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REIT Primer (Tax Technical)

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For Discussion Purposes Only

Prepared
by
Sullivan & Worcester LLP

Sarah Wellings, Connie Lee, Cameron N. Cosby, Ameek Ashok Ponda, and Paul W. Decker

This outline summarizes the federal income tax requirements that a real estate investment trust ("REIT" or the "Company") must satisfy on a continuing basis in order to be treated as a REIT under the Internal Revenue Code of 1986, as amended ("Code"). As described in detail in Section E below, in applying the income, asset, and distribution tests below, a REIT is consolidated with its qualified REIT subsidiaries and other disregarded subsidiaries ("QRSs"), but not with its taxable REIT subsidiaries ("TRSs").[1]

A. Stock Ownership Requirements. REITs must be widely held.

1. 100-Shareholder Requirement. The Company must have at least 100 shareholders for 335 days of each taxable year of 12 months, or during a proportionate part of a taxable year of less than 12 months (the "100-Shareholder Requirement"). The 100-Shareholder Requirement does not apply during a REIT's first taxable year.

2. 5/50 Rule. No more than 50% of the value of the Company's outstanding stock may be owned, directly or indirectly, by five or fewer individuals (including entities such as private foundations treated as individuals) during the last half of any taxable year (the "5/50 Rule").

   - Corporations, partnerships and other business entities (including other REITs) are looked through to their "individual" owners for this purpose.

   - Charitable organizations are generally not treated as individuals and are not looked through, but specified trusts, private foundations, and supplemental unemployment compensation benefit plans are treated as "individuals" for this purpose.

   - Government entities are not treated as "individuals" and are not looked through.

   - The 5/50 Rule does not apply during a REIT's first taxable year.

3. Shareholder Demand Letters. In order to help establish compliance with the 5/50 Rule, each year the Company is required to demand written statements from its larger shareholders disclosing their direct and indirect ownership of its stock.

[1] As described in Section E below, a QRS is generally a corporate or noncorporate subsidiary wholly owned by one or more of the REIT or another QRS (and which is not a TRS), and a TRS is generally a partially or wholly owned corporate subsidiary as to which the REIT and the TRS have made a joint election on an IRS Form 8875 for TRS status. Special "look through" rules apply to partially owned noncorporate entities such as partnerships, LLCs, etc.

4. Practical Considerations.

- In the public company context, the charter/declaration of trust should include restrictions on stock ownership so as to avoid becoming closely held under the 5/50 Rule or having affiliated tenants (described in Section B.3 below):

  - Limit shareholders to owning no more than 9.8% of any class of equity; however, if a shareholder seeks to own more than 9.8%, the board of directors in concert with tax counsel can craft a narrow waiver to satisfy the REIT tests and permit the excess shareholding;

  - Include an automatic transfer of "excess shares" into a charitable trust; and

  - Include provisions relating to shareholder demand letters and other shareholder information so that ownership can be ascertained.

    - Other solutions to the ownership limitations are viable in the private company context.

    - In the private company context, Class A Preferred Shares are typically issued in a private placement in order to satisfy the 100-Shareholder Requirement.

- The REIT shareholder requirements are generally compatible with most employee equity incentives, but a technical review is required.

B. Income Tests. REITs are required to have mostly passive income.

1. 75% Gross Income Test. At least 75% of the Company's gross income for each taxable year must generally consist of the following types of income:

- "Rents from Real Property" (described in Section B.3 below);

- Interest on obligations secured by real property (*e.g.*, mortgage loans);

- Dividends received on, and gain from the sale of, shares of other REITs;

- Dividend or interest income from the temporary investment of certain new capital raised by the REIT;

- Gain from the sale of real property (other than "dealer property", as described in Section B.5 below);

- Abatements and refunds of real estate taxes; and

- Income and gain from "foreclosure property".

2. 95% Gross Income Test. At least 95% of the Company's gross income for each taxable year must generally consist of the following types of income:

- Income that is qualifying income for purposes of the 75% income test;

- Dividends (including dividends from TRSs, as described in Section E.2 below);

- Other types of interest income (*i.e.*, from obligations that are not secured by real property); and

- Gain from the sale or disposition of stock or securities.

3. <u>"Rents from Real Property".</u>

- Amounts received for the right to use real property. (For what constitutes real property, see Section C.2 below.) Examples of agreements that confer a right to use real property include:

  - Leases;

  - Licenses; or

  - Other contracts for the use of or access to physical space.

