SULLIVAN & CROMWELL LLP

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Internal Revenue Service Issues Regulations Affecting REIT Conversions and Spinoffs

IRS and Treasury Issue Regulations to Extend the Period During Which a REIT Is Subject to Corporate Tax on Built-in Gains and Impose Corporate-Level Tax on Corporations That Transfer Property to a REIT Within 10 Years of a Spinoff

SUMMARY

Yesterday, the Treasury Department and the Internal Revenue Service (the "IRS") issued temporary and proposed regulations (collectively, the "new regulations") to extend to 10 years the period during which a real estate investment trust ("REIT") is subject to corporate-level tax on recognized built-in gain after a REIT conversion. In addition, the new regulations impose immediate corporate-level tax on corporations that either become REITs or transfer assets to REITs in certain carryover basis transactions within 10 years of a tax-free spinoff.[1] Legislation enacted in 2015 limited the ability of corporations to elect REIT status within 10 years of a spinoff. The new regulations are intended to impose immediate tax on transactions in which the assets of either the distributing or the controlled corporation are transferred to an entity that qualifies as a REIT, or in which a REIT engages in a tax-free spinoff after receiving assets from a corporation.

BACKGROUND

A "C-corporation" is generally subject to U.S. federal income taxation at a 35% rate on its net income. The income of a REIT, however, generally is not subject to entity-level tax as a result of the dividends paid deduction allowed to REITs. To qualify as a REIT, a corporation must comply with a number of detailed and technical requirements, including that the entity must satisfy two annual income tests (the

"Income Tests") and a quarterly asset test (the "Asset Test"). REITs often have taxable REIT subsidiaries ("TRSs"), which are taxed as C-corporations and which allow the REIT to hold indirectly assets and receive income through the TRS that, if held or received directly, might otherwise prevent the REIT from satisfying the Asset and Income Tests.

Special rules apply to property of a C-corporation ("converted property") that becomes the property of a REIT through either (i) the transfer of property from a C-corporation to the REIT, including in a tax-free transaction, or (ii) the qualification of a C-corporation as a REIT (either, a "conversion transaction"). Notwithstanding that a REIT is generally not subject to corporate-level tax, a REIT is subject to corporate-level tax on built-in gain recognized on converted property during a statutory period after a conversion transaction. This period has been tied to the period applicable for a similar rule for S-corporations, and the period for S-corproations was reduced to 5 years by the Protecting Americans Against Tax Hikes Act of 2015 (the "PATH Act").[2]

DISCUSSION

A. RECOGNITION OF BUILT-IN GAINS

As described above, a REIT is subject to corporate-level tax on built-in gains recognized during a statutory period after a conversion transaction. The statutory period had varied in accordance with the period applicable to S-corporations (which was reduced to 5 years by the PATH Act). The new regulations decouple the statutory periods for REITs and S-corporations and impose a 10-year recognition period for REITs. The new 10-year recognition period applies to conversion transactions that occur on or after August 8, 2016.

B. LIMITATIONS ON CONVERSIONS AND SPINOFFS

During the last few years, a significant number of so-called "Opco/Propco" structures (in which a C-corporation spun off its real estate in a REIT) were put in place.[3] Opco/Propco structures came under increased scrutiny and, in September 2015, the Treasury Department and the IRS announced that the IRS would no longer issue private letter rulings for spinoffs establishing Opco/Propco structures.[4] On December 18, 2015, the PATH Act targeted new Opco/Propco structures by (i) disqualifying spinoffs from tax-free treatment when either (but not both) the distributing corporation ("parent") or the distributed corporation ("spinco") is a REIT[5] and (ii) preventing any C-corporation involved in a tax-free spinoff (and any successor corporation) from electing REIT status for 10 years following such spinoff.[6] However, the PATH Act continues to permit tax-free spinoffs where both parent and spinco are REITs immediately after the spinoff. In addition, the PATH Act provided an exception for spinoffs where (i) parent has been a REIT for the three-year period ending on the date of the spinoff, (ii) spinco has been a TRS of the REIT for the same three-year period and (iii) parent has owned stock of the TRS constituting "control" for the three-year period ("certain TRS spinoffs").[7]

The preamble to the new regulations suggests that the Treasury Department and the IRS are concerned that taxpayers are using variations of the transactions addressed by the PATH Act to circumvent the purposes of the PATH Act. The new regulations are intended to prevent certain transactions that would otherwise avoid the PATH Act through the use of corporate affiliates.

