CHECKLIST

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REITs: Common Pitfalls and Fixes Checklist

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This Checklist identifies potential pitfalls that may cause a real estate investment trust (REIT) to lose its REIT status or be subject to penalty taxes and sets out ways to avoid or fix these problems. For more information about REITs, see Practice Note, REITs: Overview.

A REIT is an entity that satisfies certain US federal income tax requirements and elects to be taxed as a REIT. The tax requirements generally are designed to ensure that the REIT:

- Is a passive investor in real estate (and related assets).
- Does not retain its earnings.
- Is beneficially owned by a diversified stockholder base.

For general information on REITs, including a summary of the US federal income tax requirements that must be satisfied to achieve REIT status, see Practice Note, REITs: Overview.

Pitfall One: The REIT Fails the 95% Gross Income Test

The Problem

If less than 95% of the REIT's income for the taxable year is passive (known as the 95% gross income test, IRC § 856(c)(2)), it can lose REIT status and cannot elect to be treated as a REIT for five years (IRC § 856(g)). For example if the REIT loses its REIT status in 2023, it cannot elect again to be treated as a REIT until 2028.

The Fix

File a statement pursuant to Schedule J Line 2f with the REIT's US federal income tax return and demonstrate that the failure was due to reasonable cause (IRC § 856(c)(6) and Treas. Reg. § 1.856-7). However, tax is imposed on the shortfall (IRC § 857(b)(5)). Reasonable cause generally depends upon the exercise of ordinary business care and prudence, and one common way that REITs establish reasonable cause is by obtaining and relying upon written opinions from tax counsel regarding their proposed activities.

Pitfall Two: The REIT Fails the 75% Gross Income Test

The Problem

If less than 75% of the REIT's income for the taxable year is real estate related (known as the 75% gross income test, IRC § 856(c)(3)), it can lose REIT status and cannot elect again to be treated as a REIT for five years (IRC § 856(g)).

The Fix

File a statement pursuant to Schedule J Line 2f with the REIT's US federal income tax return and demonstrate that the failure was due to reasonable cause (IRC § 856(c)(6) and Treas. Reg. § 1.856-7). However, tax is imposed on the shortfall (IRC § 857(b)(5)).

Pitfall Three: The REIT Fails the 75% Asset Test

The Problem

If less than 75% of the REIT's assets held at the end of any calendar quarter are real estate related, cash items, or government securities, each as defined under the REIT rules (known as the 75% asset test, IRC § 856(c)(4)), it can lose REIT status and cannot elect to be treated as a REIT for five years (IRC § 856(g)).

The Fix

This pitfall is only triggered if the failure is caused by an acquisition and is not cured within 30 days of the end of the quarter (IRC § 856(c)(4)).

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Otherwise, file a statement pursuant to Schedule J, Line 2f with the REIT's US federal income tax return, demonstrate that the failure was due to reasonable cause and, within six months of the end of the quarter in which the REIT identified the problem, either dispose of the bad assets or otherwise solve the problem (IRC § 856(c)(7)). However, there is still a penalty tax imposed of at least $50,000.

Pitfall Four: The REIT Provides Services to Tenants That Are Not Considered Customary

The Problem

If the REIT provides services to tenants that are not considered customary for tenants in similar properties in the area, all rent from the property can fail to qualify as good income for purposes of the REIT's 75% and 95% gross income tests (IRC § 856(d)(7)). As a result, the REIT can lose REIT status and cannot elect to be treated as a REIT for five years (IRC § 856(g)).

The Fix

Several exceptions can help REITs avoid this pitfall:

- The services are not of a type that would cause rents to be treated as unrelated business taxable income (UBTI) if earned by a tax exempt entity.
- The services are provided by an independent contractor from which the REIT does not receive any income (such as dividends or rent) or by a taxable REIT subsidiary (TRS) (IRC § 856(d)(7)(C); see also Rev. Rul. 2003-86).
- Receipts from these services are not more than 1% of the amounts received by the REIT from the property. For this purpose, the service income is treated as not less than 150% of the direct cost of the service (IRC § 856(d)(7)(B) and (D); see also Rev. Rul. 98-60).

Pitfall Five: The REIT Fails the 5% or 10% Asset Test

The Problem

If the REIT has more than 5% of its assets in securities of one issuer or owns more than 10% of the vote or value of one issuer's securities (other than a TRS or securities that are themselves qualifying assets) at the close of any quarter (known as the 5% and 10% asset tests (IRC § 856(c)(4)(B)(iv)), it can lose REIT status and cannot elect to be treated as a REIT for five years (IRC § 856(g)).

