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The Real Estate Roundtable

November 30, 2011

VIA EMAIL: notice.comments@irscounsel.treas.gov

CC: PA: LPD: PR (NOT-121556-10)
Room 5203
Internal Revenue Service
PO Box 7604
Ben Franklin Station
Washington, DC 20044

Dear Sir / Madam:

The Foreign Account Tax Compliance Act (“FATCA”)

The Real Estate Roundtable (The Roundtable) represents the leadership of the nation’s top privately owned and publicly held real estate ownership, development, lending and management firms, as well as the elected leaders of the 17 major national real estate industry trade associations. Collectively, Roundtable members hold portfolios containing over 5 billion square feet of developed property valued at over \$1 trillion; over 1.5 million apartment units; and in excess of 1.3 million hotel rooms. Participating Roundtable trade associations represent more than 1.5 million people involved in virtually every aspect of the real estate business. More information on The Roundtable can be found at www.rer.org.

We welcome the opportunity to provide the U.S. Treasury Department (“Treasury”) and Internal Revenue Service (“IRS”) with comments regarding FATCA, which was enacted into law on March 18, 2010 as part of the Hiring Incentives to Restore Employment Act (P.L. 111-147) (H.R. 2847). Our comments address issues raised by FATCA, in general, along with particular issues raised by the preliminary guidance contained in IRS Notices 2010-60,¹ 2011-34,² and 2011-53.³

The Real Estate Roundtable fully supports FATCA’s objective of preventing tax evasion by U.S. persons and promoting transparency in investment structures in furtherance of that objective. However, the Real Estate Roundtable is concerned that the FATCA regime adds substantial and unnecessary complexity and cost to foreign investment in U.S. real estate, severely discouraging the inflow of foreign capital that is critical to the U.S. real estate market and the over-all economy (particularly in the current economic climate). Moreover, we believe that imposing these burdens on investments in U.S. real estate is not necessary to achieve the policy objectives of FATCA, as various special rules for real estate investments already discourage investment by U.S. persons in U.S. real estate through foreign entities. Accordingly, **we respectfully request that the Treasury and IRS exercise their broad grant of regulatory authority under the FATCA rules so as not to unduly impose substantial burdens on U.S. real estate that are not justified by FATCA’s underlying policy objectives.**

¹ I.R.S. Notice 2010-60, 2010-37 I.R.B. 329.

² I.R.S. Notice 2011-34, 2011-19 I.R.B. 765.

³ I.R.S. Notice 2011-53, 2011-32 I.R.B. 124.

Appendix A to this letter contains additional information regarding the FATCA rules and foreign investments in U.S. real estate and explains in more detail how applying the FATCA rules to such investments could cause significant harm to the real estate sector of the economy, without achieving any significant policy or revenue benefit. Appendix A also sets forth several recommendations with regard to administrative guidance.

As is explained in Appendix A, unlike any other asset class, real estate is subject to the “FIRPTA”⁴ regime, set forth in Code Section 897(a)⁵. Under the FIRPTA rules, capital gains and losses from the disposition of real estate (including the sale of stock and certain distributions from corporations that have real estate investments) are generally considered to be effectively connected to a U.S. trade or business.⁶ Due to the FIRPTA rules, in combination with the branch profits tax and “Chapter 3” withholding rules, foreign entities (including foreign entities with U.S. persons as investors) already are subject to tax on investments in U.S. real estate. Indeed, because of these rules, U.S. persons typically invest “directly” into U.S. real estate (rather than indirectly through foreign entities); as such, their investment income already is reported to the IRS by U.S. real estate investment entities via the Schedule K-1 or Form 1099 mechanisms.

As is also explained in Appendix A, it is clear that Congress considered certain asset classes to be outside the realm of the FATCA rules when it excluded from the definition of a “withholdable payment” payments with respect to income that is effectively connected to a U.S. trade or business.⁷ Congress apparently believed that it was not necessary to apply the burdens of the FATCA regime to payments with respect to effectively connected income because rules already exist that discourage U.S. persons from evading tax through investing in U.S. trades or businesses indirectly through foreign entities (*e.g.*, rules requiring withholding on effectively connected income by U.S. partnerships, the requirement to file a U.S. income tax return on receipt of such income, and the application of the branch profits and interest regimes). Congress’ intent not to impose the burdens of the FATCA regime in situations in which there is little or no compliance benefit also is reflected in its grant of authority to Treasury to except from the FATCA rules entities that pose a low risk of tax evasion.⁸

Because investing in U.S. real estate indirectly through foreign entities does not provide an opportunity for tax avoidance, there is no policy or compliance reason to subject the FATCA regime to payments to foreign entities that invest in U.S. real estate. Thus, as indicated in Appendix A, we respectfully recommend that, consistent with the congressional intent described above, the definition of a “withholdable payment” be clarified so as to exclude those payments with respect to foreign investment in U.S. real estate that do not give rise to the concerns FATCA was designed to address. Specifically, we recommend that the definition of “withholdable payment” exclude:

⁴ “FIRPTA” refers to the Foreign Investment in Real Property Tax Act of 1980.

⁵ All references to Code Sections refer to the Internal Revenue Code of 1986, as amended. All references to Treas. Reg. are to the regulations promulgated under the Code.

⁶ Capital gains are a key source of income in the real estate context.

⁷ See Code Section 1473(1)(B).

⁸ See Code Section 1471(f)(4).

- Any distribution of dividends or interest from a United States Real Property Holding Corporation (“USRPHC”), as defined in Code Section 897(c)(2);
- Any liquidating distribution from an entity that would be a USRPHC, had it not fully disposed of all of its U.S. Real Property Interests (“USRPIs”) in fully taxable transactions, as outlined in Code Section 897(c)(1)(B);
- Any payment of U.S.-source dividends, interest, or liquidating proceeds from a U.S. Real Estate Investment Trust (“REIT”), as defined in Code Section 856; and
- Any payment made by an entity classified as a partnership for U.S. federal income tax purposes that, if it were a corporation, would qualify as a USRPHC under Code Section 897(c)(2).

