

**REIT**

**Wise<sup>®</sup> 2017**

NAREIT's Law, Accounting & Finance Conference

March 22 – 24, 2017

**REIT Tax Big Brains Conversation**



# Presenters

- ◆ Moderator:

- ◆ Scott Winer, SVP-Tax, Park Hotels & Resorts

- ◆ Panelists:

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# Agenda

- ◆ Subsidiary REITs
- ◆ Constructive Ownership and Related Party Rents
- ◆ Intangible Assets

# Reasons for Forming Subsidiary REITs

- ◆ Tax-exempt entities may wish to own real estate through a REIT, since dividend income generally does not constitute UBTI.
- ◆ Non-U.S. persons may invest in U.S. real estate through a “domestically controlled” REIT to minimize U.S. income taxes on operating income and, possibly, upon the sale of the property.
  - ◆ PATH Act legislation provides additional flexibility.
- ◆ An UPREIT engaging in a TMP securitization may form a subsidiary REIT so the TMP will be treated as a QRS.

# Impact on Public Parent REIT

- ◆ A subsidiary REIT's failure to qualify as a REIT can adversely affect its public parent's REIT status.
  - ◆ Interests in the subsidiary would be subject to the 5%, 10% and 25% Asset Tests.
  - ◆ Dividends would no longer be qualifying income for purposes of the 75% income test.

# Board Management

- ◆ Who qualifies as a “director” or “trustee” of a non-corporate REIT for purposes of Section 856(a)(1)?
  - ◆ Manager of an LLC or GP of a partnership?
  - ◆ What types of rights and obligations are required?
- ◆ Consider timing of deemed election under Treas. Reg. Section 301.7701-3(c)(1)(v)(B) or as a result of filing of IRS Form 8832.

# 100 Shareholders

- ◆ A REIT is required to have 100 shareholders at least 335 days in a taxable year (or a proportionate part of the taxable year).
  - ◆ This requirement does not need to be met for the first taxable year.
  - ◆ Consider putting stockholders in place in the first year if the REIT may be sold or liquidated in the second year.
- ◆ One needs to be comfortable that the shareholders will be respected as such.
- ◆ Preferential dividend rules still applicable
  - ◆ Make sure the terms of each class of stock will not raise preferential dividend issues in practice.
- ◆ Consider whether the issuance of a second class of stock to satisfy the requirement will affect the taxation of the contribution of appreciated property.

# Corporate Formalities and Cash Management

- ◆ Steps should be taken so that the separateness of a subsidiary REIT will be respected.
- ◆ The subsidiary REIT should enter into agreements on its own account.
- ◆ Cash Management
  - ◆ Bank accounts should be maintained at subsidiary REIT.
  - ◆ Cash from preferred issuance should be deposited into subsidiary REIT.
  - ◆ Cash management between the subsidiary REIT and other entities should be carefully documented.



# Dividend Payments

- ◆ Preferential dividend rules still apply to subsidiary REITs
  - ◆ Preferred dividends must be declared and paid on time.
  - ◆ If more than one common holder, each common holder should receive payment at same time.
- ◆ Beware certain state DPD statutes
  - ◆ Some states disallow a state-level DPD for “captive” REITs
    - Trap for the unwary in the case of purchase of single asset REIT followed by liquidation
- ◆ Consider impact of distributions from subsidiary REITs to the shareholders of a parent REIT

# Transferability of Shares

- ◆ Best Practice: no restrictions, but may not be realistic from business perspective.
  
- ◆ Other Options:
  - ◆ Shareholders' Agreement to which REIT is not a party
    - ◆ Transfer of shares with consent of non-transferring shareholders, not to be unreasonably withheld.
    - ◆ ROFO/ROFR
  - ◆ Restrictions on transfer at partnership level above the REIT
    - ◆ Partnership remains free to transfer shares in the REIT

# Contribution of Property

- ◆ 368(c) control: ensure parent owns 80% of each class of stock, including preferred.
- ◆ Beware potential “busted” 351 in connection with actual or deemed contribution.
  - ◆ Contribution by one party to REIT, followed by sale of shares sufficient to break control to another party
    - ◆ Step transaction: binding commitment; end result; interdependence.
  - ◆ Contributions of non-identical assets may result in diversification.

