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REITs: Overview

by Mitchell Snow and Jonathan Hagler, Adler & Stachenfeld LLP, with Practical Law Corporate & Securities

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This Note provides an overview of the US federal income tax requirements that must be satisfied to achieve real estate investment trust (REIT) status. It also discusses the different types of REITs, typical tax structures for REIT investments, the benefits of REIT status, the use of taxable REIT subsidiaries, REIT spin-offs, transfers and mergers, withholding tax issues for REITs, and the taxation of foreign investors in REITs.

This Note provides a summary of the US federal income tax requirements that must be satisfied to achieve real estate investment trust (REIT) status, typical tax structures for REIT investments, and the tax treatment of REITs engaging in various transactions. While many states follow the US federal income tax treatment of REITs, a discussion of the state or foreign taxation of a REIT is beyond the scope of this Note.

For a checklist that provides a list of common pitfalls that can arise with REITs and how they can be fixed, see REITs: Common Pitfalls and Fixes Checklist.

What is a REIT?

A REIT is an entity that satisfies certain US federal income tax requirements and elects to be taxed as a REIT. The tax requirements generally are designed to ensure that the REIT:

- Is treated as a passive investor in real estate (and related assets).
- Does not retain its earnings.
- Is beneficially owned by a diversified shareholder base.

State Law Entity Classification

There is generally no limit on the type of state law entity that can qualify as a REIT. While most REITs are formed as trusts or corporations, there may be state or foreign tax planning reasons to form a REIT as a partnership, an LLC, or a Delaware Statutory Trust. However, a REIT must be a US entity. In addition, a REIT is treated as a corporation for tax purposes, regardless of its state law form (Taxable as a US Corporation).

For more information about US business entities, see Choosing an Entity Comparison Chart and Practice Note, Choice of Entity: Tax Issues.

Public or Private REITs

A REIT can be publicly traded or privately held as long as it satisfies restrictions on ultimate beneficial ownership (Not More Than 50% Owned by Five or Fewer Individuals) and is directly held by at least 100 investors (Beneficially Owned by 100 or More Persons). A REIT can also issue common equity, preferred equity, and debt instruments. It should be noted that if a REIT issues multiple classes of debt, there may be unfavorable tax consequences to the REIT or its shareholders, similar to the tax consequences to the holder of a residual interest in a real estate mortgage investment conduit (REMIC) (see also REIT TMP and FIRPTA Issues below).

Types of REITs

A REIT can invest in different types of real estate assets or limit its investment activities to a particular class of permitted real estate investment. It can be:

- An equity REIT owning direct or indirect equity interests in real estate (including retail, commercial, residential, and industrial real estate).
- A mortgage REIT investing in debt instruments secured by real estate.

- A hybrid REIT owning any combination of permitted debt and equity investments.
- A REIT that invests exclusively or primarily in a particular class of property (sometimes referred to as a "sector REIT"). For example, a health care REIT generally invests only in properties leased for use as medical facilities or nursing homes (Box, Hotel and Health Care REITs).

As discussed further below, one key exception to the type of real estate activities a REIT can engage in is the limitation on a REIT's ability to earn income from so-called dealer activities, like the development and sale of condominiums (Prohibited Transaction Income).

Benefits of REIT Status

The benefits of REIT status include:

- No entity level tax even for publicly traded REITs.
- The ability to attract tax-exempt and foreign investors with favorable tax treatment.
- A reduced tax rate for qualified REIT dividends.

No Entity Level Tax Even for Publicly Traded REITs

A C-corporation is taxed on its net income without a reduced tax rate for capital gains. A REIT is a type of pass-through entity that can eliminate its taxable income because, unlike most other corporations, it deducts the amount of any dividends it paid when calculating its taxable income. This exemption from an entity level tax is the primary reason that a publicly traded entity desires to qualify as a REIT. Publicly traded entities that are not REITs are generally taxed at the entity level, though there are exceptions (see Practice Notes, Choice of Entity: Tax Issues and Taxation of Publicly Traded Partnerships).

Unlike a C-corporation, a REIT can use the following methods to deal with its capital gain income:

- A REIT can designate dividends it distributes as capital gain dividends to the extent that it has capital gains. This allows individual US shareholders to pay tax on that capital gain dividend at a preferential rate (maximum rate of 20% for dividends that qualify for long-term capital gains treatment plus applicable Medicare tax).
- A REIT can elect to pass through to its shareholders all or a portion of its undistributed capital gains. The REIT pays taxes on the capital gains and each shareholder pays tax on its allocable share of the capital gains at its respective rate. The shareholders receive a credit for their share of taxes deemed paid by the REIT, and may receive a tax refund if the amount deemed paid is greater than the amount such shareholder is required to pay on its share of the capital gain. Therefore, the effective net rate paid by the REIT and each of its shareholders is that shareholder's tax rate (for example, 0% for a tax-exempt shareholder). The shareholder would then increase its basis in the REIT shares accordingly.

If a REIT is selling assets, the second method enables the REIT to keep the after-tax proceeds resulting from a sale. A 4% excise tax is imposed on REITs that do not distribute sufficient amounts of income (4% Excise Tax on Certain Undistributed Income). However, this excise tax is not imposed on the capital gains dealt with by any of these methods as long as an actual distribution is made by January of the following year.

A REIT, particularly a private REIT, that lacks cash, may be able to meet the 90% distribution requirement by means of consent dividends, where, pursuant to shareholder agreement, dividends would effectively be deemed paid on the last day of the calendar year and then contributed back to the REIT pro rata (IRC § 565(c)).

Unlike other pass-through entities (for example, a partnership or S-corporation), a REIT cannot pass losses through to its shareholders. In addition, dividends paid by a REIT are generally not eligible for the lower rates for qualifying dividend income paid by a US corporation (maximum rate of 20% for individual shareholders and effectively 10.5% for corporate shareholders after the corporate dividends received deduction). An additional 3.8% tax applies to "net investment income" (which includes dividends and gains) earned by high income individuals. A real estate professional with the option to invest in a partnership below a REIT may want to consider investing in that partnership, as in certain circumstances, the 3.8% tax may not apply. As discussed below, certain REIT dividends qualify for reduced tax rates.

Dividends received from foreign corporations generally are not eligible for the corporate dividends received deduction. IRC Section 245, however, allows this deduction for the portion of a dividend received by corporations from qualified 10% owned foreign corporations that is attributable to the post-1986 undistributed US earnings of the foreign corporation. Post-1986 undistributed US earnings means the portion of the post-1986 undistributed earnings attributable to

(1) income of the qualified 10% owned foreign corporation which is effectively connected with the conduct of a trade or business within the US and subject to tax or (2) any dividend received from a domestic corporation in which at least 80% is owned by the qualified 10% owned foreign corporation. However, the Protecting Americans from Tax Hikes Act of 2015 (PATH Act) clarified that dividends received from REITs are ineligible for this deduction.

IRC Section 245A, enacted as part of the Tax Cuts & Jobs Act (TCJA), generally allows US corporations a 100% deduction for the foreign source portion of dividends received from a foreign corporation in which the US corporation owns a 10% interest. However, this deduction is not available for REITs.

