# REIT Wise® 2017

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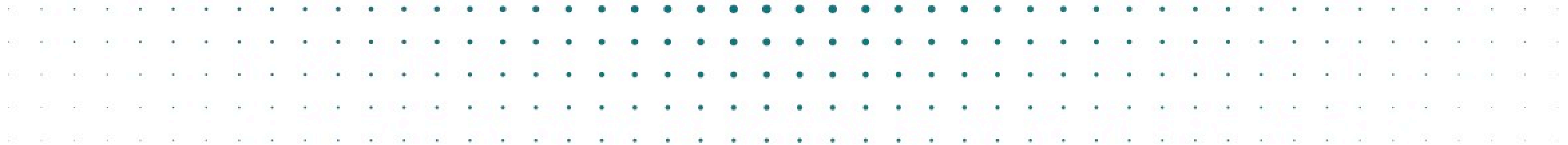
# Implementing PATH Act Tax Changes



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# Agenda

1) Preferential Dividend Rule
2) REIT Spin-Offs
3) FIRPTA
4) U.S REIT Act

# Preferential Dividend Rule

# Preferential Dividends, Pre-PATH Act

- Fear of foot-faults resulting in current or potential REIT-qualification problems (REIT qualification, undistributed income)
- Confusion as to whether certain actual or deemed distributions were tainted
- Solving the problem without a closing agreement generally required a deficiency dividend or use of the “reasonable cause” provisions of Section 856(g)(5)

# PATH Act – Publicly Offered REITs



- New Section 562(c)(1) – "publicly offered REITs" no longer denied a deduction on preferential dividends
    - "Publicly offered REIT" – a REIT required to file annual reports with the SEC under the Securities Exchange Act of 1934 (Section 562(c)(2))
    - Includes REITs traded on US exchanges and well as "public, non-listed REITs"
    - May not include REITs traded on foreign exchanges, such as in Canada

# PATH Act – "Private" REITs



- New Section 562(e)(2)

  In the case of a failure of a distribution by a REIT to comply with the requirements of subsection (c) [i.e., the preferential-dividend provision], *the Secretary may provide* an appropriate remedy to cure such failure in lieu of not considering the distribution to be a dividend for purposes of computing the dividends paid deduction if:

*emphasis added*

# PATH Act – “Private” REITs (cont’d)



(A) *the Secretary determines* that such failure is inadvertent or is due to reasonable cause and not due to willful neglect, or

(A) such failure is of a type of failure *which the Secretary has identified* for purposes of this paragraph as being described in subparagraph (A).

*emphasis added*

# NAREIT Comments



- May 16, 2016
- Consider treating REITs that are subsidiaries of “publicly offered REITs” (i.e., REITs included in the consolidated GAAP financial statements, filed with the SEC, of a parent REIT) as being exempt from the preferential dividend rule

# NAREIT Comments (cont'd)



- Issue a revenue procedure where the IRS uses its authority under Section 562(e)(1) to:
  - List certain *de minimis* violations with respect to which REITs will not be treated as having paid a preferential dividend
  - Permit REITs otherwise to remedy a preferential dividends violation by self-assessing a penalty (rather than by paying a deficiency dividend) where the problem is either (A) inadvertent or (B) due to reasonable cause and not willful neglect

# State of Play



- For most Public REITs, then, the preferential dividend issue is now off the table (but see: the fast-pay rules and other possibilities for recharacterization)
- Private REITs (and some foreign-traded Public REITs)
  - There has been no guidance from the IRS as to how it would exercise its authority under Section 562(e)(2)
  - Absent IRS guidance, it seems that nothing has changed *for REITs other than publicly-offered REITs*
  - Significant questions remain for certain structures

# Remaining Issues



- Absent IRS guidance, practitioners may look to either the potential availability of deficiency dividend procedures or the reasonable cause provisions of Section 856(g)(5)
    - Deficiency dividends require cash or consent dividends, may duplicate shareholder income, and present E&P complexities
    - Section 856(g)(5) appears to require the payment of penalty to be effective, and may not apply to the REIT's initial election-year
    - Neither technique is sure to be available after a REIT has liquidated, depending on the specific type of  transaction

# Remaining Issues (cont'd)



- Divergent sharing of certain expenses, including and management fees in REIT-fund structures
  - PLR 201444022 – the IRS ruled that a "Class A/B structure," where economics associated with a REIT's classes of stock reflected different sharing of the burden associated with management fees would result in preferential dividends
    - IRS disregarded the separate, formal rights of the classes
    - Not clear that the IRS's view is correct

