



AFIRE News

July/August 2007

The Official Voice of the Foreign Real Estate Industry

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Taxation of Liquidating REIT Distributions to be Challenged by the IRS

Bruce Hood, Wiggin and Dana LLP

The US Internal Revenue Service (the "IRS") issued a notice on June 13, 2007, indicating that it intended to challenge the position taken by some foreign investors in real estate investment trusts ("REITs") that a liquidating sale and distribution by a REIT is not subject to taxation under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"). In Notice 2007-55, I.R.B. 2007-27, the IRS stated that it not only would oppose under current statutory and regulatory provisions an assertion by any foreign taxpayer that the provisions of FIRPTA do not apply to distributions in complete liquidation of REITs or other qualified investment entities, but that it would also issue regulations to that effect applicable for distributions taking place after June 13, 2007.

Under FIRPTA, stock in a US corporation whose assets consist primarily of interests in US real property is treated as an interest in US real estate that is subject to taxation if disposed on by a foreign person in a transaction in which gain is recognized. Excepted from this treatment are portfolio holdings of publicly-traded stock and interests in "domestically controlled qualified investment entities." Qualified investment entities for these purposes

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AFIRE 2007 Annual Membership Meeting: The End of the Beginning?

SEPTEMBER 16-18, 2007

Ritz-Carlton • Washington, DC

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Meeting Registration on back cover

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include REITs, and domestically controlled means that the percentage of stock of the investment entity held directly and indirectly by foreign persons is less than 50% in value.

While sales of stock of domestically controlled investment entities by foreign investors are thus free from FIRPTA taxation, sales by the entities of their real estate holdings followed by a distribution of the proceeds as a capital gain dividend are subject to taxation under I.R.C. section 897(h)(1). Of course, if a REIT's shares are publicly traded, the shareholders can obtain liquidity by selling shares in the open market and avoiding taxation on gains. However, in order for shareholders of private REITs to take advantage of the absence of taxation on the sales of stock, they must arrange to sell their stock in advance of a sale by the REIT of its real property, and it will be necessary in most cases for the sponsors of the investment to establish one REIT per property. Even with this type of structure, it may not be possible to convince a purchaser of the real estate to acquire the REIT shares instead of the property itself.

Under the rules governing the taxation of REITs generally, REITs are not subject to taxation as long as they meet certain requirements regarding the types of assets that they hold and the types of income that they earn and distribute the bulk of their income to their shareholders on a current basis. The shareholders are themselves subject to taxation on the amounts distributed to them to the extent that the amounts represent earnings of the REIT. The freedom from taxation at the REIT level is accomplished through the operation of the dividends-paid deduction under I.R.C. section 561. The taxation of the shareholders occurs via the application of I.R.C. section 301.

In 1990, the IRS published a private letter ruling

(PLR 9016021) addressing the tax consequences of the sale by a REIT of all of its properties followed by a liquidating distribution to it two foreign pension fund common shareholders and its 100-plus preferred shareholders. Since the foreign pension funds owned substantially all of the value of the REIT shares, it was not domestically controlled under FIRPTA. The IRS ruled that the distribution of the sales proceeds by the REIT qualified for the dividends-paid deduction. It also held that the shareholders were entitled to treat the distributions as payment in exchange for their REIT shares under I.R.C. section 331 rather than as dividends under section 301. The authority for this treatment was cited as Treas. Regs. section 1.856-1(e)(3), which provides that the tax rules applicable to corporations (including the taxation of liquidating distributions under section 331) apply to REITs unless inconsistent with the REIT rules themselves. It is not clear whether the conclusion reached in the private letter ruling resulted in a lower overall tax than would have been the case if the taxpayer had been required to take the distributions into account as capital gain dividends under I.R.C. sections 301 and 897(h), but it must be assumed that taxpayer would not have sought the ruling if it did not.

The underlying rationale of the private letter ruling provided the fodder for some tax planning opportunities that went somewhat beyond the situation that it addressed. For example, if a domestically-controlled REIT sold its properties pursuant to a plan of liquidation and distributed the proceeds to its shareholders, the foreign investors would not be subject to taxation because the distribution would be treated as having been made in exchange for their shares. Moreover, even if a REIT were not domestically controlled, it is arguable that

the “purging rule” of I.R.C. section 897(c)(1)(B), which provides that the disposition of an interest in a corporation that has transferred all of its US real property interests in transactions in which the gain if any was fully recognized by the corporation is not subject to FIRPTA taxation, would permit foreign shareholders to avoid taxation in a liquidating sale of the REIT’s properties. Finally, a foreign government could argue that the disposition of a non-controlling interest in a REIT constitutes income that is exempt from taxation under Treas. Regs. section 1.892-3T(b) Example 1.

Apparently in response to concerns about the implications of the holding in the 1990 private letter ruling, the IRS issued another ruling in the fall of 2004 indicating that it was withdrawing the portion of the ruling and the accompanying discussion regarding the tax consequences of REIT liquidating distributions. The subsequent ruling was effective prospectively, and as in the case of all private letter rulings was binding only upon the taxpayer to which it was issued. The foreign investment community took note, however, and awaited further IRS action on the subject.

That action came in the form of Notice 2007-55. The notice indicated that it was principally aimed at liquidating distributions by privately-held, domestically-controlled REITs to non-controlling, foreign governmental shareholders. As mentioned above, if a liquidating distribution to such a shareholder were viewed as proceeds derived from

the disposition of its shares in the REIT, the foreign government would not be subject to taxation on any gain. The IRS takes the position in the notice that the provisions of I.R.C. section 897(h) require that any distribution by a REIT that is attributable to the sale or exchange by the REIT of an interest in US real estate will be treated by the foreign government as gain from the sale of a US real property interest that is subject to taxation under FIRPTA and not entitled to coverage under section 892 and the regulations thereunder. The notice also goes on to provide that the same rules would apply to any foreign taxpayer receiving such a distribution.

The IRS has the authority to amend the regulations under the REIT taxation regime to provide that liquidating distributions to foreign shareholders will be subject to taxation under FIRPTA. However, it is less clear that it can ignore the regulations as they currently read to tax distributions that have already occurred. The notice does not elaborate in any significant detail upon the legal basis for ignoring the provisions of Treas. Regs. section 1.856-1(e)(3) other than to note that they conflict with I.R.C. section 897(h). Whether this will be sufficient to overturn positions taken by foreign investors with respect to liquidating distributions that have already taken place remains to be seen, but there can be no doubt that many AFIRE members and their advisors will have a keen interest in the ultimate outcome. ★



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