For more information about the taxation of dividends paid by a corporation that is not a REIT, see Practice Notes, US Equity Offerings in the US: Tax Consequences for Investors and Foreign Equity Offerings in the US: Tax Consequences for Investors.

Ability to Attract Tax-Exempt and Foreign Investors

Other benefits of REIT status, as compared to owning real estate in an entity that is a pass-through entity for tax purposes (for example, an entity treated as a partnership for tax purposes), include the ability for:

- Tax-exempt investors to invest in leveraged real estate without incurring tax on unrelated trade or business income (UBTI). However, there are particular REIT rules for pension-held REITs (a REIT in which either a pension fund owns more than 25% of the REIT or one or more pension funds, each of which owns more than 10% of the REIT, hold in the aggregate more than 50% of the REIT) which may cause dividends to be treated as UBTI for pension plan investors.
- Foreign investors (including sovereign wealth funds) to invest in US real estate without having to pay a tax on the sale of the indirect interests in the real estate in certain circumstances, and, with respect to certain "qualified" foreign pension funds, the sale of direct interests in real estate held by a REIT without having to pay such tax (REIT TMP and FIRPTA Issues and Box, Foreign Income Guidance for REITs).

One potential negative consequence of electing REIT status is the need to distribute cash (or possibly issue dilutive stock) to comply with the annual REIT distribution requirements (REIT Distribution Requirements). This could prevent the REIT from accumulating cash that could otherwise be used to make future acquisitions or capital improvements to properties it already owns.

A Reduced Tax Rate for Qualified REIT Dividends

Qualified REIT dividends (meaning, REIT dividends, other than capital gain dividends and portions of REIT dividends designated as qualified dividend income eligible for capital gain tax rates) and certain other income items are eligible for a 20% deduction for individuals under the TCJA. The deduction, if allowed in full, results in a maximum 29.6% tax rate on REIT dividends. The deductions are effective beginning in 2018, and without further legislation, sunset after 2025.

Organizational Requirements for REITs

A REIT must:

- Be managed by trustees or directors (Managed by Trustees or Directors). If properly structured, a US limited partnership may be used, and is, in fact, preferred, for certain state and foreign treaty reasons.
- Be beneficially owned by 100 or more persons (Beneficially Owned by 100 or More Persons).
- Issue transferable shares or certificates (Transferable Shares or Certificates).
- Be taxable as a US corporation (Taxable as a US Corporation).
- Not be a bank or insurance company (Not a Bank or Insurance Company).
- Not be more than 50% owned by five or fewer individuals (Not More Than 50% Owned by Five or Fewer Individuals).

(IRC § 856(a)).

Managed by Trustees or Directors

One or more trustees or directors must manage the REIT. This requirement must be satisfied at all times during every REIT taxable year. However, as long as a REIT is formed as a state law trust, corporation or LLC, this requirement is not usually difficult to meet (although the organizational documents must be carefully drafted to ensure the entity is not impermissibly "member" or "shareholder" managed).

Beneficially Owned by 100 or More Persons

One hundred or more persons must own a REIT. However, this requirement does not apply until after the first taxable year for which a REIT election is made. After the first taxable year, it generally must be met during at least 335 days of each taxable year. For example, an entity that elects to be taxed as a REIT beginning in 2023 satisfies this requirement if it has 100 or more shareholders at all times on and after January 31, 2024.

Ownership for purposes of this requirement is based on actual ownership, without any attribution rules. Generally, this requirement is not an issue for publicly traded REITs. Private REITs often engage facilitators to locate 125 investors (the extra 25 investors are to ensure qualification at all times) that each purchase $1,000 of REIT stock. The stock sold to these private investors is often a special class of non-voting preferred stock issued under an offering memorandum:

- With an aggregate liquidation preference of $125,000.
- Which earns a fixed return payable semi-annually (generally in the 10% to 12% range).

In many cases, the distribution provisions in the designation of the non-voting preferred stock allows for common dividends to be paid if the preferred is current to the last dividend payment date. Occasionally, the owner of the common stock in a private placement also purchases sufficient shares of the non-voting preferred stock to make certain it owns 80% of each class of outstanding stock (this may allow the shareholder to contribute appreciated assets to the REIT in a tax-free transaction in the future). Depending upon the circumstances, certain shareholders contributing assets may prefer not to have a tax-free transaction.

A REIT's organizational documents almost always contain provisions restricting transfers of stock that would result in a violation of this ownership requirement.

Transferable Shares or Certificates

The REIT must issue transferable shares or transferable certificates to evidence its beneficial ownership (IRC § 856(a)(2)). This requirement must be satisfied at all times during every REIT taxable year. However, securities law restrictions, restrictions on transferability of stock issued to employees, and restrictions imposed by shareholder level agreements generally should not result in a violation of this requirement.

Taxable as a US Corporation

The REIT must be taxable as a US corporation. This requirement must be satisfied at all times during every REIT taxable year. If the REIT is formed as a state law entity other than a corporation, this requirement is satisfied if the entity files its US federal income tax return for its first year as a REIT on an IRS Form 1120-REIT. The entity does not need to separately file a "check the box" election to be treated as a corporation for tax purposes, but there may be circumstances in which the REIT prefers to make a check the box election for a specific date. For more information about check the box elections, see Practice Note, Choice of Entity: Tax Issues.

Not a Bank or Insurance Company

The REIT must not be a financial institution or an insurance company within the meaning of IRC Section 816. This requirement must be satisfied at all times during every REIT taxable year. It is unusual for this requirement to be an issue for REITs.

Not More Than 50% Owned by Five or Fewer Individuals

Not more than 50% in value of the REIT's outstanding stock may be owned actually or constructively by five or fewer individuals or certain specified entities (known as the closely held test). This requirement does not apply until after the REIT's first taxable year and thereafter generally must be satisfied during the last half of each taxable year. This requirement does not restrict ownership of a REIT by publicly traded, widely held corporations because there generally are not five or fewer individuals or other specified entities who beneficially own more than 50% of the REIT's stock (treating the shareholders of the publicly traded corporation as if they owned the REIT stock held by the publicly traded corporation). The determination of more than 50% ownership is based on the value of the stock. "Individuals" is specifically defined for this purpose and could include certain tax-exempt entities.

If a REIT complies with applicable rules that require it to determine the actual ownership of its stock and the REIT does not know, or would not have known through the exercise of reasonable diligence, that it failed to meet the limitation on ownership by five or fewer individuals, the REIT is treated as having met this requirement. To comply with these rules, the REIT must demand annual written statements from the record holders of significant percentages of its capital stock asking them to disclose the shares' beneficial owners (meaning, the persons required to include in gross income the dividends paid by the REIT). Failure by the REIT to comply with these record keeping requirements could subject the REIT to monetary penalties.

