Real Estate Investment Trusts (REITs): Formation, Compliance, and Taxation of REITs

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Topics for Discussion

- Overview of REITs (Structure & Compliance)
- Issues Presented in M&A Deals and Joint Ventures
- Types Of REITs and Industry-Specific Concerns
- Recent Developments

Overview of REITs (Structure & Compliance)

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

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
- Designed like a mutual fund: provides a vehicle for passive investors to acquire a portfolio of real estate
- 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 federal income tax
  - Owners are subject to federal income tax on the dividends received
  - Most states in the U.S. conform to this federal treatment
  - Non-U.S. jurisdictions generally do not follow this U.S. federal treatment

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
- Unlike a partnership, REITs issue IRS Forms 1099 and 1042-S to shareholders (instead of Schedule K-1 to partners)
  - 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

REIT Industry Overview: Public Market

Constituent Companies of the FTSE Nareit All REITs Index (as of December 31, 2009)		
Number of REITs	Company	Equity Market Capitalization ($M)
115	**Equity REITs**	**$248,355.10**
28	Industrial/Office	$53,805.50
16	Office	$32,862.60
7	Industrial	$13,153.20
5	Mixed	$7,789.70
25	Retail	$59,667.90
15	Shopping Centers	$24,475.10
6	Regional Malls	$29,971.80
4	Free Standing	$5,221.00
18	Residential	$35,982.60
15	Apartments	$33,984.80
3	Manufactured Homes	$1,997.70
9	Diversified	$16,925.80
12	Lodging/Resorts	$14,664.40
4	Self Storage	$16,520.40
12	Health Care	$33,959.90
7	Specialty	$16,828.70
4	**Hybrid REITs**	**$740.80**
23	**Mortgage REITs**	**$22,103.20**
14	Home Financing	$20,890.60
9	Commercial Financing	$1,212.6
142	**Industry Totals**	**$271,199.10**

FTSE Nareit Index https://www.reit.com/data-research/reit-indexes/monthly-index-constituents

Constituent Companies of the FTSE Nareit All REITs Index (as of May 31, 2024)		
Number of REITs	Company	Equity Market Capitalization ($M)
154	**Equity REITs**	**$1,247,423.60**
22	Office	$62,954.10
11	Industrial	$151,270.80
29	Retail	$184,999.70
17	Shopping Centers	$64,222.80
3	Regional Malls	$53,398.60
9	Free Standing	$67,378.30
20	Residential	$185,324.10
14	Apartments	$123,586.50
3	Manufactured Homes	$27,371.20
3	Single Family Homes	$34,366.40
17	Diversified	$24,321.90
15	Lodging/Resorts	$35,585.20
5	Self Storage	$91,308.40
16	Health Care	$123,808.40
3	Timberland	$29,847.60
4	Telecommunications	$157,733.00
2	Data Centers	$116,871.70
2	Gaming	$41,690.40
8	Specialty	$41,708.20
39	**Mortgage REITs**	**$54,066.50**
20	HomeFinancing	$32,175.40
19	CommercialFinancing	$21,891.2
193	**193 Industry Totals**	**$1,301,490.10**

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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

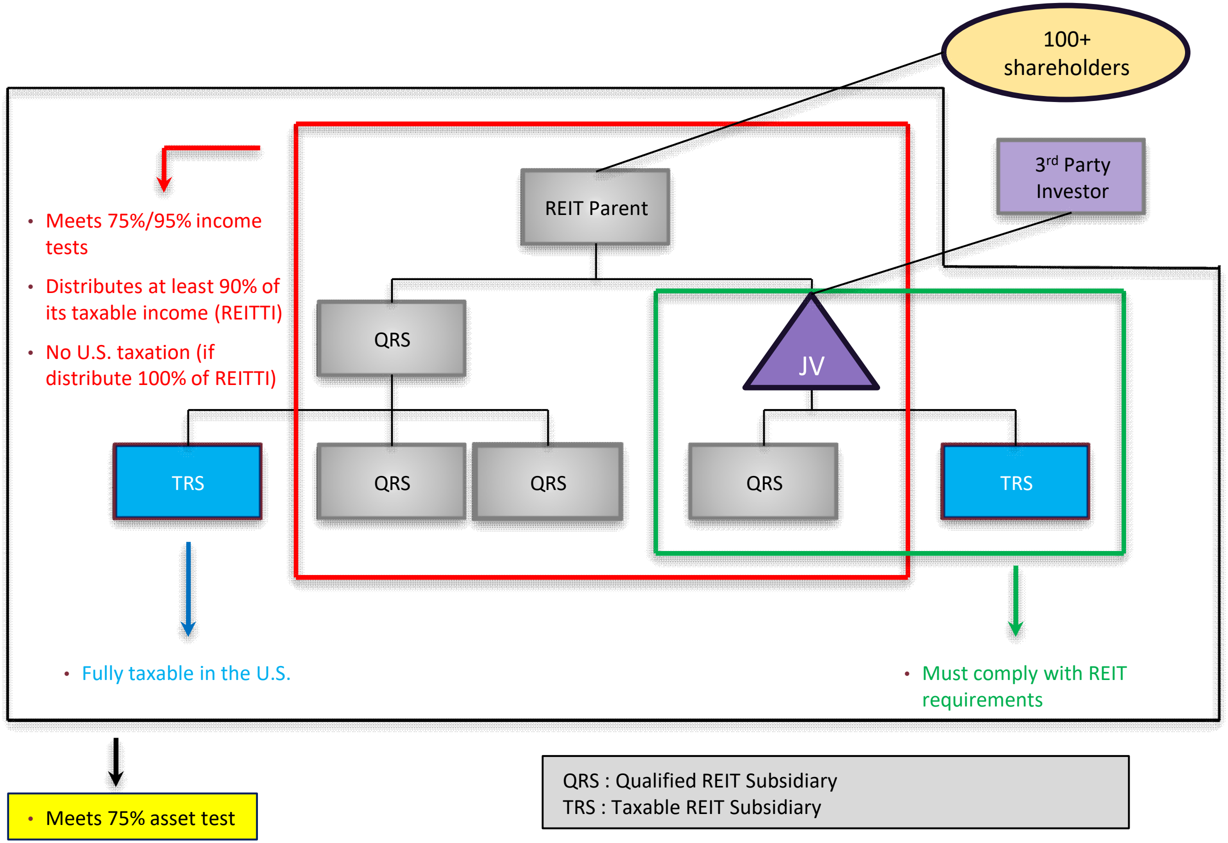
Organization & Capital Structure

- Organized as a domestic entity that is taxable as a corporation (Form 8832)
- 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"
- Various recordkeeping is required for quarterly asset and annual income tests, shareholder demand letters, related-party 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



QRS : Qualified REIT Subsidiary
TRS : Taxable REIT Subsidiary

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 one or more trustees or 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 certain circumstances (e.g., 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 real property), 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 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 secured by *Real Property* (such as *Mortgage Loans*);
- Dividends received on shares of other REITs;
- Gain from the sale of shares of other REITs;
- 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;
- Income and gain from *Foreclosure Property;* and
- Dividends and interest from temporary investments of new capital (TINC) raised by the REIT.

