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March 30 - April 1

2016

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REIT Tax Issues When You Arrive at Work

March 30-April 1, 2016

REIT Tax Issues When You Arrive at Work

Panelists



- ◆ Mark Patterson, Duke Realty
- ◆ Charlie Temkin, Deloitte
- ◆ Josh Cox, Tanger Outlets
- ◆ Carol Bradshaw, Westfield

REIT Tax Issues When You Arrive at Work



- ◆ Tax Automation
- ◆ ITSI & Rev. Rul. 2002-38
- ◆ 1033(g)(3) in Non-billboard REITs
- ◆ Managing Taxable Income Using Repair Regs; Sec. 1031
- ◆ E&P Impact: Capital losses, Accelerated depr. post-PATH Act

Tax Automation



- ◆ Top Five Complaints about Tax Automation (or lack thereof)

- ◆ ?

- ◆ ?

- ◆ ?

- ◆ ?

- ◆ ?

Tax Automation



- ◆ Survey says!
 - ◆ 1) Cost
 - ◆ 2) Executive support/buy-in/prioritizing
 - ◆ 3) Finding software savvy tax talent
 - ◆ 4) Maintenance
 - ◆ 5) Customization/proprietary solutions



Asset Test

Asset Item	REIT Share	75% Test	25% Test	25% TRS Test	5% Test
Accounts Receivable, Net	31,755,648	30,881,528	874,120	-	-
Accrued Straight-Line Rents	182,808,790	182,808,790	-	-	-
Buildings, Net	9,314,595,872	9,314,468,541	127,331	-	-
Cash and Cash Equivalents	50,200,777	50,200,777	-	-	-
Construction in Progress	489,491,881	489,491,881	-	-	-
Deferred Financing Costs, Net	36,986,333	2,967	36,983,365	-	-
Goodwill	28,185,855	28,185,855	-	-	-
Investments in Subsidiaries	134,355,872	(4,792,930)	139,148,802	139,148,802	-
Land	2,792,076,090	2,792,076,090	-	-	-
Other Assets, Escrow Deposits, N/R - Net	615,734,771	394,528,035	221,206,736	1,427,084	20,572,716
Other Deferred Costs, Net	528,207,797	514,015,728	14,192,069	-	-
Other Receivables, Net	15,387,525	7,643,582	7,743,943	-	-
Tenant Improvements, Net	982,277,272	982,277,272	-	-	-
Total	15,202,064,483	14,781,788,118	420,276,365	140,575,885	20,572,716
REIT Asset Test Percentages		97.2354%	2.7646%	0.9247%	0.1353%



Income Test

Income Item	REIT Share	95% Test	75% Test
Base Rents	813,395,689	813,395,689	813,395,689
Construction Mgmt. and Dev. Fees	9,151,665	-	-
Dividend Income	380,290	380,290	380,290
Expense Reimbursement	255,364,085	255,364,085	255,364,085
Gain from Property Sales	546,888,748	546,888,748	546,888,748
Gain From Stock Sale	652,719	652,719	-
Interest Income	12,966,946	12,966,946	-
Other Income	6,631,698	-	-
Property Mgmt., Maint. and Leasing	22,011,127	-	-
Tenant Finish Reimbursed Fees	3,310,944	3,310,944	3,310,944
Total	1,670,753,910	1,632,959,420	1,619,339,755
REIT Income Test Percentages		97.7379%	96.9227%

Tax Balance Sheet



Description	Book	Book Adj.	Adj. Book	Tax Adj.	Tax
Total Assets	53,276,762.48	188,781.26	53,465,543.74	1,715,145.34	55,180,689.08
				-	
Total Liabilities	(43,190,195.32)	(188,781.26)	(43,378,976.58)	45,963.90	(43,333,012.68)
Total Capital	(10,086,567.16)	-	(10,086,567.16)	(1,761,109.24)	(11,847,676.40)
Total Liabilities & Capital	(53,276,762.48)	(188,781.26)	(53,465,543.74)	(1,715,145.34)	(55,180,689.08)

Tax Income Statement



Income Item	Book	Book Adj.	Adj. Book	Tax Adj.	Tax	E&P Adj.	E&P
Total Rental Income	8,926,527.75	1,768.05	8,928,295.80	58,969.21	8,987,265.01	-	8,987,265.01
Total Service Income	(85,956.42)	85,956.42	-	-	-	-	-
Total Other Income	4,613.86	(4,497.05)	116.81	-	116.81	-	116.81
Total Operating Expenses	(636,499.36)	-	(636,499.36)	(368.23)	(636,867.59)	-	(636,867.59)
Total Amortization	(57,921.42)	-	(57,921.42)	(2,222.25)	(60,143.67)	-	(60,143.67)
Total Depreciation	(304,068.75)	-	(304,068.75)	188,733.53	(115,335.22)	(97,744.46)	(213,079.68)
Total Other Expenses	7,956.51	2,729.00	10,685.51	(12,076.20)	(1,390.69)	-	(1,390.69)
Total	7,854,652.17	85,956.42	7,940,608.59	233,036.06	8,173,644.65	(97,744.46)	8,075,900.19



Benefits

- ◆ Realize annual cost savings (an annuity)
 - Some apps run for 7-10 years without updates
 - Tax preparation time for \$1 Billion JV reduced by 80 to 90%
- ◆ Building blocks (unit record)
- ◆ Scalability
 - Can handle unlimited number of JVs
 - Blackstone sale



Benefits (continued)

- ◆ Benefits to other departments
 - Asset strategy roadmap
 - Equity compensation
 - GAAP depreciation
- ◆ Not tied to any single 3rd party provider
 - Conversion costs
 - Flexibility



Benefits (continued)

