Inbound and outbound tax issues and update

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Terms

► CCE – Controlled Commercial Entity
► CE – Controlled Entity
► FIRPTA – Foreign Investment in Real Property Tax Act of 1980
► QRS – Qualified REIT Subsidiary
► TRS – Taxable REIT Subsidiary
► USRPHC – United States Real Property Holding Corporation
► USRPI – US Real Property Interest
Agenda

Inbound

► Considerations in structuring co-investment with foreign investors
► Proposed legislation to amend FIRPTA

Outbound

► Refresher on key considerations in structure of outbound investments by US REITs
► Structuring idea for acquisitions of foreign “per se” corporations
  ► Using a sub REIT to acquire a per se corporation
► Special EIK (eligible independent contractor) rule for foreign TRSs
US REIT forming JV with foreign investors
Background

Structuring will be Impact by Type of Foreign Investor

► All foreign investors generally can be expected to use a corporate blocker to avoid a US filing obligation and other effects of investing in an unblocked US trade or business

► Using a REIT as the blocker may provide certain advantages over regular US C corporation (e.g., avoidance of corporate level tax on ordinary income or on sale of blocker stock) but distributions of gains attributable to sales of US real property would subject the foreign investor to FIRPTA (and possibly branch profits taxes (BPTs))

► Public REIT may be required to co-invest in a Sub-REIT, introducing some additional risk for the public REIT
Co-Investing with Non-Government Foreign Investor

**Structural Considerations**

- Implication of foreign investor(s) owning <50%
  - Advantages of Sub-REIT qualifying as a domestically controlled REIT
  - Reduces investable cash or the REIT’s ability to cash out of a contributed asset initially or over time
- Impact of REIT’s ownership on Sub-REIT’s status as a DC (domestically-controlled) REIT
- Impact on exit
  - Foreign investor(s) likely require no or limited asset sales by Sub-REIT to minimize FIRPTA reporting and tax
  - Likely exit transactions are sale of entire portfolio through sale of REIT shares or an IPO of Sub-REIT allowing foreign investor(s) to sell into the public market

**Structural Considerations**

- Greater flexibility for REIT to:
  - Increase size of the foreign investor(s) ownership interest or allow for a larger initial cash out by the REIT
  - Shareholder mix of the REIT is non-consequential to tax position of foreign investor(s)
  - No exit avoids FIRPTA (sale of assets or stock of Blocker). In case of a foreign-controlled (FC) REIT, asset sales would also subject any foreign corporation that is a shareholder of FC REIT to BPT.
Co-Investing with Foreign Government

**Structural Considerations**

- No single Foreign Government will be able to own more than 50% of the JV, but all Foreign Governments in aggregate may own more than 50%.
  - DC REIT status not a necessity for Foreign Governments
  - Test is not simply numeric, but considers whether any single Foreign Government has “effective practical control” of the REIT.
- Foreign Government likely will require no or limited asset sales by Sub-REIT to minimize FIRPTA reporting and tax.
- Likely exits for Sub-REIT are sale of entire portfolio through sale of REIT shares, merger with public REIT or IPO allowing Foreign Government(s) to sell over time into the market.

**Alternative Structure**

- Requires more than a single Foreign Government to avoid any single Foreign Government holding more than 50% of the blocker.
- If blocker is a C corporation, allows for sales of single assets rather than portfolio transactions.
US REIT forming JV with foreign investors – more on section 892 investors
Background

Structuring objectives

► Ability to utilize the exemption under section 892 for investments
► Avoidance of tax return compliance and reporting obligations in the US for the foreign sovereign

Issues

► Avoiding the commercial activity taint
► Avoiding US real property holding company (USRPHC) status of controlled entities and other limitations under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA)
► Extent and ability of the foreign sovereign to rely on the proposed regulations under section 892 issued in November 2011
Scope of the section 892 exemption
Classes of income

- Foreign government investing in the US real property may qualify for exemption from US federal tax under section 892 on:
  - Dividends or interest received from a non-controlled US REIT or US C corporation
  - Gain on the sale of a non-controlled US REIT or US C corporation

