



## US International Tax Alert

Final FIRPTA regulations on domestically controlled QIEs

### Overview

On April 24, 2024, the IRS and Treasury released final regulations (the “Final Regulations”) under section 897 (the Foreign Investment in Real Property Tax Act (FIRPTA)) addressing whether a qualified investment entity (a QIE, which is defined as a real estate investment trust (REIT) and certain regulated investment companies (RICs)) is “domestically controlled” under section 897(h)(4), and related final regulations under section 1445.<sup>1</sup> The Final Regulations adopt the 2022 proposed regulations<sup>2</sup> (the “Proposed Regulations”) with limited modifications, but add additional rules described below. The Final Regulations generally are effective as of April 25, 2024 (the date of their publication in the Federal Register).

The Final Regulations adopt a look-through rule with respect to certain foreign-controlled domestic corporations (the “Domestic Corporation Look-through Rule”, as defined below) for the purpose of determining whether a QIE is domestically controlled under section 897(h)(4). This approach was widely criticized by commenters as inconsistent with existing regulations, changes made to section 897 by the PATH Act in 2016, a prior private letter ruling, and market practices. The Final Regulations provide for a 10-year transition rule for the Domestic Corporation Look-through Rule and raise the relevant “foreign ownership” threshold for its application from the 25%-or-more threshold in the Proposed Regulations to a more-than-50% standard.

This alert provides a high-level overview of the Final Regulations.

### Background

#### Section 897

- In general, section 897 imposes US tax on the gain realized by nonresident alien individuals and foreign corporations from the disposition of a United States real property interest (USRPI). The definition of USRPI is broad and includes interests (other than solely as a creditor) in any domestic corporation unless the taxpayer establishes

<sup>1</sup> 89 FR 31618.

<sup>2</sup> 87 FR 80097.

that such corporation was at no time a United States real property holding corporation (USRPHC) during the five-year period ending on the date of the disposition or the holding period of the taxpayer, if shorter.<sup>3</sup>

- In addition, the FIRPTA rules treat distributions from QIEs to a nonresident alien individual, a foreign corporation, or another QIE to the extent attributable to the QIEs' disposition of USRPI, as gain recognized by such foreign investor from the sale or exchange of USRPI unless an exception applies.<sup>4</sup>
- Section 897(h)(2) provides that an interest in a domestically controlled QIE is not USRPI ("DC-QIE exception"). A QIE is a DC-QIE if less than 50% of the value of its stock is held directly or indirectly by foreign persons at all times during the five-year period ending on the date of the relevant disposition.<sup>5</sup>

### Section 1445

- Section 1445 generally provides rules regarding circumstances where a transferee of USRPI is required to withhold on the transferor.
- Treas. Reg. § 1.1445-2(c)(3) provides that no withholding is required when the transferor provides the transferee with a copy of a statement issued by the corporation pursuant to Treas. Reg. § 1.897-2(h) that the interest in the corporation is not USRPI.

### Final Regulations under section 897

#### Look-through rule

**General approach:** The Proposed Regulations included new rules for determining the direct or indirect holders of QIE stock for purposes of section 897(h)(4). The Final Regulations adopt the rules from the Proposed Regulations with some modifications. The preamble to the Final Regulations explains that the intention of these rules is to "give effect to the term 'indirectly' as used in section 897(h)(4)(B)".<sup>6</sup> Under the Final Regulations, "look-through persons" (generally, non-publicly traded partnerships, trusts, S corporations, RICs or REITs that are not publicly traded, and "foreign-controlled" US corporations)<sup>7</sup> generally are not treated as direct or indirect holders of QIE stock.<sup>8</sup> Instead, the shareholders, partners, or beneficiaries of the look-through person are treated, proportionately, as the direct or indirect holders of the QIE stock, applied successively, if relevant, through tiers of look-through persons.<sup>9</sup> Non-look through persons (generally, individuals, foreign corporations, domestic corporations other than foreign-controlled domestic corporations, tax-exempts, publicly traded partnerships, public RICs, international organizations, QFPFs/QCEs)<sup>10</sup> are considered to directly or indirectly hold QIE stock.<sup>11</sup>

<sup>3</sup> Section 897(c)(1)(ii).

<sup>4</sup> See Section 897(h)(1).

