Tax Alert

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U.S. Treasury Proposes Sweeping Changes Narrowing a Key Exception from U.S. Taxation for U.S. Real Estate Investments Made by Non-U.S. Investors Through Domestically Controlled REITs and Related Changes to the Treatment of Non-U.S. Pension Fund Investors

January 20, 2023

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Key Points

- Recently proposed regulations would significantly curtail the ability for private fund sponsors and non-U.S. investors to use a so-called D-REIT to facilitate a tax-efficient exit from U.S. real property investments, by no longer permitting the use of certain foreign-owned U.S. "blocker" corporations to achieve "domestic control."
- The rules would also make clear that ownership of a REIT by a QFPF does not count towards the domestic control requirement for D REIT status.
- Fund sponsors and their investors should carefully evaluate the impact of these rules on any pre-existing or new investment and transaction structures, as well as any associated contractual exposure. Additional tax mitigation strategies may be warranted, particularly in light of an effective date rule that apparently grants the IRS authority to challenge positions contrary to the proposed regulations, irrespective of when such positions were entered into.
- Aside from the specifically targeted structure, we generally expect that the proposed regulations should have a limited impact on investment funds' use of REITs, which should continue to offer significant tax benefits to U.S. investors (including U.S. tax-exempts), non-U.S. sovereigns, pension funds and other investors.

Newly proposed Treasury Regulations target a structure commonly used by non-U.S. investors in U.S. real estate asset platforms to obtain an exemption from U.S. tax upon an exit from real estate investment trust (REIT) shares. In such platforms, a fund sponsor or non-U.S. investor may interpose a U.S. "blocker" corporation between a portion of the non-U.S. investor's investment and the REIT to achieve the requisite level of U.S. ownership for a "domestically controlled" REIT (D-REIT) status. To the extent non-U.S. investors sell shares in a D-REIT, no U.S. federal income taxation applies absent unusual circumstances. The proposed rules, however, would no longer

permit taking the position that any such interposed corporation with material non-U.S. ownership counts as “good” ownership for D-REIT status. The proposal includes an effective date rule that grants the U.S. Internal Revenue Service (IRS) apparent authority to challenge positions even where such positions relate to transactions entered into prior to the time when the proposed regulations are finalized (and, apparently, also to transactions entered into prior to the issuance of the proposed regulations). Additional changes are proposed confirming the treatment of a “qualified foreign pension fund” (QFPF) investors and their subsidiaries.[1]

Importance of the D-REIT Exception for Non-U.S. Investors

Under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), non-U.S. investors are generally required to pay U.S. tax and file U.S. tax returns upon a disposition of a U.S. real property interest, which includes an investment in stock issued by a U.S. corporation or a U.S. REIT with material U.S. real property-related assets (i.e., a U.S. real property holding corporation (USRPHC)). FIRPTA **deems** any associated gain or loss to be connected with the conduct of a U.S. trade or business, irrespective of whether the non-U.S. investor is actually engaged in such a trade or business. Accordingly, U.S. real property investments generally give rise to tax payment and filing requirements upon exit that non-U.S. investors frequently seek to mitigate.

Certain statutory exemptions can reduce or eliminate FIRPTA tax. In particular, QFPFs and entities all of the interests in which are held by QFPFs (i.e., qualified controlled entities) benefit from a broad exemption from FIRPTA. U.S. tax treaties generally do not provide exemptions in this regard.

Non-U.S. investors who cannot claim an exemption from FIRPTA in their own right often make investments in U.S. real property assets through a D-REIT. The FIRPTA exemption for D-REITs allows such non-U.S. investors to exit any REIT stock that they hold directly or through a flow-through in a tax-free manner, provided that less than 50 percent in value of the REIT stock is held “directly or indirectly” by “foreign persons” at all times in the five-year period preceding the exit. As the FIRPTA tax can be significant, and the associated U.S. filing obligations even more so, the availability of the D-REIT exemption is often a material factor in a non-U.S. investor’s investment underwriting, and the D-REIT exemption is commonly employed by private fund sponsors and their non-U.S. investors in structuring U.S. real estate investments.

The statute, however, does not provide guidance on the meaning of “indirect” foreign ownership for purposes of testing whether a REIT meets the “domestically controlled” threshold. Private Letter Ruling 200923001 (the “Ruling”), the only existing guidance from the IRS on the topic prior to the proposed regulations, concluded that a REIT held by two U.S. corporations was “domestically controlled,” even though the corporations were indirectly owned by foreign persons.[2] The IRS reasoned that the U.S. C-corporations were considered the “actual owners” of the REIT stock for purposes of testing “domestically controlled” status since they were fully taxable on any distributions from the REIT.[3] Crucially, the Ruling did not require taxpayers to “look through” fully taxable U.S. C-corporations. The legislative history of the Protecting Americans from Tax Hikes Act of 2015 (PATH Act) appeared to cite with approval the Ruling’s conclusion in this regard.

New Look-Through Rule for Purposes of Determining Domestic Control

On December 29, 2022, the U.S. Treasury Department and the IRS published newly proposed regulations that would modify the scope of the D-REIT exemption in a manner that would make it substantially more difficult for non-U.S. investors to rely on.

In particular, in determining whether a REIT is a D-REIT, the proposed regulations would require taxpayers to take into account REIT stock that is held indirectly by foreign persons through a “look-through person,” but not stock that is held through a “non-look-through person.”[4] A look-through person includes, among others, REITs, regulated investment companies (RICs) and non-publicly traded partnerships (both domestic and foreign). More significantly to many existing D-REIT structures, a domestic C-corporation would also be a look-through person if foreign persons own, directly or indirectly, 25 percent or more of the entity’s outstanding stock by fair market value (referred to as a “foreign-owned domestic corporation”).

