TAXATION OF REAL ESTATE INVESTMENT TRUSTS AND SHAREHOLDERS[1]

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Taxation of Real Estate Investment Trusts and Shareholders[2]

I. Overview.

A. The rules governing taxation of real estate investment trusts (REITs) are set forth in subchapter M of chapter 1 of the Code,[3] which also contains the rules applicable to regulated investment companies and real estate investment conduits (REMICs). Each of these specialized entities has in common that they can achieve a general absence of tax at the entity level by complying with very detailed restrictions on the manner in which they operate. Many of the limitations imposed upon the operation of REITs and taxes to which they are potentially subject can be understood in terms of the original notion that the activities of REITs were to consist predominantly of passive investment in real estate.

II. Summary of REIT qualification requirements:

A. Must have centralized management (Code Section 856(a)(1)).

B. Must have transferable shares (Code Section 856(a)(2)).

C. Would be a domestic corporation but for the REIT election (Code Section 856(a)(3)).

D. Must not be a financial institution or insurance company (Code Section 856(a)(4)).

E. Shares must be beneficially owned by at least 100 persons (Code Section 856(a)(5)).

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[2] For REITs formed as trusts, the term shareholder should be read as referring to holders of beneficial interests in the trust.

[3] All references to the Code are to the Internal Revenue Code of 1986, as amended.

F. Must not be "closely held" (Code Section 856(a)(6)).

G. Must satisfy the income and assets tests (Code Section 856(a)(7)).

H. Must satisfy the distribution and earnings and profits requirements (Code Section 857(a), Code Sections 561 through 565).

I. Must make a REIT election (Code Section 856(c)(1)).

J. Must have a calendar year tax year (Code Section 859).

III. Detailed Discussion of REIT Qualification Requirements:

A. Must have centralized management (Code Section 856(a)(1)).

1. This test must be satisfied continuously. Code Section 856(b).

2. This test is ordinarily not a problem. In essence it means that the REIT must have the type of centralized management that would have counted as a corporate characteristic under the old entity classification regulations (Former Treasury Regulations Section 301.7701-2(c)). See Treasury Regulations Section 1.856-1(d)(1). The REIT regulations have not been updated to reflect the new entity classification regulations.[4] Note that REITs are often formed as Maryland business trusts.

B. Must have transferable shares (Code Section 856(a)(2)).

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[4] As to permissible delegation of authority by REIT trustees, see Rev. Rul. 72-254, 1972-1 C.B. 207. As to permissible shareholder approval rights, see Treasury Regulations Section 1.856-1(d)(1); and Rev. Ruls. 64-259, 1964-2 C.B. 180, 70-569, 1970-2 C.B. 147 and 74-471, 1974-2 C.B. 198.

1. This test must be satisfied continuously. Code Section 856(b).

2. In general, the question is which limitations on transferability are permissible without running afoul of this requirement. The IRS has generally looked to the definition of free transferability of interests in the old entity classification regulations (Former Treasury Regulations Section 301.7701-2(e)(1)) as instructive to determine whether interests in REITs are "transferable" within the meaning of Code Section 856(a)(2). See, e.g., Private Letter Ruling 200052037, December 29, 2000. The REIT regulations have not been updated to reflect the new entity classification regulations. The following limitations are addressed in regulations or Private Letter Rulings:

(i) Provisions in the trust instrument or corporate charter or bylaws which permit the trustee or directors to redeem shares or to refuse to transfer shares in any case where the trustee or directors, in good faith, believe that a failure to redeem shares or that a transfer of shares would result in the loss of status as a REIT will not render the shares "nontransferable." Treasury Regulations Section 1.856-1(d)(2).

(ii) The IRS has ruled in numerous Private Letter Rulings that properly structured "excess stock" provisions and other provisions designed to police the closely-held requirement and 100 shareholder requirement (e.g., prohibiting and voiding transfers that cause a violation) do not violate the requirement of transferable shares. See, e.g., Private Letter Ruling 9627017, April 15, 1996.

(iii) The IRS has ruled privately that issuance of a limited number of shares of restricted stock as a traditional incentive compensation program does not violate the requirement of transferable shares. Private Letter Ruling 9747034, August 25, 1997.

(iv) The IRS has ruled privately that a limit designed to prevent a Code Section 382 ownership change does not violate the requirement of transferable shares. Private Letter Ruling 200052037, December 29, 2000.

(v) The IRS has ruled privately that a requirement of consent prior to a transfer, if consent cannot be unreasonably withheld is permissible. Private Letter Ruling 200052037, December 29, 2000.

(vi) The IRS has ruled privately that a provision voiding a proposed transfer *ab initio* if it violates an applicable jurisdiction's securities laws or regulations. Private Ruling 9630016, April 26, 1996.

(vii) The IRS has ruled privately that a provision voiding a proposed transfer *ab initio* if it will result in the REIT's failure to qualify as a domestically controlled REIT does not violate the requirement of transferable shares. Private Ruling 9630016, April 26, 1996.

(viii) It is permissible for a REIT to have multiple classes of shares.[5]

C. Would be a domestic corporation but for the REIT election (Code Section 856(a)(3)).

1. This test must be satisfied continuously. Code Section 856(b).

2. Under the REIT regulations, the determination of whether an unincorporated organization would be taxable as a domestic corporation in the absence of the REIT election is to be made in accordance with the provisions of Code Section 7701(a)(3) and (4) and the regulations thereunder.

(i) The current REIT regulations provide that, for this purpose, an otherwise qualified REIT is deemed to satisfy the "objective to carry on business" requirement of former Treasury Regulations Section 301.7701-2(a). See Treasury Regulations Section 1.856-1(d)(3). The REIT regulations

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[5] See Rev. Rul. 69-610, 1969-2 C.B. 149 (preferred and common); Rev. Rul. 71-405, 1971-2 C.B. 263 (income shares and capital shares).

have not been updated to reflect the new entity classification regulations. The new entity classification regulations should lead to the same result, since, under those regulations, a “business entity” is any entity recognized for federal tax purposes that is not properly classified as a trust under Treasury Regulations Section 301.7701-4 or otherwise subject to special treatment under the Code. Under the current version of Treasury Regulations Section 301.7701-4: “Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.”

(ii) Note that under the current entity classification regulations, an “eligible entity” (i.e., one that is eligible to elect classification as a partnership or association taxable as a corporation) that files an election under Code Section 856(c)(1) to be treated as a REIT is treated as having made an election under the entity classification regulations to be classified as an association taxable as a corporation. The deemed election is effective as of the first day the entity is treated as a REIT.

D. Must not be a financial institution or insurance company (Code Section 856(a)(4)).

1. This test must be satisfied continuously. Code Section 856(b).

2. A financial institution is defined in Code Section 582(c)(2) (essentially banks and thrifts), and insurance company is defined by reference to subchapter L of chapter 1 of the Code.

E. Shares must be beneficially owned by at least 100 persons (Code Section 856(a)(5)).

1. This test must be satisfied during at least 335 days of a taxable year of 12 months, or during a proportionate part of a taxable year of less than 12 months. Code Section 856(b).

2. The 100 shareholder requirement does not apply to the first taxable year for which a REIT election is made. Code Section 856(h)(2).

3. No attribution or constructive ownership rules apply for purposes of the 100 shareholder requirement. Treasury Regulations Section 1.856-1(d)(2). Thus, any “person” (under Code Section 7701(a)(1), person includes, an individual, a trust, estate, partnership, association, company or corporation) that beneficially owns shares counts as one person toward the 100 shareholder requirement without any look-through rules, constructive ownership rules, etc. But see Private Letter Ruling 7311230330A, November 23, 1973, applying the definition of “person” in the 1940 Act.[6]

4. Ordinarily for a public REIT, the 100 shareholder requirement is not a significant planning issue. However, for so-called “private” REITs it can be quite significant.

5. The chief concerns are making sure that there will always be at least 100 beneficial owners and that each one is a beneficial owner (e.g., pays for the shares or receives them as compensation that is included in income) with enough of an ownership interest (say $500) not to be ignored. See Private Letter Ruling 7311230330A, November 23, 1973. It was recited that the REIT would sell not less than one hundred shares of beneficial interest at book value to at least one hundred individuals. The ruling held that each shareholder of one or more shares of beneficial interest of the trust would constitute a person for the purpose of determining that the trust is beneficially owned by one hundred or more persons.

6. On occasion, the counting issues for a private REIT can get complex if the REIT is simultaneously trying to

[6] Citing House Report No. 2020, 86th, Congress, 2d. Session 1960-2 C.B. 821, which indicates that the one hundred or more ownership test is substantially the equivalent of a requirement which regulated investment companies must meet in complying with the Investment Company Act of 1940.

satisfy the 100 shareholder tax requirement while also avoiding classification as an investment company under the Investment Company Act of 1940 ("1940 Act"). Many REITs will be exempt from the 1940 Act based on their activities.

7. A REIT's organizational documents typically contain provisions prohibiting, and rendering void *ab initio* transfers that would cause a violation of the 100 shareholder requirement. The IRS has ruled that if such a provision is properly structured and is valid under applicable state law, and if the REIT uses its best efforts to enforce the provisions, a transfer made in violation of the restrictions to a prohibited transferee will not result in those shares being owned by the prohibited transferee for federal income tax purposes. See, e.g., Private Letter Ruling 9552047, September 29, 1995.

F. Must not be closely held (Code Sections 856(a)(6), 856(h) and 856(k)).

1. The REIT closely held requirement does not apply to the first taxable year for which a REIT election is made. Code Section 856(h)(2).

2. The REIT closely held rule incorporates the stock ownership definition from the personal holding company rules (Code Section 542(a)(2)), i.e., a REIT is closely held if, at any time during the last half of the taxable year, more than 50% in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals. Code Section 856(h)(1)(A).

(i) The REIT closely held rule also incorporates the constructive ownership rules applicable in making the personal holding company determination (Code Section 544), except that partner-to-partner attribution does not apply. Code Section 856(h)(1)(A).

(ii) Normally, for purposes of the REIT closely held rule, an organization described in Code Section 401(a), 501(c)(17) or 509(a), or the portion of a trust set aside for charitable purposes described in Code Section 642(c), is treated as a single individual. Code Section 542(a)(2).

(iii) However, a special look-through rule applies to "qualified trusts" (described in Code Section 401(a) and exempt under Code Section 501(a)), so that the stock held by the pension trust is treated as held directly by its beneficiaries in proportion to their actuarial interests. Code Section 856(h)(3).[7] This look through rule does not apply if certain disqualified persons with respect to the qualified trust own 5% or more (by value) of the REIT and the REIT has accumulated earnings and profits from a C corporation tax year.

3. A special rule applies to "pension-held" REITs, which can cause pension trusts holding interests in the REIT to realize unrelated business taxable income. See section VII below.

4. Requirements to ascertain share ownership and relief provisions relating to closely held rule. Under Code Section 856(k), if a REIT meets certain requirements regarding ascertaining the actual ownership of its shares, and if the REIT does not know, or exercising reasonable diligence would not have known, whether it failed the "not closely held" requirement, then the REIT is treated as having met the requirement for the taxable year.

(i) Ascertaining share ownership. Code Section 857(f)(1) directs REITs to comply with regulations prescribed for the purpose of determining actual ownership of its shares.

(ii) Penalties for failure to comply. If the REIT fails to comply with these requirements, it may be subject to a penalty of $25,000 (or $50,000 for intentional disregard). Whichever penalty applies may be doubled if the REIT continues its failure to comply after notice and demand from the IRS. There is a reasonable cause exception to these penalties.

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[7] Note that any entity that qualifies as a REIT for any taxable year by reason of the look-through rule, is not treated as a personal holding company for such taxable year for purposes of the personal holding company tax. Code Section 856(h)(3)(B).

(iii) Requirements of regulations.

(a) Under Treasury Regulations Section 1.857-8, every REIT must maintain in the internal revenue district in which it is required to file its income tax return permanent records showing information relative to the actual owners of its stock, which is contained in written statements required by the regulations to be demanded from the REIT's shareholders. Such records must be kept at all times available for inspection by any internal revenue officer or employee, and are to be retained so long as the contents thereof may become material in the administration of any internal revenue law.

(b) Actual owner of stock. The actual owner of stock of a REIT is the person who is required to include in gross income in his return the dividends received on the stock. If the shareholder of record is not the actual owner of the stock, the stockholding record of the REIT may not disclose the actual ownership of such stock. Accordingly, the REIT must demand written statements from shareholders of record disclosing the actual owners (see (d) below).

(c) Closely held test. The permanent records of the REIT must show the maximum number of shares of the REIT (including the number and face value of securities convertible into REIT stock) to be considered as actually or constructively owned by each of the actual owners of any of its stock at any time during the last half of the REIT's taxable year.

(d) Statements to be demanded from shareholders. The information required by (b) and (c) above must be set forth in written statements demanded from shareholders of record as follows:

(1) In the case of a REIT having 2,000 or more shareholders of record of its stock on any dividend record date, from each record holder of 5% or more of its stock; or

(2) In the case of a REIT having less than 2,000 and more than 200 shareholders of record of

its stock on any dividend record date, from each record holder of 1% or more of its stock; or

(3) In the case of a REIT having 200 or less shareholders of record of its stock on any dividend record date, from each record holder of one-half of 1% or more of its stock.

(e) Demands for statements. The written statements are to be demanded within 30 days after the close of the REIT's taxable year. The demand must inform each shareholder of the duty to submit at the time the shareholder's income tax return is filed certain statements by required by Treasury Regulations Section 1.857-9 if the shareholder fails or refuses to comply with the demand. A list of persons failing or refusing to comply in whole or in part with the REIT's demand must be maintained as a part of the REIT's records required by the regulations.

5. Excess stock provisions. It is common for the governing documents of a REIT (e.g., the Articles of Incorporation) to contain so-called excess stock provisions. See for example, the provisions described in Private Letter Ruling 9552047, September 29, 1995. The essence of these provisions is that if a person attempts to transfer stock to a person who would own stock in excess of the ownership restrictions (the Articles also impose a restriction on the permissible stock ownership), the prohibited transferee will not become the owner of the excess stock for purposes of Code Section 856(a)(6). Rather, that transfer will result in stock being held by a designated agent for the exclusive benefit of a designated charity on the day prior to the date of the violative transfer. The prohibited transferee will be unable to benefit economically from ownership of any stock held by the designated agent as a result of the transfer, will have no rights to dividends, and will not possess any rights to vote or other rights attributable to that stock. The excess stock will continue to be considered outstanding stock while held for the benefit of the designated charity. The stock is then sold in the market and the prohibited transferee gets back no more than what it paid for the stock. The REIT also follows other practices designed to police the closely-held rule: requirements to be notified of a prohibited

transfer, ongoing monitoring of stock ownership and compliance with the regulations regarding demands to shareholders and maintenance of records. The IRS has ruled that if such a provision is properly structured and is valid under applicable state law, and if the REIT uses its best efforts to enforce the provisions, a transfer made in violation of the restrictions to a prohibited transferee will not result in those shares being owned by the prohibited transferee for federal income tax purposes.

G. Must satisfy income and assets tests (Code Section 856(a)(7)).

1. 75% gross income test. Code Section 856(c)(3). At least 75% of a REIT's gross income, excluding gross income from prohibited transactions, described in section VI below, for its taxable year (thus, the test applies on an annual basis) must consist of:

(i) Rents from real property;[8]

(ii) Interest on obligations secured by mortgages[9] on real property or on interests in real property;[10]

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[8] The definitions of underscored items are discussed further below.

[9] The term "mortgages on real property" includes deeds of trust on real property. Treasury Regulations Section 1.856-3(b)(1).

[10] Interest on certain obligations secured indirectly by mortgages also qualify. See Rev. Rul. 84-10 (certain government agency mortgage-backed pass-through certificates and participation certificates); Rev. Rul. 77-349, 1977-2 C.B. 20 (certain mortgage backed pass-through securities with private credit support); Rev. Rul. 76-101 (notes secured by stock in a cooperative housing corporation); Rev. Rul. 77-459, 1977-2 C.B. 239 (loan secured by an interest in an Illinois land trust). Generally, an obligation that is treated as a separate loan secured by one or more mortgages does not qualify. However, Rev. Rul. 80-280, 1980-2 C.B. 207, treated certain hypothecation loans as mortgages. See also Private Letter Ruling 200513002, Apr. 1, 2005 (warehouse line of credit secured by committed mortgages that are secured by real property, held analogous

(a) The IRS has ruled privately that certain loans secured by the sole membership interest of a limited liability company that is a disregarded entity for federal income tax purposes under Treasury Regulations Section 301.7701-3(b)(1), or secured by an interest in a partnership, and substantially all of the assets of the limited liability company and the partnership consist of real property, is treated as a "real estate asset" for purposes of Code Sections 856(c)(4)(A) and 856(c)(5)(B). See, e.g., Private Letter Ruling 200225034, June 21, 2002.

(b) Currently, Rev. Proc. 2003-65 sets forth a safe harbor under which a loan from a REIT secured by an interest in a partnership or by the sole membership interest in a disregarded entity will be treated as a real estate asset for purposes of Code Sections 856(c)(4)(A) and 856(c)(5)(B), and the interest on the loan will be treated as interest on an obligation secured by a mortgage on real property or an interest in real property for purposes of Code Section 856(c)(3)(B). Such loan must satisfy the following requirements:

(1) The borrower is either a partner in a partnership or the sole member of an eligible entity that has not elected to be treated as a corporation for federal tax purposes and is therefore disregarded as an entity separate from its owner under Code Section 7701 and Treasury Regulations Section 301.7701-3(b)(1).

(2) The loan is nonrecourse, secured only by the partner's interest in the partnership, or the member's interest in the disregarded entity;

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to hypothecation loans in Rev. Rul. 80-280; consequently, warehouse line of credit constituted a real estate asset within the meaning of Code Section 856(c)(5)(A)) and Private Letter Ruling 200705001, Feb. 2, 2007 (repurchase agreement through which a REIT loans money to its taxable REIT subsidiary secured by an assignment of mortgage loans and mortgage backed securities also held analogous to hypothecation loans in Rev. Rul. 80-280; consequently, repurchase agreement constituted a real estate asset within the meaning of Code Section 856(c)(5)(A)).

thus, in the event of default, the sole recourse is against the pledged ownership interest.

(3) The lender is granted a first priority security interest in the pledged ownership interest. This security interest will place the lender's claim as lender ahead of the claims of other creditors of the partner or limited liability company member. The pledged ownership interest cannot be further encumbered unless the security interest created is subordinate to the lender's security interest.

(4) Upon default and foreclosure on the secured loan, the lender will replace the borrower as a partner in the partnership or as the sole member of the disregarded entity. In the case of a loan secured by a partnership interest, the other partners in the partnership must have agreed that upon default and foreclosure they will not unreasonably oppose the admission of the lender as a partner.

(5) On the date the commitment by the lender to make or acquire the loan becomes binding on the lender, the partnership or disregarded entity holds real property within the meaning of Treasury Regulations Section 1.856-3(d). If all or part of this real property is subsequently sold or otherwise transferred, the loan will become due and payable upon the sale or transfer of the real property.

(6) On each testing date, the value of the real property, within the meaning of Treasury Regulations Section 1.856-3(d), held by the partnership or disregarded entity is at least 85% of the value of all of the assets of the partnership or disregarded entity. For this purpose a testing date means the close of the first quarter of the lender's taxable year following the date on which the commitment by the lender to make or acquire the loan becomes binding on the lender, and the close of each subsequent quarter in which the partnership or disregarded entity acquires any assets other than real estate assets, cash and cash items (including receivables), or government securities, within the meaning of Code Section 856(c)(4)(A), or reasonable quantities of equipment and materials customarily used for the maintenance and repair of real property. For this purpose, asset

acquisitions by a partnership or disregarded entity include additional partnership or member contributions.

(7) The loan value of the real property owned by the partnership or disregarded entity equals or exceeds the amount of the loan as determined under Treasury Regulations Section 1.856-5(c)(2). For this purpose, the loan value is reduced by any liens encumbering the real property, as well as by any other liabilities of the partnership or disregarded entity on the date the commitment by the lender to make the loan becomes binding on the lender. If the real property is owned by a partnership, only the proportionate share of the loan value (determined using the principles of Treasury Regulations Section 1.856-3(g)) attributable to the interest that secures the lender's loan is taken into account.

(8) Interest on the loan meets the requirements of Treasury Regulations Sections 1.856-5(a) and (b); thus, the interest includes only an amount that constitutes compensation for the use or forbearance of money, and, subject to the exception contained in Treasury Regulations Section 1.856-5(d), the determination of the amount does not depend in whole or in part on the income or profits of any person.

