Concurrent Session: REIT Taxes All Around Us

Thursday, March 31st
2:45pm – 4pm
Marriott Marquis, Washington DC

Moderator:
Brian Wood, SVP & Chief Tax Officer, Ventas, Inc.

Panelists:
Michael Brody, Partner, Latham & Watkins
David Lee, Partner, KPMG LLP
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REITWise 2016 – REIT Taxes All Around Us

REIT Investments in Non-Controlled Partnerships

Sample Provision[1]

ARTICLE I
REIT PROTECTION PROVISIONS.

Section 1.1 Generally.

The Members acknowledge and agree that the REIT Member is an Affiliate of REIT Parent and that REIT Parent is a real estate investment trust for U.S. federal income tax purposes (a "REIT") and is therefore subject to the requirements set forth in Code Sections 856 through 859. Notwithstanding anything herein to the contrary, each Member acknowledges and agrees that, for so long as REIT Parent (which term also refers to any successor to REIT Parent, whether by merger or otherwise, that also is intended to qualify as a REIT) directly or indirectly owns interests in the Company, through REIT Member or otherwise, it is intended that the Company and each Subsidiary shall be operated in such a manner so that REIT Parent may continue to so qualify as a REIT and avoid U.S. federal income and excise tax liability to the extent permitted under the Code. The Company shall, promptly upon the request of REIT Member, make available to REIT Member all data and information in the possession of the Company which is determined by REIT Member to be necessary or helpful to (1) determine the tax treatment of REIT Parent, or (2) monitor REIT Parent's compliance with the requirements relating to the status of REIT Parent as a REIT. In the event of any conflict or inconsistency between the terms of this Article I and any other provision of this Agreement, the terms of this Article I shall control.

Section 1.2 Covenants.

Notwithstanding anything in the Agreement to the contrary, the Members acknowledge and agree that neither the Company nor any Subsidiary shall, without the prior written consent of REIT Member:

(A) own assets other than interests in real property, furniture, fixtures, equipment and intangible property associated with such real property, cash, bank time deposits, interests in money market accounts or receivables which arise in the ordinary course of its rental business, such as for rent from occupancy of space;

(B) directly or indirectly acquire (whether by purchase, contribution, distribution, operation of law, or otherwise) or own any equity interest in any corporation, partnership, limited

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[1] This provision may not be appropriate for any particular joint venture. The provision used for any joint venture should be drafted to address the specific circumstances.

liability company, trust, or other entity, except in the case of interests in money market accounts or in an entity that is either (1) disregarded as separate from the Company for U.S. federal income tax purposes or (2) with the prior written consent of REIT Member not to be unreasonably withheld, treated as a partnership for U.S. federal income tax purposes (subject to the condition that such disregarded entity or partnership shall have agreed to be bound by the entirety of this Article I);

(C) directly or indirectly acquire (whether by purchase, contribution, distribution, operation of law, or otherwise), own, or originate any loan or debt instrument, or consent to any modification, alteration, or amendment of any of the same; provided that this Section 1.2(C) shall not restrict the Company's ownership of bank time deposits or interests in money market accounts;

(D) directly or indirectly derive income in any taxable year other than rent from occupancy of real property and associated personal property, interest income from bank time deposits or money market accounts, or gain from sale of properties that satisfy the requirements of the prohibited transaction safe harbor set forth in Section 857(b)(6)(C) of the Code with respect to REIT Parent, [to the extent such income would exceed X percent (X%) of the total gross income of the Company for such year];

(E) enter into any lease of space for a term of less than thirty (30) days;

(F) directly or indirectly enter into any lease with a Person (A) that is a corporation for U.S. federal income tax purposes, if REIT Parent would be considered to own (x) ten percent (10%) or more of the total value of shares of all classes of stock of such Person or (y) stock of such Person possessing ten percent (10%) or more of the total combined voting power of all classes of stock of such Person entitled to vote, or (B) that is an entity that is not a corporation for U.S. federal income tax purposes, if REIT Parent would be considered to own an interest of ten percent (10%) or more in the assets or net profits of such Person, with ownership by REIT Parent in either case determined taking into account the rules for constructive ownership described in Section 318(a) of the Code, as modified by Section 856(d)(5) of the Code (a "Related Party Tenant");

(G) directly or indirectly enter into any lease which provides for rent based on any Person's net income or profits;

(H) directly or indirectly permit any sublease or license of any portion of any Property if either (A) the rent or other amounts to be paid by the proposed subtenant or licensee thereunder would be based, in whole or in part, on the income or profits derived by such proposed subtenant or licensee from the property, or (B) the sublessee or licensee, as the case may be, would be a Related Party Tenant;

(I) directly or indirectly permit any assignment of a lease (or sublease or license) of all or any portion of any Property if either (A) any amounts to be paid by the proposed assignee thereunder to the assignor would be based, in whole or in part, on the income or profits derived by such proposed subtenant or licensee from any property, or (B) the assignee would be a Related Party Tenant;

(J) enter into any lease which provides for the rental of personal property, except a lease which provides for the rental of both personal property and real property and in which the rent attributable to such personal property for the taxable year does not exceed [ten percent (10%)] of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease (as determined pursuant to Code Section 856(d)(1));

(K) directly or indirectly derive in any year, “impermissible tenant service income” (as defined under Code Section 856(d)(7)) with respect to any property, which exceeds [0.8%] of all income received or accrued during such taxable year from such property;

(L) provide services or amenities at any Property that are (i) not customarily provided to tenants of comparable properties in the same geographic area, unless such services or amenities are provided by an entity that is a “taxable REIT subsidiary” (as defined in Section 856(l) of the Code) with respect to REIT Parent (a “TRS”), or (ii) primarily for the convenience of the tenant, unless such services or amenities are provided either by an entity that (A) is a TRS or (B) qualifies as an “independent contractor” (within the meaning of Section 856(d)(3) of the Code) with respect to REIT Parent and from which REIT Parent does not directly or indirectly derive any income;

(M) fail to [use commercially reasonable efforts to] cause the Company to make distributions to Members so that the annual distributions paid to REIT Member are an amount equal to or greater than the amount of taxable income derived by REIT Member from the Company for each taxable year;

(N) elect to be taxed as, or take any other action or position the effect or import of which would be that the Company, any Subsidiary, or any of their subsidiaries is or would be treated as, other than a partnership or disregarded entity for U.S. federal income tax purposes;

(O) take any other action, if the Company or any Subsidiary is informed in writing by REIT Member in the exercise of REIT Member’s reasonable judgment, that such action could cause REIT Parent to lose its qualification as a REIT; or[2]

(P) commit to do any of the foregoing.

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[2] Due to its uncertainty, the REIT may need to offer to indemnify the other partner for any losses associated with the use of this provision.

REIT Wise®

NAREIT's Law, Accounting & Finance Conference

March 30 - April 1 2016

NAREIT

REIT Taxes All Around Us

March 31, 2016

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LATHAM & WATKINS LLP

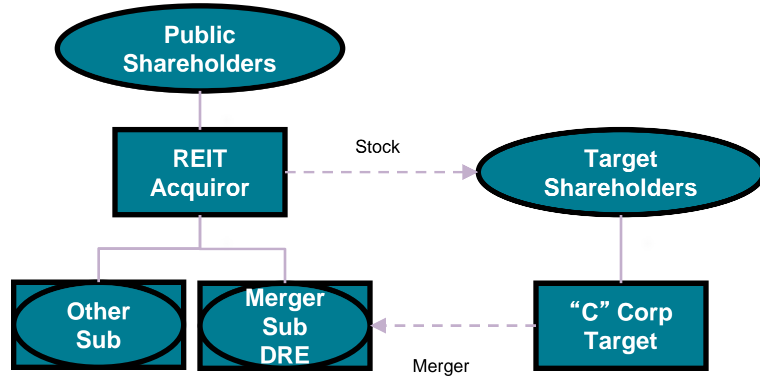
CRAVATH, SWAINE & MOORE LLP

REIT’s Acquisition of a C Corporation

REIT's Acquisition of a C Corporation

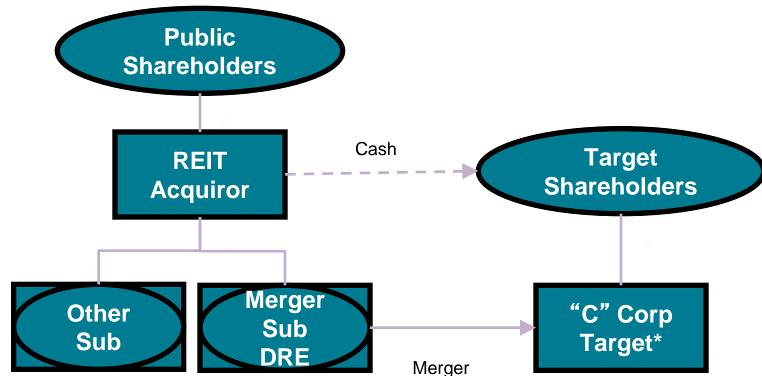
- Many REIT-able assets (e.g., infrastructure, healthcare, etc.) may potentially be separated from operations and acquired via carve-out transactions.
- Tax-exempt and foreign investors may sometimes favor ownership and operation of REIT-able assets in leveraged "C" blockers and may be exempt from U.S. tax on sales of "blocker" shares.
- A REIT is likely a longer term investor and can wait out the recognition period on "converted" assets (now being reduced to 5 years under the PATH Act).
- Recent transactions in data-center, healthcare, communications towers, record storage, office, etc.
- Common structures
  - Forward subsidiary merger (stock)
  - Reverse subsidiary merger (stock or cash)
  - Cash purchase