# Remaining Issues (cont'd)



- Similar concerns sometimes arise in partnership-over-REIT structures where partners share burden of management fees (or certain other REIT expenses) differently
    - The level of concern generally depends on the facts associated with the structure, and specifically the risk of the partnership being disregarded (under the partnership anti-abuse regulations or otherwise)

# Opinions & Preferential Dividends (cont'd)

- In many cases, advisers may be able to issue a will-level REIT-qualification opinion even where they cannot reach a will-level of comfort on each point necessary to REIT qualification, relying on the assumed availability of savings provisions
- As mentioned above, though, those savings provisions that, absent new guidance from the IRS under Section 562(e)(2), are most appropriate to solving preferential-dividend problems require some future action – either a deficiency dividend or the payment of a penalty (under Section 856(g)(5))

# Opinions & Preferential Dividends (cont'd)



- Query whether reliance on the savings provisions to reach an overall will-level of comfort will always be reasonable where there preferential dividends concerns – particularly when the REIT is being sold and it is known that the buyer intends to liquidate the REIT
    - Some of these concerns might still remain if the draft revenue procedure is implemented – if the payment of the penalty is a condition to curing the *non-de minimis* failure to comply with the preferential dividend rule

# Opinions & Preferential Dividends (cont'd)



- A REIT-qualification opinion can fulfill several purposes:
  - Forces the REIT's advisers, who have superior information, in some sense to stand behind the REIT
  - Reflects a good faith investigation, potentially making the buyer more sympathetic in instances where a problem subsequently is discovered
  - In theory at least, may be a potential source of recovery of damages

# Opinions & Preferential Dividends (cont'd)



- And so, what is the value of a will-level opinion in these circumstances?
    - Where the buyer's advisers are aware of the REIT-qualification issue, and are not themselves at a will-level of comfort, what additional comfort does a will-level of comfort provide?

# Opinions & Preferential Dividends (cont’d)



- Is a something other than a “clean” will-level opinion sufficient?
  - “Reasoned” should
  - Will with a should-level carveout
  - Will with qualifications

# REIT Spin-offs

# Spin-Offs: General Rules



- New section 355(h): spin-off in which the distributing corporation (D) or the controlled corporation (C) is a REIT do not qualify for tax-deferred treatment under section 355.
- New section 856(c)(8): no corporation that was a D or a C in a section 355 transaction may elect REIT status for 10 years following the distribution.

# PATH Act Spin-Off Exceptions



- TRS Exception. A spin-off of a taxable REIT subsidiary (TRS) by a REIT can qualify for tax-deferred treatment under section 355 so long as
  - The REIT has qualified as a REIT at all times during the 3-year period before the distribution,
  - C had been a TRS of the REIT at all times during that 3-year period, and
  - The REIT had "control" (under section 368(c)) of the TRS at all times during that 3-year period.
    - Note that the general 5-year active trade or business (ATB) requirement in section 355(b) still applies to a TRS-on-REIT spin-off.

# PATH Act Spin-Off Exceptions



- REIT-on-REIT Spin-Offs. A spin-off can qualify under section 355 so long as both C and D are, immediately after the distribution, REITs.
  - C or D will be treated as a REIT immediately after the distribution as a result of a REIT election made after the spin-off that is effective immediately after the distribution. *See* Treas. Reg. 1.337(d)-7T(f)(3)(i); *Bluebook* at 264, footnote 896.

# REIT-on-REIT Spin-Offs

- A REIT-on-REIT spin-off still must satisfy the requirements of section 355, including the ATB requirement.
  - Rev. Rul. 2001-29: the provision of customary services under a lease producing “rents from real property” may be treated as an active trade or business.
    - Most, if not all, REITs involved in tax-deferred spin-offs have not relied on Rev. Rul. 2001-29 to satisfy the ATB requirement.

# REIT-on-REIT Spin-Offs

- End of the "Hot Dog Stand" Spin-Off?
  - Prop. Treas. Reg. § 1.355-9:
    - At least 5% of the value of C and D must have been active business assets during the 5-year period to satisfy the ATB requirement.
  - Prop. Treas. Reg. § 1.355-2:
    - Even if 5% threshold is satisfied, significant non-business assets can be evidence of a "device."

