Foreign Investors in a REIT – Taxation by the Country of the REIT's Organization

Panel 2: Double Tax Treaties and Nonresident Taxation

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How Are Foreign Investors in a REIT Taxed by the Country in Which it is Organized?

- What are the issues?
  - First, is the REIT "fiscally transparent" – that is, a pass-through entity? If so, need to be concerned about
    - Whether the foreign investors will be taxed directly by the country in which the REIT is organized
      - With treaty benefits determined at the level of the investors, not the REIT
    - Whether the activities of the REIT will be attributed to the foreign investors
      - So that the foreign investors may be doing business, or have a permanent establishment, in the REIT's country of organization

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How Are Foreign Investors in a REIT Taxed by the Country in Which it is Organized?

Continued

- If the REIT is not a pass-through – which is the case for most countries – the tax issues are the treatment by the country of the REIT's organization of
  - Distributions to investors, which may be made by the REIT out of
    - Gain from the sale of real (or "immovable") property by the REIT, or
    - Other net income, such as rent or mortgage interest
  - Gain from the sale of the foreign investor's interest in the REIT

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What Does the OECD Commentary Say?

- The OECD Commentary has no single set of rules for REITs, but lays out choices
- In general, the Commentary would treat a REIT as a "person" and a "resident" of the country in which it is organized
  - Because it is "liable to tax" by reason of its place of organization, although not in fact subject to entity-level tax
- As a consequence, source country taxation of distributions by the REIT would be covered by Article 10 of the OECD Model, which
  - Applies to "dividends paid by a company which is a resident of a Contracting State"

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What Does the OECD Commentary Say?

Continued

- If the REIT is not a "resident" or a "company", its distributions might still be covered if it is "organized under the laws of" the source country

- Article 10 may reduce the rate of withholding tax on dividends paid by a resident corporation to
  - 15%,
  - 5% in the case of a corporate shareholder owning 25% or more of the capital of the corporation, or
  - Zero in the case of a pension fund or a corporate parent
- Does this apply to dividends paid by a REIT?
  - The "real policy issue" in applying Article 10 to REITs, according to the OECD, is whether distributions by a REIT should be treated as income from immovable property or not

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What Does the OECD Commentary Say?

Continued

- The OECD concluded that the distributions should not be treated as income from immovable property in the case of a "small" investor
  - Thus the Commentary would apply the reduced treaty rates only to a "small" investor in a REIT
    - Defined as a shareholder holding, directly or indirectly, capital of the REIT representing less than 10% in value of all of its capital
  - If the shareholder's ownership was 10% or more, the statutory rate of withholding of the source country would apply to the distribution
- Under Article 13 of the OECD Model, a country may tax gains from the sale or other disposition of
  - Real (or "immovable") property located in that country, and

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What Does the OECD Commentary Say?

Continued

- Shares of a company "deriving more than 50 per cent of their value directly or indirectly from immovable property situated in" that country
  - This would cover shares of most "equity" REITs, *i.e.*, REITs that invest in property as opposed to mortgages secured by real property
- But the Commentary suggests that treaties may exempt from tax gain from sale of investments in a REIT by a "small" investor
  - Again, those owning 10% or less in value of the REIT's capital

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How Do These Rules Apply to US REITs?

- REITS are the predominant vehicle in the US for retail investment in real estate
  - More than 200 publicly-traded REITs
  - With a total market capitalization of about $804 billion, of which
    - $740.3 billion is of equity REITs and
    - $64.6 billion is of mortgage REITs
  - These numbers do not include private (including public non-traded) REITs, which are important
- By segment of publicly-traded REITs, the market capitalization of
  - Industrial/office REITs is $130.5 billion,
  - Retail REITs, $200.6 billion, and
  - Residential REITs, $101 billion

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REITs in the US

- Huge growth in REITs since the 1960 enactment of the REIT rules
  - From 34, with a total market capitalization of $1.49 billion in 1971, to
  - 138, with a total market capitalization of $12.97 billion in 1991, to
  - 182, with a total market capitalization of $154.9 billion in 2001, to
  - More than 200 in July of 2014, with a total market capitalization of more than $800 billion

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REITs in the US

Continued

- Of the 34 publicly-traded REITs in 1971, only 12 were equity REITs – the balance were mortgage REITs and hybrids
    - Today, equity REITs account for about 80% of the market capitalization of publicly-traded REITs
    - Mortgage REITs are divided between home and commercial financing

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REITs in the US

Continued

- Also, significant expansion in what US REITs may do
  - Today, for example, they own and operate cellular and other communication systems, data storage facilities, outdoor billboards, timber properties, private correctional facilities, and gaming casinos
- Expansion in what REITs do is generally attributed to
  - The Internal Revenue Service's broad interpretation of what is real property and rent from real property
  - The ability of REITs to have, within limits, "taxable REIT subsidiaries" which are taxable but not limited in what they may do
  - The ability of regular corporations, at acceptable tax costs, to move some or all of their operations into REITs

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How are US REITs and their Shareholders taxed?