* Terms in italics are defined in the Code or Regulations

Revenue from Real Property

- *Rents from Real Property* **include**:
  - Payments for use or occupancy of real property or interests in real property (§ 1.856-4(a))
  - 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) (§ 1.856-4(b)(2))
  - Income received or accrued for certain services furnished to tenants, including:
    - Charges for 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 (§ 1.512(b)-1(c)(5))
    - Charges for services customarily furnished or rendered in connection with the rental of real property, whether or not separately stated an performed by a TRS or independent contractor
      - 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 (§ 1.856-4(b)(1))
    - 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)

Revenue: Services at REIT-Owned Properties

- Services that are primarily for the convenience of the tenant must be performed by either an Independent Contractor from which the REIT receives no income or a TRS.
- *Independent Contractor (IK),* as defined § 856(d)(3), means any person or corporation that does not own, directly or indirectly, more than 35% of shares by vote or value of the REIT.
  - Customary Services: (i) must qualify as an "independent contractor" and (ii) REIT must not receive any income from IK
  - Non-customary Services: (i) and (ii), plus (iii) service charges must be separately stated, (iv) service revenue must be collected by IK, (v) service revenues must be retained by IK, and (vi) IK must be adequately compensated
- *Taxable REIT subsidiaries (TRS)* are corporations directly or indirectly held by the REIT and for which a special election to be treated as a TRS has been made § 856(l)
  - Not a REIT qualification issue, but a 100% tax applies to REIT if the TRS isn't adequately compensated for services (treated as redetermined rents)
  - Address by (i) ensure arm's length fee (transfer pricing) or 50% markup on TRS costs, (ii) TRS provides significant amount of similar services to unrelated parties for substantially comparable fees, or (iii) charges are separately stated and rent paid by tenant is comparable to rent paid by tenants not receiving the service (note: no separately stated or received requirement for non-customary services)

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

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) (§ 1.856-4(b)(3))
  - Any amount received from a "**related-party tenant**", which includes:
    - 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 (§ 1.856-4(b)(4))
  - Any amount received that is "**Impermissible tenant service income**" (ITSI)
    - ITSI is any amount received or accrued directly or indirectly by the REIT (from real or personal property) for (i) services furnished or rendered by the REIT to the tenants of such property, or (ii) managing or operating such property (§ 856(d)(7))
    - Favorable exception to ITSI for service that either satisfies the standard of § 1.512(b)-1(c)(5) or is provided through a TRS or an IK from which the REIT doesn't receive any income
  - **Practical Consideration**: With a baseline rental relationship in place, a TRS can be used to accommodate any services that the tenant requires. When in doubt, use a TRS.

Income from Other Sources

- At least 95% of a REIT's gross income on an annual basis must generally be passive in nature
  - Income from real property that satisfies the 75% requirement
  - 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 tenant services
  - Businesses other than rental real estate ("SLOB")
  - **Practical Consideration:** REIT income tests basically come down to managing the 5% bad basket
- 100% tax on net income from sales or other dispositions of "dealer property"

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* exception for the 10% vote or value tests—thus, a small security held by a REIT can cause a failure

Assets

Treas. Reg. §1.856-10: Definition of Real Property

- 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 of Inherently Permanent Structures
  - Certain Intangible Assets
- These rules are for REIT purposes only

See public comments of Ameek Ashok Ponda to Proposed Treasury Regulations § 1.856-10, available at 2014 TNT 177-22 (Aug. 11, 2014)

Distributions of Income

- A REIT must meet certain distribution requirements
  - 90% distribution of taxable income (excluding certain items such as capital gains and COD income) is required to be a REIT
  - 100% distribution of taxable income maximizes tax efficiency
  - A REIT that fails to distribute at least 85% of its ordinary income or 95% of its capital gains is subject to a 4% excise tax in addition to the regular corporate rate

Distributions of Income

- A REIT will typically make regular quarterly distributions of income based on taxable income estimates
- A REIT that is under-distributed has three options:
  - Spill-Over. Declare a dividend with record dates in October, November, or December of year 1 and pay during January of year 2: dividend is treated as paid and received on December 31 of year 1
  - Throw-Back. (i) declare a dividend in year 2 before the due date of the tax return for year 1 (including extensions); (ii) distribute the dividend in the 12-month period following the close of the year 1 taxable year, and not later than the date of the first regular dividend payment made after such declaration (in year 2); and (iii) elect in its tax return for year 1 to have a specified dollar amount of such dividend paid in year 2 treated as if paid in year 1
  - Consent. A REIT may satisfy the 90% distribution requirement utilizing consent dividends (generally available for a private REIT but impractical for a public REIT)
    - 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
  - Preferential Dividend Rules
    - In order to meet the 90% distribution requirement, the REIT must distribute dividends that qualify for the dividends-paid deduction (DPD). Preferential dividends do not qualify for the DPD
    - 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 (in the case of a state law corporation)
      - LLCs have more flexibility in that the organic document can provide that any preferred dividends paid are deemed to be duly authorized dividends

Relief Provisions

- Certain asset test violations may be cured by:
  - Disclosing the violation (Section 856(c)(7)(A)(i)),
  - Disposing of assets to the extent necessary to come into compliance with the asset test requirements (Sections 856(c)(4), 856(c)(7)(A)(iii) and 856(c)(7)(B)(ii)), and
  - If necessary, paying a penalty tax of the greater of $50,000 and the net income generated by violating assets (Section 856(c)(7)(C))
- Certain income test violations may be cured by a Section 856(c)(5)(J) PLR from the IRS, or by:
  - Disclosing the violation (Section 856(c)(6)(A)), 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 (Section 857(b)(5))
- Distribution violations may be cured by:
  - Making deficiency dividends or other distributions (Sections 852(e) and 860)
- Other violations may be cured by:
  - Paying a penalty tax of $50,000 (Section 856(g)(5))