Correspondingly, the definition of “U.S. Asset,” as described in Notice 2011-34, should be modified to exclude any direct or indirect investment in the kinds of entities described above.

In addition, we recommend that the list of “deemed compliant” Foreign Financial Institutions (“FFIs”) include foreign entities that derive at least 90 percent of their U.S.-source income from U.S. real estate. This is important because real estate funds typically hold a small amount of non-real estate assets for liquidity reasons. As a result, even if the definition of “withholdable payment” is modified as described above, some portion of payments to foreign entity investors that hold the majority of their investments in U.S. real estate could be inappropriately subject to the FATCA regime – causing U.S. real estate funds and their foreign investors to bear the costs and burdens associated with that regime.

Finally, we believe that certain additional aspects of the FATCA rules need to be clarified, particularly to the extent that the FATCA regime ultimately might end up applying to some foreign investments in U.S. real estate (notwithstanding our recommendations to the contrary). Some of the issues needing clarification extend beyond real estate concerns to issues that may be of interest to other industries and taxpayers as well. Appendix A summarizes clarifications needed with regard to the rules applicable to partnerships with foreign investors, the definition of “gross proceeds”; the classes of persons to whom the FATCA rules do not apply because of a low risk of tax evasion; and the potential requirement of “account closure” in the context of debt or equity interests.

The Real Estate Roundtable appreciates the opportunity to share these comments and hopes that Treasury and the IRS will take into account the existing rules applicable to investments in U.S. real estate in evaluating to what extent the FATCA rules need to be applied to such investments. While we fully support the goals underlying the FATCA regime, we respectfully contend that imposing the costs and burdens of the FATCA regime on foreign investments in U.S. real estate, without providing appropriate exceptions, would not serve any significant policy objective, but could have a detrimental impact upon the U.S. real estate market, inhibiting much needed foreign capital. Such a move could create a broader economic detriment that would touch the livelihoods of all Americans.

We would welcome the opportunity to discuss the issues addressed in this letter with you. Please do not hesitate to contact me at your earliest convenience.

Sincerely,



Jeffrey D. DeBoer
President and Chief Executive Officer

cc: Ms. Manal Corwin
International Tax Counsel
U.S. Department of Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Mr. Michael Danilack
Deputy Commissioner (International)
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Mr. Stephen A. Musher
Associate Chief Counsel (International)
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Mr. John Sweeney
Senior Technical Reviewer
Office of Associate Chief Counsel (International)
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Mr. Michael Plowgian
Attorney Advisor
Office of Tax Policy
U.S. Department of Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

APPENDIX A

I. Overview of the FATCA Regime

FATCA is designed to identify U.S. persons who hold U.S. investments through foreign entities. It is intended to be a disclosure regime, with withholding rules providing an impetus for compliance with the disclosure requirements. The FATCA rules are very complex. The statutory FATCA rules (Code Sections 1471 – 1474) and the guidance issued thus far are summarized at a very high level below.

The FATCA rules provide a complex withholding and reporting regime for payments to “foreign financial institutions” (“FFIs”), as well as to foreign entities that are not FFIs (“NFFEs”), subject to limited exceptions. Under FATCA, an FFI will be subject to a 30-percent tax on certain Withholdable Payments made to it, unless it complies with certain due diligence, reporting, and withholding requirements, *i.e.*, unless it elects to become a “Participating FFI.” Similar, but less onerous, obligations are imposed on NFFEs. The tax is collected and paid by the “withholding agent,” who is any person (U.S. or foreign) who makes a “Withholdable Payment” or a “Passthru Payment.”⁹ Thus, unless appropriate exceptions are provided, a U.S. real estate fund that is considered to make payments to foreign entities (including foreign entity investors) will have to set up systems for identifying and complying with potential withholding and reporting obligations under FATCA.

The definition of an FFI is very broad and includes not only foreign banking and broker-dealer institutions, but also foreign entities that are engaged primarily in the business of investing, reinvesting, or trading in (1) securities (including stock in corporations); (2) partnership interests; (3) commodities; or (4) interests in such securities, interests, or commodities.¹⁰ The IRS has indicated that the definition of “business” for FATCA differs from the concept of a “trade or business” used elsewhere in the Code and that the FATCA standard for being engaged in a business may be lower than in other contexts.¹¹ Thus, a foreign entity that invests in partnerships or corporations holding real estate could be considered an FFI. Further, persons who hold equity or debt interests in such an FFI would be considered to be “account holders” of the FFI.

Withholdable Payments include (1) interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensation, and other fixed or determinable annual or periodical gains, profits, and income from sources within the United States (*i.e.*, “FDAP” income); and (2) *gross proceeds* from sales or other dispositions of property that could produce interest or dividends from sources within the United States. An exception is provided for certain income that is effectively connected with the conduct of a U.S. trade or business (the “ECI Exception”).¹² Treasury and IRS have not yet provided guidance on what will constitute “gross proceeds” for purposes of the definition of Withholdable Payment. They

⁹ Code Section 1473(4).

¹⁰ The IRS has provided limited exceptions to the FATCA rules for foreign entities that pose a “low risk of tax evasion,” such as foreign governments and certain international organizations.

¹¹ Notice 2010-60, at page 7-8.

¹² Code Section 1473(1)(B).

also have not provided guidance regarding how the definition of Withholdable Payment will apply when a partnership with foreign partners has FDAP income or gross proceeds from the sale or disposition of property that could produce U.S.-source dividends or interest.

