Preparing for the Unthinkable: What Real Estate Investment Trusts Should Do Now to Establish Reasonable Cause Under the Internal Revenue Code's REIT Savings Provisions

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In this article, the author provides a brief overview of the real estate investment trust "savings provisions" provided by the Internal Revenue Code and how a REIT would take advantage of the provisions if it ever needed their safeguard. The author then takes a deep dive into the "reasonable cause" standard and the steps a REIT can take today to make sure the REIT has access to the savings provisions if the unthinkable should ever occur. The article finishes with some concluding thoughts and reflections by the author.

In the third quarter of 1994, Edwin Frankel served as the chief financial officer (CFO) of RPS Realty Trust—a publicly traded REIT that continues to operate today under the name RPT Realty. Frankel decided to move the company's cash reserves around in search for greater yield. The CFO sold the Treasury bills held by the company and used the proceeds to buy Treasury bills via overnight repurchase agreements. For GAAP purposes, these transactions are booked as cash equivalents. Unfortunately for RPS Realty Trust's REIT qualification, the "buyer" under a repurchase agreement is generally treated for tax purposes as lending money to the "seller," not as owning the asset subject to the repurchase agreement.[1] The fateful decision was made without consulting tax advisors, and by the time the company's advisors discovered the shift in cash reserves, it was too late. At the end of the third quarter of 1994, the repurchase agreements comprised more than 25% of the company's assets, causing the company to fail the 75% asset test for that quarter.[2]

To rectify the failure, RPS Realty Trust would need to take advantage of one of the REIT savings provisions provided by the Internal Revenue Code (the Code). The REIT savings provisions act as a counterbalance to the Code's myriad of rules and requirements for maintaining REIT status, a minefield of ambi-

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guities and ever evolving guidance. The provisions provide a safety net for REITs, allowing them to dispose of the nonqualifying investments and pay a penalty tax to the Internal Revenue Service (IRS). The result may sting but it represents a slap on the wrist compared to losing REIT status and becoming subject to the 5-year lockout rule.[3]

To take advantage of several of the REIT savings provisions, however, a REIT must show that its REIT failure was due to "reasonable cause and not willful neglect." The reasonable cause analysis examines the decisions a REIT made leading up to the REIT failure and asks whether these decisions reflect ordinary business care and prudence. To show reasonable cause, the REIT needs to demonstrate that it took certain concrete steps—prior to the REIT failure—to protect itself. A reasoned, written tax opinion represents the "gold standard" of business care and prudence for handling legal uncertainty. However, the REIT also needs to be proactive in working with outside tax counsel and providing the relevant information so that REIT issues can be identified before they cause a REIT failure. These proactive measures include regular due diligence and quarterly REIT compliance reviews. The key for a REIT is to establish internal procedures to keep its tax advisors informed of changes to its portfolio and to seek tax advice when considering new investments or changing its practices.

As RPS Realty Trust found out the hard way, the reasonable cause standard is not a "gimme" or a simple matter of good intentions. The CFO's decision to invest the company's cash reserves in nonqualifying assets launched a decade-long fight with the IRS. As discussed in Part II of this article, the IRS disputed the company's assertion that the failure was due to reasonable cause and not willful neglect. That fight ultimately led to the company losing its REIT status for its 1994 and 1995 tax years under a closing agreement with the IRS. Along with losing its REIT status, RPS Realty Trust agreed to pay taxes and penalties to the IRS of more than $5 million, a tidy sum in those days, but was allowed to reelect REIT status for its 1996 taxable year.

RPS Realty Trust's debacle with the REIT asset test should serve as a cautionary tale for REITs, a tale that may become more common with Congress' injection of additional funding into the IRS. It is difficult to predict how the additional funds will affect IRS audits and what an IRS with greater resources and sharper teeth will mean for REITs.

In Part I, this article provides a brief overview of the REIT savings provisions and how a REIT would take advantage of the provisions if it ever needed their safeguard. Then, in Part II, this article takes a deep dive into the "reasonable cause" standard and the steps a REIT can take today to make sure the REIT has access to the savings provisions if the unthinkable should ever occur. Part III of this article finishes with some concluding thoughts and reflections.

I. THE REIT SAVINGS PROVISIONS

The Code contains three separate REIT savings provisions with reasonable cause requirements: one for the income tests,[4] one for the asset tests,[5] and one for REIT failures that fall outside of the income or asset tests (another qualification failure).[6] Each of the REIT savings provisions operates in a similar manner and contains similar requirements.

First, the REIT must dispose of the investments causing the failure or otherwise return to compliance with the relevant test.[7]

Second, the REIT must disclose the failure on its tax return for the year and explain why the failure was due to reasonable cause and not willful neglect.

And finally, the REIT must pay a penalty tax to the IRS to rectify the failure. Any penalty taxes paid under a REIT savings provision are deducted from the net income of the REIT in determining the amount the REIT must distribute under the 90% distribution test.[8]

In addition to the REIT savings provisions with reasonable cause requirements, the asset test contains a couple of additional savings provisions—the 30-day savings provision and the de minimis savings provision—that do not require reasonable cause and represent the first line of defense for an asset test failure.

Legislative history notes that Congress viewed REIT disqualification and taxation at regular corporate rates as a harsh result for a REIT that "reasonably and in good faith" believed it had met the relevant requirements.[9] Under these circumstances, a penalty tax imposed on the REIT would be a more appropriate outcome.

a. Asset Test Failures

REITs that fail one of the asset tests have a couple of different options depending on the nature of the failure. Helpfully for REITs, two of the savings provisions—the 30-day savings provision and the de minimis savings provision—do not require the failure to be due to reasonable cause and do not require a penalty to be paid.

Under the 30-day savings provision, a REIT is able to dispose of any nonqualifying assets within thirty days and avoid failing any of the asset tests. If the asset test is met within thirty days, the REIT is treated as having met the asset test as of the end of the relevant quarter. A REIT just needs to have satisfied the asset tests for at least one prior quarter to take advantage of the provision.[10] The 30-day savings provision provides REITs with a simple and easy solution to asset test failures that are found quickly.

