FIXING A HOLE WHERE THE REIT FELL IN[1]

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I. RELIEF PROVISIONS FOR ASSET TEST VIOLATIONS

A. <u>30-Day Cure Period Following Quarter-End</u>

1. A REIT that meets the asset tests at the end of a calendar quarter will not fail them "because of a discrepancy during a subsequent quarter between the value of its various investments and the [asset test] requirements … unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition." Section 856(c)(4) (flush language). In other words, mere fluctuations in value that are beyond the REIT's control can't create an asset test violation. But acquisitions of securities or other property can, if they wholly or partly contribute to a violation at the end of the next quarter.

2. A REIT has 30 days (not a month) following the end of the calendar quarter to eliminate an asset test discrepancy at quarter-end, such as by disposing of assets or securities that caused the discrepancy. Section 856(c)(4) (flush language). This is a get-out-of-jail free card; no proof of reasonable cause required, no penalty. And the REIT can re-acquire the offending asset (at least after the 30-day cure period, and maybe even during the 30-day cure period) in the next quarter without causing a problem as long as the REIT meets the tests at the end of the next quarter.

a. <u>Example</u>. Investments in commercial paper may create a REIT bust if the REIT invests a substantial amount in the commercial paper of a single corporate issuer and thus violates the 5% asset test. Some bank accounts are set up to do overnight sweeps of the end-of-day account balance into commercial paper issued by a holding company affiliated with the bank. The IRS takes the position that commercial paper is a security and not a "cash-equivalent" (a cash-equivalent is a "good" asset, i.e., not a "security"). To avoid this problem, some REITs have instructed their bank not to sweep to commercial paper on the last day of the quarter. This should eliminate the tax issue, even if the sweep resumes the following day.

3. During the 30-day cure period the REIT can sell the offending securities or otherwise cure the asset test violation, such as by increasing its gross asset base so that a 5% securities test violation disappears.

4. What happens if the REIT disposes of the offending asset within the 30-day period and then reacquires it (or a similar asset) before the end of the 30-day period? Under a literal interpretation of the statute, this ought not affect the validity of the cure, but there is no authority on point and tax advisors generally prefer to see the cure last until the 30-day period is over.

5. Because of the introductory language of the 30-day cure provision ("A REIT that meets the asset tests at the end of a calendar quarter.."), it is generally thought that the 30-day cure cannot

[1] Sadly, no one will understand this title except another aging Beatles fan (Fixing a Hole from the Sgt. Pepper's album) or perhaps a really hip young person.

be relied on to cure a discrepancy relating to the end of the REIT's initial calendar quarter for its first REIT taxable year.

B. Protective TRS Elections and Failsafe Asset Trusts

1. Consider implementing self-help for a potential asset test violation. For example, a REIT might make a protective TRS election for a REIT subsidiary of a parent REIT, in the event that the IRS determines that the REIT subsidiary is not a qualified REIT. Another example might be a protective TRS election for a property owner's association that is organized as a corporation if there is a concern that such interest might be viewed as a "security" and not a "real estate asset." It does not appear that the IRS has ruled on the efficacy of such a protective election.

2. In 2004 NAREIT submitted to the IRS a proposed revenue procedure setting out the details for a protective or "failsafe" asset trust whose purpose would be to cure one or more identified types of asset test violations by automatically causing the offending asset to be placed in a trust whose beneficiary is a TRS of the REIT (or a person unrelated to the REIT). The concept was similar to the protective excess shares trust. The deemed transfer occurs on the day immediately prior to the last day of the calendar quarter on which the violation otherwise would have occurred. The IRS has not acted on this recommendation.

a. In PLR 200234054 (May 21, 2002), the IRS ruled that such a failsafe trust would be effective to prevent any future violation of the 10% securities test that might occur. The REIT represented that it had been advised by counsel that the trust would be enforceable under state law and that it would use its best efforts to give effect to all transfers required by the trust agreement. This concept is similar to the IRS rulings that have approved the so-called "excess shares" transfer restrictions that are widely used and are intended to preclude a REIT from violating the five-or-fewer stock ownership test due to subsequent transfers or non-transfer events. See, e.g., PLR 9552047 (Sept. 29, 1995) (IRS required the REIT to represent that the excess shares restriction was enforceable under state law).

b. Some REITs have adopted such protective asset trusts, but the REIT has to carefully consider (i) whether tax counsel will be willing to opine on the efficacy of the trust arrangement should an asset test violation occurs, and (ii) whether the REIT is prepared to accept the resulting corporate-level tax incurred by the TRS beneficiary on the income from the offending asset. Given the alternative of self-determining reasonable cause and paying the tax required by section 856(c)(7)(C) (discussed later in this outline) or a painful closing agreement process, such a trust may be a more appealing alternative, particularly if a ruling is obtained as to its efficacy.

c. What happens if a failsafe trust is put in place and later there is a potential asset test violation but not a crystal clear violation? The REIT might take the position that there is no deemed transfer to the trust until the IRS or a court determines that the asset test was violated, at which time a retroactive transfer to the trust is deemed to occur that automatically cures (if it works) the potential violation. The TRS's tax returns would have to be amended to report the additional income.

C. 9100 Relief for Late TRS Elections

1. One way to cure a 5% or 10% securities test bust with respect to securities of a subsidiary corporation (or non-corporate entity that has checked the box to be treated as a corporation) is to seek 9100 relief to make a late TRS election for such corporation so that the REIT's ownership of non-mortgage debt or stock of the corporation is exempt from the 5% and 10% securities tests by reason of the flush language of section 856(c)(4)(B)(iv) (but remains subject to the 75% asset test of section

856(c)(4)(A) and the mirror image 25% TRS securities test (which will shrink to a 20% TRS securities limit starting in 2018) of section 856(c)(4)(B)(ii)). See Treas. Reg. § 301.9100-1; Section 5.03, Rev. Proc. 2016-1, 2016-1 I.R.B. 1, 12 ("An Associate office will consider a request for an extension of time for making an election or other application for relief under § 301.9100-3 of the Treasury Regulations, even if submitted after the return covering the issue presented in the § 301.9100 request has been filed, an examination of the return has begun, or the issues in the return are being considered by Appeals or a Federal court").

2. A number of REITs have received private letter rulings permitting such a late election in order to cure a 10% securities test violation with respect to an overlooked corporate subsidiary. See, e.g., PLR 201452013 (Sept. 29, 2014) (a REIT-owned partnership acquired a hotel and leased it to a wholly owned LLC; the plan, as set out in the LLC's operating agreement, was to have the LLC make a check-the-box election to be taxed as a corporation and to make a TRS election for the LLC, but both were initially overlooked; then 9100 relief was sought and received to make a late check-the-box election but somehow the late TRS election was apparently overlooked a second time; despite what appears to have been a comedy of errors, the IRS permitted a late TRS election to be filed by the REIT and the LLC retroactive to the date the hotel lease was put in place); PLR 201144007 (Aug. 5, 2011) (IRS granted 9100 relief for a late TRS election for an LLC that had made a timely check-the-box election to be taxed as a corporation and that was organized to operate a cafeteria in an office building in which the REIT owned an interest; the REIT intended to make a TRS election for the LLC to insulate the REIT from impermissible tenant service income but screwed up); PLR 201002020 (Sept. 30, 2009) (permission granted to make late check-the-box and TRS elections for an LLC subsidiary of a REIT).

a. The regulations provide that the taxpayer, in order to get discretionary 9100 relief, must establish that it acted reasonably and in good faith, and that the grant of relief does not prejudice the government's interests. Treas. Reg. § 301.9100-3(b)(3)(iii). See PLR 200607016 (Feb. 17, 2006) (taxpayer transferred appreciated property to a foreign corporation with the intent of selling the property tax-free, unaware that section 367 rendered the initial contribution a fully taxable sale; when the taxpayer realized its mistake of law, it requested 9100 relief to file a late check-the-box election to treat the foreign entity as a disregarded entity; IRS refused, stating that the taxpayer failed to prove it had acted reasonably and in good faith). The IRS also wants to see that the taxpayer took prompt action when it discovered the failure to make the election.

3. It is always helpful to have an advisor fall on his or her sword and take the heat for the blown election deadline, which is typically documented with an affidavit submitted as part of the ruling request submission. Sometimes, though, the fault is the client's alone, or sometimes it is the fault of a third party. One 9100 ruling involved a REIT ("REIT A") that owned an interest in a joint venture. The other joint venture partner was also a REIT ("REIT B"). REIT B caused the joint venture to form a corporation and made a timely TRS election as to that corporation, but neglected to tell REIT A about the corporate subsidiary so that REIT A could also make a TRS election. It is understood that REIT B provided an affidavit taking the blame for failing to notify its partner.

4. In general, the IRS has been pretty forgiving in 9100 relief situations. One extreme example involved a REIT that was doing a public offering years ago and discovered at the last minute that a corporation that had been formed three years before to hold an interest in a limited partnership as part of a financing transaction was indirectly more than 10%-owned by the REIT, and yet no TRS election had been made. It is understood that the REIT got a 9100 relief private letter ruling one day after the 9100 ruling request was filed. An interesting aspect to this story is that tax counsel to the REIT reportedly gave an opinion, at the closing of the offering, that the IRS would grant the 9100 relief because (i) the REIT, in its view, met the IRS's announced requirements for the discretionary 9100 relief and (ii) the IRS had granted similar relief to other REITs. This opinion may have been rendered on the

strength of oral assurances from the IRS that the relief would be forthcoming, but this obviously had to be white knuckle time for the REIT and its law firm.

5. As an aside, the IRS has also granted 9100 relief to file a corrected consent dividend election. In PLR 201045004 (Aug. 3, 2010), a private REIT whose sole shareholder was a listed property trust (presumably Australian) was granted 9100 relief to increase the amount of a consent dividend election. The REIT made an error in computing the section 163(j) earnings stripping limitation on its interest deduction and also failed to take into account a property dividend from a TRS of the REIT, thus resulting in an understatement of its REIT taxable income for year 1. This meant its original consent dividend was not sufficient to zero out REIT taxable income as adjusted.

a. Treas. Reg. § 1.565-1(b)(3) provides that a consent may be filed not later than the due date (including extensions) of the REIT's tax return for the taxable year for which the consent dividend deduction is claimed.

b. The IRS concluded that the taxpayer's failure to make a proper consent dividend election was due to inadvertent errors and communications failures on the part of employees of the REIT's shareholder, and that the REIT was not using hindsight to request relief and acted before the IRS discovered the failure. Thus, it determined that the REIT acted reasonably and in good faith under Treas. Reg. § 301.9100-3(b)(1)(i), and thus granted the taxpayer 45 days from the date of the ruling to file a consent dividend election with an amended return.

