Alert
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Treasury Issues Game-Changing Final Regulations on Domestically Controlled REIT Status

The United States Department of Treasury issued final regulations (Final Regulations) that arguably change the test (DC Test) for determining whether a REIT is a domestically controlled qualified investment entity (DC-REIT). A REIT's status as a DC-REIT matters to its foreign shareholders. If the REIT is a DC-REIT, those shareholders may sell shares of a REIT without being subject to U.S. income tax.

The Final Regulations change the DC Test by introducing a look-through approach for REIT shareholders that are look-through persons. Under the look-through approach, the owners of each look-through person are treated as owning REIT shares directly.

Background

Generally, a foreign person pays U.S. tax on gains they realize from sales of a United States real property interest (USRPI). Those gains are treated as income effectively connected with a U.S. trade or business (ECI).

A foreign person generally wants to avoid ECI. That's especially true for foreign persons (such as foreign governments) whose U.S. tax status depends on avoiding anything other than certain types of passive income.

There is an important exception to this general rule. Under this exception, shares in a DC-REIT are not USRPIs. As a result, a foreign person can sell shares of a DC-REIT without being subject to US tax on gains realized from selling those shares.

A REIT will be a DC-REIT if, at all times during a testing period (typically five years), less than 50% of its shares (by value) are owned (directly or indirectly) by foreign persons. That's the DC Test.

Most (if not all) investors and their tax counsel believed that shares held by a U.S. C corporation were owned by that corporation for DC Test purposes. The Internal Revenue Service issued a private letter ruling confirming that belief. The Final Regulations discredit that belief as to some U.S. corporations. The Final Regulations establish, as a matter of law, the look-through approach for many of those corporations.

Final Regulations

The new look-through test applies to REIT shareholders who are look-through persons. A look-through person includes a/an:

- REIT
- S Corporation
- tax partnership (including an LLC with two or more members that has not elected to be treated as a corporation)
- non-publicly-traded C corporation that is a foreign-controlled domestic corporation

A U.S. C corporation is a foreign-controlled domestic corporation if foreign persons own more than 50% of the fair market value of that corporation's stock. In such cases, for purposes of the DC Test, the non-look through shareholders of the corporation are treated as holding REIT shares directly. A non-look-through shareholder includes a/an:

- domestic publicly-traded corporation
- domestic publicly-traded partnership
- foreign corporation

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Special rules apply to publicly-traded entities. For example, if the REIT has actual knowledge that a domestically publicly-traded corporation or partnership is foreign-controlled, that corporation or partnership will be a look-through person. A publicly-traded REIT is treated as a look-through person, but a shareholder holding 5% or less of that publicly-traded shares of that REIT is treated as a domestic person, absent actual knowledge to the contrary.

The Final Regulations also provide that a qualified foreign pension fund is a foreign person for the DC Test, though that fund is treated as a domestic person for other purposes.

The Final Regulations contain an important transition rule. Under the transition rule, the DC Test for existing REITs can treat any domestic corporation as a U.S. person, regardless of whether it is foreign-controlled. This treatment does not last forever, though. The treatment will end on the sooner of:

i. April 24, 2034;
ii. the date the REIT acquires a significant amount of new USRPIs; and
iii. the date the REIT undergoes a significant change of ownership.

Finally, the Final Regulations authorize (but do not require) a REIT to confirm that it is a DC-REIT to a shareholder who requests confirmation.

Action Plan

REIT managers and investors must become familiar with the new rules for determining DC-REIT status. In particular, managers of existing REITs should be alert to the triggers that can cause a REIT to lose transition rule benefits. Additionally, investors and managers should understand that planning future REIT investments has changed significantly.