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New IRS Regulations May Cool REIT Spinoffs

By **Andrew McIntyre**

Law360, Minneapolis (June 8, 2016, 7:57 PM ET) -- The Internal Revenue Service's regulations released Tuesday that impose taxes on transfers of property into real estate investment trusts close a loophole in a law signed by President Barack Obama in December and will likely slow or halt such transactions, lawyers say.

The Protecting Americans from Tax Hikes Act of 2015, or PATH Act, sought to ban tax-free spinoffs of real property into newly created REITs, but the IRS subsequently found that law did not fully prevent all REIT spinoffs from being tax-free. The new regulations, which are already in effect, all but end any possibility of such tax-free deals, unless both companies are already REITs, lawyers say.

“The regulations are significant in that they complete the implementation of PATH Act changes to REIT conversion spinoffs,” said Laurence E. Crouch of Shearman & Sterling LLP. "There was this perceived hole by the [U.S. Department of] Treasury.”

While PATH attempted to make all REIT spinoffs taxable, per a loophole in the law, so-called spincos — companies that hold part of the larger company's assets — could still merge into a REIT, and presuming the REIT hasn’t had a taxable asset sale for five years, companies could avoid paying corporate tax.

The new rules, though, close that loophole. The traditional spinoff model many companies have used, and which PATH made subject to tax, had been a non-REIT spinning off certain real estate assets into a newly created REIT. But REIT-to-REIT transactions can still be tax-free.

“This is going to be a factor that’s going to have to be considered as to whether doing a spinoff of property into a REIT makes sense,” Michael L. Hermsen of Mayer Brown LLP said. “The additional cost could be prohibitive.”

Indeed, lawyers say such clarity will likely mean most companies will opt against REIT spinoffs, which have been popular ways for nonreal estate companies to monetize certain real estate assets.

“This really closes off some loopholes for C corps spinning off REITs,” said Patricia McGowan of Venable LLP.

Such transactions became particularly popular when the IRS two years ago broadened its definition of real property for REIT purposes, and companies started spinning off assets such as copper wiring and telecommunications networks into REITs.

“These [rules] make it more difficult to engage in these transactions,” said Jennifer H. Weiss of Greenberg Traurig LLP, who added that the deals are now also more unlikely to happen. “When you impose an additional cost ... it’s going to minimize those transactions.”

REIT spinoff transactions initially could be structured as tax-free, but the IRS pulled back on that later, resulting in companies having to seek private-letter rulings from the agency to have their transaction be tax-free.

But this didn't stop various companies from looking into it, and CBS Corp., for one, received a favorable ruling from the IRS. In 2014, CBS spun off certain assets into a REIT while Macy’s Inc. and McDonald’s Corp. recently opted not to.

For the companies that received private-letter rulings prior to the new rules, the IRS is grandfathering in those deals. One such company is a Hilton Worldwide Holdings Inc. REIT spinoff that’s currently in the works, and because its deal will be grandfathered in, it will still be allowed to go forward despite the new rules.

The rules take effect immediately but are also "proposed," and lawyers interpret that to mean the IRS has left room for comment and given itself the chance to make changes if needed.

Even though the IRS may have left the latest rules open for comment, lawyers say the new rules clearly indicate that the Treasury intends to make REIT spinoffs subject to tax.

“This has been ongoing. It's part of the discussion of companies doing some sort of spinoff,” Hermsen said. “Now, we have a better idea of what the IRS is thinking and what the potential costs of doing that will be."

Treasury couldn't be immediately reached for comment on Wednesday.

--Additional reporting by Vidya Kauri. Editing by Christine Chun and Emily Kokoll.