taxnotes federal

Volume 165, Number 10 ■ December 9, 2019

The 5-Year REIT Lockout Rule: Kill It or Fix It?

by David F. Levy, Nickolas P. Gianou, and Christian J. Husby

Reprinted from *Tax Notes Federal*, December 9, 2019, p. 1553

For more *Tax Notes* content, please visit www.taxnotes.com.

SPECIAL REPORT
tax notes federal

The 5-Year REIT Lockout Rule: Kill It or Fix It?

by David F. Levy, Nickolas P. Gianou, and Christian J. Husby

David F. Levy and Nickolas P. Gianou are partners and Christian J. Husby is an associate with Skadden, Arps, Slate, Meagher & Flom LLP.

In this report, the authors analyze the operation and history of the lockout rule in section 856(g)(3), explore the ways in which the rule creates unexpected and counterintuitive real estate investment trust qualification issues in routine REIT transactions, and conclude on policy grounds that it should be repealed or at least modified so that would-be REITs can reliably determine whether they're eligible to elect REIT status.

Copyright 2019 David F. Levy, Nickolas P. Gianou, and Christian J. Husby. All rights reserved.

Table of Contents

I. Introduction 1553
II. REITs and the Need for Certainty 1554
III. The Lockout Rule 1557
A. Overview of the Lockout Rule 1557
B. Application of the Lockout Rule 1559
IV. Practical Implications for REIT Compliance 1568
V. Policy Recommendations 1572
A. History Supports Repeal 1572
B. Make the Successor REIT Rule Administrable 1575
VI. Conclusion 1576

I. Introduction

Recent months have seen an uptick in mergers and acquisitions involving real estate investment trusts in both the public and private sectors, while capital-markets developments and increasing action by activist investors suggest that more M&A deals are in the offing. Given these developments, we thought it might be helpful to examine — and ultimately, reexamine — one of the most surprising, conceptually difficult, and counterintuitive REIT qualification rules ever drafted: the rule that prohibits a REIT and its successor from reelecting REIT status within five years of the termination or revocation of that status (the lockout rule).[1]

As discussed in greater detail later, there are four aspects of the lockout rule that, when combined, relentlessly torment any REIT tax professional unfortunate enough to encounter the rule while in the middle of a transaction. First, the lockout rule is the rule that sits above all other REIT rules and functions as the gatekeeper to REIT status. Even if an entity satisfies every REIT qualification test with flying colors, it still will be ineligible to make a REIT election if the lockout rule applies. Second, because the lockout rule is drafted in such a simple way, one can get the false impression that the rule is easy to apply and hardly ever relevant. Third, once one begins to parse that fairly simple language, it becomes clear that the lockout rule appears simple only because it is drafted so broadly and uses such vague language. Once that point sinks in, taxpayers begin to realize that rather than being easy to apply and relevant hardly anywhere, the lockout rule is incredibly difficult to apply and relevant seemingly everywhere. Finally, because the lockout rule governs whether an entity is eligible to elect REIT status in the first instance, the rule can make it quite difficult for stakeholders in even the most pristine would-be REITs to achieve true certainty on REIT status.

This report makes the case that the lockout rule is exceedingly punitive from the perspective of day-to-day transactions; is completely unnecessary from the perspective of tax policy, as

[1] Section 856(g)(3).

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

the policy objective served by the lockout rule is already satisfied completely by the C corporation earnings and profits blowout rule (described later); and it should be either repealed or, at the very least, modified so that would-be REITs in the everyday scenarios described later can determine with certainty whether they are eligible to elect REIT status.

Our examination of the lockout rule and the truly troublesome successor REIT rule embedded therein proceeds in four parts: Section II of this report provides a brief background on the taxation of REITs, highlighting their pros and cons and demonstrating how high the stakes can be in situations in which the lockout rule is relevant. Section III describes how the lockout rule operates on a technical and theoretical level, and it explains various ambiguities in the rule and the ways in which those ambiguities can create unintended and inappropriate results. Section IV lays out the practical implications of the lockout rule for REIT compliance and opinion practice, illustrating the headaches that the rule can create for REITs and their advisers, and the ways in which the rule can disrupt everyday disposition and M&A transactions involving REITs. Finally, Section V argues — based on the history of the REIT rules in general and the lockout rule in particular, as well as current policy considerations — that the rule should be repealed or, at the very least, amended in a way that makes it administrable.

II. REITs and the Need for Certainty

A REIT, as its name implies, is a real-estate-focused investment vehicle that is designed to provide investors, both large and small, with exposure to real estate assets and businesses.[2] With the exception of an unfortunate interlude between 1935 and 1960, REITs have been the vehicle of choice for some types of real estate assets since colonial times. REITs were formed to finance commercial infrastructure in the years leading up to the Revolutionary War, and they participated in the build-out process of our major cities throughout the 19th and early 20th centuries.[3]

Although the REIT tax and legal environment has changed a great deal over the years, the REIT vehicle has historically owed much of its popularity to two features, one of which is common and one of which is anathema to widely held corporations. Like regular corporations, REITs provide equity holders with limited liability, meaning that equity owners are not responsible for REIT-level debts and obligations. But unlike regular corporations, REITs have never been permitted to retain their earnings.

This combination of attributes has a tendency to place at odds the objectives of corporate managers and shareholders. For corporate managers, the inability to retain earnings is one of the biggest — if not the single biggest — drawback of the REIT vehicle and is the feature most likely to convince them (particularly managers of large public companies) that REIT status is undesirable, even when the corporation could otherwise satisfy the various REIT qualification tests. The reality is that any public company that is unable to retain its earnings must return to the capital markets any time it wishes to pursue a major acquisition, finance a new business line, or pursue a capital-intensive corporate initiative. This inherent lack of capital deployment flexibility at the corporate level simply represents too big a commercial constraint for many corporations to manage. From the perspective of shareholders, a REIT's inability to retain earnings can be expressed in the inverse: REITs pay dividends to shareholders at least annually. Therefore, for investors seeking yield, the inability of a REIT to retain earnings may be the most attractive feature of the entire regime. In fact, that feature helps explain the wide variety of

[2] *See* Theodore S. Lynn, Micah W. Bloomfield, and David W. Lowden, *Real Estate Investment Trusts* (2018); and Dean A. Halfacre et al., *Real Estate Investment Trusts*, Portfolio 742 (2018).

[3] The history of REITs and REIT taxation in the United States is explored in detail in David F. Levy, Nickolas P. Gianou, and Kevin M. Jones, "Modern REITs and the Corporate Tax: Thoughts on the Scope of the Corporate Tax and Rationalizing Our System of Taxing Collective Investment Vehicles," 94 *Taxes* 205 (Mar. 2016).

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

mutual fund vehicles devoted to the REIT sector, as well as the deep capital markets enjoyed by many public REITs.[4]

The fact that the same attribute can simultaneously discourage corporate managers from adopting REIT status and fuel tremendous growth of a real-estate-focused capital market that is both deep and broad[5] illustrates a long-standing feature of the REIT vehicle: REITs are all about the trade-offs between drawbacks and benefits, and the way in which different market participants weigh the two.

The inability of a REIT to retain earnings is not the only feature of the REIT regime that some view as a drawback. A REIT also (1) is generally subject to a less favorable shareholder-level tax regime than a regular C corporation;[6] (2) is subject to an exceedingly intricate tax regulatory regime that governs the nature and composition of its assets and gross income (both of which are generally limited to real estate and other passive investments);[7] and (3) is limited in the extent to which its outstanding equity can be concentrated among specific types of shareholders (with strict limitations on the concentration among individuals).[8] These limitations can frustrate a REIT's ability to grow and enter new business lines. Also, the limitations on a REIT's assets and income sometimes prevent it from making investments and engaging in activities that would otherwise be commercially advantageous.

By contrast, in terms of benefits, a REIT is not subject to corporate tax on the income it distributes to shareholders. Moreover, because REITs are technically corporations for tax purposes, investors in REITs are not subject to many of the burdensome tax payment and reporting obligations that generally arise for investors in true passthrough entities such as partnerships. For example, tax-exempt and foreign investors in REITs are generally relieved of burdensome unrelated business taxable income[9] and effectively connected income[10] tax reporting, and all REIT investors are relieved of the need to file tax returns in every state in which the REIT operates.

The combination of these corporate- and shareholder-level advantages typically provides REITs with a lower cost of capital than other corporations. Indeed, the lower cost of capital (and its correlative positive effect on REIT share prices, which can also facilitate growth through M&A activity) is often the only reason public company managers are willing to endure the annual distribution requirement and the other drawbacks described earlier.

Given the scale of the public REIT sector and the proliferation of the private REIT sector,[11] it is beyond dispute that a sizable portion of the real estate community has concluded that the benefits of the REIT regime are worth the drawbacks. But any time investors find themselves weighing the trade-offs between the benefits and drawbacks of an investment, they need to understand whether there is any risk that they will not realize the expected benefits, and whether the drawbacks they signed up for are the only drawbacks they will face.

On that score, the consequences of erroneously claiming REIT status can be

---

[4] *See, e.g.*, National Association of REITs (NAREIT), "U.S. Real Estate Mutual Funds" (Nov. 4, 2019); and NAREIT, "87 Million Americans Own REIT Stocks" (Oct. 2019).

[5] *See, e.g.*, *id.*; NAREIT, "Joint Ventures Could Become a Bigger Alternative Capital Source for REITs, Attorney Says" (May 7, 2019); and Chris Hudgins, "Foreign Institutional Investors Own 16 Percent of Total U.S. Equity REIT Market Cap," S&P Global (July 2, 2018).

[6] For example, REIT dividends are generally ineligible for the favorable tax rates applicable to qualified dividend income paid by C corporations to noncorporate U.S. shareholders. Sections 1(h)(11)(D)(iii) and 857(c)(2). Also, REIT dividends are generally ineligible for the most favorable withholding rates provided by the U.S. treaty network. *See* IRS, "Tax Rates on Income Other Than Personal Service Income Under Chapter 3, Internal Revenue Code, and Income Tax Treaties" (Feb. 2019).

[7] *See* section 856(c).

[8] *See* section 856(a)(6) and (h).

[9] Section 511(a)(1) (imposing a tax on UBTI); section 512(b)(1) (exempting dividend income from UBTI); section 512(c)(1) (treating income recognized from a partnership as UBTI when the partnership is engaged in an unrelated trade or business regarding the tax-exempt partner).

[10] Foreign persons engaged in a U.S. trade or business (USTB) may be subject to regular U.S. tax on income that is, or is treated as, effectively connected with that USTB and are generally obligated to file U.S. tax returns. *See* sections 871 and 881. Section 875(1) provides that a foreign individual or corporation that is a partner in a partnership will be considered to be engaged in a USTB if the partnership is so engaged. The code and regulations contain no analogous provision for foreign shareholders of a corporation. Consequently, a foreign shareholder of a corporation is generally not considered engaged in a USTB solely because the corporation is so engaged. *See, e.g.*, LTR 8914002. *But see* section 897(h).

[11] At the end of 2017, public REITs had a market capitalization exceeding $1 trillion, and as of this year, public and private REITs in the United States collectively own more than $3 trillion of gross real estate assets. *See* EY (prepared for NAREIT), "Economic Contribution of REITs in the United States" (Feb. 2019).

