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The REIT PATH Forward – Mostly a Smooth Ride but Watch Out for the Potholes

Overview

The Protecting Americans from Tax Hikes Act of 2015[1] (the "PATH Act"), signed by President Obama on December 18, 2015, does more than merely extend various expired tax provisions as most other "tax extender" laws have done in the past.[2] In addition to the substantial modifications that apply to individual and small business taxpayers, the PATH Act introduces significant changes to provisions of the Internal Revenue Code of 1986, as amended (the "Code"),[3] with respect to real estate investment trusts (REITs) and the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).[4]

"If you want to succeed you should strike out on new **paths**, rather than travel the worn **paths** of accepted success." **John D. Rockefeller**

A REIT is a corporate investment vehicle for real estate that is comparable to a mutual fund. It allows both small and large investors to acquire ownership in commercial and residential real estate interests such as apartment complexes, hospitals, office buildings, timberland, warehouses, hotels and shopping malls. REITs have existed for more than 50 years[5] in the US and are taxed in a manner that typically results in REITs offering higher dividend yields than regular corporations. Further, the same tax considerations that attract investors to public REITs likewise position private REITs as the

[1] Protecting Americans from Tax Hikes Act of 2015 enacted as a small part ("Division Q") of the "Consolidated Appropriations Act, 2016," Pub. L. No. 114-113, the omnibus bill that allowed Congress to end its 2015 session. The primary legislative history for the PATH Act is the Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029 (Rules Committee Print 114-40)*, (JCX-144-15), December 17, 2015 (hereinafter, "JCT Technical Explanation").

[2] *The Working Families Tax Relief Act of 2004*, signed into law October 4, 2004, retroactively extended through 2005 most expired business tax provisions. *The Tax Relief and Health Care Act of 2006*, signed into law December 20, 2006, extended through 2007 provisions that expired the previous year and some that were scheduled to expire that year and created some new temporary tax measures. *The Emergency Economic Stabilization Act of 2008, Energy Improvement and Extension Act of 2008*, and *Tax Extenders and Alternative Minimum Tax Relief Act of 2008*, signed into law October 3, 2008, renewed and created extenders. *The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010*, signed into law December 17, 2010, renewed extenders through the end of 2011, providing for a retroactive extension for provisions that expired at the end of 2009. *The American Taxpayer Relief Act of 2012,* signed into law January 2, 2013, renewed extenders through the end of 2013, providing for a retroactive extension for provisions that expired at the end of 2011.

[3] Unless otherwise indicated, all "section" and "§" references are to the Internal Revenue Code of 1986, as amended, and all "Reg. §" references are to regulations issued thereunder.

[4] The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), enacted as Subtitle C of Title XI of the Omnibus Reconciliation Act of 1980, Pub. L. No. 96-499, 94 Stat. 2599, 2682 (Dec. 5, 1980).

[5] Congress granted legal authority to form REITs in 1960 as an amendment to the Cigar Excise Tax Extension of 1960, enacted to amend § 5701 of the Internal Revenue Code of 1954 with respect to the excise tax on cigars, and for other purposes, See Pub. L. No. 86-779, § 10(a), 74 Stat. 998, 1004.

vehicle of choice for US real estate investments of global private equity firms and non-US financial investors.

FIRPTA was enacted by Congress as a means to tax the gains on foreign investors' income from the sale of US real property.[6] The new law was also applied to investments in US companies whose predominate assets are real estate assets whether as investments or as part of business operations.[7] As a result, it may arguably create disincentives to foreign investment in not only US real estate but in US infrastructure and other real estate intensive industries.[8] The Obama administration, which actively supported FIRPTA reform, offered that "foreign investors including large foreign pension funds regularly cite FIRPTA as an impediment to their investment in US infrastructure and real estate assets."[9]

Provisions included in the PATH Act generally are favorable toward REITs and the taxation of foreign investors in US REITs, thereby somewhat modifying such tax disincentives of investing in the US real estate market. Such provisions benefit both existing and newly created REITs by reducing the incidence of FIRPTA on investments through this vehicle. These changes in law are expected to lead to increased foreign capital investment in US commercial real estate. According to Kenneth Rosen, chairman of the Fisher Center for Real Estate and Urban Economics at University of California, Berkeley, it has been estimated that as much as $20 billion to $30 billion[10] of new capital will be invested in the US commercial real estate markets in the wake of the PATH Act's relaxation of FIRPTA.

This article provides a high-level overview of certain of the provisions in the PATH Act that impact REITs, including the revisions to the FIRPTA rules. A discussion of issues that have been identified requiring further legislative and regulatory guidance follows. The authors also offer their views on certain areas requiring caution in moving forward with the new rules absent further guidance.

Changes to Certain REIT Provisions

In general, a REIT is an entity that otherwise would be taxed as a US corporation but elects to be taxed under a special regime that permits it to get a deduction for dividends paid. To qualify as a REIT, the entity must satisfy several tests, including:

a) 75% and 95% of its gross income must be derived from real estate and passive-type sources, respectively;[11] and

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[6] *See* H.R. Rep. No. 96-1167, 96th Cong. 2nd Sess. H.R. 7765 (1980).
[7] *See* § 897(c)(1)(A)(ii).
[8] Evan J. Cohen, *An Analysis of the 1984 Withholding Requirements Under the Foreign Investment in Real Property Tax Act: Are New Methods of Handling U.S. Real Estate Transactions on the Horizon*, 8 J. Int'l L. 319; available at: http://scholarship.law.upenn.edu/jil/vol8/iss3/4.
[9] The White House Proposal, *The "Rebuild America Partnership": The President's Plan to Encourage Private Investment in America's Infrastructure*. Released on March 29, 2013; available at https://www.whitehouse.gov/the-press-office/2013/03/29/rebuild-america-partnership-president-s-plan-encourage-private-investment. *See also,* Jeffrey D. DeBoer, *Unlocking Foreign Investment to Fix U.S. Infrastructure: A Bridge to Bipartisanship | Commentary*. Posted on Jun 12, 2014; available at: http://www.rollcall.com/news/unlocking_foreign_investment_to_fix_us_infrastructure_a_bridge_to-233760-1.html
[10] Liz Moyer and Michael J. de la Merced, *House Approves Bill to End Tax-Free Real Estate Spinoffs*, The New York Times, Dec. 18, 2015, at B5.
[11] § 856(c)(3) and § 856(c)(2).

b) 75% of the value of its assets must consist of cash and cash items, real estate assets, and Government securities.[12]

A REIT is allowed a deduction for dividends paid, as defined in § 561, in computing its taxable income for the year, preserving "a single layer" of taxation.[13] A REIT must distribute at least 90% of its "real estate investment trust taxable income" for a taxable year, determined without regard to the deduction for dividends paid, to its shareholders in order to qualify as a REIT for such year.[14] Any amounts not distributed to its shareholders is taxable at the REIT level. Additionally, certain distributions by REITs can be designated as capital gain distributions or qualified dividend income, which may be subject to special capital gain tax rates for individual shareholders and US withholding tax under the FIRPTA provisions for foreign shareholders, as discussed below. A REIT is not required to distribute its capital gain income.[15] If it chooses to retain its capital gains, a REIT may pay tax on the retained capital gains and still maintain its REIT status.

The PATH Act makes substantial changes to certain areas of the REIT rules as described below. Most of the provisions make it easier for REITs to operate their businesses, provide REITs with more flexibility regarding the nature of their assets and/or income, and make REITs more attractive as investment vehicles for non-US taxpayers; however, a few provisions are more restrictive. These more restrictive provisions limit the ability of a corporation in certain situations to avail itself of the REIT regime and reduce the ability of REITs to engage in non-REIT activities. In addition, other provisions of the PATH Act tighten up some areas of the REIT tax law to provide more equitable results to shareholders and impose additional controls on the REIT's operations.

1. Smooth Pavement – Generally Favorable Changes to the Law

Changes to the Prohibited Transaction Safe Harbors

REITs are subject to tax of 100% of the net income derived from prohibited transactions.[16] A prohibited transaction is a sale of property held as inventory or primarily for sale to customers in the ordinary course of a REIT's business.[17] A sale will not be considered a prohibited transaction, however, if it meets certain safe harbor requirements.[18] One of those requirements is that (i) the aggregate adjusted bases of property sold during the taxable year does not exceed 10% of the aggregate bases of all the assets of the REIT as of the beginning of the taxable year, or (ii) the aggregate fair market value of property sold during the taxable year does not exceed 10% of the fair market value of all of the assets of the REIT as of the beginning of the taxable year.[19]

The PATH Act helps REITs meet the safe harbor requirements by providing alternate safe harbor tests for the amount of certain assets that can be sold in a given year. The alternate safe harbor provides that a REIT may sell up to 20% of the aggregate adjusted bases or fair market value of its assets in a single year provided that its 3-year average adjusted bases or fair market value of assets

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[12] § 856(c)(4)(A).
[13] § 857(b)(2)(B).
[14] § 857(a)(1).
[15] § 857(a)(1)(A)(i).
[16] § 857(b)(6)(A).
[17] § 857(b)(6)(B)(iii) and § 1221(a)(1).
[18] The safe harbor requirements are set forth in § 857(b)(6)(C) and § 857(b)(6)(D).
[19] § 857(b)(6)(C)(iii)(II), § 857(b)(6)(C)(iii)(III), § 857(b)(6)(D)(iv)(II), and § 857(b)(6)(D)(iv)(III).

sold does not exceed 10% on a lookback basis.[20] This provision generally applies to taxable years beginning after December 18, 2015.[21]

Guidance needed: While the expansion of the 10% limitation on sales for the prohibited transaction safe harbor to allow a 3-year average of 10% and up to 20% of a REIT's portfolio to be sold in any one year is more favorable, a REIT's ability to rely on the new rule still remains unclear in some situations. In order for this safe harbor to apply, not only must these thresholds for percentage of the REIT portfolio sold be satisfied, but substantially all of the marketing and development expenditures with respect to the properties must be performed, now by a taxable REIT subsidiary (TRS)[22], or an independent contractor from whom the REIT derives no income.[23] There is currently no guidance on what "substantially all" means in this context. Until this prong of the prohibited transaction safe harbor is clarified, there may be risk associated with a REIT's reliance on the new safe harbor provisions.

