Simpson Thacher

Memorandum

Summary of FIRPTA and REIT Tax Reform Provisions Contained In the Path Act of 2015

December 22, 2015

On December 18, 2015, President Obama signed into law the Consolidated Appropriations Act, 2016. Division Q of such law, Protecting Americans From Tax Hikes Act of 2015 ("PATH") includes significant reforms to the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") and the taxation of real estate investment trusts ("REITs"), as described below.

For further information about these reforms and the other tax provisions of PATH, please contact a Member of the Firm's Tax Department listed below.

Key FIRPTA Reforms

Exemption for interests held by foreign retirement funds or pension funds.

The legislation exempts certain foreign pension funds ("qualified foreign pension funds") from FIRPTA on their disposition of U.S. real property interests held directly, or indirectly through one or more partnerships (or with respect to any distribution received from a REIT), provided the qualified foreign pension fund meets certain requirements under the laws of the jurisdiction in which it is created or organized, including being subject to government regulation and providing annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates.[1] That amendment generally applies to dispositions and REIT distributions on or after December 18, 2015.

- Simpson Thacher Observation:
  - While that change will benefit foreign pension funds holding stock of a United States real property holding corporation ("USRPHC") or REIT, a foreign pension fund that is a partner in a partnership owning real estate assets may still choose to participate in the partnership indirectly through a

[1] The Bill also contains an exception to FIRPTA for a very narrow category of foreign investment entities.

corporation to avoid U.S. taxation on income that is effectively connected with the conduct of the partnership's U.S. trade or business without regard to FIRPTA (in other words, the FIRPTA reform does not preclude taxation of a qualified foreign pension fund on U.S. trade or business income).

Increase in permitted ownership by foreign persons holding publicly traded stock.

A foreign shareholder may now hold up to 10% (formerly 5%) of the stock of a publicly traded USRPHC, which is a REIT without such ownership being treated as a U.S. real property interest under FIRPTA. The same increase applies with respect to the exemption of capital gain dividends from a publicly traded REIT under FIRPTA. This provision will apply as of December 18, 2015.

Determination of "domestic control".

For purposes of determining whether a REIT is domestically controlled (and therefore not treated as a U.S. real property interest), a holder of stock of a REIT that is regularly traded on an established securities market in the U.S. who owns less than 5% of such class of stock shall be presumed to be a U.S. person unless the REIT has actual knowledge that such person is not a U.S. person. With respect to any stock in such REIT held by another REIT, any class of stock of which is regularly traded on an established securities market, or by a registered investment company (a "RIC") that issues redeemable securities, such stock shall be treated as held by a foreign person, except that if such other REIT or RIC is itself domestically controlled, such stock will be treated as held by a U.S. person. Any stock in the REIT held by another REIT not described above shall be treated as held by a U.S. person to the extent stock in the other foreign investment entity is held (or treated as held) by a U.S. person (i.e., on a look-through basis). This provision became effective on December 18, 2015.

Increase in rate of withholding of tax on dispositions of U.S. real property interests.

The rate of withholding on disposition of a U.S. real property interest has been increased from 10% to 15%, except on dispositions of a personal residence for $1M or less. This provision will apply to dispositions occurring after the date which is 60 days after December 18, 2015.

REIT Spin-Off Reforms

Restriction on tax-free spin-offs involving REITs.

The legislation significantly restricts the ability of a REIT to be part of a tax-free spin-off transaction. Under the Bill, a spin-off of a REIT will be eligible for tax-free treatment only if both the distributing and controlled corporations are REITs immediately after the distribution (i.e., a spin-off of a REIT by a REIT is permissible). The REIT spin-off prohibition applies to distributions on or after December 7th, but not to any distribution pursuant to a transaction for which a private letter ruling was requested before December 7th, which has not been withdrawn, or on which a ruling has not been issued or denied.

- Simpson Thacher observations:
  - a spin-off of a taxable REIT subsidiary ("TRS") may still qualify as tax-free if the REIT and TRS meet certain requirements.
  - the legislation does not seem to apply to a tax-free spin-off of a non-REIT corporation followed by its subsequent merger into an existing REIT (assuming the other requirements of the tax-free spin-off rules are met).

After a tax-free spin-off, both the distributing and controlled companies are prohibited from making a REIT election for 10 years.

- Simpson Thacher observation:
  - Rather than causing the prior transaction to be treated as taxable, this rule prohibits a REIT election for a 10-year period, a particularly harsh result.

Other Key REIT Reforms:

Reduction in percentage limitation on assets of REIT which may be taxable REIT subsidiaries.

The securities of one or more taxable REIT subsidiaries ("TRSs") may not represent more than 20% of the value of a REIT's assets (lowers the existing limitation of 25%). This amendment applies to tax years beginning after December 31, 2017.

Repeal of preferential dividend rule for "publicly offered" REITs.

A publicly offered REIT will no longer be denied a dividends paid deduction for dividends paid by the REIT which are preferential (i.e., paid or deemed to be paid on a differential basis amongst shares of the same class or with a preference to one class over another class, except to the extent the former is entitled to such preference). A "publicly offered REIT" means a REIT which is required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Exchange Act of 1934. This provision may be very helpful to listed, non-traded REITs which have been limited in their ability to vary dividend payments to different classes of stock based upon concerns regarding preferential dividends. This amendment applies to distributions in tax years beginning after December 31, 2014.

Certain REIT distribution failures.

In the case of a non-publicly offered REIT which makes a preferential dividend distribution, the IRS has the authority to determine an "appropriate remedy," rather than treat such dividend as not qualifying for purposes of the dividends paid deduction and the income distribution requirement, provided that such dividend is "inadvertent or due to reasonable cause and not due to willful neglect." This extends similar treatment to other provisions in the REIT rules that address failures to meet the REIT requirements such as

the asset and income tests. This amendment applies to distributions in tax years beginning after December 31, 2015.

Debt instruments of publicly offered REITs treated as real estate assets.

For purposes of the 75% asset test, debt instruments offered by publicly offered REITs, as well as interests in mortgages on interests in real property, will be treated as real estate assets. Income from debt instruments issued by publicly offered REITs will be treated as qualifying income for the 95% gross income test, but not the 75% gross income test, unless the income is otherwise qualifying income under current law. No more than 25% of a REIT's assets may be publicly offered REIT debt instruments. This provision is effective for tax years beginning after December 31, 2015.

Ancillary personal property leased with real property counts as real property for purposes of the 75% asset test.

Also, if the fair market value of personal property is 15% or less of the total fair market value of the real and personal property, an obligation secured by a mortgage on ancillary personal property is considered real property under the 75% asset and income tests. This provision is effective for tax years beginning after December 31, 2015.

Treatment of certain services provided by a taxable REIT subsidiary.

A TRS will now be treated in the same manner as independent contractors for certain purposes (allowed to operate foreclosed real property, and engage in marketing and development activities for purposes of the safe harbor for prohibited transactions). However, if amounts paid for services paid by a REIT to a TRS are determined not to be at arms-length, the difference between the amount paid and the fair value is subject to a 100% tax. (e.g., if the REIT underpays the TRS for services to avoid shifting gain to an entity subject to tax). These amendments will apply to tax years beginning after December 31, 2015.

Extension of reduction in recognition period for built-in gains tax.

The "built in gain" recognition period for REITs which have assets formerly held by C corporations and acquired in a "conversion transaction" has been reduced from 10 years to five years. This amendment will apply to tax years beginning after December 31, 2014.

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