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Treasury Regulations Finalized Under FIRPTA Regarding Domestically Controlled REITs

Go-To Guide:

- New regulations narrow FIRPTA exemption for domestically controlled REITs
- Controversial proposed look-through rule for domestic C corporations is retained, but softened
- Upstream entities are characterized as either "look-through persons" or "non-look-through persons"
- Important 10-year transition relief added

Under U.S. tax law, gains recognized by foreign persons and entities upon the disposition of investments in certain U.S. assets (e.g., corporate stock and securities) are generally sourced outside of the United States and not subject to U.S. tax. An important exception exists, however, pursuant to the Foreign Investment in Real Property Tax Act of 1980, as amended (FIRPTA), where a foreign person sells real property located in the United States, or sells certain stocks or securities that derive most of their value from interests in U.S. real property. These assets are known as United States real property interests, or USRPIs, and gains recognized by foreign persons from selling USRPIs generally are subject to U.S. tax.

FIRPTA, which is codified in Sections 897 and 1445 of the Internal Revenue Code of 1986, as amended (the Code), provides various exemptions from the tax on dispositions of USRPIs (i.e., exceptions to the exception). One such exemption is in the case of the disposition of stock of a qualified investment entity

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(or QIE), as described below, that is considered to be "***domestically controlled***." The term "QIE" includes real estate investment trusts (REITs) as well as certain regulated investment companies (RICs), such as mutual funds, to the extent that they primarily hold investments in U.S. real property (indirectly through holdings of stock of other companies). According to the Code, a QIE is domestically controlled if foreign persons hold, "***directly or indirectly***," throughout a prescribed testing period (generally five years ending on the date of a disposition), less than 50% in value of the entity's stock.

On April 25, 2024, the Internal Revenue Service and Treasury Department issued final regulations regarding the meaning of "domestic control" in this context. The final regulations adopt, with some modification, controversial proposed regulations released on December 28, 2022. The final regulations were issued, along with a preamble containing explanatory government commentary, as Treasury Decision 9992. They include amendments to Sections 1.897-1, 1.897-2 and 1.1445-2 of the pre-existing Treasury Regulations.

High-Level Takeaways

The final regulations generally follow the proposed regulations with two notable exceptions, which are explored in more detail below: (1) the final regulations provide a 10-year transition rule that grandfathers existing qualifying domestically controlled entities under certain circumstances; and (2) the final regulations narrow the scope of the corporate look-through rule.

Framework for Determining 'Domestic Control'

In determining whether a QIE is considered to be domestically controlled, the final regulations categorize persons and entities that hold interests in the QIE as either "look-through persons" or "non-look-through persons." As these names suggest, the domestic control analysis stops at non-look-through persons (and then considers whether such persons are foreign or domestic), but in the case of look-through persons inquires further as to the status of the owners or beneficiaries of such look-through persons. Where an owner of a QIE is a look-through person, and that look-through person in turn has owners which themselves are look-through persons, the domestic control analysis proceeds upwards through multiple tiers of look-through persons until ultimately terminating upon reaching indirect owners that are non-look-through persons.

In general, subject to certain exceptions, non-look-through persons include individuals, corporations, tax-exempt entities, foreign governments, certain foreign pension funds (i.e., "qualified foreign pension funds") and estates. Look-through persons include partnerships (other than certain publicly traded partnerships), REITs and RICs that are not considered to be public companies, S corporations, and trusts. To illustrate, assume that a QIE has one class of stock that is owned as follows: 10% each by five individuals who are U.S. residents, and the remaining 50% is owned by a foreign corporation. All of the stockholders in this example are non-look-through persons, and on these facts, the QIE is not domestically controlled, because foreign persons own ***exactly*** 50% of the value of the QIE's stock; ***not less than*** 50%. That would be the result, even if some of the owners of the foreign corporation were U.S. resident individuals. Conversely, if the foreign corporation in this example instead were a foreign partnership having some partners who were U.S. resident individuals, the analysis would then require looking through the foreign partnership to its partners, with the result that the QIE would be considered domestically controlled.

A potentially important exception to the foregoing rules applies in the case of certain non-public domestic C corporations (i.e., regular U.S.-based taxable corporations that are not publicly traded). While such corporations are generally non-look-through persons (and are treated as U.S. persons, which can be

helpful in achieving domestically controlled status), under the final regulations they are considered to be look-through persons to the extent that foreign persons directly or indirectly hold more than 50% of the fair market value of the corporation's stock. Such corporations are referred to as "foreign-controlled domestic corporations" in the final regulations. Consequently, if, for example, non-resident alien individuals own 60% of the stock of a non-public domestic C corporation (thereby causing it to be a foreign-controlled domestic corporation), which in turn holds stock of a QIE, in testing whether the QIE is domestically controlled, the indirect ownership of the non-resident alien individuals must be taken into account. This is where the proposed regulations were most controversial and unwelcome. Many taxpayers and advisors had previously concluded that there should be no look-through of a domestic C corporation that would itself be subject to entity-level tax on any gain recognized upon a sale of its interest in a QIE. This position was validated in a private letter ruling issued by the IRS to a particular taxpayer in 2009 (PLR 200923001). The minimum threshold of foreign ownership required for looking through a non-public domestic C corporation under the final regulations (i.e., "more than 50 percent") represents a liberalization from the prior proposed regulations (which utilized a more stringent "25 percent or more" standard), although the basic concept of a limited look-through is retained.

