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Impact of Proposed FATCA Regulations on U.S. Real Estate Ventures With Non-U.S. Investors or Lenders

The Internal Revenue Service (IRS) recently proposed enormously complex regulations under the Foreign Account Tax Compliance Act.[1] This *Alert* looks at the challenges that a U.S. real estate fund or joint venture with foreign investors or lenders will face under these proposed rules.

Scope of FATCA

FATCA "targets non-compliance by U.S. taxpayers using foreign accounts."[2] The purpose of the legislation is to help the IRS obtain information about foreign bank accounts owned by U.S. taxpayers in order to prevent them from avoiding their U.S. tax obligations.[3] Although U.S. real estate ventures[4] are not even mentioned by the IRS on its main web page devoted to FATCA,[5] they are impacted because they must withhold taxes on certain types of payments to foreign financial institutions that do not agree to report the identity of their U.S. account holders to the IRS.

The driving mechanism of FATCA is to force foreign financial institutions (called "FFIs" in FATCA jargon) to become "participating FFIs" by entering into prescribed FFI agreements with the IRS. The IRS designed the FFI agreement to make FFIs effective instruments for enforcing U.S. tax compliance by American holders of foreign financial accounts. Toward that end, the FFI agreement imposes onerous obligations on a participating FFI, most notably a requirement that an FFI deduct and withhold 30% from its own FATCA payments (for example, certain interest payments) to certain uncooperative account holders and financial institutions. Unless qualifying for some specific exemption, an FFI that refuses to enter into such an agreement with the IRS will be considered a "non-participating FFI" and thereby become subject to U.S. withholding tax on certain income of its own.

Thus, a U.S. fund, REIT, corporation, or JV that makes FATCA payments to a non-participating FFI must generally deduct and withhold a 30% U.S. tax from those payments.

The new regulations delay the application of the statute, phasing in different parts at different times between 2013 and 2017. The FATCA rules are highly controversial, especially to foreign governments and foreign financial institutions (such as banks, brokers, custodians, and funds). Various requirements could change, and effective dates may be pushed back again.

The complexity and length of the proposed regulations limit the scope of this article to a high-level summary of some of FATCA's more notable requirements. U.S. funds, JVs, and REITs should consult with their tax lawyers and accountants to develop plans to comply with these regulations when they become effective, including changes to the representations contained in their subscription agreements and changes to their partnership agreements and other investment documents.

U.S. Fund and JV Requirements. U.S. real estate funds, REITs, and joint ventures will be directly impacted by FATCA's withholding, due diligence, and reporting requirements. These requirements, now scheduled to take effect on January 1, 2014, will impose a heavy new compliance burden on many U.S. real estate ventures with foreign investors or foreign lenders. In particular, FATCA's compliance burden will fall on any real estate fund or joint venture having a foreign investor holding its interest through a U.S. blocker corporation, REITS with foreign investors, regular C corporations with foreign institutional investors, real estate funds and joint ventures with foreign lenders, and funds and joint ventures deriving passive rental income (such as from net leases).

For these types of U.S. real estate funds, REITs, and joint ventures, the 394 pages of the new FATCA regulations are filled with certifications to be obtained, documentation to be maintained, and IRS forms to be filed. Such U.S. entities also face potentially severe financial obligations under FATCA: They must collect withholding taxes, generally at a 30% rate, from certain payments to undocumented payees, which will be presumed to be non-participating FFIs in various circumstances. U.S. funds and JVs must furnish annual accountings of the withheld amounts to both the IRS and the affected foreign payees on prescribed forms, and penalties are imposed for noncompliance.

The IRS has gone to extraordinary lengths to provide detailed guidance. That is why, for example, U.S. withholding agents must sort through more than a hundred specially defined terms in these provisions.[6] Similarly, it takes more than 80 pages of proposed regulations[7] to cover what a withholding agent — such as a U.S. fund[8] — must do to determine whether the nominal recipient of a payment is the true payee for FATCA purposes and then to determine the status of the payee under a wordy and convoluted classification framework.

