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## **Tax Issues for Real Estate Investment Trusts**

Structuring REIT Investments and Navigating Tax Treatment of REIT Transactions

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WEDNESDAY, JANUARY 23, 2013

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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**Tax Issues for Real  
Estate Investment  
Trusts**

*January, 23 2013*

Micah Bloomfield  
Mayer Greenberg

# The Basic REIT Framework

- Organizational Requirements
  - Principal requirement is broad ownership
- Three Basic Operational Requirements
  - Assets: Must primarily hold real estate assets
  - Income: Must primarily earn passive income from real estate
  - Distribution: Must distribute most of its income to shareholders

## Basic REIT Benefits

- No entity level tax provided organizational and operational requirements are met and all income distributed
- Access to Capital: May be publicly traded
  - Other Master Limited Partnerships and Regulated Investment Companies, the only way to have public status and be free from entity-level tax
- Flexibility: May be any type of U.S. entity
  - Usually organized as corporations or trusts, but may also be LLCs

# Some Overlooked REIT Benefits

- Useful vehicle for many international investors to invest in U.S. real estate while avoiding FIRPTA and branch profits tax
  - Domestically controlled REIT not treated as a U.S. real property holding company under FIRPTA
  - Dividend attributable to sale of U.S. real estate may be subject to branch profits tax
- Pension-held REITs: Provide a 5% cushion for UBTI-sensitive taxpayers
  - UBTI generally more strict than REIT income rules
    - Especially the case on parking
  - Smaller tax-exempt ownership stakes avoid many UBTI issues entirely
- Not necessarily limited to “traditional” real estate businesses
  - Could include energy, storage, communications, retail, casinos

# Organizational Requirements

- Managed by trustees or directors
- Not beneficially owned by five or fewer persons
- Beneficially owned by 100 or more persons
  - Look-through to underlying shareholders for REITs owned by public company
- Have transferable shares or certificates
- Not a bank or insurance company
- Taxable as a U.S. corporation

# Potential Issues & Structuring Opportunities

- Five or fewer provisions as takeover defenses
  - “Excess share” provisions in articles of incorporation generally restrict number of shares of any single shareholder to 9.9% or less
  - Not impenetrable: some REITs still implement shareholder rights plans (“poison pills”)
    - Less case law on excess share provisions
- Finding Shareholders needed to satisfy 100 shareholder requirement
  - Private REITs often engage facilitators to find these investors
  - Often use special class of stock with aggregate liquidation preference of \$100,000 with fixed return in 9-12% range

# Asset Tests

- 75% of value: real estate assets, cash, cash items
  - Rev. Rul. 2012-17 money market accounts are now confirmed as cash items
- No more than 25% of value represented by securities
  - No definition of “securities” in REIT rules
  - RIC rules refer to the SEC Act of 1940 definition
- The value of any one issuer’s securities may not exceed 5% of the REIT’s total assets
  - In absence of REIT definition, reliance on definition of issuer under § 2(a) of the SEC act of 1940
- Ownership of any issuer may not exceed 10%
- No more than 25% of value may be made up of one or more TRS