A REIT that fails the 5% value test or the 10% vote or value tests may be able to avoid REIT disqualification if the failure is sufficiently small. The de minimis savings provision forgives violations of those asset tests where the failure does not exceed the lesser of (i) 1 percent of the total value of the REIT's assets at the end of the quarter for which such measurement is done, and (ii) $10 million.[11] While it is unclear from the Code whether the "1 percent" refers to the entire value of the nonqualifying asset or just the part of the asset that exceeds the 5% or 10% threshold, the latter interpretation must have been intended, otherwise the de minimis provision would not be available for a 5% value test failure.

As noted, neither the de minimis savings provision nor the 30-day savings provision requires that the failure be due to reasonable cause and not willful neglect. In fact, even an intentional failure that falls within these savings provisions appears to be covered. Additionally, the REIT does not need to file anything to take advantage of these savings provisions. The REIT just needs to return to compliance and try to avoid making the same misstep again.

Prior to the advent of the current savings provisions, some taxpayers used non-statutory structuring to protect against violations in the case of the 10% vote or value tests and potentially the 5% asset test. PLR 200234054 dealt with a REIT that had an inherent risk of violating the 10% value test due to the complexity and national scope of its operations.[12] The REIT represented to the IRS that it had conducted extensive due diligence to identify all assets owned directly or indirectly by its operating partnership that might reasonably threaten to violate the 10% value test and would continue such due diligence in the future. Still, a risk remained that a violation may have been overlooked or may occur in the future.

To address these concerns, the operating partnership set up a protective trust with the REIT's TRS as the sole beneficiary. The trust's estate was defined to include all assets that the operating partnership could not own without violating the 10% value test. Any such property would be deemed automatically transferred to the trust on the last day of the applicable calendar quarter without any further action by the operating partnership. The trust represented that the transfer would be effective under state law. The IRS ruled that for purposes of the 10% value test, any assets that would otherwise be treated as owned by the REIT in violation of the 10% value test would instead be treated as owned by the trust for the benefit of the TRS. Hence, the REIT would automatically avoid violating the 10% value test and presumably a similar mechanism would work for the 10% voting test and 5% asset test. While protective trusts gained some popularity after the IRS released PLR 200234054, they have largely been relegated to history following the expansion of the reasonable cause savings provision to asset test failures two years later with the enactment of the American Jobs Creation Act of 2004.[13]

Since 2004, REITs have an expanded arsenal to deal with an asset test failure. In order to take advantage of the reasonable cause savings provision for an asset test failure, the failure must have been due to reasonable cause and not willful neglect, and the REIT must pay a penalty and disclose the failure. The REIT must dispose of the assets that caused the failure within six months of the end of the quarter containing the failure or otherwise return to compliance with the asset test within those six months.[14]

Once the failure has been identified and resolved, the REIT must attach a statement to its Form 1120-REIT providing an explanation of why the REIT failed to meet the asset test requirements and a description of why such failure is due to reasonable cause and not willful neglect. The schedule must also include a description of each asset that caused the REIT to fail the asset test.[15]

While there is some ambiguity in the case of the 75% asset test of whether the schedule must describe every nonqualifying asset held by the REIT, or only the nonqualifying assets in excess of the limit, the latter interpretation seems reasonable. If the former interpretation were adopted, the penalty tax would be based on all of the REIT's nonqualifying assets, a harsh result that seems out of line with the remedial nature of the provision.

Additionally, the requirement to dispose of the assets listed on the schedule would become superfluous because the REIT would return to compliance with the 75% asset test long before all of its nonqualifying assets were disposed. If the schedule only lists the assets that exceed the relevant threshold in the case of the 75% asset test, the REIT may have some discretion on which nonqualifying asset to list.

Finally, the asset test savings provision requires the REIT to pay a penalty tax that is designed to approximate the amount of corporate tax that would be owed on income from the nonqualifying assets if the REIT did not have the advantage of the dividends paid deduction. In connection with an asset test failure, the REIT will owe a tax equal to the greater of (I) $50,000, or (II) an amount determined by multiplying the net income generated by the assets described in the schedule and the highest corporate tax rate (currently 21%) for the period from the first asset test failure to the earlier of when the assets listed on the schedule are disposed of or when there is no longer an asset test failure.[16]

b. Income Test Failures

REITs have fewer options in the case of an income test failure. Only a reasonable cause savings provision is available for a REIT that fails either the 75% or 95% income tests. To take advantage of the savings provision, the failure must have been due to reasonable cause and not willful neglect, and the REIT must provide a schedule describing the failure on its federal tax return for the year of the failure.[17] Additionally, the REIT must pay a penalty tax.[18]

To take advantage of the provision, the REIT must set forth a description of each item of its gross income that qualified under the 75% and 95% income test on a schedule attached to its Form 1120-REIT.[19]

In the case of an income test failure, the REIT is required to pay a penalty tax equal to the amount of gross income that caused the failure multiplied by a profitability factor. The legislative history describes the penalty as "a 100-percent tax" on the net income attributable to the nonqualifying gross income.[20] In practice however, this description is not quite right. The profitability factor is unrelated to the specific nonqualifying investment and instead reflects the overall profitability of the REIT. Hence, the nonqualifying investment could be very profitable but if the REIT did not have any REIT taxable income that year, no penalty tax would be owed.

The penalty tax is calculated by taking the amount of gross income that exceeded the relevant threshold for the 75% or 95% income test—or whichever is greater if the REIT failed both tests. The amount of nonqualifying income is then multiplied by the profitability factor, which is a fraction with the REIT's taxable income as the numerator and the REIT's total gross income as the denominator, with certain adjustments for both numbers.

