

December 24, 2015

## Bill Includes Significant Changes to Tax Law Regarding FIRPTA, REITs, and RICs

On December 18, 2015, President Obama signed into law the [Protecting Americans from Tax Hikes Act of 2015](#) (the “Act”). The Act includes significant changes to tax laws relevant to private equity, real estate and mutual fund investors and managers. In particular, the Act contains important modifications to the Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”), and to rules applicable to real estate investment trusts (“REITs”) and regulated investment companies (“RICs”). In addition, the changes make permanent certain “extenders,” and thus provide valuable clarity in several important areas. Overall, the changes are taxpayer-friendly. In particular, they reduce impediments for non-U.S. investors investing in U.S. real estate.

The changes include the following key items:

### FIRPTA Amendments

**Background.** FIRPTA imposes U.S. federal tax and return filing obligations on most non-U.S. investors with respect to dispositions of “U.S. real property interests,” which include stock in REITs and other so-called “U.S. real property holding corporations,” and with respect to distributions by REITs that are attributable to the sale of U.S. real property interests. Prior to its amendment by the Act, FIRPTA included special exemptions that generally applied to (i) 5%-and-smaller positions in publicly-traded real property holding companies and (ii) stock in “domestically controlled” REITs (very generally, REITs less than 50% of whose equity, by value, was owned by non-U.S. persons during the applicable testing period). Also prior to its amendment by the Act, FIRPTA provided that purchasers of U.S. real property interests were required to withhold 10% of the associated gross sales proceeds payable to non-U.S. investors.

**New Exemption for “Qualified” Non-U.S. Pension Funds.** In a major departure from prior law, the Act exempts from FIRPTA dispositions of U.S. real property interests held directly or indirectly by “qualified foreign pension funds” and their wholly-owned subsidiaries. A non-U.S. pension fund is “qualified” if it meets a number of technical requirements, including that it is subject to regulation and reporting requirements about its beneficiaries in its jurisdiction, has no beneficiary with a right to greater than 5% of its income or assets, and benefits from tax breaks on contributions or investments in its jurisdiction. Such pension funds will, however, continue to be subject to the general rules imposing U.S. federal tax and return filing obligations with respect to U.S. trade or business activities. Thus, for example, although a “qualified foreign pension fund” may no longer be subject to FIRPTA as a result of its direct investment in U.S. real estate property, further structuring may still be required to manage the risk of being treated as engaged in a U.S. trade or business (e.g., as a result of certain rental or other operating activities).

**New and Increased Exemptions for Investments in REITs.** The Act increases from 5% to 10% the percentage of publicly-traded stock that a non-U.S. investor may hold in a public REIT (but not a RIC or any other type of U.S. real property holding company) and still qualify for an exemption from FIRPTA on sale of stock of, and distributions by, the public REIT. The Act also provides an exemption from FIRPTA for certain treaty-eligible publicly-traded entities that invest in REITs even if the 10% limitation is exceeded. This exemption applies whether or not the shares of the applicable REIT are publicly traded and whether the REIT is domestically controlled, except to the extent income is attributable to investors of such publicly-traded entities that hold more than a 10% interest in the REIT.

**Increased Withholding Obligations.** The Act increases the rate of tax withholding on various dispositions of U.S. real property interests by non-U.S. persons from 10% to 15%.

**Domestic Control Determinations.** The Act includes helpful presumption rules to determine whether publicly-traded REITs are “domestically controlled”, allowing a REIT to treat less-than-5% investors as U.S. persons (absent actual knowledge to the contrary). The Act also requires stock of a REIT held by a publicly-traded REIT to be treated as held by a non-U.S. person, unless such publicly-traded REIT is domestically controlled, in which case the interest is treated as held by a U.S. person. If stock of a REIT is held by a private REIT, such stock is treated as held by a U.S. person in proportion to the holdings of stock in such private REIT.

**Permanent Treatment of Certain RICs as Qualified Investment Entities.** The Act makes permanent, for tax years beginning after 2014, the treatment of RICs that are U.S. real property holding companies as “qualified investment entities” under FIRPTA. Distributions to non-U.S. investors from a qualified investment entity attributable to gain from the sale of U.S. real property interests (including distributions received from a REIT) are taxable under the FIRPTA rules and subject to U.S. withholding tax, except for distributions to certain small shareholders. An exemption from the FIRPTA rules now applies to interests in RICs that are domestically-controlled qualified investment entities.

**Effective Date.** The FIRPTA changes are generally effective after December 18, 2015, with the increase in the rate of withholding effective sixty days after December 18, 2015.

### **REIT-Related Amendments**

**Restrictions on Tax-Free Spinoffs Involving REITs.** With narrow exceptions, the Act eliminates tax-free treatment of spinoffs if either the distributing corporation or controlled corporation becomes a REIT. Tax-free spinoff treatment may be achieved only if (1) immediately after the distribution, both the distributing and the controlled corporations are REITs, or (2) a REIT spins off a taxable REIT subsidiary (“TRS”), and the REIT has been a REIT at all times during the three years preceding the distribution, the TRS has been a TRS of the REIT at all times during that period, and the REIT has had control of the TRS at all times during that period. This change is effective as of December 7, 2015, but there is a limited grandfathering rule for taxpayers that have submitted letter ruling requests regarding proposed REIT spinoffs to the IRS on or prior to December 7, 2015.

**Preferential Dividend Rules Eliminated for Publicly-Traded REITs.** The Act repeals the preferential dividend rule for publicly-traded REITs, effective for tax years after 2014, thus allowing “preferential dividends” to be eligible for the deduction for dividends paid. Private REITs remain subject to the preferential dividend rule. The Act gives the Secretary of the Treasury authority to provide an appropriate remedy to cure a REIT’s failure to comply with the preferential dividend rule requirements.

**Reduction in Ability to Utilize Taxable REIT Subsidiaries.** The Act reduces the permitted percentage of the value of total REIT assets that may be securities of one or more TRSs from 25% to 20%. The change is effective for tax years beginning after December 31, 2017.

**Debt Instruments Issued by Publicly-Traded REITs.** The Act treats debt instruments issued by publicly-traded REITs, and interests in mortgages on interests in real property, as qualified real estate assets for purposes of the 75% asset test. However, income from debt instruments issued by publicly-traded REITs that would not have been treated as real estate assets but for this provision will not constitute qualified income for purposes of the 75% income test, and not more than 25% of the value of a REIT’s total assets may be represented by such debt instruments.

### **Certain Other Significant Changes to REITs and RICs**

**Reduction of “Sting Tax” Recognition Period.** Generally, a corporation that converts to a REIT or a RIC, or a REIT or RIC that receives property from a corporation in a tax-free transaction, historically would have been required to pay corporate-level tax on the pre-conversion or pre-contribution appreciation recognized within the 10-year period beginning in the year of such conversion or contribution. Congress had in prior years temporarily shortened the 10-year period to 5 years. The Act makes this shorter period permanent.

Permanent Exemption for Interest-Related and Short-Term Capital Gain Dividends Paid by RICs. The Act makes permanent the exemption from withholding tax on interest-related dividends and short-term capital gain dividends paid to non-U.S. investors by RICs. The permanent exemption is effective for tax years beginning after 2014.

### Effective Date

The REIT and RIC provisions have varying effective dates, but generally will become effective either on December 18, 2015 or for taxable years after December 31, 2015. The effective date of each provision should be separately confirmed.

If you have any questions with respect to these developments, please contact a member of Ropes & Gray's [tax](#) practice group.