

TAX CONSIDERATIONS
IN
REAL ESTATE TRANSACTIONS

Investment by Foreign Persons in
U.S. Real Estate

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Overview

- U.S. taxation of foreign persons
 - Portfolio income
 - Gross withholding tax
(IRC §§ 871(a), 881, 1441 & 1442)
 - Business income
 - Net income tax
(IRC §§ 871(b) & 882)
 - Real property income
 - Net income tax
(IRC §§ 897 & 1445)
- Effect of tax treaties
- Foreign Investment in U.S. Real Property Tax Act of 1980 (“FIRPTA”)
 - Substantive tax liability
(IRC § 897)
 - Withholding obligations
(IRC § 1445)



Foreign vs. U.S. Persons

Nonresident alien:

- Green card test
(IRC § 7701(b)(1)(A)(i))
- “Substantial presence” in the U.S.
(IRC § 7701(b)(1)(A)(ii))

Foreign corporation
(IRC § 7701(a)(5), (a)(30)(E))

Foreign estate
(IRC § 7701(a)(31)(A))

Foreign trust
(IRC § 7701(a)(31)(B))

Foreign partnership
(IRC § 7701(a)(5), (a)(30)(B))



Taxation of Current U.S. Business Income

U.S. trade or business
(IRC § 864(b))

“Effectively connected” income
(IRC § 864(c))

Real estate “trade or business” election:
(IRC §§ 871(d) & 882(d))

Branch taxes

- Branch profits tax
(IRC § 884(a))
- Branch interest tax
(IRC § 884(f))

Pre-FIRPTA Rules

Foreign seller of U.S. real estate was not subject to U.S. income tax on any gain recognized on the sale unless:

1

The foreign seller's real estate activities were substantial enough to constitute "doing business" in the U.S.

2

The foreign seller had made a "net election" under IRC §§ 871(d) or 882 (d)

3

In the case of an individual, the foreign seller was physically present in the U.S. for 183 days or more in the year of the sale

Basic FIRPTA Rules and Concepts

Applies to dispositions of “United States real property interests” (“USRPIs”) by foreign persons

Effect is to treat gain realized as “effectively connected” income subject to regular net income tax

Significant restrictions on otherwise applicable nonrecognition provisions (*e.g.* IRC § 1031 exchanges)

FIRPTA tax liability generally enforced through a 10% withholding obligation imposed by IRC § 1445 on the purchaser or transferee of a USRPI

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Basic FIRPTA Rules and Concepts

(continued)

Will not affect character of any recognized gain (*i.e.*, capital vs. ordinary)

Treatment of losses

Sourcing and tax credit rules

Tax treaty override

“United States Real Property Interests” Direct Interests

Basic definition

An interest in real property (including an interest in a mine, well, or other natural deposit) located in the U.S. or the Virgin Islands. IRC § 897(c)

Debt carve-out

An interest in property solely as a creditor will not be a USRPI.

Types of property included in definition of USRPI:

Fee ownership or co-ownership	Leasehold interests
Time-shares	Life estates, remainders and reversionary interests
Improvements (e.g., buildings and other permanent structures)	Personal property “associated with the use of real property” (e.g. mining equipment, farming machinery, certain construction equipment)
Options to acquire land or improvements thereon (even if not currently exercisable), including rights of first refusal	Direct or indirect rights to share appreciation of USRPI

“United States Real Property Interests”

Indirect Interests

Certain interests in entities that hold USRPIs are also treated as USRPIs for purposes of FIRPTA