In calculating the profitability factor, the company's REIT taxable income is computed without regard to the dividends paid deduction, the deduction for the REIT savings penalty taxes discussed herein, any NOL deductions, and any net capital gain. The company's REIT gross income is computed without regard to gross income from prohibited transactions, foreclosure property, long-term capital gain and short-term capital gain to the extent of any short-term capital loss.[21] Depending on the REIT's performance for the year and amount of nonqualifying income, the penalty for an income test failure could potentially be quite steep or quite low.

c. Other Qualification Failures

For failures that fall outside of either the asset test or the income test, the Code provides a separate reasonable cause savings provision. Similar to the reasonable cause savings provisions for the asset and income tests, the savings provision for another qualification failure requires that the failure be due to reasonable cause and not willful neglect.[22]

Additionally, the REIT must disclose the failure by attaching a statement to its Form 1120-REIT for the year of the failure explaining why the REIT failed to meet the qualification requirements at issue and a description of why such failure is due to reasonable cause and not willful neglect.[23]

Finally, the REIT must pay a penalty tax in the amount of $50,000 for each such failure.[24]

II. DETERMINING REASONABLE CAUSE

Each of the three REIT savings provisions—outside of the de minimis and 30-day savings provisions for the asset tests—require that the failure be due to "reasonable cause and not due to willful neglect." That phrase is seen across a number of Code provisions dealing with tax penalties, and the IRS takes the position that the standard should be interpreted and applied in a consistent manner in its varying contexts.[25]

For the REIT savings provisions, Treasury regulations define the reasonable cause standard but only for the purposes of the income test failures. The IRS has not however promulgated regulations that specifically define the reasonable cause standard in the case of an asset test failure or an other qualification failure. Given the similarity of the three tests, practitioners normally analogize to the regulations addressing reasonable cause for income test failures when faced with an asset test or other qualification test failure.[26]

Under the regulations, an income test failure will be treated as due to reasonable cause and not willful neglect if the REIT exercises "ordinary business care and prudence" in attempting to maintain its REIT status.[27] The regulations require that such care and prudence be exercised at the time each transaction is entered into by the REIT.[28]

Even if ordinary business care and prudence is exercised on entering the transaction, the REIT must continue exercising that level of care and prudence throughout the course of the deal or investment. The regulation explains that "if the [REIT] later determines that the transaction results in the receipt or accrual of nonqualified income and that the amounts of such nonqualified income, in the context of the [REIT]'s overall portfolio, reasonably can be expected to cause a source-of-income requirement to be failed, the [REIT] must use ordinary business care and prudence in an effort to renegotiate the terms of the transaction, dispose of property acquired or leased in the transaction, or alter other elements of its portfolio."[29] The regulations conclude by warning that if the failure is willful and could have been avoided by using ordinary business care and prudence, the reasonable care standard will not be met.[30]

This part examines the tax advice and corresponding processes and procedures that can justify reasonable cause under IRS guidance and court cases. The discussion starts with the strongest source of advice—a reasoned, written opinion—and then moves to the implicit tax advice that occurs when a tax advisor reviews the facts of a transaction. Along the way, this part examines the reasons tax advice—whether explicit or implicit—may not create reasonable cause for the taxpayer's missteps.

a. Written Opinion

A written tax opinion from an outside tax advisor is considered the gold standard of tax advice, and the REIT regulations recognize the importance of such opinions in establishing reasonable cause. The regulations note that reasonable reliance on a "reasoned, written opinion" as to the characterization of gross income from a transaction will generally satisfy the "reasonable cause" standard.[31] The opinion does not need to be specific to the transaction at hand. Rather the opinion can evaluate and analyze a "standard form of transaction or standard operating procedure" that the REIT regularly engages in.[32]

For these purposes, a written opinion means an opinion, in writing, rendered by an acceptable tax advisor. The tax advisor must have sufficient competence and expertise so that relying on the opinion constitutes ordinary business care and prudence under the circumstances. Helpfully for REITs, the regulations make clear that a reasoned, written opinion from in-house tax counsel can potentially provide the necessary reasonable cause defense assuming the in-house counsel has the necessary expertise and the other requirements for reasonable cause are met.[33]

A written opinion can still qualify as "reasoned" if it reaches a conclusion that is determined later on to be incorrect. The opinion must be based on a full disclosure of the facts and must address the facts and law applicable to the issue at hand.[34] Reliance, however, is not reasonable if the REIT has reason to believe that the opinion is incorrect. For instance, a written opinion will be ineffective if the REIT withholds relevant facts from the advisor rendering the opinion.[35]

Because of the value of a reasoned, written opinion in establishing reasonable cause, if a REIT or its advisor identifies an issue where there is uncertainty as to REIT treatment prior to entering into a transaction, the REIT would be best served to obtain a reasoned, written opinion on the issue to support a "reasonable cause" defense if the position is ever successfully challenged by the IRS.

It's worth noting that the short-form REIT opinions normally issued in connection with stock offerings and SEC filings likely would not meet this "reasoned written opinion" standard. These opinions state a set of assumptions and then a conclusion without identifying the facts or the reasoning behind the opinion given. As we'll see later on, however, the diligence conducted in connection with issuing these opinions may be able to separately provide the basis for reasonable cause.

b. Competence and Expertise

While a reasoned, written opinion represents an obvious source of comfort, such an opinion will only be effective if it comes from an independent, competent professional who, importantly, has access to all of the relevant information. As a result, REITs need to be careful about who they select as tax advisors and make sure to provide their advisors with all of the information that might possibly be relevant. The advice does not necessarily need to come from a tax lawyer. Competent tax accountants can also provide the advice needed to establish reasonable cause.

In *Neonatology Associates, P.A. v. Commissioner*, the Tax Court examined when reliance on the opinion of a tax advisor establishes reasonable cause in the context of the accuracy-related penalty under Section 6662.[36] The Tax Court concluded that good faith reliance on the advice of an independent, competent professional as to the tax treatment of an item can satisfy the ordinary business care and prudence standard and hence the reasonable cause requirement.[37]

To make this determination, the court laid out a three-part test.

First, the advisor must be a "competent professional who had sufficient expertise to justify [the taxpayer's] reliance."

Second, the taxpayer must provide all the necessary and accurate information to the advisor.

And finally, the taxpayer must "actually rel[y] in good faith on the [advisor's] judgement."[38]

REITs should consider whether each of these factors have been met when relying on the advice of their tax advisor in engaging in new transactions and investments.

