Tax Considerations in REIT Joint Venture Transactions

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In this article, Homayoun discusses the tax risks implicated when a real estate investment trust enters into a dispositional joint venture. He focuses on the prohibited transactions rules under section 857(b)(6) and suggests how to manage and mitigate the tax risks prospectively.

I. Background

Real estate investment trusts have historically entered into joint ventures for a variety of reasons. A joint venture, for instance, allows REITs to diversify their revenue stream by earning potentially lucrative fees, as well as a promote interest, from managing the joint venture's properties. Joint ventures also effectively enable REITs to reduce exposure to specific markets or disproportionally large assets by shifting a portion of the risk to one or more institutional investors. Perhaps most importantly, REITs often enter into joint ventures to raise capital for a variety of reasons, including, but not limited to, repurchasing stock, paying special dividends, or supporting ongoing operations (for example, by paying down or retiring debt, funding the development pipeline, or financing future acquisitions). This attraction has been especially relevant in recent years, as prevailing market conditions have made raising capital more difficult for REITs. Although commercial real estate prices have generally increased, many REITs have traded at a discount to net asset value, which makes accessing capital in public markets more expensive. Moreover, although the debt markets continue to be accommodating, taking on more debt can adversely affect credit ratings and therefore is not an ideal solution. A joint venture enables a REIT to raise capital without incurring debt or issuing additional shares of stock.

While joint ventures have proven to be an effective strategy for raising capital, there are significant federal income tax considerations that a REIT should address when entering into a joint venture. This is especially true in the case of a dispositional joint venture, in which a REIT sells interests in properties to an institutional investor in exchange for cash, while retaining an interest in the properties through the joint venture.[1]

For example, assume that a REIT, which we will refer to as JV REIT, requires capital to support ongoing operations and agrees to sell properties held in its real estate portfolio to an institutional investor. JV REIT, however, does not wish to completely divest itself of these properties and therefore the parties agree that JV REIT will sell only a 40 percent interest in the properties. From a structural perspective, JV REIT contributes the properties to the joint venture, while the institutional investor contributes cash equal to 40 percent of the value of the properties to the joint venture, which then pays the cash to JV REIT. The joint venture, which we will assume is organized as a limited liability company for purposes of this example, issues a 60 percent membership interest to JV REIT in exchange for a capital contribution equal to 60 percent of the value of the properties. Following these transfers, the institutional investor would hold a 40 percent membership interest in the LLC, and JV REIT would hold a 60 percent membership interest in the LLC. For federal income tax purposes, JV REIT will treat and report the transaction as a (i) sale of 40 percent of the properties to the institutional investor in exchange for cash equal to 40 percent of the value

[1] Pension funds, insurance companies, and sovereign wealth funds have been particularly interested in dispositional joint ventures in recent years.

of the properties, and (ii) contribution of 60 percent of the properties to the LLC in exchange for a membership interest.

The primary benefit of this transaction from JV REIT's perspective is that JV REIT will acquire much-needed capital while continuing to hold a majority interest in the properties through the joint venture. This transaction, however, also raises significant federal income tax issues for JV REIT. Specifically, the sale component implicates the prohibited transaction rules under section 857(b)(6) and therefore it will be critical for JV REIT to ensure that the sale satisfies the requirements of the safe harbor under section 857(b)(6)(C). Moreover, once the transaction is completed and the joint venture commences business operations, JV REIT should ensure that the joint venture's ongoing activities do not create adverse prohibited transaction implications for JV REIT going forward.

This article discusses the tax risks that arise when a REIT enters into a dispositional joint venture, and specifically focuses on the prohibited transactions rules under section 857(b)(6) and includes suggestions on how to manage and mitigate these tax risks prospectively. It also includes a general overview of the disguised sale rules that apply to the contribution of encumbered properties to a partnership.

