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Proposed Amendment to FIRPTA Could Make U.S. REITs More Attractive to Canadian Real Estate Investors

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Legislation is pending in Congress that would reduce the US tax burden imposed on non-US shareholders in some real estate investment trusts (REITs). This article explores how REITs can be used by Canadian investors to structure real estate investments in the United States and examines how the proposal would affect such investors.

US real estate investment trusts (REITs) are an increasingly popular vehicle for investments in real estate in the United States and in mortgages secured by such real estate. The reason is that although REITs are treated as corporations for US tax purposes,1 they are entitled to claim a deduction for dividends paid to their shareholders and as a result can largely avoid US federal corporate-level income tax.2 While REITs have historically been marketed primarily to domestic investors, there is a growing awareness among tax practitioners of the utility of REITs as vehicles for US real estate investments by non-US persons.

A bill was introduced during the first session of the current Congress that is intended to make portfolio investments in publicly traded REITs more attractive to non-US investors.3 This article will explore the US tax treatment of Canadian investors in a REIT and consider the significance of the proposed legislation.

General Requirements for Taxation as a REIT

In order for an entity to qualify as a REIT, it must elect to be so treated and must satisfy certain organizational requirements, distribution requirements, income tests, and asset tests. The organizational requirements are as follows: (1) the REIT must be taxable as a domestic corporation;4 (2) the REIT must be managed by one or more trustees or directors;5 (3) the shares

1 A REIT may be formed as a corporation, business trust, partnership, or limited liability company under local law. Regardless of the legal form of the entity, however, it will be treated as a corporation for tax purposes by virtue of electing to become a REIT. Treas. Reg. §301.7701-3(c)(1)(v)(B).

2 Code section 857(b).

3 Real Estate Investment Trust Improvement Act of 2003, S 1568, 108th Cong., 1st sess., introduced August 1, 2003, and the identical Real Estate Investment Trust Improvement Act of 2003, HR 1890, 108th Cong., 1st sess., April 30, 2003.

4 Code section 856(a)(3). See supra note 27.

5 Code section 856(a)(1).

of the REIT must be freely transferable;6 (4) the REIT must have at least 100 shareholders;7 and (5) five or fewer individuals cannot own, directly or indirectly, more than 50 percent of the value of the shares of the REIT (“ the five-or-fewer test”), taking into account for this purpose certain constructive ownership rules under which a shareholder may be treated as owning shares that are actually owned by certain related persons.8 There is no requirement that a REIT be publicly traded.

A REIT is required to distribute each year at least 90 percent of its taxable income, determined for this purpose by excluding any net capital gain (that is, the excess of net long-term capital gains over short-term capital losses) and certain non-cash income.9 If the REIT’s shareholders consent, however, the REIT and its shareholders can jointly elect to be treated for all US federal income tax purposes as if the REIT had made a distribution to its shareholders (“ a consent dividend”), who will be subject to tax on the deemed distribution.10 The REIT may also elect to treat certain dividends paid after the close of the year as having been paid during the year. This election permits the “ throwback dividends” to be used to satisfy the distribution requirements for the taxable year even though the dividends are includible in the income of the REIT’s shareholders only in the following year.11

A REIT is required to meet two annual income tests. The first test requires that at least 95 percent of the REIT’s gross income be derived from the following items: “ rents from real property,” as defined below; dividends; interest; gain from the disposition of real property interests (other than dealer property), stocks, or securities; abatements and refunds of taxes on real property; income and gain derived from certain property acquired by foreclosure; and loan or lease commitment fees.12 The second test requires that at least 75 percent of the REIT’s gross income be derived from items that qualify under the 95 percent test, other than non-mortgage interest, non-REIT dividends, and gains from the sale of stock or securities other than REIT shares.13 The term “ rents from real property” includes rents from interests in real property and charges for services customarily furnished in connection with the rental of such property, and also includes rent attributable to personal property leased under, or in connection with, a lease of real property if the rent attributable to the personal property does not exceed 15 percent of the total rent.14 “ Rents from real property” do not include any rental income where (1) any portion of the rent paid by a tenant is dependent on the profits of the tenant, (2) the tenant is 10 percent owned by the REIT (taking into account ownership by certain related persons), or (3) the REIT is providing non-customary services to tenants of the property.15

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[6] Code section 856(a)(2).
[7] Code section 856(a)(5).
[8] Code section 856(a)(6) and (h).
[9] Code section 857(a)(1). The categories of non-cash income that are eligible for this exception include prepaid rental income, income from taxable exchanges of property, original issue discount, and cancellation of indebtedness.
[10] Code section 565(a).
[11] Code section 858.
[12] Code section 856(c)(2).
[13] Code section 856(c)(3).
[14] Code section 856(d)(1).
[15] Code section 856(d)(2).

