REITs With International Operations Get Welcome IRS Ruling

By **David Miller and Christian Brause** · November 7, 2018, 3:21 PM EST

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On Sept. 13, 2018, the Internal Revenue Service published revenue procedure 2018-48 concerning the proper treatment of certain types of income from foreign operations for purposes of the real estate investment trust, or REIT, income tests after the enactment of the Trump Administration's Tax Cuts and Jobs Act of December 2017.[1] The revenue procedure provides important, and very welcome, albeit limited, relief to REITs with international operations on certain unanswered questions, both existing under old law, as well as created by the TCJA.

Background

U.S. REITs predominately invest in U.S. real estate assets. However, U.S. REITs may also invest in non-U.S. real estate assets since it has been long established that foreign real estate is a good real estate asset for REITs.[2] Some larger, typically publicly traded, REITs have not insubstantial foreign operations. For non-U.S. tax and business reasons, these operations often involve the formation of one or more foreign subsidiaries, some of which are treated as "taxable REIT subsidiaries," or TRS.

Each TRS is treated like a normal C corporation as opposed to a foreign corporation that is treated as a disregarded "qualified REIT subsidiary"[3] (or disregarded entity or partnership under general check-the-box election principles). Accordingly, a TRS is subject to the regular set of international tax rules, including the Subpart F rules,[4] the passive foreign investment company, or PFIC, rules[5] and, most importantly after the enactment of the TCJA, the new “global low taxed intangible income,” or GILTI, rules.[6] It has been a long-standing question whether Subpart F income and PFIC inclusions are good REIT income for purposes of either the 75 percent gross income test[7] (i.e., income from real estate) or the 95 percent gross income test[8] (i.e., income from real estate and other passive investments, such as dividends and interest on bonds or loans) because neither the code nor the U.S. Department of the Treasury regulations thereunder nor any revenue ruling mention these types of income, thereby creating, following the statute’s structure, the presumption that such types of income are nonqualifying, or bad, income for REIT purposes.

The IRS, however, has, over the years, repeatedly, based on Section 856(c)(5)(J),[9] taken the position in various private letter rulings, or PLRs, that such income inclusions are often good REIT income[10] on the ground that they are very similar to dividend income[11] and that Subpart F inclusions are good income for “regulated investment company,” or RIC, purposes.[12] A similar problem arises under the newly enacted GILTI rules since these rules cause a domestic corporation, including a REIT,[13] to have phantom income inclusions in a manner similar to the Subpart F income inclusions with no corresponding clarification how such GILTI inclusions should be treated for REIT income test purposes.

Example

U.S. REIT R owns a number warehouses in Boston and New York City, which it rents out to various logistics companies. In 2018, R earns $100 of good gross rental income from such warehouse leases. In addition, U.S. REIT R owns numerous warehouses in London, which it owns through a U.K. subsidiary that it treats as a TRS. In 2018, some of the TRS’s gross income

($90) is rental income ($50), and some income is attributable to logistics services ($40). Suppose, for sake of simplicity, the GILTI inclusion from TRS for 2018 is $30 before the application of the 50 percent deduction pursuant to Section 250. Suppose further that we ignore the U.S. dollar/U.K. pound foreign currency conversion issue. In this example, the question arises whether R is still a good REIT in 2018 given that 23.1 percent (or 30/130) of its gross income of $130 consists of GILTI inclusions. If GILTI inclusions are bad income for purposes of the 95 percent gross income test, then R would not qualify as a REIT because only 5 percent of a REIT's annual gross income may consist of bad income.

Summary of Revenue Procedure

The revenue procedure provides that:

- Any Subpart F inclusions under Section 951(a)(1) (other than any such inclusions pursuant to the one-time transition tax rules of Section 965) are treated as good income for purposes of the 95 percent gross income test; this includes Subpart F income inclusions under Section 956;

- Any GILTI inclusions under Section 951A(a) are treated as good income for purposes of the 95 percent gross income test;

- Any PFIC inclusions under Section 1291(a), 1293(a)(1) (relating to the so-called "QEF election") and Section 1296(a) (mark-to-market regime) are treated as good income for purposes of the 95 percent gross income test;

- Any foreign currency gains that a REIT needs to recognize under Section 986(c) with respect to distributions from foreign subsidiaries of previously taxed earnings and profits are ignored for purposes of the REIT gross income tests; and

- The revenue procedure is effective for any calendar tax year beginning after Dec. 31, 2018. However, a REIT, which must use the calendar year as its tax year, may elect to apply this revenue procedure to all prior years.

