Advantages and Challenges of Foreign Investment in U.S. Rental Real Estate Through REITs

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Introduction

Foreign investors in U.S. real estate must weigh a number of variables when deciding which structure will accomplish their objectives. Inevitably, no one structure will achieve the perfect result. One structure may result in the lowest income tax burden, while potentially subjecting the investor to U.S. transfer taxes. Another structure may insulate the investor from U.S. transfer taxes but result in multiple levels of income tax. This article discusses foreign investment through REIT structures, which can often meet many of the usual objectives foreign investors desire.

Background

Overview of Taxation of Foreign Investors

Foreign investors generally are subject to U.S. Federal income tax:

1. On a net basis,[1] at the same rates applicable to U.S. investors, on any income that is considered to be "effectively connected" with the conduct of a trade or business in the United States ("effectively connected income"), provided that foreign

[1] *See* sections 872(a)(2) , 873, 882(b)(2), 882(c)(1) of the Internal Revenue Code of 1986, as amended (the "Code"). Unless otherwise stated, "section" and "§" references in this article are to the Code. However, pursuant to an extremely punitive rule designed to discourage noncompliance by foreign taxpayers, a nonresident alien or foreign corporation that fails to file a federal income tax return will lose the ability to claim otherwise allowable deductions with respect to effectively connected income. *See* §§ 874(a) and 882(c)(2) The applicable regulations specify certain "drop-dead" dates by which returns must be filed in order to avoid such loss of deductions, and the validity of those regulations has been the subject of some litigation. See *Swallows Holding, Ltd.,* 126 TC 96 (2006), vacated and remanded, 515 F. 3d 162 (3d Cir. 2008).

corporations are also subject to a branch profits tax (at a 30% rate, unless an exemption or reduced rate applies under a U.S. income tax treaty); and

2. On a gross basis, *i.e.*, with no allowance whatsoever for deductions, at a 30% rate (unless a lower treaty rate or treaty exemption is available) on any fixed or determinable annual or periodical income, such as dividends, interest, rents, and royalties, that has a U.S. source and does not constitute effectively connected income ("FDAP income").[2] The gross-basis tax on FDAP income generally is collected by withholding.[3]

In the absence of a special rule, dealing with rental income may be particularly challenging for foreign investors. First, the authorities regarding the level of activity needed to be considered engaged in the conduct of a trade or business in the United States ("ETBUS") are unclear at best.[4] Thus, depending on the particular facts and circumstances, it may be extremely difficult to determine whether rent is considered effectively connected income, subject to tax on a net basis, or FDAP income, subject to tax on a gross basis. Second, the taxation of rent that constitutes FDAP income is typically quite burdensome, as the foreign owner may have substantial expenses, *e.g.*, interest and depreciation, for which no deduction is permitted.

Recognizing those challenges, Congress provided foreign investors with a special "net income election" pursuant to which all of their income from real property located in the United States, including gains from disposition, is treated as effectively connected income. The effect of that election is that their rental income is taxable on a net basis, whether or not the level of rental activity is sufficient to result in ETBUS status.[5] Once made, though, the election may not be revoked without the consent of the Internal Revenue Service ("IRS").

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2 *See* §§ 872(a)(2), 871, 882(b)(1) & 881.

3 *See* §§1441, 1442.

4 For a recent case addressing this issue that raises more questions than it answers, *see Y.A. Global v. Commissioner*, 161 T.C. No. 11 (2023).

5 §§ 871(d) and 882(d).

In the "olden days," prior to the enactment of FIRPTA, as described and defined below, a foreign investor's decision of whether or not to make the net income election could potentially be very difficult. While the election was highly favorable in that it permitted rental income to be taxed on a net basis (eliminating either the certainty or the risk of burdensome taxation on a gross basis), it was potentially quite costly in that it also caused the gain (if any) on disposition to be taxable as effectively connected income; prior to FIRPTA, that gain could generally be avoided.

FIRPTA

In 1980, Congress decided that foreign investors generally should be taxable on their gains from dispositions of "United States real property interests" (or "USRPIs", for short), regardless of whether a particular foreign investor is ETBUS. Thus, Congress enacted the Foreign Investment in Real Property Tax Act of 1980, commonly known as "FIRPTA".[6]

The FIRPTA rules, principally set forth in section 897, generally provide, among other things, that nonresident aliens and foreign corporations are subject to U.S. tax on all gains recognized in connection with a sale or other disposition of USRPIs as if such gains were effectively connected with the conduct of a trade or business in the United States.[7]

Pursuant to section 897(c)(1)(A), a USRPI generally includes (i) any interest in real property (as broadly defined) located in the United States, and (ii) any interest, other than solely as a creditor, in any domestic corporation unless the taxpayer establishes that the corporation was not, at any time during a specified look-back period, a United States real property holding corporation ("USRPHC").[8] Pursuant to section 897(c)(2), a corporation

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6 Pub. L. 96-499, 96th Cong. § 1122 (1980).

