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IRS and Treasury Issue Final Regulations Regarding Domestically Controlled REIT Qualification Test

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The Final Regulations modify the "look-through" rule for certain domestic C corporations, and introduce a new ten-year transition rule. On April 24, 2024, the IRS and Treasury issued final regulations for determining whether a real estate investment trust (a "REIT")[1] qualifies as a "domestically controlled qualified investment entity" (a "DREIT," and the final regulations, the "Final DREIT Regulations"). These regulations modify certain provisions of the regulations proposed by the IRS and Treasury in December 2022 (the "Proposed DREIT Regulations"), detailed in our previous Client Alert. Compared with the Proposed DREIT Regulations, the Final DREIT Regulations:

> (1) increase the threshold of foreign ownership required to look through a domestic C corporation that owns a REIT from 25 percent or more to more than 50 percent for purposes of determining whether the REIT qualifies as a DREIT (the "C Corporation Look-Through Rule"); (2) provide a ten-year transition rule for application of the C Corporation Look-Through Rule to existing REITs, subject to certain restrictions; and (3) clarify or modify certain rules relating to publicly traded entities, qualified foreign pension funds ("QFPFs"), and withholding taxes.

Background Subject to certain exceptions discussed below, section 897[2] and related sections added to the Code by the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") require foreign persons that recognize gain from the sale or disposition of a United States real property interest (a "USRPI") to file U.S. federal income tax returns reporting that gain and pay U.S. federal income tax on that gain at regular graduated rates, even if the gain is not otherwise effectively connected with the conduct of a U.S. trade or business. The definition of a USRPI is broad. In addition to including a wide array of interests in U.S. real estate (which itself is a very broad term) and interests in disregarded entities and certain partnerships that own U.S. real estate, USRPIs include equity interests in domestic corporations that are United States real property holding corporations ("USRPHCs"). Generally, a USRPHC is any corporation, including a REIT, if the value of its USRPIs represents at least 50 percent of the aggregate value of its real estate (both U.S. and non-U.S.) and business assets. Even though equity interests in domestic USRPHCs generally are treated as USRPIs, section 897(h)(2) provides that an interest in a DREIT is not a USRPI. Under section 897(h)(4), a REIT is a DREIT if less than 50 percent of the value of its stock is held "directly or indirectly" by "foreign persons" at all times during the shorter of (1) the 5-year period ending on the relevant determination date and (2) the period during which the REIT was in existence (the "Testing Period"). Importantly, gain recognized by a foreign person on the disposition of an interest in a DREIT is not subject to U.S. federal income tax under FIRPTA, even if the DREIT is a USRPHC. Foreign persons often seek to invest in U.S. real estate through DREITs because, in these structures, foreign persons can exit the investment via a sale of DREIT stock without being subject to U.S. tax on the gain or being required to file a U.S. tax return. **Proposed Regulations** Before the promulgation of the Proposed DREIT Regulations, there was relatively little guidance regarding when the stock of a REIT owned by one person was treated as held "indirectly" by another person for purposes of determining DREIT status.[3] The Proposed DREIT Regulations included a broad look-

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through rule for this purpose that applied to various types of passthrough and quasi-passthrough entities, including REITs, partnerships (other than publicly traded partnerships), S corporations, and RICs (the "Proposed Look-Through Rule").[4] The Proposed Look-Through Rule would have been implemented by imputing ownership of REIT stock to the owners of such entities *pro rata* based on the owners' proportionate interests in such entities.[5] Diverging from informal IRS guidance that treated domestic C corporations as non-foreign owners of REITs for purposes of determining DREIT status, the Proposed Look-Through Rule also would have applied to "foreign-owned domestic corporations."[6] Specifically, a "foreign-owned domestic corporation" was defined as any non-publicly traded domestic C corporation if foreign persons held directly or indirectly 25 percent or more of the value of its outstanding stock, applying certain look-through rules.[7] Thus, a "foreign-owned domestic corporation" would not have been treated as a domestic owner of a REIT; rather, ownership of the REIT's stock would have been imputed to the owners of the "foreign-owned domestic corporation" to determine if the REIT qualified as a DREIT. **Final Regulations** The Final DREIT Regulations generally maintain the provisions of the Proposed Look-Through Rule, with certain changes described below. *Increased Ownership Threshold for Foreign-Controlled Domestic C Corporations* The IRS and Treasury narrowed the scope of the C Corporation Look-Through Rule. Specifically, the IRS and Treasury increased the threshold of foreign ownership required to qualify as a foreign-controlled domestic C Corporation from 25 percent or more to more than 50 percent.[8] *Ten-Year Transition Rule for Existing REITs* Generally, the C Corporation Look-Through Rule and other provisions of the Final DREIT Regulations apply to transactions (*e.g.*, sales of REIT shares) occurring on or after April 25, 2024.[9] Importantly, however, the C Corporation Look-Through Rule does not apply to existing REITs until April 24, 2034, provided certain requirements are satisfied, as discussed below (the "Transition Rule").[10] Under the Transition Rule, the C Corporation Look-Through Rule does not apply until April 24, 2034 to a REIT in existence as of April 24, 2024, provided:

> (1) the REIT qualifies at all times on and after April 24, 2024 as "domestically controlled", taking into account all provisions of the Final DREIT Regulations other than the C Corporation Look-Through Rule; (2) the REIT does not directly or indirectly acquire, on and after April 24, 2024, USRPIs with an aggregate fair market value exceeding 20 percent of the aggregate fair market value of the USRPIs it holds directly or indirectly as of April 24, 2024; and (3) the percentage of the REIT's stock held directly or indirectly by one or more "non-look-through persons" does not increase by more than 50 percentage points over the percentage of the REIT's stock held directly or indirectly by such non-look-through persons as of April 24, 2024.[11]