The Fix

This pitfall is avoided if the value of the bad assets does not exceed the lesser of 1% of the value of the REIT's assets and $10,000,000, and the REIT disposes of the bad assets or otherwise solves the problem within six months of the end of the quarter in which it identified the problem (IRC § 856(c)(7)(B)). A REIT might also be able to obtain relief from the IRS by submitting a "private letter ruling" request. Alternatively, the REIT may be able to obtain so-called "9100 relief" under Treas. Reg. §§ 301.9100-1 through -3 and elect to retroactively make a TRS election for the securities and therefore avoid losing its REIT status. Other solutions include ensuring that the security satisfies the "straight debt" safe harbor, or the "debt issued by a partnership" exception, which requires certain REIT qualifying income. To satisfy this requirement if the underlying property does not produce income, the partnership may rely on "qualifying temporary investment income" or invest in publicly traded REIT stock.

Pitfall Six: The REIT has More Than 20% of the Value of its Assets in TRSs or More than 25% of the Value of its Assets in Nonqualified Publicly Offered REIT Debt Instruments

The Problem

Not more than 20% (reduced from 25% as of January 1, 2018) of the value of a REIT's total assets can be represented by the securities of one or more TRSs, and not more than 25% of the value of a REIT's total assets can be represented by nonqualified publicly offered REIT debt instruments (defined as certain debt instruments issued by a REIT that do not otherwise qualify as REIT assets (IRC § 856(c)(4) and (5)). If the REIT does not satisfy these tests, it can lose REIT status and cannot elect to be treated as a REIT for five years (IRC § 856(g)).

The Fix

Pursuant to Schedule J, Line 2f of the REIT's US federal income tax return, file a statement demonstrating that the failure was due to reasonable cause, and dispose of the bad assets within six months of the end of the quarter in which the REIT identified the problem (IRC § 856(c)(7)). However, there is still a tax imposed of at least $50,000.

Pitfall Seven: The REIT's Rent Depends on the Profits of a Tenant or Subtenant or the REIT's Interest Receipts Depends on the Profits of a Borrower

The Problem

If the amount the REIT receives as rent depends on the net profits of a tenant or subtenant, or if the REIT receives interest income that depends on the net profits of the borrower (in both cases, gross rents are fine), all such rent or interest, as applicable, can fail to qualify as good income for purposes of the REIT's 75% and 95% gross income tests (IRC §§ 856(d)(2) and 856(f)). As a result, the REIT can lose REIT status and cannot elect to be treated as a REIT for five years (IRC § 856(g)).

The Fix

Pursuant to Schedule J, Line 2f of the REIT's US federal income tax return, file a statement demonstrating that the failure was due to reasonable cause and pay a $50,000 penalty (IRC § 856(g)).

Pitfall Eight: The REIT Fails Certain Organizational Requirements

The Problem

A REIT must be:

- Managed by trustees or directors.
- Taxable as a US corporation (aside from the specialized REIT rules).
- A non-bank.
- A non-insurance company.

If the REIT fails any of these tests at any time during the taxable year, it can lose REIT status and cannot elect to be treated as a REIT for five years (IRC §§ 856(a) and 856(g)).

The Fix

Pursuant to Schedule J, Line 2f of the REIT's US federal income tax return, file a statement demonstrating that the failure was due to reasonable cause and pay a $50,000 penalty (IRC § 856(g)). Tax practitioners have suggested various alternative solutions for the failure to be managed by trustees or directors.

Pitfall Nine: The REIT Fails the 100 or More Persons Test

The Problem

A REIT must be owned by 100 or more persons. This requirement generally is not a concern for public REITs due to their diversity of ownership. Private REITs generally address this by using a service provider that assists in the issuance of more than 100 shares of a special class of stock. If the REIT fails this ownership test for more than 30 days (31 days if the year has 366 days) in a taxable year of 12 months, it can lose REIT status and cannot elect to be treated as a REIT for five years (IRC §§ 856(a)-(b)). The test is pro-rated for taxable years shorter than 12 months.

The Fix

This test does not need to be satisfied in the REIT's first taxable year (IRC § 856(h)).

Otherwise, pursuant to Schedule J, Line 2f of the REIT's US federal income tax return, file a statement demonstrating that the failure was due to reasonable cause and pay a $50,000 penalty (IRC § 856(g)).

Pitfall Ten: The REIT Fails the Closely Held Test

The Problem

Not more than 50% in value of the REIT's outstanding stock can be owned actually or constructively by five or fewer individuals or certain specified entities (known as the closely held test). If the REIT fails this closely held test at any time during the last half of any year, it can lose REIT status and cannot elect to be treated as a REIT for five years (IRC §§ 856(h), 542 and 856(g)).

The Fix

This test does not need to be satisfied in the REIT's first taxable year (IRC § 856(h).

In addition, if the REIT inquired about stockholder ownership under IRC Section 857(f) and in exercising due diligence would not have known of the failure, it will not fail this test (IRC § 856(k)).

