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THE PATH ACT-FIRPTA

THE PATH ACT TAKETH ... AND GIVETH

While putting an end to the use of a tax-free spinoff using REITs, numerous provisions seemed to be meant to steer investors toward real estate.

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[pg. 91]

There have been as many as 15 tax-free spinoffs of real estate investment trusts (REITs) since 2010 worth a total of \$21.6 billion. **1** Just last year, Darden Restaurants completed a \$747 million spinoff of Outback Steakhouses to Four Corners Property Trust. **2** Unexpectedly, at the end of 2015, the "Protecting Americans from Tax Hikes Act of 2015" ("PATH Act" or "Act") **3** put an end to the use of a tax-free spin-off to unlock real estate values through the "OpCo-PropCo" structure using a REIT. **4** Yet in what seemed to be a move to steer investors toward real estate, the PATH Act included numerous changes to the tax rules governing REITs and foreign investment in U.S. real estate. Consequently, it is estimated that as much as \$20 billion to \$30 billion **5** of new capital will be invested in U.S. commercial real estate markets in the wake of the Act's changes to Foreign Investment in Real Property Tax Act of

1980 (FIRPTA). **6** This article discusses the FIRPTA related changes made by the PATH Act, certain unanswered questions, and possible solutions. **7**

Key concepts

FIRPTA, which has been the law of the land-and other real property interests-since 1980, generally taxes foreign investors on the disposition of their "United States real property interests" (USRPIs). **8** Under FIRPTA, a gain from the disposition of a USRPI by a nonresident alien individual or a foreign corporation (collectively, "a foreign investor") is generally taxable in the United States as "income effectively connected to a U.S. trade or business" (ECI). **9** As a result, the foreign investor is generally (1) subject to tax on its gain on a net basis (i.e., with allocable deductions) at graduated rates, **10** (2) required to file a U.S. tax return reporting the gain and pay any U.S. tax due, **11** and (3) subject to interest and penalties in case of failure to comply with the above. **12** Additionally, prior to the PATH Act, FIRPTA generally required a transferee of a USRPI to withhold 10% of the gross amount realized by a foreign transferor on the transfer. **13** Failure to withhold may result in interest and penalties. **14**

On a related note, a foreign investor with substantial U.S. real estate holdings will tend to find that the rental income is taxed as ECI. **15** It is really a factual question whether the foreign

[pg. 92]

investor's activities are considered to rise to the level of a trade or business with respect to the real estate holding. **16** Other types of income from real estate are more obviously ECI-e.g., hotel operating income. For a foreign investor who is not considered engaged in a trade or business, the rental income is taxed differently. A foreign investor's U.S.-source "fixed or determinable, annual or periodical income" (FDAP)-e.g., most dividends, which are not ECI-is taxed by means of withholding at the source of the payment. **17** FDAP is taxed on a gross basis (i.e., no deductions allowed) at a rate of 30%. **18** This rate may be reduced by an applicable tax treaty **19** or by statute (e.g., the portfolio debt exemption). **20** Generally, non-ECI capital gains are altogether excluded from tax. **21**

A USRPI generally is defined as (1) an interest in real property located in the United States or U.S. Virgin Islands, and (2) any interest (other than an interest solely as a creditor, e.g. of a mortgage debt) in a domestic corporation unless it is established that such corporation was not a U.S. real property holding corporation (a USRPHC) at any time during the shorter of the taxpayer's holding period or five years preceding the disposition of the stock. **22** A USRPHC generally is defined as a corporation with at least one-half of the value of its assets consisting of USRPIs. **23** A REIT is capable of being a USRPHC and FIRPTA adopts a "look through" approach to its distributions to foreign investors to the extent attributable to the REIT's gain realized from the disposition of a USRPI (a "capital gain dividend"). **24** Under the REIT rules, a REIT's capital gain dividend is treated by its shareholders as a long-term capital gain. **25** Where a foreign shareholder of the REIT qualifies for the "Regularly Traded Exception" (as defined below), **Section 857(b)(3)(F)** provides that the capital gain dividend is not

[pg. 93]

treated as a long-term capital gain, but rather as a regular dividend to the foreign shareholder otherwise subject to FDAP withholding (the "Deemed Dividend Rule").

