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In this report, Leitner explains the history of collective investment vehicle investments in real estate investment trusts and the issues surrounding those structures to understand the significance of section 897(k). He offers suggestions for how future guidance should interpret this provision.

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I. Introduction

The Protecting Americans From Tax Hikes (PATH) Act of 2015 introduced two major new exceptions to the 1980 Foreign Investment in Real Property Tax Act for special categories of foreign investors in U.S. real property.[1] The qualified foreign pension fund (QFP) exception in new section 897(l) has won the most attention from tax professionals. And there are good reasons for that: The QFP exception is extremely significant because of its nature, the large number of affected investors, and the large amounts of capital those investors represent. The QFP rules have attracted substantial scrutiny and comment, and the IRS has indicated that it intends to issue guidance on the QFP exception soon.

The second exception, found in new section 897(k), applies to specific qualified collective investment vehicles (CIVs) that invest in domestic real estate investment trusts that qualify under section 856. Unlike the QFP rules, the CIV exception has attracted so little attention in the tax community that several practitioners the author spoke to were unaware of its existence. To many who have perused it, section 897(k) is a mysterious provision with an unclear purpose. This report sheds light on the history of CIV investments in REITs and related issues in order to provide an appropriate context for understanding the significance of section 897(k), and it offers suggestions for how Treasury and the IRS should interpret this provision in future guidance.

II. CIVs

CIVs are widely held investment fund vehicles that may be listed on a stock exchange and that generally hold passive investment assets to generate a current yield or capital appreciation for their unit holders. Mutual funds are one well-known example of a type of CIV, but CIVs can be formed as corporations, trusts (including REITs), limited partnerships, or other special forms of entities that exist under the law of various foreign jurisdictions. CIVs are generally not subject to entity-level taxation in their country of residence, although the mechanism for achieving that result varies. Some CIVs are treated as "true" flow-through entities, with unit holders who are taxed currently on their proportional share of the CIV's income (in a manner similar to a partnership), while others are entitled to

[1]FIRPTA, which added section 897 to the code, generally imposes tax on all sales of real property interests by foreign taxpayers.

a deduction for dividends paid (in a manner similar to a mutual fund) or are simply exempt from income taxation in their country of residence. Many, though not all, jurisdictions impose a withholding tax on distributions by a resident CIV to nonresident unit holders.

While CIVs historically invested in stocks and securities, they have become popular vehicles for real estate investments marketed to retail investors. Foreign CIVs investing in the U.S. real estate market seek to structure their investments in a manner that preserves their general tax treatment as entities that are able to flow income to their unit holders without any entity-level taxation. Thus, CIVs have frequently turned to the use of qualifying REITs as investment vehicles for their U.S. investments. A U.S. REIT structure has many advantages for a foreign CIV, but as discussed below, there have also been significant drawbacks.

III. Treatment of U.S. REITs

The corporate tax imposed by section 11 on the taxable income of every corporation does not apply to REITs.[2] Instead, under section 857, a REIT is taxable (in the manner computed under section 11) only on its "real estate investment trust taxable income."[3] REIT taxable income is computed by starting with taxable income computed under the usual rules applicable to ordinary corporations, then applying specific adjustments to arrive at the REIT taxable income figure. The key difference between ordinary taxable income and REIT taxable income is that, under section 857(b)(3)(B), in computing its REIT taxable income, a REIT generally may claim a deduction under section 561 for dividends paid to its shareholders, thereby eliminating its tax liability in most cases.[4] Moreover, the payment of those deductible dividends is a privilege accorded to REITs and an obligation that must be satisfied as a condition to maintaining REIT qualification. Under section 857(a)(1) the deduction for dividends paid must be at least equal to 90 percent of the REIT taxable income (determined without regard to the dividends paid deduction).[5] In practice, the dividends paid deduction available to REITs means that REITs are effectively exempt from corporate-level taxation.

The tradeoff for avoiding corporate-level tax on the REIT's income is that REIT dividends are generally ineligible for the reduced 20 percent tax rate applicable to "qualified dividend income" earned by a noncorporate taxpayer under section 1(h)(11) and are treated as ordinary income in the hands of the REIT's noncorporate shareholders.[6]

A. REIT Capital Gains

When a REIT has a net capital gain for a tax year,[7] it may designate a portion of the dividends it pays to its shareholders as "capital gain dividends." Capital gain dividends are treated by shareholders of the REIT as a capital gain from the sale of an asset held for more than one year (that is, as long-term capital gain), and noncorporate shareholders are eligible for the reduced long-term capital gains rates on those dividends.[8]

The designation of capital gain dividends is made by the REIT in a written notice mailed to its shareholders within the first 30 days after the close of its tax year.[9] There is no requirement that the designation be prorated among all of the dividends the REIT paid during the tax year. Rather, the REIT may designate a dividend that was paid on a particular date as being entirely a capital gain dividend, while not designating any portion of another dividend paid on a different date as a capital gain dividend. The only limitation on those designations is that the total amount of designated capital gain dividends for the tax year cannot exceed the net capital gain for the year.[10]

Special rules also apply at the REIT level when a REIT has a net capital gain. The obligation imposed by section 857(a)(1) that a REIT's dividends paid deduction be at least equal to 90 percent of the REIT taxable income applies only to the REIT's ordinary income (and only ordinary dividends count toward the 90 percent threshold). Thus, there is no requirement that the REIT pay any minimum amount of

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[2]Section 11(c).

[3]Section 857(b)(1).

[4]Other differences are, for purposes of determining REIT taxable income: (1) no deduction for dividends received under section 241, etc., is allowed; (2) the special computations required for a change in tax year under section 443(b) don't apply; and (3) net income from foreclosure property and from prohibited transactions (both of which are taxable at the REIT level) is excluded.

[5]The REIT is also required to distribute at least 90 percent of its income from foreclosure property and may reduce its required distributions by the amount of excess noncash income as defined in section 857(e).

[6]Sections 1(h)(11)(D)(iii) and 857(c)(2). Qualified dividend income treatment is available, however, to the extent that the REIT earned those dividends or to the extent that the REIT was subject to corporate-level tax (either resulting from underdistributing income in prior years or under the section 337(d) regulations discussed below).

[7]The term "net capital gain" is defined as the excess of the net long-term capital gain for the tax year over the net short-term capital loss, if any. Section 1222(9).

[8]Section 857(b)(3)(B).

[9]Section 857(b)(3)(C).

[10]*Id.* If the total amount designated exceeds the net capital gain, the required reductions are allocated proportionately among the dividends so designated.

capital gain dividends. If a REIT elects not to designate capital gain dividends in an amount sufficient for the resulting dividends paid deductions to fully shelter its net capital gain, the REIT is subject to corporate tax on the retained net capital gain.[11] If the REIT later pays dividends out of the resulting earnings and profits in a later year (for example, by paying dividends that exceed the REIT's taxable income in the later year), the dividends are taxable in the hands of the shareholders as ordinary dividends.[12] Thus, forgoing capital gain dividends results in double taxation of the gain. However, the REIT can avoid double taxation of the retained capital gain by designating the undistributed capital gain as a capital gain of its shareholders that the shareholders are required to include on their own income tax returns for the year the capital gain was earned by the REIT.[13] That designation is made in a written notice that must be mailed to the REIT's shareholders within the first 60 days after the close of the tax year. IRS Form 2439 is used for this designation.