- In the US, there is “double” taxation of the net income of a regular corporation – first to the corporation and then, when distributed, to the shareholder
    - REITs are corporations for US tax purposes but double taxation is avoided by a deduction allowed for dividends paid
- REITs in practice distribute all of their net ordinary income and capital gain and so generally pay no entity level tax
    - There are exceptions to the no-entity-level-tax rule in cases where the REIT engages in activities viewed as inconsistent with the purpose of the REIT rules
        - For example, it is a “dealer” in real estate

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Taxation of US REITs and their Shareholders

Continued

- The intent of the REIT rules was to allow “mutual funds for real estate”
  - That is, to achieve parity between the taxation of direct investment in passive real estate assets, such as leased property and mortgages, and investments made through REITs
  - But, as noted, REITs today own and operate businesses which are not “passive” such as
    - Cellular and other communication systems,
    - Data storage facilities,
    - Outdoor billboards,
    - Timber properties,
    - Private correctional facilities, and
    - Gaming casinos

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What are the rules for taxing foreign shareholders of a US REIT?

- Until 1980, the taxation of foreign shareholders of a US REIT was straightforward
  - Treated like any investment in shares of a U.S. corporation
    - No tax on gain from the sale of shares or on distributions of capital gain
    - 30% tax on other dividends, generally reduced by treaty to 15%
- In 1980, however, FIRPTA* was enacted — legislation that was, broadly, intended to tax gain derived by any foreign person from the sale of US real estate as business income that is subject to regular rates of tax
  - And for this purpose, interests in US real property are generally defined to include "interests", other than as a creditor, in a corporation of 50% or more in value of its business assets are interests in US real property
    - So-called "United States real property holding corporations"

* Or the Foreign Investment in Real Property Tax Act of 1980

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What are the rules for taxing foreign shareholders of a US REIT?

Continued

- For purposes of the FIRPTA rules, REITs make two kinds of distributions to shareholders
  - Those which are attributable to gains from the sale of real property by the REIT
    - Generally, dividends that are designated as capital gain dividends
  - Distributions out of other net income
    - Such as rent or mortgage interest

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Taxation of Foreign Shareholders of a US REIT – Ordinary Dividends

- Distributions not from gain from the sale by the REIT of real property (*e.g.*, those paid out of net rental income) are taxed at the 30% withholding tax rate that applies to dividends paid to foreign shareholders by any US corporation
    - US tax treaties reduce the 30% withholding tax
        - To zero in the case of a foreign pension fund which owns 10% or less of the REIT, and
        - To 15% in some cases
            - But not to
                - The 5% rate that applies to dividends paid to corporate shareholders owning 10% or more of the voting stock of the US corporation or
                - The zero rate that applies to parent-subsidiary dividends

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Taxation of Foreign Shareholders of a US REIT – Ordinary Dividends

Continued

- Not all US tax treaties are the same, but the treaty reduction to 15% for dividends is generally available in US treaties only where
  - The beneficial owner of the dividends is an individual (or a pension fund, if no zero rate) with an interest of not more than 10% in the REIT, or
  - The dividends are paid with respect to a class of stock that is publicly traded and the beneficial owner of the dividends is a person holding an interest of not more than 5% of any class of the REIT’s stock, or
  - The beneficial owner of the dividends is a person holding an interest of not more than 10% in the REIT and the REIT is “diversified”
- A REIT is “diversified” if the value of no single interest in real property exceeds 10% of its total interests in real property (with a look-through rule if the REIT invests in partnerships)

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US Tax Treaties

- Some US tax treaties are more generous than others in the case of shareholders which are the equivalent of REITs in the other country
  - The U.S.-Netherlands treaty extends the 15% rate on ordinary dividends to any dividends paid to a Dutch *beleffingsinstelling*
  - The U.S.-Australia treaty treats dividends paid to a listed Australian property trust (or LAPT) as paid on a class of traded shares and extends the 15% rate to ordinary dividends paid to LAPT to the extent of its 5% or smaller interest holders

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Taxation of Foreign Shareholders of a US REIT – Distributions of Gain

- But regular rates of US tax apply to distributions by a REIT to foreign shareholders of gain realized by the REIT on a sale of real property – that is, rates
  - Of up to 35% in the case of a corporate shareholder, and
  - Of up to 39.6% in the case of an individual
- Tax treaties do not change this rule, but it is subject to an important statutory exception which
  - Eliminates regular tax on distributions on a class of shares regularly traded on a securities market in the case of a shareholder who owns, and in the last year has owned, no more than 5% of the class
    - Still subject to withholding tax of 30% or, under treaties, 15% or zero in the case of a pension fund
    - To the extent paid out of earnings and profits

