Strafford

Presenting a live 90-minute webinar with interactive Q&A

Foreign Investments in U.S. REITs: Tax Challenges for Investors and Funds Seeking Foreign Capital

Navigating FIRPTA and Its Exceptions, Section 892 and REIT Investment Structures to Obtain Favorable Tax Outcomes for Investors

THURSDAY, MAY 14, 2015

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Robert J. Le Duc, Co-Chair, National REIT Tax Practice, **DLA Piper**, Minneapolis

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 10**.

NOTE: If you are seeking CPE credit, you must listen via your computer — phone listening is no longer permitted.

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-866-328-9525** and enter your PIN when prompted. Otherwise, please **send us a chat** or e-mail **sound@straffordpub.com** immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

NOTE: If you are seeking CPE credit, you must listen via your computer — phone listening is no longer permitted.

Viewing Quality

To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.

Continuing Education Credits

FOR LIVE EVENT ONLY

For **CLE** credits, please let us know how many people are listening online by completing each of the following steps:

- Close the notification box
- In the chat box, type (1) your **company name** and (2) the **number of attendees at your location**
- Click the word balloon button to send

For **CPE** credits, attendees must **listen** throughout the program, including the Q & A session, and **record** verification codes in the corresponding spaces found on the CPE form, in order to qualify for full continuing education credits. Strafford is required to monitor attendance.

If you have not printed out the “CPE Form,” please print it now (see “Handouts” tab in “Conference Materials” box on left-hand side of your computer screen).

Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 10**.

DLA PIPER

EVERYTHING MATTERS

Foreign Investment in U.S. REITs
Challenges for Investors and Funds Seeking Foreign Capital

May 14, 2015

Key Issues

- Summary of tax rules regarding income from U.S. real estate with respect to foreign investors and a discussion of typical structures.
- Overview of REIT qualification.
- Tax advantages (and drawbacks) of investments in REITs compared to non-REIT investments in U.S. real estate. Primary advantages of a REIT with regard to U.S. real estate investors are that (i) a REIT can convert business income into more lightly taxed dividends without a corporate-level tax, and (ii) certain sales of REIT stock can be tax-free to non-U.S. investors.
- Tax treatment of REIT distributions.
- FIRPTA rules and exceptions to optimize tax outcomes for foreign investors.
- Common REIT investment structures that can be utilized to (i) achieve favorable tax outcomes for foreign investors, and (ii) allow fund sponsors to efficiently attract non-U.S. capital.
- Issues regarding REIT operations and dispositions of REIT shares.

U.S. Source Income – Foreign Investors

Income from real estate and real estate related investments:

- Rents.
- Capital gains.
- Interest from mortgages and other debt instruments.
- Dividends from corporations (including REITs).

Tax rules:

- Two general classes of income from U.S. sources, with different tax results:
  - "FDAP" – Fixed or determinable annual periodical income. Generally excludes gain from the disposition of assets and active business income. Also excludes returns of capital.
  - "ECI" – Effectively connected income.
- "Branch Profits Tax" for non-U.S. corporate investors.
- REIT can convert ECI into FDAP without a corporate-level tax and sales of REIT shares as an exit can avoid FIRPTA and the branch profits tax.
- FATCA.

FDAP

- FDAP generally includes interest, dividends, rents, annuities and gains.
- These income streams can, however, occasionally be ECI depending on the circumstances of how such income is generated.
- In addition, FIRPTA rules can convert what would typically be potentially lightly taxed FDAP into more heavily taxed ECI.
- Loan originations (and perhaps even loan modifications) can create ECI, in particular if regularly occurring.
- Gross basis withholding with potential treaty benefits. Income tax returns typically avoided.

ECI

- ECI is income which is “effectively connected” with the conduct of a trade or business in the United States.
- Rental income is usually ECI.
  - However, income from property that is net leased may be investment income absent an election under certain U.S. tax rules. The election (made under Section 871(d) or Section 881(d)) is typically beneficial to the non-U.S. Investor in that it will allow for deductions such as interest expense and depreciation against the rental income.
- Interest income is typically FDAP.
  - Loan origination issues.
  - REIT solution for origination-related ECI.
- “Net income” based taxation, with U.S. income tax returns required.

