TECHNICAL EXPLANATION 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)

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B. Real Estate Investment Trusts

Present Law for Provisions related to Real Estate Investment Trusts (secs. 311-326 of the bill)

In general

A real estate investment trust ("REIT") is an entity that otherwise would be taxed as a U.S. corporation but elects to be taxed under a special REIT tax regime. To qualify as a REIT, an entity must meet a number of requirements. At least 90 percent of REIT income (other than net capital gain) must be distributed annually;[499] the REIT must derive most of its income from passive, generally real-estate-related, investments; and REIT assets must be primarily real-estate related. In addition, a REIT must have transferable interests and at least 100 shareholders, and no more than 50 percent of the REIT interests may be owned by five or fewer individual shareholders (as determined using specified attribution rules). Other requirements also apply.[500]

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its shareholders as a dividend or qualifying liquidating distribution each year is deductible by the REIT (whereas a regular subchapter C corporation cannot deduct such distributions).[501] As a result, the distributed income of the REIT is not taxed at the entity level; instead, it is taxed only at the investor level. Although a REIT is not required to distribute more than the 90 percent of its income described above to retain REIT status, it is taxed at ordinary corporate rates on amounts not distributed or treated as distributed.[502]

A REIT may designate a capital gain distribution to its shareholders, who treat the designated amount as capital gain when distributed. A REIT also may retain net capital gain and pay corporate income tax on the amount retained, while the shareholders include the undistributed capital gain in income, obtain a credit for the corporate tax paid, and step up the basis of their REIT stock for the amount included in income.[503] In this manner, capital gain also is taxed only once, whether or not distributed, rather than at both the entity and investor levels.

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[499] Even if a REIT meets the 90-percent income distribution requirement for REIT qualification, more stringent distribution requirements must be met in order to avoid an excise tax under section 4981.

[500] Secs. 856 and 857.

[501] Liquidating distributions are covered to the extent of earnings and profits, and are defined to include redemptions of stock that are treated by shareholders as a sale of stock under section 302. Secs. 857(b)(2)(B), 561, and 562(b).

[502] An additional four-percent excise tax is imposed to the extent a REIT does not distribute at least 85 percent of REIT ordinary income and 95 percent of REIT capital gain net income within a calendar year period. In addition, to the extent a REIT distributes less than 100 percent of its ordinary income and capital gain net income in a year, the difference between the amount actually distributed and 100 percent is added to the distribution otherwise required in a subsequent year to avoid the excise tax. Sec. 4981.

[503] Sec. 857(b)(3).

Income tests

A REIT is restricted to earning certain types of generally passive income. Among other requirements, at least 75 percent of the gross income of a REIT in each taxable year must consist of real estate-related income. Such income includes: rents from real property; gain from the sale or other disposition of real property (including interests in real property) that is not stock in trade of the taxpayer, inventory, or other property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business; interest on mortgages secured by real property or interests in real property; and certain income from foreclosure property (the "75-percent income test").[504] Qualifying rents from real property include rents from interests in real property and charges for services customarily furnished or rendered in connection with the rental of real property,[505] but do not include impermissible tenant service income.[506] Impermissible tenant service income includes amounts for services furnished by the REIT to tenants or for managing or operating the property, other than amounts attributable to services that are provided by an independent contractor or taxable REIT subsidiary, or services that certain tax exempt organizations could perform under the section 512(b)(3) rental exception from unrelated business taxable income.[507] Qualifying rents from real property include rent attributable to personal property which is leased under, or in connection with, a lease of real property, but only if the rent attributable to such personal property for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, the lease.[508]

In addition, rents received from any entity in which the REIT owns more than 10 percent of the vote or value generally are not qualifying income.[509] However, there is an exception for certain rents received from taxable REIT subsidiaries (described further below), in which a REIT may own more than 10 percent of the vote or value.

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[504] Secs. 856(c)(3) and 1221(a)(1). Income from sales that are not prohibited transactions solely by virtue of section 857(b)(6) also is qualified REIT income.

[505] Sec. 856(d)(1)(A) and (B).

[506] Sec. 856(d)(2)(C).

[507] Sec. 856(d)(7)(A) and (C). If impermissible tenant service income with respect to any real or personal property is more than one percent of all amounts received or accrued during the taxable year directly or indirectly with respect to such property, then the impermissible tenant service income with respect to such property includes all such amounts. Sec. 856(d)(7)(B). The amount treated as received for any service (or management or operation) shall not be less than 150 percent of the direct cost of the trust in furnishing or rendering the service (or providing the management or operation). Sec. 856(d)(7)(D). For purposes of the 75-percent and 95-percent income tests, impermissible tenant service income is included in gross income of the REIT. Sec. 856(d)(7)(E).

[508] Sec. 856(d)(1)(C).

[509] Sec. 856(d)(2)(B).

In addition, 95 percent of the gross income of a REIT for each taxable year must be from the 75-percent income sources and a second permitted category of other, generally passive sources such as dividends and interest (the "95-percent income test").[510]

A REIT must be a U.S. domestic entity, but it is permitted to hold foreign real estate or other foreign assets, provided the 75-percent and 95-percent income tests and the other requirements for REIT qualification are met.[511]

Asset tests

At least 75 percent of the value of a REIT's assets must be real estate assets, cash and cash items (including receivables), and Government securities[512] (the "75-percent asset test").[513] Real estate assets are real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs.[514] No more than 25 percent of a REIT's assets may be securities other than such real estate assets.[515]

Except with respect to securities of a taxable REIT subsidiary, not more than five percent of the value of a REIT's assets may be securities of any one issuer, and the REIT may not possess securities representing more than 10 percent of the outstanding value or voting power of any one issuer.[516] In addition, not more than 25 percent of the value of a REIT's assets may be securities of one or more taxable REIT subsidiaries.[517]

The asset tests must be met as of the close of each quarter of a REIT's taxable year. However, a REIT that has met the asset tests as of the close of any quarter does not lose its REIT status solely because of a discrepancy during a subsequent quarter between the value of the REIT's investments and such requirements, unless such discrepancy exists immediately after the

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[510] Sec. 856(c)(2).

[511] See Rev. Rul. 74-191, 1974-1 C.B. 170.

[512] Government securities are defined for this purpose under section 856(c)(5)(F), by reference to the Investment Company Act of 1940. The term includes securities issued or guaranteed by the United States or persons controlled or supervised by and acting as an instrumentality thereof, but does not include securities issued or guaranteed by a foreign, state, or local government entity or instrumentality.

[513] Sec. 856(c)(4)(A).

[514] Temporary investments in certain stock or debt instruments also can qualify if they are temporary investments of new capital, but only for the one-year period beginning on the date the REIT receives such capital. Sec. 856(c)(5)(B).

[515] Sec. 856(c)(4)(B)(i).

[516] Sec. 856(c)(4)(B)(iii).

[517] Sec. 856(c)(4)(B)(ii).

acquisition of any security or other property and is wholly or partly the result of such acquisition.[518]

Taxable REIT subsidiaries

A REIT generally cannot own more than 10 percent of the vote or value of a single entity. However, there is an exception for ownership of a taxable REIT subsidiary ("TRS") that is taxed as a corporation, provided that securities of one or more TRSs do not represent more than 25 percent of the value of REIT assets.

A TRS generally can engage in any kind of business activity except that it is not permitted directly or indirectly to operate either a lodging facility or a health care facility, or to provide to any other person (under a franchise, license, or otherwise) rights to any brand name under which any lodging facility or health care facility is operated.[519]

However, a TRS may rent a lodging facility or health care facility from its parent REIT and is permitted to hire an independent contractor[520] to operate such facility. Rent paid to the parent REIT by the TRS with respect to hotel, motel, or other transient lodging facility operated by an independent contractor is qualified rent for purposes of the REIT's 75-percent and 95-percent income tests.[521] This lodging facility rental rule is an exception to the general rule that rent paid to a REIT by any corporation (including a TRS) in which the REIT owns 10 percent or more of the vote or value is not qualified rental income for purposes of the 75-percent or 95-percent REIT income tests.[522] An exception to the general rule also exists in the case of a TRS that rents space in a building owned by its parent REIT if at least 90 percent of the space in the building is rented to unrelated parties and the rent paid by the TRS to the REIT is comparable to the rent paid by the unrelated parties.[523]

REITs are subject to a tax equal to 100 percent of redetermined rents, redetermined deductions, and excess interest. These are defined generally as the amounts of specified REIT

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[518] Sec. 856(c)(4). In the case of such an acquisition, the REIT also has a grace period of 30 days after the close of the quarter to eliminate the discrepancy.

[519] The latter restriction does not apply to rights provided to an independent contractor to operate or manage a lodging or health care facility if such rights are held by the corporation as a franchisee, licensee, or in similar capacity and such lodging facility or health care facility is either owned by such corporation or is leased by such corporation from the REIT. Sec. 856(l)(3).