# Mechanics and Tax Consequences of Liquidating

- ◆ Redeem preferred shares
  - ◆ Beware proportionate 100 shareholders rule for short year
    - ◆ Redeem preferred shares close in time to liquidation
  
- ◆ Mechanics
  - ◆ “uncheck” the box (if possible)
  - ◆ Otherwise, merge entity with and into OP or another disregarded sub
  
- ◆ Liquidation treated as sale/exchange from shareholder (OP or Parent REIT) perspective
  - ◆ Gain to shareholder measured by difference between basis in REIT stock and FMV of assets received.

# Mechanics and Tax Consequences of Liquidating *(con't)*

- ◆ Liquidation triggers gain at lower-tier REIT in the amount of the difference between FMV of assets and tax basis of assets.
  
- ◆ REIT gets DPD for distribution of assets
  - ◆ Ensure DPD is sufficient to eliminate gain plus any remaining taxable income for REIT's final year
    - ◆ Consent dividend to eliminate remaining income if necessary
  - ◆ Beware state statutes that can disallow DPD at state level for “captive” REITs
    - ◆ This trap for the unwary can result in taxable gain at the state level

# Constructive Ownership of Stock

- ◆ For purposes of determining whether rents may be excluded from “rents from real property” under the related party exclusion in § 856(d)(2)(B); and
- ◆ For purposes of determining whether a person may qualify as an “independent contractor” as defined in § 856(d)(3), or an “eligible independent contractor “ § 856(d)(9),
- ◆ The rules prescribed in § 318(a) for determining ownership of stock shall apply in determining the ownership of stock, assets or net profits of any person with certain modifications.

# Constructive Ownership of Stock *(con't)*

- ◆ § 856(d)(5) modifies § 318(a) for these purposes to lower the 50% threshold to 10% increasing possible upward and downward attribution and modifies attribution from a partner to a partnership by taking into account only partners who own (directly or indirectly) 25% or more of the capital interest or the profits interest in the partnership
- ◆ The constructive ownership rules may apply in the case of a TRS held by a REIT as there is no exception from § 318(a) attribution from or to a TRS
- ◆ The constructive ownership rules of § 318(a) provide for attribution to and from family member and to and from entities and for certain operating rules in applying the attribution rules, such as

# Constructive Ownership of Stock *(con't)*

- ◆ Stock constructively and owned by a person due to attribution to the person shall be considered as actually owned by such person
- ◆ *Accordingly, there can be Re-attribution except as limited by other operating rules*
- ◆ Stock constructively owned by a partnership, estate, trust, or corporation by reason of attribution to such entity (downward attribution) shall not be considered as owned by such entity for purpose of attributing upward such stock in order to make another the constructive owner of such stock



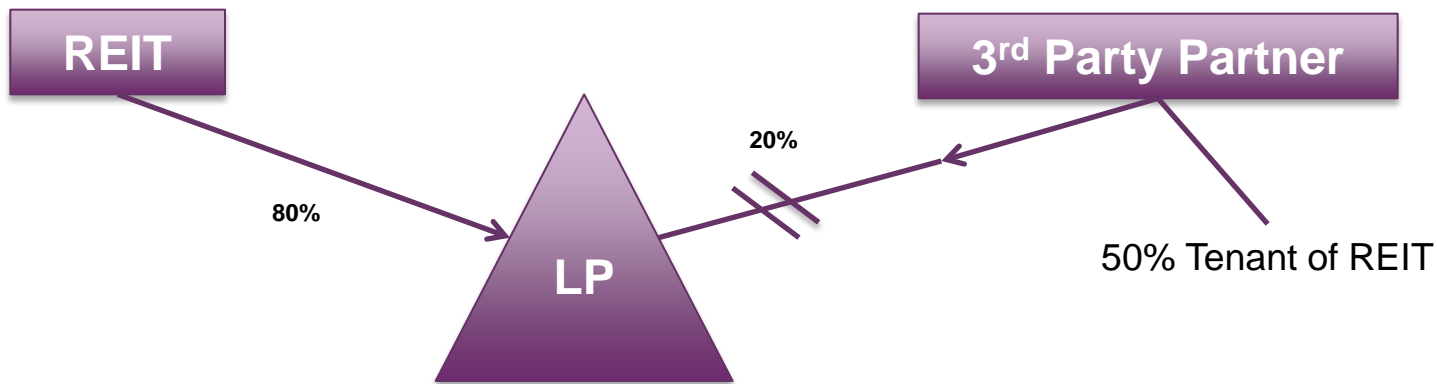
# Constructive Ownership of Stock *(con't)*

- ◆ *Accordingly, stock attributed by a partner to a partnership will not be attributed upward to another partner of the partnership; however, the operating rule does not preclude downward attribution*
- ◆ If any person has an option to acquire stock, such stock shall be considered as owned by such person.
- ◆ Consider Rev. Rul. 74-605

