

Treasury Finalizes Look-Through Rule for Domestically Controlled REITs

On April 25, 2024, the IRS promulgated final regulations addressing the qualification of a REIT as “domestically controlled” under Section 897(h)(4)(B) of the Code.¹ A “domestically controlled” REIT is not a United States Real Property Interest (“USRPI”), and thus the sale of an interest in the REIT is generally not subject to U.S. tax under FIRPTA. Prior to the regulations discussed below, foreign investors commonly planned into this “domestically-controlled exception” by investing some or all of their capital in a REIT through U.S. blocker corporations and taking the position that taxable U.S. corporations were not looked through for purposes of Section 897(h)(4)(B).

However, in proposed regulations released in December 2022, the IRS proposed to look through private U.S. corporations where at least 25% of value of the stock is held by foreign persons. As a result, the U.S. blocker structure would no longer permit a REIT with significant indirect foreign ownership to qualify as domestically controlled. The proposed regulations engendered substantial criticism from industry participants, who argued that the look-through rule should be withdrawn because it is inconsistent with the purpose of the domestically-controlled exception, imposes substantial compliance and administrative burdens and will negatively impact the U.S. real estate market.

The final regulations retain the look-through rule for private U.S. corporations but increase the threshold for foreign ownership required to look through the corporation from at least 25% to more than 50%. While this change narrows the scope of the rule, it does not address most of the criticisms about the proposed regulations. It is clear that this is a deliberate choice, as the preamble to the final regulations includes an extensive discussion responding to objections raised by the industry.

The final regulations include an important transition rule intended to reduce disruption in the industry. Any existing REIT that does not (i) acquire a significant amount of new USRPIs or (ii) undergo a significant change in its ownership is not required to apply the new look-through rule in determining its domestically-controlled status for the next ten years.² A REIT acquires a “significant amount of new USRPIs” if the total fair market value of newly acquired USRPIs exceeds 20% of the total fair market value of the USRPIs held directly and indirectly as of April 25, 2024.³ A REIT undergoes a significant change in ownership if the direct or indirect ownership of the REIT by non-look-through persons increases by more than 50% in the aggregate, relative to the REIT stock owned by such non-look-through persons on April 25, 2024.⁴ A REIT will become subject to the new look-through rule beginning the day after it fails to meet either of these requirements.

¹ Section 897(h)(4)(B) generally provides that a REIT will be domestically controlled if less than 50% of the value of the stock of the REIT is held “directly or indirectly” by foreign persons. Note that similar provisions apply for RICs that invest predominantly in real estate.

² Acquisitions of USRPIs and changes in ownership occurring after April 24, 2024, but pursuant to binding commitments dated before April 24, 2024, are treated as occurring on April 24, 2024, for purposes of applying these rules.

³ This is a “gross” test, such that assets acquired with proceeds of debt are still taken into account. In addition, there does not appear to be a recycling exception—thus, new assets acquired with the proceeds of the disposition of old assets would also be taken into account.

⁴ The look-through rules apply for purposes of determining the ultimate ownership of non-look-through persons. Accordingly, exchanges among holders of a domestic blocker corporation must still be taken into account, even if the blocker is not otherwise looked through under the transition relief.

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