Recent Legislative Changes on REITs' Investments in Debt Instruments

A real estate investment trust ("REIT") is intended to serve as a pooling arrangement for small investors to secure the advantages normally available to institutional investors (including investment diversification and expert investment counsel). This article explains how changes to the REIT rules are helpful and can enable investors to benefit from the REIT structure for investments in debt instruments.

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Overview

On December 18, 2015, the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act") was enacted as part of Pub. Law 114-113, the "Consolidated Appropriations Act, 2016." The new law includes many significant changes to the REIT rules, including favorable treatment under the Foreign Investment in Real Property Tax Act ("FIRPTA") regime for investments in U.S. real estate through REITs.

The new law also includes other favorable changes concerning a REIT's investments in debt instruments that generally simplify the complicated REIT qualification requirements and may make the REIT structure a more attractive investment vehicle. For example, one of the changes eliminates the potential risk of a REIT failing to satisfy the 75-percent income test as applied under Revenue Procedure 2014-51 when it acquires a mortgage loan with a principal amount that significantly exceeds the real property collateral value. Furthermore, a REIT may now be less concerned with failing the securities diversification requirements when its mortgage loan investment is partially supported by personal property incident to real property collateral. Another change increases a REIT's permitted investment in unsecured debts issued by a publicly offered REIT, so the REIT has more investment options while gaining exposures to other REITs in addition to pure stock investments. The new law also expands the prohibited transaction safe harbor by permitting a REIT to sell a maximum of 20 percent of its loan investments in a tax year, including those originated by its taxable REIT subsidiary, provided that the average of its

total sales over a three-year period does not exceed 10 percent. Finally, a REIT may now use a taxable REIT subsidiary to operate certain real property acquired through foreclosures without risking a failure to satisfy the income tests or incurring the prohibited transaction tax.

This article provides an overview of how REITs are affected by these changes as well as briefly identifying ambiguities in certain circumstances that require further guidance or clarification.

General REIT Considerations

In 1960, Congress passed REIT legislation that created a pooling arrangement similar to regulated investment companies for small investors to invest in real estate and real estate mortgages while restricting the "conduit" treatment to "what is clearly passive income from real estate investments, as contrasted to income from the active operation of businesses involving real estate."[1] To this end, for an entity to qualify as a REIT, it must satisfy certain organizational, asset holding, income source, and distribution requirements. Additionally, a REIT is subject to a 100-percent tax on net income derived from prohibited transactions[2] "to prevent a REIT from retaining any profit from ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project."[3] For this purpose, a prohibited transaction is a sale or other disposition of property that is considered inventory or held primarily for sale to customers in the ordinary course of a trade or business other than foreclosure property ("dealer property").[4]

Income Source Requirements

A REIT must derive at least 75 percent of its gross income (other than gross income from prohibited transactions and certain hedging and foreign currency transactions) from real-estate related sources, including, among other things, rents from real property, interest on obligations secured by mortgages on real property, and gain from the sale or other disposition of real property (including interests in mortgages on real property) that is not dealer property.[5] Additionally, a REIT must derive at least 95 percent of its gross income (other than gross income from prohibited transactions and

Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

[1] H. Rept. 2020, C.B. 1960-2.

[2] Section 857(b)(6)(A).

[3] S. Rep. No. 94-938 (1976).

[4] Section 857(b)(6)(B)(iii).

[5] Section 856(c)(3).

certain hedging and foreign currency transactions) from sources qualifying for the 75-percent income test, dividends and interest, and gain from the sale or other disposition of stock and securities that are not dealer properties.[6]

Generally speaking, when a mortgage covers both real property and other property, interest income from the mortgage is apportioned entirely to real property (i.e., qualifying for the 75-percent income test) if the fair market value of the real property equals or exceeds the highest principal amount of the loan outstanding during the tax year.[7] Otherwise, the interest income apportioned to the real property is based on a fraction, the numerator of which is the fair market value of the real property, and the denominator of which is the highest principal amount of the loan outstanding during the tax year.[8] For this purpose, the fair market value is determined as of the date on which the REIT's commitment to make or acquire the loan becomes binding on the REIT (referred to as "REIT's loan commitment date").[9]

The following examples illustrate the above interest apportionment rules.

Example 1

In 2007, X, a REIT, made a $100 mortgage loan to A. X's loan to A was secured by both real property and personal property. When X's commitment to make the loan became binding on X, the real property had a fair market value of $115. At all times through the end of 2010, the highest principal amount of the loan outstanding continued to be $100. By the start of 2009, the fair market value of the real property securing the loan had fallen to $55 and the fair market value of the personal property was $5. The values remained at these levels throughout 2009 and 2010.

