Institute for Portfolio Alternatives

February 27, 2023

Via electronic submission

CC:PA:LPD:PR (REG-100442-22), Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Guidance on the Foreign Government Income Exemption and the Definition of Domestically Controlled Qualified Investment Entities (REG-100442-22)

Dear Sir or Madam:

On behalf of the Institute for Portfolio Alternatives (the "**Institute**"), we are writing in response to the proposed regulations under Sections 892 and 897 issued on December 29, 2022 (the "**Proposed Regulations**").[1]

For over 35 years, the Institute has advocated for increased investor access to alternative investment strategies with low correlation to equity markets, as part of a diversified portfolio. Such strategies include real estate, public and private credit and other real assets through investment vehicles such as non-traded publicly registered real estate investment trusts ("**REIT**"), non-traded publicly registered regulated investment companies ("**RIC**"), business development companies, closed-end funds, interval funds and private placements, among others. With nearly $300 billion in capital investments, these portfolio diversifying investments are a critical component of an effectively balanced investment portfolio and serve an essential capital formation function for our national, state and local economies. The mission of the Institute is to advocate for portfolio diversifying investments through education and public awareness.

The Institute strongly recommends that the Proposed Regulations' "look-through rule" (the "**Look-Through Rule**"), as contained in Proposed Treasury Regulations Section 1.897-1(c)(3)(ii)-(iii) in determining a "domestically controlled qualified investment entity" ("**DCQIE**"), be withdrawn. The Institute believes that the Look-Through Rule is inconsistent with the statute, legislative history, and existing IRS authority. Further, the Institute believes that the Look-Through Rule will have an adverse impact on existing and future foreign investments in U.S. real estate while also discrediting the United States as an investment jurisdiction with coherent and stable tax policy.

I. Current Law

Section 897(a)(1) provides that gain or loss of a nonresident alien individual or foreign corporation from the disposition of a United States real property interest ("**USRPI**") is treated as if the nonresident alien individual or foreign corporation were engaged in a trade or business within the United States. Section 897(h)(1) generally provides that any distribution by a qualified investment

[1] 87 Fed. Reg. 80097 (Dec. 29, 2022).

entity ("**QIE**") to a nonresident alien individual, a foreign corporation, or other QIE, to the extent attributable to gain from sales or exchanges by the QIE of USRPIs, is treated as gain recognized by such nonresident alien individual, foreign corporation, or other QIE from the sale or exchange of a USRPI. For this purpose, Section 897(h)(4)(A) defines a QIE as any (i) REIT, and (ii) RIC which is a United States real property holding corporation ("**USRPHC**") or which would be a USRPHC if certain exceptions did not apply to interests in any REIT or RIC.

Section 897(h)(2) provides that a USRPI does not include an interest in a domestically controlled QIE (the "**DCQIE Exception**"). A QIE is "domestically controlled" ("**DCQIE**") if less than 50% of the value of its stock is held "directly or indirectly" by foreign persons at all times during the testing period prescribed in Section 897(h)(4) (generally, the five-year period ending on the date of the disposition). Thus, in PLR 200923001 (the "**2009 PLR**"), the Internal Revenue Service ruled that QIE stock held by U.S. C corporations would be treated as "domestically owned" for purposes of the DCQIE determination, even if the U.S. C corporations were owned primarily by foreign investors.[2]

The legislative history accompanying the enactment of Section 897 indicates that Congress intended for the DCQIE Exception to apply to entities controlled by United States persons.[3] Further, Congress expressly intended the DCQIE Exception to encourage investment in U.S. real estate, with the Protecting Americans from Tax Hikes Act ("**PATH Act**") Finance Committee Report stating that "[i]t is essential to increase foreign investment in U.S. real estate."[4]

II. Proposed Regulations: the Look-Through Rule

The Proposed Regulations interpret the term "directly or indirectly" in Section 897(h)(4)(B) by using a "look through" approach in determining QIE ownership. The term "look-through persons" means any person other than a "non-look-through person."[5] The term "non-look-through person" means, among others, an individual, a domestic U.S. C corporation (other than a foreign-owned domestic corporation), a nontaxable holder, a publicly traded partnership (domestic or foreign), or an estate (domestic or foreign).[6] The upward attribution process required by Proposed Treasury Regulations Section 1.897-1(c)(3)(ii)-(iii) continues until all QIE stock is treated as owned by one or more non-look-through persons. If a domestic C corporation is non-public and foreign persons hold directly or indirectly 25% or more of the corporation's stock (by value), then such corporation is a "foreign-owned domestic corporation" and is therefore a look-through-person.[7]

