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In this article, Homayoun reviews the requirements of the real estate investment trust prohibited transactions safe harbor and the factors that courts have historically considered in determining whether REIT property is held primarily for sale or for investment. He explores some of the most frequent scenarios in which REITs consider selling property outside the safe harbor and the authorities that can provide reassurance despite the prohibited transactions risk.

I. Background

Congress enacted the real estate investment tax rules in 1960, with the primary objective of providing small investors with an opportunity to invest in a diversified portfolio of real estate and real estate-backed loans that would otherwise be unavailable to them.[1] However, Congress also intended real estate investment trusts to be widely held, passive investment vehicles that are not engaged in active management or "dealer-like" activities for their real estate portfolios.

As a result, under section 857(b)(6)(A), a REIT is subject to a 100 percent tax on the net income from prohibited transactions.[2] A prohibited transaction is a sale or other disposition of property held as inventory or primarily for sale to customers in the ordinary course of business (other than foreclosure property).[3] Pursuant to the legislative history, the purpose of the prohibited transactions tax is "to prevent a REIT from retaining any profit from ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project."[4] Accordingly, consistent with the general policy underlying the REIT tax rules, a REIT should not be acting as a dealer and instead should be holding its assets as a long-term investment. However, there is often much uncertainty under the tax law in determining whether a taxpayer is acting as a dealer or investor, as evidenced by the countless cases and rulings on this issue alone. Fortunately, to address this uncertainty, the REIT tax rules provide for a safe harbor under which a sale of property will not be considered a prohibited transaction.[5] In other words, even if there is uncertainty about the nature of an asset, a REIT can avoid prohibited transactions treatment and the penal 100 percent tax if it can satisfy the requirements of the safe harbor.

As described in greater detail below, the safe harbor includes several requirements, the main one being that the REIT has held the property for at least two years for the production of rental income before the sale. Understandably, considering the penal nature of the prohibited transactions rules, some REITs are reluctant to sell

[1] H.R. Rep. No. 2020, 86th Cong., 2nd. Sess. (1960).

[2] Section 857(b)(6)(B)(i) defines "net income from prohibited transactions" as the excess of the gain (including any foreign currency gain) from prohibited transactions over any deductions (including any foreign currency loss) that are directly connected with the sale. However, in determining the amount of net income from prohibited transactions, any item attributable to a prohibited transaction for which there was a loss is not considered. *See* section 857(b)(6)(B)(ii).

[3] Section 857(b)(6)(B)(iii).

[4] S. Rep. No. 94-938, Part 1 at 470 (1976).

[5] Section 857(b)(6)(C).

a property that has been held for less than two years or otherwise does not satisfy the safe harbor requirements. But what if a REIT receives a strong, unsolicited offer for a property that it has held for only one year? Should a REIT postpone a potentially strong sale, which after all is often the ultimate goal of acquiring the property, solely because of the prohibited transactions rules? Alternatively, what if a REIT needs to sell properties outside of the safe harbor to rebalance or improve its portfolio, which may be overweight in certain asset classes or geographic locations? Or perhaps a cash-strapped REIT is experiencing financial difficulties and, as a result, desires to sell properties outside of the safe harbor to raise capital to make debt payments under a loan or credit facility. While the safe harbor provides certainty regarding the prohibited transactions issue, failing to satisfy the safe harbor in connection with a particular sale does not necessarily mean the sale will be conclusively treated as a prohibited transaction. In fact, there are several helpful cases and rulings, both within and outside the REIT context, with facts similar to the aforementioned scenarios, that can provide some comfort on the issue.

This article will provide an overview of the requirements of the safe harbor and the factors courts have historically considered in determining whether property is held primarily for sale or for investment. This article will also discuss some of the most frequent scenarios in which REITs consider selling property outside of the safe harbor and the authorities that should provide some comfort in connection with those sales despite the prohibited transactions risk.[6]