Observations and Practical Significance

Revenue Procedure Confirms the IRS' Prior PLR Practice

The revenue procedure confirms the taxpayer-friendly positions taken by the IRS in prior PLRs. However, in the context of Subpart F inclusions it arguably went beyond prior PLR positions because it does not require that the underlying Subpart F income results from real estate (i.e., passive rents). Accordingly, no matter what the source of the Subpart F income is, it is treated as good REIT income. This makes sense since Subpart F income is akin to dividend income which is clearly good income no matter what the source for the dividend payments are. In addition, the Subpart F income is good income even if it is not accompanied with a concurrent distribution of the earnings and profits associated with such Subpart F income. This issue was somewhat controversial given the "current distribution requirement" in the regulated investment company, or RIC, rules.[14] Finally, unlike the RIC rules, the revenue procedure treats Subpart F inclusions under Section 956 as good income.[15] Confirming the prior PLR practice is important because it facilitates the issuance of REIT tax opinions in connection with capital market transactions entered into by REITs.

Sensible New GILTI Position Within the Limits of the Code

The position taken by the IRS makes sense because GILTI is, as a technical matter, imbedded in the Subpart F rules[16] and therefore very similar to Subpart F income. It would have been odd, to say the least, for the Service to conclude that Subpart F income is good income but GILTI income is bad REIT income. This conclusion is well supported by the fact that Section 951A(f))(1) expressly treats GILTI inclusion for purposes of the RIC rules the same way as Subpart F inclusions.[17] Presumably the failure to mention the REIT rules in Section 951A(f)(1) is attributable to the fact that the treatment of Subpart F inclusions for REIT purposes is set forth in a series of PLRs and not in the IRS.

The welcome relief provided by the revenue procedure is limited, however. First, the revenue procedure does not change the fact that REITs are subject to the GILTI rules in the first place. The application of the GILTI rules to REITs is, as a tax policy matter, a bit of a mystery, given that GILTI arguably targets mobile income sources and real estate is the least mobile income source.[18] Second, because REITs remain subject to GILTI rules, all new GILTI inclusions, if any, will affect a REIT's minimum distribution requirement (very generally speaking, 90 percent of a REIT's taxable income).[19] Accordingly, after the enactment of the TCJA, a REIT with international operations may have, under certain circumstances, a structurally higher distribution requirement than before the tax reform as a result of the enactment of the new GILTI rules. Third, the revenue procedure does not change the oddity that while REITs are domestic corporations subject to GILTI, they are not entitled to the special 50 percent deduction provided for by Section 250.

While this result is clear by way of statutory interpretation,[20] it is far from clear why this result makes any sense: Why in the example above should the GILTI inclusion be $30 for R as a REIT while it would be $15 if R were a regular C corporation and not a REIT? It looks like that it is more an inadvertent result of the non-REIT related statutory drafting decision to structure the desired GILTI rate reduction (from the general corporate tax rate of 21 percent to the target rate of 10.5 percent) by way of a 50 percent special deduction rather than carefully weighted REIT tax policy considerations. But in the absence of any legislative history on point, we do not know the answer to this question.

No Longer a Need for PLRs

Given the published PLRs of the IRS in connection with Subpart F and PFIC inclusions, REITs and their advisers took different views regarding the need for obtaining a separate PLR on these questions. Some argued that, based on Section 6110(k)(3), because a PLR is issued to a specific taxpayer, only such taxpayer may rely on those PLRs. Others argued that (at least the repeated) issuance of PLRs on the same issue should amount to an exercise of authority to issue additional guidance under Section 856(c)(5)(J)(ii) on which all taxpayers may rely because the PLRs are based on Section 856(c)(5)(J)(ii) and otherwise the principle of equal treatment of taxpayers would be violated (i.e., granting a PLR to one taxpayer but not to the other would amount to abuse of discretion in administrative determinations). The revenue procedure makes it now clear that taxpayers no longer need to consider obtaining a new PLR on these issues. This should free up scarce resources within the IRS.

