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IRS Should Allow QCIV Self-Designation Under FIRPTA

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As part of the Protecting Americans from Tax Hikes Act of 2016 (the ''PATH Act''),[1] Congress enacted a new exemption from the Foreign Investment in Real Property Tax Act of 1980 (''FIRPTA'')[2] for foreign entities that are ''qualified shareholders'' of certain publicly traded real estate investment trusts (''REITs'') and other entities.[3] In order to be a qualified shareholder, a foreign entity must be a ''qualified collective investment vehicle'' (''QCIV''). As discussed below, most entities that are qualified shareholders are likely to require specific designation by the Treasury Department.[4] This article suggests procedures that Treasury should adopt for foreign entities to obtain such designation, and provides an example of how the suggested procedures would apply to a publicly listed Canadian REIT.

Congress has not provided guidance on why it required specific designation for foreign entities to qualify as QCIVs or how the designation process should be implemented. The procedure for obtaining designation suggested in this article — referred to herein as ''deemed designation'' — was selected because that method would enable the Treasury Department and the Internal Revenue Service (''IRS'') to make designation available quickly and with a comparatively small burden on government resources.[5] Moreover, since the goal of the PATH Act is to encourage foreign investment in U.S. real estate and infrastructure assets, deemed designations would enable the IRS to carry out Congress's intent to provide relief without excessive delay to a class of investors that could potentially contribute significant amounts of capital to the U.S. economy .

The IRS is rumored to be considering doing nothing to provide a designation procedure. Instead, the IRS would make investors wait for an applicable tax treaty to be amended to allow for a reduced rate of withholding with respect to REIT dividends even for a holder of more than 10% of the REIT's stock (which

[1] Enacted as part of the Consolidated Appropriations Act, Pub. L. No. 114-113, §322(a)(1).

[2] Pub. L. No. 96-499.

[3] §897(k)(2). All section (''§'') references are to the U.S. Internal Revenue Code of 1986, as amended, or the Treasury regulations thereunder, unless otherwise indicated.

[4] *See* §897(k)(3)(B).

[5] A discussion of procedures to provide QCIV designation was included in a recent bar report submitted to the Treasury Department and the IRS by the New York State Bar Association's Tax Section. New York State Bar Association Tax Section, *Report on the Changes to FIRPTA Under the Protecting Americans from Tax Hikes Act of 2015* (Oct. 3, 2016) (the ''NYSBA Report'').

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would enable an investor to qualify as a qualified shareholder under §897(k)(3)(B)(i)). Such an approach would effectively write the qualified shareholder exemption out of the Code because the U.S. Model Tax Treaty does not include a provision that would enable investors to qualify under §897(k)(3)(B)(i) and, even if the Treasury Department renegotiates an existing tax treaty, the tax treaty approval process has been blocked for years through the efforts of Sen. Rand Paul (R-Tenn.). With Sen. Paul's recent re-election, there is currently no prospect for any new treaties to become effective. We hope that the Treasury Department and the IRS will give effect to Congress's intent as expressed in the PATH Act and provide some way — such as the procedures described in this article — for foreign institutional investors to access the qualified shareholder exemption.

BACKGROUND

In 1980, Congress enacted FIRPTA, which generally imposes a tax on a foreign person's disposition of an interest in real property located in the United States. This tax on disposition applies to a foreign person's disposition of a ''United States real property interest'' (''USRPI''), which includes direct interests in real property located in the United States as well as interests in partnerships, corporations and certain trusts whose assets include more than a threshold amount of USRPIs. Under §897(h), any distribution from a REIT or regulated investment company (''RIC'') is treated as gain from the disposition of a USRPI to the extent that the distribution is attributable to the disposition of a USRPI by the REIT or RIC.

One goal of the PATH Act, signed into law on December 18, 2015, is to encourage foreign institutional investors to increase their investments in U.S. real estate and infrastructure assets. The Senate conference report on the PATH Act described the purpose of the PATH Act as follows:

> It is essential to increase foreign investment in U.S. real estate. Increased investment in building and infrastructure will create American jobs. Increased investment will also provide equity capital for existing U.S. real estate ventures that have outstanding loans that are maturing, and will thus reduce the potential for foreclosures. [FIRPTA] contains tax rules that impose significant penalties on foreign investment in domestic real estate through REITs that do not exist in other types of U.S. corporate investments such as corporate stocks and bonds.[6]