Potential Structure - Forward Sub Merger (Stock)



- Section 1.368-2(b)(1)(iii) - Example 2 - Merger of a target corporation into a disregarded entity in exchange for stock of the owner - This transaction could qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A) if other requirements are satisfied.
- Intended to be non-recognition to both Target and its shareholders; carryover-basis transaction and non-REIT E&P.
  - If recognition, see Rev. Rul. 69-6 (deemed sale of assets by Target).

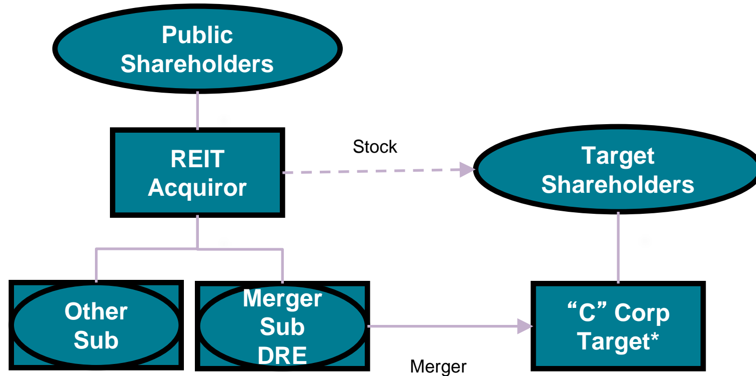
Potential Structure - Reverse Sub Merger (Cash)



***Target becomes a QRS (unless making TRS election) and is deemed liquidated into Acquiror REIT**

- Rev. Rul. 90-95 (Situation 2) - P acquired all of the stock of T in a reverse cash merger and promptly liquidated T by merging T upstream into P. The ruling held that the transaction was properly treated as a taxable stock purchase followed by a tax free section 332 liquidation, and not as a taxable purchase of T's assets by P under the Kimbell-Diamond case.
- Target becoming a QRS and deemed liquidated into Acquiror REIT; carryover-basis transaction and non-REIT E&P.

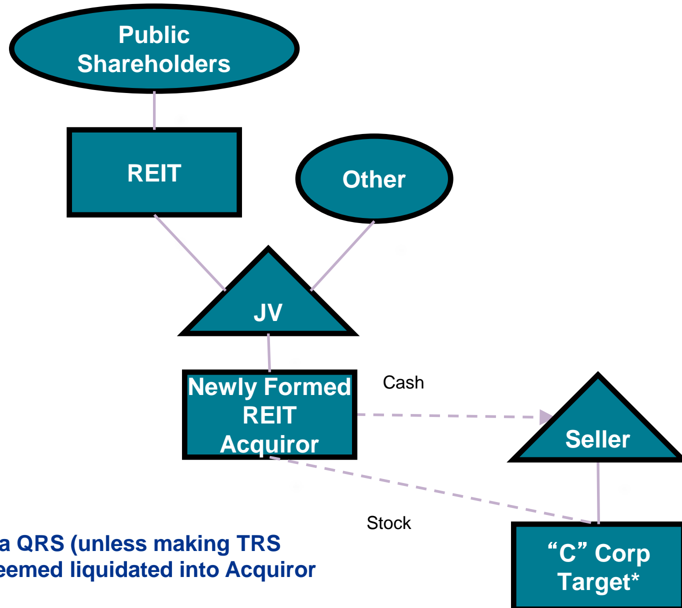
Potential Structure - Reverse Sub Merger (Stock)



***Target becomes a QRS (unless making TRS election) and is deemed liquidated into Acquiror REIT**

- Section 1.368-2(b)(1)(iii) - Example 6 - Merger of a disregarded entity into a corporation - The transaction cannot qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).
- However, can this qualify as a stock-for-assets reorganization of section 368(a)(1)(C) – Target transferred its assets to Acquiror in exchange for Acquiror voting stock and then distributing such stock to Target shareholders in liquidation?
- Target becoming a QRS and deemed liquidated into Acquiror REIT; carryover-basis transaction and non-REIT E&P.

Potential Structure – Cash Purchase



*Target becomes a QRS (unless making TRS election) and is deemed liquidated into Acquiror REIT

- Taxable sale of Target stock
- Target becoming a QRS and deemed liquidated into Acquiror REIT; carryover-basis transaction and non-REIT E&P.

Why Should We Care?

- A REIT must comply with specific asset-holding and income-source requirements.
- A REIT must distribute 90 percent of its "ordinary" taxable income and is taxed on any undistributed taxable income.
- A REIT must not have any non-REIT E&P at a year end.
- A REIT is subject to corporate level tax on net built-in gain recognized (during the recognition period) on assets acquired from a "C" corporation in a carryover-basis transaction.
- A REIT is subject to a 100-percent tax on prohibited transactions.
- A "C" corporation is subject to corporate level tax on its taxable income, including income recognized as the result of being acquired by a REIT.

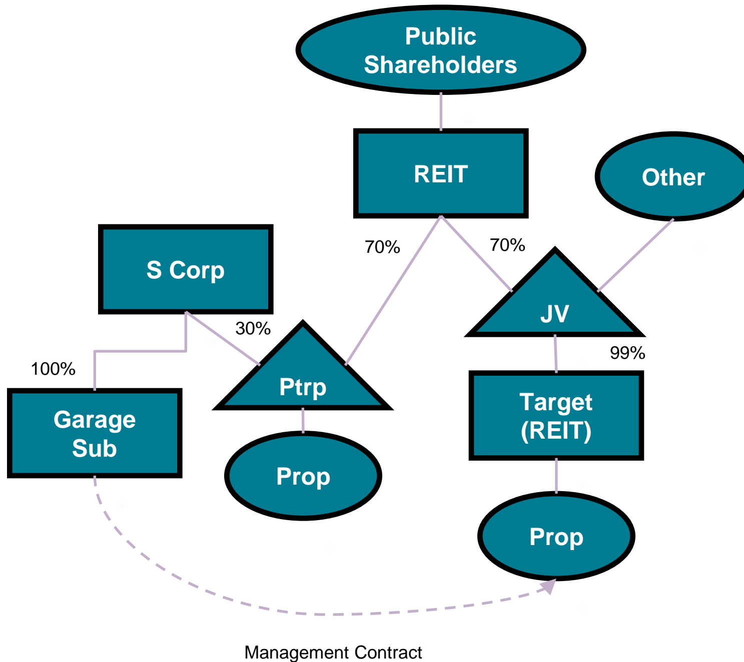
Tax Considerations - Asset & Income

- Typical property acquisition due diligence (e.g., lease vs. management contract; lease vs. financing; lease review; related tenants; TRS limited rental; cross-checking tenants/IKs; customary determination; impermissible tenant services; garage's predominate-use documentation; TRS election and service agreements; cost reimbursements; etc.)
- Review of acquired assets (e.g., intangibles; non-tenant receivables; section 467 loans; partner loan in connection with a defaulted capital contribution; mezzanine loan with bad boy carve-outs; other securities; etc.)
- Corporate (e.g., investments in corporate or partnership subsidiaries; beneficiary interest in trusts; pure preferred equity investments; guaranteed payments; identification of qualified derivative instruments; 481(a) adjustments; etc.)

Tax Considerations – Distribution Requirement

- For a taxable stock transaction, can Acquiror REIT preserve its ability to obtain FMV basis with respect to Target's assets by converting Target to a REIT, and waiting out the recognition period under section 1374?
  - After the recognition period has expired, Target may be liquidated in a taxable transaction (i.e., recognizing a gain on the distributed property under section 336(a) and may claim a deduction for dividend paid based on the liquidation distribution under section 562(b)(1)(B) to eliminate section 336(a) gain.
- What are the risks of maintaining a subsidiary REIT? E.g., inadvertent/foot faults, ownership attrition and related tenants/IKs, etc.

