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Tax Issues Arising From Inbound Investment Into US REITs

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(a/k/a FIRPTA, FIRPTA, FIRPTA)

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Overview of Topics

- ◆ Overview of US Taxation of Non-US Investors in US REITs
 - ◆ Legislative Proposals
- ◆ Domestically Controlled REITs
- ◆ REIT Joint Ventures
 - ◆ Preparing for the Exit Strategy
 - ◆ Understanding the Unique Tax Rules for Foreign Governments
- ◆ Capital Gain Dividends and other Section 897(h)(1) Distributions
 - ◆ Substantive Tax
 - ◆ Withholding Obligations
- ◆ Other FIRPTA/Inbound Issues
 - ◆ What is a USRPI?
 - ◆ Fund/Alternative Investment Vehicle (“AIV”) Investments

Overview of US Taxation of Non-US Investors in US REITs

Taxation of Non-US Persons



◆ Is the US-source income effectively connected with a US trade or business (“ECI”)?

◆ If Yes:

◆ Subject to US tax at regular rates

◆ Corporations taxed at a maximum of 35% under current law on ordinary income and capital gains

◆ Individuals taxed at a maximum of 39.6% on ordinary income and 20% on capital gains (25% on depreciation recapture)

◆ Additional 30% branch profits tax imposed on non-US corporations, subject to exemption or reduction under an applicable tax treaty

◆ Tax return filing obligations

◆ US tax may be creditable against foreign tax obligations

Taxation of Non-US Persons

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◆ Is the US-source income effectively connected with a US trade or business?

◆ If No:

- ◆ US-source fixed or determinable annual or periodical income (i.e., dividends, interest, certain rents)
 - ◆ 30% US withholding tax on gross basis, but subject to exemption or reduction under applicable income tax treaties
- ◆ Most capital gains
 - ◆ Generally not taxable
- ◆ Generally no US tax return filing obligation

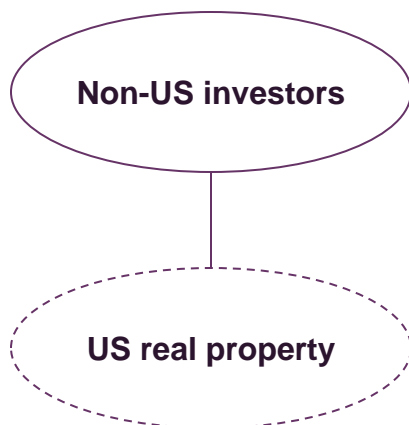
Taxation of Non-US Persons – US Real Estate



- ◆ Real estate rental income generally ECI (unless net lease)
- ◆ Gain from disposition of a US real property interest (“**USRPI**”) is ECI and subject to withholding, US tax and tax return filing obligations under FIRPTA
- ◆ USRPI includes US real estate and stock of a US corporation if the fair market value of such corporation’s US real property interests is at least 50% of the value of most of its assets (“**USRPHC**”)
 - ◆ Exception for sale of stock in domestically controlled REITs
 - ◆ Exception for sale of certain small interests in listed USRPHCs

Direct Investment

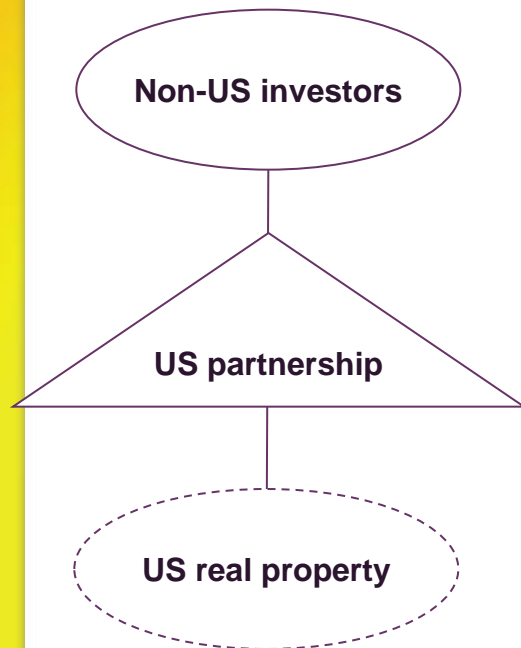
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- ECI rules probably apply to all income (unless net lease property).
- Non-US investors must file US tax returns.
- Corporate foreign investors:
 - (a) Maximum 35% federal tax (under current law) on ordinary income and capital gains; state taxes also generally apply.
 - (b) Additional 30% US “branch profits tax” payment obligation for foreign corporate investors, which may increase the 35% federal rate by about 19.5%, such that the total US federal tax impact may be approximately 54.5%. May be reduced by applicable tax treaty and certain exceptions may apply.
- Individual foreign investors:
 - (a) Maximum 39.6% federal tax on ordinary income.
 - (b) Long-term capital gains eligible for 20%, or 25% in the case of unrecaptured section 1250 gain.
 - (c) US real property subject to US estate tax.

