

FREQUENTLY ASKED QUESTIONS ABOUT REAL ESTATE INVESTMENT TRUSTS

REIT Basics

What is a REIT?

The term REIT refers to a “real estate investment trust” as set forth in subchapter M of chapter 1 of the Internal Revenue Code of 1986 (the “Code”). An entity that qualifies as a REIT under the Code is entitled to preferential tax treatment. It is a “pass-through” entity that can avoid most entity-level federal tax by complying with detailed restrictions on its ownership structure, distributions and operations. REIT shareholders are taxed on dividends received from a REIT. See “Tax Matters” below for more detail.

When and why were REITs created?

Congress passed the original REIT legislation in 1960 in order to provide a tax-preferred method by which average investors could invest in a professionally managed portfolio of real estate assets. Many of the limitations imposed upon the operation of REITs and the taxes to which they are potentially subject are perhaps best understood in terms of the original notion that the activities of REITs were to consist predominantly of passive investments in real estate.

What are the required elements for forming a REIT?

In order to qualify for the tax benefits available to a REIT under the Code, the qualifying entity must:

- have centralized management (Code Section 856(a)(1));
- have transferable shares (Code Section 856(a)(2));
- be a domestic corporation for federal tax purposes (Code Section 856(a)(3));
- not be a financial institution or insurance company (Code Section 856(a)(4));
- have shares beneficially owned by at least 100 persons (Code Section 856(a)(5));
- not be “closely held” (Code Section 856(a)(6));
- satisfy annual income and assets tests (Code Section 856(a)(7));
- satisfy distribution and earnings and profits requirements (Code Section 857(a), Code Sections 561 through 565);
- make a REIT election (Code Section 856(c)(1)); and
- have a calendar year tax year (Code Section 859).

What are the required elements for maintaining REIT status?

An entity that wishes to maintain its status as a REIT must satisfy the requirements described under “*What are the required elements for forming a REIT?*” for each year in which it wishes to so qualify, subject to the following exceptions:

- The entity must satisfy the 100 or more beneficial owner test only on at least 335 days of a taxable year of 12 months in which it wishes to qualify as a REIT, or during a proportionate part of a taxable year of less than 12 months.
- The requirements that a REIT have at least 100 beneficial owners and that it not be “closely held” do not apply to the first taxable year for which a REIT election is made.
- The requirement that a REIT not be closely held must be met only for the last half of each taxable year.

What types of REITs are there?

Most broadly, there are equity REITs that own primarily interests in real property and mortgage REITs that own primarily loans secured by interests in real property. Equity REITs typically lease their properties to end users and may concentrate on a market segment, such as office, retail, commercial or industrial properties, high end or middle market segments or a specific industry segment such as healthcare or malls or lodging. Mortgage REITs may also have a focus on particular types of loans (first mortgages, distressed property mortgages, mezzanine financings) or borrowers. Hybrid REITs are relatively rare and own a

combination of equity and mortgage interests in real property.

In recent years, the IRS has approved REIT status for businesses not traditionally associated with the REIT structure, such as billboards, data centers, cell tower companies and private correctional facilities.

Is an equity REIT a commodity pool?

According to a 2012 interpretative letter from the U.S. Commodity Futures Trading Commission (the “CFTC”),¹ an equity REIT is not a commodity pool and, therefore, is not subject to the Commodity Exchange Act if the equity REIT meets the following conditions:

- the primary income of the REIT comes from the ownership and management of real estate and it only uses derivatives for mitigating exposure to interest rate or currency risk;
- the REIT complies with all the requirements of a REIT election under the Code, including the 95% and the 75% income test (Code Sections 856(c)(2) and 856(c)(3)); and
- the REIT has identified itself as an equity REIT in Item G of its last U.S. income tax return or, if it has not filed its first tax return, it has expressed its intention to do so to its participants and effectuates such intention.

Is a mortgage REIT a commodity pool?

According to a 2012 interpretative letter from the “CFTC”),² while a mortgage REIT is considered a commodity pool, the Division of Swap Dealer and

¹ CFTC Letter No. 12-13, *see* <http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-13.pdf>.

² CFTC Letter No. 12-44, *see* <http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-44.pdf>.

Intermediary Oversight will not recommend that the CFTC take enforcement action against the operator of a mortgage REIT that satisfies the following criteria:

- limits the initial margin and premiums required to establish its commodity interest positions to no more than 5% of the fair market value of the REIT's total assets;
- limits the net income derived annually from its commodity interest positions that are not qualifying hedging transactions to less than 5% of the REIT's gross income;
- interests in the REIT are not marketed to the public as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity futures, commodity options, or swaps markets; and
- the company either has identified itself as a "mortgage REIT" in Item G of its last U.S. income tax return or has not yet filed its first U.S. income tax return but has disclosed to its shareholders that it intends to so identify itself.

This no-action relief is not self-executing, and the mortgage REIT must file a claim to perfect the use of the relief. Any such claim will be effective upon filing, so long as the claim is materially complete.

Do other countries have REITs?

A number of countries, including Australia, Brazil, Bulgaria, Canada, Finland, France, Germany, Ghana, Hong Kong, India, Japan, Malaysia, Mexico, Nigeria, Pakistan, Philippines, Saudi Arabia, Singapore and the United Kingdom have REIT-type legislation. The details of the rules may vary from the U.S. rules and from country to country.

Structuring a REIT

How is a REIT formed?

A REIT is formed by organizing an entity under the laws of one of the 50 states or the District of Columbia as an entity taxable as a corporation for federal income tax purposes, and by electing to be treated as a REIT. An entity may elect to be treated as a REIT for any taxable year by filing with its tax return for that year an election to be a REIT. The election generally remains in effect until terminated or revoked under Code Section 856(g). The election is made by the entity by computing taxable income as a REIT in its return for the first taxable year for which it desires the election to apply (generally on Form 1120-REIT), even though it may have otherwise qualified as a REIT for a prior year. No other method of making such election is permitted. See Treasury Regulations Section 1.856-2(b).

What types of entities can be REITs?

Any entity that would be treated as a domestic corporation for federal income tax purposes but for the REIT election may qualify for treatment as a REIT. Under the REIT regulations, the determination of whether an unincorporated organization would be taxable as a domestic corporation in the absence of the REIT election is made in accordance with the provisions of Code Section 7701(a)(3) and (4) and the regulations thereunder. The net effect of these rules is that an entity formed as a trust, partnership, limited liability company or corporation can be a REIT. Publicly traded REITs are typically corporations or business trusts.

Where are REITs typically formed?

Most publicly traded REITs are formed as trusts under the Maryland REIT law or as corporations under Maryland law. Many, if not most, non-REIT public companies prefer to be incorporated or formed under Delaware law because of its well-developed corporate law and a judicial system designed to be responsive to corporate law issues. However, Maryland has a specific statute for REIT trusts and has developed an expertise in such law. Unlike the relevant Delaware law, the Maryland REIT law provides that a REIT may issue shares of beneficial interest without consideration for the purpose of qualifying it as a REIT under the Code, and unless prohibited in the declaration of trust, a majority of the entire board of trustees, without action by the shareholders, may amend the declaration of trust. According to the National Association of Real Estate Investment Trusts ("NAREIT"), about 75% of publicly traded REITs are formed under Maryland law.

What are the ownership and holder requirements for REITs?

In order to qualify as a REIT, an entity must be beneficially owned by 100 or more persons and must not be "closely held." A REIT is deemed to be closely held if, at any time during the last half of the taxable year, more than 50% in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals (Code Section 856(h)(1)(A)).