Tax Treatment - FDAP and ECI

FDAP and ECI are generally subject to the tax treatment displayed below:

Type of income	Highest U.S. federal tax rate (in general)	Taxed on a net income basis?	Potential tax treaty benefits?	U.S. income tax return filing requirement?
FDAP	30% (withholding tax)	No	Yes	No
ECI (including deemed ECI)	35% (corporate) (plus potential BPT) 39.6% (individual)	Yes	No	Yes

Tax Treaties

- Treaties can reduce the withholding tax rate on interest and dividends.
- Note that REIT dividends are often subject to special rules under treaties – in particular modern treaties. It is difficult to provide “one size fits all” guidance on REIT withholding even on a jurisdiction-by-jurisdiction basis as treaties will often have different rates for different classes of investors (i.e. corporations will often have a different rate than individuals).
- Gains from the sale of U.S. real estate generally not benefitted under such treaties.
- Permanent establishment benefits and reduced branch profits tax rates.
- “Treaty Shopping” is difficult under modern treaties.

Non-U.S. Investors and U.S. Real Property Interests

- Gains from dispositions of United States real property interests (USRPIs) by foreign persons are generally taxed (in effect) as U.S. source business income under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).
- Such gain is typically treated as ECI. Branch profits tax can apply (even on capital gain dividends from a REIT).
- U.S. tax is due on this gain.
- Tax returns are required to be filed.
- FIRPTA withholding.
  - Reduced withholding certificate.
- Trap for the unwary: Section 897(e) and non-recognition transactions.
  - Counterintuitive rules.
  - Enhanced informational reporting.

Slide Intentionally Left Blank

USRPI Defined

USRPIs include:

- Land, buildings, leasehold interests, options to acquire U.S. real estate, and similar items.
- Interests "solely as a creditor" are excluded, but a shared appreciation mortgage or other forms of participating debt are generally USRPIs. Such USRPI status notwithstanding, interest and principal on a shared appreciation mortgage can be received free of FIRPTA tax, but participating debt raises debt-equity issues (even leaving aside FIRPTA).
- A USRPI also includes a U.S. corporation, with (generally speaking) 50% or more of its assets consisting of USRPIs during a specified testing period (such corporation, a USRPHC).
- Exception: Stock in a domestically controlled REIT, even if the REIT is otherwise a USRPHC, is *per se* not a USRPI. This rule is a primary driver of foreign investor interest in using REITs for their U.S. real estate investments.

FIRPTA

FIRPTA tax triggered:

- Disposition of USRPI.
  - Directly, or via a sale through a pass-through entity such as a partnership.
- Sale of stock of a USRPHC.
- REIT disposes of U.S. real estate and distributes a capital gain dividend.
  - Publicly traded REIT 5% exception.
  - Notice 2007-55 and REIT liquidations.

USRPHC Exceptions

Important exceptions – no FIRPTA tax on sale of USRPHC provided:

- The USRPHC is a “domestically controlled” REIT.
  - Domestically controlled means less than 50% foreign ownership, directly and indirectly, during a specified testing period.
  - Significant ambiguity in how to test for domestically controlled REIT status.
    - Regulations.
    - PLR 200923001.
  - Exception is not available for a non-REIT C corporation – no “domestically controlled” C corporation “out” from FIRPTA.
  - Wash sale rule.

or

- If a REIT or C corporation is publicly traded, and the foreign investor holds 5% or less, such stock can generally be sold without FIRPTA consequences. Such investor cannot (in general) have owned more than 5% during the prior five years.
- Cleansing rule.

Summary of Basic Rules for Non-U.S. Investors

- FDAP.
- Treaties.
- ECI – Non-U.S. investor (or a partnership in which it invests) engaged in a U.S. trade or business such as active rental and/or lending business).
- Branch Profits Tax for corporate investors.
- FIRPTA.
- REIT solutions.
  - Convert at least some ECI into FDAP.
  - Avoid (in some cases) FIRPTA.

So what is a REIT?

What is a REIT – Overview of REIT Qualification

- A REIT is not literally a “flow-through” or “pass through” entity but rather is (generally speaking) a C corporation that can effectively avoid corporate income tax due to a dividends paid deduction.
- Converts rental income ECI/ordinary income into dividends.
  - Does not convert gains from U.S. real estate into other than ECI in most cases, nor does a REIT allow branch profits tax to be avoided (in general) on such USRPI gains distributed as capital gain dividends.
- Must meet certain tests to obtain this effective “pass through” tax treatment.
  - Quarterly asset tests.
  - Annual gross income tests.
  - Dealer sale prohibition.
  - Organizational requirements.
  - Required annual distributions.
- Potential REIT taxes even if all requirements above are met include:
  - Dealer sales “prohibited transaction tax.”
  - Corporate income tax on undistributed income.
  - Built-in gain tax on former C corporation assets.
  - Foreclosure property.
  - Excise taxes.

