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Real Estate Investment Trusts (REITs) and the Foreign Investment in Real Property Tax Act (FIRPTA): Overview and Recent Tax Revisions

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Summary

The Consolidated Appropriations Act of 2016 (P.L. 114-13) made several changes to the tax treatment of Real Estate Investment Trusts (REITs) and the Foreign Investment in Real Property Tax Act (FIRPTA, enacted in the Omnibus Reconciliation Act of 1980, P.L. 96-499) as it relates to REITs. REITs are corporations that issue shares of stock, are largely invested in real property, and do not generally pay corporate tax. REITs distribute and deduct most income as dividends to shareholders. U.S. individual shareholders pay tax at ordinary individual income tax rates on those dividends (rather than the lower rates normally applied to dividends on corporate stock).

REITs were initially introduced, in part, to allow taxpayers of more modest means to invest in real estate. The size and scope of REITs has been increasing in past years, due in part to legislative and regulatory changes. REITs today are estimated to own $1.8 trillion in real estate. Legislative changes have meant REITs are increasingly not only owning and renting property as a passive investment, but also managing it through taxable subsidiaries. U.S. corporations have been spinning off (transferring to a separate corporation organized as a REIT) buildings (and other assets defined as real estate) in a tax-free reorganization. The expanding scope and size of REIT activities has raised issues as to whether the intent of the preferred treatment is still appropriate.

Another issue concerning REITs is that provisions in FIRPTA have been discouraging foreign investors from purchasing REIT shares by taxing investments that exceed 5% of the REIT's shares. Capital gains paid to foreign investors are generally exempt from U.S. tax. FIRPTA, however, imposes a capital gains tax on foreign investments for gains related to real estate, with an exception for a 5% or less ownership of a REIT. Investment in other types of securities is not subject to the U.S. capital gains tax.

The Consolidated Appropriations Act makes several changes in response to these issues. The act

- disallows tax-free spin-offs of assets into a tax-exempt REIT by a regular corporation;
- increases from 5% to 10% the amount of ownership in a REIT by a foreign investor before the capital gains tax applies; and
- exempts foreign pension funds investing directly or indirectly in real estate from the FIRPTA capital gains tax.

These provisions, taken together, result in federal tax revenue losses. There are also some smaller (in revenue effect) provisions affecting foreign investors that gain revenue.

In addition to these rules, P.L. 114-13 includes some minor provisions, the most significant of these changes relating to the treatment of taxable REIT subsidiaries.

The changes in the Consolidated Appropriations Act may lead to a period with no further REIT revisions. If tax reform is considered, however, additional REIT base broadening provisions might be considered. For example, former Chairman of the House Ways and Means Committee Dave Camp's proposed Tax Reform Act of 2014 (H.R. 1, 113th Congress) contained more restrictive provisions relating to spin-offs as well as other provisions primarily focused on the definition of real estate. Changes in a tax reform, such as lowering the corporate rate or allowing a corporate dividend deduction, could also affect the relative tax benefit of REITs.

This report describes REITs and FIRPTA, provides historical developments, presents an overview of REIT size and activity, explains the provisions in the Consolidated Appropriations Act, and discusses possible policy issues in the future.

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The Consolidated Appropriations Act enacted three types of changes to the rules regarding REITs: (1) provisions to prevent tax-free spin-offs of real property into tax-exempt REITs by currently taxable, operating corporations; (2) provisions to increase foreign investment in U.S. REITs by liberalizing FIRPTA rules; and (3) a series of technical revisions to REITs that had been under consideration for some time.

Additional modifications to REIT provisions might still be considered in the future if general tax reform is considered. For instance, the REIT provisions proposed in former Ways and Means Chairman Camp's proposed Tax Reform Act of 2014 (H.R. 1, 113th Congress) were generally more restrictive and raised more revenue than the provisions in the Consolidated Appropriations Act. Moreover, other changes made in a tax reform might affect the relative advantage of REITs.

This report describes REITs and FIRPTA, provides historical developments, presents an overview of REIT size and activity, explains the provisions in the Consolidated Appropriations Act, and discusses possible policy issues in the future.

Description of REITs

A REIT is a real estate company that would otherwise be taxed as a corporation, except that it meets certain tests and faces a number of restrictions. These requirements and restrictions are listed in **Table 1**. Its primary business is ownership of real estate assets. Unlike ordinary corporations, REITS generally face little or no corporate level tax because distributions to shareholders are treated as deductible expenses. To qualify, a REIT must meet a number of tests, including having at least 75% of its assets and gross income in real estate and distributing at least 90% of profits to shareholders. Dividends paid to individual shareholders are taxed at ordinary individual income tax rates (rather than the lower rates that generally apply to dividends).[1] Basically a REIT is taxed similarly to a partnership in many ways, which is subject to the individual income tax, and largely avoids the corporate-level tax.[2]

REITs have a number of restrictions that require concentration of their assets in passive investments, primarily real estate, and ensure broad ownership. The allowance for taxable REIT subsidiaries adopted in 1999, however, has expanded the scope for REITs to operate properties.