In addition, even if all of the REIT's marketing and development expenditures are incurred by a TRS or independent contractor, there may still be uncertainty in computing the annual and 3-year average percentages of the portfolio sold. For example, do you look through partnerships? How is a sale of a partnership interest treated? And what happens if the entity has not been around for 3 taxable years? More guidance on these types of details would help REITs use the safe harbor more effectively.

Caution: The PATH Act provides favorable new rules in the safe harbor provisions for REIT prohibited transactions. These provisions, however, only address certain of the requirements needed in order to satisfy the safe harbor. A REIT seeking to rely on the safe harbors still needs to satisfy the other requirements as set forth in § 856(b)(6)(C) or § 856(b)(6)(D). If all safe harbor prongs cannot be satisfied, the REIT must satisfy a "facts and circumstances" analysis of whether its sales constitute dealer sales that will be subject to a 100% tax. Most REITs, therefore, are likely to still find themselves in a situation where they will need to rely on the specific facts and circumstances of each sale. The haven of the safe harbors, although now to some degree more attainable, may still not be completely achievable in many cases.

Repeal of the Preferential Dividend Rule for Publicly Offered REITs

As previously mentioned, a REIT is required to distribute 90% of its REIT taxable income on an annual basis.[24] Generally a REIT is allowed a deduction for dividends paid if the distribution is (i) pro rata, (ii) with no preference to any share of stock as compared with other shares of the same class, and (iii) no preference to one class of stock as compared with another class except to the extent that the former is entitled to such preference.[25] Distributions violating these requirements, regardless of whether the violation is inadvertent or de minimis, are considered "preferential dividends," and the dividends paid

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[20] § 857(b)(6)(C)(iii)(II), § 857(b)(6)(C)(iii)(III), § 857(b)(6)(D)(iv)(II), and § 857(b)(6)(D)(iv)(III).
[21] PATH Act, § 313(c).
[22] See discussion under "Expansion of Ability to Use a TRS" below.
[23] § 857(b)(6)(C)(v).
[24] § 857(a)(1).
[25] § 857(b)(2)(B), § 561(b), and § 562(c)(1).

deduction for such dividends is generally not allowed to REITs. The disallowance extends to the distribution in its entirety, subjecting a REIT to potential corporate income tax, payment of deficiency dividends or even loss of REIT status.

The PATH Act repeals the preferential dividend rule for publicly offered REITs effective for distributions made in tax years after December 31, 2014.[26] A publicly offered REIT is a REIT that is required to file annual and periodic reports with the Securities and Exchange Commission.[27] Prior to the PATH Act, a number of private letter rulings had been issued that ruled that a discount on a REIT's dividend reinvestment plan ("DRIP") would not be considered preferential if the discount did not exceed 5%.[28] For publicly offered REITs, presumably this limitation for DRIP discounts is no longer applicable.

Privately held REITs are still subject to the preferential dividend rule. Congress recognized, however, that denial of the deduction for dividends paid was overly harsh in the case of small foot faults or comparable mistakes in the payment of dividends. The PATH Act grants the IRS authority to provide an appropriate remedy for violations of the preferential dividend rule by REITs that are not publicly offered that were inadvertent or resulting from reasonable cause.[29]

Guidance needed: As stated in the new statute, guidance may be forthcoming for inadvertent preferential dividends paid by non-publicly offered REITs.[30] The REIT industry is keenly interested in such guidance as the lack of a de minimis threshold has caused much angst. It has not been unusual for REIT transactions to be delayed or restructured as a result of due diligence in which immaterial, yet near fatal, foot faults have been discovered. The National Association of Real Estate Investment Trusts has submitted suggestions for such guidance in hopes that the guidance will be coming soon.[31]

Application of Curative Provisions for Hedge Identifications

Although the REIT income tests are based on gross income as determined under § 61, there are a number of items that may be disregarded for purposes of the REIT income tests even though they are includible in taxable income of the REIT.[32] Income from transactions entered into to hedge risk of (1) interest rate changes with respect to a borrowing made or to be made to acquire or carry real estate assets or (2) currency fluctuations with respect to an item of income or gain that qualifies for the 75% or 95% gross income test may be excluded in calculating both the 75% and 95% income tests, if such hedging transactions are properly identified as tax hedges under the rules of § 1221(a)(7).[33] Among other requirements, the identification rules provide that a hedging transaction must be

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[26] § 562(c)(1).
[27] § 562(c)(2).
[28] PLR 9837008, PLR 9731007.
[29] § 562(e)(2).
[30] § 562(c)(1).
[31] National Association of Real Estate Investment Trusts, *Re: Notice 2016-26: Request for Comments Regarding Recommendations for Items that Should be Included on the 2016-2017 Priority Guidance Plan*, May 16, 2016.
[32] *E.g.*, passive foreign exchange gain and real estate foreign exchange gain as provided in § 856(n), discharge of indebtedness as provided in § 108(e)(9), and items designated as such under the authority of § 856(c)(5)(J)(i).
[33] § 856(c)(5)(G).

clearly identified as such before the close of the day on which it is acquired, originated, or entered into, and identification must be unambiguous.[34]

Prior to the PATH Act, if a REIT inadvertently failed to properly identify a hedge, it was unclear whether, for purposes of the REIT income tests, the REIT could rely on the remedies for inadvertent identification failures set forth in the regulations under § 1221. The PATH Act clarified that, for tax years beginning after December 31, 2015, a REIT may take into account the curative provisions provided in the regulations for purposes of determining the REIT income test treatment of hedge income.[35]

Expansion of Ability to Use a TRS

Subject to certain limitations, a REIT is able to own up to 100% of the stock of a corporate entity through which it may conduct activities that may be non-qualifying for REIT purposes. A REIT must jointly elect for such a corporation to be treated as a TRS of the REIT.[36] When the TRS provisions were enacted,[37] a TRS was permitted to perform many services for a REIT that previously were required to be performed by an independent contractor. Certain provisions of the Code requiring the use of independent contractors were, however, not modified.

The PATH Act modifies two such provisions to allow a TRS to provide certain services for the REIT effective for taxable years beginning after December 31, 2015. These provisions are as follows:

(i) A REIT was permitted to rely on one of the prohibited transaction safe harbors only if substantially all of the marketing and development expenditures with respect to the property were made through an independent contractor. The PATH Act expanded this requirement to allow a TRS to also provide such services.[38]

(ii) When a REIT acquires property through foreclosure, it may make an election to treat, for a limited time, the property as "foreclosure property."[39] Income and gain from foreclosure property is qualifying income for the REIT income tests.[40] This election would terminate, however, if after 90 days following the date the property was acquired by the REIT, the property were used in a trade or business that was not conducted by the REIT, other than through an independent contractor. The Path Act expanded this requirement to allow such trade or business to be conducted through a TRS.[41]

Debt Instruments of Publicly Offered REITs

As mentioned above, a REIT must meet certain asset and income tests. Under pre-PATH Act law, unsecured debt instruments of publicly offered REITs and interests in mortgages on interests in real property were not qualifying assets

[34] Reg. § 1.1221-2(f)(1), (4)(ii).
[35] § 856(c)(5)(G)(iv).
[36] § 856(l).
[37] Real Estate Investment Trust Modernization Act, Part II, Subpart A of Public Law 106-170.
[38] § 857(b)(6)(C)(v).
[39] § 856(e)(5).
[40] § 856(c)(2)(F) and § 856(c)(3)(F).
[41] § 856(e)(4)(C).

under the 75% asset test and income from such assets was not qualifying income under the 75% income test.

