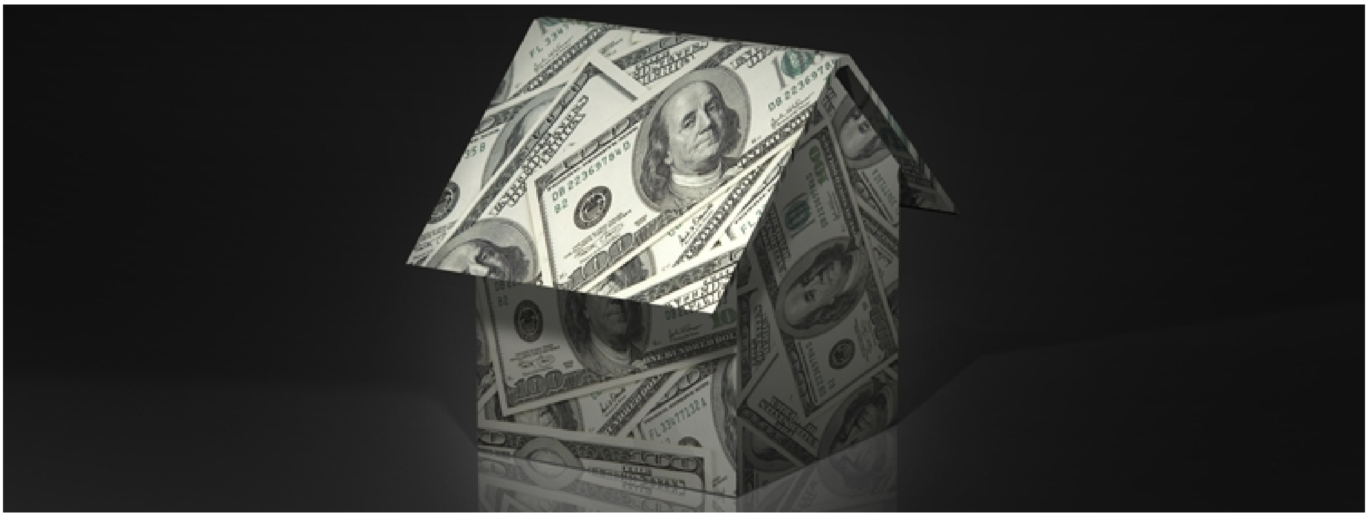

C Corporation to REIT Conversions

Recent rulings by the Internal Revenue Service have led to a significant amount of publicity surrounding the conversion of C corporations to real estate investment trusts (REITs), particularly those in non-traditional asset classes. However, the tax implications of REIT conversions are often misunderstood in today's rapidly evolving tax, business and regulatory landscape, as McRae Thompson, Managing Director with Alvarez & Marsal Taxand, recently examined in *Business Entitie*s.

Commentators and lawmakers have historically focused on corporate tax issues when publicly evaluating the implications of REIT conversions, but this concentration may miss the full picture, according to McRae. This viewpoint ignores factors such as tax revenues generated on the dividends derived by individual REIT investors, the acceleration of investor level taxation on both current and deferred corporate earnings, the generally higher tax rates paid by investors on REIT dividends and the retention of the C corporation tax taint on corporate built-in gain assets for an extended period of time.

While REIT conversions can be advantageous to a select group of C corporations, McRae emphasizes that they may not benefit the majority. A company considering a REIT conversion should consider the potential benefits of converting against other key business considerations such as:

- Strategic concerns (i.e. significant changes to the current business model and / or legal structure which may conflict with the company's long-term growth strategy),
- Financial considerations involving liquidity and certain debt covenants, and
- Both initial and ongoing regulatory and compliance issues.

Companies can take steps to best determine whether the potential benefits of a REIT conversion are substantial enough to outweigh the adverse consequences, says McRae. A&M is well positioned to assist in this process which may include preparing financial models to quantify the potential cash benefits / detriments, as well as examining the most beneficial structure in which to convert. McRae has also helped clients identify and evaluate strategic alternatives that do not involve REIT conversions to ensure their objectives, as well as those of key stakeholders, are achieved in the most prudent and efficient manner. McRae also notes that after the deal has closed when many transaction advisors have long moved on, there is a significant need to manage the ongoing compliance and qualification process.

To learn more about non-traditional REIT conversions and the potential tax implications, read McRae's recent article in *Business Entities* below.

While recent IRS rulings have generated increased interest in REIT conversions, the tax consequences are often misunderstood.

