Real Estate Investment Trusts:

What is a REIT and Lending Considerations

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Agenda

• Game:	What is a REIT?
• Object:	Why are REITs Utilized?
• Rules:	ORIAD Requirements
• Pieces:	REIT Subsidiaries
• Gameplay:	Lending to a REIT

What is a REIT?

- A company that owns or finances investment real estate and that qualifies for and makes a special tax election
- 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 income and therefore owe no income tax
  - Taxes are paid by shareholders on the dividends received
  - Most states conform to this federal treatment
- Note difference between qualification as a "REIT" for federal income tax purposes and 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

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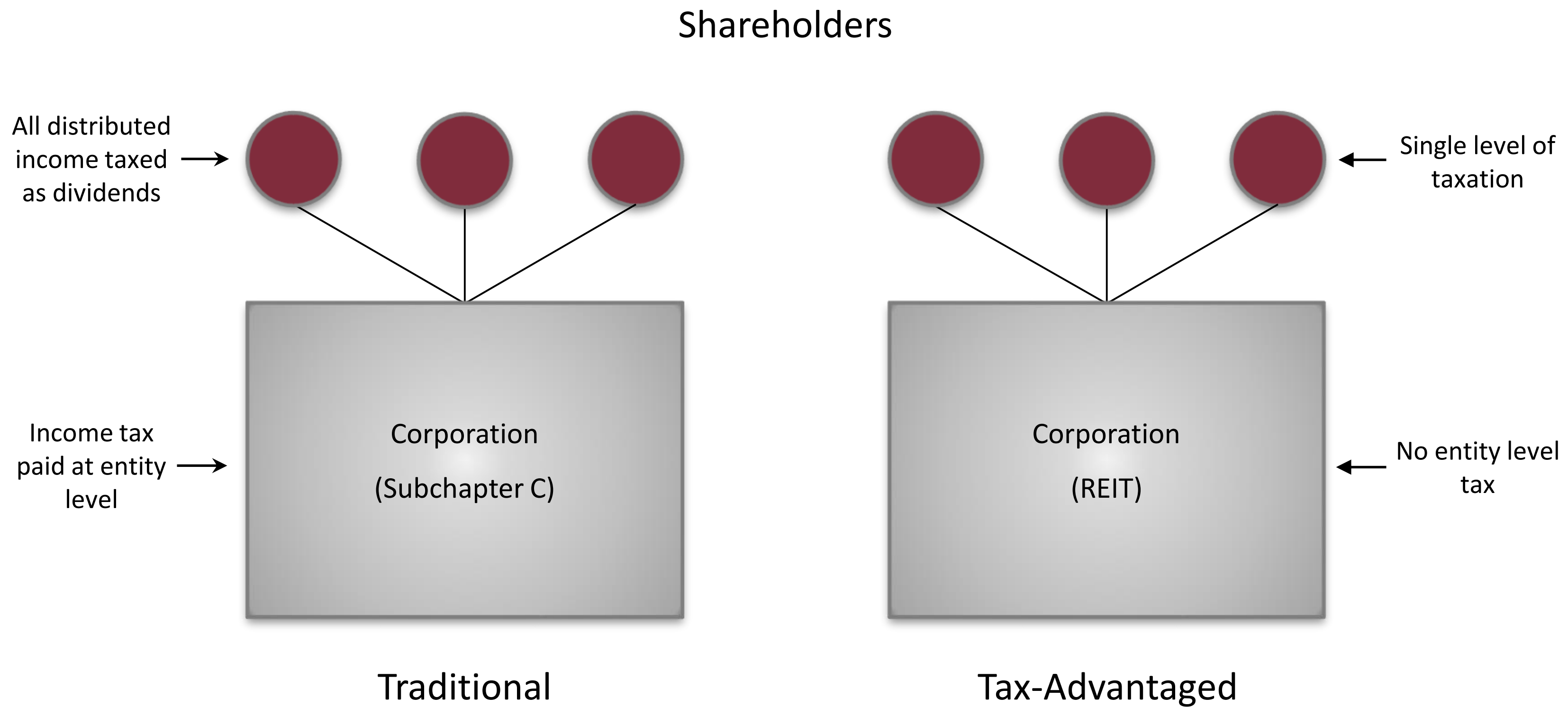
REIT Tax Structure



- In both cases, the entity can be a corporation, trust or certain other legal forms

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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
- REITs issue Forms 1099 to shareholders instead of Forms K-1
  - Generally results in no state income tax filing requirement for a shareholder; contrast to ownership of entities taxed as partnerships where partners may have to file multiple state income tax returns
- 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

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Why are REITs Utilized?

- REITs are attractive vehicles through which non-U.S. persons can invest in U.S. real estate
- As a regarded taxable entity, a REIT serves as a blocker for non-U.S. persons
  - A non-U.S. shareholder will generally not be treated as engaged in a U.S. trade or business as a result of its investment in a REIT
- No U.S. tax returns generally required for non-U.S. persons
  - Dividends paid by REITs are generally subject to the U.S. withholding rules applicable to non-qualified dividends paid by any U.S. corporation (rate is generally 30%, but often reduced by treaty)
  - If not "domestically controlled," distributions attributable to the disposition of underlying U.S. real estate may be subject to additional tax under the FIRPTA regime and obligate non-U.S. persons to file U.S. income tax returns

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ORIAD Requirements

- To maintain REIT status, various requirements must be met:
  - **O**rganization & Capital Structure
  - **R**ent
  - **I**ncome
  - **A**ssets
  - **D**istributions of Income

