THE PRIVATE REIT: SELECTED TAX ISSUES

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Perceived Abuses of the Treasury Department's Rulemaking Authority, 52 Tax Lawyer 501 (1999).

The Private REIT: Selected Tax Issues

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INTRODUCTION

In recent years, the use of a private REIT (i.e., a real estate investment trust whose shares are held by a limited group of investors, are not publicly traded and are generally offered pursuant to an exemption from registration under the securities laws) as an investment vehicle has become increasingly popular. Although REITs, in general, are much more cumbersome and less flexible than partnerships, the use of a REIT may afford investors certain tax advantages. This outline will address some of the advantages and tax issues related to the formation, use and operation of a private REIT.

I. USES AND ADVANTAGES OF PRIVATE REITS

Although a REIT has the advantage of being, effectively, a pass-through entity for federal income tax purposes, its use as a privately-held investment vehicle is severely limited by the restrictions on the type of investments and activities that a REIT may engage in under the Code.[1] Specifically, substantially all of the assets and income of a REIT must be derived from real estate related investments. Moreover, a REIT must have at least one hundred shareholders and more than 50% of the value of its outstanding shares may not be held by five or fewer individuals. Nevertheless, numerous private REITs have been set up as so called "incubator REITs" in anticipation of taking the fledgling REIT public in the future. Moreover, there are a number of situations where a private REIT can be used to obtain tax advantages. Some examples of the benefits of private REITs are set forth below.

A. <u>To Avoid UBTI</u>. Under Sections 511–514, tax-exempt entities are subject to tax on unrelated business taxable income ("UBTI"). UBTI generally includes all income earned by a tax-exempt entity other than certain enumerated types of passive income, such as rents, interest, dividends, royalties and capital gains. Even such passive income is treated as UBTI if the tax-exempt investor directly or through a partnership incurs indebtedness to acquire the income-producing assets, although an exemption is provided for certain tax-exempts that incur debt to acquire and improve real property if

certain other rules are followed. In general, dividends and capital gains derived from the ownership of REIT shares are not UBTI provided that the shares are not acquired by the tax exempt investor with debt proceeds. Rev. Rul. 66–106, 1966-1 C.B. 151; see also PLR 199952071 (Sept. 24, 1999) (charitable remainder unitrust that holds shares in a private REIT will not recognize UBTI on dividends received from the REIT or on capital gains arising from sales of the REIT shares held by the trust, but not ruling whether the private REIT qualified as a REIT for federal tax purposes). This is the rule even if the REIT recognizes income that would be UBTI if earned directly by the tax-exempt investor, subject to a special UBTI "look through" rule if the REIT is a "pension held REIT" (as described further below). Therefore, as long as the "pension held REIT" rules are not applicable, a tax-exempt investor may use a private REIT to avoid recognizing UBTI.

Example: A tax-exempt pension fund and a widely-held corporation desire to form a joint venture to purchase, originate and hold mortgage pools and the parties intend to utilize significant leverage. If a partnership is formed, the tax-exempt will recognize UBTI under Section 514 because the partnership's debt financing is attributed to the tax-exempt partner. Instead, the parties may form a private REIT and, as long as the stock ownership does not result in the REIT qualifying as a pension held REIT, the tax-exempt pension fund should be able to avoid the incurrence of UBTI.

B. To Avoid FIRPTA.[2] Gain recognized by a foreign shareholder upon the sale of stock in a U.S. corporation holding primarily real estate is normally subject to U.S. tax on any recognized gain, or to U.S. withholding tax on the gross sales proceeds. However, if more than 50% of the shares of a REIT are held by U.S. shareholders (i.e., if the REIT is domestically controlled), gain recognized by a foreign shareholder upon the sale of its REIT shares is exempt from U.S. tax under Section 897(h). In addition, foreign shareholders that qualify as an "integral part" or "controlled entity" of a foreign government may be exempt from tax under Section 892 on such gain even if the REIT is not domestically controlled, provided the REIT is not a "controlled commercial entity" under Section 892(a)(2)(B). But note that the IRS' position is that such entities

are taxable under FIRPTA on distributions by a REIT to the extent that the amount distributed is attributable to gain on the disposition of a U.S. Real Property Interest. See Notice 2007-55, 2007-27 I.R.B. 13. Therefore, a joint real estate venture between U.S. and foreign parties may be structured as a private REIT to enable the foreigner to avoid capital gains and/or withholding taxes upon the sale of its REIT shares.[3] This can be accomplished by selling the shares of the REIT to a prospective buyer instead of the property itself. The buyer can then liquidate the REIT tax-free (as the REIT obtains a dividends paid deduction equal to the full liquidating distribution) and achieve a full step-up in the tax basis of the property while allowing the selling foreign shareholders to avoid FIRPTA. As a result, a number of real estate investment funds are currently acquiring each of their real estate acquisitions through special purpose REITs so that foreign investors in the fund can avoid FIRPTA when the shares of the individual REITs are sold.

C. As a Financing Vehicle. Private REITs have been utilized to serve as financing vehicles. In the most basic scenario, a "borrower" creates a private REIT which issues nonvoting, nonparticipating preferred stock to investors. The REIT then lends the cash contributed to it by the investors to the borrower (usually a subsidiary of the holder of the REIT's common stock) secured by a mortgage on real property held by the borrower. Since the REIT is allowed a dividends paid deduction in the amount of the dividends paid on the preferred stock, the borrower achieves the same tax results as

a traditional mortgage arrangement with the key difference being that for GAAP (but not tax) purposes the REIT may be consolidated with the borrower, the mortgage is eliminated in consolidation and the preferred stock is booked as minority equity. This allows the borrower to achieve "off-balance" sheet financing. Eventually, this structure evolved into the "fast-pay preferred stock" REIT structure where the preferred stock was established with a declining dividend rate and other attributes which arguably allowed the borrower to effectively deduct payments that economically represented the repayment of principal. See Point II.H.5, infra. In any event, this technique is no longer feasible in light of IRS Notice 97-21, 1997-1 C.B. 407, and Treas. Reg. § 1.7701(*l*)-3 (effective for payments made in taxable years ending after February 26, 1997). However, there are taxpayers that attempted to achieve similar tax results by utilizing "phantom" consent dividends and arguing that such a non-cash dividend is not prohibited under such notice and treasury regulations. But see CCA 200842039 (June 19, 2008) (IRS intends to challenge consent dividends as a sham where the consent dividends declared exceed the true economic benefit to which the recipient shareholders are entitled).

As a general matter, the ability of a borrower, in effect, to deduct (through the private REIT) the dividends paid by the REIT on its outstanding preferred stock may also allow taxpayers to avoid certain of the limitations on a borrower's ability to deduct interest payments under various sections of the Code. For example, if a private REIT purchases tax exempt bonds with a portion of the proceeds of a preferred stock issuance (subject to the REIT income and asset tests set forth in Section 856), the dividends paid deduction for dividends paid on the preferred stock should be allowed (unlike the general disallowance rule of Section 265 with respect to interest deductions on debt) and a positive tax arbitrage may be achieved (assuming the REIT has other taxable income which is reduced by such dividend payments), subject to the need for a valid business purpose and a pre-tax profit motive (and, of course, assuming that the dividends are really dividends and not a return of capital under Notice 97-21, the applicable Treasury regulations and/or pre-existing general principles of tax law and such dividend payments are not otherwise treated as a sham).

D. As a Securitization Vehicle. If multiple tranche debt obligations are issued against a pool of real estate mortgages, the issuing entity must make a REMIC election to avoid characterization as a taxable mortgage pool ("TMP") under Section 7701(i). (A taxable mortgage pool is treated as a separate corporation that may not be included in a consolidated return with any other corporation.) Under the REMIC rules,

the issuance of the debt obligations is treated effectively as the sale of a pro rata portion of the mortgage pool thereby often generating taxable gain for the party forming the REMIC. An issuer may avoid such tax by forming a private REIT which originates and acquires the mortgage pool and then either itself or through a qualified REIT subsidiary issues the multiple tranche debt obligations. Cf. PLR 200513002 (Dec. 28, 2004) (where wholly-owned subsidiary of qualified REIT subsidiary of a public REIT issued pools of mortgages, taxpayer withdrew ruling request regarding TMP and REMIC issues). Although all or part of the REIT will be classified as a taxable mortgage pool (or "TMP-REIT"), subjecting its shareholders to the "excess inclusion income" rules of Section 860E(d)[4], the entitlement of the TMP-REIT to the dividends paid deduction effectively treats the TMP-REIT as having filed a consolidated tax return with its corporate shareholder.

II. SELECTED TAX ISSUES

To qualify as a REIT, an entity must comply with the organizational and distribution requirements set forth in Sections 856 and 857 and other sections of the Code. These requirements are discussed below with a particular emphasis on certain issues which affect private REITs.

A. Managed by Trustees or Directors. Often in the case of closely-held corporations, many of the management decisions are granted to the shareholders as opposed to the board of directors of the corporation. Moreover, closely held investment funds often hire an outside manager to make all decisions on behalf of the fund. This is problematic in the context of a private REIT since to qualify as a REIT, the trust or

corporation, as the case may be,[5] must be managed by one or more trustees or directors from inception and for the duration of each taxable year. Section 856(a)(1) & (b); Treas. Reg. § 1.856-1(b)(1).

1. The term "directors" is not specifically defined in the Code or the Treasury regulations for purposes of the REIT provisions of the Code. However, Section 856(c)(5)(F) invokes the definitions in the Investment Company Act of 1940 (the "'40 Act") for any term that is used in, but not specifically defined under, the REIT rules.

   The '40 Act, in turn, defines "director" as a "director of a corporation or any person performing similar functions with respect to any organization, whether or not incorporated, including any natural person who is a member of a board of trustees of a management company created as a common law trust." 15 U.S.C. § 80a-2(a)(12) (West 1997). The scope of this definition is quite broad. See, e.g., Chabot v. Empire Trust Co., 301 F.2d 458 (2d Cir. 1962) (corporate trustee of mutual investment fund organized as a common law trust was a "director" for '40 Act purposes where the corporate trustee was responsible for managing all aspects of the fund other than purchasing and selling its portfolio securities).

In light of the '40 Act definition, the member-managers of a limited liability company ("LLC") or the general partner of a state limited partnership should be treated as directors for purposes of qualifying the LLC or state law partnership as a REIT if the LLC or state law partnership (1) elects to be an association taxable as a corporation under the check-the-box regulations (before making a REIT election), Treas. Reg. § 301.7701-3(a), or (2) is deemed to have made such a check-the-box election by reason of electing to be a REIT, see Treas. Reg. § 301.7701-3(c)(v)(B). Cf. Prop. Treas. Reg. § 1.856-1(d)(1), 26 Fed. Reg. 603 (1961) (partner managing a limited partnership under state law is not a trustee for REIT purposes and thus such a partnership cannot qualify

as a REIT for federal income tax purposes; but this provision was eliminated in the final regulations). Thus, since LLCs and state law partnerships can elect REIT status under the Code, organizers of private REITs may prefer to convert an existing LLC or partnership into a REIT directly, rather than having the LLC or partnership transfer all of its properties to a new corporation before making the REIT election which could give rise to real estate transfer taxes under state and/or local law and may require lender consents and other such matters.

2. A trustee is defined in applicable regulations as "a person who holds legal title to the [REIT's] property . . . , and has such rights and powers as will meet the requirement of 'centralization of management'" (apparently under pre- "check-the-box" regulations under Section 7701), including the continuing exclusive authority to manage the REIT, conduct its affairs, and manage and dispose of the REIT's property. Treas. Reg. § 1.856-1(d)(1). In essence, trustees of a REIT in the form of a trust serve the equivalent role as directors of a corporation. See, e.g., Terrydale Liquidating Trust v. Barness, 611 F. Supp. 1006, 1016-17 (S.D.N.Y. 1984), aff'd, 846 F.2d 845 (2d Cir. 1988) (trustees are akin to directors, and REITs in the form of business trusts are akin to corporations).

(i) A trustee may hold legal title to the property of the REIT, for purposes of Section 856(a)(1), whether the title held is in the name of (i) the REIT, (ii) one or more of the trustees, or (iii) a nominee for the exclusive benefit of the REIT. Treas. Reg. § 1.856-1(d)(1).

(ii) A mere fiduciary relationship does not, standing alone, make one a "trustee" for purposes of Section 856(a)(1). Id. Likewise, performing ministerial acts solely at the discretion of the REIT shareholders (and subject to their approval) does not make one a “trustee” for purposes of the REIT rules. See, e.g., Former Treas. Reg. § 301.7701-2(c)(3); PLR 6908250350A (Aug. 25, 1969) (REIT shareholders cannot be given power to approve or reject properties to be acquired by the trustee on behalf of the REIT).

