

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

### PENpoints

*New tax legislation blocks tax-free REIT spinoffs.*

On December 18, 2015, the “Protecting Americans from Tax Hikes Act of 2015” (the “Act”) enacted a number of sweeping tax law changes impacting U.S. private equity and real estate.

#### **Prohibition on Tax-free REIT Spinoffs**

In recent years, many U.S. businesses (including private equity portfolio companies) with significant ownership of real estate have considered separating their real estate assets from their operating assets in a tax-free spinoff, with the spun-off real estate entity leasing the real estate back to the operating company. The “spinee” real estate entity then elects to be treated as a real estate investment trust (a “REIT”), which is not subject to corporate-level income tax as long as it distributes all of its taxable income each year to its shareholders. With the exception of a handful of grandfathered transactions (in which companies have already requested an IRS private letter ruling), the Act, effective immediately, prohibits tax-free REIT spinoffs.

In recent years the market has perceived that a tax-free real estate spinoff could afford significant benefits to the shareholders of a company with substantial real estate assets by unlocking (or maximizing) the real estate’s value, more efficiently deploying capital and permitting increased operational focus between the operating and real estate businesses. As a result, activist investors have taken positions in real estate-rich public companies advocating for a real estate spinoff (e.g., McDonald’s), and private equity portfolio companies have unlocked value by means of tax-free REIT spinoffs (e.g., the recently confirmed Energy Future Holdings bankruptcy reorganization and the proposed Caesars Entertainment bankruptcy reorganization). These strategies are no longer viable (with the exception of Energy Future Holdings and Caesars, which are grandfathered).

However, the Act does not affect certain other transactions involving REITs. Recently, REITs have been successful bidders in competitive sale processes involving private equity portfolio companies with substantial real estate assets, in part because their lower cost of capital enables them to offer higher purchase prices than comparable bidders. The Act should not impact these transactions which generally do not involve tax-free spinoffs. Instead, REIT bidders have generally separated the real estate assets by retaining the real estate assets and selling, in a taxable transaction, the target’s operating assets.

#### **Improved Treatment of Non-U.S. Pension Investors in U.S. REITs**

The Act also grants significantly more favorable treatment to non-U.S. pension investors in a U.S. REIT. U.S. private equity funds focused on the real estate industry frequently form REITs to attract investment by non-U.S. investors. Under the Code’s previously existing “FIRPTA” rules,<sup>1</sup> a non-U.S. investor must file a U.S. tax return and pay U.S. federal income tax on 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 owning U.S. real estate assets, including equity interests in most REITs) at generally applicable tax rates.

The Act makes several important pro-taxpayer changes to the FIRPTA and REIT rules that are relevant to a U.S. private equity or real estate fund seeking to attract capital from non-U.S. investors. Most significantly, the Act entirely exempts from FIRPTA tax a non-U.S.

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pension fund established under non-U.S. law with no single 5% beneficiary that is subject to a reduced tax rate (or exempt from tax) in its home country. As a result, where appropriate structures are in place, a non-U.S. pension fund may be able to invest in U.S. real estate directly or through a REIT sponsored by private

equity and real estate funds without paying any U.S. federal income tax on its share of proceeds from a profitable disposition.

For additional details on these items and other topics covered by the Act, please see our prior [Kirkland Alert](#).

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- 1 FIRPTA stands for Foreign Investment in Real Property Tax Act, which is generally designed to ensure that non-U.S. investors are subject to U.S. federal income tax on an investment into U.S. real property. Many countries have similar tax regimes that apply to investment in local real estate.
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## PENnotes

**Drafting and Negotiating Corporate Agreements 2016****New York, New York, January 8, 2016****Chicago, Illinois, February 4, 2016**

This PLI seminar will teach the basics of drafting and negotiating corporate agreements — from how the provisions of an agreement fit together, to the fundamental drafting and negotiating principles common to all corporate agreements. Kirkland partner Kevin Morris is co-chair of the Chicago event and partner Sarkis Jebejian will be a panelist at the New York event. Click [here](#) for more information.

**43rd Annual Securities Regulation Institute****Coronado, California, January 25-27, 2016**

Hosted by Northwestern Law, the 43rd Annual Securities Regulation Institute will take place in Coronado, California. One of the most visible and highly regarded securities and corporate law conferences in the country, the Securities Regulation Institute reaches prominent attorneys from both firm and in-house practices. Kirkland partner Robert Khuzami will be a panel member for the Enforcement and Government Investigations session. Click [here](#) for more information.

**15th Annual Beecken Petty O’Keefe & Company Private Equity Conference****Chicago, Illinois, February 19, 2016**

Kirkland is a sponsor of the Chicago Booth Private Equity Conference (PEC), an annual event that brings together financiers, students and entrepreneurs to network and share insights into the dynamics of investing in a constantly changing economy. This year’s conference is themed “Navigating Industry Cycles: Investing in an Evolving Market.” Click [here](#) for more information.

**Columbia Business School’s 22nd Annual Private Equity & Venture Capital Conference****New York, New York, February 19, 2016**

Kirkland will sponsor Columbia Business School’s 22nd Annual Private Equity & Venture Capital Conference, which will focus on the emerging challenges and opportunities facing the private equity and venture capital industries in the coming year. The event will bring together industry professionals, students, alumni and faculty to share their knowledge and experiences. Kirkland partners Daniel Lavon-Krein, Paul Watt and Sean Rodgers will give a lunchtime presentation on sales of minority interests.

**11th Annual Stern Private Equity Conference****New York, New York, March 4, 2016**

Kirkland will sponsor New York University’s Stern School of Business’ 11th Annual Stern Private Equity Conference. The conference will provide a forum for industry leaders to discuss the opportunities and risks of today’s private equity and venture capital environment, including how tepid global growth, regulatory dynamics, political pressure and financial market conditions are posing challenges to fundraising, deal financing and operations. Kirkland partner Chris Torrente will speak on the LBO panel and partner Andrew Calder will be on the Energy panel.

**22nd Annual Harvard Business School Venture Capital and Private Equity Conference****Boston, Massachusetts, March 5, 2016**

Kirkland will sponsor Harvard Business School’s 22nd Annual Venture Capital and Private Equity Conference, held on the Harvard campus. The panels will address a range of today’s most relevant topics, from growth equity investing and fundraising to geography-specific investment opportunities. Kirkland partner Nicole Washington will speak on the Diversity in Private Equity panel and partner Armand Della Monica will speak on the State of the Private Equity Industry panel.

# Private Equity Practice at Kirkland & Ellis

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Kirkland & Ellis' nearly 400 private equity attorneys have handled leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 400 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in 2012, 2013, 2014 and 2015 by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. Kirkland was named "Law Firm of the Year in Mergers and Acquisitions Law" by U.S. News Media Group and Best Lawyers in its 2014 "Best Law Firms" rankings. The Firm was named "Best M&A Firm" at *World Finance's* 2014 Legal Awards, "North American Law Firm of the Year: Fund Formation" and "North American Law Firm of the Year: Transactions" at *Private Equity International's* 2014 Private Equity International Awards and "Private Equity Deal of the Year" at the 2014 IFLR Americas Awards.

In 2012, 2013 and 2014, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, United Kingdom, Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011, 2012, 2013 and 2014*, and has consistently received top rankings among law firms in Private Equity by The Legal 500 and IFLR, among others.

*The Lawyer* has recognized Kirkland as one of its "Transatlantic Elite" every year since 2008, having noted that the Firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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