Tax Considerations – Distribution Requirement (continued)



- Ownership attribution risk?
  - REIT's charter typically contains excess share provisions to ensure REIT compliance.
  - Can such provisions be effective to prevent Target (REIT) from having a disqualified IK?
  - Pursuant to modified section 318(a)(3)(A) and then 318(a)(3)(C), Garage Sub would be deemed to own Target and not qualify as an IK.

Tax Considerations - Non-REIT E&P

- What if the determined and distributed amount is low? - Section 1.857-11(c) directs REITs to section 852(e) (procedures similar to deficiency dividend) for non-REIT E&P.
- What is the risk of a pre-transaction distribution by Target being re-characterized as part of the stock purchase price?
  - Rev. Rul. 75-493 held that a cash amount to a sole shareholder prior to the sale of the stock was a dividend, where the buyer had no legal obligation to purchase the stock upon the declaration and payment of the dividend.
  - Waterman Steamship Corp. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970) and TSN Liquidating Corp., Inc. v. United States, 624 F.2d 1328 (5th Cir. 1980)
  - PLR 9717036 - The IRS respected the pre-sale distribution (including the issuance of promissory notes if cash reserves are insufficient) because “the Notes will be paid with cash from the continuing operations of Target and the Subsidiaries or from loans against their assets, and not from the assets of [the buyer REIT].”

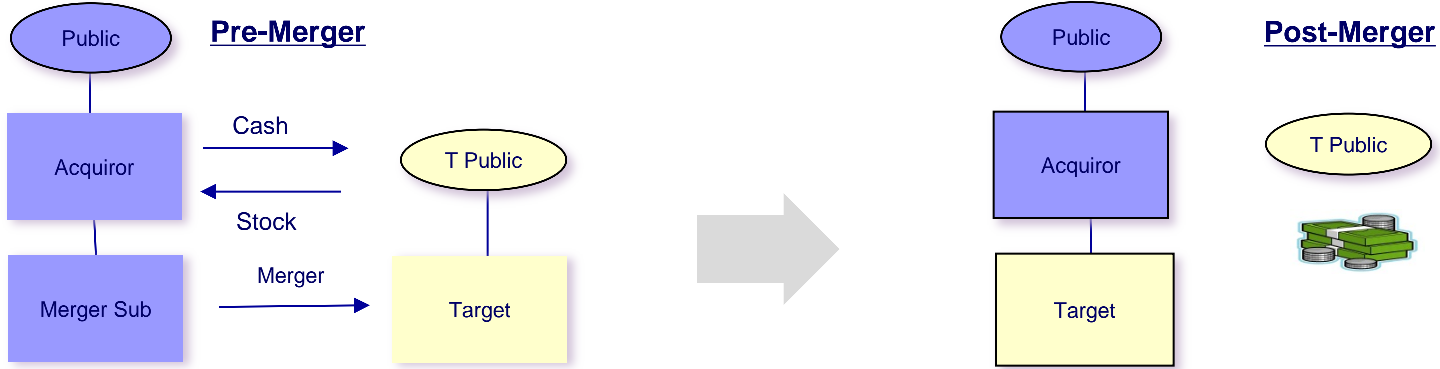
Tax Considerations - Income Tax Exposures

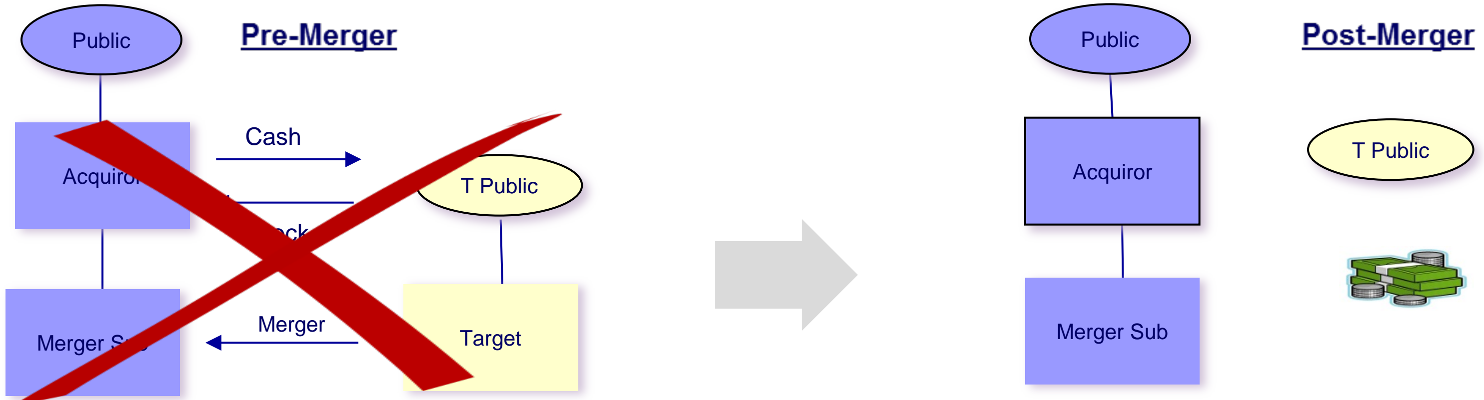
- If consolidated group, Target's excess loss account (akin to negative basis; to recapture P's negative adjustments with respect to S stock to the extent the negative adjustments exceed P's basis in the stock)
- Built-in gain
- Sale of unwanted assets and prohibited transactions
- If Target claims to be a QRS of another REIT, can it have any income tax exposures?
- If intended to be a reorganization, is Target an undiversified investment company?

