# THE IMPACT OF CAPITAL GAINS TAXES ON FOREIGN PORTFOLIO INVESTMENT IN U.S. REAL ESTATE

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## 1. Introduction

This paper examines a unique withholding tax—levied only on foreign investors in U.S. real estate and only on capital gains from the sale of real estate in the U.S. Before 2004, the withholding tax rate on these gains was 35%. Since 2004, the tax rate has varied by home country with rates ranging up to 30%. Foreign investors in U.S. real estate investment trusts (REITs) face these taxes on capital gains generated from REIT sales of real estate because REITs are entities that pass their taxable income through to their investors.[1] As a consequence, the capital gains taxes that a REIT's foreign investors face are determined by the REIT managers' turnover strategy.

This study examines how these withholding taxes affect both foreign investment in U.S. REITs and their managers' decisions to sell appreciated holdings. Using a difference-in-differences approach that exploits both cross-temporal and cross-country variation in tax rates and cross-firm variation in turnover strategy, we attempt to isolate the impact of the capital gains withholding tax on foreign portfolio investment.

Little is known about the impact of host country's capital gains taxes on foreign portfolio investments. Desai and Dharmapala (2011), Amiram and Frank (2010, 2012), and a few other studies show that foreign portfolio investments are inversely related to the dividend taxes levied by home and/or host countries.[2] However, to our knowledge, this is the first study to focus on

[1] REITs are a major source of capital for the U.S. commercial real estate market and a popular means for foreigners to invest in U.S. real estate.[1] According to the National Association of Real Estate Investment Trusts, in 2011, 160 public, exchange-traded REITs with a total market capitalization of $451 billion owned about $500 billion of real estate or 10-15% of the institutionally owned real estate in the U.S. In addition, 57 public, non-exchange-traded REITs owned $71 billion dollar of real estate. Another 900 REITs are privately held.

[2] Desai and Dharmapala (2011) report that, after the U.S. cut dividend tax rates in 2003 for companies located in countries that have a tax treaty with the U.S., but not for firms in countries without a tax treaty, U.S. investors shifted their holdings from the tax-disfavored countries to the tax-favored countries. These results are consistent with dividend taxes on foreign portfolio investments affecting the level of foreign investment. Amiram and Frank

capital gains taxes on foreign portfolio investment. Prior work has ignored capital gains taxes because the capital gains enjoyed by foreign portfolio investors are typically exempt from host country taxation. In this case, they are not exempt because of unique U.S. taxes on real estate. Another unusual aspect of this study is that the capital gains are not the ones that investors normally impose on themselves when they sell their equity interests. Instead, the capital gains in this setting arise because managers decide to sell their real estate properties. An implication of this atypical tax is that the REIT's trading strategy determines the capital gains taxes faced by the foreign investors. From a research perspective, the uniqueness of these taxes provides a powerful setting to test both investor responsiveness to capital gains taxes and managerial sensitivity to the taxes faced by their (prospective) investors.

We predict that the 2004 reduction in the capital gains withholding rate increased foreign investment in all REITs. Moreover, the boost in investment should have been increasing in the size of the rate reduction, which, as mentioned above, varies with the home country of the investor. Furthermore, we expect a disproportionate increase in foreign investment for those REITs with a high-turnover approach to managing their properties. Before the rate cut, REITs that sold properties more often were more tax-disadvantaged for foreign investors than less active REITs. Although high-turnover REITs remain more tax-disadvantaged, the difference is much smaller. Thus, the playing field among U.S. REITs has shifted more toward high-turnover REITs than other ones.

The contributions of this paper should be three-fold. First, it should increase our understanding of how U.S. taxes affect foreign portfolio investment. Second, it should enhance

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(2010) provide a more comprehensive analysis of foreign portfolio investments. They compare cross-country holdings around the globe and find that equity holdings are inversely related to the dividend taxes levied by both home and host countries. Amiram and Frank (2012) show that foreign portfolio investment is less in countries with imputation systems that with classical systems because the former prevents foreign investors from enjoying the benefits of franked dividends, i.e., offset the taxes levied on the company against the investor's tax liability.

our knowledge about the sensitivity of managers to investors' capital gains taxes. Third, it should aid ongoing Congressional proposals to further reduce the taxes remitted by foreigners on the sale of appreciated U.S. real estate. Advocates contend that the tax has retarded the recovery of U.S. real estate by discouraging foreign capital. By quantifying the effects of the 2004 rate reduction on inbound portfolio investment, we should be able to shed light on ongoing proposals to reduce the tax further.