[520] An independent contractor will not fail to be treated as such for this purpose because the TRS bears the expenses of operation of the facility under the contract, or because the TRS receives the revenues from the operation of the facility, net of expenses for such operation and fees payable to the operator pursuant to the contract, or both. Sec. 856(d)(9)(B).

[521] Sec. 856(d)(8)(B).

[522] Sec. 856(d)(2)(B).

[523] Sec. 856(d)(8)(A).

transactions with a TRS of the REIT, to the extent such amounts differ from an arm's length amount.[524]

Prohibited transactions tax

REITs are subject to a prohibited transaction tax ("PTT") of 100 percent of the net income derived from prohibited transactions. For this purpose, a prohibited transaction is a sale or other disposition of property by the REIT that is "stock in trade of a taxpayer or other property which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held for sale to customers by the taxpayer in the ordinary course of his trade or business"[525] and is not foreclosure property. The PTT for a REIT does not apply to a sale if the REIT satisfies certain safe harbor requirements in section 857(b)(6)(C) or (D), including an asset holding period of at least two years.[526] If the conditions are met, a REIT may either (1) make no more than seven sales within a taxable year (other than sales of foreclosure property or involuntary conversions under section 1033), or (2) sell either no more than 10 percent of the aggregate bases, or no more than 10 percent of the aggregate fair market value, of all its assets as of the beginning of the taxable year (computed without regard to sales of foreclosure property or involuntary conversions under section 1033), without being subject to the PTT tax.[527]

REIT shareholder tax treatment

Although a REIT typically does not pay corporate level tax due to the deductible distribution of its income, and thus is sometimes compared to a partnership or S corporation, REIT equity holders are not treated as being engaged in the underlying activities of the REIT as are partners or S corporation shareholders, and the activities at the REIT level that characterize its income do not generally flow through to equity owners to characterize the tax treatment of REIT distributions to them. A distribution to REIT shareholders out of REIT earnings and profits is generally treated as an ordinary income REIT dividend and is treated as ordinary income taxed at the shareholder's normal rates on such income.[528] However, a REIT is

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[524] Sec. 857(b)(7).

[525] This definition is the same as the definition of certain property the sale or other disposition of which would produce ordinary income rather than capital gain under section 1221(a)(1).

[526] Additional requirements for the safe harbor limit the amount of expenditures the REIT can make during the two-year period prior to the sale that are includible in the adjusted basis of the property, require marketing to be done by an independent contractor, and forbid a sales price that is based on the income or profits of any person.

[527] Sec. 857(b)(6).

[528] Because a REIT dividend is generally paid out of income that was not taxed to the distributing entity, the dividend is not eligible for the dividends received deductions to a corporate shareholder. Sec. 243(d)(3). A REIT dividend is not eligible for the 20 percent qualified dividend rate to an individual shareholder, except to the extent such dividend is attributable to REIT income from nondeductible C corporation dividends, or to certain income of the REIT that was subject to corporate level tax. Sec. 857(c).

permitted to designate a "capital gain dividend" to the extent a distribution is made out of its net capital gain.[529] Such a dividend is treated as capital gain to the shareholders.[530]

REIT shareholders are not taxed on REIT income unless the income is distributed to them (except in the case of REIT net capital gain retained by the REIT and designated for inclusion in the shareholder's income as explained in the preceding footnote). However, since a REIT must distribute 90 percent of its ordinary income annually, and typically will distribute or designate its income as capital gain dividends to avoid a tax at the REIT level, REIT income generally is taxed in full at the shareholder level annually.

REIT shareholders are not entitled to any share of REIT losses to offset against other shareholder income. However, if the REIT itself has income, its losses offset its income in determining how much it is required to distribute to meet the distribution requirements. Also, REIT losses that reduce earnings and profits can cause a distribution that exceeds the REIT's earnings and profits to be treated as a nontaxable return of capital to its shareholders.

Tax exempt shareholders

A tax exempt shareholder is exempt from tax on REIT dividends, and is not treated as engaging in any of the activities of the REIT. As one example, if the REIT borrowed money and its income at the REIT level were debt-financed, a tax exempt shareholder would not have debt-financed unrelated business income from the REIT dividend.

Foreign shareholders

Except as provided by the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")[531] a REIT shareholder that is a foreign corporation or a nonresident alien individual normally treats its dividends as fixed and determinable annual and periodic income that is subject to withholding under section 1441 but not treated as active business income that is effectively connected with the conduct of a U.S. trade or business, regardless of the level of real estate activity of the REIT in the United States.[532] A number of treaties permit a lower rate of withholding on REIT dividends than the Code would otherwise require.

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[529] Sec. 857(b)(3)(C). Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the taxable year. Sec. 1222.

[530] A REIT may also retain its net capital gain without distribution, while designating a capital gain dividend for inclusion in shareholder income. In this case, the REIT pays corporate-level tax on the capital gain, but the shareholder includes the undistributed capital gain in income, receives a credit for the corporate level tax paid, and steps up the basis of the REIT stock for the amount included in income, with the result that the net tax paid is the shareholder level capital gain tax. Sec. 857(b)(3)(D).

[531] Pub. L. No. 96-499. FIRPTA treats income of a foreign investor from the sale or disposition of U.S. real property interests as effectively connected with the operation of a trade or business in the U.S. Such income is taxed at regular U.S. rates and withholding obligations are imposed on payors of the income. Secs. 897 and 1445.

[532] As noted above, REITs are not permitted to receive income from property that is inventory or that is held for sale to customers in the ordinary course of the REIT's business. However, REITs may engage in certain

Although FIRPTA applies in many cases to foreign investment in U.S. real property through a REIT, REITs offer foreign investors some ability to invest in U.S real property interests without subjecting gain on the sale of REIT stock to FIRPTA (for example, if the REIT is domestically controlled).[533] Also, if the REIT stock is publicly traded and the foreign investor does not own more than five percent of such stock, the investor can receive distributions from the sale by the REIT of U.S. real property interests without such distributions being subject to FIRPTA.[534]

1. Restriction on tax-free spinoffs involving REITs (sec. 311 of the bill and sec. 355 of the Code)

Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) to its shareholders as if the corporation had sold such property for its fair market value.[535] In addition, the shareholders receiving the distributed property are ordinarily treated as receiving a dividend equal to the value of the distribution (to the extent of the distributing corporation's earnings and profits),[536] or capital gain in the case of a stock buyback that significantly reduces the shareholder's interest in the parent corporation.[537]

An exception to these rules applies if the distribution of the stock of a controlled corporation satisfies the requirements of section 355. If all the requirements are satisfied, there is no tax to the distributing corporation or to the shareholders on the distribution.

One requirement to qualify for tax-free treatment under section 355 is that both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least five years and was not acquired in a taxable transaction during that period (the "active business test").[538]

For this purpose, the active business test is satisfied only if (1) immediately after the distribution, the corporation is engaged in the active conduct of a trade or business, or (2)

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activities, including acquisition, development, lease, and sale of real property, and may provide "customary services" to tenants.

[533] Sec. 897(h)(2).

[534] Sec. 897(h)(1).

[535] Sec. 311(b).

[536] Sec. 301(b)(1) and (c)(1).

[537] Sec. 302(a) and (b)(2).

[538] Sec. 355(b).

immediately before the distribution, the corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.[539] For this purpose, the active business test is applied by reference to the relevant affiliated group rather than on a single corporation basis. For the parent distributing corporation, the relevant affiliated group consists of the distributing corporation as the common parent and all corporations affiliated with the distributing corporation through stock ownership described in section 1504(a)(1) (regardless of whether the corporations are otherwise includible corporations under section 1504(b)),[540] immediately after the distribution. The relevant affiliated group for a controlled distributed subsidiary corporation is determined in a similar manner (with the controlled corporation as the common parent).

In determining whether a corporation is directly engaged in an active trade or business that satisfies the requirement, IRS ruling practice formerly required that the value of the gross assets of the trade or business being relied on must ordinarily constitute at least five percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.[541] The IRS suspended this specific rule in connection with its general administrative practice of moving IRS resources away from advance rulings on factual aspects of section 355 transactions in general.[542]

Section 355 does not apply to an otherwise qualifying distribution if, immediately after the distribution, either the distributing or the controlled corporation is a disqualified investment corporation and any person owns a 50 percent interest in such corporation and did not own such an interest before the distribution. A disqualified investment corporation is a corporation of which two-thirds or more of its asset value is comprised of certain passive investment assets. Real estate is not included as such an asset.[543]

The IRS has ruled that a REIT may satisfy the active business requirement through its rental activities.[544] More recently, the IRS has issued a private ruling indicating that a REIT that

[539] Sec. 355(b)(1).

[540] Sec. 355(b)(3).

[541] Rev. Proc. 2003-3, sec. 4.01(30), 2003-1 I.R.B. 113.