On the other hand, the Tax Court noted certain facts would make it unreasonable for a taxpayer to rely on the advice of a professional, none of which should come as a surprise.

According to the Tax Court, reliance may not be reasonable if the advice is being offered by a tax professional that has a conflict of interest in the transaction. The court gives the example of an insider or promoter in the transaction.[39] Presumably, the taxpayer would need to know, or have reason to know, about the conflict to make relying on the advice unreasonable.

Additionally, reliance would be "unreasonable when the taxpayer knew, or should have known, that the [advisor] lacked the requisite expertise to opine on the" issue in question.[40] Ultimately, whether a taxpayer's reliance on professional advice is reasonable depends on the facts and circumstances of the particular case.

Unfortunately for the taxpayer in *Neonatology Associates*, the Tax Court found that the taxpayer could not rely on the advice of a professional to avoid the accuracy-related penalty. The taxpayer had relied on the advice of a "professional," but the professional in the case was an insurance broker peddling the tax advantages of certain life insurance policies. The insurance broker was not a tax professional and never represented himself to be one. In addition, the taxpayers knew the insurance broker would gain a financial benefit from their investment.[41]

c. Passive Sources of Tax Advice

The reasonable cause analysis becomes more interesting and complex where a REIT does not seek specific legal advice on an issue but instead waits passively on its advisors to offer the needed correction. The IRS and courts recognize that taxpayers are not expected to inquire about specific legal doctrines. Instead, if the tax advisor receives the relevant information in a timely manner, the tax advisor is responsible for raising the issue with their client. While not a replacement for seeking tax advice, this doctrine means that regular due diligence conducted by tax lawyers can potentially provide the basis for reasonable cause if the issue should have been discovered.

This section looks first at a private letter ruling from the IRS where diligence provided the source for reasonable cause. Then this section examines another form of passive reliance, the kind that comes from relying on an accounting firm to prepare the REIT's tax returns every year. Finally, this section returns to the case of RPS Realty Trust noted in the introduction and examines the pitfalls that led the REIT to fail the reasonable cause standard.

i. *Reliance on Due Diligence*

As an additional source of comfort for REITs, having due diligence conducted by a law firm with recognized experience in REIT tax issues in connection with issuing a REIT opinion can provide the basis for reasonable cause. PLR 9550019 describes a company formed in 1994 that planned to elect REIT status and conduct an IPO of its shares.[42] In connection with the IPO, the company retained a nationally recognized law firm with REIT expertise to review its tax status. The company provided due diligence reports to the law firm that included all of the facts relevant to a reimbursement arrangement of the company's management partnership and to certain services provided at two of its properties. As a result of the diligence, the law firm gave a standard REIT opinion in connection with the IPO, opining that the company's "organization and proposed method of operation would enable it to meet the requirements for REIT qualification."[43]

The PLR notes that following the IPO, the company continued to prepare monthly checklists in order to monitor its REIT status on a regular basis. The company also submitted the monthly checklists to its independent accountants.[44]

Sometime after the REIT opinion was issued and the company completed its IPO, the company was advised that the reimbursement arrangements of its management partnerships and the services provided at its properties may cause a portion of the company's gross income to be nonqualifying. The company had been excluding the reimbursements from gross income but it was unclear if the amounts could be properly excluded. Additionally, the services represented impermissible tenant services that disqualified all of the income received from the two corresponding properties.[45] The company voluntarily approached the IRS for a ruling on reasonable cause.[46]

The company represented in the ruling that it would treat all accrued income from the two properties as nonqualifying income and pay the penalty tax imposed by Section 857(b)(5) necessary to take advantage of the REIT savings provision. Further, the company promised to restructure its operations at the two properties so that the meal, maid, and transportation services would not prevent income from the properties from failing the 75% and 95% income tests going forward. Separately the company told the IRS it would submit additional materials to determine whether the reimbursements could be excluded from gross income, and if they could not, the company said it would pay the REIT savings penalty tax with respect to the reimbursements as well.[47]

Based on these facts and representations, the IRS concluded that any failure of the REIT to satisfy the 95% gross income test would be due to reasonable cause and not willful neglect to the extent the failure was caused by the services provided or the reimbursements received. Hence the REIT would have access to the REIT savings provisions and would be able to avoid a REIT failure.[48]

While PLRs do not provide specific reasoning for their conclusions, we can deduce based on the facts provided that the REIT never sought specific tax advice and never received a reasoned, written opinion on these matters. Instead, the REIT was able to rely on the fact that a nationally recognized law firm conducted diligence of its operations and received and reviewed materials describing these practices. This private letter ruling shows how important it is for REITs to engage in regular diligence and monitoring and the benefits that such practices can provide.

ii. *Professionally Prepared Tax Returns*

REITs commonly and almost exclusively use professional accounting firms to prepare and file their tax returns. However, authorities present a mixed picture on whether this practice on its own can provide a reasonable basis defense for REITs.

In *Haywood Lumber and Mining Co. v. Commissioner*, the U.S. Court of Appeals for the Second Circuit looked at whether the failure of a personal holding company to file personal holding company returns was due to reasonable cause and not willful neglect.[49] The taxpayer had used a certified public accountant, whom the court described as competent, to prepare the proper corporate tax returns.

Further, the taxpayer disclosed to its accountant all the necessary information. The accountant knew based on the information disclosed that the taxpayer was a personal holding company. However, the accountant "through inadvertence" did not inform the taxpayer of this fact or prepare the required personal holding company surtax return.

On the other hand, the taxpayer's treasury-secretary did not specifically ask the accountant whether the taxpayer would be treated as a personal holding company. Instead, the treasury-secretary merely waited passively for such tax advice as the accountant would provide.

The Tax Court ruled against the taxpayer, holding that that the taxpayer did not prove that ordinary business care and prudence were exercised in failing to file the returns. The Second Circuit however disagreed on appeal. The Second Circuit noted that the taxpayer selected a competent tax expert, supplied him with all the necessary information, and requested that he prepare the proper tax returns. Based on these facts, the Second Circuit concluded that the taxpayer had "done all that ordinary business care and prudence can reasonably demand."[50] A taxpayer does not need to inquire about specific legal doctrines to satisfy the standard.

