Taking REITs Private: Selected Tax Issues

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INTRODUCTION

A REIT [1] is a fairly unique entity in the world of tax law. It is treated as a corporation for nearly all purposes of the Code, makes distributions that are treated as either dividends or long-term capital gains, can be organized as a corporation, partnership, limited liability company or business trust as desired, and yet, if it is operated according to fairly strict but manageable rules, generally incurs no federal income tax liability at the entity level. As a result, a REIT can be used to allow investors in real estate to achieve a variety of business and tax goals that cannot easily be achieved with any other entity. In addition, a REIT can be combined with more typical tax entities such as partnerships and corporations to achieve results that no single entity could achieve alone. These factors have combined to help create the huge and well-known growth in the size and number of publicly traded REITs. They also create unique planning opportunities for private equity funds and other private investors, both U.S. taxable and tax-exempt investors, and foreign investors, seeking to invest their substantial capital resources in U.S. real property. This article looks at a variety of tax issues that arise when private investors seek to take a public REIT private (or turn a public C corporation into a private REIT).

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[1] As used here, the term “REIT” refers to an entity that qualifies as a real estate investment trust under the requirements of § § 856–860 of the Internal Revenue Code of 1986, as amended (the “Code”). Unless otherwise indicated, all section references are to the Code and the Treasury Regulations issued pursuant to the Code.

STRUCTURING CONSIDERATIONS

The acquisition of a public REIT by a private equity fund or other joint venture vehicle that wishes to end the public status of the REIT presents a number of interesting tax issues. Chief among these is whether the joint venture wishes to continue to own the property held by the REIT through a (now *private*)REIT vehicle. If, for example, the business plan primarily involves turning the REIT's rental properties into condominiums or otherwise quickly selling off the REIT's properties individually, continued ownership through a REIT will likely not be desirable because of the 100% tax imposed on REITs who become dealers in property by engaging in “prohibited transactions.” [2] If the investors envision a more leisurely

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sale of the REIT's property, it may be desirable to structure the acquisition in a manner that keeps the existing REIT intact for tax purposes, so that the REIT can continue to benefit from any time that has passed since it acquired the property for purposes of the four-year safe harbor period of § 857(b)(6)(C)(i).[3]

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[2] § 857(b)(6).

[3] Section 857(b)(6)(C) provides that a REIT that sells no more than seven properties a year and complies with other various requirements will not be considered to have engaged in a prohibited transaction if it has held the property for at least four years prior to the time of sale.

In the event that the business plan anticipates operating losses and some of the joint venture participants are U.S. individuals, they may be interested in structuring ownership of the property in a manner that allows the losses to be passed through directly to the investors, which would necessitate either eliminating the REIT or having these investors maintain their interest in the property through an interest in an UPREIT or DownREIT. Tax-exempt and foreign investors will often prefer to invest in the property through the (now private) REIT.

Acquisition Form

A critical consideration in any acquisition is the tax treatment to the selling shareholders. When the acquiror is a private equity fund or similar joint venture, it will generally not be possible or desirable to structure the acquisition in a tax-free manner, since there will be no ability to issue shares of a publicly-traded acquisition entity that could be received by the shareholders of the publicly-traded target in a transaction qualifying as a tax-free reorganization under § 368. Instead, the acquisition will usually involve the purchase of shares for cash, with the cash coming from either the acquiror (which itself will be funded with a combination of debt and equity) or, in part, from the target itself (in a so-called bootstrap acquisition).

Forward or Reverse Merger

Usually the transaction will be structured as a merger under state law, to take advantage of provisions allowing for the squeeze-out of shareholders who do not explicitly tender their shares pursuant to a tender offer made for all of the shares of the public REIT. The merger can normally be structured as either a “forward”merger, with the acquisition company surviving the merger and the target company going out of existence, or a reverse merger, with the acquisition company going out of the existence and the target company continuing to survive for state law purposes. The direction of the merger often does not have great consequences under state corporate law (though at times surprising differences can exist, such as whether preferred shareholders get a separate vote as a class on the proposed merger), but makes all the difference for tax purposes. A forward merger is treated as an acquisition of assets by the acquiring company, followed by a liquidation of the target company to the selling shareholders.[4] A reverse merger, by contrast, is generally treated as a stock acquisition, with the merger simply treated as a means to effect the stock purchase.[5]

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[4] Rev. Rul. 69-6, 1969-1 C.B. 104.

[5] Rev. Rul. 73-427, 1973-2 C.B. 301.

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In a forward merger, the acquiring company acquires the assets with an aggregate basis equal to the total cash price paid by the acquiring company to the selling shareholders. This basis is allocated among the assets based on their relative fair market value.[6] The target REIT is treated as selling all of its assets to the acquiring company in a fully taxable transaction and then liquidating. The target REIT gets a dividends-paid deduction for liquidating dividends on its final tax return,[7] and so no tax is normally incurred at the REIT level. REIT shareholders are treated as selling their shares for tax purposes.[8]

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[6] § 1060.

[7] § 562(b)(1). The REIT generally should be able to take advantage of the rule of § 562(b)(1)(B) for liquidating distributions occurring within 24 months after the adoption of a plan of liquidation, which allows the REIT a deduction for the full amount of earnings and profits of the REIT for the taxable year of the distribution. Otherwise, the REIT would have to rely on § 562(b)(1)(A), which allows a deduction only to the extent the distribution is "properly chargeable" to accumulated earnings and profits, which could prevent the REIT from having a dividend sufficient to offset its income for the year of the distribution in the event that it has current year earnings and profits but a deficit in accumulated earnings and profits or the liquidating distribution otherwise does not sufficiently exceed the paid-in capital of the corporation. *See* Regs. § 1.562-1(b)(1) (noting that the paid-in capital must be deducted from the amount of distributions properly chargeable to accumulated earnings and profits). In the event that the REIT has liabilities that exceed the basis of its assets, it is possible that the net proceeds left to distribute to the shareholders after the payment of the liabilities will be less than the taxable income generated by the deemed asset sale. The REIT would then need to either declare a consent dividend or pay tax at the REIT level and make an election under § 857(b)(3)(D) to allow the REIT's shareholders to include the gain realized by the REIT and receive a credit for the tax paid at the REIT level.

[8] § 331(a).

In a reverse merger, the REIT survives for tax purposes, and its basis in its assets remains unchanged. The period for which it has considered to have held its assets for purposes of the safe harbor of § 857(b)(6)(C) also continues. The REIT's shareholders are treated as selling their shares for tax purposes.

