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Extenders Bill Would Curtail OpCo-PropCo Spin-Off Transactions

On Monday, December 8, 2015, House Ways and Means Committee Chairman Rep. Kevin Brady (R-Texas) introduced the “Tax Increase Prevention and Real Estate Investment Act of 2015” (the “Extenders Bill”). This bill, if enacted in its present form, retroactively extends, and in some cases modifies, a number of tax relief provisions that expired at the end of 2014, generally through the end of 2016.

Unexpectedly, and perhaps more significantly for our clients, the Extenders Bill also contains a number of provisions that would severely curtail “OpCo-PropCo” spin-off transactions.

In an OpCo-PropCo spin-off transaction, the assets of either the parent corporation (“Distributing”) or the spun-off subsidiary (“Controlled”) consist primarily of real estate assets (“PropCo”), while the other corporation continues to operate the historic pre-spin business (“OpCo”) and leases the real estate from PropCo, which seeks to qualify as a real estate investment trust (“REIT”). Under current law, subject to meeting certain conditions, such spin-offs are tax-free to the constituent corporations and their shareholders.

Significant recent OpCo-PropCo spin-off transactions include Penn National Gaming (casinos), CBS Outdoor (outdoor advertising), The Ensign Group (assisted living facilities), Windstream Holdings (telecommunications) and, most recently, Darden Restaurants (restaurants).

OpCo-PropCo Spin-Off Transactions Under the Extenders Bill

The Extenders Bill would prevent either Distributing or Controlled from electing to be taxable as a REIT for 10 years following a tax-free spin-off transaction completed on or after December 7, 2015. This would have applied to each of the OpCo-PropCo spin-off transactions listed above if they had occurred on or after the effective date.

The Extenders Bill would also amend Section 355 of the U.S. Internal Revenue Code of 1986, as amended (the “Code”), to deny tax-free treatment to spin-off transactions in which either Distributing or Controlled is a REIT prior to the spin-off transaction. An exception would allow spin-off transactions to be tax-free if both Distributing and Controlled are REITs immediately after the spin-off transaction. An additional exception would apply to a REIT that spins off a taxable REIT subsidiary (“TRS”) (*i.e.*, a subsidiary of a REIT that is subject to corporate tax) but only if, for the last three years, (1) Distributing has been a REIT, (2) Controlled has been a TRS and (3) Distributing had “control” (within the meaning of Section 368(c) of the Code) of Controlled. These provisions would apply to any transactions consummated on or after December 7, 2015.

Percentage Rents and Interest from Certain Corporations Not REIT Qualifying Income

Generally, following an OpCo-PropCo spin-off transaction, OpCo continues to operate the historic pre-spin business and leases the real property from PropCo under long-term leases that are based in whole or in part on a fixed percentage of receipts or sales. For many such PropCos, OpCo is initially the primary (often only) tenant.

The Extenders Bill would require these REITs, and other REITs that rely heavily on a small number of tenants that pay percentage rents, to significantly diversify their tenant base. Under the proposed legislation, if over 25% of a REIT's combined rent and interest income received or accrued in any taxable year is (1) from any C corporation (and members of its affiliated group) and (2) based on a fixed percentage of the tenant's or borrower's receipts or sales, any such rent or interest income attributable to leases entered into after, or debt instruments acquired after, December 31, 2015 would not be treated as rents from real property or interest. In addition, if any lease or debt instrument is materially modified (including any extension) it would be treated as if it was entered into at the time of the modification. Although not entirely clear, it appears that the statutory language would disqualify not only percentage rent and interest, but also the fixed component of any such payment.

Because REITs must satisfy certain gross income tests, excluding fixed percentage rents or interest income from a primary tenant from REIT qualifying income would cause REITs that rely on such rent and interest income to lose their REIT status. REITs could avoid the impact of this provision by diversifying their tenant base or moving away from leases that are based on a fixed percentage of receipts or sales. However, for some this would require significant changes to their operating model. REITs with existing long-term leases, such as the REITs involved in recent OpCo-PropCo spin-off transactions, may not be immediately affected by this proposed rule.

These provisions would apply to any leases or debt instruments entered into or materially modified after December 31, 2015.

Changes to FIRPTA

Under the provisions of the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"), non-U.S. persons are generally subject to U.S. federal income tax on gains from investments in U.S. real property interests ("USRPIs"), which include stock of U.S. real property holding corporations ("USRPHCs"). As equity REITs are generally USRPHCs, foreign REIT shareholders are generally subject to FIRPTA. Currently, any class of USRPHC stock (including that of a REIT) that is publicly traded is not subject to FIRPTA, except with regard to persons that hold (or held within a certain period) over 5% of such class of stock.

The Extenders Bill would (i) extend the publicly traded exception described above from 5% to 10% in the case of REITs, (ii) generally exempt foreign pension trusts from FIRPTA and (iii) generally allow certain publicly traded non-U.S. entities to acquire, hold and dispose of stock of a REIT without being subject to FIRPTA.

These provisions would apply after the legislation is enacted.

Other Proposed Changes

Certain other, largely liberalizing, changes to the REIT prohibited transaction, preferential dividend and income and asset tests were also included in the Extenders Bill, as is a new rule limiting to 20% (down from 25%) the portion of a REIT's assets that consist of TRS securities (effective beginning in 2018).

The Extenders Bill includes numerous other provisions and many details this summary does not address. We will monitor its progress through Congress and keep our clients informed with respect to material future developments.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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