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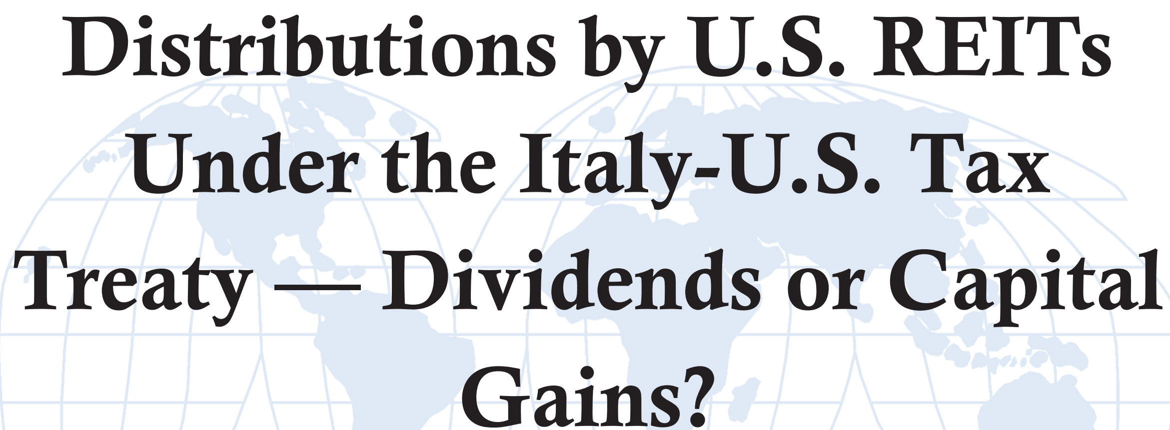

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by Alessandro-Adelchi Rossi

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PRACTITIONERS' CORNER

Distributions by U.S. REITs Under the Italy-U.S. Tax Treaty — Dividends or Capital Gains?

by Alessandro-Adelchi Rossi

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Cosmopolitan cities like New York and Miami have long been among the most sought-after destinations for Italian *pied-à-terre* hunters. But the trend is growing. Hordes of Italian homebuyers are now flocking to the United States to take advantage of the severe decline of the dollar against the euro, which has made U.S. homes more affordable. In spite of the tightened lending standards and the uncertain future of the U.S. currency, Italian investors are snapping up everything from studio apartments to entire high-rise buildings. And, at a time when problems in mortgage lending are keeping many Americans out of the market, U.S. real estate developers are enjoying the swarms of those shoppers from abroad.[1]

When structuring their purchases of U.S. real estate, Italian investors need to quantify and evaluate many factors, including federal, state, and local income and estate tax ramifications as well as privacy and liability issues. Although in any given case an issue may prove to be of particular importance, one consideration that typically plays a significant role in the planning of the investment is the Foreign Investment in Real Property Tax Act of 1980.

FIRPTA refers to the special rules provided under sections 897 and 1445 for the disposition of an investment in U.S. real property.[2] FIRPTA imposes a tax on any gain from the disposition of a U.S. real property interest (USRPI). In relevant part, a USRPI includes real estate located in the United States and stock in a domestic corporation that is a U.S. real property holding corporation (USRPHC). A USRPHC means any corporation if 50 percent or more of the fair market value of its assets are USRPIs.[3]

In some circumstances, the investment may be structured to enable foreign investors to avoid the FIRPTA tax. One such circumstance may occur when the investment is made through a real estate investment trust.

This article discusses the U.S. tax treatment of distributions received by a foreign shareholder from a U.S. REIT, the interaction of the FIRPTA rules with the Italy-U.S. income tax treaty currently in force (the 1984 treaty), and the position recently taken by the IRS on this matter.

U.S. Tax Treatment of REITs

Congress created REITs in 1960 to make investments in large-scale, income-producing real estate accessible to smaller investors. Congress decided that

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[1]This is a phenomenon that brings back memories of the late 1980s, when Japanese buyers single-handedly propped up a dead market — until they didn't, which made the ensuing drop all the more steep and painful. But that is another story.

