AKIN GUMP
STRAUSS HAUER & FELD LLP

February 3, 2010

TAX ALERT

BILL INTRODUCED TO ENCOURAGE FOREIGN INVESTMENT IN REAL ESTATE

On January 27, 2010, U.S. Reps. Joseph Crowley, D-N.Y., Patrick Tiberi, R-Ohio, and Melissa Bean, D-Ill., introduced a bill (H.R. 4539) to enact the Real Estate Revitalization Act of 2010. If enacted, the bill would allow foreign persons to invest in corporations that own U.S. real estate without becoming subject to U.S. tax, and might also reduce the tax cost for such persons to invest directly in U.S. real estate.

BACKGROUND

Under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), a foreign person who recognizes a gain on the sale of U.S. real estate is subject to U.S. tax on such gain even if such person is otherwise not engaged in a U.S. trade or business. Thus, a foreign individual who sells U.S. real estate is taxed on the gain at regular rates (usually capital gain, although so-called "recapture" items could be taxable as ordinary income); a foreign corporation that invests in U.S. real estate is subject to corporate income tax, and might also be subject to branch profits tax.

Similar rules apply to a sale of stock in a U.S. corporation if at least 50 percent of the value of its assets consists of interests in U.S. real estate (a "U.S. real property holding corporation," or USRPHC). An exception is provided for stock of publicly traded corporations, but only if the foreign person owned less than 5 percent of the corporation's stock. The application of the FIRPTA rules to interests in USRPHCs can produce surprising results when the values of assets other than real estate (for example, goodwill) are falling relative to the values of real estate. In such an economic climate, it is possible that even a company that is not primarily in the real estate business, but which owns, or has favorable leases on, the premises where it operates can become a USRPHC. Moreover, once a corporation becomes a USRPHC at any time while a foreign person owns its stock, a sale by that person is "tainted" (subject to the 5 percent exception for publicly traded corporations) for at least five years even if the company has subsequently ceased to be a USRPHC.

Where a foreign person owns stock in a real estate investment trust (REIT), special rules apply. A distribution from the REIT that is attributable to a sale of U.S. real estate by the REIT is generally taxed to the foreign person under FIRPTA (as though it were from a direct sale of real property by him). In addition, a sale of REIT stock is generally subject to tax unless either the REIT is "domestically controlled" or the 5 percent exception for publicly traded corporations applies.

Where real estate is held through a partnership (or an entity, such as a limited liability company, that is treated as a partnership for tax purposes), gain recognized by the partnership on sale of an interest in real estate or in a USRPHC is generally subject to tax in the hands of foreign partners. In addition, a sale of the partnership interest itself is generally treated as though the foreign partner had sold his pro rata share of each asset (so that FIRPTA tax would apply to the extent the partnership's assets consist of real estate or interests in USRPHCs). However, regulations provide a rule (generally mirroring the statutory rule exempting less than 5 percent interests in publicly traded USRPHCs) that exempts a sale of an interest in a publicly traded partnership if (i) the foreign partner owned less than 5 percent of such partnership and (ii) the partnership's assets are such that, if it were a corporation, it would be a USRPHC.

Tax imposed under FIRPTA cannot be reduced or eliminated under any current income tax treaties.

THE BILL

Eliminate Application of FIRPTA to USRPHCs. The bill would eliminate the application of FIRPTA to stock of USRPHCs. Thus, a foreign person could invest in stock of a corporation, including a corporation whose assets consist primarily of real estate, without being taxed on the gain upon sale of the stock. As a result, the special rules for domestically controlled REITs and for less than 5 percent interests in publicly traded corporations would be unnecessary.

Amend FIRPTA Rules for REITs. The bill would also provide that a distribution from a REIT would not be treated as gain subject to FIRPTA. However, it would instead be treated as an ordinary dividend (with the result that, in most cases, it would be subject to a 30 percent withholding tax, unless such tax is reduced or eliminated under a tax treaty). The same treatment would generally apply to liquidating distributions from REITs. However, gain on a sale of REIT shares would not be subject to FIRPTA. Thus, under the bill, a foreign shareholder of a REIT would be well-advised to consider an exit by means of a sale before receiving a dividend or liquidating distribution.

