REAL ESTATE INVESTMENT TRUSTS 101©

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I. INTRODUCTION

The real estate investment trust (REIT) was originally intended to be a mutual fund for real estate. The original REIT legislation, enacted in 1960, was intended to provide a tax-favored vehicle through which the average person could invest in a professionally managed portfolio of real property. The complex rules governing REITs are all meant to further this intent: that a REIT remains predominantly a real estate entity, that its real estate is professionally managed, that the REIT itself (and thus its investors) avoids the risks of conducting an active business, and that the fruits of the investments are regularly distributed to the investors.[1] The reward for compliance is exemption from federal income taxes at the REIT level. Contrary to the purposes of the original legislation, REITS are now active business entities that compete with taxable corporations and expose their shareholders to business risk.[2] This outline examines the rules governing the qualification and taxation of REITS, and notable issues that have been addressed by modern REITs.

II. QUALIFICATION REQUIREMENTS

A. <u>Structure</u>

1. **Form**. Throughout the taxable year, a REIT must:

    - be a corporation, trust or association;
    - be otherwise taxable as a domestic corporation;
    - not be a financial institution under section 582(c)(2);
    - not be an insurance company under subchapter L; and
    - file with its return an election to be treated as a REIT (or, if it has previously made an election, the election must not have been terminated or revoked under section 856(g).

2. **Management**. Throughout the taxable year, a REIT must be managed by 1 or more trustees or directors.

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[1] *See* Steven F. Mount, *Real Estate Investment Trusts*, 742 Tax Mngt. Port. A-1 (BNA 2000).

[2] *See* David M. Einhorn, *Unintended Advantage: Equity REITs vs. Taxable Real Estate Companies*, 51 Tax Lawyer 203.

3. Ownership.

- Throughout the taxable year, ownership must be evidenced by transferable shares or transferable certificates of beneficial interest.
  - Provisions in a trust instrument or corporate charter or by-laws that permit the trustee or directors to refuse to transfer shares where the trustee or directors believe in good faith that a transfer would result in the loss of REIT status does not render the shares "nontransferable."[3]
  - The IRS has ruled that an "excess share" provision in the REIT's governing instrument designed to prevent violation of the closely-held prohibition (see below) will not cause the shares to be nontransferable.[4]
- Beneficial ownership must be held by 100 or more persons at least 335 days of every taxable year or a proportionate part of a tax year less than 12 months.
  - Beneficial ownership is determined without reference to any attribution rules.[5]
  - This requirement is waived for the first year of a REIT election.[6]
- A REIT must not be closely held, *i.e.*, an entity will be disqualified as a REIT if more than 50% of the value of its shares is owned directly or indirectly by or for five or fewer individuals at any time during the last half of the REIT's taxable year (the "5/50 test").[7]
  - This requirement is waived for the first year after a REIT election.[8]

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3 Treas. Reg. § 1.856-1(d)(2).

4 Priv. Ltr. Rul. 8921067 (Feb. 28, 1989). The provision considered in the ruling was an amendment to the articles of incorporation that would prohibit any transfer that would cause a transferee to own more than 3.9 percent in value of all of the outstanding stock of the REIT. Excess Shares are generally a separate class of common shares that have no voting or distribution rights; Shares transferred to a party contrary to a REIT's articles are transformed by operation of law into Excess Shares held in trust for the benefit of the transferee. Upon a permitted transfer of the shares, they transform into common shares.

5 Treas. Reg. § 1.856-1(d)(2).

6 I.R.C. § 856(h)(2).

7 I.R.C. §§ 856(h)(1), 542(a)(2).

8 I.R.C. § 856(h)(2).

- For purposes of this requirement, stock attribution rules of section 544 apply, but without attribution among partners.[9]
    - Thus, substantially all of the shares of a REIT can be owned by a corporate sponsor such a REIT, a "captive REIT"). The 5/50 test and the 100 beneficial owners requirement would both be satisfied if, for example, the corporate sponsor has 10 equal shareholders and the remaining shares of the REIT are owned by 99 employees of the corporate sponsor.
- For purposes of this requirement, stock owned by a tax-exempt 401(a) plan is deemed to be owned by plan beneficiaries.[10]
- A REIT that complies with regulations prescribing methods of ascertaining actual and beneficial ownership may avoid disqualification if it reasonably does not know that it failed to satisfy the 5/50 test.[11]
- An entity that runs afoul of the 5/50 test would be disqualified as a REIT and taxed as a personal holding company.[12]

4. **Tax Year**. An entity making the REIT election in any taxable year beginning after October 4, 1976 must adopt the calendar year as its taxable year, and may not change its taxable year as long as the REIT election is in effect.[13]

B. <u>**Asset Composition**</u>

1. **Real Estate and Low-Risk Assets**. At the close of each quarter of the taxable year,[14] <u>at least 75%</u> of a REIT's assets must consist of:

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9 I.R.C. § 856(h)(1).

