CLIENT MEMORANDUM

Tax Extenders Act Provides Relief for REIT Investments

December 23, 2015

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The Protecting Americans from Tax Hikes Act of 2015 (the “PATH Act”), signed on December 18, 2015, provides new relief from taxation under the Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”) for foreign investors in U.S. real estate investment trusts (“REITs”), with the intent of encouraging investment in U.S. REITs by foreign persons. The PATH Act also provides a special rule that exempts foreign retirement and pension funds from the application of the FIRPTA regime.

FIRPTA generally taxes a foreign person’s gain from the direct or indirect disposition of U.S. real property interests (“USRPIs”) as income effectively connected with a U.S. trade or business, thereby exposing foreign persons to tax at the rates applicable to U.S. persons. FIRPTA is enforced via withholding. USRPIs include interests in real estate held directly, or through a partnership, and include stock of a domestic corporation (whether a REIT or a regular C-corporation) if, during the preceding five years, 50% or more of the assets of the corporation consist of USRPIs. REITs other than mortgage REITs will almost always be considered USRPIs, subject to an exception for “domestically controlled REITs” (generally, REITs where direct or indirect foreign ownership during a “testing period” is under 50%).

The changes provided by the PATH Act are as follows:

Expansion of FIRPTA Exception for Sales of Publicly Traded REIT Stock

Under current law, the shares of a U.S. corporation held by a foreign person are not treated as USRPIs, and thus sales of such shares are not subject to FIRPTA (and generally therefore not subject to U.S. income tax), as long as (i) the company's shares are regularly traded on an established securities market, and (ii) the foreign person has held 5% or less of the company's shares for the previous five years. The PATH Act expands this exception to exempt from FIRPTA a foreign person's sale of REIT shares that regularly trade on an established securities market, as long as the foreign person has held 10% or less of the REIT's shares for the previous five years. A related exception applies to capital gain dividends received from a regularly traded REIT, so that such dividends are now not subject to FIRPTA (but are instead treated as regular dividends) when received by a less than 10% foreign shareholder.

New FIRPTA Exception for Sales of REIT Stock by Qualified Shareholders

The PATH Act creates a new exemption from FIRPTA taxation for sales of REIT stock (whether or not publicly traded) by certain "qualified shareholders" that themselves have shares that are publicly traded.

The PATH Act defines a "qualified shareholder" as a foreign shareholder that (i) meets certain treaty requirements (including a "regularly traded" requirement); (ii) is a "qualified collective investment vehicle"; and (iii) maintains records as to the identity of any of its interest holders that directly owns more than 5% of its interests.

The treaty requirements that must be met are that either (i) the foreign shareholder (A) is eligible for benefits under a comprehensive income tax treaty between the United States and the shareholder's resident country (which includes an exchange of information program) and (B) has its principal class of interests listed and regularly traded on at least one recognized stock exchange as defined in the relevant treaty, or (ii) the foreign shareholder (A) is a foreign partnership (that is organized as a limited partnership) in a jurisdiction that has an exchange of information program with the United States with respect to taxes and (B) has a class of limited partnership units that are regularly traded on the New York Stock Exchange or Nasdaq Stock Market and such class of limited partnership units' value is greater than 50% of the value of all of the partnership units.

A foreign shareholder will be a "qualified collective investment vehicle" for this purpose if (i) it is eligible for a reduced rate of withholding on ordinary dividends paid by the REIT regardless of the size of its holdings; (ii) it is a publicly traded partnership, withholding foreign partnership, or partnership that would be a U.S. real property holding corporation if it were a corporation; or (iii) it is otherwise identified by the U.S. Treasury as a qualified collective investment vehicle and meets certain other requirements.

Under the PATH Act, REIT shares held by a qualified shareholder would not be classified as USRPIs except to the extent that an investor in the qualified shareholder holds (directly or indirectly) more than 10% of the REIT's shares; accordingly, sales of such shares will not be subject to FIRPTA (and generally therefore not be subject to U.S. income tax). Certain constructive ownership rules must be taken into account in determining whether an investor in the qualified shareholder holds more than 10% of the REIT's shares.

New FIRPTA Exception for Interests Held by Foreign Retirement or Pension Funds

The PATH Act also provides that the FIRPTA provisions of IRC section 897 will not apply to USRPIs or distributions from REITs held directly or indirectly by "qualified foreign pension funds." In order to be a qualified foreign pension fund, the fund must meet five requirements specified in the PATH Act.[1]

However, foreign retirement or pension plans may still be subject to U.S. tax on their U.S. real estate holdings to the extent that such holdings are treated as a U.S. trade or business. They may also be subject to 30% withholding on rent received from U.S. real estate (or dividends received from REITs), unless such withholding is otherwise reduced by treaty.

In certain respects, a foreign pension plan is treated more favorably than a domestic pension plan; notably, the latter may be subject to tax on its share of unrelated business taxable income of a "pension-held" REIT, but this rule does not apply to foreign pension plans.

Domestically Controlled REITs

As briefly noted above, stock of a domestically controlled REIT is not a USRPI; thus one of the most tax-efficient forms of real estate investment for a foreign taxable investor has historically been to invest in a domestically controlled REIT. The PATH Act provides guidance addressing ownership of publicly traded REITs and ownership of REITs by mutual funds. For example, absent actual knowledge to the contrary, a less than 5% shareholder of a publicly traded REIT may be presumed to be a U.S. person. In addition, if a mutual fund focusing on REITs holds an interest in a REIT, for purposes of determining whether the REIT is domestically controlled, the mutual fund will be considered foreign unless it is itself domestically controlled, but for this purpose, the presumption for less than 5% shareholders can be applied for purposes of determining whether the mutual fund is foreign or domestic.

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[1] These five requirements are: (i) it is created or organized in a non-U.S. country; (ii) it is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered; (iii) it does not have a single participant or beneficiary with a right to more than 5% of its assets or income; (iv) it is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates; and (v) under the laws of the country in which it is established or operates, (A) contributions to such entity are deductible or excluded from the gross income of such entity or taxed at a reduced rate, or (B) taxation of income of such entity is deferred or reduced.

Withholding Rates

As noted above, FIRPTA is enforced by withholding. The PATH Act increases the withholding rate from 10% to 15%, effective for dispositions 60 days after enactment.

If you have any questions regarding this memorandum, please contact Henry M. Cohn (212-728-8209, hcohn@willkie.com) or the attorney with whom you regularly work.

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