<sup>5</sup> Section 897(h)(4)(B).

<sup>6</sup> TD 9992.

<sup>7</sup> See Treas. Reg. § 1.897-1(c)(3)(v)(C).

<sup>8</sup> Treas. Reg. § 1.897-1(c)(3)(ii)(B).

<sup>9</sup> Ibid.

<sup>10</sup> See Treas. Reg. § 1.897-1(c)(3)(v)(D).

<sup>11</sup> Treas. Reg. § 1.897-1(c)(3)(ii)(A).

**Domestic corporation look-through rule:** While the Proposed Regulations treated a US corporation as a look-through person if it was “foreign-owned,” which was defined as having 25% or more of the fair market value of its stock held directly or indirectly by foreign persons, the Final Regulations change the definition of look-through person to include “foreign-controlled” US corporations. A US corporation is “foreign-controlled” if it is a “non-public domestic C corporation”<sup>12</sup> and more than 50% of the fair market value of its stock is held directly or indirectly by foreign persons.<sup>13</sup>

**Observation:**

The “look-through” of “foreign-controlled” domestic corporations is inconsistent with a prior private letter ruling<sup>14</sup> and with common practice prior to the Proposed Regulations, based in part on an interpretation of the regulations and the reference therein to “actual owners of the stock” as defined by Treas. Reg. § 1.857-8. Additionally, the Final Regulations introduce a new threshold of more-than-50% ownership of the fair market value of a domestic corporation’s stock, which appears to look strictly at fair market value and across all classes of outstanding stock, rather than testing each class of stock or looking at voting rights.

**Actual knowledge exception:** In addition to the rules adopted from the Proposed Regulations, the Final Regulations add that for purposes of determining whether a QIE is domestically controlled, if the QIE has actual knowledge that a public domestic C corporation shareholder is foreign-controlled, then the corporation is treated as if it were a “non-public domestic C corporation” requiring look-through.<sup>14</sup> Additionally, similar rules apply to treat both public RICs and publicly traded partnerships as look-through persons for determining DC-QIE status if the QIE in question has actual knowledge that the shareholder is foreign-controlled (treating the entity in question as if it were a non-public domestic C corporation).<sup>15</sup>

**Observation:**

This rule apparently applies even when it is the foreign shareholder – rather than the QIE – that is making the determination; for example, if a foreign shareholder sells shares in a QIE that has not provided the “optional” certification that it is a DC-QIE (described below), in order for the selling foreign shareholder to make the determination of whether it has sold shares in a DC-QIE, it would seem to require such a shareholder to have access to what the QIE knows about the QIE’s other shareholders.

**Ten-year transition rule for the domestic corporation look-through rule for existing QIEs**

While the Final Regulations generally are effective as of April 25, 2024, the effective date of the Domestic Corporation Look-through Rule is April 24, 2034 for QIEs in existence as of April 25, 2024 that satisfy the following requirements (the “Transition Rule Limitations”):

<sup>12</sup> Defined by Treas. Reg. § 1.897-1(c)(3)(v)(E) as “any domestic C corporation that is not a public domestic C corporation.”

<sup>13</sup> See Treas. Reg. § 1.897-1(c)(3)(v)(B).

<sup>14</sup> Treas. Reg. § 1.897-1(c)(3)(v)(G).

<sup>15</sup> See Treas. Reg. § 1.897-1(c)(3)(v)(I)-(J).

1. The QIE must be domestically controlled (without regard to the application of the Domestic Corporation Look-through Rule) at all times on and after April 25, 2024;<sup>16</sup>
2. After April 25, 2024, the QIE does not directly or indirectly acquire USRPI with an aggregate fair market value that is more than 20% of the aggregate fair market value of USRPI held (directly or indirectly) on April 25, 2024 (as determined by Treas. Reg. § 1.897-1(c)(3)(vi)(D)) (the “Twenty Percent Additional Asset Limitation”);<sup>17</sup> and
3. The QIE stock held directly or indirectly by one or more “non-look through persons” does not increase by more than 50% from the amount held by such “non-look through persons” on April 25, 2024 (the “Fifty Percent Ownership Change Limitation”).<sup>18</sup>

In order for a QIE to qualify for delayed application of the Domestic Corporation Look-through Rule, it must exist on April 25, 2024.<sup>19</sup> While there is a binding commitment rule that treats acquisitions of USRPI by a QIE and stock in a QIE as occurring on April 25, 2024 if there was a binding written agreement in place prior to April 25, 2024,<sup>20</sup> there is no such rule that applies to a QIE when there is a binding commitment from investors but the entity was not formed on or before April 25, 2024. Similarly, it appears that a QIE that is owned by another QIE and is formed after April 25, 2024, must apply the Domestic Corporation Look-through Rule to determine whether it is a DC-QIE, even if the upper-tier QIE can apply the transition rule.