10 I.R.C. § 856(h)(3).

11 I.R.C. § 856(k).

12 Treas. Reg. § 1.856-1(d)(5).

13 I.R.C. § 859(a).

14 Failure to satisfy the asset test at a quarter end will not cause a disqualification if the asset test is satisfied at the close of the preceding quarter and either (i) the discrepancy between the value of the REIT's assets and the asset test requirements arose from changes in the market value of its assets and was not caused by acquisition of one or more nonqualifying assets, or (ii) the discrepancy is eliminated within 30 days after the close of the quarter in which it arose. I.R.C. § 856(c)(4)(B).

- interests in real property, including interests in mortgages on real property;[15]
    - "mortgages on real property" include deeds of trust on real property;[16]
    - "interests in real property" include foreign real property and security interests in foreign real property that are legally equivalent to U.S. mortgages or deeds of trust.[17]
- shares (or certificates of beneficial interest in) other REITS;[18]
- for a 1-year period after the REIT receives "new capital," any stock or debt instrument attributable to a temporary investment of the new capital, defined as amounts received either:
    - in exchange for stock of the REIT, or
    - in a public debt offering in exchange for debt having maturities of at least 5 years;[19]
- interests in REMICs;
    - if less than 95% of REMIC assets are composed of real estate assets (assets described in a. through d. herein, tested as if the REIT held the assets directly), the REIT is treated as holding directly its proportionate shares of REMIC assets.[20]
- cash and cash items;
    - cash items include certificates of deposit and ordinary receivables arising from the ordinary operation of the REIT, but not purchased receivables;[21]
    - repo agreements in which a REIT "purchases" Treasury notes to be "sold" back to a bank are not cash items.[22]

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15 I.R.C. § 856(c)(5)(B);

16 Treas. Reg. § 1.856-3(b)(1).

17 Rev. Rul. 74-191, 1974-1 C.B. 170.

18 I.R.C. § 856(c)(5)(B).

19 I.R.C. § 856(c)(5)(D)(ii).

20 I.R.C. § 856(c)(5)(E).

21 Treas. Reg. § 1.856-2(d)(1).

22 Rev. Rul. 77-59, 1977-1 C.B. 196.

- U.S. government securities.

  - As with all terms not defined in section 856(c)(5), the meaning of this term has the same meaning as used in the Investment Company Act of 1940 (the "1940 Act").[23] Under the 1940 Act, "security" generally includes any note, stock, bond or evidence of indebtedness.[24]

  - The IRS has provided in revenue rulings that "government securities" in this context include securities of the Federal Housing Administration, Federal National Mortgage Association, Federal Home Bank, Federal Land Bank, Federal Intermediate Credit Bank, Banks for Cooperatives, Public Housing Administration, U.S. Postal Service, Commodity Credit Corporation, Small Business Administration, and General Services Administration.[25] In addition, the IRS has ruled in the context of RICs that "government securities" include obligations of the Student Loan Marketing Association (Sallie Mae).[26]

2. Diversification Requirement.

- Securities (other than those described in 1. above) must account for <u>no more than 25%</u> of the value of a REIT's total assets.

  - Note that a REIT that satisfies the 75% test described above will also satisfy this requirement.

  - Stock in other REITs and REMIC interests that qualify as real estate assets, are excluded for purposes of the diversification requirement.

  - "Value" is generally defined as fair market value, but the value of stock in another REIT is the greater of the stock value or the value of the underlying assets.[27]

- Beginning in 2001, securities of a taxable REIT subsidiary (a "TRS") must account for <u>no more than 20%</u> of the value of a REIT's total assets in the aggregate.

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23 *See* I.R.C. § 856(c)(5)(F).

24 15 U.S.C. § 80(a)-2(a)(36).

25 Rev. Rul. 64-85, 1964-1 C.B. 230; Rev. Rul. 71-537, 1971-2 C.B. 262; G.C.M. 34648 (Oct. 19, 1971); Rev. Rul. 74-440, 1974-2 C.B. 19; Rev. Rul. 76-426, 1976-2 C.B. 17; Rev. Rul. 77-342, 1977-2 C.B. 238; G.C.M. 36522 (Dec. 17, 1975).

26 Rev. Rul. 73-548, 1973-2 C.B. 14.

27 I.R.C. § 856(c)(5)(A).

- Except with respect to securities of a TRS and securities described in 1. above, securities of any 1 issuer <u>must not account for</u>

  i. more than 5% of the value of the REIT's total assets,

  ii. more than 10% of the total voting power of the outstanding securities of the issuer, and

  iii. beginning in 2001, more than 10% of the total value of the outstanding securities of the issuer.[28]

  - <u>Safe harbor for straight debt.</u> Straight debt[29] is excluded for purposes of this test if:

    - the issuer is an individual,

    - the REIT and its TRSs, if any, hold only straight debt of the issuer, or

    - the issuer is a partnership in which the REIT holds a 20% or greater profits interest.

