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Hoarders, REIT Edition: Cash Conservation in the Time of Coronavirus

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Businesses of all types, including REITs, are scrambling to preserve liquidity in the face of unprecedented uncertainty. There are some things that REITs can do (or at least consider) now to conserve cash and prepare for the impending economic fallout.

Picture it. Washington, DC, 2020. A paunchy, not-quite middle-aged tax lawyer is typing furiously on his laptop (at home, of course). The tax director of an equity-REIT client has just called to say that the coronavirus (COVID-19) pandemic has created massive uncertainty for the REIT's business; the REIT's CFO had called the tax director earlier for ideas on reducing the amount of cash leaving the REIT's bank accounts. The REIT's quarterly distributions might be on the chopping block, but the CFO does not want to cause a REIT failure.

To some, this will sound familiar. And not just because they are fans of *The Golden Girls*. The last two weeks have seen some of the greatest market turmoil since 2008, and perhaps since 1929. And it has occurred at nothing short of lightning speed. Businesses of all types, including REITs, are scrambling to preserve liquidity in the face of unprecedented uncertainty.

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A REIT generally must have, on an annual basis, a dividends-paid deduction ("DPD") of at least 90 percent of its ordinary taxable income (determined prior to taking into account the DPD). The REIT is also subject to federal corporate income tax to the extent that its pre-DPD REIT taxable income (including net capital gain) exceeds its DPD. Public REITs make distributions quarterly; the practice for private REITs varies. This means REITs generally can't simply choose to retain their earnings, even if their business needs demand it.

But everything is in flux. Congress is considering extraordinary stimulus measures, including significant changes to the tax laws. Much may change in the next 10 days, if not the next two or three. And REITs may not want to see cash out the door, even to investors, but sitting as comfortably as possible in bank accounts or in safe, liquid assets. Here are some things that REITs can do (or at least consider) now to conserve their cash.

Section 1031 Like-Kind Exchanges (All REITs)

The use of section 1031[1] exchanges is a tried and true way to "conserve" cash. We use quotation marks here because a sale of property with gain entirely deferred through a like-kind exchange generally will not produce any cash. The REIT might, however, instead choose to preserve the size of its asset base by recycling its capital into new assets in a tax-deferred manner rather than by distributing cash attributable to the sale (or the gain on the sale) to its shareholders. This might allow the REIT greater flexibility for drawing down under existing lines of credit or other credit sources, and avoid the need to go to equity or debt markets for new capital.

In effecting like-kind exchanges, taxpayers should keep a close eye on the clock. The periods for completing forward or reverse exchanges is just about six months from the date of the first leg of the transaction.[2] The ability to effectively close transactions—for either replacement property or relinquished property—will be impeded during this time when the United States (and the rest of the globe) is in a state of partial or full lockdown.

Increasing Cost Recovery Deductions (All REITs)

REITs, and public REITs in particular, have not historically placed as much emphasis on reducing taxable income as other corporate taxpayers. The primary reason is that REITs generally do not pay U.S. federal income tax, at least to the extent they distribute their REIT taxable income. And many REITs, both public and private, have investor bases composed to a large extent of U.S. tax-exempt investors, whose primary focus is on cash flow and not the tax characterization of distributions.

First, REITs might want to revisit decisions not to elect out of the interest-deductibility limitations of section 163(j) for 2019. A REIT might have intended not to "elect out" of section 163(j) for 2019 for a

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[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

[2] *See* sections 1031(a)(3), 1.1031(k)-1(b)(2) (forward exchanges); Rev. Proc. 2000-37, 2002-2 C.B. 308 (reverse exchanges).

number of reasons. For instance, a REIT might have been agnostic about the portion of its distributions that would be characterized as taxable dividends for U.S. federal income tax purposes (and may already have issued Forms 1099-DIV reflecting dividend treatment). Or, a REIT may even have had a loss without regard to the effect of section 163(j) and did not want to forgo the opportunity for future cost recovery benefits by making an irrevocable election under section 163(j)(7)(B) for interest deductions that it could not immediately use. That calculus may now have changed (though not necessarily). By electing out for 2019, however, the REIT might be able to generate greater interest deductions for 2019. A net operating loss ("NOL") for 2019, or an increase in that NOL, can, subject to applicable limitations (such as, for instance, section 382), be used to reduce up to 80 percent of taxable income of the REIT (prior to the application of any dividends-paid deduction) for 2020.[3]

