Remediation of M&A REIT Targets

"To err is human; to forgive, divine" – Alexander Pope

The ORIAD: How to be a REIT (Sections 856-860)[1]

- Organization
- Rents from real property
- Income from passive sources
- Assets that are real property and real estate assets, and are not excessive securities
- Distributions that are formal, sufficient, timely, and not (as applicable) preferential

Public REIT Compliance v. Private REIT Compliance

- Different levels of controls and compliance
- Mistakes happen for everyone
- Rescission (and possible redo) if within same taxable year[2] vs. Remediation in a later taxable year

REIT Remediation in the First REIT Year

The past is prologue: Do REIT qualification issues close with tax years, do they persist for ten (10) years (being the sum of five (5) years on account of the Section 856(g)(3) "lock out" plus another five (5) years of built-in gains tax exposure under Reg. § 1.337(d)-7), or do they live on forever (e.g., a "rolling" five-year lock out)?

Does the 5-year lockout rule of Section 856(g)(3) apply if an aspiring REIT elects under Section 856(c)(1) but botches something in its very first year, or can the aspirant simply "try again" and elect REIT status the next year?

- One read of the general rule under Reg. § 1.856-8(c)(1) might suggest the draconian result (lockout).
- But certain IRS rulings would suggest the better and more lenient answer under certain circumstances.[3]

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[1] All "Section" references are to sections of the United States Internal Revenue Code of 1986, as amended from time to time ("Code"), and all "Reg. §" references are to the regulations published thereunder, unless otherwise indicated. All "IRS" or "Service" references are to the United States Internal Revenue Service.

[2] *See* New York State Bar Association Tax Section, "Report on the Rescission Doctrine" (Aug. 11, 2010), available at: https://nysba.org/app/uploads/2020/03/1216-Report.pdf.

[3] Pursuant to Reg. § 301.9100-3, the IRS has thrice granted consent to disregard an inadvertent REIT election for a taxpayer that has filed an initial IRS Form 1120-REIT. The IRS treated these taxpayers as having not (i) made an election to qualify as a REIT or (ii) terminated or revoked a REIT election, where the taxpayer discovered that this initial IRS Form 1120-REIT had been filed for a taxable year earlier than such filing was intended by the taxpayer's REIT-experienced advisors and then promptly filed an IRS Form 1120-X as a non-REIT taxpayer. PLRs 202344007 (Aug. 8, 2023) (consent granted where taxpayer's advisor and primary tax consultant determined taxpayer should not file an initial IRS Form 1120-REIT for year 1, taxpayer accordingly did not secure 100+ preferred shareholders by January 30 of year 2 and taxpayer filed an extension for an IRS

- Watch out for the Section 856(g)(3) lockout for "successors", which is a very broad concept under Reg. § 1.856-8(c)(2), and (perhaps) no Section 856(g)(5) remediation is possible. Still, there is deal precedent for cleansing prior REIT infirmities and starting anew with a new entity that carefully avoids "successor" status.[4]
- If a successor REIT cannot be avoided, can the successor REIT remediate the failures of its predecessor REIT *à la* Section 381(c)(23)? Or instead, should Target REITs set up a "protective trust" and/or "self-assess" various remediation penalties before liquidating or merging out of existence? Per the logic of Pascal's Wager, deathbed confessions can only help.

REIT Remediation Rules: "Reasonable Cause"

The REIT remediation rules, which are generally predicated upon the non-compliance being "due to reasonable cause and not due to willful neglect" (hereinafter (and as the standard is colloquially known) "reasonable cause"),[5] are uniformly broad enough to remediate not only errors in legal interpretation but also both factual errors and inadvertent mistakes:

- The IRS is of the view that "reasonable cause" can and does mean something slightly different when deployed in different sections of the Code.[6]

Form 1120 (not 1120-REIT), but an initial IRS Form 1120-REIT was nonetheless prepared and filed while the primary tax consultant was on parental leave), 202305005 (Nov. 4, 2022) (consent granted where taxpayer's legal counsel determined taxpayer should not file an initial IRS Form 1120-REIT for year 1 or year 2, but an initial IRS Form 1120-REIT (and apparently an extension for the same) for year 2 was nonetheless prepared and filed and where taxpayer's controller did not understand that the filing of IRS Form 1120-REIT constituted a REIT election or that the REIT requirements must be met prior to such election), and 201523015 (Feb. 5, 2015) (consent granted where, after previously intending to file an initial IRS Form 1120-REIT for year 1, taxpayer's advisor determined in year 2 that taxpayer should not file an initial IRS Form 1120-REIT for year 1, but an initial IRS Form 1120-REIT (and related extension) was nonetheless prepared because taxpayer's tax consultants were not informed of the changed decision, the taxpayer's as-filed Form 10-Q included inconsistent information regarding which year it intended to first qualify as a REIT, and its Chief Accounting Officer did not understand that the filing of IRS Form 1120-REIT constituted a REIT election or that the REIT requirements must be met prior to such election). The approach taken by these taxpayers, that of obtaining a ruling from the Service confirming that the filing of the IRS Form 1120-X as a non-REIT taxpayer was effective in place of the initial IRS Form 1120-REIT such that the accidental and erroneous election had no effect, is arguably not strictly required and was taken by the taxpayers out of an abundance of caution.

[4] *See* Mobile Infrastructure Trust, Amendment No. 3 to Form S-4 (Sep. 29, 2022), available at: https://www.sec.gov/Archives/edgar/data/1918056/000175392622001337/g083214_s4a.htm; *see also* InfraREIT, Inc., Amendment No. 4 to Form S-11 (Jan. 28, 2015), available at: https://www.sec.gov/Archives/edgar/data/1506401/000119312515023105/d724324ds11a.htm#toc724324_26.

[5] *Compare* Sections 852(e)(4) and 860(i) and Reg. § 1.857-11(c) (relief predicate is the absence of fraud with intent to evade tax) *with* Sections 856(c)(6)-(7), 856(g)(4)-(5), 857(e)(2)(B), and 857(f)(2) (relief predicate is the presence of "reasonable cause").

[6] *See* LB&I Concept Unit, "Reasonable Cause and Good Faith", p. 5, available at: https://www.irs.gov/pub/fatca/int_practice_units/reasonable_cause_good_faith.pdf (last updated Mar. 18, 2021). Per IRS thinking, the "reasonable cause" legal standard is generally two prongs – "due to reasonable cause" and "not due to willful neglect" – both of which must be met, rather than a single prong where the second part merely emphasizes the first (e.g., "look up and not down"). *See id*, pp. 3, 7. As an example of "reasonable cause" having a particular nuance outside of the REIT context, upon release of certain IRS Appeals Office training materials addressing the application of "reasonable cause" relief in the context of

- That said, it is interpretive canon that statutory relief provisions throughout the Code are meant to be applied broadly and generously in order to effectuate best their plain meaning and intent.[7]
- Moreover, per legislative history, "reasonable cause" is meant to have a generally uniform meaning when used throughout the REIT remediation provisions of the Code.[8]

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certain late filing and other penalties, some practitioners expressed concern that the trainings instructed IRS personnel to limit application of "reasonable cause" relief that would fully abate penalties and instead issue no or only partial abatement of penalties under a "mitigation" theory. *See* Andrew Velarde, *IRS Appeals Training Materials on Reasonable Cause Worry Practitioners*, 108 Tax Notes International 144 (Oct. 6, 2022). Still, within the REIT area, "due to reasonable cause" and "not due to willful neglect" appear to be a homogenous, single-prong standard. *See infra* notes 8 through 11.

[7] *See* Brian E. Hammell & Ameek Ashok Ponda, "What a Relief: Avoiding 'REIT M&A Drama' via the Temporary Investment of New Capital Rules", 22 *J. Passthrough Ent*. 71, 72 and 76-77 n.9 (Nov.-Dec. 2019), and authorities cited therein, available at: https://878449.fs1.hubspotusercontent-na1.net/hubfs/878449/Hammell-Ponda.pdf. *Cf.,* Portia's speech in Shakespeare in "The Merchant of Venice," Act IV, Scene I ("The quality of mercy is not strained. It droppeth as the gentle rain from heaven Upon the place beneath. It is twice blest: It blesseth him that gives and him that takes. 'Tis mightiest in the mightiest; it becomes The throned monarch better than his crown. His scepter shows the force of temporal power. The attribute to awe and majesty Wherein doth sit the dread and fear of kings; But mercy is above this sceptered sway. It is enthroned in the heart of kings; It is an attribute to God himself; And earthly power doth then show like God's When mercy seasons justice.").

