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Client Alert Commentary

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Final Regulations Issued on Domestically Controlled REIT Determinations and Energy Credit Transfers

Two sets of recently finalized regulations provide guidance for REITs.

Key Points:

- Final FIRPTA regulations provide rules for determining whether a REIT is domestically controlled, including a look-through rule for certain domestic C corporations.
- Final renewable energy tax credit regulations provide rules favorable to REITs holding and transferring credits.

Domestically Controlled REIT Ownership

Relevance of Domestic Control

Under Section 897[1] (commonly known as FIRPTA), a nonresident alien individual or foreign corporation is subject to US federal income tax on the disposition of a US real property interest (USRPI) as if the taxpayer were engaged in a US trade or business.[2]

If a REIT qualifies as a domestically controlled qualified investment entity, however, its stock is not treated as a USRPI, and thus a holder can dispose of such stock without being subject to tax under FIRPTA.[3] In general, for a REIT to be domestically controlled, less than 50% in value of its stock must be held "directly or indirectly" by non-US persons at all times during a five-year testing period.[4]

Proposed Regulations

In December 2022, the IRS issued proposed regulations implementing look-through rules for determining whether a qualified investment entity, including a REIT, is domestically controlled.[5] These rules purported to give effect to the statutory requirement to consider ownership directly *or indirectly* by non-US persons.[6]

The proposed regulations generally required looking through certain pass-through entities and US corporations, including non-public REITs and certain non-public foreign-owned domestic C corporations (discussed in more detail below). The proposed regulations treated a public qualified investment entity (generally, a regulated investment company or REIT) as a non-US person unless such entity is itself a domestically controlled qualified investment entity. Nevertheless, a person who at all times holds less than 5% of any class of US publicly traded stock of a REIT would have been treated as a US person unless the REIT has actual knowledge that such person is not a US person.[7]

The proposed regulations also confirmed that a qualified foreign pension fund is treated as a non-US person,[8] even though qualified foreign pension funds generally are not treated as nonresident alien individuals or foreign corporations under FIRPTA if they meet certain requirements.[9]

The look-through rule for certain non-public foreign-owned domestic C corporations under the proposed regulations would have required looking through any such corporation if non-US persons held, directly or indirectly, 25% or more of the value of its stock.[10] A number of commenters requested that the IRS withdraw this rule, arguing that (1) the Code does not permit looking through domestic C corporations for this purpose, including because the Code does not refer to constructive ownership rules in determining whether a qualified investment entity is domestically controlled, (2) the rule is inconsistent with congressional intent, and (3) the rule is not necessary because domestic C corporations are subject to US tax.[11]

Final Regulations

Notwithstanding the above comments, on April 24, 2024, the IRS issued final regulations that generally follow the proposed regulations with some modifications.[12] The final regulations retain a look-through rule for non-public foreign-controlled domestic C corporations; however, the amount of non-US ownership needed before the look-through rule applies has been increased to more than 50% of the value of the corporation's stock (rather than 25% or more).[13]

The final regulations also modify the presumption that, if a person holds less than 5% of any class of US publicly traded stock of a REIT, such person is treated as a US person absent actual knowledge to the contrary. As modified, the presumption further requires that the REIT not have actual knowledge that the person is foreign controlled (treating such person as a non-public domestic C corporation).[14] In other words, if the REIT knows that a shareholder is more than 50% owned by non-US persons, then the REIT cannot assume that the shareholder is a US person.

In addition, the final regulations add a transition rule that delays application of the new look-through rules for non-public foreign-controlled domestic C corporations for up to 10 years for REITs that meet certain requirements regarding share ownership and asset composition.[15]

While these look-through rules will need to be taken into account in structuring private REITs to be domestically controlled, and not every existing REIT may be able to take advantage of the transition rule because of its requirements, public REITs are still able to rely on the presumption that less than 5% shareholders of a class of US publicly traded stock are US persons absent actual knowledge to the contrary or actual knowledge that the shareholders are foreign controlled.

REIT Ownership and Transfer of Energy Credits

Under Section 6418, added by the Inflation Reduction Act of 2022, an eligible taxpayer may elect to transfer all or a portion of certain renewable energy tax credits.[16] Of particular note to REITs, consideration received upon transfer of such credits is excluded from gross income.[17] Thus, such consideration is not taken into account for purposes of either the REIT income tests[18] or the REIT prohibited transactions tax.[19]

On April 25, 2024, the IRS issued final regulations governing the transfer of such tax credits.[20] These regulations largely finalize proposed regulations issued in June 2023[21] (for more information, see this Latham Client Alert). However, the IRS added two helpful clarifications for REITs:

- The tax credits are disregarded for purposes of the REIT asset tests under Section 856(c)(4).[22]

- A transfer of the tax credits with a valid transfer election is not treated as a sale for purposes of a REIT's prohibited transaction safe harbor limits under Sections 857(b)(6)(C)(iii) and 857(b)(6)(D)(iv) (i.e., the "7 sales" or basis or value limits).[23]

As noted above, income realized as a result of the transfer of these tax credits is excluded from gross income under the Code, and so will not be subject to the prohibited transactions tax for REITs. However, until the clarification added by the final regulations, it was not clear whether a transfer of a tax credit could nevertheless count toward the prohibited transaction safe harbor limits.

The final regulations provide welcome guidance for REITs earning applicable renewable energy tax credits. However, questions remain for REITs that are considering producing renewable energy, including whether selling such energy may be treated as a prohibited transaction or may cause the REIT to be treated as a dealer for purposes of selling real estate. While a commenter had requested guidance on these issues, the IRS declined to provide additional guidance in this area in these regulations.[24]

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Endnotes

1 All references to "Section" are to the Internal Revenue Code of 1986, as amended (the Code), unless otherwise indicated.

2 Section 897(a).

3 Section 897(h)(2).

4 Section 897(h)(4)(B); Section 897(h)(4)(D).

5 Prop. Treas. Reg. § 1.897-1(c)(3) (2022).

6 Guidance on the Foreign Government Income Exemption and the Definition of Domestically Controlled Qualified Investment Entities, 87 Fed. Reg. 80,097, 80,100-80,102 (Dec. 29, 2022).

7 Prop. Treas. Reg. § 1.897-1(c)(3) (2022).

8 Prop. Treas. Reg. § 1.897-1(c)(3)(iv)(A) (2022).

9 Section 897(l); Prop. Treas. Reg. § 1.897(l)-1 (2022).

10 Prop. Treas. Reg. § 1.897-1(c)(3)(v)(B) (2022).

11 T.D. 9992, 89 Fed. Reg. 31,618, 31,619-31,621 (Apr. 25, 2024).

12 T.D. 9992, 89 Fed. Reg. 31,618 (Apr. 25, 2024).

13 Treas. Reg. § 1.897-1(c)(3)(v)(B).

14 Treas. Reg. § 1.897-1(c)(3)(iii)(A).

15 Treas. Reg. § 1.897-1(c)(3)(vi).

16 Section 6418(a).

17 Section 6418(b)(2).

18 *See* Section 856(c)(2) and Section 856(c)(3).

19 *See* Section 857(b)(6).

20 T.D. 9993, 89 Fed. Reg. 34,770 (Apr. 30, 2024).

21 Prop. Treas. Reg. § 1.6418-5 (2023).

22 Treas. Reg. § 1.6418-5(i)(1).

23 Treas. Reg. § 1.6418-5(i)(2).

24 T.D. 9993, 89 Fed. Reg. 34,770, 34,797 (Apr. 30, 2024).