

REIT

Wise®

NAREIT's Law, Accounting
& Finance Conference

March 30 - April 1

2016

REIT
INVESTMENT



Fixing a Hole Where
the REIT Fell In

March 30-April 1, 2016



◆ Moderator

- ◆ Craig Stern, Vornado Realty Trust

◆ Panelists

- ◆ Peter Genz, King & Spalding
- ◆ Leslie Honig, IRS
- ◆ David Silber, IRS
- ◆ Dianne Umberger, EY



Overview of Topics

- ◆ Statutory Relief Provisions — Dianne Umberger
- ◆ Reasonable Cause — Peter Genz
- ◆ IRS Comments — David Silber, Leslie Honig
- ◆ Tax Opinions — Peter Genz



Failure to meet gross income requirements — reasonable cause exception

- ◆ Relief under § 856(c)(6), if meet safe harbor:
 - ◆ Report violation-causing income (requirements in Treas. Reg. § 1.856-7(b))
 - ◆ Show reasonable cause and that violation not due to willful neglect
- ◆ Additional tax due under § 857(b)(5) in the amount of the product of:
 - ◆ the amount of income that caused the REIT to fail the 75% or 95% gross income test; and
 - ◆ a fraction meant to approximate the profitability of the REIT



Failure to meet gross asset requirements — 30-day cure

For any gross asset requirement violation (under § 856(c)(4)), 30-day cure period after the end of each quarter:

- ◆ Usually for 10% asset tests — stock or securities of an issuer
- ◆ Within 30 days of close of quarter, may cure violation caused by the acquired asset in such quarter
- ◆ No need to cure if failure merely due to valuation fluctuation of assets
- ◆ May cure by either disposing of asset that causes violation or by increasing gross asset base
- ◆ No need to show reasonable cause
- ◆ No penalty
- ◆ Generally believed to not be available for first quarter of REIT's first year



Failure to meet gross asset requirements — de minimis exception

Relief under § 856(c)(7)(B) for de minimis violation of 5% or 10% securities tests:*

- ◆ Applies when the excess asset that caused the violation of a 5% or 10% securities test is less than the *lesser* of:
 - ◆ \$10,000,000; or
 - ◆ 1% of the REIT's gross asset value at the end of the tested quarter
- ◆ Usually for 10% asset test (small loans or stock interests)
- ◆ Must cure within six months of the end of the quarter in which the REIT *discovers* the violation (not the quarter in which the violation occurred)
- ◆ May cure either by disposing of assets that cause the violation or other means (e.g., making a TRS election, issuer modifying security (into mortgage or straight debt), REIT increasing gross asset value, contribute security to a TRS (which means paying corporate-level tax on income from security))
- ◆ No need to show reasonable cause
- ◆ No penalty

* The PATH Act failed to update the cross reference to the 5% and 10% securities tests, which are now located at § 856(c)(4)(B)(iv).



Failure to meet gross asset requirements — other exceptions

Relief under § 856(c)(7)(A) for any violation of the gross asset requirements *other than* a de minimis violation of the 5% and 10% securities tests:

- ◆ Requirements to meet safe harbor:
 - ◆ Report violation-causing assets to IRS
 - ◆ Show reasonable cause and that violation not due to willful neglect
 - ◆ Cure within six months of the end of the quarter in which the REIT *discovers* the violation (not the quarter in which the violation occurred)
- ◆ Under § 856(c)(7)(C), additional tax imposed in the amount of the *greater* of:
 - ◆ \$50,000; or
 - ◆ the product of (i) the net income generated by the “excess assets”; and (ii) the highest rate under § 11
- ◆ May cure either by disposing of assets that cause the violation or other means (e.g., making a TRS election, issuer modifying security, REIT increasing gross asset value)
- ◆ Query whether \$50,000 must be paid for each year the violation occurred



Failure to meet requirements other than income and asset requirements — omnibus exception

Under § 856(g)(1) and (5), a REIT may be relieved from a failure to meet a requirement other than an income or asset requirement:

- ◆ The safe harbor relief applies if:
 - ◆ the failure was due to reasonable cause and not willful neglect; and
 - ◆ the REIT pays a \$50,000 penalty per violation
- ◆ Helpful for issues such as “transferable shares,” “managed by directors,” five or fewer, 100 shareholders, undistributed C corp. E&P
- ◆ Query whether \$50,000 must be paid for each year the violation occurred