Effective for tax years beginning after December 31, 2015, debt instruments issued by publicly offered REITs and interests in mortgages on interests in real property are qualifying assets for purposes of the 75% asset test.[42] Income from debt instruments of publicly offered REITs, including gain from the sale of such instruments, does not qualify for the 75% income test, however, unless the income qualified for the 75% income test under pre-PATH Act law.[43]

Caution: The addition of unsecured publicly offered debt instruments to the definition of "real estate assets" for purposes of the REIT 75% asset test carries with it some cautions. These instruments now carry an unusual characteristic of being an instrument that qualifies as real estate for purposes of the REIT asset test, but unlike mortgages, REIT stock, and other qualifying real estate assets, the income generated by debt instruments of publicly offered REITs does not automatically qualify under the 75% income test. This disconnect lends itself to the potential for misclassification of the income by the unwary. To further add to the potential for misclassification, this exception only applies to debt instruments of publicly offered REITs. A perhaps more common investment by a REIT is an investment in debt instruments of REITs that are not publicly offered, e.g., a subsidiary REIT, since it is typical to partially fund subsidiary REITs with downstream loans. Such instruments continue not to qualify for the REIT 75% asset test.

Ancillary Personal Property

Under the general rule, rent received from a lease of personal property in connection with the lease of real property is treated as qualifying rental income if the amount of the rent attributable to personal property does not exceed 15% of the total rent received under the lease.[44] Prior to the PATH Act, however, such ancillary personal property was not considered real estate for any other REIT purpose.

For tax years beginning after December 31, 2015, the PATH Act conforms the asset test to the income test for certain ancillary personal property that is leased with real property. Such personal property is treated as qualifying real estate for the 75% asset test if the rent attributable to that personal property is treated as rent from real property for the 75% income test.[45] Furthermore, the PATH Act provides that an obligation secured by a mortgage on both real and personal property is treated as producing qualifying income for both of the income tests and as a qualifying real estate asset for the 75% asset test if the fair market value of the personal property is not more than 15% of the total fair market value of the personal property and real property combined.[46]

Caution: Although the change to the ancillary personal property rules to conform the asset test treatment to the income test treatment is generally a welcomed and logical change, it should be noted that no corollary was added to the statute

[42] § 856(c)(5)(B).
[43] § 856(c)(3)(H).
[44] § 856(d)(1)(C).
[45] § 856(c)(9)(A).
[46] § 856(c)(9)(B).

to cause the gain from the sale of such personal property to be qualifying income for purposes of the REIT income tests. Therefore, the gain from sales of personal property, no matter how small in relation to the property as a whole, continues to be nonqualifying income for purposes of both the REIT 95% and 75% income tests. It should also be noted that the 15% threshold is a cliff. Thus once the value of the personal property exceeds 15%, the entire value of the personal property is treated as nonqualifying for the 75% asset test, not just the incremental percentage in excess of 15%.

Counteracting Hedges

As stated above, income from transactions entered into to hedge risk of (1) interest rate changes with respect to a borrowing made or to be made to acquire or carry real estate assets or (2) currency fluctuations with respect to an item of income or gain that qualifies for the 75% or 95% gross income tests may be excluded in calculating both the 75% and 95% income tests, if such hedging transactions are properly identified as tax hedges under the rules of § 1221(a)(7).[47]

The PATH Act expands the scope of the exclusion to include income from positions that manage risk of a prior hedge in connection with the extinguishment or disposal, in whole or part, of the liability or asset associated with such prior hedge, if the new position qualifies as a hedging transaction under § 1221(b)(2)(A) or would qualify if the hedged position were ordinary property.[48] Such counteracting hedges have been the subject of private letter rulings.[49] With the new statute, a request for a private ruling on such transactions is no longer necessary.

2. Potholes – Not-So-Favorable Changes to the Law

Restrictions on Tax-Free Spinoffs involving REITs

In order to qualify for tax-free treatment under the Code, a spinoff must meet certain requirements, including the requirement that the distributed corporation be engaged in the active conduct of a trade or business. In 2001, the IRS ruled that a REIT could satisfy the active trade or business requirement solely by virtue of functions engaged in with respect to its rental activity.[50] More recently, the IRS issued a private letter ruling indicating that a REIT with a TRS could satisfy the active trade or business requirement by virtue of the active business of its TRS.[51] Subsequently, an increasing number of operating companies attempted to structure tax-free REIT spinoffs in which a business conducted by a TRS was used to satisfy the active trade or business requirement. Section 355, related to tax free spinoffs, can generally be used to separate business activities into multiple entities, subject to certain requirements. Among other requirements, there must be a valid business purpose for the spinoff, both the distributing corporation and distributed corporation (referred to as the "controlled corporation") must be actively engaged in the conduct of a trade or business

[47] § 856(c)(5)(G)
[48] § 856(c)(5)(G)(iii).
[49] *See e.g.*, PLR 201406009, PLR 201527013.
[50] Rev. Rul. 2001-29, 2001-1 C.B. 1348.
[51] PLR 201337007.

immediately after the transaction, and each trade or business must have been conducted for five years prior to the transaction.

With two exceptions, the PATH Act prohibits tax-free treatment of a spinoff if either the distributing or controlled corporation is a REIT.[52] Exceptions apply if (i) a REIT spins off another REIT or (ii) a REIT that has been a REIT for three years spins off a TRS in which it has held a controlling interest for three years, or a lower-tier TRS held by upper-tier TRSs meeting the three-year test.[53] Furthermore, neither a distributing nor a controlled corporation in a tax-free spinoff transaction is permitted to make a REIT election for ten years following the transaction unless the controlled corporation was owned by a REIT and is a REIT immediately after the spin.[54]

This provision applies to distributions occurring on or after December 7, 2015; however, if a ruling request had already been submitted with respect to a spin-off transaction prior to this date, and the request had not been either denied or withdrawn, the transaction may qualify for tax-free treatment under transition rules.

Percentage Limitations on Certain Assets of a REIT

A REIT generally is not permitted to own securities representing more than 10% of the vote or value of any issuer, nor is it permitted to own securities of a single issuer comprising more than 5% of REIT value.[55] An exception to each of these limitations applies in the case of securities of a TRS; however, ownership of TRS securities is also subject to a limitation. Currently, up to 25% of a REIT's assets may consist of securities of one or more TRSs. Effective for taxable years beginning after December 31, 2017, the PATH Act reduces the maximum ownership to 20% of total REIT assets.[56] In practice, this reduction may not have a significant impact since a REIT whose TRS securities represent 25% of the REIT's total assets would have no cushion under the 75% asset test for other non-qualifying assets. That is, a REIT typically strives to stay below the current 25% threshold in order to preserve room for other non-qualifying assets and for the unexpected.

The PATH Act also introduced a new limitation on a REIT's asset mix. As described above, the PATH Act added unsecured debt instruments issued by publicly offered REITs to the definition of "real estate asset."[57] Under this new asset test limitation, however, the value of a REIT's interests in nonqualified publicly offered REIT debt instruments may not account for more than 25% of a REIT's total asset value.[58] A debt instrument is considered a nonqualified publicly offered REIT debt instrument if it would not be considered a real estate asset but for the PATH Act change to include it as such.[59] As with the reduction to the limitation on TRS securities, this new limitation on a REIT's ability to concentrate investments in debt instruments of other publicly offered REITs is not anticipated to have a significant impact. Prior to the change in law to make such instruments

[52] § 355(h)(1).
[53] § 355(h)(2).
[54] § 856(c)(8).
[55] § 856(c)(4)(B)(iv).
[56] § 856(c)(4)(B)(ii).
[57] § 856(c)(5)(B).
[58] § 856(c)(4)(B)(iii).
[59] § 856(c)(5)(L)(ii).

qualifying real estate assets, a REIT was limited in its ability to invest in them. Even with the change, the authors would not expect to see a significant increase in investment activity in such instruments by REITs.

Caution: The new 25% asset test limitation on a REIT's ability to invest in nonqualified publicly offered REIT debt instruments was added to the statute as § 856(c)(4)(b)(iii).[60] The 10% vote and value tests and 5% asset tests were contained in this section prior to the PATH Act and were redesignated as § 856(c)(4)(b)(iv) by the PATH Act. Many references to § 856(c)(4)(b)(iii) within other parts of the REIT rules, however, were not updated, including certain safe harbors and savings provisions with respect to the 10% vote and value tests and 5% asset tests.[61] While the failure to update certain parts of the statute is clearly an oversight, and legislation to make the technical corrections has been proposed,[62] until such corrections are made, it is not entirely certain whether a REIT may rely on such provisions.

Limitations on Designation of Dividends by REITs

As mentioned above, although a REIT is not a full pass-through entity, it does have the ability to designate the character of its dividends as capital gains and qualified dividend income to the extent it earns income qualifying for such designation within its taxable year. Effective for distributions in tax years beginning after December 31, 2014, the PATH Act limits the total amount of dividends that can be designated by a REIT as qualified dividends or capital gains dividends to the dividends actually paid by the REIT.[63] For this purpose, certain dividends paid after the close of the taxable year for which an election is made under § 858(a) are treated as paid with respect to such year.[64] While the JCT Technical Explanation of this provision references a practice used by regulated investment companies,[65] the authors are not aware of situations where REITs designated capital gains and qualified dividend income in excess of the dividends paid for the year, so this provision appears to be a "clean-up" of sorts.

