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2015 TNT 244-2 NEWS ANALYSIS: THE END IS IN SIGHT FOR REIT SPINOFFS. (Section 355 -- Controlled Firm Stock) (Release Date: DECEMBER 16, 2015) (Doc 2015-27642)

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ABSTRACT: In news analysis, Marie Sapirie traces congressional and Treasury action that aims to stop the tax-free treatment of real estate investment trust spinoffs.

SUMMARY: Published by Tax Analysts(R)

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Congress's last-minute agreement on the extenders bill may not have come as much of a surprise, but the inclusion of major changes to the tax treatment of spinoffs of real estate investment trusts was an unlooked-for addition.

Although the rapidity with which the REIT provisions were introduced and passed is a remarkable display of legislative haste, the writing may have been on the wall for REIT spinoffs nearly two years earlier, even though it caused little stir at the time. Taxpayers should now consider themselves on notice that the proposals in former House Ways and Means Committee Chair Dave Camp's Tax Reform Act of 2014 are likely candidates for potential inclusion in future bills. Tax reform may be done entirely piecemeal.

On December 7, in the Tax Increase Prevention and Real Estate Investment Act of 2015 (H.R. 34 (Doc 2015-26896)), House Ways and Means Committee Chair Kevin Brady, R-Texas, signaled the end of REIT spinoffs by proposing to halt them in their tracks. On December 16 he released the Protecting Americans From Tax Hikes (PATH) Act of 2015 (Amdt. 2 to H.R. 2029 (Doc 2015-27580)), which includes a similar provision to eliminate tax-free treatment if either the distributing corporation or controlled corporation is a REIT, except when a REIT is spun off another REIT, or for spinoffs of specific taxable REIT subsidiaries. Neither the distributing nor the controlled corporation would be allowed to make a REIT election for 10 years following the transaction. The PATH Act, unlike its predecessor, includes a transition rule for transactions that are already in progress. The PATH Act also removes the limitation on fixed percentage rent and interest exceptions for REIT income tests.

Although the REIT spinoff provision was unexpected, tax provisions that generate revenue, provide a perception of curbing excessive creativity, or both, are often resurrected in subsequent bills, making it a prime candidate for inclusion in the extenders bill. The revenue score for restricting tax-free spinoffs was not particularly large at $ 4.3 billion over 10 years, but coupled with the apparently growing congressional disapproval of REIT spinoffs, it seems to have been enough to advance the legislation.

For legislators looking for tax ideas, the Camp plan is proving to be fertile ground for ready-made revenue provisions. The origins of the partnership audit rules that were enacted in the Bipartisan Budget Act of 2015 (H.R. 1314 (Doc 2015-23743)) can also be traced to Camp's proposals. The problem with this type of lawmaking is that, when combined with contemporary budgetary pressures, it leaves little to no room for policy discussion.

History

For years it was considered impossible to do a spinoff of the type that the Brady bill proposes to shut down. However, the REIT rules were incrementally broadened over time to include features like taxable REIT subsidiaries (TRSs), which allow REITs to retain oversight of specific aspects of the business in exchange for paying tax, and which have also been used to operate a qualifying active trade or business for section 355 purposes. Also, the enactment of the more flexible separate affiliated group rules for spinoffs allowed taxpayers to form such a qualifying business with less hassle and restructuring. "These legal changes through the years facilitated the structure that was put in place in Penn National," the transformational 2013 transaction that reinvigorated the debate over REIT spinoffs, said Richard M. Nugent of Cadwalader, Wickersham & Taft LLP.

The Penn National Gaming Inc. transaction became the prototypical spinoff. In it, a C corporation spun off its real estate into a REIT tax free. The IRS later released letter rulings indicating that other companies had been given a green light on similar transactions.

In 2014 Camp released his proposal for tax reform (H.R. 1 (Doc 2014-29326)), which included a provision that would make REITs ineligible to participate in a tax-free spinoff as either distributing or controlled corporations under section 355. The change would have also restricted REIT elections for 10 years following a distribution under section 355. The purpose of the provision was to prevent operating companies from putting real estate into a REIT and running the business operations in a taxable REIT subsidiary, but its application was broader than that. (Prior coverage: *Tax Notes*, Oct. 27, 2014, p. 369 (Doc 2014-25229).) Following the unveiling of the Tax Reform Act, Congress seemed to lose interest in REIT spinoffs until Brady released his proposals. The provision gained traction through its two iterations and became a staple of the bill, even though its appearance in the first proposed amendment was unexpected.

Notice 2015-59 and Rev. Proc. 2015-43

While congressional action on REITs came as something of a surprise, further regulatory changes were already being contemplated when Brady released his proposal. In September the IRS announced that the government is studying issues under sections 337(d) and 355 regarding REIT spinoffs. Notice 2015-59, 2015-40 IRB 467, (Doc 2015-20740) announced new restrictions on obtaining letter rulings for REIT spinoffs and explained the government's belief that some transactions may present evidence of a device for the distribution of earnings and profits, lack an adequate business purpose or a qualifying business, or violate other requirements in section 355. Rev. Proc. 2015-43, 2015-40 IRB 459,(Doc 2015-20739) added issues regarding the qualification of some distributions involving REITs to the no-rule list. IRS officials have recently expressed concerns about the ability of the current regulations and the traditional heavy reliance on letter rulings to keep up with innovations in transactions. (Prior coverage: *Tax Notes*, Nov. 2, 2015, p. 608 (Doc 2015-23695).)

