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VENTURES WITH TAX-EXEMPT AND FOREIGN INVESTORS

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More and more frequently, U.S. real estate companies are raising capital from tax-exempt institutions and non-U.S. investors. In order to raise this capital, it is almost always necessary for the U.S. company and its advisors to have a working knowledge of the U.S. tax issues that are important to these investors. This outline will discuss some of the most frequently encountered of these issues.

I. FOREIGN INVESTOR/FOREIGN JV ISSUES

A. U.S. Trade or Business

1. Effectively Connected Income

a. A non-U.S. investor is subject to U.S. tax on U.S. source income that is effectively connected with the conduct of a trade or business in the U.S. ("ECI"). See Sections 871(b) and 882(a). ¹ (For foreign persons eligible to claim treaty benefits, the income generally must be "attributable to" a U.S. "permanent establishment.") If a partnership is engaged in a U.S. trade or business, each foreign partner, including a limited partner, is deemed to be engaged in that trade or business. See Section 875(1).

b. Tax on ECI is imposed on a net basis, just as with a U.S. person. Sections 1445 and 1446 impose a withholding regime, but amounts withheld are merely credited against the actual amount of tax ultimately shown on the non-U.S. person's U.S. income tax return.

c. Absent treaty protection, foreign corporations also bear a 30% branch profits tax imposed by Section 884 (subject to reduction by treaty) on deemed repatriations of ECI from the U.S. to the foreign jurisdiction. Thus, foreign corporations may bear effective U.S. tax on ECI at a combined federal rate of as much as 54.5%.

d. A U.S. partnership that has ECI must withhold on its foreign investors' shares of such ECI, even if it does not make distributions, as discussed below.

2. Tax Reporting/Filings

a. A non-U.S. person who is engaged in a U.S. trade or business (or is deemed so engaged pursuant to Sections 875(1) or 897) must file a U.S. income tax return on Form 1040NR (for a nonresident individual) or Form 1120F (for a foreign corporation). Treas. Reg. §§ 1.6012-

¹ All references to a "Section" herein are to a section of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

* We would like to acknowledge contributions to this paper from our King & Spalding colleague, Peter Genz.
This filing requirement applies even if the non-U.S. person has no ECI or other U.S. source income.

b. Failure by a non-U.S. person to file a “true and accurate return” may result in the denial of all otherwise allowable deductions. See Sections 874(a) and 882(c)(2). Although the regulations require a non-U.S. person to “timely” file a return in order to avail itself of otherwise allowable deductions, the Tax Court recently held that the regulations were invalid as applied to a case in which a foreign corporation filed its tax returns before the Service became aware of the corporation’s failure to file. See Treas. Reg. §§ 1.874-1(a), (b); 1.882-4(a); Swallows Holding, Ltd. v. Commissioner, 126 T.C. 96 (2006). The majority opinion inspired three dissents admonishing the majority for not applying Chevron deference to the regulatory interpretation of Section 882.

B. FIRPTA

1. General Rules

a. Under Section 897(a), as enacted by the Foreign Investors in Real Property Tax Act of 1980 (“FIRPTA”), gain or loss of a nonresident alien individual or foreign corporation from the disposition of a United States real property interest (“USRPI”) is taken into account “as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with such trade or business.”

b. The term USRPI is defined by Section 897(c)(1)(A) to mean: (i) a direct interest in U.S. real property, and (ii) any interest (other than solely as a creditor) in a domestic corporation unless the taxpayer establishes (at such time and in such manner as the Secretary by regulations prescribes) that such corporation was at no time a “U.S. real property holding corporation” (“USRPHC”) during the shorter of (i) the five-year period ending on the date of disposition of the interest, or (ii) the taxpayer’s holding period for the interest.

c. Interests in partnerships generally are not considered USRPIs. However, under a look-through rule under Section 897(g), consideration received by a nonresident alien individual or nonresident corporation in exchange for all or part of a partnership interest is, to the extent attributable to USRPIs, considered an amount realized from the sale or exchange in the United States of such property.

2. Real Property Holding Companies

a. Under Section 897(c)(2), a domestic corporation qualifies as a USRPHC if, on any applicable testing date, the fair market value of its USRPIs equals or exceeds 50% of the value of its USRPIs, foreign real estate, and assets used or held for use in a trade or business. Because real estate investment trusts (“REITs”) are required to hold primarily real estate interests, they generally are classified as USRPHCs unless they are mortgage REITs.

b. There are several exceptions to the general rule that stock of a USRPHC (or former USRPHC) is treated as a USRPI.

(1) Domestically Controlled REIT Exception. Section 897(h)(2) provides that shares of a “qualified investment entity” (“QIE”) that is “domestically controlled” are not treated as USRPIs. A QIE includes any domestically controlled REIT that is classified as a USRPHC. See Section 897(h)(4)(A). A domestically controlled REIT is one in which non-U.S. persons have owned, directly or indirectly, less than 50% of the value of the REIT’s stock at all times during a
prescribed testing period. Section 856(h)(4)(B). That period is generally the lesser of the five-year period ending on the date of the disposition of the shares or the period during which the REIT has been in existence. Section 856(h)(4)(D). This exception applies to both public and private REITs.

(2) Publicly Traded Exception. Under Section 897(c)(3), the shares of a USRPHC are not treated as USRPIs if (i) they are regularly traded on an established securities market (including a foreign exchange that meets certain conditions) and (ii) the non-U.S. shareholder in question held (actually or constructively) no more than 5% of the publicly traded shares during the shorter of the five-year period ending on the date of the disposition or the shareholder's holding period. Section 897(c)(3) and (c)(6)(C).

(3) Cleansing Exception. Under Section 897(c)(1)(B) (the “Cleansing Exception”), interests in a USRPHC cease to be USRPIs on the first date on which (i) the corporation does not hold any USRPIs, and (ii) all of the USRPIs held by such corporation at any time during the previous five years were disposed of in transactions “in which the full amount of gain (if any) was recognized.” Note that the Cleansing Exception only requires gain to be “recognized”--it does not require that the gain be “subject to tax” at the entity level. Thus, the Cleansing Exception should be available to REITs, despite the fact that REIT taxable income is typically reduced to zero through the dividends paid deduction.

3. Application to REIT Distributions

a. General Treatment of REIT Distributions to Non-U.S. Shareholders

(1) Ordinary dividends paid by a REIT to a non-U.S. person are subject to a 30% U.S. withholding tax except to the extent that (i) an applicable tax treaty lowers the withholding rate, (ii) in the case of a non-U.S. governmental investor, Section 892 applies to exempt the dividends from withholding tax, or (iii) the dividends are attributable to gain from the sale of USRPIs, in which case they are taxed as income effectively connected with a U.S. trade or business under FIRPTA, as discussed below. Many tax treaties reduce the withholding tax on dividends paid by a REIT.

(2) Dividends designated by a REIT as “capital gain dividends,” as defined in Section 857(b)(3)(C), are taxed to its shareholders as “gain from the sale or exchange of a capital asset held for more than 1 year” under Section 857(b)(3)(B) and not as ordinary income. Note that capital gain dividends are not treated as gain from the sale of REIT shares; rather, the dividend is simply treated as “gain from the sale or exchange of a capital asset.” Thus, absent Section 897(h)(1) (discussed below), capital gain dividends would not be subject to tax under FIRPTA, even if the REIT’s shares constitute a USRPI. Instead, they would ordinarily be tax free to a non-U.S. investor -- i.e., neither subject to the 30% U.S. gross basis tax under Sections 871(a)(1) or 881(a) nor the graduated rate tax imposed on ECI. See generally Section 865 (capital gain recognized by a non-U.S. person on the sale of personal property is generally sourced to the person’s country of residence and does not constitute U.S. source income).

b. Special Rule for REIT Distributions Attributable to USRPI Gains

(1) Section 897(h)(1) provides that “[a]ny distribution” by a QIE to a nonresident alien individual, a foreign corporation, or other QIE will be treated as gain recognized by the nonresident alien, foreign corporation, or QIE from the sale of a USRPI “to the extent attributable to gain from sales or exchanges by the [QIE] of United States real property interests.” (Emphasis added; for convenience, such distributions are referred to as “FIRPTA Distributions.”)
A non-U.S. investor receiving a FIRPTA Distribution is subject to regular income tax at graduated rates on such gain and is required to file a U.S. federal income tax return.

