

IRS Issues Proposed Regulations Impacting the Determination of Domestically Controlled REIT Status

A Practical Guidance® Article by Shiukay Hung, Joshua Lingerfelt, Allen Ashley, Katie LaKoma, Matthew Hilowitz, and Allan Bowen, DLA Piper LLP (US)



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On December 29, 2022, the Treasury Department and the Internal Revenue Service (the IRS) published proposed regulations (the Proposed Regulations) in the Federal Register under Section 897 of the Internal Revenue Code of 1986 (26 U.S.C. § 897), as amended (the Code) that would significantly modify the interpretation of the definition of “domestically controlled” real estate investment trust (REIT) status. In particular, the Proposed Regulations would disallow the common practice of foreign investors using a foreign-owned domestic corporation to create a domestically controlled REIT which was permitted under prior guidance. This practice note will review the determination of domestically controlled REIT status under prior guidance and the proposed changes under the Proposed Regulations. The guidance in this practice note is current as of December 29, 2022.

For further guidance on REITs, see [Real Estate Investment Trusts](#). For guidance on using REITs for commercial real estate purposes, see [REITs: Use in Commercial Real Estate Transactions](#). For an overview of tax considerations that arise in many REIT transactions, see [REIT Tax Considerations](#).

Overview and Background

Under the Foreign Investment in Real Property Tax Act of 1980 (commonly known as FIRPTA), foreign investors are generally taxed on gain or loss upon disposition of US real property investments in the same manner as if the foreign investor were engaged in a trade or business within the US and if such gain or loss were effectively connected with such trade or business.

One of the exceptions to the application of FIRPTA frequently relied on by foreign investors is the sale of stock in a domestically controlled REIT. A domestically controlled REIT is a REIT in which non-US persons hold directly or indirectly less than 50% of the interests in the REIT. Accordingly, foreign investors frequently acquire US real estate through a domestically controlled REIT and structure their exit in US real estate as a sale of shares in such domestically controlled REIT instead of a sale of a fee simple interest in order to avoid the FIRPTA tax. Therefore, the determination of whether a REIT is domestically controlled is often critical to a foreign investor's investment decision.

Determination of Domestically Controlled REIT Status Under Prior Guidance

Section 897(h)(4)(B) generally provides that a domestically controlled REIT is a REIT in which less than 50% in value of the stock is held "directly or indirectly" by foreign persons. The Code does not provide specific guidance interpreting the words "directly or indirectly."

The IRS considered whether a foreign-owned US corporation should be viewed as a US person for purposes of determining whether a REIT is domestically controlled in Private Letter Ruling 200923001 (June 5, 2009) (the Ruling). The REIT that was the subject of the ruling was held by two domestic corporations that were owned in part by foreign shareholders. The IRS concluded that the REIT was considered to be "domestically controlled" even though the REIT was indirectly owned by a foreign corporation. The Ruling refers to 26 C.F.R. § 1.897-1(c)(2)(i), which provides that "the actual owners of stock, as determined under Section 1.857-8, must be taken into account." 26 C.F.R. § 1.857-8(b) provides that the actual owner of stock of a REIT is the person who is required to include in gross income any dividends received on the stock. The Proposed Regulations do not retain the reference to 26 C.F.R. § 1.857-8 in 26 C.F.R. § 1.897-1(c)(2)(i).

The Ruling concluded that the domestic C corporations would be considered domestic holders of REIT stock, even though the domestic corporations were owned by foreign shareholders, on the rationale that the corporations were fully taxable as domestic C corporations and were required to include in their income, and pay tax on, any distributions from the REIT.

In addition, the legislative history of the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act) supports this conclusion. The legislative history cited the Ruling's conclusion that the term "directly or indirectly" for purposes of Section 897(h)(4)(B) does not require looking through domestic C corporations.

Determination of Domestically Controlled REIT Status Under the Proposed Regulations

Look-Through Persons and Non-Look-Through Persons

The Proposed Regulations introduce a new concept of look-through persons and non-look-through persons. Under the Proposed Regulations, in order to determine if a REIT is domestically controlled, it is necessary to review each look-through person until you reach a non-look-through-person.

A look-through person is any person other than a non-look-through person and includes a regulated investment company, a REIT, an S corporation, a non-publicly traded partnership (domestic or foreign), and a trust (domestic or foreign). A public REIT is treated as a foreign person that is a non-look-through person unless it is a domestically controlled REIT, in which case the public REIT is treated as a US person that is a non-look-through person.

A non-look-through person is an individual, a domestic C corporation (other than a foreign-owned domestic corporation), a nontaxable holder, a foreign corporation (including a foreign government pursuant to Section 892(a)(3)), a publicly traded partnership (domestic or foreign), an estate (domestic or foreign), an international organization (as defined in Section 7701(a)(18)), a qualified foreign pension fund within the meaning of Section 897(l) (a QFPF) (including any part of a QFPF), or an entity wholly owned by one or more QFPFs (a Qualified Controlled Entity). A person holding less than 5% of US publicly traded REIT stock is treated as a US person that is a non-look-through person with respect to that stock, unless the REIT has actual

(18)), a qualified foreign pension fund within the meaning of Section 897(l) (a QFPF) (including any part of a QFPF), or an entity wholly owned by one or more QFPFs (a Qualified Controlled Entity). A person holding less than 5% of US publicly traded REIT stock is treated as a US person that is a non-look-through person with respect to that stock, unless the REIT has actual knowledge that such person is not a US person.

A nonpublic-public domestic C corporation is treated as a look-through-person if it is a foreign-owned domestic corporation. A foreign-owned domestic corporation is any nonpublic-public domestic C corporation if foreign persons hold directly or indirectly 25% or more of the fair market value of the nonpublic-public domestic C corporation's outstanding stock. This means that, contrary to prior guidance discussed above, a REIT shareholder that is a private taxable domestic C corporation is a look-through person if 25% or more of the value of its outstanding stock is held by shareholders which are foreign persons. The Treasury Department and the IRS intend this new foreign-owned domestic corporation rule to prevent the use of intermediary domestic C corporations to create domestically controlled REITs.

No Attribution or Constructive Ownership Rules

While the Proposed Regulations import this new concept of look-through persons and non-look-through persons, they continue to rely only on actual chains of ownership and do not import the attribution or constructive stock ownership rules found in other parts of the Code (e.g., Sections 267 and 318).

