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SPECIAL REPORT

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In this article, Ravichandran examines the tax treatment of various transactions under the U.S. 1980 Foreign Investment in Real Property Tax Act.

The views expressed in this article are solely those of the author.

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The U.S. 1980 Foreign Investment in Real Property Tax Act is meant to ensure that a foreign person is taxed on direct or indirect dispositions of U.S. real property in the same way as a U.S. person. Although FIRPTA is not new, recent statutory changes, as well as changes in the marketplace, warrant a fresh analysis of the basic ground rules. For example, the 2015 Protecting Americans From Tax Hikes (PATH) Act introduced additional exceptions to the FIRPTA rules, and the 2017 Tax Cuts and Jobs Act modified other relevant IRC provisions. Meanwhile, more and more capital has flown into U.S. real estate from tax-advantaged investors, including sovereign wealth funds (SWFs) and foreign pension funds.

This article reexamines the FIRPTA rules with a transactional focus. Section I discusses the basics of FIRPTA taxation, Section II discusses FIRPTA exceptions, and Section III discusses how the FIRPTA rules apply to several common types of transactions. The article concludes with tables illustrating the rules applicable to different classes of interests and investors.

I. FIRPTA Basics

Foreign persons not engaged in a U.S. trade or business are generally not subject to U.S. tax on capital gains.[1] Capital gains include gain from the sale of stock of domestic corporations and direct interests in U.S. real property. In contrast, foreign persons engaged in a U.S. trade or business are subject to U.S. tax on a net income basis at the same graduated rates as U.S. persons on all income that is effectively connected with that trade or business (effectively connected income, or ECI).[2]

Under FIRPTA, all dispositions of U.S. real property interests (USRPIs) by foreign persons are automatically treated as ECI. Therefore, all gain on dispositions of USRPIs is subject to U.S. tax on a net income basis, regardless of whether that disposition would otherwise be connected with a U.S. trade or business.[3]

FIRPTA applies to interests in U.S. real property. An interest is any interest other than an interest solely as a creditor.[4] Loans or other instruments that convey rights to appreciation in value, net proceeds, or profits from U.S. real property are interests.[5] Similarly, options are treated as interests because the holder benefits from appreciation above the strike price.[6] Several different categories of interests may constitute USRPIs.

A. U.S. Real Property

Most direct interests in U.S. real property are USRPIs. This includes fee ownership of U.S. land, natural products of land before harvest, leaseholds, and improvements on land, such as buildings and other inherently permanent structures. Interests in personal property associated with real property, such as movable walls and furnishings, are also USRPIs.[7]

B. Domestic Corporations

An interest in a domestic corporation that is a U.S. real property holding company (USRPHC) is a USRPI. Subjecting dispositions of domestic corporation stock to FIRPTA is necessary to ensure foreign persons pay U.S. tax on appreciation in U.S. real property.[8] Otherwise, a foreign person could monetize any appreciation in U.S. real property held by a domestic corporation by transferring stock in that corporation.[9] Meanwhile, no U.S. tax would be owed on this appreciation until the domestic corporation itself sold the U.S. real property, which it might never do.

A USRPHC is a corporation that holds USRPIs, the fair market value of which is at least 50 percent of the FMV of its USRPIs, foreign real property interests, and U.S. and foreign trade or business assets.[10] For these purposes, a corporation is treated as owning its proportionate share of assets held through partnerships and subsidiary corporations.[11] Business goodwill is an asset of a domestic corporation, although the

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[1] Foreign persons are otherwise subject to U.S. tax at a fixed 30 percent gross rate on U.S.-source income; *see* sections 871, 881. The sourcing rules are in IRC sections 861-865. Gains on property are excluded from taxation; *see* reg. sections 1.1441-1(2)(b)(2) and 1.871-7(a)(1). Section 865(a) also provides that the sale of stock is sourced to the seller's residence. Therefore, stock sales often do not give rise to U.S.-source income in the first instance. Gain from the disposition of U.S. real property is U.S. source; *see* section 861(a)(5).

[2] Sections 871(b), 882.

[3] Section 897(a). Foreign corporations are exempt from the branch profits tax that would otherwise apply to ECI on the disposition of USRPIs that are interests in USRPHCs; *see* section 884(d)(2)(C).

[4] Reg. section 1.897-1(d)(1). Except as otherwise specifically denoted, a reference to interest in this article refers to the concept of interest as it applies under FIRPTA.

[5] *Id.* That an instrument is characterized as debt for U.S. tax purposes is not determinative of whether an interest is an interest solely as a creditor.

[6] Section 897(c)(6); reg. section 1.897-1(d)(3). Accordingly, convertible debt is clearly an interest for FIRPTA purposes.

[7] *See* section 897(c)(6) and reg. section 1.897-1(b)(2)-(4).

[8] *See* S. Rep. No. 96-504, at 6 (1979). *See also* testimony of Donald Lubick, Treasury assistant secretary for tax policy, during a hearing on the taxation of foreign investments in the United States (June 25, 1979). Early legislative history would have applied the concept to interests in all entities that held substantial U.S. real estate, whether domestic or foreign and whether corporations or partnerships. In conference, the language was narrowed to only domestic corporations, but the history provides no explanation for this change. *See* Leonard R. Olsen Jr., "Analysis of the Foreign Investment in Real Property Tax Act of 1980," 7 *Int'l Tax J.* 262 (1981).

[9] As discussed above, the sale of personal property such as stock in a corporation is sourced to the residence of the seller for U.S. tax purposes; *see* section 865(a). Thus, for a foreign person, any gain or loss would not ordinarily be U.S.-source income subject to U.S. tax.

[10] Section 897(c). An alternative way to administer the test would be to compare the FMV of USRPIs with the FMV of all non-U.S. real property and other trade or business assets. For determining whether a corporation is a USRPHC, interests in foreign corporations that are USRPHCs are also treated as USRPIs; *see* section 897(c)(4)(A). Foreign corporations may be USRPHCs (even though only an interest in a domestic corporation may be a USRPI). This can be relevant in determining whether domestic corporations are themselves USRPHCs and to the application of some FIRPTA nonrecognition provisions.

[11] *See* reg. section 1.897-1(e)-(f), (o).

valuation of self-created goodwill may be complex.[12]

Any interest in a domestic corporation is presumed to be a USRPI unless it is established that the domestic corporation was not a USRPHC at any time during the five-year period ending on the date of disposition of the interest in the USRPHC (or, if shorter, the taxpayer's holding period for the interest).[13] Because of this rule, FIRPTA must be considered in nearly every disposition of domestic corporation stock.

C. Partnerships

Interests in partnerships are generally not USRPIs.[14] However, the statute provides that under regulations, the disposition of a partnership interest shall be treated as a disposition of a USRPI to the extent the sales proceeds are attributable to USRPIs held by the partnership.[15] The regulations provide that the disposition of a 50/90 partnership is treated as a disposition of USRPIs to the extent of the USRPIs held by that partnership.[16] A 50/90 partnership is a partnership in which at least 50 percent of the gross FMV of the partnership assets constitutes USRPIs and at least 90 percent of the gross FMV of the partnership assets constitutes USRPIs or cash (or cash equivalents). The rule appears to apply to both foreign and domestic partnerships.