(c) The IRS has privately ruled that "bond issuance premium" (generally, the excess of a bond's issue price over its stated redemption price at maturity) of debt issued by a qualified REIT subsidiary would "not be treated as other than qualifying REIT income".[11]

(iii) Gain from the sale or other disposition of real property (including interests in real property and interests in mortgages on real property) which is not "dealer property";[12]

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[11] Private Letter Ruling 200732014, August 10, 2007.

[12] Dealer property commonly refers to property described in Code Section 1221(a)(1), or "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of

(iv) Dividends or other distributions on, and gain (other than gain from prohibited transactions) from the sale or other disposition of, shares in other REITs;[13]

(v) Abatements and refunds of taxes on real property;

(vi) Income and gain derived from foreclosure property;

(vii) Amounts (other than amounts the determination of which depends in whole or in part on the income or profits of any person) received or accrued as consideration for entering into agreements (i) to make loans secured by mortgages on real property or on interests in real property or (ii) to purchase or lease real property (including interests in real property and interests in mortgages on real property);[14]

(viii) Gain from the sale or other disposition of a real estate asset which is not a prohibited transaction solely by reason of Code Section 857(b)(6); and

(ix) Qualified temporary investment income.

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the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." If a borrower defaults on a mortgage loan, the REIT takes over the property as mortgagee in possession, completes construction of the property securing the loan and sells the property to recover the principal and interest on the loan, the property is not held primarily for sale to customers. Rev. Rul. 74-352, 1974-2 C.B. 197.

[13] To qualify as stock in another REIT for purposes of the income and assets tests, the other REIT must be a good REIT for the whole tax year. Treasury Regulations Section 1.856-3(f).

[14] If the loan, lease or purchase relates to both real property and other property, an apportionment is required. Treasury Regulations Section 1.856-2(c)(3). See also Treasury Regulations Section 1.856-5(c).

2. 95% gross income test. Code Section 856(c)(2). At least 95% of the REIT's gross income (excluding gross income from prohibited transactions) must be derived from:

(i) Items that meet the 75% income test.

(ii) Other dividends.

(iii) Other interest.

(iv) Gain from the sale or other disposition of stock or securities that are not dealer property.

3. Income limits implicit in the affirmative income tests.

(i) Because at least 75% of the REIT's gross income must consist of the items specified in the 75% income test, it follows that no more than 25% of a REIT's income can consist of the additional items that qualify under the 95% income test.

(ii) Further, because at least 95% of the REIT's gross income must consist of the items specified in the 95% income test, it follows that no more than 5% of a REIT's income can consist of items not enumerated in the 75% income test and 95% income test. REITs carefully monitor this so-called "bad" income.

4. Foreign Investments.

(i) Foreign currency gains and losses. Code Section 856(n).

(a) To the extent that a REIT holds or acquires foreign investments, such as doing business in foreign jurisdictions or holding mortgages or other loans denominated in foreign currencies, such investments may generate foreign currency gains and losses under Code Sections 987 or 988. Until recently, it was unclear whether Code Section 988 foreign currency gains recognized by a REIT are qualifying income for purposes of the 95% or 75% gross income tests. The Housing and Economic Recovery Act of 2008 added, among other things, Code Section 856(n), regarding the treatment of foreign currency gains under the 95% and 75% gross income tests.

(1) Under Code Section 856(n), effective for foreign currency gains and income recognized after July 30, 2008, (i) "passive foreign exchange gain" is not counted as gross income for purposes of the 95% gross income test and (ii) "real estate foreign exchange gain" is not counted as gross income for purposes of the 75% gross income test.[15] Thus, for purposes of the 95% gross income tests, passive foreign exchange gain is not factored into the numerator or the denominator. Similarly, for purposes of the 75% gross income tests, real estate foreign exchange gain is not factored into the numerator or the denominator.

(2) For purposes of the exclusion from the 95% gross income test, "passive foreign exchange gains" are (A) real estate foreign exchange gains, (B) foreign currency gains that are not described in item (A) and are attributable to: (1) any item that qualifies under the 95% gross income test, (2) the acquisition or ownership of obligations (other than foreign currency gains attributable to any item described in item (B)(1)), or (3) becoming or being the obligor under obligations (other than foreign currency gains attributable to any item described in item (B)(1)), and (C) any other foreign currency gains determined by the IRS.[16] For a REIT that enters into a Code Section 988 transaction, these rules only apply to foreign currency gain that is directly attributable to income items that otherwise would be qualifying income under the 95% and 75% gross income tests (or directly attributable to the acquisition or ownership of, or to becoming the obligor under, obligations secured by mortgages on real property or on interests on real property). Any additional foreign currency gain arising from subsequent disposition of the

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[15] Code Section 856(n)(1).

[16] Code Section 856(n)(3).

foreign currency received upon payment of the accrued interest would be attributable to holding the foreign currency after its receipt and falls outside the scope of this exclusion.[17]

(3) For purposes of the exclusion from the 95% or 75% gross income test, "real estate foreign exchange gains" are (X) foreign currency gains (as defined in Code Section 988(b)(1)) that are attributable to: (1) any item that qualifies under the 75% gross income test, (2) the acquisition or ownership of obligations secured by mortgages on real property or on interests in real property (other than foreign currency gains attributable to any item described in item (X)(1)), or (3) becoming or being the obligor under obligations secured by mortgages on real property or on interests in real property (other than foreign currency gains attributable to any item described in item (X)(1)), (Y) Code section 987 gains attributable to a qualified business unit (as defined in Code Section 989) of the REIT, but only if the qualified business unit meets both the 75% gross income test for the tax year and the 75% asset test[18] at the close of each quarter that the REIT has directly or indirectly held the qualified business unit, and (Z) any other foreign currency gains determined by the IRS.[19] Hence, under these rules, Code Section 987 gain on a remittance from a qualified business unit to a REIT is excluded from the REIT's computation of its 95% and 75% gross income tests, provided the qualified business unit itself meets both the 75% gross income test for the tax year and the 75% asset test at the close of each quarter of the tax year. Only Code Section 987 gain as of the time of, and resulting from, the remittance is attributable to the qualified business unit and is excluded from the 95% and 75% gross income tests; any currency gain arising from holding

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[17] See Staff of the Joint Committee on Taxation, *Technical Explanation of Division C of H.R. 3221, the "Housing Assistance Tax Act of 2008," as Scheduled for Consideration by the House of Representatives on July 23, 2008* (JCX-63-08), July 23, 2008, *available at* http://www.jct.gov/x-63-08.pdf.

[18] See Section III.G.5.(i).

[19] Code Section 856(n)(2).

currency after the remittance is not attributable to the qualified business unit and falls outside the scope of this exclusion.[20]

(4) Notwithstanding the exclusions from the 95% and 75% gross income tests described above, Code Section 988 foreign currency gain derived by a corporation, trust, or association from engaging in substantial and regular trading or dealing in securities (as defined in Code Section 475(c)(2)) remains gross income that is not qualifying income under either the 95% or 75% gross income tests, unless such Code Section 988 gain qualifies under the hedging exception.[21]

(b) Prior to the enactment of the Housing and Economic Recovery Act of 2008, the IRS had issued very limited guidance on the proper treatment of a REIT's Code Section 988 foreign currency gains. The IRS first addressed foreign currency gains recognized by a REIT in May 2007.

(1) In Rev. Rul. 2007-33, 2007-21 I.R.B. 1281, a REIT owned both real property outside the United States from which it derived rental income in euros and euro-denominated debt instruments that are partially or fully secured by mortgages on real property. The IRS generally held that the REIT's Code Section 988 foreign currency gain is treated as qualifying income under the 95% and 75% gross income tests to the extent that the underlying income generating such foreign currency gain would so qualify. The IRS based this ruling on the close nexus between Code Section 988 gain on payments received by the REIT and the income from which that payment is derived. The Housing and Economic Recovery Act of 2008 clearly changes the result in Rev. Rul. 2007-33.

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[20] See Staff of the Joint Committee on Taxation, *Technical Explanation of Division C of H.R. 3221, the "Housing Assistance Tax Act of 2008," as Scheduled for Consideration by the House of Representatives on July 23, 2008* (JCX-63-08), July 23, 2008, *available at* http://www.jct.gov/x-63-08.pdf.

[21] Code Section 856(n)(4). For a more detailed discussion of the hedging exception, see Section III.G.7.(iii).

(2) One issue left unresolved by Rev. Rul. 2007-33 was whether Code Section foreign currency gains derived as a result of a REIT's being an obligor on a debt instrument is qualifying income for purposes of the 95% or 75% gross income tests. In 2008, the IRS concluded that to the extent a REIT that is the obligor recognizes foreign currency gains on loans used to acquire assets from which the REIT earns qualifying income, there is sufficient nexus so that the foreign currency gains should also be treated as qualifying income. See Private Letter Ruling 200808024, Feb. 22, 2008.[22]

(3) In May 2007, the IRS also issued Notice 2007-42, 2007-21 I.R.B. 1288, which generally provides interim guidance for REITs that earned foreign currency gains under Code Section 987. Notice 2007-42 essentially provided that, until further guidance was published, a REIT that recognized gain under Code Section 987 could apply the principles of certain proposed regulations issued under Code Section 987 to determine whether such Code Section 987 gain is income that qualifies under the 95% or 75% gross income tests. The Housing and Economic Recovery Act of 2008 supersedes Notice 2007-42.

(ii) Subpart F income. In general, United States shareholders of CFCs are required to include in gross income currently their pro rata share of certain income of the CFC (referred to as "Subpart F income"), without regard to whether the income is distributed by the CFC to its shareholders in the year the income is earned. Code Section 951(a). It is not clear whether Subpart F Income inclusions under Code Section 951(a) of a REIT that is a United States shareholder in a CFC is treated as income that qualifies under the 95% or 75% gross income tests.[23]

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[22] In another private ruling, the IRS allowed a REIT's subsidiaries (which operated outside the United States) to adopt the local currency of the economic environment in which a significant part of their activities was conducted as their functional currency. See Private Letter Ruling 200821020, May 23, 2008.

[23] The IRS has stated that "[n]either section 951(a)(1) nor the corresponding regulations characterize a section 951(a)(1) inclusion as a dividend," and accordingly, Subpart F income inclusion cannot constitute

(iii) Functional currency issues.

(a) In general, Code Section 985(a) provides that all determinations for federal income tax purposes are to be made in the taxpayer's functional currency. Code Section 985(a). Under Treasury regulations, except as otherwise provided by ruling or administrative pronouncement, a "qualified business unit" (a "QBU") that has the United States as its residence (as defined in Code Section 988(a)(3)(B)) is required to use the U.S. dollar as its functional currency. Treasury Regulations Section 1.985-1(b)(1)(iii). A QBU that is not required to use the U.S. dollar as its functional currency, is required to use as its functional currency the currency of the "economic environment" in which a significant part of the QBU's activities are conducted, if the QBU keeps, or is presumed to keep, its books and records in such currency. Treasury Regulations Section 1.985-1(c)(1).

(b) Thus, to the extent that a REIT or a QBU of a REIT has the United States as its residence (such as a domestic corporation, see Code Section 988(a)(3)(B)(i)(II)) but does not conduct any trade or business within the United States and instead invests and operates in a foreign jurisdiction that uses a currency other than the U.S. dollar, the REIT or QBU may generate significant foreign currency gains and losses under Code Sections 987 or 988. See discussion above.

(c) The IRS has, in several private rulings, granted administrative relief to certain REITs and

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qualified dividend income. See Notice 2004-70, 2004-44 I.R.B. 724. However, the regulated investment company rules provide that Subpart F income inclusions are treated as dividends for purposes of the gross income requirements for regulated investment companies to the extent that, under Code Section 959(a)(1), there is a distribution by the CFC out of its earnings and profits of the taxable year which are attributable to the amounts so included. See Code Section 851(b)(3) (flush language). It is unclear whether similar rules should also apply for REITs or whether the general rule treating Subpart F income inclusions as income that is not a dividend applies (in which case it would not be treated as qualifying income for purposes of the REIT gross income tests).

QBUs of REITs that maintain a currency other than the U.S. dollar to adopt such currency as their functional currency to avoid the risk of losing their REIT status as a result of gain or loss under Code Section 987 or changes in asset valuations as a result of currency fluctuations. See, e.g., Private Letter Rulings 200625019, June 23, 2006; 200550025, December 16, 2005; 200548004, December 12, 2005; 200532015, August 12, 2005; 200531013 , August 5, 2005; 200519007, May 13, 2005.[24]

5. Asset tests (these tests apply at the close of each calendar quarter).[25]

(i) 75% asset test. At least 75% of the value of the REIT's total assets is represented by real estate assets, cash[26] and cash items[27] (including receivables[28]), and Government securities.[29]

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[24] The rulings generally rely on the legislative history to the functional currency rules which states that "[i]n appropriate circumstances, a domestic QBU (such as a regulated investment company organized to invest in securities denominated in a specific currency) may have a foreign currency as the functional currency." See Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 1093-94 (Comm. Print 1987).

[25] In the case of short taxable year, at the close of each calendar quarter refers to the quarterly periods that end, to the extent possible, on the same dates as the quarters of a 12-month year, even though the use of 3-month quarters may result in one quarter of less than three months. See Rev. Rul. 80-50, 1980-1 C.B. 146.

[26] Cash and time or demand deposits with financial institutions. Rev. Rul. 72-171; see also Treasury Regulations Section 301.7701-13A(e)(1). For this purpose, effective July 31, 2008, "cash" also include foreign currency if the REIT or its qualified business unit (as defined in Code Section 989) uses the foreign currency as its functional currency (as defined in Code Section 985(b)) but only to the extent the foreign currency (i) is held for use in the normal course of the activities of the REIT or qualified business unit that give rise to items of income and gain that qualify under the 95% or 75% gross income tests or are directly related to acquiring or holding assets that qualify under the assets tests, and (ii) is not held in connection with a trade or business involving the

(ii) Asset tests applicable to non-Government securities.[30] Code Section 856(c)(4)(B) provides as follows:

(a) Overall 25% asset test. Not more than 25% of the value of the REIT's total assets is represented by non-Government securities that are not otherwise treated as real estate assets (including securities of taxable REIT subsidiaries).[31]

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substantial and regular trading or dealing in securities). Code Section 856(c)(5)(K).

[27] Certificates of deposits with financial institutions qualify, Rev. Rul. 77-199, 1977-1 C.B. 195, repurchase agreements and bankers acceptances do not. Rev. Rul. 72-171, 1972-1 C. B. 208; Rev. Rul. 75-59, 1975-1 C. B. 177. Generally, a loan is a security unless it is a mortgage; but "straight debt" and other excluded debt instruments are not treated as a security for purposes of the 10% value test, as discussed below.

[28] "Receivables" means only those receivables which arise in the ordinary course of the trust's operation and does not include receivables purchased from another person. Treasury Regulations Section 1.856-3(d)(1).

[29] Government securities generally refers to securities issued or guaranteed by the U.S. government or an instrumentality. There are various rulings addressing securities issued by various agencies. A repo of a Government security is not itself a Government security but rather a loan to the private counterparty and, thus, is a non-Government security. Rev. Rul. 77-59, 1977-1 C.B. 196.

[30] Subject to the limitations in Section 856(c)(4)(B), the character of the remaining 25% (or less) of the value of the total assets is not restricted. Treasury Regulations Section 1.856-2(d)(1).

[31] If the REIT meets the 75% asset test in Code Section 856(c)(4)(A), it will also meet the first test under Code Section 856(c)(4)(B) since it will, of necessity, have not more than 25% of its total assets represented by securities other than those described in Code Section 856(c)(4)(A). Treasury Regulations Section 1.856-2(d)(2).

(b) TRS 25% asset test. Not more than 25% of the value of the REIT's total assets is represented by securities of one or more <u>taxable REIT subsidiaries</u>.[32]

(c) 5%/10% asset tests. Separate limit on non-Government securities that are not otherwise treated as real estate assets (does not apply to securities of taxable REIT subsidiaries):

(1) not more than 5% of the value of the REIT's total assets is represented by securities of any one issuer,

(2) the REIT does not hold securities possessing more than 10% of the total voting power[33] of the outstanding securities of any one issuer, and

(3) the REIT does not hold securities having a value of more than 10% of the total value

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[32] Code Section 856(c)(4)(B)(ii) (the asset test applicable to securities of taxable REIT subsidiaries) was recently amended by the Housing and Economic Recovery Act of 2008 to increase the percentage limit from 20% to 25% effective July 31, 2008. Although Code Section 856(c)(4)(B)(ii) does not specifically exclude securities described under Code Section 856(c)(4)(A), i.e., securities that are otherwise treated as real estate assets, the IRS has privately ruled that for purposes of the then-20% TRS-related asset test, "securities" do not include securities that are otherwise treated as real estate assets. See Private Letter Ruling 200630010, Aug. 14, 2006. See also footnote 51 and accompanying text.

[33] All facts and circumstances should be considered in determining voting rights. GCM 36823, August 24, 1976; cf. Rev. Rul. 66-339, 1966-2 C. B. 274. The IRS has ruled privately that a redemption of its stock by an issuer over which the REIT had no control or advance notice, but which resulted in the REIT temporarily holding more that 10% of the voting securities of the issuer, should be treated in the same manner as mere changes in value unaccompanied by acquisition of a new security for purposes of the 5% test. Private Letter Ruling 9237022, June 12, 1992.

of the outstanding securities of any one issuer.[34] There is a grandfather rule for securities of a corporation held directly or indirectly by a REIT on July 12, 1999.[35] Except for certain tax-free transactions, the grandfather protection is lost if the corporation acquires a new trade or business or substantial new assets or if the REIT acquires new securities in the corporation.

6. Definitions related to the income and assets tests. Code Sections 856(c)(4) and 856(c)(5).

(i) Gross income. Gross income has the same meaning as that term has under Code Section 61 and the regulations thereunder. Thus, in determining the gross income requirements under Section 856(c) (2), (3), and (4), a loss from the sale or other disposition of stock, securities, real property, etc. does not enter into the computation. See Treasury Regulations Section 1.856-2(c)(1).

(a) If a borrower pays expenses of the REIT for services provided to the REIT in connection with a loan (e.g., legal fees), this may be gross income to the REIT. GCM 36168, February 27, 1975. Similarly, if a lessee pays real property taxes of the lessor REIT, this is gross income to the REIT. Rev. Rul. 73-426, 1973-2 C.B. 223.

(b) However, Code Section 108(e)(9) provides that: “Any amount included in gross income by reason of the discharge of indebtedness shall not be taken into account for purposes of paragraphs (2) and (3) of section 856(c).”

(c) Further, certain items that may be gross income for Code Section 61 purposes have been held

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[34] See Private Letter Ruling 200234054, May 21, 2002, regarding an operating partnership’s loan (presumably not straight debt) to a partnership in which it held a profits interest. The portion of the loan corresponding to the operating partnership’s percentage ownership interest in the partnership borrower is ignored in applying the 10% value test. This has been codified at Code Section 856(m)(4)(A).

[35] P.L. 106-170, Section 546.

not to be gross income for purposes of the REIT income tests: (i) litigation awards and settlements (see, e.g., Private Letter Ruling 200127024, April 4, 2001); (ii) if a third party reimburses the REIT for expenses of the third party paid by the REIT, so long as the REIT does not make a profit (Rev. Rul. 84-138, 1984-2 C.B. 123). See, however, Private Letter Ruling 200236037, May 10, 2002, which distinguished Rev. Rul. 84-138, and held that reimbursements were gross income where the Operating Partnership whose expenses were being reimbursed was generally in the business of receiving compensation for services of the type being reimbursed. Gross income generated by a wrap-around mortgage is only the portion of interest attributable to funds actually advanced by the REIT. Rev. Rul. 75-99, 1975-1 C.B. 197.

(d) The IRS has privately ruled that a REIT's allocable share of rents paid by a limited partnership in which the REIT is a member (the "LP") to a limited liability company (the "LLC") in which the LP is member could be excluded from the REIT's gross income to the extent of the REIT's allocable share of the LP's deductions for rents paid to the LLC. Private Letter Ruling 200705019, Feb. 2, 2007.

(e) The IRS has privately ruled that the Code Section 162(m) deduction limitation would not apply (i) to a REIT's operating partnership with respect to remuneration paid to an individual who was (1) an employee of both the REIT and its operating partnership and (2) a "covered employee" within the meaning of Code Section 162(m)(3) of the REIT as compensation for services performed as an employee of the operating partnership, and (ii) to a REIT with respect to its distributive share of income or loss from the operating partnership that includes compensation expense of the covered employee to the extent such compensation expense is attributable to services performed as an employee of the operating partnership.[36]

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[36] See, e.g., Private Letter Ruling 200837024, Sept. 12, 2008; Private Letter Ruling 200727008, July 6, 2007; Private Letter Ruling 200725014, June 22, 2007; and Private Letter Ruling 200614002, April 7, 2006.

