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AUTHOR: Howe, III, Joseph G.

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**THE AMERICAN BAR ASSOCIATION
Section of Taxation**

**The Real Estate Committee
REITS – Going Abroad and Other Timely Issues**

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STRUCTURING FOREIGN INVESTMENTS BY U.S. REITS

Presented by:

Joseph G. Howe III
Arnold & Porter, LLP
Joseph_Howe@aporter.com
(202) 942-5230

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OVERVIEW

- Foreign Investment by REITS
- Crafting Investment Structures
 - Host Country Considerations
 - US Tax Considerations
- Holding Company Regimes
- Representative Real Estate Investment Structures
 - United Kingdom
 - France
 - Russia
 - Germany

Foreign Investment by REITs

- While the IRS has confirmed that REITs can invest in real estate outside the United States, a REIT will confront certain structuring issues under the REIT gross income and assets tests when investing abroad.
- There is no specially crafted “foreign REIT subsidiary” structure.

Foreign Currency Gain and Losses

- Investment activities outside the United States will subject a REIT to gains and losses attributable to fluctuations in the relative values of the host country's currency when compared to the U.S. dollar.

Investment Through Pass-Through Entities

- A foreign exchange gain or loss may occur when the qualified business unit (“QBU”) distributes funds to the U.S. investor using a functional currency other than the U.S. dollar. Generally, the foreign currency gain would equal the difference between the value of the distributed funds and the value of such funds at the time they were earned by the QBU.
- Foreign currency gains may arise under section 988 if the investment vehicle undertakes certain customary activities, including borrowings denominated in the local currency or the accrual of expenses in the local currency with later payment.

- There is uncertainty as to the proper treatment of section 987 and 988 gains under the REIT gross income tests. This uncertainty has driven some REITs to either severely limit their foreign based activities, thus limiting their potential exposure to such income, or to use investment structures which mitigate the potential risks.

- Due to this uncertainty, NAREIT is and has been active in pursuing regulatory relief in the form of revenue procedures which would, to the extent that certain criteria pertaining to the underlying activities of the REIT are satisfied, either: (i) disregard foreign currency gains and losses; or (ii) treat such gains and losses as qualifying income. NAREIT's efforts are ongoing, and the Treasury Department and the IRS have included the above issues in their 2006-2007 Business Plan.

Investment Through a Taxable REIT Subsidiary (“TRS”)

- Indirect investment in real estate outside the United States through a TRS, with appropriate planning, may shield a REIT from foreign currency gains or losses by avoiding section 987 gains and by capturing section 988 gains within the TRS.

- Investment in foreign real estate through a TRS may subject the REIT to the anti-deferral rules governing the taxation of a passive foreign investment company (a “PFIC”) or a controlled foreign corporation (a “CFC”).
- These anti-deferral rules are extremely complicated, and are designed to limit potential tax deferral arrangements through the use of foreign corporations by U.S. taxpayers.
- There may be significant rewards for a REIT that carefully structures its operations to avoid these regimes.

Investment Through a Subsidiary REIT: The “For Ex REIT”

- A REIT can form a subsidiary REIT under U.S. law to conduct operations in a foreign jurisdiction through a “For Ex REIT.” A properly structured For Ex REIT can serve as a vehicle for direct or indirect investment in real estate outside the United States, and can shield the parent REIT from foreign currency gains under both sections 987 and 988.
- Each For Ex REIT must obtain a private letter ruling allowing the use of the foreign currency of the host country as its “functional currency.”

Advantages and Risks for the For Ex REIT

- The shares of the For Ex REIT are “good” REIT assets in the landing of the Parent REIT (not subject to the 20 percent limit on the value of TRS shares, the dividends paid by the For Ex REIT are included in the 75 percent income basket and the For Ex REIT is not subject to the TRS excise tax provisions for related party transactions).
- These risks and complexities include:
 - The necessity of the formation of a For Ex REIT for each foreign jurisdiction to facilitate the “functional currency” private letter rulings.
 - The potential formation of multiple For Ex REITs in a single jurisdiction to be used as a vehicle to “joint venture” different projects in a host country with multiple partners.

Advantages and Risks of the For Ex REIT (cont'd)

- The necessity of placing shares with at least 100 shareholders for each For Ex REIT, and the administrative aspects of servicing the same.
- Additional burdens under Sarbanes-Oxley.
- The requirement of REIT asset and income compliance at each For Ex REIT level.
- The increased complexity in the corporate structure at a time when the public capital market and analyst community strongly favors corporate transparency.

