December 23, 2015

Extenders Bill Puts an End to Tax-Free REIT Spinoffs but Includes a Number of Favorable Changes to the Taxation of REITs

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On December 18, 2015, the President signed the Omnibus Appropriations Act (the "Act") into law.[1] Notably, the Act contains a number of substantive changes to the tax laws applicable to "real estate investment trusts" ("REITs"). Although several changes will adversely affect certain REITs, on balance REITs and their investors fared favorably under the Act.

Front and center, the Act generally prohibits REIT tax-free spinoffs by non-REIT entities and bans corporations from electing REIT status within 10 years of being spun off. Shareholders of corporations with significant real estate hoping to minimize the tax burden on the corporation's overall business by spinning-off the real estate on a tax-free basis will be frustrated by the new restrictions on tax-free REIT spin-offs.

Aside from these limits, the changes in the REIT rules generally are favorable to REITs and their investors. Significant changes further chip away at the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") (*i.e.*, the rules applicable to foreign investments in U.S. real estate). These changes generally will benefit foreign pension plans investing in U.S. real estate and other foreign minority investors in REITs, which may encourage increased investment in U.S. real estate from abroad. The Act contains a number of favorable technical changes as well such as the introduction of a new "prohibited transactions" safe harbor, a reduction in the recognition period for built-in gains on REIT conversions, the expanded use of REIT hedges, and an expansion of the definition of qualifying "real estate assets." The changes also liberalize the use of taxable REIT subsidiaries ("TRSs") in some situations, but constrain their use for REIT qualification purposes. A discussion of the Act's chief provisions follows.

RESTRICTIONS ON TAX-FREE REIT SPINOFFS

The Act's restrictions on REIT spinoffs are the most significant change. Tax-free REIT spinoffs have become increasingly prevalent in the market, with real estate-owning businesses, including household names like Darden, casino companies such as Penn National Gaming, and infrastructure companies such as Windstream, establishing OpCo-PropCo structures to minimize corporate-level taxes with respect to the real estate component of the business. The legislation eliminates tax-free treatment for REIT spinoffs, except in transactions where one

[1] H.R. 2029. Originally, the extenders bill was part of the Protecting Americans from Tax Hikes Act of 2015, and the spending bill was the Consolidated Appropriations Act of 2016. The two bills were combined in the Senate as the Omnibus Appropriations Act. Some of the REIT provisions in the Act previously were included in former Ways and Means Chairman Camp's Tax Reform Act of 2014 (and the "Real Estate and Investment Jobs Act of 2015").

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REIT spins off another REIT or (in some cases) where the corporation spun off is a TRS. The rules also prohibit a spun off corporation from electing REIT status within 10 years of the spin. These major changes to the reorganization landscape are effective for spinoff transactions occurring on or after December 7, 2015, with an exception for transactions that have a pending ruling request with the IRS. This change in law is expected to put a stop to a number of REIT spinoffs that have been planned but which did not have a ruling request pending with the IRS before December 7, 2015. Moreover, it raises uncertainty for spinoffs with ruling requests pending as to whether the IRS will grant such requests in light of "Congressional intent" regarding REIT spinoffs and, if not, whether practitioners will be comfortable issuing tax opinions.

REDUCTION OF RECOGNITION PERIOD FOR BUILT-IN GAINS

Effective starting after December 31, 2014, the recognition period for the corporate-level built-in gains tax to REITs, RICs, and S-corporations is reduced to five years. S-corporations, RICs, and REITs must all pay corporate level tax on any net built-in gains recognized for a certain period after electing their status. Before the Act, the recognition period of ten years was reduced to five years on a year-by-year extension; the Act makes this extension permanent.

INCREASE IN THRESHOLD FOR "PUBLICLY TRADED" EXCEPTION TO FIRPTA

The Act makes two investor-friendly changes that narrow FIRPTA's reach. The first change increases the ownership threshold for the "publicly traded" exception to FIRPTA. Previously, shares of a publicly traded class of stock (including REIT stock) constituted a "United States real property interest" ("USRPI") only in the hands of a person that owned more than 5% of that class. As a result, when it came to publicly traded stock, only shareholders with a stake greater than 5% could be subject to FIRPTA on dispositions of the stock itself. Similarly, shareholders owning 5% or less of the publicly traded stock of a REIT were exempt from FIRPTA on capital gain distributions. The Act increases this threshold to 10% in both cases. This change applies only to REIT distributions made during taxable years that end after the Act's enactment. The Act also provides a number of technical changes to the attribution rules applicable to direct and indirect holders of REIT stock; these changes are effective immediately.