(iii) Beneficial owners of REIT shares can have certain rights or powers with respect to trustees of the REIT. Thus, the regulations specifically authorize REIT shareholders to “elect or remove trustees; to terminate the trust, and to ratify amendments to the trust instrument proposed by the trustee” without violating this requirement for qualification. Treas. Reg. § 1.856-1(d)(1). The REIT shareholders may also have the power to approve or reject increases in the compensation to be paid to the

trust advisor and the power to vote on a sale, merger or reorganization involving the REIT, Rev. Rul. 70-569, 1970-2 C.B. 147, and to vote to terminate a trust advisory agreement, Rev. Rul. 74–471, 1974-2 C.B. 198, without violating the centralization of management requirement set forth in Treas. Reg. § 1.856-1(d)(1). However, caution must be exercised that the REIT shareholders are not given too much power other than the right to approve major decisions involving the REIT as is customarily given by corporations to their shareholders.

3. Since a private REIT may have few investments, its trustees or directors may be inclined to delegate many administrative decisions to a professional advisor, such as a property manager or investment advisor. This is not fatal to classification of the entity as a REIT because trustees or directors of REITs generally may delegate management and investment duties to a day-to-day manager or to an investment advisor acting on behalf of the REIT.

(i) Several administrative releases suggest that such delegation of authority is permissible because the manager/advisor is treated as an agent of the trustee of the REIT. See, e.g., Rev. Rul. 74–471, 1974-2 C.B. 198, *modified by*, Rev. Rul. 75–136, 1975-1 C.B. 195; PLR 7409240270A (Sept. 24, 1974); GCM 35797 (May 1, 1974); see also Rev. Rul. 72–254, 1972-1 C.B. 207 (trustee or directors may delegate discretionary authority to advisory company acting as their agent to make loans up to a specified amount in conformity with policies and guidelines set forth in the trust agreement); PLR 7103290150A (Mar. 29, 1971) (same).

(ii) Another line of authority outside of the REIT area (e.g., Rev. Rul. 88-79, 1988-2 C.B. 361, *obsoleted by*, Rev. Rul. 98-37, 1998-2 C.B. 133) ignores the ministerial trustees to find that the managers/advisors themselves satisfy the centralized management requirement under the Treasury regulations.[6] This authority implies that

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the REIT trustees need not actively manage the REIT's property, but rather, to the extent that *someone* is actively managing such property, such management must be centralized and not reside generally in the hands of the REIT beneficiaries. Cf. Former Treas. Reg. § 301.7701-2(c)(1) (in describing centralization of management, "the persons who are vested with such management authority resemble in powers and functions the directors of a . . . corporation. The effective operation of a business organization composed of many members generally depends upon the centralization in the hands of a few of exclusive authority to make management decisions for the organization . . . .").

(iii) As a practical matter, it would appear that a REIT may delegate all authority to a third party manager or advisor — and still be deemed to be managed by its directors or trustees — provided the directors or trustees of the REIT supervise and monitor the activities of the manager or advisor and have the ability to remove the manager or advisor. Query if the removal power must be absolute or if it may be limited to special circumstances (e.g., removal for "cause" or upon the occurrence of specified events).

B. Transferable Shares. To qualify as a REIT, beneficial ownership interests in the entity — whether it be a trust, corporation or unincorporated association — must continuously be "evidenced by transferable shares, or by transferable certificates of beneficial interest." Section 856(a)(2) and (b); Treas. Reg. § 1.856-1(b)(2) and (d)(2). This may create significant issues in the context of a private REIT where the parties have a real concern as to the identity of their joint venturer. In particular, standard provisions of closely-held entities such as "consent to transfer" and "right of first refusal" provisions must be analyzed in the context of the "transferability requirement." For example, it has been reported that an IRS auditor challenged a private REIT arrangement under Section 856(a)(2) where individual minority shareholders could not transfer their shares without first obtaining Board approval.

1. The Treasury regulations specifically permit the trust agreement, corporate charter or bylaws, as the case may be, to grant discretionary authority to the trustees or directors to redeem shares or certificates of interest or to refuse to transfer such securities where the trustees or directors harbor a good faith belief that, absent such redemption or after the proposed transfer, the entity would be disqualified as a REIT under the Code. See Treas. Reg. § 1.856-1(d)(2). However, it is wise to include any such restrictions in the REIT's charter or trust agreement, rather than the bylaws, because a court could find that the subsequent adoption of a bylaw by a Trustee is invalid if there is (x) no comparable provision in the trust agreement or (y) a contrary

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provision in the trust agreement. See San Francisco Real Estate Investors v. Real Estate Investment Trust of America, 701 F.2d 1000, 1005 (1st Cir. 1983) (granting preliminary injunction against enforcement of ownership limit in newly enacted bylaw on the ground that the bylaw effectively repealed a related provision in the trust agreement); Pacific Realty Trust v. APC Investments, 651 P.2d 163 (Ore. App. 1982) (refusing to enjoin potential suitor from acquiring in excess of 9.8% ownership limit in bylaw adopted by trustees of the REIT where ownership limit was not in the trust agreement).

2. In line with the foregoing Treasury regulation, private REITs should include "excess shares provisions" in their charters to prevent either the disqualification of the REIT (e.g., violations of the 100 shareholder and closely-held rules) or the shareholders from being subject to adverse tax consequences arising from concentrated ownership of shares in the REIT (e.g., foreign shareholders that become subject to tax upon selling shares in a REIT by reason of the REIT failing to qualify as a "domestically controlled REIT"). Although the typical excess shares provision used by publicly-traded REITs to limit any shareholder's ownership of REIT shares to less than 10% is often inapposite for private REITs (which, by definition, often have a high concentration of shares held by a few shareholders), an excess shares provision is still of great value to private REITs. For example, if a private REIT is formed by two widely-held, publicly-traded corporations as its principal shareholders, the excess shares provision should be written to prevent violations of the closely-held rule of Section 856(a)(6) as a result of (a) the sale by the shareholders of large amounts of stock in the REIT to individuals (b) the acquisition by a few individuals through the public markets of a high concentration of the stock of a corporate shareholder of the REIT such that even after looking through the public corporation, the REIT may still be deemed to be closely-held or (c) the acquisition by a few individuals of a large amount of the stock of a corporate shareholder of the REIT pursuant to a bankruptcy proceeding of such corporate shareholder (in which case the excess shares provision described below should be drafted in a manner that will minimize the possibility that a bankruptcy court would set aside the terms of that provision under its equity power). In the case of clauses (b) and (c) above, the excess shares provision typically provides that the corporate shareholder would automatically relinquish a number of REIT shares necessary and sufficient to maintain the REIT's status under the Code, as described more fully below.

(i) The excess shares provisions that have been addressed in private rulings are those adopted by REITs to prevent so-called "prohibited transfers" of REIT shares to another person (a "prohibited transferee") that will result in the disqualification of the

REIT for failing the 100 shareholder requirement (discussed at Point II.D, infra) or the non-closely held requirement (discussed at Point II.E, infra).

The following are typical terms found in excess shares provisions of private REITs. First, if an existing holder attempts to transfer REIT shares to a prohibited transferee, the transfer is void from the outset. Second, if as a result of a change in the beneficial ownership of an entity that is a shareholder in the REIT (an “Entity Shareholder”) the REIT would become closely-held within the meaning of Section 856(h), such Entity Shareholder is deemed to immediately exchange for “Excess Shares” the number of REIT shares that would permit the REIT to continue to avoid being closely-held (Excess Shares are typically of the same class, but in at least one ruling the REIT’s charter established a third class of “Excess Stock” in addition to common stock and preferred stock). The Excess Shares remain outstanding REIT shares, but are automatically transferred to a new trust or to a designated agent for the sole benefit of a charity. The charitable beneficiary is entitled to exercise the voting rights and to receive all dividends and distributions made by the REIT on the Excess Shares. The Entity Shareholder may receive proceeds from the Excess Shares in two instances: (i) if the trustee or designated agent sells the Excess Shares to an unrelated person that can hold the REIT shares without disqualifying the REIT (a “permitted transferee”) or if the Company redeems the Excess Shares from the charitable trust within a 90-day period after the date of the change in stock ownership of the Entity Shareholder or (ii) if the REIT liquidates and distributes its assets in liquidation. In the case of (i) above, the Entity Shareholder and the charitable beneficiary will share the sales proceeds; the Entity Shareholder will receive the lesser of (w) the price paid for the shares deemed exchanged for Excess Shares (or the fair market value of those shares if the Entity Shareholder received those shares via gift or for no consideration) and (x) the amount received by the trustee or the designated agent from the sale of the Excess Shares. In the case of a liquidation of the REIT described in clause (ii) above, the Entity Shareholder will get the lesser of (y) the price paid for the shares deemed exchanged for the Excess Shares and (z) the amount distributed on liquidation of the REIT with respect to such shares. In all cases, the charitable beneficiary receives any excess proceeds over the amount payable to the Entity Shareholder. In effect, the excess shares provision are intended to strip the Entity Shareholder of a substantial portion of any interest in the Excess Shares (i.e., voting, dividend, transfer and right to share in appreciation of such shares) and to confer all such economic benefits associated with such stock to a charitable beneficiary or other permitted transferee (e.g., via a sale by the trustee to an unrelated purchaser that is a permitted transferee). See, e.g., PLR

9719018 (Feb. 4, 1997); PLR 9627017 (Apr. 5, 1996); PLR 9621032 (Feb. 26, 1996); PLR 9552047 (Sept. 29, 1995); PLR 9552046 (Sept. 29, 1995); PLR 9439005 (June 27, 1994); PLR 9430022 (Apr. 29, 1994). The benefit of using a charitable beneficiary in the excess shares provision is that the shares held for the benefit of the charitable beneficiary are considered outstanding stock of the REIT for purposes of making the closely-held determination required under Section 856(h) (discussed below at Point II.E). The IRS has been less consistent when analyzing excess shares provisions which do not provide for a charitable trust. Compare PLR 9440026 (July 11, 1994) (excess shares provision not providing for charitable beneficiary is valid, but excess shares are not considered to be outstanding for purposes of Section 856(h), thus making it more likely that the REIT would be closely-held based on the fewer total REIT shares outstanding) with PLR 9205030 (Nov. 5, 1991) (excess shares provision valid without charitable beneficiary, and excess shares are considered outstanding for purposes of the closely-held determination of Section 856(h)); PLR 8921067 (Feb. 28, 1989) (same). See also Letter from Tony Edwards of NAREIT to the IRS, dated May 14, 2003, elect. cit. 2003 TNT 113-23 (requesting that the IRS issue formal guidance on excess shares provisions of REITs notwithstanding that such a project was not included in the IRS' 2002–2003 Business Plan).

(ii) In the private REIT context, tax-exempt pension-fund investors typically seek to have the excess shares provision in the charter or trust instrument protect any tax-exempt pension-fund investor that owns 10% or more (by value) of the REIT shares from being subject to UBTI on dividends received from a "Pension Held REIT" within the meaning of Section 856(h)(3)(D) (added by OBRA 1993). There are indications that a taxpayer could obtain a private ruling that such provisions are valid. See, e.g., PLR 9534022 (May 31, 1995) (respecting excess shares provision to prevent excessive ownership by pension trusts). Further, the IRS has previously extended the excess shares provision in the non-publicly traded REIT context to prevent a foreigner from being subject to FIRPTA with respect to gain from the sale of REIT shares if the REIT no longer qualifies as a "domestically-controlled REIT" within the meaning of Section 897(h). See PLR 9630016 (Apr. 26, 1996) (noting that such an extension was supported by the same rationale underlying Treas. Reg. § 1.856-1(d)(2)).

Although there is no authority on point, the reasoning expressed in those private rulings should apply equally to an excess shares provision designed to protect a tax-exempt pension fund investor from holding shares in a Pension-Held REIT. Cf. PLR 200234054 (May 21, 2002) (approving trust arrangement whereby trust would receive all securities that would otherwise cause REIT to own more than 10% of the

outstanding securities of any one issuer contrary to Section 856(c)(4)(B)(iii)(III)); PLR 200132008 (May 4, 2001) (approving excess shares provision designed to prevent REIT from owning 10% of total voting power or value of a lessee for purposes of the asset test of Section 856(c)(4) or "Related Party Rent" under Section 856(d)(2) (see Point II.F.1, infra)). Moreover, when Congress enacted the beneficial look-through rules with respect to qualified pension funds that invest in the REIT for purposes of the closely-held determination of Section 856(a)(6) and (h), a REIT was less likely to become disqualified for being closely-held within the meaning of those sections but — in the spirit of what one hand giveth, the other taketh away — Congress simultaneously provided for the potential recognition of UBTI by a pension fund investor if the REIT was a pension held REIT. It would thus appear that an excess shares provisions designed to address a "pension held REIT" concern of pension fund investors is merely the corollary of the previously permitted excess shares provisions designed to prevent a REIT from becoming closely-held (see private rulings cited above).

