"Taxpayer Relief Act of 1997: Provisions Affecting Real Estate Investment Trusts"

Thomas R. Popplewell
The Real Estate Tax Digest
1998

Originally published by ***Matthew Bender***. Vol. 16 ***The Real Estate Tax Digest*** 6, 171 (June 1998).

Thomas R. Popplewell is a tax lawyer and partner of the Dallas office of Houston's Andrews & Kurth. His e-mail address is tpopplewell@akllp.com. The views represented here are his own and do not represent those of the firm.

Copyright 2001, *Matthew Bender*. All rights reserved.

The Taxpayer Relief Act of 1997 (the "Act")1 contained twelve provisions relating to real estate investment trusts ("REIT"). The provisions of the Act apply for taxable years beginning after its date of enactment, August 5, 1997, which for most REITs is the calendar year beginning January 1, 1998. The following article summarizes these provisions and assumes that the reader has a general understanding of the taxation of real estate investment trusts.2

The SPE also should be structured to reduce the possibility that a bankruptcy court, in a proceeding involving the parent or other affiliate, would order "substantive consolidation" of the assets of the SPE with those of its parent or affiliate. Assuming the SPE is bankruptcy remote, the transfer to the SPE should further be structured to be a true sale in order that the assets will not be deemed a part of the transferor's estate in the event of the transferor's bankruptcy or insolvency. References in this article to bankruptcy laws will be to the United States Bankruptcy Code (the "Bankruptcy Code").

1. Definition of Real Estate Investment Trust and Determination of Stock Ownership.
Section 856(a)(6)3 requires that a REIT not be "closely held" within the meaning of certain provisions dealing with personal holding company rules4; *i.e.,* five or fewer individuals (and certain trusts) may not own more than 50% of the REIT's stock by value in the last half of each calendar year. Under prior Section 857(a)(2) a REIT would be disqualified for any year in which it did not comply with certain Treasury Regulations5 which set forth rules to determine the actual ownership of the REIT's outstanding shares of stock each year. The Act added Section 857(f) which generally requires a REIT to comply with Treasury Regulations requiring the ascertainment of the actual ownership of outstanding shares of the REIT. However, it also provides that if a REIT fails to comply with these Treasury Regulations, upon notice and demand by the IRS, the REIT is subject to a penalty of $25,000 ($50,000 if the failure is intentional). No penalty applies if it is shown that the failure to comply is due to reasonable cause and not to willful neglect. Furthermore, the Act added Section 856(k) which provides that if the REIT follows the Treasury Regulations requiring an ascertainment of the actual ownership of the REIT, and does not know, or exercising reasonable diligence would not have known, whether the REIT failed to meet the closely held requirements the REIT would nevertheless be treated as meeting the closely held requirements.
2. Taxation of Undistributed Capital Gains to Shareholders.
The Act added Section 857(b)(3)(D) which allows a REIT to retain net long-term capital gains from the sale of property just as mutual funds are permitted to do under existing law. In general, the mechanism is as follows:
1. Every REIT shareholder shall include in his long-term capital gains his allocated share of undistributed long-term capital gains as designated by the REIT,
2. The REIT must notify each shareholder in writing within sixty (60) days of the close of its taxable year of the capital gain that the shareholder must include in his income,
3. The shareholder shall be deemed to have paid the shareholder's share of the tax paid by the REIT and shall be allowed a credit or refund for such tax,
4. The REIT must pay the tax within thirty (30) days after the end of its taxable year, and
5. The adjusted basis of the shareholder's shares shall be increased by the amount of the undistributed long-term capital gains (net of the allocable income tax paid by the REIT) included in the shareholder's long-term capital gains.

6. Income from Prohibited Transactions.

A REIT is subject to a tax of 100% on net income from "prohibited transactions" which means from the sale or other disposition of property which is inventory or held by the REIT primarily for sale to customers in the ordinary course of its trade or business, and which is not "foreclosure property".[6] However there is a safe harbor that generally provides that if the REIT sells property that has been held for at least 4 years and the REIT does not make more than 7 sales of property during the taxable year or the aggregate adjusted basis of the property sold does not exceed 10% of the aggregate basis of all assets of the REIT as of the beginning of the year then no prohibited transaction has occurred.[7] In determining whether 7 sales of property have been made, sales of foreclosure property are not included. The Act also excludes sales of property to which Section 1033 applies, *i.e.,* involuntary conversion of property.

