Extenders Bill Makes Important REIT Reforms and Closes Door on REIT Spin-Offs

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President Obama signed into law a bill that will significantly reform the taxation of real estate investment trusts (REITs). Most notably, the Protecting Americans from Tax Hikes Act of 2015 (the Bill) prevents companies from performing tax-free spin-offs of their real estate assets into separate REITs. It also includes several very favorable REIT reform provisions, including the biggest reform in 35 years to the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA). The Bill reduces REITs' permitted holdings in taxable REIT subsidiaries (TRS), modifies REIT earnings and profit calculations, changes the treatment of gross income tied to hedging, and allows publicly offered REIT debt instruments to be treated as real estate assets. Changes made to the taxation of REITs include:

Restriction of Tax-Free Spin-Offs

Effective immediately, the Bill severely restricts the ability of companies to engage in REIT spin-offs. The tax law previously permitted companies (regardless of REIT status) to spin off their real estate assets tax free into a REIT, or to spin off other operations and elect REIT status following the spin-off. Under the Bill, a spin-off involving a REIT does not qualify for tax-free treatment unless both the distributing corporation and the corporation being distributed in the spin-off are REITs immediately after the distribution. Moreover, if both parties to a spin-off are not REITs immediately after the distribution, then neither a distributing corporation nor a distributed corporation are permitted to elect REIT status for 10 years following a tax-free spin-off.

A REIT's tax-free spin-off of a TRS is still permitted if, at all times during the three-year period ending on the date of distribution, (1) the distributing corporation has been a REIT and the distributed corporation has been a TRS, and (2) the REIT has had control of the TRS.

The anti-REIT spin-off provision removes a significant bludgeon that activists seeking monetization of corporate real estate assets have been using in their fights against corporate boards. With this technique now unavailable, activists will likely push for other means for companies to monetize the latent value in their real estate.

This provision applies to distributions on or after December 7, 2015. However, the provision does not apply to any distributions pursuant to a transaction described in a ruling request that was initially submitted to the IRS on or before December 7, 2015, so long as such request had not been withdrawn and no ruling had been issued or denied in its entirety as of such date with respect to the request.

Permanent Reduction of Built-in Gains Tax to Five Years

A corporate-level built-in gains tax, at the highest marginal rate applicable to corporations (currently 35 percent), is imposed on a REIT's built-in gains (calculated as of the date the corporation converts to a REIT) that are recognized during the recognition period. The Bill makes permanent the reduction of the recognition period to five years (down from 10) that has been in place for the past three years.

FIRPTA Reforms

The Bill contains significant FIRPTA reforms, demonstrating continued legislative commitment to attracting additional foreign capital into the U.S. real estate market. The Bill completely exempts "qualified foreign pension funds" and entities wholly owned by such funds from FIRPTA taxation. Also, under prior law, foreign investors owning 5 percent or less of a publicly traded REIT were not subject to FIRPTA taxation upon a sale of the REIT's stock or the receipt of a capital gain dividend from the REIT. The Bill increases this ownership threshold from 5 to 10 percent. For further discussion on the Bill's significant FIRPTA reforms, see "New FIRPTA Reform: The Long-Awaited Game Changer for U.S. Real Estate" (Dec. 18, 2015), available here.

Reduction of TRS Percentage Limit

The Bill reduces the percentage of gross assets that a REIT can hold in securities of TRSs. Current law permits TRS securities to constitute up to 25 percent of the value of a REIT's gross assets. The Bill reduces this 25 percent limitation to 20 percent, making it more difficult for REITs to operate the non-real estate portions of their businesses in fully taxable corporations. This provision is effective for tax years beginning after 2017.

Additional Prohibited Transaction Safe Harbor

The Bill expands the prohibited transaction safe harbor for REITs by introducing a new alternative three-year averaging safe harbor based on either aggregate adjusted basis or fair market value in order to determine the percentage of assets that a REIT may sell annually. This provision is effective beginning in 2016.