3. The IRS has also ruled that restrictions on transferability required to comply with applicable securities laws will not render the certificates of interest or shares "non-transferable". See, e.g., PLR 9630016 (Apr. 26, 1996) (this exception is warranted because, otherwise, "it would be virtually impossible for any entity to qualify as a REIT because the entity cannot sanction transfers of its securities that violate any applicable law."); PLR 7311230330A (Nov. 23, 1973) (securities law restrictions do not taint REIT shares).

4. Several private rulings seem to create a special exception from the "transferability" requirement for "small percentages" of restricted shares that are issued to employees or managers of the REIT pursuant to a formal stock incentive plan. For example, in PLR 9747034 (Aug. 25, 1997), a (publicly traded) REIT established a stock incentive plan that provided, among other things, for the issuance of restricted stock to its employees representing a small percentage of the REIT's outstanding shares. All such restricted stock was subject to a vesting schedule and the REIT held all shares of restricted stock awarded to its employees until they became vested shares. After the restricted stock vested, the employee would receive the stock certificates. The employee was entitled to any dividends declared and to exercise the voting rights associated with vested and unvested shares of such restricted stock. The restricted stock was also subject to (i) restrictions on the employee's ability to transfer shares and (ii) a risk of forfeiture before the shares vested, e.g., if the employee terminated employment before the vesting date. The IRS ruled that, since the REIT stock awarded to employees represented a small percentage of the REIT's total outstanding stock, the general thrust

of the transferability requirement — viz., to allow small investors to pool their funds in a pass-through investment entity — would not be frustrated through the issuance of such restricted stock. See also PLR 9613018 (Dec. 27, 1995) (similar restricted stock awarded to REIT employees but with the added features that the stock was deemed to be conveyed back to the REIT upon certain forfeiture events without any required payment from the REIT to the forfeiting party and that the REIT's directors could waive the transferability restrictions associated with the restricted stock); PLR 9534022 (May 31, 1995) (same where restricted stock awarded to REIT employees and other service providers and any shares transferred by the recipient before the scheduled vesting date would be forfeited by the transferee to the REIT); PLR 9440026 (July 11, 1994).

Query whether the rationale underlying the cited rulings — viz., that the small amount of stock issued to employees will not affect the ability of other REIT investors to transfer their shares in the open market — is anything other than a result-oriented determination by the IRS in the employer-employee context. Thus, a similar ruling might be issued for a private REIT even though there are few shareholders other than the employees receiving restricted stock.

5. Each of the principal shareholders of a private REIT often want to have the ability to block a transfer of shares by any other shareholder to a new party without the prior approval of the non-transferring shareholder. What if the restrictions on transferability appear in a shareholders' agreement, but not in the trust instrument or in the corporation's charter?

(i) Presumably, this is not fatal since the underlying shares are inherently transferable. Cf. Treas. Reg. § 1.1361-1(*l*)(2)(iii) (in S corporation context, restrictions on transferability of shares imposed by shareholder agreements do not alter the rights of outstanding, identical shares so as to cause some shares to be treated as a second class of stock that would terminate the entity's S corporation election); Parker Oil Co. v. Commissioner, 58 T.C. 985, 990-91 (1972) (S corporation context; same principle applied), acq. in result, 1973-2 C.B. 3; PLR 200052012 (Sept. 26, 2000) (restriction in shareholders' agreement prohibiting any shareholder from transferring S corporation stock to an ineligible shareholder respected); see also GCM 39855 (Mar. 1, 1991) (shareholders' agreement pursuant to which a private foundation agreed not to vote voting stock that it held in a corporation did not convert such stock into non-voting stock permitted to be held by such foundation under Section 4943(c)(2)); but see GCM 36823 (Aug. 24, 1976) (REIT that only held non-voting stock of a corporation was deemed to hold "voting securities" within the meaning of Section 856(c)(5)(B) under

particular facts and circumstances as REIT could influence decisions of the issuer's directors under terms of shareholders' agreement pursuant to which the sole holder of the voting stock of the corporation granted the REIT the right to vote his stock; overruling PLR 7203310630A (Mar. 31, 1972)). Note that the cited S corporation authorities are particularly analogous to the private REIT setting in that, like the private REIT, S corporations are closely-held by a limited number of shareholders. See Parker Oil, 58 T.C. at 992-93 (Featherston, J., concurring) (agreeing with majority opinion that exception to statutory "one class of stock" rule is warranted due to closely-held nature of S corporations).

(ii) However, caution must be exercised if all current (and future) shareholders are (or automatically become) parties to a shareholders' agreement that restricts the transferability of the REIT shares or beneficial interests. Especially where there is no realistic possibility in nearly all circumstances that the shares will ever be transferred, the IRS could conclude that such REIT shares are not, in substance, "transferable."

Moreover, if the REIT itself is a party to a shareholders' agreement that contains restrictions on transferability of the REIT shares, there is a significant risk that such restrictions would be deemed the equivalent of comparable restrictions set forth in the REIT's charter or trust agreement and, therefore, considered to be inherent in the REIT shares.

6. What if shareholders in the private REIT are prohibited from transferring shares without the consent of the non-transferring shareholders, but such required consent could not be unreasonably withheld by the non-transferring shareholders? Cf. Larson v. Commissioner, 66 T.C. 159, 183 (1976) (holding in partnership classification context that the existence of a reasonableness standard limiting the withholding of one party's consent for another party to transfer the latter's interests in an entity permitted such interest to be considered "freely transferable").

   What if shareholders in the private REIT were obligated to give non-transferring shareholders the right of first refusal? Cf. Former Treas. Reg. § 301.7701-2(e)(2) (requirement of right of first offer to existing members of an organization by any member interested in transferring its interest in the organization is considered a "modified" form of free transferability of interest – this should satisfy the "transferable shares" requirement for REITs).

   It is not certain, however, that the partnership classification authorities regarding "free transferability of interest" (before the check-the-box regulations) are controlling for

   purposes of the REIT organizational requirement. See William B. Brannan, Lingering Partnership Classification Issues (Just When You Thought It Was Safe To Go Back Into The Water), 1 Fla. Tax Rev. 197, 220-21 & nn. 79 & 80 (1993) (noting that the absolute requirement in Section 856(a)(2) and Treas. Reg. § 1.856-1(d)(2) that shares or beneficial interests in a REIT must be "transferable" (other than the express exceptions described above) seems to be contrary to the application of the Larson holding cited above to REITs); but see PLR 200052037 (Oct. 2, 2000) (Larson is "instructive" for purposes of determining what is a "transferable" REIT interest even after issuance of check-the-box regulations). Notwithstanding the foregoing, it can be strongly argued that the "transferability" requirement for REITs is easier to satisfy than the "freely transferable" standard under the old partnership classification authorities.

C. Otherwise Taxable as a Domestic Corporation. A REIT must qualify, and be otherwise taxable, as a domestic corporation (except as provided under the REIT rules). See Section 856(a)(3); Treas. Reg. § 1.856-1(b)(3) & (d)(3). Thus, a foreign entity cannot be a REIT, Rev. Rul. 89–130, 1989-2 C.B. 117, although a domestic entity that has elected REIT status can be controlled by foreigners, see Section 897(h).

   1. The existing Treasury regulations issued under Section 856 refer to Section

7701(a)(3) and (4) and to the regulations promulgated thereunder (now the "Check-the-Box Regulations") as demonstrative of what types of domestic, corporate entities can qualify as REITs. See Treas. Reg. § 1.856-1(d)(3); see also PLR 7203220260A (Mar. 22, 1972) (applying pre-Check-the-Box Regulations test for determining whether REIT in the form of a business trust was taxable as a corporation); PLR 6301284790A (Jan. 28, 1963) (same). The Check-the-Box Regulations provide a detailed list of per se corporations in Treas. Reg. § 301.7701-2(b) (all of these entities should be able to elect REIT status (assuming that they can satisfy the other REIT requirements), except for the foreign entities specified in Treas. Reg. § 301.7701-2(b)(8)), and elective rules for certain other eligible entities to be taxed as corporations for federal income tax purposes, see Treas. Reg. §§ 301.7701-3(a) (effective for elections before March 23, 1998); 301.7701-3T(a) (same for elections on or after March 23, 1998).

2. To further streamline the REIT eligibility process — and to avoid the situation in which a domestic entity that elects REIT status fails to "check the box" to be taxed as an association taxable as a corporation — Treas. Reg. § 301.7701-3(c)(v)(B) deems any eligible entity that has elected to be taxed as a REIT, to have implicitly elected to be taxed as a corporation. The definition of "eligible entity" in the

regulations does not include passive trusts. However, since Treas. Reg. § 1.856-1(d)(3) provides that an otherwise qualified REIT (which can be in the form of an unincorporated trust or unincorporated association) is "deemed to satisfy the 'objective to carry on business' requirement" of Treas. Reg. § 301.7701-2(a), query whether this would allow a passive trust with minimal investments and no ability to vary its investments to qualify as a REIT if it otherwise satisfies the REIT requirements (and elects to be taxed as a REIT and, thereby, to be taxed as an association).

3. The Treasury regulations also extend the otherwise "taxable as a domestic corporation" concept to incorporate any other provision under Chapter 1 of the Code (including the corporate tax provisions of Subchapter C) that does not conflict with the REIT provisions. Thus, for example, a REIT (whether in trust or corporate form) and its shareholders generally follow corporate tax principles in computing the REIT's taxable income and its earnings and profits; determining whether distributions by the REIT to its shareholders are treated as dividends or redemptions, and other similar tax rules. See Treas. Reg. § 1.856-1(e); GCM 36877 (Sept. 30, 1976) (distinction between non-business debts and business debts in Section 166(d) for taxpayers other than corporations does not apply to a REIT which is generally taxed in accordance with the rules applicable to corporate taxpayers); GCM 36185 (Mar. 10, 1975) (REIT in form of a trust is treated as a corporation for purposes of the specified sections in the regulations and, where applicable, the Section 318 attribution rules).

D. 100 or more Persons as Shareholders of the REIT. The beneficial ownership of all REITs (whether in the form of trusts, unincorporated associations or corporations) must be held by 100 or more "persons" for at least 335 days of each taxable year of

12 months,[7] or a proportionate amount of a shorter taxable year (i.e. 335/365 times the number of days in the short taxable year). Section 856(a)(5) & (b); Treas. Reg. § 1.856-1(b)(6). The number of days in the complete or short taxable year need not be consecutive, and fractional days are disregarded. Treas. Reg. § 1.856-1(c). There is a special exemption from this organizational requirement (and from the closely-held determination discussed below) for a REIT's first taxable year. See Section

856(h)(2). Since, by definition, a private REIT is not widely-held, the 100 shareholder requirement presents an obstacle for such entities to qualify as REITs.

1. There are no look-through rules for purposes of the 100 shareholder test. See Treas. Reg. § 1.856-1(d)(2) (attribution rules not applicable); see also Rev. Rul. 65-3, 1965-1 C.B. 267 (no look-through rule for pension trusts that are REIT shareholders); Rev. Rul. 64–218, 1964-2 C.B. 179 (no look-through rule for insured associations that were REIT shareholders); PLR 6301284790A (Jan. 28, 1963) (similar rule with respect to REIT shareholders that are pension trusts). It is also clear that 100 shareholders need not own shares of each class of stock issued by the REIT. See, e.g., PLR 9016021 (Jan. 18, 1990) (beneficial ownership of the REIT split between a few holders of common shares and many holders of preferred shares), *withdrawn on other grounds by,* PLR 200453008 (Sept. 27, 2004); PLR 8342016 (July 13, 1983) (same).
2. To satisfy the 100 shareholder requirement, some private REITs sell (or grant) a limited number of shares to individuals that (i) have a par value per share that is less than the par (and actual) value of the shares held by the principal shareholders or (ii) have the same par value as the other REIT shares, but are issued to such individuals for a price that is substantially less than the price paid by the principal shareholder for their shares in recognition of other value furnished to the REIT or to the other REIT shareholders by those individuals (e.g., the performance of services by an employee). As described below, recent rules issued by the SEC may adversely affect the ability of private REITs to satisfy the 100 shareholder requirement.

    (i) Arguably, the 100 shareholder minimum threshold is a mere technical requirement that was modeled on a similar requirement under Section 3(c)(1) of the '40 Act (per the legislative history to the REIT provisions reprinted at 1960-2 C.B. 819, 821 and 859, 864) that, among other things, an entity must have 100 beneficial owners to register as an investment company. In the RIC context, such requirement can be met with 100 nominal shareholders. Thus, it would appear that as long as each shareholder holds shares or a beneficial interest in the REIT with more than a de minimis value, this organizational requirement should be met. In practice, practitioners generally insist that each of 120 shareholders hold stock with an initial minimum value in the range of $500 to $1500, depending on the practitioner's viewpoint and the particular facts. See also JOINT COMMITTEE ON TAXATION, REPORT ON INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND

COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS (Volume I) at 152 & nn. 359 & 360, 156, 157 & n.371 (Feb. 2003) (100 shareholders each purchased share of stock for $1000; law firm opined that

the REIT "should" qualify as a REIT for federal income tax purposes; and IRS examination team agreed that the REIT qualified as a REIT for federal income tax purposes).

