Newly-Enacted REIT Legislation Paves the Way for REIT-Friendly Guidance

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Introduction

A “Real Estate Investment Trust” (a “REIT”) is an entity that otherwise would be taxable as a corporation but that instead makes a special election to be taxable as a REIT. REITs provide taxpayers with two distinct advantages: the ability to attract capital from public markets, and the ability to deduct dividends paid to shareholders, resulting in only a single layer of tax at the shareholder level. The key downside to REITs, however, is the stringent income and asset tests that REITs must comply with. Very generally, these tests mandate that (a) at least 75% of a REIT’s assets must consist of “real estate assets” (including interests in real property and interests in mortgages on real property), cash and government securities, and (b) that (i) at least 95% of the REIT’s gross income must be derived from certain passive sources, including dividends, interest, rents from real property, and gain from the sale of stock, securities and real property, and (ii) at least 75% of the REIT’s gross income must be derived from certain real estate sources, including dividends from other REITs, interest on obligations secured by mortgages on real property, rents from real property, and gain from the sale of real property. As a result, REITs face a constant battle to police their asset base and sources of gross revenue to ensure REIT compliance, yet grow and produce additional revenue from novel sources as new opportunities arise.

Code Section 856(c)(5)(J)

Prior to the enactment of Code Section 856(c)(5)(J), REITs occasionally received income from sources not listed in the REIT income tests and sought letter rulings from the IRS as a result. The legislative history of Code Section 856(c)(5)(J) references two of these rulings – Private Letter Ruling 200039027 and Private Letter Ruling 200127024. In Private Letter Ruling 200039027, the IRS ruled that settlement payments received by a REIT in connection with the development of real property were excluded from the REIT’s income for purposes of the 75% and 95% gross income tests. Likewise, in Private Letter Ruling 200127024, the IRS ruled that a break-up fee received by a REIT as a penalty from a failed merger was excluded from the REIT’s income for purposes of the 75% and 95% gross income tests. Both rulings were issued based on the original legislative intent that REITs should receive only passive income and on findings that Congress did not intend to discourage REITs from pursuing legal remedies. More

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2 Other sources of income qualify under the REIT gross income tests, as more specifically set forth in Code Sections 856(c)(2) and 856(c)(3).

3 October 10, 2000.

recently, in Private Letter Ruling 200614024, the IRS considered a situation where a REIT received state tax credits generated as a result of developing and rehabilitating real property that had been contaminated by an oil spill. The IRS ruled that “taxable income associated with the receipt of the State tax credits will not be considered in determining whether Taxpayer satisfies the REIT income tests . . . .” The IRS reasoned that receipt of the credits was closely connected to development and rehabilitation of the underlying contaminated real estate, and that furthermore of this public policy did not interfere with the policy objectives of Congress in enacting the REIT income tests.

In 2008, as a means to provide the IRS with more power to interpret the REIT income tests, Congress enacted Code Section 856(c)(5)(J) as part of the Housing and Economic Recovery Act of 2008. That section provides:

To the extent necessary to carry out the purposes of this part, the Secretary is authorized to determine, solely for purposes of this part, whether any item of income or gain which—

(i) does not otherwise qualify under paragraph (2) or (3) may be considered as not constituting gross income for purposes of paragraphs (2) or (3), or

(ii) otherwise constitutes gross income not qualifying under paragraph (2) or (3) may be considered as gross income which qualifies under paragraph (2) or (3).

Legislative history explains that the provision authorizes the IRS “to issue guidance that would allow other items of income to be excluded for purposes of the computation of qualifying gross income under either the 75 percent or the 95 percent test, respectively, or to be included as qualifying income for either of such tests, respectively, in appropriate cases consistent with the purposes of the REIT provisions.” In essence, the provision bestows broad authority upon the IRS to determine whether an item of income not specifically enumerated in the 75% or 95% gross income tests nevertheless should either be excluded from both the numerator and denominator of the equation or should be included in both the numerator and denominator of the equation. Somewhat surprisingly, the provision remained dormant until mid-2011, when the IRS first utilized its new power in a series of private letter rulings issued in the second half of 2011. These rulings are analyzed below.

5 April 7, 2006.

6 P.L. 110-289.

Private Letter Rulings Interpreting Code Section 856(c)(5)(J)

1. **Private Letter Ruling 201122016.** In PLR 201122016, real property owned by a REIT was taken by State under eminent domain. State paid an “Initial Amount” to the REIT for the taking and the REIT filed a claim for additional compensation. Later, a state court granted the REIT’s claim and awarded an “Additional Amount” of compensation plus interest, attorney fees and costs. The REIT requested rulings from the IRS concerning the affect of its claim for the Additional Amount (with interest, attorney fees and costs) on its asset and income tests.