7 *See* §897(a).

8 For practical purposes, the look-back period now is the shorter of the Taxpayer's holding period or the 5-year period ending on the date of disposition of the interest in the corporation. § 897(c)(1)(A)(ii).

(whether domestic or foreign) is a USRPHC if the fair market value of its USRPIs equals at least 50% of the total value of its USRPIs, its interests in real property located outside the United States, and any other of its assets that are used, or held for use, in a trade or business.[9]

Pursuant to a "cleansing exception" set forth in section 897(c)(1)(B), an interest in a domestic corporation is not a USRPI if (i) as of the date of the disposition of such interest, the corporation did not own any USRPIs, and (ii) all of the USRPIs held by the corporation during such period (a) were disposed of in transactions in which the full amount of gain (if any) was recognized, or (b) themselves ceased to be USRPIs by reason of prior application of the cleansing exception.

Notwithstanding the generally broad application of section 897, a number of special rules ameliorate the consequences of the FIRPTA rules in certain circumstances. In particular, a number of these favorable rules make it particularly beneficial for foreign investors to invest in U.S. rental real estate through real estate investment trusts ("REITs").[10]

Special Rules for REITs

Super-Brief Introduction to REITs

REITs are nominally classified as corporations for U.S. tax purposes,[11] but they receive a deduction for distributions to their shareholders, so in practice REITs distribute all of their taxable income and very rarely pay any corporate income tax.[12] In order to qualify as a

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9 For purposes of applying this test, special rules for interests held through other entities are set forth in sections 897(c)(4) & (5). Also, "newbies" are cautioned that not all assets of the domestic corporation are necessarily included in the denominator of this fraction.

10 This article assumes that the real estate being acquired is rental real estate being held for investment.

11 *See* Treas. Reg. § 301.7701-3(c)(1)(v)(B).

12 §857(b)(2)(B). Moreover, a REIT must distribute at least 90% of its "real estate trust taxable income" (determined without regard to its dividends paid deduction) to qualify as a REIT. §857(a)(1)(A)(i). A discussion of the requirements for REIT status is beyond the scope of this paper.

REIT, among other requirements, an entity must have at least 100 shareholders and it must not be closely held.[13] The 100-shareholder test is easily satisfied, as preferred stock counts toward the 100 shareholders there are multiple service providers who place investors with REIT preferred equity.

Navigating the requirement that a REIT cannot be closely held can be more challenging, especially for individual investors and large family offices. The REIT qualification rules include a "five or fewer" prohibition pursuant to which more than 50% of the value of the REIT cannot generally be held (directly or indirectly, taking into account certain constructive ownership rules)[14] by five or fewer individuals at any point during the last half of the taxable year.[15] As such, REITs are more suited to investment funds or investment groups where no one family group will own a majority of the REIT equity.

Distributions by REITs to foreign shareholders generally are treated as (1) taxable "FIRPTA gain" to the extent attributable to gains recognized by the REIT from dispositions of USRPIs (the "FIRPTA pass-through rule"),[16] and otherwise as (2) ordinary dividends (to the extent of the REIT's current and accumulated earnings and profits).

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13 §§ 856(a)(5)-(6).

14 § 856(h)(1)(A) (referring to § 542(a)(2)). Constructive ownership and attribution rules apply, including a rule attributing ownership by one family member to other family members. *See* § 544(a) (but note that partnership attribution is excluded from § 856 attribution).

15 §856(a)(6) & (h).

16 §897(h)(1).

Exception for Domestically Controlled REIT Stock

Several exceptions apply to treat stock of a domestic corporation that is (or, during the look-back period, was) a USRPHC as a non-USRPI in certain circumstances. Of particular interest here is the exception set forth in section 897(h)(2), which provides that an interest in a "domestically controlled qualified investment entity" is not a USRPI.

Pursuant to section 897(h)(4)(A), a qualified investment entity ("QIE") is any REIT (or regulated investment company ("RIC")) that is (or, absent the application of certain special rules, would be) a USRPHC. Section 897(h)(4)(B) provides that a REIT (or RIC) is domestically controlled if, at all times during a specified testing period,[17] less than 50 percent in value of its stock was held, directly or indirectly, by foreign persons.[18] For ease of discussion, RICs generally will be disregarded and a REIT that meets the domestic control requirements of section 897(h)(4)(B) is referred to herein as a "domestically controlled REIT" or "DC REIT".

