

# TAXATION OF REAL ESTATE INVESTMENT TRUSTS

© January 2012 – J. Walker Johnson and Alexis MacIvor

## I. Taxation of Real Estate Investment Trusts

### A. Qualification as a REIT

#### 1. Eligible entities

Section 856(a) lists numerous organizational requirements. To be eligible, an entity must be:

- a. a corporation, trust, or association,
- b. otherwise taxable as a domestic corporation (See Rev. Rul. 89-130, 1989-2 C.B. 117),
- c. managed by one or more trustees or directors,
- d. issuing transferable shares or certificates,
- e. which are held by 100 or more persons (no attribution rules apply)(Section 856(h)), and
- f. 50 percent of which are not owned, directly or indirectly, by 5 or fewer individuals (attribution rules apply).

(1) For purposes of this 5-or-fewer rule, a pension trust is not treated as a single shareholder. Rather, the beneficiaries of the pension trust are counted in determining the number of REIT shareholders. Section 856(h)(3).

(2) For tax years beginning after August 5, 1997, an entity that complies with Treasury regulations that require the REIT to maintain records that allow the IRS to ascertain actual ownership of its shares, and does not know whether it meets this test, is treated as having met the ownership rule. Section 856(k). No regulations have been issued yet.

g. Section 856(h)(2) waives the last two requirements (e and f) for the REIT's first year.

#### h. Recordkeeping Requirements

(1) The REIT must keep records that allow the IRS to ascertain its actual ownership.

(2) Former Rule - If the entity failed to keep records, the entity was disqualified from REIT status. Former section 857(a)(2).

(3) New Rules -

- (a) If the entity fails to keep records, the REIT pays a \$25,000 penalty for each tax year in which the failure occurs. Section 857(f)(2).
- (b) As described above, section 856(k) provides relief if a REIT complies with the recordkeeping rules.

## 2. Election of REIT status

- a. An eligible entity must elect to be taxed as a REIT. Section 856(c)(1).
- b. To be able to make the election, the entity must have been taxed as a REIT for all tax years beginning after February 28, 1986, or have no earnings and profits from any year in which it was not taxed as a REIT. Section 857(a)(2). See also section 859, which requires a REIT to use the calendar year as its accounting period.
- c. If an election is terminated due to failure to qualify as a REIT, or is revoked, REIT status generally may not be reelected for five years. Section 856(g)(3). The 2004 Jobs Act allows an entity that has failed to qualify as a REIT (for reasons other than a failure of the 95-percent and 75-percent income tests, and other than the rules for failures of the asset tests) to pay a \$50,000 penalty for each failure and retain its REIT status, as long as the failure is due to reasonable cause and not willful neglect. New section 856(g)(5).

## 3. Income requirements

- a. There are two income requirements, both of which must be met annually, and which are intended to ensure that the REIT receives primarily passive real estate income.<sup>1</sup>
- b. First, at least 75 percent of the REIT's gross income must be derived from "rents" from real property, "interest" from loans secured by real property or interests in real property, gain from the sale of investment real property, REIT dividends, income from "foreclosure property," "qualified temporary investment income," and other specified sources. Section 856(c)(3).
  - (1) "Rents from real property" includes traditional rent, as well as certain charges for services customarily furnished in connection with the rental of real property. Section 856(d)(1)(A)-(B). See also, Rev. Rul. 2004-24, 2004-10

---

<sup>1</sup> A third "less than 30%" requirement was repealed by the 1997 Act for years after 1997.

I.R.B. 550 (amounts paid for parking facilities); LTR 9013043 (Dec. 28, 1989).

