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## SUPPOSE FIRPTA WAS REPEALED

by

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### ABSTRACT

*This article argues, as others have before, that the Foreign Investment in Real Property Tax Act of 1980 (or “FIRPTA”), or at least the provisions of FIRPTA relating to “United States real property holding corporations,” should be repealed. Their enactment in 1980 was misguided and in any event changes in the Internal Revenue Code since then have made the provisions obsolete. But if FIRPTA is repealed, in whole or in part, the article argues that the lack of parity between foreign investment in real property that is made directly or through a partnership, on the one hand, and foreign investment in a real estate investment trust (or a regulated investment company that invests in shares of real estate investment trusts) should be dealt with. Otherwise, repeal will exacerbate existing distortions (which were already pushed further by FIRPTA) resulting from the choice of the entity used to make an investment in US real property. The article also suggests that repeal of FIRPTA would provide an opportunity to look at the taxation of foreign investment in the United States more broadly and in particular the rules that tax income from U.S. real property. The tax treatment of inward investment is a generally neglected subject.*

*The article concludes by arguing against legislation that would keep the FIRPTA rules and simply expand provisions of present law that favor foreign investment through real estate investment trusts, such as the Real Estate Jobs and Investment Act of 2011.*

<b>I. INTRODUCTION</b> .....	2
<b>II. SUMMARY OF FIRPTA</b> .....	5
A. <i>How did FIRPTA Change the Law?</i> .....	7

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<i>B. Why Was FIRPTA Enacted?</i> .....	10
<i>C. How Did FIRPTA Respond to These Issues?</i> .....	13
<i>D. FIRPTA and Income Tax Treaties</i> .....	16
<i>E. FIRPTA and “Pass-Throughs”</i> .....	17
1. <i>Fixed Investment Trusts</i> .....	18
2. <i>Partnerships</i> .....	19
3. <i>REITs</i> .....	21
4. <i>RICs</i> .....	27
<i>F. Do the Rules That Apply to Business Intermediaries</i> <i>Make Sense?</i> .....	28
<b>III. REPEALING THE FIRPTA RULES</b> .....	29
<i>A. Real Estate Investment Trusts</i> .....	31
<i>B. Repealing the FIRPTA Rules for USRPHCs</i> .....	33
<i>C. Repeal of All of FIRPTA</i> .....	35
<i>D. Tax Treaties</i> .....	38
<b>IV. LEGISLATION OTHER THAN REPEAL</b> .....	41

## I. INTRODUCTION

The Foreign Investment Real Property Tax Act of 1980 (“FIRPTA”) amended the Internal Revenue Code to provide that gain realized by a nonresident alien individual or foreign corporation on the sale or other disposition of an interest in U.S. real property would always be income “effectively connected” with the conduct of a U.S. business and thus would be subject to regular rates of tax and possibly also to branch profits tax if the interest was sold or disposed of by a foreign corporation. It also defined U.S. real property to include land, buildings and improvements, whether acquired as a personal investment or to produce income, personal property “associated” with the use of real property, and equity and certain other interests in a U.S. corporation if 50 percent or more by value of its business assets and interests in real property were (or in the last five years had been) interests in real property located in the United States.<sup>1</sup>

In its perfect world, the U.S. real estate industry would repeal FIRPTA, arguing that it discourages foreign investment.<sup>2</sup> So would some

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1. I.R.C. § 897 FIRPTA which applies to dispositions of interests in U.S. real property after June 18, 1980 (and also provides a carryover basis for certain related party transfers after December 31, 1979 and before the effective date). This paper deals with FIRPTA as in effect today and, with a few exceptions, does not discuss amendments made since 1980. All citations in the text to sections are to the Internal Revenue Code of 1986, as amended.

2. See Statement of Jeffrey D. Deboer on Behalf of the Real Estate Roundtable Before the Subcommittee on Select Revenue Measures, REAL ESTATE

more disinterested commentators.<sup>3</sup> And the late Senator Wallup, one of the driving forces behind FIRPTA's enactment, seemed amenable to repeal, other than with respect to farm land, when the Senate took up the issue four years after the enactment of FIRPTA.<sup>4</sup> The FIRPTA tax on shares of a U.S. real property holding corporation (hereafter, a "USRPHC") — which has been a particular focus of critics — has also been classified as a "negative" tax expenditure, i.e., as a deviation from a "normal" income tax that collects more tax than would be collected under a "normal" income tax system.<sup>5</sup> Since real property includes infrastructure projects such as roads, tunnels and railroads, critics of FIRPTA cite the need to encourage investment in U.S. infrastructure as another argument for repeal.<sup>6</sup> Nonetheless, while FIRPTA

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ROUNDTABLE (June 23, 2011.), [www.rer.org/FIRPTA-testimony-June2011.aspx](http://www.rer.org/FIRPTA-testimony-June2011.aspx) ("FIRPTA has succeeded beyond its enactors wildest dreams in discouraging foreign investment in U.S. real property. It is a deterrent to foreign investors, an administrative drain . . . , and without policy justification. If budgetary constraints were not a factor, the Roundtable would recommend that FIRPTA be repealed in its entirety now.")

3. See, e.g., Richard L. Kaplan, *Creeping Xenophobia and the Taxation of Foreign-Owned Real Estate*, 71 GEO. L.J. 1091, 1095, 1128 (1983) [hereinafter Kaplan, *Creeping Xenophobia*] ("For reasons of tax complexity, international relations, and economic policy . . . FIRPTA should be repealed in its entirety posthaste." And FIRPTA "is an unmitigated disaster."); Fred Brown, *Wither FIRPTA?*, 57 TAX LAW. 295, 296–97, 302 (2004) [hereinafter Brown, *Wither FIRPTA*] ("An area that is ripe for . . . a deadwood analysis is . . . [FIRPTA] . . . . This Article suggests that the repeal of portions of FIRPTA may be in order. . . ." And concluding that "fundamental policy considerations call for the retention of [the FIRPTA treatment of directly held interests, but] . . . serious consideration should be given to eliminating the rules that apply to dispositions of stock in certain U.S. real property holding corporations. . . .").

4. *Repeal of the Foreign Investment in Real Property Tax Act: Hearing Before the Subcomm. on Energy and Agric. Taxation of the Comm. on Fin. United States Senate*, 98th Cong. 22 (1984) (statement of Senator Wallop) (" . . . I . . . feel reluctant at this point to advocate repeal of FIRPTA as it effects farmlands, but with respect to other investments . . . the case for repeal may be more apparent."). The result of the hearing seems to have been the enactment of the section 1445 withholding tax.

5. STAFF OF THE JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2008-2012, 110th Cong. 5, 23 (2008) [hereinafter 2008-2012 ESTIMATES]. This was "scored" as costing \$50 million or less a year. See *id.* at Table 3. The most recent estimate omitted FIRPTA. See STAFF OF THE JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2011-2015, 112th Cong. (2012). See also Congressional Research Service, *Tax Expenditures – Compendium of Background Materials on Individual Provisions*, Comm. on the Budget United States Senate, 111th Cong. 75 (2010).

6. In Announcement 2008-115, 2008-2 C.B. 1228, the IRS stated its intention to issue regulations that would define an interest in real property to include

has been amended over the years, none of the changes have altered its basic structure or its premise that gain from the disposition by a foreign person of an investment in U.S. real property, whether made directly or through a partnership or a U.S. corporation, should generally be taxed as gain from a U.S. trade or business.

Are the critics of FIRPTA right? Would repeal make sense? There are dissenters,<sup>7</sup> but repeal is certainly worth considering, and the revenue loss would seem to be small.<sup>8</sup> FIRPTA was enacted in 1980, more than thirty years ago, by amendment to an Internal Revenue Code which in important respects was different from what we have today or had even ten years after the enactment of FIRPTA and on the basis of arguments, such as “horizontal equity” between U.S. and foreign investors, that are difficult to accept.

But if FIRPTA is repealed, whether in its entirety or in part, are there issues in the taxation of foreign investment in U.S. real property that should be addressed? Certainly one issue is the significant difference between the rules that now, and would then, apply to an investment made directly or through a partnership and one made through a real estate investment trust (“REIT”) or a regulated investment company (“RIC”) that invests in shares of REITs. Why should the tax treatment of foreign investment turn on the entity that makes the investment or, put differently, should there be a single system that does not distinguish between direct investment and investment made through any “pass-through” entity? Other issues raised by a repeal of FIRPTA would be the definition of real property, whether there should be a distinction between an investment that is part of a U.S. trade or business and one that is not, and the apparent international consensus that income and gain

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government granted permits and similar rights with respect to infrastructures, such as toll roads. This would be consistent with the position the IRS has taken with respect to government permits for purposes of section 856 (*see, e.g.*, PLR 9843020 (Oct. 23, 1998)), and the definitions of real property for purposes of sections 897 and 856 are for this purpose the same. There are, however, dissenters who argue that such an investment should be bifurcated between an intangible and real property. *See, e.g.*, Kimberly S. Blanchard, *Infrastructure and FIRPTA: Advance Notice of Proposed Rulemaking*, 38 TAX MGM'T INT'L J. 166 (2009).

7. *See* A.L.I., FED. INCOME TAX PROJECT: INT'L ASPECTS OF UNITED STATES INCOME TAXATION: PROPOSALS OF THE AMERICAN LAW INST. ON UNITED STATES TAXATION OF FOREIGN PERSONS AND OF THE FOREIGN INCOME OF UNITED STATES PERSONS 38 (1987) (that the USRPHC and other FIRPTA rules “seem appropriate. While the line between real property interests and non-real property interests may be somewhat arbitrary, nothing measurably better than current law suggests itself. . . . Accordingly, this study recommends the retention of the provisions of current law in this area.”).

8. *See* 2008-2012 ESTIMATES, *supra* note 5, at Table 3 (estimate of the Joint Committee staff of less than \$50 million a year).

from real property should always be fully taxed in the country where it is located. Repeal might also offer an opportunity to evaluate the U.S. taxation of inward investment more generally.

Part II of this article summarizes what FIRPTA does, why it was enacted, how it changed the law and affected U.S. income tax treaties, and how it applies to direct investments and investments made through partnerships, REITs and other pass-through entities. Part III considers, first, the consequences of repealing the USRPHC provisions of FIRPTA and, second, the consequences of repealing the other FIRPTA rules. Part IV evaluates legislation that has recently been introduced that would change, but not repeal, the FIRPTA rules, such as the Real Estate Jobs and Investment Act of 2011.

## II. SUMMARY OF FIRPTA

What does FIRPTA do? Broadly, FIRPTA treats gain from the disposition of any interest in U.S. real property other than an interest solely as a creditor (hereafter, an interest in “USRP”)<sup>9</sup> by a foreign person, whether acquired for personal reasons or to produce income, as gain that is “effectively connected” with the conduct of a U.S. trade or business<sup>10</sup> (or, if a tax treaty applies, is attributable to a U.S. permanent establishment), and thus as taxable at regular rates and possibly subject to branch profits tax if the investor is a foreign corporation and the interest in USRP is not an interest in a USRPHC.<sup>11</sup> FIRPTA also defines an interest in USRP to include shares of and other interests in a USRPHC or a U.S. corporation that was

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9. Real property for this purpose includes (1) land and unsevered products of the land, (2) improvements and (3) personal property associated with the use of real property. Regs. § 1.897-1(b)(1). Improvements, such as buildings and inherently permanent structures, are defined by reference to the definition of a building or other inherently permanent structure in the now-repealed investment tax credit, i.e., section 48(a)(1)(B), but the definition for purposes of the REIT rules in section 856 is also relevant since the definition of real property in section 897(c)(6) is word-for-word the same as the definition in section 856(c)(5)(C), except that it does not exclude mineral and oil or gas royalties but does exclude foreign real property. Regs. § 1.897-1(b)(3).

10. I.R.C. § 897(a)(1) (providing that gain or loss of a nonresident alien individual or a foreign corporation from the disposition of an interest in USRP “shall be taken into account . . . as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with such trade or business.”)

11. Earnings from the disposition of an interest in USRP, whether derived directly or as a partner, may result in branch profits tax for a foreign corporation; but under section 884(d)(2)(C) gain from the sale of shares of a USRPHC is excluded from earnings that are subject to branch profits tax.

such a corporation in the five years preceding the disposition of the interest.<sup>12</sup> Logically (because this is the rule that applies to gain recognized by a partnership), it also provides (with exceptions) that distributions by a REIT or a RIC which, because it invests in shares of REITs, is a USRPHC to a foreign shareholder of gain from the sale of an interest in USRP are taxable as though the shareholder had sold the interest and recognized the gain.<sup>13</sup> FIRPTA does not affect sales of shares of a foreign corporation, regardless of the extent to which the corporation holds interests in USRP, and thus draws a sharp distinction between investing through a U.S. and through a foreign corporation.<sup>14</sup> With exceptions and limitations, however, FIRPTA does tax a foreign corporation on a distribution to a shareholder of interests in USRP, including of shares of a USRPHC, in an otherwise tax-free spin-off, reorganization or liquidation.<sup>15</sup>

Originally a self-assessed tax with extensive reporting requirements,<sup>16</sup> FIRPTA is now enforced by complex withholding tax rules that were added in 1984 and, broadly, require withholding by the transferee from the proceeds of a sale of an interest in a USRPHC or of an interest in a partnership or trust holding interests in USRP unless they are publicly-traded or otherwise exempt; withholding by the corporation from distributions to shareholders of interests in USRP by foreign or in certain circumstances domestic corporations; and withholding by a partnership, a REIT or a RIC that is a USRPHC because it invests in shares of REITs from distributions of gain from sales of interests in USRP by the partnership, REITs and RICs. Under the statute, the base for withholding (e.g., gain realized, amount realized or fair market value) and the rate of withholding (10 percent to 35

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12. I.R.C. § 897 (c)(1)(A)(ii).