3. **QRS Look-Through Rule**. The existence of a qualified REIT subsidiary ("QRS") is disregarded.[30] Accordingly, its assets, liabilities, and items of income, deduction and credit are deemed to be those of its parent REIT.

   - A QRS is a corporation wholly owned by a REIT as to which a TRS election is not in effect.[31]

4. **Partnership Look-Through Rule**. A REIT that is a partner in a partnership is deemed to own its proportionate share of each of the assets of the partnership, determined in accordance with capital interests (notwithstanding different allocations under section 704).[32] It is unclear how guaranteed payments are treated.

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[28] For taxable years beginning before Jan. 1, 2001, the diversification requirement was satisfied by complying with a. and c.1. above, and the requirement that the REIT hold no more than 10 percent of the outstanding voting securities of any issuer. The addition of b. and c.iii. above reinforces the statutory TRS regime that is meant to limit a REIT's use of nonvoting preferred stock subsidiaries to perform prohibited transactions.

[29] As defined in section 1361(c)(5) without regard to section 1361(c)(5)(B)(iii).

[30] I.R.C. § 856(i)(1).

[31] I.R.C. § 856(i)(2).

[32] Treas. Reg. § 1.856-3(g).

C. Income Requirements

1. **75% Test**. At least 75% of a REIT's gross income for each taxable year must be composed of:

- interest on obligations secured by mortgages on real property or interests in real property;
- rents from real property, including
  - rents from interests in real property
  - charges for services customarily rendered in connection with the rental of real property, whether or not such charges are separately stated, and
  - rent attributable to personal property leased in connection with the lease of real property that does not exceed 15% of the total real and personal property rent from the lease for the taxable year:
    - rent attributable to personal property with respect to a lease of real property is determined using the average of the fair market values at the beginning and end of the taxable year of the personal property and the real property;[33]
- gain from the disposition of interests in real property (including interests in real property mortgages) that is not section 1221(a)(1) property (generally, property held primarily for sale in the course of ordinary business);
- abatements and refunds of real property taxes;
- income and gain from "foreclosure property," which is defined as any interest in real property and any personal property incident to the real property that (i) is acquired by the REIT by bidding at a foreclosure, or otherwise acquired by agreement or legal process after a default or imminent default on lease of such property or on debt secured by such property, and (ii) is not property acquired as a result of debt arising from the REIT's disposition of section 1221(a)(1) property; and as to which the REIT makes an election.[34]

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[33] I.R.C. § 856(d)(1).

[34] This election is valid for 3 years after the taxable year in which the election is made, and may be extended for another 3 years with IRS approval, but will terminate if the REIT receives nonqualifying income from new construction or uses the property in a trade or business. I.R.C. § 856(e).

- consideration, other than amounts that depend on income or profits of any person, received or accrued for entering into agreements to (i) make real property mortgage loans, or (ii) purchase or lease interests in real property (including interests in real property mortgages);

- gain from disposition of a real estate asset that is not a prohibited transaction (see section III.F. below);

- distributions on, and gain from the disposition of, transferable shares in other REITs; and

- qualified temporary investment income.

2. **95% Test**. At least 95% of a REIT's gross income for each taxable year must be composed of items that satisfy the 75% test and/or:

   - dividends;

   - interest;

   - gain from the disposition of stock and securities that are not section 1221(a)(1) property; and

   - "hedging income."[35]

3. **Considerations in Applying Income Tests**.

   - Gross income for the 75% test and the 95% test does not include income from prohibited transactions.

   - COD recognized by a REIT is excluded from its gross income for purposes of both the 75% test and the 95% test.[36]

   - QRS items of income are included as items of its REIT parent.

   - A REIT that is a partner in a partnership is deemed to receive partnership income attributable to its share of partnership assets determined in accordance with capital interests.[37]

   - A REIT that fails to satisfy either or both income tests due to reasonable cause and not willful neglect will not be disqualified as long as the nature and amount of each item of gross income described in the 75% and 95% tests are set forth in a schedule

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[35] I.R.C. § 856(c)(5)(G).

[36] I.R.C. § 108(e)(9).

[37] Treas. Reg. § 1.856-3(g).

attached to its tax return.[38] However, the REIT will be subject to a 100% tax on disqualifying income, as discussed in section III.D. below.

4. Income-Based Rents and Interests

- "Rents from real property" does not include amounts that depend on the income or profits derived by any person from the property.
    - If a. above applies solely because the tenant of a REIT receives amounts from subtenants that depend on the income or profits derived by any person from the property, only a proportionate part of the income is excluded.[39]
    - If a REIT receives amounts that depend on the income or profits of a tenant that derives substantially all of its income with respect to the property from subleasing the property, and a portion of the amounts would be treated as "qualified rents" (i.e., rents from real property if received directly by the REIT), the amount received by the REIT attributable to such qualified rent is included as rent from real property.[40]
- "Interest" does not include amounts that depend on the income or profits derived by any person.
    - If b. above applies solely because the debtor of a REIT receives amounts from any person that depend on the income or profits derived by any person, only a proportionate part of the income is excluded.[41]
    - If a REIT receives amounts on debt secured by a mortgage or interest in real property that depends on the income or profits of a debtor deriving substantially all of its income with respect to the property from leasing the property, and a portion of the amounts would be treated as qualified rents, the amount received by the REIT attributable to such qualified rent is included as interest.[42]

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38 I.R.C. § 856(c)(6).

