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
- Relief provisions are meant to be applied broadly and generously[3]
- The past is prologue: Do REIT issues close with tax years, or do they live on forever?

Can a Successor Remediate the Failures of its Predecessor *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.

Possible Role of Private Tax Insurance

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?

[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] *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://www.sullivanlaw.com/assets/htmldocuments/Hammell-Ponda.pdf.

- 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 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 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.[4]
- Section 857(f)(2)(D) adds "reasonable cause" 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 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 deemed election by eligible entity electing REIT status to be classified as association effective as of the first day the entity is treated as a REIT.
- Form 8832 check-the-box (CTB) late filing relief under Rev. Proc. 2009-41 is on the very form itself.
- Relief for late elections under Regs. §§ 301.9100-1 and 301.9100-3.[5]

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 PLRs 202305005 (Nov. 4, 2022) and 201523015 (Feb. 5, 2015) would suggest the better and more lenient answer under certain circumstances.[6]

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

---

[4] 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).

[5] See 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.

[6] In these cases, the REIT stated that it did not intend to make the REIT election until a later year when it was certain it had satisfied all REIT requirements and that the filing of Form 1120-REIT was an error due to miscommunication and/or lack of sufficient expertise, so the IRS agreed to ignore the year 1 election. The approach taken by these taxpayers, that of obtaining a ruling from the Service confirming 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.

precedent for cleansing prior REIT infirmities and starting anew with a new entity that carefully avoids "successor" status.[7]

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".[8] 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;[9] 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 questions may arise whether the taxpayer had "reasonable cause".

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.[10]

- 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.

---

[7] *See* Mobile Infrastructure Trust Form S-4 (Sep. 29, 2022), available at: https://www.sec.gov/Archives/edgar/data/1918056/000175392622001337/g083214_s4a.htm ; see also InfraREIT Form S-11 (Jan. 28, 2015), available at: https://www.sec.gov/Archives/edgar/data/1506401/000119312515023105/d724324ds11a.htm#toc724324_26.

[8] 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.

[9] At the cutting edge, Section 856 "rents from real property" can be a nuanced inquiry. *See* Ameek Ashok Ponda, "Comments on Proposed Regulations: Classification of Cloud Transactions and Transactions Involving Digital Content" (Oct. 24, 2019, with particular attention to Exhibit B therein), available at: https://www.sullivanlaw.com/assets/htmldocuments/Ameek%20Ponda%20Comments%20Letter%20-%20October%202020S2728706.pdf

[10] *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.

- There are also cogent arguments that Sections 318 and 856(d)(5) attribution is more narrowly applied than first glance might suggest.[11]
- 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).[12] 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.[13]

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[14], 2002-38,[15] and 98-60[16] are a good starting point for understanding them, as is this seminal article by members of Sullivan Tax.[17]

- The 1% threshold is very low and easy to exceed under the glare of fulsome diligence.

---

[11] *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 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).

[12] *See also Estate of Nettie S. Miller*, 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]").

[13] 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.

[14] 2004-1 C.B. 550 (addressing commonly encountered arrangements for parking at REIT properties).

[15] 2002-2 C.B. 4 (concluding that gross income from tenants for noncustomary services provided through a TRS constitutes rents from real property).

[16] 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).

[17] *See* Decker, Kaplan, and Ponda, "Non-Customary Services Furnished by Taxable REIT Subsidiaries", 148 *Tax Notes* 413 (Jul. 27, 2015), available at: https://www.sullivanlaw.com/assets/htmldocuments/B1910892.pdf

- Is the applicable "property" a single building…or an entire campus…or an entire fiber network?
- 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.
- Backfilling the "geographically customary" and "customary-for-rental" requirements.

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.

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?[18]
    - The better read of Section 856(c)(2)-(3) is that zero gross income is fine because the applicable 95% and 75% REIT gross income testing percentages in Section 856(c)(2)-(3) are applied to a multiplicand of zero, yield a threshold of zero, and then clear the threshold by being zero.
    - But, particularly because Reg. § 1.856-2(c)(1) articulates the REIT gross income tests as involving a numerator and a denominator, some remain concerned that Section 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 suggest 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-taxpayer way;[19] accordingly, zero gross income leads to REIT gross income testing compliance rather than REIT gross income testing failure.

---

[18] 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), and 1275(a)(1) "temporary investment of new capital rules", 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 3.

[19] *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); Tech. Adv. Memo. 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 (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").

- Still, out of an abundance of caution, some choose 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".[20]

Failure to designate hedges under Section 856(c)(5)(G): possible remediation under Sections 856(c)(5)(G)(iv) and 1221(a)(7) as well as Reg. § 1.1221-2(g)(2).

