

The provision also allows a TRS to make marketing expenditures with respect to property under section 857(b)(6)(C)(v) or 857(b)(6)(D)(v) without causing property that is otherwise eligible for the prohibited transaction exclusion to lose such qualification.

The provision allows a TRS to operate foreclosure property without causing loss of foreclosure property status, under section 856(e)(4)(C).

The items subject to the 100-percent excise tax on certain non-arm's-length transactions between a TRS and a REIT are expanded to include "redetermined TRS service income." Such income is defined as gross income of a TRS of a REIT attributable to services provided to, or on behalf of, such REIT (less the deductions properly allocable thereto) to the extent the amount of such income (less such deductions) would be increased on distribution, apportionment, or allocation under section 482 (but for the exception from section 482 if the 100-percent excise tax applies). The term does not include gross income attributable to services furnished or rendered to a tenant of the REIT (or deductions properly attributable thereto), since that income is already subject to a separate provision of the 100-percent excise tax rules.

Effective Date

The provision is effective for taxable years beginning after December 31, 2015.

11. Exception from FIRPTA for certain stock of REITs; exception for interests held by foreign retirement and pension funds (secs. 322 and 323 of the bill and secs. 897 and 1445 of the Code)

Present Law

General rules relating to FIRPTA

A foreign person that is not engaged in the conduct of a trade or business in the United States generally is not subject to any U.S. tax on capital gain from U.S. sources, including capital gain from the sale of stock or other capital assets.⁵⁹²

However, the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")⁵⁹³ generally treats a foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") as income that is effectively connected with the conduct of a U.S. trade or

⁵⁹² Secs. 871(b) and 882(a). Property is treated as held by a person for use in connection with the conduct of a trade or business in the United States, even if not so held at the time of sale, if it was so held within 10 years prior to the sale. Sec. 864(c)(7). Also, all gain from an installment sale is treated as from the sale of property held in connection with the conduct of such a trade or business if the property was so held during the year in which the installment sale was made, even if the recipient of the payments is no longer engaged in the conduct of such trade or business when the payments are received. Sec. 864(c)(6).

⁵⁹³ Pub. L. No. 96-499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See secs. 897, 1445, 6039C, and 6652(f).

business, and thus taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain.⁵⁹⁴ With certain exceptions, if a foreign corporation distributes a USRPI, gain is recognized on the distribution (including a distribution in redemption or liquidation) of a USRPI, in an amount equal to the excess of the fair market value of the USRPI (as of the time of distribution) over its adjusted basis.⁵⁹⁵ A foreign person subject to tax on FIRPTA gain is required to file a U.S. tax return under the normal rules relating to receipt of income effectively connected with a U.S. trade or business.⁵⁹⁶

The payor of amounts that FIRPTA treats as effectively connected with a U.S. trade or business (“FIRPTA income”) to a foreign person generally is required to withhold U.S. tax from the payment.⁵⁹⁷ Withholding generally is 10 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI (but withholding is not required in certain cases, including on any sale of stock that is regularly traded on an established securities market⁵⁹⁸), and 10 percent of the amount realized by the foreign shareholder in the case of certain distributions by a corporation that is or has been a U.S. real property holding corporation (“USRPHC”) during the applicable testing period.⁵⁹⁹ The withholding is generally 35 percent of the amount of a distribution to a foreign person of net proceeds attributable to the sale of a USRPI from an entity such as a partnership, REIT, or RIC.⁶⁰⁰ The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person’s total U.S. effectively connected income and deductions (if any) for the taxable year.

USRPHCs and five-percent public shareholder exception

USRPIs include not only interests in real property located in the United States or the U.S. Virgin Islands, but also stock of a USRPHC, generally defined as any domestic corporation, unless the taxpayer establishes that the fair market value of the corporation’s USRPIs was less than 50 percent of the combined fair market value of all its real property interests (U.S. and worldwide) and all its assets used or held for use in a trade or business, at all times during a

⁵⁹⁴ Sec. 897(a).

