



# Final Rules on Measuring Domestic Control of REITs

Newly issued final Treasury Regulations address when a real estate investment trust (“REIT”) is “domestically controlled,” which directly impacts foreign investors.

On December 29, 2022, the Treasury Department and the IRS published proposed regulations (REG-100442-22) relating to, among other things, the determination of whether a qualified investment entity (“QIE”) such as a REIT is “domestically controlled” under section 897(h)(4)(B) of the Internal Revenue Code (the “Code”) and the Federal tax treatment of certain entities, such as qualified foreign pension funds (“QFPFs”) in the Federal Register (87 FR 80097) (the “Proposed Regulations”).<sup>1</sup>

The Treasury Department has finalized the proposed regulations (the “Final Regulations”) other than those addressing the tax treatment of foreign governments under Code section 892, which will be addressed in a separate Treasury Decision.<sup>2</sup> The final regulations are to be published in the Federal Register on April 25, 2024 and are available online at <https://federalregister.gov/d/2024-08267> and on <https://govinfo.gov>.

By way of background, a foreign investor in a domestically controlled REIT (“DCR”) generally is not subject to U.S. taxation upon the sale of DCR shares.<sup>3</sup> A REIT is “domestically controlled” if foreign persons hold directly or indirectly less than 50 percent of the fair market value of the stock at all times during the testing period (generally a

five-year look-back period).<sup>4</sup> A foreign person who holds stock in a REIT via a passthrough entity, such as a limited partnership, would be treated as holding a proportionate amount of the REIT shares indirectly.<sup>5</sup> On the other hand, based on IRS private-letter ruling PLR 200923001 (February 26, 2009), a foreign investor that holds REIT shares through a U.S. C corporation would not be treated as the indirect owner of the REIT shares.<sup>6</sup>

The Proposed Regulations were issued to address how foreign investors holding REIT shares through a domestic C corporation should be treated for purposes of determining DCR status. To the surprise of many (in light of the 2009 PLR) the Proposed Regulations treated non-publicly traded domestic C corporations as look-throughs if foreign persons hold a 25% or greater interest (by value) in the domestic C corporation.<sup>7</sup>

The Final Regulations, in response to many comments from tax practitioners, narrowed the scope of the Proposed Regulations to address compliance concerns and to ensure the corporate look-through rule applies only where foreign control exists.

As a result, the Final Regulations increased the amount of foreign ownership required to look through a non-public domestic C corporation from 25% or more to over 50%.<sup>8</sup>

The increased threshold is intended to significantly narrow the applicability of the look-through treatment of non-public domestic C corporations to those that are controlled by foreign persons.

A simple example illustrates the general application of the Final Regulations. A REIT is 51% owned by a non-public domestic C corporation, and 49% is owned directly by a non-U.S. individual. The domestic C corporation is owned 60% by a non-U.S. corporation and 40% by a U.S. individual. Because a non-U.S. corporation owns more than 50% of the domestic C corporation, the domestic C corporation is treated as foreign controlled and a look-through for purposes of determining the REIT's DCR status. The non-U.S. corporation is treated as owning indirectly 30.6% of the REIT (60% x 51%). When added to the 49% of the REIT shares owned directly by a non-U.S. individual, the REIT is considered to be owned 79.6% by non-U.S. persons. Therefore, the REIT is not domestically controlled. As a result, a sale by the non-U.S. individual of the shares owned directly will be subject to U.S. taxation (of course, the REIT shares owned by the U.S. corporation will be subject to U.S. tax when sold, pursuant to general Federal tax principles).<sup>9</sup>

The Final Regulations stipulate that existing structures will be exempt from the corporate look-through rule until April 24, 2034, provided the existing REIT does not acquire a significant amount of new U.S. real property and does not undergo a significant change in ownership (subject to an exception for acquisitions of U.S. real property or change of ownership pursuant to a previous binding commitment).<sup>10</sup> If either of these two requirements is violated, the REIT at that time becomes subject to the final domestic corporation look-through rule, like any other REIT.<sup>11</sup>

A REIT is considered to have acquired a significant amount of new U.S. real property if the total fair market value of U.S. real property it acquires, directly and indirectly, exceeds 20% of the fair market value of the U.S. real property it holds, directly and indirectly, as of the filing of the Final Regulations with the Federal Register.<sup>12</sup>

