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FIELDS and DREAMS — Potential U.S. Real Estate Investment Opportunities Created by §897(l)

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Foreign investors in U.S. real estate face two potential U.S. federal income tax obstacles.

The first is the potential tax imposed on operating income while owning the property. Under §871(b) and §882, passive rental income is subject to a 30% withholding tax for foreign investors, without deduction for operating costs or depreciation. Rarely reduced by treaty, this tax can be confiscatory in nature as it is imposed on the gross amounts of the rent. To avoid this tax, investors can either ensure that the investment is sufficiently active so that the income from the property is considered effectively connected to the conduct of a U.S. trade or business (referred to as ''ECI'' or effectively connected income) or else make the election under §871(d) or §882(d) to treat the property as producing ECI. The ECI is then subject to tax at regular federal income tax rates, which for a corporate investor, or an individual who invests through a ''blocker'' corporation, reach a maximum rate of 35%. While this is higher than the 30% withholding tax rate, the tax on ECI is imposed only on *net* income and allows deductions for operating costs, depreciation, and interest income, including interest income paid to shareholders of the REIT (subject to certain earnings-stripping and other limitations).

The second obstacle is the potential tax imposed on gains realized on exit from the investment, which for more than 30 years have been taxable to foreign investors under §897, euphemistically referred to as ''FIRPTA,'' the acronym for the U.S. Foreign Investment in Real Property Tax Act enacted in 1980. The FIRPTA tax is imposed on gains realized with respect to direct investments in U.S. real estate, gains realized from a disposition of a partnership or other pass-through entity that owns U.S. real estate, and gains realized from selling shares in a United States real property holding corporations — e.g., a corporation a majority of whose assets consist of U.S. real estate, including most REITs.[1] The FIRPTA tax is also seldom reduced or eliminated by treaty.

Investing through a real estate investment trust (REIT) has allowed certain categories of investors to avoid one or both of these tax obstacles.[2] In the case of public REITs, shareholders who own less than 10% (formerly 5%) of the REIT are exempt from the FIRPTA tax that would otherwise apply to gains.[3] Certain governmental investors, including qualifying sovereign wealth funds and governmental pensions that, in each case, qualify for the benefits of §892, can invest in a non-controlling interest in a REIT, including a private REIT, and be exempt both on dividends received from the REIT and on gains realized on a sale of their shares in the REIT.[4] Because a REIT is generally not subject to entity-level taxes due to its ability to pay out its operating income in the form of

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[1] *See* §897(a), §897(c), §897(g).

Limited exceptions are provided for less than 10% (previously 5%) shareholders of public REITs and for interests in domestically controlled REITs, discussed more below.

All ''§'' references are to the U.S. Internal Revenue Code of 1986, as amended (the ''Code''), and references to ''Reg. §'' are to the regulations issued thereunder. References to the ''IRS'' or the ''Service'' are to the U.S. Internal Revenue Service.

[2] References to a REIT are to an entity that qualifies as a real estate investment trust pursuant to §856. *See generally* Carnevale, Bree, Schneider, Temkin & Witt, 742 T.M., *Real Estate Investment Trusts*.

[3] *See* §897(a)(3), §897(h)(1), §897(k)(1). Due to the requirement that the REIT be publicly traded and the 10% limit, however, this exception is not particularly useful for structuring targeted investments by foreign pension investors in specific U.S. real estate opportunities.

[4] *See* §892(a)(1)(A); Nikravesh, Maloney, & Dick, 913 T.M., *U.S. Income Taxation of Foreign Governments, International Organizations, Central Banks, and Their Employees* (Foreign Income Series), at II.E.2.b.(2)(a).

deductible dividends, a sovereign investor can invest tax efficiently in U.S. real estate, as long as it is willing to take a non-controlling interest in that real estate through its interest in the REIT and the real estate is of a type that produces rental income that qualifies as good REIT income.

Qualifying foreign pension investors that reside in a jurisdiction, such as Canada or the Netherlands, that has a treaty with the U.S. with a special article applicable to certain tax-exempt pension funds can enjoy a similar exemption from U.S. tax on dividends received from a REIT, provided they are not considered to be ''related'' to the REIT.[5] This treaty exemption typically applies only to ordinary dividends, however, and does not provide an exemption with respect to gains realized on a sale of the shares of the REIT or to dividends attributable to a sale of real estate by the REIT that are taxable under §897(h).

