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Tax Update

IRS, Department of Treasury Release Proposed Rules and Regulations Affecting Non-U.S. Real Estate Investors

Late last year, towards the end of December 2022, the Internal Revenue Service ("IRS"), in conjunction with the United States Department of the Treasury ("Treasury Department"), released Guidance on the Foreign Government Income Exemption and Definition of Domestically Controlled Qualified Investment Entities by announcing proposed rules and regulations related to the tax treatment of certain entities in the real estate industry.[1] Specifically, the proposed rules relate to sections 892 and 897 of the Internal Revenue Code ("Code") and would impact certain exemptions presently available, including most notably the restriction of the ability of non-U.S. persons from investing in a real estate investment trust ("REIT") without impacting the status of the REIT as "domestically controlled" for tax purposes.

Under Section 897 of the Code, enacted under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), non U.S. persons are subject to U.S. tax on disposition of U.S. real property interests ("USRPI").[2] USPRIs include not only real property but also equity interests in U.S. real property holding corporations ("USRPHC"), which are generally corporations whose assets consist of 50 percent or more USRPIs in value.[3] Under FIRPTA, however, a key exception

[1] Federal Register, Vol. 87, No. 249, 80097-80108.
[2] 26 U.S.C § 897.
[3] 26 U.S.C § 897(c)(1).

has exempted REITs that are deemed “domestically controlled”, meaning non-U.S. investors historically were able to avoid U.S. income tax in such a situation.

Under existing regimes, a REIT has been deemed to be ‘domestically controlled’ if less than 50 percent of stock in the REIT is held directly or indirectly by foreign investors at all times during a prescribed testing period (generally five years).[4] The section also provided that stockholders who own less than 5 percent of a REIT publicly traded on a securities exchange are U.S. holders unless the REIT has actual knowledge to the contrary.[5] Typically, this would mean a REIT would not “look through” to stockholders of a domestic corporation to determine whether the ultimate shareholders were foreign. As such, and because stock of a domestically controlled REIT is not considered USRPI under FIRPTA, foreign stockholders were able to avoid being subject to U.S. federal income tax upon the sale of such stock.[6] On the other hand, non-domestically controlled REITs are treated as USRPI and sales of stock by those foreign holders are typically subject to U.S. federal income tax upon the sale. The proposed rules and regulations released expect to impact these arrangements substantially.

Under the proposed rules and regulations, there is a new and different “look through” that would need to be done for the purposes of determining the domestic of foreign status of direct and indirect stockholders of a REIT. To determine whether a REIT can be categorized as domestically controlled, the proposed rules have categorized persons to be either a “look-through person” or a “non-look-through person” for a determination of whether the ultimate owner of the stock is given domestic or foreign status. A domestic C corporation is a primary example given of a “non-look-through person”, as well as individuals, foreign corporations, international

[4] Section 897(h)(4)(B).
[5] Section 897(h)(4)(E)(iii).
[6] Section 897(a)(1) and Section 897(h)(2).

organizations, nontaxable holders and publicly traded partnerships, as well as qualified foreign pension funds ("QFPF") and qualified control entities ("QCE").[7] A "look-through" person is any person other than a "non-look-through person", including REITs, regulated investment companies ("RIC"), S corporations, non-publicly traded partnerships and trusts.[8] All "look-through" persons are looked through until they reach a "non-look-through" person, and that person is treated as the direct or indirect stockholder of a qualified investment entity ("QIE") for the purposes of determining whether that stockholder is a nonresident alien individual or foreign corporation, and therefore a foreign person, or whether they are domestic based.

This has a substantial impact on non-U.S. investors, as distributions to nonresident alien individuals and foreign corporations are subject to tax on disposition or sale of stock pursuant to Section 897(a) and 897(h)(1). There had been an exception known as the DC-QIE exception, under which many REITs had previously been able to exempt gains or loss on disposition of stock from tax based on its the domestic control status, which meant less than 50 percent of the value of stock was held by foreign persons.[9] The proposed rules intend to prevent foreign investors from creating domestic C corporations to become a domestically controlled QIE and fit within the exception. The rules also clarify that a QIE, which include REITs, may be domestically controlled if the non-public domestic C corporation is a foreign-owned corporation, meaning one with foreign persons holding directly or indirectly 25 percent or more of the fair market value of the corporation's then-outstanding stock.[10] For REITs and other entities who previously relied on a structure similar to the above which had what were known as "blocker corporations" in order to qualify for the domestically controlled exception under Section 897, it

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[7] Section 1.897-1(c)(3)(ii)(C), 1.897-1(c)(3)(v)(D) and 1.897-1(c)(3)(iv)(A).
[8] Section 1.897-1(c)(3)(iii)(C) and 1.897-1(c)(3)(v)(C)
[9] Section 897(h)(4)(B).
[10] 1-897.1(c)(3)(v)(B).

will be imperative to understand the complete structure in place for each entity, and the status of all of the entity's stockholders, in order to determine whether the disposition and tax status of stakeholders will be impacted by the proposed rules and regulations advanced by the IRS and Treasury Department.

In addition to the significant proposed rules and regulations related to Section 897, the IRS and Treasury Department propose rules and regulations that would impact controlled commercial entities and foreign governments under Section 892. Presently, foreign governments are exempt from U.S. tax on income from investments including stock of a USRPHC; however, when income is derived from "commercial activities" by a foreign government or received from a commercial controlled entity ("CCE"), including dividends received from a gain or sale of stock or interests, the exemption provided under Section 892 does not apply.[11] Commercial controlled entities are controlled by foreign governments and determined by majority vote or value ownership, or exercising effective control of and conducting commercial activities by the foreign government.[12] Under the proposed regulations, USRPHCs may no longer automatically be deemed CCEs solely by reason of interests in other USRPHCs not controlled by the foreign government, meaning that if a USRPHC owns minority interests in USRPHCs not otherwise controlled by the foreign government they will not be taxed on dividends, or capital gains on the sale of interests, received from that USRPHC.[13] Other controlled entities that are QFPFs and QCEs would also be impacted by the proposed rules to Section 892.[14]

[11] 26 U.S.C § 892.
[12] 26 U.S.C § 892(a)(2)(B).
[13] Section 1.892-5T(b)(1).
[14] Section 1.892-5T(a).

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