NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

October 28, 2010

The Honorable Michael Mundaca
Assistant Secretary (Tax Policy)
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Room 3120
Washington, DC 20220

Re: FY 2012 Budget

Dear Assistant Secretary Mundaca:

As you consider the composition of the Administration's Fiscal Year 2012 Budget proposals, the National Association of Real Estate Investment Trusts® (NAREIT) respectfully requests that the Administration consider including the following: 1) the enhanced "REIT Savings" provisions described more fully on Exhibit A that would allow real estate investment trusts (REITs) to choose to apply an increased monetary penalty for an inadvertent REIT test failure as an alternative to proving that the current "reasonable cause" standard is met, so long as the principal purpose of the failure is not to circumvent one or more of the REIT test requirements, and, 2) the repeal of the preferential dividend rule for publicly offered REITs. Besides better calibrating the purposes behind the underlying REIT rules with appropriate remedies, both provisions would be helpful to the government by eliminating the need for IRS personnel to devote inappropriate resources in addressing inadvertent failures of the REIT tests and by providing a better range of penalties to the IRS.

NAREIT is the worldwide representative voice for REITs and publicly traded real estate companies with an interest in U.S. real estate and capital markets. Members are REITs and other businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses.

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EXECUTIVE SUMMARY

Under current law, and as further described below, REITs that fail to satisfy one or more REIT qualification tests face loss of REIT status unless they can satisfy the "REIT Savings" rules enacted by Congress in 2004. These rules were based on the successful legislation that imposed "intermediate sanctions" on tax-exempt institutions instead of the previous sole remedy (virtually never enforced) of making an institution lose its exempt status. Generally, the REIT Savings rules impose a monetary penalty on such a REIT provided any non *de minimis* REIT test failure is attributable to "reasonable cause." Similar savings provisions were included in H.R. 4337, the Regulated Investment Company Modernization Act, passed overwhelmingly by the House of Representatives on September 28, 2010, with respect to mutual fund qualification test failures.

Because the determination of "reasonable cause" can be difficult to determine with complete certainty, a possible revision to the existing REIT Savings provisions was developed over a number of years based on discussions with the Treasury Department's Tax Legislative Counsel office, the IRS' Office of Chief Counsel (Financial Institutions & Products) and its Large and Mid-Size Businesses Division (as then known). Simply stated, these proposals coalesced into a basic framework: in lieu of having to establish reasonable cause, increased penalties would apply. Current law penalties would continue to apply if reasonable cause could be established. Similar to the enactment in 1996 intermediate sanctions on tax-exempt organizations, we believe that enactment of the enhanced REIT Savings provisions would raise revenue.

A related dialogue has been ongoing with Treasury and IRS personnel regarding the archaic preferential dividend rule that can result in loss of a REIT's dividends paid deduction (DPD) for an inadvertent "foot fault" with respect to dividend distributions that are considered "preferential" because they treat shareholders of the same class of stock differently – no matter how nominal the difference or how inadvertent the error. H.R. 4337 would eliminate the preferential dividend rule for "publicly offered" mutual funds. Because publicly offered REITs — those required to file annual and periodic reports with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (the 1934 Act) — already are subject to intense governmental and market scrutiny as well as significant liability for violations of securities laws and state law, the preferential dividend rule for REITs similarly should be repealed for publicly offered REITs.

DISCUSSION

I. MODIFY AND IMPROVE THE REIT SAVINGS RULES

A. Background

The Internal Revenue Code[1] contains REIT Savings[2] provisions, most of which were enacted in 2004, that generally allow a REIT to remedy one or more failures to satisfy the REIT asset tests under section 856(c)(4), income tests under sections 856(c)(2) and (3), or "other" REIT requirements under section 856(g) by remedying the failure and paying a monetary penalty. One requirement in order to remedy most of the REIT test failures is that the failure be due to "reasonable cause and not due to willful neglect." As mentioned above, H.R. 4337 generally would apply the existing REIT Savings rules to mutual funds.

