REITs for Real Estate and Tax Counsel
Understanding Organizational, Operational and Tax Considerations When Dealing With REITs

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Basic REIT Benefits

• No entity level tax provided organizational and operational requirements are met and all income distributed

• Access to Capital: May be publicly traded
  – Other Master Limited Partnerships and Regulated Investment Companies, the only way to be publicly traded and be free from entity-level tax

• Flexibility: May be any type of U.S. entity
  – Usually organized as corporations or trusts, but may also be LLCs
The Basic REIT Framework

• Organizational Requirements
  – Principle requirement is broad ownership
  – No E&P from non-REIT year. (10 year tax on appreciated property)
    Treas. Reg. §1.337(d)-7.

• Four Basic Operational Requirements
  – Assets: Must primarily hold real estate assets (75%)
  – Income: Must primarily earn passive income from real estate (75%)
  – Income: 95% of gross income must be passive
  – Distribution: Must distribute most of its income to shareholders (90%)
Organizational Requirements

- Managed by trustees or directors
- Not beneficially owned by five or fewer “individuals”
  - Lookthrough to underlying shareholders for REITs owned by public company
  - Special definition of “individual”
- Actually owned by 100 or more persons
- Have transferable shares or certificates
- Not a bank or insurance company
- Taxable as a U.S. corporation
Potential Issues & Structuring Opportunities

• Five or fewer provisions as takeover defense
  – “Excess share” provisions in articles of incorporation generally restrict number of shares of any single shareholder to 9.9% or less
  – Restrictions may go beyond tax rules: some REITs still implement shareholder rights plans (“poison pills”)
    • Less case law on excess share provisions

• Finding Shareholders needed to satisfy 100 shareholder requirement
  – Private REITs often engage facilitators to find these investors
  – Often use special class of stock with aggregate liquidation preference of $100,000 with fixed return in 9-12% range
Asset Tests

• 75% of value: real estate assets, cash, cash items
  – Rev. Rul. 2012-17 money market accounts are now confirmed as cash items
• No more than 25% of value represented by non-real estate securities
  – No definition of “securities” in REIT rules
  – RIC rules refer to the SEC Act of 1940 definition
• The value of any one issuer’s securities may not exceed 5% of the REIT’s total assets
  – In absence of REIT definition, reliance on definition of issuer under § 2(a) of the SEC act of 1940
• Ownership of any issuer may not exceed 10%. Vote or value. Not just equity
• No more than 25% of value may be made up of TRS
Special Asset REITs

- Hotel REITs
  - Enabled by TRS related party rent exception
  - Hotel must be managed by independent contractor, not TRS. § 856(l)(3).

- Healthcare REITs
  - Recent developments in senior care facilities
    - PLR 201104023: “age in place” senior assisted living facility was healthcare facility; qualified for TRS related party rent exception
    - But see PLR 2008130015: certain independent living facilities may not be healthcare facilities
    - Must be managed by independent contractor, not TRS.

- Mortgage REITs

- Other REITs
  - Sale of timber qualifies as sale of real estate asset
  - The Service has blessed income from sale of carbon credits as “good” income
    - PLR 201123005
New Developments in Classifying Real Estate Assets

• Proposed REIT Asset Regulations

• Critical commentary
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Income Tests

- 75% of gross income must be real-estate related
- 95% of gross income must be passive
- QRS income is treated as having been earned directly
- No more than 1% of gross income from a property attributable to impermissible tenant services
  - Based on single property, not entire REIT; but not lease by lease either!
- Certain hedging income & most foreign currency gains are excluded from REIT income test calculations
Some Overlooked REIT Benefits

• Useful vehicle for many international investors to invest in U.S. real estate while avoiding FIRPTA and branch profits tax
  – Domestically controlled REIT not treated as a U.S. real property holding company under FIRPTA. (Only w/r stock sale)
  – Dividend attributable to sale of U.S. real estate may be “ECI” and subject to branch profits tax
• Pension-held REITs: Provide a 5% cushion for tax exempt taxpayers sensitive to the tax on unrelated business taxable income (UBTI)
  – UBTI generally has stricter standards than REIT income rules
    • Especially the case on parking
      – Smaller tax-exempt ownership stakes avoid many UBTI issues entirely
• Not necessarily limited to “traditional” real estate businesses
  – Possibly includes energy, storage, communications, retail, casinos
The Nebulous Boundary Between Impermissible Tenant Services, Ordinary Bad Income, and Good Rent

• To avoid impermissible tenant services income, must be “customary” and not primarily for convenience of tenant
  – Maid service is an impermissible tenant service
  – Comparatively little guidance exists on services provided in more modern buildings and situations
    • Concierge, technology services, construction management
    • Marketing funds

• Little guidance on what constitutes a “tenant service”
  – PLR 9646027: charges for “courtesy services” not impermissible tenant services income, but bad income
    • Limited to “infrequent, limited, insubstantial” services
Related Party Rents: Selected Issues

- Rent generally not good rent if received from a tenant that the REIT actually or constructively owns a 10% or greater interest in.

