

REIT Tax Potpourri Meeting

Wednesday, April 1st

9:45am – 11am

*JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ*

Moderator:

Michael Stauffer, VP-Taxes, Kilroy Realty Corporation

Panelists:

Adam Handler, Principal, PwC

Jennifer Weiss, Partner, Greenberg Traurig, LLP

Nabil Andrawis, EVP & Director-Taxation, Lexington
Realty Trust

Ross Wehman, VP-Tax, Camden Property Trust



NAREIT's Law, Accounting & Finance Conference

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REIT Tax Potpourri

March 31-April 2, 2015

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Jennifer Weiss, Shareholder, Greenberg Traurig, LLP

Customary Services

Summary of rule

- ◆ Regs. 1.856-4(b)(1) Charges for customary services
 - ◆ Qualifying rental income includes charges for services customarily furnished or rendered in connection with the rental of real property
 - ◆ If a service is not customary, then it generally is impermissible tenant service income (ITSI)

Customary Services

How to determine

- ◆ Geographic market
 - ◆ Services customarily furnished to tenants of buildings of a similar class in the same geographic area
 - ◆ Services that are ordinarily furnished to tenants in connection with the rental of real property and not primarily for the convenience of the occupants.

Customary Services

How to determine (cont.)

◆ Survey - REIT Status Questionnaire

- ◆ A REIT Questionnaire is generally completed to determine rent structure and types of services provided at the property

◆ Examples

1. Car charging stations
2. Wifi
3. Fitness Centers
4. Happy Hour

◆ Legal Requirements

Customary Services

Use of RR 2002-38

- ◆ Applies when a REIT uses a TRS to perform non-customary services in a property.
- ◆ Section 857(b)(7)(B)(ii) through (vii) contains exceptions, or safe harbors, from the 100 percent tax on redetermined rents.
- ◆ Requirements
 1. Gross income of the TRS from the service must be at least 150 percent of the TRS's direct cost of rendering the service § 857(b)(7)(B)(vi)
 2. Arm's length charge Section 1.482-2(b)(3)
- ◆ Limits

Pitfalls of Baby REITs

Uses of baby REITs

◆ Acquisition of C Corps.

1. C corp. to REIT conversion
 - a. Distribution of C Corp E&P
 - b. Section 1374 built in gain tax

◆ JVs with Foreigners, Pensions, etc.

1. The sale of stock in a "domestically controlled" REIT is exempt from FIRPTA tax
2. In general, REIT dividends do not generate UBTI, unless the REIT is a "pension held REIT"

Pitfalls of baby REITs

Uses of baby REITs (cont.)

◆ State Tax

1. Alleviate any income taxes at the property level, e.g., TN
2. Some states provide preferential statutes for REITs on the imposition of franchise taxes or realty transfer taxes as well as other similar taxes.
3. Some states classify baby REITs as a captive REIT for state purposes -- denying the entity DPD e.g., franchise taxes in a state like New York or New York City.
4. Increased complexity on the sale of shares due to possible difference in inside and outside basis when dividends paid from baby REIT to parent company are either deferred, eliminated or not allowed (in the case of consent dividends).

Pitfalls of baby REITs

Special Issues

- ◆ Personal Holding Company (PHC)
- ◆ Closely-held Test
- ◆ Related Party Rents
- ◆ 100 Shareholders
- ◆ TRS Election
- ◆ Management Fees
- ◆ Independent Contractor

Pitfalls of baby REITs

Special Issues

1. Personal Holding Company (PHC)

- ◆ A REIT is taxed as a personal holding company under section 542 if: at least 60% of its adjusted ordinary gross income for the tax year is largely of investment character, and it is closely held as defined under Code Section 856(h)(1)(A).

2. Closely-held Test

- ◆ At any time during the last half of the taxable year, more than 50% in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals. Code Section 856(h)(1)(A). Initial year excluded.

Pitfalls of baby REITs

Special Issues (cont.)

3. Related Party Rents

- ◆ Generally, a REIT is prohibited from leasing property to a tenant in which it directly or indirectly holds a 10 percent or greater interest
- ◆ Broad attribution rules apply to attribute ownership by a 10 percent shareholder of the REIT or a 25 percent partner in a partnership, including the operating partnership of an UPREIT
- ◆ Violating the ownership limitation at any time during the year taints the rents from the lease for the entire year

Pitfalls of baby REITs

Special Issues (cont.)

4. 100 Shareholders

- ◆ Must have at least 100 shareholders (but no minimum value for each shareholder) during at least 335 days of the taxable year. Initial year excluded.

5. TRS Election

- ◆ Must be filed no later than 75 days after effective date.
- ◆ If a timely election is not filed, Section 9100 relief may be requested from the IRS.

Pitfalls of baby REITs

Special Issues (cont.)

