Updated Earnings and Profits Rules for REITs

To qualify as a real estate investment trust ("REIT"), an entity, among other things, must make a minimum "dividend" distribution to its shareholders. REITs generally can deduct these dividends for corporate-level income tax purposes. Since 1960, unique rules modified a REIT's earnings and profits ("E&P") determination so that sufficient E&P existed to support the treatment of distributions as "dividends," allowing the REIT to satisfy its distribution requirement while lowering corporate-level tax. This article explains how the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act") amended these modification rules to eliminate potential double taxation of "deemed" E&P to REIT shareholders, but why the PATH Act also created—or highlighted—other ambiguities.

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Overview

On December 18, 2015, the PATH Act was enacted as part of Pub. Law 114-113, the "Consolidated Appropriations Act, 2016." The new law includes many significant changes to the REIT rules, such as favorable treatment under the Foreign Investment in Real Property Tax Act ("FIRPTA") regime for investments in U.S. real estate through REITs. The new law also modifies the unique REIT E&P rules designed to provide REITs with sufficient E&P to support the dividend distribution requirement by eliminating the potential double taxation to shareholders of the "deemed" E&P. For many REITs, the revised and simplified rules will require minimal efforts to follow. However, for others, guidance from the IRS may be needed to coordinate the interplay between a REIT's E&P determination and certain other provisions.

This article first discusses the E&P operating rules prior to the enactment of the PATH Act. It then reviews the revised provisions that are effective for tax years beginning after December 31, 2015, and the effects that presumably were intended. Finally, the article highlights potential uncertainties that may require further clarifications or guidance from the IRS.

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REIT E&P Rules Prior to PATH Act

Generally, a dividend is a distribution of property by a corporation to its shareholders out of the corporation's accumulated E&P or current E&P,[1] and a REIT and its shareholders are subject to the tax rules applicable to a domestic corporation.[2] For various reasons, a corporation's taxable income and E&P for a given year may differ. For example, a corporation is required to use longer cost recovery periods in computing depreciation in determining its E&P and cannot reduce its current E&P following the energy efficient commercial buildings provision.[3] Furthermore, an expense that is not allowed as a deduction in computing taxable income (i.e., permanently disallowed) usually is reflected in E&P except when the Code specifically provides otherwise.[4] Finally, a corporation's E&P is reduced by a loss recognized on the sale or disposition of property even though the loss is not allowed as a deduction (or may be deferred until capital gains are recognized) by the operation of section 267 or 1211 (e.g., net capital loss).[5]

A REIT is a tax-efficient vehicle for owning and operating real estate because, while it is taxed as a corporation, it can avoid corporate-level tax on its taxable income by claiming a deduction for dividends paid to its shareholders.[6] To qualify and maintain status as a REIT, the entity must, among other things, distribute generally 90 percent of its "ordinary" taxable income in the form of "dividends."[7] Thus, absent special rules, a REIT may lack E&P to treat distributions as dividends, and thus, may fail to meet this distribution requirement or incur corporate-level tax because of

Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

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1 Section 316(a).

2 Section 1.856-1(e).

3 Section 312(k)(3).

4 Rev. Rul. 71-165, 1971-1 C.B. 111, stated "[a]n expense of an accrual basis corporation that under the Code is never an allowable deduction in computing taxable income usually is reflected in earnings and profits in the year to which it is attributable, except where the Code specifically provides that the corporation's earnings and profits shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income."

5 Section 1.312-7(b)(1).

6 Section 857(b)(1) and (2).

7 Specifically, pursuant to section 857(a)(1), a REIT must make distributions that qualify for a dividends paid deduction (without regard to capital gain dividends) equal to at least the sum of 90 percent of the REIT taxable income for the tax year (determined without regard to the deduction for dividends paid and by excluding any net capital gain), and 90 percent of the excess of the net income from foreclosure property over the tax imposed on such income, minus any "excess noncash income."

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the disparity between its taxable income and E&P. To this end, prior to the enactment of the PATH Act, a REIT's determination of E&P was subject to the following rules:

- Section 857(d)(1)–A REIT's current E&P is not reduced by any amount that is not allowable in computing its taxable income for such taxable year.
- Section 562(e)–For purposes of computing the dividends paid deduction, a REIT's current E&P is increased by the total amount of gain (if any) on the sale or exchange of real property by the REIT during such taxable year.