⁵⁹⁵ Sec. 897(d). In addition, such gain may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

⁵⁹⁶ In addition, section 6039C authorizes regulations that would require a return reporting foreign direct investments in U.S. real property interests. No such regulations have been issued, however.

⁵⁹⁷ Sec. 1445(a).

⁵⁹⁸ Sec. 1445(b)(6).

⁵⁹⁹ Sec. 1445(e)(3). Withholding at 10 percent of a gross amount may also apply in certain other circumstances under regulations. See sec. 1445(e)(4) and (5).

⁶⁰⁰ Sec. 1445(e)(6) and Treasury regulations thereunder. The Treasury Department is authorized to issue regulations that would reduce the 35 percent withholding on distributions to 20 percent during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 20 percent.

“testing period,” which is the shorter of the duration of the taxpayer’s ownership of the stock after June 18, 1980, or the five-year period ending on the date of disposition of the stock.⁶⁰¹

Under an exception, even if a corporation is a USRPHC, a shareholder’s shares of a class of stock that is regularly traded on an established securities market are not treated as USRPIs if the shareholder holds (applying attribution rules) no more than five percent of that class of stock at any time during the testing period.⁶⁰² Among other things, the relevant attribution rules require attribution between a corporation and a shareholder that owns five percent or more in value of the stock of such corporation.⁶⁰³ The attribution rules also attribute stock ownership between spouses and between children, grandchildren, parents, and grandparents.

FIRPTA rules for foreign investment through REITs and RICs

Special FIRPTA rules apply to foreign investment through a “qualified investment entity,” which includes any REIT and certain RICs that invest largely in USRPIs (including stock of one or more REITs).⁶⁰⁴

Stock of domestically controlled qualified investment entities not a USRPI

If a qualified investment entity is “domestically controlled” (defined to mean that less than 50 percent in value of the qualified investment entity has been owned (directly or indirectly) by foreign persons during the relevant testing period⁶⁰⁵), stock of such entity is not a USRPI and a foreign shareholder can sell the stock of such entity without being subject to tax under FIRPTA, even if the stock would otherwise be stock of a USRPHC. Treasury regulations provide that for purposes of determining whether a REIT is domestically controlled, the actual owner of REIT shares is the “person who is required to include in his return the dividends received on the stock.”⁶⁰⁶ The IRS has issued a private letter ruling concluding that the term

⁶⁰¹ Sec. 897(c)(1) and (2).

⁶⁰² Sec. 897(c)(3). The constructive ownership attribution rules are specified in section 897(c)(6)(C).

⁶⁰³ If a person owns, directly or indirectly, five percent or more in value of the stock in a corporation, such person is considered as owning the stock owned directly or indirectly by or for such corporation, in that proportion which the value of the stock such person so owns bears to the value of all the stock in such corporation. Sec. 318(c)(2)(C) as modified by section 897(c)(6)(C). Also, if five percent or more in value of the stock in a corporation is owned directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person. Sec. 318(c)(3)(C) as modified by section 897(c)(6)(C).

⁶⁰⁴ Sec. 897(h)(4)(A)(i). The provision including certain RICs in the definition of qualified investment entity previously expired December 31, 2014. See section 133 of this bill, however, which makes that provision permanent.

⁶⁰⁵ The testing period for this purpose is the shorter of (i) the period beginning on June 19, 1980, and ending on the date of disposition or distribution, as the case may be, (ii) the five-year period ending on the date of the disposition or distribution, as the case may be, or (iii) the period during which the qualified investment entity was in existence. Sec. 897(h)(4)(D).

⁶⁰⁶ Treas. Reg. sec. 1.897-1(c)(2)(i) and -8(b).

