February 24, 2023

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

To Whom It May Concern:

We are writing on behalf of the members of the National Multifamily Housing Council (NMHC) and the National Apartment Association (NAA) to provide comments on proposed regulations (REG-100442-22) providing Guidance on the Foreign Government Income Exception and the Definition of Domestically Controlled Qualified Investment Entities. For more than 20 years, NMHC and NAA have partnered to provide a single voice for America's apartment industry. Our combined memberships are engaged in all aspects of the apartment industry, including ownership, development, management and finance. NMHC represents the principal officers of the apartment industry's largest and most prominent firms. As a federation of 141 state and local affiliates, NAA encompasses over 95,000 members representing more than 11.6 million rental housing units globally.

We respectfully request that the Treasury Department and Internal Revenue Service (IRS) withdraw the portion of the proposed regulations regarding the definition of domestically controlled qualified investment entities (i.e., the rule in Prop. Reg. § 1.897-1(c)(3)(iii)(B), which would require looking through a non-publicly traded C corporation to identify foreign owners for purposes of the domestic control test in Section 897(h)(4)(B) (the Look-Through Rule)). We believe that Treasury does not have the authority to issue these regulations. However, even if Treasury were to have the authority, this proposed rule is an incorrect interpretation of the statute and conflicts with the legislative history and Congressional intent.

A. Section 897

In general, foreign investors are not subject to tax on capital gains from the sale of stock in U.S. corporations.[1] The FIRPTA regime is an exception to this rule. Under Section 897(a)(1), foreign investors are subject to tax on the disposition of a U.S. real property interest (USRPI). A USPRI includes stock in a U.S. C corporation if the assets of the corporation primarily consist of USPRIs. This includes qualified investment entities (QIEs) such as real estate investment trusts and regulated investment companies, both of which are C corporations.

However, there is an exception to the general rule under section 897(a)(1). If a QIE is domestically controlled (a DCQIE), there is, again, no capital gains tax on the disposition of a USPRI (or a distribution from a USPRI). To be DCQIE, foreign investors must own less than 50 percent of the stock (by value, directly or indirectly) of a QIE during the testing period.[2] Generally, the testing

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[1] *See, e.g.*, Section 865, Treas. Reg. §1.1441-2(b)(2)(i).
[2] Section 897(h)(4)(B).

period is the five-year period ending on the date of the disposition of a USPRI. As noted above, the Look-Through Rule would modify the domestic control test by requiring QIEs to look through a non-publicly traded domestic corporation and count foreign shareholders when determining the amount of foreign ownership.

B. Treasury Lacks the Authority to Propose the Look-Through Rule

We believe Treasury lacks the authority to propose the Look-Through Rule. First, there is no grant of regulatory authority in Section 897 that would include such a rule. There are several grants of authority in the statute to provide regulatory guidance:

> 1) Section 897(c)(5) authorizes regulations to cover when assets are considered held by a first corporation where that corporation has a controlling interest in a second corporation.
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> 2) Section 897(d)(1) authorizes regulations to cover distributions to foreign corporations.
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> 3) Section 897(e)(2) authorizes regulations to cover corporate reorganizations and non-recognition transactions.
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> 4) Section 897(g) authorizes regulations to cover an exchange of a partnership interest with foreign persons.
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> 5) Section 897(l)(3) authorizes regulations to cover qualified foreign pension funds.

Not a single one of these statutory provisions authorizes regulatory guidance for a look-through rule, nor could the language be stretched to infer the authority to issue such a rule.

It would appear, instead, that Treasury is relying on its general authority under Section 7805 for the Look-Through Rule. There are two reasons why Section 7805 also does not provide Treasury with sufficient authority to issue the Look-Through Rule. First, Section 7805(a) is a general grant of authority to "issue regulations as may be necessary by reason of any alteration of law in relation to the internal revenue." The *Protecting Americans from Tax Hikes (PATH) Act* (P.L. 114-113) modified Section 897 in 2015. However, there were no changes made that directly or indirectly address looking through a C corporation to identify foreign shareholders, nor did any of the changes made at that time create an ambiguity that would need to be addressed in regulations.

Treasury claims that that use of "directly or indirectly" in the statute to describe ownership by foreign person provides the basis for creating the Look-Through Rule. This is simply not the case. While the phrase itself may be unclear, it is well established that it does not mean that Treasury has the authority to create a look-through rule or a constructive ownership rule. When Congress intends for such rules to apply, the language used in a statute is explicit.[3] In fact, Section 897(c)(6)(C) does specifically reference the constructive ownership rules under Section 318 for purposes of determining a greater than 5 percent owner for a publicly traded C corporation (10 percent in the case of a publicly traded REIT). If Congress wanted to have a look-through or

[3] *See e.g.*, Sections 267(c), 304(c)(3), 544(a), 707(b)(3), 856(d)(5), and 958(a) and (b).

constructive ownership rule apply for purposes of the domestically controlled test in Section 897(h)(4)(B), there is language in Section 897 that would do exactly that. Congress chose not to use that language, and there is no ambiguity to resolve that would require the Look-Through Rule.

Second, Section 7805(b)(3) gives Treasury the authority to issue regulations to prevent abuse and may do so retroactively. A common structure used to ensure a QIE is domestically controlled is to have a non-publicly traded C corporation own 51 percent of the entity and foreign investors directly own the remaining 49 percent. The IRS embraced this structure in a 2009 private letter ruling.[4] Treasury has not identified any aspect of this structure that is abusive since 2009. The preamble to the proposed regulations is also silent on how the use of a non-publicly traded C corporation to maintain domestic control of a QIE is abusive. Treasury's silence indicates that, in fact, these transactions are not abusive, and there is no authority to support a look-through rule.