13. I.R.C. § 897(h)(1). The interpretation of this rule is a source of dispute. See *infra* note 103 and accompanying text.

14. The absence of a step up in the basis of the underlying asset no doubt affects the pricing for the shares of a foreign corporation (as it would for the shares of a USRPHC that were acquired in a transaction in which there was no basis step up). At one point, the legislation that ultimately became FIRPTA would have taxed shareholders of a foreign corporation that invested in USRP interests.

15. I.R.C. § 897(d). Under Temporary Regulations section 1.897-5T(c), recognition of gain is generally required unless the distribution is to a foreign parent corporation in an section 332(a) liquidation, the foreign parent acquires the interest in USRP with a carryover basis and certain other requirements are met; and, in the case of an section 355 distribution of shares of a USRPHC by a foreign corporation, the gain that is recognized is limited to the basis step up to the distributees.

16. Thus, reporting was required by non-publicly traded USRPHCs with respect to foreign shareholders and by foreign corporations, partnerships, trusts and estates with respect to substantial investments in USRP.

percent) vary depending on the transaction.<sup>17</sup> The withholding tax, of course, is a prepayment of a liability that may be more or less than the amount withheld and it does not always eliminate the need for a foreign person that is subject to the FIRPTA tax to file a tax return.<sup>18</sup> The separate FIRPTA reporting rules were largely eliminated when the withholding tax was added in 1984.<sup>19</sup>

A. *How Did FIRPTA Change the Law?*

Gain from the sale of U.S. real property was U.S. “source” income before FIRPTA.<sup>20</sup> But before FIRPTA there was no U.S. tax on gain from a sale by a foreign person of personal, or non-business, real property, such as a personal residence, because the gain, although U.S. source, was not “effectively connected” with a U.S. trade or business (or, if a tax treaty applied, was not “attributable to” a U.S. permanent establishment). The same rule applied to a business investment in real property except that, because such an investment often involved the conduct by the investor of significant activities in the United States, it would often result in income that was “effectively connected” with a U.S. trade or business. Even if that was not the case, because the activities in the United States were occasional or minimal, the foreign investor would frequently elect under the Internal Revenue Code or a tax treaty to treat the income as effectively connected in order to take a current deduction for expenses, such as interest, depreciation and real estate taxes, and not be subject to a 30 percent withholding tax on

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17. I.R.C. § 1445. Thus the rates of withholding vary from 10 percent of the amount realized (e.g., by a foreign person on the disposition of an interest in USRP or an interest in a partnership or trust that owns an interest in USRP) or of the fair market value (on a taxable distribution of an interest in USRP by a partnership or trust to a foreign partner or beneficiary) to 35 percent of the gain realized (e.g., on gain from a disposition of an interest in USRP by a partnership, trust or estate that is attributable to a foreign partner or foreign beneficiary), and the rules are further modified by a complex set of regulations. See Kimberly S. Blanchard, *FIRPTA in the 21st Century, Installment Four: FIRPTA Withholding Mechanics*, 37 TAX MGM'T INT'L J. 402 (2008) (for comments on limited aspects of the withholding tax regulations); David R. Herzig, *Rethinking FIRPTA*, 4 COLUM. J. TAX L. \_\_\_\_ (2013) [forthcoming].

18. See Regs. § 1.1445-1(f)(1) (in the case of tax withheld on a sale of an interest in a USRPHC or a partnership or a trust).

19. Section 6039C now requires a foreign person who directly owns and interest in USRP to report if the value is \$50,000 or more and ownership is not a U.S. trade or business, but reporting is only “[t]o the extent provided by regulations” and there are no regulations. Proposed regulations under the original section 6039C were withdrawn when the withholding tax was enacted.

20. I.R.C. § 861(a)(5).

gross rental income.<sup>21</sup> Apart from the withholding tax on non-effectively connected rents or royalties, the tax on U.S. real property income or gain was, before FIRPTA, self-assessed.

While gain from the sale or other disposition of an interest in USRP is, with specific exceptions, always “effectively connected” income under FIRPTA, FIRPTA did not change the different treatment of rent, mineral royalties or other current income from a investment in real property that is a U.S. trade or business (taxation at regular rates on the taxable income) or a business investment that is not a U.S. trade or business (30 percent tax on the gross income). It thus retained the statutory election to treat income from a non-trade or business investment in real property held for the production of income as “effectively connected” income.<sup>22</sup> Whether ownership of an interest in real property is or is not a trade or business is sometimes simple (for example, ownership of an interest in a royalty trust that is a fixed investment trust would not be) and sometimes more complicated (for example, where a foreign person owns and leases one or more commercial properties), turning in such a case on the level and continuity of the owner’s U.S. activities.<sup>23</sup>

Before FIRPTA, there was no tax on gain from the sale of shares of a REIT, RIC or other U.S. corporation, regardless of the nature of its

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21. Sections 871(d) and 882(d), which apply to “income . . . from real property held for the production of income and located in the United States,” and thus exclude a personal investment in real property, such as a residence, and permit an election “to treat all such income as income which is effectively connected with the conduit of a trade or business within the United States.” The same election is provided by U.S. tax treaties. *See, e.g.*, United States Dep’t of Treasury, United States Model Income Tax Convention of November 15, 2006, art. 6, ¶ 5 [hereinafter 2006 U.S. Model Treaty]. Once made, the election can be revoked only with the consent of the IRS. Regs. § 1.871-10(d).

22. The election does not apply, of course, to real property not held for the production of income, such as a personal residence.

23. In Revenue Ruling 73-522, 1973-2 C.B. 226, the IRS held that a nonresident alien who leased U.S. real property on a long-term basis, net of expenses, and who was in the U.S. only for one week during the year for the purpose of supervising the negotiation of new leases was not engaged in a U.S. trade or business. It summarized prior court decisions as holding that there was a trade or business when the U.S. activities of a nonresident alien individual, or the individual’s agents, went beyond the mere receipt of income and the activity was “considerable, continuous, and regular,” which was not the case in the ruling because the leases were net and the U.S. activity not considerable, continuous or regular. *See also* Lewenhaupt v. Commissioner, 20 T.C. 151 (1953), *aff’d*, 221 F.2d 227 (9th Cir. 1955); Herbert v. Commissioner, 30 T.C. 26 (1958); and De Amodio v. Commissioner, 34 T.C. 894 (1960), *aff’d*, 299 F.2d 623 (3rd Cir. 1962). The ruling also holds that expenses paid by the lessee and netted against the rent are expenses of the lessee and not income and deductions of the lessor.



underlying assets. Gain from a disposition of shares of what would under FIRPTA be a USRPHC was treated no differently than gain from the sale of shares of any U.S. corporation. Likewise, the tax free reorganization and other nonrecognition provisions of the Internal Revenue Code applied without regard to the nature of the corporation's underlying assets. Whether gain from the sale of a partnership interest was taxable was arguably unsettled at the time. Some took the view that gain from the sale of a partnership interest was from the sale of personal property and was sourced on the basis of the title-passage rule which then applied.<sup>24</sup> Whatever the merits of that position then, the IRS now views a partnership, whether foreign or domestic, as an aggregate, not an entity, for the purpose of determining the source of a partner's income, and this is consistent with case law.<sup>25</sup> As a consequence, a foreign partner that sells an interest in a partnership is taxed on the partner's distributive share of the unrealized gain the partnership's assets that are effectively connected with a U.S. trade or business (or attributable to a permanent establishment), whether under FIRPTA or otherwise.

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24. See Arthur A. Feder & Lee S. Parker, *The Foreign Investment In Real Property Tax Act of 1980*, 34 TAX LAW. 545, 548 n.18 (1981) [hereinafter Feder & Parker, *Foreign Investment*].

25. Revenue Ruling 91-32, 1991-1 C.B. 107 (which may have been inspired in part by section 897(g), although it deals only with partnership property that is not an interest in USRP, leaving interests in USRP held by a partnerships to section 897), sources a foreign partner's gain from the sale of an interest in a partnership, whether U.S. or foreign, on the basis of the partner's distributive share of unrealized gain or loss that would be effectively connected with a U.S. trade or business (or attributable to a United States permanent establishment) or not. In applying Revenue Ruling 91-32, there is a presumption that the gain from the sale of an interest in a partnership that is engaged in a trade or business in the U.S. (or has a permanent establishment there) is U.S. source effectively connected income, but that a loss from the sale of such an interest is foreign source and not effectively connected. *Id.* See also Tech. Adv. Mem. 200811019 (Mar. 14, 2008) (taking an aggregate approach to the determination of the extent to which a foreign partner's distributive share of partnership investment income was, or was not, income effectively connected with a U.S. trade or business). The result in Revenue Ruling 91-32 seems entirely consistent with cases that have considered other aspects of the treatment of foreign partners, such as *Unger v. Commissioner*, 936 F.2d 1316 (D.C. Cir. 1991) and *Donroy v. United States*, 301 F.2d 200 (9th Cir. 1962), but Revenue Ruling 91-32 has nonetheless been criticized and doubt expressed as to whether the ruling would apply to the sale of an interest in a publicly-traded partnership. See Stuart E. Leblang, Robert P. Rothman & Daniel J. Paulos, *Rationalizing Inbound Taxation of Passive Portfolio Investments*, 121 TAX NOTES 693, 696 n.25 (Nov. 10, 2008) [hereinafter Leblang, Rothman & Paulos, *Rationalizing*]. Revenue Ruling 91-32 is also consistent with the authority of the IRS under Regulations section 1.701-2(e).

FIRPTA provided a comprehensive definition of real property (land, buildings and other improvements, personal property associated with the use of real property, leaseholds, and certain options) and, separately, of “interests” in real property. Broadly, “interests” include any interest other than an interest solely as a creditor.<sup>26</sup> While many provisions of the Internal Revenue Code now turn on what is or is not real property, before FIRPTA there was much less guidance for purposes of determining the source of gain from a sale or disposition of real property;<sup>27</sup> and there was no authority for extending the definition for purposes of the source rules to options on real property or real property based rights or derivatives — that is, to “interests other than solely as a creditor” — or to personal property associated with the use of real property.

*B. Why Was FIRPTA Enacted?*

FIRPTA was preceded by a Congressionally-mandated study by the Treasury Department (hereafter, the “Treasury Study”) of the taxation of foreign investment in U.S. real estate, which in turn apparently grew out of Congressional concerns about increasing foreign ownership of U.S. agricultural or farm land.<sup>28</sup> While the Treasury Study found that foreign

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26. While the words “any other interest (other than an interest solely as a creditor)” are used in section 897 only with respect to a USRPHC, the regulations extend the “other than” rule to all interests in real property and to interests in partnerships, trusts and estates. Regs. § 1.897-1(d)(2)(i), (d)(3).

27. Section 861(a)(5) simply treated as U.S. source any gain derived from the disposition of “real property located in the United States,” without any further definition in the Code or regulations. *See* Regs. § 1.861-6; T.D. 6258, 1957-2 C.B. 368. The few authorities dealing with source looked to local law definitions of real property. *See* *Texas-Canadian Oil Corp. v. Commissioner*, 44 B.T.A. 913, 916–18 (1941) (accepting the IRS’ argument that Texas law determined whether oil and gas leases were real property and citing other cases that had invoked state law). There are now many other situations in which it is important to know what is or is not real property. These include the rules in section 856 with respect to REIT qualification, the rules in section 860G with respect to REMIC qualification, the like-kind exchange rules in section 1031, the exception to the publicly-traded partnership rules in section 7704(d), and the cost recovery rules of section 168.

28. UNITED STATES DEP’T OF THE TREASURY, TAXATION OF FOREIGN INV. IN U.S. REAL ESTATE (1979) [hereinafter TREASURY STUDY]. *See also* STAFF OF THE JOINT COMM. ON TAXATION, 96TH CONG., DESCRIPTION OF S. 192 AND S. 208 RELATING TO THE TAX TREATMENT OF FOREIGN INVESTMENT IN THE UNITED STATES (Comm. Print 1979), which largely repeats the Treasury Study. The Senate version of the Revenue Act of 1978 would have taxed gain from the sale of agricultural land. Because the House or Treasury had not considered this, the Conference Committee did not agree on that provision and only included a provision in the final bill that

ownership of U.S. farm land or other real property was not significant,<sup>29</sup> it also concluded that, while most foreign-owned real estate was used in a U.S. trade or business, “foreign persons rarely incur capital gains tax on the disposition of their U.S. property holdings,”<sup>30</sup> principally because of the use of a corporation to own the real property and the ability in such a case, before the 1986 repeal of the *General Utilities* doctrine,<sup>31</sup> to provide a stepped-up basis to a purchaser without gain to the seller. And it went on to suggest legislative solutions.

Starting with the Treasury Study’s premise that there should be parity between the tax treatment of gain of a foreign and U.S. person from the disposition of a business investment in U.S. real estate (or “horizontal” equity), since otherwise foreign investors had an unfair advantage,<sup>32</sup> there were two defects in the pre-FIRPTA rules. First, in the case of directly-owned real estate, current tax on rent was largely eliminated through deductions for interest, depreciation and like expenses but the end-of-the-day tax on the gain from the later sale or other disposition could be avoided by an installment sale in which most of the gain was deferred to years after the U.S. trade or business was terminated or by a tax-free like-kind exchange of U.S. for foreign real property. Second, in the case of real property held by a foreign or U.S. corporation, the corporation could likewise deduct current expenses and then could later sell the real property and liquidate without tax on the corporation or its shareholders (or its shares could be acquired and then it could be liquidated with the same result).<sup>33</sup> Additionally, a few U.S. tax treaties made the election to treat income from real estate as “effectively connected” an annual, rather than a one-time, election with the consequence that the election would only be made for years before the year in which the property was sold or disposed of.<sup>34</sup>

Hostility to foreign ownership of real estate may have played an important role in the enactment of FIRPTA, notwithstanding the conclusion of the Treasury Study that foreign investment in U.S. real estate was not

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required the Treasury Study. See Michael Knott, *FIRPTA Then And Now: A Selective Review*, PLI – The Corporate Tax Practice Series (2009).