   The IRS found that the REIT’s claim for compensation was not specifically described in the REIT asset tests set forth in the Code or Regulations. Nevertheless, the IRS ruled that the claim would be ignored for purposes of determining whether the REIT satisfied the REIT asset test under Code Section 856(c)(4). The IRS further ruled under Code Section 856(c)(5)(J) that the interest and costs derived by the REIT from the claim also would be ignored in determining whether the REIT satisfied the 75% and 95% gross income tests.

   The conclusion regarding interest and costs falls precisely within the purposes and scope of Code Section 856(c)(5)(J). With the enactment of Code Section 856(c)(5)(J), the IRS obtained power and discretion to exclude the income at issue without the need to resort to statutory gymnastics. The conclusion to exclude the claim from the REIT asset test, however, is somewhat surprising. It is clear that Code Section 856(c)(5)(J) grants the IRS discretion to exclude non-listed items of income from the income tests. However, this authority does not stretch to the REIT asset test. While the conclusion to exclude the claim from the asset test is defendable on policy grounds, there was no statutory basis for this conclusion. Rather, the IRS would have been more justified in concluding that the claim itself was a real estate asset as had been done in the past.

2. **Private Letter Ruling 201123003.** In PLR 201123003, a REIT owned timberland and real estate in a foreign country. The REIT, through its subsidiary, participated in a carbon emissions program run by the foreign government. Under the program, the foreign government allocates “Carbon Emission Units” (each of which represents one ton of carbon dioxide removed from the atmosphere) to certain forest

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8 June 3, 2011.

9 *Cf.* P.L.R. 200916014 (April 17, 2009) (ruling that a REIT’s claim for state tax credits generated from the rehabilitation of real property would be excluded from the REIT’s assets for purposes of determining compliance with the REIT asset test).

10 *Cf.* P.L.R. 200813009 (March 28, 2008) (ruling that real estate intangibles that were “inextricably linked” to the underlying real estate assets were themselves real estate assets); PLR 201123003 (June 10, 2011) (discussed infra). Arguably, the intangible claim also was “inextricably linked” with the real property taken via eminent domain and so should have been treated as a real estate asset for the same reason.

11 June 10, 2011.
owners to account for the carbon captured by their forests. Under the program, each time a forest owner harvests trees it must either replant a sufficient number of trees or surrender an adequate number of units. Thus, the program effectively imposes land use restrictions on the forest owner and the units serve as compensation for such restrictions. Forest owners that hold units may use them in future compliance periods or sell them. Allocated units are issued to forest owners at no cost. The REIT requested guidance as to the affect of the units on its asset and income tests.

Regarding the asset test, the IRS found that to qualify as a real estate asset, “any asset other than the physical real estate itself must be inextricably tied or connected to the real estate” to fall within the definition. In this case, the IRS ruled that the units were “inextricably linked to the specific stands of growing trees that sequester carbon dioxide” and accordingly that the units qualified as real estate assets.

Regarding the income test, the IRS ruled that receipt of the units from the foreign government was qualifying income for the REIT under Code Section 856(c)(5)(J). The IRS reasoned that this was an “appropriate case” to invoke the authority granted in Code Section 856(c)(5)(J) “because of the relationship of the income to REIT qualifying assets.” The IRS found that the income derived by the REIT from allocation of the units was “inextricably linked to the underlying timberland and standing timber thereon, which are qualifying REIT assets” and therefore that treating the income as qualifying income under Code Section 856(c)(5)(J) was “consistent with the purposes of the REIT provisions.”

PLR 201123003 provides useful insights into the situations in which the IRS might be expected to apply Code Section 856(c)(5)(J). Specifically, the IRS stated that Code Section 856(c)(5)(J) should apply because the income derived by the REIT from receipt of the units was “inextricably linked” to the REIT’s ownership of the underlying timberland, which was a qualifying REIT asset.

3. **Private Letter Ruling 201123005**. PLR 201123005 also addresses carbon credits but under different facts. In the ruling, a REIT owned timberlands through a subsidiary. Unrelated “Company” developed a “Program” pursuant to which forest owners agreed to manage their existing forests and maintain trees in the forests over a set term of years. Company in turn sold the right to take credit for the carbon sequestered by the forest over this term to customers who desired to offset their carbon footprints. The Program was purely contractual and participation was voluntary.