- Rents from Real Property do not generally include:

  - Rents from a tenant based in whole or in part on income or profitability, except that formulas based on gross receipts or sales are generally permitted;

  - Rents from a tenant in which the Company actually or constructively (pursuant to attribution rules) owns a 10% or greater equity interest; or

  - Any amount received if the Company provides impermissible services to the tenant (in more than a de minimis amount) other than through an "independent contractor" or a TRS. Services provided by an "independent contractor" are subject to additional requirements.

- Limitation on Services:

  - Certain services customarily furnished in connection with the rental of real property (*e.g.*, furnishing of heat and light; the cleaning of public entrances, exits, stairways and lobbies; and the collection of trash) may be provided by a REIT in connection with the rental of real property and will generate Rents from Real Property; but

  - Most other services must be provided by an "independent contractor" or a TRS, as noted above.

- Personal property limitation:

  - No more than 15% of the amount received under a lease/license/contract may be attributable (based on fair market values) to the use of personal property, or else the amount received that is attributable to the personalty component is not Rents from Real Property.

4. <u>Excluded Income.</u> Certain other income is excludible from the 75% and/or 95% gross income tests, such as:

- Income from the cancellation of indebtedness;

- Certain foreign exchange gains;

- Certain hedging transactions;

- Amounts covered by Rev. Proc. 2018-48 (*e.g*., Subpart F and PFIC inclusions); and

- Amounts covered by a Section 856(c)(5)(J) private letter ruling (*e.g.,* Section 481(a) inclusions, state incentive inclusions, etc.).

5. Dealer Property. Dealer property generally consists of property held primarily for sale to customers in the ordinary course of business.

   - Gain from the sale of dealer property (other than certain foreclosure property) is excluded from the 75% and 95% gross income tests.

   - There is a 100% tax on net income from sales or other dispositions of dealer property (as described in Section F.2 below).

6. Practical Considerations.

   - In M&A settings, diligence is necessary to determine whether the target's leases/licenses/contracts are REIT compliant.

   - All services provided must be reviewed to determine if they are customary services or need to be performed by a TRS.

     - All customer revenue (including revenue for services performed for tenants by a TRS but disregarding amounts collected on behalf of independent contractors) will qualify as Rents from Real Property.

     - Care must be taken to ensure that TRSs are adequately compensated for services provided to the REIT or the REIT's tenants/customers (as described in Section E.2 below) so as to avoid redetermination of rents and associated tax penalties.

   - Rent must be allocated to personal property based on the relative fair market value of real and personal property leased to the tenant in order to gauge compliance with the 15% personal property limitation.

   - Note that income earned in TRSs is not consolidated with the REIT for purposes of the 75% gross income test or the 95% gross income test.

C. Asset Tests. REIT assets must be predominantly related to "real estate assets".

1. 75% Asset Test. At the end of each calendar quarter, at least 75% of the value of the Company's assets must consist of the following types of qualifying assets:

   - Real property (including interests in real property and interests in mortgages on real property or on interests in real property);

   - Personal property (to the extent rents attributable to the personal property are treated as Rents from Real Property under the rule described above);

- Shares of other REITs;
- Debt interests of publicly offered REITs;
- Cash and cash items (including short-term receivables);
- Certain U.S. Federal Government securities; and
- Temporary investments in stock or debt instruments attributable to the receipt of certain new capital.

2. Definition of Real Property. Treasury Regulations § 1.856-10 provides a comprehensive definition of what constitutes "real property" under Section 856.

   - Generally, the regulations provide that (i) land, (ii) improvements to land constituting inherently permanent structures or structural components thereof, and (iii) certain intangible assets that derive their value from real property and that are inseparable from real property are treated as "real property" under Section 856.

3. 5% and 10% Asset Tests.

   - At the end of each calendar quarter, a REIT's ownership of the securities of an issuer must comply with the following tests:
     - The value of the securities of any one issuer owned by a REIT may not exceed 5% of the aggregate value of the REIT's assets (the "5% asset test");
     - A REIT may not own securities (other than "straight debt" securities) having a value of more than 10% of the total value of the outstanding securities of any one issuer (the "10% value test"); and
     - A REIT may not own securities possessing more than 10% of the total voting power of the outstanding securities of any one issuer (the "10% voting test").
   - These three asset tests are intended primarily to limit the Company's ownership of securities issued by C corporations. These asset tests do not apply to the following types of securities:
     - Securities that are qualifying assets for purposes of the 75% asset test, including stock in other REITs, debt instruments of publicly offered REITs, debt securities that are directly and fully secured by a mortgage on real property, and certain temporary investments of new capital;
     - Stock and debt securities of a TRS or a QRS; and
     - Ownership interests in an entity that qualifies as a partnership for tax purposes.