Although the regulations do not apply to dispositions of any other partnership interests, the IRS takes the position that the statute is self-executing for all partnerships.[17] Thus, the IRS's view is that any disposition of a partnership interest is subject to FIRPTA to the extent of the USRPIs held by the partnership. Although this position is debatable, its import is limited because section 864(c)(8) provides that the disposition of an interest in a partnership conducting a U.S. trade or business gives rise to ECI to the same extent as if the partnership sold its assets directly.[18] As a result, only taxpayers disposing of interests in partnerships that are not 50/90 partnerships and that do not conduct a U.S. trade or business need to consider the merits of the IRS's position. Dispositions of any other partnership interest will clearly be subject to FIRPTA or ECI taxation.[19]

In some circumstances, foreign holders might also want to affirmatively treat an interest in this kind of partnership as subject to FIRPTA if doing so would result in a loss that would offset FIRPTA gain. This may occur when the foreign partner has FIRPTA gain on other investments or when a foreign partner acquires an interest in a partnership in a secondary transaction and the partnership then disposes of the USRPI and liquidates.[20] In the second situation, it is unclear whether a foreign partner could take the position that the liquidation exchange is subject to FIRPTA because the partnership no longer holds USRPIs;

[12]Reg. section 1.897-1(f)(1)(ii), (o)(4). Whether an asset is held in a trade or business is determined under the principles of reg. section 1.864-4(c)(2); *see* reg. section 1.897-1(f)(2). It is unclear whether goodwill closely connected with real estate is a USRPI. Regulations defining real property for real estate investment trust rules indicate that real property includes intangible assets that derive their value from real property, are inseparable from real property, and do not contribute to the production of income other than for the use or occupancy of space. However, there is no comparable provision in the FIRPTA regulations, nor is there any provision importing the definition of real property from the REIT regulations. Instead, the FIRPTA regs regarding goodwill appear to assume that goodwill is a trade or business asset and not a USRPI.

[13]Section 897(c)(1)(A)(ii). The regulations also offer other relief, such as including a presumption of non-USRPHC status for corporations with limited USRPIs by book value and by permitting corporations to determine valuations only on specific dates.

[14]Further, like sales of stock in U.S. corporations, sales of interests in partnerships are sourced to the residence of the seller; *see* section 865(a). *See also Grecian Magnesite Mining, Industrial & Shipping Co. SA v. Commissioner*, 149 T.C. 63 (2017), *aff'd*, 926 F.3d 819 (D.C. Cir. 2019). Thus, before the introduction of section 864(c)(8), which was passed in part to overturn *Grecian Magnesite*, many foreign persons took the position that sales of partnership interests did not generally give rise to U.S. tax.

[15]Section 897(g). Although the statute references money or property, relief from liabilities should also be subject to section 897 under section 752 principles; *see* reg. section 1.752-1(h).

[16]Reg. section 1.897-7T.

[17]Notice 88-72, 1988-2 C.B. 383.

[18]As discussed in note 14, *supra*, section 864(c)(8) was enacted only recently to clarify that dispositions of interests in partnerships conducting a U.S. trade or business would be subject to U.S. taxation. Before the enactment of that section, the validity of the IRS's position was a bigger concern for taxpayers disposing of partnership interests that held some USRPIs, especially if the taxpayer intended to take the position that the disposition would otherwise not be subject to U.S. tax.

[19]Section 864(c)(8)(C) provides that FIRPTA supersedes section 864(c)(8) in that any amount treated as ECI under the FIRPTA rules reduces the amount treated as ECI under section 864(c)(8). However, reg. section 1.864(c)(8)-1(d) effectively reverses that order.

[20]The disposition of the USRPI will result in FIRPTA tax allocable to the foreign partner that increases the partner's basis in the partnership interest. Because the partner's basis should have already reflected the asset's FMV, that increased basis is noneconomic and ordinarily offset by a loss on liquidation. Foreign persons can avoid this result by insisting a section 754 election be in place in connection with the acquisition of a partnership interest.

thus, it is unclear whether the liquation exchange is attributable to a USRPI (rather than the cash proceeds).[21]

Interests in publicly traded partnerships are not subject to these rules but are instead treated as interests in domestic corporations.[22] Thus, whether interests in the partnership constitute USRPIs is determined by testing whether the partnership would be a USRPHC if it were a domestic corporation.

When a partnership itself sells a USRPI, foreign partners are clearly subject to FIRPTA tax on their shares of the gain on the USRPI. This applies whether the partnership is domestic or foreign.[23]

D. REIT Capital Gain and Liquidating Distributions

Real estate investment trusts can designate a portion of their distributions as capital gain distributions if they reflect gains on the disposition of property they hold.[24] REIT shareholders treat these dividends as gains from the sale or exchange of property, and absent FIRPTA, foreign holders would not generally be subject to U.S. tax on these gains.[25]

FIRPTA provides that distributions from a REIT that are attributable to the disposition of USRPIs are treated as if the foreign person disposed of the USRPI itself.[26] Thus, a foreign holder is subject to FIRPTA tax on the capital gain distribution to the extent attributable to a disposition of USRPIs.[27]

The IRS also takes the position that liquidating distributions are subject to the same rule, even though shareholders typically treat a liquidation as a sale or exchange of REIT stock under section 331 rather than a capital gain distribution.[28] Thus, shareholders are subject to FIRPTA tax on liquidating distributions if the proceeds received are attributable to the pre-liquidation disposition of USRPIs.[29]

E. Application of Nonrecognition Provisions

FIRPTA also overrides other IRC nonrecognition provisions when a USRPI is transferred, subject to some exceptions.[30] While a full discussion of these rules and their exceptions is beyond the scope of this article, a few generalizations may be helpful in determining when they should apply.[31]

First, a transfer of a USRPI may still qualify for nonrecognition treatment if it is exchanged for another USRPI and the USRPI received is subject to U.S. taxation, including FIRPTA taxation, on its disposition.[32] For example, it is impermissible to transfer a direct interest in U.S. real property in exchange for stock in a domestic corporation,

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[21] As discussed below, the IRS takes the position that liquidating distributions from REITs may be attributable to cash proceeds from the disposition of USRPIs for section 897(h)(1) purposes. A taxpayer may argue that similar logic ought to apply for section 897(g) and that a contrary result would seem unduly harsh.

[22] Reg. section 1.897-l(c)(2)(iv).

[23] Although section 897 refers only to nonresident alien individuals and foreign corporations, a partner is required to recognize its distributive share of a partnership's gain or loss; *see* section 702(a). The character of that gain or loss flows through to the partner as if the partner directly incurred the gain or loss; *see* section 702(b).

[24] Section 857(b)(3). FIRPTA is not relevant to most distributions from domestic corporations to foreign persons because dividends are already subject to U.S. tax under the general international provisions of the code; see sections 871(a) and 881. If the distribution exceeds earnings and profits (and basis), such that a portion is treated as a sale under section 301, FIRPTA would still apply, with the transferee being the domestic corporation itself.

[25] Section 857(b)(3)(A). As discussed above, gains on property sales by foreign persons are generally subject to U.S. tax only if effectively connected with a U.S. trade or business. However, the mere receipt of a capital gain distribution should not give rise to a U.S. trade or business, and there is no provision in the code akin to section 875 that would attribute the REIT's trade or business to its foreign shareholder.

[26] Section 897(h)(1).