[8] *See* Pub. L. No. 108-357 (2004), §§ 243(f)(1) (adding, as new Section 856(c)(7), a reasonable cause remediation provision for the Section 856(c)(4) asset tests), (f)(2) (modifying the existing Section 856(c)(6) reasonable cause remediation provision for the Section 856(c)(2)-(3) gross income tests to conform to the new and more streamlined Section 856(c)(7) asset test reasonable cause remediation provision), and (f)(3) (adding a new reasonable cause remediation provision for non-compliance outside of the Section 856(c)(6) and (c)(7) specific remediation provisions for gross income and asset tests), available at https://www.congress.gov/108/plaws/publ357/PLAW-108publ357.pdf; H.R. Rep. No. 108-755, at 328-29, 331, 334-35 (2004) (Conf. Rep.) (explaining the changes to the reasonable cause standard for the gross income tests as "[t]he provision conforms the reporting and reasonable cause standards for failure to meet the income tests to the new asset test standards"), available at: https://www.congress.gov/108/crpt/hrpt755/CRPT-108hrpt755.pdf. *See also infra* notes 9 and 10.

Further, testimony provided to the House Ways and Means Committee in connection with the Regulated Investment Company Modernization Act indicates that a single and cohesive "reasonable cause" standard was intended to apply for all of Subchapter M of the Code. Enacted on December 22, 2010, the Regulated Investment Company Modernization Act added Sections 851(d) and (i) to the Code to provide curative provisions for Regulated Investment Companies ("RICs") to remediate Section 851(b)(2) income test failures and Section 851(b)(3) asset test failures; mirroring the language in the REIT income and asset tests curative provisions under Sections 856(c)(6) and (7), the Sections 851(d) and (i) curative provisions also require as a condition of remediation that the failure(s) be "due to reasonable cause and not due to willful neglect". *See* Pub. L. No. 111-325 (2010), § 201(b); *compare* Section 851(d)(2)(A)(ii) ("the failure to meet the requirements of such subsection [Section 851(b)(3) asset tests] for such quarter is due to reasonable cause and not due to willful neglect") *and* Section 851(i)(1)(B) ("the failure to meet such [gross income test] requirement is due to reasonable cause and not due to willful neglect") *with* Section 856(c)(7)(A)(ii) ("the failure to meet the requirements of such paragraph [Section 856(c)(4) asset tests] for a particular quarter is due to reasonable cause and not due to willful neglect") *and* Section 856(c)(6)(B) ("the failure to meet the [gross income test] requirements of paragraph (2) or (3), or of both such paragraphs, is due to reasonable cause and not due to willful neglect"). Although no IRS guidance has yet been issued that interprets either Section 851(d) or (i), testimony provided to the House Ways and Means Committee indicates that the Section 851(d) and (i) "due to reasonable cause and not willful neglect" standard is intended to be interpreted consistently with the standard under the REIT rules. *See* Rep. Richard E. Neal Holds a Hearing on Regulated

Investment Companies Modernization before the H. Subcommittee on Select Revenue Measures, House Committee on Ways and Means, 111th Cong. 9 (2010) (statement of Stephen Fisher, Senior Vice President and Deputy General Counsel, Fidelity Investments) (". . . a mutual fund that fails to meet certain of the qualification requirements under Subchapter M is subject to corporate level tax on 100 percent of its income, no matter how small or inadvertent the failure. H.R. 4337 would correct this unduly harsh result so that the penalty is more commensurate with the nature of these violations, similar to the provisions that were recently enacted for REITs.") *and* (statement of William Paul) ("In 2004, Congress amended the qualification rules for REITs to provide a lesser sanction when a REIT inadvertently fails one of the REIT gross income or asset tests. The bill would amend the RIC rules to include a savings provision modeled on these REIT precedents.").

- Finally, applicable REIT legislative history,[9] echoed in the text of the regulations,[10] contemplates that REIT remediation is available not only for errors in legal interpretation but also for both factual errors and inadvertent mistakes.[11]

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[9] The Tax Reform Act of 1976 enacted three REIT remediation and relief provisions: (i) gross income test remediation (*i.e.*, current Section 856(c)(6), originally enacted as Section 856(c)(7)), (ii) five-year lock out relief (*i.e.*, Section 856(g)(4)), and (iii) deduction for deficiency dividends (i.e., current Section 860, originally enacted as Section 859). Pub. L. No. 94-455 (1976), §§ 1601(a) (deficiency dividend), 1602(a) (remediation for gross income tests), 1604(k) (exception to five-year lock out on REIT election termination). The original House Bill proposed a slightly different legal standard for each provision: (i) "reasonable grounds" for remediating a gross income test failure under former Section 856(c)(7) and (ii) "reasonable cause" for remediation through the deficiency dividend procedure under former Section 859 (the original House Bill had no Section 856(g) provision regarding REIT election terminations). H.R. 10612, 94th Cong. (1975), §§ 1601(a) (deduction for deficiency dividend), 1602(a) (gross asset test remediation). The Senate Amendment provided: (i) "due to reasonable cause and not due to willful neglect" for remediating a gross income test failure under former Section 856(c)(7), (ii) "due to reasonable cause and not due to willful neglect" for avoiding application of the new five-year lock out upon termination of a REIT election under Section 856(g)(4), and (iii) "no fraud" for remediation under the deficiency dividend procedure under former Section 859. S. Rep. No. 94-938(I), at 465, 471, and 478 (1976). In conference, the Senate Amendment was followed in each instance. H. Conf. Rep. No. 94-1515, at 513 (1976).

The legislative history to the Tax Reform Act of 1976 indicates that Congress intended the "reasonable cause" concept to be broad and inclusive of inadvertent errors, although arguably somewhat higher than a "no fraud" standard. This "reasonable cause" standard was first articulated by the House (but as "reasonable cause" and not as "reasonable cause and not . . . willful neglect") in its discussion of former Section 859. This remediation provision was initially drafted by the House with a "due to reasonable cause" standard before ultimately being enacted with the "not due to fraud . . . or willful failure" standard advanced by the Senate. *Compare* H.R. 10612, 94th Cong. (1975), § 1601(a) (as reported to the House on Nov. 7, 1975) (providing new Section 859(g) to read "Deduction Allowed Only if Original Underdistribution Resulted From Reasonable Cause.—A deficiency dividend deduction shall be allowed under section (a) only if the entire amount of the adjustment was due to reasonable cause") *with* Pub. L. No. 94-455 (1976), § 1601(a) ("Deduction Denied in Case of Fraud.—No deficiency dividend deduction shall be allowed under subsection (a) 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 or prescribed by the Secretary in pursuance of law.").

House Report 94-658 indicates that the process for a REIT to obtain a deficiency dividend deduction was implemented because "where a REIT originally acted with reasonable cause in determining and reporting its income and dividend distributions, the sanction of disqualification [for nonetheless failing to satisfy the annual distribution requirement] is too severe". H.R. Rep. No. 94-658, at 356 (1975); *cf.* S. Rep. No. 94-938(I), at 463 ("The committee believes that where a REIT originally acted without fraud in determining and reporting its income and dividend distributions, the sanction of disqualification is too severe."). The House Report describes the scope of "reasonable cause" as follows:

> Reasonable cause.-- The deficiency dividend deduction is to be available only if the entire amount of the adjustment was due to reasonable cause. *It is intended that in making a reasonable effort to comply with the distribution requirements, the officers and directors of a REIT are to act with the reasonable diligence that is incumbent upon persons who are responsible for assuring that the income of a business enterprise (with public shareholders) is preserved*.
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> Generally, the question of whether the REIT had reasonable cause to believe that the income distribution requirements were satisfied will depend on all the facts and circumstances. For example, if a REIT had a pattern of satisfying the requirements, but overestimated its depreciation for a particular year, based on reasonable factual assumptions and interpretations of then current law, generally the reasonable cause standard would be satisfied. *On the other hand, if a REIT made*

> *mistakes of a similar nature, year after year (involving different pieces of property), it would often be the case that the standard had not been satisfied*.
>
> If the REIT had relied on the written reasoned advice of independent experts, for example, certified public accountants or independent tax counsel, this generally would be evidence that the failure to meet the requirements was due to reasonable cause.