[542] Rev. Proc. 2003-48, 2003-29 I.R.B. 86. Since then, the IRS discontinued private rulings on whether a transaction generally qualifies for nonrecognition treatment under section 355. Nonetheless, the IRS may still rule on certain significant issues. See Rev. Proc. 2015-1, 2015-1 I.R.B. 1; Rev. Proc. 2015-3, 2015-1 I.R.B. 129. More recently, the IRS announced that it will not rule in certain situations in which property owned by any distributing or controlled corporation becomes the property of a RIC or a REIT; however, the IRS stated that the policy did not extend to situations in which, immediately after the date of the distribution, both the distributing and controlled corporation will be RICs, or both of such corporations will be REITs, and there is no plan or intention on the date of the distribution for either the distributing or the controlled corporation to cease to be a RIC or a REIT. See Rev. Proc. 2015-43, 2015-40 I.R.B. 467.

[543] Sec. 355(g).

[544] Rev. Rul. 2001- 29, 2001-1 C.B. 1348.

has a TRS can satisfy the active business requirement by virtue of the active business of its TRS.[545] Thus, a C corporation that owns REIT-qualified assets may create a REIT to hold such assets and spin off that REIT without tax consequences (if the newly-formed REIT satisfies the active business requirement through its rental activities or the activities of a TRS). Following the spin-off, income from the assets held in the REIT is no longer subject to corporate level tax (unless there is a disposition of such assets that incurs tax under the built in gain rules).

Explanation of Provision

The provision makes a REIT generally ineligible to participate in a tax-free spin-off as either a distributing or controlled corporation under section 355. There are two exceptions, however. First, the general rule does not apply if, immediately after the distribution, both the distributing and the controlled corporations are REITs. Second, a REIT may spin off a TRS if (1) the distributing corporation has been a REIT at all times during the 3-year period ending on the date of the distribution, (2) the controlled corporation has been a TRS of the REIT at all times during such period, and (3) the REIT has had control (as defined in section 368(c)[546] applied by taking into account stock owned directly or indirectly, including through one or more partnerships, by the REIT) of the TRS at all times during such period.

A controlled corporation will be treated as meeting the control requirements if the stock of such corporation was distributed by a TRS in a transaction to which section 355 (or so much of section 356 as relates to section 355) applies and the assets of such corporation consist solely of the stock or assets of assets held by one or more TRSs of the distributing corporation meeting the control requirements noted above. For this purpose, control of a partnership means ownership of 80 percent of the profits interest and 80 percent of the capital interests.

If a corporation that is not a REIT was a distributing or controlled corporation with respect to any distribution to which section 355 applied, such corporation (and any successor corporation) shall not be eligible to make a REIT election for any taxable year beginning before the end of the 10-year period beginning on the date of such distribution.

Effective Date

The provision generally applies to distributions on or after December 7, 2015, but does not apply to any distribution pursuant to a transaction described in a ruling request initially submitted to the Internal Revenue Service on or before such date, which request has not been withdrawn and with respect to which a ruling has not been issued or denied in its entirety as of such date.

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[545] Priv. Ltr. Rul. 201337007. A private ruling may be relied upon only by the taxpayer to which it is issued. However, private rulings provide some indication of administrative practice.

[546] Under section 368(c), the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

2. Reduction in percentage limitation on assets of REIT which may be taxable REIT subsidiaries (sec. 312 of the bill and sec. 856 of the Code)

Present Law

A REIT generally is not permitted to own securities representing more than 10 percent of the vote or value of any entity, nor is it permitted to own securities of a single issuer comprising more than 5 percent of REIT value.[547] In addition, rents received by a REIT from a corporation of which the REIT directly or indirectly owns more than 10 percent of the vote or value generally are not qualified rents for purposes of the 75-percent and 95-percent income tests.[548]

There is an exception from these rules in the case of a TRS.[549] No more than 25 percent of the value of total REIT assets may consist of securities of one or more TRSs, however.[550]

Explanation of Provision

The provision reduces to 20 percent the permitted percentage of total REIT assets that may be securities of one or more TRSs.

Effective Date

The provision applies to taxable years beginning after December 31, 2017.

3. Prohibited transaction safe harbors (sec. 313 of the bill and sec. 857 of the Code)

Present Law

REITs are subject to a prohibited transaction tax ("PTT") of 100 percent of the net income derived from prohibited transactions. For this purpose, a prohibited transaction is a sale or other disposition of property by the REIT that is "stock in trade of a taxpayer or other property which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held for sale to customers by the taxpayer in the ordinary course of his trade or business"[551] and is not foreclosure property. The PTT for a REIT does not apply to a sale if the REIT satisfies certain safe harbor requirements in section 857(b)(6)(C) or (D),

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[547] Sec. 856(c)(4)(B)(iii).

[548] Sec. 856(d)(2)(B).

[549] Sec. 856(d)(8).

[550] Sec. 856(c)(4)(B)(ii).

[551] This definition is the same as the definition of certain property the sale or other disposition of which would produce ordinary income rather than capital gain under section 1221(a)(1).

including an asset holding period of at least two years.[552] If the conditions are met, a REIT may either (1) make no more than seven sales within a taxable year (other than sales of foreclosure property or involuntary conversions under section 1033), or (2) sell either no more than 10 percent of the aggregate bases, or no more than 10 percent of the aggregate fair market value, of all its assets as of the beginning of the taxable year (computed without regard to sales of foreclosure property or involuntary conversions under section 1033), without being subject to the PTT tax.[553]

The additional requirements for the safe harbor limit the amount of expenditures the REIT or a partner of the REIT can make during the two-year period prior to the sale that are includible in the adjusted basis of the property. Also, if more than seven sales are made during the taxable year, substantially all marketing and development expenditures with respect to the property must have been made through an independent contractor from whom the REIT itself does not derive or receive any income.

Explanation of Provision

The provision expands the amount of property that a REIT may sell in a taxable year within the safe harbor provisions, from 10 percent of the aggregate basis or fair market value, to 20 percent of the aggregate basis or fair market value. However, in any taxable year, the aggregate adjusted bases and the fair market value of property (other than sales of foreclosure property or sales to which section 1033 applies) sold during the three taxable year period ending with such taxable year may not exceed 10 percent of the sum of the aggregate adjusted bases or the sum of the fair market value of all of the assets of the REIT as of the beginning of each of the 3 taxable years that are part of the period.

The provision clarifies that the determination of whether property is described in section 1221(a)(1) is made without regard to whether or not such property qualifies for the safe harbor from the prohibited transactions rules.

Effective Date

The provision generally applies to taxable years beginning after the date of enactment. However, the provision clarifying the determination of whether property is described in section 1221(a)(1) has retroactive effect, but does not apply to any sale of property to which section 857(b)(6)(G) applies.

[552] Additional requirements for the safe harbor limit the amount of expenditures the REIT can make during the two-year period prior to the sale that are includible in the adjusted basis of the property, require marketing to be done by an independent contractor, and forbid a sales price that is based on the income or profits of any person.

[553] Sec. 857(b)(6).

4. Repeal of preferential dividend rule for publicly offered REITS; authority for alternative remedies to address certain REIT distribution failures (secs. 314 and 315 of the bill and sec. 562 of the Code)

Present Law

A REIT is allowed a deduction for dividends paid to its shareholders.[554] In order to qualify for the deduction, a dividend must not be a "preferential dividend."[555] For this purpose, a dividend is preferential unless it is distributed pro rata to shareholders, with no preference to any share of stock compared with other shares of the same class, and with no preference to one class as compared with another except to the extent the class is entitled to a preference.

Similar rules apply to regulated investment companies ("RICs").[556] However, the preferential dividend rule does not apply to a publicly offered RIC (as defined in section 67(c)(2)(B)).[557]

Explanation of Provision

The first provision repeals the preferential dividend rule for publicly offered REITs. For this purpose, a REIT is publicly offered if it is required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Exchange Act of 1934.

For other REITs, the second provision provides the Secretary of the Treasury with authority to provide an appropriate remedy to cure the failure of the REIT to comply with the preferential dividend requirements in lieu of not considering the distribution to be a dividend for purposes of computing the dividends paid deduction where the Secretary determines the failure to comply is inadvertent or is due to reasonable cause and not due to willful neglect, or the failure is a type of failure identified by the Secretary as being so described.

Effective Date

The provision to repeal the preferential dividend rule for publicly offered REITs applies to distributions in taxable years beginning after December 31, 2014.

The provision granting authority to the Secretary of the Treasury to provide alternative remedies addressing certain REIT distribution failures applies to distributions in taxable years beginning after December 31, 2015.

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[554] Sec. 857(b)(2)(B).

[555] Sec. 562(c).

[556] Sec. 852(b)(2)(D).

[557] Sec. 562(c).

