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Memorandum

IRS Releases Final Regulations Under Section 897 on Domestically Controlled REITs

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On April 24, 2024, the Internal Revenue Service ("IRS") released final Treasury Regulations that address the determination of whether a qualified investment entity (which include real estate investment trusts ("REITs")) qualifies as domestically controlled under Section 897 of the Internal Revenue Code[1] (such regulations, the "Final Rules"). The Final Rules adopt the basic structure of the proposed Treasury Regulations (such regulations, the "Proposed Rules"), but modify the look-through rule for domestic corporations (the "Look-Through Rule") in a manner that will allow REITs to qualify as domestically controlled with a higher indirect percentage of foreign ownership than under the Proposed Rules. The Final Rules also provide a transition rule designed to mitigate the immediate impact of the final Look-Through Rule with respect to existing structures.

Background: The Proposed Rules

Section 897 ("FIRPTA") provides that foreign investors are generally subject to U.S. federal income tax as if they are engaged in a trade or business within the United States (i) on the disposition of a United States real property interest ("USRPI") and (ii) on distributions from REITs to the extent attributable to gain from the sale of USRPIs. However, an interest in a domestically controlled REIT is not treated as a USRPI (and a sale of its interest will not be taxable pursuant to FIRPTA). This exception allows foreign investors in a REIT to sell shares of the REIT without the gain being subject to U.S. federal income tax, if at least 50% of the value of the REIT shares was held "directly or indirectly" by U.S. persons for at least 5 years prior to the date of disposition (or, if shorter, the period during which the REIT was in existence).

Prior to the issuance of the Proposed Rules, there was no statutory or regulatory guidance on the meaning of "direct or indirect" ownership for purposes of determining whether this 50% threshold had been met, and whether "indirect" ownership required looking through an entity to determine its beneficial ownership. The Proposed Rules introduced a limited look-through approach for purposes of determining whether a REIT is domestically controlled by identifying two categories of owners: "look-through persons" and "non-look-through persons." Stock held by a look-through person is considered held by that look-through person's shareholders, partners, or beneficiaries (as applicable), in each case based on each owner's proportionate interest in the look-through person. If a shareholder, partner, or beneficiary is also a look-through person, the same look-through treatment

[1] All "Section" references are to the Internal Revenue Code of 1986, as amended.

applies until a non-look-through person is identified. Stock held by a non-look-through person is treated as held by that person.

Under the Proposed Rules and the Final Rules, a look-through person includes (i) non-publicly traded REITs and regulated investment companies ("RICs"); (ii) S Corporations, (iii) non-publicly traded partnerships (both domestic and foreign), and (iv) trusts (both domestic and foreign). Although U.S. C corporations are generally treated as non-look-through persons, the Proposed Rules and Final Rules prescribe special treatment in the case of certain foreign-owned domestic corporations, which are considered look-through persons. A "foreign-owned domestic corporation," as defined under the Proposed Rules, was a non-publicly traded domestic C corporation owned (by reference to fair market value) 25% or more, directly or indirectly, by foreign persons. These corporations were subject to the Look-Through Rule, with each foreign owner of the foreign-owned domestic corporation treated as owning a pro rata share of the REIT after applying the look-through approach discussed above.

Accordingly, if a REIT was held by one or more foreign-owned domestic corporations, the foreign owners of such corporations would be treated as owning a pro rata share of the REIT for purposes of determining whether the REIT was domestically controlled.

Summary of Principal Changes in the Final Rules as Compared With the Proposed Rules Relating to Domestically Controlled REITs

SCOPE OF THE LOOK-THROUGH RULE

The Final Rules narrow the scope of the Look-Through Rule as applied to non-publicly traded domestic C corporations by increasing the amount of foreign ownership required to treat such corporations as a look-through person. Under the Final Rules, a domestic C corporation whose stock is not regularly traded on an established securities market will not be treated as a look-through person unless it is owned (by reference to fair market value) more than 50% directly or indirectly by foreign persons (instead of 25% or more as provided in the Proposed Rules). Therefore, if a REIT is held by one or more non-publicly traded domestic C corporations, so long as 50% or less of the stock of each such corporation (determined by reference to the fair market value of such stock) is held by foreign persons, for purposes of determining whether the REIT is domestically controlled, the REIT stock will be considered to be held directly by the domestic corporations without regard to the indirect ownership in such corporations. The Final Rules replace the term "foreign-*owned* domestic corporation" with the new concept of "foreign-*controlled* domestic corporation," which reflects the change in the Look-Through Rule.