REITs might also look to other ways to increase cost recovery deductions. They might do this by using MACRS to depreciate newly placed in service assets or electing bonus depreciation, even when these steps were previously thought unnecessary. REITs might seek to increase cost recovery by increasing the depreciable basis of assets. Cost segregations have become increasingly popular for even public REITs, particularly following the adjustments made to the rules applicable to REIT earnings and profits enacted in the Protecting Americans from Tax Hikes (PATH) Act of 2015.

Delaying Distributions (All REITs)

To conserve cash, a REIT might simply cut or delay its dividend. CFOs are, of course, all over this. And—if the REIT would otherwise be expected to distribute an amount in 2020, taking into account amounts already distributed, that would exceed its 2020 taxable income—cutting the dividend generally wouldn't present a U.S. federal income tax issue for the REIT.

But what if the REIT can't be sure whether it will have an overall tax loss for 2020, even after taking steps to reduce its taxable income (or, as discussed below, generate an NOL for 2019 that can be carried over)? The distribution requirement applicable to REITs is an *annual* requirement. The REIT need not pay distributions to generate a DPD prior to the end of the year (or in January of the next year, taking into account section 857(b)(9)). The REIT can then hold onto its cash for somewhat longer, and see how events transpire. That might calm some nerves. And using the "throwback dividend" procedure of section 858, a REIT might even be able to wait until the third quarter of 2021 to make any distributions necessary for 2020, subject to the application of the four percent excise tax under section 4981.

Using NOL Carryovers (All REITs)

The way that REITs use (and account for) NOL carryovers is complicated. The basic rule is that the REIT can deduct an NOL carryover against the amount of its income remaining after its DPD.[4] REITs, both public and private, often seek to maximize cash flow to their investors, resulting in a DPD. For

[3] *See* sections 172(a), (d)(6)(C).

[4] *See* sections 172(d)(6), 857(b)(2).

each dollar of DPD taken, the REIT generally loses the ability to use a dollar of NOL carryover. In other words, dividends crowd out the usage of NOL carryovers. Often, a REIT's NOLs loiter about, unused, for years.

But if a REIT is willing to reduce its dividends, a correspondingly larger amount of its NOLs may be used to offset its taxable income. The less taxable income the REIT has, the smaller its distribution requirement (and the smaller the amount it must distribute in order to zero-out its income).

A caveat. For NOLs arising in tax years beginning after 2017, a REIT may use carryovers of those NOLs to offset 80 percent of its taxable income (determined prior to the application of the DPD).[5] These NOLs can be carried forward indefinitely. Importantly, 2017's tax reform did away with the corporate alternative minimum tax, which often complicated a REIT's use of NOL carryovers.

Cash/Stock Election Dividends (Primarily Public REITs)

Corporations converting to REIT status frequently face decisions about how to distribute their accumulated earnings and profits without digging too far into their cash resources or possibly even borrowing. Their advisers often point to section 1.305-1(b)(2). This regulation provides that, if a corporation that "regularly distributes its earnings and profits, such as a regulated investment company" declares a dividend, and the shareholder can elect to receive either money or stock of the corporation of equivalent value, "the amount of the distribution of the stock received by any shareholder electing to receive stock will be considered to equal the amount of the money which could have been received instead." The regulation does not state that any particular portion of the total distribution need be available in cash.

A series of private letter rulings were issued that permitted corporations to offer "cash/stock election" distributions.[6] In a plain-vanilla case[7], the corporation would declare a dividend of $100 to holders of its common stock. A shareholder could elect to receive all or some portion of the dividend in cash or shares of common stock with a corresponding value; the shares' value would be determined by reference to a trading-price formula. Most shareholders would be expected to choose the maximum amount of cash offered. The aggregate amount of cash available would, however, be subject to a cap. These rulings generally conclude that the REIT could treat the entirety of a cash/stock election distribution as dividend, provided that no less than 20 percent of the total distribution would be available in cash to electing shareholders.