The following illustrates how these rules have been applied.

Example 1

A REIT acquires a single residential apartment building for $1,000 and computes depreciation over 27.5 years and 40 years, respectively, for taxable income and E&P purposes. The REIT distributes all its available cash every year and has no accumulated E&P at the beginning of Year 30, which suggests that its shareholders have recognized dividend income based on smaller annual E&P depreciation deductions. The REIT distributes $90 to its shareholders in Year 30, has a pre-depreciation taxable income of $90 for Year 30, and computes its depreciation for taxable income and E&P purposes to be $0 and $25, respectively. Under former section 857(d)(1), the excess E&P depreciation of $25 for Year 30 would not be allowable in determining Year 30's taxable income because it was claimed in prior years, so such amount could not reduce REIT's current E&P for Year 30, resulting in a current E&P balance of $90. Accordingly, the REIT would be able to claim a dividends paid deduction of $90 to eliminate its taxable income. However, notwithstanding that in this example REIT's shareholders have already recognized dividend income based on smaller E&P depreciation deductions and have not benefited from larger tax depreciation deductions in prior years, the shareholders would recognize dividend income of $90 reflecting the "deemed" E&P of $25.

Example 2

Continuing with the example above, the REIT sells the building for $1,000 in Year 31 and computes its gain for taxable income and E&P purposes as $1,000 and $750, respectively, ignoring the mid-month convention. The

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REIT has no accumulated E&P at the beginning of Year 31, has no other activities in Year 31, and distributes $1,000 to its shareholders. Under former section 562(e), the REIT would treat its tax gain of $1,000 as its E&P gain for purposes of determining the dividends paid deduction. Accordingly, the REIT could claim a dividends paid deduction of $1,000 to eliminate its taxable income, and its shareholders would recognize dividend income of only $750 (because the modification under former section 562(e) was only for purposes of determining the dividends paid deduction).

It is worth noting that, while Congress crafted these provisions to allow REITs to have sufficient E&P for purposes of satisfying the minimum distribution requirement or avoiding corporate-level tax,[8] the above modifications were not always effective. For example, certain income items that are treated differently between taxable income and E&P were not captured under a literal reading of former section 857(d)(1) and required private letter rulings from the IRS. In Private Letter Rulings 201537020 and 201503010, the IRS relied on the legislative history accompanying the Tax Reform Act of 1986, which amended former section 857(d)(1),[9] to treat a REIT as having sufficient E&P

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[8] For example, Congress included section 562(e) as part of the Technical Corrections Act of 1982, and the accompanying legislative history explained "[w]here the amount of taxable gain from the sale or disposition of real property is greater than the current or accumulated earnings and profits because of the different recovery periods used for computing taxable income and earnings and profits, the real estate investment trust may not have sufficient earnings and profits to pay enough dividends to meet the 95-percent test [currently a 90-percent test] or to avoid taxation of all income from the sale or other disposition of the real property through dividend distributions to its shareholders." See S. Rep. No. 97-592, 97th Cong., 2d Sess. (1982).

[9] Prior to 1986, section 857(d) read "[t]he earnings and profits of a real estate investment trust for any taxable year (but not its accumulated earnings and profits) shall not be reduced by any amount which is not allowable *as a deduction* in computing its taxable income for such taxable year." [Emphasis added] As part of the legislative process of the Tax Reform Act of 1986, the Senate proposed and passed amendments to (1) delete the phrase "as a deduction" and (2) to insert a new provision providing that a REIT's current E&P would not be less than its REIT taxable income before the dividends paid deduction. S. Rep. 99-313, 99th Cong., 2d Sess. (May 29, 1986). In conference, the Senate's amendment to delete the phrase "as a deduction" from section 857(d) was adopted. However, the addition to ensure REIT's current E&P would in no event be less than its REIT taxable income before the dividends paid deduction was not adopted "since the conferees believe that this provision is a restatement of present law." H.R. Conf. Rep. No. 99-841, at 218 (1986).

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notwithstanding that the REIT's positive section 481(a) adjustment for taxable income purposes was greater than the amount for E&P purposes.

