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New IRS proposed regulation would reverse longstanding IRS ruling and upend commonly used real estate fund structures

Shortly before the new year, the Internal Revenue Service ("IRS") dropped a holiday bombshell on the tax community when it issued a proposed regulation under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"). The proposed regulation would, if enacted in its current form, reverse a longstanding IRS ruling interpreting FIRPTA (the "2009 PLR") and significantly increase the tax exposure for certain existing foreign investors in fund vehicles that invest in U.S. real estate through REITs. As discussed below, the proposed regulation would appear to apply to currently existing REIT structures that are disposed of after the effective date of the rule, meaning that in certain situations, the proposed regulation will, as a practical matter, have retroactive effect. In addition, and much more ominously, the IRS explicitly reserved the right to challenge positions taken under current law to the extent inconsistent with the proposed regulation. Regardless of whether the final rule incorporates a grandfather clause exempting current REIT structures or pre-finalization REIT sale transactions from its application, however, the rule can be expected to reduce the amount of capital deployed by certain foreign investors in U.S. real estate projects that are held in REIT form and increase the level of structuring effort required by fund sponsors wishing to attract those investors to their future real estate fund vehicles.

Investors affected by the proposed regulation.

The proposed regulation is most relevant to foreign investors — often referred to as "taxable foreign investors" — who are neither qualified foreign pension funds ("QFPFs") nor sovereign wealth funds ("SWFs") owning less than 50% of a REIT. By extension, the proposed regulation would have a major impact on sponsors of private equity real estate funds that have taxable foreign investors. In addition, in certain situations discussed below, the proposed regulation can have an adverse economic (as opposed to tax) impact on QFPFs and SWFs in situations where they acquire a majority interest in a REIT in anticipation of a future syndication.

Background — the current lay of the land.

The FIRPTA regime is one of the most intricate and maddeningly complex regulatory regimes in the entire tax code. As a general rule, foreign investors are exempt from U.S. tax on capital gains they derive from their U.S. investments. FIRPTA provides an exception to that rule and converts what would otherwise be tax exempt capital gain income from the sale or exchange of U.S. real property interests ("USRPIs")

into income that is treated as effectively connected with a U.S. trade or business (“ECI”). ECI is subject to tax at the same rates applicable to U.S. taxpayers and, depending on the context, may also subject foreign corporate investors to an additional “branch profits tax.”

The FIRPTA legislation classifies as a USRPI stock and other equity interests in a U.S. real property holding corporation (“USRPHC”), which is a corporation whose assets consist primarily of U.S. real estate. Because REITs are a type of U.S. corporation, the stock of a REIT whose assets consist primarily of U.S. real estate generally would be classified as a USRPI and subjected to FIRPTA tax in the hands of a taxable foreign investor. The statute, however, provides an exception to that general USRPHC rule in the case of a REIT that is “domestically controlled” (a “domestically controlled REIT, or “DCR”).

A REIT qualifies as a DCR if more than 50% of the value of the REIT stock is held “directly or indirectly” by domestic investors at all times during a 5-year “lookback period.” Legislation enacted in 2015 (the “PATH Act”) provides rules under which certain REIT shareholders are deemed to be foreign investors for purposes of determining whether the REIT is a DCR, as well rules under which foreign investors are deemed to own a proportionate share of REIT stock held through certain upper tier investment vehicles. These rules do not contemplate that REIT stock held by a fully taxable U.S. “C-corporation” would ever be treated as foreign owned, and the overall structure of the current DCR regime supports the conclusion that any stock in a REIT held by a U.S. C-corporation is treated as domestically owned for purposes of the DCR determination regardless of whether the C-corporation itself is foreign owned. In fact, prior to the enactment of the PATH Act, the IRS National Office issued the 2009 PLR, in which it concluded that REIT stock held by a U.S. C-corporation is treated as held by a domestic investor for purposes of determining whether the REIT is a DCR. Even though the legislative history to the 2015 legislation quotes the 2009 PLR favorably as a description of then-current law, the proposed regulation takes aim at that prior IRS conclusion; and because the underlying law has not changed since 2015, the proposed regulation also takes aim, by extension, at the PATH Act itself.

How the DCR rule currently works.

Since its inception, the FIRPTA legislation has tried to achieve some type of balance between the xenophobic impulse to penalize foreign investors who invest in U.S. real estate and the rather practical view that foreign capital is critical to the development of U.S. real estate and the maintenance of U.S. real estate values.

The DCR rule, at its core, represents one outcome of that balancing process. By classifying a REIT as a DCR if domestic investors own more than 50% of the value of the REIT’s stock, the DCR rule stands for the basic proposition that, so long as more than half of the income from REIT stock is subject to the taxing jurisdiction of the United States, the United States is willing to apply the general rule that foreign investors are exempt from U.S. tax on their capital gains.

