New Proposed Regulations Would Affect the Taxation of US Real Estate for Foreign Investors

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01 / 03 / 23

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On December 28, 2022, the Treasury Department released a set of proposed regulations that, if finalized, would alter key rules affecting many real estate funds, sovereign wealth funds and other foreign investors in U.S. real estate.[1] The proposed regulations are likely to receive a mixed reception from market participants. On the one hand, the regulations provide a helpful rule that would give foreign government investors increased flexibility in structuring their investments. On the other hand, they contain a controversial new rule for determining whether a real estate investment trust (REIT) is "domestically controlled," threatening to disrupt the tax planning of many real estate funds, private equity funds, real estate joint venture (JV) participants and other non-U.S. investors in U.S. real estate.

Background

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), contained principally in Section 897 of the Internal Revenue Code (the Code), created an important exception to the general rule that a foreign investor is not subject to U.S. taxation on capital gains. Under FIRPTA, a foreign investor that recognizes gain on a "United States real property interest" (USRPI) is subject to tax on that gain at regular U.S. tax rates as if they were a U.S. person. The term USRPI includes direct interests in real property as well as equity interests in a domestic "U.S. real property holding corporation" (USRPHC). The term USRPHC generally includes any corporation if a majority of its assets consists of USRPIs. A foreign corporation may be a USRPHC if it meets the asset test (though interests in the foreign USRPHC will generally be treated as USRPIs only for purposes of determining whether an owner of such interests is itself a USRPHC).

Importantly, equity interests in a "domestically controlled REIT" are not USRPIs, regardless of the quantum of real estate owned by the REIT. Thus, a foreign investor generally may sell shares in a domestically controlled REIT without being subject to U.S. taxation. If, on the other hand, the REIT ceased to be domestically controlled, a foreign investor would generally be subject to full U.S. taxation on any gain from selling the REIT's stock.

A REIT is domestically controlled if less than 50% of its stock is held "directly or indirectly" by foreign persons at all times during a testing period (generally, the five-year period preceding the sale of the REIT's stock). The Code and existing regulations generally do not specify what "indirect" ownership encompasses for this purpose and, in particular, whether and to what extent a REIT must look through a domestic C corporation to the C corporation's shareholders. For example, if 60% of a REIT is owned by a domestic corporation but the corporation's shareholders are entirely foreign, is the REIT domestically controlled because the majority of its stock is held directly by a U.S. corporation, or is it foreign controlled because foreign shareholders of the U.S. corporation indirectly own more than 50% of the REIT?

Although the answer is not explicit in the Code or current regulations, it appears that taxpayers are not required to look through domestic corporations under current law. This interpretation is supported by the current regulations, which state that for purposes of determining domestic control, the "the actual owners of stock, as determined under [Treasury Regulation Section] 1.857-8, must be taken into account." Importantly, under Treasury Regulation Section 1.857-8, the "actual owner" of REIT stock is the person who is required to include the dividends on that REIT stock in their income, which, in the case of REIT stock owned by a domestic corporation, would be only the corporation itself and not the corporation's shareholders.

[1] On the same date, Treasury issued final regulations concerning the special rules for "qualified foreign pension funds." Those regulations are outside the scope of this discussion.

Moreover, in the Protecting Americans From Tax Hikes (PATH) Act of 2015, Congress expressly included certain look-through (and modified look-through) rules for REIT stock that is held by an upper-tier REIT, but those rules do not apply to regular C corporations. The clear implication of the PATH Act rules is that Congress did not intend similar rules to apply to regular C corporations. For these reasons, most practitioners believe that current law does not require look-through of domestic corporations. Indeed, even before the PATH Act, the Internal Revenue Service (IRS) concluded as much in Private Letter Ruling 200923001.

The general FIRPTA rules described above are modified for entities that qualify as "foreign governments" under Section 892 of the Code. Such an entity is generally exempt from U.S. taxation on income from investments in securities, including, in general, stock of a USRPHC, whether or not the USRPHC is a domestically controlled REIT. The Section 892 exception does not, however, apply if either the foreign government investor or the USRPHC in whose stock it has invested is a "controlled commercial entity" of the foreign government.

A "controlled commercial entity" is, in general, any entity that is both engaged in "commercial activities" (which includes most business or profit-making activities other than investments in securities) and is "controlled" by the foreign government. Thus, if the foreign government investor is itself engaged in commercial activity, it will generally not qualify for the Section 892 exemption on any of its investments, and even if it is not so engaged, the exemption will not apply to income or gain recognized from a USRPHC or other corporation that is engaged in commercial activity and that the foreign government investor controls.

Existing temporary regulations provide that an entity will be deemed to be engaged in commercial activities if it is a USRPHC. Thus, if a sufficient portion of a foreign government investor's assets consists of stock of USRPHCs that are not domestically controlled REITs, it would lose its Section 892 exemption even though its only activity is investing in securities (which otherwise does not constitute commercial activity).

