Clients&FriendsMemo

The PATH Act

December 28, 2015

I. Introduction.

On December 18, 2015, President Obama signed into law the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act). In short, the PATH Act:

- extends or makes permanent a number of temporary tax provisions that had expired or were set to expire,
- significantly restricts the ability of companies that are not real estate investment trusts (REITs) to spin off REIT subsidiaries on a tax-free basis,
- expands the opportunities for certain foreign investors to invest in U.S. real estate without paying FIRPTA (Foreign Investors in Real Property Tax Act) taxes, and
- modifies a number of the REIT and FIRPTA rules.

Part II of this memorandum summarizes certain of the temporary provisions that were extended or made permanent, Part III discusses the REIT spinoff provisions, Part IV discusses the expanded opportunities for foreigners to invest in U.S. real estate without incurring FIRPTA tax, and Part V discusses the other REIT and FIRPTA provisions.

II. The Extender Provisions.

The PATH Act extends or makes permanent over 50 separate provisions that had expired or were set to expire. This part II summarizes certain of those provisions:

- **Research And Development Tax Credit Made Permanent.** The R&D tax credit is now permanent.
- **Fifteen-Year Straight-Line Cost Recovery For Certain Improvements Made Permanent.** The 15-year cost recovery period for qualified leasehold improvements, qualified restaurant property, and qualified retail improvement property is now permanent.
- **Exemption Of Certain Regulated Investment Company (RIC) Dividends From U.S. Withholding Tax Made Permanent.** Dividends paid by mutual funds that relate to (i) interest that would have qualified for the portfolio interest exemption and (ii) short-term capital gains are now permanently exempt from U.S. withholding tax.

- **Active Financing Income Exception From Subpart F Income Made Permanent.** The active financing income of controlled foreign corporations (CFCs) is now permanently excluded from subpart F income and therefore is not taxable to their 10% United States shareholders until distributed.
- **RICs Permanently Treated As Qualified Investment Entities So That, If They Are Domestically-Controlled, Their Foreign Investors Can Qualify for Exemption From FIRPTA On Distributions and Redemptions.** RICs are now permanently treated as "qualified investment entities" (QIEs). Foreign investors in domestically controlled QIEs may be exempt from FIRPTA on a sale or redemption. See "Clarifications to the Definition of 'Domestically Controlled'," below.
- **The Look-Through Rule For Payments Between Related CFCs Is Extended Through 2019.** Dividend and interest payments made between related CFCs will generally be treated as having the character of the payor's income for purposes of determining the tax treatment of the recipient through 2019.
- **Built-In Gain Recognition Period Reduced To 5 Years**. The period during which an S corporation, RIC or REIT that acquired an asset from a C corporation in a carryover basis transaction could be subject to a corporate tax upon a sale of the acquired asset has been permanently reduced to 5 years.
- **New Markets Tax Credits For Up to $3.5 Billion In Qualified Equity Investments Allocated For Each Year From 2015-19.** New markets tax credits for up to $3.5 billion in qualified equity investments are allocated to each year from 2015 to 2019.
- **Extension And Modification Of Bonus Depreciation.** Bonus depreciation is available for property acquired and placed in service during 2015-2019; bonus depreciation extends through 2020 for certain property with a longer production period. The bonus depreciation is 50% for property placed in service during 2015-2017, 40% for property placed in service during 2018, and 30% for property placed in service during 2019. Taxpayers may continue to accelerate the use of AMT credits in lieu of bonus depreciation for property placed in service during 2015. Beginning in 2016, the amount of unused AMT credits that may be claimed lieu of bonus depreciation will increase.

Energy Provisions.

- **Two-Year Extension Of Second Generation Biofuel Producer Credit.** The credit for cellulosic biofuels producers is extended through 2016.
- **Two-Year Extension Of Biodiesel And Renewable Diesel Incentives.** The existing $1/gallon tax credit for biodiesel and biodiesel mixtures, the 10 cent/gallon small agri-biodiesel producer tax credit, the $1/gallon tax credit for diesel fuel created from biomass, and the fuel excise tax credit for biodiesel mixtures are all extended through 2016.
- **Two-Year Extension And Modification Of Production Credit For Indian Coal Facilities.** Beginning in 2016, the placed-in-service date limitation on the $2/ton production tax credit for coal produced on land owned by an Indian tribe and sold to unrelated third parties is repealed, and the credits will be able to offset the AMT. The tax credit is extended through 2016.
- **Extension Of Production Tax Credit For Certain Renewable Electricity Produced By Facilities With Respect To Which Construction Commences By The End Of 2016.** The production tax credit is extended for certain renewable sources of electricity to facilities for which construction commences by the end of 2016.
- **Two-Year Extension Of 50% Bonus Depreciation For Second Generation Biofuel Plant Property.** The 50% bonus depreciation for cellulosic biofuel facilities is extended through 2016.