II. Prohibited Transactions

A. General Rule and Safe Harbor

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.[3] A sale, however, will not be treated as a prohibited transaction if the REIT satisfies the requirements of the safe harbor. Significantly expanded as part of the Protecting Americans From Tax Hikes Act of 2015, the requirements are as follows[4]:

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;[5]
3. the REIT must hold the property (other than property acquired through foreclosure or lease termination) to produce rental income for at least two years; and
4. the REIT must satisfy one of the following tests:
   a. the REIT did not make more than seven sales of property (other than sales of foreclosure properties or properties that were involuntarily converted under section 1033) during the year (the seven sales rule);[6]
   b. the aggregate adjusted bases of all properties sold (other than sales of foreclosure properties or properties that were involuntarily converted under section 1033) during the year does not exceed 10 percent of the aggregate bases of all the REIT's assets as of the beginning of the year;
   c. the fair market value of all properties sold (other than sales of foreclosure properties or properties that were involuntarily converted under section 1033) during the year does not exceed 10 percent of the FMV of all the REIT's assets as of the beginning of the year;

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

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

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

[5]Expenditures regarding property acquired through foreclosure (or deed in lieu of foreclosure) or termination of a lease that 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).

[6]If a REIT does not satisfy this requirement, substantially all the marketing and development expenditures regarding the property must be made through an independent contractor, from whom the REIT does not derive or receive any income, or a taxable REIT subsidiary. *See* section 857(b)(6)(C)(v).

d. the aggregate adjusted bases of all properties sold (other than sales of foreclosure properties or properties that were involuntarily converted under section 1033) during the year does not exceed 20 percent of the aggregate bases of all the REIT's assets as of the beginning of the year, provided that the three-year average adjusted bases percentage[7] for the tax year does not exceed 10 percent; or

e. the FMV of all properties sold (other than sales of foreclosure properties or properties that were involuntarily converted under section 1033) during the year does not exceed 20 percent of the FMV of all the REIT's assets as of the beginning of the year, provided that the three-year average FMV percentage[8] for the tax year does not exceed 10 percent.[9]

In applying the seven sales rule, the sale of more than one property to one buyer as part of a single transaction is treated as one sale.[10] Accordingly, if a REIT sells five properties to one buyer as part of a single transaction, the transaction would be treated as one sale for purposes of the seven sales rule. However, if a REIT engages in more than seven sales during a tax year, the legislative history suggests that the safe harbor would not apply to any of the REIT's sales of property.[11] Accordingly, if a REIT wishes to rely on the seven sales rule, which is often the case, it will be critical to make sure that the REIT does not engage in more than seven sales during the tax year. As described in greater detail below, a sale can be viewed broadly for these purposes.

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. Rather, a sale will be treated as a prohibited transaction only if the property is determined to be held for sale to customers in the ordinary course of business. The courts have articulated several factors to determine whether property is held primarily for sale or for investment. These factors include, but are not limited to:

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.[12]

No single factor is controlling, and each transaction must be evaluated based on all the facts and circumstances. The REIT will have the burden of proof to demonstrate that a sale is not a prohibited transaction.

Depending on the facts, a REIT may be able to make a strong case that a sale should not be treated as a prohibited transaction, but there can be no assurances that the IRS will agree with that assessment. There are numerous cases on the issue of whether property is held for sale or investment, and Congress enacted the safe harbor rules in large part because of the uncertainty over this issue. Accordingly, there would be inherent risk in proceeding with sales outside of the safe harbor.

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[7] The three-year average adjusted bases percentage for these purposes means (A) the aggregate adjusted bases of such property sold during the three-tax-year period ending with such 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).

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

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

[10] 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).

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

[12] *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); and *Rouse v. Commissioner*, 39 T.C. 70 (1962); *see also* Rev. Rul. 76-327, 1976-2 C.B. 212.

B. What Is a Sale?

It is important to recognize that a sale for purposes of the prohibited transactions rules is not limited to transactions that are treated as sales for legal or financial accounting purposes. For instance, the following transactions are likely to be treated as sales for purposes of the prohibited transaction rules:

- a condemnation;[13]
- the grant of a permanent or perpetual easement in exchange for consideration;[14] and
- as described in greater detail below, 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 the partnership.