29. It was less than one half of one percent of U.S. farmland. The legislation introduced by Senator Wallup in response to concerns about foreign ownership of agricultural land would have affected only agricultural land. TREASURY STUDY, *supra* note 28, at 47. See also *id.* at 65 Appendix C.

30. See *id.* at 1.

31. For a discussion of the *General Utilities* doctrine and its 1986 repeal, see BORIS I. BITTKER, JAMES S. EUSTICE & JOHN P. STEINES, JR., *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 8.21 (7th ed. 2012).

32. TREASURY STUDY, *supra* note 28, at 48–52 (setting out the perceived advantages).

33. *Id.* at 30–31, 46.

34. *Id.* at 31.

significant.<sup>35</sup> The stated Congressional objective, however, was not to deter or penalize foreign investment but simply to achieve parity, or “horizontal equity,” between the tax treatment of gain from the disposition of a business investment in real property by a U.S. person and by a foreign person. The concern was that foreign persons, while treating the income as effectively connected (and thus deducting expenses, such as depreciation and interest), escaped tax on the sale or other disposition of the investment.<sup>36</sup> Thus, the Report of the Committee on Finance says that “The Committee believes that it is essential to establish equity of tax treatment in U.S. real property between foreign and domestic investors,” and that the United States “should not continue to provide an inducement through the tax laws for foreign investments in U.S. real property which affords the foreign investor a number of mechanisms to minimize or eliminate his tax on income from the property while at the same time effectively exempting himself from U.S. tax on the gain realized on disposition of the property.”<sup>37</sup> It went on to identify “a number of planning techniques . . . [which] offer the opportunity to avoid tax on the capital gain which would result on the sale of . . . property” by a foreign person who treated the current income as effectively connected, and stated that the USRPHC rules were necessary because “[o]therwise, a foreign investor could, as under present law, avoid tax on the gain by . . . disposing of his interest in that entity rather than having the entity itself sell the real estate.”<sup>38</sup>

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35. See Kaplan, *Creeping Xenophobia*, *supra* note 3, at 1128 (“The clear intention of [FIRPTA], therefore, is not to eradicate inequities, but rather to discourage foreign investment in United States real estate. . . .[.] manifest[ing] a disturbing xenophobia that lacks any economic rationale or common sense foundation.”)

36. See William D. Metzger, *Foreign Investors Real Property Tax Act: Historical Perspective and Critical Evaluation*, 5 W. NEW ENG. L. REV. 161 (1982); Feder & Parker, *Foreign Investment*, *supra* note 24 (discussing the background to FIRPTA). See also *Repeal of the Foreign Investment in Real Property Tax Act: Hearing Before the Subcomm. on Energy and Agric. Taxation of the Comm. on Fin. United States Senate*, 98th Cong. 22-23 (1984) (statement of Senator Wallup on the purpose of FIRPTA).

37. S. REP. NO. 96-504, at 6 (1979). Like the Treasury Study, the Committee on Finance Report then listed (1) an installment sale in which most payments are received after the sale, and thus the end of the trade or business, occurs; (2) a like kind exchange of the U.S. real property for foreign real property; and (3) an investment made by a leveraged foreign corporation that is entitled to a reduced rate of withholding tax on dividends and interest and then, at the point of sale, used then section 337 or sold to a US corporation which then liquidated and stepped up the basis of the underlying real estate. *Id.* at 4-7.

38. *Id.* at 4, 6.

C. *How Did FIRPTA Respond To These Issues?*

The first two transactions that the Treasury Study and Congress identified were dealt with by amending the like kind exchange rules to specify that foreign real property is not of a like kind with U.S. real property<sup>39</sup> and by amending the “effectively connected” rules to specify that gain recognized in a year after a taxpayer ceases to have a U.S. trade or business with respect to an asset used in that business is nonetheless “effectively connected.”<sup>40</sup> The third was addressed by the FIRPTA rule that taxes dispositions of interests in USRPHCs. FIRPTA also provided for gain recognition in some situations not specifically identified by the Treasury Study or Congress but consistent with their overall approach — i.e., it provides that a foreign corporation will generally recognize gain on the distribution of an interest in USRP to a foreign shareholder<sup>41</sup> or on a capital contribution of an interest in USRP to a foreign corporation;<sup>42</sup> and it also provides more general rules for overriding non-recognition provisions of the Internal Revenue Code in cases where there would otherwise be an arguable avoidance of the FIRPTA tax.<sup>43</sup>

Under FIRPTA, an interest in a USRPHC is any interest in a U.S. corporation other than an interest “solely as a creditor” if at the time of disposition, or in the five preceding years, USRP interests were 50 percent or more in value of the sum of the corporation’s interests in real property, whether U.S. or foreign, and its assets used in a trade or business.<sup>44</sup> Interests “solely as a creditor” do not include obligations that share, directly or indirectly (e.g., through interest indexed to real property values), in the appreciation or income from real property.<sup>45</sup> The interests in real property of a U.S. corporation are determined by looking through partnerships and

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39. I.R.C. § 1031(h) (which also provides that personal property predominantly used within the United States is not of a like kind with personal property predominantly used outside the United States, and section 897(e) which denies nonrecognition of gain or loss for an exchange of an interest in USRP for property whose disposition would not be subject to tax)

40. I.R.C. § 864(c)(6)–(7).

41. I.R.C. § 897(d).

42. I.R.C. § 897(j).

43. I.R.C. § 897(e). There were a number of different legislative proposals before FIRPTA, with differences including enforcement by withholding as opposed to information reporting; a narrow focus on transactions identified as involving tax avoidance as opposed to a broader proposal to tax all gains from dispositions of USRPIS; and a proposal to tax sales of shares of foreign corporations investing in USRP as well as U.S. corporations. *See* Feder & Parker, *Foreign Investment*, *supra* note 24, at 547–49.

44. I.R.C. § 897(c)(1)(A)(ii), (c)(2).

45. Regs. § 1.897-1(d)(2).

“controlling interests” in lower-tier corporations and taking into account the corporation’s proportionate share of their assets.<sup>46</sup> There is a so-called “cleansing” rule that shuts down the five-year waiting period, but it is strictly limited since it is generally available only if all of the interests in USRP held by the corporation have been disposed of in transactions in which gain is recognized (or have ceased to be interests in USRP).<sup>47</sup> As an exception to the definition of an interest in USRP, an interest in USRP does not include shares of a class of stock of a USRPHC that is regularly traded on a securities market<sup>48</sup> if at the time of disposition the holder owns, and in the last five years, has owned no more than 5 percent of the class, directly or constructively.<sup>49</sup> In the case of a REIT or a RIC that is a USRPHC, there is a further exception if the REIT or RIC is “domestically controlled.”

The FIRPTA regulations relax the rules for determining whether a U.S. corporation is or is not a USRPHC, limiting the “determination dates” to the last day of the corporation’s taxable year and any date on which the corporation acquired an interest in USRP or disposed of an interest in the other assets taken into account in the calculation (i.e., interests in foreign real property or in business assets)<sup>50</sup> and establishing a rebuttable presumption that a corporation is not a USRPHC if on a determination date the book value of its interests in USRP is 25 percent or less of the book value of its interests in real property, whether U.S. or foreign, and its business assets.<sup>51</sup> The relaxations are helpful but hardly eliminate the pain of determining, in a case that is at all close, whether a corporation is or is not a USRPHC or possible foot faults (resulting, for example, from the sequence in which a U.S. corporation acquires “good” and “bad” assets); and the regulations do not meaningfully relax the five-year waiting period for dispositions of shares of corporations that are no longer USRPHCs.<sup>52</sup> The only relaxation of the cleansing rule is one that permits a corporation to be “cleansed” although it

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46. I.R.C. § 897(c)(4)–(5).

47. I.R.C. § 897(c)(1)(B). And thus is not available if the sales are on an installment basis unless the seller foregoes the benefit of installment sale reporting and recognizes all of the gain.

48. Regulations section 1.897-9T(d) set out when shares will be “regularly traded,” using different tests for trading in domestic and foreign markets.

49. I.R.C. § 897(c)(3). See Kimberly S. Blanchard, *FIRPTA in the 21st Century – Installment Two: The 5% Public Shareholder Exception*, 37 TAX MGM’T INT’L J. 44 (2008) [hereinafter Blanchard, *Installment Two*].

50. Regs. § 1.897-2(c)(1). Or alternatively, on a monthly basis with certain adjustments to the acquisition/disposition determination date rules. Regs. § 1.897-2(c)(3).

51. Regs. § 1.897-2(b)–(c).

52. Regs. § 1.897-2(f).

retains a lease on real property if the lease has no fair market value and is used in the conduct of a trade or business.<sup>53</sup>

Taking the pursuit of foreign investment in USRP further, FIRPTA provided that, subject to regulations, the nonrecognition provisions of the Internal Revenue Code would not apply to an exchange of an interest in USRP for other property unless a sale of the other property would be subject to U.S. tax.<sup>54</sup> As a consequence, for example, gain would be recognized on an exchange of shares of a USRPHC for shares of a U.S. corporation that is not a USRPHC or for shares of a foreign corporation, notwithstanding that the exchange would otherwise be tax free under section 351 or as part of a tax-free reorganization. The implementation of these rules is one of the most complicated parts of FIRPTA, requiring, first, an analysis of the Internal Revenue Code provisions generally relating to liquidations, reorganizations and other non-recognition transactions; and, then, an analysis of how those rules are affected by the separate FIRPTA rules.<sup>55</sup> Most of the guidance, both published and private, with respect to FIRPTA has been with respect to the impact of FIRPTA on the nonrecognition rules, often in cases where shares of a USRPHC are simply being moved around within a group of related corporations, the potential tax is not reduced, and the abuse, if any, is not apparent.<sup>56</sup> The override of the non-recognition provisions may also affect partnership transactions.<sup>57</sup>

The definition of real property in FIRPTA tracked to a large degree what U.S. tax treaties permitted the United States to treat as real property, although before FIRPTA that authority had not been fully exercised.<sup>58</sup> The

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53. Regs. § 1.897-2(f)(2).

54. I.R.C. § 897(e), which is sometimes referred to as the “hot-to-hot” requirement.

55. Regs. § 1.897-5T, -6T.

56. See David F. Levy, *Nonrecognition Transactions Involving FIRPTA Companies*, 2008 TNT 107-32 (June 3, 2008) [hereinafter Levy, *Nonrecognition Transactions*]; Jeffrey Farrell & Charles Cope, *The Application of § 304 to a Disposition of Shares in a U.S. Real Property Holding Corporation*, 38 TAX MGM'T INT'L J. 155 (2009).

57. See Regs. § 1.897-6T(a)(2)-(3) (for example, in the case of a section 721 contribution of an interest in USRP to a partnership for a partnership interest, limit the gain on the transferred that is not recognized to the amount that would be taxed on a disposition of the partnership interest received in the exchange).

58. E.g., United States Dep't of Treasury, United States Model Income and Capital Tax Convention, May 17, 1977, art. 6, ¶ 2 [hereinafter 1977 Model Treaty] which, while defining “immovable” or “real” property to “have the meaning which it has under the law of the Contracting State in which the property in question is situated,” said that “[t]he term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct[s] of immovable property and rights to variable or fixed payments as consideration for

definition obviously provides clarity, but the inclusion of options to acquire land or improvements or leaseholds on land or improvements is odd, since options are not ordinarily viewed as ownership; and the inclusion in an “interest” of any interest other than an interest solely as a creditor (which obviously duplicates the inclusion of options) took the potential scope of FIRPTA far beyond what had been the rule before.

D. *FIRPTA and Income Tax Treaties*

FIRPTA diverged sharply from existing U.S. law, including from U.S. tax treaties. Treaties commonly exempted gain of a resident of one state from the sale of shares of a corporation resident in the other state from tax by the state of the corporation’s residence.<sup>59</sup> The exemption was in both the U.S. and the OECD model treaties.<sup>60</sup> The Treasury Study noted that taxing foreign investors on gain from the disposition of directly-held real property was consistent with international standards (and, indeed, that the pre-FIRPTA exemption for non-effectively connected gain from the disposition of real property was “unusual by international standards.”)<sup>61</sup> It also stated, however, that taxing a foreign person on gain on the sale of shares of a U.S. corporation “would not be justified by general international practice and would, in fact, run contrary to U.S. tax treaties.”<sup>62</sup>

Congress nonetheless proceeded to override tax treaties that would otherwise have barred the taxation of sales by foreign persons of shares of a USRPHC. Picking up on a suggestion in the Treasury Study,<sup>63</sup> however,

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the working of, or the right to work, mineral deposits, sources and other natural resources . . .” and also that the right to tax income derived from immovable property “shall apply to income derived from the direct use, letting, or use in any other form” of the property.

59. *E.g.*, Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, Sept. 26, 1980; Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Dec. 18, 1992. And the extension of the tax to options and other non-ownership “interests” in real property might also be viewed as inconsistent with treaty obligations.

60. *E.g.*, 1977 Model Treaty, *supra* note 58, at art. 13, ¶ 4; Organization for Economic Co-operation and Development, Model Tax Convention on Income and on Capital, art. 13, ¶ 4 (Apr. 11, 1977).

61. TREASURY STUDY, *supra* note 28, at 52

62. *Id.* at 52–53.

63. *Id.* at 54 (“[T]here should be considerably less international objection to a prospective override of . . . treaties, coupled with a sufficient time lag so that reciprocal international agreements on limited taxation of shares can be negotiated.”).