The remainder of the paper is organized as follows: Section 2 provides background. Section 3 develops the testable hypothesis. Section 4 details the empirical design. Section 5 discusses the data. Closing remarks follow.

## 2. REIT and FIRPTA Background

A REIT is a corporate entity (corporation, trust, or association) that invests in real estate. The investments may be equity (ownership and operation) or debt (direct lending or investment in mortgage backed securities). Similar to mutual funds, investors buy shares in REITs, which can be publicly-traded or privately-traded. By pooling the investors' capital and investing in real estate assets, REITs enable individuals and entities to invest in liquid, diversified, professionally managed, income-producing real estate. However, the distinguishing feature of REITs is that they are exempt from corporate-level U.S. taxes (and thus avoid double taxation), if they meet certain conditions.[3] The exemption arises because REITs can deduct distributions paid to

[3] To qualify as a REIT, a company must meet ownership, income, and distribution tests. First, REITs must have at least 100 different shareholders (the "100 Shareholder Test") and more than 50% of the value of the REIT's stock (the "5/50 Test") cannot be owned by five or fewer investors. To ensure compliance, most REITs limit ownership, e.g., provisions may limit a single shareholder from owning more than a certain percentage of outstanding shares. Second, at least 75% of a REIT's annual gross income must be real estate related (rents from real estate, interest on mortgages, gain on sale), and 95% of its gross income must be either real estate related or from some limited passive investments. Quarterly, at least 75% of a REITs' assets must be in real estate. Third, REITs must distribute at least 90% of its annual ordinary taxable income to shareholders; else the REIT must pay tax on its income, i.e., double taxation is restored. Consequently, external capital is needed to fund a REIT's growth.

shareholders from taxable income, leaving the sole taxation at the shareholder-level on both ordinary dividend and capital gains dividend distributions.

Although the REIT entity tax-exemption arose as part of the Cigar Tax Excise Tax Extension of 1960, REITs only became widely used in 1993, when many real estate partnerships converted to a REIT form of ownership. Now they are a major source of equity for U.S. commercial real estate markets.[4] Other countries have followed with REIT-like corporate structures. Before 1990, the Netherlands, Australia and Luxemburg were the only non-U.S. countries with REITs. Now, most U.S. trading partners have REITs with about half of the global REIT market outside the U.S., principally in Australia, Japan and the U.K.[5]

Despite the tax benefits of REITs, foreign investors in U.S. real estate, including REITs, are tax-disadvantaged. Historically, foreign investors were not taxed on capital gains from the sale of U.S. assets, including real estate. Xenophobic fears in the 1970s about foreign purchases of prime U.S. real estate led Congress to enact Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), imposing a special withholding tax on foreign investors selling U.S. real estate. Specifically, a foreign investor is subject to U.S. income tax on income from disposition of U.S. real estate property interests (USRPI). USRPI includes both a direct investment in real estate and an indirect investment through the stock of a U.S. real property holding corporation (i.e., a USRPHC, a corporation whose assets are primarily made up of USRPIs). A foreign investor who sells stock of a U.S. REIT is considered selling stock of a USRPHC and is therefore subject to FIRPTA. In addition, FIRPTA applies if a foreign investor receives a capital gains dividend distribution from a U.S. REIT, as a result of its selling real property. The FIRPTA withholdings ensure that taxes are paid by foreigner investors. REITs making distributions to a foreign

[4] For a timeline of REIT history, see http://www.reit.com/timeline/timeline.php.
[5] Ideally, we would expand our analysis to consider REIT investments outside the U.S. To our knowledge, no study has examined the global REIT market.

investor must collect the withholding tax and remit it to the U.S. (or be liable for the amount owed). FIRPTA takes precedence over existing tax treaties that might provide otherwise.