Modification of REIT E&P Calculation to Avoid Duplicate Taxation of Shareholders

Generally, distributions made by a REIT are treated as dividends by shareholders to the extent of the REIT's current and accumulated earnings and profits (E&P). Under current law, current (but not accumulated) REIT E&P for any tax year is reduced only by amounts that are allowable in computing taxable income for such tax year.[66] Normally, a REIT electing to use an accelerated or bonus method of depreciation is permitted a larger deduction in its early depreciation years with respect to its taxable income, but not for purposes of calculating E&P (so that depreciation for E&P purposes in such situations generally is lower in earlier years and higher in later years when compared to REIT taxable income).

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[60] § 856(c)(4)(b)(iii).
[61] *E.g.*, § 856(m)(1), § 856(m)(3), § 856(m)(4), § 856(m)(5), § 856(m)(6).
[62] Technical Corrections Act of 2016, H.R. 4891, 114th Cong., 2d Sess., § 2 (as introduced April 11, 2016).
[63] § 857(g)(1).
[64] § 857(g)(1). Under § 858(a), a REIT may elect to treat certain subsequent year dividends as paid in the prior year for purposes of the REIT dividends paid deduction and the REIT's 90% distribution requirement.
[65] *See supra* note 1 (citing JCT Technical Explanation), p. 174.
[66] § 857(d)(1)(A).

Under pre-PATH Act law, in the later depreciation years the REIT would be permitted to reduce its E&P by its depreciation deductions only to the extent of the depreciation allowable in that year for REIT taxable income purposes, effectively disallowing for E&P purposes the amount accelerated for taxable income purposes.

For tax years after December 31, 2015, the PATH Act retains this rule for the purpose of determining a REIT's deduction for dividends paid, but modifies it for purposes of determining whether distributions to shareholders constitute dividends. For the latter purpose, current REIT E&P may be reduced by amounts allowable in computing taxable income during prior years.[67] As a result of this new provision, shareholders will no longer be taxed on certain E&P on which they had, in effect, already been taxed in earlier years.

Caution: While the PATH Act eliminated potential whipsaws to REIT shareholders with respect to certain fact patterns, e.g., where a REIT depreciates its assets more quickly for regular tax purposes than it does for E&P purposes, other situations may still create an unexpected disconnect for REIT shareholders. This result stems from the fact that the change to the statute currently only applies to situations in which the tax deduction is taken prior to the E&P deduction, as is the case with accelerated depreciation. Situations exist, however, in which the E&P deduction occurs prior to the tax deduction (such as interest expense limited under § 163(j)) and the E&P income occurs prior to the regular tax income (such as installment sales). Therefore, in order to truly fix the E&P disconnect issue for shareholders of REITs, additional statutory or regulatory changes are needed.

Additionally, even though there was a bit of an E&P disconnect between a REIT and its shareholders prior to the PATH Act with respect to gains on sales of assets[68] there is now clearly a "shareholder" version of E&P, used for determining taxability of distributions to shareholders, and a "REIT" version of E&P, used for determining the REIT dividends paid deduction. The fact that there are two separate E&P calculations raises the question of which one should be used in determining key REIT items such as the amount of consent dividend that may be paid, the E&P limitation for "spillover" distributions under § 857(b)(9), and the amount of "throwback" dividends under § 858(a). While it appears most practitioners believe the "REIT" version of E&P should control in these situations, guidance to clarify the question would be helpful.

Treatment of Certain Services Provided by TRSs

Certain transactions between a REIT and its TRSs may be subject to a 100% tax if the amounts charged are determined not to be arm's length.[69] Prior to the PATH Act, this tax applied to "redetermined rents," "redetermined deductions," and "excess interest".[70] These amounts are generally amounts that the REIT pays to a TRS for services it renders to REIT tenants, amounts paid by a TRS that are not considered arm's length, and interest a TRS pays to the REIT that is not commercially reasonable.

[67] § 857(d)(1)(B).
[68] *See supra* note 1 (citing JCT Technical Explanation), p.179-180.
[69] § 857(b)(7)(A).
[70] § 857(b)(7)(B), § 857(b)(7)(C), and § 857(b)(7)(D).

> The PATH Act added another category of transactions to this list of items that may be subject to 100% tax on redetermination. The new category is "redetermined TRS service income," which is generally amounts that a REIT pays to a TRS for services it renders to or on behalf of the REIT.[71] This addition is effective for tax years beginning after December 31, 2015. Although another category of transactions subject to a potential 100% tax could certainly be viewed as more restrictive, we have observed that in practice, REITs tend to be extremely diligent in arranging the terms of all transactions with their TRSs and frequently perform transfer pricing studies to support their intercompany arrangements.

Changes to Certain FIRPTA Provisions Impacting REITs

The United States taxes nonresident alien individuals and foreign corporations on gains recognized from the sale or exchange of a property if such gain is effectively connected with the conduct of a trade or business in the United States ("effectively connected income" or "ECI") as provided in § 864(b) and § 864(c). Under § 897, introduced by FIRPTA, gain recognized from the sale of a US real property interest (USRPI)[72] is treated as if the seller was engaged in a US trade or business and as if the gain or loss were effectively connected with such trade or business. Such ECI is taxed on a net basis at the graduated rates generally applicable to domestic taxpayers, regardless of whether the foreign person is actually engaged in any US trade or business.[73]

The term "USRPI" includes an interest in real estate located within the territory of the US[74] as well as stock of any domestic corporation unless it can be established that such corporation is not a current or former US real property holding corporation (USRPHC) as defined in § 897(c)(2). A USRPHC generally includes any domestic corporation if the value of the corporation's USRPIs equals or exceeds 50% of the combined value of its interests in USRPI, non-US real property, and its trade or business assets.

Specific exceptions, however, apply to exclude certain US real estate investments from being USRPI. Most notably, a USRPI does not include any interest in a "domestically controlled" REIT. A domestically controlled REIT is any REIT in which, at all times during the testing period more than 50% in value of the stock was held directly or indirectly by US persons.[75] Both public and private REITs have faced challenges in documenting this favored status. As discussed below, the PATH Act offers some clarification for REITs in this regard and provides further modifications to § 897 and § 1445 (the rules for enforcing FIRPTA by imposing a withholding obligation on transferors of USRPIs).

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[71] § 857(b)(7)(E).
[72] Under § 897(c)(1)(A), USRPI means (i) an interest in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the Virgin Islands, and (ii) any interest (other than an interest solely as a creditor) in any domestic corporation unless the taxpayer establishes (at such time and in such manner as the Secretary by regulations prescribes) that such corporation was at no time a United States real property holding corporation during the shorter of—(I) the period after June 18, 1980, during which the taxpayer held such interest, or (II) the 5-year period ending on the date of the disposition of such interest. Section 897(c)(1)(B), however, further provides exclusions for interests in certain corporations.
[73] *See* § 871(b) and § 882(a). See also §871(d) and §882(d) where certain taxpayers may elect to treat certain income as ECI.
[74] Interests in real property located in the U.S. Virgin Islands are also USRPIs as provided in § 897(c)(1)(A)(i).
[75] § 897(h)(4)(D). The testing period generally means the shorter of the 5-year period ending on the date of the disposition or distribution, or the period during which the REIT was in existence.

1. Smooth Pavement – Generally Favorable Changes to the Law

New Rules for Determining whether a REIT is "Domestically Controlled"

Under the existing rules provided in § 897(h)(3), regardless of whether REIT stock is or is not publicly traded, such stock is not a USRPI if it is determined that the REIT is "domestically controlled." The PATH Act does not change the definition of a domestically controlled REIT; however, effective December 18, 2015, it adds new ownership testing rules to § 897(h)(4) for applying the "domestically controlled" definition to a REIT when stock in such REIT is either publicly traded or owned by another REIT.

Publicly traded REITs may have difficulty determining whether they are domestically controlled as they do not have detailed records on all minority shareholders. The PATH Act added new § 897(h)(4)(E)(i),which provides that any shareholder owning less than 5% of a publicly traded REIT at all times during the testing period will be treated as a US shareholder unless the REIT has actual knowledge to the contrary.

Further, prior to the PATH Act, it was not clear how domestic control of a REIT was determined when such REIT was owned by another REIT. The PATH Act provides two new rules for evaluating domestic control: [76]

a) A REIT's stock is treated as held by a US person in the case where such stock is held by a domestically controlled publicly traded REIT as determined under new § 897(h)(4)(E)(i). If the publicly traded REIT does not qualify as a domestically controlled REIT, it is viewed as a foreign shareholder. There is no partial look-through in this situation.

b) If a REIT's stock is held by a private REIT, such ownership by the private REIT will be considered US owned only to the extent the stock of the private REIT itself is held by a US person (a look-through rule).

Guidance needed: If a publicly traded REIT is determined to be domestically controlled by applying the rules discussed above, then it would be treated as a domestic shareholder for purposes of a lower tier REIT's determination of its status. These new rules are not only helpful, but seem to indicate that Congress is aware of the issues REITs are dealing with in confirming this favored status. It is thus both interesting and inconsistent that the JCT Technical Explanation mentioned PLR 200923001, which ruled that a private REIT could determine its status as a domestically controlled REIT by treating its US non-public corporate shareholders as domestic shareholders. The private letter ruling did not require a look through to the ultimate non-US shareholders of the US corporations. It is believed that the IRS will not entertain any future ruling requests in this area. Absent any other comment, it is difficult to ascertain whether the reference to PLR 200923001 in the JCT Technical Explanation and its silence as to the look through rules for regular corporations, was an affirmation or denial of its ultimate result. Additional guidance in this area would be welcomed by all REITs, particularly private REIT sponsors.