For purposes of the REIT closely held rule, an organization described in Code Section 401(a), 501(c)(17) or 509(a), or the portion of a trust set aside for charitable purposes described in Code Section 642(c), is normally treated as a single individual (Code Section 542(a)(2)). However, a special look-through rule applies

to "qualified trusts" (generally, tax-exempt pensions or profit sharing plans and technically, trusts described in Code Section 401(a) and exempt under Code Section 501(a)), so that the stock held by the qualified trust is treated as held directly by its beneficiaries in proportion to their actuarial interests (Code Section 856(h)(3)). This look-through rule does not apply if certain disqualified persons with respect to the qualified trust own 5% or more (by value) of the REIT and the REIT has accumulated earnings and profits from a corporation tax year.

Do REITs limit share ownership?

To qualify as a REIT, an entity must not be "closely held," meaning, at any time during the last half of the taxable year, more than 50% in value of its outstanding stock cannot be owned, directly or indirectly, by or for five or less individuals. Although not legally required, all REITs, including publicly traded REITs, typically adopt ownership and transfer restrictions in their articles of incorporation or other organizational documents that provide that no person shall beneficially or constructively own more than 9.8% or 9.9% in value of the outstanding shares of the entity and any attempted transfer of shares that may result in a violation of this ownership limit will be null and void. Larger holders, typically sponsors or founders of a REIT, who own more than 9.9%, are usually "grandfathered," and there may be a related decrease in the ownership threshold. This provision can also be seen as an anti-takeover device for publicly traded REITs.

How can a REIT be structured?

REITs can be structured as umbrella partnership REITs ("UPREITs"), DownREITs, paired-share REITs or

stapled REITs, and paper clip REITs. REITs may be formed for a finite life or in perpetuity.

What is an UPREIT?

The term “UPREIT,” an abbreviation of “umbrella partnership real estate investment trust,” describes a particular structure through which a REIT can hold its assets. UPREITs are the most common operating structure for publicly traded equity REITs. In a typical UPREIT structure, the REIT holds substantially all of its assets through one operating partnership (“OP”). The REIT typically owns a majority of the OP, but the OP ordinarily has minority limited partners (“OP Unit Holders”) as well. The UPREIT structure can be set up either in an original REIT formation, or in connection with the acquisition of a particular portfolio of properties. For example, holders of a real estate portfolio that want to form a REIT can contribute their assets to the OP in exchange for OP Units at the same time that a newly formed REIT contributes cash, raised from issuance of its stock to the public, in exchange for interests in the OP. Alternatively, a pre-existing REIT can contribute its assets to a new OP in exchange for interests in the OP at the same time that property owners contribute their properties to the OP in exchange for OP Units. Once the UPREIT structure is in place, the REIT can acquire additional portfolios of assets by having the OP acquire the assets in exchange for an issuance of OP Units.

In the typical OP Unit structure, after an initial holding period, the Holders’ OP Units are redeemable for cash or, at the option of the REIT, shares of the REIT, typically on a 1:1 basis. The customary justification for this is that the OP Units and the REIT shares represent essentially identical percentage rights to an essentially

identical pool of assets. That is, on an as-converted basis, the number of units of interest in the OP and the number of REIT shares are essentially equal.³

What are the benefits and drawbacks of UPREITs?

The principal benefit of the UPREIT structure is that it enhances a REIT’s ability to acquire properties by allowing non-corporate holders of low tax-basis real estate to participate in property/OP Unit exchanges on a tax-deferred basis. That is, a transfer of real property (or interests in a partnership owning real property) to an OP solely in exchange for OP Units may qualify as a tax-deferred transaction under Code Section 721. In contrast, a transfer of real properties directly to the REIT in exchange for REIT shares would ordinarily be fully taxable. The IRS has recognized the validity of the tax deferral for a properly designed UPREIT structure.

In addition, the OP Units received in the exchange offer two liquidity advantages over the original direct ownership of the real estate. First, because of the redemption feature, a fair market value can be established for the Holder’s OP Units, which can then be borrowed against without being subject to immediate taxation. Second, the redemption feature itself provides liquidity. Upon redemption, the holder may sell publicly traded REIT shares⁴ or receive cash of equivalent fair market value in redemption of the

³ For example, assume that the OP holds assets worth \$100 and has 100 units outstanding, 60 of which are held by the REIT as general partner and 40 of which are held by 40 minority limited partners each holding one OP Unit. The REIT would have 60 shares outstanding and each of the 40 minority limited partners would have the right to convert his one OP Unit for one share of the REIT. Thus, if all conversion rights were exercised, there would be 100 REIT shares outstanding and 100 units of interest in the OP outstanding, all held by the REIT.

⁴ In accordance with a no-action letter issued by the Securities and Exchange Commission in March 2016, the holding period for purposes of Rule 144(d)(1) commences upon the acquisition of the OP Units and not the publicly traded REIT shares.

Holder's OP Units. Note, however, that exercise of the redemption feature is a fully taxable transaction. Accordingly, the OP Unit Holder will typically not elect to redeem unless the Holder plans a prompt sale of the REIT shares. Holders who are individuals may find it desirable to retain the OP Units until death, in which case the Holder's OP Units will receive a fair market value "stepped-up" tax basis, allowing the individual's estate or beneficiaries to redeem or convert the OP Units on a tax-free basis at such time.

Despite the benefits described above, UPREIT structures have some drawbacks. UPREIT structures introduce a level of complexity that would not otherwise exist within a normal REIT structure. Additionally, the disposition of property by an UPREIT may result in a conflict of interest with the contributing partner because any disposition of that property could result in gain recognition for that partner. As a result, contributing partners often negotiate mandatory holding periods and other provisions to protect the tax deferral benefits they expect to receive through contribution of appreciated property to an UPREIT.

What is a DownREIT?

DownREITs are similar to UPREITs, in that both structures enable holders of real property to contribute that property to a partnership controlled by the REIT on a tax-deferred basis. The primary difference between the two structures is that DownREITs typically hold their assets through multiple operating partnerships (each of which may hold only one property), whereas UPREITs typically hold all of their assets through only one operating partnership. The DownREIT structure enables existing REITs to compete with UPREITs by

allowing them to offer potential sellers a way to dispose of real estate properties on a tax-deferred basis.

As with an UPREIT structure, in a DownREIT, limited partnership interests in the operating company are redeemable for cash for REIT shares based upon the fair market value of the REIT shares, or for REIT shares. As distinguished from an UPREIT, however, for a DownREIT, the value of each operating partnership is not directly related to the value of the REIT shares, because the value of REIT shares is determined by reference to all of the REIT's assets rather than by reference to the assets of only one operating partnership (as in the case of an UPREIT). As a result, there is no necessary correlation between the value of each operating partnership's assets and the value of the REIT shares, which adversely affects the liquidity of the operating partnership's interests. However, as a practical matter, almost all DownREIT agreements tie the redemption to a 1:1 ratio. Such a structure raises additional issues regarding the tax free nature of a contribution by a property seller to a DownREIT operating partnership.

What is a paired-share REIT or stapled REIT?

A paired-share REIT, or stapled REIT, is a structure in which a REIT owns real properties and an affiliate operates these real properties. Although the REIT will receive pass-through tax benefits, the affiliate will be taxed separately as a C corporation. The shares of the REIT and its affiliate are combined and traded as a unit in equal allotments under one ticker symbol. This structure successfully resolved the problem of lack of control over real properties owned by a REIT. However, in the Deficit Reduction Act of 1984, Congress added Section 269B(a)(3) to the Code, which provides

that all income of a stapled REIT, including its affiliate's income, is included in the REIT's income for purpose of determining its qualification as a REIT, if more than 50 percent of the ownership if the REIT and the affiliate are traded as a unit. A stapled REIT can still qualify as a REIT under the Code after 1984 if the income generated by its subsidiary does not exceed 5% of its gross income, including its operating subsidiary's income, and it meets other conditions under the Code. In addition, there is a "grandfather" clause in the Deficit Reduction Act, which allowed existing stapled REITs to unwind without time limit. In November 2013, a semi-paired share REIT completed its IPO based on the idea that less than 50 percent of the interests of the REIT were traded as a unit with its affiliate corporation.