The PATH Act attempts to meet this goal by providing a number of exemptions from FIRPTA targeted for large institutional investors outside of the United States.[7] These exemptions are generally much broader than previously enacted exemptions, and they apply both to dispositions of USRPIs and to distributions from REITs that are recharacterized as gain from the disposition of a USRPI under §897(h)(1). The new provisions include the following:

- Foreign pension funds that meet certain requirements have been granted a complete exemption from FIRPTA.[8]
- An interest in a publicly traded REIT is exempt from FIRPTA for a foreign investor that holds less than a threshold amount of the publicly traded REIT's shares.[9] The PATH Act increased the threshold from 5% to 10%.[10]
- Publicly traded investment funds that meet certain requirements (referred to as ''qualified shareholders'') have been granted a potentially complete exemption from FIRPTA.[11]

The exemption for qualified shareholders is the main focus of this article. In order to be a qualified shareholder, a foreign person must either (a) be eligible for the benefits of a comprehensive income tax treaty with the United States that includes an exchange of information program and have its principal class of interests listed and regularly traded on a recognized stock exchange or (b) be a limited partnership in a jurisdiction with an agreement for the exchange of tax information and have at least 50% of the value of its limited partnership units regularly traded on the New York Stock Exchange or NASDAQ Stock Market. In addition, in order for a foreign person that satisfies either (a) or (b) to be a qualified shareholder, it must (c) be a QCIV and (d) meet certain recordkeeping requirements.

A qualified shareholder that is a REIT enjoys an exemption from FIRPTA only to the extent that the qualified shareholder does not have any ''applicable

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6 S. Rep. No. 114-25 (Apr. 14, 2015), 2.

7 Foreign investors should bear in mind that, even if they qualify for an exemption from FIRPTA, income from FIRPTA assets may still be subject to U.S. federal income tax if that income is effectively connected to a trade or business of the foreign investor in the United States.

8 §897(*l*).

9 §897(c)(3).

10 §897(k)(1).

11 §897(k)(2) and §897(k)(3).

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investors."[12] For this purpose, an applicable investor is a person that is not itself a qualified shareholder and that holds more than 10% of the qualified shareholder's stock.

Certain distributions from corporations (including all REITs, which are automatically classified as corporations for U.S. federal tax purposes) are treated as capital gain under applicable provisions of the Code. This is the case for distributions in excess of a shareholder's basis in the corporation's stock, certain distributions in redemption of a shareholder's stock, and certain liquidations of a corporate subsidiary where the parent holds less than 80% of the subsidiary's stock. Under §897(k)(2)(C), these types of distributions are recharacterized as an ordinary REIT dividend when received by a qualified shareholder (except to the extent that there are applicable investors on the qualified shareholder).

As noted above, only QCIVs can be qualified shareholders. Section 897(k)(3)(B) defines a QCIV as a foreign person

> (i) which, under a comprehensive income tax treaty, is eligible for a reduced rate of withholding with respect to ordinary dividends paid by a REIT even if such person holds more than 10% of the stock of such REIT,
>
> (ii) which—
> (I) is a publicly traded partnership that is not treated as a corporation for U.S. federal tax purposes,
> (II) is a withholding foreign partnership,
> (III) if such foreign partnership were a U.S. corporation, would be a U.S. real property holding corporation (determined without regard to paragraph (1)) at any time during the 5-year period ending on the date of disposition of, or distribution with respect to, such partnership's interests in a REIT, *or*
>
> (iii) which is *designated as a QCIV* by the Secretary and is either—
> (I) fiscally transparent within the meaning of Code section 894, or
> (II) required to include dividends in its gross income, but entitled to a deduction for distributions to persons holding interests (other than interests solely as a creditor) in such foreign person.[13]

As of the time of this writing, the test in clause (i) above is likely to be met only by certain entities formed under the laws of the Netherlands, Australia, or possibly a limited number of other jurisdictions. The number of entities that qualify under clause (ii) is also likely to be small. *Therefore, the test with the broadest potential applicability is the test articulated in clause (iii) above, which requires the Treasury Department, through delegation to the IRS, to designate entities as QCIVs.*

LEGISLATIVE HISTORY

The version of the QCIV provision that was enacted in the PATH Act was preceded by several substantially similar legislative proposals. The term "qualified collective investment fund" first appeared in connection with a proposed exemption from FIRPTA in the Real Estate Investment and Jobs Act of 2011, introduced in the House by Rep. Kevin Brady (R-Tex.) (now Ways and Means Committee Chair) on September 21, 2011[14] and in the Senate by Sen. Robert Menendez (D-N.J.) on September 22, 2011.[15] Those bills included a requirement that a QCIV be designated by Treasury.