Since an interest in a DC REIT is deemed not to be a USRPI, foreign investors may sell DC REIT stock without being subject to U.S. tax under FIRPTA.[19] The possibility of such a tax-free exit is extremely attractive to foreign investors. Nevertheless, care should be taken to keep in mind several practical difficulties.

For various reasons, the owner(s) of the DC REIT may have difficulty convincing a buyer to accept REIT stock as opposed to the underlying property. For example, certain buyers cannot acquire the DC REIT without disqualifying it under the five or fewer prohibition.

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[17] The testing period is the shortest of (i) the period beginning on June 19, 1980, and ending on the date of the applicable disposition or distribution, (ii) the 5-year period ending on the date of the applicable disposition or distribution, and (iii) the period during which the QIE was in existence. §897(h)(4).

[18] A key issue in applying Section 897(h)(4)(E) is how far up the ownership chain one must look for a foreign person that holds stock of the REIT (or RIC). Proposed regulations providing guidance on this issue were issued in December 2022.

[19] It is conceivable that such gain may be taxable to a foreign investor as effectively connected income, but only in very limited circumstances.

Accordingly, many potential purchasers that are closely held by a small group of individuals would cause the five or fewer prohibition to be violated upon acquisition of the REIT (or, at the latest, within six months thereafter).

A sophisticated purchaser that is not itself a REIT may nevertheless be willing to acquire the stock of a REIT if it can safely liquidate the REIT shortly thereafter to take direct ownership of the underlying property. However, some foreign purchasers will be unwilling to do so, due to a phantom income issue. For example, suppose that that (1) a DC REIT has zero basis in a property that is worth $100 Million (the "Property"); (2) a foreign partnership (that is not closely held) acquires 100% of the stock of a DC REIT for $100 Million; and (3) immediately thereafter, the REIT distributes the Property to the foreign partnership in liquidation.[20]

Under generally applicable tax principles, the foreign partnership would not recognize any income in connection with the liquidation of the REIT, because its amount realized on the exchange, $100 Million, would be equal to its basis in the REIT shares. But keep in mind that, pursuant to the FIRPTA pass-through rule, the distributions by the REIT to the foreign partnership are treated as taxable "FIRPTA gain" to the extent attributable to gains recognized by the REIT from dispositions of USRPIs. In this case, the amount of gain recognized by the REIT upon its distribution of the Property pursuant to the liquidation is $100 Million, so the foreign partnership arguably recognizes $100 Million of FIRPTA gain in connection with the liquidation. There should be an offsetting loss with respect to the REIT stock, but depending on the

[20] A REIT must have at least 100 shareholders, pursuant to §856(a)(5), but for the sake of simplicity the shares held by the other REIT shareholders, which will have relatively nominal value, are disregarded.

circumstances, that loss may or may not be a FIRPTA loss,[21] and even a FIRPTA loss will not necessarily be an adequate offset.[22]

Potential Limitation on DC REIT Qualification

In December 2022, the IRS proposed regulations that would significantly limit the ability of REITs to qualify as DC REITs.[23] Under these regulations, many non-publicly traded domestic entities are "looked through" to determine if they have foreign owners. This look-through rule even applies to domestic C corporations 25% of the value of whose stock is owned, directly or indirectly, by one or more foreign persons.[24] In the past, one strategy to achieve DC REIT status was to establish one or more US corporations that collectively would own just over 50% of the REIT equity value. While this resulted in the imposition of US tax on the sale of the portion of REIT equity owned by the US corporations, it allowed the rest of the REIT equity to be sold without US tax. The proposed look-through rules would do away with this strategy.

FIRPTA Exemption for Qualified Foreign Pension Funds

Pursuant to a special exemption set forth in section 897(l)(1), a qualified foreign pension fund ("QFPF") is simply exempt from FIRPTA. Thus, a QFPF that recognizes gain

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21 For example, depending upon how much of the foreign partnership is directly or indirectly owned by foreign persons, the REIT may be a domestically controlled REIT in the hands of the foreign partnership. In that event, its loss with respect to the REIT shares would not be a FIRPTA loss.

22 In the case of a foreign corporation that is a partner in the foreign partnership, the FIRPTA gain that passes through pursuant to the FIRPTA pass-through rule should increase the foreign corporation's "effectively connected earnings and profits" and thus may result in a branch profits tax pursuant to section 884. Any FIRPTA loss recognized with respect to the stock of the REIT would not have any impact on the amount of effectively connected earnings and profits. *Compare* Treas. Reg. §1.884-1(f)(1) & (2)(iii).

