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# PATH Act Gives Tax Benefits to Emerging Growth Companies and Investors

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On December 18, 2015, as part of passing an omnibus spending bill for fiscal year 2016, President Obama signed into law the **Protecting Americans from Tax Hikes Act of 2015** (the "PATH Act"). The PATH Act extends, in some cases permanently, many taxpayer-friendly tax provisions which in prior years had been "extended" on a temporary year by year basis. In addition, the PATH Act includes a substantial relaxation of the taxation of investments in US real estate by non-US persons. This Alert briefly summarizes a couple of the most consequential tax extenders for emerging growth companies and their investors, relating to "qualified small business stock," as well as some of the significant changes in the taxation of US real estate.

## Exclusion of 100% of gain on qualified small business stock

Non-corporate taxpayers who acquired qualified small business stock, or QSBS, after September 27, 2010 and before 2015 and satisfy a 5-year holding period have been entitled to a 100% exclusion from taxation of their gain on sale of such stock (including alternative minimum tax), subject to certain limitations. Prior to the effectiveness of the PATH Act, QSBS acquired after 2014 would have received only a 50% gain exclusion upon sale after five years. The PATH Act extends and makes permanent the full 100% tax exemption for QSBS acquired at any time after September 27, 2010 (various lower exclusion percentages apply to QSBS acquired earlier).

Stock of a domestic "C corporation" may qualify as QSBS if it meets the following main requirements: (i) it is acquired in an original issuance from the corporation for money, stock itself that was QSBS, property other than stock, or as compensation for services, (ii) it is issued by a corporation whose aggregate gross assets at all times since inception through the issuance do not exceed $50 million, (iii) during substantially all of the taxpayer's holding period at least 80% of the issuing corporation's assets are used in active conduct of a qualified business, which is any business other than certain service businesses, and businesses engaged in financial, farming, public accommodation and certain natural resource activities, and (iv) the issuing corporation has not made any specified disqualifying redemptions of its stock or violated certain other requirements. The amount of gain eligible for exclusion is generally limited to the greater of $10 million or ten times the taxpayer's tax basis in the QSBS.

The PATH Act's adoption of a permanent 100% QSBS gain exclusion makes it critical for taxpayers to determine whether stock of a corporation in which the taxpayer has invested qualifies as QSBS. We routinely assist taxpayers in making this determination and are happy to continue to do so.

## Reduction in S corporation recognition period for built-in gains tax

Unlike C corporations, S corporations generally pay no corporate-level tax; instead, items of income and loss of an S corporation pass through to its shareholders. If an S corporation was formerly a C corporation, however, the S corporation is subject to corporate-level tax on any "built-in gains" recognized within a "recognition period" following its election to become an S corporation. This corporate-level tax also applies if the S corporation (even if it has always been an S corporation) disposes of built-in gain assets that it acquired from a C corporation in a carryover basis transaction (for example, pursuant to a tax-free reorganization) within the recognition period.

Prior to the effectiveness of the PATH Act, the recognition period for built-in gains recognized by an S corporation in tax years beginning after 2014 would have been ten years. The PATH Act permanently changes the recognition period from ten years to five years.

## Real estate related tax changes

Under the Foreign Investment in Real Property Tax Act or 1980 ("FIRPTA"), non-US persons are generally subject to US federal income tax, and are required to file US federal income tax returns, with respect to gain from the disposition of investments in US real estate (including stock in a domestic corporation the majority of the business and real estate assets of which comprise US real estate (a "USRPHC"). If a non-US person owns stock of a real estate investment trust ("REIT"), DFIRPTA also generally applies to the investor's receipt of certain distributions attributable to gain from the sales of US real property interests by the REIT. To help enforce the collection of such taxes, FIRPTA imposes withholding taxes on the payer of such sale proceeds or distributions.

The US real estate industry has lobbied Congress for several years to liberalize the tax treatment of non-US persons in US real estate on the basis that increased investment in US real estate would help the US economy. Several of the US real estate industry's proposals made their way into the PATH Act.

First, small holders of publicly traded USRPHCs generally are not subject to FIRPTA, provided they own no more than five percent of the publicly traded class of stock during an applicable testing period (generally the shorter of five years, or the taxpayer's holding period). The PATH Act increases the threshold to ten percent in the case of publicly trade REITs. The five percent threshold continues to apply to publicly traded stock of USRPHCs that are not REITs.

Second, and probably most significantly, non-US pension funds (as specifically defined under the PATH Act) are no longer subject to FIRPTA whatsoever with respect to dispositions of US real property interests (including distributions from and dispositions of interests in REITs). The intent of this change is to harmonize the taxation of US real estate investment as between US and non-US pension funds and is an enormous change in US taxation.

Third, certain publicly traded non-US investment vehicles that meet recordkeeping and other requirements are generally not subject to tax under FIRPTA at all upon a disposition of stock in a REIT, except to the extent that an investor in such investment vehicle holds more than ten percent of the stock of the REIT (directly or indirectly).

To pay for the cost of these taxpayer friendly provisions, the PATH Act also contains some real-estate related provisions which increase revenue. Chief among them are a prohibition on certain tax-free spin-offs involving REITs and an increase in the withholding tax FIRPTA imposes on the gross proceeds from the sale of US real property interests to non-US persons (from 10% to 15%) as well as other technical changes related to certain REIT testing rules.

These real estate-related changes generally take effect as of the date of enactment of the PATH Act (which means they are currently effective for dispositions and applicable distributions). One exception is the increase in the withholding rate under FIRPTA which is effective for dispositions on or after February 16, 2016.

*If you would like more information regarding the foregoing changes in tax law and how they may affect your particular situation, please contact one of the lawyers here or any member of your Cooley tax team.*

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