(ii) Value. Value means, with respect to securities for which market quotations are readily available, the market value of such securities; and with respect to other securities and assets, fair value as determined in good faith by the trustees, except that in the case of securities of other REITs such fair value shall not exceed market value or asset value, whichever is higher. Code Section 856(c)(5)(A). See also Treasury Regulations Section 1.856-3(a).

(iii) Total assets. The term "total assets" means the gross assets of the trust determined in accordance with generally accepted accounting principles. Treasury Regulations Section 1.856-(2)(d)(3).

(iv) Real estate assets. Code Section 856(c)(5)(B). Real estate assets includes:

(a) Real property (including interests in real property and interests in mortgages on real property).[37]

(b) Shares in other REITs which meet the requirements of the Code.

(c) Temporary investment of new capital. Any property (not otherwise a real estate asset) attributable to the temporary investment of new capital, but only if such property is stock or a debt instrument, and only for the 1-year period beginning on the date the real estate investment trust receives such capital.

(v) Interests in real property. Interests in real property includes fee ownership and co-ownership of land

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[37] If a mortgage loan is secured both real property and other property, the IRS has privately ruled that a REIT may use the method for apportioning interest income under Treasury Regulations Section 1.856-5(c) to determine the portion of the mortgage loan that qualifies as a real estate asset for purposes of the 75% asset test. See Private Letter Ruling 199923006, June 11, 1999.

or improvements thereon, leaseholds[38] of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon,[39] but does not include mineral, oil, or gas royalty interests.[40] Code Section 856(c)(5)(C). The term also includes timeshare interests that represent an undivided fractional fee interest, or undivided leasehold interest, in real property, and that entitle the holders of the interests to the use and enjoyment of the property for a specified period of time each year. The term also includes stock held by a person as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in Code Section 216). Treasury Regulations Section 1.856-3(c).

(vi) Real property. Real property includes improvements, such as buildings or other inherently permanent structures thereon (including items which are structural components of such buildings or structures). Local law definitions are not controlling for purposes of determining the meaning of the term real property. The term includes, for example, the wiring in a building, plumbing systems, central heating, or central air-conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business,

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[38] The IRS has privately ruled that a “concession” agreement granted by a foreign city to a REIT’s joint venture entity to redevelop construct, finance, operate, and maintain commercial real property located in a historical complex was equivalent to a leasehold, accordingly, the concession was an “interest in real property” under Code Section 856(c)(4)(A). Private Letter Ruling 200705013, Feb. 2, 2007.

[39] However, where a REIT writes an option giving the holder the right to acquire land or improvements thereon or a leasehold thereof, any income that the REIT recognizes because the option expires unexercised is not considered to be gain from the sale or other disposition of real property (including interests in real property).

[40] Such as a retained economic interest in coal or iron ore with respect to which the special provisions of Code Section 631(c) apply. Treasury Regulations Section 1.856-3(c).

such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc., even though such items may be termed fixtures under local law. Treasury Regulations Section 1.856-3(d).[41]

(vii) Rents from real property. Code Section 856(d). One of the major categories of REIT income. See detailed discussion in section IV below.

(viii) Foreclosure property. Code Section 856(e); Treasury Regulations Section 1.856-6; and Treasury Regulations 5.856-1.

(a) Significance of classification as foreclosure property. Income and gain from foreclosure property is good income for both income tests even if it would not otherwise qualify as good income. Thus, the income cannot disqualify the REIT. However, the price for this protection is that the REIT is subject to tax at regular corporate rates on income from foreclosure property that does not otherwise qualify as good income under the 75% income test. See section VI below. The election to treat property as foreclosure property does not alter the character of the income derived from the property (other than for purposes of the 75% and 95% income tests). For example, if foreclosure property is sold, the determination of whether it is property described in Code Section 1221(a)(1) (i.e., dealer property) will not be affected by the fact that it is foreclosure property. Treasury Regulations Section 1.856-6(a).

(b) Foreclosure property means any real property (including interests in real property), and any personal property incident to such real property, acquired by a REIT as the result of such REIT having bid in such property at foreclosure, or having otherwise reduced such property to ownership or possession by agreement or process of law, after

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[41] There are a significant number of published and private rulings addressing the classification of property as real property.

there was default (or default was imminent) on a lease of such property or on an indebtedness which such property secured. Foreclosure property does not include property acquired by the REIT as a result of indebtedness arising from the sale or other disposition of dealer property not originally acquired as foreclosure property.

(c) Ceasing to be foreclosure property.

(1) General. Generally, property ceases to be foreclosure property as of the close of the third taxable year following the taxable year in which the REIT acquired such property. However, a REIT can obtain up to a 3 year extension by establishing to the satisfaction of the IRS that it is necessary for the orderly liquidation of the REIT's interests in such property.

(2) Special rule. Foreclosure property ceases to be such on the first day on which:

(i) a lease is entered into with respect to such property which, by its terms, will give rise to income which does not qualify under the 75% income test (ignoring the special rule that treats income from foreclosure property as good income), or any amount is received or accrued, directly or indirectly, pursuant to a lease entered into on or after such day which does not so qualify,

(ii) any construction takes place on such property (other than completion of a building, or completion of any other improvement, where more than 10% of the construction of such building or other improvement was completed before default became imminent), or

(iii) the property has been held by the REIT more than 90 days and the property is used in a trade or business which is conducted by the REIT (other than through an independent contractor[42] from

[42]See text accompanying footnote 101.

whom the REIT itself does not derive or receive any income). Property is not treated as used in a trade or business by reason of activities that produce rents from real property.

(d) Election required. Property is treated as foreclosure property only if the REIT so elects in the manner provided in regulations on or before the due date (including extensions) for filing its return for the taxable year in which the REIT acquires such property. A REIT may revoke any such election for a taxable year by filing the revocation (in the manner provided by the Secretary of the Treasury) on or before the due date (including extensions) for filing its return for the taxable year. A revocation prevents re-election with respect to the same property.

(e) There is a special foreclosure property rule for certain qualified health care properties. See Code Section 856(e)(6).

(ix) Interest.

(a) Interest includes only amounts which constitute compensation for the use or forbearance of money. For example, a fee received or accrued by a lender which is in fact a charge for services performed for a borrower rather than a charge for the use of borrowed money is not interest. Treasury Regulations Section 1.856-5(a).

(b) Disqualification of amounts based on income or profits. Interest does not include any amount received or accrued directly or indirectly the determination of which depends in whole or in part on the income or profits of any person, except for amounts based on a fixed percentage or percentages of receipts or sales. Code Section 856(f). If a loan provides for both a fixed amount of interest and a percentage of the borrower's income or profits, neither the fixed interest nor the amount based upon the percentage will qualify as interest. Treasury Regulations Section 1.856-5(b).

(c) Apportionment of amounts based indirectly on income or profits. If an amount is treated as not being interest because of the indirectly rule (i.e., the debtor of the REIT receives or accrues any amount the determination of which depends in whole or in part on the income or profits of any person), only a proportionate part of the amount received or accrued by the REIT from the debtor will be excluded from the term interest. Code Section 856(f). Under Treasury Regulations Section 1.856-5(d), the proportionate part that is non-qualified is the lesser of:

(1) The amount received or accrued from the debtor that is based on a fixed percentage or percentages of receipts or sales, or

(2) A fraction of the total amount received or accrued from the debtor. The numerator is the amount of receipts or sales of the debtor that is based, in whole or in part, on the income or profits of any person and the denominator is the total amount of the receipts or sales of the debtor. The only receipts or sales to be taken into account are those taken into account in determining the payment to the REIT pursuant to the loan agreement.

(d) Apportionment where there is mix of real and other property security. Under Treasury Regulations Section 1.856-5(c), where a mortgage covers both real and other property, an apportionment of the interest income must be made for purposes of the 75% income test, as follows:

(1) If the loan value[43] of the real property is equal to or exceeds the amount of the loan, then the entire interest income is to be apportioned to the real property.

(2) If the amount of the loan exceeds the loan value of the real property, then the interest income apportioned to the real property is an amount equal to the interest income multiplied by a fraction, the numerator of which is the loan value of the real property, and the denominator of which is the amount of the loan. The interest income apportioned to the other property is an amount equal to the excess of the total interest income over the interest income apportioned to the real property.

(3) The amount of the loan means the highest principal amount of the loan outstanding during the taxable year.

(e) Special rule for property leased by debtor. If a REIT receives or accrues with respect to an obligation secured by a mortgage on real property or an interest in real property amounts from a debtor which derives substantially all of its gross income with respect to such property (not taking into account any gain on any disposition) from the leasing of

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[43] The loan value of the real property is the fair market value as of the date on which the commitment to make the loan becomes binding. If the loan is purchased, the loan value is the fair market value as of the date on which the commitment to purchase becomes binding. However, in the case of a construction loan, loan value is the fair market value (determined as of the date the loan commitment is binding) of the land plus the reasonably estimated cost of the improvements or developments (other than personal property) which will secure the loan and which are to be constructed from the proceeds of the loan. If the REIT commits itself to provide long-term financing following completion of construction, loan value is determined by using the principles for determining the loan value for a construction loan. Moreover, if the mortgage on the real property is given as additional security (or as a substitute for other security) for the loan after the REIT's commitment is binding, the loan value is its fair market value when it becomes security for the loan (or, if earlier, when the borrower makes a binding commitment to add or substitute the property as security).

substantially all of its interests in such property to tenants, and a portion of the amount which such debtor receives or accrues, directly or indirectly, from tenants consists of qualified rents, as defined in Code Section 856(d)(6)(B),[44] then the amounts which the REIT receives or accrues from such debtor are not excluded from the term interest by reason of being based on the income or profits of such debtor to the extent the amounts so received are attributable to qualified rents received or accrued by such debtor.

(f) Interest income generated by a wrap-around mortgage is only the portion of interest attributable to funds actually advanced by the REIT. See Rev. Rul. 75-99, 1975-1 C.B. 197. The IRS has issued a number of rulings as to the types of interest qualifying under the 95% and 75% income tests.

(x) Qualified temporary investment income. Code Section 856(c)(5)(D). Qualified temporary investment income generally means any income which is attributable to stock or a debt instrument, within the meaning of Code Section 1275(a)(1), and which is attributable to the temporary investment of new capital, and is received or accrued during the 1-year period beginning on the date on which the REIT receives such capital. New capital means any amount received by the REIT in exchange for stock (other than amounts received pursuant to a dividend reinvestment plan), or in a *public offering* of debt obligations of such REIT which have maturities of at least 5 years. This gives the REIT a grace period to deploy newly raised capital, but note the limitation to publicly offered debt.

(xi) Taxable REIT Subsidiary (TRS). Code Section 856(l).

(a) Purpose of TRS rule. A TRS can engage in certain business activities that could disqualify the REIT if engaged in other than through a TRS because such activities could prevent certain income from qualifying as rents from real property. Specifically, a TRS can provide services to

[44] Any amount which would be treated as rents from real property if received by the REIT.

tenants of REIT property (even if such services were not considered services customarily furnished in connection with the rental of real property), 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. Further, rents paid to a REIT generally are not qualified rents if the REIT owns (directly, indirectly or through special attribution rules) more than 10% of the value, (as well as of the vote) of a corporation paying the rents. There are, however, limited exceptions for rents that are paid by a TRS.[45] In addition, a TRS cannot directly or indirectly operate or manage a "lodging" or "healthcare" facility.[46]

(b) Thus, the TRS provisions enable the REIT to preserve its REIT status at the price of the income of the TRS being subject to corporate level tax (like any other C corporation). REITs will still want to determine carefully which income would be qualifying income if received directly by the REIT, because they will not want to subject otherwise qualifying income to corporate tax unnecessarily.

(c) Interest paid or accrued by a TRS to a REIT is subject to the earnings-stripping rules of Code Section 163(j). See Code Section 163(j)(3)(C) which includes interest paid or accrued (directly or indirectly) by a TRS to a REIT as "disqualified interest." Accordingly, if a TRS meets the

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[45] See discussion in section IV.B.2(ii) below.

[46] The term "lodging facility" means a hotel, motel, or other establishment more than one-half of the dwelling units in which are used on a transient basis. See Code Section 856(d)(9)(D)(ii). The term "health care facility" means a hospital, nursing facility, assisted living facility, congregate care facility, qualified continuing care facility (as defined in Code Section 7872(g)(4)), or other licensed facility which extends medical or nursing or ancillary services to patients and which, immediately before the termination, expiration, default, or breach of the lease of or mortgage secured by such facility, was operated by a provider of such services which was eligible for participation in the medicare program under title XVIII of the Social Security Act with respect to such facility. See Code Section 856(e)(6)(D)(ii).

applicable thresholds under Code Section 163(j), i.e., if the TRS's debt to net equity ratio exceeds 1.5:1 and its net interest expense exceeds 50% of its adjusted taxable income (before interest expense, depreciation, and NOLs), any interest paid or accrued to the REIT by the TRS, to the extent of the TRS's excess interest expense for the taxable year, would not be deductible.

(d) As noted above, a REIT's ownership interest in a TRS is subject to a more relaxed asset test than the one generally applicable to other non-Government securities.

(e) In general, a taxable REIT subsidiary ("TRS") is a corporation (other than a REIT or a qualified REIT subsidiary) in which the REIT directly or indirectly[47] owns stock and for which the REIT and the corporation jointly elect treatment as a taxable REIT subsidiary.[48] Thus, the REIT need not own any stock directly, and any level of indirect stock ownership is sufficient to permit a TRS election.

(f) Revocation of a TRS election requires consent of both the REIT and the TRS, but not of the IRS.

(g) If a TRS owns directly or indirectly securities possessing more than 35% of the total voting power of the outstanding securities of another corporation (other than a REIT or a qualified REIT subsidiary), or securities having a value of more than 35% of the total value of the outstanding securities of another corporation, that corporation is also automatically a TRS without the need for an election.[49] (For

[47] See Private Letter Ruling 200234054, May 21, 2002, illustrating that no direct stock ownership is required. In that ruling, the REIT's operating partnership owned less than 5% of a non-TRS corporation that owned 100% of the TRS.

[48] The election is made on Form 8875. Announcement 2001-17, February 20, 2001.

[49] However, the IRS requires that an attachment must be made to the Form 8875 containing a statement with the name and EIN of the subsidiary corporation that is to be treated as an automatic TRS of the

purposes of the value test, certain safe harbors and partnership debt instruments do not constitute "securities," as described further below.)

(h) Certain entities cannot be a TRS:

(1) any corporation which directly or indirectly operates or manages a lodging facility or a health care facility, and

(2) any corporation which directly or indirectly provides to any other person (under a franchise, license, or otherwise) rights to any brand name under which any lodging facility or health care facility is operated.[50]

(xii) Securities. Neither the Code nor the Treasury Regulations specifically define "securities" for purposes of the REIT rules. As discussed below, terms not defined in the REIT provisions have the same meaning as when used in the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 and following). Code Section 856(c)(5)(F). Thus, "securities" for

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REIT. In addition, if at the time that a TRS election is filed on Form 8875, the TRS directly or indirectly owned less than 35% of the total voting power or value of the outstanding securities of the subsidiary corporation and subsequently acquires securities in that corporation that results in an ownership interest of 35% or more, the TRS and REIT that filed Form 8875 must file a copy of Form 8875 marked "Automatic Taxable REIT Subsidiary" at the top of the form and attach a statement including the name and EIN of the new lower tier TRS. The new Form 8875 must be filed in the same manner as the original Form 8875 within 30 days of the end of the quarter of the REIT's tax year in which the lower tier corporation became a TRS. See General Instructions to Form 8875, Line 16.

[50] This exception does not apply to rights provided to an eligible independent contractor to operate or manage a lodging facility if such rights are held by such corporation as a franchisee, licensee, or in a similar capacity and such lodging facility is either owned by such corporation or is leased to such corporation from the real estate investment trust.

purposes of the REIT rules generally has the same meaning as when used in the Investment Company Act of 1940. The Treasury Regulations do state that the term "securities" does not include "interests in real property" or "real estate assets." Treasury Regulations Section 1.856-3(e).[51]

7. Definitions of other terms related to income and assets tests.

(i) Shared Appreciation Mortgages. In applying the income and assets tests, and the rules on prohibited transactions (discussed in section VI below), any income derived from a shared appreciation provision is not treated as interest, but rather is treated as gain recognized on the sale of the secured property (i.e., the real property or interest in real property that secures the obligation held by the REIT).[52]

(a) For this purpose, the REIT is treated as holding the secured property for the period during which the REIT held the shared appreciation provision (or, if shorter, for the period during which the secured property was held by the person holding such property).

(b) The secured property is treated as dealer property if it is dealer property in the hands of the person holding the secured property (or would be if held by the REIT).

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[51] See also Code Sections 856(c)(4)(B)(i) and 856(c)(4)(B)(iii) (for purposes of the 25% asset test and the 5% and 10% asset tests, securities described under Code Section 856(c)(4)(A), i.e., securities that are otherwise treated as real estate assets, are excluded). Although Code Section 856(c)(4)(B)(ii) (the TRS 25% asset test) does not specifically excluded securities described under Code Section 856(c)(4)(A), the IRS has ruled in a private letter ruling that for purposes of the then-20% asset test, "securities" do not include securities that are otherwise treated as real estate assets. See Private Letter Ruling 200630010, Aug. 14, 2006. See also footnote 32 and accompanying text.

[52] Code Section 856(j).

(c) For purposes of the prohibited transactions safe harbor in Code Section 857(b)(6)(C), the REIT is treated as having sold the secured property when it recognizes any income from the shared appreciation provision, and any expenditures made by any holder of the secured property are treated as made by the REIT. Further, the REIT is treated as having held such property for at least 4 years if the sale is required by the court or is pursuant to a plan approved by the court in a bankruptcy of the seller, unless the secured property was acquired by the seller with the intent to evict or foreclose, or the REIT knew or had reason to know that default on the obligation would occur.

(d) Shared appreciation provision defined. Shared appreciation provision is defined as any provision which is in connection with an obligation which is held by the REIT and is secured by an interest in real property, and which entitles the REIT to receive a specified portion of any gain realized on the sale or exchange of such real property (or of any gain which would be realized if the property were sold on a specified date) or appreciation in value as of any specified date.

(ii) Interests in REMICs. Code Section 856(c)(5)(E). A regular or residual interest in a REMIC is treated as a real estate asset, and any amount includible in gross income with respect to such an interest is treated as interest on an obligation secured by a mortgage on real property; except that, if less than 95% of the assets of such REMIC are real estate assets (determined as if the REIT held such assets), such REIT is treated as holding directly (and as receiving directly) its proportionate share of the assets and income of the REMIC. Generally, any interest held by a REMIC in another REMIC is treated as a real estate asset under similar principles, except that, REMICs that are part of a tiered structure are treated as one REMIC. See also Treasury Regulations Section 1.856-3(b)(2).

(iii) Certain hedging transactions. Code Section 856(c)(5)(G).

(a) Except to the extent provided by regulations, any income of a REIT from a hedging transaction (as defined in Code Section 1221(b)(2)(A)(ii) or (iii)) which is clearly identified pursuant to Code Section 1221(a)(7), including gain from the sale or disposition of such a transaction, shall not constitute gross income under the 95% gross income test to the extent that the transaction hedges any indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets. For transactions entered into after July 30, 2008, such REIT income from a hedging transaction is also excluded from gross income under the 75% gross income test.[53] Code Section 1221(b)(2)(A)(ii) and (iii) provide that the term "hedging transaction" means any transaction entered into by the REIT in the normal course of the REIT's trade or business primarily to manage the risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the REIT, or to manage such other risks as the IRS may prescribe in regulations. Code Section 1221(a)(7) requires any hedging transaction to be 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 IRS may prescribe in regulations). Note that under Treasury Regulations Section 1.1275-6, if the hedge is integrated with the debt instrument, they are generally treated as a single synthetic debt instrument, income from which or deductions attributable to which will simply be treated as part of the interest on the synthetic debt instrument.[54]

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[53] Code Section 856(c)(5)(G)(i), as amended by the Housing and Economic Recovery Act of 2008, Sec. 3031(b).

[54] A detailed discussion of the tax rules governing the integration of a hedge with a "qualifying debt instrument" (as defined in Treasury Regulations Section 1.1275-6(b)(1)) is beyond the scope of this outline. However, it should also be noted that if a REIT can integrate a qualifying debt instrument it owns that otherwise satisfies the 95% and 75% gross income tests and the REIT asset tests with a qualifying hedge, then the resulting synthetic debt instrument should also satisfy the 95% and 75% gross income tests and the REIT asset tests and the hedge will not be separately tested for REIT qualification purposes. In addition, due to certain conditions and requirements which must be satisfied in order to integrate a debt instrument with a hedge under Treasury Regulations Section 1.1275-6, it appears that a REIT would be prevented from using the integration rules to exclude speculative hedges for purposes of the 95% and 75% gross income tests and the REIT asset tests.