Partnership Level Treatment

When the target REIT is an UPREIT, which is often the case, the acquisition is slightly more complicated. Typically, an acquisition of an UPREIT is structured as a double merger with the acquiring entity forming a subsidiary partnership. When the acquiring company merges with the target REIT, the acquiring partnership merges with the UPREIT partnership. Generally, it does not matter which way the partnership merger is structured. In the case where the REIT merges in a forward merger, the acquiring company will be considered to acquire all of the assets of the REIT, including its interest in the partnership. If the acquiring company also acquires all of the other interests in the partnership (e.g., any UPREIT units held by an investor who had previously contributed property to the partnership in exchange for UPREIT units), and does not attempt to keep the partnership "alive"for tax purposes by holding some of those partnership interests in a separate taxable entity, the acquiring company will be considered to have made an asset acquisition of all the assets owned by the partnership.[9]

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[9] Rev. Rul. 99-6, 1999-1 C.B. 432.

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If the acquiring entity and another taxable entity (such as a corporate sister or corporate subsidiary of the acquiring entity that is treated as a separate corporation, such as a taxable REIT subsidiary but not a qualified REIT subsidiary) together acquire the partnership interests in a forward merger that is treated as an asset acquisition, such that a partnership continues to exist for tax purposes, the acquiring entities will be treated as acquiring all of the partnership interests. As a result of a transfer of more than 50% of the interests in the partnership, the partnership will be considered to have "terminated" under the § 708 regulations and transferred its assets to a "new" partnership owned by the acquiring entities. Under the deemed transaction constructed by the regulations, the existing partnership will be treated as having contributed all of its assets to the new partnership in exchange for interests in the new partnership which are then distributed in liquidation to the terminated partnership's partners.[10] If the terminated partnership does not have a § 754 election in effect, the "new" partnership will continue to have the same basis in its assets as the old partnership. If a § 754 election is in effect or is made by the terminated partnership on its final return, the purchase will result in an adjustment to the basis of the partnership's assets, which should then have a basis equal to their fair market value.[11]

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[10] Regs. § 1.708-1(b)(4).

[11] Regs. § 1.708-1(b)(5).

In a reverse merger, if the partnership is kept alive by acquiring some of the partnership interests not owned by the acquired REIT through a separate taxable entity, the partnership will generally not terminate because the majority-owner of the partnership —the REIT — remains the same after the merger. If the partnership interests that are not owned by the REIT become owned by the REIT as a result of the form of the merger, the partnership will cease to exist for tax purposes. The acquisition of all of the partnership interests by the REIT will result in the constructive liquidation of the partnership, and the REIT will take a basis in the partnership's assets equal to the REIT's basis in its partnership interests, including its basis in the newly acquired partnership interests.[12]

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[12] Rev. Rul. 99-6, 1999-1 C.B. 432. Since the REIT will typically have acquired its partnership interests for cash, and the properties owned by the partnership will often have been acquired by a contribution of the properties to the partnership by partners receiving UPREIT units in exchange for their contribution, the assets of the partnership will often have a basis that differs from the REIT's basis in its partnership interests. On the constructive liquidation of the partnership, this difference will be eliminated, as will any remaining § 704(c) adjustments and other partnership attributes. The partners whose interests are acquired, however, will recognize gain on the transaction, effectively recognizing the remaining § 704(c) gain that would have been recognized inside the partnership and allocated to them on a disposition of partnership assets by the partnership.

Bootstrap Acquisitions

A bootstrap acquisition essentially involves the target reducing its net equity value to a level that the acquiror can fund. This reduction can take place by having the target pay a pre-closing dividend to the selling shareholders or a post-closing distribution to the acquiror that the acquiror uses to pay debt incurred to finance the acquisition. In either case, the distribution can be financed by cash or other assets held by the target or by borrowing secured by the target's assets. Analytically, two related questions are presented by bootstrap acquisitions, and the answers to both affect a number of REIT-related issues. First, to whom is the distribution that reduces the net equity value of the target considered to be made for

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tax purposes? Second, how is the distribution to be treated by the recipient? There are cases that support multiple outcomes on similar facts, and even the Service has acknowledged that form plays a critical role in determining the tax treatment of situations that economically are ultimately more similar than they are different.[13]

[13] *See* TAM 9003003.

Desirability of a Pre-closing Distribution

A pre-closing dividend can be funded either by operating cash accumulated by the REIT, borrowings by the REIT against the value of its properties, or a sale by the REIT of some of its properties. A sale by the REIT of properties will need to be analyzed carefully to ensure that it will not create a prohibited transaction that would subject the REIT to the 100% penalty tax of § 857(b)(6). A sale of properties will also generate taxable income at the REIT level that will need to be distributed to shareholders in a fashion that generates a dividends-paid deduction or else the REIT will incur a tax at the REIT level.

In fact, a pre-closing dividend may be necessary in a reverse merger, not because the acquiror cannot fund the total purchase price of the REIT without the dividend, but because the REIT has taxable income earned before the closing. In this case, it is more tax-efficient for the selling shareholders to receive the pre-closing dividend than for the acquiror to acquire a REIT that has taxable income that needs to be distributed after closing. Absent the payment of a pre-closing dividend, the acquiror would be paying to buy a REIT and would need to pay itself an amount that economically represents a return of a portion of its purchase price but would be taxable as a dividend. If the target in a reverse merger is a C corporation and the plan is to have the target elect REIT status after the merger, it will also be desirable to have the target make a distribution of all its C corporation earnings and profits prior to the acquisition, so that it will not have to be distributed to the buyer to comply with § 857(a)(2)(B).

On the other hand, if the target is a REIT and a greater than 5% selling shareholder is a non-U.S. person, and the acquiror intends to cause the REIT to sell properties after the acquisition but in the same taxable year, the sellers may not want to pay any pre-closing dividends in order to avoid the subsequent sale causing the pre-closing distribution to be subject to § 897(h)(1). Although such a distribution should arguably not be considered to be “attributable”to gain realized on a subsequent property disposition occurring after the shareholders receiving the distribution no longer own the REIT, there are currently no regulations or authority defining what “attributable”means for purposes of § 897(h)(1).

Post-closing Liquidation/§ 332(c)

If the buyer intends to liquidate the REIT in a transaction governed by § 331 after the acquisition, it will not be necessary from the buyer's perspective to have a pre-closing distribution to strip out earnings and profits because the REIT will get a dividends-paid deduction in the liquidation. However, in the unlikely event that the buyer intends to liquidate the REIT in a transaction that will be governed by § 332 — e.g., where a single corporation acquires all of the shares of the REIT and then the REIT liquidates – an interesting issue arises under § 332(c).

