HUNTON& WILLIAMS

Client Alert

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Congress Encourages Foreign Investment in REITs and Enacts Other REIT Reforms

On December 18, 2015, President Obama signed into law the Protecting Americans from Tax Hikes Act of 2015 (the "Act"). The Act encourages foreign investments in REITs and ends certain tax-free REIT spin-offs. The Act also includes a largely helpful set of technical revisions to the REIT tax rules.

Continue reading a summary of the more significant REIT provisions of the Act.

Act Encourages Foreign Investment in REITs

A major impediment to foreign investment in equity REITs is the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"). If gain from the sale of REIT stock or a REIT capital gain dividend is subject to FIRPTA, a foreign investor must pay US income tax on the income or gain, is subject to withholding, and is required to file a US tax return. The Act makes several changes that create or expand FIRPTA exemptions for certain foreign investors. As a result, the Act is expected to encourage and significantly increase foreign investment in equity REITs.

- New FIRPTA Exemption for Foreign Pension Funds. The Act completely exempts qualified foreign pension funds from FIRPTA, both as to investments in REITs and direct investments in US real property. However, income derived by such pension funds from the ownership of rental real estate, either directly or through a partnership, will continue to be subject to US income taxation as effectively connected income. Thus, investing through a REIT is still important for purposes of avoiding effectively connected income. REIT dividends will continue to be subject to US withholding tax at a 30% rate, subject to reduction by applicable tax treaty. The FIRPTA exemption applies to all REIT stock, regardless of whether a REIT is publicly traded or domestically controlled. There are a number of requirements for a foreign pension fund to be qualified under the Act, but in general it must resemble a US pension plan. The exemption covers both governmental and private pension plans, but not sovereign wealth funds.

- Broader FIRPTA Exemption for Portfolio Investors in Public REITs. Under prior law, FIRPTA did not apply to investments in the stock of publicly traded REITs if the foreign investor owned no more than 5% of the REIT's stock during the applicable holding period. The Act increases that threshold to 10%.

- New FIRPTA Exemption for Foreign Collective Investment Vehicles. The Act creates a new FIRPTA exemption for investments in REIT stock by certain foreign "collective investment vehicles" that are publicly traded, widely held, and resident in a country that has an income tax treaty with the United States If any shareholder of the collective investment vehicle directly or indirectly owns more than 10% of the REIT's stock, the exemption does not apply to the extent of the shareholder's interest in the vehicle. This exemption is intended to benefit foreign public REIT-equivalent entities, such as Australian listed property trusts, and applies even if the foreign entity owns more than 10% of the REIT's stock or the REIT is not publicly traded.

- Domestically-Controlled REITs. The sale of stock in a domestically controlled REIT is exempt from FIRPTA. Under prior law, publicly traded REITs often had difficulty determining whether they were domestically controlled because most or all of their shares are held in street name. The Act allows a publicly traded REIT to treat shareholders owning less than 5% of its stock as US persons unless the REIT has actual knowledge to the contrary. This change will create greater certainty as to whether publicly traded REITs are domestically controlled. The Act also clarifies how the domestically controlled rules apply when a REIT (whether publicly traded or not) has another REIT as a shareholder. If the REIT shareholder is publicly traded, it is treated as a US person if it is domestically controlled, and as a foreign person if it is not, for purposes of determining whether the REIT in which it owns shares is domestically controlled. If the REIT shareholder is not publicly traded, there is look-though to its shareholders in determining whether the REIT in which it owns shares is domestically controlled.

Act Ends Certain Tax-Free REIT Spinoffs

- End of Certain Tax-Free Spin-Offs Involving REITs. In a number of high-profile transactions, public companies with significant real estate holdings have transferred their real estate assets into separate publicly-traded REITs in tax-free spin-offs. The Act generally prevents a spin-off of a REIT by a C-corporation, or a spin-off of a C-corporation by a REIT, from qualifying for tax-free treatment. The Act also prevents any corporation involved in a tax-free spin-off from making a REIT election until the 10th taxable year beginning after the taxable year in which the spin-off occurred.
  - Certain Tax-Free Spinoffs Still Allowed. Under the Act, a REIT could spin-off another REIT on a tax-free basis. In addition, there is a limited ability of a REIT to spin-off a taxable REIT subsidiary ("TRS") on a tax-free basis, provided that the distributing REIT has owned the TRS for at least three years.
  - Taxable Spin-Offs Allowed. The Act does not prevent a taxable spin-off involving a REIT or limit the ability of an entity to qualify as a REIT after a taxable spin-off.

Helpful REIT Rule Revisions

The Act includes a number of helpful revisions to certain technical REIT tax rules, including:

- REIT Asset Tests.
  - Expanded Definition of Real Estate Assets.
    - Personal Property/Loans. The Act also treats debt instruments secured by a mortgage on real and personal property as being real estate assets in their entirety and producing qualifying income in their entirety if the fair market value of the personal property does not exceed 15% of the total fair market value of all the property securing the debt.
      - This change should expand the ability of REITs to invest in distressed debt that is secured by both real and personal property.
    - Personal Property/Leases. The Act treats personal property as a good real estate asset to the extent that rents attributable to personal property are treated as rents from real property under the 15% rule for rents from real property.

    - This change will allow a REIT to treat a greater proportion of its assets as good assets and will eliminate concerns regarding whether the sale of personal property leased with real property will produce bad income for a REIT.

  - Debt of Publicly-Offered REITs as Good REIT Assets. The Act provides that debt instruments of "publicly offered REITs" (which includes any REIT that is required to file with the SEC under the Securities Exchange Act of 1934) that are not secured by real property will be treated as good REIT assets. However, those debt instruments may not constitute more than 25% of the REITs assets at the end of each calendar quarter.

- Repeal of Preferential Dividend Rule. The Act repeals the preferential dividend rules for publicly offered REITs. The repeal applies to 2015 and future years.

  - Rule Still Applies to True Private REITs. The repeal does not apply to REITs that are not SEC reporting companies (i.e., "private" or "baby" REITs).

  - Treasury Authority. Although the preferential dividend rules still apply to private REITs, the Act grants authority to Treasury to issue rules that remedy violations in situations where there is reasonable cause or an inadvertent failure to comply.

- 100% Prohibited Transaction Tax: The Act provides increased flexibility in satisfying the safe harbor from the 100% prohibited transaction tax. Under the Act, a REIT can qualify for the safe harbor from the 100% prohibited transaction tax if, among other requirements, it disposes of no more than 20% of its assets during the year, so long as the annual average percentage of property sold by the REIT in the current and prior two years did not exceed 10%.

Adverse REIT Rule Revisions

The Act also includes some provisions that limit the operational flexibility of certain REITs or impose new taxes on REITs, including:

- Reduction in Allowable TRS Holdings: Under prior law, up to 25% of the total value of a REIT's assets could consist of non-qualifying assets, including stock and securities of one or more TRSs. The Act creates a sub-limit of 20% for TRS stock and securities. This provision applies to taxable years beginning after December 31, 2017.

- New Penalty Tax on Services Provided by TRSs. The Act imposes a 100% tax on non-arm's-length fees paid by a REIT to a TRS for services performed for the REIT.

View a copy of the Act.

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