

Concurrent Session: REIT Tax Primer

Thursday, March 23rd

1:45pm – 3pm

La Quinta Resort & Club, La Quinta, California

Moderator:

Lary Wolf, Partner, Roberts & Holland LLP

Panelists:

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REIT

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NAREIT's Law, Accounting & Finance Conference

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REIT Tax Primer



Panel

◆ Moderator

- ◆ Lary S. Wolf, ROBERTS & HOLLAND LLP

◆ Panelists

- ◆ Kenneth Betts, WINSTON & STRAWN LLP
- ◆ Wendi L. Kotzen, BALLARD SPAHR LLP
- ◆ Ameeek Ashok Ponda, SULLIVAN & WORCESTER LLP
- ◆ Agnes Webb, EDUCATION REALTY TRUST, INC. (EDR)

What is a REIT?

- ◆ A REIT is a form of real estate ownership, sometimes called a "mutual fund for real estate." Essentially, investors pool money to purchase real estate together.
- ◆ The name is somewhat misleading: A REIT may actually be a trust, a corporation, a limited liability company, or any other type of business entity.
- ◆ REITs do not pay corporate income tax. In exchange for this benefit, the IRS heavily regulates REITs, including their assets and activities.

Organizational Requirements

- ◆ Must be “managed by one or more trustees or directors”
- ◆ “Beneficial ownership of [the REIT must be] evidenced by transferable shares, or by transferable certificates of beneficial interest”
- ◆ May be neither a “financial institution” nor an “insurance company”
- ◆ Must have 100 or more shareholders
- ◆ Five or fewer individuals may not own more than 50% of the REIT

Asset Tests

- ◆ Testing at the end of each quarter
- ◆ At least 75% of a REIT's assets must be related to real property or passive in nature:
 - ◆ Real property
 - ◆ Personal property to the extent such property comports with the 15% rule described below
 - ◆ Debt secured by real property
 - ◆ Shares of other REITs
 - ◆ Debt instruments issued by publicly offered REITs
 - ◆ Cash and cash items (including short term receivables)
 - ◆ Government securities
 - ◆ Temporary investments in stock or debt instruments attributable to new capital

Asset Tests

- ◆ No more than 25% of a REIT's assets may be represented by assets that do not count favorably toward the 75% asset test
- ◆ No more than 25% (20% for taxable years beginning after December 31, 2017) of a REIT's assets may be represented by stock or other securities of taxable REIT subsidiaries ("TRSs")
- ◆ No more than 25% of a REIT's assets may be represented by specified debt instruments issued by public REITs
- ◆ Except for TRSs, the value of the securities of any one issuer owned by the REIT may not exceed 5% of the aggregate value of the REIT's assets
- ◆ Except for TRSs, a REIT may not own securities constituting more than 10% of the total value or voting power of the outstanding securities of any one issuer

REIT Real Property Regulations

- ◆ Property must be broken down into “distinct assets”
- ◆ Distinct assets must be evaluated individually
- ◆ Assets that fall into one of three categories are considered real property for REIT purposes:
 - ◆ Land
 - ◆ Improvements to land
 - ◆ Inherently permanent structures (e.g., buildings)
 - ◆ Structural components
 - ◆ Certain intangible assets
- ◆ These new rules are for REIT purposes only, not depreciation, FIRPTA, etc.

75% Gross Income Test

- ◆ At least 75% of the REIT's gross income for each taxable year must consist of:
 - ◆ Rents from real property
 - ◆ Interest on obligations secured by mortgages on real property or by first-tier mezzanine interests in real property
 - ◆ Dividends received on shares of other REITs
 - ◆ Gain from the sale of shares of other REITs
 - ◆ Dividends and interest from certain investments of new capital raised by the REIT

[Underlined terms are defined in the Code or Regulations.]

75% Gross Income Test

- ◆ At least 75% of the REIT's gross income for each taxable year must consist of (cont.):
 - ◆ Gain from the sale of real property that is not dealer property (gain on dealer property is subject to a 100% tax)
 - ◆ Abatements and refunds of real estate taxes
 - ◆ Income and gain from foreclosure property

95% Gross Income Test

At least 95% of the REIT's gross income for each taxable year must consist of:

- ◆ Income that qualifies for the 75% gross income test
- ◆ Dividends (other than from other REITs)
- ◆ Interest income from obligations not secured by real property
- ◆ Gain from the sale or disposition of stock or securities (other than stock of other REITs or interests in partnerships)

