Key REIT Conversion Considerations:

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Key REIT Conversion Considerations

- What is a REIT?
- Why is a REIT Exempt from Tax?
- Corporate Tax Structures
- REIT Conversion Milestones
- Conversion Toll Charges
- REIT Frontiers
- ORIAD Requirements
- REIT Subsidiaries

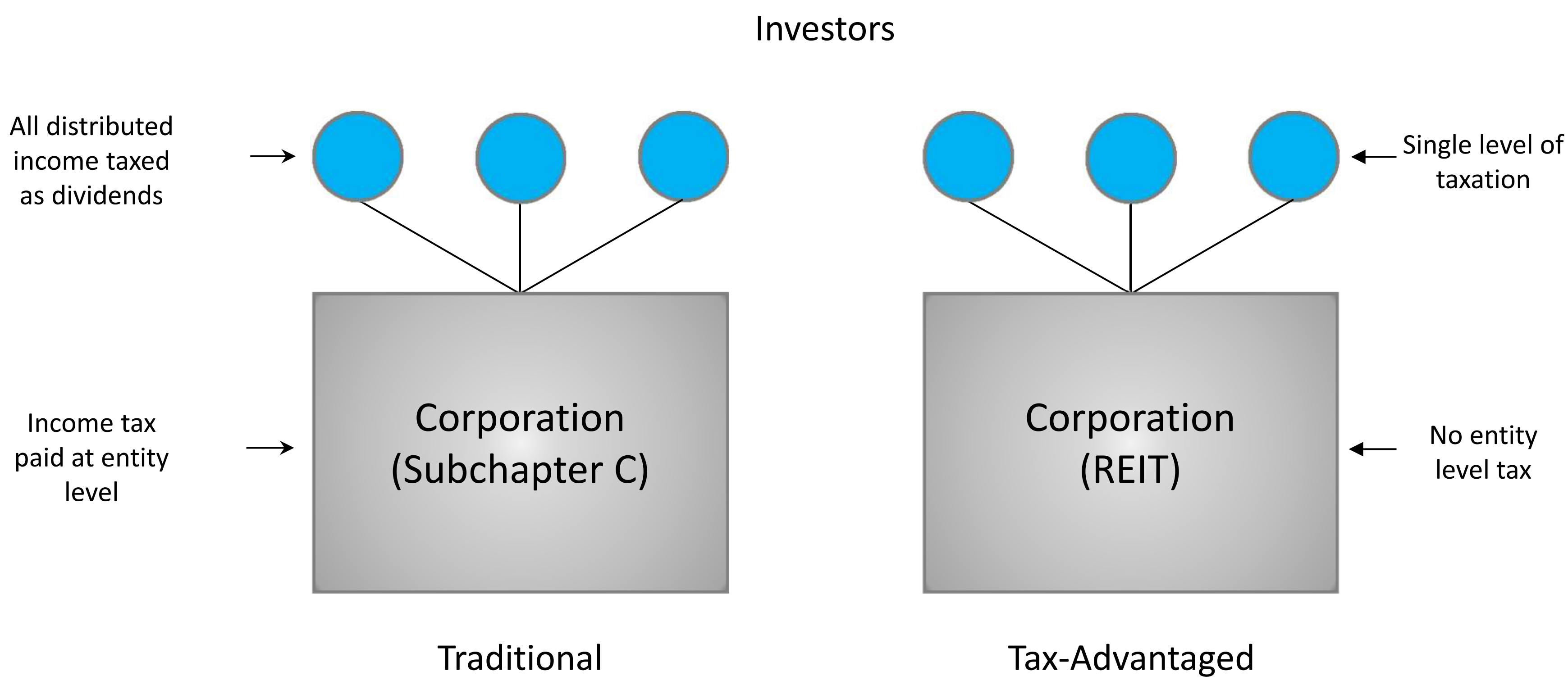
What is a REIT?

- A company that owns and leases real estate and that qualifies for and makes a special tax election
- 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 income and therefore owe no income tax
  - Taxes are paid by shareholders on the dividends received
  - Most states conform to this federal treatment
  - Non-U.S. jurisdictions do not follow this federal treatment
- Note difference between qualification as a “REIT” for federal income tax purposes and real estate investment trust as a business form
- Non-tax laws don’t key off of REIT status; REIT status keys off of facts and other laws
- REIT Subsidiaries (see slides 22-24)
  - Qualified REIT Subsidiary (QRS) — consolidated with REIT for tax purposes
  - Taxable REIT Subsidiary (TRS) — separate from REIT for tax purposes

Why is a REIT Exempt from Tax?