The asset tests require that (1) at least 75 percent of the value of the REIT's assets be comprised of real estate assets, cash and cash items (including receivables), and government securities;16 (2) not more than 20 percent of the REIT's assets be represented by securities in one or more taxable REIT subsidiaries (that is, non-REIT corporate subsidiaries that have elected to be taxed as separate entities from the REIT);17 (3) not more than 5 percent of the REIT's assets be represented by securities of any one issuer (other than a taxable REIT subsidiary);18 and (4) the REIT not own more than 10 percent of the vote or value of any issuer (other than a taxable REIT subsidiary).19 The term " real estate assets" is defined to include interests in real property including leases (but not mineral, oil, or gas royalty interests), mortgages on real property, and shares in other REITs.20

Private REITs

As mentioned above, there is no requirement that a REIT be publicly traded. However, structuring a private REIT requires careful attention to be paid to the ownership limitations. The beneficial ownership of the REIT's shares must be sufficiently dispersed among enough individuals in order not to run afoul of the five-or-fewer organizational test. This test is applied by looking through any entities that are shareholders of the REIT to the ultimate individual owners. Thus, the test would not be violated by having a partnership or corporation own more than 50 percent of the REIT's shares, as long as the ownership of such partnership or corporation is not overly concentrated.21 However, legislation has been proposed several times that would prohibit a single entity from owning 50 percent or more of the stock of a REIT, and in fact there are several bills pending in Congress that include such a provision.22

Another hurdle that has to be overcome in structuring a private REIT is the requirement that there be at least 100 shareholders. In contrast to the five-or-fewer test, there is no specified minimum amount of shares that must be held by the 100 shareholders. In addition, the 100 shareholder test may be satisfied not only by common stock holders but also by preferred stock shareholders. Many private REITs are structured with a separate class of non-voting preferred stock that is issued to a sufficient number of unrelated shareholders to ensure that this requirement is satisfied.

REIT Taxation

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16 Code section 856(c)(4)(A).

17 Code section 856(c)(4)(B)(ii).

18 Code section 856(c)(4)(B)(iii)(I).

19 Code section 856(c)(4)(B)(iii)(II) & (III).

20 Certain temporary investments of new capital in stock or debt instruments are also treated as real estate assets. Code section 856(c)(5)(B) and (C).

21 The five-or-fewer test has its genesis in the personal holding company provisions of Code section 542(a), under which an individual is treated as owning any stock owned, actually or constructively, by his or her partner. Since each partner is treated as owning his or her proportionate share of any stock owned by the partnership, each individual partner is also treated as owning all of the shares owned by the partnership (through attribution from his or her partners). However, the partner-to-partner attribution rule does not apply for purposes of the REIT five-or-fewer test. Code section 856(h)(1)(B)(i).

22 The Sales Tax Equity Act of 2003, S.1436, 108th cong., 1st sess., introduced July 21, 2003 and the Working Taxpayer Fairness Restoration Act, S 1162, 108th Cong., 1st Sess., introduced June 2, 2003, which are pending in the Senate, include such a controlled REIT prohibition. A version of each of these bills is also pending in the House of Representatives.

While a REIT is only required to distribute 90 percent of its “ ordinary” taxable income in order to maintain its qualification as a REIT, a REIT that fails to distribute all of its taxable income, including capital gains, will be subject to corporate-level tax on the undistributed income just as if it were an ordinary corporation.23 In addition, the REIT may be subject to a 4 percent excise tax on undistributed amounts.24

Treatment of Shareholders

Distributions made by a REIT to its shareholders are treated as dividends to the extent of any current or accumulated earnings and profits of the REIT.25 Except in the case of “ capital gain dividends,” such dividends are includible in the gross income of domestic shareholders as ordinary income and generally do not qualify for the 15 percent rate applicable to other dividends paid by US corporations unless the dividends are attributable to qualifying dividend income earned by the REIT.26 Consent dividends are treated in the same manner as actual distributions. Distributions that exceed the REIT’s earnings and profits are treated as a non-taxable return of the shareholder’s investment to the extent of the shareholder’s basis in the shares. Distributions in excess of the shareholder’s basis are treated in the same manner as gain from a disposition of the shares.27

To the extent that a REIT has a net capital gain for the taxable year, the REIT may designate dividends that it pays during the year as capital gain dividends. Such dividends are treated as capital gains and are eligible for beneficial long-term capital gains rates in the hands of the REIT’s individual shareholders, without regard to the holding period of the REIT shares in the hands of the shareholders.28 Such dividends nonetheless reduce the REIT’s taxable income. In addition, if the REIT does not distribute its capital gains to its shareholders, and consequently must pay tax on those amounts, double taxation may be avoided by the REIT’s designating the gains as includible in its shareholders’ income (as if the amounts had actually been distributed). This designation, which does not require the consent of the shareholders, permits the shareholders to claim a credit for the tax actually paid by the REIT on the net capital gain.29 In

[23] Code section 857(b).

[24] Code section 4981. The excise tax is imposed only to the extent that the REIT did not pay any corporate-level tax on the undistributed amounts. This normally occurs only in the case of a “ throwback dividend” under Code section 858, which may be deducted by the REIT prior to the year in which it is paid. The excise tax is designed to deter REITs from using such dividends to obtain tax deferral for the shareholders, who are not required to include the dividends in income until they are actually received.

[25] Distributions made by the REIT out of earnings and profits on which the REIT paid a corporate-level tax in a prior year are also treated as taxable dividends.

[26] Note that, unlike regulated investment companies (that is, mutual funds), REITs cannot pass foreign tax credits through to their shareholders. This limitation generally makes a REIT an inefficient vehicle for US investors seeking to invest in real estate outside the United States.

[27] See the discussion below.

[28] Code section 857(b)(3). Note that the fact that the shareholder’s basis in the REIT shares may exceed the amount designated by the REIT as a capital gain dividend will not prevent such amounts from being taxable to the shareholder since the amount of gain is determined at the corporate level. The capital gain character of the dividends may also permit such dividends to be offset by capital losses, which can also be helpful for corporate shareholders. But see Code section 291(d), which requires corporate shareholders to treat 20 percent of capital gain dividends received from a REIT as ordinary income to the extent that the dividends are attributable to certain depreciation recapture amounts.

