

U.S. REITs Investing Globally

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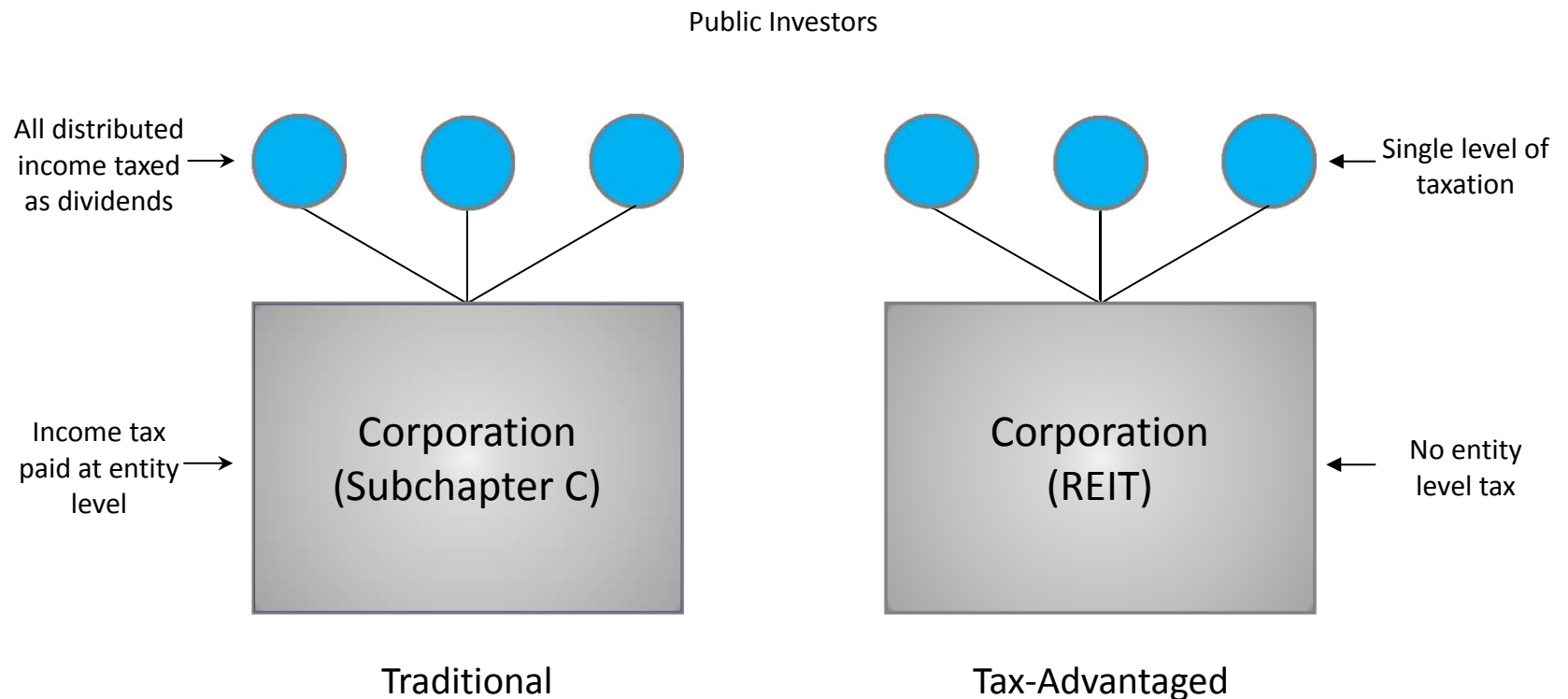
What is a REIT?

- A company that owns and leases real estate and that qualifies for and makes a special tax election
- A REIT is permitted to deduct dividends paid to its shareholders from its corporate taxable income
 - › Most REITs distribute 100% of income and therefore owe no income tax
 - › Taxes are paid by shareholders on the dividends received
 - › Most states honor this federal treatment
- Note difference between qualification as a “REIT” for federal income tax purposes and real estate investment trust as a business form
- Non-tax laws don’t key off of REIT status; REIT status keys off of facts and other laws
- REIT Subsidiaries
 - › Qualified REIT Subsidiary (QRS) — consolidated with REIT for tax purposes
 - › Taxable REIT Subsidiary (TRS) — separate from REIT for tax purposes

Why is a REIT Exempt from Tax?