“directly or indirectly” for this purpose does not require looking through corporate entities that, in the facts of the ruling, were represented to be fully taxable domestic corporations for U.S. federal income tax purposes “and not otherwise a REIT, RIC, hybrid entity, conduit, disregarded entity, or other flow-through or look-through entity.”⁶⁰⁷

FIRPTA applies to qualified investment entity (REIT and certain RIC) distributions attributable to gain from sale or exchange of USRPIs, except for distributions to certain five-percent or smaller shareholders

A distribution by a REIT or other qualified investment entity, to the extent attributable to gain from the entity’s sale or exchange of USRPIs, is treated as FIRPTA income.⁶⁰⁸ The FIRPTA character is retained if the distribution occurs from one qualified investment entity to another, through a tier of REITs or RICs.⁶⁰⁹ An IRS notice (Notice 2007-55) states that this rule retaining the FIRPTA income character of distributions attributable to the sale of USRPIs applies to any distributions under sections 301, 302, 331, and 332 (*i.e.*, to dividend distributions, distributions treated as sales or exchanges of stock by the investor, and both nonliquidating and liquidating distributions) and that the IRS will issue regulations to that effect.⁶¹⁰

There is an exception to this rule in the case of distributions to certain public shareholders. If an investor has owned no more than five percent of a class of stock of a REIT or other qualified investment entity that is regularly traded on an established securities market located in the United States during the one-year period ending on the date of the distribution, then amounts attributable to gain from entity sales or exchanges of USRPIs can be distributed to such a shareholder without being subject to FIRPTA tax.⁶¹¹ Such distributions that are dividends are treated as dividends from the qualified investment entity,⁶¹² and thus generally would be subject to U.S. dividend withholding tax (as reduced under any applicable treaty), but are not treated as income effectively connected with the conduct of a U.S. trade or business. An IRS

⁶⁰⁷ PLR 200923001. A private letter ruling may be relied upon only by the taxpayer to which it is issued. However, private letter rulings provide some indication of administrative practice.

⁶⁰⁸ Sec. 897(h)(1).

⁶⁰⁹ In 2006, the Tax Increase Prevention and Reconciliation Act of 2005 (“TIPRA”), Pub. L. No. 109-222, sec. 505, specified the retention of this FIRPTA character on a distribution to an upper-tier qualified investment entity, and added statutory withholding requirements.

⁶¹⁰ Notice 2007-55, 2007-2 C.B.13. The Notice also states that in the case of a foreign government investor, because FIRPTA income is treated as effectively connected with the conduct of a U.S. trade or business, proceeds distributed by a qualified investment entity from the sale of USRPIs are not exempt from tax under section 892. The Notice cites and compares existing temporary regulations and indicates that Treasury will apply those regulations as well to certain distributions. See Temp. Treas. Reg. secs. 1.892-3T, 1.897-9T(e), and 1.1445-10T(b).

⁶¹¹ Sec. 897(h)(1), second sentence.

⁶¹² Secs. 852(b)(3)(E) and 857(b)(3)(F).

Chief Counsel advice memorandum concludes that such distributions which are not dividends (because made in a complete liquidation of a REIT) are not subject to tax under FIRPTA.⁶¹³

Explanation of Provisions

Exception from FIRPTA for certain REIT stock

In the case of REIT stock only, the provision increases from five percent to 10 percent the maximum stock ownership a shareholder may have held, during the testing period, of a class of stock that is publicly traded, to avoid having that stock be treated as a USRPI on disposition.

The provision likewise increases from five percent to 10 percent the percentage ownership threshold that, if not exceeded, results in treating a distribution to holders of publicly traded REIT stock, attributable to gain from sales or exchanges of USRPIs, as a dividend, rather than as FIRPTA gain.

The attribution rules of section 897(c)(6)(C) retain the present-law rule that requires attribution between a shareholder and a corporation if the shareholder owns more than five percent of a class of stock of the corporation. The attribution rules now apply, however, to the determination of whether a person holds more than 10 percent of a class of publicly traded REIT stock.

The provision also provides that REIT stock held by a qualified shareholder, including stock held indirectly through one or more partnerships, is not a U.S. real property interest in the hands of such qualified shareholder, except to the extent that an investor in the qualified shareholder (other than an investor that is a qualified shareholder) holds more than 10 percent of that class of stock of the REIT (determined by application of the constructive ownership rules of section 897(c)(6)(C)). Thus, so long as the “more than 10 percent” rule is not exceeded, a qualified shareholder may own and dispose of any amount of stock of a REIT (including stock of a privately-held, non-domestically controlled REIT that is owned by such qualified shareholder) without the application of FIRPTA.

