Proposed Debt-Equity Regs Cast Too Wide a Net, Firm Says

June 21, 2016

Department of the Treasury
Internal Revenue Service

Re: REG-108060-15 Treatment of Certain Interests in Corporations as Stock or Indebtedness

Dear Sir or Madam,

This letter, which is submitted on behalf of John C. Dworkin P.C., considers the proposed regulations (REG-108060-15) (the "Proposed Regulations") issued under Section 385 of the IRC. This letter recommends changes to the Proposed Regulations.

The Proposed Regulations (principally, the -2 proposed regulations) issued under § 385 affect many common ownership structures relating to foreign investment in U.S. real property which have no relation to corporate inversion transactions. For example, in a typical U.S. real property ownership structure, a domestic corporation (the "USCO") would hold the U.S. real property and a foreign corporation ("Foreign Holdco") would hold the non-voting stock of the USCO. The investment fund sponsor or a third-party property manager would hold the voting stock of the USCO in exchange for their co-investment commitment in the underlying real property. Foreign Holdco is owned by an entity ("Foreign Opco"), the ultimate investor, which is organized in a jurisdiction without a comprehensive income tax treaty with the United States. 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 § 881(c)(2) as Foreign Holdco would not directly, indirectly or constructively own the voting stock of the USCO. The Proposed Regulations apply to this typical structure.

In this typical structure, interest on the shareholder loans would likely already be subject to the "earnings-stripping" limitations of § 163(j) as (i) Foreign Holdco would be treated as related person in respect of the USCO under § 163(j)(4) and (ii) the 1.5 to 1 safe harbor ratio of debt to equity of the USCO would most likely be exceeded under § 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.

Suggestions:

1. A new subparagraph in Prop. Reg. § 1.385-2(a)(2) should be added as follows:

> Notwithstanding the foregoing, this section does not apply to an EGI issued by a domestic corporation treated as a U.S. real property holding corporation under § 897.
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> Comment: The rationale here is that the EGI was not issued in connection with a corporate inversion transaction as thus should be excluded by the Proposed Regulations. The corporate inversion structure presents no advantages to U.S. real estate companies and thus is inapplicable in this real estate context.

2. A new subparagraph in Prop. Reg. § 1.385-2(a)(2) should be added as follows:

> Notwithstanding the foregoing, this section does not apply to an EGI issued by a domestic corporation treated as a U.S. real property holding corporation under § 897 during which the EGI gives rise to "disqualified interest" within the meaning of § 163(j)(1)(A).
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> Comment: The rationale here is that the EGI is already subject to "earnings stripping" limitations, and therefore the EGI was most likely included in the capital structure principally for reasons other than base erosion and profit shifting. In the typical case of an EGI issued by a domestic USPRHC and subject to § 163(j)(1)(A), the principal purpose for issuing the EGI is to avoid a second-level withholding tax on dividends issued by the USRPHC as the interest on the EGI would ordinarily be structured as "portfolio interest" within the meaning of § 881(c)(2). Therefore, as the intent of the Proposed Regulations is to limit base erosion and profit shifting, EGIs issued in this context should not be subject to the Proposed Regulations.

3. Reporting to foreign limited partners by a U.S. real estate investment fund should be excluded from the "Applicable Financial Statement" definition in Prop. Reg. § 1.385-2(a)(2)(iv) thus excluding typical foreign-directed U.S. real estate investment funds from the Proposed Regulations.

> Comment: This suggested change would apply to the following two typical real estate

investment fund structures for foreign investors in U.S. real property.

A. Offshore Feeder Limited Partnership is a Member of the ''Expanded Group.'' A real estate investment fund sponsor with foreign limited partners forms a limited partnership in an offshore tax favorable jurisdiction. The foreign limited partnership (''Feeder LP'') elects to be treated as a corporation for U.S. federal income tax purposes, and the Feeder LP capitalizes a domestic USRPHC in the typical ''portfolio interest'' shareholder loan structure described above. Under the Proposed Regulations, the Feeder LP and the USCO would be included within the ''expanded group'' under the proposed ''vote or value'' modification to the § 1504(a) affiliated group definition. The ''vote or value'' test pulls Feeder LP and the USCO into the ''expanded group'' because the investment fund sponsor would normally own the voting stock of the USCO under this structure and thus a ''vote and value'' test would not ordinarily be met. Furthermore, assuming Feeder LP has over $100 million in assets, because Feeder LP would normally be providing typical fund-level financial reporting to its limited partners, the ''applicable financial statement'' requirement would be met and the Proposed Regulations apply. This real estate investment fund structure has no relation to corporate inversions and thus should be excluded.

B. Corporate Limited Partner Owns at least 50% of Offshore Feeder Limited Partnership and is a Member of the ''Modified Expanded Group.'' Same as above, except that Feeder LP does not elect to be treated as a corporation for U.S. federal income tax purposes and one or more corporations (each, a ''Holdco'') formed in a tax-favorable jurisdiction is interposed between the domestic USRPHC and the Feeder LP. If a foreign limited partner of Feeder LP is an corporate entity owning at least 50% of Feeder LP, then the USCO, Holdco and Feeder LP are included in the ''modified expanded group.'' *See* Prop. Reg. § 1.385-1(b)(5). Furthermore, assuming Holdco and Feeder LP have over $100 million in assets, because Holdco and/or Feeder LP would normally be providing typical fund-level financial reporting to its limited partners, the ''applicable financial statement'' requirement would be met and the Proposed Regulations apply. This real estate investment fund structure has no relation to corporate inversions and thus should be excluded.

4. There is a reference to a USRPHC in the ''Assumed Facts'' of the Examples. *See* Prop. Reg. § 1.385-3(g). The example assumes the domestic corporation is not a USRPHC in Example 1. It's unclear as to Treasury's intent in making this assumption and thus clarification is in order.

If you have any questions, please feel free to call me at (212) 960-3146 or contact me at John C. Dworkin P.C., 375 Park Avenue, Suite 2607, New York, NY 10152 and via email at john@dlonyc.com.

Respectfully Submitted,

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