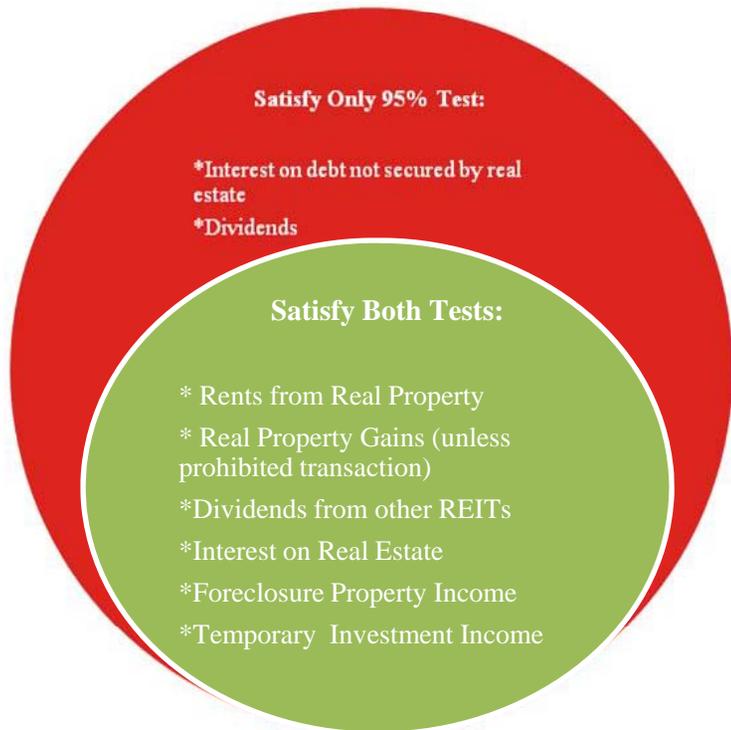
# Special Asset REITs

- Hotel REITs
  - Enabled by TRS related party rent exception
  - Hotel must be managed by independent contractor. § 856(1)(3).
- Healthcare REITs
  - Recent developments in senior care facilities
    - PLR 201104023: “age in place” senior assisted living facility was healthcare facility; qualified for TRS related party rent exception
    - But see PLR 2008130015: certain independent living facilities may not be healthcare facilities
- Timber REITs
  - Sale of timber qualifies as sale of real estate asset
  - The Service has recently blessed income from sale of carbon credits as “good” income
    - PLR 201123005; PLR 20113005

# New Developments in Classifying Real Estate Assets

- Generally more liberal attitude regarding the classification of structures as real estate assets
  - PLR 201204006: signage structures real estate assets due to inherent permanence
  - New ruling in the pipeline regarding solar power generating structures
- Facts and circumstances test distinguishing real property from “assets accessory to the operation of business” under Treas. Reg. 1.856-3(d).
  - Context important: solar structures may qualify if used to generate power for REIT owned property, but not in a commercial production facility
- Uncertain: status of freestanding billboard structures
- PLR 201234006: excess mortgage servicing spreads have been approved as good real estate assets

## Income Tests



- 75% of gross income must be real-estate related
- 95% of gross income must be passive
- QRS income is treated as having been earned directly
- No more than 1% of gross income from a property attributable to impermissible tenant services
  - Based on single property, not entire REIT
- Certain hedging income & most foreign currency gains are excluded from REIT income test calculations

# The Nebulous Boundary Between Impermissible Tenant Services, Ordinary Bad Income, and Good Rent

- To avoid impermissible tenant services income, must be “customary” and not primarily for convenience of tenant
  - § 856(d)(7)(C)(i): specifically lists only maid service as impermissible tenant service
  - Comparatively little guidance exists on services provided in more modern buildings and situations
    - Concierge, technology services, construction management
    - Marketing funds
- Little guidance on what constitutes a “tenant service”
  - PLR 9646027: charges for “courtesy services” not impermissible tenant services income, but bad income
    - Limited to “infrequent, limited, insubstantial” services

# Related Party Rents: Selected Issues

- General exception for TRS: rent paid will qualify if 90% of space leased to persons other than TRS or related parties
  - Special exceptions for lodging and healthcare facilities
  - Calculation is made using leased; not leasable space
- Attribution rules may create unanticipated related party rents for multiple partnerships with overlapping ownership
  - Under § 318 attribution rules, partner deemed to own what its partners owned
  - § 856(d)(5) substantially relaxes rule: provides only 25%+ ownership results in attribution

# Parking Problems

- Rev. Rul. 2004-24 alleviated significant problems, but some issues remain
  - Now clear that income paid parking, both reserved and unreserved generates good income when connected to leased property
  - Nebulous standard for valet: unclear when it may be impermissible services income
    - Requires some safety or capacity justification
- JV with Tax Exempt
  - Tax exempt not covered by Rev. Rul. 2004-24, cannot accept income from paid parking
  - Related Party Rent problem: the tax-exempt can use a taxable affiliate as a JV partner, but the REIT cannot use a TRS
    - Tax exempt related party rent rule requires more than 50%. § 512(b)(13).