An FFI that is engaged in investment activities must enter into an agreement (“an FFI Agreement”) with the IRS under which the FFI agrees to obtain information about direct and indirect holders of its debt and equity interests (as well as, in certain cases, holders of debt and equity interests in affiliated entities), to report to the IRS certain information about “U.S. account holders” (including U.S. persons who own interests through other entities),¹³ and to withhold upon Passthru Payments made to certain “recalcitrant” investors who do not comply with requirements of the FATCA regime. The FFI Agreement will bind the FFI to undertake verification and due diligence procedures to identify U.S. account holders; provide additional information to the IRS where necessary; and, where appropriate, obtain waivers of any local secrecy or privacy laws that prevent the provision of the information requested as a result of FATCA. Further, if a recalcitrant holder will not provide the FFI with the needed information, the FFI may be required to terminate the holder’s debt or equity interest.¹⁴

A Passthru Payment is defined by the Code as any amount attributable to a Withholdable Payment.¹⁵ IRS guidance issued to date has indicated that Passthru Payments will be calculated via a complex “Passthru Payment Percentage” mechanism.¹⁶ Very generally, this calculation hinges upon the ratio of an FFI’s “U.S. Assets” to its “Total Assets,” although the Passthru Payment Percentage of lower-tier foreign entities can affect this calculation as well. The IRS and Treasury have indicated that FFIs will be allowed to elect to have the withholding agent withhold the tax due with respect to recalcitrant holders; thus, U.S. withholding agents may be responsible for collecting and paying over withholding tax with respect to Passthru Payments.

A U.S. Asset is considered to be any asset that could produce a Withholdable Payment, such as an investment in a U.S. corporation.¹⁷ Once a Passthru Payment Percentage has been calculated, it will be utilized to determine the extent of withholding on all payments made to non-participating FFIs and other such recalcitrant investors, regardless of the source of the underlying income that is distributed.

Because FATCA is intended to be a disclosure regime, Treasury and the IRS have indicated that withholding is not intended to be a long-term solution to non-compliance and that account closure may be required.¹⁸ Thus, it appears that withholding agents might be required to terminate relationships with FFIs who do not comply with the disclosure regime, rather than to collect withholding tax on an ongoing basis with respect to Withholdable Payments to such holders. If the withholding agent is a partnership, the “account closure” requirement seemingly

¹³ U.S. account holders include holders of debt or equity interests who are either U.S. persons or U.S.-owned foreign entities. In the case of FFIs that are investment entities, a foreign entity debt or equity holder with *any* level of U.S. ownership qualifies as a “U.S.-owned foreign entity.”

¹⁴ Code Section 1471(b)(1)(F).

¹⁵ Code Section 1471(d)(7)

¹⁶ Notice 2011-34, at pages 19 – 28.

¹⁷ *Id.* at 24.

¹⁸ *Id.* at 19.

might require the partnership to somehow terminate its relationship with non-compliant partners, investors, and lenders.

Congress granted Treasury broad regulatory authority to prescribe regulations or other guidance as may be necessary to carry out the purposes of, and prevent the avoidance of, the FATCA rules.¹⁹

As a general matter, complying with the FATCA rules can be expected to be burdensome not only for foreign entities that are treated as receiving Withholdable Payments (such as foreign entity investors in U.S. real estate funds), but also for withholding agents (such as U.S. real estate funds that are considered to make Withholdable Payments). A number of other commentators already have described issues, including foreign country legal issues, the FATCA regime potentially can raise for foreign entities that invest in the United States. From a U.S. real estate fund's perspective, issues raised include the need to develop systems for identifying Withholdable Payments and classifying and documenting foreign entities to which such payments are made. Further, unless appropriate exceptions are provided, U.S. real estate funds that are treated as making Withholdable Payments will have to assess the impact of FATCA on foreign investor behavior, investor relations, and capital raising strategies. These funds also will need to address legal issues (taking into account fund agreements) associated with imposing withholding on a class of investors and potentially having to terminate prematurely certain investors' interests.

Per Notice 2011-53, FATCA provisions will become effective in phases, from June 30, 2013, through January 1, 2015. The phase-in rules presumably were intended to give the Treasury and the IRS time to flesh out the details of the regime and taxpayers time to determine what new processes need to be implemented and what additional resources need to be deployed

II. Application of FATCA to Investment in U.S. Real Estate

As a threshold matter, the Real Estate Roundtable is concerned that the FATCA regime adds an unnecessary layer of cost and complexity to foreign investment in U.S. real estate, severely discouraging the inflow of foreign capital that is critical to the U.S. real estate markets, in particular, and the U.S. economy, in general. Moreover, applying the FATCA provisions to U.S.-source income generated by U.S. real estate is not necessary to achieve the policy objectives of the FATCA regime, as various special rules for real estate investments already discourage investment by U.S. persons in U.S. real estate through foreign entities. Thus, the potentially dire economic consequences of imposing the FATCA regime on investments in U.S. real estate would not be offset by any significant compliance benefit.

Accordingly, we respectfully request that the rules applicable to investment in U.S. real estate be modified in the manner described below. As is explained below, we believe that such modifications not only are appropriate from a policy perspective, but also are consistent with Congressional intent underlying the FATCA regime.

¹⁹ Code Section 1474(f).

A. Background

In 2007 alone, around **\$50 billion** of foreign capital was directly invested in U.S. commercial real estate.²⁰ Further, it has been estimated that foreign investment accounts for approximately **24 percent** of the institutional equity invested in all income-producing real properties in the United States.²¹

Statistics like these make it clear that the U.S. real estate industry relies upon foreign investors as a key source of capital, much of which is supplied via foreign investment funds. A large portion of these foreign entity investors are expected to be classified as FFIs (given the broad scope of the definition of an FFI and the limited exceptions available). As is indicated in the example below, these foreign entity investors, in effect, may have to choose between complying with the FATCA regime (and potentially accepting lower economic returns on their investments) or simply not investing in real estate funds that hold U.S. property.