[1] To the extent that distributions exceed earnings, some of the payment to shareholders is a return of capital and not taxed. The Real Estate Investment Trust (REIT) can distribute capital gains, which retains its character and is taxed at lower rates.

[2] Unlike partnerships, losses cannot flow through to REIT shareholders. For a discussion of the various business types and their tax treatment, see CRS Report R43104, *A Brief Overview of Business Types and Their Tax Treatment*, by (name redacted) .

Table 1. Requirements and Restrictions for REIT Status

Income Test	At least 75% of gross income is derived from real estate (e.g., rents, mortgages), 95% from real estate or passive income (dividends and interest).
Asset Test	At least 75% in real estate assets, cash, and government securities; no more than 25% in non-qualifying securities or stock or a taxable REIT subsidiary. Except for taxable REIT subsidiaries, a REIT may own no more than 10% of the securities of a single issuer. No more than 5% of a REIT's assets may be the securities of a single issuer.
Distribution Requirements	Must distribute at least 90% of taxable income to shareholders; distributions are deductible from the corporate tax base.
Shareholder Restrictions	At least 100 shareholders; no more than 50% of shares owned by five or fewer shareholders. Shares must be transferable. Institutional investors are treated as multiple shareholders representing beneficiaries.
Corporate Restrictions	Must be taxable as a domestic corporation but for REIT status; foreign corporations cannot be REITs.
Tax Treatment of Shareholders	Shareholders taxed at ordinary rates on dividends and capital gains rates on distributions representing capital gains. Tax-exempt shareholders are not subject to the unrelated business income tax.

Source: Internal Revenue Code, Sections 856-860.

Over time, the rules governing REITs have been relaxed, both by legislative and regulatory changes, to allow more involvement not just in holding real estate assets, but also in managing properties and services. REITs were originally designed to be passive real estate owners (if they did not simply own mortgages), with properties operated by others. The Tax Reform Act of 1986 allowed REITs to perform customary services and, thus, to operate their properties directly rather than to employ independent contractors. Legislation in the late 1990s, especially allowing taxable REIT subsidiaries, also expanded the scope of operations. Taxable REIT subsidiaries also introduced the possibility of reducing taxes by shifting profits into the REIT parent through higher than market rents, an effect for which some evidence was found (although such transactions are subject to a 100% penalty).[3] These and other changes expanded the scope of assets organized as REITs.

Prior to the 2015 legislation and following a regulatory change in 2001, corporations have been able to spin off their real estate assets into a separate REIT through a tax-free reorganization. The number of firms spinning off their properties or considering doing so has been growing.[4] One of the changes in the Consolidated Appropriations Act was to restrict this practice.

REITs are organized as equity, mortgage, or hybrid REITs, depending on whether they hold real estate, mortgages, or a combination of both. Today, most REITs are equity REITs.[5] REITs fall into three classes as far as regulation and trading: (1) public REITs traded on the stock exchange, (2)

[3] Thornton Matheson, "Do Pass-Through Entities Strip Income from Their Corporate Subs: Evidence from Taxable REIT Subsidiaries," National Tax Association, *Proceedings from the 101st Conference, 2008*, http://www.ntanet.org/images/stories/pdf/proceedings/08/45.pdf. This study did not find effects through differential leveraging, however.

[4] See Martin A. Sullivan, "The Revenue Costs of Nontraditional REITs," *Tax Notes*, September 8, 2014, pp. 1103-1111, and Eric Lipton and Liz Moyer, "Hospitality and Gambling Interests Delay Closing of Billion-Dollar Tax Loophole, *New York Times*, December 20, 2015, http://www.nytimes.com/2015/12/21/us/politics/hospitality-and-gambling-interests-delay-closing-of-dollar1-billion-tax-loophole.html?_r=2#.

[5] An alternative to mortgage REITs, adopted in 1986, was a similar conduit treatment (with no entity level tax) for real estate mortgage investment conduits (REMICs). These entities hold a pool of mortgages and issue mortgage-backed securities (MBS).

public REITs not traded on the stock exchange but subject to registration with the Securities and Exchange Commission (SEC), and (3) private REITs.

REITs are subject to a number of other restrictions and rules. REITs were intended to have passive investments in real estate assets and not to hold property for sale to customers in the ordinary course of business (as a developer would). Gain from these sales would be considered sale of inventory. Such income is not classified as qualified real estate income and there is a 100% prohibited transactions tax on such gain. This tax does not apply to property obtained through foreclosure and there are safe harbors from the tax including limits on the size of the sale and a holding period of two years.