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

catastrophic, especially for a public REIT. These consequences include a corporate-level income tax on taxable income from all open years (even though cash attributable to that income will have already been distributed to satisfy the REIT distribution requirement); a corporate-level income tax on some asset repositioning transactions (which often accompany a REIT M&A transaction); a breach of many, if not all, of the REIT's debt covenants (which, combined with the absence of retained earnings, will make it difficult to raise the cash necessary to satisfy the corporate tax liability for open years); and the loss of market capitalization as a result of all of these consequences, which can create cascading securities law exposure and investor relations problems. On top of all this, investors are likely to find that they overpaid taxes in prior years and might be unable to obtain refunds because the statute of limitations has expired.

None of these consequences stemming from failed REIT status are on the list of the drawbacks of the REIT regime outlined earlier. Consequently, as the public REIT sector began to expand in the 1990s,[12] investors and securities underwriters began to focus on the parade of horribles that accompanies a loss of REIT status and began to demand that REITs issuing stock to the public provide a "clean will" REIT tax opinion (the strongest level of tax opinion) concurrently with the offering. Today, such an opinion is typically required for every target REIT acquired in an M&A transaction, whether public or private, and for every acquiring REIT issuing stock in connection with an M&A transaction.[13]

As the REIT regulatory regime became more and more complicated over the years, REITs often found that a simple foot fault on a hypertechnical rule could prevent counsel from issuing the required "clean will" REIT tax opinion. The inability to obtain such a tax opinion could lock a REIT out of the capital markets pending the receipt of an IRS closing agreement or a private letter ruling affirming REIT status, or it could prevent the closing (or lead to the termination) of an M&A transaction, whether public or private.

To give REITs some reprieve from these situations, Congress enacted a series of relief provisions that allow a REIT to maintain REIT status in the face of a technical rule violation by demonstrating reasonable cause and paying a penalty tax. Those provisions also granted the IRS statutory authority to treat some types of otherwise nonqualifying income as qualifying income for purposes of the REIT requirements,[14] thereby mitigating some of the most notorious sources of technical rule violations. Taken together, this set of rules allows most REITs to obtain certainty about their REIT status and get a "clean will" REIT tax opinion, despite the existence of ambiguities in several highly technical areas that implicate REIT status.

The relief provisions do not, however, clearly address the REIT compliance issues that can be created by a key component of the lockout rule. As discussed in greater detail later, the lockout rule prohibits not only the entity whose REIT status was terminated or revoked, but also any of its successors, from electing REIT status within five years of when the first entity lost REIT status.[15] In other words, if a REIT converts to a C corporation, intentionally or not, both the former REIT and any successor to the former REIT are generally prohibited from electing REIT status for five years, regardless of whether the successor is aware that it might be a successor.[16] We refer to the feature of the lockout rule pertaining to successors as the successor REIT rule. Unlike the relief provisions that are intended to allow REIT status for some entities notwithstanding a REIT qualification issue, the lockout rule is designed to disallow REIT status for some entities despite the fact that they otherwise satisfy all the requirements for REIT status. It is thus difficult to see what role the relief provisions play in situations in which the successor REIT rule is creating a REIT qualification problem.

[12] The market capitalization of public REITs grew from approximately $8.8 billion at the end of 1990 to nearly $125 billion at the end of 1999. NAREIT, "U.S. REIT Industry Equity Market Cap" (Sept. 27, 2019).

[13] A "clean will" REIT tax opinion would also be required with respect to an acquiring REIT issuing stock following, but not necessarily in connection with, an M&A transaction.

[14] *See, e.g.*, section 856(c)(5)(J), (6)(B), (7)(A)(ii), and (g)(5).

[15] Section 856(g)(3).

[16] *Id.*

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

Although section 856(g)(4) provides a reasonable cause exception specifically for the lockout rule (including the successor REIT rule), its usefulness is extremely limited. This exception applies in situations in which the termination of REIT status was attributable to reasonable cause and other requirements have been satisfied; however, it requires that reasonable cause be "establishe[d] to the satisfaction of the Secretary."[17] This suggests that the taxpayer must receive affirmative approval from Treasury to avail itself of this exception. Consequently, a taxpayer will not know with certainty in advance whether it will ultimately be able to satisfy the secretary on this point. The procedures for getting secretary approval are not clear, but given that it now commonly takes a year or so to obtain a private letter ruling, one can assume that the process for obtaining secretary approval of reasonable cause will likely take longer than is tolerable in many M&A transactions.[18] Moreover, the exception applies only when the original loss of REIT status was the result of reasonable cause; it does not apply if the original loss of REIT status was intentional or attributable to negligence, even if the successor had reasonable cause for mistakenly believing that it was not a successor.[19] Thus, the reasonable cause exception of section 856(g)(4) is likely to be useless in many of the situations described in this report.[20]

Relief provisions aside, because the term "successor" is so poorly defined, it is often impossible to determine with certainty whether one entity is a successor to another and, if so, whether the successor's REIT status depends to any extent on the REIT status (or lack thereof) of that other entity. And even when the application of the rule is clear(er), its scope is often unduly broad and produces absurd results that were likely unintended by Congress or the IRS. To make matters worse, in many situations the IRS will be unable to issue a ruling confirming that the lockout rule has not been violated. That is because the application of the lockout rule often depends on factual determinations that are beyond most taxpayers' due diligence abilities. The bottom line to all this is that the lockout rule can make it impossible in many everyday situations to determine with certainty whether a particular REIT truly is a REIT.

Given that the uncertainty around REIT status is unpalatable in the best of circumstances and deal-threatening in the worst of circumstances, one purpose of this report is to advocate for removal of the lockout rule or, barring that, the issuance of regulatory guidance that enables REITs to apply the rule in a way that allows them to determine with certainty whether the rule has been violated. Those recommendations are discussed in Section V of this report. But first, we examine the lockout rule itself, including its various issues and implications.

III. The Lockout Rule

A. Overview of the Lockout Rule

A corporation[21] elects to be taxed as a REIT by filing its tax return as a REIT, on Form 1120-REIT. The corporation's REIT election remains in effect from its initial REIT year until the election is terminated or revoked under section 856(g).[22]

A termination of a REIT election occurs if a REIT fails to satisfy one of its technical requirements.[23] In contrast, a revocation is a voluntary election by a REIT to terminate its REIT election.[24] To be effective, a revocation must be made on or before the 90th day after the first day of the first tax year for which the revocation is to be effective.[25] In contrast, a termination can occur

[17] Section 856(g)(4)(C).

[18] *See* reg. section 1.856-8(d) ("In order to meet the requirements of section 856(g)(4)(C), the corporation, trust, or association must establish, to the satisfaction of the district director for the internal revenue district in which the corporation, trust, or association maintains its principal place of business or principal office or agency, that its failure to be a qualified [REIT] for the taxable year in question was due to reasonable cause and not due to willful neglect."). *See also* FSA 1996-9; and FSA 456 (Sept. 2, 1993).

[19] *See, e.g.*, GCM 37708 (Sept. 29, 1978) (An "organization remains ineligible for REIT status for a period of five years after it has been disqualified from such status. . . . The [five] year prohibition is inapplicable only if the disqualification from REIT status was due to reasonable cause and not due to willful neglect.").

[20] *See, e.g.*, Section IV.

[21] This includes limited liability companies that elect to be taxed as corporations for U.S. federal income tax purposes. *See* reg. section 301.7701-2(b)(2); and Form 8832, "Entity Classification Election."

[22] *See* section 856(c)(1).

[23] Section 856(g)(1).

[24] Section 856(g)(2).

[25] *Id.*

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

at any time, by violating one of the mandatory REIT requirements. In each case, the REIT status of the relevant entity ends at midnight on December 31 of the year preceding the year in which the revocation or termination occurs.[26] As of January 1 of the year of termination or revocation, the REIT becomes a regular C corporation.

Section 856(g)(3) contains both the lockout rule and the successor REIT rule in a single, 81-word sentence. The lockout rule provides that subject to some exceptions, if the REIT election of a corporation (the former REIT) has been terminated or revoked for any tax year (the termination year),[27] the former REIT will be ineligible to reelect REIT status for the four tax years following the termination year (the lockout period). For example, a REIT whose REIT status is terminated in 2020 will be prevented from reelecting REIT status until 2025.

The successor REIT rule prevents any "successor corporation, trust, or association" to the former REIT (a successor REIT) from making a new REIT election during the same lockout period of the former REIT.[28] Because the lockout rule applies to prevent the making of a *new* REIT election,[29] the successor REIT rule apparently does not apply to an entity that made a REIT election before the termination or revocation of the former REIT's REIT election.

Reg. section 1.856-8(c)(2) provides further guidance on the requirements that must be satisfied before an entity can be treated as a successor REIT to a former REIT. The regulation defines a successor REIT as a corporation, trust, or association (a tested entity) that meets both a continuity of ownership requirement and a continuity of assets requirement.

A tested entity meets the continuity of ownership requirement if at any time during "the taxable year," persons who own, directly or indirectly, 50 percent or more in value of the outstanding shares of the tested entity owned, at any time during the termination year, 50 percent or more in value of the outstanding shares of the former REIT.[30]

The continuity of assets requirement is met if either (1) a substantial portion of a tested entity's assets were assets of the former REIT, or (2) the tested entity acquires a substantial portion of the former REIT's assets.[31] The continuity of assets requirement does not describe the time period(s) during which it is tested. Thus, it is unclear whether momentary or short-term ownership of an offending asset during the lockout period can cause an entity to be a successor REIT to a former REIT.[32]

The successor REIT rule is designed to backstop the lockout rule by preventing taxpayers from engaging in the following transactions to avoid the adverse consequences of the lockout rule:

Example 1: *Avoiding the lockout rule with a merger*. In year 2 Former REIT loses its REIT status. Under the lockout rule, Former REIT will not be eligible to make another REIT election during the lockout period (that is, not until year 7). To avoid the lockout rule, shareholders of Former REIT (representing more than 50 percent of the ownership by value of Former REIT) establish Tested Entity in year 3. Former REIT merges into Tested Entity in a tax-free reorganization (other than an F reorganization, in which case Tested Entity would be treated as a

---

[26] Section 856(g)(1) ("Such termination shall be effective for the taxable year for which the corporation, trust, or association is not a [REIT] to which the provisions of this part apply, and for all succeeding taxable years."); and section 856(g)(2) ("A revocation under this paragraph shall be effective for the taxable year in which made and for all succeeding taxable years.").

[27] There is ambiguity whether a corporation that made an initial REIT election for a given year would be subject to the lockout rule if that election was never valid to begin with — for example, because the corporation failed to satisfy the REIT requirements for that year or was prohibited by the lockout rule from making the election as a result of losing its REIT status in an earlier year. In one instance, the IRS granted relief to a corporation under reg. section 301.9100-3, when the corporation filed a Form 1120-REIT electing REIT status but failed to qualify in its first year. In LTR 201523015 the IRS allowed the corporation to file a Form 1120X, "Amended U.S. Corporation Income Tax Return," for that year to replace the originally filed Form 1120-REIT and further ruled that the Form 1120X filed by the corporation would not be treated as a termination or revocation for purposes of section 856(g).

[28] Section 856(g)(3).

[29] Reg. section 1.856-8(c)(1) ("If a [former REIT] made an election under section 856(c)(1) to be a [REIT] and the election has been terminated or revoked under section 856(g)(1) or (2), the [former REIT] (and any [successor REIT]) is not eligible to make a *new* election under section 856(c)(1)" during the lockout period (emphasis added).).