QFPFs Treated as Foreign Persons

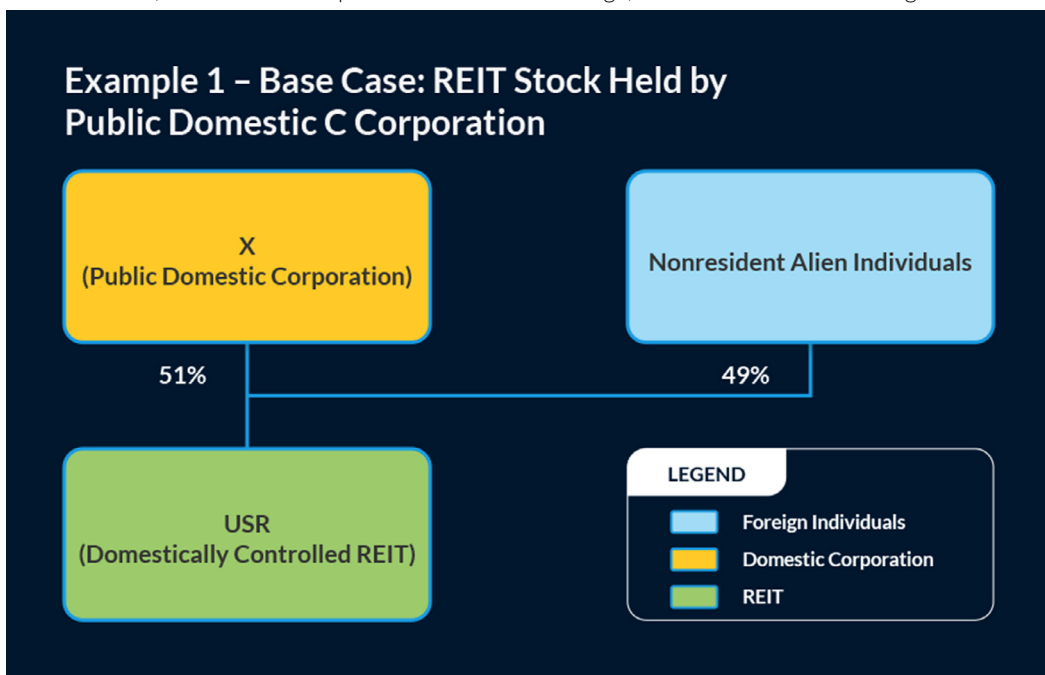
A technical reading of Section 897(l) might lead one to conclude that a QFPF or Qualified Controlled Entity is essentially viewed as a US person for purposes of exempting such entity from FIRPTA and such QFPF or Qualified Controlled Entity would count as a US person for purposes of the domestically controlled test. The Proposed Regulations clarify that such a technical reading is not the intent and that QFPFs and Qualified Controlled Entities are treated as foreign persons for the purposes of domestically controlled REIT status.

Illustrative Examples

The Proposed Regulations are complex and require careful analysis in each case. Helpfully, they include some examples illustrating the rules. We have diagrammed and included these examples below.

Example 1 – Base Case: REIT Stock Held by Public Domestic C Corporation

The following chart depicts an example wherein REIT stock is held by a public domestic C corporation. Foreign individuals are shaded in blue, the domestic corporation is shaded in orange, and the REIT is shaded in green.

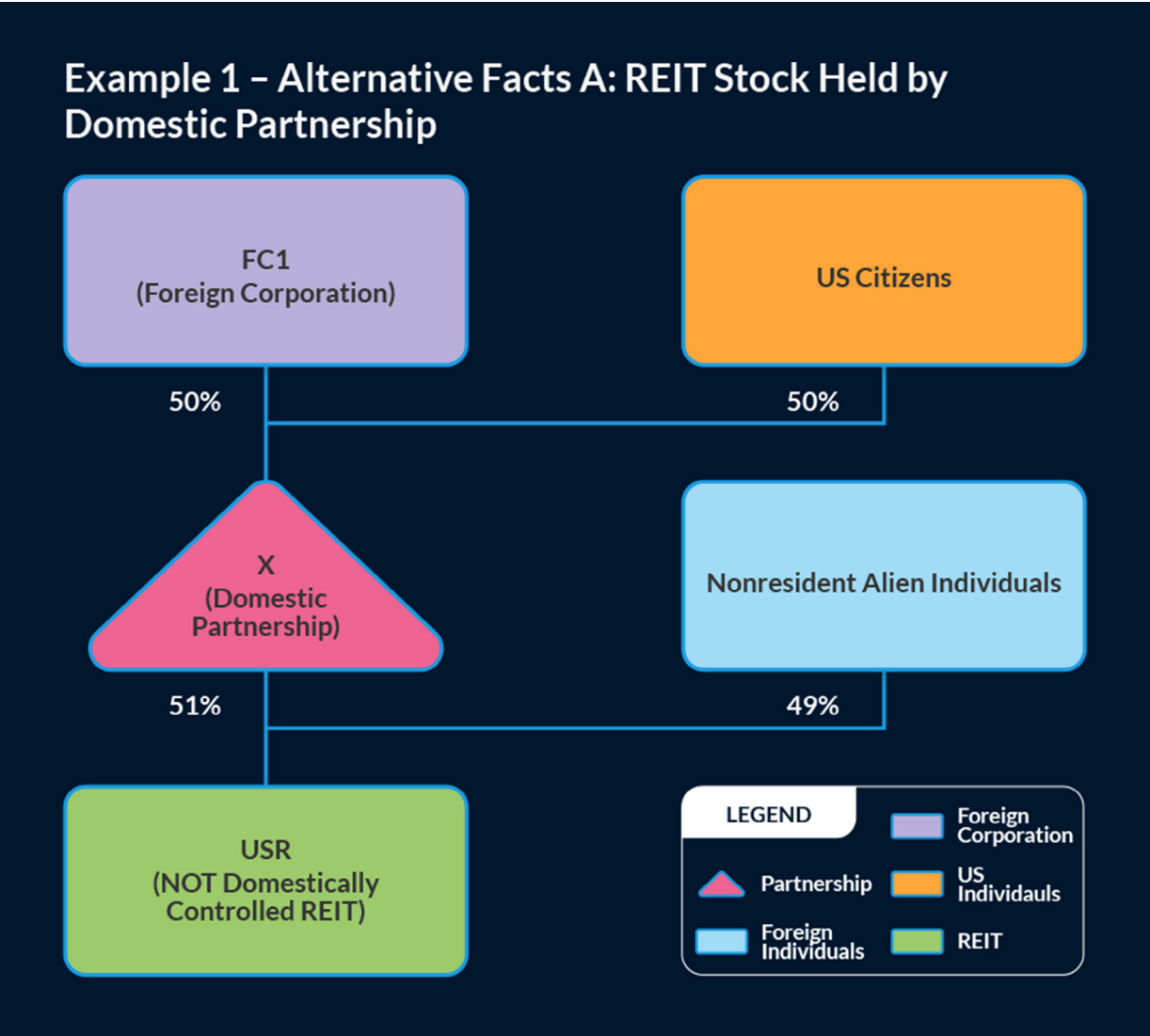


Visualization of Example 1- Base Case: REIT Stock Held by Public Domestic C Corporation

USR is a REIT. X is a non-look-through person. Thus, X is considered as holding directly or indirectly stock of USR for purposes of determining whether USR is a domestically controlled REIT. The USR stock held directly or indirectly by X is not considered held directly or indirectly by any other person, including the shareholders of X. Because X is not a foreign person and hold directly or indirectly 51% of the single class of outstanding stock of USR, foreign persons hold directly or indirectly less than 50% of the fair market value of the stock of USR, and USR is therefore a domestically controlled REIT.