# Distribution Requirements

- Undistributed income subject to tax at regular corporate tax rates
- To retain REIT status, REIT must distribute dividends equal to at least the **sum** of:
  - 90% of REIT taxable income
  - 90% of after-tax net income from foreclosure property
  - **Less** excess of the sum of certain items of non-cash income over 5% of REIT taxable income
- 4% additional excise tax if REIT fails to distribute 85% of ordinary income and 95% of capital gain
  - Dividends declared by December, but paid in January are credited to the prior tax year. § 857(b)(9)
- Distribution may not constitute a “preferential dividend”

# Planning for the Distribution Requirements and Fixing Failures

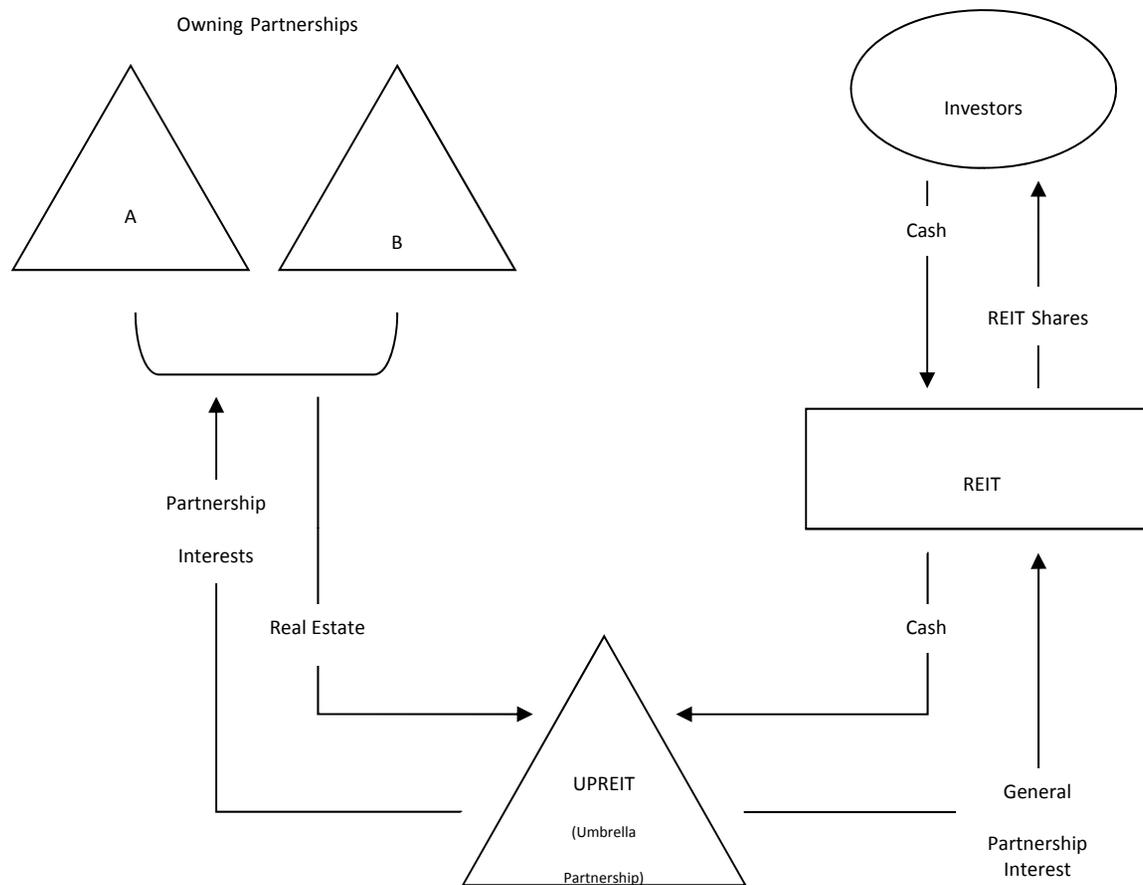
- “Foot Faults” – inadvertent disproportionate distributions could cause loss of REIT status
  - May happen through accidental timing mismatch or miscalculation of the amount due to a shareholder
  - There are various foot fault relief provisions
  - Previously, Rev. Proc. 2010-12 provided some relief
    - Allowed certain non-cash transfers to avoid preferential dividend treatment
      - Only applied to dividends paid prior to the end of 2012
- Disproportionate distributions and conversions: PLR 20127004: exchange of new class of stock for old class based on value over two-year period in preparation for REIT conversion not preferential dividend