What is a paper-clip REIT?

Paper-clip REITs were developed to address the issue presented in Section 269B(a)(3) of the Code. A paper-clip REIT does not own an operating subsidiary. Rather, the REIT has an intercompany agreement with an operating company, which allows each entity to participate in certain transactions and investments of the other entity. For example, the operating company has the right of first refusal to manage all future real properties acquired by the REIT and the REIT has the right of first refusal to acquire real properties presented by the operating company. In addition, the two companies may have the same senior managers and board directors. Although the shares of the two companies are not paired or traded as a unit, investors may purchase the shares of the two companies and "paper-clip" them to capture the symbiotic relationship between the two companies.

What is a finite life REIT?

A finite life REIT is one formed for a specific time period, usually based on the nature of its assets. In a finite life entity, the proceeds from the sale, financing or refinancing of assets or cash from operations, rather than being reinvested in new assets, are distributed to the partners or shareholders of the entity. At the end of the time period, the entity is dissolved and the partners or shareholders receive final distributions in accordance with the terms of the organizational documents.

What is a blind pool REIT?

A blind pool REIT is a REIT that does not tell investors what specific real properties will be acquired when raising capital from the public; rather, after capital has been raised, the sponsor or the general partner will determine what properties the REIT will acquire based on a predetermined investment strategy. Therefore, the reputation and past experience of the sponsor or the general partner is critical when establishing a blind pool REIT because an investor will make investment decisions based on that information. Accordingly, a blind pool REIT may be required to disclose prior performance of similar investments by the sponsor or the general partner to obtain investors' trust. Most non-traded REITs start out as blind pools. In August 2012, FINRA alerted investors of the higher risks associated with non-traded REITs, particularly blind pool REITs, because no property has been specified.⁵ A REIT may specify at least a portion of the real properties to be acquired to reduce that risk.

⁵ Available at <http://www.finra.org/investors/protectyourself/investoralerts/reits/p124232>.

What is the difference between internally and externally managed REITs?

In a REIT with an internal management structure, the REIT's own officers and employees manage the portfolio of assets. A REIT with an external management structure usually resembles a private equity style arrangement, in which the external manager receives a flat fee and an incentive fee for managing the REIT's portfolio of assets.

There is continuing debate over which management method is preferential. The controversy has centered on which method of management produces higher returns for investors, with some arguing that conflicts of interest underpinning compensation arrangements for external managers create incentives not necessarily in the best interest of the shareholders. Many new mortgage REITs are externally managed.

What fees does a manager of an externally managed REIT receive?

An external manager will typically receive a flat fee and an incentive fee. Generally, the flat fee is based on the asset value under management, which gives the manager incentive to purchase assets, while the incentive fee is based on the returns based upon income, total shareholder return or from the sale of assets.

What types of assets do REITs own and manage?

Broadly speaking, REITs generally own real property or interests in real property and loans secured by real property or interests in real property.

What are the limitations on the types of assets REITs may own and manage?

Entities must satisfy various income and assets tests in order to qualify for treatment as a REIT (see "*What are the income and assets tests for REITs?*"). These tests effectively limit the types of assets that REITs can own and manage to real estate or real estate related assets.

What kinds of services or activities are REITs prohibited from offering or conducting?

The Code distinguishes between the ordinary course activities of owning real property or mortgages and more active management functions. A partial list of prohibited services includes:

- For real estate-owning REITs
 - Hotel operations
 - Health club operations
 - Landscaping services
- For mortgage REITs
 - Servicing of third-party mortgage loans (this may be done by a taxable REIT subsidiary ("TRS"))
 - Loan modifications
 - Dealing with foreclosures
 - Creating and holding mortgage loans for sale
 - Securitization

In order to benefit from the REIT provisions of the Code, an entity must comply with the requirements set forth in "*What are the required elements for forming a REIT?*" above. Moreover, a REIT will be subject to a 100% tax on any net income derived from "prohibited transactions." A prohibited transaction is a sale or other disposition of dealer property that is not foreclosure

property. See *“What are the tax advantages of being a REIT?”*

How does a REIT engage in otherwise prohibited activities?

Up to 25% of the total value of a REIT’s assets can currently be invested in one or more TRS. The Omnibus Appropriations Act reduces this cap from 25% to 20% beginning on January 1, 2018. A TRS is permitted to engage in activities that the REIT cannot engage in directly, but the TRS is taxable as a regular non-REIT corporation. For example, a mortgage REIT may originate residential mortgage loans and then sell them at cost to a TRS. The TRS would then securitize the loans. In this way, profit from the service of securitizing the loans is not earned at the REIT level and no prohibited transaction tax is triggered. Use of a TRS can enable the REIT to engage in otherwise prohibited activities without endangering its REIT status, but at the price of the TRS paying corporate tax on the net income from those activities.

In addition, the REIT Investment Diversification and Empowerment Act of 2007 (“RIDEA”), allows a REIT to engage in a higher level of entrepreneurial activities through a TRS. For example, a TRS cannot directly run hotel and healthcare facilities and cannot lease such facilities unless the facility is managed by an eligible independent contractor (an entity that actively engages in the business of managing such facilities). Generally, a REIT will own a healthcare or hotel facility that is leased to its TRS, which then hires an eligible independent contractor to manage the facility. Rents received from a corporation in which a REIT owns 10% or more of the total voting power or total value of shares are excluded as “rent from property” under the

Income Tests (“related party rent rule”). Hotel REITs were exempt from the related party rent rule if they used an eligible independent contractor to manage the facility. Under the RIDEA amendments, healthcare REITs are similarly exempt. See *“What are the limitations on a TRS?”* below.

What are the income and assets tests for REITs?

Income Tests. A REIT is subject to two income tests. The first requires that at least 75% of a REIT’s gross income for the taxable year must be derived from:

- rents from real property;
- interest on obligations secured by mortgages on real property or on interests in real property;
- gain from the sale or other disposition of real property (including interests in real property and interests in mortgages on real property) that is not “dealer property”;
- dividends or other distributions on, and gain (other than gain from prohibited transactions) from the sale or other disposition of, shares in other REITs;
- abatements and refunds of taxes on real property;
- income and gain derived from foreclosure property;
- commitment fees;
- gain from the sale or other disposition of a real estate asset that is not a prohibited transaction; and
- qualified temporary investment income.

In addition, at least 95% of the REIT’s gross income for the taxable year must be derived from:

- items that meet the 75% income test;
- other dividends;
- other interest; and
- gain from the sale or other disposition of stock or securities that are not dealer property.

“Dealer property” commonly refers to property described in Code Section 1221(a)(1), or “stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.”

Assets Tests. The REIT must also satisfy certain assets tests.

- at least 75% of the value of the REIT’s total assets must be represented by real estate assets, cash and cash items (including receivables), and Government securities;
- not more than 25% of the value of the REIT’s total assets may be represented by non-Government securities that are not otherwise treated as real estate assets (including securities of any TRS);
- not more than 25% of the value of the REIT’s total assets may be represented by securities of one or more TRS (reduced to 20% beginning in 2018 and going forward); and
- as applied to any non-Government securities owned by the REIT that are not otherwise treated as real estate assets,
 - not more than 5% of the value of the REIT’s total assets may be represented by securities of any one issuer, and

- the REIT may not hold securities possessing more than 10% of the total voting power, or having a value of more than 10% of the total value of, the outstanding securities of any one issuer.

