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Alert

New Proposed Regulations Would Affect the Taxation of Foreign Investors in U.S. Real Estate

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On Dec. 28, 2022, the Internal Revenue Service ("IRS") released proposed regulations (REG-100442-22) ("Proposed Regulations") that provide guidance on how indirect ownership is taken into account for purposes of determining whether a real estate investment trust ("REIT") is "domestically controlled." The Proposed Regulations also address the tax treatment of certain sovereign investing entities and modify the definition of "controlled commercial entity" under Section 892 of the Internal Revenue Code. The rules are particularly important for the real estate investment fund industry and for sovereign investors.

Proposed Regulations Under Section 897

Under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), foreign corporations and nonresident aliens are generally subject to U.S. federal income tax on any gain arising from the disposition of a U.S. real property interest ("USRPI"). A USRPI includes an interest in a domestic corporation that was a United States real property holding corporation ("USRPHC") at any time during the shorter of the five-year period ending on the date of the disposition of the interest or the period during which the taxpayer held the interest. A USRPHC is any corporation if the fair market value of its USRPIs equals or exceeds 50 percent of the sum of the fair market value of its real property interests and any other assets used or held for use in a trade or business. However, a USRPI does not include an interest in a REIT (or a regulated investment company ("RIC") that is a USRPHC) that is "domestically controlled" ("DCREIT"). Accordingly, gain or loss on the disposition of stock in a DCREIT is not subject to tax under FIRPTA ("DCREIT Exception") and ownership of a DCREIT would not cause a domestic corporation to become a USRPHC.

A REIT is generally considered "domestically controlled" if at all times during the five-year period ending on the date of the disposition of an interest in the REIT (or during the REIT's existence if shorter) less than 50 percent of the value of the REIT's stock is held "directly or indirectly" by foreign persons. Existing regulations generally define "foreign persons" as nonresident alien individuals, foreign corporations, foreign partnerships, foreign trusts or foreign estates. The Proposed Regulations clarify that qualified foreign pension funds ("QFPFs") and certain entities owned by QFPFs are considered foreign persons for purposes of determining whether a REIT is domestically controlled.

Neither the statute nor existing regulations interpret the phrase "directly or indirectly," which has resulted in uncertainty as to how non-U.S. ownership through a U.S. partnership and U.S. ownership through a non-U.S. partnership should be regarded. In addition, in Private Letter Ruling 200923001 ("PLR"), the IRS concluded that no look through was required in a case where two of the direct owners of the REIT in question were domestic C corporations. The PLR is cited in the legislative history accompanying the Protecting Americans from Tax Hikes Act of 2015 ("PATH Act"), which notes that, while a "private letter ruling may be relied upon only by the taxpayer to which it is issued," it provides

“some indication of administrative practice.” Furthermore, in a 2013 legislative discussion draft, Congress considered adding new constructive ownership rules that would address the possibility of looking through C corporations, but that proposal was not adopted by the PATH Act, while other proposals were. Based on the PLR, a common structuring technique has been to cause foreign investors in a REIT that would not otherwise have been a DCREIT to make a portion of their investment in the REIT through a domestic C corporation.

The Proposed Regulations offer an interpretation of the phrase “directly or indirectly” that clarifies the treatment of DCREIT ownership through partnerships and overturns the conclusion of the PLR as it relates to certain non-publicly traded corporations. Balancing ease of administration with the statutory requirement to take into account indirect ownership, the Proposed Regulations adopt a partial look-through approach, dividing owners into “non-look-through persons” and “look-through persons.” Only non-look-through persons are taken into account in determining whether a REIT is domestically controlled. Where a non-look-through person holds an interest in a REIT through a look-through person, the non-look-through person’s ownership of the REIT is determined based on the non-look-through person’s proportionate interest in the look-through person. No guidance is provided for a situation in which the look-through person is a partnership with diverging capital and profits interests.

Non-look-through persons include individuals, domestic C corporations (other than non-public foreign-owned domestic corporations discussed below), certain tax exempt organizations and governmental entities, foreign corporations (including foreign governments), publicly traded partnerships (domestic or foreign), estates (domestic or foreign), certain international organizations, certain public REITs, qualified foreign pension funds and qualified controlled entities. Non-look-through persons also include any person that holds less than five percent of any class of stock of a REIT that is regularly traded on an established securities market (with such person treated as a U.S. person unless the REIT has actual knowledge to the contrary). Look-through persons are any persons who are not non-look-through persons and include, for example, non-public REITs and RICs, S corporations, non-publicly traded partnerships (domestic and foreign) and trusts (domestic and foreign). The Proposed Regulations’ partnership look-through rule resolves existing uncertainty regarding the status of REITs owned by U.S. persons through foreign partnerships.

However, notwithstanding the general rule treating C corporations as non-look-through persons, the Proposed Regulations treat a “foreign-owned” domestic C corporation whose stock is not regularly traded on an established securities market as a look-through person. A domestic C corporation is considered foreign-owned if foreign persons hold directly or indirectly 25 percent or more of the fair market value of the corporation’s outstanding stock. The determination of whether a domestic C corporation is foreign-owned is made by applying the same rules that apply for purposes of determining whether a REIT is domestically controlled.