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Taxation of Foreign Shareholders of a US REIT – Gain From Sales of Shares

- Regular rates of tax also apply to gain from a sale of shares of a REIT, if it is a "United States real property holding corporation"
- Not changed by US tax treaties, but subject to two statutory exceptions
    - First, an exception for sales of shares of a class of stock that is regularly traded on an established securities market by a shareholder who does not own and, in the last five years has not owned, more than 5% of the class
        - Similar to the exception for distributions attributable to gain of the REIT from the sale of real property

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Taxation of Foreign Shareholders of a US REIT – Gain from Sales of Shares

Continued

- Second, a statutory exception for the sale of shares of a REIT that is "domestically controlled"
  - That is, for shares of a REIT that
    - Is owned to the extent of more than 50% in value by US persons, and
    - Has been so owned for the last five years
- The domestically controlled exception for gain from the sale of shares creates tax planning opportunities
  - Consider, for example, a case where a foreign investor owns each investment in U.S. property in a separate REIT, bringing in US investors to make sure the REITs are domestically controlled
    - The US investors may be affiliates — ownership does not include ownership by related persons

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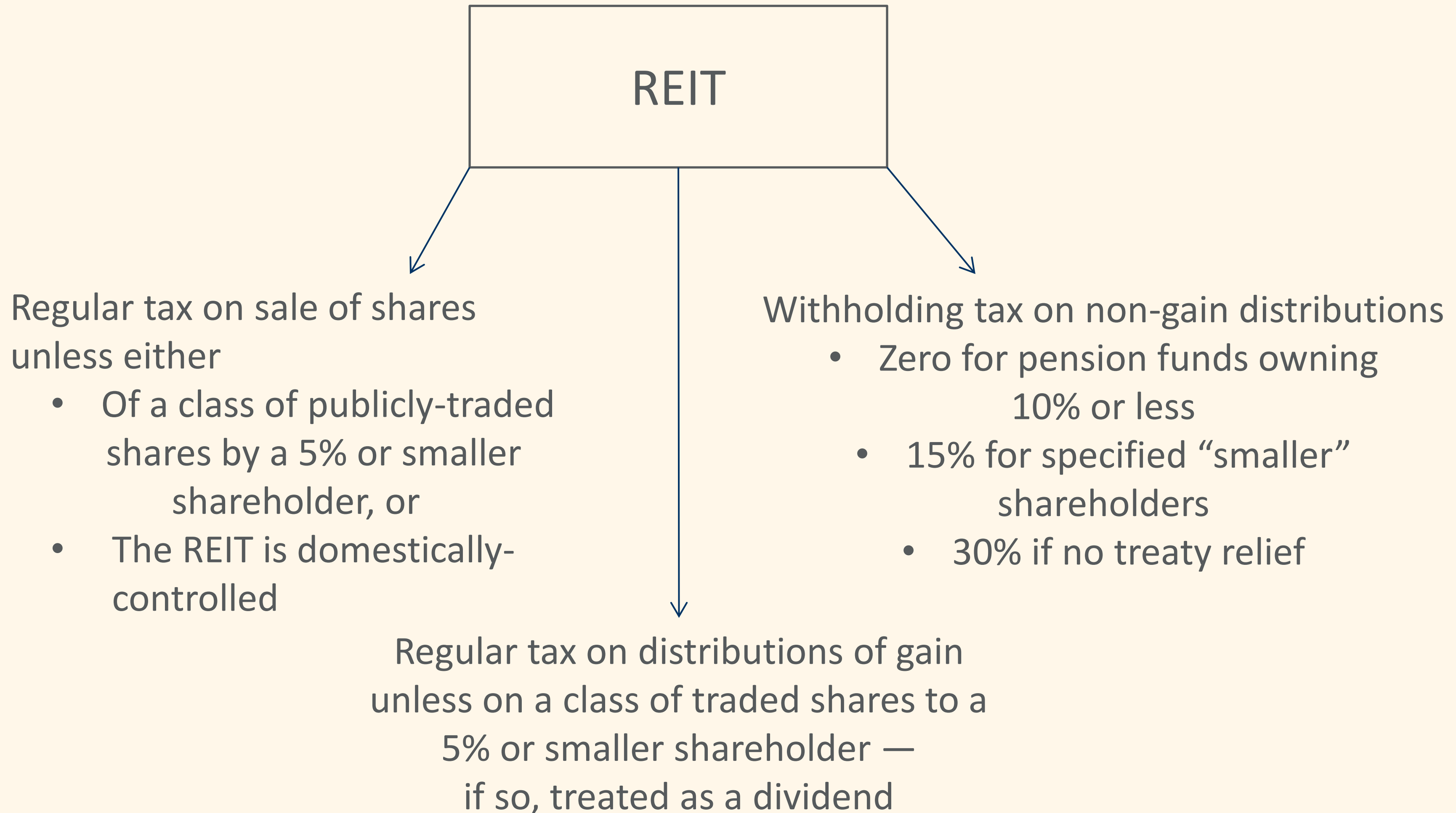
Taxation of Foreign Shareholders of a US REIT