EXEMPTION FROM FIRPTA FOR QUALIFIED PENSION FUNDS

The Act adds a FIRPTA exemption for "qualified pension funds" and their wholly owned subsidiaries. Generally, qualified pension funds are non-U.S. retirement or pension funds that do not have a single participant or beneficiary with a right to 5% or more of the fund's assets or income, are subject to governmental regulation, and (in their country of establishment or operation) receive preferential tax treatment on either contributions to the fund or on investment income. This new exception covers both directly and indirectly held USRPIs, as well as REIT distributions. It applies to dispositions and distributions that occur after the Act's enactment. This is expected to significantly increase the amount of foreign capital invested in U.S. real estate by removing the most significant barrier for non-U.S. pension plan investors.

INCREASED FIRPTA WITHHOLDING RATE

The Act increases the amount of withholding tax on dispositions of USRPIs by a foreign person from 10% to 15%. If a property is acquired by the buyer to be used as the buyer's residence, and the price paid for the property does

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not exceed $1,000,000, the 10% withholding rate under prior law would still apply. The new withholding rate is effective starting 60 days after the enactment of the Act.

EXPANSION OF WHAT CONSTITUTES A USRPI UNDER FIRPTA

Prior to enactment of the Act, under Code section 897(c), the definition of a USRPI excluded an interest in a corporation if, as of the date of disposition of that interest, the corporation did not hold any USRPIs, and all USRPIs held by the corporation at any time during the preceding five years were disposed of in transactions in which all gain was recognized. The Act adds another requirement, that neither the corporation nor its predecessor has been a REIT or a RIC during the preceding five years.

REDUCTION IN TRS OWNERSHIP LIMIT

The Act reduces the extent to which a REIT may hold securities of one or more TRSs. Currently, securities of TRSs can constitute up to 25% of a REIT's assets; the Act reduces that cap to 20%.[2] The limit will be effective January 1, 2018.

CHANGE IN TREATMENT OF DEBT INSTRUMENTS ISSUED BY PUBLICLY OFFERED REITS FOR THE INCOME AND ASSET TESTS

The Act expands the definition of real estate assets that qualify under the 75% REIT asset test to include debt instruments issued by publicly offered REITs and, for purposes of clarification, mortgages on "interests" in real property. However, the Act excludes income from "nonqualified" publicly offered REIT debt instruments as qualifying income for purposes of satisfying the 75% gross income test while retaining its treatment as qualifying income for the 95% income test. Moreover, a REIT may not have more than 25% of the value of its total assets represented by nonqualified publicly offered REIT debt instruments. The Act defines a "nonqualified publicly offered REIT debt instrument" as any real estate asset that would cease to be a real estate asset under Code section 856(c)(5)(B) when ignoring the reference to "debt instruments issued by publicly offered REITs."

CLARIFICATION IN TREATMENT OF ANCILLARY PERSONAL PROPERTY FOR INCOME AND ASSET TESTS

The Act clarifies how the asset and income tests apply to ancillary personal property. Currently, rents from personal property are considered "rents from real property" (*i.e.*, good REIT income) if the personal property is leased under, or in connection with, a lease of real property and the rents allocable to personal property do not exceed 15% of the total rent. The Act extends this test to questions of whether personal property constitutes a "real estate asset" for purposes of the 75% asset test. For tax years beginning after December 31, 2015, personal property will be treated as a real estate asset for purposes of the 75% asset test to the extent that rents attributable to such personal property are treated as rents from real property.

The Act also includes a new rule for obligations secured by a mortgage on both real property and personal property. If the fair market value of the personal property is 15% or less of the total fair market value of the property, the obligation will, in its entirety, be treated as a "real estate asset" for purposes of the 75% asset test and as an obligation bearing interest that qualifies for purposes of the 75% income test.

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[2] The limit was increased from 20% to 25% in 2008.

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MORE TYPES OF HEDGING INCOME CONSTITUTE QUALIFYING REIT INCOME

The Act provides additional rules pertaining to hedging transactions entered into by REITs. Currently, the Code excludes from gross income hedging transactions entered into with respect to any indebtedness incurred by the REIT to acquire real estate assets and income from hedging transactions entered into by the REIT to manage the risk of currency fluctuations. The Act adds that income from certain additional hedging transactions will be excluded from gross income for purposes of the 75% and 95% gross income tests. Such hedges are those entered into with respect to any type of hedging transactions that previously qualified for the exclusion for gross income after the REIT has extinguished or disposed of a portion of the underlying indebtedness or property of that hedging transaction, to the extent the new position qualifies as a hedge described in Code section 1221(b)(2)(A).

