfolio" investor limit in FIRPTA 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 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. So, while most of our U.S. tax treaties with our leading trading partners encourage foreign ownership up to 10%, FIRPTA effectively caps a foreigner's ownership at 5%.

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 bill before the Senate Finance Committee on February 11, 2015 would modify the 5% FIRPTA "portfolio" investor ceiling to conform to the modern 10% treaty standard both for the FIRPTA sales rule and the REIT capital gains rule modified in 2004 while also applying that rule to certain widely-held publicly-traded "qualified collective investment vehicles", which are entities that qualify under a comprehensive income tax treaty with the United States and meet certain detailed reporting requirements.

Revenue Raisers. The budgetary impact of these FIRPTA reforms is offset by five revenue raiser proposals. Most of these proposals generally do not impose any new tax but instead merely collect unpaid FIRPTA taxes. First, the required rate of FIRPTA withholding imposed on the disposition or distribution of a U.S. real property interest would be increased from 10% to 15%, to ensure that FIRPTA withholding collects a sufficient share of amounts owed. Second, USRPHCs would be required to make their FIRPTA status readily accessible to shareholders and the IRS through disclosures in their annual returns. Third, brokers whose clients sell more than 5% of a publicly-traded U.S. real property holding corporation (10% for publicly-traded, foreign controlled REITs upon passage of the bill) would be required to withhold 15% of the proceeds of a disposition of their client's interests in such corporation. Again, each of these provisions imposes no new taxes, but rather collects taxes that are current going unpaid in many cases.

Fourth, the FIRPTA "cleansing rule" exception would no longer apply when a REIT or RIC disposes U.S. real property and claims a dividends paid deduction on the subsequent distribution to shareholders. Finally, for purposes of determining whether dividends from a foreign corporation (attributable to dividends from an 80% owned domestic corporation) are eligible for a dividends received deduction under Section 245 of the Code, dividends from REITs and RICs would no longer be treated as dividends from domestic corporations. The fourth and fifth revenue raisers were included in H.R. 1 in the last Congress.