The facts of the ruling indicate that the Company agreed to purchase from the REIT certain carbon dioxide offset credits from a defined portion of the REIT’s timberland. The amount paid to the REIT was based on the total amount of carbon that could be sequestered from the standing timber on the designated timberland. The ruling noted that the credits were not granted by any governmental authority; rather, they were simply a measure of the carbon absorption capability of the trees. By selling the credits,

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12 June 10, 2011.
the REIT became obligated to use sustainable forest management, which included harvesting timber, thinning, clearing, or reducing the volume of the carbon or timber in the designated timberland. However, if the volume of carbon or timber in the designated timberland was reduced other than for forest management issues, the REIT was obligated to substitute a different portion of the forest or be subject to sanctions, including decertification of existing credits (which would require remitting payment back to the Company). The REIT requested a ruling concerning whether income from the sale of the credits qualified for purposes of the 75% and 95% gross income tests.

The IRS noted that the income derived by the REIT from selling credits did not fit squarely within any of the qualifying income categories. Nevertheless, the IRS found this to be an “appropriate case to invoke the authority granted in § 856(c)(5)(J).” According to the IRS, such treatment was appropriate because the income derived by the REIT was “inextricably linked to the underlying timberland and standing timber thereon.”

As in PLR 201123003, the IRS was willing to invoke Code Section 856(c)(5)(J) in a situation where the income at issue was found to be “inextricably linked” to the underlying real estate assets. However, a key difference between PLR 201123003 and PLR 201123005 is that in the former ruling, the REIT realized income upon receiving credits from the foreign government as part of a mandatory carbon reduction program, whereas in the latter ruling the REIT realized income from voluntarily issuing credits and selling them to the Company under a purely contractual arrangement. In both situations, however, receipt of the credits or cash served to compensate the REIT for land-use restrictions (whether mandatory or contractual) placed on the REIT’s timberland. Together, the rulings indicate that where a REIT owns a qualifying real estate asset and voluntarily or involuntarily agrees to limit its right of use (i.e., land use restrictions) of such asset in exchange for compensation, if not otherwise listed under the 75% or 95% gross income tests, the compensation should be qualifying income per Code Section 856(c)(5)(J).

4. Private Letter Ruling 201137004. In PLR 201137004, a REIT, through a wholly-owned subsidiary taxed as a partnership for federal tax purposes (“Subsidiary”), owned and leased commercial real estate located in the United States. Subsidiary, through a disregarded entity, borrowed funds from an unrelated party (the “Loan”). The Loan bore both fixed-rate and variable-rate interest and was used to acquire or carry real estate assets. The REIT desired to manage risk associated with the fixed interest portion of the Loan, and so entered into an interest rate swap agreement with a counterparty (the “Swap”). Under the Swap, the REIT agreed to pay floating rate interest to the counterparty and the counterparty agreed to pay fixed rate interest to the REIT, each based on the same notional principal amount. The REIT identified the Swap as a hedge on the date it entered into the agreement, contemporaneously identified the related transaction and risk being hedged, and represented that it entered into the Swap in the normal course of its trade or business to manage the risk of interest rate fluctuations with

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13 September 16, 2011.
The IRS began its analysis by restating the general qualifying income rules for REITs and the exceptions for income from hedging transactions. Generally, Code Section 856(c)(5)(G) provides that income of a REIT from a “hedging transaction” (as defined in Code Section 1221(b)(2)(A)(ii) or (iii)) that is clearly identified does not constitute gross income for purposes of the 75% or 95% gross income tests to the extent that the transaction hedges indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets. Under Code Section 1221(b)(2)(A)(ii), a “hedging transaction” includes any transaction entered into by the taxpayer in the normal course of trade or business primarily to manage the risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer. The IRS also referenced Code Section 856(c)(5)(J)(i) in its statement of legal authority.

After reciting the applicable law, the IRS found that the Swap income did not fall within any of the specific categories in the 75% or 95% gross income tests. The IRS also ruled that the Swap did not meet the definition of a hedging transaction because it was not entered into by the REIT with respect to debt incurred by the REIT but rather with respect to debt incurred by a different taxpayer – i.e., the Subsidiary. Nevertheless, the IRS looked to Treasury Regulation Section 1.856-3(g) for guidance.