A substantially identical version of the provision later appeared in the Real Estate Investment and Jobs Act of 2013,[16] introduced by Menendez and Brady in their respective chambers on June 18, 2013 and July 31, 2013.[17] The provision appeared again in a version of the bill that was introduced in the House by Brady on September 16, 2014.[18] The following year, 2015, saw multiple appearances of similar versions of the provision: first, in a Senate bill introduced by Finance Committee Chair Orrin Hatch (R-Utah) on April 14, 2015[19] and in a House bill introduced by Brady on April 30, 2015,[20] and then as an amendment to the Consolidated Appropriations Act, which ultimately became law.

The legislative history of the QCIV provisions begins with the Senate Finance Committee Report on S. 915.[21] Unfortunately, this report does not include any discussion of the reasons for designation of entities for QCIV status.

After the enactment of the PATH Act, the Joint Committee on Taxation published a Technical Expla-

[12] §897(k)(2)(D).

[13] Emphases added.

[14] Real Estate Investment and Jobs Act of 2011, H.R. 2989, 112th Cong. §2(a)(3).

[15] Real Estate Investment and Jobs Act of 2011, S. 1616, 112th Cong. §2(a)(3).

[16] Real Estate Investment and Jobs Act of 2015, S. 1181, 113th Cong. §2(a)(3).

[17] Real Estate Investment and Jobs Act of 2013, H.R. 2870, 113th Cong. §2(a)(3).

[18] Real Estate Investment and Jobs Act of 2014, H.R. 5487, 113th Cong. §2(a)(3).

[19] Real Estate Investment and Jobs Act of 2015, S. 915, 114th Cong. §2(a)(1).

[20] Real Estate Investment and Jobs Act of 2014, H.R. 2128, 114th Cong. §2(a)(1).

[21] S. Rep. No. 114-25 (Apr. 14, 2015).

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nation that includes a discussion of the QCIV provision.[22] Like the Senate Finance Committee Report on S. 915, the Technical Explanation describes the QCIV provisions but offers no guidance as to which entities should qualify.

While the goals of the PATH Act in general have been the subject of much discussion,[23] the legislative history of these provisions does not shed light on Congress's intent in requiring designation as a QCIV by the Treasury Department. Since there is no guidance as to why QCIV qualification under the most broadly applicable §897(k)(3)(B) test requires a special designation, Treasury has some discretion in the procedures that it adopts to effect such designations. Nevertheless, the procedures that are adopted should be based on sound principles, should be described in clear guidance, and should facilitate Congress's policy of making the qualified shareholder exemption available to a broad class of foreign investors in U.S. real estate and infrastructure assets, while not allowing for tax avoidance.

Alternatives

We considered several alternative approaches to the designation of foreign entities as QCIVs before settling on deemed designation as the one recommended in this article. Deemed designation strikes a balance between providing a workable and expeditious solution for foreign entities to obtain designation and minimizing the burden on the government to provide timely advice at a reasonable cost to administer the procedure.

In this part of the article, we describe the alternative approaches that we considered.

Deemed Designations

As described more fully below, under the deemed designation approach, the IRS allows entities to be ''deemed'' to be designated as QCIVs if they meet certain requirements. This approach avoids many of the problems with other approaches. The IRS could implement this approach without undue delay and with no need to develop foreign law expertise. The IRS would also not have to coordinate determinations with foreign government agencies.

In addition, since the interest of Congress in enacting the qualified shareholder exemption is to expand investment in U.S. real estate and infrastructure, it is not likely that Congress meant the definition of QCIV to be a substantial impediment to foreign investors who wish to access the qualified shareholder exception. Accordingly, the interest of Congress is best served by creating a procedure, such as deemed designation, that allows foreign investors to be designated as QCIVs without individual review by Treasury.

Deemed designation is not meant to be an exclusive means for foreign investors to obtain designation as a QCIV. Other entities that merit designation as a QCIV, but do not meet the requirements for deemed designation, would apply for a separate determination from the IRS on QCIV status. By allowing for a more extensive application from entities that do not meet the requirements for deemed designation, the deemed designation approach avoids being underinclusive and gives the IRS the flexibility to designate QCIVs outside of the main procedure.

