

Real Estate Tax Alert



The impact of FATCA withholding on real estate funds, real estate companies and real estate joint ventures

Part 1: US entities

Introduction

The US Internal Revenue Service recently released proposed regulations under the Foreign Account Tax Compliance Act (“FATCA”) related to withholding and reporting. These rules can have a significant impact on entities that invest in US real estate. The rules are complex, and, while not all questions have been answered, it is clear that the withholding and reporting process will be far more complicated going forward.

Although real estate entities often have complex international structures with investments and investors that cross the US border, there are different concerns and considerations with respect to FATCA withholding and reporting as it relates to US and non-US entities. Therefore, we will issue two alerts on FATCA withholding and reporting. This alert focuses on US entities and their obligations under the new FATCA withholding and reporting regime. Another alert will be published in the near future focusing on the issues that non-US entities will need to face.

FATCA withholding and reporting: Why does it matter?

Withholding and reporting can seem a tedious process. It normally takes a back seat in tax discussions, which focus on the ultimate tax owed, instead of the withholding and reporting that is required to occur along the way. However, failure to comply with the FATCA withholding and reporting regime can have significant consequences. Most apparent, failure to properly withhold can subject an entity to liability for the amount it should have withheld, as well as interest and penalties. Aside from the tax cost, a failure to properly withhold can have a significant impact on a company’s financial statements. In addition, a company that intends to enter into a significant transaction may be subject to outside due diligence in which the other party to the transaction will insist on compliance with FATCA (or utilize instances where there was a failure to withhold in its negotiations). The IRS has elevated withholding to its top tier of issues on which auditors should focus. As you would expect, we have noticed an increase in audit activity with respect to withholding generally and as a result have noted an increase in the effort devoted to withholding diligence in connection with significant transactions.

Another important factor for US entities to consider is how non-US investors might react to FATCA withholding and reporting. Some non-US entities that hold interests in US entities will be required to enter into an agreement with the IRS and undertake additional diligence, withholding and reporting obligations with respect to their investors when they invest in US entities (or, alternatively, be subject to FATCA withholding at a rate of 30%). US entities should consider how their investors may respond to FATCA.

How does FATCA change how withholding and reporting is done?

While it is not practical to provide details in this alert on all of the changes that are brought about by FATCA in the 388 pages of proposed regulations and commentary from the IRS, we would like to highlight two important consequences of the proposed FATCA regulations that all US entities will need to consider when they make payments to non-US persons.

FATCA will subject more payments to US withholding tax and information reporting

More types of payments are subject to withholding and reporting under FATCA than have previously been subject to withholding and reporting under other US tax rules. Prior to FATCA, US entities were concerned with withholding and reporting on:

- Fixed or determinable annual and periodic (“FDAP”) income (such as US Source dividends, interest, and rents);
- Income allocated to foreign partners from activities effectively connected with a US trade or business (such as income from an active real estate business), otherwise known as effectively connected income (“ECI”); and
- Payments associated with the disposition of a US real property interest, which are subject to withholding under the Foreign Investment in Real Property Tax Act (“FIRPTA”).

With the advent of FATCA, US entities will need to be concerned with the application of FATCA withholding and reporting to FDAP as well as its application to gross proceeds associated with the disposition of assets that produce US source interest and dividends.

Payments that might be subject to FATCA withholding and reporting, but generally were not subject to withholding and reporting before FATCA, include:

- The repayment of principal on a note; and
- With respect to the stock in a US corporation (even if gain on the sale of its shares would not be subject to FIRPTA)
 - Proceeds from the sale of stock, or
 - Distributions to shareholders that are not treated as dividend distributions.

Therefore, US entities will need to consider a broader range of payments that may be subject to FATCA withholding and reporting rules and establish mechanisms to ensure that these rules are taken into consideration when they make such payments.

In addition, many of the exemptions that might apply to FDAP income do not apply in the FATCA context. For example, while payments of portfolio interest might not be subject to FDAP withholding and reporting, such payments would still be subject to the FATCA withholding and reporting regime.

While FATCA will cause US entities to consider a wider variety of payments for potential withholding, there are some important exceptions to FATCA applicable to US entities. For example, payments in the ordinary course of business for non-financial services, goods or the use of property are generally not subject to FATCA withholding or reporting. Therefore, to the extent that a US entity pays for consulting or design services performed by a non-

US entity, FATCA generally would not apply to that payment. However, these payments may still be subject to the current FDAP withholding and reporting regime.

FATCA withholding and reporting will be more complicated than the current withholding and reporting regimes

The new FATCA withholding and reporting rules are exponentially more complicated than the currently applicable rules. In part, this is simply because FATCA does not replace the old withholding and reporting regime. Instead, it is an additional regime, coordinated with the current withholding and reporting regimes with the intent to avoid double withholding.

However, even if FATCA was a stand-alone regime, the process of determining whether a payee is subject to withholding and information reporting would nevertheless be far more complex than the current withholding and reporting regimes. Non-US entities have been working with the IRS since the FATCA legislation was adopted in order to reduce the compliance burden of entities that are not likely to be used as vehicles for US tax evasion (which is the target of the FATCA rules). As a result, the Proposed Regulations provide exceptions to reduce the compliance burdens of different types of non-US entities. While the creation of these exceptions may be beneficial to the non-US entity that can qualify for the exception, it will be up to the US payor to make sure that it obtains and evaluates the appropriate documentation to confirm that the payee qualifies for an exception. In some cases, the process will require reviewing a Form W-8, often in conjunction with cross-checking a new FFI-EIN number provided by the payee with an IRS database to confirm that the payee qualifies for a withholding exemption. In other cases, determining whether a payee qualifies for an exception may require the payor to review an entity's organization documents, financial statements, legal opinions, or other information regarding the entity's classification under FATCA. Further, in some cases, US entities withholding under FATCA may have to look through the payee to indirect owners further up the ownership chain, which could require looking at each beneficiary's information to determine if withholding is necessary.