The types of qualifying real property traditionally held by real estate investment trusts (REITs) have predominantly included multi-family residential properties, office buildings, warehouses, certain lodging facilities (e.g., hotels and assisted living residences), and shopping centers. Recently a perception has seemed to develop that the IRS has inappropriately used its authority to *broaden the definition of qualifying real property* for REIT qualification purposes, so as to include many non-traditional asset classes.

Evolution of Qualifying Real Property

Some critics may state that this perception is accurate as evidenced by the Service's issuance of proposed regulations clarifying and expanding on what qualifies as real property[1], as well as its willingness to issue numerous favorable private letter rulings to companies seeking to qualify as REITs in non-traditional, yet real estate intensive, businesses.[2] The issuance of these rulings, and the related publicity created by various commentators, has resulted in an enormous amount of interest in the evaluation of the REIT conversion alternative by corporate America.

Recent Corporate Activity

As the IRS continues to issue favorable REIT qualification rulings, it has been widely reported in the media that companies in various industries including (but not limited to) gaming, outdoor advertising, prisons, data and document storage, timber, and cell towers have either undergone REIT conversions or are currently exploring the potential benefits of converting. For example, all of the real property of Penn National Gaming was spun off as a REIT, Gaming Leisure Properties, which elected REIT status for the 2014 tax year.

Also, Windstream Holdings began the process in 2014 of spinning off its fiber optic and copper cable lines into a REIT, Communications Sales & Leasing, Inc., and reportedly completed the tax-free spinoff in April of 2015. Finally, in July of 2015, Sears Holding Corporation announced that it sold several of its owned stores to Seritage Growth Properties, a REIT that it has established, in a sale-leaseback transaction; Caesars Entertainment and its private-equity majority owners are reportedly seeking support for a plan to turn the bankrupt company into a REIT as part of a debt restructuring plan (prior to filing bankruptcy Caesars had proposed to split its operating division in two, a REIT and an operating company); and Life Time Fitness explored the possibility of a conversion of its real estate assets into a REIT prior to its acquisition in June of this year.

Criticism of Non-Traditional Conversions

Corporate activity around REIT conversions is not limited to the aforementioned public company examples, but the sample clearly illustrates the immense amount of interest in exploring the potential benefits, both tax and business motivated, of real estate ownership in the form of a REIT. Some critics of these non-traditional REIT conversions perceive that companies are seeking to avoid taxes through a "loophole" in the tax code at a detriment to tax revenue and the U.S. economy. The surge in non-traditional REIT conversions has also grabbed the attention of lawmakers, including Senator Dave Camp (RMich.). As part of his Tax Reform Act of 2014 discussion draft, Senator Camp proposed sweeping changes to many REIT-related tax provisions, including:

1. Imposing immediate taxation on a C corporation's built-in gain on a REIT election.
2. Preventing tax-free REIT spinoffs.
3. Requiring non-REIT earnings and profits to be distributed in cash only.
4. Limiting the definition of "qualifying real property" for purposes of the REIT income and asset tests.
5. Reducing the benefits associated with using a taxable REIT subsidiary (TRS).

Need for Clarification

The heightened corporate activity surrounding companies owning non-traditional real estate engaging in REIT conversions, operating company/property company splits, REIT spin-off transactions, and REIT mergers and acquisitions has led some to believe that such transactions are quite simply an unfair abuse that must be curbed in order to preserve the integrity of the U.S. federal income taxation system. However, the true tax burden (in the form of decreased tax revenue collected by the U.S. Treasury) of owning and operating real estate assets in REIT form is often misunderstood. This article seeks to (1) clarify and to some extent quantify the tax implications which may result from REIT conversion transactions, and (2) highlight that such benefits may not necessarily be as large as they are perceived to be.

Background—What is a REIT?

A REIT is often described as a mutual fund for real estate. A REIT generally pays no entity- level federal corporate income tax if it distributes 100% of its REIT taxable income to its shareholders on an annual basis. Additionally, a REIT must maintain compliance with numerous, complex organizational and operational requirements. Some of the key requirements are:

- A REIT must predominantly own qualifying "real property."[3]
- A REIT must predominantly realize income from renting or selling qualifying real property used in a trade or business.[4]
- A REIT may not hold more than a 10% interest (by vote or value) in any corporation other than another REIT, a TRS, or a qualified REIT subsidiary (QRS).[5]
- Not more than 5% of the total value of a REIT's assets may be made up of stock in a corporation other than a TRS, a QRS, or another REIT.[6]
- A REIT must distribute at least 90% of its REIT taxable income to its shareholders on an annual basis (note that any

retained income may be subject to ordinary corporate income tax rates).[7]

- A REIT must have at least 100 direct shareholders.[8]
- Five or fewer individuals generally cannot own more than 50% of the value of the REIT's stock.[9]

Tax Impact Often Misunderstood

Those opposed to an expanded definition of what constitutes qualifying real property, for REIT purposes, often cite the potential reduction in corporate income taxes resulting from the removal of earnings related to real estate from taxable corporate form. However, any potential reduction of such corporate taxes must also be viewed in conjunction with certain mitigating factors examined below.