A REIT's organizational documents generally provide for restrictions regarding ownership and transfer of REIT shares to assist the REIT in continuing to satisfy these ownership requirements. These provisions often provide that transfers that result in ownership above a defined percentage (known as the ownership limit) of the REIT's stock will be null and void, and that any dividends paid to a shareholder holding shares in violation of the restrictions are deemed held on behalf of a named charity. The ownership limit may be determined by class of stock or by value of all classes of stock held by a particular holder. Because the ownership limit is generally defined by beneficial or constructive ownership (meaning, "looking through" a corporation or partnership to determine whether any individual owns economic interests in the REIT shares by virtue of their ownership interest in the corporation or partnership), a transfer of the interests in an entity that is an indirect owner of the REIT can trigger a violation of the ownership limit. It is important to note that although recognized by the IRS, these restrictions are contractual and not statutory.

The ownership limit provisions in the organizational documents often restrict ownership beyond what is required for the REIT to maintain its REIT status. A common limitation restricts ownership in the REIT by a shareholder to 9.8% of the REIT. The REIT uses these provisions to monitor its ownership. The organizational documents generally permit the REIT to waive the ownership limit if it determines that an acquisition will not result in a violation of the REIT rules. In connection with the waiver, the REIT often requires the potential purchaser to make various representations regarding its ownership of the REIT stock and the concentration of the ownership in the purchaser. Points that are often negotiated for this waiver letter include:

- How often must the purchaser update the representations.
- What actions the purchaser must take to confirm the continued accuracy of the representations.

In the context of a private REIT (particularly one with significant institutional or publicly traded investors), there is often negotiation regarding the contractual provisions limiting indirect transfers of interests in the REIT, and the impact of those restrictions on REIT qualification should be considered.

REIT Income Tests

A REIT must annually satisfy two income tests:

- 75% gross income test (75% Gross Income Test: Must Be Real Estate Related).
- 95% gross income test (95% Gross Income Test: Must Be Passive Income).

75% Gross Income Test: Must Be Real Estate Related

75% of the REIT's annual gross income must be real estate related (known as the 75% gross income test) (IRC § 856(c)(3)). For purposes of this test, six primary categories of income items generally are treated as real estate related:

- Rents from real property (Rents from Real Property).
- Real property gains (Real Property Gains).
- Dividends and gains from other REITs (Dividends and Gains from Other REITs).
- Interest on real estate secured obligations (Real Estate-Related Interest).
- Income from foreclosure property (Income from Foreclosure Property).
- Income from temporary investments (Income from Temporary Investments).

Rents from Real Property

The first category of qualifying income is rents from real property. For many REITs, this is the primary source of qualifying income. To qualify, the amount of rent must not be based in any way on the income or profits of any person, but may be based on a fixed percentage or percentages of receipts or sales from the leased property.

The rents also must not be "related party rents." Related party rents are rents received from a tenant if an actual or constructive owner of 10% or more of a REIT's capital stock actually or constructively owns 10% or more of the interests in the tenant (IRC § 856(d)(2)(B) and § 856(d)(5)). Ownership is measured by capital or profits interest in the tenant if the tenant is a partnership or LLC, or by voting power or value of all classes of stock if the tenant is a corporation.

However, rent received from a taxable REIT subsidiary (TRS) is not treated as related party rent if at least 90% of the leased space at the property is leased to third parties and the rents paid by the TRS are substantially comparable to rents paid by the REIT's other tenants for comparable space (IRC § 856(d)(8)(A)(i)). There is an additional exception to the related party rent prohibition for hotel and health care REITs (IRC § 856(d)(8)(B)). A TRS includes a corporation other than a REIT that is:

- A direct or indirect subsidiary of a REIT and that has made a joint election with the REIT to be treated as a TRS.
- A subsidiary of a TRS if the TRS owns securities possessing more than 35% of the total voting power or value of the outstanding securities of that corporation.

Whether rents paid by a TRS are substantially comparable to rents paid by other tenants is determined anew each time the lease with the TRS is entered into, extended, or modified (if a modification increases the rents due under the lease). For more information about TRSs, see Use of Qualified REIT Subsidiaries and Taxable REIT Subsidiaries.

If a lease with a controlled TRS (CTRS) is modified during the term of the lease and the modification increases the rents payable by the CTRS, the amount of this increase does not qualify as rents from real property. For purposes of this rule, a CTRS is a TRS in which a REIT owns stock possessing more than 50% of the voting power or more than 50% of the total value of the outstanding stock of the CTRS (IRC § 856(d)(8)(A)(iv)).

It can be helpful to provide significant investors in a REIT with a list of the tenants at the property whose rent exceeds more than 5% of the gross income of the REIT and would impact REIT status if those rents were treated as related party rents. This issue is often discussed in the context of a non-publicly traded entity that owns a single property or a small portfolio of properties and is electing REIT status to accommodate either foreign or tax-exempt investors.

Rent attributable to personal property leased in connection with a lease of real property is treated as rent from real property if the amount of rent attributable to the personal property is not greater than 15% of the total rent received under the lease. Rent is allocated between a REIT's real property and personal property based on the relative fair market values of the properties. If this condition is not met, the portion of the rent attributable to personal property does not qualify as rents from real property.

For rent received from REIT tenants to constitute qualifying income for purposes of the REIT income tests, there are limits on the types of services that the REIT can provide to its tenants. A REIT can only perform services that are usually or customarily rendered in connection with the rental of space for occupancy. Examples of permitted services include the provision of light, heat, or other utilities, trash removal, and general maintenance of common areas. In addition, a REIT may employ an independent contractor (from whom the REIT derives no revenue, among several other requirements) or a TRS, which may be wholly or partially owned, to provide both customary and certain non-customary services to a REIT's tenants and still have the rent received from those tenants be treated as qualifying income for purposes of the REIT income tests. Often, as a matter of best practices, tax advisors will have REITs or property managers complete a comprehensive questionnaire about activities at the property to verify compliance with the REIT rules. The IRS has issued multiple rulings addressing the types of services that REITs can perform directly without using an independent contractor or a TRS.

Real Property Gains

The second category of qualifying income is gain from the sale or other disposition of real property (unless held as inventory).

Dividends and Gains from Other REITs

The third category of qualifying income is dividends and other distributions on, and gain from the sale or other disposition of, transferable units or certificates of beneficial ownership in other REITs.

Real Estate-Related Interest

The fourth category of qualifying income is interest on obligations secured by mortgages on real property or on interests in real property (including certain qualified mezzanine financings indirectly secured by interests in real property). For this purpose, interest generally does not include any amount received or accrued, directly or indirectly, if the determination of all or some of the amount depends in any way on the income or profits of any person. However, an amount of interest received or accrued generally is not excluded from the term interest solely because it is based on a fixed percentage or percentages of receipts or sales from the mortgaged property.

Income from Foreclosure Property

The fifth category of qualifying income is income and gain derived from foreclosure property. Foreclosure property is defined as any real property (along with incidental personal property), acquired by a REIT through foreclosure or similar process after a default (or if default is imminent) on a lease of such property or on an indebtedness which such property secured (IRC § 856(e)(1), Treas. Reg. § 1.856-6). A REIT must make an election to treat property as foreclosure property, and the election is effective until the end of the third taxable year following the year of acquisition. The effect of this election is that income from the sale of such property is subject to 21% corporate tax rates, even if the income would otherwise be dealer income subject to a 100% tax. Operating income from the foreclosure property is also subject to the 21% corporate tax.