REIT distributions are commonly made-up of three distinct cash flows that all have different tax implications: ordinary income, return of capital, and capital gains.[6] We need to look at the FIRPTA tax implications for all sources of U.S. REIT cash flows to foreign investors to fully understand the impact of FIRPTA. See Table 1 for a summary of the tax rules governing U.S. REIT investments.

Ordinary income distributions from rental income are not treated as real estate under FIRPTA, and therefore are taxed at the 30% withholding rate for dividends, or lower depending on foreign country tax treaties.[7] Under most tax treaties, a foreign investor is taxed at a rate of 0 – 30% if the foreign investor owns less than a certain percent of the shares of stock in a company. The average tax treaty rate is 15%, although many foreign pension plans are exempt altogether from any tax on ordinary income. [8]

When REITs sell appreciated property (creating capital gain distributions), U.S. investors are taxed at their personal capital gains tax rate, presently capped at 15%. In contrast, capital gains dividend distributions from sale of U.S. REIT assets are treated as real estate under

[6] Publicly traded RETIS paid approximately $18 billion in dividends in 2010. While the distribution mix varied by REIT, on average, that consisted of 68% in ordinary income, 20% in capital gains, and 12% in return of capital. http://www.reit.com/portals/0/PDF/NAREIT-December-2011-REIT-Market-Update.pdf .

[7] Prior to 1997, most U.S. tax treaties excluded ordinary income distributions from a REIT from the lower treaty rate on dividends but, rather, were subject to the full 30% withholding rate. In 1997 the U.S. changed its treaty policy with respect to REIT dividends. See http://www.reit.com/PolicyPolitics/~/media/Portals/0/Files/Nareit/htdocs/policy/government/npb4703.ashx

[8] For example, with the U.S./German income tax treaty, the 30% withholding is reduced to 15% if the foreign investor owns less than 10% of the REIT; with the U.S./Netherlands income tax treaty, the 30% withholding is reduced to 15% if paid to Dutch “beleggingsinstelling” or to an individual owning under 25% of REIT; Dutch pension funds are completely exempt. A list of tax treaties related to REITS can be found in the document entitled Tax Treaties: U.S. Withholding Tax Rates on Ordinary REIT Dividends to Non-U.S. Investors at http://www.afire.org/images/1-11NAREITSpecialIssueTaxChart.pdf.

FIRPTA, and therefore foreign investors are subject to a 35% withholding tax rate.[9] Perhaps even more significant than the rate itself, are the additional tax complexities that result from this type of income tax trigger. Capital gains are also treated as income that is "effectively connected with" the conduct of a U.S. trade or business (Effectively Connected Income, ECI). Foreign investors that receive ECI have an obligation to file a US federal tax return, and then become subject to the subpoena powers of the IRS with respect to all of its US investments. Additionally, if a foreign investor is a corporation and receives ECI, a second entity level tax applies to distributions by the corporation called "branch profits" tax. This is levied at 30% rate on the after-tax proceeds of an ECI investment, and is intended to mirror the tax that US taxpayers pay on dividends received from US corporations. Consequently, a U.S. REIT capital gain distribution to a foreign investor can carry an effective tax rate as high as 54.5% (35% capital gains tax plus 30% branch profits tax on 65% after-tax proceeds (30% of remaining 65% is 19.5%). Note that FIRPTA takes precedence over existing tax treaties that might provide otherwise.

In 2004, Congress carved out an exception to the FIRPTA treatment of capital gains dividend distributions as part of the American Jobs Creation Act of 2004 (AJCA).[10] This was in response to assertions that FIRPTA taxes were depressing the value of U.S. commercial real

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[9] Withholding is generally 10 percent of the sales price, in the case of a direct sale by the foreign investor, and 35 percent of the amount of a distribution to a foreign person of proceeds attributable to such sales a REIT. If applicable, the foreign investor can request a refund with its U.S. tax return, based on total U.S effectively connected income and deductions. Internal Revenue Code section 1445 and related Treasury regulations. Interestingly enough, the Treasury Department is authorized to issue regulations that would reduce the 35 percent withholding on distributions to 15 percent during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 15 percent.