[30] Reg. section 1.856-8(c)(2).

[31] *Id.*

[32] *See infra* Section III.B.3.a for further discussion regarding the issues concerning the timing of the satisfaction of the continuity of assets requirement.

For more *Tax Notes®* *Federal* content, please visit www.taxnotes.com.

continuation of Former REIT for general tax purposes). Tested Entity makes a REIT election.

Without the successor REIT rule, Tested Entity would not be prohibited from making a REIT election because it did not previously have in effect a REIT election that was either terminated or revoked.

Example 2: *Avoiding the lockout rule with an asset transfer*. Same facts as Example 1, except that Former REIT transfers its assets to a new or existing tested entity that is more than 50 percent owned by the same shareholders that own Former REIT.

As in Example 1, without the successor REIT rule, Tested Entity would not be prohibited from making a REIT election for the same reasons. In both examples 1 and 2, Tested Entity would satisfy both the continuity of ownership and continuity of assets requirements. As a result, Tested Entity would be a successor to Former REIT and would accordingly be barred by the lockout rule from making a new REIT election during former REIT's lockout period.

B. Application of the Lockout Rule

The lockout rule contains a number of ambiguities that create a seemingly inexhaustible source of uncertainty for any tested entity that finds itself owning assets that were formerly owned by another entity that filed an election to be taxed as a REIT. This Section III.B explores in more detail several of those ambiguities.

1. The successor REIT rule is limited to 'new' REIT elections.

Under the successor REIT rule, as in life, timing is everything. A threshold question, before going through the traps of the successor REIT rule, concerns the time of the tested entity's REIT election.

As mentioned earlier, the lockout rule forbids a former REIT and a successor REIT from making a new REIT election for the four tax years following the termination year of the former REIT. Thus, even if a tested entity satisfies both the continuity of ownership requirement and the continuity of assets requirement with respect to a former REIT, the tested entity's REIT election cannot be "new" in a situation in which the former REIT's revocation or termination occurs after the successor REIT's REIT election was made. The facts in examples 1 and 2 highlight the difficulties faced by newly created entities. But if in each example the tested entity had been an old-and-cold entity whose REIT election was made in year 0, the tested entity would not have been subject to the lockout rule. That is because although it may have satisfied the definition of a successor, the tested entity's year 0 REIT election cannot be "new" in relation to the termination or revocation of the former REIT's REIT election, which occurred in year 2.

As discussed later, because the successor REIT rule applies only to new REIT elections, older REITs may have an advantage in dealing with the various ambiguities presented by the lockout rule and the successor REIT rule in some circumstances.

Example 3: *A sufficiently old REIT is impervious to the successor REIT rule*. Target REIT is a publicly traded REIT. Target REIT makes a REIT election in year 3 but discovers at least one REIT qualification issue that could jeopardize its REIT status. Old REIT is also a publicly traded REIT. Old REIT made its REIT election in year 1. Tested Entity is a publicly traded C corporation that competes with both Old REIT and Target REIT in the same field. Tested Entity plans to make a REIT election in year 4. Target REIT and Tested Entity cannot determine all the owners of their shares with actual knowledge. Both Old REIT and Tested Entity are interested in acquiring Target REIT.

Because Old REIT already made a REIT election, it is not concerned with the successor REIT rule because that rule applies only to new REIT elections made after the former REIT's REIT status was lost. Thus, although Target REIT's potential REIT qualification issues involve corporate income tax exposure, they do not affect Old REIT's ability to continue its own REIT election and, depending on the circumstances, may not be an insurmountable obstacle to Old REIT's acquisition of Target REIT.

On the other hand, the stakes for Tested Entity are much higher: If Target REIT's REIT status is sufficiently uncertain, Tested Entity may be unable to make its own REIT election following the acquisition absent a private letter ruling or an IRS closing agreement. This is because Tested Entity will satisfy the continuity of assets

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

requirement by acquiring all of Target REIT's assets and might not be able to determine with certainty whether the continuity of ownership requirement would be met. As a result, any of Target REIT's REIT qualification issues could prove fatal to Tested Entity's ability to acquire Target REIT, at least in a situation in which Tested Entity wants certainty on its ability to elect REIT status. This places Tested Entity at a disadvantage in the bidding process, despite otherwise being similarly situated to Old REIT.

2. Issues concerning the continuity of ownership requirement.

a. Timing of ownership overlap.

As noted above, a tested entity meets the continuity of ownership requirement if at any time during "the taxable year" persons who own, directly or indirectly, 50 percent or more in value of the outstanding shares of the tested entity owned, at any time during the termination year, 50 percent or more in value of the outstanding shares of the former REIT. It is clear that for the former REIT's shareholder composition, it is only the termination year — not any earlier or later year — that is relevant (although every single second of the termination year is apparently subject to testing). But, for the tested entity, the reference to "*the* taxable year" is ambiguous.

Given that the purpose of the successor REIT rule is to determine when a tested entity will be prohibited from making a new REIT election, one can assume (subject to the issue of transitory overlapping ownership, discussed later) that the continuity of ownership requirement will be satisfied if the tested entity has 50 percent ownership overlap at any time in the year of the new REIT election. But it is not entirely clear whether the year of the new REIT election is the only relevant year. For example, if 50 percent ownership overlap first occurs after the tested entity makes a REIT election but before the end of the lockout period, is the tested entity's earlier REIT election terminated in the year in which the overlap occurs? Is it retroactively invalidated altogether, or is it not affected at all? In our experience, the answer is completely clear: No one knows for sure.

Example 4: *Ownership overlap after year of new REIT election*. Former REIT, a public REIT, loses its REIT status in year 1. In the same year, Tested Entity, a newly formed, privately owned entity whose shareholders can confirm they have never owned stock of Former REIT, acquires assets from Former REIT (constituting a substantial portion of Tested Entity's assets) and makes a REIT election. In year 3 Tested Entity undergoes an initial public offering in which more than half its shares become owned by the public. It thus has no way to confirm the extent to which its new public shareholders overlapped with Former REIT's public shareholders in year 1, the termination year.

If Tested Entity's shareholders in year 3 overlap by 50 percent or more with Former REIT's year 1 shareholders, it is unclear whether the lockout rule negatively impacts Tested Entity's REIT status. Although there is no policy reason why the facts of Example 4 should result in application of the lockout rule to Tested Entity, a strict application of the continuity of ownership requirement that looked only to the tax year of the new REIT election could easily be circumvented.

Example 5: *Ownership overlap after year of new REIT election under a plan*. Former REIT, a privately held REIT owned 51 percent by Institutional Investor A and 49 percent by Institutional Investor B, loses its REIT status in year 1. In year 2 B forms Tested Entity, which acquires all the assets of Former REIT and makes a REIT election. At this point, Former REIT and Tested Entity have only 49 percent ownership overlap. In year 4, under a plan, A acquires 51 percent of Tested Entity, thus causing 100 percent ownership overlap with Former REIT for year 4, a tax year after Tested Entity's new REIT election but still within the lockout period.

Although the policy case for applying the lockout rule to Tested Entity is significantly stronger in Example 5 than in Example 4, the application of the rule even to Example 5 is uncertain.

Similarly, it is unclear whether the continuity of ownership requirement is satisfied if the overlapping ownership occurs before the new REIT election but ceases to exist by the time the new REIT election is made.

Example 6: *Ownership overlap in year before new REIT election*. Former REIT, a public REIT, loses its REIT status in year 1. In year 1 Tested Entity, a

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

publicly traded corporation that cannot confirm the extent to which its public shareholders overlap with those of Former REIT, acquires a substantial portion of Former REIT's assets. In year 2 Tested Entity is taken private by an institutional investor that can confirm it did not own any shares of Former REIT during year 1. In year 3 Tested Entity wants to make a REIT election.

Rather surprisingly, the lockout rule does not provide clarity on whether Tested Entity's potential (and hard-to-confirm) overlapping ownership with Former REIT during year 1 would be an obstacle to Tested Entity's year 3 REIT election.

Although it is reasonably clear that 50 percent overlapping ownership in the year of the new REIT election will generally satisfy the continuity of ownership requirement, it is less clear whether the requirement is satisfied if the overlapping ownership in that year is only transitory. Some common transactions may produce brief moments of ownership overlap that implicate this uncertainty.

Example 7: *Momentary ownership overlap*. Former REIT is a publicly traded mortgage REIT that operates two businesses, Business 1 and Business 2, which are equal in size. The two businesses attract different investors, so there is a large amount of turnover of Former REIT stock. Former REIT wants to separate these two businesses. In year 1 Former REIT contributes Business 1 to a wholly owned corporate subsidiary, Tested Entity. Immediately thereafter, Former REIT distributes Tested Entity to the public in a taxable split-off in which shares of Tested Entity are distributed in full redemption of some shareholders' interest in Former REIT. Less than half of Former REIT's shareholders receive all the Tested Entity stock in exchange for all their Former REIT stock. In the year of the split-off, Former REIT, holding only Business 2, loses its REIT status. Tested Entity, the corporation now holding Business 1, satisfies the continuity of assets requirement because it received substantially all its assets from Former REIT. In year 1 Former REIT and Tested Entity had complete (albeit indirect, in the case of Tested Entity[33]) overlap in ownership for the moment immediately before Tested Entity was split off to the public.

There is no clear answer to whether a brief moment of ownership overlap prohibits Tested Entity from making a valid REIT election for the entire lockout period. Although there would seem to be little policy reason to apply the lockout rule in this case, the language of the regulations does not provide a clear basis for that result.

b. Other issues concerning the continuity of ownership requirement.

The continuity of ownership requirement raises a host of additional issues beyond the timing issues discussed in the Section III.B.2.a.

As described in more detail below in Section V.A, the lockout rule is substantially identical to section 1362(g), which provides that if an entity terminates or revokes its S corporation status, neither the entity nor any successor to the entity may reelect S corporation status within five years. Reg. section 1.1362-5(b) provides a continuity of ownership requirement and a continuity of assets requirement that are substantially identical to the continuity of ownership requirement and the continuity of assets requirement described earlier. Because S corporations cannot be widely held[34] and can be held only by individuals, some trusts, and specified tax-exempt organizations,[35] they typically have perfect knowledge about their shareholder base and therefore have no trouble applying the S corporation continuity of ownership requirement.

In contrast, REITs can be, and often are, owned in a manner that does not allow them to readily identify their shareholders. For example, many REITs are public companies or are owned by investment funds that, although not publicly traded, are fairly widely held through upper-tier fund-of-fund vehicles. In these situations, the

[33] *See infra* Section III.B.2.b for uncertainties regarding the meaning of indirect ownership in this context.

[34] S corporations are limited to 100 shareholders, which generally must be individuals. Section 1361(b)(1). Before 1997, when the successor REIT rules were enacted, an S corporation could not have more than 35 shareholders. *See* Small Business Job Protection Act of 1966, section 1301.

[35] *See* section 1361(b)(1)(B), (c)(2), and (c)(6).

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

direct or indirect ownership of the REIT may be difficult or even impossible to determine. A public REIT, for example, will have no knowledge of who its shareholders are except for the limited information that can be gleaned from SEC filings, investor reports, and one-on-one dealings with individual shareholders or investors.