Country-by-Country Determinations

Another alternative would be for the Treasury Department or the IRS to accept applications from individual countries with respect to particular types of entity in those countries. Applications could be accepted under a revenue procedure or similar announcement.

One drawback to this approach is that it is not clear which constituencies in a given country would have standing or even an incentive to make the application. Since the IRS would be required to analyze the law of each foreign jurisdiction and how that law applies to all existing entities resident in that jurisdiction, this would add to Treasury's workload and cause considerable delay in issuing urgently needed guidance.

Angels List

This alternative would be similar to the country-by-country application process described above, but Treasury would do the work of designating eligible entities in various jurisdictions on its own initiative, without application from individual countries. This approach, advocated in the NYSBA Report, could result in a published list of acceptable foreign entities in every jurisdiction that has rules for public REITs, now or in the future, like the list of *per se* corporations in the check-the-box regulations.[24]

One advantage of this approach is simplicity for taxpayers, because there would be little question whether a particular entity on the list qualifies for designation. No further requirements regarding the entity's ownership or other factors would be required.

[22] Staff of the Joint Committee on Taxation, 114th Cong., Technical Explanation of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029 (Dec. 17, 2015).

[23] *See, e.g.,* Peter A. Glicklich, Abraham Leitner & Heath Martin, *Will Canadian Pension Plans Feast on U.S. Infrastructure (Without FIRPTA)?* 45 Tax Mgmt. Int'l J. 217 (Apr. 2016).

[24] Reg. §301.7701-2(b)(8).

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A drawback to this approach is that the IRS would have to do extensive work to identify and analyze foreign entities that would potentially be included in the angels list, resulting in excessive delay. Moreover, the IRS would have to constantly monitor foreign law and capital share listings to update the angels list.[25]

Ad Hoc Applications

Another approach would be for Treasury to entertain individual applications from private entities in each relevant country. Under this alternative, a foreign entity that desires QCIV status would apply directly to the IRS for designation. Without the benefit of a deemed designation, each applicant would have to submit a brief on why it should be considered a QCIV, similar perhaps to applications for recognition of tax-exempt status (on IRS Form 1023).

The drawback of this alternative is that the IRS would have to review a large number of complex applications from many foreign entities. This would probably entail additional personnel and result in delays and other pitfalls for applicants.

This alternative would give Treasury the maximum flexibility and discretion to decide which entities qualify as QCIVs. However, the level of uncertainty facing the applicants would be greater than in the other alternatives, since a foreign entity would not be able to evaluate on its own whether QCIV status would be granted.

FATCA QCIVs

In addition to the approaches described above, we also considered using an existing definition of a QCIV under the FATCA regulations (a ''FATCA QCIV''). The relevant provision of the FATCA regulations identifies certain types of foreign entity as ''deemed-compliant'' and exempt from FATCA withholding because such entities present a low risk of tax avoidance. One type of deemed-compliant foreign financial entity is the FATCA QCIV. The definition of a FATCA QCIV, however, would be too narrow for the purposes of §897(k).

A FATCA QCIV is defined as an entity:

- that is a foreign financial entity only because it is an ''investment entity,'' as defined under FATCA;
- that is regulated as an investment fund either in its country of incorporation or organization or in all of the countries where it is registered and in which it operates;
- in which each holder of either $50,000 or more of the entity's debt or of any of the entity's equity, and every other account holder is one specified on a ''good'' list of entities for FATCA purposes; and
- that is part of an expanded affiliated group that only consists of other specified ''good'' entities.[26]

A FATCA QCIV is defined differently from the definition of a QCIV for the purposes of §897(k), which reflects a difference in the purposes of the two statutes. The purpose of FATCA is to discourage foreign financial institutions from allowing U.S. taxpayers to hide assets from disclosure to the IRS. Accordingly, FATCA's main concern is with the disclosure of persons who hold interests in those institutions. The concept of a FATCA QCIV addresses this concern by granting deemed-compliant status to entities whose interest holders are either disclosed under other provisions of FATCA or to entities that pose a low risk of tax avoidance.

In contrast, the purpose of the qualified shareholder exemption under §897(k) is to identify legitimate treaty-country residents that are listed and regularly traded and that qualify for reduced taxation or flow-through treatment in their country of residence under a regime similar to the U.S. system for RICs and REITs. It is unlikely that a publicly traded vehicle that qualifies as a QCIV under any of the prongs of §897(k)(3)(B) would also be a FATCA QCIV. Accordingly, the procedures to designate a QCIV under §897(k)(3)(A) should clearly be broader than those for a FATCA QCIV.

