

## Foreign Investment

### **Industry, Obama Agree on Need to Lower Tax on Foreign Investment in Real Property**

**A**lthough the United States offers a vibrant commercial real estate market to investors around the world, industry advocates are pushing for reforms to the 1980 Foreign Investment in Real Property Tax Act (FIRPTA), which they regard as a major barrier to foreign investment.

And at a time when many real estate mortgages are approaching their maturity dates, the United States has restrictions that hamper its ability to be even more competitive with respect to foreign investment.

#### **"[FIRPTA] is very discriminatory against foreign investment in U.S. real estate."**

JEFFREY D. DEBOER, PRESIDENT AND CEO  
REAL ESTATE ROUNDTABLE

"The commercial real estate marketplace needs additional equity in order to help rebalance and re-equitize all of these loans," Jeffrey D. DeBoer, president and chief executive officer, Real Estate Roundtable, told BNA April 24. "Estimates are that between \$1.4 and \$1.7 trillion in commercial real estate mortgages are coming due in the next few years, and many of those loans need equity infusions in order to refinance them."

**Barrier to Foreign Investment.** FIRPTA was enacted at a time when large-scale purchases of U.S. properties by foreign investors roused defensive sentiments. It imposes a tax on the capital gain of a foreign investor in U.S. property, and those who oppose it are quick to note that it is a tax foreign investors in other U.S. assets do not face.

"For example, a foreign investor can purchase shares of stock in non-real estate companies, sell that stock at a gain, and not pay any U.S. capital gains taxes," DeBoer said. "They pay a tax, of course, in their home country, but they don't pay a U.S. tax on that."

If they invest in real estate, they have a significant amount of administrative paperwork to fill out. Also, a U.S. buyer of a real estate asset held by a foreign investor is subject to a withholding requirement equal to 10 percent of the U.S. proceeds of the sales price.

"It is very discriminatory against foreign investment in U.S. real estate," DeBoer said.

The real estate sector's share of foreign direct investment has fallen from more than 8 percent in 1981 to less than 2 percent in 2011, DeBoer said, adding that the decline demonstrates the significant effect of FIRPTA on inbound real estate investment.

**Legislative Priority.** The roundtable has made changing FIRPTA one of its highest legislative priorities, and it notes that amending the law has bipartisan support on Capitol Hill. Anticipated House and Senate proposals by Reps. Kevin Brady (R-Texas) and Joe Crowley (D-N.Y.) and Sens. Robert Menendez (D-N.J.) and Mike Enzi (R-Wyo.) would increase the level a foreigner can invest in a listed U.S. real estate investment trust (REIT)

from 5 percent to 10 percent before triggering taxation under FIRPTA.

The proposal also would exempt any liquidating distributions from domestically controlled REITs from FIRPTA requirements. The latter provision was established by an Internal Revenue Service policy in 2007 (Notice 2007-55) (114 DTR G-1, 6/14/07).

The roundtable and key lawmakers insist the provision on liquidating distributions could be accomplished either legislatively or administratively by IRS. Before 2007, as a general IRS rule, when an entity completely liquidated its assets, the proceeds were distributed back to investors and were treated as if they were the sale of the shares of the stock of that entity.

A domestically controlled REIT was defined when Congress enacted FIRPTA in 1980 as one that was more than 50 percent controlled by U.S. investors, and the proceeds from the sale of stock in such REITs were not subject to the FIRPTA tax rules.

Since then, they have been governed by the general rules under the Internal Revenue Code, which does not impose U.S. tax on non-U.S. investors when they sell capital assets such as stock. Before 2007, most tax practitioners and investors (based in part on a private letter ruling IRS issued in the early 1990s) believed that the proceeds received by the minority non-U.S. investors from the liquidation of a domestically controlled REIT are proceeds from the sale of stock (rather than from the sale of real estate) and therefore are not subject to FIRPTA.

**IRS Notice Added to Burden.** But IRS Notice 2007-55 changed the tax treatment of proceeds from the sale of a domestically controlled REIT. "In that case, and that case alone, the liquidating distributions would be treated as proceeds from the sale of the real estate and subject to FIRPTA," DeBoer said. "When that came down in 2007, it had a tremendous chilling effect on foreign pension plan investments in U.S. real estate, as well as sovereign wealth fund investments, and other types of foreign investments."

Since 2007, many stakeholders, including foreign governments and investors, U.S. real estate industry participants, economists, and the American Bar Association Section of Taxation have sought the repeal of the 2007 notice. DeBoer said these groups spoke often with former Treasury Secretary Timothy Geithner about it but the change did not go through on his watch.

The roundtable on April 12 posted a video clip on its website of an April 11 exchange between Menendez and newly confirmed Treasury Secretary Jacob J. Lew during a Senate hearing. During that exchange, Menendez questioned Lew about the administration's policy.

"My understanding is that the administration is making this a legislative proposal, even though the Treasury Department has the authority to begin reforming FIRPTA rules tomorrow," Menendez said. "So, am I right about that, that you are seeking a legislative proposal?"