Despite this fact, the continuity of ownership requirement under the successor REIT rule was copied essentially verbatim from the S corporation successor rules. Treasury thus took a rule that works well only in situations in which the corporation always has perfect knowledge of its shareholder base and mandated its application in a situation in which the relevant tested entity often has nothing approaching perfect knowledge about its shareholder base. Not surprisingly, applying the continuity of ownership requirement in these circumstances leads to issues that are impossible to resolve, as Example 8 illustrates.

Example 8: *Public corporation acquires public REIT*. Former REIT, a publicly traded REIT, discovers potential REIT qualification issues in year 1. In year 2 Tested Entity, a publicly traded corporation, wants to acquire all of Former REIT's assets and elect REIT status. Both Former REIT and Tested Entity, being widely traded companies, cannot determine the owners of their shares with actual knowledge. Tested Entity will certainly meet the continuity of assets requirement because it is acquiring all of former REIT's assets. However, it is likely impossible to ascertain whether Tested Entity will also meet the continuity of ownership requirement. That is because Former REIT and Tested Entity cannot identify Former REIT's shareholders at all times during year 1, nor can they identify Tested Entity's shareholders at all times during year 2 (let alone years 3 through 5, if relevant in light of the timing uncertainties discussed in Section III.B.2.a).

It is likely impossible to conclude with certainty that Tested Entity can successfully make a REIT election after purchasing Former REIT's assets. Without being able to conclude on the successor issue with certainty, and in light of the potential unavailability of the reasonable cause exception for successor REIT issues, it would be difficult for Tested Entity to obtain certainty about its REIT status.

Further difficulties arise from the fact that the continuity of ownership requirement does not limit the number of persons that are grouped together for purposes of testing overlapping ownership, nor does it require a minimum ownership percentage for any given person to be included in the group. This can lead to strange results when persons in the group own very small amounts of stock in either the former REIT or the tested entity.

Example 9: *Unequal overlapping ownership*. Investor A owns 99 percent of Former REIT, and Investor B owns the other 1 percent. Investor A owns 1 percent of Tested Entity, and Investor B owns the other 99 percent. Former REIT loses its REIT status in year 1. In year 2 Former REIT sells all its assets to Tested Entity in a taxable sale.

Here, Tested Entity meets the continuity of assets requirement with respect to Former REIT. Tested Entity also appears to meet the continuity of ownership requirement with respect to Former REIT because the same persons, as a group (A and B), own more than 50 percent of Former REIT and own more than 50 percent of Tested Entity. Because A owns 99 percent of Former REIT but only 1 percent of Tested Entity, while B owns only 1 percent of Tested Entity but 99 percent of Former REIT, the overlap in ownership on a shareholder-by-shareholder basis of Former REIT and Tested Entity is minimal, which ought to militate against application of the lockout rule. And yet one could not determine with certainty that the lockout rule does not apply.

The continuity of ownership requirement is also plagued by uncertainty surrounding the concept of indirect ownership, which expressly must be taken into account (at least for the tested entity) but is not defined for this purpose.[36]

Example 10: *Tested entity formed under a partnership*. Former REIT loses its REIT status. During the lockout period, Former REIT's shareholders form Partnership, which forms a new corporate subsidiary, Tested Entity. Former REIT then merges into Tested Entity. The continuity of assets requirement is met, and the continuity of ownership requirement would be

[36]On the face of reg. section 1.856-8(c)(2), indirect ownership applies when examining the ownership of the tested entity, but it does not expressly apply when examining the ownership of the former REIT.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

satisfied if the shareholders of Former REIT are, through their ownership of Partnership, considered to own Tested Entity for purposes of applying the successor REIT rule to Tested Entity.

Example 11: *Former REIT owned through a partnership*. Investors own 100 percent of Partnership, and Partnership further owns substantially all the stock of Former REIT. Former REIT loses its REIT status. During the lockout period, the investors in Partnership form a new corporation, Tested Entity. Former REIT then merges into Tested Entity. The continuity of assets requirement is met, and the continuity of ownership requirement would be satisfied if the investors are considered to own Former REIT for purposes of applying the lockout rule to Tested Entity.

The successor REIT rule does not define indirect ownership, nor does it provide for rules of attribution or constructive ownership. There is a long-established principle that the constructive ownership rules of section 318 do not apply unless another code provision specifically incorporates them by reference.[37] Moreover, based on various provisions of the code and regulations, indirect ownership often means something different from either constructive ownership or ownership by attribution from an entity to its owners.[38]

Guidance on the meaning of indirect ownership could also be drawn from the S corporation successor rule because (1) reg. section 1.1362-5(b), promulgated under the S corporation successor rule, is substantively identical to reg. section 1.856-8(c), promulgated under the successor REIT rule, and neither set of regulations contains ownership attribution rules; and (2) Congress explicitly stated that it intended similar rules to apply for both the successor REIT rule and the S corporation successor rule.[39] Given that the ownership limitations for S corporations prohibit corporations and partnerships from owning S corporation stock and impose severe restrictions on the types of trusts that can own S corporation stock, ownership attribution through entities such as corporations and partnerships would not have

[37] Section 318(a) provides constructive ownership rules "for purposes of those provisions . . . to which the rules contained in [section 318] *are expressly made applicable*" (emphasis added). That language has been interpreted strictly by both the courts and the IRS, which have refused to apply constructive ownership principles in situations in which those principles were not expressly incorporated into the relevant statute or regulation. *See, e.g.*, TAM 200733024; *Yamamoto v. Commissioner*, T.C. Memo. 1986-316; *Berghash v. Commissioner*, 43 T.C. 743 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966); and Rev. Rul. 56-613, 1956-2 C.B. 212.

[38] A distinction between indirect and constructive ownership can be found in numerous constructive ownership rules throughout the code. *See, e.g.*, sections 267(c)(1), 318(a)(3)(C), 424(d)(2), 958(a)(2), 544(a), 707(b), 864(e)(4)(C)(iii), 883(c)(4), 902(c)(7), 954(c)(3)(C), 1298(a), and 1563(e). The inclusion in these code sections of both explicit constructive ownership rules alongside the phrase "directly or indirectly" seems to imply that Congress generally intended the concept of constructive ownership and the phrase "directly or indirectly" to mean two different things. *See Freytag v. Commissioner*, 501 U.S. 868, 877 (1991); and TAM 200733024. Reading "indirect" ownership to include upward constructive ownership — so that stock owned constructively through a vertical chain of entities is treated as actually owned for purposes of reattributing that stock to another person through a non-vertical chain of ownership or other relationship — is contrary to the existence of operating rules in sections 267(c)(5) and 318(a)(5) that expressly delineate the circumstances in which constructively owned stock can be reattributed. If "indirectly" were interpreted to create a unique type of constructive ownership, the explicit constructive ownership rules under sections 318(c)(2), (c)(3), and 267(c)(1) (or at least their corresponding operating rules in sections 267(c)(5) and 318(a)(5)) would likely be rendered redundant — a result that probably conflicts with congressional intent and is contrary to courts' preference to interpret statutes so that every word has meaning and to avoid creating redundancies. *See Freytag*, 501 U.S. at 877.

[39] S. Rep. No. 94-938, at 478 (1976) ("It is the intent of the committee that similar rules apply for purposes of determining whether a corporation, trust, or association is a successor for purposes of section 856(g)(3) as apply for the purposes of determining under section 1372(f) whether a corporation is a successor to an electing small business corporation.").

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

been contemplated by the S corporation successor rule.[40] Thus, one could argue that the term "indirect" in the successor REIT rule regulations cannot mean attribution through entities.

Although we were able (after some struggle) to draft that argument with straight faces, we dare say that one would be hard-pressed to find a tax lawyer willing to bet the REIT status of a publicly traded entity on that interpretation. The problem is that an entity cannot be an S corporation unless it is owned entirely by individuals, specific trusts, or specific tax-exempt organizations, and those permitted shareholders are prohibited from owning S corporation stock through entities such as partnerships, corporations, and nonqualifying trusts.[41] Constructive ownership and attribution in the successor S corporation context are essentially irrelevant concepts. By contrast, REITs are designed to be widely held and are allowed to have, and usually do have, entities as shareholders. Thus, relying on the S corporation successor rule to support the proposition that the successor REIT rule does not require one to look through partnerships and corporations to their ultimate owners would seem too cute by half. Moreover, interpreting "indirectly" to not include attribution through entities would, as examples 10 and 11 illustrate, allow shareholders to easily circumvent the lockout rule.

Many practitioners therefore assume that at a minimum, indirect ownership under the continuity of ownership requirement requires looking through entities to their owners. Although this is easy to do in examples 10 and 11, one can readily imagine circumstances in which this feature of the rule makes it virtually impossible to determine indirect ownership all the way up the chain, such as for a tested entity that is owned by a private equity fund whose own investors include funds of funds or similar entities that are ultimately owned by persons whose identities are invisible to the tested entity.

3. Issues concerning the continuity of assets requirement.

a. Timing of satisfaction of continuity of assets requirement.

Timing issues similar to those described in Section III.B.2.a above also apply in the context of the continuity of assets requirement. One of the most vexing challenges with the continuity of assets requirement is that the regulation does not discuss when the requirement is tested or whether it applies continuously through the lockout period. This uncertainty on the temporal application of the requirement places doubt on whether a tested entity that is not a REIT can acquire its way out of a continuity of assets requirement problem and become a REIT. Perhaps more important, this uncertainty leaves open the possibility that an entity can either grow or shrink its way into a continuity of assets requirement problem, and it casts significant doubt on whether a tested entity can "undo" a continuity of assets requirement problem by disposing of the assets that are creating that problem.

Example 12: *Assets acquired from former REIT after new REIT election*. Former REIT loses its REIT status in year 1. In year 1 Tested Entity is formed with cash contributed to it by its investors and acquires assets that have never been held by a REIT. Tested Entity makes a REIT election for year 1. In year 3 Tested Entity acquires substantially all the assets of Former REIT.

It is unclear whether Tested Entity's satisfaction of the continuity of assets requirement in year 3 — after its REIT election but within the lockout period — is relevant to the validity of Tested Entity's REIT election. In other words, even if one were to assume that Tested Entity satisfies the continuity of ownership requirement at all times, it is not clear whether the satisfaction of the continuity of assets requirement in year 3 has any effect on the validity of Tested Entity's year 1 REIT election.

Example 13: *Assets acquired from former REIT before REIT election; assets do not satisfy the continuity of assets requirement from and after REIT election*. Former REIT loses its REIT status in year

[40] The successor REIT rule was modeled after the successor rule in the S corporation space. The current successor rule for S corporations, in reg. section 1.1362-5, was enacted in 1992 and does not include attribution or constructive ownership rules. T.D. 8449. When the S corporation successor rule was enacted, S corporations were limited to a maximum of 35 shareholders, all of which had to be individuals (with exceptions for estates and some trusts). Former section 1361(b)(1) (1993). Thus, indirect ownership in terms of ownership attribution through entities would generally not have been contemplated by the S corporation successor rule.

[41] Section 1361(b)(1)(B).

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

1. In year 1 Tested Entity acquires a property from Former REIT worth $10. The property is Tested Entity's only asset but represents only a de minimis portion of Former REIT's assets. In year 2 Tested Entity, using newly contributed capital, acquires an additional property that has never been held by a REIT and is worth $990. In total, Tested Entity now owns $1,000 of real estate properties. Tested Entity wants to make a REIT election for year 3.

