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Protecting Americans from Tax Hikes Act of 2015: Effects on Taxation of Investment in U.S. Real Estate

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The authors of this article discuss the Protecting Americans from Tax Hikes Act of 2015, which provides exemptions from certain taxes applicable to non-U.S. investors in U.S. real estate under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), increases the FIRPTA withholding tax rate, and modifies certain rules relating to real estate investment trusts.

The U.S. Congress passed and President Obama signed into law the Protecting Americans from Tax Hikes Act of 2015 (the "Act"). The Act provides exemptions from certain taxes applicable to non-U.S. investors in U.S. real estate under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), increases the FIRPTA withholding tax rate and modifies certain rules relating to real estate investment trusts ("REITs"). The Act has the potential to significantly reduce the U.S. tax cost to foreign pension funds and other foreign investors of investment in U.S. real estate.

FIRPTA Provisions

Under FIRPTA, non-U.S. investors in U.S. real estate (including investments in REITs and other U.S. companies for which 50 percent or more of the company's assets are U.S. real estate assets) are generally subject to U.S. federal income tax in the same manner as U.S. investors on sales of such U.S. real property interests ("USRPIs"). The Act makes a number of changes to FIRPTA that will be very significant to certain classes of non-U.S. investors.

New Exemption from FIRPTA for Certain "Qualified Foreign Pension Funds"

A new exemption from FIRPTA ("Pension

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Exemption") is provided for "qualified foreign pension funds" and entities wholly owned by qualified foreign pension funds. A qualified foreign pension fund is an entity that

(i) is organized under the laws of a foreign country,

(ii) is established to provide retirement or pension benefits to current or former employees,

(iii) does not have a single beneficiary with a right to more than five percent of its assets or income,

(iv) is subject to government regulation and reporting requirements regarding its beneficiaries, and

(v) is subject to deferred or reduced taxation in its home country.

This new exception from FIRPTA for qualified foreign pension funds could significantly increase the amount that non-U.S. pension funds invest in U.S. real estate.

The Internal Revenue Service ("IRS") was given authority to promulgate regulations as may be necessary or appropriate to carry out the purposes of this new Pension Exemption. The timing and content of any such regulations is currently uncertain and the application of the Pension Exemption to certain categories of investors remains unclear. However, legislative history accompanying the Act suggests that certain government-sponsored public pension funds, as well as pension funds established for one or more companies or professions, may qualify for this new exemption.

Because this new exemption will provide substantial benefits for qualifying foreign pension funds, confirming eligibility for the exemption will be very important for these investors.

Increase in Exception for Small Interests in Publicly Traded REITs

Under prior law, FIRPTA did not apply to non-U.S. investors holding five percent or less of a class of publicly traded stock of a U.S. real property holding corporation (including a public REIT). The Act increases the threshold for this small interest exception to 10 percent in the case of publicly traded REITs (but not for other types of U.S. real property holding corporations). Accordingly, a non-U.S. shareholder of publicly traded class of REIT stock that does not own more than 10 percent of such class of stock will not be subject to U.S. tax under FIRPTA when selling or receiving capital gain distributions on that stock. However, capital gain distributions on such REIT stock will be treated as ordinary dividends from the REIT, and potentially be subject to dividend withholding.

New Exceptions for Qualified Foreign Shareholders of REITs

The Act provides a new exception from FIRPTA for REIT stock (including stock of a privately held non-domestically controlled REIT) held by a "qualified shareholder." A qualified shareholder is defined as a foreign person that

(i) is either

(a) eligible for benefits under a comprehensive U.S. tax treaty and listed and regularly traded on one or more recognized stock exchanges (as defined in the relevant treaty) or

(b) a foreign limited partnership that is organized in a jurisdiction that has an exchange of information agreement with the United States and has a class of interests (representing more than 50 per-

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cent of the value of all partnership interests) that is regularly traded on the NYSE or NASDAQ market,

(ii) is a qualified collective investment vehicle (which requires the entity to satisfy certain additional requirements), and

(iii) maintains records on the identity of each person that directly holds five percent or more of certain classes of interest in the entity.

