

Concurrent Session: REIT Tax Issues When You Arrive at Work

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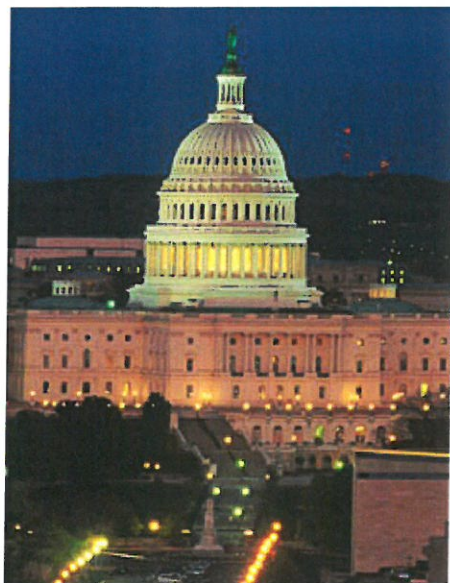
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Updated Earnings and Profits Rules for REITs

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.

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

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."

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").

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

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

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).

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.

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

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.

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

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."

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

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

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.

	<u>Year 30</u>	<u>Year 31</u>	<u>Year 32</u>
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.

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

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).

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.

Non-Customary Services Furnished By Taxable REIT Subsidiaries

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Non-Customary Services Furnished By Taxable REIT Subsidiaries

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In this report, the authors argue that real estate investment trust revenues from tenants for non-customary services provided by taxable REIT subsidiaries constitute rents from real property under section 856(d) regardless of whether the services are billed to tenants separately or as part of a bundled charge.

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I. Introduction

The typical real estate investment trust is a taxpayer, otherwise taxable as a regular C corpora-

tion, that continuously complies with numerous, stringent requirements under the code and Treasury regulations, such as the following:

- its share ownership must be sufficiently diversified such that the REIT is neither closely held nor 10 percent-or-more affiliated with its tenants;
- its assets must be principally real property or related to real property leasing, with the possibility of investing in the portfolio securities of other issuers being very limited;
- its gross income must be principally rental revenues and fees for related services, with the balance of any gross income being principally composed of passive investment income such as interest, dividends, and capital gains;
- its subsidiaries, assets, and operations must be properly divided among disregarded entities and partnerships on one hand, and section 856(l) taxable REIT subsidiaries (TRSs) on the other; and
- its distributions to shareholders must be meticulously in sync with its underlying organic documents, pro rata within each class of outstanding shares, and sufficiently large and timely to contemporaneously (or nearly contemporaneously) distribute to shareholders all of its taxable income and any accumulated earnings and profits inherited from regular C corporations.¹

¹See generally sections 561, 562, 565, 856-860, and 4981. Meeting these numerous, stringent standards requires a REIT to have the right ownership, assets, income streams, and distribution amounts, all accompanied by continuous monitoring. But even so, the financial and tax press contain some shrill voices opposed to the recent (and likely transitory) phenomenon of so-called REIT conversions, with "REIT nativist" commentators decrying any taxpayer or type of real estate being treated as REIT-compliant if it did not come over on the "REIT Mayflower," i.e., either by being a company originally set up as a REIT or investing in a property type held by REITs since 1960. See, e.g., Bradley T. Borden, "Rethinking the Tax-Revenue Effect of REIT Taxation," 17 Fla. T. Rev. 527, 530 (2015) ("The comparison of REIT spinoffs to [transactions that potentially harm the fisc] borders on misplaced hysteria."); Richard M. Nugent, "REIT Spinoffs: Passive REITs, Active Businesses," Tax Notes, Mar. 23, 2015, p. 1513, at p. 1514 ("Traditional REIT spinoffs are fairly well supported by current law and [the] common criticisms of these transactions generally miss the mark."); Nugent, "REIT Spinoffs: Passive REITs, Active Businesses, Part 2," Tax Notes, Mar. 30, 2015, p. 1635, at p. 1648 ("Some have suggested

(Footnote continued on next page.)

COMMENTARY / SPECIAL REPORT

In general, a REIT pays no regular corporate income tax because it receives a deduction for taxable income distributed to its shareholders;² however, REITs still pay entity-level income and excise taxes in several circumstances designed to protect the integrity of the corporate income tax base.³ More important, a REIT's distribution of its

restricting only the spinoff element of REIT spinoffs. It is unclear what purpose that ban would serve, because REIT spinoffs typically satisfy all the policy and technical requirements of section 355." More sober voices, including Treasury and the IRS, recognize that the standards for what constitute real estate have remained essentially unchanged over time, even though the particular types of real estate crucial to the national and global economy will (and should) evolve. For example, the preamble to the proposed REIT real property regulations, REG-150760-13, states that Treasury and the IRS "view these proposed regulations as a clarification of the existing definition of real property and not as a modification that will cause a significant reclassification of property." 79 F.R. 27508, 27510 (May 14, 2014). The preamble makes clear that the definition of real property was never as plain vanilla as the REIT nativists contend, citing published and private rulings dating back to 1969, which for all practical purposes is the dawn of the REIT statute:

The IRS issued revenue rulings between 1969 and 1975 addressing whether certain assets qualify as real property for purposes of section 856. Specifically, the published rulings describe assets such as railroad properties, mobile home units permanently installed in a planned community, air rights over real property, interests in mortgage loans secured by total energy systems, and mortgage loans secured by microwave transmission property, and the rulings address whether the assets qualify as either real property or interests in real property under section 856. Since these published rulings were issued, REITs have sought to invest in various types of assets that are not directly addressed by the regulations or the published rulings, and have asked for and received letter rulings from the IRS addressing certain of these assets.

Id. at 27508 (footnotes omitted).

Practitioners commended the proposed regulations for their conformity with existing precedent and their articulation of a workable legal standard. *See, e.g.,* comments by the National Association of Real Estate Investment Trusts (NAREIT) on proposed REIT regulations (Aug. 12, 2014); comments by Ameek Ashok Ponda on proposed REIT regulations (Aug. 11, 2014). Indeed, some 55 years ago, REITs may have owned factories to house manufacturing tenants, whereas today a REIT is more likely to own data centers that house technology tenants whose equipment form the backbone of Internet and cloud commerce. *Compare* H.R. Rep. No. 86-2020, at 4 (1960) (stating that REITs can alleviate shortages of private capital "for individual homes, apartment houses, office buildings, factories, and hotels") with prop. reg. section 1.856-10(g), Example 6 (concluding that a data center's core building systems are real property). For a discussion of some of the more esoteric aspects of REIT conversions, see Ponda, "How Much Gain Would a REIT Defer if a REIT Could Defer Gain?" *Tax Notes*, June 4, 2012, p. 1249.

²*See generally* sections 561, 562(a), 562(c), 562(e), 565, 857(b)(1)-(3), 857(b)(9), 858, and 860.

³*See generally* sections 55(a) (tax on alternative minimum tax items); 337(d)(1) and 1374 (tax on reorganization or liquidation of a C corporation cannot be circumvented through use of

(Footnote continued in next column.)

taxable income to shareholders will generally be treated as ordinary dividend income (or sometimes as capital gain dividend income)⁴ that is subject to far more fulsome taxation at the shareholder level than the dividends paid to shareholders by non-REITs.⁵

As demonstrated by the requirements above, a REIT's primary function under the code is to hold and lease real property for occupancy. As with all landlords, REITs must also provide a variety of related services to their tenants. The extent to which a REIT's revenues from those tenant services qualify for purposes of the 75 percent and 95

REITs); 856(c)(7) (tax on asset test failure remediation); 856(g)(5) (tax on miscellaneous remediation); 857(b)(1)-(3) (tax on income not distributed to shareholders); 857(b)(4) (tax on income from foreclosure property); 857(b)(5) (tax on income test failure remediation); 857(b)(6) (tax on prohibited transactions, such as dealer property gains); 857(b)(7) (tax on misallocations or mispricing involving a TRS); 860 (interest and additions to tax for deficiency dividends); and 4981 (excise tax on delayed distributions to shareholders). Also applicable are reg. sections 1.337(d)-7 (tax on recognized built-in gains inherited from C corporations) and 1.857-11 (interest charge on delayed distributions to shareholders). Further, a REIT's TRSs are regular C corporations under the code, subject to the same corporate income taxes on their income as all other C corporations. *See* sections 11, 163(j), 856(l), and 857(b)(7).

⁴*See* section 857(b)(3).

⁵For example, a REIT's dividend to its shareholders generally cannot qualify for the preferential tax rates on qualified dividend income for noncorporate taxpayers (sections 1(h)(11)(D)(iii) and 857(c)(2)); cannot qualify for the dividends received deduction for corporate taxpayers (sections 243(d)(3) and 857(c)(1)); can be subject to tax as unrelated business taxable income (section 856(h)(3)(C)); can be subject to tax as income effectively connected with a U.S. trade or business (sections 897(h) and 1445(e)(6)-(7); reg. section 1.1445-8; Ponda, "Foreign Pension Plans Investing in Shares of a U.S. REIT," *Tax Notes*, Mar. 24, 1997, p. 1593); and can qualify only under restricted circumstances for the otherwise generally applicable treaty-based reductions in U.S. withholding and income taxes on dividends paid to non-U.S. shareholders (Ponda, *id.*; 2006 U.S. model income tax treaty (Nov. 15, 2006), art. 10, para. 4, at 16-17). *See also* Borden, *supra* note 1, at 579-589 (concerns that REIT conversions damage the fisc are grossly exaggerated, given that over a variety of realistic assumptions regarding shareholder composition and corporate payout ratios, the erosion in the corporate income tax base is generally offset by the higher tax rates (and higher taxes) on the REIT's dividends to its shareholders; thus, REIT conversions generally have only a modest, insignificant net effect on total revenues of the fisc and in some cases may even have a positive impact on those revenues). Moreover, a REIT cannot pass foreign tax credits and similar tax attributes through to its shareholders (unlike a partnership or limited liability company taxed under subchapter K), meaning that the REIT structure can result in those tax attributes being lost forever (section 702; Ponda, "REITs Abroad," in Practising Law Institute's *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings* (2006-2008), para. I(F); cf. section 853 (regulated investment company passthrough of FTCs, but no analogous provision for REITs in sections 856-860)).

percent REIT gross income qualification tests of section 856(c)(2) and (3)⁶ has been revisited many times since REITs were introduced in 1960, with each visit by Congress producing more expansive qualification. As discussed below, two intertwined and critical inquiries have generally been at the crux of each iteration of congressional expansion: (1) Is the service customarily provided by similarly situated landlords to similarly situated tenants, and (2) who is the service provider?

The advent of affiliated TRSs as providers of non-customary services to REIT tenants introduced a novel structural paradigm for addressing those critical inquiries. It was also a watershed moment in the effectiveness of the REIT statute⁷ and the full realization of the REIT model of real estate ownership and operation.⁸ By approaching both critical inquiries in a new way, the TRS structure created the foundation for asking and resolving a third critical question that did not arise under prior law: For purposes of the 75 percent and 95 percent REIT gross income qualification tests, how should a REIT's gross income from tenants for non-customary services supplied through TRSs be treated?

⁶See *supra* text accompanying note 1, and in particular the third bullet point there. The 75 percent REIT gross income qualification test of section 856(c)(3) mandates that 75 percent of the REIT's gross income consist of rental revenues and fees for related services (as well as a few other elements of income consistent with that classification), and the 95 percent REIT gross income qualification test of section 856(c)(2) mandates that 95 percent of the REIT's gross income consist of income qualifying under the 75 percent REIT gross income test plus passive investment income such as interest, dividends, and capital gains.

⁷See NAREIT, "REIT Industry Timeline: Celebrating 50 Years of REITs and NAREIT," available at <http://www.reit.com/timeline/timeline.php>.

⁸The REIT model of real estate ownership and operation has many advantages, including providing access to the real estate market for smaller investors, providing investor liquidity, reducing leverage, and generating investor income. As 2013 economics Nobel Prize winner Robert Shiller of Yale University said:

REITs were created by law in 1960 to democratize the real estate market and make it possible for a broad base of investors to participate in this huge asset class. That was absolutely the right thing to do, because portfolio theory tells us people should diversify across major asset classes, and real estate is one of them.

NAREIT, "The REIT Story," available at <https://www.reit.com/sites/default/files/media/PDFs/The-Reit-Story.pdf>. Another prominent real estate economist, Timothy Riddiough of the University of Wisconsin, found that a "well-structured real estate securitization market," to which REITs contribute, moderates "construction boom and bust tendencies" and thus generates "positive spillover benefits to the economy at large." *Id.*

Although this question was both posed and resolved favorably by Rev. Rul. 2002-38,⁹ which concluded that the gross income constitutes section 856(d) rents from real property,¹⁰ the ruling's analysis and conclusions are extremely subtle and become clear only after examining the evolution of the REIT statute. To illuminate the full application of Rev. Rul. 2002-38, this report explains and analyzes the treatment of REIT revenues from tenants for services provided to those tenants by a REIT's TRS (1) in cases in which those revenues do not represent section 856(d)(1)(B) charges for services customarily furnished or rendered in connection with the rental of real property¹¹ and (2) regardless of whether the services are billed to tenants separately or as part of a bundled charge.¹² For purposes of

⁹2002-2 C.B. 4.

¹⁰Section 856(d) rents from real property satisfy both the 95 percent REIT gross income qualification test and the 75 percent REIT gross income qualification test. See section 856(c)(2)(C) and (c)(3)(A).

¹¹Section 856(d)(1)(B). See also reg. section 1.856-4(b)(1), which states:

The term "rents from real property", for purposes of paragraphs (2) and (3) of section 856(c), includes charges for services customarily furnished or rendered in connection with the rental of real property, whether or not the charges are separately stated. Services furnished to the tenants of a particular building will be considered as customary if, in the geographic market in which the building is located, tenants in buildings which are of a similar class (such as luxury apartment buildings) are customarily provided with the service. . . . To qualify as a service customarily furnished, the service must be furnished or rendered to the tenants of the [REIT] or, primarily for the convenience or benefit of the tenant, to the guests, customers, or subtenants of the tenant.

