
SELECTED US TAX DEVELOPMENTS

Co-Editors: Peter A. Glicklich* and Michael J. Miller**

GUIDANCE ON QUALIFIED SHAREHOLDERS OF REITS STILL LACKING

*Peter A. Glicklich and Heath Martin**

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) imposes tax and withholding requirements with respect to gain realized by a foreign person on the disposition of an interest in real property located in the United States. The Protecting Americans from Tax Hikes Act of 2015 created two new exemptions from FIRPTA, one for foreign pension funds and another for “qualified shareholders,” which are essentially foreign publicly traded real estate investment trusts (REITs). In order to qualify for the exemption for qualified shareholders, a foreign REIT would likely need to be designated by the Internal Revenue Service as a “qualified collective investment vehicle,” but no guidance has been provided on how a foreign REIT may obtain such designation. In the absence of such guidance, the exemption for qualified shareholders is effectively unavailable, and as time passes, taxpayers are losing their ability to take advantage of the exemption in current- or prior-year tax returns. The authors suggest that a foreign publicly traded REIT be allowed to “self-designate” as a qualified collective investment vehicle if it meets certain requirements.

KEYWORDS: REIT ■ EXEMPTIONS ■ FIRPTA ■ REAL ESTATE ■ PUBLIC COMPANIES ■ INTERNATIONAL TAXATION

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* Of Davies Ward Phillips & Vineberg LLP, New York (e-mail: pglicklich@dwpv.com); HMartin@dwpv.com).

** Of Roberts & Holland LLP, New York and Washington, DC (e-mail: mmiller@rhtax.com).

INTRODUCTION

One purpose of the Protecting Americans from Tax Hikes Act of 2015¹ (“the PATH Act”), enacted by the US Congress on December 18, 2015, was to encourage foreign investment in US real estate. Accordingly, the PATH Act included two new exemptions from the Foreign Investment in Real Property Tax Act of 1980² (FIRPTA) for foreign institutional investors: an exemption for qualified foreign pension funds (QFPFs) in section 897(l) of the Internal Revenue Code³ and an exemption for qualified shareholders of real estate investment trusts (REITs) in section 897(k)(2), which mainly applies to foreign publicly traded REITs. The exemption for QFPFs received extensive discussion in the tax press and is the subject of recently proposed regulations, but the exemption for qualified shareholders has been virtually ignored.

One reason for the lack of interest may be that, in most cases, the qualified shareholder exemption is not available without further guidance from the Treasury Department and the Internal Revenue Service (IRS). As discussed below, most taxpayers who could potentially qualify for the qualified shareholder exemption would have to be “designated” by the IRS as a “qualified collective investment vehicle” (QCIV). Currently, there is no guidance on how a taxpayer can obtain this designation; as a result, the exception is effectively unavailable.

This situation should be frustrating for US tax advisers of Canadian (and other foreign) publicly traded REITs. As discussed below, the potential scope of the qualified shareholder exemption is broad, and taxpayers who should be eligible for the exemption are in danger of losing out because of the lack of guidance.

We begin by providing context for our discussion of the issue.

FIRPTA IN GENERAL

Under FIRPTA, a foreign person is subject to US federal tax on any gain resulting from a disposition of an interest in real property located in the United States (a “USRPI”). FIRPTA operates by recharacterizing such gain as income effectively connected to a US trade or business, which is generally taxed at graduated rates, currently up to 37 percent for individuals and 21 percent for corporations. In addition, FIRPTA requires the purchaser of a USRPI to withhold 15 percent of the purchase price as an advance payment of the substantive tax.

An interest in a corporation is itself treated as a USRPI if the corporation holds more than a threshold amount of other USRPIs. (Such a corporation is known as a “United States real property holding corporation” or “a USRPHC.”) Generally, a corporation is a USRPHC if 50 percent or more of its assets (excluding certain passive

1 Protecting Americans from Tax Hikes Act of 2015, division Q of title IV of the Consolidated Appropriations Act, 2016, Pub. L. no. 114-113, enacted on December 18, 2015.

2 Foreign Investment in Real Property Tax Act of 1980, subtitle C of title XI of the Omnibus Reconciliation Act of 1980, Pub. L. no. 96-499, enacted on December 5, 1980.

3 Internal Revenue Code of 1986, as amended. Unless otherwise stated, statutory references in this article are to the Internal Revenue Code.

investment assets) consist of USRPIs. A REIT that invests primarily in real estate (as opposed to mortgages) is almost certain to be treated as a USRPHC, so a foreign person that holds shares in a so-called equity REIT would likely be subject to withholding and taxation under FIRPTA if the foreign person sold its shares in the equity REIT and no other exemption from FIRPTA applied.