Foreign Shareholders, REITs, and FIRPTA

In general, a foreign person or corporation is not taxed on U.S. source capital gains income. However, if the income is from selling U.S. real property, the distribution is taxed at the same rates as a U.S. person under the Foreign Investment in Real Property Tax Act (FIRPTA). The FIRPTA rules, adopted in 1980, considered investment in real property to be income effectively connected to business, which is generally subject to U.S. taxes. There is an exception if (1) the investment is made through a qualified investment entity; (2) the U.S. real property is regularly traded on an established U.S. securities market; and (3) the recipient foreign person or corporation did not hold more than 5% of that class of stock or beneficial interest within the one-year period ending on the date of distribution. The American Jobs Creation Act of 2004 (P.L. 108-357) extended the exception to cover capital gains distributions as well as stock sales.

Due to a concern that FIRPTA rules discouraged investment in REITs by foreign persons, liberalizing FIRPTA was also included in the Consolidated Appropriations Act.

Historical Developments

As mentioned above, REITs have changed significantly over time, beginning largely as entities that passively held real estate mortgages, then becoming largely entities holding standard real properties (e.g., apartments and commercial properties) directly, and more recently expanding into entities holding nontraditional assets (such as prisons, timber, billboards, and cell towers). Recent periods have also been marked by a number of tax-free spin-offs of real property of operating corporations, so that their real property was now in a separate tax-exempt REIT.[6]

Pre-1960 History of REITs

Shortly after the first corporate income tax was introduced in 1909, a Supreme Court Case in 1911, *Eliot v. Freeman*,[7] ruled that real estate trusts were not taxable entities for purposes of the tax.[8] The issue subsequently came into question again. In 1935, the Supreme Court, in *Morrisy v. Commissioner*,[9] ruled that realty trusts were corporations subject to the corporate tax.[10] (The

[6] Initially, the same shareholders own both companies, although the composition will diverge over time.

[7] 220 U.S. 178 (1911) at http://caselaw.findlaw.com/us-supreme-court/220/178.html.

[8] The 1909 act applied to corporations and joint stock associations that were "organized under the laws of the United States or of any State.... " The Court concluded that the real estate trusts at issue were not organized under the law of the United States or any state, and therefore were not taxable entities.

[9] 296 U.S. 344 (1935) at https://supreme.justia.com/cases/federal/us/296/344/case.html.

[10] For purposes of the corporate income tax, the relevant laws (the Revenue Acts of 1924 and 1926) defined (continued...)

Court also ruled that RICs were subject to the corporate tax as well, although these firms applied for relief from Congress and received it.) REITs, largely experiencing losses during the depression, and thus not affected by the tax, made no appeals to reverse the treatment through legislation, and most were eventually liquidated. Those that remained appealed to Congress in 1955, but in 1956 President Eisenhower vetoed the first real estate investment trust bill. His veto message contained two reasons for rejecting the legislation.[11] First, he noted that REITs were different from regulated investment companies whose income was derived from the securities of corporations already subject to the tax and thus were not comparable to REITs, who would pay no corporate tax. Secondly, he expressed concern that the provision, although aimed at a small number of trusts, could expand to many other real estate corporations and erode the corporate base. A REIT proposal in 1958 was incorporated into legislation but dropped in conference. Eventually, legislation allowing for REITs that were exempt from the corporate-level tax on distributions was added to the Cigar Excise Tax Act of 1960.[12] The reasons given by legislators were the need for real estate financing due to economic conditions at that time and the creation of a vehicle to allow taxpayers of more modest means to invest in real estate. In addition, the Treasury, which had initially objected to the legislation, withdrew those objections after the resignation of Dan Throop Smith, Under Secretary of Treasury for Tax Policy, who opposed the REIT legislation.

Further Developments 1960-1996

REITs were more restricted in the early years than they are today, especially with respect to REITs providing tenant services and taking a more active role in operating properties. REITs were first listed on the stock exchange in 1965, were allowed to acquire and temporarily operate foreclosed property in 1974, and first allowed to organize as corporations in 1976. During the early years, REITs were largely mortgage REITs. By 1971, public equity REITs constituted 22% of total public REIT value (with the remainder about evenly divided between mortgage REITs and hybrids); today they constitute more than 90% of the total and hybrids have virtually disappeared.[13] The growth in equity REITS was in part due to changes in the Tax Reform Act of 1986 which allowed REITs to both own and manage property.[14] Prior to that act, REITs could not

(...continued)

corporation to include "associations, joint-stock companies, and insurance companies." The Court held that the trusts at issue were taxable associations.