Current IRS regulations provide that the determination of whether a REIT is a DCR is made by reference to whether the dividends paid by the REIT are subject to tax in the hands of domestic U.S. taxpayers and does not take into account rules of constructive ownership or attribution of stock. This position is in keeping with the fact that courts have long held that “direct or indirect” ownership of stock is determined without regard to rules of constructive ownership or attribution of stock unless those rules are made applicable explicitly via statue, and the DCR provisions of the FIRPTA regime do not provide for the application of constructive ownership or attribution rules. Thus, many sponsors desiring to achieve DCR

status in funds that are majority foreign owned have relied on lower tier taxable C-corporations to hold a portion of each REIT investment, such that the value of REIT stock held by the C-corporation (which is a tax paying entity in its own right), when combined with the value of REIT stock held by the fund's domestic investors, would ensure domestic control of the REIT. This approach reflects the policy underlying the DCR rule — i.e., that so long as more than half of the value of REIT stock is subject to U.S. tax, the government is willing to apply the general rule exempting foreign investors from U.S. tax on their capital gains — as well as the logic underlying the 2009 PLR.

How the proposed regulation would apply if finalized.

If finalized, the proposed regulation would ignore the existence of any non-publicly traded C-corporation that is more than 25% foreign owned and would treat the shareholders of that C-corporation as owning any REIT stock held by the corporation. Put differently, the proposed regulations would treat a fully taxable U.S. C-corporation as if it were a pass through entity such as a partnership for purposes of the DCR determination, which in our experience is unprecedented.

In most funds where the sponsor is relying on a C-corporation to ensure domestic control of a REIT, the C-corporation is owned primarily by foreign investors, meaning that those foreign investors would be treated as REIT shareholders for purposes of determining whether the REIT is a DCR. Thus, widely used structures which work today to achieve DCR status under current IRS regulations, the PATH Act, and the logic underlying the 2009 PLR will cease to work if the rule is finalized, resulting in taxable foreign investors becoming subject to FIRPTA tax on exit.

Key topics to consider.

- **Practical retroactivity**. As currently written, the proposed regulation applies to "transactions" occurring after its effective date, and there is no rule that "grandfathers" C-corporation holding structures currently in existence. Accordingly, because the only "transaction" relevant in the DCR context is a sale of stock in the REIT, and because a REIT must satisfy the 50% DCR test *at all times* during the 5-year look back period, the regulation would deny DCR status to any REIT stock sale that occurs a nanosecond or more after finalization, regardless of whether the REIT was a DCR prior to finalization. In light of that situation, some sponsors might want to consider an internal restructuring prior to the finalization of the regulations so that the holding structures of relevant REIT entities can managed while they are still DCRs; this would help avoid restarting the 5-year clock when and if the proposed regulations are finalized. That said, any sponsors considering this approach should be mindful of the potential literal retroactivity issue described below.
- **Potential literal retroactivity.** In the preamble to the proposed regulation, the IRS made a statement that none of us can recall having seen before: The IRS reserved the right to challenge DCR determinations made in connection with prior sales of REIT stock to the extent those determinations are inconsistent with the proposed regulations. To be perfectly blunt, it is difficult to know what to make of this statement. If the IRS believes that the proposed regulation is a proper interpretation of current law, then at the very least it ought to have revoked the 2009 PLR prior to issuing the proposed regulations. And if the IRS believes they are changing the law, then it is difficult to see how a retroactive change is good tax policy. At the end of the day, we can say at least two things about this sentence. First, it is difficult to imagine a court ruling against a foreign investor on a DCR determination in a situation where the investor was acting in accordance with the language of the PATH Act and the accompanying legislative history, the existing regulations on DCR determinations, the case law concerning the application of constructive ownership and attribution of stock, and the

logic underlying the 2009 PLR. Second, the IRS is unlikely to want to chase foreign investors, which means that the real exposure here lies with withholding agents, which include fund sponsors who are often the withholding agents for distributions made by their funds. Given the potential investor relations issues associated with unnecessary withholding coupled with the unpalatable consequences of withholding agent liability, it may be prudent for sponsors who are also withholding agents to consider obtaining insurance against tax liability for DCR determinations made in connection with sales occurring prior to the finalization of the proposed regulation. For this reason alone, one would have thought it makes sense for the industry to mount a concerted effort to have this proposed regulation withdrawn.