Section 332(c) provides that a corporation receiving a liquidating distribution from a REIT is required to treat the distribution as a taxable dividend to the extent that the liquidation produces a dividends-paid deduction for the REIT. The question arises whether the acquiring corporation can avoid the consequences of § 332(c) by having the target distribute all of its earnings and profits prior to the closing of the acquisition. The acquiror would then not need the dividends-paid deduction in the subsequent liquidation. However, even if the acquiror can cause the REIT to avoid claiming a dividends-paid deduction in the liquidation, § 332(c) requires the corporation receiving the assets of the liquidating

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corporation to include as a dividend an amount "equal to the deduction for dividends paid *allowable*" to the liquidating REIT "by reason of" the distribution. Arguably, the "amount allowable"is determined by allocating the earnings and profits *pro rata* to all distributions made during the year, including the liquidating distribution, in accordance with the rules under § 316.[14] Such a result, however, would be inconsistent with the abuse targeted by § 332(c).

[14] *See* Regs. § 1.562-1(b)(1)(ii)(b), which states that a dividend paid deduction is "allowable"to the extent of current earnings and profits. Regs. § 1.316-2(b) states that earnings and profits are allocated ratably to all distributions made during the year. However, Rev. Rul. 74-339, 1974-2 C.B. 103, states that earnings and profits are allocated first to ordinary distributions and then to redemption proceeds and suggests that the same result would apply for purposes of liquidating distributions, meaning that a REIT that paid a pre-closing distribution that was treated as a dividend would allocate earnings and profits first to the pre-closing dividend. If the pre-closing dividend was at least as great as the REIT's earnings and profits for the year, and Rev. Rul. 74-339 applied to allocate earnings and profits first to the ordinary distribution, there would be no earnings and profits remaining to apply to the liquidating distribution, and § 332(c) could not apply.

Section 332(c) was designed to prevent the income of a REIT from escaping taxation altogether as a result of the dividends-paid deduction being combined with the tax-free receipt of income in a § 332 liquidation.[15] In the case of a bootstrap acquisition with a pre-closing distribution, however, the distribution is taxable to the selling shareholder. A better technical reading of § 332(c) would therefore be that no amount of a dividends-paid deduction is allowable to the REIT "*by reason of*" the liquidating distribution, because the REIT would have been entitled to the same dividends-paid deduction if there was no liquidation at all, as a result of the pre-closing dividend. Where the pre-closing dividend is sufficient to carry with it all of the REIT's earnings and profits, the liquidation does not have *any* effect on the total dividends-paid deduction allowable to the REIT, and so § 332(c) should not be applicable.[16] A buyer contemplating a post-closing liquidation that will be subject to § 332 should therefore also prefer that a seller pay a pre-closing distribution equal to the REIT's earnings and profits.

[15] *See* H.R. Rep. No. 105-817, 105th Cong., 2d Sess., at 59 (1998), *reprinted in* 1998-4 C.B. 307.

[16] As noted, if earnings profits are allocated first to the pre-closing distribution by virtue of Rev. Rul. 74-339, this will also avoid the application of § 332(c) to a subsequent liquidation.

Tax Consequences of a Pre-closing Distribution/ Dividend vs. Redemption

How a pre-closing distribution will be treated for various tax purposes is not entirely clear and, as noted, will depend in large part on the form of the transaction. Under the principles of cases such as *Zenz v. Quinlivan*,[17] a distribution made in the form of redemption by a corporation as part of an acquisition of all of the corporation's shares is normally treated as a redemption that completely terminates the shareholders' interests in the corporation and therefore is treated as a redemption under § 302(b)(3) rather than as a dividend. This result occurs whether the redemption occurs before or after the sale of the remaining shares, as long as it is part of the same plan.[18]

[17] 213 F.2d 914 (6th Cir. 1954). *See also* Rev. Rul. 54-458, 1954-2 C.B. 167; Rev. Rul. 55-745, 1955-2 C.B. 223.

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[18] *See* Rev. Rul. 75-447, 1975-2 C.B. 113.

If the distribution takes the form of a dividend and occurs before the acquisition of shares, there is authority that suggests that it should be treated in accordance with its form as a dividend to the selling shareholders, rather than as a redemption.[19] Support for this view comes from the fact that the proceeds come from the corporation itself, not from the acquiror,[20] and that no shares are actually surrendered in the distribution. With respect to the last point, however, the Service has ruled in Rev. Rul. 90-13 that an actual surrender of shares in a pro rata distribution would be a "meaningless gesture" and a surrender of shares is therefore not necessary to treat the distribution as a redemption rather than a dividend.[21] Where the target is a REIT, an individual seller would normally prefer redemption treatment which will be taxable at capital gains rates, while a corporate seller would normally be indifferent.[22]

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[19] *See, e.g.*, *Walker v. Comr.*, 544 F.2d 419 (9th Cir. 1976); *Joseph L. O'Brien Co. v. Comr.*, 301 F.2d 813 (3d Cir. 1962); *Litton Indus., Inc. v. Comr.*, 89 T.C. 1086 (1987); *Reitz v. Comr.*, 61 T.C. 443 (1974); *Gilmore v. Comr.*, 25 T.C. 1321 (1956). *See also* Rev. Rul. 75-493, 1975-2 C.B.-109; Rev. Rul. 69-130, 1969-1 C.B. 93; PLR 9813004. *See generally* Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (7th ed., 2002) ¶ 8.07[2][a], at 8-64 to -67.

[20] If the cash in fact comes from the acquiror, including through the target corporation's distribution of a note that is ultimately paid off with funds from the acquiror, cases such as *Waterman Steamship Corp. v. Comr.*, 430 F.2d 1185 (5th Cir. 1970), indicate that the form may be disregarded and the distribution treated as additional sales proceeds. However, see *Litton Indus., Inc. v. Comr.*, 89 T.C. 1086 (1987), where the target corporation distributed a note prior to the acquisition that was ultimately purchased by the acquiror corporation from the selling shareholders. Due to the fact that no formal action had been taken to initiate the sale at the time of the distribution of the note, the Tax Court respected the distribution as a dividend. See Action on Decision 1988-028 (where the Service acquiesced in the result in *Litton* because there was no final decision to sell at the time the dividend was declared). See also *TSN Liquidating Corp. v. U.S.*, 624 F.2d 1328 (5th Cir. 1980), where the court declined to follow *Waterman* where the target distributed unwanted assets to the seller, and the buyer, immediately after the acquisition, contributed cash and other assets in a similar amount to the corporation.

[21] *See also Moloney v.U.S.*, 521 F.2d 491 (6th Cir. 1975) (concluding that a redemption took place for tax purposes even when there was no actual surrender of shares).

[22] A corporate seller of a REIT would be largely indifferent because a distribution treated as a dividend would result in ordinary income to the extent of earnings and profits and otherwise would decrease the selling corporation's basis in the shares being sold, resulting in additional capital gain on the sale. Although the character of the amount treated as a dividend would be ordinary, there would ultimately be the same net income amount as if the distribution was treated as a redemption. If the selling corporation had capital losses that it wanted to use to offset capital gain on the sale, it might prefer to maximize the amount treated as capital gain income and would then prefer redemption treatment.