FIRPTA Exemption for Certain Foreign Retirement and Pension Funds

The PATH Act introduces new § 897(l), which provides an exemption from the FIRPTA provisions for any USRPI held directly or indirectly through one or more

[76] *See* § 897(h)(4).

partnerships by a qualified foreign pension fund (QFPF) or any other entity all of the interest of which are held by such QFPF. As a result, gain from sale of stock in a REIT recognized by a QFPF or a QFPF-owned entity will be exempt from US tax even if the REIT is not domestically controlled. This new exemption also applies to distributions received by a QFPF from a REIT attributable to the REIT's disposition of a USRPI. The withholding provisions of § 1445 were revised to coordinate with this new exemption.[77]

New § 897(l)(2) defines a QFPF as any trust, corporation, or other organization or arrangement:

a) which is created or organized under the laws 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 5% 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 its 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, either (i) contributions to it which would otherwise be to subject to tax under such laws are deductible, excluded from gross income or taxed at a reduced rate; or (ii) taxation of its investment income is deferred or such income is taxed at a reduced rate.

This new provision may be the most significant change made by the PATH Act as it provides a broad exemption from FIRPTA for a potentially large investor source. When the Obama Administration proposed a change along these lines in its last three budget proposals, it gave as its "Reason for Change" the fact that gain of a US pension fund from the disposition of a USRPI generally is exempt from US tax.[78] By exempting foreign pension funds' USRPI gains from FIRPTA, this provision is intended to put QFPFs on a comparable footing with US pension funds in order to encourage greater investment in real estate in the United States.[79] Although this exemption is not limited to investments in REITs, a QFPF's income from the ownership and operation of improved real estate directly or through a partnership continues to be generally taxed as ECI as prescribed by § 882. Compare this treatment to some or all of this income being taxed as unrelated business taxable income or "UBTI" to a US pension fund.[80] Investment

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[77] *See* revisions to § 1445(f)(3). See also revisions to Reg. § 1.1445-2(b), issued pursuant to T.D. 9751 (2/19/16).
[78] Department of the Treasury, General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals 123 (April 2013); Department of the Treasury, General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals 138 (March 2014); Department of the Treasury, General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals 91 (February 2015).
[79] *Id.*
[80] *See* § 511 through § 514.

by US pension funds in a REIT can greatly reduce the possibility of UBTI.[81] Therefore, investing through a REIT may become as important for a QFPF as it has been for a US pension fund.[82]

Guidance needed: Under US domestic law, the definition of a US pension fund is well defined.[83] It is also common for US tax treaties to define pension funds or similar arrangements.[84] Further, regulations promulgated under the Foreign Account Tax Compliance Act of 2010 (FATCA)[85] define specific non-US pension arrangements that have special exemptions from reporting obligations.[86] See e.g., Reg. § 1.1471-6(f) that provides the definition of certain retirement funds that are treated as exempt beneficial owners under the FATCA provisions. Although the drafters used certain fragments of such existing definitions, they did not use the broader definition of pension funds that are currently exempt from the FATCA reporting requirements under such regulations or give any deference to non-US pensions otherwise qualifying for US treaty benefits. As a result, certain requirements for this new QFPF status require additional guidance either in the form of technical corrections of the legislation or regulations. Below is a summary of such matters:

a) QFPF's ownership of USRPI through fiscally non-transparent subsidiaries: Under § 897(l)(1), it is clear that a directly held, non-US entity, wholly-owned by a QFPF would not be subject to tax under FIRPTA on the disposition of a USRPI. The language of the statute, however, does not provide any specific indication as to whether (i) the QFPF could own USRPI through a chain of wholly owned non-US entities or (ii) whether a single non-US entity could be 100% owned by multiple QFPFs and still avail itself of the exemption. Both the JCT Technical Explanation and the JCT General Explanation[87] do not provide additional insight to the language, although they both use the term "wholly-owned" in describing an entity that would qualify for this exception.[88] Industry organizations and other commentators have asserted that the language as enacted may be ambiguous and have requested that guidance be given to confirm that such arrangements (both a chain of wholly owned entities and an entity

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[81] Because § 512(b) specifically excludes dividends from UBTI, a real estate investment fund structured as a private REIT, or a fund that owns its properties through a REIT subsidiary, may be used to "cleanse" UBTI because income from a REIT is distributed to its investors in the form of dividends as prescribed by § 857(a)(1). The use of a REIT to eliminate UBTI may not be successful, however, in the case of REITs with significant pension fund ownership. Section 856(h)(3)(C) through – § 856(h)(3)(E) provide that if a pension fund holds more than 10% (by value) in any "pension-held REIT" at any time during a taxable year, UBTI that would have been "cleansed" may nevertheless still constitute UBTI to such pension fund.
[82] Joint Committee on Taxation, *Description of Certain Revenue Provisions Contained in the President's Fiscal Year 2014 Budget Proposal (JSC-4-13)*, December 2013, p.91-92.
[83] *See* § 401.
[84] *See e.g.,* United States Model Income Tax Convention of November 15, 2006. *See also e.g.* Convention between the Government of United States of America and the Government of the United Kingdom of Great Britain and Northern Irelands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, signed July 24, 2001 and amended by protocol signed July 19, 2002.
[85] *See* The Hiring Incentives to Restore Employment Act of 2010, signed into law on March 18, 2010 (Pub. L. No. 111-147) which added chapter 4 to Subtitle A of the Code (§ 1471 through § 1474).
[86] *See e.g.,* Reg. § 1.1471-6(f) that provides the definition of certain retirement funds that are treated as exempt beneficial owners under the FATCA provisions.
[87] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 2015* (JCS-1-16), March 2016 (herein "JCT General Explanation").
[88] *See supra* note 1 (citing JCT Technical Explanation).

100% owned by multiple QFPFs) be included within this new provision.[89] There does not appear to be any evidence in the legislative record that such arrangements were excluded intentionally or were otherwise viewed as a potential tax avoidance scheme. It is not uncommon for multiple non-US pension plans to aggregate their portfolio investments into common investment vehicles.[90] This aggregation can assist in managing the administration costs of investing in a wide variety of different asset types. Furthermore, such pension funds generally may also create special purpose local country entities to allocate capital toward specific asset types or portfolios, and such entities may be used to invest in USRPI directly or jointly with other non-US pension funds. As such, specific guidance on these ownership variations is needed so these pension funds may determine if they need to restructure their US investments in order to claim the benefits of the new law.

b) Scope of pension or retirement benefits limited to employees: Section 897(l)(2)(B) requires that the plan should be "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." A number of questions are raised by this language. Are pension funds that are set up for the benefit of self-employed persons, which is quite common in many countries, included in the definition?[91] What about government sponsored pension funds that provide retirement and other disability benefits for their citizens; are they precluded as they do not exclusively provide more traditional pension benefits to "employees"? The JCT General Explanation to this new exemption for QFPFs provided some additional insight as follows:

> "Multi-employer and government-sponsored public pension funds that provide pension and pension-related benefits may satisfy this prong of the definition. For example, such pension funds may be established for one or more companies or professions, or for the general working public of a non-US country".[92]

From this footnote, it appears that a QFPF is, in fact, intended to include non-US pension funds that provide benefits to self-employed persons including, for example, doctors, entrepreneurs and their families, just as Individual Retirement Accounts are considered retirement savings in the United States. Further, it appears that government pensions, per se, are not intended to be excluded.

Additional questions are raised, however, by this language, such as whether a foreign government pension fund that provides pension benefits to persons who were never government employees, but is based in part on employment history (as does the US Social Security system) might qualify

[89] *See* 2016 Tax Analysts TNT 98-14, *NAREIT Proposes Revenue Procedure on Preferential Dividends* (May 16, 2016).
[90] For example, in the Netherlands, a *fonds voor gemene rekening* (a limited fund for mutual account), and, in Denmark, a *kontoførende investeringsforening* (an account based fund).
[91] For example, in Germany, professionals such as lawyers, physicians, tax consultants, vets or pharmacists may join special pension funds for their professional peer group (known as "Versorgungswerke"). Similar, ENPAM, a national organization of social security and assistance of physicians and dentists in Italy, provides a pension scheme for medical doctors and dentists.
[92] *See supra* note 87 (citing JCT General Explanation), p.283, n. 968.

as a QFPF? Also, whether public or government plans that provide coverage for all citizens regardless of employment would qualify? The statute does not use the term "exclusive" or "exclusively" when it provides that the fund should be established to provide retirement or pension benefits to current or former employees as is in the case with other provisions.[93] As such, a broader coverage may have been intended.