Direct and Partnership Investments Generally Unchanged. Direct investments in U.S. real estate, as well as investments through a partnership, would continue to be subject to taxation under FIRPTA to the same extent as under current law. However, there does appear to be a possible technical issue relating to publicly traded partnerships. As noted above, there is a regulatory exception for less than 5 percent interests in publicly traded partnerships that essentially incorporates by reference the rules of the corresponding statutory exception for less than 5 percent interests in publicly traded USRPHCs. Since the bill would eliminate as unnecessary the latter exception, it is not clear how the exception for publicly traded partnerships would continue to apply. The purpose of the bill is generally to liberalize the rules governing foreign investments in U.S. real estate, not to make them stricter. Thus, it would not make sense for the exception for less than 5 percent interests in publicly traded partnerships not to be available as a result of the enactment of the bill. However, it would seem that preservation (or possibly broadening) of the publicly traded partnership exception would arguably require regulatory action if the bill were passed in its current form.

Possible Elimination of Branch Profits Tax on FIRPTA Gain. According to a statement released by Rep. Crowley's office, the bill is also intended to provide explicitly that where a foreign corporation recognizes gain on a sale of U.S. real property, the branch profits tax would not apply to such gain. However, this provision does not appear to be present in the language of the bill as initially introduced. It is not clear at this time whether the provision would be included.

Effective Date. The bill would be effective for tax years beginning after December 31, 2009.

It is our understanding that a similar (although not identical) bill is being developed by senior members of the Senate Finance Committee. At the present time, the timing of introduction of a Senate FIRPTA bill is uncertain. Beyond the introduction of the House bill and the anticipated introduction of a similar bill in the Senate, it is also not clear what legislative action might be taken on the FIRPTA issue by either of the two tax-writing committees. However, the House sponsors have invited comment and input from the public.

PRACTICAL CONSEQUENCES

Overall, the bill, if enacted, would be expected to have four major effects.

First, the current disincentive for foreign investment in U.S. corporations that are primarily in the real estate business would largely be eliminated, since gain on the sale of stock of a U.S. corporation would not be taxed in the foreign taxpayer's hands.

Second, a possible disincentive for investments in U.S. corporations that are not primarily real estate companies, but which might technically become USRPHCs as a result of relative changes in asset value, would likewise be eliminated.

Third, if the branch profits tax provision is included, the disincentive for a foreign person who wishes to invest directly (or through a partnership) in U.S. real estate would be reduced (although not totally eliminated). U.S. tax could not be avoided altogether on gain on such an investment. However, the bill would nonetheless place such a taxpayer in a somewhat clearer position than under current law. The reason is that a foreign taxpayer who incurs FIRPTA tax is also required to file a U.S. tax return; to many foreign persons, the prospect of identifying oneself to, and filing forms with, the U.S. taxing authorities is as unpalatable as the tax itself. The solution is to isolate the FIRPTA gain in a foreign "blocker" corporation (that then files the return and pays the tax instead of its owner). The use of a foreign blocker corporation can also be a useful estate planning tool for foreign persons who own U.S. real estate; depending on what Congress does with the estate tax, this may once again become relevant. However, while current law is not entirely clear, the cost of using a foreign blocker corporation is the risk of a second level of tax (i.e., branch profits tax) in addition to the single (and unavoidable) level of income tax. By clarifying that branch profits tax will not apply to a foreign corporation that recognizes FIRPTA gains, the bill would facilitate the use of a foreign blocker corporation to isolate the FIRPTA tax (and the attendant return filing obligation) without risking yet an additional level of tax. We note that many practitioners believe that this risk is small under current law; thus, the importance of this clarification may be limited.

Fourth, the bill would make REITs a more attractive vehicle for foreign persons investing in U.S. real estate in situations where the 5 percent exception for publicly traded corporations is not available.

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