Later, during the financial crisis that began in 2008, the IRS provided temporary guidance allowing the minimum cash pool to be 10 percent (as opposed to 20 percent).[8] Revenue Procedure 2017-45[9]

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[5] *See* sections 172(a), (d)(6)(C).

[6] *See, e.g.*, PLR 200122001 (Dec. 5, 2000), PLR 201304002 (Oct. 4, 2012).

[7] A number of variations were in fact implemented.

[8] *See* Rev. Proc. 2008-68, 2008-2 C.B. 1373 (2008 and 2009); Rev. Proc. 2009-15, 2009-4 I.R.B. 356 (2008 and 2009); Rev. Proc. 2010-12, 2010-3 I.R.B. 302 (2010 and 2011).

[9] 2017-35 I.R.B. 216. Effective for distributions on or after August 11, 2017.

permitted REITs, on a permanent basis, to receive a DPD for cash/stock election distributions, provided that cash was available to electing shareholders in a minimum amount of 20 percent. REITs can take advantage of this guidance to limit the amount of cash needed to carry out a dollar of DPD. And there are arguments the IRS's 20 percent minimum is properly viewed as a merely a safe harbor, and that the section 305 regulations justify a lower percentage; the IRS previously acknowledged that a lower minimum (10 percent) would work just the same.

Perhaps it will be *déjà vu* all over again. On March 18, 2020, the National Association of Real Estate Investment Trusts (Nareit) sent a letter to the Treasury Department asking for a temporary reversion to the 10 percent minimum amount.

Distributing Preferred Equity or Debt (Primarily Public REITs)

What if a REIT does not want to part with any cash, at least not in the near future. While a pure, *pro rata* common-stock dividend generally will not generate a DPD for the REIT, another approach might be for the REIT to give common shareholders an election for either common stock or another security, such as preferred stock (including participating preferred) or notes of the REIT (including convertible notes). The Treasury regulations under section 305 generally permit this type of distribution to be treated as a distribution for purposes of section 301, and therefore eligible to generate a DPD to the REIT, subject to normally applicable limitations.[10] The same regulations clarify that a *pro rata* distribution of convertible preferred stock might also be treated as a section 301 distribution.

The issuance of single class of convertible equity might be sufficient. An example in the regulations allows this result when the economics of the convertible preferred stock, the conversion of which must be exercised within six months, makes "it is reasonable to anticipate that within a relatively short period of time some shareholders will exercise their conversion rights and some will not."[11] Again, REITs may not want to increase debt on their balance sheets or otherwise recapitalize in this way. But not every REIT will be in the same situation.

Taxable Split-ups (All REITs)

REITs, unlike regular C corporations, receive a DPD. When a REIT distributes assets in-kind, like any other corporation, it typically recognizes gain on the assets distributed.[12] But, if the distribution is treated as a section 301 distribution, the REIT is generally entitled to a DPD to the extent of the net value of the assets distributed.[13] The distribution (the amount of which generally would be net value of the assets distributed to the REIT) is a taxable dividend to the shareholders to the extent of the REIT's

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[10] *See* section 1.305-4.

[11] *See* section 1.305-4(b), Example 2.

[12] *See* sections 311, 1.856-1(e).

[13] *See* sections 857(b)(2)(B), 561(a)(1), 562(a). Steps would need to be taken to cause any such distribution not to be treated as a distribution under section 355. The rules on "partial liquidations" should also be considered; they can operate to limit the DPD to the REIT. *See* sections 302(b)(4), (e), 562(b)(1) (flush).

current and accumulated earnings and profits; any excess portion of the distribution generally is treated as a return of the shareholders' respective capital, and reduces basis in their distributing-REIT shares.[14]

Here's what is important. The gain recognized on a section 301 distribution by the REIT of assets often (and hopefully) will be less than the amount of the distribution, meaning that the distribution itself will "flush" the entirety of the gain triggered by the distribution. The "excess" portion of the distribution generally would be available to carry out a DPD, reducing the REIT's income (including operating income), which, undistributed, presumably is largely held as cash. The assets distributed might be structured as stock in another REIT; the distribution might leave the shareholders with stakes in two different REITs, which may even trade separately. After the distribution, the shareholders hold an investment in essentially the same assets as prior to the distribution. The shareholders may not like the dry income associated with the taxable receipt of an asset other than cash, but that might be mitigated by their receipt of a liquid asset (i.e., a listed security).

