REIT Update and Case Study of the Construction of a Data Center in a Private REIT

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Agenda

- What is a REIT?
- ORIAD Requirements
  - **O**rganization & Capital Structure
  - **R**evenue from Real Property
  - **I**ncome from Other Sources
  - **A**ssets
  - **D**istributions of Income
- Why are Private REITs Utilized?
- REIT Remediation
- Exit Issues for Private REITs
- Case Study – Construction of a Data Center in a Private REIT

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; some states disallow the dividends paid deduction for "captive REITs"
  - Some non-U.S. jurisdictions 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

ORIAD Requirements

- To maintain REIT status, various requirements must be met:
  - **O**rganization & Capital Structure
  - **R**evenue from Real Property
  - **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 related-party 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”
  - Beneficial ownership of the REIT must be “evidenced by transferable shares”

Organization & Capital Structure

- Annual Reporting
  - IRS Form 1099-DIV 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-party tenants, and independent contractors

Organization & Capital Structure

- Taxable REIT Subsidiary ("TRS")
  - TRSs are subject to federal and state 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
  - Subsidiary 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 capital gains, and simplifies a future sale of REIT shares (a very popular form of M&A exit as compared to the REIT selling the underlying real property), in that a future buyer can transact with the selling partnership and its general partner (to buy 100% of the target REIT shares)
    - 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 any non-U.S. investors

Revenue from Real Property

At least 75% of the REIT's gross income for each taxable year must consist of:

- *Rents from Real Property**;
- Interest on obligations to the extent secured by *Real Property* (such as mortgage loans);
- Dividends received on shares of other REITs;
- Gain from the sale of shares of other REITs;
- Dividends and interest from temporary investments of new capital raised by the REIT;
- Gain from the sale of *Real Property* that is not "dealer property" (gains on dealer property are subject to a 100% tax);
- Abatements and refunds of real estate taxes; and
- Income and gain from *Foreclosure Property*

* Terms in italics are defined in the Code or Regulations

Revenue from Real Property

- *Rents from Real Property* **include**:
  - Payments for use or right to use of real property or interests in real property
  - Income received or accrued for certain services furnished to tenants, including:
    - Charges for services customarily furnished or rendered in connection with the rental of real property, whether or not separately stated
      - Services that are (a) furnished or rendered to the tenants of the REIT or, primarily for the convenience or benefit of the tenant, to the guests, customers, or subtenants of the tenant, and (b) are customarily provided to tenants in buildings which are of a similar class and in the same geographic market in which the building is located
      - Services that either are not provided primarily for the tenant's convenience or are usually or customarily rendered in connection with the rental of rooms or other space for occupancy only
    - Amounts received for services performed by TRSs
      - For a discussion on the treatment of bundled versus separately stated charges for services performed by TRSs, see Decker, Kaplan, and Ponda, "Non-Customary Services Furnished By Taxable REIT Subsidiaries", 148 Tax Notes 413 (July 27, 2015)
  - Rent attributable to personal property leased under or in connection with a lease of real property (only if such rent does not exceed 15% of the total rent for the lease of both real and personal property)

Revenue from Real Property

- *Rents from Real Property* **<u>exclude</u>**:
  - Rents determined in whole or in part on the income or profit of any person (though rent based on a fixed percentage or percentages of receipts or gross sales is acceptable)
  - Any amount received from:
    - a corporation, of which the REIT owns (actually or constructively) 10% or more of the stock by vote or value, and
    - any other entity, of which the REIT owns an interest (actually or constructively) of 10% or more of the assets or profits
  - *Impermissible tenant service income*
    - Favorable exception for service that either satisfies the standard of § 1.512(b)-1(c)(5) or is provided through a TRS
    - When in doubt, use a TRS to provide services
  - **Practical Consideration**: With a baseline rental relationship in place, a TRS can be used to accommodate any related services that the tenant requires

REIT Services Timeline

- 1909: First corporate income tax
- 1911: *Eliot v. Freeman*, 220 U.S. 178 (real estate trusts exempt from corporate tax)
- 1935: *Morrissey v. Comm'r*, 296 U.S. 344 (real estate trusts subject to corporate tax)
- 1956-58: Early REIT legislation is vetoed and struggles
- 1960: Section 856 (REITs are born)
- 1962: § 1.856-4(b)(3) – rents based on income or profits
- 1976: Section 856(d)(1)(B) and §§ 1.856-4(b)(1) and 1.856-4(b)(5) – charges for customary services
- 1986: Section 512(b)(3) – UBTI Exception

  See also Rev. Rul. 2004-24, 2004-1 C.B. 550 (parking revenue)
- 2001: Section 856(l) – Taxable REIT Subsidiary
- 2002: Rev. Rul. 2002-38, 2002-2 C.B. 4* – noncustomary services provided by TRS

* For a detailed exposition, *see* Decker, Kaplan, and Ponda, "Non-Customary Services Furnished By Taxable REIT Subsidiaries", 148 Tax Notes 413 (July 27, 2015)

Services at REIT-Owned Properties

Independent Contractors

Treas. Reg. §1.856-4(b)(5)

Independent Contractor may perform noncustomary services only if:

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

Services that are:
1) Usual or customary for such property; or
2) Not primarily for the convenience of tenant.

Treas. Reg. § 1.512(b)-1(c)(5) standard
Satisfies Section 856(d)(7)(C)(ii)

Anyone can perform these services, including REITs, TRSs and Independent Contractors

E.g., PLRs 200008036, 200101012, 201204006

E.g., Rev. Rul. 2004-24

Services that are customarily furnished.