If an investor in the qualified shareholder (other than an investor that is a qualified shareholder) directly, indirectly, or constructively holds more than 10 percent of such class of REIT stock (an “applicable investor”), then a percentage of the REIT stock held by the qualified shareholder equal to the applicable investor’s percentage ownership of the qualified shareholder is treated as a USRPI in the hands of the qualified shareholder and is subject to FIRPTA. In that case, an amount equal to such percentage multiplied by the disposition proceeds and REIT distribution proceeds attributable to underlying USRPI gain is treated as FIRPTA gain in the hands of the qualified shareholder.

The provision is intended to override in certain cases one of the conclusions reached in AM 2008-003. Specifically, the provision contains special rules with respect to certain distributions that are treated as a sale or exchange of REIT stock under section 301(c)(3), 302, or

⁶¹³ AM 2008-003, February 15, 2008.

331 with respect to a qualified shareholder. Any such amounts attributable to an applicable investor are ineligible for the FIRPTA exception for qualified shareholders, and thus are subject to FIRPTA. Any such amounts attributable to other investors are treated as a dividend received from a REIT for purposes of U.S. dividend withholding tax and the application of income tax treaties, notwithstanding their general treatment under the Code as capital gain.

A qualified shareholder is defined as a foreign person that (i) either is eligible for the benefits of a comprehensive income tax treaty which includes an exchange of information program and whose principal class of interests is listed and regularly traded on one or more recognized stock exchanges (as defined in such comprehensive income tax treaty), or is a foreign partnership that is created or organized under foreign law as a limited partnership in a jurisdiction that has an agreement for the exchange of information with respect to taxes with the United States and has a class of limited partnership units representing greater than 50 percent of the value of all the partnership units that is regularly traded on the NYSE or NASDAQ markets, (ii) is a qualified collective investment vehicle (as defined below), and (iii) maintains records on the identity of each person who, at any time during the foreign person's taxable year, is the direct owner of 5 percent or more of the class of interests or units (as applicable) described in (i), above.

A qualified collective investment vehicle is defined as a foreign person that (i) would be eligible for a reduced rate of withholding under the comprehensive income tax treaty described above, even if such entity holds more than 10 percent of the stock of such REIT,⁶¹⁴ (ii) is publicly traded, is treated as a partnership under the Code, is a withholding foreign partnership, and would be treated as a USRPHC if it were a domestic corporation, or (iii) is designated as such by the Secretary of the Treasury and is either (a) fiscally transparent within the meaning of section 894, or (b) required to include dividends in its gross income, but is entitled to a deduction for distributions to its investors.

The provision also contains rules with respect to partnership allocations of USRPI gains to applicable investors. If an applicable investor's proportionate share of USRPI gain for the taxable year exceeds such partner's distributive share of USRPI gain for the taxable year then such partner's distributive share of non-USRPI income or gain is recharacterized as USRPI gain for the taxable year in the amount that the distributive share of USRPI gain exceeds the proportionate share of USRPI gain. For purposes of these partnership allocation rules, USRPI gain is defined to comprise the net of gain recognized on disposition of a USRPI, distributions from a REIT that are treated as USRPI gain, and loss from the disposition of USRPIs. An investor's proportionate share of USRPI gain is determined based on the applicable investor's largest proportionate share of income or gain for the taxable year, and if such proportionate amount may vary during the existence of the partnership, such share is the highest share the applicable investor may receive.

⁶¹⁴ For example, the U.S. income tax treaties with Australia and the Netherlands provide such a reduced rate of withholding under certain circumstances.

