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CLIENT ALERT

IRS Publishes Final "Look-Through" Rules for Measuring Domestic Control of REITs

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The Internal Revenue Service has published final regulations (which can be accessed here) for determining whether a real estate investment trust ("REIT") qualifies as a "domestically controlled" REIT ("DC-REIT"), gain from the sale of which is not subject to tax under FIRPTA. The final regulations generally follow the proposed regulations (published December 29, 2022) and apply certain "look-through" rules, including with respect to a REIT's non-public domestic corporate shareholders, to determine whether a REIT qualifies as a DC-REIT. However, the final regulations increase the foreign ownership threshold required to look through a non-public domestic C corporation from at least 25% to more than 50%. Subject to certain exceptions, the final regulations provide a 10-year transition rule for structures existing as of their publication. New REITs should consider the final look-through rules when planning their holding structures, and existing REITs should consider investment activity and ownership changes that could affect their capacity to rely on the transition rules.

Background

Under Sections 897(a) and 1445 of the Internal Revenue Code (the "Code"), gain or loss of a foreign person from the disposition of a United States real property interest ("USRPI") is treated as income effectively connected with a U.S. trade or business subject to U.S. federal income taxation and withholding ("FIRPTA Taxation"). An interest in a DC-REIT is not treated as a USRPI and thus a sale or other disposition of a DC-REIT is not subject to FIRPTA Taxation. Under Section 897(h)(4)(B) of the Code, to qualify as "domestically controlled," the REIT must, at all times during the "testing period" (generally, the prior five-year period or, if shorter, the period during which the entity was in existence), have had less than 50% of the value of its stock held "directly or indirectly" by foreign persons. The final regulations address the meaning of indirect ownership by setting forth certain look-through rules.

Look-Through Rule

Under the look-through rules, whether a REIT qualifies as a DC-REIT must take into account indirect foreign ownership of the REIT held through “look-through persons.” If a REIT shareholder is classified as a look-through person, then the REIT’s stock would be proportionally attributed to such look-through person’s shareholders, partners or beneficiaries (as applicable), to be further attributed up the ownership chain to “non-look through persons.” Stock of a REIT attributed to a non-look through person is not further attributed to any other person, and the domestic or foreign status of such non-look through persons would determine whether the domestic ownership requirement is met for a REIT to qualify as a DC-REIT.

Under these rules, domestic C corporations are classified as non-look through persons and are therefore U.S. persons for purposes of the “domestically controlled” determination, so long as such corporations are not “foreign-controlled domestic corporations.” Foreign-controlled domestic corporations are defined as non-public domestic C corporations where foreign persons directly or indirectly own more than 50% of the fair market value of stock in such corporation. A foreign-controlled domestic corporation is classified as a look-through person. Accordingly, foreign shareholders holding their interest in the REIT through a foreign-controlled domestic corporation generally will be counted as foreign persons for purposes of the “domestically controlled” test, notwithstanding that the foreign-controlled domestic corporation is subject to U.S. federal income tax.

Furthermore, for purposes of determining the ownership of a REIT to establish its DC-REIT status, the final regulations also provide that a “qualified foreign pension fund” (“QFPF”) is treated as a foreign person, irrespective of whether the QFPF qualifies for an exemption from FIRPTA Taxation.

Transition Rule

Although the final regulations are effective as of April 25, 2024, the regulations provide a 10-year transition rule for existing structures that applies until April 24, 2034. Under the transition rule, until its expiration, the look-through rule for foreign-controlled domestic C corporations generally would not apply with respect to an existing REIT so long as (i) the REIT does not acquire, directly or indirectly, new USRPIs exceeding 20% of the fair market value of USRPIs held directly or indirectly by the REIT as of April 24, 2024, and (ii) the REIT does not undergo an aggregate increase in ownership by non-look through persons (considering application of the final look-through rule for domestic corporations) by more than 50 percentage points relative to their ownership as of April 24, 2024.

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