[11] 102 *Congressional Record* 15304-15305 (daily ed. July 27, 1956).

[12] This history is based on the following sources: Commerce Clearing House, "Since 1960, Tax Treatment of Realty Trusts Has Been Similar to that of Investment Companies," *Federal Tax Guides*, December 30, 1971, p. 3; A. Overton Durrett, "The Real Estate Investment Trust: A New Medium for Investors," *William and Mary Law Review*, vol. 3, issue 1, 1961, pp. 140-163, http://scholarship.law.wm.edu/cgi/viewcontent.cgi?article=3227&context=wmlr; Bradley T. Borden, "Reforming REIT Taxation (Or Not)," *Houston Law Review*, vol. 53, no. 1 (fall 2015), pp. 1-101; Carson Siemann, "Promoting Equity for REIT Investors," *Seton Hall Legislative Journal*, vol. 36, no. 2. 2012, pp. 271-296; Peter E. Boos, "Runaway REIT Train? Impact of Recent IRS Rulings," *Tax Notes*, September 15, 2014, http://www.taxanalysts.com/www/features.nsf/Articles/FFF8F863CF33DB1E85257E1B004BAD8F; Amy S. Elliott, "The Surprising Details of Camp's Attack on REIT Conversions," *Tax Notes*, March 31, 2014, pp. 1385-1392 and "Tax Lawyers Disagree Over Whether REIT Spins Are Abusive," *Tax Notes*, November 16, 2015, pp. 870-871; Peter Barnes, "Why Did REITs Come Into Existence?," *Market Watch*, August 24, 2015, http://marketrealist.com/2015/08/REITs-come-existence/; "Timeline," National Association of Real Estate Investment Trusts (NAREIT), https://www.reit.com/investing/reit-basics/reit-industry-timeline#0; Brent W. Ambrose and Peter Linneman, "Old REITs and New REITs," March 23, 1998, http://realestate.wharton.upenn.edu/research/papers/full/300.pdf.

[13] See data on National Association of Real Estate Investment Trusts (NAREIT), "Historical REIT Industry Market Capitalization: 1972-2014," at https://www.reit.com/data-research/data/us-reit-industry-equity-market-cap.

[14] As noted above, this act also allowed REMICs.

provide services to tenants; the 1986 act allowed the provision of customary services, such as heat, light, and trash collection.

The first UPREITs, in which a partnership (umbrella partnership) is formed with the REIT as a general partner, were offered in 1992; this structure avoided recognition of capital gains on conversion of debt to equity. In 1993, the five-or-fewer ownership rule was liberalized by counting pensions as multiple investors, reflecting pension beneficiaries. This change made it easier for pension plans to invest in REITs. In 1996, Internal Revenue Service (IRS) guidance began expanding the type of services REITs could provide, beginning with cable television.

Expanding the Scope of REITs, Spin-offs, and Tax Rate Changes

During the past years, beginning in the late 1990s, REITs began to expand in scope and size, in part due to legislative and regulatory changes. The REIT provisions of the Taxpayer Relief Act of 1997 (P.L. 105-34) expanded the types of services that REITs could offer without being disqualified and made changes that allowed timber REITs.[15] The first timber REIT, Plum Creek, appeared in 1999. In addition, in 1999, taxable REIT subsidiaries were first allowed.[16] These taxable subsidiaries allowed REITs to actively manage and operate properties and provide services beyond customary tenant services. The 1999 legislation also reduced the required distribution from 95% to 90%. In 2004, legislation allowed REITs that violated rules to address them and pay a penalty rather than lose REIT status.[17] In 2008, health care REITs (e.g., REITs that hold assets such as nursing homes) were allowed taxable subsidiaries.

In 2001, the IRS held in Revenue Ruling 2001-29[18] that rental activity was an active business (reflecting changes that expanded the scope of REIT activity), which allowed firms to spin off their real estate assets in a tax-free reorganization. Following this ruling, Georgia Pacific spun off a timber REIT subsidiary, which then merged with Plum Creek to create a Fortune 500 company.[19] Through a series of private letter rulings, IRS also ruled that assets such as billboards, electrical distribution systems, security components, fire protection systems, telecommunications systems, and data storage are real property. Note, however, that related items that might be thought of as nontraditional had long been allowed as real property, including television towers (General Counsel Memorandum 32907, September 1, 1964), railroad property (Revenue Ruling 69-94, in 1969), and microwave towers (Revenue Ruling 75-424). These later rulings led to growth of conversions of parts of ordinary corporations into tax-exempt REIT conversions, spurring concerns about erosion of the corporate base that ultimately led to legislative proposals.