# REIT-on-REIT Spin-Offs

- Independent Contractors.
  - Treas. Reg. § 1.335-3(b)(2)(iii): activities conducted by persons outside of the corporation, including independent contractors, generally do *not* count for the ATB requirement.
    - Externally advised REITs
    - Hotel and health care REITs in RIDEA structures

# Taxable REIT-on-REIT Spin-Offs



- PATH Act did not change the rules for taxable REIT spin-offs.
- A taxable REIT-on-REIT spin-off is significantly more tax efficient than a taxable spin-off by a C corporation.
  - D REIT will recognize gain (but not loss) on the distribution of the stock the C REIT. I.R.C. § 311(b).
    - If there is a significant loss in the assets of C, consider using intercompany sales before the spin-off to trigger losses that would be recognized at the time of the spin-off. *See* PLR 201705004 (Feb. 2, 2017).

# Taxable REIT-on-REIT Spin-Offs



- D REIT will receive a dividends paid deduction in an amount equal to the value of stock of the C REIT distributed to shareholders.
  - Dividends paid deduction from the spin-off stock should offset any gain at the REIT level.
- D REIT shareholders will have additional dividend income attributable to the earning and profits recognized by D REIT on the spin-off
  - A significant portion of the additional dividend income should be eligible to be a designated as a capital gain dividend.
    - End Result: Transaction will generally involve tax only at the shareholder level.

# Taxable REIT-on-REIT Spin-Offs



- Section 336(e) Election/Basis Step-Up. C REIT with built-in gain may receive a step-up in basis in its assets if a section 336(e) election is made. Treas. Reg. § 1.336-2.
  - A section 336(e) election would cause a C REIT to be treated as selling all of its assets to a new corporation at fair market value in a taxable transaction and liquidating. D REIT would be treated as acquiring the stock of the new corporation for the cash and then distributing the stock of the new corporation.

# Taxable REIT-on-REIT Spin-Offs



- Among other requirements for a section 336(e) election, D REIT must spin-off a controlled C REIT (section 1504(a)(2), *i.e.*, 80% or more).
- If D REIT distributes more than 80% but less than 100% of the stock of C REIT, the section 336(e) election may cause D REIT shareholders to have more dividend income than they would without the election.
  - However, benefit of the step-up on all of C REIT's assets may outweigh the detriment of additional gain recognition.

# Temp. Treas. Reg. § 1.337(d)-7T



- Treasury and the IRS were concerned that the combination of a tax-deferred spin-off by a C corporation of a C owning REIT-qualifying assets and a later merger of that C into an existing REIT would violate the policy behind the repeal of *General Utilities.*
  - The spin-off/merger transaction did not appear to be prohibited by the PATH Act.
  - Treasury and the IRS attacked the spin-off/merger transaction through the built-in gains tax.

# Temp. Treas. Reg. § 1.337(d)-7T



- Temp. Treas. Reg. § 1.337(d)-7T
  - A C corporation engaging in conversion transaction (*i.e.*, makes a REIT election or transfers assets to a REIT in a tax-deferred transaction) within a ten-year period following a section 355 transaction is treated as making an election to recognize all of its built-in gain as of the conversion date.
  - If a REIT participates in a tax-deferred spin-off within 10 years of having engaged in a conversion transaction, then the REIT must recognize any remaining built-in gain in the year of the spin-off.

# Temp. Treas. Reg. 1.337(d)-7T



- The deemed sale provisions apply if either the C corporation or a member of its “separate affiliated group” engage in a section 355 transaction with the 10-year period.
- The provisions also apply to any “successor” or “predecessor.”
  - Those terms are defined broadly to include entities that engage in certain tax-free transactions qualifying for section 381 treatment.

# Temp. Treas. Reg. § 1.337(d)-7T

- Like the PATH Act, the Temporary Regulations have exceptions for TRS-on-REIT spin-offs and REIT-on-REIT spin-offs.
  - But the exception for REIT-on-REIT spin-offs in the Temporary Regulation applies only if both C and D
    - are REITs immediately after the section 355 transaction **and**
    - remain qualified as a REITs for the next two years.

# Temp. Treas. Reg. 1.337(d)-7T



- The broad scope of the Temporary Regulations will trigger the deemed sale treatment even when the conversion transaction has only a very attenuated link to the section 355 transaction. *See* example in NAREIT comment letter.
- In addition, the built-in gain that may be recognized under the Temporary Regulations is not limited to the built-in gain at the time of the conversion transaction or the section 355 transaction.
- Temporary Regulations will require additional due diligence when, for example, a C corporation contemplating a REIT election acquires another C corporation.

# Temp. Treas. Reg. § 1.337(d)-7T



- Built-In Gain Recognition Period.
  - Permanently reduced by the PATH Act to 5-years for S corporations.
  - When initially released, Temporary Regulations established a 10-year recognition period for REITs, decoupling for the recognition period for REITs and S corporations for the first time.
  - T.D. 9810 reversed course and amended the Temporary Regulations to apply a 5-year recognition period for REITs, same as for S corporations.

