



**Introduction to the taxation of
foreign investment in US real estate**

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Introduction

Impact of taxes on real estate

There has been a continued interest in investment in US real estate especially in light of the recent domestic economic and employment growth. Access to capital in an environment of relatively low interest rates along with the sharp demand for alternative investments in the portfolio allocations of institutional investors has further fueled the growth of real estate development and related transactions. Historically, obstacles to investing in US real estate have included relatively high US tax corporate tax rates on capital gains, the taxation on the disposition of real estate investments, and complicated US withholding tax and income tax reporting requirements. However, on December 22, 2017, President Trump signed the Tax Cuts and Jobs Act (P.L. 115-97) (the “2017 Act”). The 2017 Act represents one of the most significant overhauls of the Internal Revenue Code (the “Code”) since 1986. While it can be argued whether this new law offered simplification, many of its real estate “friendly” provisions can enhance the relative attractiveness of real estate as an investment class for a broader group of non-US investors. Examples of such provisions include the lowering of corporate rates from 35% to 21% and excluding certain real estate operations from limits on the deductibility of financing expenditures. As such, it remains important that investors understand the tax rules in place in order to effectively develop a US real estate investment strategy.

This guide, originally published in July 2015, is an introduction to some of the more significant tax issues that should be considered by non-US investors in this regard. For more specific information and assistance with investments in US real estate, please contact a member of our Global Funds Tax Advisory – Real Estate and Infrastructure Practice or our Inbound Services Practice, which are listed at the end of this guide.



Taxation of income from US real estate

Investing in US real estate market

The Code includes provisions for the taxation of international investors, although in some cases the tax imposed by the Code may be reduced under an applicable income tax treaty. Thus, international investors generally structure their investments to take advantage of treaty benefits whenever possible.

Taxation of US entities and individuals

Prior to the 2017 Act, the United States taxed its citizens, residents, and domestic corporations and trusts on all their income regardless of where it was earned, i.e., on a worldwide basis. Under the 2017 Act, domestic corporations continue to be taxed on their worldwide income; however, they can seek to exempt certain foreign-source dividends received from US taxation through a dividends received deduction ("DRD"). US citizens and residents, however, continue to be taxed on a worldwide basis. Noncitizens, who are lawfully admitted to the United States as permanent residents (green card holders) or are physically present in the United States for a sufficient period of time (generally, at least 183 days during any year, or a greater number of days over a three-year testing period), are considered US residents. Income tax is imposed on net income, i.e., gross income from all sources reduced by allowable deductions, such as interest expense, taxes, and depreciation.

Under the 2017 Act, the corporate tax rate was reduced to a flat 21%. Previous law had graduated corporate tax rates ranging from 15% to 35% as the top rate. The 2017 Act also repealed the corporate alternative minimum tax (retained for individuals). The applicable DRD for dividends received from domestic corporations (and certain US-source dividends received from foreign corporations) is also reduced from 70% to 50% and from 80% to 65%. As noted above, the 2017 Act implemented a somewhat territorial system of taxation for domestic corporations. In this regard, the 2017 Act enacted section 245A, which generally provides a 100% DRD for certain qualified dividends received by US corporations from foreign subsidiaries out of previously untaxed earnings. To transition to this new territorial system, section 965 was amended to require a one-time deemed repatriation of currently deferred foreign profits, generally with an effective tax rate of 15.5% for cash and cash-equivalent profits and 8% for other foreign earnings.

To address base erosion, the 2017 Act included a base erosion anti-avoidance tax ("BEAT") under new section 59A. In certain cases, section 59A imposes an additional corporate tax liability on corporations (other than a regulated investment company ("RIC"), a real estate investment trust ("REIT"), or an S corporation) that make base erosion payments to related foreign persons. The BEAT generally applies to US corporations and to foreign corporations with income effectively connected with a US trade or business if they satisfy both a gross receipts test and one that looks to the percentage of its deductions that are with respect to amounts paid to foreign related persons (the "base erosion percentage test"). The gross receipts test is satisfied if the corporation's average annual gross receipts for the three-year period ending with the preceding taxable year was at least \$500 million. The base erosion percentage test is satisfied if this percentage is less than 3% (2% for certain banks and securities dealers) for the taxable year. Both tests are determined by "aggregating" the results on certain corporations under common ownership. The BEAT rate equals 10% (5% for the 2018 calendar year) of the corporation's "modified taxable income" less the regular tax liability reduced by certain credits. Beginning in 2026, the applicable BEAT rate increases to 12.5%. Modified taxable income is determined after adding back to taxable income certain payments, including interest, made to related foreign parties. On December 2, 2019, the US Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") issued final proposed regulations under section 59A (the "section 59A Final and Proposed Regulations") to provide guidance on the BEAT. The section 59A Final and Proposed Regulations provide guidance for taxpayers in a number of areas included, how to account for net operation loss ("NOL") carryforwards when computing modified taxable income and provide exceptions in certain circumstances. In addition, these section 59A Final and Proposed Regulations contain complicated rules on the treatment of BEAT payments made by partnerships where the partners are related. Partnerships are essentially treated as "aggregates" of their partners. Special attention should be given to these rules in the case of partnerships with partners that are considered related parties as defined in these regulations.

With respect to pass-through entities, a deduction of up to 20% is allowed for qualified business income ("QBI") of a partnership, S corporation or sole proprietorship. QBI is generally income that is effectively connected with a US trade or business. QBI, however, is limited to the greater of 50% of wages or 25% of wages plus 2.5% of the depreciable unadjusted tax basis of qualifying property. Ordinary REIT dividends and income from certain publicly traded partnerships qualify for the deduction. However, income from certain professional or highly skilled services, such as health and law, generally are not treated as QBI. Business losses in excess of business income from pass-through entities would not be deductible on a current basis. Rather, such losses are carried forward and treated as part of the taxpayer's NOL carry forward in subsequent tax years. For partnerships and S corporations, the limitation is determined at the partner or shareholder level.

For individual taxpayers and trusts, the graduated tax rate system remains in place. However, the lowest tax rate is 10% and the highest rate is 37%, plus a 3.8% net investment income tax for those that have income above the statutory threshold amount. Under prior law, the US income tax rates for individuals and trusts were separated into tax brackets and ranged from 10% to 39.6%, plus a 3.8% net investment income tax for those that have income above the statutory threshold amount. The reduced tax rates, however, will expire after 2025. Capital gains rates remain the same. Under current law, for those in the higher end income bracket, capital gains are taxed at a rate of 25% (to the extent of gain attributable to depreciation recapture) and 20% (to the extent of gain in excess of prior years' depreciation). Certain "qualified dividends" are taxed like capital gains.

Prior to the 2017 Act, business losses in excess of income were first carried back two years and then carried forward 20 years to reduce income in those years, although a business may elect to waive the carryback period. Under the 2017 Act, business losses are limited to 80% of taxable income (determined without regard to the deduction). Further, the two-year carryback is eliminated and instead, the losses would be carried forward indefinitely.

Taxpayers are also permitted to immediately expense the entire cost of certain depreciable assets acquired and placed in service after September 27, 2017 and before January 1, 2023. The immediate expensing is phased out beginning in 2023.

The 2017 Act also repealed and replaced section 163(j). Under the new section 163(j), business interest expense deductions are limited to 30% of adjusted taxable income (ATI) plus business interest income. For tax years beginning before 2022, ATI is analogous to EBIDTA and for the following years, the calculation is similar to EBIT. An exception to the interest expense limitation, however, is provided for an electing Real Property Trade or Business ("RPTOB"), discussed in more detail below. On November 26, 2018, proposed regulations under section 163(j) were released (the "section 163(j) Proposed Regulations"). The section 163(j) proposed regulations provide guidance addressing the definition of "interest" for purposes of section 163(j), the interaction of section 163(j) with other provisions of the Code, the treatment of disallowed business interest expense carryforwards under old section 163(j), and elections made available under "old" section 163(j), among other things.

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The 2017 Act also enacted new section 267A to address related party payments of interest and royalties pursuant to hybrid transactions or that involved hybrid entities. Section 267A denies a deduction for interest or royalties paid or accrued in certain transactions involving a hybrid arrangement. According to the legislative history, this provision is intended to address situations where a taxpayer is provided a deduction under US tax law but the payee does not have a corresponding income inclusion under foreign law (referred to as “deduction/no-inclusion” (D/NI) outcome). On December 20, 2018, Treasury and the IRS released proposed regulations that would implement the anti-hybrid provisions under section 267A (the “section 267A Proposed Regulations”). The section 267A Proposed Regulations revise the scope of section 267A in a number of respects as only applying to deductions of payments made to related parties. The section 267A Proposed Regulations in certain cases would limit the application to D/NI outcomes that result from hybridity. The section 267A Proposed Regulations provide special rules for payments to a reverse hybrid entity and add rules not provided in the statute, including with respect to “imported” mismatches. The section 267A Proposed Regulations also define the terms “royalty” and “interest,” broadly.

Taxation of foreign entities and international investors

Foreign corporations and trusts, as well as individuals who are neither US citizens nor US residents (“international investors”), generally are subject to US income tax only on income that is either effectively connected with a US trade or business (“effectively connected income,” or “ECI”), regardless of source, or, if not ECI, is US source income that is classified as fixed, determinable, annual, or periodic (“FDAP”) income.

Rental income and gains from the sale of real estate located in the United States (and other US real property interests, which are described in more detail below) is US source income. As a general rule, dividends and interest paid by a US corporation are also US source income. In some cases, interest paid by a foreign corporation or a foreign or domestic partnership is also US source income.

Rental income and gains from the sale of real estate located in the United States (and other US real property interests, which are described in more detail below) is US source income. As a general rule, dividends and interest paid by a US corporation are also US source income. In some cases, interest paid by a foreign corporation or a foreign or domestic partnership is also US source income.