(ii) In each of the private rulings cited below, the IRS has either respected the form of the structure (i.e., the 100 shareholder requirement was assumed to have been met) or explicitly declined to rule on the question. In PLR 8342016 (July 13, 1983), the IRS determined that where all of the common stock of a REIT was owned by a single trust and 125 shares of non-voting preferred stock were issued to employees of the REIT's parent, resulting in the trust owning 100 percent of the total voting power and in excess of 99.9 percent of the value of the REIT's stock, the REIT satisfied the shareholder requirement of section 856(a)(6). See also PLR 8840018 (July 7, 1988) (noting that nominal shares were distributed in order to satisfy the 100 shareholder requirement; issued in connection with GCM 39756 (June 30, 1988)); PLR 8839067 (July 7, 1988); PLR 7311230330A (Nov. 23, 1973) (incubator REIT respected where not less than 100 beneficial ownership certificates were sold for cash to individuals, some of whom were related to existing shareholders or to employees of the REIT (or to shareholders or employees of the REIT's predecessor entity)).

3. The term "person" is not specifically defined in the Code or the Treasury regulations for purposes of the REIT provisions of the Code. "Person" is broadly defined in Section 7701(a)(1) as "an individual, a trust, estate, partnership, association, company or corporation," to the extent "not otherwise distinctly expressed or manifestly incompatible with the intent [of, for example, the REIT rules]." Thus, to the extent a private REIT grants shares of its stock to its employees (in exchange for services), those individuals would appear to count towards the 100 shareholder requirement. However, because Section 856(c)(5)(F) invokes the '40 Act definitions for any term that is used in, but not specifically defined under, the REIT rules, it is conceivable that certain recent rules issued by the SEC under the '40 Act could adversely affect private REITs that meet the 100 shareholders requirement through the issuance of stock to certain employees and to donees. See Rev. Rul. 65-3, 1965-1 C.B. 267 (applying predecessor statute of Section 856(c)(5)(F) to the definition of "person" in Section 856(a)(5)); PLR 6301284790A (Jan. 28, 1963) (invoking definition of "person" from '40 Act for purposes of the REIT rules).

On April 3, 1997, the SEC adopted final rules (see 17 C.F.R. §§ 270.3c-5 and 270.3c-6 (1997)) to provide needed flexibility for certain privately offered investment companies to avoid being required to register as investment companies under the '40 Act. See

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Privately Offered Investment Companies, Investment Company Act Release No. 22597, 62 Fed. Reg. 17512 (Apr. 3, 1997). Generally, among other requirements, an investment company must have fewer than 100 beneficial owners to avoid registration under section 3(c)(1) of the '40 Act. This restriction on the number of beneficial owners was believed to unnecessarily hamper the ability of privately-offered investment companies to grant shares to certain high-level employees (defined in the new SEC rules as "knowledgeable employees") even though those employees were sophisticated investors. Likewise, if a privately-offered investment company had exactly 99 shareholders and one or more shareholders unilaterally transferred shares via gift (to a relative) or incident to a divorce, this too could cause the entity to be required to register under the '40 Act.

SEC Rule 3c-5 provides that, if certain requirements are satisfied, a privately-offered investment company may issue shares to "knowledgeable employees" without fear of losing its exemption from '40 Act registration. In essence, that new rule ignores shares held by such employees for purposes of determining whether the entity's shares are held by 100 or more persons. Obviously, if a similar rule was implicitly incorporated into the REIT rules under Section 856(c)(5)(F), private REITs will find it increasingly difficult to satisfy the 100 shareholder requirement of Section 856(a)(5).

SEC Rule 3c-6 similarly provides that, for purposes of determining whether an entity is exempt from registration under Sections 3(c)(1) and (7) of the '40 Act, if shares of the entity being examined under the '40 Act are held by persons who received those shares involuntarily (for example, by way of "gift or bequest or pursuant to an agreement relating to a legal separation or divorce"), such shares are treated as being beneficially owned by the "person" who transferred them. The implications of such a rule — if incorporated into the private REIT context — could be problematic in that gifts of shares by shareholders of a private REIT (or transfers of shares for no consideration by the private REIT itself, e.g., donations to charities) could be ignored when analyzing whether the REIT satisfies the 100 shareholder requirement. Thus, while the securities law rules were clearly intended to allow companies more flexibility in avoiding the registration of private investment companies under the '40 Act, those rules could have an adverse effect on companies attempting to qualify as REITs. See Tony M. Edwards and Margaret C. Jaffe, Private REITs: Potential Pitfalls and Obligations, REIT Report 26 (Spring 1998) (suggesting that private REITs sell shares to accredited investors to

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avoid the issue, rather than transferring shares to employees or donating shares to various charities).[8]But see Fleet Funding, Inc. v. Commissioner, Docket No. C271862-63, 2008 Mass. Tax LEXIS 12, at *57-*58 (Mass. App.

Tax Bd. Feb. 21, 2008) (State tax board recognized the validity of issuing shares of preferred stock of the REIT to 133 employee-shareholders).

On a practical level, if these recent securities law changes are interpreted to prevent private REITs (and their principal shareholders) from giving or selling REIT shares to certain persons for purposes of satisfying the 100 shareholder requirement, it may be problematic for private REITs to satisfy this test because the large shareholders may not be willing to allow shares to be held by minority shareholders (even if accredited investors) that are not (x) family members of the principal shareholders of the REIT or (y) employees of the REIT or of the principal shareholders.

4. Some states are trying to make it easier for Private REITs to satisfy the 100 shareholder requirement by allowing REITs to issue more than 100 shares for no consideration. See, e.g., Section 8–207 of the Maryland REIT Law (amended by H.B. 958, effective June 1, 2005), which now permits a Maryland REIT to issue shares without consideration to more than 100 persons. This enables a Private REIT to issue shares to a larger group without consideration and thereby avoid inadvertently violating the 100 shareholder requirement. Previously, Maryland law had limited the number of recipients of REIT shares for no consideration to a maximum of 100 shareholders.

E. Closely Held Determination. Section 856(a)(6) requires that a REIT not be "closely held", as determined under section 856(h). An entity is closely held if, at any time during the last half of the taxable year, more than 50 percent of its outstanding stock (by value) is owned, directly or indirectly, by or for not more than 5 individuals (the "Five-or-Fewer Rule"). Section 856(h)(1) (incorporating Section 542(a)(2) of the personal holding company ("PHC") rules). For example, in the case of any corporate shareholders of a REIT, the Five-or-Fewer Rule is applied by looking through to the ultimate beneficial ownership by individuals of those corporate shareholders. Thus, under current law, a widely-held corporation can set up a majority-owned private REIT with relative ease (assuming it also satisfies the 100 shareholder requirement described above).

1. As noted above (see Point II.B.2, supra), the charter or declaration of trust of REITs typically provides for an excess shares provision to prevent the inadvertent disqualification of a REIT upon transfers of its shares or the beneficial ownership of any of its stockholders. For purposes of the closely-held determination under Section 856(a)(6) and (h), the IRS has ruled that excess shares under certain excess shares provisions are considered to be outstanding.
2. Even if a REIT would otherwise be closely held under the Five-or-Fewer Rule, the REIT will be deemed not to be closely held in any taxable year in which it (x) makes the shareholder demand required by Section 857(f)(1)[9] and (y) does not know, or exercising reasonable diligence would not have known, that it was closely held in violation of Section 856(a)(6). See Section 856(k) (enacted as part of TRA 1997).

Query how the lack of knowledge provision of Section 856(k) applies if a REIT believes that it is not closely held based on the actuarial look-through rule of Section 856(h)(3)(A) with respect to pension trust shareholders only to discover that such provision is inapplicable, for example, because a related person owns 5% or more (by value) of the outstanding REIT interests as provided in Section 856(h)(3)(A)(ii). The

problem arises because the shareholder demand rules of Treas. Reg. § 1.857-8 have not been updated to reflect the 1993 legislation (<u>see</u> Point II.E.4, <u>infra</u>). Thus, a REIT may not know if the beneficial look-through rule with respect to pension trusts is available.

3. The attribution rules of section 544, with some exceptions noted in section 856(h)(1)(B), are applied to determine if the REIT is closely-held. In general, all corporate and pass-through entities are looked-through in determining the number of individuals that own stock of the REIT based on their proportionate interests in the intermediate entity (so called "from-entity" attribution). Section 544(a)(1); <u>see also</u> PLR 9051043 (Sept. 26, 1990) (grantor trust rules of the Code operate to treat the settlor of a trust that holds REIT interests as being held directly by such settlor).

(i) A REIT must therefore be concerned that no single individual acquires control of any entity that is a major shareholder of the REIT (as defined above in Point II.B.2, an "Entity Shareholder") due to the look-through treatment of any such Entity Shareholder. A private REIT should consider protecting itself from being disqualified as such by causing the Entity Shareholder to automatically relinquish its shares in the REIT if the ownership of the Entity Shareholder itself becomes too concentrated in the hands of individuals, as described in Point II.B.2, <u>supra</u>.

(ii) Family attribution applies as set forth in Section 544(a)(2) & (4) but, unlike the PHC rules, "partner-to-partner" attribution is not taken into account for purposes of testing whether a REIT is closely held. <u>See</u> Section 856(h)(1)(B)(i) (modifying Section 544(a)(2)). The no "double family" attribution rule under Section 544(a)(5) has been interpreted by the IRS to mean that multiple family members cannot simultaneously be counted, through actual and constructive ownership of the <u>very same shares of stock</u>, to be more than one of the largest shareholders of the entity being examined. <u>See</u> Rev. Rul. 89-20, 1989-1 C.B. 170.

(iii) Section 544(a)(3) and (a)(4)(A) treat options as having been exercised but only to the extent that such deemed exercise by the holder causes the company to be a PHC. The PHC rules similarly treat securities of a class of convertible securities, as well as <u>all</u> convertible securities with an earlier conversion date as having been converted into outstanding stock of the company (even if the convertible securities are not convertible within the applicable taxable year), but only to the extent that such deemed conversion causes the company to be classified as a PHC. <u>See</u> Section 544(b) (and flush language). The foregoing principles apply equally for purposes of the REIT determination under Section 856, except as otherwise provided in Section 856(h). See

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Section 856(h)(1)(B)(ii) (modifying the option attribution and convertible securities rules under Section 544 to apply only if the result is to cause the REIT to be closely-held as defined in Section 856(h)(1)).

4. A pension trust within the meaning of Section 401(a) and other specified organizations are considered "individuals" for purposes of the PHC test under Section 542(a)(2), but other tax-exempt organizations are not considered individuals for PHC purposes. See, e.g., PLR 200403027 (Oct. 1, 2003). However, in an attempt to make it easier for entities to qualify as REITs, in 1993 Congress enacted a special look-through rule for domestic pension trusts (within the meaning of Section 401(a)) that invest in REITs (but only for purposes of the REIT provisions of the Code). Section 856(h)(3). Section 856(h)(3)(A) provides that a pension trust is not considered an individual for purposes of the closely held determination applicable to REITs, unless certain disqualified persons hold 5% or more of the value of the interests in the REIT and the REIT has accumulated E&P from any year in which it did not qualify as a REIT. If the look-through rule applies, each beneficial owner of the pension trust is deemed to hold a proportionate share of the REIT shares held by the pension trust based on the individual's actuarial interest in such pension trust. If an entity qualifies as a REIT by reason of the pension trust look-through rule, the REIT is not subject to tax as a PHC under Section 856(h)(3)(B) even though it comes within the definition of a PHC under Section 542(a)(2) (last sentence) under the general rule that a pension trust is considered an individual for purposes of the PHC rules (in contrast to the special rule that a pension trust is not considered to be an individual in determining whether a REIT is closely-held).

5. When it enacted the beneficial look-through rule for pension trusts, Congress simultaneously provided that pension trusts that are large REIT investors owning more than 10% by value of the outstanding interests in a "Pension-Held REIT" may recognize UBTI through their investment.

   (i) A REIT is a "Pension-Held REIT" if (I) the REIT would have been closely-held by five or fewer individuals (if the pension trust was treated as an individual for this purpose and the look-through rule did not apply) and (II) (y) if at least one pension trust holds more than 25% (by value) of the interests in the REIT or (z) one or more pension trusts (each of whom owns more than 10% (by value) of the outstanding REIT interests) collectively own more than 50% (by value) of the interests in the REIT. Section 856(h)(3)(D).

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   (ii) Presumably the Section 544 attribution rules (as modified by Section 856(h)(1)(A)) apply for purposes of determining whether a pension trust owns 10% or more (or 25% or more) by value of a REIT in order to classify a REIT as a "Pension-Held REIT." Cf. Section 318(a)(2)(B)(i) and (a)(3)(B)(i) (under the general attribution rules of the Code there is no attribution to pension trusts from its beneficiaries and vice versa). However, the statute is silent regarding whether attribution rules are to be considered at all and, if so, which particular rules one should apply. Cf. Section 897(h)(3) & (4)(B) (statute is silent concerning any attribution rules for determining the "domestically controlled" REIT exception from FIRPTA).