When X made the mortgage loan in 2007, the real property's fair market value was $115, determined as of REIT's loan commitment date. Because this value exceeded the highest principal amount, all the interest from the loan was apportioned to the real property for 2007 through 2010, even though the real property value had fallen below the highest principal amount starting in 2009.

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[6] Section 856(c)(2).

[7] Section 1.856-5(c).

[8] Section 1.856-5(c)(1)(ii).

[9] Section 1.856-5(c)(2).

Example 2

The facts include all the facts in Example 1. Additionally, during the first quarter of 2010, Y, a REIT, committed to purchase, and purchased, the mortgage loan from X for $60.

According to Revenue Procedure 2014-51,[10] because the highest principal amount (of $100) exceeds the real property's fair market value (of $55) determined as of Y's loan commitment date, only 55 percent of the interest income is apportioned to the real property (i.e., $55 over $100). If this loan were the sole asset of Y, Y would have failed to satisfy the 75-percent income test. Thus, the conclusion advocated in Revenue Procedure 2014-51 presented a significant hurdle for REITs being used as vehicles to acquire and hold significantly distressed mortgages because personal property is likely always part of the collateral even if it was de minimis in value. To alleviate the risk of failing the 75-percent income test and work within the interest apportionment rules, some REITs attempted to modify the acquired distressed debts by reducing the principal amount (i.e., the denominator of the fraction) while increasing the stated interest rate. The new law changes the outcome in this example by modifying how REITs acquiring distressed properties apply the interest apportionment rules.

Under the PATH Act and effective for tax years beginning after December 31, 2015, the entire interest is treated as interest on "obligations secured by mortgages on real property" (i.e., qualifying for the 75-percent income test) if the fair market value of the personal property does not exceed 15 percent of the total fair market value of both real property and personal property. [11] For this purpose, the value is similarly determined as of the REIT's loan commitment date. Thus, this new law effectively overrides the unfavorable result for the 75-percent income test under Revenue Procedure 2014-51 in Example 2 above. That is, because the personal property represents no more than 15 percent of the total value of personal property and real property determined as of Y's loan commitment date (i.e., $5 over $60), the entire interest income is treated as interest on obligations secured by mortgages on real property.

It should be noted that the interest apportionment rules do not address the effect on the real property collateral value when a REIT's secured loan

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[10] 2014-37 I.R.B. 543, *modifying and superseding* Rev. Proc. 2011-16, 2011-5 I.R.B. 440.

[11] Section 856(c)(9)(B)(i).

(such as home equity line of credit) is subordinate to a first mortgage held by the senior lender. In Private Letter Ruling 199923006,[12] the IRS ruled that the fair market value of real property determined as of REIT's loan commitment date had to be reduced by the amount of all senior encumbrances on the real property because the value securing the senior mortgages would not be economically available to the REIT's mortgage. It is not entirely clear whether this methodology should be employed for purposes of the 15-percent test.

It does seem clear, however, that the new law simply overrides the interest apportionment rules "if" the 15-percent test is satisfied. In the event that the 15-percent test is not met, the interest apportionment rules should continue to apply. That is, the entire interest is treated as being apportioned to real property and qualifies for the 75-percent income test so long as the value of real property collateral determined as of REIT's loan commitment date equals to or exceeds the highest principal amount of the loan. Further, it is worth noting that although the new provision specifies the treatment as "for purposes of [interest on obligations secured by mortgages on real property]," the technical explanation prepared by the Joint Committee on Taxation treats the personal property as real property "for purposes of the 75-percent income and 75-percent asset test computations."[13] Thus, presumably, any gain on such obligation (if the 15-percent test is satisfied) should also be treated as entirely qualifying for the 75-percent income test if not a dealer property.[14] Similarly, and again presumably, any amount received as consideration for entering into the agreement to make such an obligation (if the 15-percent test is satisfied, if the determination of the amount does not depend in whole or in part on the income or profit of any person, and if it does not

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[12] Written determinations such as private letter rulings represent the IRS's analysis of the law as applied to a taxpayer's specific facts, and these types of written determinations are not intended to be relied on by third parties and may not be cited as precedent. Section 6110(k). They do, however, provide an indication of the IRS's position on the issues addressed.

[13] Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029 (Rules Committee Print 114-40), (JCX-144-15) (Dec. 17, 2015).