(b) In addition, for transactions entered into after July 30, 2008, income of a REIT from a transaction entered into by the REIT primarily to manage risk of currency fluctuations with respect to any item of income or gain that would be qualifying income under the 95% or 75% gross income tests (or any property which generates such income or gain), shall not constitute gross income under the 95% or 75% gross income tests, provided that the 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 IRS may prescribe).[55]

(iv) Safe Harbor Provisions. Code Section 856(m)(1). This section provides certain safe harbor provisions in applying the assets test, specifically in applying the requirement that the REIT must not hold non-Government securities that are not otherwise treated as real estate assets having a value of more than 10% of the total value of the outstanding securities of any one issuer (Code Section 856(c)(4)(B)(iii)(III)). Under the safe harbor provisions, the following are not considered securities held by the REIT: "straight debt" securities of an issuer which meet certain requirements, described further below; any loan to an individual or estate; certain rental agreements; any obligation to pay rents from real property; any security issued by a State or any political subdivision thereof, the District of Columbia, a foreign government or any political subdivision thereof, or the Commonwealth of Puerto Rico, but only if the determination of any payment received or accrued under such security does not depend in whole or in part on the profits of any entity not described in this category or payments on any obligation issued by such an entity; any security issued by a REIT; and any other arrangement as identified by the IRS. For this purpose, "straight debt" is defined as it is for S corporations in Code Section 1361(c)(5) (without regard to subparagraph (B)(iii) thereof).[56]

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[55] Code Section 856(c)(5)(G)(ii), as amended by the Housing and Economic Recovery Act of 2008, Sec. 3031(b).

[56] Under the applicable portions of Code Section 1361(c)(5), the definition of straight debt would be any written unconditional promise to

(a) Special rules relating to certain contingencies. Any interest or principal will not be treated as failing to satisfy Code Section 1361(c)(5)(B)(i), which disallows certain contingent payments, solely by reason of the fact that—

(1) the time of payment of such interest or principal is subject to a contingency, but only if:

(i) any such contingency does not have the effect of changing the effective yield to maturity, as determined under Code Section 1272, other than a change in the annual yield to maturity which does not exceed the greater of one fourth of 1% or 5% of the annual yield to maturity, or

(ii) neither the aggregate issue price nor the

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pay on demand or on a specified date a sum certain in money, if (i) the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors, and (ii) there is no convertibility (directly or indirectly) into stock. See also Treasury Regulations Section 1.1361-1(l)(5), which (x) clarify that the written unconditional obligation need not be embodied in a formal note, (y) add contingency on payment of dividends on common stock to the list of impermissible contingencies and (z) clarify that subordination of the straight debt to other debt of the borrower is not fatal.

aggregate face amount of the issuer's debt instruments held by the trust exceeds \$1,000,000 and not more than 12 months of unaccrued interest can be required to be prepaid thereunder, or

(2) the time or amount of payment is subject to a contingency upon a default or the exercise of a prepayment right by the issuer of the debt, but only if such contingency is consistent with customary commercial practice.

(b) Special rules relating to corporate or partnership issuers. Securities of certain corporate or partnership issuers that otherwise would be permitted to be held without limitation under the straight debt rules will not be so permitted if the REIT holding such securities, and any of its TRSs, holds any securities of the issuer which are not permitted securities and have an aggregate value greater than 1% of the issuer's outstanding securities, without regard to the look-through rules for partnerships in Code Section 856(m)(3)(A)(i), described below.

(v) Partnership Securities. Code Section 856(m)(3). For purposes of applying the requirement that the REIT must not hold non-Government securities that are not otherwise treated as real estate assets having a value of more than 10% of the total value of the outstanding securities of any one issuer (Code Section 856(c)(4)(B)(iii)(III)), a REIT's interest as a partner in a partnership (as defined in Code Section 7701(a)(2)) shall not be considered a security, and for purposes of applying the 10% value test to the securities owned by a partnership in which the REIT owns an interest, the REIT will be deemed to own its proportionate share of each of the assets of the partnership. The REIT's interest in the partnership assets will be the REIT's proportionate interest in any securities issued by the partnership (determined without regard to Code Sections 856(m)(3)(A)(i) and 856(m)(4), but not including securities described in Code Section 856(m)(1)), and the value of any debt instrument shall be the adjusted issue price thereof, as defined in Code Section 1272(a)(4).

(vi) Certain Partnership Debt Instruments. Code Section 856(m)(4). For purposes of applying the requirement that the REIT must not hold non-Government securities that are not otherwise treated as real estate assets having a value of more than 10% of the total value of the outstanding securities of any one issuer (Code Section 856(c)(4)(B)(iii)(III)), any debt instrument issued by a partnership and not already described under the safe harbor provisions will not be considered a security to the extent of the REIT's interest as a partner in the partnership. Also, any debt instrument issued by a partnership and not already described under the safe harbor provisions will not be considered a security if at least 75% of the partnership's gross income (excluding gross income from prohibited transactions) is derived from sources referred to in Code Section 856(c)(3), such as rents, dividends, interest, etc.

(vii) Undefined Terms. Terms not defined in the REIT provisions have the same meaning as when used in the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 and following). Code Section 856(c)(5)(F).

8. Relief provisions related to the income tests. Code Section 856(c)(6). A REIT which fails to meet the requirements of the 95% or the 75% income test, or both, for any taxable year is nevertheless considered to have satisfied those requirements, if:

(i) following the REIT's identification of the failure to meet the requirements of the 95% or the 75% income test, or both, for any taxable year, a description of each item of its gross income described in such tests is set forth in a schedule for such taxable year filed in accordance with regulations prescribed by the Secretary; and

(ii) the failure to meet the requirements of the 95% or the 75% income test, or both, is due to reasonable cause and not due to willful neglect.[57]

Even if these relief provisions apply, however, a tax is imposed upon the profit attributable to the amount by which the REIT fails to satisfy the particular gross income test. See discussion in section VI.D. below.

9. Operating rules and relief provisions related to asset tests.

(i) A REIT which meets the assets tests requirements at the close of any quarter will not lose its status as a REIT solely because of a discrepancy[58] during a subsequent quarter between the value of its various investments and such requirements unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition.[59] A REIT which does not meet such requirements at the close of any quarter by reason of a discrepancy existing immediately after the acquisition of any security or other property which is wholly or partly the result of such acquisition during such quarter will not lose its status as a REIT for such quarter if such discrepancy is eliminated within 30 days after the close of such quarter and in such cases it is considered to have met

[57] Treasury Regulations Section 1.856-7 sets forth details regarding the required contents of schedules and what constitutes reasonable cause, including reliance on expert advice and opinions.

[58] For purposes of this rule, a discrepancy includes any discrepancy that arises solely by change in the foreign currency exchange rate used to value a REIT's foreign asset. Code Section 856(c)(4)(B)(iii)(III), as amended by the Housing and Economic Recovery Act of 2008, Sec. 3032(a).

[59] A stock split is not an acquisition for this purpose. However, receipt of stock of an acquiring company in a reorganization is an acquisition for this purpose. Rev. Rul. 74-133, 1974-1 C.B. 165.

such requirements at the close of such quarter for purposes of applying this rule. Code Section 856(c)(4) (flush language).[60]

(a) In order to determine the effect, if any, which an acquisition of any security or other property may have with respect to the status of an entity as a REIT, Code Section 856(c)(4) requires a revaluation of the REIT's assets at the end of the quarter in which such acquisition was made. A revaluation of assets is not required at the end of any quarter during which there has been no acquisition of a security or other property since the mere change in market value of property held by the REIT does not, of itself, affect the status of the entity as a REIT. A change in the nature of cash items, for example, the prepayment of insurance or taxes, does not constitute the acquisition of other property for purposes of this rule. Treasury Regulations Section 1.856-2(d)(3).[61]

(b) See also examples in Treasury Regulations Section 1.856-2(d)(4).

(1) Example 4 illustrates that acquisition of any new security, including an additional amount of a security already held, requires a revaluation of all assets if a discrepancy exists immediately after the acquisition and is wholly or partly the result of such acquisition (25% value test).

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[60] This relief, as well as the rule that the mere change in market value of property held by the REIT does not, of itself, affect the status of the entity as a REIT, is available only if the REIT has met the asset tests for at least one previous quarter without relying on these relief provisions. Rev. Rul. 72-83, 1972-1 C.B. 205.

[61] A REIT must keep sufficient records as to investments so as to be able to show that it has complied with the provisions of Code Section 856(c)(4) during the taxable year. Such records must be kept at all times available for inspection by any internal revenue officer or employee and must be retained so long as the contents thereof may become material in the administration of any internal revenue law. Treasury Regulations Section 1.856-2(d)(3).

(2) Example 5 illustrates a situation where an acquisition occurs, but the discrepancy is solely the result of a value change (5% value test). The principle of this example has been applied in private letter rules to other value tests, as well.

(c) As described above, the Tax Relief Extension Act of 1999 made various changes to Code Section 856(c)(4)(B), including adding Code Section 856(c)(4)(B)(iii)(III) which requires with respect to non-Government securities (other than securities in a TRS) that the REIT must not hold securities having a value of more than 10% of the total value of the outstanding securities of any one issuer.

(1) Query: is it clear the rule providing that a REIT will not lose its status as a REIT because of a discrepancy resulting solely from a value change will apply if securities held by the REIT violate this new value test because of changes in the relative value of outstanding securities of the issuer or a reduction in the outstanding securities of the issuer? See Private Letter Ruling 9237022,[62] June 12, 1992, discussed above, regarding a similar issue for purposes of the 10% limit on voting securities.

(2) See also Private Letter Ruling 200234054, May 21, 2002 approving a trust structure designed to protect a REIT from violating Code Section 856(c)(4)(B)(iii)(III). In this structure (analogous to the structure for excess share provisions, discussed above), the REIT operating partnership ("Partnership") and the REIT's management company ("Management"), a C corporation, established a "Trust" with the Partnership as trustee and Management as sole beneficiary. The Trust's estate is defined under its declaration of trust to consist of all assets that the Partnership could not own without causing the REIT to violate the 10% limitation set forth in Code Section 856(c)(4)(B)(iii)(III). Pursuant to the terms of the Trust, any such property that otherwise would be considered to be owned by the Partnership or any subsidiary is deemed automatically, and without

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[62] See text accompanying footnote 33.

the need for further action by the Partnership or the relevant subsidiary, to have been transferred to the Trust on the day before the last day of the applicable calendar quarter. Under the terms of the Trust, Management, as the sole beneficiary, can demand the payment of the Trust's income and principal at any time. For federal income tax purposes, all income of the Trust will be reported on the tax returns of Management. Accordingly, any income attributable to any assets that are determined to have been transferred to the Trust will be subject to corporate income tax as income of Management. The IRS concluded that for purposes of Code Section 856(c)(4)(B)(iii)(III), any assets that otherwise would be treated as owned by the Company in violation of that prohibition are owned by the Trust for the exclusive benefit of Management and are not owned by the Company. This conclusion was based on the following: the Company represented that it had been advised by counsel that the terms of the Trust are enforceable under state C law; Company, the Partnership and Management have and will continue to use their best efforts to enforce the provisions of the Trust and to give effect to all transfers required pursuant to the terms of the Trust; and, the Company represented that it will monitor the composition of its assets so as to ensure that the Trust is in compliance with the various REIT asset tests and review the composition of its assets not less frequently than on a quarterly basis. However, it does not appear that the IRS is willing to continue to provide Private Letter Rulings regarding "protective trust" structures in view of the enactment of relief provisions for violations of the REIT asset tests, discussed immediately below.

(ii) Relief provisions related to the asset tests. Code Section 856(c)(7).

(a) In General. A REIT which fails to meet any of the asset tests for a particular quarter (other than certain de minimis failures of the 5% or 10% asset tests, as described below) will nevertheless be considered to have satisfied the requirements of the tests for such quarter if:

(1) following its identification of the failure, the REIT files a schedule with a description of each asset that caused the failure;

(2) the failure was due to reasonable cause and not to willful neglect; and

(3) the REIT disposes of the assets within 6 months after the last day of the quarter in which the identification occurred (or such other time period prescribed by the Treasury) or the requirements of the rules are otherwise met within such period.

The REIT is required to pay a tax on such failures equal to the greater of $50,000 or an amount determined by multiplying the highest rate of tax for corporations, under Code Section 11, by the net income generated by the assets for the period beginning on the first date of the failure and ending on the date the REIT has disposed of the assets or otherwise satisfy the requirements. Such tax will be treated as an excise tax.

(b) De minimis failures of the 5% and 10% Asset Tests. A REIT which fails to meet the requirements of the 5% or the 10% asset tests for a particular quarter will nevertheless be considered to have satisfied the requirements of the tests for such quarter if:

(1) the failure is due to the ownership of assets the total value of which does not exceed the lesser of (i) 1% of the total value of the REIT's assets at the end of the quarter for which such measurement is done, or (ii) $10,000,000; and

(2) the REIT, following the identification of such failure, either disposes of the assets within 6 months after the last day of the quarter in which it identifies the failure (or such other time period prescribed by the IRS and in a manner prescribed by the IRS), or otherwise meets the requirements of the tests by the end of such time period.

(iii) Look through rule for partnerships. In the case of a REIT which is a partner in a partnership, as defined in Code Section 7701(a)(2) and the regulations thereunder, the REIT will be deemed to own its proportionate share of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share.

(a) For purposes of Code Section 856, the interest of a partner in the partnership's assets is determined in accordance with his capital interest in the partnership.[63] The character of the various assets in the hands of the partnership and items of gross income of the partnership retains the same character in the hands of the partners for all purposes of Code Section 856. Thus, for example, if the REIT owns a 30% capital interest in a partnership which owns a piece of rental property the REIT will be treated as owning 30% of such property and as being entitled to 30% of the rent derived from the property by the partnership.[64] Similarly, if the partnership holds any property primarily for sale to customers in the ordinary course of its trade or business, the REIT will be treated as holding its proportionate share of such property primarily for such purpose. Also, for example, where a partnership sells real property or a REIT sells its interest in a partnership which owns real property, any gross income realized from such sale, to the extent that it is attributable to the real property, is deemed gross income from the sale or disposition of real property held for either the period that the partnership has held the real property or the period that the REIT was a member of the partnership, whichever is the shorter. Treasury Regulations Section 1.856-3(g).[65]

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[63] However, as discussed above, for purposes of the 10% value test, the REIT will be deemed to own its proportionate share of each of the assets of the partnership determined by the REIT's proportionate interest in any securities issued by the partnership (other than certain excluded securities). See discussion in section III.G.7(v) above.

[64] Thus, this rule is not based on income allocated to the REIT by the partnership under Code Section 704(b).

[65] The IRS has also privately ruled that where a REIT makes a loan to a partnership in which the REIT is a member, payments on the loan from the partnership to the REIT are not treated as separate items of income or assets by the REIT to the extent such payments are reflected in the REIT's income and

(b) Note: because of the prevalence of UPREIT structures (discussed in section IX below), this look through rule takes on great importance in advising REIT clients.[66]

H. Must satisfy the distribution and earnings and profits requirements (Code Section 857(a), Code Sections 561 through 565).

1. Required amount of distributions. Code Section 857(a)(1). The REIT provisions do not apply to an entity for a taxable year unless the deduction for dividends paid (determined without regard to capital gains dividends) during the taxable year equals or exceeds:

(i) the sum of

(a) 90% of the real estate investment trust taxable income for the taxable year (determined without regard to the deduction for dividends paid and by excluding any net capital gain[67]); and

(b) 90% of the excess of the net income from foreclosure property over the tax imposed on such income by Code Section 857(b)(4)(A); *minus*

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assets as derived from its capital interest in the partnership. Private Letter Ruling 200740004, October 5, 2007. This prevents double counting of income since the REIT is required under Treasury Regulations Section 1.856-3(g) to account for its proportionate share of the partnership's income and assets.

[66] The IRS has issued a number of Private Letter Rulings (see, e.g., Private Letter Ruling 9452032), holding that a REIT's share of income of a service partnership is ignored for purposes of the income and assets tests to the extent attributable to services provided by the service partnership to the REIT or its operating partnership.

[67] The term "net capital gain" means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the taxable year. Treasury Regulations Section 1.856-3(h).

(ii) any excess noncash income.

2. Relief provisions for required distributions. The Secretary of the Treasury may waive the distribution requirements of Code Section 857(a)(1) for any taxable year if the REIT establishes to the satisfaction of the Secretary that it was unable to meet such requirements by reason of distributions previously made to meet the REIT excise tax requirements of Code Section 4981, discussed below.

3. Excess non-cash income.

(i) Relief is provided under this rule for a limited amount and limited types of noncash income. Excess noncash income means the excess (if any) of the amount computed below over 5% of the real estate investment trust taxable income for the taxable year.

(ii) This amount is computed as the sum of the following:

(a) Increased income inclusions resulting from the application of Code Section 467,

(b) any income resulting from a determination[68] that a disposition of a real estate asset is not eligible for nonrecognition under Code Section 1031 if failure to meet the requirements of Code Section 1031 was due to reasonable cause and not to willful neglect,

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[68] As defined in Code Section 860(e): (1) a decision by the Tax Court, or a judgment, decree, or other order by any court of competent jurisdiction, which has become final; (2) a closing agreement made under section 7121; (3) under regulations prescribed by the Secretary, an agreement signed by the Secretary and by, or on behalf of, the qualified investment entity relating to the liability of such entity for tax; or (4) a statement by the taxpayer attached to its amendment or supplement to a return of tax for the relevant tax year. See Treasury Regulations Section 1.860-2(b).

(c) the amount (if any) by which gross income inclusions under the REMIC excess inclusion rules (Code Section 860E(a)) or the original issue discount rules (Code Section 1272) exceed the amount of money and the fair market value of other property received during the taxable year under such instruments, and

(d) amounts includible in income by reason of cancellation of indebtedness.

4. Earnings and profits requirement. Code Section 857(a)(2). The REIT provisions do not apply to an entity for a taxable year unless, either:

(i) The entity qualified as a REIT for all taxable years beginning after February 28, 1986,[69] or

(ii) As of the close of the taxable year, the REIT has no earnings and profits accumulated in any non-REIT year.[70] Under Treasury Regulations Section 1.857-11(c) distribution procedures similar to those for regulated investment companies in Code Section 852(e) apply to non-REIT earnings and profits of REITs.[71]

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[69] If a REIT qualifies under this rule and acquires the assets of a REIT that does not so qualify, it must make distributions of the earnings and profits of the acquired company. Treasury Regulations 1.857-11. This would occur, for example, where a C corporation merges into a REIT in a tax-free reorganization under Code Section 368.

[70] Under Treasury Regulations 1.857-11(b)(2), this rule does not apply to earnings and profits that by the operation of Code Section 381 pursuant to a transaction that occurred before December 22, 1992, became the earnings and profits of a corporation to which part II of subchapter M applied and, at all times thereafter, were the earnings and profits of a corporation to which part II of subchapter M applied.

[71] The tax treatment of distributions made to comply with this requirement is specified in Code Section 857(d)(3).

5. Dividends paid deduction. In general, the dividends paid deduction consists of dividends paid during the taxable year[72] plus consent dividends for the taxable year. Code Section 561(a).

6. Dividends eligible for dividends paid deduction.

(i) Generally, for purposes of the dividends paid deduction, "dividend" includes only dividends described in Code Section 316 (relating to definition of dividends for purposes of corporate distributions).[73] Code Section 562(b)(1) provides special rules for determining the dividends paid deduction in connection with a liquidation. See also Treasury Regulations Section 1.562-1(a) and (b).

(a) For all REITs, it appears that a stock distribution treated as a Section 301 distribution pursuant to Section 305 would be a way to preserve cash and meet distribution requirements. See, e.g., Private Letter Ruling 200817031, April 25, 2008, and Private Letter Ruling 200832009, August 8, 2008 (in each of these two private letter rulings, shareholders of the REIT could choose whether to receive a distribution from the REIT in REIT stock, cash or a combination of the two and a shareholder's choice could be adjusted in order for the REIT to limit the amount of total cash distributed to no more than 20% of the proposed distribution); see also Rev. Rul. 76-328, 1976-2 C.B. 216.

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[72] A dividend is generally considered paid when received by the shareholder. See Treasury Regulations 1.561-2 for detailed rules regarding when a dividend is considered paid and records required to be kept by the REIT.

[73] Code Section 562(e) provides that in the case of a REIT, in determining the amount of dividends under Code Section 316 for purposes of computing the dividends paid deduction, the earnings and profits of such REIT for any taxable year beginning after December 31, 1980, shall be increased by the total amount of gain (if any) on the sale or exchange of real property by such REIT during such taxable year.

