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Significant changes may be on the horizon for the Foreign Investment in Real Property Tax Act

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That the Foreign Investment in Real Property Tax Act (FIRPTA) should be revised is one of the few areas of Congressional bi-partisan agreement.

Originally enacted in 1980 to restrict certain tax benefits accruing to foreign investors in real estate, the common view today is that FIRPTA discourages much-needed foreign capital financing of U.S. real estate and infrastructure projects. Further, due to various legislative changes, many of the rules relating to the treatment of foreign corporations holding real estate are viewed as obsolete.

FIRPTA generally taxes net income from the sale (vs. operation) of U.S. real property as income earned from a U.S. trade or business. In other words, a foreigner owning U.S. real property is taxed at the same rate on gain from sale as is a U.S. citizen. FIRPTA applies both to sales of U.S. real property as well as sales of stock in a U.S. corporation that owns U.S. real property ("USRPHC").

A distribution to shareholders from an USRPHC that is a REIT may also be subject to FIRPTA to the extent of its underlying sale of U.S. real estate.

To combat this, many foreign investors structure their investments to own stock in a REIT that is "domestically controlled," i.e., 50% or more of the stock in the REIT is owned by U.S. shareholders. Under this structure, sale of the domestically controlled REIT shares is exempt from FIRPTA, and thus exempt from U.S. taxation.

As an alternative, foreign investors may form a U.S. C corporation to invest in USRPHC, and use the "cleansing rule" to avoid a second layer of taxation.[1] Earlier this year, the Real Estate Roundtable, which represents a host of real estate related organizations, petitioned the Senate Finance Committee to revise FIRPTA's "punitive" measures in order to encourage foreign private capital to finance transportation and infrastructure investments.

"The petition points out that allowing foreign investment could ramp up the number of projects, thereby improving transportation, boosting employment, and increasing tax revenue."

Noting that the tax burden can be as high as 55%, the petition states that FIRPTA is anti-competitive and, as a result, diverts capital to investments such as stocks and bonds, where the tax rate is much lower. Although the Roundtable's letter was oriented primarily toward Highway Trust Fund legislation, it went on to identify other potential benefits of foreign investment:

1. Foreign investors, such as pension funds and insurance companies typically have a long time horizon to realize the returns that these projects can provide.
2. Infrastructure and transportation usually generate predictable and stable income streams.
3. Real estate offers an important inflation hedge.

In addition, the petition points out that allowing foreign investment could ramp up the number of projects, thereby improving transportation, boosting employment, and increasing tax revenue.[2]

The bipartisan Real Estate Investment and Jobs Act of 2015 was passed by the Senate earlier this year, with the House reintroducing its own version, which includes many of the Senate's changes. The stated rationale for the Act is that "increased investment in building and infrastructure will create American Jobs."[3] Provisions of the proposed acts would:

1. Increase from 5% to 10% the ownership limit required for (i) the sale of stock of a publicly traded corporation to be exempt from FIRPTA; and (ii) distributions attributable to sales of real property interests by REITs to be exempt from FIRPTA (Senate and House versions).
2. Eliminate the ownership threshold for certain "qualified" shareholders that are qualified investment vehicles (at the moment this only includes Dutch or Australian REITs) (Senate and House versions).
3. Exempt from FIRPTA foreign pension funds receiving income from the sale of S. real property (House version only).
4. Provide a certain presumption that will allow investors to rely more confidently on the FIRPTA exemption for the sale of domestically controlled REIT shares (Senate and House Versions).
5. Restrict the "cleansing rule" so that it does not apply to a REIT or RIC that was a S. real property holding company at any time in the prior five years (Senate version only).
6. Increase FIRPTA withholding from 10% to 15% (Senate Version only).
7. Require corporations to disclose if they are (or had been in the last five years) a S. real property holding company (Senate Version only).

The Senate and House versions of the Real Estate Investment and Jobs Act are a welcome attempt to reform FIRPTA. Although they do not address every issue, the proposals seek to liberalize the rules for certain large investors, i.e., Foreign Pension Funds and Foreign REITs.

They also are intended to simplify the process to qualify a REIT as domestically controlled, allowing more investors to take advantage of the exemption for a sale of domestically controlled REIT shares. Congress, currently in recess, may have an incentive to pass the legislation soon.

Going into an election year, both parties need every advantage possible. The FIRPTA changes could make a big difference in the outcome.

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[1] A USRPHC does not include a corporation that has disposed of its real property interest in a gain recognition transaction. A common tax strategy to "cleanse" potentially two layers of U.S. taxation is for the C corporation to sell its USRPI, pay corporate tax, and then liquidate tax free.

[2] https://www.reit.com/sites/default/files/documents/NationalTradeOrganizationsStatementonHowFIRPTAReformcanhelpU_S_InfrastructureNeeds%286-17-15%29.pdf

[3] See S. Rep 114-25.

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