Example 1 – Alternative Facts A: REIT Stock Held by Domestic Partnership

The following chart depicts an alternative scenario wherein REIT stock is held by a domestic partnership. The foreign corporation is shaded in purple, foreign individuals are shaded in blue, U.S. individuals are shaded in orange, the partnership is shaded in pink, and the REIT is shaded in green.

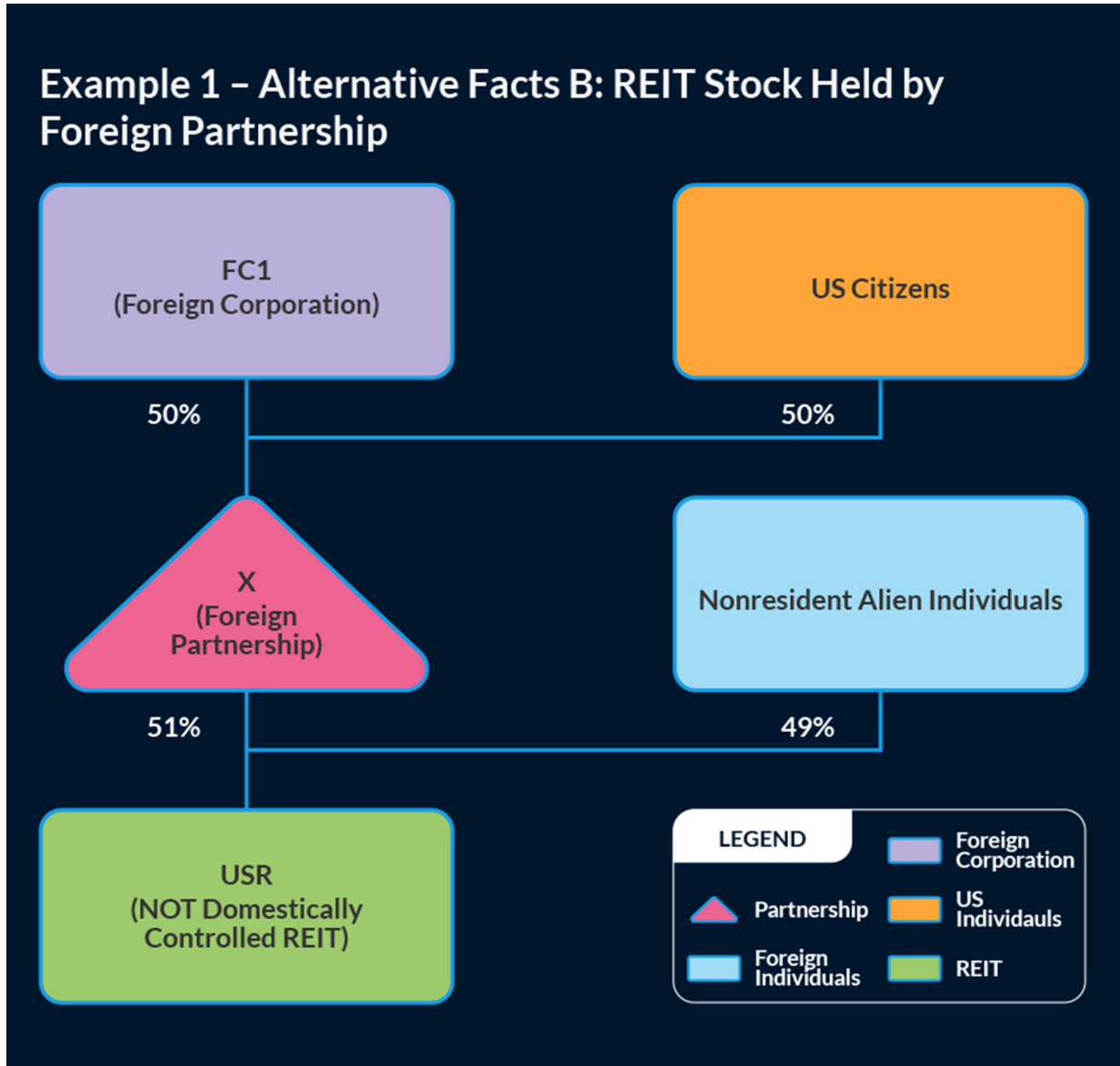


Visualization of Example 1- Alternative Facts A: REIT Stock Held by Domestic Partnership

X is a look-through person and is not considered as holding directly or indirectly stock of USR for purposes of determining whether USR is a domestically controlled REIT. The stock of USR that is considered held by X, a look-through person, is instead considered held proportionately by X's partners that are non-look-through persons. Accordingly, because FC1 and the U.S. citizen partners in X are non-look-through persons, 25.5% of the stock of USR is considered as held directly or indirectly by FC1 (50% x 51%), a foreign person, and 25.5% (in the aggregate) of the stock of USR is considered as held directly or indirectly by the U.S. citizen partners in X (50% x 51%), who are not foreign persons. Foreign persons therefore hold directly or indirectly 74.5% of the stock of USR (49% of the stock of USR held directly or indirectly by nonresident alien individuals, who are non-look through persons plus the 25.5% held directly or indirectly by FC1), and USR is not a domestically controlled REIT.

Example 1 – Alternative Facts B: REIT Stock Held by Foreign Partnership

The following chart depicts an alternative scenario wherein REIT stock is held by a foreign partnership. The foreign corporation is shaded in purple, foreign individuals are shaded in blue, U.S. individuals are shaded in orange, the partnership is shaded in pink, and the REIT is shaded in green.



