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John C. Dworkin of John C. Dworkin P.C. looks at how the proposed regulations under Section 385 would affect common ownership structures for foreign investment in U.S. real property that have no relation to ''inversion'' transactions. Dworkin explains how the rules would affect foreign operating companies, sovereign wealth funds and foreign family offices.

# How the Proposed Section 385 Rules Would Affect Foreign Investment in U.S. Real Property

By John C. Dworkin

The proposed regulations (REG-108060-15) issued by the Treasury Department under tax code Section 385 affect many common ownership structures relating to foreign investment in U.S. real property that have no relation to ''inversion'' transactions.

For example, in a typical foreign ownership structure, a domestic corporation (the ''USCO'') would hold the U.S. real property and a foreign corporation (''Foreign Holdco'') formed in a tax-favorable jurisdiction would hold the non-voting stock of the USCO. The investment fund sponsor or a third-party manager would hold the voting stock of the USCO in exchange for a relatively small co-investment commitment in the property. Foreign Holdco is owned by an entity (''Foreign Opco''), the ultimate investor, that is organized in a jurisdiction without a comprehensive income tax treaty with the U.S.

The proposed regulations apply to this typical structure.

Foreign Holdco would typically capitalize the USCO with a combination of equity and shareholder loans. The shareholder loans would be subordinated to the underlying bank loan on the U.S. real property. Interest on the shareholder loans would be treated as ''portfolio interest'' under Section 881(c)(2) as Foreign Holdco wouldn't directly, indirectly or constructively own the voting stock of the USCO.

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In this typical structure with a single Foreign Opco, interest on the shareholder loans would be subject to the ''earnings-stripping'' limitations of Section 163(j) as:

- Foreign Holdco would be treated as a related person in respect of the USCO under Section 163(j)(4); and
- the 1.5-1 safe harbor ratio of debt to equity of the USCO would most likely be exceeded under Section 163(j)(2)(A)(ii), as both the underlying bank loan and the subordinated shareholder loan are aggregated in making this debt to equity calculation.

Specifically, under Prop. Reg. Section 1.385-1(b)(3), the members of an ''expanded group'' potentially subject to the proposed regulations include the members of an affiliated group as defined in Section 1504(a) with the following changes:

- without regard to paragraphs (1) through (8) of Section 1504(b), which thus now includes foreign corporations;
- by substituting ''directly or indirectly'' for ''directly'' in Section 1504(a)(1)(B)(i); and
- by replacing the vote ''and'' value test of Section 1504(a)(2)(A) with a vote ''or'' value test.

Therefore, USCO, Foreign Holdco and Foreign Opco would all be included as members of the expanded group.

Under Prop. Reg. Section 1.385-2(a)(2)(i), while not entirely clear, the proposed regulations apply to an expanded group not otherwise traded on an established financial market within the meaning of Treasury Regulations Section 1.1092(d)-1(b) if, alternatively, the expanded group has total assets of $100 million or total annual revenue exceeding $50 million on any ''applicable financial statement.''

Under Prop. Reg. Section 1.385-2(a)(4)(iv), the definition of applicable financial statements pulls in typical institutional entity-type reporting by Foreign Opco. For example, audited financial statements used for credit purposes, reporting to shareholders or any other substantial non-tax purpose would be included in the definition of applicable financial statements.

## Foreign Operating Companies

Foreign operating companies would be subject to the proposed regulations provided the $100 million in assets or $50 million annual revenue threshold is satisfied for the operating company.

Note, for operating companies publicly traded on a foreign exchange and tax resident in a jurisdiction without a comprehensive income tax treaty with the U.S., such foreign exchange would likely not be treated as an established financial market within the meaning of Treas. Reg. Section 1.1092(d)-1(b) (including the exchanges located in the U.K., France, Ireland, Germany and Japan) and thus the assets/revenue threshold would still need to be met.

## Sovereign Wealth Funds

Sovereign wealth funds would be subject to the proposed regulations. Sovereign wealth funds are treated as foreign corporations under Section 892(a)(3) and most if not all sovereign wealth funds would exceed the $100 million in assets or $50 million annual revenue threshold on an applicable financial statement.

By way of background, Internal Revenue Service Notice 2007-55 limited the benefits of private real estate investment trust structures for sovereign wealth funds. The IRS's position asserted in this notice is that capital gain distributions by private REITs to sovereign wealth funds aren't exempt under Section 892. As a result of this notice, many sovereign wealth funds own U.S. real property through the portfolio interest shareholder loan structures described above.

Note also in the case of an investment fund with a ''feeder fund'' for sovereign wealth funds, in the event any particular sovereign wealth fund owns at least 50 percent of the feeder fund the proposed regulations are applicable.*

## Foreign Family Offices

Many foreign family offices would be subject to the proposed regulations provided the $100 million in assets or $50 million annual revenue threshold is satisfied for the family office entity. For family offices in many non-U.S. jurisdictions, investment assets are held through corporate entities not organized as limited partnerships and hence are treated as foreign corporations by default under Treas. Reg. Section 301.7701-3(b)(2), and thus also ''foreign parent corporations'' under the expanded group definition.

It may be possible for the foreign family entity to make an election on IRS Form 8832, Entity Classification Election, to be treated as a foreign eligible entity electing to be classified as a partnership. In that case, presumably the family entity wouldn't be included in the expanded group and therefore the assets and revenue of the family entity wouldn't be included in determining if the $100 million in assets or $50 million annual revenue threshold is met and the family entity's reporting to its shareholders would also not be included as an applicable financial statement.

**Many foreign family offices would be subject to the proposed regulations provided the $100 million in assets or $50 million annual revenue threshold is satisfied for the family office entity.**

However, the fiscally transparent nature of the family entity may expose its partners to U.S. tax and/or reporting obligations on U.S. source income or U.S. situs assets, so the partnership election may not be feasible in many cases.

Under the proposed regulations, shareholder loans funded by foreign investors in U.S. real property holding structures as described above would need to satisfy the documentation and information requirements applicable to ''expanded group instruments'' (EGIs) under Prop. Reg. Section 1.385-2(b).

Furthermore, those shareholder loans are most often subordinated to the underlying bank loan on the U.S. real property and are often unsecured with permitted interest accrual provisions based upon the real estate borrower's available net cash flow. Certain provisions of the proposed regulations could be interpreted to prohibit such terms.

For instance, Prop. Reg. Section 1.385-2(b)(2)(i) provides that there must be an unconditional obligation to pay a sum certain. While further guidance from Treasury on this point is needed, if this provision were interpreted to prohibit interest accruals based upon available net cash flow, this would materially impact the feasibility of this U.S. real property holding structure.

Notably, under Prop. Reg. Section 1.385-1(d), the IRS may also treat an EGI as in part indebtedness and in part stock, which represents a departure from current law generally prohibiting such a debt and equity bifurcation of one instrument.

The proposed regulations, if implemented, apply to debt instruments issued or deemed issued on or after the date the proposed regulations are published as final regulations.

* See Prop. Reg. Section 1.385-1(b)(5), which substitutes ''50'' for ''80'' in Section 1504(a)(2)(A) and (B) in determining the ''modified expanded group.''

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