- (2) “Rents from real property” also includes rent from personal property which is leased in connection with the lease of real property, if the rent from the personal property does not exceed 15% of the total rent for the combined lease. Section 856(d)(1)(C).
- (3) The definition of “rents” excludes amounts determined by reference to the net income or profits of the lessee or other third party. Section 856(d)(2)(A).
  - (a) Rent includes amounts based on fixed percentages of gross receipts or sales.
  - (b) There is a limitation on this exclusion rule. If a lessee subleases the property and receives contingent rents, only a portion of those rents are excluded from the rental income of the REIT. Section 856(d)(4).
  - (c) An exception to the exclusion rule applies if a lessee derives substantially all of its income with respect to the leased property from subleasing the property, and a portion of the lessee’s income consists of “qualified rents,” *i.e.*, payments that would constitute rents from real property if received directly by the REIT. Under the exception, such qualified rents are not excluded from the rental income of the REIT. Section 856(d)(6).
- (4) The definition of “rents” excludes amounts received from certain related entities. Thus, if a REIT owns 10% or more (by vote or value, assets, or net profits) of an entity, and directly or indirectly receives amounts from that entity, those amounts are excluded from the rental income of the REIT. Section 856(d)(2)(B).
  - (a) An exception to this rule is provided for amounts received from a “taxable REIT subsidiary.” The exception applies if either:
    - i) At least 90% of the leased space is rented to individuals or entities other than taxable REIT subsidiaries or entities that are less than 10% owned by the REIT, and the rental

paid by all renters is “comparable.” Section 856(d)(8)(A).

- a) Comparable rents are to be tested at the time the lease is entered into, any time the lease is extended, and any time the lease between the REIT and the taxable REIT subsidiary is modified to increase the rental.
  - b) Increases in rent paid by a “controlled REIT subsidiary” (defined as a REIT where more than 50% of the voting power or more than 50% of the value is owned by the REIT whose qualifying income is being determined) are not taken into account.
- ii) The property leased to the taxable REIT subsidiary is a “qualified lodging facility” as defined in section 856(d)(9)(D) that is operated on behalf of the taxable REIT subsidiary by an eligible independent contractor, as defined in section 856(d)(3) and (d)(9)(A). Section 856(d)(8)(B).
- (5) The definition of “rents” excludes impermissible tenant service income, which is defined in section 856(d)(7) to include income from services furnished to tenants by the REIT, and income for management or operation of the property by the REIT.
- (a) If services, including management or operation services, are furnished through an independent contractor from whom the REIT does not receive any income, or through a taxable REIT subsidiary, the tenant service income is not excludible from the rental income of the REIT. Section 856(d)(7)(C)(i). See also, Rev. Rul. 2003-86, 2003-32 I.R.B. 290 (services provided by joint venture between taxable REIT subsidiary and third party corporation do not disqualify rents paid to REIT).
  - (b) A 1% de minimis exception to the exclusion rule applies. Section 856(d)(7)(B).

(c) An exception also applies to income that would not otherwise qualify as unrelated business taxable income (“UBIT”). Section 856(d)(C)(ii).

(d) The purpose of these rules is to ensure that the REIT does not carry on an active service business. LTR 9014022 (Jan. 2, 1990).

(6) “Interest” excludes certain amounts determined by reference to the net income or profits of the lessee or other third party. Section 856(f).

The purpose is to ensure that the REIT is not a joint venturer with the lessee.

(7) “Foreclosure property” is property acquired in foreclosure or on threat thereof. In order for property to be treated as foreclosure property, the REIT must make an election prior to the due date for filing the return for the tax year in which the property is acquired. Such property ceases to qualify as foreclosure property after the REIT has held it for 3 years (2 years for qualified health care facilities), or up to 6 years, if extended. Section 856(e)(2)-(3) and (e)(6).

(8) “Qualified temporary investment income” is income from certain stock or debt attributable to investment of new capital during the 1-year period following receipt of the capital. Section 856(c)(5)(D).

c. Second, at least 95 percent of the REIT’s gross income must be from the sources specified in the 75-percent test, plus income from interest, dividends, and gains from the sale of stock or securities. Section 856(c)(2). Certain hedging transactions also qualify. Section 856(c)(5)(G) (amended by 2004 Jobs Act and the Housing Assistance Tax Act of 2008).

d. Failure to satisfy the 75 percent and 95 percent tests will not cause loss of REIT status if such failure was due to reasonable cause and if all income is listed on a schedule to the return. Section 856(c)(6).

e. See Example #14

#### 4. Investment diversification requirements

a. There are three investment requirements, all of which must be met at the close of each quarter. (The second requirement was added by the 1999 Act.)