Each of the assets tests described above are measured at the close of each calendar quarter.

How does a REIT maintain compliance with REIT tax requirements?

The types of assets that a REIT can hold and the types of income it can earn are limited by the REIT rules. Therefore, a REIT must establish procedures, typically in coordination with its outside auditors, tax preparers and legal counsel, to ensure that it is investing in the correct types and proportions of assets and earning the right types and amounts of income.

What are a REIT’s distribution requirements?

A REIT must satisfy the distribution and earnings and profits requirements set forth in Code Section 857(a) in order to qualify for a dividends paid deduction under Code Section 562. This means that, in general, a REIT must distribute most of its income during the course of the year to maintain its favored status as a REIT.

Specifically, a REIT’s deduction for dividends paid during the taxable year must equal or exceed:

- the sum of
 - 90% of the REIT’s taxable income for the taxable year (determined without regard to the deduction for dividends paid and by excluding any net capital gain); and

- 90% of the excess of the net income from foreclosure property over the tax imposed on such income by Code Section 857(b)(4)(A),

- *minus* any excess non-cash income.

Assuming that a REIT meets the distribution requirements necessary to maintain its REIT status, it is generally subject nevertheless to an entity-level tax (at corporate progressive rates) on its undistributed taxable income for a tax year. Note that a REIT is not required to distribute its capital gains in order to maintain its REIT status. However, most REITs typically make distributions at least equal to their taxable income (including capital gains) so as not to incur tax at the REIT level.

Can a REIT issue “preferential dividends”?

“Preferential dividends” does not refer to dividends paid on preferred stock. “Preferential dividends” refers to certain types of distributions that give preference to any share of stock as compared to any other stock in its class in contrast to distributions that are made on a strictly pro rata basis, subject to certain limitations and detailed exemptions. The preferential dividend rule would prevent an issuer from claiming a dividends paid deduction with respect to the distribution. A REIT uses the dividends paid deduction to reduce its taxable income (usually to zero). The Omnibus Appropriations Act exempts publicly offered REITs from the preferential dividend rule.

What is FFO?

Funds from Operations, or FFO, is a financial term used to measure a REIT’s operating performance. FFO equals the sum of (a) earnings plus (b) depreciation expense

plus (c) amortization expenses. REIT professionals believe that FFO provides a more accurate picture of the REIT’s cash performance than earnings, which include non-cash items. FFO is not the same as Cash from Operations, which includes interest expenses.

FFO was originally defined by NAREIT in its White Paper in 1991 and subsequently revised from time to time. Most REITs disclose a modified or adjusted FFO, although the SEC requires them to show the standard NAREIT definition as well. *See:*

https://www.reit.com/sites/default/files/media/Portals/0/Files/Nareit/htdocs/policy/accounting/2002_FFO_White_Paper.pdf.

Is FFO a “non-GAAP measure” under the federal securities laws?

Yes. Regulation G and Item 10(e) of Regulation S-K permit a public REIT to disclose FFO as defined by NAREIT as a non-GAAP financial measure. The disclosure of FFO must be quantitatively reconciled with the most directly comparable GAAP financial measures used by the REIT. The Compliance and Disclosure Interpretations of the Securities and Exchange Commission (the “SEC”) for disclosure of non-GAAP measures clarify that a REIT may use an adjusted FFO calculation and may even disclose a per share FFO measure provided that it is used as a performance and not a liquidity measure. However, if adjusted FFO is intended to be a liquidity measure, it may not exclude charges or liabilities that required, or will require, cash settlement. *See:*

http://www.sec.gov/divisions/corpfin/guidance/nongaa_pinterp.htm

What other financial metrics do REITs commonly disclose?

Other metrics commonly used to measure the performance of a REIT are net asset value, adjusted funds from operations and net operating income.

How does a REIT finance its activities?

A REIT typically requires significant and continuing capital to buy additional assets and to fund distributions. A REIT generally finances its activities through equity offerings of preferred and/or common stock and debt offerings, including subordinated and senior debt, as well as through financing agreements (credit agreements, term loans, revolving lines of credit, warehouse lines of credit, etc.) with banks and other lenders. Mortgage REITs may also securitize their assets. An equity REIT may also incur ordinary course mortgage debt on its real property assets.

Publicly Traded REITs

How can REITs go public?

REITs become public companies in the same way as non-REITs, although REITs have additional disclosure obligations and may need to comply with specific rules with respect to roll-ups, which are discussed below. REITs may also take advantage of the more lenient requirements available to “emerging growth companies” included in the Jumpstart our Business Startups (JOBS) Act of 2012.⁶ For more information, see our “Frequently Asked Questions about Initial Public Offerings.”

⁶ <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf>.

Are there special disclosure requirements for publicly traded REITs?

Yes. In addition to the statutes and regulations applicable to all public companies, REITs must comply with the disclosure requirements of Form S-11 and SEC Industry Guide 5 of the Securities Act of 1933, as amended (the “Securities Act”), and under certain circumstances, Section 14(h) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”).

What is Form S-11 and SEC Industry Guide 5?

SEC rules set forth specific disclosures to be made in a prospectus for a public offering of securities as well as for ongoing disclosures once the issuer is public. The general form for an initial public offering by a U.S. domestic entity is Form S-1. Real estate companies, such as REITs, are instead required to use Form S-11 and to include information responsive to SEC Industry Guide 5. In addition to the same kinds of disclosures required by Form S-1, Form S-11 sets forth the following additional disclosure requirements:

- Investment policies with respect to investments in real estate, mortgages and other interests in real estate in light of the issuer’s prior experience in real estate;
- Location, general character and other material information regarding all material real properties held or intended to be acquired by or leased to the issuer or its subsidiaries; for this purpose, “material” means any property whose book value is 10% or more of the total assets of the consolidated issuer or the gross revenues from which is at least 10% of aggregate gross revenues of the consolidated issuer for the last fiscal year;

- Operating data of each improved property, such as the occupancy rate, number of tenants, and principal provisions of the leases; and
- Arrangements with respect to the management of its real estate and the purchase and sale of mortgages for the issuer.

SEC Industry Guide 5 sets forth the following additional requirements:

- Risks relating to (i) management's lack of experience or lack of success in real estate investments, (ii) uncertainty if a material portion of the offering proceeds is not committed to specified properties, and (iii) real estate limited partnership offerings in general;
- General partner's or sponsor's prior experience in real estate; and
- Risks associated with specified properties, such as competitive factors, environmental regulation, rent control regulation, fuel or energy requirements and regulations.

Depending on the nature of the specific REIT—UPREIT, DownREIT, equity, mortgage, externally managed, internally managed, or internally administered blind pool, etc. — there are additional necessary disclosures. In July 2013, the SEC issued guidance regarding disclosure by non-traded REITs, particularly the applicability of certain provisions of Guide 5, which may also be instructive for REITs that are intended to be traded.⁷

⁷ CF Disclosure Guidance: Topic No. 6, "Staff Observations Regarding Disclosures of Non-Traded Real Estate Investment Trusts," (July 16, 2013), available at <http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic6.htm>. See also the FINRA Investor Alert, *supra* note 3.

What is a limited partnership roll-up transaction?