23 Prop. Reg. § 1.897-1(c)(3) (Dec. 29, 2022).

24 Prop. Reg. § 1.897-1(c)(1)(v)(B).

from the disposition of a USRPI will not be taxed under section 897 on the gain from such disposition. However, this does not necessarily mean that the QFPF will be able to escape U.S. tax on the gain.

While section 897(l) effectively repeals FIRPTA for QFPFs, nothing in this provision, or elsewhere in the Code, prevents a QFPF from being ETBUS or earning effectively connected income. Thus, for example, if a QFPF were to engage in the business of developing and selling condominium units in the United States, the gains from such sales would be effectively connected and would be subject to U.S. tax, notwithstanding section 897(l).

Alternatively, suppose that a QFPF does not engage in any business at all. Rather, the QFPF acquires a single U.S. property that it rents out passively, pursuant to a single triple net lease. In such case, the QFPF has the same difficult choice that other foreign investors had prior to the enactment of FIRPTA in 1980. If the QFPF wishes to avoid paying a 30% gross-basis tax on its rent income (FDAP), it can make the net income election. But, if it does that, its eventual gain on sale of the property will be taxable as effectively connected income by reason of the net income election. Thus, in many cases, the QFPF has no choice but to make the net income election, and the FIRPTA exemption provided by section 897(l) is useless.

But, enter the REIT! Suppose that instead of acquiring a property directly, a QFPF acquires an indirect interest through a REIT. The REIT rents out the property for many years, distributes an amount equal to its taxable income each year as an ordinary dividend, eventually sells the property, and distributes the sales proceeds in liquidation. In such case, the QFPF will be taxable on its share of the ordinary dividend each year, but this taxable amount will reflect the QFPF's share of the REIT's *net* income, so the QFPF will effectively have the benefit of a net

income election, without needing to make one.[25] When the REIT ultimately sells the property and distributes the proceeds to its shareholders, the QFPF will recognize its share of the FIRPTA gain, but will not be taxable because, as noted above, QFPFs are exempt from FIRPTA.

Note that this tax-free exit for the QFPF is achieved without any need to worry about whether the REIT is domestically controlled (a potentially very difficult determination) and without any need to convince the buyer to accept REIT shares. Accordingly, while REITs typically are desirable investment vehicles for foreign investors, the benefits for QFPFs are particularly substantial.

Other REIT Goodies

Publicly Traded Stock Exception

Another exception to the FIRPTA rules applies to certain publicly traded stock. Section 897(c)(3) provides that, if any class of stock of a corporation is regularly traded on an established securities market, stock of such class shall be treated as a USRPI "only in the case of a person who, at some time during [a certain look-back period] held more than 5 percent of such class of stock."[26] Thus, a foreign investor who owns a less-than-5% interest in certain publicly traded stock can sell tax-free.

But what, you ask, does this have to do with REITs? By its terms, section 897(c)(3) applies to stock of any corporation, not just REIT stock. But, you forget, REITs are special. Pursuant to section 897(k)(1)(A), the 5% ownership threshold is increased to 10% if the publicly traded corporation is a REIT. Inasmuch as REITs pay no corporate tax, the rationale for

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[25] Note also that, even if the REIT is considered ETBUS, such status will not pass through to the QFPF because REITs are classified as corporations (notwithstanding the FIRPTA pass-through rule).

[26] *See also* Treas. Reg. §1.897-1(c)(2)(iii), which expands upon (and, moreover, expands) the publicly traded stock exception set forth in section 897(c)(3).

allowing a higher ownership threshold for REIT stock than for C corporation stock is elusive, to say the least.

Special Exemption for Qualified Shareholders

Pursuant to section 897(k)(2)(A), REIT stock held by a "qualified shareholder" (either directly or through one or more partnerships) generally is treated as a non-USRPI. Pursuant to section 897(k)(2)(B), however, this exemption does not apply to the "applicable percentage" of the REIT stock held by the qualified shareholder. The applicable percentage of such REIT stock generally is the portion allocable to "applicable investors" in the qualified shareholder. Pursuant to section 897(k)(D), an applicable investor with respect to a qualified shareholder is a person that (1) holds an interest (other than solely as a creditor) in the qualified shareholder, and (2) taking into account stock of the REIT constructively owned through the qualified shareholder (and also any other REIT such person may be considered to own), holds more than 10% of the stock of the REIT.

A detailed discussion of the qualified shareholder exception is beyond the scope of this discussion.

Conclusion

While REITs are not suitable for every investor, in many cases they can limit tax compliance and reporting obligations for foreign investors. However, the proposed regulations regarding DC REITs could limit the benefit of relatively closely held REITs for foreign investors in certain circumstances.