For most other investors, ordinary dividends from a REIT will usually be subject to a 30% withholding tax, though for certain less-than-10% investors who either are individuals or who invest in a REIT that owns a diversified portfolio of U.S. real estate, the rate may be reduced, often to 15%, by an applicable treaty. Even with the 30% withholding tax, however, a REIT may still be a relatively tax-efficient vehicle for non-U.S. investors compared to investing directly in real estate, because the amount the REIT needs to pay in taxable dividends is limited to the net operating income of the REIT, which is reduced by the REIT's operating costs, including depreciation and interest expense.

To exempt gains on exit from their investment from the FIRPTA tax that would otherwise apply, non-governmental foreign investors, including pension funds, have had to look to another available exemption form FIRPTA, which until recently has meant looking to the exception provided in §897(h) for interests in ''domestically controlled'' REITs. Under this special exception, gains realized with respect to interests in a domestically controlled REIT — a REIT that is majority owned by U.S. investors — are not subject to FIRPTA tax.

As is the case with the §892 exemption, however, taking advantage of the domestically controlled REIT exception requires exiting from the investment by selling REIT shares. A sale of property by the REIT, in contrast, followed by a distribution of the proceeds of the sale by the REIT to its shareholders, even if done as part of a liquidation of the REIT, is taxable to the REIT's shareholders under §897(h), as interpreted by the IRS in Notice 2007-55.[6]

While many investors, including most U.S. investors, will be able to buy REIT shares tax-efficiently, many are reluctant to do so because real estate investors generally prefer to buy the real estate itself rather than an entity that owns the real estate, in order to avoid or minimize inheriting entity-level liabilities. Moreover, some investors, such as an investment group that comprises five or fewer individuals, cannot buy REIT shares without disqualifying the REIT due to the application of the closely-held rules.[7] Foreign investors may also be reluctant to acquire shares of a REIT that owns appreciated property because of the risk that liquidating the REIT will trigger a tax under §897(h)(1) even though they have paid fair market value for the REIT shares and therefore do not have any economic gain.[8] Nevertheless, until recently, the domestically controlled REIT exception was the only exemption available for investors in private REITs that were not eligible for the exemption available to foreign governmental investors under §892.

In December of 2015, however, the PATH Act[9] added §897(l) to the Code, which provides another avenue of exemption from FIRPTA for ''qualified foreign pension funds'' or ''QFPFs.''

A QFPF is defined to include a foreign pension ''trust, corporation, or other organization or arrangement'' that, among other requirements, provides pension or retirement benefits to current or former employees, ''in consideration for services rendered.''[10] The plan generally has to be subject to government regulation, be exempt from tax, or accept tax deferred or deductible contributions, and has to report on its beneficiaries to the ''relevant tax authorities.''[11] It also cannot have a single beneficiary that is entitled to more than 5% of its income or assets.[12]

A host of questions have arisen as to how to apply this definition to the myriad types of pension plans that exist under foreign law. For example, can a plan that benefits the ''general working public'' of a foreign country rather than the employees of a specific employer country qualify? What about a plan sponsored by a professional organization or union rather

[5] The Netherlands treaty defines related using an 80% or greater threshold, while the Canada treaty is generally thought to require only a greater than 50% overlapping ownership threshold. To take advantage of the exception, a pension would therefore need to own either less than 80%, or a 50% or smaller interest, for Dutch and Canadian pensions, respectively.

[6] 2007-27 I.R.B. 13.

[7] *See* §856(a)(6), §542(a)(2).

[8] *See generally New York State Bar Association Report on Notice 2006-55 and Possible Administrative Guidance Addressing Sections 897(h)(1) and 1445(e)(6)*, 2014 TNT 6–12.

[9] The Protecting Americans From Tax Hikes Act of 2015, Pub. L. No. 114-113, Div. Q, §322.

[10] §897(l)(2).

[11] *Id.*

[12] *Id.*

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than an employer or a plan that provides benefits in addition to pension and retirement benefits, such as disability benefits? Similar questions arise where a foreign pension comprises separately organized entities one or more of which provide or administer the pension benefits and one or more of which own and invest the funds that are ultimately used to pay those benefits. Do these separate entities together comprise an ''arrangement'' that qualifies if it meets the requirements in the aggregate, or does each entity need to satisfy all of the various definitional aspects? What if multiple pensions are required by statute to pool their funds, which are then invested by a single entity? What type of reporting is required and to whom does the pension plan need to report? This is a particularly vexing question for pensions organized in jurisdictions that don't have a Western style tax authority or that require the plan to report to other governmental agencies or authorities rather than the tax authorities.