A foreign corporation receiving a FIRPTA Distribution (including a foreign government treated as a corporation under Section 892(a)(3)) is also subject to the branch profits tax imposed by Section 884, except to the extent the branch tax rate is reduced by an applicable tax treaty or the corporation complies with the demanding requirements of the “branch termination exception” for the year of the distribution. See Treas. Reg. § 1.884-1(d)(2)(xi), Example (4). By contrast, gain from the sale of USRPHC stock, including REIT stock, is not subject to the branch profits tax. Section 884(d)(2)(C); Treas. Reg. § 1.884-1(f)(2)(iii). From a policy standpoint, it is not clear why gain on an actual or deemed sale of foreign controlled REIT shares (taxable under FIRPTA) is excluded from the branch tax, while FIRPTA Distributions are not.

The FIRPTA Distribution rule does not apply to distributions to a nonresident alien or foreign corporation with respect to any class of stock which is regularly traded on an established securities market located in the United States if the non-U.S. investor did not hold more than 5% of the class of stock at any time during the one-year period ending on the date of distribution. Section 897(h)(1) (second sentence). Section 857(b)(3)(F) provides that, in the case of a non-U.S. shareholder to which Section 897(h)(1) does not apply by reason of the 5% exception, “the amount which would be included in computing long-term capital gains for such shareholder under [Sections 857(b)(3)(B) or (D)]” is included in the shareholder’s gross income as a dividend from the REIT rather than as long-term capital gain, and thus is subject to the 30% U.S. withholding tax (or lower treaty rate).

Section 897(h)(1) applies to distributions by domestically controlled REITs.

Section 897(h)(5) contains a wash sale rule designed to prevent foreign taxpayers from avoiding tax on FIRPTA Distributions paid by domestically controlled REITs by selling their REIT shares shortly before the ex-dividend date of a distribution and then reacquiring shares in the REIT shortly thereafter. See generally Section 897(h)(5)(A).

It has long been debated whether Section 897(h)(1) applied to distributions made by a liquidating REIT and what the consequences were to non-U.S. shareholders, particularly foreign governments. The Internal Revenue Service (the “Service”) formally announced its position on this issue in IRS Notice 2007-55, which states that regulations will clarify that the term “distribution,” as used in Sections 897(h)(1) and 1445(e)(6), includes any distribution described in Sections 301, 302, 331, and 332 where the distribution is attributable, in whole or in part, to gain from the sale of a USRPI by the REIT or other pass-through entity.

These regulations will apply to distributions occurring on or after June 13, 2007. The Notice warns that, for pre-effective date distributions, the IRS will challenge under current statutory and regulatory provisions an assertion by any foreign taxpayer that Section 897(h)(1) does not apply to distributions in complete liquidation under Sections 331 and 332.

The Notice also states that the regulations will provide that a foreign government’s FIRPTA Distributions will be treated, for purposes of Section 892, as gain from the disposition of a USRPI described in Section 897(c)(1)(A)(i) (and not as income or gain from stock). Thus, in the Service’s view a foreign government is subject to FIRPTA tax on Section 897(h)(1) distributions notwithstanding Section 892 (discussed below).
(8) Notice 2007-55 leaves a host of unanswered technical questions that presumably will be dealt with in regulations. See Section of Taxation, American Bar Association, Request for Guidance on Certain Tax Issues Arising in REIT Liquidations, Including Issues Relating to Notice 2007-44, reprinted in 2008 TNT 114-23. In the meantime, taxpayers are left with no guidance on how to answer these questions.

4. Contingent Debt

a. Although most debt obligations do not constitute FIRPTA assets, any loan that includes a right to share in the appreciation of real property (commonly referred to as an “equity kicker”) constitutes a USRPI. See Treas. Reg. § 1.897-1(d)(2)(i).

b. Even though an equity kicker loan is a USRPI, all payments made pursuant to the terms of the loan that constitute interest for federal income tax purposes are treated as interest and therefore are not subject to tax under FIRPTA. See Treas. Reg. § 1.897-1(h), Example 2. In other words, the fact that an equity kicker is a USRPI is relevant from a FIRPTA perspective only if and when the note is sold to a third party.

c. Debt obligations with equity kickers offer a potential planning opportunity under FIRPTA, provided that the debt holder qualifies for treaty benefits or another exception from the general 30% U.S. withholding tax on interest payments. See Part III.A.2 for a discussion of the “portfolio interest” exemption to the withholding tax on interest. However, taxpayers must be careful to ensure that the equity kicker indeed qualifies as interest and is not recharacterized as a partnership for tax purposes.

5. FIRPTA Withholding

a. Generally

(1) Section 1445(a) generally requires a transferee to withhold 10% of the amount realized on any disposition of a USRPI by a foreign person.

(2) Note, however, that no withholding under FIRPTA is required on the disposition of a class of stock that is regularly traded on an established securities market. See Section 1445(b)(6). This rule applies even if the seller owns more than 5% of the shares, although a substantive tax liability would still be imposed under Section 897.

b. Dispositions of Partnership Interests

(1) Section 1445(e)(5) provides that, to the extent provided in regulations, the transferee of a partnership interest is required to withhold 10% of the amount realized on the disposition.

(2) Pursuant to Treas. Reg. § 1.1445-11T(d), a purchaser of a partnership interest from a foreign seller is required to withhold under Section 1445(e)(5) only if 50% or more of the partnership’s gross assets are USRPIs and 90% or more of its gross assets are made up of USRPIs, cash, and cash equivalents (the “50/90 test”). Treas. Reg. § 1.1445-11T(d).

(3) How these provisions apply to a distribution in partial redemption of a partner’s interest in a partnership is not entirely clear. Withholding under Section 1445(e)(5) is required on any "disposition" of a partnership interest to the extent the 50/90 test is met.
Treas. Reg. § 1.897-1(g) defines a disposition for purposes of both Sections 897 and 1445 as “any transfer that would constitute a disposition by the transferor for any purpose of the Internal Revenue Code and regulations thereunder.” An argument can be made, and we believe the better view is, that Section 731 provides that there is no disposition for tax purposes until the distribution exceeds basis, and therefore no withholding is required by a partnership on a distribution in partial redemption of a foreign partner’s partnership interest until the distribution exceeds the distributee’s basis in its interest. On the other hand, Section 897(e) states that nonrecognition provisions generally do not apply for purposes of Section 897 unless a USRPI is exchanged for another USRPI. One could argue, therefore, that Section 731 does not apply in this context, in which case Section 897(g) would treat such a transaction as a partial disposition of a partnership interest that is subject to withholding.

c. Application to REIT Distributions

(1) Prior to the enactment of the Tax Increase Prevention and Reconciliation Act of 2005 (“TIPRA”), withholding against FIRPTA Distributions was required, not by any provision of Section 1445, but by Treas. Reg. § 1.1445-8—a regulation that was stated to be issued under the authority of Section 1445(e)(1), notwithstanding that such provision refers only to partnerships, trusts, and estates. Given the absence of any authority interpreting Section 897(h)(1), this regulation not only has guided withholding agents, but has also provided de facto guidance to non-U.S. taxpayers in determining their substantive FIRPTA tax liability.

(2) New Section 1445(e)(6) (as enacted by TIPRA) provides that if any portion of a REIT distribution to a nonresident alien individual or foreign corporation is treated under Section 897(h)(1) as gain from the sale or exchange of a USRPI, the REIT must withhold 35% (or, to the extent provided in regulations, 15%) of the amount so treated. Treas. Reg. § 1.1445-8 has not been amended since this legislative change.

(3) Unamended Treas. Reg. § 1.1445-8 generally provides that a REIT is required to withhold at a 35% rate from any distribution that is designated by the REIT as a capital gain dividend. Thus, the regulations effectively presume that capital gain dividends paid to a non-U.S. shareholder are USRPI gains (although this may not be true for any number of reasons, e.g., the gain may be attributable to a capital asset that is not a USPRI, such as foreign real estate). For purposes of the 35% withholding rule, any distribution is deemed to be designated as a capital gain dividend to the maximum extent possible to so designate the distribution under Section 857(b)(3)(C) (i.e., to the extent of the REIT’s net capital gain for the year). Treas. Reg. § 1.1445-8(c)(2)(i).