REIT Quarterly Asset Tests

75% Test.

- "Gross" value.
- Real estate mortgages and other real estate related debt obligations.
- Cash and cash items.
- Government securities.
- Shares in other REITs.
- Temporary investment of new capital.

25% taxable REIT subsidiary limitations.

- Gross value limitation <u>but</u> value of stock must take into account liabilities at corporate level.
- Real estate asset strategy for 25% value issues.

REIT Quarterly Asset Tests (Cont.)

- 10% value test for securities.
- 10% voting test for securities.
  - Straight debt exception.
- 5% test.
- TRS "outs" from such tests.
- Partnerships and Treas. Reg. section 1.856-3 – "capital interest" testing.
- Qualified REIT subsidiaries.
- Relief provisions for asset test failures.
- Traps for the unwary.
  - No "pass" on first-quarter.
  - Ambiguity on testing when no assets are owned.

Annual Gross Income Tests and Dealer Sale Prohibition

- Annual tests.
- Gross not net or taxable income – even unprofitable investments can cause problems.
- 75% Test.
- 95% Test.
  - Rents from real property.
  - Mortgage loan interest.
  - Gain on sale of real estate assets.
- Relief provisions for gross income test failures.
- Traps for the unwary.
- Ambiguity on testing when no gross income is earned.
- Dealer sale prohibition.

REIT Organizational Tests

- 5/50 or “Closely Held” Test.
  - Generally based on “personal holding company” concepts.
  - Family attribution.
  - Commonly encountered issues.
  - Does not apply to first REIT year.
  - Second half of tax year.
- 100 Shareholders.
  - January 30th of second taxable year deadline.
  - Service companies.
  - Traps for the unwary.
- Excess share provisions.
  - Ownership limits.
  - Charitable trust.

REIT Organizational Tests (Cont.)

- Must be a U.S. entity.
- Taxable as a corporation but for REIT rules.
- Partnerships, business trusts, LLCs, corporations, and even more specialized entities, can all qualify as REITs (with proper drafting of organizational documents).
- Transferability of shares.
  - Note: test is <u>not</u> "freely transferable" and securities law restrictions and tax-related restrictions are clearly permissible.
- Managed by directors or trustees.
  - Typical issues raised by management structures in private REIT.
- Bank and insurance company prohibitions.
- Relief provisions for organizational test failures.

Slide Intentionally Left Blank

REIT Distribution Requirements

- 90% ordinary income distribution requirements.
- Capital gains.
  - REIT’s option to retain capital gains.
  - Tax credit or refund for tax paid at REIT.
- As a REIT will pay corporate tax on any retained ordinary income and/or any retained capital gains, there is generally an “effective” 100% distribution requirement.
- Non-cash income “exception” to distribution requirements.
- “Taxable” stock distributions.
- Preferential dividends.
  - Structuring issues.
  - Management fees.
  - Promotes/carried interest.
  - Multiple classes of stock.

REIT Distribution Requirements - Mechanics

- Section 857(b)(9).
  - Timing issues.
- Section 858.
  - Timing issues.
- Consent dividends.
  - Consent stock.
  - Withholding issues.
- Relief provisions for distribution test failures.
- 4981 excise test.

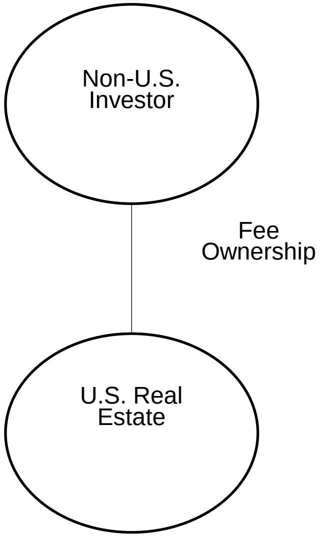
Tax Advantages of REITs Compared to Other Investment Structures

Typical non-REIT investment structures for U.S. real estate.

- Direct investment.
- Partnership investment.
- C corporations.
  - Leveraged “blocker.”
  - Domestic versus offshore “blocker” structures.
- Loans.
  - “Standard” loans.
  - Participating or contingent loans.