# Use of REIT Subsidiaries

- QRS primarily exists to provide limited liability
  - May be useful in M&A context
    - PLR 9512020 (one of two active business acquired in spin off transaction acquired)
    - PLR 9717036 (target qualified as QRS after reverse cash merger)
  - Less useful in light of the availability of UPREIT/DOWENREIT structures and LLCs
- REIT deemed to own proportionate share of partnership or LLC assets
  - Issue: partnership or LLC could undertake an action that would cause REIT to fail income or asset tests
- TRS can generally provide any type of service
  - But see: hotel and healthcare REITs
  - But see: 100% penalty tax for bad TRS fees
    - Factual examination required

# Structuring Considerations

- Use of UPREITs
  - Tax deferral: allows REIT sponsors to avoid tax liability if properties sold for cash or swapped with REIT shares
  - May provide edge for property acquisitions
  - May create conflict between sponsor and shareholders
- Use of DOWNREITs
  - Each acquisition results in formation of new partnership
  - Provides many UPREIT advantages to traditionally structured REITs
  - Eliminates potential conflict of interest present in UPREITs



# The UPREIT Structure

Assets are held through umbrella partnership rather than directly by REIT.

# The Unique Concerns of Pension-Held REITs

- Pension-held REIT if single qualified trust holds 25% of REIT (by value), or qualified trusts (each owning at least 10%) hold more than 50%. § 856(h)(3).
  - Subject to unrelated business transaction income (“UBTI”) rules as well as REIT income rules
    - UBTI rules generally less generous than REIT income test rules
    - Maximum of 5% UBTI
- Non-pension held REIT use may provide alternative to relying on fractions rule under § 514(c)(9)(E)
  - Argument that even pension-held REIT is not a QO, and therefore not subject to fractions rule compliance
- Issue: may be subject to ERISA fiduciary requirements

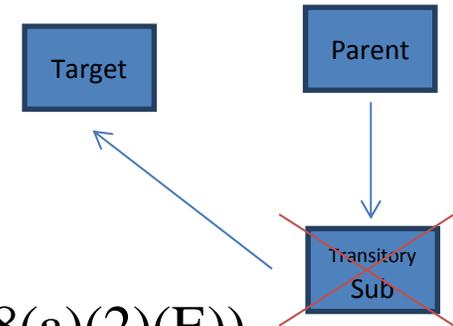
# Selected International Issues

- Receipt of capital gains dividend from a REIT may be taxed as income effectively connected to a U.S. trade or business
  - May subject foreign shareholder to U.S. filing requirement
  - § 897(h) amended in 2004 to treat distribution as ordinary dividends if foreign shareholder has less than 5% interest in a class of stock of a publicly traded REIT
- Sovereign wealth and § 892
  - Notice 2007-55: distribution from a lower-tier to upper-tier REIT subject to FIRPTA
    - Notice states that IRS will challenge assertion that 897(h) does not apply to complete liquidations, or that § 892 exempts a sovereign entity from taxation under FIRPTA
  - Proposed regulations relax and clarify rules
    - Interest in a REIT will be subject to tax, but will not cause sovereign wealth fund to be deemed to engage in “commercial activity” and lose tax status