In addition, under FIRPTA, a distribution from a REIT that is attributable to gain from the disposition of a USRPI is treated as gain from a disposition of a USRPI in the hands of a foreign shareholder of the REIT. Accordingly, such a distribution would be subject to withholding and taxation under FIRPTA, in much the same way as gain from the sale of the REIT's shares.⁴

FIRPTA has historically provided some relief for foreign investors holding interests in publicly traded REITs and REITs that are controlled by US persons. Specifically, section 897 includes exemptions for the following:

- *The publicly traded REIT exemption.* Section 897(c)(3), as modified by section 897(k)(1), provides that an interest in a publicly traded REIT (or other corporation) is not subject to FIRPTA where the shareholder holds 10 percent or less of the REIT's stock. Under this rule, a foreign REIT can hold the stock of a publicly traded US REIT without being subject to FIRPTA, as long as the foreign REIT holds 10 percent or less of the US REIT's stock. Under section 897(h)(1), distributions from a REIT to a foreign shareholder that holds 10 percent or less of the REIT's stock are not characterized as FIRPTA gain but are instead taxed as regular distributions from a corporation to a foreign person.
- *The domestically controlled REIT exemption.* Section 897(h)(2) provides that an interest in a "domestically controlled" REIT, which is a REIT where less than 50 percent of the interests are held directly or indirectly by foreign persons, is not subject to FIRPTA. Under this rule, a foreign REIT avoids FIRPTA taxation with respect to an interest in either a public or a private US REIT as long as most of the US REIT is owned by US persons. Distributions from a domestically controlled REIT are not exempt from recharacterization as FIRPTA gain.

Thus, before adoption of the new exemptions for QFPFs or qualified shareholders, a foreign shareholder of a US REIT was subject to FIRPTA only with respect to the following situations:

- a sale of REIT stock if the REIT was publicly traded and the foreign person held more than 10 percent of the REIT,
- a sale of REIT stock if less than 50 percent of the REIT was held by US taxpayers, and

⁴ Note that any portion of a distribution from a REIT to a foreign person that is not subject to section 897(h)(1) would be treated just like a distribution from a domestic corporation to a foreign person—that is, the distribution would generally be subject to withholding tax at a rate of 30 percent, unless a reduced rate is available under an applicable tax treaty.

- distributions from a REIT if the REIT was not publicly traded or if the REIT was publicly traded and the foreign person held more than 10 percent of the REIT.

APPLICATION OF THE TWO NEW EXEMPTIONS FROM FIRPTA IN THE PATH ACT

The effect of the new exemptions under the PATH Act for QPPFs and qualified shareholders is to eliminate FIRPTA taxation with respect to the situations described immediately above, other than for an investor in a qualified shareholder that has a direct or indirect interest of more than 10 percent in the domestic REIT (referred to as an “applicable investor”).⁵ Applicable investors are still subject to FIRPTA with respect to their gain on a sale of REIT stock (unless the REIT is domestically controlled) and on distributions from the REIT.

A foreign person that qualifies for the QPPF exemption or the qualified shareholder exemption should pay no tax on the sale of REIT shares.⁶ As noted,⁷ however, certain distributions from a REIT that are no longer subject to FIRPTA are treated as taxable dividends that are subject to withholding tax at 30 percent (unless reduced by treaty).

Tax treaties typically include a special rule for REIT dividends. In the case of a Canadian publicly traded REIT, the US-Canada tax treaty⁸ reduces the rate of withholding from 30 percent to 15 percent as long as

- the US REIT is publicly traded and the Canadian REIT holds not more than 5 percent of the US REIT’s stock, or
- the Canadian REIT holds not more than 10 percent of the US REIT’s stock and the US REIT is diversified.

ENCOURAGING FOREIGN INVESTMENT

The Senate conference report on the PATH Act includes the following statement of one congressional purpose of the legislation:

It is essential to increase foreign investment in U.S. real estate. Increased investment in building and infrastructure will create American jobs. Increased investment will also provide equity capital for existing U.S. real estate ventures that have outstanding

5 Section 897(k)(2)(B).

6 A foreign person’s gain from the sale of personal property is generally foreign-source gain under section 865, and accordingly is not subject to US federal income tax if FIRPTA does not apply.

7 *Supra* note 4.

8 The Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 16, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007.

loans that are maturing, and will thus reduce the potential for foreclosures. [FIRPTA] contains tax rules that impose significant penalties on foreign investment in domestic real estate through REITs that do not exist in other types of U.S. corporate investments such as corporate stocks and bonds.⁹

The method used by the PATH Act to encourage investment in US real estate is to provide exemptions from the application of FIRPTA for institutional investors with large pools of capital to invest in relevant asset classes. For instance, the QPFF exemption provides a blanket exemption from FIRPTA for foreign pension funds, which include some of the largest institutional investors by assets under management and which typically allocate some of their capital to almost every type of asset. By exempting QPFFs from FIRPTA, Congress hoped to maximize the bang it got from its tax-exemption buck.