REIT E&P Rules under the PATH Act

To address the potential double taxation of "deemed" E&P under former section 857(d)(1), the PATH Act provides a somewhat circuitous solution. It first modifies section 857(d)(1), so that current E&P is not reduced for amounts that have not been allowable for computing taxable income in the current "*or*" prior taxable years. For purposes of the dividends paid deduction, new section 857(d)(5) cross-references amended section 562(e)(1) for special rules, which then applies section 857(d)(1) without regard to the provision relating to prior taxable years. The net result is that, for purposes of the dividends paid deduction, section 857(d)(1) (as modified by section 562(e)(1)(B)) would prevent a current year reduction of E&P for amounts that are attributable to prior year taxable income deductions.

As amended, the determination rules are now as follows:

- Section 857(d)(1)–A REIT's current E&P is not reduced by any amount that
  - (A) Is not allowable in computing its taxable income for such taxable year, and
  - (B) Was not allowable in computing its taxable income for any prior taxable year.
- Section 562(e)(1)--For purposes of computing the dividends paid deduction,
  - (A) REIT's current E&P is increased by the amount of gain (if any) on the sale or exchange of real property that is taken into account in determining the taxable income for such taxable year, and
  - (B) Section 857(d)(1) is applied without regard to section 857(d)(1)(B).

Amounts subject to amended section 857(d)(1) continue to include items that are permanently disallowed in determining taxable income, such as nondeductible penalties and disallowed entertainment expenses.

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Amended section 857(d)(1) also applies to amounts that would ordinarily reduce E&P, but the deduction for which might be deferred to a future year for taxable income purposes, such as a net capital loss or a disallowed section 163(j) interest.[10] However, for purposes of determining the taxability of distributions to shareholders (i.e., Form 1099-DIV), this change means that an item—such as the excess of E&P depreciation over tax depreciation in later years due to the use of different recovery periods—is no longer subject to amended section 857(d)(1). This means the normal current year E&P adjustments (negative), which in fact are attributable to prior year taxable income deductions, would be permitted. This reduces the amount of current year distributions that would otherwise be taxable as dividends to shareholders.

On the other hand, for determining the dividends paid deduction (and not for Form 1099-DIV), such excess amount cannot reduce the REIT's current E&P pursuant to amended section 562(e)(1)(B). Thus, under Example 1 above, the REIT would have sufficient E&P (i.e., $90) to support a dividends paid deduction large enough to offset its current taxable income, but the shareholder would recognize a smaller amount of dividend income (i.e., Form 1099-DIV of $65), to the extent that all prior year E&P was previously distributed as taxable dividends.

Uncertainties under the PATH Act

While the amendment appears to accomplish the apparent objective of eliminating the potential double taxation of the "deemed" E&P, it also raises questions over how certain provisions that are affected by E&P, such as the January dividend, the throwback dividend, and the consent dividend, should operate under the new determination rules.

Relevant to a REIT, the term "deduction for dividends paid" includes generally the sum of the dividends paid during the tax year and consent dividend for the tax year.[11] For this purpose, dividends paid by a REIT during the year following a relevant year may be included. For example, under section 857(b)(9) (or the so-called January dividend), any dividend declared by a REIT in October, November, or December of any calendar year and payable to shareholders of record on a specified date in one of

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[10] Section 1.163(j)-1(e) provides "[t]he disallowance and carryforward of a deduction for interest expense under this section shall not affect whether or when such interest expense reduces earnings and profits of the payor corporation."

[11] Sections 857(b)(2)(B), 561, and 562.

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those months is deemed paid by the REIT on December 31 of that calendar year if the dividend is paid during January of the following calendar year. This special timing rule also treats shareholders as receiving the dividend on December 31. Further, section 858 (or the throwback dividend) provides that a REIT may elect to treat a dividend declared before the return due date (including extension) for a relevant year and distributed in the 12-month period following the relevant year as being paid during the relevant year. However, contrary to the January dividend, the elected amount is treated as being received by shareholders in the distribution year. Because of this timing difference (i.e., deducted by a REIT earlier than recognized as income by shareholders), Congress passed section 4981, under which a REIT is subject to a four-percent excise tax if it relies on the throwback dividend generally for more than 15 percent of its ordinary income.[12] Finally, pursuant to section 565(a) (or the consent dividend), a REIT's common shareholder(s) may elect to treat as a dividend the amount specified in such election (i.e., a hypothetical distribution deemed occurring on December 31).[13]