[14] Income qualifying for the 75-percent income test includes "gain from the sale or other disposition of real property (including interests in real property and interests in mortgages on real property) which is not property described in section 1221(a)(1)" pursuant to section 856(c)(3)(C).

become part of the original issue discount computation) should also be treated as entirely qualifying for the 75-percent income test.[15]

Asset Holding Requirements

New laws enacted as part of the PATH Act also change asset holding requirements for REITS. Prior to the PATH Act, at the end of each quarter of each tax year, a REIT was required to have at least 75 percent of the value of its total assets represented by cash and cash items (including ordinary receivables), real estate assets, and Government securities.[16] Furthermore, any securities owned by a REIT were required to comply with the following:

- Securities of an issuer (other than securities of taxable REIT subsidiaries or those qualifying for the 75-percent asset test) may not represent (1) more than five percent of the value of the REIT's total assets, or (2) more than 10 percent of the total voting power or the total value of the outstanding securities of such issuer (collectively, "securities diversification requirements").[17]
- Securities of taxable REIT subsidiaries may not represent more than 25 percent of the value of the REIT's total assets.[18]
- Not more than 25 percent of the value of the REIT's total assets may be represented by securities (other than those qualifying for the 75-percent asset test).[19]

The term "securities" is not specifically defined in the REIT provisions, but according to the Investment Company Act of 1940[20] it includes "any note, stock ... bond, debenture, evidence of indebtedness...."[21]

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[15] Income qualifying for the 75-percent income test includes "amounts (other than amounts the determination of which depends in whole or in part on the income or profits of any person) received or accrued as consideration for entering into agreements (i) to make loans secured by mortgages on real property or on interests in real property or (ii) to purchase or lease real property (including interests in real property and interests in mortgages on real property)" pursuant to section 856(c)(3)(G).

[16] Section 856(c)(4)(A).

[17] Section 856(c)(4)(B)(iv) (or former section 856(c)(4)(B)(iii)).

[18] Section 856(c)(4)(B)(ii).

[19] Section 856(c)(4)(B)(i).

[20] Pursuant to section 856(c)(5)(F), any undefined terms are to have the same meaning as when used in the Investment Company Act of 1940.

However, securities that are considered real estate assets, such as interests in mortgages on real property, are not considered securities[22] and, thus, not subject to the securities diversification requirements.

Obligations Secured by Mortgages on Real Property and Personal Property

In Private Letter Ruling 199923006, the IRS acknowledged that neither the Code nor regulations provides a specific methodology for determining the value of an interest in a mortgage on real property for purposes of the 75-percent asset test when a loan is secured by real and personal property or is only partially secured by real property. In the letter ruling, the IRS extended the interest apportionment rules mentioned above for purposes of the 75-percent asset test. Subsequently, Revenue Procedure 2014-51[23] announced a safe harbor: The IRS will not challenge a REIT's treatment of a loan as being in part a "real estate asset" for purposes of the asset tests if the REIT treats the loan as being a real estate asset in an amount equal to the lesser of (1) the value of the loan (e.g., market value, if market quotations are readily available, or fair value, as determined in good faith by REIT's directors); or (2) the greater of (a) the current value of the real property collateral, or (b) the fair market value of the real property collateral as of REIT's loan commitment date.

The following example illustrates the effects of the asset safe harbor under Revenue Procedure 2014-51.

Example 3

On January 1, 2011, Z, a REIT, purchased for $60 a distressed mortgage loan with a principal amount due of $100. The fair market value of the real property securing the loan on the date Z committed to purchase the loan was $55 and the value of the personal property securing the loan was $5. At the end of the second calendar quarter of 2011, the current value of the real property securing the loan had increased to $65, and the value of the loan had increased to $70.

Pursuant to the safe harbor, Z may treat $65 of the loan as a "real estate asset" for purposes of the 75-percent asset test, i.e., the lesser of (1) the value of the loan (of $70), or (2) the greater of (a) the current value of the

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[21] Section 2(a)(36) of the 1940 Act.

[22] Section 1.856-3(e).

[23] 2014-37 I.R.B. 543.

real property (of $65), or (b) the fair market value of the real property as of Z's loan commitment date (of $55).

It should be noted that because a portion of the value of the loan is not treated as a real estate asset (i.e., $5), that portion is subject to the securities diversification requirements (or more specifically the 10-percent value limitation). Thus, unless the loan is one of those securities exempt from the 10-percent value limitation (e.g., a loan to an individual, a loan to a "real estate" partnership, or a "straight debt"),[24] then that portion could raise a noncompliance risk.[25] The new law changes the outcome in this example by eliminating the potential risk that the REIT will fail to satisfy the securities diversification requirements under Revenue Procedure 2014-51 when the value of a mortgage loan exceeds the real property collateral value.

For tax years beginning after December 31, 2015, the PATH Act expands the term "real estate asset" to include an obligation secured by a mortgage on both real property and personal property if the fair market value of the personal property does not exceed 15 percent of the total fair market value of both real property and person property.[26] That is, if the 15-percent test is satisfied, the obligation is treated as a real estate asset and not a security,[27] and thus, no portion of the obligation will be subject to the securities diversification requirements. For this purpose, the value is similarly determined as of the REIT's loan commitment date. For example, a REIT agrees to make a loan of $100 that is to be secured by a hotel and

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[24] Section 856(m).

