An Introduction to REIT Compliance for Timber REITs

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REITs

- What is a REIT?
- REIT Tax Structure
- Why are REITs Utilized?
- ORIAD Requirements
  - **O**rganization & Capital Structure
  - **R**evenue from Timber
  - **I**ncome from Other Sources
  - **A**ssets
  - **D**istributions of Income

What is a REIT?

- A company that owns or finances investment real estate and that qualifies for and makes a special tax election
  - Note difference between qualification as a "REIT" for U.S. federal income tax purposes and organization as a real estate investment trust as a business form
- Unlike a regular C corporation, a REIT is permitted to deduct dividends paid to its shareholders from its corporate taxable income
  - Most REITs distribute 100% of taxable income and therefore owe no income tax
  - Owners are subject to federal income tax on the dividends received
  - Most states in the U.S. conform to this U.S. federal treatment
  - Non-U.S. jurisdictions do not follow this U.S. federal treatment
- Designed like a mutual fund: provides a vehicle for passive investors to acquire a portfolio of real estate

REIT Tax Structure

Traditional C Corporation	Tax-Advantaged REIT
Corporation Earns Return on Investment	REIT Earns Return on Investment
↓	↓
C Corporation Pays Tax on Income	REIT Pays No Tax on Income*
↓	↓
Corporation Pays Dividend to Shareholders	REIT Pays Dividend to Shareholders
↓	↓
Shareholders Pay Tax on Dividend	Shareholders Pay Tax on Dividend

*Assuming that all REIT taxable income is paid out as a dividend to REIT shareholders

Why are REITs Utilized?

- REITs generally pay no income tax at the entity level
  - Income earned by a REIT is generally subject to only a single layer of tax at the shareholder level if the REIT distributes 100% of its REIT taxable income as a dividend to its shareholders
- REITs issue IRS Forms 1099 and 1042-S to shareholders instead of Forms K-1
  - Generally, results in no state income tax and no state filing requirement for a shareholder
  - If there are any state income tax or state filing requirements, they are only in the shareholder's state of residence – i.e., there is no source-based state income taxation
- Investing in a REIT can be attractive to tax-exempt investors as dividends from a REIT typically are not treated as unrelated business taxable income (UBTI)
- REITs are attractive vehicles through which non-U.S. persons (particularly sovereign investors and non-U.S. pension funds) can invest in U.S. real estate and be excused from some or all of otherwise applicable U.S. taxes

Why are Private REITs Utilized?

Non-U.S. persons are subject to tax on Effectively Connected Income (ECI)

FIRPTA* can cause some REIT distributions and gain from the sale of REIT shares to be treated as if it was ECI

Non-U.S. persons are still generally subject to tax and withholding on distributions from a REIT, even if FIRPTA does not apply

REITs serve as blockers such that non-U.S. persons generally will not earn ECI by virtue of their investment in the REIT

Exceptions from FIRPTA exist for certain REITs

Certain classes of foreign investors can avoid even this withholding

** FIRPTA refers to The Foreign Investment in Real Property Tax Act of 1980, which is incorporated into the U.S. Internal Revenue Code of 1986, as amended*

Why are REITs Utilized?

- **General rules of taxation for non-U.S. persons**
  - Non-U.S. persons are taxed on ECI from a U.S. trade or business, regardless of source
    - ECI generally triggers a tax return filing requirement in the U.S.
    - ECI is typically taxed at high rates, including potential branch profits tax and U.S. state income taxation
  - Non-U.S. investors are taxed on U.S. source passive income (non-ECI), such as dividends and interest paid by a U.S. corporation, subject to reduction or elimination by treaty or by U.S. statute
    - The tax is generally collected via withholding at the source of payment to the foreign person
    - Treaties and U.S. statute can often reduce the tax rate to 15% or even 0%

Why are REITs Utilized?