6. Independent Contractor (IK)

- ◆ IK cannot own directly or indirectly more than 35% of the interest in the REIT
- ◆ One or more persons owning 35% of the REIT cannot own more than 35% or more of the interest in the IK.
- ◆ A REIT may not derive or receive any income from the independent contractor

7. Management Fees

Transfer Pricing Update

Increased audit activity

1. Desert Capital

- ◆ Bankruptcy Case involving intercompany allocations from REIT to TRS
- ◆ 100% excise tax upheld!
- ◆ Court opined on the interplay between 482 and 857(b)(7)
 - Best method under Section 482 must be applied
 - Reasonable method 857(b)(7) focuses on reasonable results

2. Other transfer pricing audits being disclosed by companies under their SEC Filings

Transfer Pricing Update

Landscape is changing

- ◆ OECD's Base Erosion & Profit Shifting (BEPS) influencing the way the IRS is conducting audits
- ◆ Collateral damage on the REIT industry dealing with common intercompany transactions (loans, leases, cost sharing)

Transfer Pricing Update

Lessons Learned

- ◆ Intercompany loans (including leveraged blockers)
 - Need to support principal amount and interest rate
 - Business purpose is key
- ◆ Intercompany Leases
 - Supporting leakage is not enough!
 - Watch out for terms imposed by management and lender agreements
 - Lease-by-lease analysis (avoid risk to entire portfolio)
- ◆ Shared Services
 - Demonstrate benefit from services
 - Document rationale for a TP methodology (i.e., markup vs markup, allocation key)

Transfer Pricing Update

Lessons Learned (cont.)

◆ Shared Services

- Demonstrate benefit from services
- Document rationale for a TP methodology (i.e., markup vs markup, allocation key)

◆ Best Practices

- Good documentation at the beginning of an intercompany arrangement is key
- Need to monitor transfer pricing policies periodically

Managing Non-Qualifying income from Joint Ventures

Non-Qualifying Fees – REIT is managing member

- ◆ On-going Management Fees
 - ◆ Usually % of gross income or % of Invested Capital
 - ◆ Can be easily forecasted
 - ◆ Usually can be Managed within a REIT non-qualifying income basket, depending on the size of the JV.
- ◆ Acquisition Fees
 - ◆ Usually % of property purchase price
 - ◆ Can fluctuate from one year to the other
 - ◆ Is usually earned by the TRS.
 - ◆ JV agreement needs to entitle the TRS to the fees

Managing Non-Qualifying income from Joint Ventures

Non-Qualifying income from operations – REIT is non- managing member

- ◆ Managing member to operate the partnership as a standalone REIT
- ◆ The partnership to use only approved Lease form.
- ◆ REIT member approve any new entity formation or tax election.
- ◆ The partnership shall not engage in the provision of any services that would produce impermissible tenant services income within the meaning of section 856(d)(2)(C).
- ◆ The Managing member shall complete, sign and provide to REIT member a property questionnaire, the form of which shall be provided by the REIT partner

Managing Non-Qualifying income from Joint Ventures

- ◆ REIT member to approve third party service providers.
- ◆ The partnership shall not lease to any person that would cause the REIT member to derive related party rent as defined in section 856(d)(2)(B)
- ◆ The Buy/sell provision in the agreement cannot be triggered before 2 years of the date the property is placed in service.
- ◆ Partnership shall not dispose of a property in a transaction the would be treated as a “prohibited transaction” unless it qualifies for the safe harbor taking into account the REIT member dispositions.

Managing Non-Qualifying income from Joint Ventures

- ◆ The partnership shall use reasonable efforts to make distributions in compliance with the 90% distribution requirement of section 857(a)(1)
- ◆ The managing member shall provide such information and additional reports as the REIT member may reasonably request in connection with its REIT compliance.

Working with Outside Tax Advisors

◆ Best Practices

- ◆ Frame the discussion/engagement clearly from the start to manage expected outcome and fees. Set boundaries
- ◆ Get to the subject-matter expert quickly rather than general client engagement manager. Have engagement manager get expert up to speed on issue before first discussion
- ◆ Follow up frequently with advisor to monitor progress of work. Demand responsiveness
- ◆ Make sure advisor is working with you and not against you. If a “bad” answer is coming, have them suggest alternatives

Working with Outside Tax Advisors

- ◆ Keep a good relationship going with primary advisor during the year rather than just at tax return time. Quarterly lunches/discussions can shortcut surprises at year end
- ◆ Know who to call first—accountants vs. attorneys vs. consultants
- ◆ Deal with advisors who are compatible to you, your staff and co-workers. Don't work with condescending or demanding advisors, work with those who are instructive.
- ◆ Consider conflicting views of firms on certain issues

Working with Outside Tax Advisors

- ◆ If practical, present all the facts and relevant points on the issue at hand to the advisor in writing/email form. This might make you really think through the issue and focus on the technical point of discussion. It might save the advisor time by narrowing the scope of the issue and possibly generate an email response (rather than a phone call) which can be saved for future reference.
- ◆ Avoid advisors who push “add on services” beyond those requested
- ◆ Avoid advisors who “nickel and dime” you on bills