In this report, we refer to the standard created by Congress in section 856(d)(1)(B), as implemented by reg. section 1.856-4(b)(1), as the "section 856(d)(1)(B) standard." The section 856(d)(1)(B) standard and its use of the term "customary" is not coterminous with the use of "customary" under reg. section 1.512(b)-1(c)(5) (described *infra* in notes 47-51 and their accompanying text), in which the term has been interpreted in a slightly more limited fashion. See *infra* notes 49, 51, and 57. For purposes of this report, the section 856(d)(1)(B) standard will be used throughout, unless the discussion or context specifically references section 512(b)(3) and reg. section 1.512(b)-1(c)(5) (referred to in this report as the "section 512(b)(3) standard").

¹²The IRS recently opened a regulations project regarding "clarifying the definition of income in section 856(c)(3) for purposes of the [REIT] qualification tests." Treasury, "2014-2015 Priority Guidance Plan," at 12, item 11 (Aug. 26, 2014). During a NAREIT conference on March 31, 2015, a branch chief noted that the IRS was "looking at all of the different aspects of REIT income testing. There's a lot in there. It's a lot more complex than what is real property." Amy S. Elliott, "REIT Industry Stressed Over Preferential Dividend Ruling," *Tax Notes*, Apr. 6, 2015, p. 58. This report illustrates that complexity and provides an analysis consistent with the code and prior guidance. We recommend that the conclusions of Rev. Rul. 2002-38, as articulated and explicated in this report, be preserved in any future regulations that touch on the topic.

this report, the term “subject revenues” refers to a REIT’s section 61 gross income from all revenues for TRS-provided non-customary services, whether the associated charges to tenants are itemized separately or part of an overall bundled charge to tenants.¹³

II. The REIT World Before TRSs

A. The 1960 Standard

When REITs were created in 1960, Congress excluded from the definition of rents from real property amounts when the REIT directly furnished or rendered services to the tenants or managed the property.¹⁴ Thus, initially, Congress did not want REITs to provide services to their tenants directly. Instead, as a practical matter, the statute permitted a REIT to provide those services only through an independent contractor.¹⁵

To implement the law, regulations first proposed in 1961 stated that all REIT income attributable to tenant services (and, through guilt by association, apparently all income from a property where the REIT performed tenant services) did not constitute rents from real property. Accordingly, a REIT could not perform those services without running afoul of the REIT gross income tests, and any fees for those services had to be included in the income of an independent contractor rather than the REIT.¹⁶

¹³As Rev. Rul. 2002-38 makes abundantly clear, in a typical commercial setting, the REIT itself bills and collects for subject revenues, and accordingly the REIT itself has section 61 gross income for those amounts, which is the starting point for REIT 75 percent and 95 percent gross income testing under section 856(c)(2) and -(3), according to reg. section 1.856-2(c)(1).

¹⁴H. Rep. No. 86-2020 (June 28, 1960). See former section 856(d)(3) (1960).

¹⁵*Id.*

¹⁶Prop. reg. section 1.856-4(b)(3)(i) (Jan. 19, 1961). To be precise, this proposed regulation provided that “certain amounts, although received or accrued for the use of, or the right to use, real property of the [REIT], will not be includible as ‘rents for real property’ for the purposes of the gross income requirements,” including:

any amount received or accrued, directly or indirectly, with respect to any real property if the [REIT] furnishes or renders services to the tenants of such property, or manages or operates such property, other than through an independent contractor from whom the [REIT] itself does not derive or receive any income. . . . If any services are performed for tenants, such services must be performed by, and the charges therefor (whether such charges are separately stated or included in the amount paid as rent) must be included in the income of, an independent contractor. . . . Thus, the [REIT] must not receive any income which is attributable to the services performed for the tenants of the [REIT] by an independent contractor.

Thus, the amount that the REIT landlord would have to pay the independent contractor would have to at least equal the amount that the REIT received from the tenants for the services

(Footnote continued in next column.)

However, the final regulations issued in 1962, T.D. 6598,¹⁷ “extensively revised the proposed regulations on the issue of ‘independent contractor’” and introduced the concept of “customarily provided services” to the REIT lexicon.¹⁸ They retained the proposed regulations’ requirement that all services provided by a REIT landlord to its tenants be provided through an independent contractor, but they created two separate regimes for those services: one for services for which no separate charge was made (limited to customarily provided services)¹⁹ and one for all services for which a separate charge was made (including customarily provided services with a separate charge *and* all non-customarily provided services).²⁰ The combination of the 1960 code and the 1962 final regulations is referred to in this report as “the 1960 standard.”

The 1960 standard made a slight bow to commercial reality by treating the full amount received by a REIT landlord from its tenant as rents from real property in the case of customary services for which no separate charge was made.²¹ However, a REIT was still required to furnish those services through an independent contractor, and the facilities through an which those services were furnished were required to be maintained and operated by an independent contractor²² that had to be “adequately compensated” by the REIT.²³ Meanwhile,

(or the amount it was deemed to receive, in the case of bundled service charges). Apparently, if the REIT retained even a penny of services income, the entire amount of rent that it received (including for basic occupancy) would fail to qualify as rents from real property. However, then as now, normal commercial practice required landlords to provide services to tenants. See *infra* text accompanying note 28. As a result, a contemporary commentator noted that “more time was devoted to the concept of ‘independent contractor’ at the hearings [on] the [proposed] regulations than to all the other problems combined.” Theodore Lynn, “Real Estate Investment Trusts: Problems and Prospects,” 31 *Fordham L. Rev.* 73, 90 (1962).

¹⁷27 F.R. 4089 (Apr. 28, 1962).

¹⁸Lynn, *supra* note 16, at 91.

¹⁹Former reg. section 1.856-4(b)(3)(i)(b) (1962). New subdivision (b) was titled “Customary Services for Which No Separate Charge Is Made.”

²⁰Former reg. section 1.856-4(b)(3)(i)(c) (1962). New subdivision (c) was titled “Services for Which a Separate Charge Is Made.”

²¹Former reg. section 1.856-4(b)(3)(i)(b) (1962). This result was achieved by stating in new subdivision (b) (but not in (c)) that:

for purposes of [the REIT provisions], an amount will not be disqualified as “rent” if services, such as are usually or customarily furnished or rendered in connection with the mere rental of real property, are furnished or rendered to tenants of the property through an independent contractor.

²²*Id.*

²³Former reg. section 1.856-4(b)(3)(i)(d) (1962). The term “adequately compensated” was given a lengthy definition that

(Footnote continued on next page.)

services for which a separate charge was made, regardless of whether the services were customary or non-customary, required the independent contractor to bear the cost of the services and to receive and retain the entire amount of the separate charge.²⁴ The 1962 final regulations enumerated services that may be customary and services that were usually non-customary,²⁵ although it provided no means of discerning if or when the services were to be considered customary.

Although the 1962 final regulations were a substantial improvement over the 1961 proposed regulations, the 1960 standard's shortcomings remained obvious to many. As a former commissioner of internal revenue noted at the time regarding the new regime, "Favorable tax treatment does not assure favorable investment."²⁶ He believed that the most difficult aspect of the 1960 standard was the relationship between the REIT and the independent contractor.²⁷ Another commentator of the time expressed the problem succinctly:

The emphasis on the distinction between active and passive income probably devolved from the fact that mutual funds have only passive income; yet the ownership of securities differs substantially from that of real estate. Ownership of real estate today is hopelessly encumbered with management functions, as well as the duty to provide certain incidental services, and these management functions and services result in income, "active" income no less. Needless to say, it is often "good management" and the incidental services which make one multiple-occupancy building more desirable (and hence more valuable) than another.²⁸

can be summarized as a requirement that the independent contractor receive fair market value for its services.

²⁴Former reg. section 1.856-4(b)(3)(i)(c) (1962). This requirement was broken into two parts. For non-customary services:

The cost of such services must be borne by the independent contractor, a separate charge must be made therefor, and the amount thereof must be received and retained by the independent contractor; no amount attributable to such services shall be included in the gross income of the [REIT].

And for customary services:

If a separate charge is made for the customary services described in (b) of this subdivision, such charge must be made, and the amount thereof must be received and retained, by the independent contractor rather than by the [REIT].

²⁵See former reg. section 1.856-4(b)(3)(i)(b)-(c) (1962).

²⁶Mortimer Caplin, "Foreword," 48 *Va. L. Rev.* 1007, 1009 (1962).

²⁷*Id.*

²⁸J.B. Riggs Parker, "REIT Trustees and the 'Independent Contractor,'" 48 *Va. L. Rev.* 1048, 1051 (1962). This commentator

(Footnote continued in next column.)

A third commentator noted that the "independent contractor concept, so vague in theory, may become chaos in practice."²⁹ Congress kept revisiting tenant services and the independent contractor/REIT relationship over the next 40 years to bring order to the chaos.

B. The 1976 Revisions

The weaknesses of the 1960 standard, including the differentiated treatment between customary services bundled in the rental charge versus customary services for which a separate charge was made, did not permit the REIT format to be a useful vehicle for real estate ownership and investment, defeating the very purpose of the statute.³⁰ In 1976 Congress made a first attempt to address those weaknesses. The Tax Reform Act of 1976 (P.L. 94-455) provided that rents from real property included "charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated."³¹ It also set standards regarding when services provided by a landlord to a tenant should be considered customary.³² In explaining those changes, the Senate report stated:

Under present law, amounts received by a REIT for services rendered to tenants, where no separate charge is made, will qualify for the

also examined the 1960 standard and found it wanting because the REIT itself was merely an aggregation of individual properties requiring the management and services that the 1960 standard forbade the REIT from supplying directly:

The apparent conclusion is that only a true *uncontrolled, unsupervised* "agency law" type of independent contractor will qualify under the REIT tax provisions. . . . The REIT trustees are, in effect, *required by the Code* to delegate to a real estate management company the duty of managing individual properties and providing services to the tenants of such properties if such services are necessary or desirable and proper, and to *relinquish control* over the real estate management company in the performance of those management functions. . . . [The regulation] seems to assume that the distinction between the REIT trustee's fiduciary duty to manage the "trust itself" and managing or "operating the property" of the trust is obvious. Such an assumption appears to be at least an oversimplification. What is the "trust itself" other than an agglomeration of properties which must be individually managed? [Emphasis in original.]

Id. at 1053-1054.

²⁹Lynn, *supra* note 16, at 92.

³⁰A Goldman Sachs report from 1996 stated that only 10 REITs of any real size existed during the 1960s but that those REITs had "miniscule" portfolios of real property when compared with other property owners. See Ralph L. Block, *Investing in REITs: Real Estate Investment Trusts* 110-111 (2006) (quoting the report's finding that REIT industry-wide real estate investments in the 1960s amounted to slightly more than \$200 million).

³¹Section 856(d)(1)(B), which is still in effect today.

³²See *supra* text accompanying note 25.

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75-percent and 95-percent source tests if the services are customary and are furnished by an independent contractor. However, if a separate charge is made for customary services furnished by an independent contractor, the income tax regulations take the position that the amount of the charge must be received and retained by the independent contractor and not by the REIT. This restriction on separate charges for customarily furnished services does not follow normal commercial practice. Consequently, the committee amendment and House bill provide that amounts received by a REIT as charges for services customarily furnished or rendered in connection with the rental of real property will be treated as rents from real property whether or not the charges are separately stated.³³

At the same time, TRA 1976 created a standard for determining the circumstances under which services should be considered customary for section 856(d) purposes:

The committee intends that, with respect to any particular building, services provided to tenants should be regarded as customary if, in the geographic market within which the building is located, tenants in buildings which are of a similar class (for example, luxury apartment buildings) are customarily provided with the service.³⁴

³³S. Rep. No. 94-938, at 473-474 (June 10, 1976).

³⁴*Id.* As part of its customary services analysis in TRA 1976, the legislative history also stated that the submetering of electricity (and, by extension, other utilities) by a REIT landlord should be considered a customary service. For the long-standing definition of submetering, see Morway Pickett, "The Legal Status of the Submeterer of Electric Current," 37 *Col. L. Rev.* 227 (1937) ("Submetering is the term applied to the remetering and resale of public utility services, purchased by the building owners through a master meter at wholesale rate, to their tenants at retail rates."). Before TRA 1976 it was unclear how submetering should be treated by a REIT landlord. It was clear that the provision of utilities by a landlord was a customary service for a tax-exempt landlord under the section 512(b)(3) standard. See, e.g., Rev. Rul. 69-178, 1969-1 C.B. 158 (the rental of a meeting hall where only usual and customary services — but including all utilities — were provided by the landlord-generated rents from real property for a tax-exempt entity). But in the 1960 standard, submetering was listed under "services for which a separate charge is made," a provision that included both separately charged customary services and all non-customary services. See former reg. section 1.856-4(b)(3)(i)(c) (1962). In Rev. Rul. 75-340, 1975-2 C.B. 270, the IRS implied that submetering was a non-customary service, differentiating between the situation where "a separate charge is made for a usual or customary service" and the situation "where electric current is purchased by the [REIT] and then sold to tenants at a price in excess of the purchase price (for example, submetered)." After TRA 1976, however, the IRS abandoned this implied nuance.

Thus, TRA 1976 followed normal commercial practice and overturned the artificial differentiation in the 1960 standard between bundled customary services and separately stated customary services. Accordingly, after TRA 1976 all amounts received by a REIT for customary services constituted rents from real property under section 856(d)(1)(B), regardless of whether a separate charge or an allocation was made. However, the prohibition on a REIT providing services directly instead of through an independent contractor remained in the code.³⁵

In response to TRA 1976, the IRS revised the regulations governing section 856(d) rents from real property.³⁶ In the revised regulations, all services (whether customary or non-customary) still had to be provided through an independent contractor,³⁷ but a REIT could now treat any amounts received from tenants from the provision of customary services as rents from real property (whether those services were bundled with the rent or separately stated).³⁸ A new regulation addressing the treatment of independent contractors was put in place to address the rendering of non-customary services, which was substantially similar to the provision in the 1960 standard.³⁹ Under this new regulation, the only way a REIT landlord could deliver non-customary services to its tenants was to meet each of the following six requirements of the code and Treasury regulations:

³⁵See former section 856(d)(2)(C) (1976):

For purposes of paragraphs (2) and (3) of subsection (c), the term "rents from real property" does not include . . . any amount received or accrued, directly or indirectly, with respect to any real or personal property if the [REIT] furnishes or renders services to the tenants of such property, or manages or operates such property, other than through an independent contractor from whom the [REIT] itself does not derive or receive any income.

Even with TRA 1976's improvements to the REIT structure, the public equity market capitalization of the REIT industry was smaller at the end of 1979 than it had been at the end of 1972. See Block, *supra* note 30, at 113.