To be a qualified collective investment vehicle, the foreign shareholder must be

(i) eligible for a reduced rate of withholding under the applicable comprehensive U.S. tax treaty, even if the shareholder holds more than 10 percent of the stock of the REIT,

(ii) publicly traded, treated as a partnership under U.S. tax law, a withholding foreign partnership and would be treated as a U.S. real property holding corporation if it were a domestic corporation, or

(iii) designated as qualified by the Secretary of the Treasury and either

  (a) fiscally transparent or

  (b) required to include dividends in its gross income, but entitled to a deduction for distributions to its investors.

As a result of these requirements, the classes of foreign investors that are eligible for the qualified shareholder exception may be somewhat limited. Examples of potential beneficiaries include Australian listed property trusts, certain Dutch mutual funds ("beleggingsinstelling") and investors resident in certain countries having pre-1987 tax treaties with the United States.

Qualified shareholder treatment does not apply with respect to the portion of the REIT interest attributable to an "applicable investor" (generally an investor in the qualified shareholder that directly or indirectly owns a more than 10 percent interest in the REIT). Moreover, REIT capital gain distributions to qualified shareholders, although excluded from withholding under FIRPTA, will instead be treated as ordinary dividends from the REIT.

Elimination of "Cleansing Rule" for RICs and REITs

Under prior law, stock in a corporation would not be deemed a USRPI if (i) the corporation did not hold any USRPIs and (ii) any USRPIs held by it during the shorter of the shareholder's ownership period or five years had been disposed of in fully taxable transactions. The Act modifies this rule this by adding a third requirement: that the liquidating corporation was not a REIT or regulated investment company ("RIC") during the shorter of the shareholder's ownership period or five years. This prevents foreign investors from avoiding FIRPTA withholding by having a REIT sell its property and then liquidate, which would meet the literal requirements of the cleansing rule while potentially avoiding both entity-level and foreign shareholder-level tax.

Look-Through Rule Changes Testing for Domestically Controlled REIT Status

A non-U.S. investor is subject to tax under FIRPTA on any gain recognized from the disposition of an interest in a REIT that constitutes a U.S. real property holding corporation, unless the REIT is "domestically controlled," or certain other exemptions apply. A REIT is "domestically controlled" if less than 50 percent of the

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value of its stock is held, directly or indirectly, by non-U.S. investors. The Act provides that in applying this test, all holders of less than five percent of any class of publicly traded REIT stock are treated as U.S. persons unless the REIT has actual knowledge that a holder is not a U.S. person. The Act also provides that stock in a REIT held by a publicly traded REIT will be treated as held by a foreign person unless the shareholder REIT is itself domestically controlled, in which case such stock will be treated as held by a U.S. person. These rules simplify the application of domestically controlled testing for public REITs and for private REITs that have a public REIT as a direct or indirect shareholder. For REIT stock held by a private REIT, however, the Act provides a look-through rule treating such stock as held by a U.S. person only to the extent that the stock of the shareholder REIT is held by U.S. persons.

Increase in FIRPTA Withholding Tax Rate

Finally, the Act increases the rate of withholding required under FIRPTA from 10 to 15 percent of a foreign seller's gross proceeds from the disposition of a USRPI.

New Restrictions on Tax-Free Spinoffs Involving REITs

The Act's most publicized change relates to the treatment of tax-free spinoffs involving REITs under Section 355 of the Internal Revenue Code (the "Code"). The modified Section 355 generally states that a spinoff involving a REIT will be tax free only if, immediately after the transaction, both the distributing and controlled corporations are REITs or if an existing REIT is distributing stock in a taxable REIT subsidiary ("TRS"). The Act also modifies Section 856(c) so that neither the distributing nor the controlled corporation can elect to be treated as a REIT for 10 years after a spinoff. These changes likely put an end to a recent wave of REIT spinoffs, although transactions for which a ruling request has been submitted to the IRS prior to December 7, 2015 are grandfathered in and protected from changes to the law.