For further discussion of the relief provisions, see Ponda and Wellings, "Remediation of M&A REIT Targets," Feb. 28, 2023 https://www.jdsupra.com/legalnews/remediation-of-m-a-reit-targets-2418392/

Issues Presented in M&A Deals and Joint Ventures

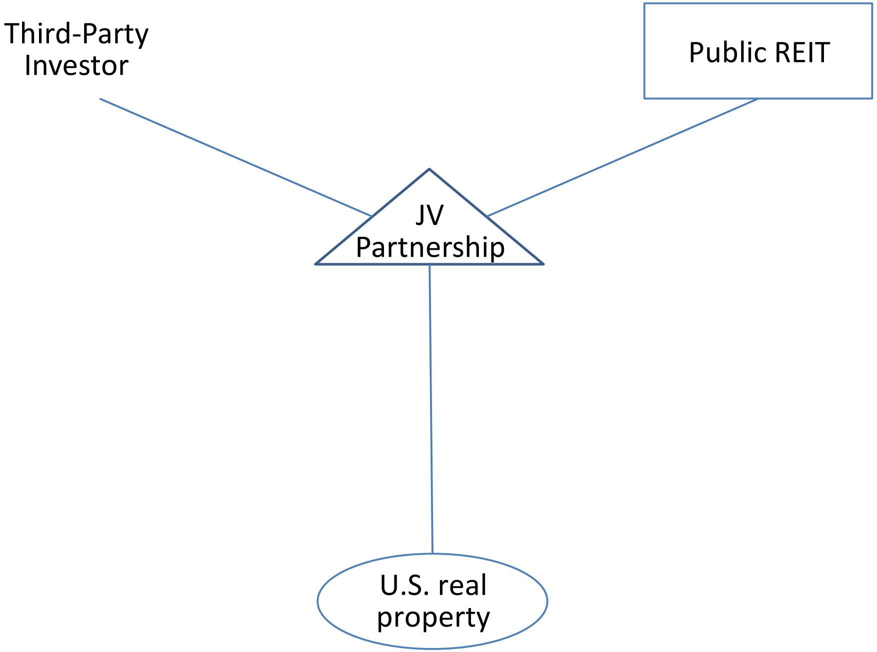
- JV Structures (private and public)
- Tax Related Deal Issues for JV REITs
- Exit Issues for JV REITS
- REIT Compliance Considerations in M&A

Structures for JV Between Public REIT and Third-Party Investor

- Structures require a weighing of the access to capital versus the additional operational complexity, tax costs/savings, and potential friction costs on exit
- Partnership agreement must clearly restrict partnership activities to REIT-compliant ones, even if that is contrary to the interests of non-REIT partners
- Subsidiary REITs, or “Baby REITs,” must separately meet the requirements imposed under the Code to qualify for taxation as a REIT
    - Some issues that are not of primary concern to public REITs will matter greatly for the Baby REIT (e.g., preferential dividend rule, 100 shareholder requirement)
    - Related-party tenant issues stemming from attribution from third-party investors can negatively impact REIT qualification
    - REIT qualification deficiencies at the Baby REIT level can cascade up to the parent REIT, and so a “protective” TRS election is warranted

Structures for JV Between Public REIT and Third-Party Investor

Domestic Partnership Model



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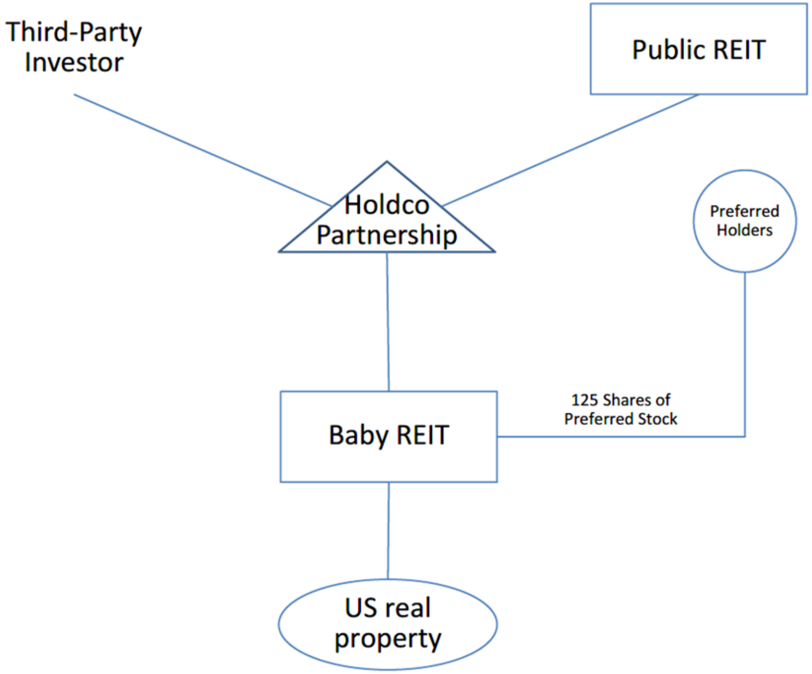
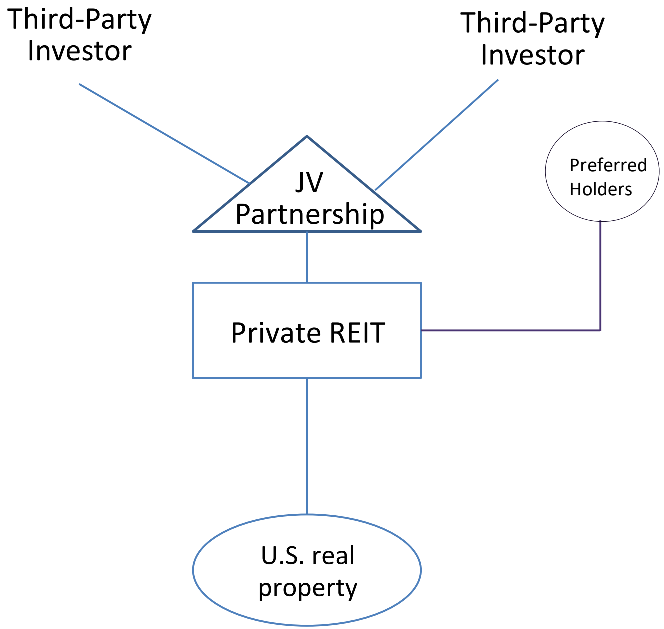
Structures for JV Between Public REIT and Third-Party Investor