D. De Minimis Failures of 5% or 10% Securities Tests

1. Under a relief provision that is intended to be applicable to de minimis failures of the 5% and 10% securities tests set forth in section 856(c)(4)(B)(iv), a REIT that owns securities in excess of the 5% or 10% securities test limits at the end of a quarter is nevertheless considered to meet such test if:

a. The "failure is due to the ownership of assets the total value of which" does not exceed the lesser of 1% of the total value of the REIT's assets at the end of the quarter for which the failure occurred or $10 million, and

b. within six months after the last day of the quarter in which the REIT identifies the failure (not the quarter in which the failure occurred), the REIT either (i) "disposes of assets in order to meet the requirements" of the 5% or 10% securities tests, or (ii) otherwise meets such requirements within such time frame (such as by making a TRS election to cure a 10% violation as to an overlooked C corporation subsidiary). Section 856(c)(7)(B).

2. Note: section 317(a)(3) of the Protect Americans from Tax Hikes Act of 2015 ("PATH Act") added a new 25% securities asset test limitation relating to a REIT's holdings of "nonqualified publicly offered debt instruments" in subparagraph (iii) of section 856(c)(4)(B), which resulted in the 5% and 10% tests being redesignated as new subparagraph (iv). However, the asset test relief provisions in section 856(c)(7) continue to refer to subparagraph (iii) – so under a literal reading of the statute as it currently exists, there is no de minimis exception for the 5% and 10% securities test. This presumably will be fixed by a technical correction.

3. Unlike the other REIT savings provisions, the de minimis securities tests savings provision requires only identification of the failure and prompt corrective action following identification. It does not require the REIT to prove reasonable cause and does not impose a monetary sanction.

4. For REITs with $1 billion or more of gross asset value, the applicable de minimis cap is $10 million. For REITs with less than $1 billion of assets, the applicable cap is 1% of gross (e.g., a REIT with $100 million of gross assets has a $1 million cap).

5. The statute also provides that, in lieu of the six-month disposition period, the disposition can occur within "such other time period prescribed by the Secretary and in the manner prescribed by the Secretary." Section 856(c)(7)(B)(ii)(I).

6. The legislative history states that a REIT might "otherwise" meet such requirements (i.e., without a "disposition") in the case of the 5% test, by increasing its gross asset denominator, or in the case of the 10% test, by the issuer modifying the amount or value of its total securities. See H.R. Rep. (Conf.) No. 755, 108th Cong., 2d Sess. at 321, n. 147 (the "2004 Act Conference Report").

7. It seems logical that the de minimis threshold should be applied by reference to the amount by which the value of the security in question exceeds the 5% or 10% value limitations, as the case may be, and if the violation is a 10% voting power violation, by reference to the value of a portion of the shares corresponding to the excess voting power. On the other hand, the use of the word "total" in the phrase "failure is due to the ownership of assets the total value of which" might suggest that the entire value of the issuer's securities held by the REIT is taken into account. However, such an interpretation would mean that there is no de minimis relief for a 5% asset test violation caused by one security, because the offending security would by definition exceed 1% of the REIT's total assets. The 2004 Act Conference Report (p. 321) makes it clear that this relief was intended to apply for purposes of the 5% securities test.

8. The instructions to the 2015 Form 1120-REIT (p. 15) state as follows with respect to the de minimis savings provision:

> "**Note**. There is no tax imposed and you are not required to attach a schedule of assets to Form 1120-REIT for the de minimis relief provision under section 856(c)(7)(B)."

9. The de minimis securities test savings provision is not often helpful because of the size constraints. However, it may provide immunity for small loans that don't meet a safe harbor and might otherwise cause a 10% securities test violation, or for a REIT's ownership of stock of a largely dormant non-QRS corporation (e.g., a corporation owned by a partnership in which the REIT is a partner) for which no TRS election was made and the stock of which has little value because the TRS has little or no assets and operations.

E. Other Asset Test Failures

1. A second asset test relief provision is provided in section 856(c)(7)(A). It has a broader scope than the de minimis savings provision in that it applies to failures to satisfy any of the asset tests in section 856(c)(4) (not just the 5% and 10% securities tests). Unlike the de minimis exception, though, the subparagraph (A) exception requires proof of reasonable cause and imposes a tax sanction.

2. The subparagraph (A) exception applies if the failure to meet the asset tests for a particular quarter involves the "ownership of assets the total value of which" exceeds the 1%/$10 million de minimis threshold described above. Section 856(c)(7)(A). In that event, the failure is excused – that is, "is nevertheless considered to have satisfied the requirements of [section 856(c)(4)]" if all three of the following conditions are met:

a. The REIT, after identifying a failure for a particular quarter, files a schedule with the IRS in accordance with regulations prescribed by the Secretary that sets forth a description of each asset that caused the REIT to fail to satisfy the asset tests at the close of any quarter. Section 856(c)(7)(A)(i).

b. The failure to meet the asset test requirements at the end of a particular quarter is due to reasonable cause and not to willful neglect. Section 856(c)(7)(A)(ii). ("Reasonable cause" is discussed later in this outline.)

c. The REIT disposes of the assets set forth on the schedule within six months after the last day of the calendar quarter in which the REIT first identified the failure "or such other time period prescribed by the Secretary and in the manner prescribed by the Secretary," or otherwise meets such requirements during such time period. Section 856(c)(7)(A)(iii).

d. The instructions to the 2015 Form 1120-REIT (p. 15) describe the filing of the schedule as follows:

> "The REIT sets forth a description of each asset that causes the REIT to fail to satisfy the requirements of the asset test at the close of a quarter in a statement for the quarter attached to its timely filed Form 1120-REIT;"

e. Because of the reference to a "timely filed" return, it would appear that the schedule is attached to the Form 1120-REIT filed for the current taxable year in which the failure is identified, even if failures are identified for calendar quarters in prior taxable years for which returns have already been filed. Attaching the schedule to an amended return for a prior year in which the failure occurred should also be sufficient.

3. If the subparagraph (A) exception "applies [to a REIT] for any taxable year," it must pay an excise tax equal to the greater of (a) $50,000 or (b) an amount (determined under as-yet unissued regulations) equal to the product of (i) the net income generated by the assets described in the schedule for the period beginning on the first date that the failure occurred (i.e., the end of the calendar quarter for which the problem first arose) and ending on the earlier of the date the REIT disposed of the assets or the end of the first quarter when there is no longer an asset test failure, and (ii) the highest rate of tax specified in section 11 for corporations, currently 35%. Section 856(c)(7)(C).

a. Note that this tax (unlike the "penalty" imposed under section 856(g)(5)) is technically not a condition to obtaining the safe harbor relief. Thus, if there is a later dispute over the determination of the proper penalty, the fact that an incorrect amount was initially remitted by the REIT does not invalidate the safe harbor relief if the three requirements (filing of schedule, timely cure and reasonable cause) are otherwise met.

b. The section 856(c)(7)(C) tax is deductible in computing REIT taxable income. Section 857(b)(2)(E).

4. Because section 856(c)(7)(C)(i) refers to the subparagraph (A) exception applying "for any taxable year" instead of "any calendar quarter" (and the instructions to the 2015 Form 1120-REIT discussing the tax do the same thing), the tax should be determined without regard to the number or type of asset test failures that occur during the year -- that is, failures occurring at the end of one, two, three or four quarters, failures involving different asset tests or different assets, etc., should all be lumped together so that only one $50,000 tax applies (assuming that amount is less than a tax on the income from the problematic assets).

a. By contrast, the omnibus savings provision in section 856(g)(5) for other REIT failures imposes a $50,000 "penalty" -- not a "tax" -- "for each failure to satisfy a provision of this part."

b. It is unclear what happens if a particular asset test failure crosses over one taxable year and into the next. The tax-on-net-income component of the section 856(c)(7)(C) tax does not reference taxable years; it merely focuses on the period during which the failure persisted. Arguably the $50,000 tax should be imposed (if it is the lesser of the two amounts) only once, even if the asset test failure related to calendar quarters occurring in more than one taxable year. Under this view, the penalty presumably would be determined after the failure was cured and would be remitted with the tax return for the taxable year of the cure. The IRS may assert, however, that the penalty is determined on a year-by-year basis once a failure persists in successive taxable years, since subparagraph (C) begins with the language "If subparagraph (A) applies [to a REIT] for any taxable year,…"

c. Although the statutory language is not entirely clear, the "net income based" component of the tax should be imposed only on the portion of the asset that caused the failure -- e.g., if a REIT owns securities of a corporation that equal 7% of its gross assets and thus violates the 5% securities test, the tax should be imposed only on the net income attributable to the 2% excess portion.

II. SAVINGS PROVISION FOR GROSS INCOME TEST FAILURES

A. <u>Section 856(c)(6)</u>

1. Section 856(c)(6) provides that if a REIT fails the 95% or 75% gross income tests for any taxable year, it is nevertheless considered to have satisfied such tests if, following the identification of the failure by the REIT, the REIT files with the IRS a schedule setting forth "a description of each item of its gross income that is described in [sections 856(c)(2) or section 856(c)(3)]" for such taxable year. The schedule must be filed in accordance with regulations prescribed by the Secretary, which have not been issued. In addition, the failure must be due to reasonable cause and not to willful neglect.

a. Prior to amendment by the 2004 Jobs Act, section 856(c)(6) provided that the relief from disqualification applied if the REIT attached to its tax return for the taxable year a schedule setting forth "the nature and amount of each item of gross income described in [sections 856(c)(2) and (c)(3)]," and any error in the schedule was not due to fraud.

b. Note that section 856(c)(6) relief provision did not apply to the former 30% gross income test, which was repealed for taxable years beginning on or after August 5, 1997.

2. The regulations under such provision require disclosure of the totals of each type of gross income derived by the REIT from sources described in sections 856(c)(2) (95% test) and 856(c)(3) (75% test), but not separate lease-by-lease or loan-by-loan amounts. Treas. Reg. § 1.856-7(b). However, the REIT is required to maintain adequate records to substantiate the total amounts.