Investment Through Partnership

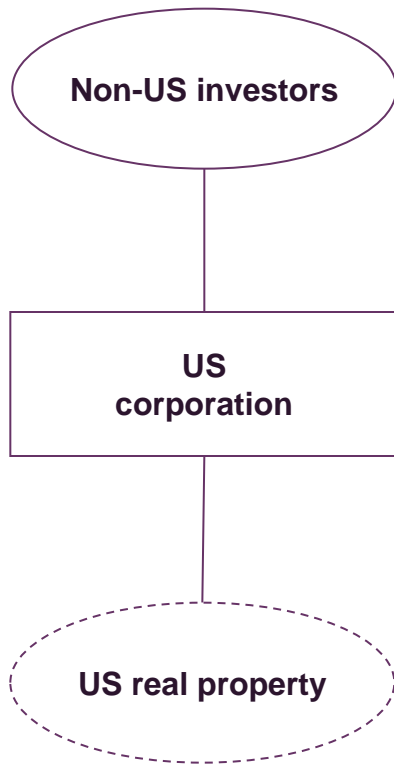
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- Partnership income flows through to investors. Non-US investors will likely be treated as engaged in a US business as a result of directly investing in the US partnership, which engages in US business (unless net lease property). Thus, essentially same consequences as direct investment.
- Allocable shares of operating income and gains from the sale of real estate subject to US tax at regular rates.
- Non-US investors must file US tax returns. State taxes generally apply.
- The Partnership must withhold quarterly on net ECI allocable to non-US partners at highest applicable rates under section 1446 and the regulations thereunder.
- Additional 30% US “branch profits tax” payment obligation for foreign corporate investors (unless reduced by treaty or exceptions apply), which may increase the 35% federal rate by about 19.5%, such that the total US federal tax impact may be approximately 54.5%
- Potential US estate tax consequences.
- Sale of interest in the US partnership
 - Gain on sale (capital gain) likely treated as ECI and taxable to investors at regular individual or corporate rates, as applicable. See IRC § 897(g); Rev. Rul. 91-32.
 - Seller withholding obligations – see IRC § 1445(e)(5); Treas. Reg. § 1.1445-11T(b).

Investment Through US Corporation

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- US corporation pays tax at regular rates on operating income and gains from sale.
- Dividends subject to 30% US withholding tax (subject to treaty reduction). No filing obligation on dividends.
- Return of capital distributions subject to 10% FIRPTA withholding in absence of applicable exception.
- Gain on sale of US corporation stock taxable under FIRPTA and subject to 10% withholding in absence of applicable exception.
- No branch profits tax for foreign corporate investor.
- Could capitalize US corporation with debt payable to shareholders in order to offset income with interest deductions. (Limitations under section 163(j) if debt-equity ratio exceeds 1.5-to-1. Also, limits in certain cases if rate is too high or interest is accruing but unpaid.)
- Interest payments may be exempt as "portfolio interest" if lending shareholders do not own more than 10% of stock. Otherwise, 30% US withholding tax applies to interest payments, subject to treaty reduction.
- US corporation stock subject to US estate tax, subject to treaty exemption.