US trade or business

In general, a foreign corporation or international investor that engages in considerable, continuous, or regular business activity in the United States is considered to be engaged in a trade or business within the United States. Mere ownership of unimproved real property or residential property held for personal use (for instance, an apartment or condominium) does not create a US trade or business. Further, ownership of a single piece of property rented to one tenant on a net-lease basis (i.e., where the tenant is required to pay all expenses connected with the real estate) generally does not give rise to a US trade or business.

Leasing commercial buildings on a net-lease basis may or may not create a US trade or business. Where, however, a foreign corporation or international investor (or agents of either) actively manages commercial property and pays all expenses, taxes, and insurance, the activities constitute a US trade or business.

A partner of a partnership that is engaged in a US trade or business under the above guidelines will also be considered to be engaged in a US trade or business. Conversely, an investor who owns shares in a corporation that is engaged in a US trade or business will not be considered to be engaged in a US trade or business by virtue of the investor’s share ownership.

Effectively connected income

The effectively connected income of a foreign corporation or international investor is taxed on a net basis at the same graduated rates applicable to US corporations, citizens, and residents.

Generally, certain types of US source income, including rents, interest, dividends and capital gain are considered ECI if one of two alternative tests — the business-activities test and the asset-use test — is met. The business-activities test looks to whether the activities of the US business are a material factor in generating the income. The asset-use test looks to whether the income is derived from assets used or held for use in the conduct of a US business. Under regulations, the business activities test is generally applicable to rental income from real estate. For example, rental income earned on a building used in a US trade or business is ECI under these tests. In addition, as described below, foreign corporations and international investors may elect to treat all of their income from US real property as ECI if it would not otherwise be treated as such.

Under a special set of rules for gains on dispositions of real property interests (the “FIRPTA rules”), gains from the sale of a US real property interest (“USRPI”), such as real estate, or interests in partnerships, trusts, and US corporations that own primarily US real estate, are taxed as ECI regardless of whether the taxpayer is actually engaged in a US trade or business. The same treatment may also apply to a distribution by a REIT attributable to the REIT’s gains from the disposition of US real property. These rules are also discussed in the next section.

Non-effectively connected income

A 30% tax is generally imposed by the Code on the gross amount of FDAP income of a foreign corporation or nonresident alien individual that is not ECI and is US source income, although this tax generally does not apply to income from the sale of property. The rate of this “gross basis” tax can in some cases be reduced or eliminated by a tax treaty or by a specific statutory exemption. For example, “portfolio interest,” bank deposit interest, and interest on certain short-term obligations is exempt from this tax under domestic US law.

The portfolio interest exemption applies to qualified interest payments made to nonbank entities where, among other things, the foreign lender owns less than 10% of the US borrower. The debt must be in registered form (e.g., if the obligation must be transferred through a book entry system maintained by the issuer or its agent).

The tax on US source income that is not ECI (“non-ECI”) is generally collected via withholding at source, i.e., when the income is paid to a foreign person. For this reason, the gross basis tax is sometimes referred to as “withholding tax.”

Categories of US source income to which this tax may apply include dividends, interest, royalties, and certain rental income that is earned by a foreign corporation or international investor which is not engaged in a US trade or business.

Net basis elections

Sections 871(d) and 882(d) allow a foreign corporation or international investor that derives income from real property, but that is not otherwise treated as ECI (e.g., income from “raw” land or certain net-leased property) to elect to be taxed on a net basis ECI. This “net basis election” can be beneficial because the production of realty income generally involves substantial expense. Upon making the election, the investor is relieved of the 30% tax on gross rents and is allowed to treat deductions connected with the real estate to which the election applies, such as depreciation and interest, as connected with ECI. It is possible that such deductions would exceed income and therefore no US tax would be due. The net basis election may be revoked only with consent of the Secretary of the Treasury and applies to all US real estate held at the time of the election, as well as to property that may be acquired in the future. Further, the net basis election applies to all income from real property that is located in the United States and held for the production of income. The election does not, however, apply to certain income, including:

- Interest income on a debt obligation secured by a mortgage on US real property;
- Rental income from personal property; and
- Income from real property, such as a personal residence, that is not held for the production of income.

Branch profits tax

The earnings and profits of a foreign corporation that are derived from its ECI are generally taxed when withdrawn from the corporation’s US trade or business (or “branch”). The tax, called the branch profits tax (“BPT”), is 30% of the corporation’s “dividend equivalent amount,” unless a treaty specifies a lower rate or prohibits the BPT. A foreign corporation may be exempt from the BPT for the taxable year in which it completely terminates all of its US trade or business. A branch will not be deemed to have completely terminated, however, if the foreign corporation has any US assets, or generates any ECI, within three years of the year of termination.

A foreign corporation that is not engaged in a US trade or business generally is not subject to the BPT, unless it makes a net basis election or is deemed to have ECI because it sells a US real property interest.

Because the BPT is imposed in addition to the net basis US corporate tax, a foreign corporation subject to BPT may pay a combined US tax on its earnings at an effective rate in excess of 40%, unless the BPT rate is reduced by an applicable treaty. Often, this increased tax liability may make a real estate investment through a foreign corporation operating via a US branch uneconomical.

Tax on excess interest

If a foreign corporation has ECI, and it deducts interest expense in computing its US tax on its ECI, a tax may be imposed on the corporation as if the amount deducted had been interest income received by it from a subsidiary US corporation. The tax is imposed either at the statutory 30% rate, or at a lesser (or zero) treaty rate if a treaty is applicable. The base of this tax is the excess, if any, of the deduction over the amount of (US source) interest paid by the foreign corporation’s US trade or business.

US withholding tax on payments made to the foreign investor

By US corporations — If a foreign corporation or international investor establishes a US corporation to hold a real estate investment, then dividends, and interest paid by the corporation to the investor are considered non-ECI and the payor must deduct and withhold 30% for payment to the IRS, unless this rate is reduced by treaty, or, in the case of interest, unless the interest qualifies for a statutory exemption, such as the one for portfolio interest.

By foreign corporations — If the foreign corporation or international investor creates a foreign corporation to hold the investment, dividends paid by the foreign corporation are generally not subject to US tax. Interest paid by the foreign corporation's US trade or business is US source income. It is taxed and subject to withholding tax like interest paid by a US corporation.

By partnerships — Interest paid by a partnership that engaged in a trade or business in the United States generally is US source income, and generally subject to the tax and withholding rules described above. A US partnership is required to withhold and pay the IRS the gross basis tax on its own income that is US source non-ECI and that is allocable to its foreign partners. Foreign and US partnerships are also required to withhold tax on a foreign partner's distributable share of the partnership's net ECI (e.g., the partnership's gains from sales of US real estate).

By REITs — A REIT is a type of US corporation. Dividends paid by REITs in general are subject to the US withholding rules applicable to dividends paid by any US corporation, with certain exceptions. For example, treaties often provide somewhat less of a reduction in the US withholding tax imposed on a REIT's dividends than they do on a regular C corporation's dividends.

Additionally, distributions attributable to the REIT's disposition of US real estate are subject to withholding tax at 21%. The tax rate is reduced from 35% to 21% under the 2017 Act.

Documentation — In almost all situations where income is paid to a non-US investor, some form of documentation from the investor will be required to be provided prior to the payment to determine the proper rates and reporting of withholding taxes. These documentation rules can be complex and need to be considered in conjunction with any proposed investment.





US tax implications of specific investment vehicles

US corporations

An international investor may choose to own US real estate indirectly through a US corporation formed to hold the property. When a US corporation holds the real estate investment, both the taxation of the entity and the taxation of the repatriated earnings must be considered. Additionally, gain from the disposition of stock of a US corporation is also subject to US taxation if the stock of the US corporation constitutes a USRPI.

Tax on the US corporation — US corporations are taxed on their worldwide income on a net basis with deductions for operating expenses, subject to certain base erosion provisions. Unless the corporation is a REIT or a RIC, it is not allowed a deduction for dividends paid to its shareholders. Currently, the corporate US tax rate is 21%. State and local income taxes will also apply to income from sources in those jurisdictions. There is not a preferential tax rate for capital gains when earned by a US corporation. Thus, a US corporation selling appreciated real estate is taxable on its gain at 21%. Because the United States generally imposes tax on dividends paid by US corporations, even when paid to non-US persons, US corporations are not subject to the BPT.

Because international investors may seek to use related-party financing arrangements to reduce a corporation's taxable income subject to US tax, investors should pay close attention to the new section 163(j) business interest expense limitation as discussed above. For an entity that is an electing RPTOB, however, the limitation under section 163(j) may not apply and financing arrangements may continue to be a viable method to reduce US taxable income. A RPTOB is broadly defined as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. If an election is made, the election is irrevocable and the entity would generally be required to depreciate its real property assets using the less-favorable Alternative Depreciations Systems ("ADS").

Repatriation of earnings — Several methods are available to repatriate earnings of a US corporation. First, the investor can simply receive any or all of the corporation's earnings as a dividend. While dividends are subject to a 30% withholding tax under the Code, tax treaties generally reduce that rate, when they apply. Dividends received may be subject to more favorable taxation schemes in the investor's home country than other forms of earnings repatriation.

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An alternative to earnings repatriation can be the receipt of interest on loans made to the corporation by its shareholder. This method has two major advantages over repatriation by dividend distributions. First, the corporation may realize an interest deduction for the amount paid to its shareholder as opposed to the lack of deduction for amounts paid as a dividend. This deduction lowers the corporation's US taxable income and its US corporate tax liability. Second, the rate of US gross basis tax on interest received by a foreign lender may be limited by US tax treaties, where applicable, to a rate lower than the rate of tax that can be imposed on dividends. Interest may also be exempt under domestic US law, e.g., the portfolio interest exemption. As previously stated, the 2017 Act added new section 267A which disallows deductions for interest and royalties in the case of certain payments pursuant to hybrid arrangements or that involve hybrid entities. Therefore, investors should analyze the financing transaction to ensure a deduction can be claimed. Similarly, the business interest limitation under section 163(j) should also be considered.