5. Limitations on designation of dividends by REITs (sec. 316 of the bill and sec. 857 of the Code)

Present Law

A REIT that has a net capital gain for a taxable year may designate dividends that it pays or is treated as paying during the year as capital gain dividends.[558] A capital gain dividend is treated by the shareholder as gain from the sale or exchange of a capital asset held more than one year.[559] The amount that may be designated as capital gain dividends for any taxable year may not exceed the REIT's net capital gain for the year.

A REIT may designate dividends that it pays or is treated as paying during the year as qualified dividend income.[560] Qualified dividend income is taxed to individuals at the same tax rate as net capital gain, under rules enacted by the Taxpayer Relief Act of 1997.[561] The amount that may be designated as qualified dividend income for any taxable year is limited to qualified dividend income received by the REIT plus some amounts subject to corporate taxation at the REIT level.

The IRS has ruled that a RIC may designate the maximum amount permitted under each of the provisions allowing a RIC to designate dividends even if the aggregate of all the designated amounts exceeds the total amount of the RIC's dividends distributions.[562]

The IRS also has ruled that if a RIC has two or more classes of stock and it designates the dividends that it pays on one class as consisting of more than that class's proportionate share of a particular type of income, the designations are not effective for federal tax purposes to the extent that they exceed the class's proportionate share of that type of income.[563] The Internal Revenue Service announced that it would provide guidance that RICs and REITs must use in applying the capital gain provision enacted by the Taxpayer Relief Act of 1997.[564] The announcement referred to the designation limitations of Revenue Ruling 89-91.

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[558] Sec. 857(b)(3)(C).

[559] Sec. 857(b)(3)(B).

[560] Sec. 857(c)(2).

[561] Sec. 1(h)(11) enacted in Pub. L. No. 105-34.

[562] Rev. Rul. 2005-31, 2005-1 C.B.1084.

[563] Rev. Rul. 89-81, 1989-1 C.B. 226.

[564] Notice 97-64, 1997-2 C.B. 323. Recently, the IRS modified Notice 97-64 and provided certain new rules for RICs; the designation limitations in Revenue Ruling 89-81, however, continue to apply. Notice 2015-41, 2015-24 I.R.B. 1058.

Explanation of Provision

The provision limits the aggregate amount of dividends designated by a REIT for a taxable year under all of the designation provisions to the amount of dividends paid with respect to the taxable year (including dividends described in section 858 that are paid after the end of the REIT taxable year but treated as paid by the REIT with respect to the taxable year).

The provision provides the Secretary of the Treasury authority to prescribe regulations or other guidance requiring the proportionality of the designation for particular types of dividends (for example, capital gain dividends) among shares or beneficial interests in a REIT.

Effective Date

The provision applies to distributions in taxable years beginning after December 31, 2015.

6. Debt instruments of publicly offered REITs and mortgages treated as real estate assets (sec. 317 of the bill and sec. 856 of the Code)

Present Law

At least 75 percent of the value of a REIT's assets must be real estate assets, cash and cash items (including receivables), and Government securities (the "75-percent asset test").[565] Real estate assets are real property (including interests in real property and mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITS.[566] No more than 25 percent of a REIT's assets may be securities other than such real estate assets.[567]

Except with respect to a TRS, not more than five percent of the value of a REIT's assets may be securities of any one issuer, and the REIT may not possess securities representing more than 10 percent of the outstanding value or voting power of any one issuer.[568] No more than 25 percent of the value of a REIT's assets may be securities of one or more TRSs.[569]

The asset tests must be met as of the close of each quarter of a REIT's taxable year.[570]

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565 Sec. 856(c)(4)(A).

566 Such term also includes any property (not otherwise a real estate asset) attributable to the temporary investment of new capital, but only if such property is stock or a debt instrument, and only for the one-year period beginning on the date the REIT receives such capital. Sec. 856(c)(5)(B).

567 Sec. 856(c)(4)(B)(i).

568 Sec. 856(c)(4)(B)(iii).

569 Sec. 856(c)(4)(B)(ii).

570 Sec. 856(c)(4). However, a REIT that has met the asset tests as of the close of any quarter does not lose its REIT status solely because of a discrepancy during a subsequent quarter between the value of the REIT's

At least 75 percent of a REIT's gross income must be from certain real estate related and other items. In addition, at least 95 percent of a REIT's gross income must be from specified sources that include the 75 percent items and also include interest, dividends, and gain from the sale or other disposition of securities (whether or not real estate related).

Explanation of Provision

Under the provision, debt instruments issued by publicly offered REITs are treated as real estate assets, as are interests in mortgages on interests in real property (for example, an interest in a mortgage on a leasehold interest in real property). Such assets therefore are qualified assets for purposes of meeting the 75-percent asset test, but are subject to special limitations described below.

As under present law, income from debt instruments issued by publicly offered REITs that is interest income or gain from the sale or other disposition of a security is treated as qualified income for purposes of the 95-percent gross income test. Income from debt instruments issued by publicly offered REITs that would not have been treated as real estate assets but for the new provision, however, is not qualified income for purposes of the 75-percent income test, and not more than 25 percent of the value of a REIT's total assets is permitted to be represented by such debt instruments.

Effective Date

The provision is effective for taxable years beginning after December 31, 2015.

7. Asset and income test clarification regarding ancillary personal property (sec. 318 of the bill and sec. 856 of the Code)

Present Law

75-percent income test

Among other requirements, at least 75 percent of the gross income of a REIT in each taxable year must consist of real estate related income. Such income includes: rents from real property; income from the sale or exchange of real property (including interests in real property) that is not stock in trade, inventory, or held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business; interest on mortgages secured by real property or interests in real property; and certain income from foreclosure property (the "75-percent income test"). Amounts attributable to most types of services provided to tenants (other than certain "customary services"), or to more than specified amounts of personal property, are not qualifying rents.

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investments and such requirements, unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition. Sec. 856(c)(4).

The Code definition of rents from real property includes rent attributable to personal property which is leased under, or in connection with, a lease of real property, but only if the rent attributable to such property for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease.[571]

For purposes of determining whether interest income is from a mortgage secured by real property, Treasury regulations provide that where a mortgage covers both real property and other property, an apportionment of the interest must be made. If the loan value of the real property is equal to or exceeds the amount of the loan, then the entire interest income is apportioned to the real property. However, if the amount of the loan exceeds the loan value of the real property, then the interest income apportioned to the real property is an amount equal to the interest income multiplied by a fraction, the numerator of which is the loan value of the real property and the denominator of which is the amount of the loan.[572] The remainder of the interest income is apportioned to the other property.

The loan value of real property is defined as the fair market value of the property determined as of the date on which the commitment by the REIT to make the loan becomes binding on the REIT. In the case of a loan purchased by a REIT, the loan value of the real property is the fair market value of the real property determined as of the date on which the commitment of the REIT to purchase the loan becomes binding.[573]

75-percent asset test

At the close of each quarter of the taxable year, at least 75 percent of the value of a REIT's total assets must be represented by real estate assets, cash and cash items, and Government securities.

Real estate assets generally mean real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs.

Neither the Code nor regulations address the allocation of value in cases where real property and personal property may both be present.

Explanation of Provision

The provision allows certain ancillary personal property leased with real property to be treated as real property for purposes of the 75-percent asset test, applying the same threshold that

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[571] Sec. 856(d)(1)(C).

[572] Treas. Reg. sec. 1.856-5(c)(1). The amount of the loan for this purpose is defined as the highest principal amount of the loan outstanding during the taxable year. Treas. Reg. sec. 1.856-5(c)(3).

[573] Special rules apply to construction loans. Treas. Reg. sec. 1.856-5(c)(2).

applies under present law for purposes of determining rents from real property under section 856(d)(l)(C) for purposes of the 75-percent income test.

The provision also modifies the present law rules for determining when an obligation secured by a mortgage is considered secured by a mortgage on real property if the security includes personal property as well. Under the provision, in the case of an obligation secured by a mortgage on both real property and personal property, if the fair market value of such personal property does not exceed 15 percent of the total fair market value of all such property, such personal property is treated as real property for purposes of the 75-percent income and 75-percent asset test computations.[574] In making this determination, the fair market value of all property (both personal and real) is determined at the same time and in the same manner as the fair market value of real property is determined for purposes of apportioning interest income between real property and personal property under the rules for determining whether interest income is from a mortgage secured by real property.

Effective Date

The provision is effective for taxable years beginning after December 31, 2015.