Withholding Obligations Imposed on U.S. Funds and JVs. FATCA relies on fiscal and procedural mechanisms to force foreign banks, foreign broker/custodians, and foreign investment funds to disclose their U.S. account holders.[9] An important IRS weapon deployed in this campaign is a new withholding tax required to be collected by U.S. funds and JVs on payments to foreign recipients. The FATCA regulations effectively say to foreign institutions that if they do not give the IRS the disclosure it demands about their U.S. account holders, the IRS will require U.S. businesses to withhold a very large tax when they make payments (such as interest and dividends on U.S. investments) to the foreign institutions and that the institutions may not get that withholding tax back if they have not complied with IRS demands for disclosure about U.S. ownership.

This is the context in which the proposed FATCA regulations will subject U.S. funds, REITs, and JVs having undocumented or noncompliant foreign investors to formidable new withholding, documentation, and reporting obligations in respect of their payments to foreign recipients. U.S. withholding agents (such as U.S. real estate funds, REITs, and JVs) are being saddled with this new IRS compliance burden purely to pressure foreign banks and other foreign investment entities to produce unrelated information that the IRS is demanding about non-tax-compliant American account holders. In the proposed FATCA regulations, the IRS has created a densely woven and intricate regulatory net and spread it across an immense transactional area. A great deal of irrelevant information will inevitably become entangled in that regulatory net.

Unintended Chilling of U.S. Investment by Foreign Financial Institutions. The FATCA regulations apply to payments to FFIs that are not subject to U.S. Foreign Investment in Real Property Tax Act (FIRPTA) or "effectively connected income" (ECI) withholding (including interest payments or liquidating dividends from a U.S. blocker corporation or REIT). The regulations are so burdensome both on U.S. fund/JV/REIT sponsors and on the FFIs themselves that FFIs having U.S. investors may well avoid U.S. real estate investment to avoid having to comply.

U.S. Funds/JVs Must Make Many Determinations Under FATCA

For simplicity, the discussion here assumes that (1) the fund or JV is organized as a U.S. partnership, C corporation, or REIT; (2) the fund or JV assets will consist primarily of U.S. real estate interests, held directly or through a pass-through entity (e.g., a partnership, a REIT, or an LLC); and (3) the fund, REIT, C corporation, or JV (collectively, a "U.S. fund/JV") will distribute its profits to foreign equity holders or pay interest to foreign lenders.

Determinations to Be Made by U.S. Fund/JV. FATCA forces a U.S. fund/JV to conduct what amounts to an extensive investigation of the U.S. tax profile of its foreign investors. The extent of a U.S. fund/JV's FATCA withholding, documentation, and reporting obligations is driven by the following factual determinations that FATCA requires the U.S. fund/JV to make:

1. When the U.S. fund/JV is a partnership with foreign partners, what is the relevant "payment" for purposes of the FATCA withholding requirement?
2. Who is treated as the recipient of the payment?
3. Is the payment a "withholdable payment" under the FATCA rules?
4. Does that payment—even if it is classified as a withholdable payment—nonetheless qualify as an "excepted payment" under FATCA so that no withholding is required?
5. Is the recipient a foreign financial institution?. If so, the U.S. fund/JV must go on to determine what type of FFI it is dealing with.
6. If the recipient is not an FFI, is it nevertheless classifiable as a "non-financial foreign entity" (an "NFFE" in FATCA-speak)? If so, the U.S. fund/JV must determine what type of NFFE it is dealing with.

A U.S. fund/JV must carry out all these determinations in compliance with strict procedures spelled out in the proposed FATCA regulations, or it is subject to penalties.[10]

Determinations Examined. The following discussion examines these key determinations that a U.S. fund/JV must make under the FATCA regulations regarding each payment to a foreign recipient.

1. When the U.S. fund/JV is a partnership with foreign partners, what constitutes the potentially withholdable payment under FATCA?

Under U.S. tax law, a partnership or an LLC is a pass-through entity: The partners must include in their own gross income their share of the partnership's income, whether or not it is distributed to them. FATCA applies to payments made to a foreign recipient, which raises the question of when a foreign partner is deemed to receive a payment of the partnership's income. FATCA withholding applies not just when partnership income is distributed to a foreign partner. The FATCA regulations follow the approach used in the regular U.S. withholding system for passive ("fixed and determinable") income, such as interest, and provide that if a fund that is a partnership receives income of a withholdable character under FATCA, a foreign partner's share of that income—whether or not distributed to the partner—is subject to FATCA withholding tax.