(4) Typically, the designation of a distribution as a capital gain dividend does not occur until after the distribution is made. If a REIT designates all or part of a prior distribution as a capital gain dividend, the prior distribution is not subject to withholding. However, the REIT must withhold from future distributions the amount it would have been required to withhold from prior distributions if the characterization had been made at the time of the prior distributions. See Treas. Reg. § 1.1445-8(c)(2)(C).

C. Foreign Governments

1. Special rules apply for foreign governments that invest in the U.S. The income of a foreign government received from certain types of investments in the U.S. (including stocks, bonds, other domestic securities, and deposits in U.S. banks) is exempt from U.S. income tax under Section 892. See Treas. Reg. § 1.892-3T(a). Rental income is not exempt under Section 892. In addition, gain recognized by a foreign government from the sale of a USRPI described in Section 897(c)(1)(A)(i) (e.g.,
direct interests in U.S. real property) does not qualify for the Section 892 exemption. See Treas. Reg. § 1.892-3T(a) (flush language).

2. The term “foreign government” is defined in Treas. Reg. § 1.892-2T(a) to include integral parts and controlled entities of a foreign sovereign. In general, an entity is a controlled entity of a foreign sovereign if it is directly or indirectly wholly owned and controlled by the foreign sovereign, it is organized under the laws of the foreign sovereign, its earnings are credited to the foreign sovereign (with no portion of its income inuring to the benefit of a private person), and its assets vest in the foreign sovereign upon dissolution. See Treas. Reg. § 1.892-2T(a)(3). Certain pension trusts established for the benefit of employees and former employees of the foreign government may also qualify as controlled entities. Treas. Reg. § 1.892-2T(c).

3. The Section 892(a) exclusion, however, does not apply to income (i) derived from the conduct of any commercial activity, (ii) received by or from a “controlled commercial entity,” or (iii) derived from the disposition of any interest in a controlled commercial entity.

4. A controlled commercial entity is any entity engaged in commercial activities if the government (i) holds (directly or indirectly) 50% or more of the total interests in such entity (by vote or value) or (ii) holds (directly or indirectly) any other interest in the entity that provides it with effective control of the entity. Section 892(a)(2).

5. The regulations define “commercial activities” broadly to include all activities that are ordinarily conducted by the taxpayer or by other persons with a view toward the current or future production of income or gain. In general, however, investments in stocks, bonds, and similar securities for the foreign government’s own account are not considered commercial activities. See Treas. Reg. § 1.892-4T.

6. A REIT is treated as a corporation for tax purposes. Therefore, ordinary distributions from a REIT to a foreign government and gain from the sale of REIT shares by a foreign government should qualify for the Section 892 exclusion, provided (i) the REIT is not a controlled commercial entity with respect to the foreign government, and (ii) if the gain is recognized by a “controlled entity” of a foreign government, such entity itself is not a controlled commercial entity. Treas. Reg. § 1.892-5T(b)(1) provides that a USRPHC is treated as engaged in a commercial activity and, therefore, is a controlled commercial entity with respect to a foreign government if the control requirements described above are met.

7. The regulations do not address whether FIRPTA Distributions are eligible for the Section 892 exemption.

a. Although distributions described in Section 897(h)(1) appear to be “income from stock” that is exempt under Section 892, tax advisors have worried that the Service would assert that, because Section 897(h)(1) characterizes FIRPTA Distributions as “gain from the sale or exchange of United States real property” by the REIT, such distributions also should be treated as gain from the sale of a USRPI described in Section 897(c)(1)(A)(i). Under that position the gain would not be eligible for the Section 892 exemption. As noted above, Notice 2007-55 states that to-be-issued regulations will resolve this uncertainty in the U.S. government’s favor (retroactive to June 13, 2007), and that the Service will interpret current law for pre-effective date periods in a consistent manner.

b. A second issue, not addressed by Notice 2007-55, is whether a FIRPTA Distribution received by a controlled entity of a foreign government from a REIT constitutes “commercial income” that would cause the controlled entity to be classified as a controlled commercial entity.
Assume, for example, that a controlled entity of a foreign government owns shares of a domestically controlled REIT and no other assets. Ordinary dividends should be exempt under Section 892, provided the controlled entity does not have effective practical control of the REIT. But what happens if the controlled entity receives a FIRPTA Distribution? Does the controlled entity become a “controlled commercial entity” to which the Section 892 exemption does not apply? Treas. Reg. § 1.892-4T(c)(1)(i) provides that “investments in stock” are not “commercial activities.” A controlled entity that receives a FIRPTA Distribution derives the income from an “investment in stock,” and therefore the FIRPTA Distribution should not constitute “commercial income,” even if (as Notice 2007-55 states) the FIRPTA Distribution is not eligible for the Section 892 exemption.

Until the IRS issues a public pronouncement on the issue, however, the issue is not free from doubt. One is tempted to draw some comfort from Notice 2007-55’s silence on the issue, on the theory that if the IRS believed the FIRPTA gain was commercial income, it surely would have said so at the same time it was announcing, for the first time, that Section 897(h)(1) trumps Section 892.

### D. Withholding Taxes

1. A partnership with foreign limited partners may face several different withholding obligations on income allocated and distributed to those investors. Withholding is required regardless of whether the partnership makes distributions to its partners during the taxable year. Treas. Reg. § 1.1446-3(b)(1).

   a. First, a partnership with foreign LPs generally must withhold a 30% tax on a foreign LP’s distributive share of U.S. source “fixed or determinable annual or periodic” (“FDAP”) income. See Sections 1441 and 1442. (FDAP income generally consists of U.S. source interest, dividends, rents, and royalties that are not effectively connected with the conduct of a trade or business within the U.S.)

   (1) A key exception to the 30% withholding tax for interest (including original issue discount) is the so-called “portfolio interest” exemption. See Sections 871(h)(1), 881(c)(1), 1441(c)(9), and 1442(a). The portfolio interest exception is discussed in detail below in connection with blocker corporation structures.

   (2) The 30% withholding rate specified in Sections 1441 and 1442 may be reduced (potentially to zero) by an income tax treaty if the foreign LP receiving the payment is a resident of the relevant treaty country. (Many tax treaties lower the withholding rate on dividends and eliminate withholding on interest.)

   b. Second, a partnership generally must withhold tax on a foreign LP’s distributive share of FDAP income and ECI if that LP is a foreign tax-exempt organization and the income constitutes UBTI to the LP. See Section 1443. The regulations promulgated under Section 1441, 1443, and 1446 govern the withholding procedures on this income. See generally Treas. Reg. § 1.1443-1.

   c. Third, a partnership generally must withhold on a foreign LP’s distributive share of ECI. See Section 1446.

   (1) For purposes of Section 1446, the partnership’s ECI is allocated to its foreign partners by considering allocations respected under Section 704 and the regulations.
thereunder, including special allocations in the partnership agreement and adjustments to basis under Sections 743 and 754. Treas. Reg. § 1.1446-2(b)(1).

(2) Withholding tax on each foreign partner’s allocable share of the partnership’s ECI is imposed at the highest rate of income tax applicable to each particular foreign partner (e.g., a corporation, partnership, individual, trust, or estate). See Section 1446(b); Treas. Reg. § 1.1446-3(a)(2)(i). In calculating the partnership’s Section 1446 withholding, the Fund is permitted to consider the highest rate of tax associated with the particular type of partnership items of income and gain (e.g., long-term capital or unrecaptured Section 1250 gain), provided that if the application of the preferential rate depends on the corporate or non-corporate status of the foreign partner, the partnership has received the proper documentation from the partner. Treas. Reg. §§ 1.1446-2(b)(1); 1.1446-3(a)(2)(i)-(ii). Interestingly, in the case of a partnership that holds REIT stock, this regulation would seem to permit the partnership to withhold at preferential rates with respect to a non-corporate foreign partner’s allocable share of REIT distributions attributable to gain from the sales of USRPIs, even though the REIT would have been required to withhold at a rate of 35% on such distributions, at least until regulations providing for a 15% rate are adopted under Section 1445(e)(6).