FIRPTA sought to mitigate the treaty override by deferring for some four plus years the effective date of FIRPTA in a case where taxing gain from the sale of shares in a USRPHC would be inconsistent with a treaty and by allowing treaties renegotiated during the four year window to defer the effective date for a further two years.<sup>64</sup> FIRPTA's treaty override was nonetheless criticized by the subsequent OECD report on treaty overrides.<sup>65</sup>

The treatment of foreign corporations under FIRPTA (for example, the recognition of gain by a foreign corporation that distributed an interest in USRP to a shareholder), because it did not conform to the treatment of U.S. corporations, could also be seen as violating the general anti-discrimination of provisions of U.S. tax treaties.<sup>66</sup> FIRPTA addressed this by allowing a foreign corporation to elect to be a U.S. corporation.<sup>67</sup> It thus provided that in such a case (that is, where "the foreign corporation is entitled to nondiscriminatory treatment with respect to" an interest in the USRP) the corporation could elect to be a U.S. corporation (and thus waive treaty protection) and that this would be "the exclusive remedy" for any corporation asserting discrimination.<sup>68</sup>

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64. Omnibus Reconciliation Act of 1980, Pub. L. No. 96-499, § 1125(c), 94 Stat. 2599 (1980) (which in effect deferred to the treaty override from June 18, 1980 to December 31, 1984).

65. See OECD Committee on Fiscal Affairs, *Report on Tax Treaty Overrides*, 2 TAX NOTES INT'L 25 (Jan. 1, 1990); Reuven Avi-Yonah, *Tax Treaty Overrides: A Qualified Defense of U.S. Practice*, in TAX TREATIES AND DOMESTIC LAW, 65-80 (Guglielmo Maisto ed., 2006). The OECD Model treaty was revised in 2003 to permit the taxation of gain of a resident of one state from the disposition of shares of a corporation of the other state if 50 percent or more in value of the corporation was attributable to immovable property. Organization for Economic Cooperation and Development, Model Tax Convention on Income and on Capital, art. 13, ¶ 4 (Jan. 1, 2003)

66. E.g., 1977 Model Treaty, *supra* note 58, at art. 24, ¶ 1 (which provides that "[n]ationals of a Contracting State shall not be subjected in the other State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.").

67. I.R.C. § 897(i).

68. I.R.C. § 897(i)(1), (4).

E. *FIRPTA and “Pass-Throughs”*

Apart from a direct investment or an investment in shares of a “regular” U.S. corporation (that is, one subject to Subchapter C and not Subchapter M) that invests in USRP, a foreign person may invest in USRP as a partner in a partnership that makes the investment, as shareholder of a REIT that invests in USRPs, a shareholder of a RIC that invests in shares of REITs, or as the owner of an interest in a “fixed investment trust” that holds interests in USRP.

How did FIRPTA affect these investments in USRP? Before FIRPTA, there was no tax on gain from the sale of shares of a U.S. corporation, whether it was a USRPHC or not; but it was unclear whether this was so in the case of an interest in a partnership.<sup>69</sup> FIRPTA created inconsistencies in the treatment of gain from sales of shares. On the one hand, the FIRPTA exemption for sales of interests in publicly-traded entities by a foreign investor who owns 5 percent or less of the publicly-traded interests applies to publicly-traded fixed investment trusts, partnerships and corporations, including REITs, and RICs. On the other hand, the exception for shares of an entity that is “domestically controlled” is available only for shares of a REIT and shares of a RIC that is a USRPHC, and the exemption from FIRPTA for distributions of gain from sales of interests in USRP is available to 5 percent of smaller holders of a class of publicly-traded shares of a REIT or a RIC that is a USRPHC but not for partners in a publicly-traded partnership.

The rules for fixed investment trusts, partnerships, REITs, and RICs are discussed further below.

1. *Fixed Investment Trusts*

There are a meaningful number of publicly-traded trusts that own royalties (typically, overriding royalties measured by net profits) on oil and gas and other minerals in the United States.<sup>70</sup> These are “fixed investment,”

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69. See Leblang, Rothman & Paulos, *Rationalizing*, *supra* note 25, at 696 n.25.

70. Oil and gas royalty trusts include BP Prudhoe Bay Royalty Trust, Cross Timbers Royalty Trust, Dominion Resources Black Warrior Trust, Easter American Natural Gas Trust, Hugoton Royalty Trust, Marine Petroleum Trust, Mesa Royalty Trust, MV Oil Trust, Panhandle Royalty Trust, Permian Basin Royalty Trust, Sabine Royalty Trust, Sandridge Mississippian Royalty Trust, San Juan Basin Royalty Trust, Tidelands Royalty Trust, and Torch Energy Royalty Trust. There are also trusts that hold royalties on other minerals, including Mesabi Trust, Great Northern Iron Ore Trust, Penn Virginia Resources and Williams Coal Seam Gas Royalty Trust.

and therefore “grantor,” trusts.<sup>71</sup> As a consequence, a unit holder is treated as directly owning the unit holder’s share of the trust’s assets and deriving directly the unit holder’s share of trust income and expense. A foreign unit holder would not be engaged in a trade or business in the U.S. on account of such an investment — the trust assets are “fixed” and the trustee has no power to vary the assets — and the royalty income would therefore be subject to withholding tax at a 30 percent rate unless the holder elected under the Internal Revenue Code or a treaty to treat the income as “effectively connected” so that expenses, such as cost depletion, were deductible. Whether or not an election is made, however, gain on the disposition of the interest would ordinarily be taxed under FIRPTA as “effectively connected” income.

If any class of interests in the trust is regularly traded on an established securities market, however, the FIRPTA regulations provide, as they do in the case of publicly-traded partnerships, that for FIRPTA purposes the trust is a corporation.<sup>72</sup> As a consequence, under the publicly-traded shares exception that applies to sales of shares of corporations, there is no tax on gain from a sale or other disposition of an interest in the trust by a person who owned 5 percent or less of the publicly traded class at the time of sale or in the preceding five years, directly or constructively; but, in the case of a more than 5 percent owner, the trust would have to determine whether it would, as a notional corporation, be a USRPHC or not and, if it is, the entire gain of the unit holder would be treated as gain from the disposition of an interest in USRP and subject to tax. An acquisition from a foreign person of a publicly-traded interest in a publicly-traded trust is generally not subject to withholding.<sup>73</sup>

## 2. Partnerships

Whether a partnership is U.S. or foreign or the partner is a general or limited partner, a foreign partner is engaged in a trade or business in the

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71. Fixed investment trusts are classified as grantor trusts. Regs. § 1.671-2(e)(3). Qualification as a fixed investment trust requires that the trust have a single class of ownership interests and that there be no power under the trust agreement to vary the investment of the certificate holders. Regs. § 301.7701-4(c)(1). Because of the no power to vary requirement, the assets of the trust must be “passive” (e.g., royalties or securities) and cash receipts must be periodically distributed to the certificate holders (since owning operating assets would mean there was a power to vary the investment by making operating decisions and the retention of cash would likewise vary the assets).

72. Regs. § 1.897-1(c)(2)(iv).

73. Regs. § 1.1445-2(c)(2), but cross-referencing reserved regulations in Regs. § 1.897-1(c)(2)(iii)(B).

United States if the partnership is so engaged.<sup>74</sup> That would normally be the case if the partnership has significant activities in the United States. The foreign partner would as a consequence be currently taxed on the partner's distributive share of the income or gain of the partnership, including gain from the disposition of interests in USRP or other assets of the U.S. trade or business.

If the partnership is not publicly traded, the tax on the foreign partner's shares of partnership income or gain is collected from the partnership, i.e., by requiring the partnership to withhold on the income at the highest rate applicable to the partner (individual or corporate, as the case may be), and pay over the tax withheld on a quarterly basis during the year that the income is earned and whether or not it is distributed.<sup>75</sup> Gain of a partner in a non-publicly traded partnership from a sale or other disposition of the partner's interest in the partnership would also be subject to tax to the extent attributable to interests in USRP<sup>76</sup> or assets of a U.S. trade or business. For purposes of the withholding tax, an interest in a partnership that is not publicly traded is treated in its entirety as an interest in USRP if 50 percent or more of the value of the gross assets of the partnership are interests in USRP and 90 percent or more of the value of its assets are interests in USRP and cash or cash equivalents.<sup>77</sup> The person acquiring the interest is required to withhold 10 percent of the amount realized by the transferring partner.

Different rules apply to publicly-traded partnerships.<sup>78</sup> The foreign partner's share of the income or gain of a publicly-traded partnership is

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74. Likewise, the partner would have a permanent establishment in the United States if the partnership had a permanent establishment there. *See Unger v. Commissioner*, 936 F.2d 1316 (D.C. Cir. 1991); *Donroy v. United States*, 301 F.2d 200 (9th Cir. 1962). Under section 871(a), the same rule applies to foreign beneficiaries of a trust. *See Portanova v. United States*, 690 F.2d 169 (Ct. Cl. 1982).

75. Regs. § 1.1446-3. Under the specific circumstances set out in Regulations section 1.1446-6, losses and deductions of the partner that are effectively connected with a U.S. business may be taken into account by the partnership in determining the amount to be withheld.

76. I.R.C. § 897(g).

77. Regs. § 1.897-7T(a).

78. A publicly-traded partnership is classified as a partnership, and not as an "association," only if it meets the "good" gross income test of section 7704 for each year in which it is publicly traded. I.R.C. § 7704(c). The Credit Suisse Equity Research, reports that there are now about ninety "traditional" publicly-traded partnerships (and more if those traded over the counter or otherwise not on a public exchange are included) with an aggregate market capitalization of more than \$220 billion. *See Credit Suisse Equity Research, CS MLP Primer – Part Deux* (Nov. 23, 2011), [http://www.naptp.org/documentlinks/Investor\\_Relations/CS\\_MLP\\_Primer-Part\\_Deux.pdf](http://www.naptp.org/documentlinks/Investor_Relations/CS_MLP_Primer-Part_Deux.pdf). These consist generally of publicly-traded partnerships in the oil and gas, other natural resources, pipeline, fuel distribution and marine transportation businesses. The National Association of Publicly Traded Partnerships represents the

subject to withholding tax only when distributed, again at the highest applicable rate.<sup>79</sup> In addition, in the case of a sale or other disposition of a partnership interest, the regulations treat a publicly-traded partnership as a U.S. corporation for FIRPTA purposes.<sup>80</sup> As a consequence, under the rule that applies to publicly-traded corporations, there is no tax on gain from the sale of a 5 percent or smaller interest in a class of publicly-traded interests, but a more than 5 percent interest in the partnership would be treated in its entirety as an interest in USRP if the notional corporation was a USRPHC.<sup>81</sup> The 5 percent or less exception is important because many if not most publicly-traded partnerships invest heavily in assets that are interests in USRP, such as mineral properties or “inherently permanent” structures, such as pipelines, storage facilities and the like.<sup>82</sup>

The exception for sales of interests in publicly-traded partnerships does not eliminate the need for a 5 percent or smaller partner to file on the basis that the partner is engaged in a U.S. trade or business or eliminate U.S. tax on the partner’s share of partnership income, including gain from the disposition of interests in USRP.<sup>83</sup>

The FIRPTA rules that turn off non-recognition provisions of the Code that might otherwise eliminate or dilute the FIRPTA tax apply to partnership non-recognition provisions such as sections 721 and 731.<sup>84</sup> It is not clear, however, that the turn off will always be successful in the case of a privately-held partnership.<sup>85</sup>

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“traditional” publicly-traded partnerships in lobbying matters, and its membership does not include the more recent publicly-traded partnerships in the investing and asset management businesses, such as Fortress Investment Group LLC, Apollo Global Management LLC, The Blackstone Group L.P., KKR Financial Holdings LLC, or Och-Ziff Capital Management Group LLC. *PTPs Currently Traded on U.S. Exchanges*, NATIONAL ASSOCIATION OF PUBLICLY TRADED PARTNERSHIPS, <http://www.naptp.org/PTP101/CurrentPTPs.htm> (last visited Feb. 5, 2013).

79. Regs. § 1.1446-4.

80. Regs. § 1.897-1(c)(2)(iv).

81. Regs. § 1.897-1(c)(2)(iv), Example.

82. See *infra* note 131.

83. The notional U.S. corporation rule seemingly applies whether the partnership is U.S. or foreign, and taxes the holder of a non-publicly traded interest in the partnership as a holder of a USRPHC if the partnership would be a USRPHC. See Kimberly S. Blanchard, *FIRPTA in the 21st Century, Installment Three: FIRPTA and Foreign PTPs*, 37 TAX MGM’T INT’L J. 176 (2008) (for criticism of the rule).

84. Temp. Regs. § 1.897-6T(a)(2).

85. The override of section 721, for example, addresses the transfer of an interest in USRP that has a built-in gain to a partnership that holds foreign real property or other assets whose disposition would not be effectively connected with a U.S. trade or business, but it would not effectively deal with a case in which the partnership held appreciated interests in USRP and then issued partnership interests

### 3. REITs

A U.S. corporation that meets certain income, asset, ownership, and dividend distribution requirements may elect to be a REIT.<sup>86</sup> If the election is made, the REIT may deduct dividends to shareholders; and, since REITs generally distribute all ordinary income and capital gain,<sup>87</sup> they generally pay no entity-level tax.<sup>88</sup> The original concept of the REIT rules, when enacted in 1960, was that REITs would be essentially passive investors in portfolios of real estate and/or in mortgages secured by real property.