A corporate seller selling a target that is a C corporation included in its consolidated return would often also be indifferent, since a dividend would be excluded from income but would reduce its basis in the shares being sold. *See* Regs. § 1.1502-13(f)(2)(ii). However, such a transaction would often be structured to be treated as an asset acquisition with an election being made under § 338(h)(10).

Effect of Pre-Closing Distribution on Earnings and Profits

The characterization of the distribution as a dividend or a redemption is also relevant to the target REIT itself in an acquisition treated as a stock purchase because it may influence the amount of the dividends-

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paid deduction to which the REIT is entitled with respect to the distribution.[23] It is also relevant in the case of an acquisition of all of the shares of a C corporation that will elect REIT status following the acquisition, because the C corporation needs to distribute all of its C corporation earnings and profits prior to the end of the year during which it makes its REIT election.[24]

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[23] In a transaction treated as a forward merger, the distribution by the REIT will be treated as a distribution made in liquidation of the REIT subject to the more favorable rule of § 562(b)(1)(B), which will generally ensure that the REIT has a sufficient dividends-paid deduction on its final tax return to offset the full amount of its real estate investment trust taxable income for purposes of § 857(b).

[24] § 857(a)(2)(B).

If the distribution is treated as a redemption subject to § 302 rather than as a dividend, the REIT will still get a dividends-paid deduction pursuant to § 562(b)(1)(A), but the deduction will be limited to the “part” of the distribution that is “properly chargeable” to the REIT's earnings and profits. It is not clear how the amount of the distribution which is properly chargeable to earnings and profits is to be calculated. Section 312(n)(7) states that in the case of a redemption subject to § 302, the part of the distribution which is properly chargeable to earnings and profits is the pro rata share of the earnings and profits of the corporation that is attributable to the redeemed stock. If no actual stock is surrendered for redemption, but a pre-acquisition pro rata distribution is treated as a redemption, what portion of the stock should be considered to have been redeemed? Arguably a portion of each share is redeemed, and so the redemption should be treated as being attributable to all of the earnings and profits of the corporation.

The Service reached a different result in PLR 200352015, which addressed a bootstrap acquisition of an REIT. In a reverse cash merger, the former shareholders were entitled to receive a certain amount representing the cash held by the acquired REIT and an additional amount from the purchasers. The ruling states as part of the “summary of facts” that the amount representing the cash held by the acquired REIT would be treated as payment in exchange for some of the shares under § 302, and the remainder of the cash received in the merger would be treated as amounts received from the purchasers of the stock.[25] The ruling then concludes that the percentage of earnings and profits properly chargeable to the redemption for purposes of § 312(n)(7) and § 562(b)(1)(A) in computing the REIT's dividends-paid deduction will be equal to the value of the shares treated as redeemed over the value of all of the REIT's outstanding shares prior to the acquisition. The ruling used the amount treated as distributed in redemption as the value of the shares treated as being redeemed. Under the rationale of the ruling, a REIT would therefore normally be entitled to a dividend-paid deduction for only a portion of the amount distributed in the redemption.

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[25] The ruling does not assert any authority for this statement of “facts” and does not specify whether the shareholders actually tendered their shares to the corporation or whether the money treated as being paid in the redemption actually came from the target corporation rather than the acquiror. PLR 9813004 reached an opposite result with respect to this “fact,” concluding that distributions made a day prior to the closing of a stock acquisition constituted dividends that cleansed C corporation earnings and profits for purposes of § 857(a)(2). The ruling reached this result even though the distributions were funded by debt put in place to finance the distributions.

Suppose, for example, that a REIT is acquired in a transaction where the former shareholders received $10 from the corporation and $90 from the purchasing shareholders. If the REIT has $10 of earnings and profits, the rationale of PLR 200352315 would allow the REIT a dividends-paid deduction of only $1 (e.g.,

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10% of the total earnings and profits of $10). However, given that all of the shareholders of the REIT are participating in the redemption, the ratable share of the corporation's earnings and profits within the meaning of § 312(n)(7) and § 562(b)(1)(A) should arguably be 100%. This would also be the logical result in a situation where a pro rata distribution is treated as a redemption where no specific shares are actually tendered to the REIT. This result would be consistent with viewing § 312(n)(7), as designed to appropriately allocate a redemption's effects on a corporation's earnings and profits when only some of the corporation's shareholders are redeemed.

To avoid the potential result of PLR 200352015, and so avoid having to make additional taxable dividend distributions following the merger, the case for dividend rather than redemption treatment could be improved by not conditioning the pre-closing dividend on the closing of the merger.[26] However, this could create a business risk to the target that it could be less attractive to other suitors should something prevent the merger transaction from going through after the pre-closing distribution is made.

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[26] See, e.g., Rev. Rul. 75-493, 1975-2 C.B. 109, where the IRS ruled that a distribution made in anticipation of a sale, but one day prior to the creation of a legal obligation to undertake the sale, will be treated as a dividend.

Pre-closing Distribution as Additional Purchase Price

A few cases treat a pre-closing distribution as neither a dividend nor a redemption but as part of the purchase price, with the result that the distribution is either ignored or viewed as a dividend to the buyer who then uses it to pay the seller the amount owed by the buyer. However, these cases are generally limited to situations where the distribution was clearly a conduit for funds provided by the buyer,[27] the court viewed the buyer as having beneficial ownership of the corporation at the time of the distribution,[28] or the distributed asset was also sold to the buyer.[29] Ultimately, to the extent this line of cases has continuing relevance, their ambit should be avoidable by stating the purchase price in the acquisition agreement as a fixed amount with respect to the assets that will be retained by the target, with the value of the excluded assets that will be distributed inuring solely to the benefit or detriment of the selling shareholders.[30]

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[27] *See Waterman S.S. Corp. v. Comr.*, 430 F.2d 1185 (5th Cir. 1970); *see also* FSA 200117004.

[28] *See, e.g.*, *Casner v. Comr.*, 450 F.2d 379 (5th Cir. 1971); *Steel Improvement & Forge Co. v. Comr.*, 314 F.2d 96 (6th Cir. 1963); TAM 9003003.

[29] *See, e.g.*, *Basic Inc. v. U.S.,* 549 F.2d 740 (Ct. Cl. 1977).

[30] *See, e.g.*, Rev. Rul. 79-273, 1979-2 C.B. 125, *TSN Liquidating Corp. v. U.S.*, 624 F.2d 1328 (5th Cir. 1980). *See also Wilson v. Comr.*, 27 T.C. 976 (1957); *Gilmore v. Comr.*, 25 T.C. 1321 (1956); *Coffey v. Comr.*, 14 T.C. 1410 (1950).

