New Legislation Significantly Changes Taxation of REITs and Non-U.S. Investors in U.S. Real Estate

On December 18, 2015, the "Protecting Americans from Tax Hikes Act of 2015" was enacted. This legislation includes a number of sweeping tax law changes that impact U.S. private equity and real estate.

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Prohibition on REIT Spinoffs

In recent years, many business corporations with significant real estate portfolios have separated their real estate assets from their operating assets in a tax-free spinoff, after which the spun-off real estate entity leases its real estate assets back to the operating company. The spun-off real estate entity then elects to be treated as a real estate investment trust (a "REIT"), which is not subject to corporate-level tax so long as it distributes 100% of its taxable income to its shareholders each year.

These transactions provide significant benefits to shareholders by unlocking (or maximizing) the real estate's value, including by more efficiently deploying capital and permitting increased operational focuses between different businesses. The recently confirmed Energy Future Holdings chapter 11 reorganization, as well as the proposed Caesars Entertainment chapter 11 reorganization, contemplate REIT spinoffs (although the former involves both a taxable and a tax-free spinoff).

The recently enacted legislation generally eliminates the opportunity for a corporation to spin off its real estate portfolio into a REIT in a tax-efficient manner, unless after the spinoff *both* the corporation *and* the spun-off real estate entity are REITs. The legislation does provide a limited exception for a REIT's spinoff of its "taxable REIT subsidiary," if certain requirements are met. As a result of the legislation, a corporation's spinoff of its real estate assets into a separate REIT would be taxable at both the corporate and shareholder level, even if all of the other spinoff requirements of the U.S. federal tax laws were satisfied. Under the legislation, if a corporation successfully effectuates a tax-free spinoff, *neither* resulting entity may elect REIT status for 10 years following the spinoff. The legislation is applicable to any spinoff that occurs on or after December 7, 2015, unless it was the subject of an IRS ruling request filed prior to December 7, 2015.

FIRPTA Reform — Improved Treatment of Non-U.S. Investors in U.S. REITs

The legislation also provides for significantly more favorable treatment of non-U.S. investors in U.S. REITs. Under the Code's previously existing "FIRPTA" rules,

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non-U.S. investors are required to file a U.S. tax return and pay tax upon gains from the sale of U.S. real estate assets (including both direct sales of U.S. real estate assets and sales of ownership interests (e.g., stock) in certain entities that own U.S. real estate assets, including most REITs) at a 35% rate for corporate investors or 20% for individual and certain trust investors.[1]

However, under current law, the owner of less than 5% of the value of a class of publicly traded REIT stock is not subject to FIRPTA taxation or required to file a U.S. federal income tax return upon either (1) sale of the REIT's stock or (2) the receipt of a "capital gain dividend" distribution from the REIT.

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- First, the 5% threshold described above with respect to sales of or distributions on a class of stock of a public REIT is increased to 10%.
- Second, certain non-U.S. publicly traded companies (such as Australian-listed property trusts) will be exempt from FIRPTA taxation upon (1) sale of a REIT's stock, (2) the receipt of a "capital gain dividend" distribution from a REIT (although these distributions would still be subject to the 30% U.S. withholding tax applicable to REIT dividends to non-U.S. shareholders, which may be reduced or eliminated under applicable tax treaties or statutory exemptions) and (3) certain redemptions or liquidating distributions by a REIT, except to the extent of 10% shareholders of such non-U.S. publicly traded company. Additionally, this change apparently does not apply to REIT "capital gain dividend" distributions to non-U.S. pension funds investing through partnerships (except where all members of the partnership are non-U.S. pension funds), which may require certain investments to be restructured in order for non-U.S. pension funds to receive the benefits of this rule.
- Third, under current law, a non-U.S. investor's sale of stock in a "domestically-controlled" REIT (generally a REIT that is majority owned, by value, by U.S. investors) is exempt from FIRPTA. The legislation treats any owner of less than 5% of the value of a class of a publicly traded REIT's stock as a U.S. person for purposes of the "domestically-controlled" REIT rules, unless the REIT had actual knowledge that such owner was not a U.S. person.[2]
- Finally, the legislation makes a number of general changes to the requirements for REIT qualification that are not specific to non-U.S. investors. The general intent of such changes is to simplify REIT compliance and to curtail rules which for a long period of time have been viewed as outdated relics of the initial legislation creating REITs in 1960.