U.S. Taxation of Non-U.S. Shareholders of U.S. REITs

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	Listed (Equity) REIT	Nonlisted (Equity) REIT	Mortgage REIT
Ordinary Dividends	30% withholding, subject to applicable treaty rate	30% withholding, subject to applicable treaty rate	30% withholding, subject to applicable treaty rate
C/G Dividends			
$\leq 5\%$ S/Hs	30% withholding, subject to applicable treaty rate	Taxable under FIRPTA; 35% withholding	Exempt to the extent not attributable to sale of a USRPI
$> 5\%$ S/Hs	Taxable under FIRPTA; 35% withholding	Taxable under FIRPTA; 35% withholding	Exempt to the extent not attributable to sale of a USRPI
Gain on Sale of Shares			
$\leq 5\%$ S/Hs	Exempt	Exempt if domestically controlled REIT; otherwise taxable under FIRPTA and subject to 10% withholding	Exempt – not a USRPHC
$> 5\%$ S/Hs	Exempt if domestically controlled REIT; otherwise taxable under FIRPTA and subject to 10% withholding	Exempt if domestically controlled REIT; otherwise taxable under FIRPTA and subject to 10% withholding	Exempt – not a USRPHC
Liquidating Distributions			
$\leq 5\%$ S/Hs	Exempt	Taxable under FIRPTA; 35% withholding	Exempt to the extent not attributable to sale of a USRPI
$> 5\%$ S/Hs	Taxable under FIRPTA; 35% withholding	Taxable under FIRPTA; 35% withholding	Exempt to the extent not attributable to sale of a USRPI

Treaty Rates for Ordinary REIT Dividends

◆ US Model Treaty

- ◆ 0% for pension funds that do not own more than 10% of the REIT
- ◆ 15% for individuals who do not own more than 10% of the REIT
- ◆ 15% for persons who do not own more than 5% of any class of the REIT's listed stock
- ◆ 15% for $\leq 10\%$ shareholders if the REIT is diversified, i.e., if no REIT property is worth more than 10% of the value of its total real property interests.

◆ Exemption for pension funds in certain (e.g., Canadian, Dutch, UK) treaties

- ◆ Limitations, e.g., exemption inapplicable to dividends received by Canadian pension plan from "related" REIT or by Dutch pension plan that owns more than 80% of any class of the REIT's stock

◆ Idiosyncratic treaty rates – 10% dividend rate under US treaties with Japan and China

Taxation of Capital Gain Dividends

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- ◆ Distributions that are attributable to gain from sale of USRPIs are treated as FIRPTA gain – subject to recharacterization rule for $\leq 5\%$ shareholders (one-year look-back period) of publicly traded REITs. IRC §§ 897(h)(1) & 857(b)(3)(F).
- ◆ Treat as C/G dividends the maximum amount that could have been treated as a C/G dividend. Treas. Reg. § 1.1445-8(c)(2)(ii)(A).
- ◆ Retention of FIRPTA treatment for distributions through tiered REITs. IRC § 897(h)(1).
- ◆ Wash sale anti-abuse rule. IRC § 897(h)(5).
- ◆ 35% withholding. IRC § 1445(e)(6).
- ◆ Because “net capital gain” not determinable until end of year, can withhold in subsequent year. Treas. Reg. § 1.1445-8(c)(2)(ii)(C).

Legislative Proposals Affecting Taxation of Non-US Investors in US REITs



◆ Obama Budget Proposal

- ◆ Would exempt foreign pension funds from FIRPTA.

◆ Senate Finance Committee Proposals

- ◆ C/G dividends of publicly traded REITs would be recharacterized as ordinary dividends for $\leq 10\%$ shareholders.
- ◆ Gain on sale of shares of publicly traded REIT by $\leq 10\%$ shareholders would not be taxable under FIRPTA.
- ◆ FIRPTA would be inapplicable with respect to holdings in REITs (whether private or publicly traded) by certain listed Dutch beliggingsinstellings and listed Australian property trusts except with respect to investors therein that indirectly own more than 10% of the REIT's stock.
- ◆ 15% withholding rate on sales of USRPHC stock.
- ◆ Cleansed USRPHC rule would be inapplicable to REITs and RICs.