- ◆ Spot issues/trends earlier (interim reviews)
- ◆ Eliminate transposition/polarity/excel formula errors
- ◆ Create better audit trail (extreme detail)
- ◆ Standardized results (next man up)
- ◆ Fosters better work morale (less overtime)



Future Tax Automation

- ◆ Integrated/modular based solutions
- ◆ Platform independent solution
 - Abstraction layer(s)
- ◆ Cloud computing
 - Data encryption
 - Multi-factor authentication



Primary Data Accumulation

- ◆ General Ledger data sources (e.g., CTI, Timberline, Yardi)
- ◆ Fixed Asset data sources (e.g., BNA, FAS)
- ◆ Automate data retrieval
- ◆ Summarize results
- ◆ Reconcile results to financial statements/reports

Secondary Data Sources



- ◆ True tax locations
- ◆ Budgeted/projected information
- ◆ Expected sales/exchanges
- ◆ Managed property systems
- ◆ Purchase card systems



Tax Books

- ◆ Tax chart of accounts
- ◆ Tax versus legal entity accounting
- ◆ Tax and book ownership differences
- ◆ Account mapping of trial balance to tax report headers
- ◆ Account mapping to tax returns

Adjusting Journal Entries



- ◆ Identify tax sensitive accounts/subaccounts
- ◆ Automate standard adjusting journal entries from CTI, FAS, etc.
- ◆ Differentiate between types of adjusting journal entries
- ◆ Manual adjusting journal entries
- ◆ Archive adjusting journal entries each year



Standard Adjusting Journal Entries

- ◆ Book to tax depreciation differences
- ◆ Book to tax property sale differences
- ◆ Prepaid rents
- ◆ Bad debt expense
- ◆ Other as identified in G/L



Reporting

- ◆ Identify relevant worksheets
- ◆ Collaborate on worksheet format
- ◆ Automate basic calculations (totals/subtotals)
- ◆ Automate diagnostics
- ◆ Allow for tax workbook updating

Assorted ITSI Issues



- ◆ The main steps in addressing ITSI
- ◆ Treatment of income from noncustomary services performed by TRS



Assorted ITSI Issues

- ◆ Restaurant, café, food services
 - ◆ If this is customary in the geographic area for comparable properties, which is frequently the case, can a REIT use an IK? Does the REIT receive any net profits or have to pay for any net losses—i.e., the IK gets a management fee and no exposure? Do the profits and losses get reflected on the REIT's books? Could the tax on prohibited transactions apply?
 - ◆ Can the REIT lease the facilities to an operator at below-market rent, assuming that the facilities do not need any additional subsidy beyond the discount on the rent? Apparently so. See [PLR 199917039](#) (See [NAREIT Compendium Memorandum 1999-9](#)).



Assorted ITSI Issues

- ◆ Restaurant, café, food services
 - ◆ If the REIT engages its TRS to provide the food service, and the TRS hires the IK, do the operations on the facility go on the IK's books, the TRS's books, or the REIT's books? If the REIT pays the TRS a premium on top of any anticipated fees to the IK and overall subsidy, and the REIT is not entitled to any share of profits if there are any, are the operations then on the TRS's books? Does the TRS need to have employees of its own, since it will be relying on the IK? Does the REIT have to charge the TRS any rent?



Assorted ITSI Issues

- ◆ Restaurant, café, food services
 - ◆ Note that if the TRS is paid less than an arm's length amount, the REIT will be liable to a 100% penalty on the shortfall, either because there is redetermined rent or because it is redetermined TRS service income (added by the PATH Act).
 - ◆ What is a reasonable rate? There is a 150%-of-expenses safe harbor for redetermined rent; did someone forget the safe harbor for redetermined TRS service income?



Assorted ITSI Issues

◆ Gyms/sports facilities

- ◆ Easy if unattended facilities with workout machines and little else. See, e.g., [PLR 200101012](#) (unattended fitness center); PLR 9510030 (same).
- ◆ One step up is facilities that are unattended, except that there are classes provided by personal trainers. PLR 9646027 (fitness instruction provided by IKs) (See [NAREIT Compendium Memorandum 1996-20](#)). Is there a risk in using individuals as IKs?



Assorted ITSI Issues

◆ Gyms/sports facilities

- ◆ Frequently so upscale that unclear if customary, with both significant personal services (classes, personal trainers) and retail sales. It is therefore more common to involve a TRS.
- ◆ Similar issues to food services.



Assorted ITSI Issues

- ◆ Strictly speaking, not ITSI, but related: if the REIT receives income from a noncustomary service provided by a TRS, is the income rent from real property?
 - ◆ Income from a customary service is rent, whether or not separately stated. Section 856(d)(1)(B).
 - ◆ [Rev. Rul. 2002-38](#) (See NAREIT [Compendium Memorandum 2002-3](#)) concluded that where the charges for a noncustomary service are not separately stated, the rent is, in its entirety, rents from real property. Is it significant whether the charge for the service is or is not separately stated?
 - ◆ P. Decker, D. Kaplan, and A. Ponda, "[Non-customary Services Furnished by Taxable REIT Subsidiaries](#)," Tax Notes Today (July 28, 2015).

Sec. 1033(g)(3) is not just for Lamar & CBS Outdoor



- ◆ Legislative history of 1033(g)
- ◆ Advertising as REIT qualifying income is not new
- ◆ Billboard structures as real estate is not new
- ◆ Implementation
- ◆ UBTI considerations



Sec. 1033(g)(3) is not just for Lamar & CBS Outdoor

- ◆ Legislative history of 1033(g)(3)
- ◆ Highway Beautification Act of 1965 - LBJ and Lady Bird Johnson
- ◆ This legislation called for the control of outdoor advertising along the nation's highways. Condemnation and removal of advertising billboards that don't comply with the standards is one way to enforce compliance with the law.
- ◆ Highway Beautification Act anticipated billboards would be characterized as real property for purposes of this rule. By 1976 a number of courts had concluded that billboards were personal property and not eligible for exchange treatment.