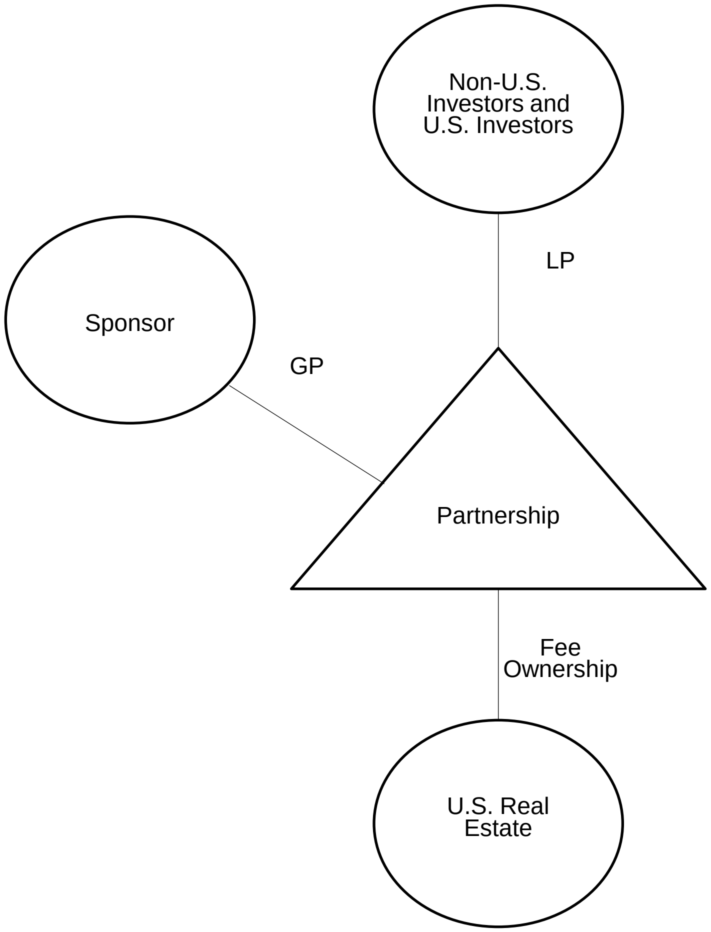
Compare and Contrast Non-REIT to REIT Structures.

Direct Investment Structure



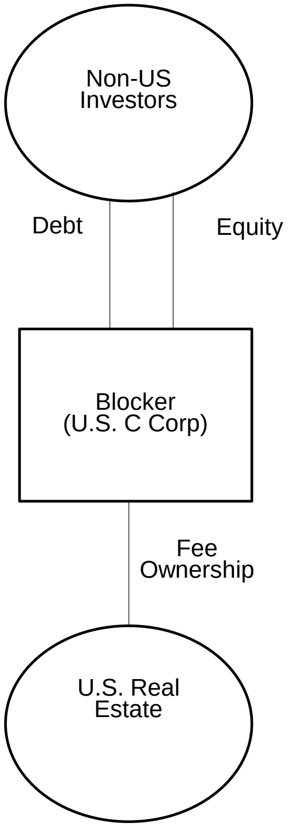
- In this direct investment structure, a non-U.S. investor will simply purchase U.S. real estate.
- Net rental income (assuming the asset is part of a U.S. trade or business) will be subject to U.S. taxation at the federal level and potentially state and local tax (“net leases” and trade or business income issues).
- Gain on sale will generally be fully taxable in the U.S., and withholding will usually be imposed via buyer withholding on purchase proceeds. Tax returns are required. The rate imposed on a non-U.S. investor who is an individual should generally be the favorable long-term capital gain rate applicable to U.S. individuals.
- Some categories of non-U.S. investors may actually desire this full U.S. taxation as they may then be exempt from higher home country taxes on such income.
- Tax credit regimes in home country.
- Of course, many non-U.S. investors will not however want to pay U.S. tax and file U.S. tax returns.

Partnership Investment Structure



- In the typical partnership structure, a non-U.S. investor will simply be a partner in a real estate owning partnership. The partnership's U.S. trade or business will be attributed to its partners.
- The partnership is usually a U.S. entity.
- FIRPTA tax results will generally be (in effect) the same as in a direct investment except withholding will be imposed at and by the partnership.
- Assuming the partnership is a domestic entity, the buyer of real estate will not withhold on sales proceeds from U.S. sales. Rather such withholding will be conducted by the partnership.
- Withholding at partnership level allows the actual gain to be considered as opposed to more standard FIRPTA buyer imposed gross basis withholding.

