REAL ESTATE INVESTMENT TRUSTS

USA

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Real Estate Investment Trusts

Quick reference guide enabling side-by-side comparison of local insights, including into the definition, advantages and disadvantages of REITS, and market climate; organisational and governance considerations; key regulatory requirements, including for publicly traded REITS; categories of REIT and relevant property sectors; eligible investors; and recent trends.

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PRELIMINARY CONSIDERATIONS

Definition

What constitutes a real estate investment trust (REIT) in your jurisdiction?

In general, a US real estate investment trust (REIT) is a business entity that meets two requirements: it makes an election under the US Internal Revenue Code, and it satisfies a number of prerequisites related to organisation, sources of income, the composition of assets, and the amount and type of distributions. Cumulatively, these requirements are intended to limit a REIT's status to a passive real estate company that earns a significant majority of its revenue from real estate investments (whether equity or debt). No ruling from the US Internal Revenue Service is required to qualify for taxation as a REIT – satisfying these requirements and unilaterally electing to be taxable as a REIT is sufficient.

The advantage to becoming a US REIT is that, unlike other corporations, a REIT is generally allowed to deduct distributions made to its shareholders from its taxable income; thus, a REIT that distributes 100 per cent of its taxable income generally will pay no federal corporate income tax (nor any state income tax, because state income tax laws generally have been conformed to federal income tax law, though a REIT does typically bear non-income tax liabilities). Under the Internal Revenue Code, there are essentially only two tax-efficient entities available for non-US persons investing in rental real estate: a partnership (or limited liability company taxed as a partnership, which in either case results in US federal and state tax return filing obligations on the part of the investor) under subchapter K of the Internal Revenue Code, and a corporation (or other entity taxed as a corporation) that qualifies as a REIT under subchapter M of the Internal Revenue Code. However, REITs still pay entity-level income and excise taxes in some circumstances designed to protect the integrity of the corporate income tax base.

Law stated - 07 October 2021

Pros and cons of REITs

Why were REITs created in your jurisdiction? What are the advantages and disadvantages of using REIT structures in your jurisdiction?

When introduced in 1960, REITs were initially envisioned as permitting small investors to access to the same kinds of real estate investment opportunities that large, sophisticated investors could access directly (eg, real estate portfolios with most or all of the following: risk diversification; professional management; competitive returns; diversified tenants and geography; varying lease maturities; and scaled fixed-cost synergies). However, it took decades to realise that expansive vision, in part because the initial REIT law limited a REIT's form of organisation and its ability to manage property. Accordingly, the first REIT was not listed on the New York Stock Exchange until 1965, five years later; entities organised under local law as corporations could not become REITs until 1976, 16 years later; no REIT had an equity market capitalisation in excess of $1 billion until 1991, more than 30 years later; and REITs could not provide tenants with cutting-edge services until the Internal Revenue Code permitted taxable REIT subsidiaries (TRSs) in 2001, more than 40 years later. In those early days, REITs were so limited in specific areas that they were sometimes viewed as the province of the very sophisticated. Now, though, more than 60 years after the REIT structure was created, it has finally achieved the ambitious vision that motivated its creation.

The major advantage to using a REIT structure is that REITs are generally subject only to single-tier taxation on their earnings. Normally, under the Internal Revenue Code, a corporation pays tax on its entire corporate taxable income, regardless of any distributions that it makes to its shareholders, and then its shareholders are also responsible for paying tax on the distributions that they receive from the corporation. This is referred to as 'two-tier taxation', because the dividends paid by the corporation have already been subject to federal income tax at the corporate level, and now they are again subject to federal income tax at the individual level. However, a REIT that distributes all of its taxable income is entitled to a deduction from its corporate taxable income for all such distributions. Thus, a REIT which distributes all of its corporate taxable income to its shareholders will have no taxable income at the corporate level and will pay no federal income tax (and typically no state income tax). The shareholders are taxed on the distributions received from the REIT, but that is the sole level of taxation on the REIT's earnings.

Such a distribution structure means that a REIT generally will not have retained earnings to reinvest, which is a disadvantage, and the REIT will need to generate investor capital to acquire additional properties, generally through the issuance of corporate debt. But because of the very structure of the REIT rules in the Internal Revenue Code, a company that satisfies REIT requirements is well suited for receiving investor capital, for three principal reasons:

- a REIT is, by definition, focused on investments in real estate, typically in a single real estate vertical, with a (capped) ability to invest in businesses that are not real estate;
- the single-level-of-tax regime means that profits from a REIT's real estate investments are only taxed at the investor level, not at the entity level as well; and
- as a REIT has an ongoing, implied covenant with the marketplace to return to the market in order to make its case for additional capital to fund new, accretive projects, REITs are generally forced to adopt disciplined and detailed market reporting.

