ROBERT G. GOTTLIEB
JOSEPH G. HOWE, III

WILLIAM M. FUNK

The Sun Also Sets

Making the Most of TIPRA's Cha

For managers of mutual funds, also called regulated investment companies (RICs), that are heavily invested in real estate investment trusts (REITs) and other real estate companies, the past few years have been a time of changing tax laws, some of which have favored taxpayers who have invested in these vehicles. Some of these provisions are scheduled to sunset at the end of 2007, so this is the final opportunity to take advantage of the sunsetting provisions. Other changes are permanent, or as permanent as anything is in U.S. tax law. This article will describe some of the changes in the law and their expected sunsets, discuss their application to some typical situations, and suggest internal controls to help with compliance.

Background Generally, the Foreign Investment in Real Property Tax Act (FIRPTA), enacted in 1980, added special rules to the Code that govern taxation of foreign persons disposing of interests in U.S. real property. Under the FIRPTA rules, any gain realized by a foreign person on the disposition of a U.S. real property interest (USRPI) is treated as income effectively connected with the conduct of a U.S. trade or business and is subject to normal U.S. net income taxation. Generally, a purchaser of a USRPI from a foreign person is required to withhold a tax equal to 10% of the amount realized (generally gross purchase price).[1] The person in control of the payment, usually the buyer, is required to deduct and withhold such portion of the payment and pay it over to the IRS.[2] The foreign seller must file a U.S. tax return with the IRS.[3] A foreign seller that is a corporation may also be subject to a branch profits tax of 30% when repatriating proceeds on its "dividend equivalent amount," as applicable.[4] Gain from the disposition of

nges to FIRPTA While They Last

a U.S. real property holding comany (USRPHC), however, is excluded from the scope of the branch profits tax.

A USRPI is generally defined to include direct or indirect interests in real property, other than solely as a creditor, located in the United States or the U.S. Virgin Islands, including interests (through corporations that are more than 50% controlled by another corporation, partnerships, or other pass-through entities) or interests in USRPHCs.[5] Real property includes not just the land, but improvements and inherently permanent structures as defined under the former investment tax credit rules of Reg. 1.48-1(c) and (d).[6] Shares in U.S. corporations are USRPIs if, at any time during a testing period equal to the shorter of five years or the period the foreign shareholder has held an interest in the corporation, the corporation was a USRPHC. A domestic corporation is a USRPHC if 50% or more of the fair market value of its holdings in real property and in assets used in its trade or business consisted of holdings of U.S. real property interests (unless the corporation has disposed of

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all its interests in USRPIs held during the testing period in transactions in which all the gain was recognized).[7] Interests in U.S. real property holding corporations are not considered U.S. real property interests if they consist of ownership, during the testing period, of no more than 5% of a class of stock that is regularly traded on a recognized U.S. securities exchange.[8]

Pre-AJCA Treatment of RIC and REIT Distributions

Dividend distributions from a REIT derived from such REIT's disposition of U.S. real property, e.g. capital gains dividends, were deemed to be gain from the sale or exchange of a U.S. real property interest and subject to a withholding tax of 35%.[9] Sales of stock of domestically controlled REITs were exempt from U.S. taxation.[10] A domestically controlled REIT is a REIT in which foreign ownership is less than 50% at all times in the five-year testing period ending on the date of distribution or disposition of REIT interests.[11] Recipients of capital gain distributions from a domestically controlled REIT were treated as receiving effectively connected income (ECI) and were required to file U.S. tax returns prior to recent changes in the law. On the other hand, distributions of capital gains dividends by RICs, including gains attributable to sales of U.S. real property interests, were not subject to U.S. taxation.[12]