[29] Code sections 857(b)(3)(D)(i) and (ii). However, no credit is available to the shareholders for state and local income taxes paid by the REIT on the net capital gain.

the case of individual shareholders, who are entitled to a beneficial long-term capital gain rate, the credit will exceed the tax due on the deemed capital gain dividend and may offset any tax liability for the shareholders' other income or allow the shareholders to obtain a refund.

REIT shares are ordinarily treated as a capital asset in the hands of its shareholders. A sale of the shares will result in long-term capital gain or loss if the shares are held for more than one year.

Treatment of Non-US Shareholders30

Ordinary Dividends

Ordinary dividends (that is, dividends other than capital gain dividends) received by a non-US shareholder of a REIT are subject to US withholding tax at a 30 percent rate, subject to reduction under any applicable income tax treaty.31 Many US treaties, however, limit the availability of relief from US withholding tax on dividends paid by REITs.32 In particular, the US-Canada income tax treaty does not permit dividends paid by a REIT to qualify for the 5 percent rate otherwise applicable to 10 percent or more corporate shareholders. Further, the 15 percent rate applies only to dividends received by individuals who own less than 10 percent of the REIT's shares, and all other recipients are subject to 30 percent US withholding tax.33

Gain on Disposition

Gain recognized by a non-US shareholder from the sale of stock in a US corporation is generally not taxable in the United States. However, under the Foreign Investment in Real Property Tax Act of 1980 34 (" FIRPTA"), gain recognized by a non-US person from a disposition of a US real property interest is treated as effectively connected to a US trade or business and is subject to US federal income taxation. Further, a shareholder who recognizes such income is required to file a US federal income tax return.35 A US real property interest includes stock in a US corporation that is, or was at any time during the preceding five years, a " United States real property holding corporation" (USRPHC).36 A USRPHC is any US corporation the fair market value of the US real property interests of which equals or exceeds 50 percent of the total fair market value of the corporation's US and non-US real property interests plus any of its other assets used in a trade or business.37 Since the REIT asset tests require that 75 percent of a REIT's assets consist of real estate assets (or cash, cash equivalents, or government securities), most REITs are USRPHCs under this definition. However, unlike the

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[30] For a comprehensive discussion of the treatment of foreign investors in a REIT, see Robert J. Staffaroni, " Foreign Investors in RICS and REITS" (2003) vol. 56, no. 3 *The Tax Lawyer* 511-69.

[31] Code sections 817(a), 881, 1441, 1442. Since REITs are required to be domestic entities, REIT dividends would normally constitute US-source income. Note that U.S. withholding tax is also imposed on the amount of any consent dividends required to be taken into account by a non-U.S. shareholder. Code section 565(e).

[32] The policy reason behind such limitations is that, since the REIT paying the dividends will be eligible to claim a dividends-paid deduction, the distributed amounts escape US corporate-level tax.

[33] The limitations on REIT dividends in more recent US treaties are more generous, permitting certain portfolio investments of non-individual shareholders to qualify for a 15 percent rate.

[34] Foreign Investment in Real Property Tax Act of 1980, subtitle C of the Omnibus Reconciliation Act of 1980, Pub. L. no. 96-499, enacted on December 5, 1980.

[35] Code section 897(a). However, no US branch profits tax is imposed on such gain. See Code section 884(d)(2)(C).

[36] Code section 897(c)(1)(A)(ii).

[37] Code section 897(c)(2).

REIT asset test, the 50 percent test applicable in determining USRPHC status allows the gross value of the corporation's real estate to be reduced by any mortgage debt in connection with the property.38 Thus, it is possible for a REIT to meet the 75 percent test, while still avoiding USRPHC status.39

Even if a REIT is a USRPHC, there are two important exceptions that can protect a non-US investor in the REIT from being subject to US federal income tax on a disposition of the REIT's shares. Under one exception, if any class of stock of a corporation is regularly traded on an established securities market, stock of such class that is held by a person who, at no time during the five-year period preceding the date of sale, owned more than 5 percent of such class is not treated as a US real property interest.40

Under the second exception, stock of a REIT is not treated as a US real property interest if the REIT is a " domestically controlled REIT." 41 A REIT is treated as a domestically controlled REIT with respect to a sale if, at all times during the five-year period preceding the date of the sale, less than 50 percent in value of the stock was held directly or indirectly by foreign persons.42 This exception applies to both public and privately held REITs.

Capital Gain Dividends

Under Code section 897(h)(1), any distribution by a REIT to a non-US shareholder that is attributable to gain from sales or exchanges by the REIT of US real property interests is treated as if it were gain recognized directly by the shareholder from a disposition of such property. Such gain is treated as income effectively connected to a US trade or business subject to US federal income tax, and a distributee non-US shareholder is required to file a US federal income tax return. In the case of a foreign corporation, such gain could also be subject to a 30 percent US branch profits tax. The tax is enforced through a requirement imposed on the REIT to withhold 35 percent of the capital gain distribution.43 Note that capital gain distributions attributable to US real property gains are taxable even if the REIT is not a USRPHC or if the shareholder who receives the distributions would qualify under one of the two exceptions to FIRPTA described above. Thus, the tax consequences of a capital gain distribution may be more onerous than an actual sale of the REIT shares. However, the shareholder may be able to avoid being subject to section 897(h)(1) by disposing of the REIT shares prior to the distribution.