Under the Twenty Percent Additional Asset Limitation, the Final Regulations provide that the value of USRPI held on April 25, 2024, is the value of such property as calculated under the RIC and REIT asset tests in section 851(b)(3) or 856(c)(4), respectively, as of the close of the most recent quarter of the QIE’s taxable year ending before April 25, 2024. The fair market value of USRPI acquired after April 25, 2024, is determined as of each acquisition date using a consistently applied reasonable method.<sup>21</sup>

**Observation:**

Importantly, the Twenty Percent Additional Asset Limitation is not indexed for inflation. As a result, its utility is expected to diminish over time. Specifically, the denominator for the test is based on a valuation performed in 2024, so any additional assets that are acquired during the ten-year period are compared based on that static valuation. An additional area of uncertainty under the Twenty Percent Additional Asset Limitation is the treatment of real property received in a section 1031 exchange, and whether that property would be treated as “acquired” for this purpose.

Under the Fifty Percent Ownership Change Limitation, the transferor and resulting corporation following a section 368(a)(1)(F) reorganization are treated as the same corporation.<sup>22</sup> Further, in the case of a publicly traded QIE,

<sup>16</sup> Treas. Reg. § 1.897-1(c)(3)(vi)(A)(1).

<sup>17</sup> Treas. Reg. § 1.897-1(c)(3)(vi)(A)(2).

<sup>18</sup> Treas. Reg. § 1.897-1(c)(3)(vi)(A)(3).

<sup>19</sup> Treas. Reg. § 1.897-1(c)(3)(vi)(A).

<sup>20</sup> Treas. Reg. § 1.897-1(c)(3)(vi)(E).

<sup>21</sup> Treas. Reg. § 1.897-1(c)(3)(vi)(D).

<sup>22</sup> Treas. Reg. § 1.897-1(c)(3)(vi)(F).

all stock held by persons holding less than 5% of such publicly traded class of stock are treated as a single non-look through person unless the QIE has actual knowledge regarding the ownership of a person holding such stock.<sup>23</sup>

**Observation:**

The Fifty Percent Ownership Limitation seems more likely to apply to “open-ended funds” rather than “closed-end funds” as a closed-end fund is much less likely to have relevant ownership changes that could trigger the QIE’s disqualification for the transition rule. The Domestic Corporation Look-through Rule applies prospectively from the date that a QIE ceases to satisfy one or more of the Transition Rule Limitations.<sup>25</sup>

**QFPFs treated as foreign persons for determining DC-QIE status**

Consistent with the Proposed Regulations, the Final Regulations clarify that qualified foreign pension funds<sup>24</sup> (QFPFs) (including qualified controlled entities (QCEs)) and international organizations<sup>25</sup> are treated as foreign persons for determining whether a QIE is “domestically controlled” under section 897(h)(4).<sup>26</sup> This rule is effective as of April 25, 2024.

**Less-than-5% holders of publicly traded QIEs treated as US persons**

Consistent with the Proposed Regulations, the Final Regulations provide that a person holding less than 5%<sup>27</sup> of US publicly traded stock in a QIE is treated as a United States person that is a “non-look-through person” with respect to that stock unless the QIE has actual knowledge that the person is not a US person. The Final Regulations extend this actual knowledge rule to include a person that is known by the QIE to be foreign-controlled under Treas. Reg. § 1.897-1(c)(3)(v)(B).<sup>28</sup> This provision generally is effective as of April 25, 2024.

