

April 30, 2024

Treasury and IRS Finalize Regulations Impacting the Determination of “Domestically Controlled REIT” Status

Agencies Adopt Proposed Regulations’ Controversial Look-Through Rule with Limited Modifications

SUMMARY¹

On April 24, 2024, the Internal Revenue Service (“IRS”) and the Treasury Department released final regulations (the “Final Regulations”) under Section 897 of the Internal Revenue Code of 1986, as amended (the “Code”), for determining whether a real estate investment trust (“REIT”) qualifies as a “domestically controlled REIT” (“DREIT”).^{2, 3} The Final Regulations retain the application of a look-through rule set forth in the proposed regulations issued in December 2022 (the “Proposed Regulations”) but increase the threshold of foreign ownership required to look through a domestic C corporation that owns a REIT from 25% or more to more than 50%. Further, the Final Regulations provide a ten-year transition rule for the application of the look-through rule to existing REIT structures.

BACKGROUND

Under the Foreign Investment in Real Property Tax Act of 1980 (commonly known as “FIRPTA”), a nonresident alien individual or foreign corporation that recognizes gain on the disposition of a “U.S. real property interest” (“USRPI”) is subject to U.S. federal income tax in the same manner as if such gain were effectively connected with a trade or business in the United States.⁴ Although equity interests in a domestic corporation that is a U.S. real property holding corporation are generally USRPIs, the Code provides an important exception to the foregoing rule that an equity interest in a DREIT is not a USRPI. Accordingly, gain on the disposition of stock in a DREIT is not subject to FIRPTA.⁵ A REIT is a DREIT for this purpose if, at all times during the testing period (the shorter of the five-year period ending on the date of the

disposition or the REIT's existence), less than 50% of the value was "held directly or indirectly" by foreign persons.⁶

DISCUSSION

Prior to the Proposed Regulations, there was limited guidance on how "indirect" ownership of REIT stock should be taken into account for purposes of determining whether a REIT qualifies as a DREIT. For example, if a U.S. corporation owns stock in a non-publicly traded REIT, and that U.S. corporation is owned (in whole or in part) by non-U.S. persons, it was unclear if the DREIT analysis could stop at the level of the U.S. corporation, with the REIT's stock being treated as owned by a U.S. person, or if it required looking through to the ultimate owners of the U.S. corporation.

The Proposed Regulations adopted a "look-through" approach to stock of a REIT. Under this approach, only stock of a REIT held by a "non-look-through person" would be treated as "held directly or indirectly" by that person, while stock of a REIT held by any intervening "look-through persons" would be treated as held proportionately by the person's owners that are non-look-through persons. "Non-look-through persons" would include individuals, domestic C corporations⁷ (but crucially, subject to the exception discussed below for 25%-or-more foreign-owned domestic corporations), foreign corporations (including foreign governments), nontaxable holders such as government entities, publicly traded partnerships, qualified foreign pension funds ("QFPFs") and entities that are wholly owned by one or more QFPFs. The term "look-through person" referred to any person that is not a non-look-through person, and would include, for example, a non-publicly traded REIT or a regulated investment company ("RIC"), an S corporation, a domestic or foreign non-publicly traded partnership, and a domestic or foreign trust.⁸

Importantly, the Proposed Regulations provided that, although a domestic C corporation would generally be a non-look-through person (and thus treated as a U.S. person for purposes of determining whether REIT stock held by such corporation is owned by a U.S. person), a non-publicly traded domestic C corporation would be a look-through person if foreign persons hold directly or indirectly 25% or more of the fair market value of its stock. In determining whether the 25% ownership threshold is satisfied, the look-through rule described above would apply.⁹

The Proposed Regulations were met with significant negative comments from both statutory interpretation and policy perspectives. Some commentators pointed out that Section 897(h)(4)(E) already provides rules on determining whether stock of a DREIT is held by a foreign person, and argued that the Proposed Regulations conflicted with congressional intent by creating additional circumstances of deemed foreign person ownership.¹⁰ The preamble to the Final Regulations counters that there is no evident congressional intent that Section 897(h)(4)(E) provides an exclusive list of such circumstance, and that it does not prescribe how to interpret the meaning of "indirectly" in Section 897(h)(4)(B), so the addition of the look-through rule is appropriate and necessary. Furthermore, the preamble notes that the Joint Committee on