Rents from Real Property

- ◆ Rents from real property are amounts received for the right to use real property
- ◆ Includes impositions such as real estate taxes, late charges, tenant's share of certain operating expenses, utilities
- ◆ Also include certain services income (discussed in detail later)

Rents from Real Property

Rents from real property *do not include*:

- ◆ Certain contingent rent
- ◆ Related-party rent
- ◆ Amounts received with respect to impermissible tenant services
- ◆ Rents from personal property (if they do not meet the 15% rule described below)

Contingent Rent

- ◆ Defined as amounts dependent in whole or in part on the income or profits derived by any person (including a subtenant) from such property
- ◆ Rent as a percentage of gross sales is OK
- ◆ Gross sales can be exclusive of (net of) certain items
 - ◆ Sales taxes, discounts, refunds – yes
 - ◆ Cost of goods sold – no!

Related-Party Rent

- ◆ Defined as amounts received from any entity 10%-or-more owned by the REIT
- ◆ Complex rules apply to “attribute” ownership among related parties
- ◆ Even a small ownership percentage can raise issues
- ◆ Potential related-party rent problems:
 - ◆ (Major) shareholder of REIT is also 10% owner of tenant
 - ◆ Leases to taxable REIT subsidiaries (certain exceptions apply)

Services

- ◆ Incidental to the rental of real property, a REIT often provides certain services to its tenants (cleaning, security, maintenance, etc.)
- ◆ Provision of impermissible tenant services can cause **all** rent from a property to be treated as income **other than** rents from real property (even if no income is received with respect to such services) (discussed in detail later)

Rent from Personal Property

- ◆ Rent from personal property is treated as rents from real property if the rent from personal property does not exceed 15% of the total rent from the real and personal property
- ◆ Rent is allocated between real and personal property based on a fraction, the numerator of which is the average fair market value of the personal property and the denominator of which is the sum of the average fair market values of the real and personal property; this is a lease-by-lease test, with possible aggregation of similar leases at a facility
- ◆ More likely a concern in hotel or restaurant lease

Foreclosure Property

- ◆ Foreclosure property is real property (and personal property incident thereto) acquired either by foreclosure on a mortgage or as a result of a default on a lease, and for which a foreclosure property election was made and is still in effect
- ◆ The income from foreclosure property will be good income for purposes of the 75% gross income test, but the REIT will owe tax at corporate rates on the net income from the foreclosure property

Failure to Satisfy Income Tests

If a failure to satisfy an income test is due to reasonable cause and not willful neglect and if the REIT discloses such failure to the IRS, the REIT can maintain its REIT status

Failure to Satisfy Income Tests

Among other requirements to cure an income test failure, the REIT must pay a tax equal to:

- ◆ the greater of the amount by which it failed
 - ◆ the 95% income test; or
 - ◆ the 75% income test
- ◆ multiplied by a fraction
 - ◆ the numerator of which is the REIT's taxable income for the year of the failure determined without regard to the dividends paid deduction and without regard to deduction for taxes paid by the REIT (other than on foreclosure property or if the REIT distributed between 90% and 100% of its REIT taxable income); and
 - ◆ the denominator of which is the REIT's gross income for the year of the failure (excluding gross income from prohibited transactions and gross income and gain from foreclosure property, long term capital gain, and short term capital gain to the extent of any short term capital loss).

Distributions and Related Compliance

- ◆ In general, each year a REIT must distribute dividends equal to at least 90% of its taxable income.
- ◆ Capital gains: a REIT may retain capital gains and pay tax on them, or distribute a capital gain dividend.
- ◆ In order to determine what portion of a REIT's distribution qualifies as a dividend (as opposed to a return of capital), the REIT must calculate its earnings and profits.
- ◆ The character of the distribution (i.e. ordinary income, capital gain, or return of capital) is reported to shareholders annually on 1099s.

Other Compliance: Shareholder Demand Letters

- ◆ In order to help establish that a REIT is not closely held, within 30 days after the close of the REIT's taxable year, the REIT is required to demand written statements from larger shareholders disclosing their direct and indirect ownership.
- ◆ Demand letters are sent to the following shareholders of record:
 1. For a REIT with 2,000 or more shareholders of record, to each record holder of 5% or more
 2. For a REIT with fewer than 2,000 but more than 200 shareholders of record, to each record holder of 1% or more
 3. For a REIT with 200 or fewer shareholders of record, to each record holder of ½% or more.
- ◆ Failure to comply with shareholder demand letter requirements can result in a \$25,000 fine (\$50,000 in case of intentional disregard) but no longer jeopardizes REIT status.