Another alternative to earnings repatriation is the realization of proceeds from the disposition of the corporation's stock. If the corporation is a US Real Property Holding Corporation ("USRPHC"), or if it was a USRPHC at any time during a five-year lookback period or foreign investors ownership period, if shorter (the "Relevant Holding Period"), the gain resulting from the sale is subject to US tax as ECI. However, if the shareholder is a foreign corporation, the gain from the sale of stock is not subject to the BPT. This method of income realization is not subject to the gross basis tax that would be imposed if the earnings were distributed as a dividend.

If the US corporation has not been a USRPHC during the Relevant Holding Period and the foreign investor obtains a non-USRPI certification from the US corporation, it may not be subject to tax when the stock is sold assuming the foreign shareholder doesn't otherwise have a US trade or business to which such gain could be attributed. Earnings may also be repatriated by selling off the assets and liquidating the corporation. If a corporation, the stock of which is a USRPI, disposes of all its property in a taxable transaction in which the full amount of gain is recognized, the stock in the corporation ceases immediately to be a USRPI, and gain realized by foreign shareholders on a subsequent disposition of such stock should not be ECI. However, this "cleansing exception" no longer applies to a corporation that is or has been a RIC or a REIT at any time during the five-year period preceding the date of the liquidation, as it was repealed for RICs and REITs by the Protecting Americans from Tax Hikes ("PATH Act"). Foreign shareholders receiving distributions in liquidation of the US corporation are generally not subject to the gross basis tax applicable to dividend distributions.

Foreign corporations

Foreign corporations owning US real estate are generally taxed under the Code on a gross basis on their US-source FDAP income, and on a net basis, under rules similar to those applicable to US corporations, on their ECI. Foreign corporations are also subject to BPT on their effectively connected earnings and profits that are not considered reinvested in their US trade or business. As noted earlier, when the maximum rate of BPT applies, the earnings of the foreign corporation in any particular year may be subject to a combined effective US federal income tax rate in excess of 44%.

Repatriation of earnings — The earnings of foreign corporations can be repatriated in many of the same ways as those of US corporations. Dividends paid by the foreign corporation generally are not subject to further US taxation. However, interest paid by the foreign corporation's US trade or business is US source income, and thus potentially subject to US withholding tax. The stock of a foreign corporation can be sold free of US tax. The stock does not constitute a USRPI under FIRPTA.

Partnerships

Ownership of US real estate through a partnership involves distinct US tax consequences.

Generally, a partnership, whether domestic or foreign, general or limited, is not a taxpaying entity. Instead, a partnership allocates to its partners each partner's share of partnership items of income and expense and each partner is taxed on that share, regardless of whether the partnership actually distributes any money or property to the partner. Each foreign partner of a partnership that has income effectively connected with a US trade or business, which can include the rental of US real estate must file a US income tax return.

US taxation of foreign partners depends on how the partnership income is categorized. US source FDAP is taxed at the partners level on a gross basis, and subject to withholding either at the partnership level or by the payer of the income to the partnership. If the partnership's income is ECI, it is taxed to the partners accordingly. Generally, a partner's share of a partnership item is characterized as if the item were realized directly from the source from which the partnership realized the item. For example, rental income earned by the partnership is taxed at the partner level as ECI. Similarly, gain from the sale of a USRPI is taxed at the partner level as ECI. The normal tax rates applicable to US individuals and corporations apply. Partners that are foreign corporations may also have BPT liability.

Note that the 2017 Act included new section 864(c)(8), which generally causes some portion of the gain (or loss) on a non-US person's sale of an interest in a partnership that is engaged in a trade or business within the United States to be ECI. US tax would apply to the gain from the sale of the partnership interest to the extent of the portion of the partner's share of ECI from a hypothetical sale or exchange of all partnership assets at their fair market value as of the date of the sale of the partner's partnership interest. Gain that is taxable under FIRPTA is not subject to the aforementioned rule. However, the FIRPTA rules themselves have a substantially similar rule that will treat gain or loss from the disposition of a partnership interest as ECI to the extent that such gain is attributable to such partnership's USRPI whether or not such USRPI is held or used in a U.S. trade or business by the partnership. Proposed regulations under section 864(c)(8) were subsequently issued on December 27, 2018 (the "section 864(c)(8) Proposed Regulations"), which provide further guidance on the provision. Therefore, the rules should be carefully reviewed.

Each partner's tax liability is determined by his personal status. For example, similar items of income may be taxed differently in the hands of different partners in the same partnership. Thus, a corporate partner would be treated differently from an individual partner. Different treaties could apply, depending on the residence of the partners. One partner might have losses from another investment, which could be used to shelter his share of the partnership's net positive ECI, while other partners may not have the benefit of such losses.

Because the partners, and not the partnership, are taxed currently on their share of the partnership income, there is, with notable exceptions, generally no additional US tax on distributions of money or property from the partnership as there would be in the case of a corporation. Thus, repatriation strategies are generally of less concern for investments through partnerships. However, there are withholding provisions designed to ensure collection of the tax owed by foreign partners on their share of the partnership's United States trade or business income that should be considered. Partnerships are required to withhold on a foreign partner's share of net ECI. This is similar to the partnership making estimated tax payments on behalf of its foreign partners. These payments are applied to the partner's tax liability for the period. Any over-withholding of the foreign partner's regular tax liability has to be recovered by the partner through the filing of his own tax return.

The 2017 Act also included new section 1446(f), which provides that, if any portion of the gain (if any) on any disposition of a partnership interest would be treated as ECI under section 864(c)(8), discussed above, the transferee (or purchaser) is required to withhold 10% on the amount realized on the disposition unless an exemption applies. If the transferee fails to withhold under section 1446(f), then the partnership is subject to a secondary withholding obligation with respect to distributions made to the transferee under section 1446(f)(4). Notice 2018-29, released on April 2, 2018 provides the following exemptions from withholding: (1) non-foreign status of transferor; (2) no realized gain by transferor;

(3) transferor earned less than 25% effectively connected taxable income from the partnership over the last three years; (4) partnership would have less than 25% effectively connected gain (including FIRPTA gains) if it were to hypothetically sell all of its assets at fair market value; and (5) no recognized gain by the transferor by reason of the operation of a non-recognition provision of the Code. Each of the five exemptions require a certification to be made by the seller of the partnership being sold in order for withholding to not apply. Notice 2018-29 also suspends the partnership's secondary withholding obligation and provides for some coordination rules with respect to section 1445(e)(5), which provides the FIRPTA withholding rule applicable to non-US partner's disposition of a partnership interest that is, in whole or in part, considered a USRPI. Generally, if a US partnership only owns an interest in a domestically controlled REIT, a sale of an interest in the partnership would likely be exempt from withholding under section 1446(f) pursuant to the fourth exemption above and exempt from FIRPTA withholding under section 1445(e)(5) as the partnership interest would not be considered a USRPI by virtue of the fact that the domestically controlled REIT stock is not considered a USRPI. However, to the extent a US partnership owns an interest in a REIT that is not a domestically controlled REIT, the sale of an interest in that partnership would be subject to withholding under section 1445(e)(5) and not under section 1446(f) as the coordination rule should apply. Current guidance provides that when FIRPTA withholding under section 1445(e)(5) and ECI withholding under section 1446(f) both apply; the buyer is only required to apply section 1445(e)(5). This rule does not apply in the case where a withholding certificate is received to reduce the FIRPTA withholding to a lower amount, where for example 21% of the expected taxable gain is less than 15% of the amount realized. In such a case, there may be withholding required under section 1446(f). This may be the case even if the seller is a qualified foreign pension fund and withholding under section 1445 would generally not apply, as such pension fund would not be considered foreign only for purposes of FIRPTA withholding and not for purposes of withholding under section 1446(f). The ultimate tax liability of a non-US seller will be determined on the net gain. Any amount over withheld can be claimed on the US tax return of such non-US seller.

On May 7, 2019, Treasury and the IRS issued proposed regulations under section 1446(f) (the "section 1446(f) Proposed Regulations"). The section 1446(f) Proposed Regulations modify Notice 2018-29 and when finalized, would make Notice 2018-29 obsolete (and re-instate the partnership's secondary withholding obligation). The section 1446(f) Proposed Regulations provide six exceptions to withholding and allow the transferee to rely on certain certifications that it receives from the transferor or partnership, unless it has actual knowledge that the certifications are incorrect or unreliable. Most of the exemptions carry over from Notice 2018-29 but with lower thresholds in some cases.

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The exemptions under the section 1446(f) Proposed Regulations are as follows: (1) non-foreign status of transferor; (2) no realized gain by transferor; (3) transferor earned less than 10% effectively connected taxable income from the partnership over the prior three years; (4) partnership would have less than 10% effectively connected gain (including FIRPTA gains) if it were to hypothetically sell all of its assets at fair market value; (5) no recognized gain by the transferor by reason of the operation of a non-recognition provision of the Code (6) qualification of treaty benefits. In determining the amount to withhold, a transferee may rely on certification from the transferor regarding the transferor's maximum tax liability. In general, the section 1446(f) Proposed Regulations are effective 60 days after the date that they are finalized. Until the 1446(f) Proposed Regulations are finalized, taxpayers may follow guidance provided in either the section 1446(f) Proposed Regulations or Notice 2018-29.

Real Estate Investment Trusts

The tax regime for REITs was created for the specific purpose of encouraging widespread ownership of real estate by small investors. Basically, a REIT is an entity, otherwise taxable as a US corporation, that meets certain technical requirements and that elects REIT status. The key difference between a conventional US corporation and a REIT is that a REIT is allowed a tax deduction for dividends paid to its shareholders. To qualify for this special treatment, a REIT must distribute at least 90% of its net income exclusive of capital gains to its shareholders. In practice, most REITs typically distribute 100% of their income in order to not be subject to a corporate level tax on earnings that are not otherwise required to be distributed by the REIT.

