ALERTS

PATH Act: Recently Enacted Legislation Modifies the FIRPTA and REIT Rules

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On Dec. 18, 2015 (the "Enactment Date"), President Barack Obama signed into law the Protecting Americans from Tax Hikes Act of 2015 (the "Act"), which makes several important changes to the taxation of foreign investment in real estate and real estate investment trusts ("REITs"). These changes are important for funds that invest in public REITs and real estate. Most significantly, the Act: (1) exempts certain foreign pension funds from the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"); (2) broadens the exception from FIRPTA for publicly traded REITs; and (3) restricts the use of "Opco/Propco" structures through tax-free REIT spinoffs. The Act makes several additional changes to the FIRPTA and REIT regimes that are described in this *Alert*.[1]

Exemption from FIRPTA for Qualified Foreign Pension Funds

Under FIRPTA, foreign investors are generally subject to U.S. tax and withholding on dispositions of U.S. real property interests ("USRPI"), which include actual ownership of U.S. real property as well as shares of U.S. real property holding corporations ("USRPHC").

The Act exempts "qualified foreign pension funds" (and entities wholly owned by such pension funds, e.g., Cayman subsidiaries) from tax and withholding, which would otherwise have been required by FIRPTA on the sale of USRPIs (including sales through partnerships).

It is not generally expected that foreign pension funds will begin to invest directly (i.e., without the use of a corporate blocker) in U.S. real estate to any substantial degree. Although foreign pension funds are now exempt from FIRPTA, they remain subject to U.S. tax and withholding with respect to income effectively connected with a U.S. trade or business ("ECI"). Because the active operation of real estate produces ECI, most such real estate investments generally would still be subject to U.S. tax and expose foreign pension funds to filing obligations despite the new FIRPTA exemption. In addition, even where there is no U.S. trade or business activity, some foreign pension funds would remain subject to 30-percent gross withholding tax on any rental income.

Foreign pension funds primarily will benefit from this new exemption by investing through REITs. Prior to the Act, foreign pension funds typically invested in U.S. real estate through domestically controlled REITs. Pursuant to the Act, a qualified foreign pension fund may invest in non-domestically controlled REITs and will be exempt from U.S. tax and withholding both on dispositions of the REIT shares and on capital gain distributions from such REITs (thus allowing an asset sale exit).

This exemption for qualified foreign pension funds applies to dispositions and distributions after the Enactment Date.

FIRPTA Exception Expanded for Publicly Traded REITs

A foreign person's disposition of stock of any corporation that is a USRPI (such as most equity REITs) is generally taxable. A distribution by a REIT or other qualified investment entity to a foreign person is also generally subject to tax to the extent the distribution is attributable to gain from sales or exchanges of USRPIs by the REIT. Prior to the Act, an exception existed for a foreign person that held no more than 5 percent of a publicly traded class of stock of a USRPI at all times during the five-year period ending on the date of disposition. An exception also existed for distributions by a REIT if the foreign person did not own more than 5 percent of the REIT stock at all times during the one-year period ending on the date of distribution (in which case the distribution was subject to the regular 30-percent withholding tax on dividends). The Act increases the ownership threshold for these FIRPTA exceptions from 5 percent to 10 percent for dispositions of stock of, or distributions from, publicly traded REITs.

Investment funds investing in publicly traded equity REITs may now invest in up to 10 percent of such REITs without a FIRPTA risk for their foreign funds. Investment funds need to be mindful of cross ownership among the funds (including any sponsor investment and carry), which can cause the 10-percent limit to be exceeded under the applicable constructive ownership rules.

This change is generally effective for dispositions and distributions on or after the Enactment Date.

The Act does not provide a similar increase for publicly traded shares of non-REIT USRPIs.

Restrictions on Tax-Free REIT Spinoffs

Although a corporation is generally required to recognize gain on the distribution of appreciated property to shareholders, a corporation may distribute stock of a controlled corporation to its shareholders in a nontaxable transaction, as long as it meets the requirements in Section 355 of the Internal Revenue Code to qualify as a tax-free spinoff. A number of corporations have separated their real estate assets from operational activities by utilizing "Opco/Propco" structures in combination with tax-free spinoffs. In a typical transaction, the spun-off subsidiary ("Propco") holds the real estate assets and elects to be treated as a REIT, while the distributing company ("Opco") continues to operate the business and leases the property back from Propco. Prior to the Act, REIT spinoffs had come under increased scrutiny, largely due to the erosion of the corporate tax base. The Internal Revenue Service (the "IRS") announced that it was studying the tax-free treatment of such spinoffs and that it would no longer issue private letter rulings in this area (see IRS Notice 2015-59 and Rev. Proc. 2015-43).

The Act restricts the use of Opco/Propco spinoffs in two ways. First, a spinoff will not qualify for tax-free treatment if either (but not both) the distributing or controlled corporation is a REIT. Second, in the case of a qualified tax-free spinoff, neither the distributing nor the controlled corporation (nor any successor corporation) may elect REIT status for 10 years following the spinoff. However, there are two exceptions under the Act under which a REIT spinoff may receive tax-free treatment. A REIT spinoff may qualify for tax-free treatment if both the distributing and controlled corporations are REITs immediately after the transaction.

Another exception provides for tax-free treatment of the spinoff by an existing REIT of its taxable REIT subsidiary ("TRS") in certain limited circumstances.

These provisions of the Act are effective for distributions on or after Dec. 7, 2015. However, the provisions will not apply to any distribution for which a private letter ruling had been submitted to the IRS and was still pending on Dec. 7, 2015.