B. Issue: "Reasonable Cause" Generally Required, But Difficult to Ascertain With Complete Certainty

Although the enactment of the REIT Savings provisions was welcome, the operation of these provisions could be significantly improved for both REITs and the government. It is frequently difficult for both taxpayers and the IRS to conclude with certainty that any REIT test failure is due to reasonable cause and not willful neglect, largely because there is little precedent dealing with taxpayers that are attempting to comply with complex technical rules. In addition, because many technical failures are due to inadvertence, loss of REIT status in those circumstances would be grossly disproportionate to the technical nature of the violation. Further, the time spent both by the government and taxpayers on closing agreements to resolve these issues is significant and inefficient. As a result, NAREIT suggests the proposal in Exhibit A as an improvement to avoid the above-noted problem for the government and REITs.[3]

C. Proposal: Increased Monetary Penalty if Unclear "Reasonable Cause" Met So Long as Principal Purpose to Circumvent Rule is Absent

Our proposal would allow REITs to choose to apply an increased monetary penalty for inadvertent REIT test failures when the current "reasonable cause" standard is not met so long as the principal purpose of a failure is not to circumvent one or more of the REIT test requirements. *The existing penalties still would apply if it is clear to the REIT that reasonable cause exists*.

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[1] The Internal Revenue Code of 1986, as amended (the Code), and, unless otherwise provided, "section" refers to a section of the Code.

[2] The REIT Savings provisions are codified as Internal Revenue Code sections 856(c)(7) and 856(g)(5). They originated as Title III of H.R. 1890 and S. 1568, the REIT Improvement Act of 2003, which was enacted as part of the American Jobs Creation Act of 2004, Pub. L. No. 108-357. A related provision, section 856(c)(6), which imposes a tax in connection with the failure to satisfy the REIT gross income tests under sections 856(c)(2) and (c)(3), originated as part of the Tax Reform Act of 1976, Pub. L. No. 94-455.

[3] Alternatively, NAREIT would support a regulatory clarification that reasonable cause is met when a REIT has rigorous internal controls (*e.g.*, when it complies with the controls mandated by the Sarbanes-Oxley Act) but did not discover a failure of one of the REIT tests in which the REIT did not display willful neglect.

Specifically, we request that the Administration's FY 2012 Budget include legislative proposals to accomplish the following:

1) Asset Test Failures: Increase the current penalty from the greater of $50,000 or 100% of the income generated by the offending asset beginning on the date of the asset test failure multiplied by the highest corporate tax rate to the greater of $100,000 or 110% of the income generated by the offending asset beginning on the date of the asset test failure multiplied by the highest corporate tax rate, plus interest accruing on the latter amount from the original due date of the tax return for the year in which the violation first occurred until the date of payment.

2) Income Test Failures: Increase the current penalty of 100% to 110% of the amount by which the REIT failed either the 75% or 95% income test, as reduced by deductions allocable to such income, plus interest from the due date of the tax until the date of payment.

3) Other REIT Test Violations Under Section 856(g): Increase the current penalty from $50,000 to $100,000 for the first identification of such failure and to a specific level, *e.g.,* $250,000 for any subsequent failures, plus interest from the original due date of the tax return applicable to the year in which the failure occurred until the date of payment. Additionally, in response to an IRS request, the REIT would be required to provide separate notice to the IRS of its identification of a section 856(g) failure, and the IRS would have a specific opportunity to review.

These provisions are discussed in more detail on Exhibit A to this letter.

II. CONFORM THE PROPOSED ELIMINATION OF THE PREFERENTIAL DIVIDEND RULE FOR "PUBLICLY OFFERED" MUTUAL FUNDS TO "PUBLICLY OFFERED" REITS

A. Background: Preferential Dividends

Both mutual funds and REITs are allowed a DPD. In order for a dividend to qualify for the DPD, it must not be a "preferential dividend." A dividend is considered to be preferential unless it is distributed pro rata to shareholders, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class compared with another except to the extent the class is entitled to such preference. A preferential dividend is not deductible and can cause a REIT or mutual fund to fail to satisfy its annual distribution requirement. H.R. 4337 would eliminate the preferential dividend rule for "publicly offered" mutual funds (generally regularly traded, continuously offered, or held by at least 500 shareholders).

