Generally, foreign investors are exempt from U.S. tax on the capital gain they recognize on the sale of stock or debt instruments issued by U.S. corporations (if the gain is not effectively connected with the conduct of a U.S. trade or business). Foreign investment in U.S. real property is treated differently. Since 1980, the Foreign Investment in Real Property Tax Act (FIRPTA) has required foreign investors to file a U.S. tax return and pay U.S. tax on gain from the disposition of U.S. real property interests (USRPIs), which include interests in real property and interests in corporations (including REITs) that own substantial U.S. real property. Subject to the exceptions discussed immediately below, distributions (whether liquidating or non-liquidating) by real estate investment trusts (REITs) to foreign investors of net capital gain are also subject to FIRPTA tax if attributable to the disposition by the REIT of any of its USRPIs.

Prior to the enactment of the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act), only limited exceptions to FIRPTA tax applied, specifically:

- dispositions of publicly traded REIT stock if the foreign investor (a “portfolio investor”) is a minority (five percent or less) owner;
- net capital gain distributions from a publicly traded REIT if the foreign portfolio investor owns no more than five percent of the REIT’s stock;
- dispositions of the stock of publicly traded or privately owned REITs that are “domestically controlled” (i.e., less than 50 percent owned by foreign investors); and
- dispositions of the stock of publicly traded or privately owned REITs by a foreign government that owns a non-controlling interest.

On December 18, 2015, President Obama signed the PATH Act into law. The PATH Act represents the most significant change to the taxation of foreign investment in U.S. real property since FIRPTA was enacted. The PATH Act significantly facilitates foreign investment in U.S. real estate by (i) fully exempting from FIRPTA tax “qualified” foreign pension funds that own U.S. real estate through a REIT, (ii) increasing from five percent to ten percent the amount of stock a foreign portfolio investor can own in publicly traded REITs without incurring FIRPTA tax, and (iii) permitting certain widely-held, publicly traded foreign investors to qualify for such treatment as portfolio investors in REITs,
regardless of whether the REIT is public or private. The PATH Act pays for these tax benefits in part by restricting some of the rules applicable to REITs, including a prohibition on the recent trend of corporations in industries other than real estate spinning off their real property into entities treated as REITs in tax-free transactions.

“Qualified Foreign Pension Funds” Are Exempt from FIRPTA

The PATH Act creates a new exemption from FIRPTA for qualified foreign pension funds (QFPFs). On or after December 18, 2015, any disposition of a USRPI by a QPF, or any distribution to a QPF by a REIT, is exempt from FIRPTA.

A QPF is any foreign trust, corporation, or other organization or arrangement:

- which is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees of one or more employers in consideration for services rendered;

- which does not have a single participant or beneficiary with a right to more than five percent of its assets or income;

- 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

- either:
  - the contributions to such organization or arrangement are tax deductible or excluded from the gross income of such entity or taxed at reduced rates, or
  - the taxation of any investment income of such organization or arrangement is deferred or taxed at a reduced rate.

A QPF includes a foreign entity wholly-owned by a QPF.

Observation: There are questions as to which foreign pensions satisfy the requirements to be a QPF. The requirement that the pension fund provides benefits “to participants or beneficiaries that are current or former employees of one or more employers in consideration for services rendered” may be a significant limitation. The quoted language is taken from the definition of a “broad participation retirement fund” under the Treasury regulations for the Foreign Account Tax Compliance Act of 2010 (FATCA). Many foreign governments provide retirement benefits to citizens, regardless of whether the citizens have been employees. Accordingly, the FIRPTA exemption granted to QPFs appears to benefit only certain employer-sponsored foreign pension plans and may not benefit foreign pension plans where the right to benefits is premised on citizenship or residency rather than employment status. Each foreign pension fund needs to do its own analysis, with assistance from its tax advisors, to determine whether it qualifies as a QPF. There may be questions that cannot be resolved until the U.S. Treasury Department and Internal Revenue Service issue guidance on the PATH Act, or if Congress enacts “technical correction” legislation.