Distributions by a REIT to a foreign shareholder that are not distributions of gain from a sale or other disposition of interests in USRP are, to the extent out of earnings and profits, subject to the 30 percent withholding tax that applies to dividends paid by any U.S. corporation. Under the distribution “look through” rule of section 897(h)(1), distributions of gain from a sale or other disposition of an interest in USRP are treated as gain from a disposition by the shareholder and thus are generally subject to tax as effectively connected income (regardless of whether or not the REIT is a USRPHC or the gain is capital gain). This is subject to an exception for distributions paid on a class of shares that is regularly traded on an established securities market in the United States to a foreign shareholder that owns 5 percent or less of the class.<sup>89</sup> Although exempt from FIRPTA, the distribution would be subject to withholding tax as a regular dividend to the extent out of earnings and profits.<sup>90</sup> A “wash sale” rule targets sales or

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in exchange for foreign real property or other assets whose disposition would not be effectively connected with a U.S. trade or business.

86. See generally Robert J. Staffaroni, *Foreign Investors in RICs and REITs*, 56 TAX LAW. 511 (2003) [hereinafter Staffaroni, *Foreign Investors*].

87. Capital gain of the REIT, whether or not distributed as a dividend, is taxed to a shareholder as though realized by the shareholder. If distributed, the tax is on the shareholder (under section 857(b)(3)(B), which provides that “[a] capital gain dividend shall be treated by the shareholders . . . as a gain from the sale or exchange of a capital asset held for more than 1 year”); and, if retained, the tax is paid by the REIT (under section 857(b)(3)(D)), but the shareholders are entitled to refundable credits for the tax and an adjustment to the basis for their shares in the REIT for the after-tax gain recognized by the REIT.

88. REITs may have taxable REIT subsidiaries (which, as the name implies, are taxed on their income), and there are also a series of taxes that may be imposed on specific transactions or items of income (e.g., on income from foreclosure property). While a REIT need not distribute capital gain and may also retain 10 percent of its real estate investment company taxable income, in practice REITs distribute all real estate investment company taxable income and capital gain.

89. I.R.C. § 897(h)(1).

90. I.R.C. § 857(b)(3)(F). In the case of a RIC, see section 852(b)(3)(D). Section 897(h) provides that a distribution of an interest in USRP by a domestically-controlled REIT or RIC to its shareholders will result in the recognition of gain to

other dispositions of REIT shares in anticipation of distributions of gain from the REIT's disposition of an interest in USRP.<sup>91</sup>

Equity (as opposed to mortgage) REITs would ordinarily be USRPHCs because they primarily invest in interests in USRP. As a consequence, gain from a sale by a foreign shareholder of shares of the REIT would generally be taxable under FIRPTA. There are, however, two exceptions to this rule.

First, shares of a REIT that is a USRPHC may be covered by the rule that applies to any U.S. corporation (and also, under regulations, to publicly-traded partnerships and fixed investment trusts) and excludes from the definition of an interest in a USRPHC shares of a class that is regularly traded on a securities market if the holder owns, and in the last five years has owned, no more than 5 percent of the class, directly or constructively.<sup>92</sup>

Second, the statute also provides a separate exception for dispositions of shares of a domestically-controlled REIT, defined for this purpose as a REIT that was for the five years preceding the sale owned to the extent of more than 50 percent in value by U.S. persons. The domestically-controlled exception is available only to REITs and RICs that are USRPHCs. No constructive ownership rules apply for this purpose, which is odd, given that they do for purposes of the exception for a 5 percent or smaller holder of shares of a class that is publicly traded; and so the more than 50 percent owned by U.S. persons might, for example, be owned by a subsidiary of the foreign corporation that directly owned the less than 50 percent interest.<sup>93</sup> While the statute says that the domestically-controlled test is whether foreign persons "held (directly or indirectly)" 50 percent or more during the five-year period, it looks only at the actual owner, and under the regulations this

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the extent of the "foreign ownership percentage" of the REIT or RIC. It is not clear what this provision accomplishes, given the subsequent enactment of section 311(b).

91. Under the wash sale rule in section 897(h)(5), gain from the sale of shares of a REIT or RIC during the thirty-day period preceding the ex-dividend date for a distribution that would in whole or in part be treated as a sale or exchange of an interest in USRP by the shareholder is treated as gain from the sale of a USRPI to the extent of the amount of the distribution that would be so treated if the shareholder acquires or enters into a contract or option to acquire a substantially identical interest in the entity during the sixty-one-day period beginning on the first day of the thirty-day period. Similar rules apply to substitute dividend or similar payments.

92. I.R.C. § 897(c)(3). See Blanchard, *Installment Two*, *supra* note 49.

93. See PLR 200923001 (Feb. 26, 2009). See also Seth J. Entin, *IRS Provides Important Guidance for Inbound Investments in REITs*, 129 TAX NOTES 215–22 (Oct. 11, 2010).

is the person who is required to include dividends on the shares in gross income.<sup>94</sup>

The exception for domestically-controlled REITs allows a foreign investor to structure investments in U.S. real estate that in effect permit it to elect out of almost half of the FIRPTA tax that would otherwise be due on a sale of its entire interest. Changes in the regulations that define what is “portfolio interest” in the case of a partnership, and therefore exempt from withholding tax, exacerbate the distortions from the rule that applies to domestically-controlled REITs.<sup>95</sup> For example, suppose a foreign entity forms a REIT, or several REITs, to invest in U.S. real estate and elects to be a partnership, and then the REIT (or REITs) borrows from the partnership. Although the REIT is (or the REITs are) directly or indirectly wholly owned by the foreign entity, the interest paid by the REIT (or REITs) will be exempt from withholding tax as portfolio interest so long as there is no 10 percent or greater partner in the partnership (if there is, the interest paid by the REIT will be subject to withholding tax only in respect of such a partner’s share of the interest).<sup>96</sup> Measuring ownership at the partner level makes no sense if the purpose of the exclusion from portfolio interest of interest paid to 10 percent or greater owners was to exclude interest in cases where the debtor held sufficient equity to affect the terms of the debt.

The distribution look through rule in section 897(h)(1) treats distributions of gain by a REIT as recognized by the shareholders to the extent attributable to gains of the REIT from sales or other dispositions of interests in USRP. How this rule should be interpreted in the case of a

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94. Regs. § 1.897-1(c)(1)(ii), (c)(2)(i) (referring to the “actual owners of stock,” as determined under Regs. § 1.857-8, which in turn defines the actual owner as the person required to include dividends in income). Some believe this is unclear in the case of shares held by a REIT or RIC, suggesting that the shareholders of the REIT or RIC might also be regarded as owners because they will take the income into account when it is distributed by the REIT or RIC. See Levy, *Nonrecognition Transactions*, *supra* note 56.

95. Portfolio interest, which is exempt from U.S. withholding tax, is defined by sections 871(h) and 881(c) to exclude interest received by a 10 percent or greater shareholder.

96. Under Regulations section 1.871-14(g)(3), the determination of whether the interest is portfolio interest, and therefore exempt from withholding tax, is made on a look through basis, i.e., at the partner level. Interest is thus portfolio interest to any partner who, looking through the partnership, is not a 10 percent or greater shareholder of the REIT. The REIT’s deduction for interest would be subject to the earnings stripping limitation in section 163(j), but the benchmark (“adjusted taxable income”) adds all depreciation back to taxable income; and taxable income would, unlike REIT taxable income, not be reduced by dividends. The portfolio interest rule is, of course, not limited to REITs, although in practice that may be the most common application.



liquidation or a redemption is a source of disagreement.<sup>97</sup> Some REITs took the view, apparently bolstered by a private letter ruling which was later withdrawn,<sup>98</sup> that section 897(h)(1) did not apply to a distribution of gain in the complete liquidation of a REIT, since that was a sale or exchange of the REIT shares; and, therefore, if the REIT was domestically controlled, a foreign shareholder recognized no taxable gain from the liquidating distribution. The theory, if correct, would also extend to a distribution in redemption of shares of a foreign shareholder by a domestically-controlled REIT if the redemption was treated as a sale or exchange by the shareholder. And a foreign shareholder of a REIT that was not domestically controlled might take the view that the liquidation of a REIT did not result in tax because of the “cleansing exception” that excludes from the definition of USRPHC a U.S. corporation which no longer owns interests in USRP and has disposed of all of the interests that it did own in gain recognition transactions.

In Notice 2007-55, the IRS disagreed with the view that the section 897(h)(1) look through does not apply to liquidating distributions and said that it applied to any distribution, whether as a dividend, in redemption of shares or in complete liquidation.<sup>99</sup> The Notice promised that regulations would be issued, retroactive to the date the Notice was issued, which would apply section 897(h)(1) to distributions to a foreign shareholder in a complete liquidation or in a redemption that is treated by the shareholder as a sale or exchange.

The Notice was limited to distributions in the liquidation of, or in the redemption of shares of, a domestically-controlled REIT and did not address liquidating distributions to, or a redemption of shares of, a shareholder holding a 5 percent or smaller interest in a regularly traded class of shares. The IRS subsequently concluded that such a redemption or distribution

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97. There are also other interpretive issues, such as (1) whether it is limited to capital gain distributions, (2) whether distributions of capital gain previously taxed to the REIT are covered, (3) whether losses are netted against gains of the REIT in determining what is taxed, and (4) how to determine what part of a distribution is attributable to gains from the disposition of interests in USRP when the REIT has other capital gains that are not attributable and less than all the gains are distributed. See Elaine Platt, *Using U.S. REITs in Cross-Border Transactions*, 31 TAX NOTES INT’L 147–57 (July 14, 2003) [hereinafter Platt, *Cross-Border Transactions*]; see also, Stanley L. Blend, *ABA Members Comment on Guidance Addressing Distributions Between Foreign Governments, REITs*, 2008 TNT 114-23 (June 12, 2008) [hereinafter Blend, *ABA Members Comment*].

98. PLR 9016021 (Jan. 18, 1990) (dealing with the liquidating distributions of a foreign-controlled REIT that was largely owned by two foreign pension trusts, and was withdrawn by PLR 200453008 (Sept. 27, 2004)).

99. 2007-2 C.B. 13. More precisely, the Notice applies to any distribution covered by sections 301, 302, 332 or 332.

would not be subject to tax<sup>100</sup> because of the exclusion from the section 897(h) distribution look through rule for distributions of gain to a holder of a 5 percent or smaller interest and because it was a sale or exchange by the shareholder and not a dividend.<sup>101</sup>

The Notice has been criticized by the National Association of Real Estate Investment Trusts, the ABA Section on Taxation, and others,<sup>102</sup> largely on the basis that it misinterprets the words of the statute (specifically, what is a “distribution”) or does not conform the treatment of distributions to shareholders to the exemption provided for sales of shares of a domestically-controlled REIT. None seem to suggest that the result is bad tax policy and, indeed, it is hard to see how a persuasive policy argument can be made for exempting the distributions targeted by the Notice from tax if the starting point is a comparison with the treatment of direct investment or investment through a partnership.<sup>103</sup> If gain from an investment in USRP that is made directly or through a partnership is taxed, why should the result differ for an investment in a REIT? The only argument seems to be that a REIT is just different.<sup>104</sup>

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100. See I.R.S. Advice Memorandum 2008-03 (Feb. 15, 2008) (dealing with a complete liquidation under section 331).

101. See, e.g., I.R.C. §§ 857(b)(3)(F), 852(b)(3)(D) (treating capital gain distributions by a REIT or RIC to a shareholder eligible for the 5 percent or smaller interest in regularly traded shares as ordinary dividends).

102. E.g., Jeffrey D. DeBoer, *Real Estate Group Seeks Withdrawal of Guidance on Treatment of Some Liquidating Distributions*, 2012 TNT 114-13 (June 13, 2012).

103. Separately, Notice 2007-55 concluded that, if a foreign government was a shareholder, section 892 did not exempt gain from a liquidating distribution from the tax that would result from applying section 897(h)(1) to the distribution. This too provoked dissent. See, e.g., Benita Warmbold, *Canada’s Pension Investment Board Comments on Guidance on Distributions Between Foreign Governments, REITs*, 2008 TNT 215-10 (Nov. 5, 2008); Ng Kok Song, *Investment Company Criticizes Guidance Addressing Distributions Between Foreign Governments, REITs*, 2008 TNT 161-15 (Aug. 19, 2008); Roger Robineau, *Canadian Pension Association Criticizes Guidance on Distributions Between Foreign Governments, REITs*, 2008 TNT 248-20 (Dec. 24, 2008).

104. See Kimberly S. Blanchard, *Is There a FIRPTA Tax on REIT Distributions*, 112 TAX NOTES 1071, 1072 (Sept. 18, 2006) (arguing that “[a] REIT is not a partnership or passthrough entity. It is a corporation and thus a character converter, in the sense that regardless of the type of income it earns, its distributions are treated as corporate distributions . . . .”); Kimberly S. Blanchard, *Notice 2007-55 Rules Liquidating Distributions from REITs Are Taxable Under § 897(h)(1)*, 36 TAX MGM’T INT’L J. 381, 381 (2007) (saying the Notice is “clearly incorrect . . . and should be withdrawn”); Robert Hanson, *Ernst & Young, Seeks Withdrawal of Guidance on Forthcoming Regs on Distributions Between Foreign Governments, REITs*, 2007 TNT 225-11 (Nov. 21, 2007) (urging withdrawal of Notice 2007-55).

Comments on the Notice pointed out that, unless the Notice was correct (and wholly apart from distributions in a liquidation or redemption of shares of a domestically-controlled REIT), foreign shareholders of a foreign-controlled REIT could arguably avoid FIRPTA under the “cleansing” rule if the REIT disposed of all of its interests in USRP in gain recognition transactions and there was then a complete liquidation of the REIT. Even critics of the Notice thought that result went too far.<sup>105</sup>

#### 4. RICs

A U.S. corporation may elect to be a RIC if it is registered under the Investment Company Act of 1940 (‘40 Act) as a management company or unit investment trust<sup>106</sup> and it meets certain income, assets and dividend distribution tests. A RIC may deduct dividends to shareholders and pass through to shareholders capital gains and certain other items.<sup>107</sup> Like REITs, RICs generally pay no tax on their income or gains because of the deduction allowed for dividends paid to shareholders.