Domestically Controlled REITs

Benefit of Domestically Controlled REIT

- ◆ Section 897(h)(2) provides that stock in a “domestically controlled qualified investment entity” is not a USRPI
 - ◆ Therefore, a foreign person can sell stock in a domestically controlled REIT without a FIRPTA tax liability or FIRPTA withholding
 - ◆ But domestically controlled REIT status *does not* confer any FIRPTA exemption on capital gain dividends or other distributions from a REIT that are captured by section 897(h)(1)

Definition of Domestically Controlled REIT

◆ Section 897(h)(4)(B)

- ◆ The term “domestically controlled qualified investment entity” means any qualified investment entity [REIT] in which at all times during the testing period less than 50 percent in value of the stock was held directly or indirectly by foreign persons.
- ◆ Generally, the testing period is the five-year period ending on the date of disposition or, if shorter, the period during which the REIT was in existence.
 - ◆ USRPHC that makes REIT election after first USRPHC year?
- ◆ Charter restrictions to maintain domestically controlled REIT status will not violate transferable share requirement. See, e.g., PLR 9630016.

Domestically Controlled REIT Status

- ◆ What indirect ownership is/should be taken into account?
 - ◆ Actual owners of shares, i.e., persons required to include dividends in income to be taken into account. Treas. Reg. § 1.897-1(c)(2)(i).
 - ◆ No clear authority on whether to look through US partnerships, US C corporations, or US REITs, or whether base erosion could be relevant.
 - ◆ In PLR 200923001, the IRS concluded that it would not look through US C corporations, noting that they were not a REIT, RIC, hybrid entity, conduit, disregarded entity or other flow-through or look-through entity.
 - ◆ Publicly traded REIT disclosures regarding domestically controlled status versus practical impossibility to confirm domestically controlled status.
 - ◆ Process for establishing domestically controlled status for withholding agents uncertain. See Treas. Reg. §§ 1.897-2(g)(3) & (h)(3).

Legislative Proposals to Clarify Domestically Controlled Determination

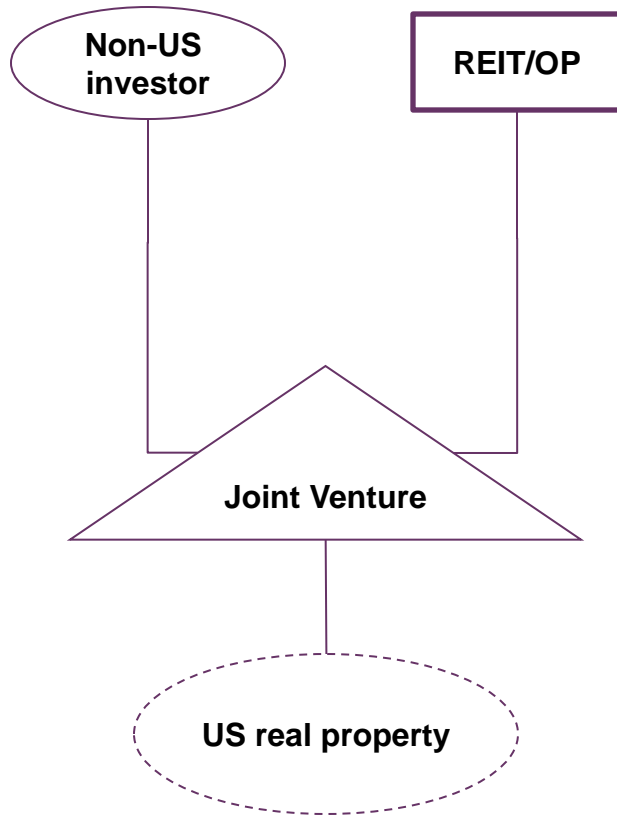
◆ Senate Finance Proposals

- ◆ Presumption that less than 5% shareholders of publicly traded REITs are US persons, absent actual knowledge to the contrary.
- ◆ Stock held by a publicly traded REIT or an open-end RIC is treated as held by foreign persons unless the shareholder REIT or RIC is itself domestically controlled, in which case it would be treated as a US person. Look-through for other shareholder REITs and RICs.
- ◆ Treated as not domestically controlled unless publicly disclose domestically controlled status.