The other REIT requirements fall into three categories: ownership, assets, and income. First, there must be 100 or more owners, and no five or fewer "individuals" (defined to include certain tax-exempt entities) may own directly or indirectly more than 50% of the total value of the REIT stock. Second, at least 75% of the total value of the REIT's assets must consist of cash, real estate, loans secured by real estate, or US government securities. Third, at least 95% of the REIT's gross income must be composed of interest, dividends, and rents from real property, plus certain other passive sources of income. In addition, 75% of the REIT's gross income must consist of rents from real property, interest on loans secured by real estate, and certain other real estate-related sources of income.

REITs must adopt a calendar year as their tax year. Existing US corporations that wish to elect REIT status must distribute all earnings and profits for tax years beginning after February 28, 1986. If a REIT meets the above requirements, it may not be subject to tax at the corporate level if it distributes all net income currently to shareholders, thereby eliminating the normal double taxation of corporate income. REITs are not subject to the BPT and REITs are permitted to have 100%-owned subsidiaries.

The U.S. taxation of a non-US shareholder of a distribution from a REIT depends on whether the distribution is attributable to ordinary operating profits or to gain from sales or exchanges of USRPI. To the extent the REIT makes a distribution to an international investor or foreign corporation attributable to gain from sales or exchanges of USRPI by the REIT, the distribution is taxed as ECI.

In general, FIRPTA withholding rules apply to require the REIT to withhold 21% of the amount distributed to non-US shareholders that is attributable to gain from the REIT's sale of USRPI or that could be designated as a capital gain dividend by the REIT. Corporate investors will also be subject to BPT on such distributions. To the extent a distribution could not be designated as a capital gain dividend, the distribution generally is treated as a regular dividend of non-ECI subject to the 30% statutory withholding tax rate for dividends or a lower treaty rate, if applicable.

Generally, international investors or foreign entities that dispose of shares in a private REIT are likely to be subject to US tax on their gain if the REIT is foreign controlled, i.e., if 50% or more of the REIT stock is owned by non-US persons (and the REIT stock is otherwise a USRPI). Gain subject to tax is treated as ECI. Thus, the investor must file a US tax return and report the gain.

However, if the shares of a foreign-controlled REIT are considered to be "publicly traded" and the investor owned no more than a 10% interest over the five-year period preceding the date of disposition, no tax is imposed. Note that this threshold percentage was increased from 5% to 10% for publicly traded REITs as part of the PATH Act. A foreign investor disposing of shares in a domestically controlled REIT (i.e., if 50% or more of the REIT stock is owned by US persons) generally is not subject to US tax on the gain.

Ordinary REIT dividends to domestic shareholders that are taxed in the United States are taxed at a maximum of 33.4%, accomplished through a 20% deduction. For example, if a taxpayer receives a \$100 dividend from a REIT, then the 20% deduction reduces the income to \$80. The \$80 of income can be taxed at a maximum marginal rate of 37% resulting in an income tax liability of \$29.60. In that case, the 3.8% net investment income tax would apply to the entire \$100, resulting in a \$3.80 net investment income tax liability and a total tax liability of \$33.40. Foreign investors that are not otherwise subject to US taxation are generally taxed on a gross basis on distributions from the REIT. The REIT must withhold 30% from each ordinary dividend unless a treaty provision is applicable to the non-US investors. Distributions representing return of capital and/or distributions of realized capital gains by the REIT are subject to FIRPTA as discussed later in this publication.

Appendices A, B and C illustrate the use of these different types of specific investment vehicles.



Treaty protection from Taxation

The United States has income tax treaties with many nations that are designed to alleviate double taxation of income from transactions that cross-national boundaries and to encourage foreign investment. Accordingly, treaties typically reduce tax rates on certain types of portfolio investment income such as dividends, interest, and royalties. In addition, they limit taxation of other types of business profits of a resident of one country that are generated in the other country. Treaties also generally provide that investors resident in one country carrying on business in the other country are entitled to nondiscriminatory tax treatment in the other country.

The benefits of a treaty are, by its terms, extended only to residents of the contracting states. Over the years, the US government and the governments of other countries have become increasingly concerned about preventing third-country residents' use of US treaties, or "treaty shopping." As a result, most US treaties now contain a limitation on benefits ("LOB") article, which expressly limits the benefits of the treaty to individual residents of a treaty country, companies primarily owned by individual residents of the treaty partner country, and certain other companies deemed not to be "treaty shopping." Any treaty analysis must confirm that any entities involved qualify under the LOB article or any other provisions limiting the application of a treaty. In addition, internal US law anti-abuse rules, such as section 267A, dealing with disallowance of deductions from hybrid transactions, section 894(c), dealing with income received by hybrid entities, and section 7701(l) and related regulations, covering back-to-back financing arrangements, must also be addressed. Appropriate documentation of the residence of the payee and entitlement to treaty benefits is required to protect withholding agents that withhold tax at a rate less than 30% (e.g., Forms W-8BEN-E, W-8ECI, W-8IMY)

Dividend income

Tax treaties generally provide for a reduced rate of gross-basis tax on dividends paid by US corporations to a resident of the other treaty country. Treaty tax rates on dividend income from US corporations vary from 0% to 15% or higher, in contrast to the 30% statutory rate provided under the Code. The reduced dividend tax rates are generally restricted in the case of dividends paid by REITs. Under some treaties, dividends from REITs to treaty-resident shareholders generally are not eligible for tax rates below 15%, and to be eligible for any treaty benefits, one of three requirements must be met:

- The beneficial owner is an individual or pension fund that owns less than 10% of the REIT;
- The stock of the REIT is publicly traded and the owner holds an interest of less than 5%; or
- The beneficial owner is a person (individual, estate, trust, or company) holding an interest of less than 10% and the REIT is diversified.

Branch profits tax

The BPT was enacted to provide parity between a foreign corporation that operates in the United States through a US subsidiary corporation, on the one hand, and one that operates through a US branch, on the other. While the net income from the business in each case is subject to standard US corporate tax rates, the foreign corporate parent of the US corporation is subject to an additional 30% tax (which can be reduced by treaty) when it receives dividend distributions. The BPT imposes a similar tax to the extent the US branch's net equity does not increase at the same pace as it generates earnings and profits from ECI. Thus, treaties reduce the rate of BPT in tandem with their reductions in gross-basis tax rate on dividends from wholly owned subsidiaries.

Interest income

Under many US treaties, the US gross-basis tax on US source interest is reduced or eliminated, except that the tax is often imposed at a 15% rate if the interest is contingent on profits, etc., of the payer or a related person.

Business profits

Under most of its treaties, the United States generally may not tax the business profits of a treaty country resident generated in the United States, unless such business is carried on through a permanent establishment ("PE") located in the United States. If a PE exists, the business profits may be taxed only to the extent they are attributable to the US PE.

Income from real property

Most tax treaties provide that income from real property, including income from the direct use of the real property by the owner and the rental income for use of the property, is taxable in the country in which the property is located. For rental income generated from US real property, a foreign recipient may be subject to a 30% US withholding tax on the gross amount of the rental income, unless a net basis election has been made to tax net rental income at the federal income tax rate (21% for corporations, and up to 37% for individuals).

Capital gains

Under many US treaties, residents of the treaty country are exempt from US tax on gain from the sale of assets, unless such assets form part of the resident's US PE, or the assets are US real property or are otherwise a USRPI. Under many treaties, gains from the sale of stock or securities are generally taxable exclusively in the country of the seller's residence, except where such stock or securities are USRPIs.

Third-country use of treaties/limitation on benefits

Under a typical LOB article in a US tax treaty, the benefits of the treaty (i.e., reduced withholding tax rates, nondiscrimination, etc.) are granted to a company resident in a treaty country only if one of a number of potential LOB tests is met—for example, if the stock of the company is regularly and primarily traded on a recognized stock exchange, or at least 50% of the corporation's stock is owned by residents of the treaty country and less than 50% of the income of the company is used to make deductible payments to nontreaty-country-resident persons. A treaty country resident that cannot meet either of the above tests may be able to qualify for treaty benefits by satisfying other LOB tests (e.g., the active trade or business test) under an applicable treaty.

An additional limitation on treaty benefits is imposed by section 894(c) and treaty provisions that restrict treaty benefits for payments to partnerships or other fiscally transparent entities. These provisions have the effect of denying treaty benefits on certain payments made to "hybrid entities," or entities that are seen as flow-through entities for US tax purposes (e.g., LLCs, partnerships, disregarded entities), but whose income is not treated for tax purposes by the other treaty country as in the income of a resident.

Multilateral Instrument

A "Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting" (the "Multilateral Instrument" or "MLI") entered into force on July 1, 2018 and as of November 26, 2019 cover 90 jurisdictions (not including the United States). The MLI reflects changes to the OECD Model Tax Convention arising from the OECD/G20 "BEPS Project." These changes deal with, for example, hybrid mismatches, tax treaty abuse, the definition of PE, and dispute resolution. The MLI provides each of its signatories a method for conforming its existing bilateral treaties to the BEPS Project treaty recommendations that the signatory, and its bilateral tax treaty counterparties, have separately decided to adopt, without their having to renegotiate each relevant bilateral treaty. Where applicable, the MLI will apply alongside a tax treaty and modify its application. As of July 15, 2019, the MLI affects more than 1,500 tax treaties. The United States has not signed the MLI and, unless it does so in the future, its treaties will not be affected by the MLI.



Dispositions of US real estate investments

US real property interests

In general, FIRPTA treats the gain or loss of an international investor or a foreign corporation from the disposition of a USRPI as income or loss effectively connected with a US trade or business. Consequently, such gain or loss will be included with the international investor's other effectively connected income (if any) and subject to US income tax on a net basis.