[10] The proposed law was introduced in the House as H.R. 4520 on June 4, 2004, but at that point did not contain any FIRPTA revisions. That bill passes the House on June 17, 2004. An amended bill that included the FIRPTA revisions passed in the Senate on July 15, 2004. Due to differences in the two passed bills, it was sent to conference committee. Conference report H. Rept. 108-755 was filed on October 7, 2004 and included the Senate's FIRPTA revisions. It was agreed to by the House on October 7, 2004 and the Senate on October 11, 2004. The bill became Public Law 108-351 on October 22, 2004.The FIRPTA change applied starting in the 2005 taxable year. For more information on the history of the Act, see the Library of Congress legislative information site at http://thomas.loc.gov, Congressional Record, 108th Congress, H.R. 4520.

estate by constraining the supply of foreign capital in U.S. REITs.[11] Now, a REIT capital gain dividend distribution is treated as ordinary dividend income if (1) the REIT is traded on an established securities market in the U.S., and (2) the foreign shareholder owns 5% of less of the REIT (at any time during 1 year prior).[12] Foreign shareholders face a rate that varies from zero and 30% if and only if the REIT is publicly-traded and the foreign investor owns no more than 5% of the REIT. In 2010, the U.S. House of Representatives passed legislation that would have raised the ownership cap from 5% to 10%, but the bill died in the U.S. Senate.[13] A similar bill has been reintroduced in 2011.[14]

REITs may also have cash to make distributions greater than their accounting income figure, since real estate depreciation is a significant non-cash expense taken into account when calculating income. This type of distribution is deemed a return of a shareholders original investment, and referred to as a return of capital. For U.S. shareholders, it is not taxed as ordinary income, but reduces the cost basis of shares by the amount received. In general, FIRPTA views income received from the return of capital similarly to the sale of REIT stock, which is discussed more fully below. Briefly, foreign shareholders are subject to a 10%

[11] For instance, see testimony in the *Congressional Record* (August 1, 2003, p. 20,862) asserting that foreign investors steered away from buying REITs because of FIRPTA taxes. Also see Tony Edwards (NAREIT Senior Vice President and General Counsel) Barriers to Foreign Investment in REITs Removed, AFIRE Newsletter, November/December 2004, http://www.afire.org/newsletter/2004/ajca.shtm.

[12] The FIRPTA revision basically removed capital gains distributions from treatment as effectively connected income for a foreign investor provided the two requirements are met. This means that a foreign investor is not required to file a U.S. federal income tax return by reason of receiving such a distribution, and the branch profits tax no longer applies to the distribution. See Internal Revenue Code section 897(c)(3).

[13] The U.S. House of Representations passed the Real Estate Jobs and Investment Act of 2010 on July 29, 2010, by a 406-11 vote. On December 1, 2010, fourteen Senate Finance Committee members from both parties asked Committee leadership to consider FIRPTA reforms "as soon as possible." They asserted that foreign capital was needed to help the U.S. commercial real estate industry solve its equity problem, which would restart credit markets and create jobs. See http://www.reit.com/Portals/0/FinanceCommitteeFIRPTAReformLetter1212010.pdf. No action was taken in the U.S. Senate.

[14] The House introduced the Real Estate Jobs and Investment Act of 2011, H.R. 2989, (REJIA2011) on September 21, 2011. The Senate introduced the Real Estate Investment and Jobs Act of 2011, S. 1616, (REIJA2011) on September 21, 2011. For more information and bill tracking see the Library of Congress legislative information site at http://thomas.loc.gov.

withholding for return of capital distributions. However, there are two exceptions: the first if the owned REIT is domestically controlled, and the second if the owner REIT is foreign-controlled but the foreign shareholder owns 5% or less.