[25] It is worth noting that for purposes of the 10-percent value limitation, the portion treated as a real estate asset might not be regarded as outstanding because it is held by a REIT, and section 1.856-3(e) excludes real estate assets from being considered "securities." In Private Letter Ruling 200936026, a corporation through disregarded entities borrowed funds from unrelated lenders to acquire properties and secured these loans with mortgages on the properties ("mortgage loans"). The corporation also obtained mezzanine loans through the tiered-SMLLC structure. The REIT in the letter ruling proposed to acquire one or more of the mezzanine loans. The REIT was concerned that it could be viewed as owning more than 10 percent of the "total value of the outstanding securities" of the corporation if the mortgage loans were excluded from being considered "securities" because they would meet the definition of "real estate assets" if being held by a REIT. The IRS reasoned that "[a]lthough section 856(c)(5)(B) provides that loans secured by real property are real estate assets, that rule is only applicable to loans that are held directly or indirectly by a REIT."

[26] Section 856(c)(9)(B)(ii).

[27] Section 1.856-3(e).

the furnishings, and as of REIT's loan commitment date hotel's real property and personal property is valued at $110 and $15, respectively. Because the value of the personal property does not exceed 15 percent of the total value, the entire loan is considered a real estate asset. The loan is treated so even if the value of the personal property subsequently represents more than 15 percent of the total for some reason because the value is determined only once (i.e., as of REIT's loan commitment date).

This new law may also minimize non-compliance risks faced by a REIT that is engaged in a "parking" like-kind exchange and advances all costs related to the acquisition of the replacement property as illustrated immediately below. For example, assume a REIT has entered into a purchase agreement to acquire Hotel B and intends to use Hotel B as the replacement property for its disposition of Hotel A pursuant to an exchange agreement. The REIT enters into a qualified exchange accommodation agreement with "Accommodator" pursuant to Revenue Procedure 2000-37[28] for the "parking" of Hotel B until the disposition of Hotel A. The REIT advances $102 to a single-member limited liability company of Accommodator ("exchange accommodation titleholder" or "EAT"), which pays $100 as the purchase price of Hotel B and $2 towards transaction costs (such as realty transfer tax but excluding proration of operating items). Pursuant to the purchase agreement, the purchase price is allocated $90 to land and building and $10 to furnishings. REIT's advance is evidenced by a promissory note secured by a deed of trust encumbering Hotel B.

Prior to the PATH Act, and pursuant to Revenue Procedure 2014-51, the REIT could treat the loan to EAT as a real estate asset up to the current value of the land and building of between $90 and $92 by including the transaction costs as part of the fair market value.[29] Still, the portion of the

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[28] 2000-40 I.R.B. 308.

[29] In Publicker v. Commissioner, 206 F.2d 250, the donor purchased two items of jewelry. As part of the purchase, the donor was required to pay a federal excise tax (computed as a percentage of the purchase price) on each item. Subsequently, the donor transferred the jewelry to her daughter. The court concluded that, in determining the fair market value of the transferred jewelry for gift tax purposes, the "price at which such property would change hands between a willing buyer and a willing seller" includes the excise tax paid by a purchaser of the property. The court noted, "[o]bviously, valuing the property as a sale, the amount of the excise tax must be included for both the buyer and the seller would have in mind and necessarily would calculate the amount of the excise tax as part of the cost of the property."

loan not treated as a real estate asset would be subject to the securities diversification requirements. That is, the value of that portion cannot represent more than 10 percent of the outstanding securities of the issuer and cannot represent than more than five percent of value of REIT's total assets. For purposes of the 10-percent value limitation, it is not entirely clear whether EAT, a single purpose entity, or Accommodator, which presumably has more assets and outstanding securities, should be treated as the issuer.[30] Further, whether the loan could be treated as a straight debt exempt from the 10-percent-value limitation might not always be clear (e.g., cash-flow based interest rate or debt repayment by using the "parked" property). With the amendment under the PATH Act, the entire loan to EAT in the example is treated as a real estate asset because the value of personal property does not exceed 15 percent of the total.