In the late 1980s, the management of a number of finite life entities, whether public or private, decided to convert their entities into, or to cause interests in such entities to be exchanged for securities of, publicly traded perpetual life REITs. Typically, these transactions involved a number of these entities being "rolled up" into one publicly traded REIT. The SEC saw a number of conflicts and abuses arising from this process. In response, the SEC issued rules on "roll-up transactions," Congress enacted Section 14(h) and related provisions of the Exchange Act in 1993 and the Financial Industry Regulatory Authority ("FINRA," then the NASD) also issued rules governing the responsibilities of broker-dealers in roll-up transactions. Section 14(h)(4) of the Exchange Act defines a limited partnership roll-up transaction as a transaction involving the combination or reorganization of one or more limited partnerships, directly or indirectly, in which, among other things, investors in any of the limited partnerships involved in the transaction are subject to a significant adverse change with respect to voting rights, the term of existence of the entity, management compensation, or investment objectives; and any of such investors are not provided an option to receive or retain a security under substantially the same terms and conditions as the original issue. Section 14(h)(5) of the Exchange Act provides that the following transactions are not "limited partnership roll-up transactions":

- the transaction only involves a limited partnership that retains cash available for distribution and reinvestment in accordance with the SEC requirements;
- in such transaction, the interests of the limited partners are redeemed in accordance with a

preexisting agreement for securities in a company identified at the time of the formation of the original limited partnership;

- the securities to be issued or exchanged in the transaction are not required to be and are not registered under the Securities Act;
- the issuers are not required to register or report under the Exchange Act before or after the transaction;
- unless otherwise provided in the Exchange Act, the transaction is approved by not less than two thirds of the outstanding shares of each of the participating limited partnerships and the existing general partners will receive only compensation set forth in the preexisting limited partnership agreements; and
- unless otherwise provided in the Exchange Act, the securities were reported and regularly traded not less than 12 months before the securities offered to investors and the securities issued to investors do not exceed 20% of the total outstanding securities of the limited partnership.

See also Item 901 of Regulation S-K.

If the transaction is a limited partnership roll-up not entitled to an exemption from registration, in addition to the requirements of Form S-11 and SEC Industry Guide 5 (*see “What is Form S-11 and SEC Industry Guide 5?”* above), Section 14(h) of the Exchange Act and Items 902 through 915 of Regulation S-K will require significant additional disclosure on an overall and per partnership basis, addressing changes in the business plan, voting rights, form of ownership interest, the compensation of the general partner or another entity

from the original limited partnership, additional risk factors, conflicts of interest of the general partner, and statements as to the fairness of the proposed roll-up transaction to the investors, including whether there are fairness opinions, explanations of the allocation of the roll-up consideration (on a general and per partnership basis), federal income tax consequences and pro forma financial information.

Are there any specific FINRA rules that affect REITs?

FINRA rules regulate the activities of registered broker-dealers. As with any offering of securities of a non-REIT, a public offering by a REIT involving FINRA members must comply with FINRA Rule 5110, known as the “Corporate Financing Rule.” In addition, while under FINRA Rule 2310 a REIT is not deemed a direct participation program,⁸ certain provisions of Rule 2310 do apply to REIT offerings.

Rule 2310 prohibits members and persons associated with members from participating in a public offering of a REIT transaction or a limited partnership roll-up transaction, unless the specific disclosure and organization and offering expense limitations of Rule 2310 are satisfied. Rule 2310 requires firms, prior to participating in a public offering of a real estate investment program, to have reasonable grounds to believe that all material facts are adequately and accurately disclosed and provide a basis for evaluating the offering. The rule enumerates specific areas of disclosure including compensation, descriptions of the physical properties, appraisal reports, tax consequences, financial stability and experience of the general partner

⁸ Under FINRA Rule 2310(a)(4), a “direct participation program” is a program which provides for flow-through tax consequences regardless of the structure of the legal entity or vehicle for distribution or industry.

and management, conflicts of interest, and risk factors. A member may not execute a purchase agreement unless the prospective participant is informed about liquidity and marketability during the term of the investment, including information about the sponsor's prior programs or REITs. Under Rule 2310, the total amount of underwriting compensation (as defined and determined under FINRA rules) shall not exceed 10% and the total organization and offering expenses, including all expenses in connection with the offering, shall not exceed 15% of the gross proceeds of the offering, and there are additional limitations on non-cash compensation. Rule 2310 also imposes annual statements by the issuer of the estimated value of the securities issued.

As with the SEC and exchange rules, FINRA Rule 2310 also contains detailed rules on compliance in connection with limited partnership roll-up transactions.

What are the stock exchange rules applicable to REITs?

REITs seeking to be listed on an exchange are generally subject to the same rules as non-REITs. However, for a REIT that does not have a three-year operating history, the NYSE will generally authorize listing if the REIT has at least \$60 million in stockholders' equity, including the funds raised in any IPO related to the listing.

In addition, NASDAQ Rule 5210(h) provides that securities issued in a limited partnership roll-up transaction are not eligible for listing unless, among other conditions, the roll-up transaction was conducted in accordance with procedures designed to protect the rights of limited partners as provided in Section 6(b)(9) of the Exchange Act (which section was adopted at the same time as Section 14(h) and requires exchanges to prohibit listing securities issued in a roll-up transaction

if the procedures are not satisfied), a broker-dealer that is a member of FINRA participates in the roll-up transaction, and NASDAQ receives an opinion of counsel stating that the participation of that broker-dealer was conducted in compliance with FINRA rules. NYSE Manual Section 105 contains similar provisions regarding the listing of securities issued in a limited partnership roll-up transaction.

Are there Investment Company Act considerations in structuring and operating a REIT?

In addition to a REIT's special federal income tax treatment, a REIT has other regulatory advantages. For example, under Section 3(c)(7) of the Investment Company Act of 1940, as amended (the "Investment Company Act"), a REIT can qualify for an exemption from being regulated as an "investment company" if its outstanding securities are owned exclusively (subject to very limited exceptions) by persons who, at the time of acquisition of such securities, are "qualified purchasers"⁹ and the issuer is neither making nor

⁹ Section 2(a)(51) defines "qualified purchaser as: "(i) any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 3(c)(7) 15 USCS § 80a-3(c)(7) with that person's qualified purchaser spouse) who owns not less than \$5,000,000 in investments, as defined by the Commission; (ii) any company that owns not less than \$5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons; (iii) any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv); or (v) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than \$25,000,000 in investments."

proposing to make a public offering (as defined under the Investment Company Act).

In addition, a REIT can qualify for an exemption under Section 3(c)(5)(C) of the Investment Company Act, which is available for entities primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. The exemption generally applies if at least 55% of the REIT's assets are comprised of qualifying assets and at least 80% of its assets are comprised of qualifying assets and real estate-related assets. For these purposes, qualifying assets generally include mortgage loans and other assets that are the functional equivalent of mortgage loans, as well as other interests in real estate. In 2011, the SEC published a Concept Release¹⁰ that solicited public comment on how the Investment Company Act should apply to mortgage-related pools and calls for tighter restriction on REITs. The SEC commented that many mortgage-related pools are managed in a manner that is similar to the way in which investment companies are managed, and that these pools are perceived as investment vehicles, rather than as companies engaged in the mortgage banking business, which Section 3(c)(5)(C) was originally intended to cover. The SEC asked whether it should develop a test to differentiate companies that are primarily engaged in real estate and mortgage banking business from companies that look like traditional investment companies. It is seeking this information, presumably, with the view of evaluating whether it should narrow the scope of the interpretations of the statutory exception.

¹⁰ Available at <http://www.sec.gov/rules/concept/2011/ic-29778.pdf>.

Rule 3a-7 of the Investment Company Act excludes from the definition of "investment company" any asset-backed issuer that holds specified assets, issues fixed-income securities and meets the rule's other conditions. In a 2011 release,¹¹ the SEC proposed to eliminate the requirement that fixed-income asset-backed securities be rated by a nationally recognized statistical rating organization or credit rating agency. The SEC asked whether an asset-backed issuer that relies on Rule 3a-7 should still be considered an investment company for other purposes, such as whether an investor in an asset-backed issuer is itself an investment company that should comply with the Investment Company Act's requirements. The SEC has not published any updates on its proposals and questions.