(b) For publicly-traded REITs, the IRS issued Rev. Proc. 2008-68, 2008-52 I.R.B., Dec. 10, 2008, providing temporary guidance regarding certain stock distributions. Effective January 1, 2008 and for taxable years ending on or before December 31, 2009, the IRS will treat a distribution of stock by a publicly traded REIT pursuant to certain elections to receive stock or cash as a taxable distribution of property in an amount equal to the amount of cash that could have been received instead. Under Rev. Proc. 2008-68, REITs can limit the aggregate amount of cash available to shareholders pursuant to the election to 10% of the aggregate distribution of cash and stock taken together. In addition, it should be noted that Rev. Proc. 2008-68 does not address the preferential dividend rules of Code Section 562(c), which a REIT must be considered prior to relying on taxable stock distribution to meet its distribution requirements.

(ii) Preferential dividend not eligible.

(a) Code Section 562(c) provides that the amount of any distribution is not considered as a dividend for purposes of computing the dividends paid deduction, unless such distribution is pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class except to the extent that the former is entitled (without reference to waivers of their rights by shareholders) to such preference.

(b) Treasury Regulations 1.562-2 amplifies the statute by providing that the limitation imposed by Code Section 562(c) is unqualified, except in the case of an actual distribution made in connection with a consent distribution under Code Section 565, if the entire distribution composed of such actual distribution and consent distribution is not preferential. Thus, it appears that where there is a combination of actual distributions and consent distributions, the preferential distribution rule is applied to the aggregate distributions.

(1) The existence of a preference is sufficient to prohibit the deduction regardless of the fact (a) that such preference is authorized by all the shareholders of the corporation or (b) that the part of the distribution received by

the shareholder benefited by the preference is taxable to him as a dividend.

(2) A corporation will not be entitled to a deduction for dividends paid with respect to any distribution upon a class of stock if there is distributed to any shareholder of such class (in proportion to the number of shares held by him) more or less than his pro rata part of the distribution as compared with the distribution made to any other shareholder of the same class.

(3) Nor will a corporation be entitled to a deduction for dividends paid in the case of any distribution upon a class of stock if there is distributed upon such class of stock more or less than the amount to which it is entitled as compared with any other class of stock. A preference exists if any rights to preference inherent in any class of stock are violated.

(4) The disallowance, where any preference in fact exists, extends to the entire amount of the distribution and not merely to a part of such distribution. For these purposes, the term distribution includes a dividend as defined in subchapter C, chapter 1 of the Code, and a distribution in liquidation referred to in Code Section 562(b).

(5) Examples in the regulations illustrate the strictness of the rule. Example 1 holds that dividends of the same amount paid on different dates to different shareholders are preferential. Example 2 holds that a partial redemption of 3 out of 4 shareholders (which apparently did not qualify for exchange treatment under Section 302) was preferential. Example 3 illustrates that differences in distributions based on different classes of stock (preferred and common) are permissible, but only if the distributions adhere strictly to the entitlements provided for the different classes.[74]

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[74] Regarding permissibility of multiple classes of shares, see Rev. Ruls. 69-610, 1969-2 C.B. 149, 71-405, 1971-2 C. B. 263 and 89-81, 1989-1 C. B. 226.

(6) Sometimes a REIT may need to consider carefully what will qualify as separate classes of stock, since only separate classes of stock justify differences in distributions.

(7) The IRS takes the position that any preferential dividend which is not allowable as a deduction in computing the REIT's taxable income would also not reduce the REIT's earnings and profits for that tax year.[75]

(c) Properly structured excess share provisions and other provisions designed to police the close-held requirement and 100 shareholder requirement do not violate preferential dividends prohibition.

(d) Dividends paid under a properly structured dividend reinvestment plan with a maximum discount of 5% qualify for the dividends paid deduction. Rev. Rul. 83-117, 1983-2 C.B. 98.

7. Dividends Paid After the Close of the Year. Code Sections 857(b)(9) and 858.

(i) Generally a dividend is considered paid during the year for purposes of the dividends paid deduction only if mailed in time to be received by the shareholder before year-end.[76] However, Code Sections 857(b)(9) and 858 provide exceptions to this rule.

(ii) Code Section 857(b)(9) provides that for all purposes of the Code, any dividend declared by a REIT in October, November, or December of any calendar year and payable to shareholders of record on a specified record date in such a month shall be deemed to have been received by each shareholder on December 31 of such calendar year, and to have been paid by the REIT on December 31 of such calendar year (or,

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[75] Private Letter Ruling 200729021, July 20, 2007.

[76] Treasury Regulations Section 1.561-2(a).

if earlier, as provided in Code Section 858), but only if the dividend is actually paid during January of the following calendar year.

(iii) Code Section 858. Under the general rule of Code Section 858(a), if a REIT declares a dividend before the time prescribed for filing its return for a taxable year (including extensions granted),[77] and distributes the amount of such dividend to shareholders in the 12-month period following the close of such taxable year and not later than the date of the first regular dividend payment[78] made after such declaration,[79] the amount so declared and distributed shall is considered as having been paid during such taxable year, to the extent the REIT elects in such return (and specifies in dollar amounts) in accordance with regulations.[80]

(a) Time of shareholder inclusion. Under Code Section 858(b), except as provided in Code Section 857(b)(9), amounts to which the general rule applies are treated as received by the shareholder in the taxable year in which the distribution is made.

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[77] If no extension is obtained, the original due date is an absolute deadline for declaring a dividend qualifying under Code Section 858. Rev. Rul. 76-176, 1976-1 C.B. 189.

[78] The first regular dividend is the first dividend payment to which the Code Section 858 election does not apply. Rev. Rul. 76-328, 1976-2 C.B. 216. (The Code Section 858 dividend included a deemed distribution under Code Section 305 as a result of an adjustment in a conversion ratio.)

[79] If another dividend is declared earlier than the dividend intended to qualify under Code Section 858, then the other dividend must be paid either before the dividend intended to qualify under Code Section 858 is declared or after it is paid. Rev. Rul. 75-183, 1975-1 C.B. 193.

[80] See Treasury Regulations Section 1.858-1(b) for the method of making the election, limitations on the amount specified and the irrevocability of the election.

(b) Notice. Code Section 858(c) provides that for amounts to which the general rule applies, any notice to shareholders required under the REIT rules shall be made not later than 30 days after the close of the taxable year in which the distribution is made (or mailed to shareholders with the annual report for the taxable year).[81]

(iv) Deficiency Dividend. Code Section 860(a) provides that: if a determination[82] with respect to a REIT results in any adjustment[83] for any taxable year, a deduction shall be allowed to such entity for the amount of deficiency dividends for purposes of determining the deduction for dividends paid (for purposes of Code Section 852 or 857, whichever applies) for such year. Deficiency dividends are distributions of property which would have qualified for the dividends paid deduction if made during the tax year to which the adjustment relates[84] and which are made by the REIT on or within 90 days after the date of determination and before filing a claim as required by Code Section 860(g). The claim must be filed within 120 days after the date of the determination. The deficiency dividend is actually paid

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[81] See e.g., the notice requirement of Code Section 857(b)(3)(C) and Treasury Regulations Section 1.857-6(f) with respect to capital gains dividends. Treasury Regulations Section 1.858-1(e).

[82] As defined in Code Section 860(e). See footnote 68.

[83] The types of adjustments to which the procedure applies are essentially increases in REITTI, net capital gain, net income from foreclosure property and decreases in the deduction for dividends paid. No deficiency dividend deduction is allowed if the determination contains a finding that any part of any deficiency attributable to an adjustment with respect to the taxable year is due to fraud with intent to evade tax or to willful failure to file an income tax return within the time prescribed by law. Code Section 860(i).

[84] Under Code Section 316(b)(3), any deficiency dividend is deemed to be a dividend for purposes of Code Section 316. Further, if a distribution qualifies as a deficiency dividend, the earnings and profits of the REIT in the year of the distribution are not relevant. Treasury Regulations Section 1.860-2(a)(3).

to the persons who are shareholders at the time it is paid. Note: the deficiency dividend allows the REIT to comply with the distribution requirements on a retroactive basis if its income is adjusted on audit, and thus to avoid disqualification based on the results of an audit. However, the REIT must still pay interest and penalties based on the amount of the deficiency dividend. Code Section 860(c).

8. Consent Dividends. Code Section 565 provides generally that if any person owns consent stock in a corporation on the last day of the taxable year of such corporation, and such person agrees, in a consent filed with the return of such corporation in accordance with regulations prescribed by the Secretary, to treat as a dividend the amount specified in such consent, the amount so specified shall constitute a consent dividend for purposes of Code Section 561.

(i) A consent dividend cannot include any amount which, if distributed in cash, would be disqualified under the preferential dividend rules or any amount that would not be a dividend under Code Section 316.

(ii) A consent dividend is a hypothetical distribution. It is treated as if it were distributed to the shareholder on the last day of the year and contributed to the capital of the corporation by the shareholder on such day.

(iii) Consent stock is defined as the class or classes of stock entitled, after the payment of preferred dividends, to a share in the distribution (other than in complete or partial liquidation) within the taxable year of all the remaining earnings and profits, which share constitutes the same proportion of such distribution regardless of the amount of such distribution. Preferred dividends means a distribution (other than in complete or partial liquidation), limited in amount, which must be made on any class of stock before a further distribution (other than in complete or partial liquidation) of earnings and profits may be made within the taxable year.

I. Must make a REIT election (Code Section 856(c)(1)).

1. To be a REIT for a taxable year, the entity must file with its return for the taxable year an election to be a REIT or must have made such election for a previous taxable year, and such election must not have been terminated or revoked under Code Section 856(g).

2. The election is made by the entity by computing taxable income as a REIT in its return for the first taxable year for which it desires the election to apply (generally on Form 1120-REIT), even though it may have otherwise qualified as a REIT for a prior year. No other method of making such election is permitted. Treasury Regulations Section 1.856-2(b).

J. Must have a calendar year tax year (Code Section 859).

IV. Detailed discussion of rents from real property.[85]

A. Amounts included. There are three basic categories of receipts included within rents from real property:

1. rents from interests in real property,[86]

2. charges for services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated,[87] and

3. rent attributable to personal property which is leased under, or in connection with, a lease of real property, but

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[85] Note that Treasury Regulations Section 1.856-4 has not been amended since 1981. Hence, many statutory changes are not reflected in the regulations.

[86] Generally, this means the gross amounts received for the use of, or the right to use, real property. Treasury Regulations. Section 1.856-4(a).

[87] This provision states an overall rule as to the type of services charges for which can be treated as part of rents from real property.

only if the rent attributable to such personal property for the taxable year does not exceed 15% of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease.[88]

4. As to what constitutes services customarily furnished, Treasury Regulations Section 1.856-4(b) provides as follows: "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. The furnishing of water, heat, light, and air-conditioning, the cleaning of windows, public entrances, exits, and lobbies, the performance of general maintenance and of janitorial and cleaning services, the collection of trash, and the furnishing of elevator services, telephone answering services, incidental storage space, laundry equipment, watchman or guard services, parking facilities, and swimming pool facilities are examples of services which are customarily furnished to the tenants of a particular class of buildings in many geographic marketing areas. Where it is customary, in a particular geographic marketing area, to furnish electricity or other utilities to tenants in buildings of a particular class, the submetering of such utilities to tenants in such buildings will be considered a customary service. To qualify as a service customarily furnished, the service must be furnished or rendered to the tenants of the real estate investment trust or, *primarily for the convenience or benefit of the tenant*, to the guests, customers, or subtenants of the tenant." The IRS has also issued numerous rulings addressing the definition of services customarily rendered.

[88] Rent attributable to personal property for the taxable year is that amount which bears the same ratio to total rent for the taxable year as the average of the *fair market values* of the personal property at the beginning and at the end of the taxable year bears to the average of the aggregate *fair market values* of both the real property and the personal property at the beginning and at the end of such taxable year. Code Section 856(d)(1)(flush language). The 1999 tax act changed the highlighted words from adjusted basis to fair market value. See also Treasury Regulations Section 1.856-4(b)(2), which does not reflect this change to the statute.

B. Amounts excluded. Rents from real property does not include:

1. Any amount the determination of which depends in whole or in part on the income or profits derived by any person from such property (except that any amount so received or accrued is not excluded from the term rents from real property solely by reason of being based on a fixed percentage or percentages of receipts or sales).[89]

(i) Contingent rents do not include rents that are based on a fixed percentage or percentages of receipts or sales that are adjusted for returned merchandise, or federal, state or local sales taxes or rents where the lease provides for differing percentages of receipts or sales from different departments or from separate floors of a retail store so long as each percentage is fixed at the time of entering into the lease. However, an amount will not qualify as rents from real property if, considering the lease and all the surrounding circumstances, the arrangement does not conform with normal business practices but is in reality used as a means of basing the rent on income or profits. Treasury Regulations Section 1.856-4(b)(1). The IRS has ruled that rents received by a REIT based on a percentage of a tenant's gross sales, but excluding from gross sales returns of merchandise, exchange of merchandise between stores of the tenant, sales of used fixtures, and sales and excise taxes, qualified as rents from real property. See Rev. Rul. 74-134, 1974-1 C.B. 170. The IRS has also privately ruled that other adjustments that fall within normal business practices will not cause the rents to be treated as contingent rents. See, e.g., Private Letter Ruling 9719018 February 4, 1997; Private Letter Ruling 7836030 June 8, 1978.

(ii) Special rule for certain contingent rents. Where a REIT receives or accrues, with respect to real or personal property, any amount which would be excluded from the term rents from real property solely because the tenant of the REIT receives or accrues, directly or indirectly, from subtenants any

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[89] See Treasury Regulations Section 1.856-4(b)(3).

amount the determination of which depends in whole or in part on the income or profits derived by any person from such property, only a proportionate part (determined pursuant to regulations) of the amount received or accrued by the REIT from that tenant will be excluded from the term rents from real property.

(iii) Special rule for certain property subleased by tenant of REITs. If a REIT receives or accrues, with respect to real or personal property, amounts from a tenant which derives substantially all of its income with respect to such property from the subleasing of substantially all of such property, and a portion of the amount such tenant receives or accrues, directly or indirectly, from subtenants consists of qualified rents, then the amounts which the REIT receives or accrues from the tenant are not excluded from the term rents from real property by reason of being based on the income or profits of such tenant to the extent the amounts so received or accrued are attributable to qualified rents received or accrued by such tenant. Qualified rents means any amount which would be treated as rents from real property if received by the REIT.[90]

2. Related party rents.

(i) The general rule excludes from rents from real property any amount received or accrued directly or indirectly from any person if the REIT owns, directly or indirectly (or through attribution, as discussed in section IV.C.2 below):

(a) in the case of any person which is a corporation, stock of such person possessing 10% or more of the total combined voting power of all classes of stock entitled to vote, or 10% or more of the total value of shares of all classes of stock of such person; or

[90] See also Treasury Regulations Section 1.856-4(b)(6). As to the treatment of escalator clauses, see Rev. Ruls. 64-50, 1964-1 C.B. 231, 75-340, 1975-2 C.B. 270 and 69-107, 1969-1 C.B. 189.

(b) in the case of any person which is not a corporation, an interest of 10% or more in the assets or net profits of such person.[91]

(ii) Special rule for TRS. Amounts paid to a REIT by its TRS are not excluded from rents from real property by reason of the related party rent rule if one of the following sets of requirements is met:

(a) Limited rental exception. At least 90% of the leased space of the property is rented to persons other than TRSs of the REIT and other than persons meeting the general definition of a related party tenant. This rule applies only to the extent that the amounts paid to the REIT by the TRS and related parties are substantially comparable to such rents paid by the other tenants of the REIT's property for comparable space.[92] The substantial comparability requirement must be met under the terms of the lease on the following testing dates:

(1) at the time the lease is entered into;

(2) at the time of each extension of the lease, including a failure to exercise a right to terminate; and

(3) at the time of any modification of the lease between the REIT and the TRS if the rent

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[91] See also Treasury Regulations Section 1.856-4(b)(4). These regulations are quite old and do not fully reflect the current language of the statute. See also Private Letter Ruling 200234054, May 21, 2002, regarding the application of this rule where a TRS is a partner in a joint venture with an unrelated operator that leases property from the REIT's operating partnership.

[92] See Private Letter Ruling 200234054, May 21, 2002, regarding the application of this rule where a TRS is a partner in a joint venture that leases property from the REIT's operating partnership and where there is no comparable space in the property in question (comparability applied in the same geographic area).

under such lease is increased pursuant to such modification. If the TRS is a controlled TRS, however, the term "rents from real property" does not include rent under such lease to the extent of the increase in such rent on account of such modification. For this purpose, a controlled TRS means any TRS of a REIT if such REIT owns directly or indirectly stock possessing more than 50% of the total voting power of the outstanding stock of such subsidiary, or stock having a value of more than 50% of the total value of the outstanding stock of such subsidiary.

(b) Exception for certain lodging facilities and health care facilities. This exception applies to a "qualified lodging facility"[93] or a "qualified health care property"[94] leased by the REIT to its TRS if the property is operated on behalf of the TRS by an "eligible independent contractor."

3. Any impermissible tenant service income.

(i) Generally, impermissible tenant services income includes any amount *received or accrued directly or indirectly by the REIT for*:

(a) *services furnished or rendered by the REIT* to the tenants of such property, or

[93] The term "qualified lodging facility" means any lodging facility unless wagering activities are conducted at or in connection with such facility by any person who is engaged in the business of accepting wagers and who is legally authorized to engage in such business at or in connection with such facility. See Code Section 856(d)(9)(D)(i).

[94] The exception for "qualified health care properties" is only effective after July 31, 2008 since it was only created in 2008 as part of the Housing and Economic Recovery Act of 2008; prior to that, only an exception for qualified lodging facilities existed. The term "qualified health care property" means any real property (including interests therein), and any personal property incident to such real property which (a) is a health care facility or (b) is necessary or incidental to the use of a health care facility. Code Section 856(e)(6)(D).

(b) managing or operating such property.

(ii) De minimis rule/amount of rent disqualified. If the impermissible tenant services income with respect to a property for any taxable year exceeds 1% of all amounts received or accrued during such taxable year directly or indirectly by the REIT with respect to such property, the impermissible tenant service income of the REIT with respect to the property includes all such amounts.

(iii) Amount deemed attributable to impermissible services. The amount treated as received for any service (or management or operation) shall not be less than 150% of the direct cost of the REIT in furnishing or rendering the service (or providing the management or operation).

(iv) Coordination with gross income tests. For purposes of the 95% and 75% income tests, impermissible tenant services income is included in the gross income of the REIT.

(v) Exceptions to impermissible tenant services income.

(a) Independent contractor/TRS. Services furnished or rendered, or management or operation provided, through an independent contractor[95] from whom the REIT itself does not derive or receive any income or through a taxable REIT subsidiary of such REIT *shall not be treated as furnished, rendered, or provided by the REIT.* [96] As to the scope of

[95] See text accompanying footnote 101.

[96] See Rev. Rul. 2002-38, 2002-26 I.R.B. 4 (non customary housekeeping services provided by a TRS to tenants of a REIT's building; TRS pays all the costs of providing the services and the REIT compensates TRS for services at 125% or 160% of TRS's costs; the value of the services exceeds the de minimis exception; no service charge is separately stated; held: services are considered to be rendered by the TRS and not the REIT; thus no impermissible tenant services income and no disqualification of rents). See also Private Letter Ruling 200234054, May

the independent contractor exception, see generally Treasury Regulations Section 1.856-4(b)(5), although these regulations do not reflect several changes to the statute.[97] The Regulations provide in relevant part:

(1) "The prohibition against the trust deriving or receiving any income from the independent contractor applies regardless of the source from which the income was derived by the independent contractor. Thus, for example, the trust may not receive any dividends from the independent contractor. The requirement that the trust not receive any income from an independent contractor requires that the relationship between the two be an arm's length relationship. The independent contractor must be adequately compensated for any services which are performed for the trust. Compensation to an independent contractor determined by reference to an unadjusted percentage of gross rents will generally be considered to be adequate where the percentage is reasonable taking into account the going rate of compensation for managing similar property in the same locality, the services rendered, and other relevant factors. 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

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21, 2002, regarding the application of the independent contractor rule where a TRS is a partner in a joint venture with an unrelated third party service provider.

[97] For example, the Regulations provide, among other requirements, that a separate charge must be made for noncustomary services rendered to tenants of the property by an independent contractor. See discussion at section IV.B.3(v)(a)(1) below. However, pursuant to Rev. Rul. 2002-38, the IRS has ruled that no service charge is required to be separately stated for services rendered by a TRS. It is unclear whether the intent was for services rendered by a TRS and an independent contractor to be different in this regard, although based on the statutory language, there should not be any difference.

retained by the independent contractor, and the independent contractor must be adequately compensated for the services."