Sale of Property in Connection with Acquisition

If an acquisition is to be financed in part by a sale of property or loan secured by a mortgage of the property that, in either case, is effected after the acquisition of the shares, issues can arise as to whether these transactions have an effect on the tax treatment for both the buyer and the seller. By analogy to *Court Holding v. Comr.*,[31] a sale of property by the target (or the acquiror in a forward merger) after the

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acquisition, particularly where it occurs on the same day and immediately after the closing of the acquisition and where the proceeds of the sale are used to pay a portion of the purchase price, could potentially be treated as a sale of the property by the corporation prior to the acquisition and a distribution of the proceeds of the sale in redemption of the selling shareholders' shares in the target. If the sale is treated as part of a sale prior to the acquisition and a redemption of some of the seller's shares, the effect of the redemption on the target's earnings and profits could be different than would be the case if the sale was considered to take place after the sale followed by a distribution of the proceeds to the buyer as a dividend, which the buyer then used to satisfy its pre-existing obligation to make a payment to the seller.[32] If the sale of the asset is considered to take place before the change in ownership, the corresponding redemption could also be treated as a distribution to any foreign selling shareholder that is subject to § 897(h)(1).[33]

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[31] 324 U.S. 331 (1945).

[32] See discussion above regarding a redemption's effect on earnings and profits.

[33] *See* Notice 2007-55, 2007-27 I.R.B. 13. The reasoning of Notice 2007-55 suggests that a redemption that is treated as a sale or exchange under § 302 is, like a liquidating distribution subject to § 331, still a “distribution” that is subject to § 897(h)(1). The Notice currently says that regulations will provide that a distribution will include a transaction subject to § 302 but, with respect to current law, states only that the IRS will challenge an assertion that a § 897(h)(1) does not apply to a distribution subject to § 331 and is silent on transactions subject to § 302 under current law. Even if the sale is respected as taking place after the acquisition, § 897(h)(1) could conceivably still apply to a pre-closing distribution, if the distribution and sale were viewed as connected.

Given that § 897(h)(1) does not apply to a shareholder who owns 5% or less of a publicly traded REIT, it is likely that a purchaser of a public REIT would prefer that a sale take place prior to the acquisition, so that any non-U.S. members of the acquiror are not potentially subject to § 897(h)(1) immediately after their acquisition of the target.

The risk that a *Court Holding* type of argument could be applied to recharacterize a sale that nominally takes place after closing as taking place prior to the closing can be lessened by ensuring that the potential sale is negotiated by the buyer rather than the selling shareholders or the target corporation itself,[34] and by having the sale conditioned on the acquisition having already taken place, which should be viewed as giving only the buyer the right to receive the distribution in the same way as having a record date for a dividend set for after an acquisition.[35]

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[34] *See, e.g.*, *U.S. v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950); *Martin Ice Cream Co. v. Comr.*, 110 T.C. 189 (1998). *See also Caruth v. U.S.*, 688 F. Supp. 1129 (N.D. Tex. 1987).

[35] See, e.g., Regs. § 1.61-9(c), which states that when stock is sold after a dividend is declared but before it is paid, and the sale takes place at a time such that the purchaser is entitled to the dividend, the dividend will “ordinarily”be income to the purchaser.

There are numerous cases that hold that a distribution by a corporation made after a transfer of the shares of the corporation is taxable to the purchaser, even where the sale was made in contemplation of the distribution. However, many of those cases do not address situations where the distribution was used to pay the purchase price to the seller.[36] The cases put a great deal of emphasis on who is legally entitled

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to the dividend, but the question remains who should be considered to be entitled to the distribution when the proceeds are paid directly to the seller. Form ultimately plays an important role here,[37] and when the purchaser has an obligation to pay the full purchase price, regardless of the amount of the distribution, the distribution should be treated as made to the purchaser.[38]

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[36] *See, e.g.*, *Winton v. Kelm*, 122 F. Supp. 649 (D. Minn. 1954) (if stock is transferred before a liquidation takes place and is formally approved by the corporation's shareholders, the liquidation proceeds are included in the income of the purchaser of the shares, even though the transfer was made in contemplation of the subsequent liquidation); *Bishop v. Shaughnessy*, 95 F. Supp. 759 (N.D.N.Y. 1951) (dividends are taxable to the purchaser of the shares if the shares are transferred before the dividends are declared, even if the dividends have already been authorized prior to the sale). *See also Caruth v. U.S.*, 688 F. Supp. 1129 (N.D. Tex. 1987). In *Caruth*, the taxpayer was the majority owner of one corporation and the sole owner of a second corporation. Prior to the first corporation declaring a dividend, Caruth contributed some of the stock of the first corporation to the second corporation. After the declaration of the dividend but prior to the record date for the payment of the dividend, Caruth donated some shares of the first corporation to charity. The Service argued that the dividends paid on both blocks of stock should be taxable to Caruth rather than to the second corporation and the charity. The court held for Caruth on both transfers, stating that the contributions should be treated the same as sales are treated by the regulation, and further stating that income cannot be assigned for tax purposes to someone who had no legal right to the income, such as a shareholder who transfers stock before the shareholder has any legal right to the receipt of a dividend. The fact that Caruth was on the board of the corporation and controlled when the dividend was declared did not change this result.

[37] *See* TAM 9003003.

[38] *See, e.g.*, *Sullivan v. U.S.*, 363 F.2d 724 (8th Cir. 1966); *Wall v. U.S.*, 164 F.2d 462 (4th Cir. 1947). Note that in both cases the purchaser owned the shares of the corporation at the time of the distribution.

Debt Financing

Where the purchase is financed in part by debt that will be serviced by the target, the tax consequences depend on the form of the acquisition. In a reverse merger, where the debt is incurred by the corporation that merges into the target, with the target surviving and becoming the obligor of the debt, the purchase price attributable to the debt proceeds should be treated as being paid to the selling shareholders in a redemption.[39] As a result, the buyer will have a basis in the shares equal only to the equity contributed to the acquisition company.

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[39] *See* TAM 9123002. In substance, a lender making a loan to the acquisition company that is merged into the target is making a loan to the target and is relying on the assets of the target for repayment of the loan. *See, e.g.*, *Plantation Patterns, Inc. v. Comr.*, 462 F.2d 712 (5th Cir. 1972). *See also* Rev. Rul. 79-273, 1979-2 C.B. 125, cited by Ginsburg and Levin as precedent for this proposition. Ginsburg & Levin, *Mergers, Acquisitions, and Buyouts* ¶ 1402.1.3 n.32, at 14-30. However, Rev. Rul. 79-273 involved a distribution by the target corporation of property that was owned by the target corporation prior to the acquisition and the transaction specifically contemplated this property being distributed to the target corporation's shareholders, whatever its value. For a contrary viewpoint, see FSA 200117004, where the Service stated that it is of the view that if the buyer has an unconditional obligation to pay the entire purchase price, the use of a loan to target to redeem the selling shareholders, even if made *prior to* the acquisition, can be treated as a dividend to buyer.