Treas. Reg. § 1.856-4(b)(1) standard
Satisfies Section 856(d)(1)(B)

Only a TRS or Independent Contractor may perform

Charges do not need to be separately stated:
Treas. Reg. § 1.856-4(b)(5)
Rev. Rul. 2002-38

Taxable REIT Subsidiaries

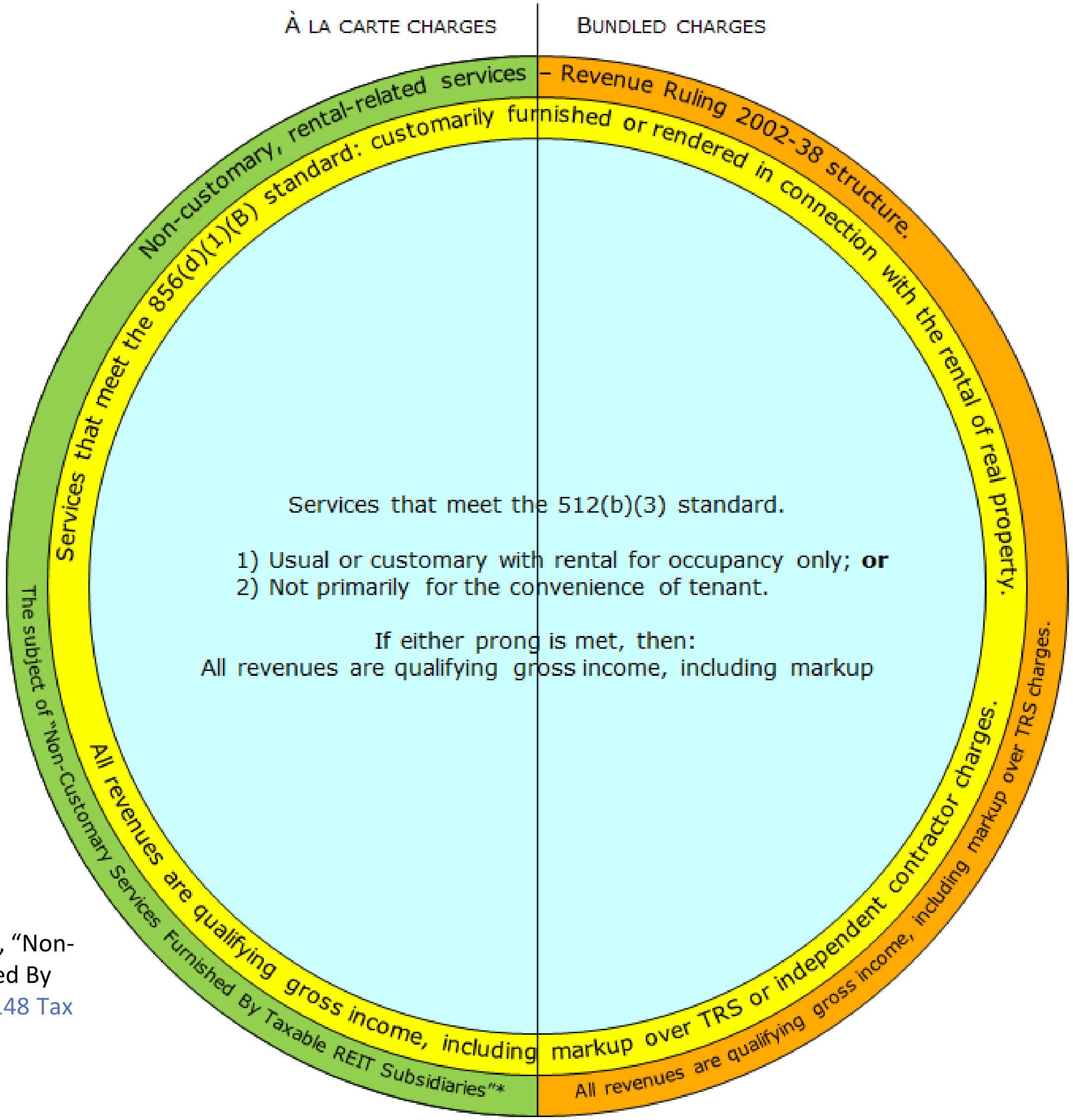
Section 857(b)(7)

Rev. Rul. 2002-38

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

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

Services at REIT-Owned Properties



*Decker, Kaplan, and Ponda, "Non-Customary Services Furnished By Taxable REIT Subsidiaries", 148 Tax Notes 413 (July 27, 2015).

Data Center REIT Alternatives

- Two models that might be deployed so that interconnection solutions fit within the REIT framework:
  - Super Rental Model, with a QRS handling all interconnection business
  - Pure Services Model, with a TRS occupying less than 10% of the leased property and operating the high-end of the interconnection business as a subcontractor for the QRS
- Each alternative draws a different line between rental and services
- The choice between the alternatives may depend upon technical information, industry developments, IRS feedback, contractual wording, etc.

Super Rental Model

- The interconnection operates as a single integrated system with all components in a QRS
- Customer “leases” access to interconnection infrastructure from a QRS
  - All revenues received by a QRS for rental access are treated as rent and thus qualifying REIT gross income
  - Very little tax leakage because there is little-to-no TRS involvement
- Routing the signal through the interconnection infrastructure is not viewed as a service, but instead is part of the access rights
  - All routing functions are performed automatically by components “leased” to customers
  - Thus, with the exception of elements such as humans performing “remote hands” and/or use of third-party services, no outside intervention or services are needed
- This is the model used for colocation (or retail) and hyperscale data centers

Pure Services Model

- Interconnection components are owned and operated by a TRS
- Customers purchase services from a QRS which in turn subcontracts to a TRS, which runs the high-end interconnection business
  - QRS leases to a TRS necessary floor space which represents less than 10% of total occupied floor space
    - Under REIT rules, as long as the percentage leased by the TRS is less than 10% of the total "leased space" (usually a square footage concept), the TRS rent payments to the QRS can count as qualifying rent
    - Transfer pricing may be an issue, leading to both high tax leakage and TRS valuations that push up against the 25% TRS asset test limit
    - Perhaps transfer pricing can take into account "exclusive" permitted use
- This is effectively an internal PropCo-OpCo model
- This is the model used by REITs for staffed office suites, internal cafeterias, childcare centers, etc., and (for the time being) complex interconnections

Income from Other Sources

- At least 75% of a REIT's gross income must be derived from real property
  - Such as rents from real property, 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
  - 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
- Reminder: 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"; such net income is excluded from REIT gross income tests

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 TRSs
  - 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 25% 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

Basic Framework of REIT Real Property Regulations

- Property must be broken down into "distinct assets"
- Distinct assets must be evaluated individually
- Assets that fall into one of three categories are considered real property for REIT purposes:
  - Land
  - Improvements to Land
    - Inherently Permanent Structures
    - Structural Components
  - Certain Intangible Assets
- Examples
- These rules are for REIT purposes only, not depreciation, FIRPTA, etc.