The new regulations target conversion transactions that occur within 10 years before or after a spinoff. If a REIT receives converted property from a C-corporation within the 10-year period before a spinoff, the REIT must recognize built-in gain in the taxable year in which the spinoff occurs. If a C-corporation engages in a conversion transaction involving a REIT within the 10-year period following a tax-free spinoff, the C-corporation is treated as making an election to recognize gain and loss as if it had sold all of the converted property to an unrelated party at fair market value at the end of the last day before either (i) the first taxable year in which the C-corporation qualifies to be taxed as a REIT, if the conversion transaction is a qualification of the C-corporation as a REIT, or (ii) the day of the property transfer, for any other conversion transaction.

To prevent avoidance, the new regulations also apply to (i) predecessors and successors of parent and spinco and (ii) all members of the separate affiliated groups of parent and spinco. Thus, if, within 10 years after a tax-free spinoff or split-off, a REIT acquires parent, spinco or any C-corporation in the separate affiliated group of parent or spinco (the "acquired C-corporation") and the acquired C-corporation's assets are owned by a REIT (as opposed to a TRS) after the acquisition, then, immediately prior to the acquisition, the acquired C-corporation must recognize built-in gain and loss on all of its assets, even if there was no plan at the time of the spinoff for any C-corporation to be acquired by a REIT.[8]

In addition, the new regulations that are in proposed form define converted property broadly to include both (i) property owned by a C-corporation that becomes the property of a REIT and (ii) any other property the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of the property owned by a C-corporation that becomes the property of a REIT (the "proposed expanded definition of converted property").

Consistent with the PATH Act, the new regulations contain two exceptions: First, the new regulations permit tax-free spinoffs where both parent and spinco are REITs immediately after the spinoff and at all times during the two years thereafter. Second, the new regulations continue to except certain TRS spinoffs.

The new regulations pertaining to conversion transactions are effective for (i) conversion transactions that close on or after June 7, 2016, and (ii) conversion transactions and spinoffs for which the conversion transaction closes before, and the spinoff closes on or after June 7, 2016. The new regulations do not apply to spinoffs that are described in a ruling request that was submitted to the IRS on or before December 7, 2015, which request was not withdrawn and with respect to which a ruling had not been issued or denied as of December 7, 2015. The proposed expanded definition of converted property applies to conversion transactions that close on or after the date the proposed regulations are published in the Federal Register as final regulations.

The Treasury Department and the IRS have requested comments on "all aspects" of the new regulations. In particular, comments are requested regarding (i) the scope of the terms predecessors and successors, and (ii) whether the new regulations should also apply to conversion transactions involving regulated investment companies. The deadline for submitting comments on the new regulations is August 8, 2016.

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ENDNOTES

[1] T.D. 9770 (final and temporary regulations, published at Certain Transfers of Property to Regulated Investment Companies [RICs] and Real Estate Investment Trusts [REITs]; Final and Temporary Regulations, 81 Fed. Reg. 36,793-01); Certain Transfers of Property to Regulated Investment Companies [RICs] and Real Estate Investment Trusts [REITs], 81 Fed. Reg. 36,816-01 (June 8, 2016) (proposed regulations).

[2] The statutory period during which the entity-level tax on such built-in gains would apply was originally 10 years from conversion, but was reduced to 7 years from conversion for taxable years beginning in 2009 to 2011 and then to 5 years from conversion for taxable years beginning in 2012 to 2014. Subsequently, the statutory period reverted to 10 years for taxable periods beginning in 2015 and thereafter. However, the PATH Act retroactively reduced the statutory recognition period to 5 years for taxable years beginning in 2015 and permanently extended such reduction for later taxable years. See S&C publication of December 21, 2015, *Tax Extenders 2015* for a detailed description of the PATH Act provision.

[3] Opco/Propco structures separated operating and real estate assets, with "Opco", a C-corporation, holding the operating assets, and "Propco", usually a REIT, holding related real estate assets. For example, an operating business would contribute its real estate to a new Propco, while retaining the operating business, and thereafter spin off Propco to shareholders. Opco would then lease real estate from Propco, with rents under the lease often including a fixed percentage of the revenues from Opco's operation of the leased properties. Amounts paid under the lease generally were deductible to Opco (reducing income subject to entity-level taxation), and the income to Propco generally avoided entity-level taxation under the REIT rules.

[4] Notice 2015-59. See S&C publication of September 15, 2015, *Internal Revenue Service Limits Rulings on Tax-Free Spinoffs* for a detailed description of the notice.

[5] Code Section 355(h)(1).

[6] Code Section 856(c)(8).

[7] Code Section 355(h)(2). See S&C publication of December 17, 2015, *Proposed Tax Extenders Legislation Would Limit "Opco/Propco" Spinoffs, Modify FIRPTA and Affect Treatment of REITs* for a detailed description of the PATH Act legislation.

[8] The REIT would not be allowed to make the election ordinarily available to REITs to defer recognition of built-in gain or loss on assets until disposition of such assets during the 10-year statutory recognition period.

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