³⁶The IRS proposed new regulations on July 7, 1978, and finalized them with only minor, inconsequential changes in T.D. 7767, 46 F.R. 11282 (Feb. 6, 1981). In a key revision, the TRA 1976 standard adopted by Congress for determining which services should be considered customary (see *supra* text accompanying note 34) replaced the enumerated lists of customary and non-customary services in the 1960 standard. The version of reg. section 1.856-4(b)(1) that was adopted as part of T.D. 7767 is still in effect today.

³⁷See, e.g., reg. section 1.856-4(b)(1): "The service must be furnished through an independent contractor from which the [REIT] does not derive or receive any income."

³⁸*Id.* See *supra* text accompanying note 31.

³⁹See *infra* note 42.

- the REIT and the independent contractor had to be less than 35 percent affiliated;⁴⁰
- the REIT could not earn interest, dividend, rental, or other income from the independent contractor;⁴¹
- the charges for the services had to be separately stated;
- the service revenues had to be collected by the independent contractor;
- the service revenues had to be retained by the independent contractor; and
- the independent contractor had to be adequately compensated.⁴²

These six independent contractor rules were split in applicability: the first two applied to all services provided by independent contractors, whereas the last four applied only to the provision of non-customary services by the independent contractor. Yet, even after all the useful changes made by TRA 1976, there was still the fundamental problem of the 1960 structure for both customary and non-customary services: a REIT was required to “relinquish control” over the services to an “uncontrolled, unsupervised” agent.⁴³

C. The 1986 Revisions

Congress returned to the REIT provisions a decade later, in the Tax Reform Act of 1986 (P.L. 99-514). Again, a main focus was the REIT’s inability to control the services provided to tenants. TRA 1986 was the first legislation to provide that a REIT could actively provide services to tenants without using an independent contractor. As the 1986 blue book put it:

The Congress believed that [the] requirements of present law, that are intended to assure that the REIT is more a passive entity than one engaged in an active trade or business, may be overly restrictive and should be liberalized consistent with maintaining the essential pas-

sivity of the REIT. Congress believed that REITs should be permitted to perform certain services in connection with the rental of real property without being required to use an independent contractor (to assure that rents from such property are considered to qualify as “rent from real property”). The Congress believed that the same standard should be applied to REITs for the purpose of determining whether amounts being received are from the passive rental of real property or from an active trade or business, that is applied to tax-exempt entities in determining whether amounts are treated as income from an “unrelated trade or business.”⁴⁴

This liberalization was implemented by TRA 1986, which added a new exception to former section 856(d)(2)⁴⁵ to treat as qualifying rents from real property “any amount if such amount would be excluded from unrelated business taxable income under section 512(b)(3) if received by an organization described in section 511(a)(2).”⁴⁶ The new exception explicitly made reg. section 1.512(b)-1(c)(5) and the section 512(b)(3) a standard part of the REIT rules.⁴⁷ Accordingly, the test used by the IRS exempt organizations group to determine

⁴⁴Joint Committee on Taxation, “General Explanation of the Tax Reform Act of 1986,” at 391 (1986 blue book).

⁴⁵See *supra* note 35.

⁴⁶Former section 856(d)(2) (last sentence) (1986), reformulated in 1997 as section 856(d)(7)(C)(ii), which is still in effect today. As Rev. Rul. 98-60, 1998-2 C.B. 751, makes clear, section 856(d)(7)(C)(ii) and its incorporated section 512(b)(3) standard are not concerned with a too-literal application of the statutory “would be [as] if” wording, but instead create an outright exemption for any property-related services that a tax-exempt organization may perform without being in receipt of unrelated business taxable income.

⁴⁷When Congress originally created the rules governing UBTI for some nonprofits, it left to the regulations most of the tough choices regarding real estate rental and services income. See, e.g., S. Rep. No. 81-2375 (1950) (noting that some types of investment income “have long been recognized as a proper source of revenue for educational and charitable organizations and trusts”). Reg. section 1.512(b)-1(c)(2), included in T.D. 6301, 23 F.R. 5192 (July 9, 1958), provided the first real guidance for those nonprofits regarding the treatment of investment income from rental real estate and services — and, with the exception of a few minor, insignificant changes (including the substitution of the term “rents from real property” for the term “rentals from real estate” and its later renumbering as reg. section 1.512(b)-1(c)(5)), this same regulation has provided the standard for nonprofits to use in differentiating UBTI from nontaxable rents from real property for more than 55 years. A variant of the section 512(b)(3) standard is also used in other areas of the code and regulations. See, e.g., the self-employment regulations, reg. section 1.1402(a)-4(c)(1)-(2) (titled, respectively, “No services rendered for occupants” and “Services rendered for occupants”).

⁴⁰See section 856(d)(3).

⁴¹See *infra* note 42. See also section 856(d)(7)(C)(i).

⁴²See reg. section 1.856-4(b)(5)(i):

No amount . . . qualifies as “rents from real property” if the [REIT] furnishes or renders services to the tenants of the property . . . other than through an independent contractor from whom the [REIT] itself does not derive or receive any income. . . . To the extent that services (other than those customarily furnished or rendered in connection with the rental of real property) are rendered to the tenants of the property by the independent contractor, the cost of the services must be borne by the independent contractor, a separate charge must be made for the services, the amount of the separate charge must be received and retained by the independent contractor, and the independent contractor must be adequately compensated for the services.

⁴³See *supra* note 28.

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whether services performed for a tenant of a non-profit organization give rise to rents from real property under the section 512(b)(3) standard became the standard for services that a REIT could perform directly for its tenants without needing to use an independent contractor. The plain, unambiguous language⁴⁸ of reg. section 1.512(b)-1(c)(5) sets out a two-prong test⁴⁹:

For purposes of this paragraph, payments for the use or occupancy of rooms and other space where services are also rendered to the occupant [do] not constitute rent from real property. Generally, services are considered rendered to the occupant *if* they are provided primarily for his convenience *and* are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.⁵⁰ [Emphasis added.]

⁴⁸As the Supreme Court has repeatedly confirmed, the “plain meaning rule” of statutory construction means that the plain meaning of a statute or regulation “must prevail.” *Atlantic Mutual Insurance v. Commissioner*, 523 U.S. 382, 387 (1998). See, e.g., *Gitlitz v. Commissioner*, 531 U.S. 206, 219-220 (2001) (holding that the plain meaning of the code permitted S corporation shareholders to deduct previously suspended losses).

⁴⁹Both the IRS and the courts have interpreted reg. section 1.512(b)-1(c)(5) as containing a two-prong test. See, e.g., Internal Revenue Manual section 7.27.6.7.4.5, “Rendering of Personal Services,” which, similar to, and using wording almost identical to, reg. section 1.512(b)-1(c)(5), shows two prongs as separate requirements introduced by an “if” and connected by the conjunction “and”:

1. Payment for the use or occupancy of rooms or other space where services are also rendered to the occupant does not constitute rent from real property. . . .

2. Generally, services are considered rendered to the occupant *if* they are primarily for his/her convenience *and* are different from those usually or customarily rendered in connection with the rental of rooms or space for occupancy only. [Emphasis added.]

See also *Ocean Pines Association, Inc. v. Commissioner*, 135 T.C. 276, 287 (2010):

But the test in the regulation for determining whether the services are rendered to the occupant (and therefore disqualify the organization from using the rental exception) is not whether the services provided are substantial, but whether the services are (1) “primarily” for the “convenience” of the occupant and (2) are “other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.”

IRS private letter rulings have also noted the two-prong test. See, e.g., LTR 200241050 (requested ruling 7) (“Even if the Service determines that the marketing and promotional activities related to the Property fail to meet the *two-prong test* of section 1.512(b)-1(c)(5) of the Income Tax Regulations” (emphasis added)).

⁵⁰The regulations do not explain further what is meant by “provided primarily for [the tenant’s] convenience.” On closer inspection, some services that might seem oriented to tenant convenience are in fact more closely related to property-wide safety and security. See, e.g., LTR 9014022, in which an apartment REIT:

(Footnote continued in next column.)

Accordingly, clearing either prong of the above test would mean that the particular service is not considered rendered to the occupant, and the associated payments would therefore not be disqualified from section 512(b)(3) rents from real property.

Thus, by incorporating the section 512(b)(3) standard, TRA 1986 permitted REITs (for the first time) to directly render customary services to tenants without using an independent contractor and to include the amounts received for those services in section 856(d) rents from real property. If the section 512(b)(3) standard (and thus, as a practical matter, also the section 856(d)(1)(B) standard)⁵¹ were satisfied, *all* revenues from the provision of those services qualified as rents from real property, regardless of whether they were bundled or separately stated under section 856(d)(1)(B) and regardless of whether they were provided at cost or at a markup over cost.⁵²

For example, the archetypal service performed by a landlord, and explicitly noted as a customary service in the 1960 standard, is the provision of

will continue a longstanding practice of changing light bulbs in certain built-in light fixtures located in particular apartments. These fixtures constitute valuable and integral components of the apartment properties and the Company’s policy of insisting that light bulbs (which are paid for by the tenant) in these fixtures be removed and replaced only by management personnel is designed to reduce breakage of these valuable fixtures.

See also LTR 8914048 (apartment REIT may “install and/or remove air conditioning units during a tenant’s lease term as is also usual and customary. In connection with the installment and removal of such units [the REIT] may charge a small fee”).

⁵¹In theory, this exception for section 512(b)(3) in former section 856(d)(2) (now in section 856(d)(7)(C)(ii)) did not mean that any service qualifying under the section 512(b)(3) standard automatically satisfied the section 856(d)(1)(B) standard, but in practice this is so. Cf. LTR 200101012 (holding that the provision of Internet, telephone, cable television, security services, and computer room facilities in some apartment complexes is exempt under section 512(b)(3) (and also under the section 856(d)(1)(B) standard), but the provision of private shuttle bus services for tenants of the apartment complexes is exempt only under the section 856(d)(1)(B) standard enumerated in section 856(d)(7)(C)(i)). In words often attributed to Yogi Berra: “In theory there is no difference between theory and practice. In practice there is.”

⁵²For example, on submetering of utilities, LTR 200148074 and LTR 200147058 both clearly state that the landlord “will retain the difference between the price it charges its tenants and the amount it owes the utility provider for the Utility Services, which may result in a profit to the” landlord and conclude that: any income derived by the [landlord] in connection with the provision of electricity, water, sewer and gas service is not service income, but is includable in “rents from real property” within the meaning of section 512(b)(3) of the Code, whether or not the charges for electricity, water, sewer or gas service are separately stated or are incorporated into the tenant’s rental obligations.

utilities.⁵³ Under TRA 1986, REITs could now provide utility services directly without any involvement from an independent contractor.⁵⁴ Accordingly, REITs could now be engaged in the active trade or business of providing customary services satisfying the section 512(b)(3) standard to tenants. In response to TRA 1986, the IRS published a ruling appropriately changing its position about REIT involvement in a trade or business.⁵⁵

Of course, REITs could also continue to provide customary services through independent contractors and continue to treat the amounts received for those services as rents from real property.⁵⁶ In effect, TRA 1986 created a middle ground for REIT tenant services that satisfy the section 856(d)(1)(B) standard but not the section 512(b)(3) standard. Those middle ground services could not be performed by the REIT directly but could be performed by an

⁵³See *supra* note 34. Reg. section 1.512(b)-1(c)(5) specifies that “the furnishing of heat and light” is a service that clears the two-prong test, even though at some level furnishing a utility is for the benefit of the tenant and in theory does not pass the first prong of the section 512(b)(3) standard — yet, it is considered so basic to the rental relationship that it has been designated as the archetypical good service that satisfies reg. section 1.512(b)-1(c)(5). See, e.g., Rev. Rul. 69-178; LTR 199952084 (ruling in favor of a REIT when “the telecommunication services provided to tenants of the Properties are similar to the provision of services by public utilities and are essential for business communications and information transmission”). Cf. reg. section 1.856-4(b)(1) (“The furnishing of water, heat, light, and air-conditioning... are examples of services which are customarily furnished to” tenants); prop. reg. section 1.856-10(d)(3)(iii)(D) (performance of “a utility-like function” supports real property treatment).

⁵⁴See *supra* text accompanying note 47.

⁵⁵See *supra* text accompanying note 44. In Rev. Rul. 2001-29, 2001-1 C.B. 1348, the IRS acknowledged the impact of the TRA 1986 change:

Consequently, as a result of the 1986 amendment, a REIT is permitted to perform activities that can constitute active and substantial management and operational functions with respect to rental activity that produces income qualifying as rents from real property under section 856(d).

* * *

A REIT can be engaged in the active conduct of a trade or business within the meaning of section 355(b) solely by virtue of functions with respect to rental activity that produces income qualifying as rents from real property within the meaning of section 856(d).

⁵⁶As the 1986 blue book, *supra* note 44, at 395, clearly explained: “The Act does not alter the provision of prior law under which amounts received by a REIT are treated as rents from real property if the REIT provides customarily furnished services to its tenants through an independent contractor.”

For a general background on customary services performed by REITs under these code provisions and their associated regulations (including reg. section 1.856-4(b)(1)), see, e.g., Peter J. Genz, “REIT Customary Services Issues,” 2007 ABATAX-CLE 0928051 (Sept. 6, 2007), updated Feb. 20, 2015 (manuscript in possession of the authors).

independent contractor under an arrangement with the REIT that had to satisfy the first two (but not necessarily the last four) independent contractor rules discussed in Section II.B.⁵⁷ However, TRA 1986 did not affect the treatment of non-customary services provided by a REIT to its tenants. Those still had to be performed by an independent contractor under an arrangement that satisfied all six rules in reg. section 1.856-4(b)(5)(i), meaning that a REIT was still required to relinquish control over some of its customary services and all of its non-customary services to an uncontrolled, unsupervised agent.⁵⁸

III. The Advent of TRSs

After almost 40 years of REITs being handicapped in attracting and competing for tenants, the REIT Modernization Act of 1999 (RMA) finally removed the barrier that prevented REIT landlords from being able to control and supervise the offering of non-customary services to their tenants. The RMA was included in the Ticket to Work and Work Incentives Improvement Act of 1999 (P.L. 106-170) and became effective January 1, 2001. It created a new type of REIT subsidiary, the section 856(l) TRS, that would be permitted to perform non-customary services for tenants that otherwise would have to be done by one or more independent contractors. The tradeoff was that unlike other REIT subsidiaries (but like an independent contractor), a TRS would be fully taxable. When introducing the RMA in the House, then-Rep. Bill Thomas, the principal sponsor of the act, said:

Our legislation would allow REITs to create taxable subsidiaries that would be allowed to

⁵⁷See, e.g., Rev. Rul. 2004-24, 2004-1 C.B. 550 (“The definition of rents from real property in section 856(d), which applies to REITs, differs significantly in scope and structure from the definition of rents from real property under section 512(b)(3), which applies to exempt organizations.”); LTR 200101012 (holding that the provision of Internet, telephone, cable television, security services, and computer room facilities in some apartment complexes are exempt under section 512(b)(3) (which, as described *supra* at text accompanying note 51, is as a practical matter encompassed by the section 856(d)(1)(B) standard), but the provision of private shuttle bus services for tenants of the apartment complexes meets only the section 856(d)(1)(B) standard). See also LTR 200008036, LTR 9642027, and LTR 9316024 (involving various transportation services apparently provided to tenants under the section 856(d)(1)(B) standard but not the section 512(b)(3) standard, although the facts and exposition are not entirely clear). Significantly, according to reg. section 1.856-4(b)(5)(i), these middle-ground services need to meet only the first two, but not all six, of the independent contractor requirements enumerated in Section II.B. See *supra* text accompanying notes 40-42.