Can Tested Entity make the year 3 REIT election? Tested Entity would have satisfied the continuity of assets requirement throughout year 1 and for some portion of year 2 because all its assets during that time were assets of Former REIT. Thus, assuming the continuity of ownership requirement was met, Tested Entity would not have been able to make the REIT election in year 1 (or potentially in year 2). However, after the year 2 acquisition of the $990 property, only 1 percent (presumably not a "substantial portion") of its assets would have come from Former REIT. Surprisingly, or perhaps unsurprisingly given the overall lack of clarity surrounding the successor REIT rule, there is no clear authority that Tested Entity does not have a lockout rule issue regarding a REIT election after year 2.

Example 13 illustrates the uncertainty an entity would face if it were to try to acquire its way out of a problem with the continuity of assets requirement. But the lack of temporal guidance on the application of the continuity of assets requirement can work in even more devious ways.

Example 14: *Growing into a successor REIT problem*. Former REIT loses its REIT status in year 1 and during all relevant times owns $10,000 of assets. In year 1 investors form Tested Entity with a $1,000 capital contribution. Tested Entity uses that $1,000 to acquire a $900 real estate asset that was never held by a REIT, and a $100 real estate asset from Former REIT. By year 3 the $900 asset has kept the same value, but the asset acquired from Former REIT has appreciated in value and is now worth $300. Tested Entity wants to make a REIT election for year 3.

In this example, Tested Entity started with no successor REIT problem because only 10 percent of its assets (presumably not a substantial portion) came from Former REIT. But by year 3 Tested Entity, based solely on market forces, seems to have grown into a successor REIT problem because the asset it acquired from Former REIT might now constitute a substantial portion of its assets in satisfaction of the continuity of assets requirement. If the continuity of ownership requirement were also satisfied, Tested Entity would have serious doubts about its ability to maintain REIT status, although there is absolutely no guidance on whether or when (if at all) its ability to be a REIT would be affected by Former REIT. What's worse, the rules are completely unclear as to whether Tested Entity can "unring the bell" by selling the $300 offending asset. Put differently, even after purging itself of the offending asset, Tested Entity's REIT status would remain uncertain. The uncertainty around an entity's ability to cure a continuity of assets requirement issue through a disposition of the offensive assets becomes particularly problematic when one considers that the term "assets" may include cash, as shown later in Example 18.

Just as an entity in acquisition mode can grow its way into a problem with the continuity of assets requirement, an entity in disposition mode can shrink its way into such a problem.

Example 15: *Shrinking into a successor REIT problem*. Former REIT loses its REIT status in year 1 and during all relevant times owns $10,000 of assets. In year 1 investors form Tested Entity with a $10,000 capital contribution. Tested Entity uses that $10,000 to acquire a $9,500 real estate asset that was never held by a REIT and a $500 real estate asset from Former REIT. Assume that the $500 asset was not a substantial portion of either entity's assets by any standard definition of the word "substantial." In year 3 Tested Entity spins off the $9,500 real estate asset in a taxable distribution, leaving it with only the $500 real estate asset acquired from Former REIT in year 1.

Once again, Tested Entity seems to satisfy the continuity of assets requirement during year 3, given that following the spinoff of the $9,500 "clean" asset, all its assets are assets of Former REIT. If the continuity of ownership requirement were also satisfied, Tested Entity would once again have serious doubts about its ability to elect REIT status in year 3, or its ability to maintain REIT status if it already elected REIT status in years 1 or 2.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

b. Other issues concerning the continuity of assets requirement.

The continuity of assets requirement is drafted in a way that creates a number of issues beyond the timing concerns described earlier. For example, the requirement uses the phrase "substantial portion" twice without defining it. Substantial portion presumably means something different from (and less than) "substantially all" — a term that, at least in some contexts, has a more well-defined meaning — but how much less is anyone's guess. There are, however, other places in the code where substantial portion might mean as little as 10 percent.[42]

Beyond the uncertainty in the meaning of substantial portion, the continuity of assets requirement, as drafted, applies to several transactions that Congress may not have intended to cover because they would seem to not implicate any legitimate policy concern. Much of the requirement's over-inclusiveness results from the fact that the relevant assets will constitute a substantial portion if they are substantial by reference to *either* the tested entity or the former REIT. Thus, the rule can apply when a large tested entity acquires a de minimis amount of assets from a very small former REIT, as well as when a very large former REIT sells a de minimis amount of assets to a very small tested entity. In neither case would a tax lawyer normally refer to any of these entities as "successors" and "predecessors" to one another.

Example 16: *Large tested entity acquires a de minimis asset from former REIT*. Tested Entity is a private C corporation that owns rental real estate and is worth more than $10 billion. Three of Tested Entity's institutional shareholders own more than 50 percent of Tested Entity. Those three shareholders also own more than 50 percent of Former REIT, which is worth $1 million and owns a single real estate asset. In year 1 Former REIT loses its REIT status. Also in year 1, Former REIT transfers its assets to Tested Entity in a tax-deferred transaction. In year 2 Tested Entity wishes to make a REIT election.

Tested Entity satisfies the continuity of ownership requirement with respect to Former REIT. Tested Entity also appears to satisfy the continuity of assets requirement with respect to Former REIT, because Tested Entity owns 100 percent of the assets of Former REIT. As a result, Tested Entity would have legitimate uncertainty about its ability to make a REIT election during the lockout period based on a plain reading of the successor REIT rule. It is hard to imagine that Congress intended that a C corporation that otherwise qualifies to make a REIT election would be barred from doing so because it acquired a single asset representing 0.01 percent of its total assets, but there is no de minimis exception or similar rule to make clear that the lockout rule does not apply in Example 16.

Example 17: *Large former REIT sells de minimis asset to tested entity*. Former REIT is a public REIT that owns rental real estate and is worth more than $10 billion. In year 1 Former REIT loses its REIT status and sells a $1 million asset to Tested Entity, which is a special purpose subsidiary of a widely held investment fund. The $1 million asset is Tested Entity's only asset, at least initially. Tested Entity wants to make a REIT election.

For the reasons discussed in Section III.B.2.b, Tested Entity may be unable to achieve certainty that it does not satisfy the continuity of ownership requirement with respect to Former REIT. Further, Tested Entity also appears to satisfy the continuity of assets requirement with respect to Former REIT because 100 percent of Tested Entity's assets, at least initially, came from Former REIT.[43] As a result, Tested Entity would have significant uncertainty about its ability to make a REIT election during the lockout period.

Another potentially overbroad application of the continuity of assets requirement arises from the use of the word "assets." In particular, if assets include cash, and there is no authority to say they do not, then the lockout rule can apply in circumstances that were very likely not contemplated by Congress.

[42] *See* reg. section 1.148-1(f)(2)(i) and (4)(ii) ("The issue price of bonds issued for money is the first price at which a substantial amount of the bonds is sold to the public. . . . Ten percent is a substantial amount."); *see also* section 6662(d)(1)(a) (defining a "*substantial* understatement of income tax" as an understatement for a tax year that "exceeds the greater of *10 percent* of the tax required to be shown on the return for the taxable year or $5,000") (emphasis added).

[43] As discussed later, this appears to be true even though Tested Entity's acquisition of the asset was a fully taxable transaction to Former REIT.

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Example 18: *Successor to cash*. Former REIT loses its REIT status in year 1. Former REIT contributes $100 of cash to a new wholly owned subsidiary corporation, Tested Entity. Tested Entity uses the cash to buy a $100 real estate asset from a third party.

At the moment it acquires $100 cash from Former REIT, Tested Entity likely satisfies both the continuity of ownership requirement (because Former REIT's shareholders own, indirectly, 100 percent of Tested Entity[44]) and the continuity of assets requirement (because all its assets, $100 cash, were assets of Former REIT). It is uncertain whether Tested Entity's "disposal" of that cash in connection with its acquisition of the $100 real estate asset undoes the fact that Tested Entity satisfied the continuity of assets requirement. Thus, it is unclear whether Tested Entity would be prohibited from making a REIT election during the lockout period because it acquired all its initial assets from Former REIT.

It is difficult to see a policy justification for this result. None of Former REIT's historic "REITable" assets have made their way into Tested Entity, so real estate assets are not moving in and out of REIT status. Yet a literal reading of the word "asset," combined with the lack of temporal guidance on the continuity of assets requirement, raises questions about Tested Entity's ability to make a REIT election.

There is likewise nothing that limits the application of the continuity of assets requirement to transactions in which the tested entity has acquired assets from the former REIT in a tax-deferred transaction.

Example 19: *Fully taxable asset purchase*. Former REIT's REIT election terminates in year 1. Also in year 1, Tested Entity, an entity that satisfies the continuity of ownership requirement with respect to Former REIT, purchases some of Former REIT's assets for cash in a fully taxable transaction, and those assets represent all of Tested Entity's assets. In year 2 Tested Entity wants to make a REIT election.

Because all of Tested Entity's assets were assets of Former REIT, Tested Entity in Example 19 apparently satisfies the continuity of assets requirement. Consequently, the lockout rule brings into question Tested Entity's ability to make a REIT election even though all the built-in gain in its assets was triggered and subject to corporate-level tax in the hands of Former REIT. It is not clear why the lockout rule should apply in this case. The implications of Example 19 become particularly perplexing in situations in which the assets of Former REIT pass through an unrelated, third-party buyer in a fully taxable sale before ending up in the hands of the successor REIT, as shown in Example 20.

Example 20: *Meandering assets*. In year 1 PE Fund 1, a private equity fund, forms REIT 1, which purchases a single building for $100,000. In year 2 REIT 1 sells the building, its sole asset, to a third-party buyer (Third Party) in a fully taxable transaction. In year 3 Third Party sells the building to Tested Entity, a newly formed corporate subsidiary of PE Fund 2, another private equity fund. Third Party is completely unrelated to PE Fund 1 and PE Fund 2, and the sponsors of the two funds are unrelated to one another. Tested Entity holds the building as its sole asset. The parties suspect PE Fund 1 and PE Fund 2 share sufficient institutional owners to cause Tested Entity to satisfy the continuity of ownership requirement with respect to REIT 1. Tested Entity wants to make a REIT election for year 3.

In Example 20, must PE Fund 2 perform the diligence necessary to ensure that REIT 1 satisfied all the REIT requirements, and if so, how would it do that? Or does the intervening acquisition and sale by Third Party cleanse the asset, and if so, under what authority? Although no policy objectives are achieved by applying the lockout rule in Example 20, Tested Entity, which arguably falls under the regulatory definition of successor, has no clear authority to rely on to assume the third-party sale cleanses the transaction.

Similarly, as the following example demonstrates, there is no guidance clarifying whether the lockout rule applies if the tested entity receives its assets in a section 1031 transaction under which tax deferral is affirmatively provided for by the code.

Example 21: *Section 1031 exchange*. In year 1 Former REIT loses its REIT status. In year 2 Tested Entity sells its only asset, a real estate asset that

[44] *See infra* Section III.B.2.b for a discussion of indirect ownership.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

was never owned by a REIT, and acquires replacement property from Former REIT in a section 1031 exchange. In year 3 Tested Entity wishes to make a REIT election.

Because the replacement property is Tested Entity's only asset, Tested Entity satisfies the continuity of assets requirement with respect to Former REIT, reading the rule literally. Even though the replacement property is (in theory) a continuation of Tested Entity's interest in the clean asset that was relinquished in the section 1031 exchange, Tested Entity would not be certain whether the lockout rule applies if Tested Entity also satisfies the continuity of ownership requirement.