Where the acquiror purchases the selling shares without a merger, and a portion of the purchase price is

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paid from the proceeds received from a mortgage loan placed on the target corporation's property following the acquisition, the tax result depends on whether the debt is treated as being made to or assumed by the target before or after the stock acquisition. If the debt is treated as being made to or assumed by the target after ownership of the shares takes place for tax purposes, the proceeds of the borrowing would be treated as being distributed to the purchasing shareholder, who then uses these proceeds to satisfy the pre-existing obligation to pay the purchase price to the seller (or the assumption of the debt by the target from the acquiror would itself be treated as a distribution).[40] This distribution will be a dividend to the buyer to the extent of the target's earnings and profits for the taxable year, which will be allocated proportionately among all distributions made during the year, regardless of whether they were made before or after the closing.[41] To the extent the distribution is not made out of earnings and profits, it will reduce the buyer's basis in the acquired shares.[42] The transaction could also be treated as, in substance, a loan to the target which the target uses to redeem the selling shareholders.[43] Support for this view comes from the fact that the shares are not legally transferred unless and until the selling shareholders receive the full payment, which includes both the equity funding of the purchaser and the proceeds of the borrowing. As a practical matter, all of the funds are usually deposited with an escrow agent or the title holding company, and released to the buyer simultaneously as part of the sequence of events that take place at the closing.

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[40] The purchaser's obligation to pay the full purchase price is normally reflected in the acquisition agreement and, at least in theory, may also be reflected in a formal short-term note given by the buyer to the seller, which would only be outstanding momentarily on the day of the closing. *See, e.g.*, Ginsburg & Levin, *Mergers, Acquisitions, and Buyouts* ¶ 1402.1.5, at 14-40. The use of such a short-term note can, in practice, cause significant confusion for the escrow agent and on the closing statement.

[41] *See* Regs. § 1.316-2(b).

[42] *See, e.g.*, FSA 200117004.

[43] See the discussion in 770 T.M., *Structuring Corporation Acquisitions — Tax Aspects*.

Where the target is to remain in existence, the buyer would normally prefer to avoid being treated as receiving a dividend as part of the acquisition. A dividend distribution paid after the acquisition but in the same taxable year would automatically be considered to be made from a *pro rata* portion of the earnings and profits of the target for the entire year and would be taxable to the buyer. To the extent that the distribution made to the buyer is not out of earnings and profits, the buyer would reduce its basis in the shares.[44]

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[44] The application of § 382 should be the same under either characterization as a result of § 382(e)(2).

In a forward merger, debt incurred by the acquisition company should be considered as debt incurred by the buyer to acquire the assets, and should increase the buyer's basis in the assets.

CONTINUING REIT REQUIREMENTS

In a reverse merger, it will be also necessary to ensure that the REIT continues to satisfy the requirement that it has at least 100 shareholders after the elimination of the public shareholders if the buyer desires to continue the target's status as a REIT. Section 856(b) provides that this requirement needs to be

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satisfied for at least 335 out of 365 days of the year, leaving the REIT with a maximum period of 30 days to comply with the requirement. Typically, if the intention is to continue the existence of the REIT as a private REIT, the REIT will issue over 100 preferred shares to separate individuals.[45] Given the narrow 30-day window to get the preferred shareholders in place, the offering of the preferred shares will typically begin before the merger transaction is closed.

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[45] *See, e.g.,* PLR 8342016.

Intentionally Terminating REIT Status

If the acquiror does not wish to continue to hold the properties in a REIT, but the acquisition is nevertheless structured as a reverse merger, it will be necessary to liquidate the REIT after the acquisition closes. The acquisition might be structured as a reverse merger in such circumstance for corporate law purposes or because some of the selling shareholders are not U.S. persons and want to avoid being subject to § 897(h)(1).[46]

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[46] This should rarely be the case with respect to a target that is public, since § 897(h)(1) only applies to a non-U.S. person that owns more than five percent of the shares of a publicly traded REIT.

Section 331

If the transaction is structured as a reverse merger but ownership through a REIT on a long-term basis is not desired, the purchaser will likely want to structure the ownership of the REIT so that § 332 would not apply to a subsequent liquidation of the REIT, as § 332 would prevent the acquiror from stepping up the basis of the assets of the REIT and would also create potential issues under § 332(c). If the acquiror owns the REIT through a non-corporate entity or otherwise structures its ownership of the REIT so that a corporation does not own more than 80% of the REIT's shares, a liquidation would be governed by § 331.[47] As long as the REIT is liquidated before the assets have appreciated substantially following the acquisition date, the fair market value of the assets received in the liquidation should equal the price paid in the acquisition for the shares of the REIT, and so the acquiror should not recognize any gain in the liquidation.

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[47] Two well-known cases have held that the creation of an ownership structure designed to avoid the application of § 332 will be respected if the purported ownership of stock is bona fide. *See Granite Trust Co. v. U.S.*, 238 F.2d 670 (1st Cir. 1956); *Comr. v. Day & Zimmermann*, 151 F.2d 517 (3d Cir. 1945).

The liquidation will cause the REIT to recognize gain with respect to its property.[48] Under § 562(b), the REIT will get a dividends-paid deduction on its final return for the liquidating distribution. By virtue of § 562(b)(1)(B), the REIT should normally get a sufficient dividends-paid deduction to offset whatever gain is considered to be recognized in the liquidation. However, if the REIT has liabilities that exceed its basis in its assets, it is possible that the REIT could have less proceeds to distribute than the net amount of the gain. The dividends-paid deduction is limited to the amount distributed, however. For example, if the REIT has property with a basis of $20, a value of $100, and liabilities of $72, the REIT will have a gain of

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$80, but only $28 of net proceeds to distribute, creating a potential tax liability at the REIT level.

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[48] *See* § 311(b). This gain should not be treated as being part of a prohibited transaction. In PLR 8938004, the IRS has ruled that an actual sale of all of the REIT's properties prior to and in contemplation of a complete liquidation of the REIT should not, barring other suspect facts, cause the REIT to have engaged in a prohibited transaction. In addition § 857(b)(6)(E)(vi) provides that for purposes of the prohibited transaction safe harbor, a sale of more than one property to one buyer as part of one transaction constitutes one sale. In addition, there are cases under § 1221 that support the view that a sale of property to a single buyer is not a sale of property to “customers” in the ordinary course. *See, e.g.*, *Reese v. Comr.*, 615 F.2d 226 (5th Cir. 1980); *Comr. v. Williams*, 256 F.2d 152 (5th Cir. 1958); *Mitchell v. Comr.*, 47 T.C. 120 (1947). Likewise, the gain realized under § 311(b) should also not be treated as a sale to “customers.”