Distinct Assets – § 1.856-10(e)

- Each “distinct asset” is evaluated separately from any other asset to which the distinct asset might relate, in order to determine if it is real property
- Whether or not a separately identifiable item is distinct is based on all facts and circumstances
- In particular, four factors must be taken into account:
  - Whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset;
  - Whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset;
  - Whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part; and
  - Whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset

Land – § 1.856-10(c)

- Includes water and air space superjacent to land
- Natural products and deposits that are unsevered from the land (such as timber, crops, ores and minerals) are real property
  - Once natural products are severed, extracted, or removed from the land, they no longer constitute real property
  - Natural products severed, extracted, or removed from the land do not become real property by the fact that they are stored in or upon real property

Improvements to Land – § 1.856-10(d)

- Inherently Permanent Structures
  - Includes buildings and other structures that are permanently affixed to either land or other inherently permanent structures
  - Affixation is considered permanent if it is reasonably expected to last indefinitely based on all of the facts and circumstances
  - Any distinct asset that serves an active function is not an inherently permanent structure
- Structural Components of Inherently Permanent Structures

Inherently Permanent Structures – § 1.856-10(d)(2)

- A building is defined as a structure that encloses a space within its walls and is covered by a roof
  - Safe harbor - If permanently affixed, the following constitute buildings: houses, apartments, hotels, motels, enclosed stadiums and arenas, enclosed shopping malls, factory and office buildings, warehouses, barns, enclosed garages, enclosed transportation stations and terminals, and stores
- Other inherently permanent structures are structures that serve passive functions, such as to contain, support, shelter, cover, protect, or provide a conduit or a route – they do not serve any active function such as to manufacture, create, produce, convert, or transport
  - Safe harbor - If permanently affixed, the following constitute other inherently permanent structures: microwave transmission, cell broadcast and electrical transmission towers; telephone poles; parking facilities; bridges; tunnels; roadbeds; railroad tracks; transmission lines; pipelines; fences; in-ground swimming pools; offshore drilling platforms; storage structures; and stationary wharves and docks

Inherently Permanent Structures

- For distinct assets that fall outside the safe harbors, a facts and circumstances approach is used to determine if they are inherently permanent structures. In particular, five factors must be taken into account:
  - The manner in which the distinct asset is affixed to real property;
  - Whether the distinct asset is designed to be removed or to remain in place indefinitely;
  - The damage that would be caused to the item or to the real property to which it is affixed if the item were to be removed;
  - Circumstances that that might suggest that the affixation is not indefinite (such as lease terms); and
  - The time and expense required to move the distinct asset

Structural Components – § 1.856-10(d)(3)

- A structural component is any distinct asset that:
  - is a constituent part of and integrated into an inherently permanent structure,
  - serves the inherently permanent structure in its passive function, and
  - does not produce or contribute to the production of income other than consideration for the use or occupancy of space (even if it is capable of producing such income)
- Interconnected assets that work together to serve an inherently permanent structure with a utility-like function (such as electric, water, or heat systems) are analyzed as a single distinct asset

Structural Components

- A structural component may only qualify as real property if the REIT holds an interest in the structural component together with a real property interest in the space in the inherently permanent structure served by the structural component
  - The REIT need not hold equivalent interests in both the structural component and the inherently permanent structure that it serves
  - An affirmation and update of Rev. Rul. 73-425, 1973-2 C.B. 222, and a rejection of *Samis v. Comm'r*, 76 T.C. 609 (1981), in the REIT arena
  - For example, a REIT may lease a building shell or floor from a superior landlord, do a tenant-owned build-out of the interior, and the build-out can constitute the REIT's real property structural components within its leased (but not owned) space
- Safe harbor – The following distinct assets and systems are structural components if integrated into the inherently permanent structure and held together with a real property interest in the space in the inherently permanent structure served by the distinct asset or system:
  - Wiring; plumbing systems; central heating and air-conditioning systems; elevators or escalators; walls; floors; ceilings; permanent coverings of walls, floors and ceilings; windows; doors; insulation; chimneys; fire suppression systems, such as sprinkler systems and fire alarms; fire escapes; central refrigeration systems; security systems; and humidity control systems

Structural Components

- For distinct assets that fall outside the safe harbor, a facts and circumstances approach is used to determine if they are structural components. In particular, eight factors must be taken into account:
  - The manner, time, and expense of installing and removing the distinct asset;
  - Whether the distinct asset is designed to be moved;
  - The damage that removal of the distinct asset would cause to the item itself or to the inherently permanent structure to which it is affixed;
  - Whether the distinct asset serves a utility-like function with respect to the inherently permanent structure;
  - Whether the distinct asset serves the inherently permanent structure in its passive function;
  - Whether the distinct asset produces income from consideration for the use or occupancy of space in or upon the inherently permanent structure;
  - Whether the distinct asset is installed during construction of the inherently permanent structure; and
  - Whether the distinct asset will remain if the tenant vacates the premises
- Customized structural components are acceptable, and thus *Hospital Corp. of Am. v. Comm'r*, 109 T.C. 21 (1997), *nonacq.,* is rejected in the REIT arena

Intangible Assets – § 1.856-10(f)

- An intangible asset may be real property to the extent it meets three conditions:
  - It derives its value from real property or an interest in real property;
  - It is inseparable from that real property or interest in real property; and
  - It does not produce or contribute to the production of income other than consideration for the use or occupancy of space
- Licenses and Permits
  - A license, permit, or other similar right that is solely for the use, enjoyment, or occupation of land or an inherently permanent structure and that is in the nature of a leasehold or easement generally is an interest in real property
  - A license or permit to engage in or operate a business is not real property or an interest in real property if it produces or contributes to the production of income other than consideration for the use or occupancy of space

Examples – § 1.856-10(g)

- Thirteen examples
- An exposition of real estate verticals – towers, pipelines, solar energy sites, data centers, cold storage warehouses
  - Outdoor real estate
  - Specialty buildings
- An applied demonstration of the various, multi-pronged facts-and-circumstances analyses
- A unified framework for real property intangibles, particularly the concept of capitalized value of Section 856(d)(1) “rents from real property” in § 1.856-10(g)(*Example 11, Above-market lease*)

What Impact on Prior Private Letter Rulings?