# Safeguards and Best Practices

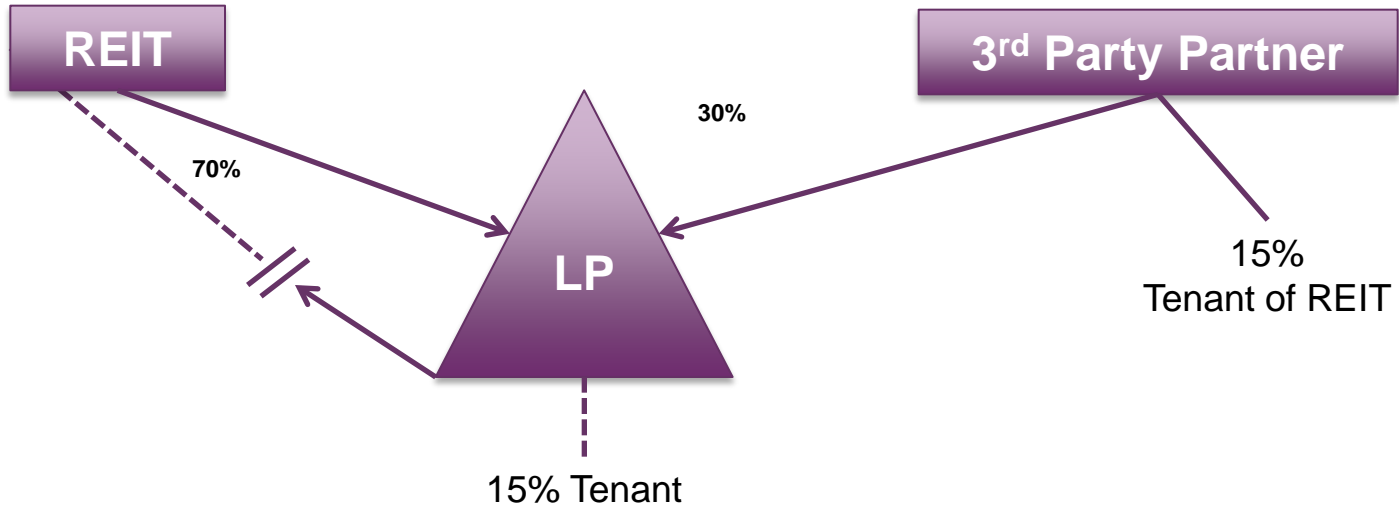
- ◆ Excess Share provisions in Articles
- ◆ Waivers of ownership limitations in the Articles need a mechanism to protect against related party rents
- ◆ REIT protective provisions in joint venture agreements and partnership agreements
- ◆ Limitation on the effectiveness of such safeguards in complex structures