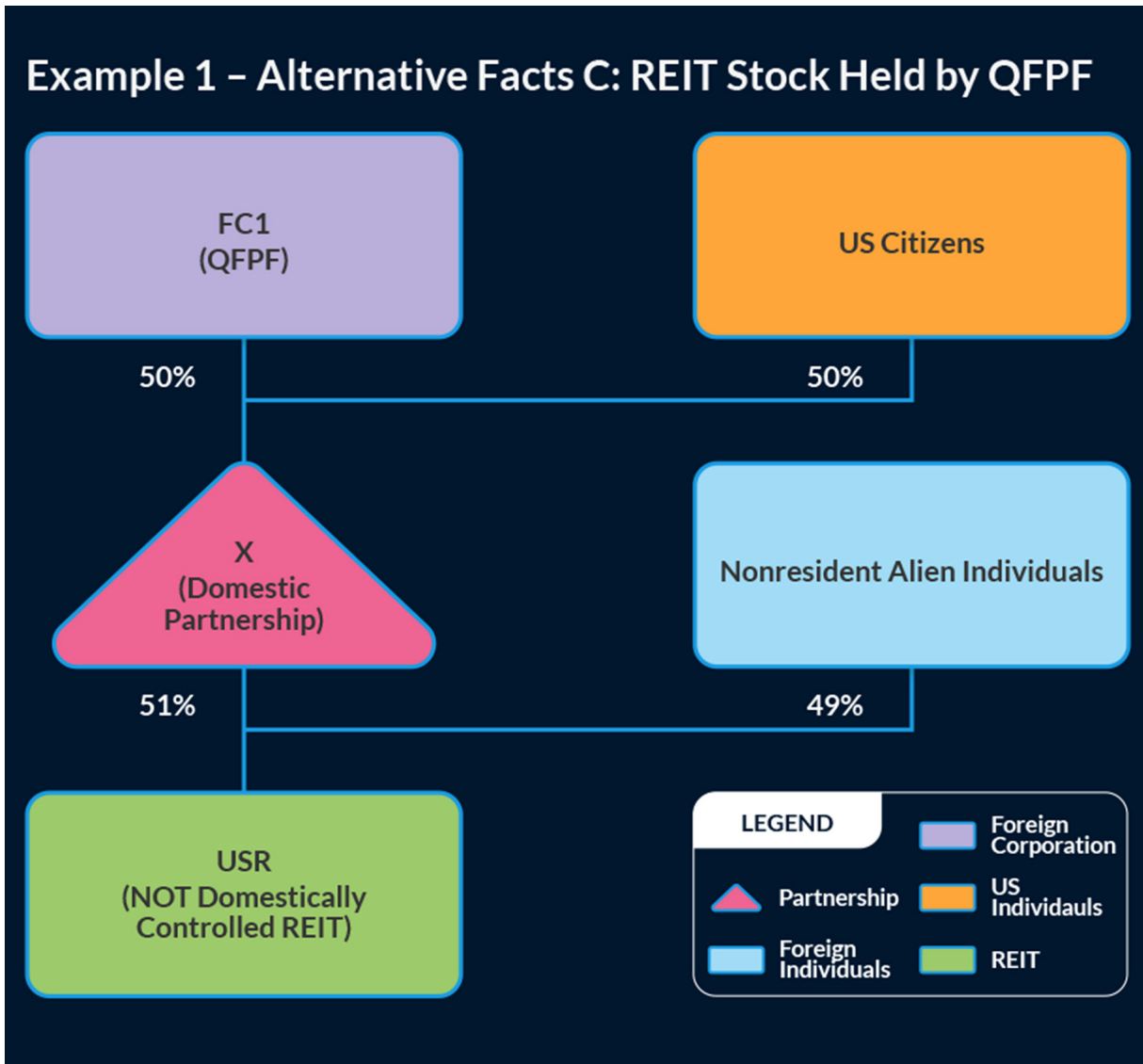
Visualization of Example 1- Alternative Facts B: REIT Stock Held by Foreign Partnership

The result is the same as Alternative Facts A.

Example 1 – Alternative Facts C: REIT Stock Held by QFPF

The following chart depicts an alternative scenario wherein REIT stock is held by a qualified foreign pension fund. The foreign corporation is shaded in purple, foreign individuals are shaded in blue, U.S. individuals are shaded in orange, the partnership is shaded in pink, and the REIT is shaded in green.

Example 1 – Alternative Facts C: REIT Stock Held by QFPF



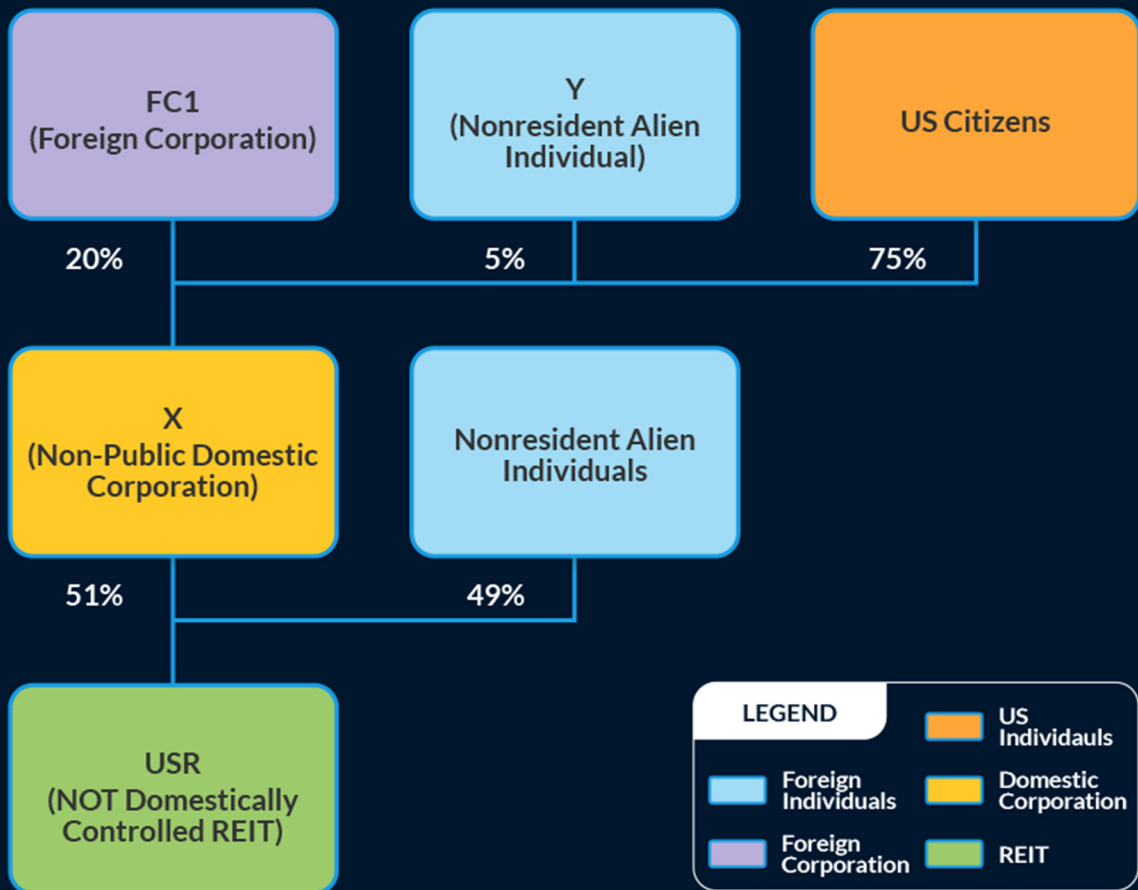
Visualization of Example 1- Alternative Facts C: REIT Stock Held by QFPF

X is treated as a look-through person. FC1, a foreign person, is a non-look-through person. Because FC1 and the U.S. citizen partners in X are non-look-through persons, 25.5% of the stock of USR is considered as held directly or indirectly by FC1 ($50\% \times 51\%$), and 25.5% (in the aggregate) of the stock of USR is considered as held directly or indirectly by the U.S. citizen partners in X ($50\% \times 51\%$). Foreign persons therefore hold directly or indirectly 74.5% of the stock of USR (49% of the stock of USR held directly or indirectly by nonresident alien individuals, who are foreign persons and non-look-through persons, plus the 25.5% held directly or indirectly by FC1), and USR is not a domestically controlled REIT.