Later on, the Supreme Court cited the *Haywood Lumber* decision approvingly but reached a somewhat different conclusion in *U.S. v. Boyle*.[51] The *Boyle* case looked at whether the "reasonable cause" standard was met under Section 6651(a)(1), to defeat a statutory penalty incurred because of a late tax return filing. Robert Boyle was appointed executor of his mother's estate after she died in 1978. Boyle retained an attorney for the estate to file a federal estate tax return. Boyle provided the attorney with all relevant information and also followed up several times to ensure everything remained on track. The attorney did not advise Boyle of the filing deadline, nor did Boyle inquire as to the deadline. The attorney realized later on however that the deadline had been missed, apparently based on a calendar oversight.[52]

The Supreme Court held that Boyle's reliance on his attorney did not satisfy the "heavy burden" imposed by the "reasonable cause" standard.[53] It is difficult to square the Supreme Court's decision in *Boyle* with the Second Circuit's in *Haywood Lumber*. Even though Boyle seemed to do everything right, the different results in *Boyle* and *Haywood Lumber* appear to stem from the mechanical nature of the tax return filing deadline in *Boyle*. Unlike the complex, legal determination in *Haywood Lumber* on which tax return to file, the Supreme Court explained in *Boyle* that tax return deadlines are inherently arbitrary, but that fixed dates are essential for the country's tax filing system. It takes no special training for a taxpayer to ascertain such deadlines and make sure they are met. Relying on an agent—even a tax professional—will not excuse such a failure.

While REITs can and should rely on their tax advisors for important tax determinations, REITs should not do so blindly. REITs still need to monitor their tax advisors and ensure that important deadlines and similar administrative requirements are met. For instance, the Tax Court has said in another case that even where all the relevant information is provided to the return preparer, the taxpayer still has a duty to review the return to make sure all items of income are included.[54] The Tax Court has also held that "[t]he mere fact that a certified public accountant has prepared a tax return does not mean that he or she has opined on any or all of the items reported therein."[55]

An additional issue exists for REITs that would try to rely passively on their tax return preparers to avoid REIT qualification issues. Tax returns by their nature look retroactively at the prior tax year and are completed well after the tax year finishes. Any REIT issues found while preparing a return would likely already be set in stone and could already have caused a REIT failure. As a result, REITs need to be proactive in keeping their tax advisors informed and asking the right questions.

iii. *The Limits of Passive Tax Advice*

Returning to the case of RPS Realty Trust, the company had less luck than the REIT in PLR 9550019 discussed above in establishing reasonable cause. In the third quarter of 1994, the CFO of the REIT, apparently without consulting the company's tax advisors, decided to begin investing the REIT's available cash in overnight Treasury bill repurchase transactions. Unlike the reverse repurchase transactions commonly used as financing today, RPS Realty Trust was the buyer in these transactions and thus was, for tax purposes, lending money to the sellers, resulting in an asset on the REIT's balance sheet. These overnight repurchase agreements are treated as cash equivalent transactions for GAAP purposes. The IRS however has taken the position in Rev. Rul. 77-59 that the repurchase agreements where the REIT is the buyer do not qualify as cash or cash items for purposes of the 75% asset test.[56]

The issue was identified and corrected at the beginning of 1995, allowing the REIT to use the 30-day safe harbor to satisfy the 75% asset test for the fourth quarter of 1994.[57] The damage however was already done. RPS Realty Trust had failed the test for the third quarter and, with it, REIT qualification for the year. The current version of the REIT savings provision for the asset tests did not exist at the time, only the less helpful version found in Section 856(g)(4). Under that provision, RPS Realty Trust would still lose its REIT status for 1994, but if it could establish reasonable cause, would be able to avoid the five-year lockout rule and reelect REIT status for its 1995 tax year.

In examining the reasonable cause question in FSA 1996-9, the company provided the IRS with affidavits from its CFO, its outside tax counsel, and its outside tax accountant.[58] The CFO stated that he was aware of the 75% asset test but had not heard of the IRS's position on repurchases. The IRS expressed some skepticism that someone with the CFO's background had not heard of the repurchase rule. FSA 1996-9 notes that the REIT regulations appear to require "some degree of knowledge" that the proposed course of action could reasonably be expected to cause a REIT failure.[59] The CFO's background and experience may have undercut the company's reasonable cause defense to the extent that the CFO should have been aware of the rule even if he did not have actual knowledge of it.

The company apparently did not consult its outside tax counsel before changing its investments. A tax partner with the firm indicated that he was unaware of the REIT's new investment. The law firm partner explained further that no advice was requested by the company or given on the issue.[60] The apparent decision by the company to not specifically inform their outside tax advisors of the move may have been the key misstep that led to the IRS's refusal to allow reasonable cause.

In the third affidavit, a partner in the REIT's accounting firm also indicated that RPS Realty Trust had not requested any advice on the issue and no advice was given. The accounting partner said he had knowledge of the company's 75% asset test but apparently had failed to spot the issue. The IRS characterized the accounting firm's failure to offer proper advice as a "breach of its duty to the client" and noted that the accounting firm should have known that the taxpayer's investments were not cash equivalents.[61]

While mentioned only in passing in FSA 1996-9, another fact may have weighed against reasonable cause for RPS Realty Trust. Since its inception as a REIT in 1988, RPS Realty Trust had failed to satisfy the shareholder demand letter requirements applicable to REITs through its 1992 taxable year, which at the time represented a REIT qualification issue. The company was able to resolve this issue through a closing agreement with the IRS without triggering a REIT failure. However, the company's collective REIT failures might have suggested that the company wasn't taking its REIT monitoring seriously.[62]

The key points of analysis on whether reasonable cause exists is redacted from the FSA. However, the FSA concludes that "[o]nce the District Director is satisfied as to whether [the] taxpayer's violation of the 75% asset test was due to reasonable cause or willful neglect, use of a closing agreement [would be] a suitable means of bringing finality to this matter."[63] The guidance suggests that a closing agreement may be appropriate even in cases where reasonable cause is present. A closing agreement might, for instance, be helpful to resolve any uncertainty on the presence of reasonable cause or to deal with the tax penalties that stem from the REIT savings provisions.

