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Key Advantages of Using REITs by Funds for Foreign Investors

SPEAKERS

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Welcome back to “[The Tax Blueprint: Structuring Funds, Joint Ventures, and REITs.](#)” In the third episode of our three-part series, hosts Saba Ashraf, Aresh Homayoun, and Tom Phelan explore the advantages that may be offered to foreign investors in U.S. real estate funds by using REITs.

This episode discusses how REITs can be utilized to minimize U.S. tax return filing obligations and tax liabilities for foreign investors. Saba, Aresh, and Tom discuss a side-by-side comparison of the results of using a C-corporation blocker by the fund and a REIT blocker by the fund.

Stay tuned for upcoming series covering structuring by funds and GPs to ensure maximum utilization of Section 1202, characterization of preferred equity investments, management fee waivers, management compensation structuring, and other topics of interest.

Saba Ashraf (00:04):

Welcome to another episode of [The Tax Blueprint, Structuring Funds, Joint Ventures, and REITs](#). This is the last in our three-part series exploring the advantages of the use by funds of REITs for different groups of stakeholders. In the first two parts, we covered benefits to U.S. individual investors, U.S. tax-exempt investors, the GP stakeholders. And that leads us to today’s episode, where we are covering foreign investors. I’m Saba Ashraf. I’m joined once again by Aresh Homayoun and Tom Phelan. We are all members of the tax group at Troutman Pepper Locke. As I said, the focus today is on foreign investors. Foreign investors are a significant source of capital for U.S. funds, including U.S. funds that target investments in U.S. real estate. We’ll walk you through the advantages that REITs can offer for attracting this source of capital.

(01:00):

GOALS OF FOREIGN INVESTORS

Turning generally to the goals of foreign investors, as a general matter, not for every investor, but generally, foreign investors investing in funds would like to, one, minimize U.S. tax return filing obligations, and two, to the greatest extent possible, minimize U.S. tax liability. With these goals in mind, I’ll turn it over to Tom to describe the U.S. taxation of foreign investors in general, and after that we’ll turn to comparing the tax to them under different forms of investment, using regular C corporation blockers and alternatively using REIT blockers. Go ahead, Tom.

U.S. TAXATION OF FOREIGN INVESTORS IN GENERAL

Tom Phelan (01:36):

Just setting the stage on the general U.S. taxation of foreign investment into the U.S. Generally speaking, a non-U.S. investor is subject to tax in the U.S., in situations in which Congress has determined there is sufficient nexus or connection to operations in the U.S., that warrant U.S. taxation. The primary distinction between the two major types of taxation and the nature of the nexus that results in that type of taxation are, one, taxation when a foreign investor is treated as engaged in a trade or business in the United States, and the second being when that U.S. investor is making more of a passive investment portfolio type investment that generates what we call FDAP, or Fixed, Determinable, Annual, or Periodical income, which is stuff like interest, dividends, stuff to that effect, which usually is indicative of a lower level of connection to operations in the U.S.

(02:31):

Very generally, the distinction is that if you're engaged in a trade or business in the U.S., then a foreign investor is generally taxable on their income on a net income basis at graduated rates, just like as a U.S. taxpayer would be, and they're generally required to file a U.S. tax return, being federal, state, and local as well. For portfolio-like investments, like an investment in a stock, issued by a U.S. corporation, or debt issued by a U.S. corp, generally they're taxed based on the source of the income and are subject to withholding when that income is paid out, right? The U.S. corp pays a dividend subject to withholding.

(03:12):

So, with respect to whether someone's engaged in a trade or business in the U.S., the discussion is really well beyond the scope of this podcast, but it's very much a factual question, depending on the nature of the business contacts that the person has with the U.S., and looking for particularly continuous, systematic and ongoing contacts, there's special rules for employees and then depending contractors depending on where they're located, but it's a fact-based thing. Notably, if you're engaged in a trade or business in the U.S., or if you invest in a partnership that's engaged in a trade or business in the U.S. as a foreign person, then the act of trade or business of that partnership is imputed up to the partner.