Amounts that are so designated are treated largely in the same manner as if the REIT would have distributed those amounts, designating them as a capital gain dividend, and the shareholders then recontributed those amounts back to the REIT. Thus, the shareholders are entitled to a basis increase in their REIT shares equal to the amount of the deemed capital gain distribution, and the REIT's earnings and profits are reduced by the same amount.

B. The Section 337(d) Built-In Gain Regime

Following the repeal of *General Utilities* in 1988, Congress was concerned that a corporation could avoid paying corporate tax on gains that accrued on its real properties by converting into a REIT and then benefiting from the dividends paid deduction to eliminate the corporate tax when the gains are realized. Section 337(d) was amended to provide that:

> The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the amendments made by subtitle D of title VI of the Tax Reform Act of 1986, including — (1) regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations and part III of this subchapter) or through the use of a regulated investment company, real estate investment trust, or tax-exempt entity.

After many years of delay and several sets of temporary rules, in 2003 the IRS issued a final set of regulations addressing the treatment of a C corporation that converts into a REIT. Under the final rules,[14] if property that was formerly owned by a C corporation (converted property) becomes the property of a REIT in a "conversion transaction" either resulting from the C corporation's making a REIT election or resulting from an acquisition in which no gain or loss is recognized (for example, a reorganization), "section 1374 treatment" applies unless the C corporation elects deemed sale treatment for the conversion transaction. The section 1374 regime — which applies to a subchapter S corporation that has acquired property from a C corporation, either resulting from a subchapter S election by the C corporation or a nonrecognition transaction — imposes corporate-level tax on the "net recognized built-in gain" attributable to converted property during the "recognition period" following the conversion transaction. The recognition period under section 1374 was historically 10 years, but was temporarily shortened by Congress to seven years in 2009 and then to five years in 2010; it was then permanently shortened in the PATH Act to five years. However, Treasury then decided five years is too short of a recognition period for REIT conversions (even though Congress was presumably fully aware that by shortening the section 1374 recognition period they were also shortening the REIT built-in gain recognition period), and the section 337 regulations were amended in June 2016 to decouple the two periods and restore the 10-year recognition period for REIT conversion transactions. Following intense criticism, including from members of Congress, the IRS recently announced

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[11]During tax years when corporations are eligible for a reduced rate of tax on net capital gain (as was the case before 1987), section 857(b)(3) imposes an alternative tax regime that separates the taxable income of the REIT into a net capital gain component and a non-net capital gain component, and the two components are then separately taxed under section 11. Under the two-part tax regime of section 857(b)(3), the REIT's ordinary income is reduced only by ordinary dividends (that is, dividends other than capital gain dividends), while the REIT's net capital gain is reduced only by its capital gain dividends.

[12]As noted, those dividends would be eligible for qualified dividend income treatment under section 1(h)(11).

[13]Although the statute limits the designation to "that part of the amount subjected to tax in subparagraph [(b)(3)](A)(ii) which he would have received if all of such amount had been distributed as capital gain dividends by the trust to the holders of such shares at the close of its taxable year," the designation is available even in a year in which there is no capital gain rate differential for corporations and the alternative tax under section 857(b)(3)(A) does not apply, as shown by the continued availability of a current version of Form 2439.

[14]Reg. section 1.337(d)-7.

that it would amend the regulations to restore the five-year recognition period.[15]

The net recognized built-in gain for a tax year is equal to the sum of the recognized built-in gains and the recognized built-in losses for the tax year from all of the sales, if any, of converted property during the year.[16] The amount of recognized built-in gain from a sale of converted property is equal to the amount of gain from the sale to the extent such gain does not exceed the amount of unrealized gain in the asset on the date of the conversion transaction.[17] The amount of net recognized built-in gain is capped at the amount of the corporation's taxable income for the year. Any excess of the net recognized built-in gain over the taxable income is carried over to subsequent years in the recognition period. Apart from the foregoing limitation, the net recognized built-in gain is not reduced by any other item of loss or deduction incurred by the corporation during the tax year. However, net recognized built-in gain can be offset by net operating loss carryovers or capital loss from prior years in which the corporation was a C corporation.[18]

The section 1374 S corporation rules are generally incorporated into the section 337(d) regime for a REIT that converts or acquires property from a C corporation. Unlike the reg. section 1.337(d)-7 rule that applies to REITs, however, section 1374 treatment is mandatory for S corporations, and no deemed sale election is available. In contrast, the section 337(d) regulations permit an election to recognize gain on the conversion transaction in lieu of becoming subject to section 1374 treatment.[19] This election is made by the C corporation that is becoming a REIT or that is transferring property to a REIT in a nonrecognition transaction. The effect of the election is to trigger a deemed sale of all of the converted property at its fair market value, triggering both gains and losses, with the resulting net gain being reported on the federal income tax return of the C corporation in the usual manner. For a C corporation that makes a REIT election, the gain is deemed to be recognized by the transferor on the last day of its final C corporation year, and for a nonrecognition transfer, on the date before the property was transferred to the REIT. The election is available only if there is a net built-in gain in the converted property, so the election cannot be used to trigger a net loss on a nonrecognition transaction.[20] The section 337(d) gain recognition includes an anti-stuffing rule to prevent the inclusion in the deemed sale of additional built-in loss assets that were acquired in a section 351 transaction or a capital contribution as part of a plan, the principal purpose of which is to reduce the amount of the net built-in gain.[21]

The amount of net recognized built-in gain that is subject to tax under the section 337(d) rules is also included in the REIT's capital gain or REIT taxable income, but the tax paid under those rules is allowed as a deduction from the REIT taxable income.[22] Thus, despite being subject to corporate taxation in the hands of the REIT, the net recognized built-in gain must be distributed by the REIT under section 857(a) and is then taxed to the shareholders as a (qualified) dividend or as a capital gain distribution.

IV. FIRPTA

Congress added section 897 to the code as part of FIRPTA in order to impose tax on foreign investors that recognize gain from U.S. real estate investments. Section 897(a) provides that gain or loss recognized by a nonresident alien individual or a foreign corporation from the disposition of a U.S. real property interest (USRPI) is treated as if the taxpayer were engaged in a U.S. trade or business and the gain or loss were effectively connected to the U.S. trade or business. USRPI is defined to

[15]Andrew Velarde, "Final REIT Regs Will Cut Back on Recognition Period," *Tax Notes*, Nov. 14, 2016, p. 919 (quoting Brett York, of the Treasury Office of Tax Legislative Counsel).

[16]Section 1374(d)(2).

[17]Section 1374(d)(3). Likewise, the amount of built-in loss from a sale of converted property is equal to the amount of loss from the sale to the extent the loss does not exceed the amount of the unrealized loss in the asset on the date of the conversion transaction. Section 1374(d)(4). The recognized built-in gains and losses in the year are then added together and if the net is a positive built-in gain, the gain is subject to corporate tax at the highest marginal rate applicable under section 11 (currently 35 percent). However, the total amount of net recognized built-in gain that must be accounted for during the recognition period is capped at the amount of the net unrealized gain in all converted property on the date of the relevant conversion transaction. Section 1374(c)(2).