- b. First, at least 75 percent of the value of the REIT's total assets must consist of "real estate assets," cash and cash items, and government securities. Section 856(c)(4)(A).
  - (1) "Real estate assets" include fee ownership, leaseholds, options, mortgages, REIT shares, all or part of interests in REMICs, and "temporary investments of new capital." Section 856(c)(5)(B) and (C).
    - (a) Generally, loans secured by interests in partnerships and disregarded entities that own a substantial amount of real property may qualify as real estate assets. Rev. Proc. 2003-65, 2003-32 I.R.B. 336; LTR 200225034 (Mar. 21, 2002); LTR 200225033 (Mar. 21, 2002); LTR 200226013 (Mar. 21, 2002).
  - (2) The term excludes mineral, oil, and gas interests. Section 856(c)(5)(C).
  - (3) Voting interests in property owners' associations that are inextricably linked to property ownership, constitute "real estate assets" and not "voting securities" LTR 9826049 (Apr. 1, 1998).
- c. Second, not more than a certain percentage of the value of the REIT's assets can be securities of a "taxable REIT subsidiary."
  - (1) For tax years beginning on or before July 30, 2008, the applicable percentage is 20%.
  - (2) For tax years beginning after July 30, 2008, the applicable percentage is 25%
- d. Third, (excluding government securities, securities that are real estate assets, and securities of taxable REIT subsidiaries) not more than 25 percent of the value of the REIT's total assets can consist of securities that are:
  - (1) an amount that is in value greater than 5 percent of the value of the REIT's assets,
  - (2) more than 10 percent of the voting power of the issuer.
  - (3) more than 10 percent of the value of the issuer's securities. Section 856(c)(4)(B).
    - (a) Section 856(m) provides a safe harbor for certain investments that will not be treated as "securities"

for the third part of the third test. These investments include (1) "straight debt" as defined by section 1361(c)(5); (2) loans to an individual or an estate; (3) section 467 rental agreements; (4) an obligation to pay rents from real property; (5) certain state, municipal, and foreign securities; (6) REIT securities; and (7) any other arrangement designated by the Secretary of the Treasury as not constituting a security. Section 856(m)(1).

- (b) Under the "straight debt" rule, certain contingencies related to the timing of payments of principal or interest will not disqualify an instrument -- it can still be excluded from the 10 percent test. Contingencies will not cause failure if
  - i) they do not change the annual yield to maturity under section 1272 by more than the greater of 1/4 of 1%, or 5 percent of annual yield, or
  - ii) neither the aggregate issue price nor the aggregate face amount of the issuer's debt instruments held by the REIT exceeds \$1 million and not more than 12 months of unaccrued interest can be required to be prepaid under the instrument, or
  - iii) the time or amount of payment is subject to a contingency upon default or the exercise of a prepayment right by the issuer, but only if such contingency is "consistent with customary commercial practice."
- (c) If a REIT owns securities described in section 856(m)(1) of an issuer that is a corporation or a partnership, such securities will not be excluded from the 10-percent test if: (1) the REIT or any of its controlled taxable REIT subsidiaries holds any securities of that issuer not described in section 856(m)(1); and (2) have an aggregate value of greater than 1 % of that issuer's outstanding securities. Section 856(m)(2)(C).
- (d) The provision provides also that, for purposes of the 10 percent test, if a REIT owns an interest in a partnership, the REIT will be treated as owning its

proportionate share of the assets of the partnership (the “partnership look-through rule”). Section 856(m)(3).

