FIRPTA Increased Withholding and Other Changes

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Most international tax professionals have familiarity with the Foreign Investment in Real Property Tax Act ("FIRPTA"), especially those that provide planning for foreign clients investing in U.S. real estate. Navigating through FIRPTA can be challenging for many practitioners, specifically when dealing with REITs. However, on December 18, 2015, the President signed into law the Protecting Americans from Tax Hikes Act of 2015 ("PATH Act"). The PATH Act significantly alters FIRPTA withholding for foreign persons disposing of investments in U.S. real estate. Of particular note are six modifications: (1) an increase in the FIRPTA withholding rate in certain situations;[1] (2) an exemption for qualified shareholders of REIT stock;[2] (3) the elimination of the "cleansing rule" for REITs;[3] (4) a definition for domestically controlled REITs;[4] (5) an exemption from FIRPTA for qualified foreign pension funds;[5] and (6) an exemption from FIRPTA for shareholders of 10 percent or less of publicly traded REIT stock.[6]

1. Increase in FIRTPA Withholding Rate

The PATH Act increases the FIRPTA withholding rate from 10 percent to 15 percent on certain dispositions and distributions of United States Real Property Interests ("USRPIs").[7] Similarly, the withholding rate for the transfer of a partnership interest or the beneficial interest in a trust or estate has been increased from 10 percent to 15 percent.[8] The new withholding rate applies to all such dispositions that take place after February 16, 2016.[9] However, the new FIRPTA rules allow for a 10 percent withholding rate where the amount realized on the disposition of property being used as a residence is between $300,000.00[10] and $1 million.[11] In other words, if a foreign person sells his or her personal residence for $999,000.00 the amount to be withheld shall be $99,900.00. However, if the foreign person sells his or her personal residence for $1,000,100.00, the amount to be withheld on the sale shall be $150,015.00. The amount withheld is offset by the gain on the disposition of the USRPI and is refundable to the extent the amount withheld exceeds the underlying tax liability.[12] The increased FIRPTA withholding rate is not an actual increase in tax, but a means of ensuring compliance with U.S. tax law. An exemption found in the old rule remains in place, providing that a foreign person is not subject to FIRPTA withholding where the property sold is used as a residence and the amount realized does not exceed $300,000.00.[13]

2. Qualified Shareholders of REIT Stock Exempt

The PATH Act provides a new exception from FIRPTA withholding for qualified shareholders.[14] A qualified shareholder is defined in section 897(k)(3)(A). Qualified shareholders owning REIT stock are exempt from FIRPTA withholding because the REIT stock is not a USRPI.[15] Rather, REIT distributions made to qualified shareholders are treated as a sale or exchange of stock under sections 301(c)(3), 302, or 331; whereas, the portion of the distributions attributable to other investors is classified as income subject to dividend withholding.[16] This exemption is limited to the extent that a qualified shareholder has an investor that owns, whether indirectly through the qualified shareholder or otherwise, more than 10 percent of a REIT in which the qualified shareholder owns an interest.[17]

3. "Cleansing Rule" for REITs Eliminated

The FIRPTA "cleansing rule" previously provided that an interest in a corporation was not a USRPI where (1) the corporation did not own USRPIs on the date of disposition and (2) all USRPIs held during the applicable testing period were disposed of in transactions where the full amount of gain was subject to U.S. tax. The "cleansing rule" caused confusion in the REIT context with regard to whether a shareholder could claim a stock loss resulting from a liquidation of an unprofitable investment in a foreign-controlled private REIT as an effectively connected income ("ECI") loss. The PATH Act repeals the cleansing rule's application to REITs, thereby eliminating the technical concern.[18]

4. Defining Domestically Controlled REITs

Foreign investors selling shares of a "domestically controlled" REIT are exempt from FIRPTA withholding. "Domestically controlled" is defined as any qualified investment entity, such as a REIT, in which less than 50 percent of its shares have, at all times during the testing period, been held, directly or indirectly, by foreign investors.[19] However, under FIRPTA, it was difficult to determine whether REITs were "domestically controlled."[20] The PATH Act provides some clarity, defining a United States shareholder as any shareholder owning less than 5 percent of a publicly traded REIT unless the REIT has actual knowledge to the contrary.[21] Under FIRPTA, it was often unclear whether a REIT was "domestically controlled" when it was owned by another REIT. The

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PATH Act elucidates this issue as well, providing that (1) a publicly traded REIT that owns an interest in a subsidiary REIT is treated as a domestic shareholder of the subsidiary REIT if the parent REIT is itself "domestically controlled"; and (2) a private, subsidiary REIT is treated as a domestic shareholder in proportion to the extent of the parent REIT's domestic ownership.[22]

5. Foreign Pensions Exempt from FIRPTA

"Qualified foreign pension funds" are retirement funds that are subject to non-U.S. governmental regulation and meet certain other requirements set forth in section 897(l)(2). The PATH Act creates a new exemption from FIRPTA withholding for qualified foreign pension funds, as well as for any other entity where all of its interests are held by a qualified foreign pension fund.[23] The exemption applies to dispositions and distributions from qualified foreign pension funds.[24] The extent to which a retirement fund must be subject to non-U.S. governmental regulation to constitute a qualified foreign pension fund is not entirely clear.

6. Exemption for Publicly Traded REITs

The PATH Act expands the exclusion for publicly traded REITs, providing that a publicly traded REIT will not be treated as a USRPI unless the holder owns more than 10 percent of a particular class of stock.[25] Shareholders owning 10 percent or less of a class of stock in a publicly traded REIT will be exempt from FIRPTA on their distributions.[26] The expanded exclusion does not apply to U.S. real property holding corporations or privately held REITs.

Presumably treasury regulations will provide additional clarity left out by the PATH ACT. However, the increased visibility that the PATH Act has already provided is certainly a boon to any international tax professional that finds themselves navigating FIRPTA.

(Endnotes)

1 Protecting Americans from Tax Hikes Act of 2015, Pub. L. No. 114-113, § 324, 2029 Stat. 799, 862; 26 U.S.C. § 1445(a).

2 § 322, 2029 Stat. at 857.

3 § 325, 2029 Stat. at 862.

4 § 322, 2029 Stat. at 857.

5 § 323, 2029 Stat. at 861.

6 § 322, 2029 Stat. at 857.

7 26 U.S.C. § 1445(a).

8 § 1445(e)(5).

9 Treas. Reg. § 1.1445-2(e).

10 26 U.S.C. § 1445(b)(5).

11 § 1445(c)(4).

12 Treas. Reg. § 1.1445-1(f).

13 § 1445(b)(5).

14 § 897(k)(3)(A).

15 § 897(k)(2)(A).

16 § 897(k)(2)(C).

17 § 897(k)(2)(B).

18 § 897(c)(1)(B)(iii).

19 § 897(h)(4)(B).

20 *Id*.

21 § 897(h)(4)(E)(i).

22 § 897(h)(4)(E).

23 § 897(l)(1).

24 *Id*.

25 § 897(k)(1).

26 *Id*.