- **As a regarded taxable entity, a REIT serves as a blocker for non-U.S. persons**
  - A non-U.S. shareholder will generally not be treated as engaged in a U.S. trade or business as a result of its investment in a REIT
  - U.S. tax return filing requirements are generally minimized for non-U.S. persons
  - Dividends paid by REITs are generally subject to the U.S. withholding rules applicable to dividends paid by any U.S. corporation
  - Rate of withholding on dividends is generally 30%, but often reduced by treaty or by U.S. statute to as little as 15% or even 0%
- **But, FIRPTA is an exception to the above favorable rules**

Why are REITs Utilized?

- **FIRPTA and REITs – General Concepts**
  - REIT distributions attributable to the disposition of underlying U.S. real estate may be subject to tax under FIRPTA and obligate non-U.S. persons to file U.S. income tax returns
    - FIRPTA considerations often lead to careful tax structuring of U.S. real estate transactions, including possible activity restrictions on the monetization and disposition of the investment
  - FIRPTA treats the gain or loss realized by a non-U.S. investor from the disposition of a U.S. real property interest as ECI
    - FIRPTA generally applies to any dividend by a REIT attributable to the REIT's gain from the disposition of a U.S. real property interest
    - If a non-U.S. person disposes of a U.S. real property interest, a portion of the sale proceeds generally is subject to a U.S. withholding tax
  - U.S. real property interests include land, improvements, leasehold interests, unsevered natural products, and certain personal property associated with real property
  - As important, U.S. real property interests include equity interests in U.S. corporations that are considered to be a "U.S. real property holding corporation"

Why are REITs Utilized?

- **Exceptions to application of FIRPTA to REIT shareholders**
  - Stock in a “domestically controlled” REIT
  - Publicly traded stock in a REIT held by a 10%-or-less shareholder
  - Certain publicly traded entities, pensions, and similar investment funds may own and dispose of any amount of stock in a REIT without the REIT stock being treated as a U.S. real property interest, except to the extent an investor in such a shareholder holds more than 10% of that class of REIT stock

Why are REITs Utilized?

- **FIRPTA and Non-U.S. Governmental Entities (i.e., sovereign investors)**
  - Generally, non-U.S. governmental entities are not subject to U.S. federal income taxation on dividends, interest, and capital gains
  - To qualify for this exemption, it is important that the investment not be made by or through a "controlled commercial entity" (generally defined as an entity that is controlled by a non-U.S. government and is engaged in commercial activity)
  - REITs are used to avoid the recognition of income from commercial activities, but they must be structured to avoid classification as a controlled commercial entity of the foreign government
    - To cede "control", sovereign investor may opt for fewer veto/control rights
    - REIT shares can be held indirectly through a partnership
    - Exit events must generally be structured as a sale of shares in the REIT rather than a sale of fee title in real estate held by the REIT
  - An eligible investor may utilize this status to eliminate U.S. tax on regular REIT dividends and also on sales of REIT shares (even if not "domestically controlled"), but the exemption does not extend to REIT dividends attributable to FIRPTA dispositions

Why are REITs Utilized?

- **FIRPTA and "Qualified foreign pension funds"**
  - Qualified foreign pension funds (including wholly-owned subsidiaries of such funds) are entirely exempt from FIRPTA
  - In order to qualify as a qualified foreign pension fund, certain U.S. requirements must be satisfied, including requirements relating to:
    - the taxation of the fund and its beneficiaries under the laws of the country in which it was formed
    - the composition of its beneficiaries
  - Although exempt from FIRPTA, qualifying foreign pension funds may still be subject to U.S. federal income tax under the general rules applicable to all non-U.S. persons, such as U.S. federal withholding tax on dividends from a REIT
    - However, income tax treaties often eliminate or reduce the U.S. federal withholding tax for pension funds
  - **Practical Consideration:** When the FIRPTA exemption for qualified foreign pension funds is combined with the elimination of dividend withholding, a foreign pension fund can effectively invest in U.S. real estate through a REIT without any U.S. federal or state income tax

ORIAD Requirements

- To maintain REIT status, various requirements must be met:
  - **O**rganization & Capital Structure
  - **R**evenue from Timber
  - **I**ncome from Other Sources
  - **A**ssets
  - **D**istributions of Income