- A REIT is exempt from entity-level tax as a practical matter, because of the dividends paid deduction and the fact that most REITs distribute 100% of their taxable income
- Designed like a mutual fund: to provide a vehicle for passive investors to acquire a portfolio of real estate
- Lease/license financing and mortgage financing are comparable
- Rental real estate is often considered passive under the Tax Code
 - › Tax exempts such as Harvard, the Red Cross, or the Catholic Church generally pay no taxes on income from rental real estate
 - › But NYU had to pay taxes on its pasta manufacturing business (*see C. F. Mueller Co. v. Commissioner*, 14 T.C. 922 (1950))
- Why does a REIT invest abroad?
 - › Existing REIT seeks global investments
 - › Existing MNC seeks to become a REIT

Public Company Tax Structures

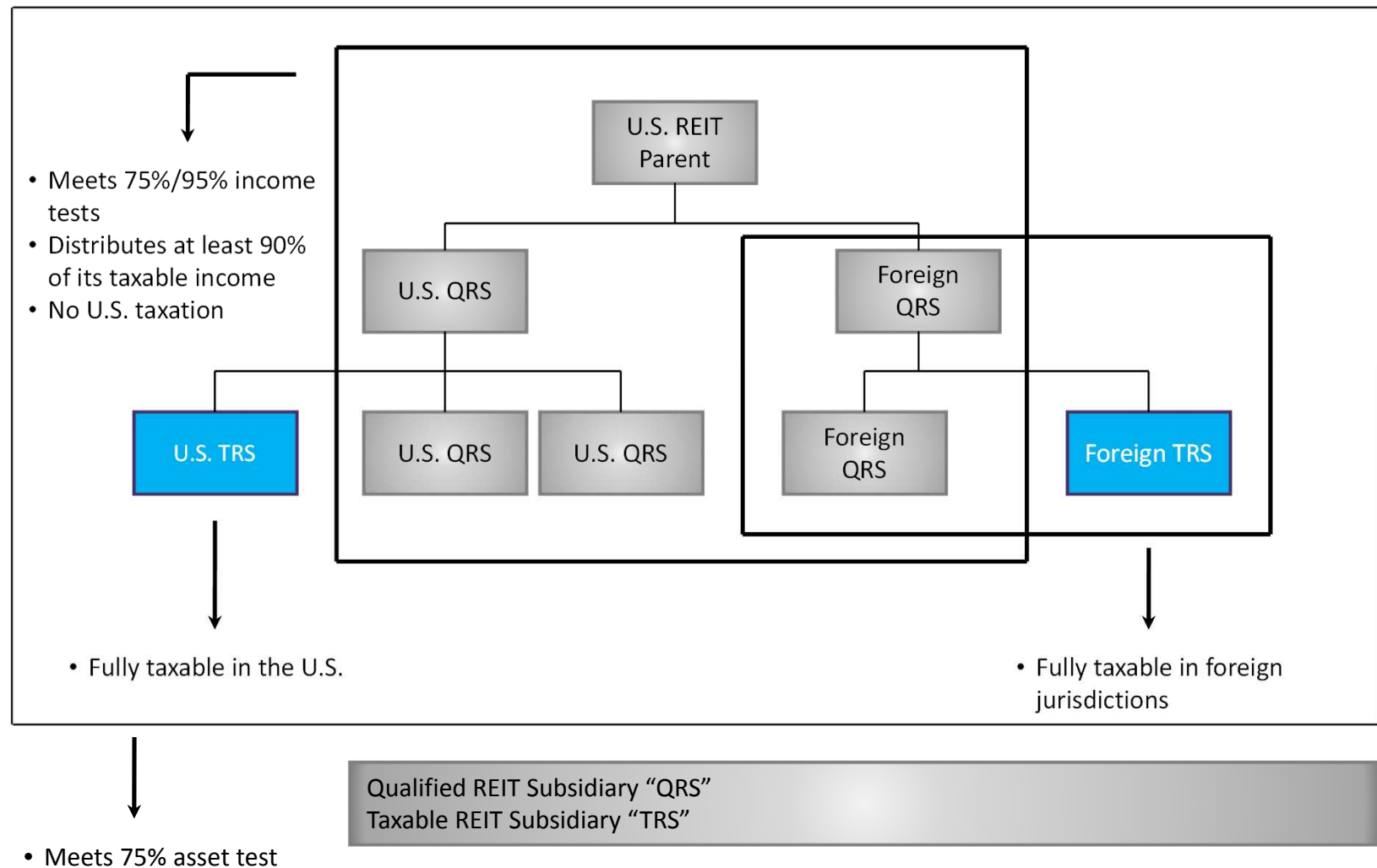


- In both cases, the entity can be a corporation, trust or certain other legal forms
- For “corporate” and certain state tax reasons, REITs (as defined for federal income tax purposes) are commonly organized under Maryland or Delaware law