⁵⁸See *supra* note 28.

perform noncustomary services to REIT tenants without disqualifying the rents a REIT collects from tenants, that is, performance of these services would no longer trigger a technical violation of the REIT rules.⁵⁹

In his introductory remarks for the RMA in the Senate, then-Sen. Connie Mack concurred:

As a result [of the customary services rule], REITs increasingly have been unable to compete with privately-held partnerships and other more exclusive forms of ownership. Today, the rules prevent REITs from offering the same types of customer services as their competitors, even as such services are becoming more central to marketing efforts.

* * *

Certainly, this is not consistent with what Congress intended when it created REITs, and when it modified the REIT rules over the years. In keeping with the Congressional mandate to provide a sensible and effective way for the average investor to benefit from ownership of income-producing real estate, REITs should be able to provide a *range of services* through taxable subsidiaries.⁶⁰ [Emphasis added.]

The Senate report noted the control issue that existed under the independent contractor regime, stating:

Certain kinds of activities that relate to the REIT's real estate investments should be permitted to be performed *under the control of the REIT*, through the establishment of a "taxable REIT subsidiary" where there are rules that limit the amount of the subsidiary's income that can be reduced through transactions with the REIT.⁶¹ [Emphasis added.]

⁵⁹145 Cong. Rec. E795 (Apr. 28, 1999).

⁶⁰145 Cong. Rec. S5377 (May 14, 1999).

⁶¹S. Rep. No. 106-201, at 57 (Oct. 6, 1999). The Clinton administration also agreed with this change, as shown in its proposed 2000 budget:

Many of the businesses performed by the REIT subsidiaries are natural outgrowths of a REIT's traditional operations, such as third-party management and development businesses. While it is inappropriate for the earnings from these non-REIT businesses to be sheltered through a REIT, it also is counter-intuitive to prevent these entities from taking advantage of their evolving experiences and expanding into areas where their expertise may be of significant value.

Treasury, "Explanation of the REIT-Related Items in the Fiscal Year 2000 Budget" (Feb. 1, 1999). The administration's caveat was satisfied in the enacted legislation in two ways: (1) the TRS vehicle created to render non-customary services is fully taxable, so all of its revenue is fully exposed to federal income tax;

(Footnote continued in next column.)

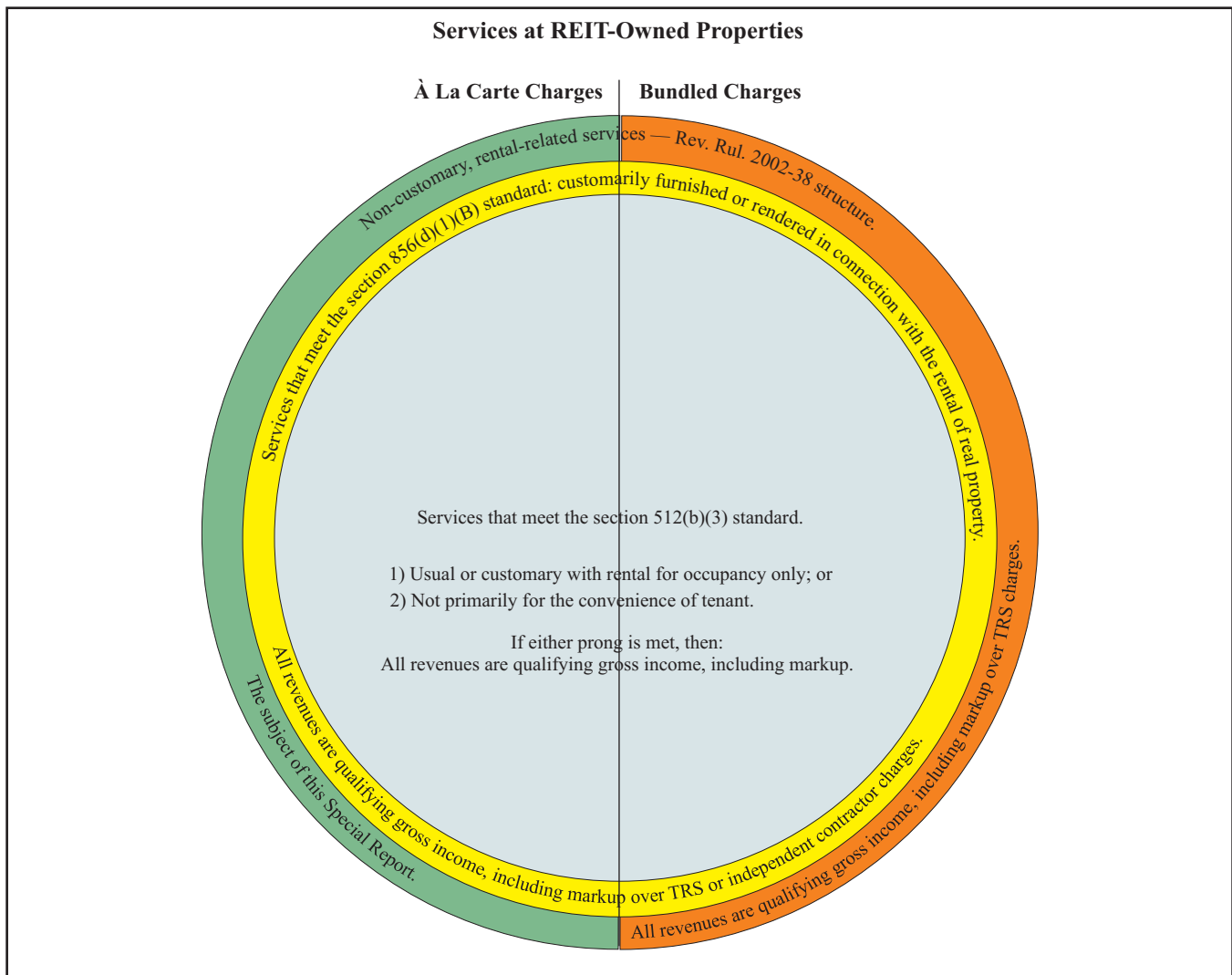
Thus, with the introduction of TRSs, REITs could finally compete for tenants with other, more flexible types of landlords without first involving an uncontrolled and unsupervised agent.⁶² But with the advent of TRSs creating a novel structural paradigm for tenant services by permitting for the first time a REIT-controlled entity to be the provider for non-customary services, the TRS structure created the foundation for asking and resolving an entirely new third question: Do subject revenues qualify as section 856(d) rents from real property?⁶³

In the figure, subject revenues compose the outermost ring, which is shaded green (for unbundled service charges) and orange (for bundled service charges). The inner circle consists of charges for services that qualify as usual and customary under both reg. sections 1.512(b)-1(c)(5) (the section 512(b)(3) standard) and 1.856-4(b)(1) (the section 856(d)(1)(B) standard), while the middle ring consists of charges for services that qualify as customary only under reg. section 1.856-4(b)(1) (only the

and (2) improper allocations of revenues between the REIT and its TRS could trigger the 100 percent "redetermined rents" penalty tax discussed in Section IV.B *infra*.

⁶²See *supra* note 28. In general, a TRS may engage in any manner of business activity, regardless of whether it is related to the provision of services to REIT tenants, except that section 856(l)(3) prohibits a TRS from operating or managing a lodging facility or a healthcare facility (as well as providing specific franchise or license rights for those facilities). This prohibition concerns day-to-day management and operations, not the type of supervisory functions described in reg. section 1.856-4(b)(5)(ii) and LTR 7930040. See, e.g., LTR 201232032; see also section 856(d)(7)(A), (d)(8)(B) (second sentence), (d)(9)(A), (d)(9)(B), and (d)(9)(E). Further, a REIT's investment in the equity and debt of its TRSs, together with other nonqualifying assets, generally cannot exceed 25 percent of the REIT's total assets. See section 856(c)(4)(A) (25 percent limit as the mathematical complement of the 75 percent REIT asset test requirement) and section (c)(4)(B)(ii) (direct limit of 25 percent on securities of TRSs); and text accompanying note 1 (in particular the second and fourth bullet points there). For these purposes, however, a REIT's investment in TRS debt securities, to the extent secured by mortgages on real property, or a REIT's investment in TRS equity or debt securities, to the extent and for the duration qualifying as a temporary investment of new capital, will qualify as a real estate asset that counts toward the 75 percent REIT asset test requirement and is therefore not a security subjected to the 25 percent limit. See section 856(c)(4)(A), (c)(4)(B), (c)(5)(B), and (c)(5)(D); reg. section 1.856-3(c) ("The term 'securities' does not include 'interests in real property' or 'real estate assets' as those terms are defined in section 856 and" reg. section 1.856-3); LTR 201503010, LTR 201431020, LTR 201315007, LTR 201129007, LTR 200705001, and LTR 200630010 (debt securities of a TRS adequately secured by real estate are not securities for purposes of section 856(c)(4)(B)(ii)); and LTR 9342021 (long-term investment can qualify as a temporary investment of new capital for a temporary duration).

⁶³See *supra* text accompanying notes 6-13.



section 856(d)(1)(B) standard).⁶⁴ Both inner circle and middle ring services have been acknowledged since TRA 1976 and TRA 1986 to represent section 856(d) rents from real property, whether bundled with the rent or separately charged. But what about subject revenues? If collected by the REIT, do they also represent rents from real property? Does it matter if they are bundled or separately charged? Should it matter?

The treatment of subject revenues from bundled services charges was answered clearly by Rev. Rul. 2002-38.⁶⁵ As discussed in Section IV.C below, when analyzing a fact pattern that involved bundled charges for a non-customary housekeeping service, Rev. Rul. 2002-38 concluded that the entire amount received by the REIT (including the bundled service charges for non-customary services) constituted

rents from real property and were thus subject to any required redetermination of rents under section 857(b)(7). However, some have posited a distinction, similar to the 1960 standard,⁶⁶ between bundled subject revenues versus separately stated subject revenues, whereby separately stated subject revenues collected by a REIT might not represent section 856(d) rents from real property.

IV. Subject Revenues as Qualifying Rents

There are at least six interconnected and mutually reinforcing reasons why subject revenues (whether bundled or separately stated) constitute section 856(d) rents from real property.

A. Congressional Intent

As shown below, Congress intended that all subject revenues be treated as section 856(d) rents

⁶⁴See *supra* note 57.

⁶⁵See *supra* note 9.

⁶⁶See *supra* text accompanying notes 19-24.

from real property. The RMA itself does not distinguish between separately stated versus bundled subject revenues, so the legislative history must be examined to see if that differentiation was intended.

The principal sources of legislative history regarding the treatment of TRS activities are the Senate report for the RMA and the 2000 blue book, the latter of which says:

A taxable REIT subsidiary can engage in certain business activities that under prior law could disqualify the REIT because, but for the provision, the taxable REIT subsidiary's activities and relationship with the REIT would have prevented certain income from qualifying as rents from real property. Specifically, the subsidiary can provide services to tenants of REIT property (even if such services were not considered services customarily furnished in connection with the rental of real property [under the section 856(d)(1)(B) standard]), and can manage or operate properties, generally for third parties, without causing *amounts received or accrued* directly or indirectly by the REIT for such activities to fail to be treated as rents from real property.⁶⁷ [Emphasis added.]

In parsing the above legislative intent, three points stand out. First, the legislative history uses the phrase “amounts received or accrued” rather than “rents received or accrued,” which implies that *all amounts* received by a REIT, including amounts for non-customary services, are intended to be included in rents from real property. That is, the legislative intent is clearly to include all of a REIT's receipts or accruals, not just charges for occupancy and customary services. Second, the term “such activities” specifically refers to services provided to tenants of REIT property that give rise to subject revenues, which again makes clear that subject revenues are encompassed by the legislative intent. Third, the legislative history makes no distinction between subject revenues that are separately stated versus those that are bundled with basic rent or customary services charges, and Congress has never created that distinction. (In fact, with TRA 1976, Congress overturned the distinction that the IRS created in the 1960 standard.⁶⁸) Accordingly, there is no basis in the legislative history to distinguish between separately stated versus bundled subject revenues.

⁶⁷JCT, “General Explanation of Tax Legislation Enacted in the 106th Congress,” JCS-2-01, at 70 (Apr. 19, 2001) (2000 blue book); see also S. Rep. No. 106-201, at 59 (Oct. 6, 1999) (using identical language to the 2000 blue book except for verb tenses and a typo).

⁶⁸See *supra* Section II.

While the above legislative history uses double negatives (“without causing [subject revenues] to fail to be treated” as section 856(d) rents from real property), the rule that it created is in fact meant as an affirmative rule, particularly when read in the context of how tenant services were treated before the RMA⁶⁹: Subject revenues *are* section 856(d) rents from real property. As explained below, this affirmative rule is confirmed by the structure of section 857(b)(7) and by Rev. Rul. 2002-38.