4. Other Asset Tests.[2]

[2] Each of these additional asset tests provides that no more than 25% of a REIT's total assets may be represented by certain types of assets. Accordingly, if at least 75% of a REIT's assets relate to the qualifying

- At the end of each calendar quarter,
  - no more than 25% of the value of a REIT's total assets may be represented by securities other than those securities that count favorably toward the 75% asset test;
  - no more than 25% of the value of a REIT's total assets may be represented by stock or other securities of its TRSs; and
  - no more than 25% of the value of a REIT's total assets may consist of debt instruments of publicly offered REITs that are not adequately secured by real property.

5. Practical Considerations.

- "Bad" assets may be segregated into TRSs.
  - Shares of stock in TRSs are "bad" assets for a REIT, but the stock is valued on a net equity basis.
    - While no specific valuation method is required, it is important to develop a reasonable method that can be consistently applied over time.
  - Assets held in TRSs are not considered part of the REIT for asset testing purposes; rather they enter into REIT asset testing through the net equity value of any TRS stock owned by the Company.
- Because the value of any TRS stock and securities owned by the Company may fluctuate, the Company should monitor its compliance with these asset tests on an ongoing basis.
- In order to facilitate compliance with the 75% asset test, certain assets which a company converting to a REIT has historically classified and depreciated as personal property likely need to be reclassified as real property. Such reclassification is likely to result in an inclusion of income under Section 481 related to depreciation recapture.
  - Section 481 inclusions may generally be spread over four years.
  - Section 481 inclusions are generally subject to corporate income tax, even if recognized during a REIT year.
  - Reclassification may lead to certain assets having different depreciable lives for tax and GAAP purposes.

D. Distribution Requirements and Considerations.

1. 90% Distribution Requirement. Each taxable year, a REIT must distribute to its shareholders at least 90% of its taxable income (other than capital gain, original issue

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assets described in Section C.1, above, then each of these additional asset tests will have been satisfied in full because 25% is the mathematical complement to 75%.

discount, and cancellation of indebtedness income) (the "90% Distribution Requirement").

- The Company must make distributions pro rata among members of the same class of shareholders and must pay such distributions simultaneously in order to avoid characterization of its distributions as "preferential." In addition, the Company may not make preferential allocations of capital gain dividends to any shareholder. The preferential dividend rule is inapplicable to publicly offered REITs that are required to file annual and periodic reports with the SEC under the Securities Exchange Act of 1934.

- The Company must have a valid basis for ceasing to accrue for federal income tax purposes any rent or interest as a result of a default, delinquency, or forbearance agreement. Otherwise, the Company must accrue any such unpaid amounts, and such unpaid amounts will be included in the Company's taxable income and be subject to the 90% Distribution Requirement.

2. Corporate Income and Excise Tax.

- If the Company satisfies the 90% Distribution Requirement but distributes less than 100% of its taxable income in a taxable year, it will be subject to tax at ordinary corporate income tax rates on its retained taxable income.

- In addition, if the Company fails to distribute during each calendar year at least the sum of (i) 85% of its ordinary income for such year, (ii) 95% of its capital gain income for such year, and (iii) any undistributed taxable income from prior years, the Company will be subject to a 4% nondeductible excise tax on the excess of such required distribution over the amounts actually distributed.

- For purposes of the distribution requirements, distributions with declaration and record dates falling in October, November, or December of a calendar year will be treated as paid on December 31 of that year if such distributions are actually paid during the month of January of the following calendar year.

- In the private company context, consent dividends to common shareholders are often possible via applicable tax elections and filings. In the public company context, the Company can pay cash/stock dividends, subject to certain limitations.

3. Retaining Long-Term Capital Gains. A REIT may elect to retain and pay corporate income tax at a 21% rate on its net long-term capital gain, in which case the Company will be deemed to distribute the gain amount as a capital gain dividend.