For purposes of the second requirement, the fair market value of a REIT's USRPIs as of April 24, 2024 is the value the REIT used for purposes of its REIT asset testing as of March 31, 2024.[12] The fair market value of any USRPI acquired after March 31, 2024 must be determined as of the date the USRPI is acquired "using a reasonable method," as long as the REIT "consistently" uses the same method with respect to all of its USRPIs for purposes of the Transition Rule.[13] If a REIT violates any of these requirements, the C Corporation Look-Through Rule will begin to apply to that REIT on the day after the REIT first violates the requirement.[14] Therefore, a REIT that becomes ineligible for the Transition Rule can still apply the Transition Rule to the portion of its Testing Period ending on the day the REIT violates the Transition Rule requirement. *Other Rules* In addition to the rules described above, the Final DREIT Regulations clarify or modify the following rules:

- Consistent with the Proposed DREIT Regulations, a QFPF and a "qualified controlled entity" is a foreign person for purposes of determining whether a REIT is domestically controlled.[15]
- In a departure from the Proposed DREIT Regulations, subject to the limitation described below, a publicly traded RIC generally is treated as a non-look-through

person.[16] This aligns the treatment of publicly traded RICs with the treatment of publicly traded C corporations and publicly traded partnerships.

- Under a newly introduced rule, a publicly traded domestic C corporation, publicly traded RIC, or publicly traded partnership will be treated as a look-through person if the REIT being tested for DREIT status has actual knowledge that the public domestic C corporation, publicly traded RIC, or publicly traded partnership is foreign controlled.[17]
- A publicly traded REIT is permitted to treat as a U.S. person that is a non-look through person any person holding less than 5 percent of the REIT's U.S. publicly traded stock ("5 Percent Person"), unless the REIT has actual knowledge that the 5 Percent Person is a non-U.S. Person or is foreign controlled (treating the 5 Percent Person as a non-public domestic C corporation for this purpose).[18]
- To avoid section 1445 withholding on the transfer, a transferee of an interest in a DREIT can rely on a statement issued by the DREIT certifying that the interest is not a USRPI.

The IRS and Treasury declined to provide guidance in the Final DREIT Regulations on how a domestic C corporation certifies to a REIT whether it is foreign controlled, or any other guidance on procedures for determining whether a REIT will qualify as a DREIT, including what records a REIT must maintain in this regard. **Takeaways** Sponsors of, and investors in, existing and new REITs intended to qualify as DREITs should consider evaluating whether those REITs qualify as DREITs under the Final DREIT Regulations. Sponsors also should review the information, representations, and covenants that they request from investors in determining whether a REIT will qualify as a DREIT and should consider what records to maintain with respect to their determination of DREIT status. Further, REIT sponsors should consider any obligations they may have to cause a REIT to qualify as a DREIT. Sponsors of and investors in existing REITs that seek to rely on the Transition Rule to continue to be classified as DREITs should consider limiting acquisitions of new USRPIs by, and changes of ownership in, these REITs so as not to cause the Transition Rule to cease to apply before April 24, 2034. In particular, sponsors and investors should be aware that seemingly innocuous changes in the indirect ownership of a REIT (*e.g.*, restructurings that do not change the ultimate beneficial ownership of the REIT) could inadvertently cause the Transition Rule to cease to apply to the REIT.

_____ [1] The rules also apply to certain registered investment companies ("RICs"). In our discussion, however, we focus on REITs and DREITs because foreign persons are more likely to invest in U.S. real estate through REITs than through RICs. [2] Unless indicated otherwise, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the Treasury regulations promulgated under the Code. [3] See our previous Client Alert for a discussion of the available guidance before the promulgation of the Proposed DREIT Regulations. [4] Prop. Treas. Reg. § 1.897-1(c)(3)(ii)(B). [5] *Id.* [6] *Id.* See our previous Client Alert for more details. [7] Prop. Treas. Reg. § 1.897-1(c)(3)(v)(B). [8] Although the Proposed DREIT Regulations refer to these entities as "foreign-owned domestic corporations," the Final DREIT Regulations refer to these entities as "foreign-controlled domestic corporations." 89 F.R. 31621; Treas. Reg. § 1.897-1(c)(3)(v)(B). [9] Treas. Reg. § 1.897-1(a)(2). [10] Treas. Reg. § 1.897-1(c)(3)(vi). [11] Treas. Reg. § 1.897-1(c)(3)(vi)(A). There is an exception for acquisitions of USRPIs or interests in the REIT pursuant to a written agreement that was binding before April 24, 2024. Treas. Reg. § 1.897-1(c)(3)(vi)(E). [12] Treas. Reg. § 1.897-1(c)(3)(vi)(B)(1), (C). [13] Treas. Reg. § 1.897-1(c)(3)(vi)(D). [14] *Id.* [15] See our previous Client Alert for further discussion of QFPFs and qualified controlled entities. [16] For purposes of the Final DREIT Regulations, the term "public RIC" (that is, a publicly traded RIC) excludes a RIC that is also a "qualified investment entity." Treas. Reg. § 1.897-1(c)(3)(v)(I); I.R.C. § 897(h)(4)(A). [17] To test whether a RIC is foreign controlled, the Final DREIT Regulations treat the RIC as a non-public domestic C corporation. Treas. Reg. § 1.897-1(c)(3)(v)(I). [18] Treas. Reg. § 1.897-1(c)(3)(iii)(A). Under the Proposed DREIT Regulations, 5 Percent Persons were considered non-look-through U.S. persons unless the REIT had actual knowledge that the 5 Percent Person

was not a U.S. person.

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