In general, foreign shareholders that sell U.S. REIT stock are subject to a 10% withholding on any gain. This is in contrast to sale of other U.S. securities, in which case foreign shareholders are not taxed. From inception, FIRPTA carved out an exception for foreign owners of domestically controlled REITs (less than 50% foreign ownership), in which case the REIT stock is not treated as a USRPI, and no tax is imposed on gain from the sale of the REIT shares.[15] For foreign controlled REITs (50% or more foreign ownership), the REIT stock is treated as an USRPI if it holds at least 50% of the value of its assets in U.S. real estate.

Gain from the sale of a foreign controlled U.S. REIT by a foreign shareholder is not subject to FIRPTA if (1) the REIT is regularly traded on an established securities market, and (2) the shares are sold by a foreign investor that owns 5% of less of the REIT (at any time during the previous 5 years). The previously discussed recent proposed legislation would also expand this exception by increasing the foreign ownership threshold for foreign controlled REITs from 5% to 10%.

It appears as if all publicly traded U.S. REITs are domestically controlled.[16] However, it may be difficult for a foreign shareholder to determine domestically controlled status, as there

[15] Internal Revenue Code section Sec. 897(h)(2). The term "domestically controlled" is defined to mean that less than 50 percent in value of the REIT has been owned (directly or indirectly) by foreign shareholders during the five-year period ending on the date of stock sale. Internal Revenue Code sections 897(h)(2), 897(h)(4)(B).
Given the tax rules for gain on sale of REIT shares (domestically controlled requirement) in comparison to REIT capital gains dividend distributions (5% of less and publicly traded requirement), it has been suggested that a foreign investor might consider a "dividend play" to convert impending REIT dividends into gain from the sale of REIT shares by selling REIT shares after a dividend has been declared but before the ex-dividend date and then repurchasing the shares. Of course, such strategy comes with transaction costs and potential home country tax consequences.

[16] See Data section of this paper. While the authors have seen that most publicly traded REITs appear to be domestically controlled, it is not clear how a foreign investor could make such a determination, especially given that

does not seem to be any type of REIT reporting requirement regarding shareholder make-up. Therefore we surmise that many foreign shareholders rely more on the 5% of less exemption from U.S. income tax on gain from the sale of REIT shares than on the domestically controlled exception.[17]

## 3. Hypothesis Development

As discussed above, as long as a REIT distributes 90% of its profits to its investors, it can avoid entity-level income taxes on these distributed profits. Instead, the taxes on the profits pass directly through to the REIT investors. One source of profits is gains on the sale of appreciated real estate. From 1980-2004, when REITs distributed these "capital gains" profits to foreign investors, they were required to withhold 35% of the profits and remit them to the federal government.

Responding to assertions that the 35% withholding tax was depressing the value of U.S. commercial real estate by constraining the supply of foreign capital in U.S. REITs, Congress in 2004 set the capital gains withholding tax equal to the rate levied on distributions arising from

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the definition refers to shares being held directly or indirectly. This has led one commentator to declare that "Nothing in FIRPTA is clear." David F. Levy, Nonrecognition Transactions Involving FIRPTA Companies, Tax Notes International, July 7, 2008.

To attempt to clarify this issue, the IRS issued a private letter ruling on June 5, 2009 that held that a foreign controlled U.S. corporation would be considered a domestic shareholder for purposes of determining whether a REIT is domestically controlled. Private Letter Ruling 2009230001. The ruling added a requirement not found in either FIRPTA and REIT regulations, that a domestic entity that actually is subject to and pays U.S. taxon dividends and gains from REIT shares will be considered domestic for ownership purposes, even if the domestic entity is owned by foreigners. The ruling does not apply if the domestic entity is a pass-through entity or does not actually pay the U.S. tax on distributions from the REIT. For a more thorough discussion on this ruling, see Domestically Controlled REITs under FIRPTA, KPMG What's News in Tax, July 10, 2009, http://us.kpmg.com/microsite/taxnewsflash/2009/Jul/FIRPTA_Ruling.pdf .