B. Issue

As is the case for mutual funds, the preferential dividend rule for REITs is redundant in light of current securities laws and not necessary to prevent tax avoidance. In addition, the preferential dividend rule does not allow for *de minimis* or inadvertent errors, or for corrections of those errors, that technically may constitute preferential dividends, with the draconian consequence of loss of REIT/mutual fund status far exceeding the severity of the error. The foregoing is particularly true in the case of REITs and mutual funds that are required to file annual and periodic reports with the SEC under the 1934 Act due to the transparency these reports provide to the public and the government. These REITs are companies with more than $10 million in assets whose securities are held by more than 500 owners.

The body of federal and state corporate and securities law has evolved significantly since the 1936 enactment of the preferential dividend rule. The preferential dividend rule was adopted: i) prior to the enactment of the Investment Company Act of 1940 that contains its own protections against the use of preferential dividends to create overly complicated capital structures and ensures equal and fair treatment for investors in mutual funds;[4] and, ii) without taking into account the developing body of corporate and securities law cases that protect corporate shareholders against unequal treatment,[5] and certain rules of the Securities Exchange Act of 1934 that provide disclosure to shareholders of "public" entities.[6] The preferential dividend rule contained in the tax code has largely served as an unintended trap for REITs and mutual funds that make inadvertent processing or computational errors. It is not necessary to prevent tax avoidance.[7] Moreover, the burden it creates on REITs and the IRS far outweighs any benefit that it may achieve.

Congress enacted the preferential dividend rule to prevent tax avoidance by shareholders of personal holding companies (PHCs) and to promote shareholder fairness.[8] PHCs by definition are closely-held corporations.[9] PHCs can effect tax avoidance by obtaining waivers of dividend

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[4] Investment Company Act, 15 U.S.C. § 80a-18 (1940).
[5] *McPhail v. L.S. Starrett Co*., 157 F. Supp. 560 (D. Mass. 1957); *Penfield v. Davis*, 105 F. Supp. 292 (N.D. Ala. 1952); *Bodell v. General Gas & Electric Corp.*, 132 A. 442 (Del. Ch. 1926); *Hannigan v. Italo Petroleum Corp. of America*, 77 A.2d 209 (Del. 1949).
[6] Securities Exchange Act, 15 U.S.C. § 78i (1934).
[7] For further discussion of this issue, *see* New York State Bar Association, Tax Section, Report on the Application of Code Section 562(c) to Regulated Investment Companies and Real Estate Investment Trusts (April 7, 2008) [http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1153Letter.pdf].
[8] *See* sections 561, 562 and 565. Congress enacted the Preferential Dividend Rule in the Revenue Act of 1936; The legislative record indicates that tax avoidance was the primary concern of Congress:

> No dividends-paid credit should be allowed in the case of a distribution not in conformity with the rights of shareholders generally inherent in their stockholdings, whether the preferential distribution reflects an act of injustice to shareholders or a device acquiesced in by shareholders, rigged with a view to tax avoidance…The committee believes that no distribution which treats shareholders with substantial impartiality and in a manner consistent with their rights under their stockholding interests should be regarded as preferential by reason of minor differences in valuations of property distributed. H.R. Rep. No. 1860, 75th Cong., at 31 (1938).

[9] Section 542(a)(2) (requiring that 50% in value of a PHC's outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals).

rights from some shareholders with higher marginal tax rates and paying larger dividends to other shareholders (often family members) with lower marginal tax rates. The preferential dividend rule prevents this income splitting means of tax avoidance.

The rationale of such a tax avoidance rule, which is designed to prevent abuses by shareholders of closely-held PHCs, does not apply to publicly offered REITs. Publicly offered REITs have widespread ownership and no incentive or ability to minimize tax. In fact, such REITs would typically have no way of knowing what the shareholders' tax rates are and, since most shares are in "street name", do not know who are the beneficial owners of their shares other than with respect to shareholders who own more than five percent of the company's stock (in which they must file forms with the SEC). Accordingly, the shareholders of publicly offered REITs cannot, as a practical matter, coordinate amongst themselves and with the REIT to effect income splitting through dividend waivers or unanimous agreements among shareholders, thereby favoring some shareholders over others.[10]

Moreover, shareholders of publicly offered REITs likely do not have knowledge of other shareholders to permit such coordination among shareholders with respect to dividend waivers. In the case of publicly offered REITs, the preferential dividend rule simply does not provide additional protection against tax avoidance through income splitting because as a practical matter the public shareholders do not and will not act in concert to favor one group of shareholders over another group. And, absent such waivers or unanimous agreements, applicable state law generally prohibits treating shareholders of an identical class of shares differently with respect to dividends on such shares.