Investing through a REIT is an attractive alternative for a QPF that invests in U.S. real estate. The sale of the REIT stock, and distributions by the REIT to the QPF that are attributable to the
disposition by the REIT of its USPRIs, are exempt from FIRPTA. It is important to note that, although QFPFs are exempt from FIRPTA tax, they are not exempt from other U.S. withholding taxes. For example, a U.S. dividend withholding tax of 30 percent (subject to reduction by treaty or exempt from taxation in the case of foreign governments) continues to apply. In addition, a QFPF should be prepared to certify to the REIT stock purchaser (or the REIT) that it is a QFPF to avoid FIRPTA tax withholding.

FIRPTA Exemption Expanded to Ten Percent Portfolio Investors

Pre-PATH Act, if a class of a REIT’s shares were “regularly traded” on an established securities market and a foreign portfolio investor held five percent or less of that class of shares during the five-year period ending on the date of the sale (or, if shorter, the duration of the ownership of the shares), the sale of those shares would not be subject to tax under FIRPTA. In addition, pre-PATH Act, a REIT’s distributions with respect to any class of such “regularly traded” stock were not subject to tax under FIRPTA if paid to a foreign portfolio investor who held five percent or less of that class of stock at any time during the one-year period ending on the date of the distribution. Those distributions instead were treated as ordinary income dividends paid by the REIT and subject to U.S. dividend withholding tax of 30 percent (subject to reduction by treaty or exempt from taxation in the case of foreign governments). The PATH Act increases the five percent threshold in both cases for such portfolio investors to ten percent or less, effective for dispositions or distributions on or after December 18, 2015.

Certain Widely Held, Publicly Traded Foreign Investors Are Exempt from FIRPTA

The PATH Act creates an exemption from FIRPTA tax for REIT stock held by certain publicly traded foreign entities, such as listed Australian property trusts (Qualified Shareholders), except to the extent that a foreign investor in a Qualified Shareholder holds more than ten percent of the REIT’s stock, whether or not by reason of such investor’s ownership interest in the Qualified Shareholder. If a foreign investor in a Qualified Shareholder directly or indirectly holds more than ten percent of the REIT’s stock, then a portion of the REIT stock held by the Qualified Shareholder (based on the foreign investor’s percentage ownership of the Qualified Shareholder) is treated as a USRPI in the hands of the Qualified Shareholder and is subject to FIRPTA tax.

A Qualified Shareholder is a foreign person that:

- either is:
  - eligible for the benefits of a comprehensive income tax treaty with the United States and whose interests are listed and regularly traded on one or more recognized stock exchanges (as defined in such comprehensive income tax treaty); or
  - a foreign limited partnership in a jurisdiction that has an agreement with respect to taxes with the United States and that has more than 50 percent of its limited partnership interests regularly traded on the NYSE or NASDAQ markets;
- maintains records on the identity of each person who is the direct owner of five percent or more of the interests in such foreign person; and
- meets one of the following requirements:
  - it would be eligible for a reduced rate of withholding under a comprehensive income tax treaty with the United States, even if such foreign person holds more than ten
percent of the REIT stock (for example, the U.S. tax treaties with Australia and the Netherlands);

- it is publicly traded, treated as a partnership for U.S. tax purposes, is a withholding foreign partnership and would be treated as a “United States real property holding corporation” if it were a U.S. corporation; or

- it is designated by the Secretary of the Treasury and is either (i) “fiscally transparent” within the meaning of Section 894 of the Internal Revenue Code or (ii) required to include dividends in its gross income, but is entitled to a deduction for distributions to its investors.

If a Qualified Shareholder owns REIT stock and no foreign investor in the Qualified Shareholder directly or indirectly owns more than ten percent of the REIT stock (for example, the Qualified Shareholder is widely held and the foreign investors in the Qualified Shareholder do not own the REIT stock other than through the Qualified Shareholder), the Qualified Shareholder may own and dispose of the REIT stock without the application of FIRPTA tax. That exemption applies regardless of whether the REIT stock is publicly traded and regardless of whether the REIT is “domestically controlled.” Thus, certain widely-held, publicly traded foreign entities can make investments in U.S. real estate through private REITs and will not be subject to tax under FIRPTA on gain on the sale of the REIT stock.