REIT-to-REIT M&A

Taxable Deals

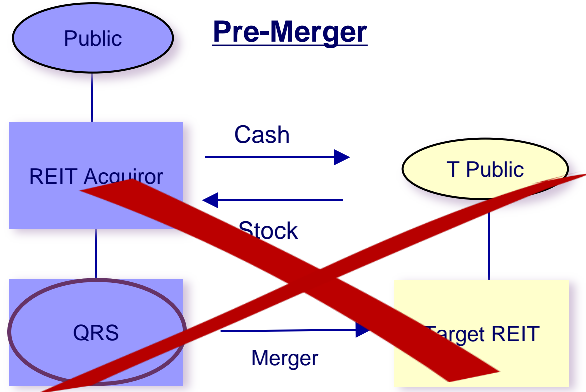
Triangular Mergers – T is Not a REIT

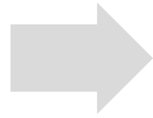


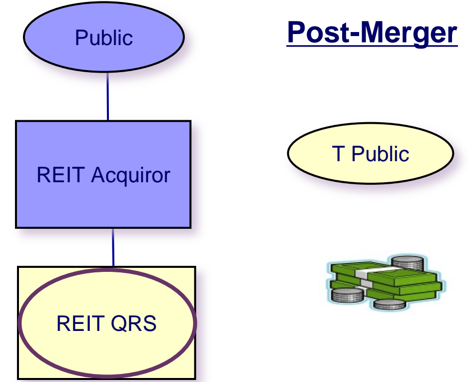


Triangular Mergers – T is a REIT

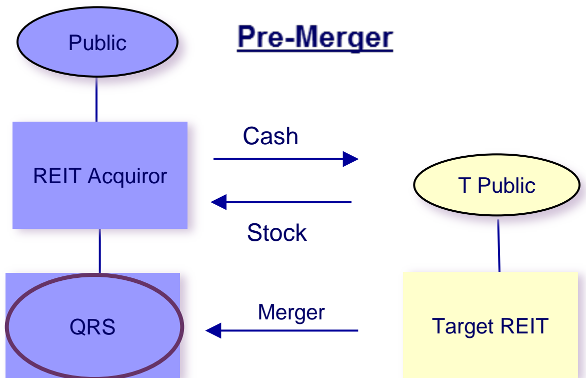
Reverse Triangular Merger

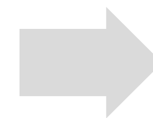


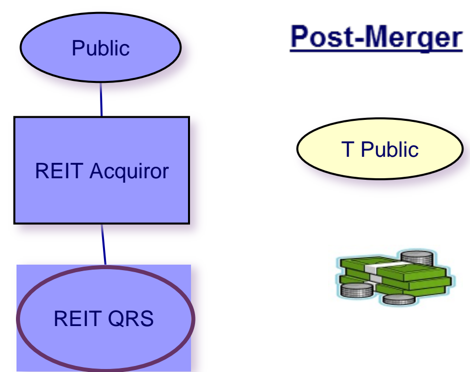




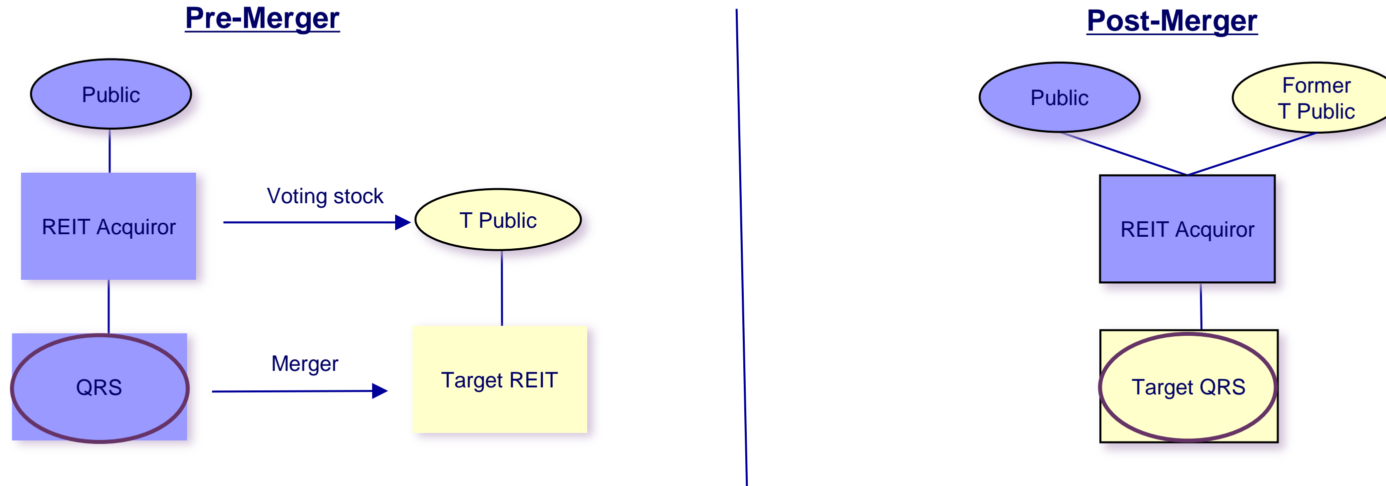
Forward Triangular Merger



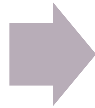




Reverse Subsidiary Merger: A2E, B or C?



To qualify as a reorganization under § 368(a)(2)(E), the consideration in a reverse subsidiary merger must consist of at least 80% voting stock (i.e., ≤ 20% boot).

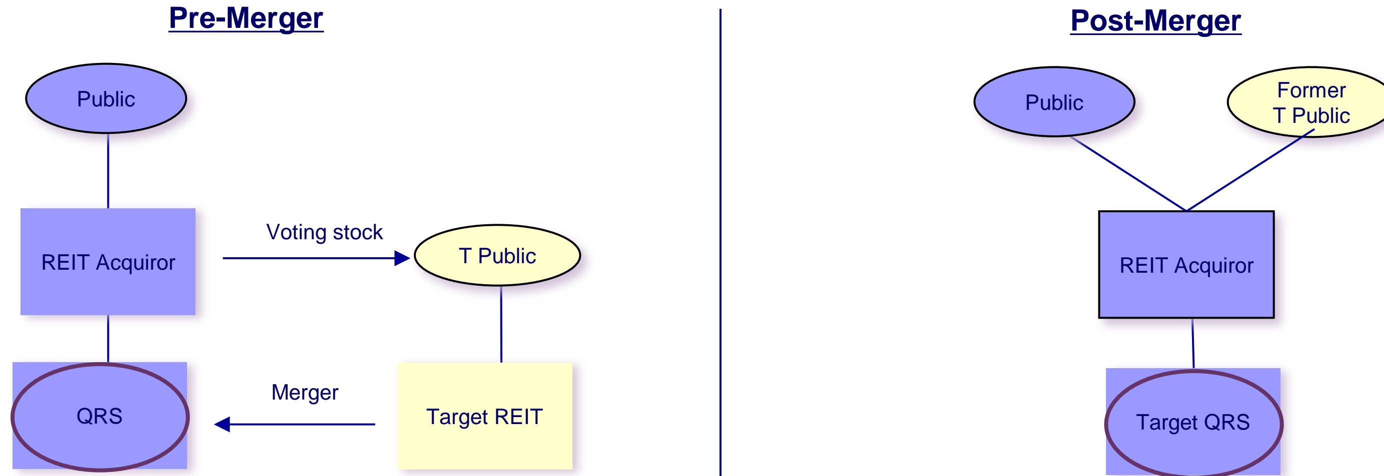


Because the merger subsidiary is a QRS and the target REIT will become a QRS, the merger cannot qualify as a reorganization under § 368(a)(2)(E) (or § 368(a)(1)(B)).

Because the target REIT is deemed to liquidate after the merger, the merger qualifies as a reorganization under § 368(a)(1)(C) (Rev. Rul. 67-274)

If the merger consideration had included any boot, it would generally be treated as a fully taxable stock purchase followed by a liquidation (Rev. Rul. 90-95)

Forward Subsidiary Merger: A2D or A?



To qualify as a reorganization under § 368(a)(2)(D), the consideration in a forward subsidiary merger must consist of at least 40% stock (i.e., ≤ 60% boot).

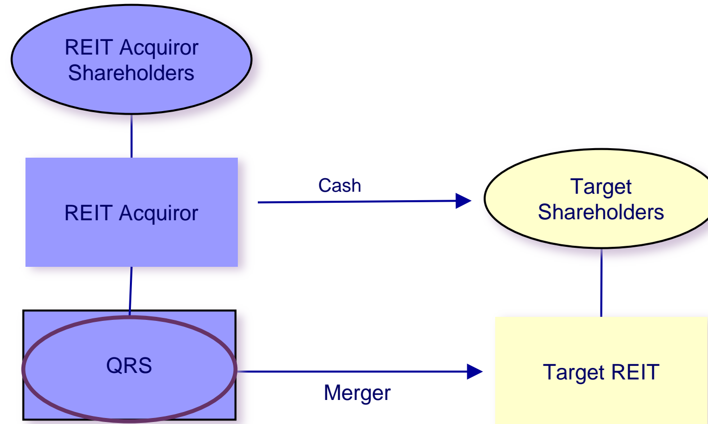
Because the merger subsidiary is a QRS and the target REIT will become a QRS, the merger cannot qualify as a reorganization under § 368(a)(2)(D).

Because the target REIT is deemed to merge directly into the acquiring REIT, the merger should qualify as a reorganization under § 368(a)(1)(A).

If more than 60% of the merger consideration is cash or other property, the merger will be treated as a taxable sale of assets followed by a liquidation. (Rev. Rul. 69-6)

Achieving a Basis Step-Up in a Cash Merger

Reverse Subsidiary Merger?



Tax Result:

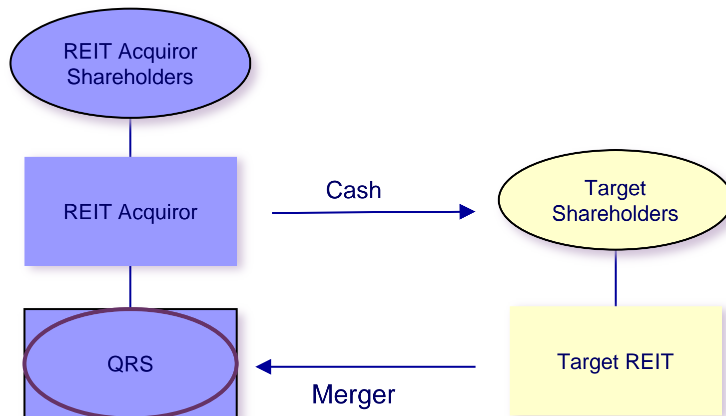
Because the merger subsidiary is a QRS, the merger is treated as a qualified stock purchase by the acquiring REIT.

Because it will become a QRS after the merger, the target REIT will be deemed to transfer its assets and liabilities to the acquiring REIT in a § 332 liquidation.

1. No Basis Step Up
2. Tax at shareholder level
3. What about FIRPTA?

Achieving a Basis Step-Up in a Cash Merger

Forward Subsidiary Merger?