[17] To complicate matters even further, liquidating distributions from a REIT or redemptions of REIT stock are not considered a sale of a REIT stock for foreign shareholders, but rather treated as capital gains distributions subject to FIRPTA. IRS Notice 2007-55. Note that prior to this IRS ruling, liquidating distributions or redemptions were generally considered a sale of the REIT's stock, and foreign shareholders could avoid FIRPTA taxes with the domestically-controlled sale of stock exemption; after 2007 foreign shareholders could only rely on the 5% or less capital gains exemption. This provision has constrained foreign investment in private REITs. *New FIRPTA Reform Would Revitalize Global Investment in U.S. REITs*, Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates, September 22, 2011.

rents and other sources of ordinary income *if* the REIT is publicly-traded and the foreign investor owns no more than 5% of the REIT.[18] The effect of the AJCA was to lower the withholding tax for qualifying foreign investors from 35% to no more than 30%, the maximum dividend withholding rate.

Since AJCA did not affect the tax treatment on dividends or gains from the sale of REIT stock, this legislation enables us to isolate the effect of the withholding taxes for foreigners arising from the sale of appreciated real property by REITs. The turnover of REIT real estate holdings varies with the managers' investment strategy. Some REITs pursue an active acquisition and disposition strategy based on changing market conditions (A&D)others adopt a more long-term buy-and-hold (B&H) approach.[19] Although AJCA should have benefited all REITs by increasing the supply of foreign capital, because the 2004 change only affected gains from the REIT's sale of property, the legislation should have benefited those REITs with high turnover more than those with low turnover.[20] Accordingly, we would expect that the legislation increased the share prices of all REITs, but even more so for REITS with an A&D strategy as compared with a B&H strategy. Likewise, ceteris paribus, when the withholding rates declined, we would expect that more capital flowed to A&D than B&H. The reason is that before AJCA, the high turnover approach of A&D resulted in a higher effective tax for them than foreigners

[18] Pressure for further tax relief continues. In 2010, the U.S. House of Representatives passed legislation that would have raised the ownership cap from 5% to 10%, but the bill died in the U.S. Senate.[18] (See Table 1 for a summary of the tax rules governing REIT investments.)

[19] REITs are restricted from holding property primarily for sale to customers in the ordinary course of their business, i.e. being a "dealer" of real estate. REITs are potentially subject to a tax equal to 100% of the net income derived from dealer transactions. A prohibited transaction safe harbor is provided for properties held for a minimum of 2 years (for sales on or after July 31, 2008; 4 years prior to that time) among other requirements. See IRC sections 857(b)(6)(C) and (D), and Daniel F. Cullen, "The New REIT Prohibited Transactions Safe Harbor", *Journal of Passthrough Entities*, January-Feburary 2009. See Muhlhofer (2009) for a discussion of the bindingness of property holding constraints.

[20] If a REIT exchanges a property for another property, no capital gains tax is recognized and the remaining tax basis in the original property is transferred to the new property. See IRC section 1031. These like-kind exchanges would not have resulted in capital gains tax to foreign investors and would not be considered high turnover. We control for this in our variable for turnover by tracking accumulated depreciation and basis in acquired properties.

faced on their investments in REITs with a B&H strategy. Thus, pre-AJCA, foreign capital likely was more underweighted in A&D than B&H REITs.

This leads to the primary hypothesis in the paper, stated in alternative form:

> H1: AJCA should have increased the attractiveness of U.S. REITs to foreign investors because it reduced the U.S. taxes that investors had to pay on capital gains arising from the sale of real estate owned by the REIT. Since capital gains can only arise from the sale of real estate, the attractiveness should have been increasing in the REIT's turnover.