Example 2 – Base Case: REIT Stock Held by Non-Public Domestic C Corporation that is a Foreign-Owned Domestic Corporation

The following chart depicts an example wherein REIT stock is held by a non-public domestic C corporation that is a foreign-owned domestic corporation. The foreign corporation is shaded in purple, foreign individuals are shaded in blue, U.S. individuals are shaded in orange, the domestic corporation is shaded in yellow, and the REIT is shaded in green.

Example 2 – Base Case: REIT Stock Held by Non-Public Domestic C Corporation that is a Foreign-Owned Domestic Corporation

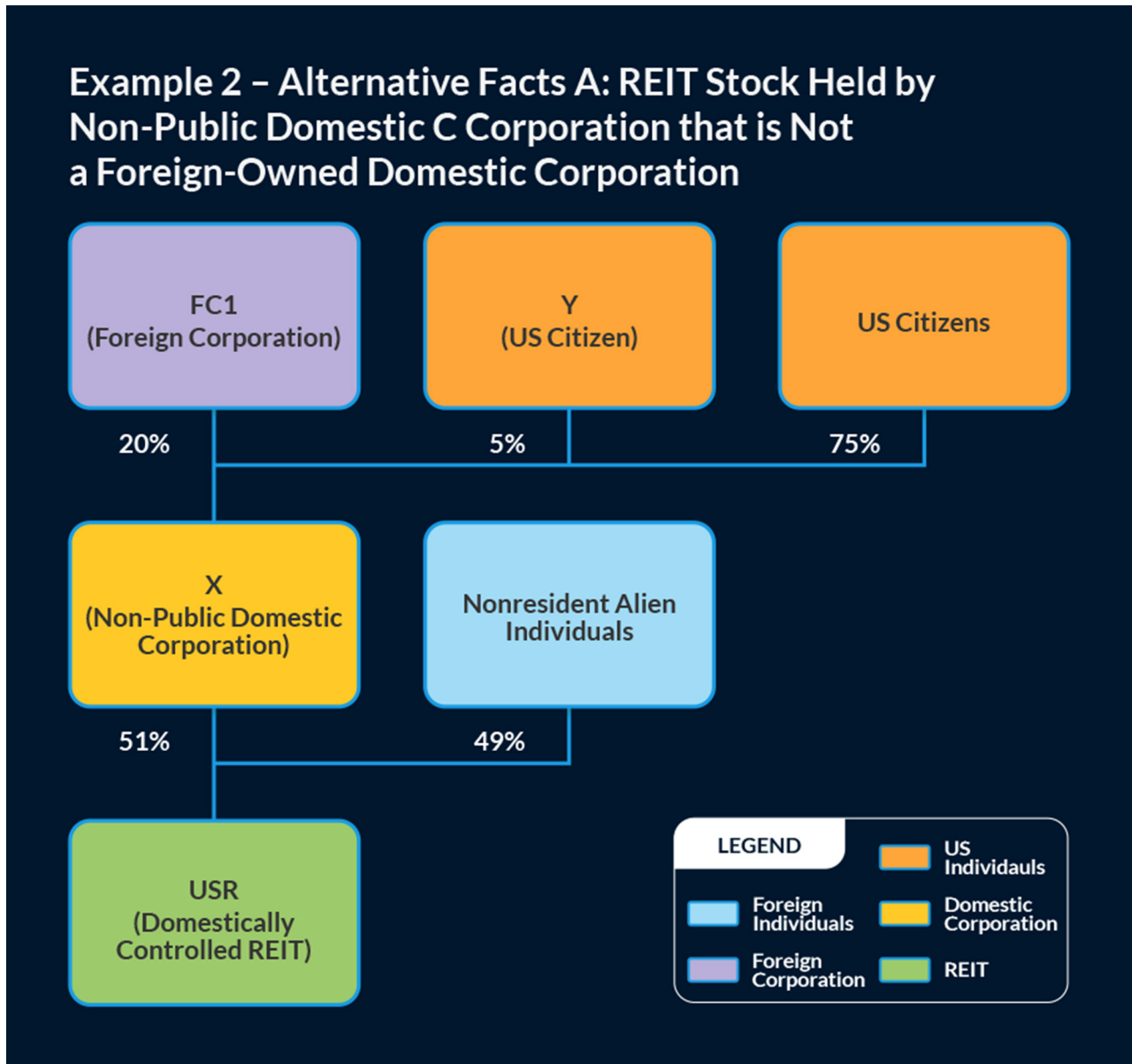


Visualization of Example 2- Base Case: REIT Stock Held by Non-Public Domestic C Corporation that is a Foreign-Owned Domestic Corporation

X is a non-look-through person, unless it is a foreign-owned domestic corporation. FC1, Y, and the U.S. citizen shareholders of X are non-look-through persons. FC1, Y, and the U.S. citizen shareholders are all considered as holding directly or indirectly stock of X for purposes of determining whether X is a foreign-owned domestic corporation. The stock held directly or indirectly by FC1, Y, and the U.S. citizen shareholders is not considered held directly or indirectly by any other person. Because FC1 and Y, both foreign persons, hold directly or indirectly 20% and 5% of the stock of X, respectively, foreign persons hold directly or indirectly 25% of the fair market value of the stock of X, and X is a foreign-owned domestic corporation. Accordingly, X is a look-through person and, therefore, is not considered as holding directly or indirectly stock of USR for purposes of determining whether USR is a domestically controlled REIT. The stock of USR that is considered held by X, a look-through person, is instead considered held proportionately by X's shareholders that are non-look-through persons. Accordingly, because FC1, Y, and the U.S. citizen shareholders of X are non-look-through persons, 10.2% of the stock of USR is considered as held directly or indirectly by FC1 (20% x 51%), and 38.25% (in the aggregate) of the stock of USR is considered as held directly or indirectly by the U.S. citizen shareholders (75% x 51%). Foreign persons therefore hold directly or indirectly 61.75% of the stock of USR (49% of the stock of USR held directly by nonresident alien individuals, who are foreign persons and non-look-persons, plus the 10.2% and 2.55% held indirectly by FC1 and Y, respectively), and USR is not a domestically controlled REIT.

Example 2 – Alternative Facts A: REIT Stock Held by Non-Public Domestic C Corporation that is Not a Foreign-Owned Domestic Corporation

The following chart depicts an alternative scenario wherein REIT stock is held by a non-public domestic C corporation that is not a foreign-owned domestic corporation. The foreign corporation is shaded in purple, foreign individuals are shaded in blue, U.S. individuals are shaded in orange, the domestic corporation is shaded in yellow, and the REIT is shaded in green.



