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Proposed FIRPTA Changes Could Facilitate Greater Non-U.S. Equity Investment in U.S. Real Estate

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With the federal government shutdown ended and the debt ceiling lifted (for now), a significant focus of Congress over the next few months will likely be on budget negotiations, including changes to the tax laws. Among these possible changes are certain recently proposed changes to the Foreign Investment in Real Property Tax Act, otherwise known as FIRPTA, which, if enacted, would facilitate greater non-U.S. investment in U.S. real estate.

Background on FIRPTA

Prior to the enactment of FIRPTA, non-U.S. investors were exempt from U.S. tax on their passive U.S. real estate investments. This tax exemption was consistent with the treatment in other developed countries of foreign real estate investors. Nevertheless, as widespread fear over growing non-U.S. ownership of U.S. real estate grew during the 1970s, Congress parted ways with this tax exemption and instituted the FIRPTA tax regime in 1980.

FIRPTA has two basic elements:

- First, non-U.S investors must pay capital gains taxes on U.S. real estate investments at the applicable tax rates for similarly situated U.S. investors.
- Second, and more significantly, to assure that such taxes will be paid, a buyer of U.S. real estate from a non-U.S. investor must withhold 10% of the gross sales price (not net profit) from the selling non-U.S. investor and pay it to the IRS. The withholding tax can only be recovered (if at all) months or even possibly years after the sale, when the non-U.S. investor files a U.S. tax return with respect to the real estate sale.

While efforts to repeal or modify FIRPTA have been proposed at various times since it became law, the recent collapse and slow recovery of U.S. credit markets have sharpened interest in relaxing some of the FIRPTA rules applicable to non-U.S. equity investment in U.S. real estate.

Proposed Revisions to FIRPTA

The following three proposed changes to the FIRPTA rules are currently being discussed:

A. *REIT Liquidating Distributions:* Prior to 2007, it was generally understood that liquidating distributions from a domestically controlled real estate investment trust ("REIT") could be characterized as a sale of the REIT stock, which would be exempt

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from FIRPTA. However, in 2007, the IRS issued guidance which concluded that liquidating REIT distributions should be treated as capital gain distributions, which causes such distributions to be subject to FIRPTA. This IRS position has caused significant distress in the non-U.S. real estate investment community and has arguably reduced non-U.S. investor appetite for U.S. REITs. A proposal sponsored by U.S. Representatives Kevin Brady (R-TX) and Joseph Crowley (D-NY) and supported by the National Association of Real Estate Investment Trusts ("NAREIT"), however, would reverse the IRS position. If enacted, liquidating distributions from a domestically controlled REIT would be treated as sales of stock exempt from FIRPTA.

B. *Expanded Definition of "Portfolio Investors" in Publicly Traded REITs:* Another proposal sponsored by U.S. Representatives Brady and Crowley and supported by NAREIT would expand the definition of "portfolio investors" in U.S. publicly traded REITs who are exempt from FIRPTA from 5% to 10%. Increasing the FIRPTA-exempt ownership threshold to 10% would bring FIRPTA in line with the portfolio interest exemption (exempting non-U.S. holders of debt instruments from U.S. tax on interest so long as they own less than 10% of the debt issuer) and the threshold for beneficial tax withholding rates under the Model U.S. Tax Treaty.

C. *Exemption of Non-U.S. Pension Funds from FIRPTA Withholding:* One final proposal, contained in President Obama's proposed budget for FY 2014, would eliminate FIRPTA withholding taxes imposed on non-U.S. pension funds. If enacted, this change to the FIRPTA rules would have the effect of putting non-U.S. pension funds on equal tax footing with U.S.pension funds with respect to U.S. real estate investments.

Summary

Although these proposed changes to the FIRPTA tax regime are incremental, they would not only have a meaningful impact on the U.S. tax treatment of certain non-U.S. investments in U.S. real estate, but would also send the important message that the U.S. real estate market is becoming more welcoming to non-U.S. investors.

We will keep you posted on developments in FIRPTA and other areas of tax law. If you have any questions, don't hesitate to contact us at your convenience.

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