A disadvantage to the US REIT structure is that they must meet specific requirements on a continual basis to retain their status under the Internal Revenue Code, and these requirements can prevent a REIT from pursuing certain types of activities. These requirements are sometimes referred to as ORIAD (from their first letters):

- organisation and capital structure;
- rent;
- income;
- assets; and
- distributions.

For more detail on ORIAD requirements, see Ponda et al., 'REIT Primer (Tax Technical)' (Dec. 7, 2018).

Law stated - 07 October 2021

Market climate

How would you describe the state of the REIT market in your jurisdiction? How common are REITs in practice?

Although it took decades after their introduction for REITs to achieve significant penetration into the US real estate market, today there are more than 225 REITs listed on US stock exchanges, with a combined equity market capitalisation of more than US$1 trillion. It is estimated that US REITs own more than US$3.5 trillion in gross assets across the United States, and additional property abroad. REITs in the United States are so common because they are effective at raising capital for real estate investments that, among other things, revitalise neighbourhoods, enable the digital economy, power essential services in communities, and build and maintain the infrastructure of tomorrow.

Law stated - 07 October 2021

ORGANISATION

Choice of entity and organisational requirements

What forms of entity are used for REITs and what basic organisational requirements apply?

Under the Internal Revenue Code, a real estate investment trust (REIT) is required to be an entity taxed as a corporation for federal income tax purposes. Within that range, REITs can be publicly listed, publicly held but not listed (referred to as 'nonlisted REITs', and combined with publicly listed REITs, 'public REITs'), or privately held by institutional investors (but not closely held by individuals or a small number of families) (referred to as 'private REITs'). REITs also can be internally or externally managed.

Most state-law entities (including corporations, limited liability companies, business trusts, etc) can qualify under the Internal Revenue Code as a REIT. The key prerequisite is that such an entity be taxed as a corporation under the Internal Revenue Code, which is easily achievable through a US Internal Revenue Service Form 8832 'check-the-box election'. Some states (such as Maryland) also offer a state-law entity also called a 'real estate investment trust' that is a collective investment vehicle to hold real estate. Such state-law entities are eligible to qualify as a US REIT under the Internal Revenue Code, but a Maryland real estate investment trust is not automatically a US REIT under the Internal Revenue Code despite the similar name. For non-US investors, most US REITs keep things simple and organise as a state-law corporation or a limited liability company, often in the preferred REIT-friendly jurisdictions of Delaware or Maryland.

In addition to the above customary approaches to forming a state-law entity, there are a number of organisational and ownership requirements imposed by the Internal Revenue Code upon REITs.

A REIT's share ownership must be sufficiently diversified such that the REIT is neither closely held (defined generally as ownership of at least 50 per cent of the REIT's value by five or fewer individuals and their related family members and trusts) nor 10 per cent or more affiliated with its tenants, including in both cases indirect ownership by virtue of a web of complex attribution rules.

For liability reasons, most REITs prefer to hold individual properties in separate entities. Under the Internal Revenue Code, properties owned by disregarded entities and partnerships are treated as if the REIT owned them directly. In setting up such a structure, the REIT needs to ensure that its disregarded entities are truly disregarded for the appropriate tax purposes. See Hammell, Kupiec, and Ponda, '"Cogito, Ergo Sum": Is that Disregarded Entity in Fact Regarded?', 22 Journal of Passthrough Entities 4, 53-63 (July-Aug. 2019) . Then, a REIT's subsidiaries, assets, and operations must be properly divided among disregarded entities and partnerships on the one hand and taxable REIT subsidiaries (TRSs) on the other.

A REIT must have at least 100 shareholders. This is an easy standard to meet for public companies, although they need to be certain that they do meet it. In the case of private REITs, this is often accomplished through broker-dealer firms that specialise in introducing 100 preferred shareholders (with a requisite modest amount of capital) into the private REIT's capital structure.

Law stated - 07 October 2021

Partnerships as subsidiaries

Are REITs permitted to have partnerships as subsidiaries in your jurisdiction?

Yes. In fact, real estate investing is generally premised on achieving a single-tier-of-taxation regime, which under the Internal Revenue Code basically limits the entities used for such investments to REITs and entities treated as partnerships under the Internal Revenue Code (eg, limited liability companies or limited partnerships). Thus, REIT structures commonly involve the use of partnerships. In addition, a REIT in the US is commonly structured in one of two methods: either as a traditional REIT, which owns its assets itself or through disregarded entities, or as an umbrella partnership REIT (UPREIT).

In a typical UPREIT, a REIT partners with others to create an operating partnership. The operating partnership owns the assets, and the assets are contributed to the partnership in return for operating partnership units (OP units). Typically, the REIT is the general partner of the partnership and owns the largest share of the OP units. Individuals who contribute property to the operating partnership in return for OP units generally get to defer their recognition of capital gains until such time as they convert their OP units into REIT stock. Thus, the OP units in the UPREIT may be used as an acquisition currency that permits sellers to dispose of their real property on a tax-deferred basis.