II. Prohibited Transactions Safe Harbor

While the purpose of this article is to explore how to become comfortable with certain sales of property outside of the safe harbor, a brief overview of the safe harbor and its requirements is worthwhile, as it is clearly the most effective way to avoid prohibited transactions treatment. Unlike certain other safe harbors under the REIT tax rules (for example, the safe harbor for mezzanine loans under Rev. Proc. 2003-65, 2003-2 C.B. 336), the prohibited transactions safe harbor is, for the most part, rather straightforward and practical. The safe harbor also is considerably broader than it was before the Housing and Economic Recovery Act of 2008, when the holding period was four years rather than two years, and the Protecting Americans From Tax Hikes Act of 2015, which added the three-year average bases/fair market value percentage tests set forth in requirements 4(d) and (e) below. The requirements of the safe harbor are as follows[7]:

1. the REIT must hold the property for at least two years;
2. the total expenditures made by the REIT during the two-year period preceding the sale must not exceed 30 percent of the net sales price;[8]
3. the REIT must hold the property (other than property acquired through foreclosure or lease termination) for the production of rental income for at least two years;[9]
4. either (a) the REIT does not make more than seven sales of property (other than foreclosure property or involuntary conversions) during the tax year (the seven sales rule); (b) the aggregate adjusted basis of property (other than foreclosure property or involuntary conversions) sold by the REIT during the tax year does not exceed 10 percent of the aggregate basis of all of the REIT's assets as of the beginning of the tax year; (c) the FMV of the property (other than foreclosure property or involuntary conversions) sold by the REIT during the tax year does not exceed 10 percent of the FMV of all of the REIT's assets as of the beginning of the tax year; (d) the REIT

[6]This article does not address every scenario in which a REIT may sell properties outside of the safe harbor. For instance, in the case of mortgage REITs, loan modifications and securitization activities often implicate the prohibited transactions rules. Rather, this article focuses on several scenarios that seem to arise with some frequency in the context of equity REITs.

[7]Separate rules apply to timber sales. *See* section 857(b)(6)(D).

[8]Expenditures regarding property acquired through foreclosure (or deed in lieu of foreclosure) or termination of a lease, which are made by or for the account of the mortgagor or lessee after default became imminent, are treated as made by the REIT. *See* section 857(b)(6)(E)(ii).

[9]It is not entirely clear when the two-year holding period starts, but a certificate of occupancy or general readiness of the property should be reasonable indicators.

satisfies the requirements of clause (b) above applied by substituting "20 percent" for "10 percent" and the "three-year average adjusted bases percentage"[10] for the "tax year does not exceed 10 percent"; or (e) the REIT satisfies the requirements of clause (c) above applied by substituting "20 percent" for "10 percent" and the "three-year average FMV percentage" for the "tax year does not exceed 10 percent"; and

5. if the seven sales rule is not satisfied, substantially all the marketing and development expenditures for the property are made through an independent contractor from whom the REIT does not derive or receive any income or, after December 31, 2015, a taxable REIT subsidiary.[11]

Under the seven sales rule, the sale of more than one property to one buyer in a single transaction is treated as one sale.[12] However, legislative history suggests that, if a REIT engages in more than seven sales during a tax year, the safe harbor would not apply to any of its property sales.[13] Accordingly, a REIT wishing to rely on the seven sales rule must ensure that it does not engage in more than seven sales during the tax year.

A sale[14] can be viewed broadly for these purposes and includes a condemnation[15] as well as the grant of a permanent or perpetual easement in exchange for consideration.[16] Moreover, to the extent that a REIT holds a direct or indirect interest in an entity taxable as a partnership for federal income tax purposes, the sale of property by that partnership also should be treated as a sale for these purposes.[17]

However, for purposes of prohibited transaction rules, the IRS has privately ruled that certain other transactions should not be treated as sales. A disposition of property, which satisfies the section 1031 requirements of a like-kind exchange, should not be treated as a sale of property for purposes of the seven sales rule.[18] Moreover, as discussed below, a sale of all of a REIT's properties under a plan of complete liquidation should also not be treated as a prohibited transaction.[19]

III. Sales of Property Outside of the Prohibited Transactions Safe Harbor

A. General Factors

As noted above, failing to satisfy the safe harbor in connection with a particular sale does not necessarily mean that the sale will conclusively be treated as a prohibited transaction; it will only be treated as such if the property is deemed held for sale to customers in the ordinary course of business. To determine whether property is held primarily for sale or for investment, the courts have articulated several factors, including but not limited to the following:

1. the number, frequency, and continuity of sales;
2. the extent and timing of improvements;
3. the nature and extent of promotional selling activities;
4. the length of the holding period;
5. the proportion of income from real estate activities;
6. the purpose for acquiring the property; and
7. the purpose of the disposition.[20]

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[10] The three-year average adjusted bases percentage for these purposes means (A) the aggregate adjusted bases of the property sold during the three-tax-year period ending with the tax year divided by (B) the sum of the aggregate adjusted bases of all the assets of the REIT as of the beginning of each of the three tax years. *See* section 857(b)(6)(G).