- Any failure of the For Ex REIT to satisfy the REIT qualification rules could potentially result in the parent REIT failing to satisfy an asset test because of the ownership of shares in the failed For Ex REIT
- For example, if a parent REIT forms a For Ex REIT to undertake a joint venture project in another country that is primarily managed and operated by the staff of the local “partner,” the potential risk of non-customary services being provided to the tenants, and a possible violation of the 1% percent basket for such services, is likely greater without extensive training and monitoring of the local staff.

Tax Deferral Opportunities and Tax Traps

The Deferral of U.S. Taxation

- Absent the application of an anti-deferral regime, a domestic corporation can achieve U.S. tax deferral with respect to its foreign activities by conducting its foreign operations through a foreign subsidiary or a holding company structure formed in a foreign jurisdiction.
- The foreign corporation is not brought into the U.S. tax net because of the TRS election. Accordingly, if the operations of the foreign TRS can be conducted in a tax efficient manner in the foreign jurisdiction, and at a marginal effective rate lower than the U.S. corporate tax rate, then the tax deferral may be more tax efficient than a domestic TRS from a “treasury” and “time value” perspective.
- The retained earnings of the foreign TRS would also be available to fund further operations abroad.
- However, the 20 percent value limitation on TRS securities must be carefully monitored when using the TRS structure to hold and expand foreign operations.

Anti-deferral Regimes

- The principal anti-deferral regimes which should be considered when conducting foreign operations through a TRS are: (i) the “subpart F” rules, found in sections 951 through 964; (ii) the passive foreign investment company rules, found in sections 1291 through 1298; and (iii) Section 1248.
- Generally, these regimes either deny tax deferral with respect to income, whether or not distributed, that is earned from certain “tainted” activities. Such a tax deferral is denied either by a current income inclusion or by punitive tax burdens when certain income is ultimately repatriated.

Subpart F Regime

- The subpart F regime should be considered if the REIT owns more than 50 percent of the vote or value attributable to the shares of a foreign TRS. The subpart F rules require the REIT to recognize a deemed dividend to the extent of certain tainted income, or if the foreign TRS invests its earnings in U.S. property.
- Certain categories of income which may otherwise be treated as “good” income under the REIT income tests may be treated as subpart F income without appropriate planning.

Subpart F: Deemed Dividends

- Assuming that the TRS is subject to the subpart F regime, a REIT will be required to recognize deemed dividend income under section 951 if the TRS earns subpart F income. Assuming there is no available exception or limitation, this will result in the income being included whether or not distributed as a dividend by the TRS, and such income must be taken into account for purposes of the 90 percent distribution requirement. There is some uncertainty as to whether such deemed dividends are treated as dividends for purposes of the REIT income trusts.
- Though the actual distribution of earnings that were previously included in income under subpart F as deemed dividends will not be subject to inclusion in income, the distribution may result in foreign currency exchange gains as an exception to the general protection provided by the TRS structure.

Subpart F: Active Rental Income Exceptions

- As a general rule, subpart F income includes interest, rents and royalties and capital gains realized on the disposition of assets that generate subpart F income.
- Rents derived from an unrelated person in the active conduct of a trade or business are excluded from subpart F income. To qualify as the active conduct of trade or business, the foreign corporation must derive the rents from leasing operations in which it regularly performs active and substantial management and operational functions through its own employees.
- Gains from the disposition of rental properties which generate active rental income are also exempt from Subpart F.

The Passive Foreign Investment Company Regime (“PFIC”)

- A U.S. investor may be subject to the PFIC provisions, another anti-deferral regime, if it owns a minority interest in a foreign corporation which is not a CFC.
- Generally, under section 1297(a), a foreign corporation will qualify as a PFIC if: (i) 75 percent or more of its gross income for the taxable year is passive income; or (ii) the average percentage of assets held by the corporation during the taxable year, which produce passive income or which are held for the production of passive income, is at least 50 percent.

- “Passive income” is defined under section 1297(b)(1) as any income which is of a kind which would be foreign personal holding company income under the subpart F rules.
- This would include rents which do not satisfy the active trade or business exception under subpart F. Accordingly, the same planning is needed to avoid the PFIC rules.

Foreign REITs

- Numerous foreign jurisdictions have enacted REIT or REIT-like legislation as part of the globalization of the REIT structure. U.S. REITs may consider foreign investment structures through these vehicles in the host country, and there may be tax efficiencies to such vehicles. However, for U.S. REIT asset testing purposes, shares in a REIT organized outside the United States are not “REIT shares” for REIT qualification purposes.