[27] The rule also applies to regulated investment companies that are USRPHCs because they hold large amounts of REIT stock or securities. RICs also may make capital gain distributions, including further distributions of capital gain distributions received from REIT shares held by the RIC; *see* section 852(b). Section 897(h)(4)(A)(ii) extends FIRPTA treatment of capital gain distributions to RICs that are USRPHCs. Solely for determining whether a RIC is a USRPHC, all interests in REITs (including publicly traded REITs or domestically controlled REITs) are treated as USRPHCs.

[28] Notice 2007-55, 2007-27 IRB 13. REITs are still eligible for a dividends paid deduction for a liquidating distribution; *see* section 562(b)(1).

[29] Before 2015, foreign holders that disagreed with the IRS's view might have been able to avoid FIRPTA tax if a REIT disposed of all its assets for cash before liquidating. In addition to arguing that the liquidating distribution was not attributable to the sale of USRPIs under section 897(h)(1), the foreign holders would have had to argue that the REIT avoided USRPHC status as a "cleansed" company. As discussed in Section II, *infra*, REITs are no longer eligible for that exception. Accordingly, the merits of the IRS's position are primarily relevant to some SWFs that are eligible for FIRPTA relief under section 892.

[30] Section 897(d)-(e).

[31] *See* Guy Bracuti, Josh Kaplan, and Michael Plowgian, "U.S. Taxation of Foreign Investment in U.S. Real Estate," *Bloomberg Tax* (May 14, 2021) (describing the rules as a "complex set of substantive and procedural rules that are riddled with uncertainties and traps for the unwary").

[32] Reg. section 1.897-6T(a).

even if the corporation is a USRPHC, if the disposition of stock in that corporation would not be subject to tax.[33]

Second, special exceptions, which help facilitate several types of asset reorganizations and incorporations involving foreign corporations that hold USRPIs, apply when a USRPI is transferred to a foreign corporation.[34] The requirements vary depending on the type of reorganization, the foreign corporations' asset composition, and whether the foreign corporations are publicly traded or privately held.[35]

Finally, there is limited authority addressing the interaction of these rules and the various partnership nonrecognition provisions. There is IRS guidance (LTR 200851023) providing that a transfer of a USRPI to a partnership is eligible for nonrecognition under section 721,[36] but there does not appear to be direct guidance on applying nonrecognition provisions to distributions or circumstances in which a partnership with foreign partners itself engages in a nonrecognition transfer.

F. Treaties

Treaty relief from FIRPTA is generally unavailable. To avoid any potential conflict with FIRPTA, U.S. income tax treaties typically include articles providing a country the right to tax dispositions of real property located there.[37] Treaty language is generally modeled on FIRPTA to avoid any inadvertent gaps.

The language addressing dispositions of real property also serves to clarify a technical issue in reconciling FIRPTA and U.S. tax treaties. In particular, taxation under FIRPTA arises because dispositions are deemed ECI. Under many treaties, this type of income may be taxed only if the business is conducted through a permanent establishment.[38] However, inclusion of a specific real property article makes clear that FIRPTA gains are subject to tax regardless of whether the foreign person has a PE in the United States.[39]

G. Withholding

The rules discussed above impose substantive tax liability on foreign persons for disposition of USRPIs. However, to ensure collection of the substantive tax, FIRPTA also includes withholding provisions.

1. Dispositions of USRPIs and USRPHCs

When an interest in a USRPI is transferred, the transferee must withhold 15 percent of the amount realized on the disposition.[40] Because withholding is required on the amount realized rather than the cash purchase price, the required withholding tax might exceed the cash purchase price.[41] In this case, the transferee must fund any excess from other sources.

The FIRPTA withholding provisions also apply to the transfer of USRPIs that are interests in USRPHCs (such as stock). Also, when interests in a USRPHC constitute USRPIs and the USRPHC redeems them — whether on an ongoing basis or in complete liquidation — the USRPHC must withhold 15 percent of the amount of cash or FMV of any property distributed in redemption.[42]

2. Capital Gain and Liquidating Distributions

REITs and regulated investment companies must withhold on capital gain distributions to foreign persons to the extent attributable to the

[33] Reg. section 1.897-6T(a)(7), Example 6.

[34] Because interests in foreign corporations cannot be USRPIs, the USRPI-for-USRPI exception does not apply.

[35] Reg. section 1.897-6T(b)(1); Notice 2006-46, 2006-1 C.B. 1044. The rules also provide relief for some incorporation-type transactions that take the form of "B" reorganizations or section 351 transactions. They also seem to require that the transactions otherwise qualify for nonrecognition in their entirety — that is, there is no tolerance for boot.

[36] The letter ruling indicated a remedial method allocation was made for the contributed property, but it is not clear if electing the remedial method is necessary to qualify.

[37] *See, e.g.*, article 13 of the U.S. model income tax treaty. Congress also specifically and deliberately overrode any extant contrary treaty provisions when enacting FIRPTA. *See* section 1125(c) of the Omnibus Reconciliation Act of 1980.

[38] *See, e.g.*, U.S. model article 7.

[39] *See* Rev. Rul. 73-419, 1973-2 C.B. 436 (comparable analysis under treaty provisions addressing ordinary income derived from real property when a foreign person derived ordinary real property income but did not have a PE).

[40] Section 1445(a). The rate used to be 10 percent but was increased to 15 percent as part of the PATH Act.

[41] Although uncommon, this is most likely to occur when the disposition of an interest in real property is taken subject to a mortgage that absorbs most of the equity value of the property or a disposition of an interest in a partnership that holds similar property.

[42] Reg. section 1.1445-5(e). There is an exception for cleansed companies; *see* Section II.E, *infra*.

disposition of USRPIs.[43] As discussed above, the IRS takes the position that liquidating distributions are also subject to this treatment.[44]

The withholding rate is the maximum corporate rate, and the amount of withholding is determined by multiplying the withholding rate by the amount of the capital gain distribution treated as gain from the sale of a USRPI.[45]

3. Dispositions of Partnership Interests

Withholding on the disposition of partnership interests is required only when the transferred interest is an interest in a 50/90 partnership. The withholding rate is 15 percent of the amount realized.[46] For withholding purposes, the entire partnership interest is treated as a USRPI even though the substantive tax on the person disposing of the interest is imposed only on the portion of gain attributable to USRPIs.[47] In all other cases, no withholding is required, regardless of whether substantive FIRPTA tax may be imposed.

Section 1445 regulations provide that withholding for dispositions of these other partnership interests will apply only on or after the date in which regulations under section 897(g) are finalized. The same is true for taxable distributions from a partnership to a partner. However, as with the section 897(g) rule itself, recent legislative changes largely eliminate any reason to finalize these rules. This is because most partnerships holding real property would likely generate ECI, and section 1446(f) — the withholding companion to section 864(c)(8) — would impose withholding on dispositions of interests in those partnerships, as well as taxable distributions.[48]

4. Dispositions by Partnerships

When a domestic partnership disposes of a USRPI, it must withhold at the maximum corporate rate on the amount of gain realized that is allocable to its foreign partners.[49] Partnerships with more than 100 partners may instead elect to withhold when they distribute amounts attributable to the sale of the USRPI to foreign partners (rather than when they dispose of the USRPI). Generally, the first distributions after the sale will be treated as attributable to the disposition of the USRPI.[50] Publicly traded partnerships must withhold in accordance with the procedures for large partnerships.[51]

Foreign partnerships are not permitted to assume primary FIRPTA withholding liability even if they assume primary liability for other types of withholding.[52] Thus, foreign partnerships cannot withhold on behalf of foreign partners in accordance with the rules described in the previous paragraph. Instead, when a foreign partnership transfers a USRPI, the transferee will be required to withhold in accordance with the general FIRPTA withholding rules.