Income from Temporary Investments

The sixth category of qualifying income is income from certain types of temporary investments. This provision recognizes the practical difficulties of identifying and purchasing real estate immediately after the receipt of new capital. Therefore, it allows a REIT to receive qualifying income from stock or debt instruments attributable to the temporary investment of new capital for one year from the date the REIT receives the capital.

95% Gross Income Test: Must Be Passive Income

95% of the REIT's annual gross income must be passive income (known as the 95% gross income test) (IRC § 856(c)(2)). Passive income for purposes of the 95% gross income test generally includes the categories of income items treated as real estate related (75% Gross Income Test: Must Be Real Estate Related) plus two additional primary sources of income:

- Dividends (IRC § 856(c)(2)(A)).
- Interest that would otherwise qualify under the 75% gross income test except that it is not secured by real estate (IRC § 856(c)(2)(B)).

Special Rules that Apply to REIT Income Tests

In applying the 75% and 95% gross income tests, a REIT is treated as directly earning the income of a qualified REIT subsidiary (QRS) and its proportionate share of the income of an entity treated as a partnership for tax purposes. Each item of gross income retains the same character in the hands of the REIT as it has when earned by the QRS or partnership. A QRS is a wholly-owned corporate subsidiary that is not a TRS, and is treated as a disregarded division of the REIT for tax purposes. For more information about QRSs, see Use of Qualified REIT Subsidiaries and Taxable REIT Subsidiaries. For more information about entities treated as partnerships for tax purposes, see Special Rules for REITs Owning Partnership and LLC Interests.

Hedging Transaction Income Exempt from REIT Income Tests

REITs often enter into hedging transactions. A qualifying hedging transaction generally is any transaction that a REIT enters into in the normal course of its business primarily to manage risk of either:

- Interest rate changes or fluctuations with respect to borrowings made or to be made to acquire or carry real estate assets.
- Currency fluctuations with respect to an item of qualifying income under the 75% or 95% gross income test.

A REIT's qualifying hedging activities can include entering into interest rate swaps, caps, floors, options to purchase these items, and futures and forward contracts. Income from a hedging transaction (including gain from the sale or disposition of a hedge that is clearly identified as a hedging transaction) is not treated as gross income and is exempt from the 75% and 95% gross income tests (IRC § 856(c)(5)(G)).

Additionally, if a REIT enters into a qualifying hedging transaction but extinguishes the underlying indebtedness or disposes of the underlying property, the REIT can enter into a hedge thereof and income from this subsequent hedging transaction will also be disregarded for purposes of the gross income tests.

The hedge must be properly identified on the day it is entered into. It is important to note that IRC Section 856(c)(5)(G)(iv) clarifies that a REIT may take into account any curative provisions provided under the regulations, and, in light of those clarifications, REITs should consider a global hedging policy. If a REIT does not properly identify a transaction as a hedge, the income from the hedging transactions will be treated as non-qualifying income for purposes of the 75% and 95% gross income tests.

Special Categories of Income for REIT Income Tests

There are special rules for the following five categories of income:

- Prohibited transaction income (Prohibited Transaction Income).

- Cancellation of indebtedness income (CODI).
- Certain fee income (Certain Fee Income).
- Foreign currency gain or loss (Foreign Currency Gain or Loss).
- Income from certain 10% owned foreign corporations and passive foreign investment companies (PFICs) (Certain Foreign Income).

Prohibited Transaction Income

Any gain that a REIT realizes (including any net foreign currency gain recognized after July 30, 2008) on the sale of property held as inventory or otherwise held primarily for sale to customers in the ordinary course of the REIT's business (including a REIT's share of any gain realized directly or indirectly by a REIT's operating partnership) is treated as income from a prohibited transaction and subject to a 100% penalty tax (IRC § 857(b)(6)(A)) unless certain safe harbor exceptions apply. Whether property is held as inventory or primarily for sale to customers in the ordinary course of the REIT's trade or business depends on all the facts and circumstances surrounding the particular transaction.

One of the more useful safe harbor exemptions is for limited sales of property held for at least two years and meeting certain additional requirements (IRC § 857(b)(6)(C)). An additional exception exists for property that is foreclosure property. A REIT recognizes income on net income from foreclosure property (defined in IRC § 857(b)(4)(B)) at the highest corporate tax rate only to the extent that it is not classified as qualifying income for the purposes of the 75% gross income test.

CODI

If a REIT owns distressed property and negotiates a reduction in the amount of debt securing the property, the REIT generally is required to recognize CODI. CODI is ignored for purposes of the 75% and 95% gross income tests (IRC § 108(e)(9)). It also will not cause a REIT to fail the 90% distribution requirement (IRC § 857(e) and REIT Distribution Requirements). However, if the REIT does not distribute an amount equal to the CODI, it will have to pay tax on that income.

If a REIT modifies distressed mortgages to prevent default or purchases distressed mortgages subject to modification, Revenue Procedure 2011-16 provides a safe harbor that prevents income from the modified loan from being classified as prohibited transaction income (Prohibited Transaction Income). Because Revenue Procedure 2011-16 did not address distressed mortgages secured by property that increased in value after the mortgage was purchased, Revenue Procedure 2014-51 modifies and supersedes Revenue Procedure 2011-16 by taking into account the current value of the real property securing the mortgage debt in determining the portion of the debt treated as a real estate asset for purposes of the REIT asset test.

Certain Fee Income

In certain circumstances, a REIT can receive fees for property management, brokerage, and leasing services that it provides for properties that is does not entirely own. These fees do not qualify under the 75% or 95% gross income test for the portion of the properties not owned, directly or indirectly, by the REIT.

Foreign Currency Gain or Loss

For purposes of the 75% and 95% gross income tests, foreign currency gain is excluded if the income is attributable to:

- Real estate foreign exchange gain (in the case of the 75% and 95% gross income test).
- Passive foreign exchange gain (in the case of the 95% gross income test).

(IRC § 856(n), and Rev. Proc. 2018-48).

However, except for income from hedging transactions, foreign currency gain that results from dealing or engaging in substantial and regular trading in securities is included in the calculation of both the 75% and the 95% gross income tests as "bad" income.

Certain Foreign Income

Revenue Procedure 2018-48 describes how the IRS will treat income from controlled foreign corporations (CFCs) and PFICs for the REIT gross income tests, but not for purposes of the repatriation rule of IRC Section 965. Under the revenue procedure, income required to be included in gross income is treated as good income for purposes of the 95% gross income test of IRC Section 856(c)(2). Furthermore, foreign currency gain with respect to distributions of previously taxed earnings and profits is excluded from gross income for purposes of IRC Section 856(c)(2). Prior to the revenue procedure, there was uncertainty, and taxpayers looked to private letter rulings to ascertain the views of the IRS. Taxpayers may choose to apply the rules of the revenue procedure to prior taxable years.