Host or Source Country Tax Considerations

Mitigation of Source Taxation:

- Income Tax on Rental Income and Disposition Gains
- Real Estate Transfer Taxes
 - Direct Transfers
 - Indirect Transfers
- Tax Deferred Transfers
 - Reinvestment Regimes
 - Reorganizations
- VAT
- Withholding Taxes on repatriation of cash flow and disposition proceeds
- Branch Profits Taxes
- Local and Trade Taxes
- Foreign Currency Gains and Losses

Tax Planning Opportunities for Mitigating Host Country Income Taxation

Limited Tax Treaty Relief

Base Erosion/Earnings Stripping

- Shareholder Leverage – Interest Deductions (tax treaty and domestic tax law relief from withholding)
- Depreciation
- License of Trademarks and Intellectual Property
- Management Fees – Head Office Charges
- Loss carry forwards
- Inter-group leverage

Tax Planning Opportunities for Mitigating Host Country Income Taxation (cont'd)

- Hybrid debt instruments
- Double-dip financing structures

Other Considerations

- Special VAT Elections
- Special structures to avoid local trade taxes by structuring service activities in separate vehicles

Tax Planning Tools for Tax Efficient Exits

- The tax planning tools include, but are not limited to, the following:
 - Tax exemptions under the domestic tax legislation of the host country for capital gains derived by nonresident taxpayers;
 - Exceptions under older tax treaties which exempt capital gains derived from the disposition of real estate that does not constitute a permanent establishment in the host country;
 - Indirect transfers of real estate investments by share transfers of real estate holding companies in host countries without Foreign Investment Real Property Tax Act (“FIRPTA”)-like legislation;
 - Indirect transfers by share transfers of real estate holding companies which benefit from tax treaty overrides of domestic tax law or FIRPTA-like legislation;

Holding Company Structures

- Due to the U.S. FIRPTA rules which impose U.S. taxation on the sale of shares of a U.S. Real Property Holding Company held by a nonresident alien or foreign corporation, most U.S. tax treaties with other countries include provisions allowing both contracting states to tax indirect transfers of real estate through share transfers of real estate companies
- However, many tax treaties between other countries (for example, Luxembourg – France) do not contain any special “FIRPTA” like provision and cede taxation on such transfers of shares to the resident country of the seller
- This creates an opportunity to sell the shares of the real estate site company without any host country taxation, and the gains from the disposition generally escape taxation in the holding company jurisdiction due to domestic law exemptions (for example, the participation exception)

Holding Company Structures (cont'd)

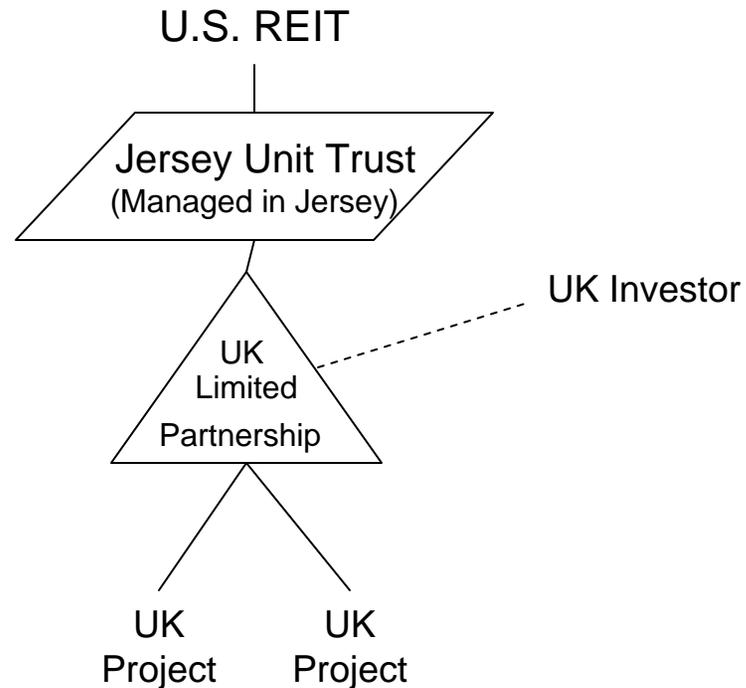
- Further, such treaties or EU Directives (in the case of European holding companies) will generally provide for reduced withholding taxes on dividends and interest
- Inbound tax planning structures often use intermediate holding companies in order to claim tax treaty benefits under the tax treaty network of the holding company country
- Substance requirements
 - Anti-avoidance rules
 - Refund procedure (testing mechanism)
 - Recent German rules