(3) Section 1445 and the Section 1446 regulations provide that gain realized by a domestic partnership that is attributable to the sale of USRPIs is ECI (and therefore subject to withholding) to the extent allocable to a foreign partner, essentially adopting a look through rule. See Section 1445(e)(1); Treas. Reg. §§ 1.1445-5(c)(1); 1.1446-2(b)(2)(i); 1.1446-3(c)(2)(i).

E. State Taxes

1. In general. If an investor has a U.S. trade or business, it probably has a trade or business in one or more states.
   a. Additional Taxes.
   b. Additional Filing Obligations. In some states, the partnership may be permitted to file a composite return for the partners who are not residents of that state.
   c. Partnerships may be required to withhold income for state purposes.

2. Force of Attraction
   a. Many states are not clear.
   b. Illinois has used a “force of attraction” argument to go after unrelated income.

II. U.S. TAX-EXEMPT INVESTOR/UBTI ISSUES

A. General Rules

1. In general, tax-exempt investors are subject to tax on net income derived from any “unrelated trade or business.” See Section 511.
   a. An “unrelated trade or business” is any “trade or business” regularly carried on by a tax-exempt organization that is not “substantially related” to the performance of the organization’s charitable or educational purpose. See Section 513(a).
b. Unrelated business taxable income or “UBTI” is the net income that a
tax-exempt organization derives from an unrelated trade or business. See Section 512(a).

c. A tax-exempt organization is subject to federal income tax on its UBTI.
The rate of tax can depend on whether the organization is treated as a corporation (rates applicable to
corporation) or as a trust (rates applicable to individuals) for federal income tax purposes. See Section
511(a), (b).

d. If a tax-exempt organization is a partner in an entity classified as a
partnership for federal income tax purposes that regularly carries on an unrelated trade or business, the
organization is subject to tax on its share of the income received by the partnership from the business.
See Section 512(c).

e. Some tax-exempt organizations are extremely sensitive about filing a
federal income tax return reporting any UBTI, even if the dollar amounts are small.

2. Exception for Passive Income

a. One of the purposes of the UBTI rules is to prevent tax-exempt
organizations from using their income tax exemption to compete unfairly with taxable businesses.

b. Passive investments by tax-exempt organizations generally do not
present these “unfair competition” concerns. Therefore, dividends, interest, and capital gains -- as well as
other specified types of passive income--generally are exempt from UBTI. See Section 513(b). The
principal exception to this general rule is discussed in below in the section on debt financed income.

B. Rents from Real Property

1. “Rents from real property” are excluded from UBTI under Section 512(b)(3), but
only if several requirements (directed at the active / passive income distinction) are satisfied:

a. Personal Property Limitation:

(1) Income from the rental of personal property is treated as UBTI
unless the personal property is leased in connection with a lease of real property and the rents attributable
to the personal property are an “incidental” amount of the total rents received or accrued under the lease,
determined at the time the personal property is placed in service. See Section 512(b)(3)(A)(ii).

(2) The regulations provide that rents attributable to personal
property generally are not an incidental amount of the total rents if such rents exceed 10% of the total
rents from the property leased. See Treas. Reg. § 1.512(b)-1(c)(2)(ii)(b). The regulations do not address
how to determine the extent to which rents are “attributable” to personal property, as opposed to real
property.

(3) If the rents that are attributable to personal property are between
10% and 50%, then a pro rata portion of the rents will be treated as UBTI. If the rents attributable to
personal property exceed 50% of the total rents, then all rents are treated as UBTI. See Section
512(b)(3)(B)(i); Treas. Reg. §§ 1.512(b)-1(c)(2)(iii)(a); 1.512(b)-1(c)(2)(iv).

b. Prohibition Against Net Profits Leases: Real property rents are treated as
UBTI “if the determination of the amount of such rent depends in whole or in part on the income or
profits derived from any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales).” See Section 512(b)(3)(B)(ii).

(1) The entire amount of the rents received from a tenant (i.e., including fixed base rent) is disqualified as UBTI if any part of the rent is based on the tenant’s net income or profits (other than an amount based on a fixed percentage or percentages of receipts or sales). See Treas. Reg. §§ 1.512(b)-1(c)(2)(iii)(b); 1.856-4(b)(3).

(2) The regulations provide that rents that are based on a fixed percentage of gross sales or receipts may be adjusted for returned merchandise and sales taxes. Other adjustments are not mentioned in the regulations. See Treas. Reg. § 1.856-4(b)(3).

(3) Rents to a prime tenant that are based on a fixed percentage of its rents received from a subtenant may violate the “net profits” lease rule if the prime tenant’s rents from the subtenant are based on the subtenant’s net profits. See Treas. Reg. § 1.856-4(b)(6)(i).

(4) If percentage rents are based on the tenant’s gross sales, the regulations nevertheless require scrutiny if the percentage rent feature is renegotiated during the lease term (or during any renewal periods) in a manner that has the effect of basing rent on income or profits. See Treas. Reg. § 1.856-4(b)(3).

c. Customary Services: The UBTI regulations provide as follows:

Payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts, or motels, or for the use or occupancy of space in parking lots, warehouses, or storage garages, does not constitute rent from real property. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily furnished or rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such service, whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, the collection of trash, etc. are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in any office building, etc., are generally treated as rent from real property.

Treas. Reg. § 1.512(b)-1(c)(5).

(1) The rules regarding noncustomary services are again an attempt to distinguish between the more passive activity of holding property for rental and the more active activities associated with operating hotels or parking lots.

(2) The IRS generally takes the position that if any noncustomary services are provided at a property, then the entire amount of the rents received from the tenants are treated as UBTI—not just the portion of the rents attributable to the noncustomary services. See e.g., Rev. Rul. 80-298, 1980-2 C.B. 197 (rents received by a tax-exempt organization from leasing a stadium to a professional football team treated as UBTI in their entirety because the organization provided services to
the team, such as maintenance of the playing surface, dressing rooms, linen, stadium security services, and crowd and traffic control).

(a) It should be noted that there is some case law in the self-employment tax area that supports a *de minimis* exception to the noncustomary services rule. (The regulations under Section 1402 generally exclude rental income from the definition of self-employment income and contain a noncustomary services exception that is almost identical to the UBTI regulation.) See *Hopper v. Commissioner*, 94 T.C. 542 (1990) (certain services provided in connection with the lease of self-storage facilities, including providing contents insurance, soft drink machines, sales of locks, packaging materials and pallets, and advising the tenants on how to determine the amount of storage space needed, were insubstantial and therefore did not disqualify the losses from such activities as losses from the rental of real estate for purposes of computing self-employment income); *Bobo v. Commissioner*, 70 T.C. 706 (1978) (providing and maintaining laundry facilities to mobile home park tenants, while clearly a service for the tenant's convenience, was an insubstantial part of the tenant's rent and therefore did not disqualify the income as rent from real property).

(b) In at least two private rulings, the Service appears to have relied on a *de minimis* rule in the UBTI context. See PLR 200241050 (July 16, 2002) (certain marketing and promotional services provided by a tax-exempt organization in connection with the rental of space in a shopping center was "insubstantial" and therefore did not taint the rents from the property); PLR 8925029 (Mar. 24, 1989) (similar ruling with respect to similar facts).

(3) Services provided to tenants of a property must be scrutinized in order to determine whether they meet the "customary services" standard quoted in the regulation. Much of the "law" in this area comes from private letter rulings issued to REITs, which interpret the regulation quoted above. Some examples of troublesome services include the following:

(a) Maid service provided to apartment residents.

(b) Personal fitness instruction (tennis, aerobics, etc.).

(c) Shuttle bus service.

(4) Parking is another troublesome service in the UBTI context.

(a) Treas. Reg. § 1.512(b)-1(c)(5) states that rents from real property does not include "payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as ... for the use or occupancy of space in parking lots."

(b) This regulation has commonly been understood to mean that a tax-exempt organization cannot exclude income from freestanding public parking decks or lots from UBTI (i.e., parking facilities that are unconnected to rental real property such as an office building), unless the parking facility is master leased to a third party operator. Practitioners, however, generally have not understood this regulation to mean that payments for unattended surface parking by a tenant of an apartment property or office building constitute UBTI.