Domestic Leveraged C Corporation Structure



- In this structure, non-US investors will invest in U.S. real estate via a U.S. corporation (the "Blocker").
- The Blocker will be capitalized in large part with shareholder debt.
- Rationale for a "leveraged blocker" is primarily to convert real estate income (ECI) and FIRPTA gains into more lightly taxed interest income.
- U.S. income tax returns are typically avoided for the non-US investors.
- Blocker will be fully taxable as a C corporation but, properly structured, should be able to claim significant interest deductions (subject to certain limitations).
- Best outcome for the interest paid by the Blocker is to qualify either as portfolio interest and/or for no withholding under a treaty.
- Cleansing rule.
- Organizing the Blocker as a limited partnership that "checks the box" can provide certain tax credit benefits and/or treaty benefits to some non-US investors.

Certain Tax Hurdles with Leveraged C Corporations

- Debt – Equity Considerations.
- Arm’s Length Interest Rate.
- Section 163(j).
- Treaties.
- Portfolio interest.

Debt - Equity

Criteria in testing for "debt for tax" purposes include:

- Intent of the parties.
- Relationship between lenders and equity holders.
- Management participation/voting power held by the lender.
- Ability of the borrower to obtain funds from other sources.
- "Thin" capital structure.
- Formal indicia of debt such as fixed maturity date, creditor remedies, etc.
- Lender's position as to other creditors.
- Interest rate mechanics (fixed, participating, deferrals etc.).

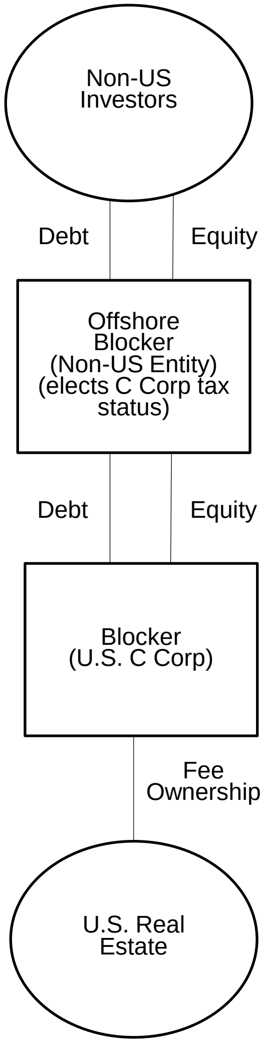
Arm’s Length Interest

- Most important factor in testing for “arm’s length” rate is what is really happening in the market.
- Section 482 and Section 7872.
- AFR.
- Documentation is important.

Section 163(j)

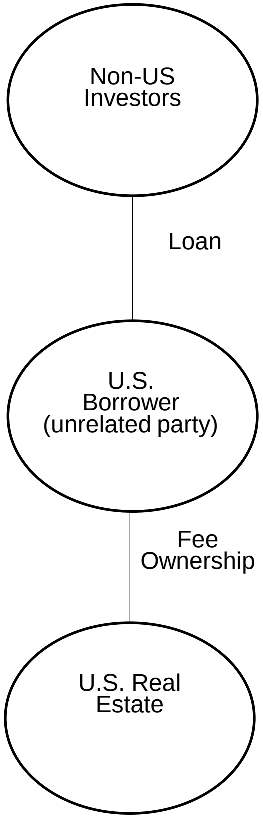
- The Blocker in our previous examples is a corporation. Section 163(j) can limit a corporation's interest deduction to the lesser of (i) the corporation's "disqualified interest" paid or accrued during the year, or (ii) the corporation's "excess interest expense" for the year.
- Section 163(j) applies only if the corporation's ratio of debt to equity at the end of the year exceeds 1.5. <u>Equity for this purpose means adjusted tax basis</u>. Deductions for interest that are disallowed under Section 163(j) for any year can potentially be deducted in succeeding years.
- Under Section 163(j)(3), "disqualified interest" is interest paid by the taxpayer (directly or indirectly) to a "related person" if no U.S. tax (or reduced rates of withholding apply) is imposed with respect to the interest. A shareholder of a corporation is a "related person" if the shareholder owns more than 50% in value of the stock of the corporation.
- Related party guarantees and back-to-back loans generally will not avoid the application of Section 163(j).

Offshore Blocker Structure



- On this alternative, an offshore corporate Blocker – typically organized in a tax haven but not always – will be the "investor" for U.S. tax purposes as a general matter.
- No U.S. tax returns should be required by non-US investors.
- U.S. tax filings and U.S. tax payment obligations can be due from offshore Blocker but generally are avoided.
- Offshore Blocker might be organized as a limited partnership that elects to be taxable as a corporation to accommodate certain non-U.S. tax credit planning and/or for treaty benefits.
- The non-U.S. investors might sell offshore Blocker shares free of FIRPTA, but economically the purchase price of shares should reflect the embedded tax in the structure, in large part.

