Proposed regulations providing definition of domestically controlled real estate investment trust

Initial analysis and observations

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The U.S. Treasury Department and IRS on December 28, 2022, released proposed regulations (REG-100442-22) providing rules for determining whether a real estate investment trust (REIT) is a domestically controlled REIT for purposes of section 897. The proposed regulations also provide two new exceptions to the rule in the section 892 regulations that generally treats a U.S. real property holding corporation as a "controlled commercial entity" for purposes of section 892.

This report provides initial analysis and observations regarding the proposed regulations.

Treasury and the IRS on December 28, 2022, also released final regulations (T.D. 9971) under section 897(l), which generally provide qualified foreign pension funds (QFPFs) and their wholly owned subsidiaries ("qualified controlled entities" or QCEs) with a complete exemption from section 897 on gain from the disposition of a U.S. real property interest and the receipt of certain distributions described in section 897(h). The final regulations were published in the Federal Register on December 29, 2022. **Read KPMG report on the final QFPF regulations** [PDF 1.3 MB].

Proposed section 897 regulations

Background

Section 897(a) (commonly referred to as FIRPTA) treats gain or loss of a foreign person attributable to the disposition of a U.S. real property interest (USRPI) as gain or loss that is effectively connected with the conduct of a trade or business in the United States. Stock in a domestic corporation that is a U.S. real property holding corporation (USRPHC) is treated as a USRPI. Section 897(h)(2) provides an exception to the definition of a USRPI for stock in a "domestically controlled" REIT (DC REIT).[1]

A DC REIT is a REIT where less than 50% of the fair market value of the outstanding stock was "held directly or indirectly" by "foreign persons" at all times during the testing period. The testing period for this purpose is the shorter of: (1) the five-year period ending on the date of a disposition of the REIT stock or distribution by the REIT, as relevant; or (2) the period during which the REIT was in existence. Thus, if foreign persons hold less than 50% of the value of the REIT stock at all times during the testing period, a foreign person may sell its REIT stock without triggering FIRPTA tax, regardless how much stock the foreign person owns.

The statute does not define the meaning of "indirect" ownership for this purpose. The current section 897 regulations provide that for purposes of determining whether a REIT is domestically controlled, the "actual owners of stock, as determined under Treas. Reg. §1.857-8, must be taken into account." Treas. Reg. §1.857-8 provides that the actual owner of REIT stock is the person who is required to include in income on his return the dividend received with respect to the stock.

In Private Letter Ruling 200923001 (the 2009 PLR), the IRS held that two domestic corporations with foreign corporate owners were domestic holders of REIT stock for purposes of section 897(h)(4)(B) because the domestic corporations were fully taxable Subchapter C corporations for U.S. income tax purposes and were not otherwise a REIT, regulated investment company (RIC), hybrid entity, conduit, disregarded entity, or other flow-through or look-through entity. Implicit in the IRS's holding was that look-through principles did not apply to treat the foreign corporate owners of the two domestic corporations as holding indirectly the stock of the REIT.

In the 2015 PATH Act Congress amended section 897(h)(4) to add new rules for determining whether REIT stock held by another REIT is treated as held directly or indirectly by foreign persons. The statutory changes do not address REIT stock owned by domestic C corporations, but the Joint Committee on Taxation's report on the 2015 PATH Act includes a footnote citation to the 2009 PLR.

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[1] The exception also applies to domestically controlled regulated investment companies.

Proposed regulations

Look-through rules

The proposed regulations provide detailed guidance for determining whether stock of a REIT is held "directly or indirectly" by foreign persons for purposes of the DC REIT exception. The proposed regulations would require a REIT to look through all "look-through persons" to determine the REIT stock ultimately owned by "non-look-through persons" and test DC REIT status at that level. A non-look-through person is treated as owning its proportionate share of REIT stock held by or through one or more intervening "look-through persons."