[2]Unless otherwise stated, all section references are to the 1986 Internal Revenue Code, as amended, and the regulations issued thereunder.

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

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average investors could invest in large-scale commercial properties the same way they invest in other industries — through the purchase of equity. In the same way shareholders benefit by owning stocks of other corporations, the stockholders of a REIT earn a pro rata share of the economic benefits that are derived from the production of income through commercial real estate ownership. REITs offer distinct advantages for investors: greater diversification through investing in a portfolio of properties (rather than a single building) and management by experienced real estate professionals.

For many, REITS are an efficient way to invest in commercial and residential real estate businesses. As an investment, REITs combine the best features of real estate and stocks. They give an investor a practical and effective means to include professionally managed real estate in a diversified investment portfolio.

Despite the name ''real estate investment *trust*,'' for U.S. income tax purposes REITs are classified as corporations. The IRC provides that they must:

- have shares that are fully transferable;
- have a minimum of 100 beneficial owners;
- have no more than 50 percent of its shares held by five or fewer individuals during the last half of the taxable year;
- invest at least 75 percent of its total assets in real estate assets;
- derive at least 75 percent of its gross income from rents from real estate property or interest on mortgages on real property; and
- have no more than 20 percent of its assets consist of stocks in taxable REIT subsidiaries.[4]

There is no mandatory listing requirement. To qualify as a REIT, a company must distribute in the form of dividends at least 90 percent of its taxable income to its shareholders annually.[5] A company that qualifies as a REIT is permitted to deduct dividends paid to its shareholders from its corporate taxable income.[6] As a result, REITs that remit 100 percent of their taxable income to their shareholders should owe no corporate tax. Most states piggyback on the federal treatment. Like other businesses but unlike partnerships, a REIT cannot pass any tax losses through to its investors.

[4]Section 856(a) and (c).

[5]Section 857(a)(1). Because of this requirement, as investments, REITs tend to be among those companies paying the highest dividends.

[6]Section 857(b)(2)(B).

Taxation of REIT Shareholders

REIT shareholders are generally taxed in the same way as shareholders in other corporations; their gross incomes include dividends and gains on sales of their shares. A REIT shareholder must include dividends from the REIT in his gross income.

However, a capital gains dividend is included as long-term capital gain.[7] A capital gain dividend is a dividend, or a portion of a dividend, attributable to gain from the sale of a USRPI that is so designated in a notice mailed to shareholders with the REIT's annual report for the year or, if not included with the annual report, within 30 days after the close of the REIT's taxable year.[8]

In May 2003 the U.S. Congress passed the Jobs and Growth Tax Relief Reconciliation Act, which cut income tax rates on qualified dividends and capital gains to a 15 percent maximum. Under that act, however, dividends from REITs are excluded from the definition of qualified dividend income and are ineligible for the 15 percent rate. REITs by definition must pay out at least 90 percent of their taxable income to shareholders and receive a dividends paid deduction for this amount. This combined effect allows a REIT to bypass the corporate tax.

Because REITs generally do not pay corporate taxes, most REIT dividends continue to be taxed as ordinary income at rates up to 35 percent.

Accordingly, because REITs generally do not pay corporate taxes, most REIT dividends continue to be taxed as ordinary income at rates up to 35 percent. The 15 percent rate will, however, apply to REIT capital gains distributions and REIT dividends attributable to dividends received by REITs from non-REIT corporations.[9] Also, the maximum 15 percent capital gains rate applies generally to the sale of REIT stock.

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

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

[9]Section 857(c)(2)(A) and (B). Typically, a REIT will not have much qualified dividend income, since REITs are required to invest primarily in real estate assets rather than in corporate stock.

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FIRPTA Rules and U.S. REITs

As indicated above, under the FIRPTA provisions, special rules apply for the disposition of an investment in a USRPHC. Because for U.S. tax purposes REITs are treated as corporations, typically REITs are USRPHCs.