Loan Structure



- Generally speaking, non-U.S. investors who lend money can avoid being taxed on their U.S. source interest income.
- A significant exception would be origination activity and assets related thereto – investors are favored over active lenders in general under U.S. tax rules.
- Such withholding exemption is typically found under tax treaties and/or the portfolio interest rules. Tax treaties can (in some cases) also be of significant benefit to investors making loans but <u>not</u> via a U.S. permanent establishment (results depend on treaty provisions).
- Participating interest typically is not exempt under either the portfolio interest rules or tax treaties (some older treaties may exempt contingent or participating interest).
- Section 892 likely exempts contingent interest, but Section 892 has significant limitations.

Tax Treatment of Distributions by REITs

- REIT is a (generally speaking) corporation for U.S. tax purposes.
- ECI blocker in many cases.
- Ordinary dividends.
  - Classic FDAP.
- Capital gains.
  - ECI/FIRPTA.

Slide Intentionally Left Blank

Ordinary Dividends

- What is an “ordinary” dividend?
- Withholding.
- Treaties – sampling of treaty rates.
  - Corporate and individual investors from Germany – 15% provided certain requirements are met.
  - UK Pension Fund – zero rate (also provided certain requirements are met).
  - Chinese individuals, corporations, etc., all a 10% rate – note: not for investors from Hong Kong.
- Governmental investors from any jurisdiction – zero rate under Section 892.

Capital Gain Dividends

- Section 897(h)(1) and REIT capital gain dividends.
  - Derived from disposition of a USRPI.
  - "Net capital gain" concept.
  - Ambiguities when losses are also incurred in same taxable year.
  - Wash sale rule.
- Public REIT 5% or less shareholder. FIRPTA will not apply to capital gain dividends if the REIT is publicly traded and the foreign investor owns (in general) 5% or less of the REIT. In such case, the income is taxed as regular dividend investment income.
  - 30% withholding tax rate in general.
  - Possibly lower rate if a treaty applies.
  - Section 892 for non-U.S. governmental investors and some sovereign wealth funds.

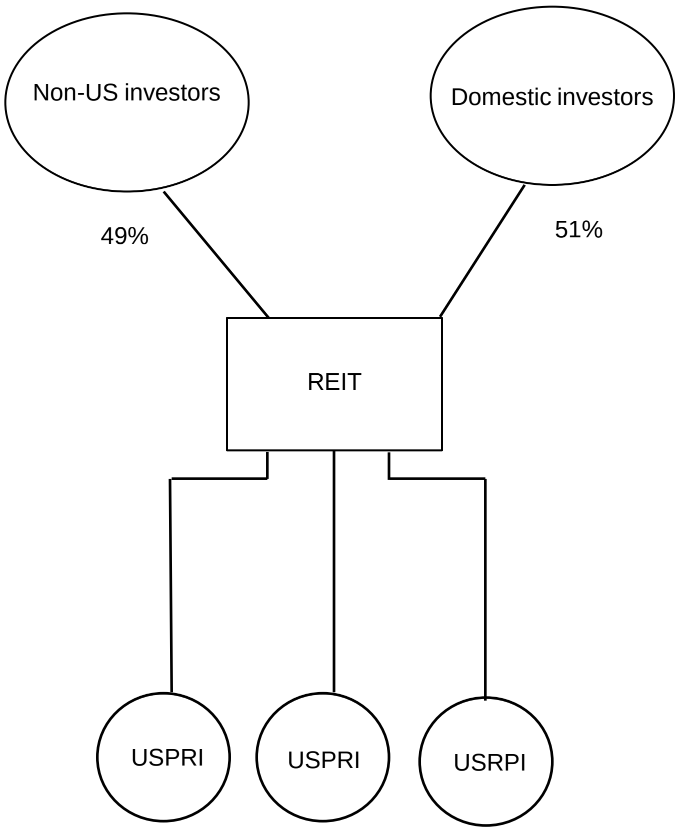
FIRPTA Exception on Certain Dispositions

- Most important exception is the domestically controlled REIT rule.
- Section 892 – for foreign governments/sovereign wealth funds – will also exempt “non-controlled” REITs.
- Publicly traded REITs (and C corporations).
- Former exceptions prior to Notice 2007-55.
  - Section 331 liquidations.
  - PLR 9016021.
  - Perhaps this strategy will return if Notice 2007-55 is revoked.