If a REIT does not meet the exemption requirements provided in Section 3(c)(5)(C) or Section 3(c)(7), unless the REIT qualifies for another exemption under Section 3(b) or other provisions of Section 3(c) of the Investment Company Act, the REIT will be viewed as an investment company and required to comply with the operating restrictions of the Investment Company Act. These restrictions are generally inconsistent with the operations of a typical mortgage REIT. Therefore, most mortgage REITs monitor their Investment Company Act compliance with the same level of diligence they apply to monitoring REIT tax compliance, as violation of either set of rules can lead to adverse consequences.

What is a non-traded REIT?

"Non-traded REITs" are REITs that have offered securities to the public pursuant to the Securities Act and are subject to the ongoing disclosure and other

¹¹ Available at <http://www.sec.gov/rules/concept/2011/ic-29779.pdf>.

obligations of the Exchange Act but are not listed on an exchange. Shares of non-traded REITs are sold directly and their prices are set by the REIT sponsor or may be based on net asset value as determined by independent valuation firms.

What are the differences between exchange-traded REITs and non-traded REITs? What are the additional risks related to non-traded REITs?

Exchange-traded REITs and non-traded REITs are both publicly registered REITs but shares of non-traded REITs are not listed and do not trade on a national securities exchange. Shares of non-traded REITs typically have limited secondary markets and are generally significantly less liquid than exchange-traded REITs.

Because there is a limited market in the securities of non-traded REITs, for many years it was industry standard to set the initial offering price at \$10 per share and to maintain that, sometimes for many years, irrespective of the operating performance of the issuer. Non-traded REITs may have limited annual redemption programs to provide some liquidity to investors.

In recent periods, non-traded REITs have been scrutinized by the SEC, FINRA and others because of allegedly high upfront and continuing fees paid to the sponsor and its affiliates, the fact that the share price (which is based on the net asset value calculated by the REIT sponsor) generally does not change even with changes in the issuer's operating results and related matters, including calculation of dividend yields and appreciation.

In a notice to members in early 2009,¹² FINRA reminded members that customer account statements are required to include an estimated value for the REIT interests shown on the statements and that members are prohibited from using a per share estimated value based on data that is of a date more than 18 months prior to the customer account statement's date. During the offering period, it is permitted to use the value at which the shares are being offered to the public. However, 18 months after the conclusion of the offering, that value would be aged data and should not be the basis for the valuation provided on a customer's account statement. This notice resulted in non-traded REITs updating their net asset values every 18 months after their initial offering or even more frequently. The 2009 notice also reminded members that under Rule 2310 they should be inquiring into the amount or composition of the REIT's dividend distributions, including determining the amount of the distributions that represents a return of investors' capital and whether that amount is changing, whether there are impairments to the REIT's assets or other material events that would affect the distributions, and whether disclosure regarding dividend distributions needs to be updated to reflect these events. The reminder about dividends should also result in greater transparency about dividends and their sources, which can include offering proceeds and bank borrowings.

¹² Available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117795.pdf>

In October 2011, FINRA issued an investor alert¹³ to warn investors of certain risks of publicly registered non-traded REITs, including those listed below:

- Distributions are not guaranteed and may exceed operating cash flow. Deciding whether to pay distributions and the amount of any distribution is within the discretion of a REIT's Board of Directors in the exercise of its fiduciary duties.
- Distributions and REIT status carry tax consequences.
- Lack of a public trading market creates illiquidity and valuation complexities.
- Early redemption is often restrictive and may be expensive.
- Fees can add up.
- Properties may not be specified.
- Diversification can be limited.

In August 2012, FINRA reissued an alert to inform investors of the features and risks of publicly registered non-traded REITs.¹⁴ FINRA also provides investors with tips to deal with these risks. On July 16, 2013, the SEC also issued guidance regarding disclosures by non-traded REITs on distributions, dilution, redemptions, estimated value per share or net asset value, supplemental information, compensation to sponsor, and prior performance, etc.¹⁵

In January 2014, FINRA proposed to amend NASD Rule 2340 to require the inclusion in customer account

statements of a per share estimated value for unlisted REIT securities, which was approved by the SEC in October 2014; however, the amendment will not be effective until April 11, 2016.¹⁶

Are REITs considered "alternative investment funds" subject to the European Union's Alternative Investment Fund Managers Directive (AIFMD)?

Any REIT, whether traded or non-traded, conducting a securities offering should evaluate whether it may be considered an alternative investment fund, or AIF. Although the AIFMD was intended to regulate private funds, like hedge funds, the AIFMD defines "alternative investment fund" quite broadly to include any number of collective investment vehicles with a defined investment strategy. There is no exemption for U.S. REITs or for SEC-registered securities. As a result, any REIT that would like to offer its securities in European jurisdictions should assess whether it is an AIF, in which case it would be subject to certain disclosure and compliance requirements, or an "operating company," which is not an AIF.

Mortgage REITs

What is the history of mortgage REITs?

In the 1960s and 1970s, several major banks formed construction loan REITs, the earliest mortgage REITs, by making loans to developers and real estate owners. Many of these mortgage REITs went bankrupt in the

¹³ Available at <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/REITS/P124232>.

¹⁴ *Id.*

¹⁵ Available at <http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic6.htm>.

¹⁶ Available at <http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p601293.pdf>; the amended rule is available at http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=16008&element_id=3647&highlight=2340#r16008.

mid-1970s when the real estate market went into a downturn.

The next wave of mortgage REITs began with Strategic Mortgage Investment, Inc. ("SMI") in 1982. SMI's strategy was to originate non-conforming mortgage loans and sell a 90% senior interest in loans originated by SMI while retaining a 10% subordinated interest. The IRS granted a private letter ruling ("PLR") allowing non-recognition of income on the sale of the senior interest so long as the senior interest was sold for par. SMI was followed by a number of other mortgage REITs, all aimed at the same niche: non-conforming mortgages. Each received its own IRS PLR. The IRS later revoked these PLRs after it reconsidered the technical basis for the rulings. Mortgage REITs then shifted to borrowings through Collateralized Mortgage Obligations ("CMOs"). CMOs were treated as borrowings rather than sales for U.S. federal income tax purposes, resulting in no gain and no prohibited transactions tax.

In the Tax Reform Act of 1986, Congress created the Real Estate Mortgage Investment Conduit ("REMIC"), which is a pass-through vehicle designed to facilitate mortgage loan securitization and was intended to be the sole vehicle for securitizing mortgages. Congress decided to treat REMIC transactions as sales for federal income tax purposes. However, Congress also provided a path for REITs to securitize mortgages. Instead of using a REMIC, a REIT may issue mortgage-backed securities that are treated as debt for federal income tax purposes, an "old style" CMO. The chief consequence, however, is that residual income from the CMO when paid to REIT shareholders is treated as "excess inclusion income," which cannot be offset by the shareholders' net operating losses.

In the 1990s, mortgage REITs boomed. Large REITs, such as American Home Mortgage, Impac, and others, created successful businesses originating and securitizing residential and commercial mortgages, although a few REITs suffered in the mid-1990s.

During the early 2000s, many mortgage REITs expanded into subprime lending. The financial crisis beginning in 2007 wiped out this entire segment of mortgage REITs, but this segment has since rebounded somewhat.

What are common investment strategies for mortgage REITs?