- The Company's shareholders, in turn, will receive a credit for the tax paid by the Company on their own tax returns and will be deemed to recontribute the after-tax amount (*i.e.*, 79% of the gain amount) to the Company.

- Any such deemed capital gain dividend will be treated as having been distributed for purposes of the 4% excise tax described in section D.2 above.

- The Company must designate which portion of its distributions (including deemed distributions of retained capital gains) are capital gain dividends in a written notice mailed to its shareholders either by January 30 after the close of the relevant taxable year or with its annual report for the taxable year.

4. C Corporation Earnings & Profits. A REIT may not have any undistributed C corporation earnings and profits at the end of any taxable year.

   - A C corporation converting to a REIT is required to distribute to its stockholders all of its accumulated earnings and profits prior to the end of its first taxable year as a REIT.

   - In an M&A context, and upon the liquidation of a TRS or the conversion of a TRS to a QRS, a REIT must purge any inherited earnings and profits from the acquired C corporation target or the TRS by the end of the calendar year of the acquisition/liquidation/conversion.

5. Practical Considerations.

   - Most REITs distribute 100% of their taxable income annually to eliminate corporate income tax and REIT excise tax.

     - Within prescribed limits, there is some ability under the Code to distribute income in the year after it was earned.

     - A private company's dividend payout strategy will be shaped in part by the following forces: (i) REIT tax law, (ii) investor return hurdles, and (iii) debt covenants that limit dividend payouts.

     - Interval for paying dividends is in the discretion of the Company and is not dictated by the Code.

   - Options and other equity incentives to employees may need to be rethought in light of the dividend-paying context.

   - To the extent a REIT has debt, loan covenants must permit distributions to shareholders.

   - Earnings & Profits

     - A "purging dividend" of all C corporation earnings and profits must be made prior to the end of a company's first taxable year as a REIT.

     - The earnings and profits of C corporation targets must be determined during the M&A diligence process in order to plan for any distributions that will be required upon acquisition.

     - A REIT should not acquire a C corporation in a Code Section 381 transaction or liquidate a TRS between the REIT's last dividend payment for the year and the close of the year.

E. REIT Subsidiaries.

1. Qualified REIT Subsidiaries. For purposes of this primer, a QRS is (i) a corporation that is wholly owned by the Company (or by other QRSs) and for which a TRS election is not made or (ii) a noncorporate entity that for federal income tax purposes is not treated as separate from its REIT under Treasury regulations issued under Section 7701 of the Code.

- Functionally, QRSs are disregarded entities for federal income tax purposes and generally for other federal tax purposes (except employment and specified excise taxes). Accordingly, all of the assets, liabilities, and items of income, deduction, and credit of a QRS are treated for REIT purposes as assets, liabilities, and items of income, deduction, and credit of the Company.

- QRSs are consolidated with the Company for REIT income and asset testing.

2. Taxable REIT Subsidiaries. TRSs are C corporations in which a REIT directly or indirectly owns stock (i) that jointly elect with the REIT to be treated as a TRS, or (ii) of which a TRS of the REIT owns, directly or indirectly, more than 35% of the voting power or value of its outstanding securities.

- A TRS is treated as a separate corporation and is not consolidated with the Company for REIT income and asset testing or other federal income tax purposes. Accordingly, the Company is not deemed to receive its proportionate share of the income of, or to own its proportionate share of the assets of, a TRS of the Company.

- The Company may own up to 100% of the stock of one or more TRSs.

- TRSs are subject to federal corporate income tax on their taxable income; typically, domestic TRSs are organized as a consolidated group filing a single consolidated federal income tax return.

  - For some state tax purposes, a REIT together with one or more of its TRSs may file some form of combined return.

- Dividends paid by a TRS to the Company will be treated as nonqualifying income for purposes of the 75% gross income test but as qualifying income for purposes of the 95% gross income test.

- Rent paid by a TRS to the Company will not generally be qualifying income for purposes of the income tests unless both of the following conditions apply:

  (i) at least 90% of the leased space in the property is leased to persons other than TRSs and other than tenants with whom the Company is 10% or more affiliated (as discussed in Section B.3), and

  (ii) the amounts paid by the TRS to rent space at the property are substantially comparable to rents paid by other tenants of the property for comparable space, measured at the time that the lease is entered into, extended or modified, if the modification increases the rent paid by the TRS.

- Permissible Activities.