The IRS, however, has privately ruled that some other transactions should not be treated as sales for purposes of the prohibited transaction rules. For instance, a disposition of property, which satisfies the requirements of a like-kind exchange under section 1031, should not be treated as a sale of property for purposes of the seven sales rule.[15] Moreover, a sale of all of a REIT's properties under a plan of complete liquidation should not be treated as a prohibited transaction.[16]

III. Joint Venture Tax Analysis

A. Sales in Connection With Joint Venture

Based on these rules, it will be critical for a REIT and its tax advisers to confirm that any sales of property in connection with a joint venture qualify for the safe harbor. Accordingly, as part of the safe harbor analysis, it would be advisable for the REIT to go through its records and transactional history in detail to confirm that there have not been any condemnations, grants of perpetual easements, or other transactions that could be treated as sales for federal income tax purposes. For instance, if a REIT intends to rely on the seven sales rule and plans to engage in seven sales of property during the tax year, the REIT should treat each condemnation or grant of a perpetual easement as a separate sale for these purposes.

By way of example, assume JV REIT, which requires capital to support ongoing operations, enters into a dispositional joint venture with an institutional investor and agrees to sell a 40 percent interest in 10 multifamily properties as part of one transaction that will close in 2018. JV REIT has held and rented each of the properties for over two years and otherwise satisfies the requirements of the safe harbor. Under section 857(b)(6)(E)(vi), even though JV REIT will be selling interests in 10 separate properties, this transaction should be treated as one sale for purposes of the seven sales rule. During 2018, JV REIT also sold five properties to different purchasers as part of five separate transactions. Unbeknownst to JV REIT's tax advisers, during 2018, JV REIT granted one perpetual easement in exchange for $25,000, and a local municipality condemned a right of way in February 2018, after JV REIT refused the municipality's lowball offer of $15,000 to purchase the right of way. Based on these facts, JV REIT would likely be deemed to have engaged in eight sales during 2018 (that is, the joint venture transaction, which counts as one sale, the five separate sales of individual properties to five different buyers, the condemnation, and the grant of the perpetual easement).

These facts represent a worst-case scenario for JV REIT because it engaged in more than seven sales during 2018. Consequently, the legislative history suggests that none of the sales would qualify for the safe harbor and JV REIT will instead have to resort to a facts and circumstances analysis to demonstrate that the properties were not held for sale to customers in the ordinary course of business.[17] While JV REIT may be able to make a strong case in this regard, the IRS has a

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

[14] *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.

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

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

[17] *See* Finance Committee report, *supra* note 11.

history of challenging the held for sale/held for investment issue and JV REIT will likely have to expend valuable time and resources to prevail. Of course, if JV REIT is treated as a dealer for these purposes, gain on the sales would be subject to the 100 percent prohibited transactions tax.

Accordingly, REITs should be exceedingly cautious when entering into dispositional joint ventures, especially when they have engaged in prior sales or intend to engage in additional sales during the year of the joint venture transaction. Importantly, before entering into a dispositional joint venture, REITs should closely examine any real estate transactions that may have occurred during the year to determine if those transactions may unwittingly be characterized as sales for purposes of the safe harbor.

B. Sales at the Joint Venture Level

The prior discussion emphasizes the prohibited transaction tax risks in connection with the joint venture transaction and the corresponding sale to the institutional investor. Similar tax risks exist for the REIT once the joint venture commences operations and, more specifically, sells properties.

Under reg. section 1.856-3(g), if a REIT is a partner in an entity that is treated as a partnership for federal income tax purposes, the REIT will be deemed to own its proportionate share of each asset of the partnership and will be deemed to be entitled to its proportionate share of the partnership's income (the look-through rule). There is a dearth of authority on the application of the look-through rule to the prohibited transactions tax and the safe harbor, but at least one private letter ruling suggests that the IRS takes the position that the look-through rule should be applied broadly for these purposes and in fact seems to apply a strict aggregate approach. As described in greater detail below, based on this approach, a partnership, which includes a REIT as a direct or indirect partner, could have substantial limitations regarding property sales.

In LTR 200824018, the taxpayer — a corporation that elected to be treated as a REIT for federal income tax purposes — was a partner in an operating partnership that owned numerous real properties, one of which was acquired in a like-kind exchange under section 1031. The REIT wished to reconfigure its portfolio and dispose of the replacement property in a taxable sale. The taxpayer represented that the replacement property satisfied the requirements of the safe harbor. The issue under the ruling was whether the holding period of the replacement property included the holding period of the relinquished property under section 1223(1), so that the sale would qualify under the safe harbor.[18] The IRS ruled that the holding period of the replacement property should include the holding period of the relinquished property and therefore the sale satisfied the safe harbor. While the ruling does not include much in the way of analysis, the IRS seems to take the position that the look-through rule applies not only to the REIT income and assets tests, but also to prohibited transactions and the safe harbor.[19]

Accordingly, to the extent that a REIT holds a direct or indirect interest in an entity taxable as a partnership, the partnership's sale of property may be treated as a sale by the REIT for purposes of the prohibited transaction rules and the safe harbor. At the very least, unless and until the IRS provides more specific guidance on this issue, and considering the potential adverse tax implications of not qualifying under the safe harbor, it may be advisable for planning purposes to take a more conservative approach and treat a sale at the partnership level as a sale for purposes of the safe harbor.