7. Distribution of Non-REIT Earnings and Profits.

Section 857(a)(2) requires that either the REIT must have qualified as a REIT for all its taxable years beginning after February 28, 1986 or must not have any earnings and profits accumulated in any non-REIT years. Therefore, a previously existing corporation that desires to elect REIT status must distribute its existing earnings and profits in the form of a dividend. The general distribution rules under Section 316 would require it to distribute all of its current earnings and profits before its accumulated earnings and profits. This is problematical to a REIT because it is sometimes difficult to determine the earnings and profits before the end of a taxable year. The Act added Section 857(d)(3) which provides that for purposes of meeting the required distribution of non-REIT earnings and profits, distributions will be treated as made from the earliest accumulated earnings and profits first and such distribution will not be treated as a distribution for purposes of computing the dividend paid deduction.

8. Excess Non-Cash Income.

A REIT must distribute at least 95% of its taxable income each year.[8] However, in determining the amount that must be distributed certain non-cash income may be excluded to the extent it exceeds 5% of taxable income.[9] The Act added three additional non-cash items that may be considered:

1. The Act expands the treatment of certain original issue discount as excess non-cash income to REITs that use the accrual method of accounting,
2. The Act expands the definition of original issue discount type income to include excess inclusion income described in Section 860E(a), and
3. The Act adds income received by reason of cancellation of indebtedness.

9. Repeal of the 30% Gross Income Test. Under prior law, Section 856(c)(4) provided that a REIT was disqualified if 30% or more of its gross income was derived from the sale of (i) stock or securities held for less than a year, (ii) property sold in a prohibited transaction and (iii) real property held less than 4 years. The Act repealed this provision in its entirety. This is very important for many REITs because, provided that its sales are not prohibited transactions, a REIT may now sell securities that are held for less than a year, and real property and discounted mortgages held for less than 4 years. Furthermore, it allows the creation of timber REITs using the "UPREIT" structure.[10] Under existing Treasury Regulations [11] applicable to a REIT, for assets contributed to a partnership the holding period is the shorter of the period that the partnership held the assets or the period that the REIT is a partner. In many cases this prevented formation of a timber REIT because it was not economic to wait 4 years to sell the timber. Now timber can be contributed to an UPREIT and sold immediately, provided that the sale is not otherwise a prohibited transaction.

10. Treatment of Certain Hedging Instruments. The Code previously provided a limited exception to treat certain income from interest rate swap or cap agreements used to hedge variable rate indebtedness as qualifying income for purposes of the 95% test.[12] The Act expanded the types of hedging instruments to include options, future contracts, forward rate agreements and other similar financial instruments, in addition, to the existing rate swap or cap agreements. Also, each of these instruments qualify if they are entered into by the REIT in a transaction to reduce the interest rate risk with respect to any indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets. Thus, fixed rate indebtedness may now be hedged.[13]

11 Rents from Real Property and "Impermissible Tenant Service Income".
Generally, a REIT cannot treat amounts received from rentals of property as "rents from real property"[14], if the REIT furnished or rendered services to the tenant of such property or managed or operated such property, other than through an independent contractor from whom the REIT itself did not derive or receive income, unless such amount would be excluded from unrelated business taxable income under Section 512(b)(3) if received by a tax exempt organization described in Section 511(a)(2). The Act provides that if "impermissible tenant service income" is equal to or less than 1% of all amounts received or accrued during the taxable year with respect to the real property, then all amounts are treated as rents from real property. For these purposes "impermissible tenant service income" means any amount received or accrued with respect to real or personal property by the REIT for (i) services furnished or rendered by the REIT to the tenants of such property, or (ii) managing or operating such property. However, services furnished or rendered, or management or operations provided, through an independent contractor from whom the REIT itself does not derive or receive any income is not treated as furnished, rendered or provided by the REIT, and there is not taken into account any amount which would be excluded from unrelated business taxable income under Section 512(b)(3). For these purposes the amount treated as received for any service is not less than 150% of the direct costs in furnishing or rendering the service.[15] This new provision is very helpful for property REITs, particularly those owning office buildings and apartments, because it is often difficult to determine under existing law whether a particular service constitutes a permissible service which would not "taint" the rental income from the property.