5. Overlap With ECI Withholding

Both domestic and foreign partnerships are required to withhold on a foreign person's share of ECI earned by the partnership at the highest marginal rate for individuals or corporations, as applicable.[53] A disposition of a USRPI will also often give rise to ECI because the property sold is used in a U.S. trade or business.

The regulations coordinate the ECI and FIRPTA withholding provisions to reflect the different treatment of domestic and foreign partnerships under the FIRPTA rules.[54] A domestic partnership that withholds on proceeds received on a disposition of a USRPI under the

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[43]Section 1445(e)(6). In the absence of FIRPTA withholding, REIT capital gain distributions likely would not be subject to fixed or determinable annual or periodic withholding because the distribution does not represent FDAP; *see* section 857(a) and reg. section 1.1441-2(b)(2).

[44]Because most REITs would be USRPHCs, liquidating distributions would likely be subject to FIRPTA withholding under the general rules discussed above.

[45]Section 1445(e)(6).

[46]*See* reg. section 1.1445-11T and section 1445(e)(5).

[47]Reg. section 1.897-7T(a).

[48]Reg. section 1.1446(f)-2.

[49]Reg. section 1.1445-5(c). The transferee would not be required to withhold because the transferor is a U.S. partnership and so not a foreign person.

[50]Reg. section 1.1445-5(c)(3).

[51]Reg. section 1.1445-8.

[52]Rev. Proc. 2017-21, 2017-6 IRB 791.

[53]Section 1446(a)-(b).

[54]Publicly traded partnerships generally must withhold on ECI only upon making distributions to their interest holders; *see* reg. section 1.1446-4. The regulations similarly provide that compliance with ECI withholding satisfies the publicly traded partnerships FIRPTA withholding liability; *see* reg. section 1.1446-4(f)(4).

ECI rules is deemed to satisfy its FIRPTA withholding obligations.[55] In contrast, dispositions by a foreign partnership will be withheld on by the acquirer, as discussed above, and the partnership can claim a credit against its ECI withholding requirements for the amount of FIRPTA withholding.[56]

Dispositions of interests in ECI partnerships are also subject to ECI withholding of 10 percent of the amount realized.[57] If a partner disposes of a partnership interest in a transaction that would be subject to both ECI and FIRPTA withholding (such as a sale of an interest in a 50/90 partnership), FIRPTA withholding generally supersedes ECI withholding.[58]

II. The Exceptions

There are various exceptions to the imposition of FIRPTA tax that may apply based on the type of interest being disposed of, the status of the entity itself, or the status of the investor.

A. Public Corporations

There are several exceptions for corporations with at least one class of publicly traded stock.[59] For the exception to apply, there must be a class of publicly traded stock, not merely any interest.[60] If there is a class of publicly traded stock, the exception can also apply to both publicly traded non-stock interests and non-publicly traded interests.

First, interests in a domestic corporation that are regularly traded on an established securities market are USRPIs only for any person that owned more than 5 percent of the interests' FMV (as a class) at any time during the five-year period preceding the disposition.[61] An established securities market includes both domestic and foreign securities exchanges, as well as over-the-counter markets.[62] Interests are treated as regularly traded if they are regularly quoted on a domestic securities market or if trading meets specific volume requirements.[63]

Second, non-publicly traded interests that are convertible into publicly traded interests are USRPIs only if the interests have an FMV greater than 5 percent of the FMV of the class of publicly traded interests they are convertible into.[64] Unlike the rule for publicly traded interests, the relative values of each class are tested on the date the interest was initially acquired rather than at all times during the preceding five years. This rule seems to be targeted at convertible debt, and it is possible that the difference in measurement date is intended to avoid causing an interest to be treated as USRPI because of fluctuations in relative value.[65]

Finally, nonconvertible, non-publicly traded interests in corporations that have at least one class of publicly traded stock are USRPIs only if the FMV of the interests is more than 5 percent of the FMV of the class of the corporation's publicly traded stock with the lowest FMV.[66] That too is measured on the date of acquisition. This rule appears targeted at preferred stock and, as with the previous rule, one possible reason for it is to avoid subjecting the interests to FIRPTA as a result of fluctuations in relative value.

When multiple interests of the same non-publicly traded class of interests are acquired, the

[55] Reg. section 1.1446-3(c)(2)(i). The acquirer would not be required to withhold because the transferor partnership is domestic.

[56] Reg. section 1.1446-3(c)(2)(ii).

[57] Section 1446(f).

[58] Reg. section 1.1446(f)-1(d).

[59] Publicly traded partnerships are eligible for the same exceptions described in this section.

[60] Reg. section 1.897-1(c)(2)(iii).

[61] Section 897(c)(3) and reg. section 1.897-1(c)(2)(iii). The section 318 constructive ownership rules, with some modifications, apply in determining whether the holder meets the 5 percent test; *see* section 897(c)(6)(C). When a partnership holds one of the interests described in this section, there is uncertainty regarding whether the 5 percent tests are applied at the partnership or partner level.

[62] Reg. section 1.897-1(m).

[63] Reg. section 1.897-9T(d).

[64] Reg. section 1.897-9T(b). Unlike the next rule discussed, this rule applies by reference to interests into which the instrument is convertible and therefore may apply even if the publicly traded interest into which the instrument is convertible is not stock.

[65] Because the FMV is measured by reference to the equity into which the debt might convert rather than the value of the debt itself, it is possible for a small sliver of convertible debt to be USRPI if the borrower is thinly capitalized. If the convertible debt is itself publicly traded, however, the first rule would presumably apply, and the convertible debt would be measured relative to other debt.

[66] Reg. section 1.897-9T(b).

5 percent tests in the second and third rules above are retested as of each subsequent acquisition date. In performing that test, the holder's entire interest is retested, not just the newly acquired amount. Further, an antiabuse rule requires holders to aggregate separate classes of non-publicly traded interests that were acquired with a principal purpose of avoiding the 5 percent tests.[67]

1. Withholding Exception

No withholding is required on the disposition of any interest in a domestic corporation if the corporation has a class of stock that is regularly traded on an established securities market,[68] regardless of the amount of interests disposed. This is in contrast to the exception to substantive FIRPTA tax for publicly traded interests, which generally applies only to small holders of the domestic corporation.[69]

However, withholding on dispositions of non-publicly traded interests is required when the dispositions are also subject to substantive FIRPTA tax.[70] As discussed above, this generally requires interests that amount to greater than 5 percent of the FMV of the corporation's publicly traded stock. Although not entirely clear, it appears withholding is required only on the transfer of a single block of nonpublic interests meeting the 5 percent test as measured at the time of the transfer.[71] This is the case even though substantive FIRPTA tax would be imposed on the disposition of any interest by a holder meeting the 5 percent test.

B. REITs

To satisfy the various REIT tests, the majority of the assets of most REITs must be U.S. real property.[72] Thus, interests in REITs are likely to constitute USRPIs so that their disposition would generally be subject to FIRPTA tax. However, Congress has crafted several unique exceptions for REITs.