SUGGESTED GUIDANCE

We believe that deemed designation, based on the requirements described below, strikes the right balance between providing a workable and expeditious solution for foreign entities to obtain designation and minimizing the burden on the government to provide timely advice at a reasonable cost to administer the procedure.

Entities that fall outside of the guidelines proposed below would still be allowed to seek QCIV status by applying for a separate determination from the IRS. Such entities might be required to show that designating the entity as a QCIV would not pose any undue risk to the fisc and that granting such designation would be consistent with Congressional intent.

[25] The following countries currently have publicly listed REITs: Australia, Belgium, Bulgaria, Canada, Dubai, Finland, France, Germany, Greece, Ireland, Italy, Japan, Hong Kong, Malaysia, Mexico, Netherlands, New Zealand, Pakistan, Singapore, South Africa, South Korea, Spain, Taiwan, Thailand, Turkey, United Kingdom, United States. *See* European Public Real Estate Association, *Global REIT Survey 2016*, available at http://www.epra.com/regulation-and-reporting/taxation/reit-survey.

[26] Reg. §1.1471-5(f)(1)(i)(C).

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An entity that meets each of the following requirements would be deemed to be designated as a QCIV:

1. Treaty Limitation on Benefits. *Interests in the entity would be listed and traded on a recognized stock exchange, within the meaning of the definition of "qualifying person" in the limitation on benefits provision of an applicable tax treaty.* QCIV designation is intended for public entities. By using an already-existing standard for public listing and trading, the government would avoid proliferating similar definitions and creating conflicts with different areas of the tax law. This requirement corresponds to one requirement to be a qualified shareholder under §897(k)(3)(A), and is included because under current law there is no reason to designate an entity as a QCIV unless it will also qualify as a qualified shareholder.

2. Local REIT. *The entity qualifies as a REIT or its equivalent in its home country, or as a publicly traded entity that is entitled to flow-through treatment,*[27] *in either case, under local law for the year in question.* A QCIV is meant to be an investment fund that is widely held and enjoys tax-favored status. By requiring an entity to be a REIT (or a publicly traded flow-through entity) in its local jurisdiction, deemed designation would be limited to entities resident in a treaty country that are collective investment funds, that are taxed at a reduced rate on income distributed or allocated to their investors, and that routinely report to their home tax authority the income that they distribute or allocate to their investors. We would expect that requirements #1 and #2 would generally be met by publicly traded REITs seeking designation as a QCIV under §897(k)(3)(B)(iii).

3. Local Tax Treatment. *The following tax characteristics of the entity's income and distributions would be as determined under the entity's own local law:*

- *Income of the entity must meet local standards for real estate or similar funds that are taxed on a flow-through or modified pass-through basis.*
- *The entity is either entitled to a deduction for distributions to its interest holders, or an amount equivalent to the entity's net income is currently includible in the income of its interest holders.*

This requirement would clarify that, for the purposes of §897(k)(3)(B)(iii)(II), the local jurisdiction's law should apply in making these determinations.[28] By looking to local law for this determination, taxpayers would avoid the uncertainty inherent in applying U.S. tax law concepts to entities and transactions that may not have close parallels outside of their home jurisdictions.

4. Regulatory Limits. *Holders of more than 10% of the entity's interests are disclosed under a securities regulatory regime or listing requirements in the local jurisdiction.* Since a QCIV is meant to be publicly traded, an entity seeking QCIV status will generally be subject to comprehensive securities regulation in its home jurisdiction. If a local securities regulation regime requires disclosure of owners of more than a threshold interest in the entity, creating and maintaining special ownership records for the purposes of §897 would be duplicative of the entity's compliance with local securities law. Accordingly, if the Treasury Department is comfortable with a threshold of 10% (as opposed to the 5% ownership threshold provided in the recordkeeping requirements of §897(k)(3)(A)(iii)), Treasury could rely on the securities filings instead of such recordkeeping requirements. Since most countries require similar disclosure under their securities regimes, Treasury should have access to information on the entity's ownership where public disclosure is available, regardless of whether §897-specific recordkeeping requirements are implemented.

Possible Further Restrictions

Requirements #1 through #4 above would limit deemed designations to publicly traded REITs that are generally subject to one level of tax in their home jurisdictions and provide public information about their large shareholders.