The recently released Blue Book expresses the Congressional intent that the definition was intended to be flexible and apply broadly,[13] but many plans are waiting for the IRS to provide further guidance before committing themselves to invest in the United States on the basis that they are entitled to the benefits of §897(l).

The benefits of §897(l) also extend to an entity all of the interests of which are owned by ''a'' QFPF.[14] The statutory language arguably limits this rule to an entity that is owned by a single QFPF, and to only a ''first-tier'' subsidiary of a QFPF. In addition, however, any first-tier subsidiary appears to qualify, even one that was recently acquired from a third party rather than formed by the QFPF, and even if the entity — whether recently acquired or originally formed by the QFPF — is an investment entity or a commercial enterprise. For example, if a QFPF acquires 100% of a commercial entity, it appears the commercial entity will then be able to take advantage of the exemption provided by §897(l) with respect to any investment it makes or has made in U.S. real estate. Does this make sense, or should this subsidiary rule extend to any investment subsidiary, even a lower-tier subsidiary or one owned by multiple QFPFs, but also apply *only* to investment subsidiaries and not to commercial enterprises? The IRS is given authority to issue regulations ''necessary and appropriate'' to carry out the ''purposes'' of §897(l)[15] and, in addition to clarifying what is a QFPF, the rule governing subsidiaries of a QFPF will need elaboration as well. Exactly what form these rules take will depend in part on what the IRS views as the ''purposes'' of §897(l).[16]

For plans and entities that do qualify, §897(l) provides a complete exemption from FIRPTA. For investments in REITs, this means that both a sale of REIT shares and a sale of property by the REIT followed by a distribution by the REIT of the proceeds of the sale are not subject to tax under §897. The ability to exit via property sales and distributions of the proceeds by the REIT will allow for more flexible exits and allow a REIT owned by QFPFs to sell its property to buyers who would otherwise be unable or reluctant to purchase REIT shares. This will allow QFPFs to invest in REITs that can own property in markets with less sophisticated buyers who might not be as familiar with purchasing REIT shares and still be able to exit tax efficiently by having the REIT sell its property to these type of buyers and then distribute the proceeds to the QFPF.

While §897(l) therefore provides a valuable exemption from FIRPTA, it is important to note that it does nothing to eliminate the tax imposed by §882 on effectively connected income from investing in U.S. real estate or the 30% withholding tax imposed on passive rents.

This means that a foreign investor, including a QFPF, that makes a direct investment in U.S. real estate, or an investment through a partnership or other pass-through entity, will continue to be subject to the 30% gross withholding tax on passive rents from the property, or to 35% net basis tax on the income from the property (and will have to file a U.S. tax return with respect to that ECI).[17] As a result, most QFPFs will want to structure their investment through REITs, which both ''block'' ECI and thereby prevent the QFPF from having to file a U.S. tax return, and avoid tax at the entity level by paying deductible dividends. While these dividends will still potentially be subject to 30% withholding tax, the amount of taxable dividends the REIT needs to pay will be reduced by operating costs incurred by the REIT, including depreciation and interest costs. These interest costs can include shareholder-level debt, subject to the various restrictions on interest expenses in the Code, such as the earnings-stripping rules of §163(j).

[13] *See* Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 2015, at nn. 967 & 968 (Comm. Print 2016).

[14] §897(l)(1)(B).

[15] §897(l)(3).

[16] The use of the plural in the statute implies that there is more than one ''purpose'' to the new exemption. One purpose is clearly to exempt foreign pensions from the FIRPTA tax that would otherwise be imposed by §897, and the broader ''purpose'' of this exemption is clearly to encourage additional investment by foreign investors in U.S. real estate. Were there other purposes as well?

[17] The reference to the 35% corporate tax rate assumes that the QFPF either will invest through an entity treated as a corporation or will itself be organized as an entity treated as a corporation for U.S. tax purposes.

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For QFPFs organized in a jurisdiction that has a tax treaty with the United States that exempts U.S.-source interest income, even when received from a related party, the QFPF can capitalize the REIT in part with shareholder debt and reduce the amount of taxable dividends the REIT needs to pay and instead receive interest in this amount that will not be subject to withholding tax. Moreover, as discussed above, some QFPFs will be able to avoid the withholding tax on dividends altogether if they are organized in a jurisdiction that has a tax treaty with the United States that provides an exemption for dividends received by an exempt pension plan from an unrelated U.S. entity, including a REIT.

