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# PRESIDENT OBAMA SIGNS APPROPRIATIONS BILL EXEMPTING NON-U.S. PENSION FUNDS FROM FIRPTA, TAXING REIT SPINOFFS, AND MAKING OTHER IMPORTANT CHANGES TO THE TAXATION OF U.S. REAL PROPERTY INVESTMENTS BY NON-U.S. INVESTORS AND THE REIT RULES

To Our Clients and Friends:

On December 18, 2015, President Obama signed into law the Consolidated Appropriations Act of 2016 (the "Act"), an omnibus spending bill that includes a number of changes to the provisions of the Internal Revenue Code (the "Code") governing the taxation of U.S. real property investments by non-U.S. investors, the tax treatment of real estate investment trusts ("REITs") and REIT-related transactions. These changes provide benefits to certain non-U.S. investors and REITs, while other changes will eliminate certain planning techniques, such as certain tax-free spinoffs of REITs. We summarize below the provisions of the Act pertaining to investments in U.S. real estate and REITs.

**Changes to the Taxation of U.S. Real Property Investment by Non-U.S. Investors**

The Act makes a number of changes to the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), which generally treats a non-U.S. individual's or non-U.S. corporation's gain or loss from the disposition of a U.S. real property interest ("USRPI"), including interests in a U.S. real property holding corporation ("USRPHC"), as subject to U.S. federal income tax on a net basis.

One of the more significant changes to FIRPTA made by the Act is to exempt qualifying non-U.S. pension plans from FIRPTA. Under this new exemption, a sale of any USRPI by a qualifying non-U.S. pension plan, as well as the receipt of a distribution from a REIT that is attributable to gain from the disposition of a USRPI, generally will not be subject to U.S. tax under FIRPTA; although such gain may in certain circumstances still remain subject to U.S. federal income tax if it is effectively connected with a U.S. trade or business. To qualify for this exemption, a non-U.S. pension plan must be a "qualified foreign pension fund," which is defined under the Act to mean any trust, corporation, or other organization or arrangement:

(A) which is created or organized under the law of a country other than the United States,

(B) which is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered,

(C) which does not have a single participant or beneficiary with a right to more than five percent of its assets or income,

(D) which is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates, and

(E) with respect to which, under the laws of the country in which it is established or operates–(i) contributions to such trust, corporation, organization, or arrangement which would otherwise be subject to tax under such laws are deductible or excluded from the gross income of such entity or taxed at a reduced rate, or (ii) taxation of any investment income of such trust, corporation, organization or arrangement is deferred or such income is taxed at a reduced rate.

The Act grants the Treasury Department and the IRS the authority to prescribe regulations as may be necessary or appropriate to carry out the purpose of this new exemption.

The addition of this new exemption from FIRPTA for qualified foreign pension funds will be extremely helpful for the U.S. real estate community when marketing U.S. real property investments to these types of investors. In this regard, although certain governmental pension funds are already exempt from FIRPTA on the sale of stock in a USRHPC (including a REIT) through the exemption available for non-U.S. governments under Section 892, this new exemption for non-U.S. pension plans is broader than the Section 892 exemption: it is not limited to sales of stock, it does not limit a non-U.S. pension fund to holding less than 50% of a USRPHC (including a REIT), and it exempts from tax distributions from a REIT that are attributable to the sale of USRPIs. However, it should be noted that this exemption is not comprehensive–for example, it does not exempt from U.S. federal income tax rental income earned on a real property investment or gain from such an investment to the extent attributable to a U.S. trade or business. We expect that the IRS will need to provide guidance as to the foreign pension funds to which the exemption applies, but the new statute suggests that in any event the qualified foreign pension fund exemption would not apply to non-U.S. government entities that are not established to provide pension benefits.

In addition to the exemption for non-U.S. pension plans, the Act also makes the following other changes to FIRPTA:

- The Act expands the exclusion from FIRPTA for shares in publicly traded REITs, so that now a non-U.S. person can own up to 10% (rather than 5%) of the shares of a publicly traded REIT without being subject to U.S. federal income tax on a net basis on the disposition of shares in the REIT or on the receipt of distributions from the REIT attributable to gain from the disposition of a USRPI by the REIT.

- The Act provides that REIT shares held by a non-U.S. "qualified shareholder" will not be treated as a USRPI and distributions received from a REIT by such a non-U.S. qualified shareholder attributable to gain from the disposition of a USRPI by the REIT will not be treated as gain from a USRPI, except to the extent that an investor in the non-U.S. qualified shareholder (other than another non-U.S. qualified shareholder) holds (including by attribution) more than 10% of the

stock of the REIT. A non-U.S. qualified shareholder is defined narrowly under the Act to generally include only an entity that, among other requirements, (i) is either (a) publicly traded or (b) a non-U.S. partnership that has a class of units that is regularly traded on the New York Stock Exchange or the Nasdaq Stock Market, which class represents more than 50% of the value of all of its units, and (ii) is either (a) entitled to a reduced rate of withholding on REIT dividends under an income tax treaty regardless of the amount of its REIT holdings, (b) a publicly traded partnership that would be a USRPHC were it a corporation, or (c) designated as a "qualified collective investment vehicle" by the IRS.