Post-AJCA, Pre-TIPRA

To encourage foreign investment in publicly traded REITs, Congress included in the American Jobs Creation Act of 2004 (AJCA) an exception from ECI treatment for some REIT distributions; in particular, capital gain distributions from a REIT with respect to a class of stock regularly traded on an established U.S. securities exchange when the foreign investor has not owned more than 5% of such class during the one-year period ending on the date of the distribution.[13] Such a dividend would instead be treated as a fixed or determinable annual or periodical (FDAP) dividend, subject to 30% withholding.[14]

FIRPTA was also amended to tax distributions by RICs of gains from the sales of USRPIs. The new rules provided that distributions by qualified investment entities (QIEs) of amounts attributable to gains from the sales of USRPIs and distributed to foreign persons would be deemed to be gains from the sales of USRPIs subject to the 35% withholding rate.[15] QIEs were defined as any RIC or any REIT.[16] This extension of FIRPTA to all RICs was originally scheduled to sunset after 12/31/07.

TIPRA

In 2005, Congress passed the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) and revisited some of the FIRPTA provisions of the AJCA. Congress modified the definition of QIEs so that they are now (1) RICs that are U.S. real property holding corporations; (2) RICs that would be real property holding corporations if their holdings in stock in USRPHCs regularly traded on U.S. exchanges were treated as U.S. real property interests; or (3) any REIT.[17] In particular, Congress expressed concern that the FIRPTA taint on distributions of gains from the sales of U.S. real property was being cleansed by distributions to RICs before their ultimate distribution to foreign shareholders and noted that some RICs took the position that no withholding was required.[18] Therefore, Congress changed the rules so that distributions by QIEs to foreign shareholders or other QIEs retained the FIRPTA taint.[19] Congress provided an exception for distributions by QIEs with respect to any class of QIE stock regularly traded on a U.S. exchange and held by foreign shareholders not owning more than 5% of such class during the one-year period ending on the date of such distribution.[20] Such distributions would be treated as not from a sale of U.S. real property interests. Congress then also clarified that such distributions will be subject to the 30% dividend withholding tax.[21]

This is a mixed bag for foreign investors in, and, therefore for managers of, RICs. On the one hand, the FIRPTA taint of a distribution from a REIT continues in the hands of the RIC. On the other hand, if a RIC that is not a QIE disposes of U.S. real property interests, the gains attributable thereto are not subject to FIRPTA and are therefore exempt from withholding as merely foreign-source capital gains![22] This, therefore, poses to managers of RICs important decisions concerning their holdings.

Congress also acted to shut down an attempt to avoid taxation of RIC or REIT distributions to foreign shareholders who attempted to engineer receiving the economic benefits of a distribution without the form. The foreign shareholder would sell the RIC or REIT stock on which distributions were anticipated. Because these distributions were anticipated, the seller could command a price that took the distributions into account. Once the stock was ex-dividend, the foreign person would repurchase the stock at a lower value. Because the shareholder received only foreign-source capital gains, the shareholder took the position that the gains were exempt from U.S. taxation.

Congress therefore added a "wash sale" provision under which, if a foreign person sells an interest in a domestically controlled QIE in an "applicable wash sale transaction," the foreign person or QIE will have gain from the sale of a U.S. real property interest in an amount equal to the portion of the distribution (including substitute dividend payments) the foreign person would have received but for the transaction and that would have been treated as gain from the sale of a U.S. real property interest.[23] An applicable wash sale transaction is a transaction in which a foreign person or a QIE disposes of an interest in a domestically controlled QIE within 30 days prior to the ex-dividend date and then acquires or enters into a contract or option to acquire a substantially identical interest in the 61-day period starting with the first day of the 30-day period.[24]

The amendments provide for limited exceptions to wash sale treatment for circumstances in which there appear to be no attempt to engineer tax savings. If the foreign person or QIE actually receives the distribution with respect to the interest that was disposed or repurchased, wash sale treatment would not apply.[25] The wash sale rules also contain an exception that is similar to other TIPRA provisions, in which the rules would not apply to transactions in a class of stock of a QIE in which the foreign person or QIE did not own more than 5% of such class of the issuer's stock in the one-year period ending on the date of the dividend distribution.[26]

Sunsets

Congress, apparently having grown particularly fond of sunsetting tax provisions, starting with the Economic

gn person on the disposition of a USRPI is treated as ness and is subject to normal U.S. net income taxation.