39 I.R.C. § 856(d)(4).

40 I.R.C. § 856(d)(6).

41 I.R.C. § 856(f)(1)(B).

42 I.R.C. § 856(f)(2).

- Rents from real property and interest include income or profits based on a fixed percentage or percentages of receipts or sales.[43]

5. **Rent from Related Tenants**. "Rents from real property" does not include amounts received from the following related persons:

- Corporations in which the REIT owns 10% or more of the total combined voting power of all classes of stock entitled to vote, or 10 percent or more of the total value[44] of all shares, applying modified section 318 constructive ownership rules;

- Non-corporate entities in which the REIT owns an interest of 10% of more of the assets or net profits, applying modified section 318 constructive ownership rules.[45]

- Rent received by a REIT from its TRS is treated as rent from real property where:

  i. at least 90 percent of the leased space of the property is rented to non-TRS tenants and persons not described in a. above, to the extent the rents paid by the TRS are substantially comparable to rents paid by other tenants for comparable space, or

  ii. the rent is paid for a non-gambling lodging facility leased by the REIT to the TRS, and the property is operated on behalf of the TRS by an "eligible independent contractor," *i.e.*, an independent contractor that, at the time it enters into a service contract with the TRS, is actively engaged in the trade or business of operating such facilities for any person who is not related to the REIT or the TRS.[46]

6. **Impermissible Tenant Service Income**. "Rents from real property" does not include "impermissible tenant service income" ("ITSI"),[47] defined as amounts received (directly or indirectly) by a REIT for services rendered by the REIT to tenants, or for managing or operating the property, subject to the following exceptions and special rules:

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[43] I.R.C. §§ 856(d)(2)(A), (f)(1)(A).

[44] For taxable years beginning on or before December 31, 2000, the test applied to the number rather than value of all shares.

[45] I.R.C. § 856(d)(2)(B), (d)(5).

[46] I.R.C. § 856(d)(8), (9). These paragraphs relating to taxable REIT subsidiaries apply for taxable years beginning after December 31, 2000.

[47] I.R.C. § 856(d)(2)(C).

- services provided through a TRS or an independent contractor from whom the REIT does not derive any income are not treated as services rendered by the REIT;

- amounts that would be excluded from treatment as UBTI under section 512(b)(3) if received by an exempt organization are not ITSI;[48]

- if amounts received by a REIT for services with respect to a property that are not excluded from ITSI treatment under a. or b. above exceed 1 percent of the income received (directly or indirectly) by the REIT with respect to the property, all amounts received by the REIT with respect to the property are treated as ITSI;[49] and

- amounts received by a REIT for services are treated as being at least equal to 150 percent of the REIT's direct cost of providing the services.[50]

- Note that if a service is not customarily rendered in connection with the rental of real property, amounts received are excluded from rental income even if they fall under the exceptions described above.

7. **Independent Contractor**. As used in sections 5. and 6. above, an "independent contractor" is any person that satisfies the following tests, applying certain constructive ownership rules of section 318:

   - The person does not own more than 35% of the interests in the REIT;

   - If the person is a corporation, not more than 35% of the total combined voting power of its stock (or 35% of the total shares of its stock) is owned by one or more persons owning 35% or more of the interests in the REIT; and

   - If the person is not a corporation, no more than 35% of the interest in its assets or net profits is owned by one or more persons owning 35% or more of the interests in the REIT.

   - Beginning with taxable years after 2000, for any class of stock of the REIT or the related person that is regularly traded on an

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48 I.R.C. § 856(d)(7)(C).

49 I.R.C. § 856(d)(7)(B). Effective for tax years beginning after August 5, 1997. The 1% safe harbor applies on a property-by-property basis. Rev. Rul. 98-60, 1998-51 I.R.B. 6.

50 I.R.C. § 856(d)(7)(D).

established securities market, only persons who own more than 5 percent of such class is taken into account as owning any of the stock of such class for purposes of applying the 35% limit of b. and c. above.[51]

D. Distribution Requirements

1. **90% Test**. A REIT must distribute, and be eligible to take a dividends paid deduction for, at least the difference between:

   - 90%[52] of the sum of (i) the REIT taxable income (excluding net capital gains) for the taxable year before taking the dividends paid deduction and (ii) the net income from foreclosure property, minus the tax imposed on such foreclosure property income, and

   - excess noncash income, which is[53] the sum of the amounts of four categories of noncash items, minus 5% of the REIT taxable income determined without any net capital gain and before subtracting the dividends paid deduction.[54] The four categories of noncash items are:

     - the excess of Section 467 income (relating to certain payments for the use of property or services) over other items of gross income,

     - gain from disqualified like-kind exchanges of real estate assets, if the REIT intended the exchange to qualify under section 1031 and the disqualification was due to reasonable cause,

     - the amount of OID and market discount accrued on instruments to which sections 860E(a) or 1272 apply, and

     - COD income.