Distribution Requirement

- ◆ As a general rule, each tax year, a REIT must distribute as a dividend (i.e., out of its E&P) at least 90% of its REIT taxable income.
- ◆ As a general rule, a distribution will not be treated as a dividend eligible for the dividends paid deduction if it is a “preferential dividend.” This rule applies to publicly offered REITs for tax years before 2015 and to private REITs.

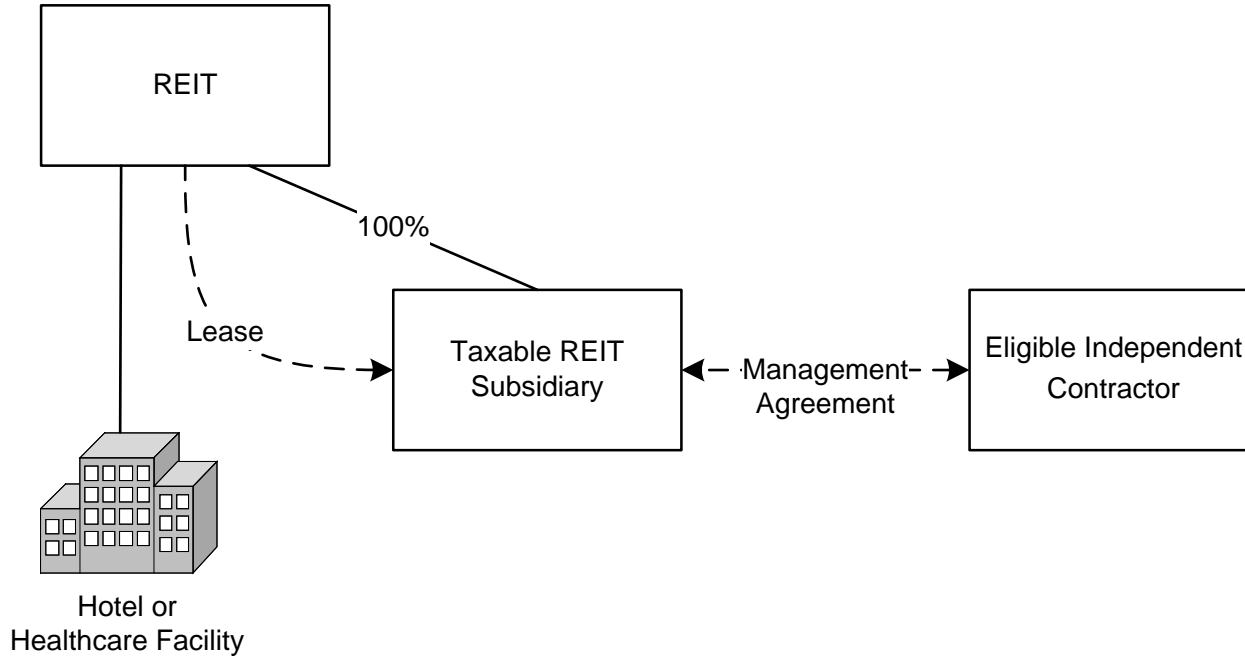
Preferential Dividends

- ◆ A preferential dividend is one that prefers one share of stock to another of the same class.
- ◆ Care must be exercised to make sure that dividend preference language in the governing trust instrument or articles of incorporation is scrupulously followed. Failure to do so could cause a distribution intended to qualify as a dividend (and for the dividends paid deduction) to fail to so qualify. Particular attention should be paid to baby REITs.

Hotels and Healthcare Facilities

- ◆ A REIT's operation of a hotel or healthcare facility may (or may not) give rise to income other than rents from real property.
- ◆ In order to prevent the REIT from earning income other than rents from real property, a REIT may lease a hotel or healthcare facility to its taxable REIT subsidiary in the manner described below.
- ◆ The rent under the lease to the taxable REIT subsidiary will be rents from real property (and not related-party rent), if the structure meets the following requirements:
 - ◆ the leased property is a (i) "lodging facility" (hotel, motel, or other establishment more than one-half of the dwelling units in which are used on a transient basis) or (ii) certain kind of healthcare facility; and
 - ◆ the taxable REIT subsidiary hires an "eligible independent contractor" to operate the facility