Important also is that the dividend withholding tax generally will apply only to ordinary dividends. Capital gain dividends, which previously would have been taxable under §897(h), will no longer be subject to FIRPTA tax to a QFPF.[18]

On interesting technical issue that has arisen in this regard is whether the recapture portion of capital gain dividends — e.g., that portion attributable to certain previous depreciation deductions taken by the REIT — could continue to be subject to tax in the hands of a QFPF under §291, notwithstanding §897(l).

Section 291(d) and §291(a) combine to potentially treat a portion of a REIT capital gain dividend as ''gain which is ordinary income under §1250'' and that is ''recognized'' notwithstanding ''any other provision of this title.'' As §897(l) is another provision of ''this title,'' this could mean that §291 overrides §897(l) and somehow causes the recapture portion of a capital gain dividend from a REIT to be taxable to a QFPF. However, a closer analysis reveals this not to be the case.

For starters, §291 merely causes the dividend to be treated as ''gain which is ordinary income under §1250.'' Importantly, it is still treated as ''gain.'' This is confirmed by the regulations under §1250, which states that §1250 amounts are treated as gain from the sale or exchange of property that is not a capital asset.[19] Reg. §1.1441-2(b)(2) confirms that gain from a sale of property, even if the gain is treated as ordinary income because the property is not a capital asset, is not ''FDAP'' income and is therefore not subject to the 30% withholding tax. Therefore, the only basis on which any amount subject to §291 could be taxable to a non-U.S. investor would be if it is ECI or is deemed to be ECI under §897. Under §864(b)(2), however, owning shares in a REIT does not cause a QFPF to be considered to be engaged in a U.S. trade or business, so a distribution from the REIT cannot be treated as ECI. The only exception to this rule is the special statutory rule of §897(h) for distributions attributable to a sale by a REIT of U.S. real estate. However, §897(l) exempts a QFPF from *all* of §897, including §897(h). As a result, there is nothing that causes a QFPF to be subject to tax on any amounts that are subject to the recharacterization rule of §291. Moreover, the fact that §291 says that amounts recharacterized as §1250 gain are ''recognized'' notwithstanding any other provision is itself a red herring. Nothing in §897(l) causes gains realized by a QFPF not to be ''recognized.'' There is therefore nothing for §291 to override.

As a result of the need to block ECI and avoid 30% withholding on the gross amount of passive rents, for ''traditional'' rent-producing assets, such as retail, residential rental real estate, and office properties, REITs will usually be the most tax-efficient vehicles for QFPFs seeking to take advantage of §897(l). For assets like hotels and health care properties, QFPFs will similarly be able to take advantage of the special REIT regimes that are available for these assets, where the REIT is permitted to own the real estate and lease it to a wholly owned taxable REIT subsidiary, which then engages an eligible independent contractor to operate the hotel or health care facility.[20]

For less ''traditional'' REIT real estate, such as some infrastructure assets and energy assets that do not typically produce rental income, including midstream assets like pipelines and transmission towers, whether a REIT will be tax-efficient will depend on whether it is possible to separate the real estate and operating components of the investment by establishing a REIT to own the real estate and lease it to an unrelated operator. Similar structures potentially can be used for dairy farms, cropland, vineyards, and other non-traditional REIT assets.

Due to the fact that the lease between the REIT and the operator can have a component based on the gross

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[18] Although there is some potential ambiguity as to their source, because a QFPF that invests in a REIT normally will not be considered to be engaged in a U.S. trade or business by virtue of §864(b)(2), capital gain dividends will generally not be ECI and are also not treated as ''FDAP'' income subject to 30% withholding. *See* Reg. §1.1441-2(b)(2).

[19] *See* Reg. §1.1250-1(a)(1)(i).

[20] The taxable REIT subsidiary or ''TRS'' is generally wholly owned by the REIT and is taxable only on the ''spread'' it earns from the excess of the operating income of the property over the amount it pays the REIT in rent. This rent usually contains a percentage component that is based on the gross revenues, but not profit, of the TRS tenant. The TRS tenant then is required to engage an eligible independent contractor or EIK to manage the property. An EIK must be unrelated to the REIT and in the active business of managing either hotel properties (in the case of a TRS that leases a hotel) or health care properties (in the case of a TRS that leases a health care facility). *See generally* §856(d)(2)(A), §856(d)(3), §856(d)(9).