Representative Real Estate Investment Structures

- United Kingdom
- France
- Russia
- Germany

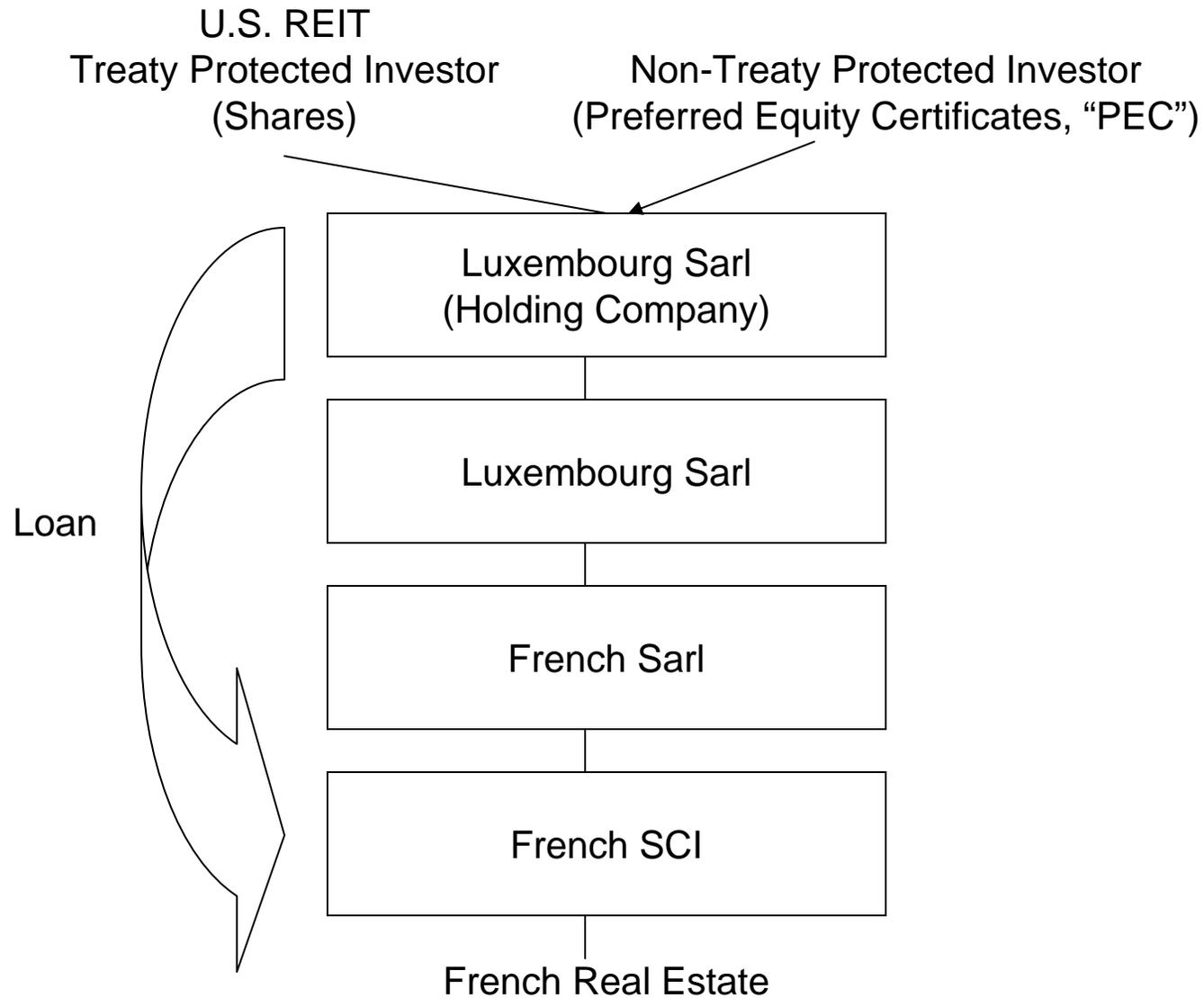
* All of these structures can either be structured with “check-the-box” elections to have pass-through treatment or tax deferral through foreign corporate structures