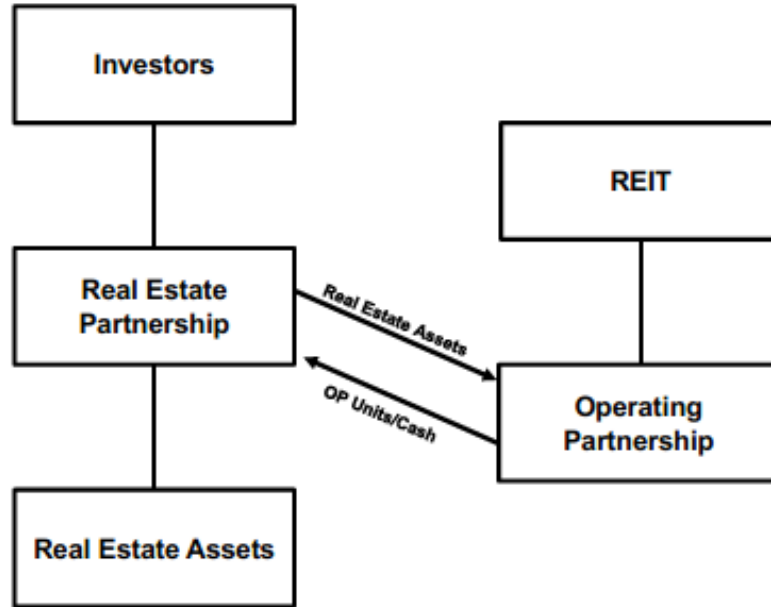
Hotels and Healthcare Facilities



Umbrella Partnership REIT (UPREIT)

- ◆ Structured properly, the contribution of property by a contributor to the operating partnership (OP) of a REIT in an “UPREIT transaction” in exchange for partnership interests in the OP is generally a tax-deferred transaction.
- ◆ In an UPREIT transaction, the OP acquires the contributed property with a carryover basis.
- ◆ The contributor’s initial tax basis in the OP partnership interests received in the transaction is (adjusted for debt levels) equal to its tax basis in the contributed property.
- ◆ The built-in gain in the properties at the time of contribution will generally be allocated to the contributor on the OP’s subsequent sale of the properties regardless of whether any cash distributions are made.

UPREIT Structure



UPREIT: Elements of the Transaction

- ◆ The contribution is generally effected pursuant to a contribution agreement containing terms comparable to other real estate purchase and sale agreements, and may include a “collar” related to the price of the REIT’s common stock.
- ◆ Typically, each OP unit received by the contributor is the economic equivalent of one share of the REIT’s common stock, and this parity includes the OP units and REIT shares receiving identical distributions.
- ◆ The OP units include redemption rights under the OP’s partnership agreement, which typically commence 12 months following the closing.

UPREIT: Elements of the Transaction (cont.)

- ◆ The redemption rights, if exercised, are typically satisfied through the exchange, on a one-for-one basis, of OP units for shares of the REIT's common stock, which is a taxable transaction.
- ◆ In order to protect against unexpected taxation from the OP's sale of the properties, the contributor and the OP often enter into a tax protection agreement.
- ◆ The tax protection agreement typically requires the OP to make a tax indemnity payment to the contributor on a subsequent taxable sale of the contributed properties by the OP that is conducted during the tax protection period, which is a negotiable term typically between 5 and 10 years.

UPREIT: Special Tax Issues

- ◆ If a contributing partner contributes property and liabilities to the OP and its share of such liabilities after the contribution is reduced, such reductions are treated the same as a distribution of cash by the OP to such partner.
- ◆ Any cash distribution, or deemed cash distribution arising from a reduction of debt, may be taxable to the contributing partner to the extent such distribution:
 - ◆ exceeds the partner's tax basis in the OP interest received in the contribution;
 - ◆ results in a "disguised sale"; or
 - ◆ causes the contributing partner to have a negative amount "at risk"

UPREIT: Special Tax Issues (cont.)

- ◆ The disguised sale rules create the presumption that any contribution of property to the OP followed by a distribution of cash or other property by the OP to the contributing partner within two years of such contribution is a sale of the property to the OP for income tax purposes, subject to certain exceptions including the reimbursement of certain preformation capital expenditures.
- ◆ As a result, a contributor's exercise of its redemption right within two years of the property contribution will generally cause all or a portion of the contribution to be presumed to be a sale, except that the contributor can take the position that there was no disguised sale because it was subject to the risks of OP unit ownership during the time the units were owned.

UPREIT: Special Tax Issues (cont.)