Baby REIT Model



Structures for JV Between Private REIT and Third-Party Investor

Private REIT Model



Tax-Related Deal Issues for JV REITs

- Public REITs are increasingly using Baby REITs as a means to attract tax-exempt and foreign co-investors because Baby REITs can serve as blockers for ECI and UBTI

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%
- 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

Tax-Related Deal Issues for JV REITs

General rules of taxation for non-U.S. Governmental Entities (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

Tax-Related Deal Issues for JV REITs

General Rules for "Qualified foreign pension funds" (QFPF)

- QFPFs (including wholly-owned subsidiaries of such funds) are entirely exempt from FIRPTA
- In order to qualify as a QFPF, certain U.S. requirements must be satisfied, including:
  - 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, QFPFs 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 QFPFs 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

Tax-Related Deal Issues for JV REITs

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*

Tax-Related Deal Issues for JV REITs

- Organizational documents will generally include provisions to address U.S. tax concerns of third-party investor, including with respect to:
  - Requirements that exit events be structured as sales of REIT shares, and other limitations on the sale or disposition of real property interests
  - Maintenance of U.S. tax elections (including REIT and TRS elections)
  - Restrictions on transfers of interests and on admission of additional joint venturers, including affirmative obligations to maintain “domestically controlled” REIT status
  - Provisions governing treatment of distributions and intended withholding procedures

Exit Issues for JV REITs

- Exit events generally involve a sale of 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 and warranties 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 Baby 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

REIT Compliance Considerations in M&A

- REIT organizational requirements are generally compatible with most dividend reinvestment plans, share repurchase plans, and employee equity incentives
- Check for debt covenants that restrict cash dividends; authorize enough shares to allow for cash-and-stock dividends
- Diligence
  - 75% and 95% income tests
  - Asset tests
  - Rents, leases, and licenses of Target should be diligenced to ensure they are REIT compliant, particularly if the Target is not a REIT
- **Practical Considerations**:
  - If a REIT acquires a C corporation, the REIT must distribute all of the C corporation's earnings and profits inherited in the acquisition in the first year
  - Reclassification of assets to real property for depreciation purposes may result in additional income due to depreciation recapture, which must also be distributed

Types of REITs and Industry-Specific Concerns

- Office Properties
- Data Centers, DAS, Towers
- Healthcare and Lodging Facilities (RIDEA)
- Timber

Office Properties

- Office buildings are becoming more sophisticated and diverse in the types of amenities they offer (e.g., parking services, gyms, in-house healthcare, cafés, day care centers, cafeterias)
  - Must carefully analyze whether the REIT can provide the service directly or must instead subcontract to a TRS
- What are "customary" services provided by landlords?
  - Consider geographic traits (e.g., shuttle services in remote cities without transportation, snow removal in northeast)
  - Providing EV Stations can be accomplished directly by the REIT in certain circumstances (PLR 202413004)
  - REITs should utilize TRSs or independent contractors to provide services that are for the benefit of the tenant, or whenever in doubt

Data Centers, DAS, Towers

- Interconnection solutions: Exchange of data from one point to another, achieved through point-to-point cross connects, exchange ports, or other offerings
- Super Rental Model, with a QRS handling all interconnection business
  - 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 "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
  - This is the model used for distributed antenna systems (DAS), digital billboards, and master antennas, and might be used for complex interconnections
- 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
  - Interconnection components are owned and operated by a TRS
  - Tenant purchase services from a QRS which in turn subcontracts to a TRS, which runs the high-end interconnection business
    - Transfer pricing may be an issue, leading to both high tax leakage and TRS valuations that push up against the 20% asset limit
  - This is the model used by REITs for staffed office suites, internal cafeterias, childcare centers, etc., and complex interconnections
- Each model 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.

Healthcare & Lodging Facilities (RIDEA)

REIT Investment Diversification and Empowerment Act of 2007

- Permits REITs to lease qualified healthcare and lodging facilities to a TRS provided various conditions are met, including that such properties are managed by an eligible independent contractor (EIK)
  - Healthcare facility: a hospital, nursing facility, assisted living facility (AL), congregate care facility, qualified continuing care facility, or other licensed facility that provides medical or nursing or ancillary services to patients and which is operated by a Medicare-eligible provider
  - Lodging facility: lodging facility is generally defined as a hotel, motel, or other establishment wherein more than half of the dwelling units are used on a transient basis
  - EIK: independent contractor who, at the time of entering into a management agreement with a TRS to manage a property, is actively engaged in the trade or business of operating lodging or health care facilities, respectively, for a person who is not related to the REIT or TRS; REIT cannot derive income from IK

Timber REITs

Sales of Timber – REIT Compliance Considerations

- Holding periods
  - First Year Timber
  - Over-One-Year Timber
- Ramp-up Period
- Income from Other Sources

Timber REITs

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.*

Timber REITs

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 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

Timber REITs

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 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

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
- 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)

Timber REITs

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, a Timber REIT can employ a TRS (i.e., a cutting subsidiary) to synthesize such a sale without jeopardizing REIT qualification

Timber REITs

Cutting Subsidiaries (TRSs)

- Cutting subsidiary will enter into pay as cut or lump sum contracts with the landowner REIT to acquire stumpage
- Cutting subsidiary will then sell the severed timber into the marketplace via delivered log sales
- 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
- **Practical Consideration:**
  - 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

Timber REITs

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**

Timber REITs

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 slide reflects 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

Timber REITs

No TRS Needed:

- Ground Leases
  - Fixed-fee rents for use of land (viz. windmills, hydroelectric dams, cell phone towers) and the placement of inherently permanent structures thereon generate rent from real property and are thus good REIT income
- Hunting Leases
  - Generates good REIT income provided that little or no services are provided to the tenants/hunters
- Right of Way/Road Use “Temporary Easements”
  - Term – must be temporary; permanent easements are viewed as deemed sales by the IRS
  - Consideration – generally must be fixed and determinable
- Water Rights (Riparian water rights)
- Seismic Surveys
  - Amounts paid by unrelated third parties to conduct surveys is good REIT income because the payment is for use of the REIT’s land