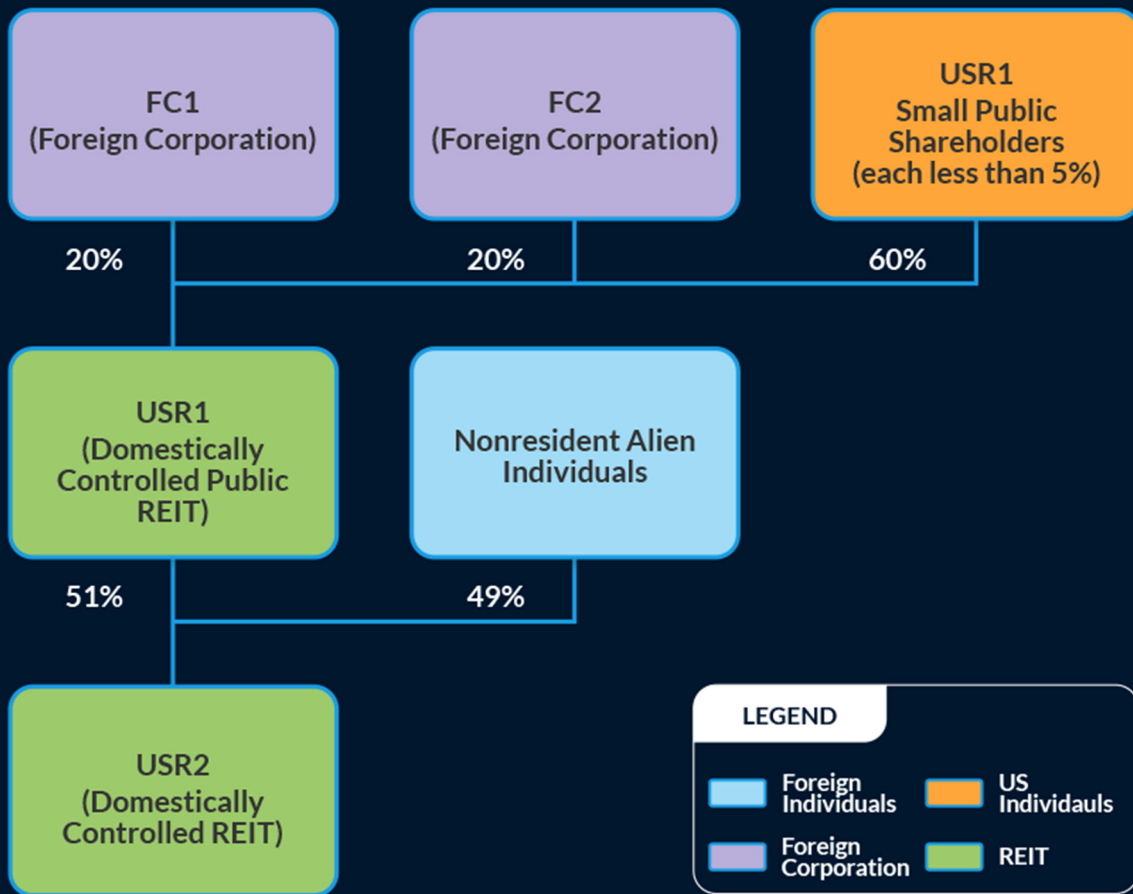
Visualization of Example 2- Alternative Facts A: REIT Stock Held by Non-Public Domestic C Corporation that is Not a Foreign-Owned Domestic Corporation

If Y were a U.S. Citizen instead of a nonresident alien individual, X would be a non-look-through person because it is not a foreign-owned domestic corporation and, consequently, USR would be a domestically controlled REIT.

Example 3 – Base Case: REIT Stock Held by Public REIT that is a Domestically Controlled REIT

The following chart depicts an example wherein REIT stock is held by a public REIT that is a domestically controlled REIT. The foreign corporation is shaded in purple, foreign individuals are shaded in blue, U.S. individuals are shaded in orange, and the REIT is shaded in green.

Example 3 – Base Case: REIT Stock Held by Public REIT that is a Domestically Controlled REIT



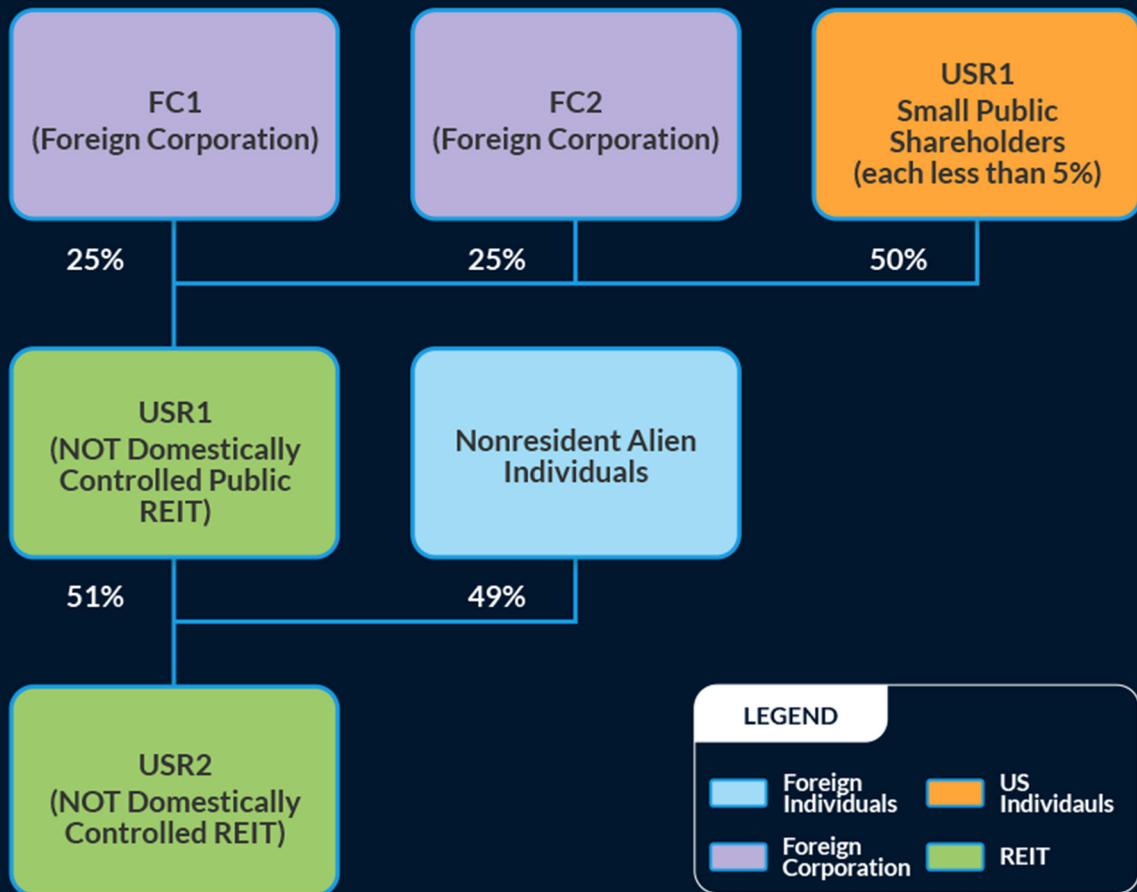
Visualization of Example 3- Base Case: REIT Stock Held by Public REIT that is a Domestically Controlled REIT

Each of the USR1 small public shareholders is treated as a United States person that is a non-look-through person. Consequently, USR1 is a domestically controlled REIT because FC1 and FC2, each a foreign person, together hold directly or indirectly only 40% of the stock of USR1 and, thus, foreign persons hold directly or indirectly less than 50% of the fair market value of the stock of USR1. In addition, the USR2 stock held by USR1 is treated as held directly or indirectly by a United States person that is a non-look-through person. Because USR1 holds directly or indirectly 51% of the stock of USR2, foreign persons hold directly or indirectly less than 50% of the fair market value of the stock of USR2, and USR2 is a domestically controlled REIT.