- e. If a REIT fails to satisfy these asset requirements for a quarter, REIT status will not be lost. Section 856(c)(7).
  - (1) If the failure is other than for failing to meet 856(c)(4)(B)(iii), REIT status can be preserved by filing an informational schedule, proving reasonable cause, and disposing of the offending assets and satisfying the tests within 6 months of the close of the quarter. Section 857(c)(7)(A).
    - (a) In this case, a tax is imposed equal in amount to the greater of \$50,000 or the income generated by the assets times the highest rate of tax specified in section 11.
  - (2) If the failure is for failing to meet section 856(c)(4)(B)(iii) for any quarter, it may cure the failure if it is caused by the REIT’s ownership of assets the total value of which does not exceed the lesser of 1% of the total value of the REIT’s assets at the end of the quarter for which the measurement was done, or \$10 million. Once such failure is identified, the REIT must dispose of the offending assets within 6 months from the end of the quarter in which the failure was identified. Section 856(c)(7)(B).
  - (3) See Example #15.
- 5. For purposes of the income and asset tests, the income and assets of a REIT and its wholly-owned “qualified REIT subsidiary” are aggregated. The subsidiary is not treated as a separate entity. Section 856(i). See, e.g., LTR 200236037 (May 10, 2002) (income from partnership interests owned by qualified REIT subsidiaries is included in gross income of REIT).
- 6. Distribution requirements
  - a. For each year, the REIT must distribute an amount, ignoring capital gains, that equals or exceeds (section 857(a)(1)(A)):
    - (1) 90 percent of “REIT taxable income,” excluding net capital gain, plus
    - (2) 90 percent of net income from foreclosure property less the tax imposed thereon, minus

- (3) any excess noncash income.
  - (4) For years prior to 2001, the foregoing percentage was 95% rather than 90%.
- b. “Excess noncash income” is the excess of noncash income over 5 percent of ordinary REIT taxable income. Noncash income includes amounts of income, for example income from cancellation of indebtedness and OID, that are accrued but not received. Section 857(e).
  - c. These distribution requirements may be waived if the REIT is unable to comply due to prior distributions made to avoid imposition of the section 4982 excise tax. Section 857(a).
  - d. In order to meet these requirements, a REIT may elect to treat certain dividends paid after the close of a taxable year as paid during the taxable year.
    - (1) Section 857(b)(9) provides that dividends declared and payable during the last three months of a calendar year (and actually paid during January of the following calendar year) are deemed paid on December 31 of that calendar year (or, if earlier, as provided by section 858).
    - (2) Section 858(a) provides that if a REIT declares a dividend before its return due date, and distributes the dividend within 12 months of year end (but not later than its first regular dividend payment), the REIT may elect in the return to treat the dividend as paid for the year covered by the return.
    - (3) Section 860 allows for the deduction of deficiency dividends. The definition of a deficiency dividend includes additional amounts required to be paid, as determined by the REIT prior to any controversy with the IRS. Section 860(e)(4).
  - e. See Example #16

## B. Taxation of REITs

- 1. REITs are potentially subject to tax on the following amounts:
  - a. undistributed REIT taxable income,
  - b. undistributed net capital gain,

- c. income from foreclosure property,
  - d. the income “shortfall” in failing to meet the 75 or 95 percent tests,
  - e. income from prohibited transactions,
  - f. income from redetermined rents, etc.
2. Tax on undistributed REIT income
- a. A tax is imposed on “REIT taxable income”:
    - (1) Taxable income (including undistributed capital gains, excludes foreclosure and prohibited transaction income)
    - (2) Less deduction for dividends paid (but not of foreclosure income)
    - (3) Less items c and e (listed in the preceding paragraph), the tax on items d and f (listed in the preceding paragraph), and the section 856(c)(7)(C) tax. Section 857(b)(2).
  - b. The tax is imposed at section 11 rates.
3. Tax on undistributed capital gains
- a. An alternative tax is provided in the case of capital gains, net of distributed capital gains, similar to section 1201. Section 857(b)(3).
  - b. The REIT may elect to retain its net long term capital gains and pay tax on those gains. Section 357(b)(3)(D).
4. Tax on income from foreclosure property
- a. A separate tax is imposed on the excess of ordinary income on the sale of (noninvestment) foreclosure property and income derived from the operation of foreclosure property, over deductions allowable in connection with production of such income. Section 857(b)(4).
  - b. “Conduit” treatment is not available for this type of income.
  - c. The tax is imposed at the highest section 11 rate.
5. Tax on income requirement “shortfalls”
- a. As discussed above, an entity may qualify for REIT tax status even if it fails the 75 or 95 percent test.

- b. However, a tax is imposed equal to the greater of the shortfall in failing to meet the 75 percent test, and the shortfall in failing to meet the 95 percent test. Section 857(b)(5).

6. Tax on Income from prohibited transactions

A tax is imposed equal to the net income derived in prohibited transactions. A “prohibited transaction” is the sale of property, other than foreclosure property, that is held primarily for sale under section 1221(a)(1). Section 857(b)(6).