   - The calculation of income that must be distributed takes into account items of phantom income that do not produce distributable cash.

2. **Accumulated E&P**. If an entity was a corporation before electing to be treated as a REIT, the entity must distribute all of its accumulated earnings

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[51] I.R.C. § 856(d)(3).

[52] 95% for taxable years beginning on or before December 31, 2000.

[53] I.R.C. § 857(a)(1).

[54] I.R.C. § 857(e)(1).

and profits ("E&P") before the close of the taxable year in which it makes the election.[55] For taxable years beginning after August 5, 1997, distributions required under this rule are treated as made from the earliest of E&P that were accumulated in non-REIT years.[56] This first-in, first-out rule facilitates the purging of non-REIT E&P from newly electing REITs during the first taxable year of REIT status. However, the distribution of non-REIT E&P does not qualify for the dividends received deduction for purposes of computing the REIT taxable income (see section III.A below).[57]

III. TAXES IMPOSED

A. REIT Taxable Income

1. **Regular Corporate Tax**. A REIT is taxed at regular corporate rates on its taxable income (computed under section 11), reduced by

   - the deduction for dividends paid, other than dividends attributable to foreclosure income, and
   - amounts taxed under other subsections (net income from foreclosure property, penalties on failure to meet income tests and reallocations, and net income from prohibited transactions).[58]

2. **Net Capital Gain**. A REIT that has net capital gain for the taxable year is subject to:

   - regular corporate tax under 1. above, computed by excluding the net capital gain from its taxable income and computing the dividends paid deduction without capital gain dividends, plus
   - tax of 35% (the section 1201(a) rate) on undistributed net capital gain.[59]

B. Treatment of REIT Shareholders

1. **Dividend Treatment**. REIT shareholders are taxed on distributions of ordinary income in the same manner as they are taxed on other corporate

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55 I.R.C. § 857(a)(2)(B); Treas. Reg. § 1.857-11(b).

56 I.R.C. § 857(d)(3)(A).

57 I.R.C. § 857(d)(3)(B).

58 I.R.C. § 857(b)(1),(2).

59 I.R.C. § 857(b)(3).

distributions, except that REIT distributions to corporations do not qualify for the dividends received deduction.[60]

2. **Capital Gains**. A capital gain dividend is taxed as long-term capital gain to shareholders.

- However, an anti-abuse rule applies that renders any capital loss arising from a shareholder's sale of REIT stock treated as held for 6 months or less (after applying holding period rules of section 246(c)(3) and (4)) a long-term capital loss to the extent of the capital gain dividends received by the shareholder.[61]
- A capital gain dividend must be declared in a written notice to shareholders within 30 days (or with the annual report) after the close of the REIT's taxable year.[62]
- If a REIT chooses to retain and pay income tax on net long-term capital gains received during a taxable year, shareholders must include in income their pro rata share of the undistributed long-term gains and receive a credit for their share of the tax paid by the REIT.[63] The REIT must designate with respect to each shareholder and mail within 60 days of the close of the taxable year or with its annual report.

C. **Income from Foreclosure Property**

1. **Tax**. A REIT is taxed at the highest corporate rate on net income from property that the REIT has elected to treat as foreclosure property. However, the income is treated as qualifying income for the 95% and 75% tests.

2. **Calculation**. Net income from foreclosure property is defined as:

- income derived from foreclosure property that does not otherwise qualify under the 75% income test, plus
- gain from the disposition of foreclosure property that is section 1221(a)(1) property, reduced by
- deductions directly connected with the production of this net income.

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60 I.R.C. § 857(c); Treas. Reg. § 1.857-6(a), (d).

61 I.R.C. § 857(b)(8).

62 I.R.C. § 857(b)(3)(C).

63 I.R.C. § 857(b)(3)(D).

D. Income Test Deficiencies

1. **Tax**. A REIT is taxed on the greater of its deficiencies under the 75% or the 95% income test.[64]

   - For taxable years beginning after December 31, 2000, the deficiency under the 95% test is only the amount by which the items of income included under the 95% test fail to represent 90% of the REIT's gross income.[65]

2. **Amount of Tax**. The amount in 1. above is multiplied by a fraction that effectively yields a 100% tax on the amount of the deficiency, adjusted for corresponding deductions.

E. Excise Tax

1. **Distribution Requirement**. Section 4981 imposes a 4% excise tax on REITs that fail to distribute a minimum amount in each taxable year. The minimum distribution amount for each calendar year is the sum of

   - 85%[66] of the REIT's ordinary income for the calendar year, and
   - 95% of the REIT's capital gain net income for the calendar year.
     - Capital gain net income is the excess of capital gains over capital losses, minus any net ordinary loss (determined in a manner similar to the calculation of net operating loss).[67]
   - Note that this minimum distribution amount is different than the amount that a REIT must distribute to avoid disqualification.