Further, would other benefits in addition to traditional pension or retirement benefits qualify? Recently, Jason Yen, attorney advisor, Treasury Office of International Tax Counsel, offered at a March 15, 2016 meeting of the International Tax Institute that the related budget proposal had a "substantially all" threshold. Yen further stated: "We recognize that not every fund will provide 100 percent, and they often provide other types of services—insurance, disability. This is something I would expect that we would clarify." Such a clarification would be quite significant for many non-US public and government funds that offer a number of different benefits and services to a wide spectrum of their citizenship.

c) Deductible, excluded, or reduced rate contributions: Section 897(l)(2)(E) provides that contributions must be "deductible or excluded from the gross income of such entity or taxed at a reduced rate." This requirement is potentially problematic in that it does not provide for a situation where the contributions to the entity are deductible or excludable from the gross income of the pension fund's beneficiaries as opposed to from the gross income of the QFPF itself. It was also acknowledged by Yen at the same meeting of the International Tax Institute that there has been some confusion with respect to this requirement; however, he did not offer any specific clarification. This requirement will hopefully be clarified or corrected.

d) Requirement of government regulation and reporting: Section 897(l)(2)(D) provides that a QFPF must be subject to government regulation. What constitutes "government regulation" for this purpose is unclear. It has been suggested that it may have been "intended to grant benefits only to recognized pension funds that don't result in private inurement."[94] Since foreign pension funds, however, are subject to country specific regulation that may also vary whether the fund is private or public, a statute that seeks to provide a special carve-out exemption for such funds should offer more clarity. In addition to being subject to government regulation, this provision also requires annual reporting to the relevant tax authorities in the country in which the pension fund is established or operates. Again, foreign pension funds will have varying reporting obligations by country. In the case of a government pension fund, there may be no specific reporting or regulatory filing requirement (to itself) under local law. This regulation and reporting requirement language is essentially taken from Reg. § 1.1471-6(f)(2)(ii), which sets forth requirements for a "broad participation retirement fund." Such funds may be exempt from the reporting requirements of FATCA. As no additional guidance or interpretation is given by these regulations, however, many countries have negotiated specific criteria defining such pension funds under their laws as part of their

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[93] *E.g.,* § 401(a) and Reg. § 1.892-2T(c)(1)(i).
[94] Kim Blanchard, N*ew Section 897(l) Exempts Qualified Foreign Pension Funds from FIRPTA,* TAX MANAGEMENT INTERNATIONAL JOURNAL (March 11, 2016).

Intergovernmental Agreements (IGAs) with the US.[95] The IGA process was already established by FATCA, and is being effectively used to provide clarification to the application of the rules in this area. While one would not expect a similar IGA type regime for QFPF qualification, further guidance or a procedure is needed to address these requirements.

Caution - QFPF v. SWF: Under § 892, an integral part of or a controlled entity of a foreign government, such as a sovereign wealth fund (SWF), is exempt from US tax on certain types of US source income. Included in this exemption is gain from the sale of securities of companies that are not "controlled commercial entities", which are essentially operating companies or USRPHCs in which the SWF does not have actual or effective control. Generally, SWFs prefer investing in REITs where they maintain actual ownership of less than 50% so that income received from the REIT and gain on disposition of REIT shares falls within this exemption. In the public context, their interest is ideally maintained at 10% (previously 5%)[96] or less to avoid FIRPTA taxation on gains of real estate held by the REIT. In a private transaction, they would opt for a situation where they have an exit strategy through the sale of their interest in the REIT itself versus dealing with the FIRPTA taint of the gain from the sale of the underlying assets. Similarly, non-US pension funds would be interested in private REIT transactions where the REIT qualified as a domestically controlled REIT, whose sale would also be exempt from FIRPTA. As a result, the interests of non-US pension funds and SWFs were aligned, as both investor groups understood the value of a share sale exit versus an asset sale exit and were willing to deal with the additional administrative costs, the reduction of the audience of potential buyers, and the possibly lowered sales price associated with share sales. Now, with the enactment of the PATH Act, if one of the non-US pension fund investors believes it can qualify as a QFPF, it no longer has the same incentives to require a share sale. As discussed above, an asset sale at the REIT level followed by a capital gain distribution would not be subject to FIRPTA or any other US taxation to a QFPF. Thus, in a private transaction which includes both QFPF and SWF investors, it is anticipated that this lack of alignment as to share sales will likely create tensions in structuring transactions.

Caution - QFPF v. ECI: Although the new exemption for QFPFs is a broad exclusion from FIRPTA, such entities' investment in US assets remain subject to all other provisions of US tax law. Specifically, US source income such as dividends and interest remains subject to gross basis taxation unless reduced by a treaty or some other domestic law exemption.[97] Further, the realization of ECI remains subject to net basis taxation at graduated rates and could also be subject to further taxation under the branch profits tax provisions.[98] An investment through a REIT is not the only way that a QFPF can take advantage of this new exemption from FIRPTA; however, the QFPFs must be well informed

[95] *See*, e.g., U.S.-Australia, U.S.-Belgium, and U.S. Canada IGAs, which provide lists of non-U.S. pension funds that are treated as exempt beneficial owners and therefore are exempt from FATCA reporting requirements.
[96] See discussion below under the heading "Exclusion from USRPI Status of Stock in Publicly Traded REITs".
[97] *See* e.g., § 871 and § 881. See also § 871(h) and § 881(c) which provide an exemption from U.S. withholding tax for "portfolio interest" if such interest (A) would be subject to tax if not for this exception and (B) is paid on an obligation (i) which is in registered form and (ii) with respect to which the U.S. person who would otherwise be required to deduct and withhold tax from such interest receives an appropriate Form W-8 from the person earning the interest.
[98] *See* § 871, § 882, and § 884.

of the issues associated with other investment structures. For example, a QFPF could sell an interest in a USRPHC, which is not a REIT, and such gain should now be exempt from FIRPTA. Of course the regular corporation, not being a REIT, would be subject to US income taxation on its worldwide income. Consider a direct investment in a single passive investment such as a tract of land that is net leased. Whether the income from this investment, the rents or the gain on its disposition, is taxable as ECI is dependent upon whether such activity constitutes a US trade or business.[99] In the case of a single passive investment, the activity in the US may not be sufficient to result in a trade or business and thus the income from the investment may not be ECI.[100] Contrast this treatment to the ownership of a multifamily housing or a commercial real estate activity where the income realized during operations is likely ECI, as would be the gain from the sale of the underlying asset notwithstanding FIRPTA.[101] Consider also, the sale of a partnership interest. Under § 897(g), gain from the sale of a partnership interest can be a taxable as ECI to the extent that such gain is attributable to the underlying assets of the partnership that would be taxable under FIRPTA. A QFPF, however, is no longer subject to FIRPTA, including gain treated as ECI pursuant to § 897(g). Yet, consider whether the sale of the partnership interest results in ECI notwithstanding FIRPTA. The IRS's position in Rev. Rul. 91-32[102] is that a sale of a partnership interest does create ECI to the extent attributable to the underlying assets that generate ECI. While the ruling has been criticized as unsupportable on its technical merits, if Rev. Rul. 91-32 were to apply, a QFPF would not be exempt from US taxation to the extent attributable to non-USRPI ECI assets of the partnership.

For a QFPF to apply Rev. Rul. 91-32, it must identity "buckets" of assets owned by the partnership- namely, FIRPTA assets, ECI assets and non-ECI non-USRPI assets of the partnership. Under Rev. Rul. 91-32, the QFPF would then be subject to tax on the gain from the sale of its partnership interest to the extent attributable to its ECI assets. Hence, while the QFPF may avoid taxation on some or all of the gain associated with selling a partnership interest (to the extent attributable to USRPI and subject to gain under § 897(g)), it may not be able to avoid all US tax if there are other non-FIRPTA ECI assets within the partnership. Furthermore, notwithstanding the technical merits of Rev. Rul. 91-32, during the life of the partnership, income that is generated from operations and any underlying sales of US trade or business assets will likely produce ECI that is not exempt income to QFPFs.

Caution - QFPF v. FIRPTA withholding: The FIRPTA provisions of § 897 are buttressed by the withholding provisions of § 1445 and the regulations

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[99] *See* Rev. Rul. 88-3, 1988-1 C.B. 268, and *de Amodio v. Commissioner*, 34 T.C. 894, 906 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962). Additionally, a nonresident alien may elect under § 871(d) or a foreign corporation under § 882(d) to treat such income as if it is ECI.

[100] Holding one property that is triple-net leased has been held to not constitute engaging in a U.S. trade or business. *Neill v. Commissioner*, 46 B.T.A. 197 (1942). By contrast, multiple properties holdings tend to lead to the finding of a trade or business, where the foreign investor's (including through its partnership) management activities (performed directly or through an agent, or through a partnership (§ 875)) are substantial, regular and continuous. *Pinchot v. Commissioner*, 113 F.2d 718 (2d Cir. 1940) (taxpayer owned 11 properties that were actively managed by an agent); *de Amodio v. Commissioner*, 34 T.C. 894 (1960), *aff'd on another issue*, 299 F.2d 623 (3d Cir. 1962); *Lewenhaupt v. Commissioner*, 20 T.C. 151 (1953), *aff'd per curiam*, 221 F.2d 227 (9th Cir. 1955).