(c) In Rev. Rul. 2004-24, 2004-1 C.B. 550, the Service analyzed three different parking fact patterns in the REIT context. Although the Service ruled that the parking income in all three fact patterns constituted rents from real property for REIT purposes, the Service stated that the income did not qualify as rents from real property for UBTI purposes. The UBTI conclusions were surprising to tax advisors of pension trusts and other tax-exempt organizations,
especially with respect to the first fact pattern, which involved the provision of unattended, unreserved parking facilities adjacent to leased property. There is no indication in this fact pattern that the tenants paid a separately stated charge for the use of the facilities. Did the Service really mean to say that every tax-exempt organization that owns an office or apartment building with surface parking has to treat all or a portion of the tenant's income as not qualifying for the rents from real property exclusion from UBTI?

(d) Notably, the Service's UBTI conclusions in Rev. Rul. 2004-24 are inconsistent with case law in this area. See Madden v. Commissioner, 74 T.C.M. 440 (1997) (the provision of parking spaces by a tax-exempt organization in connection with the lease of an outdoor amphitheater through license agreements entered into by the tax-exempt organization with nearby owners of parking lots did not result in the disqualification of the income under the lease as rents from real property for UBTI purposes). Moreover, in a recent private letter ruling, the Service ruled, contrary to its conclusions in Rev. Rul. 2004-24, that payments made by tenants of a residential property for parking spaces constituted rental income within the meaning of Section 512(b)(3). See PLR 200621031 (Mar. 1, 2006). The Service noted that the parking fees would be received only from tenants for spaces adjacent to the residential units and that the tax-exempt organization would not be operating a parking lot for the use of the general public. The Service therefore ruled using a facts and circumstances analysis that the income from the parking fees would be considered part of the rent.

(e) Most tax advisors in this area continue to believe that the provision of unattended parking spaces to tenants in connection with a lease of real property does not give rise to UBTI.

d. Related Party Rents Exception

(1) Section 512(b)(13) provides that rent received by a tax-exempt organization from a "controlled entity" is treated as UBTI to the extent that the rent reduces the controlled entity's income that would be treated as UBTI if the controlled entity were a tax-exempt organization.

(2) A "controlled entity" is an entity as to which the tax-exempt organization owns, actually or constructively, more than 50%. See Section 512(b)(13)(D).

(3) Because of the "controlled entity" rule, for example, a tax-exempt organization cannot derive qualifying rents from real property by leasing a hotel or a parking lot to a wholly-owned C corporation.

e. Miscellaneous Income: A tax-exempt organization may derive various types of miscellaneous income in connection with its real estate activities. Some examples include income from vending machines and laundry machines, car wash income, and telephone, cable TV, and Internet commission income.

(1) Although it is possible that the provision of these amenities could be viewed as a "rent-tainting" service under the Service's "all or nothing approach" described above, this would obviously be a Draconian result.

(2) To avoid UBTI in the case of vending, laundry, and carwash machines made available to tenants of an apartment or office building, the amenities can be provided by a third party operator who owns and operates the machines and merely pays a share of the gross revenues to the tax-exempt organization as rent for the use of the space. In this case, the tax-exempt organization should be viewed as deriving income from rent, akin to an easement payment.
(3) If, instead, the machines are owned by the tax-exempt organization, then it is not entirely clear whether the related income is UBTI. Some tax preparers take the position that the income is not UBTI. Presumably, the rationale is either that (i) the income is a separately stated charge for a customary amenity provided in connection with the lease of real property and therefore should be treated as “rent” (the Service has given numerous rulings to this effect in the REIT context); (ii) the income is de minimis and therefore permissible under the self-employment authorities described above; or (iii) the machines are in substance personal property provided to tenants in connection with their leases and therefore qualify for the 10% de minimis exception for incidental personal property leased with real property.

C. Sale of Real Property

1. Section 512(b)(5) of the Code provides that UBTI does not include gains or losses from the sale, exchange, or other disposition of property, other than so-called “dealer property” -- defined as (1) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year or (2) property held primarily for sale to customers in the ordinary course of business.

2. Thus, a tax-exempt organization generally will be subject to tax on its income derived from the development and sale of condos, residential lots, and build-to-suit-to-sell properties.

3. At the other end of the spectrum is a tax-exempt organization that holds an office building, shopping center, or apartment complex for investment and, after several years, sells the property as part of its investment strategy.

4. The classification of property as “dealer property” depends on all of the relevant facts and circumstances -- how long the property in question has been held, the taxpayer’s development and marketing activities with respect to the property, the taxpayer’s intent when it acquired the property in question, the extent of the taxpayer’s sales activities, etc.

5. The UBTI exclusion for gain from investment property does not apply to gain from the cutting of timber pursuant to an election under Section 631(a), although the IRS has ruled privately that Section 631(b) gain is not UBTI. See e.g., Section 512(b)(5)(flush language); Treas. Reg. 1.512(b)-1(d)(1); PLR 200151046 (Dec. 21, 2001); PLR 9815056 (Apr. 10, 1998).

D. Debt-Financed Income Rules

1. Under Section 514 of the Code, otherwise qualifying rental income or gain from the sale of property may be treated as UBTI if there is “acquisition indebtedness” with respect to the property and the organization is not eligible for Section 514(c)(9) (discussed below).

2. “Acquisition indebtedness” is debt incurred to acquire or improve property, or debt incurred before or after the acquisition or improvement that would not have been incurred but for the acquisition or improvement. See Section 514(c)(1).

3. In the case of rental income, the amount of income included in UBTI is based on the “average acquisition indebtedness” on the property during the year in which the rents are received. See Section 514(a)(1).

Example: If a tax-exempt organization’s adjusted basis in an office building is $100,000 during the year 2008 and the
“average acquisition indebtedness” outstanding on the building during that year is $75,000, then 75% of the rental income ($75,000 / $100,000) will be recharacterized as UBTI.

4. In the case of sale gain, a “look-back” rule applies, and a portion of the gain will be treated as UBTI if there was acquisition indebtedness on the property at any time during the 12-month period preceding the sale. See Sections 514(b)(1); 514(c)(7).

5. Section 514(c)(9) Exception.
   a. Section 514(c)(9) allows certain types of exempt organizations to incur acquisition indebtedness with respect to real estate investments without creating UBTI under the rules discussed above.
   b. Section 514(c)(9) is available only to a “qualified organization,” which includes:
      (1) educational organizations described in Section 170(b)(1)(A)(ii) (such as colleges and universities), as well as their affiliated support organizations;
      (2) qualified trusts under Section 401, such as pension trusts; and
      (3) title holding companies or trusts described in Section 501(c)(25).
   c. In order for Section 514(c)(9) relief to apply, the following rules must be satisfied:
      (1) Fixed Purchase Price. The price for the acquisition or improvement must be a fixed amount as of the date of the acquisition or improvement -- no “earn-outs” or other contingencies may be provided. The legislative history of Section 514(c)(9), however, provides that purchase price adjustments stipulated by the terms of the sales contract that are due to “customary” closing adjustments (such as a proration of property taxes) and that depend on the subsequent resolution of limited, external contingencies (such as zoning approvals, title clearances, and the removal of easements) are permissible.
      (2) Fixed Debt. The amount of the debt, any amount payable with respect to the debt, or the time for making any payment under the debt cannot depend on any future revenue, income, or profits derived from the real property.
      (3) Sale-Leaseback. The property cannot at any time after the acquisition be leased to the seller or a party related to the seller, unless the seller takes up no more than 25% of the leasable floor space in the building (or complex of buildings) and the terms of the lease are “commercially reasonable.”
      (4) Pension Trust Rule. A pension trust cannot acquire the property from, or lease the property back to, certain “disqualified persons” that are related to the plan under which the pension trust was formed, unless the disqualified person takes up no more than 25% of the leasable floor space in the building (or complex of building) and the terms of the lease are “commercially reasonable.”
(5) Seller Financing. If the seller of the property provides the financing, or if a disqualified person provides financing to a pension trust, the terms of the financing must be "on commercially reasonable terms" in order for the Section 514(c)(9) exception to apply.

(6) Partnerships. A tax-exempt organization that is a partner in a partnership holding debt-financed real property must satisfy any one of the following three requirements:

(a) All of the partners of the partnership are "qualified organizations."