Sec. 1033(g)(3) is not just for Lamar & CBS Outdoor

- ◆ Tax Reform Act of 1976
- ◆ In response to the court cases and billboard lobby, Congress enacted Code section 1033(g)(3) allowing a taxpayer to elect to treat its “outdoor advertising displays” as real property. This applies to Chapter 1 of the Code which includes the REIT provisions and UBTI provisions.
- ◆ 1033(g)(3)(C) - The term “outdoor advertising display” is defined as a rigidly assembled sign, display, or device permanently affixed to the ground or permanently attached to a building or other inherently permanent structure constituting, or used for the display of, a commercial or other advertisement to the public.

Sec. 1033(g)(3) is not just for Lamar & CBS Outdoor



- ◆ Opportunities for non-billboard REITs
 - ◆ Any REIT with road frontage that wants to erect billboards: Timber, Farmland, Prison, Student housing, Industrial, Retail
 - ◆ Office REITs that add permanent signs on sides of buildings
 - ◆ Signs on building walls inside and out in shopping centers
 - ◆ Strip center retail REITs



Sec. 1033(g)(3) is not just for Lamar & CBS Outdoor

- ◆ Leasing of advertising space by REITs is not new
 - ◆ PLR 8830076, the Service ruled that the income derived by the REIT from its proposed leasing advertising space in shopping center common areas would qualify as rents from real property
 - ◆ PLR 9808011 (See [NAREIT Compendium Memorandum 1998-5](#)), the Service ruled that the REIT's share of amounts "received pursuant to tenant and licensee arrangements with respect to ... space on mall directories and other locations at the retail projects for the placement of advertisements will qualify as 'rents from real property' under section 856(d)



Billboards - Eligibility

◆ Permanency of Structures

- ◆ May be properly classified as real property
- ◆ Asset class 00.3 vs 57.1
- ◆ Is 1033(g) election necessary? Consider if leasing sign structure as well as other components not typically classified as real property.

◆ Sign Structures Eligible for Sec.1033(g) election

- ◆ [PLR 201450004](#) Sign structures leased to unrelated 3rd party for FMV rent
 - ◆ Sign structures inherently permanent
 - ◆ Ancillary housing structures/sign assets are dedicated and integral parts of sign structures, i.e. parts of the outdoor advertising display since necessary to make sign function and therefore the Sec. 1033(g) election applies to these assets as well.



Billboards – Property Depreciation

- ◆ 1033 (g) Election
 - ◆ Change in use rules seem to indicate no tax accounting method change in year election is made
 - ◆ See Reg. Sec. 1.168(i)-4(d) through (f)
 - ◆ [PLR 200041027](#) & [PLR 201450001](#)
 - ◆ Generally, if sign structures/outdoor advertising displays already classified as land improvements under asset classes 00.3 or 57.1, then election has no impact on depreciation method or life
 - ◆ If some or all of the sign structure assets classified as tangible personal property (and depreciated accordingly), the change of classification to real property constitutes a change in use of the property and not a change in method of accounting



Billboards – Digital Boards

- ◆ The 2014-2015 “Billboard” PLRs state that “certain Qualified Outdoor Advertising Displays allow for multiple Rental Agreements to be in place at one time.”
 - ◆ Use of the defined term “Qualified Outdoor Advertising Displays” from IRC 1033(g)(3) means the taxpayer is treating the digital board as well as the structure to which it is affixed as real property.
 - ◆ The digital board must be attached to the structure in a way intended to remain for the duration of its useful life.
 - ◆ As real property, the digital board must be depreciated as real property, not personal property.



Billboards – Short Term Rentals

- ◆ Recent Billboard REIT PLRs address short term rentals as small part of billboard revenue
 - ◆ [201522002](#) (See [NAREIT Tax Report 2015-8](#))
 - ◆ Specifies that the portion of its revenue attributable to such short-term Rental Agreements will not be material
 - ◆ [201431020](#) (See [NAREIT Tax Report 2014-27](#))
 - ◆ Specifies short term rentals are approximately 3% of total revenues from billboards
 - ◆ [201431018](#) (See [NAREIT Tax Report 2014-26](#))
 - ◆ specifies short term rentals of x weeks are approximately 2% of total revenues from billboards
- ◆ Consider the standard industry contract duration for advertising

Billboards – Election Statement



◆ Sample 1033 (g) Election

Election to Treat Outdoor Advertising Displays as Real Property

Pursuant to Code Sec. 1033(g)(3)

Pursuant to Reg. Sec. 1.1033(g)-1, TAXPAYER hereby elects, beginning with the taxable year ending 12/31/20xx, that outdoor advertising displays owned by taxpayer be treated as real property in accordance with the provisions of Code Sec. 1033(g). TAXPAYER has not elected to expense under Code Section 179(a) any part of the cost of the above mentioned advertising displays.