- Real property regulations' impact on prior private letter rulings
  - Rev. Proc. 2017-1, 2017-1 I.R.B. 1, § 11.04(4)
  - "Nobody has a private letter ruling anymore"?
  - Prior rulings still valid to the extent "consistent" with real property regulations?
  - Prior rulings still valid to the extent "not inconsistent" with real property regulations?
  - Impact on public REIT markets
- Might older private letter rulings survive as "gloss" on the real property regulations? Yes, but caution is warranted in any such reliance:
  - Real property regulations use a detailed framework for making "real property" determinations, whereas prior private rulings are not as clear on the applied criteria
  - PLR 200725015 (Mar. 13, 2007) (transmission and distribution system analyzed as an "integrated system" rather than real property regulations' framework of an inherently permanent structure and its constituent components)
- Caution is especially warranted when analyzing and concluding on intangible assets such as goodwill – real property regulations have a tighter definitional framework

What Impact on Prior Private Letter Rulings?

- Real property regulations “restate/codify” and solidify prior published rulings
- Except as specifically described in Treasury Decision 9784 and the prior Notice of Proposed Rule Making, the real property regulations were not intended to override or change prior published rulings
  - *See* Ponda, “How Much Gain Would a REIT Defer if a REIT Could Defer Gain?”, 135 Tax Notes 1249 (June 4, 2012)
- Do prior published rulings thus survive as a favorable “gloss” on the real property regulations – *i.e.*, different analysis but same bottom line conclusion? Yes, and Rev. Rul. 69-94, 1969-1 C.B. 189 (certain railroad assets are REIT real property) presumably fits this mold
- Might the real property regulations override or chip away at some conclusions from prior published rulings?

Chain-Link Fencing in a Data Center

- PLR 201314002 (Oct. 9, 2012) says that chain-link fencing within a data center is real property, presumably in partial reliance on the conclusion in Rev. Rul. 75-424 that outdoor fencing is real property
- But § 1.856-10(d)(3)(iii) and § 1.856-10(g)(*Example 7, Partitions*) now compel a much more nuanced and multi-factor analysis, and for this reason PLR 201537020 (May 22, 2015) is apparently more stingy on cage fencing

Distributions of Income

- A REIT must distribute dividends, other than capital gain dividends, each year equal to 90% of "REIT taxable income" (computed without regard to the dividends paid deduction and net capital gain).
- REITs are subject to a 4% nondeductible excise tax on the excess of the "required distribution" over the sum of (i) amounts actually distributed for the calendar year, (ii) excess distributions from the preceding taxable year, and (iii) amounts retained for which U.S. federal income tax was paid.
  - The required distribution for each calendar year is equal to the sum of (i) 85% of REIT ordinary income for the year, (ii) 95% of REIT capital gain net income for the year other than capital gains the REIT elects to retain and pay tax on, and (iii) any undistributed taxable income from prior taxable years.
- A private REIT may satisfy the 90% distribution requirement and avoid a corporate tax and the 4% excise tax by utilizing consent dividends.
  - Consent dividends are not actual cash distributions, but rather are amounts which the shareholders 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 and the 4% excise 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
  - Not all state income tax regimes follow the federal rules for “consent dividends” or deductions for dividends paid by “captive REITs” to their 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)

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

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

Exceptions from FIRPTA exist for certain REITs

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

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 Private 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 Private 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 Private 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 Private 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 Private 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 Private 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

REIT Remediation

- Certain asset test violations may be cured by:
  - disclosing the violation,
  - disposing of assets to the extent necessary to come into compliance with the asset test requirements, and
  - if necessary, paying a penalty tax of the greater of (i) $50,000 and (ii) the net income generated by violating assets multiplied by the highest corporate tax rate
- Certain income test violations may be cured by:
  - a Section 856(c)(5)(J) PLR from the IRS, or
  - disclosing the violation, and paying a penalty tax roughly equal to the amount by which the income test(s) was missed multiplied by a fraction intended to reflect the REIT’s profitability
- Distribution violations may be cured by:
  - making deficiency dividends or other distributions
- Other violations may be cured by:
  - paying a penalty tax of $50,000

REIT Remediation

- REIT remediation in the first REIT year
  - Is rescission available?
  - Watch out for the Section 856(g)(3) lockout for "successors", which is a very broad concept under Reg. § 1.856-8(c)(2), and (perhaps) no Section 856(g)(5) remediation is possible
- "Reasonable cause"
  - The REIT remediation rules are generally predicated upon the non-compliance being "due to reasonable cause and not due to willful neglect" (as the standard is colloquially known, "reasonable cause")
  - The REIT remediation rules should be uniformly broad enough to remediate not only errors in legal interpretation but also both factual errors and inadvertent mistakes
- Curing asset test violation within 30 days after the close of a quarter
  - After initially meeting the asset tests at the close of any quarter, a REIT will not lose its status as a REIT for failure to satisfy the asset tests solely by reason of changes in the relative values of its assets
  - If failure to satisfy the asset tests results from an acquisition of securities or other property during a quarter, a REIT can cure this failure by disposing of sufficient non-qualifying assets within 30 days after the close of that quarter
- Possible role of tax insurance
- In an M&A transaction, what happens if the target REIT is liquidated or merged out of existence?

REIT Remediation

- REIT remediation of organization requirements
  - Managed by a board and transferable shares, per Sections 856(a)(1) and (2)
  - 100+ shareholders, per Section 856(a)(5), and five-or-fewer (5/50%) proscription, per Sections 856(a)(6), 856(h), 856(k), and 857(f)(1)
    - Neither requirement applies for the first REIT year, per Section 856(h)(2)
  - Missed or muddled REIT (IRS Forms 1120-REIT, 7004, and 8832) and TRS (IRS Forms 8832 and 8875) elections

REIT Remediation

- REIT remediation of rents from real property
  - Section 856(d)(1) is generally not at issue; it's all about the Section 856(d)(2) exclusions
  - Section 856(d)(2)(A) bad formulas are thankfully rare, but they do happen from time to time
  - Section 856(d)(2)(B) related party rents are difficult to diligence
    - Overbroad Section 318 attribution is a nightmare
    - Nareit has been seeking regulatory relief and a legislative fix. *See* Nareit, "Comments on Double Downward Attribution and the REIT Related Party Rent Rules" (Feb. 27, 2020), available at: https://www.reit.com/sites/default/files/Related_party_rent_Nareit%20submission_02-27-2020.pdf and Retail Revitalization Act of 2021, available at: https://www.congress.gov/bill/117th-congress/house-bill/840/text
  - Section 856(d)(2)(C) and 856(d)(7) "impermissible tenant service income" ("ITSI") rules can be fiendishly complicated to apply, but Rev. Ruls. 2004-24, 2002-38, and 98-60 are a good starting point for understanding them
    - *See* Decker, Kaplan, and Ponda, "Non-Customary Services Furnished by Taxable REIT Subsidiaries", 148 *Tax Notes* 413 (Jul. 27, 2015), available at: https://878449.fs1.hubspotusercontent-na1.net/hubfs/878449/Non-Customary%20Services%20Furnished%20by%20Taxable%20REIT%20Subsidiaries.pdf

