REITs: Common Pitfalls and Fixes Checklist

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This Checklist provides a list of common pitfalls that can arise with REITs and how they can be fixed. For more information about REITs, see Practice Note, REITs: Overview (http://us.practicallaw.com/8-504-7098).

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), it can lose REIT status and cannot elect to be treated as a REIT for five years (see IRC § 856(g)).

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

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), it can lose REIT status and cannot elect to be treated as a REIT for five years (see IRC § 856(g)).

THE FIX
This pitfall is only triggered if the failure is caused by acquisition and is not cured within 30 days of end of quarter (see IRC § 856(c)(4)). Otherwise, file a schedule J Line 2f with the REIT’s US federal income tax return, demonstrate that the failure is due to reasonable cause and dispose of the bad assets within six months of the end of the quarter (see IRC § 856(c)(7)). However, there is still a tax imposed of at least $50,000.
**PITFALL FOUR: THE REIT PROVIDES SERVICES THAT ARE NOT CONSIDERED CUSTOMARY TO TENANTS.**

**THE PROBLEM**
If the REIT provides services that are not considered customary to tenants, all rent from the property can fail to qualify as good income for purposes of the REIT's 75% and 95% gross income tests (see 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 (see IRC § 856(g)).

**THE FIX**
There are several helpful exceptions that avoid this pitfall:
- The service income is not treated as unrelated trade or business income (UBTI) by a tax exempt person.
- 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).
- The service income is not more than 1% of the amounts received by the REIT from the property. For this purpose, the service income is not treated as less than 150% of the direct cost of the service (see Rev. Rul. 98-60 and Rev. Rul. 2003-86).

**PITFALL FIVE: THE REIT’S RENT OR INTEREST DEPENDS ON THE PROFITS OF A TENANT OR SUBTENANT.**

**THE PROBLEM**
If the REIT's rent or interest depends on the profits of a tenant or subtenant, all rent from the property can fail to qualify as good rent for purposes of the REIT's 75% and 95% gross income tests (see 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 (see IRC § 856(g)).

**THE FIX**
File schedule J line 2f with the REIT's US federal income tax return, demonstrate that the failure is due to reasonable cause and pay a $50,000 penalty (see IRC § 856(g)).

**PITFALL SIX: 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 at the close of any quarter (known as the 5% and 10% asset tests), it can lose REIT status and cannot elect to be treated as a REIT for five years (see IRC § 856(g)).

**THE FIX**
This pitfall is avoided if the value of bad assets is no more than the lesser of 1% of the value of all its assets or $10,000,000 and the REIT disposes of the bad assets within six months of the end of the quarter (see IRC § 856(c)(7)).

**PITFALL SEVEN: THE REIT FAILS CERTAIN ORGANIZATIONAL REQUIREMENTS.**

**THE PROBLEM**
A REIT must be:
- Managed by trustees or directors.
- A US corporation.
- 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 (see IRC §§ 856(a) and 856(g)).

**THE FIX**
File a schedule J line 2f with the REIT’s US federal income tax return, demonstrate that the failure is due to reasonable cause and pay a $50,000 penalty (see IRC § 856(g)).

**PITFALL EIGHT: THE REIT FAILS THE 100 OR MORE PERSONS TEST.**

**THE PROBLEM**
A REIT must be owned by 100 or more persons (known as the 100 or more persons test). 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 (see IRC § 856(a)-(b)). For less than a 12-month taxable year, the test is pro-rated.

**THE FIX**
This test does not need to be satisfied in the REIT’s first taxable year. Otherwise, file a schedule J line 2f with the REIT’s US federal income tax return, demonstrate that the failure is due to reasonable cause and pay a $50,000 penalty (see IRC § 856(g)).

**PITFALL NINE: 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
PiTFall Twelve: The reIT has more than 25% of the value of its assets in TRSs.

**THE PROBLEM**
Not more than 25% of the value of a REIT’s total assets can be represented by the securities of one or more TRS. If the REIT has more than 25% of the value of its assets in TRSs, it can lose REIT status and cannot elect to be treated as a REIT for five years (see IRC §§ 856(h), 542 and 856(g)).

**THE FIX**
This test does not need to be satisfied in the REIT’s first taxable year.
Also if the REIT inquired about ownership under IRC Section 857(f) and in exercising due diligence would not have known of the failure, it will not fail this test (see IRC § 856(k)).
Otherwise, file a schedule J line 2f with the REIT’s US federal income tax return, demonstrate that the failure is due to reasonable cause and pay a $50,000 penalty (see 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."
- 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).

