

# Client Update

## New Legislation Relating to the Taxation of REITs and Foreign Investment in U.S. Real Property

### NEW YORK

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On December 18, 2015, President Obama signed into law the Consolidated Appropriations Act, 2016 (the “Act”). The Act includes significant changes to the application of the Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”) and the taxation of spin-off transactions involving real estate investment trusts (“REITs”), in addition to provisions that extend (in many cases on a permanent basis) a significant number of popular tax breaks set to expire.

### FIRPTA

In general, FIRPTA imposes U.S. federal income tax (and, in certain cases, branch profits tax) upon the disposition by non-U.S. persons of United States real property interests (“USRPIs”), which include real property located in the United States and stock of domestic corporations that hold USRPIs as a majority of their worldwide real property and business assets (“USRPHCs”). The Act changes the application of FIRPTA in four important ways:

- *Exemption for Qualified Foreign Pension Funds.* The Act provides a general exemption from FIRPTA for “qualified foreign pension funds” and their wholly owned entities. A qualified foreign pension fund is generally any trust, corporation, or other organization or arrangement that (a) is organized under the laws of a country other than the United States, (b) is established to provide retirement or pension benefits to current or former employees, (c) does not have a single beneficiary entitled to more than 5% of its assets or income, (d) is subject to government regulation, including information reporting and (e) is entitled to certain tax benefits under the laws of the country in which it is organized.

Pursuant to the Act, a qualified foreign pension fund’s gain on the disposition of a USRPI is not subject to FIRPTA. As a result, a qualified foreign pension plan generally may now sell interests in USRPIs (to the

extent ownership of such USRPI does not otherwise cause the pension fund to be engaged in a U.S. trade or business) without incurring any U.S. federal income tax. Moreover, while a qualified foreign pension fund used to be subject to U.S. federal income tax upon receipt of a distribution from a REIT of proceeds from the sale of USRPIs by that REIT, such distributions are now generally exempt from U.S. federal income tax. Importantly, the exemption appears to apply both to private and governmental non-U.S. pension funds that meet the definition of a “qualified foreign pension fund.”

The new FIRPTA exemption under the Act goes well beyond the exemption many governmental pension funds enjoy under section 892 of the Internal Revenue Code. This section 892 exemption applies only to minority interests in USRPHCs, does not apply (under the IRS’s view) to dividends paid by a REIT out of the proceeds from the sale of USRPIs and is wrought with many technical requirements. The expansive and straightforward exemption provided to pension plans under the Act will surely be welcomed by non-U.S. governmental and private pension funds alike.

These changes apply to dispositions and distributions made after the date of the Act’s enactment.

- *Increase to Publicly Traded Exception for REIT Stock.* The Act broadens the existing exception to the FIRPTA rules relating to minority ownership interests of publicly traded REITs from 5% to 10%. This rule generally applies to dispositions and distributions made on or after the date of the Act’s enactment.
- *Exemption for Qualified Shareholders.* The Act provides a general exemption from FIRPTA for REIT stock held by, and certain distributions made to, a “qualified shareholder.” A qualified shareholder is generally a non-U.S. person that (a) is eligible for the benefits of a comprehensive income tax treaty with the United States, (b) has a class of interests that is publicly traded and (c) is a “qualified collective investment vehicle” within the meaning of the Act. This exemption does not apply with respect to any investor in a qualified shareholder that owns, directly, indirectly or constructively, more than 10% of the REIT’s stock.

This rule generally applies to dispositions and distributions made on or after the date of the Act’s enactment.

- *Increased Rate of FIRPTA Withholding.* FIRPTA also imposes a withholding tax on certain dispositions and distributions of USRPIs. The Act generally increases the applicable rate of withholding from 10% to 15% for dispositions and distributions otherwise subject to withholding that occur on or after 60 days following its enactment.

## SPIN-OFFS

In recent years a number of companies have engaged in, or have announced plans for, tax-free spin-off transactions involving the separation of real estate holdings from core business lines, commonly referred to as an “OpCo-PropCo Spin-Off”. An OpCo-PropCo Spin-Off generally involves a parent corporation (“Distributing” or “OpCo”) that contributes its real estate assets to a wholly owned subsidiary (“Controlled” or “PropCo”) and then distributes shares of Controlled to its shareholders. Controlled typically elects to be taxable as a REIT and leases the real property back to Distributing. Under prior law, an OpCo-PropCo Spin-Off was generally tax-free for both corporations and their shareholders if certain requirements were met. After the OpCo-PropCo Spin-Off, rent payable from OpCo to PropCo would be deducted by OpCo, while PropCo, as a REIT, would generally be able to avoid U.S. federal income tax on such rent.

- *Exception for REITs.* In an effort to end these transactions, the Act generally prohibits a REIT from participating in a tax-free spin-off as either the Distributing or Controlled corporation.

However, the Act provides two exceptions to this general rule. First, the restriction will not apply if immediately after the distribution of Controlled stock, both Distributing and Controlled are REITs. Second, the restriction will generally not apply if at all times during the 3-year period ending on the date of the distribution of Controlled stock (a) Distributing has been a REIT, (b) Controlled has been a taxable REIT subsidiary of Distributing and (c) Distributing has owned 80% of the shares and total combined voting power of Controlled.

- *REIT Election Following Spin-Off.* The Act also generally provides that a corporation that was a Distributing or Controlled corporation in a tax-free spin-off may not elect to be taxable as a REIT for ten years following such spin-off.

These rules apply to spin-off distributions occurring on or after December 7, 2015, but do not apply to distributions with outstanding ruling requests submitted to the Internal Revenue Service on or before such date.

## TECHNICAL CHANGES TO THE REIT REGIME

In addition to the new rules that generally prohibit REIT spin-offs, the Act revises several technical aspects of certain rules that are generally applicable to REITs, including:

- *Taxable REIT Subsidiary Limitation.* The Act reduces the percentage of the value of a REIT's assets that may consist of taxable REIT subsidiaries from 25% to 20%.
- *Preferential Dividends.* The Act repeals the preferential dividend rule for publicly offered REITs and authorizes the Secretary of the Treasury to provide a remedy for private REITs to cure distributions that fail to comply with the preferential dividend requirement.
- *Prohibited Transaction Safe Harbor.* In general, REITs are subject to a tax of 100% of the net income derived from prohibited transactions, which are intended to cover sales of inventory such as condo sales. The Act alters certain of the safe harbors that allow a REIT to avoid such tax in a manner that provides additional flexibility to satisfy the safe harbors.
- *Increased Flexibility to Hedge.* The Act expands an existing exclusion from the REIT "income tests" that applies to income earned from certain hedging transactions with respect to foreign currency and indebtedness to acquire or carry real property, which should provide REITs with more flexibility to engage in hedging transactions.

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Please do not hesitate to contact us with any questions.