

Coronavirus Crisis Spurs REIT Distribution Relief Discussions

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By



Rules that would temporarily modify stock-cash distribution requirements for real estate investment trusts could mitigate liquidity issues amid the coronavirus crisis, but

additional considerations might be warranted.

The pandemic undoubtedly is having far-reaching effects, including for REITs, but the extent depends on the business sector, with retail and lodging along with event spaces and coworking locations among those experiencing difficulties, according to Libin Zhang of Fried, Frank, Harris, Shriver & Jacobson LLP.

The 2008 financial crisis playbook will likely be a starting point for REIT relief, but today's situation isn't as straightforward, according to practitioners who spoke to *Tax Notes*. The practitioners said they have faith in the government's responsiveness and ability to navigate these uncharted waters.

In prior crises, Treasury and the IRS have responded to alleviate "the harsh impact of the [REIT] rules where appropriate, and I have every confidence they would do the same again," Ameek Ashok Ponda of Sullivan & Worcester LLP said.

Developing a complete playbook for a "worldwide systemic pandemic" seems extremely challenging, according to Ponda, a Tax Analysts board member. What should the government do if most businesses have lower revenues this year compared with 2019? he asked.

Richard M. Nugent of Jones Day emphasized that "any goals designed to ameliorate the current situation . . . not only have to be logical as a policy matter, but that logic has to be coupled with sufficient statutory authority for the government to act."

REITs are generally thought of as companies that own and manage several income-producing real estate properties such as shopping malls or office buildings, but also include healthcare facilities, data centers, cell towers, and other businesses.

Congress created REITs and gave them preferential tax treatment like mutual funds because it wanted the average investor to be able to own an interest in large-scale commercial real estate as a means of portfolio diversification.

Distribution Dilemmas

Amid the coronavirus pandemic, Nugent said he expects that “many REITs may be reducing their dividend levels because of declines in projected rents given current events.”

That’s important, because to qualify for REIT tax treatment — distributed earnings are taxed only at the investor level — an entity must, among other things, distribute at least 90 percent of its taxable income annually.

Qualifying REITs are permitted to deduct dividends paid to shareholders from their corporate taxable income, which is the mechanism for achieving single-level tax treatment.

Thus, if REITs distribute all their earnings and the distributions otherwise qualify for a deduction, they pay no corporate-level tax. To get this treatment, REITs are also subject to restrictions regarding ownership, assets held, and permissible activities, and must satisfy gross income tests.

If tenants stop paying rent temporarily because of the coronavirus outbreak, the REITs must still accrue the rental income, which means they have taxable income subject to the 90 percent distribution requirement without having cash coming in, Zhang explained.

Because REITs, and regulated investment corporations, might not have enough cash, [section 305](#) allows the total amount of some part-stock, part-cash distributions to qualify

as a [section 301](#) distribution if the entities' shareholders can make a stock or cash distribution election.

In 2017 the IRS formalized its historic (pre-2008-2009 financial crisis) requirements for stock-cash distribution letter rulings in [Rev. Proc. 2017-45](#), 2017-35 IRB 216. That guidance allows publicly offered REITs and RICs to give shareholders the choice of receiving a distribution in either cash or stock, if the entity's distribution is at least 20 percent cash.

If the entity satisfies the requirements in the revenue procedure, the IRS will treat the stock as a [section 301](#) distribution of property, and the value of the stock a shareholder receives in lieu of cash will be treated as equal to the amount of cash for which the stock is substituted.

During the financial crisis, the IRS issued a series of revenue procedures to address liquidity issues at that time, with the last one ([Rev. Proc. 2010-12](#), 2010-3 IRB 302) extending the effective date through 2011. The procedures allowed part-stock, part-cash distributions if the distribution was at least 10 percent cash.

The Ask

Undoubtedly, the government will consider that reprieve with the coronavirus pandemic, according to practitioners.

Similar policy concerns "animate the request" for relief in the current environment and the government presumably has determined that no legal impediments preclude allowing for a 90 percent stock distribution in appropriate circumstances, Nugent said.