Interestingly and surprisingly, RPS Realty Trust's outside tax counsel, Battle Fowler LLP, rendered an opinion on March 6, 1996, a year and a half after the asset test failure, that the company's investments in repurchase agreements would not adversely affect the company's REIT status.[64] RPS Realty Trust appears to have requested the opinion to facilitate a merger that was completed two months later. The after-the-fact opinion may have satisfied the "reasoned, written opinion" standard noted above. However, the opinion was of course ineffective to establish reasonable cause for the company's past failure because it was not rendered at the time the transaction was entered into.

On December 4, 2003, RPS Realty Trust—by then known as Ramco-Gershenson Properties Trust—ended its saga with the IRS. The company and IRS entered into a closing agreement settling the issue. Pursuant to the terms of the closing agreement, the company and the IRS agreed that the company's REIT election was terminated for the 1994 taxable year due to the asset test failure. The company was not permitted to reelect REIT status until its 1996 taxable year and had to pay the IRS approximately $5.1 million in taxes and interest as a result of the misstep.[65] Hence, the company was able to avoid the full effect of the five-year lockout rule through its settlement with the IRS but was unable to reelect REIT status in 1995 as it would have if the reasonable cause standard had been satisfied.

Ultimately, the key difference between RPS Realty Trust and the REIT in PLR 9550019 that was able to claim reasonable cause is that RPS Realty Trust failed to keep its outside tax advisors informed of its major changes in investment strategy, either by specifically requesting their input on key decisions or through regular REIT compliance monitoring and diligence. A REIT doesn't necessarily need to raise specific tax issues, but REITs should always keep their tax advisors informed of new developments.

III. CONCLUSION

REITs face a complex set of rules and regulations in order to maintain their REIT status and gain the privilege of avoiding corporate income tax through the dividends paid deduction. In monitoring REIT status, it's not enough for a company to maintain a real estate portfolio of plain vanilla investments and assume that the Code will provide a fair result and forgive any mistakes. Instead, REITs need to develop internal procedures to specifically monitor compliance with the Code's many requirements.

Some REIT compliance procedures should occur on a regular basis. REITs should have a system in place to prepare, or have their tax accountants prepare, quarterly checklists and compliance schedules monitoring the company's REIT tests. Having an outside law firm with REIT expertise conduct regular due diligence on the company's operations with an eye towards REIT compliance could also bolster a reasonable cause position. And, of course, the company should have a competent accounting firm prepare and file its tax returns.

Other REIT compliance procedures operate more on an as-needed basis but are just as important. REITs should involve their outside tax advisors when they are considering new investments or novel structures. In situations where a REIT seeks to engage in an ambiguous area of law or push the limits of common practice, the REIT should seek and receive a reasoned, written tax opinion on the issue. When seeking this advice, REITs should consider and make sure they have provided their tax advisors with all the information that might possibly be relevant.

These procedures operate not just to minimize the chances of a REIT failure, but also to make sure that the REIT is able to take advantage of the Code's REIT savings provisions should the unthinkable—a REIT failure—ever occur.

NOTES:

[1]A repurchase agreement involves a buyer that buys an asset from a third party for cash and agrees to sell the asset back to the seller for a slightly higher price. In most cases, the agreement is economically the same as a loan from the buyer to the seller secured by the asset with the difference in purchase price representing interest. The tax law follows the economic substance and treats properly structured repurchase agreements as secured loans, rather than a purchase and sale of assets. Rev. Rul. 74-27, 1974-1 C.B. 24. A reverse repurchase agreement is the same transaction but from the seller's perspective. A repurchase agreement where the REIT is the buyer represents a loan from the REIT to the seller secured by the "sold" securities that can negatively affect the asset tests, while a properly structured reverse repurchase agreement is a financing transaction with no effect on the asset tests.

[2]RPS Realty Trust's issues and facts are described in greater detail in Part II.c.iii. below.

[3]Section 856(g)(3). Unless otherwise specified, all section references are to a section of the Internal Revenue Code of 1986, as amended (the Code).

[4]Section 856(c)(6), 857(b)(5).

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

[6]Section 856(g)(5).

[7]The requirement for the REIT to return to compliance with REIT qualification requirements is only stated specifically in the context of the asset test saving provision. Under Section 856(c)(7)(A)(iii), the REIT must dispose of the assets that caused the asset test failure within 6 months of the end of the quarter containing the failure or otherwise return to compliance with the asset test within 6 months. While not stated explicitly, presumably if the REIT continued to fail the income tests or other REIT requirements in subsequent tax years, the REIT would no longer have the reasonable cause required to access the savings provisions again.

[8]Section 857(b)(2)(E); Staff of J. Comm. on Tax'n, 109th Cong., General Explanation of Tax Legis. Enacted in the 108th Cong. 208 (Comm. Print 2005).

[9]Staff of J. Comm. on Tax'n, 94th Cong., General Explanation of the Tax Reform Act of 1976 452 (Comm. Print 1976).

[10]Section 856(c)(4) (flush text).

[11]Section 856(c)(7)(B).

[12]I.R.S. Priv. Ltr. Rul. 2002-34-054 (Aug. 23, 2002).

[13]American Jobs Creation Act of 2004, Pub. L. No. 108-357, Section 243(f), 118 Stat. 1418, 1443 (2004).

[14]Section 856(c)(7)(A).

[15]Internal Revenue Serv., 2022 Instructions for Form 1120-REIT (2023), https://www.irs.gov/pub/irs-pdf/i1120rei.pdf.

[16]Section 856(c)(7)(C).

[17]Section 856(c)(6).

[18]Section 857(b)(5).