8. Hedging provisions (sec. 319 of the bill and sec. 857 of the Code)

Present Law

Except as provided by Treasury regulations, income from certain REIT hedging transactions that are clearly identified, including gain from the sale or disposition of such a transaction, is not included as gross income under either the 95-percent income or 75-percent income test. Transactions eligible for this exclusion include transactions that hedge indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets and transactions entered primarily to manage risk of currency fluctuations with respect to items of income or gain described in section 856(c)(2) or (3).[575]

Explanation of Provision

The provision expands the scope of the present-law exception of certain hedging income from gross income for purposes of the income tests, under section 856(c)(5)(G). Under the provision, if (1) a REIT enters into one or more positions described in clause (i) of section 856(c)(5)(G) with respect to indebtedness described therein or one or more positions described in clause (ii) of section 856(c)(5)(G) with respect to property that generates income or gain described in section 856(c)(2) or (3); (2) any portion of such indebtedness is extinguished or any portion of such property is disposed of; and (3) in connection with such extinguishment or disposition, such REIT enters into one or more transactions which would be hedging transactions described in subparagraph (B) or (C) of section 1221(b)(2) with respect to any position referred

[574] Sec. 856(c)(3)(B) and (4)(A).

[575] Sec. 856(c)(5)(G).

to in (1) above, if such position were ordinary property,[576] then any income of such REIT from any position referred to in (1) and from any transaction referred to in (3) (including gain from the termination of any such position or transaction) shall not constitute gross income for purposes of the 75-percent or 95-percent gross income tests, to the extent that such transaction hedges such position.

The provision is intended to extend the current treatment of income from certain REIT hedging transactions as income that is disregarded for purposes of the 75-percent and 95-percent income tests to income from positions that primarily manage risk with respect to a prior hedge that a REIT enters in connection with the extinguishment or disposal (in whole or in part) of the liability or asset (respectively) related to such prior hedge, to the extent the new position qualifies as a section 1221 hedge or would so qualify if the hedged position were ordinary property.

The provision also clarifies that the identification requirement that applies to all hedges under the hedge gross income rules is the requirement described in section 1221(a)(7), determined after taking account of any curative provisions provided under the regulations referred to therein.

Effective Date

The provision is effective for taxable years beginning after December 31, 2015.

9. Modification of REIT earnings and profits calculation to avoid duplicate taxation (sec. 320 of the bill and secs. 562 and 857 of the Code)

Present Law

For purposes of computing earnings and profits of a corporation, the alternative depreciation system, which generally is less accelerated than the system used in determining taxable income, is used in the case of the depreciation of tangible property. Also, certain amounts treated as currently deductible for purposes of computing taxable income are allowed as a deduction ratably over a period of five years for computing earnings and profits. Finally, the installment method is not allowed in computing earnings and profits from the installment sale of property.[577]

In the case of a REIT, the current earnings and profits of a REIT are not reduced by any amount which is not allowable as a deduction in computing its taxable income for the taxable year.[578] In addition, for purposes of computing the deduction for dividends paid by a REIT for a

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[576] Such definition of a hedging transaction is applied for purposes of this provision without regard to whether or not the position referred to is ordinary property.

[577] Sec. 312(k)(3) and (n)(5).

[578] Sec. 857(d)(1). This provision applies to a REIT without regard to whether it meets the requirements of section 857(a) for the taxable year.

taxable year, earnings and profits are increased by the total amount of gain on the sale or exchange of real property by the trust during the year.[579]

These rules can by illustrated by the following example:

Example.–Assume that a REIT had $100 of taxable income and earnings and profits in each of five consecutive taxable years (determined without regard to any energy efficient commercial building deduction[580] and without regard to any deduction for dividends paid). Assume that in 2014 (the first of the five years),[581] the REIT had an energy efficient commercial building deduction in computing its taxable income of $10, reducing its pre-dividend taxable income to $90. Assume further that the deduction is allowable at a rate of $2 per year over the five-year period beginning with the first year in computing its earnings and profits.

Under present law, the REIT's earnings and profits in the first year are $98 ($100 less $2). In each of the next four years, the REIT's current earnings and profits are $100 ($98 as computed for year 1 plus an additional $2 under section 857(d)(1) for the $2 not deductible in computing taxable income for the year).

Assume the REIT distributes $100 to its shareholders at the close of each of the five years. Under present law, the shareholders have $98 dividend income in the first year and a $2 return of capital and $100 dividend income in each of the following four years, for a total of $498 dividend income, notwithstanding that the REIT had only $490 pre-dividend taxable income over the period. The dividends paid by the REIT reduce its taxable income to zero in each of the taxable years.

Explanation of Provision

Under the provision, the current earnings and profits of a REIT for a taxable year are not reduced by any amount that (1) is not allowable as a deduction in computing its taxable income for the current taxable year and (2) was not so allowable for any prior taxable year. Thus, under the provision, if an amount is allowable as a deduction in computing taxable income in year one and is allowable in computing earnings and profits in year two (determined without regard to present-law section 857(d)(1)), section 857(d)(1) no longer applies and the deduction in computing the year two earnings and profits of the REIT is allowable. Thus, a lesser maximum amount will be a dividend to shareholders in that year. This provision does not change the present-law determination of current earnings and profits for purposes of computing a REIT's deduction for dividends paid.

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[579] Sec. 562(e).

[580] Sec. 179D.

[581] The energy efficient commercial buildings deduction under section 179D has currently expired for property placed in service after December 31, 2014. Sec. 179D(h).

In addition, the provision provides that the current earnings and profits of a REIT for a taxable year for purposes of computing the deduction for dividends paid are increased by any amount of gain on the sale or exchange of real property taken into account in determining the taxable income of the REIT for the taxable year (to the extent the gain is not otherwise so taken into account). Thus, in the case of an installment sale of real property, current earnings and profits for purposes of the REIT's deduction for dividends paid for a taxable year are increased by the amount of gain taken into account in computing its taxable income for the year and not otherwise taken into account in computing the current earnings and profits.

The following illustrates the application of the provision:

Example.−Assume the same facts as in the above example. Under the provision, as under present law, in the first taxable year, the earnings and profits of the REIT were $98 and the shareholders take into account $98 dividend income and $2 is a return of capital. Under the provision, in each of the next four years, the earnings and profits are $98 (*i.e.*, section 857(d)(1) does not apply) so that the shareholders take into account $98 of dividend income in each year and $2 is a return of capital each year.

For purposes of the REIT's deduction for dividends paid, present law remains unchanged so that the REIT's taxable income will be reduced to zero in each of the taxable years.

Effective Date

The provision is effective for taxable years beginning after December 31, 2015.

10. Treatment of certain services provided by taxable REIT subsidiaries (sec. 321 of the bill and sec. 857 of the Code)

Present Law

Taxable REIT subsidiaries

A TRS generally can engage in any kind of business activity except that it is not permitted directly or indirectly to operate either a lodging facility or a health care facility, or to provide to any other person (under a franchise, license, or otherwise) rights to any brand name under which any lodging facility or health care facility is operated.

REITs are subject to a tax equal to 100 percent of redetermined rents, redetermined deductions, and excess interest. These are defined generally as the amounts of specified REIT transactions with a TRS of the REIT, to the extent such amounts differ from an arm's length amount.

Prohibited transactions tax

REITs are subject to a prohibited transaction tax ("PTT") of 100 percent of the net income derived from prohibited transactions.[582] For this purpose, a prohibited transaction is a sale or other disposition of property by the REIT that is stock in trade of a taxpayer or other property that would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held for sale to customers by the taxpayer in the ordinary course of his trade or business and is not foreclosure property. The PTT for a REIT does not apply to a sale of property which is a real estate asset if the REIT satisfies certain criteria in section 857(b)(6)(C) or (D).

Section 857(b)(6)(C) provides that a prohibited transaction does not include a sale of property which is a real estate asset (as defined in section 856(c)(5)(B)) and which is described in section 1221(a)(1) if (1) the REIT has held the property for not less than two years; (2) aggregate expenditures made by the REIT, or any partner of the REIT, during the two year period preceding the date of sale which are includible in the basis of the property do not exceed 30 percent of the net selling price of the property; (3) either: (A) the REIT does not make more than seven sales of property[583] during the taxable year, or (B) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property[584] sold during the taxable year does not exceed 10 percent of the aggregate bases (as so determined) of all of the assets of the REIT as of the beginning of the taxable year, or (C) the fair market value of property[585] sold during the taxable year does not exceed 10 percent of the aggregate fair market value of all the assets of the REIT as of the beginning of the taxable year; (4) in the case of land or improvements, not acquired through foreclosure (or deed in lieu of foreclosure), or lease termination, the REIT has held the property for not less than two years for production of rental income; and (5) if the requirement of (3)(A) above is not satisfied, substantially all of the marketing and development expenditures with respect to the property were made through an independent contractor (as defined in section 856(d)(3)) from whom the REIT does not derive or receive any income.

Section 857(b)(6)(D) provides that a prohibited transaction does not include a sale of property which is a real estate asset (as defined in section 856(c)(5)(B)) and which is described in section 1221(a)(1) if (1) the REIT has held the property for not less than two years in connection with the trade or business of producing timber; (2) the aggregate expenditures made by the REIT, or any partner of the REIT, during the two year period preceding the date of sale which (A) are includible in the basis of the property (other than timberland acquisition expenditures), and (B) are directly related to operation of the property for the production of timber or for the preservation of the property for use as a timberland, do not exceed 30 percent of

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[582] Sec. 857(b)(6).