(2) The regulations also provide that: "the trustees or directors may do all those things necessary, in their fiduciary capacities, to manage and conduct the affairs of the trust itself. For example, the trustees or directors may establish rental terms, choose tenants, enter into and renew leases, and deal with taxes, interest, and insurance, relating to the trust's property. The trustees or directors may also make capital expenditures with respect to the trust's property (as defined in section 263) and may make decisions as to repairs of the trust's property (of the type which would be deductible under section 162), the cost of which may be borne by the trust."

(3) See also Private Letter Ruling 200234054, May 21, 2002, regarding the application of the independent contractor rule where a TRS is a partner in a joint venture with an unrelated third party service provider.

(b) Section 512 exception. Under this exception, there is not to be taken into account as impermissible tenant services income any amount which would be excluded from unrelated business taxable income under Code Section 512(b)(3) if received by an organization described in Code Section 511(a)(2).[98] In essence , in the 1986 tax act, Congress grafted onto the REIT provisions a rule that permits a REIT to provide whatever services a tax exempt entity could provide without disqualifying rent as non-trade or business income for purposes of the unrelated business income tax.

(1) The regulations[99] under Section 512 provide that payments for the use or occupancy

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[98] This class of services can be furnished directly by the REIT and amounts attributable to these services can be received by the REIT without having to use an independent contractor or a TRS (if a TRS is used, the earnings will be subject to corporate level tax).

[99] Treasury Regulations Section 1.512(b)-1(c)(5).

of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts, or motels, or for the use or occupancy of space in parking lots, warehouses, or storage garages, does not constitute rent from real property.

(2) Under the regulations, services are generally considered rendered to the occupant if they are 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*. The supplying of maid service, for example, constitutes such service; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in any office building, etc., are generally treated as rent from real property.[100]

C. Definitions and operating rules applicable to definition of rents from real property.

1. Independent contractor.[101] Any person:

(i) who does not own, directly or indirectly, more than 35% of the shares, or certificates of beneficial interest, in the REIT; and

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[100] See Rev. Rul. 2001-29, 2001-1 C.B. 1348 (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 Code Section 856(d); held that a REIT's rental activities could constitute an active trade or business for purposes of the tax free spin-off rules of Code Section 355).

[101] This definition applies for purposes of the rules regarding impermissible tenant services income and the rules regarding foreclosure property in Code Section 856(e).

(ii) if such person is a corporation, not more than 35% of the total combined voting power of whose stock (or 35% of the total shares of all classes of whose stock), or, if such person is not a corporation, not more than 35% of the interest in whose assets or net profits is owned, directly or indirectly, by one or more persons owning 35% or more of the shares or certificates of beneficial interest in the REIT.

(iii) If any class of stock of either the REIT or such person is regularly traded on an established securities market, only persons who own, directly or indirectly, more than 5% of such class of stock shall be taken into account as owning any of the stock of such class for purposes of applying the 35% limitation (but all of the outstanding stock of such class shall be considered outstanding in order to compute the denominator for purpose of determining the applicable percentage of ownership).[102]

2. Constructive ownership of stock. In applying Code Section 856(d) regarding rents from real property, e.g., the definition of a related tenant and the definition of an independent contractor, the rules prescribed by Code Section 318(a) for determining the ownership of stock apply in determining the ownership of stock, assets, or net profits of any person; except that (i) 10% shall be substituted for 50% in subparagraph (C) of paragraphs (2) and (3) of Code Section 318(a), and (ii) Code Section 318(a)(3)(A) is applied in the case of a partnership by taking into account only partners who own (directly or indirectly) 25% or more of the capital interest, or the profits interest, in the partnership. In addition, while the Code Section 318 constructive ownership rules generally do not apply for purposes of the REIT asset tests, there is at least one Private Letter Ruling in which the IRS applied the Code Section 318 constructive ownership rules to find that a hotel REIT which did not directly or indirectly own stock of an entity the hotel REIT sought to be treated as one of its taxable REIT subsidiaries ("sister corporation") constructively owned sister corporation because the limited partnership that owned the both the hotel REIT and the sister corporation owned more than 10% of the REIT's stock and, therefore, the hotel REIT

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[102] See also Treasury Regulations Section 1.856-4(b)(5)(iii).

was treated as constructively owning all of the stock in sister corporation that is owned by the limited partnership.[103]

3. Eligible independent contractor. For purposes of the exception to the related party rent rule for certain lodging facilities and certain health care properties, the term "eligible independent contractor" means any independent contractor (within the meaning of Code Section 856(d)(3)) if, at the time such contractor enters into a management agreement or similar service contract with the TRS to operate a qualified lodging facility or qualified health care property, such contractor (or any related person) is actively engaged in the trade or business of operating qualified lodging facilities or qualified health care properties, respectively, for any person who is not a related person with respect to the REIT or the TRS. Code Section 856(d)(9). For purposes of determining whether an independent contractor is actively engaged in the trade or business of operating qualified lodging facilities, the IRS has relied on Treasury Regulations Section 1.355-3(b)(2)(iii) (regarding whether a corporation is actively conducting a trade or business for purposes of Code Section 355(b)) and Rev. Rul. 2001-29, 2001-1 C.B. 1348 (where IRS addressed whether rental activities of a REIT satisfy the active trade or business requirement of Code Section 355(b)). See Private Letter Ruling 200825034, June 20, 2008.

V. Termination of REIT Status.

A. Termination by election. Code Section 856(g)(2) permits revocation of a REIT election. For timing, effectiveness and related procedures, see Code Section 856(g)(2) and Treasury Regulations Section 1.856-8(a).

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[103] Private Letter Ruling 200716015, April 20, 2007 (It should be noted that in this Private Letter Ruling, the only issue was whether the IRS would grant a hotel REIT relief under Code Section 9100 for failure to timely make a taxable REIT subsidiary election. Applicability of the Code Section 318 constructive ownership rules was only relevant in determining whether the REIT was eligible to make the taxable REIT subsidiary election with respect to the sister corporation).

B. Termination by failure to qualify. Pursuant to Code Section 856(g)(1) a REIT election may also terminate by reason of failure to meet the REIT requirements, unless Code Section 856(g)(5) applies. Termination applies for the entire year when the requirements are first not met, which can include the first REIT year. The election terminates whether the failure to be a qualified real estate investment trust is intentional or inadvertent. Treasury Regulations Section 1.856-8(b).

1. Code Section 856(g)(5) provides that if (A) a corporation, trust, or association that fails to comply with one or more REIT provisions (other than a failure described in Code Section 856(c)(6) with respect to the 95% or the 75% income tests, or a failure described in Code Section 856(c)(7) with respect to the asset tests), (B) such failures are due to reasonable cause and not due to willful neglect, and (C) such corporation, trust, or association pays (as prescribed by the Secretary in regulations and in the same manner as tax) a penalty of $50,000 for each failure to satisfy a REIT provision due to reasonable cause and not willful neglect, such corporation, trust, or association will not lose its REIT status.

C. Election after termination or revocation. Code Section 856(g)(3) provides generally that following termination of REIT status the entity shall not be eligible to make a REIT election for any taxable year prior to the fifth taxable year which begins after the first taxable year for which such termination or revocation is effective. Code Section 856(g)(4) provides an exception to the five-year where the termination results from failure to qualify (Code Section 856(g)(1)) and certain requirements are met.

VI. Tax Treatment of REIT.

A. Tax on REIT taxable income. Code Section 857(b)(1), (2).

1. A REIT is generally taxed at Code Section 11 progressive rates on its real estate investment trust taxable income (REITTI).[104]

2. REITTI generally means taxable income,[105] with the following adjustments:

(i) No dividends received deduction is allowed.

(ii) Dividends paid deduction is allowed (except the portion attributable to net income from foreclosure property).[106]

(iii) Section 443(b) does not apply.

(iv) Net income from foreclosure property is excluded.

(v) Certain taxes are allowed as a deduction: the tax imposed by Code Section 857(b)(5) where the REIT fails to meet the income tests but qualifies for relief under Code Section 856(c)(6); the tax imposed by Code Section 857(b)(7) on income from redetermined rents, etc.; Code Section

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[104] Technically a REIT can be subject to the alternative minimum tax. Code Sections 55. However, the items which are treated differently for AMT and regular tax purposes are to be apportioned between the REIT and its shareholders. Code Section 59(d). In effect, if the REIT makes distributions of all of its taxable income, all of these items will be apportioned to the shareholders. A REIT may also have tax consequences if it holds the residual interest in a REMIC (Code Section 860E(d)), or if the REIT is considered to be a taxable mortgage pool under Code Section 7701(i).

[105] Computed in the same manner as that of a domestic corporation. Treasury Regulations Section 1.856-1(e)(1).

[106] As a result, no tax will be paid under this provision if adequate distributions qualifying for the dividends paid deduction are made.

856(c)(7) where the REIT fails to satisfy certain asset tests but qualifies for relief under 856(c)(7)(B); and Code Section 856(g)(1) where the REIT fails to satisfy one or more requirements for REIT qualification, other than the income and asset tests, but qualifies for relief under Code Section 856(g)(5).

(vi) Net income from prohibited transactions is excluded.

B. Alternative tax on capital gains. Code Section 857(b)(3). If a REIT has a net capital gain for the taxable year, and if it will produce a lower tax, then the REIT tax is the sum of (1) tax at Code Section 11 progressive rates on REITTI excluding net capital gain and computing dividends paid deduction without regard to capital gain dividends, and (2) tax at Code Section 1201(a)[107] rates on net capital gain less dividends paid deduction with reference to capital gain dividends only.[108]

1. Capital gain dividends. In general, a capital gain dividend is one designated as such by the REIT in a written notice mailed to its shareholders at any time before the expiration of 30 days after the close of its taxable year (or mailed to its shareholders with its annual report for the taxable year).[109] If the

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[107] Section 1201(a) caps the tax rate on capital gains at 35% if the Section 11 tax rate is higher than 35%.

[108] For purposes of the net operating loss rules of Code Section 172, if a REIT pays capital gain dividends during any taxable year, the amount of the net capital gain for such taxable year (to the extent such gain does not exceed the amount of such capital gain dividends) is excluded in determining (i) the net operating loss for the taxable year, and (ii) the amount of the net operating loss of any prior taxable year which may be carried through such taxable year under Code Section 172(b)(2) to a succeeding taxable year. Thus, the amount of capital gain that can be paid as capital gain dividends is not reduced by ordinary loss of the REIT.

[109] If there is an increase in the excess of net capital gain over dividends paid with respect thereto which results from a determination (as defined in Code Section 860(e)), the designation may be made with respect to such increase at any time before the expiration of 120 days

aggregate amount designated with respect to a taxable year of the REIT (including capital gain dividends paid after the close of the taxable year described in Code Section 858) is greater than the net capital gain of the taxable year, the portion of each distribution which is a capital gain dividend is only that proportion of the amount so designated which such net capital gain bears to the aggregate amount so designated.[110]

2. Procedure for retaining capital gains. If a REIT chooses to retain its capital gain and pay tax on those gains, then the shareholders are specially treated. See section VII below. As described above, if a REIT chooses to retain capital gains, the gain will be taxed to the REIT under Code Section 857(b)(1) or 857(b)(3)(A), as applicable.

C. Tax on income from foreclosure property. Code Section 857(b)(4). The REIT is taxed on net income from foreclosure property at the *highest* tax rate specified in Code Section 11(b). Net income from foreclosure property is gain from sale of foreclosure property that is dealer property and gross income from foreclosure property (excluding amounts that qualify as good income under the 75% income test under Code Section 856(c)(3)(A),(B),(C), (D), (E) or (G)), less deductions directly connected with production of such income.[111]

D. Tax on failure to meet income requirements. Code Section 857(b)(5).

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after the date of such determination. See discussion of deficiency dividends above.

[110] See section VII.C below regarding designation of capital gains dividends with multiple classes of stock.

[111] See Treasury Regulations Section 1.857-3 regarding the calculation of net income from foreclosure property.

1. If a REIT fails to meet the income requirements, but qualifies for the relief provided by Code Section 856(c)(6), discussed above,[112] it is subject to a special tax.

2. The tax is equal to the greater of:

(i) the excess of (i) 95% of the gross income (excluding gross income from prohibited transactions) of the real estate investment trust, over (ii) the amount of such gross income which is derived from sources referred to in the 95% income requirement of Code Section 856(c)(2); or

(ii) the excess of (i) 75% of the gross income (excluding gross income from prohibited transactions) of the real estate investment trust, over (ii) the amount of such gross income which is derived from sources referred to in the 75% income requirement of Code Section 856(c)(3),

(iii) multiplied by a fraction the numerator of which is REITTI for the taxable year (without deducting dividends paid, taxes or net operating losses and excluding net capital gain) and the denominator of which is the gross income for the taxable year (excluding gross income from prohibited transactions; gross income and gain from foreclosure property not qualifying under the 75% income test; long-term capital gain; and short-term capital gain to the extent of any short-term capital loss).

(iv) Thus, the basic effect is to impose a tax equal to a portion of the shortfall in qualifying income.

E. Tax on income from prohibited transactions. Code Section 857(b)(6).

1. The REIT is subject to a 100% tax on net income derived from prohibited transactions.[113]

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[112] See text accompanying footnote 57 above.

2. Definitions.

(i) Net income derived from prohibited transactions means the excess of the gain[114] from prohibited transactions (there is no netting of losses from prohibited transactions) over the deductions directly connected with prohibited transactions;

(ii) Prohibited transaction means a sale or other disposition of property described in Code Section 1221(a)(1) (generally, property held primarily for sale to customers in the ordinary course of a trade or business, sometimes referred to as "dealer property"), which is not foreclosure property.

(iii) The legislative history underlying the prohibited transactions tax indicates that Congress wanted to deter REITs from engaging in "ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project." See S. Rep. No. 94-938, 94th Cong., 2d Sess. 470 (1976).

3. Exception for certain sales.

(i) Before July 30, 2008:

(a) Prohibited transaction does not include a sale of property which is a real estate asset if (i) the REIT has held the property for not less than 4 years; (ii) aggregate expenditures made by the REIT, or any partner of the REIT, during the 4-year period preceding the date of sale which are includible in the basis of the property do not exceed 30% of the net selling price of the property; (iii) either (I) during the taxable year the REIT does not make more than 7 sales of property (other than

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[113] See Treasury Regulations Section 1.857-5 regarding the definition of prohibited transactions and the calculation of net income from prohibited transactions.

[114] This includes certain income derived from a shared appreciation provision. See footnote 52 and accompanying text.

sales of foreclosure property or sales to which Code Section 1033 applies), or (II) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property (other than sales of foreclosure property or sales to which Code Section 1033 applies) sold during the taxable year does not exceed 10% of the aggregate bases (as so determined) of all of the assets of the REIT as of the beginning of the taxable year; (iv) in the case of property, which consists of land or improvements, not acquired through foreclosure (or deed in lieu of foreclosure), or lease termination, the REIT has held the property for not less than 4 years for production of rental income; and (v) if more than 7 sales are made during the year (excluding sales of foreclosure property and Section 1033 transactions), substantially all of the marketing and development expenditures with respect to the property were made through an independent contractor from whom the REIT itself does not derive or receive any income.[115]

(b) Prohibited transaction does not include a sale of property which is a real estate asset if (i) the REIT held the property for not less than 4 years in connection with the trade or business of producing timber; (ii) the aggregate expenditures made by the REIT, or a partner of the REIT, during the 4-year period preceding the date of sale which (I) are includible in the basis of the property (other than timberland acquisition expenditures), and (II) are directly related to operation of the property for the production of timber or for the preservation of the property for use as timberland, do not exceed 30% of the net selling price of the property; (iii) the aggregate expenditures made by the REIT, or a partner of the REIT, during the 4-year period preceding the date of sale which (I) are includible in the basis of the property (other than timberland acquisition expenditures), and (II) are *not* directly related to operation of the property for the production of timber, or for the preservation of the property for use as timberland, do not exceed 5% of the net selling price of the property; (iv) either (I) during the taxable year the REIT does not make more than 7 sales of property (other than sales of foreclosure property or sales to which Code Section 1033 applies), or (II) the

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[115] In applying this exception, various special rules set forth in Code Section 857(b)(6)(D) apply.

aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property (other than sales of foreclosure property or sales to which Code Section 1033 applies) sold during the taxable year does not exceed 10% of the aggregate bases (as so determined) of all of the assets of the REIT as of the beginning of the taxable year; (v) in the case that the requirement of clause (iv)(I) is not satisfied, substantially all of the marketing expenditures with respect to the property were made through an independent contractor (as defined in Code Section 856(d)(3)) from whom the REIT itself does not derive or receive any income, and (vi) the sales price of the property sold by the REIT is not based in whole or in part on income or profits, including income or profits derived from the sale or operation of such property.

(ii) After July 30, 2008:

(a) On July 30, 2008, H.R. 3221 (The Housing and Economic Recovery Act of 2008) (the "2008 Housing Act") was signed into law. The 2008 Housing Act contained several changes to the REIT rules, including two changes to the exceptions from prohibited transactions. These changes are effective beginning on the date of enactment of the 2008 Housing Act.

(b) The first such change was to reduce the REIT's holding period for non-dealer property from four years[116] to two years.

(c) The second such change was to allow a REIT to measure the 10% limit[117] by either continuing to use tax bases or instead using a fair market value measurement (i.e., the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property (other than sales of foreclosure property or sales to which Code Section 1033 applies) sold during the taxable year does not exceed 10% of the aggregated bases (as so determined) of all of the assets of the REIT

[116] See clause (i) of Section VI.E.3(i) above.

[117] See clause (iii)(II) of Section VI.E.3(i) above.

as of the beginning of the taxable year. The IRS clarified this change by issuing Rev. Proc. 2008-69.[118] Rev. Proc. 2008-69 essentially provides that for a REIT's tax year that begins on or before July 30, 2008 and ends on or after July 31, 2008, the REIT may test its total 2008 transactions by using either tax basis or fair market value provided that the REIT satisfies the 10% test as measured by tax basis for transactions occurring before July 30, 2008.

4. Code Section 1031 like-kind exchanges.

(i) For purposes of the safe harbors described above, the IRS has ruled privately that an exchange of property with no cash ("boot") that qualifies as a like-kind exchange under Code Section 1031 is not considered a "sale" of property. Private Letter Ruling 200728037, July 13, 2007; Private Letter Ruling 200701008, January 5, 2007.

(ii) The IRS has also ruled privately that to the extent that there is gain recognized in a like-kind exchange that qualifies under Code Section 1031 because of the receipt of cash, only a portion of the adjusted basis of the property (in proportion to the ratio that the boot bears to the total consideration received) will be used for calculating the 10% basis rule for purposes of the safe harbors described above. Private Letter Ruling 200702021, January 12, 2007.

(iii) Furthermore, the IRS has also privately ruled that a REIT could effect a like-kind exchange under Code Section 1031 by selling property to one of its taxable REIT subsidiaries for cash and then, through an unrelated "qualified intermediary", taking the sale proceeds to purchase replacement property from an unrelated seller. Private Letter Ruling 200709036, March 2, 2007.

(iv) Finally, the IRS has also privately ruled that where a REIT's operating partnership sought to sell property acquired in a Code Section 1031 like-kind exchange, the

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[118] 2008-48 I.R.B. 1217, November 13, 2008.

operating partnership could “tack on” the holding period of the property relinquished in the like-kind exchange to the holding period of the acquired property in determining whether the operating partnership satisfied the four-year holding period requirement of the Code Section 857(b)(6)(C)(i) prohibited transactions tax safe harbor. Private Letter Ruling 200824018, June 13, 2008.

F. Tax on income from redetermined rents, etc. Code Section 857(b)(7).

1. Code Section 857(b)(7)(A) imposes on the REIT a 100% tax on redetermined rents, redetermined deductions and excess interest.

2. The purpose of this tax is to police transactions between a REIT and a TRS. Because a TRS is taxed as a regular C corporation and a REIT is generally not subject to entity level tax, non-arm’s length transactions between the REIT and the TRS that reduce the income or increase the deductions of the TRS could produce tax savings.

3. When tax is imposed under Code Section 857(b)(7) on redetermined rents, redetermined deductions or excess interest the Code Section 482 adjustment that would otherwise occur is not made. Code Section 857(b)(7)(E).[119]

4. Redetermined rents. Redetermined rents means rents from real property the amount of which would (but for Section 857(b)(7)(E)) be reduced on distribution, apportionment, or allocation under Code Section 482 to clearly reflect income as a result of services furnished or rendered by a taxable REIT subsidiary of the REIT to a tenant of such REIT.

(i) Exceptions.

[119] See Rev. Rul. 2002-38, discussed in footnote 96 above and footnote 120 below.