# § 318(a)(3)(A) as modified by § 856(d)(5)(B)



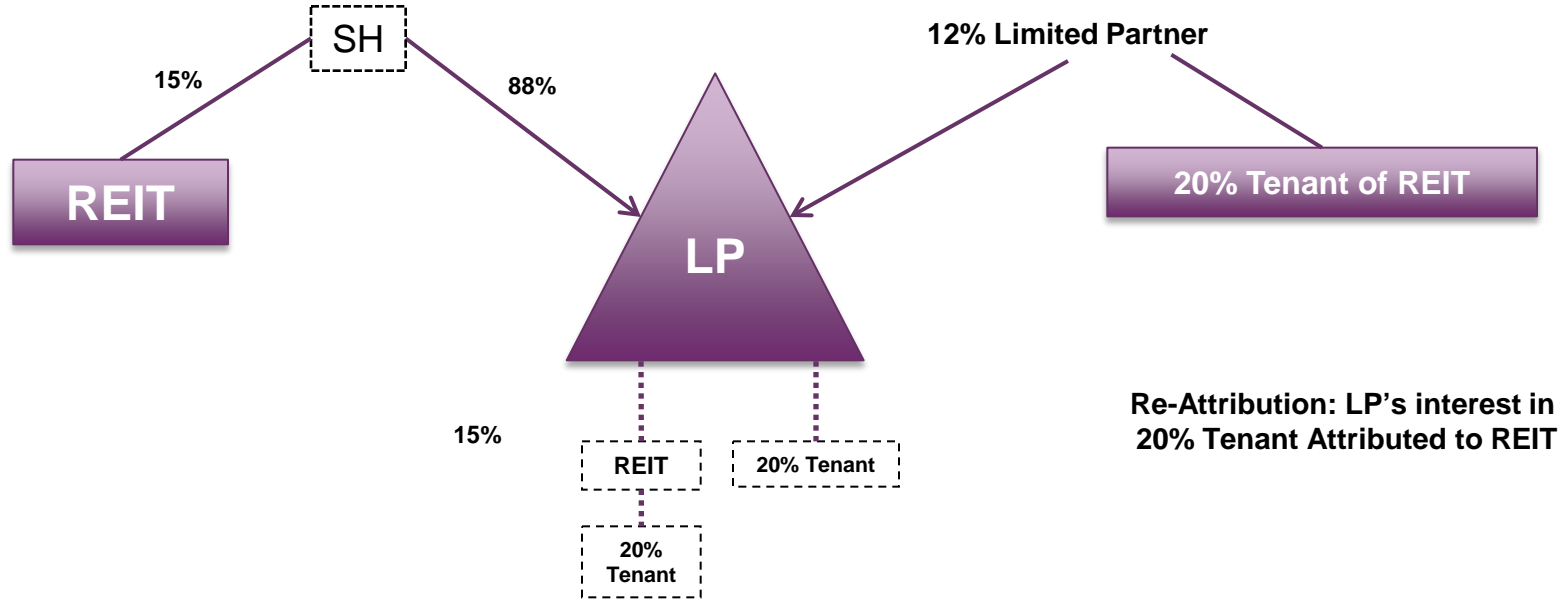
No attribution of Tenant to LP as 3<sup>rd</sup> Party Partner owns less than a 25% interest in the LP

## § 318(a)(5)(C) -- Operating Rule



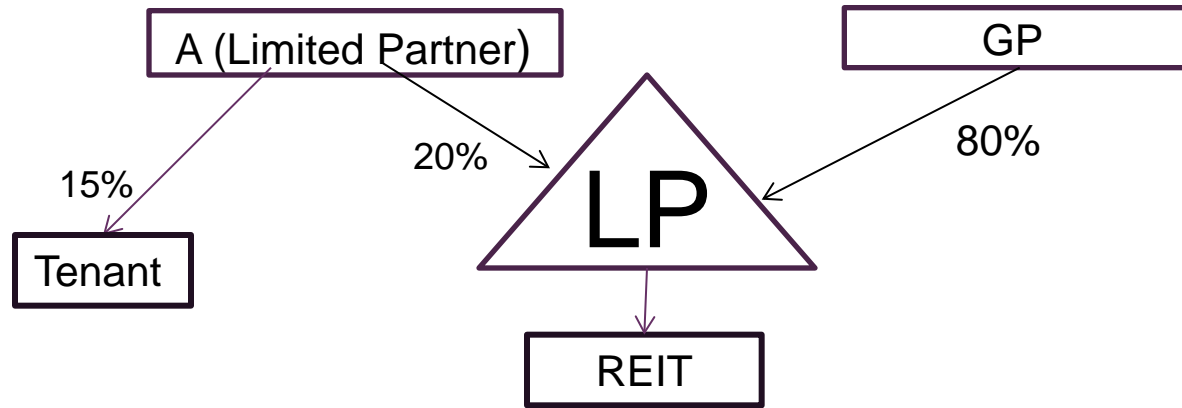
Through attribution of the 15% Tenant to LP, there is no further upward attribution to REIT due to § 318 operating rule.