[583] Sales of foreclosure property or sales to which section 1033 applies are excluded.

[584] Sales of foreclosure property or sales to which section 1033 applies are excluded.

[585] Sales of foreclosure property or sales to which section 1033 applies are excluded.

the net selling price of the property; (3) the aggregate expenditures made by the REIT, or a partner of the REIT, during the two year period preceding the date of sale which (A) are includible in the basis of the property (other than timberland acquisition expenditures), and (B) are not directly related to operation of the property for the production of timber or for the preservation of the property for use as a timberland, do not exceed five percent of the net selling price of the property; (4) either: (A) the REIT does not make more than seven sales of property[586] during the taxable year, or (B) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property[587] sold during the taxable year does not exceed 10 percent of the aggregate bases (as so determined) of all of the assets of the REIT as of the beginning of the taxable year, or (C) the fair market value of property[588] sold during the taxable year does not exceed 10 percent of the aggregate fair market value of all the assets of the REIT as of the beginning of the taxable year; (5) if the requirement of (4)(A) above is not satisfied, substantially all of the marketing expenditures with respect to the property were made through an independent contractor (as defined in section 856(d)(3)) from whom the REIT does not derive or receive any income, or, in the case of a sale on or before the termination date, a TRS; and (6) the sales price of the property sold by the trust is not based in whole or in part on income or profits derived from the sale or operation of such property.

Foreclosure property

Under current law, certain income and gain derived from foreclosure property satisfies the 95-percent and 75-percent REIT income tests.[589] Property will cease to be foreclosure property, however, if used in a trade or business conducted by the REIT, other than through an independent contractor from which the REIT itself does not derive or receive any income, more than 90 days after the day on which the REIT acquired such property.[590]

Explanation of Provision

For purposes of the exclusion from the prohibited transactions excise tax, the provision modifies the requirement of section 857(b)(6)(C)(v), that substantially all of the development expenditures with respect to the property were made through an independent contractor from whom the REIT itself does not derive or receive any income, to allow a TRS to have developed the property.[591]

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[586] Sales of foreclosure property or sales to which section 1033 applies are excluded.

[587] Sales of foreclosure property or sales to which section 1033 applies are excluded.

[588] Sales of foreclosure property or sales to which section 1033 applies are excluded.

[589] Sec. 856(c)(2)(F) and (3)(F).

[590] Sec. 856(e)(4)(C).

[591] The requirement limiting the amount of expenditures added to basis that the REIT, or a partner of the REIT, may make within two years prior to the sale, as well as other requirements for the exclusion, are retained.

The provision also allows a TRS to make marketing expenditures with respect to property under section 857(b)(6)(C)(v) or 857(b)(6)(D)(v) without causing property that is otherwise eligible for the prohibited transaction exclusion to lose such qualification.

The provision allows a TRS to operate foreclosure property without causing loss of foreclosure property status, under section 856(e)(4)(C).

The items subject to the 100-percent excise tax on certain non-arm's-length transactions between a TRS and a REIT are expanded to include "redetermined TRS service income." Such income is defined as gross income of a TRS of a REIT attributable to services provided to, or on behalf of, such REIT (less the deductions properly allocable thereto) to the extent the amount of such income (less such deductions) would be increased on distribution, apportionment, or allocation under section 482 (but for the exception from section 482 if the 100-percent excise tax applies). The term does not include gross income attributable to services furnished or rendered to a tenant of the REIT (or deductions properly attributable thereto), since that income is already subject to a separate provision of the 100-percent excise tax rules.

Effective Date

The provision is effective for taxable years beginning after December 31, 2015.

11. Exception from FIRPTA for certain stock of REITs; exception for interests held by foreign retirement and pension funds (secs. 322 and 323 of the bill and secs. 897 and 1445 of the Code)

Present Law

General rules relating to FIRPTA

A foreign person that is not engaged in the conduct of a trade or business in the United States generally is not subject to any U.S. tax on capital gain from U.S. sources, including capital gain from the sale of stock or other capital assets.[592]

However, the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA")[593] generally treats a foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") as income that is effectively connected with the conduct of a U.S. trade or

[592] Secs. 871(b) and 882(a). Property is treated as held by a person for use in connection with the conduct of a trade or business in the United States, even if not so held at the time of sale, if it was so held within 10 years prior to the sale. Sec. 864(c)(7). Also, all gain from an installment sale is treated as from the sale of property held in connection with the conduct of such a trade or business if the property was so held during the year in which the installment sale was made, even if the recipient of the payments is no longer engaged in the conduct of such trade or business when the payments are received. Sec. 864(c)(6).

[593] Pub. L. No. 96-499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See secs. 897, 1445, 6039C, and 6652(f).

business, and thus taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain.[594] With certain exceptions, if a foreign corporation distributes a USRPI, gain is recognized on the distribution (including a distribution in redemption or liquidation) of a USRPI, in an amount equal to the excess of the fair market value of the USRPI (as of the time of distribution) over its adjusted basis.[595] A foreign person subject to tax on FIRPTA gain is required to file a U.S. tax return under the normal rules relating to receipt of income effectively connected with a U.S. trade or business.[596]

The payor of amounts that FIRPTA treats as effectively connected with a U.S. trade or business ("FIRPTA income") to a foreign person generally is required to withhold U.S. tax from the payment.[597] Withholding generally is 10 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI (but withholding is not required in certain cases, including on any sale of stock that is regularly traded on an established securities market[598]), and 10 percent of the amount realized by the foreign shareholder in the case of certain distributions by a corporation that is or has been a U.S. real property holding corporation ("USRPHC") during the applicable testing period.[599] The withholding is generally 35 percent of the amount of a distribution to a foreign person of net proceeds attributable to the sale of a USRPI from an entity such as a partnership, REIT, or RIC.[600] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's total U.S. effectively connected income and deductions (if any) for the taxable year.

USRPHCs and five-percent public shareholder exception

USRPIs include not only interests in real property located in the United States or the U.S. Virgin Islands, but also stock of a USRPHC, generally defined as any domestic corporation, unless the taxpayer establishes that the fair market value of the corporation's USRPIs was less than 50 percent of the combined fair market value of all its real property interests (U.S. and worldwide) and all its assets used or held for use in a trade or business, at all times during a

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[594] Sec. 897(a).

[595] Sec. 897(d). In addition, such gain may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

[596] In addition, section 6039C authorizes regulations that would require a return reporting foreign direct investments in U.S. real property interests. No such regulations have been issued, however.

[597] Sec. 1445(a).

[598] Sec. 1445(b)(6).

[599] Sec. 1445(e)(3). Withholding at 10 percent of a gross amount may also apply in certain other circumstances under regulations. See sec. 1445(e)(4) and (5).

[600] Sec. 1445(e)(6) and Treasury regulations thereunder. The Treasury Department is authorized to issue regulations that would reduce the 35 percent withholding on distributions to 20 percent during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 20 percent.

"testing period," which is the shorter of the duration of the taxpayer's ownership of the stock after June 18, 1980, or the five-year period ending on the date of disposition of the stock.[601]

Under an exception, even if a corporation is a USRPHC, a shareholder's shares of a class of stock that is regularly traded on an established securities market are not treated as USRPIs if the shareholder holds (applying attribution rules) no more than five percent of that class of stock at any time during the testing period.[602] Among other things, the relevant attribution rules require attribution between a corporation and a shareholder that owns five percent or more in value of the stock of such corporation.[603] The attribution rules also attribute stock ownership between spouses and between children, grandchildren, parents, and grandparents.

FIRPTA rules for foreign investment through REITs and RICs

Special FIRPTA rules apply to foreign investment through a "qualified investment entity," which includes any REIT and certain RICs that invest largely in USRPIs (including stock of one or more REITs).[604]

Stock of domestically controlled qualified investment entities not a USRPI

If a qualified investment entity is "domestically controlled" (defined to mean that less than 50 percent in value of the qualified investment entity has been owned (directly or indirectly) by foreign persons during the relevant testing period[605]), stock of such entity is not a USRPI and a foreign shareholder can sell the stock of such entity without being subject to tax under FIRPTA, even if the stock would otherwise be stock of a USRPHC. Treasury regulations provide that for purposes of determining whether a REIT is domestically controlled, the actual owner of REIT shares is the "person who is required to include in his return the dividends received on the stock."[606] The IRS has issued a private letter ruling concluding that the term

[601] Sec. 897(c)(1) and (2).

[602] Sec. 897(c)(3). The constructive ownership attribution rules are specified in section 897(c)(6)(C).