[18]Section 1374(b)(2). Business credit carryforward from C corporation years are also allowed, but no other credits are allowed. Section 1374(b)(3).

[19]Reg. section 1.337(d)-7(c).

[20]Reg. section 1.337(d)-7(c)(1). This seems like a reasonable limitation because the election is intended to be a substitute for section 1374 treatment, which does not apply if there is no built-in gain.

[21]Reg. section 1.337(d)-7(c)(4). For this purpose, the principles of section 336(d)(2) (which provide a bad purpose presumption for transfers within the preceding two years) apply. The section 1374 regulations likewise include an anti-stuffing rule under which any loss or deduction attributable to property that was acquired with a principal purpose of avoiding tax under section 1374 is disregarded in determining the amount of the net recognized built-in gain, net unrealized built-in gain, or the taxable income limitation. Reg. section 1.1374-9.

[22]Reg. section 1.337(d)-7(b)(3)(i) and (ii).

include any interest in real property located in the United States and any interest (other than an interest solely as a creditor) in any domestic corporation that is (or that was at any time during the preceding five years) a U.S. real property holding corporation (USRPHC).[23] A USRPHC includes any corporation if the FMV of its USRPIs equals or exceeds 50 percent of the FMV of the sum of: (1) its USRPIs; (2) its interests in a non-U.S. real property; and (3) any other of its assets that are used or held for use in a trade or business.[24] However, stock in a USRPHC that is regularly traded on an established securities market, including a securities market located outside of the United States, is not treated as a USRPI in the hands of a shareholder who holds 5 percent or less of such class of stock.[25]

The determination of whether a class of interests that is traded on one or more established securities markets is regularly traded depends on whether the securities market is located in the United States. If the securities market is located in the United States, the stock is considered to be regularly traded for any calendar quarter during which it is regularly quoted by brokers or dealers making a market in those interests.[26]

On the other hand, stock that is traded on an established securities market located outside of the United States is subject to a much stricter test, under which the stock is considered to be regularly traded for a calendar quarter only if the following three requirements are met: (1) trades in the class are effected, other than in de minimis quantities, on at least 15 days during the calendar quarter; (2) the aggregate number of the interests in the class traded is at least 7.5 percent or more of the average number of interests in the class outstanding during the calendar quarter; and (3) the corporation complies with reporting requirements regarding its 5 percent shareholders.[27] Also, if at any time during the calendar quarter, 100 or fewer persons own 50 percent or more of the outstanding shares of a class of interests, the class of stock is not to be considered to be regularly traded in any event.[28]

Section 897(g) provides for look-through treatment on the sale of a partnership interest: ''Under regulations prescribed by the Secretary, the amount of any money, and the fair market value of any property, received by a nonresident alien individual or foreign corporation in exchange for all or part of its interest in a partnership, trust, or estate shall, to the extent attributable to United States real property interests, be considered as an amount received from the sale or exchange in the United States of such property.'' Although the statute provides that the look-through rule is to apply ''under regulations prescribed by the Secretary,'' and no regulations were ever issued by the IRS under this section, the IRS announced in Notice 88-72 that section 897(g) is self-implementing and is not contingent on the issuance of regulations.[29]

Despite the general look-through rules of section 897(g), partnerships or trusts with interests that are regularly traded on an established securities market are treated as a publicly traded corporation for purposes of sections 897 and 1445.[30] Accordingly, those interests can be real property interests only in the hands of a person that holds a greater than 5 percent interest. Also, for purposes of determining whether greater-than-5-percent interests in the entity constitute U.S. real property interests, the entity is subject to the same 50 percent test as a corporation in order to determine whether the assets it holds would cause it to be classified as a U.S. real property holding corporation if it were a corporation.[31] However, the treatment of dispositions of U.S. real property interests by publicly traded partnerships and trusts is unaffected by this rule, and foreign partners or beneficiaries are subject to tax on their distributive share of any gain recognized upon such dispositions by the partnership or trust in the same manner as a nonpublicly traded partnership.

[23]Section 897(c)(1)(A). The five-year taint of USRPHC status can be purged by the corporation disposing of all of its USRPIs in fully taxable transactions. Section 897(c)(1)(B). However, section 325 of the PATH Act eliminated the availability of the purging exception for a USRPHC that is a REIT.

[24]Section 897(c)(2).

[25]Section 897(c)(3). Constructive ownership rules apply for purposes of the 5 percent ownership threshold.

[26]Reg. section 1.897-9T(d)(2). A broker or dealer is considered to be making a market in a class of interests if the broker-dealer holds itself out to buy or sell interests in that class at the quoted price.

[27]Reg. section 1.897-9T(d)(1)(i). When finalized, reg. section 1.897-9T(d) will become reg. section 1.897-1(n). For a class of interests that is held by 2,500 or more record shareholders, the threshold is 2.5 percent instead of 7.5 percent.

[28]Related persons are treated as one person for purposes of this rule.

[29]Notice 88-72, 1988-2 C.B. 383. The IRS has issued regulations providing for relief from the FIRPTA withholding rules of section 1445 in the case of a sale of an interest in a partnership in which, directly or indirectly, 50 percent or more of the value of the gross assets consist of U.S. real property interests, and 90 percent or more of the value of the gross assets consist of U.S. real property interests plus any cash or cash equivalents.

[30]Reg. section 1.897-1(c)(2)(iv).

[31]It is unclear whether a *foreign* partnership that meets the USRPHC test is treated as a USRPHC for this purpose.

A purchaser of a USRPI generally must withhold 15 percent (increased by the PATH Act from 10 percent) of the amount realized by the seller from the sale of the USRPI.[32]

V. Special FIRPTA REIT Rules

Special rules apply to REITs under FIRPTA.[33] These rules, which are contained in section 897(h), include the following:

- Under section 897(h)(1), any distribution by a REIT to a nonresident alien individual or a foreign corporation that is attributable to gain from a sale or exchange by the REIT of a USRPI (a section 897(h)(1) distribution) is treated as gain recognized by the foreign shareholder from the sale or exchange of a USRPI and is consequently taxable under section 897(a). Moreover, a REIT (the parent REIT) that receives a section 897(h)(1) distribution from another REIT is treated as having recognized gain from the sale of a USRPI with the result that a distribution by the parent REIT to a foreign shareholder is in turn treated as a section 897(h)(1) distribution.
- A REIT that pays a section 897(h)(1) distribution to a foreign shareholder generally must withhold 35 percent of the amount of the distribution.[34]
- Stock in a ''domestically controlled REIT'' is not treated as a USRPI, and a sale of that stock by a foreign shareholder is not taxable.[35] This exception applies regardless of whether the REIT is publicly traded and without regard to whether the shareholder holds a greater-than-5-percent or 10 percent interest in the REIT. A REIT is treated as domestically controlled if at all times during the preceding five years (or, if shorter, the period of the REIT's existence) the REIT was less than 50 percent owned directly or indirectly by foreign shareholders.[36]
- The exception from USRPI treatment for a shareholder of a USRPHC whose shares are regularly traded on an exchange is increased from 5 to 10 percent in the case of a REIT.
- If the shares of a REIT are regularly traded on an established securities market located in the United States, a foreign shareholder that holds 10 percent (before the PATH Act, the threshold was 5 percent)[37] or less of such class of stock is not subject to section 897(h)(1) treatment.[38] Instead, the foreign shareholder is treated as receiving an ordinary dividend potentially subject to U.S. withholding tax.[39]