Example. A U.S. fund classified as a partnership for U.S. federal income tax purposes invests in U.S. real estate, both directly and through U.S. corporations, U.S. Real Estate Investment Trusts (“REITs”), and debt instruments tied to U.S. real estate. The U.S. fund relies on foreign investors for a significant portion of its capital. The foreign investors typically will pool their capital in non-U.S. entities created specifically for the purpose of investing in the U.S. fund; these non-U.S. entities are likely to be considered FFIs. Thus, as a practical matter, unless the non-U.S. entity investors fall within one of the limited exceptions to the FATCA rules, they will need to become Participating FFIs or will be subject to withholding by the U.S. real estate fund with respect to payments of interest, dividends, and gross proceeds from certain dispositions. From the foreign entity investor’s perspective, either becoming a Participating FFI or becoming subject to a 30-percent withholding tax increases the costs of investing in the U.S. real estate and, thereby, lowers the investor’s return. As was indicated above, becoming a Participating FFI may involve, among other things, upgrading systems and procedures to identify account holders (including indirect owners of foreign entity account holders), facilitating FATCA withholding on Withholdable Payments made to the FFI’s entity investors that will not agree to disclose their direct and indirect owners, and, possibly, terminating the interests of such recalcitrant holders. Moreover, as is explained below, the FFI’s efforts to identify U.S. account holders are likely to yield little fruit because special tax rules applicable to real estate make it uneconomic for U.S. persons to invest in U.S. real estate through foreign entities.

The Real Estate Roundtable is concerned that, rather than agree to the cumbersome requirements, additional costs, and lower returns associated with the FATCA regime, foreign investors simply may decide to avoid investing in U.S. real estate. This could have dire consequences for the U.S. real estate market and would be counter to sound economic policy.

²⁰ *Foreign Investment in U.S. Real Estate – Current Trends and Historical Perspective*, The National Association of Realtors, June 2010, at page 9.

²¹ Leon, Hortense, “Foreign Investment in U.S. Real Estate Continues to Rise,” *National Real Estate Investor*, (May 2005), at pages 20-24.

As previously noted, it has been estimated that foreign investment accounts for close to a quarter of investment in income-producing real properties in the United States. Further, the economic crisis is far from over in the context of real estate. According to the Congressional Oversight Panel,²² **\$1.4 trillion** of commercial real estate loans are coming due between 2010 and 2014, growing to \$2.4 trillion through to 2018.²³ Foreign capital flows clearly are required to support this refinancing process. Impeding this capital flow could further weaken the real estate sector and increase the risk of additional bank failures, with repercussions throughout the U.S. and global economy. As the Congressional Oversight Panel indicated:

A significant wave of commercial mortgage defaults would trigger economic damage that could touch the lives of nearly every American. Empty office complexes, hotels, and retail stores could lead directly to lost jobs. Foreclosures on apartment complexes could push families out of their residences, even if they had never missed a rent payment. Banks that suffer, or are afraid of suffering, commercial mortgage losses could grow even more reluctant to lend, which could in turn further reduce access to credit for more businesses and families and accelerate a negative economic cycle.²⁴

More generally, the Joint Committee on Taxation has recognized that, as a net importer of capital, the U.S. is heavily reliant on the inflow of foreign capital to further its economic growth.²⁵ Thus, discouraging foreign investment in real estate could have significant negative economic repercussions.

Moreover, given that the FATCA regime is intended to be a disclosure regime, the real estate industry is concerned that, as the FATCA regime evolves, the IRS may require real estate funds to terminate the interests of FFIs that do not agree to comply with the FATCA rules (as opposed to allowing the funds to collect withholding tax on an ongoing basis). This would raise significant practical and legal issues for real estate funds, while potentially offering a mechanism for FFI investors to exit funds prematurely. Unlike typical publicly-traded securities, nonpublic REITs and real estate funds involve largely illiquid assets and can be closed- or open-ended. As such, funding early redemptions could require premature sales of real property, to the detriment of other investors and the larger real estate market. Moreover, the funds may not have rights under their organizational documents or within the foreign regulatory environment in which they were formed to redeem or terminate investors that do not comply with the FATCA requirements, such that efforts to terminate interests could create uncertainty and potentially foster litigation.

The Real Estate Roundtable understands and appreciates the policy goals underlying enactment of the FATCA regime and the importance to the U.S. tax system of identifying U.S. taxpayers who invest in foreign entities in an effort to circumvent their obligations to pay U.S. taxes. Nonetheless, as is explained below, we do not believe these policy concerns are present in

²² Congress created the Congressional Oversight Panel in 2008 to respond to the economic crisis by reviewing the current state of financial markets and the regulatory system.

²³ Congressional Oversight Panel, *February Oversight Report – Commercial Real Estate Losses and the Risk to Financial Stability*, February 20, 2010, at pages 2 and 73 (“the ‘COP Report’”).

²⁴ COP Report at p. 3.

²⁵ Joint Committee of Taxation, *Economic and U.S. Income Tax Issues Raised by Sovereign Wealth Fund Investment in the United States* (JCX-04-08), June 17, 2008 at page 1.

the context of real estate. Thus, imposing the FATCA rules in this context could cause significant harm to the real estate sector and the economy as a whole, without achieving any significant policy or revenue benefit.

B. FATCA Provides No Significant Benefit in the Context of U.S. Real Estate Investments

Applying the FATCA regime to foreign entity investors that generate U.S.-source income from U.S. real estate is not necessary to achieve the policy objectives of FATCA. Foreign investment in U.S. real estate investment has long been subject to a combination of various tax regimes (*e.g.*, FIRPTA and / or branch profits tax) that other forms of U.S. investments do not face.

Very generally, the FIRPTA regime (Code Section 897) converts capital gain from the sale of U.S. real estate (or from the sale of entities holding a majority of their assets in U.S. real estate) into U.S.-source income that is effectively connected to a U.S. trade or business (“ECI”) and that, therefore, is taxable in the United States. In many instances, without FIRPTA, foreign investors would not be taxable in the United States on these gains. In essence, the combination of FIRPTA tax and withholding ensures that foreign entity investors are taxed on their capital gains from U.S. real estate.

