

President Trump signs Omnibus Spending Bill with Favorable Real Estate Tax Provisions

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In Brief

On 23 March 2018, President Trump signed the Consolidated Appropriations Act of 2018 (the Omnibus Act), an omnibus government spending bill which includes several technical corrections of previously enacted tax provisions related to FIRPTA, REIT spin-off transactions, REIT income tests and the partnership audit rules. The Omnibus Act also includes new low-income housing tax credit provisions.

Technical Corrections

Definition of a Qualified Foreign Pension Fund

The concept of a qualified foreign pension fund (QFPF) was introduced into law with the Protecting Americans from Tax Hikes of 2015 (the PATH Act). The PATH Act provided that foreign pensions funds that satisfied certain requirements were exempt from the foreign investment in real property act (FIRPTA).

Under the PATH Act, there were several uncertainties concerning the requirements necessary to be treated as a QFPF. For example, one of the requirements was that a QFPF must be established to provide current or former employees with certain pension benefits. Pension funds that were not formed for employees of a specific employer were unsure whether they satisfied this requirement. In particular, many pension plans in non-US countries are set up for self-employed individuals or are set up by foreign governments for employees of many employers. These foreign pension plans were uncertain whether they satisfied the QFPF requirement that a pension fund is established to provide benefits for current or former employees.

The Omnibus Act attempted to clarify this ambiguity by revising the requirement to

qualify as a QFPF to encompass a fund established by a government which provides public pension benefits to certain current or former employees (regardless of whether the beneficiaries were employed by the government). The Omnibus Act also attempted to clarify that pension funds established for self-employed individuals in specific professions may be eligible for QFPF status.

While the changes related to government pension plans and pension plans covering the self-employed were intended to be beneficial, the new language is drafted in a manner in which it appears to require that the pension plan be established by a government or an employer. This language was not present in prior versions and entities that may be qualified foreign pension funds should consider whether this new language negatively impacts their ability to qualify as a qualified foreign pension fund.

The Omnibus Act clarified other requirements related to qualifying as a QFPF. Specifically, the PATH Act indicated that to qualify as a QFPF, a pension fund was required to provide annual information on its beneficiaries to the relevant tax authorities. The Omnibus Act changed the requirement to allow pension funds to meet the requirement if the relevant information is made available to tax authorities even if it is not actually provided to them.

The Omnibus Act also clarified the QFPF requirement related to the taxation of the entity by providing that the requirement can be satisfied if under the laws of the country of the pension fund, the investment income of the fund would either be excluded from gross income or subject to a reduced rate met the QFPF requirement. The original language in the PATH Act required that a QFPF's income would be subject to a reduced rate but did not explicitly provide that a QFPF could qualify if its income was excluded for gross income altogether.

Qualified Foreign Pension Funds and Domestically Controlled REITs

The Omnibus Act clarified that for purposes of FIRPTA, a QFPF is not treated as a foreign individual or as a foreign corporation. This change may be read in a manner that indicates that for domestically controlled REIT purposes, a QFPF would not be considered a 'foreign person'.

REIT Personal Property

The Omnibus Act clarifies two aspects of the REIT income tests. First, the Omnibus Act treats gain from the sale or disposition of ancillary personal property that is leased with real property as gain from the sale or disposition of a real estate asset for purposes of the REIT income tests. Second, the Act treats gain from the sale or disposition of certain obligations secured by mortgages on both real property and personal property as gain from the sale or disposition of real property for purposes of the REIT income tests.

Other FIRPTA Clarifications

The Omnibus Act includes a number of technical corrections in connection with the changes that the PATH Act made to the FIRPTA rules. The technical corrections include, among others, the following:

Definition of Qualified Shareholder: The Omnibus Act added a new USRPI exception for stock held in a REIT by 'qualified shareholders.' Qualified shareholders include entities traded on foreign stock exchanges and qualified collective investment vehicles. Stock of a REIT that is held by a qualified shareholder is not a USRPI unless there is an investor in the qualified shareholder (other than an investor that is a qualified shareholder) who holds directly or indirectly owns more than 10% of the stock of such REIT (referred to as an 'applicable investor').