Consistent with the term "dividend" (rather than "distribution") being used in the statute for these provisions, the income tax regulations specifically limit the application of a throwback dividend and a consent dividend to the E&P of the relevant tax year. For example, section 1.858-1(b)(2) provides in part that a REIT can elect a throwback dividend "to the extent that the earnings and profits of the taxable year (computed with the application of sections 857(d) and 1.857-7) exceed the total amount of distributions out of such earnings and profits actually made during the taxable year." Thus, if a REIT has taxable income and E&P of $100,000 for Year 1, distributes $85,000 in Year 1, and elects on its Year 1 return to treat $40,000 paid in Year 2 as a dividend paid during Year 1 pursuant to

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[12] Pursuant to section 4981, a REIT is subject to a tax equal to generally four percent of the excess of the required distribution over the sum of (1) the amounts actually distributed during the calendar year, (2) retained amounts on which income tax is paid, and (3) the excess of dividends paid deductions over REIT taxable income before such deductions of prior years. For this purpose, the required distribution is the sum of (1) 85 percent of its ordinary income, (2) 95 percent of its capital gain net income, and (3) any prior-year undistributed income.

[13] Section 1.565-3(a) provides in part that "[t]he amount of the consent dividend… shall be considered, for all purposes of the Code, as if it were distributed in money by the corporation to the shareholder on the last day of the taxable year of the corporation, received by the shareholder on such day, and immediately contributed by the shareholder as paid-in capital to the corporation on such day."

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section 858, the election is valid only to the extent of $15,000.[14] Similarly, for a consent dividend, section 1.565-2(c)(1) treats an elected amount as effective not exceeding "the amounts which would constitute a dividend (as defined in section 316) if the corporation had distributed the total specified amounts in money to shareholders on the last day of the taxable year of the corporation."

Considering that a REIT now may have two different current E&P amounts (i.e., section 857(d)(1) vs. section 562(e)(1)), the threshold question then is: Which E&P amount serves as the limitation for these purposes (including the January dividend)?[15]

Pursuant to section 1.565-1(b)(1), a consent dividend election is made on Form 972, *Consent of Shareholder To Include Specific Amount in Gross Income*. If the amount so elected is limited to only the amount that a consent shareholder will include in its gross income, the use of a consent dividend may not be possible in certain circumstances. For example, assume that the REIT in Example 1 above intends to rely solely on the consent dividend (rather than the actual distribution of cash). If the amount specified on Form 972 cannot exceed $65 (i.e., the E&P determined for Form 1099-DIV), the REIT would fail to satisfy the minimum distribution requirement. It should be noted that section 1.565-2(c)(1) provides if only a portion of the specified amount would constitute a dividend (i.e., due to insufficient E&P), then only a corresponding portion of each specified amount is treated as a consent dividend. Thus, can common stockholders of the REIT under Example 1 above specify $90 on Form 972 but recognize only $65 as dividend income on their tax returns?[16]

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[14] See Example 2 of section 1.858-1(d).

[15] Technically, except in the case of a sale of property, the special E&P adjustments are all made pursuant to section 857(d)(1). The application of section 857(d)(1) is then modified by section 562(e)(1)(B) for purposes of the dividends paid deduction. For simplicity, we refer to the two different E&P calculations as made pursuant to section 857(d)(1) for shareholder purposes, or section 562(e)(1) for dividends paid deduction purposes.

[16] The example under section 1.565-2(c)(2) provides:

> The X Corporation, a corporation described in §1.565-(a)(1) or (2), which makes its income tax returns on the calendar year basis, has only one class of stock outstanding, owned in equal amounts by A and B. It makes no distributions during the taxable year 1987. Its earnings and profits for the calendar year 1987 amount to $8,000, there being at the beginning of such year no accumulated earnings or profits. A and B execute proper consents to include $5,000 each in their gross income as a dividend received by them on December 31, 1987. The sum of the amounts

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With respect to the January dividend and throwback dividend, it is possible that a distribution that may not qualify as a January dividend, because of the application of section 857(d)(1), may be eligible for the throwback dividend election. Thus, which E&P determination controls may be more complex and may require further coordination as illustrated below:

Example 3

Continuing with Example 1 above, and for Year 30 and Year 31, the REIT's current E&P is $90 and $65, respectively, as determined under amended sections 562(e)(1) and 857(d)(1). The REIT has no accumulated E&P at the beginning of Year 30 and makes quarterly distributions of $22.50 each in Year 30 and Year 31. The REIT declares the 4th quarter distribution of $22.50 in December of Year 30 and Year 31 and pays such amount in January of Year 31 and Year 32.