(03:56):

Generally, that's not the case if you invest in a corporation which can serve as a blocker, and we'll talk about that a bit more. For a portfolio like investments, like investments in stock and owning debt, other things like royalty, they create FDAP income, again, that's generally taxed through withholding, I think we mentioned that, right? If you own stock in a U.S. corporation and it pays dividends to a foreign shareholder, those dividends are U.S. sourced, by nature of the fact that it's a U.S. corporation that's paying the dividend, that's sufficient nexus to the U.S. to warrant taxation, and it's generally subject to a 30% withholding tax, subject to things like treaty reduction and also FACA status of the holder. If you hold stock in a corporation, generally speaking, and you're a foreign investor, the disposition of the stock, the sale of the stock, typically is taxed sourced to the resident of the selling party.

(04:53):

So, if you're a foreign person and you sell stock, you're generally not subject to tax because it's foreign source income, and it's just entirely not subject to U.S. tax unless for some reason that capital gain is effectively connected with the U.S. trader business.

U.S. TAXATION OF FOREIGN INVESTOR'S INCOME FROM U.S. REAL ESTATE – IN GENERAL

When it comes to investment in real estate, there are certain special rules. A rent earned from a real estate investment is generally subject to the same rules that we discussed before, with respect to classification as effectively connected income, if it's associated with the trader business, or FDAP, if it's just rent received from a U.S.-based property. But there's special rules with respect to the disposition of U.S. real property interests, and generally speaking, those rules fall under what we call the FIRPTA rules, and they treat gain from the disposition of a U.S. real property interest as effectively connected income for tax purposes.

(05:45):

So, this means that even portfolio type like investments in U.S. real property can be subject to U.S. tax on disposition. So, what does the U.S. real property interest? Generally speaking, it's just any real property interest that's located in the U.S., if they own a building, or a mine, or anything else that's classified as U.S. real property. Notably interest in U.S. real property holding companies are also U.S. real property interest. So, a U.S. real property holding company is a domestic corporation, where 50% or more of the total value of its assets are U.S. real estate assets. So, if you own an interest in a U.S. real property holding company and you sell that stock, generally a foreign person wouldn't be subject to tax on the sale of stock, but if it's a U.S. real property holding company, under the FIRPTA rules they are subject to U.S. tax on the gain from the sale of the stock, and that tax is generally collected via withholding. With that general background, I'll pass it over to Saba to talk about how this applies in the context of REITs.

COMPARING STRUCTURES: FUND MAKES U.S. REAL ESTATE INVESTMENT VIA C-CORPORATION BLOCKER VERSUS VIA REIT

Saba Ashraf (06:52):

Thanks, Tom. We thought it might be helpful for Aresh and I to walk you through an investment structure where the fund is using C corporation blockers to make the investment in real estate, and alternatively where it's using REIT to make the investment, and the difference in tax treatment to the investors, to the foreign investors. Now, I will say that there may be foreign investors that have come to the conclusion that they're fine with investing directly in a fund that doesn't have any blockers. It may be that a foreign investor perceives that due to significant upfront deductions that are often associated with real estate investments, there will be no taxable income in the early years, and they think it's just fine, it's in line with their planning, and they don't mind being subject to U.S. tax on a net basis and filing tax returns. So, in that case, they can always invest directly in a fund without having any blockers.

(07:45):

That's all fine. We're not addressing that. We're focused on foreign investors that are seeking to minimize tax return filing obligations and be blocked in some fashion. So, Aresh and I are going to focus on, I think it's helpful to think of the tax treatment for three different types of income that would be generated by the fund, one is dividends attributable to operating income, like rents, the second is dividends attributable to the sale of real property, like capital gains dividends by REITs, and the third is gain from the sale of either the stock of the blocker or the shares of the REIT.

OPERATING INCOME/DIVIDENDS: C-CORP BLOCKER VERSUS REIT

So, turning first to dividends attributable to operating income, like rental income, in the case of a C corporation blocker, the C corporation would pay 21% tax on its operating income, and maybe this corporate tax is reduced by deductions, maybe it's reduced in part because the C corporation blocker is a leverage blocker, capitalized partly with debt and partly with equity.