Besides the usual lack of power, there are at least three reasons why we may fail to find that the 2004 tax rate reduction boosted foreign investment in U.S. REITs. First, capital gains taxes on REIT sales of real estate may have little impact on foreign portfolio investments. Instead, fundamentals, such as rental income, price appreciation, inflation, currency exchange rates, liquidity, and other non-tax considerations, may dominate investor decisions. Second, home country taxes may sop up any U.S. taxes that AJCA reduced. If so, the total global taxes of foreign investors may have been little changed by the reduction in U.S. capital gains withholding taxes. Third, anecdotal evidence suggests that foreign investors can easily structure their REIT investments to avoid negative tax implications, although recent IRS rulings have attempted to thwart tax avoidance through indirect ownership structures. Thus, it is an empirical question whether the 2004 legislation affected foreign investments in U.S. REITs.[21]

If we do observe the predicted investment and price responses to the 2004 legislation, we will interpret them as consistent with capital gains withholding taxes constraining foreign

[21] The impact of the 2010 legislation to raise the cap to 10% was equally uncertain. The Rosen Consulting Group, retained by the Real Estate Roundtable, determined that FIRPTA constrains the inflow of foreign capital to U.S. commercial real estate markets. However, the Congressional Budget office had predicted that the proposed 2010 reforms would have only marginally increased foreign capital flows into REITs. Also, Deloitte is reporting that from 2008 to 2010 (a period that saw no FIRPTA reform) transactions values of foreign investment in U.S. REITs more than tripled, from $749 million to nearly $2.456 billion, and then another $3.540 billion in the first of 2011.

investments in U.S. REITs. Such findings will imply that further relaxation, e.g., raising the exemption cap to 10%, would result in even more foreign investments in U.S. REITs. However, finding that FIRPTA taxes constrain foreign investments in U.S. REIT does not mean that the foreigners holdings in U.S. commercial real estate increased after 2004 (or would increase further if tax relief were expanded). Foreigners may be simply shifting their U.S. real estate holdings from non-REIT organizational forms to REITs now that REITs are less tax-disfavored. If so, the net effect of tax relief on the U.S. commercial real estate market could be marginal, at best. Additional tests will be needed to determine whether the AJCA change affected total inbound foreign investment real estate capital.

## 4. Research Design

We use two approaches to test our prediction that foreign portfolio investment increased following the AJCA tax cuts in 2004. First, we measure the extent to which foreign capital increased following the 2004 rate reduction, the countries from which the increase came, and the turnover strategies of the REITs that received the bulk of the inbound investment.

Second, we test for changes in stock returns around those dates where we believe there were the greatest changes in the probability that the legislation would be passed. We anticipate that all REITs benefited from the legislation with the largest increases in stock prices for those REITs with the highest turnover. We expect that the stock returns for high-turnover REITs should have outperformed (underperformed) the stock returns for low-turnover REITs as the probability of reform increased (decreased) during the legislative deliberations.

To test this prediction, we look for an association between turnover strategy and equity returns around dates when news about the legislation likely reached the equity markets. Dates

include (a) September 18, 2003, when a bill entitled, "Jumpstart Our Business Strength Act," which included REIT capital gains tax reform, was read on the U.S. Senate floor; (b) May 11, 2004, when that bill passed the Senate; (c) July 15, 2004, when the Senate passed released a bill with capital gains tax reform (a month earlier, the House of Representatives had passed a bill that did not include REIT tax reform); and October 7, 2004, when the conference committee, which was designed to reconcile differences in the House and Senate bills, released its report, which included the reduction in the capital gains withholding tax rate. We examine neither the date when President Bush signed the bill into law nor its effective date for the bill because we would expect that stock returns would have fully impounded the impact of the legislation by then.

## 4. Data

To examine the effect of capital gains withholding taxes on foreign ownership of U.S. REITs, we have gathered data from SNL Financial on institutional shareholder records, including their country of residence and ownership percentage, for all U.S. REITs from 2000 to 2010. The shareholders identified are primarily based on 13F filings with the Securities and Exchange Commission (SEC), and include institution investment managers with over $100 million of equity investments that have bought REIT stock for either their own account or as an investment manager with discretion over which securities are bought and sold for the accounts of others.[22] They include investment funds, banks, insurance companies, broker-dealers, pension funds, and