Tax Result:

In a forward subsidiary merger, the target recognizes gain in a deemed sale of assets followed by a liquidation. (Rev. Rul. 69-6)

If the target is a REIT, the liquidating distribution should qualify for the dividends paid deduction (DPD) under § 562(b).

1. Taxable Sale of Assets
2. DPD Shelters the Gain
3. Full Basis Step Up
4. Capital Gain to Shareholders
5. What about FIRPTA?

Reverse Subsidiary Merger with a Partnership

Pre-Merger

Post-Merger

Because Opco (rather than the REIT parent) owns the Target REIT after the merger, the liquidation of the Target REIT is taxable.

Although the Target recognizes § 311 gain in the liquidation, the gain is sheltered by the DPD.

Opco recognizes no gain b/c it has a FMV basis in the Target stock.

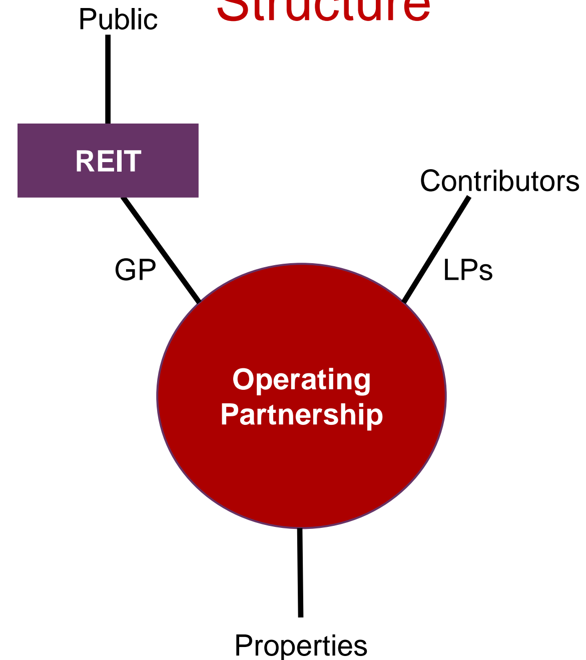
Tax Result:

1. Full Basis Step Up
2. No Add'l Tax to Public
3. Avoids FIRPTA?

Operating Partnership M&A Transactions

What is an UPREIT and Why Contribute to It?

- In a typical REIT IPO, a sponsor creates a new UPREIT structure, including a REIT parent and an OP subsidiary.
- The OP acquires the sponsor's management business and properties through a series of merger or contribution transactions, referred to as a roll-up.
- Participants in the roll-up receive cash, OP units or REIT shares.



Why Use an UPREIT?

- A transfer of property to a REIT in exchange for its shares would be fully taxable to the transferor in most cases.
- The UPREIT structure allows for property contributions to the OP in exchange for OP units on a tax-deferred basis.
- One REIT share and one OP unit each represent an undivided and equal slice of a single pool of assets (i.e., the assets owned by the OP), so there is economic fungibility.
- REIT shares and OP units are typically entitled to identical distributions.
- An OP Unitholder has the right to put some or all of its OP units to the OP in exchange for cash based on the current REIT stock price.
- Alternatively, the REIT has the right to acquire the OP units in exchange for REIT shares on a one-for-one basis.
- The redemption or exchange is taxable.

Merger and Contribution Issues

- The merger and contribution issues discussed in these slides may arise in:
  - Private contributions of property or partnership interests in exchange for OP units.
  - Merger and acquisition transactions between two UPREITs or DOWN REITs.
  - A REIT's acquisition of a C corporation, followed by the REIT's contribution of the assets of the corporation to its OP.

Partnership Mergers

- Code and Treasury Regulations do not define partnership mergers.
- Working Definition – Transaction in which:
  - Assets/liabilities of a target partnership are transferred to acquiring partnership.
  - At least one partner in the target partnership becomes a partner in the acquiring partnership.
  - Target partnership ceases to exist for Federal income tax purposes.
- TR § 1.708-1(c)(1) determines the direction of the merger (i.e., which partnership survives)
  - The resulting partnership is the continuation of any merging partnership whose partners own more than 50% of the capital and profits in the resulting partnership.
  - If the above could be more than one partnership, it's the partnership which contributed the most net assets.
  - The direction of the merger under these rules may differ from the direction taken in form.
- The direction of the merger may affect the need to make tax elections, and the tax consequences of the merger (e.g., the applicability of § 704(c) and the mixing-bowl rules).
- TR § 1.708-1(c)(3) determines the form of the merger.

UPREIT: Form of Merger

Assets Up

Public

OP Units

(2)

Properties

REIT

OP Units

(2)

Properties

A

B

(1)

Target LLC

(1)

Properties

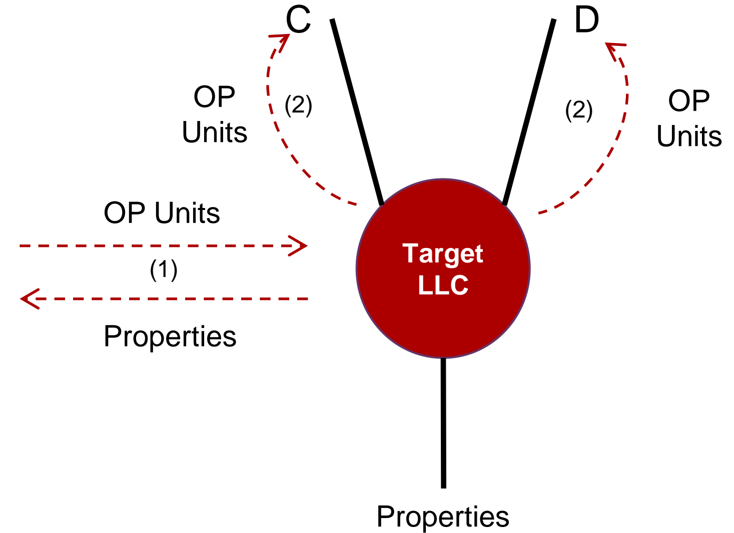
Properties

OP

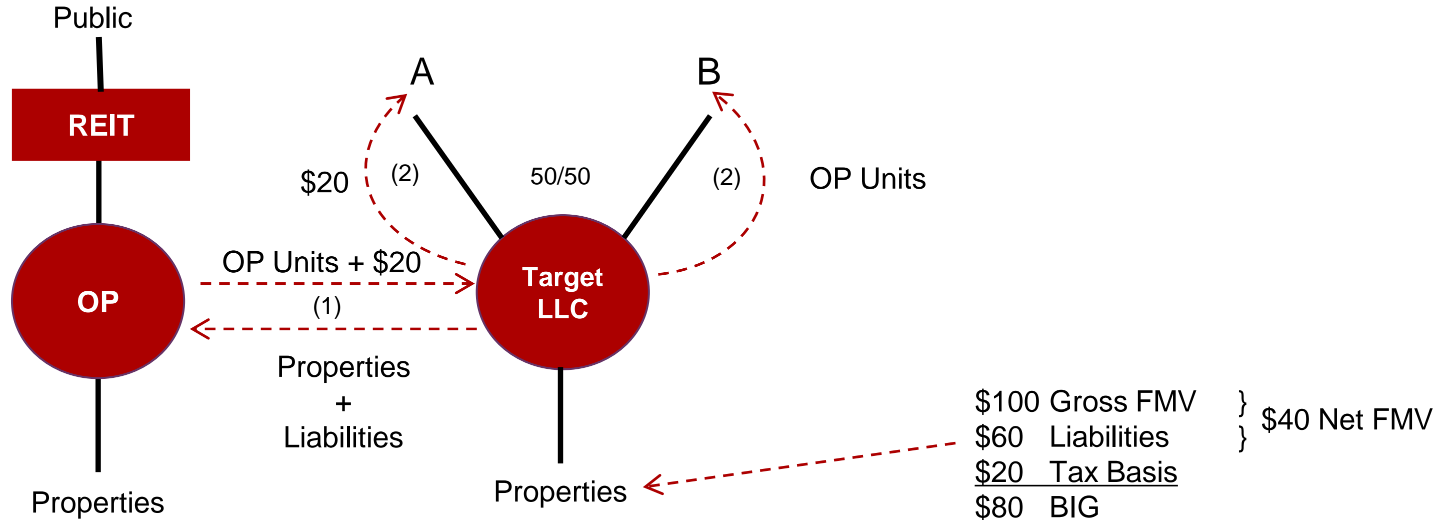
Properties

Properties

Assets Over



Simple UPREIT Contribution Example: Assets over Merger



- Cash causes Target LLC to recognize $40 [$80 BIG x 50%] of gain.
- Gain would be allocated $20 (50%) to A and $20 (50%) to B, even though B received no cash.
- B could recognize additional gain due to a reduction in liabilities (discussed later).