[11] Section 857(b)(6)(C).

[12] Section 857(b)(6)(E)(vi). The properties need not be contiguous or located near each other if they are sold in a single transaction. *See* S. Rep. No. 1263, 95th Cong., 2d Sess. 179 (1978).

[13] *See* Senate Finance Committee report to accompany the Revenue Act of 1978, Rep. No. 95-1263.

[14] A sale for these purposes does not include any transaction in which the net selling price is less than $10,000. *See* section 857(b)(6)(E)(vii).

[15] *See* LTR 8626067 (condemnation of property treated as a sale for purposes of the safe harbor).

[16] *See* LTR 201045014 (income recognized as a result of the grant of a permanent easement qualifies as gain from the sale of interests in real property); *see also* LTR 201250008; LTR 201149003.

[17] *See* Aresh Homayoun, "Tax Considerations in REIT Joint Venture Transactions," *Tax Notes*, Aug. 27, 2018, p. 1247.

[18] *See* LTR 201614009; *see also* LTR 200701008; LTR 200728037.

[19] *See* LTR 201707010; *see also* LTR 201609004; LTR 201640007.

[20] *See Los Angeles Extension Co. v. United States*, 315 F.2d 1 (9th Cir. 1963); *Wineberg v. Commissioner*, 326 F.2d 157 (9th Cir. 1963); *Sanders v. United States*, 740 F.2d 886 (11th Cir. 1984); *Farley v. Commissioner*, 7 T.C. 198 (1946); *Gamble v. Commissioner*, 242 F.2d 586 (5th Cir. 1957); *Vidican v. Commissioner*, T.C. Memo. 1969-207; *Case v. United States*, 633 F.2d 1240 (6th Cir. 1980); *see also* Rev. Rul. 76-327, 1976-2 C.B. 212.

While no single factor is controlling and each transaction must be evaluated based on all the facts and circumstances, some courts have suggested that the frequency and substantiality of sales are among the most important factors to consider.[21] The REIT bears the burden of proof to demonstrate that a sale is not a prohibited transaction.

To illustrate, there would be a heightened risk of prohibited transactions treatment if a REIT with a history of frequent sales sells property shortly after making substantial improvements to it, while engaging in marketing and promotional activities in connection with the sale. Alternatively, there would be considerably less risk of prohibited transactions treatment if the REIT originally acquired the property for long-term investment purposes, did not make significant improvements to it, has no history of prior sales, and engages in no marketing or promotional activities in connection with the sale. Of course, the facts often fall somewhere in between these extremes.

B. Unsolicited Offers

It is not uncommon, especially in a strong commercial real estate market, for a REIT to receive an unsolicited offer from an interested buyer to purchase property held in the REIT's portfolio. While a REIT does not typically make efforts to sell or market the property under this fact pattern, there is nonetheless concern over the application of the prohibited transactions rules and the related 100 percent tax if the sale would be outside of the safe harbor. Fortunately, both the IRS and the courts have addressed this issue.

In LTR 200945025,[22] a public REIT owned a large portfolio of rental properties that it originally acquired with the intention of holding them on a long-term basis for the production of rental income and appreciation in value. The REIT received an unsolicited offer from a buyer's broker to purchase one of its properties — an office property that the REIT had recently leased to a tenant. While the facts of the ruling are not entirely clear, it appears that the REIT had held the office property for less than two years and had expended substantial funds to convert it from one use to another. Therefore, a sale of the property would not satisfy at least two of the requirements of the safe harbor. Further, the REIT did not have a history of frequent or continuous sales and had not made any effort to sell the property. Noting that the REIT's purpose for selling the property was to obtain liquidity as a result of the "extreme economic conditions," the IRS ruled that the REIT did not hold the property for sale in the ordinary course of business and therefore concluded that the sale should not be treated as a prohibited transaction.

