Lending to REITs

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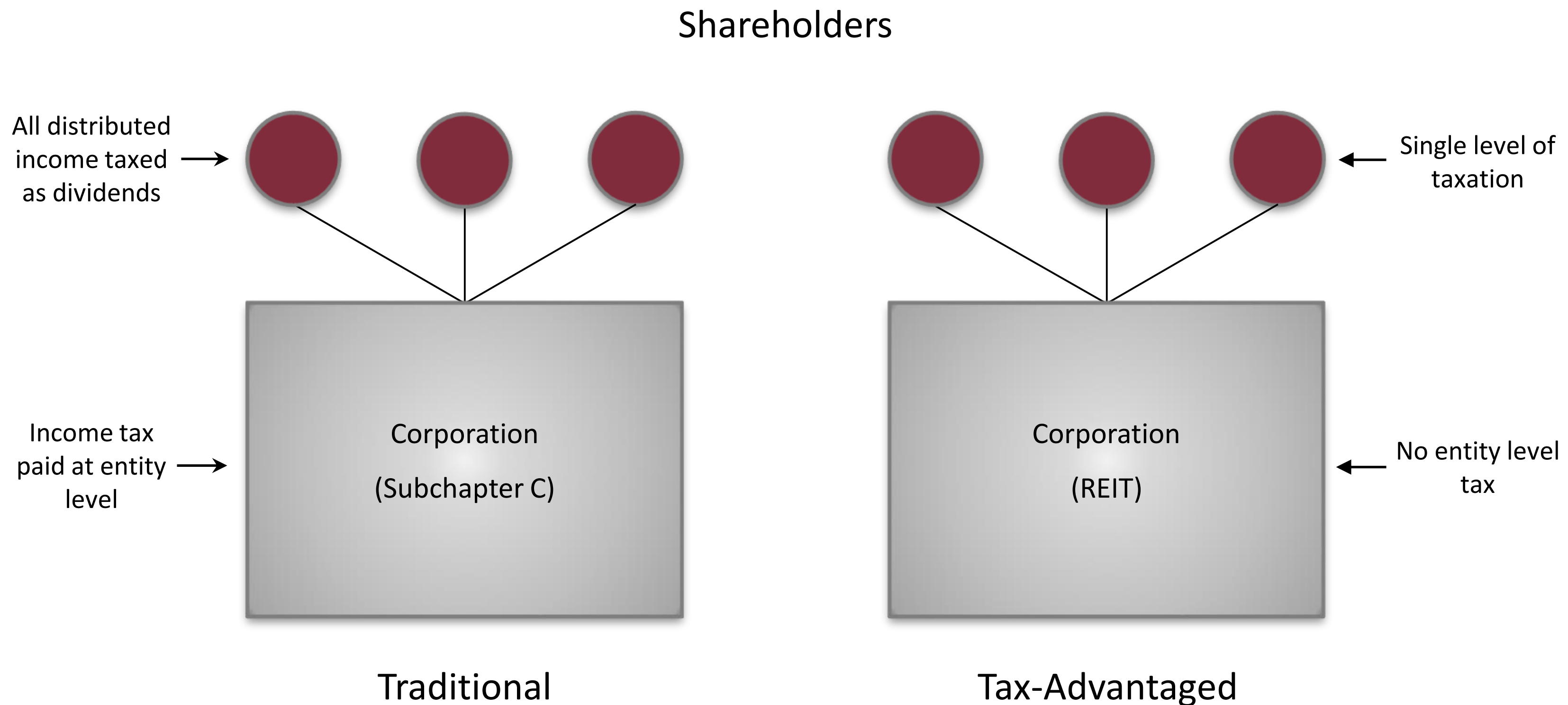
REIT Tax Structure



- In both cases, the entity can be a corporation, LLC, trust or certain other legal forms
- A REIT benefits from a dividends paid deduction, which typically zeros out taxable income