Law stated - 07 October 2021

REITs as subsidiaries

Are partnerships permitted to have REITs as subsidiaries in your jurisdiction?

Yes. It is very common for US-based real estate funds, typically organised as partnerships or limited liability companies taxed under subchapter K of the Internal Revenue Code, to own US investment real estate through REIT subsidiaries.

This gives the various investors in the partnership – including high net-worth individuals, tax-exempt institutions, and non-US investors – a stacked single-level-of-taxation regime, but with all of the blocker and semi-blocker advantages that come with a REIT. Such a structure also may be employed by a multinational fund that only wants its US investments in real property to be subject to the US REIT rules, due to the advantages that those provide for certain types of foreign investors, but chooses other forms of organisation for its investments in real property (or other types of assets) in other countries.

Law stated - 07 October 2021

Governance

What governance issues should the boards of REITs in your jurisdiction be aware of? How are these issues navigated in practice?

One of the requirements to maintain REIT qualification is that a REIT must satisfy several tests regarding asset composition at the close of each quarter. Most of these tests require the REIT to determine the ‘value of its total assets’ and also the value of particular assets. The REIT’s board of directors has the duty of valuing these assets, and the Internal Revenue Code affords great deference to the board’s determination.

The Internal Revenue Code affords enormous deference to board-determined valuations by prescribing that the value of assets, other than those for which market quotations are readily available, shall be the ‘fair value as determined in good faith by the [REIT’s board]’. We believe that a REIT’s board of directors may, in addition to determining the value of assets, establish the nature of a REIT’s assets under the governance guidelines established for REITs.

Law stated - 07 October 2021

KEY REGULATORY REQUIREMENTS

Sources of income

What are the basic source-of-income requirements for a REIT?

An entity must satisfy two gross income tests annually to maintain its qualification for taxation as a REIT under the Internal Revenue Code:

- at least 75 per cent of the entity's gross income for each taxable year must be derived from investments relating to real property, including:
  - 'rents from real property' (a term of art under the Internal Revenue Code);
  - interest and gain from mortgages on real property or on interests in real property;
  - income and gain from foreclosure property;
  - gain from the sale or other disposition of real property (including specified ancillary personal property treated as real property under the Internal Revenue Code); or
  - dividends on and gain from the sale or disposition of shares in other REITs (but excluding in all cases any gains subject to the 100 per cent tax on prohibited transactions); and
- at least 95 per cent of the entity's gross income for each taxable year must consist of income that is:
  - qualifying income for purposes of the 75 per cent gross income test;
  - other types of interest and dividends;
  - gain from the sale or disposition of stock or securities; or
  - any combination of these.

The following items are excluded from both the numerator and the denominator in both gross income tests:

- income from the sale of property held primarily for sale to customers in the ordinary course of business;
- income and gain from specified 'hedging transactions' that are clearly and timely identified as such;
- income from the repurchase or discharge of indebtedness; and
- income or gain earned by TRSs.

In addition, specified foreign currency gains are excluded from gross income for purposes of one or both of the two gross income tests above.

Under the Internal Revenue Code, 'rents from real property' is a term of art with exacting standards. Non-qualifying rental income is limited to comprising less than 5 per cent of an entity's gross income (this being the mathematical complement to the 95 per cent gross income test). For rental (and related service) gross income to qualify as 'rents from real property' the following rules apply.

The amount of rent received generally must not be based on the income or profits of any person, but it may be based on a fixed percentage or percentages of receipts or sales.

Rents, generally, do not qualify if, whether directly or after application of attribution rules, the REIT owns 10 per cent or more of the tenant by vote or value of stock or other equity (or 10 per cent or more of the interests in the tenant's assets or net profits, if the tenant is not a corporation). Special rules apply to REITs invested in lodging facilities and healthcare facilities. In addition, there is a limited exception to the prohibition on earning 'rents from real property' from a 10 per cent-affiliated tenant, if the tenant is a TRS. If at least 90 per cent of the leased space of a property is leased to tenants other than TRSs and 10 per cent to affiliated tenants, and if the TRS's rent to the REIT for space at that property is substantially comparable to the rents paid by non-affiliated tenants for comparable space at the property, then otherwise qualifying rents paid by the TRS to the REIT will not be disqualified under the rule prohibiting 10 per cent-affiliated tenants.

In order for rents to qualify, a REIT generally must not manage the property, or furnish or render services to the property's tenants, except through an independent contractor from which it derives no income or through one of its TRSs. There is an exception to this rule, permitting a REIT to perform customary management and tenant services of the sort that a tax-exempt organisation could perform without being considered in receipt of 'unrelated business taxable income' as defined in the Internal Revenue Code. In addition, a de minimis amount of non-customary services provided to tenants will not disqualify income as 'rents from real property', if the value of the impermissible tenant services does not exceed 1 per cent of the gross income from the property.