Example 3 – Alternative Facts A: REIT Stock Held by Public REIT that is Not a Domestically Controlled REIT

The following chart depicts an alternative scenario wherein REIT stock is held by a public REIT that is not a domestically controlled REIT. The foreign corporation is shaded in purple, foreign individuals are shaded in blue, U.S. individuals are shaded in orange, and the REIT is shaded in green.

Example 3 – Alternative Facts A: REIT Stock Held by Public REIT that is Not a Domestically Controlled REIT



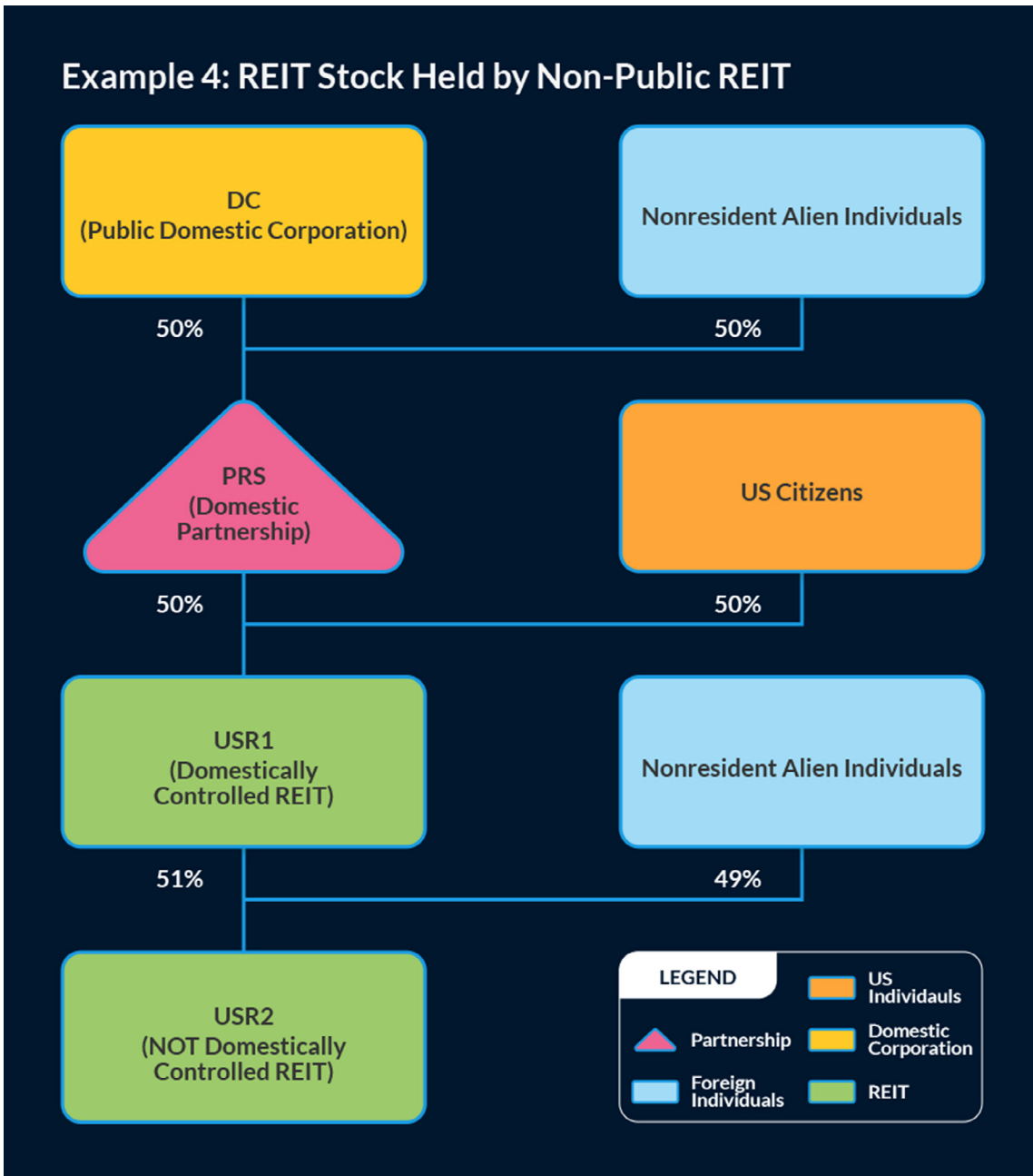
Visualization of Example 3- Alternative Facts A: REIT Stock Held by Public REIT that is Not a Domestically Controlled REIT

Regardless of the treatment of the USR1 small public shareholders, USR1 is not a domestically controlled QIE because FC1 and FC2, each a foreign person, together hold directly or indirectly 50% of the stock of USR1 and, thus, foreign persons do not hold directly or indirectly less than 50% of the fair market value of the stock of USR1. In addition, the USR2 stock held by USR1 is treated as held by a foreign person that is a non-look-through person. Because USR1 holds directly or indirectly 51% of the stock of USR2, foreign persons do not hold directly or indirectly less than 50% of the fair market value of the stock of USR2, and USR2 is not a domestically controlled REIT.

Example 4: REIT Stock Held by Non-Public REIT

The following chart depicts an example wherein REIT stock is held by a non-public REIT. The domestic corporation is shaded in yellow, foreign individuals are shaded in blue, U.S. individuals are shaded in orange, the partnership is shaded in pink, and the REIT is shaded in green.

Example 4: REIT Stock Held by Non-Public REIT



Visualization of Example 4- Base Case: REIT Stock Held by Non-Public REIT

USR1 is not treated as a non-look-through person because USR1 is not a public REIT. Each of USR1 and PRS is a look-through person that is not treated as holding directly or indirectly stock in USR2 for purposes of determining whether USR2 is a domestically controlled REIT. Stock of a REIT that would be considered held by a look-through person but for the application of paragraph (c)(3)(ii)(A) is considered held directly or indirectly proportionately by the look-through person's direct or indirect owners that are non-look-through persons. Because the U.S. citizens who hold USR1 stock are non-look-through persons, those U.S. citizens are treated as holding directly or indirectly 25.5% of the stock of USR2 through their USR1 stock interest (50% x 51%). Similarly, because DC and the nonresident alien partners in PRS are non-look-through persons, each is treated as holding directly or indirectly the stock of USR2 through its interest in PRS and PRS's interest in USR1. Thus, DC is treated as holding directly or indirectly 12.75% of the stock of USR2 (50% x 50% x 51%) and the nonresident alien individual partners, which are foreign persons, are treated as directly or indirectly holding a 12.75% aggregate interest in the stock of USR2 (50% x 50% x 51%). Foreign persons therefore hold directly or indirectly 63.25% of the stock of USR2 (the 49% stock in USR2 directly held

by nonresident alien individuals, who are foreign persons and non-look-through persons, plus the 12.75% in stock indirectly held by the nonresident alien individual partners in PRS), and USR2 is not a domestically controlled REIT.