Even if the government were inclined to address REIT spinoffs through regulation, Treasury and the IRS might have had a challenge in trying to write regulations that constrain REIT spinoffs in the way contemplated in the extenders proposal in the absence of legislation. "Writing regulations to limit the ability of taxpayers to do this would have involved a significant departure from what the law is regarding tax-free spinoffs," said Jay M. Singer of Ivins, Phillips & Barker Chtd. In contrast, the notice format and the decision not to rule on issues related to the qualification of a distribution under section 355 in a transaction with a REIT election allowed the IRS and Treasury to air concerns without raising questions about their authority to regulate. "It was clear from reading [the notice] that their thinking was not particularly well crystallized, and they still had a lot of work to do," Singer said. "It's not clear how they would get to a place where they would prevent people from making REIT elections."

Camp and Brady

The similarities between the Camp and Brady proposals suggest that although legislators were quick to dismiss the Camp plan as politically infeasible, they paid close attention to it. However, the REIT proposals are not identical. The December 7, 2015, effective date of the REIT spinoff provision in Brady's first proposed amendment to the extenders bill met with resistance from taxpayers because it would have stopped transactions that are already underway. The Camp proposal included a grandfather clause for some planned, but not yet completed, transactions. Brady's second take on containing REIT spinoffs includes a transition period that looks more like the Camp plan in that it allows transactions that are described in a ruling request submitted to the IRS before December 7 to proceed, which Nugent noted should include the Caesars and EFH/TXU reorganizations and the recently announced Hilton spinoff.

There are other ways in which the Brady and Camp proposals are not carbon copies. Under the Camp provision, if a C corporation converted to a REIT, it would have to recognize built-in gain on its assets at the time of the conversion, an issue on which the IRS also commented in Notice 2015-59. Also, the Camp proposal would have redefined real property under the REIT rules to exclude assets with a class life under 27 1/2 years, including the assets of some newer, nontraditional REITs, such as billboards or transmission cables. Nugent noted that the Brady proposal does not include such requirements, suggesting that it is focused on

REIT spinoffs rather than REIT qualification issues. He pointed out that other types of REIT transactions, such as the whole-company conversions of Iron Mountain Inc. and Lamar Advertising Co., appear less affected by the Brady proposal.

Both Camp and Brady proposed to make REIT elections unavailable for 10 years after a tax-free spinoff. "The 10-year rule for not making an election is harsh," Singer said. He noted that section 1374 already applies in the context of a REIT election following a spin and that this prevents a newly formed REIT from being able to dispose of pre-REIT assets without recognizing corporate-level gain.

Nugent noted two more wrinkles with the Brady amendment. First, although the new REIT provisions are described as revenue raisers, they would reduce the cap on a TRS's maximum size from 25 percent of a REIT's total assets to 20 percent. Nugent said that while this change will limit the TRS's business and other non-real-estate activities, which some have questioned, and that it may render REIT conversions more difficult, the reduction in the maximum size of a TRS, a taxable entity, generally would mean a corresponding increase in REIT assets that are not subject to tax. The Brady amendment would also require a three-year waiting period before a REIT could spin off a TRS tax free. "However, it's not entirely clear what the issue is with a REIT spinning off a TRS or how requiring the REIT to hold the TRS for three years addresses the issue," he said, noting that the uncertainty over the provision's rationale makes it difficult to plan a transaction that complies with it.

Impetus for Change?

There is a debate within the tax community about the broader policy justification for advantaging REITs, including through rules that allow tax-free spinoffs. (Prior analysis: *Tax Notes*, Nov. 16, 2015, p. 870 (Doc 2015-24811).) Congress's quick decision on the policy issues left next to no time for deliberation. The enactment of the Brady amendment, with little public discussion of the impetus for the change, continues the recent trend of tax lawmaking by surprise fiat, possibly driven in part by revenue considerations.

Restricting REIT spinoffs is not clearly about raising revenue, said Bradley Borden of Brooklyn Law School. Even though there may be corporate tax base erosion as a result of spinoffs, there is not necessarily much lost tax revenue, he said. Based on his calculations using publicly available data, the government loses little revenue from REIT spinoffs because REIT dividends are taxed to individuals as ordinary income. There may be policy questions to address regarding tax-exempt and foreign shareholders, but those are not REIT issues, he said.

Curbing REIT spinoffs is a curious objective for Congress to pursue in the context of the extenders bill and with so little opportunity for discussion. But in light of the concern about REIT spinoffs expressed in the Tax Reform Act and recent changes in IRS ruling policy, the passage of the Brady amendment is less of a surprise than a disappointing commentary on the new mode of making tax laws.

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