If the REIT fails this distribution requirement, it can lose REIT status and cannot elect to be treated as a REIT for five years (see IRC §§ 857(a)(1) and 856(g)).

**THE FIX**
File a schedule J line 2f with the REIT’s US federal income tax return, demonstrate that the failure is due to reasonable cause and dispose of the bad assets within six months of end of quarter (see IRC § 856(c)(7)). However, there is still a tax imposed of at least $50,000.

PiTFall Ten: The reIT fails to inquire about ownership of a stockholder.

**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). To comply with this test, the REIT must demand annual written statements from the record holders of significant percentages of its capital stock asking that they disclose the shares’ beneficial owners (meaning, the persons required to include in gross income the dividends paid by the REIT). If the REIT fails to inquire about ownership of a stockholder, it can lose REIT status and cannot elect to be treated as a REIT for five years (see IRC § 856(g)).

**THE FIX**
The REIT pays $25,000 to $100,000 penalty (see IRC § 857(f)).

PiTFall Eleven: 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, it can lose REIT status and cannot elect to be treated as a REIT for five years (see IRC § 856(g)).

**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 (see IRC § 857(a)(2)).
Otherwise, file a schedule J line 2f with the REIT’s US federal income tax return, demonstrate that the failure is due to reasonable cause and pay a $50,000 penalty (see IRC § 856(g)).
for the purposes of the 90% distribution requirement as long as they are declared on or before December 31, 2012. Under the terms of this guidance, up to 90% of a REIT’s distributions could be paid in shares of a REIT’s common stock. However, the Revenue Procedure may not prevent the assessment of an excise tax under IRC Section 4981 if a distribution with respect to calendar year 2011 is made after January 2012.

**PITFALL FOURTEEN: THE REIT HAS INCOME FROM THE SALE OF INVENTORY.**

**THE PROBLEM**
Income from sale of inventory is treated as prohibited transaction income unless the inventory is foreclosure property. If the REIT has this type of prohibited transaction income, it is subject to a 100% penalty tax (see IRC § 857(b)(6)).

**THE FIX**
There is a safe harbor for limited sales of inventory held for at least two years (see IRC § 857(b)(6)(D)).

**PITFALL FIFTEEN: THE REIT CHARGES MORE THAN AN ARM’S-LENGTH AMOUNT TO ITS TRS OR CHARGES ITS TENANTS MORE BECAUSE OF SERVICES GIVEN THE TENANTS BY ITS TRS.**

**THE PROBLEM**
If the REIT charges more than an arm’s-length amount to its TRS or charges its tenants more because of services given the tenants by its TRS, that income is subject to a 100% penalty tax (see IRC § 857(b)(7)).

**THE FIX**
There is an exception for interest that is commercially reasonable.

For purposes of this pitfall, ignore services provided by a TRS:
- That are separately stated if 25% of tenants (by leased space) are not getting the service and are paying comparable rent.
- If the income of the TRS from the service is at least 150% of its direct costs.

**PITFALL SIXTEEN: 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 shortfalls (see IRC § 4981). In each following year, if less than 100% 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 (see 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.

**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. See also Revenue Procedure 2010-12 (ability to partially satisfy distribution requirements with stock).

**PITFALL SEVENTEEN: 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 may cause serious problems for a 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 the purposes of the dividends paid deduction (see IRC § 857(a)). Through a so-called “foot fault”, minor errors such as the accidental payment of 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 which in turn could cause a loss of REIT status.

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

President Obama’s 2012 budget would eliminate the possibility of preferential dividend treatment for publicly traded REITs. The budget would also give authority to the Treasury Department to pass regulations eliminating the potential harm from inadvertent
violations by non-publicly traded REITs. There are some doubts, however, that these changes will become law.

Additionally, Revenue Procedure 2010-12 provides a safe harbor from preferential dividend treatment for publicly traded REITs. Under the safe harbor, a distribution is not treated as a preferential dividend if:
- It is made with respect to the REIT’s stock.
- It is declared on or before December 31, 2012 with respect to a taxable year ending on or before December 31, 2011.
- No less than 10% of the aggregate distribution consists of cash.
- The number of shares to be received are calculated over a period of up to two weeks ending as close as practicable to the payment date.
- Any stockholder participating in a dividend reinvestment plan will receive stock under the plan only to the extent the stockholder would have received cash.

The safe harbor does not provide protection for non-publicly traded REITs and does not fully protect against the possibility of a foot fault. Accordingly, lobbying efforts are ongoing to eliminate or reduce the potential impact of this pitfall.