1. Publicly Traded REITs

When a REIT has stock that is regularly traded on an established securities market, the rules for publicly traded corporations apply with a 10 percent threshold instead of a 5 percent threshold.[73] The regulations on dispositions of non-stock interests and non-publicly traded interests have not been updated to reflect this statutory change for REITs. Although it would be logical to apply those rules using a 10 percent, rather than 5 percent, threshold, there is no authority explicitly permitting this. Because the statute itself references only publicly traded stock, and because there is no express reference to implementing regulations for other interests in either statutory provision, it is unclear whether a 10 percent or 5 percent threshold applies for dispositions of nonpublic interests in publicly traded REITs.

The 10 percent threshold also applies for capital gain distributions on publicly traded REIT stock.[74] As discussed above, the exception for distributions on publicly traded interests is statutory. There are no regulations extending this exception to non-publicly traded interests of publicly traded corporations. Accordingly, it appears there is no exception for distributions on non-publicly traded interests, even if the corporation has publicly traded stock.

[67] *Id.* The rule does not apply if the separate interests were acquired more than three years apart.

[68] Section 1445(b)(6) and reg. section 1.1445-2(c)(2).

[69] As with the rules for substantive tax, publicly traded partnerships are eligible for the same exceptions described in this section; *see* reg. section 1.1445-2(c)(2).

[70] Reg. section 1.1445-2(c)(2).

[71] *See* T.D. 8113 (in the context of multiple transferors):

> A commentator suggested that the rule was unclear in its application to a single transferee's acquisition of a number of interests, no one of which alone would be considered an interest described in section 1.897-1(c)(2)(iii)(B), from several transferors. . . . If the transferors are not related, a transferee would not aggregate the interests acquired in determining whether the 5 percent threshold of section 1.897-1(c)(2)(iii)(B) was exceeded.

[72] Section 856. In general, at least 75 percent of a REIT's gross assets must constitute real property interests. The definition of real property interests under section 856 does not precisely overlap with the definition of a USRPI, so it is possible for some REITs not to qualify as USRPHCs.

[73] Section 897(k)(1). The statute does not extend the 10 percent threshold to the publicly traded exception from the FIRPTA wash sale rules, which use a 5 percent threshold; *see* section 897(h)(5)(iv). The FIRPTA wash sale rules are intended to prevent a shareholder from avoiding the rules on capital gain distributions by disposing of, and then re-acquiring, shares around the ex-dividend date for a capital gain distribution; *see* section 897(h)(5).

[74] Section 897(k)(1)(B).

The FIRPTA exception for capital gain distributions does not exempt the distributions from U.S. taxation. Instead, they are treated as ordinary dividends from a REIT and subject to U.S. tax accordingly.[75] Ordinary dividends from REITs are generally subject to U.S. tax at a 30 percent rate, which the REIT must withhold.[76]

Although treaties sometimes reduce U.S. taxation on dividends, most modern treaties limit the extent to which this relief applies to dividends from REITs.[77] Accordingly, the FIRPTA exemption for capital gain dividends is not an exemption from all U.S. taxation.[78]

2. Domestically Controlled REITs

Stock and other interests in domestically controlled REITs are not USRPIs.[79] Accordingly, gain on their disposition is not subject to FIRPTA. A REIT is domestically controlled if less than 50 percent of the value of its stock has been held at all times during the preceding five years by foreign persons.[80] Although the statute uses the word "control," the test is solely a value test and does not explicitly take voting power into account.[81] A special rule permits publicly traded REITs to generally presume their less-than-5-percent shareholders are domestic.[82] Thus, very large foreign shareholders of public REITs may be able to rely on this exception if they cannot rely on the publicly traded exceptions above.

Distributions from domestically controlled REITs are not exempt from section 897(h)(1). Thus, capital gain distributions — and, according to the IRS, liquidating distributions — from domestically controlled REITs are subject to FIRPTA unless another exception is available.[83]

3. Qualified Collective Investment Vehicles

Interests in REITs held by certain "qualified collective investment vehicles" are exempt from FIRPTA. The definition of a qualified collective investment vehicle is very technical, but it is generally intended to include foreign REITs in specific favorable jurisdictions.[84] The narrow exception is intended to encourage investment by these foreign REITs.[85]

The exception also applies to all capital gain distributions from REITs.[86] As with a capital gain distribution from a public REIT, the application of this exception merely converts the capital gain distribution into an ordinary distribution subject to U.S. tax under the general FDAP provisions.[87] Similarly, distributions from REITs that are otherwise treated as sales or exchanges, such as redemptions and liquidations, are treated as ordinary dividends subject to FDAP.[88]

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[75] Section 857(b)(3)(E).

[76] Sections 871(a), 881, 1441, 1442.

[77] *See, e.g.*, U.S. model article 10.4 (REIT dividends eligible for reduced 15 percent rate only for minority interests in specific REITs).

[78] Although its position is that liquidating distributions are also subject to section 897(h)(1), the IRS has said (AM 2008-003) the conversion of capital gain dividends to ordinary dividends under section 857(b)(3)(E) does not apply to liquidating distributions. Thus, small foreign shareholders should remain exempt from U.S. tax on liquidations of REITs.

[79] Section 897(h)(2).

[80] Section 897(h)(4)(B).

[81] By the same token, the rule does not explicitly disregard voting power, and there is no regulatory provision comparable to reg. section 1.382-2(a)(3)(i), providing that control premiums are disregarded. Thus, voting power might be relevant in a multiclass structure if differences in voting power affect value.

[82] Section 897(h)(4)(E).

[83] *See* discussion at note 35, *supra*. Further, section 897(h)(3) provides that rules requiring foreign corporations to recognize gain on the distribution of USRPIs in section 897(d) apply to domestically controlled REITs. This rule was introduced before *General Utilities* was repealed, and section 311(b), which now mandates gain recognition on distributions of property from corporations in most cases. Thus, section 897(h)(3) generally remains relevant only to asset reorganizations involving domestically controlled REIT targets.

[84] Section 897(k)(3)(B)(i) requires the entity to be eligible for the benefits of a tax treaty with the United States that includes a favorable withholding rate for dividends paid from a REIT, even if the foreign person owns more than 10 percent of the REIT. Few treaties permit this, and generally only for entities that are equivalent to REITs under foreign law. The statutory language also encompasses foreign partnerships that have a portion of their interests traded on NASDAQ or the New York Stock Exchange, although this too is a rare fact pattern.

[85] The legislative history identifies the Netherlands and Australia as having foreign REIT-equivalents that could qualify under those rules. *See* Joint Committee on Taxation, "Technical Explanation of the Revenue Provisions of the Protecting Americans From Tax Hikes Act of 2015," JCX-144-15 (Dec. 17, 2015).

[86] Section 897(k)(2)(A)(ii).

[87] Section 857(b)(3)(E) specifically applies to capital gain distributions exempt under section 897(k)(2)(A)(ii).

[88] Section 897(k)(2)(C)(ii). It is unclear how this provision interacts with the exceptions for publicly traded REITs. It appears on its face to apply to any distribution from a REIT that is so treated, but section 857(b)(3)(E) refers only to cases in which section 897 does not apply "by reason of" the second sentence of section 897(h)(1) or the exceptions in section 897(k). For a publicly traded REIT, section 897 does not apply to the distributions due to other provisions of section 897. Therefore, it appears that a qualified collective investment vehicle ought to remain eligible for the FIRPTA exemption for shareholders holding less than 10 percent of publicly traded REITs.