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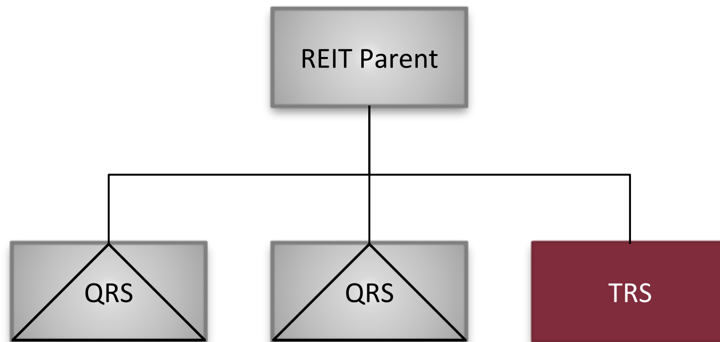
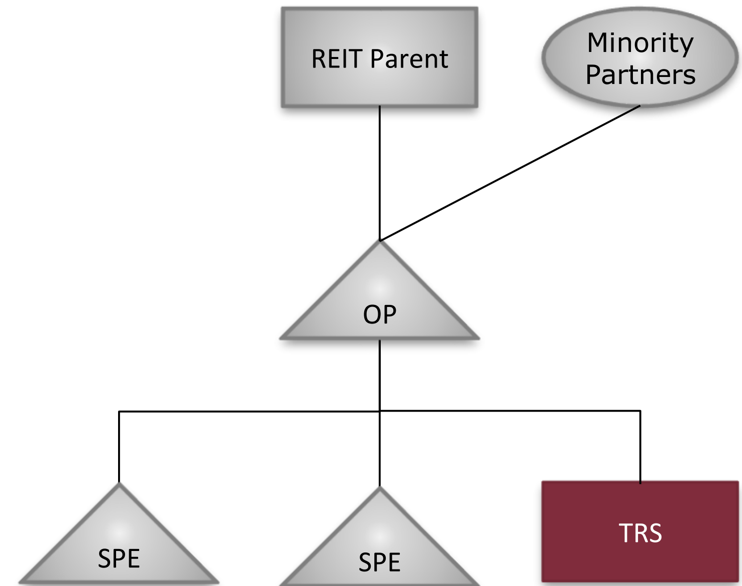
Traditional REITs vs UPREITs

Traditional



UPREIT



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Lending to a REIT

- REIT status is a creation of tax law, and general state law corporate and business statutes continue to apply
  - From creditor's rights perspective, there are generally no material differences between lending to an entity taxed as a REIT versus lending to any other legal entity
  - REIT organizational structures in line with structures of other business entities
- General risk management and "know your customer" policies should be followed
- REIT diligence must be performed and adequate representations and warranties must be obtained
  - REIT organizational documents should be reviewed, as well as materials evidencing REIT income and asset testing
  - Care must be taken to ensure that REIT has no outstanding tax liability
- A loan to a RIET is a real estate credit

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Lending to a REIT

- Special economic concerns relating to lending to a REIT
  - Distribution requirements
  - Recharacterization of debt as equity
    - Where debt arrangements contain nonstandard provisions that provide the lender material participation in the upside of the enterprise of the debtor, the IRS is empowered to recharacterize such debt as equity for tax purposes
    - REIT-specific consequences:
      - Can create affiliated tenant and preferential dividend concerns
      - Strain the closely-held test in the case of a highly leveraged REIT
- A failure to meet the REIT qualification tests, whether prior to entering into the loan or after, can lead to costly remediation (including payment of applicable income or excise taxes) or REIT disqualification
  - Costs could materially impact the ability of the REIT to satisfy its obligations under the lending arrangement

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Diversification

- REITs are designed like a mutual fund: provides a vehicle for passive investors to acquire a portfolio of real estate
- Geographic concentration: Lending to multiple REITs, each of which appears to be geographically diverse may not yield a diverse portfolio for the lender if each REIT is in similar areas
- Sector concentration: REITs tend to specialize in a specific type of property
- Loss of an anchor tenant can trigger
  - Co-tenancy and/or sales-based kick-out provisions in leases
  - Cascading failures
- Percentage rent
  - Income received by a REIT does not qualify as rents from real property if it is based on the income or profits from any person
  - Rents based on a fixed percentage of receipts or sales are not excluded
- Expansion into non-core businesses?

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Potential Limitations on Liquidity

- Distributions of REIT taxable income
  - In order to maintain qualification for taxation as a REIT, a REIT must meet distribution requirements
    - 90% distribution of taxable income is required to be a REIT
    - 100% distribution of taxable income is needed to be tax-efficient
  - The distribution requirement makes it difficult for a REIT to retain capital
    - Upcoming maturities generally refinanced or satisfied with an infusion of equity
- Prohibited transactions
  - 100% tax on net income from sales or other dispositions of “dealer property”
- Tax protection agreements may restrict a REIT’s ability to dispose of a property

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Security

- REITs have secured and unsecured debt
  - Distribution requirement leads many REITs to have a large, unsecured facility for acquisitions and to bridge funding needs
- Assets
  - Unsecured facility will typically contain a negative pledge ensuring the unencumbered pool of assets will not be pledged to secure other debt
- Equity
  - Affiliated tenant rents do not qualify as rents from real property for a REIT's income testing
  - Closely-held rules
    - 5 or fewer rule
    - 100 shareholder requirement

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Ratings and Capital Charges

- Access to capital markets is key to REIT growth and survival
- Reduction in credit ratings could affect access to cash under revolving facilities, higher interest rates
- Because income is distributed and a REIT does not pay taxes, REITs tend to be less leveraged than other businesses

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