(iii) If a pension trust owns more than 10% (by value) of the interests in a Pension-Held REIT at any time during the taxable year and receives distributions (whether actually paid or treated as paid) during such taxable year, it is required to recognize amounts so distributed (or treated as distributed) to the pension trust by the REIT as UBTI in the same ratio as the distributed amounts bear to a fraction; (x) the numerator of which is the gross income (less direct expenses) of the REIT derived from an unrelated trade or business (as if the REIT was considered a tax-exempt pension trust) and (y) the denominator of which is the REIT's total gross income (less direct expenses) for the taxable year, provided that such ratio exceeds 5%. Section 856(h)(3)(C).

6. Often, private REITs avoid running afoul of the Five-or-Fewer Rule by ensuring that the ownership of entities that are the principal shareholders is sufficiently diverse that a small group of individuals do not own, directly or indirectly, more than 50% of the value of the outstanding stock of the private REIT.

To prevent the use of private REITs in transactions arguably structured to circumvent corporate tax principles, in 2003, Congress proposed to amend the "closely-held" REIT provisions by preventing any single "person" from owning, directly or indirectly, 50% or more of (x) the total combined voting power of all classes of voting stock or (y) the total value of all the outstanding REIT interests. While this proposed legislation was ultimately not included in the final legislation, it would have incorporated the rule of Section 7701(a)(1), which defines "person" to include corporations and partnerships, in addition to individuals. It is noteworthy that the proposal would have exempted from its scope REITs in which the prohibited threshold of stock ownership (by vote or value) is held by another REIT or by a partnership in which one REIT owns at least 50% of the capital and profits interests in the partnership. The proposal would also have exempted certain "incubator REITs."

In proposing this legislation, Congress was concerned that a single corporate shareholder or a small group of shareholders might utilize a REIT to achieve tax benefits based on their individual tax profiles. One example of such use might be to place various assets in a REIT in order to obtain "dividend" treatment for income from the REIT when desired, even though the assets, if held directly, might produce a different form of income (e.g., interest income). See STAFF OF SENATE COMM. ON FINANCE, 108TH CONG., JOBS AND GROWTH

RECONCILIATION TAX ACT OF 2003 AT 62 (Comm. Print 2003).

If the 2003 proposed legislation were enacted by Congress, it would not replace, but would be in addition to, the existing Five-or-Fewer Rule. Further, unlike the existing Five-or-Fewer Rule under the Code, the proposed legislation would apply the modified Section 318 attribution principles set forth in Section 856(d)(5) of the Code (relating to tainted rental income received by a REIT from a "Related Party Tenant" that is discussed immediately below at Point II.F.1), rather than the modified PHC constructive ownership rules used for purposes of the closely-held determination under Section 856(h).

F. REIT Income and Asset Tests. An entity will not qualify as a REIT for any taxable year in which it does not meet the REIT income and asset tests, including the requirement that at least seventy-five percent (75%) of a REIT's gross income for each taxable year must be qualifying income. Section 856(c)(3). The REIT may satisfy the income and asset tests directly or indirectly through its interest in a partnership. See, e.g., PLR 200740004 (Oct. 5, 2007). The IRS has recently made it easier for a REIT to satisfy the asset tests involving debt secured by real estate that has declined in fair market value. See Rev. Proc. 2011-16, 2011-5 IRB.

Qualifying income generally includes, among other things, (i) rents from real property (except as modified below); (ii) interest on obligations collateralized by mortgages on, or interests in, real property (and, on or after August 11, 2003, includes interest received on loans that are secured by partnership interests or interests in a disregarded entity if the requirements of Rev. Proc. 2003-65, 2003-32 I.R.B. 1, are satisfied); (iii) gains from the sale or other disposition of real property and real estate mortgages (including interests therein), other than gain from property held primarily for sale to customers in the ordinary course of the company's trade or business; (iv) dividends or other distributions on shares in other REITs, as well as gain from the sale of such shares; and (v) certain qualified temporary investment income attributable to the investment of new

capital received by the REIT in exchange for its stock but only during the one-year period following the receipt of such new capital.

Income related to certain intangible assets held by the REIT can also qualify as "good" income. The IRS has recently determined that goodwill arising from a taxable disposition of all of the assets of a REIT that is engaged in an active trade or business of managing shopping centers is to be allocated proportionately among all of the REIT's assets and retain the character of the asset to which it is allocated. PLR 200823014 (Feb. 22, 2008). Likewise, the IRS recently determined that rent payments received by a REIT that are attributable to certain real estate intangible assets was qualifying income for purposes of Section 856(c)(3). PLR 200813009 (Dec. 13, 2007).

In addition, a REIT must derive at least ninety-five percent (95%) of its gross income for each taxable year from similar sources as that qualifying for the foregoing 75%

test, as well as dividends, interest and/or certain gains from the sale or disposition of stock or other securities. Section 856(c)(2).

1. Rents received or accrued from a tenant will not, however, qualify as rents from real property for purposes of satisfying the 75% test (and the 95% test) if the REIT, or an owner of ten percent (10%) or more of the value of the REIT, directly or constructively owns ten percent (10%) or more (by vote or by the total number of outstanding shares) of such tenant (a "Related Party Tenant"). Section 856(d)(2)(B) & (d)(5); Treas. Reg. § 1.856-4(b)(4) (requiring a REIT to disclose relevant information when it files its tax return); see also PLR 200525013 (Mar. 22, 2005); PLR 200039017 (June 26, 2000). Even if the REIT is in the form of a trust or unincorporated association, the "to/from" corporate attribution rules of Section 318 apply for these purposes. See GCM 36185 (Mar. 10, 1975) (REIT in the form of a trust is treated as a corporation and the modified Section 318 attribution rules are applied for purposes of determining if any rent from real property is tainted).
2. Since private REITs typically have shareholders which own more than 10% of the REIT's stock, it is possible that the REIT may receive rental income from a Related Party Tenant. Query whether rental income will not be qualified income for purposes of the 75% and 95% gross income tests if the tenant itself owns 10% or more (by value) of the REIT's outstanding shares or beneficial interests. Cf. Arizona Department of Revenue, Private Taxpayer Ruling LR03-003 (May 2, 2003) (addressing exemption from state tax where a wholly-owned subsidiary of the tenant owned all of

the voting shares in a private REIT-lessor). Under the general prohibition of any entity constructively owning its own shares through the attribution rules of Section 318, the REIT should not be deemed to own any shares or interests in its tenant-owner. See Rev. Rul. 74–605, 1974-2 C.B. 97 (sale of stock of a second tier subsidiary ("Sub2") by a first tier subsidiary ("Sub1") to its corporate parent ("Parent") was not a transaction subject to Section 304(a)(1) since Sub1 could not be deemed to be in "control" of Parent under the constructive ownership rules of the Code as it would then be deemed to own its own shares).
3. Rental income is clearly tainted if the same person owns a tenant and owns 10% or more by value of the REIT since separate chains of ownership do not invoke a similar prohibition against an entity constructively owning its own shares or beneficial interests. See, e.g., GCM 35414 (July 25, 1973) (discussing Rev. Rul. 74–605; constructive ownership rules of the Code apply so that subsidiaries in different tiers of separate corporate chains are deemed to be in "control" of the other); Action on Decision 1981-1 (Oct. 9, 1980) (discussing IRS' position of Broadview Lumber Co. v. United States, 561 F.2d 698 (7th Cir. 1977), and disagreeing with that decision based on similar rationale as that expressed in GCM 35414)); PLR 8515041 (Jan 11, 1985) (sale of second tier subsidiary by first tier subsidiary to fourth tier subsidiary in different corporate chain is a Section 304(a)(1) transaction), amplifying, PLR

8510070 (Dec. 12, 1984).

4. If a REIT is a partner in a partnership, and an entity that is owned, directly or indirectly, by another partner in the partnership leases property from the REIT, the Related Party Tenant rules will not apply, notwithstanding that Section 856(d)(2)(B) is broadly written to taint any rent that is received or accrued "directly or indirectly from any person [related], directly or indirectly, [to the REIT]." See Section 856(d)(5) (incorporating modified attribution rules under Section 318(a), which does not provide for partner-to-partner attribution under Section 318(a)(5)(C)); PLR 200842010 (July 9, 2008) (corporate tenant owned by other partner in a limited partnership in which the REIT was a party did not result in related party rent); but see PLR 9510030 (Dec. 9, 1994) (perhaps supporting proposition that rent received from tenant owned by the REIT's partner in a partnership is tainted under the Related Party Tenant rule).

5. A REIT receives income qualifying as "rents from real property" even if the rent received by the REIT includes "charges for services customarily furnished or rendered in connection with real property, whether or not such charges are separately

stated." Section 856(d)(1)(B); Treas. Reg. § 1.856-4(b)(1) ("customary" services are dependent on geographic location of the real property); see also PLR 200828025 (Apr. 8, 2008) (REIT's generation and provision of electricity and steam to tenants in property was customary in that geographic area and permissible for that REIT). However, for rents received to qualify as rents from real property, the REIT generally must not furnish or render impermissible services to tenants, other than through an "independent contractor" from whom the REIT derives no revenue. Section 856(d)(2)(C) and (d)(7); Treas. Reg. § 1.856-4(b)(1) and (b)(5). For these purposes, the IRS generally permits the REIT to perform, directly or indirectly, only services that are "usually or customarily rendered" in connection with the rental of space for occupancy. See Section 856(d)(7)(C) (incorporating similar principles as those used to exclude rents received by a tax-exempt entity from UBTI under Section 512(b)(3)); Treas. Reg. § 1.512(b)-1(c)(5) (exclusion from UBTI rule); PLR 9552046 (Dec. 29, 1995). The qualified rents permitted to be received by a REIT for "customary" services under section 856(d)(1)(B) are clearly more extensive than those permitted to be received without UBTI by a tax-exempt organization. See, e.g., Rev. Rul. 2004-24, 2004-10 I.R.B. 550 (Mar. 8, 2004) (addressing three situations where REIT received income qualifying as "rents from real property" from parking facilities and pointing to legislative history as supporting broader "customary" services exception for REITs under Section 856(d) than for tax-exempt organizations under Section 512).

6. A REIT will also receive qualifying "rents from real property" under section 856(c)(2)(C) and (c)(3)(A) if an independent contractor furnishes or renders any impermissible services to tenants and from which services the REIT derives no revenue. Section 856(d)(2)(C) and (d)(7)(C)(i); Treas. Reg. § 1.856-4(b)(5). See, e.g., PLR 201014042 (Apr. 9, 2010) (independent contractor can lease office space in the premises from the REIT at fair market value without tainting

its status as an independent contractor); PLR 200921019 (Feb. 13, 2009) (personal services provided to tenants by independent contractor from whom the REIT does not receive or derive any income will not taint such rent); PLR 200825034 (Mar. 17, 2008) (hotel management company whose owners were the executive officers of the REIT could manage hotels owned by the REIT and provide services to the guests if the hotel management company was an independent contractor); PLR 200410010 (Dec. 2, 2003) (capital improvements (or build-outs) made by independent contractors to tenant space did not taint rental received by the REIT). An "independent contractor" is any person (y) which does not own more than 35% of the outstanding REIT shares or beneficial interests, provided that (z) no person that owns REIT shares or interests exceeding the

35% threshold owns 35% of such "independent contractor" (by vote or by number of outstanding shares, if the independent contractor is a corporation, or by interest in assets or net profits, if the independent contractor is not a corporation). Because private REITs are closely-held, there is obviously a greater possibility that the prohibited 35% threshold will be an issue for such REITs.

7. A REIT may also receive rents that qualify as rents from real property if a taxable REIT subsidiary ("TRS") furnishes or renders impermissible services to tenants. Section 856(d)(7)(C)(i); see also PLR 200840028 (June 17, 2008) (TRS may provide housekeeping functions and other noncustomary services in connection with temporary housing without tainting the REITs status); PLR 200532009 (May 6, 2005); PLR 200510002 (Nov. 19, 2004). Moreover, if a TRS and an independent contractor, both of whom may provide impermissible services to tenants without disqualifying the rental income received by the REIT, form a joint venture to furnish or render impermissible services to tenants, this too has been blessed by the IRS. See Rev. Rul. 2003-86, 2003-32 I.R.B. 1; Rev. Proc. 2003-66, 2003-33 I.R.B. 1. However, care must be exercised that no portion of the income earned by the TRS from providing services to unrelated tenants is shifted to the REIT and characterized as "redetermined rents" under section 857(b)(7). The REIT is subject to a 100% tax on any such "redetermined rents." See, e.g., PLR 200428019 (Mar. 25, 2004) (where REIT and its TRS entered into cost-sharing arrangement for services provided by the TRS to the REIT's tenants, IRS noted that the arrangement between the REIT and its TRS could become subject to the "redetermined rents" provision in section 857(b)(7)). Indeed, for tax years beginning after the enactment of the American Jobs Creation Act of 2004 ("AJCA 2004"), which was signed into law on October 22, 2004, there is no longer a safe harbor for amounts received, directly or indirectly, by a REIT for (i) "customary" services provided by its TRS within the meaning of section 856(d)(1)(B) or (ii) for rents from the TRS that are for real property or from incidental personal property provided with such real property. See Point II.F.6, supra.