Obviously, there are significant commercial and legal issues associated with effecting a split-up of a REIT, including whether two separate companies are viable.

Consent Dividends (Private REITs)

In the Soviet Union, the old joke went "we pretend to work, and they pretend to pay us." Well, with consent dividends, the REIT pretends to pay a dividend, and the shareholder pretends to receive it. In other words, REITs can get a DPD without giving up cash, and the REIT's shareholders (or shareholder) are treated as receiving a dividend for U.S. federal income tax purposes.[15]

This technique is frequently used for private, closely held REITs, and in particular fund structures in which the REIT's sole common shareholder is a single entity treated as a partnership for U.S. federal income tax purposes. The reason for a consent dividend's limited usefulness is its limited practicality. A REIT's shareholder must agree with the REIT to receive a consent dividend (hence, "consent").[16] And a consent dividend is treated for U.S. federal income tax purposes as if it had been actually paid on the last day of the REIT's tax year.[17] That means phantom income. Withholding may also be required to the extent that REIT has any foreign shareholders (or that partnerships with foreign partners invest in the REIT).[18]

Although all common shareholders need not consent to all or even any portion of a distribution being converted into a consent dividend, those common shareholders that do consent will be treated as contributing capital (to the extent of the consent dividend, less any tax withheld) to the REIT; but that capital contribution does not expand the shareholder's share of the REIT's equity (merely its paid-in

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[14] *See* section 311.

[15] *See* sections 561(a)(2), 565, 1.565-1(c).

[16] *See* section 1.565-4(c).

[17] *See* sections 561, 1.565-3(a).

[18] *See* sections 565(e), 1.565-5.

capital).[19] In other words, it does not work like the cash-stock election dividend described above. So, consent dividends tend to be "paid" to shareholders, if at all, in the same proportion. For closely held REITs, shareholders (if there are more than one, and if they are not under common management) might be convinced to agree to *pro rata* consent dividends. The more widely held the REIT is, then, the less likely it is that consent dividends are feasible. As you can imagine, then, consent dividends generally are not a viable strategy for public REITs. Private REITs, particularly in fund structures, should be looking carefully at the utility of consent dividends as part of their near-term planning.[20] The state treatment of consent dividends should also be kept in mind.[21]

Retaining Income and Paying Tax (All REITs)

A REIT can choose to "retain" (i.e., not to distribute and receive a DPD for) up to 10 percent of its pre-DPD REIT taxable income (determined without regard to its net capital gain), and simply pay federal corporate income tax.[22] This is a form of tax heresy (and one might have been duly incinerated in the past for even uttering it). REITs can also retain up to all of their net capital gain, and pass through a credit for taxes they have paid to their shareholders. Consideration of retaining net capital gain has become a bit more common, particularly since the reduction in tax rates that passed with the TCJA. But with corporate tax rates relatively low and the equity and credit capital markets reeling from the effects of social distancing, the heretical might find some space for itself in the canon.

REITs should also keep in mind the rules relating to "excess noncash income." A REIT's annual distribution requirement generally is 90 percent of its REIT taxable income, without regard to net capital gain and before the application of a DPD.[23] That amount is reduced, however, by the REIT's excess noncash income for the year.[24] Excess noncash income is the amount by which the sum of four specific categories of noncash income exceeds five percent of the REIT taxable income (determined without regard to the DPD and excluding any net capital gain).[25] One of the categories of income is cancellation

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19 *See* section 1.565-3.

20 You might notice that we referred above only to common shareholders. The reason is that consent dividends may be "paid" only on "consent stock." *See* section 561(a). Consent stock includes only stock that is "entitled, after the payment of preferred dividends, to a share in the distribution (other than in complete or partial liquidation) within the taxable year of all the remaining earnings and profits, which share constitutes the same proportion of such distribution regardless of the amount of such distribution." *See* section 565(a), (f)(1).