Domestically controlled qualified investment entity

The provision redefines the term “domestically controlled qualified investment entity” to provide a number of new rules and presumptions relating to whether a qualified investment entity is domestically controlled. First, a qualified investment entity shall be permitted to presume that holders of less than five percent of a class of stock regularly traded on an established securities market in the United States are U.S. persons throughout the testing period, except to the extent that the qualified investment entity has actual knowledge that such persons are not U.S. persons. Second, any stock in the qualified investment entity held by another qualified investment entity (I) which has issued any class of stock that is regularly traded on an established stock exchange, or (II) which is a RIC that issues redeemable securities (within the meaning of section 2 of the Investment Company Act of 1940) shall be treated as held by a foreign person unless such other qualified investment entity is domestically controlled (as determined under the new rules) in which case such stock shall be treated as held by a U.S. person. Finally, any stock in a qualified investment entity held by any other qualified investment entity not described in (I) or (II) of the preceding sentence shall only be treated as held by a U.S. person to the extent that the stock of such other qualified investment entity is (or is treated under the new provision as) held by a U.S. person.

Exception for interests held by foreign retirement and pension funds

The provision exempts from the rules of section 897 any USRPI held directly (or indirectly through one or more partnerships) by, or to any distribution received from a real estate investment trust by, a qualified foreign pension fund or by a foreign entity wholly-owned by a qualified foreign pension fund. A qualified foreign pension fund means any trust, corporation, or other organization or arrangement (A) which is created or organized under the law of a country other than the United States, (B) which 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, (C) which does not have a single participant or beneficiary with a right to more than five percent of its assets or income, (D) which 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 (E) with respect to which, under the laws of the country in which it is established or operates, (i) contributions to such organization or arrangement that would otherwise be subject to tax under such laws are deductible or excluded from the gross income of such entity or taxed at a reduced rate, or (ii) taxation of any investment income of such organization or arrangement is deferred or such income is taxed at a reduced rate.

The provision also makes conforming changes to section 1445 to eliminate withholding on sales by qualified foreign pension funds (and their wholly-owned foreign subsidiaries) of USRPIs.

The Secretary of the Treasury may provide such regulations as are necessary to carry out the purposes of the provision.

Effective Date

The provision to extend exceptions from FIRPTA for certain REIT stock applies to dispositions and distributions on or after the date of enactment.

The provision to modify the definition of a domestically controlled REIT is effective on the date of enactment.

The exception for interests held by foreign retirement and pension funds generally applies to dispositions and distributions after the date of enactment.

12. Increase in rate of withholding of tax on dispositions of United States real property interests (sec. 324 of the bill and sec. 1445 of the Code)

Present Law

A purchaser of a USRPI from any person is obligated to withhold 10 percent of gross purchase price unless certain exceptions apply.⁶¹⁵ The obligation does not apply if the transferor furnishes an affidavit that the transferor is not a foreign person. Even absent such an affidavit, the obligation does not apply to the purchase of publicly traded stock.⁶¹⁶ Also, the obligation does not apply to the purchase of stock of a nonpublicly traded domestic corporation, if the corporation furnishes the transferee with an affidavit stating the corporation is not and has not been a USRPHC during the applicable period (unless the transferee has actual knowledge or receives a notification that the affidavit is false).⁶¹⁷

Treasury regulations⁶¹⁸ generally provide that a domestic corporation must, within a reasonable period after receipt of a request from a foreign person holding an interest in it, inform that person whether the interest constitutes a USRPI.⁶¹⁹ No particular form is required. The statement must be dated and signed by a responsible corporate officer who must verify under

⁶¹⁵ Sec. 1445.

⁶¹⁶ Sec. 1445(b)(6).

⁶¹⁷ Sec. 1445(b)(3). Other exceptions also apply. Sec. 1445(b).

⁶¹⁸ Treas. Reg. Sec. 1.897-2(h).

⁶¹⁹ As described previously, stock of a U.S. corporation is not generally a USRPI unless it is stock of a U.S. real property holding corporation (“USRPHC”). However, all U.S. corporate stock is deemed to be such stock, unless it is shown that the corporation’s U.S. real property interests do not amount to the relevant 50 percent or more of the corporation’s relevant assets. Also, even if a REIT is a USRPHC, if it is domestically controlled its stock is not a USRPI.

In addition to these exceptions that might be determined at the entity level, even if a corporation is a USRPHC, its stock is not a USRPI in the hands of the seller if the stock is of a class that is publicly traded and the foreign shareholder disposing of the stock has not owned (applying attribution rules) more than five percent of such class of stock during the relevant period.