Treasury Regulation Section 1.856-3(g) provides that for purposes of the REIT rules, a REIT that is a partner in a partnership is deemed to own its proportionate share of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share. Based on this rule, the IRS ruled that solely for purposes of the 75% and 95% gross income tests, the determination of whether the Swap constituted a hedging transaction had to take into account Treasury Regulation Section 1.856-3(g), which would treat the REIT as owning its proportionate share of the assets and earning its proportionate share of the income of the Subsidiary. Of key importance, the IRS ruled that although the Loan was a liability rather than an asset of the Subsidiary, it was consistent with the purposes of the REIT rules “to attribute to Taxpayer the liability for its proportionate share of the Loan for purposes of section 856(c)(2) and (3).” Based on this conclusion, the IRS ruled that the Swap income was excluded from the REIT’s gross income for purposes of the 75% and 95% gross income tests.

Although the IRS referenced Code Section 856(c)(5)(J)(i) in its statement of law, it did not rely on this provision for its ultimate conclusion to exclude the Swap income. Rather, the conclusion rests on a finding that, under Treasury Regulation Section 1.856-3(g), the Swap in fact qualified as a hedging transaction, but only for purposes of the 75% and 95% gross income tests. It is difficult to understand why the IRS rested its conclusion on a finding that Treasury Regulation Section 1.856-3(g) – which applies only to assets and income of REIT subsidiary partnerships – should be extended to liabilities of the Subsidiary. Perhaps this conclusion could be justified prior to the enactment of Code Section 856(c)(5)(J) as a means to a logical end. But following the enactment of
Code Section 856(c)(5)(J), which clearly empowers the IRS to exclude non-listed sources of income from the gross income tests, the IRS should have tied its conclusion to such section rather than relying on a convoluted interpretation of Treasury Regulation Section 1.856-3(g). The reason for such failure is not apparent and is particularly troubling in light of the fact that the IRS specifically referenced Code Section 856(c)(5)(J)(i) in its statement of law.

5. Private Letter Ruling 201145008. In PLR 201145008, a REIT (through a subsidiary partnership) purchased a participation interest in a mezzanine loan from a Bank. The REIT represented that its interest in the loan constituted a qualifying real estate asset. The issuer of the loan filed for Chapter 11 bankruptcy protection, and the REIT filed a lawsuit against the Bank alleging that at the time the REIT purchased the participation interest, the Bank either knew or should have known that the loan was in default or that events which could lead to its default existed. The claim asserted breach of contract by the Bank. The parties settled and the Bank made a cash payment to the REIT in satisfaction of all claims. The issue was whether the settlement payment counted against the REIT’s 75% and 95% gross income tests.

The IRS found that the settlement payment constituted gross income that did not specifically qualify under either the 75% or 95% gross income tests. Nevertheless, pursuant to Code Section 856(c)(5)(J)(i), the IRS ruled that the settlement payment would be excluded from the REIT’s gross income for purposes of such tests. Notably, the IRS was silent about whether the settlement payment was “inextricably linked” to real estate assets of the REIT.

Conclusion

Code Section 856(c)(5)(J) is a new and powerful tool that must be considered by REITs faced with novel sources of income not specifically enumerated under the 75% and 95% gross income tests. The recent flurry of Private Letter Rulings addressing Code Section 856(c)(5)(J) indicates that the IRS is more than willing to consider non-listed sources of income and in many cases will issue favorable rulings. Where the questionable income is “inextricably linked” to “real estate assets” held by the REIT, the IRS appears inclined to include the income in both the numerator and denominator of the formula. Where such income is not inextricably linked to real estate assets, the IRS appears more inclined to exclude the income for purposes of the 75% and 95% gross income tests.

In most cases, REITs will prefer for an item of gross income to be included in the gross income tests instead of being excluded entirely. Consider the following example: Timber-REIT has $130 of gross income for the year from the following sources: $94 of gain from the sale of timber, $6 from selling bio-diesel made from excess wood pulp (non-qualifying income), and $30 of income from the sale of carbon offset credits. If the carbon credits are excluded from the gross income tests, then Timber-REIT fails the 95%

14 November 10, 2011.
test because only 94% of its gross income qualifies ($94/$100). But if the carbon credits are included in the 95% test, then Timber-REIT will have 95.4% qualifying income ($124/$130). Thus, REITs seeking rulings on questionable sources of income should take measures to tie the income as closely as possible to qualifying real estate assets in an effort to ensure that the income is “inextricably linked” to such property. If the IRS agrees, the IRS will be more willing to include the income for both the 75% and 95% gross income tests, which generally will be to the REIT’s advantage.