[19]Internal Revenue Serv., 2022 Instructions for Form 1120-REIT 15 (2023), https://www.irs.gov/pub/irs-pdf/i1120rei.pdf. The regulations explain that this schedule should list separately the total amount of dividends, the total amount of interest, the total amount of rents from real property, and so on. The schedule is not required to list each separate lease or loan or project. The REIT however must maintain adequate records on such a basis with which to substantiate each total amount listed on the schedule. Treas. Reg. Section 1.856-7(b). The Instructions to the Form 1120-REIT note that the income test failure must be due to reasonable cause and not willful neglect but don't actually require a description of why the failure is due to reasonable cause and not willful neglect. Internal Revenue Serv., 2022 Instructions for Form 1120-REIT 15 (2023), https://www.irs.gov/pub/irs-pdf/i1120rei.pdf. The different treatment compared to an asset test failure appears to be due to the fact that the disclosure requirements have been promulgated in regulations for the income tests and no corresponding regulations exist for an asset test failure. As a practical matter, taxpayers may choose to include this information with an initial filing.

[20]Staff of J. Comm. on Tax'n, 94th Cong., General Explanation of the Tax Reform Act of 1976, 453 (1976).

[21]Section 857(b)(5).

[22]Section 856(g)(5).

[23]Internal Revenue Serv., 2022 Instructions for Form 1120-REIT (2023), https://www.irs.gov/pub/irs-pdf/i1120rei.pdf.

[24]Section 856(g)(5)(C).

[25]IRM 20.1.1.3.2(2) (Nov. 21, 2017).

[26]See generally Robert Beard, Working with the REIT Savings Provisions, Part II: Exploring Reasonable Cause, 31 Real Est. J. 167, n.7 (June 3, 2015). Treas. Reg. Section 1.856-8(d) notes that the principles of the reasonable cause definition in Treas. Reg. Section 1.856-7(c) will apply to the reasonable cause standard under Section 856(g)(4), which provides an exception to the 5-year lockout rule for a REIT failure due to reasonable cause. The safe harbor under Section 856(g)(4) has largely been subsumed by the protection of the REIT savings provision for other qualification failures in Section 856(g)(5).

[27]Treas. Reg. Section 1.856-7(c)(1).

[28]Treas. Reg. Section 1.856-7(c)(1).

[29]Treas. Reg. Section 1.856-7(c)(1).

[30]Treas. Reg. Section 1.856-7(c)(1).

[31]Treas. Reg. Section 1.856-7(c)(2)(i). "If the opinion indicates that a portion of the income from a transaction will be nonqualified income, the [REIT] must still exercise ordinary business care and prudence with respect to the nonqualified income and determine that the amount of that income, in the context of [the REIT's] overall portfolio, reasonably cannot be expected to cause a source-of-income requirement to be failed." Treas. Reg. Section 1.856-7(c)(2)(ii).

[32]Treas. Reg. Section 1.856-7(c)(2)(i). The regulations thankfully note that the absence of a "reasoned, written opinion" does not by itself create an inference that the failure was without reasonable cause. Id.

[33]Treas. Reg. Section 1.856-7(c)(2)(iii). The regulations note, however, that an opinion is not considered "reasoned" if it does nothing more than recite the facts and express a conclusion. Id.

[34]Treas. Reg. Section 1.856-7(c)(2)(iii).

[35]Treas. Reg. Section 1.856-7(c)(2)(ii).

[36]*Neonatology Associates, P.A. v. C.I.R.*, 115 T.C. 43, Tax Ct. Rep. Dec. (RIA) 115.5, 2000 WL 1048512 (2000), decision aff'd, 299 F.3d 221, 28 Employee Benefits Cas. (BNA) 1865, 2002-2 U.S. Tax Cas. (CCH) P 50550, 90 A.F.T.R.2d 2002-5442 (3d Cir. 2002). The accuracy related penalty applies where an underpayment is due to negligence. A taxpayer can show that the underpayment is not due to negligence if the underpayment is due to "reasonable cause and good faith," technically a slightly different standard than the "reasonable cause and not willful neglect" used in the REIT rules. However, the case and its analysis has also been cited by courts in cases where the Code refers to reasonable cause and not willful neglect. See *Charlotte's Office Boutique, Inc. v. C.I.R.*, 425 F.3d 1203, 2005-2 U.S. Tax Cas. (CCH) P 50593, 96 A.F.T.R.2d 2005-6451 (9th Cir. 2005) (addressing penalties under Section 6651).

[37]*Neonatology Associates, P.A. v. C.I.R.*, 115 T.C. 43, 98, Tax Ct. Rep. Dec. (RIA) 115.5, 2000 WL 1048512 (2000), decision aff'd, 299 F.3d 221, 28 Employee Benefits Cas. (BNA) 1865, 2002-2 U.S. Tax Cas. (CCH) P 50550, 90 A.F.T.R.2d 2002-5442 (3d Cir. 2002).

[38]*Neonatology Associates, P.A. v. C.I.R.*, 115 T.C. 43, 99, Tax Ct. Rep. Dec. (RIA) 115.5, 2000 WL 1048512 (2000), decision aff'd, 299 F.3d 221, 28 Employee Benefits Cas. (BNA) 1865, 2002-2 U.S. Tax Cas. (CCH) P 50550, 90 A.F.T.R.2d 2002-5442 (3d Cir. 2002).

[39]*Neonatology Associates, P.A. v. C.I.R.*, 115 T.C. 43, 98, Tax Ct. Rep. Dec. (RIA) 115.5, 2000 WL 1048512 (2000), decision aff'd, 299 F.3d 221, 28 Employee Benefits Cas. (BNA) 1865, 2002-2 U.S. Tax Cas. (CCH) P 50550, 90 A.F.T.R.2d 2002-5442 (3d Cir. 2002).

[40]*Neonatology Associates, P.A. v. C.I.R.*, 115 T.C. 43, 99, Tax Ct. Rep. Dec. (RIA) 115.5, 2000 WL 1048512 (2000), decision aff'd, 299 F.3d 221, 28 Employee Benefits Cas. (BNA) 1865, 2002-2 U.S. Tax Cas. (CCH) P 50550, 90 A.F.T.R.2d 2002-5442 (3d Cir. 2002).