Section 897(h)(1) on its face appears to apply to any dividends attributable to dispositions of US real property interests, whether or not the dividends are designated by the REIT as capital gain dividends, but no regulations have been issued by Treasury under section

[38] Treas. reg. §1.897-1(o)(2)(iii).

[39] For example, a REIT holding $1,000 of real estate, which is subject to acquisition indebtedness of $800, and $300 of other assets held for use in a trade or business would satisfy the 75 percent test but would not be a USRPHC. A real estate mortgage that has no equity kicker is treated as a real estate asset for purposes of the REIT asset test but not for purposes of the FIRPTA rules, so that it is also possible for a REIT that invests only in mortgages to avoid being a USRPHC.

[40] Code section 897(c)(3). This exception is not limited to REITs, but since most publicly traded corporations do not own enough real estate to be treated as USRPHCs, REITs are major beneficiaries of this exception.

[41] Code section 897(h)(2).

[42] Code section 897(h)(4)(B).

[43] Treas. reg. §1.1445-8(c)(2).

897(h)(1). Regulations have been issued under the related provisions of Code section 1445(e)(1), which contain the withholding requirements on capital gain distributions to non-US shareholders, but they shed little light on the operation of section 897(h)(1).44 For withholding tax purposes, the regulations require the REIT to withhold on the maximum amount of dividends that could have been designated as capital gain dividends.45

Comparison with Other Forms of Investment in US Real Estate

As discussed above, gain recognized by a non-US taxpayer from a sale of REIT shares will be exempt from US taxation in the following three situations: (1) where the value of the REIT's US real property interests, as defined for FIRPTA purposes, is less than 50 percent of the total value of the REIT's real property interests and trade or business assets; (2) where the shareholder holds 5 percent or less of a class of the REIT's shares that is publicly traded; or (3) where the REIT is a domestically controlled REIT. For Canadians interested in investing in US real estate, an investment in such " exempt REIT shares" offers significant advantages over a direct investment in US real estate.46

Direct Investment

Gain on Sale

The principal benefit of structuring an investment in US real estate through exempt REIT shares derives from the treatment of gain on the sale of the investment. Gain on the sale of a direct interest in real estate would be fully taxable under FIRPTA. In contrast, gain on the sale of the exempt REIT shares is not subject to US federal income taxation.47 While a sale of the underlying real estate may give a rise to a distribution that would be taxable in the hands of the Canadian shareholders, it is often possible to arrange for a sale of the stock prior to the distribution of any sale proceeds.48 Alternatively, the shareholder could sell the shares of the REIT instead of selling the underlying real estate. A US purchaser of the REIT stock (other than a corporation that becomes an 80 percent shareholder of the REIT) could simply liquidate the

[44] Treas. reg. §1.1445-8(c). Code section 1445(e)(1) applies to distributions by domestic partnerships, trusts, and estates following a disposition of US real property. While a REIT is generally treated as a corporation for federal income tax purposes (and, in fact, may be formed as a corporation), the regulations are based on the premise that Treasury has the authority to treat REITs as trusts for purposes of section 1445(e), presumably on the reasoning that, since section 897(h)(1) effectively looks through the REIT to characterize the distribution to the shareholder, it is appropriate to treat the REIT as a passthrough entity for this purpose. See former Reg. §1.1445-5T(c)(4).

[45] The regulations reserve on the issue of how, if at all, the withholding tax applies to short-term capital gain from the disposition of a US real property interest.

[46] The treatment of REIT dividends is less favorable than the treatment of interest income earned directly by a non-US person from holding a real estate mortgage. Such interest could typically be structured to qualify for the " portfolio interest exemption" from US withholding tax if earned directly by a foreign person. See Code sections 871(h) and 881(c). Since REITs are not treated as true trusts but rather as corporations for US federal income tax purposes, the interest earned by a REIT does not retain its character when it is distributed to the REIT's shareholders, but is instead converted into an ordinary dividend subject to US withholding tax. Thus, REITs are not tax-efficient vehicles for investments by foreign persons in real estate mortgages and passthrough certificates.

[47] Note that any US tax that is imposed on the sale of non-exempt REIT shares should be treated as having a US source and should be creditable in Canada under Article 24(3) of the US-Canada income tax treaty.

[48] Since a REIT, unlike a regulated investment company, is not required to meet any diversification requirements, it is possible to use a separate REIT for individual real estate investments.

REIT immediately and obtain a fair market value basis in the real estate without paying any tax.[49]

A direct investor in real estate can generally obtain proceeds from a refinancing of the property without paying any current tax, even if the proceeds exceed the investor's basis in the property. Similarly, if the REIT refinances its real property, the proceeds can be distributed tax-free to the extent that they exceed the REIT's earnings and profits, provided that the investor's shares qualify as exempt REIT shares.