William M. Funk is a U.S. Tax Manager in the New York office of PricewaterhouseCoopers LLP. He is part of the International Tax Services practice. This article marks Mr. Funk's first appearance in these pages. The opinions expressed herein do not represent the opinions of PricewaterhouseCoopers LLP.

Growth and Tax Relief Reconciliation Act of 2001, has compounded the complexity in having some parts of the same subsections sunset while others do not. In particular, the QIE provisions require close attention.

The classification of real estate oriented RICs as QIEs sunsets after 12/31/07, except for two important items.[27]

This has particular impact on the sale of foreign investors stock in RICs. Section 897(h)(2) exempts sales of stock in domestically controlled QIEs. The 12/31/07 sunset, therefore, will again subject to taxation foreign investors' gain from the disposition of 5% or greater interests in regularly traded RICs and any interests in all other RICs that have sufficient holding in USRPIs to be considered USRPHCs themselves. Therefore, those who are advising foreign investors should be acquainted with the possible effects of these sunsets.

Under FIRPTA, distributions by qualified investment en interests and distributed to foreign persons are deeme

Excluded from the sunset, however, are the provisions related to distributions from and wash sales involving QIEs. The classification of these real estate oriented RICs continues with respect to the look-through rules governing distributions and the wash sales rules discussed above.

The Rules in Operation

To illustrate how these rules operate, several examples are provided.

Example 1. Tech Growth Fund is a domestically controlled mutual fund that primarily invests in NASDAQ listed technology corporations. Its stock is regularly traded on a U.S. exchange. Only 10% of its portfolio is invested in U.S. real property holding corporations or other U.S. real property interests.

Result: Tech Growth Fund is not a QIE. If it declares and pays a capital gains dividend based on its sale of U.S. real property interests, such distribution will not be subject to any withholding. It should be noted that some language in the legislative history is broader than the statutory language.[28]

Example 2. The Wall Street Fund is a domestically controlled mutual fund that invests primarily in U.S. real property holding corporations regularly traded on the New York Stock Exchange and in classes of domestically controlled REITs. The fund has never owned more than 5% of the publicly traded classes of stock of any corporation or REIT in its portfolio. The fund sells some of its REIT stock and some of its stock in U.S. real property holding corporations. The fund has not received any REIT dividends this tax year.[29]

Result: Although the Wall Street Fund is a QIE, none of the proceeds are from sales of U.S. real property interests and so are not subject to FIRPTA withholding in 2007. Provided that the fund designates the distribution as a capital gains distribution, there will be no FDAP withholding on distributions to foreign persons, regardless of their percentage ownership of the fund.

Example 3. The Pacific and Northeastern Fund is a domestically controlled mutual fund that invests more than half of its portfolio in REITs. Its stock is regularly traded on a U.S. exchange. The fund receives capital gains distributions from its REITs and distributes such amounts to its shareholders.

Result: The fund must withhold 30% on distributions to foreign shareholders owning no more than 5% of the fund's publicly traded class of stock and in 200835% on capital gain distributions to foreign shareholders owning more than 5% of such class.

Example 4. Bermcay Advisors manages a portfolio for several major foreign investors. Bermcay's portfolio has significant exposure to the U.S. real estate market (but in no case owning more than 5% of any one fund) through funds such as the Grand Central Fund, a domestically controlled mutual fund, which invests primarily in NASDAQ-traded, real-estate-oriented companies like the Plains Group, Inc, a company specializing in Midwestern office construction and rental, but in any event does not hold more than 5% of any one company. Bermcay has decided to reduce its exposure to the U.S. real estate market by selling off shares of RICs such as the Grand Central Fund over the next three years.

