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Client Alert

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Proposed Regulations Would Impact Taxation of Investment in U.S. Real Estate by Non-U.S. Investors

On December 29, 2022, the IRS and Treasury issued proposed regulations (the "Proposed Regulations") addressing (1) whether a real estate investment trust (a "REIT") or a regulated investment company (a "RIC") will constitute a "domestically controlled qualified investment entity" under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") and (2) the definition of a "controlled commercial entity" for purposes of the exemption for sovereign wealth fund investors under Internal Revenue Code (the "Code") section 892. The Proposed Regulations, if finalized, are likely to have a significant impact on the continued viability of certain common structures used by non-U.S. investors in U.S. real estate.[1] Moreover, the discussion in the preamble to the Proposed Regulations ("Preamble") suggests that the IRS may challenge certain positions being taken by taxpayers under current law, without regard to the new rules.

I. Determination of Domestically Controlled Status

a. Background

i. FIRPTA Generally

By enacting FIRPTA, as embodied in Code section 897, Congress established an important exception to the rule that non-U.S. investors are not subject to U.S. federal income tax on their capital gains. Specifically, a non-U.S. investor who disposes of a "United States real property interest" ("USRPI") is subject to tax on any gain with respect to that disposition at regular U.S. tax rates as if the non-U.S. investor were a U.S. person. A USRPI includes a direct interest in U.S. real property as well as equity interests in "U.S. real property holding corporations" ("USRPHCs"). Generally, a

corporation will constitute a USRPHC if more than 50 percent of its aggregate real estate assets and other trade or business assets consist of USRPIs.

ii. Domestically Controlled REITs

Although equity interests in USRPHCs generally are considered to be USRPIs, there is an important exception to this rule for interests in "domestically controlled qualified investment entities." Specifically, an interest in a domestically controlled qualified investment entity is not a USRPI. A qualified investment entity ("QIE") is a REIT or a RIC that is a USRPHC.[2]

A QIE is considered to be domestically controlled under Code section 897, if less than 50 percent of its stock (by value) is held "directly or indirectly" by "foreign persons" at all times during the shorter of (1) the 5-year period ending on the relevant determination date or (2) the period during which the QIE was in existence (the "Testing Period"). Accordingly, a non-U.S. investor that owns an interest in a domestically controlled REIT ("DCREIT") can dispose of that interest without incurring any U.S. federal income or withholding tax with respect to gain on that disposition under FIRPTA, despite the fact that the DCREIT would constitute a USRPHC. By contrast, a non-U.S. investor who disposes of an interest in a REIT that is not considered domestically controlled would generally be subject to U.S. federal income taxation with respect to any gain on that disposition.

Due to the beneficial tax treatment provided to holders of DCREITs, non-U.S. investors (in particular, those that are not eligible for the Code section 892 exemption and that are not "qualified foreign pension funds" under Code section 897(l)) commonly structure investments in U.S. real estate through DCREITs. This structure permits those non-U.S. investors holding direct interests in the REITs (or indirect interests held through pass-through entities) to exit their investment via sales of stock in the DCREITs tax-free. Moreover, the non-U.S. investors are not required to file any U.S. federal income tax returns in connection with the investment or upon exiting the investment.

iii. Look-Through Issue

The term "directly or indirectly," which is the lynchpin of the DCREIT test, has never been defined in this context under the Code or the Treasury regulations. In particular, the FIRPTA rules do not clearly specify whether one must look through a domestic C corporation[3] to the C corporation's shareholders.

Nonetheless, there is some authority supporting the position that one should not look through a domestic C corporation for this purpose. This includes a 2009 private letter ruling,[4] as well as legislative history surrounding tax legislation enacted in 2015.[5] Also, current Treasury regulations section 1.897-1(c)(2)(i) provides that, for purposes of determining whether a REIT is a DCREIT, the actual owners of stock, as determined under Treasury regulation section 1.857-8, must be taken into account. Treasury regulation section 1.857-8(b) states that the actual owner of stock is the person who is required to include in income the dividends received with respect to the stock. It further states that such person is generally the shareholder of record of the REIT.[6]

As a result, many taxpayers have taken the position that they are not required to look through to the shareholders of a domestic C corporation. That is, if a domestic C corporation owns stock in a REIT, the REIT, in determining whether it is a DCREIT, should not be required to look through to the corporation's shareholders to treat them as indirectly owning stock in the REIT for that purpose, regardless of the extent of the C corporation's non-U.S. ownership.

b. Proposed Regulations

i. New Look-Through Rule

Under the Proposed Regulations, if 25 percent or more, by value, of any nonpublic corporation's stock is owned by foreign persons, then the entity is a "foreign-owned domestic corporation," and any REIT stock owned by that corporation must be treated as owned by its shareholders in determining whether the REIT constitutes a DCREIT (the "Look-Through Rule").[7] The Look-Through Rule is applied by imputing REIT stock to the corporation's shareholders on a pro rata basis. A domestic corporation that is publicly traded, or that is less than 25 percent foreign owned, is not subject to this Look-Through Rule and, consequently, is treated as a U.S. person owning REIT shares for the purpose of determining whether a REIT is domestically controlled.