It is unclear why the lockout rule should apply to Tested Entity in Example 21, given that Tested Entity could have made a REIT election had it continued to own its original asset and that all of Tested Entity's built-in gain in that original asset has been preserved in the asset acquired from Former REIT. Moreover, from a tax perspective, Tested Entity is essentially in the same position before and after the section 1031 exchange. This result is especially egregious in situations in which the transfer of property by Former REIT to Tested Entity also qualifies as a section 1031 transaction from the perspective of the former REIT. In that case, all built-in gain in all assets remains static, and yet a literal reading of the lockout rule would seem to affect Tested Entity's ability to make a REIT election.

IV. Practical Implications for REIT Compliance

In everyday life, the problems presented by the lockout rule stem from the fact that the taxpayer bears the burden of proof on all facts that go to REIT status, and the burden of persuasion on all legal issues that go to REIT status. Because reasonable cause relief may not be available for lockout rule failures,[45] the rule effectively requires a REIT to prove a negative — that the lockout rule does not apply — to achieve a "clean will" level of certainty on its ability to make a REIT election. This can make it extremely difficult, and in some cases impossible, in many routine M&A transactions to determine whether an entity is a REIT.

To determine whether a tested entity runs afoul of the lockout rule, the entity must resolve a series of questions of law, questions of fact, and mixed fact/law questions (the lockout quiz):

1. Is the tested entity going to acquire assets that are or were the assets of an entity that purported to be taxed as a REIT at any time within the last five years (regardless of whether treatment as a REIT was valid)?
2. If the answer to question 1 is yes, are there any issues involving the REIT status of the purported REIT whose assets the tested entity is going to acquire?
3. If the answer to question 2 is yes, is the tested entity's REIT election "new" vis-à-vis the potential termination year of the purported REIT?
4. If the answer to question 3 is yes, does the tested entity satisfy both (a) the continuity of assets requirement; and (b) the continuity of ownership test?

If any one of these four questions is answered no, the tested entity will not be subject to the lockout rule and will be eligible to make a REIT election, assuming it satisfies all the other REIT qualification requirements. If all four questions are answered yes, the tested entity may be subject to the lockout rule.

When put that way, the application of the lockout rule sounds straightforward. But in many routine REIT M&A transactions, the answers to any or all of those four questions could range from "maybe" at best to "unknown" or "unknowable" at worst. In a world where stakeholders desire certainty on REIT qualification issues and the market demands a "clean will" REIT tax opinion, words such as "unknown," "unknowable," and "maybe" don't really cut it.

Example 22: *Complicated analysis on simple facts*. Tested Entity is formed in year 3 and, immediately after formation, acquires a parcel of real estate from a seller that had previously filed an election to be taxed as a REIT (Seller REIT) and whose REIT election has not been revoked by a voluntary act of Seller REIT. Tested Entity intends to own only this single asset and intends to elect REIT status beginning in year 3.

[45] *See infra* discussion in Section II.

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

This transaction happens all the time, and the facts could not be simpler. Still, the lockout rule analysis can get quite complicated. From the perspective of Tested Entity's REIT compliance process, 100 percent of Tested Entity's assets are assets that were owned by a seller that purports to be a REIT. Working through the lockout quiz, questions 1 and 4(a) are answered yes, meaning that to obtain certainty on its own REIT status, Tested Entity would have to develop facts and/or obtain contractual covenants necessary to support a "no" result on any of questions 2, 3, or 4(b).

To support a "no" result for question 4(b), Tested Entity would have to develop facts sufficient to prove the nonexistence of ownership overlap between its own direct and indirect investors and the investors in Seller REIT. As described in Example 8, it is often impossible for a taxpayer in Tested Entity's position to establish the nonexistence of the ownership overlap. And as described in Example 4, it is unclear how long that nonexistence of ownership overlap would have to last.

Once the parties determine that it is probably impossible to obtain with certainty a "no" on question 4(b), the parties are left with questions 2 and 3. These questions apply in a strange way to a newly formed tested entity. Because Tested Entity is newly formed and will make its first REIT election for year 3 (the year of the transaction), and because Seller REIT will be required to satisfy all REIT tests through the end of year 3 (even for the portion of year 3 occurring after closing[46]) to be a REIT for any part of year 3, Tested Entity cannot get certainty on question 2 or 3 unless, at the very minimum, it receives (and is willing to rely on) covenants that Seller REIT will maintain its REIT status at all times at least through the end of year 3.

Thus, to address questions 2 and 3 with certainty, Seller REIT would have to provide Tested Entity with both a representation that it is a qualifying REIT at the time of the sale and with a covenant that Seller REIT will maintain REIT status until Tested Entity is able to make its own REIT election. These types of representations and covenants are customary in situations in which one REIT spins off another REIT. In a situation in which one entity buys assets from another for cash, however, we have seen these types of representations and covenants on only one occasion — it was, in fact, the transaction that motivated us to write this report.

Sometimes, when an adviser to a tested entity in a situation like Example 22 mentions the lockout rule and the successor REIT rule, it makes the seller REIT paranoid about its own REIT status, which is rarely a pleasant experience.

Example 23: *Lockout rule analysis for seller REIT*. As a prequel to the facts in Example 22, Seller REIT was formed in year 1 and filed a REIT election effective upon its formation. Seller REIT purchased two properties (neither of which was the property purchased by Tested Entity in Example 22), each of which was worth $50, from two different REIT sellers in year 1.

In Example 23, Seller REIT's status as a REIT in year 3 generally depends on whether it was a REIT in year 1. Seller REIT's eligibility to make a REIT election in year 1, in turn, depends on the results of its own lockout quiz. Because both of Seller REIT's year 1 assets were acquired from entities that had elected REIT status, and because each asset presumably represented a substantial portion of Seller REIT's year 1 assets, Seller REIT would have to answer the lockout quiz for each of the parties from which it acquired its year 1 assets. Needless to say, even in the unlikely event that Seller REIT could have answered those questions back in year 1, they will likely be impossible to answer two years later, in year 3.

If examples 22 and 23 seem a bit absurd, consider what happens when one starts to layer in additional real-world facts.

Example 24: *Small cash contribution to a subsidiary REIT*. Public REIT made a REIT election in year 1. Public REIT has a portfolio of 300 assets worth $100 million. In year 3 Public REIT and Institutional Investor want to enter into a joint venture owned 51 percent by Public REIT and 49 percent by Institutional Investor, with the joint venture to be structured as a REIT. Accordingly, in year 3 the parties form Subsidiary REIT as the joint venture entity. Public REIT and Institutional Investor contribute cash of $510,000 and $490,000,

[46]For example, the REIT income test is an annual test based on full-year results. Similarly, Seller REIT would have to meet the quarterly asset tests as of the last day of the tax year and on any other quarter-end falling after the closing date. Failing any one of these tests would generally terminate REIT status for *all* of year 3.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

respectively, to Subsidiary REIT, which uses the cash to acquire and develop a real estate asset. In year 5 Subsidiary REIT sells its asset at a gain to Tested Entity, a newly formed REIT owned by a private equity fund, for $1.5 million. At the time of sale, the sold asset represented a substantial portion of Tested Entity's assets and the parties did not have sufficient knowledge to answer "no" to question 4(b) of the lockout quiz (regarding the continuity of ownership requirement).

Again, these facts are quite simple and yet the lockout rule creates intellectual havoc for anyone unfortunate enough to actually focus on it. For starters, Subsidiary REIT acquired 51 percent — likely a substantial portion — of its initial assets (that is, cash) from Public REIT and by definition has maintained more than 50 percent indirect ownership with Public REIT at all times since its formation. Thus, while it held the cash, Subsidiary REIT would seem to have satisfied both the continuity of assets requirement and the continuity of ownership requirement (depending on how indirect ownership is interpreted).[47] However, as discussed in Example 18, although there is meaningful risk that cash is an asset for purposes of the continuity of assets requirement, there is no guidance on whether the disposition of that cash (in this case, through the use of that cash to purchase a real estate asset) cleanses Subsidiary REIT such that it would not meet the continuity of assets requirement.

What this means is that, from the perspective of Tested Entity, its ability to qualify as a REIT beginning in year 5 depends on Subsidiary REIT's ability to qualify as a REIT beginning in year 3, which in turn depends on Public REIT's ability to qualify as a REIT between year 1 and the making of Subsidiary REIT's initial REIT election, depending on how literally one reads the successor REIT rule. So to obtain certainty on the REIT status of Tested Entity, one would have to perform diligence for (1) Subsidiary REIT between year 3 and the time at which Tested Entity's REIT election was made and (2) Public REIT between year 1 and the time at which Subsidiary REIT's REIT election was made. On these facts, that would amount to a full-company M&A due diligence process on a $100 million REIT as a prerequisite to the acquisition of a $1.5 million asset.

In real life, a full-company due diligence process on a large public REIT takes at least several weeks; involves scores of accounting, legal, and in-house professionals; and can easily cost millions of dollars. Public REIT would also have to devote significant resources to prepare the appropriate data room and assist Tested Entity in its efforts. Would any tax lawyer with a reasonably well-honed sense of self-preservation ask a client in the position of Tested Entity to undertake that process? Would any tax lawyer representing Public REIT suggest that its client oblige? It doesn't take much imagination to guess the answer to either of these questions.

Further, the private sector isn't lucky enough to be spared from this viral due-diligence morass.

Example 25: *Cash contribution to tested entity, a subsidiary REIT*. In year 1 the sponsor and a consortium of institutional investors contribute $50 million cash to Parent REIT, which contributes that cash to a series of five subsidiary REITs, one of which is Tested Entity. Each subsidiary REIT, including Tested Entity, uses the $10 million cash received from Parent REIT to acquire properties. The investors plan to take Parent REIT public at some point, but those plans fizzle and Parent REIT enters liquidation mode in year 3. During year 3 Parent REIT sells all the stock of the subsidiary REITs, except for Tested Entity. At the end of year 3, Tested Entity is Parent REIT's sole asset. In year 4 Parent REIT sells the stock of Tested Entity to Buyer PE Fund.

Here, the diligence issue is as glaring as it can possibly be. Tested Entity started its existence with a cash infusion from Parent REIT. Parent REIT and its subsidiary Tested Entity by definition maintained identical indirect ownership at all times. The continuity of ownership requirement thus is likely satisfied, and the continuity of assets requirement may be satisfied if one believes that the term "assets" includes cash. Again, from a due diligence perspective, the REIT status of Tested Entity depends on the REIT status of Parent REIT at all times — from year 1 through the time at which Tested Entity made its REIT election. Because Parent REIT's sole asset was the stock of various

[47] *See infra* Section III.B.2.b for a discussion of indirect ownership.

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

subsidiary REITs, the REIT status of Parent REIT necessarily depends on the REIT status of all or a portion of the other subsidiary REITs. All the other subsidiary REITs have been sold to other buyers, none of which is likely to provide due diligence information, for obvious reasons. So even if Buyer PE Fund wanted to perform the necessary due diligence on all those other entities to confirm the REIT status of Parent REIT and thus of Tested Entity, it likely could not.