Structures for JV Between REIT and Non-US Investor

Simple JV with Non-US Investor

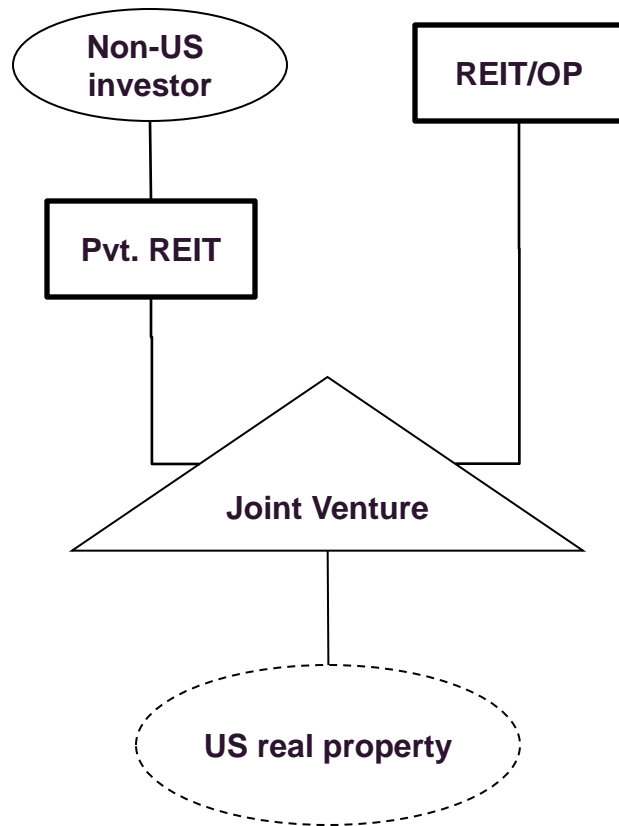
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- Basic Consequences
 - Operating income taxable.
 - Gain on sale of property or JV interest taxable
- Foreign Government investor – generally section 892 is not helpful
- Issues associated with property contribution by non-US investor? Nonrecognition transactions under FIRPTA

Non-US Investor Invests Through REIT

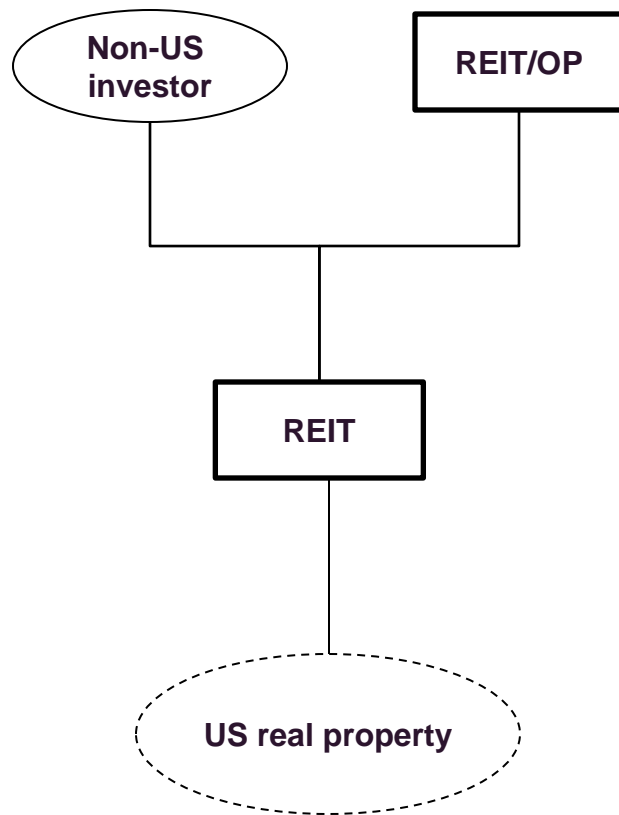
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- Dividends taxable
- Lower withholding rates for interest may favor leveraged REIT
- Gains from JV sales of USRPIs taxable under section 897(h)(1)
- Stock sale gain taxable (foreign-controlled REIT)
- Liquidating distributions taxable
- Other Issues
- Foreign Government
 - REIT is controlled commercial entity so section 892 not helpful

Non-US Investor and REIT Form Jointly Owned Private REIT

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- Ordinary dividends taxable
- Distributions attributable to gains from property sales taxable
- Stock sale gain – No tax if REIT is domestically controlled
- Foreign Government Investors
 - Ordinary dividends exempt unless recipient or REIT is a controlled commercial entity
 - Distributions attributable to gains from property sales taxable
 - Stock sale gain exempt (but if seller or REIT is a controlled commercial entity, and if REIT is foreign controlled, then taxable)