## Re-Attribution Prior to 1997 – Impetus for § 856 (d)(5)(B)

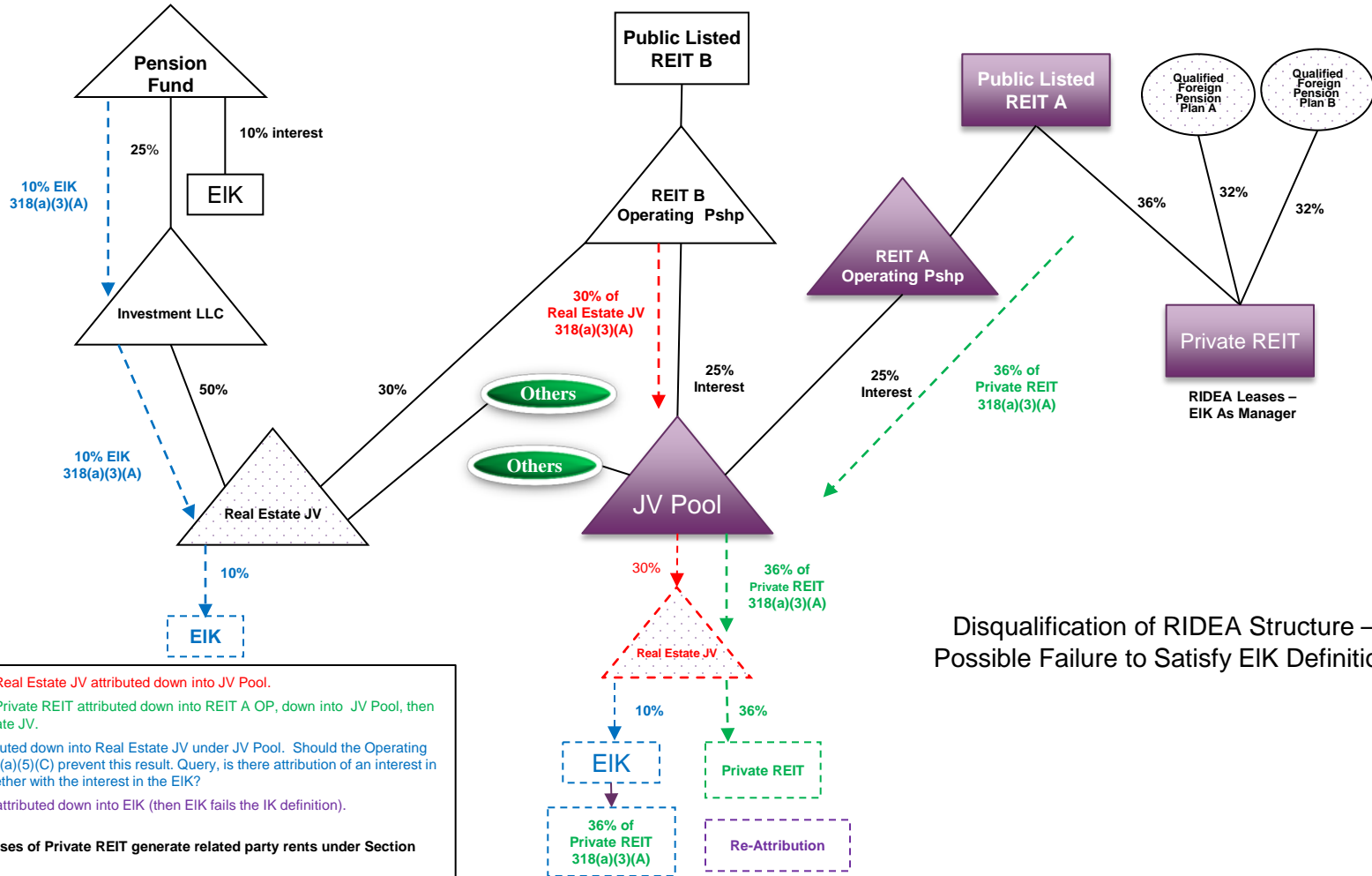


Post 1977 – There would be no attribution to the LP due to the 25% gate (§ 318(a)(3)(A) as modified by § 856(d)(5)(B)).

However, if the limited partner held a 25% interest in the LP, then Re-attribution would apply. The operating rule of § 318(a)(5)(C) does not protect against downward attribution.