A non-look-through person is: an individual; a domestic C corporations (other than a "foreign-owned domestic corporation"); a "nontaxable holder"; a foreign corporation; a publicly traded partnership (domestic or foreign); an estate (domestic or foreign); an international organization (as defined in section 7701(a)(18)); or a QFPF or QCE (as defined in the section 897(l) regulations).

Look-through persons are all persons other than non-look-through persons and include: foreign owned domestic corporations; RICs, REITs, and S corporations; non-publicly traded partnerships (domestic or foreign); and trusts (domestic or foreign).

The definition of foreign-owned domestic corporation is perhaps the most surprising and unwelcome aspect of the proposed regulations. A foreign-owned domestic corporation is a non-public domestic C corporation in which foreign persons directly or indirectly own 25% or more of the value of the corporation's stock. A nontaxable holder generally is a tax-exempt entity, the United States or a U.S. state or territory (or a political subdivision of either), or an Indian tribal government.

The proposed regulations are proposed to apply to transactions occurring on or after the date final regulations are published. The final regulations will apply, however, in determining whether a REIT was domestically controlled during any portion of a testing period preceding the issuance of the final regulations.

KPMG observation

The use of a DC REIT is a cornerstone of structuring for non-U.S. investors into U.S. real estate tax efficiently. The proper use of a DC REIT in structuring for an inbound real estate investor permits the elimination of U.S. federal capital gains tax on the real estate gain on exit to that investor. Failure to qualify as a DC REIT means, typically (unless another exception applies), full taxation of the inbound investor on exit in the form of FIRPTA. If this proposed regulation is implemented as currently proposed, it would likely mean that many existing structures (as discussed below) would not work as intended, and future capital investment into the United States by affected classes of investors will need to take into account the likelihood of additional exit taxes that were thought to be previously inapplicable.

Since the 2009 PLR, many REITs and fund sponsors have taken the position that REIT stock owned by a domestic C corporation with foreign shareholders is treated as owned by a U.S. person—and is not treated as indirectly owned by the U.S. corporation's foreign shareholders—for DC REIT testing purposes. The proposed regulations would reverse the holding of the 2009 PLR and would have a significant impact on both current and future REIT structures.

The proposed regulations in defining foreign-owned domestic corporation do not draw a distinction between foreign owners of the domestic corporation who are also direct or indirect owners of the DC REIT (or are related to any such owner) and completely unrelated foreign owners that obtain no benefit from the domestically controlled status of the REIT. The proposed regulations cast a wide net in this regard.

As noted above, it would appear that the current drafting of the proposed regulation would impact existing structures as well. While the regulations are proposed to apply to sales of REIT stock

occurring on or after the date final regulations are published, because the final regulations would apply in determining whether a REIT was domestically controlled at all times during the testing period (up to five years), the regulations effectively would retroactively impact numerous existing structures; the proposed regulations do not include any transition rules for existing structures or investors. This development would change the expected after-tax return on many foreign investments in DC REIT structures. For example, assume a REIT that was formed on January 1, 2020, has been domestically controlled at all times based on the position that domestic C corporations are treated as domestic holders for DC REIT testing purposes.

If the regulations are finalized on January 1, 2024, and a foreign shareholder sells REIT stock on January 31, 2024, the foreign shareholder will be subject to FIRPTA tax on any gain recognized, notwithstanding that the REIT was formed prior to the release of the proposed regulations. Further, the preamble to the proposed regulations also states that the IRS may challenge positions contrary to the proposed regulations prior to the issuance of final regulations.

Fund sponsors often provide special covenants that a REIT will be domestically controlled to ensure that they can rely on the DC REIT status of the structure to mitigate against a potential future exit tax. Fund sponsors should consider the impact of the proposed regulations on covenants and side letters with foreign shareholders that contemplate a tax-free sale of DC REIT stock.

While the look-through rule for foreign-owned domestic corporations is unfavorable, the proposed regulations provide helpful guidance that confirms that non-public foreign partnerships are treated as look-through persons and not foreign holders of REIT stock for DC REIT testing purposes.