REIT Remediation

- REIT remediation of income from passive sources (other than rents)
  - Be careful during “ramp up” and “ramp down” periods
    - What if a REIT with zero gross income in its first or last taxable year?
    - The better read of Sections 856(c)(2)-(3) is that zero gross income is fine; the IRS has confirmed its agreement with this very analysis. *See* PLR 202440007 (Jun. 25, 2024)
  - Failure to designate hedges under Section 856(c)(5)(G), including an actual, potential, or perceived failure to comply fully and completely with designation requirements
    - Possible remediation (including protective remediation) under Sections 856(c)(5)(G)(iv) and 1221(a)(7) as well as Reg. § 1.1221-2(g)(2), including for “inadvertent error” such as a mistaken belief
  - If the target REIT is “closely held” within the meaning of Sections 465(a)(1)(B) or 469(j)(1), then it would be precluded from netting its business losses and loss carryovers against certain forms of gross income, especially items like gross interest income
    - In turn, this would create a positive or additional REIT taxable income amount that must be distributed per Section 857(a)(1)

REIT Remediation

- REIT remediation for assets that are real property or real estate assets, and are not excessive securities
  - As with the REIT income tests, be careful during “ramp up” and “ramp down” periods
    - What of a REIT with zero assets at its first few or final few quarter-ends?
    - The better read of Section 856(c)(4) is that zero assets are fine; the IRS has confirmed its agreement with this very analysis. *See* PLR 202440007 (Jun. 25, 2024)
  - The 30-day remediation in Section 856(c)(4) (flush language) may not apply to the REIT’s first quarter-end
  - Real property depreciated as personal property
    - An erroneous accounting method, once adopted and unless challenged by IRS, does not impact reporting for REIT “taxable income”, or for the associated REIT distribution requirement(s), on as-filed REIT income tax returns; an erroneous accounting method should also have no bearing on the proper characterization of real property or personal property under Reg. §§ 1.856-3(d) and 1.856-10
    - File IRS Form 3115 to change depreciation methods, pick up associated Section 481(a) gross income over 4 years (subject to acceleration), and obtain Section 856(c)(5)(J) relief for the positive Section 481(a) adjustments

REIT Remediation

- Bad securities under the 10-10-5 asset tests in Sections 856(c)(4)(B)(iv)(I)-(III)
  - Section 856(c)(5)(F) defines "security" as under the Investment Company Act of 1940, and thus contractually owed amounts embedded in a lease or similar "real estate" document (*e.g.,* a deposit in a lease or in a real estate purchase & sale agreement) are almost certainly not "securities" for these purposes
  - Definition of "cash" under Section 856(c)(5)(K) and Rev. Rul. 2012-17 also helps a lot
  - A Reg. § 1.856-2(d)(1)(iii) ordinary course "receivable" is included within Section 856(c)(4)(A) and thus by definition not subjected to the 10-10-5 asset test limits in Sections 856(c)(4)(B)(iv)(I)-(III)
- Move bad assets into a TRS through a Section 351 contribution or elect with the issuer of the potentially bad securities to have the issuer become a TRS by timely filing an IRS Form 8875 with the REIT
- Remedying REIT asset testing for prior calendar quarters can usually be achieved with Section 856(c)(7)(A) or (B) relief, including (as applicable) any Section 856(c)(7)(C) penalty in respect of prior periods of failure (which penalty, when it applies, is typically reasonable and not punitive)
- Should REITs still use a "protective" transfer of bad assets to a TRS or to a trust, especially in the final calendar quarter just before liquidation?

REIT Remediation

- REIT remediation for distributions that are formal, sufficient, timely, and not preferential
  - Formal corporate distributions require serial board resolutions, but perhaps ongoing LLC distributions can be approved once (at inception when preferred equity is first issued)
    - Best practice is to adhere to maximum formalisms around timely resolutions
    - Does a later board ratification help if an earlier board resolution is missing?
  - If a target REIT is "closely held" within the meaning of Section 465(a)(1)(B) or 469(j)(1), then its prior taxable years should be reviewed for positive or additional REIT taxable income (*e.g.,* on account of passive investment income that cannot be offset with business operating losses), which taxable income must then be distributed per Sections 857(a)(1) and 860
    - In some cases, the target REIT's distribution history (or reporting thereof) would not have been sufficient to meet the Section 857(a)(1) distribution requirement

REIT Remediation

- Typically, a Target REIT is liquidated in the calendar year following the acquisition, on acquiror's sole "watch", in a Sections 331 and 336 taxable liquidation, for the purpose of acquiror achieving an asset basis "step up" in the target REIT's assets. But if the target REIT has aggregate liabilities in excess of its aggregate asset tax bases (so-called "negative basis"), then the taxable liquidation (without additional planning) will generate net taxable gain at the REIT level that is in excess of the aggregate amount distributed in liquidation (i.e., the fair market value of assets less aggregate liabilities) for purposes of Sections 562(b) and 857(b), thereby jeopardizing compliance with the distribution requirement of Section 857(a) or frustrating the intent to "zero out" all taxable income and gains at the REIT level with a sufficiently large dividends paid deduction.
  - Fortunately, there is a simple, generally painless solution to this conundrum for private REITs: a Section 565 "consent dividend" provides the extra dividends paid deduction needed at the REIT level to "zero out" taxable income and gains, all with no additional taxable income or gain (and thus no additional tax) to the acquiror because the additional amount deemed received by consent under Sections 565(a)-(c) is offset fully in the acquiror's Section 331 liquidating gain computation by the additional tax basis deemed received by the acquiror on account of Sections 565(c)-(d).