Some RICs — so-called “mutual funds for real estate,” although there are also closed-end and exchange traded funds that make the same investments — invest significantly in shares of REITs,<sup>108</sup> and as a consequence may be USRPHCs if 50 percent or more of their assets are interests in USRP (determined without regard to the exclusions for shares of domestically-controlled REIT or publicly-traded shares of a REIT held by a 5 percent or smaller shareholder).<sup>109</sup>

In 2004, the distribution look through rule that applies the FIRPTA tax to distributions of gain realized by a REIT from the disposition of interests in USRP, the exception to that rule for distributions to 5 percent or

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105. See Blend, *ABA Members Comment*, *supra* note 97 (describing this as “a clear loophole” and recommending that Notice 2007-55 be limited to this case or that the Treasury seek a legislative remedy); Tony Edwards, *NAREIT Recommends Topics for IRS’s Guidance Priority List*, 2012 TNT 95-23 (May 16, 2012) (expressing the view that “Notice 2007-55 should be reversed except” in the cleansing exception case identified by the ABA Section on Taxation, and arguing that in other cases there should be no FIRPTA tax on distributions on shares that could be disposed of without tax because of the domestically-controlled exception).

106. Or as a business development company. Certain common trust or similar funds may also qualify. I.R.C. § 851(a)(1).

107. See generally Staffaroni, *Foreign Investors*, *supra* note 86. Other pass through items are “qualified” dividend income, the foreign tax credit, the dividends received deduction, tax-exempt interest and, in the case of foreign shareholders, before the end of 2011, short term capital gain and interest income.

108. See *List of REIT Funds*, REIT.COM, <http://www.reit.com/Investing/ListofREITFunds.aspx> (last visited Feb. 3, 2013).

109. See I.R.C. § 897(h)(4)(A)(i)(II).

smaller holders of a class of publicly traded shares, and the exception from FIRPTA for sales of shares of a domestically-controlled REIT were extended to RICs that were USRPHCs (with REITs and RICs then being included in the definition of a “qualified investment entity”).<sup>110</sup> The wash sale rule was also extended to RIC shares.<sup>111</sup>

A '40 Act registered investment company that invests in shares of REITs may sometimes qualify as a RIC or a REIT at its election, but all (or most) elect to be RICs. There are tax differences: among others, securities other than shares of a REIT would be “good” assets for a RIC but not for a REIT (unless they are mortgages secured by real property); withholding on RIC dividends paid to foreign investors is generally reduced from 30 percent to 15 percent by treaty, without the treaty restrictions that apply to the withholding tax reduction on REIT dividends; and short-term capital gain and interest related dividends of a RIC are exempt from withholding tax altogether.<sup>112</sup>

*F. Do the Rules That Apply to Business Intermediaries Make Sense?*

Under FIRPTA, there are significant differences between investments by foreign persons in USRP that are made directly, through a fixed investment trust, or through a partnership and those that are made through a REIT or a RIC. There is, for example, no domestically-controlled exception for fixed investment trusts or partnerships and no exemption for a partner's share of the partnership's gain from the disposition of an interest in USRP if the partner owns 5 percent or less of a class of publicly-traded interests. Gain from sales of shares in a USRPHC is excluded from the branch profits tax, but gain from the sale of an interest in a partnership or trust that holds interests in USRP is not.<sup>113</sup> Direct investors and partners in partnerships must file returns, notwithstanding that the income of the partner that is effectively connected with the partnership's business is subject to withholding tax.<sup>114</sup>

Are these differences the result of a thoughtful process or simply an inadvertent by-product of legislative changes? The RIC provisions were enacted in 1936, and the REIT provisions followed in 1960. Investors in REITs plainly benefitted from the exclusion from the definition of a USRPHC of a domestically-controlled REIT and later benefitted from the exclusion of distributions to 5 percent or smaller holders of shares of a

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110. *See* I.R.C. § 897(h)(4).

111. *See* I.R.C. § 897(h)(5).

112. I.R.C. §§ 871(k), 881(e).

113. I.R.C. § 884(d)(2)(C).

114. Under either section 1445 or 1446.

publicly traded class of shares of gain of a REIT from the disposition of interests in USRPs. But those amendments came much later, in 1980 and 2004, and there is no reason to conclude that foreign investment was a focus when the basic REIT rules were enacted in 1960 and that there was a Congressional consensus that foreign investment in REITs should be given preferential treatment. Likewise, the rules that treat foreign partners in partnerships as engaged in a business in the United States if the partnership is so engaged came in long before there were publicly-traded or even widely-held partnerships and before the enactment of the rules in section 1446 (as well as section 1445) that require partnerships to withhold on foreign partner's share of effectively connected income. Given the withholding tax rules (which are in effect an entity level tax), is it necessary to treat foreign partners as engaged in a trade or business in the United States? U.S. income tax could be made simpler if there was a top-to-bottom reevaluation of the rules that apply to entities such as REITs and publicly-traded partnerships; but short of that, there should at least be an effort to limit the distortions that result from the rules.

### III. REPEALING THE FIRPTA RULES

With the benefit of hindsight, are the FIRPTA rules with respect to USRPHCs sensible? The arguments used to justify the USRPHC rules made no sense then and certainly do not after the repeal of the *General Utilities* doctrine<sup>115</sup> and other statutory changes since 1980.<sup>116</sup> All that the USRPHC rules in FIRPTA do now is to accelerate the tax due on the disposition of an interest in USRP, and, contrary to the purpose of FIRPTA, which was to ensure one tax, possibly result in double taxation — once to the shareholder and again to the corporation.<sup>117</sup> That creates an obvious disparity between the possible double tax on an investment made through a U.S. corporation and one made through a foreign corporation, in which case there is only the tax upon a sale by the entity. And repeal would not cost that much.<sup>118</sup>

The argument that the USRPHC rules were needed to achieve “horizontal equity” between U.S. and foreign business investment in real

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115. See *supra* note 31.

116. See generally Cynthia Blum, *How The United States Should Tax Foreign Shareholders*, 7 VA. TAX REV. 583 (1988); Alan L. Feld, *Is FIRPTA (Partially) Obsolete?*, 35 TAX NOTES 607 (May 11, 1987); Kaplan, *Creeping Xenophobia*, *supra* note 3.

117. That one tax was the purpose of the USRPHC rules seems clear, not only from the legislative history, but also from the “cleansing” exception and from the exceptions from gain recognition where basis was preserved and the ownership remained unchanged. See I.R.C. §§ 897(c)(1)(B), 897(d)(2), 897(e)(1).

118. The estimate of the staff of the Joint Committee was less than \$50 million a year. See *supra* note 5.

estate was misguided. In the first place, that is not the standard by which the taxation of foreign investment is tested. Horizontal equity would, for example, imply the repeal of the portfolio interest exemption (since no such exemption applies to interest received by a domestic lender), reducing the withholding tax on dividends paid to nonresident aliens to 15 percent (since that is the rate that applies to U.S. residents and citizens), and so on.<sup>119</sup> “Horizontal equity” is simply not the rule applied to investments other than in interests in USRP. Nor does the conventional understanding of the “source” rules justify taxing gain from the disposition of an interest in a USRPHC. There is no other place in the Internal Revenue Code where the source of gain from the sale of shares of a U.S. corporation is based on the assets of the corporation.

Then there is the enormous complexity involved in identifying and taxing interests in USRPHCs and the distortions that result from the domestically-controlled REIT (or RIC) rules. Consider, for example, the definition of a USRPHC (e.g., the identification of “determination dates,” the methods of valuation, etc.) or of an interest “other than a creditor” in a USRPHC. And, having applied FIRPTA to sales and other taxable dispositions of interests in USRPHCs, the legislation went on to apply FIRPTA to any transactions in which an interest in a USRPHC was exchanged unless the exchange was for an interest in a USRPHC or unless regulations provided further exceptions.<sup>120</sup> Presumably the concern was that, absent such rules, the unrecognized gain could in a section 351 exchange or a tax-free reorganization be shifted to someone else.<sup>121</sup> The regulations start with the already complex rules relating to tax-free reorganizations and section 351 transfers, often involving a foreign corporation (and thus section 367) and layer on top of that a whole new set of rules intended to implement FIRPTA. Many of the transactions addressed are relevant to publicly-traded corporations that restructure operations which may include an USRPHC, not the closely-held corporations that FIRPTA seems to have been focused on; and most of the FIRPTA guidance in the last ten years has been with respect to these transactions.<sup>122</sup>

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119. For a defense of the horizontal equity argument, see Brown, *Wither FIRPTA*, *supra* note 3, at 301.

120. I.R.C. § 897(e).

121. Section 897(d) provides that a distribution of a USRPI by a foreign corporation will result in the recognition of gain as though the interest had been sold at fair market value unless there was a carryover basis to the shareholder and the shareholder would be taxed on a subsequent distribution or unless the regulations provided a further exemption. Additionally, section 897(j) provides that a contribution of an interest in USRP to the capital of a foreign corporation would be taxed as a sale at fair market value.

122. See Levy, *Nonrecognition Transactions*, *supra* note 56, (recommending the use of “a simple rule that permits any foreign corporation to rely

A. *Real Estate Investment Trusts*

The exception for sales of shares of domestically-controlled REITs is bizarre. Why was this enacted? There is no meaningful legislative history.<sup>123</sup> Starting with the premise that the purpose of FIRPTA was to quash “planning techniques” of foreign investors then it is possible that the concern that a REIT could be used for that purpose would be mitigated if the REIT was domestically controlled. It may also have been that REITs were just not as important in 1980 for investing in U.S. real estate as they are now. But if the exception was good for REITs, why not for others? It was ultimately extended to RICs that were USRPCs and domestically controlled, but not to other USRPHCs or to partnerships.

And was the premise — that domestic control would prevent “planning techniques” and “mechanisms” to avoid tax — correct? Because REITs can easily be controlled by one or a few investors, they are from a planning perspective not really a more complicated choice than a privately-held partnership or a corporation. This seems evident from some of the uses to which REITs have been put, both in the case of foreign investment in USRP and in other contexts.

Indeed, one point that the debate on FIRPTA repeal neglects is the treatment of pass-throughs. Some seem to assume that there is either direct investment in USRP or investment by a corporation, whether U.S. or foreign, and thus do not consider the central importance of REITs to foreign investment in U.S. real property.<sup>124</sup> Although promoted as “mutual funds for real estate” when the REIT rules were enacted in 1960, that view misses the point that today a large part of the REIT population consists of REITs created by a few investors for the purpose of making specific investments. While REIT qualification requires that there be 100 or more beneficial owners (presumably by analogy to the trigger for ’40 Act registration in the case of a RIC),<sup>125</sup> the ownership of the shares needed to meet this requirement can be nominal in both voting power and value; and if there is

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on any nonrecognition provision in connection with the transfer of any USRPI to any other corporation (whether foreign or domestic) as long as the recipient corporation of the USRPI takes a carryover basis in the USRPI, and that the recipient would be subject to U.S. tax on . . . a disposition of the USRPI.”). On the regulations, see generally Kimberly S. Blanchard, *FIRPTA in the 21st Century – Installment One: A Closer Look at Regs. §1.897-5T(c)*, 36 TAX MGMT INT’L J. 520 (2007).

123. See H.R. REP. NO. 96-1479, at 188 (1979) (Conf. Rep.) (stating simply that “[i]n the case of REITs which are controlled by U.S. persons, sales of the REIT shares by foreign shareholders would not be subject to tax (other than in the case of distributions by the REIT).”).

124. See, e.g., Brown, *Wither FIRPTA*, *supra* note 3, at 300.

125. See I.R.C. § 856(a)(5) (requiring that “the beneficial ownership . . . is held by 100 or more persons”).

no other way to scrape up the needed shareholders, they can be found online — as one organization says, “Call us today. You’ll be amazed at how easy we make it.”<sup>126</sup> Thus, a REIT can be largely owned by a single investor<sup>127</sup> and can be created solely for the purpose of a specific investment; indeed this has facilitated some of the more abusive uses of REITs over the years, not only in the case of foreign investment in U.S. real property<sup>128</sup> but also in other areas. For example, REITs have been used in “abusive” transactions (most famously, to issue so-called fast-pay stock)<sup>129</sup> and in state and local tax planning.<sup>130</sup>

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126. *The Fastest, Most Economical and Easiest Way to Fulfill the 100 Shareholder Requirement*, REIT FUNDING, LLC, <http://www.reit-funding.com> (last visited Feb. 3, 2013) (reporting that since it “pioneered the third-party approach to helping REITs obtain accommodation shareholders over ten years ago . . . REIT Funding has provided shareholders for over 900 private REITs . . .”). *See also, e.g.*, REIT INV. GRP., <http://www.reitinvestmentgroup.com> (last visited Feb. 3, 2013).

127. Under section 856(a)(6), a REIT may not be “closely held,” but this looks only at ownership by individuals and certain tax-exempt organizations.

128. Some of the roles that REITs play in structured investments in U.S. real property is clear from the transactions described in Notice 2007-55 — a domestically-controlled REIT with a foreign government shareholder which liquidated in order to enable the shareholder to take the view that the liquidating distributions were exempt from FIRPTA or in any event not taxed under section 892.

129. The REIT would issue preferred stock to tax indifferent holders and use the proceeds to make a mortgage loan (or buy mortgages from) a corporation that owned its common stock. The preferred stock would pay dividends at an extraordinarily high, off-market rate for a period and, at the end of the period, at an extraordinarily low, off-market rate. The corporation would deduct the interest on its mortgage (or exclude the income on the transferred mortgages from its income), which would be taxed entirely to the holders of the preferred stock and then, at the end, the preferred could be cashed-out for much less than issue price — in effect allowing the corporation to deduct principal on a financing. The Treasury put an end to this by issuing Notice 97-21, 1997-1 C.B. 407, and then Regulations section 1.7701(l)-3. The regulations entitle the IRS to treat the transaction as though it was a loan from the holder of the fast-pay stock, i.e., the preferred, to the holder of the benefited stock, i.e., the corporation that holds the common.