Simple UPREIT Contribution Example: Deemed Sale Election – TR § 1.708-1(c)(4)

Public

REIT

OP

$

(1)

LLC Interest

A

B

Target LLC

Properties

Public

REIT

OP

(2)

OP Units

B

(2)

Target LLC

(3)

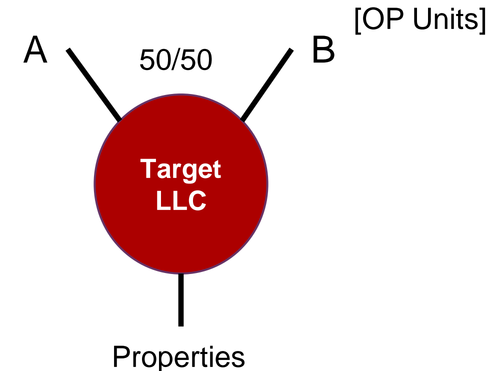
OP Units

Properties:
- 50% for OP Units
- 50% in Redemption of Target LLC Interest

- Avoids gain recognition to B because no cash is received by Target LLC.
- Deemed sale election must be made with A's consent given prior to or contemporaneous with the transaction.

Simple UPREIT Contribution Example: Gain from Deemed Cash Distributions

- Partnership liabilities are allocated to its partners.
- A reduction in a partner's share of partnership liabilities is treated as a cash distribution.
- B received OP units and expects tax deferral.
- Suppose B's share of OP liabilities is $5:
  - $30 Target LLC liabilities - $5 OP liabilities = $25 deemed cash distribution
  - $25 distribution - $10 tax basis = $15 gain recognition
- Treasury Regulations provide alternatives for debt allocations.
- B may be able to increase non-recourse debt allocation from OP (reducing its gain) with a more favorable alternative for non-recourse liabilities or by a guarantee of OP debt.
- If B also guaranteed $15 of OP debt, it would not recognize gain.



$100 Gross FMV
$60 Liabilities
$20 Tax Basis

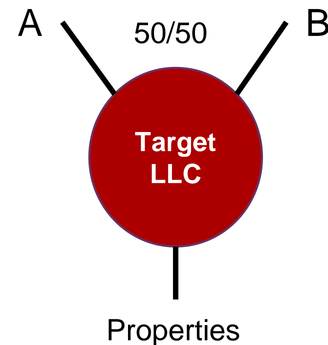
Assume A + B each have:
- $10 tax basis in LLC interest
- $30 share of LLC liabilities

Simple UPREIT Contribution Example: Other Ways to Recognize Gain on Contributions

- At-Risk Rules
  - Will recognize gain to extent of prior losses if negative amount at-risk.
  - Rules operate similar to tax basis rules, but there are differences.
- Disguised Sale Rules
  - A partnership's distribution of cash or other property to a partner within 2 years of a property contribution are presumed to be a sale of the property to the partnership.
  - A contrary position requires that the facts/circumstances "clearly establish" that the transfers do not constitute a sale, and requires tax return disclosure.
  - Applicable to deemed distributions of cash resulting from a reduction of liabilities other than "qualified liabilities," and in limited circumstances, a reduction of "qualified liabilities."
- Mixing-Bowl Rules – May apply if a partner contributed property to Target LLC in the prior 7 years.

Simple UPREIT Contribution Example: Sale of Contributed Property - § 704(c) Issues

- B received OP units and expects tax deferral.
- If OP sells the former Target LLC property, gain attributable to B's share of the $80 BIG ($40, subject to adjustments) is specially allocated back to B.
- B may be subject to substantial tax without a commensurate cash distribution.
- Any gain in excess of B's share of the BIG is generally allocated to all partners.



Simple UPREIT Contribution Example: Tax Matters Agreement

- Debt Allocation - May require OP to make a tax indemnity payment to contributing partner if OP fails to use agreed upon method of allocating non-recourse debt or to make OP liabilities available for guarantee.
- Sale Limit - May require OP to make a tax indemnity payment to contributing partner if OP sells contributed property in a taxable transaction.
- Allocations - May require the OP to make use of a particular 704(c) method (e.g., the “traditional method”) to account for the difference between the book (or contribution) value of the contributed property and its tax basis.
  - Issues potentially subject to heavy negotiation include:
  - Number of properties subject to the sale limit.
  - The duration of the sale limit and debt assurances.
  - Risk profile restrictions on the debt to be guaranteed.
  - The remedy for a violation of the restrictions:
    - Full tax obligation versus time value of money.
    - Gross up for tax on the indemnity payment.

UPREIT Contributions
Tax Deferred Receipt of Cash or REIT Shares

- A contributor's receipt of cash or REIT shares from the OP will generally be taxable, but there are limited exceptions allowing for the receipt of cash on a tax deferred basis.
  - CapEx - If the contributors have made capital expenditures with respect to the contributed property during the 2 years preceding the contribution date, the contributors may be permitted to receive cash from the OP on a tax-deferred basis to the extent of some or all of such capital expenditures.
  - Debt Financed Distribution - A cash distribution may be structured as a debt financed distribution (i.e., a distribution of the proceeds of a new loan made to the OP). Generally requires that the contributors guarantee such loan (among other requirements).
  - Loan - It may also be possible for the OP to loan cash to the contributors, secured by their OP units (and, most likely, recourse to the contributors).

UPREIT Contributions Conclusion

- A contribution of property to an OP may be an attractive alternative for property owners seeing to dispose of their property. It may allow the contributors to -
  - Diversify their investment, acquiring OP interests with common, preferred or other economic rights,
  - Obtain increased liquidity and transparency as to value, and
  - Receive a limited amount of cash or loan proceeds.
- The contributors in most cases should be able to accomplish the outcome described above on a tax efficient basis.
- Similar issues arise in the context of an UPREIT merger and acquisition transaction.

Can a REIT be a market leader with customary services?

Can a REIT be a market leader with customary services?

- Generally speaking, a REIT cannot be a market leader with customary services because a REIT's realization of impermissible tenant service income may cause a failure to meet the income tests, and significant uncertainties may exist with respect to the "customary" determination.
- However, a REIT may evaluate the potential effects of offering cutting-edge services on its ability to satisfy the income tests and follow strictly a set of pre-established procedures to prevent adverse effects, including the appropriate use of its taxable REIT subsidiary.

Why “Customary” Matters

- A REIT must derives 75% and 95% of its gross income (subject to certain adjustments) from statutorily defined sources, including rents from real property.
- Rents from real property are generally amounts received for the use of, or the right to use, real property and include charges (whether separately stated or not) for services customarily furnished in connection with the rental of real property.
- However, rents from real property do not include impermissible tenant service income (ITSI).
  - If ITSI exceeds 1% of gross amounts received from property, then ITSI includes all such amounts (i.e., all rents are tainted).
  - Impermissible tenant service income (ITSI) means with respect to any real or personal property, any amount received by a REIT (i) for services furnished or rendered by the REIT to tenants of the property, or (ii) for managing or operating the property.

Why "Customary" Matters (continued)

- ITSI exceptions
  - Unrelated business taxable income (UBTI) exception – REIT may directly perform services that are not primarily for the tenant's convenience <u>and</u> are usually or customarily rendered in connection with the rental of rooms or other space for occupancy only, e.g., furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, the collection of trash… [Different from geographic market determination]
  - Independent contractor (IK)/taxable REIT subsidiary (TRS) exception - Services or management provided through an IK from whom the REIT does not derive income, or through TRS are not considered furnished by the REIT.
    - The use of an IK for noncustomary services is subject to the separate charge requirement, i.e., the cost of the services must be borne by the IK; a separate charge must be made for the services and received and retained by the IK; and the IK must be adequately compensated for the services.

Why “Customary” Matters (continued)

- In summary, a REIT risks of failing the income tests, if
  - It realizes ITSI, which itself is nonqualifying income but could also taint property’s otherwise qualifying rents, because
    - It uses its employees or a nonqualifying IK for noncustomary services, or
    - It uses an IK for noncustomary services but keeps the separate charges.
  - It realizes too much income attributable to noncustomary services even if it uses its taxable REIT subsidiary.

Services – Customary Determination

- "Services furnished to the tenants of a particular building will be considered as customary if, in the geographic market in which the building is located, tenants in buildings which are of a similar class (such as luxury apartment buildings) are customarily provided with the service." [See § 1.856-4(b)(1)]

- Uncertainties exist with respect to the determination of "geographic market," "similar class," and "customarily provided".
  - Some questions – How is the geographic market defined? What are buildings of a similar class? How many such buildings must offer the service in question for it to be considered customary? What is the service? How about "the only property in town"?