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[30] The term "issuer" is not defined in section 856 or the regulations thereunder. However, section 856(c)(5)(F) provides that all terms not defined in sections 856-860 shall have the same meaning as when used in the Investment Company Act of 1940, as amended. In General Counsel Memorandum 39456, the IRS relied on the SEC's construction of such term in concluding "[w]hen a [regulated investment company or RIC] acquires an industrial development bond exempt under section 103(b)(4) or 103(b)(6), issued by a state agency or municipality for the benefit of a private user, with the interest and principal payable solely out of the revenues from the project financed and from the assets of the private user, the [RIC] may treat the private user as the 'issuer' of the obligation for purposes of the diversification requirements of section 851(b)(4)." Further, in Private Letter Ruling 200526011, a regulated investment company subjecting to certain diversification rules intends to invest in special obligation revenue bonds that were issued by State, the proceeds of which are exclusively dedicated to finance State's highway projects. As described, interest and principal are payable solely out of an infrastructure fund, which has been legally segregated from State's other assets. The IRS looked to SEC determination of the identity of the issuer of a security in the context of the registration requirement for purposes of section 3 of the Investment Company Act of 1940 and ruled for purposes of section 851(b)(3), the infrastructure fund should be treated as the issuer of the bonds. However, Private Letter Ruling 200936026 could suggest that a corporation borrowing funds through disregarded entities might be considered the issuer for debts issued by its disregarded entities. In the letter ruling, the corporation through disregarded entities borrowed funds from unrelated lenders to acquire properties and secured these loans with mortgages on the properties ("mortgage loans"). The corporation also obtained mezzanine loans through the tiered-SMLLC structure. The REIT in the ruling proposed to acquire one or more of the mezzanine loans. The REIT was concerned that it could be viewed as owning more than 10 percent of the "total value of the outstanding securities" of the *corporation* if the mortgage loans were excluded from being considered "securities" because they would meet the definition of "real estate assets" if being held by a REIT.

It is important to note that this new provision only addresses circumstances in which the 15-percent test is satisfied. It does not suggest how an obligation secured by a mortgage on both real property and personal property should be treated for purposes of the asset holding requirement if the 15-percent test is not satisfied. To this end, one can view the PATH Act as an expanded safe harbor for matters described in Revenue Procedure 2014-51, although its availability is limited to situations in which the new 15-percent test is satisfied. Thus, the rules in Revenue Procedure 2014-51 should not be "deemed" obsolete.[31] A REIT ought also to be able to continue relying on the asset safe harbor provisions in Revenue Procedure 2014-51 for circumstances not affected by the PATH Act.

Further, it is worth noting that for most U.S. federal income tax purposes, a significant modification of a loan results in an exchange of the original loan for a modified loan that differs materially either in kind or in extent.[32] Thus, a REIT may need to re-determine a property's fair market value upon a significant modification of an existing loan. Fortunately, Revenue Procedure 2014-51 allows REITs to treat certain loan modifications occasioned by default or reasonably foreseeable default as not being a new commitment to make or purchase a loan for purposes of the 75-percent income test. Thus, if a REIT can continue to rely on this safe harbor, it should not be required to re-determine the value or should not be concerned that a "qualified" modification might risk its compliance with the asset holding requirements.

Unsecured Public REIT Debts

For tax years beginning after December 31, 2015, the PATH Act also expands the term "real estate asset" to include debt instruments (not otherwise real estate assets) issued by REITs that are required to file annual and periodic reports with the Securities and Exchange Commission

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[31] Pursuant to Revenue Procedure 89-14, 1989-1 C.B. 814, a taxpayer generally may rely upon a revenue procedure published in the Internal Revenue Bulletin in determining the tax treatment of its own transactions and needs not request a specific ruling applying the principles of a published revenue procedure to the facts of its particular cases. However, Revenue Procedure 89-14 also cautions the taxpayer to determine whether a revenue procedure on which it seeks to rely has been, among other things, revoked, declared obsolete, or otherwise affected by subsequent legislation, treaties, regulations, revenue rulings, revenue procedures, or court decisions.

[32] Section 1.1001-3(b).

under the Securities Exchange Act of 1934 (each a "publicly offered REIT" and "unsecured public REIT debt").[33] However, the PATH Act (1) limits the value represented by unsecured public REIT debts to 25 percent of the value of a REITs total assets for purposes of the asset holding requirement,[34] and (2) continues to treat gains on these securities as only qualifying for the 95-percent income test.[35]

Although an unsecured public REIT debt has not been subject to the 10-percent-value limitation,[36] prior to the PATH Act, a REIT interested in such debt for higher yields or exposures to other REITs had to be mindful of the five-percent value limitation. With this new provision, a REIT has additional investment options that may deliver yields similar to corporate bonds with one less asset-holding restriction (i.e., not being subject to the five-percent limit).

It should be noted that some publicly offered REITs conduct substantially all their business and own substantially all their assets through their respective operating partnerships,[37] which may be the issuers of unsecured debts and may be regarded as entities separate from the REITs for U.S. federal income tax purposes.[38] These debt instruments do not appear to qualify as unsecured public REIT debts (i.e., not issued by the REIT for both tax and legal purposes).