REIT Subsidiaries

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

REIT Subsidiaries



ORIAD Requirements

- To maintain REIT status, various requirements must be met:
 - › Organization & Capital Structure
 - › Rent
 - › Income
 - › Assets
 - › Distributions

Organization & Capitalization

- No more than 50% of the value of a REIT's outstanding stock may be owned, directly or indirectly, by 5 or fewer individuals
- A REIT must be less than 10% affiliated with its tenants
- Articles of Incorporation and ByLaws
 - › Should provide restrictions on stock ownership to avoid becoming closely held or having affiliated tenants
 - Limit shareholders to owning 9.8% of any class of equity
 - Include an automatic transfer of “excess shares” into a charitable trust
 - › Should include provisions relating to shareholder demand letters so that ownership can be ascertained
- REIT organizational requirements are generally compatible with most dividend reinvestment plans, share repurchase plans, and employee equity incentives

Rent

- Fixed rent and percentage rent based on gross receipts is acceptable, but percentage rent based on cash flow or net income results in “bad” income
- No extraordinary services may be performed by the REIT
 - › REITs are designed to be passive
 - › Certain customary services may be provided by a REIT in connection with a lease
 - › Impermissible tenant services income
 - Limited to 1%, after which all property revenues are tainted
 - › Impermissible services must be provided by an independent contractor or a TRS
- No 10% affiliated tenants
 - › Applicable charter restrictions prevent 10% affiliated tenant
 - › Exception: Rent from a TRS is qualifying if 90% of leased space at the site is leased to third parties
- Personal property limitations
 - › No more than 15% of the value of a lease/license may be for personal property

Income

- At least 75% of a REIT's gross income must be derived from real property
 - › Qualified rents
 - › Other income from real property such as gain from the sale of real property, mortgage interest, or refunds of real property taxes
- At least 95% of a REIT's gross income must generally be passive in nature
 - › Income from real property that satisfies the 75% requirement above
 - › Other interest, dividends, or gains from the sale of stock or other securities
 - › PLR to address Subpart F, PFIC, and similar gross income items
- Thus, only 5% of gross income may come from “bad” sources
 - › Bad rents
 - › Impermissible services
 - › Businesses other than rental real estate
 - › Some hedges
- Income earned in TRSs is not consolidated with the REIT for income testing

Assets

- Testing at the end of each quarter
- At least 75% of a REIT's assets must be related to real property or passive in nature:
 - › Real property
 - Real estate intangibles (but not other intangibles) qualify as real property
 - These assets may need to be “reclassified” for depreciation purposes
 - › Debt secured by real property
 - › Shares of other REITs
 - › Cash and cash items (including short term receivables)
 - › Government securities
 - › Temporary investments in stock or debt instruments attributable to new capital

Assets

- No more than 25% of a REIT's assets can collectively be in TRSs, personal property, and other assets not described above
- “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
 - › Section 357(c) and excess loss account recapture if too much debt and not enough tax basis
- 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
 - › There is no *de minimis* test for the 10% value test—thus, a small security held by a REIT can cause a failure
 - › Diligence is important to uncover any debt or equity of third parties held by a REIT; these securities should be put in a TRS or constantly monitored by the REIT

Distributions

- A REIT must meet certain distribution requirements
 - › 90% distribution requirement
- Most REITs distribute 100% of their taxable income to eliminate corporate income tax
- Because a REIT generally does not pay income taxes on income paid out to shareholders, REITs tend to be less leveraged than other businesses
 - › Capital expansion is achieved through equity and debt offerings
 - › REITs are dividend paying stocks, but can also be growth stocks
- Public and private debt covenants must permit distributions
- Because REIT shares are dividend paying, equity incentives migrate away from options and toward share ownership, such as restricted stock units
- A REIT may not have any undistributed C corporation earnings and profits at the end of any taxable year
- Distributions can be made in a mix of stock/cash in 80/20 proportions