Mortgage REITs currently generally have one of the following three investment strategies:

- Arbitrage – these REITs acquire government backed mortgage securities and other high quality mortgage securities with leverage. The mortgage securities are good REIT assets, and the REITs earn an arbitrage spread. The assets can be residential mortgage-backed securities ("RMBS"), and in some cases, commercial mortgage-backed securities ("CMBS").
- Operating - these REITs originate and/or acquire residential or commercial mortgage loans. They use a TRS for non-qualifying activities, such as servicing. These REITs may securitize the mortgages to enhance returns.
- Distressed – These REITs invest in distressed mortgages, which can be somewhat tricky for a REIT because of the foreclosure property rules (see "*What are the tax consequences of a REIT entering into a 'prohibited transaction'?*" above). In general, a REIT can foreclose on a mortgage and, for a temporary period, can earn income

on the foreclosed real estate which can pass through to shareholders. The REIT, however, cannot take advantage of the foreclosure property rules if it has acquired the mortgage with intent to foreclose. Accordingly, these REITs will have to make decisions about which mortgages to purchase. Alternatively, they can acquire the properties in a TRS to avoid foreclosure property issues.

What other regulatory compliance obligations may mortgage REITs have?

Mortgage REITs are subject to the lending requirements of Fannie Mae and Freddie Mac and general mortgage lending laws and regulations, such as the Dodd-Frank Wall Street Reform and Consumer Protection Act, Home Ownership and Equity Protection Act of 1994, Housing and Recovery Act 2008, Truth in Lending Act, Equal Credit Opportunity Act, Fair Housing Act, Real Estate Settlement Procedures Act, Equal Credit Opportunity Act, Home Mortgage Disclosure Act and Fair Debt Collection Practices Act.

Private REITs

How are private REITs established?

A REIT, like any other company, may issue equity securities without registration under the Securities Act if there is an available exemption from registration, such as Section 4(a)(2) of the Securities Act (often in accordance with Regulation D) or Regulation S or Rule 144A under the Securities Act.

Are there constraints on private REITs that are not relevant for public REITs?

Yes. Private REITs are subject to restrictions on how many shareholders they may have even though they must have at least 100 holders. For example, Section 12(g) of the Exchange Act requires a company to register under the Exchange Act and be subject to its periodic reporting and other obligations if it has at least 2,000 shareholders of record or 500 shareholders who are not accredited investors, and the Investment Company Act requires registration of investment companies that have more than 100 holders who are not qualified purchasers unless another exemption (such as under Section 3(b) or Section 3(c) of the Investment Company Act) is available. In addition, the equity securities of private REITs are not traded on public stock exchanges, and generally have less liquidity than those of public REITs.

Can a private REIT satisfy the ownership and holder requirements?

Yes. In a typical private REIT structure, one or a handful of shareholders may own all the common stock while a special class of preferred shares may be owned by at least 100 holders in order to satisfy the requirement of having at least 100 shareholders. A private REIT also must satisfy the “not closely held” requirement, but, in most cases, it is not an issue because the holders of shares in the private REIT will be corporations or partnerships with many investors. The “not closely held rule” is applied by looking through those entities to their investors. Special considerations can apply when direct or indirect shareholders are tax-exempt.

How do private REITs comply with the ownership and holder requirements?

If there are no willing “friends and family,” there are companies that provide services to help a private REIT fulfill the 100 shareholder requirement. They may also provide administrative services relating to the ownership and holder requirements, such as maintaining the shareholder base, creating and maintaining all shareholder records and keeping track of the ownership changes.

Tax Matters

What Internal Revenue Code provisions apply to REITs?

The basic rules governing REITs are set forth in Sections 856 through 860 of the Code. Sections 561 through 565, governing the deduction for dividends paid, are also relevant to REITs. Other sections of the Code provide special rules applicable to foreign investors in REITs.

What are the tax advantages of being a REIT?

A REIT is generally taxed at normal income tax rates (as determined by corporate progressive rates) on its real estate investment trust taxable income (“REITTI”). REITTI generally means taxable income, with the following adjustments:

- No dividends received deduction is allowed;
- Dividends paid deduction is allowed (except the portion attributable to net income from foreclosure property);
- Code Section 443(b) does not apply;
- Net income from foreclosure property is excluded;
- Certain taxes are allowed as deductions; and
- Net income from prohibited transactions is excluded.

An alternative tax structure under Code Section 857(b)(3) applies to a REIT’s capital gains. If a REIT has a net capital gain for the taxable year, and if the following method will produce a lower tax, then the REIT tax is the sum of (1) tax at corporate progressive rates on REITTI excluding net capital gain and computing the dividends paid deduction without regard to capital gain dividends, and (2) tax at Code Section 1201(a) rates on net capital gain less the dividends paid deduction with reference to capital gain dividends only.

In general, a capital gain dividend is one designated as such by the REIT in a written notice mailed to its shareholders prior to 30 days after the close of its taxable year (or mailed to its shareholders with its annual report for the taxable year). If the aggregate amount designated as capital gain dividends with respect to a taxable year of the REIT (including capital gain dividends paid after the close of the taxable year described in Code Section 858) is greater than the REIT’s net capital gain of the taxable year, then the portion of each distribution that is a capital gain dividend is only that proportion of the amount so designated that such net capital gain bears to the aggregate amount designated as capital gain dividends.

If a REIT chooses to retain its capital gain and pay tax on those gains, then the shareholders must include specific information in their tax returns.¹⁷ The REIT will

¹⁷ If the REIT chooses not to distribute its capital gains, and to pay entity level tax on such gains, then every shareholder at the close of the REIT’s taxable year must include, in computing long-term capital gains for the shareholder’s taxable year in which the last day of the REIT’s taxable year falls, such amount

be taxed on the gain under Code Section 857(b)(1) or 857(b)(3)(A), as applicable.

Code Section 857(b)(4) applies a tax on income from foreclosure property. The REIT is taxed on net income from foreclosure property at the highest corporate tax rate. Net income from foreclosure property is (i) gain from sale of foreclosure property that is dealer property and (ii) gross income from foreclosure property (excluding certain amounts that qualify as good income under the 75% income test), *less* (iii) deductions directly connected with production of such income.

Will the IRS issue private letter rulings regarding REIT status?

Historically, the IRS has issued private letter rulings regarding REIT status. Beginning in June 2013, certain companies stated in public disclosure that they were notified by the IRS that the IRS has formed a new internal working group to study the current legal standards the IRS uses to define “real estate” for REIT purposes and whether any changes should be made to those current legal standards. By November 2013, the working group had completed its review and the IRS rescinded its hold on private letter rulings. In April 2014, the IRS proposed new regulations clarifying the definition of “real property” for purposes of the REIT rules.

as the REIT designates in a written notice mailed to its shareholders at any time prior to the expiration of 60 days after the close of its taxable year (or mailed to its shareholders with its annual report for the taxable year). Under this rule, the amount includible by any shareholder can not exceed that part of the amount subjected to tax at the REIT level that the shareholder would have received if all of such amount had been distributed as capital gain dividends by the REIT to the holders of such shares at the close of its taxable year.

Are there any relief provisions related to failure to satisfy the REIT's income tests?

Under Code Section 856(c)(6), if a REIT fails to meet the requirements of the 95% or the 75% income test, or both, for any taxable year, then it is nevertheless considered to have satisfied those requirements if:

- following the REIT's identification of the failure to meet the requirements of the 95% or the 75% income test, or both, for any taxable year, a description of each item of its gross income described in such tests is set forth in a schedule for such taxable year filed in accordance with regulations prescribed by the Secretary; and
- the failure to meet the requirements of the 95% or the 75% income test, or both, is due to reasonable cause and not due to willful neglect.