Operating Income[50]

While net rental income from directly held[51] US real estate would generally be subject to federal income taxation in the hands of a Canadian individual or corporate shareholder at ordinary maximum rates of up to 35 percent, operating income of a REIT will escape US taxation at the corporate level as long as the earnings are distributed to the REIT's shareholders.[52] Although ordinary dividends may be subject to US withholding tax, the withholding rate for Canadian individual investors who own less than 10 percent of the REIT is reduced from 30 percent to 15 percent, which should be fully creditable in Canada. Canadian corporate shareholders would suffer withholding tax at a 30 percent rate, but that is more favorable than the 35 percent US corporate tax rate that would otherwise apply to the net rental income, and the interposition of a REIT also enables the corporation to avoid the 5 percent branch profits tax that would otherwise apply under the US-Canada income tax treaty. Another important advantage of investing through a REIT is that, unlike a direct investor in US real estate, an investor who receives ordinary (as opposed to capital gain) dividends from a REIT will not be required to file a US federal income tax return as long as withholding taxes were properly withheld at source by the payer.[53] Like income derived from a direct investment in US real estate, the taxable income of a REIT is reduced by depreciation deductions and interest deductions on mortgages and other debt of the REIT. Thus, the US tax savings customarily realized by foreign investors in US real estate from such deductions may still be achieved by funding the REIT through a combination of debt and equity.[54]

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49 This result is achieved because, while the REIT recognizes gain on the liquidation under Code section 331, the REIT is able to claim a dividends-paid deduction for the liquidating distribution it makes to the shareholder. At the same time, in the hands of the shareholder the " dividend" is treated as a liquidating distribution by the REIT in exchange for the shareholder's stock (which has a basis equal to the net fair market value of the REIT's assets). However, if a corporation purchases 80 percent of the REIT's stock, the receipt of the liquidating distribution by the shareholder is treated as a taxable dividend under Code section 332(c) to the extent that the REIT claims a dividends-paid deduction for the distribution.

50 The comparison of the treatment of operating income of a REIT with operating income of directly held real estate applies equally to a REIT the shares of which are *not* exempt from FIRPTA.

51 This includes investments through partnerships or limited liability companies.

52 Rental income would theoretically be subject to a 30 percent gross US tax if the rental activity does not constitute a US trade or business. However, owners of rental real estate are normally advised to elect under Code section 871(d) or 882(d) to treat the rental income as effectively connected to a US trade or business, so that the income can be offset by deductions attributable to the activity. One effect of this election is to require that a US federal income return be filed with respect to the rental activity.

53 Treas. reg. sections 1.6012-1(b)(2) and 1.6012-2(g)(2).

54 One advantage of a REIT over a direct investment in US real estate is that its interest deductions are not subject to the allocation and apportionment rules that apply to interest deductions of foreign taxpayers. However, interest payments to Canadian taxpayers will be subject to a 10 percent US withholding tax under the US-

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For tax-exempt investors, such as pension funds and charities, the U.S.-Canada income tax treaty should exempt the dividends from US withholding tax, provided that the REIT is not a related person with respect to the tax-exempt entity.55 In contrast, income derived directly by a Canadian pension fund exempt investor from a US real estate operation would be subject to US taxation under the US-Canada income tax treaty. Such income would also be taxable to a Canadian charitable organization if the real estate operation constituted a trade or business.

Comparison with Investment Through a C Corporation

Foreign corporate investors often choose to make investments in US real estate through a US C corporation (that is, an ordinary non-REIT corporation). Assuming that the US corporation is a USRPHC, any gain on the sale of the stock by the Canadian shareholder (or gain resulting from a distribution of proceeds of a refinancing that exceeds the corporation's earnings and profits) will be subject to US taxation under FIRPTA. The only way to avoid this shareholder-level tax is for the US corporation to first dispose of the real estate in a fully taxable transaction. In contrast, in the case of exempt REIT shares, the shares can be disposed of free of US taxation even if the REIT still owns the real estate.

Gain on a sale of the real estate by the C corporation is subject to US taxation in the hands of the corporation at a 35 percent rate. Gain on the sale of real estate by a REIT will be subject to US tax in the hands of the shareholder upon distribution of the sale proceeds. However, such taxation can be avoided by the shareholder's selling the REIT shares prior to such distribution.

A C corporation that owns real estate pays US tax at a maximum marginal rate of 35 percent on its net rental income. Dividend distributions to Canadian corporate shareholders of the C corporation are subject to an additional US withholding tax, which under the US-Canada income tax treat is reduced to 5 percent for corporate shareholders that own at least 10 percent of the US corporation's stock (resulting in a combined corporate and shareholder tax rate of 38.25 percent) and to 15 percent for other qualifying shareholders. An investment made through a REIT eliminates the US corporate-level tax on net rental income, and while the 30 percent withholding rate on REIT dividends is higher than the withholding rate on ordinary subsidiary dividends, that rate still compares favorably with the combined corporate and shareholder rate of 38.25 percent for rental income of a C corporation distributed to a Canadian corporate shareholder.56

Investments in REITs by Canadian Real Estate Investment Trusts

A great deal has been written in the press recently regarding the use of Canadian income trusts (a form of mutual fund) as a vehicle to pool significant amounts of capital from Canadian individual investors to make acquisitions in the United States. The US investments are

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Canada income tax treaty unless the interest qualifies for the portfolio interest exemption. Generally this requires that the recipient of the interest own less than 10 percent of the REIT's voting power. Note that the availability of interest deductions is premised on any loans made to the REIT being respected as indebtedness for US federal income tax purposes. Note also that interest deductions may be limited by the earnings-stripping rules contained in Code section 163(j) and that other limitations on interest deductions could apply.