21 There are certain states that limit the DPD when the REIT is a "captive REIT". The rules vary by state. Particular attention should be paid to Alabama, Arkansas, Colorado, Connecticut, Georgia, Illinois, Indiana, Kentucky, Louisiana, Mississippi, Maryland, New York, North Carolina, North Dakota, Oklahoma, Oregon, Rhode Island, Tennessee, Utah, Virginia and West Virginia. DPD-disallowance rules might be further exacerbated if the REIT is in a combined and/or unitary group that includes its taxable REIT subsidiary, especially for REITs in the hospitality industry.

22 *See* section 857(a)(1), (b).

23 *See id.*

24 *See* section 857(a)(1).

25 *See* section 857(e)(1).

of indebtedness income.[26] Another is the rental accrual to the REIT under section 467, in excess of the rent that would have been accrued by the REIT under general tax principles absent the application of section 467.[27]

While the excess noncash income rules are helpful, REITs should be aware: These rules do not alter the REIT's accrual of taxable income. They merely reduce the REIT's annual distribution requirement. To the extent that the REIT does not have a DPD at least equal to all of its REIT taxable income (including net capital gain), it generally will be subject to federal corporate income tax.[28]

Reorganizing as a Publicly Traded Partnership (Public REITs)

None of us thought we would be working from home indefinitely right now, so out-of-the-box (or at least out-of-the-office) thinking may be appropriate. Let's say that none of the above options work and that the REIT is sufficiently widely held so that a consent dividend simply won't do much good.

A partnership, unlike a REIT, does not have a distribution requirement, and does not pay U.S. federal income tax. So what if the common REIT shares held by the public were to become interests in a partnership? Bear with us.

A new entity that will be treated as a partnership for U.S. federal income tax purposes is formed (the "Newco"), say as a Delaware limited liability company. Newco forms a wholly owned subsidiary, another Delaware limited liability company. REIT, a public company, merges with the subsidiary, with REIT surviving. REIT's shareholders receive interests in Newco, which are publicly listed. Newco would clearly be a publicly traded partnership, but would expect to satisfy the qualifying income exception of section 7704(c), because its sole source of income would be dividends from REIT. Foreign and U.S. tax exempt investors would continue to be effectively "blocked," and U.S. partners' share of the partnership's REIT dividends would continue to be eligible for the benefits of section 199A and the capital gain dividends-provisions applicable to REITs.

What's the point of this? Well, Newco would own all the common stock of REIT. Newco can more readily agree to a consent dividend from the REIT, which is otherwise not typically helpful for a public REIT. Foreign withholding would be an issue, and the REIT would have to distribute a sufficient amount to enable Newco to satisfy those obligations. A prudent question would naturally be: Why would the REIT's shareholders agree to facilitate one of their investments generating phantom income? But not all those shareholders would have a choice. If a sufficient number of shareholders can be convinced—particularly U.S. institutional investors who might not be tax-sensitive, very significant commercial and legal issues associated with this approach may be outweighed by fundamental business and risk issues. But nowadays, using the phrase "very significant issues" almost seems quaint.

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[26] *See* section 857(e)(2)(D).

[27] *See* section 857(e)(2)(A).

[28] *See* section 857(b)(1).

De-REITing (All REITs)

Then there is an atom bomb. There will be businesses for whom the next several months will lead to existential uncertainty. That is tragic, and for many of the businesses' stakeholders, it will be a catastrophe. Some REITs might find that the value of its assets has decreased to such an extent, and its operating income plunged so far into the red, that REIT status is not valuable, particularly with 21 percent federal corporate income tax rates. The termination of a REIT election locks out the former REIT (and its successors) from making a new election during the four years following the year of the termination. So this decision should not be taken lightly.

In light of the extraordinary events transpiring in the United States and around the world, preservation and survival are paramount. As liquidity tightens, hopefully this article provides some ideas that will aid in REITs getting through the fallout of COVID-19.

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