In a [March 18 letter](#), Nareit, formerly known as the National Association of Real Estate Investment Trusts, requested that Treasury "issue guidance similar to the earlier revenue procedures with respect to 2020 and 2021" to allow REITs and RICs to use a mix of up to 90 percent stock and 10 percent cash to qualify as dividends for purposes of the distribution test and the dividends paid deduction.

Increasing the allowable percentage of stock distributions would provide the business entities “the option to conserve capital in these challenging times,” Nareit said.

Collateral Effects

Zhang pointed out an even greater problem for REITs that bought back stock over the past several years at high prices.

Those businesses have less cash now because of the stock buybacks, and the economic effects of the coronavirus pandemic are requiring them to pay stock dividends instead of cash, which is essentially issuing new stock at the current market price, Zhang said. He added, “And that’s not a great deal because the REIT stock prices are pretty low right now.”

“Buy high, sell low” obviously isn’t what you want to do, Zhang said.

That phenomenon doesn’t just exist with REITs because other companies, such as the airlines, have been buying back stock, Zhang said. The difference is that the airlines don’t have to issue stock dividends to meet distribution requirements, he added.

Zhang also noted that “REITs typically don’t get a dividends paid deduction for their past stock buybacks, so that’s tax-inefficient money out the door.”

Prohibited Transaction Rulings

Perhaps the government might become more receptive to providing “rulings that sales do not give rise to a prohibited transaction,” as further relief for REITs, according to Nugent.

REITs are generally taxed at 100 percent on net income from a prohibited transaction, “which is the sale of property held by the REIT primarily for sale to customers in the ordinary course of its business,” Nugent explained.

[Section 857](#) provides a safe harbor but if the REIT’s transactions fall outside of those rules, “the IRS ordinarily does not rule on factual issues such as whether property is held primarily for sale to customers in the ordinary course of a trade or business,” Nugent said.

However, in 2009 the IRS issued two letter rulings ([LTR 200945025](#) and [LTR 200953018](#)) in which it concluded that the sales didn't represent prohibited transactions, Nugent said.

He noted that in those rulings the IRS "referred to the 'extreme economic conditions' prevalent at the time and basically recognized that the REITs at issue had limited options for obtaining the cash necessary to meet their operating needs."

"The government hopefully would be similarly receptive to any such requests made now," Nugent said.

Reasonable Cause Relief

Several REIT rules under sections 856 and 857 say that if an entity's failure to satisfy specific requirements is "due to reasonable cause and not due to willful neglect" — and it satisfies any other specified requirements — the failure won't jeopardize its REIT status.

Ponda's wish list includes more generous use of REIT relief provisions, such as those reasonable cause rules.

As an example, Ponda pointed to how the IRS addressed concerns that arose in the aftermath of the 2005 hurricanes stemming from potential effects on hotels and motels that housed people for extended periods.

In a series of notices — the last one issued in 2006 ([Notice 2006-58](#), 2006-2 C.B. 59) extended the date — the IRS said that hotels, motels, and other establishments providing temporary housing to victims of hurricanes Katrina and Rita would nonetheless satisfy the definition of lodging facilities under [section 856\(d\)\(9\)](#), provided adequate records were maintained.

REITs that had owned lodging facilities "expressed concern that extended stays at those facilities by persons affected by these disasters may cause the REITs to fail to satisfy the income tests" under [section 856\(c\)\(2\)](#) and (c)(3), the notice said.

That was a different crisis with different problems from what's occurring now with the novel coronavirus, Ponda said. However, he said it illustrates how responsive Treasury and the IRS have been in situations in which an entity might otherwise lose REIT status because of circumstances beyond their control if relief isn't provided.

The current environment continues to evolve and it's still a bit premature to know all the circumstances for which REITs might need relief, according to Ponda. But he said he could envision an entity bumping up against the gross income requirements if one of its portfolios is under stress and the other is maintaining its own.

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