- General exception for TRS: rent paid will qualify if 90% of space leased to persons other than TRS or related parties
  - Special exceptions for lodging and healthcare facilities
  - Calculation is made using leased (not leasable) space

- Attribution rules may create unanticipated related party rents for multiple partnerships with overlapping ownership
  - Under § 318 attribution rules, partner deemed to own what its partners owned
  - § 856(d)(5) substantially relaxes rule: provides only 25%+ ownership results in attribution
Parking Problems

- Rev. Rul. 2004-24 alleviated significant problems, but some issues remain
  - Now clear that income from paid parking, both reserved and unreserved generates good income when connected to leased property
  - Nebulous standard for valet: unclear when it may be impermissible services income
    - Requires some safety or capacity justification
- JV with Tax Exempt
  - Tax exempt not covered by Rev. Rul. 2004-24, cannot accept income from paid parking
  - Related Party Rent problem: the tax-exempt can use a taxable affiliate as a JV partner, but the REIT cannot use a TRS
    - Tax exempt related party rent rule requires more than 50%. § 512(b)(13).
Distribution Requirements

• Undistributed income subject to tax at regular corporate tax rates
• To retain REIT status, REIT must distribute dividends equal to at least the sum of:
  – 90% of REIT taxable income
  – 90% of after-tax net income from foreclosure property
  – Less excess of the sum of certain items of non-cash income over 5% of REIT taxable income
• 4% additional excise tax if REIT fails to distribute 85% of ordinary income and 95% of capital gain
  – Dividends declared by December, but paid in January are credited to the prior tax year. § 857(b)(9)
• Distribution may not constitute a “preferential dividend”
Planning for the Distribution Requirements and Fixing Failures

• “Foot Faults” – inadvertent disproportionate distributions could cause loss of REIT status
  – May happen through accidental timing mismatch or miscalculation of the amount due to a shareholder
  – There are various foot fault relief provisions. See Stroock website.
  – Previously, Rev. Proc. 2010-12 provided some relief
    • Allowed certain non-cash transfers to avoid preferential dividend treatment
      – Only applied to dividends paid prior to the end of 2012
• Disproportionate distributions and conversions: PLR 201244012: exchange of new class of stock for old class based on value over two-year period in preparation for REIT conversion not preferential dividend
Use of REIT Subsidiaries

• Qualified REIT Subsidiary (QRS) primarily exists to provide limited liability
  – Wholly owned subsidiary of a REIT
  – May be useful in M&A context
    • PLR 9512020 (one of two active business acquired in spin off transaction acquired)
    • PLR 9717036 (target qualified as QRS after reverse cash merger)
  – Less useful in light of the availability of UPREIT/DOWNREIT structures and LLCs

• REIT deemed to own proportionate share of partnership or LLC assets
  – Issue: partnership or LLC could undertake an action that would cause REIT to fail income or asset tests

• Taxable REIT Subsidiary (TRS) used to provide services that would otherwise create non-qualifying income
  – Can generally provide any type of service
  – But see: hotel and healthcare REITs
  – But see: 100% penalty tax for bad TRS fees
    • Factual examination required
Structuring Considerations

• Use of UPREITs
  – Tax deferral: allows REIT sponsors to avoid tax liability that could result if properties sold for cash or swapped with REIT shares
  – May provide edge for property acquisitions
  – May create conflict between sponsor and shareholders
  – Issues with debt. IRS talk of changing rules regarding allocation of liabilities among partners.