8. A REIT receives income qualifying as "rents from real property" even if the rent

received by the REIT includes amounts received from a Related Party Tenant if (i) such Related Party Tenant is a TRS, (ii) the real property leased by the REIT to such TRS is a “qualified lodging facility” (as defined in Section 856(d)(9)(D) – generally includes hotels and motels) or a “qualified health care property” (as defined in Section 856(e)(6)(D)(i) – generally includes hospitals, nursing facilities or similar facilities), and (iii) such “qualified lodging facility” or “qualified health care property” is operated on behalf of the TRS by a person who is an “eligible independent contractor” (as

defined in Section 856(d)(9)(A)). Section 856(d)(8)(B); PLR 201033022 (Aug. 20, 2010).

While a TRS may lease a qualified lodging facility or qualified healthcare property from its parent REIT if the facility is operated by an eligible independent contractor, a TRS may not, directly or indirectly, operate or manage a lodging facility or health care facility. Section 856(l)(3). However, Section 856(d)(8)(B) provides that a TRS will not be deemed to be operating or managing a qualified healthcare property or qualified lodging facility solely because (i) it owns a license or permit to do so; or (ii) it is the employer of the employees at the facility or property outside the United States, so long as the daily supervision and direction of such employees is the responsibility of the eligible independent contractor.

9. If a Private REIT undertakes real estate rehabilitation projects and receives substantial state tax credits, any taxable income to the Private REIT arising from those state tax credits does not count towards the REIT income tests of Section 856(c)(2) and (c)(3). See, e.g., PLR 200614024 (Dec. 28, 2005); PLR 200528004 (Apr. 5, 2005).

G. REIT Distribution Requirements. A REIT must distribute annually to its shareholders at least 90% of its taxable income in the form of dividends that qualify for the dividends paid deduction (“DPD”). Section 857(b)(2)(B). Such dividends reduce the REIT’s taxable income and cause a REIT to be, in effect, a pass-through entity for federal income tax purposes. However, the DPD does not automatically carry through for state and local tax purposes. See, e.g., New Plan Realty Trust Inc. v. Tax Commissioner of Cincinnati, Appeal No. C-000748, 2002 Ohio 5577, 2002 Ohio App. LEXIS 5587 (Ct. App. Oct. 18, 2002) (DPD available under federal tax law was not available for purposes of computing local taxes); but see Autozone Development Corp. v. Finance and Administration Cabinet, File No. K04-R-16, Order No. K-19832, 2005 Ky. Tax LEXIS 168 (Bd. Tax App. Oct. 10, 2005) (DPD for federal tax purposes is also available for Kentucky state tax purposes), aff’d, Kentucky v. Autozone Development Corp., No. 2006-CA-002175-MR, 2007 Ky. App. LEXIS 401 (Ct. App. Oct. 12, 2007).

1. Some companies have established a captive REIT (i.e., that is more than 50% owned by a corporation) for state tax planning purposes. Generally, the corporation holds all of the common REIT shares, and individual shareholders (typically employees) own the preferred REIT shares to satisfy the 100-

shareholder requirement. See Point II.D., supra. The corporate shareholder transfers real estate

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assets to the REIT and then leases back those assets from the REIT. The corporate shareholder claims rental expense on its tax return, the REIT eliminates any state tax on its rental income by distributing dividends to the corporate shareholder, and the corporate shareholder enjoys a dividends received deduction or similar provision in its home state so that it pays little or no tax on such REIT dividends. Thus, the REIT claims the DPD on dividends distributed to its corporate shareholder and the corporate shareholder claims a DRD. Some state courts have upheld the taxing authority's right to ignore a captive REIT whose sole purpose is to allow its corporate shareholder to avoid state taxes. See, e.g., HMN Financial, Inc. v. Commissioner, Docket No. 7911-R, 2009 Minn. Tax LEXIS 13 (Minn. Tax Ct., Ramsey Co. May 27, 2009) (ignoring captive REIT structure as lacking economic substance), rev'd, No. A09-1164 (Minn. S. Ct.) (May 20, 2010) (tax commissioner did not have the statutory authority or common law right to ignore the captive REIT structure). Other states have disallowed the DPD for a captive REIT under specific legislation. See, e.g., Va. Code Ann. § 58.1-402(B)(10)(a) (disallowing 50% of the federal DPD for captive REITs during the 2009 and 2010 tax years and disallowing 100% thereafter);; "Oklahoma Final SB 916 Modifies Income Tax Computation for Captive REITs", elect. cit. 2009 STT 96-29 (May 11, 2009) (amending Section 2358(F) of the Oklahoma Code to disallow the DPD for dividends paid by a captive REIT); "Alabama Final HB 62 Clarifies Treatment of REITs for Tax Purposes", elect. cit. 2008 STT 118-2 (June 9, 2008) (recently enacted legislation in Alabama curtails dividends paid deduction for captive REITs, retroactive to January 1, 2007). Some states undo the tax benefits of the captive REIT structure by denying a rent expense to the corporate shareholder. See, e.g., O.C.G.A. § 48-7-28.4(a)(2) and (b) (Georgia requires a corporation to "add back all expenses and costs directly or indirectly paid, accrued or incurred to a captive [REIT]"); Ga. Reg. § 560-7-3-.04(1)-(3) (same). Finally, some states disallow the DRD for captive REIT dividends in the hands of the corporate shareholders. See Point II.H.2. below.

2. Even if a state respects the DPD for state tax purposes, a non-domiciliary corporate shareholder may be taxed on dividends received from a REIT that is derived from rental income from real properties within the state. See, e.g., Bridges v. Autozone Properties, Inc., 900 So. 2d 784, 808-09, 2005 La. LEXIS 688 (La. S. Ct. Mar. 24, 2005).

3. Distributions of stock that are treated as taxable dividends under Section 305 may qualify for the DPD, such as where shareholders are given a choice between a cash dividend or stock dividend of equal value, with the cash portion being equal to a minimum specified percentage (e.g., 20% or 10%) of the total dividend distribution.

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See, e.g., PLR 200953015 (Sept. 29, 2009); PLR 200946023 (Aug. 11, 2009); PLR 200942030 (July 1, 2009); PLR 200917020 (Jan. 16, 2009); PLR 200852020 (Sept. 23, 2008), *supplemented by* PLR 200915032 (Jan. 8, 2009); PLR 200850022 (Sept. 10, 2008); PLR 200832009 (May 8, 2008); PLR 200817031 (Jan. 28, 2008); PLR 200122001 (June 1, 2001); see also Letter from Steven Wechsler of NAREIT to the Treasury Department, dated October 31, 2008 at n.5, elect. cit. 2008 TNT 221-33 (collecting PLRs that reflect the 20% cash floor, and requesting that the Treasury Department issue administrative guidance that would bless a lower 5% cash floor in this tighter credit environment for all REITs). In response, the IRS issued Rev. Proc. 2008-68 and Rev. Proc. 2010-12, blessing a 10% cash floor for distributions declared by a public REIT on or before December 31, 2012 and with respect to a taxable year ending on or before December 31, 2011.

4. However, dividends only qualify for the DPD if they are made pro rata with no preference to any share of stock as compared to any other share of stock of the same class. Sections 561(a)-(b), 562(c) and 857(b)(2)(B). In each of the private rulings cited in the preceding paragraph, the IRS declined to rule if the mixed cash-and-stock special dividend was a preferential dividend under Section 562(c). As noted below, separate classes of stock (such as common stock and preferred stock) with varying preferences are allowed under Section 562(c). See Point II.H.3, infra; but see PLR 200729021 (Apr. 17, 2007) (distribution to Class B shareholders to “makeup” for omitted distribution in prior year that was made to Class A and Class C shareholders was a preferential distribution to Class B shareholders); cf. PLR 200730009 (Apr. 25, 2007) (similar corrective distribution in S corporation context does not give rise to a second class of stock). If the REIT distributes a capital gain dividend to one class of shareholders and issues a notice to another class of shareholders that they are in receipt of “undistributed capital gains” under Section 857(b)(3)(B)-(D), this should not be a preferential dividend. Cf. PLR 200716007 (Jan. 12, 2007) (RIC has not made a preferential distribution when it distributes capital gains to one class of shareholders while retaining the deemed capital gains distribution to its common shareholders).

5. Distributions of cash to REIT shareholders in lieu of fractional shares of stock distributed by the REIT also do not run afoul of the preferential dividend rules. See PLR 200213017 (Dec. 21, 2001). If any preferential dividend payments are made with respect to a particular distribution, the DPD for the entire distribution may not be permitted and the entity may lose its REIT status for failing to meet the 90% or 95% distribution requirement, whichever is applicable. The IRS may seek to challenge the reasonableness of any compensation paid by the REIT to its manager or employee with

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the possible consequence that a portion of the compensation paid would be recharacterized as a preferential dividend in comparison to other holders of stock of the same class of shares. This is particularly an issue where the manager or employee is, or is related to, a stockholder of the REIT.

6. Under Section 562(b), a distribution by a REIT to a shareholder in redemption

of shares held by such shareholder in a transaction which is a "redemption of stock to which section 302 applies" will generate a DPD to the REIT to the extent the distributed amount is "properly chargeable to earnings and profits." In general, this means that to the extent the distribution exceeds the shareholder's "capital account" in the REIT (i.e., generally its original investment in the REIT), the REIT enjoys a DPD. Treas. Reg. § 1.562-1(b)(1)(ii). Thus, like Section 736 in the partnership context prior to amendment by OBRA 1993, the continuing shareholders of a REIT can, effectively, deduct immediately a portion of the price paid to acquire the redeemed shareholder's stake in the REIT. At the same time, the redeemed shareholder may enjoy capital gains treatment under Section 302(a).

Example: A and B each contribute $100 to a qualifying private REIT (that has 100 nominal shareholders). The REIT uses the proceeds contributed by A and B to purchase real estate with a value of $200. After five years when the property has appreciated to $400, A causes the REIT to redeem B for $200 with current/accumulated cash flow and refinancing proceeds. The REIT may enjoy a DPD for the $100 paid to B in excess of its capital account to the extent the REIT has available E&P. Such DPD reduces the income otherwise allocable to A, allowing A to effectively deduct part of the purchase price for acquiring B's stake. At the same time, B enjoys favorable capital gains treatment with respect to the $100 under Section 302.

However, a redemption will not qualify for the DPD where the REIT qualifies as a "mere holding or investment company" within the meaning of Section 533(b). Furthermore, query whether a distribution in redemption of one REIT shareholder can be a "preferential distribution."

7. Liquidating distributions of a REIT also generate a DPD to the extent of the REIT's E&P if such distributions are made within 24 months after the adoption of a plan of liquidation. Thus, ordinary income recognized by the REIT during such period is converted to capital gain in the hands of the shareholders of the REIT, to the extent the liquidating distribution exceeds the shareholder's basis in its REIT shares. See Section 331.

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8. Under a literal reading of the statute and the regulations, liquidating distributions were entitled to a DPD even where more than 80% of the shares of the REIT were owned by a corporation and the distributions were tax-free to such shareholders under Section 332. Thus, at least two years of income could effectively escape tax. This technique was eliminated in 1998 through the enactment of Section 332(c), which subjects corporate shareholders of a REIT that receive liquidating distributions to tax in the amount of the DPD taken by the REIT with respect to such liquidating distribution. More recently, the IRS has announced its position that, under current rules, a liquidating distribution received from a REIT by a foreign shareholder (such as a foreign government) is subject to U.S. tax under the FIRPTA rules if such distribution is attributable to gain from the sale or exchange by the REIT of a "United States real property interest", and that the Treasury Department intends to issue Regulations to

clarify this rule. See IRS Notice 2007-55 (June 13, 2007); see also AM 2008-003 (Feb. 15, 2008) (applying principles set forth in IRS Notice 2007-55).

9. A REIT may also obtain a DPD without actually distributing cash through "fictional" consent dividends deemed distributed to shareholders that consent to the arrangement. In contrast to widely-held public REITs, private REITs can issue consent dividends with relative ease. See, e.g., PLR 200043035 (July 27, 2000) (REIT with two principal shareholders recomputed the amount of consent dividends required to be allocated to those shareholders and received an extension from the Commissioner in which to reflect the correct amount of consent dividends on the appropriate IRS forms).