If rent attributable to personal property leased in connection with a lease of real property is 15 per cent or less of the total rent received under the lease, then the rent attributable to personal property will qualify as 'rents from real property.' However, if this 15 per cent threshold is exceeded, then the rent attributable to personal property will not qualify. The portion of rental income treated as attributable to personal property is determined according to the ratio of the fair market value of the personal property to the total fair market value of the real and personal property that is rented.

Finally, 'rents from real property' includes both charges an entity receives for services customarily rendered in connection with the rental of comparable real property in the same geographic area, even if the charges are separately stated, as well as charges received for services provided by TRSs when the charges are not separately stated. Although the matter is not free from doubt, 'rents from real property' should also include charges received for services provided by TRSs when the charges are separately stated, even if the services are not geographically customary.

Thus, for a typical REIT, its tenant revenues from TRS-provided services, whether the charges are separately stated or not, and whether the services do or do not satisfy the geographically customary standard, should qualify as 'rents from real property.' See Decker, Kaplan, and Ponda, 'Non-Customary Services Furnished by Taxable REIT Subsidiaries', 148 Tax Notes 413 (July 27, 2015) for a comprehensive discussion of the evolution of the REIT rules, and how REITs today can provide most kinds of tenant services through a taxable REIT subsidiary.

Law stated - 07 October 2021

Asset composition

What are the basic asset composition requirements for a REIT?

A REIT's assets must be principally 'real property' (as defined in the Internal Revenue Code and the US Treasury Regulations thereunder) or related to real property leasing, with the possibility of investing in the portfolio securities of other issuers being very limited. More specifically, at the close of each calendar quarter of each taxable year, in order to qualify for taxation as a REIT for federal income tax purposes, the value of the entity's total assets must meet the following requirements:

1. at least 75 per cent must consist of 'real estate assets', defined as:
   1. real property (including interests in real property and interests in mortgages on real property or on interests in real property);
   2. ancillary personal property to the extent that rents attributable to such personal property are treated as rents from real property in accordance with the rules described above;
   3. cash and cash items;
   4. shares in other REITs;
   5. debt instruments issued by 'publicly offered REITs' as defined in the Internal Revenue Code;
   6. government securities; and
   7. temporary investments of new capital.
2. no more than 25 per cent may be represented by securities (other than those that count favourably toward the 75 per cent asset test);
3. the value of any single non-REIT issuer's security may not exceed 5 per cent of the value of the entity's total assets;

4. the entity may not own more than 10 per cent of the vote or value of any single non-REIT issuer's outstanding securities unless it is a straight debt security or otherwise excepted;
5. no more than 20 per cent of the value of the entity's total assets may be represented by stock or other securities in its TRSs; and
6. no more than 25 per cent of the value of the entity's total assets may be represented by 'nonqualified publicly offered REIT debt instruments', as defined in the Internal Revenue Code.

An entity's stock and securities in a TRS are exempt from the 5 per cent and 10 per cent asset tests described in (3) and (4).

Significantly, there is no Internal Revenue Code requirement for a REIT's investment real estate to be diversified, although portfolio diversification is sometimes a requirement, found in bilateral income tax treaties with the United States, for reducing the cross-border withholding upon a REIT dividend paid to a non-US investor resident in a treaty country. In practice, most all public REITs are well diversified, but some private REITs invest in single properties.

'Real property' for this purpose includes inherently permanent structures, structural components thereof, and certain intangible assets that are inseparable from, and derive their value from, such real property. 'Real property' may also include air rights, water rights, and natural products of the land, such as crops and timber prior to harvesting. For further discussion of the types of real property that may be owned by a REIT, see Ponda, 'REIT Taxation Developments', Boston Tax Forum (May 1, 2017).

Law stated - 07 October 2021

Distributions

What are the basic distribution requirements for a REIT?

In order to qualify for taxation as a REIT under the Internal Revenue Code, an entity's distribution must be sufficiently large and timely so as to contemporaneously (or nearly contemporaneously) distribute to shareholders all (or nearly all) of its taxable income and any accumulated earnings and profits inherited from regular (non-REIT) corporations.

In particular, a REIT is required to make annual distributions (other than capital gain dividends) to its shareholders in an amount at least equal to the excess of:

- the sum of:
  - 90 per cent of its 'real estate investment trust taxable income';
  - 90 per cent of its net income after tax from property received in foreclosure; and
  - 100 per cent of any accumulated earnings and profits inherited from regular (non-REIT) corporations, over:
- the amount by which its non-cash income (eg, imputed rental income or income from transactions inadvertently failing to qualify as like-kind exchanges) exceeds 5 per cent of its 'real estate investment trust taxable income'.