In addition to FIRPTA, Code Section 884 imposes branch profits tax on a foreign corporation’s “effectively connected earnings and profits.” The branch profits tax is intended to ensure that foreign corporations investing directly in the United States have the same burdens as U.S. corporations with foreign investors. It does so by emulating the foreign dividend withholding tax by calculating a “dividend equivalent amount” on a foreign corporation’s effectively connected earnings and profits, which includes operating income and certain capital gains from U.S. real estate.

Finally, the withholding regime imposed by Chapter Three of the Code (more specifically, Code Sections 1441 – 1446) ensures that a foreign investor’s share of tax on certain payments of fixed and determinable income (“FDAP”) and ECI derived is collected and paid over to the IRS by U.S. withholding agents, be they U.S. partnerships, U.S. REITs, or transferees of U.S. real estate.

Real estate is unique in that no other industry or asset class faces the combination of the above tax and withholding regimes. These regimes impose significant tax costs on U.S. taxpayers who invest in U.S. real estate through foreign entities and make it very unlikely that U.S. taxpayers will invest in U.S. real estate through FFIs or NFFEs, rather than simply investing directly (or through U.S. entities). Instead, U.S. taxpayers are more likely to invest directly in U.S. real estate, or via a U.S. partnership or a U.S. REIT. Thus, applying the FATCA rules in the real estate context will do little in the way of identifying non-compliant U.S. taxpayers or encouraging compliance.

Consider the following example. Assume that a U.S. person will be investing in U.S. commercial real estate that will generate the following income stream:

Figure One: Investment in U.S. Real Estate			
Initial Investment			1,000
Annual Return			9%
Sales Price - Year 5			1,412
Income Stream			
Year One			90
Year Two			90
Year Three			90
Year Four			90
Year Five			90
Year Five - Sale			412
Total Returns:			
Ordinary Income			450
Capital Gain			412

The U.S. person is considering investing in the U.S. real estate either (1) directly (or through a U.S. passthrough entity) or (2) through a foreign entity, such as a foreign fund. As a practical matter, a foreign fund typically will invest in U.S. real estate either (1) through a U.S. corporation or (2) through a foreign corporation.²⁶ Thus, the foreign fund can be subject to FIRPTA rules that convert capital gains into effectively connected income, as well as dividend withholding on distributions from U.S. corporations, or the branch profits tax imposed on foreign corporations that earn ECI.

As a result, as the chart below indicates, the U.S. person's effective tax rate typically will be higher, and (correlatively) his or her after-tax economic return typically will be lower, if he or she invests in the U.S. real estate through a foreign entity (such as a foreign fund) than if he or she invests directly or through a U.S. passthrough entity. Thus, a rational U.S. person is not likely to invest in U.S. real estate through a foreign entity. As such, requiring foreign funds that invest in U.S. real estate to adopt complex systems and procedures in an effort to ferret out U.S. investors that are potentially evading U.S. taxation is not likely to be productive from a U.S. revenue and compliance perspective.

²⁶ The foreign fund typically will not invest via a passthrough entity for administrative reasons. For example, if the fund invests through a partnership (or is itself a partnership and invests directly), large numbers of foreign investors can be considered to be engaged in a U.S. business and can be required to receive Schedules k-1 and file U.S. tax returns. If the foreign partnership invests in the U.S. real estate through a corporate entity, however, that entity pays the U.S. tax and has the return filing requirement.

Figure Two: Calculation of Federal Effective Tax Rates from U.S. Real Estate Investment

Tax Rate Analysis	U.S. Individual		Foreign Fund	
	Direct / U.S. Partnership	U.S. Corp	Foreign Entity	
Ordinary Income	35%	35%	35%	
Capital Gains*	15%	35%	35%	
Dividend Withholding	n/a	30%	n/a	
Branch Profits Tax	n/a	n/a	30%	
Effective Tax Rate				
Ordinary Income	157.50	157.50	157.50	
Capital Gains	61.74	144.05	144.05	
Tax on Dividend Income	-	168.01	-	
Branch Profits Tax	-	-	168.01	
Total Tax	219.24	469.56	469.56	
Effective Tax Rate	25%	54.5%	54.5%	

*Does not take into account unrecaptured section 1250 gain for simplicity

In addition, consider a situation where the person looking to invest in U.S. real estate is a corporation. Despite the lack of reduced capital gains rates, a direct investment in the real estate still yields a lower effective tax rate than an indirect investment through a foreign entity.

Figure Three: Calculation of Federal Effective Tax Rates from U.S. Real Estate Investment

Tax Rate Analysis	U.S. Corporation		Foreign Fund	
	(1) Direct / Partnership	(2) U.S. Corp	(3) Foreign Entity	
Ordinary Income	35%	35%	35%	
Capital Gains*	35%	35%	35%	
Dividend Withholding	n/a	30%	n/a	
Branch Profits Tax	n/a	n/a	30%	
Effective Tax Rate				
Ordinary Income	157.50	157.50	157.50	
Capital Gains	144.05	144.05	144.05	
Tax on Dividend Income	-	168.01	-	
Branch Profits Tax	-	-	168.01	
Total Tax	301.55	469.56	469.56	
Effective Tax Rate	35%	54.5%	54.5%	

*Does not take into account unrecaptured section 1250 gain for simplicity

Finally, as indicated below, a similar outcome occurs when the potential investor is a U.S. REIT (because of the general lack of treaty benefits for REIT dividends, combined again with the FIRPTA rules and the branch profits tax).