REIT Investment Structures

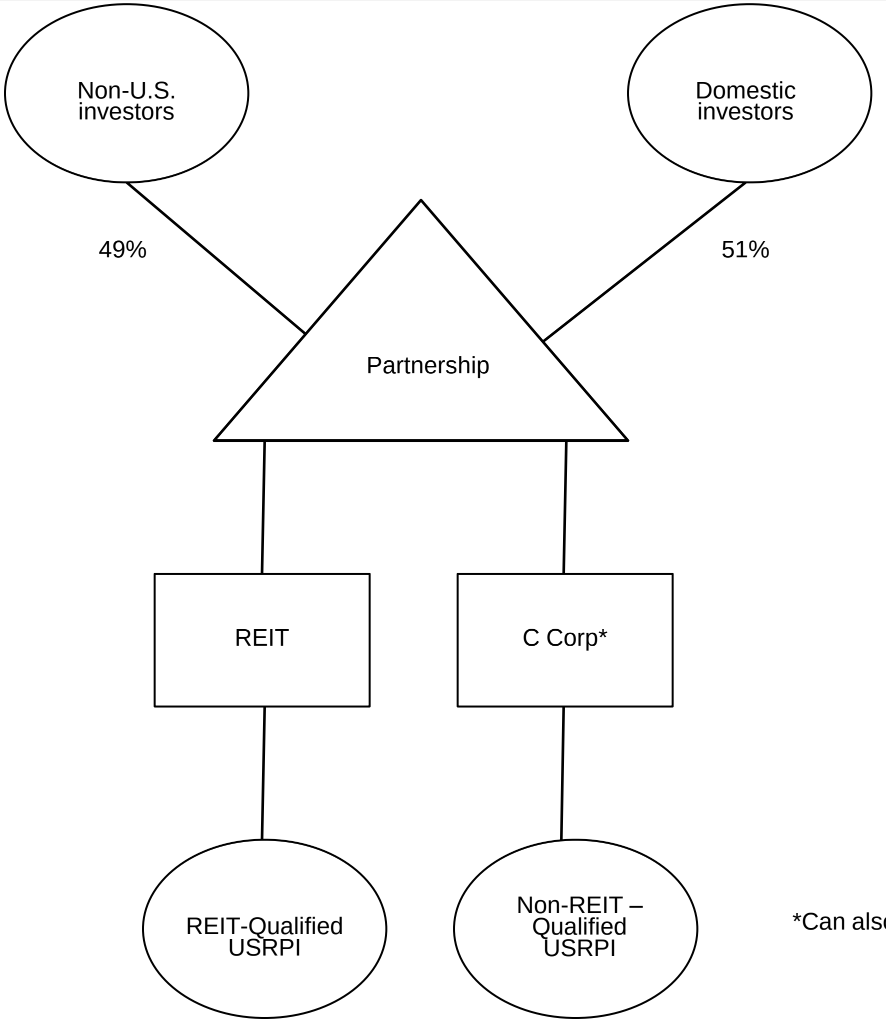
- How to use REITs to improve a non-US investor's tax results.
- REITs as ECI blockers.
- Parent and subsidiary REITs to create domestically controlled REIT dispositions.
- Leveraged blockers <u>along</u> with REITs to create domestically controlled REITs.
- Leveraged REITs.

Standard Domestically Controlled REIT Structure



- In a relatively standard structure non-US investors would collectively hold less than half of the REITs shares.
- Such a REIT would generally be domestically controlled and the non-US investors could sell such shares free of U.S. tax.
- Domestically controlled REIT status, however, does not mean ordinary dividends are free of withholding tax.