For these purposes, a REIT's 'real estate investment trust taxable income', as defined in the Internal Revenue Code, is computed without regard to the dividends paid deduction and the REIT's net capital gain. Esoteric (and thus often overlooked) rules regarding net interest expense, net operating loss carryovers, passive activity loss and at-risk rules for certain REITs closely held by institutional investors, and similar loss limitation rules may lead to a REIT having a higher amount of 'real estate investment trust taxable income' (and thus a concomitant higher distribution requirement) than it may anticipate.

Distributions must be paid in the taxable year to which they relate, or in the following taxable year if declared before the entity timely files its federal income tax return for the earlier taxable year and if paid on or before the first regular distribution payment after that declaration. If a dividend is declared in October, November or December to shareholders of record during one of those months, and is paid during the following January, then for federal income tax purposes such dividend will be treated as having been both paid and received on 31 December of the prior taxable year to the extent of any undistributed earnings and profits.

A REIT may be able to rectify a failure to pay sufficient dividends for any year by paying ‘deficiency dividends’ to shareholders in a later year. These deficiency dividends may be included in the REIT’s deduction for dividends paid for the earlier year, but an interest charge would be imposed upon the REIT for the delay in distribution. While the payment of a deficiency dividend will apply to a prior year for purposes of the REIT distribution requirements and the REIT’s dividends paid deduction, it will be treated as an additional distribution to the shareholders receiving it in the year such dividend is paid.

For REITs that are not public (eg, a private REIT held by an investment fund or by institutional investors), the applicable distributions must also satisfy the ‘preferential dividend rule’. This means that for distributions to be deductible, an entity must meticulously observe its organisational documents with regard to the amount, timing, order, and formalities in declaring distributions upon its outstanding common and preferred shares, such that no distribution is too early, too late, too little, too much, or too informal.

Law stated - 07 October 2021

Consequences of non-compliance

What happens if a REIT fails to meet the basic regulatory requirements? Is relief available if a company fails to meet any of these requirements?

If a REIT fails to meet the requirements to qualify for taxation as a REIT in any year, it will be subject to federal income taxation as if it were a corporation, meaning that federal income tax generally will be applied at both the corporate and shareholder levels. A REIT is generally disqualified from re-electing to be taxed as a REIT for the four taxable years following the taxable year in which it lost its status as a REIT.

There is generally no relief available for a REIT that deliberately fails one of the REIT requirements. However, in general, the REIT rules have an array of ‘intermediate sanctions’ such that inadvertent failures are ‘reprimanded’ with measured penalties and fines, rather than the draconian imposition of REIT disqualification. These ‘intermediate sanction’ penalties cover various failures of the REIT requirements, but generally only if the failures are due to reasonable cause and not willful neglect. See ‘Relief Provisions’, page 54, Ponda, ‘REIT Taxation and Data Centers: Basics, Developments, Structures & Predictions’ (May 14, 2018).

Law stated - 07 October 2021

Compliance best practices

What best practices should be considered to ensure compliance with the key regulatory requirements for REITs in your jurisdiction?

A public company’s REIT status typically represents 25 per cent to 35 per cent of its total enterprise value, and the same is presumably true for a private company’s REIT status. In other words, REIT status is often a ‘crown jewel’ for a company. Knowledge of REIT requirements thus becomes a shared responsibility across a number of segments within the company, including not just the tax and accounting functions (which manage the testing measures being used to verify compliance) but also legal, business operations, business development, financial planning and analysis, financial reporting, treasury, etc. All of these areas must be trained on the REIT requirements in their areas to maintain REIT compliance.

Moreover, a failure to operate within the REIT rules can represent a ‘deficiency’, a ‘significant deficiency’ or (worst case) a ‘material weakness’ under applicable US Securities and Exchange Commission (SEC) and accounting standards, which in turn invites enhanced scrutiny from financial auditors, investors and (possibly) government regulators, something which the company can only remedy with intense focus and potentially expensive remediation. Most companies, therefore, choose to build up their internal knowledge of REIT requirements and REIT compliance before making a REIT election, which usually requires one or more full-time employees committed to this task.

Law stated - 07 October 2021

Public REITs – regulatory treatment

Are the requirements for a publicly traded REIT raising capital different from those imposed on private REITs or public non-REIT companies?

Yes. REITs raising funds in a public offering (or that have registered with the SEC) are subject to extensive SEC disclosure requirements and filings that do not apply to private REITs raising capital. The US Securities Act of 1933, as amended, requires a REIT that is raising equity or debt capital in the public markets to register the offering of the securities, generally by filing a registration statement with the SEC. In addition to describing the details of the particular securities offering, the registration statement must contain (either directly or indirectly by incorporating the REIT’s other SEC filings) detailed information on a wide range of topics regarding the REIT’s business, including its:

- strategy;
- executive compensation;
- corporate governance practices and procedures;
- risk factors;
- legal proceedings;
- directors and executive officers;
- security ownership of key beneficial owners and management;
- certain types of relationships and related transactions;
- financial statements and analyses; and
- auditor fees and services incurred by the REIT.