Organization & Capital Structure

- Shares must be held by at least 100 shareholders (aggregating common and preferred shareholders)
- No more than 50% of the value of a REIT’s outstanding stock may be owned, directly or indirectly, by 5 or fewer individuals
- Organizational Documents
  - Typically contain restrictions on stock ownership/transfer to avoid becoming closely held or having affiliated tenants
  - Typically contain provisions relating to shareholder demand letters so that ownership can be ascertained
  - REIT must be “managed by one or more trustees or directors”

Organization & Capital Structure

- Annual Reporting
  - IRS Form 1099-type reporting to shareholders
  - IRS Form 8937 reporting with respect to distributions treated as a return of capital
- Various recordkeeping is required for asset tests, shareholder demand letters, related tenants, and independent contractors

Organization & Capital Structure

- Taxable REIT Subsidiary (TRS)
  - TRSs are subject to federal corporate income tax on their taxable income
  - TRSs are treated as separate corporations and are not consolidated with the REIT for income and asset testing, and are generally outside the activity restrictions and distribution requirements and considerations
  - “Bad” assets and businesses should be assigned to TRSs
- Qualified REIT Subsidiary (QRS)
  - QRSs are corporations that are wholly-owned by the REIT and for which a TRS election is not made
  - QRSs are transparent for income and asset testing purposes and thus are consolidated with the REIT for income and asset testing, and also for activity restrictions
  - Among REIT practitioners, QRSs colloquially include disregarded entities under the Section 7701 regulations
- Partnerships and Disregarded Entities
  - Partnerships and disregarded entities are transparent for income and asset testing purposes
  - A REIT’s proportionate share of a partnership’s or a disregarded entity’s income and assets rolls up for purposes of the REIT’s income and asset tests
  - Partnerships should be operated to fit within ORIAD

Organization & Capital Structure

Practical Considerations:

- Class A Preferred Shares are often issued in a private placement in order to satisfy the 100-shareholder requirement
- Investors will often indirectly own REIT shares through an entity taxed as a partnership for U.S. federal income tax purposes
- The limited partnership agreement of the holding partnership contains provisions designed to maintain the REIT's organizational requirements
  - "Qualified Assignee" concept prevents transfers that would cause REIT failure or cause qualifying REIT income to cease to so qualify
  - Investors are required to respond to shareholder demand letters
  - No changes should be made to the Organization or Capitalization of the REIT structure (whether by waiver, amendment or otherwise) without legal documentation being reviewed by outside REIT counsel

Organization & Capital Structure

Practical Considerations:

- A partnership holding structure is safer with regard to a number of existential REIT requirements, as well as with respect to cross-border withholding mechanics and exposure
  - Governance provisions are documented in the upper-tier partnership agreement, reducing pressure on the “managed by [a board of] directors” requirement
  - REIT common dividends are paid to a single shareholder, narrowing the opportunities for the REIT to make problematic “preferential dividends”
  - Interposing a partnership on top of the REIT simplifies withholding mechanics under the Internal Revenue Code, reducing exposure on withholding in respect of routine capital gains from harvesting timber
  - Simplifies a future sale of REIT shares (a very popular form of M&A exit as compared to the REIT selling the underlying timberlands), in that a future buyer can transact with the selling partnership and its general partner (to buy 100% of the target REIT)
    - FIRPTA compliance is also simplified as the buyer can accept a FIRPTA affidavit from the selling U.S. partnership as a U.S. person, and not have to investigate the status of the non-U.S. investors

Revenue from Timber

Sales of Timber – REIT Compliance Considerations

- Holding periods
  - First Year Timber
  - Over-One-Year Timber
- Forms of sales agreements
  - Pay as Cut Sales
  - Lump Sum Sales
  - Delivered Log Sales

Revenue from Timber

Description	Lump Sum Sales	Pay as Cut	Delivered Log Sales
First Year Timber			
Can a REIT directly sell timber owned less than 12 months in this manner to third parties?	No	Yes	No
Can a REIT directly sell timber owned less than 12 months in this manner to a captive cutting subsidiary (TRS)?	No	No	No
Can a captive cutting subsidiary (TRS) sell timber (acquired by capital contribution from the REIT) in this manner?*	Yes	Yes	Yes
Over-One-Year Timber			
Can a REIT directly sell timber owned 12 months or more in this manner to third parties?	Yes	Yes	No
Can a REIT directly sell timber owned 12 months or more in this manner to a captive cutting subsidiary (TRS)?	Yes	Yes	No
Can a captive cutting subsidiary (TRS) sell timber (acquired by purchase of stumpage from the REIT) in this manner?	Yes	Yes	Yes