[603] If a person owns, directly or indirectly, five percent or more in value of the stock in a corporation, such person is considered as owning the stock owned directly or indirectly by or for such corporation, in that proportion which the value of the stock such person so owns bears to the value of all the stock in such corporation. Sec. 318(c)(2)(C) as modified by section 897(c)(6)(C). Also, if five percent or more in value of the stock in a corporation is owned directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person. Sec. 318(c)(3)(C) as modified by section 897(c)(6)(C).

[604] Sec. 897(h)(4)(A)(i). The provision including certain RICs in the definition of qualified investment entity previously expired December 31, 2014. See section 133 of this bill, however, which makes that provision permanent.

[605] The testing period for this purpose if the shorter of (i) the period beginning on June 19, 1980, and ending on the date of disposition or distribution, as the case may be, (ii) the five-year period ending on the date of the disposition or distribution, as the case may be, or (iii) the period during which the qualified investment entity was in existence. Sec. 897(h)(4)(D).

[606] Treas. Reg. sec. 1.897-1(c)(2)(i) and -8(b).

"directly or indirectly" for this purpose does not require looking through corporate entities that, in the facts of the ruling, were represented to be fully taxable domestic corporations for U.S. federal income tax purposes "and not otherwise a REIT, RIC, hybrid entity, conduit, disregarded entity, or other flow-through or look-through entity."[607]

FIRPTA applies to qualified investment entity (REIT and certain RIC) distributions attributable to gain from sale or exchange of USRPIs, except for distributions to certain five-percent or smaller shareholders

A distribution by a REIT or other qualified investment entity, to the extent attributable to gain from the entity's sale or exchange of USRPIs, is treated as FIRPTA income.[608] The FIRPTA character is retained if the distribution occurs from one qualified investment entity to another, through a tier of REITs or RICs.[609] An IRS notice (Notice 2007-55) states that this rule retaining the FIRPTA income character of distributions attributable to the sale of USRPIs applies to any distributions under sections 301, 302, 331, and 332 (*i.e.*, to dividend distributions, distributions treated as sales or exchanges of stock by the investor, and both nonliquidating and liquidating distributions) and that the IRS will issue regulations to that effect.[610]

There is an exception to this rule in the case of distributions to certain public shareholders. If an investor has owned no more than five percent of a class of stock of a REIT or other qualified investment entity that is regularly traded on an established securities market located in the United States during the one-year period ending on the date of the distribution, then amounts attributable to gain from entity sales or exchanges of USRPIs can be distributed to such a shareholder without being subject to FIRPTA tax.[611] Such distributions that are dividends are treated as dividends from the qualified investment entity,[612] and thus generally would be subject to U.S. dividend withholding tax (as reduced under any applicable treaty), but are not treated as income effectively connected with the conduct of a U.S. trade or business. An IRS

[607] PLR 200923001. A private letter ruling may be relied upon only by the taxpayer to which it is issued. However, private letter rulings provide some indication of administrative practice.

[608] Sec. 897(h)(1).

[609] In 2006, the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"), Pub. L. No. 109-222, sec. 505, specified the retention of this FIRPTA character on a distribution to an upper-tier qualified investment entity, and added statutory withholding requirements.

[610] Notice 2007-55, 2007-2 C.B.13. The Notice also states that in the case of a foreign government investor, because FIRPTA income is treated as effectively connected with the conduct of a U.S. trade or business, proceeds distributed by a qualified investment entity from the sale of USRPIs are not exempt from tax under section 892. The Notice cites and compares existing temporary regulations and indicates that Treasury will apply those regulations as well to certain distributions. See Temp. Treas. Reg. secs. 1.892-3T, 1.897-9T(e), and 1.1445-10T(b).

[611] Sec. 897(h)(1), second sentence.

[612] Secs. 852(b)(3)(E) and 857(b)(3)(F).

Chief Counsel advice memorandum concludes that such distributions which are not dividends (because made in a complete liquidation of a REIT) are not subject to tax under FIRPTA.[613]

Explanation of Provisions

Exception from FIRPTA for certain REIT stock

In the case of REIT stock only, the provision increases from five percent to 10 percent the maximum stock ownership a shareholder may have held, during the testing period, of a class of stock that is publicly traded, to avoid having that stock be treated as a USRPI on disposition.

The provision likewise increases from five percent to 10 percent the percentage ownership threshold that, if not exceeded, results in treating a distribution to holders of publicly traded REIT stock, attributable to gain from sales of exchanges of USRPIs, as a dividend, rather than as FIRPTA gain.

The attribution rules of section 897(c)(6)(C) retain the present-law rule that requires attribution between a shareholder and a corporation if the shareholder owns more than five percent of a class of stock of the corporation. The attribution rules now apply, however, to the determination of whether a person holds more than 10 percent of a class of publicly traded REIT stock.

The provision also provides that REIT stock held by a qualified shareholder, including stock held indirectly through one or more partnerships, is not a U.S real property interest in the hands of such qualified shareholder, except to the extent that an investor in the qualified shareholder (other than an investor that is a qualified shareholder) holds more than 10 percent of that class of stock of the REIT (determined by application of the constructive ownership rules of section 897(c)(6)(C)). Thus, so long as the “more than 10 percent” rule is not exceeded, a qualified shareholder may own and dispose of any amount of stock of a REIT (including stock of a privately-held, non-domestically controlled REIT that is owned by such qualified shareholder) without the application of FIRPTA.

If an investor in the qualified shareholder (other than an investor that is a qualified shareholder) directly, indirectly, or constructively holds more than 10 percent of such class of REIT stock (an “applicable investor”), then a percentage of the REIT stock held by the qualified shareholder equal to the applicable investor’s percentage ownership of the qualified shareholder is treated as a USRPI in the hands of the qualified shareholder and is subject to FIRPTA. In that case, an amount equal to such percentage multiplied by the disposition proceeds and REIT distribution proceeds attributable to underlying USRPI gain is treated as FIRPTA gain in the hands of the qualified shareholder.

The provision is intended to override in certain cases one of the conclusions reached in AM 2008-003. Specifically, the provision contains special rules with respect to certain distributions that are treated as a sale or exchange of REIT stock under section 301(c)(3), 302, or

[613] AM 2008-003, February 15, 2008.

331 with respect to a qualified shareholder. Any such amounts attributable to an applicable investor are ineligible for the FIRPTA exception for qualified shareholders, and thus are subject to FIRPTA. Any such amounts attributable to other investors are treated as a dividend received from a REIT for purposes of U.S. dividend withholding tax and the application of income tax treaties, notwithstanding their general treatment under the Code as capital gain.

A qualified shareholder is defined as a foreign person that (i) either is eligible for the benefits of a comprehensive income tax treaty which includes an exchange of information program and whose principal class of interests is listed and regularly traded on one or more recognized stock exchanges (as defined in such comprehensive income tax treaty), or is a foreign partnership that is created or organized under foreign law as a limited partnership in a jurisdiction that has an agreement for the exchange of information with respect to taxes with the United States and has a class of limited partnership units representing greater than 50 percent of the value of all the partnership units that is regularly traded on the NYSE or NASDAQ markets, (ii) is a qualified collective investment vehicle (as defined below), and (iii) maintains records on the identity of each person who, at any time during the foreign person's taxable year, is the direct owner of 5 percent or more of the class of interests or units (as applicable) described in (i), above.

A qualified collective investment vehicle is defined as a foreign person that (i) would be eligible for a reduced rate of withholding under the comprehensive income tax treaty described above, even if such entity holds more than 10 percent of the stock of such REIT,[614] (ii) is publicly traded, is treated as a partnership under the Code, is a withholding foreign partnership, and would be treated as a USRPHC if it were a domestic corporation, or (iii) is designated as such by the Secretary of the Treasury and is either (a) fiscally transparent within the meaning of section 894, or (b) required to include dividends in its gross income, but is entitled to a deduction for distributions to its investors.

The provision also contains rules with respect to partnership allocations of USRPI gains to applicable investors. If an applicable investor's proportionate share of USRPI gain for the taxable year exceeds such partner's distributive share of USRPI gain for the taxable year then such partner's distributive share of non-USRPI income or gain is recharacterized as USRPI gain for the taxable year in the amount that the distributive share of USRPI gain exceeds the proportionate share of USRPI gain. For purposes of these partnership allocation rules, USRPI gain is defined to comprise the net of gain recognized on disposition of a USRPI, distributions from a REIT that are treated as USRPI gain, and loss from the disposition of USRPIs. An investor's proportionate share of USRPI gain is determined based on the applicable investor's largest proportionate share of income or gain for the taxable year, and if such proportionate amount may vary during the existence of the partnership, such share is the highest share the applicable investor may receive.

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[614] For example, the U.S. income tax treaties with Australia and the Netherlands provide such a reduced rate of withholding under certain circumstances.