One potential solution is for the REIT to declare a consent dividend under § 565 on its final return. A consent dividend is treated as being distributed to the REIT's shareholders as a taxable dividend on the last day of the taxable year and then recontributed to the REIT, thereby increasing the shareholders' basis in their shares by the amount of the dividend.[49] The increased basis will reduce any gain or increase any loss realized in the liquidation.

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[49] *See* § 565(c). *See* Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (7th ed., 2002) ¶ 3.13[4], at 3-80 to 82.

One potential obstacle to declaring a consent dividend, however, is § 565(b)(2), which states that the amount treated as a consent dividend cannot include any amounts that would “not constitute a dividend (as defined in [§]316)” if distributed in cash. Section 316 defines the term “dividend” as “any distribution”made out of a corporation's earnings and profits. Unless the REIT has a deficiency in accumulated earnings and profits, the REIT should have sufficient earnings and profits for this purpose. However, the hypothetical distribution would be one being made in connection with the liquidation of the REIT, and so it arguably could not be considered a “dividend.”

Ultimately, the fact that the distribution would be treated under § 331 as being made in payment in exchange for the stock of the REIT should not affect the fact that it is still a “distribution”as that term is used in § 316. Supporting this argument is Notice 2007-55, which treats a payment made in a liquidating distribution governed by § 331 as still being a “distribution” as that term is used in § 897(h)(1). In addition, § 565(b)(2) specifically refers only to § 316, not to whether the distribution would generally be treated as a dividend to the shareholder. One problem with this latter argument is that it arguably renders § 562(b), which provides a dividends-paid deduction for amounts distributed in liquidation, as unnecessary, since § 562(a) already provides for any “dividend described in § 316.” On the other hand, the language in § 562(a), which refers to a “dividend” that is “described in [§]316”(and therefore is referring to something that is *both* a dividend *and* is described in [§]316) is not identical to the language of § 565(b)(2), which refers to a dividend *as defined in* § 316. In addition, if a distribution made as part of a liquidation could not be a dividend within the meaning of § 316, there would presumably be no reason for § 331(b) to provide for the nonapplication of § 301 to distributions subject to § 331(a). Thus, the better view is likely that a consent dividend would be available.

Another potential solution in this situation is for the REIT to pay tax at the REIT level and then elect under § 857(b)(3)(D) to treat the shareholders as realizing the gain realized by the REIT and as paying the tax paid by the REIT. The gain realized minus the amount of the REIT level tax will increase the

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shareholders' basis in their shares, as if the REIT distributed this amount and it was recontributed, which will reduce the gain realized or increase any loss realized in the liquidation.[50]

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[50] § 857(b)(3)(D)(iii).

Example: Returning to our example, if the REIT has a taxable gain of $80, it could declare a consent dividend of $80. The shareholders will have a taxable dividend of $80 and will increase the basis of their shares by $80. If the liquidation is governed by § 331, the deemed distribution via the consent dividend should be treated as an amount paid in exchange for the shareholders' stock.[51] At the same time, their basis will be increased by the $80 deemed contribution, resulting in no net change in the amount of gain or loss recognized in the liquidation.

If the REIT does not declare a consent dividend but pays tax at the REIT level and makes the election under § 857(b)(2)(D), the REIT will owe a tax of $28.[52] The shareholders will be treated as earning a capital gain of $80, paying a tax of $28, and will increase their basis in the REIT shares by $52 ($80 minus $28).[53] As a result of the REIT paying$28 in taxes, it will have $28 less to distribute in the liquidation. The $28 less to distribute plus the $52 increase in basis will result in $80 less gain (or more loss) in the liquidation. This will exactly offset the $80 capital gain deemed earned by the shareholders, and the shareholders will be entitled to a refund of the $28 tax paid(or can use it as a credit against any other taxes owed by the shareholders).[54] Thus, the economic result of paying the tax at the REIT level and making an election under § 857(b)(3)(D) will be the same as paying a consent dividend, though the consent dividend avoids the need to remit any tax at the REIT level and then claim a refund or credit at the shareholder level.

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[51] Under § 565(c)(1), the deemed distribution will be treated as taking place on the last day of the REIT's taxable year, which, if the consent is filed for the taxable year in which the complete liquidation occurs, will be during the liquidation period.

[52] See § 857(b)(3)(A)(ii), which refers to the 35% rate specified in § 1201(a) (35% of $80= $28).

[53] § 857(b)(3)(D)(iii).

[54] § 857(b)(3)(D)(ii).

Stock Purchase and Liquidation Respected as Separate Steps

The Service should not be able to recharacterize a share sale followed by a liquidation as a sale of property by the REIT while the REIT was still owned by the selling shareholders in a transaction that could be treated as a prohibited transaction, or as giving rise to a deemed distribution to a non-U.S. selling shareholder subject to § 897(h)(1). Prior to 1982, *Kimbell-Diamond Milling Co. v. Comr.*,[55] allowed both the IRS and taxpayers to recharacterize certain transactions that took the form of stock sales as constituting sales of assets for federal income tax purposes. Section 334(b)(2)under the 1954 Code also allowed a taxpayer to elect to have a stock purchase followed by a liquidation of the purchased company produce the same general tax consequences as an asset sale. In the 1982 Tax Equity and Fiscal Responsibility Act, Congress repealed former § 334(b)(2) and enacted § 338, which to date provides the exclusive statutory election to treat stock purchases as asset purchases. The legislative history of the 1982 Act clearly indicated that the Congress intended § 338 to "replace any nonstatutory treatment of a

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stock purchase as an asset purchase under the *Kimbell-Diamond* doctrine." [56]

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[55] 14 T.C. 74 (1950).

[56] S. Rep. No. 97-494, 97th Cong., 2d Sess., at 192 (1982), *reprinted in* 1982 U.S.C.C.A.N. 781, 951. *See also* H. Conf. Rep. No. 97760, 97th Cong., 2d Sess., at 536 (1982), *reprinted in* 1982 U.S.C.C.A.N. 1190, 1310.

In Rev. Rul. 90-95,[57] the IRS confirmed that, at least in cases where over 80% of the stock of a target corporation is acquired in a taxable transaction, such that § 338 is applicable, the step-transaction doctrine and *Kimbell-Diamond* doctrine do not apply and the transaction is treated as a stock purchase unless an election is made under § 338. The ruling states that this result applies even where the target is immediately liquidated by the purchaser pursuant to a prearranged plan.[58]

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[57] 1990-2 C.B. 67.