Exceptions to characterization as a prohibited transaction apply if (1) the REIT has held the property for a specified number of years before selling it [4 years for sales made on or before July 30, 2008 and 2 years for sales made after July 30, 2008], and (2) other conditions are satisfied. Section 857(b)(6)(C).

7. Tax on Income From Redetermined Rents, etc.

- a. A 100% tax is imposed on “redetermined rents,” redetermined deductions,” and “excess interest.”

- (1) “Redetermined rents” are defined as rents from real property to the extent that the rents “would be” reduced under section 482 to clearly reflect income as a result of services rendered by a taxable REIT subsidiary to a tenant of the REIT. Section 857(b)(7)(B). Exceptions to the definition of redetermined rents similar to the exceptions to the definition of impermissible tenant service income are available. See, e.g., Rev. Rul. 2002-38, 2002-26 I.R.B. 4 (addressing the applicability of the section 857(b)(7)(B)(vi) safe harbor to housekeeping services performed by a taxable REIT subsidiary).

- (a) The 2004 Jobs Act repealed the section 857(b)(7)(B)(ii) customary services exception to redetermined rents for amounts received by a REIT from its taxable REIT subsidiary. However, a REIT can still avoid the 100% excise tax by paying its taxable REIT subsidiary at least 150 percent of the cost to the subsidiary of providing the services. See 2004 Jobs Act Conference Report, at 320.

- (2) “Redetermined deductions” are defined as deductions of a taxable REIT subsidiary to the extent that the amount of such deductions “would be” decreased under section 482 to clearly reflect income.

(3) “Excess interest” is defined as deductions for interest payments by a taxable REIT subsidiary to the REIT to the extent the interest rate exceeds a commercially reasonable rate.

b. Under section 857(b)(7)(E), the imposition of the 100% tax under section 857(b)(7) and the imposition of tax under section 482 are mutually exclusive.

8. Excise tax on undistributed income

The REIT is subject to an excise tax on undistributed income. The amount of the excise tax is 4 percent of the excess of (1) 85 percent of the REIT’s ordinary income plus 95 percent of the REIT’s net capital gain, over (2) the amount distributed. This amount will be increased by amounts not distributed in the preceding year. Section 4981.

9. Penalty for Failure to Comply with Reporting Requirements

Prior to the 1997 Act, a REIT could be disqualified if it failed to comply with Treasury regulations governing the ascertainment of its ownership. The 1997 Act provides an “intermediate” penalty of \$25,000 (\$50,000 in the case of intentional disregard) for any year the REIT fails to comply. Section 857(f).

10. See Example #17

C. Taxation of REIT Shareholders

1. Ordinary income dividends

REIT dividends of ordinary income are includible in gross income, to the extent of the REIT’s earnings and profits. Treas. Reg. § 1.857-6(a). See section 857(d).

Section 1(h)(11) provides that “qualified dividend income” is taxed as capital gain instead of ordinary income. Dividends distributed by REITs are “qualified dividend income,” but are subject to the limitations of section 857(c)(2), which include the limits of section 854(b)(1)(B) and (C) that are applicable to RIC dividends.

2. Capital gain dividends

REIT dividends of capital gain are taxable to shareholders as long term capital gain, regardless of holding period. Section 857(b)(3)(B). Capital gain dividends must be so designated by written notice to shareholders.

Shareholders are taxed on the capital gain dividends at the capital gains rates of section 1(h).

3. Year in which dividends are taxable

- a. Generally, amounts paid to REIT shareholders are taxable to the shareholders in the year received. Treas. Reg. § 1.857-6(a). See section 858(b).
- b. Section 857(b)(9) provides that dividends declared and payable to shareholders of record on a date during the last three months of a calendar year (and actually paid during January of the following calendar year) are deemed paid on December 31 of that calendar year.

4. Sales of REIT shares

- a. In general, sales of REIT shares are treated like sales of other capital assets.
- b. However, if REIT shares are held for 6 months or less, and then sold at a loss, then the loss, to the extent of any capital gain dividend received, shall be a long-term capital loss. Section 857(b)(8).