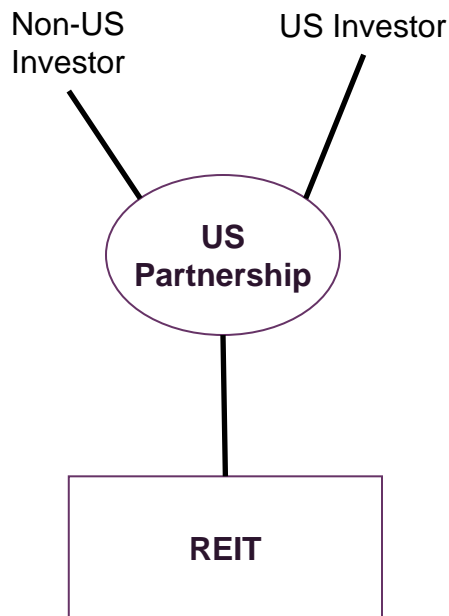
Tax-related Deal Issues for Joint Ventures Between US and Non-US Investors

Single-Property Domestically Controlled REIT

- ◆ Exemptions for ordinary dividends for foreign pension funds under tax treaties and for foreign governments under section 892, combined with exemption for gain on sale of shares of domestically controlled REITs, led to widespread use of single-property domestically controlled REITs.
- ◆ Uncertainty whether liquidation distributions should be treated as section 897(h)(1) distributions of FIRPTA gains or as section 331 distributions in exchange for stock of a domestically controlled REIT.
 - ◆ PLR 9016021: liquidating distributions treated as section 331 distributions in exchange for stock (not a domestically controlled REIT, but section 331 treatment allowed shareholders to recover outside basis).
 - ◆ PLR 200453008: revoked PLR 9016021.
 - ◆ Notice 2007-55: liquidating distributions treated as section 897(h)(1) distributions of FIRPTA gain (and is taxable notwithstanding Section 892).
 - ◆ AM 2008-003: liquidating distributions to $\leq 5\%$ shareholder of publicly traded REIT not recharacterized as ordinary dividends.

US Partnership to Hold Domestically Controlled REIT

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- ❖ No FIRPTA withholding with US seller, whereas reliance on domestically controlled REIT status less certain.
- ❖ Partnership agreement addresses business deal regarding maintaining domestically controlled REIT status, exit structure, etc.
 - ❖ Could partnership provisions implicate REIT rules, e.g., transferable share requirement, preferential dividend rules, etc.?

Deal Issues – Non-US Investor/Seller

- ◆ Sale of REIT shares (or partnership owning REIT shares) is optimal exit strategy for non-US partner.
- ◆ Coordinated sale of entire REIT so buyer can liquidate and get a step-up (and pay higher price) preferred.
- ◆ Maintenance of domestically controlled REIT status.
 - ◆ US partner cannot sell its interest in REIT shares (or partnership owning REIT shares) to non-US person.
 - ◆ Buyer must maintain REIT status through end of REIT's taxable year for year of sale – and indemnify non-US seller if it fails to do so – given no FIRPTA exception for sales of domestically controlled non-REIT USRPHCs.

Deal Issues – US Partner/Seller

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- ◆ May or may not benefit from REIT structure
- ◆ Possibility of haircut on exit if sell REIT shares (or partnership owning REIT shares)
- ◆ Restrictions on transfer of its interest
- ◆ Costs of establishing and maintaining the REIT structure and executing the domestically controlled REIT strategy

Deal Issues – “Typical” Joint Venture Matters

◆ Contributing appreciated property

- ◆ Tax-deferral
- ◆ Allocation of built-in gain

◆ Buy-sell provisions

- ◆ Can both partners be “buyers” without affecting REIT qualification
- ◆ Basis – if no step-up for the buying partner that is buying REIT shares
 - ◆ Impact on REIT distribution requirements

◆ Forced sale and drag and tag rights

- ◆ Impact of REIT shares sale
 - ◆ Limiting buyers
 - ◆ Valuation / pricing

◆ Governance issues

- ◆ REITs must be managed by directors or trustees

Deal Issues – Buyer Issues

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- ◆ Confirming REIT status of target REIT
- ◆ Withholding issues
- ◆ Costs of liquidating the target REIT to get stepped-up basis

Deal Issues – Buyer Step-Up Strategy

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- ◆ Properly and carefully structured, a Buyer post-closing can undertake a section 331 liquidation, e.g., into a partnership purchaser that results in a tax basis step up in the assets. Buyers has no outside gain, and liquidating REIT's inside gain offset with dividends-paid deduction.
 - ◆ The net impact to Buyer is akin to elections under section 336(e), 338, and 754
 - ◆ Buyers are increasingly comfortable and accommodating of this M&A structure
 - ◆ Structuring issue on how to handle “blocker” C corporations inserted into the structure to push the REIT across the domestically controlled threshold

Will Buyer pay the tax on the inside gain of these C corporations?

