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Final 'domestically controlled REIT' regulations retain corporate look-through with some modifications

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On April 24, 2024, the Treasury Department released final regulations that alter key rules affecting many real estate funds and foreign investors in U.S. real estate.

The final regulations (like the proposed regulations, discussed in our January 3, 2023, client alert)[1] require a real estate investment trust (REIT) to look through certain taxable domestic corporations in determining whether the REIT is domestically controlled, with two key differences from the proposed regulations:

(1) The foreign ownership threshold that triggers this "look-through rule" was increased from 25% to 50%.

(2) The final regulations include a transition rule grandfathering existing ownership structures for up to 10 years if certain requirements are met.

Look-through of taxable corporations appears to be inconsistent with the Code and congressional intent, prompting harsh criticism of the proposed regulations.

Although these changes may at first glance seem to narrow the application of the look-through rule, many real estate funds, private equity funds, real estate joint venture (JV) participants and other non-U.S. investors in U.S. real estate will remain impacted.

Background

Under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), contained principally in Section 897 of the Internal Revenue Code (the Code), a foreign investor that recognizes gain on a "United States real property interest" (USRPI) is subject to tax on that gain at regular U.S. tax rates, as if they were a U.S. person.

The term USRPI includes direct interests in real property as well as equity interests in a domestic "U.S. real property holding corporation" (USRPHC). The term USRPHC generally includes any corporation if a majority of its assets consists of USRPIs.

Importantly, equity interests in a "domestically controlled REIT" are not USRPIs, regardless of the quantum of real estate owned by the REIT. A REIT is domestically controlled if less than 50% of its stock is held "directly or indirectly" by foreign persons at all times during a testing period (generally, the five-year period preceding the sale of the REIT's stock).

The Code does not specify what "indirect" ownership encompasses for this purpose and, in particular, whether and to what extent a REIT must look through a domestic C corporation to the C corporation's shareholders.

Final regulations

The domestic control look-through rule

As noted above, the proposed regulations required a REIT to look through any nonpublic domestic corporate shareholder to determine whether the REIT is domestically controlled if more than 25% of that shareholder's stock (by value) is owned by foreign persons.

As discussed in our prior client alert,[2] look-through of taxable corporations appears to be inconsistent with the Code and congressional intent, prompting harsh criticism of the proposed regulations and leading many commentators to advocate for complete withdrawal of the look-through rule. Treasury, unwilling to fully withdraw the rule, attempted in the final regulations to narrow it by increasing the foreign ownership threshold from 25% to 50%.

While the increase in the applicable threshold theoretically narrows the scope of the look-through rule, it is unlikely to significantly reduce the impact of the rule in practice.

Many private equity funds, real estate funds and JVs and other investors in private REITs have created structures whereby certain foreign investors who are willing to bear corporate-level tax are investing in a REIT indirectly through domestic corporate "blockers." In many cases, those structures are designed primarily to shield those foreign investors from the administrative burdens of owning REIT shares directly, such as U.S. tax return filing obligations.

In most of these structures, the blocker is owned entirely or almost entirely by non-U.S. persons, because it is generally inefficient for

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U.S. investors to invest in a REIT through a blocker. As a result, most domestic C corporations that met the 25% threshold under the proposed regulations will also meet the 50% threshold under the final regulations.

The final regulations contain a transition rule that exempts existing domestically controlled REITs from the look-through rule for 10 years following finalization if certain conditions are met.

In promulgating the final regulations, Treasury rejected several other alternatives offered by commenters that taxpayers may have found more helpful — for example, a rule that would apply look-through only if the REIT and domestic taxable corporation had sufficiently overlapping ownership.

The transition rule

In response to criticism that the proposed regulations were effectively retroactive and thereby undermined tax planning that preceded the proposed regulations, the final regulations contain a transition rule that exempts existing domestically controlled REITs from the look-through rule for 10 years following finalization if certain conditions are met:

(1) The aggregate value of USRPIs acquired by the REIT after finalization cannot exceed 20% of the aggregate value of USRPIs held by the REIT as of finalization (the Asset Trigger).

(2) The REIT cannot undergo what is essentially a 50% ownership change (measured by value) following finalization (the Ownership Trigger).

Once an otherwise grandfathered REIT no longer meets either of these requirements, the transition rule ceases to apply.

Although the transition rule is helpful and likely to preserve the tax planning objectives of many foreign investors in U.S. real estate, many others will find the rule to be of little consolation. Doubtless many investors wishing to benefit from the transition rule will wake up one day to find that direct or indirect transfers of REIT shares have caused an Ownership Trigger.

A foreign investor in existing domestically controlled REITs should carefully monitor direct and indirect transfers, but in many situations restricting such transfers will not be possible, leaving the investor's continued qualification for the transition rule out of its hands.

Similarly, the Asset Trigger may be an issue for any REIT that has plans to grow — and, as described below, potentially also for many REITs that do not grow. In situations where the investors want to acquire new properties, they might consider establishing a new parallel REIT for the acquisitions; although the new REIT would not be grandfathered, this may at least preserve any existing REIT's eligibility for grandfathering.

But a parallel REIT may not be feasible where the investors, instead of looking to acquire new properties, want to develop their existing properties. Whether development would cause an Asset Trigger once the value of improvements hits the 20% threshold remains an open question.

It is similarly unclear whether a REIT that replaces, rather than adds to, its existing portfolio can cause an Asset Trigger. For example, assume a REIT that owns a $100 portfolio of properties sells one $30 property and acquires another $30 property in its place, as in a typical Section 1031 like-kind exchange.

A literal reading of the transition rule arguably does not permit the disposition to offset the acquisition, thereby causing an Asset Trigger. And a separate parallel REIT could not be used in this case without disqualifying the transaction as a tax-deferred 1031 exchange.

It is also unclear whether ordinary course maintenance or repairs count as "acquisitions" under the transition rule — for example, where a REIT pays $25 to repair or replace a damaged or simply worn roof, HVAC system or other structural component of a $100 building.

Finally, because the base against which the 20% threshold is measured is fixed at current asset value whereas the value of future acquisitions is presumably measured at the time of acquisition, inflation exacerbates all of these issues and is not accounted for in the transition rule.

Notes:

[1] https://bit.ly/3WwONLh

[2] *Id.*

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