Failure to meet distribution requirements — deficiency dividend

- ◆ Under § 860, if, within 90 days of a “determination” that a REIT did not distribute sufficient dividends to meet the 90% dividend distribution requirement, the REIT may make such a dividend distribution with respect to the taxable year in which it failed to meet the requirement (and cure the failure)
- ◆ For relief, the REIT must also:
 - ◆ File a claim within 120 days of the determination
 - ◆ Pay an interest charge, calculated as if the amount of the deficiency dividend was additional tax due in the year with respect to which such distribution was paid
- ◆ A determination, for these purposes, means:
 - ◆ a judicial determination;
 - ◆ “a closing agreement made under section 7121”; or
 - ◆ “a statement by the taxpayer attached to its amendment or supplement to a return of tax for the relevant tax year” (Form 8927)



Reasonable Cause

- ◆ With respect to relief under § 856(c)(6) (for gross income requirements):
 - ◆ “Reasonable cause” if the REIT “exercised ordinary business care and prudence in attempting to satisfy the requirements” under Treas. Reg. § 1.856-7(c)(1)
 - ◆ Per Treas. Reg. § 1.856-7(c)(2)(i), “reasonable reliance on a reasoned, written opinion as to the characterization for purposes of section 856 of gross income to be derived (or being derived) from a transaction generally constitutes ‘reasonable cause’”
 - ◆ Same principles apply for relief under § 856(g)(4) (the provision that permits a waiver of the four-year prohibition on re-electing REIT status after a termination year if reasonable cause can be shown, discussed later)
- ◆ With respect to other relief, not clear how a REIT shows reasonable cause; REIT’s case is bolstered if REIT has a history of good compliance and due diligence policies



Reasonable Cause

- ◆ REIT tax advisors sometimes asked for tax opinions on reasonable cause when required for statutory relief, such as where a prior tax advisor provided an opinion or memorandum analyzing an issue and the REIT opinion giver is asked to opine that the REIT's reliance on the prior advisor's advice constituted reasonable cause
- ◆ Tax advisors are often unwilling to do this, particularly at the “will” level, as:
 - ◆ The REIT, the tax advisor, and the IRS may all have differing opinions on what constitutes reasonable cause
 - ◆ Difficult to opine on fact-specific issues
- ◆ Without a tax opinion, REIT may have to seek IRS ruling (if the failure is of recent origin) or a closing agreement
- ◆ It would be helpful if IRS were to issue rulings on reasonable cause under the REIT savings provisions, even if the returns in question have already been filed (as this system has worked well in the 9100 relief context)



Preferential Dividends

The PATH Act changes to preferential dividend rules:

- ◆ *For tax years beginning after Dec. 31, 2014*, the prohibition on “preferential” dividends (per § 562(c)(1)) now only applies to private REITs (that is, the prohibition no longer applies to public REITs)
- ◆ *For tax years beginning after Dec. 31, 2015*, new § 562(e)(2) permits the Secretary to “provide an appropriate remedy” for a REIT’s distribution of a preferential dividend, where either:
 - ◆ “the Secretary determines that such failure is inadvertent or is due to reasonable cause and not due to willful neglect”; or
 - ◆ “such failure is of a type of failure which the Secretary has identified” as due to reasonable cause and not willful neglect
- ◆ Statutory language suggests PLR would be appropriate path to resolve preferential dividend issue for private REITs



Closing Agreements

- ◆ REIT may have concern regarding time-barred tax years, as years could still cause issues with respect to:
 - ◆ built-in gains tax exposure resulting from loss of REIT status; or
 - ◆ § 856(g)(3) four-year prohibition on re-election of REIT status
- ◆ Per Treas. Reg. § 301.7121-1(a), a closing agreement under § 7121 can “permanently and conclusively” resolve issues lurking from both time-barred and open tax years
- ◆ Closing agreements are handled by National Office or by the geographic LB&I Practice Area with exam authority. The Program Manager in the Practice Area is a contact.
- ◆ REIT should act swiftly after discovering issue and demonstrate prompt corrective actions
- ◆ REIT will typically have to pay a “toll charge” for the closing agreement, generally equal to the statutory relief provision penalty (toll charge will also apply to time-barred tax years)



9100 Relief (Late TRS Election)

- ◆ Often for overlooked securities that failed the 10% test
- ◆ TRS securities are not subject to 5% and 10% tests
- ◆ Private letter ruling under Treas. Reg. § 301.9100-3
- ◆ With permission from IRS, elect to treat certain securities as TRS securities, after the standard election period
- ◆ TRS securities not subject to 5% and 10% tests of § 856(c)(4)(A)(iv)
- ◆ *However*, TRS securities are subject to the general 75% asset test (§ 856(c)(4)(A)), as well as the 25% TRS securities test (§ 856(c)(4)(B)(i)*)
- ◆ Must show reasonable cause (although not technically required, some party accepts blame for failure)
- ◆ No penalty

