Important FIRPTA and REIT Reforms Enacted

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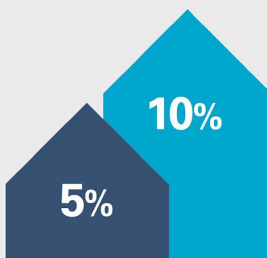
The newly signed Protecting Americans from Tax Hikes Act of 2015 (the Act) includes several reforms to the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) and the taxation of real estate investment trusts (REITs). The Act's FIRPTA reforms constitute the most significant changes to FIRPTA since its enactment 35 years ago and demonstrate continued legislative commitment to attracting additional foreign capital into the U.S. real estate market. Of the Act's many REIT reforms, the most significant is a provision preventing companies from performing tax-free spin-offs of their real estate assets into separate REITs. The anti-REIT spin-off provision removes a significant tool that activists seeking the separation of real estate and operating 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 separate operating and real estate assets so they may be valued separately by the markets. The Act also includes favorable REIT reforms, such as a provision that permanently reduces the recognition period for built-in gains to five years from 10. These reforms will make it easier for managers to operate REITs in a more flexible manner.

FIRPTA Reforms

Foreign Pension Funds

The Act completely exempts "qualified foreign pension funds" and entities wholly owned by such funds from FIRPTA taxation, providing foreign pension funds with the same tax treatment on the disposition of U.S. real property interests as domestic funds. A foreign pension fund is "qualified" if it is subject to government regulation and certain reporting requirements in its home jurisdiction, is established to provide retirement benefits to current or former employees, has no greater than 5 percent beneficiaries, and enjoys tax benefits on either contributions or investment income in its home jurisdiction. The new exemption applies to both direct investments and investments through partnerships.

For publicly traded REITs, the Act opens the door to substantial new foreign investment by expanding the FIRPTA exemption available to small foreign "portfolio investors."



Increase in Ownership Threshold

Threshold Increased for Publicly Traded REIT Stock

For publicly traded REITs, the Act opens the door to substantial new foreign investment by expanding the FIRPTA exemption available to small foreign "portfolio investors." 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 Act increases this ownership threshold from 5 to 10 percent, bringing the FIRPTA regime in line with the definition of a portfolio investor used in most U.S. tax treaties. The Act also provides for the first time that the exemption for small foreign portfolio investors applies to interests in REITs held through certain widely held, publicly traded "qualified collective investment vehicles," including certain listed Australian property trusts and certain foreign publicly traded partnerships that qualify under a comprehensive income tax treaty with the United States.

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Domestically Controlled Determination

The Act contains important clarifying presumptions that will allow publicly traded REITs and their shareholders to rely on the domestically controlled exception to FIRPTA taxation with greater confidence. (See December 18, 2015, Skadden client alert "New FIRPTA Reform: The Long-Awaited Game Changer for US Real Estate.")

The FIRPTA reform provisions are effective immediately.

REIT Reforms

Restrictions on Tax-Free Spin-Offs

Effective immediately, the Act severely restricts the ability to engage in REIT spin-offs on a tax-free basis. Previously, corporations (regardless of REIT status) could spin off their real estate assets tax-free into a REIT or spin off other operations and elect REIT status following the spin-off. Under the Act, a spin-off involving a REIT does not qualify for tax-free treatment unless both corporations that are party to the spin-off are REITs immediately after the distribution. Otherwise, neither corporation is permitted to elect REIT status for 10 years following a tax-free spin-off. A REIT's tax-free spin-off of a taxable REIT subsidiary (TRS) is still permitted if, at all times during the three-year period preceding the distribution date, (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.

Permanent Reduction of Built-in Gains Tax From 10 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 a corporation converts to a REIT or a REIT acquires assets from a corporation in a carryover basis transaction) that are recognized during the recognition period. The Act makes permanent the reduction of the recognition period from 10 to five years.

Reduction of TRS Percentage Limit

The Act reduces the percentage of its gross assets that a REIT can hold in TRS securities. Current law permits such securities to constitute up to 25 percent of the value of a REIT's gross assets. The Act 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. (See December 18, 2015, Skadden client alert "Extenders Bill Makes Important REIT Reforms and Closes Door on REIT Spin-Offs.")

Conclusion

Investment in U.S. real estate is central to the U.S. economy's health. FIRPTA taxation substantially deters foreign investment in U.S. real estate by creating unintended economic distortions that drive foreign capital to real estate opportunities abroad. The FIRPTA reform provisions reduce some of these barriers to foreign investment and should increase foreign capital investment in U.S. real estate. Also, although the Act's REIT provisions may inhibit certain REIT transactions by closing the door on spin-offs, many of the other reforms will help REIT managers by loosening certain operational requirements and providing helpful clarifications. This is unlikely to be the final chapter in REIT and FIRPTA reform. We may very well see further reforms in the near future that facilitate foreign investment in U.S. real estate and provide REIT managers with greater flexibility.