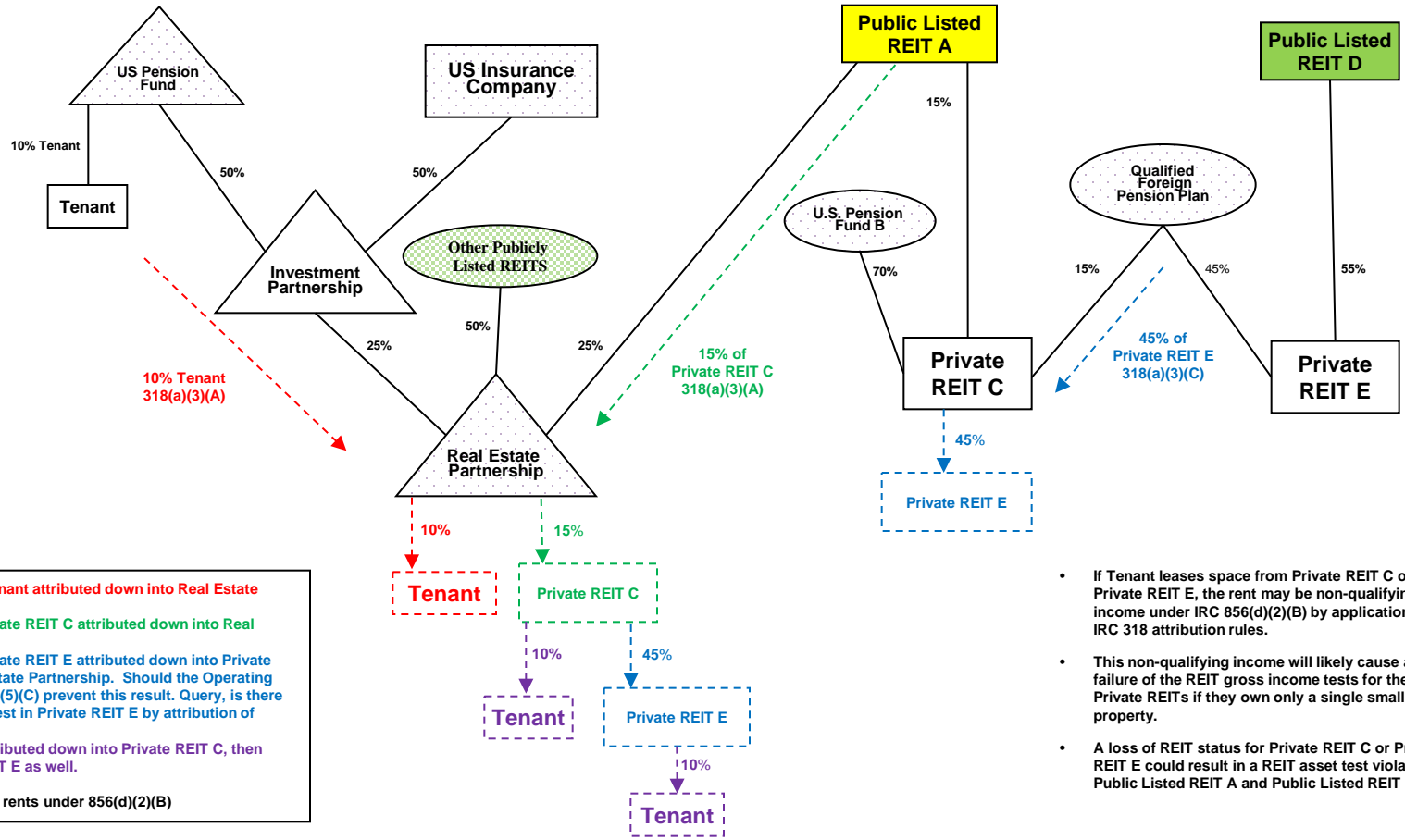
- JCT Explanation (Example): 1997 Modification providing for the 25% gate:
- "Thus, a REIT and a tenant will not be treated as related (and, therefore, rents paid by the tenant to the REIT will not be treated as nonqualifying rents) if the REIT's shares are owned by a partnership and a partner owning a directly and indirectly less-than-25-percent interest in that partnership also owns an interest in the tenant."
- However, if the shares of the REIT held by the LP are attributed to A, and if the shares held by A in the tenant are attributed to the REIT, then the rent paid by the tenant will be treated as non-qualifying rents. This separate attribution path disqualifies the tenant even though A owns less than 25% of LP.



1. 30% interest in Real Estate JV attributed down into JV Pool.
  2. 30% interest in Private REIT attributed down into REIT A OP, down into JV Pool, then down into Real Estate JV.
  3. EIK (10%) attributed down into Real Estate JV under JV Pool. Should the Operating Rule in Section 318(a)(5)(C) prevent this result. Query, is there attribution of an interest in Real Estate JV together with the interest in the EIK?
  4. If Private REIT attributed down into EIK (then EIK fails the IK definition).
- Result:** RIDEA leases of Private REIT generate related party rents under Section 856(d)(2)(B).