A foreign publicly traded REIT is similar to a foreign pension fund in that both are institutional investors that are likely to have an interest in investing some portion of their capital in US real estate. In fact, data released by the Toronto Stock Exchange suggest that, at least in Canada, publicly traded REITs control a considerable amount of capital that could be invested in US real estate.¹⁰ According to these data, as of October 2019, there were at least 35 publicly traded REITs in Canada, with an aggregate market capitalization of more than Cdn\$72 billion, that could potentially benefit from the qualified shareholder exemption. That is a major amount of investment capital, some of which could be opened up for investment in the United States.

There are many other countries with publicly listed REITs that are similarly situated to Canada. Currently, more than 30 countries have REIT regimes similar to the US regime.¹¹ Data published by the National Association of Real Estate Investment Trusts (“Nareit”) suggest that there are approximately 250 publicly traded REITs and other publicly traded real estate companies outside the United States.¹² Data

9 S rep. no. 114-25, 114th Cong., 1st sess. (April 14, 2015), at 2.

10 See Toronto Stock Exchange, “Real Estate Companies Listed on TSX and TSV” (www.tsx.com/resource/en/122).

11 Those countries are Australia, Bahrain, Belgium, Brazil, Bulgaria, Canada, Costa Rica, Dubai, Finland, France, Germany, Greece, Hong Kong, Hungary, India, Ireland, Israel, Italy, Japan, Kenya, Malaysia, Mexico, the Netherlands, New Zealand, Oman, Pakistan, the Philippines, Portugal, Saudi Arabia, Singapore, South Africa, South Korea, Spain, Taiwan, Thailand, Turkey, the United Kingdom, and Vietnam. See National Association of Real Estate Investment Trusts, “Global Real Estate Investment” (www.reit.com/investing/global-real-estate-investment).

12 Nareit is one of the creators of the FTSE EPRA/Nareit Global Real Estate Index, which contains 476 publicly listed global real estate companies, including REITs. See “Global Real Estate Investment,” *supra* note 11. In addition, according to Nareit, there are 225 publicly traded REITs in the United States. See National Association of Real Estate Investment Trusts, “Frequently Asked Questions About REITs” (www.reit.com/what-reit/frequently-asked-questions-about-reits). The difference between 476 and 225 is approximately 250.

published by Cohen & Steers suggest that, as of August 31, 2017, the market capitalization of publicly listed REITs outside the United States was US\$901 billion.¹³ Publicly listed REITs outside the United States control a massive amount of capital that could potentially benefit from the qualified shareholder exemption, but the lack of guidance prevents them from doing so.

THE QUALIFIED SHAREHOLDER EXEMPTION

In order to be eligible for the qualified shareholder exemption under section 897(k)(2), a foreign person must either

- be eligible for the benefits of a comprehensive income tax treaty with the United States that includes an exchange-of-information program and have its principal class of interests listed and regularly traded on a recognized stock exchange, or
- be a limited partnership in a jurisdiction with an agreement for the exchange of tax information and have at least 50 percent of the value of its limited partnership units regularly traded on the New York Stock Exchange or NASDAQ Stock Market.

In addition, a qualified shareholder must

- be a QCIV, and
- meet certain record-keeping requirements.

A QCIV is defined in section 897(k)(3)(B) as a foreign person

(i) which—

(I) is eligible for benefits under [a comprehensive income tax treaty], but only if the dividends article of such treaty imposes conditions on the benefits allowable in the case of dividends paid by a real estate investment trust, and

(II) is eligible under such treaty for a reduced rate of withholding with respect to ordinary dividends paid by a real estate investment trust even if such person holds more than 10 percent of the stock of such real estate investment trust,

(ii) which—

(I) is a publicly traded partnership [that is not treated as a corporation for US federal tax purposes],

(II) is a withholding foreign partnership . . . ,

13 Jon Cheigh and Thomas Bohjalian, *REITs: Think Local, Invest Global* (New York: Cohen & Steers, September 2017) (https://staging.cohenandsteers.com/assets/content/resources/insight/REITs_Think_Local_Invest_Global.pdf). The publication states that total market capitalization of the global REIT securities market is US\$1.7 trillion and that the United States represents 47 percent of that market capitalization.

- (III) if such foreign partnership were a domestic corporation, would be a United States real property holding corporation . . . at any time during the 5-year period ending on the date of disposition of, or distribution with respect to, such partnership's interests in a real estate investment trust, or
- (iii) which is designated as a qualified collective investment vehicle by the Secretary and is either—
- (I) fiscally transparent within the meaning of section 894, or
 - (II) required to include dividends in its gross income, but entitled to a deduction for distributions to persons holding interests (other than interests solely as a creditor) in such foreign person.

