

Real Estate Investment Trust Corner

By Daniel F. Cullen

The New REIT Prohibited Transactions Safe Harbor

Overview

On July 30, 2008, President Bush signed into law the Housing and Economic Recovery Act of 2008 (the “2008 Housing Act”) which liberalized a number of the tax rules governing real estate investment trusts (“REITs”).¹ Some of the key changes provided by the 2008 Housing Act were the amendments affecting the prohibited transactions safe harbor for REITs.² Generally speaking, a highly punitive tax is imposed on income that a REIT earns from a “prohibited transaction”—a tax equal to 100 percent of the net income derived from the prohibited transaction.³ Given the punitive nature of this tax, REITs almost always structure their dispositions in a manner that qualifies for the safe harbor from this tax as provided under the Code. This column provides an overview of the new rules governing the REIT prohibited transactions safe harbor.

REIT Prohibited Transactions

Generally speaking, although a REIT is not a pure “passthrough entity” (as are limited liability companies, partnerships and, to a lesser extent, S corporations⁴), a REIT is entitled to a deduction for dividends paid.⁵ Accordingly, it is possible for a REIT to avoid taxation at the entity level by distributing all of its income as dividends. Most REITs take full advantage of the dividends paid deduction and therefore operate as *de facto* passthrough entities. However, even if the dividends paid by a REIT equal its taxable income, there remains a potential for an entity-level tax in the event the REIT enters into a prohibited



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transaction, subjecting the REIT to a 100-percent tax on the net income earned from such transaction.⁶

A prohibited transaction is generally defined as the sale or other disposition of property that is described in Code Sec. 1221(a)(1) and which is not foreclosure property. One type of property described under Code Sec. 1221(a)(1) is real estate held by a the taxpayer primarily for sale to customers in the ordinary course of business (“dealer property”). Unfortunately, classifying an investment as “dealer property” is one of the most litigated and difficult areas of tax law.

The determination of whether a specific property or real estate project is described in Code Sec. 1221(a)(1) is an issue that turns on the facts and circumstances of each case. In *Malat v. Riddell*,⁷ the Supreme Court (in one of its only discussions of the definition of “dealer property”) held that where both a business motive

and investment motive for holding a particular parcel of real estate exists, the taxpayer’s primary motivation controls in determining whether the property was held primarily for sale to customers (*i.e.*, as dealer property). Because the inquiry into a taxpayer’s motivation for owning a particular piece of real property is a factual one, the courts have developed sets of factors to help determine whether the asset was held for investment or as dealer property. The following list set forth in *United States v. Winthrop*⁸ is representative of factors most often considered by the courts (many of which are interrelated questions and even somewhat duplicative):

1. the nature and purpose of the acquisition of the property and the duration of the ownership;
2. the extent and nature of the taxpayer’s efforts to sell the property;
3. the number, extent, continuity and substantiality of the sales;
4. the extent of subdividing, developing and improving the property that was done to increase sales;
5. the use of a business office and advertising for the sale of the property;
6. the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and

7. the time and effort the taxpayer actually devotes to the sale of the property.

Although a list of factors to consider is helpful, the Fifth Circuit simplified the complexity of the application of these factors in *Biedenharn Realty Co. v. U.S.*⁹ as follows:

No one set of criteria is applicable to all economic structures. Moreover, within a collection of tests, individual factors have varying weights and magnitudes, depending on the facts of the case. The

relationship among the factors and their mutual interaction is altered as each criteria increases or diminishes in strength, sometimes changing the controversy’s outcome.

Fortunately, the Code provides a “safe harbor,” which allows most REITs to avoid the “investment” vs. “dealer property” issue.

Due to the devastatingly punitive tax imposed on a REIT that engages in a prohibited transaction, the safe harbor for avoiding prohibited transaction status is critical to REITs when entering into proposed transactions.

Prohibited Transaction Safe Harbor

The REIT prohibited transaction safe harbor provided in Code Secs. 857(b)(6)(C) and (D) helps mitigate the uncertainty of determining whether sales are prohibited transactions. The safe harbor excludes certain sales of real estate (or timber assets) from the definition of prohibited transactions largely based upon the scale of the REIT’s sales activities.

To qualify for the safe harbor during a given tax year, either (1) the REIT must have made no more than seven sales of property (other than sales of foreclosure property or sales that are involuntary conversions) (the “7-Sales Test”), or (2) if more than seven sales were made, the aggregate adjusted bases of the properties sold (other than foreclosures or sales that are involuntary conversions) must not exceed 10 percent of the aggregate bases of all the REIT’s assets as of the beginning of the tax year (the “10-Percent-Bases Test”). Code Sec. 857(b)(6) (E) further provides that the sale of more than one property to one buyer as part of the same transaction constitutes one sale for purposes of the 7-Sales Test, and any sale in which the net selling price is less than \$10,000 is excluded. Practically speaking,

the 10-Percent-Bases Test recognizes the simple fact that large REITs must acquire and sell numerous properties each year and frequently must enter into more than seven sales of their investment real estate in any given year, often making the 7-Sales Test of no use to them. Accordingly, most large REITs have relied on the 10-Percent-Bases Test.