This means that the partnership must make a withholding payment to the IRS on income for which it may not yet have received the cash and on income it otherwise would not yet distribute.[11]

When a distribution to a foreign partner includes any FATCA income, the partnership's withholding obligation with respect to that income is triggered by the distribution, and if some portion of the partnership's FATCA income remains undistributed at year-end, the partnership must pay withholding tax to the IRS on a foreign partner's share of that amount no later than the due date for furnishing K-1 forms to the partners.[12]

2. Who is treated as the recipient of the payment?

The extent of a U.S. fund/JV's FATCA obligations with regard to a given payment depends on how the recipient is characterized under an elaborate payee classification scheme developed by the IRS in the proposed regulations. It makes a great deal of difference, for example, whether the payee is an FFI (such as a foreign bank) or merely an NFFE, with an FFI being treated far more harshly than an NFFE under FATCA. At an even more granular level, the proposed regulations distinguish numerous subtypes of FFIs, and these distinctions have important operative consequences for the U.S. fund/JV's compliance obligations.

Before it can classify a payee under this scheme, the withholding agent must have ground rules for dealing with nominees, agents, and intermediaries and for other situations (such as payments to a foreign partnership or disregarded entity) in which the record titleholder of an asset may differ from the beneficial or ultimate owner. Section 1.1471-3(a)(3) prescribes the rules for identifying the relevant payee for FATCA purposes in such situations (beyond the scope of this article). These rules contain a detailed set of sharply but arbitrarily drawn distinctions designed to provide some clarity in the midst of complexity.

3. Is the payment a "withholdable payment"?

The FATCA rules will apply to a U.S. fund/JV on a payment-by-payment basis. Only if a payment to a foreign entity falls within FATCA's definition of "withholdable payment" will a U.S. fund/JV need to examine its FATCA obligations any further with regard to that payment. As to payments that are not withholdable payments, a withholding agent (such as a U.S. fund/ JV) has no FATCA obligations.

FATCA's definition of "withholdable payment" is an untidy patchwork (like much else in FATCA). From the perspective of a U.S. fund/JV, the principal types of withholdable payment include the following:

Withholdable Payments Received by a Partnership

- In the hands of a partnership, rental or interest income that is passive income under general tax concepts is characterized as a withholdable payment.[13] Rental income earned by a property owner under a triple-net lease is treated as passive income under some precedents.[14] Thus, for a partnership U.S. fund/JV, such passive rentals likely would be treated as withholdable payments.

- Sales proceeds derived by a U.S. fund/JV from the sale of shares in a domestically controlled REIT are withholdable payments for a partnership.[15] But if the REIT is not domestically controlled, the partnership's proceeds from the sale of its REIT shares do not constitute withholdable payments.

    - In addition, all income derived by a U.S. fund/JV from the active conduct of a business is excluded from treatment as a withholdable payment for a partnership because the partnership already is subject to U.S. withholding tax on this income (at graduated rates) under another set of Code provisions.[16] Thus, in principle, the active management and operation of rental real estate owned by a U.S. fund/JV will not give rise to withholdable rental payments to the fund's foreign partners.
    - Proceeds derived by a foreign corporation as a partner in a U.S. fund/JV from the sale of a U.S. real estate interest are per se classified as active business income.[17] Thus, a U.S. fund/JV's gain on its disposition of U.S. real property will typically be exempt from FATCA withholding under the proposed regulations because the gain is subject to FIRPTA withholding instead.[18]

- As mentioned earlier, withholdable payments received by a U.S. fund/JV that is a partnership with certain types of foreign partner are subject to FATCA withholding whether or not they are actually distributed to the foreign partner. Under FATCA, the partnership is deemed to pay the foreign partner its share of the withholdable payments, whether or not those amounts are actually distributed.

Withholdable Payments Made by a Partnership, REIT, or C Corporation[19] (Including U.S. Blocker Corporations)

- FATCA treats interest paid by a U.S. fund/JV (whether it is a partnership or a corporation) to a foreign lender having no U.S. branch or active business operations as a withholdable payment to the lender.[20]

Withholdable Payments Made by a REIT or C Corporation (Including U.S. Blocker Corporations)

- Dividends paid by a C corporation to a foreign shareholder also constitute a withholdable payment by the corporation to the shareholder. Moreover, liquidating distributions from a C corporation, after a taxable sale of its assets has removed its FIRPTA taint, would be deemed to be withholdable payments.