Will Buyer “downstream” merge the C corporations in tax-free reorganizations?

- ◆ Buyer's section 331 liquidation for a basis step up may be delayed or difficult, if:
 - ◆ Target REIT was a “personal holding company” in Seller's hands
 - ◆ Buyers is a fund/partnership with foreign investors that would have FIRPTA exposure
 - ◆ Seller contractually insists on a delayed liquidation in order to maximally protect from FIRPTA taint any pre-closing dividend distributions to Seller from the target REIT.

Take-aways

- ◆ Structuring a REIT Joint Venture with a non-US partner means weighing access to capital against additional operational complexity, structure and potential friction costs on exit.
- ◆ Tax will play a key role in identifying costs associated with the operations, structure and exit strategy so that those costs can be allocated in the deal; up-front planning is key.
 - ✓ Number of entities
 - ✓ Funding, distributions and intercompany agreements
 - ✓ REIT qualification, procedures and documentation
 - ✓ Domestically controlled compliance and documentation
 - ✓ Indemnifications and warranties

Understanding the Unique Tax Rules Applicable to Foreign Governments

Sovereign Wealth Funds

◆ Overview

◆ Sovereign wealth funds (“SWFs”)

- ◆ Government investment vehicles funded by foreign exchange assets and managed separately from official reserves
- ◆ Rapidly growing in number and size
- ◆ Roughly 50 countries have SWFs
- ◆ The Sovereign Wealth Fund Institute estimates the top 25 SWFs have aggregate investments of USD 6 trillion (www.swfinstitute.org/fund/rankings)

Sovereign Wealth Funds

◆ Overview

- ◆ Commodity SWFs – funded by commodity exports that are either owned or taxed by the government
- ◆ Non-commodity SWFs – typically funded through transfers of assets from official foreign exchange reserves
 - ◆ The excess reserves generally result from large balance-of-payment surpluses
 - ◆ The “excess” reserves are transferred to investment funds that can be managed for higher returns

Sovereign Wealth Funds

◆ Other sovereign investors

- ◆ International reserves – external assets that are controlled by and readily available to finance ministries and central banks for direct financing of international payments
- ◆ Public pension funds – investment vehicles funded with assets set aside to meet the government's future entitlement obligations to its citizens
- ◆ State owned enterprises – companies over which the state has significant control through full, majority or significant minority ownership

Sovereign Wealth Funds

◆ IRC Section 892 investors

◆ Foreign government

- ◆ Integral part
- ◆ Controlled entity

◆ May include:

- ◆ SWF
- ◆ Public pension funds
- ◆ International reserves

◆ Does not include:

- ◆ State owned enterprises

Sovereign Wealth Funds

◆ IRC Section 892 exemption

- ◆ Exempt income generally includes income from securities
 - ◆ Stocks, bonds, loans, but not interests in partnerships
- ◆ Income derived by or from controlled commercial entities is not exempt

Sovereign Wealth Funds

◆ Controlled commercial entity

- ◆ An entity (broadly defined) that engages in commercial activities where the foreign government (controlled entity or integral part):
 - ◆ Holds, directly or indirectly, a 50% or more (by vote or value) of the interests in the entity, or
 - ◆ Holds interests that provide the foreign government with “effective practical control”

Sovereign Wealth Funds

◆ Effective practical control

- ◆ A sufficient interest by value or voting power or any other interest that provides the foreign government with effective practical control of the entity
- ◆ Can be achieved through a minority interest that is sufficiently large to achieve effective control, or through the combination of an equity interest and a creditor, contractual or regulatory relationship
- ◆ A foreign government may have effective practical control if it owns a small minority interest in an entity but is also a substantial creditor or is in control of a strategic natural resource used by the entity in its business
- ◆ Veto or blocking rights on specific decisions/actions must be carefully evaluated.