- **Side letter compliance.** In order to attract foreign capital, many sponsors have agreed in side letters to structure any REIT investments as DCRs. Typically, the level of effort required by the sponsor varies from commercially reasonable efforts to reasonable best efforts. It may be prudent for sponsors in these situations to review their existing side letters and determine what, if anything, they need to do prior to finalization in order to satisfy their side letter obligations.
- **Effect on anticipated syndication structures.** As noted above, while the proposed regulation would not have an immediate averse *tax* impact on typical structures involving SWFs and QFPFs, the rule could have an adverse *economic* impact on these investors in situations where they acquire a majority interest in a REIT in anticipation of a future syndication. For example, assume that an SWF or QFPF will be the initial majority investor in a REIT and that there are plans in place to syndicate REIT stock to new investors in the future, some of whom are expected to be taxable foreign investors. In this situation, although the initial SWF or QFPF majority investor might not care whether the REIT ever achieves DCR status, the same is not true for a future taxable foreign investor — the future investor is likely to be averse to purchasing the stock of a REIT which has been majority foreign owned at any time during the 5-year lookback period. Therefore, it would not be unexpected for the initial investors to hold enough of the REIT stock inside a C-corporation to achieve DCR status from the time of formation. In this example, if the C-corporation is more than 25% foreign owned, the proposed regulation would attribute ownership of the REIT stock to the initial majority investors, meaning that the REIT would not satisfy the 5-year lookback requirement; if this discourages participation by taxable foreign investors who would otherwise purchase REIT stock in the syndication, the consequence could be a lower sale price for the REIT stock or a more difficult sale process. This lower sale price would also affect any domestic U.S. investors who invest in the REIT prior to syndication.
- **New funds.** Many sponsors are currently in the process of raising new real estate funds, and it is inevitable that some of these sponsors will need to continue thinking about how best to ensure DCR status for any REIT that sits beneath the fund. Even under the proposed regulation, it will continue to be possible to achieve DCR status in many situations. That said, the structuring process is likely to be far more intricate than the typical process currently in place and any potential impact of this structuring on U.S. investors will require a type of balancing of investor interests that does not exist under the current DCR regime. In situations where alternate structures are not feasible, sponsors will need to consider how best to address the withholding tax concerns of affected taxable foreign investors, particularly in light of the potential retroactivity issues described above.

Conclusions on a truly radical position. Tax lawyers and their clients are used to thinking about partnerships as aggregates of their partners, meaning that it’s natural for us to think of the partners as owning a share of each partnership asset. For that reason, even in the absence of explicit rules, most tax lawyers concluded that any REIT stock held by a partnership was treated as held by the partners for purposes of determining DCR status. But fully taxable C-corporations have always been thought of as

separate entities for income tax purposes and as investors, shareholders, and taxpayers in their own right. At one time, this thinking existed inside the IRS National Office, as evidenced by both the 2009 PLR and the existing regulations concerning the determination of DCR status, as well as inside Congress, as evidenced by the fact that the legislative history to the PATH Act refers favorably to the 2009 PLR as an expression of then current law. The statute and IRS regulations governing DCR status have not changed since 2015. The longstanding line of judicial decisions refusing to apply rules of constructive ownership or attribution of stock absent explicit statutory authorization (which is not present in the DCR regime) are still good law. When viewed against this backdrop, the proposed regulation's treatment of a fully taxable U.S. C-corporation as an aggregate of its shareholders for purposes of the DCR determination can only be viewed as a radical departure from both current law and past administrative practice. And the fact that the IRS has indicated that it is open to applying the proposed regulations to prior transactions that were consistent with current law is even more surprising. Given the potential for this rule to adversely affect the ability to U.S. real estate companies to attract foreign capital at a time when the interest rate environment is tightening and real estate companies need all the capital they can get, one would hope that policymakers inside the IRS would reverse course and simply withdraw this proposed regulation.

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If you have questions concerning the contents of this alert, please speak to your regular contact at Weil, or to:

Name	Bio	Email	Phone
David Levy	View Bio	david.levy@weil.com	+1 212 310 8160
Devon Bodoh	View Bio	devon.bodoh@weil.com	+1 202 682 7060
Greg Featherman	View Bio	greg.featherman@weil.com	+1 212 310 8250
Robert Frastai	View Bio	robert.frastai@weil.com	+1 212 310 8788
Hillel Jacobson	View Bio	hillel.jacobson@weil.com	+1 212 310 8230
Andrew Morris	View Bio	andrew.morris@weil.com	+1 212 310 8960
Lauren Gorsche	View Bio	lauren.gorsche@weil.com	+1 214 746 8173
Brian Senie	View Bio	brian.senie@weil.com	+1 212 310 8793
Jonathon Soler	View Bio	jonathon.soler@weil.com	+1 212 310 8278
Cassie Kimmelman	View Bio	cassie.kimmelman@weil.com	+1 212 310 8760
Stephanie Epstein Srulowitz	View Bio	stephanie.srulowitz@weil.com	+1 212 310 8310
Evan Levy	View Bio	evan.levy@weil.com	+1 212 310 8630
Pejman Razavilar	View Bio	pejman.razavilar@weil.com	+1 305 577 3282
Jannelle Seales	View Bio	jannelle.seales@weil.com	+1 212 310 8383
Avelina Burbridge	View Bio	avelina.burbridge@weil.com	+1 212 310 8053
Carolyn Stoner	View Bio	carolyn.stoner@weil.com	+1 212 310 8006

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