Billboards - ITSI

- ◆ [PLR 201143011](#) (See [NAREIT Tax Report 2011-34](#)) REIT leased sign structures, rent did not include payments for non-customary services
 - ◆ Some rent based on gross receipts, which such receipts only included those from customary services
 - ◆ Non customary services such as installation services provided by TRS (Rev. Rul. 2002-38)
- ◆ [PLR 201204006](#) (See [NAREIT Tax Report 2012-2](#))
 - ◆ Sign Superstructures constituted real property and therefore so did use rights
 - ◆ License fees considered similar to rental payments required under a lease and therefore consider rents from real property
 - ◆ Installation services provided by independent contractors represented by taxpayer as customary in geographic market

Billboards – UBTI



- ◆ Gross advertising income is defined in Reg. 1.512(a)–1(f)(3) as all amounts derived from the unrelated advertising activities of the exempt organization.
- ◆ IRC Sec. 1033(g)(3) applies for all purposes of Chapter 1 of the Code
- ◆ UBTI rulings re revenue from short term contracts is rent from real property:
 - ◆ Rev Rul 69-178, [TAM 199924059](#) & [PLR 200222030](#)
 - ◆ Short term rentals of space are rental income for purposes of IRC Sec. 512(b)(3)
- ◆ Payments for occupancy of space where services are also rendered to the occupant are not rents from real property per Reg. Sec. 1.512(b) – 1(c)(5)
- ◆ Personal property included in the lease may not exceed 10% of the total value per Reg. Sec. 1.512(b) – 1(c)(2)
- ◆ Use a lease form and not a license form of agreement



Managing Taxable Income

- ◆ Communication with senior management
- ◆ Like kind exchanges
- ◆ Tangible property regulations



Managing Taxable Income

- ◆ Questions to Consider
 - ◆ Is your 90% test under pressure?
 - ◆ Will you have enough dividend to cover taxable income?
 - ◆ Do you have a plan for tax department communication with senior management and/or the Board of Directors regarding:
 - ◆ Dividend rate increases
 - ◆ Special dividend payments
- ◆ Recommendation: Develop a formal plan and present to CFO and other senior management to gain buy in and educate
 - ◆ Pinpoint key dates during year where dividend planning/updates are on the agenda



Managing Taxable Income Con't.

- ◆ Like Kind Exchange
 - ◆ Deferring gain may not always be the best strategy.
 - ◆ Questions to Consider
 - ◆ Are we currently estimating return of capital distributions for the year?
 - ◆ How large is the gain and therefore how large is the potential distribution required?
 - ◆ Are there any other losses or deductions that can be taken in the current tax year to offset the gain?



Managing Taxable Income Con't.

◆ Like Kind Exchange

◆ Questions

- ◆ Is there visible replacement property?
- ◆ How will gain deferral/lack of gain deferral impact my shareholders/unitholders?
- ◆ Can the company afford lost depreciation deductions in the future?
- ◆ Are there any state tax implications that should be considered?



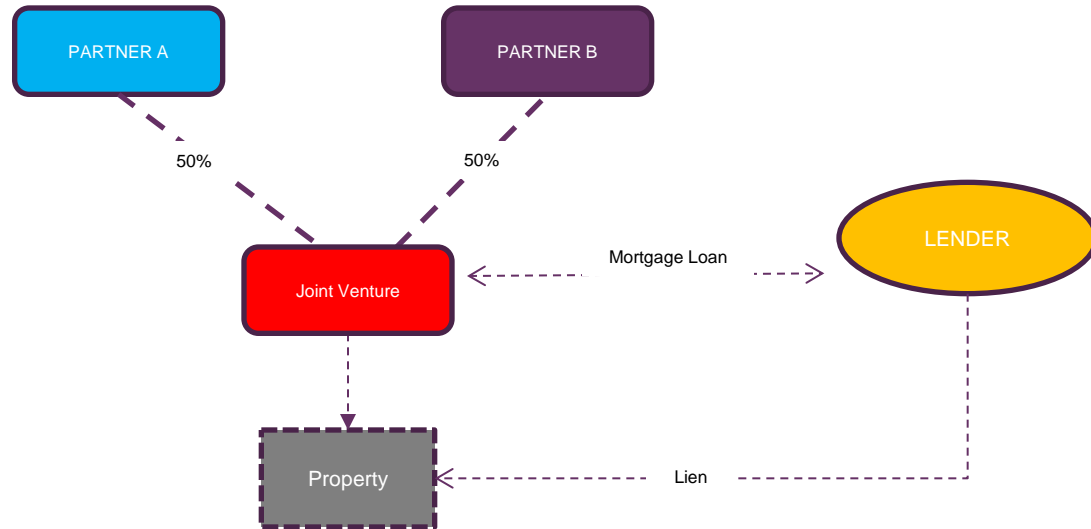
Managing Taxable Income Con't.

- ◆ Like Kind Exchange
 - ◆ Using an Exchange Accommodator Titleholder (EAT) to unencumber property
 - ◆ To defer 100% of gain on sale, replacement property must equal or exceed both the relinquished property FMV and taxpayer's net equity in the property
 - ◆ In some instances, an EAT can be used to purchase encumbered replacement property and facilitate a debt paydown or payoff prior to the taxpayer's purchase of the replacement property
 - ◆ Potentially useful in JV partner buyouts where there is property level debt (see following step charts S1 – S5 for example)