Increased Shareholder-Level Dividend Taxation. If all of the qualification requirements are met, a REIT is allowed to take a dividends-paid deduction on the current distribution of REIT taxable income.[10] This has the effect of eliminating the federal corporate-level income tax, provided that the REIT distributes to its shareholders an amount at least equal to 100% of its annual taxable income. When viewed in a vacuum, this potential elimination of entity-level taxation would appear to decrease federal tax revenue by 35%[11] when compared to the tax liability of a regular C corporation. However, since qualifying REITs do not pay entity-level tax only when they distribute 100% of their taxable income to their shareholders, the tax obligation on the full amount of the REIT earnings (i.e. not reduced by any entity-level taxes) are passed on to the REIT shareholders in the form of taxable dividends. It is important to note that dividends received by U.S. corporate REIT shareholders are not generally eligible for the dividends-received deduction.[12] Due to the non-applicability of the dividends-received deduction, there is generally no federal income tax benefit for a taxable U.S. domestic corporation to invest in a REIT. (As such, this discussion focuses on the implications to taxable individual investors where applicable).

Shareholder Dividends. The REIT is effectively a hybrid flow-through entity in the sense that it can pass both ordinary income dividends and capital gain income dividends (assuming that it sold qualifying trade or business property or long-term investment property) through to its shareholders. However, it is important to note that the reduced capital gains rate applicable to qualified dividend income generally does not apply to REIT ordinary income dividends, with limited exceptions potentially including dividends paid out of prior C corporation earnings and profits.[13] Generally speaking, the non-traditional REIT businesses mentioned above may be more likely to generate a substantial amount of their income from recurring business operations (e.g., ordinary income rental activities). Therefore the REIT dividends

passed through to the shareholders would likely constitute ordinary dividend income derived from the operating business of the entity rather than capital gain income from the sale of qualifying property. This is due in part to the nature of the entities that non-traditional REITs transact with as well as the REIT built-in gain tax discussed below. This means that the favorable capital gains tax rates are generally not as likely to be available to non-traditional REIT individual investors, and as a result such dividends are going to be taxed at the individual's ordinary income tax rate (i.e. up to 39.6% for taxpayers in the highest bracket plus the 3.8% net investment income tax if applicable).

Comparison with C Corporations. When compared to dividends paid by traditional C corporations to individual investors qualifying for capital gains rates on such dividends, the dividends paid by a REIT represent a potential net tax rate increase of 19.6% in the hands of individual shareholders (top ordinary income tax rate on ordinary dividends of 39.6% plus net investment income tax rate of 3.8% if applicable, less the 20% capital gain rate on qualified dividends plus the net investment income tax rate of 3.8% if applicable).

Example. In the following example, a REIT distributes all of its profits of $100,000 to individual investors and pays no corporate federal income tax. Its individual shareholders pay $43,400 in federal individual income tax, consisting of ordinary income tax and net investment income tax. Solely for purposes of this example, it is assumed that the C corporation also distributes 100% of its after-tax earnings, and pays federal corporate income tax of $35,000. Its individual shareholders pay $15,470 in federal individual income tax on the dividends received. The total federal tax liability paid by the C corporation and its individual shareholders is thus $50,470 while the REIT individual shareholders' total federal tax liability is $43,400, representing an incremental difference of only $7,070. This comparison is illustrated in Exhibit 1.

	REIT		C-Corporation	
Earnings	$ 100,000		$ 100,000	
Dividends Paid Deduction	$ (100,000)		$ -	
Taxable Income	$ -		$ 100,000	
Corporate Federal Taxes	$ -		$ 35,000	(35% x $100,000)
Dividend	$ 100,000		$ 65,000	
Shareholder Federal Taxes	$ 43,400	(43.4%[1] x $100,000)	$ 15,470	(23.8%[2] x $60,000)
Total Federal Taxes	$ 43,400		$ 50,470	

Deferral of Shareholder-Level Taxation Eliminated. Traditional C corporations generally retain a substantial portion of their corporate earnings for reinvestment rather than distributing such earnings to the investors on an annual basis. In some instances, these corporations may even decline to pay dividends entirely. While such corporate earnings may eventually be subject to taxation at the shareholder level, the lack of current distributions to investors defers any such shareholder-level taxation to an undetermined future time. Conversely, in order to eliminate ordinary corporate income tax rates on its earnings, the REIT is statutorily required to distribute all of its taxable income to the shareholders on an annual basis. This accelerates the assessment of shareholder-level tax.