* As of Jan. 1, 2018, the 25% TRS securities test will be reduced to 20%



Protective TRS Elections

Elect TRS treatment in the case of:

- ◆ Subsidiary REIT (to mitigate concern the subsidiary may not qualify as a REIT)
- ◆ Interests in associations (e.g., property owners' association) organized as corporations (to mitigate concern that such interests are not real estate assets)
- ◆ Protects status of Parent REIT



Failsafe Asset Trusts

- ◆ As outlined in Rev. Proc. proposed by NAREIT in 2004:
 - ◆ Concept based on protective excess shares trust
 - ◆ Any assets that cause violation of asset requirements are automatically transferred to a trust in which a TRS or unrelated person is the beneficiary
- ◆ PLR 200234054 ruled favorably with respect to such an arrangement in the context of a 10% securities test violation
- ◆ In case of TRS beneficiary, violations may incur corporate-level tax (which may still be preferable to costs associated with curing violation)
- ◆ Can the REIT receive or rely on a tax opinion that the asset trust is valid?
 - ◆ Will the IRS respect?
- ◆ Query whether charitable trust must be named in advance of failure in order for transfer to be effective

Re-electing “REIT Status” after a violation



- ◆ Under § 856(g)(1), if an entity fails to meet the REIT requirements (and does not cure), its REIT status is terminated in the year the failure(s) occurred
- ◆ Under § 856(g)(3), if an entity terminates or has revoked its REIT status, neither that entity nor a successor entity may re-elect REIT status for the four taxable years subsequent to the year of failure
- ◆ However, § 856(g)(4) provides an exception to the four-year re-election rule (that is, the REIT is only busted with respect to the year of failure) if:
 - ◆ the entity did not “willfully fail to [timely] file” its return in the year of failure
 - ◆ the inclusion of any incorrect information was not fraudulent; and
 - ◆ the REIT establishes to the satisfaction of the Secretary that the failure was due to reasonable cause and not willful neglect (per Treas. Reg. § 1.856-8(d), made with reference to such standard in gross income requirements)
- ◆ This relief rarely if ever seen in PLRs since REIT status has been preserved through other means (e.g., relief provisions, closing agreements)



Successor Entities

- ◆ The four-year prohibition on re-electing REIT status applies to successor entities as well as to de-REITed entity
- ◆ Under Treas. Reg. § 1.856-8(c)(2), for these purposes, “successor” means an entity that meets the following requirements with respect to the de-REITed entity:
 - ◆ the “continuity of ownership requirement,” meaning the same persons own directly or indirectly 50% or more of value of the potential successor and 50% or more of value of de-REITed entity at any time during the termination year; and
 - ◆ the “continuity of assets requirement,” meaning that a “substantial portion” of the potential successor’s assets were assets of the de-REITed entity or the successor acquired a substantial portion of the assets of the de-REITed entity



Successor Entities

- ◆ If Parent REIT acquires then liquidates Target REIT, and Target REIT has blown its REIT status, Parent REIT:
 - ◆ likely a successor;
 - ◆ inherits corporate tax liability; and
 - ◆ inherits built-in gain period for Target REIT's assets
- ◆ If de-REITed entity drops assets down to Target REIT in a § 351 transaction, then sells Target REIT, Target REIT may be successor



Tax Opinions

- ◆ Tax opinion is part of acquisition due diligence
- ◆ A REIT opinion for an open (or closed) tax year can be interpreted to subsume an opinion for the previous five tax years, even if time barred (that is, REIT cannot be a good REIT today if busted in the last five years)
- ◆ Although IRS cannot assert corporate tax for closed years, it may still question REIT status in time-barred years (as it may affect open years)
- ◆ Tax opinion needs to consider status of successor entities