A USRPI includes an interest in real property located in the United States and the Virgin Islands. Real property includes land, real property improvements (e.g., buildings), leasehold interests, and un-severed natural products of land (e.g., growing crops, timber, mines, wells, and other natural deposits). It also includes certain personal property associated with the use of real property, such as moveable walls, furnishings, mining equipment, farming equipment, drilling rigs, and other personal property associated with the use of real property

USRPIs also include shares and other equity interests in a US corporation (other than solely as a creditor) that was considered to be a USRPHC at any time during the five-year period ending on the date of disposition of the interest. A corporation is considered to be a USRPHC if its assets are primarily USRPI (but see the more detailed discussion below). Therefore, it is not possible to not be subject to US tax on the disposition of real property by holding the property indirectly through a US corporation and selling its stock. As an exception to this rule, the term USRPI does not include an interest in a publicly traded domestic corporation unless the investor owned more than 5% of the fair market value of such stock (or 10% for REIT stock) at any time during the five-year period ending on the date of the investor's disposition of such stock. Also, an interest in a domestically controlled REIT does not constitute USRPI.

An interest in real estate that is solely a creditor's interest is not considered to be USRPI, and thus is not subject to FIRPTA. Such interest may include a right of foreclosure on real property under a mortgage, a financing statement, or other instrument securing a debt. If the interest in the real estate goes beyond that of a creditor, however, FIRPTA may come into play, and the exception is defined in narrow terms. In addition, any right to share in the appreciation in value of real property or in the gross or net proceeds or profits generated by real property is a USRPI. For example, a loan with an "equity kicker" is treated as a USRPI.

Definition of a USRPHC

A corporation (special rules apply to REITs- see below) is considered to be a USRPHC if the fair market value of its USRPI is 50% or more of the sum of the fair market values of its USRPIs, foreign real property interests, and US or foreign trade or business assets (including financial assets, depreciable property, inventories, and intangibles). Determination of USRPHC status can sometimes be difficult because of uncertainties over the characterization of corporate assets for these purposes.

A foreign entity or international investor is not subject to US tax on the disposition of its interest in a corporation that was not a USRPHC on any of the specified dates during the relevant testing period (i.e., the shorter of the international investor's holding period or the five-year period ending on the date of the disposition of the stock of the corporation). The stock of any domestic corporation is presumed to be a USRPI unless the taxpayer establishes (by obtaining a non-USRPI certification from the corporation) that such corporation was at no time a USRPHC during the previous five years. An optional book value test allows a corporation to presume that the fair market value of its USRPI is less than 50% of the aggregate fair market value of its assets if the book value of the corporation's aggregate USRPI is 25% or less than the total book value of the corporation's assets. Because an interest in any domestic corporation is presumed to be a USRPI, particular pressure is placed on contemporary reporting and documentation rules in almost all transactions involving US corporations.

In determining whether a corporation is a USRPHC, if the first corporation owns less than 50% of the shares of a second corporation, these shares are treated as a USRPI unless the first corporation determines that its interest in the second corporation is not a USRPI by either obtaining a statement from the second corporation or making an independent determination. If a corporation owns 50% or more of the shares of a second corporation, the shares of the subsidiary are ignored and a look-through rule applies, whereby the upper tier corporation is deemed to own a proportionate share of all the subsidiary's assets for purposes of USRPHC testing. A similar look-through rule applies with respect to a corporation's ownership of partnerships, estates, and trusts, except that no minimum ownership requirements apply. Accordingly, a corporation's pro rata share in the assets of a partnership, estate, or trust of which it is a partner, owner, or beneficiary is taken into account in the determination of the corporation's USRPHC status.

An interest in a foreign corporation can only be treated as a USRPI for purposes of determining whether or not an upper-tier domestic corporation is a USRPHC. Gain or loss from the disposition of a foreign corporation can never constitute ECI by reason of the FIRPTA rules.

As discussed above, if a domestic corporation is a USRPHC at any time during the relevant testing period, its stock is considered to be a USRPI (even if it is not currently a USRPHC). This "taint" of USRPI status can be removed if the corporation disposes of all of its USRPIs in taxable transactions prior to the disposition of its stock. In this situation, US tax on all appreciation in USRPIs will have been paid and there is no longer a need to capture that appreciation in the stock value.

Why is USRPI status important?

For the international investor owning shares in a US company, it is important to determine whether those shares are considered USRPI as of the date of disposition of such shares in order to determine whether or not the disposition of the shares will result in US tax, whether or not the disposition will trigger US withholding tax, what documentation and reporting will be required at the time of the disposition, and whether the international investor will be required to file a US tax return.

If the US corporation is not a USRPHC during the relevant testing period, the sale of its shares by an international investor may not be subject to US tax. Moreover, if the corporation provides the international investor and the IRS with the required statements establishing that it was not a USRPHC during the testing period, the international investor is not subject to withholding and is not required to file a US tax return.

US tax consequences of investing in USRPIs through foreign corporations

The gain from the sale of an interest in a foreign corporation is not subject to tax under FIRPTA. Thus, an international investor may own US real property indirectly through a foreign corporation and ultimately sell the shares of that foreign corporation and not be subject to US tax on the gain from the sale. Of course, if the foreign corporation holding the USRPI disposes of the USRPI directly, the gain from the sale will be subject to tax under FIRPTA. At the same time, the transfer of a USRPI by a foreign corporation to another entity in a transfer or reorganization that would otherwise be nontaxable under the Code is generally taxable under FIRPTA unless the interest it receives back in exchange for the USRPI is also USRPI and strict reporting requirements are met.

Also, a distribution of a USRPI held by a foreign company to its shareholders will generally be subject to US tax to the extent of the appreciation in value of the USRPI. However, a distribution may qualify for non-recognition, such as in the case where the distributee takes the same basis in the USRPI as the distributing foreign company and such distributee will be subject to US tax on any subsequent disposition of the USRPI. Consequently, any person purchasing the stock of a foreign corporation that owns USRPI should take into account the difference between the foreign company's tax basis in the USRPI and its value, as this difference may result in future tax, either upon liquidation of the company or the disposition of the USRPI from the foreign company. Again, contemporaneous reporting and documentation will be crucial.

Election to be treated as a domestic corporation

A foreign corporation is entitled to make an election to be treated as a US corporation for FIRPTA purposes while remaining a foreign corporation for all other purposes of the Code. The election to be treated as a domestic corporation may be useful in certain planning situations to mitigate the impact of FIRPTA with respect to dispositions of USRPIs made by the foreign corporation.

Use of REITs

Interests in domestically controlled (less than 50% foreign ownership by value) REITs are not considered to be USRPIs under FIRPTA.

Consequently, foreign investors who hold interests in domestically controlled REITs will not be subject to tax under FIRPTA upon the sale of their shares. Nevertheless, except as described below, dividend distributions made by a REIT to international investors and that are attributable to the REIT's gains from sales or exchanges of USRPI are subject to US tax under FIRPTA.

The PATH Act modified the rules for how to determine whether a REIT is domestically controlled. Any stock of a REIT that is held by a domestically controlled REIT that is publicly traded will be treated as a US person. Additionally, if a person holds less than 5% of a REIT which is publicly traded on an established securities market in the US, the person holding the REIT stock will be treated as a US person, unless the REIT has knowledge that such person is not a US person.

In the case of a publicly traded REIT, dividend distributions attributable to gains from the sale or exchange of USRPI are not taxed as ECI to a non-US shareholder if the non-US shareholder did not own greater than 10% of the REIT stock at any time during the one-year period ending on the date of the distribution.

FIRPTA withholding

Generally, any disposition of a USRPI by an international investor requires the purchaser to withhold 15% of the gross sale price (or 15% of the fair market value of the property exchanged). Certain exemptions may apply or the IRS may agree to a reduced withholding amount. However, in general, the 15% withholding is required regardless of the actual amount of tax due or the amount of cash received. Note that the rate was increased from 10% to 15% as part of the PATH Act.

There are special withholding rules that apply to distributions and dispositions by corporations, partnerships, trusts, and estates.

Amounts withheld by the purchaser must be promptly reported and paid to the IRS. The withholding tax is reported on Forms 8288 and 8288-A; the return is filed and the tax paid within 20 days after the transfer. If the purchaser fails to withhold the correct tax amount, the purchaser has liability for the entire amount of the withholding tax, plus interest and penalties. Accordingly, it is very important that the purchaser of USRPI determine whether there is a withholding obligation.

Withholding exceptions

There are exceptions to the above withholding requirements, including:

- The transferor may provide the transferee with an affidavit affirming its status as nonforeign.
- The transferor may provide the transferee (and the transferee provides a copy to the IRS) an affidavit stating that the transfer is pursuant to a nonrecognition transaction.
- A non-publicly traded domestic corporation may furnish non-USRPI certification to the transferee (or alternatively to the transferor, who then gives it to the transferee) that its stock is not a USRPI either because it has not been a USRPHC during the relevant period or it has cleansed its taint.
- The shares of a class of stock in a domestic corporation are publicly traded and the investor holds less than 5% of the company (or 10% if the company is a REIT).
- The withholding amount is reduced or eliminated as evidenced by a withholding certificate obtained from the IRS.
 - Either the transferor or transferee may request a withholding certificate
 - Withholding certificates are generally available when the required withholding exceeds transferor's maximum tax liability, the IRS determines that reduced withholding would not jeopardize tax collection, the transferor's gain is exempt from US tax and has no withholding liability, or the transferor or transferee has entered into agreement with the IRS to pay the tax or has provided adequate security.



Sovereign Wealth Funds

Sovereign Wealth Funds (“SWFs”) are wholly owned government funds that invest a nation’s surplus wealth. Applicable Treasury regulations have defined a SWF as “a government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from the official reserves of the monetary authorities.” SWFs may make investments in their home country or abroad. A non-US government which establishes a fund that provides certain retirement and/or pension benefits to its citizens may also qualify for the same US tax benefits as SWF’s.