(a) De minimis impermissible tenant services income. Amounts described in Code Section 856(d)(7)(A) (impermissible tenant services income) with respect to a property to the extent such amounts do not exceed the 1% threshold described in Code Section 856(d)(7)(B) with respect to such property. Thus, the exceptions in (a) through (c) are essentially for services that the REIT could have provided itself without affecting the classification of rent as "rents from real property."

(b) Comparably priced services. Services rendered by a TRS of a REIT to a tenant of such REIT if:

(1) such TRS renders a significant amount of similar services to persons other than such REIT and tenants of such REIT who are unrelated, within the meaning of Code Section 856(d)(8)(F), to such TRS, REIT, and tenants, but

(2) only to the extent the charge for such services rendered by the TRS to the REIT is substantially comparable to the charge for the similar services rendered to the other persons.

(c) Separately charged services. Certain services rendered by a TRS of a REIT to a tenant of such REIT if:

(1) the rents paid to the REIT by tenants (leasing at least 25% of the net leasable space in the REIT's property) who are not receiving such service from such TRS are substantially comparable to the rents paid by tenants leasing comparable space who are receiving such service from such TRS, and

(2) the charge for such service from such TRS is separately stated.

(d) Safe harbor based on TRS's income from the services. Any service rendered by a TRS of a REIT to a tenant of such REIT if the gross income of such TRS from such service is not less than 150% of such TRS's direct cost in furnishing or rendering the service.[120]

(e) Exceptions granted by Treasury. Treasury may waive the tax otherwise imposed by subparagraph if the REIT establishes to the satisfaction of Treasury that rents charged to tenants were established on an arm's length basis even though a TRS of the REIT provided services to such tenants. Thus, the exceptions in (d) through (g) go toward establishing that the TRS is not undercompensated for its services.

5. Redetermined deductions. The term "redetermined deductions" means deductions (other than redetermined rents) of a TRS of a REIT if the amount of such deductions would (but for Code Section 857(b)(7)(E)) be decreased on distribution, apportionment, or allocation under Code Section 482 to clearly reflect income as between such TRS and such REIT.

6. Excess interest. The term "excess interest" means any deductions for interest payments by a TRS of a REIT to such REIT to the extent that the interest payments are in excess of a rate that is commercially reasonable.

(i) Interest paid or accrued by a TRS to a REIT is also subject to the earnings-stripping rules of Code Section 163(j).[121]

7. Regulatory authority. The statute authorizes issuance of such regulations as may be necessary or appropriate to

[120] See Rev. Rul. 2002-38, discussed in footnote 96 above. The ruling illustrates that (1) compliance with the 150% of cost safe harbor protects against application of the tax on redetermined rents, but not against a Code Section 482 adjustment; and (2) failure to satisfy the safe harbor results in a tax on redetermined rents (equal to the amount by which a Code Section 482 arm's length charge exceeds the amount actually charged by the TRS), but not a Code Section 482 adjustment.

[121] See discussion in section III.G.6(xi)(c) above.

carry out the purposes of the tax on redetermined items. Until the regulations are issued, REITs and their TRSs may base their allocations on any reasonable method.

G. Excise tax for failure to make adequate distributions. Code Section 4981.

1. In order to inhibit overuse of the ability to pay dividends after the close of the taxable year, Code Section 4981 imposes a 4% nondeductible excise tax to the extent that the required distributions exceed the distributions during the year.

2. Required distributions for a calendar year are the sum of:

(i) 85% of the REIT's ordinary income, plus

(ii) 95% of the REIT's capital gain net income,[122] increased by

(iii) any shortfall for the prior year. The shortfall for the prior year is computed by increasing the required distribution percentages to 100% and also taking into account any shortfall for the year that precedes it (computed in the same fashion).

3. The amount distributed with respect to any taxable year includes,

(i) the deduction for dividends paid during the year (including amounts considered paid under Code Section 857(b)(9), but determined without regard to Section 858 and without regard to the portion attributable to net income from foreclosure property)).

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[122] Capital gain net income is generally defined as in Code Section 1222(9), but is reduced by the REIT's net ordinary loss (as defined in Code Section 4981(e)(2)(C)).

(ii) any amount of REITTI or capital gain taxed to the REIT under Sections 857(b)(1) or 857(b)(3)(A), and

(iii) any overdistribution for the prior year (computed using the same rules and using a required distribution percentage of 100%).

4. Thus, on an ongoing basis, in order to avoid the excise tax, during the current taxable year the REIT must distribute the required percentages of its current year ordinary income (85%) and capital gain net income (95%) and by the end of the current year must have distributed on a cumulative basis 100% of its ordinary income and capital gain net income from prior years. Note: if a REIT on a consistent basis zeroes out regular entity-level tax for each prior year by making succeeding year distributions that qualify for the dividends paid deduction under Code Section 858, in each current year it will as a regular practice be making distributions sufficient to eliminate the required distribution shortfall for the prior year for purposes of the excise tax. Thus, the effect of the excise tax will be to require distributions with respect to the current year's income that meet the 85% ordinary income and 95% capital gain net income distribution requirements. If the REIT chooses to retain income or capital gains for the current year, then to the extent the REIT pays tax on such income or gains, this will be counted as an amount distributed in the current year for purposes of the excise tax.

H. Excess Inclusion Income. A REIT may be subject to tax to the extent that it recognizes "excess inclusion" income and certain "disqualified organizations" own shares in the REIT. See detailed discussion in section IX.B below.

I. Application of other tax rules to a REIT.

1. To the extent not inconsistent with the REIT rules, other provisions of chapter 1 of the Code apply to a REIT and its shareholders in the same manner that they would apply to any other organization taxable as a domestic corporation. Treasury Regulations Section 1.856-1(e). This would include for example

Sections 301 through 305, 311, 312 (regarding earnings and profits, except as provided in Section 857(d)), 316, 331 and 341.

2. Code Section 857(d)(1) provides[123] that the earnings and profits of a REIT for any taxable year (but not its accumulated earnings) shall not be reduced by any amount which is not allowable in computing its taxable income for such taxable year.[124] For example, the IRS takes the position that any preferential dividend which is not allowable as a deduction in computing the REIT's taxable income would also not reduce the REIT's earnings and profits for that tax year.[125] This ensures that the REIT has enough current earnings to allow distributions that will zero out its income.

3. Net operating losses. Special rules apply to the use of net operating losses by REITs.[126]

4. Capital losses. Special rules apply to the carryover and carryback of the net capital loss of a REIT.[127]

J. Treatment of qualified REIT subsidiary (QRS). Code Section 856(i).

1. In general. For purposes of the Code: (A) a corporation which is a qualified REIT subsidiary is not treated as a separate corporation, and (B) all assets, liabilities, and items of income, deduction, and credit of a qualified REIT subsidiary are treated as assets, liabilities, and items of the REIT.

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[123] See also Treasury Regulations Section 1.857-7.

[124] For purposes of this rule, a REIT includes an entity which is a REIT determined without regard to the requirements of Code Section 857(a).

[125] Private Letter Ruling 200729021, July 20, 2007. See footnote 75 and accompanying text

[126] See Code Sections 172(b)(1) and 172(d)(6).

[127] See Code Section 1212(a).

2. A qualified REIT subsidiary is any corporation, not including a TRS, if 100% of the stock of such corporation is held by the REIT.

3. For purposes of subtitle A, if a qualified REIT subsidiary ceases to meet the 100% stock ownership requirement, it is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before such cessation from the REIT in exchange for its stock.

4. If a REIT acquires 100% ownership of an existing corporation, any such corporation is treated as being liquidated as of the time of acquisition by the REIT and then reincorporated (thus, any of the subsidiary's pre-REIT built-in gain would be subject to tax under the normal rules of Code Section 337). In addition, any pre-REIT earnings and profits of the subsidiary must be distributed before the end of the REITs taxable year. Treasury Regulations Section 1.856-9 deals with certain procedural effects of changes in QRS status.

VII. Tax Treatment of Shareholders.

A. Dividends.

1. General.

(i) A shareholder receiving ordinary income dividends from a REIT includes such dividends in gross income for the taxable year in which they are received. Treasury Regulations Section 1.857-6(a).

(ii) A corporate shareholder cannot use the dividends-received deduction against its dividends from the REIT. Code Section 857(c).

2. As discussed above, dividends paid after the close of the taxable year during January of the following year, and meeting the requirements of Code Section 857(b)(9), are treated as received by the shareholders on December 31 of the taxable year.

3. As discussed above, under Code Section 858(b), except as provided in Code Section 857(b)(9), amounts to which the general rule of Code Section 858 applies are treated as received by the shareholder in the taxable year in which the distribution is actually made.

4. Deficiency Dividend. A deficiency dividend is included in the income of the shareholders in the year in which they receive it.

B. Capital gain dividends. Code Section 857(b)(3)(B) and (D) and (b)(8).

1. General. In general, a capital gain dividend is treated by the shareholders as a gain from the sale or exchange of a capital asset held for more than 1 year. Such dividends would be included in accordance with the timing rules for other dividends.

2. Undistributed capital gains. If the REIT chooses not to distribute its capital gains, and to pay entity level tax on such gains, the treatment of the shareholders is as follows:

(i) Every shareholder at the close of the REIT's taxable year must include, in computing long-term capital gains for the shareholder's taxable year in which the last day of the REIT's taxable year falls, such amount as the REIT designates in a written notice mailed to its shareholders at any time prior to the expiration of 60 days after the close of its taxable year (or mailed to its shareholders with its annual report for the taxable year).[128] Under this rule, the amount includible by any shareholder can not exceed that part of the amount subjected to tax at the REIT level[129] which the shareholder would have received if all of such

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[128] In the event of such designation, the alternative tax on capital gains imposed on the REIT must be paid within 30 days after the close of the REIT's taxable year.

[129] Curiously, the statute refers only to tax imposed under the alternative tax on capital gains, which will only apply if the marginal rate on ordinary income is above 35%.

amount had been distributed as capital gain dividends by the REIT to the holders of such shares at the close of its taxable year.

(ii) For purposes of the Code, every shareholder is deemed to have paid, for the shareholder's taxable year in which the last day of the REIT tax year falls, the tax imposed on the REIT[130] on the amounts required to be included in computing the shareholder's long-term capital gains for that year; and the shareholder is allowed a credit or refund, as the case may be, for the tax so deemed to have been paid. The shareholder's basis is increased by the difference between the amount of includible gains and the tax deemed paid by the shareholder.[131]

C. Qualified dividend income. Code Sections 857(c)(2) and 1(h)(11).

1. General. For taxable years ending after December 31, 2002 and before January 1, 2011, all or a portion of a distribution received by an individual taxpayer may be "qualified dividend income," as defined in Code Section 1(h)(11)(B), and taxed at a reduced 15% rate of tax if it was either attributable to income that was subject to corporate tax at the REIT level (e.g., if the REIT distributed less than 100% of its taxable income) or if it was a corporate dividend received as investment income by the REIT after December 31, 2002 (i.e., it was qualified dividend income when it was received by the REIT).

2. Notice. The amount of a distribution designated as qualified dividend income must be specified in a written notice to shareholders mailed not later than 60 days after the close of the tax year. The amount of qualified dividend income taken into account by shareholders cannot exceed the amount specified in the notice.

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[130] See footnote 129.

[131] The earnings and profits of the REIT, and of a shareholder which is a corporation, are to be appropriately adjusted in accordance with regulations.

3. Limitation. The aggregate amount which may be designated as qualified dividend income cannot exceed the sum of (1) the qualified dividend income of the REIT for the tax year; (2) the excess of (a) the REIT taxable income under Code Sections 857(b)(2) and 337(d) for the preceding tax year over (b) the taxes payable by the REIT under Code Section 857(b)(1) for that preceding tax year; and (3) the amount of earnings and profits distributed by the REIT during the preceding tax year that were accumulated in a tax year to which the REIT rules did not apply.

4. Holding period. A REIT will only be treated as realizing qualified dividend income to the extent it receives dividends from certain domestic and foreign corporations and the REIT has held the shares of the stock producing such dividends for at least 61 days during the 121-day period beginning on the date that is 60 days before the date on which such shares became ex-dividend. A longer holding period applies to investments in preferred stock. An individual shareholder can only treat a REIT distribution designated as qualified dividend income as such if the shareholder has held the Fund shares producing the distribution for at least 61 days during the 121-day period beginning on the date that is 60 days before the date on which such shares became ex-dividend.

D. Rev. Rul. 89-81, 1989-1 C. B. 226 (distributions made to different classes of shares must not be composed disproportionately of dividends of a particular type). Notice 97-64, 1997-2 C.B. 323 (guidance for designation of capital gains dividends in light of differing tax rates on different types of capital gains)

E. Loss on sale or exchange of stock held less than 6 months. Section 857(b)(8).

1. General Rule. If a shareholder has held shares for 6 months or less, then loss on the sale or exchange of such shares is, to the extent of amounts designated as long term capital gain (capital gain dividends or undistributed capital gains), treated as a long-term capital loss.

2. Holding period. The rules of Code Section 246(c)(3) and (4) apply in determining the period for which the taxpayer has held any share of stock, except that "6 months" is substituted for the number of days specified in Code Section 246(c)(3)(B).

3. To the extent provided in regulations, the long term capital loss rule does not apply to any loss incurred pursuant to a plan which provides for the periodic liquidation of REIT shares.

F. Liquidating distributions.

1. In General. In the case of amounts distributed in liquidation by a REIT during a taxable year, a dividends paid deduction is permitted with respect to liquidating distributions that are either in complete or partial liquidation of the REIT pursuant to Code Sections 331, 332, or 333. Treasury Regulations Section 1.562-1(b)(1)(i).

2. Special rule for REIT Section 332 liquidations. If a corporation is the owner of stock in a REIT that possesses at least 80% of the total voting power of the stock of the REIT and has a value equal to at least 80% of the total value of the stock of REIT, and the corporation receives a distribution from a REIT in complete liquidation of the REIT that would normally qualify for non-recognition treatment under Code Section 332, the corporation is required to recognize and treat as a dividend from the REIT an amount equal to the deduction for dividends paid allowable to the REIT by reason of such distribution. Code Section 332(c).

G. Pension Held REIT. Special UBIT rule applicable to "pension-held REIT." Code Section 856(h)(3)(C), (D) and (E).

1. If any qualified trust[132] holds more than 10% (by value) of the interests in any pension-held REIT at any time

[132] Any trust described in Code Section 401(a) and exempt from tax under Code Section 501(a).

during a taxable year, the qualified trust is treated as having for such taxable year gross income from an unrelated trade or business in an amount which bears the same ratio to the aggregate dividends paid (or treated as paid) by the REIT to the qualified trust for the taxable year of the REIT with or within which the taxable year of the trust ends (the “REIT year”) as

(i) the gross income (less direct expenses related thereto) of the REIT for the REIT year from unrelated trades or businesses (determined as if the REIT were a qualified trust), bears to

(ii) the gross income (less direct expenses related thereto) of the REIT for the REIT year.

2. The rule applies only if the ratio determined under the preceding formula is at least 5%.

3. Pension-held REIT. For purposes of this rule, a REIT is a pension-held REIT if it would not have qualified as a REIT but for the look-through rule and if the REIT is predominantly held by qualified trusts.

(i) A REIT is predominantly held by qualified trusts if (I) at least 1 qualified trust holds more than 25% (by value) of the interests in such REIT, or (II) 1 or more qualified trusts (each of whom own more than 10% by value of the interests in such real estate investment trust) hold in the aggregate more than 50% (by value) of the interests in such REIT.

H. Foreign Shareholders.

1. Special tax considerations apply to foreign shareholders of a REIT, including taxation of sales of shares of the REIT and taxation of distributions by the REIT.

2. FIRPTA. Since an equity REIT will hold predominantly real property, it is potentially subject to classification as a U.S. real property holding corporation and the FIRPTA rules are implicated both as to sales of stock in the REIT

and distributions by the REIT.[133] The basic rules of FIRPTA taxation are set forth in Code Section 897 and the rules for withholding with respect to transactions subject to tax under FIRPTA are set forth in Code Section 1445.

(i) FIRPTA rules regarding sale of REIT stock.

(a) Domestically-controlled REIT.

(1) Definition. A domestically-controlled REIT is one in which less than 50% of the fair market value of the outstanding stock was directly or indirectly held by foreign persons at all times during the five-year period ending on the date of the distribution or disposition, as the case may be, or the period the REIT was in existence, if shorter. For purposes of this determination the actual owners of stock, as determined under Treasury Regulations Section 1.857-8, must be taken into account.

(2) Sale of stock in domestically-controlled REIT. An interest in a domestically-controlled REIT is not a U.S. real property interest. See Code Section 897(h)(2) and Treasury Regulations Section 1.897-1(c)(2)(i). Accordingly, sales of stock in a domestically-controlled REIT by a foreign person are generally not subject to tax under FIRPTA. See also Treasury Regulations Section 1.897-2(h)(3).

(b) Public REIT—foreign person owning 5% or less. Under Code Section 897(c)(3), if any class of

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[133] A mortgage REIT is potentially not affected by the FIRPTA rules because interests in real property solely as a creditor are carved out of the definition of US real property interests. See Treasury Regulations Section 1.897-1(d). However, a loan to an individual or entity under the terms of which a holder of the indebtedness has any direct or indirect right to share in the appreciation in value of, or the gross or net proceeds or profits generated by, an interest in real property of the debtor or of a related person is, in its entirety, an interest in real property other than solely as a creditor. See Treasury Regulations Section 1.897-1(d)(2)(i).

stock of a corporation is regularly traded on an established securities market, stock of such class is not treated as a U.S. real property interest for purposes of FIRPTA, unless the holder held more than 5% of such class of stock at some time during the five year period ending on the date of the disposition of such interest, or if shorter the period that the person held the stock.[134]

(ii) FIRPTA rules regarding distributions by REITs.

(a) Code Section 897(h) provides special rules concerning the taxability of distributions by certain investment entities, including REITs.

(1) Code Section 897(h)(1) provides generally that any distribution by a "qualified investment entity," which includes REITs and regulated investment companies,[135] to a nonresident alien individual, a foreign corporation or another qualified investment entity shall, to the extent attributable to gain from sales or exchanges by the qualified investment entity of United States real property interests, be treated as gain recognized by such nonresident alien individual, foreign corporation or qualified investment entity from the sale or exchange of a United States real property interest.[136] Notwithstanding the preceding sentence, any distribution by a REIT with respect to any class of stock which is regularly traded

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[134] See also Treasury Regulations Section 1.897-1(c)(2)(iii).

[135] Absent further legislation, for these purposes the term "qualified investment company" will not include regulated investment companies after December 31, 2007.

[136] After December 31, 2007, a distribution by a REIT to certain regulated investment companies that is attributable to gain from the sale or exchange of a United States real property interest will retain its character as gain from the sale or exchange of a United States real property interest in the hands of the regulated investment company, even though regulated investment companies will not be included in the definition of "qualified investment company" after December 31, 2007 for purposes of the general look-through rule.

on an established securities market located in the United States will not be treated as gain recognized from the sale or exchange of a United States real property interest if the shareholder did not own more than 5% of such class of stock at any time during the taxable year. The distribution instead will be treated as an ordinary dividend to that investor, taxed as an ordinary dividend that is not capital gain according to Code Section 857(b)(3)(F).[137]

(2) Code Section 897(h)(2) provides with respect to distributions by domestically-controlled qualified investment entities that rules similar to the rules of Section 897(d) (regarding distributions by foreign corporations) shall apply to the foreign ownership percentage[138] of any gain. Code Section 1445(e)(1) provides rules regarding withholding with respect to dispositions of U.S. real property interests by domestic partnerships, trusts and estates.[139]

(3) On June 13, 2007, the IRS issued Notice 2007-55, 2007027 I.R.B 13, stating that it intends to challenge (i) an assertion that distributions by a privately-held, domestically controlled REIT to a foreign government which are attributable to the REIT's disposition of a U.S. real property interest within the meaning of Code Section

[137] In such case, a foreign shareholder no longer will be required to file a U.S. federal income tax return by reason of receiving such a distribution, the branch profits tax will not apply, and the distribution will be subject to U.S. federal income tax withholding as an ordinary dividend by a REIT.

[138] The term "foreign ownership percentage" means that percentage of the stock of the REIT which was held (directly or indirectly) by foreign persons at the time during the testing period (the five-year period ending on the date of the distribution or disposition, as the case may be, or the period the REIT was in existence, if shorter) during which the direct and indirect ownership of stock by foreign persons was greatest.

[139] Treasury Regulations Section 1.1445-8(a)(2) treats any REIT, regardless of its form of organization as subject to the rules of Code Section 1445(e)(1).