# FIRPTA

# FIRPTA



- PATH Act – Lifts barriers for investing into US real estate
- Qualified Foreign Pension Funds
- Portfolio investors
- Qualified shareholders
- Determination of domestically-controlled REIT status
- Other FIRPTA changes

# Overview



- FIRPTA re-characterizes gain from the sale of United States real property interests ("USRPIs") as US source effectively connected income ("ECI")
- Exceptions to FIRPTA prior to the PATH Act:
  - Portfolio investment (no more than 5%) in publicly traded USRPHC stock
  - DC REIT stock
  - Less than 50% investments by foreign governments in stock of United States real property holding corporations ("USRPHCs")
- These exceptions apply only to gain from sale of corporate stock

# New FIRPTA Exemptions



- New FIRPTA exceptions under the PATH Act:
  - Qualified Foreign Pension Funds (“QFPFs”)  - section 897(l)
  - Public REIT portfolio investment threshold increased to 10% - section 897(k)(1)
  - Qualified shareholder exception for investment in public and private REITs – section 897(k)(2)

# QFPF



- A QFPF means any trust, corporation or other organization or arrangement that
  - Is created or organized under the law of a country other than the United States,
  - 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,
  - Has no single participant with a right to more than 5% of its assets or income,
  - 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
  - Is entitled to certain tax benefits on either contributions or investment income in its home country

# Qualified Shareholder



- Qualified shareholder
  - Exempt from FIRPTA on gains from the sale of (public or private) REIT stock (regardless of percentage interest), and
  - Capital gain dividends and distributions under section 301(c)(3) , redemptions under section 302 and liquidations under section 331 are treated as ordinary dividends

- Limitation
  - FIRPTA exemption and dividend treatment do not apply to the extent of "applicable investors"
  - "Applicable investors" are investors that, directly or indirectly, hold more than 10 percent of the stock of any REIT in which the qualified shareholder invests

# U.S. REIT Act

# Portfolio Investors – 10% or less



- Proceeds from sale of publicly-traded REIT stock (0% tax)
- Dividends attributable to publicly-traded REIT's sale of USRPIs treated as dividends

# TRS Ownership Limit



- Under current law, the total value of TRSs may not represent more than 25% of the value of the REIT's assets.
- This has been changed to no more than 20%, starting in 2018.

# Prohibited Transactions Tax



- REIT's are subject to a penalty tax at a rate of 100% for prohibited transactions. Prohibited transactions are sales of property that was held for sale in the ordinary course of business.
- There is a sale harbor for sales of property that have been held for rental for 2 years.
  - Additional rules apply to the safe harbor.
  - One of the rules limits the safe harbor to sales of 7 properties or 10% of the adjusted basis of the REIT's assets per year.
  - The 10% safe harbor has been increased to 20% and now includes a 3-year averaging concept.

# Capital Gains Dividends



- The amount that a REIT can designate as capital gains dividends or as qualified dividends distributed is limited to the amount of dividends actually paid in the taxable year.
- This provision limits the flexibility that REITs have had in designating dividends as capital gain in years where capital gains exceed earnings and profits.

# REIT Debt Instruments



- Debt instruments issued by REITs that file with the SEC qualify as real estate assets for purposes of the 75% asset test.
  - Limited to 25% of the REIT's total assets.
  - Income from such debt instruments is qualifying income under the 95% but not the 75% gross income tests.
- This creates more equality between the treatment of a REIT holding debt and equity of another REIT.

# Ancillary Personal Property



- Ancillary personal property leased in connection with the lease of real property and which does not exceed 15% of the fair market value of the real property is treated as a real estate asset under the 75% asset test.
- A debt instrument that is secured by both real and personal property will be treated as a mortgage if the personal property collateral does not exceed 15% of the total security value.
  - This decreases the likelihood that such an instrument would have to be bifurcated.

# Hedging Transactions



- Hedges entered into to effectively unwind a hedge with respect to real property indebtedness is not gross income for purposes of the 75% and 95% gross income tests.
- A hedge is also still a qualifying hedge for REIT purposes even if not timely identified as such if the mitigation provisions under Treasury regulations apply.

# Earnings & Profits



- E&P is not reduced by amounts not allowed in computing taxable income and which have not been allowed in any prior year.
- This provision reduces disparities between a REIT's taxable income and E&P, but more work in this area is still needed.

# TRSs and Foreclosure Property



- TRSs are permitted to operate and market foreclosure property.
- This conforms the treatment of TRSs and Independent Contractors for purposes of the foreclosure property rules.

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