In addition to creating the preferential dividend rule to prevent tax avoidance, Congress enacted the preferential dividend rule to provide "substantial impartiality" among shareholders. The drafting of the preferential dividend rule suggests that Congress wanted to ensure impartiality with respect to the tax burden placed on shareholders by requiring dividends to be paid pro rata, and thus spread the tax burden evenly among shareholders. The technical complexity involved in complying with the preferential dividend rule increases administrative, legal and accounting costs for REITs. REITs incur legal and accounting fees and expend resources to analyze and audit the application of the preferential dividend rule to their distributions, particularly when a REIT has several classes of stock. Additionally the IRS incurs costs and expends resources to audit and enter into closing agreements if the preferential dividend rule is violated, even if such violation is minor or inadvertent.

The binary nature of the preferential dividend rule results in insignificant errors often causing such a violation; for example, distributing money to shareholders in the correct amounts but in a chronological order other than the order set forth in underlying agreements, changing distributions due to changes in shareholder interests, decreasing distributions by different amounts for each shareholder due to differing advisory and administrative fees paid by each shareholder, and even having an incorrect shareholder address or making a rounding error. As

[10] *See* n.4 above. Corporate law has permitted shareholders of closely held corporations to agree to such preferential dividends, *see Wabash Ry. Co. v. American Refrigerator Transit Co.*, 7 F.2d 335 (8th Cir. 1925); *Speier v. US*, 9 F. Supp. 1020 (Ct. Cl. 1935).

such the preferential dividend rule increases the costs to REITs and their shareholders rather than ensuring that the shareholders receive fair treatment with respect to dividends.

By increasing the likelihood of REITs technically violating the preferential dividend rule, the tax costs to shareholders also increases. When REITs do not receive the dividends paid deduction due to a violation of the preferential dividend rule, REITs can fail to satisfy the distribution requirement and consequently the income retained by the REITs as well as the money distributed is taxable at corporate tax rates. The shareholders of REITs bear these tax costs and bear them equally even when the shareholders have not all benefited from the dividend preference. The burden placed on REITs and their shareholders due to the preferential dividend rule outweighs the benefits and often leads to more unequal treatment among shareholders.

The Treasury Department and IRS included an item on their Priority Guidance Plan in 2007 and 2008 that would have addressed corrections of minor errors by REITs and mutual funds. This guidance presumably would have addressed preferential dividends occurring as a result of a minor error.[11] Unfortunately, the 2009 Priority Guidance Plan omitted this issue, thus making the need for a legislative improvement more urgent.

C. <u>Proposal: Conform the Preferential Dividend Repeal for Publicly Offered Mutual Funds to Publicly Offered REITs</u>

Just as H.R. 4337 proposes repealing the preferential dividend rule for publicly offered mutual funds, NAREIT requests that the Administration's FY 2012 budget proposal repeal the preferential dividends rule for REITs that are required to file annual and periodic reports with the SEC under the 1934 Act.

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[11] *See* 2007-2008 Priority Guidance Plan [http://www.irs.gov/pub/irs-utl/2007-2008_pgp_initial.pdf] and 2008-2009 Priority Guidance Plan [http://www.irs.gov/pub/irs-utl/2008-2009_gpl.pdf].

Thank you for your consideration of this matter. Feel free to contact me or Dara Bernstein, NAREIT's Senior Tax Counsel, at (202) 739-9400 if you would like to discuss these issues in greater detail.

Respectfully submitted,

Tony M. Edwards
Executive Vice President & General Counsel

cc: Jeffrey Van Hove, Esq.
Michael S. Novey, Esq.