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Foreign shareholders of a RIC that invests principally in shares of REITs

- The FIRPTA rules, and the exceptions to the rules, may also apply to regulated investment companies that invest in shares of REITs
  - A large number of such funds – commonly referred to as US Real Estate Mutual Funds
  - As a consequence of investing principally in shares of REITS, such a regulated investment company would be a United States real property holding corporation for purposes of the FIRPTA rules
  - It will still be a regulated investment company for purposes of treaties, however, and thus its foreign shareholders would generally be entitled to the 15% rate on ordinary dividends without the limitations that apply to REIT dividends

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Possible legislative changes?

- Legislation introduced in Congress and supported by the real estate industry* would expand the statutory and treaty exceptions for sales of shares of REITs and for REIT distributions by
  - Increasing from 5%-or-less to 10%-or-less the ownership threshold for the exemptions for sales by, and gain distributions to, foreign shareholders of a REIT owning shares traded on an established securities market
  - In the case of a collective investment fund whose shares are listed and traded on a stock exchange and is eligible for treaty benefits, applying the 10%-or-less threshold at the level of its investors

* H.R. 5487, The Real Estate Investment and Jobs Act of 2014

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Possible legislative changes?

Continued

- Thus, under the legislation, treaty benefits would be available to a CIV to the extent it had "small" investors, but
    - Would be denied if on a look-through basis the shareholder of the CIV was deemed to own more than 10% of the REIT
    - The CIV would be required to maintain records identifying 5% or greater shareholders
- This part of the legislation would hugely expand on the ability of foreign REITs (and other CIVs) to invest in US REITs
- The legislation would also expand the "domestically controlled" REIT exception so that
    - A publicly-traded REIT could assume that less than 5% owners of a class of traded shares were US persons unless it had knowledge to the contrary

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Possible legislative changes?

Continued

- But it would also provide that shares in a REIT owned by another US REIT were not owned by a US person unless the owner was itself a domestically controlled REIT

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Is a redemption of shares by a REIT a distribution or a sale?

- Whether a redemption of shares by a REIT is a distribution or a sale is a much disputed issue
  - Redemption would include a redemption of shares in a liquidation
  - Principally relevant where the REIT is domestically controlled
- IRS's view is that a redemption is a distribution, not a sale by the shareholder
  - Thus, only exempt from the FIRPTA rules in a case where the holder owns 5% or less of a class of regularly traded shares
  - Raises complex issues of how to determine when gain is/is not from a disposition of real property by the REIT

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Suppose the foreign investor is a REIT or other collective investment fund?

- US law, and most recent US tax treaties, deny treaty benefits for dividends and other payments to “fiscally transparent” entities unless the income is taxed as the income of a resident
    - A REIT or other collective investment vehicle would not be fiscally transparent unless a pass-through in the country in which organized
- In addition, under a limitation on benefits, or LoB, article, most US tax treaties deny treaty benefits to income of a resident of the other country unless that person is also a “qualified person”

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Suppose the foreign investor is a REIT or other collective investment fund?

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- An option under Action 6 of the OECD's BEPS initiative is the incorporation of LoB article in a revised OECD Model
    - While the US has had LoB provisions in its treaties for many years, not clear whether CIVs, including REITs, are "qualified persons"
- Comments to the OECD, and its commentary on a possible LoB, acknowledge this. The CIV
    - May not be traded on a stock exchange
    - May be owned by third country residents
    - May be allowed to deduct distributions and be used to make investments, not the active conduct of a business

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Suppose the foreign investor is a REIT or other collective investment fund?

Continued

- The OECD’s suggestions include addressing CIVs directly in treaties, and
  - Treating a CIV, as defined, as a “qualified” person without restriction, or
  - Including a CIV in the definition of a “qualified”person to the extent owned by residents of its country of organization or equivalent beneficiaries

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Are there Other Open issues for REITs?

- The OECD considered a number of issues that were left unresolved, including
  - Relief for foreign income taxes paid by a REIT if no tax is imposed on the REIT – the country of the REIT's residence "should find a way to provide for … relief"
    - Not resolved in the US – no foreign tax credit passed through to shareholders of a REIT
  - Obstacles to investments by REITs in foreign real property, including REITs in the source country
    - Ameliorated by some treaties and would be further addressed by the industry-backed legislation

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