REIT Asset Tests

At the close of each quarter of a REIT's taxable year, a REIT must also satisfy the following five tests relating to the nature and diversification of its assets:

- **Test one.** At least 75% of the value of a REIT's total assets must be represented by "real estate assets," cash, cash items (including receivables), and government securities (known as the 75% asset test) (IRC § 856(c)(4)). For purposes of this test, the term real estate assets generally includes:
  - real property (including interests in real property, interests in mortgages on real property, and certain qualified mezzanine financings secured by entities that own interests in real property);
  - shares (or transferable certificates of beneficial interest) in other REITs;
  - any stock or debt instrument attributable to the investment of the proceeds of a stock offering or a public offering of debt with a term of at least five years, but only for the one-year period beginning on the date the REIT receives the proceeds;
  - personal property, to the extent rents attributable to the personal property are treated as rents from real property under the 75% income test, and obligations secured by a mortgage on both real property and personal property if the personal property's fair market value does not exceed 15% of the total fair market value of such property (IRC § 856(c)(9)); and
  - debt instruments of publicly offered REITs, although these may not account for more than 25% of the tested REIT's assets by value.
- **Test two.** Not more than 25% of the value of a REIT's total assets can be represented by securities, other than securities includable in the 75% asset test (IRC § 856(c)(4)(A)).
- **Test three.** Except for investments in other REITs and a REIT's QRSs and TRSs:
  - the value of any one issuer's securities may not exceed 5% of the value of a REIT's total assets (known as the 5% asset test) (IRC § 856(c)(4)(B)(iv)(I)); and
  - a REIT may not own more than 10% of the total vote or value of the outstanding securities of any oneissuer (known as the 10% asset test) (IRC § 856(c)(4)(B)(iv)(II) and IRC § 856(c)(4)(B)(iv)(III)). For purposes of the 10% asset test, if the REIT owns a debt instrument of a partnership that would otherwise be treated as a security, such interest is disregarded to the extent the REIT owns a partnership interest in such partnership. The determination of a REIT's interest in the assets of a partnership or LLC is generally based on the REIT's proportionate interest in any such securities (defined as, among other things, any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest, or participation in a profit-sharing agreement issued by the partnership or LLC). It is important to note that the definition of securities has the same meaning as used in the Investment Company Act of 1940, as amended (IRC § 856(c)(5)(F); 15 USC § 80a-2(a)(36)).
  - **Test four.** Not more than 20% (reduced from 25%, effective on January 1, 2018) of the value of a REIT's total assets can be represented by the securities of one or more TRSs (IRC § 856(c)(4)(B)(ii)).
  - **Test five.** Not more than 25% of the value of a REIT's total assets can be represented by "nonqualified publicly offered REIT debt instruments," which is debt that would not qualify as a REIT asset if not for a specific provision allowing the instrument to so qualify.

It is important to note that the Treasury Department finalized regulations clarifying the definition of real property, which had an impact on the asset and income tests. For situations in which a structural component of a building (for example, solar equipment that supplies the needs of the building) is held in a different capacity than the building, the structural component may be owned by someone who does not own the building. This arrangement is acceptable so long as the taxpayer owning the structural component has a real property interest in the space. Under the regulations, solar equipment that is on top of a building (supplying energy to the building) may qualify as real property in the hands of a REIT (even though the REIT owner of the solar equipment does not own the building).

Special Rules that Apply to REIT Asset Tests

If a REIT meets the asset tests at the close of any quarter, it will not lose its status as a REIT for failure to satisfy one of the asset tests at the end of a later quarter solely because of relative changes in asset values. If a REIT fails to satisfy one of the asset tests because it acquires securities or other property during a quarter, the REIT can cure this failure by disposing of sufficient bad assets within 30 days after the close of that quarter.

For purposes of the asset tests, the term "securities" generally does not include:

- Any security issued by a REIT.
- Equity or debt securities of a QRS or TRS.
- Mortgage loans that are treated as real estate assets.
- Equity interests in a partnership (but could include a portion of the underlying assets).

(IRC § 856(m)).

REIT Distribution Requirements

A REIT must annually distribute dividends (other than capital gain dividends) to its shareholders 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 "excess noncash income" over 5% of its REIT taxable income without regard to the deduction for dividends paid and by excluding any net capital gain (known as the 90% distribution requirement) (IRC § 857(a)(1)).

For purposes of this requirement, excess noncash income means income attributable to:

- Leveled stepped rents. Leveled stepped rents are variable rents that have been "leveled" by IRC § 467, which prevents certain tax deferral arrangements through variable-rent leases.
- A like-kind exchange that is later determined to be taxable. For various reasons, an exchange of real estate under IRC § 1031 can later be treated as taxable by the IRS due to a failure to satisfy the requirements for tax-free treatment.
- Original issue discount and certain REMIC inclusions.
- CODI.

REIT's are taxed on their income in the same manner an ordinary C-corporation, but without the benefit of the dividends received deduction, and without adjustments due to any change in accounting period. As a general rule, a REIT may not change to any accounting period other than the calendar year (IRC § 859(a)(1)). Moreover, a corporation, trust or association may not elect to be a REIT for any taxable year beginning after October 4, 1976, unless its accounting period is the calendar year (IRC § 859(a)(2)). Therefore, it is rare for a REIT to have a non-calendar year tax year.

A REIT is subject to tax at ordinary corporate tax rates to the extent its taxable income is not distributed. For purposes of the REIT distribution requirement, REIT taxable income is computed without regard to the dividends paid deduction and the REIT's net capital gain.

A REIT generally must pay the dividends described above in the taxable year to which they relate. Any dividend declared by a REIT in October, November, or December of any calendar year and payable to shareholders of record on a specified date in such month, are deemed to have been paid by the REIT and received by each shareholder on December 31 of that calendar year even if the dividend is paid during January of the following calendar year (IRC § 857(b)(9)).

Also, if a REIT so elects, a dividend distribution declared before its tax return for the preceding year is required to be filed is treated as paid in such preceding year for purposes of the REIT distribution requirement of IRC § 857 provided the dividend is paid both:

- On or before the first regular dividend payment after the declaration.
- During the 12-month period following the close of the preceding year.

For example, a dividend declared on October 14, 2024 (the REIT having extended its 2023 tax filing requirement to October 15, 2024) and paid on or before December 31, 2024, could qualify as a 2023 dividend for the REIT's distribution requirements (if it had no regular dividend after October 14, 2024 and before December 31, 2024) (IRC § 858(a)). These dividend distributions are taxable to a REIT's shareholders (other than tax exempt entities) in the year in which paid (see also IRC Section 860 regarding deficiency dividends).

Unless the REIT is publicly offered, the amount distributed must not be preferential (meaning, every shareholder of the class of stock to which a distribution is made must be treated the same as every other shareholder of that class, and no class of stock can be treated other than according to its dividend rights as a class).

To the extent that a REIT does not distribute (or is treated as having distributed under the rules described above) all of its net capital gain, or distributes at least 90%, but less than 100% of its REIT taxable income, a REIT must pay tax on the undistributed amount at regular corporate tax rates. Under some circumstances, a REIT may be able to rectify an inadvertent failure to meet the 90% distribution requirement for a year by paying deficiency dividends to its shareholders in a later year.