Domestically controlled qualified investment entity

The provision redefines the term "domestically controlled qualified investment entity" to provide a number of new rules and presumptions relating to whether a qualified investment entity is domestically controlled. First, a qualified investment entity shall be permitted to presume that holders of less than five percent of a class of stock regularly traded on an established securities market in the United States are U.S. persons throughout the testing period, except to the extent that the qualified investment entity has actual knowledge that such persons are not U.S. persons. Second, any stock in the qualified investment entity held by another qualified investment entity (I) which has issued any class of stock that is regularly traded on an established stock exchange, or (II) which is a RIC that issues redeemable securities (within the meaning of section 2 of the Investment Company Act of 1940) shall be treated as held by a foreign person unless such other qualified investment entity is domestically controlled (as determined under the new rules) in which case such stock shall be treated as held by a U.S. person. Finally, any stock in a qualified investment entity held by any other qualified investment entity not described in (I) or (II) of the preceding sentence shall only be treated as held by a U.S. person to the extent that the stock of such other qualified investment entity is (or is treated under the new provision as) held by a U.S. person.

Exception for interests held by foreign retirement and pension funds

The provision exempts from the rules of section 897 any USRPI held directly (or indirectly through one or more partnerships) by, or to any distribution received from a real estate investment trust by, a qualified foreign pension fund or by a foreign entity wholly-owned by a qualified foreign pension fund. A qualified foreign pension fund means any trust, corporation, or other organization or arrangement (A) which is created or organized under the law 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 five percent 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 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.

The provision also makes conforming changes to section 1445 to eliminate withholding on sales by qualified foreign pension funds (and their wholly-owned foreign subsidiaries) of USRPIs.

The Secretary of the Treasury may provide such regulations as are necessary to carry out the purposes of the provision.

Effective Date

The provision to extend exceptions from FIRPTA for certain REIT stock applies to dispositions and distributions on or after the date of enactment.

The provision to modify the definition of a domestically controlled REIT is effective on the date of enactment.

The exception for interests held by foreign retirement and pension funds generally applies to dispositions and distributions after the date of enactment.

12. Increase in rate of withholding of tax on dispositions of United States real property interests (sec. 324 of the bill and sec. 1445 of the Code)

Present Law

A purchaser of a USRPI from any person is obligated to withhold 10 percent of gross purchase price unless certain exceptions apply.[615] The obligation does not apply if the transferor furnishes an affidavit that the transferor is not a foreign person. Even absent such an affidavit, the obligation does not apply to the purchase of publicly traded stock.[616] Also, the obligation does not apply to the purchase of stock of a nonpublicly traded domestic corporation, if the corporation furnishes the transferee with an affidavit stating the corporation is not and has not been a USRPHC during the applicable period (unless the transferee has actual knowledge or receives a notification that the affidavit is false).[617]

Treasury regulations[618] generally provide that a domestic corporation must, within a reasonable period after receipt of a request from a foreign person holding an interest in it, inform that person whether the interest constitutes a USRPI.[619] No particular form is required. The statement must be dated and signed by a responsible corporate officer who must verify under

[615] Sec. 1445.

[616] Sec. 1445(b)(6).

[617] Sec. 1445(b)(3). Other exceptions also apply. Sec. 1445(b).

[618] Treas. Reg. Sec. 1.897-2(h).

[619] As described previously, stock of a U.S. corporation is not generally a USRPI unless it is stock of a U.S. real property holding corporation ("USRPHC"). However, all U.S. corporate stock is deemed to be such stock, unless it is shown that the corporation's U.S. real property interests do not amount to the relevant 50 percent or more of the corporation's relevant assets. Also, even if a REIT is a USRPHC, if it is domestically controlled its stock is not a USRPI.

In addition to these exceptions that might be determined at the entity level, even if a corporation is a USRPHC, its stock is not a USRPI in the hands of the seller if the stock is of a class that is publicly traded and the foreign shareholder disposing of the stock has not owned (applying attribution rules) more than five percent of such class of stock during the relevant period.

penalties of perjury that the statement is correct to his knowledge and belief. If a foreign investor requests such a statement, then the corporation must provide a notice to the IRS that includes the name and taxpayer identification number of the corporation as well as the investor, and indicates whether the interest in question is a USRPI. However, these requirements do not apply to a domestically controlled REIT or to a corporation that has issued any class of stock which is regularly traded on an established securities market at any time during the calendar year. In such cases a corporation may voluntarily choose to comply with the notice requirements that would otherwise have applied.[620]

Explanation of Provision

The provision generally increases the rate of withholding of tax on dispositions and certain distributions of URSPIs, from 10 percent to 15 percent. There is an exception to this higher rate of withholding (retaining the 10 percent withholding tax rate under present law) for sales of residences intended for personal use by the acquirer, with respect to which the purchase price does not exceed $1,000,000. Thus, if the present law exception for personal residences (where the purchase price does not exceed $300,000) does not apply, the 10 percent withholding rate is retained so long as the purchase price does not exceed $1,000,000.

Effective Date

The provision applies to dispositions after the date which is 60 days after the date of enactment.

13. Interests in RICs and REITs not excluded from definition of United States real property interests (sec. 325 of the bill and sec. 897 of the Code)

Present Law

An interest in a corporation is not a USRPI if (1) as of the date of disposition of such interest, such corporation did not hold any USRPIs and (2) all of the USRPIs held by such corporation during the shorter of (i) the period of time after June 18, 1980, during which the taxpayer held such interest, or (ii) the five-year period ending on the date of disposition of such interest, were either disposed of in transactions in which the full amount of the gain (if any) was recognized, or ceased to be USRPIs by reason of the application of this rule to one or more other corporations (the so-called "cleansing rule").[621]

Explanation of Provision

Under the provision, the cleansing rule applies to stock of a corporation only if neither such corporation nor any predecessor of such corporation was a RIC or a REIT at any time

[620] Treas. Reg. sec. 1.897-2(h)(3).

[621] Sec. 897(c)(1)(B).

during the shorter of the period after June 18, 1980 during which the taxpayer held such stock, or the five-year period ending on the date of the disposition of such stock.

Effective Date

The provision applies to dispositions on or after the date of enactment.

14. Dividends derived from RICs and REITs ineligible for deduction for United States source portion of dividends from certain foreign corporations (sec. 326 of the bill and sec. 245 of the Code)

Present Law

A corporation is generally allowed to deduct a portion of the dividends it receives from another corporation. The deductible amount is a percentage of the dividends received. The percentage depends on the level of ownership that the corporate shareholder has in the corporation paying the dividend. The dividends-received deduction is 70 percent of the dividend if the recipient owns less than 20 percent of the stock of the payor corporation, 80 percent if the recipient owns at least 20 percent but less than 80 percent of the stock of the payor corporation, and 100 percent if the recipient owns 80 percent or more of the stock of the payor corporation.[622]

Dividends from REITs are not eligible for the corporate dividends received deduction.[623] Dividends from a RIC are eligible only to the extent attributable to dividends received by the RIC from certain other corporations, and are treated as dividends from a corporation that is not 20-percent owned.[624]

Dividends received from a foreign corporation are not generally eligible for the dividends-received deduction. However, section 245 provides that if a U.S. corporation is a 10-percent shareholder of a foreign corporation, the U.S. corporation is generally entitled to a dividends-received deduction for the portion of dividends received that are attributable to the post-1986 undistributed U.S. earnings of the foreign corporation. The post-1986 undistributed U.S. earnings are measured by reference to earnings of the foreign corporation effectively connected with the conduct of a trade or business within the United States, or received by the foreign corporation from an 80-percent-owned U.S. corporation.[625] A 2013 IRS chief counsel advice memorandum advised that dividends received by a 10-percent U.S. corporate shareholder from a foreign corporation controlled by the shareholder are not eligible for the dividends-received deduction if the dividends were attributable to interest income of an 80-percent owned

[622] Sec. 243.

[623] Secs. 243(d)(3) and 857(c)(1).

[624] Secs. 243(d)(2) and 854(b)(1)(A) and (C).

[625] Sec. 245.

RIC.[626] Treasury regulations section 1.246-1 states that the deductions provided in sections "243 … 244 … and 245 (relating to dividends received from certain foreign corporations)" are not allowable with respect to any dividend received from certain entities, one of which is a REIT.

Explanation of Provision

Under the provision, for purposes of determining whether dividends from a foreign corporation (attributable to dividends from an 80-percent owned domestic corporation) are eligible for a dividends-received deduction under section 245, dividends from RICs and REITs are not treated as dividends from domestic corporations.

Effective Date

The provision applies to dividends received from RICs and REITs on or after the date of enactment. No inference is intended with respect to the proper treatment under section 245 of dividends received from RICs or REITs before such date.

[626] IRS CCA 201320014. The situation addressed in the memorandum involved a controlled foreign corporation that had terminated its "CFC" status before year end, through a transfer of stock to a partnership. The advice was internal IRS advice to the Large Business and International Division. Such advice is not to be relied upon or cited as precedent by taxpayers, but may offer some indication of administrative practice.