Timber REITs

TRS Needed:

- Biomass
  - Stumps, branches, and tree tops that have been severed from timber are no longer considered real property, and thus, proceeds from such sales are nonqualifying income
- Gas, Oil, and Mineral Rights – Extraction
  - “interests in real property” expressly exclude gas, oil, or mineral royalty interests
  - Note that ground leases related to production of gas, oil, or minerals can be recharacterized to royalties
- Gas, Oil, and Mineral Rights – Non-Extraction
  - Surface damage payments based on gas, oil, or mineral volume represents good REIT income only if the gas, oil, or mineral was extracted from someone else’s land

Recent Developments

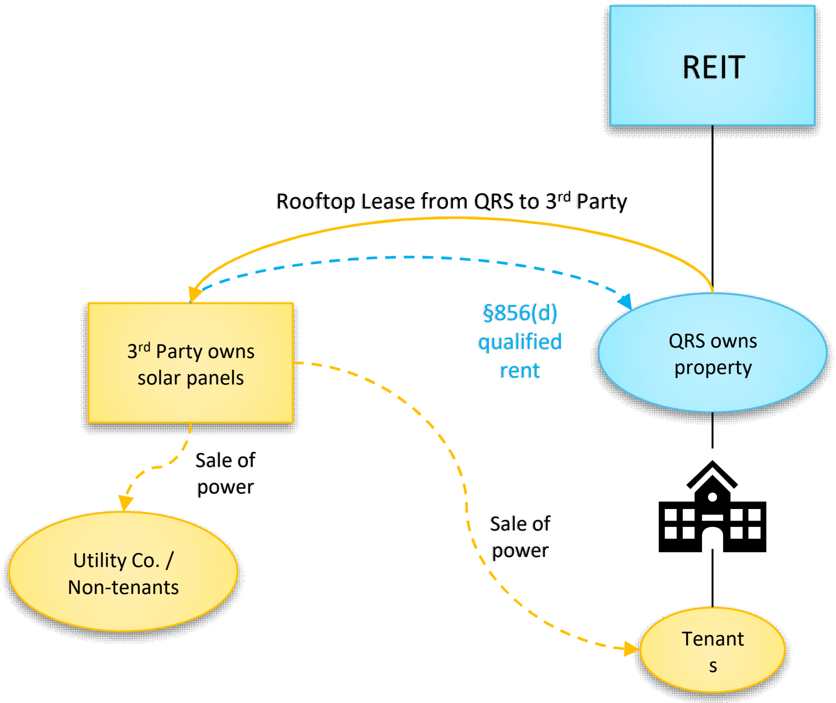
- Inflation Reduction Act
- Domestically-Controlled REIT Regulations
- IRS Priority Guidance Plan

Recent Developments

- Inflation Reduction Act (P.L. 117-169)
  - Pre-Inflation Reduction Act (2022), REITs had to deploy taxable REIT subsidiaries or a third-party contractor to utilize green energy tax credits
  - Post-Inflation Reduction Act, REITs may sell green energy tax credits directly and regulations (proposed (June 2023) and final (published April 2024, effective July 1, 2024)) clarify the impact to REITs
  - Treasury Regulations §1.6418
    - Credits not yet transferred are disregarded for purposes of calculating the asset tests under §§ 856(c)(4). See § 1.6418-5(i)(1)
    - Transfer of credits pursuant to § 6418 is not considered a sale of property for purposes of the prohibited transaction ("dealer property") safe harbor (§§ 857(b)(6)(C)(iii) and 857(b)(6)(D)(iv)). See § 1.6418-5(i)(2)
  - Preambles to the proposed and final regulations reiterate two points: (i) entitlement to receive a credit is not § 61 gross income and so entitlement to a credit will not impact a REIT's gross income test and (ii) sale of energy is still subject to the net-metering safe harbor laid out in TD 9784 (2016, Treas. Reg. § 1.856-10)

Indicative Structure – Option A1 (Baseline)

Available Pre & Post Inflation Reduction Act

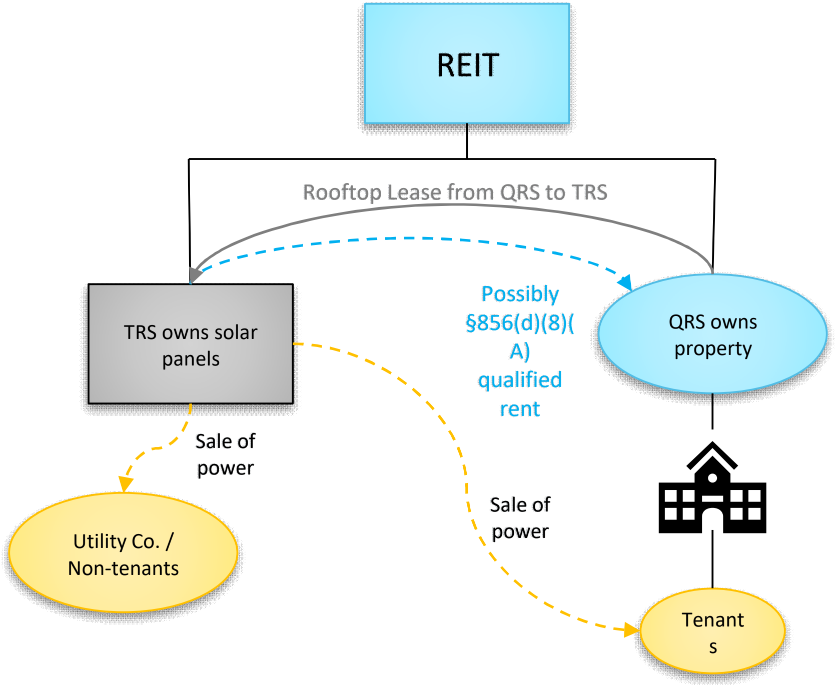


3rd Party is lessee of rooftop space and owner of all solar panels

- 3rd Party sells power to tenants and non-tenants (e.g., utility company)
- Electricity to tenants can be paid for by tenants directly to 3rd Party or through a submetering arrangement with the QRS
- 3rd Party generates ITC on all solar panels and utilizes ITC against its own taxable income (post-IRA, 3rd Party may also sell any or all excess ITC)

Indicative Structure – Option A2 (Baseline)