C. Qualified Foreign Pension Funds

Qualified foreign pension funds (QFPFs) are wholly exempt from FIRPTA.[89] QFPF is a statutorily defined term, but as the name indicates, it is generally intended to cover genuine foreign investment vehicles that hold assets supporting pension or retirement plans of foreign countries or employers.[90] QFPFs also include entities wholly owned by a QFPF, so that a QFPF can invest through wholly owned subsidiaries.

Because of this exemption, QFPFs can clearly dispose of stock of REITs — even private, non-domestically controlled REITs — and stock in other USRPHCs without incurring U.S. tax.[91] Also, no FIRPTA tax applies on capital gain distributions from REITs because QFPFs are exempt from FIRPTA. Moreover, the conversion of capital gain distributions that are exempt from FIRPTA into ordinary distributions does not apply to QFPFs.[92]

QFPFs, however, are exempt only from FIRPTA, not U.S. taxation generally. Thus, they are still subject to tax on ordinary distributions from domestic corporations, including REITs, unless treaty relief is available. They are also unlikely to invest directly in U.S. real property or in partnerships holding U.S. real property. Although a QFPF might be able to avoid U.S. tax on a direct investment in U.S. real property because capital gains are exempt from U.S. tax, the QFPF would still owe U.S. tax on ongoing income. It would also risk the possibility that the investment gives rise to a U.S. trade or business, thereby subjecting it to ECI taxation.

In most cases, it will be easy to avoid these risks by interposing a REIT that can block ECI without incurring an additional level of corporate tax on ongoing income. As a result of the FIRPTA exemption for QFPFs, there would also be no U.S. tax on a subsequent sale of the underlying USRPI by the REIT and corresponding capital gain distribution (or sale of stock in the REIT).

D. Sovereign Wealth Funds

Congress exempts portfolio income earned by foreign governments from U.S. taxation.[93] Thus, foreign governments may invest in stock or securities of domestic entities without incurring the taxes imposed on other foreign individuals or corporations, including FIRPTA tax. Under the regulations, the term "foreign government" includes wholly owned entities controlled by the government.[94]

Many modern foreign governments, particularly in resource-rich nations, have formed SWFs, which are typically separate entities that act as investment arms of the government to invest the government's surplus on behalf of citizens. As a result of the controlled entity concept, these SWFs are eligible for the exemption for foreign governments and are able to supply capital into the United States without further tax.

The exemption for foreign governments does not apply to income earned from controlled commercial entities. An entity is a controlled commercial entity if the foreign government holds at least 50 percent of the vote or value or otherwise effectively controls the entity and the entity engages in commercial activity.[95] Commercial activity includes virtually any activity undertaken for the production of income, other than investment and trading, even if the activity would not otherwise give rise to a trade or business.[96]

The upshot is that SWFs may dispose of minority investments in REITs or other USRPHCs without FIRPTA tax, even if the REIT is private and not domestically controlled.[97] SWFs should

[89] Section 897(l). The exception provides that a QFPF is not treated as a foreign person for section 897 purposes.

[90] The IRS has proposed regulations (REG-109826-17) on the various aspects of QFPF status.

[91] A QFPF might theoretically be subject to U.S. tax if it were engaged in a U.S. trade or business, but that is highly unlikely. QFPFs will mostly hold and trade securities, and the active trading of stock or securities for one's own account does not give rise to a U.S. trade or business; *see* section 864(b).

[92] Section 857(b)(3)(E) applies only if capital gain distributions are exempt from FIRPTA under the publicly traded rule or for qualified collective investment vehicles; thus, it does not apply to capital gain distributions to QFPFs.

[93] Section 892.

[94] Reg. section 1.892-2T(a). Other requirements, including that the entity be organized under the laws of the same foreign country as the foreign government, must also be met.

[95] Section 892(a)(2).

[96] Reg. section 1.892-4T(b).

[97] Reg. section 1.892-3T(a)(1).

also be exempt from ordinary-course dividends received from USRPHCs and REITs.[98]

The exemption under section 892 is generally limited to income attributable to the stock and securities of domestic corporations. Thus, income from the dispositions of USRPIs other than USRPHCs is not exempt from U.S. tax under section 892.[99] Likewise, the exemption for SWFs does not apply to dispositions of partnership interests or allocable shares of partnership operating income.[100]

Further, the IRS also maintains SWFs are not exempt from FIRPTA on capital gain distributions attributable to the disposition of USRPIs. Its position is that SWFs are exempt from FIRPTA only to the extent specifically provided under section 892.[101] For distributions from REITs attributable to the disposition of USRPIs, section 897(h)(1) provides that a foreign person is treated as selling the USRPI itself. Because a direct sale of a USRPI is not exempt from FIRPTA under section 892, which also does not specifically exclude distributions described in section 897(h)(1), the capital gain distribution is not exempt under section 892.

Because the IRS also takes the position that liquidating distributions of proceeds from the sale of USRPIs are attributable to the dispositions of USRPIs under section 897(h)(1), the same principles apply to a liquidating distribution to an SWF.[102]

Although not totally clear, a distribution attributable to the sale of a USRPI that is stock (or securities) of a USRPHC should remain exempt from FIRPTA because a distribution attributable to the sale of stock of a USRPHC would be treated as if the SWF disposed of the stock itself. Because section 892 exempts sale of stock from tax, that should override FIRPTA. In other words, a sale of an interest in a USRPHC should not lose its tax exemption for SWFs merely because it is made through a REIT.

E. 'Cleansed' Companies

As discussed above, interests in domestic corporations are USRPIs if at any time during the preceding five years the majority of the corporation's assets were USRPIs. The only relief from this onerous lookback rule is for so-called cleansed companies. A domestic corporation has been cleansed if it currently holds no USRPIs and all the USRPIs it held during the preceding five years were disposed of in transactions in which the full amount of gain was recognized.[103] In this case, interests in the domestic corporation are no longer USRPIs.

The cleansing exception is unavailable for domestic corporations that were REITs in the preceding five years.[104]

III. Transactional Observations

FIRPTA must be analyzed in every transaction involving U.S. entities and businesses, as well as in many involving foreign entities. However, FIRPTA issues manifest differently across transactions because of the combination of its breadth and disparate exceptions.

In the context of mergers and acquisitions, the analysis focuses on whether the transaction is exempt from FIRPTA and, if so, how foreign persons can demonstrate an exemption from substantive tax and acquirers can demonstrate an exemption from withholding responsibility. In the private equity context, the analysis often focuses

[98]Section 892(a)(1)(a)(i).

[99]Reg. section 1.897-9T(e) (foreign governments are subject to section 897 unless otherwise provided in section 892).

[100]Reg. section 1.892-3T(a)(2). An SWF's allocable share of partnership income attributable to a disposition of stock in a USRPHC should remain exempt under section 892.

[101]Notice 2007-55, *supra* note 28.

[102]*See* discussion at note 35, *supra*.

[103]Section 897(c)(1)(B). The corporation is not required to dispose of stock in corporations that had been USRPHCs in the lookback period if those corporations themselves are cleansed.

The regs conflict with the statute on the length of the lookback period. Under section 897(c)(1)(ii)(A), the lookback period is the shorter of the disposing taxpayer's holding period for the interest and five years; the regulations refer only to the preceding five years.