For example, assume JV REIT and an institutional investor enter into a joint venture that is taxable as a partnership for federal income tax purposes. After holding properties for three years, the manager of the joint venture elects to start selling properties. Under these facts, the availability of the safe harbor for sales of property held by JV REIT outside of the joint venture may be restricted. For instance, if the joint venture engages in five separate sales, JV REIT also may

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[18] At the time of this ruling, the safe harbor included a four-year holding period requirement, as opposed to the two-year period under current law.

[19] *See also* Robert J. Crnkovich, Mark C. Fisher, and John W. Cullins, "Will IRS Threaten Current Tax Treatment of REITs Owning Partnership Interests," 90(1) *J. Tax'n* 39-45 (Jan. 1999) (Tax advisers "should be aware of an informal view held by attorneys in the IRS Office of Chief Counsel that the [look-through rule's] reach might not be limited to the REIT income and asset tests of Section 856, but could be applicable for all purposes of the Code.").

be deemed to have engaged in five sales for purposes of the safe harbor.

It would be advisable, therefore, for the REIT to serve as the manager of the joint venture, with control over all decisions relating to the properties held in the joint venture. Moreover, the governing documents, including the joint venture agreement between the REIT and the institutional investor, should include a covenant that requires the manager and partners/members to operate the joint venture as a REIT for purposes of the REIT income and asset tests, and to avoid any taxes under sections 857 and 4981. This covenant is intended to specifically address the look-through rule and ensure that the operation of the joint venture does not cause the REIT to be deemed to hold non-real-estate assets, recognize non-qualifying income, or be subject to tax on prohibited transactions.

In some joint venture transactions, however, a REIT will hold only a minority interest in the joint venture and the institutional investor will insist on serving as the manager. While the REIT would not have direct control over dispositions under these circumstances, the REIT should negotiate some form of the covenant described above to address the look-through rule. It also would be worthwhile to negotiate consent rights regarding sales of property, so that the joint venture would not be able to sell any property without the REIT's approval. However, institutional investors with majority interests often reject such consent rights and instead insist on unilateral rights to acquire and sell property. In that case, the joint venture agreement should include a provision that requires the manager to provide reasonable notice of each potential sale to the REIT. Such notice would at a minimum allow the REIT to have the information necessary to plan its affairs and to manage the prohibited transactions risk prospectively.

C. Disguised Sales

As previously discussed, a dispositional joint venture may be treated in part as a contribution of property to an entity taxable as a partnership for federal income tax purposes. While intended to qualify under section 721, the contribution component may not necessarily be tax free because of the disguised sale rules.[20]

Although section 721(a) provides that there will be no gain or loss to a partner on a contribution of property to a partnership in exchange for a partnership interest, a contributor may recognize gain if the property contributed is subject to liabilities and the partner is not allocated an amount of liabilities that is at least equal to the partner's pre-transfer share of liabilities.[21] If, however, the liability is "qualified" and the contribution is not otherwise treated as a sale, the partnership's assumption of the liability is not treated as part of the sale.[22] If the contribution is otherwise treated as a sale, the partnership's assumption of the qualified liability will nonetheless be treated as the payment of additional consideration in an amount equal to the lesser of (A) the consideration the partnership would have been treated as transferring to the partner if the liability had been a nonqualified liability, or (B) an amount equal to the amount of the liability multiplied by the partner's net equity percentage for the contributed property.[23]

A qualified liability for these purposes generally includes any liability:

i. incurred more than two years before the partner agrees in writing to transfer the property and that has encumbered the property throughout that period;

ii. incurred within the two-year period before the transfer (while encumbering the property throughout that period), but not incurred in anticipation of the transfer;

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[20] This article provides a general overview of the disguised sale rules. Because of their complexity, a comprehensive analysis of the rules is beyond the scope of this article.