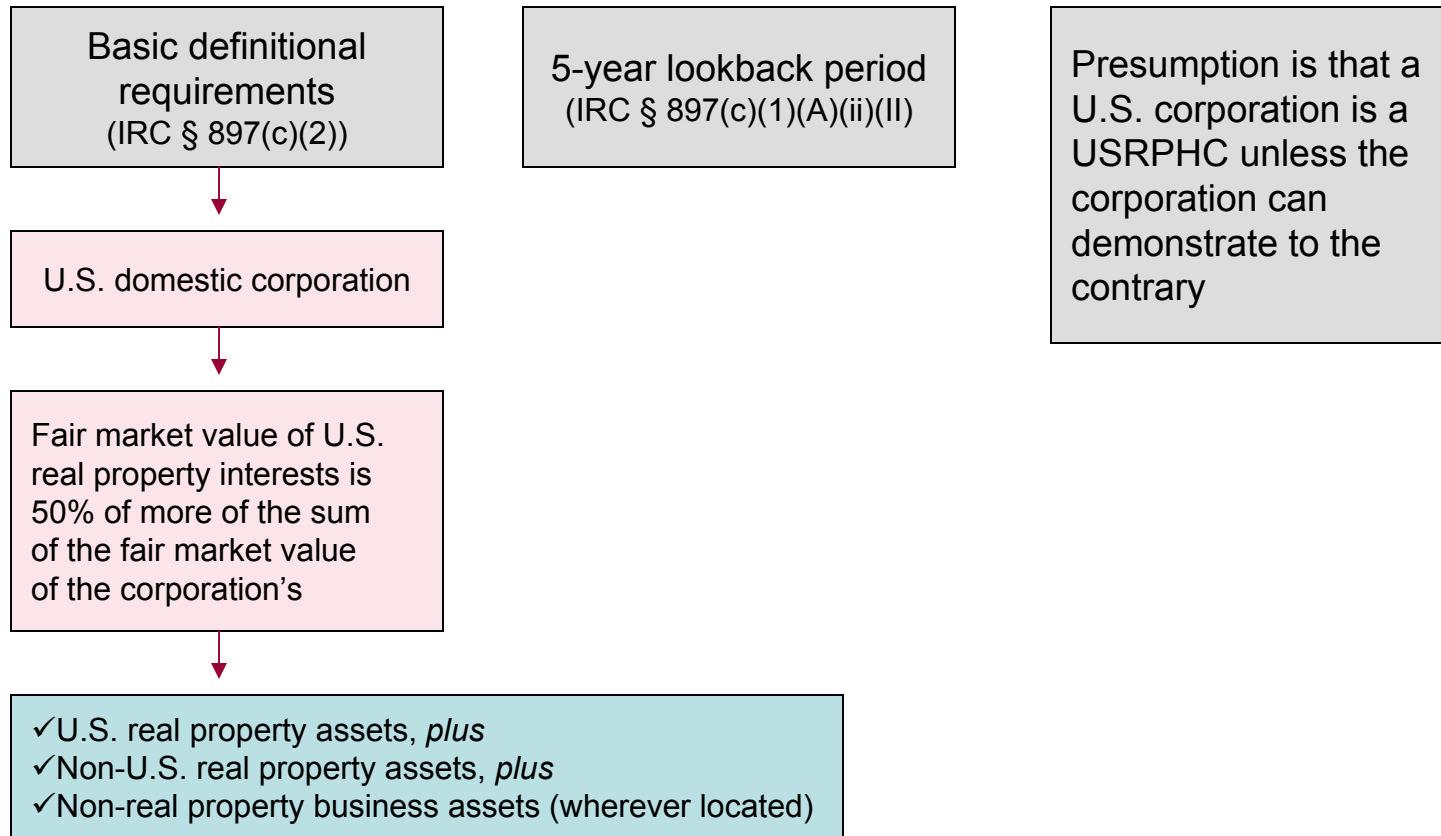
As with directly-held interests, an interest in an entity held solely as a creditor will not be classified as a USRPI

An interest in a U.S. corporation will be treated as a USRPI if the corporation is classified as a “United States Real property holding corporation” (“USRPHC”)

Partnerships, trusts and estates that hold interests in U.S. real estate cannot technically qualify as USRPIs, but the same basic effect is achieved under the IRC § 1445 withholding rules



“United States Real Property Holding Corporations”



USRPHCs - Valuation Considerations

FMV-based definitional test essentially requires that the corporation have constant appraisals of the relevant classes of its real estate and business assets

Special valuation rules apply to certain intangible property (e.g., goodwill and going concern value) (Treas. Regs. § 1.897-1(o)(4))

These assets must be valued in accordance with either book value or an actual arm's length purchase price

This tends to depress the valuation that can be assigned to a corporation's non-real property trade or business assets, and hence makes USRPHC classification more likely

Alternatively, the corporation may apply the test on the basis of accounting book value (Treas. Regs. § 1.897-2(b)(2)(i))

However, if this alternative test is used, the value of the corporation's USRPIs must be 25% or less of the total book value of its U.S. and non-U.S. real property assets and non-real property trade or business assets



Exclusions From USRPHC Status

Interests in certain U.S. corporations are excluded from USRPHC classification:

A corporation that holds no remaining USRPIs if each of the USRPIs that it owned during the 5-year lookback period were disposed of in a fully taxable transaction
(IRC § 897(c)(1)(B))

A publicly traded corporation, but only if the relevant shareholder did not own more than 5% of the stock (either directly or indirectly) for the preceding 5 years
(IRC § 897(c)(3))

A “domestically-controlled” real estate investment trust
(IRC § 897(h)(2))

A REIT is considered “domestically controlled” if less than 50% of its stock was owned directly or indirectly by foreign persons within the preceding 5 years

Disposition of USRPIs

FIRPTA only applies upon a “disposition” of a USRPI

“Disposition” is not defined in the statute, but has been broadly interpreted to include the following:

Sales and exchanges

Capital contributions to a corporation or partnership

Corporate or partnership distributions

Transfers in connection with a corporate merger

Gifts (where the transferred property is subject to liabilities
In excess of its adjusted tax basis)

FIRPTA Nonrecognition Override

FIRPTA will generally apply to create a U.S. tax liability even in the case of dispositions where a nonrecognition provision would otherwise apply, unless:

The foreign transferor receives a USRPI in exchange for the transferred USRPI

The USRPI received in the exchange, immediately following the exchange, would be subject to U.S. tax upon its deposition; and

