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Treasury and IRS Issue Guidance on Domestically Controlled REITs and Foreign Government and Pension Fund Investors in U.S. Real Property

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On December 28, 2022, the Treasury Department and IRS released proposed regulations that address the treatment of foreign government investors eligible for the tax exemption under Section 892,[1] which own, directly or indirectly, U.S. real property interests ("USRPIs") and the determination of whether a real estate investment trust (a "REIT") is "domestically controlled." Key items in the proposed regulations include:

Domestically Controlled REIT Status

"Look-Through" Rule

- The Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") generally treats a foreign person's gain or loss from the disposition of USRPIs, including shares in U.S. real property holding corporations ("USRPHCs"), as if such gain or loss were effectively connected with a U.S. trade or business. Under an exception, interests in a "domestically controlled" REIT are not treated as USRPIs, and foreign persons generally are not subject to U.S. taxation on gain from their disposition of interests in a "domestically controlled" REIT. This exception relaxes FIRPTA's general rule that taxes foreign persons on their disposition of USRPIs in a manner similar to domestic persons in order to incentivize foreign investment in domestic real property.
- The proposed regulations introduce a limited "look-through" rule for purposes of determining whether a REIT is "domestically controlled," pursuant to which: (1) a

non-publicly traded domestic C corporation is a “look-through person” if 25% or more of its outstanding stock (by value) is owned, directly or indirectly, by foreign persons, (2) “look-through persons” include non-publicly traded partnerships, REITs, RICs, trusts and S corporations and (3) REIT stock is treated as held proportionately by each look-through person’s owners that are non-look-through persons.

- The look-through rule would be effective for transactions, including sales of REIT stock, occurring on or after the date any final regulations are issued which implement the proposed regulations, and it is possible that any final regulations differ materially from the proposed regulations. The proposed regulations do not contemplate grandfathering ownership structures established prior to finalization, and Treasury stated that it may challenge positions contrary to the look-through rule prior to finalization.
- The look-through rule may impact certain private REIT structures, including those used by investment fund sponsors. Fund sponsors and other investors in private REITs should review any such REITs that are intended to be “domestically controlled” and that are owned by domestic corporations that have significant foreign ownership. Investors may need to provide additional information related to their beneficial ownership to determine the effect of the proposed regulations.

Qualified Foreign Pension Funds ("QFPFs") Treated as Foreign Persons

- The proposed regulations also clarify that QFPFs are treated as foreign persons for purposes of determining whether a REIT is “domestically controlled.”

Foreign Government Commercial Activity Exception

- The proposed regulations create a taxpayer-favorable exception to the rule that a USRPHC, or a foreign corporation that would be a USRPHC if it were domestic, is deemed to be engaged in “commercial activity” for purposes of Section 892.
- “Controlled entities” of a foreign government that otherwise would be “controlled commercial entities” by reason of direct or indirect ownership of non-controlling interests in USRPHCs, including REITs, would not be treated as engaged in “commercial activity.” If finalized, the exception generally would allow a foreign government to maintain its exemption under Section 892 with respect to income received by or from a “controlled entity” that is otherwise not engaged in a commercial activity and that holds primarily non-controlling interests in USRPHCs.
- This exception would be effective for taxable years ending on or after the date any final regulations implementing the proposed regulations are issued, although the

proposed regulations provide that taxpayers may rely on the exception for taxable years that end before any such finalization. This exception does not affect the analysis of which types of income are exempt from taxation under Section 892.

For further questions regarding the proposed regulations, please reach out to any member of the Kirkland tax team, including the authors below.

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1. Section references in this *Alert* are to the Internal Revenue Code of 1986, as amended. ↩

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- 05 January 2023 Press Release Kirkland Counsels Third Coast Infrastructure on Amendment and Restatement of Its Existing $465 Million Portfolio Financing