Geographic Market

- Transfer pricing – section 1.482-1(d)(4)(ii)(A) - "any geographic area in which the economic conditions for the relevant product or service are substantially the same."
- GCM 39726 – for section 482 purposes – "an area in which sellers compete and around which there exist economic barriers that significantly impede the entry of new competitors" and "[t]he physical boundaries… cannot be precisely drawn at any given point in time."
- In Re/Max Int'l, Inc. v. Realty One, Inc. (an antitrust case), 173 F.3d 995, the Court of Appeals for the Sixth Circuit stated:
  - "Although [a geographic market or an area of effective competition] is not subject to definition by metes and bounds, it is the locale in which consumers of a product or service can turn for alternative sources of supply. Obviously, at the outer edges of a bona fide geographic market, buyers may be able to cross into other territory for their supply of a product or service; however, this fact alone does not require a rejection of the claimed market." [Citation omitted]

Use of Taxable REIT Subsidiary

- Congress enacted the TRS provisions to, among other things, provide tenant services to remain competitive "that might not be considered customary because they are relatively new or 'cutting-edge'," and "simplify such rental operations since uncertainty whether a particular service provided by a subsidiary is 'customary' will not affect the parent's qualification as a REIT."
- Rev. Rul. 2002-38 – a REIT pays its TRS to provide noncustomary housekeeping services to tenants. The REIT does not separately state charges to tenants for the services. Thus, a portion of the amounts received by the REIT from tenants represents an amount received for services provided by the TRS. TRS employees perform all of the services and TRS pays all of the costs of providing the services. The TRS also rents space from the REIT for carrying out its services to tenants.
  - The ruling held that the services provided to the REIT's tenants are considered to be rendered by the TRS, rather than the REIT. Accordingly, the services do not give rise to ITSI and do not cause any portion of the rents received by the REIT to fail to qualify as rents from real property.

Use of Taxable REIT Subsidiary (continued)

- Rev. Rul. 2002-38 stated "[a]ll relevant facts and circumstances must be considered in determining the provider of the services for [ITSI] purpose."
- Many REITs have their employees housed one place and shared among affiliates (i.e., TRS may have no employees of its own). Thus, the use of a TRS for tenant services typically involves issues, such as
  - Is TRS respected as a tax entity? Are employees performing activities on behalf of TRS or REIT? If REIT assigns rights and obligations to TRS to avoid separately-stated noncustomary service income, is such assignment effective?
  - Note – Rev. Rul. 2002-38 does not suggest that the TRS has entered into contracts with tenants for the housekeeping services.
  - Considerations - doctrines of corporate identity and anticipatory assignment of income. [Transfer pricing being discussed elsewhere.]

Doctrine of Corporate Identity

- In *Moline Properties v. Commissioner*, 319 U.S. 436 (1943), the U.S. Supreme Court discussed:
  - "Whether the purpose be to gain an advantage under the law of the state of incorporation… or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity."
- *National Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949) - "when a corporation carries on business activity the fact that the owner retains direction of its affairs down to the minutest detail, provides all of its assets and takes all of its profits can make no difference tax-wise."
- In short, it does not take much for TRS to be respected as a tax entity.

Anticipatory Assignment of Income Doctrine

- The U.S. Supreme Court in *Lucas v. Earl*, 281 U.S. 111 (1930), stated:
  - "There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute…"
- In *Iowa Bridge Co. v. Commissioner*, 39 F.2d 777 (8th Cir. 1930), the taxpayer, a corporation, entered into certain contracts for the construction of certain bridges. Subsequently, the taxpayer's stockholders adopted a resolution selling, assigning, and transferring to the corporation's president, who was also the major stockholder of the taxpayer, certain contracts and parts of the bridge contracts for which the work had not been completed. Then, all correspondence relative to the bridge construction and the performance of the contract work conducted in and under the president's trade-name. No formal notice of assignment was given to the surety companies nor customers of the contracts.

Anticipatory Assignment of Income Doctrine (continued)

- *Iowa Bridge Co.* – The court reasoned:
  - “Unless expressly prohibited by statute, all ordinary business contracts, which are not necessarily personal in character, are assignable… There was nothing in the nature of these contracts which required the personal services of either of the contracting parties, and it appears from the stipulation that contracts of this character were frequently sublet... There was clearly a novation. The contracts were performed by the assignee and the performance thereof was accepted by the contracting parties.”
- The court rejected the decision of the Board of Tax Appeals that contracting profits were the profits of Iowa Bridge Company.

Anticipatory Assignment of Income Doctrine (continued)

- In *Alan M. Mantell, Executor v. Commissioner*, T.C. Memo. 1993-420, the taxpayer entered into an agreement to receive a fee for his involvement with a development project, including raising capital, supervising the collection of sums due to the project from the investors, and an operating deficit guarantee. Subsequently, the taxpayer formed A. Mantell, Inc. and assigned the agreement to A. Mantell, Inc., including obligations and rights to income. The taxpayer informed the project coordinator orally of the assignment of the obligations but never received a release from these obligations. To perform its obligation under the assumption agreement, A. Mantell, Inc., on its own letterhead, wrote letters to the investors who were in default to obtain collection of the funds, monitored the collection process in general, and regularly corresponded with the investors on every payment date. The Tax Court discussed:
  - "… the principles of *Lucas v. Earl*, supra, are not applicable where the income is derived from the assumption of a fully assignable bilateral contract obligation to be performed by the assignee, is not for personal services, did not represent fees for income earned prior to assignment, and was accrued by a corporation that served a legitimate business purpose…"

Anticipatory Assignment of Income Doctrine (continued)

- To avoid ITSI, it is imperative that the TRS be respected as the provider of the services (e.g., with available resources to furnish the services and corporate formality being followed).
  - Define in a TRS Service Agreement the specific services to be furnished before such services being actually rendered to service recipients
  - Make resources available to the TRS via employee sharing agreement, lease or ownership of property required for the services, contract with 3rd– party service providers, etc.
  - Maintain books and records consistent with the TRS Service Agreement (including employee costs)

REIT Investments in Non-Controlled Partnerships

REIT Investments in Partnerships

- REIT Qualification Requirements - To qualify as a REIT, a corporation must meet a number of asset and income tests, and distribution requirements.
- Partnership Look-Through - TR § 1.856-3(g) provides that if a REIT is a partner in a partnership -
  - The REIT will be deemed to own its proportionate share of each of the assets of the partnership, and
  - The REIT will be deemed to be entitled to the income of the partnership attributable to such share.
- Monitoring - As a result, a REIT must monitor the assets and income of a partnership* in which it invests to the same extent as its own assets and income.

* References to a partnership include an LLC that is taxed as a partnership.

Control of the Partnership

- No-Control - If a REIT does not, or may not always, control the partnership (e.g., as general partner*), it needs the partnership agreement to restrict the partnership's activities to REIT-acceptable activities.
- Control - Even if a REIT does control the partnership, it is good practice to include a similar provision (although perhaps less specific), so that it's clear the REIT may use its power to control the partnership in a REIT acceptable fashion, even if it's contrary to the interests of its non-REIT partners.
- LP Duties - Unless the partnership agreement states otherwise, a general partner may owe default fiduciary duties (loyalty, care) to limited partners.

* Or managing member of an LLC

REIT Compliance Issues: REIT Income Tests

- General Limitation
  - The partnership should produce income that will qualify under REIT income tests.
  - Depending on the business of the partnership, the agreement could require that at least 95% of the partnership's income be "rents from real property" to the REIT partner, or otherwise be qualifying income.
- More Specific Rent Limitations -
  - Rent not based on income or profits.
  - Tenant Services
    - Not permitted to the extent they produce impermissible tenant service income (ITSI), or possibly more than 1% ITSI with respect to any property.
    - Must be customary in the geographic area, unless provided by a taxable REIT subsidiary (TRS).
    - Must not be primarily for the convenience of the tenants, unless provided by an independent contractor (IK) from whom the REIT derives no income or a TRS.
  - Personal property - Limited to 15% of the leased property.
  - No related party tenants with respect to the REIT partner.

REIT Compliance Issues:
REIT Income Tests – Service Issues

- Service Issues - Suppose the REIT's partner wants the partnership to provide non-customary services to tenants.
  - Use of TRS - Partnership could form a subsidiary TRS to provide such services, but the REIT's partner may not like the tax cost associated with using a TRS.
  - Use of Services Partnership - REIT and its partner could form a second partnership (the service partnership) to provide the services.
    - REIT partner could participate through a TRS
    - Rev. Rul. 2003-86 concludes that the use of this structure to provide non-customary services will not cause rent to fail to qualify as "rents from real property" where –
      - JV partner participates through a corporation which is an IK from whom REIT derives no income; and
      - The tenants separately contract with the service partnership for the provision of services.