(08:48):

But there's that 21% tax rate, and when the dividends are paid by the C corporation to the fund, and in turn to the investors, including the foreign investors, the dividends would be FDAP and subject to withholding, if there's no treaty in effect, the withholding would be 30%, often with treaties, the rate is reduced to five or 15%. In the case of the REIT, if the REIT is used as the blocker, the tax consequences would be very similar. The dividends, to the extent of earnings and profits, would also be considered FDAP and be subject withholding at a rate of 30%, again, often specifically reduced for REIT dividends by treaties.

GAIN FROM SALE OF PROPERTY/CAPITAL GAIN DIVIDENDS: C-CORP BLOCKER VERSUS REIT

Turning next to the next stream of income would be dividends attributable to capital gains, so these would be dividends that are made either by the C corporation or the REIT from gain from the sale of property.

(09:47):

So, in the case of a C corporation blocker, the result would be very similar to the tax treatment of other dividends FDAP withholding. One key difference might be, in the case of a C corporation, is that if the C corporation is liquidating as part of that final distribution, in other words, let's say it was a single property C corporation blocker, it sold its property and now it's going to liquidate. In that case, the dividend would not be subject to withholding because liquidating distributions are generally not subject to withholding. You're still dealing with a corporate-level taxes payable by the blocker, which again may be somewhat reduced. Now, if the dividend were made by a REIT blocker, the foreign investors and the fund would still be subject. They would be subject to U.S. federal income tax and federal income tax filing obligations for those capital gain dividends.

(10:44):

So, the REIT does not provide a great advantage here if the dividends are, if they're going to be capital gains at the REIT level, and then they're going to be distributed to the foreign investors.

SALE OF EQUITY: C-CORP BLOCKER SHARES VERSUS SALE VERSUS REIT SHARES (Including Domestically Controlled REIT)

Gain from the sale of shares, of either the C corporation blocker or the REIT. Here, there can be a marked difference here in the tax treatment to foreign investors. In the case of a C corporation blocker, the gain would be considered gain from the sale of a U.S. real property holding corporation, which as Tom described, would be subject to U.S. taxes generally collected by withholding via FIRPTA. And then I'll turn it over to Aresh to discuss REITs.

Aresh Homayoun (11:25):

In the case of a sale of stock, one of the main benefits for offshore investors is having a REIT in the structure, because if a REIT is what we call a domestically controlled qualified investment entity, then the sale of the REIT stock is not going to be subject to FIRPTA, which is a significant benefit for offshore investors. And a REIT is domestically controlled for these purposes if less than 50% of its stock is held directly or indirectly by foreign persons at all times during a certain testing period, with the testing period basically being a five-year period up through the date of the disposition. So, that's a really big benefit is that without a REIT, with just a blocker, a C corporation blocker in the structure, the sale of stock is going to be subject to FIRPTA. Whereas, if there's a REIT in the structure and the REIT is domestically controlled, then there's going to be an exclusion from FIRPTA. Again, a big benefit.

(12:18):

And because that benefit is so significant for offshore investors, a lot of times REITs that think that they're going to have a significant offshore component will include transfer restrictions in their organizational materials such that transfers that could result in a REIT not being domestically controlled are going to be precluded. And so, by doing so, that's one way to ensure domestically controlled status, and therefore making sure the sales of stock are not going to be subject to FIRPTA. And for years, that was the position that we were in, and everyone was really, frankly, happy and content about it, and in 2023, the Treasury Department threw a curve ball to all of us. Because they issued proposed regulations that generally required REITs to look through nonpublic taxable domestic corporations and determining whether a REIT is domestically controlled. And that was in 2023, and at the time, as part of the proposed regulations, the look through threshold was 25%.