Another change in this era that might have adversely affected REITs was the reduction of the tax rate on dividends from ordinary rates to a 15% rate (or zero rate in some cases) in 2003. This change reduced the relative tax advantage of REITs because REIT dividends continued to be taxed at ordinary rates. In 2013, the top rate on dividends (and capital gains) was increased to 20% for high-income taxpayers.

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[15] The legislation did not explicitly allow timber REITS, which were already eligible, but rather repealed a gross income test that required less than 30% of income be in assets held less than four years. See Thomas R. Popplewell "Taxpayer Relief Act of 1997: Provisions Affecting Real Estate Investment Trusts" The Real Estate Tax Digest, https://www.andrewskurth.com/insights-TaxpayerReliefActof1997ProvisionsAffecting.html.

[16] The Ticket to Work and Work Incentives Improvement Act of 1999, P.L. 106-170.

[17] The American Jobs Creation Act of 2004, P.L. 108-357.

[18] See https://www.irs.gov/pub/irs-drop/rr-01-29.pdf.

[19] See discussion in Austan Goolsbee and Edward Maydew, "Taxes and Organizational Form: The Case of REIT Spin-offs," *National Tax Journal*, vol. LV, no. 3, September 2002, pp. 441-456.

Rules Affecting Foreign Investors

Tax law has in some cases encouraged and in others discouraged investment in REITs by foreigners. In 1980, Congress enacted the FIRPTA provisions, which imposed capital gains taxes and a capital gains withholding tax on real estate investments, including those made through REITs. There was an exception for sale of REIT stock of publicly traded U.S. real estate corporations by owners with a 5% or less share. Its general rationale was to equalize the treatment of foreign and domestic investors, although it was also partly in response to concerns about purchases of U.S. farm land by foreign investors.[20] In 1997, amid concerns about the doubling of the 15% withholding tax rate on dividends paid by REITs to foreign investors (the standard withholding rate in the absence of a treaty provision is 30%), the rate in the Model U.S. Tax Convention was set at 15% for investors with a 5% or less interest in a publicly traded REIT or a 10% or less interest in a diversified REIT. In 2003, a U.S.-UK treaty provided no dividend withholding taxes for UK pension funds (for REIT investments, so long as the pension plan owned 10% of less of the REIT), and this provision was later extended to other treaties. The 2004 tax legislation (the American Jobs Creation Act) allowed an exemption from capital gains tax for capital gains distributions to foreign REIT investors with a 5% or less share of the firm.

REITs: Size and Scope

The National Association of Real Estate Investment Trusts (NAREIT), as of November 2015, estimates the current market capitalization of public REITs at $935 billion.[21] Equity REITs (i.e., REITs that invest in property rather than mortgages) account for 94% or the total ($875 billion). REITs traded on the stock market account for 95% of public REITs ($890 billion). These REITs own $1.8 trillion of real estate. In 2014, public traded REITS paid $42 billion in dividends, and public non-traded REITs paid $4 billion. On average, 67% of the annual dividends paid by REITs qualify as ordinary taxable income, 17% qualify as return of capital, and 16% qualify as long-term capital gains. NAREIT data do not include private REITs, but they appear to be worth less than $100 billion.[22]

The tax benefits from a REIT vary depending on the taxpayer's circumstances. From a tax perspective, tax-exempt investors have the largest benefit from REIT treatment compared with treatment as a regular corporation because they have a zero personal level tax and are not subject to the unrelated business income tax. Without REIT treatment, income would be subject to a 35% corporate tax rate. An individual investor with a high tax rate investor who receives all income in dividends would pay a tax of 50.47% with a regular corporate investment (a 35% corporate tax and a 23.8% individual level tax, including the 39.6% income tax and the additional 3.8% tax enacted in the Affordable Care Act, on the remaining profit of 65%). With REIT treatment, dividends would be taxed at 39.6% plus the 3.8% tax, which is a 7.17 percentage point difference. (For earnings received as capital gains the difference is greater.) For an investor in an ordinary

[20] See "U.S. Eases 25-Year Old Real Estate Tax on Foreign Investors," *Gulf News*, December 20, 2015, http://gulfnews.com/business/economy/us-eases-35-year-old-real-estate-tax-on-foreign-investors-1.1640654. As this article notes, FIRPTA is sometimes connected to Japanese purchases of trophy property (such as the Rockefeller Center), but these purchases occurred after the enactment of FIRPTA.

[21] Data in this section, unless otherwise specified, are from the NAREIT website at https://www.reit.com/data-research/data, or the most recent issue of REITWatch, reporting data at the end of November 2015, https://www.reit.com/sites/default/files/reitwatch/RW1512.pdf.