H.R. Rep. No. 94-658, at 358-59 (emphasis added). Thus, the House's understanding of the reasonable cause standard expressly included an inadvertent mistake within its scope. *See id*. (providing a specific example that REIT personnel who "mak[e] a reasonable effort to comply" and act with "reasonable diligence", but nonetheless make an inadvertent "mistake", can and should be absolved on account of satisfying the reasonable cause standard). *See also infra* text accompanying note 41.

The Senate, in proposing its amendment to shift to a "no fraud" standard in former Section 859, did not quibble with the scope of the "reasonable cause" standard. Instead, the Senate stated that the shift was preferred as it believed an even lower standard was sufficient for the deficiency dividend deduction. *See* S. Rep. No. 94-938(I), at 465 (stating that the "fraud standard [rather than the reasonable cause standard] is more appropriate in this area, because the interest and penalty provisions discussed below will be sufficient to encourage current distributions in the usual case"). The Senate, however, went on to use the "reasonable cause" standard in its proposal for the gross income test remediation provision (moving away from the House's "reasonable grounds" language) and the relief from the five-year lock out on termination of REIT election provision. *See* S. Rep. No. 94-938(I), at 478. Given the Senate's analysis of and determination to move away from the reasonable cause standard as proposed and articulated by the House in former Section 859, it must be assumed that the Senate utilized this same understanding of the reasonable cause standard in former Sections 856(c)(7) and (g)(4) with equal analysis and determination. Further, although the Senate Amendment shifted from the two-word phrase "reasonable cause" utilized in the House's version of former Section 859 to the fuller phrase "due to reasonable cause and not due to willful neglect", the Senate reports make no indication that this change in phrasing was intended to shift the standard for relief away from the meaning applied by the House in its discussion of the term "reasonable cause" in connection with its version of former Section 859. *See also infra* notes 10 and 41, and the text accompanying the same, for a discussion of why in this context the additional words "and not due to willful neglect" do not contract, but rather only clarify, the "reasonable cause" standard.

[10] Reg. § 1.856-7(c), which provides the definition of "reasonable cause" for purposes of the gross income test remediation rule, was originally promulgated in 1981, approximately five years after the enactment of the statutory gross income test remediation provision of former Section 856(c)(7) as part of the Tax Reform Act of 1976. *See* T.D. 7767, 1981-1 C.B. 82 (Feb. 6, 1981) and Pub. L. No. 94-455 (1976), § 1602(a). It is perhaps unsurprising, then, that Reg. § 1.856-7(c) largely tracks the discussion of "reasonable cause" from the legislative history of the Tax Reform Act of 1976. *Compare* Reg. § 1.856-7(c)(1) ("The failure to meet the [gross income test requirements] will be considered due to reasonable cause and not due to willful neglect *if the real estate investment trust exercised ordinary business care and prudence in attempting to satisfy the requirements. Such care and prudence must be exercised at the time each transaction is entered into by the trust*.") *with* H.R. Rep. No. 94-658, at 358-59 ("It is intended that in making a reasonable effort to comply with the distribution requirements, the officers and directors of a REIT are to act with the reasonable diligence that is incumbent upon persons who are responsible for assuring that the income of a business enterprise (with public shareholders) is preserved. . . . if a REIT had a pattern of satisfying the requirements, but overestimated its depreciation for a particular year, based on reasonable factual assumptions and interpretations of then current law, generally the reasonable cause standard would be satisfied. On the other hand, if a REIT made mistakes of a similar nature, year after year (involving different pieces of property), it would often be the case that the standard had not been satisfied."). *Also compare* Reg. § 1.856-7(c)(2)(i) ("The reasonable reliance on a reasoned, written opinion as to the characterization for purposes of section 856 of gross income to be derived (or being derived) from a transaction generally constitutes 'reasonable cause' if income from that transaction causes the trust to fail to meet the [gross income test requirements].The absence of such a reasoned, written opinion [addressing legal interpretations] with respect to a transaction does not, by itself, give rise to any inference that the failure [...] was without reasonable

Presumably, a REIT can avail itself of the reasonable cause remediation provisions to remediate a prior remediation that was itself based on having reasonable cause (i.e., reasonable cause that reasonable cause existed)

Possible Role of Private Tax Insurance

Insurance may cover REIT compliance matters through Representations & Warranties Insurance ("RWI"), a Tax Indemnity Insurance Policy ("TIIP"), or through a hybrid RWI and TIIP policy. REITs and

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cause.") *with* H.R. Rep. No. 94-658, at 359 ("If the REIT had relied on the written reasoned advice of independent experts, for example, certified public accountants or independent tax counsel, this generally would be evidence that the failure to meet the requirements was due to reasonable cause."). *C.f.* 46 Fed. Reg. 11256 (Feb. 6, 1981) (In amending Reg. § 1.856-7(c), the IRS declined "to prescribe a specific list of persons whose opinions may constitute reasonable cause" and instead provided "that the opinion must be rendered by a tax advisor (including house counsel) whose opinion would be relied on by a person exercising ordinary business care and prudence in the circumstances of the particular transaction" because "the general overall requirement that the REIT must exercise ordinary business care and prudence in attempting to satisfy the requirements of sections 856(c)(2) and (3) in order to have reasonable cause for failure to do so".).

The regulations also provide additional evidence that the phrase "due to reasonable cause and not due to willful neglect" is not meant to constitute two separate prongs, but instead constitute two mutually reinforcing phrases (*i.e.*, "look up and not down"). To start, the regulation text articulates the standard as being satisfied through a single analysis rather than one analysis for "reasonable cause" and a second additional analysis for "not willful neglect". The regulation states: "[t]he failure to meet the requirements of paragraph (2) or (3) of section 856(c) (or of both paragraphs) will be considered due to reasonable cause and not due to willful neglect if the real estate investment trust exercised ordinary business care and prudence in attempting to satisfy the requirements. Such care and prudence must be exercised at the time each transaction is entered into by the trust." Reg. § 1.856-7(c)(1). That a single analysis determines the result of application of the standard indicates that the word "and" in the phrase "due to reasonable cause and not due to willful neglect" represents a dividing line between reasonable cause and willful neglect so that one way of knowing a taxpayer has reasonable cause is ascertaining that it was not willfully neglectful (or, inversely, that a taxpayer did not have reasonable cause because it was willfully neglectful). In addition, when discussing a taxpayer's reliance on an expert opinion, Reg. § 1.856-7(c)(1) states that "[t]he reasonable reliance on a reasoned, written opinion as to the characterization for purposes of section 856 of gross income to be derived (or being derived) from a transaction generally constitutes 'reasonable cause' if income from that transaction causes the trust to fail to meet the requirements of paragraph (2) or (3) of section 856(c) (or of both paragraphs)". That there is no reference to "and not due to willful neglect" here indicates that once "reasonable cause" has been established no further analysis is required; this reinforces that the standard is a single concept ("reasonable cause") containing language that clarifies the boundary of that concept (*i.e.*, reasonable cause ends where willful neglect begins). *Cf.* Reg. § 1.856-7(c)(header) (the header to Reg. § 1.856-7(c), which reads simply the two-word phrase "Reasonable cause" rather than the fuller phrase "due to reasonable cause and not due to willful neglect", suggesting that the standard is a single concept and not two separate prongs); CCAs 200923034 (Feb. 17, 2009) (without also referencing the phrase "willful neglect", stating that if the District Director were to find that a REIT had "reasonable cause" for its failure to satisfy the 75% gross asset test, the REIT would not be subject to the five-year lock out of Section 856(g)(3)) and 200913057 (Feb. 27, 2009) (same); FSA 1996-14 (March 5, 1996) (indicating the IRS's interpretation of the "reasonable cause" standard of Section 856(g)(4)(C) is applied as a single analysis (and not two separate prongs) by stating "failure to qualify was due to reasonable cause *rather than* willful neglect" and quoting from section (20)935 of the then in effect Internal Revenue Manual describing the Section 6653 "reasonable cause" standard, which stated: "provide[d] that 'if a taxpayer can show reasonable cause and good faith, then the definition for negligent conduct will not have been met and the penalty would not apply.'") (emphasis added).

[11] *See also infra* text accompanying notes 40 through 42.

buyers of a REIT may use insurance to protect against specific, known REIT compliance infirmities through the use of a TIIP, a buyer may require RWI during an acquisition transaction, or a buyer and seller may agree to use a hybrid RWI and TIIP policy in a transaction where, for example, the buyer seeks a rep and warranty indemnity but the seller will not provide such an indemnification.