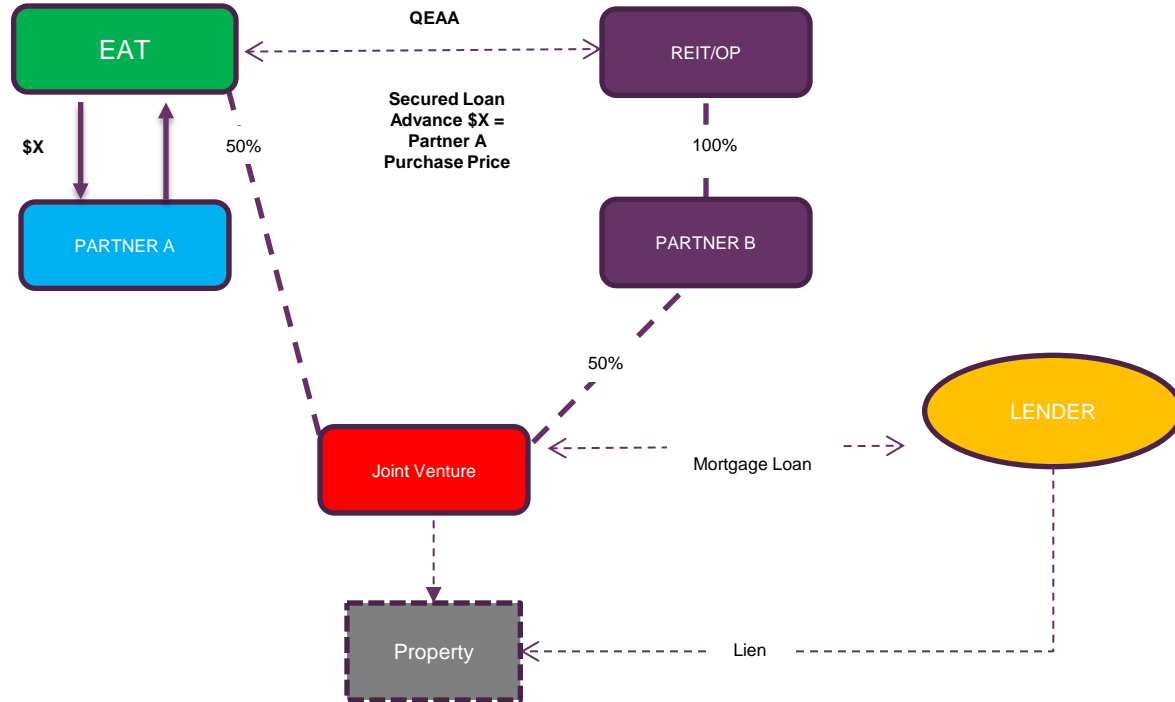
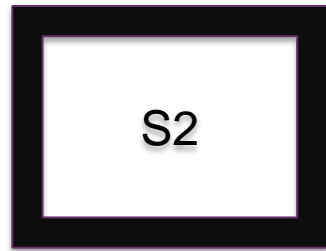
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S1
Current
Structure