[58] *See also* Regs. § 1.338-3(d); Rev. Rul. 2008-25, 2008-21 I.R.B. 986 (where newly formed subsidiary (X) of parent (P)merges into target (T) in a statutory merger and then P liquidates T, merger of X into T does not qualify as a § 368(a) reorganization;P treated as making qualified stock purchase of T followed by § 332 liquidation). In light of these authorities, the Service would also have difficulty in arguing that a stock purchase and liquidation could be an "intermediary transaction" described in Notice 2008-20, 2008-6 I.R.B. 406.

CASHING OUT UPREIT UNIT HOLDERS —EFFECT ON HOLDING PERIOD

In the case of an acquisition of a public UPREIT that is structured as a reverse merger, the acquiror will usually try to find a way to cash out the exiting partnership unit holders, so that its business plan for the assets will not be burdened going forward by obligations under the various tax protection agreements that would otherwise survive the acquisition. If, for example, the acquiror is interested in ultimately having the REIT transfer some of the properties to a newly created subsidiary REIT, this could likely not be done in a manner that would allow the REIT to comply with its obligations under an applicable tax protection agreement, as the contribution to the subsidiary REIT could trigger gain under § 357 that would be allocated under § 704(c) to the relevant partnership unit holders. The acquiror would encounter a similar problem if it wanted to sell some properties following the acquisition. Transactions that violate the terms of a tax protection agreement would result in the REIT having to make an indemnity payment. An acquiror would normally prefer to factor in this cost upfront and make an offer to the operating partnership unit holders that will convince them to exit the target altogether.

As noted, many tax protection agreements have specific requirements in the event a public UPREIT is taken private, and an acquiror will have to comply with any requirements with respect to the consideration that has to be offered in addition to offering consideration sufficient to get the deal approved in the manner that is desired by the acquiror.

An acquiror who cashes out all of the partnership unit holders in a reverse merger may end up with a split holding period in the assets of the REIT for purposes of the prohibited transaction safe harbor. If the acquiror causes the REIT to own all of the interests in the partnership after the merger, the operating partnership would be treated as a disregarded entity beginning on the date of the acquisition, and the REIT would be treated as owning the properties owned by the operating partnership directly.[59] With

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respect to the percentage of each property equal to the REIT's interest in the partnership prior to the acquisition, the REIT's holding period for purposes of the safe harbor would include the period during which the property was held by the operating partnership.[60] With respect to the percentage of each property acquired as a result of the acquisition of the partnership interests not held by the REIT, it is possible that the REIT's holding period for purposes of the safe harbor would be considered to begin on the day immediately following the day of the acquisition.[61]

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[59] *See* Regs. § 301.7701-3(f)(2). This would also be the result if the partnership is liquidated into the REIT as part of the transaction.

[60] *See* § 735(b).

[61] See Rev. Rul. 99-6, 1999-1 C.B. 432, which implies that the REIT would be treated as acquiring the assets attributable to the acquired partnership interests, and would have a holding period with respect to this portion of the operating partnership's assets beginning on the day immediately after the day of the acquisition. There is no guidance on whether such a bifurcated holding period applies for purposes of the prohibited transaction safe harbor.

As a result, it is possible that a future sale of property by the REIT could be partially within the safe harbor and partially not within the safe harbor.

If the acquisition is structured such that the partnership remains a partnership for tax purposes, for example by having some of the acquired partnership interests owned by a TRS of the REIT, Regs. § 1.856-3(g) would determine how long the REIT would be considered to have held the properties owned by the operating partnership for purposes of determining whether the four-year period of the safe harbor would be satisfied. Regs. § 1.856-3(g) states that the REIT shall be considered to have held the property for the shorter of the time that the “partnership has held the real property or the period that the [REIT] was a *member of* the partnership” (emphasis added). There is no indication in the regulation that the REIT has to bifurcate its holding period whenever its membership interest in the partnership fluctuates, and the language of the regulations could be read to support a view that the REIT would look to how long it has held *any* membership interest in the partnership, regardless of whether that interest was subsequently increased.

ACQUISITION OF C CORPORATIONS — TERMINATING THE TAXABLE YEAR

When the target is a C corporation that the acquiror intends to convert to a REIT, the operations of the target will often have to be restructured to comply with the REIT rules. These changes will have to be implemented before the target elects REIT status. Due to the fact that the REIT election relates to the entire year, the company will have to satisfy the REIT rules for an entire calendar year. Therefore, if the changes are made in the middle of a year and the company then elects REIT status, something needs to be done to allow the company to close its old taxable year and elect a new year that begins after the operations have been restructured.[62] If the operational changes necessary to comply with the REIT rules can be implemented at or prior to the closing of the acquisition, one technique to close the taxable year is to form a new company to acquire the target at the closing. The new company will elect REIT status and its acquisition of the target will cause the target to be considered a QRS. The transaction should be treated as a stock purchase and a liquidation of the target,[63] which will cause the target's taxable year to end as of the acquisition date. The liquidation should be tax free under § 332.[64] The acquisition company should be formed immediately prior to the acquisition, to make sure that it will not own any assets or earn any income prior to the acquisition that could prevent it from qualifying as a REIT for its first year.

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[62] Section 859(a)(2) provides that a entity electing to be a REIT needs to adopt a calendar year if it does not already have a calendar year as its accounting period. Section 859(b), which allows an entity to change to a calendar year without the approvals normally required under § 442, does not apply if the company has engaged in a trade or business. Normally, the target will have engaged in a trade or business and so will not be able to take advantage of this provision.

[63] The result should occur by analogy to Regs. § 301.7701-3(g)(1)(iii), which provides that when an entity treated as a corporation elects to be treated as a disregarded entity, the entity is deemed to distribute all of its assets to its owner in liquidation. Regs. § 301.7701-3(g)(2)(ii) provides that the election to change its status satisfies the requirement of adopting a plan of liquidation for purposes of § 332. Likewise, the plan to be acquired and become a QRS should satisfy the requirement of adopting a plan of liquidation for purposes of § 332, though the target can also explicitly adopt a resolution providing that this is its intent. *See* H. Conf. Rep. No. 220, 105th Cong., 1st Sess. 1997 at 684, *reprinted at* 1997 U.S.C.C.A.N. 1129.

Under Rev. Rul. 90-95, 1990-2 C.B. 67, the stock purchase and liquidation should not be stepped together to be treated as an asset acquisition, even though the liquidation in this case is one that occurs only for tax purposes.

[64] Upon the conversion of a C corporation to a REIT, either by electing REIT status or transferring the C corporation's assets to the REIT, which will be the case where the C corporation is liquidated, the built-in gains tax rules of Regs. § 1.337(d)-7 become applicable.

CONCLUSION

Although the pace of highly-leveraged privatizations of publicly-traded U.S. companies has slowed considerably in the past year, U.S. real estate remains an essential component of a well-diversified international investment portfolio, and structuring tax-efficient private acquisitions of public REITs will continue to be a challenging and important task.

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