It should be noted that the ruling is in the context of the 2008 financial crisis — the worst economic downturn since the Great Depression. This background raises the question of whether the result would have been different if the REIT had received an unsolicited offer under better or even normal economic conditions. Fortunately, there is also favorable case law that involves unsolicited offers. In *Dean*,[23] the taxpayer originally acquired property for investment purposes, but subsequently rezoned it for residential and retail use to avoid a possible condemnation. The taxpayer made no effort to sell or market the property but later sold a portion of it in response to an unsolicited offer. The Tax Court held that the taxpayer acquired the property for investment purposes, and that purpose remained constant throughout the holding period of the property despite the change in use. As such, the gain on the sale did not result in ordinary income.

In addition, in *Cousins Properties*,[24] the taxpayer received an unsolicited offer to exchange an apartment property for undeveloped land to be developed in a preferred geographic market. On audit, the IRS took the position that the exchange should result in ordinary income, but

[21] *See Suburban Realty Co. v. United States*, 615 F.2d 171 (5th Cir. 1980); *Phelan v. Commissioner*, T.C. Memo. 2004-206; *but see Suburban Realty*, 615 F.2d at 171 ("Substantial and frequent sales activity, standing alone, has never been held to be automatically sufficient to trigger ordinary income treatment.").

[22] LTR 200945025. It is important to note that while private letter rulings generally reflect the IRS's position on the tax issues presented therein, they are not binding on the IRS and do not serve as precedential guidance.

[23] *Dean v. Commissioner*, T.C. Memo. 1974-236 (1974).

[24] *Cousins Properties Inc. v. United States*, 77-2 U.S. T.C. para. 9508 (Ct. Cl. 1977).

the Court of Federal Claims disagreed and found that the taxpayer originally acquired the property to generate rental income. Accordingly, in determining that the taxpayer did not sell the property in the ordinary course of business, the court of claims focused on the taxpayer's original intent in acquiring it.

Based on these authorities, and assuming there are no other factors that weigh heavily in favor of dealer status (for example, a history of frequent or continuous sales), a REIT should be able to take the position that a sale of property outside of the safe harbor and pursuant to an unsolicited offer should not be treated as a prohibited transaction, as long as its original intent was to hold the property on a long-term basis for the production of rental income. To take this position, it will be critical for the REIT to have contemporaneous written documentation that clearly evidences that intent (for example, an investment committee memo or board materials).

C. Strategic Realignment

Another scenario that frequently arises is when a REIT wishes to sell properties outside of the safe harbor to rebalance or improve its portfolio. For instance, a REIT may believe that it is overweight in a particular asset class or heavily concentrated in a specific geographic area and, as a result, wishes to sell properties as part of a strategic realignment to rebalance or improve its portfolio. The question, of course, is whether such a sale of properties outside of the safe harbor and pursuant to a change in strategic direction could be treated as a prohibited transaction. Fortunately, there are two public rulings that address these circumstances.

In Rev. Rul. 73-398, 1973-2 C.B. 211, the taxpayer, a mortgage REIT, followed a policy of investing in long-term development and construction loans secured by mortgages on real property. This policy resulted in a heavy imbalance of long-term loans over short-term loans, thereby constraining the REIT's ability to acquire additional funds through short-term borrowing. As a result, the REIT proposed to sell several long-term mortgages to an unrelated mortgage broker to reduce its investment in long-term loans and increase investments in short-term and intermediate loans. The IRS noted that the REIT had not previously sold any mortgage loans and that the sales in question were not contemplated at origination. Based on these facts, the IRS ruled that the REIT did not hold the mortgages primarily for sale to customers in the ordinary course of business.

Similarly, in Rev. Rul. 74-554, 1974-2 C.B. 199, the taxpayer, also a mortgage REIT, sold several long-term mortgages to two unrelated mortgage brokers to reduce its investment in long-term financing and instead focus on short-term borrowings. The IRS noted that the REIT did not previously sell any mortgages, the sales in question were not contemplated at origination, and the REIT did not intend to engage in any other selling activities. Based on these facts, the IRS ruled that the REIT did not hold the mortgages primarily for sale to customers in the ordinary course of business.