[41]*Neonatology Associates, P.A. v. C.I.R.*, 115 T.C. 43, 99, Tax Ct. Rep. Dec. (RIA) 115.5, 2000 WL 1048512 (2000), decision aff'd, 299 F.3d 221, 28 Employee Benefits Cas. (BNA) 1865, 2002-2 U.S. Tax Cas. (CCH) P 50550, 90 A.F.T.R.2d 2002-5442 (3d Cir. 2002).

[42]I.R.S. Priv. Ltr. Rul. 95-50-019 (Sept. 15, 1995).

[43]I.R.S. Priv. Ltr. Rul. 95-50-019.

[44]I.R.S. Priv. Ltr. Rul. 95-50-019.

[45]Section 856(d)(7).

[46]I.R.S. Priv. Ltr. Rul. 95-50-019 (Sept. 15, 1995).

[47]I.R.S. Priv. Ltr. Rul. 95-50-019.

[48]I.R.S. Priv. Ltr. Rul. 95-50-019.

[49]*Haywood Lumber & Min. Co. v. C.I.R.*, 178 F.2d 769, 50-1 U.S. Tax Cas. (CCH) P 9131, 38 A.F.T.R. (P-H) P 1223 (2d Cir. 1950).

[50]*Haywood Lumber & Min. Co. v. C.I.R.*, 178 F.2d 769, 770–71, 50-1 U.S. Tax Cas. (CCH) P 9131, 38 A.F.T.R. (P-H) P 1223 (2d Cir. 1950).

[51]*U.S. v. Boyle*, 1985-1 C.B. 372, 469 U.S. 241, 105 S. Ct. 687, 83 L. Ed. 2d 622, Unempl. Ins. Rep. (CCH) P 16388, 85-1 U.S. Tax Cas. (CCH) P 13602, 55 A.F.T.R.2d 85-1535 (1985).

[52]*U.S. v. Boyle*, 1985-1 C.B. 372, 469 U.S. 241, 242–43, 105 S. Ct. 687, 83 L. Ed. 2d 622, Unempl. Ins. Rep. (CCH) P 16388, 85-1 U.S. Tax Cas. (CCH) P 13602, 55 A.F.T.R.2d 85-1535 (1985).

[53]*U.S. v. Boyle*, 1985-1 C.B. 372, 469 U.S. 241, 245, 251, 105 S. Ct. 687, 83 L. Ed. 2d 622, Unempl. Ins. Rep. (CCH) P 16388, 85-1 U.S. Tax Cas. (CCH) P 13602, 55 A.F.T.R.2d 85-1535 (1985).

[54]*Woodsum v. C.I.R.*, 136 T.C. 585, 596, Tax Ct.

Rep. (CCH) 58658, Tax Ct. Rep. Dec. (RIA) 136.29, 2011 WL 2416379 (2011).

[55]*Neonatology Associates, P.A. v. C.I.R.*, 115 T.C. 43, 100, Tax Ct. Rep. Dec. (RIA) 115.5, 2000 WL 1048512 (2000), decision aff'd, 299 F.3d 221, 28 Employee Benefits Cas. (BNA) 1865, 2002-2 U.S. Tax Cas. (CCH) P 50550, 90 A.F.T.R.2d 2002-5442 (3d Cir. 2002).

[56]Rev. Rul. 77-59, 1977-1 C.B. 196. In concluding that repurchase agreements do not qualify as cash or cash items for purposes of the REIT rules, Rev. Rul. 77-59 relies on Rev. Rul. 74-27 for the proposition that repurchase agreements where the REIT is the buyer are treated as loans for tax purposes rather than actual purchases and sales of the underlying assets. See Rev. Rul. 74-27, 1974-1 C.B. 24.

[57]Section 856(c)(4) (flush text).

[58]*Field Service Advisory*, 1996 WL 33107125 (I.R.S. FSA 1996). FSA 1996-9 redacts all identifying information of the taxpayer in question, but the facts stated in SEC disclosures from RPS Realty Trust match perfectly with the facts described in FSA 1996-9. See RPS Realty Trust, Form 10-K (1995) (filed April 16, 1996), available at https://www.sec.gov/Archives/edgar/data/842183/0000950123-95-001967.txt.

[59]*Field Service Advisory*, 1996 WL 33107125 (I.R.S. FSA 1996).

[60]*Field Service Advisory*, 1996 WL 33107125 (I.R.S. FSA 1996).

[61]*Field Service Advisory*, 1996 WL 33107125 (I.R.S. FSA 1996).

[62]The closing agreement for the shareholder demand letter issue is noted in footnote 2 of FSA 1996-9 and in the company's Form 8-K (filed Apr 24, 1995) (Exhibit 2.1), available at https://www.sec.gov/Archives/edgar/data/842183/000095012395001100/0000950123-95-001100-index.htm. The IRS released two Field Service Advice memos, FSA 1993-456 and 1993-459, also dealing with REITs seeking reasonable cause relief for failing the shareholder demand letter requirements. *Field Service Advisory*, 1993 WL 1469662 (I.R.S. FSA 1993); *Field Service Advisory*, 1993 WL 1469636 (I.R.S. FSA 1993). It's not clear if either or both of these pieces of guidance relate to RPS Realty Trust.

[63]*Field Service Advisory*, 1996 WL 33107125 (I.R.S. FSA 1996).

[64]Ramco-Gershenson Properties Trust, Form 10-K (2001) (filed March 13, 2002), at 5, available at https://www.sec.gov/Archives/edgar/data/842183/000095012402000796/k67896e10-k.htm. Some of the later SEC filings refer to "reverse repurchase agreements" rather than "repurchase agreements." Regardless of the nomenclature, it is clear that the problematic transactions were repurchase agreements where the REIT was the buyer.

[65]Ramco-Gershenson Properties Trust, Form 10-K (2003) (filed March 15, 2004), at 5, available at https://www.sec.gov/Archives/edgar/data/842183/000095012404000899/k82513e10vk.htm.