3. Under amended section 856(c)(6), the schedule is not filed with the IRS until a gross income test failure has been identified by the REIT. The instructions to the Form 1120-REIT say little about this schedule. Part III of Form 1120-REIT provides for the calculation of the section 857(b)(5) tax, but it is not clear that simply filling out Part III constitutes a sufficient disclosure of the sources and amounts of qualifying gross income. Therefore, a separate schedule should be attached to the return (or to an amended return if the failure relates to a prior taxable year).

B. Section 857(b)(5) Tax

1. The gross income test failure savings provision in section 856(c)(6) is tantalizing because it appears to have no sanction, but one must read on -- a special tax is imposed by section 857(b)(5).

2. In a nutshell, if the relief afforded by section 856(c)(6) applies to a REIT for any taxable year, section 857(b)(5) imposes a 100% "tax" equal to the product of the amount by which the nonqualifying gross income caused the REIT to fail the 95% or 75% gross income tests for such year, multiplied by a fraction intended to reflect the REIT's overall profitability (in effect, converting the tax base to which the 100% tax applies from gross excess bad income to net excess bad income).

3. Part III of the Form 1120-REIT lays out the complex mechanics for computing this tax. The fact that the form provides for self-assessment indicates that the IRS expects that taxpayers will make their own reasonable cause determination.

4. The section 857(b)(5) tax is deductible in computing REIT taxable income. Section 857(b)(2)(E).

III. OMNIBUS REASONABLE CAUSE EXCEPTION FOR FAILURES OTHER THAN INCOME TEST AND ASSET TEST FAILURES

A. Section 856(g)(5)

1. Section 243(f)(3) of the 2004 Jobs Act enacted section 856(g)(5), along with a corresponding amendment to section 856(g)(1).

2. If a REIT's election terminates for a taxable year due to one or more failures to comply with the provisions of sections 856-860 other than a failure to comply with the income tests in section 856(c)(2) and (c)(3) or the asset tests in section 856(c)(4), then sections 856(g)(1) and (5) collectively provide that the REIT's election does not terminate if:

a. The failures are due to reasonable cause and not willful neglect, and

b. The REIT pays a "penalty" of $50,000 "for each failure to satisfy a provision of this part" that is due to reasonable cause and not willful neglect. (Emphasis added.)

3. The penalty is paid in the manner prescribed by regulations and in the same manner as a tax. Section 856(g)(5)(C).

a. The section 856(g)(5) penalty is deductible in computing REIT taxable income. Section 857(b)(2)(E).

b. Unlike the taxes imposed by section 856(c)(7)(C) and 857(b)(5), the payment of the penalty is a condition precedent to obtaining the safe harbor relief.

c. Schedule J, line 2(f) of the Form 1120-REIT provides for the payment of this penalty (as well as the tax imposed as a result of non-de minimis asset test failures under section 856(c)(7)) and again contemplates self-assessment based on the taxpayer REIT's own determination that it had reasonable cause for the failure. The instructions to the 2015 Form 1120-REIT (p. 15) state as follows regarding the section 856(g)(5) relief:

"Under section 856(g)(5), a REIT that fails to meet the REIT qualification requirements under sections 856–859, except for section 856(c)(2), 856(c)(3), and 856(c)(4), may avoid loss of its REIT status if the failure is due to reasonable cause and not due to willful neglect. In addition, the REIT must pay (as prescribed by regulations and in the same manner as tax) a penalty of $50,000 for each failure to satisfy a provision of sections 856-859. See section 856(g)(5)."

4. This relief provision potentially can help a REIT in remediating an organizational or structural failure, such as issues relating to "transferable shares," "managed by directors," the five or fewer test, 100-shareholder requirement, undistributed C earnings and profits, etc.

B. Application of Savings Provisions to Time-Barred Years

1. The effective date provisions of Section 243(g) of the 2004 Jobs Act relating to the savings provisions were amended by Section 403(d) of the Gulf Opportunity Zone Act of 2005 ("GO Zone Act") to provide that they apply with respect to failures that are satisfied after the date of enactment, and the legislative history of the Go Zone Act makes it clear that the two asset test savings provisions, the omnibus savings provision, and the amendment to the deficiency dividend procedures (discussed later in this outline) apply to "failures occurring in taxable years beginning on, before, or after the date of enactment" of the 2004 Jobs Act. The Joint Committee Explanation states as follows:

"*REIT provisions (Act sec. 243).* -- The REIT may cure de minimis failures of asset requirements (other than the requirement that the REIT may not hold more than 10 percent (five percent for certain prior years) of the value of securities of a single issuer, for which failure-specific procedures are provided) by using the same procedures as the REIT may use for larger failures of asset tests.

The provision clarifies that the new rules that permit the curing of certain REIT failures apply to failures with respect to which the requirements of the new rules are satisfied in taxable years of the REIT beginning after the date of enactment. Similarly, the provision clarifies that the new rules governing deficiency dividends that allow the taxpayer to make a determination by filing a statement with the IRS apply to statements filed in taxable years of the REIT beginning after the date of enactment.

It is intended that the provisions of the Act that allow a REIT to correct failures of REIT qualification without losing its REIT status apply to corrections of failures for which the requirements for correction are satisfied after the date of enactment, regardless of whether such failures occurred in taxable years beginning on, before, or after the date of enactment. Similarly, it is intended that the provisions of the Act that allow deficiency dividends under section 860 to correct distribution failures, provided the deficiency is identified in a statement filed after the date of enactment in accordance with the provisions of the Act, apply to failures occurring in taxable years beginning on, before, or after the date of enactment." (Emphasis added.)

See Staff of Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 109th Congress, p. 242 (Comm. Print. Jan. 17, 2007).

2. There is no specific guidance as to how the savings provisions discussed above for income test, asset test and other REIT failures apply to failures that occurred in taxable years that are, at the time of identification, time-barred.

3. It is often important to have finality if an issue is discovered in a time-barred year as well as open years because of the section 856(g)(3) four-year prohibition on re-election after a

termination year and the 10-year BIG tax hangover that arises when a corporation goes from REIT status to C status and back to REIT status (provided the corporation meets the REIT requirements in the re-election year, such as no C earnings and profits). Further, no matter now theoretical or remote the risk of a barred-year REIT bust may be, it can still hold up a merger transaction or public offering until it is finally resolved.

4. A REIT could file an amended return for a barred year, attach the required schedules relating to the failure, explain the basis for reasonable cause, and pay the required tax or penalty. But without any assurance that the IRS will see reasonable cause through the same rose-colored glasses that the taxpayer and its advisors may be wearing may propel the REIT to seek a closing agreement. As will be discussed, in the closing agreement process the IRS generally seeks a penalty for barred year relief as well as open year relief, usually insisting on the same tax or penalty that applies to an open year.

C. <u>No Savings Provisions Apply to the Prohibited Transactions Tax</u>

1. There is no relief under the prohibited transaction tax provisions comparable to that provided by section 856(c)(6), section 857(b)(5) and Treas. Reg. § 1.856-7 (reasonable cause waiver of gross income test violation with a net income tax penalty on the excess bad income) where the taxpayer proceeds with a sale of property on the basis of a reasoned opinion of counsel, either to the effect that a sale was not a dealer sale or that the prohibited transactions tax safe harbor applied, and the IRS later prevails with a dealer challenge. Similarly, the section 856(g)(5) omnibus relief for REIT disqualification screw-ups also does not extend to the prohibited transactions tax.

2. T.D. 7767, 1981-1 C.B. 82, added Treas. Reg. § 1.857-5 (Net income and loss from prohibited transactions) and made major revisions and additions to the REIT regulations in 1981 to give effect to changes to the REIT laws made by the Tax Reform Act of 1976. In the preamble to the regulations, the IRS stated that commentators had requested a reasonable cause exception for REITs that sell foreclosure property without using an independent contractor in the belief that the foreclosure property was not held primarily for sale to customers in the ordinary course of a trade or business. The commentators asked for a reasonable cause exception to be provided if the REIT believed it was not holding the property primarily for such purpose (other than in the case of readily identifiable dealer activity such as condominium sales or sales of subdivided parcels). The IRS rejected this comment, stating that "to adopt a reasonable cause test would be tantamount to exempting property from the rules of section 856(e)(4)(C) if a favorable opinion had been received with respect to its character in the hands of the REIT." <u>See</u> T.D. 7767 (Information Supplementary), 1981-1 C.B. 82, 86.

3. Note that, because dealer gain is nonqualifying gross income and is excluded from the gross income test denominator (sections 856(c)(2) and (c)(3), flush language), characterizing real estate gains as dealer gain could indirectly create a gross income test failure by shrinking the 5% basket.

IV. PROHIBITION ON RE-ELECTION OF REIT STATUS AFTER TERMINATION OF STATUS

A. <u>Overview of Section 856(g)</u>

1. Section 856(g)(1), captioned "Failure to Qualify," provides as follows:

> "An election under subsection (c)(1) made by a corporation, trust, or association shall terminate if the corporation, trust, or association is not a [REIT] to which the provisions of this part apply for

the taxable year with respect to which the election is made, or for any succeeding taxable year unless paragraph (5) applies. Such termination shall be effective for the taxable year for which the corporation, trust, or association is not a [REIT] to which the provisions of this part apply, and for all succeeding taxable years."

2. This means that an entity that has elected to be taxed as a REIT loses its status automatically if it fails to qualify to be taxed as a REIT for a taxable year (and none of the savings provisions described above apply). The termination is effective for that taxable year and all subsequent taxable years, subject to the corporation's right to re-elect REIT status when permitted by section 856(g)(3). Section 856(g)(1).

3. Section 856(g)(3) provides that if the election to be treated as a REIT is revoked or terminated for a taxable year, the entity (and any "successor" to that entity within the meaning of Treas. Reg. § 1.856-8(c)(2)) generally may not again elect to be treated as a REIT until the fifth taxable year after the first taxable year for which the revocation or termination is effective.

4. It can be argued that a REIT election for the first REIT taxable year cannot "terminate" if the corporation had a REIT failure in that same taxable year, and therefore the initial election is simply a nullity and the corporation should not be prohibited from re-electing in the succeeding taxable year. However, the regulations seem to say otherwise. Treas. Reg. § 1.856-8(b) provides that an election of a corporation under section 856(c)(1) to be a REIT "shall terminate if the corporation … is not a qualified [REIT] for any taxable year (including the taxable year with respect to which the election is made)." Based on the parenthetical language, a corporation with a blown initial REIT election for year 1 apparently will not be permitted to elect REIT status again until year 6 unless either (i) the section 856(g)(3) reasonable cause exception applies, in which case the REIT is disqualified for year 1 but is not subject to the four-year wait on re-election, or (ii) the section 856(g)(5) omnibus exception for REIT failures (other than income and asset test failures) applies, in which case it appears the REIT election never terminates (not even for the first failure year).

