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Foreign Investment in REITs Subject to New IRS Regulations

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The IRS recently finalized regulations (TD 9992) that stand to significantly affect foreign investment in real estate investment trusts (REITs) structured to qualify as "domestically-controlled" REITs (D-REITs). D-REITs have long been a popular investment vehicle for foreign persons due to various tax benefits. Namely, certain foreign persons can avoid filing a U.S. tax return or paying capital gains taxes under FIRPTA rules when selling stock in a D-REIT.

To qualify as a D-REIT, a majority of a REIT's stock must be held (directly or indirectly) by U.S. persons (including business entities). Prior to the new IRS regulations, foreign investors did not affect the calculation of the D-REIT qualification threshold if such foreign investment was made through a U.S. C-corporation that owned stock in the D-REIT. IRS guidance from 2009 held that C-corporations will be treated as domestic holders of REIT stock for purposes of D-REIT qualification (PLR 200923001).

With exceptions, the new regulations generally allow the IRS to "look through" U.S. C-corporations and determine whether the corporations' shareholders are foreign persons. If more than 50% of a U.S. C-corporation's shareholders are foreign persons, the C-corporation will not qualify as a U.S. person for purposes of D-REIT qualification. Accordingly, many REITS that have relied on the previous guidance may stand to lose D-REIT status under the new IRS regulations.

Luckily for foreign D-REIT investors, the new regulations provide a 10-year transition period for existing D-REITs to come into compliance. Provided such existing D-REITs do not trigger an early expiration of the transition period through certain new acquisitions, new foreign investment, or other pitfalls provided in the new regulations, U.S. C-corporations will continue to be treated as U.S. persons, despite a majority interest being held by foreign shareholders, until 2034.

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