2. **Amount Taxed**.

   The 4% excise tax is imposed on the difference between (i) the minimum required distribution amount and (ii) the distributed amount, defined as the sum of (x) the deduction for dividends paid during the calendar year (excluding amounts attributable to net income from foreclosure property), and (y) any amount already taxed as REIT taxable income or net capital gains for the taxable year ending during the calendar year.[68]

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64 I.R.C. § 857(b)(5).

65 I.R.C. § 857(b)(5)(A)(i).

66 95% for taxable years beginning on or before December 31, 2000.

67 I.R.C. § 4981(e)(2).

68 I.R.C. § 4981(a),(b),(c).

- The 1988 House Report provides that dividends declared and payable to shareholders of record between October 1 and December 31 are deemed to have been paid and received on December 31, as long as dividends are actually paid in January of the following year.

F. **Prohibited Transactions**

1. **Tax**. A 100% excise tax is imposed on net income from prohibited transactions, defined as sales of section 1221(a)(1) property other than foreclosure property.[69]

2. **Safe Harbor**. A sale of a real estate asset is not a prohibited transaction if:

   - the REIT held the property for at least 4 years, using carryover rules for property acquired through foreclosure that secured the defaulted loan made by the REIT, and property acquired upon termination of a lease;

   - capital expenditures made by the REIT and any partners with respect to the property during the 4 years preceding the sale do not exceed 30% of the sales price; and

   - either of the following is satisfied:

     i. the REIT does not make more than 7 sales of property during the taxable year (other than sales of foreclosure property or property converted under section 1033), or

     ii. substantially all of the marketing and development expenditures with respect to the property were made through an independent contractor, and the aggregate adjusted bases of all properties (other than foreclosure property or property converted under section 1033) sold during the taxable year does not exceed 10% of the aggregate bases of all REIT assets as of the beginning of the taxable year; and

   - in the case of real property not acquired through foreclosure or lease termination, the REIT has held the property for at least 4 years for the production of rental income.[70]

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[69] I.R.C. § 857(b)(6)(A),(B).

[70] I.R.C. § 857(b)(6)(C).

G. Reallocations of Rents, Deductions and Interest

1. **Tax**. A 100% excise tax is imposed on rents, deductions and interest that shift income properly reportable by a TRS to a REIT.

2. **Redetermined Rents**. The 100% tax is imposed on rents from real property that would be reduced under section 482 to clearly reflect income arising from services that a TRS provides to a tenant of the REIT.

   - Amounts received directly or indirectly by a REIT for services that are customarily rendered in connection with the rental of real property are excluded.[71]

   - Amounts received directly or indirectly by a REIT for services rendered, or for management or operation provided, are excluded <u>if</u> either:

     i. the services or management is provided through an independent contractor from whom the REIT does not receive any income, or

     ii. the amounts are not greater than 1 percent of the total income received directly or indirectly by a REIT with respect to the rental property.[72]

   - Rent is excluded if the service charges are separately stated and the rent paid by the tenant receiving the service is substantially comparable to the rent paid by other tenants leasing the REIT property.[73]

   - Rent is excluded if the TRS's gross income from the service is at least 150 percent of its direct cost in rendering the service.[74]

   - Redetermined rents nevertheless count as rent from real property for purposes of the income tests.[75]

3. **Redetermined Deductions**. The 100% tax is imposed on deductions of a TRS the amount of which would be decreased, with a corresponding reallocation to the REIT, under section 482.[76]

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[71] I.R.C. § 857(b)(7)(B)(ii).

[72] I.R.C. § 857(b)(7)(B)(ii),(iii).

[73] I.R.C. § 857(b)(7)(B)(v).

[74] I.R.C. § 857(b)(7)(B)(vi).

[75] Conf. Rpt. 106-478 (PL 106-170) at 179.

[76] I.R.C. § 857(b)(7)(C).

4. **Excessive Interest**. The 100% tax is imposed on deductions for interest paid to a REIT by its TRS to the extent that the interest is more than what is commercially reasonable.[77]

H. **Failure to Determine Beneficial Ownership**

1. **Requirement**. A REIT must comply with rules set out in Treasury Regulations section 1.857-8 for ascertaining actual ownership of the REIT's outstanding shares or certificates of beneficial interest.

2. **Penalty**. A penalty of $25,000 is imposed on a REIT that fails to comply with the regulations, increased to $50,000 for failure due to intentional disregard of the requirement.

IV. HOT ISSUES

A. **Taxable REIT Subsidiaries**

1. **Background**. The Tax Relief Extension Act part of the Ticket to Work and Work Incentives Improvement Act of 1999 (the "1999 Act"), created a new entity, the TRS, that is the subject of a new statutory regime governing a REIT's use of subsidiaries to conduct active businesses.