Figure Three: Calculation of Federal Effective Tax Rates from U.S. Real Estate Investment - U.S. REIT			
Tax Rate Analysis	U.S. Corporation	Individual	Foreign Fund (Corp)
Ordinary Income / Dividend Withholding	35%	35%	30%
Capital Gains	35%	15%	35%
Branch Profits Tax	n/a	n/a	30%
Effective Tax Rate			
Ordinary Income	157.50	157.50	157.50
Capital Gains	144.05	61.74	144.05
Dividend Withholding	-	-	-
Branch Profits Tax	-	-	168.01
Total Tax	301.55	219.24	469.56
Effective Tax Rate	35%	25%	54.5%

C. Congressional Intent

It is clear that Congress considered certain asset classes to be outside the realm of the FATCA rules when it excluded from the definition of a Withholdable Payment income that is effectively connected to a U.S. trade or business.²⁷ Congress apparently believed that it was not appropriate to apply the burdens of the FATCA regime to ECI because rules already exist that discourage U.S. persons from evading tax through investing in U.S. trades or businesses indirectly through foreign entities (*e.g.*, rules requiring withholding on ECI by U.S. partnerships, the requirement to file a U.S. income tax return on receipt of such income, and the application of the branch profits and interest regimes). Congress' intent not to impose the burdens of the FATCA regime in situations in which there is no compliance benefit also is reflected in its grant of authority to Treasury to except from the FATCA rules entities that pose a low risk of tax evasion.²⁸

D. Recommendations

We believe that excluding certain payments with respect to U.S. real estate from the definition of Withholdable Payment is consistent with the ECI Exception and Congressional intent. As was explained above, under the FIRPTA rules, capital gains and losses from the disposition of U.S. real estate (including the sale of stock and certain distributions from corporations that have real estate investments) are generally considered to be effectively connected to a U.S. trade or business. Moreover, the FIRPTA rules, in combination with the branch profits tax and Chapter 3 withholding rules, already deter U.S. persons from investing in U.S. real estate through foreign entities. Thus, we respectfully recommend that, for purposes of the FATCA rules, the definition of a Withholdable Payment should exclude:

²⁷ See Code Section 1473(1)(B).

²⁸ See Code Section 1471(f)(4).

- Any distribution of dividends or interest from a United States Real Property Holding Corporation (“USRPHC”), as defined in Code Section 897(c)(2);
- Any liquidating distribution from an entity that would be a USRPHC, had it not fully disposed of all of its U.S. Real Property Interests (“USRPIs”) in fully taxable transactions, as outlined in Code Section 897(c)(1)(B);
- Any payment of U.S. source dividends, interest, or liquidating proceeds from a U.S. Real Estate Investment Trust (“REIT”), as defined in Code Section 856; and
- Any payment made by an entity classified as a partnership for U.S. federal tax purposes that, if it were a corporation, would qualify as a USRPHC under Code Section 897(c)(2).

Correspondingly, the definition of “U.S. Asset” as described in Notice 2011-34, should be modified to exclude any direct or indirect investment in the kinds of entities described in (1), above.

In addition, we recommend that the list of “deemed compliant” FFIs include the subset of foreign entity investors that derive at least 90 percent of their U.S.-source income from U.S. real estate.²⁹ This exemption is necessary because real estate funds typically hold a small amount of non-real estate assets for liquidity reasons. As a result, even if the definition of withholdable payment were modified in the manner described above, some portion of payments to foreign entity investors that hold the majority of their investments in U.S. real estate still could be inappropriately subject to the FATCA regime – making it necessary for both U.S. real estate funds and their foreign investors to bear the substantial costs and burdens associated with the FATCA rules, notwithstanding the lack of a compelling policy justification for imposing the FATCA regime on top of the existing rules that discourage U.S. persons from investing in real estate through foreign entities.

Moreover, we believe that certain additional aspects of the FATCA rules need to be clarified, particularly to the extent that the Treasury and the IRS decide to apply the FATCA regime to any foreign investment in U.S. real estate. Some of the issues needing clarification extend beyond real estate concerns and may be of interest to other industries and taxpayers as well. The issues on which clarification is needed include the following.

1. Withholdable Payments Made by Partnerships

It is not clear what constitutes a Withholdable Payment when an entity classified as a partnership for U.S. federal income tax purposes (1) receives U.S.-source FDAP or gross proceeds from disposing of property that generates U.S.-source dividends or interest, and (2) has foreign entity partners or investors. Language throughout the FATCA rules refers to Withholdable Payments “to” or “made to” foreign entities. Further, the withholding tax is to be deducted and withheld from such payments. Such language suggests that partnerships may have

²⁹ The determination of whether U.S.-source income is derived from real estate could be made by reference to the rules under Code Section 856(c)(2), with respect to what income is considered to be “qualifying” income for purposes of the REIT rules.

to actually *pay or distribute* amounts that are attributable to certain dividends, interest, compensation, and gross proceeds to foreign entity investors for the withholding rules to be triggered.

Nonetheless, the existing rules for withholding on non-resident aliens and foreign corporations contained in Chapter Three of the Code generally require U.S. partnerships to withhold on U.S. source FDAP on the *earlier* of the distribution of cash or the provision of a schedule K-1.³⁰ Thus, it is not clear whether a partnership might be considered to make a Withholdable Payment merely by allocating certain kinds of income to foreign entity partners. The lack of clarity is compounded in the case of gross proceeds received by a partnership given that the amount of gain, income, or loss allocated to a partner under the tax rules can be quite different than such partner's allocable share of the proceeds from a disposition. That is, the fact that a partnership generates gross proceeds from the disposition of an asset does not mean that there will be a corresponding income or gain item to allocate. In fact, a partnership presumably can generate gross proceeds on a disposition in which it recognizes no gain, or even a loss.

We believe it is important for the IRS and Treasury to provide clear guidance as to how the Withholdable Payment rules will apply in the partnership context. To alleviate the confusion with regard to gross proceeds, such guidance could clarify that FATCA withholding would only be required when a partnership either (1) makes a payment of FDAP or of applicable gross proceeds to a foreign payee (*e.g.*, a payment to a foreign entity that sells the partnership U.S. stock), or (2) distributes to a foreign partner an amount that is derived from FDAP or applicable gross proceeds received by the partnership (*e.g.*, a distribution to a foreign partner of an amount received by the partnership on its sale of U.S. stock). The partnership could determine the extent to which a payment constitutes a Withholdable Payment by applying a proportionate approach to all distributions made (or by another reasonable method).