- Exemption under section 892 does not include:
  - Amounts derived from the conduct of a “commercial activity” or amounts received from or by a “controlled commercial entity”
  - Examples include:
    - Rents from real property
    - Gains on the direct or indirect sale of a USRPI held directly by the foreign government or through a partnership
    - Dividends or interest paid by a directly or indirectly controlled entity
    - Gain from the disposition of a controlled USRPHC
    - REIT dividends attributable to sales of USRPIs whether or not the REIT is controlled
    - Gain from the disposition of a US partnership interest, generally regardless of the property held by the partnership
Foreign government means either an (A) integral part or (B) controlled entity of a foreign sovereign

- The foreign government will provide notice of its status on Form W8-EXP

If an integral part engages in commercial activity, it will lose the section 892 exemption only for the income from that activity

A controlled entity loses the benefits of section 892 entirely (for all investments) if it engages in any amount of commercial activity anywhere in the world

A controlled entity, which based on its assets would be considered a USRPHC, is deemed to be engaged in a commercial activity. Consequently, it is treated as a controlled commercial entity and loses the benefits of section 892 for all income derived from the US for all investments.
Scope of section 892 exemption
Limitations for commercial activities and Controlled Commercial Entities (CCEs)

**Topic**
- Section 892 exemption
  - CCEs

**Comments**
- As noted above, amounts received from or by a CCE are not eligible for exemption under section 892.
- An entity (which can be a partnership or corporation) is a CCE if:
  - The entity is engaged in a commercial activity (note a USRPHC or a foreign corporation which, based on its assets, would be considered a USRPHC, is deemed to be engaged in a commercial activity); and
  - The foreign government (directly or indirectly) holds (A) at least 50% of the vote or value of the entity or (B) any other interest which provides effective control.
- Terms of any debt instrument or any other agreement between the foreign government and the entity should be reviewed for any impact on vote, value or effective control tests.
- Commercial activities of a partnership are not necessarily attributed to limited partners (Proposed Regulations).
The Internal Revenue Service (Service) issued proposed regulations under section 892 in November 2011 (Proposed Regulations).

In contrast to final or temporary regulations, proposed regulations technically are not binding on taxpayers or the Service until issued in final form.

As a practical matter, it is difficult for the Service to take positions contrary to its own proposed regulations.

The preamble to the Proposed Regulations states, however, that taxpayers are entitled to rely on the Proposed Regulations prior to the date they are finalized.

The Proposed Regulations clarify the application of section 892 in numerous areas and generally are favorable to taxpayers.

However, a number of issues of interpretation remain unresolved.
Considerations

► Foreign sovereign investors generally tend to rely on the Proposed Regulations for interpreting the application of the rules to existing investment structures.

► However, some foreign sovereign investors are reluctant to rely on the Proposed Regulations for entering into new structures if critical aspects of the new structures depend on reliance on certain aspects of the Proposed Regulations, generally for two reasons:
  ► The Proposed Regulations raise interpretation issues of their own.
  ► It is not clear that the Proposed Regulations will be finalized in their current form; if a critical aspect of a new structure depends on a specific formation in the Proposed Regulations, and the regulations are finalized in a different form, the foreign sovereign may be forced to restructure its investment.

► It is not clear when the Proposed Regulations will be finalized or whether they will be finalized in the form proposed.
Overview
► Foreign Sovereign (FS) intends to invest in US real estate through CE and obtain section 892 benefits on income and gain from the investment
► CE acquires up to 49% of the interests in a US limited partnership (LP)
► The interest in LP is the sole asset of CE and CE does not engage in any activities other than owning the interest in LP
► The remaining 51% of the interests in LP are owned by US investors
► LP forms a US REIT ("Sub-REIT") and funds REIT with equity
► Sub-REIT acquires and operates a commercial real estate investment in the US

Tax Treatment
► Sub-REIT is domestically controlled, because less than 50% of the interests in the Sub-REIT are held by foreign persons (indirectly through LP)
► Therefore, interests in Sub-REIT are not USRPIs with respect to CE
► Because the interests in Sub-REIT are not USRPIs, and because CE is not engaged in any activity other than owning the interest in LP, CE is not a USRPHC and is not otherwise engaged in commercial activities
► Therefore, CE’s allocable share of dividends LP receives from Sub-REIT should be exempt from tax under section 892, and CE’s allocable share of gain LP derives from the sale of Sub-REIT shares is exempt under section 892
► CE would be subject to tax on its allocable share of any distributions by Sub-REIT to LP of any gain Sub-REIT derives from the sale of the US real estate at a maximum rate of 35% and such distributions may be subject to BPT at a rate of 30% or a lower rate established by an applicable treaty
► Although CE would be subject to tax on such gain, the Proposed Regulations clarify that deriving that gain will not cause CE to be engaged in a commercial activity
FIRPTA Considerations