In some cases, the IRS may believe that the potential for tax avoidance is greater than would be addressed by these requirements. For instance, there may be a concern that persons are taking advantage of the deemed designation procedure in a way analogous to treaty shopping, or the IRS may decline to grant a deemed designation where a majority of an entity's holders are "applicable investors" that are not eligible for the benefit of §897(k)(2). If the IRS prefers to further narrow the scope of the deemed designation procedure to address such concerns, we suggest adding the following two additional requirements:

5. Local Ownership. *At least 50% of the aggregate value of the entity's interests is held by investors who are residents of the jurisdiction in which the entity is*

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[27] For instance, in Canada a publicly traded entity may be entitled to flow-through treatment if its investments are almost exclusively made directly or indirectly in foreign assets. *See* n. 35, below.

[28] See the NYSBA Report for further discussion of the advantages of using the entity's home jurisdiction for this determination.

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organized. The Treasury Department has increased its scrutiny of arrangements where entities are used to obtain tax benefits under a tax treaty for interest holders that are not resident in the treaty jurisdiction.[29] This requirement would serve as a backstop to requirement #3 by ensuring that substantial timing or income mismatch issues do not arise as a result of treaty-shopping by interest holders that are resident in non-treaty jurisdictions.[30]

6. Widely Held. *Not more than 50% of the entity's interests are held by one or more persons that separately own more than 10% of the entity's stock (other than persons that are themselves qualified shareholders for the purposes of §897(k)).* An essential element of the U.S. REIT and related regimes is that tax benefits are granted only to entities whose interests are not concentrated in only a few owners. This requirement would limit deemed designation to entities with an analogous ownership structure. This restriction would not apply to owners such as investment funds which hold interests in the entity for other beneficial owners. In such a case, a look-through rule could apply. This requirement is similar to the exceptions to the regularly traded interests for closely held U.S. real property holding corporations under the FIRPTA regulations.[31]

Effective Date

When Treasury publishes guidance on the designation of QCIVs for the purposes of the qualified shareholder exemption, such guidance should be retroactive to the effective date of §897(k)(2) and §897(k)(3), as well as §897(*l*), added by the PATH Act.[32] That is the date from which FIRPTA distributions and dispositions were to be exempt under these provisions. The legislative history has already announced that ''the provisions to extend exceptions from FIRPTA for certain REIT stock applies to dispositions and distributions on or after the date of enactment.''[33] There is no reason to delay the availability of the qualified shareholder exemption beyond the date on which Congress enacted the exemption into law.

EXAMPLE: CANADIAN REITs

The following example shows how a deemed designation system based on the criteria outlined above would work in the case of a publicly traded Canadian REIT.[34]

Canadian REIT Rules Generally

For a publicly traded Canadian entity to qualify as a REIT that is eligible for flow-through treatment under the Canadian tax rules,[35] the following requirements must be met:

a. The entity must be a ''mutual fund trust.'' To qualify as a mutual fund trust, the entity must be a unit trust (i.e., a trust whose units are redeemable by the holder on demand or whose assets satisfy detailed diversification tests), must restrict its direct activities to investing its funds or carrying on specified real estate activities, must have at least 150 unitholders and must not have been established, or be currently maintained, primarily for the benefit of non-Canadian persons.

b. At least 90% of the total fair market value of the entity's ''non-portfolio properties'' (generally

[29] For example, see the ''triangular permanent establishment'' provision in the recent revision of the U.S. Model Tax Treaty.

[30] Since QCIVs are public entities that may have many shareholders, holders of less than 5% of a REIT's stock would be presumed to be local for the purposes of this requirement because it would be unduly burdensome to analyze numerous small stockholders and because a holder of a small percentage of the REIT's stock would not be able to influence the structure of a public REIT in order to obtain tax benefits.

[31] Reg. §1.897-1(c)(2)(iii)(B).

[32] We understand that the effective date of a QCIV designation should generally be limited in light of practical considerations such as the burden of filing amended tax returns for previous tax years. The difficulties that arise as a result of coordinating the effective date of QCIV designation and the effective date of the PATH Act underscore the urgent need for guidance under the qualified shareholder and QCIV provisions.

[33] Staff of the Joint Committee on Taxation, 114th Cong., Technical Explanation of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029 (Dec. 17, 2015), 191.

[34] This part of the article reflects input from Neal H. Armstrong of Davies Ward Phillips & Vineberg LLP in Toronto.

