IRS Expands REIT Spin-Off Restrictions, Extends REIT Built-in Gains Period to 10 Years

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On June 7, 2016, the Internal Revenue Service (IRS) and Treasury Department issued new temporary regulations that have dramatic implications for all merger-and-acquisition activity by C corporations and real estate investment trusts (REITs). Under the new regulations, any entity that engages in a spin-off or acquires or combines with an entity that has engaged in a spin-off within the past 10 years cannot become a REIT or be acquired by a REIT without triggering a potentially prohibitive tax cost.

Prior to yesterday, a large corporation that chose to spin off a small business did not view itself as having foreclosed the possibility of engaging in REIT-related transactions for 10 years. The new regulations purport to backstop the Protecting Americans from Tax Hikes Act of 2015 (PATH Act), which, in relevant part, severely restricted the ability of companies to engage in tax-free REIT spin-offs after December 7, 2015. The new regulations also appear to retroactively apply the PATH Act prohibition to any spin-off transaction that has occurred since June 2006. Moreover, although Congress made permanent in the PATH Act the shorter five-year period during which newly converted REITs are subject to corporate-level tax on built-in gains, the new regulations seemingly overrule Congress and reinstate the 10-year rule that has not been in effect since 2008.

Expansion of Prohibition on REIT Spin-Offs

Before the PATH Act, companies could engage in tax-free spin-offs of their real estate assets, or spin off other operations, into a corporation and elect REIT status for the real estate company following the spin-off. As we previously discussed in our December 18, 2015, client alert "Extenders Bill Makes Important REIT Reforms and Closes Door on REIT Spin-Offs," the PATH Act restricted the ability of companies to engage in REIT spin-offs by generally (i) denying tax-free treatment to REIT spin-off transactions and (ii) preventing an entity that has engaged in a tax-free spin-off after December 7, 2015, from electing to be a REIT for 10 years. The PATH Act also contained a limited grandfathering rule that exempted spin-offs after December 7, 2015, if the corporation had a pending request for an IRS private letter ruling.

Despite the sweeping changes it made to the spin-off and REIT regimes, the PATH Act left a critical question open: If one C corporation spins off another and both C corporations exist as separate entities for some period of time, can an unrelated REIT acquire either the distributing C corporation or the spun off C corporation during the 10-year period following the spin-off? As expected, the new regulations prevent this transaction by imposing immediate corporate-level tax on the acquired C corporation's built-in gain in its assets.

If the new regulations stopped there (applying only to those C corporations involved in a spin-off after December 7, 2015, that were prohibited from converting to REIT status under the PATH Act), they would reflect a reasonable application of the PATH Act. However, the new regulations seem to go beyond the PATH Act restrictions. While the PATH Act only applied to spin-offs after December 7, 2015, the new regulations do not seem to follow that effective date and preclude REIT-related transactions for all C corporations involved in spin-offs within the last 10 years. The only spin-offs since June 7, 2006, that would not trigger immediate gain recognition on a REIT conversion or acquisition after yesterday are those that had a pending IRS ruling request on December 7, 2015.

The divergence of these rules from the PATH Act can be illustrated by considering a C corporation that engaged in a spin-off transaction in 2010. The PATH Act imposed no restrictions on this C corporation's ability either to elect REIT status or be acquired by a REIT. Under the new regulations, this C corporation would be subject to immediate corporate taxation on the built-in gain in its assets at the time of a REIT conversion or combination with a REIT. This would be the result even if this C corporation had

not itself engaged in a spin-off but rather had acquired another corporation that engaged in a spin-off since June 2006, even where the acquired corporation was very small relative to the acquirer. Thus, going forward, any entity engaging in an acquisition will need to be diligent about whether its counterparty, or an entity the counterparty has acquired, is tainted by prior spin-off activity and whether the benefits of the proposed transaction outweigh giving up future flexibility to engage in a REIT conversion or otherwise combine with a REIT for up to 10 years.

The new regulations preserve the PATH Act's limited grandfathering rule for entities with pending IRS private letter ruling requests on December 7, 2015. These entities that consummate a spin-off and REIT conversion in July 2016 pursuant to a ruling request that was pending on December 7, 2015, have a significant advantage over C corporations that did a spin-off in 2010 with no contemplation of any REIT conversion or combination (even where the spin-off was pursuant to a favorable IRS private letter ruling). This anomalous result suggests that the application of the new regulations to spin-offs that occurred prior to December 7, 2015, may have been unintentional. We hope that the new regulations will be corrected shortly to extend relief to spin-offs that occurred before the December 7, 2015, effective date of the PATH Act. Even if this correction is made, corporations will still need to exercise diligence and evaluate proposed transactions to take into account the limitations on future flexibility.

Reinstatement of 10-Year Built-in Gain Recognition Period

The last time a 10-year built-in gain recognition period applied to S corporations, REITs and regulated investment companies (RICs) was in 2008. The PATH Act permanently reduced the "recognition period" from 10 to five years (after years of reducing this period annually in an extenders bill). The recognition period for S corporations, REITs and RICs has consistently been the same since 1986. The Joint Committee on Taxation's technical explanation of the PATH Act confirms that the new five-year recognition period applies to REITs and RICs, as well as S corporations.[1]

In the case of REITs and RICs, the new regulations seem to overrule the PATH Act change by re-establishing a 10-year recognition period. The new regulations thus create an illogical disconnect between the rules governing RICs and REITs, on the one hand, and the rules governing S corporations, on the other. There is no discernable tax policy justification to distinguish among REITs, RICs and S corporations, especially in light of the recent congressional action in the PATH Act to permanently set the period at five years. This provision is effective with respect to REIT conversions and acquisitions occurring after August 8, 2016. REITs that convert or acquire assets from a C corporation prior to August 8, 2016, continue to be subject to the five-year period under the PATH Act with respect to built-in gains in those transactions.

[1] See Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029 (Rules Committee Print 114-40) (JCX-144-15), December 17, 2015. ("[A RIC or a REIT] that was formerly a C corporation (or that acquired assets from a C corporation) generally is subject to the rules of section 1374 as if the RIC or REIT were an S corporation, unless the relevant C corporation elects 'deemed sale' treatment.")