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Client Alert
Commentary

Latham & Watkins Real Estate Investment Trust Practice December 23, 2015 | Number 1910

Congress Enacts Significant Changes to the REIT and FIRPTA Rules

Changes include restrictions on tax-free REIT spinoffs and other reforms generally favorable to REITs and non-US investors in US real estate

On December 18, 2015, President Obama signed into law the Protecting Americans from Tax Hikes Act of 2015 (Act), also known as the PATH Act. The Act, which extends various tax benefits for individuals and businesses that were set to expire, contains several provisions affecting real estate investment trusts (REITs) and non-US investors in US real estate. Among other things, these provisions (1) limit tax-free REIT spinoffs; (2) make it easier for REITs to comply with certain REIT qualification requirements; and (3) limit the application of the Foreign Investment in Real Property Tax Act (FIRPTA) to non-US investors, providing non-US investors with more opportunities to invest in US real estate without being subject to US tax and withholding.

Restrictions on Tax-Free REIT Spinoffs

Under Section 355 of the Internal Revenue Code (Code), a distribution by a corporation (Parent) to its shareholders of the stock of a controlled subsidiary (Spinco) may be tax-free to Parent and Parent's shareholders if certain requirements are satisfied. In recent years, a number of companies with substantial real estate assets have separated, or have announced plans to separate, their operating business from their real estate holdings via a tax-free spinoff. In these spinoffs, the company holding the real estate assets typically would make a REIT election. Raising concerns this structure may violate one or more requirements under Section 355 of the Code, the Internal Revenue Service (IRS) announced in September 2015 that it was studying such issues and, absent unique and compelling circumstances, the IRS would not issue rulings on a spinoff in which Parent or Spinco (but not both) elects to be a REIT in conjunction with the spinoff.

The Act places limits on the ability to engage in tax-free spinoffs involving REITs by providing that Section 355 of the Code does not apply to any spinoff where either Parent or Spinco is a REIT. Further, the Act provides that neither Parent nor Spinco may make a REIT election during the 10-year period following a tax-free spinoff. The Act permits tax-free spinoffs involving REITs in two special cases: (1) both Parent and Spinco will be REITs immediately after the distribution, or (2) Parent is a REIT, Spinco is a taxable REIT subsidiary (TRS) and Parent has controlled (directly or indirectly) Spinco for at least three years.

These provisions of the Act apply to spinoffs occurring on or after December 7, 2015, except if the spinoff occurs pursuant to a transaction described in a pending private letter ruling request submitted to the IRS on or before such date.

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Changes to the REIT Rules

Relief from Preferential Dividend Rule

A REIT is required to distribute at least 90% of its ordinary taxable income annually, and is subject to corporate-level tax to the extent the REIT distributes less than 100% of its taxable income. However, under the pre-Act law, "preferential dividends" did not count toward satisfying these requirements. A dividend is generally "preferential" unless the dividend is distributed pro rata to a class of shareholders, with no preference to any class of stock except to the extent that class is entitled to such preference.

The Act repeals this preferential dividend rule for "publicly offered" REITs (*i.e.*, REITs that are required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Exchange Act of 1934), effective for distributions in taxable years beginning after December 31, 2014.

Although the preferential dividend rule will continue to apply to other REITs, the Act grants the US Treasury authority to provide an appropriate remedy to cure any REIT's failure to comply with such rule, if the failure is inadvertent or due to reasonable cause and not wilful neglect. This regulatory authority will be effective for distributions in taxable years beginning after December 31, 2015.

Expansion of REIT Asset and Income Tests

A REIT must comply with, among other requirements, both a "75% income test" and "95% income test," as well as a "75% asset test." Under the 75% and 95% income tests, at least 75% and 95%, respectively, of the REIT's gross income in each taxable year must consist of rents from real property, interest on mortgages secured by real property, and certain other types of qualifying income. Under the 75% asset test, at least 75% of the REIT's assets at the close of each quarter of the taxable year must consist of real estate assets, cash and cash items, and US government securities. For purposes of the income tests, rents from real property may include rent attributable to personal property leased in connection with a lease of real property, provided the rent attributable to the personal property for the taxable year does not exceed 15% of the total rent for the taxable year attributable to both the real and personal property leased in connection with such lease.