(13:27):

And so, relatively low threshold, and if you had 25% offshore investors in a blocker entity, then those would be included as part of determining whether you've got a domestically controlled REIT. And the issue is that a lot of REITs and JVs and real estate funds, they specifically engaged in tax planning with blocker corporations, comprised predominantly of offshore investors, to make sure that they did have a domestically controlled REIT. And so, when these rules came out, they were heavily criticized, mostly because most people, including myself, thought that they were inconsistent with existing tax law, and in particular a private letter ruling that specifically said that you don't look through for those purposes. And the Treasury was urged to pull the regulations, and they did not do so, and instead they bumped up the threshold from 25% to 50%. Which is helpful, but again, in cases where you're using blocker corporations for purposes of ensuring domestically controlled status, usually 25 to

50% isn't going to make that much of a difference for planning considerations.

(14:43):

So, that remains an issue, and there's a lot of work and attention being paid to it, but the final regulations also did include a transition rule. And under that transition rule, REITs were exempt for up to... Domestically controlled REITs were exempt up to 10 years if they met certain requirements. The requirements, it's a very helpful transition rule, but some of the requirements have to do with the amount of assets and control changes, and as a practical matter, again, less than ideal, this issue remains a work in progress. If you're in a situation where you're not engaging in specific tax planning and using blocker corporations, then having a domestically controlled REIT and the standard practices with respect to that are going to continue to be helpful. But for those real estate funds and JVs that are using blocker corporations, I think that's something that people are really looking at closely and thinking about ways to fall within the transition rule.

Saba Ashraf (15:41):

For foreign investors that are investing in REITs, Aresh already described this, but they will want to require the fund, one, to not only ensure that their REITs are domestically controlled, but also to exit through the sale of REIT shares rather than a sale of the underlying property. For the sponsor or the GP, the important thing to remember there is that one REIT holding all the property is not going to serve the foreign investor's goals unless the REIT is able to sell all the properties to a single or the REIT has a potential buyer that is interested in purchasing, or agreeable to purchasing all of the property. If that doesn't exist, then to achieve the foreign investor's goal will require essentially single property REIT.

[FOREIGN GOVERNMENT INVESTORS AND QUALIFIED FOREIGN PENSION FUNDS]

So, that's just a quick note as to special rules that apply to particular types of foreign investors, there are generally more favorable rules that can apply to foreign governmental investors under Section 892, and qualified foreign pension funds.

(16:47):

Qualified foreign pension funds, which are basically foreign funds established to provide retirement or pension benefits to current or former employees, they don't have large beneficiaries and they're subject to various forms of regulation and reporting. So, for them, they are exempt from FIRPTA. Therefore, they will not be subject to U.S. tax on REIT capital gains dividends, or on the gain on the sale of a U.S. blocker or U.S. REIT. They will, however, be subject to FDAP withholding on ordinary dividends, from a blocker or a REIT. And asked to form governments, they can qualify for complete elimination of withholding on ordinary dividends and on the sale of the REIT shares, as long as the governmental entity does not control the REIT. They would, however, continue to be subject to tax on capital gain dividends. So, with that, we wrap up this final installment on the benefits of REIT and look forward to seeing you on our next episode.

[UPDATE AS OF 10/20 RE DOMESTICALLY CONTROLLED REITS]

Saba Ashraf (17:37):

The podcast you just listened to was recorded a few days ago. Today, on October 20th, the treasury issued proposed regulations that touch on one of the topics we covered, specifically the topic of domestically controlled REITs and how they offer particular benefits to foreign investors.

Please do look at the advisory that we are simultaneously releasing. It is listed as a resource on this podcast page. It's titled, "[Taxpayer Favorable Proposed Regulations Would Repeal the "Domestic Corporation Look-Through Rule" for Domestically Controlled REITs.](#)" So as noted, they are taxpayer friendly. They do give more flexibility in qualifying as a domestically controlled REIT. So please do note that.

Thank you for tuning into this three-part series, focused particularly on the benefits of REITs to all classes of investors as well as the general partner. We hope you will tune in to our next episodes and series where we expect to focus on numerous topics of interest, including structuring by funds and GPs to ensure maximum utilization of Section 1202, characterization of preferred equity investments, management fee waivers, and other topics of interest.

Thank you again.

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