EXPANSION OF THE PROHIBITED TRANSACTIONS SAFE HARBOR

The Act addresses the “prohibited transactions” safe harbor, expanding the manner in which a REIT can clearly avoid “dealer” treatment and a 100% penalty tax. Currently, REITs must satisfy several requirements to meet the safe harbor, including that (1) they sell no more than seven properties during the tax year at issue, (2) the tax bases of properties sold during the taxable year is 10% or less than the aggregate bases of properties held at the beginning of the year, or (3) the fair market value of properties sold during the taxable year is 10% or less of the fair market value of all properties held at the beginning of the year. The Act adds more flexibility by increasing the percentages in alternatives (2) and (3) to 20%. However, this increase is available only if the results of the relevant test, applied to the tax year at issue and each of the two preceding years, average out to 10% or less. This portion of the Act takes effect upon enactment.

EXCEPTION FROM PREFERENTIAL DIVIDEND RULES FOR PUBLICLY TRADED REITS

The Act excludes publicly offered REITs from the obscure and much reviled preferential dividends rule of Code section 562(c). Currently, to qualify for the REIT dividends-paid deduction, dividends must be paid pro rata, with no preference to any share of stock as compared to other stock in its class, and with no preference to one class of stock compared to another. Previously, the dividends-paid deduction of publicly offered RICs was not subject to these restrictions. The Act extends the same benefit to publicly offered REITs, defined as REITs that are required to file annual and periodic reports with the SEC. Thus, this applies to both publicly traded REITs and non-traded REITs that register with the SEC. This provision is effective for tax years that begin after December 31, 2014.

ADMINISTRATIVE REMEDY FOR PREFERENTIAL DIVIDEND RULES

The Act gives the Secretary of the Treasury authority to provide a remedy for REITs that fail to comply with the preferential dividend rules. As noted above, to qualify for the dividends-paid deduction, a dividend must be paid pro rata, with no preference to any share of stock as compared to other stock in its class. The Secretary can remedy a failure to satisfy these requirements when such failure is either inadvertent, due to reasonable cause, or of a type that the Secretary has identified. Publicly offered REITs will not need any benefit under this rule because they will be exempt from application of the preferential dividend rules. This provision is effective for tax years that begin after December 31, 2015.

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ELIMINATION OF DISPROPORTIONATE DISTRIBUTIONS OF CERTAIN TYPES OF INCOME AMONG CLASSES OF REIT SHAREHOLDERS

Currently, a REIT can designate an amount of its dividends as capital gain dividends or a portion of its dividend income as qualified dividend income if received from a corporation. The Act limits the aggregate amount designated as capital gain or qualified dividend income to the amount that the REIT actually distributes. In addition, the Act provides the Secretary of the Treasury authority to prescribe regulations or other guidance requiring the proportionality of the designation for particular types of dividends (among shares or beneficial interests in a REIT).

CHANGES TO TRS RULES

The Act liberalizes the use of TRSs, but also expands the 100% excise tax in Code section 857(b)(7) to certain TRS gross income. The first liberalization loosens the general prohibited transaction safe harbors generally to allow TRS marketing and developing of the applicable property. Previously, if a REIT had made more than seven sales during a taxable year, only an independent contractor could make marketing or development expenditures on the property at issue. The second liberalization allows TRSs to use foreclosed real property in a trade or business without terminating the grace period for the property.

The Act also expands the 100% prohibited transactions excise tax that applies to a TRS's gross income that either (i) is attributable to services provided to (or on behalf of) the REIT and (ii) would be increased under transfer pricing principles. TRS income subject to the excise tax is reduced by applicable deductions and excludes redetermined rents. Both the liberalizing changes and the excise tax's expansion are effective for tax years that begin after December 31, 2016.

DIVIDENDS DERIVED FROM RICS AND REITS INELIGIBLE FOR DEDUCTION FOR U.S.-SOURCED PORTION OF DIVIDENDS FROM CERTAIN FOREIGN CORPORATIONS

The Act limits the deduction allowed for the U.S.-sourced portions of a dividend received from certain 10%-owned foreign corporations. Under pre-existing rules, the deduction allowed for a particular dividend hinges on the ratio of "undistributed U.S. earnings" to overall undistributed earnings. The new rule carves out dividends from RICs and REITs in calculating undistributed U.S. earnings. It applies to dividends received from a RIC or a REIT after the Act's enactment.

REVISED CALCULATION OF A REIT'S E&P

The Act revises the calculation of a REIT's earnings and profits ("E&P") for a taxable year. Currently, amounts that are disallowed in computing the REIT's taxable income for the year cannot be used to reduce a REIT's E&P for that taxable year. The Act expands this prohibition to amounts that are not allowed in computing the REIT's taxable income for any prior years (in addition to the taxable year at issue). This expansion does not apply to the calculation of a REIT's earnings and profits for purposes of the dividends-paid deduction. These changes are effective for tax years that begin after December 31, 2015.

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