- Prior to the enactment of TRS rules, REITs used "preferred stock subsidiaries" ("PSS") to circumvent the limited scope of the REIT rules. REIT ownership of nonvoting preferred stock of a subsidiary satisfied the diversification requirement in place for taxable years ending on or before December 31, 2000, because the requirement contained a 10% voting stock limitation but not the 10% value limitation that was enacted in 1999 together with the TRS regime. Thus, a PSS could earn active, non-rental income and pass on earnings to the REIT by way of dividend or interest, which qualify under the income tests.

- The new TRS regime limits the manner in which REITs can convert disqualifying income into qualifying income without a corporate-level tax, but also provides new opportunities for REITs.[78]

2. **Conversion of PSS to TRS**. An existing PSS could convert to a TRS at any time before 2004. The conversion would have been treated as a tax-free A reorganization.[79]

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[77] I.R.C. § 857(b)(7)(D).

[78] *See* Brandon and DeLuca, *Opportunity Knocks for Taxable REIT Subsidiaries*, 92 J. Tax'n 141 (2000).

[79] 1999 Act, § 226.

3. Definition of TRS.

- A corporation in which the REIT holds stock is a TRS if both the REIT and the corporation make an election.[80]

    - The election can be revoked with the consent of both the REIT and the TRS.[81]

- A corporation in which a TRS holds, directly or indirectly,

    i. 35% of the voting power of the outstanding securities, or

    ii. 35% of the total value of the outstanding securities (applying the straight debt safe harbor),

  will also be treated as a TRS with respect to the same REIT.[82]

- A qualified REIT subsidiary ("QRS") will not be treated as a TRS by reason of the 35% test.[83]

- A "TRS" does not include any corporation that directly or indirectly operates, manages, or provides rights to a brand name to, a lodging facility or health care facility.

    - A corporation that provides rights to a brand name to an independent contractor to operate or manage a lodging facility is not excluded from being a TRS with respect to a REIT if the corporation is a franchisee or licensee with respect to the rights and the lodging facility is either owned by the corporation or leased by the corporation from the REIT.[84]

4. Activities of TRS. The only statutory restrictions on the activities of a TRS relate to lodging and healthcare facilities. Thus, a TRS should be able to provide general moving services, such as moving belongings into and out of leased space and leasing trucks to tenants. TRSs may also provide business and marketing consultation to retail tenants, operate food courts in malls, provide store design services and construction services,

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80 I.R.C. § 856(l)(1).

81 I.R.C. § 856(l)(1).

82 I.R.C. § 856(l)(2).

83 I.R.C. § 856(l)(2).

84 I.R.C. § 856(l)(3).

and should be able to operate parking lots without using independent contractors.[85]

a. The definition of "TRS", coupled with the inclusion in "rents from real property" of rent paid for a non-gambling lodging facility leased by the REIT to a TRS and operated by an eligible independent contractor, allow REITs to own hotels and receive rents if the hotel is operated through an independent contractor.

5. Ensuring Taxation of TRS Earnings.

- Potential redetermination of rents and deductions between a TRS and a REIT, as discussed in Section III.G.

- Denial of Interest Deduction. If a TRS has "excess interest expense" under section 163(j), it will be denied a deduction for interest paid to its REIT parent.[86] This result is designed to preclude tax-free earnings distributions by the TRS through interest on excessive debt owed to the REIT that bears commercially reasonable interest rates, which would not be subjected to the 100% tax on excessive interest.

B. Satisfying Distribution Requirements with Stock

1. Section 305(b). Several REITs have utilized the dividend treatment rules of section 305(b) to obtain a dividends paid deduction for distributions of its stock while preserving cash for expansion of its investments. Because section 305(b) was intended to tax shareholders on distributions that have the effect of a dividend, the IRS has interpreted the section expansively. The wide net cast by section 305(b) to treat stock distributions as "property" to which section 301 applies provides a favorable result for REITs, because the distribution requirement for REIT qualification, and the requirement to avoid the 4% excise tax, are based on the amount of a REIT's dividends paid deduction. [87]

2. Examples. Examples of the use of section 305(b) for this purpose include:

- Patriot American Hospitality's 4th quarter distribution for 1998, which offered shareholders a choice of either receiving additional shares of paired common stock or cumulative preferred stock callable after a year. This distribution was designed to "flunk"

[85] Brandon and DeLuca, n.78, *supra*, at 146.

[86] I.R.C. § 163(j)(3)(C).

[87] *See* Willens, *REITs Pursue Bold Strategies to Satisfy Distribution Requirements*, 92 J. Tax'n 110 (2000).

section 305(b)(3) by resulting in the receipt of common stock by some common shareholders and of preferred stock by other common shareholders.

- In September 1999, CRIIMI MAE declared a dividend on its common stock that was paid in shares of a new series of convertible preferred stock designed to satisfy the terms of section 305(b)(5) and Treasury Regulations section 1.305-6.

- Public Storage has recently declared a special distribution that will consist, at each shareholder's election, of either a newly created class of common stock or in cash. This distribution should constitute property subject to dividend treatment under section 305(b)(1).