All of this information becomes fully public, and thus freely available and subject to review by the SEC, as well as investors, analysts and other stakeholders.

A REIT raising capital in a public offering registered with the SEC is generally required to file a registration statement on Form S–11, at least initially, which includes more disclosure related to the REIT’s business than a registration statement by a non-REIT company on Form S–1 (the form generally available to public companies that are not REITs). Among the additional requirements on a Form S–11 are:

- Investment policies with respect to investments in real estate, mortgages, and other types of interests in real property, taking into account the REIT’s prior experiences. For example, a public REIT will want to disclose the types of real estate that it holds and/or seeks to acquire, such as office buildings, apartment buildings, shopping centres, industrial and commercial properties, special purpose buildings, undeveloped acreage, etc.
- Material information with regard to all material real properties held or intended to be acquired by, or leased to, the REIT or its subsidiaries. For this purpose, ‘material’ refers to any property with a book value of 10 per cent or more of the total assets of the REIT or any property from which the gross revenues are 10 per cent or more of the

aggregate gross revenues of the REIT.

- Operating data on each such property, such as occupancy rate and principal provisions of the leases.
- Arrangements with regard to the management of the property or properties involved.
- A tax opinion on material issues (such as REIT status). Generally, either a REIT's legal counsel or an independent public or certified accountant will provide a tax opinion supporting the tax matters and consequences to REIT shareholders described in the filing. A private letter ruling from the US Internal Revenue Service can also satisfy part or all of this tax opinion requirement.

While perhaps not strictly required to do so, a private REIT may also choose to disclose some or all of the above information, especially if it is competing against public REITs for access to capital.

Law stated - 07 October 2021

Public REITs – ongoing requirements

What are the ongoing securities and disclosure requirements for publicly traded REITs?

Once a REIT is publicly traded in the United States, it becomes subject to extensive ongoing and periodic reporting requirements under the US Securities Exchange Act of 1934, as amended. These include annual and quarterly reports with financial statements, analyses and other detailed information, proxy statements for shareholder meetings with extensive requirements, and reporting requirements for a wide range of material developments and events. These filings require detailed disclosure on a wide range of items impacting the REIT's business. Additionally, periodic filings also require certain material contracts and other company agreements to be publicly disclosed and filed. Further, directors, officers and 10 per cent shareholders of public companies must report substantially all of their trading activity in the REIT's securities and are subject to restrictions on their trading activities. Shareholders owning more than 5 per cent of a public company are subject to certain reporting obligations and restrictions. For more information, see Berkenblit and Ben-Bassatt, 'Public Company Compliance Manual (2021)' .

Law stated - 07 October 2021

Public REITs – listing rules

Do the stock exchanges in your jurisdiction have any special rules that do not apply to unlisted or private REITs?

While US stock exchanges do not have REIT-specific requirements, listing on a US stock exchange requires that a company meet certain initial and continuing listing criteria regarding share price, number of holders, and applicable financial thresholds, all of which vary by market. If a private or non-listed REIT decides to list its securities for trading on a national stock exchange, such as the New York Stock Exchange or the Nasdaq Stock Market, it becomes subject to additional rules of that exchange, which can be (and often are) above and beyond the SEC's requirements. For example, stock exchange listing requirements generally require the board of directors to be comprised of a majority of independent directors. Further, the board of directors must have certain committees (typically an audit committee, a compensation committee and a nominating committee), each with mandatory responsibilities, as well as certain mandated policies and procedures, including a code of ethics for directors, officers and employees. New York Stock Exchange-listed companies must also maintain corporate governance guidelines covering additional duties, policies and responsibilities of the REIT. The stock exchanges also have additional shareholder approval rules regarding certain equity issuances and compensation plans that would not necessarily be required for non-listed or private REITs. Finally, the stock exchanges require prompt disclosure of material information, even if not necessarily mandated by SEC rules.

Law stated - 07 October 2021

SCOPE OF ACTIVITIES AND INVESTMENTS

Categories of REIT and relevant property sectors

What kinds of REIT are available in your jurisdiction? In which real property sectors are REITs used?

There are two basic types of real estate investment trusts (REITs) available in the United States: equity REITs and mortgage REITs. The majority of REITs are equity REITs, which own or operate income-producing real estate. Mortgage REITs (mREITs) provide financing for income-producing real estate by purchasing or originating mortgages and mortgage-backed securities and earn income from the interest on these investments.

REITs currently invest in a wide array of real property verticals – domestically, abroad, or both – including such real property items as:

- mortgages;
- office buildings;
- retail properties;
- logistical and industrial properties;
- multi-family residential properties and student housing;
- senior living facilities;
- business storage facilities;
- hotels and travel centres;
- timberland;
- cold storage facilities;
- communications towers;
- data centres;
- dark and lit fibre networks;
- traditional and digital billboards;
- distributed antenna systems;
- docks and marinas;
- solar, wind and power infrastructure;
- transmission and distribution infrastructure;
- liquid storage and delivery systems;
- railroads; and
- vineyards, greenhouses and other agricultural properties (including cannabis facilities).