REIT Remediation

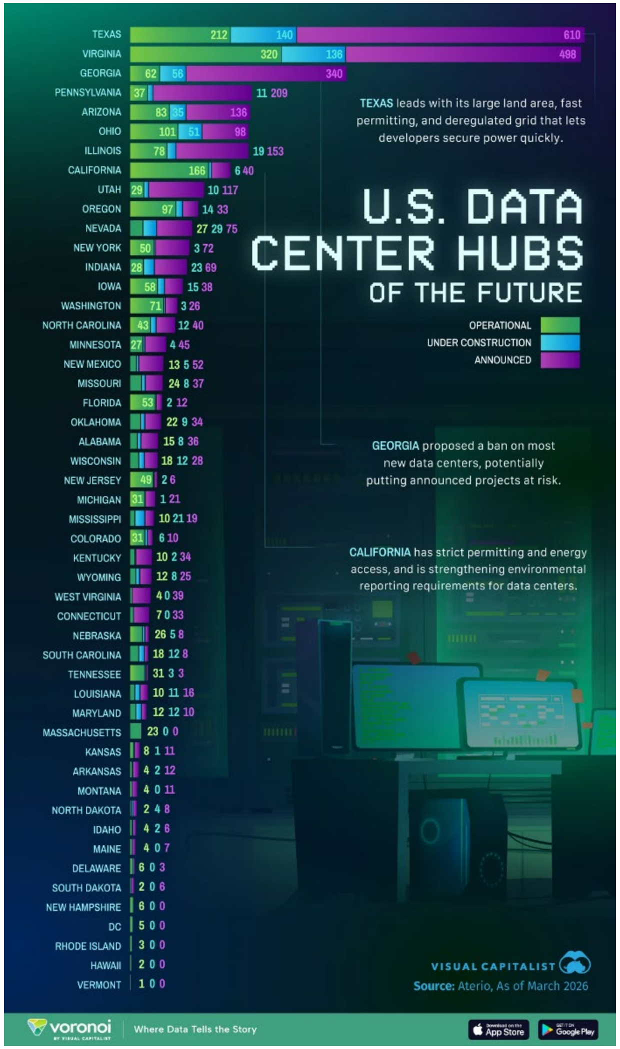
- The Section 562(c) preferential dividend rule typically applies to a private REIT but does not apply to a publicly offered REIT or its subsidiary REIT (assuming that the subsidiary REIT is included in the parent REIT's public SEC reporting)
  - One of the most challenging aspects of the Section 562(c) preferential dividend rule is that, at least according to the IRS, a REIT cannot charge differential asset management fees to different classes of common equity investors (though it is permitted, within limits, to charge differential administrative fees to investors participating via different placement channels)
- For previously ineffective, insufficient, or preferential distributions, relief is possible under Sections 852(e) and 860, and relief may also be possible for a successor REIT in respect of a REIT predecessor under Section 381(c)(23)
  - More generally, if the target REIT is liquidated or merged out of existence, consideration should be given to a final relief dividend under Sections 852(e) and 860 before the last day of the REIT's final taxable year

For a more complete discussion, *see* Remediation of M&A REIT Targets at https://878449.fs1.hubspotusercontent-na1.net/hubfs/878449/Remediation%20of%20MA%20REIT%20Targets%20(4884-9137-8219.17).pdf

Exit Issues for JV REITs

- Exit events generally involve a sale of private REIT shares to avoid adverse FIRPTA consequences to non-U.S. investors
- Buyer will diligence REIT compliance matters since liabilities stemming from any failure will stay with the target and come over to the Buyer
  - Transaction documentation will include representations, warranties and covenants relating to REIT qualification, as well as a closing REIT tax opinion
  - Rep & warranty insurance may be obtained
- FIRPTA considerations must be examined, and appropriate certificates must be obtained from applicable sellers
- If acquisition is properly structured, Buyer should be able to use a captive partnership to acquire the target REIT and thereby obtain a step-up in tax basis through a Section 331, taxable (but tax-efficient) liquidation of the subsidiary REIT into the acquiring partnership following closing
  - Timing of liquidation can be impacted by integration concerns of the Buyer
  - Timing of liquidation is likely pushed to the following January if Sellers have taken out pre-closing dividends in the year of closing

Case Study – Construction of a Data Center in a Private REIT



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Case Study – Construction of a Data Center in a Private REIT

Case Study Facts

- Your client has entered into a purchase and sale agreement to acquire land on which the client wants to construct data centers
- The land will be subdivided into 3 parcels with a data center building to be constructed on each parcel
- A common area association will be formed as a non-stock corporation to own and maintain the common areas in the subdivision
- For financing purposes and flexibility in selling each data center (or selling off a partial interest in each data center), the client wants each parcel to be held by a separate legal entity
- The client's equity partner must invest in the data center through a private REIT
- Each REIT will enter into a construction agreement with a general contractor that will govern the construction of the building; the construction period is expected to be one to three years and could be as long as three to four years

Case Study – Construction of a Data Center in a Private REIT

Case Study Facts

- Each REIT expects to purchase directly some of the building's "materials" and some or all of the building's "components"
  - Materials comprise building materials that will be incorporated into the building during its construction and thereupon become a permanent part of the building within the meaning of Treas. Reg. § 1.856-10 – examples of the materials include construction elements such as steel, cement, plaster, millwork, fastenings and brackets, bricks and concrete blocks, sheetrock (drywall), and tile
  - Components comprise various building system elements and components of these building system elements, each of which will be integrated as a structural component into the data center building within the meaning of Treas. Reg. § 1.856-10 – examples of the components include systems of building infrastructure such as central HVAC systems, electrical distributions panels and systems (including breaker panels), electrical redundancy systems, electrical generators, telecommunications systems, security systems, fire suppression systems, water circulation piping and pumping systems, water chillers, and humidity control systems

Case Study – Construction of a Data Center in a Private REIT

Case Study Facts

- Each REIT expects a significant amount of lead time between the ordering and the receipt of both materials and components
- Because of these long lead times between ordering and receipt for the components, each REIT expects that it will need to make advance payments to most of the relevant suppliers that will supply these items, with initial payments due at the time of initial contracting or shortly thereafter, and additional payments occurring at different time milestones prior to delivery
  - Some of these advance payments will be deposits, which represent those intangible rights that accrete to the REIT under the relevant purchase contracts upon payment of these advance amounts – that is, a deposit constitutes a prepayment to the supplier of a portion of the purchase price for the relevant material or component
  - Other payments may represent soft costs (such as engineering design work) that are recorded as part of the purchase cost of a component if (as is often the case) that particular component needs to be customized by the supplier for use in the to-be-constructed data center building