Treatment of qualified holders and international organizations as foreign persons

Section 897(l)(1), as amended by the Consolidated Appropriations Act of 2018, provides that a QFPF is not treated as a nonresident alien individual or foreign corporation for purposes of section 897. Treas. Reg. §1.897-9T(e) provides that an international organization (as defined in section 7701(a)(18)) is not a foreign person with respect to USRPIs and is not subject to section 897 or 1445 (FIRPTA withholding) on the disposition of a USRPI.

The proposed regulations would treat a QFPF, a QCE, and an international organization (as defined in section 7701(a)(18)) as a foreign person for purposes of the DC REIT exception.

KPMG observation

Some taxpayers and practitioners took the position that because a QFPF is not a foreign person for purposes of section 897—which includes the DC REIT exception—a QFPF should be treated as a U.S. person for purposes of the DC REIT exception. The proposed regulations would make clear that QFPFs, QCEs, and international organizations are foreign persons for purposes of the DC REIT exception. The preamble to the proposed regulations also states that the IRS may challenge contrary positions regarding the treatment of QFPFs and QCEs for purposes of the DC REIT exception prior to the issuance of final regulations.

Proposed section 892 regulations

Background

Section 892 generally exempts a foreign government and its controlled entities from U.S. tax on income or gains attributable to investments in U.S. stocks, bonds, or other securities, including gains from the sale of

stock in a noncontrolled USRPHC. Section 892 does not apply, however, to income received from the conduct of a commercial activity or income received by or from a controlled entity that is engaged in commercial activities (a CCE).

The temporary regulations under section 892 contain a rule that deems a USRPHC—including a foreign corporation that meets the definition of a USRPHC—to be engaged in commercial activities, regardless of whether the corporation actually conducts any commercial activities. Thus, if a controlled entity of a foreign government is itself a USRPHC, the controlled entity will be a CCE and, therefore, will be ineligible for the benefits of section 892.

Proposed regulations

The proposed regulations would provide an exception to the deemed CCE rule for (1) a "qualified holder" under the section 897(l) regulations (i.e., a QFPF or qualified controlled entity), or (2) a corporation that is a USRPHC solely by reason of its direct or indirect ownership in one or more noncontrolled USRPHCs (including non-domestically controlled REITs).

The proposed rules are proposed to apply to tax years ending on or after December 28, 2022, but the preamble to the proposed regulations states that taxpayers may rely on the proposed regulations until final regulations are published.

KPMG observation

The deemed CCE rule in the temporary regulations presents a particularly harsh trap for the unwary because a foreign controlled entity that constitutes a USRPHC (or would be a USPRHC if it was a U.S. corporation) will be ineligible for the section 892 exemption on all of its U.S. source income, including income completely unrelated to USRPI investments. The rule also has led foreign government investors to forgo USRPI investments in situations where the investment would cause a controlled entity to become a USRPHC. The new exceptions in the proposed regulations provide helpful relief that will allow controlled entities whose USRPIs consist solely of interests in non-controlled USRPHCs or that are qualified holders under the FIRPTA regulations to qualify for the benefits of section 892 without having to track their USRPHC status. The changes thus will provide eligible controlled entities with greater flexibility in how they structure their USRPI investments (e.g., a foreign government may form a special purpose vehicle to hold a noncontrolling interest in a non-domestically controlled REIT).

The proposed regulations do not appear to provide relief, however, to a controlled entity that holds a limited partner interest in a partnership that holds direct USRPIs (e.g., U.S. land or buildings), unless the controlled entity is a qualified holder. This would appear true even if an entity held only a de minimis interest in direct USRPI (e.g., a foreign controlled entity that holds only interests in noncontrolled USRPHCs and a sliver of a direct interest in U.S. land would appear to still be a CCE and not eligible for this exemption). Such entities therefore must continue monitor their USRPHC status.

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