UNITED KINGDOM



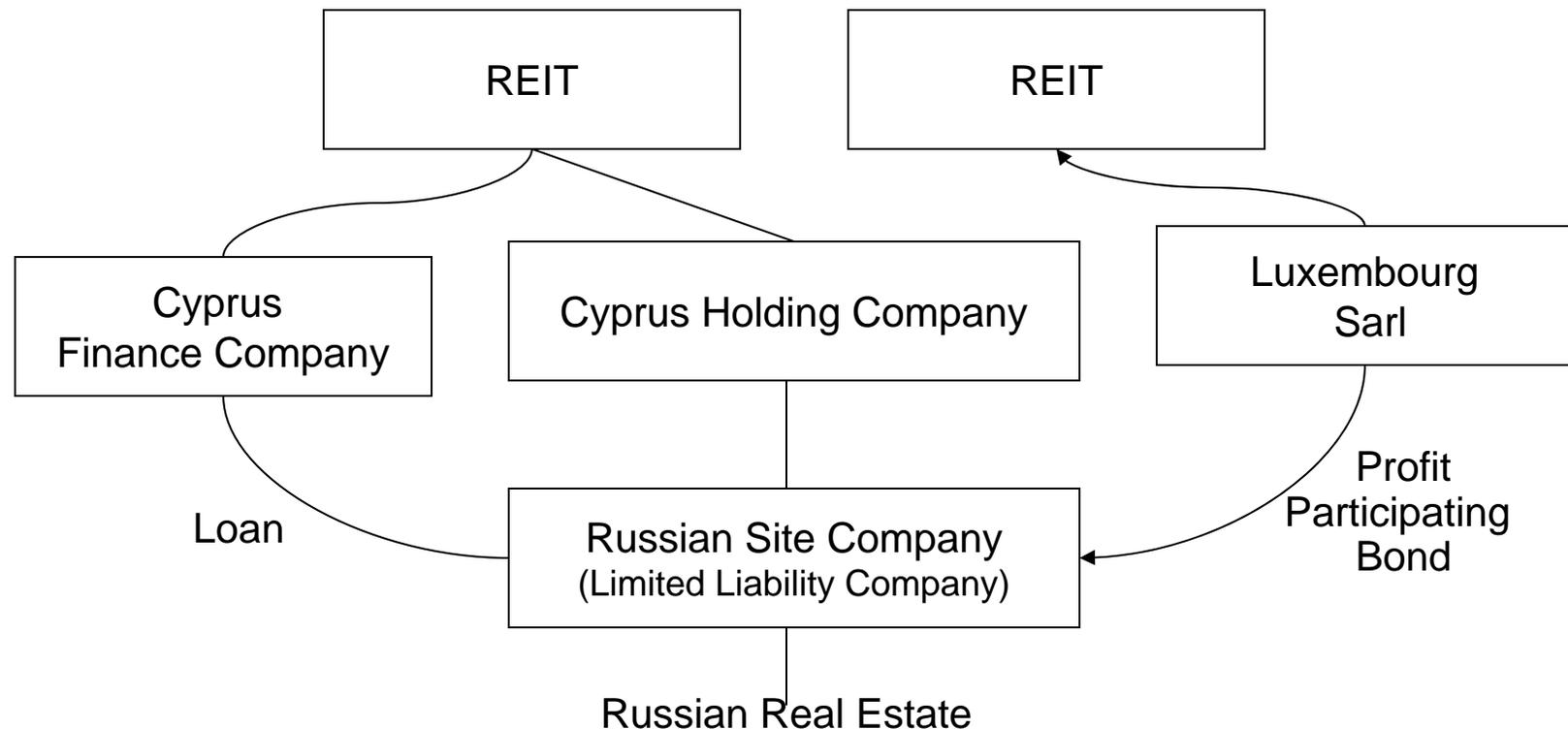
- UK domestic tax law exempts nonresident individuals and corporations from capital gains taxation
- Transfer of units in Jersey Unit Trust exempt from 4% stamp duty
- Base Erosion through leverage
- UK limited partnership allows joint venture with UK resident