B. The Section 857(b)(7) Structure

As shown below, the statutory structure of the section 857(b)(7) 100 percent penalty tax is predicated on, and only consistent with, treating subject revenues as rents from real property. With the advent of TRSs as providers of services to REIT tenants, Congress gave the IRS a powerful new antiabuse tool: section 857(b)(7) (reproduced in the Appendix, *infra* Section VI), which was designed to prevent REITs from profiting through the misallocation of revenue or profit in arrangements involving their TRSs.⁷⁰ Added to the code by the RMA,⁷¹ section 857(b)(7) provides for a 100 percent penalty tax that can be imposed only on redetermined rents, redetermined deductions, and excess interest, each as defined in section 857(b)(7). Redetermined rents are defined to include only section 856(d) rents from real property.⁷² When the penalty tax is applied, it supersedes the application of section 482 remedies,⁷³ because it is a more powerful tool. However, this tool can be applied only to amounts that constitute section 856(d) rents from real property in the first place. Thus, for the entire legislative structure of penalties to work as intended for TRS-provided services, subject revenues must constitute rents from real property.

⁶⁹See *supra* Section II.

⁷⁰See *supra* note 61.

⁷¹The wording of section 857(b)(7) in the RMA was corrected by a technical corrections bill (fixing a nit in section 857(b)(7)(B)(ii) that referenced paragraph “(7)(C)(i)” instead of “(7)(C)(ii)” before the January 1, 2001, effective date of the TRS provisions. See Consolidated Appropriations Act of 2001 (P.L. 106-554), Appendix G (H.R. 5662), section 311(b). The corrected wording, which represents the wording of this provision as of January 1, 2001, is used in the Appendix, *infra* Section VI.

⁷²See section 857(b)(7)(B)(i). That redetermined rents must first be section 856(d) rents from real property has been true throughout the entire existence of section 857(b)(7), as amended from time to time. The section 857(b)(7) concepts of redetermined deductions and excess interest are limited to deductions by the TRS for payments to the REIT; by definition, they cannot cover a REIT's undercompensation of its TRS for services provided by the TRS to REIT tenants, because only redetermined rents can do that. See section 857(b)(7)(C)-(D).

⁷³See section 857(b)(7)(E).

The above point is particularly obvious in light of former section 857(b)(7)(B)(ii), which was deleted in a 2004 legislative change but was still in effect when Rev. Rul. 2002-38 was issued.⁷⁴ Former section 857(b)(7)(B)(ii) exempted services described within section 856(d)(1)(B) or section 512(b)(3) from the then reach of the 100 percent penalty tax. Sections 856(d)(1)(B) and 512(b)(3) cover all customarily provided services performed by REITs or their TRSs. Thus, under the statutory structure initially created by the RMA, if section 857(b)(7) redetermined rents did not apply to subject revenues, the provision would have applied to nothing at all because former section 857(b)(7)(B)(ii) exempted everything that satisfied the section 856(d)(1)(B) standard.⁷⁵

Accordingly, an interpretation under which subject revenues were not rents from real property would have rendered the section 857(b)(7) redetermined rents provision entirely superfluous. One of the few universally accepted canons of statutory construction is that any interpretation that renders a statutory term as surplusage or a nullity is strongly disfavored.⁷⁶ In sum, subject revenues must have been section 856(d) rents from real property; otherwise, section 857(b) redetermined rents as initially created by the RMA would be surplusage. The later

⁷⁴As the 2004 legislative history indicates, the deletion of former section 857(b)(7)(B)(ii) was intended to eliminate the “free pass” given to payments made by a REIT to its TRS for customary services and instead subject those payments to the rigor of section 857(b)(7). See H. Rep. No. 108-755, at 333 (Oct. 7, 2004).

⁷⁵See *supra* Section III, particularly the figure.

⁷⁶See, e.g., *Duncan v. Walker*, 533 U.S. 167, 174 (2001) (refusing to adopt a construction of a statute that would leave a statutory term “insignificant, if not wholly superfluous”); *Williams v. Taylor*, 529 U.S. 362, 404 (2000) (describing this rule as a “cardinal principle of statutory construction”); *United States v. Menasche*, 348 U.S. 528, 538-539 (1955) (“It is our duty ‘to give effect, if possible, to every clause and word of a statute’” (quoting *Montclair v. Ramsdell*, 107 U.S. 147, 152 (1883))); *Market Co. v. Hoffman*, 101 U.S. 112, 115 (1879) (“As early as in Bacon’s Abridgment, sec. 2, it was said that ‘a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant.’”); and *BLAK Investments v. Commissioner*, 133 T.C. 431 (2009) (quoting *Menasche*). The IRS has adopted this doctrine in its own interpretations. See TAM 9637008 (rejecting an interpretation of section 58(h) that would leave section 56(b) as “statutory deadwood”); and TAM 8940005 (rejecting an interpretation of reg. section 1.864-4(c)(2)(ii) that would make the word “otherwise” in reg. section 1.864-4(c)(2)(ii)(c) meaningless).

Moreover, because former section 857(b)(7)(B)(ii) was corrected in 2000 (see *supra* note 71), the very next year after it was added to the code by the RMA, section 857(b)(7) redetermined rents would most likely have been entirely deleted at that point, not revised, were it intended to be a nullity. Therefore, section 857(b)(7) redetermined rents must have been intended to apply to subject revenues.

amendment to section 857(b)(7) has not affected the original intent to include subject revenues within section 856(d) rents from real property and thus within the reach of the section 857(b)(7) 100 percent penalty tax.⁷⁷

Further, former section 857(b)(7)(B)(v) (current section 857(b)(7)(B)(iv)) specifically excluded some separately charged services from the reach of the 100 percent penalty tax on redetermined rents. If separately charged subject revenues were not intended by the RMA to be included in section 856(d) rents from real property, this exclusion would have been mere surplusage because *all* separately charged subject revenues would have been excluded from the reach of section 857(b)(7) as not being section 856(d) rents from real property in the first place. That is, such a view of separately charged subject revenues would render former section 857(b)(7)(B)(v) a nullity and thus is incorrect.⁷⁸ Accordingly, former section 857(b)(7)(B)(v) illustrates that Congress intended separately charged subject revenues, and not just bundled subject revenues, to constitute section 856(d) rents from real property under the RMA.

In sum, without applying section 857(b)(7) and its 100 percent penalty tax to subject revenues (whether bundled or separately stated), there would have been no purpose for section 857(b)(7) redetermined rents after the RMA. Because section 857(b)(7)(B)(i) applies only to section 856(d) rents from real property, subject revenues must have been intended to constitute rents from real property. Further — and again, to avoid interpretations that render statutory terms as surplusage or nullities — the fact that only some separately charged subject revenues are specifically excluded from the reach of section 857(b)(7)(B)(i) means that Congress intended that separately charged subject revenues generally (as well as bundled subject revenues) constitute section 856(d) rents from real property.

C. Rev. Rul. 2002-38

Rev. Rul. 2002-38 confirms that subject revenues, including unbundled subject revenues, are treated as rents from real property. Rev. Rul. 2002-38 analyzes an apartment REIT that provides non-customary housekeeping services to its tenants through a wholly owned TRS that administers and

⁷⁷Although the 2004 amendment that deleted former clause (ii) commensurately expanded the scope of section 857(b)(7) redetermined rents, that amendment did not alter the RMA treatment of subject revenues. As Section IV.B clearly illustrates, subject revenues were originally intended by Congress to come within the ambit of redetermined rents, and to do so they had to have been section 856(d) rents from real property in the first place. See *supra* note 74.

⁷⁸See *supra* note 76.

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manages the services and bears all the related costs. The housekeeping services are bundled as part of the monthly rent charge to tenants, and the REIT pays the TRS for providing the services to the REIT's tenants. In Situation 1, the REIT pays the TRS 160 percent of the cost of the services. In Situation 2, the REIT pays the TRS only 125 percent of the cost of the services, which is stipulated to be less than the arm's-length transfer price under section 482. Rev. Rul. 2002-38 concludes that all the subject revenues in both situations — even when the TRS is undercompensated by the REIT in Situation 2 — constitute section 856(d) rents from real property.

In analyzing this extreme fact pattern of bundled charges,⁷⁹ Rev. Rul. 2002-38 concludes as an intermediate step that the non-customary housekeeping services performed by the TRS “do not give rise to impermissible tenant service income and thus do not cause any portion of the rents⁸⁰ received by [the REIT] to fail to qualify as rents from real property under section 856(d).”⁸¹

But the legal exposition and analysis do not end there. Rev. Rul. 2002-38 adds in the very next line: “As rents from real property, those rents⁸² are subject to being treated as redetermined rents under section 857(b)(7)(B)(i).”⁸³ This is important because, by definition, redetermination under section 857(b)(7)(B)(i) can be performed only for amounts that first constitute section 856(d) rents from real property.⁸⁴ Thus, the remainder of the analysis and the conclusions in Rev. Rul. 2002-38 are predicated on a determination that all the amounts received by the REIT (which included both occupancy charges and services charges, bundled together as “rents”) constitute section 856(d) rents from real property. That is, Rev. Rul. 2002-38 both explicitly and implicitly concluded that the appropriate treatment of the subject revenues was as section 856(d) rents from real property. In short, the genius of Rev. Rul.

2002-38 is that for subject revenues, it both creates a workable rule for REIT gross income testing⁸⁵ and imposes the discipline of the section 857(b)(7) 100 percent penalty tax,⁸⁶ all as Congress and the statutory structure intended.

Some have wondered whether Rev. Rul. 2002-38 might have come to a different conclusion if subject revenues had been separately stated as opposed to bundled with occupancy charges. For several reasons, that would not have been the case. First, nothing in the legislative history or structure of the RMA indicates that result. In fact, those authorities suggest the opposite: that all subject revenues, whether bundled or unbundled, constitute section 856(d) rents from real property.

Second, the scenarios considered in Rev. Rul. 2002-38 were meant to be the hardest, most extreme situations possible. The facts of the revenue ruling represent an explicit rejection of the older independent contractor requirements of reg. section 1.856-4(b)(5) for non-customary services and thus demonstrate the utility and flexibility of a TRS as a provider of non-customary services to REIT tenants.⁸⁷ Necessarily then, simpler and easier facts, including compliance with the old independent

⁸⁵See *infra* Section IV.D.

⁸⁶See *supra* Section IV.B.

⁸⁷As discussed in Section II, before the creation of the TRS regime, the six independent contractor requirements represented the only way for a REIT to provide tenants services that could not meet the section 856(d)(1)(B) standard. That is, these six requirements applied to both halves of the outer ring in the figure of Section III. To demonstrate the utility and flexibility of TRSs as providers of non-customary services, Rev. Rul. 2002-38 recited extreme, expansive facts to reject each of the six independent contractor (IK) requirements as having any application to TRS arrangements:

Under the IK Regime:	Rev. Rul. 2002-38 Facts:
• The REIT and the independent contractor (IK) must have been less than 35 percent affiliated.	• The REIT and the TRS were 100 percent affiliated, well beyond the 35 percent threshold.
• The REIT could not earn interest, dividend, rental or other income from the IK.	• The REIT expected to earn dividends and rent from its TRS.
• The charges for the services had to be separately stated.	• There was no separate charge to tenants for the housekeeping services.
• The service revenues had to be collected by the IK.	• Revenues for the TRS services (which happened to be part of the bundled charge) were collected from the tenants by the REIT, and the existence and role of the TRS were opaque to the tenant.

(Footnote continued on next page.)

⁷⁹See *infra* text accompanying notes 87-88. The fact pattern in Rev. Rul. 2002-38 was “extreme” because of its intentional contrast to the six requirements of the prior independent contractor regime for non-customary services, one of those prior requirements being that service fees be separately stated. See *supra* text accompanying notes 39-43.

⁸⁰Rev. Rul. 2002-38 used the word “rents” in this instance to include the service charges bundled therein in the facts of the revenue ruling (which states that “no service charges are separately stated from the tenants’ rents”). 2002-2 C.B. 4, 5. As shown in Sections III and IV.A above, the legislative history is clear that all amounts received by the REIT, including amounts for services such as subject revenues, are also properly covered by the RMA.

⁸¹Rev. Rul. 2002-38, 2002-2 C.B. 4, 5.

⁸²See *supra* note 80.

⁸³See *supra* note 81.

⁸⁴See *supra* Section IV.B.

contractor rule of separately stated charges, are subsumed into the conclusion of Rev. Rul. 2002-38.⁸⁸ The IRS has apparently concluded in at least two private letter rulings that subject revenues are section 856(d) rents from real property.⁸⁹ Although

both cases involved bundled subject revenues, the same conclusion would apply to unbundled subject revenues. To suggest that the liberation from separately stated charges in Rev. Rul. 2002-38 has somehow become a requirement to use bundled charges is to misread Rev. Rul. 2002-38 and get its intent backwards.

D. Industry Practice

As shown below, the treatment of subject revenues as section 856(d) rents from real property faithfully and fairly applies the REIT gross income tests, and treating subject revenues in this fashion is critical to many traditional public REITs. Consistent with the critical commentary regarding the 1960 standard, REITs today use their TRSs as a control point for property access and the provision of services to REIT tenants. Many activities that require widespread access through the landlord's property (including over and under the rented space of other REIT tenants) are now performed by TRSs for the orderly leasing and maintenance of the property, not primarily for the convenience of the tenant.⁹⁰ Otherwise, giving an independent party that access would create safety and security vulnerabilities for the other tenants of the property.⁹¹ Also, the performance of non-customary services by a TRS of a REIT landlord increases the tenants' clout and comfort regarding the quality and reliability of service. This occurs because the REIT (unlike an

Under the IK Regime:	Rev. Rul. 2002-38 Facts:
<ul style="list-style-type: none"> The service revenues had to be retained by the IK. 	<ul style="list-style-type: none"> Revenues for the TRS services collected by the REIT from the tenants (which happened to be part of the bundled charge) were not paid over to the TRS, but instead the REIT hired the TRS under a subcontract and paid the TRS for its services based on an intercompany contractual arrangement.
<ul style="list-style-type: none"> The IK had to be adequately compensated. 	<ul style="list-style-type: none"> In the first of the two situations, the TRS may not have been adequately compensated by the REIT, and in the second of the two situations, the TRS definitely was not adequately compensated by the REIT.

As this comparison demonstrates, the facts of Rev. Rul. 2002-38 are consciously liberated from the six independent contractor requirements, creating a system in which the separate existence of the TRS could remain opaque to REIT tenants, as the existence and use of subsidiaries already could be for non-REIT landlords. In the RMA, Congress intended its new TRS legislation to produce those benefits for REITs. See *supra* Sections III and IV.A, and in particular text accompanying notes 60, 67, and 69.

