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# RELIEF FOR CANADIAN INVESTORS IN US REALTY

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**Attorneys**

Britta McKenna

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On December 18, 2015, President Obama signed into law the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act). The PATH Act includes revised income tax rules that are favourable to Canadians investing in US real property and in US real estate investment trusts. The act demonstrates that the US government is committed to making US tax rules more favourable to Canadian and other foreign investors in US real estate.

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) subjects foreign investors to US federal income tax on certain income and sales proceeds from US real property interests (USRPIs). The income or sales proceeds are treated as effectively connected with a US trade or business and are therefore taxable at income tax rates
(including individual capital gain rates) applicable to US persons. A USRPI includes an interest in US real property, in certain domestic corporations (referred to as "US real property holding companies," or USRPHCs), and in a real estate investment trust (REIT) that has the majority of its worldwide real estate and business holdings in USRPIs.

Before the PATH Act was enacted, a non-US investor (including a Canadian pension plan) was taxed on the sale of US real property and a USRPHC, with limited exceptions. Under the PATH Act, a "qualified foreign pension
fund" (including a Canadian pension fund) and its wholly owned subsidiaries are completely exempt from FIRPTA taxation and withholding on the gain from the sale of a USRPI and also on a distribution from a REIT attributable to the gain from the disposition of a USRPI. A qualified foreign pension fund is a pension fund that (1) was created under the laws of a foreign country, (2) is subject to regulation and annual reporting in the foreign country where it was established or operates, (3) was established to provide retirement or pension benefits to current or former employees, (4) has no single beneficiary who has more than a 5 percent interest, and (5) enjoys tax benefits on contributions or on investment income in the foreign country where it was established or operates. It is not clear what type of regulation and annual reporting in the foreign pension fund's home country is sufficient to meet the

exemption. The qualified foreign pension fund is still subject to US withholding tax on rental income earned from US real property and on an ordinary dividend distribution from a REIT that is not attributable to the gain from a USRPI disposition.

The PATH Act also provides relief to a foreign small “portfolio investor” in a publicly traded REIT. Previously, a FIRPTA exemption existed for a foreign investor who owned 5 percent or less of the stock of a publicly traded REIT at any time during the five years ending on the disposition date or the investor’s shorter holding period. The PATH Act increases this exemption for a foreign investor who owns 10 percent or less of a publicly traded REIT and also exempts a distribution from such a REIT that is attributable to a gain from the disposition of a USRPI. Furthermore, “qualified shareholders” (which include certain publicly traded Canadian limited partnerships) that invest in publicly traded or private REITs may be wholly or partly exempt from FIRPTA on the disposition of a REIT interest and on a distribution from the REIT that is attributable to a gain from the disposition of a USRPI. A qualified shareholder must, among other things, be traded on the New York Stock Exchange or on NASDAQ.

The PATH Act includes helpful clarification of the FIRPTA exception applicable to a domestically controlled REIT. Under existing law, the gain from the sale or disposition of a publicly traded or private REIT in which US persons hold 50 percent or more of the stock is exempt from FIRPTA. Under the PATH Act, a publicly traded REIT can assume that all of its shareholders that hold less than a 5 percent interest are US shareholders unless it has knowledge to the contrary. Stock that is held by another publicly traded REIT or qualifying regulated investment company (RIC) is treated as held by a foreign person unless that REIT or RIC is also domestically controlled. Stock that is held by a private REIT or another type of RIC is treated as held by US persons in the same proportion that the shareholder entity is owned.

The PATH Act includes offsetting revenue-raising provisions that codify the so-called cleansing rule’s inapplicability to REITs and RICs. The cleansing rule provides that a USRPHC is no longer treated as a USRPI if, at the date of disposition of its stock, all USRPIs previously held by the USPRHC have already been disposed of and the full amount of the gain has been recognized. The PATH Act also increases the FIRPTA withholding rate imposed on the sale or distribution of a USRPI from 10 to 15 percent of the amount realized; the increase does not apply to the sale of a personal residence if the amount realized is $1 million or less and the exemption for a purchase at no more than $300,000 does not apply. The increased FIRPTA withholding applies to a sale or disposition at least 60 days after the PATH Act’s enactment.