Result: Bermcay's investors will not receive FIRPTA-tainted distributions in 2007 and will be subject to 30% withholding. However, in 2008 and beyond, Bermcay's investors will be subject to 35% withholding and they will have to file U.S. tax returns, an unwelcome development. Because RICs like the Grand Central Fund are no longer qualified investment entities for purposes of Section 897(h)(2), holdings of their stock now become holdings of U.S. real property interests.

Example 5. In 2007, Beijing America Corp., a corporation based in the

1 Section 1445(a).
2 Section 1445(c); Reg. 1.1445-1(a).
3 Section 897(a)(1).
4 Section 884(a). This rate and the FDAP rate (defined infra) are subject to reduction by treaty, but will be referred to as a 30% rate for simplicity.
5 Section 897(c); Reg. 1.897-1(c) and -2(e).
6 Reg. 1.897-1(b)(3).
7 Section 897(c)(5).
8 Section 897(c)(3).
9 Former Section 897(h)(1); Reg. 1.1445-8(c).
10 Section 897(h)(2).
11 Section 897(h)(4)(B) and (h)(4)(D).
12 See Sections 871 and 881
13 Former Section 897(h)(1).
14 Section 857(b)(3)(F). Special rules apply to governmental entities under Section 892.
15 Former Section 897(h)(1).
16 Former Section 897(h)(4)(A).
17 Section 897(h)(4)(A).
18 H.R. Conf. Rep. No. 109-455.
19 H.R. 4297, Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, Section 505. H.R. Conf. Rep. No. 455, 109th Cong., 1st Sess. (2005).
20 Section 897(h)(1). This, however, is not a final tax. The foreign investor is still required to calculate tax and file a Form 1120F or 1040F.
21 Section 852(b)(3)(E)(ii).
22 Apparently, Congress intended the relief for RICs that are not primarily invested in U.S. real property to be retroactive. H.R. 4297, TIPRA, P.L. 109-222, Section 504.
23 Section 897(h)(5)(A).
24 Section 897(h)(5)(B)(i).
25 Section 897(h)(5)(B)(iii)
26 Section 897(h)(5)(B)(iv)
27 Section 897(h)(4)(A)(ii); H.R. Conf. Rep. No. 109-455.
28 "The conference agreement clarifies that the treatment of a RIC as a qualified investment entity continues after December 2007 with respect to a RIC that receives a distribution from a REIT." Based on the statutory language, this applies only to RICs that have the requisite ownership of U.S. real property interests.
29 Usually REITs do pay dividends, but I have created the fact pattern to focus. on one issue in this example.

People's Republic of China, sells stock in the Washington Realty Corp., a domestically controlled mutual fund whose entire portfolio consists of stock of domestically controlled REITs and U.S. real property corporations (but never more than 5% thereof) that are regularly traded on U.S. exchanges.