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revenue, but not profits, of the operator,[21] these structures make it possible for the REIT to capture much of the economics of the investment. Because the lease cannot be based, in fact or in substance, on the operator's net profits, however, and because of the requirement that the operator be unrelated to the REIT, which prohibits overlapping ownership of 10% or more (applied with certain constructive ownership rules),[22] this structure will require that the QFPF be comfortable giving up control of the operator and accepting less than complete alignment between the economic interest of the REIT, which will be exposed only to its percentage of the operator's gross revenue, and the operator, which will be concerned with its ultimate operating profit. While the lease cannot be renegotiated in a manner that effectively causes the rent to be based on the net profits of the tenant,[23] the lease can potentially allow the parties to adjust the rent at regular renewal intervals, perhaps as frequently as every five years, to what the fair market value rent should be based on the circumstances that exist at that time. As a result, through careful planning it is possible to largely align the interests of the tenant and the REIT and create a tax-efficient structure that produces a return for an investor in the REIT that does not diverge significantly from the return they would have earned if the lease structure were not required.[24]

Are there structures other than a REIT that a QFPF can use to take advantage of its exempt status? What if, for example, operating income is not expected to be significant, and the main component of the return is expected to come in the form of appreciation? One idea would be for the QFPF to own the real estate through a direct or pass-through structure, such as a triple net lease, that avoids ECI. While the rental income will be subject to the 30% gross basis withholding tax, if this income is not expected to be significant, this structure will allow the QFPF to avoid tax on the capital gain that it realizes when it sells the asset.

If the real estate asset will produce ECI, however, because for example it requires active management or operation by the QFPF or its agents or partners, even if the ECI from operations is not significant and is therefore tolerable, the fact that the real estate assets generate ECI then creates a risk that gain from these assets, even though attributable to real estate, will be taxable to the QFPF under §882 on exit. Because §897(l) creates an exemption only from the FIRPTA provisions of §897, it has no effect on the taxation of ECI under §882.[25]

One potential idea is for the QFPF to acquire an option to purchase the real estate in this scenario rather than make a direct investment in the real estate.[26] Although the option will not give the QFPF direct exposure to the operating income of the property, it will allow the QFPF to benefit from any appreciation in the value of the real estate and avoid tax when it disposes of the option on exit.[27] If the operating income is not expected to be significant, this will allow the QFPF to obtain the benefit of the §897(l) exemption without creating the risk that capital gains will be subject to tax as ECI under §882.

Are there limits to a QFPFs ability to use options to invest tax efficiently? As noted, one limit is that the QFPF will need to avoid being engaged in a U.S. trade or business with respect to the property, so that any gains will not be considered to be ECI. Another potential obstacle is the regulations issued under §761 that relate to noncompensatory options issued by a partnership, which, in certain circumstances, deem the option holder to be considered a partner in the partnership.[28] If these rules apply, since the option structure is designed to reduce the present value of the tax liabilities of the option holder, the transfer of the option is likely a ''measurement event'' at a time when the option is ''reasonably certain to be exercised'' such that it would be treated as a partnership interest ''for all federal tax purposes'' at that time.[29]

If the QFPF is considered to be a partner in a partnership that owns the property, however, gains on the option would then be treated as gain realized with re-

[21] *See* §856(d)(2)(A).

[22] *See* §856(d)(2)(B).

[23] *See* Reg. §1.856-4(b)(3).

[24] These structures will also require finding an operator willing, and adequately capitalized, to lease the property from the REIT and earn an arm's length profit or ''spread'' on the difference between what it makes operating the property and what it pays in rent, including percentage rent, to the REIT. As noted, the operator and the REIT need to avoid being ''related'' by avoiding a greater than 10% overlap in ownership, as determined by applying certain constructive ownership rules. *See generally* Semer & Alexander, 743 T.M., *Structuring Real Estate Joint Ventures with Private REITs*, at III.B.3.

[25] An interesting question is whether a QFPF could take the view that §897(l) evidences a congressional intent to exempt capital gains, even if they otherwise would be ECI? Could this be one of the other ''purposes'' of §897(l)?

[26] This option structure can also be used when there is no practical way to hold the assets in a REIT structure, because for example there is no viable way (such as no ability to find a third party operator to serve as an unrelated tenant) to earn qualifying rental income.