- Designed like a mutual fund: provides a vehicle for passive investors to acquire a portfolio of real estate
- Lease/license financing and mortgage financing are comparable
- Rental real estate is often considered passive under the Tax Code
  - Tax exempts such as Harvard, the Red Cross, or the Catholic Church generally pay no taxes on income from rental real estate
  - But NYU had to pay taxes on its pasta manufacturing business (see C. F. Mueller Co. v. Commissioner, 14 T.C. 922 (1950))

Corporate Tax Structures



- In both cases, the entity can be a domestic corporation, trust or certain other legal forms
- For "corporate" and certain state tax reasons, REITs (as defined for federal income tax purposes) are commonly organized under Maryland or Delaware law

REIT Conversion Milestones

- Feasibility: Can the business fit within a REIT?
- Desirability: Should the business become a REIT? Culminates in a public announcement.
- Execution: 6+ month timeline
  - Start date: January 1
  - Private Letter Ruling (IRS), if needed
- Sustainability: De-REITing is not an option
  - Impact on M&A
  - Impact on foreign assets and operations

Conversion Toll Charges

- Depreciation recapture and associated recapture tax
  - Income from recapture included over four-year period
  - IRS audit exposure if depreciation recapture is not voluntary
- Acceleration of deferred intercompany gains
- Triggering of dual consolidated losses
- Distribution of pre-REIT earnings and profits
- Built-in gains tax on property disposed of during the five-year period following REIT conversion
- Expenses for internal reorganization, systems conversion, debt modifications, etc.

REIT Frontiers

Successes	Next Frontier
Transmission and Distribution Infrastructure/Liquid Storage and Delivery Systems	Alternative Energy Infrastructure/Water Infrastructure
Wholesale/Colocation Data Centers	Cloud
Distributed Antenna Systems	Fiber Optic Networks
Cold Storage Warehousing/Prisons	Landfills
Records Storage Facilities	
Wireless Telecommunications Infrastructure/Media Billboards	
Railroads	
Agriculture	Greenhouses
Farmland	
Vineyards	
Timberland	

ORIAD Requirements

- To maintain REIT status, various requirements must be met:
  - **O**rganization & Capital Structure
  - **R**ent
  - **I**ncome
  - **A**ssets
  - **D**istributions

Organization & Capitalization

- Shares must be held by at least 100 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
- **Practical Considerations:**
  - Privately held REITs can satisfy the 100 shareholder requirement through a private placement of preferred stock to accommodation stockholders.
  - Articles of Incorporation and Bylaws
    - Should provide restrictions on stock ownership to avoid becoming closely held or having affiliated tenants
      - Limit shareholders to owning 9.8% of any class of equity
      - Include an automatic transfer of "excess shares" into a charitable trust
    - Should include provisions relating to shareholder demand letters so that ownership can be ascertained
  - Many REITs are incorporated in Maryland to maximize the enforceability of these provisions
  - Outstanding convertible debt may need to be recapitalized to ensure continuing compliance with these provisions

Organization & Capitalization

- Annual Reporting
  - Disclosure of REIT tax considerations
  - 1099 reporting to shareholders
  - 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
- **Practical Considerations**: REIT organizational requirements are generally compatible with most dividend reinvestment plans, share repurchase plans, and employee equity incentives
- **Practical Considerations**: Check for debt covenants that restrict cash dividends; authorize enough shares to allow for cash-and-stock dividends

Rent

- Fixed rent and percentage rent based on gross receipts is “good” income, but percentage rent based on cash flow or net income results in “bad” income
- No extraordinary services may be performed by the REIT
  - REITs are designed to be passive
  - Certain customary services may be provided by a REIT in connection with a lease
  - Impermissible tenant services income
    - Limited to 1%, after which all property revenues are tainted
  - Impermissible services must be provided by an independent contractor or a TRS
  - **Practical Considerations**: All services provided must be reviewed to determine if they are customary services or need to be performed by a TRS
    - All customer revenue collected by a REIT (including revenue for services performed by a TRS) will qualify as rents from real property
    - Care must be taken to ensure that TRSs are adequately compensated for provided services so as to avoid redetermination of rents and associated tax penalties (see slide 23)