Organization

Managed by a board, transferable shares, per Sections 856(a)(1) and (2)

- What about shareholder control/veto over board decisions?
- What about transfer restrictions on REIT shares?
- Section 856(g)(5) remediation (if needed or if protective) is available to an ongoing REIT, but what if the Target REIT is liquidated or merged out of existence?
- Should the Target REIT self-assess under Section 856(g)(5) for its final tax year?

100+ shareholders, per Section 856(a)(5), and five-or-fewer (5/50%) proscription, per Sections 856(a)(6), 856(h), 856(k), and 857(f)(1)

- Neither requirement applies for the first REIT year, per Section 856(h)(2).
  - But beware of a short initial REIT year and the corresponding need to comply with Section 856(a)(5) by January 30 of the second REIT year, per Sections 856(b), 857(f)(1) and Reg. § 1.857-8(e).
- Is a shareholder demand letter required for the first REIT year? Arguably, no.[12]
- Section 857(f)(2)(D) adds a "reasonable cause" exception for failure to send letters.
- Can shareholder demand letters be sent late (on the theory of better late than never)? Perhaps it helps on "reasonable cause", and it cannot otherwise hurt.
- Section 856(g)(5) remediation (if needed or if protective) is available to an ongoing REIT, but what if the Target REIT is liquidated or merged out of existence?

Missed or muddled REIT (IRS Forms 1120-REIT, 7004, and 8832) and TRS (IRS Forms 8832 and 8875) elections

- Reg. § 301.7701-3(c)(1)(v)(B) provides for a deemed election by an eligible entity electing REIT status to be classified as an association effective as of the first day the entity is treated as a REIT.
- IRS Form 8832 check-the-box (CTB) late filing relief under Rev. Proc. 2009-41 is on the very form itself.
- Relief for late elections is possible under Regs. §§ 301.9100-1 and 301.9100-3.[13]
- Relief for scrivener's errors on an election form (e.g., erroneous EIN or entity name reported, incomplete forms) is possible through coordination with the Entity Control Unit.[14]

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[12] PLR 8919011 (Feb. 6, 1989) (demand letter is required to help verify compliance with 100+ shareholders and five-or-fewer, neither of which apply in the first REIT year).

[13] *See, e.g.,* PLR 202336001 (Jun. 13, 2023) (granting late filing relief to an aspiring REIT that failed to file an IRS Form 7004 extending the due date of its IRS Form 1120-REIT for its first REIT year); see *also* Nareit, "Comments on IRS Draft Forms 1120-REIT and 8875 and Their Instructions" (Jan. 4, 2021), available at: https://www.reginfo.gov/public/do/DownloadDocument?objectID=107615100. *See also* notes 40 through 42, and accompanying text.

[14] *See, e.g.,* IRM Sections 3.13.5.1(2) (providing that the Entity Control Unit will correct and perfect taxpayer information such as name, filing statuses, etc. based on taxpayer-initiated contact), 3.13.222.8

An entity can be other than closely-held for purposes of Section 856 (and thus qualify as a REIT), but still constitute a Section 542 "personal holding company".[15] While not a REIT qualification issue, in this circumstance any Section 331 liquidation of the Target REIT (in order to achieve an asset basis "step up" by acquiror) may have to wait until early in the next taxable year (during the "watch" of the public buyer) in order to avoid the "personal holding company" taint within Section 562(b).

Rents from Real Property

Section 856(d)(1) is generally not at issue;[16] it's all about the Section 856(d)(2) exclusions.

Section 856(d)(2)(A) bad formulas are thankfully rare, but they do happen from time to time, and if the nonqualifying income from such formulas is sufficiently large to violate the gross income tests under Section 856(c)(2) or (3), questions may arise whether the taxpayer had "reasonable cause" under Section 856(c)(6).

Section 856(d)(2)(B) related party rents are difficult to diligence. Obvious failures are thankfully rare, but overbroad Section 318 attribution is an epistemological nightmare.[17]

- The "knowledge qualifier" approach is commonly adopted when there is no "actual knowledge" of an attribution problem.
- Some REITs rely on "excess share" provisions operating automatically and thereby solving the problem *before* it occurs.
- There are also cogent arguments that Sections 318 and 856(d)(5) attribution is more narrowly applied than first glance might suggest.[18]

(providing that Service personnel should correspond with taxpayers to perfect an incomplete form), and 3.13.222.18-.19 (providing procedures to resolve TIN/name mismatches and other TIN problems).

[15] IRS Form 1120-REIT (2020), Box B2 and Schedule J Box 5. This dual status may occur because the attribution rules are slightly different in determining Section 856 "closely held" status versus a Section 542 "personal holding company" determination. *Compare* Sections 542(a)(2) (domestic pension trust treated as a single "individual") *and* 544(a)(2) (partner-to-partner attribution) *with* Sections 856(h)(1)(B) (no partner-to-partner attribution) *and* 856(h)(3) (look through domestic pension trust to its widely-held beneficiaries). In addition, there are related but distinct definitions for "closely held" under Sections 465(a)(3) and 469(j)(1). In the case of private REITs that are owned by real estate funds and private equity funds, these various definitions of "closely held" can and do shake out differently under various real-world scenarios, and thus it is very possible for a REIT to be other than "closely held" under the REIT rules, but still be "closely held" for purposes of one or more of the personal holding company, at risk, or passive activity loss rules.

[16] At the cutting edge, Section 856 "rents from real property" can be a nuanced inquiry. *See* Ameek Ashok Ponda, "Comments on Proposed Regulations, Sections 1.861-18 and 19 (REG-130700-14): Classification of Cloud Transactions and Transactions Involving Digital Content" (Oct. 24, 2019, with particular attention to Exhibit B therein), available at: https://878449.fs1.hubspotusercontent-na1.net/hubfs/878449/Ameek%20Ponda%20Submits%20Comments%20on%20Proposed%20Cloud%20Transaction%20Regs.pdf.

[17] *See* Nareit, "Comments on Double Downward Attribution and the REIT Related Party Rent Rules" (Feb. 27, 2020), available at: https://www.reit.com/sites/default/files/Related_party_rent_Nareit%20submission_02-27-2020.pdf.

[18] *See, e.g.*, Section 318(a)(5)(C) (in certain instances, a partnership, estate, trust, or corporation will not be considered to actually own stock that it constructively owns for purposes of making another the

- Section 856(c)(5)(J) relief can perhaps provide a "pared back Section 318" approach like that found in Reg. § 1.958-2(d)(1), (e), and (h)(first sentence).[19] But will the Service use this authority to help out taxpayers? It has not done so to date.
- Others rely on a narrow read of Section 318 attribution, combined with possible "reasonable cause" remediation for REIT taxable years in which there was little-to-no profitability (measured without regard to the dividends paid deduction) on account of interest expense and depreciation. Using these tools, some aspirants "bootstrap" into REIT compliance under Section 856(c)(6), with little-to-no penalty tax liability under Section 857(b)(5).
- A legislative fix is (hopefully) on its way.[20]

Section 856(d)(2)(C) and 856(d)(7) "impermissible tenant service income" (ITSI) rules can be fiendishly complicated to apply, but Rev. Ruls. 2004-24,[21] 2002-38,[22] and 98-60[23] are a good starting point for understanding them, as is the seminal article regarding using a TRS to provide cutting-edge services, which was written by members of Sullivan Tax.[24]

- The 1% ITSI threshold is very low and easy to exceed under the glare of fulsome diligence.
- Is the applicable "property" a single building… or an entire campus… or an entire fiber network?[25]

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constructive owner of such stock); Rev. Rul. 74-605, 1974-2 C.B. 97 (indicating that the attribution rules cannot apply in a manner that would cause a subsidiary to be treated as owning the stock of its parent because the subsidiary would then own its own stock by reason of Section 318(a)(3)(C), a result that is prohibited under Reg. § 1.318-1(b)(1)); PLR 200842010 (Jul. 9, 2008) (determining that, due to application of Section 318(a)(3)(C), a tenant of a REIT is not a "related-party tenant" where such tenant is owned by an unrelated upper tier partner of the REIT's subsidiary); GCM 35414 (Jul. 25, 1973) (providing guidance that a corporation should not be treated as owning the stock of any corporation in the chain between itself and the shareholders through whom the attributive link is made); Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in 1997", 1997-3 C.B. 88, 497 (Example 3) (providing that no portion of an interest in a tenant of a REIT is held by the REIT where 10%+ of the REIT is held by partners that hold 50% of the interests in a partnership and the other partners in the partnership hold 100% of the interests in the tenant).