Disqualification of RIDEA Structure – Possible Failure to Satisfy EIK Definition

# Related Party Rents (1)

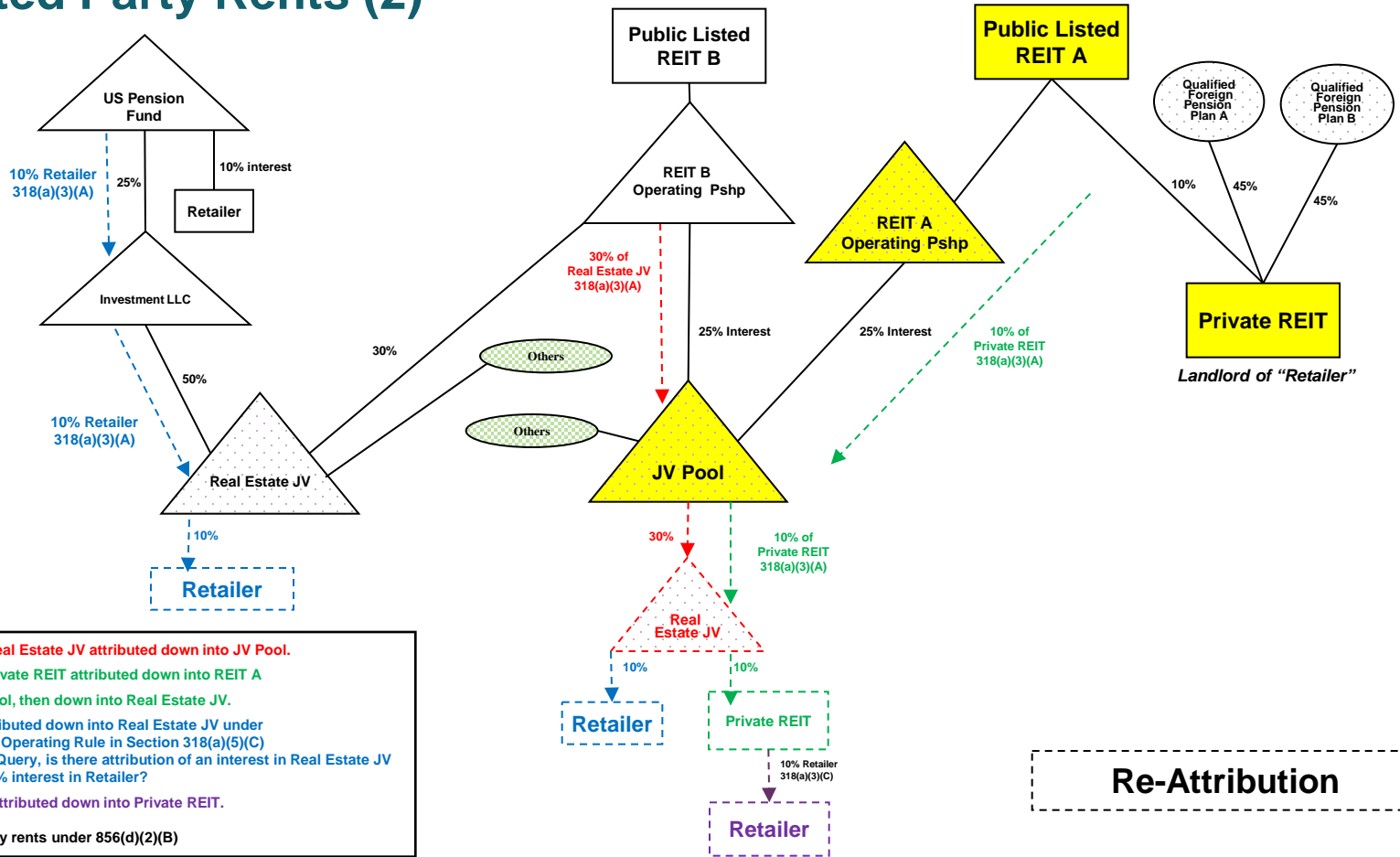


1. >10% interest in Tenant attributed down into Real Estate Partnership.  
 2. 15% interest in Private REIT C attributed down into Real Estate Partnership.  
 3. 45% interest in Private REIT E attributed down into Private REIT C under Real Estate Partnership. Should the Operating Rule in Section 318(a)(5)(C) prevent this result. Query, is there attribution of an interest in Private REIT E by attribution of Private REIT C?  
 4. If Tenant (10%) attributed down into Private REIT C, then down into Private REIT E as well.  
**Result:** Related party rents under 856(d)(2)(B)

- If Tenant leases space from Private REIT C or Private REIT E, the rent may be non-qualifying income under IRC 856(d)(2)(B) by application of the IRC 318 attribution rules.
- This non-qualifying income will likely cause a failure of the REIT gross income tests for the Private REITs if they own only a single small property.
- A loss of REIT status for Private REIT C or Private REIT E could result in a REIT asset test violation for Public Listed REIT A and Public Listed REIT D.