Case Study – Construction of a Data Center in a Private REIT

Case Study Facts

- In due course, and following any applicable prepayments, the materials and the components will be delivered to and received by the REIT (at which time the remaining balance of the purchase price will also become due)
- Upon receipt, items included in the materials and the components typically will be stored by the REIT or by its agents (*e.g.*, the general contractor) at an appropriate location (often onsite) to prevent any damage or deterioration until such time as the items are installed and permanently affixed into the data center building that is under construction; this integration and permanent affixation will often (but not always) occur in the same calendar quarter as delivery, and in most cases will occur within a few months (up to a calendar quarter or two) after delivery
- It is very possible that various materials and components, following their respective receipt by the REIT, but before their respective integration and permanent affixation in the REIT's data center building, will be in the possession of the REIT at the close of one or more calendar quarters

Case Study – Construction of a Data Center in a Private REIT

Selected 75% REIT Asset Test Issues

- Are the deposits/prepayments treated as "cash and cash items (including receivables)" within the meaning of Section 856(c)(4)(A)?
  - "Cash and cash items (including receivables)" under the RIC rules:
    - Section 851(c) provides definitions for certain terms used in the RIC rules, but not for "cash", "cash items" or "receivables"
    - Section 851(c)(6) provides that, for purposes of Section 851(b)(3), "[a]ll other terms shall have the same meaning as when used in the Investment Company Act of 1940, as amended"
    - *See* GCM 39531 (Feb. 5, 1986)
  - "Cash and cash items (including receivables)" under the REIT rules:
    - Section 856(c)(5) provides definitions for certain terms used in the REIT rules, but not definitions for "cash", "cash items", or "receivables"
    - Section 856(c)(5)(F) also provides that "[a]ll other terms shall have the same meaning as when used in the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 and following)"

Case Study – Construction of a Data Center in a Private REIT

Selected 75% REIT Asset Test Issues

- Treas. Reg. § 1.856-2(d)(1)(iii) states:

  For purposes of this subparagraph the term “receivables” means only those receivables which arise in the ordinary course of the [REIT]’s operation and does not include receivables purchased from another person.

- In describing when a REIT must revalue its assets and when it need not do so under Section 856(c)(4), Treas. Reg. § 1.856-2(d)(3) provides two examples of “cash items”:

  A revaluation of assets is not required at the end of any quarter during which there has been no acquisition of a security or other property since the mere change in market value of property held by the trust does not, of itself, affect the status of the trust as a real estate investment trust. A change in the nature of ”cash items”, for example, the prepayment of insurance or taxes, does not constitute the acquisition of “other property” for purposes of this subparagraph.

Case Study – Construction of a Data Center in a Private REIT

Selected 75% REIT Asset Test Issues

- Rev. Rul. 77-199 holds that certificates of deposits are cash items
- Rev. Rul. 2012-17 holds that money market fund shares held by a REIT are "described in [S]ection 856(c)(4)(A), which includes 'cash and cash items (including receivables)'"
- PLRs analyzing whether an entitlement to refundable state tax credits may be treated as "receivables" within the meaning of Section 856(c)(4)(A):
  - PLR 201428002 (Apr. 2, 2014)
  - PLR 201518010 (Jan. 29, 2015)
  - PLR 201816001 (Jan. 3, 2018)
  - PLR 201816002 (Jan. 3, 2018)
  - PLR 201816003 (Jan. 3, 2018)
  - PLR 201845001 (Aug. 10, 2018)

Case Study – Construction of a Data Center in a Private REIT

Selected 75% REIT Asset Test Issues

- Sensible reconciliation of authorities on the definition of “cash and cash items (including receivables)”:
  - “cash and cash items (including receivables)” always includes liquid and safe assets such as demand deposits and money market funds;
  - when the taxpayer is holding the asset under evaluation as a financial investment, then the asset must be liquid and safe in order to qualify as “cash and cash items (including receivables)”; but, if the asset is not held for financial investment (such as an ordinary course receivable), then the asset need not be liquid or safe in order to qualify as a “cash or cash item”, as further described below;
  - when not being held for financial investment, “cash and cash items (including receivables)” also includes “near cash” assets that reflect cash to which the taxpayer has an entitlement, such as tenant-related rent receivables and state tax credits generated by construction activities, in each case regardless of the creditworthiness of the tenant, governmental agency, or other payor;
  - “cash or cash items” also includes items that were previously cash and have been paid over to a supplier as a prepaid item, such as prepaid taxes and prepaid insurance (again, regardless of the creditworthiness of the supplier-payee obligated to deliver performance), thus translating into smaller cash outlays in the future; and
  - a cash item (other than a receivable) apparently need not satisfy the “ordinary course of . . . operation” standard, but even so it is absolutely clear that the “ordinary course of . . . operation” standard encompasses a REIT’s activities in constructing a building and improving land

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Selected 75% REIT Asset Test Issues

- Are construction in progress/components not (yet) affixed treated as "real property" within the meaning of Sections 856(c)(4)(A) and 856(c)(5)(A)-(B)?
  - Real Property Regulations (Treas. Reg. § 1.856-10)
    - Treas. Reg. § 1.856-10 does not address construction in progress
    - Treas. Reg. § 1.856-10 is not the exclusive definition of real property
      - The preamble to Treas. Reg. § 1.856-10 contemplates that the IRS would in appropriate circumstances entertain ruling requests on the proper meaning of "real property"
      - Treas. Reg. § 1.856-10 contemplates additional guidance published in the Internal Revenue Bulletin. *See* 1.856-10(d)(2)(iv) (for inherently permanent structures) and 1.856-10(d)(3)(iii) (for structural components)

Case Study – Construction of a Data Center in a Private REIT

Selected 75% REIT Asset Test Issues

- REIT Mortgage Rules (Treas. Reg. § 1.856-5(c))
  - Treas. Reg. § 1.856-5(c) generally treats a mortgage loan as an interest in real property (a "Good Mortgage") to the extent of the ratio that the loan value of the real property securing the loan (the "Loan Value of Real Property") bears to the highest principal amount outstanding under the loan during the year
  - The Loan Value of Real Property is the fair market value of the collateral that is real property at the time that the loan is made or, if earlier, at the time that the commitment to make the loan becomes binding on the REIT
  - Under Treas. Reg. § 1.856-5(c)(2), the Loan Value of Real Property that is under construction or development (in other words, construction in progress) equals the sum of "the fair market value of the land plus the reasonably estimated cost of the improvements or developments (other than personal property) which will secure the loan and which are to be constructed from the proceeds of the loan"
  - What happens if a REIT-lender on a construction loan forecloses? Does the same collateral become treated as other than real property in the REIT's hands?