- For a U.S. fund/JV that is a REIT, operating dividends likewise are treated as withholdable payments.

- However, a REIT's capital gain dividends attributable to U.S. real estate sales are not withholdable payments.

- Liquidation proceeds paid by a domestically controlled REIT to a foreign shareholder would constitute withholdable payments because such proceeds are not taxable under FIRPTA.[21]
  - However, if the REIT is not domestically controlled, such liquidation proceeds would not constitute withholdable payments under FATCA (the proceeds are already subject to FIRPTA withholding).

4. If a payment is classified as withholdable under FATCA, does it nonetheless qualify as an excepted payment?

FATCA grants a blanket exemption for payments made to various specified types of recipient. The exemptions relevant to U.S. fund/JVs cover payments to foreign sovereign investors and certain foreign retirement funds, as well as payments under certain "grandfathered obligations."[22] Once it documents that a payment qualifies under one of these exceptions, a U.S. fund/JV has no further FATCA compliance obligations with respect to that payment.

Several additional types of excepted payment apply only if the foreign recipient is an NFFE, rather than an FFI. These NFFE specific exceptions are noted in the discussion about NFFEs.

5. Is the recipient a "foreign financial institution"?

For each withholdable payment to a foreign entity that does not qualify as an excepted payment, the next step in a U.S. fund/JV's diligence process is to determine whether that entity is classified as an FFI. If the foreign entity is a financial institution, it is an FFI.[23] The FATCA definition of "financial institution" includes banks, trust companies, securities firms, and many organizational structures commonly used by foreign funds investing in U.S. real estate if they are in the "business" of investing in partnerships.[24] FATCA's legislative history makes it clear that in the context of defining an FFI, "the term financial institution may include among other entities, investment vehicles such as hedge funds and private equity funds."[25]

If a U.S. fund/JV's foreign investor or foreign lender is an FFI, the U.S. fund/JV must then determine what type of FFI it is dealing with. The proposed regulations differentiate among various distinct types of FFI: the "participating FFI,"[26] the "nonparticipating FFI," the "deemed-compliant FFI" (which in turn has three subtypes: "certified," "registered," and "owner- documented"), the "limited branch," the "limited FFI," and the "excepted FFI," in addition to the related concept of a "participating FFI group."[27] The FATCA duties of a withholding agent, such as a U.S. fund/JV making a payment to an FFI investor or lender, depend heavily on where the foreign recipient is placed within this unintuitive classificatory scheme.

6. If the recipient is an NFFE, what obligations does the U.S. fund/JV have?

A foreign entity that falls outside the FATCA definition of a "financial institution" will be treated as a non-financial foreign entity, or NFFE. The compliance obligations of an NFFE, while considerably less onerous than those imposed on FFIs, are by no means insubstantial. In general, an NFFE is called upon to identify its substantial U.S. account holders and to provide specified information about them in order to avoid withholding tax on its receipt of FATCA payments. A U.S. fund/JV making a FATCA payment to an NFFE must withhold tax, generally at 30%, unless the NFFE either certifies that it has no "substantial U.S. owners" or provides the name, address, and tax identification number of each such U.S. owner.[28]

Payments to several specified types of NFFE are excepted from FATCA. The excepted recipients include publicly traded companies and their affiliates and certain companies conducting active businesses.

Conclusion

As discussed, FATCA will impose onerous compliance burdens. U.S. fund/JVs (including REITS) should consult with their lawyers and accountants to develop plans to comply with these regulations when they become effective. This will include changes to the representations contained in their subscription agreements and changes to their partnership agreements and other investment documents. Until the final rules become effective, FATCA will be a moving target. As U.S. fund sponsors and foreign investors come to realize how complex and difficult it will be to do business under the proposed regulations, they are likely to demand that the IRS make substantial changes in the FATCA regulatory regime. Stay tuned.