How does FATCA withholding interact with the other withholding regimes?

Currently, US entities are concerned with withholding of income treated as FDAP and ECI (including income subject to FIRPTA). However, while FATCA withholding is broader and covers more types of payments than those regimes, there is a lot of overlap with payments covered by FATCA and the other regimes. The proposed regulations under FATCA provide guidance regarding how the FATCA regime interacts with the other regimes.

As a general matter, there are four types of payments in the pre-FATCA withholding world: (i) FDAP income subject to withholding, (ii) payments subject to ECI withholding, (iii) payments subject to FIRPTA withholding and (iv) payments not subject to FDAP, ECI, or FIRPTA withholding. For purposes of the FATCA coordination rules, if an entity (e.g., a REIT) has a choice regarding whether it treats a distribution as FDAP or FIRPTA distribution, that choice will govern which coordination rule applies.

Payments not subject to FDAP, ECI, or FIRPTA withholding and reporting are, not surprisingly, subject to FATCA withholding and reporting to the extent they are FATCA withholdable payments.

Payments currently subject to FDAP withholding and reporting that are also subject to FATCA withholding and reporting will be subject to both regimes. If withholding is actually required under FATCA, that amount will reduce (and generally eliminate) the amount actually withheld under FDAP. However, the payments will still need to be reported under both regimes.

Payments currently subject to ECI and FIRPTA withholding will not be subject to withholding under FATCA. However, this appears only to apply to payments that are actually subject to ECI or FIRPTA withholding. For example, if a payment is exempt from FIRPTA withholding because it is attributable to the acquisition of an interest in a domestically controlled REIT, the payment of the proceeds would still be subject to reporting, and possibly withholding, under the FATCA regime even though no FIRPTA withholding would be required.

How do the FATCA rules apply to US partnerships?

While the general rules described above apply to partnerships, there are some special considerations that apply in connection with partnerships and payments to their partners. First, the timing for FATCA withholding on partners attributable to FDAP income received by the partnership refers to the rules for withholding on FDAP income. With respect to the timing of FATCA withholding on the receipt of gross proceeds attributable to the disposition of an asset that can generate US source interest or dividends, the proposed regulations reserved on this topic. Therefore, additional guidance will be needed before partnerships can determine when they will need to withhold on these payments.

Second, a partnership is currently required to withhold on income and payments with respect to all of its ECI (which includes income subject to FIRPTA) allocable to a foreign partner. This income will not be subject to withholding and reporting under FATCA to the extent it is actually subject to withholding and reporting under the current regime for withholding on partnership ECI.

There is also no guidance in the proposed FATCA regulations regarding how the sale of a partnership interest (or a transaction that reduces a partner's basis in its partnership interest) is treated for purposes of FATCA. It is not clear if this will be addressed by the final regulations.

What should US entities be doing now with respect to FATCA?

While it is important to take FATCA withholding seriously, and the withholding process will be significantly more complicated going forward, there is some time for US entities to make the changes needed to comply with FATCA withholding. The withholding provisions begin to apply in 2014, and the proposed regulations provide a variety of rules meant to make the transition easier. Final regulations are expected this summer.

Still, while there is some time to prepare for FATCA withholding, there are steps that all US entities should be taking at this point. In particular, each US entity should develop a plan and timetable to make sure that it takes the steps needed to be ready to withhold the appropriate amounts in 2014. As part of that process, each US entity should look to its investor base to determine what types of information it will need to obtain from each of its investors and develop a plan to obtain the needed information. In addition, each US entity should examine the types of payments it makes to investors to determine what additional procedures might need to be in place to ensure that FATCA withholding is taken into account when these payments are made.

To the extent that a new US entity is being formed (such as a new real estate fund), or a new arrangement is being entered into, the new entity should consider what additional information should be obtained from its investors at the time of subscription, or what information might need to be obtained in the future, and take those into account in connection with information it collects and provisions that might need to be included for subscription or other agreements.

As part of this process, US entities will want to consider how this affects their relationships with their non-US investors. The issues that will need to be considered with respect to FATCA withholding include:

- Identifying internal and external teams to address FATCA;
- Training people internally;
- Determining what information should be provided to current non-US investors regarding FATCA withholding;
- Determining how to get any needed information from non-US investors;
- Addressing concerns of non-US investors;
- Considering whether additional disclosure is required with respect to new entities created in connection with investment offerings; and
- Considering whether any restrictions should be placed on the types of investors that the US entity has in order to lessen its FATCA withholding burden.

Conclusion

FATCA withholding is an important change with respect to payments to non-US entities and will have a significant impact on the withholding process. While there is time for US entities to consider how they will address the new FATCA withholding rules, it is important that US entities with non-US investors take the new rules seriously and develop a plan to make sure the US entity is in a position to satisfy the new rules as they become effective.

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