In addition to the above requirements, it is critical to note that to qualify for this safe harbor, the following additional requirements must be met: (1) the REIT property at issue must be held for a minimum of four years, and (2) the REIT cannot have made improvements to such property during that period that represent more than 30 percent of the net sales price of a property.¹⁰

The legislative history indicates that Congress created this highly punitive tax to discourage REITs from engaging in “ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project.”¹¹ Congress believed that “REITs should have a safe harbor within which they can modify the portfolio of their assets without the possibility that a tax would be imposed equal to the entire appreciation in those assets” and that the restrictions on the availability of REITs to avail themselves of the safe harbor would “prevent REITs from using the safe harbor to engage in an active trade of business such as the development and subdivision of land.”¹²

Changes Made by the 2008 Housing Act

As discussed above, prior to the enactment of the 2008 Housing Act, Code Secs. 857(b)(6)(C)(iii) and (D)(iv) provided that the prohibited transaction safe harbor applied only if:

1. the REIT held the property for the production of rental income for at least four years prior to sale;
2. the aggregate capital expenditures made by the REIT for a property during the four-year holding period preceding the sale had not exceeded 30 percent of the net selling price of the property; and
3. during the tax year:
 - (a) the REIT made no more than 7 sales of property (other than foreclosures or sales to which Code Sec. 1033 (involuntary conversions) applied); or
 - (b) the aggregate adjusted bases (as determined for purposes of computing earnings and profits) of properties (other than foreclosures

or involuntary conversions) sold during the tax year did not exceed 10 percent of the aggregate bases of all of the assets of the REIT as of the beginning of the taxable year.

Section 3052 of the 2008 Housing Act amended Code Secs. 857(b)(6)(C)(iii) and (D)(iv) to provide an additional alternative test for the number of permitted property sales by a REIT. Under this alternative test, the requirements of Code Secs. 857(b)(6)(C)(iii) or (D)(iv) are satisfied if the aggregate *fair market value* of properties (other than foreclosures or involuntary conversions) sold during the tax year does not exceed 10 percent of the fair market value of all of the assets of the REIT as of the beginning of the taxable year (the “10-Percent Fair Market Value Test”). Substituting “aggregate fair market value” test for “aggregate adjusted bases” test in the permitted sales equation portion of the REIT prohibited transactions safe harbor should provide REITs with much needed flexibility in managing their real estate portfolios for their investors in the midst of the current economic environment.

In addition, the 2008 Housing Act changed the holding period requirements of the REIT prohibited transactions safe harbor: both (1) the holding period during which the REIT is required to hold the property and (2) the period during which the 30-percent limit on capital expenditures is measured is reduced from four years to two years. This change also provides much needed flexibility to REIT in managing their portfolios.

Revenue Procedure 2008-69

The amendments provided under the 2008 Housing Act were made effective for sales made after July 30, 2008. However, because the effective date was expressed in terms of sales made after a particular date, questions arose about how to interpret the new 10-Percent Fair Market Value Test for substantive provisions that apply as alternatives and are expressed in terms of sales during a tax year. To address this concern, the IRS issued Rev. Proc. 2008-69,¹³ which provides the following clarification for applying the 10-Percent Fair Market Value Test:

[f]or a REIT’s taxable year that begins on or before July 30, 2008, and ends on or after July 31, 2008, satisfaction of [Code Secs.] 857(b)(6)(C)(iii) or of [Code Secs.] 857(b)(6)(D)(iv) means that either —

- The REIT satisfies the 7-Sales Test (for the entire taxable year);
- The REIT satisfies the 10-Percent Adjusted Bases Test (for the entire taxable year); or
- Both—[t]he aggregate adjusted bases (as determined for purposes of computing earnings and profits) of property (other than sales of foreclosure property or sales to which [Code Sec.] 1033 (involuntary conversions) applies) sold during the portion of the taxable year ending on July 30, 2008, did not exceed 10 percent of the aggregate bases (as so determined) of all of the assets of the REIT as of the beginning of the taxable year (that is, the REIT satisfies the 10-Percent Adjusted Bases Test *as if the portion of the taxable year ending on July 30, 2008, were an entire taxable year*); and [t]he REIT satisfies the 10-Percent Fair Market Value Test (*for the entire taxable year*) (emphasis added).

Conclusion

Due to the devastatingly punitive tax imposed on a REIT that engages in a prohibited transaction, the safe harbor for avoiding prohibited transaction status is critical to REITs when entering into proposed transactions. Because the determination of whether a taxpayer is acting as a dealer is often murky at best (and, at times, dark as mud), most REITs rely strictly on the safe harbor, rather than wade into the murky waters of “dealer property” determinations. The alternative tests provided by the 2008 Housing Act grants much needed additional flexibility to REITs to dispose of assets during these troubled economic times without having to take on the often difficult “dealer property” analysis and assume the related tax audit risk for such determinations.

ENDNOTES

¹ Housing and Economic Recovery Act of 2008 (P.L. 110-289). Many of the provisions in the 2008 Housing Act impacting REITs were proposed by NAREIT in 2007. A discussion of all of the REIT provisions in the 2008 Housing Act is outside the scope of this column.

² See Code Secs. 857(b)(6)(C) and (D).

³ Code. Sec. 857(b)(6).

⁴ Note, however, the following provisions applicable to S corporations: Code Secs. 1374 (tax imposed on certain built-in gains) and

1375 (tax generally imposed when passive investment income of corporation having subchapter C earnings and profits exceeds 25 percent of gross receipts).

⁵ Code Secs. 857 and 561.

⁶ Code Sec. 857(b)(6).

⁷ *Malat v. Riddell*, SCt, 66-1 USTC ¶9317, 383 US 569, 86 SCt 1030.

⁸ *A.B. Winthrop*, CA-5, 69-2 USTC ¶9686, 417 F2d 905.

⁹ *Biedenbarn Realty Co., Inc.*, CA-5, 76-1 USTC

¶9194, 526 F2d 409.

¹⁰ See Code Secs. 857(b)(6)(C), (C)(ii), (D)(i) and (D)(ii).

¹¹ S. Rept. No. 94-938, 94th Cong., 2d Sess. 470 (1976).

¹² S. Rept. No. 95-1263, 95th Cong., 2d Sess. 178-179 (1978).

¹³ Rev. Proc. 2008-69, IRB 2008-48 (Nov. 13, 2008).

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