Outside of the REIT context, the taxpayer in *Curtis Co.*[25] sold numerous residential properties to focus on the development of shopping centers because of rental restrictions and concerns over future appreciation. Noting that the taxpayer originally acquired the property for investment purposes, the U.S. Court of Appeals for the Third Circuit held that the taxpayer's sales were not in the ordinary course of business.

These rulings suggest that a REIT should not be viewed as acting as a dealer if it sells properties as part of a strategic realignment to rebalance or improve its portfolio. Such a realignment could include selling properties within a particular asset class to focus on other asset classes (such as selling real estate properties to focus on mortgage loans secured by real estate) or selling assets located in certain geographic areas to focus on assets in other strategically selected geographic locations. To have the strongest position to avoid prohibited transactions treatment, a strategic realignment should, in all cases, be evidenced by contemporaneous internal documentation and/or public announcements that clearly set forth the REIT's goals and objectives (for example, board resolutions, public disclosures, press releases, etc.). Moreover, to establish that it is moving away from a particular asset class or geographic

[25] *Curtis Co. v. Commissioner*, 232 F.2d 167 (3rd Cir. 1956).

location, the REIT should demonstrate that it is divesting all properties with those characteristics and expressly commit not to acquire those assets in the near future.

D. Changes in Circumstances

A REIT may also find it necessary to sell properties outside of the safe harbor because of unforeseen events or unexpected changes in circumstances. Those circumstances could include sales caused by reduced liquidity, changes in the capital or real estate markets, failure to acquire financing or zoning approval, or changes in credit quality.

In LTR 200953018, a REIT desired to sell properties to generate cash to repay and refinance debt and improve its working capital position. While the REIT held each of the properties for over two years before the sale, it appears that the REIT did not satisfy the safe harbor because the amount of expenditures during the two-year period preceding the sale exceeded 30 percent of the net selling price. The REIT represented that it acquired the properties for long-term investment and rental purposes and was selling the properties because of the prevailing extreme economic conditions. Under these facts, the IRS ruled that the REIT was not holding the properties for sale to customers in the ordinary course of business. Rather, according to the IRS, the facts and representations "amply demonstrate" that the REIT was selling the properties because of the extreme economic conditions.

While LTR 200953018 again arises out of extreme economic conditions, older rulings suggest that a sale of property caused by unforeseen events also should not result in dealer status. For instance, in LTR 9123042, an economic downturn forced a REIT to cancel its planned public offering and sell a property to pay down debt. Under these facts, the IRS ruled that the REIT was not acting as a dealer because it originally acquired the property for long-term investment purposes.

Moreover, in LTR 9041047, a REIT sold a mall and shopping center outside of the safe harbor so that its anchor tenant, which was experiencing severe financial difficulties, could merge with a potential buyer. The buyer conditioned the merger on a sale of the mall and shopping center, and the REIT believed that the anchor tenant would declare bankruptcy if the merger did not proceed. The REIT, therefore, effectively felt compelled to sell the properties outside of the safe harbor so that it would not lose an important anchor tenant. On these facts, as well as the REIT's representation that it acquired the property for long-term investment purposes, the IRS ruled that the REIT was not selling the properties to customers in the ordinary course of business.[26]

Based on these rulings, and again assuming there are no other factors that strongly weigh in favor of dealer status, there should be a position to sell property outside of the safe harbor as a result of certain unforeseen events — as long as the REIT can demonstrate that it acquired the property for long-term investment purposes. To be clear, the lack of contemporaneous written documentation evidencing that intent would make such a position much more challenging and would involve more risk from a prohibited transactions perspective.

E. Sales Under a Plan of Liquidation

While not as useful for REITs that are going concerns, beginning in 2013 the IRS issued several private letter rulings on the application of the prohibited transactions rules to REITs that are undergoing complete liquidations. In most of these rulings, the liquidating REITs sold too many properties to satisfy the safe harbor.