Attachment: Exhibit A

EXHIBIT A

PROPOSED MODIFICATION TO “REASONABLE CAUSE” REQUIREMENT WITH INCREASED PENALTIES AND INTEREST IN “REIT SAVINGS” PROVISIONS

I. BACKROUND

A. Current Law

There are numerous so-called "death trap" provisions in the REIT rules, a violation of which results in the disqualification of the REIT. Naturally, REIT managers expend significant resources to avoid such a drastic result. In 2004, Congress enacted the REIT Improvement Act, which included certain provisions that built in some flexibility to the REIT tax rules and imposed monetary penalties, in lieu of REIT disqualification, for the failure to meet certain REIT rules when there was reasonable cause for the failure (the REIT Savings provisions).

More specifically, the REIT Savings provisions generally allow a REIT to avoid loss of REIT status due to the failure to satisfy the REIT asset tests under section 856(c)(4), income tests under sections 856(c)(2) and (3), or “other” REIT requirements under section 856(g) by remedying the failure and paying a monetary penalty.[12] However, this option is only available if the failure is due to “reasonable cause and not willful neglect.”

B. Issue

Because the determination of this issue is so factual, and there is virtually no guidance which applies this standard in the context of a REIT, it is frequently difficult for both taxpayers and the IRS to conclude with certainty that any REIT test failure is due to reasonable cause and not willful neglect. In addition, many technical failures are due to inadvertence; loss of REIT status in those circumstances would be grossly disproportionate to the technical nature of the violation. Further, the time spent both by the government and taxpayers on closing agreements to resolve these issues is significant and inefficient.

C. Proposal

Accordingly, NAREIT proposes legislative changes to the REIT Savings provisions that would provide relief from REIT disqualification for a REIT test failure when “reasonable cause and not willful neglect” cannot be demonstrated, provided that the failure is not due to the principal purpose of circumventing the REIT rules. When reasonable cause can be demonstrated, the current law penalty structure would apply, but the IRS would have an opportunity to review the self-assessment notice citing reasonable cause. It is anticipated that interested parties would work with the IRS to assist in the development of appropriate forms and procedures in order that, to the extent possible, the changes proposed, including increased penalties in certain cases, be self-assessable without the need for taxpayers to seek advance closing agreements.

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[12] Unless otherwise indicated, all section references are, to the Internal Revenue Code of 1986, as amended (the Code).

II. EXECUTIVE SUMMARY

In all three cases described below, the requirement that a REIT meet the "reasonable cause and not willful neglect" standard would be modified. For REITs that meet this standard, current law would continue to apply. For REITs that do not meet this standard, in many cases due to the difficulty in making such a demonstration with certainty, the increased penalties and procedures described below would apply. Furthermore, relief under the latter approach would not be available if the violation was the result of the principal purpose of circumventing one or more of the REIT test requirements. The ultimate penalty of de-REITing thus would be limited by the same standard that now applies to the loss of S corporation status as a result of the failure to meet the single class of stock requirement.[13]

A. Asset Test Failures

For non-*de minimis* asset test failures under section 856(c)(4)(B)(iii), asset test failures that are due to the ownership of assets the total value of which does exceed the lesser of 1% of the total value of the REIT's assets at the end of the quarter for which such measurement is done and $10 million, the current penalty is the greater of $50,000 or 100% of the income generated by the offending asset during the period in which the REIT held the nonqualifying asset and ending on the earlier of the date on which the REIT disposes of the nonqualifying asset or the REIT is otherwise in compliance with the asset test, multiplied by the highest corporate tax rate.

If a non *de minimis* asset test failure of a REIT results from reasonable cause and not willful neglect, the current law penalty would be retained. However, if the REIT does not have reasonable cause, this penalty would be increased to the greater of: a) $100,000 or b) 110% of the income generated by the "bad" asset as multiplied by the highest corporate tax rate, plus interest on the latter amount accruing on such amount from the original due date of the tax return for the year in which the violation first occurred until the date of payment.

As under current law, the IRS would retain the ability to challenge on audit whether the asset failure was due to reasonable cause (if claimed) or to the principal purpose of circumventing the REIT rules.