Otherwise, pursuant to Schedule J, Line 2f of the REIT's US federal income tax return, file a statement demonstrating that the failure was due to reasonable cause and pay a $50,000 penalty (IRC § 856(g)).

Pitfall Eleven: The REIT Fails to Inquire About Ownership of a Stockholder

The Problem

To comply with the closely held test (see Pitfall Ten: The REIT Fails the Closely Held Test), the REIT must demand annual written statements from the record holders of significant percentages of its capital stock asking that they disclose the beneficial owners of the shares (meaning, the persons required to include in gross income the dividends paid by the REIT) (Treas. Reg. § 1.857-8). If the REIT fails to inquire about ownership of a stockholder and the REIT is closely held, it can lose REIT status and cannot elect to be treated as a REIT for five years (IRC § 856(g)).

The Fix

Pay a $25,000 to $100,000 penalty (IRC § 857(f)). This is in addition to any penalty for failing to satisfy the closely held test.

Pitfall Twelve: The REIT has Earnings and Profits from a Non-REIT Year

The Problem

If the REIT has earnings and profits from a non-REIT year (IRC § 857(a)), it can lose REIT status and cannot elect to be treated as a REIT for five years (IRC § 856(g)). Corporations converting to REIT status generally declare a dividend to purge all of their non-REIT earnings and profits.

The Fix

This test does not need to be satisfied if the REIT has been a REIT in all taxable years beginning after February 28, 1986 (IRC § 857(a)(2)).

Otherwise, pursuant to Schedule J, Line 2f of the REIT's US federal income tax return, file a statement demonstrating that the failure was due to reasonable cause and pay a $50,000 penalty (IRC § 856(g)).

Pitfall Thirteen: The REIT Fails the 90% Distribution Requirement

The Problem

A REIT must annually distribute dividends, other than capital gain dividends, to its stockholders in an amount at least equal to the **sum** of 90% of its "REIT taxable income" and 90% of its after-tax net income, if any, from foreclosure property **minus** the excess of the sum of certain items of non-cash income over 5% of its REIT taxable income (known as the 90% distribution requirement) (IRC § 857(a)).

REIT's failing the 90% distribution requirement are subject to a 4% excise tax on undistributed income (IRC § 4981), US federal income tax at corporate rates on all of their income (with no deduction for dividends paid), as well as the earnings and profits provisions of IRC Section 857(d) (treating certain distributions as dividend payments without earnings and profits). Although somewhat unclear, this failure alone likely will not cause a REIT to lose its REIT status for purposes of the rule disallowing REIT status for five years.

The Fix

Pursuant to Schedule J, Line 2f of the REIT's US federal income tax return, file a statement demonstrating that the failure was due to reasonable cause, and pay a $50,000 penalty (IRC § 856(g)).

In some cases, a REIT may be able to correct an inadvertent failure to meet the 90% distribution requirement for a year by paying deficiency dividends to its stockholders in a later year (IRC § 860).

A REIT, particularly a private REIT, that lacks cash may be able to meet the 90% distribution requirement by means of consent dividends, where, pursuant to stockholder agreement, dividends would effectively be deemed paid and contributed back to the REIT pro rata (IRC § 565(c)).

Revenue Procedure 2017-45 provides that if a publicly offered REIT makes a distribution of stock in a transaction in which up to 80% of the distribution could be paid in shares of the REIT's common stock, the IRS will treat the distribution of stock as a distribution of property to which IRC Section 301 applies by reason of IRC Section 305(b) and thus as a distribution for purposes of the 90% distribution requirement. The value of stock received by the stockholder is treated as equaling the amount of cash for which the stock is substituted. Note that Revenue Procedure 2017-45 does not have an expiration date. In recognition of the need for enhanced liquidity during the economic disruption caused by COVID-19, Revenue Procedure 2020-19 temporarily lowered the minimum cash component from 20% to 10% of the total distribution for distributions declared by a publicly offered REIT on or after April 1, 2020 and on or before December 31, 2020, and Revenue Procedure 2021-53 similarly lowered the minimum cash threshold to 10% for distributions declared by publicly offered REITs on or after November 1, 2021, and on or before June 30, 2022.

Pitfall Fourteen: The REIT Fails to Distribute 85% of its Ordinary Income and 95% of its Capital Gain Income

The Problem

If the REIT fails to distribute 85% of its ordinary income and 95% of its capital gain income during any year, there is a 4% excise tax on the shortfall (IRC § 4981). In each following year, if any of the ordinary income and capital gain from prior years remains undistributed, the 4% excise tax applies to that shortfall and any new shortfall.

For excise tax purposes, distributions during a year include:

- Dividends declared during October, November or December, and paid during January of the following year ("spillover dividends," IRC § 857(b)(9)).
- Amounts that were subject to tax because they were not distributed.