LTR 201640007 is representative of these rulings. Under the facts of this ruling, a REIT adopted a plan of liquidation after considering other alternatives to enhance shareholder value. In ruling that the sales of properties pursuant to the plan of liquidation will not constitute prohibited transactions, the IRS noted that the REIT (1) acquired the properties for long-term investment and appreciation in value, (2) only adopted a plan of liquidation after exploring alternatives that would allow it to continue to hold the properties; (3) sold only a small percentage of its assets since inception; and (4)

[26] *See also Malat v. Riddell*, 275 F. Supp. 358 (S.D. Cal. 1996) (holding that taxpayer was not acting as a dealer when taxpayer sold undeveloped land less than one year after acquisition because of the inability to develop the land as a result of zoning and financial difficulties).

made substantially all marketing expenditures for the sales through an independent contractor or a taxable REIT subsidiary.[27]

Based on these rulings, a REIT, which adopts a plan of liquidation and can make representations similar to those listed above (for example, originally acquiring the properties for long-term investment purposes, adopting the plan of liquidation only after considering other alternatives, having a limited history of sales, etc.), should have a position to avoid prohibited transactions treatment when it sells properties outside of the safe harbor and pursuant to a plan of liquidation.

IV. Conclusion

In addition to the unsettling prospect of a 100 percent tax on the net income from prohibited transactions, the fact that losses from prohibited transactions may not offset gains from prohibited transactions in calculating the 100 percent tax further exacerbates the issue.[28] Therefore, REITs should be exceedingly cautious when selling properties. While satisfying the safe harbor is clearly the safest and best approach to avoid the prohibited transactions tax, failing to satisfy the safe harbor in connection with a particular sale does not mean that the sale will conclusively be treated as a prohibited transaction. Rather, a REIT can avoid prohibited transactions treatment if it can demonstrate, based on all the facts and circumstances, that it is not acting as a dealer and is not holding properties for sale to customers in the ordinary course of business. Although cases and rulings identify several factors to be considered in connection with this determination, which a taxpayer should certainly consider and apply as part of its analysis, a common theme is the taxpayer's original intent for acquiring the property. These authorities clarify that a taxpayer can avoid dealer status if it demonstrates that it originally acquired the property for long-term investment and appreciation in value, even if it cannot satisfy one or more of the requirements of the safe harbor. Moreover, the focus should not be on the taxpayer's intent at the time of sale, but rather on the taxpayer's intent when it initially acquired the property and whether there is evidence of a change in that intent before the sale.[29]

In the rulings discussed in this article, the IRS recognized that a sale of assets that a taxpayer originally acquired for long-term investment purposes should not be treated as a prohibited transaction under certain circumstances. Those circumstances include unsolicited sales because of changes in the real estate or financial markets, sales as part of a strategic realignment to rebalance or improve a REIT's portfolio, sales as a result of unforeseen events or unexpected changes in circumstances (for example, reduced liquidity, changes in the capital or real estate markets, etc.), and sales pursuant to a plan of liquidation. To mitigate the prohibited transactions risk, it will be critical for the taxpayer to produce contemporaneous documentation that evidences the taxpayer's original intent to hold the property for long-term investment and appreciation in value. Indeed, best practices from a prohibited transactions perspective would be to prepare an investment committee memo or similar document at the time of each acquisition that clearly establishes the taxpayer's intent regarding the acquisition.

Notwithstanding the considerations discussed in this article, in some cases, a taxpayer may conclude that there is simply too much risk to proceed with a sale outside of the safe harbor. Perhaps the holding period is too short. Perhaps, as some courts have emphasized, there is a history of frequent and significant sales. Or perhaps, the REIT cannot produce any contemporaneous documentation that evidences the taxpayer's

[27] *See also* LTR 20134004; LTR 201346005; *see also* LTR 201609004; LTR 201707010.

[28] *See* section 857(b)(6)(B)(ii).

[29] *Suburban Realty Company*, 615 F.2d 171; *see also Goldberg v. Commissioner*, 223 F.2d 709 (5th Cir.), *rev'g and remanding* 22 T.C. 533 (1954) ("The original purpose is important, for to counterbalance it there must be significant objective evidence of a change in that purpose."); *Erfurth v. Commissioner*, T.C. Memo. 1987-232 (taxpayer's original purpose for acquiring the property had "some enduring vitality").

original intent in acquiring the asset. In these cases, the REIT could transfer the asset to a taxable REIT subsidiary before the sale. While not the most efficient approach from a tax perspective, a 21 percent tax is certainly more palatable than a 100 percent tax. To mitigate the risk of recharacterization by the IRS, it would be advisable for the REIT to transfer the property to the taxable REIT subsidiary before commencing negotiations to sell it. ■