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[1] All references to “Sections” or “Treas. Regs.” are to the Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated thereunder.

[2] Revenue Ruling 74-191, 1974-1 C.B. 170.

[3] Section 856(i).

[4] Sections 951(a) et seq.

[5] Sections 1291 et seq.

[6] New Sections 951A, 250 and 960(d).

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

[8] Section 856(c)(2).

[9] Section 856(c)(5)(J)(ii), enacted in 2008, expressly gives, among other things, the Service the authority to treat otherwise non-qualifying income as good REIT income.

[10] PLR 201649013, PLR 201605005, PLR 201503010, PLR 201537020, PLR 201431018, PLR 201423011, PLR 201431020, PLR 201314002, PLR 201251005, PLR 201246013, PLR 201226004, PLR 201129007, PLR 201119001.

[11] But see, in a non-REIT context, Rodriguez v. Commissioner, 722 F.3d 306, aff'g 137 T.C. 14 (5th Cir. 2011), in which the Tax Court ruled against the taxpayer and found that, despite the similarities between Subpart F income and dividends noted above, Subpart F income does not constitute qualified dividend income for purposes of Section 1(h)(11) because it does not meet the definition of "dividend" at Section 316(a), which requires a distribution to occur. The Tax Court concluded that a notional distribution giving rise to a Subpart F Inclusion does not meet that requirement. On appeal, the Fifth Circuit of the U.S. Court of Appeals affirmed the Tax Court's decision against the taxpayer by essentially adopting the Tax Court's analysis. Relevant for the

conclusion of the Fifth Circuit was the fact that Congress had chosen to specify that Subpart F income is considered a "dividend" for the purposes of certain Code provisions, but did not do so in respect of Section 1(h)(11).

[12] REITs are, in essence, RICs for real estate, see H.R. Rep. No. 86-2020 at 3–4 (1960); see generally Levy, David F., Gianou, Nickolas P. & Jones, Kevin M., Modern REITs and the Corporate Tax: Thoughts on the Scope of the Corporate Tax and Rationalizing Our System of Taxing Collective Investment Vehicles, Taxes Magazine (Feb. 2, 2016) (discussing, among other things, the history of the REIT rules).

[13] Section 951A(a) applies to any 10% U.S. shareholder of a CFC. Pursuant to Section 856(a)(3) and Treas. Reg. § 1.856-1(e), a REIT is, by definition, a U.S. corporation. Accordingly, in the absence of any express exclusions for REITs, REITs are subject to the GILTI rules.

[14] Section 851(b) ((…) [f]or purposes of paragraph 92)[the 90% income test], there shall be treated as dividends amounts included in gross income under Section 951(a)(1)(A) or 1293(a) for the taxable year to the extent that, under section 959(a)(1) or 1293(c) (as the case may be), there is a distribution out of the earnings and profits of the taxable year which are attributable to the amounts so included.(…). Emphasis added. For a discussion of this "current distribution" requirement, see NYSBA Tax Section, Report on Proposed Regulations under Section 851 Dealing with Imputations from CFCs and PFICs, Rep. No. 1359 (November 29, 2016).

[15] The RIC rules treat income inclusions under Section 951(a)(1)(A) as good income [for RIC purposes], while the Revenue Procedure treats income inclusions under Section 951(a)(1)(A) and (B) as good income [for REIT purposes].

[16] Section 951A(f)(1) makes numerous Subpart F rules applicable to for purposes of the GILTI rules, but fails to expressly mention Section 856.

[17] Section 951A(f)(1) references Section 851(b).

[18] If, by contrast, one conceptualizes the GILTI rules as a general switch of the U.S. international tax regime to a worldwide income system without deferral, then the inclusion of REITs makes sense. However, through such a prism, the design and labeling of a various aspects of GILTI, including its very name and the 10% tangible profits reduction, appear to be questionable.

[19] Section 857(b).

[20] Section 857(b)(2)(A) states that the deductions provided by Sections 241-250 (with the exception of Section 248) shall not apply in connection with calculating REIT taxable income.