C. The Look-Through is an Incorrect Reading of the Statute

Even if Treasury had the authority to issue the Look-Through Rule, such a rule is an incorrect reading of the statute. As noted above, there is no ambiguity with the domestic control test. Congress knows exactly how to draft a look-through or constructive ownership rule and chose not to do so. There is additional language in the statute, specifically in section 897(h), that provides support for the conclusion that the Look-Through Rule is incorrect.

In 2015, the PATH Act added paragraph (E) to Subsection 897(h)(4). This paragraph has special ownership rules for determining when an entity is domestically controlled and calculating the foreign ownership percentage, namely Section 897(h)(4)(B) and (C). There are three rules that:

> 1) Allow a shareholder with less than 5 percent of the stock of a publicly traded QIE to be treated as domestic person,
>
> 2) Treat a QIE that holds stock (if it is publicly traded or a RIC) in another QIE as a foreign person, unless the QIE is domestically controlled, and
>
> 3) Treat all other stock in a QIE held by another QIE as held by a United States person in proportion to the amount of stock in such QIE held by United States persons.

These rules are significant for several reasons. First, at the time paragraph (E) was added to help determine ownership for the domestic control test, no constructive ownership rule was included. Congress is presumed to have knowledge of current law, and in this case made no change that would support a look-through or constructive ownership rule.[5] Second, the one rule that explicitly references the domestic control test (rule (2)) relies on the concept of domestic control as an end point to any look-through that must be done. The proposed Look-Through Rule directly contradicts the unambiguous statutory language in paragraph (E). Third, the rules in paragraph (E) provide a way to read "indirect and direct foreign ownership" in paragraph (B) that allows both paragraphs to have meaning and not be in conflict. "Indirect" ownership is addressed by the

[4] PLR 200923001.

[5] *See, e.g.,* Griffith v. United States, 206 F.3d 1389, 1394 (11th Cir. 2000) ("Congress is presumed to know the context of existing, relevant law and … where Congress knows how to say something but chooses not to, its silence is controlling.") (internal citations and quotations omitted).

two rules in paragraph (E) that look through to another QIE (but not through a C corporation). "Direct" denotes ownership without the need to look through another QIE. The proposed Look-Through Rule ignores this simple and straightforward reading of the statute and creates a rule that both contradicts the statutory language and fails to take into account congressional intent.[6]

D. Retroactivity

If Treasury decides to finalize the Look-Through Rule despite its lack of authority and incorrect reading of the statute, such action should not apply retroactively. As currently drafted, the Look-Through Rule would apply to existing transactions. Generally, a QIE determines ownership percentage based on the five-year period ending on the date of a disposition or distribution of stock.[7] This retroactive testing period will increase the tax exposure under FIRPTA for transactions that were structured prior to the Look-Through Rule. This is particularly concerning given how the Look-Through Rule upends current law. Taxpayers should not face a changed regulatory landscape because the government changed its view on the appropriateness of a tax structure. For these proposed regulations or any other, taxpayers should be able to rely on government pronouncements regarding the tax law without being worried that transactions underway can suddenly be held not to meet the requirements of existing tax laws. Thus, the proposed regulations, if finalized, should only apply to future transactions.

E. Effect on Real Estate Investment

Even if the proposed regulations are effective for future transactions only, they would likely reduce foreign investment in U.S. real estate held by REITs or, at a minimum, require fund sponsors to restructure real estate investment vehicles significantly. Given the nation's housing supply shortage and the necessity of attracting significant amounts of capital to fund the construction of new multifamily buildings, as well as the rehabilitation of existing units, tax regulations should avoid discouraging capital formation for multifamily investment and forcing resources to be inefficiently allocated toward structuring investments for tax purposes. This result would directly contradict the intent of the changes to Section 897 in the PATH Act. As the Senate Finance Committee stressed, it "is essential to increase foreign investment in U.S. real estate."[8] A prospective-only rule would result in Treasury directly undermining congressional intent.

F. Conclusion

It is our conclusion that: (1) Treasury does not have the authority to issue the Look-Through Rule; (2) even if there were such authority, the Look-Through Rule is an incorrect reading of the statute; (3) if the Look-Through Rule were finalized in its current form, it would be impermissibly retroactive; and (4) if only applied to future transactions, the Look-Through Rule would likely result in the loss of critical capital needed to develop housing in the United States, thereby

[6] One of the "longstanding canons of statutory construction" is the "rule that [courts] must normally seek to construe Congress's work 'so that effect is given to all provisions, so that no part will be inoperative or superfluous, void, or insignificant.'" *Ysleta Del Sur Pueblo v. Texas*, 596 U.S. ____, 142 S. Ct. 1929, 1939 (2022) (citing *Corley v. United States*, 556 U.S. 303, 314 (2009). If there is an interpretation of a statute that gives effect to every clause and word of such statute, then such interpretation should generally prevail over a competing interpretation which does not. *Microsoft v. i4i Ltd. Partnership*, 564 U.S. 91, 106 (2011).

[7] See Section 897(h)(4)(D).

[8] Senate Finance Committee Report on the Protecting Americans from Tax Hikes Act at 2.

ignoring congressional intent. For these reasons, the Look-Through Rule in the Proposed Regulation should be withdrawn.

NMHC and NAA thank you for considering our views. Please feel free to contact Cindy Chetti, NMHC's Senior Vice President of Government Affairs, at 202-974-2300 or Greg Brown, NAA's Senior Vice President of Government Affairs, at 703-518-6141, should you have any questions.

Sincerely,

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