VI. Notice 2007-55

Section 897(h)(1) applies when a REIT makes a ''distribution'' that is attributable to gain from a disposition of a USRPI. Section 331(a) provides that when a shareholder receives a distribution from a corporation in complete liquidation of the corporation, the shareholder is treated as having received a payment in exchange for its stock. Also, section 331(b) provides that such a distribution is not treated as a distribution for purposes of section 301. Because REITs are classified as corporations for federal tax purposes,[40] many taxpayers historically took the position that a liquidating distribution is not characterized as a distribution for purposes of section 897(h)(1). When the REIT was domestically controlled, treating the liquidating distribution as a payment in exchange for the foreign shareholder's shares (which, as noted above, are not treated as a USRPI) meant that the distribution was not subject to tax under section 897(a). The IRS reached the same conclusion in LTR 9016021, but later partially withdrew that ruling to retract this conclusion in LTR 200453008. In Notice 2007-55, 2007-1 C.B. 13, the IRS announced that it plans to issue regulations

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[32]The 10 percent withholding rate was retained for personal residences that are sold for less than $1 million. Section 1445(c)(4).

[33]Several of these rules also apply to regulated investment companies as well as REITs, which are referred to as a class of ''qualified investment entities,'' but RICs are not the focus of this report.

[34]Section 1445(e)(6) and reg. section 1.1445-8. The statute and regulations indicate that the rate of withholding should be reduced to 20 percent to the extent provided in regulations (when the distributee is an individual or trust), but the IRS has not issued regulations providing for a lower rate of withholding.

[35]Section 897(h)(3).

[36]Section 897(h)(4)(B). The PATH Act has clarified some long-standing issues regarding how to determine the foreign ownership percentage of a REIT that is publicly traded or that is **(Footnote continued in next column.)** owned by another REIT. For any class of stock of a REIT that is regularly traded on an established securities market in the United States, a person holding less than 5 percent of that class of stock at all times during the testing period is treated as a U.S. person unless the REIT has actual knowledge to the contrary. Any stock in the REIT held by another REIT, any class of stock of which is regularly traded on an established securities market, is treated as held by a foreign person unless the shareholder REIT is itself domestically controlled (including under the preceding presumption), and in that case the stock is treated as held by a U.S. person. Finally, any stock in the REIT held by any other non-listed REIT is only treated as held by a U.S. person in proportion to the stock of such other REIT, which is (or is treated as) held by a U.S. person.

[37]*See* section 897(k)(1).

[38]*Id.*

[39]Section 857(b)(F).

[40]Section 856(a) requires, as a condition of classification for REIT status, that an entity be classified as a domestic corporation.

to "clarify" that a distribution described in section 331 is treated as a distribution for purposes of section 897(h)(1). While the IRS has not yet issued or proposed those regulations, Notice 2007-55 has effectively shut down the use of section 331 liquidations as a way to escape section 897(h)(1). While some commentators have questioned whether the IRS has the authority to issue a rule treating section 331 transactions as distributions for purposes of section 897(h)(1), Congress appears to have implicitly blessed that approach in section 897(k)(2)(C), added by the PATH Act, which treats such distributions as ordinary dividends when they are exempt from section 897(h)(1).

The IRS also indicated in Notice 2007-55 that it intends to issue regulations clarifying that a section 897(h)(1) distribution is not treated as a distribution for purposes of the section 892 governmental exemption and for purposes of treaty reductions or exemption from U.S. withholding tax.

VII. FIRPTA and CIV-Owned REITs

As mentioned, several countries have adopted REIT (or pure flow-through) regimes for widely held real estate CIVs. Like the U.S. regime for REITs, these rules are intended to facilitate tax-efficient investment in real estate by retail investors by allowing those investment vehicles to avoid an entity level of tax. Foreign CIVs, based in countries such as Australia, Canada, and the Netherlands have become a significant source of capital in the U.S. real estate market. In some cases, CIVs have added U.S. investments to their portfolios of non-U.S. investments in order to diversify risk or to find additional opportunities. But in other cases those vehicles are formed to raise capital from foreign investors for the specific purpose of investing in U.S. real estate. Fund sponsors often avoid U.S. REITs for valid nontax considerations, even when the target investments are located in the United States, because of the stricter SEC rules that apply to U.S. issuers or for foreign regulatory or tax reasons.[41]

Foreign CIVs have various options available to them in structuring their U.S. real property holdings, including investing directly, through a partnership, or through a domestic corporation (typically relying on the use of internal leverage to reduce the domestic corporation's taxable income). However, in many cases the most efficient alternative is for the foreign CIV to hold its U.S. properties through one or more U.S. REIT subsidiaries. The U.S. REIT subsidiary may hold a single property or multiple properties and may be owned almost entirely by the foreign REIT or as a joint venture with another investor. Although a REIT must have at least 100 shareholders, that requirement can be satisfied by the issuance of a small amount of stock (often a single preferred share) to the requisite number of investors.

The use of a U.S. REIT results in the elimination of U.S. entity-level tax and enables the operating income from the U.S. real properties to effectively be converted into dividend income. While those dividends are subject to U.S. withholding tax as U.S.-source fixed or determinable annual or periodic income, the rate of withholding tax on dividends under the code (which is 30 percent in the absence of a treaty) is lower than the 35 percent corporate tax rate and the 39.5 percent individual tax rate. Also, there may be state tax benefits to converting what would otherwise be rental income into dividend income.[42] Moreover, many foreign CIVs are classified as flow-through entities for U.S. federal or local tax purposes, and the public shareholders of those entities may be eligible to claim U.S. treaty benefits to reduce the U.S. withholding tax rate to 15 percent or lower.[43] When such a foreign CIV satisfies the requirements to be treated as regularly traded on an exchange, shareholders who own no more than 5 percent can sell their interests without being subject to U.S. tax on the gain under FIRPTA.

The fly in the ointment of these CIV-owned REIT structures is section 897(h)(1). If the U.S. REIT subsidiary sells a USRPI and recognizes a gain, the U.S. REIT must distribute the gain to the foreign CIV in order to eliminate corporate-level tax on the gain at the U.S. REIT level. Section 897(h)(1) would apply to this distribution and would subject it to tax in the hands of the foreign CIV. If the foreign CIV is classified as a corporation for U.S. federal tax purposes (which would most likely be the default classification of the REIT assuming the REIT's shareholders are not liable for debts of the REIT), the section 897(h)(1) gain will be subject to corporate tax at a 35 percent maximum rate. Under Notice 2007-55, no treaty relief is available for

[41]For example, Canadian pension vehicles, such as registered retirement savings plans, are restricted from investing in non-Canadian securities.