55 Article XXI(1), (2) and (3) of the US-Canada income tax treaty.

56 In addition, the US withholding tax should be creditable in Canada.

typically held through a US holding company, which is subject to US corporate-level tax. Various creative debt-financing structures are used to reduce US federal income and withholding taxes.57 The Canadian mutual fund trusts are entitled to claim a deduction for distributions for Canadian income tax purposes. Thus, these structures seek to allow the individual investors to receive the income from the underlying US investments with little or no entity-level taxation in the United States or Canada. At least one Canadian real estate investment trust has been formed to acquire a portfolio of US real property, but the authors are not aware of Canadian real estate investment trusts58 or other mutual fund trusts that have acquired material interests in REITs.59

A Canadian trust may be characterized for US tax purposes either as a business entity, which could be either a corporation or a partnership, or as a fixed investment trust. If the Canadian trust is a fixed investment trust, the owners of the trust will be treated as owning directly their proportionate shares of the trust's assets and earning directly any dividends or gains derived from those assets. A discussion of the rules applicable in determining the US tax characterization of an entity formed under foreign law is beyond the scope of this article. However, it should be noted that a Canadian trust can be structured to fit within any of these three classes of entities.

A Canadian real estate investment trust or other mutual fund (" a Canadian trust") may find an investment in exempt REIT shares very appealing. However, one significant issue is the imposition of US withholding taxes on dividends paid by the REIT. Whether or not the Canadian trust's unitholders are individuals, because the trust is the owner of the REIT shares the dividends will not be eligible for any treaty benefits and will be subject to the full 30 percent rate of US withholding tax. The trust itself is not eligible for the 15 percent rate, since that rate is available only to individuals.60 Regardless of how the Canadian trust is structured to qualify for US tax purposes, the unitholders should be eligible for a foreign tax credit in Canada, although this will not be helpful to tax-exempt unitholders.61

Some practitioners have argued that if a Canadian trust is structured to qualify for US tax purposes as an investment trust, the United States is required to afford treaty benefits to individual unitholders of the trust.62 However, this argument fails because under the section 894

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[57] One issue that has proved to be a difficult one for many such income trusts is the risk that debt issued by the US holding company to the Canadian trust will be recharacterized as equity.

[58] Unlike US REITs, Canadian real estate investment trusts are not subject to a separate tax regime, but rather are a subcategory of mutual fund trust.

[59] One fund has been formed to offer Canadian investors the opportunity to invest in a diversified portfolio of REITs, but the fund (USA REIT Fund LLC) was structured as a US regulated investment company. In addition, Trizec Hahn restructured its US real estate portfolio into a US publicly traded REIT owned, in part, by a Canadian mutual fund corporation.

[60] If the trust were treated as the beneficial owner of the dividends, it would apparently not be eligible to claim treaty benefits as an individual notwithstanding that trusts are generally taxed as individuals under both Canadian and US law. This conclusion is supported by the existence of a limited safe harbor in Article 10(7)(c) under which certain testamentary trusts receiving dividends from a REIT are treated as individuals.

[61] This is because a Canadian trust can designate a portion of its foreign source income as payable to its unitholders so that the unitholders can claim the foreign tax credit to offset Canadian tax.

[62] The IRS issued a pair of private rulings in which it concluded that dividends paid by a US corporation on shares held for the benefit of a foreign corporation in a grantor trust are treated for US tax purposes as beneficially owned by the foreign corporation and are eligible for the 5 percent reduced rate of withholding under an unidentified treaty, but those rulings predate the regulations under Code section 894 described in the text that

(continued)

regulations an owner of a Canadian entity (even if the entity is disregarded under US law) is treated for treaty purposes as deriving an item of income earned by the entity only if the owner is treated as having earned the income under the laws of Canada.63 Since mutual fund trusts are not fiscally transparent for Canadian tax purposes, it is the trust rather than the unitholders that will be treated as deriving the dividends under these regulations.64

Note that if an investment in a REIT were structured through a Canadian publicly traded limited partnership, then, assuming that the entity were also structured to qualify as a partnership for US tax purposes,65 dividends allocable to individual limited partners who indirectly own less than 10 percent of the REIT would arguably qualify for the 15 percent rate under the US-Canada income tax treaty.66 In contrast to the Canadian trust situation, here the Code section 894 regulations would treat the limited partners as the ones deriving the income for treaty purposes because the partnership is fiscally transparent for Canadian purposes. Similarly, dividends allocable to a limited partner that is a Canadian tax-exempt entity, such as a qualified pension plan, would arguably qualify for an exemption from US withholding tax under the US-Canada income tax treaty.67

follows. PLR 8516073. January 23, 1985 and PLR 8749069, September 10, 1987.

63 Treas. reg. 1.894-1(d). This rule is intended to deal with abuses involving situations in which the owners of a hybrid entity are not resident in the entity's country of residence, but the language of the rules is, on its face, not limited to such situations.

64 Treas. reg. sections 1.894-1(d)(3)(ii) and (iii). The fact that Canadian trusts can pass through income to their unitholders by paying dividends would not be sufficient to make them fiscally transparent for this purpose. There is an argument that even though Canadian law governs for purposes of determining initially who " derived the income" and thus whether the income is eligible for a claim of treaty benefits under Code section 894, once the treaty is determined to apply, US law governs for purposes of determining the " beneficial owner" of the income, which determines the nature of the relief available under the treaty. (The temporary regulations under section 894 that preceded the current regulations made it clear that the determination of the identity of the " beneficial owner" of an item of income under a treaty is separate from the determination of who is treated as " deriving the income" for purposes of section 894. Moreover, the preamble to the temporary regulations stated that the identity of the beneficial owner is determined under the law of the source country. However, the discussion in the preamble focuses on the distinction between legal ownership and economic ownership rather than fiscally transparent entities. The preamble also notes that the proposed regulations then in existence under Code section 1441 used the term " beneficial owner" to mean the person who is subject to tax on the income in the taxpayer's country of residence and is entitled to claim treaty benefits with respect to the income, but that the term actually has a different meaning when used in treaties, where it refers to the person who is subject to tax on the income under the law of the source country. The Treasury department technical explanation of the United States Model Income Tax Convention of September 20, 1996 states that the term " beneficial owner" means the person treated as owning the income under the law of the country of residence and relates this rule to the treatment of fiscally transparent entities under the model treaty, but the model treaty predates the temporary regulations under section 894, in which Treasury appears to have changed its view of the meaning of " beneficial owner/" There appears to be no authority to support this argument, however.