[27] To avoid being engaged in a trade or business, the QFPF will generally want to exit by selling the option rather than exercising it and owning the property before selling the property itself.

[28] Reg. §1.761-3. For a general discussion of these rules as applied to a similar option structure, see Needham, 735 T.M., *Private Equity Funds*, at VIII.B.3.a.

[29] *See* Reg. §1.761-3. The transfer of the option would normally occur only when it is being transferred to a buyer who wants to exercise the option to acquire the property.

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spect to its partnership interest which could be treated as ECI taxable under §882.[30] If the option is not granted by a partnership,[31] but by the owner of the property, does that avoid the noncompensatory partnership rules altogether? In other words, do the rules apply only to an option to acquire an interest in an existing partnership, or could they be read to create a potential or deemed partnership between the option holder and the acquiror of the option?

Taken literally, this argument that a deemed partnership could be created between any investor that holds an option to acquire property and the grantor of the option would mean that the §761 regulations could be read to recast every grant of an option to acquire real estate as creating a deemed partnership between the grantor and the option holder. It's hard to see what support there would be, or what policy would justify such a wholesale change to the taxation of partnerships and real estate options. However, could a more limited application be justified where a QFPF is attempting to use an option in conjunction with a related investment in the real property to exempt gains from the tax that could otherwise apply?

For example, suppose a QFPF invests through a taxable blocker in U.S. real estate, accepting that the blocker will be subject to full U.S. tax on ECI attributable to operating the property.[32] What if the blocker grants the QFPF an option to acquire the property? If the QFPF later sells the option, any gain on the appreciation in the value of the option would not be subject to tax by virtue of §897(l). Would it make sense to apply the §761 regulations to change this result by treating the option as an interest in a deemed partnership between the blocker and the QFPF? The answer depends largely on what the underlying purposes of §897(l) are thought to be. If the purpose is to encourage foreign investment in U.S. real estate by allowing capital gains earned by QFPFs to avoid U.S. tax, then the answer is ''no'' because there is nothing abusive about the structure. The investor's blocker is paying U.S. tax on the operating income in the same manner as any other unrelated investor. Why should it matter whether that tax is paid by an affiliate of the QFPF or a wholly unrelated party? In either case, it is only the capital gain attributable to the appreciation in the value of the option that would be exempt under §897(l), which is exactly what §897(l) was intended to do. Why should a partnership regulation that has nothing to do with foreign investment in U.S. real estate be applied to change that result? Moreover, for investments in assets that may not be suitable for a REIT, such as many infrastructure assets, this option structure may be the only way for a QFPF to be able to take advantage of the new exception to invest tax-efficiently. If the purpose of §897(l) was at least in part to spur foreign investment in U.S. infrastructure, the use of this option structure should be encouraged rather than threatened by an uncertain application of unrelated partnership rules.

Nevertheless, until there is more certainly, QFPFs may limit themselves to utilizing REITs to make investments, which will require continuing to evaluate creative ways to allow REITs to own less ''traditional'' REIT assets and earning qualifying rental income by master leasing these real estate assets to independent operators.

One interesting by-product of the new QFPF regime with respect to REITs is that there will now effectively be two classes of investors in private REITS: QFPFs and everyone else, including all §892 investors who are not QFPFs.

The main difference between these two types of investors is that QFPFs will be indifferent between selling REIT shares and having the REIT sell its real estate. As a result, a QFPF will potentiality be able to invest in REITs that can own a broader variety of assets in markets or in a class where it is not possible or customary to exit by selling REIT shares rather than through asset sales. Non-QFPFs may not be able to invest in these types of REITs, however, because they will need to exit by selling REIT shares to take advantage of the FIRPTA exception for domestically controlled REITs or the exemption available for §892 investors. Similarly, a QFPF will be able to structure an investment in a portfolio of assets through a single REIT, rather than having to use multiple REITs or a parent/baby REIT structure.[33] This is because the QFPF will be able to structure exits as a sale by the

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[30] Whether this is the case depends in part on whether the IRS's position in Rev. Rul. 91-32 — that gain realized from a disposition of an interest in a partnership that earns ECI is itself ECI — is correct, and if so, whether this conclusion extends to real estate owned by the partnership. The statement in Rev. Rul. 91-32 that ''for purposes of these rules, the ECI (United States source) property of a partnership does not include United States real property interests held by the partnership,'' which are instead subject to the rules of §897(g), casts considerable doubt on the latter point, however, although the ruling obviously predates §897(l) and therefore did not need to consider what would happen if §897(g) was inapplicable because the investor was a QFPF.