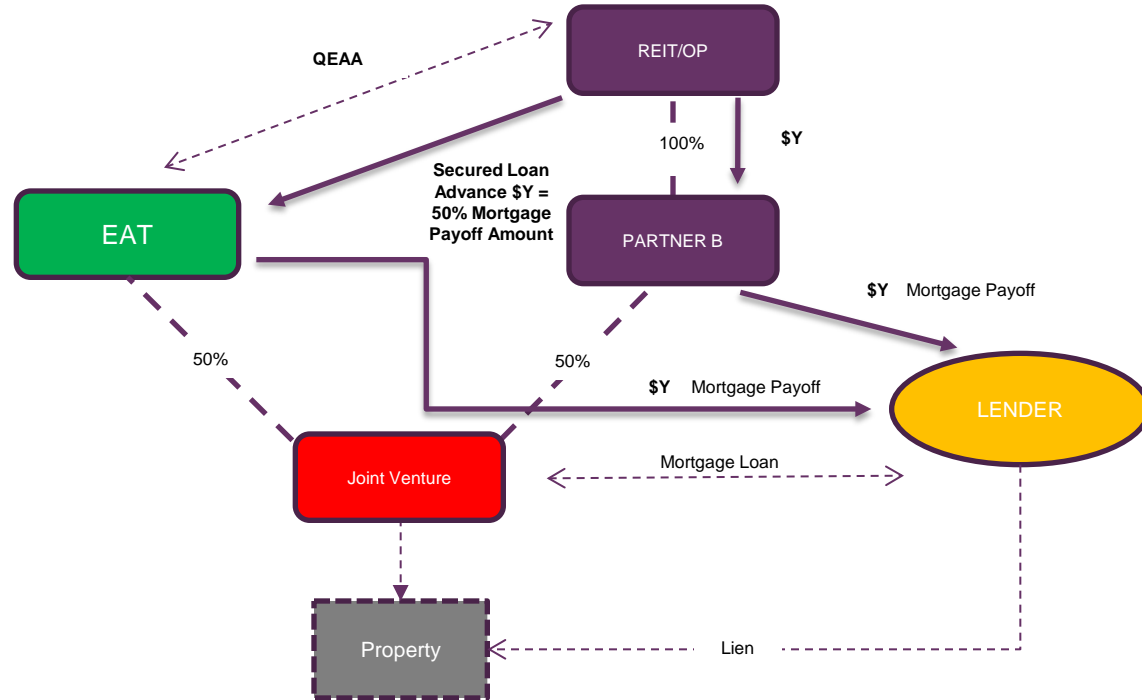


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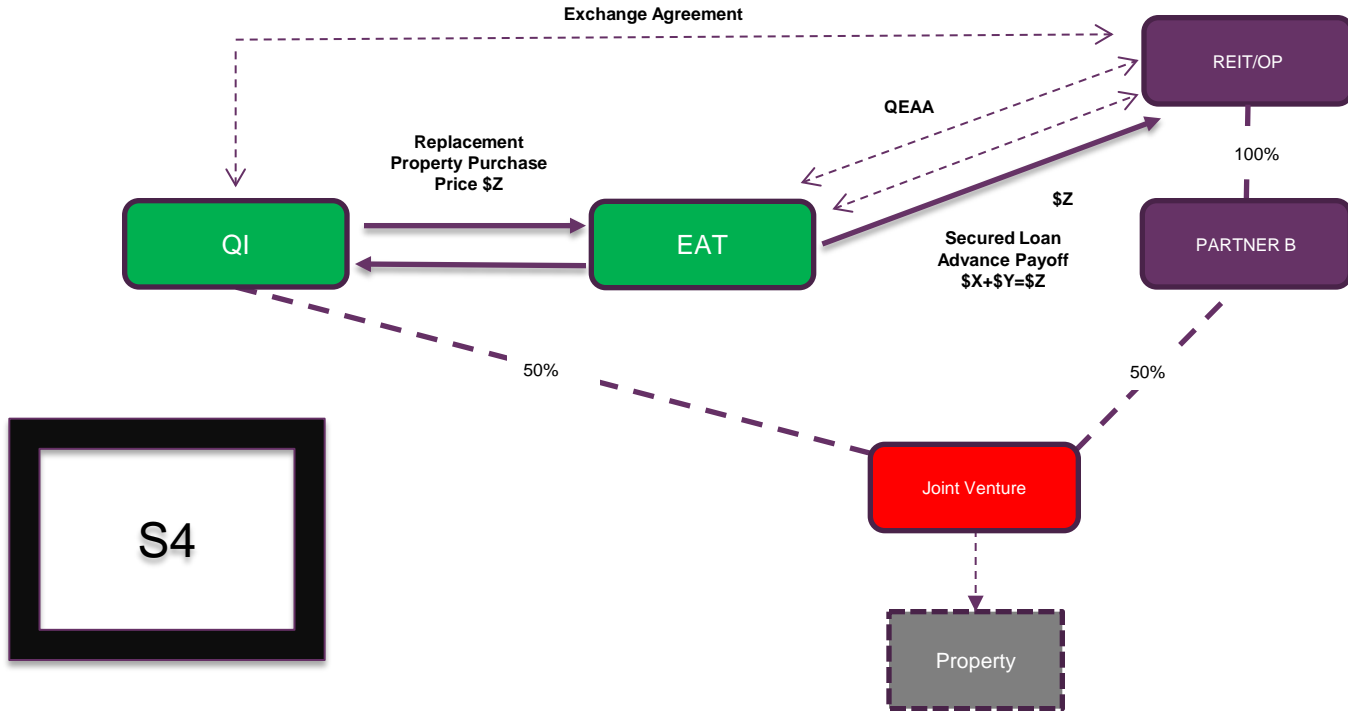
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S3



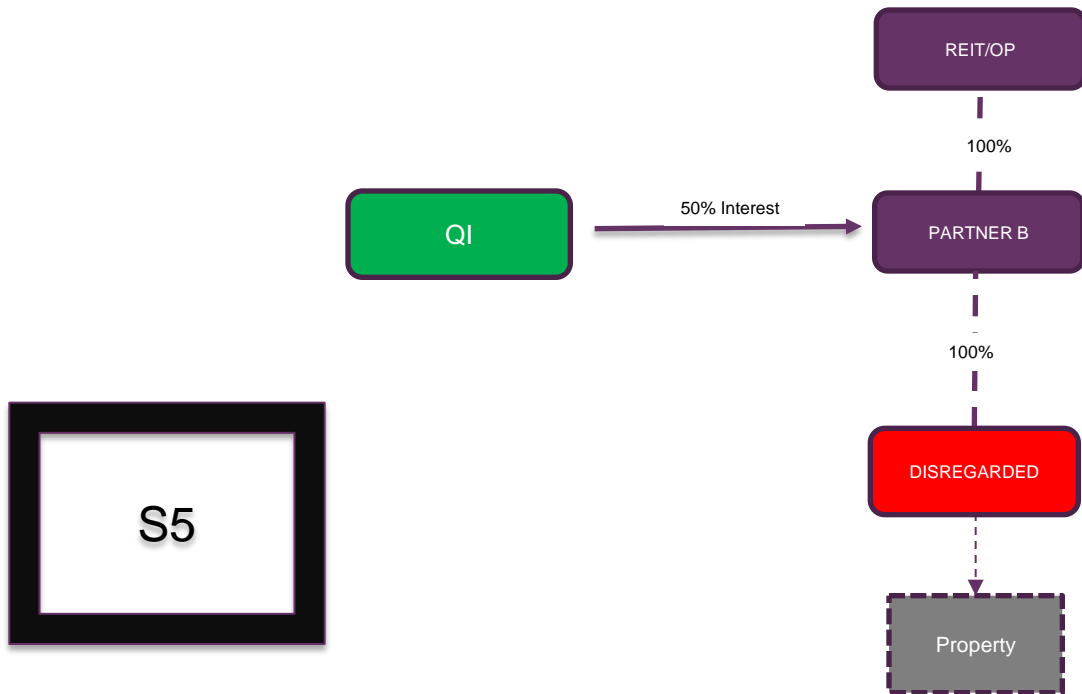


Managing Taxable Income Con't.





Managing Taxable Income Con't.





Managing Taxable Income Con't.

◆ Like Kind Exchange

◆ Option for Extending the 180 day window

- ◆ Lease structure in which properties are constructed and/or acquired pursuant to an operating lease and the assets are later acquired by the taxpayer from the lessor to use as replacement property
- ◆ Requires a financing partner willing to invest capital into the project and agreeable to lease terms conducive to facilitating a LKE
 - ◆ Interest only payments during construction period
 - ◆ Purchase option at cost
 - ◆ No obligation to purchase, can remain in lease
- ◆ Purchase Option allows taxpayer to time purchase to match LKE needs
- ◆ Can potentially extend parking period up to 2 years



Managing Taxable Income Con't.