FRANCE



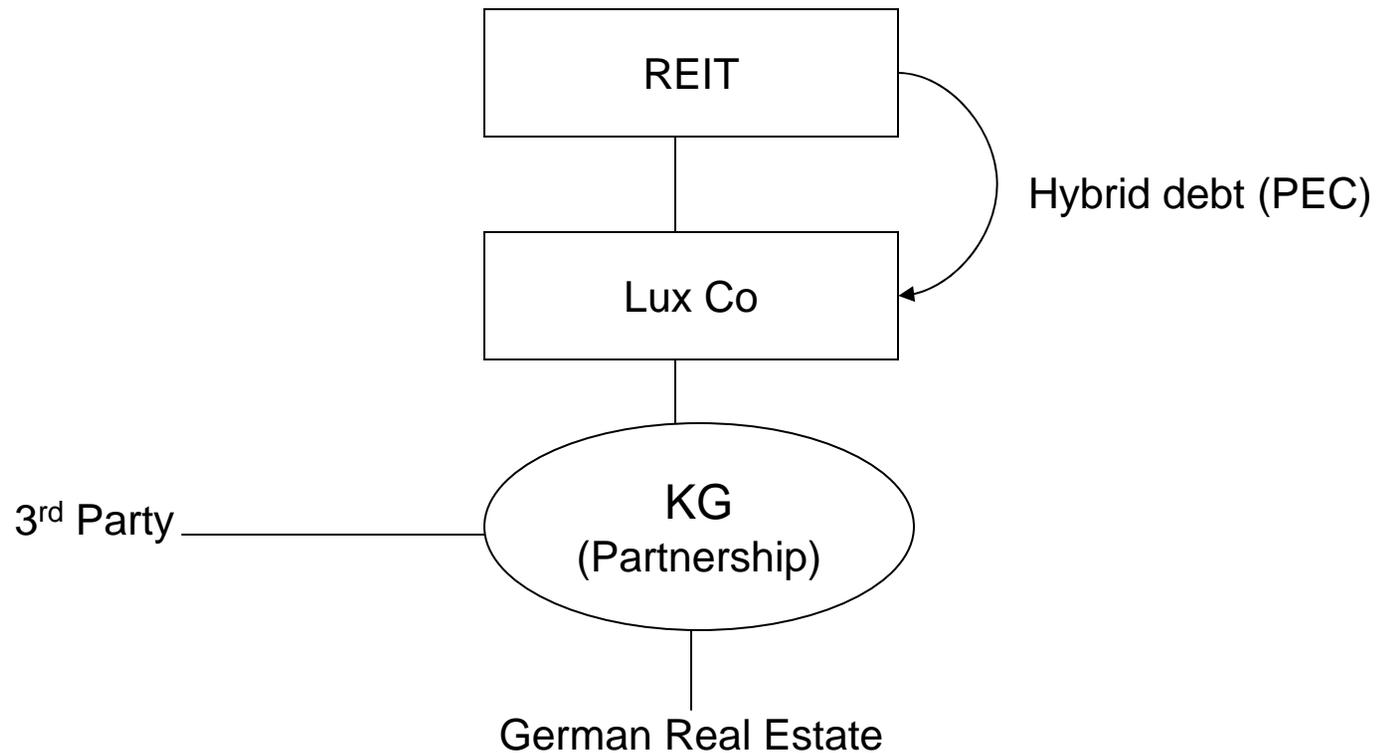
- Withholding on distributions from Luxembourg Sarl are reduced to under available tax treaties or EU Directives or as debt repayment on the PEC
- Dual Luxembourg Sarl allows for use of liquidation exemption from Luxembourg withholding taxes
- Luxembourg-French tax treaty cedes taxation on the disposal gains from the sale of the French Sarl to Luxembourg
- Alternatively, under French domestic law the French Sarl can sell the shares of the French SCI and pay tax at a reduced tax rate (16%) and the purchaser can claim a full loss step up
- Under French domestic tax law, there is no withholding on interest paid on qualified loans

RUSSIA



- EU investors in Cyprus Holding Company can claim benefits of EU Directives
- Reduced withholding (5%) on dividend distributions paid to Cyprus HoldCo
- Reduced withholding (0%) on interest paid to Cyprus FinCo
- Cyprus-Russian tax treaty overrides Russian domestic tax rules similar to US FIRPTA (and cedes taxation of share disposal to Cyprus)
- The Luxembourg Sarl investment through a profit participating bond is an example of a hybrid debt instrument – equity for Luxembourg tax purposes and debt for Russian tax purposes (exempt dividend income in Luxembourg and interest expense (0% withholding in Russia)

GERMANY



- Avoids local trade tax (15% - 19%)
- Possible mitigation of 3.5% Real Estate Transfer Tax
- Possible consolidation in Germany
- Possible exemption from capital gains taxation upon exit
- Alternative Structure: Head lease structure to avoid trade tax