B. Gross Income Test Failures

Again, if a REIT has reasonable cause and not willful neglect, the current penalty would be retained. However, if not, the current penalty of 100% of the amount by which the REIT failed either the 75% or 95% income test, as reduced by deductions allocable to such income, would be increased to 110% of such amount, plus interest from the due date of the tax until the date of payment.

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[13] *See* Treas. Reg. § 1.1361-1(l)(4)(ii)(2).

C. "Other" Test Failures

If the REIT has failed a REIT test other than those described above, and it has reasonable cause and no willful neglect for such failure, the current penalty of $50,000 per failure would be retained.

If the REIT does not have reasonable cause for this reason, the penalty for "other" REIT test failures would be increased from $50,000 to $100,000 for the first such failure and some maximum, *e.g*, $250,000 for any subsequent failures, plus interest from the original due date of the tax return applicable to the year in which the failure occurred until the date of payment. A continuing failure would be treated as a single failure, not as separate failures for each year in which the failure continued.

In response to an IRS request for the opportunity to review "other test" failures, the proposal would require the REIT to notify the IRS of an "other test" failure, and provide the IRS with an opportunity to review the notification in an expedited fashion. Specifically, the REIT would be required to notify the IRS of the existence of an "other test" failure within six months of discovery of the failure. The REIT also would be required to inform the IRS whether the failure was due to "reasonable cause", and, accordingly, the current law penalty structure would apply, or, if not, and the proposed higher penalty structure would apply. The IRS then would have 30 days to notify the REIT of its intent to review the REIT's notice.

If the IRS declined to review the notice, the REIT could self-assess at the appropriate penalty level, although the IRS always could challenge on audit whether the cause of the REIT's failure was due to the REIT's principal purpose of circumventing the REIT rules. If the IRS reviewed the notice, it would have an additional 90 days to determine whether the REIT had reasonable cause for the failure (if claimed by the REIT) or the REIT's failure was or was not attributable to the principal purpose of circumventing the REIT rules. The reason for this procedure is that, although the uncertainty in resolving whether the reasonable cause/not willful neglect standard has been met is the impetus for our proposal generally, there are some situations in which REITs may conclude that a REIT test failure is due to reasonable cause and not willful neglect. In those situations, the current law remedy and penalty would be retained, but the IRS would have the opportunity to challenge this conclusion on an expedited basis. As above, the IRS would retain the ability to challenge on audit whether the particular failure was due to the principal purpose of circumventing the REIT rules.

D. Generally

The foregoing assumes that the REIT has not engaged in these actions or failures to take action due to a principal purpose to circumvent one or more provisions of the REIT tax rules. This proposal does not address failures that relate to *de minimis* and/or "minor" errors resulting in a potentially preferential dividend, because it assumes either that Congress will repeal the preferential dividend rule for publicly offered REITs or that the IRS will issue adequate guidance that would prevent the loss of REIT status for "minor errors," as contemplated by under item number 6 for Financial Institutions And Products (FI&P) of the IRS' 2008-09 Priority Guidance Plan dated September 10, 2008, listing guidance providing relief for common errors that may affect qualification as a mutual fund or REIT. This item was on the Priority Guidance Plan for two years, but was not included on the 2009-10 Priority Guidance Plan. Thus, a legislative change with respect to such preferential dividends is even more important.

Purely for consistency purposes, NAREIT proposes that the penalty provisions described above be re-situated to section 857, along with other penalty provisions.

III. REIT SAVINGS PROVISIONS IN DETAIL: CURRENT LAW AND PROPOSALS FOR CHANGE

As described further below, the RIA's "REIT Savings" provisions addressed three potential failures of the REIT rules:

1) asset test violations, including failures of the 10% vote or value tests of section 856(c)(4)(B)(iii)(II) and (III); the 5% value test of section 856(c)(4)(B)(iii)(I); the 20% TRS value test of section 856(c)(4)(B)(ii); the 75% value test of section 856(c)(4)(A); and the 25% value test of section 856(c)(4)(B);

2) failures of the 75% and 95% gross income tests of sections 856(c)(2) and (c)(3); and,

3) all other REIT test failures pursuant to which a REIT election would terminate under section 856(g)(5). These current "REIT Savings" provisions also are set forth below.

