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IRS Relaxes Rules for Domestically Controlled REITs

Authors: Jonathan M. Rhein and Zaira Cortes Rivero

Non-U.S. investors are generally subject to U.S. federal income tax on gains from investments in private U.S. real estate investment trusts (REITs). Two exceptions (among others) are for investments in "domestically controlled" REITs and for investors that are "qualified foreign pension funds." A domestically controlled REIT is one that is more than 50% owned by U.S. persons, which, until the proposed regulations described below were issued, included any U.S. corporation—even one that was 100% owned by non-U.S. persons.

In a prior bulletin, we described proposed regulations that targeted commonly used structures with a REIT that qualified as domestically controlled because it was 51% owned by a U.S. corporation (which in turn may be 100% owned by non-U.S. investors); thus the remaining 49% of the REIT was permitted to be owned by non-U.S. investors generally free of U.S. tax under the *Foreign Investment in Real Property Tax Act* (FIRPTA)[1]. The proposed regulations would have "looked through" any U.S. corporation that was more than 25% owned by non-U.S. persons, resulting in such a REIT failing to qualify as domestically controlled. This rule would also have applied retroactively to existing investments, upsetting careful planning and potentially reducing returns on numerous investments in U.S. real property.

The Internal Revenue Service (IRS) has now issued final regulations, which retain the look-through rule in cases in which the U.S. corporation is more than 50% owned by non-U.S. persons, but, in an important departure from the proposed regulations, the final regulations include a "grandfather" rule for existing structures for up to 10 years so long as there are not significant changes in ownership or acquisitions of additional U.S. real property. Investors in existing domestically controlled REIT structures that include non-U.S. owned U.S. corporations will therefore need to monitor and ensure they do not lose grandfathered status under the regulations. We expect these structures will remain mostly static until they are sold. In addition, those investors should consider the potential impact of sales by their co-investors and whether contractual restrictions could be imposed for the protection of all non-U.S. investors.

The new look-through rule will make inbound investments in U.S. REITs less attractive if non-U.S. investors do not have substantial U.S. co-investors that would allow a REIT to qualify as domestically controlled. Unsurprisingly, the regulations also finalized the proposed rule that ownership by qualified foreign pension funds does not count as U.S. ownership to qualify a REIT as domestically controlled.

[1] Many have used these structures in reliance on a 2009 IRS private letter ruling, even though that ruling was previously repealed and, in general, private letter rulings may not be relied upon by anyone other than the person to which they are addressed.

Key Contacts: Peter Glicklich, Jennifer Lee, Jonathan M. Rhein, R. Ian Crosbie, Christopher Anderson, Nathan Boidman and Michael N. Kandev