Most REITs in the United States focus their investments on a particular type of property, but some hold multiple types of properties in their real estate portfolios.

Law stated - 07 October 2021

Special rules

Are there any special rules for different types of REIT?

The organisation, income, asset and distribution rules for REITs are generally the same across all real estate verticals, but some types of REITs are subject to special rules.

Public REITs are free of the nettlesome ‘preferential dividend’ rule (which provides that in order to be eligible for the dividends paid deduction, a distribution must be made in strict accordance with the rights and procedures set forth in the REIT’s governing documents), but private REITs are not. A private REIT must meticulously observe its organisational documents with regard to the amount, timing, order, and formalities in declaring distributions upon its outstanding common and preferred shares, with even small deviations inviting penalties or the potential for REIT disqualification.

In addition, while most REITs must lease out their investment real estate to less-than-10 per cent-affiliated tenants, REITs in some industries can deploy an up-to-100 per cent-owned taxable REIT subsidiary (TRS) as their tenants or customers. For example, REITs focused in the lodging and healthcare sectors may lease out their lodging and healthcare properties to a fully captive TRS, provided such a TRS-tenant engages an eligible manager to manage the properties. (See Decker, Ponda, and Stein, ‘Toward a Workable Definition of REIT Healthcare Facility’, 133 Tax Notes 1231 (Dec. 5, 2011).) Similarly, a timber REIT can sell its standing timber to a TRS, and the resulting timber harvesting gains generally represent qualifying REIT gross income. (See Ponda and Hammell, ‘An Introduction to REIT Compliance for Timber REITs’ (Apr. 25, 2019) .)

Law stated - 07 October 2021

Eligible investment property

What assets are treated as qualifying real property under the REIT rules in your jurisdiction? Can REITs located within your jurisdiction invest in real property outside your jurisdiction?

The definition of qualifying REIT ‘real property’ is now well settled by detailed and administrable guidance in US Treasury Regulations section 1.856–10. From their creation in 1960, REITs also have been permitted to invest in real property outside the United States. This was explicitly confirmed by the US Internal Revenue Service in a 1974 published revenue ruling. However, a number of technical impediments persisted for many years, including whether various forms of currency gain or loss would be viewed as qualifying REIT income, and whether various forms of cash balances in offshore bank accounts would be viewed as cash or instead as (potentially) impermissible securities. (See Ponda, ‘REITs Abroad’, Practising Law Institute’s Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings (2006-2008) and Ponda, ‘US REITs Investing Globally’ .) Substantially all of these technical impediments have been resolved by improvements to the Internal Revenue Code since 2008, and today several of the country’s largest REITs have significant investments outside the United States.

Note that the US tax advantages of the REIT form do not persist into these foreign jurisdictions. The operations of US REITs that operate abroad are subject to taxation in the foreign countries in which they own assets and operate. At the same time, these US REIT foreign operations (unless held in TRSs) are still subject to the Internal Revenue Code rules that govern REIT qualification.

Law stated - 07 October 2021

Permitted activities

Are REITs in your jurisdiction allowed to engage in any ancillary non-investment activities, such as real property management and development?

REITs are permitted to self-manage most types of real property. However, specified property types and non-customary services require special structuring. For example, a REIT may not self-manage a healthcare facility or a lodging facility.

A REIT also may not manage property owned by third parties, but a TRS can often play this role. There are a number of activities considered ancillary to a REIT's primary business of leasing real property and providing customary services that the REIT is only able to perform through the use of one or more TRSs.

Law stated - 07 October 2021

Eligible investors

Who may invest in REITs in your jurisdiction? What types of investor do they typically attract? Are there any restrictions on foreign investors?

REITs were designed to allow small investors access to real estate portfolios that had previously been available only to large institutions. It has been estimated that nearly half of all US households have investments in REITs (eg, through retirement accounts).

But the REIT vehicle is sufficiently versatile and desirable such that its appeal extends to all kinds of investors. One particularly desirable advantage of a REIT investment (versus an investment in a real estate partnership) is that the holder of shares in a REIT is not required to file a state tax return in each jurisdiction in which the REIT holds property.

Because REIT shares usually generate a steady dividend stream, REITs are also favoured by investors desiring a steady cash flow, ranging from administrators of section 401(k) plans seeking a relatively constant dividend stream to income-conscious investors.

In addition, tax-exempt investors (eg, pension plans, charitable organisations, universities and private foundations), favour REIT investments because a REIT will act as a 'blocker' for taxes on 'unrelated business taxable income' that these investors would otherwise have to pay on direct investments into real estate.