Case Study – Construction of a Data Center in a Private REIT

Selected 75% REIT Asset Test Issues

- Certain Personal Property Mortgaged in Connection with Real Property (Section 856(c)(9)(B))
  - Section 856(c)(9)(B) cross-references Section 856(c)(3)(B) for use in determining the value of real property – thus, the rules applicable for valuing the collateral under Section 856(c)(3)(B) are applicable for valuing the collateral in the entire REIT rules, not just for a special rule involving mortgage loan assets, since the value of the collateral is what feeds into the rest of Section 856(c)(9)
  - Congress re-adopted this rule in 2018 when it moved the subject language from the flush language of then Section 856(c)(9)(B) into the present Section 856(c)(9)(B)(ii)(I); the 2018 re-enactment of this principle post-dates the finalization of Treas. Reg. § 1.856-10, thus confirming the statutory primacy of the broader meaning of "real property"
  - There is no statutory indication that the meaning of Section 856 "real property" should have one meaning for purposes of determining the existence of collateral for a mortgage and a different meaning more generally – there should be a single and consistent meaning to "real property" throughout Section 856

Case Study – Construction of a Data Center in a Private REIT

Selected 75% REIT Asset Test Issues

- Is an interest in a common area association treated as “real property” within the meaning of Sections 856(c)(4)(A) and 856(c)(5)(A)-(B)?
  - Yes, according to the following authorities:
    - Rev. Rul. 76-197
    - GCM 36580 (Feb. 11, 1976)
    - PLR 8040113 (July 15, 1980)
    - PLR 9826049 (Apr. 1, 1998)
    - PLR 201515009 (Dec. 24, 2014)
  - For purposes of the Investment Company Act of 1940, the interests in a cooperative rental housing project do not constitute a “security”. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975)

Case Study – Construction of a Data Center in a Private REIT

Selected 75% REIT Income Test Issues

- In general, non-mortgage interest income is qualifying under Section 856(c)(2) (the "95% Income Test") but is not qualifying under Section 856(c)(3) (the "75% Income Test")
  - Non-mortgage interest income includes bank account interest income
  - Non-mortgage interest income is relevant during the ramp-up period before rental income is recognized
- However, qualified temporary investment income ("TINC") is qualifying income under the 75% Income Test
  - TINC means any income which –
    - is attributable to stock or a debt investment (within the meaning of Section 1275(a)(1)),
    - is attributable to the temporary investment of new capital, and
    - is received or accrued during the 1-year period beginning on the date on which the real estate investment trust receives such capital
  - New capital means any amount received by a REIT –
    - in exchange for stock in such REIT (other than amounts received pursuant to a DRIP), or
    - in a public offering of debt obligations of such REIT which have maturities of at least 5 years

Case Study – Construction of a Data Center in a Private REIT

Selected 75% REIT Income Test Issues

- Under Section 1275(a)(1)(A), a "debt instrument" means a bond, indenture, note, or certificate or other evidence of indebtedness
  - Under Treas. Reg. Section 1.1275-1(d), a debt instrument means any instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law (including, for example, a certificate of deposit or a loan)
  - The predecessor to Section 1275 was Section 1232
  - Before Section 1232 was repealed, the Treasury regulations under Section 1232 provided that the term "other evidence of indebtedness" includes "certificates of deposit, time deposits, bonus plans, and other deposit arrangements with banks, domestic building and loan associations, and similar financial institutions". Treas. Reg. Section 1.1232-3A(e)(1)
  - In Rev. Rul. 62-183, a bank deposit was not a loan for purposes of Section 503(c)(1) but did create a debtor-creditor relationship
  - In Rev. Rul. 82-59, the IRS ruled that a bank must report interest earned on an interest-bearing checking account on Form 1099-INT
  - Based on these authorities, interest income on a bank account should be income attributable to a debt instrument for purposes of the TINC rules

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Case Study – Construction of a Data Center in a Private REIT

Selected 75% REIT Income Test Issues

- **Practical Considerations**:
  - Avoid comingled bank accounts, if possible (i.e., only deposit new capital in the account); there is always some comingling because interest earned is credited to the account and is not "new capital"
  - Although good arguments can be made that debt incurred by a partnership in which the REIT is a partner qualifies as debt issued by the REIT for purposes of the TINC rules, that question is not clear under existing authorities – as such, proceeds from debt incurred by a subsidiary partnership should be treated as non-qualifying under the TINC rules and those proceeds should not be commingled with qualifying new capital

Case Study – Construction of a Data Center in a Private REIT

Selected 75% REIT Income Test Issues

- Tenant fit-out
  - Data center REITs may receive payments from their tenants for providing "fit-out services" (i.e., procurement and installation of components)
  - If the components are owned by the REIT, the tenant fit-out "contribution payment" should qualify as "rents from real property"
  - If the components are owned by the tenant (i.e., the REIT conveys title to the components to the tenant), the revenue from the sale of the components to the tenant could be considered prohibited transaction income and should be done through a TRS to avoid the prohibited transaction tax in Section 857(b)(6); if the installation services are provided by a TRS (i.e., the REIT subcontracts with the TRS to provide the installation services), the revenue from the installation services received by the REIT should qualify as "rents from real property"

Case Study – Construction of a Data Center in a Private REIT

Selected 75% REIT Income Test Issues

- **Practical Considerations**:
  - The data center lease (and other documents between the REIT and its tenant) should give the REIT, as landlord, the right to assign part or all of its interest and obligations under the lease to a TRS of the REIT, and should provide that any amounts paid with respect to the services described in the lease that are assigned to and provided by the TRS may be received by the REIT as landlord or as agent and then paid over to the TRS
  - Transfer pricing studies supporting the transactions between the REIT and its TRS are always a good idea