If a REIT qualifies for the relief provided by Code Section 856(c)(6), then it is subject to a special tax. The tax is equal to the greater of: (i) the excess of (a) 95% of the gross income (excluding gross income from prohibited transactions) of the REIT, over (b) the amount of such gross income which is derived from sources referred to in the 95% income requirement; or (ii) the excess of (a) 75% of the gross income (excluding gross income from prohibited transactions) of the REIT, over (b) the amount of such gross income which is derived from sources referred to in the 75% income requirement, multiplied by a fraction the numerator of which is REITTI for the taxable year (without deducting dividends paid, taxes or net operating losses and excluding net capital gain) and the denominator of which is the gross income for the taxable year (excluding gross income from prohibited transactions;

gross income and gain from foreclosure property not qualifying under the 75% income test; long-term capital gain; and short-term capital gain to the extent of any short-term capital loss). Thus, the basic effect is to impose a tax equal to a portion of the shortfall in qualifying income.

What are the tax consequences of a REIT entering into a “prohibited transaction”?

Pursuant to Code Section 857(b)(6), REITs are subject to a 100% tax on net income derived from “prohibited transactions”. For these purposes, a prohibited transaction is a sale or other disposition of “dealer property” that is not foreclosure property. Net income derived from prohibited transactions means the excess of the gain from prohibited transactions (there is no netting of losses from prohibited transactions) over the deductions directly connected with prohibited transactions. The legislative history underlying the prohibited transactions tax indicates that Congress wanted to deter REITs from engaging in “ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project.”¹⁸

What are the limitations on a TRS?

A TRS provides a REIT with the ability to carry on certain business activities that could disqualify the REIT if engaged in directly by the REIT (*i.e.*, such activities could prevent certain income from qualifying as rents from real property). Specifically, a TRS can provide services to tenants of REIT property (even if such services are not considered services customarily furnished in connection with the rental of real

property), and can manage or operate properties, generally for third parties, without causing amounts received or accrued directly or indirectly by the REIT for such activities to fail to be treated as rents from real property. Further, rents paid to a REIT generally are not qualified rents if the REIT owns (directly, indirectly or through special attribution rules) more than 10% by vote and value of a corporation paying the rents. There are, however, limited exceptions for rents that are paid by a TRS.

Thus, the TRS provisions enable REITs to preserve their REIT status at the price of the income of the TRS being subject to corporate level tax (like any other C corporation). REITs will still want to determine carefully which income would be qualifying income if received directly by the REIT, because they will not want to subject otherwise qualifying income to corporate tax unnecessarily.

In general, a TRS is a corporation (other than a REIT or a qualified REIT subsidiary) in which the REIT directly or indirectly owns stock and for which the REIT and the corporation jointly elect treatment as a TRS. Revocation of a TRS election requires consent of both the REIT and the TRS, but not of the Internal Revenue Service.

If a TRS directly or indirectly owns securities possessing more than 35% of the total voting power of the outstanding securities of another corporation (other than a REIT or a qualified REIT subsidiary), or securities having a value of more than 35% of the total value of the outstanding securities of another corporation, that corporation is also automatically a TRS without the need for an election.¹⁹

¹⁸ See S. Rep. No. 94-938, 94th Cong., 2d Sess. 470 (1976).

¹⁹ For purposes of the value test, certain safe harbors and partnership debt instruments do not constitute “securities.”

Certain entities cannot be a TRS. These include any corporation that directly or indirectly operates or manages a lodging facility or a healthcare facility and any corporation that directly or indirectly provides to any other person (under a franchise, license, or otherwise) rights to any brand name under which any lodging facility or healthcare facility is operated.

When a partnership or corporation is converted to a REIT, will the REIT be subject to tax on built-in gains?

A conversion of a partnership into a REIT typically will be treated as a taxable contribution of property to a corporation under Code Section 351(e). As a result, holders of partnership interests exchanged for shares of the REIT would be subject to tax on the built-in gains of the partnership's assets. This tax can be deferred through use of various structures, including UPREITs and DownREITs. See *"What is an UPREIT?"* and *"What is a DownREIT?"* above for more information about these structures.

Corporations, however, may elect to be treated as a REIT simply by satisfying the requirements outlined in *"What are the required elements for forming a REIT?"* above. The election to be treated as a REIT will not subject shareholders to taxation on the built-in gains on the corporation's assets.

How is the election to be treated as a REIT terminated or revoked?

An entity may revoke or terminate its REIT election in one of two ways. First, Code Section 856(g)(2) permits explicit revocation of a REIT election.²⁰

²⁰ For timing, effectiveness and related procedures, see Code Section 856(g)(2) and Treasury Regulations Section 1.856-8(a).

Second, pursuant to Code Section 856(g)(1), a REIT election may also terminate by reason of failure to meet the REIT requirements, unless Code Section 856(g)(5) applies. Termination applies for the entire year in which the requirements are first not met, which can include the first REIT year. The election terminates whether the failure to be a qualified real estate investment trust is intentional or inadvertent.²¹ Code Section 856(g)(5) provides that if

- a corporation, trust, or association that fails to comply with one or more REIT provisions (other than a failure described in Code Section 856(c)(6) with respect to the 95% or the 75% income tests, or a failure described in Code Section 856(c)(7) with respect to the assets tests);
- such failures are due to reasonable cause and not due to willful neglect; and
- such corporation, trust, or association pays (as prescribed by the Secretary in regulations and in the same manner as tax) a penalty of \$50,000 for each failure to satisfy a REIT provision due to reasonable cause and not willful neglect,

then such corporation, trust, or association will not lose its REIT status.

Code Section 856(g)(3) provides generally that following termination of REIT status, the entity shall not be eligible to make a REIT election for any taxable year prior to the fifth taxable year that begins after the first taxable year for which such termination or revocation is effective.²²

²¹ Treasury Regulations Section 1.856-8(b).

²² Code Section 856(g)(4) provides an exception to the five-year rule where the termination results from failure to qualify and certain other requirements are met.

Are there any state tax benefits to being a REIT?

In certain states, state tax benefits may exist for companies with captive REITs.²³ However, through legislation and case law, several states have minimized the potential tax benefits of REITs. Different approaches by the states to reduce the tax benefits of REITs have included denying dividends received deductions; challenging the substance of the REIT and imputing the REIT's earnings to the taxable in-state affiliate; forcing in-state affiliates to include the REIT in a combined report; and generalized efforts to apply the states' broad discretionary authority to make adjustments to include REIT income in the taxable base of the affiliate paying rent to the REIT.²⁴

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²³ See, e.g., *HMN Fin., Inc. v. Commissioner of Revenue*, 782 N.W.2d 558 (Minn. May 20, 2010) (rejecting the state's attempt to attribute REIT income to an affiliate that was subject to tax in the state); *AutoZone Dev. Corp. v. Finance and Admin. Cabinet*, File No. K04-R-16, 2005 Ky. Tax LEXIS 168 (Ky. B.T.A. 2005), *aff'd*, No. 2006-CA-002175-MR, 2007 Ky. App. LEXIS 401 (Ky. Ct. App. 2007) (upholding dividends received deduction).

²⁴ See, e.g., *Wal-Mart Stores East, Inc. v. Hinton*, 676 S.E.2d 634 (N.C. Ct. App. 2009) (upholding the forced combination of the REIT with its in-state affiliates); *BankBoston Corp. v. Commissioner of Revenue*, 861 N.E.2d 450 (Mass. App. Ct. 2007) (upholding disallowance of dividends received deduction); *Bridges v. AutoZone Props., Inc.*, 900 So. 2d 784 (La. 2005) (requiring REIT shareholder to pay tax on the amount it received as rental income attributable to in-state property).