Other FIRPTA Provisions

*FIRPTA Exception for Qualified Foreign Shareholders of REITs*The Act excepts from the definition of a USRPI stock of a REIT (public or private) that is held by a "qualified shareholder" (defined below). Under this exception, dispositions of REIT stock by qualified shareholders are not subject to FIRPTA tax or withholding, and REIT distributions to a qualified shareholder are not subject to FIRPTA tax or withholding (but will be subject to the regular 30-percent withholding tax on dividends), except to the extent that an investor in the qualified shareholder holds, directly or constructively, more than 10 percent of the REIT stock. If an investor holds, directly or constructively, more than 10 percent, the qualified shareholder exception will not apply with respect to the portion of the qualified shareholder's REIT stock attributable to such investor.

A "qualified shareholder" is a foreign entity that: (1) either (a) is eligible for benefits of a U.S. tax treaty and is publicly traded, or (b) is a foreign limited partnership organized in a jurisdiction that has an agreement for the exchange of information with the United States and has a class of interests (representing more than 50 percent of all partnership interests) that is publicly traded on the NYSE or Nasdaq; (2) is a qualified collective investment vehicle (requiring it to meet certain additional requirements); and (3) maintains records of each person that holds 5 percent of the publicly traded interests of such entity.

This FIRPTA exception applies to REIT dispositions and distributions after the Enactment Date.

Increase in FIRPTA Withholding Rate

When a USRPI is disposed of by a foreign person, FIRPTA generally requires a transferee to withhold 10 percent of the gross purchase price. This 10-percent withholding is also required on certain distributions by

USRPHCs. The Act increases the FIRPTA withholding rate from 10 percent to 15 percent. This change is effective for dispositions occurring 60 days after the Enactment Date.

Determination of Domestically Controlled REIT Status

The disposition of shares of a domestically controlled REIT is exempt from FIRPTA. A REIT is domestically controlled if foreign persons directly or indirectly own less than 50 percent of the value of the REIT's stock. The Act provides three new rules for determining whether a REIT is domestically controlled. First, in the case of a publicly traded class of stock of a REIT, a person holding less than 5 percent of such class at all relevant times is treated as a U.S. person, unless the REIT has actual knowledge that such person is not a U.S. person. Second, any stock of a REIT (either public or private) held by a publicly traded REIT (or by certain regulated investment companies ("RICs")) shall be treated as held by a foreign person, unless that REIT (or RIC) is domestically controlled, in which case the stock would be treated as held by a U.S. person. Finally, stock of a REIT (either public or private) that is held by a private REIT (or certain private RICs) will be treated as held by a U.S. person to the extent the stock of such private REIT (or RIC) is held by U.S. persons. The above provisions take effect on the Enactment Date.

Other REIT Provisions

Reduction in Percentage Limitation on TRS Holdings

Under prior law, up to 25 percent of the gross assets of a REIT could be represented by one or more TRSs. The Act reduces from 25 percent to 20 percent the permitted percentage of total REIT assets that may be securities of one or more TRSs. The amendment is effective for taxable years beginning after Dec. 31, 2017. Any REIT-owning TRS representing a non-de minimis portion of its assets should undertake a valuation study to ascertain compliance with this new 20-percent limit prior to 2018.

Debt Instruments of Publicly Offered REITs and Mortgages on Real Property Interests Treated as Real Estate Assets

A REIT is subject to a quarterly asset test, under which at least 75 percent of the REIT's assets must be real estate assets, cash and government securities (the “75% Asset Test”). A REIT is also subject to two income tests: (1) at least 75 percent of the REIT’s gross income must be from rents from real property, gain from the disposition of real property, interest on mortgages secured by real property, and certain other items (the “75% Income Test”); and (2) at least 95 percent of the REIT’s gross income must be derived from sources included in the 75% Income Test, as well as interest, dividends and gain from the sale or disposition of securities (the “95% Income Test”).

The Act provides that debt instruments issued by publicly offered REITs are treated as real estate assets for the purposes of the 75% Asset Test. The interest income or gain from the sale or disposition of debt instruments issued by publicly offered REITs is not treated as qualified income under the 75% Income Test (unless it qualifies as such regardless of the Act) but will continue to be treated as qualified income under the 95% Income Test. However, not more than 25 percent of the value of the REIT’s total assets can be represented by such debt instruments.

A mortgage on real property is treated as a real estate asset. Under the Act, mortgages on interests in real property (e.g., a mortgage on a leasehold interest in real property) are also treated as real estate assets.

The provision is effective for tax years beginning after Dec. 31, 2015.

Ancillary Personal Property

Rent attributable to personal property that is leased together with real property is treated as qualified income for the purposes of the 75% Income Test if such rent does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property under the lease. The Act clarifies that such ancillary personal property is treated as a real estate asset for purposes of the 75% Asset Test. This provision is effective for taxable years beginning after Dec. 31, 2015.

Authored by Noah D. Beck, Philippe Benedict, Dan A. Kusnetz, Shlomo C. Twerski and Elie Zolty.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] Some of the additional changes that the Act makes to the FIRPTA and REIT rules are beyond the scope of this *Alert*, including modifying the

FIRPTA “cleansing rule,” expanding the REIT prohibited transaction safe harbor, and repealing the preferential dividends rule for publicly offered REITs.

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Related People

Philippe Benedict

Partner

New York

Dan Kusnetz

Of Counsel

New York

Shlomo Twerski

Partner

New York

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