

Client Alert

October 2016

Final Section 385 Treasury Regulations Offer Good News for Most REITs

On October 13, 2016, the Internal Revenue Service (“IRS”) and Treasury Department published final and temporary Treasury regulations (the “Final Regulations”) on the classification of certain related-party debt obligations as equity instruments. Click [here](#) for the text of the Final Regulations. The Final Regulations significantly narrow the scope of the proposed regulations issued in April of this year. Click [here](#) for our client alert describing the proposed regulations.

Among other exclusions, the Final Regulations do not apply to REITs unless the REIT is 80% owned, directly or indirectly, by members of an otherwise existing “expanded group.” An “expanded group” generally includes chains of corporations connected by 80% common ownership with a common parent corporation that is not a REIT, regulated investment company or S corporation. Thus, for non-controlled REITs, loans made by the REIT to one of its TRSs would not be subject to the Final Regulations. In addition, if a non-controlled REIT owns all of the common equity of a subsidiary REIT, loans between the non-controlled REIT and the subsidiary REIT also would not be subject to the Final Regulations.

A TRS can be a common parent corporation of an expanded group that includes a REIT. For example, if a TRS of a non-controlled REIT (or other non-REIT corporation) owns 80% of a subsidiary REIT, and the subsidiary REIT owns 80% of its own TRS, then the TRS, the subsidiary REIT and the subsidiary REIT’s TRS would all be included in an expanded group and debt instruments between the members of such expanded group would be subject to the Final Regulations.

Even for related-party debt instruments that are subject to the Final Regulations, the Final Regulations are narrower than the proposed regulations. The Final Regulations require, for debt instruments issued after January 1, 2018, certain documentation to be maintained to support the debt character of the instrument. The Final Regulations also retain the per se recharacterization of certain instruments if they are issued within 36 months before or after certain funding transactions, including distributions. Unlike the proposed regulations, the Final Regulations exclude for this purpose all distributions out of accumulated earnings and profits accrued since April 4, 2016 (the date of the proposed regulations). The Final Regulations do not include the general bifurcation rule that was included in the proposed regulations.

If you would like more information about the Final Regulations and their impact on REITs and TRSs, please contact one of the attorneys listed below.

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