Repeal of the Preferential Dividend Rule for Publicly Offered REITs and Preferential Dividend Remedies for Non-Publicly Offered REITs

The Bill finally corrects the preferential dividend rule for publicly offered REITs. Prior law provided that if a REIT made a dividend that was not pro rata to all shareholders of a particular class, that dividend was a "preferential dividend" that did not qualify for the dividends paid deduction. The preferential dividend provision has been a particular scourge and "trap for the unwary" for REITs, with a minor foot fault by a REIT potentially resulting in loss of REIT status. Under the Bill, this rule no longer applies to publicly offered REITs. This provision has retroactive effect and is applicable to 2015 distributions.

Moreover, if a non-publicly offered REIT makes a preferential dividend, the Bill provides the secretary of the Treasury with the authority to grant an appropriate remedy to cure the preferential dividend if the preferential dividend was inadvertent or due to reasonable cause and not due to willful neglect. This provision applies to distributions in tax years beginning in 2016.

Treatment of Certain Debt Instruments and Ancillary Personal Property as Real Estate Assets

The Bill expands the definition of "real estate assets" for purposes of the REIT rules to include debt instruments issued by publicly offered REITs and interests in mortgages on interests in real property to the definition of real estate assets for purposes of the 75 percent REIT asset test. Income from non-mortgage debt instruments issued by publicly offered REITs also is treated as qualified income for purposes of the 95 percent income test. However, no more than 25 percent of the value of a REIT's total assets may consist of such debt instruments. This provision is effective for tax years beginning in 2016.

Further, the Bill clarifies that personal property that is leased in connection with real property is treated for purposes of the 75 percent REIT asset test as a real estate asset to the extent that rents attributable to the personal property are treated as rents from real property. Additionally, an obligation secured by a mortgage on both real property and personal property is treated for purposes of the 75 percent asset test and the 75 percent income test as a real estate asset if the fair market value of the personal property does not exceed 15 percent of the combined fair market value of the real property and personal property. This provision is effective for tax years beginning in 2016.

Expanded REIT Hedges

The Bill allows a REIT to use a counteracting hedge to offset a prior qualifying hedge in a situation where either the prior debt is repaid or the prior asset was sold. The IRS has issued favorable private letter rulings consistent with the new rule, but those rulings could not be relied upon by other REITs. Because it is generally applicable, the new rule will enable REITs to more efficiently manage their interest rate exposure without having to go to the IRS for a private ruling. This provision is effective for tax years beginning in 2016.

Limitations on Designations of Qualified and Capital Gain Dividends

The Bill adds limitations on the designation of dividends by REITs. Under the Bill, the aggregate amount of dividends designated as qualified dividends or capital gain dividends with respect to any taxable year cannot exceed the amount of dividends actually paid with respect to that year. Additionally, the secretary of the Treasury can prescribe regulations or other guidance requiring proportionality with respect to the designation of particular types of dividends among shares or beneficial interests in a REIT. This provision is effective for distributions in tax years beginning in 2016.

Treatment of Certain Services Provided by TRSs

The Bill expands the permissible activities that a TRS may engage in. Under the Bill, TRSs are permitted to develop and market REIT real property without causing the REIT to lose its ability to rely on the prohibited transaction safe harbor in connection with the sale of certain property held for sale to customers. Regarding the sale of property that is a real estate asset, the Bill permits a TRS of a timber REIT to make substantially all of the marketing expenditures with respect to the property either before, on or after the date that the lease on the property is terminated. Furthermore, the Bill permits a TRS to operate foreclosed real property without causing income from the property to fail to satisfy the REIT income tests. This provision also expands the 100 percent excise tax on non-arm's length transactions to include services provided by the TRS to its parent REIT. This provision is effective for tax years beginning in 2016.

REIT E&P Calculation Modified to Avoid Double Taxation

The Bill also modifies REIT earnings and profits (E&P) calculations to avoid double taxation at the shareholder level. Under existing law, current (but not accumulated) E&P of a REIT for any tax year is not reduced by any amount that was not allowable in computing taxable income for that year. The Bill modifies this rule slightly to provide that current E&P of a REIT is not reduced by any amount that is not allowable in computing taxable income both for that year and any prior taxable year. The provision applies only for purposes of determining whether REIT shareholders are taxed as receiving a REIT dividend or as receiving a return of capital. This provision is effective for tax years beginning in 2016.

Please contact us if you would like additional information on the Bill.

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

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