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July 31, 2013

New FIRPTA Reform Would Attract Foreign Investment in US REITs

This afternoon, Reps. Kevin Brady of Texas and Joseph Crowley of New York proposed a major reform to the Foreign Investment in Real Property Tax Act (FIRPTA). Introduced as H.R. 2870, the Real Estate Investment and Jobs Act of 2013 demonstrates the continued bipartisan legislative commitment to reforming FIRPTA and attracting additional foreign capital into the U.S. real estate market. H.R. 2870 is the companion bill to S. 1181, a FIRPTA reform bill introduced by Sens. Robert Menendez of New Jersey and Mike Enzi of Wyoming on June 18, 2013, which is sponsored and cosponsored by a bipartisan group of 28 senators. The bill largely follows H.R. 5901, which passed the House of Representatives in 2010 by a vote of 402-11. The need to reform FIRPTA also has been acknowledged by the Obama administration, with President Obama reaffirming his commitment to FIRPTA reform in yesterday's call for a "Rebuild America Partnership."

If enacted, H.R. 2870 would draw significant new foreign capital into U.S. real estate by modernizing certain exemptions from FIRPTA, as well as by clarifying the application of certain FIRPTA provisions to REITs and their shareholders.

For publicly traded REITs, H.R. 2870 opens the door to substantial new foreign investment by expanding the FIRPTA exemption available to small foreign "portfolio investors" in publicly traded REITs. Under current law, foreign shareholders owning 5 percent or less of a publicly traded REIT are not subject to FIRPTA upon a sale of the REIT's stock or the receipt of a capital gain distribution from the REIT. The bill would increase this ownership threshold from 5 to 10 percent, bringing the FIRPTA regime in line with the definition of a portfolio investor used in U.S. tax treaties, as well as the definition applicable to foreign investors in U.S. debt securities. This will allow foreign investors to dramatically increase their investments in publicly traded U.S. REITs without being subjected to FIRPTA.

H.R. 2870 also provides significant incentive to foreign investors investing in real estate by avoiding inconsistent tax treatment based on the form of a sale transaction. The bill accomplishes this by overriding the harmful effects of Notice 2007-55 on foreign investment. Prior to 2007, in accordance with general provisions of tax law, liquidating distributions from a REIT or redemptions of REIT stock generally were considered a sale of the REIT's stock. In 2007, the IRS issued Notice 2007-55, in which it asserted that REIT redemptions and liquidating distributions should be treated as capital gain distributions generally subject to FIRPTA if paid to foreign shareholders. By changing the U.S. tax consequences of disposing of REIT stock, Notice 2007-55 fundamentally altered investors' settled expectations regarding the after-tax economics of investment in U.S. real property and made investment in U.S. real property via REITs far less attractive to foreign investors. H.R. 2870 clarifies that REIT redemptions and liquidating distributions are, as they were prior to the publication of Notice 2007-55, to be treated as sales of stock. This provision restores the original position of the IRS and resolves present uncertainty regarding the U.S. tax consequences, and therefore the after-tax economics, of foreign investment in U.S. real property.

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Finally, H.R. 2870 provides a workable mechanism for publicly traded REITs to rely on the domestically controlled exception to FIRPTA. Under FIRPTA, gain resulting from the sale or disposition of stock of a domestically controlled REIT (*i.e.,* a REIT, 50 percent of the stock of which is held by U.S. persons) is not subject to FIRPTA. In the past, it has proven difficult for many publicly traded REITs to employ this exception, as they frequently lack information as to the identity of their "small" shareholders (*i.e.,* those holding a less than 5 percent interest in the REIT). In addition, there has been enduring uncertainty as to whether a REIT, the interests in which are held by another REIT, may qualify as domestically controlled. H.R. 2870 addresses both of these concerns. It provides that a publicly traded REIT may presume that all less than 5 percent shareholders are U.S. persons, except where the REIT has actual knowledge to the contrary, and states that stock in a REIT held by an upper-tier REIT will be treated as held by a foreign person unless the upper-tier REIT is itself domestically controlled. These reforms would afford foreign investors additional certainty as to the tax result of an investment in a U.S. REIT.

In sum, H.R. 2870 reduces current barriers to foreign investment in U.S. real estate and will attract significant investment capital into the U.S. real estate market, providing real estate owners with the capital needed to develop and renovate existing properties, acquire and build new properties, and create much-needed jobs throughout the U.S. economy.