Section 892 exemption

Under section 892, income earned by a foreign government through certain investments in the United States is exempt from US income tax. Three specific conditions must be satisfied to qualify for the exemption:

- The income must be derived by a “foreign government”;
- The income must be derived from only certain types of investments; and
- The income must not be derived from “commercial activities.”

Temporary regulations issued under section 892 provide additional details for application of the statutory language.

Foreign government

A foreign government for purposes of the section 892 exemption only includes the “integral parts” or “controlled entities” of a foreign sovereign.

Integral part

An integral part of a foreign sovereign is any person, body of persons, organization, agency, bureau, fund, instrumentality, or other body, however designated, that constitutes a governing authority of a foreign country. All of the net earnings of the governing authority must be credited to the governing authority’s own account or to other accounts of the foreign sovereign with none of the income inuring to the benefit of a private person. Generally, the integral part must exercise functions traditionally undertaken by governments. An individual who is a sovereign, official, or administrator acting in a private or personal capacity will not be considered an integral part of a foreign sovereign.

Controlled entity

A controlled entity of a foreign sovereign is an entity that is separate from a foreign sovereign or otherwise constitutes a separate juridical entity if:

- It is wholly owned and controlled by a foreign sovereign either directly or indirectly through one or more controlled entities;
- It is organized under the laws of the foreign sovereign that owns the entity;
- Its net earnings are credited to its own account or other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person; and
- Its assets vest in the foreign sovereign on dissolution.

A controlled entity does not include a partnership or any other entity owned and controlled by more than one foreign sovereign.

Income inuring to private persons

If earnings of an otherwise integral part or controlled entity of a foreign sovereign inure to the benefit of private persons, then such integral part or controlled entity will not be considered part of a foreign government for purposes of section 892. Accordingly, the income earned will not be granted an exemption from US tax.

Income is considered to inure to the benefit of a private person in two cases. First, if the income benefits private persons through such persons' use of the governmental entity as a conduit for their own personal investment, the income is considered to inure to the benefit of private persons. Second, the income of a governmental entity will be considered to inure to the benefit of private persons if the private persons' use, influence, or control that is implicitly or explicitly approved of by the foreign sovereign to divert the income of the governmental entity from such entity's intended use of such income. However, income is presumed not to inure to the benefit of private persons when such persons are the intended beneficiaries of a governmental program carried on by the foreign sovereign when the activities of such program constitute governmental functions (for example, a generally available social welfare system).

Exempted income

The section 892 exemption only applies to income earned from the following sources:

- Income from the foreign government's investments in the United States consisting of stocks, bonds, or "other securities";
- Income from the foreign government's investments in the United States consisting of financial instruments held in the execution of the government's financial or monetary policy; and
- Interest earned by the foreign government from its deposits of funds in US banks.

Income from investments includes the gain from their disposition. Further, "other securities" includes any note or other evidence of indebtedness but does not include partnership or trust interests.

The exemption afforded to foreign governments is also circumscribed by the FIRPTA rules described above. The interaction between these two sets of tax rules is complex and must be examined case by case.

Commercial activities exclusion

If income is earned from commercial activities or from a controlled commercial entity, whether or not the income is derived from one of the sources described above, then section 892 will not apply to such income. In the case where a controlled entity has a commercial activity, the whole of the income earned by the controlled entity is not exempt under section 892. In contrast, only the portion of the income related to the commercial activities earned by an integral part will not be exempt under section 892. This distinction can be of paramount importance for foreign governments interested in structuring US investments.

Commercial activities are activities that are ordinarily conducted by the taxpayer or any other persons with a view to the current or future production of income or gain. This definition applies whether the activities are conducted within or without the United States. Investments in income-producing real estate are considered commercial activities; however, the holding of net leases on real property or land that does not produce income is specifically excepted from the definition of commercial activities.

A controlled commercial entity is any entity engaged in commercial activities, even to a very limited extent, if the foreign government holds (directly or indirectly) a 50% or more interest in the entity or if the foreign government holds (directly or indirectly) other types of interests that provide it with effective control of such entity. Again, this definition applies whether the activities are performed within or without the United States.

Introduction to the taxation of foreign investment in US real estate

On November 3, 2011, Treasury and the IRS issued proposed regulations providing additional guidance for purposes of determining when a foreign government's US-sourced investment income is exempt from US taxation. The proposed regulations include the following key provisions and highlights:

- Clarifies that gain on the sale of real estate (including a REIT distribution attributable to the REIT's disposition of USRPI) is not itself a commercial activity. Further, the proposed regulations indicate that real estate dispositions are still taxable and not exempt, so the proposed regulations do not modify guidance provided in Notice 2007-55 with respect to sovereigns.
- Clarifies that an activity can be considered commercial even if not a trade or business for section 162 or section 864(b) purposes.
- Provides that certain investments in financial instruments will not be considered commercial activity.
- Provides that commercial activity status is tested annually.
- Provides reasonable cause relief in certain cases for those controlled government entities that inadvertently have an investment in a commercial activity, cure it appropriately, and have procedures in place to monitor.
- Provides relief in that if a controlled government entity is a limited partner (with no management or control rights) in a partnership and the partnership itself is engaged in certain commercial activities then the commercial activity won't be attributed up to the controlled government entity (however, the income is still fully taxable).

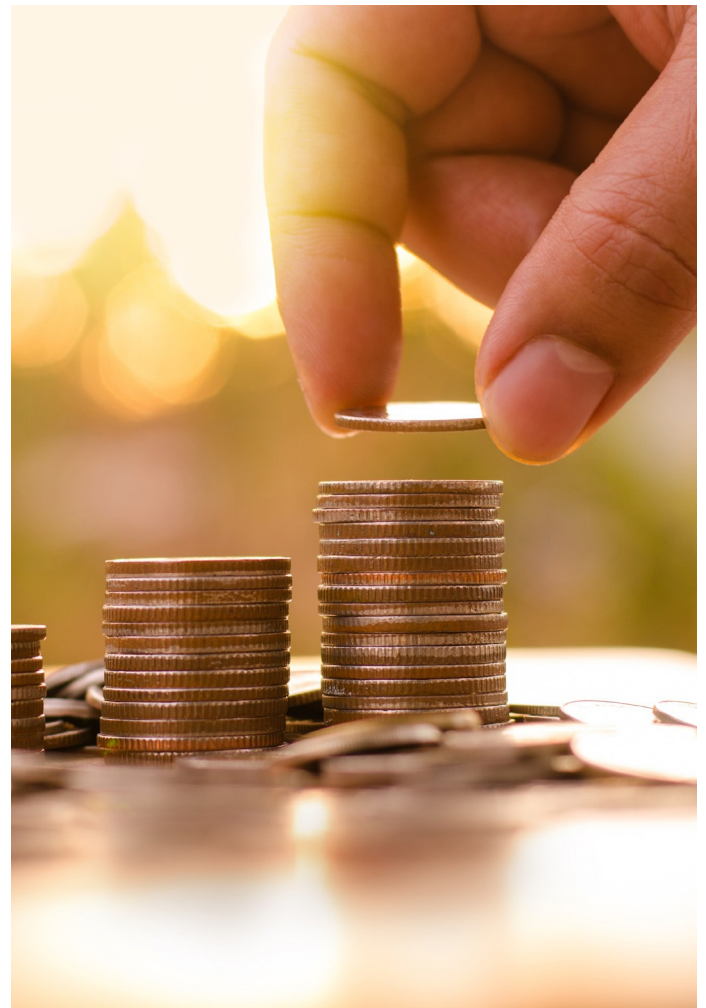
The proposed regulations specifically indicate that taxpayers may rely on these provisions until final regulations are published.

REIT issues and Notice 2007-55

A REIT is a special purpose entity for US federal income purposes. As discussed above, if certain conditions with respect to ownership, composition of assets and income, and distributions are satisfied, REITs are allowed to deduct dividends paid to their shareholders so that their earnings are not subject to corporate-level tax. As suggested by their name, REITs are generally USRPHCs for US federal income tax purposes. Because of this, the section 892 exemption rules overlap with US tax legislation specific to gains from the sale of USRPI.

REITs can be very tax favorable investment entities for foreign governments that qualify under section 892. Dividends and gains on disposition of REIT shares can be exempt from US tax while the REIT itself is also not subject to US tax.

Historically, taxpayers may have taken the position that capital gain distributions from REITs are also exempt under section 892. However, in Notice 2007-55, the IRS stated its position that section 892 is not applicable to capital gain distributions and that it will challenge any such assertions. The IRS has also indicated that it intends to issue new regulations to support this view.





Foreign Account Tax Compliance Act

What is FATCA?

The Foreign Account Tax Compliance Act (“FATCA”) addresses perceived abuses by US taxpayers with respect to assets held outside the United States. Enacted in 2010 and effective since 2014, FATCA compels non-US entities to report certain US account holders to the IRS with a US-sourced withholding tax levied against non-cooperative, non-US entities. Specifically, the FATCA regime imposes a new 30% US withholding tax on withholdable payments made to certain non-compliant non-financial foreign entities (“NFFEs”) or foreign financial institutions (“FFIs”). The definition of an FFI is quite broad, and can include virtually all non-US investment vehicles, including foreign feeder funds, foreign stand-alone funds, and blocker corporations as well as foreign alternative investment vehicles, regardless of whether the interests in such vehicles are being offered or traded publicly. US-based investment vehicles, as US withholding agents often making withholdable payments, typically would have the obligation to withhold on those foreign investors considered to be non-compliant FFIs or NFFEs.

The definition of withholdable payments includes US-sourced payments such as interest (including original issue discount), dividends and certain other fixed or determinable annual or periodic (“FDAP”) income. Although initially within scope, the definition of withholdable payments no longer includes gross proceeds from the sale or disposition of any property that could produce US source interest or dividends. ECI and certain non-financial payments are also specifically exempt from FATCA withholding.