However, to the extent there is an applicable investor in the qualified shareholder, a percentage of the REIT stock is treated as a USRPI. Thus,

distributions from the REIT that are attributable to the sale or exchange of a USRPI are treated as ECI in the hands of the qualified shareholder. The amount treated as ECI is based on the applicable investor's percentage ownership in the qualified shareholder multiplied by the disposition proceeds and REIT distribution proceeds attributable to the underlying USRPI gain.

Domestically Controlled REIT: The Omnibus Act clarifies the effective date for the determination of the domestic control when a REIT is publicly traded or held by another REIT or RIC by stating that the rule applies with respect to each testing period ending on or after the date of enactment (note that the rule takes effect on the date of enactment).

Collective Investment Vehicles: The Omnibus Act clarifies that for purposes of a qualified shareholder, a qualified investment vehicle (QIV) exception to FIRPTA can only be met if the QIV is eligible for benefits under the comprehensive income tax treaty with the US and the dividends article in the treaty imposes conditions on the benefits allowable in the case of dividends paid by a REIT.

REIT Spin-Off Clarification

The PATH Act restricted the ability of a corporation to spin off the shares of a corporate subsidiary in a tax free manner if either the parent or the subsidiary elects REIT status within a certain time period REIT following the spinoff, unless immediately after the distribution both the distributing corporation and the controlled corporation are REITs. In order to qualify as a tax-free spinoff, a distributing corporation must control at least 80% of the distributed corporation. Control in this context is determined on a direct and indirect basis using certain attribution rules, including imputing a partnership's ownership of corporate subsidiaries to its partners on pro rata basis. The Omnibus Act clarifies that control of a partnership means ownership of at least 80% of the profits interests and at least 80% of the capital interest. That is, control is not limited to exactly 80% ownership.

Other Provisions

Partnership Audit Rules

The new partnership audit regime that was enacted as part of the Bipartisan Budget Act of 2015, (the BBA audit rules) is in effect for partnership taxable years beginning after December 31, 2017. In general terms, under the default rule of the BBA audit rules, a partnership must pay taxes, interest,

and any penalties, additions to tax, and additional amounts arising from one or more imputed underpayments from the year under audit (the reviewed year) in the year in which the adjustments giving rise to the imputed underpayments become final (the adjustment year). Alternatively, the partnership can make an election to report to each reviewed-year partner such partner's share of the adjusted items (the push-out election).

The Omnibus Act includes much anticipated technical corrections to the BBA audit rules, a version of which was first introduced in December 2016. In many cases, clarifications made in the technical corrections have already been reflected in proposed regulations issued by the IRS, e.g., rules allowing an upper-tier partnership to push out its share of a lower-tier partnership's adjusted items. But in at least one case (the rule that permits netting of increases and decreases in tax liability resulting from a push-out election) the technical correction implements a fix that the IRS has said was beyond its administrative authority.

Low Income Housing Tax Credit

The low-income housing credit (LIHTC) is the federal government's primary program to encourage the investment and development of affordable housing in the US. The federal government allocates LIHTCs to each state based on population and then the state's housing agencies award the LIHTCs to eligible projects. The Omnibus Act increases the annual federal government LIHTC allocation authority by 12.5% for 2018, 2019, 2020 and 2021, which will provide states with additional LIHTCs to award to projects.

Historically, the LIHTC has been restricted to projects that have tenants with incomes up to 60% of area median income (AMI) which directly correlates with the rent that can be charged by the landlord. While states are encouraged to give preference to developments that serve the lowest-income populations, it can be difficult to make such developments financially feasible in some cases.

The Omnibus Act creates a new test for tenant AMI, known as "income averaging," that would allow the 60% of AMI ceiling to apply to the average of all apartments in a property rather than to every individual LIHTC apartment. The maximum income to qualify for any LIHTC apartment would be limited to 80% of AMI, which is still considered low-income. The higher rents that households with incomes above 60% of AMI could afford have the potential to offset the lower rents that households below 40 or 30% of AMI could afford, allowing developments to maintain financial feasibility while providing a deeper level of affordability. This

change is much needed for the industry and will allow developers and investors to develop projects in higher income areas or areas where there may be lack of tenants to meet the 60% of AMI requirement.

Takeaway

The Omnibus Act clarified several uncertainties relevant to the real estate industry. In certain cases, these revisions may ultimately assist real estate investors, particularly non-U.S. investors, to determine the US tax consequences of their investments in U.S. real estate.

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