[42]Some states do not allow captive REITs the benefit of a dividends paid deduction, but the dividends themselves generally escape state taxation. Even states that do have captive REIT rules often exempt REITs owned by a shareholder that is a foreign CIV from those rules.

[43]Under the section 894 regulations, a resident of a treaty jurisdiction can claim treaty benefits for dividends received through an entity if the entity is fiscally transparent under the laws of the resident's jurisdiction, as determined under the rules of reg. section 1.894-1(d).

section 897(h)(1) distributions. Moreover, the section 897(h)(1) gain will also be subject to U.S. branch profits tax. Treaty relief may well be available for the branch profits tax and could reduce the rate of that tax to 5 percent, but even then the combined U.S. rate will exceed 38 percent.[44] That level of tax on income generally attributable to an underlying long-term capital gain is clearly inconsistent with a view of these structures as efficient flow-through vehicles for public investors seeking access to the U.S. real estate market.

As discussed, there is an exception to the application of section 897(h)(1) for small shareholders of a regularly traded REIT. However, this exception is narrower than the regularly traded exception that is available under section 897(a) for gain recognized from a sale of REIT shares. The section 897(a) exemption is available (subject to the additional ownership limitations described above) for entities that trade solely on a stock exchange located outside the United States. This allows shareholders of a foreign CIV that owns a U.S. REIT subsidiary to generally trade the units of the foreign CIV without having to worry about U.S. FIRPTA taxation even when the foreign CIV is classified as a partnership for U.S. tax purposes. On the other hand, the section 897(h)(1) regularly traded exemption is available only if the shares are regularly traded on a stock exchange located in the United States. Moreover, the U.S. REIT subsidiary itself must be regularly traded on such exchange, so even if the foreign CIV were listed on a U.S. exchange, that would be insufficient.

One relatively easy way to reduce the U.S. tax rate on section 897(h)(1) distributions (and eliminate entity-level taxation on such distributions) would be for the foreign CIV to check the box and elect to be classified as a partnership for U.S. federal tax purposes. This would result in the income of the foreign CIV, including any section 897(h)(1) distributions it received, being allocated to the foreign CIV's public unit holders, many of whom may be individual nonresident aliens. Because section 897(h)(1) gain would generally be long-term capital gain,[45] it would be eligible for the 20 percent reduced rates applicable to long-term capital gain in the hands of the foreign CIV's individual shareholders. Also, no U.S. branch profits tax would apply to the extent the section 897(h)(1) distribution is allocated to individuals. However, that seemingly elegant solution has two major shortcomings. First, ordinary dividends paid by the U.S. REIT to the foreign CIV will generally be ineligible for treaty benefits because most U.S. treaties restrict treaty benefits for REIT dividends to 10 percent or smaller shareholders.[46] Further, a shareholder of a foreign CIV that has elected partnership treatment who is allocated a portion of a section 897(h)(1) distribution would be treated as engaged in a U.S. trade or business and is subject to U.S. tax return filing requirements. This is different from the treatment of ordinary dividends paid by the U.S. REIT, which do not trigger a tax return filing requirement, as long as the proper amount of U.S. withholding tax has been withheld at source. A structure that results in U.S. tax return filing requirements (or even the likelihood of a future section 897(h)(1) distribution's triggering such a filing requirement) would impose an unacceptable burden on the public shareholders of a foreign CIV and would act as a huge disincentive for investors to purchase the shares of the foreign CIV.

Thus, a foreign CIV seeking to hold its U.S. properties through a U.S. REIT structure is faced with two undesirable alternatives: (1) elect partnership classification for U.S. purposes to access reduced long-term individual capital gain rates and avoid branch profits tax, but subject the foreign public shareholders to U.S. return filing requirements; or (2) retain the default classification of the foreign CIV as a corporation and accept a minimum 38 percent U.S. tax rate on section 897(h)(1) distributions. In the second case, there would still be a U.S. income tax return filing requirement, but it would be limited to the foreign CIV itself because public shareholders would from a U.S. perspective just be shareholders of a foreign corporation.

VIII. Historical CIV Investment Structures

Foreign CIVs have historically attempted to address the section 897(h)(1) issue in several different ways.

One approach adopted by many foreign CIVs that are classified as flow-through entities for U.S. tax purposes has been for the foreign CIV to indicate in its public securities filings that it will use reasonable efforts to avoid subjecting its unit holders to U.S. return filing requirements by minimizing dispositions of properties and by pursuing section 1031 exchanges when possible.

Other foreign CIVs have used more creative strategies to protect their unit holders from having

[44]Even though section 884(d)(2)(C) provides that gain from the sale of stock in a USRPHC is not subject to branch profits tax, the regulations under section 884 indicate that a section 897(h)(1) distribution for stock of a REIT is subject to the branch tax. Reg. section 1.884-1(d)(2)(xi), Example 4.

[45]As discussed below, reg. section 1.1445-8(c)(2)(ii)(B) suggests that section 897(h)(1) could apply to short-term capital gains, but this conclusion seems questionable.

[46]The Australian and Dutch treaties are exceptions.

to file a U.S. income tax return on section 897 distributions. One strategy used by several foreign CIVs was to hold the U.S. REIT through a hybrid entity that is formed as a foreign limited partnership but elects to be treated as a corporation for U.S. tax purposes. This internalizes any U.S. tax return filing requirements on section 897(h)(1) distributions in the hybrid limited partnership and protects the public unit holders from having to file returns. The benefits of using a limited partnership rather than an entity that is not treated as fiscally transparent for local foreign tax purposes is that this allows the foreign unit holders to claim treaty benefits for ordinary dividends paid to the foreign CIV. Under the section 894 regulations, the determination of whether an amount has been derived by a resident of a treaty jurisdiction through another entity for purposes of claiming eligibility under an income tax treaty is made by looking to the resident jurisdiction's characterization of the entity through which the income was earned. Treaty benefits are available to the unit holder if the entity (here, the foreign CIV) is treated as fiscally transparent under the law of the unit holder's jurisdiction even if the entity is classified as a corporation for U.S. tax purposes.

Although any section 897(h)(1) distributions would be taxable in the hands of the foreign CIV at the higher tax rate that applies to capital gains of a corporation as well as branch profits taxes, this structure can still be attractive if the U.S. REIT does not expect to have large dispositions of individual assets. Because the public shareholders can rely on the section 897(a) regularly traded exemption to avoid gain on dispositions of their foreign CIV units, an ultimate exit from the U.S. can be accomplished tax efficiently through a sale at the foreign unitholder level.

A second approach implemented by several foreign CIVs is for the foreign CIV itself to seek to qualify as a domestic REIT under section 856 through an intentional inversion transaction. This strategy has been used when the foreign CIV was formed to acquire a portfolio of U.S. real estate assets that were being rolled into the CIV in exchange for equity in the REIT (or, more precisely, in a partnership subsidiary of the CIV).[47] Section 7874(b) provides that if substantially all properties of a domestic corporation or partnership are acquired by a foreign corporation, and after the acquisition at least 80 percent of the stock of the acquirer is owned by former shareholders or partners of the domestic corporation or partnership by reason of their prior ownership in the entity, the acquiring corporation is treated as a domestic corporation for all purposes of the IRC. These structures have turned the sword of section 7874 into a shield against section 897(h)(1).