There are certain key exceptions to the USRPI and USRPHC definitions. First is the "Cleansing Exception," which excludes from the definition of a USRPI any corporation that (1) does not own any USRPI and (2) disposed of all of its USRPIs in taxable transactions. **26** The second is the "Regularly Traded Exception," which excludes from the definition of a USRPI a class of stock of a corporation-including stock of a REIT-that is regularly traded on an established securities market *if* the taxpayer does not own more than 5% of such class of stock at some time during the tracking period. **27** Lastly, stock of a "domestically controlled" REIT (DCREIT) is not a USRPI (the "DCR Exception"). **28** For these purposes, a DCREIT is any REIT if less than 50% of the value of its stock is directly or indirectly held by foreign persons during the shorter of (1) the five years preceding the date of the disposition or (2) the period of the REIT's existence. **29**

Generally, income earned by a foreign government or its "controlled entity" from certain passive investments in the United States (including certain USRPIs) is exempt from tax under **Section 892** (the "892 Exemption"). **30** The 892 Exemption does not apply to income earned from certain commercial activities, or income received by or from a controlled entity that is engaged in commercial activities ("controlled commercial entity" or "CCE"). **31** Any gain from the disposition of a USRPI that is not stock of a USRPHC is not covered by the 892 Exemption, including certain distributions from a REIT that are attributable to a USRPI gain. **32**

The 892 Exemption makes a distinction between a foreign government's "pension fund" and a "pension trust." The "pension fund" of a foreign government is merely the assets of an integral part of that government or its controlled entity, allocated to a separate account and held and invested for purposes of providing retirement benefits. **33** Under these circumstances, the income of the pension fund is not deemed to inure to the benefit of private persons. **34** Thus, passive income earned by a foreign government's pension fund qualifies for the 892 Exemption (except in the case of a controlled entity that is a CCE). A foreign government's "pension trust" is a separate and distinct legal entity. **35** The 892 Exemption is only extended to the "pension trust" if it meets certain requirements. **36** Among these requirements are the following four. **37** First, the trust must be

[pg. 94]

established exclusively for the benefit of (1) employees or former employees of a foreign government or (2) employees or former employees of a foreign government and non-governmental employees or former employees that perform or performed governmental or social services. Second, the funds that comprise the trust must be managed by trustees who are employees of, or persons appointed by, the foreign government. Third, the trust forming a part of the pension plan must provide for retirement, disability, or death benefits in consideration for prior services rendered, Fourth, income of the trust must

satisfy the obligations of the foreign government to participants under the plan, rather than inuring to the benefit of a private person.

The PATH Act's provisions

The PATH Act's new exemption to FIRPTA is designed to attract investment in U.S. real estate from certain defined foreign pension funds. The Act also makes additional FIRPTA changes.

Qualified foreign pension fund exemption.

The PATH Act provides a new exemption from FIRPTA for any "qualified foreign pension fund" or QFP (the "QFP Exemption"). [38](#) More specifically, new [Section 897\(l\)](#) provides that [Section 897](#) does not apply to any USRPI held directly (or indirectly through one or more partnerships), or to any distribution received from a REIT, by either a QFP or "any entity all of the interests of which are held by a QFP." [39](#) Thus, a QFP may hold and dispose of its USRPIs with almost no limits on what form the investments may take and face no tax on its gains. [40](#)

A QFP is defined as meaning any trust, corporation, or other organization or arrangement [41](#) that satisfies all of the following criteria:

- It is created or organized under non-U.S. law.
- It is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered (the "Employment Requirement").
- It does not have a single participant or beneficiary with a right to more than 5% of its assets or income.
- It is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates (the "Reporting Requirement").
- Under the laws of the country in which it is established or operates, either (1) contributions to the organization that would otherwise be subject to tax under such laws are deductible, excluded, or subject to tax at a reduced rate, or (2) taxation of any investment income of the organization is deferred, or such income is taxed at a reduced rate ("Excluded From Tax Requirement"). [42](#)

[pg. 95]

The QFP Exemption applies to dispositions and distributions after the PATH Act's date of enactment. [43](#) The Act grants Treasury the authority to issue such regulations as are necessary or appropriate to carry out the purposes of its provisions. [44](#)

Practical considerations. What is fairly clear is that the PATH Act was intended to exempt QFPs from

tax on their real estate gains. However, many real estate portfolios will nonetheless create rental income or other income that is considered ECI, [45](#) thereby causing the real estate gains to be ECI-gain regardless of FIRPTA. [46](#) The PATH Act did not exempt QFPs from ECI. This is a problem for any QFP that holds such real estate directly or through a partnership. Consequently, a QFP will be inclined to invest through a REIT to "block," in effect, the ECI. The REIT's distribution of the rental cash flows (i.e., a regular dividend) would be taxed as FDAP. As discussed above, a QFP's capital gain dividend from the REIT or sale of the REIT's stock is exempt from tax under the PATH Act. [47](#)