A. Asset Tests: Non De Minimis Asset Test Violations

1. *Current Law*

If a REIT fails to meet **any** of the asset test requirements for a particular quarter, and the failure exceeds the *de minimis* standard above, then the REIT will still be considered to have satisfied these tests if the REIT satisfies several requirements[14] as follows:

1) The REIT's failure to satisfy the particular asset test must be due to reasonable cause and not willful neglect;

[14] Section 856(c)(7)(B).

2) The REIT must provide a schedule of the offending assets to the IRS and must dispose of these assets during a specified time period; and,

3) The REIT must pay a monetary penalty equal to the greater of**:** $50,000 or a tax (treated as an excise tax) computed by multiplying the highest corporate tax rate by the net income generated by the scheduled assets for the period beginning on the first date that the failure occurs and ending on the date when the REIT no longer fails to satisfy the particular asset test.

2. *Suggested Change*

The present law rules would be retained for REITs that incur a non *de minimis* asset test violation when such violation is attributable to reasonable cause and not willful neglect. For failures when the REIT cannot demonstrate "reasonable cause and not willful neglect," the following is proposed: both i) increasing the current penalty, and, ii) requiring the accrual of interest on such amount during the period in which the REIT failed the relevant asset test. This penalty should be sufficient to deter inadvertent or negligent REIT test violations.

Specifically, NAREIT proposes that the penalty payable by the REIT (or its successor) be increased from the greater of $50,000 or 100% of the income generated by the offending asset beginning on the date of the asset test failure multiplied by the highest corporate tax rate to the greater of $100,000 or 110% of the income generated by the offending asset beginning on the date of the asset test failure multiplied by the highest corporate tax rate, plus interest accruing on the latter amount from the original due date of the tax return for the year in which the violation first occurred until the date of payment. The penalty should be applied only once for each asset test failure (for example, if ownership of the same asset causes the REIT to fail an asset test in several quarters before the violation is discovered, the error should be viewed as a single violation).

B. Failures to Satisfy the REIT Gross Income Tests

1. *Current Law*

A REIT that fails to satisfy the 95% and 75% REIT gross income tests of sections 856(c)(2) and (c)(3) for a particular taxable year is deemed to have satisfied these provisions if, among other things, the failure was due to reasonable cause and not willful neglect. In addition, upon the REIT's identification of the failure to meet either of the gross income tests, a description of each item of the REIT's gross income must be included in a schedule for the relevant taxable year that is filed in accordance with applicable regulations.[15] The REIT must, in effect, pay a 100% tax of the amount by which the REIT failed either the 75% or 95% income test, as reduced by deductions allocable to such income.[16]

[15] § 856(c)(6)(A).
[16] § 857(b)(5).

2. *Suggested Change*

Similar to the non-*de minimis* asset test violations, the present law rules would be retained for REITs whose failure to satisfy the income test or tests is due to reasonable cause and not willful neglect. For income test failures when this cannot be demonstrated, an income test failure would be remedied by increasing the current penalty payable by the REIT (or its successor) of 100% to 110% of the amount by which the REIT failed either the 75% or 95% income test, as reduced by deductions allocable to such income, plus interest from the due date of the tax until the date of payment.

C. Other REIT Test Violations

1. *Current Law*

For REIT test violations other than the income or asset tests, a REIT may retain its REIT qualification so long as the violations are due to reasonable cause and not willful neglect, and the REIT pays a penalty of $50,000 for each failure.[17]

2. *Suggested Change*

a. ***Increasing Penalties***

Again, the current law rules would be retained for REITs whose “other test” failures are attributable to reasonable cause and not willful neglect.

For failures that do not meet the reasonable cause standard, in general, increasing the penalty payable by the REIT (or its successor) for “other” REIT test failures from $50,000 to $100,000 for the first such failure and to a specific level, *e.g.*, $250,000 for any subsequent failures, plus interest from the original due date of the tax return applicable to the year in which the failure occurred until the date of payment, is proposed. The maximum penalty for repeat failures is significant in that it would exceed current law’s $200,000 penalty for failure to disclose a listed transaction contained in section 6707A.