Section 856(a) requires a REIT to be a domestic corporation. Thus, an entity formed under foreign law ordinarily cannot qualify as a REIT under section 856. However, a foreign corporation entity that has acquired the assets of a domestic corporation in an inversion transaction subject to section 7874(b) is treated as a domestic corporation for all purposes under the code. Accordingly, such an entity should be eligible to make a REIT election under section 856 despite it being organized under the law of a foreign country.

Ordinary dividends paid by that type of dual-resident REIT to its foreign shareholders are treated as U.S.-source dividends paid by a domestic REIT, and shareholders that are eligible for treaty benefits can claim a reduced rate of U.S. withholding tax on those dividends. Because the dual REIT is itself a listed entity that is regularly traded on a stock exchange, foreign shareholders who hold less than 10 percent of the REIT can sell their interests without being subject to FIRPTA. However, for distributions from the dual REIT that are attributable to sales or USRPIs to avoid section 897(h)(1) treatment, the shares of the REIT must also be listed on a U.S. exchange. Several dual-resident REITs have taken that step.

A third approach is for the REIT to avoid selling USRPIs altogether by contributing the unwanted properties to a taxable REIT subsidiary (TRS) in a tax-free section 351 transaction and then having the TRS market and sell the property. The gain on the sale recognized by the TRS will be subject to corporate tax in the hands of the TRS, but at least the public shareholders will not be subject to U.S. return filing requirements. The distribution of the gain proceeds by the TRS to the REIT should not carry up a section 897(h)(1) taint when the REIT redistributes those proceeds to its shareholders, as section 897(h)(1) clearly provides for the carryover of the FIRPTA taint only in the case of a distribution by a REIT or a RIC.

What if instead of contributing the property to a TRS, the REIT just sells the property itself, but does not distribute the gain as a current dividend and does not declare a deemed capital gain distribution

[47]The sponsors typically receive UPREIT-type partnership interests that can be put back to the partnership for cash at a 1:1 price ratio to the publicly traded REIT shares. The regulations under section 7874 treat such units as stock of the acquiring REIT itself for purposes of the 80 percent ownership test. *See* reg. section 1.7874-2(i).

under section 857(b)(3)(D)?[48] The REIT would then be required to pay tax on the gain itself and, as in the TRS alternative, there would be a potential for double taxation if the REIT makes a distribution in a later year from those earnings and profits. However, it would seem that in the absence of a current capital gain dividend (or any other dividend or deemed dividend) that eliminates the REIT's net capital gain from its REIT taxable income, there should be no section 897(h)(1) consequences (such as return filing requirements) to the shareholders.

Section 897(h)(1) does not include any guidelines for determining whether a distribution is attributable to capital gain. One possibility is that section 897(h)(1) was intended to apply only to distributions that are actually designated as capital gain dividends under section 857(b)(3). This interpretation would explain why section 897(h)(1) does not provide rules for attributing distributions to capital gain because no guidance would be necessary if Congress intended for section 897(h)(1) to operate based on the existing REIT capital gain designation regime. There is support for this interpretation in the FIRPTA withholding regulations for section 897(h)(1) distributions, which state that ''the amount subject to withholding is the amount of any distribution . . . designated by a REIT as a capital gain dividend.''[49]

One implication of limiting section 897(h)(1) to declared capital gain dividends would be that section 897(h)(1) would not apply to short-term capital gain recognized by a REIT because those gains are not classified as ''net capital gain'' under section 1221 and cannot be the subject of a section 857(b)(3) capital gain dividend designation. Reg. section 1.1445-8(c)(2)(ii)(B) reserves on the withholding rules applicable to distributions by a REIT that are attributable to short-term capital gain, but the legislative history of section 897(h)(1) supports the view that section 897(h)(1) does not apply to short-term capital gain. The 1980 conference report provides that:

> Distributions by a real estate investment trust (REIT) to foreign shareholders would be treated as gain on the sale of U.S. real property *to the extent of the shareholders' pro rata share of the net capital gain* of the REIT. [Emphasis added.]

This suggests that section 897(h)(1) was not intended to apply to short-term capital gains because short-term capital gains are not included in ''net capital gain'' under section 1221.

However, limiting the application of section 897(h)(1) to capital gain dividends is arguably inconsistent with the purpose of section 897(h)(1) of ensuring that the gain from the sale of USRPIs is subject to at least one level of federal income tax because that interpretation would make it possible for a REIT to reduce its taxable income below the level of its net capital gain and avoid corporate-level tax on the net capital gain by paying ordinary dividends that exceed the amount of its ordinary income. Although section 857(b)(3)(A) bifurcates the REIT's dividends paid deduction between its ordinary income and its net capital gain and does not permit the REIT's net capital gain to be reduced by a dividend that is not designated by the REIT as a capital gain dividend, section 857(b)(3)(A) does not apply in years during which there is no corporate capital gains tax rate preference. Accordingly, this interpretation of section 897(h)(1) may be too narrow.

Another interpretation of section 897(h)(1), which may be more consistent with legislative intent, is that a dividend (even an ordinary dividend) received by a foreign shareholder is treated as attributable to capital gains recognized by the REIT if the dividend reduces the taxable income of the REIT resulting from the capital gains. Under this interpretation, there would be no section 897(h)(1) distribution as long as the REIT is not relying on a dividends paid deduction to reduce its capital gain from the sale of USRPIs. This interpretation would lead to the conclusion that dividends paid in future years out of earnings and profits attributable to capital gains recognized by the REIT in a prior year are not treated as attributable to the prior year gains. That conclusion seems to be supported by the withholding rules, which require withholding on a distribution only to the extent that the REIT either is paying a capital gain dividend or would be able to designate the distribution as a capital gain dividend.

Based on the foregoing analysis, it would seem that there should be no need for the REIT to contribute the properties to a TRS to protect the

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[48]As explained above, the REIT minimum distribution requirement is determined without regard to net capital gain, so the REIT's failure to distribute the gain has no adverse impact on the REIT's qualification.

[49]Reg. section 1.1445-8(c)(2)(ii)(A). The next sentence of the regulations undermines this inference a bit by providing that ''solely for purposes of this paragraph, the largest amount of any distribution occurring after March 7, 1991 that could be designated a capital gain dividend under section 857(b)(3)(C) shall be deemed to have been designated by the REIT as a capital gain dividend.'' This suggests that designation of an actual capital gain dividend is not required, but the ''solely for purposes of this paragraph'' qualification could indicate that the hypothetical maximum capital gain dividend applies only for withholding purposes (which is necessary to prevent avoiding withholding by delaying the designation of the capital gain dividend after the distribution has been completed) but not for substantive tax purposes.