[22] See Jake Zamansky "Private REITs Backfire on Investors Again," *Seeking Alpha*, May 1, 2012, indicating about $73 billion at that time, http://seekingalpha.com/article/548681-private-REITs-backfire-on-investors-again.

corporate firm that pays little or no dividends and where gains are not realized, the tax rate for a REIT can be higher than for an ordinary corporation: 43.4% (39.6% plus 3.8%) versus 35%. In general, therefore, for individual taxpayers, REIT tax treatment is most advantageous when ordinary individual income tax rates are low and the investor prefers dividend payouts.

Although data on ownership of shares are not consistently available, evidence does not suggest that tax-exempt investors invest heavily in REITs. According to one study, defined benefit (DB) pension fund holdings in REITs were 0.6% of their portfolios.[23] DB and other pension fund assets were reported at $18.8 trillion, suggesting that about 11% of REIT shares are held by pension funds if DC pension plans invest at a similar rate.

The majority of REIT assets are in more traditional asset types:

- 24% in retail (largely shopping centers),
- 15% each in industrial and office and residential (largely apartments),
- 11% in health (such as nursing homes), and
- 8% in self-storage.

Recently, attention has been directed to nontraditional REITs and spin-offs, such as timber, data centers, cell towers, prisons, hotels, document storage, casinos, billboards, and communications. As noted earlier, however, these might be viewed as nontraditional not as a legal matter (since many of these types of assets had long been considered real estate assets) but as not the common passive building rentals. Nontraditional REIT asset types account for

- 4% in timber,
- 11% in infrastructure, and
- 4% in lodging and resorts.

In a 2014 paper that identified 20 recent nontraditional or recently converted REITs for the years 1999-2015, four timber REITs' market capitalization was $31.4 billion (with Weyerhaeuser accounting for about two-thirds of the total).[24] Five data center REITs accounted for $35.7 billion; two cell tower for $65.4 billion; one real estate for $6.3 billion; two prison for $6.9 billion; one hotel for $2.5 billion; one document storage facility for $6.9 billion; one casino for $3.7 billion; two billboards for $9.0 billion; and one communication center for $6.8 billion. The nontraditional or recently converted REITs amount to a value of $175 billion, or approximately a fifth of REIT valuations, and appeared to be accelerating.

A *New York Times* article has a somewhat overlapping list of spin-offs since 2010, which included an additional 13 tax-free spin-offs, totaling $15.8 billion.[25] Although they were spin-offs from operating companies (such as Darden restaurants, owner of Olive Garden restaurants), many were in more traditional REIT activities, such as health centers, shopping malls, and apartments. That same article noted that several additional spin-offs appeared to be grandfathered in the recent

[23] Alexander D. Beath, "Asset Allocation and Fund Performance of Defined Benefit Pension Funds in the United States Between 1998-2011," CEM Benchmarking Inc., June 2014, https://www.reit.com/sites/default/files/media/PDFs/AssetAllocationandFundPerformanceVersion2.pdf.

[24] Martin A. Sullivan, "The Revenue Costs of Nontraditional REITs," *Tax Notes*, September 8, 2014, pp. 1103-1111.

[25] Eric Lipton and Liz Moyer, "Hospitality and Gambling Interests Delay Closing of Billion-Dollar Tax Loophole, *New York Times*, December 20, 2015, http://www.nytimes.com/2015/12/21/us/politics/hospitality-and-gambling-interests-delay-closing-of-dollar1-billion-tax-loophole.html?_r=2#.

legislation, including Caesars Casinos, MGM Resorts, Boyd Gaming, Hilton, and Energy Future Holdings Corporation.

Revisions in the Consolidated Appropriations Act of 2016

This section summarizes the recent revisions enacted in the Consolidated Appropriations Act (P.L. 114-13) along with the revenue gain or loss estimates by the Joint Committee on Taxation (JCT).[26] The JCT also has a more detailed explanation of each of the changes.[27]

Restrictions on Spin-Offs

As a general rule, a corporation (i.e., the distributing corporation) may spin off part of its business into a separate corporation (i.e., the controlled corporation) without paying taxes on any capital gain from the transaction. Among the conditions required is that the firm be engaged in an active business. Spin-offs into REITs were not allowed until 2001, when the IRS determined that rental of property constituted an active business, which led to an increasing number of spinoffs of real property into REITs.

The Consolidated Appropriations Act makes REITs generally ineligible to participate in a tax-free spin-off and this restriction raises $1,902 million in federal tax revenue from FY2016-FY2025.

There are some exceptions. The restriction does not apply if, after the spin-off, both the distributing and controlled corporations are REITs. Second, a REIT can spin off its taxable REIT subsidiary if the distributing corporation has been a REIT for three years, the subsidiary has been a taxable REIT subsidiary the entire time, and the REIT had control of the subsidiary.

The provision grandfathers firms that had submitted letters requesting private rulings to the IRS on or before December 7, 2015.