Withholdable payments made to an FFI generally will not be subject to withholding if the FFI provides documentation that it has entered into a formalized agreement (an “FFI Agreement”) with the IRS or adheres with the terms of the intergovernmental agreement (“IGA”) entered into by its local jurisdiction. In either case, these FFIs are required to register with the IRs to obtain a Global Intermediary Identification Number (“GIIN”) and identify and report certain US account holders. Note there are some FFIs that satisfy requirements to be considered deemed-compliant with FATCA; these deemed-compliance FFIs generally have limited FATCA registration, due diligence, and reporting obligations. Withholdable payments to a NFFE will not be subject to withholding if the NFFE provides a tax certification about its status and, if necessary, it provides information about its substantial or controlling US owners.

FFIs that are in countries where IGAs are either subject to a Model 1 or Model 2 IGA. Under Model 1 IGAs, the FFIs in the IGA jurisdiction must report US accounts to the local jurisdiction that exchanges this information with the US government; under Model 2 IGAs, the FFIs in the IGA jurisdiction must report directly to the IRS, similar to FFIs in non- IGA jurisdictions that have signed FFI Agreements. In either case, the FFIs must document their account holders to determine their FATCA status, including whether the account holders are US or non-US, and to the extent are reportable US account holders, must report in accordance with the local country reporting guidelines.

Industry impact

Persons investing in US real estate funds and those who manage US real estate funds will need to understand when such investments give rise to FATCA withholdable payments; and regardless of whether invested in a US or non-US real estate fund, those investors – or “account holders” – must be prepared to document to those funds their FATCA status, typically on Forms W-8 or W-9. As such, investors in real estate funds and those who manage the funds must be able to analyze the application of the FATCA provisions to the real estate fund structure, including the classification of the entities in the fund structure, the need to collect or provide documentation establishing the FATCA status of the investor, and reporting that may be required by the fund with respect to certain US persons.

Within US real estate fund organizations, the scope of FATCA can impact investor relations, operations, legal, compliance, and tax. In addition to the economic issue, it is important that the fund or fund sponsor is not only properly educating its investors with respect to the FATCA rules, but also is perceived in the marketplace as being compliant with FATCA.





Qualified Foreign Pension Funds

What is a QFPF?

A Qualified Foreign Pension Fund (“QFPF”) is a foreign pension fund defined in the PATH Act as any trust, corporation, or other organization or arrangement that meets the following criteria:

- Created or organized under the law of a country other than the United States.
- Established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees, including self-employed persons (or persons designated by such employees) of one or more employers as a result of or in consideration for services rendered.
- Does not have a single participant or beneficiary with a right to more than five percent of its assets or income.
- Subject to government regulation and provides (or makes available) annual information reporting about its beneficiaries to the relevant tax authorities in its country in which it is established or operates.
- Under the laws of the country in which it is established or operates, either (i) contributions to it which would otherwise be subject to tax under such laws are deductible, excluded from gross income or taxed at a reduced rate; or (ii) taxation of its investment income is deferred, excluded, or such income is taxed at a reduced rate.

FIRPTA exemption provided to QFPFs

The PATH Act added an exemption under section 897 that provides that FIRPTA shall not apply to any USRPI held directly (or indirectly through one or more partnerships) by a QFPF. FIRPTA no longer applies to any distribution received by a QFPF from a REIT. This exemption from FIRPTA is also applied to USRPIs held, and REIT distributions received, by any entity all of the interests of which are held by a QFPF (a “qualified controlled entity,” or “QCE”). On June 6, 2019, Treasury and the IRS released proposed regulations under section 897 that provide clarifications and modifications relating to the QFPF qualification requirements (the “section 897 Proposed Regulations”). In addition, the section 897 Proposed Regulations provide certain anti-avoidance rules and rules relating to documentation required for exemption from withholding tax otherwise required by section 1445 or section 1446. The section 897 Proposed Regulations generally are proposed to be effective as of the date of publication of final regulations in the Federal Register (with some exceptions). The preamble provides, however, that a taxpayer may rely on the proposed regulations before they are finalized provided the taxpayer applies them consistently and accurately.

Prior to the issuance of the section 897 Proposed Regulations, there was significant debate as to whether the phrase “all of the interests of which are held by a QFPF” should be interpreted as “wholly owned by one QFPF” or as “wholly owned by multiple QFPFs.” The section 897 Proposed Regulations clarify that any entity all of the equity interests of which are held directly or indirectly by one or more QFPFs can be eligible for the FIRPTA exemption. In addition, an entity that is wholly owned indirectly through a chain of other QCEs or partnerships may be eligible for treatment as a QCE. The section 897 Proposed Regulations, however, do not permit even de minimis ownership of a

Introduction to the taxation of foreign investment in US real estate

QCE by persons or entities other than QCEs, QFPFs, or partnerships wholly owned by QCEs or QFPFs. Thus, de minimis ownership by managers or directors, even those required by corporate law in the relevant jurisdiction, would disqualify an entity from treatment as a QCE.

The section 897 Proposed Regulations also clarified that that government sponsored pension plans can qualify for the exemption. Furthermore, a pension fund that is organized by a professional association, or similar group is treated as established by any employer that funds, in whole or in part, the eligible fund. Finally, a self-employed individual is treated as both an employer and an employee, and therefore, the participation by self-employed individuals in the fund would not prevent the fund from qualifying for the exemption.

The section 897 Proposed Regulations set forth an “anti-avoidance” rule under which the FIRPTA exemption generally is not available to any person that was not a QFPF, part of a QFPF, or QCE at any time during the shorter of (1) the period beginning on December 18, 2015 and ending on the date of disposition or distribution; (2) the ten-year period ending on the date of the disposition or distribution; or (3) the period during which the entity (or its predecessor) was in existence. This provision generally does not apply to an entity or governmental unit that did not own USRPI as of the date it became a QFPF or QCE.

FIRPTA rules generally impose a 15% withholding rate on the sale of USRPI and a 21% withholding rate on capital gain dividends from a REIT to a foreign person. For the purposes of these FIRPTA withholding rules, QFPFs and the QFPF-owned entities referred to above are not treated as “foreign persons.”

While QFPFs are now exempt from FIRPTA, it is important to note that QFPFs are still subject to gross basis taxation on non-FIRPTA US source income and net-basis US federal income tax on income that is treated, apart from FIRPTA, as effectively connected with a US trade or business. QFPFs can be engaged in a US trade or business either directly or indirectly through a partnership that is so engaged in which the QFPF or subsidiary is a partner. Further, QFPFs are not exempt from FDAP income (i.e., ordinary dividends from a REIT) or withholding under the FDAP rules.

Application of Exemption

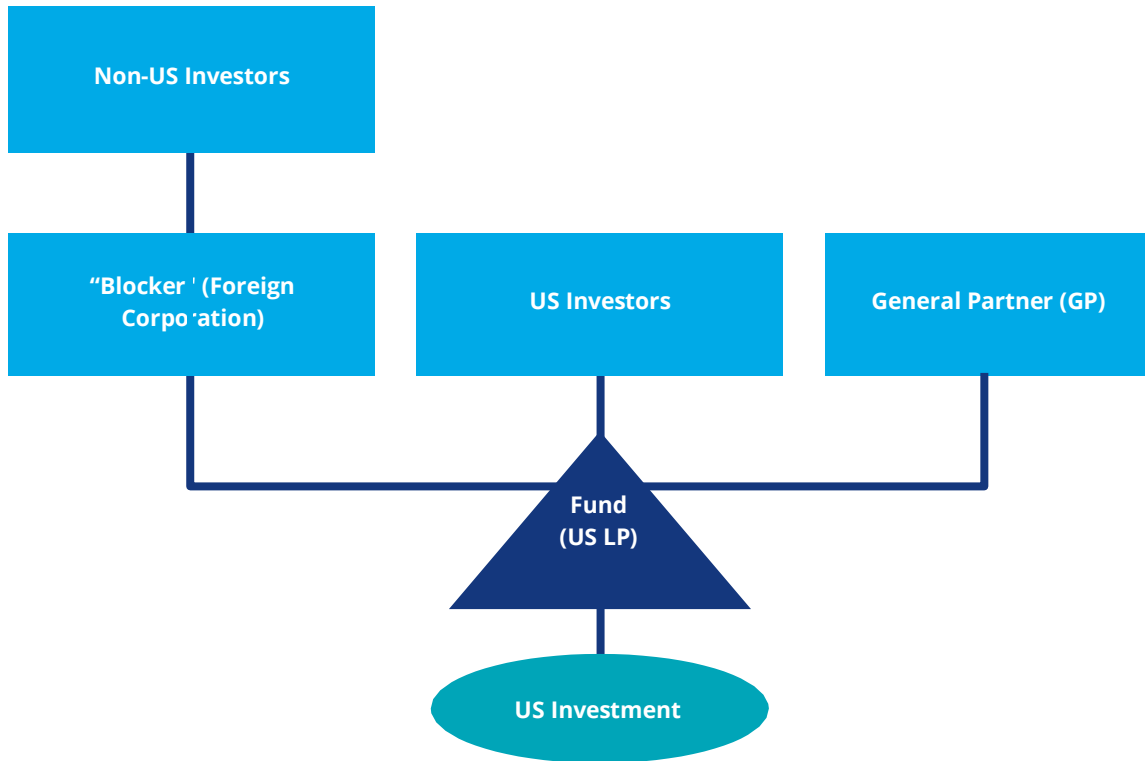
Existing non-US pension funds will need to review their governing documents to determine if they fit the definition of a QFPF. Any pension fund claiming an exemption provided by the PATH Act will need to provide documentation to the applicable US withholding agent that the exemption applies.