- ◆ To avoid any reduction in the amount that the contributor has “at risk,” the tax protection agreement may contain restrictions on the OP’s ability to repay or refinance the debt on the contributed properties for a period of time that generally mirrors the time during which sales of the properties are prohibited.
- ◆ For a partner to have a greater amount “at risk,” a partner may seek the economic risk of loss (“EROL”) on the assumed debt through guaranteeing some of such debt. Previously, partners would enter into “bottom dollar guarantees” (“BDGs”) in order to create an EROL; however, regulations under Section 752 of the Code now disregard BDGs as an adequate means of creating an EROL; partners may still have EROL with respect to “vertical slice” guarantees and for guarantees on which they are partially indemnified but retain 90% or more of the EROL (and disclose).

UPREIT (Other Considerations)

- ◆ To effect an UPREIT transaction, each holder of an interest in the target entity must agree to contribute its interests to the OP or the transaction must be consummated through a merger transaction pursuant to which the non-consenting partners are either cashed out or dragged along.
- ◆ Lender or other third party consents may be required to consummate the UPREIT transaction.
- ◆ The issuance of OP units to holders of contributed assets or interests is a private placement subject to federal and state securities laws. As a result, “nonaccredited” contributors are typically squeezed out for cash.

Services

- ◆ Rents from real property include charges for services customarily rendered in the geographic market for such class of building “whether or not such charges are separately stated”
- ◆ *Notwithstanding the foregoing:*
 - ◆ The rendering of “impermissible tenant service[s]” gives rise to income other than rents from real property (without regard to separate statement of the cost of such services)
 - ◆ Additionally, if the impermissible tenant services income (“ITSI”) with respect to a property exceeds 1% of the overall gross income of that property, *all of the rents from that building are disqualified as rents from real property*

Services (cont.)

- ◆ Services are “impermissible” if they are “primarily for [tenant’s] convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only”
- ◆ The proper use of an independent contractor (“IK”) or TRS to render an impermissible tenant service (described later) prevents ITSI

Permissible Tenant Services

- ◆ Basic cleaning
- ◆ Building security (but not security specific to a tenant)
- ◆ Repairs to the base building
- ◆ Maintenance of building systems
- ◆ Provision of HVAC, electricity, or water
- ◆ Any service that is to protect the landlord from liability or to protect the value of the building (e.g., limited construction supervision)
- ◆ Provision and maintenance of exercise equipment or pool (but not fitness classes or personal training)
- ◆ Snow removal

Impermissible Tenant Services

- ◆ Maid service
- ◆ Specialty cleaning (e.g., cleaning of food prep area)
- ◆ Security in tenant space or for specific tenant
- ◆ Services to customers of tenant
- ◆ Interior space access controls
- ◆ Concierge services

Impermissible Tenant Services (cont.)

- ◆ Fitness classes or personal training
- ◆ Maintenance or repair of certain tenant equipment
- ◆ Messenger services
- ◆ Staffing of shared conference or function rooms
- ◆ Any “special” service rendered for a specific tenant
- ◆ Any other service that is not customary and is rendered primarily for the convenience of a tenant

Services at REIT-Owned Properties

All other (non-customary) services.

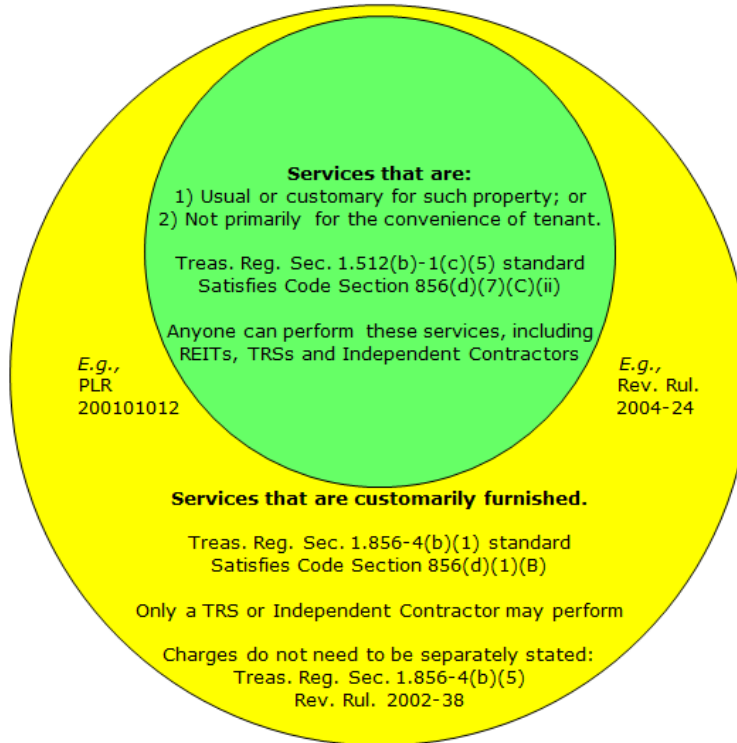
May be performed by either an Independent Contractor or TRS under certain conditions:

Independent Contractors

Treas. Reg. Sec. 1.856-4(b)(5)

Independent Contractor may perform only if:

- The cost of the services are borne by the independent contractor;
- A separate charge is made for the services;
- The amount of the separate charge is received and retained by the independent contractor; and
- The independent contractor is adequately compensated for the services.



Taxable REIT Subsidiaries

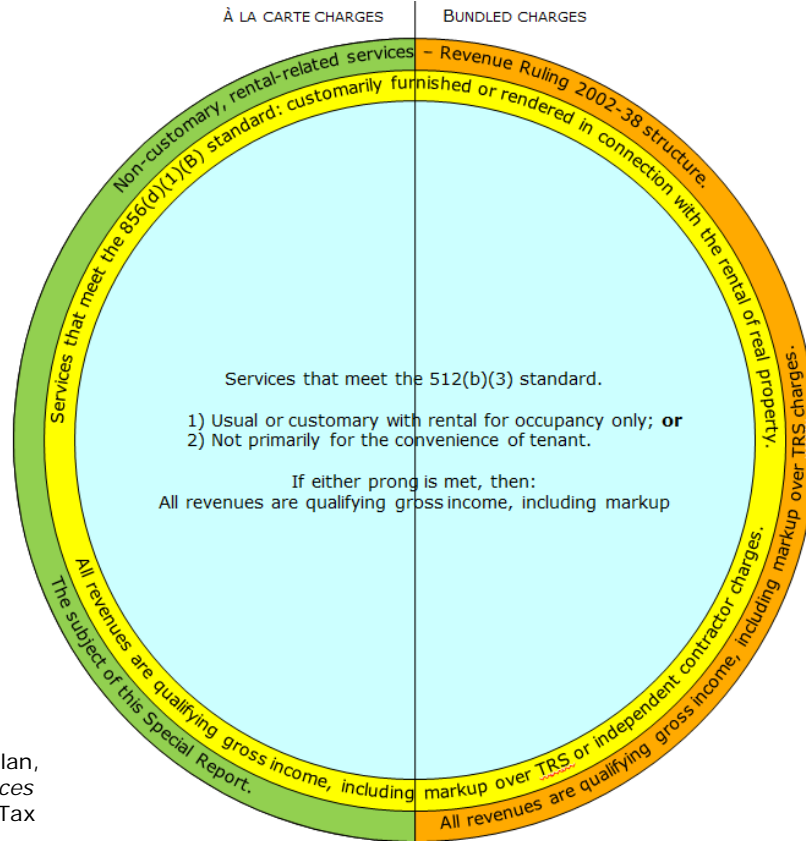
Code Section 857(b)(7)

Rev. Rul. 2002-38

Not a REIT qualification issue,
but 100% tax unless:

- The REIT pays the TRS an arm's-length charge for the services or pays a 50% markup on the TRS's costs;
- The TRS provides a significant amount of similar services to unrelated parties for substantially comparable fees within the meaning of Code Section 857(b)(7)(B)(iii); or
- The charges are separately stated and rent paid by the tenant is comparable to rent paid by tenants not receiving the service, all within the meaning of Code Section 857(b)(7)(B)(iv).

Services at REIT-Owned Properties



Excerpted from Paul W. Decker, David H. Kaplan, & Amek Ashok Ponda, *Non-Customary Services Furnished by Taxable REIT Subsidiaries*, 148 Tax Notes 413 (July 27, 2015)

What if a REIT Needs to Provide an Impermissible Tenant Service?

A REIT may render an impermissible tenant service by hiring either an IK or a TRS to perform the service (and following certain requirements):

	Independent Contractor (IK)	Taxable REIT Subsidiary (TRS)
Description	A third party that is not (i) related to the REIT or (ii) a tenant anywhere in the REIT's portfolio	A corporation owned by the REIT that is subject to corporate income tax
Separate Statement	A REIT must separately state and bill to client any charges from the IK	A REIT need not separately state and bill to tenants the charges from a TRS
Markup	A REIT may not markup to tenant the charges of an IK	A REIT may markup to tenant the charges for a TRS