5. An entity that has elected to be taxed as a REIT for a taxable year may revoke the election for any subsequent taxable year, provided that the revocation must be made within the first 90 days of the taxable year for which the revocation is to be effective. Section 856(g)(2).

6. The "successor" rules are potentially broad in scope and should be evaluated whenever a REIT acquires the assets of another REIT, by merger, liquidation or otherwise. Among other things, a REIT's status as a "successor" to another REIT can significantly expand the scope of an opinion-giver's due diligence when opining on the successor's REIT status -- in effect forcing the tax advisor to consider the qualified REIT status of the predecessor as well. This can happen even if the acquiring REIT immediately liquidates the target REIT and does not own the stock of the target REIT at the end of any calendar quarter.

B. <u>Reasonable Cause Exception in Section 856(g)(4)</u>

1. Section 856(g)(4) provides that if a REIT's election is terminated under paragraph (g)(1), "paragraph (3) shall not apply" -- meaning the four-year prohibition on re-election after the year of termination does not apply -- if (i) the REIT does not willfully fail to file a timely income tax return for the year in which the termination of the REIT election occurs, (ii) the inclusion of any incorrect information on the return is not due to fraud with intent to evade tax, and (iii) the REIT establishes "to the satisfaction of the Secretary" that its failure to qualify as a REIT is due to reasonable clause and not willful neglect.

2. The statement that "paragraph (3) shall not apply" means that establishing reasonable cause only prevents the four-year prohibition on re-election after a termination year from applying. By its terms, section 856(g)(4) does not prevent the termination of REIT status in the year of the REIT bust. (By contrast, the omnibus relief provision in paragraph (g)(5) for failures other than income test and asset test failures seems to apply to the initial REIT termination year as well as subsequent years.)

3. Unlike the savings provisions previously discussed, which merely require that the failure "be due to reasonable cause and not due to willful neglect," section 856(g)(4) requires that reasonable cause be established "to the satisfaction of the Secretary." This language has been interpreted by the courts in the context of other provisions of the Code to mean that "some amount of deference be given to the conclusion of the Commissioner … [t]o conclude otherwise would render the phrase superfluous." R.E. Deitz Corp. v. United States, 939 F.2d 1 (9th Cir. 1991). The Ninth Circuit also stated that "the appropriate amount of deference is embodied in the arbitrary and capricious standard, which allows for the exercise of discretion, although not unbounded discretion." See also Schoneberger v. Commissioner, 74 T.C. 1016 (1980) (establishing bona fide residency under section 911 to the satisfaction of the Secretary requires strong proof).

4. The regulations require that the REIT establish reasonable cause to the satisfaction of the District Director for the internal revenue district in which the REIT maintains its principal place of business or principal office or agency. Treas. Reg. § 1.856-8(d). Today, the reference to "District Director" should be construed to mean the Director of Field Operations for the Large Business & International Division ("LB&I").

5. Such regulation further provides that the principles of Treas. Reg. § 1.856-7(c) (including the principles relating to expert advice) will apply in determining reasonable cause for purposes of section 856(g)(4). Treas. Reg. § 1.856-7(c) sets forth the standards for determining reasonable cause for purposes of section 856(c)(6) (note that the regulation refers to former section 856(c)(7) and does not reflect changes to the Code since the regulation was issued.)

V. ESTABLISHING REASONABLE CAUSE

A. Failure Must be Due to Reasonable Cause and Not Willful Neglect

1. The most critical part of obtaining relief under the new savings provisions (other than the relief for de minimis asset test failures) is establishing reasonable cause.

2. The regulations that were issued under the pre-2004 Jobs Act version of section 856(c)(6) (and which are still in effect) state that a REIT meets the reasonable cause/no willful neglect standard by exercising ordinary business care and prudence in attempting to satisfy the requirements at the time the REIT enters into each transaction.

3. If the REIT enters into a transaction after exercising ordinary business care and prudence and then later determines that the transaction produces nonqualifying gross income that can reasonably be expected to violate the 95% or 75% gross income tests, the regulations state that the REIT must use ordinary business care and prudence to renegotiate or restructure the transaction or dispose of the offending property or lease. Treas. Reg. § 1.856-7(c)(1).

4. It is not clear how the taxpayer establishes reasonable cause for purposes of the savings provisions. Seeking a private letter ruling on reasonable cause for a prior REIT taxable year where the return has been filed generally is not a viable option. Section 2.01 of Revenue Procedure 2016-

1, 2016-1 I.R.B. 1, states that a "letter ruling" is a written determination "issued to a taxpayer by an Associate office in response to the taxpayer's written inquiry, filed prior to the filing of returns or reports that are required by the tax laws, about its status for tax purposes or the tax effects of its acts or transactions." Section 5.01 of Revenue Procedure 2016-1 also states that the IRS will not rule on transactions or issues relating to tax returns that have already been filed:

> "In income and gift tax matters, an Associate office generally issues a letter ruling on a proposed transaction or on a completed transaction if the letter ruling request is submitted before the return is filed for the year in which the transaction is completed. An Associate office will not ordinarily issue a letter ruling on a completed transaction if the letter ruling request is submitted after the return is filed for the year in which the transaction is completed. "Not ordinarily" means that unique and compelling reasons must be demonstrated to justify the issuance of a letter ruling submitted after the return is filed for the year in which the transaction is completed. The taxpayer must contact the Field office having audit jurisdiction over their return and obtain the Field's consent to the issuance of such a letter ruling."

5. In addition, while the issue of whether a REIT had reasonable cause for an income test, asset test or other REIT failure is not specifically identified as a "no rule" or "will not ordinarily rule" issue by the IRS (see Rev. Proc. 2016-3, 2016-1 I.R.B. 126), Section 3.02(5) of the Revenue Procedure states that a "general area" in which the IRS will not issue a ruling (as opposed to will not ordinarily issue a ruling) is "[w]hether under Subtitle F (Procedure and Administration) reasonable cause, due diligence, good faith, clear and convincing evidence, or other similar terms that require a factual determination exist." In addition, section 4.02(1) states that an area in which the IRS will not ordinarily issue a ruling is "[a]ny matter in which the determination requested is primarily one of fact, e.g., market value of property, or whether an interest in a corporation is to be treated as stock or indebtedness."

a. It appears that the only private letter ruling where the IRS ruled on reasonable cause for a REIT failure is PLR 9550019 (Sept. 15, 1995). There, the IRS ruled that certain gross income test failures were excused under the former section 856(c)(7) exception (now located in section 856(c)(6)).

b. The failures included (i) the failure to identify that the provision of meals, maid service and transportation service to the residents of two senior citizen projects raised a customary services problem and tainted the rents, and (ii) the failure to treat cost reimbursements received by certain management partnerships in which the REIT was an indirect partner as gross income for purposes of the gross income tests.

c. The facts of the ruling state that when the REIT went public in 1994, it obtained the opinion of a nationally recognized law firm with REIT experience that the REIT's "organization and proposed method of operation would enable it to meet the requirements for REIT qualification" and provided the law firm with "due diligence reports and other detailed accounts of its operations" that disclosed information pertaining to these two issues. An accounting firm later spotted the tax issues (tax lawyers and their opinions must often endure a post-opinion review from sharp-eyed due diligence teams from the major accounting firms) and the REIT voluntarily approached the IRS regarding the issues and sought the reasonable cause ruling. With respect to the senior citizens properties, the REIT represented that similar properties in the area provided the same services. The actual text of the ruling issued by the National Office is as follows:

> "Company's failure to satisfy the requirements of section 856(c)(2) of the Code for Period-A and Period-B is due to reasonable cause and not to willful neglect (within the meaning of section

856(c)(7)(C)) to the extent that such failure is caused by (i) the failure of the income from Project-A and Project-B to qualify as rents from real property due to the provision of meal, maid and transportation services, and/or (ii) the inclusion in gross income of the reimbursements paid by the unrelated owners under their agreements with the Managing Partnerships."

d. The ruling gives no analysis as to the facts on which the IRS based its reasonable cause determination. The IRS may have viewed the law firm's clean REIT opinion delivered at the time of the IPO as the grounds for reasonable cause. However, that opinion presumably was a standard short-form REIT opinion that did not specifically address the two issues subsequently identified. As such, it would not appear to be a "reasoned, written opinion" within the meaning of Treas. Reg. § 1.856-7(c)(2)(iii) (discussed further below). However, such regulation clearly leaves open the possibility that a lesser form of opinion and/or other facts showing reasonable cause could satisfy the statutory requirement.

e. The ruling states that the REIT agreed to restructure its operations to cure the two tax issues, to treat the rents derived from the two senior citizen projects as bad income until the problematic services were restructured, and to pay the tax imposed by section 857(b)(5) on such income. It agreed to take similar action on the reimbursements issue but reserved the right to seek a ruling to the effect that such reimbursements were not gross income.

6. REIT tax advisors are sometimes asked by their clients to opine on reasonable cause for a REIT failure where there is a reasonable-cause-based escape hatch. That may be wishful thinking in many cases because, as further discussed below, reasonable cause (as a REIT specialist at another law firm once said to me) is in the eye of the beholder, and while the client may be beholding one thing, the law firm may be beholding another, and the IRS might behold something else if it were to behold. The law firm may be opposed on principle to rendering an opinion on such a nebulous factual issue no matter what the facts may be, except perhaps where the REIT previously obtained and relied upon a written opinion from a tax advisor on the problematic position. As will be discussed, the regulations contain specific guidance as to when reliance on an advisor's opinion constitutes reasonable cause. If the tax advisor is unwilling to opine on reasonable cause, or will only do so at an unacceptably low comfort level, the only solution may be to seek an IRS ruling (if the failure is of very recent origin) or a closing agreement (discussed later in this outline).

7. It goes without saying that reasonable cause opinions are not something that lawyers typically do, especially at the "will" level of assurance that is customary for REIT qualification opinions. Everybody wants to transfer all risks to the lawyers and accountants, but there are limits. What REITs and their advisors desperately need is for the IRS to revise its policies and to entertain ruling requests on reasonable cause under the REIT savings provisions, even if the returns in question have already been filed. This would give REITs another way to achieve finality on issues that arise with greater speed without having to initiate a painful and possibly protracted closing agreement process. It would also ensure that the request is considered by persons in the National Office who have considerable experience with REIT issues. The IRS, after all, routinely grants 9100 relief to REITs in a variety of screw-up contexts, and does so fairly expeditiously; it would seem that giving reasonable cause rulings would not involve that much more administrative work and would be in keeping with its generally benign approach to REIT busts.