(b) Each allocation to a partner of the partnership that is a "qualified organization" is a "qualified allocation" - i.e., the allocations must be consistent with the entity being allocated the same distributive share of each item of income, gain, loss, deduction, credit, and basis, and such share must remain constant for the entire period during which the qualified organization is a partner.

(c) The partnership’s allocations meet the “fractions rule.”

(Many real estate funds are fractions rule compliant.)

d. The “Fractions Rule”

(1) The fractions rule generally provides that the qualified organization’s greatest percentage share of “overall partnership income” for any partnership taxable year cannot exceed its “fractions rule percentage,” which is defined to be the qualified organization’s smallest percentage share of “overall partnership loss” for any partnership taxable year. See Section 514(c)(9)(e)(i)(I); Treas. Reg. § 1.514(c)-2(b)(1)(i) and (c)(2). Overall partnership loss equals the excess of the aggregate items of partnership loss and deduction for the taxable year over the aggregate items of partnership income and gain for such year. See Treas. Reg. § 1.514(c)-2(c)(1).

(2) The fractions rule also requires that the partnership’s tax allocations have “substantial economic effect,” which means (among other requirements) that capital accounts must be maintained in accordance with the Section 704(b) regulations and liquidation proceeds must be distributed in accordance with capital accounts. See Section 514(c)(9)(e)(i)(II).

(3) For purposes of determining a partner’s percentage share of overall partnership income or loss, certain allocations are disregarded:

(a) For example, allocations with respect to preferred returns and guaranteed payments are disregarded if the preferred return or guaranteed payment is reasonable. See Treas. Reg. § 1.514(c)-2(d)(2), (3).

(i) A safe harbor is provided under which a rate will be deemed commercially reasonable if it is not greater than four percentage points higher than, or if it is no greater than 150% of, the highest long-term AFR for the month the partner’s preferred return or guaranteed payment is first established or for any month for which the preferred return or guaranteed payment is computed. If the preferred return or guaranteed payment rate exceeds the safe harbor, commercial reasonableness will be determined based on all the facts and circumstances. See Treas. Reg. § 1.514(c)-2(d)(4)(ii).
(ii) Another requirement for the “reasonable preferred returns” exception is the limitation on allocations of income. Under Treas. Reg. § 1.514(c)-2(d)(6)(i), “items of income and gain (or part of what would otherwise be overall partnership income) that may be allocated to a partner in a taxable year with respect to a reasonable preferred return for capital are disregarded for purposes of the fractions rule only to the extent the allocable amount will not exceed -- (A) The aggregate of the amount that has been distributed to the partner as a reasonable preferred return for the taxable year of the allocation and prior taxable years . . . , minus (B) The aggregate amount of corresponding income and gain (and what would otherwise be overall partnership income) allocated to the partner in all prior years.” (Emphasis added). In other words, income can be allocated pursuant to this exception only to the extent the preferred return is actually paid.

(b) Allocations of overall income that are made to reverse prior disproportionately large allocations of overall partnership loss are also disregarded in computing overall partnership income for purposes of the fractions rule. See Treas. Reg. § 1.514(c)-2(e)(1)(i). Prior allocations of partnership losses are disproportionately large if they exceed the partner’s fractions rule percentage. See Treas. Reg. § 1.514(c)-2(e)(2).

(c) Allocations of overall partnership losses are disregarded if they are made to chargeback disproportionately small allocations of overall partnership income in previous years. See Treas. Reg. § 1.514(c)-2(e)(1)(i). Prior allocations of partnership income are disproportionately small if they are less than the partner’s fractions rule percentage. Treas. Reg. § 1.514(c)-2(e)(2).

(d) Allocations of income pursuant to minimum gain chargebacks or partner minimum gain chargebacks, and allocations of income pursuant to qualified income offsets are also disregarded. Treas. Reg. § 1.514(c)-2(e)(1)(ii)-(iv).

(4) Tiered Partnerships. The regulations provide that if a qualified organization holds an indirect interest in real property through one or more tiers of partnerships, the fractions rule is satisfied only if (i) the avoidance of tax is not a principal purpose for using the tiered-ownership structure and (ii) the relevant partnerships can demonstrate under any reasonable method that the fractions rule is satisfied. See Treas. Reg. § 1.514(c)-2(m). Using a tiered partnership arrangement so that the fractions rule is applied on a property-by-property basis is not, in and of itself, a tax avoidance purpose. See id. The examples in the regulations provide three potential ways to satisfy the fractions rule in connection with tiered partnerships:

(a) First, the tiers can be collapsed. Under this alternative the qualified organization’s overall partnership income and loss are determined by looking at the qualified organization’s share of the income and loss from the property owning partnership. (For example, if a qualified organization has a 30% share of losses in a partnership, which in turn has a 40% share of the losses of a lower-tier property owning partnership, the qualified organization’s fractions rule percentage on a collapsed basis is 12% (30% of 40%)). See Treas. Reg. 1.514(c)-2(m)(2), Example 1.

(b) Second, an entity-by-entity approach may be used. Under this approach, each partnership agreement is individually scrutinized to determine whether it satisfies the fractions rule. For purposes of this approach, it can be assumed that each partnership in the chain is a qualified organization, thereby allowing the fractions rule to be satisfied without actual knowledge of the tax status of all indirect partners in the ownership chain. See Treas. Reg. 1.514(c)-2(m)(2), Example 2.
Third, an upper-tier partnership may use an independent chain approach. Under this approach, the upper-tier partnership can satisfy the fractions rule with respect to one lower-tier partnership, but not another, provided that the upper-tier partnership agreement allocates items from the fractions rule compliant partnership separately from the non-compliant chain. See Treas. Reg. 1.514(c)-2(m)(2), Example 3.

(5) Common Fractions Rule Pitfalls

(a) Dilution Provisions. Many partnership agreements have a dilution provision in the event a partner fails to make its pro rata share of additional capital contributions. The regulations provide that changes in partnership allocations that result from transfers or shifts of partnership interests will be closely scrutinized, but that they generally will only be taken into account in determining whether the agreement satisfies the fractions rule in the taxable year of the change and subsequent taxable years. See Treas. Reg. § 1.514(c)-2(k)(1). The change will be closely scrutinized to determine whether there was a prior agreement, understanding or plan to cause a shift in partnership allocations, or if the change was expected from the structure of the transaction. See id. Thus, although not free from doubt, a dilution caused by these types of provisions generally should constitute a shift in partnership interests within the meaning of this rule, and therefore should not be taken into account until the dilution provisions are actually triggered.

(b) Shortfall Contributions. Some partnership agreements contain provisions that require limited partners to contribute a lesser share of certain additional contributions, as compared to the limited partners' normal contribution percentages. For example, a limited partner may be required to contribute a lesser share of additional capital used to fund cost overruns or to fund expenditures incurred after a specified date. This causes a qualified organization limited partner's overall share of contributed capital to eventually become lower than its initial share, causing a fractions rule violation. Unless it is unanticipated that contributions of this type will be needed, this "shift" in shares of capital likely will not qualify for the special rule afforded to shifts in partnership interests that are not part of an overall arrangement and are unlikely to occur.

(c) Subordinate Capital from a Taxable Partner. Any time that a taxable partner's capital is subordinate to a qualified organization's capital, the allocations will not comply with the fractions rule because the tax-exempt partner will always have a share of net profits higher than its fractions rule percentage. (Because the tax-exempt partner's capital is senior, either the agreement must provide that profits build its capital account first, to the extent capital has been torn down, giving the tax-exempt member a 100% share of profits, or it must tear down the capital of the subordinated members first, giving the tax-exempt member a 0% share of overall losses.)

E. Use of REITs to avoid UBTI

1. One way for tax-exempt investors to avoid UBTI on their real estate income is to invest in the shares of a REIT (including a private REIT) that is not a "pension-held REIT." The investor realizes its profit through dividends and gain from sale of the shares, both of which are excluded from UBTI (unless the investor borrows to buy the shares). See Rev. Rul. 66-151, 1966-1 C.B. 151.

   a. Using a REIT is often the only way for a private foundation to avoid UBTI in a real estate fund, since private foundations are not eligible for the Section 514(c)(9) exception to the debt-financed property rules.
2. Such a REIT does not have to plan to avoid the UBTI rules. Thus, it does not need to avoid “debt-financed property” under the complex Section 514(c)(9) rules and can borrow to acquire property and not worry about the sale/leaseback rule or the fractions rule.

