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Kirkland Alert

Treasury and IRS Issue Final Regulations on Domestically Controlled REITs

29 April 2024

On April 24, 2024, the U.S. Department of Treasury and the Internal Revenue Service issued final regulations (T.D. 9992) (the “Final Regulations”) regarding the determination of whether a real estate investment trust (“REIT”) is “domestically controlled” – and thus not treated as a U.S. real property interest (“USRPI”) – for purposes of the Foreign Investment in Real Property Act (FIRPTA) rules under Section 897.¹ Subject to a transition rule discussed below, the Final Regulations apply to transactions occurring on or after April 25, 2024 (the “Effective Date”).

The Final Regulations reflect Treasury’s and the IRS’s consideration of comments and criticisms received with respect to proposed regulations that were issued on December 29, 2022 (the “Proposed Regulations”).² The Final Regulations (i) narrow the scope of the “look-through” rule introduced by the Proposed Regulations and (ii) include an up to 10-year transition rule for certain existing structures, but otherwise generally are consistent with the Proposed Regulations. For a summary of certain key areas of guidance set forth in the Proposed Regulations, see our *Alert: “Treasury and IRS Issue Guidance on Domestically Controlled REITs and Foreign Government and Pension Fund Investors in U.S. Real Property.”*

Narrowing of the Domestic C Corporation “Look-Through Rule”

- The Proposed Regulations introduced, and the Final Regulations retain, a “look-through” rule for purposes of determining whether a REIT is domestically controlled. Under this rule, a REIT’s interests are treated as held proportionately by a “look-through person’s” owners that are “non-look-through persons.” A “look-through person” includes non-publicly traded partnerships and REITs, certain RICs, trusts, S corporations and – notably – non-publicly traded domestic C corporations with

sufficient foreign beneficial ownership (the look-through of such domestic C corporations, “C-Corp Look-Through”). The Final Regulations do not incorporate any specific recommendations made by commenters on the look-through rule but do increase the foreign ownership threshold required for C-Corp Look-Through from 25% or more to greater than 50% (by value).

Transition Relief

- The Final Regulations provide transition relief by exempting certain pre-existing REITs from the application of C-Corp Look-Through for up to 10 years, subject to certain conditions, including –
 1. The REIT cannot directly or indirectly acquire USRPIs after the Effective Date with an aggregate fair market value that exceeds 20% of the fair market value of all USRPIs the REIT directly or indirectly owns on the Effective Date (valued at their recorded values as of the close of the most recent quarter in the REIT’s taxable year before the Effective Date), with certain pending transactions not being counted toward this threshold.
 2. The REIT cannot have a “significant change” in ownership, which generally means that REIT stock directly or indirectly owned by “non-look-through persons” (determined by applying the look-through rule) cannot increase by more than 50 percentage points in the aggregate compared to the ownership by such non-look-through persons on the Effective Date. This appears to be the case regardless of whether there is any increase (or potentially even a decrease) in the amount of direct or indirect foreign ownership of the REIT as a result of such ownership changes.
- A REIT that fails either of these conditions will lose the benefit of the transition rule. By restricting an existing REIT’s ability to acquire new investments or incur new development costs and/or admit new investors, these conditions may significantly limit the transition rule’s helpfulness in certain circumstances.
- The 20% limitation on new USRPIs may put domestically controlled REIT status at risk for REITs holding buildings currently under construction and projects built in phases – e.g., mixed-use projects, multi-phase industrial and technology infrastructure projects, multi-phase residential high-rise rental projects, etc. The rule does not contemplate either of these scenarios. It may be possible to manage this risk through the use of alternate structures in situations where the parties

desire to maintain domestically controlled REIT status for whatever portions of the project have already been completed.

- The change in ownership limitation may have significant implications for funds that are in the process of raising additional capital (including open-ended funds) or that permit secondary market transfers of fund interests, in either case, where such funds hold assets through REITs that wish to maintain domestically controlled status. Sponsors of such funds may find themselves having to balance the need for additional capital and/or the desire of one or more investors to exit a fund against the goal of maintaining domestically controlled REIT status for any remaining taxable foreign investors.

For questions regarding the application of the Final Regulations, please reach out to any member of the Kirkland tax team, including the authors below.

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

2. The Final Regulations do not address the rules in the Proposed Regulations regarding the treatment of qualified foreign pension funds (“QFPFs”) and qualified controlled entities (“QCEs”) for Section 892 purposes. Treasury and the IRS indicated that those rules will be addressed in separate guidance. Consistent with the Proposed Regulations, the Final Regulations generally treat QFPFs and QCEs as foreign persons for purposes of determining whether a REIT is domestically controlled.↩

Related Professionals

Justin Barbosa, P.C.

Partner / New York

Michael Beinus, P.C.

Partner / New York

Stephen Butler, P.C.

Partner / Austin / Houston

Bruce L. Gelman, P.C.

Partner / Chicago

Mike Greenberg

Partner / Los Angeles – Century City

David Levy, P.C.

Partner / Washington, D.C.

Meredith Levy, P.C.

Partner / New York

JoAnne Mulder Nagjee

Partner / Chicago

Ally F. Nelson

Associate / Bay Area – San Francisco

Brian Senie

Partner / New York

Joseph Tootle

Partner / New York

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