• Use of DOWNREITs
  – Each acquisition results in formation of new partnership
  – Provides many UPREIT advantages to traditionally structured REITs
  – Possibly eliminates potential conflict of interest present in UPREITs
The UPREIT Structure

Assets are held through umbrella partnership rather than directly by REIT.
The Unique Concerns of Pension-Held REITs

• Pension-held REIT if single qualified trust holds 25% of REIT (by value), or qualified trusts (each owning at least 10%) hold more than 50%. § 856(h)(3).
  – Subject to unrelated business transaction income (“UBTI”) rules as well as REIT income rules
    • UBTI rules generally less generous than REIT income test rules
    • Maximum of 5% UBTI

• Non-pension held REIT use may provide alternative to relying on fractions rule under § 514(c)(9)(E)

• Issue: may be subject to ERISA fiduciary requirements
International: Basic Rules

- Non-U.S. residents subject to either 30% withholding tax on gross amount of rent or to income tax at regular rates on net income from owning U.S. real estate directly (including through a U.S. pass-through entity) or through a non-U.S. vehicle.

- Non-U.S. residents subject to 30% withholding tax on dividends from a U.S. corporate vehicle.

- Non-U.S. residents subject to capital gains tax on a sale of shares of a United States real property holding corporation (generally any U.S. corporate vehicle that predominantly owns U.S. real estate).
International: Exceptions for REITs

- A sale of shares of a “domestically controlled” REIT by a non-U.S. resident is not subject to tax. Domestically controlled generally means a REIT that is majority owned by U.S. residents since its formation or for a period of at least five years preceding the date of sale.

- The IRS has approved share restrictions designed to ensure that a REIT remains domestically controlled as not violating the freely transferable share requirement.

- A U.S. resident for domestically controlled REIT purposes includes U.S. citizens and residents and tax-exempt investors and may include a U.S. corporation controlled by non-U.S. investors.

- A sale of publicly-traded shares of a REIT by a non-U.S. resident that owns five percent or less of the shares is not subject to tax.

- Treaties may provide a lower rate of withholding tax on dividends from certain REITs, often depending on whether the REIT is “diversified.”

- A mortgage REIT can insulate a non-U.S. investor from being considered to be engaged in a U.S. lending business.
Selected International Issues

• Receipt of capital gains dividend from a REIT may be taxed as income effectively connected to a U.S. trade or business
  – May subject foreign shareholder to U.S. filing requirement
  – § 897(h) amended in 2004 to treat distribution as ordinary dividends if foreign shareholder has less than 5% interest in a class of stock of a publicly traded REIT; can mean more tax!

• Sovereign wealth and § 892
  – Notice 2007-55: distribution from a lower-tier to upper-tier REIT subject to FIRPTA
    • Notice states that IRS will challenge assertion that 897(h) does not apply to complete liquidations, or that § 892 exempts a sovereign entity from taxation under FIRPTA
  – Proposed regulations relax and clarify rules
    • Interest in a REIT will be subject to tax, but will not cause sovereign wealth fund to be deemed to engage in “commercial activity” and lose tax status
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International: Exceptions for Specific Types of REIT Shareholders

- Treaties often provide a zero rate of withholding tax for dividends received from REITs by foreign pension funds, providing a similar exception as is provided to U.S. pension funds, often contingent on the foreign pension owning less than 50% of the REIT.

- Section 892 exempts foreign governmental investors, including foreign governmental pension plans, from dividends from “non-controlled” REITs where the sovereign investor owns less than 50% of the REIT. Gains on such an investor’s sale of shares of a non-controlled REIT are also exempt regardless of whether the REIT is domestically controlled.
International: Structuring Considerations

- Section 897(h) treats a sale of property by a REIT and a distribution of the proceeds as taxable to a non-U.S. shareholder as if they had sold the property directly. Pursuant to Notice 2007-55, Section 897(h) applies even if the REIT is being liquidated and Section 892 does not exempt such a distribution.

- Section 892 exemption and domestically controlled REIT exemption therefore require that a tax-efficient exit be structured as a sale of REIT shares.

- Certain buyers, such as one or a small group of individuals who would cause a REIT to be closely-held cannot buy REIT shares.

- Most other buyers can purchase REIT shares and can eventually liquidate the REIT in a tax-efficient manner and hold the property with a basis equal to the purchase price of the shares.
International: Structuring Considerations

• Due to REIT qualification being on an annual all-or-nothing basis, seller will want a buyer of REIT shares to ensure the REIT continues to qualify as a REIT until the tax year of sale ends.

• Whether a sale of REIT shares followed close in time by a liquidation of the REIT will be respected as separate steps is open to some debate, though the general view is that the steps should be respected if the buyer is under no obligation to liquidate and the sale is legally a share sale.