When comparing the tax generated from current REIT dividends in the hands of investors to the double layer of tax which may eventually be generated from the distribution of traditional C corporation dividends, the time value of money must also be appropriately factored into the analysis. The discounted present value of deferred C corporation dividends makes such dividends less meaningful from a tax standpoint when compared to the taxable REIT dividends distributed on an annual basis. Although it is difficult to precisely quantify the effect of discounting without defining the exact amount and timing of any C corporation dividends distributed relative to REIT dividends distributed, it is clear that the acceleration of the REIT shareholder level tax must be considered when analyzing any incremental reduction to taxes as a result of a REIT conversion transaction.

Effect of Entity-Level Taxes on the Taxability of Dividends. Dividends are distributions made by a corporation to its shareholders out of current or accumulated earnings and profits.[14] Any corporate distribution in excess of a corporation's current or accumulated earnings and profits is considered a nontaxable return of capital to the extent of the shareholder's stock basis.[15] Given that the calculation of corporate earnings and profits includes a deduction for the taxes paid by a C corporation, this generally reduces the amount of a C corporation's distribution that is taxable as dividends to the investors. Alternatively, a REIT generally pays no entity-level tax and therefore has no corresponding offset to earnings and profits for tax expense incurred. This means that a larger relative percentage of a REIT distribution is likely subject to taxation as a dividend in the hands of its shareholders (and taxed at incrementally greater rates as described above) when compared with a regular C corporation dividend.

REIT Built-In-Gains and Prohibited Transaction Tax. Despite the fact that a REIT generally incurs no corporate level income tax if it distributes the entirety of its taxable income to the shareholders, if any property owned by a C corporation becomes the property of a REIT in a conversion transaction, the REIT remains subject to full corporate level income tax on the net built-in gain in the converted property under the rules of Section 1374 (unless the C corporation elects deemed sale treatment for the conversion transaction in which case full corporate income tax is paid on the appreciation regardless).[16] This means that any recognized built-in gain on the disposition of such property during the recognition period (currently ten years from the first day of the REIT election)[17] may still be subject to entity-level tax by the REIT and therefore double tax when passed through to the REIT shareholders. Therefore, on a successful REIT conversion, the most likely income stream subject to a single level of taxation at the shareholder level for the entity's first ten REIT years will be income derived from the recurring operations of the business.

Cashing Out. This effectively prevents a C corporation from converting to REIT status and cashing out of the business via sale with only a single level of applicable tax. The ability of a C corporation to cash out of particular investments post-REIT conversion is further restricted by the risk that the 100% REIT entity-level prohibited transaction tax would apply to the gain on sale of any property which was deemed held for sale to customers in the ordinary course of a trade or business at the time of the sale by the REIT.[18] The application of this rule is potentially more prohibitive and revered than the ten year built-in gain tax rule.

Distributions of Pre-Conversion Accumulated Earnings and Profits. In a REIT conversion transaction, the converting entity is required to purge all of its current and accumulated undistributed regular c-corporation earnings and profits attributable to the periods prior to the REIT conversion.[19] In other words, before the end of the first REIT tax year, a REIT cannot have any undistributed C corporation earnings and profits attributable to a non-REIT tax year or it would not qualify as a REIT in the first place. In the context of a REIT conversion transaction, this results in a one-time taxable dividend event *which may have never occurred* without the REIT conversion. This insures that all current and prior C corporation earnings and profits attributed to the REIT are subject to the double tax that would have applied under the C corporation regime and results in a sometimes significant acceleration of the investor level taxation on the shareholders which otherwise may have continued to be deferred indefinitely.

As previously noted, the time value of money concept would generally require consideration in order to fully comprehend the impact of this taxable dividend event. In the case of certain planned REIT conversions, this taxable dividend event is extremely prohibitive to the conversion plan due to the immediate tax burden on the shareholders or the amount of cash that would be required to meet the distribution requirement. Note that there is some flexibility for the REIT conversion candidate to use a combination of cash and stock to purge earnings and profits, however current guidance suggests that a minimum of 20% must be paid out in cash.[20] In any event, the cash or stock dividends are fully taxable to the shareholders, exacerbating the potential for a successful REIT conversion when the REIT conversion candidate plans to use a significant amount of taxable stock dividends, as it creates so-called "phantom income" for the shareholders.