[21] *See generally* section 752(b).

[22] Reg. section 1.707-5(a)(5)(i).

[23] *Id*. A partner's net equity percentage equals the percentage determined by dividing (A) the aggregate amount of disguised sale proceeds (other than the qualified liability) by (B) the excess of the FMV of the property when contributed over the amount of the qualified liability encumbering the property. Reg. section 1.707-5(a)(5)(ii).

iii. allocable to capital expenditures regarding the property under the interest tracing rules of reg. section 1.163-8T; or

iv. incurred in the ordinary course of business, but only if all assets related to the business are transferred (other than assets that are not material to the continuation of the trade or business).[24]

A different set of rules applies to nonqualified liabilities. If a partnership assumes property subject to a nonqualified liability, the partnership is treated as transferring consideration to the partner (regardless of whether cash also is transferred to the partner) to the extent that the amount of the liability exceeds the partner's share of that liability immediately after the partnership assumes the liability.[25] A liability incurred by the partner within two years of the transfer is presumed to be incurred in anticipation of the transfer unless the facts and circumstances clearly establish that it was not.[26]

In the case of a refinancing, the new liability will be treated as the old liability for purposes of the disguised sale rules to the extent that the proceeds from the new liability are allocable to the discharge of the old liability under reg. section. 1.163-8T.[27] A refinancing, therefore, could result in nonqualified liability treatment if any portion of the proceeds is used for nonqualified purposes.

As previously discussed, a dispositional joint venture transaction that involves a sale of an interest in one or more properties may be bifurcated into a sale component and a contribution component. For example, revisiting the joint venture transaction described in Section I of this article, JV REIT will treat and report the transaction as a sale of 40 percent of the 10 properties to the institutional investor in exchange for cash, and a contribution of 60 percent of the 10 properties to the LLC in exchange for a membership interest. Assume further that each of the 10 properties is subject to a nonrecourse liability that the joint venture assumed as part of the transaction.

Based on these facts, the disguised sale analysis should be limited to the 60 percent contribution component, as JV REIT will treat and report the 40 percent sale component as a sale for all purposes of the code. Thus, if the liabilities are qualified liabilities within the meaning of reg. section 1.707-5(a)(6) (for example, each liability was incurred more than two years before the transfer and has encumbered the property throughout that period), and the IRS respects the part-sale/part-contribution structure, the assumption of the liabilities in connection with the 60 percent contribution component should not be treated as part of a sale. However, if the liabilities are nonqualified liabilities (for example, a liability was incurred within two years and in anticipation of the transfer), a portion of the liability would be treated as additional consideration to the extent that the amount of the liability exceeds JV REIT's share of that liability immediately after the joint venture assumes the liability.

It will be important, therefore, to determine whether each liability is qualified for disguised sale purposes. For instance, if a REIT refinances loans within two years of the joint venture transaction, it will be necessary to trace the proceeds to determine whether any of the proceeds were used for nonqualified purposes as described in reg. section 1.707-5(a)(6), in which case a portion of the liabilities could be treated as additional consideration. There also may be a related disclosure obligation regardless of whether the REIT treats the contribution as a disguised sale.[28]

IV. Closing

A dispositional joint venture represents an effective strategy for REITs to raise capital without fully disposing of properties. REITs, however, should ensure that transfers of property in connection with the joint venture qualify for the safe harbor and do not result in disguised sale

[24] Reg. section 1.707-5(a)(6)(i).

[25] Reg. section 1.707-5(a)(1).

[26] Reg. section 1.707-5(a)(7)(i). Moreover, a partner has a disclosure obligation to the IRS if the partner takes the position that a liability incurred within two years of a contribution should not be treated as a disguised sale. *See* reg. section 1.707-5(a)(7)(ii).

[27] Reg. section 1.707-5(c).

[28] *See* reg. section 1.707-5(a)(7)(ii).

treatment. Moreover, based on the look-through rule and the IRS's apparent strict application of the aggregate theory, a joint venture must not only closely monitor the REIT income and assets tests, but also make sure that sales of property at the joint venture level are not treated as prohibited transactions. ■