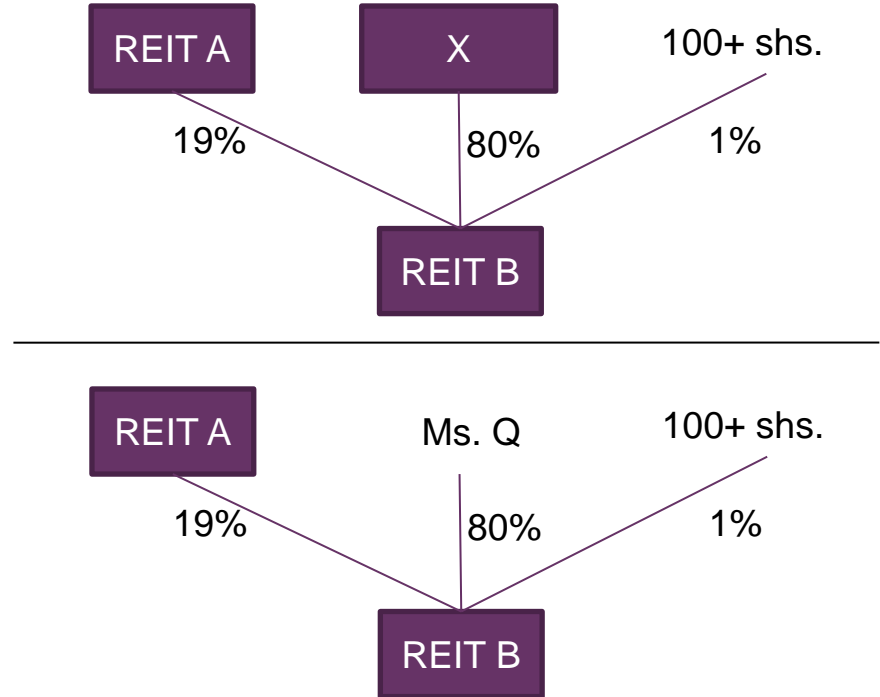
Relief for:	Requirements	Penalty Payment
De minimis asset test failure for 5% and 10% asset tests § 856(c)(7)(B)	<ul style="list-style-type: none">• Failure is due to ownership of assets which have total value equal to or less than <u>the lesser of</u> (x) 1% of total value of REIT's assets that quarter and (y) \$10 million.• Dispose of such assets (or otherwise pass asset tests) within six months after end of identification quarter• No requirement to show that failure to due reasonable cause and not willful neglect	<ul style="list-style-type: none">• None
Asset test failure <i>other than</i> de minimis failure of 5% and 10% asset tests § 856(c)(7)(A)	<ul style="list-style-type: none">• File schedule with description of each asset causing failure, following identification of failure by REIT.• Failure is due to reasonable cause and not to willful neglect.• Dispose of such assets (or otherwise pass asset tests) within 6 months.	<ul style="list-style-type: none">• Pay tax equal to greater of (i) \$50,000 <u>or</u> (ii) highest corporate tax rate times net income generated by assets that caused failure [for period beginning on first date of failure and ending on date REIT disposed of assets or otherwise passed asset test].



Relief for:	Requirements	Penalty Payment
Gross income test failure for 95% or 75% gross income tests § 856(c)(6)	<ul style="list-style-type: none">• File schedule with description of each item of REIT's gross income for taxable year following identification of failure by REIT.• Failure is due to reasonable cause and not to willful neglect.	<ul style="list-style-type: none">• Pay tax equal to the product of (x) the greater of (i) the amount by which 95% of the REIT's gross income exceeds the amount of items qualifying under the 95% income test, or (ii) the amount by which 75% of the REIT's gross income exceeded the amount of items qualifying under the 75% income test, multiplied by (y) a fraction, the numerator of which is generally the REIT's taxable income for the taxable year divided by the REIT's gross income for the taxable year. See section 857(b)(5).
Failure to meet 90% distribution requirement § 860	<ul style="list-style-type: none">• Within 90 days of a "determination," pay a "deficiency dividend"• File a claim within 120 days of determination	<ul style="list-style-type: none">• Pay interest computed on additional tax in the amount of the deficiency dividend as if such amount was tax in the year for which the deficiency dividend is paid
Any disqualification other than due to the gross income tests and asset tests § 856(g)(5)	<ul style="list-style-type: none">• Failure is due to reasonable cause and not to willful neglect.	<ul style="list-style-type: none">• REIT must pay \$50,000 for each failure.

Example 1 — Asset Test Failure

- ◆ X [in violation of a shareholders' agreement] transfers its 80% interest in REIT B to Ms. Q, an individual, on December 1 of year 2. Although REIT B fulfills all other REIT requirements, as five or fewer individuals now own more than 50% of REIT B, REIT B is disqualified as a REIT for the entire year.
- ◆ REIT A owns 20% of REIT B, which is now a taxable C corp. REIT A discovers that it has an asset test issue:
 - ◆ Before it files its return
 - ◆ After it files its return





Example 2 — Income Test Failure

In violation of operating procedure guidelines, a property manager of REIT C enters into a lease that provides for rents based on net income. The rent from the lease causes REIT C to fail the 75% gross income test. REIT C discovers the issue:

- ◆ Before it files its return
- ◆ After it files its return



Example 3 — Other Requirements Failure

In its second year of existence, REIT D admits 100 shareholders on July 1 (prior, REIT D had fewer than 100 shareholders). REIT D discovers the issue:

- ◆ Before it files its second-year return
- ◆ After it files its second-year return