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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
- Various recordkeeping is required for asset tests, shareholder demand letters, related tenants, and independent contractors

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Rent

- Fixed rent and percentage rent based on gross receipts is “good” income, 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
  - 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

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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
- Thus, only 5% of gross income may come from "bad" sources
  - Bad rents
  - Impermissible services
  - Businesses other than rental real estate
- Income earned in TRSs is not consolidated with the REIT for income testing

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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
  - 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
- No more than 25% of a REIT's assets can collectively be in TRSs, personal property, and other assets not described above
- 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

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Distributions of Income

- A REIT must meet certain distribution requirements
  - 90% distribution requirement
  - 4% nondeductible excise tax to the extent total distributions are less than the sum of:
    - 85% of REIT ordinary income;
    - 95% of REIT capital gain net income; and
    - any undistributed taxable income from prior periods
  - Distributions must be in strict accordance with organizational and other operative documents
- Practical Considerations:
  - Most REITs distribute 100% of their taxable income to eliminate corporate income tax on retained income

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REIT Subsidiaries

- Partnerships, Qualified REIT Subsidiaries (QRSs), and Disregarded Entities
- Taxable REIT Subsidiaries (TRSs)
  - 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

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Subsidiaries: 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

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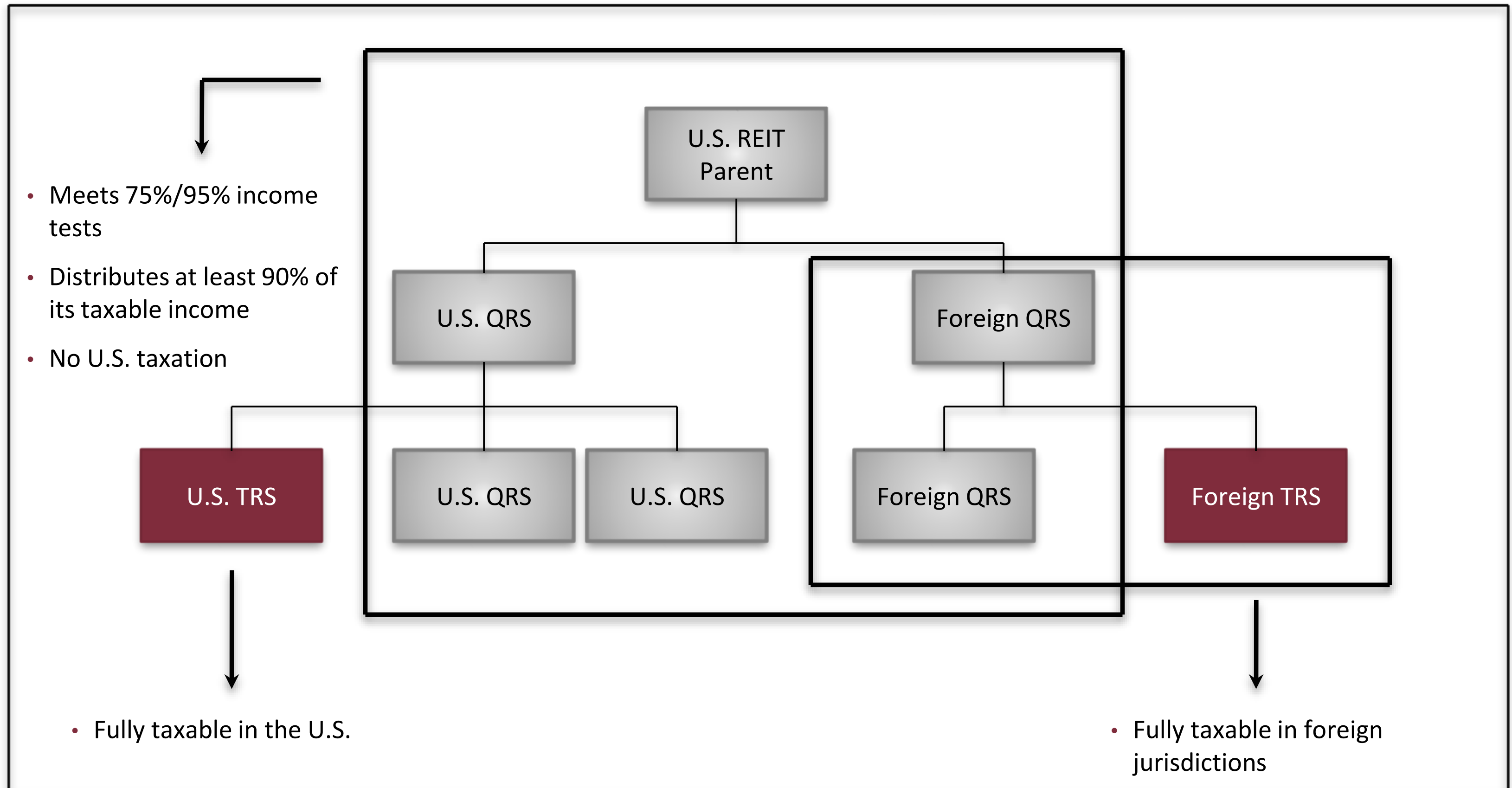
Subsidiaries: Global Org Chart



- Meets 75% asset test

Qualified REIT Subsidiary “QRS”

Taxable REIT Subsidiary “TRS”

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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 a non-tax vantage point, there are no discernible 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

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Lending to a REIT

- Special concerns relating to lending to a REIT
  - REITs must maintain flexibility to meet 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 consequecnes:
      - 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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