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IRS releases three letter rulings relating to REITs engaging in portfolio reallocation

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The IRS recently released three letter rulings relating to REITs engaging in portfolio reallocation through IRC 1031 deferred exchanges. Two letter rulings clarify if and to what extent exchanges are considered sales in determining whether a disposition is a prohibited transaction: they are PLR 200701008, issued September 29, 2006 and, PLR 200702021, issued October 3, 2006. The third explores whether REITs may use a qualified intermediary to dispose of property to a related taxable REIT subsidiary, and whether the related party must hold the relinquished property for two years thereafter: it is PLR 200709036, issued November 28, 2006.

REITs are intended to be primarily in the business of holding real estate and not to be focused on selling real estate as inventory. To ensure compliance, a draconian 100% tax applies to a REITs' net income from "prohibited transactions." Prohibited transactions are statutorily defined as sales or other disposition of property held primarily for sale to customers in the ordinary course of the REIT's trade or business (paraphrased). However a certain amount of portfolio reallocation is necessary for REITs to enable the investing public to enjoy the benefits of real estate investment without the burdens of management and without the lack of diversification associated with direct real estate investment. To that end, the Internal Revenue Code (IRC) permits REITs a limited dispositions in any given year under safe harbor tests which include among other requirements the following alternate test (again paraphrased): during the taxable year the REIT does not make more than seven sales of property, or the aggregate adjusted bases sold during the taxable year does not exceed 10% of the aggregate bases of all of the assets of the REIT as of the beginning of the taxable year. Herein, we'll refer to these as the "seven property test" and the "10% aggregate adjusted basis test" respectively.

The question arose, would a REITs' 1031 exchange constitute a sale that counted against either the seven property test and/or the 10% aggregate adjusted basis test, and further would the answer change where the exchange involved taxable boot. In PLR 2000701008, the exchange does not involve taxable boot and it is concluded that the relinquished property disposition is not a sale of property (so by implication not a prohibited transaction) and further will not be taken into account for the purposes of applying the seven property test or the 10% aggregate adjusted basis test. While the letter ruling recited that neither property involved in the exchange was encumbered, it is unclear if that has relevance. With regard to REIT 1031 exchanges involving taxable boot, PLR 200702021 concludes that notwithstanding the boot, the exchange is not a prohibited transaction, and that only the boot portion of the transaction is treated as a sale. In that regard, the adjusted basis of the relinquished property will be multiplied by the ratio that the boot bears to the overall price of the relinquished property, and only that resulting portion of the adjusted basis will be counted against the 10% aggregate adjusted basis test. It is not yet clear whether an exchange with boot might also impact the seven property test in some fashion.

The question also arose, whether a REIT might, using a qualified intermediary in an exchange, dispose of a property (for fair market value) to a related taxable REIT subsidiary (TRS) and, if so whether such a transaction is either i) an exchange between related parties subject to the two year holding requirement of IRC 1031(f)(1), or ii) is not a related party exchange due to the imposition of a qualified intermediary, but fails under IRC 1031(f)(4), as a transaction structured to avoid the related party rules. In response, PLR 2007009036 concludes that the transaction is not a related party exchange subject to the two year holding requirement because the REIT is exchanging property with a QI, and not a related person. Further, as the structure is distinguishable from the basis shifting swaps that IRC 1031(f) was intended to curtail, and as the REIT and TRS are not exchanging properties either directly or through the QI, it concludes there is no transaction, or series of transactions, structured to avoid the purposes of 1031(f) and accordingly that 1031(f)(4) which bars exchange treatment for avoidance structures, is not applicable.

The existence of these letter rulings is sure to foster increased 1031 exchange activity by REITs. Read together they suggest a greater flexibility is available to REITs in disposing of non-core assets. Additionally, given that a reverse exchange structure under Rev. Proc. 2000-37 can often minimize or eliminate boot, it is likely the majority of the additional exchanges will be structured as reverse exchanges.

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