Subsequent to the enactment of the Consolidated Appropriations Act, the Treasury issued regulations addressing potential methods of circumventing the restrictions on tax free spin-offs, for example, by first participating in a tax exempt spin-off not involving a REIT and subsequently merging into a REIT.[28] The regulations required recognition of gain on transferred assets if the reorganization with a REIT occurs within 10 years before or after a tax exempt merger.

[26] Estimated Budget Effects of Division Q of Amendment #2 to the Senate Amendment to H.R. 2029 (Rules Committee Print 114-40), The "Protecting Americans from Tax Hikes Act of 2015," Joint Committee on Taxation, JCX-143-15, December 16, 2015. https://www.jct.gov/publications.html?func=startdown&id=4860.

[27] 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), Joint Committee on Taxation, JCX-144-15, December 17, 2015, https://www.jct.gov/publications.html?func=startdown&id=4861.

[28] Treasury Decision 9770, June 7, 2016, REG-126452-15, June 8, 2018, at https://www.federalregister.gov/articles/2016/06/08/2016-13443/certain-transfers-of-property-to-regulated-investment-companies-rics-and-real-estate-investment.

Changes Relating to Foreign Shareholders, Including FIRPTA Provisions Relating to REITs

Five provisions affect the treatment of foreign shareholders of REITs and taken together cost $2,923 million in federal revenue forgone over 10 years. Two major changes lose significant revenue. One provision increases the share of ownership in REITs that will still avoid taxation under FIRPTA from 5% to 10%. This provision loses $2,297 million in revenue over FY2016-FY2025. The second provision exempts foreign pension funds from FIRPTA at a cost of $1,953 million over the same period. With this change, taxes on capital gains on real estate will not be imposed on foreign pension funds. Withholding provisions will also be adjusted to eliminate withholding of tax by the seller on sales to pension funds.

The remaining three provisions gain revenue, and do not arise specifically from the treatment of REITs. The third provision applies in general to real property sales with gain to foreign interests. These sales require a withholding rate of 10% of gross sales in certain circumstances, and this rate is increased to 15%, for a revenue gain of $209 million over FY2016-FY2025. The fourth provision excludes REITs (and RICs) from the so-called cleansing rule that allows an interest in a corporation not to be a U.S. real property interest if the corporation does not hold any real property interests as of the date of disposition and past sales under certain time periods have recognized gains. This provision gains $256 million over the same period.

The final (and fifth) provision relates to the dividends-received deduction, which is designed to prevent multiple levels of taxation due to intercorporate ownership. Dividends received from a corporation that holds stock in another corporation (which may be its controlled subsidiary) are fully or partially deductible depending on ownership (e.g., fully deductible for 100% ownership, 80% deductible for ownership between 80% and 20%, and 70% deductible for ownership of less than 20%). Dividends from a REIT are not eligible for the deduction and dividends from a RIC are eligible for a 70% deduction to the extent received from other corporations.

In general, dividends from foreign corporations are not eligible for the dividends-received deduction because this income has not been taxed under U.S. law. Dividends that reflect income earned in the United States by that foreign corporation (and thus taxed) are, however, eligible. Treasury regulations indicate that this dividend deduction is not available if attributable to interest income of a RIC and not available at all for dividends from a REIT. The law clarifies, going forward, that dividends from RICs and REITs do not qualify. This provision raises $762 million in federal tax revenue from FY2016 to FY2025.

Miscellaneous Provisions Affecting REITs

A number of minor provisions in the new law affect REITs that have, in most cases, relatively little revenue impact (revenue gain over FY2016-FY2025 is in parentheses).

1. Taxable REIT Subsidiaries: This provision reduces the permissible asset share for taxable REIT subsidiaries from 25% to 20% ($167 million).
2. Safe Harbor from Prohibited Transactions Tax: One of the rules for avoiding the prohibited transactions tax is to limit the affected sales to 10% of asset value. The revision increases the limit to 20%, but retains an average 10% limit over three years ($7 million).
3. Preferential Dividends: REITs are denied deductions for distributions that are not proportional across shareholders. This provision repeals that rule for publicly

offered REITs and allows remedies other than loss of deduction for other REITs (-$4 million).