The QFP Exemption is granted to a QFP and to a "foreign entity" wholly owned by a QFP. [48](#) Additionally, the exemption applies to any USRPI held indirectly by the QFP "through one or more partnerships." [49](#) Thus, for purposes of the exemption, if a foreign entity is utilized to hold a USRPI, the QFP must own all of its interests if the foreign entity is not a partnership. (A foreign entity owned solely by one or more QFPs appears to be non-qualifying for purposes of the exemption.) However, a QFP may own the USRPI through one or more domestic or foreign partnerships with no requirement that the other partners have to also be QFPs in order for the QFP partner to qualify for the exemption. It is not clear why Congress made this distinction between owning the USRPI through a partnership and owning it through an entity other than a partnership. The language does not state that the partnership must be treated as a partnership for U.S. federal tax purposes, possibly creating some lack of clarity on this point. Issues may arise for many existing separate account arrangements between a QFP and its advisor or sponsor if they utilize foreign entities that do not default to partnership status and in which the advisor or sponsor is a nominal owner of the entity. [50](#)

As discussed above, the QFP Exemption is now in effect, [51](#) and affected withholding agents need to be cognizant of the newly available exceptions to FIRPTA withholding, related procedures, and potential ambiguity. The PATH Act amended [Section 1445\(f\)\(3\)](#) -the definition of a "foreign person" for purposes of FIRPTA withholding-to exclude an entity described under [Section 897\(l\)](#) . [52](#) [Section 1445\(b\)\(2\)](#) and [Regs. 1.1445-2\(b\)\(2\)](#) and [1.1445-5\(b\)\(3\)](#) all provide that FIRPTA withholding is not required if the transferor or interest-holder is not a "foreign person" (a "certificate of non-foreign status"). With respect to a capital gain distribution, a REIT may similarly rely on a certificate of non-foreign status. [53](#)

The only withholding that has not been entirely addressed in the wake of the PATH Act is withholding in the context of a partnership (domestic or foreign) that is required on a partner's share of "effectively connected taxable income" (ECTI) [54](#) pursuant to [Section 1446](#) . [55](#) For that purpose, such a partnership generally would rely on obtaining the applicable Forms W-8 or Forms W-9 (as the case may be). [56](#) If the ECTI relates to FIRPTA gain (including a REIT's capital gain distribution to a domestic partnership), a non-foreign affidavit similar to the certificate of non-foreign status should be sufficient in the partnership context, although this is not entirely clear.

The QFP Exemption does not expressly include or exclude a foreign government's pension fund or pension trust. Therefore, a foreign government's pension fund or pension trust that meets the definition of a QFP qualifies for the QFP Exemption, and one that does not would continue to rely on its 892 Exemption. [57](#) There is, however, a general agreement among

[pg. 96]

practitioners that foreign government pension funds should generally qualify for the QFP Exemption, thus increasing the number of entities which may potentially qualify for exclusion from FIRPTA. The rationale behind this position is that there is no *de facto* restriction on foreign government plans. If they do not already qualify, foreign governments could always undertake some restructuring of their pension plans to better enable them to qualify.

The QFP definition itself poses certain challenges for government pension funds. A number of these challenges are described and discussed below.

The Employment Requirement. Under the Employment Requirement, the pension plan must provide retirement or pension benefits to participants or beneficiaries who are current or former employees of one or more employers "in consideration for services rendered." [58](#) A few observations about the wording of this requirement may prove helpful. It does not appear that the pension plan must be established by an employer, though the participant must have worked for at least one "employer." This may present an issue for any foreign pension plans established by certain industry groups to cover doctors, dentists, and other self-employed professionals, since there is no employee or employer. As well, in the case of a plan having or including Social Security-type benefits, it may be problematic that coverage may extend to all citizens, regardless of prior employment. Lastly, a plan may provide disability benefits as opposed to, or in addition to, "retirement or pension" benefits. [59](#)

The Reporting Requirement. The QFP definition requires reporting by the plan to "tax authorities." [60](#) Some foreign countries may have otherwise qualifying pension plans, but they may not have a tax system to which the plans may report. Moreover, there may be qualifying plans that are part of a foreign government, and that understandably do not report to the government since they are part of it. There may also be plans that report to a local authority that is not a tax authority. It is not clear how strictly this requirement will be interpreted or whether this type of non-conforming or lack of reporting will prevent a plan from qualifying.

Excluded From Tax Requirement. Similarly, it is uncertain how a pension plan in countries without a tax system would satisfy the requirement that contributions to the plan that would otherwise be subject to tax must be deductible or excluded from income, or taxed at a reduced rate, or the investment income must be deferred or taxed at a reduced rate. [61](#)

Congress may have had little existing law upon which to draw for its definition of a QFP. [62](#) The absence in federal tax law of any uniform and well-accepted definition of a foreign pension plan did not help. The author believes that the various hurdles discussed could be overcome, depending on the direction taken in the legislative history, Treasury regulations, and rulings.

Other FIRPTA changes.

The PATH Act amended FIRPTA to make helpful clarifications and create further exceptions. It increased, from 5% to 10%, the maximum ownership percentage that a foreign investor may own in a publicly traded REITs under the Regularly Traded Exception (sales of that stock or on capital gain distributions). **63** Notably, the widened exception was not extended to stock of all publicly traded USRPHCs.

