Senate Finance Committee Takes Unanimous Step Toward FIRPTA Reform

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If you have any questions regarding the matters discussed in this memorandum, please please contact the attorneys listed on Page 2, or your regular Skadden contact

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Yesterday, the Senate Finance Committee unanimously approved a significant reform to the Foreign Investment in Real Property Tax Act (FIRPTA). The proposal demonstrates the continued bipartisan legislative commitment to reforming FIRPTA and attracting additional foreign capital to the U.S. real estate market, going back to the 2010 passage of a similar FIRPTA reform bill, H.R. 5901, by the House by a 402-11 vote.

Skadden has been involved in this legislative process for the past several years. As described below, these proposed FIRPTA reforms would constitute the most significant changes to FIRPTA since its enactment almost 35 years ago.

For publicly traded REITs, the bill opens the door to substantial new foreign investment in U.S. real property, by expanding the FIRPTA exemption available to small foreign "portfolio investors." Under current law, foreign investors owning 5 percent or less of a publicly traded REIT are not subject to FIRPTA taxation upon a sale of the REIT's stock or the receipt of a capital gain dividend 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 most U.S. tax treaties, as well as the definition applicable to foreign investors in U.S. debt securities. The bill also provides that this expansion applies to interests in REITs held by certain widely held, publicly traded "qualified collective investment vehicles," which are entities that qualify under a comprehensive income tax treaty with the United States and meet certain detailed reporting requirements. These reforms will allow foreign investors to dramatically increase their investments in publicly traded U.S. REITs without being subject to FIRPTA.

The bill also contains certain clarifying presumptions that will allow publicly traded REITs and their shareholders to rely with greater confidence on the domestically controlled exception to FIRPTA taxation. Currently, 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 comfortably take advantage of this exception, because they frequently lack the information to determine the domestic or foreign status of their "small" shareholders (*i.e.*, those holding a less than 5 percent interest). The bill provides that a REIT that is publicly traded on a U.S. market may presume that all less than 5 percent shareholders are U.S. persons except where the REIT has actual knowledge to the contrary. Furthermore, stock in a REIT held by an upper-tier entity that is either a publicly traded REIT or a RIC meeting certain requirements will be treated as held by a foreign person unless the upper-tier REIT or RIC itself is domestically controlled, and REIT stock held by any other type of upper-tier REIT or RIC will only be treated as domestically controlled to the extent that stock of the upper-tier REIT or RIC is held by a U.S. person. These reforms afford foreign investors additional certainty as to the domestic status of an investment in both public and private U.S. REITs.

Unfortunately, a proposal to exempt foreign pension funds from FIRPTA taxation was not included as part of the bill. However, during the committee meeting, several senators stated they were in favor of the foreign pension fund proposal and committed to seek additional revenue offsets to enable the pension fund provision to be considered in the future.

The budgetary impact of these FIRPTA reforms is offset, in part, by several modest proposals. Most of these proposals do not impose any new tax but instead collect FIRPTA taxes owed that currently go uncollected. First, the FIRPTA withholding rate imposed on the disposition or distribution of a U.S. real property interest (other than sales of residences where the amount realized is $1 million or less) would be increased from 10 to 15 percent, to ensure that FIRPTA withholding collects a sufficient share of amounts owed. Second, U.S. real property holding corporations would be required to publicly disclose their FIRPTA status to shareholders and the IRS. Third, brokers whose clients sell stock in a FIRPTA company in which such client owns more than 5 percent of FIRPTA stock (10 percent for publicly traded REITs) would be required to withhold a portion of the sales proceeds. Again, each of these provisions imposes no new taxes, but rather collects taxes that are currently going unpaid in many cases. Fourth, the FIRPTA "cleansing rule" exception would no longer apply to a REIT or RIC. Finally, for purposes of determining whether certain dividends from a foreign corporation, attributable to dividends from an 80 percent owned domestic corporation, are eligible for a dividends received deduction under Section 245 of the Internal Revenue Code, dividends from REITs and RICs would not be treated as dividends from domestic corporations. The fourth and fifth revenue-raiser proposals were included in the Tax Reform Discussion Draft of February 2014, released by U.S. Rep. David Camp, then chairman of the House Committee on Ways and Means.

Today, FIRPTA taxation functions as a substantial deterrent to foreign investment in the U.S. real estate industry, driving foreign capital to instead invest in other U.S. industries or in real estate opportunities in other countries. The FIRPTA reform provisions of this bill address this problem by reducing some sizeable barriers to foreign investment. This bill represents a substantive, bipartisan FIRPTA reform that will generate significant foreign investment in U.S. REITs, providing REITs with the equity necessary to upgrade and renovate properties, revitalize neighborhoods and create U.S. jobs.

Please contact us if you would like additional information on the bill and its FIRPTA reform measures.

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