Things get really awkward in this space when one of these entities — Seller REIT in Example 23 or any of the tested entities in examples 22 through 25 — either decides to issue REIT stock to the public or is sold to a third party in a stock deal. At some point, someone is going to ask for a "clean will" REIT tax opinion with respect to the entity whose stock is being issued or sold. For Tested Entity in Example 22, that opinion either (1) will be made on the basis of knowledge-qualified representations to the effect that Tested Entity does not satisfy the continuity of ownership rule with respect to Seller REIT or (2) will assume that Seller REIT was a REIT when Tested Entity acquired assets from it and that Seller REIT remained a REIT until Tested Entity could make its first REIT election. For Seller REIT in Example 23, the opinion will be based on similar representations and assumptions, this time including those regarding the entities from which Seller REIT acquired assets in year 1. The REIT opinions in the other examples would be based on similar representations and assumptions.

As a practical matter, none of these assumptions and representations can be subjected to what we think of as customary REIT due diligence — that is, an examination of scores of documents sitting in a data room. In many cases, it is unlikely that the representatives of a REIT that is upstream in the chain of title, such as the REITs that sold assets to Seller REIT in Example 23, will provide any information on the record, assuming that the REITs themselves still even exist. But despite the lack of certainty and the inability to perform due diligence, these representations and assumptions will form the basis of a REIT tax opinion, one that may ultimately be used to support the REIT status of a public entity or establish a fund sponsor's compliance with customary covenants to maintain the REIT status of portfolio companies.

Lest anyone think we're being far-fetched here, consider how a recent transaction illustrates a point that we alluded to earlier but have yet to fully emphasize: Things get really odd when one combines the successor REIT rule issues described earlier with the ambiguity described in footnote 27 — namely, that a failed initial REIT election may count as a terminated election (that is, if an entity files an erroneous initial REIT election, it would appear to be subject to the lockout rule even though it never obtained REIT status).

Example 26: *Chain of REIT sellers*. In year 0 PE Fund 1 formed REIT 1, which acquired a portfolio of properties from Public REIT. PE Fund 1 was near the end of its commitment period and entered into its wind-down phase in year 3, at which point PE Fund 1 caused REIT 1 to sell the portfolio to REIT 2, a subsidiary of PE Fund 2. In year 6 PE Fund 3 came along and made PE Fund 2 an offer on the portfolio that it couldn't refuse. PE Fund 2 thus caused REIT 2 to sell the portfolio to REIT 3, which was a newly formed subsidiary of PE Fund 3. PE Fund 3 expects to take REIT 3 public as part of its exit strategy. The same person sponsored PE funds 1 and 3, but the sponsor of PE Fund 2 was unrelated. Given the players, one can safely assume that all three PE funds shared some common investors, although no one could know for sure the true extent of the overlap, for the reasons described in Section III.B.2.b.

In this fact pattern, the initial REIT years for REITs 1, 2, and 3 were years 0, 3, and 6, respectively. Because REIT 2 acquired all its assets from REIT 1, and because REIT 3 acquired all its assets from REIT 2, it follows that REIT 2 satisfied the continuity of assets requirement with respect to REIT 1 and that REIT 3 satisfied the continuity of assets requirement with respect to both REIT 1 and REIT 2. Thus, if one were to assume either sufficient overlap to satisfy the continuity of ownership requirement or insufficient facts to disprove the application of the continuity of ownership requirement, REIT 3 could be considered a successor to either or both of REIT 1 and REIT 2, and REIT 2 could be considered a successor to REIT 1 (to say nothing of the fact that no one knows whether REIT 1 performed the

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

lockout quiz analysis on Public REIT, which creates the conundrum described in Example 23).

And this brings us to the final two questions of the day:

1. If REIT 1 were to have lost REIT status in or before year 3, would REIT 2's year 3 initial REIT election be deemed a termination, such that REIT 2 could not reelect REIT status until year 8?
2. If the answer to that question is yes, does that mean that REIT 3, having acquired assets from REIT 2 (a former REIT), experienced its own REIT election termination when it made its initial REIT election in year 6, such that REIT 3 cannot reelect REIT status until year 11?[48]

These questions stem from the fact that for tax purposes, REITs 2 and 3 are new entities making their initial REIT elections, thus implicating the issue described in footnote 27. It seems obvious that the "right" answer is that any newly formed tested entity should, at the worst, step into the remaining lockout period of the former REIT that was subject to the lockout rule (REIT 1 for the prior two questions). Although most tax lawyers would likely agree that this answer is intuitively correct, the regulations provide no clear path to that solution (and do not appear to contemplate the question).

For those seeking true assurance, therefore, it would seem that REIT 2 could not be certain of its REIT status in year 3 unless REIT 1 was a REIT in years 0 through 3, and REIT 3 could not be certain of its REIT status in year 6 unless REIT 2 was a REIT in years 3 through 6. This means that REIT 3's eligibility to elect REIT status in years 6 through 10 could depend on REIT 1's ability to elect REIT status in year 0. In other words, when the vagaries of the successor REIT rule are combined with the possibility that a failed initial REIT election for a newly formed tested entity triggers the lockout rule, one can wind up with a potentially endless application of the lockout rule.

So how is this working in the real world? In public company transactions, the lockout rule risk is always described in the risk factors, and the possibility that the public entity's REIT election might be in jeopardy because of its potential status as a successor REIT to a particular former REIT is disclosed in situations in which the risk is known to exist. This occurs, for example, in situations in which one REIT spins off another, leaving the REIT status of the spun-off REIT contingent on the REIT status of the distributing REIT for the five years before the time at which the spun-off REIT makes its REIT election.

On the opinion front, most advisers seem to be relying on a client representation, or on an explicit or implicit assumption, that one of the four questions in the lockout quiz is answered in the negative (in each case backed by whatever representations the client's counterparty is willing to give and whatever facts, filings, and documents are in the public record). In the final analysis, however, taxpayers and their advisers would seem to be taking comfort in the notion that a court will not allow the IRS to create a rule that is impossible to satisfy and then argue that an entity's REIT status should be terminated for not satisfying the rule. It goes without saying that this is no way to administer, much less practice, the tax law.

V. Policy Recommendations

A. History Supports Repeal

The history of the lockout rule makes a compelling case for its own repeal.

REITs, regulated investment companies, and S corporations (the single-tax corporations) are three special types of corporation that are generally subject to a single-level of taxation, provided each entity and its owners satisfy the intricate rules under each respective regime. RICs and REITs are the only two creatures of subchapter M. Because of the structural and statutory similarities inherent in subchapter M,

[48] The questions are presented this way to illustrate the most direct path to a lockout rule issue. Note, however, that this fact pattern provides another path to a lockout rule issue. Even if REIT 2 could prove that it is not a successor REIT to REIT 1 for failure to satisfy the continuity of ownership requirement, REIT 3 could still be a successor to REIT 1 in its own right for the reasons described in Example 20. In other words, even if REIT 2 were to prove to the satisfaction of REIT 3 that REIT 2 was not a successor REIT to REIT 1, REIT 3 would still need to perform due diligence regarding its own indirect ownership to ensure that REIT 3 is not a successor REIT to REIT 1 in its own right.

For more Tax Notes® Federal content, please visit www.taxnotes.com.

the RIC and REIT regimes are meant to be read *in pari materia*.[49] Subchapter S, on the other hand, is a stand-alone regime that only provides for S corporations.

In each case, the relevant entity is defined as a corporation under section 7701(a)(3) but is not subject to tax on its net income in some situations. For REITs and RICs, the entity computes its income in much the same way as a regular C corporation but is entitled to the dividends paid deduction, which can eliminate corporate-level income that would otherwise be subject to the corporate tax.[50] The S corporation, in contrast, is more of a pure passthrough, meaning that the owners of the entity, and not the entity itself, generally report and pay tax on the entity's income as if earned directly.[51]

The single-tax corporations have been part of the code for a long time, with the RIC legislation being enacted in 1936 and the S corporation and REIT regimes following in 1958 and 1960, respectively.[52] In the absence of a special limitation, single-tax corporations would allow shareholders the flexibility to defer income that would otherwise be subject to shareholder-level tax by selectively toggling in and out of single-tax corporation status from one year to the next. Although this elective shareholder-level tax deferral would come at the expense of a corporate-level income tax that would not have otherwise been paid, the corporate-level expense could be worthwhile in situations in which the corporate tax rate is significantly lower than the shareholder-level tax rate and commercial considerations require that the corporation retain its earnings, either to expand, deleverage, or fund current or anticipated expenses.

For example, in 1958, when the S corporation regime was enacted, nominal corporate tax rates went up to 52 percent[53] and individual rates were as high as 91 percent.[54] If S corporation shareholders planned to reinvest income back into their business, they could elect C corporation status, subject the business's income to corporate tax, and then have $48 to reinvest for every $100 of income (assuming a 52 percent corporate tax and not considering state and local tax). In contrast, the S corporation shareholders would have only $9 left to reinvest if instead they operated the business through an S corporation.[55] Thus, the S corporation shareholders could effectively achieve a reduced tax rate by toggling out of S corporation status in years in which commercial needs demanded the retention of earnings.

For S corporations, Congress was wise to the deferral opportunities from day 1, and the 1958 S corporation legislation contained the S corporation lockout rule, which discouraged toggling into and out of S corporation status by requiring an entity that toggled out of S corporation status to wait five years before toggling back in.[56]

Initially, however, REITs and RICs were not subject to any type of restrictions on their ability to toggle into and out of subchapter M.[57] For REITs, that happy situation ended in 1976, when

[49] *See., e.g.*, H.R. Rep. No. 86-2020 (1960) (stating that the REIT bill "provides substantially the same tax treatment" for REITs as current law provides for RICs, and that the bill "to the full[est] extent feasible, makes the requirements and conditions now applicable to regulated investment trusts, applicable to [REITs]. . . . Most of [the REIT] requirements are similar to requirements now applying in the case of [RICs] but are adapted to real estate, rather than stock, investments."). *See also* LTR 201135002; LTR 201122016; LTR 200614024; Rev. Rul. 89-130, 1989-2 C.B. 117; and GCM 37708 (Sept. 29, 1978).

[50] *See* section 857(b)(2)(B) for REITs and section 852(a)(1) for RICs.

[51] Section 1366.

[52] The precursor to the RIC regime, the mutual investment company regime, was originally enacted by the Revenue Act of 1936, section 48(e). The REIT regime was enacted by the Cigar Excise Tax Extension of 1960. The S corporation regime was enacted two years before the REIT regime, by the Technical Amendments Act of 1958.

[53] Former section 11 (1958).

[54] Former section 1 (1958).

[55] This is because the business's income would pass through to the shareholders and be subject to individual tax rates, leaving only $9 to reinvest for every $100 of income (assuming a 91 percent individual tax rate and not considering state and local tax).

[56] H.R. Rep. No. 85-1839, 1010 (1958) ("In order to prevent a corporation from electing in and out of the application of the provisions of this new subchapter, a limitation has been added providing that if a corporation has made an election under this subchapter, and if this election has been terminated or revoked, the corporation (or any successor) is not to be eligible to elect this treatment until its fifth year after the beginning of the year in which the termination or revocation is effective.").