8. The REIT's reasonable cause defense will be bolstered if it can show that it had good REIT compliance and due diligence policies in place when the failure occurred.

9. The Instructions to the 2015 Form 1120-REIT (p. 14) require a statement to be attached to the REIT's return with respect to the REIT's reliance on the section 856(c)(6) gross income

test savings provision and the two asset test savings provisions. This statement must explain why the REIT failed the particular REIT test and provide the reason why the failure was due to reasonable cause:

> "Taxes are imposed for the failure to meet the requirements of the asset test and/ or gross income test. To qualify for relief from the failure to meet these requirements, attach an explanation of why the REIT failed to meet the asset test and/ or gross income test. Attach supporting schedules and a statement showing the computation of the amount of tax. Also, include a reason why the failure was due to reasonable cause and not willful neglect. See sections 856(c)(2), 856(c)(3), and 856(c)(4).
>
> The statement for reasonable cause should be attached to Form 1120-REIT at the time it is filed."

B. Reliance on an Advisor's Written Opinion

1. Reasonable reliance on a "reasoned, written opinion" by a tax advisor (including in-house counsel) as to the favorable characterization of a particular gross income item that later turns out to be nonqualifying gross income "generally" constitutes reasonable cause. Treas. Reg. § 1.856-7(c)(2)(i). However, the absence of such an opinion, by itself, does not give rise to any inference that the gross income test failure was without reasonable cause. Id.

2. The opinion is a "reasoned" opinion, even if subsequently determined to be incorrect, provided it is based on a full disclosure of the facts by the REIT and addresses the facts and law that the opinion giver believes to be applicable.

3. An opinion that does nothing more than "recite the facts and express a conclusion" is not considered to be "reasoned." Treas. Reg. § 1.856-7(c)(2)(iii).

4. A written opinion is considered "reasoned" even if it reaches a conclusion which is subsequently determined be incorrect, so long as opinion is based on a full disclosure of the facts by the REIT and is addressed to the facts and law which the opinion-giver believes to be applicable. Treas. Reg. § 1.856-7(c)(2)(iii).

5. As an example where the REIT does not have reasonable cause, the regulations posit a situation where the REIT entered into a lease "knowing that it will produce nonqualified income which reasonably can be expected to cause a source-of-income requirement to be failed," even if the REIT had a legitimate business purpose for entering into the lease. Treas. Reg. § 1.856-7(c)(1).

6. Obtaining a reasoned opinion prior to sale from a tax advisor to the effect that a sale is not a prohibited transaction and that the gain is qualifying gross income will not avoid the prohibited transactions tax if the sale is later determined to be a dealer sale, but it should help to avoid a potential REIT disqualification issue if removing such tainted gain from the gross income denominator (as section 856 requires) causes the 5% basket to shrink and overflow with bad income.

7. Under this regulation, even a "should" or "more likely than not" comfort level should suffice, although a more-likely-than-not opinion might cause an IRS agent to question whether it was reasonable for the REIT to rely on the opinion. A disagreement between tax advisors over the merits of the position might also raise concerns on the reasonableness of the REIT's reliance.

8. If the REIT foul-up originated in a joint venture between the REIT and a third party, the IRS may want to see evidence that the REIT took measures to ensure that the third party manager/general partner was advised of the REIT's special tax status and the various REIT compliance

tests. The REIT may want to consider expanding the typical joint venture REIT protection covenant so that it spells out more clearly the actions that might cause a REIT tax problem (such as acquiring a loan or other security or entering into a net profits lease) and ensure that management is informed of the issues. Another approach is to have the REIT's tax advisors document the venture's current business plan, operations and assets, have the venture partner acknowledge that it is accurate and complete, and prohibit the partner from deviating from that plan without the REIT's approval.

9. The extent to which the REIT can point the finger at its accountants and tax lawyers will also be relevant, of course. To be able to point the finger and establish reasonable reliance on an advisor, the REIT will need to bring tax advisors into the loop as transactions occur, leases are signed, and operations change. Formal written tax advice is increasingly being obtained by REITs, but some still take a penny-pinching approach and keep tax advisors at bay, or only involve an accounting firm on a sporadic basis and not the lawyer who will someday end up giving the REIT opinion.

10. Delivering a legal opinion after-the-fact to the effect that there was reasonable cause for a REIT bust, as part of a REIT qualification opinion, may be difficult because the issue is so fact-sensitive. However, some law firms have done so, most commonly where they (or another law or accounting firm tax advisor) previously provided the client with a contemporaneous memorandum or opinion on the issue and concluded (perhaps incorrectly in the eyes of the current opinion giver) that the REIT's position on the issue was sound.

C. Reasonable Cause In Other Contexts

1. Other than Treas. Reg. § 1.856-7, there is almost no guidance interpreting "reasonable cause and not willful neglect" in the context of a REIT failure.

2. In United States v. Boyle, 469 U.S. 241, 245 (1985), the Supreme Court, in interpreting the "due to reasonable cause and not willful neglect" language of the penalty provisions in sections 6651(a)(1) and (2) and 6656(a), stated that the taxpayer bears the "heavy burden of proving both (1) that the failure did not result from 'willful neglect' and (2) that the failure was 'due to reasonable cause.'" The Court stated that willful neglect is "conscious, intentional failure or reckless indifference." 469 U.S. at 245. "Reasonable cause" means the exercise of "ordinary business care and prudence." Treas. Reg. § 301.6651-1(c)(1); Boyle, 469 U.S. at 246.

3. There are countless provisions of the Code that employ a "reasonable cause and not willful neglect" standard, and there is a lot of interpretive authority under those provisions which is beyond the scope of this outline. (For example, TAM 200919032 (Jan. 29, 2009) contains an interesting discussion of reasonable cause under section 367, including Boyle and other authorities interpreting reasonable cause under other Code provisions.)

VI. PATH ACT RELIEF MEASURES RELATING TO PREFERENTIAL DIVIDEND RULE

A. Repeal of Section 562(c) for Public REITs

1. Section 314 of the PATH Act amends section 562(c) so that it no longer applies to a "publicly offered REIT," just as it previously did not apply to a publicly offered RIC. See Section 562(c)(1), as amended by the PATH Act.

2. New section 562(c)(2) defines a publicly offered REIT as a REIT which is required to file annual and periodic reports with the SEC under the Securities Exchange Act of 1934.

3. The repeal of the preferential dividend rule for publicly offered REITs is effective for distributions in taxable years beginning after December 31, 2014. Section 314(c) of the PATH Act.

4. This idiotic rule should have been repealed for private REITs also. For years, section 562(c) has accomplished absolutely nothing from a policy standpoint except to create yet another opportunity for well-meaning REITs to experience a go-to-pieces.

B. IRS Authority to Provide Appropriate Remedy for Private REIT Section 562(c) Busts

1. Section 315(a) of the PATH Act adds new section 562(e)(2), which provides that if a distribution by a REIT fails to comply with section 562(c), "the Secretary may provide an appropriate remedy to cure such failure in lieu of not considering the distribution to be a dividend for purposes of computing the dividends paid deduction."

2. One of two requirements must be met:

a. Either the Secretary determines that the failure is due to reasonable cause and not to willful neglect (section 562(e)(2)(A)), or

b. The failure is of a type which the Secretary has identified for purposes of section 562(e)(2) as being described in section 562(e)(2)(A) (i.e., reasonable cause failures). Section 562(e)(2)(B). This second criteria is interesting. The intent appears to be to permit the IRS to publicly identify preferential dividend "failures," or perhaps potential failures, where reasonableness is presumed to exist and, one would expect, an appropriate remedy is specified – perhaps paving the way for self-help if a taxpayer's facts clearly fall within an identified failure situation. See Staff of Joint Committee on Taxation, Technical Explanation of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029 (Rules Committee Print 114-40), p. 173, JCX-144-15 (December 17, 2015) (the "PATH Act JCT Explanation"); Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 2015, JCS-1-16, p. 267 (March 2016) (the "JCT 2015 Bluebook").

3. The new private REIT relief provision for section 562(c) busts is effective for distributions in taxable years beginning after December 31, 2015.

a. Thus, unlike the one-year retroactivity of the public REIT preferential dividend repeal, this relief provision is only effective starting in 2016.

b. Would it have killed Congress to make this relief fully retroactive for all REITs (public and private)?

4. Once again, we have a relief provision that is contingent on the IRS making a reasonable cause determination (unless it is a section 562(e)(2)(B) "identified failure"), and yet tax counsel will generally not opine on whether the IRS will or won't perceive a failure as due to reasonable cause. If the REIT is not under examination, there is currently no procedure in place for the REIT to seek such a reasonable cause determination other than by way of a closing agreement.

a. The IRS could decide to put out a revenue procedure with useful pre-determined reasonable cause situations that could allow REITs and their tax counsel to opine over the bust and avoid a closing agreement mess. But this could take years.

b. A prime candidate for intervention would be an issue that is plaguing the fund industry, which is when separate classes of REIT stock will be respected as such for purposes of applying section 562(c). A negative ruling recently issued by the IRS on a two-class stock structure has caused much turmoil. It is predicated on the idea that the IRS has the right to declare unilaterally that what corporate tax lawyers clearly perceive as separate classes of stock should be amalgamated and treated as one for purposes of applying section 562(c) in order to manufacture a preferential dividend problem.

c. Better yet, why not open up the ruling process for such reasonable cause determinations and process them rapidly like the IRS already does for busted REIT elections and TRS elections?

5. What sorts of "appropriate remedies" are contemplated?

a. The statutory language seems to preclude a remedy that would treat the dividend as nondeductible for purposes of determining a REIT's tax liability only, but not for purposes of determining whether the REIT met the 90% distribution requirement of section 857(a)(1) (which goes to REIT qualification). This is good news, since paying a corporate-level tax liability can be a catastrophic "remedy."

b. That seems to leave monetary fines or penalties as the logical remedy. How much? $50,000 per bust? How do you define each failure? What about section 562(c) failures that are of a recurring nature and potentially disqualify multiple distributions in multiple years?