# REIT Mergers and Acquisitions

- The tax-free reorganizations provisions under § 368 generally apply to REITs along with ordinary C-corporations
  - REIT merger into non-REIT investment company will not qualify for tax free treatment unless meets definition of “diversified investment company”
    - § 368(a)(2)(F)
- Most common forms
  - Merger of target into acquirer
  - Merger of target into wholly-owned subsidiary
  - Merger of subsidiary of acquirer into target

# Selected Merger Issues



- Availability of the reverse triangular merger (§ 368(a)(2)(E))
  - Ex 5 of Treas. Reg. 1.368-2(b) interpreted as limiting reverse triangular merger if both target and acquiring are REITs
  - Concern: reverse triangular could be used as divisive “A” reorganization with the supposed possibility of earnings and profits bailout
    - NAREIT comment: No actual danger- earnings and profits would need to be distributed in the transaction. To the extent danger exists, same issues apply to forward triangular.
- Merger of two UPREITs: consolidation of assets into single operating partnership
  - Drop down of assets was thought to cause remote continuity of interest problem
  - No longer creates issue due to revised remote continuity of interest regulations. *See* Treas. Reg. 1.368-1(d)(4)(iii); Rev. Rul. 2002-85 (as applied to D reorganizations)

# REIT Conversions

- Several public companies not operating traditional real estate businesses have recently announced REIT conversions
  - Dillard’s Department Stores
  - Iron Mountain (document storage)
  - American Tower (communications)
  - Lamar Advertising (outdoor signage)
- Two potential types of candidates:
  - Non-real estate businesses that can spin off real estate
    - More viable if little accumulated earnings and profits or built-in gain
  - Non-traditional real estate business that may be able to satisfy the REIT income and asset tests
    - Iron Mountain, Lamar Advertising



# Pros and Cons of REIT Conversions

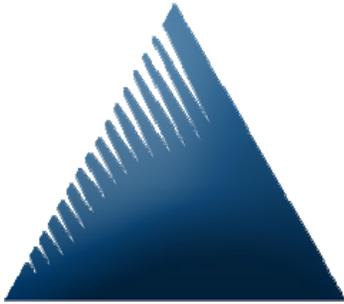
## Pros:

- Potential for substantial entity-level tax savings
- Markets have reacted favorably to conversion announcements
- Potential management advantages from splitting real-estate and operational aspects of businesses

## Cons:

- Conversion requiring spinoff may not qualify for tax-free treatment under § 355
  - Holding of real estate for own use generally will not fulfill “active business” requirement
  - May be possible to satisfy if other services are being provided
    - See Rev. Rul. 2001-29
- May cause business to forgo revenue to maintain REIT status
- Compliance and legal costs may be high

## Case Study: Can Iron Mountain Satisfy the Income Test?



- The company operates differently from a traditional storage REITs
  - Significant additional services: shipping, document destruction, electronic records, escrow, consulting
- May need to rely heavily on TRS
  - 25% TRS value limitation may become an issue
  - May reduce TRS valuation through adding debt to its TRS
    - Debt from REIT parent may suffice

# Some Fixes for Common Problems

- Failure of 100 shareholder test
  - Note: does not need to be satisfied in first year of operation
  - If failed in subsequent years, can avoid loss of REIT status with \$50,000 penalty and reasonable cause
- Failure of distribution requirement
  - May be able to make a deficiency dividend
  - Rev. Proc. 2012-12 relief no longer available as of beginning of this year
- Failure of 75% asset test
  - Pitfall only triggered if failure is caused by acquisition and is not cured within 30 days of end of quarter
- Failure of 95% or 75% income tests
  - Reasonable cause exception can be claimed on line 2f of schedule J of the REIT's return

# Changes on the Horizon

- Elimination of preferential dividend rule for publicly traded REITs.
  - Has appeared in the President's budget in recent years
  - Would bring treatment of preferential dividends in line with the RIC rules
  - Political Argument: preferential dividend rule is redundant to SEC and blue sky laws protecting shareholders
- Repeal of Notice 2007-55
  - NAREIT has requested addition to the IRS's priority guidance plan

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