Next Steps for the Treasury Department and the IRS

While these changes in the law are only proposed regulations at this time, the preamble to the Proposed Regulations noted that the IRS may challenge positions contrary to the Proposed Regulations before the issuance of final regulations. The Treasury Department will solicit comments from the public through the end of February 2023, including on the definition of look-through person and non-look-through person. The preamble to the Proposed Regulations specifically notes that the Treasury Department and the IRS did consider an alternative rule that would treat all domestic C corporations as non-look-through persons. We anticipate that taxpayers will submit comments requesting the Treasury Department to reconsider this alternative rule which would be consistent with prior guidance.

Next Steps for Real Estate Sponsors, Fund Managers, and REITs

Prudent real estate sponsors, fund managers, and REITs (collectively, real estate sponsors) will review their tax structures, fund structures, joint venture (JV) structures, REIT structures, subscription agreements, fund organizational documents, JV organizational documents, REIT organizational documents, and side letters to evaluate the impact of the Proposed Regulations. In particular, real estate sponsors are encouraged to review any domestically controlled REIT structure that contains foreign-owned domestic corporations. In order to make this determination, the real estate sponsor may need to request additional information from investors relating to ultimate ownership.

Finally, real estate sponsors should review side letters to determine what assurances/covenants relating to domestically controlled REIT status may have been provided to investors and what new representations relating to ultimate ownership may be required from investors.

Shiukay Hung, Partner, DLA Piper LLP (US)

Shiukay Hung is Co-Chair of DLA Piper's National REIT Tax Practice and a partner in DLA Piper's Investment Management and Real Estate Capital Markets Practice resident in the New York office. His primary focus is the real estate industry and particularly REITs (e.g., private REITs, public non-traded REITs/NAV REITs, US listed REITs, and Singapore listed REITs). His REIT practice is recognized by *The Legal 500 USA 2022*.

Drawing upon his experience as a lawyer in Canada and Asia, Shiukay is particularly sensitive to the tax considerations of non-U.S. investors. Shiukay is experienced in the acquisition, disposition and operation of real estate assets through fund, REIT and joint venture vehicles and has provided extensive advice on such matters to sovereign wealth funds, foreign pension funds, and other non-U.S. investors.

With over 15 years of experience, both as an in-house attorney and in private practice, Shiukay provides clients with practical advice on complex transactions that draws on his deep industry knowledge. He is actively involved in bar associations and industry groups including the Real Estate Round Table, the Institute for Portfolio Alternatives (IPA), and the National Association of Real Estate Investment Trusts (Nareit). He is a frequent legal commentator and has spoken before various audiences and media outlets including *Bloomberg*, *Law360*, the American Bar Association, *Tax Notes*, the American Institute of CPAs, the Harvard Law School Association of New York City, *Strafford*, the *Private Equity Law Report*, and the Tax Executives Institute. He has also written for *LexisNexis* and the *Real Estate Finance Journal*.

Joshua Lingerfelt, Associate, DLA Piper LLP (US)

Joshua Lingerfelt is an associate in DLA Piper's Investment Management and Real Estate Capital Markets practice. His primary focus is on the federal income tax considerations of the structuring and operation of private investment funds. Joshua's experience includes providing tax advice to a wide variety of clients in connection with the formation and operation of partnerships, limited liability companies and real estate investment trusts (REITs). He also has experience advising a wide variety of nonprofit organizations on qualifying for and maintaining tax-exempt status as well as unrelated business income considerations.

Allen Ashley, Partner, DLA Piper LLP (US)

Allen Ashley concentrates his practice in the areas of US federal income taxation and the laws affecting business entities.

Allen represents publicly-traded and privately-held multinational corporations and privately-held real estate funds. He is experienced in a broad range of business-related US federal income tax matters, including advising clients with respect to the tax aspects of domestic and international corporate acquisitions, dispositions and other reorganizations (including those involving publicly-traded corporations and REITs); capital market transactions; joint ventures; acquisition, ownership and disposition of real estate; intercompany transfer pricing and general tax planning.

Allen advises clients with respect to the formation of private real estate funds (including those established as REITs) and real estate-related joint ventures. His experience includes representing such funds in negotiations with prospective and existing investors, joint venture partners and providing guidance with respect to investments in general.

Allen's experience also includes advising clients with respect to a variety of matters related to intercompany transfer pricing, including establishing and restructuring of intercompany transfer pricing policies, preparing intercompany transfer pricing studies and representing clients with respect to controversies with tax authorities related to intercompany transfer pricing.

Katie LaKoma, Of Counsel, DLA Piper LLP (US)

Katie Philippart LaKoma regularly represents fund sponsors in all aspects of the structuring and operation of private investment funds with a particular focus on real estate and real-estate related assets. Katie also represents a variety of taxable and, tax-exempt, foreign governmental and non-US investors in structuring tax-efficient investments in real estate, private equity and hedge funds.

Katie's experience includes providing tax advice to a wide variety of clients in connection with the formation and operation of partnerships, limited liability companies and real estate investment trusts (REITs). Katie has extensive experience in representing REITs and other real estate owners in closing real estate joint venture transactions. She also advises US and foreign corporations and partnerships on acquisitions, divestitures and other restructuring transactions.

Matthew Hilowitz, Associate, DLA Piper LLP (US)

As a member of DLA Piper's Investment Management and Real Estate Capital Markets practice, Matthew advises and represents investment managers and fund sponsors with respect to all aspects of the structuring, establishment, and operation of private investment funds (including those established as REITs) with a focus on real estate, infrastructure, and private equity. Matthew also represents multinational corporations and privately-held real estate funds with a variety of U.S. federal income tax and corporate matters such as domestic and international mergers and acquisitions, dispositions, reorganizations, joint ventures, and general tax planning.

Allan Bowen, Attorney, DLA Piper LLP (US)

Allan Bowen concentrates his practice in federal and international income taxation.

Allan has significant experience in the real estate and mortgage-related areas, including representation of real estate funds, debt funds, and publicly traded and privately owned equity and mortgage real estate investment trusts (REITs). He has worked on numerous debt and equity offerings, REIT mergers and acquisitions, formations of private REITs, partnership roll-ups and various mortgage REIT transactions. In addition, Allan also regularly represents a variety of taxable, tax-exempt, foreign governmental and non-US investors in structuring tax-efficient investments.

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