130. For example, the *Autozone* litigation in Kentucky and Louisiana involving an out-of-state affiliate qualifying as a REIT that leased in-state facilities to an operating affiliate and took the view that it had no in-state income after the dividends paid deduction. *Kentucky v. Autozone Dev. Corp.*, No. 2006-CA-002175-MR, 2007 Ky. App. Lexis Unpub. LEXIS 1130 (Ky. Ct. App. Oct. 12, 2007); *Bridges v. Autozone Props., Inc.*, 900 So. 2d 784 (La. 2005). *See also*, *HMN Fin., Inc. v. Commissioner*, 782 N.W.2d 558 (Minn. 2010) (the Minnesota Commissioner of Revenue could not on “economic substance” or “business purpose” grounds disregard a captive REIT); *BankBoston Corp. v. Commissioner*, 861 N.E.2d 450 (Mass. 2007). States increasingly deal with this through legislation that restricts “captive” REITs.



Consideration of how foreign investments in REITs should be treated should also focus on the fact that, today, REITs are not simply part of the real estate sector of the U.S. economy but are significant in other economic sectors that do not primarily reflect the value of real estate. These include timber, wireless communication facilities, data storage facilities, lodging and health care facilities, and, most recently, gaming casinos.<sup>131</sup> Off shore drilling oil and gas platforms may be next.<sup>132</sup> The expansion of REITs into these businesses is essentially attributable to the ability, after a 1999 amendment to the Internal Revenue Code, to carry on any activity through a taxable REIT subsidiary;<sup>133</sup> to the view that real property is not limited to land, buildings and improvements to buildings but includes any “inherently permanent structure” and its structural components;<sup>134</sup> and to the ability to convert a “C” corporation to a REIT with limited tax costs.<sup>135</sup>

#### B. *Repealing the FIRPTA Rules for USRPHCs*

Suppose, then, that we repealed the FIRPTA rules relating to interests in USRPHCs? If the repeal was limited to the USRPHC rules (and leaving aside questions about other FIRPTA rules, such as the definition of real property, that are addressed below), gain on the disposition by a foreign person of a direct investment in USRP, including an interest in a fixed

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131. Such as Weyerhaeuser Company and Rayonier Inc. (timber); American Tower (cellular tower); Penn National Gaming (casino); and Iron Mountain Inc. (data storage facility). Others that have announced or completed conversions to REITs are the companies in the business of outdoor advertising (Lamar Advertising), conference centers (Gaylord Entertainment) and correctional facilities (Corrections Corp. of America). See Amy S. Elliott, *The Expanding Universe of REITs*, 2012 TNT 219-1 (Nov. 13, 2012).

132. See PLR 201250003 (Dec. 14, 2012) (concluding that income from the lease of an offshore oil and gas drilling platform and related machinery and equipment was rent from real property for purposes of section 7704(d), based on the definitions in the regulations under section 856).

133. The restrictions on taxable REIT subsidiaries are in the asset and income tests for REIT qualification — i.e., that not more than 25 percent in value of a REIT’s assets can be securities of taxable REIT subsidiaries, see I.R.C. § 864(c)(4)(B)(ii), and that dividends and interest from taxable REIT subsidiaries are not real estate income described in section 856(c)(3).

134. Regs. § 1.856-3(d). See also Rev. Rul. 75-424, 1975-2 C.B. 269; Rev. Rul. 73-425, 1973-2 C.B. 222; Rev. Rul. 71-220, 1971-1 C.B. 210; Rev. Rul. 69-94, 1969-1 C.B. 189.

135. A REIT that was previously a C corporation (or was spun off by a C corporation) must distribute its earnings and profits in a taxable dividend (which is usually effected by a taxable stock dividend), see I.R.C. § 857(a)(2), and will recognize any built in gain in its assets that is recognized in the gain recognition period specified by regulations under section 337(d).

investment trust that held such an interest, or of an interest in a partnership that held interests in USRP, would still be subject to tax,<sup>136</sup> as would a foreign partner's share of gain of a partnership from a disposition of an interest in USRP. There would, however, be no tax on gain from the sale of shares of a REIT (or a RIC that invests in shares of a REIT) or any other corporation that would have been a USRPHC before repeal or on distributions by a REIT (or a RIC that invests in shares of a REIT) of gain from the disposition of an interest in USRP. Other dividends of a REIT (or a RIC that invests in shares of a REIT) would be subject to withholding tax, but even that would be reduced under tax treaties to a level that is likely lower than the tax paid on a direct investment in interests in USRP or investment through a partnership in USRP.

If the USRPHC rules were repealed, therefore, it would make sense at the same time to enact consistent rules for foreign investments in USRP that are made directly or through a partnership or through a REIT (or a RIC that invests in shares of a REIT). The argument for doing so is not an argument for horizontal equity between U.S. and foreign investors but rather for uniform treatment of foreign investors and the elimination of the distortions that result from the choice of the entity that makes an investment. If a foreign person who invests directly or through a partnership in USRP would be subject to current tax on income from the investment and to tax on its sale, why should the result differ if the investment is made through a REIT (or a RIC that invests in shares of a REIT)?<sup>137</sup> Put differently, if there is to be no tax on sales by foreign persons of shares of a REIT (or a RIC that invests in shares of a REIT) or distributions by a REIT (or such a RIC) of gain to shareholders, why should there be a tax on dispositions of investments made through a partnership or made directly?

But conforming the treatment of investments made directly or through a partnership with investments made through a REIT (or a RIC that invests in shares of a REIT) poses a dilemma. Which set of rules are to be changed? Should the taxation of investments through a REIT (or a RIC that

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136. With the repeal of FIRPTA and with it the rule that excepts sales by 5 percent or smaller holders of interests in a publicly-traded partnership, a foreign partner would be taxed on the partner's share of the current income or gain of the partnership from the investment in U.S. real property and would also (assuming an aggregate view of partnerships for this purpose) be taxed at the time an interest was sold on the partner's share of the appreciation in the value of the real estate and any other assets of the U.S. trade or business.

137. The tax on the current income of REITs is diminished by very generous deductions for depreciation that came in after FIRPTA, and distributions in excess of earnings and profits simply reduce a shareholder's basis and, unlike the gain from the sale of an interest in a partnership that is attributable to depreciation or depletion deductions, are not recaptured as ordinary income on a sale of shares.

invests in shares of a REIT) be conformed to the taxation of investments made directly or through a partnership or vice versa?

There are a number of alternatives. One might be to accept the distortion that results from taxing investments through REITs (or a RIC that invests in shares of REITs) differently from other investments, but to narrow the extent that private REITs can be used for this purpose. Arguably, the main objection to not treating investments in REITs like investments made directly or through partnerships is the use of private REITs to in effect avoid, or significantly limit, any U.S. tax on investments in U.S. real estate. The requirement that a REIT have 100 or more beneficial owners could be made meaningful, for example, by excluding small shareholders if the REIT is not predominantly publicly traded. The domestically-controlled exception would be repealed.

Another alternative, which does not preclude the first, would be to conform the treatment of REITs to partnerships and tax foreign persons on sales of shares of REITs and on distributions of gain by REITs. The same rules would apply to RICs that predominantly invest in REITs. This would leave in place some of the withholding tax and other complexities of the USRPHC rules, but would limit their application. In the case of publicly-traded entities, an argument might be made on administrative grounds for an exemption for sales by and distributions to small shareholders (e.g., something similar to the present exemption for sales of 5 percent or smaller interests in publicly-traded USRPHCs, partnerships and trusts). If there was such an exception, however, it would seem sensible to extend it to allocations of gain by a publicly-traded partnership to foreign partners (as well as continuing the exception for sales of partnership interests). Since tax on the effectively connected income of a foreign partner is now collected withholding under section 1446, it would also be sensible to consider whether a partner eligible for the small holder exception should be required to file a return on the basis that the partner was engaged in a trade or business in the United States and whether the withholding tax reductions provided by treaties to dividends from REITs and RICs be extended to distributions by publicly-traded partnerships.

### *C. Repeal of All of FIRPTA*

Suppose we went further and the other FIRPTA provisions, i.e., those other than the rules relating to interests in USRPHCs, were also repealed. In other words, we threw all of section 897 out the window.

First, what about the definition of real property for purposes of the source rules? It would plainly make sense to retain the basic FIRPTA definition in the case of property held for the production of income — land (including interests in natural deposits), buildings and other improvements — and to treat leaseholds as well as ownership or co-ownership as interests

in real property. If we stopped there, however, reverting to the pre-FIRPTA rules would, in contrast to FIRPTA, (1) eliminate tax on the disposition of personal (or non-business) real property by a foreign person; (2) exclude from real property options to acquire land or improvements or leaseholds of land or improvements; (3) exclude from the definition of real property interests in personal property associated with the use of real property; and (4) limit the source of gain rule to ownership interests, rather than any interest other than solely as a creditor. Are any of these changes objectionable?<sup>138</sup>

FIRPTA includes in the definition of real property “options to acquire land or improvements . . . [or] leaseholds . . . thereon.”<sup>139</sup> Separately, the regulations provide that an “interest” in real property includes any interest other than solely as a creditor.<sup>140</sup> The scope of the definitions — of an “option” and of an “interest”— is uncertain. Convertible debt of a USRPHC or a shared appreciation mortgage on USRP are quite obviously “interests” not solely as a creditor,<sup>141</sup> but there is a no comprehensive guidance, for example, on whether an “interest” would include real-estate based on notional principal contracts or other derivatives.<sup>142</sup> Leaving that aside, the inclusion of options in the definition of real property is odd since options are generally not treated as ownership interests in the optioned property (unless on the particular facts the option amounts to such an interest because, for example, it is deep in the money), and gain from the sale of options, futures and other derivatives is generally sourced on a residence basis unless the gain is effectively connected with a U.S. trade or business.<sup>143</sup> The inclusion of options on real property and on leaseholds of real property seems to have come about simply because FIRPTA borrowed its definition of real property from the REIT provisions.<sup>144</sup> The inclusion in “interest” of

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138. For a contrary view, see Brown, *Wither FIRPTA*, *supra* note 3, at 304 (citing the ability in the absence of FIRPTA to avoid tax on the disposition of real estate that was not used in a U.S. trade or business, including personal residences, and also on options and some non-creditor interests).

139. I.R.C. § 897(c)(6)(A).

140. Regs. § 1.897-1(d)(2)(i) (providing that an interest other than as a creditor “also includes any direct or indirect right to share in the appreciation in the value, or in the gross or net proceeds or profits generated by, the real property”).

141. Regs. § 1.897-1(d)(3)(D).

142. Rev. Rul. 2008-31, 2008-1 C.B. 1180 (holding that a notional principal contract based on broad based index on commercial or residential real estate was not an option to acquire within the meaning of section 897 because the index was broad based).

143. I.R.C. §§ 865, 988; Regs. § 1.861-7.

144. I.R.C. § 856(c)(5)(C).

any interest other than solely as a creditor is in part simply regulatory zeal.<sup>145</sup> Eliminating the rule that includes options on real property or real property leaseholds from the definition of real property, and cutting back on the breadth of the definition of an interest other than a creditor, would be sensible.

FIRPTA also adds “personal property associated with the use of real property” to the definition of real property, even though that property would not by itself be real property for REIT or any other purposes.<sup>146</sup> The inclusion of personal property “associated with the use of real property” seems simply to have borrowed from what the language of U.S. and other OECD tax treaties then in effect permitted the source country to tax. Personal property associated with the use of real property is included in the definition of real property, however, only “where both the personal property and the United States real property interest with which it is associated are held by the same person or by related persons”<sup>147</sup> and, generally, where the disposition of the personal property is within one year on either side of the disposition of the real property.<sup>148</sup> Before FIRPTA, real property did not include personal property associated with the use of real property, and thus the repeal of FIRPTA would, without more, narrow the definition. But as a practical matter, personal property used in connection with U.S. real property that produced effectively connected income (or income attributable to a permanent establishment), by election or otherwise, would be an asset of the trade or business if owned by the owner of the real property, and thus any gain would be subject to tax on its disposition.<sup>149</sup> The main function of including such personal property in the FIRPTA definition is to increase the likelihood that a U.S. corporation would be a USRPHC or, put the other way around, prevent the ownership of personal property from allowing a U.S. corporation to escape the USRPHC. With the repeal of the USRPHC rules this would no longer be relevant. There seems to be no reason why personal property associated with the use of real property should be treated any

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145. While the statute includes interests in a USRPHC other than solely as a creditor, I.R.C. § 897(c)(1)(A)(ii), it does not apply that concept to other interests in real property or to interests in other entities.

146. I.R.C. § 897(c)(6)(B) (including in the definition “movable walls, furnishings, and other personal property associated with the use of real property”).

147. Regs. § 1.897-1(b)(4)(i).

148. Regs. § 1.897-1(b)(4)(ii).

149. Before FIRPTA, section 861(a)(5) defined real property for purposes of sourcing gain on its disposition as “real property located in the United States.” Income from personal property associated with the use of real property is not treated as income effectively connected with a U.S. trade or business by virtue of an election to treat the income from the real property as effectively connected. *See* Regs. § 1.871-10(b).

differently from any personal property and certainly that would be a simplification of the rules.

