Tax Alert

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PATH Act Changes to FIRPTA

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The Protecting Americans from Tax Hikes Act of 2015 (the PATH Act, Division Q of the Consolidated Appropriations Act, 2016, P.L. 114-113, enacted December 18, 2015) made some important changes to the U.S. federal income tax treatment of U.S. real estate investments by non-U.S. persons under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).

Increased Withholding

The withholding rate applicable to dispositions by non-U.S. persons of United States real property interests (USRPIs) has been increased from 10 percent to 15 percent of gross proceeds, except for sales of residences intended for personal use by the acquirer if the purchase price does not exceed $1 million.

Foreign Pension Exemption

FIRPTA and its related withholding tax no longer apply after December 18, 2015 to dispositions of USRPIs held directly (or indirectly through one or more partnerships) by, or to distributions received from a real estate investment trust (REIT) by, a qualified foreign pension fund or by a non-U.S. entity wholly owned by a qualified foreign pension fund. A qualified foreign pension fund is any trust, corporation or other organization or arrangement (i) which is created or organized under the law of a country other than the United States, (ii) which 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, (iii) which does not have a single participant or beneficiary with a right to more than five percent of its assets or income, (iv) which 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, and (v) with respect to which, under the laws of the country in which it is established or operates, (A) contributions to such organization or arrangement that would otherwise be subject to tax under such laws are deductible or excluded from the gross income of such entity or taxed at a reduced rate, or (B) taxation of any investment income of such organization or arrangement is deferred or such income is taxed at a reduced rate.

Qualified Investment Entities

Special FIRPTA rules apply to “qualified investment entities.” A qualified investment entity includes any REIT and certain regulated investment companies (RICs) that are or are deemed to be United States real property holding corporations (USRPHCs). A USRPHC is, in general, a corporation that holds USRPIs with a value of 50 percent or more of its total business assets and worldwide real property. The PATH Act modifies these rules in the following important respects:

- The inclusion of RICs as qualified investment entities, which had expired on December 31, 2014, has been permanently extended. Although this extension is generally retroactive to January 1, 2015, it does not apply with respect to FIRPTA withholding for any payment made before December 18, 2015, and a RIC that withheld and remitted tax on distributions after December 31, 2014 and before December 18, 2015 is not liable to the distributee with respect to amounts so withheld and remitted.

- The FIRPTA rule that excludes publicly traded stock of a corporation from the definition of a USRPI for certain holders of five percent or less of the publicly traded class of stock has been modified, solely in the case of REITs, to increase the maximum ownership percentage to 10 percent.

- The similar FIRPTA rule, applicable to holders of five percent or less of stock of a qualified investment entity that is publicly traded in the U.S., that prevents application of FIRPTA to distributions from the qualified investment entity attributable to the entity’s disposition of USRPIs, has been increased to 10 percent, again solely for REITs. Such distributions are instead treated and subject to withholding as dividends.

- The so-called “cleansing exception,” which exempts from FIRPTA dispositions of stock of a USRPHC that has disposed of all of its USRPIs in taxable transactions, has been modified by excluding REIT and RIC stock from the scope of the exception.

Qualified Shareholders

FIRPTA will not apply to dispositions of REIT stock (including REIT stock held indirectly through one or more partnerships) by, or distributions from a REIT attributable to the REIT’s disposition of USRPIs to, a “qualified shareholder” of the REIT. While certain holders of publicly traded REIT stock or stock in REITs that are “domestically controlled” (i.e., less than 50 percent ownership by foreign persons during a specified period) receive beneficial treatment under FIRPTA, the new rule for qualified shareholders applies even if the REIT is not publicly traded or domestically controlled. A qualified shareholder is a foreign person that (i) is eligible for the benefits of a comprehensive income tax treaty which includes exchange of information provisions and whose principal class of interests is listed and regularly traded on a recognized stock exchange, or is a partnership created or organized under foreign law as a limited partnership in a jurisdiction that has a tax information exchange agreement with the U.S. and has a class of limited partnership units traded on the NYSE or NASDAQ representing greater than 50 percent of the value of all partnership units, (ii) is a “qualified collective investment vehicle,” and (iii) maintains records on the identity of direct owners of more than five percent of the class of the foreign person’s interests or units.

A “qualified collective investment vehicle” is a foreign entity that (i) is eligible for a reduced rate of withholding under an income tax treaty even if it holds more than 10 percent of the stock of the REIT, (ii) is publicly traded, treated as a partnership under the Code, is a withholding foreign partnership, and would be treated as a USRPHC if it were a domestic corporation, or (iii) is designated as such by the Treasury Department and is either fiscally transparent or is required to include dividends in income but is entitled to a deduction for distributions.

The qualified investor exception is not applicable to the extent that an "applicable investor" (other than a qualified shareholder) holds an interest in the qualified shareholder (except for an interest solely as a creditor) and such applicable investor directly, indirectly, or constructively (through certain attribution rules) holds 10 percent or more of the REIT. In such a case, generally the qualified shareholder's interests in, and distributions from, the REIT remain subject to FIRPTA to the extent of the applicable shareholder's proportionate ownership of the qualified shareholder.

A special rule also applies to REIT distributions to a qualified shareholder that would be treated as a sale or exchange of stock under Internal Revenue Code sections 301(c)(3), 302, or 331 that treats the portion attributable to an applicable investor as FIRPTA gain and portions attributable to other investors as income subject to dividend withholding (subject to treaty reductions).

Presumptions Regarding Domestic Control

Finally, the PATH Act introduces new rules and presumptions regarding whether a qualified investment entity is domestically controlled.

- A qualified investment entity may presume that holders of less than 5 percent of a class of stock regularly traded on an established securities market in the United States are U.S. persons, except to the extent that the qualified investment entity has actual knowledge that such persons are not U.S. persons.
- Any stock in the qualified investment entity held by another qualified investment entity (i) which has issued any class of stock that is regularly traded on an established securities market, or (ii) which is a RIC that issues redeemable securities (within the meaning of section 2 of the Investment Company Act of 1940), is treated as held by a U.S. person if such other qualified investment entity is domestically controlled (as determined under the new rules), and a non-U.S. person in any other case.
- Any stock in a qualified investment entity held by any other qualified investment entity not described in the bullet point immediately above is treated as held by a U.S. person to the extent that the stock of such other qualified investment entity is (or is treated under the new rules as) held by a U.S. person.

The information presented is only of a general nature, intended simply as background material, is current only as of its indicated date, omits many details and special rules, and accordingly cannot be regarded as legal or tax advice.

Available Material

- Consolidated Appropriations Act, 2016, H.R. 2029, P.L. 114-113, as signed by the President on December 18, 2015.
- Technical Explanation of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029 (Rules Committee Print 114-40), Joint Committee on Taxation, JCX-144-15, December 17, 2015.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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