was the operating entity following the spinoff and PropCo was the newly formed, spun-off company that held the real property assets and elected to become a REIT.

It was thought to be "the next great opportunity for tax-efficient restructuring of operating corporations that were heavily laden with real estate," Willens said. "The hope was that income could be shifted, through the lease payments, from the taxable OpCo to the effectively nontaxable PropCo."

Key to the OpCo-PropCo spinoff was the ability of the REIT to lease the real property assets back to OpCo and treat the lease payments as qualifying rents for real property under section 856(d). Lease terms were drafted with the goal of tying the payments to the lessee's net income, but without violating the "rents for real property" definition, according to Willens.

In the end, the imagined potential for OpCo-PropCo transactions didn't materialize. "Congress effectively eliminated the utility of the technique through the enactment of section 355(h) and section 856(c)(8)," Willens said. ■

REITs Checking Their Leases In Wake of Ruling Revocation

by Chandra Wallace

Taxpayers that relied on a 2013 letter ruling treating some lease payments as qualified for real estate investment trusts may have a significant problem now that the IRS has withdrawn its blessing of that treatment, tax professionals say.

In the 2013 letter ruling (LTR 201337007), the IRS approved treatment of lease payments received by an umbrella partnership REIT as "rents from real property."

On February 4 the IRS released LTR 202205001, which revoked that treatment. Because the lease payments were subject to annual adjustments based on the lessee's annual revenue — a measure that the IRS found to be analogous to income and profits — they "do not qualify as rents from real property under section 856(d)(2)(A)," it said.

REIT professionals regularly advise clients based on letter rulings issued by the IRS to other taxpayers, Cristina Arumi of Hogan Lovells US LLP noted February 7 at the Practising Law Institute Real Estate Tax Forum. That is particularly true when, as here, a letter ruling has been in effect and public for almost 10 years and other taxpayers have structured REITs based on it. Taxpayers that structured REITs in accordance with the prior ruling "now have to consider whether they have a problem," she said.

> ***'This particular taxpayer is safe, because we have an agreement' between the taxpayer and the IRS that says so, but other taxpayers that relied on the prior letter ruling 'don't have that comfort,' Arumi said.***

Those taxpayers may want to amend their leases to avoid running afoul of the new treatment, although they may have to pay for the privilege, according to Sanford C. Presant of Greenberg Traurig LLP.

Other REITs Not Grandfathered

The new IRS letter ruling expressly provides relief from the revised treatment for the particular taxpayer that received the ruling, Arumi said. But the underlying substance of the IRS's treatment of lease payments has implications for other REITs that followed the treatment in the 2013 ruling to structure their own master leases. "This particular taxpayer is safe, because we have an agreement" between the taxpayer and the IRS that says so, but other taxpayers that relied on the prior letter ruling "don't have that comfort," Arumi said.

In explaining the new ruling, the IRS pointed to the formula used to calculate annual adjustments to the base rent, a formula that closely tracks EBITDAR — earnings before interest, taxes, depreciation, amortization, and rental income — according to Sarah E. Ralph of EY. The lessee's base rent was adjusted each year based on either a fixed percentage (not included in the redacted ruling) or the EBITDAR-based formula.

While EBITDAR measures look much like income and profits, the lease adjustment provision at issue could also be viewed as a question of the tenant's capacity to pay additional rent, Arumi said. "It feels a little bit strange that the rule we usually think of as preventing REITs from sharing in profits is being exercised here to say now — after considering this for 10 years — the IRS believes that measuring rent based on capacity to pay is inappropriate," she said.

In revisiting the formulas in existing REIT leases, however, taxpayers and their advisers will need more clues from the IRS on what exactly motivated the ruling, Ralph said. "Was it the frequency [of the adjustments]? Was it the mention of EBITDAR? What was driving here?" she asked. ■

Updated Filing Instructions on Schedules K-2 and K-3 Create Angst

by Kristen A. Parillo

Tax professionals are venting after learning from updated IRS instructions that partnerships might still have to file new international reporting schedules even if they have no foreign partners or activities.

The fretting was sparked by updated instructions for schedules K-2 and K-3 that the IRS posted January 18 for filers of forms 1065, 1120-S, and 8865, with many complaints focusing on the new instructions regarding who must file them.

The new schedules, which took effect for tax year 2021, apply to passthroughs and their partners and shareholders that have "items of international tax relevance." Partnerships and S corporations are required to report partners' or shareholders' total distributive share of international items on Schedule K-2 and to report a partner's or shareholder's allocable share of those items on Schedule K-3.

The IRS has said that the schedules are intended to help partners determine their U.S. income tax liability when a partnership has foreign items such as deductions and credits, as well as provide the information in a standardized format.

The IRS finalized schedules K-2 and K-3, along with their instructions, in summer 2021.

Edward K. Zollars of Thomas, Zollars & Lynch Ltd. told *Tax Notes* that based on the original instructions, many taxpayers and advisers assumed that the schedules needed to be filed only if a partnership or S corporation had foreign operations or foreign equity holders.

The IRS added to that impression, Zollars said, by stating in the "Who Must File" section of the original instructions that an entity doesn't need to file the schedules if it doesn't have "items of international tax relevance," which the instructions said typically encompass international activities or foreign equity holders.

But in another section of the original instructions, the IRS warned that if a partnership or S corporation had partners or shareholders who are claiming a foreign tax credit because of other items reported on their returns, the partnership or S corporation must complete