An exception, however, is provided for stock in a domestically controlled REIT,[10] which is not considered a USRPI.[11] It follows that a sale or exchange of that stock is not subject to tax in the United States under FIRPTA.

However, a REIT — whether or not domestically controlled — is generally subject to FIRPTA if it pays capital gains dividends to a foreign person.[12] Those capital gains distributions to foreign shareholders are subject to a 35 percent withholding tax.[13]

For a foreign shareholder holding 5 percent or less of a listed REIT's shares, however, the capital gain will be treated as an ordinary dividend rather than as a capital gains dividend.

Therefore, while a foreign investor may avoid U.S. tax when disposing of the stock in a REIT, the foreign investor would be subject to the FIRPTA tax when receiving a capital gains dividend from the REIT.

FIRPTA Rules and the Treaty

Nothing in the 1984 treaty makes any distinction between ordinary REIT dividends and capital gains dividends. In fact, article 10 (dividends) of the 1984 treaty is silent altogether about REIT dividends.

The Italy-U.S. tax treaty and protocol signed on August 25, 1999 (the 1999 treaty), added language in article 10 to address REIT dividends.[14] Also, the U.S. Treasury Department technical explanation accompanying the 1999 treaty addresses the issue of capital gains dividends by stating, in the discussion of article 13 (capital gains), that in applying paragraph 1 the United States will look through distributions made by a REIT. Paragraph 1 of article 13 provides that gains derived by a resident of a contracting state from the alienation of immovable property situated in the other contracting state may be taxed in that other state. As a result, distributions made by a REIT are taxable under paragraph 1 of article 13 and not under article 10 when they are attributable to gains derived from the alienation of real property. In other words, the U.S. position under the 1999 treaty is that section 897(h)(1) distributions are governed by the capital gains article and not the dividends article, although the U.S. Treasury Department technical explanation does not mention this fact in the dividends article discussion.

However, the 1999 treaty is still pending. Therefore, the 1984 treaty, which may help Italian residents who place their U.S. real property in a REIT to reduce the tax burden otherwise imposed under section 897(h)(1) on direct real estate investments, is still valid.

Accordingly, consider the relationship between section 897(h)(1) and the 1984 treaty. Under the later-in-time rule,[15] the 1984 treaty overrides section 897(h)(1), which was enacted in 1980.[16] Thus, an Italian resident shareholder of a REIT may take the position that distributions of section 897(h)(1) capital gains dividends are dividends rather than gains from the disposition of property for treaty purposes and that those distributions are therefore eligible for reduced withholding under the dividend article of the 1984 treaty.

Nevertheless, the United States is of the view that — for treaties that have been ratified after the 1980 enactment of FIRPTA — a treaty provision permitting it to tax gains from the disposition of a USRPI also authorizes it to tax capital gain dividends without limitation, and is also of the view that capital gains dividends are not governed by the dividends article.[17]

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[10]Under section 897(h)(4)(B), a REIT is domestically controlled if foreign persons hold, directly or indirectly, less than 50 percent in value of the stock.

[11]Section 897(h)(2).

[12]Section 897(h)(1).

[13]*See* reg. section 1.1445-8(c)(2)(i).

[14]Article 10(9) of the 1999 treaty limits the U.S. tax on dividends paid by a REIT to a reduced 15 percent rate when one of the following three tests is satisfied: 1) the beneficial owner is an individual resident of Italy who holds an interest of not more than 10 percent in the REIT; 2) the dividend is paid for a class of stock that is publicly traded and the beneficial owner of the dividends is a person holding an interest of not more than 5 percent of any class of the REIT's stock; or 3) the beneficial owner of the dividend is a person holding an interest of not more than 10 percent of the REIT and the REIT is diversified (for this purpose, a REIT will be considered diversified if the value of no single interest in the REIT's real property exceeds 10 percent of the REIT's total interests in real property).