    (i) Consent dividends may only be issued on stock entitled to distributions after the payment of preferred dividends. Consent dividends are also subject to the preferential dividend rules discussed above, applied as if the consent dividends were actually distributed. Thus, consent dividends may only be issued in the same manner that such dividends would be issued if actual cash distributions were made.

    (ii) A consent dividend is treated for all purposes of the Code as a distribution in money by the corporation to the shareholder and as a contribution to the capital of the corporation by the receiving shareholder (not in exchange for new shares of stock), both of such events being deemed to occur on the same day.

    (iii) One of the more intriguing questions with respect to consent dividends on which there appears to be little or no direct authority other than a plain reading of Section 565 is whether such dividends must be given economic effect similar to the

rules in the partnership context. For example, assume that a REIT has net cash flow of $100 and net income of $200 in Year 1, and that the REIT distributes $100 of cash as a preferred dividend to its preferred shareholders and issues a consent dividend of $100 to its common shareholders. On January 1 of Year 2, the REIT receives the $100 with respect to which it accrued $100 of net income in Year 1, but the REIT does not recognize any net taxable income in Year 2. The cash is then distributed to the preferred shareholders as a dividend in Year 2 even though the common shareholders previously bore the tax liability for that income. This would appear to be the result even if the common shareholder was tax-exempt and the preferred shareholder was a taxpayer. Depending on the circumstances, this same type of allocation might be disallowed in the partnership context as lacking "substantial economic effect." See also CCA 200842039 (June 19, 2008) (IRS intends to challenge consent dividends declared by a REIT as a sham where the amount of consent dividends exceeds the true economic benefit to which the recipient shareholders are entitled).

H. Allocation of REIT Taxable Income

1. A REIT can have more than one class of stock (e.g., common shares and preferred shares). See, e.g., Rev. Rul. 69–610, 1969-2 C.B. 149. Furthermore, the REIT may designate one class as “income shares” and another class as “capital shares” which entitle the holder to receive distributions of REIT gross income and capital gains derived from the sale of the REIT’s assets, respectively. See, e.g., Rev. Rul. 71–405, 1971-2 C.B. 263. In order to avail itself of the DPD, however, the REIT cannot make preferential distributions among its stockholders. See Treas. Reg. § 1.562-2(a).
2. Distributions to corporate shareholders of the REIT will not qualify as dividends for purposes of the dividends received deduction (“DRD”) under Section 243(d). The law is not uniform, however, for state taxation purposes. See, e.g., BankBoston Corp v. Commissioner, 68 Mass. App. Ct. 156; 861 N.E.2d 450 (2007) (Massachusetts law historically was to deny the DRD for dividends received from a REIT, without need for subsequent “clarifying” legislation); UNB Investment Co. v. Director, Docket No. 004760-2003, 21 N.J. Tax 354, 2004 N.J. Tax LEXIS 13 (N.J. Tax Ct. May 12, 2004) (upholding tax authority’s ability to issue a regulation to interpret state tax law as conforming to federal law denying DRD for dividends received from a REIT, but dismissing particular tax assessment due to failure to promulgate a regulation); Massachusetts Department of Revenue, Technical Information Release 03-9 (May 30, 2003) (explaining that recent legislative amendments in Massachusetts clarify that distributions from a REIT to its corporate

shareholders do not qualify for the DRD for state tax purposes); Massachusetts Department of Revenue, Technical Information Release 04–10 (Apr. 8, 2004) (same; noting too that recent legislative amendment in Massachusetts clarifies that any dividend received “directly and indirectly” by a corporation from a REIT is not eligible for the DRD); see also Fleet Funding, Inc. v. Commissioner, Docket No. C271862-63, 2008 Mass. Tax LEXIS 12 (Mass. App. Tax Bd. Feb. 21, 2008) (denying DPD for dividends paid by Massachusetts REITs to Rhode Island passive investment companies with respect to 1999 tax year as lacking business purpose and economic substance even before enactment of clarifying Massachusetts legislation); “*Friendly Landlord: Wal-Mart Cuts Taxes by Paying Rent to Itself*”, Wall Street Journal, Feb. 1, 2007, at A1 (stating that Wal-Mart uses ownership structure that combines DPD and DRD in 25 states to reduce its state tax burden). Several states require combined reporting of a captive REIT with its controlling corporate shareholder so as to prevent a corporate structure that seeks to take advantage of the DPD and DRD. See, e.g., Wal-Mart Stores East Inc. v. Hinton, Nos. 06-CVS-3928 and 06-CVS-3929 (N.C. Superior Ct., Wake Co. Dec. 31, 2007) (upholding Tax Commissioner’s decision to require affiliated REITs to file a combined return with other Wal-Mart affiliates), aff’d, 676 S.E.2d 634, 2009 N.C. App. LEXIS 809 (N.C. Ct. Appls. 2009); NYS Dept. of Taxation and Finance, TSB-M-09(1)C (Jan. 9, 2009) (explaining combined reporting requirement for captive REITs and captive RICs); see also Mass. Reg. § 63.32B.2(4)(b) (requiring that a REIT be included in a combined return with any corporation with which it has common ownership).

3. By creating different classes of stock with varying entitlements to REIT distributions, the investors in a private REIT can effectively allocate the income of the REIT. For example, if a REIT has two classes of stock — preferred stock with a preferred dividend and common stock — the earnings and profits and, therefore, the income of the REIT will be allocated, first, to the preferred stockholders to the extent of their preferred dividends and, thereafter, to the common stockholders. See Rev. Rul. 69–440, 1969-2 C.B. 46.

4. However, any attempt to allocate the REIT's income among its shareholders through the issuance of stock with a declining dividend rate must be scrutinized under Treasury regulations aimed at "fast-pay stock", as further described below. See, e.g., FSA 200034010 (May 22, 2000) (classifying financing arrangement involving private REIT shares with declining dividend rate as a "fast pay arrangement" under the Treasury regulations). Fast-pay stock allows a REIT to use its income that is economically allocable to one shareholder (or a group of shareholders) ("benefited

shareholder(s)") to, in effect, return the capital invested by another shareholder (or group of shareholders).

Example: A contributes $100 to a private REIT in exchange for all shares of a single class of common stock (the "Common Stock") in Year 1. The remaining REIT shareholders (typically tax-exempt investors) contribute $100 to the REIT in exchange for shares of preferred stock (the "Preferred Stock") at the same time. The REIT then lends all of the proceeds to A in exchange for a debt instrument with a ten-year term that provides for a fixed rate of interest (e.g., 7% per annum) to be paid by A to the REIT. The Preferred Stock provides for front-loading of dividend payments (e.g., 14% per annum) and substantially lower dividend payments (e.g., 1% per annum) after Year 10. Although the Preferred Stock's liquidation preference is never reduced, through techniques such as squeeze-out mergers and options, A (or its affiliate) has the ability to acquire shares of Preferred Stock after Year 10 for a fair market value at such time that reflects the lower dividend rate on the Preferred Stock. Thus, a portion of the REIT's taxable income that is properly allocable to A (as the common shareholder) has been used, in effect, to provide a return *of* the preferred shareholders' investment.

5. On February 27, 1997, the IRS issued Notice 97-21 (the "Fast-Pay Notice") announcing it would issue regulations recharacterizing certain financing transactions involving "fast-pay stock" arrangements. The Fast Pay Notice also indicated that any such future Treasury regulations would be effective for payments made in the first taxable year ending after February 26, 1997).

   (i) On January 10, 2000, the IRS issued final Treasury regulations generally effective with respect to amounts accrued or paid with respect to "fast-pay stock" in the first taxable year ending after February 26, 1997, regardless of when the fast-pay stock was issued. Since the provisions set forth in the Fast Pay Notice differ from the final Treasury regulations, the IRS has provided certain transitional relief rules whereby taxpayers may rely on statements made in the Fast Pay Notice for periods after February 26, 1997 and before April 1, 2000. See Treas. Reg. § 1.7701(*l*)-3(g)(2).

(ii) In addition to recharacterizing certain fast-pay stock arrangements, the Treasury Department amended the existing withholding tax regulations to provide specific withholding rules for payments made (or deemed made) in connection with fast-pay stock arrangements on or after January 6, 1999 (the date that related proposed Treasury regulations were first issued). The Treasury regulations also contain reporting requirements whereby the issuer of fast-pay stock (or in certain cases, the shareholders

of the issuer) must attach a statement to its tax return describing in detail the fast-pay arrangement. See Treas. Reg. § 1.7701(*l*)-3(f). The reporting requirement applies to taxable years (of the corporation or shareholder that is required to file the statement) ending after January 10, 2000. Treas. Reg. § 1.7701(*l*)-3(g)(4).[10]

(iii) Generally, under the Treasury regulations stock is fast-pay stock if it is structured so that dividends (as defined in Section 316) paid by the corporation are economically (in whole or in part) a return *of* the holder's investment, as opposed to only a return *on* the holder's investment. Treas. Reg. § 1.7701(*l*)-3(b)(2). Stock is presumed to be fast-pay stock if it is (i) structured to carry a dividend rate that is expected to decline (as opposed to a dividend rate that is expected to fluctuate or remain constant) or (ii) issued for an amount that exceeds (by more than a specified de minimis amount) the amount at which the holder can be compelled to dispose of the stock, after all of the facts and circumstances (including any related agreements) are taken into account. Id. See also PLR 200437033 (May 20, 2004) (applying fast-pay stock regulations in the controlled foreign corporation context).

(iv) If stock is classified as fast-pay stock, and (i) the fast-pay stock is issued by a REIT or a RIC or (ii) the Commissioner determines that a principal purpose for the fast-pay arrangement is the avoidance of any tax imposed by the Code, the fast-pay arrangement is recharacterized as an arrangement directly between the fast-pay shareholders and the other shareholders (the "benefited shareholders"), subject to an "anti-affirmative use" of the regulatory recast to create taxpayer favorable results. See Treas. Reg. § 1.7701(*l*)-3(c)-(d).

(v) More specifically, the benefited shareholders are deemed to (a) issue "financing instruments" directly to the fast-pay shareholders in exchange for cash equal

to the fair market value of the fast-pay stock at the time of the fast-pay stock's issuance and (b) contribute the cash to the issuing corporation.

Payments made by the issuing corporation on the fast-pay stock then are treated as made by the issuing corporation to the benefited shareholders with respect to the stock of the issuing corporation they actually own, and the benefited shareholders are deemed to make payments to the fast-pay shareholders (with the issuing corporation acting as paying agent for the benefited shareholders) at the same time and in the same amount as distributions are made on the fast-pay stock. <u>See</u> Treas. Reg. § 1.7701(*l*)-3(c)(2).

(vi) Presumably, any holder of fast pay stock in a REIT that is automatically recast (and disregarded as stock issued by the REIT under the Treasury regulations) will not be considered a shareholder for purposes of the 100 shareholder requirement and the closely-held determinations discussed above. <u>See</u> Points II.D. and II.E., <u>supra</u>.

(vii) Further, if a REIT ("A") is the benefited shareholder of another REIT ("B") (e.g., if REIT A acquires all of the common shares of REIT B), and other investors hold the fast pay stock of B, such that A is deemed to issue an equity security directly to the private investors under the recast of the Treasury regulations, presumably the regulations would require a reiteration of the recast such that A's shareholders would be deemed to have issued financing instruments directly to the fast pay stockholders of B.

(viii) The definition of fast-pay stock is broad and somewhat uncertain in scope, and the resulting recharacterization when the rules apply is neither intuitive nor clear in application. For example, if a REIT issues preferred shares with an increasing dividend rate (i.e., slow-pay stock), would the common shares be conversely treated as "fast-pay stock" even though there is no stated dividend rate on those shares? It would appear that, particularly where the future income stream of the REIT is fairly predictable, the common shares would be considered "structured so that dividends . . . paid by the corporation with respect to the stock are economically (in whole or in part) a return of the holder's investment . . . ." <u>See</u> Treas. Reg. § 1.7701(*l*)-3(b)(2).

I. <u>Contributions of Property to a Private REIT</u>

2. The Treasury regulations provide that property is transferred to an investment company if (i) the transfer results directly or indirectly in diversification of the transferor's interest, and (ii) the transferee is a RIC or a REIT. Treas. Reg. § 1.351-1(c)(1).

(i) A transfer ordinarily will result in diversification of the transferor's interest if two or more persons transfer non-identical assets to a corporation in an exchange described in Section 351. Treas. Reg. § 1.351-1(c)(5).