However, there may be operating partnerships formed solely to facilitate future contribution transactions by property owners seeking tax-deferral treatments and currently being disregarded as entities separate from the REITs for U.S. federal income tax purposes. Alternatively, a publicly

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[33] Section 856(c)(5)(B) and section 856(c)(5)(L).

[34] Section 856(c)(4)(B)(iii).

[35] Income qualifying for the 75-percent income test includes "gain from the sale or other disposition of a real estate asset *(other than a nonqualified publicly offered REIT debt instrument)* that is not a prohibited transaction solely by reason of section 857(b)(6)" pursuant to section 856(c)(3)(H). [Emphasis added.]

[36] Pursuant to section 856(m)(1)(F), any security issued by a REIT (which does not have to be a publicly offered REIT) is not considered a security for purposes of the 10-percent value limitation.

[37] These REITs use the so-called umbrella partnership REIT ("UPREIT") structure, in which a property owner may contribute appreciated property to REIT's operating partnership in exchange for partnership units that may be redeemed by the issuance of REIT stock on a one-for-one basis or cash of equivalent value. This contribution may defer gain recognition by the contributor if certain conditions are satisfied.

[38] *E.g.*, Boston Properties Limited Partnership and Simon Property Group, L.P.

offered REIT may use a single-member limited liability company or a wholly owned corporate subsidiary (other than a taxable REIT subsidiary), i.e., a qualified REIT subsidiary,[39] neither of which is treated as separate from the REIT for U.S. federal income tax purposes, to issue unsecured debts. In both circumstances, it is not entirely clear whether these unsecured debts could be treated as unsecured public REIT debts even though they are debts of the REITs for U.S. federal income tax purposes and may be fully and unconditionally guaranteed by the REITs. [40]

Further, it is worth noting that while REITs generally do not voluntarily give up the qualification status, a revocation if it is no longer in the best interests of the entity to continue to qualify as a REIT or a failure to qualify as a REIT may nevertheless occur.[41] While a REIT that has reasonably relied on "will" REIT opinions before investing in unsecured public REIT debts may try to assert a reasonable cause to avoid an asset failure, such reliance may not be entirely clear.[42]

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[39] Section 856(i).

[40] For example, the 10-Q as of September 30, 2015, filed by CareTrust REIT, Inc. disclosed "[o]n May 30, 2014, the Company's wholly owned subsidiary, CTR Partnership, L.P. (the "Operating Partnership"), and its wholly owned subsidiary, CareTrust Capital Corp. (together with the Operating Partnership, the "Issuers"), completed a private offering of $260.0 million aggregate principal amount of 5.875% Senior Notes due 2021 (the "Notes")." It is not entirely clear whether CareTrust's issuers are recognized tax entities. 10-Q available at http://www.sec.gov/Archives/edgar/data/1590717/000162828015008348/ctre2015093010q.htm. *See also* the prospectus filed by Outfront Media Inc. on December 2, 2015, which discloses that the issuers of $100 million aggregate principal amount of 5.625% Senior Notes due 2024 are wholly owned subsidiaries, Outfront Media Capital LLC and Outfront Media Capital Corporation. Prospectus available at http://www.sec.gov/Archives/edgar/data/1334628/000119312515393247/d25115d424b3.htm.

[41] For example, CapitalSource Inc. operated as a REIT from January 1, 2006, through December 31, 2008, but revoked its REIT election as of January 1, 2009. See http://www.sec.gov/Archives/edgar/data/1241199/000095012310019308/w77013e10vk.htm. Also, ACRE Realty Investors Inc. (formerly known as Roberts Realty Investors) disclosed on November 17, 2014, that it disqualified as a REIT in the tax year ending December 31, 2009, and for the periods since that date. Available at http://www.sec.gov/Archives/edgar/data/1011109/000155278114001049/e00382_rpi-nt10q.htm.