VII. DEFICIENCY DIVIDEND RELIEF PROCEDURES

A. Deficiency Dividends Defined

1. Section 860(a) provides that if there is a "determination" with respect to any REIT that results in any "adjustment" for a taxable year, a deduction is allowed to the REIT for the amount of "deficiency dividends" for purposes of determining the deduction for dividends paid under section 857 for such taxable year.

2. The deficiency dividend procedures are important, for example, if the IRS audits a prior REIT taxable year and determines that the REIT had additional unreported income that, if not distributed through a deficiency dividend, would cause the REIT to pay tax on such income or possibly lose its REIT status by failing to meet the 90% dividend distribution requirement. More typically, deficiency dividend procedures are used to "replace" a prior dividend that the REIT thought was deductible but which is later determined to have been nondeductible because, for example, it was preferential under section 562(c).

3. The term "adjustment" means any increase in REIT taxable income (determined without regard to the dividends paid deduction and excluding capital gains), any increase in the excess of capital gains over the deduction for capital gains dividends, and any decrease in the deduction for dividends paid under section 561 (determined without regard to capital gain dividends).

4. A "determination" means a court decision, a section 7121 closing agreement, an agreement signed by the Secretary by or on behalf of the REIT relating to the liability of such entity for tax, or "a statement by the taxpayer attached to its amendment or supplement to a return of tax for the relevant tax year." Section 860(e)(4).

a. The quoted language was added by the 2004 Jobs Act to permit a REIT to make a unilateral determination of an "adjustment" and engage in self-help.

b. Under prior law, a deficiency dividend could only be paid after a determination resulting from a judicial decision, closing agreement or other IRS agreement relating to the REIT's tax liability.

5. The term "deficiency dividend" means a distribution of property made by the REIT on or within 90 days after the determination and as to which a claim for deduction thereof is filed within 120 days after the date of the determination, provided the distribution would have been deductible by the REIT if actually paid in the taxable year to which the determination relates. Section 860(f)(1).

a. Deficiency dividends are not deductible for the taxable year in which they are paid, but they are included in the income of the REIT's shareholders in the year actually paid under the normal dividend rules. Section 860(f)(3).

b. Because of the timing mismatch created by the shareholders picking up the income inclusion in the year of distribution while the REIT gets the deduction for the adjustment year, the REIT must pay an interest charge (and penalties) that is determined by treating the amount of the deficiency dividend deduction as an additional tax due for the adjustment year which is not treated as paid until the claim for the deficiency dividend deduction is filed.

6. Treating the entire deficiency dividend as a tax substantially overstates the interest charge that would apply to the shareholders' aggregate unpaid tax liability on the dividends, had the dividends been timely paid in the adjustment year. This punitive aspect is intended to encourage timely distribution.

B. Relationship Between Section 860 and Section 856(g)(5)

1. Section 856(g)(5) applies to a corporation "which is not a real estate investment trust to which the provisions of the part apply due to one or more failures to comply with the provisions of this part." The 90% distribution requirement in section 857(b)(1) is a provision of subpart M. Thus, a failure to meet the 90% distribution requirement due to, for example, an improperly executed consent dividend under section 565, or a nondeductible preferential dividend under section 562(c), would seem to be within the scope of section 856(g)(5). The issue is how this provision syncs up with the deficiency dividend procedures of section 860.

2. If reasonable cause exists for the failure to meet the distribution requirement (say, due to a preferential dividend issue) and the REIT pays the $50,000 penalty, section 856(g)(5) should apply to cure the failure to meet the 90% distribution requirement and allow REIT status to be preserved. However, it does not appear to eliminate the corporate-level tax liability associated with the disallowance of the deduction for the dividends originally paid.

3. Using the deficiency dividend procedures to solve the corporate-level tax problem entails two costs: an economic outlay in the form of a current year dividend that the REIT did not expect to pay and an interest charge on the amount of such dividends.

a. If a REIT preferential dividend issue is caught early and only affects say, one taxable year, deficiency dividends may be the answer.

b. If the failure is chronic and affects numerous prior taxable years, deficiency dividends often are not feasible or tolerable as a business matter -- the cash has to come from somewhere and the interest charge can be prohibitive. Thus, a closing agreement process may be the only practical solution. In such a case, the REIT's toll charge does not necessarily require the payment of the full deficiency dividend that might otherwise be required to zero out REIT taxable income. This is not only because the deficiency dividend solution might bankrupt the company, but also because such failures or potential failures are usually not cut-and-dried from a tax law perspective. There may be good arguments that a problematic distribution was not preferential, and even if it was, the extent to which other dividends were tainted thereby and therefore rendered nondeductible may be unclear.

VIII. CLOSING AGREEMENTS

A. The Need for a Clean REIT Opinion (or an Auditor's FIN 48 Concerns) Typically Forces the Issue

1. Public REITs generally require clean REIT tax opinions in order to do offerings of debt and equity securities and to engage in an M&A transaction in which it is the target REIT (or a transaction in which it is the acquirer and is issuing its own stock as consideration). Private REITs often need them as well, either because they are required as a condition to being acquired in a tax-free reorganization by another REIT (in which case the target REIT may also insist on getting a similar opinion as to the acquiror's REIT status) or the shares of the REIT are being sold to a buyer to avoid FIRPTA tax for non-US shareholders and the buyer wants assurance that it is not acquiring a C corporation in a REIT's clothing. Or, it may be needed because the REIT's sponsor or its investors require such an opinion at formation or in a subsequent capital raise.

2. REIT opinions for public REIT's are almost always provided by lawyers. The same is generally true for private REITs, although occasionally you will see an accounting firm step up and give an opinion if it has been the principal tax advisor, and the REIT doesn't want to incur the additional costs of bringing in a law firm with no prior history with the REIT's structure, assets, and tax compliance issues and positions.

3. The problem is that there are countless ways for a REIT to screw up, and REIT tax counsel is often asked to opine back to the REIT's initial REIT taxable year, even though most prior tax years are time-barred. Why are tax lawyers routinely asked to this? Mainly because there is nothing in the tax law to prevent the IRS from asserting that a REIT failed to qualify as a REIT in a time-barred year in order to assert either, or both, that (i) the 5-year (formerly 10-year) BIG tax applies to an asset sale in an open year where the REIT is concededly a good REIT (even though its REIT status terminated in an earlier year), or (ii) that the section 856(g)(3) four-year prohibition on re-election after a termination year applies, thereby permitting the IRS to assert that the REIT is taxable as a C corporation in an open year as a result of terminating in a barred year.

4. All opinion-givers hope and pray that the IRS would not take such a draconian approach on audit and confine its examination to open tax years, and they give soothing (unwritten) assurances to their client that this would be an extraordinary and highly unlikely scenario. However, there is nothing in the tax law that says the IRS can't look at a barred year in order to create a section 856(g)(3) problem or BIG tax issue in an open year. It is well established, for example, that the IRS can redetermine an NOL arising in a time-barred source year in order to assert an adjustment in an open year to which the NOL is carried. The same is true with respect to making adjustments to the tax basis of an asset in a barred year in order to reduce tax depreciation deductions in an open year.

5. The intermediate sanction provisions discussed above contemplate a black-and-white REIT failure that is discovered by the REIT or its tax advisors after the fact. But suppose that an analysis of the facts and the applicable law leads to an uncertain resolution -- the awful black hole of uncertainty into which many REIT issues fall. What happens if the REIT initially sees the problem but determines to live with it, then later becomes involved in a merger or securities offering, and the REIT's tax counsel (who may not have been involved in the original risk assessment) determines that it cannot provide a clean REIT opinion, or determines that it can but the acquiror's counsel or underwriter's counsel won't accept it? The absence of clear authority may put the REIT in a box from which it cannot escape -- a tax lawyer who cannot opine and a deal or offering where the other parties insist on a clean opinion to close. The REIT's auditors may then get nervous about having to book a FIN 48 reserve. In this situation, even though not involving a cut-and-dried REIT failure, a closing agreement may be the only practical way to get out of the box.

B. <u>Nature of a Closing Agreement</u>

1. Closing agreements are authorized by section 7121. They can be used to resolve the tax liability of a taxpayer for any taxable period ending prior to or subsequent to the date of the agreement, and may be entered into in any case in which "there appears to be an advantage in having the case permanently and conclusively closed, or if good and sufficient reasons are shown by the taxpayer for desiring a closing agreement and the Commissioner determined that the United States will not be disadvantaged as a result." Treas. Reg. § 301.7121-1(a).

2. Delegation Order No. 8-3, I.R.M. Section 1.2.47.4, states that the IRS can enter into and approve closing agreements only with respect to (i) a taxable period or periods ending before the date of the agreement, or (ii) related specific items affecting other taxable periods.

3. The Internal Revenue Manual contains detailed closing agreement procedures in I.R.M. Section 8.13.1, although none of these appear to be focused specifically on REITs.

4. Once signed by the Secretary, a closing agreement is "final and conclusive" and the case cannot be reopened or modified as to the matters agreed upon, by the IRS or the taxpayer. Section 7121(b).

5. The IRS doesn't have to adhere to the four corners of the law in arriving at the terms of a closing agreement. It typically subjects a closing agreement to fairly rigorous review.

C. <u>Timeline for a Closing Agreement</u>

1. There is no obligation on the part of the Service to undertake a closing agreement process just because a REIT wants it. The REIT wants the closing agreement yesterday and often believes it is not a bad actor and ought to get immediate and relatively painless relief. The IRS, however, has been through budget cuts and has limited resources to throw at this type of problem. The client must understand that the official who answers the initial phone call did not come into work that morning with a perfectly clean desk expecting to sit around until a REIT called in with an urgent, all-hands-on-deck tax problem.

a. Many tax advisors believe, rightly or wrongly, that a public REIT is likely to be more sympathetic case and more likely to get the IRS' attention, because the consequences of not being able to get a clean REIT opinion are highly visible and material, the potential harm to the company obvious, and the IRS official knows that there are innocent public stockholders who will suffer if the issue is not resolved expeditiously.

b. Private REITs, on the other hand, may have a tougher time getting the attention of the IRS because there are no public stockholders to garner sympathy and there may be a view, justified or not, that private REITs are to be viewed with a more jaundiced eye. Also, there may be tax planning or tax structuring aspects associated with the use of a private REIT that may color the IRS' view of its conduct, rightly or wrongly. But the IRS' official position, as one might expect, is that all REITs are treated equally.

c. In the vast majority of cases REIT closing agreements result from voluntary disclosures by REITs, which tends to put the REIT in a more sympathetic position from the IRS' perspective. The IRS might view the issue differently if it was picked up on audit.