[19] *See also Estate of Nettie S. Miller v. Comm'r*, 43 T.C. 760 (1965) (Code provisions invoking Section 318 attribution "should not be interpreted to produce absurd consequences even though such an interpretation might be within the literal language of the [Code]").

[20] Such a fix has been introduced in both the 116th and 117th Congresses, most recently in H.R. 840: Retail Revitalization Act of 2021, available at: https://www.congress.gov/bill/117th-congress/house-bill/840/text.

[21] 2004-1 C.B. 550 (addressing commonly encountered arrangements for parking at REIT properties).

[22] 2002-2 C.B. 4 (concluding that gross income from tenants for noncustomary services provided through a TRS constitutes rents from real property).

[23] 1998-2 C.B. 749 (demonstrating that ITSI within the 1% threshold will not taint gross income otherwise qualifying as rents from real property, while ITSI above the 1% threshold will taint such gross income).

[24] *See* Decker, Kaplan, and Ponda, "Non-Customary Services Furnished by Taxable REIT Subsidiaries", 148 *Tax Notes* 413 (Jul. 27, 2015), available at: https://878449.fs1.hubspotusercontent-na1.net/hubfs/878449/Non-Customary%20Services%20Furnished%20by%20Taxable%20REIT%20Subsidiaries.pdf

[25] In industry, a taxpayer typically defines what is the unit of "property" and presumably the IRS will provide some deference to this determination. *Cf.* PLR 201129007 (Apr. 6, 2011) (finding, where the REIT leased space at multiple tower sites pursuant to separate site licenses under a master license agreement, that

- Bottom line is that TRSs are a "comprehensive solution" for REIT compliance and are better than independent contractors (IKs).
    - In fact, many well-advised REITs hire IKs through their TRSs.
- Backfill the "geographically customary" and "customary-for-rental" requirements with an after-the-fact analysis (on the theory of better late than never).

Sections 856(c)(6) and 857(b)(5) remediation is also possible, especially if on a protective basis for a Target REIT in which there was little-to-no profitability (measured without regard to the dividends paid deduction) on account of interest expense and depreciation.[26]

Remediation (if needed or if protective) is available to an ongoing REIT, but what if the Target REIT is liquidated or merged out of existence?

Income from Passive Sources (other than Rents)

Be careful during "ramp up" and "ramp down" periods.

- What of a REIT with zero gross income in its first or last taxable year?[27]

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the REIT could analyze Reg. § 1.856-4(b)(2)(ii) 15% personal property test compliance at the site license level (rather than the master license agreement level)).

[26] As discussed in *supra* note 8, the RIC and REIT income and asset tests remediation provisions are generally very parallel, and this is intentionally so. But, curiously, the intermediate sanctions penalty tax for RIC income test failures in Section 851(i)(2), which can result in a penalty tax of slightly over 110% of the amount by which the actual "bad" gross income exceeds the 10%-of-total-gross-income-basket of permitted "bad" gross income, is comparably more expensive than its Section 857(b)(5) REIT counterpart, which is based in significant part on the transgressing REIT's overall net taxable income (a number which is often quite modest and maybe even zero).

[27] Of course, when possible, the best plan is to avoid an "empty" REIT in the first place, and this is best achieved by having the aspiring REIT accept a cash infusion from its owners in exchange for the issuance of newly issued REIT equity, all as contemplated by the Sections 856(c)(3)(I), 856(c)(5)(B), 856(c)(5)(D), 1275(a)(1), and 7701(a)(7) "temporary investment of new capital rules" ("TINC"), and in this fashion contributed cash invested in an ordinary bank account will yield interest income that qualifies under both the 95% and 75% gross income tests. *See* Sections 856(c)(2)(B), 856(c)(3)(I), 856(c)(5)(D)(i)(I), and 1275(a)(1) and Reg. § 1.1275-1(d) ("debt instrument" is defined broadly so as to include an interest-earning bank account, and such interest income then qualifies under the REIT 95% and 75% gross income tests); *see also* Hammell & Ponda, *supra* note 7.

Like other statutory provisions in the Code, the TINC provisions contemplate that "new capital" will typically be received by an aspiring REIT "in exchange for" the aspirant issuing newly issued "stock". *See* Sections 856(c)(5)(D)(ii) (providing that new capital means any amount received by the aspirant "in exchange for stock (or certificates of beneficial interests) in such trust (other than amounts received pursuant to a dividend reinvestment plan)") and 7701(a)(7) (defining "stock"). But, in a typical case for an aspiring private REIT that is a subsidiary of a real estate fund, the fund already owns 100% of the common equity of the aspiring REIT and so it would be a "meaningless gesture" for the aspiring REIT to issue additional common stock to the fund in exchange for capital it receives from the fund. In other Code contexts where the statute contemplates an issuance of additional stock, that statutory language is interpreted as superfluous in factual contexts where stock issuance would be a "meaningless gesture". *See, e.g.*, Reg. § 1.368-2(l)(2)(i) (providing that a transaction otherwise described in Section 368(a)(1)(D) will be treated as meeting the requirements of Sections 368(a)(1)(D) and 354(b)(1)(B) even if no stock or securities of the transferee corporation are issued, provided the same person or persons directly or indirectly own all of the stock of the transferor and transferee

- The better read of Sections 856(c)(2)-(3) is that zero gross income is fine because the applicable 95% and 75% REIT gross income testing percentages in Sections 856(c)(2)-(3) are applied to a multiplicand of zero, yield a threshold of zero, and then clear the threshold by being zero. The IRS has recently confirmed its agreement with this very analysis.[28]
- Particularly because Reg. § 1.856-2(c)(1) articulates the REIT gross income tests as involving a numerator and a denominator, some were concerned that Sections 856(c)(2)-(3) require computation of a fraction by using division – a fraction that cannot be computed because it is mathematically impossible to divide by zero, and therefore the applicable REIT gross income tests are not satisfied.
- Apposite guidance from other parts of the Code reinforces that the multiplication approach is the correct one because the applicable REIT gross income tests (when faced with a zero) should either be ignored as inapplicable or applied in a pro-

corporations in identical proportions); Rev. Rul. 64-155 (contribution of appreciated property from domestic corporation to its wholly-owned foreign subsidiary was treated as an exchange of property for stock and, consequently, Section 367 was applicable so that the parent recognized gain). In certain other contexts, the Code explicitly provides for one tax result in the case of a mere capital contribution and another tax result in the case of a stock issuance, which demonstrates that Congress intended such differences in these instances. *Compare* Section 108(e)(6) (providing that where a debtor corporation acquires its indebtedness from a shareholder as a capital contribution, Section 118 shall not apply and instead the debtor corporation will be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness) *with* Section 108(e)(8) (providing that where a debtor corporation acquires its indebtedness from a shareholder in exchange for the debtor corporation's stock, the debtor corporation will be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock); *see also* TAM 9830002 (Mar. 20, 1998) (finding that where the debtor corporation issued stock in exchange for indebtedness held by its parent, grandparent, and great-grandparent, Section 108(e)(8) and not Section 108(e)(6) applied). In the absence of explicit rules providing for disparate treatment between a mere capital contribution versus a subscription in exchange for stock, the meaningless gesture doctrine should apply. This is especially so with regard to the TINC provisions, for there is no logical purpose served in denying an aspiring REIT applicable TINC treatment when it has received a mere capital contribution versus when it has issued new stock in exchange for subscription capital.