CIV's foreign shareholders from U.S. return filing requirements if it is willing to refrain from distributing the gain and absorb the corporate tax. Although the withholding rules described above would still require the REIT to withhold on distributions to its foreign shareholders to the extent that the REIT could declare a capital gain distribution, those withholding rules do not apply when the REIT is owned by the CIV through a domestic partnership, as is often the case.[50]

There is, however, one situation in which there would be a clear benefit to contributing the property to a TRS over the REIT selling the property itself and absorbing the tax on the gain: when the property in question is conversion property subject to section 1374 treatment. If the REIT sells the conversion property itself, the REIT will be subject to corporate tax on the sale under the section 1374 rules as described above. This is similar to the result when the TRS sells an appreciated asset. However, under reg. section 1.337(d)-7(b)(3) the gain recognized on the sale of the conversion property is includable in the REIT's REIT taxable income for purposes of section 857, even though the REIT has already paid corporate tax on this amount. Thus, if the REIT fails to distribute the capital gain, it would be subject to corporate-level tax a second time under section 857(b)(1). This result is startling because it would effectively result in the gain being taxed a third time when the REIT ultimately distributes the earnings and profits to its shareholders. Perhaps a taxpayer might be on good grounds in challenging the validity of the regulations on this point by arguing that a rule promulgated under a grant of legislative authority to prevent the avoidance of the repeal of *General Utilities*, but which provides for double tax of a gain at the corporate level, is arbitrary and unreasonable. However, to avoid that risk, the REIT might be better off contributing the property to a TRS when it is clear that there would be only one level of corporate taxation.

IX. New CIV PATH Act Exemption

Section 322 of the PATH Act added a new exemption for some foreign CIVs that own a U.S. REIT.[51] Under the new exemption, stock of a REIT held (directly or indirectly through one or more partnerships) by a CIV that is a "qualified shareholder" is not treated as a USRPI in the hands of the CIV. Also, any distribution by a REIT to a qualified shareholder is not subject to section 897(h)(1). However, unlike the new exemption for qualified foreign pension funds in section 897(l), a FIRPTA capital gain distribution to a qualified shareholder is not entirely exempt from tax. Instead, the distribution is treated as an ordinary dividend, avoiding the need for a U.S. tax return filing and potentially enabling the shareholder or its unit holders to access treaty-reduced withholding rates.[52]

The term "qualified shareholder" is defined as a foreign entity that meets three requirements:

- either (1) the entity is eligible for treaty benefits under a U.S. income tax treaty that includes a comprehensive exchange of information program, and the principal class of interests in the entity is listed and regularly traded on one or more recognized stock exchanges (as defined in the treaty); or (2) is a foreign limited partnership created under foreign law in a jurisdiction that has an agreement for exchanging information with the United States and has a class of units that represents more than 50 percent of its total outstanding partnership units and that is regularly traded on the New York Stock exchange or NASDAQ;
- the entity is a qualified collective investment vehicle (QCIV), as defined below; and
- the entity maintains records on the identity of its 5 percent owners.

The third requirement is straightforward (although there are some questions about how it would apply in practice), but the first two require further explanation. The first requirement can probably best be described as providing two alternative paths to qualified shareholder status for CIVs, depending on whether the CIV is fiscally transparent or nonfiscally transparent under the law of its jurisdiction. Although the statute does not refer to fiscal transparency explicitly, the requirement in the first prong that the entity be eligible for treaty benefits effectively means that it has to be nonfiscally transparent under section 894. Conversely, the second prong's requirement for the entity to be formed as a partnership under local law would typically mean that the entity is fiscally transparent under that law and is therefore not treated as deriving income under section 894. Consistent with

[50]The domestic partnership would be required to withhold on its foreign partners' distributive shares of effectively connected income under section 1446, but if the REIT ultimately pays no section 897(h)(1) distributions, there would be no withholding required under section 1446.

[51]Section 897(k)(2). Section 897(k)(1) increased the ownership threshold for the regularly traded exemption for REIT shareholders from 5 percent to 10 percent (both for purposes of sales of stock under section 897(a) and for purposes of capital gain distributions under section 897(h)(1)). With the exception of the

(Footnote continued in next column.)

handful of dual-resident REIT CIVs, the regularly traded exception has not been of much use to foreign CIVs, however, because it applies only when the U.S. REIT is itself listed on an exchange.

[52]Section 857(b)(3)(F), as amended by the PATH Act.

that interpretation, the second prong does not require the CIV to be eligible for treaty benefits. Further, the requirement for fiscally transparent CIVs — that more than 50 percent of the units be of a class listed on the NYSE or NASDAQ — can be understood as simply preserving the U.S.-listed condition of the small-shareholder exception in section 897(h)(1), although it is unclear why the drafters tied that requirement to the foreign tax classification of the CIV rather than its U.S. classification. The requirement that the entity be formed as a partnership under local law might be designed to ensure that the unit holders will be subject to tax on the income in their resident jurisdictions.

The second requirement is that the CIV be a QCIV. The term QCIV is defined as a foreign person who meets *one* of the following three tests:

- is eligible for a reduced rate of withholding for REIT dividends even if it holds more than 10 percent of the stock of the REIT (the only U.S. treaties that currently provide for a reduction in withholding tax on dividends paid to an entity above this 10 percent threshold are the Australian treaty, for an Australian REIT,[53] and the Dutch treaty, for a *beleggingsinstelling*);[54]
- is a foreign partnership that (1) is a publicly traded partnership (within the meaning of section 7704(b)) that is not treated as a corporation under section 7704(a) (because it meets the 90 percent qualifying income exception); (2) is a withholding foreign partnership; and (3) would be treated as a USRPHC if it were a U.S. corporation at any time during the five preceding years; or
- which is designated as a QCIV by the Treasury secretary and is either fiscally transparent within the meaning of section 894 or must include dividends in its gross income, but entitled to a deduction for distributions to its unit holders.

The logic behind the three prongs is obscure, but at first blush, it seems that the second prong for publicly traded partnerships is intended to correspond to the second prong of the qualified shareholder test for foreign fiscally transparent CIVs. The deemed USRPHC requirement in this prong is probably meant to ensure that a transfer of an interest in the partnership will be taxable under FIRPTA unless the partner owns less than 10 percent of the QCIV.[55] This ensures that shareholders can't use a foreign partnership QCIV to avoid FIRPTA. However, the statute does not explicitly restrict the second prong of the QCIV definition to entities that qualify under the foreign fiscally transparent prong of the qualified shareholder definition, so it is uncertain whether such a limitation was intended. In contrast, it seems clear that the third prong (the designated QCIV prong) of the QCIV definition applies to both foreign fiscally transparent and foreign nonfiscally transparent CIVs,[56] and therefore, there is no reason to assume that a designated QCIV cannot be classified as a partnership for U.S. purposes. Nor is there any reason to believe that an entity classified as a partnership in the United States could not qualify for the nonfiscally transparent qualified shareholder prong. It is hoped that future guidance will confirm the answers to these questions.

