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New Proposed Regulations Could Substantially Impact Taxation of Foreign Investment in U.S. Real Estate

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In this article, the authors describe proposed regulations issued recently by the Department of the Treasury and the Internal Revenue Service addressing the U.S. federal income taxation of foreign persons who invest in U.S. real estate.

The Department of the Treasury and the Internal Revenue Service (the IRS) released proposed regulations (the Proposed Regulations) on December 28, 2022 that address the U.S. federal income taxation of foreign persons who invest in U.S. real estate.[1] The Proposed Regulations provide:

1. For purposes of determining whether a real estate investment trust (REIT) is domestically controlled, the following non-publicly traded entities are "looked through" to their underlying owners:
   a. Domestic and foreign partnerships;
   b. REITs and regulated investment companies (RICs); and
   c. Domestic "C" corporations that are owned 25% or more directly or indirectly by foreign persons.
2. A qualified foreign pension fund (QFPF) is treated as a foreign person for purposes of determining whether a REIT is domestically controlled.
3. The "deeming rule" in Treasury Regulations Section 1.892-5T(b)(1) is changed to allow section 892 investors (i.e., non-U.S. governmental entities) to more easily use subsidiary entities to own minority investments in REITs and U.S. real estate companies.
4. The deeming rule is also changed to allow QFPFs to more easily use subsidiary entities to own minority and majority investments in REITs and U.S. real estate companies.

The Proposed Regulations are described in greater detail below, including their proposed

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effective dates and the potential impact on existing structures.

DOMESTICALLY CONTROLLED REIT DETERMINATION

Nonresident aliens and foreign corporations are subject to U.S. federal income taxation under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) when they directly or indirectly dispose of a United States real property interest (USRPI),[2] such as U.S. real estate or stock of a domestic corporation that is (or has been within a look-back period) a United States real property holding corporation (USRPHC).

A USRPHC generally is a corporation a majority of the assets of which are USRPIs, including stock of other domestic or foreign USRPHCs (subject to certain look-through rules).

One exception is that USRPIs do not include stocks and securities of a domestically controlled REIT,[3] which can be sold by its foreign shareholders without FIRPTA taxation. Furthermore, a domestic corporation does not become a USRPHC merely by owning (actually or constructively) a minority interest in a domestically controlled REIT, which allows the corporation's foreign shareholders to sell their stock without being subject to FIRPTA taxation.

A domestically controlled REIT is defined as a REIT that is not owned 50% or more, directly or indirectly,[4] by foreign persons at any time during the prior five years (or during the REIT's existence if shorter). Under the Proposed Regulations, foreign persons include only nonresident aliens, foreign corporations, foreign estates, publicly traded REITs that are not domestically controlled, RICs with redeemable securities that are not domestically controlled, international organizations and QFPFs (described below).

In addition, under the Proposed Regulations, certain look-through rules apply, including for non-publicly traded REITs, RICs without redeemable securities, foreign and domestic partnerships (other than certain publicly traded partnerships), trusts and S corporations.

Notably, the Proposed Regulations also look-through any non-publicly traded domestic C corporation that is 25% or more owned, directly or indirectly, by foreign persons (a foreign-owned domestic corporation). In other words, a domestic C corporation (other than a REIT or a RIC) is treated as 100% domestic only if either (x) it has a class of stock that is traded on an established securities market, or (y) it is not 25% or more owned, directly or indirectly, by foreign persons; all other domestic C corporations are looked through for purposes of determining whether a REIT is domestically controlled, including after taking into account further applications of the same 25% rule.

The Proposed Regulations' 25% rule is contrary to the IRS's conclusion in a 2009 Private Letter Ruling, PLR 200923001, which ruled that no look-through rule applies to a domestic C corporation wholly owned by foreign shareholders, as long as such corporation is not a RIC or a REIT. Congress later considered addressing the possibility of looking through C corporations with new constructive ownership rules in a 2013 discussion draft released by Senator Max Baucus, but those changes were omitted when many of the discussion draft's other provisions were included in the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act).[5]

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The PATH Act instead enacted look-through rules that applied only to certain REITs and RICs; notably, the PATH Act's legislative history mentioned the 2009 PLR in its discussion of the existing law, although the legislative history footnoted that discussion by pointing out that PLRs can only be relied upon by the taxpayer to whom they are issued but provide some indication of the federal government's "administrative practice."[6] Hence, the 25% rule comes as a surprise to many practitioners, particularly when coupled with the proposed effective date (discussed below).