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[1] IRS Notice of Proposed Rulemaking, REG-1 21647-10 (Feb. 8, 2012).
[2] IRS, "Foreign Account Tax Compliance Act (FATCA),"
http://www.irs.gov/businesses/corporations/article/0,,id=236667,00.html (accessed March 14, 2012).
[3] "Under FATCA, certain U.S. taxpayers holding financial assets outside the United States must report those assets to the IRS. In addition, FATCA will require foreign financial institutions to report directly to the IRS certain information about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest." Joint press release by IRS and U.S. Treasury, IR-201 2-15 (Feb. 8, 2012).
[4] The Real Estate Roundtable has commented that there should be broad exemptions from FATCA for investments in U.S. real estate because existing law already subjects inbound real estate investment to heavy taxation. See November 30, 2011, Real Estate Roundtable letter to IRS. The Treasury has not accepted these recommendations.
[5] IRS, "Foreign Account Tax Compliance Act (FATCA),"
http://www.irs.gov/businesses/corporations/article/0,,id=236667,00.html (accessed March 14, 2012).
[6] See, e.g., Prop. Reg. §§1.1471-1(b); 1.1471-3; 1.1473-1. These are technical and artificial constructs without much intuitive meaning. To apply FATCA to a particular situation, the reader must continually refer back to such technical definitions.
[7] See Prop. Reg. §1.1471-3.
[8] With regard to any "withholdable payment" that it makes, a U.S. fund will constitute a "withholding agent" under Prop. Reg. §§1 .1471-1 (b)(69), 1.1473-1(d). The concept of "withholdable payment" is discussed later in this article.
[9] Such disclosures would presumably be used to support an examination of whether various U.S. taxpayers have appropriately disclosed the existence of certain foreign investments and reported the income from them.
[10] See, e.g., Prop. Reg. §§ 1.1474-1; 1.1471-3; 1.1474-4.
[11] Prop. Reg. §§ 1.1473-1 (a)(5)(ii); 1.1441-5(b)(2)(ii).
[12] This due date is generally April 15 of the year following the tax year involved.
[13] See Prop. Reg. §1 .1471-1(a)(66); 1 .1473-1(a)(2).
[14] While there is authority supporting the characterization of rental income earned by a property owner under a triple-net lease as passive income, the line separating active from passive rentals in such cases is not clearly drawn.
[15] See Prop. Reg. §1 .1474-6(c)(1); IRC §897(h)(2). FATCA withholding is imposed in this instance because the proceeds are not taxable under FIRPTA.
[16] IRC§1446.
[17] See §1.1473-1(a)(4)(ii); IRC §897.
[18] Prop. Reg. §1.1474-6(c)(1).
[19] REITs or C corporations are included within a variety of fund structures.
[20] Moreover, if the debt obligation between these parties is significantly modified, retired, or redeemed, then that event, under hyper-technical rules, may give rise to a withholdable payment by the U.S. borrower to the foreign lender.
[21] See Prop. Reg. §§ 1.1474-6(c)(1); IRC §897(h)(2).
[22] IRC §§1471(f)(1) and 1472(c)(1)(D) grant an exception to "any foreign government, any political subdivision of a foreign government, or any wholly owned agency or instrumentality of any one or more of the foregoing." Two other exempted payee categories are international organizations and foreign central banks. See IRC §§1471(f)(2)-(3), 1472(c)(1)(E)-(F).
[23] See IRC §1471(d)(4)-(5).
[24] This arises mainly from FATCA's identification of "the business of investing in ... partnerships." IRC §1471 (d)(5)(C). The proposed regulations give the term "business" a different definition than is standard in U.S. tax law.
See Prop. Reg. §§1.1471-1(b)(27); 1.1471-5(e)(4).
[25] Joint Committee on Taxation report, P.L. 111-147 (2010), text at note 175.
[26] The FFI agreement requires a participating FFI to conduct due diligence on its "accounts" (e.g., investors) to determine whether they are "specified" U.S. persons under IRC section 1473. Where an indication exists that this is so and the account holder does not disprove U.S. status in a prescribed manner, the FFI must deduct and withhold 30% from its own FATCA payments to the account holder.
[27] Prop. Reg. §§ 1.1471-3(b)(23); 1.1471-3(b)(1 8);1.1471-3(b)(41).
[28] See Prop. Reg. §§1 .1472-1 (e)(2), 1.1472-1 (e)(4). The U.S. withholding agent must in turn report this information to the IRS. See Prop. Reg. §§1.1472-1(e)(2).

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