897(c)(1)(A) is exempt from tax under Code Section 892[140], and (ii) the position that liquidating distributions by a privately-held, domestically controlled REIT which are attributable to the REIT's disposition of U.S. real property interests to foreign shareholders is not subject to FIRPTA.

(b) Treasury Regulations Section 1.1445-8(c)(2) provides rules regarding FIRPTA withholding by REITs intended to implement Code Section 897(h) and Code Section 1445(e)(1). These regulations do not draw a distinction between domestically controlled REITs and other REITs.

(1) In general, the withholding tax rate with respect to a distribution by a REIT is 35%.[141]

(2) The amount subject to withholding is the amount of any distribution, determined with respect to each share or certificate of beneficial interest, designated by a REIT as a capital gain dividend, multiplied by the number of shares or certificates of beneficial interest owned by the foreign person. Solely for purposes of this rule, the largest amount of any distribution occurring after March 7, 1991 that could be designated as a capital gain dividend under Code Section 857(b)(3)(C) shall be deemed to have been designated by a REIT as a capital gain dividend regardless of the amount actually designated. [142]

(3) If a REIT makes an actual designation of a prior distribution, in whole or in part, as a

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[140] In general, Code Section 892 exempts from U.S. federal taxation income of foreign governments attributable to dividends from U.S. corporations and the sale of stock n such corporations.

[141] Code Section 1445(e)(1) authorizes regulations to provide for a 20% withholding rate in appropriate circumstances, but the regulations have not implemented this authority.

[142] The regulations currently reserve the treatment of REIT distributions attributable to net short-term capital gain from the disposition of a U.S. real property interest.

capital gain dividend, the prior distribution is not subject to withholding. Instead, solely for purposes of the FIRPTA withholding rules, the REIT must characterize and treat as a capital gain dividend distribution each distribution, determined with respect to each share made on or after such designation as a capital gain dividend until such characterized amounts equal the amount of the prior distribution designated as a capital gain dividend.[143]

(4) As part of the Tax Increase Prevention and Reconciliation Act of 2005, Congress amended code Section 1445 to provide that if any portion of a distribution from a REIT to a nonresident alien individual or a foreign corporation is treated under Code Section 897(h)(1) as gain realized by such individual or corporation from the sale or exchange of a United States real property interest, such distributions are subject to a withholding tax equal to 35% (or, to the extent provided in Treasury Regulations, 15% (20% in the case of taxable years beginning after December 31, 2010)). Code Section 1445(e)(6). The Conference Report noted that, as discussed above, Treasury Regulations under Code Section 1445 already impose FIRPTA withholding on REIT distributions. The Conference Report further noted that "[n]o inference is intended regarding the existing Treasury regulations in force under section 1445 with respect to REITs."[144]

(c) Wash sale rules. Pursuant to the Tax Increase Prevention and Reconciliation Act of 2005, a nonresident alien individual or a foreign corporation that dispose its REIT stock during the 30-day period preceding a distribution on that stock that would have been treated as a distribution from the disposition of a United States real property interest, that acquires a substantially identical interest, or enters into a contract or option to

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[143] This rule is illustrated in the example at Treasury Regulations Section 1.1445-8(c)(2)(iii). This rule does not apply in any taxable year in which the REIT adopts a formal or informal resolution or plan of complete liquidation.

[144] See H.R. Conf. Rep. No. 109-455, 109th Cong., 2d. Session, at 290 n.532 (2006).

acquire such an interest, during the 61-day period beginning the first day of such 30-day period preceding that distribution, and that does not in fact receive the distribution in a manner that subjects the nonresident alien individual or foreign corporation to tax under FIRPTA, will be subject to tax under FIRPTA on an amount equal to the amount of the distribution that was not taxed under FIRPTA as a result of the disposition. See Code Section 897(h)(5). This provision also applies to "substitute dividend payments" under stock loan transactions. However, no withholding is required on the proceeds of such dispositions. This provision is effective for taxable years of REITs beginning after December 31, 2005, except for any distribution or substitute dividend payment occurring within 30 days after May 17, 2006 (the date of the enactment of the Tax Increase Prevention and Reconciliation Act of 2005).

(d) Excess of basis distributions. Treasury Regulations under Section 1441 state that a distribution in excess of a shareholder's adjusted basis in the stock of the REIT is subject to withholding under Code Section 1445 and Treasury Regulations Section 1.1445-8, unless the interest in the REIT is not a U.S. real property interest (e.g., an interest in a domestically controlled REIT under Code Section 897(h)(2)). See Treasury Regulations Section 1.1441-3(c)(4)(i)(C). This rule does not appear to be specifically stated in the Code Section 1445 regulations.

3. Section 1441, etc. withholding for distributions by REITs. Regular Section 1441 withholding applies in appropriate circumstances with respect to dividend distributions by REITs. See Treasury Regulations Section 1.1441-3(c)(4)(i).

(i) This provision of the Code Section 1441 regulations sets forth specific rules for coordinating and avoiding duplication as between Code Section 1441 withholding with Code Section 1445 withholding and specifies procedures to be followed to effect this coordination.[145]

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[145] See also Treasury Regulations Section 1.1441-3(c)(2)(i)(E).

(ii) Regular Dividends. Treasury Regulations Section 1.1441-3(c)(4)(i)(C) provides that withholding is required under Code Section 1441(foreign individuals), 1442 (foreign corporations) or 1443 (foreign tax exempt organizations) on the portion of a distribution from a REIT that is not designated as a capital gain dividend, a return of basis, or a distribution in excess of a shareholder's adjusted basis in the stock of the REIT that is treated as a capital gain under Code Section 301(c)(3), that is, on regular dividends.

(iii) Return of Capital Distributions. A REIT should be able to follow the generally applicable procedures in the regulations that permit a distributing corporation to elect not to withhold on return of capital distributions based on a reasonable estimate of earnings and profits. Treasury Regulations Section 1.1441-3(c)(2)(i)(C).

4. Branch Profits Tax. For purposes of the branch profits tax, stock in a REIT is not a U.S. asset and sales of the stock does not give rise to effectively connected earnings and profits. See Treasury Regulations Section 1.884-1(d)(2)(xi), -1(d)(5), -1(f)(2).

5. Excess Inclusion Income. Foreign shareholders of a REIT may be subject to special rules to the extent that the REIT recognizes "excess inclusion" income. See detailed discussion in section IX.B below.

VIII. UPREIT Structures.

A. An UPREIT structure has become the most common operating structure for publicly traded equity REITs. In a typical UPREIT structure, the REIT holds substantially all of its assets through one operating partnership ("OP"). The REIT typically owns a majority of the OP, but the OP ordinarily has minority limited partners (OP Unit Holders) as well. The UPREIT structure can be put in place either in an original REIT formation, or in connection with the acquisition of a particular portfolio of properties. For example, holders of a real estate portfolio that want to form a REIT can contribute their assets to the OP in exchange for OP Units at the same time that a newly formed REIT contributes cash raised from issuance of its stock to the public in exchange interests in the OP. Alternatively, a pre-existing REIT can contribute its assets to a new OP in exchange for interests in the OP at the same time that property owners contribute their properties to the OP in exchange for OP Units. Once the UPREIT structure is in place, the REIT can acquire additional portfolios of assets by having the OP acquire the assets in exchange for an issuance of OP Units.

B. In the typical OP Unit structure, after an initial holding period, the Holders' OP Units are typically convertible into shares of the REIT on a 1:1 basis.[146] Normally, the justification for this is that the OP Units and the REIT's shares represent essentially identical percentage rights to an essentially identical pool of assets. That is, on an as converted basis, the number of units of interest in the OP and the number of REIT shares are essentially equal. For example, assume that the OP holds assets worth $100x and has 100 units of interest outstanding, 60 of which are held by the REIT as general partner and 40 of which are held by 40 minority limited partners each holding one OP Unit. The REIT would have 60 shares outstanding and each of the 40 minority limited partners would have the right to convert his one OP Unit for one share of the REIT. Thus, if all conversion rights were exercised, there would be 100 REIT shares outstanding and 100 units of interest in the OP outstanding, all held by the REIT.

C. The principal benefit of the UPREIT structure is that it enhances a REIT's ability to acquire properties by allowing non-corporate[147] holders of low tax basis real estate to participate in

[146] If an UPREIT structure is being formed in connection with the initial formation and public offering of shares of the REIT, or if a large portfolio of assets is being acquired, care may need to be taken to make sure that conversion privileges are limited so as to eliminate any potential for the REIT to become closely held. See section III.F above.

[147] If real estate is held by a corporation, it may be possible to structure the acquisition as a tax free corporate reorganization. Obviously, real estate is more commonly held in pass-through entities.

property/OP Unit exchanges on a tax deferred basis.[148] That is, a transfer of real property (or interests in a partnership owning real property) to an OP solely in exchange for OP Units is typically a tax-deferred transaction described in Section 721 of the Code.[149] In contrast, a transfer of real properties directly to the REIT in exchange for REIT shares would ordinarily be fully taxable.[150] The IRS has recognized the essential validity of a properly designed UPREIT structure from a tax perspective.[151]

D. In addition, the OP Units received in the exchange provide two elements of liquidity. First, because of the 1:1 conversion feature, a fair market value can be established for the Holder's OP Units that can be borrowed against without immediate taxation. Second, the redemption/conversion feature itself provides for a liquidity opportunity of selling publicly traded REIT shares or receiving cash of equivalent value in redemption of the Holder's OP Units. Note, however, that, if the OP Unit Holder

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[148] An UPREIT structure can also provide benefits to OP Unit Holders in terms of the ability to offset income allocated to the Holders by the OP against so-called "passive losses" generated by other activities of the Holders. In order to provide this benefit, the OP must avoid classification as a "publicly-traded partnership." Most OPs do this under a "safe harbor" that applies if they have no more than 100 partners. OPs may also want to avoid PTP status in order to facilitate cash investments by exchange funds.

[149] Persons contributing properties to the OP in exchange for OP Units must address all the tax considerations that apply to any Code Section 721 transaction: tax treatment of receipt of cash or assumption of liabilities, including disguised sale rules and Section 752 rules. In addition, contributors must consider Section 704(c) rules applicable to property contributed with built-in gain.

[150] See both the control requirement of Code Section 351 and the rules regarding transfers to investment companies in Code Section 351 and Treasury Regulations 1.351-1(c)(1) (a transfer to a REIT is considered a transfer to an investment company if it results in diversification). See also Rev. Rul. 1987-9, 1989-1 C.B. 133 (transfer of property by one transferor and cash by another results in diversification).

[151] See Treasury Regulations Section 1.701-2(d), Example 4.

actually exercises the conversion feature this is a fully taxable transaction. Accordingly, conversion would normally not be elected unless prompt sale of the REIT shares was contemplated. Holders who are individuals may find it desirable to retain the OP Units until death, in which case the Holder's OP Units will receive a fair market value "stepped-up" tax basis, which allows the individual's estate or beneficiaries to redeem or convert the units on a tax-free basis at such time.

E. As discussed above, in an UPREIT structure, for purposes of the REIT satisfying the income and assets tests applicable to it, there is a look-through rule, pursuant to which the REIT is deemed to own its proportionate share of each of the assets of the partnership (based on its capital interest in the partnership) and is deemed to be entitled to the income of the partnership attributable to such share.[152]

F. Foreign Partners of OP.

1. Special tax considerations relating to withholding tax, U.S. trade or business, branch profits tax and FIRPTA will apply to foreign partners of the OP. See Code Sections 884, 897, 1441, 1445 and 1446.

2. These are generally the same considerations that would apply to any foreign partner holding an interest in any U.S. partnership holding REIT type assets.

IX. Certain Securitization and REMIC Considerations

A. TMP Considerations.

1. In general, under Code Section 7701(i)(2), an entity or portion of an entity (other than a REMIC) is a "taxable mortgage pool" (TMP) if:

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[152] See Treasury Regulations Section 1.856-3(g) and discussion accompanying footnotes 63, 64 and 65.

(i) substantially all of its assets are debt obligations (or interests therein), and more than 50% of such debt obligations (or interests) are real estate mortgages (or interests therein);

(ii) the entity is the obligor under debt obligations with two or more maturities; and

(iii) under the terms of the debt obligations (or the underlying arrangements), payments on such obligations bear a relationship to payments on the debt assets of the entity.

2. A TMP is treated as a separate entity that is taxable as a corporation for federal income tax purposes and is ineligible to file consolidated returns. Code Section 7701(i)(1).

3. Treatment of a REIT's interest in a TMP.

(i) To the extent that a REIT makes significant investments in mortgage loans or mortgage backed securities and conveys one or more pools of such loans to a trust or other vehicle which issues several classes of mortgage-backed bonds having different maturities, and the cash flow on the real estate mortgage loans will be the sole source of payment of principal and interest on the several classes of mortgage-backed bonds (such as in a typical collateralized debt obligation (CDO) structure), the entity may be treated as a TMP, unless a REMIC election is made with respect to the securitization transaction. In addition, if a REIT is deemed to have issued debt obligations having two or more maturities, the payments on which correspond to payments on mortgage loans owned by the REIT, such an arrangement may be treated as a TMP for federal income tax purposes.

(a) If a REIT owns directly, or indirectly through one or more QRSs or other disregarded entities, 100% of the equity interest in a TMP,[153] the TMP will itself be

[153] The determination of certain interests in a non-REMIC securitization (such as a typical CDO transaction) as constituting either

treated as a QRS and, therefore, ignored as an entity separate from the parent REIT for federal income tax purposes. Thus, the treatment as a TMP would not generally affect the status of the REIT.

(b) If a REIT owns less than 100% of the ownership interests in a TMP, the TMP would be treated as a corporation for federal income tax purposes, and would potentially be subject to corporate income tax. In addition, the REIT's ownership interest in the TMP would be subject to the income and asset tests discussed above, including the 10% value test, and, if a joint TRS election is made with respect to the TMP, the 20% test. If the TMP is also a CFC, and the REIT is a United States shareholder with respect to the CFC, the REIT could be required to include its proportionate share of the TMP's Subpart F income.

(ii) A REIT's ownership interest in a TMP could have consequences to the taxation of the REIT and its stockholders with respect to any "excess inclusion" income, as described below, whether or not the REIT owns 100% of the ownership interests in the TMP.

B. Excess Inclusion Income.

1. In general.

(i) If a REIT acquires a residual interest in a REMIC, a portion of its REIT taxable income may be characterized as "excess inclusion" income and allocated to its stockholders. Code Section 860E(d). In addition, if a REIT makes investments or enters into financing and/or securitization transactions that give rise to it being considered to own an equity

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debt or equity, may not be that clear. Thus, in order to make sure that the REIT is treated as owning all of the equity interests, the REIT generally must hold all of the interests in the securitization vehicle that could potentially be treated as equity for federal income tax purposes, but is allowed to issue the securities which would be treated as debt for federal income tax purposes.

interest in one or more TMPs, or if all or a portion of a REIT itself is treated as a TMP, a portion of its REIT taxable income may also be characterized as excess inclusion income and allocated to its stockholders, generally in a manner set forth under the applicable Treasury Regulations. Code Section 7701(i)(3).[154]

(ii) Under Code Section 860E(c), excess inclusion income is an amount, with respect to any calendar quarter, equal to the excess, if any, of—

(a) income tax allocable to the holder of a residual interest in a REMIC during such calendar quarter over

(b) the sum of amounts allocated to each day in the calendar quarter equal to its ratable portion of the product of (1) the adjusted issue price of the interest at the beginning of the quarter multiplied by (2) 120% of the long term federal rate (determined on the basis of compounding at the close of each calendar quarter and properly adjusted for the length of such quarter).

2. Tax treatment of excess inclusion income.

(i) Under Code Section 860E(a), a stockholder's share of any excess inclusion income:

(a) could not be offset by net operating losses of a stockholder;

(b) in the case of a stockholder that is a REIT, a regulated investment company or a common trust fund, would be considered excess inclusion income of such entity;

(c) would be subject to tax as unrelated business taxable income to a tax-exempt holder;

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[154] It should be noted that the Treasury Department has not yet issued regulations governing the tax treatment of stockholders of a REIT that owns an interest in a TMP.

(d) would be subject to the application of the federal income tax withholding (without reduction pursuant to any otherwise applicable income tax treaty) with respect to amounts allocable to foreign stockholders.

(ii) Under Code Section 860E(e), a stockholder's share of any excess inclusion income would be taxable (at the highest corporate tax rates) to the REIT, rather than to the stockholder, to the extent allocable to the REIT's stock held in record name by "disqualified organizations" (generally, tax-exempt entities not subject to unrelated business income tax, including governmental organizations). Nominees who hold a REIT's stock on behalf of disqualified organizations may also potentially be subject to this tax.[155]

3. Reporting of excess inclusion income. It should be noted that in the absence of Treasury Regulations, the manner in which excess inclusion income would be allocated among shares of different classes of stock is not clear. Until Treasury Regulations are issued, the IRS has provided, as interim guidance, basic principles which are applicable to all excess inclusion income, whether from TMPs or REMIC residual interests. Notice 2006-97, 2006-46 I.R.B. 904.

(i) Pending the issuance of further guidance, the interim guidance provides that a REIT must:

(a) Determine whether it or its qualified REIT subsidiary (or a portion of either) is a TMP, and if so, calculate the excess inclusion income of the TMP under a reasonable method.

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[155] See also Rev. Rul. 2006-58, 2006-46 I.R.B. 876 (IRS ruled that if a charitable remainder trust is a shareholder in a REIT that has excess inclusion income, the REIT is subject to the tax under Code Section 860E(e) on the excess inclusion income allocated to the charitable remainder trust because the charitable remainder trust is a disqualified organization).

(b) Allocate its excess inclusion income to its shareholders in proportion to dividends paid (determined without regard to any special allocation of the expense for any tax paid under Code Section 860E(e)(6)) and inform the shareholders that are not "disqualified organizations" of the amount and character of the excess inclusion income allocated to them.

(c) Pay the tax imposed by Code Section 860E(e)(6) on the excess inclusion income that is allocable to its shareholders that are "disqualified organizations."

(d) As provided by Code Section 860G(b)(2), apply the withholding tax provisions with respect to the excess inclusion portion of dividends paid to foreign persons without regard to any treaty exception or reduction in tax rate.

(ii) With respect to its excess inclusion income, a pass-through entity, other than a REIT, regulated investment company, or nominee, must:

(a) Allocate its excess inclusion income to its partners, participants, beneficiaries, or patrons (collectively, "owners") in accordance with applicable provisions (i.e., Code Section 702, Code Section 584, Subchapter J, or part I of Subchapter T) and inform any owners that are not "disqualified organizations" of the amount and character of the excess inclusion income that has been allocated to them.

(b) Pay the tax imposed by Code Section 860E(e)(6) on excess inclusion income that is allocable to "disqualified organizations."

(c) As provided by Code Section 860G(b)(2), apply the withholding tax provisions with respect to the excess inclusion portion of the payments made to foreign persons without regard to any treaty exception or reduction in tax rate.

(iii) With respect to excess inclusion income, a nominee must:

(a) Inform the beneficial owners that are not "disqualified organizations" of the amount and character of their excess inclusion income.

(b) Pay the tax imposed by Code Section 860E(e)(6) on the excess inclusion income of beneficial owners that are "disqualified organizations."

(c) As provided by Code Section 860G(b)(2), apply the withholding tax provisions to the excess inclusion portion of the payments made to foreign persons without regard to any treaty exemption or reduction in tax rate.

(iv) Special transitional rules apply to the reporting of excess inclusion income earned by a regulated investment company.

C. Prohibited Transaction Considerations.

1. Transfers to a REMIC.

(i) If a REIT transfers mortgage loans or mortgage backed securities to an entity that elects to be treated as a REMIC in exchange for regular or residual interests in the REMIC, the subsequent sale by the REIT of the residual or regular interests may cause the REIT to be deemed to be engaged in a prohibited transaction. In addition, the mortgage loans or mortgage backed securities warehoused for a securitization that is done in a REMIC may be treated as "dealer property."

(ii) To the extent that the mortgage loans or mortgage backed securities held for securitization in a REMIC are held by a TRS, and the sales of the residual or regular interests in the REMIC are done by the TRS, the REIT will generally avoid the prohibited transactions tax. However, any gain by the TRS on the sale of these interests could be subject to regular corporate income tax, provided that the pricing and other terms of the REMIC interest sale between the REIT and the TRS are at arm's length.

2. Transfers to a Non-REMIC.

(i) If a REIT transfers mortgages or mortgage backed securities in a non-REMIC securitization, to the extent that the REIT sells or transfers some or all of the equity interests in the entity, the REIT may be treated as engaging in a prohibited transaction.

(ii) If a REIT transfers mortgages or mortgage backed securities in a non-REMIC securitization and retains 100% of the equity interests in the entity, the issuance of debt securities by the entity generally will not present a prohibited transaction issue for the REIT.