[22] Ideally, we would like to have the names and countries of all shareholders of record. Tracking individual investors is problematic since they tend to hold securities in "street name" meaning that the name of the beneficial owner of the stock does not appear on the REIT shareholder record file; instead, the stock is registered in the beneficial owner's broker's name. However, the SEC 13F filing requirements allow us to have access to specific information about the holdings of large institutional investment managers regardless of holdings in street name rather than beneficial ownership. This is in keeping with the data used by Chan, Leung, and Wang (1998) when they examined the strategies of institutional investors investing in REITs, and is reasonable given that institutions tend to dominate trading in REITs.

corporations.[23] For each year, we determine the percentage of shares held by all foreign institutional investors for each REIT as well as the percentage of shares held by specific country institutional investors for all REITs. We also gathered data on REIT stock information from both the National Association of Real Estate Investment Trusts (NAREIT) and CRSP. Where there was missing information, we supplemented with other sources including EDGAR filings.

## 5. Conclusion

This is still a work in progress. Results to date will be reported at the conference.

[23] For more on SEC 13F filing information, see http://www.sec.gov/answers/form13f.htm. Foreign institutional investment managers are required to file Form 13F if they: (1) use any means or instrumentality of United States interstate commerce in the course of their business; and (2) exercise investment discretion over $100 million or more in Section 13(f) securities. See Section 13(f)(1) of the Securities Exchange Act and SEC Release No. 34-14852 (June 15, 1978).

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| **Table 1** | **U.S. Investors** | **Foreign Investors pre-AJCA** | **Foreign Investors post-AJCA** | **Foreign Investors proposed 2010 and 2011 bills** |
|---|---|---|---|---|
| **Distribution:**<br>**Ordinary Dividends (from rental income)** | Taxed at investors' ordinary income tax rate. | Not treated as real estate under FIRPTA.<br>30% withholding rate for dividends, or lower based on treaties<br>Under most tax treaties rate is reduced to between 0 – 30% (average = about 15%) if foreign investor owns less than 5-10%.<br>Many foreign pension plans are exempt all together from any tax on ordinary income. | Same. | Same. |
| **Distribution:**<br>**Capital Gain Dividends (from sales of real estate owned)**<br>***(including liquidating distributions per 2008 Treasury ruling)*** | Taxed at investors' capital gains tax rate. | 35% withholding tax, obligation to file U.S. tax return, and possibly subject to branch profits tax.<br>Note that tax treaties generally don't provide relief for capital gains distributions.<br>Foreign shareholder that is considered an individual (e.g. some foreign pension trusts) may actually owe less than the withholding amount, in which case they would be entitled to a refund. | Exception: treated as ordinary dividend if (1) REIT traded on established securities market in the U.S., and (2) foreign investor owns 5% or less of REIT (at any time during 1 year prior). | Would have expanded exception by increasing foreign ownership threshold exception from 5% to 10%. |

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|---|---|---|---|---|
| **Distribution: Return of Capital** | Not taxed (but reduces the cost basis of shares). | 10% withholding tax and obligation to file US tax return.<br>No tax on gain (or U.S. tax return required to be flied) on sale in two instances.<br>Domestically controlled REITS (less than 50% foreign ownership): stock not treated as a USRPI; no tax on gain on sales of stock.<br>Foreign controlled REITS (50% or more foreign ownership): stock treated as an USRPI if it holds at least 50% of value of assets in U.S. real estate; however no U.S. tax on gain if (1) REIT is regularly traded on an established securities market, and (2) sold by foreign investor that owns 5% or less of REIT. | | |
| **Sale of Stock** | Taxed at investors' capital gains tax rate. | 10% withholding tax and obligation to file US tax return.<br>No tax on gain (or U.S. tax return required to be filed) on sale in two instances.<br>Domestically controlled REITS (less than 50% foreign ownership): stock not treated as a USRPI; no tax on | Same. | Would have expanded exception by increasing foreign ownership threshold for foreign controlled REITS from 5% to 10%. |

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|---|---|---|---|---|
| | | gain on sales of stock.<br>Foreign controlled REITS (50% or more foreign ownership): stock treated as an USRPI if it holds at least 50% of value of assets in U.S. real estate; however no U.S. tax on gain if (1) REIT is regularly traded on an established securities market, and (2) sold by foreign investor that owns 5% or less of REIT. | | |