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U.S. Tax Extenders Make Major Revisions to FIRPTA and REIT Rules

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With the end of the year looming, both houses of the U.S. Congress approved, and President Obama signed, the *Protecting Americans from Tax Hikes Act of 2015* (PATH Act). Nestled among the PATH Act's numerous "extenders" – provisions that extend favourable tax provisions that would otherwise expire – are important revisions to the U.S. federal tax rules governing REITs. These revisions encourage greater foreign investment in U.S. real estate, energy and other infrastructure by relaxing some key provisions of FIRPTA.[1]

FIRPTA subjects foreign investors to U.S. federal income tax on income and sales proceeds on interests in U.S. real property, including interests in corporations that hold more than a threshold amount of U.S. real property (U.S. real property holding companies, or USRPHCs). Before the enactment of the PATH Act, exemptions from FIRPTA existed for foreign persons that held less than 5% of the stock in a publicly traded REIT and for foreign governments (including certain foreign pension funds) that held non-controlling interests in a USRPHC. The narrow applicability of these exemptions limited the appeal of U.S. real property for large foreign institutional investors. Accordingly, President Obama and certain influential members of Congress have long sought changes to the tax law that would encourage foreign investment in U.S. real property and infrastructure.

Provisions Affecting Foreign Investors

Foreign Pension Funds Exempted from FIRPTA. One of the most significant provisions of the PATH Act is an exemption for foreign pension funds and their wholly owned subsidiaries from taxation under FIRPTA, effective on the date of enactment. This exemption is available for foreign entities established to provide retirement or pension benefits to employees.[2] The exemption will, for the first time, permit some governmental funds to hold control positions in REITs without losing their FIRPTA exemption.

The exemption also adds flexibility in exiting from U.S. real property investments. For example, under the PATH Act, if a REIT sells its real estate assets, the gain is exempt from FIRPTA without the previous requirement that such sale take the form of a sale of REIT shares.[3] Even gain from a controlled REIT is exempt from FIRPTA under this provision.

Broadened Exemption from FIRPTA for Publicly Traded Interests. The PATH Act doubles the size of holdings of publicly traded REITs that are exempt from FIRPTA to 10%, from 5%.

In addition, the PATH Act clarifies how a REIT qualifies as being domestically controlled (DC REIT). Interests in a DC REIT are not subject to FIRPTA. In determining whether a REIT is domestically controlled, the REIT may presume that any owner of less than 5% of any publicly traded shares of the REIT is a U.S. person.[4] However, stock held by another publicly traded REIT or by an open-end mutual fund is treated as held by a foreign person for this purpose unless such entity is itself domestically controlled. Stock of a REIT held by non-public REITs or other mutual funds is treated as held by U.S. persons in proportion to the U.S. ownership of these entities.

Increase in FIRPTA Withholding Rate. The purchaser of a U.S. real property interest from a foreign person was previously required to withhold 10% of the purchase price under FIRPTA. The PATH Act increases this rate to 15% for tax for dispositions occurring after the 60th day following enactment.

RICs Permanently Treated as Qualified Investment Entities Under FIRPTA. Under previous law, regulated investment companies (RICs) were treated like REITs for the purposes of the exemption from FIRPTA for gain attributable to the sale of an interest in a publicly traded, domestically controlled REIT. This provision expired in 2014, but is permanently revived under the PATH Act.

Other REIT Provisions

Extension of Built-in Gains Recognition Period. Under Section 1374 of the Code, if a C corporation that has a net unrealized gain in its assets converts into an S corporation, the S corporation is required to pay tax if it sells assets with gain attributable to periods when the S corporation was still a C corporation. This tax applies to a sale of an S corporation's assets during a specified period after its conversion from a C corporation. The PATH Act has permanently reduced this built-in gains period to five years.

REITs are similarly subject to Section 1374 with respect to assets sold with gain that is attributable to years before the REIT made its REIT election; accordingly, REITs also benefit from the reduction in the built-in gains period.

This provision is effective for taxable years beginning after December 31, 2014.

Restriction on REIT Spinoffs. In recent years it has become increasingly common for large corporate taxpayers to reduce their tax bills by contributing real estate used in their businesses to a subsidiary, spinning out the subsidiary in a tax-free transaction under Section 355, and then electing to have the spun-out subsidiary be a REIT. This strategy has been employed by companies in such diverse industries as casinos, document storage and server farms.