	Year 30	Year 31	Year 32
REIT taxable income before the dividends paid deduction	90	90	
E&P - section 562(e)(1)	90	90	
E&P - section 857(d)(1)	65	65	
Declared			
March	22.5	22.5	
June	22.5	22.5	
September	22.5	22.5	
December	22.5	22.5	
Paid			
January		22.5	22.5
April	22.5	22.5	
July	22.5	22.5	
October	22.5	22.5	
	67.5	90	22.5

specified in the consents executed by A and B is $10,000, but if $10,000 had actually been distributed by the X corporation on December 31, 1987, only $8,000 would have constituted a dividend under section 316(a). The amount which could be considered as consent dividends in computing the dividends paid deduction for purposes of the accumulated earnings tax is limited to $8,000, or $4,000 of the $5,000 specified in each consent. The remaining $1,000 in each consent is disregarded for all tax purposes.

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Option #1

If, for purposes of section 857(b)(9), E&P is determined under section 857(d)(1) and not modified by section 562(e)(1)(B), (i.e., $65, E&P for shareholder purposes), then the distribution in January may not be treated as relating back to December 31, as there is insufficient E&P to treat it as a dividend. On the other hand, an argument may be made that, for purposes of section 858, the relevant E&P calculation for the prior year should be that which is made for corporate-level purposes (i.e., the section 562(e)(1) calculation), rather than shareholder-level purposes (i.e., section 857(d)(1)), since section 858 only carries back the corporate-level dividend paid deduction to the prior year.[17] Under this approach, the relevant E&P calculation is $90 for Year 30, which would permit the REIT to fully offset its taxable income using a throwback dividend election. However, such election could subject the REIT to an excise tax of $0.36 (i.e., 85% of $90 minus $67.5 times 4%), since the REIT would fail to distribute at least 85 percent of its ordinary taxable income during Year 30 for purposes of the excise tax. That said, for purposes of the excise tax, a REIT generally can include the excess of its prior-year dividend distributions over its prior-year taxable income for purposes of satisfying its current-year required distribution.[18] Thus, the REIT in this example may not have such excise tax exposure. However, for a REIT that has acquired depreciable property in a carryover basis transaction with higher E&P basis and that has no prior-year over-distributions, it may be subject to an excise tax.

Option #2

Alternatively, if the REIT is permitted to use the E&P calculation under section 562(e)(1) (i.e., $90) for purposes of applying section 857(b)(9) to the January dividend, then the REIT would have sufficient distributions made in Year 30 (i.e., no risk of the four-percent excise tax) to offset its taxable income. However, because the REIT would have total distributions of $90 but current E&P of $65 for Form 1099-DIV purposes, a portion of every such distribution would be reported as a non-dividend distribution

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[17] Section 1.858-1(a) provides, in part, "[u]nder section 858, a real estate investment trust may elect to treat certain dividends that are distributed within a specified period after the close of a taxable year as having been paid during the taxable year," and "[t]he dividend is taken into account *in determining the deduction for dividends paid* for the taxable year in which it is treated as paid." [Emphasis added]

[18] That is, treat as prior year "overdistributions." Section 4981(c)(2).

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for purposes of Form 1099-DIV.[19] It should be noted that, if the REIT believes Option #2 is the better alternative, it would not make a throwback dividend election with respect to the amount paid in January, which could lead to insufficient "dividend" distributions for the year if the IRS disagrees with such view.

For a REIT, the E&P determination is critical because it affects not only its shareholders, but also its minimum distribution requirement and the imposition of corporate-level tax. The amended rules should help avoid double taxation of "deemed" E&P to shareholders. Hopefully, as more REITs start applying these new rules to their own situations, uncertainties can be identified and addressed to minimize risks and simplify the already complicated REIT rules.

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[19] Section 1.316-2(b) provides that if distributions made during the year consist only of money and exceed the earnings and profits of such year, then that proportion of each distribution that the total of the earnings and profits of the year bears to the total distributions made during the year shall be regarded as out of the earnings and profits of that year.

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