[57] Before 1976, a REIT election was irrevocable, but a REIT could intentionally fail to qualify as a REIT and still requalify as a REIT the next tax year. *See* S. Rep. No. 94-938, at 478 (1976). Congress believed that REITs were voluntarily disqualifying themselves because, at the time, REITs were not allowed net operating loss deductions or allowed to use ordinary losses to offset capital gains as regular corporations were allowed to do. *Id.* at 477-478.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

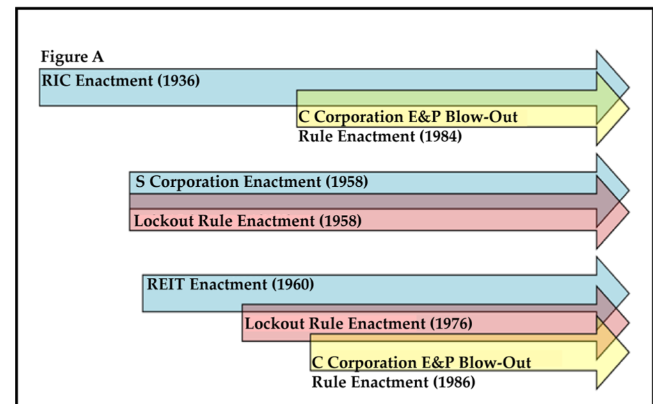
For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

Congress, while addressing other deficiencies in the REIT legislation,[58] decided to impose the S corporation lockout rule on REITs, presumably to advance the same anti-deferral policy that Congress had in mind when it enacted the original S corporation lockout rule on which the REIT lockout rule was based.[59]

At this point, RICs were the only single-tax corporation allowed to toggle into and out of passthrough corporate status without any tax friction. That flexibility ended in 1984, when Congress added section 852(a)(2) to the code, which requires any corporation that elects RIC status to distribute all its current and accumulated C corporation E&P before the end of its first RIC year (the C corporation E&P blowout rule), thus ending shareholder-level tax deferral on any retained corporate earnings.[60]

When the dust settled at the end of 1984, none of the single-tax corporations were able to freely toggle into and out of passthrough status in a way that would facilitate elective deferral of shareholder-level income. S corporations and REITs were subject to a lockout rule but were not required to distribute their C corporation E&P upon electing into passthrough corporate status, while RICs were subject to the C corporation E&P blowout rule but were not subject to a lockout rule.[61] The legislative history is silent on why S corporations and REITs were subject to one type of anti-deferral regime while RICs were subject to another, and it does not appear that Congress paid any heed to the fact that as of 1984, the two subchapter M entities were subject to different anti-deferral rules.

That situation, as unsatisfactory as it may have been, remained static until 1986, when Congress decided, for reasons that elude us, to impose the C corporation E&P blowout rule on REITs while simultaneously retaining the lockout rule.[62] At this point, as illustrated in the timeline in Figure A, REITs became the only single-tax corporation subject to two types of anti-deferral rule — the lockout rule and the C corporation E&P blowout rule. Reasonable minds can differ as to which rule is more of a burden, but one would have thought that most policymakers would agree that there is nothing so inherently evil about REITs that they ought to be treated worse than both S corporations (which remain subject to a lockout rule but are not subject to the C corporation E&P blowout rule) and RICs (which remain subject to the C corporation E&P blowout rule but are not subject to a lockout rule).



[58] Without the ability to deduct NOLs, a REIT with a $100 loss in year 1 and a $100 gain in year 2 would not be able to retain the earnings in year 2 because of the REIT distribution requirement. Moreover, when it paid out those earnings in year 2, shareholders would be subject to tax on the dividends because the year 1 loss would not have been passed through to them. These results would occur even though, over the two-year period, the REIT and its shareholders broke even — an unfair result. Consequently, that REIT would have an incentive to disqualify itself in year 2 to take advantage of the NOL deduction and retain the earnings from year 2 while absorbing the loss from year 1. The REIT could then reelect REIT status in year 3. Congress thought the NOL and capital gain limitations, by forcing REITs to switch in and out of subchapter M, imposed an "unreasonable restriction on REIT status." *Id.* Thus, in 1976 Congress added provisions allowing REITs to use ordinary losses to offset specific capital gains and permitting NOLs in computing REIT taxable income for eight tax years after the year the loss was incurred. *Id.*

[59] Having fixed the unfair result that previously encouraged some taxpayers to switch in and out of REIT status, and apparently believing that other reasons for switching in and out were inappropriate and should not be permitted, Congress as part of the same 1976 legislation enacted the lockout rule, based expressly on the S corporation analogue. *See id.* at 478. Although Congress did not expressly state the object of its concern in enacting a rule to prevent a taxpayer from switching in and out of REIT status, it is reasonable to assume that lawmakers were focused on policing the same deferral strategies that were the targets of the original S corporation lockout rule.

[60] Deficit Reduction Act of 1984.

[61] Although an S corporation is not absolutely required to distribute its C corporation E&P, an S corporation that has accumulated C corporation E&P will lose its S corporation status if it earns passive income that exceeds specified thresholds. *See* section 1362(d)(3) (enacted by the Subchapter S Revision Act of 1982).

[62] The Tax Reform Act of 1986 added section 857(a)(2)(B), which provides that any C corporation with accumulated E&P must distribute all of that E&P to qualify as a REIT. *See* Joint Committee on Taxation, "General Explanation of the Tax Reform Act of 1986," JCS-10-87, at 390 (May 4, 1987).

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

The lockout rule, as enacted, was a mistake, despite being founded (apparently) on a solid, anti-deferral policy. When it enacted the lockout rule, Congress took a provision that was tailored to S corporations, which are designed to be closely held and always have perfect or near-perfect knowledge about their shareholders, and made that rule applicable to REITs, which are designed to be widely held and almost never have perfect knowledge about their shareholders. That was an error, one that Congress compounded by allowing the REIT and RIC rules to diverge from one another on a topic for which REITs and RICs raise the same policy concerns in the same way. In a world focused on anti-deferral, the C corporation E&P blowout rule gets the anti-deferral job done in a clear and concise fashion. In fact, it already works well in the REIT space and does not raise the type of unsolvable REIT qualification issues that the lockout rule routinely creates.

Thus, from a policy perspective, the objective at which the lockout rule is aimed has already been fully achieved by the C corporation E&P blowout rule, and the lockout rule itself is responsible for its own unique set of policy problems. This rule accomplishes nothing and causes nothing but headaches in the process of accomplishing nothing. At the end of the day, it seems clear that the lockout rule needs to go.

B. Make the Successor REIT Rule Administrable

In the absence of repeal or while awaiting repeal, Treasury should take steps to make the successor REIT rule more workable in real-life settings. What follows are a few proposals for modifications to the continuity of ownership requirement and the continuity of assets requirement that would make the successor REIT rule much more administrable and much less likely to produce absurd or unintended results.

1. Modifications to the continuity of ownership requirement.

Some presumptions could alleviate the problems associated with a REIT's inability to know who directly or indirectly owns its shares. For example, a presumption of non-overlapping ownership that applies to publicly traded entities could allow the parties to analyze the continuity of ownership requirement based on actual knowledge. The following example illustrates such a presumption:

Example 27: *Actual knowledge rule*. In year 1 Former REIT, which was owned by a private equity fund with institutional investors, loses its REIT status. In year 2 Tested Entity, a widely owned publicly traded corporation, purchases all the assets of Former REIT and accordingly meets the continuity of assets requirement. By operation of an actual knowledge presumption, Tested Entity is presumed not to satisfy the continuity of ownership requirement if, following reasonable due diligence, it does not have actual knowledge of overlap in ownership with Former REIT sufficient to satisfy the continuity of ownership requirement.

Such a presumption would not be without precedent, and in fact, similar rules already apply to determine whether a REIT is domestically controlled under the 1980 Foreign Investment in Real Property Tax Act[63] and whether an entity qualifies as an independent contractor in relation to a REIT.[64]

Similarly, it would be helpful for Treasury to clarify the meaning of indirect ownership for purposes of the continuity of ownership requirement. Presumably, some sort of upward attribution through entities already applies, lest taxpayers be able to easily circumvent the rule by interposing intermediate entities into their structures. But a workable rule would require at least some limits on the attribution to reflect real-world difficulties in determining indirect ownership all the way up the chain.

Finally, as discussed in Section III.B.2.a, guidance on the meaning of "the taxable year" would also be helpful and would likely not

[63] Generally speaking, FIRPTA, codified in section 897, imposes a tax when a foreign person sells a U.S. real property interest, including equity interests in corporations that own significant U.S. real property. *See* section 897(a)(1) and (c)(1)(A)(ii). Section 897(h)(2) excludes stock in a domestically controlled qualified investment entity, which includes domestically controlled REITs, from the definition of a U.S. real property interest. In determining if a regularly traded REIT is domestically controlled, a person holding less than 5 percent of the publicly traded REIT stock is treated as a U.S. person. Section 897(h)(4)(E)(i).

[64] *See* section 856(d)(3) (for a public REIT, only 5 percent owners are taken into account). Although the rules described in footnote 63 and this footnote are expressly provided in the statute, building in regulatory presumptions to the successor REIT rule should not be an issue because the definition of successor, in the first instance, is provided in the regulations rather than in the statute.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

necessarily even require a modification to the successor REIT rule but may only require a clarification to that rule. For example, clarifying that "the taxable year" only refers to the year in which the tested entity makes its new REIT election (perhaps with appropriate antiabuse limitations to police situation such as in Example 5) and clarifying that momentary ownership overlap will be disregarded would resolve the ambiguity described in examples 4, 6, and 7 in one fell swoop.

2. Modifications to the continuity of assets requirement.

In addition to an actual knowledge presumption, Treasury should also move to a more traditional tax-driven notion of "successor," which is a taxpayer that obtains most of the assets and inherits the attributes of another taxpayer in a section 381 transaction, such as a tax-free reorganization or liquidation.[65] The consequence of doing so would mean that a taxpayer that acquires assets of a former REIT in a fully taxable transaction (that is, a basis step-up transaction) would not be considered a successor for purposes of the successor REIT rule.

Although less critical than that suggestion, the relevant assets of the former REIT for purposes of applying the continuity of assets requirement could also be limited, such as only to real estate assets as defined in section 856(c)(5)(B). Such a change would solve the application of the lockout rule in situations in which the tested entity receives only cash from the former REIT, as in Example 18.

Similar to the continuity of ownership requirement, a clarification on the timing for the application of the continuity of assets requirement could clear up a number of ambiguities. For instance, clarifying that the only relevant period in applying the continuity of assets requirement is the year of Tested Entity's REIT election could address the issues described in examples 12 through 15.

VI. Conclusion

There was a time when we thought we understood what the lockout rule meant. After all, it's a pretty simple rule that takes only a minute to read. But after working through the rule in the M&A and private equity spaces for years on end, we can say for certain that there are only a few things we truly understand about the rule. The first is that the examples in this article are far from exhaustive; it seems that every time we turn around, we discover some new way for this dreadful rule to create a hole in our REIT qualification analysis that can be filled only through an assumption, a client representation, or some other type of assurance from the client's counterparty or counterparty's counsel. The second is that the REIT qualification issues created by this rule are missed or ignored far more often than they are caught, and to those who might otherwise be happy enough with that state of affairs, we apologize for publishing this report. Third, the rule serves no discernible purpose that is not already being served completely by the C corporation E&P blowout rule, which actually works well. In an ideal world, the lockout rule would be deleted as surplus.

In the world we actually live in, the best we may be able to achieve are administrative modifications to the lockout rule. We would ask the IRS to consider the modifications described in Section V.B. In addition to making the lockout rule administrable, the modifications would avoid the type of contempt for the law that is produced by a rule with which certainty of compliance is often impossible to achieve and, for that reason, is rarely attempted. ■

[65] *See, e.g.*, reg. sections 1.337(d)-7(f)(2), 1.355-8T(c)(2)(ii), and 1.338-8(j)(6).

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2019 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.