⁸⁸This reading of Rev. Rul. 2002-38 is confirmed by the following passage from the text of the published ruling, which shows that the bundled charges were intended to make the underlying facts harder, not easier:

In *Situations 1* and *2*, charges to the tenants for the housekeeping services are not separately stated from the rents that the tenants pay to *R* for the use of their apartments. As a result, the amounts of the rents reflect the availability and use of those services. In other words, *R* receives greater rental payments than it would have received if the services had not been provided to its tenants. However, the structure of the 100 percent tax on redetermined rents indicates that Congress did not intend the lack of a separately stated service charge, by itself, to cause services to be treated as rendered by a REIT, rather than its TRS.

2002-2, C.B. 4, 5. From this passage, it is clear that Rev. Rul. 2002-38 is focused on the substance of the arrangement (*viz.*, that the rents therein included fees for services) rather than the form of the arrangement (*viz.*, that somehow the mere act of bundling service fees with rents transmutes service fees into rents).

⁸⁹See LTR 201317001 and LTR 201320007. These two private letter rulings indicate that some of the services provided by

(Footnote continued in next column.)

prison REITs under their tenant contracts and through their TRSs are outside the section 856(d)(1)(B) standard (*e.g.*, in LTR 201317001's description of halfway houses: "A few of the halfway houses employ a psychologist, but generally no other medical care is available onsite. One halfway house employs a nurse who provides basic medical services"). Despite that, all subject revenues in these private letter rulings are held to be section 856(d) rents from real property (to quote, each of the rulings states that "the *entire contract fee* will be treated as 'rents from real property' within the meaning of section 856(d)" (emphasis added)). See also LTR 201503010 (storage REIT's "related services"). By contrast, to our knowledge, there is not a single published or private letter ruling that concludes that subject revenues do not qualify as section 856(d) rents from real property. If there were, that would be expressly contrary to the structure of the statute, the legislative intent of the RMA, and Rev. Rul. 2002-38.

⁹⁰*Cf.* reg. section 1.512(b)-1(c)(5) (first prong), *supra* text accompanying notes 49-51.

⁹¹Given the heightened security demands that tenants have placed on landlords (particularly after September 11, 2001, and in general when permitting access to confidential business-critical systems), REITs would prefer to use their own TRSs to provide any services that do not meet the section 856(d)(1)(B) standard, rather than rely on independent contractors to perform these sensitive roles. *Cf.* LTR 9014022 and LTR 8914048, *supra* note 50.

independent contractor) has an extensive lease relationship with the tenant, which it wants to protect. That gives the tenant significant commercial leverage if problems arise.

The correct interpretation of Rev. Rul. 2002-38 — namely, that subject revenues are section 856(d) rents from real property — is heavily relied on by many public REITs across a variety of real estate property sectors. The following is a non-exhaustive list of common situations in which public REITs treat subject revenues as rents from real property and might otherwise fail the 95 percent REIT gross income qualification test of section 856(c)(2):

- office REITs with separate charges for building amenities such as fitness center memberships and personal trainers, conference center and reception area catering, carwashes, shuttle services, daycare services, and subsidized cafeterias;
- apartment REITs with separate charges for amenities such as housekeeping services, pet care services, daycare services, dry cleaning services, and concierge services;
- shopping mall REITs with separate charges for advertising services and promotional services; and
- self-storage REITs with separate charges for pickup, packing, and delivery services, and for inspection and disposal services.

Further, the above interpretation of Rev. Rul. 2002-38 is not being abused by public REITs to “hype” their qualifying gross income and therefore more easily pass the REIT gross income tests. That interpretation is being used because it is the correct interpretation. This point is best illustrated by a realistic example. Suppose a public REIT has the following items of gross income under section 61 and reg. section 1.856-2(c)(1):

- \$98 million of qualifying rent from occupancy charges and from charges such as utilities that are clearly covered by section 856(d)(1)(B);
- \$2 million of revenue that is definitely nonqualifying because it is outside section 856(c)(2) altogether — for example, third-party management fees or the like; and
- at most \$7 million of subject revenues.

If the subject revenues were merely excluded from REIT gross income testing altogether (say, under section 856(c)(5)(J)(i)), the REIT’s gross income test percentage would be equal to 98 percent $(98/(98+2))$, and it would pass the 95 percent REIT gross income qualification test of section 856(c)(2). By contrast, if the subject revenues are properly included as rents from real property under Rev. Rul.

2002-38,⁹² the REIT’s gross income percentage would be equal to 98.13 percent $((98+7)/(98+2+7))$, which is only immaterially higher.⁹³ The truly unfair outcome here would be to treat the subject revenues as section 61 nonqualifying income, whereby the REIT’s gross income test percentage would equal only 91.6 percent $(98/(98+2+7))$, and the REIT would not pass the 95 percent REIT gross income qualification test of section 856(c)(2). That interpretation would reduce or even block the use of TRSs, which would contradict the express intent of Congress when it created the TRS structure in the RMA.

E. Section 856(c)(5)(J)(ii)

The lack of an explicit rule of inclusion for subject revenues in the RMA was offset by the later addition of section 856(c)(5)(J)(ii), which grants the IRS authority to designate otherwise nonqualifying items of income or gain as qualifying income under section 856(c)(2) or (3). When section 856(d) was reformulated under TRA 1976, section 856(d)(1) and (2) then served a clear purpose, as noted in their titles: “Amounts included” for section 856(d)(1) and “Amounts excluded” for section 856(d)(2).⁹⁴

It is true but irrelevant that an explicit inclusion for subject revenues was not drafted into section 856(d)(1) as part of the RMA.⁹⁵ What is relevant is that Rev. Rul. 2002-38 incorporates the intended

⁹²The correct interpretation of Rev. Rul. 2002-38 is tantamount to a rule of inclusion for subject revenues under section 856(c)(5)(J)(ii). Given that there is already a prescribed treatment for subject revenues under Rev. Rul. 2002-38, it would be inappropriate and confusing to fashion a new exclusion rule for the same under section 856(c)(5)(J)(i). Moreover, a ruling under section 856(c)(5)(J)(i) would remove subject revenues from the ambit of section 856(d) rents from real property and thus from the reach of the section 857(b)(7) 100 percent penalty tax. As explained in Sections IV.A-C, that was not the intent of Congress or the IRS and would result in inappropriate and incorrect conclusions.

⁹³This numerical example shows that in practical terms and real-world cases, there is very little difference between the Rev. Rul. 2002-38 approach to subject revenues and an alternative approach under section 856(c)(5)(J)(i). “Hyping” qualifying revenue is not a concern: Mathematically, compliance with the 95 percent REIT gross income qualification test is anchored by the \$2 million of nonqualifying revenue, and it matters little whether the denominator is \$100 million or \$107 million; that is, the REIT’s so-called 5 percent bad basket (which is the mathematical complement of the 95 percent REIT gross income qualification test of section 856(c)(2)) has everything to do with the \$2 million and very little to do with the \$100 million or \$107 million, which is as it should be.

⁹⁴See TRA 1976.

⁹⁵Because the RMA did so much and had so little legislative history, some rough patches were inevitable. To see another example of rough patches in the RMA concerning the TRS provisions, see Paul W. Decker, Ponda, and Jonathan Stein, “Toward a Workable Definition of REIT Healthcare Facility,” *Tax Notes*, Dec. 5, 2011, p. 1231.

inclusion rule from the legislative history: Subject revenues are in fact intended to be section 856(d) rents from real property — both to assist in compliance with the 95 percent REIT gross income qualification test of section 856(c)(2) and to make sense of the 100 percent penalty tax of section 857(b)(7), all in accordance with the legislative intent of the RMA — and in fact Rev. Rul. 2002-38 accomplishes this despite the lack of an explicit inclusion in section 856(d)(1). Perhaps Rev. Rul. 2002-38 was purposefully subtle in its reasoning and conclusions because of the lack of an explicit inclusion for subject revenues in section 856(d)(1).

Today, however, because of the 2008 addition of the IRS's clear authority to include those amounts as qualifying income under section 856(c)(5)(J)(ii), the published conclusion of Rev. Rul. 2002-38 rests on unquestionably solid ground.

F. No Contrary Authority

There is no contrary published authority that would indicate or compel a different conclusion. Although the absence of negative authority is not definitive proof of the positive, it shows that no authority in over a decade has interpreted any of the primary legal authorities — the structure of the statute, the legislative history of the RMA, or Rev. Rul. 2002-38 — in a way that reaches a conclusion different from the one presented in this report. As noted above, both bundled and separately stated subject revenues are common among public REITs, which interpret this provision in the same manner as discussed in this report.

For example, LTR 201334033 involves a situation in which the REIT “expects to collect all, or nearly all, of the amounts owing from tenants,” including amounts for TRS-provided services that “may not be customary services within the meaning of [reg. section] 1.856-4(b)(1),” and some services provided by the TRSs to tenants “may be listed as separate line items on invoices to tenants.”⁹⁶ There is no published authority that indicates or compels a conclusion that subject revenues *are not* section 856(d) rents from real property, and the reasons presented in this report compel a conclusion that subject revenues *are* section 856(d) rents from real property.⁹⁷

⁹⁶That is, for the taxpayer in LTR 201334033, the TRS-provided services may be outside the section 856(d)(1)(B) standard and may be separately itemized and thus give rise to separately stated subject revenues.

⁹⁷As we discuss in *supra* note 12, we recommend that these conclusions, which are consistent with the code and with prior guidance, be preserved in any future regulations.

V. Conclusion

As this report illustrates, subject revenues, whether separately stated or bundled, constitute section 856(d) rents from real property for the following reasons:

1. according to the legislative history of the RMA, Congress intended that all subject revenues be treated as rents from real property;
2. the statutory structure of the section 857(b)(7) 100 percent penalty tax is predicated on, and consistent only with, treating all subject revenues as rents from real property;
3. Rev. Rul. 2002-38 confirms that subject revenues are treated as rents from real property, and that conclusion applies equally to separately stated subject revenues;
4. the treatment of all subject revenues as rents from real property faithfully and fairly applies the REIT gross income tests, and treating subject revenues this way is critical to many traditional public REITs;
5. the lack of an explicit rule of inclusion for subject revenues in the RMA is offset by the later addition of section 856(c)(5)(J)(ii); and
6. we are unaware of any contrary authority that would indicate or compel a different conclusion.

Accordingly, subject revenues constitute section 856(d) rents from real property, regardless of whether they are billed to tenants separately or as part of a bundled charge.

VI. Appendix

Section 857(b) (2001)

(7) Income from redetermined rents, redetermined deductions, and excess interest.

(A) Imposition of tax. There is hereby imposed for each taxable year of the real estate investment trust a tax equal to 100 percent of redetermined rents, redetermined deductions, and excess interest.

(B) Redetermined rents.

(i) In general. The term “redetermined rents” means rents from real property (as defined in section 856(d)) the amount of which would (but for subparagraph (E)) be reduced on distribution, apportionment, or allocation under section 482 to clearly reflect income as a result of services furnished or rendered by a taxable REIT subsidiary of the real estate investment trust to a tenant of such trust.

(ii) Exception for certain amounts. Clause (i) shall not apply to amounts

received directly or indirectly by a real estate investment trust —

(I) for services furnished or rendered by a taxable REIT subsidiary that are described in paragraph (1)(B) of section 856(d), or

(II) from a taxable REIT subsidiary that are described in paragraph (7)(C)(ii) of such section.

(iii) Exception for de minimis amounts.

Clause (i) shall not apply to amounts described in section 856(d)(7)(A) with respect to a property to the extent such amounts do not exceed the one percent threshold described in section 856(d)(7)(B) with respect to such property.

(iv) Exception for comparably priced services. Clause (i) shall not apply to any service rendered by a taxable REIT subsidiary of a real estate investment trust to a tenant of such trust if —

(I) such subsidiary renders a significant amount of similar services to persons other than such trust and tenants of such trust who are unrelated (within the meaning of section 856(d)(8)(F)) to such subsidiary, trust, and tenants, but

(II) only to the extent the charge for such service so rendered is substantially comparable to the charge for the similar services rendered to persons referred to in subclause (I).

(v) Exception for certain separately charged services. Clause (i) shall not apply to any service rendered by a taxable REIT subsidiary of a real estate investment trust to a tenant of such trust if —

(I) the rents paid to the trust by tenants (leasing at least 25 percent of the net leasable space in the trust's property) who are not receiving such service from such subsidiary are substantially comparable to the rents paid by tenants leasing comparable space who are receiving such service from such subsidiary, and

(II) the charge for such service from such subsidiary is separately stated.

(vi) Exception for certain services based on subsidiary's income from the services. Clause (i) shall not apply to any service rendered by a taxable REIT subsidiary of a real estate investment trust to a tenant of such trust if the gross income of such subsidiary from such service is not less than 150 percent of such subsidiary's direct cost in furnishing or rendering the service.

(vii) Exceptions granted by Secretary. The Secretary may waive the tax otherwise imposed by subparagraph (A) if the trust establishes to the satisfaction of the Secretary that rents charged to tenants were established on an arms' length basis even though a taxable REIT subsidiary of the trust provided services to such tenants.

(C) Redetermined deductions. The term "redetermined deductions" means deductions (other than redetermined rents) of a taxable REIT subsidiary of a real estate investment trust if the amount of such deductions would (but for subparagraph (E)) be decreased on distribution, apportionment, or allocation under section 482 to clearly reflect income as between such subsidiary and such trust.

(D) Excess interest. The term "excess interest" means any deductions for interest payments by a taxable REIT subsidiary of a real estate investment trust to such trust to the extent that the interest payments are in excess of a rate that is commercially reasonable.

(E) Coordination with section 482. The imposition of tax under subparagraph (A) shall be in lieu of any distribution, apportionment, or allocation under section 482.

(F) Regulatory authority. The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this paragraph. Until the Secretary prescribes such regulations, real estate investment trusts and their taxable REIT subsidiaries may base their allocations on any reasonable method.

One Hundred Fourteenth Congress
of the
United States of America

AT THE FIRST SESSION

*Begun and held at the City of Washington on Tuesday,
the sixth day of January, two thousand and fifteen*

An Act

Making appropriations for military construction, the Department of Veterans Affairs, and related agencies for the fiscal year ending September 30, 2016, and for other purposes.

*Be it enacted by the Senate and House of Representatives of
the United States of America in Congress assembled,*

SECTION 1. SHORT TITLE.