The Act also provided a new exception for REIT stock (public or private) held by foreign persons through certain foreign listed and traded investment entities ("qualified shareholders" **64**) in certain treaty countries, e.g., an Australian listed property trust. **65** This exception applies to a REIT's distribution and to stock of a REIT held through a partnership. **66** The exception does not apply to the extent of an investor that owns indirectly and constructively more than 10% of the REIT. **67** In this regard, the Act made a few conforming amendments to the Deemed Dividend Rule. For any qualified shareholder whose capital gain dividend is now exempt from FIRPTA, its capital gain dividend is now deemed a FDAP dividend. **68** Another amendment to the Deemed Dividend Rule was to include within its scope, with respect to a qualified shareholder, certain non-dividend distributions made by a REIT that are attributable the REIT's FIRPTA gain. **69**

In applying the foreign ownership limitation of the DCR Exception, a few presumptions were added by the PATH Act with respect to publicly traded stock of a REIT (or other QIE). The PATH Act permits a publicly traded REIT to treat all of its shareholders that have owned 5% or less of the stock at all times during the tracking period as U.S. persons unless it has actual knowledge to the contrary. **70** If a publicly

[pg. 97]

traded REIT is deemed a DCREIT, it would itself be treated as a US person for purposes of determining the status of a REIT in which it owns shares. **71** If a REIT that is not publicly traded owns stock in another REIT, for purposes of determining the status of the second REIT, the stock owned by the first REIT is considered owned by a US person in the same proportion as the first REIT is itself owned by US persons. **72** This rule, and the two immediately above, generally apply to sales after the date of enactment and to a REIT's distribution after the date of enactment. **73** Notably, Congress chose not to address the treatment of certain types of shareholders of a REIT, including a shareholder that is a domestic corporation, as was addressed by the IRS in [Ltr. Rul. 200923001](#). Presumably the logic in the private letter ruling is otherwise intact. **74**

These presumptions will better facilitate the formation of joint ventures among foreign investors and publicly traded REITs. The joint venture typically holds its real estate through a private REIT subsidiary. Certain of the foreign investors rely on the REIT's domestically controlled status. Prior to the PATH Act, it was unclear how to determine whether the REIT's stock held indirectly by the publicly traded REIT was domestically controlled. Now it is more clear and easier to perform the necessary due diligence. Many so-called "core real estate funds" are structured with private REITs and have been obliged by charter to maintain DCREIT status. **75** There may be less pressure to maintain this status given the number of foreign investors which do not require the DCR Exception under either the 892 Exemption or the QFP

Exemption.

The Cleansing Exception now no longer applies to a REIT. **76** Thus, if a REIT has disposed of all of its USRPIs in taxable transactions and liquidates, the Cleansing Exception does not

[pg. 98]

apply to turn off USRPI status of its stock (the "Cleansing Exception Amendment"). The new legislation provides that the Cleansing Exception applies to stock of a corporation only if neither the corporation nor any predecessor of such corporation was a REIT (or RIC) at any time during the shorter of (1) the period after 6/18/80 during which the taxpayer held such stock, or (2) the five-year period ending on the date of the disposition of the stock. **77** The provision applies to dispositions on or after the date of enactment. **78**

The Cleansing Exception Amendment essentially validates the Service's position in **Notice 2007-55 79** that a liquidating distribution of a REIT is capable of coming within the scope of **Section 897(h)(1)**, thereby otherwise subjecting a foreign distributee to tax. Excluding a REIT from the Cleansing Exception, however, may prove helpful in situations involving a REIT's liquidation, where a foreign investor has "high basis" stock- i.e., a loss-even though the REIT has gain. **80**

The PATH Act increased from 10% to 15% the **Section 1445** withholding applicable to a disposition of a USRPI by a foreign investor. **81** The increased rate of withholding, however, does not apply to the sale of a personal residence if the amount realized is not in excess of \$1 million. **82** The provision is effective for dispositions occurring 60 days after the date of enactment. **83**

Finally, the PATH Act provides that, for purposes of determining whether dividends from a foreign corporation (attributable to a dividend from an 80%-owned domestic corporation) are eligible for a dividend received deduction, a dividend from a REIT is not treated as a dividend from a domestic corporation, even if the REIT owns shares in a foreign corporation. **84** The provision applies to dividends received from a REIT on or after the date of enactment. **85**

Conclusion

The PATH Act has brought welcome changes to the U.S. real estate markets in the form of its amendments to FIRPTA, including the introduction of QFP Exemption, the exception for a REIT's qualified shareholders, and the widening of the Regularly Traded Exception to 10% for REITs. The Act also provided necessary clarity to FIRPTA with respect to the DCR Exception and the Cleansing Exception. To be fully effective, however, additional guidance is needed from Congress, Treasury, and the IRS, particularly with respect to the definition of a QFP.