[35] Canada has three types of publicly traded vehicles that are eligible for flow-through treatment: mutual fund trusts which qualify as REITs for Canadian income tax purposes; mutual fund trusts which do not qualify as REITs but which do not hold any ''non-portfolio property'' (described in paragraph (b) above); and limited partnerships also not holding any non-portfolio property. The funds in the second and third category generally qualify as not holding non-portfolio property (which is essential in order for them not to be subject to the equivalent of corporate income tax on their income under the Canadian ''specified investment flow-through trust'' or ''SIFT'' tax rules) by investing exclusively (with the exception of ancillary cash assets) in foreign subsidiaries or in Canadian holding entities for such subsidiaries. (Such funds could also invest directly in foreign real estate, but in practice they generally do so through subsidiaries such as LLCs or subsidiary limited partnerships.) There are examples, in both the second and third category, of funds which call themselves ''REITs'' even though they do not qualify as REITs for Canadian income tax purposes. Although in this article we specifically consider the application of our QCIV designation procedure to publicly traded REITs, we contemplate that the other types of publicly traded flow-through vehicle would also be able to obtain deemed designation under our proposed procedures.

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most properties other than cash and certain other passive assets, securities of non-Canadian entities or of Canadian holding companies (including holding partnerships or trusts) holding only such non-resident securities, other qualifying foreign assets such as directly held foreign real estate, and small ''portfolio'' holdings of various categories of Canadian entities) must be ''qualified REIT properties.''

For this purpose, a qualified REIT property is (i) a ''real or immovable property'' that is capital property (as discussed below, including debt and equity held in qualifying real estate subsidiaries), (ii) ''eligible resale property'' (generally, real estate inventory that is ancillary and contiguous to a real estate holding that is not inventory), (iii) cash (including Canadian government securities, qualifying deposits and bankers' acceptances), (iv) interests in a subsidiary for the management of real or immovable property of the entity or of first-tier subsidiaries, (v) real estate nominees (i.e., title-holding SPVs), and (vi) most property ancillary to the earning of rents and capital gains.

For the purposes of the Canadian REIT rules, ''real and immovable properties'' includes a security of an entity that meets the four tests described in paragraphs b. through e., but excludes some types of building improvements that are eligible for high rates of Canadian depreciation (e.g., for manufacturing or power generation).

c. At least 90% of the entity's ''gross REIT revenue'' (generally, business and property revenues plus proceeds from the disposition of properties net of their cost) must be derived from one or more of the following: ''rent from real or immovable properties,'' interest, dispositions of real or immovable properties that are capital properties, dividends, royalties and dispositions of eligible resale properties.

For the purposes of this requirement, rent from real or immovable properties includes rent or similar payments for the use of or right to use real or immovable properties, as well as payments for services ancillary to the rental of real or immovable properties and customarily supplied or rendered in connection therewith, but does not include any other payments for services supplied or rendered, fees for managing or operating such properties, payment for the occupation, use or right to use a room in a hotel or other similar lodging facility, or rent based on profits.

d. At least 75% of the entity's gross REIT revenue must be from one or more of the following: rent from real or immovable properties, interest from mortgages or hypothecs on real or immovable properties, and dispositions of real or immovable properties that are capital properties. An iterative ''character preservation'' rule treats inter-affiliate payments of gross REIT revenue as having the same character in the hands of the recipient so that, for example, dividends or interest paid by a rental property subsidiary would usually be treated as rent from real or immovable property in the hands of the parent recipient.

e. The fair market value of the entity's properties consisting of real or immovable properties that are capital properties, eligible resale properties, and cash must be equal to at least 75% of the equity value of the entity.

f. Interests in the entity must be listed or traded on a stock exchange or other public market.

The two asset tests in b. and e. must be satisfied throughout the entity's year (with no grace period to correct breaches) and the two revenue tests in c. and d. must be satisfied for the year as a whole — so that, for example, a sufficiently large gain realized on December 31 from the sale of a subsidiary whose shares and debt did not qualify as real or immovable property would cause the entity to have not qualified as a REIT throughout that year. For this reason, Canadian REIT public disclosures typically state that there can be no assurance that it will qualify for the current year, but that management anticipates that this will be the case.

A publicly traded mutual fund trust which fails any of the four numerical tests in b. through e. above for a year will be subject to Canadian income tax for that year in essentially the same manner as a Canadian public corporation.[36]

Application of Deemed Designation to Canadian REIT

As an example of how deemed designation might apply to a foreign entity seeking designation as a QCIV, we consider the characteristics of a publicly traded Canadian REIT.