The Act provides that personal property leased in connection with a lease of real property qualifies as a real estate asset for purposes of the 75% asset test to the extent rent attributable to such personal property meets the 15% test described above. The Act also provides that debt secured by a mortgage on both real and personal property qualifies as a real estate asset for purposes of the 75% asset test, and interest on such debt is qualifying income for purposes of both the 75% and 95% income tests, if the fair market value of the personal property does not exceed 15% of the total fair market value of the real and personal property securing the mortgage (and certain other requirements are met).

In addition, the Act provides that debt instruments issued by publicly offered REITs qualify as real estate assets for purposes of the 75% asset test. Income from such debt instruments is qualifying income for purposes of the 95% income test. Such income, however, is not qualifying income for purposes of the 75% income test, and not more than 25% of the value of a REIT's total assets may consist of such debt instruments.

These provisions are effective for taxable years beginning after December 31, 2015.

Five-Year Recognition Period for Built-In Gains Tax

If a C corporation converts into a REIT or a REIT acquires assets from a C corporation in a tax-free transaction, the REIT is subject to a corporate-level tax on any "built-in gain" recognized by the REIT

(*e.g.*, upon a sale of assets) within a specified recognition period after such conversion or acquisition. Under the pre-Act law, this recognition period was generally 10 years, but was shortened to seven years for taxable years beginning in 2009 and 2010, and five years for taxable years beginning in 2012, 2013 and 2014. For taxable years beginning in 2015 and thereafter, the recognition period was scheduled to revert to 10 years.

The Act makes permanent the five-year recognition period, effective for taxable years beginning after December 31, 2014.

Limit on Ownership of Taxable REIT Subsidiaries

Under the pre-Act law, a REIT could not own securities of one or more TRSs to the extent the value of such securities would constitute more than 25% of the value of the REIT's total assets.

The Act reduces this limit to 20%, effective for taxable years beginning after December 31, 2017.

Prohibited Transaction Safe Harbors

A REIT is subject to a 100% tax on income from "prohibited transactions" (*i.e.*, generally sales of property, other than foreclosure property, held primarily for sale to customers in the ordinary course of a trade or business). A safe harbor under the REIT rules provides, however, that a sale of property held for two or more years is not a "prohibited transaction" if certain requirements are met, including that either (1) the REIT does not make more than seven property sales during the taxable year, or (2) the aggregate adjusted basis or fair market value of property sold during the taxable year does not exceed 10% of the aggregate adjusted basis or fair market value, as applicable, of all of the REIT's property as of the beginning of the taxable year. Under the pre-Act law, if the requirement in clause (1) was not satisfied, substantially all of the marketing and development expenditures with respect to the property had to be conducted through an independent contractor from which the REIT does not derive or receive any income.

The Act provides an alternative test for satisfying the requirement in clause (2) above. Under this alternative test, the percentage limit in clause (2) above is 20%, provided that the three-year average percentage (of adjusted basis or fair market value, as applicable) for the taxable year does not exceed 10%. This change is effective for taxable years beginning after December 18, 2015.

The Act also clarifies that if the requirement in clause (1) above is not satisfied, the property marketing and development expenditures referenced above could be made through a TRS (not just an independent contractor). This change is effective for taxable years beginning after December 31, 2015.

Changes to the FIRPTA Rules

Expanded Exceptions for Small Holders of Publicly Traded REIT Stock

Certain rules imposed by FIRPTA result in US taxation of non-US persons who invest in US real property interests (USRPIs). Under the pre-Act law, stock of a US real property holding corporation (USRPHC) that is "regularly traded on an established securities market" is treated as a USRPI with respect to any non-US shareholder only if such shareholder has owned more than 5% of the stock during the shorter of (i) the shareholder's holding period or (ii) the five-year period ending on the date of the disposition of the stock (the relevant testing period). Thus, non-US investors who acquire no more than 5% of the shares of publicly traded USRPHCs generally are not subject to FIRPTA tax or withholding. A similar exception applies with respect to certain distributions (which would otherwise be subject to FIRPTA) a publicly

traded REIT makes to non-US shareholders owning no more than 5% of the REIT's stock during the one-year period prior to such distributions.

The Act increases the percentage ownership limit for these exceptions from 5% to 10% in the case of publicly traded REIT stock. For publicly traded stock of USRPHCs other than REITs, the percentage ownership limit for these exceptions will continue to be 5%.