- **Two-Year Extension Of Alternative Fuel Excise Credits.** The 50 cent per gallon alternative fuel tax credit and alternative fuel mixture tax credit is extended through 2016.

III. Restrictions On Tax-Free REIT Spinoffs.

Under prior law, C corporations were able to spin off REITs (or elect REIT status after a spinoff). This was a popular technique for separating an operating company's real estate assets into a tax-efficient REIT that would lease back substantially all of the real estate to the operating business (so-called "OpCo-PropCo structures"). Companies such as Penn National, Windstream and Darden adopted OpCo-PropCo structures. Recently, the IRS and the Treasury Department issued Notice 2015-59, which suggested significant restrictions on the ability of C corporations to separate their assets into a REIT. The PATH Act now generally bars tax-free spinoffs involving REITs except in two situations. First, a REIT may be spun off if both corporations are REITs immediately after the spinoff. Second, a REIT may spin off a taxable REIT subsidiary ("TRS") if at all times during the 3-year period ending on the distribution date (1) the distributing corporation has been a REIT , (2) the distributed corporation has been a TRS of the REIT, and (3) the REIT held at least 80% of (a) the total combined voting power of the TRS's voting stock and (b) of each class of the TRS's nonvoting stock, in each case directly or through one or more partnerships, during that 3-year period. If a corporation that is not a REIT was a distributing or controlled corporation in a spinoff, that non-REIT may not elect to become a REIT for 10 years following the spinoff. This provision applies to distributions on or after December 7, 2015, other than distributions pursuant to a transaction described in a ruling request that was initially submitted to the IRS on or before December 7, 2015 and, as of December 7, 2015, either was not withdrawn or was issued or denied in its entirety.

Partial IPOs, taxable spinoffs and other REIT transactions are not affected by this provision of the PATH Act.

IV. Expansion Of Opportunities For Foreigners To Invest In U.S. Real Property Without A FIRPTA Tax.

Increase From 5% to 10% of Maximum Stock Ownership In A Publicly Traded REIT Without FIRPTA Tax. Under prior law, a non-U.S. person could own up to 5% of the stock of a publicly traded REIT without the REIT stock being treated as a "U.S. real property interest" that is subject to a FIRPTA tax upon a sale of the stock or upon the distribution of proceeds from the sale or exchange of a U.S. real property interest by the REIT. Under the PATH Act, the 5% limit is increased to 10%. This provision applies to dispositions or distributions on or after December 18, 2015.

Exemption From FIRPTA Tax On REIT Shares Held By Certain Foreign Qualified Collective Investment Vehicles, Such As Dutch Beleggingsinstellings and Australian Property Trusts. Foreign entities that (x) either are (1) publicly traded and eligible for benefits under a tax treaty that provides for information exchange or (2) foreign limited partnerships organized in jurisdictions with a tax information exchange agreement with the United States and that have a class of limited units that (i) constitutes more than 50% of the total value of its partnership units and (ii) is regularly traded on the NYSE or NASDAQ, (y) are "qualified collective investment vehicles" and (z) maintain records of the identity of persons who hold 5% or greater interests at any time during the taxable year are treated as "qualified shareholders" of a REIT and are not subject to FIRPTA tax on REIT shares they hold. The exemption from FIRPTA tax is cut back for qualified shareholders whose investors hold (directly or indirectly) more than 10% of the REIT shares. This provision applies to dispositions or distributions on or after December 18, 2015.

Exemption From FIRPTA For Certain Foreign Retirement Or Pension Funds. Certain "qualified foreign pension funds" are now exempt from FIRPTA tax. The exemption is available for any trust, corporation, organization or other arrangement if:

- It is organized under the laws of a foreign country;
- It is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees of one or more employers;
- No single participant or beneficiary has a right to more than 5% of its assets or income;
- It is subject to government regulation and provides annual information reporting about beneficiaries to the tax authorities in the foreign country in which it is established or operates; and
- Under the laws of the country in which it is established or operated, either:
    - contributions to it that otherwise would be subject to tax under local law are "deductible or excluded from the gross income of such entity or taxed at a reduced rate," or
    - taxation of its investment income is deferred or taxed at a reduced rate.

It is not entirely clear whether government-established pension plans can satisfy these requirements. In particular, the second requirement – that the plan have been established to provide retirement or pension benefits to participants that are current or former employees of one or more employers – does not seem to have been drafted with government-established pension plans in mind, although it may nevertheless be true. Second, it is unclear whether government-established pension plans provide annual information reporting to the foreign country's tax authorities, although regulations could deem this requirement to be satisfied if a plan was established by a government. Nothing in the legislative history suggests that government pension plans were intended to be excluded from the provision. This provision applies to dispositions or distributions on or after December 18, 2015.