Available Pre & Post Inflation Reduction Act

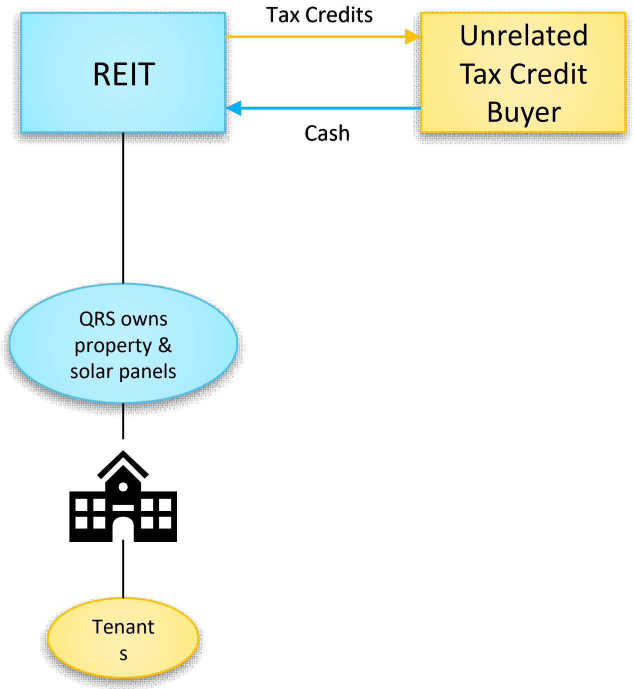


TRS is lessee of rooftop space and owner of all solar panels

- TRS sells power to tenants and non-tenants (e.g., utility company)
- Electricity to tenants can be paid for by tenants directly to TRS or through a Rev. Rul. 2002-38 arrangement
- TRS generates ITC on all solar panels and utilizes ITC against its own taxable income (post-IRA, TRS may also sell any or all excess ITC)

Indicative Structure – Option B

Available Post Inflation Reduction Act

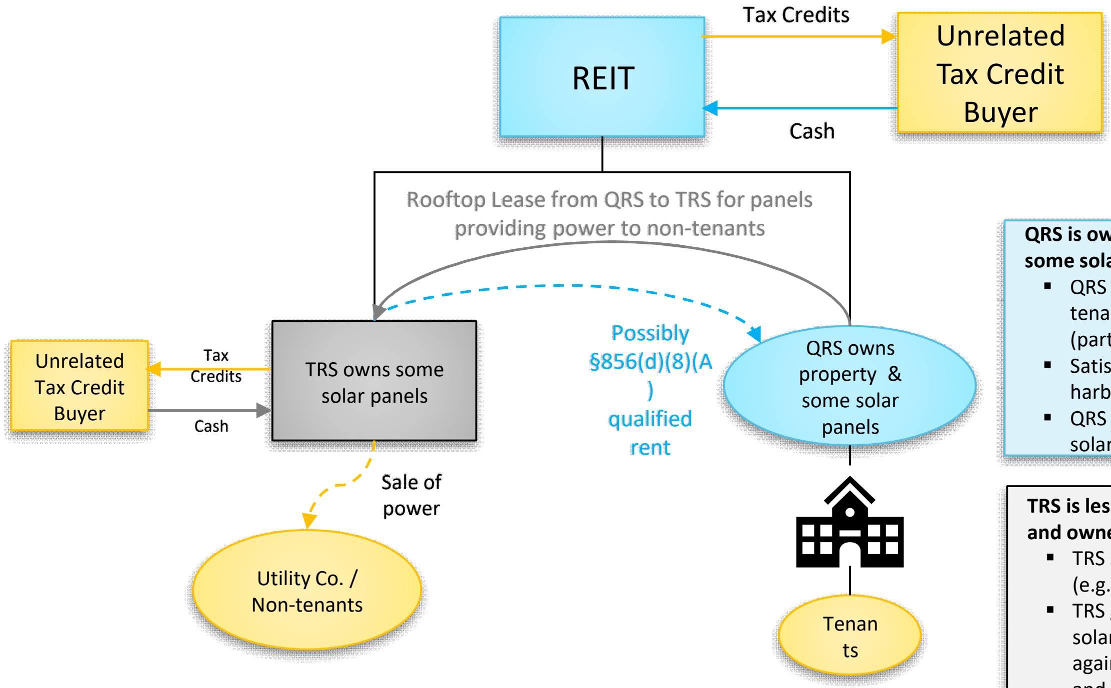


QRS is owner of building and of all solar panels

- QRS provides power only to tenants and common areas (part of building lease)
- Satisfies net metering safe harbor
- QRS generates ITC on all solar panels and REIT sells ITC

Indicative Structure – Option C*

Available Post Inflation Reduction Act



QRS is owner of building and of some solar panels

- QRS provides power only to tenants and common areas (part of building lease)
- Satisfies net metering safe harbor
- QRS generates ITC relating to its solar panels and REIT sells ITC

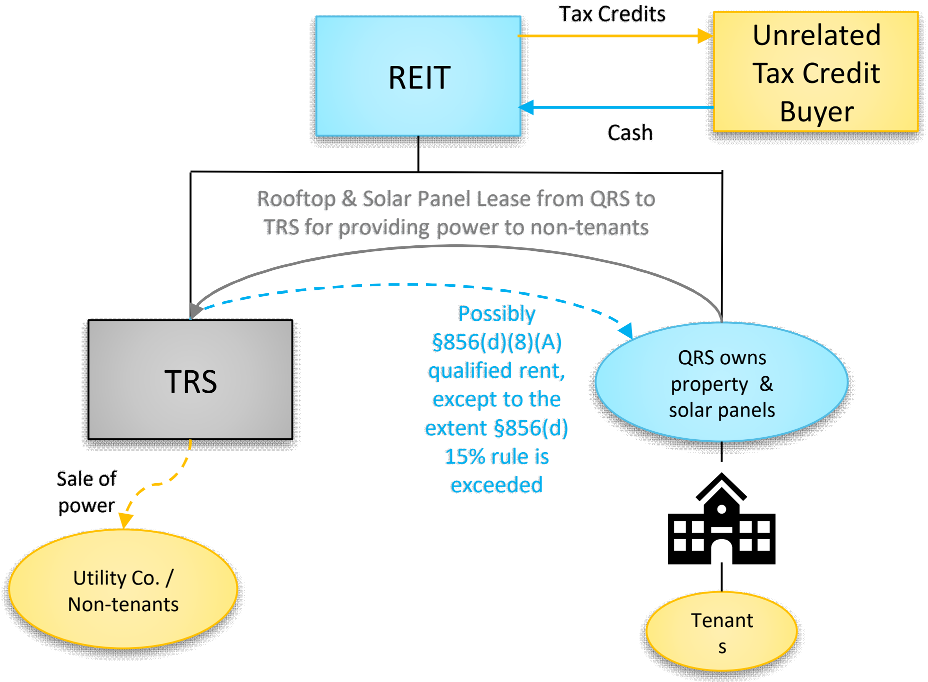
TRS is lessee of portion of rooftop and owner of some solar panels