A special rule applies to certain REIT distributions that are treated as sales or exchanges of REIT stock with respect to a Qualified Shareholder (for example, if a REIT makes a liquidating distribution to a Qualified Shareholder). In that case, if there are foreign investors in the Qualified Shareholder that own directly or indirectly more than ten percent of the REIT stock, then a portion of the REIT stock held by the Qualified Shareholder is subject to FIRPTA tax as described above. In addition, in the case of any other REIT shareholder, a REIT distribution that is treated as a sale or exchange of REIT stock with respect to that other shareholder is taxed as a dividend even though it otherwise would have been taxed as capital gain to such shareholder.

“Pay Fors”

To offset the tax revenue losses from the changes to the FIRPTA rules, Congress enacted certain changes to the rules applicable to REITs that are expected to raise tax revenues. The more significant “pay fors” are described below.

- End to Tax-Free Spinoffs Involving REITs

The PATH Act intends to ensure that assets held by corporations are subject to corporate level taxation by eliminating tax-free spin-offs in which a REIT is either the distributing or controlled corporation. Thus, effective for distributions on or after December 7, 2015, the recent “opco-propco” REIT spin-off transactions by Penn National, Windstream and Darden are not possible on a tax-deferred basis. In these transactions, an operating company in an industry other than real estate -- in this case, the gaming, telecommunications and restaurant industries, respectively -- attempts to unlock value by spinning off, in a tax-free transaction, its real property into an entity that elects tax treatment as a REIT (the property company), with the REIT then leasing the real property back to the operating company. The consequence is that the REIT’s profits that it distributes to its shareholders escape taxation at the entity level.

The prohibition is effective for distributions on or after December 7, 2015 but does not apply to distributions described in private letter ruling requests initially submitted to the Internal Revenue Service on or before that date. Private letter rulings generally are made public three months after
they are received by the taxpayer who requested them, so, in time, we should know who is still eligible to do a tax-free spin-off transaction. Hilton Worldwide Holdings recently announced that it received a private letter ruling regarding an opco-propco REIT spin-off transaction involving its hotel properties.

The PATH Act clarified that a REIT may still spin off a taxable REIT subsidiary (a TRS) or a subsidiary REIT if certain requirements are satisfied, including a spin-off transaction in which the REIT holds its interest in the TRS or subsidiary REIT through its operating partnership.

- **TRS Asset Test Limit Reduced from Twenty-Five Percent to Twenty Percent**

The PATH Act reduces the percentage of a REIT’s total assets that may be securities of a TRS from twenty-five percent to twenty percent, effective for taxable years beginning after December 31, 2017.

- **FIRPTA Withholding Rate Increased from Ten Percent to Fifteen Percent**

The PATH Act increases the FIRPTA withholding rate imposed on the disposition or distribution of a USRPI (including REIT stock) from ten percent to fifteen percent, effective for dispositions/distributions after February 16, 2016. After February 16, 2016, sales of residences are subject to different FIRPTA withholding rates, summarized below:

<table>
<thead>
<tr>
<th>Amount Realized from Sale of Residence</th>
<th>FIRPTA Withholding Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not more than $300,000</td>
<td>0%</td>
</tr>
<tr>
<td>More than $300,000, but not more than $1 million</td>
<td>10%</td>
</tr>
<tr>
<td>More than $1 million</td>
<td>15%</td>
</tr>
</tbody>
</table>

THIS ARTICLE BRIEFLY SUMMARIZES CERTAIN CHANGES TO THE U.S. TAX LAWS BY THE PATH ACT. IT WAS WRITTEN BY HOGAN LOVELLS LAWYERS FOR EDUCATIONAL AND INFORMATIONAL PURPOSES ONLY AND IS NOT INTENDED, AND SHOULD NOT BE CONSTRUED, AS LEGAL ADVICE.

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