Potential Double Tax on Earnings and Profits

As previously noted the REIT is required to purge C corporation earnings and profits before the end of the first REIT tax year, and is also required to distribute 100% of its REIT taxable income on an ongoing basis in order to completely eliminate the entity-level corporate income tax. Another significant issue when considering the tax impact of the REIT conversion is the possibility that REIT taxable income may potentially exceed REIT earnings and profits in some cases. In the traditional C corporation context, this would not be an issue because the dividends-paid deduction is not available and thus dividends are only taxable to the extent of earnings and profits regardless of taxable income. However the REIT has to possess earnings and profits in order to generate a dividends-paid deduction. When there is a shortfall of earnings and profits relative to REIT taxable income, then specific provisions may apply which effectively adjust earnings and profits upward to an amount which is at least equal to REIT taxable income.[21] Based on the current way that these rules work, this has the potential to result in double taxation at the shareholder level on certain earnings and profits.

One simple example of a deduction item which can create this problem is accelerated depreciation (including bonus depreciation). The C corporation contemplating a REIT conversion may have historically used accelerated depreciation in order to reduce its current federal corporate income tax burden. The depreciation lives for the corporation's assets will generally be significantly longer for earnings and profits purposes relative to tax depreciation purposes and the straight line method would likely also be required. As such, the converting entity that elected to use accelerated depreciation will many times face a situation where its REIT taxable income will exceed its earnings and profits absent an accounting method change involving depreciation. Note that recent IRS guidance (Ltr. Rul. 201503010) suggests that a positive Section 481(a) adjustment resulting from any aforementioned method change may be subject to the ten-year REIT built-in gains tax.

Taxable REIT Subsidiaries

In the case of a non-traditional REIT conversion, it is not uncommon that portions of the legacy business operations would generate income which would not qualify as rents from real property (e.g. certain impermissible tenant services provided to lessees or bad REIT income). If such operations are significant enough in magnitude so as to jeopardize the entity's ability to maintain REIT status, they may potentially be housed in a REIT's TRS. The TRS may generally be used to hold non-real property and earn non-real property income that would not be qualifying if owned or earned directly by the REIT, subject to the limitation that no more than 25% of the value of a REIT's total assets may consist of securities of one or more TRSs.[22] Although the REIT is not subject to entity-level tax provided it complies with the organizational and operational requirements, its TRSs are subject to corporate-level entity tax similar to a regular C corporation. As a result, the portions of the legacy business which must be held through the

TRS remain subject to the traditional corporate double income tax.

Conclusion

While the IRS continues to issue favorable REIT qualification rulings, fueling the increased interest of corporate America and the attention surrounding nontraditional REIT conversions, many critics cry foul citing decreased tax revenues. As this discussion demonstrates, however, an analysis of the quantitative tax impact of a REIT conversion is much more complicated than it would appear. Such analysis must take into account many variables and is driven by taxpayer-specific facts and circumstances. The fact of the matter is that many C corporations which evaluate the REIT conversion alternative will fail to realize the full extent of the benefits which they expected to receive.

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About the Author

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[1] Prop. Reg. 1.856-10.

[2] See, for example, Ltr. Ruls. 201431018 (outdoor advertising displays), 201129007 (cell towers), and 201314002 (data centers).

[3] Section 856(c)(4)(A).

[4] Section 856(c)(3).

[5] Section 856(c)(4)(B)(iii)(II) and (III).

[6] Section 856(c)(4)(B)(iii)(I).

[7] Section 857(a)(1)(A)(i).

[8] Section 856(a)(5).

[9] Section 856(a)(6); Section 856(h)(1)(A).

[10] Section 857(b)(2)(B).

[11] Note that for all purposes of this discussion, it is assumed that the highest graduated federal corporate income tax rate (i.e. 35%) and the highest graduated federal individual income tax rate (i.e. 39.6%) apply. Given the disparate state and local taxation of REITs and REIT investors, state and local tax considerations are outside the scope of this article.

[12] Section 857(c)(1).

[13] Section 857(c)(2).

[14] Section 316.

[15] Section 301(c).

[16] Reg. 1.337(d)-7(b)(1)(i).

[17] Section 1374(d)(7).

[18] Section 857(b)(6)(A).

[19] Section 857(a)(2)(B).

[20] See, for example, Ltr. Rul. 201404005.

[21] Section 857(d)(1); Section 562(e).

[22] Section 856(c)(4)(B)(ii).