4% Excise Tax on Certain Undistributed Income

If a 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 shortfall (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.

Distributions during a year for excise tax purposes include dividends declared during October, November, or December, and paid during January of the following year (IRC § 857(b)(9)).

Use of Qualified REIT Subsidiaries and Taxable REIT Subsidiaries

A qualified REIT subsidiary (QRS) is a wholly-owned corporate subsidiary of a REIT. A QRS can be used to insulate certain assets from specified liabilities, and can be used to issue structured finance securities. QRSs are also formed for state-specific reasons.

Taxable REIT subsidiaries (TRSs) were created to solve practical problems created by a business need to provide certain services to tenants beyond customary tenant services in the local market. Historically, most REITs relied on independent contractors to provide many tenant services. These independent contractors were limited by their inability to provide non-customary services and by the prohibition on a REIT deriving any income from the independent contractor. In response to these limitations, the Tax Relief Extension Act of 1999 (TREA) introduced the TRS as a way for REITs to provide tenant services on a taxable basis.

QRSs

A REIT can own and operate certain properties through wholly-owned subsidiaries that the REIT intends to treat as a QRS for tax purposes. A corporation qualifies as a QRS if a REIT:

- Owns 100% of the corporation's outstanding stock.
- Does not elect with the subsidiary to treat it as a TRS.

(IRC Section 856(i)(2)).

Any corporation that is wholly owned by a REIT (other than a TRS) is treated as a QRS and ignored for US federal income tax purposes. Therefore, all assets, liabilities and items of income, gain, loss, deduction, and credit of a QRS are treated as the parent REIT's assets, liabilities, and items of income, gain, loss, deduction, and credit. A QRS is not required to pay US federal income tax.

A REIT's ownership of the stock of a QRS does not violate the restrictions on ownership of securities (REIT Asset Tests). A QRS can be used by a mortgage REIT to issue structured finance securities. However, a REIT generally cannot use a REMIC for this purpose because the REIT would be treated as selling the REMIC's regular interests in prohibited transactions (Prohibited Transaction Income). A REMIC is a passive vehicle that holds mortgages, certain pass-through interests in mortgages or certain REMIC interests, and that is created under IRC Sections 860A to 860G. Unlike a mortgage REIT, a REMIC is required to have a fixed pool of assets.

TRSs

A TRS includes a corporation other than a REIT that is either:

- A direct or indirect subsidiary of a REIT and that has made a joint election with the REIT to be treated as a TRS. It is important to note that there is no requisite ownership threshold. Therefore, a REIT may own as little as one share of stock of its TRS.
- A subsidiary of a TRS if the TRS owns securities possessing more than 35% of the total voting power or value of the outstanding securities of that corporation.

A TRS is subject to income tax as a regular C-corporation. Therefore, under the TCJA, TRSs will be taxed at the rate of 21%.

Other than some activities relating to lodging and health care facilities (Box, Hotel and Health Care REITs), a TRS generally can engage in any business, including the provision of customary or non-customary services to tenants of its parent REIT, and can own and sell condominiums or other inventory. A REIT's ownership of securities of a TRS is not subject to the 5% or 10% asset test (REIT Asset Tests).

Special rules may apply if a TRS is considered a CTRS (Rents from Real Property). A CTRS is a TRS in which a REIT owns stock possessing more than 50% of the voting power or more than 50% of the total value of the outstanding stock of the CTRS (IRC § 856(d)(8)(A)(iv)).

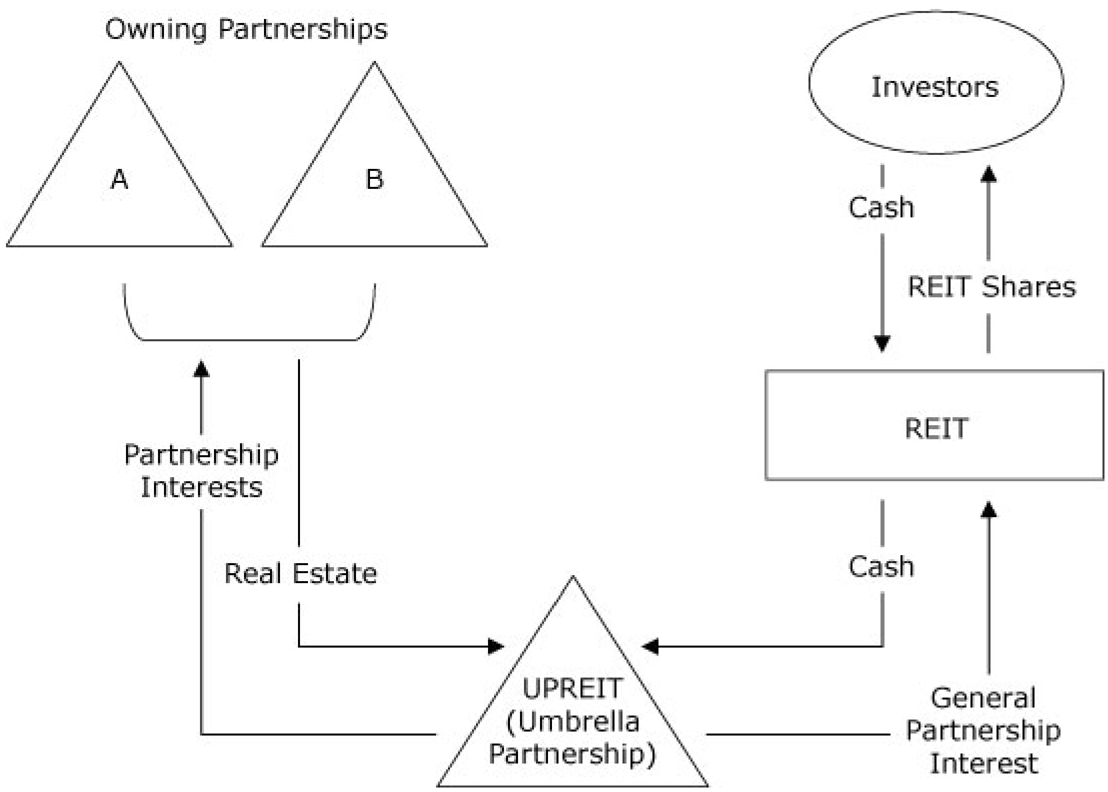
100% Penalty Tax and TRSs

Any redetermined rents, redetermined deductions, excess interest, or redetermined TRS service income a REIT generates are subject to a 100% penalty tax that is imposed on the REIT. In general, redetermined rents are rents from real property that are overstated as a result of any services provided to any of a REIT's tenants by one of the REIT's TRSs. It is important to note that the penalty tax is applicable only as to the overstated portion. Redetermined deductions and excess interest represent any amounts that are deducted by a TRS for amounts paid that are in excess of the amounts that would have been deducted based on arm's-length negotiations. Redetermined TRS service income means any amounts less than an arms-length fee for services performed by the TRS for or on behalf of the REIT, other than those services rendered to a tenant of the REIT (as those amounts would be included in redetermined rents).