The PATH Act provides that a corporation cannot make a REIT election for 10 years after that corporation was involved in a Section 355 transaction. This does not prevent a spinoff of one REIT from another REIT, or perhaps having a REIT acquire a non-REIT corporation that has been spun off (subject to a five-year built-in gain limitation).

The restriction on REIT spinoffs applies to those taking place after December 7, 2015, other than spinoffs for which private letter ruling requests have been filed with the IRS by that date.

Reduction in Percentage Limitation Applicable to TRSs. Under previous law, no more than 25% of a REIT's total assets was permitted to consist of the securities of a taxable REIT subsidiary (TRS). The PATH Act reduced that percentage to 20% for taxable years beginning after December 31, 2017.

Debt Instruments of Publicly Offered REITs. The PATH Act adds debt instruments of publicly offered REITs to the list of acceptable real estate assets for the purposes of the REIT asset tests. A REIT's holding of such debt instruments, however, is limited to 25% of the REIT's total assets. This provision is effective for taxable years beginning after December 31, 2015.

Other Tax Provisions

In addition to the REIT-related provisions described above, the PATH Act includes several important provisions of general applicability. Some examples follow:

Extension of Look-Through Rule for Payments Between CFCs. Under Subpart F of the Code, a U.S. shareholder of a controlled foreign corporation (a CFC) is required to recognize certain income of the CFC currently, regardless of whether that income is actually distributed. Subpart F income generally includes payments of dividends, interest, rents and royalties received by a CFC. In the case of a CFC that receives such payments from a related CFC, a temporary look-through rule excepts such payments from Subpart F income to the extent that these payments are attributable to income of the related CFC that is not Subpart F income or ECI. The PATH Act extended this provision to all tax years of CFCs beginning before January 1, 2020, and to taxable years of U.S. shareholders within which the CFCs' taxable years end.

Extension of Subpart F Income for Active Financing Income. Under previous law, certain "active financing income" was temporarily exempt from current income inclusion under Subpart F. The PATH Act made the active financing income exemption permanent for taxable years of CFCs beginning after December 31, 2014, and for taxable years of U.S. shareholders within which such CFCs' taxable years end.

Extension of R&D Credit. Taxpayers are entitled to a tax credit for certain R&D expenses, now made permanent by the PATH Act. In addition, for certain small businesses, the PATH Act allows the R&D tax credit to be applied against both regular and AMT liabilities, or the taxpayer may elect to use the R&D tax credit as a payroll tax credit against Old Age, Survivors, and Disability Insurance (OASDI) liability. The provision to make the R&D tax credit permanent applies to amounts paid or incurred after December 31, 2014; the provisions to allow the R&D credit against AMT and OASDI taxes are effective for taxable years beginning after December 31, 2015.

Extensions of Energy Incentives. The PATH Act extends the availability of certain energy incentive tax benefits. These extensions apply to the credits for energy-efficiency improvements to existing homes, clean-fuel vehicle refuelling property, electric two- and three-wheeled motorcycles, second-generation biofuel production, biodiesel fuels, Indian coal facilities, certain renewable electricity production facilities, new energy-efficient homes, alternative fuels and fuel mixtures and fuel cell vehicles.

Conclusion

The significance of the PATH Act for foreign investors in U.S. real estate, especially foreign pension funds, cannot be overstated. The new rules represent a potentially large expansion of the incentives for foreign investment in U.S. real estate. All foreign persons with interests in U.S. real estate should review the new provisions with their tax advisers to determine whether such persons can benefit from the PATH Act.

[1] *Foreign Investment in Real Property Tax Act of 1980.*

[2] To qualify for the exemption, no participant in or beneficiary of the pension fund may have a right to more than 5% of the fund's assets or income; the fund must be subject to government regulation and annual information reporting in the country where it is established or operates; and either contributions to the fund must be exempt from tax or the fund's investment income must be tax deferred or subject to a reduced rate of tax.

[3] Note that, although a distribution of the gain from a REIT's sale of its assets is no longer subject to FIRPTA, the distribution is subject to U.S. federal income tax withholding unless a tax treaty applies.

[4] Congress seems to be approving (or at least aware of) the IRS's holding in PLR 200923001, which held that it is not necessary to look through to any foreign owners of a U.S. C corporation to determine whether a REIT is domestically controlled.

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