This Act may be cited as the “Consolidated Appropriations Act, 2016”.

SEC. 2. TABLE OF CONTENTS.

The table of contents of this Act is as follows:

- Sec. 1. Short title.
- Sec. 2. Table of contents.
- Sec. 3. References.
- Sec. 4. Explanatory statement.
- Sec. 5. Statement of appropriations.
- Sec. 6. Availability of funds.
- Sec. 7. Technical allowance for estimating differences.
- Sec. 8. Corrections.
- Sec. 9. Adjustments to compensation.

**DIVISION A—AGRICULTURE, RURAL DEVELOPMENT, FOOD AND DRUG
ADMINISTRATION, AND RELATED AGENCIES APPROPRIATIONS ACT, 2016**

- Title I—Agricultural Programs
- Title II—Conservation Programs
- Title III—Rural Development Programs
- Title IV—Domestic Food Programs
- Title V—Foreign Assistance and Related Programs
- Title VI—Related Agencies and Food and Drug Administration
- Title VII—General Provisions

**DIVISION B—COMMERCE, JUSTICE, SCIENCE, AND RELATED AGENCIES
APPROPRIATIONS ACT, 2016**

- Title I—Department of Commerce
- Title II—Department of Justice
- Title III—Science
- Title IV—Related Agencies
- Title V—General Provisions

DIVISION C—DEPARTMENT OF DEFENSE APPROPRIATIONS ACT, 2016

- Title I—Military Personnel
- Title II—Operation and Maintenance
- Title III—Procurement
- Title IV—Research, Development, Test and Evaluation
- Title V—Revolving and Management Funds
- Title VI—Other Department of Defense Programs
- Title VII—Related Agencies
- Title VIII—General Provisions
- Title IX—Overseas Contingency Operations/Global War on Terrorism

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Title II—Department of Housing and Urban Development
Title III—Related Agencies
Title IV—General Provisions—This Act

DIVISION M—INTELLIGENCE AUTHORIZATION ACT FOR FISCAL YEAR 2016

DIVISION N—CYBERSECURITY ACT OF 2015

DIVISION O—OTHER MATTERS

DIVISION P—TAX-RELATED PROVISIONS

DIVISION Q—PROTECTING AMERICANS FROM TAX HIKES ACT OF 2015

SEC. 3. REFERENCES.

Except as expressly provided otherwise, any reference to “this Act” contained in any division of this Act shall be treated as referring only to the provisions of that division.

SEC. 4. EXPLANATORY STATEMENT.

The explanatory statement regarding this Act, printed in the House of Representatives section of the Congressional Record on or about December 17, 2015 by the Chairman of the Committee on Appropriations of the House, shall have the same effect with respect to the allocation of funds and implementation of divisions A through L of this Act as if it were a joint explanatory statement of a committee of conference.

SEC. 5. STATEMENT OF APPROPRIATIONS.

The following sums in this Act are appropriated, out of any money in the Treasury not otherwise appropriated, for the fiscal year ending September 30, 2016.

SEC. 6. AVAILABILITY OF FUNDS.

Each amount designated in this Act by the Congress for Overseas Contingency Operations/Global War on Terrorism pursuant to section 251(b)(2)(A)(ii) of the Balanced Budget and Emergency Deficit Control Act of 1985 shall be available (or rescinded, if applicable) only if the President subsequently so designates all such amounts and transmits such designations to the Congress.

SEC. 7. TECHNICAL ALLOWANCE FOR ESTIMATING DIFFERENCES.

If, for fiscal year 2016, new budget authority provided in appropriations Acts exceeds the discretionary spending limit for any category set forth in section 251(c) of the Balanced Budget and Emergency Deficit Control Act of 1985 due to estimating differences with the Congressional Budget Office, an adjustment to the discretionary spending limit in such category for fiscal year 2016 shall be made by the Director of the Office of Management and Budget in the amount of the excess but the total of all such adjustments shall not exceed 0.2 percent of the sum of the adjusted discretionary spending limits for all categories for that fiscal year.

SEC. 8. CORRECTIONS.

The Continuing Appropriations Act, 2016 (Public Law 114–53) is amended—

(1) by changing the long title so as to read: “Making continuing appropriations for the fiscal year ending September 30, 2016, and for other purposes.”;

(2) by inserting after the enacting clause (before section 1) the following: “**DIVISION A—TSA OFFICE OF INSPECTION ACCOUNTABILITY ACT OF 2015**”;

“(3) in the case of property placed in service after December 31, 2020, and before January 1, 2022, 22 percent.”.

(b) EFFECTIVE DATE.—The amendments made by this section shall take effect on January 1, 2017.

SEC. 305. TREATMENT OF TRANSPORTATION COSTS OF INDEPENDENT REFINERS.

(a) IN GENERAL.—Paragraph (3) of section 199(c) of the Internal Revenue Code of 1986 is amended by adding at the end the following new subparagraph:

“(C) TRANSPORTATION COSTS OF INDEPENDENT REFINERS.—

“(i) IN GENERAL.—In the case of any taxpayer who is in the trade or business of refining crude oil and who is not a major integrated oil company (as defined in section 167(h)(5)(B), determined without regard to clause (iii) thereof) for the taxable year, in computing oil related qualified production activities income under subsection (d)(9)(B), the amount allocated to domestic production gross receipts under paragraph (1)(B) for costs related to the transportation of oil shall be 25 percent of the amount properly allocable under such paragraph (determined without regard to this subparagraph).

“(ii) TERMINATION.—Clause (i) shall not apply to any taxable year beginning after December 31, 2021.”.

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2015.

DIVISION Q—PROTECTING AMERICANS FROM TAX HIKES ACT OF 2015

SECTION 1. SHORT TITLE, ETC.

(a) SHORT TITLE.—This division may be cited as the “Protecting Americans from Tax Hikes Act of 2015”.

(b) AMENDMENT OF 1986 CODE.—Except as otherwise expressly provided, whenever in this division an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

(c) TABLE OF CONTENTS.—The table of contents for this division is as follows:

DIVISION Q—PROTECTING AMERICANS FROM TAX HIKES ACT OF 2015

Sec. 1. Short title, etc.

TITLE I—EXTENDERS

Subtitle A—Permanent Extensions

PART 1—TAX RELIEF FOR FAMILIES AND INDIVIDUALS

Sec. 101. Enhanced child tax credit made permanent.

Sec. 102. Enhanced American opportunity tax credit made permanent.

Sec. 103. Enhanced earned income tax credit made permanent.

Sec. 104. Extension and modification of deduction for certain expenses of elementary and secondary school teachers.

Sec. 105. Extension of parity for exclusion from income for employer-provided mass transit and parking benefits.

SEC. 314. REPEAL OF PREFERENTIAL DIVIDEND RULE FOR PUBLICLY OFFERED REITS.

(a) **IN GENERAL.**—Section 562(c) is amended by inserting “or a publicly offered REIT” after “a publicly offered regulated investment company (as defined in section 67(c)(2)(B))”.

(b) **PUBLICLY OFFERED REIT.**—Section 562(c), as amended by subsection (a), is amended—

(1) by striking “Except in the case of” and inserting the following:

“(1) **IN GENERAL.**—Except in the case of”, and

(2) by adding at the end the following new paragraph:

“(2) **PUBLICLY OFFERED REIT.**—For purposes of this subsection, the term ‘publicly offered REIT’ means a real estate investment trust which is required to file annual and periodic reports with the Securities and Exchange Commission under the Securities Exchange Act of 1934.”.

(c) **EFFECTIVE DATE.**—The amendments made by this section shall apply to distributions in taxable years beginning after December 31, 2014.

SEC. 315. AUTHORITY FOR ALTERNATIVE REMEDIES TO ADDRESS CERTAIN REIT DISTRIBUTION FAILURES.

(a) **IN GENERAL.**—Subsection (e) of section 562 is amended—

(1) by striking “In the case of a real estate investment trust” and inserting the following:

“(1) **DETERMINATION OF EARNINGS AND PROFITS FOR PURPOSES OF DIVIDENDS PAID DEDUCTION.**—In the case of a real estate investment trust”, and

(2) by adding at the end the following new paragraph:

“(2) **AUTHORITY TO PROVIDE ALTERNATIVE REMEDIES FOR CERTAIN FAILURES.**—In the case of a failure of a distribution by a real estate investment trust to comply with the requirements of subsection (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 if—

“(A) the Secretary determines that such failure is inadvertent or is due to reasonable cause and not due to willful neglect, or

“(B) such failure is of a type of failure which the Secretary has identified for purposes of this paragraph as being described in subparagraph (A).”.

(b) **EFFECTIVE DATE.**—The amendments made by this section shall apply to distributions in taxable years beginning after December 31, 2015.

SEC. 316. LIMITATIONS ON DESIGNATION OF DIVIDENDS BY REITS.

(a) **IN GENERAL.**—Section 857 is amended by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) the following new subsection:

“(g) **LIMITATIONS ON DESIGNATION OF DIVIDENDS.**—

“(1) **OVERALL LIMITATION.**—The aggregate amount of dividends designated by a real estate investment trust under subsections (b)(3)(C) and (c)(2)(A) with respect to any taxable year may not exceed the dividends paid by such trust with respect to such year. For purposes of the preceding sentence, dividends

to in subclause (I) if such position were ordinary property,
any income of such trust from any position referred to in subclause (I) and from any transaction referred to in subclause (III) (including gain from the termination of any such position or transaction) shall not constitute gross income under paragraphs (2) and (3) to the extent that such transaction hedges such position.”.

(b) IDENTIFICATION REQUIREMENTS.—

(1) IN GENERAL.—Subparagraph (G) of section 856(c)(5), as amended by subsection (a), is amended by striking “and” at the end of clause (ii), by striking the period at the end of clause (iii) and inserting “, and”, and by adding at the end the following new clause:

“(iv) clauses (i), (ii), and (iii) shall not apply with respect to any transaction unless such transaction satisfies the identification requirement described in section 1221(a)(7) (determined after taking into account any curative provisions provided under the regulations referred to therein).”.

(2) CONFORMING AMENDMENTS.—Subparagraph (G) of section 856(c)(5) is amended—

(A) by striking “which is clearly identified pursuant to section 1221(a)(7)” in clause (i), and

(B) by striking “, but only if such transaction is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may prescribe)” in clause (ii).

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2015.

SEC. 320. MODIFICATION OF REIT EARNINGS AND PROFITS CALCULATION TO AVOID DUPLICATE TAXATION.

(a) EARNINGS AND PROFITS NOT INCREASED BY AMOUNTS ALLOWED IN COMPUTING TAXABLE INCOME IN PRIOR YEARS.—Section 857(d) is amended—

(1) by amending paragraph (1) to read as follows:

“(1) IN GENERAL.—The earnings and profits of a real estate investment trust for any taxable year (but not its accumulated earnings) shall not be reduced by any amount which—

“(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.”, and

(2) by adding at the end the following new paragraphs:

“(4) REAL ESTATE INVESTMENT TRUST.—For purposes of this subsection, the term ‘real estate investment trust’ includes a domestic corporation, trust, or association which is a real estate investment trust determined without regard to the requirements of subsection (a).

“(5) SPECIAL RULES FOR DETERMINING EARNINGS AND PROFITS FOR PURPOSES OF THE DEDUCTION FOR DIVIDENDS PAID.—For special rules for determining the earnings and profits of a real estate investment trust for purposes of the deduction for dividends paid, see section 562(e)(1).”.

(b) **EXCEPTION FOR PURPOSES OF DETERMINING DIVIDENDS PAID DEDUCTION.**—Section 562(e)(1), as amended by the preceding provisions of this Act, is amended by striking “deduction, the earnings” and all that follows and inserting the following: “deduction—

“(A) the earnings and profits of such trust for any taxable year (but not its accumulated earnings) shall be increased by the amount of gain (if any) on the sale or exchange of real property which is taken into account in determining the taxable income of such trust for such taxable year (and not otherwise taken into account in determining such earnings and profits), and

“(B) section 857(d)(1) shall be applied without regard to subparagraph (B) thereof.”.

(c) **EFFECTIVE DATE.**—The amendments made by this section shall apply to taxable years beginning after December 31, 2015.

SEC. 321. TREATMENT OF CERTAIN SERVICES PROVIDED BY TAXABLE REIT SUBSIDIARIES.

(a) **TAXABLE REIT SUBSIDIARIES TREATED IN SAME MANNER AS INDEPENDENT CONTRACTORS FOR CERTAIN PURPOSES.**—

(1) **MARKETING AND DEVELOPMENT EXPENSES UNDER RENTAL PROPERTY SAFE HARBOR.**—Clause (v) of section 857(b)(6)(C) is amended by inserting “or a taxable REIT subsidiary” before the period at the end.

(2) **MARKETING EXPENSES UNDER TIMBER SAFE HARBOR.**—Clause (v) of section 857(b)(6)(D) is amended by striking “, in the case of a sale on or before the termination date,”.

(3) **FORECLOSURE PROPERTY GRACE PERIOD.**—Subparagraph (C) of section 856(e)(4) is amended by inserting “or through a taxable REIT subsidiary” after “receive any income”.

(b) **TAX ON REDETERMINED TRS SERVICE INCOME.**—

(1) **IN GENERAL.**—Subparagraph (A) of section 857(b)(7) is amended by striking “and excess interest” and inserting “excess interest, and redetermined TRS service income”.

(2) **REDETERMINED TRS SERVICE INCOME.**—Paragraph (7) of section 857(b) is amended by redesignating subparagraphs (E) and (F) as subparagraphs (F) and (G), respectively, and inserting after subparagraph (D) the following new subparagraph:

“(E) **REDETERMINED TRS SERVICE INCOME.**—

“(i) **IN GENERAL.**—The term ‘redetermined TRS service income’ means gross income of a taxable REIT subsidiary of a real estate investment trust attributable to services provided to, or on behalf of, such trust (less deductions properly allocable thereto) to the extent the amount of such income (less such deductions) would (but for subparagraph (F)) be increased on distribution, apportionment, or allocation under section 482.

“(ii) **COORDINATION WITH REDETERMINED RENTS.**—Clause (i) shall not apply with respect to gross income attributable to services furnished or rendered to a tenant of the real estate investment trust (or to deductions properly allocable thereto).”.

(3) **CONFORMING AMENDMENTS.**—Subparagraphs (B)(i) and (C) of section 857(b)(7) are each amended by striking “subparagraph (E)” and inserting “subparagraph (F)”.