** The captive cutting subsidiary (TRS) will have carry-over basis in the timber and may recognize gain on the sales.*

Revenue from Timber

Sales of First Year Timber

- First Year Timber will generally be transferred to a TRS as a capital contribution, and then sold pursuant to agreements between the TRS and the ultimate customer
  - Possible taxable gain recognized by the TRS by virtue of carry-over basis from the REIT
  - Contributions should be made at least 2 weeks in advance of cutting and ideally identify the specific trees to be cut (e.g., “that timber on lot X, as marked with yellow ribbon”)
- Pay as cut sales transacted in the first year (including those conducted with a properly structured advance payment/deposit) are considered to produce royalty income, which is good REIT income for the 75% and 95% gross income tests, provided that the sales are to parties unrelated to the REIT (i.e., less than 10% affiliated)
  - Conversely, pay as cut sales from a REIT to a TRS in the first year do not generate REIT qualifying income due to relatedness

Revenue from Timber

Pay as Cut Sales of Over-One-Year Timber

- In a pay as cut sale, the timber owner sells the right to cut certain trees for a specified price on a per unit basis
- The purchaser makes periodic payments over the life of the contract based on the exact amount harvested to date
- Under this method, the landowner is basically selling the contract right to cut a specified volume of standing timber by timber type and use (i.e., pulpwood, chip-n-saw, sawlogs, etc.)
- The owner retains an economic interest in the timber until it is severed from the land
  - If during the life of the contract the standing timber is destroyed, the loss is recorded by the timber owner
- Sometimes possible to structure a pay as cut contract with an advance payment/deposit (similar to lump sum sale except including a “true-up” to actual harvest)
- **Practical Consideration: Pension-held REITs should consider utilizing lump sum agreements because the pay as cut model may not shield tax-exempt investors from “unrelated business income tax” per Sections 512(b)(13) and 856(h)(3)(C)**

Revenue from Timber

Lump Sum Sales of Over-One-Year Timber

- In the typical lump sum sale process, a timber owner will prepare a prospectus outlining the details of what is being sold in the hopes of receiving multiple bids for the right to acquire the timber
- Each bidder is responsible for placing its own estimate on the volumes of timber available and on what it will cost to cut, haul, and market those trees, and then making a fixed-price bid to acquire the timber being sold
- Once the contract is signed, the timber is considered to be the asset of the purchaser, and the risk of loss has passed to the purchaser
- Treated as a sale of real property (ownership of the standing timber), but not treated as a sale of dealer property due to special U.S. tax provisions
  - This generates good REIT income under the 75% and 95% gross income tests (capital gain)

Revenue from Timber

Delivered Log Sales

- In this type of transaction, the timber owner contracts with the loggers for the cut, yard, and hauling costs and with the mills for the ultimate price of the "delivered" product
- This type of transaction is considered nonpassive (since what is being sold is cut logs) and is not considered good REIT income under either the 75% or 95% gross income tests
- Further, the transaction may constitute a prohibited transaction under the REIT rules and thus be subject to a 100% tax on net income
- **Practical Consideration: Timber REITs should NOT employ this timber sales method directly**
  - Instead, as described below, a Timber REIT can employ a TRS (i.e., a cutting subsidiary) to synthesize such a sale without jeopardizing REIT qualification

Revenue from Timber

Cutting Subsidiaries (TRSs)

- In the context of Timber REITs, a cutting subsidiary making a TRS election may be set up to handle delivered log sales with the ultimate customers (something which the REIT generally may not engage in directly)
- Cutting subsidiary would enter into pay as cut or lump sum contracts with the landowner REIT to acquire stumpage
- Cutting subsidiary would then sell the severed timber into the marketplace via delivered log sales
- Profit earned by the cutting subsidiary would be taxed at regular corporate income tax rates, while the cutting subsidiary's retained earnings would be sent back to the REIT via an intercompany dividend (and therefore "cleansed" for purposes of the 95% gross income test as dividend income)