# Related Party Rents (2)



1. 30% interest in Real Estate JV attributed down into JV Pool.
  2. 10% interest in Private REIT attributed down into REIT A OP, down into JV Pool, then down into Real Estate JV.
  3. Retailer (10%) attributed down into Real Estate JV under JV Pool. Should the Operating Rule in Section 318(a)(5)(C) prevent this result. Query, is there attribution of an interest in Real Estate JV together with the 10% interest in Retailer?
  4. Is Retailer (10%) attributed down into Private REIT.
- Result:** Related party rents under 856(d)(2)(B)

Re-Attribution

# Revenue Ruling 74-605

(Deals with an upstream stock sale and the inapplicability of § 304(a))

Reg. § 1.318-1(b)(1) provides that a corporation will not be considered to own its own stock by reason of § 1.318(a)(3)(C) (attribution from its shareholders)

Corp X  
(U.S.)

100%

Corp Y  
(U.S.)

100%

Corp Z  
(U.S.)

100%

Corp S  
(U.S.)

Applying 318(a), X would be treated as owning Z and Z would be treated as owning Y, and Z would be treated as owning the stock owned by Y, which would include its own stock but for the operation of Reg. § 1.318-1(b)(1)

## Appendix

### Pertinent Provisions of IRC § 318(a), as Modified

For purposes of determining whether a person is a related tenant or an independent contractor, the rules prescribed in section 318(a) apply, with specific modifications, to determine the ownership of the stock, assets, or net profits of any person. As modified,

- ◆ Section 318(a)(2)(A) provides that stock, assets, and net profits interests owned by a partnership are considered to be owned proportionately by its partners.
- ◆ Section 318(a)(3)(A) provides that stock, assets, and net profits interests owned by a partner that owns (directly or indirectly) a 25-percent-or-more interest in the capital of profits of a partnership are considered to be owned by the partnership.
- ◆ Section 318(a)(2)(C) provides that if 10 percent or more in value of the stock in a corporation is owned, directly or indirectly, by any person, such person is considered as owning the stock, assets, and net profits interests owned by that corporation in the proportion that the value of the stock that the person owns bears to the value of all the stock of the corporation.

## Pertinent Provisions of IRC § 318(a), as Modified *(cont'd)*

- ◆ Section 318(a)(3)(C) provides that if 10 percent or more in value of the stock of a corporation is owned, directly or indirectly, by any person, the corporation is treated as owning the stock, assets, and net profits interests owned by that person.
- ◆ Under section 318(a)(5)(A), stock owned constructively owned by a person due to the application of the 318(a) of the Section Rules shall for purposes of such Rules be treated as owned by such person (except as provided in sections 318(a)(5)(B) and (C)).
- ◆ Under section 318(a)(5)(C), stock, assets, and net profits interests constructively owned by a partnership or corporation pursuant to section 318(a)(3) will not be considered as owned by the partnership or corporation for purposes of applying section 318(a)(2) to make another person the constructive owner of the stock, assets, or net profits interests.

# Intangible – Above Market Leases

## **General Rule Under Treas. Reg. § 1.856-10(f)(1):**

To the extent that an intangible asset, including an intangible asset established under generally accepted accounting principles (GAAP) as a result of an acquisition of real property or an interest in real property, derives its value from real property or an interest in real property, is inseparable from that real property or interest in real property, and does not produce or contribute to the production of income other than consideration for the use or occupancy of space, the intangible asset is real property or an interest in real property.

# Intangible Assets – Requirements

## Three Requirements for Treating an Intangible Asset as an Interest in Real Property:

- The intangible asset derives its value from real property or an interest in real property
- The intangible asset is inseparable from real property or an interest in real property
- The intangible asset does not produce or contribute to the production of income other than consideration for the use or occupancy of space

# Above Market Lease – Example

## ◆ Example 11 under Treas. Reg. § 1.856-10(g)

REIT K acquires an office building from an unrelated third party subject to a long-term lease with a single tenant under which the tenant pays above-market rents. The above-market lease is an intangible asset under GAAP. Seventy percent of the value of the above-market lease asset is attributable to income from the long-term lease that qualifies as rents from real property, as defined in section 856(d)(1). The remaining thirty percent of the value of the above-market lease asset is attributable to income from the long-term lease that does not qualify as rents from real property. The portion of the value of the above-market lease asset that is attributable to rents from real property (here, seventy percent) derives its value from real property, is inseparable from that real property, does not produce or contribute to the production of income other than consideration for the use or occupancy of space, and, therefore, is an interest in real property under section 856(c)(5)(C) and a real estate asset under section 856(c)(5)(B). The remaining portion of the above-market lease asset does not derive its value from real property and, therefore, is not a real estate asset.