FIRPTA Reform Opens Door to Increased Foreign Investment in US Real Estate

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

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This afternoon, Reps. Kevin Brady (R-Texas) and Joseph Crowley (D-N.Y.) re-introduced in the House of Representatives a bill to significantly reform the Foreign Investment in Real Property Tax Act (FIRPTA). Introduced as H.R. 2128, the Real Estate Investment and Jobs Act of 2015, this bill demonstrates the continued bipartisan legislative commitment to reforming FIRPTA and attracting additional foreign capital into the U.S. real estate market. The bill is the companion to S. 915, which received unanimous 24-0 approval in February of this year by the Senate Finance Committee. Today's bill largely follows H.R. 5901, which passed the House of Representatives in 2010 by an overwhelming vote of 402-11.

As described below, these proposed reforms would constitute the most significant changes to FIRPTA since its enactment almost 35 years ago. Indeed, if enacted, the bill would draw substantial new foreign capital into the U.S. real estate market 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, the bill opens the door to substantial new foreign investment 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. 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 increase their investments in publicly traded U.S. REITs dramatically without being subject to FIRPTA.

The bill also completely exempts "qualified foreign pension funds" and entities wholly owned by such funds from FIRPTA taxation, equalizing the tax treatment of domestic and foreign pension funds on the disposition of U.S. real property interests. A foreign pension fund is generally "qualified" if it is subject to government regulation and certain reporting requirements in its jurisdiction, has no greater than 5 percent beneficiaries, and enjoys tax benefits either with respect to contributions or investment income in its jurisdiction.

Finally, like its companion S. 915, the bill 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 take advantage of this exception comfortably, because they frequently lack the information needed 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. 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 or is treated as held by a U.S. person. These reforms will afford both the Internal Revenue Service and foreign investors additional certainty as to the domestic status of an investment in both public and private U.S. REITs and the administration of U.S. tax law.

Today, FIRPTA taxation creates a substantial deterrent to foreign investment in the U.S. real estate industry, creating unintended economic distortions that drive foreign real estate capital to instead invest in other U.S. industries or in real estate opportunities abroad. The FIRPTA reform provisions of the bill are long-overdue improvements that will reduce some of these barriers to foreign investment. These provisions represent substantive, bipartisan FIRPTA reforms that will attract significant foreign investment capital into U.S. REITs, providing them with the equity capital necessary to develop, upgrade and renovate properties, revitalize neighborhoods and create much-needed U.S. jobs throughout the economy.

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