2. The author is aware anecdotally of one REIT that got a closing agreement in less than three weeks, but that was many years ago. Today, however, a REIT cannot assume it can walk in and get a problem resolved in a matter of weeks or even months, although the IRS continues to be sensitive to the realities of taxpayer business transactions. If a major M&A transaction or securities offering is on hold because of the actual or potential REIT bust, the process may move more quickly. It is understood that some recent REIT closing agreements have taken a matter of months to obtain, but others have taken a year or two.

3. If it turns out that a REIT is facing that kind of extended time frame for a closing agreement, REIT tax counsel (along with the REIT's auditors) will be under increasing pressure to find a way to get comfortable and render a REIT opinion without a closing agreement. Counsel will need to consider whether it is willing to opine on reasonable cause in lieu of going for a closing agreement and have the client self-assess the prescribed statutory penalty. Also, other interested parties (e.g., M&A tax counsel on the other side, underwriter's counsel) will have to do their own review and determine if they are willing to rely on tax counsel's opinion, which might be at a lower comfort level than the customary "will" opinion.

D. <u>The Process</u>

1. As the discussion above indicates, there is no "Closing Agreement Division" or "Bureau of REIT Corrections" within the IRS.

2. If a REIT is under examination when the bust is discovered, it should notify the examination team. If not, the request is typically coordinated by the technical staff in the geographic examination area, so the request for relief should be made to the LB&I Practice Area Program Manager (formerly the LB&I Industry Executive Assistant, Technical) or one of the technical analysts in that group. A request for a closing agreement can come in through other channels, of course, such as by contacting an official in the Exam division or Financial Institutions and Products, and they will forward the request to the right place.

3. The large national accounting firms typically have on their staffs one or more former IRS personnel from the operating divisions who may have useful contacts in the Service. These firms usually have extensive closing agreement experience. Consequently, it is not uncommon for the accounting firm to take the lead and initiate the kick-off call. However, the REIT's law firm ordinarily works closely with the accounting firm in marshalling the facts, preparing the initial submission, and responding to requests for additional information.

a. This practitioner has found over the years that in the REIT world, the best product, and the best chance of a successful outcome (or maintaining a healthy REIT that doesn't have these harrowing problems) comes when the REIT's accounting firm and law firm work closely

together with each other and with the client's in-house tax personnel. Law firms and accounting firms have different strengths and weaknesses. The best REIT tax advisors know this and strive to keep the other guy in the loop and their elbows tucked in. Each tax advisor should urge a fee-sensitive client to get both firms involved when material issues arise.

4. The initial written submission needs to be succinct, complete and compelling. It must lay out the nature of the failure or the potential failure (if the law is unclear), every fact that is relevant to the reasonable cause narrative, and the corrective action taken or proposed to be taken. The submission must walk the line between putting the client's best foot forward and making sure that all bad facts are laid on the table. The law firm usually takes primary responsibility for drafting the closing agreement, which is very much like a contract but isn't exactly.

5. The IRS likes to see that the client acted quickly once the error or potential error was discovered. Putting this process off too long may doom it.

6. All potential REIT failures need to be identified at the front end and included in the initial submission. You don't want to get well down the road in a closing agreement negotiation and then discover (or have the Examination Division discover in the course of its efforts to validate the facts) another potential opinion-blocking issue that was missed in the early stages. For all practical purposes you have one bite at the apple.

7. The IRS office that takes responsibility for the matter will refer it to the Examination Division for review, and Exam will investigate the facts and do a write-up on the issues. This can take a long time. A quality, comprehensive submission can speed up the examination process and ultimately lead to a quicker resolution.

8. The Exam write-up then goes to Division Counsel's Office for review. Division Counsel may have issues or questions and often seeks input from the people in in Financial Institutions and Products at the IRS National Office who have extensive knowledge and experience with REIT issues. That injects a further delay in the process, typically 90 days or more. If the issue relates to a return not yet filed, it is understood that the IRS National Office must sign off on any closing agreement.

9. Once an agreement in principle is reached, Division Counsel will then either take the first cut at drafting the closing agreement or ask the taxpayer's counsel to produce a draft and then edit that draft.

10. An important part of the narrative is prompt remedial corrective action. The IRS will want to understand what steps the client has taken, or intends to take, to eliminate the problematic asset or source of income (or other REIT failure) for the current and future taxable years, such as the disposition of an asset that caused an asset test failure.

11. If part of the REIT's reasonable-cause story involves pointing the finger at one of the REIT's external tax advisors, the REIT should consider retaining another tax advisor who can act independently on the matter. It usually is in the best interest of the firm that is on the hot seat to lay all the cards on the table fairly and openly -- after all, getting a closing agreement and eliminating a potential REIT bust is in everyone's best interest. Nonetheless, human nature being what it is, an independent advisor may lay out the story differently from the firm that is at fault or perceived by the client, fairly or unfairly, to be at fault. This can be somewhat delicate; no professional firm enjoys falling on its sword. But in the end, the facts are the facts, and the independent advisor must ensure that the story told is accurate and fair. It may be desirable to include affidavits from the advisors in the initial written

submission, similar to the affidavits that routinely accompany requests for 9100 relief for a blown tax election deadline.

12. If the fault is largely internal, not external -- e.g., a key employee quit or was fired and a REIT ball was dropped in the transition or it was a total whiff and no outside advisor was consulted -- those facts also need to be laid out in unadorned fashion. In this process there seldom is any upside in putting lipstick on the pig -- the objective is not to invite the IRS to a barbeque.

E. Closing Agreement Penalties

1. Happily, the IRS has shown over the course of many years that it is not in the REIT-busting business, absent exceptional circumstances. This is particularly true where there are innocent public stockholders who will be harmed if the REIT is de-REITed. The IRS will, however, typically insist that the REIT pay a tax or penalty as part of the closing agreement. The client will be intensely, if not maniacally, focused on this tax/penalty and will want early front-end predictions of what it is going to cost.

2. The IRS does not have any formal "sentencing guidelines." However, sections 856 and 857 already prescribe a tax or penalty for certain REIT failures where reasonable cause is demonstrated: a "tax" on excess bad income imposed by section 857(b)(5); a "tax" equal to the greater of (a) $50,000 or (b) an amount equal to the highest corporate tax rate multiplied by the income derived from the problematic asset, in the case of a non-de minimis 5% or 10% securities test failure (section 856(c)(7)(C)); and a $50,000 "penalty" for other REIT failures (section 856(g)(5)(C)). The IRS generally views these statutory taxes/penalties as controlling if the actual or potential REIT bust falls in one of those failure categories, so the REIT should not assume that it can do better simply because of the intrinsic flexibility that the IRS has in the closing agreement process. Nor should it assume that it can do better simply because the REIT may be able to proffer legitimate arguments supporting the position that has caused the brouhaha.

a. In recent years, some closing agreements reportedly have been negotiated that involved a tax/penalty of $50,000 per year, plus interest from the due date of the return, at least where the failure did not implicate the section 857(b)(5) tax on excess nonqualifying gross income or the tax imposed by section 856(c)(7)(C) as a result of a non-de minimis 5% or 10% securities test failure.

b. It is understood that the IRS will also seek an appropriate penalty/tax (plus interest) for each time-barred year that is covered by the closing agreement.

c. One can always hold out hope that the IRS will exercise discretion on the penalty and consider a reduction from the statutory sanctions in appropriate cases, such as where the REIT has reasonable arguments that it complied with the law, where the good-faith and prompt-remedial-action facts are compelling, and/or where the statutory scheme would otherwise produce a tax/penalty that seems out of whack with the nature of the failure or potential failure and the REIT's conduct. But is it important to bear in mind that the IRS generally views the statutory penalties as controlling and Exam doesn't have settlement authority. If the manner in which the statutory sanctions apply to the particular facts is ambiguous, of course, that is something the parties can negotiate in the closing agreement context.

d. In FSA 1996-9 (Mar. 5, 1996), the IRS Office of Chief Counsel stated that it did not object to the District Director entering into a closing agreement with a REIT regarding a violation of the 75% asset test resulting from excess investments in repurchase agreements (which the IRS has ruled is a "security" for REIT asset test purposes). The FSA also invites the District Director to

collect a penalty: "As the taxpayer's violation of the 75% asset test would, in all likelihood, result in a positive tax liability (computed as for a regular subchapter C corporation) for [redacted text], the District Director may require the taxpayer to remit some reasonable portion of the foregone tax as a condition of the closing agreement."

3. The REIT and its tax advisors need to consider possible settlement offers and creative structures and rationales in situations where the statutorily prescribed tax or penalty produces a number that seems way out of proportion to the failure or potential failure, such as a minor preferential dividend problem that would require a very large deficiency dividend (plus interest charge) to cure or where it is far from clear that a failure did, in fact, occur, but one which the REIT must resolve with finality in order to move forward with its business. The REIT typically does not address the penalty in its initial submission.

IX. SUCCESSOR RULES

A. Overview

1. Section 856(g)(3) and Treas. Reg. § 1.856-8(c)(1) provide that if a corporation's election to be treated as a REIT is revoked or terminated for a taxable year, such entity, and any "successor" to that entity within the meaning of Treas. Reg. § 1.856-8(c)(2), "is not eligible to make a new election" to be taxed as a REIT until the fifth taxable year after the first taxable year for which the revocation or termination is effective.

2. Counting the REIT termination year, this means there is a five-year wait before the terminated REIT or any "successor" can make a new REIT election.

3. In theory the IRS could assert that a REIT failed to qualify in a time-barred year (even though no deficiency can be asserted), in order to invoke the five-year wait for the terminated REIT or any successor to the REIT.

4. Depending on how far back the REIT bust occurred, this could theoretically create open C corporation years or open REIT years where the REIT has re-qualified but is now subject to the 5-year built-in gains tax recognition period. As discussed, this used to be a 10-year period, which Congress had previously shortened on several occasions. The permanent reduction of the recognition period to 5 years should take some of the pressure off of the "de-REITing in a barred year" concern and shorten the scope of REIT qualification tax opinions.

5. No matter how theoretical and remote this risk may seem, it may present problems for law firms that have to give REIT opinions. The inability to render a clean opinion that encompasses a "lookback period" sufficiently long to kill off any adverse consequences from a potential de-REITing in a barred year may be problematic.

6. Although the regulation refers to being ineligible to make a "new" REIT election, there is a risk that even a taxpayer that had already elected REIT status prior to becoming a successor to a terminated REIT may be precluded from filing as a REIT until the prescribed waiting period is over.