[101] *Id.*

[102] 1991-1 C.B. 107.

thereunder. Generally, a 15% withholding obligation,[103] computed on the gross value of the property transferred, is imposed on the transferee of a USRPI unless an exemption applies. REITs are generally required to withhold 35% on distributions that are defined by § 897(h)(1).[104] The PATH Act amended § 1445 to exempt the transfer of a USRPI by a QFPF from such withholding.[105] Current regulations provide specific procedures for transferors to certify to transferees that withholding is not required when the transferor is not a foreign person.[106] Under these rules, a transferee is entitled to rely on a timely certification of such status unless it has actual knowledge the certification is false or receives notice of such falsity from an agent.[107] Moreover, the regulations provide that while a transferee is not required to obtain such a certification from the transferor if the transferee can rely on other means to ascertain the status of the transferor, obtaining a certification excuses the transferee from any liability otherwise imposed by § 1445 and the regulations thereunder.[108] Under § 1445(f)(3), a QFPF is now exempt from the definition of "foreign person" for purposes of withholding. Although the regulations were revised to modify the definition of foreign person, nothing further was changed with respect to the certification process. Prior to the PATH Act, for a transferee that did not receive a certification that a transferor was not a foreign person, it was relatively straightforward to get comfort on the reduced withholding obligation as the parties were likely in contract negotiations and may well have actual knowledge of each other's tax residency status. Whether a non-US pension fund qualifies as a QFPF would not be as obvious or as easily ascertained as has historically been the case with other transferors. Given the fact that the law is new, many non-US pension funds are currently still reviewing whether they may qualify as a QFPF. This article has highlighted a number of problem areas that may cause non-US pensions to be unsure if they can qualify. This analysis is not lost on the potential withholding agent, especially in situations where there has been a historical business relationship between the parties such as in many private equity transactions. Because the present rules provide that the transferee is entitled to rely on a certification prepared by the transferor, unless it has actual knowledge it is false, and because obtaining such a certification shields the transferee from any liability otherwise imposed by § 1445 and the regulations thereunder, there is more emphasis than ever on the transferee obtaining a certification in order to mitigate its withholding liability.[109]

Contrast the above described scenario, which appears to have been neatly addressed by excluding a QFPF from the definition of a foreign person for purposes of § 1445, to a non-US partnership transferor with a partner who asserts status as a QFPF. Under this latter scenario, the certification issue becomes more complicated. A transferor means any person foreign or domestic that disposes of a USRPI.[110] A foreign person is a nonresident alien individual,

[103] See discussion under the heading "Increased FIRPTA Withholding Rate" below.
[104] § 1445(e)(6).
[105] Under the new rules, QFPFs are not treated as "foreign persons" for purposes of the FIRPTA withholding rules as prescribed by § 1445.
[106] *See* Reg. § 1.1445-2(b). See also, Reg. § 1.1445-5(b)(3).
[107] Reg. § 1.1445-2(b)(4) and Reg. § 1.1445-5(b)(3)(iii).
[108] Reg. § 1445-2(b) and Reg. § 1.1445-5(b)(3)(i).
[109] It is worth noting that, pursuant to Reg. § 1.1445-2(b)(1), a transferee is not required to use other means to ascertain the status of the transferor and may demand a certification. If certification is not provided, the transferee may withhold tax under § 1445 and will not be subject to any penalties.
[110] Reg. § 1.1445-1(f)(3).

foreign corporation, foreign partnership, foreign trust or foreign estate.[111] The FIRPTA withholding rules do not have procedures for applying look through treatment to a partnership. As such, there would be no mechanism for a foreign partnership to assert exemption from withholding, since it cannot itself assert non-foreign status, even if its partners are not subject to FIRPTA. Consequently, while § 897 is still not applicable to a QFPF, a withholding obligation may still exist requiring the QFPF to file for refund.[112]

When a REIT makes a distribution to a US partnership, however, the initial distribution is not subject to withholding as the US partnership is not a non-US person under § 1445. The corresponding income allocated and distributed to non-US partners, however, could be subject to withholding at the partnership level if such partners are ultimately subject to FIRPTA.[113] There is no US person certification mechanism under § 1446 similar to that found in § 1445. Instead, the § 1446 withholding rules generally require that a partnership determine a partner's tax classification by obtaining a withholding certification (e.g., Form W-8 or Form W-9). This certification, however, will not address the issue of qualification for exemption under FIRPTA. A transferee would therefore prefer a more specific certification mechanism for QFPFs provided under future regulations and would welcome a revision to the current Form W-8.

Caution - QFPF v. QFPF: Formal clarification is being sought that an entity owned solely by multiple QFPFs is eligible for the QFPF exemption under § 897(l)(1)(B).[114] Assuming that such clarification is given and a non-US non-transparent entity, for example Cayman Ltd, owned 100% by multiple QFPFs now clearly qualifies for exemption under § 897(l). Cayman Ltd now invests in USRPI. Parties are likely satisfied, for the time being. Suppose, however, that one of the QFPFs wants to transfer its interest to an entity that does not qualify as a QFPF. Such a transfer, while it may not necessarily result in a current tax under FIRPTA to the transferor, would cause Cayman Ltd to no longer qualify for the § 897(l) exemption. The parties might agree contractually that such transfers are not allowed unless the new transferee would qualify as a QFPF. A consensus as to how the parties would determine if a proposed transferee of an interest in Cayman Ltd was indeed a QFPF would have to be reached. Similarly, what if one of the owners of Cayman Ltd no longer qualified as a QFPF? As discussed previously, the application of the requirements of this status to actual operations of non-US pension funds around the globe is far from clear. In an extreme case, a pension fund might subsequently offer another type of benefit or service that is not indicated in § 897(l)(2), which could have the effect of disqualifying it as a QFPF. The impact of this disqualification would be felt by all of the shareholders as Cayman Ltd is now subject to US taxation on its disposition of USRPI, having lost its exemption under § 897(l). As such, one must be cautious in the use of

[111] Reg. § 1.1445-2(b)(2). *See also*, Reg. § 1.897-9T(c), which also applies for purposes of Reg. § 1.1445-1 through Reg. § 1.1445-7 pursuant to Reg. § 1.1445-1(g)(1).
[112] It should be noted that a U.S. partner in a foreign partnership will find itself in this same predicament.
[113] Section 1446 provides that a partnership, whether domestic or foreign, must withhold a tax equal to 35% of any effectively connected taxable income ("ECTI") of the partnership for any taxable year to the extent such income is allocable to a foreign partner. ECTI includes any partnership income treated as effectively connected with the conduct of a U.S. trade or business pursuant to § 897.
[114] *See supra* note 89 (citing TNT 98-14).

such vehicles unless all the QFPFs are managed centrally by the same administrator and understand this issue clearly.

Exclusion from USRPI Status of Stock in Publicly Traded REITs

The PATH Act also expands the current law exclusion of certain stock in a regularly traded REIT from the definition of USRPI. Under the general rule, if a class of stock in a corporation is regularly traded on an established securities market, then stock of that class is not treated as a USRPI in the hands of a person who does not hold more than 5% of such class at any time during the relevant holding period.[115] Under the expanded exclusion, however, the percentage of regularly traded stock that a person can hold without the stock being treated as a USRPI with respect to that person has been increased from 5% to 10%, but only if the stock in question is REIT stock.[116] The 5% threshold still remains for other regularly traded stock. A similar increase from the 5% to 10% ownership threshold is provided under § 897(h)(1) with respect to distributions received by a foreign person from a regularly traded REIT.[117]

Exception from USRPI status for REIT Stock Held by Certain Publicly Traded Investment Vehicles

The PATH Act added new § 897(k), which provides an exception from USRPI status for stock in a REIT, whether publicly traded or not, when the REIT stock is held by certain publicly traded foreign collective investment vehicles. This new § introduces another new defined type of foreign shareholder – a "qualified shareholder" (QS). The QS rules are intended to benefit foreign public REIT equivalents, such as an Australian "listed property trust" as defined in the US-Australia treaty or a Dutch "beleggingsinstelling" as defined in the US-Netherlands treaty.[118]

To be a QS an entity must:

a) Either: (i) be eligible for treaty benefits under a comprehensive income tax treaty with the United States and have its principal class of interests traded on a recognized stock exchange (as defined in such income tax treaty), or (ii) be a US-exchange-traded foreign limited partnership;

b) Meet the requirements to be a "qualified collective investment vehicle" (QCIV) as described below; and

c) Maintain records on the identity of each person who, at any time during its taxable year, is the direct owner of 5% or more of the class of its interests that is regularly traded on the relevant exchange.[119]

[115] § 897(c)(3).
[116] § 897(k)(1).
[117] *Id.* Attribution rules for determining whether the 10% threshold of regularly traded REIT stock ownership is exceeded are the same as those for determining whether the 5% threshold of regularly traded non-REIT stock ownership is exceeded. Additionally, it should be noted that, under § 857(b)(3)(F), in the case of a shareholder of a REIT to whom § 897(h)(1) does not apply, the amount which would be included in computing long-term capital gains for such shareholder (i) is not included in computing such shareholder's long-term capital gains, and (ii) is included in such shareholder's gross income as a dividend from the real estate investment trust.
[118] *See supra* note 1 (citing JCT Technical Explanation), footnote 614.
[119] § 897(k)(3)(A).