Revenue from Timber

- Revenue stream for the delivered log sales thus would be bifurcated into two parts:
  - Stumpage sale revenue (from the TRS, as buyer of the stumpage) that goes directly to the REIT as good REIT income for both gross income tests
  - Profit of the TRS on the delivered log sales above the stumpage price, which profit is taxable, and the TRS will send a dividend of after-tax profits to the REIT that is good REIT income for the 95% gross income test
- To sell to “captive” cutting subsidiary (cutting subsidiary in which the REIT owns 10% or more), the timber must have a holding period of over one year, else stumpage must be contributed to the cutting subsidiary as a capital contribution

Revenue from Timber

Example of how use of a cutting subsidiary (TRS) can benefit REIT investors

Facts & Scenarios

Volume available for sale	10,000 units
Forecast income if sold via lump sum sales contract	$1,000,000
Forecast income if sold via delivered sales agreement	$1,250,000

Scenario A: REIT sells the volume under the lump sum contract

Scenario B: REIT utilizes a cutting subsidiary (TRS) to sell the volume as logs

Scenario A

Description		***Amount***
REIT Net Income		
Lump sum sale contract income	$	1,000,000
Costs	$	-
REIT Net Profit	$	1,000,000
TRS Net Income		
n/a	$	-
Net Cash to Investor	**$**	**1,000,000**

Scenario B

Description		***Amount***
REIT Net Income		
Lump sum sale contract income	$	1,000,000
Costs	$	-
REIT Net Profit	$	1,000,000
TRS Net Income		
Delivered logs sale income	$	1,250,000
Cost of lump sum sale contract	$	(1,000,000)
Profit	$	250,000
Taxes (assume 25%)	$	(62,500)
TRS Net Profit	$	187,500
Net Cash to Investor	**$**	**1,187,500**

Revenue from Timber

- **Practical Considerations:**
  - The cutting subsidiary (TRS) should show a reasonable profit on the timber cutting contracts and the logging business
    - Subsidizing cutting/logging losses with other profit centers is not relevant to whether the cutting contracts themselves are at arm's-length terms
  - IRS has prioritized enforcement activity in the TRS transfer pricing area
  - Auditors, underwriters/bankers, and future purchasers become additional "enforcers" for this proper transfer pricing
  - The statute does not necessarily require a TRS to be profitable on cutting/logging every year, but some REITs and TRSs do just that in order to be safe

Income from Other Sources

- At least 75% of a REIT's gross income must be derived from real property
  - Such as income from properly structured lump sum or pay as cut contracts, gain from the sale of real property, qualified rents, mortgage interest, dividends on or gains from the sale of REIT stock, or refunds of real property taxes
- At least 95% of a REIT's gross income must generally be passive in nature
  - Income from real property that satisfies the 75% requirement above
  - Other interest, dividends, or gains from the sale of non-REIT stock or other securities
- Thus, only 5% of gross income may come from "bad" sources
  - Improperly structured timber contracts
  - Bad rents from improperly structured leases
  - Impermissible services
  - Businesses other than rental real estate
  - **Practical Consideration:** REIT income tests basically come down to managing the 5% bad basket

Income from Other Sources

- Income earned in TRSs is not consolidated with the REIT for gross income testing
- 100% tax on net income from sales or other dispositions of "dealer property"

Income from Other Sources

Practical Considerations:

- Timber REITs face unique issues with respect to REIT gross income testing
- Due to use of cutting subsidiaries (TRSs) and the ability to utilize depletion deductions "above the line", revenue from the sale of timber generally represents a relatively small percentage of the REIT's gross income
  - This is especially true in the first year following the acquisition of the timberlands since timber sales are generally made by the TRS through capital contribution of the standing timber from the REIT (i.e., no intercompany sales)
- Thus, even a relatively small amount of nonqualifying revenue could result in a failure of REIT gross income testing
- The following slides reflect some common sources of revenue earned by timber REITs
  - The list is not exhaustive, and any new revenue contracts MUST be vetted by outside REIT counsel
  - Service contracts should also be reviewed by outside REIT counsel as those contracts may result in the creation or conveyance of severed timber, ownership of which must be properly managed ahead of any sale