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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



4

◆ 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



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- ◆ 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



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- ◆ 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



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- ◆ 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 20041027](#) & [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



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- ◆ 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?

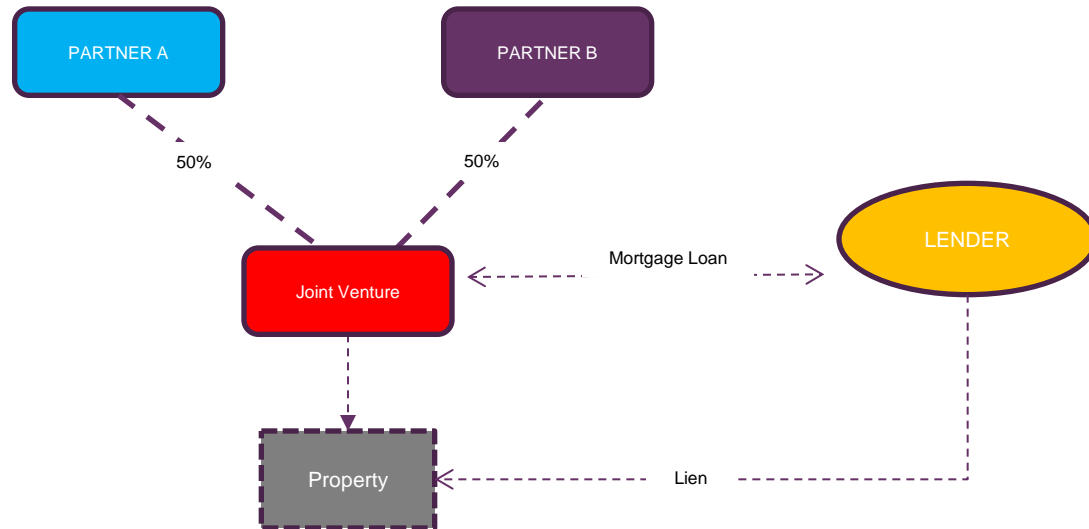
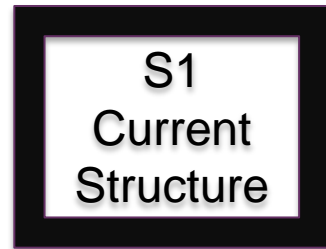
Managing Taxable Income Con't.

◆ Like Kind Exchange

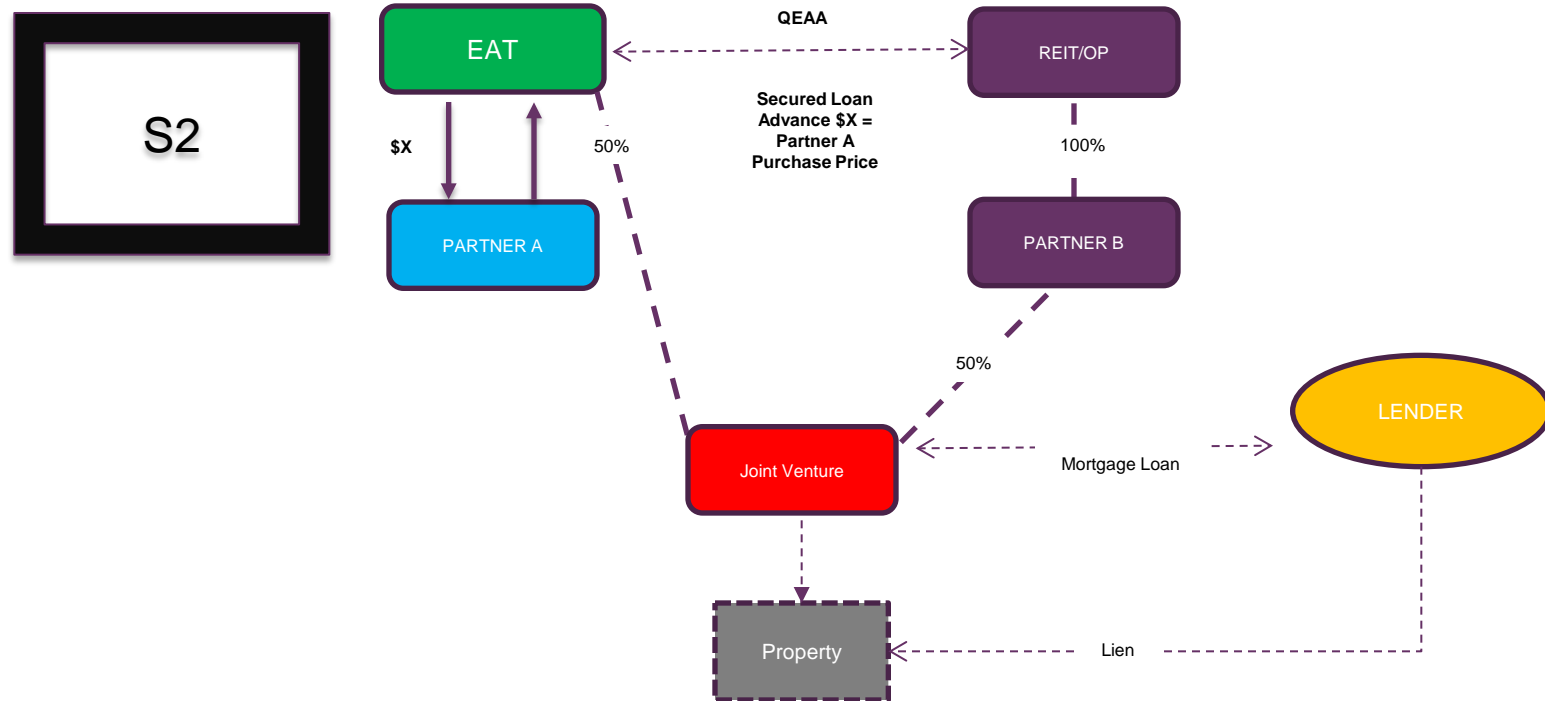
- ◆ Using an Exchange Accommodator Titleholder (EAT) to unencumber property
 - ◆ To defer 100% of gain on sale, replacement property must equal or exceed both the relinquished property FMV and taxpayer's net equity in the property
 - ◆ In some instances, an EAT can be used to purchase encumbered replacement 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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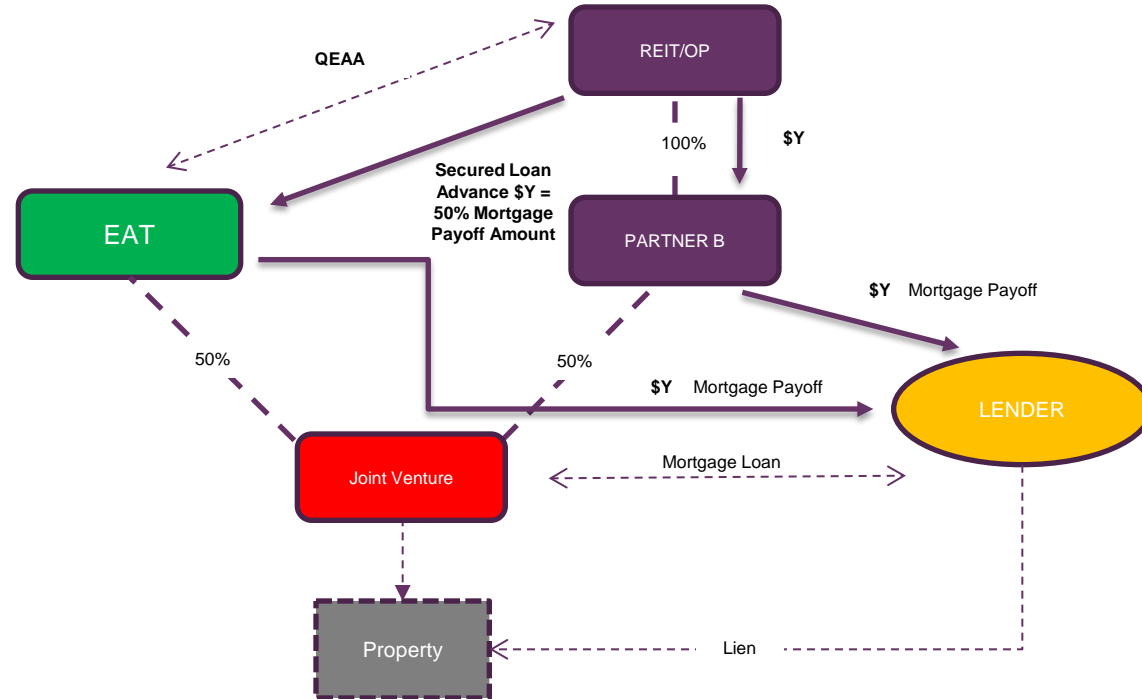


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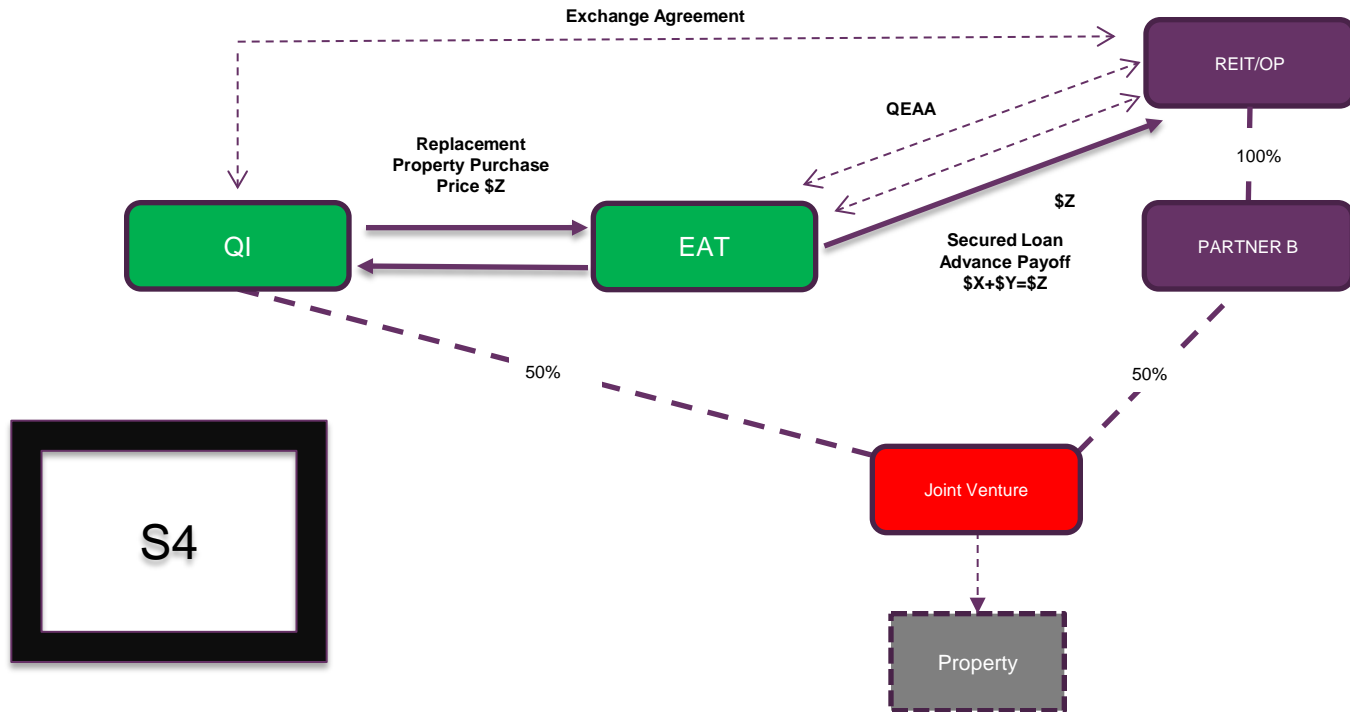
Managing Taxable Income Con't.

S3

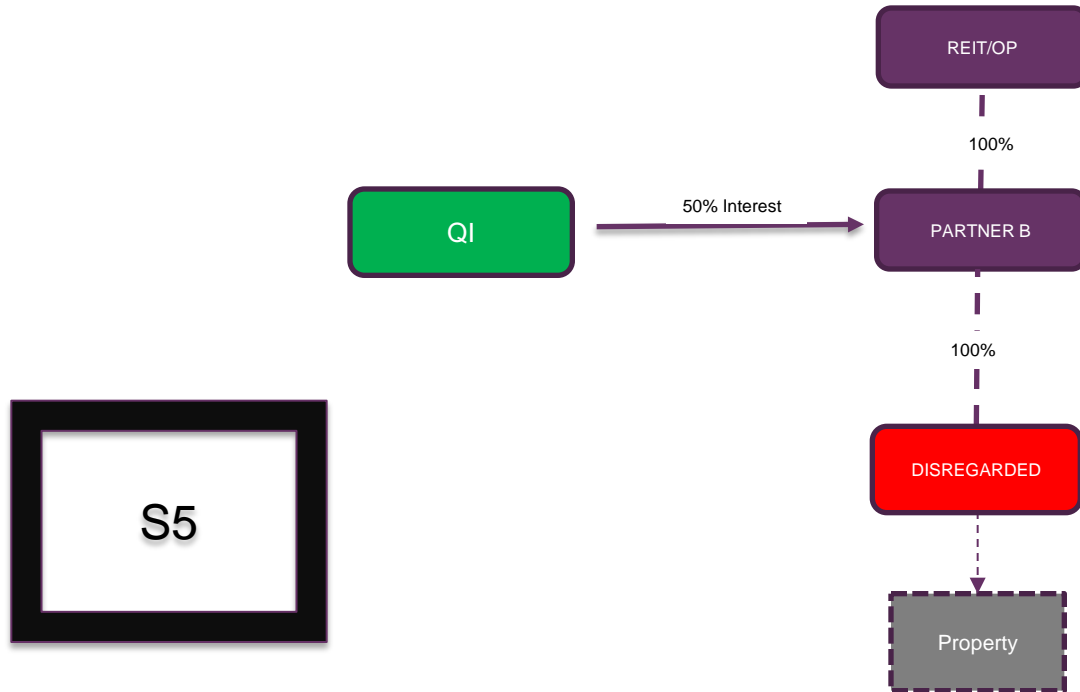




Managing Taxable Income Con't.



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.



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◆ 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.



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◆ 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 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.