Rent

- No 10% affiliated tenants
  - Applicable charter restrictions prevent 10% affiliated tenant
  - Exception: Rent from a TRS is qualifying if 90% of leased space at the site is leased to third parties
  - **Practical Considerations**: TRS can rent some space necessary to provide extraordinary services to customers
- Ground leases/licenses
  - Ground leases/licenses must be REIT compliant if rent is passed on to the REIT's lessees/licensees
  - Section 856(c)(5)(J) PLR as a solution
- Personal property limitations
  - No more than 15% of the value of a lease/license may be for personal property
  - **Practical Considerations**: Prior to REIT conversion, the Company should undertake a diligence project to identify all of the personal property that it holds in each general ledger account and to determine the value of such property
- **Practical Considerations**: In an M&A setting, diligence is necessary to determine whether a target's leases/licenses are REIT compliant

REIT "Rent" Analysis Framework

	No people or not person-intensive	Person-intensive
Real Property Assets	Rental Income QRS	Customary utility/services QRS Extraordinary customer utility/services TRS
Personal Property Assets	15% Test Rental Income or passive amenity	Operating business Must be in a TRS

Income

- At least 75% of a REIT's gross income must be derived from real property
  - Qualified rents
  - Other income from real property such as gain from the sale of real property, mortgage interest, 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 stock or other securities
  - PLR to address Subpart F, PFIC, and similar gross income items

Income

- Thus, only 5% of gross income may come from "bad" sources
  - Bad rents
  - Impermissible services
  - Businesses other than rental real estate
  - Pre-existing hedges to be solved with PLR
  - Section 481(a) adjustments for depreciation recapture to be solved with PLR
- Income earned in TRSs is not consolidated with the REIT for income testing
- Certain other income is excludible from the 75% and 95% gross income tests, such as
  - Income from the repurchase or discharge of indebtedness
  - Certain foreign exchange gains and hedging transactions
- 100% tax on net income from sales or other dispositions of "dealer property"

Assets

- 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
    - **Practical considerations**:
      - Real estate intangibles (but not other intangibles) qualify as real property
      - These assets may need to be "reclassified" for depreciation purposes
  - Personal property to the extent such property comports with the 15% rule earlier described
  - Debt secured by real property
    - **Practical considerations**: Loans to TRSs secured by "interests in real property" qualify as 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

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 Considerations**: "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
  - Section 357(c) and excess loss account recapture if too much debt and not enough tax basis
- 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 TRSs
- No more than 20% of a REIT's assets may be represented by specified debt instruments issued by public REITs

Assets

- 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 Considerations**:
    - There is no *de minimis* test for the 10% value test—thus, a small security held by a REIT can cause a failure
    - Diligence is important to uncover any debt or equity of third parties held by a REIT; these securities should be put in a TRS or constantly monitored by the REIT

Distributions

- A REIT must meet certain distribution requirements
  - 90% distribution requirement
- **Practical Considerations**:
  - Most REITs distribute 100% of their taxable income to eliminate corporate income tax on retained income
  - Because a REIT generally does not pay income taxes on income paid out to shareholders, REITs tend to be less leveraged than other businesses
    - Capital expansion is achieved through equity and debt offerings
    - REITs are dividend paying stocks, but can also be growth stocks
  - Public and private debt covenants must permit distributions
  - Because REIT shares are dividend paying, equity incentives migrate away from options and toward share ownership, such as restricted stock units

Distributions

- A REIT may not have any undistributed C corporation earnings and profits at the end of any taxable year
- **Practical Considerations**:
  - A C corporation converting to a REIT must purge its pre-REIT earnings and profits
    - For market reasons, most companies make a "purging dividend" of all C corporation earnings and profits prior to commencing their first taxable year as a REIT
    - This "purging dividend" is sometimes made partially in stock and partially in cash, rather than in all cash, because of cash requirements and loan covenants
  - Reclassification of assets to real property for depreciation purposes will result in additional income, which must also be distributed
  - If a REIT acquires a C corporation, the REIT must distribute all of the C corporation's earnings and profits inherited in the acquisition
- PLR to address the potential for amount/timing mismatches between taxable income and earnings and profits for both the pre-REIT and post-REIT periods