3. A REIT, of course, must comply with different (and equally complex) rules to maintain its REIT status, as discussed below.

4. Unfortunately, for a pension trust investor, the income of a REIT may not escape the UBTI net if the REIT is a “pension-held REIT.” Under Section 856(h)(3)(D) of the Code, a REIT will not be pension-held unless both of two mechanical tests are satisfied.

   a. The first mechanical test is satisfied if the REIT would be considered “closely held” if it were not for Section 856(h)(3)(A). To qualify as a REIT, not more than 50% of the REIT’s outstanding stock (by value) may be owned, directly or indirectly at any time during the last half of the REIT’s taxable year (commencing with the REIT’s second taxable year as a REIT), by or for five or fewer “individuals.” Certain entities, including Section 401(a) pension trusts, are treated as “individuals” under Section 542(a)(2), but Section 856(h)(3)(A) of the Code supersedes Section 542(a)(2) as applied to REITs by providing that any stock held by a Section 401(a) pension trust is treated as held directly by its beneficiaries in proportion to their actuarial interests in the trust. Thus, the pension-held REIT rules come into play only if the REIT must rely on the special Section 856(h)(3)(A) pension trust look through rule in order to qualify as a REIT under the “closely held” test.

   b. The second mechanical test requires that either (A) one Section 401(a) pension trust owns more than 25% of the REIT’s outstanding stock or (B) a group of Section 401(a) pension trusts, each owning more than 10% of the REIT’s stock, owns more than 50% of the REIT’s stock. Oddly enough, there are no constructive ownership rules in this provision, and the statute does not even say “held directly or indirectly,” as it does, for example, in the domestically controlled REIT rule in Section 897. Thus, a legitimate question exists as to whether a pension trust “holds” REIT shares when it holds them through a tax-recognized partnership. However, if the partnership is formed solely to avoid the pension held REIT rules, and has no other business purpose, it is clearly vulnerable to attack under the Subchapter K anti-abuse rule. Treas. Reg. § 1.701-2.

   c. The consequence of “pension-held REIT” status is that any Section 401(a) qualifying pension trust that holds more than 10% (by value) of the REIT’s outstanding stock must treat a portion of the dividends received from the REIT as UBTI, notwithstanding the general rule that REIT dividends are excluded from UBTI. The portion of REIT dividends treated as UBTI equals the percentage of the REIT’s income that would be UBTI if the REIT were a pension trust, subject to a de minimis rule under which no amount is treated as UBTI if the REIT’s UBTI percentage is less than 5%. See Section 856(h)(3)(C).

      (1) This rule was enacted by Congress out of concern that its relaxation of the five or fewer test could lead to pension funds jointly creating a REIT for the purpose of making real estate investments and thereby avoiding UBTI they otherwise might have incurred if they made leveraged investments directly or through real property partnerships.

F. Participating Debt

1. Another possible way for tax-exempt investors to avoid UBTI on their real estate income is to structure the investment as participating debt, as opposed to equity in a joint venture. In general, if participating debt is respected as debt, and not recharacterized as equity, UBTI-sensitive investors can loan money to a third party and the nature of the income they receive is interest and
repayment of indebtedness, neither of which is UBTI. This structure avoids the problems described above regarding acquisition indebtedness, the fractions rule, and the sale-leaseback. (Note, however, that borrowing money to loan money creates UBTI.)

2. The key in participating debt structures is to avoid recharacterization of the debt as a partnership interest in the borrower or as itself a tax partnership with the borrower. The terms of the debt must be carefully analyzed, and the analysis is a “facts and circumstances” type of review, so there are no bright lines. However, mezzanine debt with all the indicia of debt and that results in a fairly high return can often pass muster.

3. Some of the disadvantages of this kind of structure include:
   a. The tax-exempt investor must give up the upside above the “debt” return in exchange for a more conservative UBTI structure.
   b. The debt must be senior to the equity in order to be respected.
   c. The debt must have an ultimate due date, at which time it must cease to participate in real estate value.
   d. The level of control that the debt holder may have must be consistent with those of a lender, rather than a partner. In practice, this often proves to be an insurmountable problem.

III. SELECTED ISSUES RELATING TO CERTAIN INVESTMENT VEHICLES

A. Blocker Corporations

1. In General

   a. In order to reduce its U.S. federal income tax burden, a foreign investor may invest in a partnership through a U.S. “C” corporation, often referred to as a “blocker corporation.” A U.S. corporation is subject to U.S. federal income tax on its net income at a rate of 35%, but generally is entitled to deduct its expenses, including interest expense, subject to the earnings stripping rules discussed below.

      (1) Thus, if the foreign investor lends a portion of its investment to the blocker corporation, the blocker corporation’s taxable income for U.S. federal income tax purposes generally will be reduced by its interest expense.

      (2) When combined with the portfolio interest exemption or other exemption, this deduction effectively allows a non-U.S. investor to receive part of the return on its investment without U.S. federal income tax at any level.

   b. It generally will not be desirable for U.S. tax-exempt investors to invest in U.S. real estate through a blocker corporation.

      (1) As noted above, under a blocker corporation structure, an investor’s share of the property’s net income (less blocker-level interest expense) is subject to U.S. tax at a 35% rate.
(2) By contrast, a tax-exempt investor that is a qualified organization may be able to avoid U.S. tax altogether if it invests directly in a partnership that complies with the Section 514(c)(9) requirements.

(3) Even if a tax-exempt organization is not a qualified organization and therefore cannot rely on Section 514(c)(9) (e.g., a private foundation), a direct investment in leveraged real estate will only result in U.S. tax on a portion of the tax-exempt organization's share of the property's net income (based on the leverage ratio), whereas the blocker corporation structure will subject the tax-exempt organization's entire share of the venture's income to U.S. tax.

c. In general, distributions by the blocker corporation with respect to its stock (e.g., dividends) will be subject to U.S. federal income tax at a rate of 30%, unless reduced by treaty or other exemption (such as Section 892 of the Code), to the extent of the blocker corporation's current or accumulated "earnings and profits." See Sections 316(a); 871(a)(1)(A); 881(a)(1); 1441; 1442.

d. If the blocker corporation is a USRPHC, any gain from the sale of its stock, including gain recognized on a distribution in redemption of its stock, will be subject to U.S. tax under FIRPTA. However, under the Cleansing Exception, once the underlying partnership sells all of its assets and liquidates, the blocker corporation may liquidate, and the shareholder may receive the liquidating distribution without recognizing a second level of U.S. tax.

(1) In order to more easily take advantage of the Cleansing Exception, a separate blocker corporation may be established for each project. Under this approach, when a property is sold, the corresponding blocker corporation can be liquidated, and the liquidating distribution generally will not be subject to U.S. tax. By contrast, if there is only one blocker corporation for multiple projects, the blocker corporation may have to wait until all projects have been sold to repatriate the earnings from early sales in the form of tax free distributions. A downside of forming a separate blocker corporation for each property is that any losses from one property cannot be used to offset income from another property.

(2) Alternatively, the proceeds from early sales can be used to pay down shareholder debt, although this of course will reduce the interest deductions available in later years to offset the blocker corporation's income.

2. Portfolio Interest Rules

a. Blocker corporations are generally structured so that interest payments to foreign shareholders are not subject to U.S. withholding tax. As noted above, the U.S. generally imposes a flat 30% withholding tax on U.S.-source interest payments. A key exception to this withholding tax is the "portfolio interest" exemption.

b. Interest income will qualify for the portfolio interest exemption only if each of the following requirements is met:

(1) The lender must not be a "10-percent shareholder" of the borrower within the meaning of Section 871(h)(3).

(a) If the borrower is a corporation, the term "10-percent shareholder" means any person deemed to own 10% or more of the total combined voting power of all classes of the stock of such corporation entitled to vote. See Section 871(h)(3)(B)(i).
(b) A complex set of attribution rules applies to determine whether the lender is a 10% shareholder. See Section 871(h)(3); Treas. Reg. § 1.871-14(g)(2)(ii)(B).

