Foreign Investors in US Real Estate May Benefit from Proposed Modifications to FIRPTA

On January 27, 2010, US Representative Joseph Crowley, along with co-sponsors Representative Melissa Bean and Representative Patrick Tiberi, introduced H.R. 4539, the Real Estate Revitalization Act of 2010 (RERA). If passed, this legislation would amend the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) and modify the treatment of certain foreign investments in US real property under Section 897.[1] Proponents view the bill as an important measure to encourage foreign equity investment in US real estate at a time when access to debt capital remains limited.

Background

The United States generally taxes foreign investors on their US source income and income that is "effectively connected" (or treated as effectively connected) with a US trade or business. Under Section 897(a), income from the disposition of a US real property interest (USRPI) is treated as effectively connected income and, therefore, subject to net taxation in the United States.[2] Foreign investors with effectively connected income must file US tax returns.

Section 897(c) broadly defines the term USRPI to mean (i) an interest in real property located in the United States or the Virgin Islands, and (ii) any interest (other than an interest solely as a creditor) in any domestic corporation unless the taxpayer establishes that such corporation was at no time a United States real property holding corporation (USRPHC) during the five-year period ending on the date of the disposition of such interest. A USRPHC is any corporation for which the fair market value of its USRPIs equals or exceeds 50 percent of the fair market value of (i) its USRPIs, plus (ii) its interests in real property located outside the United States, plus (iii) any other of its assets which are used or held for use in a trade or business. However, shares in a USRPHC that are part of a publicly traded class of shares will not be treated as USRPIs if the foreign investor held 5 percent or less of such class of stock at all times during the past five years.

In addition to the general provisions outlined above, special rules govern the taxation of non-US persons that invest in domestic real estate investment trusts (REITs). An ownership interest in a REIT that is also a USRPHC is not treated as a USRPI if the REIT is "domestically controlled" (meaning that less than 50 percent in value of the stock of the REIT was directly or indirectly owned by foreign persons at any time during the past five years). Consequently, a foreign investor's gain from the sale of shares of a domestically-controlled REIT is not treated as effectively connected income as a result of FIRPTA.

In general, ordinary dividends paid by a REIT to a non-US person are subject to US withholding at a 30 percent rate (or lesser treaty rate), while distributions that are attributable to gains from the disposition of USRPIs held by the REIT are treated as USRPI gains subject to net taxation under FIRPTA. However, REIT distributions received by a foreign person with respect to a publicly traded class of stock will not be treated as effectively connected income under FIRPTA if the foreign investor owned 5 percent or less of such class of stock at all times during the 1-year period prior to the distribution.

Certain foreign corporations that would otherwise be subject to FIRPTA may elect to be treated as domestic corporations for purposes of Section 897 and the

related withholding and reporting provisions of the Code. The purpose of the election is to prevent claims of discrimination under FIRPTA by foreign corporations that are residents of countries whose treaties with the United States contain nondiscrimination provisions. Benefits of making this election include the ability to utilize certain nonrecognition provisions of the Code and the avoidance of FIRPTA withholding on sales of USRPIs by the electing corporation.

Proposed Legislation

RERA would modify FIRPTA in a number of ways that could impact the taxation of foreign investors in US real estate. The proposal would (i) eliminate the USRPHC provisions from the Code; (ii) characterize distributions by a "qualified investment entity" (defined as any REIT or regulated investment company (RIC)), to the extent attributable to gain from sales or exchanges by the qualified investment entity of US real property, as ordinary dividends rather than effectively connected income; (iii) treat liquidating distributions from a qualified investment entity as ordinary dividends to the extent the distributions exceed the foreign investor's basis in its stock (but not to exceed the amount attributable to gain from sales or exchanges by the qualified investment entity of US real property); and (iv) repeal the ability of foreign corporations to elect to be treated as domestic corporations under Section 897(i). The bill would also make conforming changes to various definitional, withholding, and other related provisions.

With the elimination of the USRPHC provisions from the Code, shares in domestic corporations (including REITs and RICs) that predominantly own real property would no longer be USRPIs. As a result, a foreign investor could sell or exchange its interest in such a corporation and the gain derived therefrom would not be treated as effectively connected income. However, FIRPTA would continue to apply to gain from foreign investors' dispositions of direct interests in US real property.

Under the proposed rules for qualified investment entities, dividends paid by a REIT or a RIC would be subject to uniform US withholding at a 30 percent rate (or lower treaty rate), regardless of whether such distributions are attributable to gain from sales or exchanges of US real property or other assets. Liquidating distributions of a REIT or a RIC would also be subject to a 30 percent withholding tax (or lower treaty rate) to the extent the liquidating distributions exceed the recipient shareholder's basis in its REIT or RIC shares and are attributable to gain from sales or exchanges by the REIT or RIC of US real property.

These changes may benefit foreign investors by reducing tax rates and reporting obligations. For example, a foreign investor that, under current law, must report effectively connected income and file a US tax return with respect to a disposition of stock in a USRPHC would no longer be required to do so (unless such stock is otherwise held as part of the foreign investor's US trade or business). In addition, foreign shareholders owning greater than 5 percent of a publicly traded REIT would be taxed in the same manner as are foreign shareholders owning less than 5 percent of a publicly traded REIT under current law.

The impact of the proposed repeal of Section 897(i) remains unclear. For instance, the change could result in foreign corporations claiming discriminatory treatment under applicable treaties. Moreover, the bill does not address whether a foreign corporation that currently has a Section 897(i) election in place would continue to be treated as a domestic corporation for purposes of FIRPTA after the new legislation becomes effective. These and other considerations will hopefully be addressed in any final version of the bill.

The proposed legislation does not alter the branch profits tax regime that is currently in place, in addition to FIRPTA, with respect to foreign corporations that are engaged (or treated as engaged) in a US trade or business. The bill would be effective for tax years beginning after December 31, 2009.

Endnotes

1 All section references are to the Internal Revenue Code of 1986, as amended.

2 The rate of tax that would be applied to such gain depends on whether the USRPI is properly characterized as a capital asset or an asset used in the taxpayer's trade or business and whether the taxpayer is a nonresident alien or a corporation. Generally, a nonresident alien would be subject to US federal income tax at marginal rates of up to 35 percent and if the property is a capital asset, such taxpayer

may qualify for the 15 percent capital gains rate. Generally, a corporation would be subject to federal income tax at a 35 percent rate, and may also be subject to branch profits tax. In addition, taxpayers could be subject to alternative minimum tax with respect to such gains, as well as state and local income taxes.

If you have questions with regard to the proposed legislation, or would like additional information about the topics addressed in this Client Update, please contact the Mayer Brown lawyer with whom you regularly work or one of the contacts below.

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