V. Other Changes To The REIT And FIRPTA Rules.

There were a number of other changes to the REIT and FIRPTA regimes. This part summarizes some of the most significant of these changes.

Taxable REIT Subsidiaries May Not Represent More Than 20% Of The Value Of A REIT's Assets. TRSs may not represent more than 20% (reduced from 25%) of the value of a REIT's assets. This provision applies to taxable years beginning after December 31, 2017.

Expanded Safe Harbors to Avoid Dealer Status. REITs are subject to a prohibited transaction tax of 100% of the net income derived from prohibited transactions. A prohibited transaction is a sale or other disposition of property by a REIT that is "stock in trade", would be included in inventory, or is property held for sale to customers in the ordinary course of a trade or business.

Safe harbors in section 857(b)(6)(C) and (D) of the Code require an asset holding period of at least two years and contain certain other requirements. If these requirements were satisfied under pre-PATH Act law, the REIT could avoid the 100% prohibited transfer tax so long as during the taxable year, the REIT (1) made no more than seven sales (other than sales of foreclosure property or involuntary conversions), or (2) sold no more than 10% of its assets as of the beginning of the taxable year (computed based on either their aggregate bases or their aggregate fair market value, and without regard to sales of foreclosure property or involuntary conversions).

The PATH Act increases the amount of property that a REIT may sell under the safe harbors from 10% during a taxable year to 20%, but only if the aggregate property (other than in sales of foreclosure property or involuntary conversions) sold in the three taxable year period ending with such taxable year does not exceed 10% of the aggregate assets of the REIT as of the beginning of each of the same three taxable years that are part of the period (computed based on either their aggregate bases or their aggregate fair market value).

This provision applies to taxable years beginning after December 18, 2015.

Repeal Of Preferential Dividend Rule For Publicly Offered REITs. Under the law prior to the enactment of the PATH Act, if a REIT paid a non-pro rata dividend to shareholders of a particular class, the dividend was treated as a preferential dividend and the REIT was not entitled to a dividends paid deduction (which could require the REIT to pay corporate tax, possibly excise taxes with respect to the dividend, and possibly threaten the REIT's status as a REIT). The PATH Act helpfully repeals the preferential dividend rule for distributions by publicly offered REITs in taxable years beginning after December 31, 2015, and authorizes the IRS to grant an appropriate remedy to cure a preferential dividend distribution in taxable years beginning after December 31, 2015 if it was inadvertent, or due to reasonable cause and not due to willful neglect.

Debt Instruments Of Publicly Offered REITs And Mortgages Treated As Real Estate Assets. At least 75% of the value of a REIT's assets must be real estate assets, cash and cash items, and government securities (the "75% asset test"). At least 75% of a REIT's gross income must be from rents from real property plus certain other items (the "75% income test"). At least 95% of a REIT's gross income generally must be from income that qualifies under the 75% income test, plus interest, dividends, and gain from the sale or other disposition of securities (the "95% income test").

Under the PATH Act, all debt instruments issued by publicly offered REITs, and mortgages on interests in real property, are treated in whole as good "real estate assets" for purposes of the 75% asset test. However, income from publicly offered REIT debt instruments that would not qualify as real estate assets but for the new law ("nonqualified publicly-offered REIT debt instruments") is not qualified income under the 75% income test. In addition, not more than 25% of the value of a REIT's assets is permitted to consist of these nonqualified publicly-offered REIT debt instruments. The provision is effective for tax years beginning after 2015.

Ancillary Personal Property Leased With Real Property Treated As Real Estate Assets. Certain ancillary personal property that is leased with real property is treated as real property for purposes of the 75% asset test. In addition, an obligation secured by a mortgage on both real property and personal property is treated in its entirety as real property for purposes of the 75% income and asset tests so long as the fair market value of the personal property secured by the mortgage does not exceed 15% of the total fair market value of the combined real and personal property. This provision applies for tax years beginning after 2015.

Hedges Of Prior Hedges Are Treated As Good Hedges. Income from certain REIT hedging transactions that are clearly identified is not included as gross income under either the 95% income test or the 75% income test. Hedges of previously acquired hedges that (i) qualify under the hedging exceptions from prior law and that (ii) a REIT entered to manage risk associated with liabilities or property underlying the previously acquired hedges and that have been extinguished or disposed of are treated as good REIT hedges. This provision applies for tax years beginning after 2015.