(2) The interest income must not be effectively connected with a U.S. trade or business conducted by the lender. See Sections 881(a) (flush language) (excluding effectively connected income from the 30% withholding tax), 881(c)(2) (describing “portfolio interest” as interest that would be subject to tax under Section 881(a) but for Section 881(c)).

(3) The debt obligation on which the interest is paid must be in “registered form.” Section 881(c)(2)(B). Treas. Reg. § 1.871-14(c) provides rules regarding when an obligation will be considered to be in registered form.

(4) The lender must provide proper certification of its foreign status to the person paying the interest (generally, on IRS Form W-8BEN). See Section 871(h)(2)(B)(ii).

(5) The lender must not be treated as a “bank” receiving interest “on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.” Section 881(c)(3)(A). No regulations or other controlling authorities have been issued to provide guidance on what constitutes a “bank” for this purpose. However, in two technical advice memoranda, the IRS National Office narrowly interpreted the term “bank” to mean an entity a substantial part of the business of which is both accepting deposits and making loans and which is regulated, supervised, and examined as a bank. See TAM 9822007 (May 29, 1998); TAM 9822008 (May 29, 1998).

(6) The interest income must not be contingent interest of the type described in Section 871(h)(4).

(a) Specifically, prohibited contingent interest includes any interest the amount of which is determined by reference to (i) any receipts, sales, or other cash flow of the debtor or a related person; (ii) any income or profits of the debtor or a related person; (iii) any change in value of any property of the debtor or a related person; (iv) any dividends, partnership distributions, or similar payments made by the debtor or a related person; or (v) any other type of contingent interest that is identified by regulation where a denial of the portfolio interest exemption is necessary or appropriate to prevent avoidance of federal income tax. See Section 871(h)(4)(C).

(b) Section 871(h)(4)(C) provides that the prohibition against contingent interest does not apply to the following: (i) an amount of interest solely by reason of the fact that the timing of any interest or principal payment is subject to a contingency; (ii) any amount of interest solely by reason of the fact that the interest is paid with respect to nonrecourse or limited recourse indebtedness; (iii) an amount of interest all or substantially all of which is determined by reference to any other amount of interest that does not fall into the “contingent interest” category (or by reference to the principal amount of indebtedness on which such other interest is paid); (iv) an amount of interest solely by reason of the fact that the debtor or a related person enters into a hedging transaction to manage the risk of interest rate or currency fluctuations with respect to such interest; (v) any amount of interest determined by reference to changes in the value of certain property (including stock) that is actively traded, the yield on such property (other than a debt instrument that pays contingent interest or stock or property that represents a beneficial interest in the debtor or a related person), or changes in any index of the value or yield of such property; and (vi) any other type of interest identified by regulation.

(7) The lender must not be a “controlled foreign corporation” receiving interest from a related party. See Section 881(c)(3)(C).
c. Many blocker corporation structures satisfy the 10% voting restriction by (i) having an affiliate of the sponsor or another investor contribute some relatively small percentage of the capital needed by the blocker corporation in return for 100% of the voting stock of the blocker corporation and (ii) having the foreign investor own solely non-voting stock and promissory notes of the blocker corporation.

(1) Note that under this structure, the sponsor affiliate (or other investor) must invest its own funds to acquire the voting stock of the blocker corporation and must have the right to exercise independent control over the voting stock of the blocker corporation. The owner of the voting stock cannot be subject to the control of the foreign investor or its beneficial owners.

3. Earnings Stripping Rules

a. As mentioned above, interest paid by a blocker corporation generally is deductible for U.S. income tax purposes. If the portfolio interest exemption or other exemption applies, however, the earnings stripping rules of Section 163(j) may defer or eliminate part of the blocker corporation’s interest expense deduction.

b. In order for Section 163(j) to apply, the corporation must have a debt-to-equity ratio at the close of the taxable year (computed by reference to all of its liabilities and using the adjusted tax basis of its assets, rather than fair market value) of greater than 1.5 to 1. See Section 163(j)(2)(A)(ii).

c. Section 163(j)(1)(A) disallows a deduction for “disqualified interest” paid by a corporation, but only to the extent of the corporation’s “excess interest expense,” which is defined to be the excess of the corporation’s interest expense for the taxable year (whether or not disqualified interest) over the sum of 50% of the corporation’s “adjusted taxable income” (generally, taxable income plus the net interest expense), plus any excess limitation carry forward. See Section 163(j)(2)(B).

d. Disqualified interest is interest paid or accrued by the corporation to a “related person” if no tax is imposed under the Code with respect to such interest. Section 163(j)(3)(A); Prop. Reg. § 1.163(j)-2(a).

(1) Interest that qualifies for the portfolio interest exemption will be treated as not subject to tax for purposes of this rule. In addition, if a treaty reduces the amount of U.S. tax imposed on an interest payment, a proportionate amount of the interest is treated as interest that is not subject to tax under the Code. See Section 163(j)(5)(B).

(2) A related person is any person who is related to the payor corporation within the meaning of Sections 267(b) and 707(b)(1), applying the constructive ownership and attribution rules of Section 267(c). Section 163(j)(4)(A); Prop. Reg. § 1.163(j)-2(g)(1).

(3) Section 267(b)(3) includes as related persons corporations that are members of a controlled group within the meaning of Section 1563(a), using a 50% ownership threshold rather than 80%. See Section 267(f)(1). Also included as related persons are an individual and a corporation where the individual owns, directly or indirectly, more than 50% of the value of the shares of the corporation. See Section 267(b)(2).

e. Any disallowed interest expense under the above rules is carried forward indefinitely to succeeding taxable years and is again subject to the earnings-stripping limitation in such
succeeding taxable years. See Section 163(j)(1)(B). Thus, if the underlying partnership produces
sufficient taxable income, including any gain on the sale of its assets, all of the deductions deferred under
Section 163(j) may then be used to offset the blocker corporation’s share of the income. In that case, the
detriment of the earnings stripping rules would be limited to the time value of any taxes paid in earlier
years due to deferred interest deductions.

f. Other limitations on the deduction of interest (in addition to the earnings
stripping limitation) may potentially apply, including the rules relating to “applicable high-yield discount
obligations.” See generally Section 163(e)(5). Whether these other limitations apply will depend on the
actual capital structure of the blocker corporation and the amount and timing of its cash flows.

B. REITs

1. Foreign investors (including foreign governments) and tax-exempt investors may
prefer to invest in U.S. real estate through a “domestically controlled REIT.”

a. As noted above, REITs generally serve as a UBTI filter, except in the
case of substantial pension trust investors in pension-held REITs.

b. Although Section 897(h)(1) and IRS Notice 2007-55 substantially
reduces the benefits of REITs to foreign investors, foreign investors may still achieve material tax savings
by investing in U.S. real estate through a REIT -- especially if they can exit the investment by selling
REIT shares.

(1) A REIT generally is not subject to corporate level tax, provided
that it pays out all of its earnings on a current basis.

(2) Gain from the disposition of domestically controlled REIT stock
is not subject to FIRPTA.

(3) Although dividends (other than FIRPTA Distributions) from a
REIT are generally subject to a 30% withholding tax, many tax treaties reduce this rate to 15%. Dutch
pension funds are not subject to any U.S. withholding tax on dividends (other than FIRPTA
Distributions).

2. To qualify as a REIT, an entity must file an election to be so treated and must
meet requirements relating to its organization, the ownership of its outstanding stock, the sources of its
gross income, the nature of its assets, and the levels of distributions of net income to its shareholders.

a. A detailed discussion of the rules pertaining to REITs is beyond the
scope of this outline.

b. Note, however, that REITs are subject to customary service limitations
similar to the limitations under the UBTI rules.

c. In addition, a REIT is subject to a 100% excise tax on “prohibited
transactions.” Prohibited transactions include the sale of inventory or of property held by the REIT
“primarily for sale to customers in the ordinary course of [its] trade or business.” See Sections 857(b)(6);
1221(a)(1). There is a two-year safe harbor exception, although a REIT may not be able to satisfy all of
the technical requirements of the safe harbor. See Section 857(b)(6)(C).
d. Before choosing to form a REIT, it is important to seriously consider whether the REIT qualification tests are compatible with the proposed business plans.