As discussed above, the exemption for qualified shareholders does not apply to the extent that a qualified shareholder has “applicable investors,” which are persons (other than qualified shareholders) that own, directly or indirectly, more than 10 percent of the underlying REIT's stock.

As of the time of writing, the test in clause (i) above is likely to be met only by certain entities formed under the laws of the Netherlands, Australia, and possibly a limited number of other jurisdictions. We believe that the number of entities that qualify under clause (ii) is also small. Therefore, the test with the broadest potential applicability is the test articulated in clause (iii) above, which requires the Treasury Department, through delegation to the IRS, to designate entities as QCIVs.

DESIGNATION

The qualified shareholder exemption is for all practical purposes unavailable, because most of the entities that would benefit from the exemption require designation by the IRS and there is no guidance on how a taxpayer can obtain such designation.

We have suggested previously that an eligible taxpayer should be allowed to designate itself as a QCIV, and an eligible taxpayer that self-designates would be “deemed” to be a QCIV for the purposes of section 897(k)(2).¹⁴ Under our proposal, a taxpayer would be eligible for self-designation if it met the following criteria:

1. *Treaty limitation on benefits.* Interests in the entity would have to be listed and traded on a recognized stock exchange, within the meaning of the definition of “qualifying person” in the limitation-on-benefits provision of an applicable tax treaty.
2. *Local REIT.* The entity would have to qualify as a REIT or its equivalent in its home country or as a publicly traded entity that is entitled to flowthrough tax treatment, in either case under local law for the year in question.

14 Peter A. Glicklich and Heath Martin, “IRS Should Allow QCIV Self-Designation Under FIRPTA” (2016) 45:12 *Tax Management International Journal* 734-42.

3. *Local tax treatment.* The following tax characteristics of the entity's income and distributions would be as determined under the entity's own local law:
 - a. income of the entity would have to meet local standards for real estate or similar funds that are taxed on a flowthrough or modified passthrough basis, or
 - b. either the entity would be entitled to a deduction for distributions to its interest holders, or an amount equivalent to the entity's net income would be currently includible in the income of its interest holders.
4. *Regulatory limits.* Holders of more than 10 percent of the entity's interests would have to be disclosed under a securities regulatory regime or listing requirements in the local jurisdiction.

If the IRS believes that the requirements above leave open the possibility of tax avoidance, we would propose adding the following two requirements:

5. *Local ownership.* At least 50 percent of the aggregate amount of the entity's interests would have to be held by investors who are residents of the jurisdiction in which the entity is organized.
6. *Not closely held.* Not more than 50 percent of the entity's interests could be held by one or more persons that own more than 10 percent of the entity's stock (other than persons that are themselves qualified shareholders for the purposes of section 897(k)). Note that shareholders who own 10 percent or more of the entity's stock would not benefit from the qualified shareholder exemption in the first place, so the only effect of this requirement would be to disqualify smaller shareholders.

We believe that these requirements would enable the IRS to fulfill Congress's intent to encourage foreign investment in US real estate, without placing an undue burden on the IRS to process individual applications for designation from dozens or even hundreds of foreign publicly traded REITs.

THE NEED FOR GUIDANCE IS URGENT

The PATH Act became law in late 2015, almost four years ago. Although we recognize that the IRS and the Treasury Department have been busy with guidance relating to the monumental tax reform provided in the Tax Cuts and Jobs Act, the passage of time threatens to deny the qualified shareholder exemption to taxpayers for which Congress intended it.

As provided in the PATH Act, Congress intended that the qualified shareholder exemption would be effective for transactions taking place on or after the date of enactment of the PATH Act, which was December 18, 2015.¹⁵ The due date for

¹⁵ PATH Act, section 322(c).

filing tax returns for 2015 has long passed, and taxpayers are losing their ability to amend their tax returns for 2015 and beyond. Once these years are closed, taxpayers cannot take advantage of the qualified shareholder exemption even though Congress intended the exemption to be available.

The qualified shareholder exemption is a mandatory provision, and not an elective exception. Accordingly, taxpayers that potentially qualify for the exemption face some uncertainty regarding how to report and pay US federal income tax on their FIRPTA transactions. Guidance under section 897(k)(2) would reduce this uncertainty.

CONCLUSION

Congress intended the qualified shareholder exemption to encourage foreign publicly traded REITs to increase their allocations to US real estate. The lack of guidance on how a taxpayer obtains designation as a QCIV, however, is effectively repealing this exemption, contrary to congressional intent. We hope that the Treasury Department will move quickly to allow foreign publicly traded REITs to access the qualified shareholder exemption.