  - A TRS may engage in many activities that may not be engaged in directly by the Company and may earn many types of income that would not be qualifying income if earned directly by the Company.

  - For example, a TRS may provide services to the Company's tenants that are not customary in a rental situation (such as technical support or design work) without tainting the Company's rental income.

        - The TRS need not directly or separately contract with a REIT's tenants; instead, the TRS can generally fulfill the service component of any contract between a REIT and its tenants, and then get paid for its services by the REIT, all in a manner that is opaque to the tenants.

    - The TRS must be compensated for any services it provides to the REIT or the REIT's tenants/customers on an arm's-length basis.

    - The TRS rules impose a 100% excise tax on transactions between a TRS and the Company or the Company's tenants that are not priced on an arm's-length basis.

    - If arm's-length pricing is not available, the 100% tax will not apply if the TRS is compensated at least 150% of its costs for providing the service.

- As a TRS accumulates income, it may distribute excess cash as a dividend.

    - As noted above, TRS dividends to the REIT are good income for the 95% gross income test, but not for the 75% gross income test.

- TRS financing considerations:

    - A TRS may have its own debt and borrowings.

        - If the REIT guarantees the TRS debt, this may be acceptable but is not a fully charted area of REIT tax law.

        - If the TRS guarantees the REIT debt, this may be acceptable but is also not a fully charted area of REIT tax law.

            - A TRS may borrow from the REIT.

        - Loans by a REIT to a TRS count against the 25% asset test unless secured by real estate.

        - Normal intercompany transfer pricing metrics are applicable.

        - General interest deductibility limitations are likely applicable to the TRS (e.g., a TRS likely does not enjoy the benefit of an "electing real property trade or business" election made by its REIT parent).

        - A TRS must be able to support its debt load independently, based on typical income and asset coverage metrics.

        - REITs are specifically exempt from the finalized Section 385 regulations.

3. <u>Partnerships.</u> Like QRSs, noncorporate subsidiaries that are classified as partnerships for tax purposes are transparent for REIT income and asset testing purposes. A REIT is deemed to hold its proportionate share of such a noncorporate subsidiary's assets and to earn its proportionate share of the subsidiary's gross income in applying the various REIT income and asset tests.

4. Practical Considerations.

   - Joint ventures should be run in compliance with the REIT tests.

   - If international subsidiaries cannot be TRSs (because, for example, there is no more room under the applicable REIT asset test limitation), then they must be operated in REIT-compliant fashion as QRSs despite generally being taxed by their country of location.

     - QRS conversion of foreign subsidiaries generally requires a major diligence effort.

F. Other Issues.

1. REIT Election. The Company will file a REIT election with its tax return for its first REIT taxable year by computing its income as a REIT on IRS Form 1120-REIT. That return will be required to be filed no later than April 15 (with extensions, typically October 15) of the next calendar year.

2. Prohibited Transactions Tax. The Company will be subject to a 100% tax on its net income from sales or other dispositions of "dealer property" (other than certain foreclosure property).

   - Although dealer property determinations generally are based on facts and circumstances analyses, there is a safe harbor for certain sales of real property.

   - The prohibited transactions tax can be avoided by transferring property that is held for sale and that presents a significant risk of being dealer property to a TRS prior to entering into a contract to sell the property.

   - Gain from the sale of dealer property by a TRS will be subject to corporate income tax, but it will escape the 100% prohibited transactions tax.

3. Records Maintenance. Specific records are required by the REIT rules.

   - The Company must maintain the following records:

     - Records of responses to its shareholder demand letters and a list of persons who fail to comply with its requests for information in the shareholder demand letters.

     - Records sufficient to establish that the Company has complied with the 75% asset test.

   - The Company must submit with its federal income tax return each year:

     - A schedule stating the amount of rent received directly or indirectly from any tenant in which it has an ownership interest. The name and address of the tenant and the Company's percentage ownership of such tenant must be disclosed.

     - A statement disclosing the name and address of each of its "independent contractors" (*i.e.*, any persons who provide services to the tenants of its property) and certain information regarding stock ownership by and of any such independent contractor.

4. Corporate Alternative Minimum Tax. REITs are not subject to the 15% corporate alternative minimum tax generally imposed on corporations, but their TRSs could be subject to this tax.

5. Excise Tax on Public Company Stock Buybacks. REITs are not subject to the 1% excise tax that is imposed on corporations in connection with certain corporate stock buybacks/redemptions.