Overview
► The structure is the same as in the previous slide, except a foreign investor acquires a 2% interest in LP

Tax Treatment
► Sub-REIT is no longer domestically controlled, because more than 51% of the interests in the Sub-REIT are held by foreign persons (indirectly through LP)
► Therefore, interests in Sub-REIT are USRPIs with respect to CE and the other foreign investor
► Because the interests in Sub-REIT are USRPIs, CE will be a USRPHC if the interest in LP is its only asset
► If CE is a USRPHC, it qualifies as a CCE and loses the section 892 exemption entirely
► CE’s allocable share of ordinary dividends LP derives from Sub-REIT will be subject to tax at a rate of 30% (unless reduced by applicable treaty)
► CE’s allocable share of gain LP derives from the sale of Sub-REIT shares will be taxed at 35%
► CE’s allocable share of capital gain dividends LP derives from distributions by Sub-REIT attributable to the sale of the US real estate by Sub-REIT will be taxable at a maximum rate of 35%, plus BPT at a rate of 30%, or a lower treaty rate, unless an exception, such as the branch liquidation exception, applies
FIRPTA Considerations

Overview
► The structure is the same as in the previous slide, except CE holds other investments in foreign corporations or limited partnerships that own foreign real property or assets used in a trade or business

Tax Treatment
► Sub-REIT is not domestically controlled, because more than 50% of the interests in Sub-REIT are held (indirectly through LP) by foreign persons.
► Therefore, the interests in Sub-REIT qualify as USRPIs
► CE, however, will not qualify as a USRPHC if the fair market value (FMV) of its proportionate share of the Sub-REIT stock is less than 50% of the FMV of its assets used in a trade or business and its foreign real property
► If CE owns more than 50% of a foreign corporation that conducts a trade or business, in testing for USRPHC status, CE takes into account its proportionate share of the assets of the corporation
► For purposes of section 892, the existing temporary regulations clarify that no attribution of commercial activity applies from corporations to shareholders
► The Proposed Regulations provide that no attribution of commercial activity from a partnership to a partner applies, provided the interest in the partnership qualifies as a limited partnership interest, as defined in the Proposed Regulations
► Under the Proposed Regulations, CE should be able to take into account any foreign real property held through foreign partnerships (regardless of the ownership percentage) in determining whether CE qualifies as a USRPHC
FIRPTA legislative proposals
Real Estate Investment and Jobs Act

- Increase ownership threshold from 5% to 10% of a class of publicly traded REIT shares

- Present law exempts from FIRPTA gain from a sale of shares of a USRPHC that are regularly traded on an established securities market by a holder who owns (and for the past 5 years has owned) 5% or less of the class; and, a distribution by a REIT of gains from the sale of a USRPI is treated as an ordinary distribution, subject to FDAP withholding, if the distribution is on shares of a class regularly traded to a holder who owns (and over the past 12 months has owned) 5% or less of the shares of the traded class. House and Senate bills would increase the ownership threshold under these FIRPTA exemptions from 5% to 10%.

- No ownership limit in the case of a “qualified” shareholder that is a “qualified collective investment vehicle”

- The ownership threshold, for exempting gains from the sale of traded REIT stock and treating capital gain distributions as ordinary distributions is eliminated altogether in the case of a “qualified” shareholder that is a “qualified collective investment vehicle,” except to the extent the investment vehicle has shareholders, other than “qualified” shareholders, that own more than 10% (directly or indirectly) of the REIT. Generally, qualified shareholders are specified entities eligible for tax treaty benefits, whose principal class of shares is listed or regularly traded and maintains records identifying 10% or greater shareholders (e.g., Dutch REIT and Australian LPT)
Real Estate Investment and Jobs Act (cont.)

► Exempt gain of a foreign pension from FIRPTA

► Applies to a “qualified foreign pension fund” and an entity all of whose interests were held by qualified foreign pension funds, which are exempt from tax in their home country and substantially all of whose activities are administering or providing pension benefits. House proposal requires no single participant or beneficiary has right to more than 5% of the pension’s assets and meet certain other conditions not found in the Administration’s proposal. No Senate proposal.