The section 897 Proposed Regulations further provide that the IRS intends to revise Form W-8EXP, Certificate of Foreign Government or Other Foreign Organization for United States Tax Withholding and Reporting, to permit QFPFs and QCEs to certify their status under section 897. Prior to the release of the revised W-8EXP, a QFPF or QCE may provide a non-foreign affidavit for purpose of both section 1445 and section 1446. Once the revised Form W-8EXP is released, the QFPF or QCE may provide either a revised Form W-8EXP or a non-foreign affidavit.

Industry impact

The new FIRPTA exemption extended to QFPFs may encourage greater investment in US real estate by QFPFs. By removing the FIRPTA tax obligations, QFPFs have been placed on more comparable footing with US pension funds. Many pension funds that believe they qualify as a QFPF will need to rethink their incentive structures in US real estate and be ready to provide documentation to US withholding agents and eventually the IRS supporting the qualification as a QFPF.

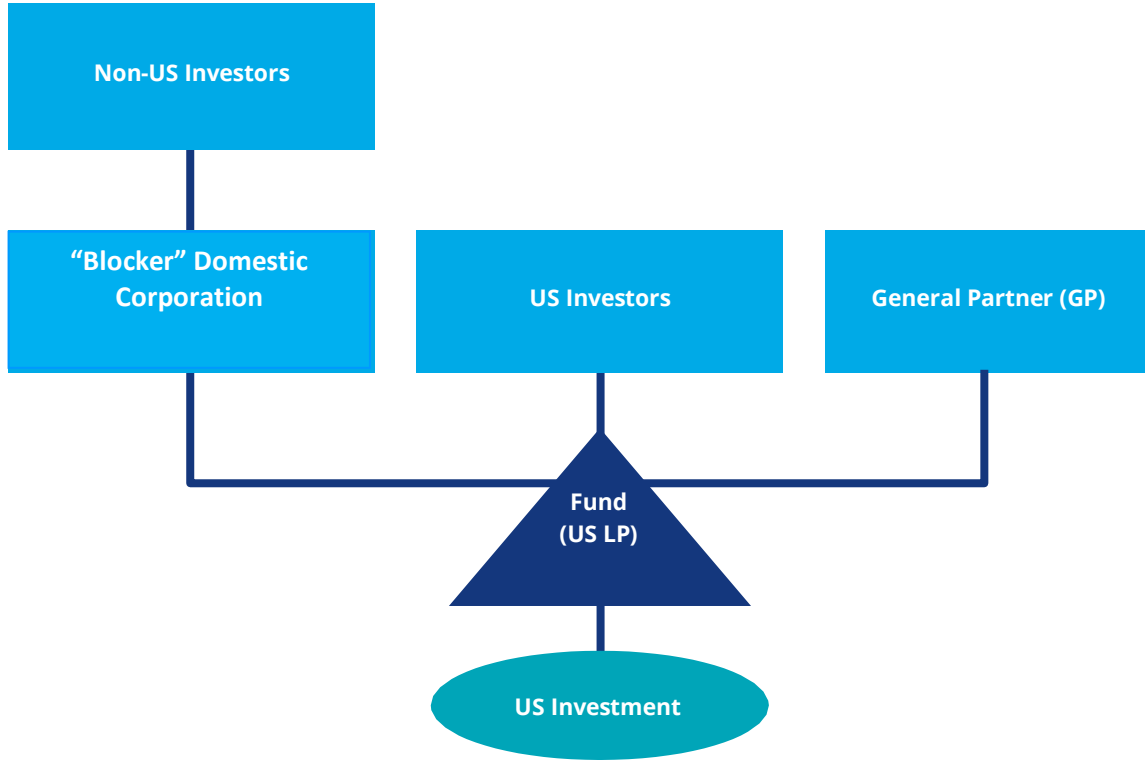
Appendix A: Foreign corporate structure



Key characteristics of structure

- Income flows from the US investments through the fund to investors.
- Foreign corporation serves as a blocker to the non-US investors preventing them from being engaged in a US trade or business, if the fund is so engaged.
- No withholding tax on distributions from blocker to non-US investors.
- Blocker may be subject to BPT, unless reduced by treaty.

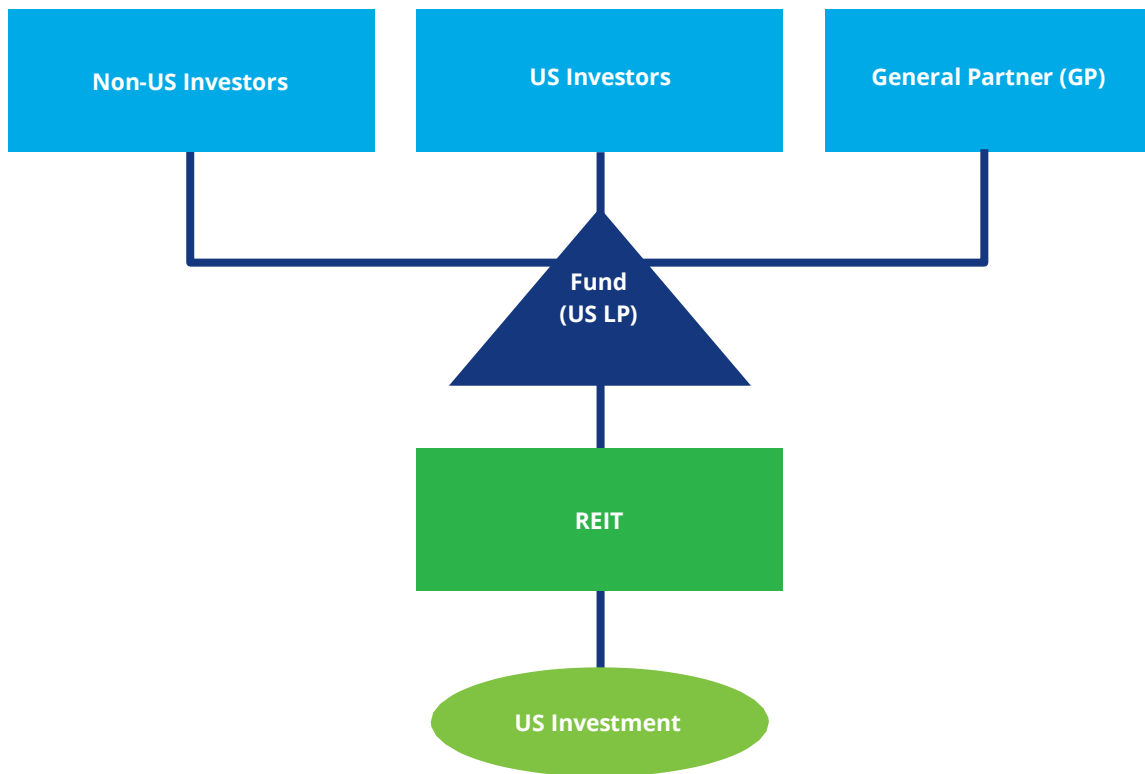
Appendix B: Leveraged US corporate structure



Key characteristics of structure

- Income flows from the US investments through the fund to investors.
- US corporation serves as a blocker to the non-US investors preventing them from being engaged in a US trade or business, if the fund is so engaged.
- US corporation is subject to US and state income tax on its net income.
- Blocker may be leveraged to reduce US taxable income.
- Withholding taxes on distributions to non-US investors will apply at various rates depending on treaty application and other particular facts.

Appendix C: REIT structure



Key characteristics of structure

- Income flows from the US investments through the REIT to the fund.
- The REIT serves as a blocker to the non-US investors preventing them from being engaged in a US trade or business, if the fund is so engaged.
- The REIT will not be taxed on its income so long as the REIT distributes its income to its shareholders.
- Withholding tax on distributions to non-US investors applies to operating dividends and distributions of capital gains.
- Non-US investors are subject to US tax on capital gains distributed by REIT.
- Qualified Foreign Pension Funds ("QFPF") can be exempt from the US tax on capital gains distributed by REIT.

About Deloitte's Global Funds Tax Advisory – Real Estate and Infrastructure Practice

Our Global Funds practice is a network of highly experienced, multi-disciplined tax professionals who specialize in the domestic and cross-border tax issues associated with attracting capital and structuring transactions with respect to investment in US and non-US real estate assets and related businesses, and infrastructure. The Global Funds group provides clients with a global integrated service offering, including advising non-US financial investors and a wide array of private fund types, such as open- and closed-end funds, publicly traded and non-traded REITs, and publicly traded partnerships. The group communicates regularly to discuss evolving trends and technology in order to be able to advise responsively on potential ownership structures, financings, and other matters. Professionals in the group possess deep knowledge and experience in resolving complexities often found in global funds including a complex set of rules including UBTI, FIRPTA, REIT qualification, real property transfer taxes and stamp duty, property taxes, tax treaty qualification, and related tax issues associated with non-US investor groups.

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About Deloitte Tax LLP's Inbound Services Tax Practice

Our Inbound Services Group is comprised of highly specialized tax professionals in Deloitte offices in the US who specialize in assisting non-US companies, that invest in the US, navigate the complicated US tax system and a wide array of federal, state, and local taxing jurisdictions. Whether clients are establishing a footprint in the US for the first time or have had a US presence for many years, our US Inbound Tax professionals help clients manage tax risks and structure tax efficient operations, all in the context of navigating the changing tax and regulatory environment. As capital starts flowing across borders, changes in one jurisdiction ripple into others. A global issue calls for a global plan. Whether it is a supply chain realignment, intellectual property migration planning or transfer pricing documentation, our group of International Inbound Tax specialists can assist. Within the Inbound Services Group, hundreds of International Inbound Tax specialists from around the world in member firms bring their "home country" and "industry" knowledge. These International Inbound Tax specialists provide clients with services relating to the overall structure of the investment or acquisition, the financing structure for the transaction if an acquisition of a US company is undertaken, transfer pricing, as well as planning with respect to intangibles, repatriation of earnings from the acquired US company to the foreign parent, and the disposition of the US company at the end of the investment cycle.

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