[28] In PLR 202440007 (Jun. 25, 2024), the taxpayer filed an initial IRS Form 1120-REIT electing REIT status and reporting zero gross income and zero gross assets. Subsequently, the taxpayer's new REIT advisor informed the taxpayer that it was unclear whether a REIT could satisfy the tests required for REIT qualification if the REIT did not have gross income or gross assets, and advised the taxpayer to file a ruling request permitting it to file an amended IRS Form 1120 as a regular C corporation and to treat it as having not made a REIT election. *Cf. supra* note 3 and the text accompanying the same. The IRS declined to provide the requested ruling because it found that the taxpayer had in fact not failed the gross income or gross asset tests by having zero gross income and zero gross assets. Echoing the long-standing articulation of the logic in this article (and its predecessors going back to 2021), the IRS stated: "Taxpayer's gross income in Year 1 was $0. The percentage is 95% under section 856(c)(2), and 95% of $0 equals $0. The percentage is 75% under section 856(c)(3), and 75% of $0 equals $0. Thus, in Year 1, at least $0 of Taxpayer's gross income was derived from the enumerated sources under the Gross Income Tests." The IRS went on to explain that Reg. § 1.856-2(c) interprets the gross income tests as being concerned with the sources of a REIT's gross income and not with whether the REIT has gross income in the first instance and that Reg. § 1.856-2(c)(1) does not prevent qualification as a REIT on account of having $0 of gross income. The IRS also analyzed the applicable legislative history, and found that the history demonstrated that its interpretation was consistent with Congressional intent, which was primarily concerned with the source (rather than the existence) of a REIT's gross income.

taxpayer way;[29] accordingly, zero gross income leads to REIT gross income testing compliance rather than REIT gross income testing failure.

- Still, out of an abundance of caution, some REITs have historically chosen to remediate a prior REIT taxable year with zero gross income through the self-reporting mechanism of Sections 856(c)(6) and 857(b)(5), and in doing so report a Section 857(b)(5) penalty tax of zero for the REIT gross income tests' "failure".[30]

Failure to designate hedges under Section 856(c)(5)(G), including an actual, potential, or perceived failure to comply fully and completely with designation requirements: possible remediation (including protective remediation) under Sections 856(c)(5)(G)(iv) and 1221(a)(7) as well as Reg. § 1.1221-2(g)(2), including for "inadvertent error" such as a mistaken belief.[31]

Contribute source of bad income into a TRS for prospective fix, and then address any prior accruals within the "reasonable cause" exception of Section 856(c)(6) and Reg. § 1.856-7(c) and pay the applicable tax, if any, imposed by Section 857(b)(5). Notably, while reliance on a "reasoned, written opinion" as to the characterization of gross income from a transaction will generally constitute "reasonable cause", the absence of such a reasoned, written opinion does not, by itself, give rise to any inference that "reasonable cause" was lacking. Reg. § 1.856-7(c)(2)(i). Instead, the reasonable

[29] *See* Former Prop. Reg. §§ 1.245A(e)-1(d)(4)(i)(B)(1)(*ii*) and (d)(4)(i)(B)(2)(*ii*) (providing that a zero denominator results in the fraction being considered zero for purposes of calculating subpart F hybrid dividend inclusions); TAM 200914021 (Dec. 8, 2008) (zero gross receipts satisfy and/or render inapplicable the Section 165(g)(3)(B) requirement of 90% of gross receipts coming from an active business); PLR 9447016 (Aug. 19, 1994) (zero gross income renders the then PFIC gross income test inapplicable); PLR 8717066 (Jan. 30, 1987) (where zero basis results in a zero denominator, Section 514(a) is rendered inapplicable and no part of certain borrowings were treated as "acquisition indebtedness").

[30] Perhaps not unexpectedly, this self-remediation under Section 857(b)(5) repeats the statutory language of Sections 856(c)(2)-(3) regarding REIT gross income testing percentages (e.g., "95 percent of the gross income"), involves the computation of a related-but-different type of statutory fraction, and leads (again) to the possible conundrum of a statutory fraction with a denominator (again, REIT gross income) that is zero. Fortunately, the Section 857(b)(5) computation is operationalized by IRS Form 1120-REIT, Part III and thereby avoids the mathematical conundrum, as follows. First, and tellingly, Part III, Lines 2f and 5f, which calculate the amount of gross income required to satisfy the 95% and 75% REIT gross income tests, respectively, are expressed as a multiplication operation rather than a division operation, thus reinforcing that the better reading of Section 856(c)(2)-(3) in the first place is that the REIT gross income testing percentages are applied to a multiplicand of zero rather than computed by reference to a fraction that uses division. Second, Part III yields the same result for the REIT (*i.e.*, no penalty) whenever Lines 4 and 7 therein equal zero, whether because the REIT has satisfied the gross income tests by having sufficient, positive qualifying gross income or whether instead because the REIT has zero gross income: in either such case, Part III, Line 8 will be zero, and as a consequence the REIT is expressly instructed to not complete the remainder of Part III. In other words, Part III never gets to the Section 857(b)(5) statutory fraction and dividing by zero gross income because Line 8 thereof will be zero whenever the REIT has zero gross income for the taxable year. In total, the foregoing special instructions and penalty computation of zero confirm that a REIT with zero gross income is best viewed as in compliance with the REIT gross income tests in the first place, for where there is no penalty there is no violation of law. *See* Romans 4:15 (King James Version) ("Because the law worketh wrath: for where no [penalty] is, there is no transgression").

[31] *See* PLRs 202419009 (Feb. 9, 2024), 202419008 (Feb. 9, 2024), 202419007 (Feb. 9, 2024), 202419006 (Feb. 9, 2024), 202419005 (Feb. 9, 2024), 202419004 (Feb. 9, 2024) (stating that "inadvertent error" should be given its ordinary meaning of an "accidental oversight; a result of carelessness" as defined in Black's Law Dictionary and finding the "inadvertent error" standard met where a taxpayer-REIT (i) relied on an accounting firm's mistaken belief that a hedge designation was not required, (ii) promptly took action to correct the error once discovered, and (iii) developed procedures to avoid the error in the future).

cause standard will be met where the REIT "exercised ordinary business care and prudence in attempting to satisfy the requirements" of Sections 856(c)(2) and (c)(3) and where such care and prudence was exercised at the time of each transaction entered into by the REIT. Reg. § 1.856-7(c)(1).[32]

If the Target REIT is "closely held" within the meaning of Sections 465(a)(1)(B) or 469(j)(1), then it would be precluded from netting its business losses and loss carryovers against certain forms of gross income, especially items like gross interest income. In turn, this would create a positive or additional REIT taxable income amount that must be distributed per Section 857(a)(1).

Assets that are Real Property or Real Estate Assets, and are Not Excessive Securities

As with the REIT income tests, be careful during "ramp up" and "ramp down" periods.

- What of a REIT with zero assets at its first few or final few quarter-ends?[33]
    - The better read of Section 856(c)(4) is that zero assets are fine because the applicable REIT asset testing percentages in Sections 856(c)(4)(A), (B)(i), (B)(ii) (B)(iii), and (B)(iv)(I) are applied to a multiplicand of zero, yield a threshold of zero, and then clear the threshold by being zero. The IRS has also recently confirmed its agreement with this very analysis.[34]
    - Some were concerned that Section 856(c)(4) requires computation of a fraction by using division a fraction that cannot be computed because it is mathematically impossible to divide by zero, and therefore the applicable REIT asset tests are not satisfied.
    - Apposite guidance from other parts of the Code reinforces that the multiplication approach is the correct one because the applicable REIT gross asset tests (when faced with a zero) should either be ignored as inapplicable or applied in a pro-taxpayer way;[35] accordingly, zero gross assets lead to REIT gross asset testing compliance rather than REIT gross asset testing failure.

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[32] *See* PLR 9550019 (Sept. 15, 1995) (finding that REIT's failure to satisfy the 95% gross income test under Section 856(c)(2) was due to "reasonable cause" where REIT's accountants identified that the REIT had for years directly provided meal, maid, and transportation services to senior citizen facilities, notwithstanding that the REIT had previously received a REIT qualification opinion and had in place a monthly REIT compliance checklist process); *see also* the discussion at notes 6 through 11 herein, and the accompanying text, for a further discussion of the "reasonable cause" standard.

[33] Again, when possible, the best plan is to avoid an "empty" REIT in the first place, and this is best achieved by having the aspiring REIT accept a cash infusion from its owners in exchange for the issuance of newly issued REIT equity; the contributed cash invested in an ordinary bank account will qualify as a good "real estate asset" for purposes of the REIT gross asset tests in Sections 856(c)(4) and 856(c)(5)(B). *See also supra* note 27.

[34] PLR 202440007 ("The value of Taxpayer's total assets in Year 1 was $0, and 75% of $0 equals $0. Thus, in Year 1, at least $0 of Taxpayer's assets was represented by the enumerated items under the Asset Test. To state that the Asset Test is not failed in the absence of any assets is consistent with the above legislative history, which demonstrates that in enacting the Asset Test, Congress was concerned with the nature of a REIT's assets and not whether the REIT had assets in the first instance. Accordingly, Taxpayer did not fail the Asset Test in Year 1."). *See also supra* note 28.