Repeal of FIRPTA would also restore the different treatment of gain from the disposition of real property that was a U.S. trade or business and one that was not. Does the different treatment make sense? With the present levels of individual and corporate tax, it is unlikely that there will be many situations in which a 30 percent tax on gross income is better for an investor than a tax on effectively connected taxable income, and this argues for a single rule under which the tax on income from real property (as redefined) would be on taxable income, whether or not it is effectively connected with a U.S. trade or business.<sup>150</sup> In order to avoid the need to file returns, the tax should be collected by withholding and, subject to treaties, imposed at a single rate that takes into account the likelihood that any investment in real property involves expenses.

#### D. Tax Treaties

U.S. tax treaties do not limit the FIRPTA tax on gains from sales of shares of USRPHCs or of distributions by REITs or RICs of gains from sales of interests in USRP. Nor do they reduce the 30 percent withholding tax on rents or oil, gas and other mineral royalties that are not effectively connected with a U.S. trade or business. More recent treaties do reduce the 30 percent U.S. withholding tax on regular dividends paid by a REIT to zero in the case of a foreign pension fund and to 15 percent in the case of other shareholders, but only in the case of a pension fund or individual shareholder owning 10 percent or less of the REIT, a shareholder owning 5 percent or less of any class of stock of a REIT if the dividend is paid on a class of shares that is publicly traded, and for a shareholder who holds an interest of 10 percent or less in the REIT if the REIT is “diversified” (which requires that no single property held by the REIT exceed 10 percent in value of the value of its total interests in real property).<sup>151</sup> A few U.S. tax treaties extend the 15 percent reduction to shareholders that are the equivalent of REITs under foreign law without regard to the amount of shares owned.<sup>152</sup> The reason for not allowing

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150. Others have suggested this. See Brown, *Wither FIRPTA*, *supra* note 3, at 311 nn.87–88.

151. See Platt, *Cross-Border Transactions*, *supra* note 97 (noting that before the 1996 Model, REIT dividends were treated like any dividends (and thus could be taxed at a 5 percent or 15 percent rate) but in the Model Convention released that year, and in subsequent treaties, the 5 percent rate was eliminated and the 15 percent rate was limited to dividends paid to specified foreign shareholders).

152. For example, Article 10 of the United States-Australia treaty reduces the rate to 15 percent for dividends paid to a listed Australian property trust, or LAPT, but to the extent there are 5 percent or greater owners of the LAPT, it applies the usual treaty provisions to that part of the dividend (treating the shares held by the

a 5 percent rate and for restricting the 15 percent rate for REIT dividends is to reduce the disparity in the treatment of current income from a direct investment and from an investment through a REIT.<sup>153</sup> On a somewhat different theory — that “small” investments in REITs are simply portfolio investments — the OECD’s Model Convention on Income and Capital seems also to be going in the direction of reducing the tax imposed on dividends by the country in which the REIT is resident.<sup>154</sup>

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LAPT as publicly traded for this purpose). 1982 Income Tax Convention, U.S.-Austl., Aug. 6, 1982, <http://www.irs.gov/Businesses/International-Businesses/Australia-Tax-Treaty-Documents>. Article 10 of the United States-Netherlands treaty reduces the rate to 15 percent for dividends paid to a *belegginstelling*, regardless of how much of the REIT it owns. 1992 Income Tax Convention, U.S.-Neth., Dec. 18, 1992, <http://www.irs.gov/Businesses/International-Businesses/Netherlands---Tax-Treaty-Documents>.

153. Thus, the Treasury Department’s technical explanation of Article 10 of the 2006 Model, which is somewhat muddled because it confuses the taxation of current income and gain from a disposition, says that the “restrictions [on the reductions in withholding tax on dividends paid by a RIC or REIT] . . . are intended to prevent the use of [REITs or RICs] to gain inappropriate U.S. tax benefits. . . . [A] resident of the other Contracting State directly holding U.S. real property would pay U.S. tax upon the sale of the property either at a 30 percent rate of withholding tax on the gross income or at graduated rates on the net income. . . . [B]y placing the real property in a REIT, [a foreign] investor could, absent a special rule, transform income from the sale of real estate into dividend income from the REIT, taxable at the rates provided in [the dividend article of the Model treaty], significantly reducing the U.S. tax that otherwise would be imposed. Paragraph 4 [of that Article] prevents this result and thereby avoids a disparity between the taxation of direct real estate investments and real estate investments made through REIT conduits. In the cases in which paragraph 4 allows a dividend from a REIT to be eligible for the 15 percent rate of withholding tax, the holding in the REIT is not considered the equivalent of a direct holding in the underlying real property.” U.S. DEP’T OF THE TREASURY, UNITED STATES MODEL TECHNICAL EXPLANATION ACCOMPANYING THE UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006, at 36, (Nov. 15, 2006), <http://www.treasury.gov/press-center/press-releases/Documents/hp16802.pdf>.

154. The July 2008 version of the OECD Model Tax Convention on Income and on Capital took the view that REIT distributions to “small investors” might be considered portfolio dividends, i.e., not dividends from an investment in immovable property, but that it “would not seem appropriate to restrict the source taxation of” REIT dividends in the case of a “larger investor.” It thus suggested that states which agreed might extend the 15 percent withholding tax rate to distributions by a REIT to a shareholder that held “directly or indirectly” at least 10 percent of the value of the capital of the REIT and that this might apply to capital gain as well as other distributions. Organization for Economic Co-operation and Development, Model Tax Convention on Income and on Capital, art. 10, ¶ 67.3, 67.4 (July 17, 2008). The commentary to Article 13 (Gains) also suggests that states may want to exempt from tax the gain of a small foreign investor from the sale of an interest in a REIT,

Repeal of FIRPTA would eliminate the need to exclude shares of USRPHCs, and the other country's equivalent, if any, from treaty provisions that exempt gains from the sales of shares from tax in the country in which the corporation is resident. Repeal might also open up the question of whether the United States should tax rents and royalties and other income from real property that is not effectively connected with a U.S. trade or business at a 30 percent rate rather than a lower rate. Before FIRPTA, there were treaties that reduced the rate to 15 percent.<sup>155</sup> Other U.S. source income from capital — interest, royalties for the use of intangible property, dividends — generally benefit from the elimination or reduction in withholding taxes. Why shouldn't the same principal be considered in the case of real estate?

If repeal of FIRPTA led to a review of the treatment of inward investment generally, and was not limited to foreign investment in U.S. real property, would it make sense to consider the rates of withholding on, and the deductions allowed to U.S. persons for, interest, royalties (both for minerals and intangibles), and other payments made to related foreign persons? The mobility of capital and of intangibles has plainly enabled U.S. corporations to reduce taxes imposed by the country of use or consumption, as well as by the United States,<sup>156</sup> and there is every reason to believe that foreign corporations investing in the United States likewise use royalties, as well as interest expense, to reduce the U.S. tax base.<sup>157</sup> Repealing or modifying FIRPTA would provide an opportunity to evaluate the current rules.

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notwithstanding the general rule in Article 13 which allows the taxation of sales of shares if “more than 50 percent of their value [is derived] directly or indirectly from immovable property situated in the” state. *Id.*, art. 13, ¶ 28.3. The July 2010 version of the OECD Model Convention on Income and on Capital takes the same approach. In the 2008 version, REITs were “loosely described as a widely held company, trust, or contractual or fiduciary arrangement that derives its income primarily from long-term investment in immovable property, distributes most of that income annually and does not pay income tax on the income related to immovable property that is so distributed.” *Id.*, art. 10, ¶ 67.1.

155. For example, see the United States–United Kingdom tax treaty involved in *Herbert v. Commissioner*, 30 T.C. 26 (1958).

156. See Edward D. Kleinbard, *Stateless Income's Challenge to Tax Policy*, 132 TAX NOTES 1021–42 (Sept. 5, 2011); Edward D. Kleinbard, *Stateless Income's Challenge to Tax Policy, Part 2*, 136 TAX NOTES 1431–48 (Sept. 17, 2012).

157. See Bret Wells, *What Corporate Inversions Teach About International Tax Reform*, 127 TAX NOTES 1345 (June 21, 2010).



#### IV. LEGISLATION OTHER THAN REPEAL

What would not make sense, if there is to be no repeal of FIRPTA, would be to enact some of the more modest proposals that have been put forward, such as the Real Estate Jobs and Investment Act which was introduced in the House of Representatives in September of 2011.<sup>158</sup> The Real Estate Jobs and Investment Act would keep the USRPHC provisions of FIRPTA but, broadly, make four changes in the present rules.

First, the Act would increase from 5 percent to 10 percent the exception for sales of shares of a class of stock of a REIT that was regularly traded on an established securities market and, correspondingly, increase from 5 percent to 10 percent the exception to the FIRPTA tax for distributions by a REIT of gain from the sale or other disposition of United States real property interests. The distribution would be treated as an ordinary distribution and would be taxed as a dividend, to the extent out of earnings and profits, at the 30 percent or lower treaty rate. These changes would only apply to REITs — the exception for sales of regularly traded shares of other USRPHCs would stay at 5 percent.

Second, the Act would reject Notice 2007-55 and not treat a distribution by a REIT of gain to a shareholder as a taxable distribution if the distribution was in the complete liquidation of the REIT or in a redemption of its shares that was treated as a sale by the shareholder if the REIT was domestically controlled or if the distribution was on a class of regularly traded shares and the shareholder held 10 percent or less of the class.

Third, in determining whether a REIT is or is not domestically controlled, the Act would expand the definition of U.S. ownership by providing that, in the absence of actual knowledge to the contrary, a REIT or a RIC could assume that less than 5 percent owners of shares of stock of a class that was traded on an established securities market in the United States were U.S. persons; but it would narrow the definition of U.S. ownership by excluding from U.S. ownership shares of the REIT owned by another REIT

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158. H.R. 2989, 112th Cong., 1st Sess. (2011). The substantially same bill was introduced in the Senate as the Real Estate Investment and Jobs Act of 2011. The House bill had been previously introduced as the Real Estate Jobs and Investment Act of 2010, H.R. 5901, and passed the House in July of that year. For a technical explanation, see STAFF OF THE JOINT COMMITTEE ON TAXATION, JCX-41-10, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF H.R. 5901, THE “REAL ESTATE JOBS AND INVESTMENT ACT OF 2010” (2010). *See, e.g.*, Statement of Jeffrey D. Deboer on Behalf of the Real Estate Roundtable Before the Subcommittee on Select Revenue Measures, REAL ESTATE ROUNDTABLE (June 23, 2011), [www.rer.org/FIRPTA-testimony-June2011.aspx](http://www.rer.org/FIRPTA-testimony-June2011.aspx). Short of repeal, the Statement advocates increasing from 5 percent to 10 percent the exception for sales of publicly-traded shares of a U.S. corporation, including a real estate investment trust, and withdrawal of Notice 2007-55.

or by a RIC unless the owner (taking into account the presumption described above) was itself domestically controlled.

Finally, in a provision that seems to benefit only Australian investment, the Act would eliminate the FIRPTA tax on gain from sales or other dispositions of shares of a REIT held by a “qualified entity” that owns 10 percent or less of the REIT and correspondingly eliminate the FIRPTA tax on distributions of gain by a REIT to such a shareholder. A distribution would be taxable as an ordinary distribution, to the extent out of earnings and profits, at the 30 percent or lower treaty rate. The definition of a qualified entity would seem to cover only listed Australian property trusts (or so-called “LAPTs”) that own (directly or through other LAPTs) 10 percent or less of the shares of a REIT — i.e., only a foreign shareholder that is eligible for a tax treaty reduction in the withholding tax on REIT dividends without regard to the amount of REIT shares that it owns and if the foreign shareholder’s principal class of interests is listed and publicly traded on a “recognized” stock exchange (within the meaning of the treaty).

Is the Real Estate Jobs and Investment Act of 2011 a good idea? Any reconsideration of FIRPTA requires an evaluation of whether investments in REITs should be given better tax treatment than any other form of investment in U.S. real estate. For example, why there is an exemption for shares of domestically-controlled REITs? The Real Estate Jobs and Investment Act, of course, does not do this. Thus, it does not reconsider the fundamentals of FIRPTA but simply makes changes at the margin which would give REITs a further advantage over other forms of investment. Nor does it address the concerns that prompted the issuance of Notice 2007-55, which was that, absent the position taken in the notice, no U.S. tax would be due if a REIT sold all its assets and distributed the proceeds in complete liquidation. And the provision that benefits listed Australian property trusts should quite clearly be taken up in a revision of the United States-Australia tax treaty, not by changes to the Internal Revenue Code.

The Real Estate Revitalization Act of 2010<sup>159</sup> would repeal the USRPHC provisions of FIRPTA and treat any REIT or RIC distribution of gain from the dispositions of interests in USRP (including the gain distributed in a liquidation or redemption that was treated as a sale or exchange) as an ordinary dividend (limited in the case of a liquidating distribution to shareholder’s gain under section 331) that would be subject to withholding at the 30 percent rate or the lower treaty rate that applies to other REIT or RIC distributions.

This deserves more consideration than the Real Estate Jobs and Investment Act, but it leaves in place the FIRPTA definition of real property (and also the tax rate distinction between “effectively connected” and non “effectively connected” income) and, more importantly, does not fully

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159. H.R. 4539, 111th Cong., 2d Sess. (2010).

address the different treatment of investments made through REITs and direct investment or investment through a partnership. The Act would tax all current income or gain of a REIT or RIC at no less than the 30 percent or lower treaty rate that applies to dividends,<sup>160</sup> but there still would be no tax on gain from a sale of shares by a foreign investor. Because the sale will step-up the basis of the shares, the gain will not be taxed on a subsequent liquidation of the REIT.

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160. REITs and RICs are required to distribute at least 90 percent of real estate investment company or regulated investment company taxable income. The REIT or RIC would be taxed on any such income not distributed. It would also be taxed on any capital gain not distributed, but the shareholder would be entitled to a refundable credit for the tax paid by the REIT or RIC on the retained capital gain.

