

Memorandum

IRS Releases Proposed Regulations Under Section 897 on Domestically Controlled REITs

January 3, 2023

On December 29, 2022, the Internal Revenue Service (“IRS”) issued a series of Proposed Treasury Regulations promulgated under Section 897 of the Internal Revenue Code (the “Code”)¹ (such Treasury Regulations, the “Proposed Rules”). Among other things, the Proposed Rules address whether qualified investment entities, which includes real estate investment trusts (“REITs”), will be treated as domestically controlled for purposes of the Foreign Investment in Real Property Tax Act (“FIRPTA”). This memorandum is a high-level summary of the background giving rise to the Proposed Rules, along with their key provisions and implications.

Background

Section 897 provides that foreign investors are generally subject to U.S. federal income tax (i) on the disposition of a United States real property interest (“USRPI”) as if the nonresident alien individual or foreign corporation was engaged in a trade or business within the United States 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 will not be treated as a USRPI (and not taxable pursuant to FIRPTA on the sale of an interest). This exception allows foreign investors in REITs to sell shares of those REITs without having the gain be subject to U.S. federal income tax to the extent 50% or more of the value of the shares of the REIT has been held “directly or indirectly” by U.S. persons for at least 5 years (or, if shorter, the period during which the REIT was in existence), and similarly allows a REIT to sell shares of a “baby REIT” meeting those requirements and distribute the proceeds without the foreign investors being treated as engaged in a trade or business within the United States. The statute and current Treasury Regulations do not provide guidance regarding “direct and indirect” ownership in determining whether holders of the REIT are U.S. or foreign. The Treasury Regulations stated that in making such determination, “actual ownership” of the shares of the REIT should be taken into account as determined under Treasury Regulation Section 1.857-8. Under that Treasury Regulation, the actual owner of REIT stock is the person that includes dividends from such stock in its gross income. This resulted in some uncertainty as to whether a partnership, foreign or domestic, would be treated as an owner for such purposes as the income is reported by the partnership, but included in the gross income of its owners. However, it was generally believed that a domestic corporation would be treated as a U.S. person for the calculation of domestic control, as it would include such amounts in gross income (and be subject

¹ All “Section” references are to the Code.

to tax on such amounts).² The Proposed Rules provide new rules for determining whether a REIT is directly or indirectly held by foreign persons for these purposes.

General Look-Through Rule

The Proposed Rules provide that to determine whether stock is “indirectly” owned by foreign persons, stock of the REIT held through certain entities is analyzed under a limited look-through approach. Stock of a REIT held by or through one or more intervening “look-through persons” is treated as held proportionally by the look-through person’s ultimate owners that are non-look-through persons. “Non-look-through persons” are treated as themselves holding directly or indirectly stock of a REIT, requiring no further look-through.

The Proposed Rules define a non-look-through person to include:

- Foreign corporations, and subject to an exception discussed below, domestic corporations,
- Domestic and foreign publicly traded partnerships,
- Publicly traded REITs and RICs,
- Qualified foreign pension funds and qualified controlled entities,
- Domestic or foreign estates,
- International organizations, and
- Tax-exempt entities.

The Proposed Rules define a look-through person as any person that is not a non-look-through person which now includes:

- REITs and RICs (other than those that are publicly traded),
- S Corporations,
- Domestic or foreign non-publicly traded partnerships,
- Domestic or foreign trusts, and
- “Foreign-owned domestic corporations.”

Under the new Proposed Rules, if a domestic corporation is both (i) not regularly traded on an established securities market and (ii) owned (by reference to fair market value) 25% or more directly or indirectly by foreign persons, it is deemed a “foreign-owned domestic corporation.” The look-through rule considers the foreign owners of a foreign-owned domestic corporation as owning a pro rata share of the REIT. The same look-through

² In 2009, the IRS issued a private letter ruling providing that a domestic corporation would be treated as a U.S. person for purposes of these rules. No Treasury Regulations were issued after this ruling, but this ruling was referenced favorably in the legislative history to the 2016 amendments to the FIRPTA rules.

rules that apply in determining whether a REIT is domestically controlled are used to determine whether a domestic corporation is foreign owned.

In addition, the Proposed Rules provide guidance regarding certain owners of entities being treated as specifically U.S. or foreign for purposes of domestically controlled REIT ownership.

Under the new rules, the following would be treated as U.S. owners:

- Shareholders of a REIT or RIC that own less than 5% of an entity that has a class of shares which are regularly traded on an established securities market, unless the REIT or RIC has actual knowledge that such shareholder is a foreign person, and
- Public REITs or RICs that are domestically controlled.

The following are treated as foreign owners:

- Shareholders of a REIT or RIC that own less than 5% of an entity that has a class of shares which are regularly traded on an established securities market if the REIT or RIC has actual knowledge that such shareholder is a foreign shareholder,
- Public REITs or RICs that are not domestically controlled,
- International organizations, and
- Qualified foreign pension funds and qualified controlled entities.

Applicability Dates

Generally, the Proposed Rules are intended to apply to transactions occurring on or after the date they are published as final Treasury Regulations in the Federal Register, but will be relevant for determining domestically controlled REIT ownership during periods before the date the Proposed Rules are published as final to the extent the testing period related to a transaction includes periods before that date. In addition, the Proposed Rules provide that the IRS may challenge positions contrary to these Proposed Rules before the issuance of final Treasury Regulations.

Important Considerations

Investment funds and fund managers, particularly those focused on real estate investments, should be aware that the Proposed Rules may be relevant for transactions that occur after they are finalized on a retroactive basis for determining whether an entity qualifies as a domestically controlled REIT for any relevant testing periods. In addition, the Proposed Rules indicate that the IRS may interpret the rules in this manner regardless of whether the Proposed Rules are ever finalized.

If finalized, fund managers that were previously reluctant to look through a foreign partnership for determining domestically controlled REIT ownership will now be able to do so. However, fund managers that used domestic

blockers which are 25% or more owned by foreign investors may be required to restructure some of those holding structures in order to maintain domestically controlled REIT ownership. Additionally, as a result of transactions at the investor level (and 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 if the Proposed Rules are finalized. 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 would invoke the foreign-owned domestic corporation rule discussed above.

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