In sum, for purposes of determining whether a QIE qualifies as a DCQIE, the Look-Through Rule provides that partnerships, trusts, and non-public U.S. C corporations with foreign ownership of 25% or greater are all treated as look-through persons, such that any QIE stock owned by such an

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[2] PLR 200923001 (holding that "[a]s fully taxable domestic Subchapter C corporations … [such U.S. C corporations] will be considered domestic holders of their respective [QIE] stock for purposes of determining whether [QIE] is a domestically controlled QIE within the meaning of section 897(h)(4)(B)").

[3] *See* H.R. Conf. Rep. No. 96-1479, at 188 (1980) ("In the case of REITs which are controlled by U.S. persons, sales of the REIT shares by foreign shareholders would not be subject to tax (other than in the case of distribution by the REIT)").

[4] PATH Act Finance Committee Report at 2.

[5] Proposed Treasury Regulations Section 1.897-1(c)(3)(v)(C).

[6] Proposed Treasury Regulations Section 1.897-1(c)(3)(v)(D).

[7] Proposed Treasury Regulations Section 1.897-1(c)(3)(v)(B).

entity, whether directly or by attribution from a lower-tier entity, is attributed upstream through successive look-through entities until all QIE stock is treated as held exclusively by non-look through persons. The preamble to the Proposed Regulations suggests the Look-Through Rule is aimed at the use of intermediary domestic U.S. C corporations by foreign investors to create DCQIEs.

The most troubling aspect of the Proposed Regulations is the treatment of domestic U.S. C corporations. Although domestic U.S. C corporations are generally treated as non-look-through persons, Proposed Treasury Regulations Section 1.897-1(c)(3)(iii)(B) provides that a limited look-through approach should apply to non-public domestic U.S. C corporations in which foreign persons hold a 25% or more interest.[8] In effect, the Look-Through Rule mandates that a foreign-owned domestic U.S. C corporation must be looked through to determine whether a QIE is domestically controlled.

III. The Look-Through Rule Should be Withdrawn

The Institute strongly believes that the Look-Through Rule must be withdrawn.

First, the Look-Through Rule is inconsistent with the statute. Neither Section 897(h)(4)(B), nor any other section of the Code, defines the term "directly or indirectly," nor does any portion of Section 897 provide for the application of constructive ownership rules to the determination of DCQIE status. If Congress intended for the term "directly or indirectly" in Section 897(h)(4)(B) to already incorporate a look-through concept in the case of QIE stock held by a domestic U.S. C corporation, the special ownership rules in Section 897(h)(4)(E) would not be needed, as the upstream attribution would already have resulted from such a look-through concept. Further, the Look-Through Rule effectively equates "direct or indirect" ownership with "constructive" ownership. These two concepts are not the same and courts have consistently held that constructive ownership can be imputed only when specifically authorized by the Code.[9] There is no such authorization in Section 897.[10]

Second, the Look-Through Rule is inconsistent with the legislative history. In enacting the PATH Act, Congress considered the 2009 PLR to be an appropriate description of the status quo with respect to DCQIE determinations.[11] Put differently, the legislative history to the PATH Act indicates that Congress presumed, consistent with the 2009 PLR, that U.S. C corporations were not subject to look-through treatment.

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[8] Proposed Treasury Regulations Section 1.897-1(c)(3)(iii)(B).

[9] *See, e.g., Yamamoto* v. *Commissioner,* T.C. Memo. 1986-316, 51 T.C.M. (CCH) 1560, 1565 (1986) ("[The constructive ownership rubric of] Section 318 attributes a proportionate share of the stock held by a corporation to its shareholders who hold 50 percent or more of its stock. Section 318 applies, however, only '[f]or purposes of those provisions of [subchapter C] to which the rules contained in this section are expressly made applicable.' . . . Neither section 368(c) nor section 351 state that the attribution rules of section 318 apply.") (emphasis added and citations omitted).