Traded on a Recognized Stock Exchange

The limitation on benefits article of the U.S.-Canada tax treaty (the ''Tax Treaty'') provides that qualifying persons generally eligible for treaty benefits include a Canadian resident that is ''a company or trust whose principal class of shares or units (and

[36] More specifically, it is subject to the ''SIFT'' tax referenced in n. 33.

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any disproportionate class of shares or units) is primarily and regularly traded on one or more recognized stock exchanges.''[37] For the purposes of this provision, recognized stock exchanges include ''any Canadian stock exchanges that are 'prescribed stock exchanges' or 'designated stock exchanges' under the Income Tax Act.''[38] The technical explanation of the provision clarifies that, at the time that the Tax Treaty was entered into, recognized stock exchanges in Canada included the Montreal Stock Exchange, the Toronto Stock Exchange, and Tiers 1 and 2 of the TSX Venture Exchange. Accordingly, a Canadian REIT that is traded on the Toronto Stock Exchange, for example, should meet this requirement.

Certification That Entity Qualifies as a REIT

This example assumes that the entity is a Canadian REIT, so the entity would provide certification that it qualifies as a REIT under the Canadian REIT rules for the current year, signed by an authorized officer of the REIT.

Tax Characteristics of Distributions

Much like a U.S. REIT, the taxable income of a Canadian REIT for a year is reduced for any distributions paid or payable to its unitholders by the end of the year. Accordingly, this requirement should be met by a Canadian REIT.

Disclosure of Holders of a Greater Than 10% Interest

National Instrument 55-103CP requires ''reporting insiders'' to make public filings of any direct or indirect changes in their beneficial ownership of, or in their control or direction over, securities of a reporting issuer, such as of a listed REIT. A reporting insider includes a person that has such beneficial ownership of, or control or direction over, securities of a reporting issuer carrying more than 10% of all the voting rights. Accordingly, Canadian REITs would meet this requirement.

If the IRS adopted the two additional requirements described under ''Possible Further Restrictions,'' above, the following additional analysis would apply:

Not More Than 50% Non-Resident Investors

In order to qualify as a mutual fund trust, a Canadian REIT cannot be held primarily for the benefit of non-Canadian unitholders. Under this test, it is likely that a Canadian REIT would fail to be a mutual fund trust (and accordingly, fail to be a REIT eligible for flow-through treatment) if more than 50% of its investors were not resident in Canada otherwise than on a transitory basis. Most or all of the Canadian REITs have provisions in their declarations of trust prohibiting the holding of more than 49% (or a lower stipulated percentage) of their units by non-resident persons or non-Canadian partnerships, together with related enforcement procedures. Accordingly, publicly traded Canadian REITs should meet this requirement.

Not More Than 50% Held by 10% Shareholders

Unlike U.S. REITs, the ownership of Canadian REITs need not be dispersed. For practical purposes, however, most publicly traded Canadian REITs would meet this test.[39] Accordingly, whether a Canadian REIT meets this requirement would depend on the circumstances of the entity applying for designation as a QCIV.

CONCLUSION

By enacting the qualified shareholder exemption in §897(k)(2), Congress clearly intended to exempt a significant category of investors from taxation under FIRPTA. The majority of these investors are likely to need designation as QCIVs to access this exemption. Immediate guidance on this issue under §897(k)(3)(B) is needed because entities that qualify for QCIV status without designation are very few and QCIVs would otherwise not be able to access the exemption under §897(k)(2) when making investments in U.S. real estate and infrastructure. Since Congress meant to encourage such investment by enacting §897(k)(2), the issuance of procedures to obtain designation as a QCIV is necessary to carry out Congress's intent, and should be effective from the PATH Act's date of enactment. We believe that the deemed designation procedure described in this article would provide a more practical way for investors to access the qualified shareholder exemption than making them wait for amendments to tax treaties which might not be approved for decades.

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[37] U.S.-Canada Tax Treaty, art. XXIXA(2)(c).

[38] *Id.*, art. XXIXA(5)(f).

[39] The principal exceptions are REITs which were formed through a Canadian corporation transferring a portion of its Canadian real estate assets on a rollover basis to a subsidiary limited partnership of a newly formed REIT, with the corporation's units of the subsidiary limited partnership being exchangeable into the units of the new publicly traded REIT, so that in substance the REIT is majority-owned by that corporation.

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