We understand that the Treasury and the IRS may be concerned that restricting partnership withholding on withholdable payments to actual distributions of cash could result in potentially abusive situations under the FATCA regime (*e.g.*, reinvesting proceeds in non-U.S. corporations). To counter this, the Treasury and the IRS could consider an anti-abuse provision, whereby FATCA imposes withholding at the time of the distribution of cash by a partnership to non-compliant foreign partners *or* the reinvestment of that cash by the partnership into a “non-liquid” asset (essentially any asset that is not cash) or non-U.S. asset (such as an “other asset” as defined in Notice 2011-34).

Furthermore, in certain instances (such as in tiered partnership structures), a U.S. partnership may be required to distribute cash in accordance with its obligations under a partnership agreement, prior to receiving any notification from a lower-tier partnership or investment regarding the exact nature of the distribution received, *e.g.*, whether the distribution constitutes gross proceeds or a return or capital, FDAP income, ECI, etc. We note that Chapter Three currently provides a mechanism whereby withholding on the distribution of an undetermined amount of income may be deposited on escrow until such time that the payment

³⁰ See Treas. Reg. section 1.1441-5(b)(2)(i).

can be identified and withholding appropriately calculated.³¹ We respectfully suggest that administrative guidance provide a similar mechanism for FATCA withholding.

2. “Gross Proceeds”

As was explained above, Withholdable Payments can include gross proceeds from sales or other dispositions of property that could produce interest or dividends from sources within the United States. As is explained below, administrative guidance should define what constitutes gross proceeds for purposes of the FATCA rules and should make clear that gross proceeds can only give rise to a withholding obligation to the extent the underlying transaction generates sufficient cash for the withholding agent to satisfy such withholding obligation. Further, guidance should make clear that liquidating distributions from a USRPHC are not gross proceeds and do not give rise to Withholdable Payments.

a. Defining Gross Proceeds

We believe a withholding agent should not be liable for withholding to the extent the transaction generating the withholding obligation does not generate sufficient cash to satisfy such obligation.

For example, U.S. real estate funds typically hold real estate that is subject to debt. If a debt instrument is modified significantly (as is common, particularly in the current economic climate), the fund might be considered to have disposed of the debt in exchange for a new instrument under Treas. Reg. Section 1.1001-3. Does a withholding obligation flow from the deemed disposition of the debt? That is, is the fund considered to be “paying” gross proceeds by virtue of exchanging the old debt for the new debt? Or, if the fund is classified as a partnership for federal income tax purposes (as is common) and has foreign investors, is it subject to a withholding obligation because of its deemed receipt of the new debt?³² As another example, consider a situation in which a U.S. real estate fund disposes of one USRPI for another USRPI in a tax-free transaction.³³ Does such a transaction generate gross proceeds, even though it does not generate any cash?

We respectfully submit that it is not appropriate to subject the U.S. fund withholding agent to liability for FATCA withholding in situations like the ones described above. If such transactions were treated as giving rise to Withholdable Payments, the U.S. fund might be liable for withholding with respect to legitimate business transactions, even though it might not have

³¹ See Treas. Reg. section 1.1441-3(d).

³² As indicated above, it is not currently clear to what extent the FATCA rules might require withholding if a partnership receives gross proceeds and has foreign investors.

³³ In the real estate context, Code Section 897 can, in many cases, override “tax-free” treatment and convert gain or loss from what otherwise would be a tax-free exchange into income that is effectively connected to a U.S. trade or business. In such a case, the transaction should not generate a Withholdable Payment under the “ECI exception” because it results in gain or loss that is effectively connected to a U.S. trade or business. In some cases, however, the tax-free treatment of such a transaction is preserved by Code Section 897(e). A complex set of rules outlined in various IRS Notices and Temporary Regulations governs the treatment of these transactions. However, very generally, the tax-free treatment is preserved when one USRPI is exchanged for another, *i.e.*, deferring the taxation of the investment under FIRPTA. See, *e.g.*, Notice 2006-46, 2006-46 I.R.B. 1044 and Notice 99-43, 1999-2 C.B. 344.

sufficient cash to meet the resulting withholding obligation. In fact, it is quite likely that the fund will not hold sufficient cash to meet the obligation given that funds predominantly hold illiquid assets and may be restricted from selling their real estate assets early to generate cash under legal agreements. Economic conditions also may mitigate against selling real estate prematurely to generate cash. Thus, the U.S. fund may be in a difficult predicament, practically and legally, if it is forced to find cash to satisfy the withholding obligation. Moreover, requiring withholding on “gross proceeds” of non-cash transactions seems particularly harsh and punitive given that the withholding agent’s withholding liability is triggered, not by anything inappropriate the agent has done, but by whether third parties (such as foreign investors and creditors) have complied with the FATCA rules.

We understand that Treasury may be concerned that restricting FATCA withholding on gross proceeds to cash transactions could result in potential abuse in certain situations. An example may be where a U.S. partnership owns a U.S. corporation, which could potentially produce a withholdable payment under FATCA, either via the distribution of a dividend or the sale of stock in that entity. However, the U.S. partnership may undertake a “tax free” reorganization of that entity, whereby that U.S. corporation is converted into a foreign corporation. This could potentially circumvent FATCA withholding on behalf of a foreign entity limited partner, as the newly organized foreign corporation would not produce a withholdable payment.

However, as these situations are limited to potentially abusive transactions that are designed to circumvent the goals of the FATCA regime, we would suggest that FATCA withholding on gross proceeds on non-cash transactions be limited to such abusive situations. This would avoid the adverse impact on U.S. withholding agents outlined above, whilst achieving the goals of the FATCA regime.

b. Liquidating Distributions

Because Withholdable Payments can include gross proceeds from sales or other dispositions of property that can produce interest or dividends from sources within the United States, a “sale or other disposition” of stock in a U.S. corporation could generate a Withholdable Payment. Under Code Section 331, certain liquidating distributions from U.S. corporations are considered to be made in exchange for stock and, therefore, seemingly might be treated as giving rise to Withholdable Payments.

