New U.S. Tax Breaks for Canadians with U.S. Real Property and U.S. REIT Investments

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Canadian investors that own U.S. real property and U.S. REIT shares may benefit from significant changes to the U.S. federal income tax rules on foreign investment in U.S. real property (the Foreign Investment in Real Property Tax Act or "FIRPTA").

For example, "qualified foreign pension funds", which may include Canadian pension funds, are now entirely exempt from U.S. federal income tax on sales of U.S. real property interests as well as real estate investment trust (REIT) distributions attributable to gains from dispositions of U.S. real estate.

Additionally, non-U.S. investors may now generally hold up to 10% (formerly 5%) of publicly traded REITs without being subject FIRPTA tax on dispositions of such REIT stock and on distributions from such REITs that are attributable to gains from dispositions of U.S. real estate.

Although the new rules include relieving measures for some taxpayers subject to FIRPTA, they also increase the FIRPTA withholding tax rate to 15% of the gross purchase price (from 10%) on dispositions of U.S. real property interests by non-U.S. investors still subject to FIRPTA.

New U.S. legislation known as the PATH Act implements these changes and extends some expiring tax provisions, including long-term extensions to U.S. wind and solar energy tax credits that may benefit Canadian companies. The new legislation also changes certain operating rules for U.S. REITs.

This *TaxNewsFlash-Canada* highlights U.S. changes that may affect Canadians owning U.S. real property and stock in U.S. REITs.

What is "real property" for FIRPTA and REITs?
The definition of real property for purposes of the FIRPTA and U.S. REIT rules encompasses more than only land and buildings. For example, certain machinery, transmission lines and intangibles could be viewed as real property within the FIRPTA context, as well as stock in a U.S. corporation that is considered a U.S. real property holding corporation.

Canadian pension funds

The recent changes to the FIRPTA rules are designed to encourage foreign investment in U.S. real property. The changes include an exemption from FIRPTA tax (including FIRPTA withholding) for qualified foreign pension funds, both on dispositions of U.S. real property interests and REIT distributions attributable to gains from the dispositions of U.S. real property. This amendment is effective for dispositions and distributions after December 18, 2015.

KPMG observation
The statutory definition of a "qualified pension fund" eligible for the FIRPTA exemption is complex. A detailed analysis is needed to determine whether a pension plan will qualify. We anticipate that the U.S. Treasury department will provide clarification on this matter.

Canadian owners of U.S. REIT stock

Currently, the FIRPTA regime exempts dispositions of minority interests (5% or less) in publicly traded REIT stock. A similar rule applies to distributions received from certain publicly traded REITs that are attributable to gains from the dispositions of U.S. real estate. The new rules increase the ownership threshold for these two exemptions to 10%.

KPMG observation
Raising the FIRPTA exemption on investments in publicly traded REIT stock from 5% shareholders to 10% shareholders is important to certain large non-U.S. investors who have expressed interest in taking larger stakes in publicly traded REITs, but for the prior 5% limit.

Also, certain publicly traded Canadian limited partnerships that invest in U.S. real estate through U.S. REITs and that meet certain requirements to be a "qualified shareholder" (including being regularly traded on the New York Stock Exchange and/or NASDAQ) may be fully or partially exempt from FIRPTA on dispositions of U.S. REIT units and distributions received by REITS which are attributable to gains from the disposition of U.S. real estate. This exemption can apply to investments in both publicly traded and private U.S. REITs.

KPMG observation
The statutory definition of a "qualified shareholder" eligible for the FIRPTA exemption is complex and a detailed analysis is needed to determine whether a Canadian limited partnership will qualify.

Both of these amendments are effective for dispositions on or after December 18, 2015, and to any distributions by a REIT on or after December 18, 2015 that is treated as a deduction for a tax year of the REIT ending after December 18, 2015.

Clarification on domestically controlled REIT determination

Under the FIRPTA regime, a U.S. real property interest does not include any interest in a domestically controlled REIT (DCREIT). Therefore, a non-U.S. investor may dispose of DCREIT stock without being subject to FIRPTA tax (regardless of its ownership in the REIT and regardless of whether the REIT is publicly traded).

A REIT is domestically controlled if foreign (i.e., non-U.S.) persons directly or indirectly own less than 50% of the value of the REIT's stock. The PATH Act provides the following three new rules to determine whether a REIT is domestically controlled from a U.S. tax perspective:

1. A shareholder owning less than 5% in a public REIT is presumed to be domestic unless the REIT has actual knowledge to the contrary.
2. A regularly traded REIT (or regulated investment company (RIC)) that is domestically controlled is treated as a U.S. person in analyzing whether a subsidiary REIT is domestically controlled (conversely, if the regularly traded REIT (or RIC)) is not domestically controlled, it is treated as a foreign person).
3. A shareholder that is a non-traded U.S. REIT will be treated as a U.S. shareholder only to the extent that stock of such REIT is held by U.S. shareholders.

This provision is effective as of December 18, 2015.

KPMG observation
The PATH Act does not address the larger uncertainty regarding the meaning of "indirect" ownership for this purpose and how it applies to C-Corp REIT shareholders (i.e., whether "indirect" ownership includes constructive ownership principals). Hopefully regulatory authority provided by the legislation will be exercised to provide some clarity for this issue.

Interestingly, the U.S. Congress Joint Committee on Taxation's Explanation states: "Treasury regulations provide that for purposes of determining whether a REIT is domestically controlled, the actual owner of REIT shares is the 'person who is required to include in his return the dividends received on the stock.'"

The IRS has issued a private letter ruling concluding that the term "directly or indirectly" for this purpose does not require looking through corporate entities that, in the facts of the ruling, were represented to be fully taxable domestic corporations for U.S. federal income tax purposes "and not otherwise a REIT, RIC, hybrid entity, conduit, disregarded entity, or other flow-through or look-through entity."

Other relieving measures

The new rules include other provisions that are generally favourable for U.S. REITs, such as assessing safe harbours for prohibited transactions, repealing the preferential dividend rules for publicly offered REITs, expanding certain items to be qualifying items for the REIT assets and income tests and avoiding double tax of earnings and profits at the shareholder level.

Measures to tighten FIRPTA and REIT rules

Some of the new measures are less favourable towards taxpayers. These include:

- Increasing the FIRPTA withholding on dispositions of U.S. real property interests to 15% (from 10%)
- Restrictions on the ability to do REIT spin-off transactions for tax purposes
- Reducing the taxable REIT subsidiary limit to 20% (from 25%)
- Denial of the FIRPTA "cleansing" exception to shareholders in REITs (though this new rule can be helpful in certain instances).

Extended tax provisions —Energy credits

The PATH Act included some tax changes not related to FIRPTA and REITs that may affect Canadian companies. For example, Canadian companies that own wind or solar energy facilities in the U.S. may benefit from long-term extensions to U.S. wind and solar energy tax credits.

Though the credits have been extended, they are scheduled to be phased out. Credits for wind facilities will be available for construction that begins before January 1, 2020. Credits for solar facilities will be available for construction that begins before January 1, 2022. The amount of the credit will depend on the period in which construction begins.

Read more about the U.S. tax changes

For details about these and other U.S. tax changes in the PATH Act, see "Legislative update: Preliminary observations regarding year-end tax legislation", from KPMG in the U.S.

We can help

Your KPMG adviser can help you assess the effect of the U.S. tax changes on your pension fund or business, and point out ways to take advantage of any benefits arising from the

changes or help mitigate their impact. For more details on these changes and their potential impact, contact your KPMG adviser.