The foreign transferor complies with certain IRS filing requirements

Treas. Regs. § 1.897-6T

Certain foreign corporations eligible for benefits under certain U.S. treaties that wish to take advantage of otherwise applicable nonrecognition rules may consider electing to be treated as a U.S. domestic corporation under IRC § 897(i)

FIRPTA Withholding – General Rules

Basic withholding requirement: 10% of amount realized

Requirement to withhold theoretically applies even if the purchaser or transferee is itself a foreign person or entity

The “amount realized” on the transfer equals the sum of cash and fair market value of other property received on the transfer plus the outstanding amount of liability assumed by the transferee or to which the USRPI is subject (Treas. Regs. § 1.1445-1(g)(5))

Selling expenses and other similar offsets are not deducted for purposes of determining a transferor’s “amount realized

Unless a withholding certificate is obtained from the IRS, a transferee is required to remit the full amount of the withholding to the IRS in cash notwithstanding the fact that there may be insufficient cash immediately payable to the foreign transferor in the transaction

Special rules apply to certain foreclosure and repossession sales in which an insufficient amount of cash is due back to the foreign borrower (Treas. Regs. § 1.1445-2(d)(3))

In many cases, the amount withheld will be in excess of the foreign transferor’s actual U.S. income tax liability on the sale. Any such excess can be recovered by the foreign transferor by filing a claim for refund

FIRPTA Withholding

Overview of Exceptions

Withholding generally not required when one of the necessary elements triggering FIRPTA liability is not present:

The transferor is not a foreign person



The transferor must properly certify, under penalty of perjury, that it is not a foreign person and must provide its taxpayer identification number in order for the transferee to be freed of its withholding obligation (Treas. Regs. § 1.1445-2(b))

The interest transferred is not a USRPI



Where stock of a domestic corporation is transferred, the corporation must certify to non-USRPHC status (Treas. Regs. § 1.1445-2(e))

The transfer of the USRPI does not constitute a “disposition”

The transferor has no amount realized on the transfer (e.g., a gift)

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FIRPTA Withholding

Overview of Exceptions

(continued)

The transferee's withholding obligation may be reduced or avoided under certain other circumstances:

The transaction is for the purchase of property for use as a personal residence for \$300,000 or less (IRC § 1445(b)(5))

The transfer is eligible for nonrecognition treatment and the transferor provides proper notice to the transferee and the IRS (Treas. Regs. § 1.1445-2(d)(2))

The transfer involves an acquisition by a U.S. governmental body (Treas. Regs. § 1.1445-2(d)(5))

A withholding certificate can be issued by the IRS that either reduces or eliminates the withholding requirement (Treas. Regs. § 1.1445-3)



Such a certificate would typically be issued in circumstances where the amount to be withheld would significantly exceed the amount of tax imposed on the foreign transferor as a result of the disposition

FIRPTA Withholding Entity Distribution and Transfer Rules

U.S. domestic partnerships are required to withhold 35% of the taxable gain recognized on dispositions of a USRPI that is allocable to foreign partners

(IRC § 1446; Treas. Regs. § 1.1445-5(c)(1)(ii))

✓ Similar rules are applicable to dispositions of USRPIs by certain U.S. trusts and estates with foreign beneficiaries (Treas. Regs. § 1.1445-5(c)(1)(iii))

Foreign corporations are generally required to withhold 35% of the taxable gain recognized on distribution of a USRPI (without regard to whether the distributee is a foreign or U.S. shareholder) (Treas. Regs. § 1.1445-5(d))

U.S. corporations that are classified as USRPHCs are generally required to withhold 10% of the value of any cash or property distributed to a foreign shareholder

(Treas. Regs. § 1.1445-5(e))

✓ This withholding requirement only applies if the distribution is treated under applicable rules as a distribution in redemption of some or all of the shareholder's stock, or is a distribution in liquidation of the U.S. corporation

FIRPTA Withholding

Entity Distribution and Transfer Rules

(continued)

Transfer of interests in partnership:

- ✓ Interests in partnerships that own U.S. real property are not generally considered to be USRPIs
- ✓ Nevertheless, a purchaser or transferee of a partnership interest from a foreign transferor is required to withhold 10% of the amount realized on the transfer if:
 - 50% or more of the gross value of the partnership's assets consist of USRPIs, and
 - 90% or more of the gross value of its assets consist of USRPIs plus cash and cash equivalents
- ✓ Pending the issuance of regulations by the IRS, no similar rules are currently in place for transfers of interest in foreign trusts and estates

(Treas. Regs. § 1.1445-11T(b), (d)(1))

Capital gain dividends distributed by REITs to foreign shareholders are subject to 35% withholding

(Treas. Regs. § 1.1445-8(c)(2))

- ✓ This withholding requirement applies even if the REIT is “domestically controlled”

FIRPTA Withholding - Mechanics

Amount withheld must be reported and paid over to the IRS by the 20th day after the transfer date

“Transfer date” is generally the first day on which the transferee pays any consideration or assumes a liability

IRS Form 8288
(U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests)





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