[104]This change was introduced by the PATH Act in 2015 and is intended to be a taxpayer-favorable rule. A foreign person's purchase of REIT stock would generally reflect the FMV of the REIT's assets. If the REIT sold its assets to achieve cleansed status and then liquidated, any built-in gain on USRPIs would be taxable as capital gain dividends subject to FIRPTA under section 897(h)(1). The purchaser's basis would have already reflected this value, so there would be an offsetting loss on liquidation. But without the rule, the loss would not be FIRPTA loss and so would be unavailable to offset the tax on the capital gain dividends. Under the rule, the REIT retains its FIRPTA taint despite its cleansing, so the loss is FIRPTA loss.

on optimizing a tax structure, both on an ongoing basis and to accommodate an eventual exit.

A. Public M&A

FIRPTA is rarely relevant to the acquisition of public corporations. The acquirer will be indifferent because it is not required to withhold on the acquisition of almost any interest in the public corporation. Similarly, minority shareholders are usually not subject to substantive FIRPTA tax. Only large shareholders of target corporations are even potentially subject to substantive FIRPTA tax, and they will typically look to the tax disclosure in the deal documents to determine the corporation's position on whether it is a USRPHC. Because the target's status as a USRPHC is a reflection of its historic assets, the application of FIRPTA tax is not a result of the transaction and so is not a negotiated point.[105]

M&A involving public REITs is even less likely to be subject to FIRPTA than M&A involving other domestic corporations. To ensure REIT qualification, most public REITs have charter provisions prohibiting ownership of more than 10 percent of the REIT's stock.[106] Those provisions also effectively ensure that every public REIT shareholder is eligible for the higher 10 percent FIRPTA exemption on a disposition of public REIT shares. Even in the unlikely event a foreign holder holds more than 10 percent of a REIT's stock, the holder is unlikely to be subject to FIRPTA because the REIT is likely to be treated as domestically controlled (because minority shareholders of a public REIT are presumed to be domestic persons).

B. Private M&A

The acquisition of private corporations must account for FIRPTA because the publicly traded exception does not apply. The acquirer will be particularly interested because withholding tax liability is imposed on it, and in many cases, it will be a more attractive party for the IRS to pursue for unpaid taxes. When the target is a domestic corporation that is not a USRPHC, it is common to obtain a certification to that effect to avoid withholding.[107] Even if a certification is provided to the acquirer, foreign sellers may need to obtain their own separate certification to avoid substantive FIRPTA tax.[108]

When the target is a partnership that is not a 50/90 partnership, foreign shareholders will typically hold through a domestic corporation, commonly called a "blocker," that absorbs the U.S. tax payment and filing obligations. The blocker will sell interests in the partnership, and it is typical to obtain Forms W-9 from each seller confirming its status as a U.S. person.

In some transactions involving partnerships, those blocker corporations are purchased in lieu of purchasing partnership interests because the sale of blocker stock does not give rise to U.S. tax. In those cases, it is typical to obtain certification that the blocker corporation is not a USRPHC.[109]

When the target is a domestic corporation that is a USRPHC (such as a REIT) or a 50/90 partnership, foreign shareholders will also generally hold through a blocker corporation. It is typical for the blocker to sell the stock of the USRPHC (or 50/90 partnership) because there is often no advantage to selling its stock in lieu of it selling its interests.[110] The blocker itself will be a USRPHC by virtue of holding only USRPIs, so the sale of its stock would still be subject to U.S. tax under FIRPTA.[111] Thus, in this case, the purchaser will typically obtain a certification that the seller is a U.S. person.

Special attention is required when stock in a USRPHC is being acquired but the foreign holders are exempt from FIRPTA. That can occur

[105] Because publicly traded partnerships are treated similarly to public corporations for FIRPTA purposes, acquisitions of publicly traded partnerships typically present similar FIRPTA issues to those involving domestic corporations.

[106] Typically, those provisions ensure the REIT does not inadvertently fail the closely held requirement of section 856(h). They are also frequently intended to ensure rents are not received from related persons under section 856(d)(2), which determines relatedness based on a 10 percent threshold, because those rents are generally not good REIT income.

[107] Reg. section 1.1445-2(c)(3).

[108] Reg. section 1.897-2(g)(1). The corporation providing the statement must also notify the IRS that it has done so.

[109] Alternatively, it may be possible to obtain the certificate that the seller is itself a U.S. person (such as a domestic partnership).

[110] One circumstance in which it would be advantageous to sell the blocker's stock is if the basis in that stock were higher than the blocker's basis in the interests in the USRPHC (or 50/90 partnership).

[111] Once a blocker sells all its USRPIs, it can distribute cash to foreign holders in liquidation without further FIRPTA tax because it will be a cleansed company.

if the holders are QFPFs or SWFs (or, in a REIT disposition, a qualified collective investment vehicle). The acquirer should obtain the special certification discussed in the regulations identifying the sellers as not subject to FIRPTA and comply with the notice requirements therein.[112]

This can also occur with a domestically controlled REIT. Although clearly a USRPHC, the REIT should be able to provide a certification showing that interests in it do not constitute USRPIs as a result of the statutory exception.[113]

C. Structuring Private Equity Investments

FIRPTA is particularly relevant when structuring private equity investments in U.S. real estate. Those investments may be structured in advance with a view toward a particular tax objective and with advanced knowledge of the expected investor base and their respective tax sensitivities.

Foreign investors do not generally invest directly in U.S. real property or in partnerships holding U.S. real property to avoid ECI risk. Instead, the main question is whether the investment should be made through a REIT or non-REIT domestic corporation.

Because REITs have strict rules regarding what types of property they can hold, as well as what types of activities they can conduct, many investments in U.S. real property cannot be held through REITs; thus, a non-REIT corporation must be used. However, when a REIT may be available, deciding whether to use a REIT or non-REIT depends on several factors regarding ongoing income and ultimate exit. The best approach varies based on the investment and the investor base.

Although outside the scope of this article, it is also critical to consider the use of leverage in any structure. Capitalizing a portion of any investment with debt offers various efficiencies. First, the debt is typically structured as straight debt — that is, with no interest in upside at all — and is therefore not subject to FIRPTA. Second, principal repayments are not subject to U.S. tax, and interest is often exempt too (either under a treaty or because of the portfolio interest exemption).[114] Third, interest deductibility reduces U.S. taxes imposed on the borrower corporation. As a result, most investments are made through a combination of debt and equity, with the equity piece requiring more FIRPTA analysis.

1. Current Income

For foreign investors other than SWFs, there is often not a substantial difference on the net effective rate of dividends received from a REIT versus a non-REIT. Although that must be modeled and varies based on the rates in effect, the combined effective tax rate on the domestic corporation and non-REIT dividends is close to the rate on ordinary-course dividends from REITs because the first are often eligible for treaty reduction and the second generally are not.[115]

SWFs, however, are not taxable on ordinary dividends, whether from REITs or non-REITs, so they may strongly prefer to avoid the corporate-level tax imposed on a non-REIT.

An additional consideration is whether reinvestment of earnings is desirable. If so, a REIT might not be an appropriate vehicle because it must distribute virtually all of its income to maintain REIT status, and this distribution will give rise to tax for its shareholders.[116] This generally imposes a cash drag because shareholders will demand at least enough cash from the REIT to pay the taxes imposed on

[112] QFPFs are not treated as foreign persons and thus provide the certification in reg. section 1.1445-2(b) for non-foreign sellers. SWFs instead provide the certification in reg. section 1.1445-2(d)(2) showing they are not subject to withholding as a result of a nonrecognition provision. The regulations have not been updated to include specific certification provisions for qualified collective investment vehicles, but presumably the same certification and procedure should be available because they are similarly treated.

