THE SERVICE’S TREND OF FRIENDLY REIT RULINGS CONTINUES

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A real estate investment trust (a “REIT”) is a corporation or an association otherwise taxable as a domestic corporation intended to own interests in real property or in debt secured by real property. The principal advantage of a REIT for holding real property is the deduction for dividends paid that enables a REIT to avoid corporate level taxation.

To qualify as a REIT, a corporation must satisfy a number of shareholder, income and asset tests, including income tests requiring that at least 75 percent of its gross income must be derived from real estate sources, principally (i) rents from real property, (ii) interest on debt obligations secured by mortgages or deeds of trust on real property, (iii) gains from the sale of real property; and that at least 95 percent of the corporation’s gross income must be derived from interest or dividends as well as real estate income qualifying for the 75 percent of income test.

As a statutorily favored entity, REITs are often the objects of generous revenue rulings and private letter rulings. For example, in late 2012, the Internal Revenue Service released several favorable private letter rulings on the issue of REITs holding an interest in a passive foreign investment company (a “PFIC”) or a controlled foreign corporation (a “CFC”), ruling that the Subpart F Income of a CFC (CFCs are foreign corporations at least 50% of whose stock, by vote and value, is owned by US shareholders and are subject to federal income tax on their undistributed “Subpart F Income”) and the foreign

personal holding company income of a PFIC in each case recognized by a REIT owning interests in a CFC or a PFIC may be treated as qualifying for the 95 percent of income test under Section 856(c)(2). 1 A PFIC is a foreign corporation, at least 75% of whose income is “passive income” and at least 50% of whose assets are held for the production of passive income. For that purpose, “passive income” is generally dividends, interest, royalties, rents, annuities, and gains from the sale of property. US shareholders are required to include in income their share of certain of the PFIC’s excess distributions.

In addition to the income tests described above, to qualify as a REIT, at least 75% of the value of the corporation’s assets must consist of real estate assets, cash and cash items and government securities as of the last day of each calendar quarter. In a recent private letter ruling, the Service held that the value of deferred organizational expenses carried as an asset on a REIT’s balance sheet would be considered zero for purposes of the quarterly asset test. 2 By so ruling, the IRS enabled the REIT not to have to consider the deferred organizational expenses in comparison to the value of its real estate, government securities and cash and cash items.

The Service has long treated various fixtures as real estate assets for REIT qualification purposes, going back to 1973 when it held that a building’s “total energy system,” powered by turbines, would qualify as a real estate asset. 3 More recently, relying in part on that 1973 revenue ruling, the Service agreed to treat an offshore oil drilling platform (exclusive of machinery) as real property. 4

The Service has also been issuing favorable “infrastructure” rulings for REITs engaged in owning wireless cell towers. In those rulings, the cell towers are held to

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qualify as real property and the income attributable to tenants’ payments for power generated by the REIT’s on-site generators is treated as includible in rents from real property.\textsuperscript{5}

The Service also provided a favorable published revenue ruling to the effect that investments in money market funds qualify as “cash items” for purposes of the 75 percent of assets quarterly REIT qualification test.\textsuperscript{6} In reaching its favorable conclusion, the Service looked to the Investment Company Act of 1940.\textsuperscript{7} While the Investment Company Act itself does not define the term “cash item,” the Securities and Exchange Commission issued a no-action letter, upon which the Service relied in issuing its private letter ruling, to the effect that an investment in a money market fund is a cash item under Section 3(a)(1)(C) of the Investment Company Act.\textsuperscript{8}

In addition to the income and asset tests, the REIT’s dividend distributions must be pro rata within the meaning of Section 562 in order to be deductible. In Private Letter Ruling 201244012 (Nov. 2, 2012), the Internal Revenue Service issued a favorable ruling on the issue of whether dividends distributed among three different classes of stock of a REIT would be deductible. In order for a REIT to be able to deduct dividend distributions, a REIT’s distributions must be made pro rata among the shareholders in accordance with the rights and preferences set forth in the REIT’s corporate charter.\textsuperscript{9} REIT “distributions must not prefer any shares of stock of a class over other shares of stock of that same class. The distribution must not prefer one class of stock over another

\textsuperscript{5} Priv. Ltr. Rul. 201301007 (Jan. 4, 2013); see also Priv. Ltr. Rul. 201129007 (Jul. 22, 2011).
\textsuperscript{7} 15 U.S.C. §§80a-1, \textit{et. seq.}  I.R.C. Section 856(c)(5)(F) so authorizes (“All other terms shall have the same meaning as when used in the Investment Company Act of 1940...”).
\textsuperscript{9} Treas. Reg. §1.562-1.
class except to the extent that one class is entitled (without reference to waivers of their rights by stockholders) to that preference.”

In that letter ruling, the subject REIT adopted some of the liquidity features of a mutual fund. The REIT had issued shares of its common stock (the “Class E Shares”) to accredited investors in a private placement on its formation. Thereafter, the REIT filed a registration statement to register the sale of two new classes of its stock, Class A and Class M. The Class A Shares and Class M Shares were to be offered for sale on a daily basis at the net asset value (“NAV”) for shares of such class plus, with respect to Class A Shares, applicable selling commissions and would be repurchased by the REIT at the NAV for such share class. Subject to certain limitations, the REIT intended the share repurchase plan to allow holders of Class A Shares and Class M Shares to request that the REIT repurchase their shares in an amount up to an agreed percentage of the REIT’s NAV after such shares have been outstanding for at least one year. The Class A Shares would be subject to a selling commission (“Selling Commission”) to the extent not otherwise waived or reduced and paid directly by the shareholder, in addition to the NAV for such shares. No Selling Commission would be charged with respect to the Class M Shares. Despite the differences among the three classes of stock, the Service held that dividend distributions on all of the classes of stock would be deductible as pro rata according to the terms and preferences stated in that REIT’s charter documents.\textsuperscript{10}

The Service continues its long-standing practice of issuing favorable rulings, private as well as published, on REIT qualification issues, including assets constituting real property, and the types of income qualifying for the 75% of income and 95% of income REIT qualification tests. Because of the Service’s willingness to accept reasonable pro-REIT analyses in issuing private letter rulings, practitioners may feel

\textsuperscript{10} See Treas. Reg. §1.562-2(a).
more comfortable relying on the analysis set forth in private letter rulings when opining on REIT issues, especially in the context of a REIT that is not publicly issued and traded.