Capital Gain Dividends and Other Section 897(h)(1) Distributions

Section 897(h)(1) Distributions

- ◆ Any distribution by a qualified investment entity (REIT or RIC) to a nonresident alien individual, a foreign corporation, or other qualified investment entity shall, to the extent attributable to gain from sales or exchanges of United States real property interests, be treated as gain recognized by such nonresident alien individual, a foreign corporation, or other qualified investment entity from the sale or exchange of a United States real property interest

Section 897(h)(1) Distributions

- ◆ Notice 2007-55 clarifies that “any distribution” includes both current and liquidating distributions, notwithstanding section 331 which treats liquidating distributions as payments in exchange for stock
- ◆ What does “attributable to” mean in the context of section 302 or other non-pro rata distributions?
- ◆ “Attributable to” issues:
 - ◆ Netting of gains and losses from sale of USRPIs during the tax year
 - ◆ Netting prior year losses from the sale of USRPIs against current year gains
 - ◆ Netting current year operating losses against gain from the sale of USRPIs
 - ◆ Netting of net operating losses from prior years
- ◆ When is a current or liquidating REIT distribution “**attributable to**” gain from sales or exchanges of USRPIs?
 - ◆ Regulations and pronouncements of the Treasury and the Service do not prescribe a methodology
 - ◆ Analogies to other Code provisions?
 - ◆ NYSBA Tax Section Report on Notice 2007-55 and Possible Administrative Guidance Addressing Sections 897(h)(1) and 1445(e)(6), 7 January 2014
- ◆ Backed up by wash sale anti-abuse rule under section 897(h)(5)

Section 897(h)(1) Distributions

- ◆ Withholding on section 897(h)(1) distributions
 - ◆ Section 1445(e)(6) – 35% withholding
 - ◆ Treas. Reg. § 1.1445-8 – withholding required on largest amount that could have been declared as a REIT capital gain dividend, whether actually declared or not
 - ◆ Both broader and narrower than substantive tax liability under sections 897(h), 871(b) and 882

Other FIRPTA/Inbound Issues

Treatment of Distressed Debt Under FIRPTA

Treatment of Distressed Debt Under FIRPTA

- ◆ Is a deeply discounted loan that can only have a value in excess of its purchase price if the underlying value of the real estate securing the loan appreciates a USRPI under FIRPTA?
- ◆ USRPI includes an interest in United States real property other than an interest solely as a creditor
- ◆ An interest other than an interest solely as a creditor includes a loan to an individual or entity under the terms of which a holder of the indebtedness has any direct or indirect right to share in the appreciation in value of, or the gross or net proceeds or profits generated by, an interest in real property of the debtor or of a related person. Such interest is in its entirety an interest in real property other than solely as a creditor (Treas. Reg. section 1.897-1(d)(2)(i)).

Treatment of Distressed Debt Under FIRPTA

(cont'd)

◆ Repossession and foreclosure rights

- ◆ A right to repossess or foreclose on real property under a mortgage, security agreement, financing statement, or other collateral instrument securing a debt will not be considered a reversionary interest in, or a right to share in the appreciation in value of or gross or net proceeds or profits generated by, an interest in real property (Treas. Reg. § 1.897-1(d)(2)(ii)(C)).
- ◆ Thus, no such right will of itself cause an interest in real property which is otherwise an interest solely as a creditor to become an interest other than solely as a creditor. In addition, a person acting as mortgagee in possession shall not be considered to hold an interest in real property other than solely as a creditor, if the mortgagee's interest in the property otherwise constitutes an interest solely as a creditor (*emphasis added*).

Fund/AIV Investments

AIV Options in Fund Investments

- ◆ Typically, real estate funds offer investments through a “main fund” or through one or more “alternative investment vehicles”
 - ◆ AIVs may exist for tax-exempt or for non-US investors
 - ◆ REITs may be used as blockers for one or both of these investor classes
 - ◆ Crossed or partially blended economics between the main fund and AIVs may create ECI, UBTI or REIT qualification issues
 - ◆ Issues for investors
 - ◆ Issues for sponsor (withholding obligations)