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Proposed Legislation Permits Foreign Shareholders to Own Increased Percentage of Domestic REITs Without Becoming Subject to FIRPTA

On July 30, 2010, the US House of Representatives passed H.R. 5901, the Real Estate Jobs and Investment Act of 2010, by a vote of 402 to 11. If it becomes law, this legislation would amend Section 897 of the Internal Revenue Code of 1986, as amended, which was enacted as part of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), and would modify certain rules that currently apply to foreign investors that own stock of domestic real estate investment trusts (REITs).

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.[1] Foreign investors with effectively connected income must file US federal income 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 US 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 its USRPIs plus its interests in real property located outside the United States plus 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 REITs that would qualify as a USRPHC under the normal rules. An ownership interest in a REIT is not treated as a USRPI if the REIT is "domestically controlled" (meaning that less than 50 percent of the value of the REIT's stock 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 one-year period prior to the distribution. Such REIT distributions are instead treated as ordinary dividend distributions.

Proposed Legislation

The bill would modify FIRPTA in a number of ways that could impact the taxation of foreign investors that own interests in domestic REITs. Several of the modifications relate to the percentage of stock that a foreign owner may hold in a publicly traded REIT before becoming subject to FIRPTA. Specifically, the proposed legislation increases the ownership threshold from 5 percent to 10 percent; this means that, with respect to foreign persons owning not more than 10 percent of a publicly traded REIT: (i) a sale of REIT stock by the foreign owner would not be subject to FIRPTA (regardless of whether the REIT is domestically controlled), and (ii) capital gain distributions to the foreign owner that are attributable to gains from the disposition of USRPIs held by the REIT would not be treated as effectively connected income under FIRPTA, but instead would be treated as ordinary dividends (subject to US withholding at a 30 percent rate, or lesser treaty rate).

In addition to the modifications applicable to investments in publicly traded REITs, the proposed legislation provides that stock of any REIT (including a *private* REIT) held by a "qualified shareholder" will not be treated as a USRPI except to the extent that an investor in the qualified shareholder owns (directly or indirectly) more than 10 percent of the REIT's stock. For this purpose, a qualified shareholder means a shareholder that (i) would be eligible for a reduced rate of withholding under any income tax treaty of the United States with respect to ordinary dividends paid by the REIT even if the shareholder holds more than 10 percent of the stock of the REIT and (ii) whose principal class of interests is listed and regularly traded on one or more recognized stock exchanges covered under such income tax treaty. Under a similar exception that would apply in the case of distributions, any capital gain distribution by a public or private REIT would not be treated as gain attributable to the sale or exchange of a USRPI if the recipient is a qualified shareholder owning not more than 10 percent of the stock of the REIT. Instead, such capital gain distributions would be treated as ordinary dividends (subject to US withholding at a 30 percent rate, or lesser treaty rate).

Under US income tax treaties currently in force, the exception for qualified shareholders would only benefit certain foreign investors from a limited number of countries. The reason for this is that many treaties specifically require REIT shareholders to own 10 percent or less of the REIT in order to benefit from a reduced rate of withholding on ordinary dividends.[2] However, other treaties have special rules that would permit certain investors to benefit from the qualified shareholder exception.

For example, under the United States-Australia treaty, dividends paid by a US REIT to a listed Australian property trust (LAPT) generally qualify for a reduced rate of withholding even if the LAPT holds more than 10 percent of the REIT.[3] In addition, under the United States-Netherlands treaty, a reduced rate of withholding applies if the person beneficially entitled to a REIT dividend is an individual holding an interest of not more than 25 percent in the REIT, or if the dividend is paid by the REIT to a *beleggingsinstelling*, which is a type of Dutch investment company.[4] As a result, certain foreign investors that are qualified shareholders could, under the proposed legislation, own up to 10 percent of a private REIT without becoming subject to FIRPTA.

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 amendments would apply to dispositions and REIT distributions made after the date of enactment.

Endnotes

[1] 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 on whether the taxpayer is a nonresident alien or a corporation. Generally, a nonresident alien individual 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.

[2] For example, under the United States-Switzerland treaty, REIT dividends are subject to a reduced rate of withholding only if the "dividend is beneficially owned by an individual holding an interest of less than 10% in the REIT." Convention between The United States of America and The Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, October 2, 1996, article 10(2); *See, also, Protocol Amending the Convention between The Government of the United States of America and The Government of the Republic of Finland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, September 21, 1989, article III*.

[3] The reduced rate of withholding tax does not automatically apply to all the dividends paid by a REIT to an LAPT with large unitholders. If a unitholder owns 5 percent or more of the beneficial interests in an LAPT and the responsible entity for the LAPT knows or has reason to know of such ownership, then a look through rule applies and the unitholder must own less than 10 percent of the REIT (taking into account all shares owned by the unitholder in the REIT whether directly or through application of the look-through rule to one or more LAPTs) in order to qualify for the reduced rate of withholding. *See, Protocol Amending the Convention between The Government of the Untied States of America and The Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, August 6, 1982, article 6.

[4] *Protocol Amending the Convention between The Government of the United States of America and The Kingdom of The Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, October 13, 1993, article 3.

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

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