(ii) The transfer of real estate by a transferor and cash by investors will generally result in diversification. Although the regulations provide that diversification does not result from contributions of a diversified portfolio of stocks and securities, <u>see</u> Treas. Reg. § 1.351-1(c)(6), it is unclear whether this exception applies when a diversified portfolio of real property is contributed to a REIT. The preamble to Treas. Reg. § 1.351-1(c)(6) indicates that the IRS received comments requesting that the final regulations extend the diversified portfolio exception to include diversified portfolios of real property, but the IRS has declined to extend this exception to cover such contributions. Nevertheless, in PLR 9744003 (July 15, 1997), the IRS ruled that the transfer of stock and partnership interests to a REIT was tax-free under section 351(a), without discussing the section 351(e) investment company issue. Commentators have also reported that the Service appears willing to issue private rulings applying a "diversified portfolio" exception to transfers of real property to a REIT. Indeed, in PLR 200450018 (Aug. 17, 2004), the IRS specifically ruled that the transfer of cash and interests in a partnership which owns real property to a newly-formed REIT was tax-free under section 351(a) and will not be treated as a transfer to an investment company under section 351(e).

3. If the contribution of appreciated property to a REIT is treated as a transfer to an investment company, it will be a taxable transaction. Thus, the contributor will recognize gain or loss to the extent of the difference between the fair market value of the REIT shares received and the adjusted basis of the property transferred.

4. Even if the initial contribution by a C corporation of built-in gain property to the REIT is tax-free under Section 351, or if an existing C corporation

holding appreciated property elects REIT status, taxpayers should be aware that the tax on any built-in gain existing when the property is first held by the REIT, or when the REIT election is first made, will be triggered if the REIT sells, exchanges or otherwise disposes such property within ten years of the contribution date or the conversion date.

(i) The genesis of this rule is the legislative history of Section 337(d) in TAMRA 1988, where Congress extended Treasury's authority to issue regulations under Section 337(d) to prevent the circumvention of the repeal of General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935) through any of the Code amendments contained in Subtitle D of Title VI of the Tax Reform Act of 1986 — not just the 1986 Code amendments to Sections 336, 337 and 338 — and authorized the Treasury to issue regulations subjecting certain transactions involving RICs, REITs or tax-exempt entities to taxation.[11] As stated in the Committee Reports to TAMRA 1988:

> The bill clarifies that the regulatory authority to prevent circumvention of the provisions of the Act extend to all the amendments made by subtitle D of Title VI of the Act. The bill also clarifies in connection with the built-in gain provisions of the Act that the Treasury Department shall prescribe such regulations as may be necessary or appropriate to carry out those provisions, including provisions dealing with the use of such pass-through entities . . . as [RICs] or [REITs]. For example, this includes rules to

require the recognition of gain if appreciated property of a C corporation is transferred to a RIC or a REIT or to a tax-exempt entity in a carryover basis transaction that would otherwise eliminate corporate level tax on the built-in appreciation.

S. Rep. No. 145, 100th Cong., 2d Sess. 66 (1988) (footnote omitted), reprinted in 6 U.S.C.C.A.N. 4515, 4589.

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(ii) Previously, the IRS had issued IRS Notice 88-19, 1988-1 C.B. 486, which stated that Treasury intended to issue regulations under Section 337(d) to provide that a contribution of property to a newly-formed REIT, or the conversion of a C corporation into a REIT, would trigger an immediate tax on any appreciated property, unless the taxpayer involved in such transactions elects to apply the built-in gain principles of Section 1374 (and a similar ten-year recognition period if the REIT sells, exchanges or disposes of the built-in gain assets during that period) before regulations are issued. Subsequently, the IRS issued a series of private rulings indicating that the IRS believed the rules set forth in Notice 88-19 were effective before the issuance of Treasury regulations. See, e.g., PLR 199920036 (Feb. 17, 1999) (C corporation with appreciated assets that elects to be taxed as a RIC may make Section 1374 election to avoid triggering gain by reason of deemed liquidation upon change in tax status); PLR 199911035 (Dec. 18, 1998) (C corporation that elects to become a timber REIT may make Section 1374 election to avoid triggering built-in gain immediately); PLR 9829051 (Apr. 22, 1998) (C corporation that elects to become a RIC may make Section 1374 election to avoid triggering built-in gain immediately); PLR 9813004 (Dec. 17, 1997) (REIT acquiring assets from C corporation via liquidation makes a Section 1374 election to avoid immediate recognition of built-in gain upon the liquidation); PLR 9744004 (July 18, 1997) (C corporation electing to be taxed as a REIT, with concomitant conversion of existing REIT subsidiary into "qualified REIT subsidiary" within meaning of Section 856(i)(2), makes Section 1374 election to avoid triggering gain upon deemed liquidation of the subsidiary); PLR 9409035 (Dec. 7, 1993) (Section 351 ruling where IRS reserves on application of future Treasury regulations described in Notice 88-19); PLR 9220019 (May 15, 1992) (addressing Section 1374 election under Notice 88-19 with respect to "C" reorganization where Acquiring is a RIC and Target is not a RIC); PLR 9024006 (June 15, 1990) (same with respect to "A" reorganization where Acquiring is a RIC and Target is not a RIC); PLR 8915041 (Apr. 14, 1989) (discussing effect of Section 1374 election for C corporation that converts to RIC); PLR 8906048 (Feb. 10, 1989) (waiving certain requirements of Section 1374 election under Notice 88-19 for REIT that would undergo hardship if rules applied literally).

(iii) On March 18, 2003, the Treasury Department issued three sets of final Treasury regulations under Section 337(d) to implement Notice 88-19. The most current of those regulations, Treas. Reg. § 1.337(d)-7 (the "-7

Regulations") , are

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effective for conversion transactions occurring in tax years starting after January 1, 2002. See Treas. Reg. § 1.337(d)-7(f).[12]

(iv) If a carryover basis transaction involving a RIC or a REIT, or the conversion of a C corporation into a RIC or a REIT is within the scope of the –7 Regulations, then Section 1374 treatment automatically applies and the RIC or REIT will only be taxed on the net built-in gain on the converted property if it disposes of the asset within a 10-year period (subject to special rules for 2010 and 2011 under Section 1374(d)(7)(B)). Treas. Reg. § 1.337(d)-7(a)(1) and (b)(1). The recognition period begins (i) in the case of a C corporation that elected RIC or REIT status, on the first day of the taxable year in which the election takes effect, and (ii) in the case of a C corporation that transferred assets to a RIC or a REIT in a carryover basis transaction, on the day that the assets are acquired by the RIC or the REIT. See Treas. Reg. § 1.337(d)-7(b)(2)(iii). The –7 Regulations allow the RIC or a REIT to use losses/credits from prior tax years in which the RIC or REIT was taxed as a C corporation to offset gains recognized by the RIC or REIT in later tax years. See Treas. Reg. § 1.337(d)-7(b)(2)(ii).

(v) Taxpayers who do not wish to have the Section 1374 rules apply can elect deemed sale treatment under Treas. Reg. § 1.337(d)-7(c)(1). If this election is made, the C corporation has to recognize immediately the net built-in gain (but not a net loss) inherent in the assets held at the time of conversion, or transferred to the RIC or REIT, as if the C corporation had sold its assets at fair market value. Id. However, taxpayers must be aware of the anti-stuffing rule under the –7 Regulations. That rule prevents a taxpayer from placing "built-in loss" assets into a corporation and then electing deemed sale treatment under the –7 Regulations to allow the realized losses in those assets to offset realized gains inherent in other assets held by or transferred to the RIC or REIT. See Treas. Reg. § 1.337(d)-7(c)(4).

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1. Unless otherwise indicated, references to Sections are to provisions of the Internal Revenue Code of 1986, as amended (the "Code"), and references to regulations are to the Treasury regulations promulgated thereunder.

2. See U.S. Patent Application 20070299761, elect. cit. 2008 TNT 8–20 (Dec. 27, 2007), purporting to describe an "invention" using a private REIT to mitigate or avoid the adverse consequences of FIRPTA on foreign investors.

3. Foreign holders of shares or beneficial interests in a publicly traded REIT are now excluded from being subject to U.S. tax under FIRPTA for certain REIT distributions in taxable years beginning after October 22, 2004, which was the date of enactment of the American Jobs Creation Act of 2004 ("AJCA 2004"). Section 897(h)(1), as amended by the AJCA 2004, now excludes from its scope distributions received by a foreign holder of any class of REIT shares that are traded on an established securities market in the United States if the foreigner did not own more than five percent (5%) of such class of stock at any time during the tax year. However, Congress simultaneously amended Section 857(b)(3) in the AJCA 2004 to require any foreign holders excluded from FIRPTA under the new language in Section 897(h)(1) to treat the receipt of capital gain distributions from the REIT as a dividend, which dividend is subject to tax withholding at a 30% rate or at a lower withholding rate if provided for in an applicable tax treaty. Section 857(b)(3)(F); see also S. Rep. No. 192, 108th Cong., 1st Sess. 49–50 (Nov. 7, 2003). This amendment brings distributions received by foreigners with respect to publicly

traded REIT shares in line with distributions with respect to other corporate stock.

4. Any excess inclusion income allocated to shareholders of the TMP-REIT is treated as income that is taxable in all events. For example, excess-inclusion income may not be offset by unrelated losses or loss carryovers of TMP-REIT shareholders; tax-exempt shareholders of the TMP-REIT will be required to recognize the "excess inclusion income" as UBTI under Section 860E(b) and (d); and foreign shareholders in the TMP-REIT will lose any withholding tax exemption with respect to dividends received from the TMP-REIT that are allocable to such excess inclusion income under Sections 860E(d) and 860G(b). Additional interim guidance relating to excess inclusion income of a REIT and other pass-through entities is in Notice 2006-97, 2006-46 I.R.B. (Oct. 27, 2006).

5. While there should be no distinction for federal tax purposes whether a REIT is organized as a corporation or a trust, there may be state law consequences to the selection of entity. See, e.g., Oklahoma Attorney General Opinion 08-11, 2008 Okla. AG LEXIS 8 (May 20, 2008) (while REIT that is a corporation must register with the Oklahoma Secretary of State before doing business in the state, a REIT that is formed as a trust is not required to register).

6. There is also authority in the REIT area to this effect. See GCM 36936 (Dec. 3, 1976) ("Accordingly, the advisor [to a REIT] operates in many respects like a [REIT] employee. In other respects an investment advisor to whom trustee duties are delegated stands in place of the trustees when it executes trustee functions on behalf of the [REIT]."); GCM 35797 (May 1, 1974), *supplemented by*, I-29-74 (Mar. 25, 1975) (same quote; and noting in footnote that an advisor to a REIT, to whom trustee duties have been delegated, is comparable to the authorization of an officer to act on behalf of a corporation).

7. A REIT must adopt a calendar year as its taxable year, unless it is grandfathered under Section 859(a).

8. Note that companies advertise in REIT publications, such as The REIT Report, that they are able to locate accredited investors for those setting up private REITs that need to satisfy the 100 shareholder requirement. See, e.g., JOINT COMMITTEE ON TAXATION, REPORT ON INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS (Volume I) at 152 & n.360 (Feb. 2003).

9. Section 857(f)(1) and related Treasury regulations generally require all REITs to ascertain ownership of their outstanding interests for purposes of determining whether the 100 shareholder requirement of Section 856(a)(5) and the non-closely held requirement of Section 856(a)(6) have been satisfied.

10. The Treasury Department has also identified "fast pay stock" involving REITs as a "listed transaction" with the attendant consequences. See IRS Notice 2004-67, 2004-41 I.R.B. 1 (Sept. 24, 2004) (sixth "listed transaction"); Treas. Reg. § 1.6011-4(a) & (b) (listed transactions must be reported to the IRS); Treas. Reg. § 301.6112-1(a) & (b)(2)(A) (requiring persons to prepare and maintain lists concerning "listed transactions" and, if requested, furnish such lists to the IRS); Treas. Reg. § 1.6662-3(a), (b)(2) & (c)(1) (failure to disclose any such reportable transaction affects the defenses available to the taxpayer against the imposition of the accuracy-related penalty); Treas. Reg. § 1.6664-4(d) (same).

11. Even before Section 337(d)(1) was amended by TAMRA 1988 to refer specifically to RICs and REITs, there was a reference to RICs and REITs in the 1986 Blue Book. See JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 at 345 (Comm. Print May 7, 1987) (the "1986 Blue Book"). Besides the reference to RICs and REITs in the 1986 Blue Book, similar legislation was introduced in Congress on June 10, 1987, as part of the Technical Corrections Act of 1987, even before the enactment of TAMRA 1988. See IRS Notice 88-19, 1988-1 C.B. 486 (effective date of June 10, 1987 tied to prior failed legislation).

12. The first of these regulations, Treas. Reg. § 1.337(d)-5 (the "-5 Regulations") , was effective for contributions of property to RICs and REITs in a carryover basis transaction occurring on or after June 10, 1987, and for conversions of C corporations into RICs or REITs in taxable years beginning on or after June 10, 1987. Treas. Reg. § 1.337(d)-5(a)(1) and (d). Likewise, Treas. Reg. § 1.337(d)-6 (the "-6 Regulations") was effective for conversion transactions (defined in Treas. Reg. § 1.337(d)-6(a)(2)(ii)) occurring on or after June 10, 1987 and before January 2, 2002. See Treas. Reg. § 1.337(d)-6(e).