1 "House Approves Bill to End Tax-Free Real Estate Spinoffs, N.Y. Times, 12/17/15) available at www.nytimes.com/2015/12/18/business/DealBook/house-approves-bill-to-end-tax-free-spinoffs.html?mwrsm=email&_r

2 *Id.*

3 The PATH Act is Division Q of the Consolidated Appropriations Act, 2016, P.L. 114-112, 12/18/15. Much of the PATH Act carries over the provisions of the "Tax Increase Prevention and Real Estate Investment Act of 2015" (i.e., "the extenders bill") introduced by House Ways and Means Committee Chairman Rep. Kevin Brady (R-Tex.) on 12/8/15.

4 The package did not contain a provision included in earlier REIT reform proposals that would mandate a deemed-sales election under **Reg. 1.337(d)-7** . Consequently, the PATH Act does not prevent REIT conversions, nor does it interfere with a REIT's acquisition of a C corporation.

5 Note 1, *supra*.

6 FIRPTA was enacted in 1980. The substantive tax provision of FIRPTA was codified as **Section 897(a)** , and an information reporting requirement was added under **Section 6039C** . Accompanying regulations to **Section 6039C** , while mandated, have never been issued; however a withholding provision was enacted in 1984 and codified under **Section 1445** .

7 REIT-related changes that are not related to FIRPTA are beyond the scope of this article. See Matejcek, "Impact of the PATH Act on Real Estate Investment Trusts," page 131 of this issue.

8 **Section 897(a)(1)** .

9 **Section 897(a)(1)** . FIRPTA losses are also considered "effectively connected."

10 **Section 871(b)** (nonresident alien individuals); **Section 882(a)(1)** (foreign corporations; deductions generally are allowed to the extent they are effectively connected and subject to proper allocation and apportionment); **Section 873** (nonresident alien individuals); **Section 882(c)** (foreign corporations). The branch profits tax, applicable to a foreign corporation that has ECI, is imposed essentially on its "earnings and profits" adjusted downward for amounts reinvested in specified U.S. assets. **Section 884** . It applies at a rate of 30% (which may be reduced by an applicable tax treaty).

11 See generally **Section 6012** ; **Reg. 1.6012-1(b)** (nonresident alien individuals); **Reg. 1.6012-2(a)** (foreign corporations). See also Instructions to Form 1040NR, "U.S. Nonresident Alien Income Tax Return" (individuals) and Form 1120F, "U.S. Income Tax Return of a Foreign Corporation."

12 See, generally, **Sections 6651** (penalties) and **6601** (interest).

13 Section 1445(a) .

14 Reg. 1.1445-1(e) (failure to withhold generally subjects the withholding agent to liability for applicable penalties and interest under **Section 1461**).

15 A foreign investor who receives rental income from U.S. real property, but who is not engaged in a U.S. trade or business, may elect to be taxed on a net basis and at graduated rates, thereby allowing the taxpayer to access usual deductions such as depreciation and interest. **Sections 871(d)** (nonresident alien individual), **882(d)** (foreign corporation).

16 Holding one property that is triple-net leased has been held to not constitute engaging in a U.S. trade or business. *Neill*, **46 BTA 197** (1942). By contrast, multiple property holdings tend to lead to the finding of a trade or business where the foreign investor's management activities (performed directly or through an agent, or through a partnership) are substantial, regular, and continuous. *Pinchot*, 113 F2d 718 **25 AFTR 447** (CA-2, 1940) (taxpayer owned 11 properties that were actively managed by an agent); *DeAmodio*, **34 TC 894** (1960), *aff'd on another issue* 299 F2d 623 **9 AFTR2d 826** (CA-3, 1962); *Lewenhaupt*, **20 TC 151** (1953), *aff'd per cur.*, 221 F2d 227 **47 AFTR 420** (CA-9, 1955).

17 Sections 871(a) (nonresident alien individuals), **882(a)** (foreign corporations).

18 Sections 1441 (nonresident alien individuals), **1442** (foreign corporations).

19 Section 894 .

20 Sections 871(h) (nonresident alien individual), **881(c)** (foreign corporation).

21 Capital gains of nonresident alien individuals that are present in the United States for a total of 183 days or more during the tax year are subject to U.S. tax. **Section 871(a)(2)** .

22 Section 897(c)(1)(A) .

23 Section 897(c)(2) . USRPHC means any corporation if the fair market value of its USRPIs equals or exceeds 50% of the fair market value of its USRPIs, its interest in real property located outside the United States, plus any other of its assets which are used or held for use in a trade or business.

24 Section 897(h)(1) . An exemption-the "Regularly Traded Exception"-applies to such distributions provided the distributee shareholder has not owned more than 5% of such stock at any time during the

one-year period prior to the distribution. A REIT's "capital gain dividend" is defined in [Section 857\(b\)\(3\)\(C\)](#) .