C. Conversions and Asset Transfers from C Corporations

1. **Notice 88-19**. Notice 88-19[88] sets forth the government's intention to issue regulations implementing section 337(d), grant of regulatory authority to ensure General Utilities repeal is not circumvented through the use of a RIC, REIT, or tax-exempt entity. The Notice provides that under these regulations C corporation assets that become assets of a REIT due to the qualification of the C corporation as a REIT or via a carryover basis transaction, will be treated as sold by the C corporation, which would at fair market value immediately liquidate, recognizing any built-in gain but not built-in loss. Alternatively, regulations could permit a REIT to elect treatment similar to the treatment of S corporations under section 1374, mandating corporate-level taxation on built-in gain recognized within a 10-year period on assets formerly held by a C corporation.

2. **New Regulations**. For conversion transactions occurring on or after January 2, 2002, regulations implement Notice 88-19 by subjecting the REIT to the 10-year gain recognition period described in section 1374, or, at the REIT's election, by requiring the C corporation to immediately recognize net built-in gain in the property converted to REIT property or transferred to the REIT.[89] Any built-in loss of the assets will not be recognized, but will be preserved through a carryover basis.[90]

   - The 10-year gain recognition period begins either on the first day of the first taxable year of REIT status or the day the assets are acquired by the REIT in a carryover basis transaction.[91]

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[88] 1988-1 C.B. 486.

[89] T.D. 8975 (Jan. 28, 2002).

[90] Temp. Reg. § 1.337(d)-7T(c)(1).

[91] Temp. Reg. § 1.337(d)-7T(b)(2)(iii).

- The deemed sale election must be attached to the C corporation's tax return for the taxable year in which the deemed sale occurs.[92]

3. **Accumulated E&P**. C corporations converting to REIT status will have to distribute its accumulated E&P during the taxable year that it makes the REIT election (see section II.D.2 above.) The required payout of E&P may be burdensome where the REIT holds in sufficient liquid assets. In this case, the REIT may be able to distribute its stock as described in section IV.B above.

4. **Conversion to QRS**. If a REIT acquires all of the interests of an existing corporation that becomes a QRS, the corporation is deemed to liquidate and recognize any built-in gain under the normal rules of section 337.[93]

D. <u>UPREITs</u>

1. **Form**. An umbrella partnership real estate investment trust ("UPREIT") is a REIT that holds substantially all of its properties through a partnership (the "operating partnership") of which it is a partner. The UPREIT was designed to give real estate owners access to public capital markets, while permitting them to defer their built-in gain.[94]

   - Built-in gain would be recognized if the owners contributed appreciated assets directly to a REIT. This is true even if the contributors obtained 80% or more of the interests in a REIT, because the nonrecognition rule of section 351 does not apply to transfers to an investment company.[95]

   - The use of an UPREIT to defer gain to the property owners does not subject the transaction to the partnership anti-abuse rules.[96] The example in the regulations considered two limited partnerships that contributed substantial real estate holdings to the operating partnership ("OP") and then liquidated, with their former partners becoming limited partners of OP. X, a newly formed C corporation that elects to be taxed as a REIT, contributed to OP substantially all of the proceeds from a public stock offering and became the general partner. Despite the fact that some of the limited partners had the right to redeem their interests in OP for either cash or interests in the REIT (at the REIT's option) after two years, the example concluded that because the rights would not be

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92 Temp. Reg. § 1.337(d)-7T(c)(5).

93 Conf. Rep. 105-220 at 698; H. Rep. 105-148 at 606 (P.L. 105-34).

94 Mount, n.1, *supra*, at A-52.

95 I.R.C. § 351(e); Treas. Reg. § 1.351-1(c)(1).

96 Treas. Reg. § 1.701-2(d), Ex. 4.

deemed exercised currently, and because the REIT may make substantial business decisions affecting OP during the two years, the form of the transaction would be respected.

- Contributing property owners may recognize gain under section 731 if the amount of liabilities allocated to them upon contribution is less than their former shares of liabilities under section 752.

- Contributing property owners may also recognize gain if the disguised sale rules under section 707(a)(2)(B) apply with respect to the grant of REIT stock conversion rights and to contributions of encumbered property to the operating partnership.

2. **Operation**. In an UPREIT structure, the REIT is treated as indirectly owning the real estate assets. For purposes of the asset and income tests of section 856, the REIT is deemed to own its proportionate share, in accordance with its capital interest, of each of the assets of the operating partnership and to receive partnership income corresponding to its share of the assets.[97] For purposes of calculating the REIT taxable income and the required distribution under section 857, the REIT's distributive share would be determined under section 704(b) and (c).

   - It will be important to consider the effect of different allocation methods under section 704(c), because under the traditional method, the REIT may not receive its full share of deductions corresponding to its allocable share of the fair market values of the properties at the time of contribution.

[97] Treas. Reg. § 1.856-3(g).