A QCIV is any foreign person that satisfies one of the following tests:

a) If the entity is a treaty-country resident, it must be eligible for a reduced withholding rate on ordinary REIT dividends under an applicable income tax treaty even when the entity owns more than 10% of the REIT's stock;

b) If the entity is a publicly traded partnership, it must (i) be classified as a partnership for US federal income tax purposes, (ii) be a "withholding foreign partnership" as prescribed by Reg. § 1.1441-5T(c)(2)(ii), and (iii) qualify as a USRPHC if it were a domestic corporation; or

c) If the entity is "fiscally transparent" within the meaning of § 894 or includes dividends in its gross income but is entitled to a deduction for dividends paid, and the entity is designated as a qualified collective investment vehicle by the Secretary.[120]

This new FIRPTA exemption is limited to the extent that the QS has an "applicable investor," which is an investor other than a QS that owns, directly or indirectly, including through the publicly traded foreign entity, more than 10% of a REIT in which the QS owns an interest.[121]

The portion, if any, of the QS's REIT stock that will continue to be treated as USRPI is determined by reference to the ratio of (a) the value of the interests in the qualified shareholder treated as held, directly or indirectly, by applicable investors to (b) the value of all interests in the qualified shareholder. If the qualified shareholder is a partnership, then the applicable investor's interest in the partnership for this purpose generally is based on the highest share of the partnership's income or gain that such investor may receive during the period in which the applicable investor is a partner in the partnership.

It is important to note that a distribution by a REIT otherwise treated as a sale or exchange of stock under § 301(c)(3), § 302, or § 331 to a QS that is excluded from the QS's USRPI income due to the operation of this new § 897(k) is treated as a dividend subject to the 30% US gross-basis tax under § 871(a), § 881, § 1441, and § 1442. This provision overrides, for applicable investors in a QS, one of the conclusions of AM 2008-003, which held that a liquidating distribution by a regularly traded REIT to a foreign shareholder that did not own more than 5% of the REIT stock during the one-year period preceding the date of the distribution, was not a dividend subject to the 30% US gross basis tax even though it was also exempt from taxation as a result of the exclusion for distributions to 5% or less shareholders of regularly traded REIT stock.[122]

Repeal of the "Cleansing Rule" for REITs

An exception to the term USRPI exists in the case of shares in certain domestic corporations that may have been USRPHCs within the relevant holding period. Specifically, § 897(c)(1)(B) provides that a taxpayer's interest in a domestic corporation is not treated as a USRPI held by the taxpayer if the corporation (i) had no USRPI on the date of the taxpayer's disposition of the interest, and (ii) all of the USRPI held by the corporation during the shorter of the taxpayer's holding

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[120] § 897(k)(3)(B).
[121] § 897(k)(2)(B).
[122] Office of Chief Counsel Advice Memorandum (International) IRS AM 2008-003 (February 15, 2008).

period, or the five-year period preceding the date of taxpayer's disposition of the interest, was disposed of by the corporation in a transaction in which gain, if any, was fully recognized. This exception to the definition of USRPI is commonly referred to as the "cleansing rule."

Prior to the PATH Act, this rule applied to all domestic corporations, including REITs, albeit that the disposition of shares or an interest in a domestically controlled REIT would have already been exempt. The PATH Act eliminates the cleansing rule effective for dispositions made on or after December 18, 2015, where the corporation, or any predecessor to the corporation, was a REIT at any time during the shorter of (i) the period during which the taxpayer held the relevant interest in the corporation, or (ii) the five-year period ending on the date of the taxpayer's disposition of the interest.[123]

In a taxable REIT liquidation, a foreign shareholder generally recognizes ECI under the FIRPTA regime for the liquidating distribution and may be left with basis in REIT shares for which the shareholder may realize a capital loss.[124] Prior to the 2015 PATH Act amendment to § 897(c)(1)(B), the capital loss would not be considered an effectively connected loss due to the application of the "cleansing exception", and therefore would essentially be unable to be used by the foreign shareholder. For dispositions on or after December 18, 2015, the capital loss on the basis of the REIT shares should be considered a FIRPTA loss that may net against the foreign shareholder's FIRPTA capital gain, if the REIT shares are otherwise a USRPI (e.g., the REIT is not a domestically controlled REIT), since the cleansing exception would not apply.

Guidance needed: Section 897(c)(1)(B) now excludes from the "cleansing exception" a corporation or a predecessor of such corporation that was a REIT at any time during the 5 year period preceding the disposition of the stock. This provision does not, however, define "predecessor". One might presume a common interpretation to mean a corporation which has transferred assets to its "successor" in a transaction either to which § 381(a) applies (*e.g.*, in a tax-free corporate liquidation or a tax-free reorganization) or, more broadly, in which the successor's basis in the transferred assets is determined in whole or in part with reference to the predecessor's assets (*e.g.*, "carryover basis" transactions). [125] The term, however, is also used to determine whether an entity is a successor to another REIT that revoked or terminated its REIT election and in that context includes a broad case where there is a sufficient overlap in ownership and assets, regardless of whether those assets were acquired in taxable transactions.[126] It does not seem reasonable to apply this same broad definition in the case of the "cleansing exception". The concept of the "cleansing exception" is that the corporation has disposed of its assets in a taxable transaction prior to the disposition of its shares. The US tax on the appreciation, if any, in the assets has

[123] § 897(c)(1)(B)(iii).
[124] Notice 2007-55, 2007-2 C.B. 13.
[125] *See supra* note 89 (citing TNT 98-14). Footnote 27 of TNT 98-14 provides examples such as Prop. Reg. § 1.163(j)-6(c)(2); Prop. Reg. § 1.172(h)-1(b)(2), Prop. Reg. § 1.355-8(b)(2) and -8(c)(1), Reg. § 1.382-2(a)(5), Reg. § 1.1374-10(a), Reg. § 1.1502-1(f)(4), and Reg. § 1.6655-4(a) ("predecessor" and "successor" defined with reference to § 381(a) transactions); Reg. § 1.851-6(d), Reg. § 1.851-6(d), and Reg. § 1.1502-33(h) ("predecessor" and "successor" defined with reference to carryover basis transactions); Reg. § 1.1502-35(d)(5) ("predecessor" and "successor" defined with reference to both § 381(a) transactions and carryover basis transactions); and Reg. § 1.1275-6(g) ("predecessor" and "successor" defined with reference to a "nonrecognition transaction").
[126] *See* § 856(g) and Reg. § 1.856-8(c)(2).

been paid. The operation of this cleansing exception is that FIRPTA does not seek to double tax the same appreciation on the disposition of the interests in the corporation. Therefore, if the corporation in question has acquired its assets from a REIT in a taxable transaction, it does not appear reasonable that the corporation should be subsequently excluded from the cleansing exception even for a limited waiting period. Further clarification of this definition for applying this specific provision is needed.

2. Pothole – Not-So-Favorable Change to the Law

Increased FIRPTA Withholding Rate

Prior to the PATH Act, the general rule provided in § 1445 required that a purchaser or transferee of a USRPI withhold 10% tax on the gross amount realized by the seller or transferor on the disposition of such USRPI if the transferor was a foreign person. The PATH Act increased the 10% rate to 15%, effective for dispositions that occur after February 16, 2016. The legislation makes an exception, however, for property (i) which is acquired by the transferee for use as a residence and (ii) where the amount realized upon disposition is greater than $300,000 but does not exceed $1,000,000. In this case, FIRPTA withholding remains at 10%.[127] Note that REITs were and are still required to withhold on distributions at a rate of 35% to the extent that any portion of the distribution is attributable to gain from the sale or exchange of USRPI by the REIT.[128]

Conclusion

For the most part, the REIT and related provisions of the PATH Act strive to live up to the law's acronym by providing a clearer path for REITs to continue as a favored vehicle of choice for US real estate investment. While these new rules have now taken effect, a number of open questions remain. Unfortunately, formal guidance in the form of technical corrections or regulations this year are not expected. It is likely however that investors will seek to take advantage of these new provisions in the interim- especially the new provision for QFPFs. This provision alone, as previously discussed, is expected to create significant new capital investment in US real estate while costing the Treasury a modest amount in relative terms.[129] There are, however, important technical questions raised by the statute, and it is hoped that these are addressed in due course to avoid undue delays in closings of transactions that ultimately would produce the benefits intended by this legislation.

[127] § 1445(c)(4).
[128] § 1445(e)(6).
[129] The qualified foreign pension fund provision was estimated to cost the Treasury $1,953 million over 10 years, while the published Congressional revenue estimate of the PATH Act combined the cost of the publicly traded REIT stock provision and a number of other revenue-losing provisions; in combination, they were estimated to cost $2,297 million over 10 years. *See* Joint Committee on Taxation, *Estimated Budget Effects of Division Q of Amendment #2 to the Senate Amendment to H.R. 2029 (Rules Committee Print 114-40)*, (JCX-143-15), December 16, 2015, page 6.

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