Limitations On Designation Of Dividends. REITs may designate certain dividends that they pay as "capital gains dividends" that are treated as long-term capital gain, or as "qualified dividend income" that is subject to reduced rates in the hands of non-corporate shareholders. In certain circumstances, RICs may designate dividends as capital gains dividends or qualified dividend income even if those amounts exceed the total amount of the RIC's dividend distributions, and under prior law it was unclear whether REITs were entitled to do the same. The PATH Act provides that, in contrast to RICs, the aggregate amount of dividends that may be designated by a REIT as "capital gains dividends" or "qualified dividends income" may not exceed the dividends actually paid by the REIT. The provision applies for distributions in tax years beginning after 2015.

Treatment Of Certain Services Provided By TRSs. TRSs can now provide certain services to a REIT that a third party previously had to provide. In addition, a TRS can now develop and market REIT real property without increasing the risk that the REIT would be subject to the 100% prohibited transaction tax. However, a TRS that provides services to its parent and receives more than an arm's length fee is now required to forfeit the excess (i.e., the excess is subject to a 100% excise tax). These provisions are effective for tax years beginning after 2015.

Repeal Of The "Cleansing Rule" For RICs and REITs. Under the "cleansing rule" of section 897(c)(1)(B) of the Code, a U.S. real property interest does not include an interest in a corporation if, on the date of the disposition of the interest, the corporation did not hold any United States real property interests, and the corporation was subject to tax on the disposition of any United States real property interests it held (or the United States real property interests ceased to be treated as such by reason of section 897(c)(1)(B)). Under pre-PATH Act law, the cleansing rule permitted REITs and RICs to sell all of their real property and liquidate without subjecting their foreign shareholders to FIRPTA tax, even though the sale and liquidation did not give rise to a corporate-level tax or dividend withholding tax. Under the PATH Act, the cleansing rule will apply to stock of a corporation (so that it is not treated as a U.S. real property interest subject to FIRPTA tax) only if neither the corporation nor any predecessor was a RIC or a REIT at any time during the shorter of (a) the period after June 18, 1980 (the date of enactment of FIRPTA) during which the taxpayer held the stock, or (b) the 5-year period ending on the date of the disposition of the stock. The provision applies to dispositions on or after December 18, 2015.

Clarifications To The Definition Of "Domestically Controlled". Very generally, if less than 50% of the value of a RIC or a REIT that is, or in certain cases would be, a U.S. real property holding company (collectively, "qualified investment entities" or QIEs) is directly or indirectly owned by foreign persons (i.e., the QIE is "domestically controlled') during the shortest of (i) the period beginning after June 18, 1980 (the enactment of FIRPTA) and ending on the date of a disposition or distribution, (ii) the 5-year period ending on the date of the disposition or of the distribution, or (iii) the period during which the QIE was in existence, then the QIE stock is not treated as a United States real property interest and is not subject to FIRPTA tax. There had been significant uncertainty as to when a QIE was treated as "indirectly owned" by a foreign person for purposes of this rule.

The PATH Act helpfully provides that a publicly traded QIE can presume that a holder of less than 5% of a class of its stock regularly traded on an established securities market in the United States is a U.S. person unless the QIE has actual knowledge that the holder is not a U.S. person.

The PATH Act also provides that any stock in a QIE that is held by a domestically controlled QIE that (i) has issued a class of stock that is regularly traded on an established stock exchange, or (ii) is a RIC that issues redeemable securities is treated as held by a U.S. person. However, if the shareholder QIE is not domestically controlled, then the stock in the lower-tier QIE is treated as held by a foreign person. Finally, if stock in a lower-tier QIE is held by another QIE whose stock is not regularly traded on an established stock exchange and which is not a RIC that issues redeemable securities, then the shares held by the shareholder QIE are treated as held by a U.S. person only to the extent that the shareholder QIE's stock is (or is treated as) held by a U.S. person. These provisions are effective as of December 18, 2015.

Built-In Gain Recognition Period Reduced To 5 Years. The period during which a REIT that acquired an asset from a C corporation in a carryover basis transaction could be subject to a corporate tax upon a sale of the asset has been permanently reduced to 5 years. The provision is effective for tax years beginning after 2014.

Increase In FIRPTA Withholding Tax Rate From 10% to 15%. The withholding tax rate on proceeds paid from the disposition of a U.S. real property interest and certain related distributions to a non-U.S. person has increased from 10% to 15% (other than for sales of personal residences for $1 million or less). Personal residences selling for $300,000 or less remain exempt from withholding, and those selling for more than $300,000 and not more than $1 million remain subject to withholding at the 10% rate. This provision is effective for dispositions after February 16, 2016 (i.e., 60 days after December 18, 2015).

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If you have any questions, please contact a member of the Tax department at +1.212.504.6000.