[113] Reg. section 1.1445-2(c). The regs do not seem to explicitly reflect the domestically controlled REIT concept, but it appears the contemplated certification would cover a USRPHC that is not a USRPI by virtue of the domestically controlled REIT exception.

[114] The lender will often be the private equity fund that owns all or a substantial majority of the corporation. However, assuming the private equity investors are sufficiently dispersed, the portfolio interest exemption is often still available because the regs clearly indicate that the exemption is determined at the partner level; *see* reg. section 1.871-14(g)(3).

[115] U.S. taxable investors are similar in that the combined effective rate between a REIT and non-REIT is similar because REIT dividends are ineligible for qualified dividend income rates but are eligible for the section 199A deduction; *see* sections 1(h)(11)(D)(iii), 199A, 857(c)(2)(B).

[116] Section 857(a)(1).

them.[117] In contrast, reinvestments in a domestic corporation effectively defer the shareholder-level tax, which can also amount to a valuable benefit, especially when (as now) the corporate rate is much lower than the individual rate.

2. Exit Considerations

Assuming a REIT is compatible with the investment objectives for current income, a key question is whether the REIT can qualify as domestically controlled.[118] If it can, all foreign investors, regardless of special status, can escape U.S. taxation on a disposition of the REIT's stock. Thus, if available, the sale of domestically controlled REIT stock will be an attractive exit option. An exit via an asset sale from a domestically controlled REIT is unlikely to be desirable because all foreign investors other than QFPFs would be subject to FIRPTA on the corresponding capital gain distribution. The same treatment would apply even if the REIT sold all its assets and the distribution were a liquidating distribution.[119]

If a REIT cannot qualify as domestically controlled, the use of an asset sale versus a stock sale is primarily relevant to SWFs[120] because they are subject to FIRPTA tax on an asset sale but not on a stock sale. Other investors are indifferent. QFPFs will be exempt from FIRPTA on either an asset or stock sale, and ordinary foreign investors will be subject to tax regardless of whether the disposition is a stock or asset sale. Accordingly, if there are significant SWF investors, a stock sale may be desirable. In other cases, however, there is not likely to be a meaningful difference.

For non-REITs, there are two typical forms of exit: sell the corporation's stock or have the corporation sell the real estate and liquidate. In the first case, the corporation will be a USRPHC, so foreign investors without a special status (such as a QFPF or SWF) will be subject to U.S. tax on the disposition of the stock. In the second case, the corporation will avoid USRPHC status as a result of the cleansing exception, but there will be domestic tax owed reflecting both value appreciation and historic tax depreciation, if any. In effect, the asset sale form substitutes U.S. corporate tax for FIRPTA tax on appreciation but at the additional cost of U.S. corporate tax on historic depreciation.[121] The choice between the two will depend on the appreciation in the assets, historic tax depreciation, and the relative share of investors exempt from FIRPTA.

A final consideration is that with a REIT disposition, a buyer can often obtain a basis step-up regardless of whether the form of the transaction is an asset sale or stock sale.[122] For non-REIT corporations, a basis step-up is available only on an asset sale. Accordingly, use of a REIT may increase the consideration received on exit.

IV. Conclusion

This article concludes with three tables identifying different types of transactions and potential FIRPTA implications for different categories of investors. The tables are intended to serve two purposes: first, to help practitioners quickly apply the rules; and second, to illustrate the effect of the proliferation of (sometimes inconsistent) FIRPTA exceptions in the modern transactional space.

[117] Although the distribution requirement would appear to require a cash distribution of the full amount of income, it is possible to "deem" the cash to be distributed (and reinvested) through use of a consent dividend; *see* section 565. Shareholders are still subject to tax on the full amount of the deemed distribution and will typically demand an actual cash distribution sufficient to pay taxes.

[118] An interesting problem outside the scope of this article is whether it is advantageous to cause U.S. taxable investors to invest through a REIT to cause that REIT to become domestically controlled. U.S. investors may be indifferent to this if the investment is expected to generate income because REITs generally flow through income, but they might not be so favorably disposed if the REIT generates losses, which do not flow through.

[119] *See* Section I.D, *supra*.

[120] Qualified collective investment vehicles are also in a similar position to SWFs, and the same principles generally apply to them.

[121] Further, if taxable U.S. investors invest through the corporation (rather than directly in the investment), they would also be subject to an additional shareholder-level tax on the liquidation. This would also weigh in favor of a stock sale.

[122] This is because a REIT's liquidating distribution is a capital gain dividend that is also eligible for the dividends paid deduction; *see* section 562(b)(1). Thus, as a practical matter, the corporate level of tax inherent in an asset sale is eliminated for a REIT.

Table 1. Substantive FIRPTA Tax on Dispositions of Interests

	Ordinary Foreign Investor	Qualified Collective Investment Vehicle	Qualified Foreign Pension Fund	Sovereign Wealth Fund
<5% Holder of Public USRPHC (non-REIT)	No	No	No	No
<10% Holder of Public REIT	No	No	No	No
Domestically Controlled REIT (private or public)	No	No	No	No
>10% Holder of Non-Domestically Controlled Public REIT	Yes	No	No	No
Private, Non-Domestically Controlled REIT	Yes	No	No	No
>5% Holder of Public USRPHC (non-REIT)	Yes	Yes	No	No
Private USRPHC (non-REIT)	Yes	Yes	No	No
50/90 Partnership	Yes	Yes	No (but likely ECI)	Yes
Other Partnership	Yes* (likely ECI also)	Yes* (likely ECI also)	No (but likely ECI)	Yes* (likely ECI also)
USRPI (non-corporation/ partnership)	Yes	Yes	No (but likely ECI)	Yes
*Reflects IRS position.				

Table 2. Substantive FIRPTA Tax on Distributions

	Ordinary Foreign Investor	Qualified Collective Investment Vehicle	Qualified Foreign Pension Fund	Sovereign Wealth Fund
Capital Gain Distribution on >10% REIT Public Stock	Yes	No (but FDAP)	No	Yes
Capital Gain Distribution on <10% REIT Public Stock	No (but FDAP)	No (but FDAP)	No	No
Capital Gain Distribution From REIT Private Stock or Interests	Yes	No (but FDAP)	No	Yes
Liquidating Distribution on >10% REIT Public Stock	Yes	No (but FDAP)	No	Yes
Liquidating Distribution on <10% REIT Public Stock	No	No	No	No
Liquidating Distribution From REIT Private Stock or Interests	Yes	No (but FDAP)	No	Yes
Ordinary REIT Distributions	No (but FDAP)	No (but FDAP)	No (but FDAP)	No

Table 3. FIRPTA Withholding Tax on Dispositions

	Ordinary Foreign Investor	Qualified Collective Investment Vehicle	Qualified Foreign Pension Fund	Sovereign Wealth Fund
Public USRPHC	No	No	No	No
Public REIT	No	No	No	No
Domestically Controlled Private REIT	No	No	No	No
Non-Domestically Controlled Private REIT	Yes	No	No	No
Private USRPHC	Yes	Yes	No	No
50/90 Partnership	Yes	Yes	No (but likely ECI)	Yes
Other Partnership	No (but likely ECI)	No (but likely ECI)	No (but likely ECI)	No (but likely ECI)
USRPI (non-corporation/ partnership)	Yes	Yes	No	Yes

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