12 Foreclosure Property.
The Act expanded the period during which a REIT may hold property and treat it as foreclosure property under Section 856(e)(2). A REIT may now hold property as foreclosure property through the end of the third taxable year following the taxable year in which the REIT acquired such property.[16] It may also request one extension from the IRS provided that such extension may not extend the grace period beyond the close of the sixth taxable year following the year in which the REIT acquired the property. Under prior and current law this grace period terminates in certain cases including if the property is used in a trade or business which is conducted by the REIT for more than 90 days, other than through an independent contractor. The Act provides that property will not be treated as used in a trade or business by reason of any activities of the REIT with respect to such property to the extent that such activities would not result in amounts received with respect to such property being treated as other than rents from real property under the general rules.

13 Qualified REIT Subsidiaries.
A qualified REIT subsidiary means any corporation if 100% of the stock in such corporation is held by the REIT.[17] The Act eliminated the requirement that such stock must have held "at all times during the period such corporation was in existence." Under the Act's legislative history, if a REIT acquires an existing corporation, the corporation is treated as liquidated and then reincorporated.[18] Under the existing law REITs had obtained the same treatment by applying to the Internal Revenue Service for private letter rulings.[19]

14 Shared Appreciation Mortgages. Section 856(j) contains special rules treating certain income from shared appreciation mortgages as qualifying income for purposes of the REIT gross income tests under Section 856(c). In general, under the Act, REITs will be treated as owning the property for at least 4 years for purposes of the prohibited transaction provisions, if the secured property is disposed pursuant to Title 11 of the United States Code (i.e., bankruptcy), the seller is under the jurisdiction of the court in such case, and the disposition is required by the court or is pursuant to a plan approved by the court. This rule does not apply if 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 the default on the shared appreciation mortgage loan would occur. In addition, the shared appreciation provision definition in Section 856(j)(5) is expanded to include not only the right to receive a specified portion of any gain realized in the sale or exchange of such property but also the right to receive a specified portion of any appreciation in value as of any specified date. This is very beneficial because may times a REIT will want to have a shared appreciation provision that will be triggered on a certain date (e.g., maturity of the loan) by means of appraisal without the necessity for the sale of the property.

15 Constructive Ownership of Stock. In general Section 856(d)(2)(B) excludes from the definition of "rents from real property" rents received from a person if the REIT owns 10% or more of the ownership interests in such person or 10% or more of the assets or net profits of such person. Special attribution rules under Section 856(d)(5) apply to determine ownership interest. In general under these attribution rules, "10%" is substituted for "50%" in subparagraph (C) of Sections 318(a)(2) and 318(a)(3). Under the Act, 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. This makes it easier to identify partners that might cause tenant income to be nonqualifying rentals or to cause a contractor to be not independent. The previous rule was overly broad. Summary

In summary each of these provisions either simplifies the application of the REIT rules or eliminates the risk that a REIT would lose its status as a REIT through an inadvertent act or failure to act. Thus, these changes make the REIT provisions more user friendly.

NOTES1) Pub. L. No. 105-34, passed by Congress on July 31, 1997 and signed by the President on August 5, 1997.

2) For a summary of the real estate investment trust provisions see Thomas R. Popplewell & Muriel C. Brown, *Special Forms of Holding Real Estate in* FEDERAL TAXES AFFECTING REAL ESTATE, 16-1 (Matthew Bender & Co., Inc., 1997). For a more detailed analysis of the REIT provisions see Steven F. Mount, *Real Estate Investment Trusts,* 742 Tax Mgmt., 1996 and THEODORE S. LYNN & MICAH BLOOMFIELD, REAL ESTATE INVESTMENT TRUSTS (1996).

3) All section references are to the Internal Revenue Code of 1986 (the "Code"), unless otherwise indicated.

4) I.R.C. § 856(h).

5) Treas. Reg. § 1.857-8(d) and (e).

6) I.R.C. § 857(b)(6)(A).

7) I.R.C. § 857(b)(6)(C).

8) I.R.C. § 857(a)(1).

9) I.R.C. § 857(e)(1).

10) See Popplewell & Brown, *supra note 2, at 16-50 to 16-54.*

11) Treas. Reg. § 1.856-3(g).

12) I.R.C. § 856(c)(6)(G), prior to amendment by the Act. The 95% test is set forth in I.R.C. § 856(c)(2).

13) I.R.C. § 856(c)(5)(G) as amended by the Act.

14) I.R.C. § 856(d)(2).

15) I.R.C. § 856(d)(7) as added by the Act.

16) Under prior law a REIT could hold foreclosure property only 2 years, subject to a possible IRS approved extension or extensions up to an additional 4 years.

17) I.R.C. § 856(i).

18) H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 698 (1997), reprinted in 1997 U.S.C.C.A.N. 1508, 1510.

19) See, e.g., private letter ruling 9718006.