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Consolidated Appropriations Act Impacts REITs, FIRPTA Requirements and Depreciation

by Alan J. Tarr, Co-Chair and Tom Lawson, Partner

The recently enacted Consolidated Appropriations Act, 2016 makes some significant changes that affect real estate investment trusts, Foreign Investment in Real Property Tax Act reporting and withholding requirements, and depreciation of real property.

REIT Provisions

A REIT is a tax-advantaged vehicle for investing in real property and mortgages on real property. Assuming its many requirements are met, the REIT generally is not taxed on its income that is distributed to its investors, and the character of the REIT's income as qualified dividends or as capital gain may be preserved for the investors.

The Act eliminates the ability of a real-estate-rich corporation to separate into an operating company and a property company REIT without incurring any income tax. Under the Act, a spin-off will be taxable if either (but not both) the distributing corporation or the controlled corporation is a REIT immediately after the distribution. The Act also prohibits either corporation from electing to be taxable as a REIT for 10 years after the distribution.

The Act reduces the percentage of the value of a REIT's assets that may be represented by securities

in a taxable REIT subsidiary from 25 percent to 20 percent for taxable years beginning after 2017.

For taxable years beginning after 2014, the Act retroactively repeals the prohibition on preferential dividend distributions for publicly offered REITs (i.e., a REIT that is required to file annual and periodic reports to the Securities and Exchange Commission under the Securities Exchange Act of 1934), but it limits a REIT's ability to designate distributions as qualified dividends or capital gain dividends to those dividends actually paid by the REIT with respect to the taxable year.

Debt instruments issued by publicly offered REITs are now qualified assets, and the income from those instruments that would not otherwise constitute qualified income is qualified income for purposes of the 95 percent income test. These debt instruments, however, may not exceed 25 percent of the value of the REIT's assets.

The Act also clarifies the treatment of ancillary personal property that is leased with real property for purposes of the asset and income tests, allows the IRS to provide alternative remedies for inadvertent

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preferential dividend distributions by nonpublicly offered REITs, and expands the services permitted to be provided by a TRS, but it imposes a 100 percent excise tax on non-arm's-length transactions with a TRS, expands the ability of a REIT to engage in certain hedging transactions and to avoid certain prohibited transactions, and modifies the method for computing earnings and profits to eliminate duplicate taxation.

FIRPTA Provisions

Generally, foreign persons are not subject to U.S. federal income tax on U.S.-source capital gain, unless it is effectively connected with a trade or business in the United States or is realized by an individual who is present in the U.S. for at least 183 days during the taxable year. For this purpose, gain from the disposition of a U.S. real property interest, including stock in a U.S. real property holding corporation, is treated as being effectively connected with a U.S. trade or business. Similarly, with certain exceptions, built-in gain is recognized upon a foreign corporation's distribution of a USRPI to a shareholder. FIRPTA requires certain reporting of and withholding on dispositions of USRPIs by foreign persons. The Act modifies the rules to encourage greater foreign investment in U.S. real property.

The Act increases from 5 percent to 10 percent the amount of REIT stock a shareholder may own in a class of publicly traded stock without the stock being treated as a USRPI. The Act similarly increases from 5 percent to 10 percent the ownership threshold for treating distributions to holders of publicly traded REIT stock attributable to gains from dispositions of USRPIs as a dividend rather than as FIRPTA gain. In addition, REIT stock held by a qualified foreign shareholder who owns not more than 10 percent of the class of

REIT stock (whether directly or indirectly through a partnership) is excluded.

The Act also excludes from FIRPTA USRPIs held (directly or indirectly through a partnership) by qualified foreign pension funds (or by a foreign entity wholly owned by a qualified foreign pension fund). A qualified foreign pension fund is a trust, corporation, or other organization or arrangement (a) which is created or organized under the law of a foreign country; (b) which is established to provide retirement or pension benefits to participants or beneficiaries who are current or former employees in consideration for services; (c) which does not have a single participant or beneficiary with a right to more than 5 percent of its assets or income; (d) which is subject to government regulation and provides for annual information reporting about its beneficiaries to the relevant tax authorities in the 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, (i) contributions to such organization or arrangement that would otherwise be subject to tax under such laws are deductible or excluded from the gross income of such entity or taxed at a reduced rate, or (ii) taxation of any investment income of such organization or arrangement is deferred or such income is taxed at a reduced rate.

On the flip side, the Act increases the required withholding from 10 percent to 15 percent of the gross purchase price or distribution of the USRPI, prevents stock in a REIT from ever ceasing to be a USRPI under the five-year cleansing rule, and prohibits dividends from a REIT from being treated by a foreign owner as a dividend from a U.S. corporation for purposes of the dividends-received deduction.

Depreciation Provisions

The Act retroactively makes permanent 15-year Modified Accelerated Cost Recovery System depreciation for qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property (collectively, qualified real property).

It also retroactively made permanent the taxpayer's ability to expense qualifying property, including qualified real property, up to \$500,000 (reduced but not to below zero by the qualifying property placed in service during the taxable year in excess of \$2 million), with the \$500,000 and \$2 million amounts being adjusted for inflation after 2015. The prior \$250,000-a-year limitation on the amount that may be attributable to qualified real property and the exclusion of air-conditioning and heating units from the definition of qualifying property are eliminated for taxable years beginning after 2015.

Loeb & Loeb's Tax Practice

JOHN ARAO	JARAO@LOEB.COM	310.282.2231
MARLA ASPINWALL	MASPINWALL@LOEB.COM	310.282.2377
RYAN M. AUSTIN	RAUSTIN@LOEB.COM	310.282.2268
CHRISTOPHER W. CAMPBELL	CWCAMPBELL@LOEB.COM	310.282.2321
TERENCE F. CUFF	TCUFF@LOEB.COM	310.282.2181

In addition, the Act retroactively extends the 50 percent bonus depreciation for qualified leasehold improvement property placed in service before January 1, 2019, at 40 percent if placed in service in 2019 and at 30 percent if placed in service in 2020. A corporation's ability to forego bonus depreciation on this property and increase its alternative minimum tax credit is also extended.

If you have any questions about these or any other changes made by the Act, please contact [Alan J. Tarr](mailto:atarr@loeb.com) (atarr@loeb.com, 212.407.4900) or [Tom Lawson](mailto:tlawson@loeb.com) (tlawson@loeb.com, 310.282.2289).

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DIARA M. HOLMES	DHOLMES@LOEB.COM	202.618.5012
THOMAS N. LAWSON	TLAWSON@LOEB.COM	310.282.2289
MARCUS S. OWENS	MOWENS@LOEB.COM	202.618.5014
JOHN F. SETTINERI	JSETTINERI@LOEB.COM	212.407.4851
ALAN J. TARR	ATARR@LOEB.COM	212.407.4900