[42] Pursuant to section 856(c)(7)(A), a REIT failing to meet any of the asset holding requirements (other than a de minimis asset failure as described in section 856(c)(7)(B)) is nevertheless considered to have satisfied such requirement if the failure is due to reasonable cause and not due to willful neglect, and the REIT disposes of such assets or the requirement is otherwise met within six months after the quarter in which such

Prohibited Transactions

"[B]ecause it is often very unclear whether property is being held by a REIT primarily for sale," Congress approved a prohibited transaction safe harbor within which REITs could "modify the portfolio of their assets without the possibility that a tax would be imposed equal to the entire amount of the appreciation in those assets."[43] Prior to the PATH Act, a sale of property, that is a real estate asset and is a dealer property, was not a prohibited transaction if:

- The REIT has held the property for not less than two years;
- The aggregate expenditures made by the REIT or any partner thereof during the two-year period preceding the date of sale and includible in the basis of the property do not exceed thirty percent of the property's net selling price;
- During the tax year, other than sales of foreclosure property or involuntary conversion, (1) the REIT does not make more than seven sales of property; (2) the aggregate adjusted bases of property sold does not exceed ten percent of the aggregate bases of all of the assets of the REIT as of the beginning of the tax year; or (3) the fair market value of property sold does not exceed ten percent of the fair market value of all of the assets of the REIT as of the beginning of the tax year;
- In the case of property that consists of land or improvements, not acquired through foreclosure (or deed in lieu of foreclosure), or lease termination, the REIT has held the property for not less than two years for production of rental income; and
- If the REIT has made more than seven sales of property during the tax year, substantially all of the marketing and development expenditures with respect to the property were made through an independent contractor from whom the REIT itself does not derive or receive any income.[44]

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failure is identified. The REIT must also comply with a reporting requirement and pay a tax pursuant to section 856(c)(7)(C) equal to the greater of (1) $50,000 or (2) the amount based on the net income generated by the assets for a specified period.

[43] S. Rep. No. 95-1263 (1978).

[44] Former section 857(b)(6)(C).

A mortgage REIT's reliance on the safe harbor has not always been easy for the following reasons: First, as discussed above, for most U.S. federal income tax purposes, a significant modification of a debt instrument results in a deemed exchange of the original debt for a modified debt. While Revenue Procedure 2014-51 treats modifications occasioned by default or reasonably foreseeable default as not being a new commitment to make or purchase a loan for the interest apportionment rules and not as prohibited transactions, it does not treat such modifications not as exchanges. Further, for U.S. federal income tax purposes, amounts received by the holder on retirement of a debt instrument are generally considered as amounts received in exchange therefor.[45] Thus, a mortgage REIT may easily have more than seven sales during a year, which means that prior to the PATH Act, the REIT had to use an independent contractor for substantially all of the marketing and development expenditures with respect to those loans. However, some mortgage REITs use their taxable REIT subsidiaries to originate and securitize mortgage loans and then acquire from the taxable REIT subsidiaries certain loans (including B-Note after participation) and REMIC interests to be held as investments.

For tax years beginning after December 31, 2015, the PATH Act permits a REIT to use its taxable REIT subsidiary (rather than solely independent contractors) for substantially all of the marketing and development expenditures with respect to the property sold during a year if the REIT has made more than seven sales. Thus, it should make the safe harbor more useful for those mortgage REITs.

The PATH Act also adds alternative tests to the seven sales and 10 percent tests by permitting a REIT to sell up to 20 percent of its property in a tax year (determined by reference either to E&P bases or to fair market value) so long as the average of its total sales over a three year period does not exceed 10 percent (determined by reference either to E&P bases or to fair market value, as the case may be). It is worth noting that it might not have been entirely clear whether, for purposes of the 10-percent test, the bases or fair market value of the property sold is as of the beginning of the year or at the time of sales.[46] However, it seems

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[45] Section 1271(a)(1).

[46] Section 857(b)(6)(C) provides in relevant part:

> For purposes of this part, the term "prohibited transaction" does not include a sale of property which is real estate asset (as defined in section 856(c)(5)(B)) if …
> (iii) … (II) the aggregate adjusted bases (as determined for purposes of computing

clear that the numerator for the three-year averaging appears to be E&P bases or fair market value of sold property at the time of sales rather than "as of beginning of the taxable year."[47]

Foreclosure Property

In 1975, the "foreclosure property" rules were enacted in response to the then economic problems and to prevent a REIT from being disqualified or having to take action which is not economically sensible to remain qualified in "a situation where a REIT, inadvertently, as the result of an unanticipated default of its debtor, takes over real property under existing mortgages or leases that yielded nonqualified income."[48] Generally speaking, pursuant to these rules, a REIT may elect to treat as "foreclosure property" real property (and incidental personal property)

> earnings and profits) of property (other than sales of foreclosure property or sales to which section 1033 applies) sold during the taxable year does not exceed 10 percent of the aggregate bases (as so determined) of all of the assets of the trust as of the beginning of the taxable year, or (III) the fair market value of property (other than sales of foreclosure property or sales to which section 1033 applies) sold during the taxable year does not exceed 10 percent of the fair market value of all of the assets of the trust as of the beginning of the taxable year, or (IV) the trust satisfies the requirements of subclause (II) applied by substituting '20 percent' for '10 percent' and the 3-year average adjusted bases percentage for the taxable year (as defined in subparagraph (G)) does not exceed 10 percent, or (V) the trust satisfies the requirements of subclause (III) applied by substituting '20 percent' for '10 percent' and the 3-year average fair market value percentage for the taxable year (as defined in subparagraph (H)) does not exceed 10 percent…