[35] *See supra* note 29 and accompanying text. In contrast to the REIT gross income tests, the REIT asset tests are nowhere in the regulations articulated in the form of a fraction, implying that multiplication is the even more correct answer in this context.

  - Some also worry whether an entity can truly have gross assets of zero (a "perfect vacuum") and whether some value must be assigned to state law registrations.[36]
- Also, the 30-day remediation in Section 856(c)(4) (flush language) may not apply to the REIT's first quarter-end.

Real property depreciated as personal property

- An erroneous accounting method, once adopted and unless challenged by IRS, does not impact reporting for REIT "taxable income", or for the associated REIT distribution requirement(s), on as-filed REIT income tax returns; an erroneous accounting method should also have no bearing on the proper characterization of real property or personal property under Reg. §§ 1.856-3(d) and 1.856-10.
- File IRS Form 3115 to change depreciation methods, pick up associated Section 481(a) gross income over 4 years (subject to acceleration), and obtain Section 856(c)(5)(J) relief for the positive Section 481(a) adjustments.

Bad securities under the 10-10-5 asset tests in Sections 856(c)(4)(B)(iv)(I)-(III)

- Section 856(c)(5)(F) defines "security" as under the Investment Company Act of 1940, and thus contractually owed amounts embedded in a lease or similar "real estate" document (*e.g.,* a deposit in a lease or in a real estate purchase & sale agreement) are almost certainly not "securities" for these purposes.
- Definition of "cash" under Section 856(c)(5)(K) and Rev. Rul. 2012-17[37] also helps a lot.
- Also, a Reg. § 1.856-2(d)(1)(iii) ordinary course "receivable" is included within Section 856(c)(4)(A) and thus by definition not subjected to the 10-10-5 asset test limits in Sections 856(c)(4)(B)(iv)(I)-(III).
  - Reg. § 1.856-2(d)(1)(iii) says that "purchased" receivables are not "ordinary course" receivables, but this exclusion should not apply to receivables acquired in a Section 381(a) carryover basis transaction.[38]
  - In addition, most receivables arising organically from the REIT's real property business, not just rent receivables, can qualify as ordinary course receivables.[39]
- 10% value asset test limit is still very tricky, even with the favorable rules of Section 856(m).

Move bad assets into a TRS through a Section 351 contribution or elect with the issuer of the potentially bad securities to have the issuer become a TRS by timely filing an IRS Form 8875 with the REIT.

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[36] *Cf.* PLR 201236006 (Jun. 7, 2012) (inclusion on balance sheet of IPO costs valued at zero by good faith determination of trustees did not cause taxpayer to fail asset tests).

[37] 2012-25 I.R.B. 1018 (shares in money market fund constitute "cash items" and are not a "security" for purposes of REIT asset testing).

[38] *Compare* Section 1012 *with* Section 7701(a)(42)-(45).

[39] *See, e.g.,* PLRs 202305009 (Nov. 9, 2022), 201845001 (Aug. 10, 2018), and 201518010 (Jan. 29, 2015) (brownfield credits are ordinary course receivables); PLRs 201816001 (Jan. 3, 2018), 201816002 (Jan. 3, 2018), and 201816003 (Jan. 3, 2018) (receivables consisting of real estate tax abatements and revenue sharing calculated on net increased revenues due to the REIT's project development are ordinary course receivables); PLR 201428002 (Apr. 2, 2014) (brownfield credits and economic incentive credits are ordinary course receivables).

Remedying REIT asset testing for prior calendar quarters can usually be achieved with Section 856(c)(7)(A) or (B) relief, including (as applicable) any Section 856(c)(7)(C) penalty in respect of prior periods of failure (which penalty, when it applies, is typically reasonable and not punitive).

- If the asset test failure relates to the 10-10-5 asset tests in Sections 856(c)(4)(B)(iv)(I)-(III) and the failure meets the statutory exception for a de minimis failure, then the REIT will be considered to have satisfied the 10-10-5 asset tests. To qualify for the statutory exception for a de minimis failure, the REIT must (i) show that the 10-10-5 asset test failure was due to ownership of assets, the total value of which does not exceed the lesser of 1% of the REIT's total assets at the end of the applicable quarter or $10 million and (ii) within six months after the end of the calendar quarter in which the REIT identifies the asset test failure (or in such time period and manner prescribed by the IRS), dispose of assets sufficient to enable it to satisfy the 10-10-5 asset tests or otherwise satisfy such tests. Section 856(c)(7)(B). Satisfying the exception does not require a REIT to show "reasonable cause" or subject the REIT to the penalty tax under Section 856(c)(7)(C).
- If the REIT asset test failure does not meet the statutory exception for a de minimis failure under Section 856(c)(7)(B), then Section 856(c)(7)(A) permits remediation for prior quarters if the REIT satisfies a three prong test: (i) following identification of the failure, the REIT attaches a description to its tax return describing each asset that caused the REIT to fail to satisfy Section 856(c)(4), (ii) the failure was "due to reasonable cause and not due to willful neglect", and (iii) within six months after the end of the calendar quarter in which the REIT identifies the asset test failure (or in such time period and manner prescribed by the IRS), the REIT disposes of assets sufficient enough to enable it to satisfy the applicable asset test(s) or otherwise satisfies such test(s). Section 856(c)(7)(A). In addition, the REIT will owe the penalty tax under Section 856(c)(7)(C), which tax is the greater of $50,000 or the tax calculated on the net income generated by the assets causing the asset test failure. Section 856(c)(7)(C)(i). While the penalty tax is due, payment of the same is technically not a prerequisite to satisfying the Section 856(c)(7)(A) remediation standard.
- Whatever the outer bounds of Section 856(c)(7)(A)(ii) may permit, the provision surely was meant to permit remediation for common occurrences such as an otherwise compliant REIT inadvertently failing to make an intended TRS election.
    - In fact, around the time the Section 856(c)(7) intermediate sanctions regime was enacted into law, a high-profile instance was in the news where an otherwise compliant public REIT inadvertently failed to make a TRS election and its failure to do so roiled public equity markets until the IRS granted relief pursuant to Reg. §§ 301.9100-1 and 301.9100-3 on an expedited basis.[40]
    - Contemporary commentary from Nareit, which promoted the passage of Section 856(c)(7), indicates that Section 856(c)(7)(C) was intended, in part, to permit otherwise compliant REITs to self-remediate compliance oversights, such as the high-profile REIT's inadvertent failure to file a TRS election, that would otherwise be a "death trap" awaiting permissive IRS relief pursuant to Reg. §§ 301.9100-1 and

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[40] *See* "PREIT Seeks Retroactive Tax Relief", *Philadelphia Business Journal* (Feb. 2, 2004), available at: https://www.bizjournals.com/philadelphia/stories/2004/02/02/daily42.html (last updated Feb. 6, 2004); Kurt Blumenau, "Mall Owner Gets Break from IRS ** Real Estate Trust's Error Could Have Stripped It of Special Tax Status", *The Morning Call* (Feb. 10, 2004), available at: https://www.mcall.com/2004/02/10/mall-owner-gets-break-from-irs-real-estate-trusts-error-could-have-stripped-it-of-special-tax-status/.

301.9100-3 and/or a closing agreement process (both of which generally take time).[41]

- Thus, because Section 856(c)(7) was intended as a self-remediation alternative to IRS relief pursuant to Reg. §§ 301.9100-1 and 301.9100-3, many practitioners view the Section 856(c)(7)(A)(ii) legal standard of "due to reasonable cause and not due to willful neglect" to subsume, in practice, the Reg. § 301.9100-3 standard of "acted reasonably and in good faith". This in turn means that a taxpayer's attempt to remediate inadvertent oversights, if discovered and remediated by the taxpayer prior to discovery by the IRS, should be *per se* eligible for applicable Section 856(c)(7) relief.[42]

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[41] *See* Tony M. Edwards & Dara F. Bernstein, "REITS Improved", p. 13 (2005), available at: https://www.reit.com/sites/default/files/media/Portals/0/Files/Nareit/htdocs/policy/government/BNAArticlefinal%201-03-05.pdf.