► Presumptions for domestically controlled REIT status

► First, bills would allow REIT to assume a holder of 5% or less of its traded stock is a domestic person unless it has knowledge to the contrary
► Second, a publicly traded REIT that itself is domestically controlled would be treated as a US person in whole by a Sub-REIT, while a foreign controlled REIT would be treated in whole as a non-US person (even if it has some domestic shareholders)
► Third, a non-publicly traded REIT would be treated as a US person only to the extent that its stock is held by US persons
► Senate bill would require a domestically controlled REIT to disclose that status publicly in its annual report or otherwise
Real Estate Investment and Jobs Act (cont.)

- Enforcement and revenue offsets
  - FIRPTA withholding would increase from 10% to 15% by purchaser of a USRPI from a non-US person.
  - Require public disclosure of an entity's USRPHC status in tax returns, Form 1099 and on the entity's website, annual reports and stock certificates. Provides for penalties of $500,000 to $5 million ($10 million for an intentional failure to report), varying based on the FMV of the corporation's assets.
  - Brokers would now be required to withhold a portion of the sale proceeds on the sale of interests in corporations when subject to FIRPTA.
  - Any corporation that had been a REIT or RIC in the prior 5-year period would not be able to avail itself of the cleansing exception.
Outbound refresher
Outbound considerations for REITs

Overview

► No limitation on ownership of non-US property
► Rules have been liberalized in recent years by statute and ruling
  ► Section 856(c)(5)(K) – foreign currency treated as “cash” to extent held for use in activities producing qualifying income or acquiring or holding qualifying assets
► Currency transactions (section 987 and section 988 FX gains)
  ► Real estate FX gain excluded from 75% gross income test (section 856(n))
    ► FX gains related to 75% qualifying income and REIT’s borrowings secured by real property
    ► Section 987 gains related to a qualified business unit (QBU) that meets 75% income and 75% asset tests
  ► Passive FX gains excluded from 95% income test (section 856(n))
    ► Real estate FX gains
    ► FX gains related to 95% qualifying income or REIT borrowings
    ► IRS rules that section 986(c) gain is excluded as substantially similar to Passive FX
Outbound considerations for REITs
Overview (cont.)

► Section 856(c)(5)(G) – hedges to manage currency fluctuations with respect to items of qualifying income for 75% or 95% test or on any property that generates such income is excluded from income tests

► PLRs addressing foreign TRSs have treated the following as qualifying income for purposes of the 95% income test relying on section 856(c)(5)(J):
  ► Sub-part F income from a TRS treated as a controlled foreign corporation (CFC)
  ► Section 956 Inclusions (CFC pledgor or guarantor of REIT debt)
  ► PFIC Inclusions
Alternative status for foreign subsidiaries

**TRS**
- Subject to the 75%/25% asset tests
- Provides blocker for non-REIT qualified income and assets
- May allow for deferral of distribution to US/REIT shareholders
- May introduce section 951, section 956 and section 986 inclusions that have been addressed by rulings

**QRS**
- Assets and income reported as directly owned by the REIT
  - Operations must be REIT compliant (e.g., are customary services in local jurisdiction consistent with IRS views)
  - Foreign cash treated favorably
  - Section 987 and section 988 gains; disregarded for REIT income testing, but such gains may result in phantom income that must be distributed
Acquisition of stock in Foreign Corporation

Overview
► OP forms Sub-REIT to acquire the shares of Foreign Corporation, a per se corporation that is unable to change its classification status
► If OP directly acquires the shares of Foreign Corporation, a TRS election must be made by REIT and Foreign Corporation
► In absence of a TRS election, Foreign Corporation becomes a QRS of Sub-REIT

Implications
► Foreign Corporation liquidates with and into Sub-REIT
► Section 367(b) implications
  ► Treatment of potential section 367(b) dividend under Sub-REIT’s gross income test
  ► Sub-REIT treated as owner of the income and assets of Foreign Corporation for purposes of REIT gross income and asset tests
Section 856(d)(8)(B) provides that a TRS is not considered to be operating or managing a qualified health care facility or qualified lodging facility solely because it employs individuals working at such facility located outside the US, but only if the EIK is responsible for the daily supervision and direction of such individuals.