25 Section 857(b)(3)(B) .

26 Section 897(c)(1)(B) ; **Regs. 1.897-1(c)(2)(ii)** , **1.897-2(f)(2)** . Thus, for example, a corporation that liquidates under [Section 331](#) (a taxable liquidation) would generally no longer be a USRPHC under the cleansing exception. See [Notice 2007-55, 2007-2 CB 13](#) , in which the IRS addresses a liquidating REIT. For a more lengthy discussion of the notice, see Friedline, "Inbound Real Estate Taxation: Revisionist History of FIRPTA," *Major Tax Planning*, (Matthew Bender, 2013) Ch. 5, ¶502.2.A.2.

27 Section 897(c)(3) ; **Reg. 1.897-1(c)(2)(iii)** . The Regularly Traded Exception refers to the tracking period defined under [Section 897\(c\)\(1\)\(A\)](#) . Note that under [Section 1445\(b\)\(6\)](#) and **Reg. 1.1445-2(c)(2)** , there is no [Section 1445\(a\)](#) withholding tax on regularly traded stock. For purposes of the Regularly Traded Exception, the constructive ownership rules of [Section 318\(a\)](#) apply with certain modifications. [Section 897\(c\)\(6\)\(C\)](#) (except that paragraphs (2)(C) and (3)(C) of [Section 318\(a\)](#) shall be applied by substituting "5 percent" for "50 percent").

28 Section 897(h)(2) . The domestically controlled exception applies to any "qualified investment entity" (QIE), which includes a REIT or certain regulated investment companies. [Section 897\(h\)\(4\)\(A\)](#) . For purposes of this article, only a REIT-QIE is discussed and hereinafter any reference to a REIT with regard to [Section 897\(h\)](#) includes a QIE.

29 Sections 897(h)(4)(C) , **(D)** . It has not been completely clear for purposes of the DCR Exception what is meant by the term "indirectly held by foreign persons" in determining if a REIT is domestically controlled. See [Ltr. Rul. 200923001](#) (addressing a REIT's stockholder that is a domestic corporation owned a foreign investor); Friedline, *supra* note 26 at ¶502.2.B.

30 Section 892(a) .

31 Section 892(a)(2)(A) ; **Temp. Reg. 1.892-1T(a)** . A CCE is generally defined as any entity engaged in commercial activities (within or outside the United States) if a foreign government holds directly or indirectly at least 50% of the total interests in the entity, or holds directly or indirectly any other interest that provides the foreign government with effective control of the entity. Commercial activities are "all activities (whether conducted within or outside the United States) which are ordinarily conducted by the taxpayer or by other persons with a view towards the current or future production of income or gain." **Temp. Reg. 1.892-4T** . For this purpose, an activity may be considered a commercial activity even if it does not constitute the conduct of a trade or business in the United

States under **Section 864(b)** . See **Section 864(b)** (generally defining trade or business within the United States). The following activities are not commercial activities: investments in stock, bonds, and other securities; loans; investments in financial instruments held in the execution of governmental financial or monetary policy; the holding of net leases on real property or land which is not producing income (other than on its sale or from an investment in net leases on real property); and the holding of bank deposits in banks. **Temp. Reg. 1.892-4T(c)** . However, holding of a shopping center lease, even if independently managed, is considered commercial activity. See **Temp. Reg. 1.892-5T(d)(4), Example 2(b)** .

32 Temp. Reg. 1.892-3T(a)(1) (flush language).

33 Temp. Reg. 1.892-2T(c)(2), Example 4(a) .

34 *Id.*

35 Temp. Reg. 1.892-2T(c) .

36 *Id.*

37 Temp. Reg. 1.892-2T(c) . A pension trust described in **Temp. Reg. 1.892-2T(c)** is treated as a CCE if such trust solely earns income that would not be unrelated business taxable income (as defined in **Section 512(a)(1)**) if the trust were a qualified trust described in **Section 401(a)** . Income of a pension trust is subject to the rules of **Temp. Reg. 1.892-5T(b)(3)** regarding the application of the rules for CCE to pension trusts.

38 PATH Act §323(a); **Section 897(l)(1)** .

39 PATH Act §323(a); **Section 897(l)(1)** . The PATH Act made conforming amendments to 1445 to eliminate withholding on dispositions of USRPI by a QFP (or entity wholly owned by a QFP) or any distribution received from a REIT by a QFP (or entity wholly owned by a QFP). See PATH Act §323(a); **Section 1445(f)(3)** .

40 While it may be obvious to the reader, it is worth observing that a domestic Subchapter C corporation that has not made a REIT election and is wholly owned by a QFP would be fully taxable on its real estate gains or any other income.