Interactions Between a REIT and a TRS

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

Challenges in Organizing as a QRS

- Foreign cash favorably addressed by Section 856(c)(5)(K) and Rev. Rul. 2012-17
- Section 987 and Section 988 gains
 - › No longer a REIT income testing issue since Section 856(n); however, such gains can involve phantom income that impact REIT distribution requirements/ planning
- Hedging gains
 - › Debt and currency hedges are covered by statute; some asset hedging is achievable
 - › With proper elections, qualified hedges are no longer a REIT income testing issue
 - › PLRs thoughtfully expand the scope of qualified hedges
- Foreign operations must be REIT-compliant in terms of asset and income testing
 - › Commercial and language barriers
 - › Issues with hiving off service employees in a separate TRS (e.g., payroll company)
 - › Local group relief and local tax sharing agreements

Challenges in Organizing as a QRS

- REIT distribution requirement imposed on QRS earnings
 - › Repatriation of profits to the U.S. may encounter headwinds – capital controls, foreign withholding taxes, distributable reserves
 - › It may be desirable instead to fund these distributions from depreciation-sheltered U.S. earnings, or from new capital raises

Opportunities in Organizing as a QRS

- Easier to satisfy 75%/25% REIT asset testing, which is the principal driver to the QRS answer, particularly if foreign assets are growing faster than U.S. assets
- Cross-border capital flows, guarantees, internal/external borrowings – all more transparent for REIT income and asset testing
- U.S. REIT parent is functionally tax-exempt, and planning possibilities often exist to limit foreign tax expense of non-U.S. subsidiaries

Challenges in Organizing as a TRS (e.g., a CFC)

- Qualification issues
 - › Satisfying 75%/25% REIT asset testing, which is the principal challenge
 - › Intercompany loans adequately secured by real estate can help on 75%/25% REIT asset testing
 - › Subpart F income can qualify for the 95% income test -- if based on TRS/CFC's FPHC income or in the case of certain Section 956 inclusions
 - › PFIC income (including QEF inclusions) can qualify for the 95% test -- if majority of TRS's income is FPHC-style passive income
 - › Section 986(c) exchange gains can be excluded from REIT income testing
 - › Commodities / foreign base company services income / insurance income
 - › Guarantee fees for REIT parent guarantee of TRS's debt – *Bank of America vs. Container Corp.* (passive financial transaction vs. service)
 - › Hedging gains
- Achieving conventional deferral
 - › Subpart F's active rental exception
 - › Single vs. multi-tenanted properties

Opportunities in Organizing a TRS

- Deferral REIT-style is not about postponing U.S. taxes, but about postponing the distribution to REIT shareholders
- Non-U.S. activities do not need to be operated in REIT-compliant fashion
- Non-REIT activities may be hived off in a foreign (or domestic) TRS
- Foreign taxes of non-U.S. subsidiaries are managed with conventional structures
- Conversion from TRS to QRS can be achieved with check-the-box election and/or revocation of TRS election
 - › Sections 481(a) and 964(a) depreciation recapture inside the TRS
 - › Section 367(b) dividend income and impact on the 95% income test
 - › Built-in gains tax on property disposed of during the ten-year period following QRS conversion
- Conversion from QRS to TRS is much harder
 - › Sections 351, 362(e)(2), 367(a)(3)(B)(v), 367(a)(3)(C), 367(d), 904(f), and 987; Treasury Regulation Sections 1.367(a)-4T(b), (c)
 - › Bottom line: some or all gain triggered on outbound transfer

Foreign Tax Credit Planning

- As a practical matter, a REIT cannot use foreign tax credits – Rev. Ruls. 72-383 and 87-65; GCM 34871
 - › No need for Sections 78 and 902
 - › Section 338(g) elections are desirable, and Section 901(m) without practical impact
- Nor can the REIT pass through foreign tax credits to shareholders – no Section 853 analog for REITs
- Foreign taxes simply become deductible expenses – Sections 164(a)(3), 275(a)(4), and 901(a)
- Therefore, foreign tax credit planning comes down to minimizing source country taxation
- OECD, “Tax Treaty Issues Related to REITs”, Paragraphs 16 and 43 (30 October 2007)

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