- TRS sells power to non-tenants (e.g., utility company)
- TRS generates ITC relating to its solar panels and may utilize ITC against its own taxable income and sell any or all excess ITC

* Option C may be viewed as combination of Options A2 and B

Indicative Structure – Option D

Available Post Inflation Reduction Act



QRS is owner of building and of all solar panels

- QRS provides power only to tenants and common areas (part of building lease)
- Satisfies net metering safe harbor
- QRS generates ITC on all solar panels, including those leased to TRS, and REIT sells ITC

TRS is lessee of portion of rooftop and of some solar panels

- TRS sells power to non-tenants (e.g., utility company)

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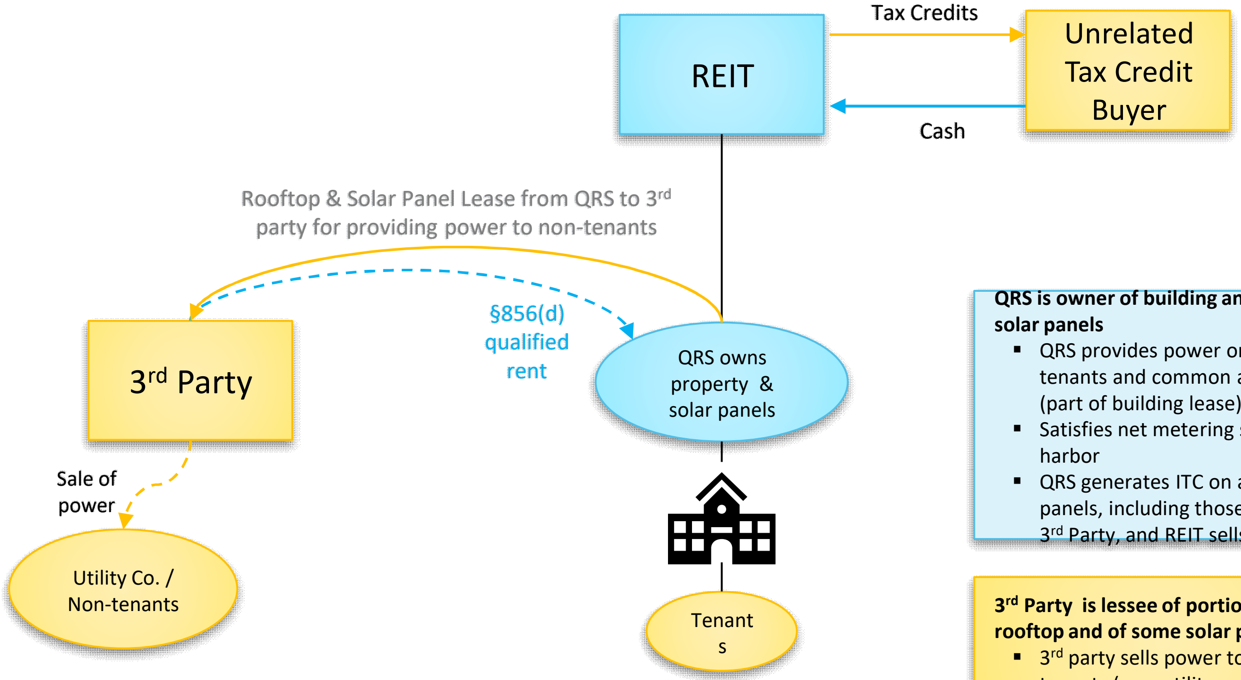
Indicative Structure – Option E

Available Post Inflation Reduction Act



QRS is owner of building and of all solar panels

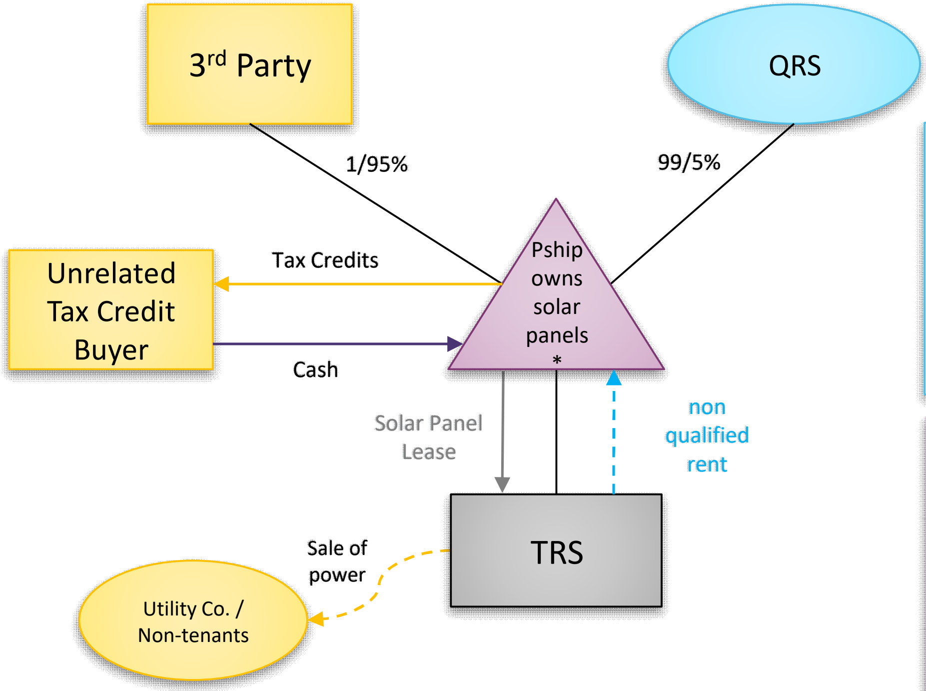
- QRS provides power only to tenants and common areas (part of building lease)
- Satisfies net metering safe harbor
- QRS generates ITC on all solar panels, including those leased to 3rd Party, and REIT sells ITC