[31] See Reg. §1.761-3(b)(2), which defines a noncompensatory option as an option ''issued by'' a partnership.

[32] The blocker could also be a U.S. corporation.

[33] A parent/baby REIT structure utilizes a ''parent'' or ''master'' REIT that owns each property through a subsidiary REIT and exits each investment by selling shares of the subsidiary REIT rather than selling the property. For this structure to work, the subsidiary REIT needs to be either domestically controlled, which will now be determined by looking through the parent REIT under new §897(h)(4)(E), or the investor will need to be entitled to the benefits of §892 and take the position that §892 exempts a sale

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REIT of each individual property and a distribution of the proceeds by the REIT, even if these sales take place over time and the distributions are not made as part of a liquidation of the REIT. By contrast, most non-QFPFs will continue to want to structure each asset that might be sold separately as contained within a separate REIT whose shares can be sold separately from the rest of the portfolio.

Finally, a QFPF will be indifferent as to whether the REIT is domestically controlled, and, unless it is also trying to exempt dividends by taking advantage of the exempt pension article of a treaty or §892, can own any percentage interest in the REIT, including a controlling interest. A non-QFPF, by contrast, will continue to want to invest in REITs that are domestically controlled, or for a non-QFPF §892 investor, will want to ensure that it owns less than 50% of the REIT and does not control the REIT. Indeed, because a QFPF can take a controlling interest in a REIT and still utilize its exemption from gains under §897(l), a QFPF may be a good partner for a non-QFPF §892 investor who needs someone else to hold the controlling interest in the REIT.

For real estate focused funds that have both classes of investors, an interesting question will be whether and to what extent they cater to both separately or decide to structure for the most restrictive investor — e.g., to accommodate non-QFPFs by structuring exits as a sale of REIT shares, even though their QFPF investors could have allowed them to pursue more flexible structures and exit strategies. It will be interesting to see the choices that funds make in this regard and whether QFPF investors will be willing to allow the fund to accommodate the needs of non-QFPFs even if doing so results in more complicated structures and exits than the QFPF investors would otherwise need.

Another interesting implication of a QFPF's ability to exit tax-efficiently via either a REIT share sale or a property sale by the REIT is whether there is any continuing justification for the IRS's position in Notice 2007-55. Before that Notice, many practitioners took the position that a REIT could sell is properties and liquidate, and if the REIT was domestically controlled, non-U.S. investors could obtain the same exemption as if they had sold their REIT stock. Similarly, a §892 investor could obtain the same benefits from a property sale and a distribution of the proceeds as if they had sold their REIT shares.[34] Given that Congress has eschewed treating a property sale by a REIT differently from a REIT share sale in the case of a QFPF, is there any continuing policy justification for continuing to treat the two types of sales differently for other investors, other than to exalt form over substance? Non-QFPF investors may not like the answer the IRS is likely to give to this latter question.

In summary, while §897(l) is not the ''revolutionary'' change that many had thought it might be, given that it exempts a QFPF from FIRPTA but leaves intact all the other Code provisions that impact a foreign investor in U.S. real estate, it will allow for ''evolutionary'' changes to investment structures. These changes will both simplify certain investments and open up opportunities to invest in a broader category of assets and structures than was previously possible. Fruitful collaboration between tax and business professionals will no doubt unleash new avenues to tax-efficiently deploy the capital of QFPFs in U.S. real estate over the years to come. Use of REITs is certain to be a major component of these structures, but there will be other possibilities as well, potentially including variations on the option structure discussed above. For §897(l) to succeed, the IRS will have to be part of this collaborative process as it develops guidance to fill in the many areas of ambiguity that arise.

In the movie *Field of Dreams*, Iowa framer Ray Kinsella is told that ''if you build it, they will come.'' With creativity, and an understanding of and commitment to its purposes, §897(l) will be able to fulfill the corollary prophesy that if we make it easier for foreign capital to help us, together we can use that capital to build what our imaginations allow us to dream.

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of the shares of the subsidiary REIT by the parent REIT followed by a distribution of the proceeds of such a sale to the §892 investor.

[34] *See generally* Semer & Alexander, 743 T.M., *Structuring Real Estate Joint Ventures with Private REITs*, at V.A.2.b.

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