In addition, the Act provides an exception from FIRPTA for "qualified shareholders" (*i.e.*, certain publicly traded non-US investment vehicles that meet certain recordkeeping and other requirements). Under this exception, a qualified shareholder may own and dispose of any amount of stock in a REIT without the REIT stock being treated as a USRPI, except to the extent an investor (that is not itself a qualified shareholder) in the qualified shareholder constructively holds more than 10% of the REIT's stock.

These changes are effective for dispositions and distributions occurring on or after December 18, 2015.

Expanded Domestically Controlled REIT Exception

Stock of a "domestically controlled" REIT is not treated as a USRPI. Thus, non-US investors who acquire stock of a domestically controlled REIT generally are not subject to FIRPTA. For this purpose, a REIT is "domestically controlled" if at all times during the shorter of (i) the five-year period ending on the date of the disposition or distribution, or (ii) the period during which the REIT was in existence, less than 50% in value of the stock was held directly or indirectly by non-US persons.

The Act provides several presumptions to facilitate the determination of domestically controlled status for publicly traded REITs. First, a REIT may presume that holders of less than 5% of a class of stock regularly traded on an established securities market in the United States are US persons throughout the testing period, except to the extent that the REIT has actual knowledge to the contrary. Second, any stock in the REIT held by another REIT that is publicly traded will be treated as held by a non-US person unless the other REIT is domestically controlled, in which case the stock will be treated as held by a US person. Finally, any stock in a REIT held by another REIT that is not publicly traded will be treated as held by a US person to the extent that US persons hold the other REIT's stock.

This provision is effective as of December 18, 2015.

Exception for Interests Held by Qualified Foreign Pension Funds

US pension funds are generally exempt from US income tax. Under the pre-Act law, however, non-US pension funds were subject to US income tax and withholding under the FIRPTA regime on gains and proceeds attributable to interests in US real property.

The Act brings the treatment of non-US pension funds more in line with the treatment of US pension funds by exempting USRPIs held by qualified foreign pension funds (as specially defined in the Act), or held by non-US entities wholly owned by qualified foreign pension funds, from FIRPTA tax and withholding.

Although a qualified foreign pension fund is no longer subject to tax under the FIRPTA regime, qualified foreign pension funds continue to be subject to tax on income that is effectively connected with a US trade or business under Section 864 of the Code. As such, if a qualified foreign pension fund invests in an entity that is treated as a partnership for US income tax purposes, the qualified foreign pension fund's allocable share of partnership income that is effectively connected with a US trade or business will continue to be subject to US income tax. In addition, under the position taken by the IRS in Revenue

Ruling 91-32,[1] gain recognized on the sale of the interest in such entity would be subject to US income tax to the extent the gain is attributable to the US trade or business. For this reason, the rule that exempts qualified foreign pension funds from tax under the FIRPTA regime is likely to be most significant with respect to investments in partnerships that are passive investors in US real estate assets or in stock of USRPHCs, such as REITs.

This provision is effective for dispositions and distributions occurring after December 18, 2015.

"Cleansing Rule" Not Applicable to REIT Stock

A USRPI includes stock of a corporation that was treated as a USRPHC at any time during the relevant testing period. Under a so-called "cleansing rule," however, a corporation's stock is not considered to be a USRPI if it meets the following requirements: (1) as of the date of the disposition of the stock, the corporation held no USRPIs, and (2) all of the USRPIs the corporation held at any time during the relevant testing period (i) were disposed of in transactions in which the full amount of any gain was recognized, or (ii) ceased to be USRPIs through application of the cleansing rule.

The Act makes the cleansing rule inapplicable to any corporation that was a REIT at any time during the relevant testing period. The rationale for this change is that even if a REIT recognized the full amount of gain inherent in its USRPIs upon their disposition, because REITs generally are not subject to a corporate-level tax, "cleansing" the REIT's stock of USRPI status would cause all the gain to escape the US tax system permanently.

This provision applies to dispositions on or after December 18, 2015.

Increase in FIRPTA Withholding Rate

Under the pre-Act law, a purchaser of a USRPI from a non-US person is required to withhold 10% of the gross purchase price, unless an exception applies.

The Act increases the withholding rate on a disposition of a USRPI to 15%. However, a limited exception provides that the old 10% withholding rate will continue to apply for any disposition of property acquired for use as a residence, where the amount realized does not exceed US$1 million.

This provision applies to dispositions after February 16, 2016.

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Endnotes

[1] Rev. Rul. 91-32, 1991-1 C.B. 107.