REIT Asset Test Changes

The Act makes several modifications to the 75 percent REIT asset test. First, it reduces the percentage of the gross asset value of a REIT's assets that may be represented by securities of one or more TRSs from 25 percent to 20 percent (for taxable years beginning after December 31, 2017). It also expands the definition of real property for purposes of the 75 percent asset test to include certain ancillary personal property leased with real property and debt instruments issued by publicly traded REITs. It should be noted that debt instruments of publicly traded REITs may not make up more than 25 percent of the value of a REIT's assets.

REIT Income Test Changes

Not surprisingly, the Act also addresses the income tests described in paragraphs (2) and (3) of Section 856(c). Income from debt instruments issued by publicly traded REITs is now treated as qualified income for purposes of the 95 percent gross income test. Such income is not, however, treated as qualified income for purposes of the 75 percent gross income test unless the income from such debt instruments was already treated as qualified income under current law.

The Act also expands the treatment of REIT hedges by permitting REITs to use a hedging instrument to terminate a prior hedging instrument that was used to manage risk associated

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with liabilities or property, without gain from such transaction constituting gross income for purposes of the 95 percent gross income test or the 75 percent gross income test.

REIT Dividends

Multiple sections of the Act relate to REIT dividends. Most notably, the Act repeals the preferential dividend rule for publicly traded REITs. It also allows the IRS to provide an "appropriate remedy" for a preferential dividend distribution by a non-publicly traded REIT in lieu of treating the dividend as not qualifying for the REIT dividends-paid deduction, provided that the preferential distribution is inadvertent or due to reasonable cause and not due to willful neglect. Finally, the Act limits the aggregate amount of dividends that may be designated by a REIT as qualified dividends or capital gain dividends to the amount of dividends actually paid by the REIT and revises the calculation of current REIT earnings and profits for purposes of determining whether REIT shareholders are taxed as receiving a REIT dividend or as receiving a return of capital (or capital gain if a distribution exceeds a shareholder's stock basis).

REIT Income Excluded from Favorable Foreign Dividend Treatment

Generally, dividends received from a foreign corporation by a 10 percent domestic shareholder are not eligible for the dividends received deduction, except to the extent of the "US-source portion" of such dividends. The Act excludes income from a REIT from the U.S.-source portion of such a dividend. As a result, if a domestic REIT pays a dividend to a foreign parent, and the foreign parent pays a dividend to its domestic parent, the domestic parent will not be able to use the dividends received deduction with respect to the portion of income attributable to the domestic REIT.

Safe Harbors and Taxable REIT Subsidiaries

Section 857(b)(6)(A) imposes a 100 percent tax on the net income derived from "prohibited transactions," defined as the sale or other disposition of inventory property or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Section 857(b)(6)(C) provides a safe harbor under which the sale of real property will not be treated as a prohibited transaction if certain requirements are met. The Act expands the safe harbor by providing for a three-year averaging method for determining the percentage of assets that a REIT may sell annually and by allowing REITs to have TRSs develop and market REIT real property without subjecting the REIT to the 100 percent prohibited transactions tax. The Act makes clear that the 100 percent excise tax on non-arm's length transactions applies to services provided by a TRS to its parent REIT or to tenants of the parent REIT.

Permanent Reduction of REIT Built-in Gains Recognition Period

The Act permanently extends the rule reducing from 10 years to five years the period for which an S corporation must hold its assets after conversion from a C corporation to an S corporation in order to avoid corporate tax on built-in gains. Because the REIT built-in gains provision cross-references the S corporation built-in gains tax provision, this change also applies to REITs that have undertaken conversion transactions or acquired assets from C corporations in certain nonrecognition transactions. This change may be very significant to REITs

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that hold former C corporation assets and to C corporations contemplating REIT conversions. The provision applies to tax years beginning after December 31, 2014.

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