Example 1: A REIT's stock is owned 49% by a taxable foreign shareholder and 51% by a domestic C corporation that is wholly owned by the same foreign shareholder. The domestic C corporation is not a REIT or a RIC. The REIT is a domestically controlled REIT under the IRS's approach in PLR 200923001, but not under the Proposed Regulations; as such, under the Proposed Regulations, the taxable foreign shareholder is subject to FIRPTA taxation when it sells its REIT stock.

Example 2: A REIT's stock is owned 40% by domestic shareholders, 20% by a foreign shareholder and 40% by a domestic C corporation that is owned by a partnership of unrelated foreign investors. The domestic C corporation is not a REIT or a RIC. The REIT is a domestically controlled REIT based on the IRS's approach in PLR 200923001, but not under the Proposed Regulations. The domestic C corporation is a USRPHC under the Proposed Regulations, in which case the partnership's investors are subject to FIRPTA taxation (and U.S. federal income tax filings) when they sell their partnership interests or when the partnership sells stock of the domestic C corporation.

The Proposed Regulations' changes for domestically controlled REITs (including the QFPF rule described below) are proposed to be effective for transactions, such as a sale of REIT stock, occurring on or after the Proposed Regulations are finalized. Because the status of a REIT as domestically controlled (or not) takes into account its status during the entire five-year period ending with the disposition (or other trigger) event, the Proposed Regulations, including the look-through rule, may impact existing structures, if enacted in its current form (i.e., even if some or substantially all of the five-year period occurred before the Proposed Regulations are finalized).

Accordingly, REITs and their sponsors may need to revisit their existing planning and investors may need to revisit their expectations for tax (and the possibility of tax filings) on exits.

In addition, in certain cases, REITs and their sponsors may need to update the domestic ownership information that they have about the REIT's direct and indirect shareholders, while investors may need to update their representations about their domestic ownership.

In addition, the Proposed Regulations' preamble states that the IRS may challenge contrary positions that are taken before the Proposed Regulations are finalized, which could possibly include sales of REIT stock before the date the Proposed Regulations were released (i.e., before December 28, 2022) and, in this regard, the IRS may be particularly focused on the QFPF rule discussed below. As such, past or present purchasers of REIT stock (or other withholding agents) should carefully consider whether

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FIRPTA withholding may be required in connection with transactions involving a foreign seller.

FOREIGN STATUS OF A QFPF

The PATH Act enacted a new FIRPTA exemption for QFPFs. QFPFs can dispose of USRPIs (or receive REIT or RIC dividends that are attributable to gain from the disposition of USRPIs) without being subject to FIRPTA taxation, though they are still subject to U.S. federal income taxation on income that is otherwise effectively connected with a U.S. trade or business. Proposed regulations were issued in 2019 that helped to define QFPFs, which were finalized with relatively minor changes on December 28, 2022.

In connection with the 2019 QFPF proposed regulations, commentators asked the IRS to determine whether QFPFs are treated as "U.S. persons" for purposes of determining whether a REIT is a domestically controlled REIT.[7] The Proposed Regulations provide that a QFPF is treated as 100% foreign, which Treasury and the IRS view as in accordance with the purpose and the legislative history of the statute.

Example 3: A REIT's stock is owned 40% by taxable foreign shareholders and 60% by a QFPF. The REIT is not a domestically controlled REIT under the Proposed Regulations. Gain on the sale of the stock would be subject to FIRPTA taxation for the taxable foreign shareholders, but not for the QFPF.

As noted above, the Proposed Regulations' changes to the QFPF rules are generally proposed to be effective for transactions occurring on or after the Proposed Regulations are finalized, but with the potential for retroactive application of the rules set forth therein.

SECTION 892 EXEMPTION FOR CONTROLLED ENTITIES

Section 892 exempts from U.S. federal income taxation a foreign government's income from investments in U.S. stocks and securities, generally including dividends, interest and gains from the sale of non-domestically controlled REITs and other domestic USRPHCs. A foreign government includes sovereign wealth funds, public pension funds and certain other entities controlled by a foreign sovereign. The Section 892 exemption does not apply to income derived from, or earned by, a "controlled commercial entity" (CCE), which is any entity that is owned 50% 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.

A special deeming rule in Treasury Regulations Section 1.892-5T(b)(1) provides that any entity that is a USRPHC (e.g., a foreign corporation that owns a significant amount of USRPIs, including stock of non-domestically controlled REITs and other USRPHCs) is treated as if it were engaged in commercial activity for purposes of determining CCE status. Such a CCE, if it were otherwise treated as a foreign government, would be ineligible for the Section 892 exemption and would be subject to U.S. federal income taxation on its U.S. real property investments in the same manner as any other foreign investor (subject to otherwise applicable exceptions, such as for QFPFs and domestically controlled REITs).