This proposed rule represents a material departure from the Ruling and prior practice in requiring taxpayers to “count” the non-U.S. ownership of certain U.S. corporations in evaluating whether a REIT qualifies as a D-REIT. This would generally limit non-U.S. investors’ ability to structure into D-REIT status by making a portion of their investment in a REIT through a U.S. blocker corporation. Note that the proposed regulations only require looking through the actual chain of ownership. The rules do not appear to provide for any attribution or constructive ownership rules.

Although publicly traded REITs are also look-though persons, special, more forgiving look-through rules would apply to such REITs in order to ease administrative and compliance difficulties that could otherwise result from applying the general look-through principles to publicly traded entities.

Treatment of QFPFs as Foreign Persons for Determining D-REIT Status

The proposed regulations also clarify that QFPFs and entities all of the interests in which are held by QFPFs (i.e., qualified controlled entities) are treated as “foreign persons” for purposes of applying the domestic control requirement for D-REIT status. This is a departure from the general treatment of such non-U.S. investors as “domestic persons” when directly claiming exemption from FIRPTA.

Applicability Dates

While the proposed regulations generally are not binding on taxpayers or the IRS until they are finalized, the preamble to the proposed regulations cautions taxpayers that the IRS may challenge positions contrary to the proposed regulations (apparently including positions taken prior to the issuance of the proposed regulations), even before the issuance of final regulations. Nonetheless, we believe there are substantial arguments that the typical D-REIT structure targeted by the proposed regulations is supported by current law.

Further, D-REIT status generally becomes relevant at the time of a sale transaction—not when the REIT is formed—but a look-back rule ordinarily requires the REIT to have been domestically controlled for the entirety of the five-year period prior to the sale transaction. Thus, even though the proposed regulations generally are only proposed to apply to exit transactions occurring after they are finalized (subject to the IRS’s apparent authority to challenge prior transactions), domestically controlled status with respect to transactions that occur post-finalization will still need to be tested by looking at the entire look-back period, which may include pre-finalization years.

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Action Items for Sponsors and Investors

Real estate sponsors and investors should consider:

- Carefully reviewing any D-REIT structures that used U.S. C-corporations or relied on the presence of U.S. C-corporations with significant foreign owners to achieve D-REIT status in order to determine the impact of the proposed regulations.
- Reviewing their structure charts, side letters, REIT organizational documents and other fund documentation to understand the scope of their contractual undertakings to investors regarding D-REIT status of any fund entity or portfolio investment, and any associated efforts standards.
- Updating investor subscription documents to include new representations or information relating to indirect ownership that should be requested from investors.
- For new investments, opportunities to mitigate the impact of the proposed regulations taking into account investor composition and other relevant factors.

Opportunities for Taxpayer Comments on the Proposed Regulations

The Treasury Department is soliciting comments from the public through the end of February 2023, including on the definition of “look-through person” and “non-look-through person.” Note that the preamble to the proposed regulations specifically states that the Treasury Department and the IRS considered and apparently rejected an alternative rule that would have treated all U.S. C-corporations as non-look-through persons in accordance with the Ruling.

We anticipate that taxpayers will submit comments requesting the Treasury Department to reconsider this alternative rule, and also to seek further clarity on existing structures that the IRS apparently believes it has the authority to challenge under current law.

Final QFPF Regulations

Separate from the proposed regulations, on December 29, 2022, the Treasury Department and the IRS issued final regulations clarifying the scope of the QFPF exemption. The final regulations are generally consistent with prior 2019 proposed regulations, but further broaden the QFPF exemption and specify the form of certificate that QFPFs must provide in order to certify their QFPF status to counterparties.

The final regulations also clarify that a non-economic interest held by a non-QFPF that is not respected as an interest under general U.S. tax principles does not cause a “qualified controlled entity” to lose its status as such. This clarification will be particularly helpful for fund sponsors that seek to offer a non-U.S. “blocker” corporation solution to their QFPF investors without seeking to offload the governance of the blocker on the investor. Existing dedicated feeder fund entities may therefore be directly eligible for FIRPTA exemption.

Foreign pension funds that did not satisfy the QFPF requirements previously may wish to reexamine their eligibility for the QFPF exemption under the criteria of the final regulations, as well as the eligibility of any dedicated fund vehicles of external sponsors in which they are invested. In addition, QFPFs and fund sponsors should

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consider reviewing existing QFPF certifications to ensure compliance with the requirements under the final regulations.

[1] Separate proposed regulations also provide relief to certain non-U.S. sovereign investors who wish to make U.S. real property investments while preserving their exemption from U.S. tax under Section 892 of the Internal Revenue Code.

[2] A private letter ruling is a response from the IRS to a written request from a particular taxpayer and generally cannot be relied upon as binding guidance by other taxpayers.

[3] The Ruling refers to Regulations Section 1.897-1(c)(2)(i), which provides that “the actual owners of stock, as determined under Section 1.857-8, must be taken into account.” Regulations Section 1.857-8(b) provides that the “actual owner” of stock of a REIT is the person who is required to include in gross income any dividends received on the stock. The proposed regulations do not retain the reference to Regulations Section 1.857-8 in Regulations Section 1.897-1(c)(2)(i).

[4] A “non-look-through person” includes, among others, publicly traded U.S. C-corporations, publicly traded partnerships (both domestic and foreign), foreign corporations, QFPFs and individuals. A non-look-through person also includes a U.S. C-corporation if less than 25 percent of the fair market value of its outstanding stock is owned, directly or indirectly, by foreign persons.

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