QFPFs

Qualified Foreign Pension Funds (QFPFs), as defined in Section 897(l) of the Code, are expressly exempt from U.S. tax under FIRPTA. Accordingly, QFPFs themselves have no stake in whether a QIE in which they invest is domestically controlled. Nevertheless, some taxpayers and advisors have argued, based upon the technical wording of the statutory exemption for QFPFs, that such QFPFs should not be treated as foreign persons for purposes of determining whether a QIE is domestically controlled, thereby potentially providing a tax benefit for other foreign investors that may otherwise be subject to FIRPTA.[1] The final regulations, however, unequivocally reject the foregoing argument and provide that QFPFs are non-look-through persons and are foreign persons specifically for determining whether a QIE is domestically controlled.

Other Features of the Final Regulations

The final regulations are complex, and include, in certain areas, special rules that apply to publicly traded entities (in recognition of both administrative difficulties that are more pronounced in ascertaining information about the ownership of such entities, as well as the lack of potential for abuse where such entities are employed). For example, where a QIE issues a class of stock that is publicly traded on an established securities market in the United States, in determining whether such QIE is domestically controlled, any person who holds less than 5% of such publicly traded class at all times during the prescribed testing period is treated as a U.S. person that is a non-look-through person, absent actual knowledge to the contrary.

While the final regulations require QIEs and other entities to ascertain information about their direct, and in some cases their indirect, owners in implementing the rules involving domestically controlled QIEs, they do not prescribe specific procedures to be followed in assembling that information. QIEs and entities that invest in QIEs may wish to include provisions authorizing the collection of relevant information in their organizational documents and other agreements.

[1] The FIRPTA statute provides that the tax applies to nonresident alien individuals and foreign corporations, and it exempts QFPFs by way of providing that such entities are not treated as nonresident alien individuals or foreign corporations for this purpose.

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The final regulations also include important transition rules, as summarized below, which represent a significant advancement over the previously proposed regulations (which contained no such transition relief).

Transition Rules

Although the final regulations generally apply with prospective effect to transactions occurring on or after April 25, 2024, and in a sense, they apply retroactively insofar as domestic control is subject to a testing period of up to five years preceding the sale, in the context of the controversial look-through rule for foreign-controlled domestic corporations, as described above, the final regulations allow for rather generous 10-year transitional relief. That is, for stock sales occurring prior to April 24, ***2034***, the look-through rule for foreign-controlled domestic corporations generally will not apply, with the result that a particular QIE may be considered to be domestically controlled so that FIRPTA tax does not apply to the sale, provided that the following three conditions are met at all times on and after April 24, 2024:

1. The QIE was otherwise domestically controlled without regard to the special look-through rule for foreign-controlled domestic corporations.

2. The QIE does not acquire meaningful additional USRPIs (i.e., add more than 20% to the value of its holdings of USRPIs as of April 24, 2024). The focus of this requirement is on acquisitions; mere increases in the market value of previously owned USRPIs will not violate this requirement.

3. The QIE does not undergo a change of control (i.e., holdings by a particular group of non-look-through persons do not increase in the aggregate by more than 50 percentage points).

To the extent that one or more of the foregoing requirements ceases to be met within the 10-year transition period, the transition relief will thereupon end prospectively, but such a termination will not adversely affect the tax treatment of any transactions that occurred prior to that time.

Conclusion

While the final regulations largely adopt the regime put forth in the proposed regulations issued in December 2022, and therefore will have some long-term adverse effect in narrowing the FIRPTA exemption for domestically controlled QIEs, nevertheless, the new and controversial look-through rule for foreign-controlled domestic corporations has been softened somewhat (replacing the 25% threshold from the proposed regulations with a more generous 50% threshold in the final regulations). Perhaps more importantly, the final regulations provide 10-year transitional relief, which should bestow a practical benefit on many taxpayers in pre-existing ownership structures to the extent that they ultimately sell prior to April 24, 2034, and do not otherwise forfeit the protection of the transition rules in the meantime as a result of intervening transactions. Some foreign investors might benefit from coordinating sales transactions with other owners in a particular QIE structure, so as to ensure applicability of the transitional relief.

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