65 This would require qualifying under an exception to the rules in Code section 7704 that treat certain publicly traded partnerships as corporations for US tax purposes.

66 The issue would be whether the 10 percent test is applied at the partner level or the partnership level. See infra note 93.

67 Treaty benefits are not available under Article XXI of the US-Canada income tax treat if the recipient is related to the company paying the dividends. Whether the REIT would be considered to be related to the exempt limited partner for this purpose would arguably be determined at the owner level rather than at the trust level.

Interest Income

It is common for Canadian trusts investing in the United States to invest a portion of the required capital of the US business in the form of debt. The treatment of interest paid by a REIT to a Canadian trust should be the same as the treatment of interest paid to such an entity by any US C corporation. Assuming that the debt qualifies as indebtedness for US tax purposes (under general debt-equity characterization principles), interest paid to a Canadian trust that is treated as a corporation for US tax purposes will qualify for the portfolio interest exemption from US withholding tax if the Canadian trust owns less than 10 percent of the REIT's voting power. However, if the Canadian trust qualifies as a fixed investment trust (or, arguably, as a partnership),[68] the 10 percent voting power test should be applied at the unitholder level rather than the trust level.

Gain on Disposition

For a Canadian trust investing in a US real estate venture, FIRPTA may be avoided by structuring the investment through a domestically controlled REIT; the Canadian trust may acquire up to a 49 percent interest in the REIT, provided that the balance of the REIT's shares are owned by US persons. Alternatively, in the case of publicly traded REITs, FIRPTA may be avoided with respect to unitholders who, through the trust, own no more than 5 percent of the REIT if the Canadian trust qualifies as a fixed investment trust for US tax purposes (or, arguably, as a partnership). In such cases, the 5 percent test should be applied at the unitholder level. Thus, the trust itself could acquire a 100 percent interest in a publicly traded REIT and still avoid FIRPTA on a sale of the REIT shares if ownership of the trust were sufficiently dispersed.[69] For greater than 5 percent shareholders, however, not only would a sale of the REIT shares by the trust be taxable in the United States, but any sale of units in the Canadian trust would be treated as a taxable sale of the underlying shares in the REIT. If the unitholder were an individual, any gain subject to FIRPTA would be eligible for 15 percent long-term capital gain rates if the unitholder held the indirect interest in the REIT for more than one year.

In the event that the REIT planned to dispose of its US real property interests, the trust could avoid taxation of a distribution under Code section 897(h)(1) by selling its shares in the REIT before the dividend was declared.

US Return Filing Requirements

Non-US taxpayers that earn any income that is treated under FIRPTA as effectively connected to a US trade or business are required to file US federal income tax returns. If a Canadian trust that is treated as a corporation for US federal tax purposes invests in a REIT, whether or not the REIT shares are exempt REIT shares, the unitholders will not be treated as earning any US effectively connected income as a result of their investment in the trust and will not be required to file US income tax returns. However, if the Canadian trust is a fixed investment trust or a partnership for US tax purposes, the unitholders will be treated as receiving their proportionate share of any dividends or gains realized by the Canadian trust, and any

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[68] See 1994 FSA Lexis 430, which concludes that where the lender is a partnership, the 10 percent ownership test is applied at the partner level.

[69] As mentioned above, the five-or-fewer ownership test for REIT qualification looks through any shareholder that is an entity to its ultimate owners, and the 100 shareholder test can be satisfied with a special class of preferred stock.

FIRTPA gains earned by the trust will trigger a US return filing requirement for the unitholders. Further, any gain recognized by a unitholder on a sale of trust units will be subject to FIRPTA, unless the REIT shares held by the trust are exempt REIT shares. As discussed earlier, the trust may structure and manage its investments in REITs so as not to be subject to FIRPTA (by owning exempt REIT shares and avoiding taxable capital gain dividends). If the trust does not wish to be so limited, the Canadian trust should be structured so that it qualifies as a corporation for US tax purposes.70 However, this characterization will prevent any capital gain earned by the trust from qualifying for favorable individual long-term capital gain rates.

Canadian Tax Issues

A Canadian trust investing in a REIT also has to consider the Canadian tax aspects of such an investment. One point to note is that dividends from non-Canadian issuers are ineligible for the gross-up and dividend tax credit rules that apply to dividends paid by Canadian issuers. However, this limitation is not a real disadvantage in the case of an investment in a REIT, since REITs ordinarily distribute all of their taxable income and do not pay any corporate-level tax. A Canadian trust making an investment in a REIT also must consider the potential application of the Canadian foreign investment entity (FIE) rules.71 The FIE rules are unlikely to apply to an investment in a REIT either because the REIT's rental activities potentially qualify as an " exempt business" (if the REIT's properties are actively managed) or because the shares represent an " exempt interest." The latter exclusion is an exception for entities that distribute all of their income currently and are publicly traded.72 Note that an investment in a REIT would be treated as " foreign property" under Canada's Income Tax Act (Canada), RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as " the Act").