[10] For these reasons, we expect that the Look-Through Rule will be challenged under the two-prong test provided by *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 863-64 (1984). First, as noted above, neither Section 897(h)(4)(B), nor any other section of the Code, defines the term "directly or indirectly," nor does any portion of Section 897 provide for the application of constructive ownership rules to the determination of DCQIE status. Thus, Congress has not spoken to the question at issue. Second, the IRS's interpretation of the statute via the Look-Through Rule is not reasonable given the legislative history discussed herein.

[11] *See* Joint Committee on Taxation Report, JCX-144-15, 184.

Third, the Look-Through Rule will have an adverse impact on existing and future foreign investments in U.S. real estate. Because of the five-year look-back period for determining DCQIE status, the Proposed Regulations affect existing U.S. real estate investment structures. Many investment sponsors have relied on the existing DCQIE rules (including the 2009 PLR) and contractually committed to such structures with their foreign investors. Because these investment sponsors will want to mitigate their contractual exposure to these foreign investors, the Look-Through Rule may cause a "fire sale" of various U.S. real estate investments. This will drive down U.S. real estate value in an already struggling U.S. real estate market.

On a prospective basis, the Look-Through Rule will discourage U.S. real estate investments by foreign investors, which was the principal purpose of the DCQIE Exception. Instead, foreign investors will prefer to invest in U.S. non-real estate investments with preferred tax treatment. Further, sponsors of U.S. real estate investment structures will be handcuffed from a structuring standpoint as they would need to restrict the number of foreign investors and/or conduct detailed diligence to determine the ownership of any domestic U.S. C corporation investor. Such a drastic shift to U.S. federal income tax laws without sufficient preview or notice to the public discredits the United States as an investment jurisdiction with coherent and stable tax laws.

IV. Two Must-Haves If the Look-Through Rule is to be Finalized

Despite the Institute's adamant position that the Look-Through Rule should be withdrawn, if the Look-Through Rule (or a variation of it) is to be finalized, we recommend, at a minimum, the Treasury incorporate two points discussed below. For the avoidance of doubt, the Institute adamantly believes that the Look-Through Rule should be withdrawn and is not conceding this position. The two suggestions made below are, in our opinion, the bare minimum revisions necessary to lessen the Look-Through Rule's catastrophic impact to the U.S. real estate market.

1. Exception for Registered Investment Vehicles

The Treasury must include registered investment vehicles (investment vehicles offered to retail investors such as non-traded publicly registered REITs, non-traded publicly registered RICs, or publicly registered open-ended funds) as a "non-look-through person." As drafted, the Proposed Regulations provide an exception to the Look-Through Rule for publicly traded domestic C corporations. But we believe this definition is too narrow given the plethora of publicly registered investment vehicles that own QIEs but are not regularly traded (e.g., a publicly registered open-end fund owning REITs or a non-traded publicly registered RIC owning REITs). Similar to the reasoning of including publicly traded partnerships as a non-look-through person,[12] we believe registered investment vehicles offered to retail investors are particularly difficult to look-through and they are unlikely to be affirmatively used as intermediary entities to create a DCQIE.

2. Grandfathering Existing Investments

The Treasury must grandfather existing investments so that there is no impact to already-existing U.S. real estate investment structures. As noted above, many investment sponsors have contractually committed with their foreign investors based on existing law, so the drastic change

[12] 87 Fed. Reg. 80097, 80101 (Dec. 29, 2022) ("a non-lookthrough person includes publicly traded partnerships (domestic or foreign) because it may be difficult to lookthrough such entities and it is unlikely that these entities could be affirmatively used as intermediary entities to create a domestically controlled QIE").

of the Look-Through Rule without grandfathering may cause a "fire sale" and drive down value in an already struggling U.S. real estate market.

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Thank you in advance for your consideration of these issues. If you have any questions or would like to discuss further these comments, please contact me at (202) 548-7190. We appreciate your thoughtful attention to our concerns.

Sincerely,

Anya Coverman
President & CEO
Institute for Portfolio Alternatives