In the aggregate, these changes substantially facilitate investment in REITs by non-U.S. investors who do not wish to be subject to U.S. taxation, and provide significant new planning opportunities for non-U.S. investors who desired to invest in U.S. real estate.

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Reduced Holding Period for REITs with "Built-in Gain" from a C Corporation

Under existing law, a REIT is subject to an entity-level tax at a maximum federal rate of 35% (plus applicable state and local taxes) if the REIT sells certain assets that were originally held by a corporation (either because (1) the corporation elected to convert into a REIT, or (2) the REIT acquired assets from a corporation in a tax-free transaction, such as a merger of a corporation into a REIT). This tax applies to the "built-in gain" (i.e. the excess of fair market value over tax basis at the time the asset was first owned by a REIT) in assets that are sold within the 10-year period following the REIT's election of REIT status or the REIT's acquisition of that asset from the C corporation, as applicable. The legislation reduces this holding period to 5-years, permitting the REIT to dispose of "built-in gain" assets more quickly without triggering a corporate level tax.

FIRPTA Reform — Other Important Developments

In addition to the REIT-specific changes highlighted above, the legislation makes these additional significant amendments affecting non-U.S. investors in U.S. real estate:

- The legislation exempts non-U.S. pension funds entirely from FIRPTA, where such pension funds were organized under non-U.S. law, were established to provide retirement or pension benefits, had no single 5% individual beneficiary, and were either exempt from tax or subject to a reduced rate of tax in their country of organization. Thus, for example, qualifying non-U.S. pension funds are generally no longer subject to U.S. tax on gain from selling shares of a "U.S. real property holding corporation." Notwithstanding this change to the FIRPTA rules, many non-U.S. pension funds would likely still prefer to invest into U.S. real estate through a vehicle such as a REIT (rather than directly), which may prevent such pension funds from recognizing income that is treated as effectively connected with a U.S. trade or business, and thus protecting such pension funds from being required to file tax returns in the U.S. Moreover, the changes in the proposed legislation apply only to FIRPTA, and non-U.S. pension funds would still be subject to tax under other general U.S. tax rules, such as the 30% U.S. withholding tax applicable to REIT dividends and interest payments to non-U.S. shareholders (which may be reduced or eliminated under applicable tax treaties between the U.S. and certain non-U.S. countries or under statutory exemptions such as the Section 892 exemption for non-U.S. governmental investors) — ironically, in some cases, this could subject non-U.S. pension plans to a higher tax rate than they would have been subject to under FIRPTA. In order to avoid this withholding tax, non-U.S. pension plans without access to a favorable tax treaty with the U.S. (such as certain Middle Eastern pension plans) might still wish to invest in U.S. real estate assets through domestically controlled REITs (as discussed further below) and structure their exits through a tax-free sale of the applicable REITs' shares, rather than requiring the REITs to sell the underlying real estate assets and distribute the proceeds as taxable dividends.

- In an unfavorable change for non-U.S. investors, the 10% FIRPTA withholding tax applicable to a non-U.S. investor's gross proceeds from the sale of a U.S. real estate asset is increased to 15% for any dispositions made more than 60 days after the legislation is enacted.

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1 The FIRPTA tax is generally collected via a 10% withholding tax on the gross proceeds of a qualifying sale of U.S. real estate (which is credited against the 35% or 20% tax described above). In addition to the foregoing, where a REIT sells its interest in a U.S. real estate asset and distributes the proceeds to its shareholders as a "capital gain dividend," the distribution is subject to U.S. FIRPTA tax.

2 This change provides substantial benefits to investors in publicly traded REITs, which may have little or no knowledge of the identities of their small shareholders, and which have historically had difficulty determining whether they qualified as "domestically-controlled." The change to the "domestically-controlled" REIT rules takes effect for any sale of REIT shares after the date of enactment of the proposed legislation, with the result that certain non-U.S. shareholders of publicly traded REITs that are now determined with certainty to be "domestically-controlled" (where previously this status was in doubt) could sell their REIT shares without triggering any FIRPTA tax on any appreciation in the value of the REIT shares.

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