[15]Section 7852(d)(1) provides that neither a treaty provision nor a statutory provision has a preferential status merely by reason of its being a treaty or a statute. Thus, in the United States, when a statute and a treaty provision conflict, the one later in time will generally trump the earlier provision. *See Lindsey v. Commissioner*, 98 T.C. 672 (1992); *Jamieson v. Commissioner*, T.C. Memo. 1995-550. However, if there is no conflict between the two, then the code and the treaty should be read harmoniously, to give effect to each. *See Xerox Corp. v. United States*, 41 F.3d 647, 658 [74 AFTR 2d 94-7097]. *See also* section 894(a)(1), under which code provisions are to be applied to any taxpayer with ''due regard'' to any U.S. treaty obligation.

[16]Conversely, there is no conflict between the statute and the 1984 treaty on the application of the FIRPTA tax to the gains from the disposal of a U.S. real property interest. *See* the protocol article of the 1984 treaty.

[17]*See, e.g.,* the Treasury Department technical explanation to the 1999 treaty and the Treasury Department technical explanation to the Netherlands-U.S. treaty and 1993 protocol thereto. For Japan, the U.S. position has been incorporated into the

(Footnote continued on next page.)

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Article 1(11) of the protocol to the 1984 treaty makes clear that for purposes of paragraph 1 of article 13 (capital gains), the term ''immovable property,'' for the United States, includes a USRPI. Like all U.S. and Italian treaties, the 1984 treaty allows the source country to define the terms used therein. As discussed above, under U.S. domestic laws, in relevant part a USRPI includes real estate located in the United States and stock in a domestic corporation that is a USRPHC.

Because the 1984 treaty permits taxation of gains from the disposition of USRPIs, it follows that the U.S. position is that the 1984 treaty also authorizes the taxation of capital gains dividends.

The question then becomes whether section 897(h)(1) can be interpreted to construct a sale of a USRPI and, therefore, whether the term ''United States personal property interest'' as used in article 13 of the 1984 treaty and protocol can be interpreted to include a section 897(h)(1) distribution. In absence of an explicit rule in the 1984 treaty and protocol or of a statement in the technical explanation, and considering that a REIT distribution is clearly a dividend as defined in article 10 of the 1984 treaty,[18] there is considerable uncertainty surrounding the U.S. view, particularly — as noted by one author — because this view is not backed up by regulations.[19]

Recent IRS Guidance

In Notice 2007-55, 2007-27 IRB 1, the IRS announced that it intends to issue regulations that will clarify the correct interpretation of section 897(h)(1). The regulations will clarify that, when applicable, those distributions are treated and taxed as gain attributable to the alienation of a USRPI under the capital gains articles of U.S. income tax treaties.

The notice does not explicitly state, as it does for positions taken by a foreign government under section 892, that the IRS will challenge taxpayers who take the position that a section 897(h)(1) distribution is treated as a dividend under a treaty.

Conclusions

Italian shareholders of a REIT may take a treaty-based position that capital gains distributions are treated as dividends rather than gains from the disposition of property and therefore eligible for reduced withholding under the dividend article of the 1984 treaty, significantly reducing the U.S. tax withholding that otherwise could be imposed if no exception applies.

However, those investors should be aware that not only the IRS but also the U.S. courts tend to interpret tax treaties more as statutes than contracts and therefore to give undue weight to unilateral interpretive materials, underemphasizing materials that reflect the views of both countries.

Therefore, Italian investors in a U.S. REIT may have to await the promulgation of regulations to see if the regulations shed more light on the interaction of the FIRPTA rules and the 1984 treaty. ◆

Japan-U.S. income tax treaty by virtue of article 9 of the 2003 protocol, signed November 6, 2003.

[18] *See* Kimberly S. Blanchard, ''Is There a FIRPTA Tax on REIT Distributions?'' *Tax Notes Int'l*, Oct. 16, 2006, p. 223, *Doc 2006-18589*, or *2006 WTD 203-6*. The author also notes that, for withholding on capital gain dividends made by a REIT, the regulations under section 1445 do not adopt the passthrough approach seemingly applied by the United States for treaty purposes.

[19] *Id.*

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