3rd Party is lessee of portion of rooftop and of some solar panels

- 3rd party sells power to non-tenants (e.g., utility company)

Indicative Structure – Option F

Available Post Inflation Reduction Act (applies Rev. Proc. 2007-65 and Reg. §§ 1.6418-2(a)(3)(iv); -3(b), (d), (e))



QRS is owner of 99/5% of Pship

- Follows Rev. Proc. 2007-65 guidelines (ensuring FMV purchase rights can be tricky)
- QRS is allocated 99/5% of ITC sales proceeds as tax exempt income
- QRS is allocated non-qualified rent – must ensure sufficient capacity in 5% bad basket

Pship is owner/lessor of solar panels

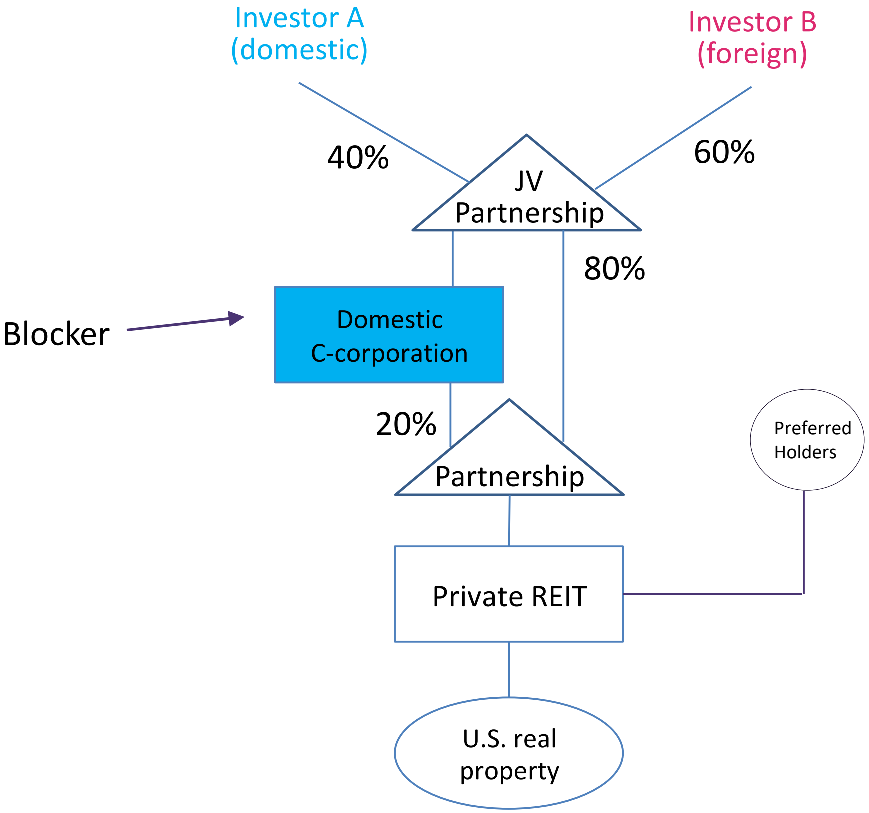
- Leases solar panels to TRS, which sells power to non-tenants (e.g., utility company)
- Sells ITC
- Distributes cash as tax exempt income to QRS in accordance with the portion of the eligible credit that would have been allocated to QRS absent the transfer

* Pship likely leases space from a 3rd party for solar panel installation

Recent Regulatory Guidance

- "Domestically-Controlled" REIT regulations, published April 24, 2024
  - An interest in a domestically-controlled REIT is not a USRPI (no FIRPTA gain on sale of REIT stock)
  - A REIT is domestically controlled if foreign persons hold directly or indirectly less than 50% of the fair market value of the REIT's outstanding stock at all times during the testing period. §1.897-1(c)(3).
  - Apply a limited look-through rule:
    - "non-look-through person" means an individual, a domestic C corporation (other than a foreign-controlled domestic corporation), a nontaxable holder, a foreign corporation (including a foreign government pursuant to section 892(a)(3)), a publicly traded partnership (domestic or foreign), a public RIC, an estate (domestic or foreign), an international organization (as defined in section 7701(a)(18)), a qualified foreign pension fund (including any part of a qualified foreign pension fund), or a qualified controlled entity
    - "look-through person" means any person other than a non-look-through person
  - 10-Year Transition Rule for certain qualified investment entities in existence prior to April 24, 2024 that are owned by foreign-controlled domestic corporations

Structure Used Before the Domestically-Controlled REIT Regulation



<u>Ownership</u>

20% Domestic C Corp
32% Investor A
48% Investor B

Potential for Regulatory Guidance

- 2024-2025 IRS Priority Guidance Plan:
  - Sullivan submitted thought-piece, "Enabling REITs to Deploy Renewable Energy: Toward a Workable Legal Standard," to the IRS Priority Guidance Plan for 2024-2025
    - Under current law, REIT landlords providing renewable energy to tenants must purchase more electricity from the grid than it sells to the grid in order for the net metering safe harbor to apply. *See* Treasury Decision 9784, I.R.B. 2016-39.
    - Considering the increasing demand and necessity for renewable energy use in the REIT industry, we propose the implementation of an "appropriate in size" legal standard for renewable energy provided by REIT landlords to tenants to satisfy the safe harbor.
  - Nareit's comment letter to 2024-2025 Priority Guidance Plan supports Sullivan's submission, stating, "*Nareit agrees with the analysis and recommendation of Sullivan & Worcester LLP in their April 18, 2024 submission with respect to the 2024-25 PGP and recommendation that the IRS issue precedential guidance that (i) confirms that the revenue generated by a real estate investment trust (a "REIT") providing electricity to its tenants from renewable-source energy that is produced onsite does not constitute Section 856(d)(7)(A) "impermissible tenant service income" and (ii) enables a REIT to deploy renewable energy infrastructure during periods of ramp up or tenant vacancies pursuant to an "appropriate in size" for the building (or other property) legal standard.*"

*Sullivan thought-piece can be found on the Federal eRulemaking Portal at https://www.regulations.gov/document/IRS-2024-0009-0001 or the Sullivan website at https://www.sullivanlaw.com/reits

*Nareit's comment letter can be found on the Federal eRulemaking Portal at https://www.regulations.gov/document/IRS-2024-0009-0001

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