IMPACT OF ACTUAL KNOWLEDGE OF FOREIGN CONTROL

The Proposed Rules included a modification to the Look-Through Rule in certain cases where actual knowledge of foreign ownership or foreign control exists. In general, under the Proposed Rules, a person that owned less than 5% of U.S. publicly traded stock of a REIT was treated as a U.S. person that is a non-look-through person with respect to that stock, absent the REIT having actual knowledge that the 5% shareholder was not a U.S. person. The

Final Rules adopt this rule and further expand it to include situations where there is actual knowledge of foreign *control* (treating all owners as non-publicly traded domestic C corporations for purposes of this test).

The Final Rules also consider actual knowledge of foreign control in determining whether look-through treatment applies to a publicly traded domestic C corporation or publicly traded partnership. While the Proposed Rules provided non-look-through treatment for all publicly traded domestic C corporations and publicly traded partnerships, the Final Rules require such entities to be looked through if actual knowledge of foreign control exists.

OWNERSHIP BY QFPFS AND ITS IMPLICATIONS FOR THE DOMESTICALLY CONTROLLED REIT RULE

The Final Rules adopt the approach taken in the Proposed Rules of treating any qualified foreign pension fund as a foreign person for purposes of determining whether a REIT is domestically controlled.

Applicability Date and Transition Rules

The Final Rules generally apply to transactions occurring after April 24, 2024 (the "Applicability Date"). However, the Final Rules include a transition rule that, for a ten-year period (until April 24, 2034), exempts existing qualified investment entities from the final Look-Through Rule for domestic corporations, provided they meet certain requirements. A REIT that is domestically controlled without regard to the Final Rules qualifies for the transition rule if (1) the REIT does not acquire USRPIs after the Applicability Date whose fair market values exceed 20% of the aggregate fair market value of the USRPIs held by the REIT on the Applicability Date,[2] and (2) the ownership percentage of the REIT stock (determined by reference to fair market value of such stock) held directly or indirectly by one or more non-look-through persons does not increase by more than 50% in the aggregate over such persons' ownership percentage of the REIT stock measured on the Applicability Date. The requirements described in the preceding sentence will nevertheless be considered met if such acquisitions of USRPIs or of interests in a REIT are pursuant to a previous written commitment that was (subject to customary conditions) binding before the Applicability Date or certain tender offers announced prior to such date. Additionally, a publicly traded REIT may disregard transfers by any less than 5% owners, unless the REIT has actual knowledge of such person's ownership. If a REIT fails to meet the requirements described above during the ten-year period, the transition rule will cease to apply to the REIT from the date on which the requirements cease to be met, and the REIT will be subject to the final Look-Through Rule for domestic C corporations at that time.

The actual protection offered by the transition rule will depend on the lifecycle stage of any given REIT. While REITs that are generally static, winding down or in the process of liquidation may be afforded protection by this

[2] For purposes of determining the value of the USRPIs held by the REIT on the Applicability Date, a REIT may use the most recently calculated amount under the quarterly asset test described in Section 856(c)(4).

rule, REITs in the start-up and portfolio acquisition phase will need to be especially mindful of the impact of the Final Rules on any existing structures.

Important Considerations

Investment funds and fund managers, particularly those focused on real estate investments utilizing private REITs, should be aware that the Final Rules may be relevant for transactions that occur after the Applicability Date (except to the extent the transition rule applies) for determining whether an entity qualifies as domestically controlled for any relevant testing periods. Additionally, as a result of transactions at the investor level (which may not be readily apparent to the sponsor), it may be impossible to determine with certainty at any particular time whether a REIT is domestically controlled in applying the Look-Through Rule. For example, a domestic corporation that is treated as a U.S. holder at the time of the acquisition of REIT shares may subsequently become a subsidiary of a foreign corporation which may prematurely terminate the application of the transition rule and invoke the Look-Through Rule discussed above.

In addition, the Final Rules acknowledge the importance of identifying foreign ownership of the direct and indirect owners of a REIT, but do not prescribe a specific form or method governing how such information may be solicited from its owners. Consideration should be given to ensure that a REIT, or a fund investing through a REIT, is able to request such information from its owners throughout the life of the REIT, and maintain appropriate records, to enable it to determine whether it is domestically controlled.

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