In determining whether there has been a significant change in the REIT's ownership, the Final Regulations look to see if the direct or indirect ownership of the REIT by non-look-through persons has increased by more than 50 percentage points in the aggregate relative to the REIT stock owned by such non-look-through persons as of the filing of the Final Regulations with the Federal Register.<sup>13</sup> Because this rule applies on a percentage basis, a non-pro-rata issuance or redemption of stock is counted towards the 50 percentage point amount (transfers by persons owning less than 5% of the REIT stock are disregarded for this purpose).

Once the transition rule no longer applies, the final domestic corporation look-through rule is prospective only.<sup>14</sup> The preamble to the Final Regulations offers, as an example, if the transition rule ceases to apply to a REIT due to a change in its ownership but, at such time, the REIT is a DCR notwithstanding the look-through rule, the determination of domestic control for the testing period of a subsequent disposition of QIE stock may disregard the final domestic corporation look-through rule to the extent the transition rule applied.

In addition, the Proposed Regulations provided that QPPFs (which are not treated as foreign for purposes of their own U.S. taxation) are treated as foreign persons for determining DCR status. The Final Regulations adopt the Proposed Regulations treatment of QPPFs as foreign for purposes of determining DCR status.

#### STEPHEN BERTONASCHI

Senior Managing Director,  
Leader of Real Estate Tax Compliance  
+1 973.852.8174  
stephen.bertonaschi@fticonsulting.com

#### SCOTT DRAGO

Managing Director  
+1 646.632.3864  
scott.drago@fticonsulting.com

*The views expressed herein are those of the author(s) and not necessarily the views of FTI Consulting, Inc., its management, its subsidiaries, its affiliates, or its other professionals. FTI Consulting, Inc., including its subsidiaries and affiliates, is a consulting firm and is not a certified public accounting firm or a law firm.*

FTI Consulting is an independent global business advisory firm dedicated to helping organizations manage change, mitigate risk and resolve disputes: financial, legal, operational, political & regulatory, reputational and transactional. FTI Consulting professionals, located in all major business centers throughout the world, work closely with clients to anticipate, illuminate and overcome complex business challenges and opportunities. © 2024 FTI Consulting, Inc. All rights reserved. [fticonsulting.com](https://www.fticonsulting.com)

## Endnotes

<sup>1</sup> REG-100442-22. <https://www.federalregister.gov/documents/2022/12/29/2022-27971/guidance-on-the-foreign-government-income-exemption-and-the-definition-of-domestically-controlled>.

<sup>2</sup> Federal Register; Vol. 89, No. 81, 26 CFR, Part 1, TD 9992. <https://www.govinfo.gov/content/pkg/FR-2024-04-25/pdf/2024-08267.pdf>.

<sup>3</sup> Treasury Regulation 1.897-1(c)(2). <https://www.law.cornell.edu/cfr/text/26/1.897-1>.

<sup>4</sup> Code Section 897(h)(4)(B). <https://www.taxnotes.com/research/federal/usc/26/897>.

<sup>5</sup> Id.

<sup>6</sup> IRS private letter ruling PLR 200923001. <https://www.irs.gov/pub/irs-wd/0923001.pdf>.

<sup>7</sup> Proposed Treasury Regulation Sections 1.897-1(c)(3)(iii)(B) and (c)(3)(v)(B). <https://public-inspection.federalregister.gov/2024-08267.pdf>.

<sup>8</sup> Treasury Regulation Section 1.897-1(c)(3)(vi)(B). <https://www.law.cornell.edu/cfr/text/26/1.897-1>.

<sup>9</sup> Id.

<sup>10</sup> Id.

<sup>11</sup> Id.

<sup>12</sup> Federal Register; Vol. 89, No. 81, 26 CFR, Part 1, TD 9992 <https://www.govinfo.gov/content/pkg/FR-2024-04-25/pdf/2024-08267.pdf>.

<sup>13</sup> Treasury Regulation 1.897-1(c)(2). <https://www.law.cornell.edu/cfr/text/26/1.897-1>.

<sup>14</sup> Id.