"I believe that's correct, and Senator, I believe I'd have to go back and check on where the line [is] where we have administrative authority," Lew replied. "We don't usually ask for legislation if we think we can do it."

Menendez said lawmakers had discussed the matter often with Geithner. "And I think we had moved forward in an understanding that in fact you can adminis-

tratively deal with what you want to achieve legislatively by repealing the relative parts of the 2007-55 IRS notice while Congress works on the rest of the issue," Menendez said.

**Obama Administration's Budget Proposal.** DeBoer noted that the Obama administration in its 2014 budget proposal acknowledged that FIRPTA was a barrier to foreign investment. But the budget document also indicated that foreign, tax-exempt pension plans should be allowed to invest in U.S. real estate and be treated in the same way domestic pension funds are when they invest in U.S. real estate.

"This is a huge step, but they needed to do that through legislative action," DeBoer said, explaining that although the administration appears to favor parity in this regard between tax-exempt domestic and foreign pension funds that invest in real estate, current rules require foreign investors to do so through domestically controlled REITs.

"It would appear they are saying any type of capital gain, whether it's a liquidating distribution or . . . they may sell just one of their assets, they seem to be saying it doesn't have to be a liquidating distribution, nor does the investment need to come through a domestically controlled REIT," DeBoer said. "And that is a very positive step."

DeBoer expressed mixed reactions to the administration's strategy, noting that although he welcomes the budget proposal's thrust, it is burdened by the requirement that it needs to navigate the legislative process to become policy.

"While we are pleased with what the administration has said, we'd also like to see some immediate relief now, which is what they could do by dealing with this IRS notice," DeBoer said.

**Move to Repeal IRS Notice.** The administration plan would, on the one hand, exceed the objectives of repealing Notice 2007-55 by extending the benefits beyond liquidating distributions to any kind of gain, but it also would narrow the policy by restricting it to foreign pension funds.

"We are going to continue to work to lower the tax on foreign investment in U.S. real estate," DeBoer said. "We are going to continue to make the case as to why the current rules are discriminatory vis-a-vis other types of assets in America."

The Real Estate Roundtable, however, also advocates reducing what it regards as other barriers to investment in U.S. real estate, such as the current capital gains tax rate on foreign investment, which DeBoer said is higher than comparable taxes assessed in many other countries.

"We are losing the competition for global funds to other nations on their real estate investments, and in the United States we are losing the competition to other asset classes," DeBoer said.

Meanwhile, the roundtable and other real estate interests will continue to pursue potential remedies whether through the tax reform process, individual legislation, or actions by Treasury.

"The issue is not going to go away because it's a global, capital-flowing world, and capital is going to flow where it can get the best returns," DeBoer said.

By all other measures, the United States real estate should be uniquely attractive to foreign investment due

to the country's favorable property rules, a sound court system, and a stable government.

"But if we have an exceedingly high tax on capital gains here, then investors will look elsewhere," DeBoer said. "We are not maximizing our opportunity here."

DeBoer suggested the roundtable prefers not to hold the prospect of making incremental changes in IRS rules hostage to larger-scale reforms of the tax code. "We continue to state that they could take a very helpful step today through administrative action," he added.

BY RICHARD COWDEN

## Tax Administration

### **IRS Issues Guidance to Managers On Annual Employee OIC Case Evaluation**

**M**anagers of Offer in Compromise field units of the Internal Revenue Service must select at least eight open OIC cases per year to review and evaluate employee performance, IRS said in guidance issued May 10.

The memorandum (SBSE-01-0513-023), issued by the Small Business/Self-Employed Division, is effective May 7, and expires May 7, 2014, IRS said.

Field managers may otherwise choose a "sufficient number" of cases to review in order to effectively evaluate each employee's performance. "This number may vary depending on the needs of the individual employee," so long as it includes at least eight cases, IRS said.

Managers are advised to review at least half of the cases prior to the midyear period, according to the memorandum, and case reviews must be documented using the Embedded Quality Review System, an internal online database used by managers to draft reports and other documents.

*Text of SBSE-01-0513-023 is in TaxCore.*

## Tax Credits

### **IRS Sets Inflation Adjusted Factor For Carbon Dioxide Sequestration Credit**

**T**he Internal Revenue Service May 14 issued the new inflation adjustment factor for the carbon dioxide sequestration under tax code Section 45Q.

In Notice 2013-34, the agency said the inflation adjustment factor, used to determine the amount of the credit allowable under Section 45Q, is 1.0626 for calendar year 2013. The inflation adjustment factor for 2012 was 1.0438.

IRS also announced that the Section 45Q credit for calendar year 2013 is \$21.25 per metric ton of qualified carbon dioxide under Section 45Q(a)(1). This section allows a credit per metric ton of qualified carbon dioxide that is captured by the taxpayer at a qualified facility, disposed of by the taxpayer in secure geological storage, and not used by the taxpayer as a tertiary injectant, IRS said.

The 2013 credit for Section 45Q(a)(2) is \$10.63, IRS said. This section provides a credit per metric ton of qualified carbon dioxide that is captured by the tax-