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Taxation report's citation of a 2009 private letter ruling, which referred to Section 1.897-1(c)(2) to rule that a REIT held directly by two domestic C corporations with ultimate foreign owners was a DREIT, does not mean that Congress endorsed the interpretation taken by that ruling, as the citation was purely neutral, adding that the report caveated that a private letter ruling is not precedential and only provides some indication of administrative practice. Finally, some commentators believed it is not necessary to apply the look-through rule to domestic C corporations because they are already subject to U.S. taxation. The preamble responds that the policy of the DREIT rules "look to foreign control, not control by taxable person."¹¹

The Final Regulations provide limited relief to the application of the look-through rule to a non-public domestic C corporation by increasing the look-through threshold from 25% or more to more than 50%. The IRS and the Treasury Department agree that "the scope of the rule should be narrowed to address compliance concerns and to ensure the rule is more appropriately limited to situations where significant indirect ownership by foreign persons indicative of foreign control is present."¹² The new threshold thus limits the look-through to non-public domestic C corporations controlled by foreign persons, and is consistent with other provisions in Section 897 that are based on a more-than-50% threshold.

While the Proposed Regulations did not contain any grandfathering rule for REITs that currently rely on any foreign-owned domestic corporation's ownership of their stock for DREIT status, the Final Regulations agree with commentators' concern of such retroactive application, and provide a ten-year transition period that exempts existing structures from the final domestic C corporation look-through rule. However, the exemption is contingent on such structures meeting certain requirements, including not acquiring a significant amount of new USRPIs and not undergoing a significant change in ownership. Existing REITs that rely on foreign-controlled domestic corporations for their DREIT status must carefully monitor their operations to avoid losing exemption.

The Final Regulations also adopted the Proposed Regulations' clarification that a QFPF is considered a foreign person for DREIT determination. There has been uncertainty around this issue, as Section 897(l) provides QFPFs are not "nonresident alien individuals or foreign corporations." The preamble to the Final Regulations explains that the term "nonresident alien individuals or foreign corporations" in Section 897(l) and the term "foreign persons" in Section 897(h)(4)(B) have different definitions, while the two provisions serve different purposes. The preamble explains that there is no evidence of congressional intent that the definition of "foreign person" should confer non-foreign person status on QFPFs for purposes of the DREIT rules.

The Final Regulations are effective as of April 25, 2024.

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ENDNOTES

- 1 Unless otherwise provided, “Section” refers to a section of the IRC. The “IRC” citations contained herein refer to Internal Revenue Code sections.
- 2 The Final Regulations also apply to RICs that are or would be U.S. real property holding corporations under Section 897(h)(4).
- 3 Guidance on the Definition of Domestically Controlled Qualified Investment Entities, 89 Fed. Reg. 31618 (April 25, 2024).
- 4 IRC § 897(a)(1).
- 5 IRC § 897(h)(2).
- 6 IRC § 897(h)(4)(B).
- 7 Defined as a domestic corporation other than an S corporation, a REIT or a RIC.
- 8 Proposed Regulations § 1.897-1(c)(3).
- 9 Proposed Regulations § 1.897-1(c)(3)(iii)(B).
- 10 IRC § 897(h)(4)(E) generally provides that (i) a person holding at all times during the testing period less than 5% of a class of REIT stock that is regularly traded is treated as a U.S. person (unless the REIT has actual knowledge otherwise), (ii) any stock in a REIT held by a publicly traded REIT is treated as held by a foreign person, except that if the publicly traded REIT is domestically controlled, such stock is treated as held by a U.S. person, and (iii) any stock in a REIT held by a non-publicly traded REIT is only treated as held by a U.S. person in proportion to the stock of the non-public REIT that is held by a U.S. person.
- 11 89 Fed. Reg. 31622.
- 12 *Id.*, 31621.

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