UPREIT Structures

In an umbrella partnership REIT (UPREIT) structure, a partnership structure enables owners of real estate to contribute the real estate to a REIT structure without being subject to current tax on any appreciation in the real estate. In this structure, a partnership holds both the historic assets of the REIT and any property contributed by the new participant. The new participant acquires a partnership interest in the UPREIT in exchange for the real estate. If properly structured, the contribution of real estate is not subject to tax until the partner exchanges his partnership interest for REIT stock.

A typical UPREIT structure is shown in the diagram below:



Special Rules for REITs Owning Partnership and LLC Interests

If a REIT is a partner in a partnership or a member of an LLC treated as a partnership for tax purposes, the REIT is deemed to own its proportionate share of the assets of the partnership or LLC based on its interest in partnership or LLC capital. The determination of ownership is also subject to special rules relating to the 10% asset test (REIT Asset Tests). In addition, the REIT is deemed to be entitled to its proportionate share of the income of that entity. For purposes of satisfying the REIT income and asset tests (REIT Income Tests and REIT Asset Tests), the assets and gross income of the partnership or LLC retain the same character in the hands of the REIT as in the partnership or LLC.

If a REIT owns an interest in partnership or LLC that takes or expects to take actions that could jeopardize the REIT's status as a REIT or require the payment of a tax, the REIT may be forced to dispose of its interest in that entity.

In addition, it is possible that a partnership or LLC could take an action which could cause the REIT to fail a REIT income or asset test and the REIT may not become aware of that action in time to dispose of a REIT's interest in that entity (or take other corrective action on a timely basis). In that case, a REIT could fail to qualify as a REIT unless the REIT is entitled to relief for reasonable cause. Although beyond the scope of this Note, the partnership disguised sale rules should also be considered.

REIT Spin-offs, Transfers & Mergers

Spin-offs

Before the PATH Act, a parent (non-REIT) entity ("distributing") that owned a corporate subsidiary ("controlled") that could qualify as a REIT could distribute or spin-off the subsidiary stock to its shareholders. After the distribution or spin-off, the subsidiary would elect to be taxed as a REIT. Several publicly traded companies (for example, Penn Gaming) partially converted to REIT status by spinning off their real estate assets into publicly traded REITs.

The PATH Act, however, has effectively prevented such REIT spin-offs, with an exception for those companies that had already submitted a ruling request to the IRS.

Tax-free treatment for a spin-off distribution is now unavailable if either the distributing or controlled corporation is a REIT, unless either (1) both distributing and controlled are REITs, or (2) distributing is a REIT and it spins off a TRS that it has controlled for at least three years. Additionally, if a spin-off involves non-REIT corporations, both distributing and controlled are prevented from making a REIT election for 10 years.

Transfers of Property to REITs

At one point, a corporation could rely on the "General Utilities" doctrine to distribute appreciated property to shareholders without recognizing gain in certain circumstances. The IRC provisions underlying this doctrine were later repealed, and now a corporation is required to recognize that gain. However, IRC Section 355 (which has been described as a limited exception to the repeal of the General Utilities doctrine) became a means for a tax-free distribution of stock to continue to take place.

Under IRC Section 355, a corporation can distribute stock of one or more controlled corporations to its shareholders without the distributing corporation recognizing income, gain, or loss on the distribution. However, IRC Section 355(h), as added by the PATH Act and as discussed above, generally turns off IRC Section 355 when the distributing corporation or controlled corporation is a REIT.

The Treasury Department released final regulations under IRC Section 337(d) (Treas. Reg. § 1.337(d)-7) to ensure that REITs (as well as Regulated Investment Companies (RICs)) were not used as a means to avoid recognizing gain. When these regulations were proposed, commenters had expressed concern that the new rules could lead to an over-inclusion of gain, specifically in situations where a large corporation acquires a small corporation that engaged in a spin-off, and the large corporation subsequently made a REIT election. The Treasury Department submitted a report in 2017 which recognized that this scenario could lead to over-inclusion of gain, and indicated that relief was being considered. Ultimately, the final regulations disregarded this concern, and the relative size of the entities does not matter.

Mergers

A REIT can merge with another REIT in either a tax-free or taxable merger. If the consideration paid in the merger is solely common stock of the acquiring REIT, the merger generally qualifies as a tax-free merger. Therefore, the target REIT and its shareholders generally do not recognize any taxable gain or loss in the merger.

If the consideration in the merger is a combination of acquiror stock and cash, a merger can still be structured as tax-free if a substantial portion of the consideration (generally at least 35% to 40%) is payable in stock. In this case, the shareholders recognize gain only to the extent of the cash consideration. If the portion of the stock received does not qualify as substantial for this purpose (less than 35% to 40%), the merger generally is a taxable transaction and the shareholders recognize gain based on the amount of cash and the value of the acquiror stock received.

The most common forms of REIT mergers are:

- **Merger of target REIT into acquiror REIT**. The merger generally is either taxable or tax-free depending on the amount of the cash consideration as described above. Since the target does not survive, it is likely that approval for the transaction is required to maintain the target's contractual relationships and regulatory licenses. (See also Treasury Regulation Section 1.368-2(b) for the merger of a target into a disregarded entity of the acquiror).

- **Merger of target REIT into wholly-owned subsidiary of acquiror REIT**. The merger generally is either taxable or tax-free depending on the amount of the cash consideration as described above. In this case, approval for the transaction is also likely required to maintain the target's contractual relationships and regulatory licenses.
- **Merger of subsidiary of acquiror REIT into target REIT**. A merger of a subsidiary of an acquiror REIT into a target REIT would in many cases be treated as a taxable transaction, because unless a TRS election is made for the wholly-owned target, it will treated as a QRS, thereby resulting in an immediate liquidation of the target REIT. This should not be true with private REITs that satisfy the 100 shareholder requirement through the issuance of preferred stock.
- **Merger of REITs that are in the UPREIT format**. For the merger to qualify as tax-free, it generally must be completed in two steps, as a merger of the REITs and a combination of the operating partnerships. The manner in which the operating partnerships are combined depends in significant part on whether any unit holders object to the merger and the provisions of the operating partnership agreement governing the approval procedures for mergers or asset sales.
- There may be unit holders of the target operating partnership who acquired their units in exchange for a contribution of property. Contribution agreements often contain tax protection provisions that trigger certain rights if the operating partnership disposes of the contributed property within a defined period of time. It is important to review the contribution agreement and any tax protection agreements to determine if the merger triggers any of the unit holders' rights.

For more general information about mergers, see Practice Notes, Mergers: Tax Overview, Tax-Free Reorganizations: Acquisitive Reorganizations, Private Mergers: Overview and Public Mergers: Overview.

REIT Taxable Mortgage Pool and FIRPTA Issues

A REIT must consider US withholding tax when it holds REMIC residuals or a subsidiary in a taxable mortgage pool (TMP) (IRS Notice 2006-97). The REIT must pay tax for any excess inclusions attributable to the REMIC residuals or TMP attributable to a shareholder that is a disqualified organization (for example, a state government). A REIT must also withhold on excess inclusions attributable to any foreign shareholder. Also, for other shareholders, it must report to them the amount of their share of the excess inclusions.