One might attempt to apply "as of the beginning of the taxable year" to both "the aggregate adjusted bases … of property … sold during the taxable year" and "the aggregate bases … of all of the assets of the trust." Unfortunately, the conference report accompanying the Tax Reform Act of 1986, which enacted the 10-percent alterative test, explained without much clarity "the adjusted basis of the property sold does not exceed 10 percent of the adjusted basis of all of the REIT's assets at the beginning of the REIT's taxable year." H.R. Conf. Rep. No. 99-841 (1986).

[47] The PATH Act adds section 857(b)(6)(G), which defines "3-year average adjusted bases percentage" to mean "the ratio (expressed as a percentage) of (i) the aggregate adjusted bases … of property … sold during the 3 taxable year period ending with such taxable year, divided by (ii) the sum of the aggregate adjusted bases (as so determined) of all of the assets of the trust as of the beginning of each of the 3 taxable years which are part of the period referred to in clause (i)." Section 857(b)(6)(G) seems to support that "as of the beginning" is only with respect to "all of the assets" by the insertion of "," between the numerator and denominator.

[48] S. Rep. No. 93-1357 (1974).

acquired as a result of the REIT having bid in the property at foreclosure, or having otherwise reduced such property to ownership or possession by agreement or process of law, after there was default (or default was imminent) on a lease of such property or on an indebtedness which such property secured.[49] Upon election, income and gain derived from such property are deemed as qualifying income for purposes of the income tests.[50] However, income from such property (netted of deductions) that would have been treated as nonqualifying but for these rules and gain from the sale of such property that is considered a dealer property are subject to tax at 35 percent.[51] Thus, taking over a foreclosure property does not cause a REIT to risk its qualification or to be subject to a 100-percent punitive tax on holding property primarily for sale.

Generally, a foreclosure property will cease to be treated as such as of the close of the third tax year following the tax year in which the property was acquired.[52] However, the foreclosure-property status may be terminated early under certain circumstances. For example, prior to the PATH Act, if the property was used in a trade or business 90 days after its acquisition, the trade or business had to be conducted through an independent contractor from whom the REIT itself does not receive any income.[53] This is so notwithstanding that a REIT is permitted to use a taxable REIT subsidiary in lieu of an independent contractor for tenant services since 2001. Further, for this early termination provision, foreclosure property held by a REIT primarily for sale to customers in the ordinary course of a trade or business is considered to be property used in a trade or business conducted by the REIT.[54] Therefore, prior to the PATH Act, the trade or business of selling the property had to be outsourced by a REIT to a third party even if the REIT might be the best person for the task due to its knowledge about the property and market. For tax years beginning after December 31, 2015, a REIT can also use a taxable REIT subsidiary to conduct the trade or business in which a foreclosure property is used.

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[49] Section 856(e)(1).

[50] Section 856(c)(2)(F) and (c)(3)(F).

[51] Section 857(b)(4).

[52] Section 856(e)(2).

[53] Section 856(e)(4)(C).

[54] Section 1.856-6(f)(2).

Summary

A REIT is intended to serve as a pooling arrangement for small investors to secure the advantages normally available to institutional investors (including investment diversification and expert investment counsel). At the time of the original enactment, a REIT is also intended to address "the shortage of private capital and mortgage money for individual homes, apartment houses, office buildings, factories, and hotels."[55] The amendments to the REIT rules discussed above are helpful and can enable investors to benefit from the REIT structure for investments in debt instruments. For example, the changes address the potential risks of not complying with the asset and income tests in connection with an investment in distressed debts and simplify the determination of compliance with qualification requirements. They also provide alternative investment options (i.e., unsecured public REIT debts) and expand safe harbor to avoid the prohibited transaction risks. However, further guidance in certain areas (such as confirming the continuing validity of Revenue Procedure 2014-51 except as being affected by the PATH Act, the treatment of other potential income items associated with mortgages secured in part by personal property if the 15-percent test is satisfied, etc.) would foster simplification and provide assurance. Finally, it will be helpful to exclude debt retirements and significant modifications from being considered sales for purposes of the prohibited transaction safe harbor. After all, as the U.S. Supreme Court held in *Fairbanks v. United States*, 306 U.S. 436 (1939), a redemption of corporate bonds prior to maturity was neither "sale nor exchange within the commonly accepted meaning of the words."

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[55] H. Rept. 2020, C.B. 1960-2.