Utilizing a closing agreement to resolve potential REIT compliance issues is a particularly cumbersome mechanism, and one that is fraught with delays and uncertainty. In a closing agreement process, the IRS will likely be hesitant to consent to an agreement that affirms the taxpayer's REIT compliance for all purposes of the Code because the IRS "does not know what it does not know". At the same time, the taxpayer-REIT is unlikely to agree to a closing agreement unless such agreement comprehensively resolves all uncertainty as to its potential REIT foot fault and resulting noncompliance for all purposes of the Code. In these cases, rather than attempt to reach agreement with the IRS that the taxpayer-REIT did not in fact violate any of the REIT requirements, it will likely be more expedient to fully resolve the potential REIT compliance issues by relying on "reasonable cause". At least one REIT faced the "death trap" of trying to secure a closing agreement with the IRS that affirmed the taxpayer-REIT had satisfied the gross income tests during a 7-year period; faced with the likely delay of its IPO, the taxpayer-REIT forwent its attempt to secure a closing agreement that affirmed it had satisfied the gross income tests and instead asked the IRS to determine that it had "reasonable cause" for any potential gross income test failure during the applicable period. At the time of the taxpayer-REIT's November 2017 SEC Form S-11 filing (the taxpayer initially filed Form S-11 in 2009, which was later withdrawn), it still had not come to agreement with the IRS, even on its more limited closing agreement request. *See* Americold Real Trust Form S-11 (Nov. 14, 2017), p.297 (https://www.sec.gov/Archives/edgar/data/1455863/000119312517342565/d421317ds11.htm) ("After concluding that an IRS determination as to whether the Australian and New Zealand storage revenues constituted Qualifying Rents was likely to entail significant delay and potentially interfere with timely completion of this offering, we asked the IRS to forgo a review of the merits and instead determine that the Reasonable Cause Exception would apply to any potential failure. We are currently negotiating with the IRS the terms of such closing agreement and the amount of any tax that would be imposed under Section 857(b)(5) as a result. The closing of this offering is contingent on our entering into a satisfactory closing agreement with the IRS that will permit [our counsel] to render its opinions on our REIT status."). The taxpayer REIT eventually completed its IPO on January 18, 2018 after definitively entering into a closing agreement with the IRS to treat certain storage revenues earned during the taxpayer's 2010 through 2016 tax years as nonqualifying income, and any resulting failures of the 95% gross income test as being due to "reasonable cause". In connection with this closing agreement, the taxpayer paid $4.3 million to the IRS. *See* Americold Real Trust Form S-11/A (Jan. 9, 2018), p. 305 (https://www.sec.gov/Archives/edgar/data/1455863/000119312518006497/d421317ds11a.htm#toc) and Prospectus dated January 18, 2018 (https://www.sec.gov/Archives/edgar/data/1455863/000119312518015245/d421317d424b4.htm).

[42] *See, e.g.,* Reg. § 301.9100-3(f)(Example 1). *See also* PLRs 202324003 (Mar. 24, 2023); 201952003 (Sep. 25, 2019); 201815014 (Jan. 8, 2018); 201614022 (Dec. 22, 2015); 201252009 (Sep. 27, 2012); 201210021 (Nov. 23, 2011); 200716015 (Jan. 17, 2007) (each granting extension of time to file intended election where taxpayer demonstrated it acted reasonably and in good faith, and the IRS would not be prejudiced).

Should REITs still use a "protective" transfer of bad assets to a TRS or to a trust,[43] especially in the final calendar quarter just before liquidation? It cannot hurt to do so.

Distributions that are Formal, Sufficient, Timely, and Not Preferential

Formal corporate distributions require serial board resolutions, but perhaps ongoing LLC distributions can be approved once (at inception when preferred equity is first issued).

- Best practice is to adhere to maximum formalisms around timely resolutions.
- Does a later board ratification help if an earlier board resolution is missing? It cannot hurt.

Some worry that Section 565 "consent dividends" and Section 857(b)(9) "spillback" dividends cannot be used effectively to purge accumulated C corporation earnings and profits ("E&P") that must be distributed by year-end in order to satisfy Section 857(a)(2) and Reg. § 1.857-11.

- The concern is that utilizing these provisions may be grounded in "circular" reasoning—*i.e.,* the corporation must be a REIT to utilize, respectively, Section 565 or Section 857(b)(9),[44] but the corporation is only a REIT if it has successfully utilized, respectively, Section 565 or Section 857(b)(9).
- The far better view is that these statutory provisions in fact do apply in maximalist fashion in order to carry out their intended purposes of timely distributing E&P to REIT shareholders. Rather than think of the operative reasoning as "circular", it is better to view the reasoning as "self-reinforcing".
- If the E&P amounts involved are modest, the REIT can also utilize Section 852(e) remediation, described below, as a safety net.

If the Target REIT is "closely held" within the meaning of Section 465(a)(1)(B) or 469(j)(1), then its prior taxable years should be reviewed for positive or additional REIT taxable income (*e.g.,* on account of passive investment income that cannot be offset with business operating losses), which taxable income must then be distributed per Sections 857(a)(1) and 860. In some cases, the Target REIT's distribution history (or reporting thereof) would not have been sufficient to meet the Section 857(a)(1) distribution requirement.

The Section 562(c) preferential dividend rule typically applies to a private REIT, but does not apply to a publicly-offered REIT or its subsidiary REIT (assuming that the subsidiary REIT is included in the parent REIT's public SEC reporting).[45] One of the most challenging aspects of the Section 562(c) preferential dividend rule is that, at least according to the IRS, a REIT cannot charge differential asset management fees to different classes of common equity investors (though it is permitted, within limits, to charge differential administrative fees to investors participating via different placement channels).[46]

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[43] *See* PLR 200234054 (May 21, 2002) (transfers to a "protective trust") and PLR 200132008 (May 4, 2001) (protective transfers to "liquidating trusts").

[44] *See, e.g.,* Reg. § 1.565-1(a).

[45] Section 562(c), as interpreted by PLRs 202051005 (Sep. 18, 2020) and 201924003 (Feb. 28, 2019).

[46] The IRS has stated this principle as follows:

Unfortunately, minor timing and amount discrepancies are potentially problematic preferential dividends,[47] but perhaps case law can limit the damage to just the individual distribution (and thus limit "collateral damage"),[48] and any resulting insufficiency can be addressed thereafter with Section 860.

For previously ineffective, insufficient, or preferential distributions, relief is possible under Sections 852(e) and 860,[49] and relief may also be possible for a successor REIT in respect of a REIT predecessor under Section 381(c)(23). But, more generally, if the Target REIT is liquidated or merged out of existence, consideration should be given to a final relief dividend under Sections 852(e) and 860 before the last day of the REIT's final taxable year.

> "[W]hile differences in distributions paid to certain larger shareholders of a class to reflect reductions in associated administrative expenses are permissible and do not cause the distributions to be preferential dividends, differences in distributions due to a reduction in investment advisory fees for a particular class are not permissible".

PLR 201444022 (Jul. 21, 2014) (special dividend on only one class of stock, to adjust for difference in asset management fees, would be preferential dividend); *see also* PLR 201408014 (Nov. 26, 2013) (differential administrative fees permitted through use of six different classes corresponding to placement channels), PLRs 201327006 (Apr. 3, 2013), 201205004 (Nov. 1, 2011), 201135002 (May 17, 2011) (differential administrative fees permitted on two different classes with separate distribution), and 201119025 (Feb. 3, 2011) (same, supplementing PLR 201109003 (Aug. 24, 2010)).

[47] See Nareit, "Comments on IRS 2016-2017 Priority Guidance Plan" (May 16, 2016), available at: https://www.reit.com/sites/default/files/pdf/5-16-16%20NAREIT%20Final%20Submission%20with%20Attachment%20re%202016-17%20Priority%20Guidance%20Plan.pdf.

[48] *Henry Schwartz Corp. v. Comm'r*, 60 T.C. 728 (1973) (preferential taint should not *per se* extend to prior and subsequent distributions in the same taxable year), *acq*. 1974-2 C.B. 4, *acq. on this issue*, A.O.D. 1981-067, *nonacq. on different issue*, 1981-2 C.B. 3; *Hanco Distributing, Inc. v. U.S.*, 32 AFTR 2d 73-5485 (D. Utah 1973) (certain inadvertent, *de minimis* discrepancies are excused); PLR 8033031 (May 20, 1980) (initial non-preferential distribution is deductible and not tainted by subsequent, preferential distributions in the same taxable year).

[49] *See* Section 316(b)(3); Reg. §§ 1.857-11(c) and 1.860-2; Rev. Proc. 2009-28, 2009-20 I.R.B. 1011; IRS Forms 976 and 8927.