B. Definition of "Successor

1. Treas. Reg. 1.856-8(c)(2) defines a "successor" as any corporation that meets both a continuity of ownership requirement and a continuity of assets requirement with respect to the corporation whose REIT election was terminated.

2. The continuity of ownership test is met if, at any time "during the taxable year" the persons who own, directly or indirectly, 50% or more of the potential successor corporation also owned, at any time during the first taxable year for which the termination was effective, 50% or more of the terminated corporation's shares.

3. The continuity of assets test is met "only if" either:

a. A substantial portion of the potential successor corporation's assets were assets of the terminated REIT, or

b. The potential successor corporation acquired a substantial portion of the assets of the terminated REIT.

(1) The regulations don't define "substantial portion."

4. Note that this sets up a nasty two-way "gotcha," because "substantial" can be measured from the perspective of either the potential successor transferee or the terminated REIT transferor.

C. <u>Parent REIT Acquires Target REIT</u>

1. Assume parent REIT acquires all of the common stock of target REIT from an unrelated fund partnership.

2. Following the share purchase, parent REIT liquidates target REIT before a calendar quarter-end is crossed and is under the impression that its own REIT status is now shielded from any damage that a de-REITing of target for a prior year might cause.

3. Note that if parent REIT owned the stock of target REIT on a calendar quarter-end, a bust of the target's REIT status causes parent REIT to have a bust also (violation of the 10% securities test) unless timely cured or a relief provision applies. Many sellers of private REITs seek to negotiate a covenant that the buyer will not liquidate the target REIT until the following taxable year to minimize FIRPTA risks to their foreign shareholders, which necessarily means that the buyer will hold the REIT shares at the end of at least one calendar quarter.

4. If target REIT is found to have blown its REIT status for the liquidation year, parent REIT's own REIT status could be jeopardized because it is now a successor to a terminated REIT.

a. Parent REIT has acquired a substantial portion of target REIT's assets (all of them).

b. The continuity of ownership test is met because, at the time of the liquidation, the same persons directly or indirectly own both REITs.

5. Note that a termination of target's REIT status in a pre-acquisition year will not give rise to a "successor" issue as long as the owners of parent REIT did not directly or indirectly own 50% of more of target REIT at the time of the target REIT's termination.

D. <u>Other Tax Consequences of Termination of Target's REIT Status in Pre-Acquisition Year</u>

1. The termination of target's REIT status in a pre-acquisition year has other tax consequences. The inherited C corporation tax liability for busted REIT years that are still open under the statute of limitations is now the buyer's problem.

2. Even if the REIT re-qualified after the five-year waiting period under section 856(g), the built-in gains tax recognition period that commenced on January 1 of the initial re-qualification year may still be running. Thus, a section 331 liquidation of target REIT by a partnership subsidiary of parent REIT may trigger a current corporate tax liability on the portion of the recognized gain that constituted "built-in gain" at the beginning of the target REIT 's initial re-qualification year.

E. Target REIT Was Organized by Parent REIT

1. Assume target REIT was formed by way of a section 351 dropdown from a parent REIT, and subsequently the target's stock is purchased from parent REIT by a fund partnership which then does a section 331 liquidation of target REIT to step up basis.

2. Target REIT is a "successor" to the selling parent REIT. Thus, if the REIT election of the parent REIT was blown for some reason and the five-year section 856(g)(3) waiting period has not run by the time target REIT is formed, the ability of target to make a REIT election may be compromised.

3. Does this mean acquiror must also conduct tax due diligence on the selling parent REIT's status for the taxable year in which the target was formed, as well as prior taxable years? The buyer who asks to diligence the parent REIT may be told to take a hike, especially in a seller's market.

4. Note that parent's REIT status for taxable years subsequent to target's first REIT year can safely be ignored.

F. Observations on Successor Risks in the Acquisition Context

1. Buyer can argue that a REIT opinion as to the target REIT (assuming seller is willing to pay for one) effectively subsumes an opinion that the parent REIT qualified as such for the taxable year in which target REIT was formed and therefore did not cause a successor problem for target REIT, or it can try to get seller's tax counsel to expressly opine on the successor issue.

2. Buyer can consider getting insurance against this remote tax risk.

3. If the buyer intends to sell the REIT vehicle at some future point, that next buyer might also raise the successor issue when performing its own due diligence; they and their advisors might not see the risk the same way.

4. The reality is that these "successor" REIT issues emanating from a hypothetical de-REITing in a barred year are extremely unlikely to be raised in an actual IRS audit. REITs are rarely audited, and even when they are, successor issues are unlikely to be raised in closed years unless the predecessor REIT is already known to have been "busted." Nevertheless, this is the type of arcane REIT tax issue that smart, experienced due diligence teams are paid to identify, and rest assured they will (if for no other reason than to score points with their client or because they relish making opposing tax advisors squirm a little bit).

5. Ultimately, the biggest problem here is for the REIT opinion giver. In a compressed deal time frame, the opinion giver now must worry about two REITs, not just one, and the parent REIT may be big, complicated and long-lived.

6. In some deals, there may be no REIT opinion proffered or requested, and the buyer must rely solely on its own due diligence and possibly an indemnity or even tax risk insurance. An example might be where the target REIT is easy to diligence and low-risk (e.g., only one or two properties and recently formed).

X. SCOPE OF REIT OPINIONS -- BARRED YEAR REIT BUSTS

A. Built-In Gains Tax

1. Section 127(a) of the PATH Act amended section 1374(d)(7) to provide that the term "recognition period" means "the 5-year period beginning with the 1st day of the 1st taxable year for which the corporation was an S corporation." The amendment is effective for taxable years beginning after December 31, 2014. See PATH Act, Section 127(b). Thus, the five-year recognition period Congress had previously enacted on a temporary basis has thankfully been made permanent.

2. The 2015 JCT Bluebook makes it clear that this welcome change applies to REITs as well as S corporations. See 2015 JCT Bluebook at p. 149 (stating that "Under current Treasury regulations, these rules, including the five-year recognition period, also would apply to REITs and RICs that do not elect 'deemed sale' treatment").

a. For any taxable year beginning in 2009 and 2010, no tax was imposed on the net recognized built-in gain of an S corporation under section 1374 if the seventh taxable year in the corporation's recognition period preceded such taxable year. Thus, with respect to gain that arose prior to the conversion of a C corporation to an S corporation, no tax was imposed under section 1374 if the seventh taxable year for which the S corporation election was in effect preceded the taxable year beginning in 2009 or 2010.

b. For any taxable year beginning in 2011, no tax was imposed on the net recognized built-in gain of an S corporation if the fifth year of the recognition period preceded such taxable year.

c. For taxable years beginning in 2012 and thereafter, the term "recognition period" is applied by substituting a five-year period for the otherwise applicable 10-year period. Thus, if an S corporation with assets subject to the built-in gains tax disposed of such assets in a taxable year beginning in a post-2011 taxable year, and the disposition occurred more than five years after the first day of the recognition period, gain or loss on the disposition is not taken into account in determining the "net recognized built-in gain."

3. None of these amendments to section 1374(d)(7), including the PATH Act amendment, specifically address their application to REITs that are subject to the built-in gains tax by reason of Treas. Reg. § 1.337(d)-7. However, because that Treasury regulation applies the rules of section 1374 to a REIT "as if the … REIT were an S corporation," the section 1374 recognition period amendments should apply equally to a REIT subject to the built-in gains tax, as the JCT 2015 Bluebook confirms and the IRS has previously ruled. See PLR 201202014 (Oct. 13, 2011) (the IRS ruled that the section 1374 recognition period shortening provided in section 1374(d)(7)(B) for 2011 applied to a REIT that proposed to undergo a taxable liquidation in such year. Also, starting with 2009, the instructions to Form 1120-REIT have consistently stated that these amendments are applicable to REITs.

B. <u>Effect of REIT Opinion Where Scope is Limited to All Open REIT Years</u>

1. Because of the potential BIG tax exposure in an open year from de-REITing in a closed year, REIT opinion givers have often been asked to opine back to inception. With the BIG tax recognition period now shortened to five years, the rationale for rendering an opinion that delves into ancient REIT history is becoming weaker and weaker.

2. Suppose, for example, that counsel to a target REIT is only willing to opine for open REIT taxable years. Assume further that the opinion is being rendered in the first quarter of 2016. The open REIT years at that time will be 2012 - 2015 and the stub period in 2016. (The extended due date for filing the 2012 return was September 16, 2013, and three years from that date is September 16, 2016.)

a. A clean REIT opinion for 2012 arguably subsumes an opinion that the REIT also qualified back to 2008. This is because a REIT bust in 2008 (unless cured through a closing agreement or one of the statutory relief provisions) would, in theory, prevent the REIT from re-electing REIT status until <u>2013</u> -- even though the original bust year is barred by the statute of limitations -- unless the REIT can prove reasonable cause to the satisfaction of the Secretary under section 856(g)(4). Section 856(g)(3). Thus, an opinion that the REIT qualified in 2012 could be read to be an implied opinion that the REIT qualified back to 2008.

b. The IRS could not assert a corporate-level tax liability (whether due to tax liability arising from regular C corporation status or to REIT built-in gains tax liability) for the years 2008 through 2011 because those years are time-barred. However, the IRS could, in theory, assert a de-REITing issue in a barred year in order to collect a built-in gains tax on built-in gain asset sales that occur in an open year. The extent to which a REIT qualification opinion provides protection against the built-in gains tax being asserted in open taxable years depends on how far back the opinion goes.

(1) A REIT bust in 2007 would mean that the corporation would be eligible to re-qualify starting in 2012. Such REIT would have built-in gains tax exposure on asset sales occurring in the open taxable years 2012 – 2016, and thereafter could sell assets free of built-in gains tax (assuming the REIT continued to qualify as a REIT from 2008 onward).

(2) A REIT bust in 2006 would mean that the corporation would be eligible to re-qualify starting in 2011. Such REIT would have built-in gains tax exposure on asset sales occurring in the open taxable years 2012 – <u>2015</u>, and thereafter could sell assets free of built-in gains tax (assuming the REIT continued to qualify as a REIT from 2008 onward).

3. In short, a REIT opinion for all open years does not necessarily provide protection with respect to potential built-in gains tax liability in such years from a REIT bust in a barred year. However, REIT opinion givers historically have not given specific opinions on the built-in gains tax.