Proposed Legislation

As discussed above, Code section 897(h)(1) imposes a US tax on dividends paid by a REIT that are attributable to gains from the disposition of US real property interests. Section 897(h)(1) applies to a non-US shareholder holding shares of a REIT even if the shares are exempt REIT shares. The Real Estate Investment Trust Improvement Act of 2003, identical versions of which are pending in both the Senate and the House of Representatives,73 would amend section 897(h)(1) to provide that any distribution made by a REIT with respect to any class of stock that is regularly traded on an established securities market will not be treated as gain recognized from the sale or exchange of a US real property interest to the extent that the dividend is paid to a shareholder who does not own more than 5 percent of such class of shares. A similar provision appears in the Jumpstart Our Business Strength (JOBS) Act, which was

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[70] Alternatively, the investment could be held by the Canadian trust through a Canadian corporate subsidiary. However, such a subsidiary would be subject to Canadian income tax unless it had deductions to offset such income. Such deductions could be generated from interest expense if the subsidiary were funded with a sufficient amount of debt.

[71] The Canadian foreign accrual property income (FAPI) rules should not be implicated unless the REIT is a controlled affiliate of the Canadian trust, which should not be the case if the REIT is a domestically controlled REIT. Even if the REIT is a controlled affiliate of the Canadian trust, the FAPI rules should not be a major concern given that REITs can be expected to distribute the bulk of their income on a current basis.

[72] Paragraph 94.1(2)(n) of the Tax Act provides that an investment in a REIT is presumed not to have a tax-avoidance motive, provided that the taxpayer includes in its income for the year any net accounting income payable to the taxpayer.

[73] Supra note 29.

passed by the Senate on May 11, 2004.74 In a speech introducing the Senate version of this bill, Senator Orrin G. Hatch described the amendment as follows:

> Title II of the bill would modify [FIRPTA] to remove barriers to foreign investment in REITs. Today, there is very little foreign investment in REITs. We understand that U.S. money managers routinely receive assignments to place foreign investment capital in the United States under which they have complete discretion to invest in any U.S. stocks except REITs. The reason they are expressly told to avoid REITs is that under FIRPTA, foreign investors that receive capital gains distributions are treated as doing business in the United States.
>
> Title II would modify the FIRPTA rules so that a publicly traded REIT's payment of capital gains dividends to a foreign portfolio investor would no longer cause the REIT investor to be considered doing business in the United States. The effect of this would be to treat investments in REITs like investment in other corporations, and the provision would parallel current law governing a portfolio investor's sale of REIT stock.75

The amendment would in fact bring the treatment of investments by 5 percent or less non-US investors in publicly traded REITs into conformity with the treatment that would apply to an investment in a US corporation that is not a USRPHC. In both cases, the only US federal income tax that the investors need be concerned with is the withholding tax on dividends. The proposed amendment would make it possible for a Canadian trust that qualifies as a fixed investment trust (or, arguably, as a partnership) for US tax purposes to avoid FIRPTA not only on sales of publicly traded REIT shares, but also with respect to capital gain dividends, as long as no individual unitholder indirectly owned more than 5 percent of the REIT. The proposed amendment would not, however, treat all capital gain distributions by a REIT with respect to exempt REIT shares in the same manner as gain on the sale of the shares. A capital gain distribution with respect to stock of a non-public REIT would continue to be subject to US income tax on distributions attributable to capital gains of the REIT under section 897(h)(1), whether or not the gain earned by the shareholder directly from a disposition of the shareholder's shares would be taxable. Thus, section 897(h)(1) would still apply to privately held REIT's that are not USRPHCs or that rely on the domestically controlled exception to avoid FIRPTA.

Conclusion

A REIT can be a very tax-efficient vehicle for foreign investors seeking to acquire interests in US real estate. Institutional and other large investors may acquire significant stakes in US real estate by entering into a joint venture structured as a domestically controlled REIT. Sales of their interests in the REIT will not be subject to FIRPTA, and US taxation of distributions of capital gain proceeds under Code section 897(h)(1) can also be avoided by carefully managing the timing of distributions and sales of the REIT's assets. For individuals and other retail investors who own a 5 percent or less interest in a publicly traded REIT, gain on the sale of shares by shareholders will be tax-free. Avoiding capital gain distributions is likely to be more

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74 S. 1637, 108th Cong., 2d sess.

75 *Congressional Record*, August 1, 2003, S10918.

difficult, but individuals can benefit from reduced long-term capital gain rates that may be available for income from such distributions.

Canadian real estate investment trusts may be a good vehicle to bring the benefits of publicly traded and domestically controlled REITs to Canadian retail investors. Because such trusts can pool significant amounts of capital under the management of professional advisors, they may have better access to REIT management. Such access may enable the trust to influence management decisions regarding property sales by the REIT, and provide sufficient notice for the trust to be able to sell the REIT shares prior to distribution of the sale proceeds. However, dividends paid by a REIT to a Canadian trust will be subject to 30 percent US withholding tax. The proposed amendment to FIRPTA would eliminate US taxation of capital gain dividends in the case of a 5 percent or less investment in a publicly traded REIT. The amendment would be particularly helpful for Canadian trusts structured to qualify as fixed investment trusts, since the 5 percent would apply at the unitholder level. The prospects of passage of the proposed amendment are, however, unclear.