The Proposed Regulations relating to the determination of whether REITs are owned directly or indirectly by foreign persons are proposed to apply to transactions that occur on or after the date the regulations are published as final regulations in the Federal Register. Since there is generally a five-year look-back period from the date of the disposition of REIT shares for purposes of determining domestic control, the proposed effective date may cover structures that are already in place today, depending on when the regulations are finalized. In addition, the preamble to the Proposed Regulations states that the IRS “may challenge positions contrary to proposed §1.897-1(c)(3) and (4) before the issuance of final regulations relating to the topics addressed in those proposed rules.” While the scope of this warning is uncertain, funds that have structured non-U.S. investors’ investments in REITs through domestic

blockers may wish to consider whether the benefits of the domestic blockers continue to outweigh their potential costs, and, if they do not, whether eliminating the blockers is feasible.

Proposed Regulations Under Section 892

Section 892 provides a U.S. tax exemption to foreign governments for certain specifically enumerated types of income. The exemption generally covers various categories of passive income including dividends and gain from the sale of non-controlled USRPHCs that would otherwise have been subject to tax under FIRPTA. However, the IRS has taken the position that dividends in respect of stock in a REIT (other than stock representing a 10-percent-or-less holding in a REIT listed on an established U.S. securities market) attributable to sales of underlying USRPIs generally are not exempt under Section 892.

Temporary regulations issued in 1988 under Section 892 ("Temporary Regulations") provide that both the "integral parts" of a foreign government and its "controlled entities" are considered foreign governments for the purposes of the exemption. A principal distinction between an integral part of a foreign government and a controlled entity of a foreign government is that if a controlled entity becomes a "controlled commercial entity," it loses the benefits of Section 892 entirely, whereas if an integral part of a foreign government engages in commercial activity, it loses the benefits of Section 892 only with respect to income from the commercial activity and not with respect to any other qualifying income. A controlled commercial entity is any entity that is owned 50 percent or more (directly or indirectly) by a foreign government (or with respect to which the foreign government exercises effective practical control) and is engaged in any commercial activity worldwide during the taxable year. Proposed regulations issued in 2011 ("2011 Proposed Regulations") clarify that while the exemption is not available for REIT dividends attributable to sales of underlying USRPIs, such dividends do not cause the REIT shareholder to be considered to be engaged in a commercial activity. On the same day that the IRS released the Proposed Regulations, the IRS also re-opened the comment period relating to the 2011 Proposed Regulations, perhaps suggesting an intent to finalize the 2011 Proposed Regulations as well.

Notwithstanding the clarification of the 2011 Proposed Regulations, the Temporary Regulations have continued to be a source of consternation for sovereign investors. In particular, the rule that a foreign controlled entity will be deemed to be engaged in commercial activity (and will thus constitute a controlled commercial entity) if it is a USRPHC ("Deemed CCE Rule"), has created traps for the unwary. Under this rule, a foreign controlled entity holding nothing other than passive assets and a single minority interest in a USRPHC could be classified as a controlled commercial entity even if the value of the passive assets significantly exceeded the value of the interest in the USRPHC. Similarly, a foreign controlled entity whose only assets are minority interests in USRPHCs would be a controlled commercial entity. Gain from the sale of any underlying domestic USRPHC interests would be taxable even though, had the domestic USRPHC interests been held directly by the foreign government, the gain would have been eligible for the exemption. Finally, under the Deemed CCE Rule, a controlled QFPF that is a USRPHC, would be treated as a controlled commercial entity. This outcome frustrates the intention of Section 897(l) to exempt QFPFs from FIRPTA. These rules have been a source of disquiet for sovereign investors anxious to avoid inadvertently causing controlled investing entities, often established for commercial liability issues, to become controlled commercial entities.

The Proposed Regulations respond to these concerns by excluding from the application of the Deemed CCE Rule any foreign controlled entity that is either a QFPF or that would be a USRPHC solely by reason of its direct or indirect ownership interest in one or more other corporations that are not controlled by the foreign government. The exclusion is proposed to be effective for taxable years ending on or after

Dec. 29, 2022 and may be relied upon by taxpayers until the Proposed Regulations are adopted as final in the Federal Register.

While the Proposed Regulations provide some welcome guidance regarding REITs and sovereign investors, they also reverse prior IRS policy that has formed the basis for a commonly used DCREIT planning technique.

Authored by Philippe Benedict, David S. Griffel, Andi Mandell, Joseph Reich, Shlomo C. Twerski, Alan S. Waldenberg, David S. Wermuth, Elie Zolty, Chaim Stern and Jacob A. Gach.

Please contact your Schulte Roth & Zabel LLP tax attorney for any questions about the Proposed Regulations.

Schulte Roth & Zabel
New York | Washington DC | London
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