Examples of REIT test failures that would fall under this rule would include: preferential dividends, failure of the requirement that REIT shares be transferable; failure of the 100 shareholder test; and failure to satisfy the “not closely held” test REIT test. Furthermore, if the maximum penalty for repeated failures was not assessed within a specific time period (such as within three years of the first identified failure), then the penalties would reset” to $100,000 for the first failure after the expiration of the three year period, and the maximum penalty for subsequent failures (plus interest).

Presumably, the REIT should be required to remedy any ongoing failure within a reasonable time frame after discovery of the failure (*e.g.*, if the REIT fails the closely held test, it must take steps to ensure that it is not closely held rather than just paying a penalty and remaining closely held).

[17] § 856(g)(5).

REIT test failures arising from a continuing or repeated failure of the same nature or of substantially the same facts and circumstances should be considered the same failure. An example would be the failure to satisfy the “not closely held” test for more than one year due to an error in applying the attribution rules, which error is discovered after two years have passed. These successive failures would be considered one failure.

Again, the new relief outlined above should not be available if the REIT test violation was undertaken with a principal purpose of circumventing one or more of the REIT test requirements. It seems as though the latter requirement[18] would be the appropriate standard for an “intentional” violation that would result in de-REITing. In this rare situation, the IRS still would have the authority to enter into a closing agreement to assess an appropriate monetary penalty rather than resorting to the draconian loss of REIT status, which would negatively affect innocent shareholders.

So long as a REIT had established internal controls in compliance with the Sarbanes-Oxley Act of 2002 (relative to taxes) for a taxable year, NAREIT proposes that any "other test" failure in that year would be deemed not to be attributable to the principal purpose of circumventing the REIT rules. (The same rules would apply for REITs not subject to the Sarbanes-Oxley Act so long as they had in place the internal controls relative to taxes that would have been required if the Sarbanes-Oxley Act of 2002 applied to them).

b. ***Procedure for IRS Notice and Review***

In response to an IRS request to have the opportunity to review self-assessed "other test" penalties, NAREIT proposes the following review process. Upon identification of an "other test" failure, the REIT would have six months to identify the failure to the IRS and attribute the failure either to: i) reasonable cause and not willful neglect, in which case, the current law penalty structure would apply; or ii) not reasonable cause, in which case, the higher penalty structure would apply.

The IRS then would have 30 days within which to accept the REIT's attribution of the failure or to notify the REIT of its intention to review the REIT's actions to determine: i) that the failure is attributable to reasonable cause, if so claimed, or, ii) that the failure is not due to the REIT's principal purpose to circumvent the REIT rules. If the IRS declined to review the REIT's failure within the 30-day period, the REIT would self-assess the penalty as appropriate based on its notice to the IRS. In such case, the REIT's tax status could be challenged on audit with respect to the failure only to the extent the IRS could show that the failure was attributable to the REIT's principal purpose to circumvent the REIT rules.

If the IRS notified the REIT of its intention to review REIT's failure within the 30-day period, the IRS then would have 90 days within which to determine whether: i) the failure is attributable to reasonable cause, if so claimed, or, ii) the failure is not due to the REIT's principal purpose to circumvent the REIT rules. If the REIT claimed the failure is attributable to reasonable cause,

[18] This penalty is the same as the penalty concerning the arrangements with a principal purpose of circumventing the S corporation requirement of only one class of stock. *See* Treas. Reg. §1.1361-1(l)(2))

and the IRS agreed, the REIT would self-assess under the current law penalty structure. The determination of "reasonable cause" could not be redetermined on audit. If the REIT claimed the failure was neither attributable to reasonable cause nor to the principal purpose to circumvent the REIT rules, and the IRS agreed, the REIT would self-assess at the proposed higher penalty structure. If the IRS determined that the failure was due a principal purpose to circumvent the REIT rules, the IRS still could choose to impose a penalty in lieu of loss of REIT status, taking into account the extent to which the REIT and its shareholders benefited from the failure, and the extent to which the REIT and its shareholders would be harmed by imposition of the penalty and/or loss of REIT status. In both cases, the issue of whether the "other test" failure was due to the REIT's principal purpose to circumvent the REIT rules still could be redetermined on audit.