Income from Other Sources

Ground Leases

- Timber REITs will often enter into ground leases with third parties who then construct structures on the land (e.g., windmills, hydroelectric dams, cell phone towers)
- Fixed-fee rents for the use of land and the placement of inherently permanent structures thereon represent rent from real property and are thus good REIT income
  - A sliding fee rent for a lease/sublease that is based on a percentage share of the tenant's gross revenue (but NOT its net income or net profit) is also considered rent from real property and good REIT income, provided that the tenant's gross revenue is not based, directly or indirectly, on any sublessee's net income or net profit

Income from Other Sources

- Some timberland owners lease land to tenants under fixed-rent leases for farming purposes (for example, leases which permit a tenant to grow and then cut hay on a cleared portion of land)
  - These leases produce good rent from real properties, since there is no issue with leasing land for farming use in return for a fixed rent payment
  - Sharecropping leases may produce good rent for REIT gross income test purposes as long as the lessor did not have actual control of the farming operations or receive a share of the overall profit

Income from Other Sources

Hunting Leases

- Hunting leases typically will generate rents from real property and thus good REIT income
- The landowner typically receives income based on the use of its land on an exclusive or semi-exclusive basis, with the landowner providing virtually little or no services to the tenants/hunters
- If the landowner provides too many services to the hunters, the treatment of the leases as rents from real property might be questioned, but such a scenario is rare for Timber REITs

Income from Other Sources

Rights of Way/Road Use "Temporary Easements"

- Contracts which enable third parties to use a REIT's land for a set period of time, but do not transfer ownership of the land, generally are easements or long-term leases
- Typical transactions include pipeline easements, access/rights of way, temporary roads, etc., and two key considerations are implicated, as follows
  1) Term – must be temporary (fixed term, generally less than 60 years); permanent easements will be viewed as deemed sales by the IRS, raising prohibited transaction issues
     - Longer periods may be used if the party seeking the easement has the power to involuntarily take the property (e.g., by eminent domain) and if condemnation proceeds are timely reinvested

Income from Other Sources

Rights of Way/Road Use "Temporary Easements" (Cont'd)

2) Consideration – in most cases, should be fixed and determinable. In some instances – such as oil/gas/mineral rights of way and strip mine ponds – consideration may be variable (i.e., revenue sharing based on how productive the project is), provided the project is not on the REIT's land

- Revenue share based on net profit or net income is always considered nonqualified income for a REIT
- Thus, any permitted revenue share should be based on a measure of gross revenue based on the volume of gas or mineral being mined elsewhere and then later transported over the REIT's land
- **Practical Consideration:** Similar to first year timber, in order to permit oil, gas, or mineral to be mined on its real property, a REIT should contribute the oil, gas, or mineral to a TRS, and the TRS can then manage the sales

Income from Other Sources

Water Rights

- Riparian water rights (rights to water that are related to the ownership of land bordering the water)
  - Water rights are not treated as mineral rights, so riparian rights qualify as interests in real property
  - A REIT can treat income generated from allowing a third party access to water on its land as good REIT income; the REIT is being compensated for granting a right of way
- A contract for selling a specific volume of water would be considered nonqualified, dealer type activity (thus, in order to engage in such sales, the water must first be contributed to a TRS)

Income from Other Sources

Carbon Credits

- The IRS has exercised its statutory authority in a few instances to rule that income attributable to the receipt of carbon emissions credits in connection with the ownership of timberlands constitutes qualifying income for purposes of REIT gross income testing
- But, recently issued regulations create the implication that “transferable credits” are not “real property” since these intangible assets are “separable” from the underlying real property
- **Practical Consideration:**
  - Creative TRS planning is sometimes, but not always, possible
  - For example, a typical compliant structure would involve a REIT’s receipt of carbon credits, followed by a prompt contribution of the same to a TRS, and then an ultimate sale by the TRS of the carbon credits in due course