Here again, foreign investment in real estate is subject to a special set of rules that are not applicable in other situations. Specifically, FIRPTA taxes foreign investors on the disposition of investments in certain corporations and debt instruments that are considered to be investments in U.S. real property (“USRPIs”). As a practical matter, a foreign entity investor typically has two options for disposing of a real estate asset held via a USRPHC, *i.e.*, an entity that holds a majority of its assets in USRPIs:

1. It can dispose of the stock in the USRPHC. In such a case, under Code Section 897(a), it generally will be subject to FIRPTA tax (and withholding) on any gain or loss as if it were engaged in a U.S. trade or business.

2. Alternatively, it can ensure that all of the USPRIs held by the USRPHC are sold in a fully taxable transaction (*i.e.*, it can ensure that the USRPHC has “cleansed” itself under the FIRPTA regime),³⁴ and then the USPRC can completely liquidate. The liquidation would be treated as a sale or exchange of stock. Because the USRPHC is no longer a USRPI under FIRPTA, the stock sale is not taxable in the United States as effectively connected income in the hands of the foreign investor. However, as indicated above, the sale of the USPRIs already would have been subject to tax.

From a U.S. federal income tax perspective, there is essentially no difference between the two alternatives. Both create taxable gain for the foreign investors under the FIRPTA rules. Nonetheless, buyers typically prefer the second option for due diligence reasons – *i.e.*, buyers typically prefer to purchase the USPRIs, rather than the stock of the USPRH. If, however, liquidating distributions from USRPHCs are treated as giving rise to Withholdable Payments under FATCA, such distributions, in effect, could be “taxed twice” -- *i.e.*, once by means of the federal (and potential state) income tax at the corporate level, and again under FATCA. This result would cause two transactions that are fundamentally identical from an economic perspective to be taxed differently. Perhaps more importantly in the FATCA context, treating distributions in liquidation of USRPHCs as Withholdable Payments appears to be inconsistent with the ECI Exception and underlying Congressional intent. As such, we respectfully suggest that the definition of a “gross proceeds” should be clarified to exclude liquidating distributions from a USRPHC.

3. Foreign Governments and Pension Plans

Code Section 1471(f) provides that the FATCA withholding and reporting rules do not apply to any payment to the extent the beneficial owner of such payment is (1) a foreign government, (2) an international organization, (3) a foreign central bank or issue, or (4) “any other class of persons identified by the Secretary for purposes of this subsection as posing a low risk of tax evasion.” We respectfully submit that the following foreign pension plans should be added to the classes of persons identified as posing a low risk of tax evasion for purposes of the FATCA rules: (1) entities that qualify as a Foreign Government or a Separately Organized Pension Plan under Treas. Reg. Section 1.892-2T; and (2) entities that are wholly owned by one or more entities described above. This would provide clarity with respect to the application of FATCA to sovereign wealth and pension plan investors (which are a key source of capital for the U.S. markets).

4. Sourcing of Withholdable Payments Made by Partnerships

An investment in a U.S. corporation can be a U.S. Asset for purposes of the Passthru Payment rules *i.e.*, because it can produce U.S.-source dividends. However, it is not clear whether an investment in a U.S. partnership can be a U.S. Asset for such purposes.

Under the current income sourcing rules in Code Sections 861 – 865, the mere existence of a U.S. partnership in an investment structure would not, in its own right, create a risk of U.S.-source income. Partnerships are, by their nature, flow-through entities and, therefore, do not re-

³⁴ See Code Section 897(c)(1)(B).

source income by reason of where they are organized. Further, we do not believe that the statutory FATCA rules provide or suggest that the current sourcing rules should be overridden to achieve the goals of FATCA. As such, we respectfully request that the Treasury and the IRS clarify that an investment in a U.S. partnership is not a U.S. Asset for purposes of the FATCA rules. In addition, we recommend that, in determining a Passthru Payment Percentage, a foreign entity would be required to look through a U.S. partnership to determine its U.S. Assets. Further, the fact that an entity in a fund distribution chain (*e.g.*, a lower-tier entity) is a U.S. partnership should not, by itself, create a Withholdable Payment; instead, the focus should be on the extent to which the U.S. partnership holds U.S. Assets.

5. Account Closure in the Context of Debt or Equity Interests

As was indicated above, we understand that the IRS and Treasury might be considering requiring withholding agents to terminate relationships, including debt and equity relationships, with FFIs who do not comply with the disclosure regime. We are concerned with this approach when the “accounts” that would be required to be closed are debt or equity interests in an entity. Terminating such relationships prematurely can be costly and can raise legal and other issues.

For example, in many instances, particularly in the realm of real estate, U.S. and foreign funds may suffer from a lack of liquidity. As a result, terminating debt and equity relationships would create cash flow problems, the resolution of which could negatively affect the fund’s investors – including those that are complying with all U.S. tax laws (including FATCA). Moreover, existing fund agreements might not allow the fund to prematurely sell assets to raise cash or to prematurely redeem a class of investors. Such actions also may raise fiduciary duty concerns, particularly in certain market conditions or at certain stages of development. It similarly may be difficult, both practically and legally, for a fund to prepay or to refinance debt to foreign creditors that are not FATCA compliant.

Thus, we respectfully request that any “account closure” requirements not be extended to equity and debt interests that are considered financial accounts. If this is not acceptable, then we recommend at least that any account closure requirements not be applied to debt or equity interests outstanding prior to January 1, 2014. Such a measure at least would allow funds to contemplate such an occurrence in developing their business plans and in drafting and/or amending their organizational and contractual agreements.

We appreciate your consideration of these comments. Please let us know if you would like to discuss these matters, or if we can assist you in any other way.