• Due to the need to sell REIT shares to take advantage of the Section 892 and domestically controlled REIT exception, it will often be more tax efficient for non-U.S. investors to have each property or small group of properties held in a separate REITs that can be sold independent of other properties that have a longer investment horizon or which could be sold to a different buyer.
International: Structuring Considerations

- U.S. investors will need to own and continue to own a majority of the REIT for it to be considered to be domestically controlled.

- A foreign pension will usually need to own less than 50% of the REIT to take advantage of zero rate of withholding for Treaty purposes.

- Governmental investors will need to own less than 50% of the REIT and not have “effective practical control” of the REIT to be able to take advantage of the Section 892 exemption. Veto rights will need to be closely monitored.

- Non-U.S. residents will often want to hold REIT shares through a U.S. partnership to better control withholding consequences and to coordinate other aspects of investing in one or more REITs.

- A REIT, like any other U.S. corporate vehicle, can be capitalized in part with debt, subject potentially to the earnings-stripping rules and debt/equity considerations. Interest on debt may be exempt under a treaty or can qualify as portfolio interest to shareholders who own less than 10% of the voting interests in the REIT. Portfolio interest exemption can potentially apply where there is a greater than 10% non-voting equity interest.
International: Withholding

- Treaty or Section 892 exemption needs to be documented by providing an appropriate IRS Form W-8.

- There is some ambiguity as to how it is determined whether a distribution is attributable to a real property sale by the REIT for purposes of Section 897(h). For withholding purposes, FIRPTA generally treats the largest amount that a REIT can designate as a capital gain dividend as subject to withholding.

- There is some ambiguity whether a distribution by a REIT that is not attributable to earnings and profits and is a return of capital to a non-resident shareholder (such as proceeds from a loan refinancing) is subject to withholding even though it is not taxable income.

- There is currently no explicit rule to certify that a sale of shares of a domestically controlled REIT is not subject to withholding.
REIT Conversions

• Several public companies not operating traditional real estate businesses announced REIT conversions
  – Dillard’s Department Stores
  – Iron Mountain (document storage)
  – American Tower (communications)
  – Lamar Advertising (outdoor signage)

• IRS had suspended private rulings on REIT conversions pending further study of the issue. Now giving them again.
  – Worry that conversions have gotten too aggressive

• Two potential types of candidates:
  – Non-real estate businesses that can spin off real estate
    • More viable if little accumulated earnings and profits or built-in gain
  – Non-traditional real estate business that may be able to satisfy the REIT income and asset tests
    • Iron Mountain, Lamar Advertising
Pros and Cons of REIT Conversions

Pros:

• Potential for substantial entity-level tax savings
• Markets have reacted favorably to conversion announcements
• Potential management advantages from splitting real-estate and operational aspects of businesses

Cons:

• Conversion requiring spinoff would need to satisfy § 355.
  • See Penn National Gaming. 201337007
  • See Rev. Rul. 2001-29
• May cause business to forgo revenue to maintain REIT status
• Compliance and legal costs may be high
• Uncertainty surrounding IRS working group on REIT conversions; IRS may not rule on tax treatment of the conversion
Some Fixes for Common Problems

• Tax consequences of failing REIT requirements can be severe, but most failures can be rectified without loss of REIT status

• Failure of 100 shareholder test
  – Note: does not need to be satisfied in first year of operation
  – If failed in subsequent years, can avoid loss of REIT status with $50,000 penalty and reasonable cause

• Failure of distribution requirement
  – May be able to make a deficiency dividend
  – Rev. Proc. 2010-12 relief no longer available as of beginning of this year

• Failure of 75% asset test
  – Pitfall only triggered if failure is caused by acquisition and is not cured within 30 days of end of quarter

• Failure of 95% or 75% income tests
  – Reasonable cause exception can be claimed on line 2f of schedule J of the REIT’s return
Changes on the Horizon

• Elimination of preferential dividend rule for publicly traded REITs.
  – Has appeared in the President’s budget in recent years
  – Would bring treatment of preferential dividends in line with the RIC rules
  – Political Argument: preferential dividend rule is redundant to SEC and blue sky laws protecting shareholders

• Comprehensive tax reform could substantially change either REIT taxation or the taxation of alternative structures

• Potential legislative of expansion for alternative energy assets
  – Senate Finance held hearings on the use of REITs for alternative energy

• Repeal of Notice 2007-55
  – NAREIT has requested addition to the IRS’s priority guidance plan