Finally, for decades REITs have been especially appealing to non-US investors. (See Ponda, 'Foreign Pension Plans Investing in Shares of a US REIT', 74 Tax Notes 1593 (Mar. 24, 1997) .) In particular, after years of streamlining the Internal Revenue Code, the United States' bilateral tax treaty network, and applicable US Treasury Regulations, today a non-US investor can invest in a public, listed US REIT with little-to-no US tax friction: the REIT represents a single-level-of-tax regime and 'blocks off' completely any permanent establishment (and profits attributable thereto); moreover, all dividends from the listed REIT are eligible for reduced rates of US source withholding, and in particular cases or under particular treaties the applicable withholding rate can be as little as zero (0 per cent); and capital gains from the disposition of the REIT stock are not taxable within the United States.

Even non-listed REITs and their non-US investors enjoy some (sometimes all) of the comprehensive streamlining that is afforded to non-US investors in listed REITs. This is particularly true for non-listed REIT investors that qualify as 'qualified foreign pension funds', a relatively new and expansive category of investors recognised under the Internal Revenue Code as deserving of little-to-no US tax friction when investing in non-listed REITs.

Non-US investors also invest in US REITs through non-US public markets (including pure-play US investments such as Manulife US REIT (Singapore Exchange) and WPT Industrial REIT (Toronto Exchange)), and through private investment funds.

Law stated - 07 October 2021

Transactions with non-REITs

Are there any special considerations when REITs negotiate purchases and sales or leases of investment real estate with non-REITs?

In addition to all of the normal diligence required for a real estate acquisition, a REIT needs to diligence the revenue contracts and services provided by the seller, in order to determine whether any contract has either a 'bad' formula that would result in not REIT-compliant gross income (and thus not good rent for REIT purposes) or calls for services to one or more tenants that cannot be provided directly by the REIT (and would thus need a TRS as service-provider). The fundamental goal in such diligence is that every revenue contract and service must be either REIT-compliant by the time of closing or else segregated into a TRS.

Further, when a REIT is negotiating a lease of its property to tenants, here too it must both eschew 'bad' revenue formulas and identify the particular tenant services that will need the involvement of a TRS. Further, the REIT needs to be mindful of potential subleases containing a 'bad' formula or TRS-type services, such that the revenue provided by the tenant/sub-landlord to the REIT is tainted; these sublease concerns are typically handled by including protective undertakings in the prime lease between the REIT and its tenant.

For public REITs, certain acquisitions (and dispositions) will also require additional historical and pro forma financial statements to be filed with the SEC.

Law stated - 07 October 2021

Acquiring non-REIT corporations

Are there any special considerations when REITs acquire non-REIT corporations?

Due to the widespread presence of REITs among real estate investments, it is now unsurprising and typical for a REIT to acquire (or bid to acquire) a regular (that is, non-REIT) corporation through mergers and acquisitions activity, such that the REIT succeeds to the corporation's assets and revenues and these additional assets and revenues immediately become part of the REIT. Many of the country's largest REITs have grown significantly in exactly this fashion. (See Hammell and Ponda, 'What a Relief! – Avoiding 'REIT M&A Drama' via the Temporary Investment of New Capital Rules', 22 Journal of Passthrough Entities No. 6, 63-71 (Nov.-Dec. 2019) .)

In addition to diligence and imposing the standard battery of REIT requirements upon the new assets and revenue becoming part of the REIT (eg, organisation of appropriate assets and revenues into TRSs as needed), there are two additional REIT requirements in connection with such an acquisition by (and absorption into) the REIT. First, the acquiring REIT must distribute the acquired corporation's accumulated earnings before the close of the REIT's tax year. Second, the REIT's disposition within five years of the assets inherited from the acquired corporation will be subject to a special, entity-level built-in gains tax that cannot be eliminated with a dividends paid deduction. More information may be found in Ponda, 'How Much Gain Would a REIT Defer if a REIT Could Defer Gain?', 135 Tax Notes 1249 (June 4, 2012) . Sometimes, the acquiring REIT will also have to file changes in accounting methods with the US Internal Revenue Service so as to conform the inherited depreciation schedules to depreciation schedules more commensurate with the acquired assets' status as real property, and the associated depreciation recapture here also attracts the special, entity-level built-in gains tax that cannot be eliminated with a dividends paid deduction.

For public REITs, certain acquisitions will also require additional historical and pro forma financial statements to be filed with the US Securities and Exchange Commission. One advantage, though, is that REITs are normally exempt from Hart–Scott–Rodino Act filings.

Law stated - 07 October 2021

UPDATE AND TRENDS

Recent developments

What have been the most noteworthy recent developments affecting REITs in your jurisdiction, including any significant legal or regulatory changes and commercial trends?

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Jurisdictions

India	AZB & Partners
Japan	Mori Hamada & Matsumoto
Luxembourg	Loyens & Loeff
USA	Sullivan & Worcester LLP