Income from Other Sources

Biomass

- Biomass is a byproduct produced by logging operations (e.g., stumps, branches, and tops) or by normal forest shedding (e.g., winds, aging)
- Generally, the sale of biomass is nonqualified income for a REIT, in that it is not considered a sale of real property because the pieces of timber have already been severed from the land
- **Practical Consideration:** A Timber REIT may make a capital contribution of biomass to a TRS, and the TRS can sell the same for a profit that is fully taxable

Income from Other Sources

Seismic Surveys

- Seismic surveys are conducted by unrelated third parties, who set up blast locations and monitoring locations and then trace the shock waves created by subterranean blasts to determine the configuration of underground deposits (for example, deposits of oil, gas, and mineral reserves)
- Amount paid by unrelated third parties to conduct these surveys is good REIT income as the payment is for the use of the REIT’s land
- **Practical Consideration:** Payments for damages to standing timber, whether the damages were expected or unexpected, can generally represent a capital gain, provided that such sales do not occur so often as to implicate a “dealer property” issue
  - However, if timber anticipated to be felled under this circumstance has a holding period greater than one year, then its felling could be handled through the use of a compliant stumpage contract

Income from Other Sources

Gas, Oil, and Mineral Rights - Extraction

- "Interests in real property" include fee ownership, co-ownership and leasehold of land and improvements on land, but expressly do not include gas, oil, or mineral royalty interests
  - The corresponding gas, oil, and mineral royalty assets and income are typically classified as non-real property assets that generally produce bad income for REIT gross income testing purposes
  - For these purposes, minerals include gravel – as such, all contracts that provide for the REIT receiving a tonnage payment for gravel extracted from the ground would produce mineral royalties that are bad income for the REIT
- Exception: Ground lease payments for fixed rent (or acceptable variations thereof) do not represent bad income, as these transactions are considered payments for occupancy
  - However, if the amount of rent for a ground lease is related to production quantities of gas, oil, or minerals located on the leased property, then the ground lease is recharacterized as a royalty arrangement that produces problematic income for a REIT

Income from Other Sources

Gas, Oil, and Mineral Rights – Non-Extraction

- Surface damage payments (via easement or license) that are based on gas, oil, or mineral volume represent "good income" for a REIT only if the gas, oil, or mineral was extracted from someone else's land
- Similarly, rent on a gas or oil pipeline easement may be measured by the volume of gas or oil traveling through the pipeline, as long as the extraction of the gas or oil took place on another's property
- **Practical Consideration:**
  - Creative TRS planning to facilitate the sale of gas, oil, or minerals on the REIT's real property is sometimes, but not always, possible

Assets

- No more than 25% of a REIT's assets may be represented by assets that do not count favorably toward the 75% asset test
- **Practical Consideration**: "Bad" assets may be segregated into taxable REIT subsidiaries
  - Stock in TRSs are "bad" assets, but are valued on a net equity basis
  - Assets held in TRSs are not consolidated with the REIT for asset testing
- No more than 20% of a REIT's assets may be represented by stock or other securities of TRSs
- 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 having a value of more than 10% of the total value or voting power of the outstanding securities of any one issuer
  - **Practical Consideration**: There is no *de minimis* test for the 10% vote or value tests—thus, a small security held by a REIT can cause a failure

Distributions of Income

- A REIT must meet certain distribution requirements
  - 90% distribution of taxable income is required to be a REIT
  - 100% distribution of taxable income maximizes tax efficiency
- A REIT may satisfy the 90% distribution requirement utilizing consent dividends
  - Consent dividends are not actual cash distributions, but rather are amounts which the stockholders consent, for federal income tax purposes, to be treated as having received in a fictional distribution on the last day of the REIT's taxable year and then as having recontributed to the capital of the REIT

Distributions of Income

- **Practical Considerations:**
  - Most REITs distribute 100% of their taxable income to eliminate corporate income tax on retained income
  - Debt covenants must permit distributions, at least in amounts necessary to satisfy REIT distribution requirements
  - Management fee waivers must be carefully reviewed to avoid preferential dividend issue
  - Preferred dividend payments must be made on preferred stock in strict accordance with the terms of the charter

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