**Optional certification of DC-QIE status**

As a general rule, Treas. Reg. § 1.897-2(g) provides that a foreign person disposing of an interest (other than solely as a creditor) in a domestic corporation must establish that such interest was not USRPI (by obtaining a certificate from the corporation pursuant to Treas. Reg. § 1.897-2(h)) or it is required to treat the gain or loss as income effectively connected with a US trade or business (“ECI”).<sup>29</sup> This general rule does not apply to a holder of an interest in a DC-QIE.<sup>30</sup>

To effectuate the general rule, Treas. Reg. § 1.897-2(h) generally provides that a US corporation must timely respond to a request from a foreign shareholder as to whether such foreign shareholder’s interest in such US corporation is

<sup>23</sup> Treas. Reg. § 1.897-1(c)(3)(vi)(G).

<sup>24</sup> As defined by section 897(l).

<sup>25</sup> As defined in section 7701(a)(18).

<sup>26</sup> Treas. Reg. § 1.897-1(c)(3)(iv).

<sup>27</sup> It is interesting that a “less-than-5%” standard is adopted here. In other places within section 897 (e.g., 897(c)(3)), a “more-than-5%” threshold is used, so this appears to create inconsistent “5%” references throughout section 897 and the regulations thereunder.

<sup>28</sup> Treas. Reg. § 1.897-1(c)(3)(iii)(A).

<sup>29</sup> Treas. Reg. § 1.897-2(g)(1)(i).

<sup>30</sup> Treas. Reg. § 1.897-2(g)(3) (flush language).

USRPI. In the case of a foreign shareholder in a corporation that seeks to establish that the corporation is a DC-QIE, the Final Regulations add a rule that a domestically controlled QIE may – but is not required to – respond to a request by issuing a statement to the shareholder that the corporation is a DC-QIE.<sup>31</sup> If a DC-QIE provides notice to a shareholder that it qualifies as a DC-QIE, it must follow the general procedures for notice under Treas. Reg. § 1.897-2(h), which include providing the notice to the IRS within 30 days of issuance unless the notice was filed with the prior period's tax return.

### Final Regulations under section 1445

The Final Regulations expand the exception from general withholding under section 1445(a) on a disposition of an interest in a US corporation by a foreign person to include circumstances in which the transferor provides the transferee with a statement, voluntarily issued by the corporation regarding an interest that is being transferred, pursuant to Treas. Reg. § 1.897-2(h) (and described above), that certifies that it qualifies as a DC-QIE.<sup>32</sup> The general provisions of Treas. Reg. § 1.1445-2(c)(3)(i) apply to the DC-QIE status certification, including that the certification must be issued no more than 30 days prior to the date of the transaction to be valid. This provision and the related notice requirement under Treas. Reg. § 1.897-2(h)(3) are applicable on or after April 25, 2024.

#### Observation:

It is unclear whether, and to what extent, the Final Regulations will change market practices upon disposition of stock in a QIE. On one hand, the QIE's issuance of a DC-QIE certification is, on its face, optional. On the other hand, the exception to withholding could imply that withholding is required absent a DC-QIE certification. As noted previously, under the Final Regulations, in many cases the determination of whether an entity is a DC-QIE will, practically speaking, be determinable only by the DC-QIE itself. Further, in the absence of a specific rule for DC-QIEs, prior to the Final Regulations, many foreign persons selling interests in QIEs relied on less-formal communication from the QIE (such as an email) that the corporation was a DC-QIE; similarly, many transferees of such interests relied on this less-formal communication to determine that withholding was not required under section 1445. A similar issue exists when a partnership, determining its section 1446(a) withholding obligation, sells an interest in a QIE for which it must determine whether the QIE is domestically controlled.

These changes to the DC-QIE rules, including the changes to the withholding tax regulations, potentially could have a significant impact on foreign investment in US real estate. Foreign investors, along with REITs and RICs, should examine their existing structures and carefully consider the Final Regulations when affected interests are transferred or new investments are made.

<sup>31</sup> Treas. Reg. § 1.897-2(h)(3).

<sup>32</sup> Treas. Reg. § 1.1445-2(c)(3)(i).

# Contacts

[Jason Smyczek](#), Washington, DC

[Anna De Young](#), Washington, DC

[Christine Piar](#), Washington, DC

[David Levine](#), Washington, DC

[Jason Robertson](#), Washington, DC



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30 Rockefeller Plaza  
New York, NY 10112-0015  
United States

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