- ◆ Making the Most of the Tangible Property Regulations
 - ◆ Tenant Allowance expensing - Regs 1.162-4(a); Automatic change #184; [Rev Proc 2015-13](#) Sec 5.01(1)
 - ◆ Disposition rules can impact deductibility - 1.263(a)-3(k)
 - ◆ Interplay with Section 110 – Regs 1.263(a)-3(f)(3)(i)
 - ◆ “2nd Generation” allowances – Regs 1.162-4, 1.263(a)-1(a)(1)
 - ◆ Consider the impact of previous method changes and IRS adjustments
 - ◆ Industry Issue Resolution for Retail and Restaurant taxpayers (Rev. Proc. 2015-56) provides a safe harbor for treating a portion of remodel/refresh costs as currently deductible



Managing Taxable Income Con't.

- ◆ Additional Tenant Allowance Opportunities
 - ◆ QLI Method Change – (from 39 to 15 year lives) - Automatic Change # 7 - Impermissible to permissible method - 1.446-1(e)(2)(ii)(d)(2)(i)
 - ◆ Lease Incentive Review – Automatic Change # 7 - Impermissible to permissible method - 1.446-1(e)(2)(ii)(d)(2)(i)
 - ◆ LHI Review for Personal property - take shorter lived depreciation based on property for QLI's at centers - (change from 39 to 7 or 5 year life) - Automatic Change #199; Regs - 1.167(a)-4(a)



Managing Taxable Income Con't.

- ◆ Making the Most of the Tangible Property Regulations
 - ◆ Election to follow GAAP and forego otherwise deductible repairs
 - ◆ Year by year analysis/election
 - ◆ Reg. Section 1.263(a)-3(n)
 - ◆ Made with timely filed tax return
 - ◆ Consider if made a previous method change to deduct repair and maintenance costs under Reg. Section 1.262-4.



Managing Taxable Income Con't.

◆ Sample Election

Section 1.263(a)-3(n) Election

For the Tax Year Ended: 12/31/20XX

[Taxpayer] is electing to capitalize repair and maintenance costs under § 1.263(a)-3(n) of the Final Repair Regulations (T.D. 9636) for the taxable year that began January 1, 20XX and ended December 31, 20XX.

[Taxpayer] is electing to treat any amounts paid for repairs and maintenance that are capitalized on the taxpayer's books and records as improvements to tangible property and began to depreciate the cost of such improvements when they were placed in service.



Managing Taxable Income Con't.

- ◆ Other Opportunities to Consider
 - ◆ Prepaid Payment Liability Acceleration
 - ◆ Automatic Change # 78
 - ◆ Reg. Section 1.263(a)-4(f), “12 month rule”
 - ◆ Insurance, software maintenance contracts, warranty contracts, annual dues
 - ◆ Year 1 481(a) adjustment and then favorable/unfavorable fluctuates depending on increasing/decreasing rates and periods to which payment relates



Managing Taxable Income Con't.

- ◆ Other Opportunities Continued
 - ◆ Timing of Incurring Real Property Taxes (and other taxes)
 - ◆ [Rev. Proc. 2015-14](#) Automatic Change # 43
 - ◆ Utilize the recurring item exception to accelerate property tax deductions under 461(h)(3) and Reg. Sec. 1.461-5(b)(1)
 - ◆ Change from deducting ratably over period to which tax relates, typically following GAAP, to deducting:
 - ◆ In the year that all events have occurred to establish the liability
 - ◆ The amount of the liability can be determined with reasonable accuracy
 - ◆ Economic Performance occurs on or before the earlier of the date the taxpayer files a timely return (including extensions), or September 15th
 - ◆ Great for companies with property in NY, CA, CT, MI, NH, MD... among others



Managing Taxable Income Con't.

◆ Other Opportunities Continued

◆ 467 Rental Agreements

- ◆ Automatic Change #136
- ◆ Possibility to defer prepaid rents pursuant to Reg. Sec. 1.467-1(d)(2)(iii)
- ◆ Check with your lease accounting team regarding the ability to run queries in your general ledger/lease accounting software
- ◆ Taxpayer only receives limited audit protection in the case of disqualified leasebacks and long-term agreements described in Reg. Sec. 1.467-(3)(b)
- ◆ See also [Rev. Proc. 2011-14](#), Section 20.01



The PATH Act Changes to E&P

- ◆ PATH Act changes to E&P rules for
 - ◆ REIT's DPD
 - ◆ Shareholders' treatment of distributions
 - ◆ Clarification of other provisions that reference E&P
- ◆ Capital loss carryover issues
- ◆ § 163(j)
- ◆ E&P after a preferential dividend



The PATH Act Changes to E&P

- ◆ Determination of E&P for purposes of determining the DPD largely the same
 - ◆ Under revised § 562(e)(1), E&P for any taxable year (but not accumulated E&P) is increased by the amount of gain on the sale of real property taken into account during the year (and not otherwise taken into account).
 - ◆ This is very similar to prior law, except that it does not require that the sale itself occur during the year, and so this would apply to installment sales.



The PATH Act Changes to E&P

- ◆ Determination of E&P for purposes of determining the DPD largely the same
 - ◆ In addition, § 857(d)(1)(A), which is the same as prior § 857(d)(1), is also applied.
 - ◆ Therefore, a REIT is entitled to receive a DPD for distributions corresponding to gains on the sale of real property and other income of the REIT, both as determined for income tax purposes, even though the gain as determined for E&P purposes would be lower or amounts not allowable for income tax purposes would otherwise have reduced E&P.



The PATH Act Changes to E&P and Capital Losses

- ◆ Determination of E&P for § 301 and 316 purposes—i.e., shareholder treatment of distributions as dividends or returns of capital
 - ◆ § 857(d)(1)(A) applies as just described, unless it is also the case that the amounts not allowable for income tax purposes in the current taxable year were allowable in a prior year, in which case § 857(d)(1)(B) cancels § 857(d)(1)(A).