Unlike the publicly traded exceptions in section 897(a) and (h)(1), the section 897(k) exemptions are available without regard to whether the qualified shareholder itself owns more than 10 percent of the U.S. REIT. However, the 10 percent ownership limitation has not been eliminated and continues to apply at the level of the qualified shareholder's unit holders. If a person holds a 10 percent or greater interest in the U.S. REIT (including indirect ownership through the qualified shareholder and direct ownership in the U.S. REIT),[57] the person is treated as an ''applicable investor.'' If a foreign CIV that is a qualified shareholder of a U.S. REIT has an applicable investor, a proportional amount of its interest in the U.S. REIT is ineligible for the section 897(k) exemptions.[58] When the qualified shareholder is a partnership, special allocation rules

[53]Article 10 of the Australia-U.S. treaty uses the term ''listed Australian property trust,'' which is defined as ''an Australian unit trust registered as a 'Managed Investment Scheme' under the Australian Corporations Act in which the principal class of units is listed on a recognized stock exchange in Australia and regularly traded on one or more recognized stock exchanges (as defined in Article 16 (Limitation on Benefits)).'' However, the type of unit trust known as a listed property trust was renamed ''real estate investment trust'' in 2008 to conform to international usage norms.

[54]The treaties with Portugal, Thailand, and Tunisia provide for a reduced rate of withholding on REIT dividends up to a 25 percent threshold, but only for individuals. Several older treaties have no special rules at all for REITs, but according to the explanation of the Joint Committee on Taxation, the intention was that only treaties with a specific REIT dividends provision would be covered. JCT, ''General Explanation of Tax Legislation Enacted in 2015,'' JCS-1-16, at 283 n.967 (2016).

[55]*See* reg. section 1.897-1(c)(2)(iv). The inclusion of this test in the QCIV definition would seem to support the view of some commentators that a foreign partnership that meets the 50 percent USRPI test of the foregoing regulation is treated like a domestic USRP.

[56]The section 894 regulations would treat an entity that includes amounts in its gross income and benefits from a deduction for dividends paid as deriving the income as potentially eligible for treaty benefits.

[57]Constructive ownership rules apply for this purpose. Section 897(k)(2)(E).

[58]Section 897(k)(2)(B).

apply to ensure that the applicable investor's share of the gain is not allocated to other investors in the qualified shareholder.[59]

The statute and legislative history do not provide any direction to Treasury and the IRS about which factors should be considered in determining whether an entity should be designated as a QCIV. It appears that the two alternative conditions explicitly mentioned in the statute (fiscal transparency or a deduction for dividends paid) are intended to limit the exemption to entities that are not subject to foreign tax at the entity level. Interestingly, CIV is not used anywhere else in the code. It appears in a few places in the regulations but is not defined there either.[60] What factors should Treasury consider in making QCIV designations?

1. Should there be a deemed USRPHC test like the one under the publicly traded partnership prong? Assuming that the reason for the deemed USRPHC test in the PTP prong is the one proposed above to make sure that sales by large CIV shareholders are subject to tax in the United States, it doesn't make sense to impose that requirement on entities classified as foreign corporations for U.S. tax purposes. Also, if Congress wanted this test to apply to all QCIVs, the drafters presumably would have provided so in the statute just as they did for partnerships.

2. A minimum distribution requirement under foreign law (similar to the one for U.S. REITs) might make sense for nonpartnership entities to ensure that another country is not collecting entity-level tax, though it might be reasonable to presume that an entity that is eligible for a dividends paid deduction is not accumulating its income as long as there is a meaningful corporate tax imposed on any income that is not distributed.

3. Perhaps Treasury could consider a requirement that the entity's activities be limited to passive investment broadly analogous to the U.S. REIT income, asset, and prohibited transaction requirements.

4. Another possible requirement would be to impose a foreign withholding tax on distributions to nonresidents. A foreign withholding tax could help inhibit treaty shopping (although limitation of benefit provisions already police that).

5. Many CIV regimes feature some degree of character retention for distributions to unit holders or flow-through of foreign tax credits, but there is no evident reason why the U.S. exemption depends on the local tax treatment of the foreign CIV's unit holders, so the extent to which there is a flow-through of character to unit holders should probably not be a factor in QCIV determinations by the IRS.

Regardless of the criteria the IRS uses in making QCIV determinations, there should be a broad designation of the entities meeting the criteria as QCIVs either on a country-by-country basis or based on a general description of the conditions for qualification of a CIV formed in any jurisdiction. For example, based on my extensive experience with Canadian REITs, I would suggest that consideration be given to designating Canadian REITs as QCIVs because they meet all of the foregoing proposed conditions and have been significant investors in U.S. real estate in recent years. For example, Canadian REITs are subject to income and asset tests that are analogous to the U.S. REIT requirements. Canadian REITs are eligible to deduct dividends paid to unit holders, but they are subject to corporate tax in Canada to the extent they fail to distribute their income. Also, Canada imposes a significant withholding tax on dividends paid by a Canadian REIT to nonresident unit holders.

It would be unfortunate if the IRS took a case-by-case approach and required QCIVs to seek individual private letter rulings to be designated as a QCIV, needlessly burdening the IRS and taxpayers.

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[59]Section 897(k)(4). There appears to be a technical drafting error in section 897(k)(4). As currently written, the applicable investor's distributive share of the gain is equal to that investor's proportional share of the gain recognized from USRPIs. However, because section 897(k) treats gain from the disposition of REIT shares by the partnership as not being from the disposition of a USRPI except to the extent of the applicable investor's interest in the partnership, the effect of this formula is to allocate less than the total amount of the gain that is carved out of section 897(k) to the applicable investor. To illustrate, assume a qualified shareholder partnership has an applicable investor who is a 20 percent partner in the partnership. If the partnership recognizes $100 of gain from the sale of stock in a U.S. REIT, section 897(k)(2)(B) will treat $20 of that gain as gain from the sale of a USRPI and will treat the remaining $80 of gain as non-USRPI gain. Because the applicable investor is allocated only a proportional amount of the gain from USRPIs, the investor's share of the FIRPTA gain would be $4, with the remaining $16 being allocated to the partnership's other partners. That is presumably not the result the drafters were trying to reach, so the statute should be clarified by a technical correction.

[60]The term appears in an example in reg. section 1.894-1 (it appears only in the heading, as the text uses the term ''collective investment fund''), in which it refers to a contractual arrangement that is not a legal entity. The term ''qualified collective investment vehicle'' is defined in reg. section 1.1471-5(f) as a type of registered deemed-compliant foreign financial institution, but the factors in that definition appear to be focused on the Foreign Account Tax Compliance Act reporting considerations and seem irrelevant outside that context.

X. Conclusion

Section 897(k) holds significant potential for foreign CIVs that have had to wrestle with how to use U.S. REITs for their domestic real estate investments. Most significantly, the extension of an exemption from section 897(h)(1) to those structures would eliminate the difficult choice between corporate-level tax and public unit holder U.S. tax return filing requirements. Unfortunately, however, Congress did not define the key statutory term that determines when a foreign CIV that is not traded on the NYSE or NASDAQ or one that is organized other than as a limited partnership under its country of formation would qualify. Instead, it was left to Treasury to designate which foreign entities will qualify as QCIVs. Also, the committee reports accompanying the PATH Act do not contain any guidance from Congress on the factors Treasury should consider in making those designations nor on the process for making them.

I hope that the IRS will publish an ''angel list'' of legal entities in specific jurisdictions (such as Canada) or otherwise provide some broad guidance on how to determine whether an entity formed under a specific regime is QCIV. If a procedure is provided for taxpayer requests for individual designations, those individual requests should serve only to supplement broader guidance and should not be the sole method of obtaining QCIV designation. ■