New Proposed Regulations

Section 892: Deemed Commercial Activity

In a helpful clarification of the existing temporary regulations, the new proposed regulations create an exception to the rule that a USRPHC is deemed to be engaged in commercial activity. In particular, the proposed regulations provide that the rule does not apply to an entity that is 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.[2] Thus, a foreign government investor that owns solely minority, noncontrolling interests in USRPHCs would not be deemed to be engaged in commercial activity even if those interests caused the foreign government investor itself to be a USRPHC. This rule would be effective for taxable years ending on or after the date the regulations are finalized, though taxpayers may rely on the rule prior to finalization.

This is a welcome change that would provide significant flexibility to many foreign government investors. Very often, such an investor would prefer to hold an investment in a special purpose vehicle (SPV) that owns no assets other than that investment. Doing so would prevent any inadvertent commercial activity generated by the investment from tainting the Section 892 exemption for other investments held by other entities in the foreign government's structure and also may have nontax benefits in terms of liability insulation, accounting/tracking and financing.

Unfortunately, though, under the existing temporary regulations, such an SPV would lose its eligibility for the Section 892 exemption if its investment is stock in a USRPHC (other than a domestically controlled REIT) or any other USRPI. Moreover, even when a foreign government holds USRPIs through an entity that also owns non-USRPIs sufficient to outweigh the USRPIs, it must continually monitor the balance of USRPIs and non-USRPIs to avoid USRPHC status. This can be burdensome due to the difficulty of getting the information necessary to reliably run the tests and the need to adjust the portfolio as portfolio composition and asset values change.

The new proposed regulations would alleviate these issues by allowing an SPV to maintain its Section 892 exemption while holding noncontrolling interests in USRPHCs and by removing the burden of having to balance USRPIs and non-USRPIs. This would provide foreign governments with significantly more flexibility to segregate U.S. real estate investments in different legal entities and to otherwise hold investments based on business or nontax legal objectives rather than tax considerations. Given that taxpayers may rely on the proposed regulations prior to finalization, they may also consider implementing favored structures now. The existing deemed commercial activity rule would, however, continue to apply in the case of a foreign government investor that is a USRPHC because of its investment in USRPIs other

[2] The proposed regulations also clarify that certain entities that are eligible for the FIRPTA exemption for "qualified foreign pension funds" (and entities wholly owned by qualified foreign pension funds) are not subject to the deemed commercial activity rule.

than stock of noncontrolled USRPHCs — for example, direct interests in U.S. real estate or majority interests in corporations that own U.S. real estate.

Section 897: Domestic Control 'Look-Through'

As noted above, it appears that existing law does not require a REIT to look through a domestic C corporation to its shareholders in determining whether the REIT is domestically controlled. In a reversal of this position — the position taken by the IRS in a prior private ruling — the new proposed regulations would require a REIT to look through any nonpublic domestic corporation if 25% or more of the corporation's stock (by value) is owned by foreign persons. Domestic corporations that are either publicly traded or whose foreign ownership is less than 25% would not be subject to the look-through rule and thus would be treated as U.S. persons for purposes of testing domestic control of the underlying REIT.

In addition, consistent with the views of most practitioners, the regulations clarify that a REIT must look through partnerships that are not publicly traded partnerships. The new look-through rules would be effective for transactions occurring on or after the date the regulations are finalized. The reference to "transactions" presumably means REIT share sales or other transactions for which the status of a REIT as domestically controlled is relevant, and there is no provision grandfathering ownership structures that have been established prior to finalization under current law. Moreover, given that domestic control must be satisfied for the entirety of the backward-looking testing period, the look-through rule could cause a REIT to lose its domestically controlled status based on current ownership even if that ownership is changed prior to finalization of the proposed regulations. Finally, Treasury noted in the preamble that it may challenge positions contrary to the look-through rule even before finalization.

The rule requiring look-through of domestic corporations with 25% or greater foreign ownership is controversial and likely to affect many private equity funds, real estate funds and JVs, and other investors in private REITs, many of which have created domestic corporate "blockers" through which certain foreign investors hold REIT interests. In situations where the blocker and other U.S. ownership of the REIT aggregates to exceed 50%, these investors generally would have expected that the REIT would be domestically controlled such that a sale of the REIT stock by any foreign investors that owned the REIT shares "unblocked" would be exempt from U.S. tax. Fund sponsors may have provided tax covenants to investors based on these expectations.

These investors and sponsors will now have to reevaluate their expectations — including with respect to existing structures, given the lack of grandfathering — and determine whether any alternative structuring is appropriate. We anticipate that Treasury will receive significant comments opposing its proposed look-through rule for domestic corporations.