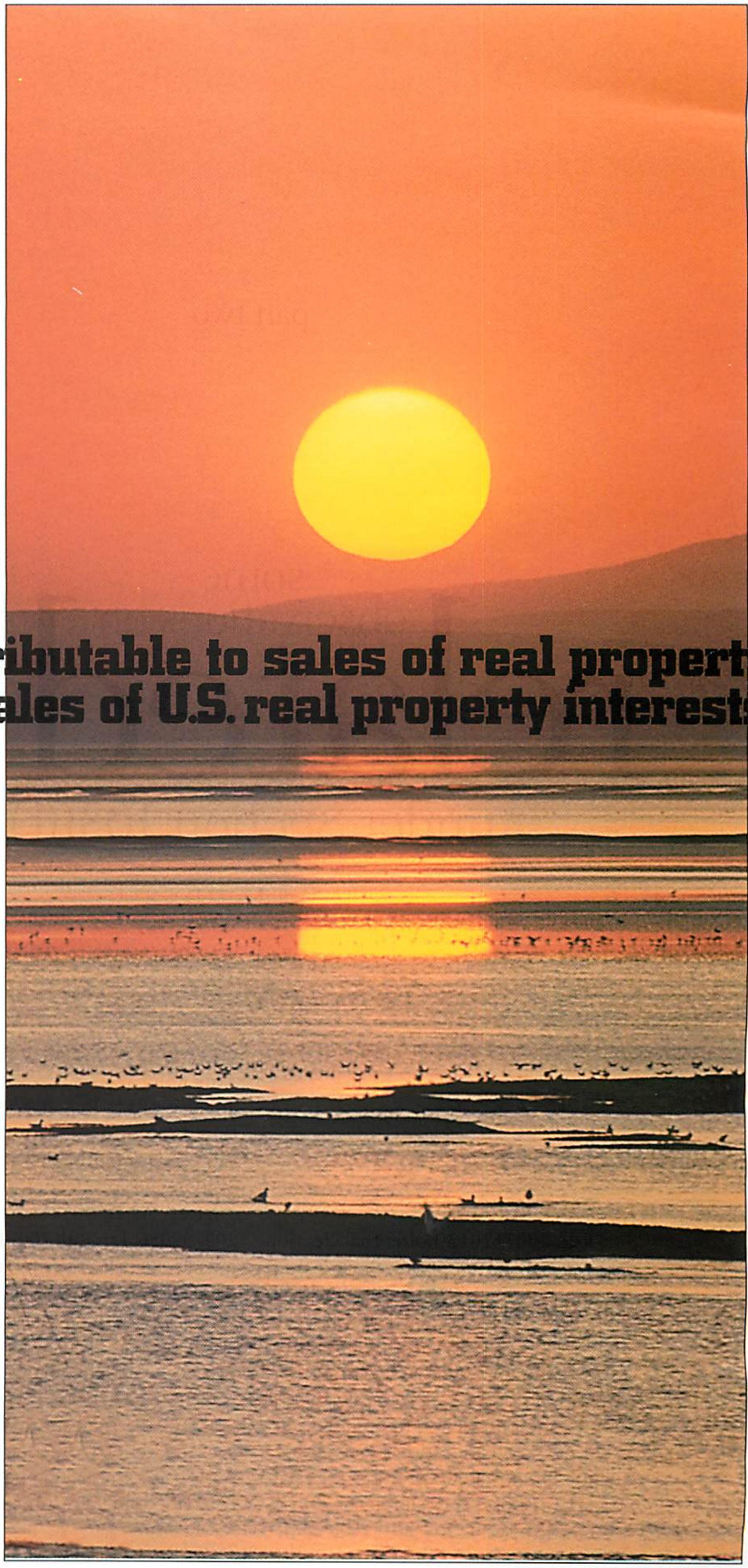
Result: Beijing America is not subject to tax. Its gains are foreign-source capital gains.

Compliance

In order not to be caught unprepared on December 31 of this year, it is not to soon for advisors of mutual funds and of foreign investors to impose internal controls to protect the interests of their advisees. A plan of action should involve:

- Identifying holdings affected by these rules including both the nature of investments and the percentage of a regularly traded class.
- Ensuring that information regarding the holdings of any look-through entity in which a person or fund holds interests is up to date.
- Identifying foreign beneficial owners of interests in a fund and their percentage ownership in a regularly traded class.
- Communicating up through chains of ownership of investments to ensure that the individuals responsible for advising investors are adequately informed of the opportunities in 2007 and the risks of investments in years afterwards.

tities of amounts attributable to sales of real property d to be proceeds of sales of U.S. real property interests.



Conclusion

The sunset of favorable rules for foreign investors in vehicles that favor U.S. real property create an incentive for exiting a number of investments. This comes at a time when the U.S. real estate market outside of the New York metropolitan area has slowed down. Although the members of this Congress are unlikely to look with favor on the odd patchwork of tax cuts and sunsets that have benefited many investors, they may wish to carefully review the policy in this area. ■