- The Act provides several new rules for determining when a REIT or a RIC (each, a "qualified investment entity") is domestically controlled and thus will not be treated as a USRPHC, including by deeming any stock in a qualified investment entity of a regularly traded class on an established securities market in the United States as held by a U.S. person unless such stock is held by a person holding 5% or more of such class or the qualified investment entity has actual knowledge that a holder is not a U.S. person.

In contrast to the above changes, the Act made two noteworthy changes that will negatively impact non-U.S. investors in U.S. real property. First, the Act increases the FIRPTA withholding rate on payments made to non-U.S. sellers of USRPIs from 10% of the gross purchase price to 15%. Note that this change was not accompanied by an increase in the actual tax rate under FIRPTA. Second, the Act eliminates for REITs and RICs a special rule that excluded a corporation from being a USRPHC if it disposed of all of its USRPIs in taxable transactions (the so called "cleansing rule"). As a result of this change, non-U.S. investors in a liquidating REIT may be subject to U.S. federal income tax on gain attributable to their stock in the REIT that is recognized on the liquidation, even in situations where the liquidating distribution otherwise would not have been subject to U.S. federal income tax under FIRPTA (such as where the distribution was not attributable to gain on the disposition of USRPIs).

**Prohibition on Tax Free Spinoffs Involving REITs**

A number of publicly traded companies with large real estate portfolios have recently undertaken restructurings to split their real estate holdings into a separate publicly traded REIT through a tax-free spin-off, thereby taking advantage of the beneficial tax treatment available to REITs. The Act generally puts an end to this practice in the future by making REITs ineligible to participate in tax-free spin-offs unless (1) both the distributing corporation and the controlled corporation are REITs or (2) a REIT spins off a TRS that it has controlled for at least three years. In addition, the Act generally provides that a corporation that participates in a tax-free spin-off is ineligible to elect to be treated as a REIT for ten years following the spinoff.

**Taxable Period for Pre-Conversion Built-In Gains of Subchapter S Corporations and REITs**

The Act extends or makes permanent a number of expiring tax provisions. One of the more noteworthy changes for REITs is a provision that makes permanent the reduction from 10 years to 5 years for the period during which a Subchapter S corporation or a REIT is subject to U.S. federal income tax on the

disposition of built-in gain assets acquired from a Subchapter C corporation, including where a Subchapter S corporation or REIT converted from a Subchapter C corporation.

**Changes to the REIT Qualification and Operating Rules**

***REIT Asset and Income Tests***

The Act makes several changes and clarifications to the rules for determining what constitute qualifying assets and qualifying income for purposes of the REIT asset and income requirements, including:

- Providing that, for taxable years beginning after December 31, 2017, no more than 20% of the value of a REIT's total assets can consist of securities of one or more taxable REIT subsidiaries (each, a "TRS"). Under current law, the limit is 25%.
- Expanding the list of REIT-qualifying assets to include debt instruments issued by publicly traded REITs and mortgages on interests in real property (for example, a mortgage on a leasehold interest in real property). However, not more than 25% of the value of a REIT's total assets can consist of debt instruments issued by publicly traded REITs.
- Providing that certain ancillary personal property leased with real property is treated as a REIT-qualifying asset if the rent attributable to such personal property is 15% or less of the total rent for real and personal property.
- Providing that a debt instrument secured by both real and personal property is a REIT-qualifying asset, and interest paid under such an instrument is qualifying income for the REIT income tests, as long as the value of the personal property is 15% or less of the total value of all property securing the obligation.
- Providing that a TRS can operate foreclosure property without causing loss of foreclosure property status. Under prior law, in order for income from foreclosure property to qualify under the income tests, a REIT could only operate the foreclosure property through an independent contractor.

***Changes to the REIT Dividend Rules***

The Act makes several changes to the rules governing REIT dividends. The Act eliminates the "preferential dividend" rule for publicly traded REITs. For all other REITs, the Act authorizes the IRS to provide an "appropriate remedy" for the failure of a REIT to comply with the preferential dividend requirements in lieu of disqualifying the entire dividend, where the failure to comply is inadvertent or is due to reasonable cause and not willful neglect.

The Act also modifies the calculation of a REIT's earnings and profits, limits the amount of dividends that a REIT may designate as dividends in a taxable year to the amount of dividends paid out by the REIT in the taxable year, and gives the IRS authority to prescribe regulations requiring proportionality

of the designation of particular types of dividends (e.g., capital gain dividends) among different classes of shares of a REIT.

***Changes to REIT Dealer and Other Taxes***

The Act makes certain minor changes to the REIT safe harbor from the 100% tax on dealer income, including by allowing a REIT to qualify for the safe harbor even if it sells up to 20% of its assets based on tax basis or fair market value, provided that over a three year period its sales have not exceeded on average 10% of its assets based on tax basis or fair market value, as applicable. In addition, the Act expands the list of transactions between a REIT and its TRS that are subject to a 100% tax if not on an arm's length basis to include services the TRS provides to the REIT (other than services furnished or rendered to a tenant of the REIT).

*Gibson, Dunn & Crutcher's lawyers are available to assist with any questions you may have regarding these developments. For further information, please contact the Gibson Dunn lawyer with whom you usually work or any of the following members of the Tax Practice Group:*

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