However, distributions for excise tax purposes do not include dividends that are treated as paid in a given year, but are declared and paid after the close of that year ("deficiency dividends," IRC § 4981).

The Fix

Failure to make the proper distributions resulting from an audit (finding that the REIT had additional income) generally does not give rise to the 4% excise tax if an agreement with the IRS is properly structured.

Pitfall Fifteen: The REIT is Deemed to Have Made a Preferential Dividend

The Problem

Under IRC Section 562(c), a dividend is not considered a dividend for the purposes of the dividends paid deduction unless it is paid pro rata, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class of stock as compared with another class, except to the extent that the class is entitled to such preference. This provision no longer applies to publicly offered REITs, but may cause serious problems for a non-public REIT because a dividend will not qualify as a distribution for purposes of meeting the 90% distribution requirement if it is not considered a dividend for purposes of the dividends paid deduction (IRC § 857(a)). However, a so-called "foot fault" (meaning, minor errors such as an inadvertent payment to stockholders at slightly different times) could potentially cause an entire distribution to fail to qualify as a distribution for the purposes of the 90% distribution requirement. This, in turn, could cause a loss of REIT status. REITs should consult with a tax advisor regarding which dividends are impacted.

The Fix

If a preferential dividend causes a REIT to fail the 90% distribution test, the procedures for fixing this problem are identical to those for pitfall thirteen (see Pitfall Thirteen: The REIT Fails the 90% Distribution Requirement).

Additionally, the PATH Act of 2015 gave the IRS authority, in cases of inadvertent failure, to provide an appropriate remedy to cure such failure in lieu of not treating the distribution as a dividend for purposes of computing the dividends paid deduction (IRC § 562(e)(2)).

Pitfall Sixteen: The REIT has Income from the Sale of Inventory, or Sales of Property that may be Treated as Held by the REIT Primarily for Sale to Customers in the Ordinary Course of Trade or Business

The Problem

Income from the sale of inventory or property held for sale in the ordinary course is treated as prohibited transaction income unless the inventory or property sold is foreclosure property. Prohibited transaction income is subject to a 100% penalty tax (IRC § 857(b)(6)).

The Fix

There is a safe harbor for sales of inventory or property that is held for at least two years and that satisfy certain other requirements (IRC § 857(b)(6)(D)), and tax practitioners have become comfortable that certain sales are not properly treated as dealer sales based on a careful analysis of the facts and circumstances. The penalty tax is best prevented by a careful evaluation of any property disposition for potential prohibited transaction status. Alternatively, a property may be contributed to a TRS in advance of a sale so that the gains are subject to corporate taxes but not the 100% penalty tax.

Pitfall Seventeen: The REIT Charges More Than an Arm's-length Amount to its TRS for Rent or Interest, the REIT Charges its Tenants More Because of Services Provided to the Tenants by its TRS or the TRS Takes Deductions Properly Allocable to the REIT

The Problem

If the REIT charges more than an arm's-length amount to its TRS for rent or interest, the REIT charges its tenants more because of services provided to the tenants by its TRS, or the TRS takes deductions properly allocable to the REIT, that amount is subject to a 100% penalty tax (IRC § 857(b)(7)).

The Fix

For purposes of redetermined rents, ignore services provided by the TRS:

- That are separately stated if 25% of tenants (by leased space) are not getting the service and are paying comparable rent.
- Or, if the income of the TRS from the service (meaning, the amount paid to it by the REIT) is at least 150% of its direct costs (IRC § 857(b)(7)).

Pitfall Eighteen: The Intended REIT Fails a REIT Test or Otherwise Wants to Rescind a Corporate Election

The Problem

Entities intending to be REITs often make elections on Form 8832 to be treated as an association taxable as a corporation, followed by a REIT election made by filing a Form 1120-REIT tax return after the close of the REIT's initial taxable year. Once filed, the corporate election cannot be retroactively rescinded, and, in some cases, the corporate election may not be changed for 60 months after the effective date of the election (Treas. Reg. § 301.7701-3(c)(1)(iv)). This could create difficulty for entities that have not yet filed their REIT tax return, but had inadvertently made the Form 8832 election or that realized they would not qualify as a REIT for the initial taxable year.

The Fix

The entity may rescind its entity classification election without triggering the 60 month limitation if the rescission occurs before the due date of the tax return for the tax year the election is to become effective (IRM Part 3.13.2.27.10). As part of the rescission, the entity must notify the IRS that Form 8832 was filed in error, and that it wishes to withdraw the entity classification election and return to its default tax classification. The IRS will then destroy the previously filed Form 8832 and the entity will not be considered to have made the election. In several non-precedential private letter rulings, the IRS noted that it allowed a rescission where the entity represented that it had no current intention to make another corporate election, so that may be a helpful fact.