Contribute source of bad income into a TRS for prospective fix, and then address any prior accruals within the reasonable cause exception of Sections 856(c)(6) and 857(b)(5).

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

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?[21]
  - The better read of Section 856(c)(4) is that zero assets are fine because the applicable REIT asset testing percentages in Section 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.
  - But some remain 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 suggest 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;[22] accordingly, zero gross assets lead to REIT gross asset testing compliance rather than REIT gross asset testing failure.

---

[20] Ironically, this self-remediation under Section 857(b)(5) involves the computation of a statutory fraction and again leads to the conundrum of a denominator (again gross income) of zero and how to compute the applicable fraction. Fortunately, the Section 857(b)(5) computation is operationalized by IRS Form 1120-REIT, Part III, and Line 8 thereof makes clear that when the numerator is zero, then the mathematical computation stops before getting to the step of dividing by zero.

[21] 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, and in this fashion 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 18.

[22] *See supra* note 19 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.[23]
- 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 Forms 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 Section 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[24] 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 Section 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.[25]
  - In addition, most receivables arising organically from the REIT's real property business, not just rent receivables, can qualify as ordinary course receivables.[26]
- 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 filing timely an IRS Form 8875 with the REIT.

---

[23] *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).

[24] 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).

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

[26] *See, e.g.,* PLR 202305009 (Nov. 9, 2022) (brownfield credits are ordinary course receivables) and PLR 201845001 (Aug. 10, 2018) (same); PLR 201816001 (Jan. 3, 2018), PLR 201816002 (Jan. 3, 2018), and PLR 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 201518010 (Jan. 29, 2015) (brownfield credits 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 REIT asset test failure exceeds the de minimis thresholds in Section 856(c)(7)(B), then Section 856(c)(7)(A)(ii) permits remediation for prior quarters only if the failure was "due to reasonable cause and not due to willful neglect"
    - Per IRS thinking, this legal standard is generally two standards – "due to reasonable cause" and "not due to willful neglect" – both of which must be met, rather than a single standard where the second part merely emphasizes the first (e.g., "look up and not down").[27]
    - In addition, per the IRS, these words can and do mean different things in different Code sections, depending on the purpose of the particular statute.[28]
    - Finally, per applicable legislative history, these particular words are meant to have a generally uniform meaning when used throughout the REIT remediation provisions of the Code.[29]
- 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.[30]
    - 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

---

[27] *See* LB&I Concept Unit, "Reasonable Cause and Good Faith", pp. 3, 7, available at: https://www.irs.gov/pub/irs-utl/reasonable_cause_good_faith.pdf (last updated Mar. 18, 2021).

[28] *See id.,* p. 5. After release of certain IRS Appeals Office training materials addressing the application of "reasonable cause" relief in the context of 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 under a broad reading of Boyle 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 (October 10, 2022).

[29] *See* H.R. Rep. No. 108-755, pp. 329, 331, 334, 335 (2004) (Conf. Rep.), available at: https://www.congress.gov/108/crpt/hrpt755/CRPT-108hrpt755.pdf. *See also* Reg. § 1.856-7(c) ("The failure to meet the [applicable REIT requirements] will be considered due to reasonable cause and not due to willful neglect if the [REIT] exercised ordinary business care and prudence in attempting to satisfy the requirements.").

[30] *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), https://www.mcall.com/news/mc-xpm-2004-02-10-3524334-story.html.

and 301.9100-3 and/or a closing agreement process (both of which generally take time).[31]

- 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.[32]

Should REITs still use a "protective" transfer of bad assets to a TRS or to a trust,[33] 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),[34] 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.
- 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

---

[31] *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.

[32] *See, e.g.,* Reg. § 301.9100-3(f)(Example 1). *See also* PLR 201952003 (Sep. 25, 2019); PLR 201815014 (Jan. 8, 2018); PLR 201614022 (Dec. 22, 2015); PLR 201252009 (Sep. 27, 2012); PLR 201210021 (Nov. 23, 2011); PLR 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).

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

[34] *See, e.g.,* Reg. § 1.565-1(a).

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).[35] 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).[36]

Unfortunately, minor timing and amount discrepancies are potentially problematic preferential dividends,[37] but perhaps case law can limit the damage to just the individual distribution (and thus limit "collateral damage"),[38] 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,[39] 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.

---

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

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

> "[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), PLR 201327006 (Apr. 3, 2013) (differential administrative fees permitted on two different classes with separate distribution), PLR 201205004 (Nov. 1, 2011) (same), PLR 201135002 (May 17, 2011) (same), and PLR 201119025 (Feb. 3, 2011) (same, supplementing PLR 201109003 (Aug. 24, 2010)).

[37] 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

[38] *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. Comm'r*, 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).

[39] *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.

Role of 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 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.