US withholding tax issues also arise in other contexts. For example, a mortgage REIT or a REIT holding mostly foreign assets generally is not a US real property holding corporation (a USRPHC). As a result, dividends the REIT pays to foreign shareholders are subject to the normal US withholding tax rules (30% withholding unless reduced by an applicable income tax treaty). However, capital gain dividends paid to foreign shareholders are not subject to US withholding tax.

In certain cases, a REIT can be treated as a USRPHC. If a REIT is a USRPHC, all distributions on account of a redemption or a liquidation to a foreign shareholder are subject to US withholding tax at a rate of 15% of the proceeds (IRC § 1445(e)(3)). However, if a distribution is attributable to the sale of US real estate, the gain may be subject to US withholding tax at the maximum tax rates (currently 21% for corporations with lower rates for individuals) (IRS Notice 2007-55). A dividend distribution from a REIT that is a USRPHC is subject to the normal US withholding tax rules (30% withholding unless reduced by an applicable income tax treaty), unless the dividend is attributable to a sale of US real estate assets. If the dividend is attributable to a sale of US real estate assets, the gain may be subject to US withholding tax at the maximum tax rates described above.

There are no US withholding tax requirements for a buyer of publicly traded USRPHC stock from a foreign seller (IRC § 1445(b)(6)). If the USRPHC stock is not publicly traded, the buyer generally must withhold 15% of the sale price that would otherwise be paid to a foreign seller. It is important to note that a "domestically controlled" REIT is not treated as a USRPHC (IRC § 897(h)(1)). Domestically controlled generally means that more than 50% of the value of the REIT's stock is owned by US persons that are not pass-through entities for foreign holders. The PATH Act added several rules and presumptions regarding this determination, including a presumption that a shareholder owning less than 5% of the entity's stock is domestic (absent actual knowledge that the shareholder is foreign). Treasury Regulations were proposed in late 2022 that would look-through non-publicly traded domestic corporations that own greater than a 25% interest in a REIT for purposes of testing domestically controlled REIT status. The impact of these proposed regulations are still being digested by the market.

For certain other US tax issues for foreign shareholders, see Box, Foreign Income Guidance for REITs.

Foreign Income Guidance for REITs

Prior to the enactment of the TCJA, a US shareholder was required to include currently in income its subpart F income earned through a CFC. However non-subpart F income earned through a CFC was not included. The TCJA added a 10.5% (increasing to 13.125% after 2025) tax on the non-subpart F income of 10% US shareholders of CFCs (note that the TCJA changed the definition of US shareholder to be defined as a US person who owns 10% or more of the vote or value of the stock of a foreign corporation), but also provided for a participation exemption for dividends received by US corporations (not including REITs) that own 10% or more of the stock of foreign corporations that are not CFCs. The TCJA also included a one-time transition tax imposed by IRC Section 965 on US shareholders (see Section 951(b) before its modification by the TCJA for the definition of a US shareholder for this purpose) that own CFCs. Generally speaking, US shareholders are required to increase their gross income by an amount equal to their pro rata share of the accumulated post-1986 deferred foreign income.

The impact of the application of IRC Section 965 could potentially cause an entity to fail to qualify as a REIT. Therefore, a special election for REITs was added under IRC Section 965(m) to resolve this potential issue. Under IRC Section 965(m), if a REIT is a US shareholder in one or more deferred foreign income corporations ("DFICs"), any amount required to be taken into account under IRC Section 951(a)(1), which pertains to the amounts to be included in the gross income of a US shareholder of a CFC by reason of IRC Section 965 will not be taken into account as gross income for purposes of applying the REIT gross income tests. A REIT can elect to include the amount required to be taken into account under IRC Section 951(a)(1) over a period of eight years. Under this election, the amounts must be included in gross income according to the below schedule:

- 8% of the amount in the case of each of the taxable years in the five taxable year period beginning with the taxable year in which the amount would otherwise be included.
- 15% of the amount in the first taxable year following such period.
- 20% of the amount in the second taxable year following such period.
- 25% of the amount in the third taxable year following such period.

A REIT that wanted to make the election must have made it no later than the due date for the first taxable year in the five taxable year period (meaning, September 2018).

In the case of a liquidation or sale of substantially all the assets of a REIT, cessation of business by the REIT, or any similar circumstance, any amount not yet included in gross income is included in gross income the day before the date of the event. Additionally, the unpaid portion of any tax liability with respect to the inclusion is generally due on the date of the event.

Taxation of Foreign Investors in REITs

Several unique US tax issues for foreign investors are worth mentioning beyond those discussed above.

A sale of REIT stock by a foreign shareholder is not be subject to US tax if the REIT is domestically controlled (IRC § 897(h)(1)). In addition, there is no US tax if the REIT stock is publicly traded and the foreign shareholder owned less than 10% of all stock at all times during the previous 12 months (IRC § 897(k)(1)). This rule is more favorable than the rule applicable to non-REITs (for no US tax in that case, the holder must have held less than 5% for five years).

An additional US branch profits tax of 30%, which normally applies to a sale by a foreign corporation of US real estate, does not apply to the sale of a REIT stock. However, the US branch profits tax may apply to a corporate shareholder that receives a dividend from a REIT that is attributable to a sale by the REIT of actual US real estate.

The PATH Act also provides that a "qualified" foreign pension fund that is not otherwise engaged in the conduct of a US trade or business, is exempt from taxation under FIRPTA on any gain from dispositions of US real property interests or capital gain distributions from REITs. Therefore, a qualified foreign pension fund investing in US real property through a REIT would not need to rely on the sale of REIT shares to ensure gains are not subject to FIRPTA.

Foreign governmental entities investing in the US are generally protected from US income taxation on their gains by IRC Section 892. This exemption does not apply when a foreign governmental entity engages in "commercial activity" in the US or when the exemption is overridden by IRC Section 897. If a foreign governmental entity engages in a commercial activity in the US through an entity it owns, the foreign governmental entity will become subject to US tax on all of its US-source income. Under proposed regulations, the disposition of real estate by a REIT will not cause its shareholders to be deemed to engage in commercial activity unless the shareholder owns a controlling interest in the REIT. However, IRC Section 897 may still impose US withholding tax on an IRC Section 892 sensitive investor that holds REIT shares.

Hotel and Health Care REITs

Neither the REITs nor their TRSs may directly run hotels and health care facilities. In addition, hotels and health care facilities cannot even be leased to a TRS (and the TRS cannot supply the rights to use its franchise name to another person) unless the facility is managed by an eligible independent contractor (IRC §§ 856(d)(8)(B) and 856(l)(3)). Generally, a REIT gets exposure to hotel or healthcare facilities by owning the hotel or healthcare facility and leasing it to its TRS, which hires an eligible independent contractor to manage the facility. An eligible independent contractor for a TRS that is leasing a lodging facility or a health care facility from a REIT is an independent contractor that is otherwise actively engaged in the business of managing lodging facilities or health care properties, respectively, for unrelated persons (IRC § 856(d)(9)).