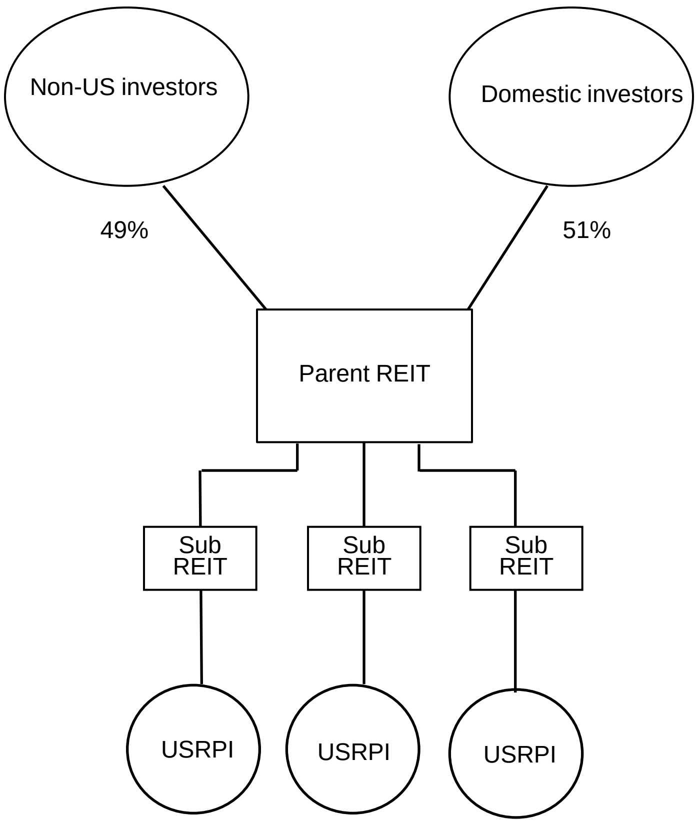
Standard Real Estate Fund With Subsidiary REIT Structure



- In a somewhat standard real estate fund structure, a U.S. partnership will own its REIT qualifying assets through a REIT and non-REIT qualifying assets (such as dealer assets) through a C corporation.
- The non-U.S. investors should only receive dividend income from the REIT and the C corporation as well as capital gain distributions from the REIT.

*Can also be placed under REIT as a TRS

Subsidiary REIT Planning



- FIRPTA tax avoided if foreign investors sell stock of Parent REIT and Parent REIT is domestically controlled.
- FIRPTA tax does apply if a subsidiary REIT sells its USRPIs and distributes cash to Parent REIT and Parent REIT then distributes cash to the investors.
- FIRPTA tax avoided however if Parent REIT disposes equity in a subsidiary REIT.

Practical Impact of REIT Usage

- For the reasons noted previously, non-U.S. investors often want to have a REIT between themselves and U.S. real estate. By way of example, a non-U.S. investor who qualifies for a zero treaty rate (or is exempt under Section 892) will be attracted to REIT investments as such investor could have an entirely tax free investment in U.S. real estate via a REIT structure.
- As discussed herein, REITs must satisfy a number of tax tests.
- Diligence with regard to REIT qualification.
  - Asset tests.
  - Gross income tests.
  - Organizational tests.

REIT Share Dispositions Issues

Although the tax benefits to non-U.S. investors of selling REIT shares can be significant, there are complications with such transactions.

- Sale of entity not real estate.
  - Potential price reduction.
  - Limitations on buyer pool.
  - Timing/diligence.
- Tax traps.
  - Purchasing E&P/taxable income.
  - Post acquisition appreciation if liquidation is delayed.
  - Potential FIRPTA whipsaw if non-U.S. investors do not have a REIT or other “blocker” between themselves and the target REIT.
  - Section 338 elections.
- Tax representations.
  - SOL.
  - Allocation of risk for pre and post closing actions and inaction.
- Indemnities and credit support.
  - Cap on indemnities.

Section 892

- A major class of investors in U.S. real estate are “foreign governments” which can include many sovereign wealth funds.
- U.S. tax exemption under Section 892 for certain types of investment income.
- Types of income.
  - Interest and dividends generally exempt provided received from non-controlled payor; also gains on sale of stock of a non-controlled corporate subsidiary.
  - FIRPTA.
    - Exempt on sales of stock of a non-controlled USRPHC.
    - However, not exempt if foreign government sells U.S. real estate directly or through a partnership, or if receives a FIRPTA dividend (Section 897(h)(1)) from a REIT.
    - Notice 2007-55.
  - Rental income and gains on dispositions of USRPIs is generally not exempt under Section 892.

Certain Requirements of Section 892

Requirements for exemption for foreign governments under Section 892:

- Investment income in general.
- "Commercial activity" prohibition.
- Entities must not be not "controlled" by the foreign government.
  - Standard for "control" is 50% or more of vote or value, or other "effective control."

High-Level Summary of Investment Vehicle Taxation

	Partnership	REIT	C Corporation
Entity level tax	No	Generally no (if all income is distributed)	Yes
ECI flow-through	Yes	Yes for FIRPTA in most cases. No on operating income	No

Proposed Legislation

- REIJA Proposal(s).
- Obama Proposals.
- Camp Proposals.
- JCT Proposals.

Contact Details

Robert LeDuc
DLA Piper LLP (US)
T +1 312.368.7055
E robert.leduc@dlapiper.com