The deeming rule's effective result is that sovereign wealth funds and other foreign

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governmental entities are often required to make their investments in U.S. real property directly in order to use their Section 892 exemption, instead of through subsidiary entities that might end up being CCEs and lose their Section 892 exemption as a result of owning too much U.S. real property.[8] Subsidiary entities may often be preferred for non-tax business reasons, such as liability protection, accounting and financing. Moreover, foreign governmental entities that do use subsidiary entities are required to monitor the values of their underlying investments in U.S. real property (including those held indirectly through funds) in order to not run afoul of the deeming rule.

The Proposed Regulations loosen the deeming rule in a taxpayer favorable manner, by providing that the rule does not apply to an entity that would otherwise be a USRPHC (and therefore deemed to be engaged in commercial activity) solely as a result of owning a direct or indirect interest in corporations that are not controlled by the foreign government. This change provides additional flexibility for Section 892 investors to use subsidiary entities to own minority investments in non-domestically controlled REITs and other USRPHCs, including interests in such entities held through funds or JVs which the Section 892 investor does not control.

Example 4: A foreign sovereign wealth fund owns 100% of a subsidiary organized in the same country (and which is treated as a "foreign government" under Section 892), which owns 40% of the stock of a non-domestically controlled REIT as its sole asset. The subsidiary is a CCE under the current rules and cannot use the Section 892 exemption. However, the subsidiary is not a CCE under the Proposed Regulations and may use the Section 892 exemption to avoid U.S. federal income tax on dividends from the non-domestically controlled REIT (except to the extent attributable to gain from the sale of certain USRPIs by the REIT) and on gain on the sale of the REIT's stock.

The Proposed Regulations also provide that the deeming rule does not apply to a QFPF or a "qualified controlled entity" (which is generally an entity that is treated similarly to a QFPF by virtue of being wholly owned by one or more QFPFs). In contrast to non-QFPF investors, QFPFs are not subject to the deeming rule even if they own a majority of, and/or control, the underlying U.S. real estate investment. The change provides additional flexibility for QFPFs that are also eligible for the Section 892 exemption (i.e., non-U.S. public pension funds), by allowing their subsidiary entities to own minority and majority/control interests in U.S. real estate investments without jeopardizing the Section 892 exemption with respect to the minority interests.

The Proposed Regulations' above changes related to Section 892 are proposed to apply to taxable years ending on or after December 28, 2022, though taxpayers may rely on the changes prior to their finalization. There is no requirement that taxpayers apply all of the Proposed Regulations in a consistent manner.

NOTES:

[1]The regulations were published the next day in the Federal Register. REG-100442-22, 87 Fed. Reg. 80097 (Dec. 29, 2022).

[2]Purchasers of USRPIs from a foreign seller are generally required to withhold U.S. federal tax from the purchase price, absent an exception.

[3]Section 897(h)(2). Unless otherwise stated, all Sec-

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tion references are to the Internal Revenue Code of 1986, as amended. Similar rules apply to certain RICs that are USRPHCs.

[4]Although both the Code and applicable Treasury Regulations refer to "direct or indirect" ownership, which suggests some form of look-through, the Treasury Regulations further specify that for purposes of the determination of domestically controlled status, the "actual owners" of stock, as determined for REIT inclusion purposes (i.e., the person required to take a REITs dividend into account for U.S. federal income tax purposes), must be taken into account.

[5]Pub. L. No. 114-113. Congress's proposed constructive ownership rules were also narrower in scope than the Proposed Regulations' 25% rule, by only looking through a corporation to any shareholder that owns (directly, indirectly, or constructively) 50% or more of the corporation's stock. See Joint Committee on Taxation, *Technical Explanation of the Senate Committee on Finance Chairman's Staff Discussion Draft of Provision to Reform International Business Taxation*, jcx-15-13, at 84 (Nov. 19, 2013) ("In order to address uncertainty in the determination of indirect ownership, the provision applies the attribution rules of section 318 for purposes of determining whether a REIT or a RIC that is a qualified investment entity is domestically controlled. Among other things, those rules impose family attribution and also treat stock owned by a corporation as owned by persons with a 50 percent or greater interest in the corporation.").

[6]S. Rep. No. 114-25, at 6 n. 19.

[7]Section 897(l), which was enacted to exempt a QFPF from the FIRPTA rules, provides that a QFPF is not treated as a foreign person for purposes of Section 897; Section 897 also includes the domestically controlled REIT exception.

[8]The deeming rule's effect is magnified by a "per se" corporation rule in Treasury Regulations Section 301.7701-2(b)(6) that treats any entity wholly owned (directly and possibly indirectly) by a foreign government as a corporation for U.S. federal income tax purposes.

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