The PATH Act Changes to E&P and Capital Losses

- ◆ Determination of E&P for § 301 and 316 purposes—i.e., shareholder treatment of distributions as dividends or returns of capital
 - ◆ To restate this in something that more closely resembles English, if there is a deduction for E&P purposes in the present year that does not correspond to a deduction for regular income tax purposes in the current year, but does correspond to a deduction for regular income tax purposes in a prior year, then the deduction reduces current year E&P.



The PATH Act Changes to E&P and Capital Losses

- ◆ Determination of E&P for § 301 and 316 purposes—i.e., shareholder treatment of distributions as dividends or returns of capital
 - ◆ The technical explanation to the PATH Act makes clear that new rules were intended to permit a REIT to get the DPD it needs to zero out taxable income, but without subjecting its shareholders to double taxation. Prior law permitted the REIT to get the DPD, but at the cost of the shareholders having to treat the additional E&P as increasing the amount of the dividend as well.



The PATH Act Changes to E&P and Capital Losses

- ◆ Determination of E&P for purposes of applying other REIT rules:
 - ◆ Section 857(b)(9)
 - ◆ Section 858
 - ◆ Section 565
 - ◆ Section 4981

- ◆ See A. Giannese and D. Lee, “PATH Act Updates Earnings and Profits Rules for REITs,” 41 Daily Tax Report J-1 (March 2, 2016).



The PATH Act Changes to E&P and Capital Losses

- ◆ Problem with items like capital losses or interest limited by § 163(j), where there is a full E&P reduction in the item occurs, but where the deduction is allowable (if at all) in a later year.
 - ◆ For the treatment of capital losses, see Rev. Rul. 76-299, 1976-2 CB 211.
 - ◆ In the year the item occurs, the REIT can get a DPD under § 562(e)(1) and 857(d)(1)(A) for its full taxable income, even though E&P would otherwise be reduced by the item. The shareholders, however, do not appear to get any benefit from § 857(d)(1)(B), since there was no deduction in an earlier year. Consequently, they are taxed on the full amount of the distribution as a dividend.



The PATH Act Changes to E&P and Capital Losses

- ◆ Problem with items like capital losses or interest limited by § 163(j), where there is a full E&P reduction in the year the item occurs, but where the deduction is allowable (if at all) in a later year.
- ◆ In the year when the deduction becomes available (e.g., there were capital losses in an earlier year, and they were carried forward to reduce capital gain in the current year), the deduction does not reduce current E&P. Consequently, if the REIT does not limit its distribution to its taxable income as determined by taking into account the now-available deduction, the shareholders will be taxable to the extent of the full current year E&P.



The PATH Act Changes to E&P and Capital Losses

- ◆ Problem with items like capital losses or interest limited by § 163(j), where there is a full E&P reduction in the item occurs, but where the deduction is allowable (if at all) in a later year.
 - ◆ The best fix would appear to require legislation to change § 857(d)(1)(B) so that it would apply whether the item was taken into account for income tax purposes in a prior year or could be taken into account in a later year. That way, the E&P for determining the DPD in the first year would be increased, but not the E&P for determining shareholder dividends.



The PATH Act Changes to E&P and Capital Losses

- ◆ Problem with items like capital losses or interest limited by § 163(j), where there is a full E&P reduction in the item occurs, but where the deduction is allowable (if at all) in a later year.
- ◆ Failing a legislative remedy, the existing regulations should be revised. At present, Treas. Reg. § 1.857-7(b) provides that if the REIT takes advantage of § 857(d)(1), and distributes the full amount of its taxable income, the accumulated E&P of the subsequent year will not reflect the reduction of E&P in the earlier year.



The PATH Act Changes to E&P and Capital Losses

- ◆ Problem with items like capital losses or interest limited by § 163(j), where there is a full E&P reduction in the item occurs, but where the deduction is allowable (if at all) in a later year.
- ◆ The mechanism for reaching this result is that the distribution corresponding to the excess of the actual distribution over the actual E&P (that is, without applying the § 857(d)(1) limitation) is treated as a return of paid-in capital. An odd result, both because paid-in capital is not a tax concept and because the shareholders are treated for tax purposes as getting a dividend, not a return of capital.



The PATH Act Changes to E&P and Capital Losses

- ◆ Problem with items like capital losses or interest limited by § 163(j), where there is a full E&P reduction in the item occurs, but where the deduction is allowable (if at all) in a later year.
- ◆ Even if the regulation were amended so that the earlier reduction in E&P reduced accumulated E&P, that would be only occasionally helpful, because dividend treatment is determined initially based upon current year E&P, which would not be affected.



Preferential Dividends

- ◆ Following a preferential dividend, does E&P remain so that it is possible for the REIT to get a DPD for a nonpreferential dividend (either during the same year, through a § 858 carryback, or through a § 860 deficiency dividend)?
 - ◆ In PLR 200729021 (See [NAREIT Compendium Memorandum 2007-24](#)), the Service ruled that a preferential dividend does not reduce E&P, on the rationale that under § 858(d)(1), deductions not allowable in computing a REIT's taxable income do not reduce current E&P. A good result, but this approach raises questions as to the proper treatment of the preferential dividend by the shareholders. The Service has indicated that they would not now issue a ruling to this effect.
 - ◆ In PLR 201503010 (See [NAREIT Tax Report 2015-2](#)) and PLR 201537020 (See [NAREIT Tax Report 2015-32](#)), the Service ruled that, in the case of a § 481(a) adjustment relating to depreciation, even if the § 481(a) exceeded the correlative E&P adjustment, there would be enough E&P for the REIT to get a DPD to offset the adjustment. The rationale, based on the legislative history of the TRA of 1986, was that Congress indicated its belief that this is how the REIT rules operate. Any such dividend would appear to be treated as a dividend both for DPD purposes and by the shareholders.