REIT Subsidiaries

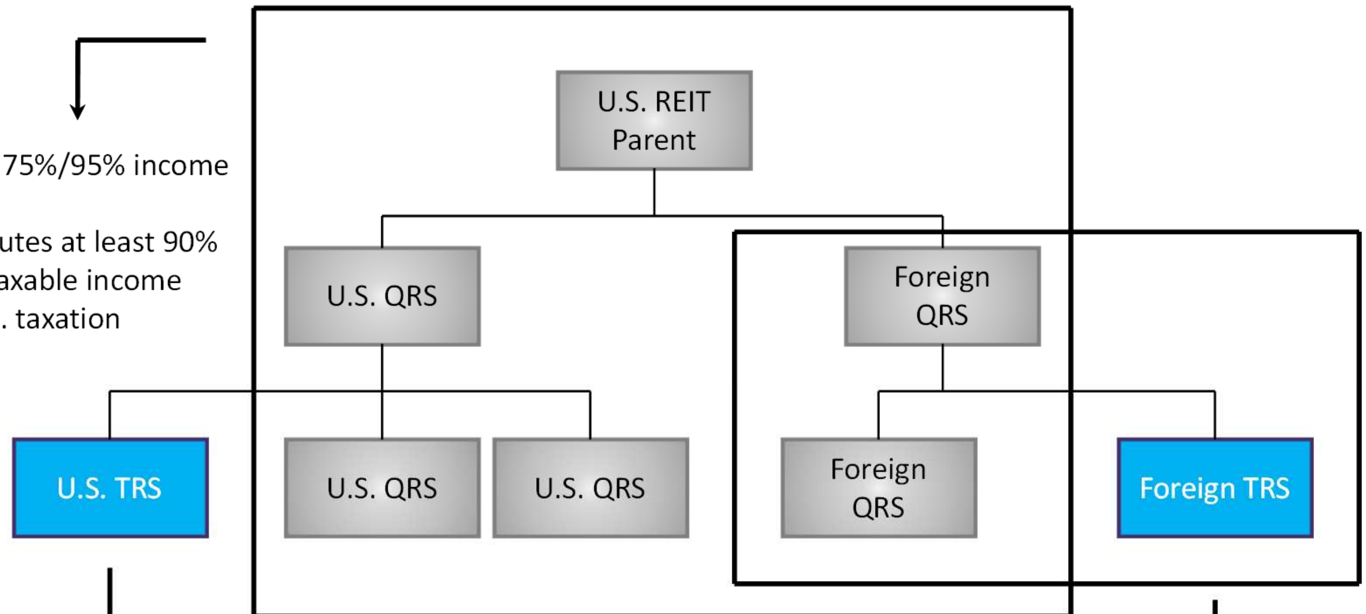
- Qualified REIT Subsidiary (QRS)
  - QRSs are corporations that are wholly-owned by the REIT and for which a TRS election is not made
  - QRSs are transparent for income and asset testing purposes and thus are consolidated with the REIT for income and asset testing, and also for activity restrictions
- 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
  - “Bad” assets and businesses should be assigned to TRSs
- Partnerships and Disregarded Entities
  - Partnerships and disregarded entities are transparent for income and asset testing purposes
  - Proportionate share rolls up for income and asset test
  - Partnerships should be run to fit within ORIAD
- Special Considerations for Foreign Subsidiaries

Subsidiaries: Interactions Between a REIT and a TRS

- A TRS must be compensated at arm's-length pricing for services performed by it to the REIT or the REIT's tenants/customers
  - The REIT must pay a 100% tax to the extent of any discount from arm's-length pricing provided by the TRS, or
  - If arm's-length pricing is not available, the 100% tax will not apply if the TRS is compensated at 150% of its costs for providing the service
- As a TRS accumulates income, it may distribute excess cash as a dividend
  - TRS dividends to the REIT are good income for the 95% gross income test, but not for the 75% gross income test
- A TRS may borrow from the REIT
  - Loans to a TRS count against the 25% asset test unless secured by real estate (e.g., foreign real estate in a foreign TRS)
  - Normal intercompany transfer pricing metrics are applicable; however,
    - a 100% excise tax applies to interest that is excessive
    - a statutory thin capitalization provision defers deductions for interest paid to the REIT to the extent certain income and asset thresholds are exceeded

REIT Subsidiaries

- Meets 75%/95% income tests
- Distributes at least 90% of its taxable income
- No U.S. taxation



- Fully taxable in the U.S.

- Fully taxable in foreign jurisdictions

- Meets 75% asset test

Qualified REIT Subsidiary “QRS”
Taxable REIT Subsidiary “TRS”

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