4. Designation of Distributions: A REIT may designate some distributions as capital gains subject to the lower rate capital gains rate (limited to net capital gains), and may also designate some dividends as qualified dividends subject to the lower rate based on dividend income or income subject to the corporate level tax. The IRS has allowed these amounts combined to exceed dividend distributions and has also required proportional designations. The provision limits the total to the amount of dividends designated by a REIT to current dividends paid and provides regulatory authority to the IRS to require proportional designations across shares ($4 million).
5. Asset Test: Debt instruments issued by publicly offered REITs and interests in mortgages on interests in real property (such as a lease) are treated as real property (-$7 million).
6. Asset and Income Test: Interest on a mortgage in which personal property is leased along with real property will be considered real property as long as the personal property is less than 15% of the total, a rule that already applies to rents (-$8 million).
7. Hedging Transactions: Under current law, hedging indebtedness incurred to acquire real estate assets or manage the risk of currency fluctuations is disregarded as part of gross income for the income tests. This provision expands the definition of hedging income that is disregarded to positions that manage risk related to certain prior hedges (-$2 million).
8. Earnings and Profits: The earnings and profits measure determines the extent to which a dividend is a return of capital. Because of an anomaly in the way earnings and profits are measured for REITs, the amount of dividend that is a return on investment can be overstated when dealing with provisions with timing differences. This issue is corrected (-$4 million).
9. Services Provided by Taxable REIT Subsidiaries: Among the rules for safe harbor from the prohibited transactions tax under some circumstances is the requirement that development costs or management of foreclosed property be done by independent contractors. This provision allows this activity to be done by taxable REIT subsidiaries. The base for the current 100% tax on the difference between actual and arm's length rents between a REIT and its taxable subsidiary is expanded to include non-arms-length prices relating to services (-$65 million).

Policy Options

The revisions in the Consolidated Appropriations Act may lead to a period with no further REIT revisions. Nevertheless, in the context of tax reform, REITs might be affected directly or indirectly.

For example, some of the revenue-raising REIT provisions in former Chairman of the House Ways and Means Committee Dave Camp's proposed Tax Reform Act of 2014 (H.R. 1, 113th Congress) were not enacted in the Consolidated Appropriations Act and might be potential base broadening targets in a tax reform. The major differences between that bill and the recently enacted provisions were a more restrictive limit on spin-offs (the revenue gain was estimated at $5.9 billion in the 2014 bill) by applying the spin-off rules to all transactions including existing REITs and imposing a tax on gain for conversions from regular corporate to REIT status. The

2014 bill also had provisions aimed at restricting nontraditional assets in qualifying for REIT status by disallowing any asset with a life of less than 27.5 years. Billboards, for example, have a life of 20 years and would have been no longer eligible to be treated as real estate qualifying for REIT status. This change was estimated, assuming the spin-off and gains provisions were adopted, to raise $0.6 billion. The bill also specifically disallowed timber REITs, with a delay in implementation. One provision that was included in an earlier version of the tax amendments to the appropriations bill and in the 2014 proposal, but not in the final act, was a cap on the amount of rent or interest based on a fixed percentage of income or sales that qualifies as rental income.[29]

A major change in how corporations are taxed could also affect REITs indirectly or even lead to proposals for fundamental changes in REIT treatment. For example, a lowering of the corporate tax rate would reduce the relative tax benefit for REITs and even make taxes on REITs with respect to dividends higher than those on ordinary corporations. A reduction in individual tax rates would benefit REITs. The 2014 proposal reduced the top individual rate to 35% and the corporate rate to 25%. A tax-exempt investor would see the tax benefit of a REIT fall from 35% to 25%, and a high-income individual would see the benefit fall from 7.17 percentage points to 4.05 percentage points.

Proposals for fundamental changes in the tax law, perhaps as an element of tax reform, could also have consequences for REITs. For example, Senate Finance Committee Chairman Orrin Hatch has indicated interest in a corporate tax integration proposal that might allow corporate dividend deductions (and presumably taxation at ordinary rates for dividends), a treatment that would move ordinary corporations closer to the treatment of REITs.[30]

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[29] For revenue effects see Estimated Revenue Effects of the Tax Reform Act of 2014, Joint Committee on Taxation, JCX-20-14, February 26, 2014, https://www.jct.gov/publications.html?func=startdown&id=4562. For a technical discussion of the REIT provisions, see Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code, Title III, Business Tax Reform, JCX-14-14, February 26, 2014, https://www.jct.gov/publications.html?func=startdown&id=4556. See also Amy S. Elliott, "The Surprising Details of Camp's Attack on REIT Conversions," *Tax Notes*, March 31, 2014, pp. 1385-1391 for a discussion of these REIT proposals. The cap on fixed percentage interest and rent was apparently criticized because it is also used by traditional REITs.

[30] See "Senator Hatch to Introduce Corporate Integration Plan," *WallStreeter*, January 20, 2016, http://ewallstreeter.com/senator-hatch-to-introduce-corporate-integration-plan-5042, and Kaustuv Basu and Dylan Moroses, "Hatch: Corporate Integration Draft Could Be Ready in a Few Months, *Tax Notes*, February 1, 2016, p. 523. One of the challenges to a dividend deduction mentioned in these discussions is the significant holding of corporate stock by tax-exempt investors such as pension funds.