41 The Act's legislative history acknowledged that "foreign pension funds may be structured in a variety of ways, and may comprise one or more separate entities and that the word 'arrangement'

encompasses such alternatives." Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 2015* ("Blue Book"), page 283.

42 PATH Act §323(a); **Section 897(I)(2)** .

43 PATH Act §323(c).

44 PATH Act §323(a); **Section 897(I)(3)** .

45 See note 15, *supra*.

46 **Section 864(c)(2)** states that in determining whether U.S.-source income of the type described in **Sections 871(a)** and **881(a)** , including capital gains and rents, is ECI, two factors must be considered: (1) whether the income is derived from assets used, or held for use, in the business (i.e. the asset-use test) and (2) whether the activities of the business were a material factor in the production of the income (i.e. the business-activities test). See **Reg. 1.864-4(c)** for elaboration of these provisions and for illustrations, derived in large part from the House Ways and Means Committee report on the 1966 Act, H Rep't No. 1450, 89th Cong., 2d Sess. (1966). See also, generally, *InverWorld, Inc.*, **TCMemo 1996-301** .

47 See note 39, *supra*.

48 PATH Act §323(a); **Section 897(I)(1)** . Although the qualifier "foreign" is not used in the statute, practically, the statute applies only to a foreign entity because a domestic corporation is not a foreign person (and therefore not subject to FIRPTA) and partnerships are separately addressed in the statute.

49 PATH Act §323(a); **Section 897(I)(1)(B)** .

50 It is possible the desired or chosen entity for the arrangement is a "per se" corporation under **Reg. 301.7701-2(b)** and therefore may not elect to be treated as a partnership or disregarded entity under **Reg. 301.7701-3(c)** .

51 See note 43, *supra*.

52 PATH Act §323(b); **Section 1445(f)(3)(B)** .

53 Reg. 1.1445-8(e) .

54 See, generally, Reg. 1.1446-2 (computation of ECTI).

55 Reg. 1.1446-1(a) . If a domestic or foreign partnership has ECTI for any partnership tax year, and any portion of such taxable income is allocable under Section 704 to a foreign partner, the partnership must pay a withholding tax under Section 1446 at the time and in the manner prescribed in Regs. 1.1446-1 through 1.1446-6).

56 For purposes of withholding under Section 1446 , the term "foreign partner" generally means any partner of the partnership that is not a "U.S. person" within the meaning of Section 7701(a)(30) . Reg. 1.1446-1(c)(1) . Thus, a partner of the partnership is generally a foreign partner if the partner is a nonresident alien, a foreign partnership of a type specified in the statute, a foreign corporation (including a foreign government pursuant to Section 892(a)(3)), a foreign estate or trust, a foreign organization described in Section 501(c) , or other foreign person. Reg. 1.1446-1(c)(1) . A partner that is treated as a "U.S. person" only for certain specified purposes is considered a foreign partner for purposes of Section 1446 , and a partnership accordingly must withhold on the portion of ECTI allocable to that partner. Reg. 1.1446-1(c)(1) . Withholding for these purposes differs from withholding under FIRPTA. Specifically, a partnership must generally determine (1) whether a partner is a foreign partner and (2) the partner's tax classification (e.g., corporate or non-corporate), by obtaining a withholding certificate from the partner. That form can be Form W-8BEN, "Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding"; Form W-8IMY, "Certificate of Foreign Intermediary, Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding"; Form W-8ECI, "Certificate of Foreign Person's Claim for Exemption from Withholding on Income Effectively Connected With the Conduct of a Trade or Business in the United States"; Form W-8EXP, "Certificate of Foreign Government or other Foreign Organization for United States Tax Withholding"; Form W-9, as applicable; or some "other acceptable suitable form" permitted under Reg. 1.1446-1(c)(5) and Temp. Reg. 1.1441-1(e)(4)(vi). Reg. 1.1446-1(c)(2)(i) . Absent knowledge to the contrary, a partnership is entitled to rely on a valid Form W-8 or W-9 or other acceptable suitable form for purposes of computing the amount of withholding under Section 1446 . Reg. 1.1446-1(c)(2)(iii)(A) .

57 See note 30, *supra*.

58 See note 42, *supra*.

59 It is not clear Congress did not expressly include "disability" benefits in the Employment Requirement. By analogy, the 892 Exemption is more explicit. As described further above, the 892 Exemption may be extended to a foreign government's "pension trust" provided it forms a part of a pension plan that provides for "retirement, disability, or death benefits" in consideration for prior

services rendered. Moreover, the definition of a "foreign retirement fund" under the FATCA regulations includes a retirement fund that provides "retirement, disability, or death benefits." See, generally, note 56, *infra*. However, the exclusion of the term "disability" from "retirement or pension benefits" in the case of the QPF Exemption may not have been intentional and arguably a disability benefit is synonymous with a "pension." FATCA refers to the Foreign Account Tax Compliance Act, which added Sections 1471-1474 to the Code in 2010.