REIT Compliance Issues: Asset Tests

- REIT Asset Tests
  - General Limitation
    - The partnership should own assets that will qualify under REIT asset tests.
    - Depending on the business of the partnership, these tests could require that at least 75% of the partnership's assets be real estate assets, cash or ordinary course receivables.
  - More Specific Asset Test Limitations –
    - Equity - No equity interests in other entities, except
      - Interests in disregarded entity subsidiaries or partnerships, in each case which are subject to the same REIT restrictions.
      - Money market investments.
    - Loans - No loans, or possibly no loans other than loans adequately secured by real property.

REIT Compliance Issues: Distribution Requirements and Information Rights

- REIT Distribution Requirements
  - Annual Distributions - Require partnership to make annual distributions so that the REIT partner's share of such distributions is at least equal to the REIT partner's allocable share of taxable income from the partnership.
- Information Rights
  - The agreement should provide the REIT partner with the right to obtain information from the partnership which will allow the REIT partner to monitor its qualification and taxation as a REIT.

Prohibited Transactions Tax Issues

- Prohibited Transactions Tax - 100% on dealer sales.
- Partnership Look Through - TR § 1.856-3(g) provides that if a REIT is a partner in a partnership that holds property primarily for sale to customers in the ordinary course of its trade or business, then the REIT will be treated as holding its proportionate share of such property primarily for the same purpose.
- Type of Sale - Prohibited transactions tax issues could arise because the partnership sells its property, or because the REIT sells its interest in the partnership (including pursuant to a buy-sell arrangement between partners).
- Limitation
  - Ideally, require that any partnership property sales, or triggering of the buy-sell arrangement, must satisfy the prohibited transactions tax safe-harbor with respect to the REIT partner.
  - Not always possible to include this provision, in which case the REIT partner may need to be the buyer, not the seller.

Buy – Sell Arrangements

- Pricing - Need to make sure pricing is fair, and that the non-REIT partner may not manipulate the pricing mechanics.
  - Typical Buy-Sell - Assume on a deadlock (or other events), a partner (the electing partner) may set a value for the partnership, and the other partner (the responding partner) may elect to either sell its partnership interest to the electing partner, or buy the electing partner's partnership interest, in each case, based on the value set by the electing partner.
  - Manipulation - If the responding partner is the REIT, and the electing partner is aware the REIT does not want to be a seller (e.g., due to prohibited transactions tax issues), the electing partner may set an unreasonably high price, expecting to be a seller.
  - Appraisal - Use of an appraisal mechanism to determine value of the partnership may be preferable, to avoid this risk.

Buy – Sell Arrangements

- Single Tax Basis - Under Rev. Rul. 84-53, a partner only has one tax basis in its partnership interest, even if portions of its partnership interest were acquired at different times and prices.
- Separate Entity - If the REIT partner may resell the acquired interest (e.g., it bought because it was concerned about prohibited transaction issues, or because it thought the price was favorable), the REIT may want to purchase the interest through a separate entity to preserve the higher tax basis in that partnership interest.
- TRS - If the REIT expects to promptly resell the interest, it may want to purchase the interest through a TRS to eliminate the risk of a prohibited transactions tax on the sale of the interest.

Single Property Issues

- Example –
  - The partnership owns many properties, but only one will be sold.
  - The REIT is concerned about gain recognition or prohibited transactions tax issues, so it elects to purchase the property.
- Purchase from Partnership - If REIT buys the property from the partnership, a portion of the gain on sale would be allocated back to the REIT, and could still raise prohibited transaction issues, or at least increase the REIT's income and distribution requirement.
- Alternative
  - The agreement could provide that the property (or interests in the LLC that owns the property) will be distributed to the partners, and the REIT will purchase the other partner's interest in the property (or such LLC).
  - This should avoid the recognition of gain with respect to the REIT's share of the property.

REIT Status Catch-All

- **Traps** – There may be situations that were not anticipated, but which could adversely affect REIT status.
- **Example** – Partnership invests in securities of an issuer which also issued debt to the REIT, intended to qualify as straight-debt.
  - REIT's deemed ownership of the partnership's securities could cause the REIT's debt to fail the straight-debt safe-harbor. § 856(m)(2)(C).
- **Example** – Partnership derives income from a party which is an IK of the REIT, and from whom the REIT may derive no income.
  - Could taint the rental income at the REIT properties where the independent contractor provides services. § 856(d)(7)(C)(i).
- **Catch-All** - The partnership agreement could provide that the partnership is not permitted to take any other action which could jeopardize the REIT's qualification as such.
  - May require written notice from the REIT partner.
  - Due to its potentially broad application, REIT may need to offer an indemnity to its partner for any losses arising from the use of this provision.

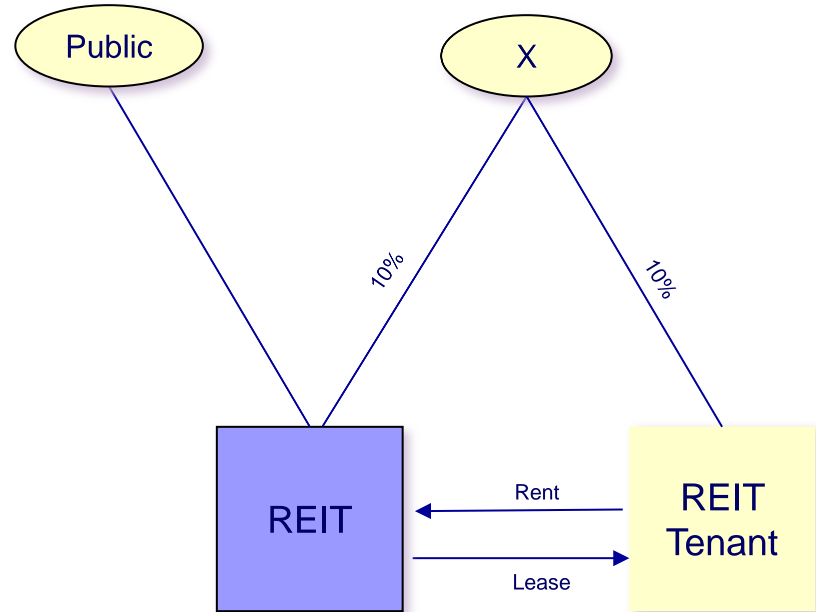
Charter Restrictions

Why Charter Restrictions?

- to facilitate compliance with Five or Fewer rule
- to facilitate compliance with 100 shareholder rule
- to minimize risk of related party rent
- to qualify foreign holders for FIRPTA relief under "domestically controlled" exception
- to minimize risk of UBTI to pension fund shareholders

Most REITs Prohibit Stock Ownership in Excess of 9.8%

- prevents violations of Five or Fewer rule
  - 9.8% x 5 < 50%
- avoids related party rent
  - related party rent does not qualify as “rents from real property” to a REIT
  - if a REIT owns 10% or more of the stock of a tenant, the rent from such tenant is related party rent
  - a REIT is deemed to own stock of any tenant held by a 10% or greater shareholder



Not Rent from Real Property!

What Happens to the “Excess Shares”?

- share ownership in excess of 9.8% triggers “excess share” provisions of charter
- under most REIT charters, the excess shares are transferred to a trust
  - REIT appoints a charity as the trust beneficiary
  - no voting rights or dividends to offending shareholder
- trustee sells shares on the market and retains any profits
  - offending shareholder receives lesser of original purchase price or sales proceeds

Charter Amendment vs Poison Pills

- Although most REITs impose these restrictions by charter, some adopt shareholder rights plans (i.e, a poison pill).
- Unlike most charter restrictions, a shareholder rights plan does not void, nullify or deny economic rights to the transferred shares; it penalizes the violator by economic dilution.
- A REIT with a shareholder rights plan must rely on *the in terrorem* effect of the pill to avoid violations of REIT ownership limitations.

Impact on REIT				
	Shareholder Approval?	**Quick to Implement?**	**Tax Impact on REIT if Violated**	**Enforceable?**
Charter Amendment	Yes	No (in most cases)	Excess share purchase treated as if it never occurred	Not against shareholders who voted against amendment
Poison Pill	No	Yes	•Related party rent? •Five or fewer? •100 shareholder? •Domestically-controlled?	Generally enforceable for future stock acquisitions; existing shareholders usually grandfathered