Also, the Proposed Regulations confirm that a REIT must look through entities taxed as partnerships for this purpose, unless they are publicly traded partnerships. This aspect of the Proposed Regulations is not controversial and is consistent with how tax advisors generally believed the DCREIT rules should be applied to partnerships. The Proposed Regulations take the same approach with respect to other pass-through entities, including REITs, S corporations, and RICs, that hold interests in REITs.[8]

Unfortunately, Treasury did not include a grandfathering rule with this new Look Through Rule. The regulations describe the rule as applying with respect to transactions occurring after the date the Proposed Regulations are finalized. Due to the 5-year lookback rule embodied in the Testing Period, the rules would nullify prior tax planning that appears to have been accepted and sanctioned by the IRS. Adopting the proposed regulation with no transition or grandfather relief is unfair, if not retroactive application of the new rule. And challenging the tax treatment of sales of REIT shares that occur prior to finalization of the new rule arguably would be retroactive application in effect. Moreover, even more ominously, Treasury explicitly states in the Preamble that the IRS may challenge positions taken by taxpayers that are contrary to the Proposed Regulations prior to the Proposed Regulations' being finalized.

ii. Implications

The new Look Through Rule is significant. It is likely to impact many real estate investment structures that were intended to provide non-U.S. investors the benefit of DCREIT status. As described above, in order to benefit from the fact that dispositions of DCREIT stock by non-U.S. investors are not subject to U.S. federal income tax under FIRPTA, many taxpayers and tax advisors have taken the position that no look-through rule should apply to foreign-owned, domestic C corporations that own interests in REITs. Now, those taxpayers will need to reevaluate their current structures and their planned exits from those investments. We expect the IRS will receive numerous comments regarding the new look-through rules.

II. Commercial Activity Exception for Sovereign Wealth Funds

The Proposed Regulations also include a taxpayer-favorable rule for sovereign wealth fund investors who are eligible for the tax exemption in section 892 of the Code. Code section 892 exempts foreign governments and their controlled entities from U.S. federal income tax on certain types of passive income, including dividends and interest. That exemption, however, does not apply with respect to income derived from the conduct of any "commercial activity", received by or from a "controlled commercial entity" ("CCE"), or derived from the disposition of any interest in a CCE.

Temporary regulations under Code section 892 currently provide that a controlled entity of a foreign sovereign will be deemed to be engaged in commercial activity (and thus will constitute a CCE) if its asset holdings would cause the controlled entity to be treated as a USRPHC (the "Deemed CCE Rule").[9] That is, a controlled entity of a foreign sovereign is deemed to constitute a CCE if a majority of its real property and trade or business assets consists of USRPIs. The Proposed Regulations, helpfully, provide that the Deemed CCE Rule will not apply to any foreign controlled entity that would be a USRPHC solely by reason of its direct or indirect ownership interests in one or more other corporations that are not controlled by the foreign government.[10] The implication of this rule is that a foreign sovereign investor that owns solely minority, noncontrolling interests in USRPHCs will not be subject to the Deemed CCE Rule.

This exclusion is proposed to be effective for taxable years ending on or after December 29, 2022 and may be relied upon by taxpayers until the Proposed Regulations are finalized. This is a welcome development for taxpayers. The Deemed CCE rule is often a trap for the unwary and has been a consistent source of concern for sovereign investors who own indirect interests in U.S. real property investments.

III. Final Thoughts

The Proposed Regulations have significant implications for foreign investors in U.S. real estate. The Look Through Rule, especially, may dramatically change the expected tax consequences of investments made by non-U.S. investors who have invested through REIT structures. Please contact us if you would like to discuss the structuring implications of these regulations or to discuss the possibility of submitting comments.

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[1] The IRS and Treasury also issued final regulations addressing "qualified foreign pension funds" under Code section 897. The details of those regulations are not addressed herein.
[2] Although the rules relating to domestically controlled qualified investment entities discussed herein, including specifically the Look-Through Rule (defined below), apply to both REITs and RICs, the focus of this discussion is on domestically controlled REITS. Non-U.S. investors more commonly invest in U.S. real estate through REITs, rather than RICs. Nonetheless, the implications of the Look-Through Rule also are relevant to RICs.
[3] The term "C corporation" is meant to refer to corporations under Subchapter C of the Code that are taxable as separate entities. This is in contrast to "S corporations" under Subchapter S of the Code that are generally taxed as pass-through entities.
[4] PLR 200923001. While private letter rulings may not be relied upon by taxpayers other than the taxpayer that requested the letter ruling, private letter rulings generally indicate IRS' view.
[5] The 2015 "PATH Act" introduced rules treating certain REIT shareholders as foreign investors for purposes of determining whether a REIT is domestically controlled, and provided for look-through treatment in the case of upper tier, non-public REITs. See I.R.C. § 897(h)(4)(E). Those rules can be taken to imply that REIT shares owned by a non-public C corporation should not be treated as owned by its shareholders. See Joint Committee on Taxation, General Explanation of Tax Legislation Enacted 2015 (JCS-1-16), March 2016, p. 279 n.959 (citing PLR 200923001).
[6] The Preamble addresses this regulation and asserts that the determination of actual ownership pursuant to Treasury regulation section 1.857-8 is only intended to ensure the beneficial owner of stock is taken into account when different from the shareholder of record and that Treasury regulation section 1.897-1(c)(2)(i) does not suggest that the actual owners of QIE stock, as determined under Treasury regulation section 1.857-8, are the only relevant persons for determining whether a QIE is domestically controlled or provide any guidance on the meaning of "held directly or indirectly by foreign persons."
[7] It is not clear that the Look-Through Rule is a reasonable interpretation of Code section 897(h)(4)(B), particularly the phrase "directly or indirectly." Arguably, the Look-Through Rule goes beyond "indirect" ownership, as that term has been applied in other areas of the Code, by requiring attribution of ownership in REIT shares from a corporation to its shareholders.
[8] The Proposed Regulations also provide that "qualified foreign pension funds" and entities wholly owned by qualified foreign pension funds will be treated as foreign persons for the purpose of determining whether a REIT is a DCREIT.
[9] Treas. Reg. § 1.892-5T(b).
[10] The Proposed Regulations also confirm that "qualified foreign pension funds" and entities wholly owned by qualified foreign pension funds are not subject to the Deemed CCE Rule.