60 See note 42, *supra*.

61 See note 42, *supra*.

62 There is a strikingly similar definition of a "foreign retirement fund" under the FATCA regulations. Many of the provisions included in the definition of a QFP are included in the definition of a "foreign retirement fund" in **Reg. 1.1471-6(f)(2)** (broad participation retirement fund). **Section 1471(f)** provides an exception from FATCA from payments made to certain specified persons, including a foreign retirement plan.

63 PATH Act §322(a)(1); **Section 897(k)(1)** .

64 A "qualified shareholder" must meet the following three requirements. First, it must be a foreign person that either (1) is eligible for benefits of a tax treaty with the United States and the interests of which are listed and regularly traded on one or more recognized exchanges, or (2) is a foreign partnership created or organized under foreign law as a limited partnership in a jurisdiction that has an agreement for the exchange of information with respect to taxes with the United States and has a class of limited partnership units that regularly traded on the New York Stock Exchange or NASDAQ Stock Market, and such class of limited partnership units value is greater than 50% of the value of all the partnership units. Second, a qualified shareholder must maintain records of its 5% or greater holders. Third, a qualified shareholder must be a "qualified collective investment vehicle" (QCIV). A QCIV either (1) is a foreign person that, under a tax treaty with the United States, is eligible for a reduced rate of withholding with respect to ordinary dividends paid by a REIT, even if such person holds more than 10% of the stock of such REIT; (2) is a foreign partnership that is a publicly traded partnership to which **Section 7704(a)** does not apply, is a withholding foreign partnership, and would, if it were a domestic corporation, be a USRPHC at any time during the 5-year period ending on the date of disposition of, or distribution with respect to, such partnership's interests in a REIT; or (3) is an entity that is designated as such by the Treasury and is either fiscally transparent within the meaning of **Section 894** or required to include dividends in its gross income, but entitled to a deduction for distributions to persons holding interests (other than interests solely as a creditor) in such foreign person.

65 PATH Act §322(a)(1); **Section 897(k)(2)(A)** .

66 PATH Act §322(a)(1); **Section 897(k)(2)(B)(ii)** .

67 PATH Act §322(a)(1); **Section 897(k)(2)(D)** .

68 PATH Act §322(a)(2)(B). Although a QFP may qualify for the Regularly Traded Exception with respect to its holding of REIT stock, any capital gain dividend it receives would not lose its exempt status under the Deemed Dividend Rule, since the QFP does not rely on the Regularly Traded Exception (i.e., the QFP relies on the QFP Exemption). As amended, **Section 857(b)(3)(F)** now reads, "In the case of a shareholder of a real estate investment trust to whom **Section 897** does not apply *by reason of the second sentence of section 897(h)(1) or subparagraph (A)(ii) or (C) of section 897(k)(2)*, the amount which would be included in computing long-term capital gains for such shareholder under subparagraph (B) or (D) (without regard to this subparagraph) shall not be included in computing such shareholder's long-term capital gains, and shall be included in such shareholder's gross income as a dividend from the real estate investment trust." Emphasis added.

69 PATH Act §322(a)(1); **Section 897(k)(2)(C)** (**Section 301(c)** , **302** , and **332** distributions treated as sales or exchanges).

70 PATH Act §322(b)(1)(A); **Section 897(h)(4)(E)(i)** .

71 PATH Act §322(b)(1)(A); **Section 897(h)(4)(E)(ii)** .

72 PATH Act §322(b)(1)(A); **Section 897(h)(4)(E)(iii)** .

73 PATH Act §322(c).

74 The Act's legislative history acknowledged that the IRS previously has ruled that, for purposes of the DCR Exception, the term "directly or indirectly" does not require looking through corporate entities. Blue Book, *supra* note 41 at 279 (citing Ltr. Rul. **Ltr. Rul. 200923001**).

75 See, generally, Friedline, " **Section 704(c)** Tracking and Basis Adjustments in Core Real Estate Funds," 42 Real Estate Tax'n 180 Vol. 42 (Third Quarter, 2015).

76 PATH Act §325(a); **Section 897(c)(1)(B)** .

77 PATH Act §325(a); **Section 897(c)(1)(B)(iii)** .

78 PATH Act §325(b).

79 Note 26, *supra*.

80 Friedline, *supra* note 26 at ¶502.2.A, p. 5-22.

81 PATH Act §324(a); **Sections 1445(a)** , **(e)(3)** , **(e)(4)** , **(e)(5)** .

82 PATH Act §324(b); Section 1445(c)(a).

83 PATH Act §324(c).

84 PATH Act §326(a); **Section 245(a)(12)** .

85 PATH Act §326(b).