Volume 1, Issue 1 | January 2020

WHAT THE REIT?!

CURRENT TAX ISSUES FOR THE REIT COMMUNITY

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INTRODUCTION

According to NAREIT, "real estate investment trusts," or REITs, own more than $3 trillion of U.S. real estate assets. With REITs having survived (and, in some respects, thrived) under recent tax reform, that number likely will rise in the ensuing decade. But what does it mean that REITs hold so much real estate? In part, it means owning and operating real estate through the prism of Section 856 *et seq* of the Internal Revenue Code, a complex web of tax laws enacted in 1960 to create the REIT and facilitate real estate investment by the public. At times a boon for the tax lawyer and a frustration for the real estate investor, such laws help shape the way real estate is owned and operated, like it or not. In this newsletter, we reflect on such laws and their current influence on the transactions and behavior of the real estate and mortgage investment communities, with the goal of shedding some light on their purpose and application. Because sometimes you want to say WTF, but instead should say What the REIT?! We hope you enjoy.

MORRISON FOERSTER

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HANDLING TAX RISK AND UNCERTAINTY AS A REIT IN THE NEW DECADE

With the new decade, let's put complying with the REIT tax laws in perspective. For the 2017 taxable year, 0.6% of individual income tax returns, 0.2% of partnership income tax returns and 0.9% of corporate income tax returns were audited by the IRS. REIT income tax returns constituted but a fraction of such audited corporate income tax returns.

Failing to qualify as a REIT may be more difficult than you think. Section 856 of the Internal Revenue Code provides various "reasonable cause" exceptions to terminating REIT status on the failure of a REIT qualification requirement. Section 860 provides a helpful procedure for declaring and paying "deficiency dividends" in case, generally, it turns out a REIT failed to pay sufficient dividends in a prior year.

The current government fee to obtain a general Private Letter Ruling ("PLR") from the IRS is $30,000. Typically, a taxpayer will retain a law or accounting firm, or both, to prepare and submit a PLR, which results in significant additional cost and time. Based on our own experiences and anecdotes from others, the IRS has been taking multiple years to get through a REIT PLR. By contrast, a written and reasoned opinion from a reputable law or accounting firm can be obtained much more quickly and at much less cost than a PLR, though how much more quickly and how much less costly…we here at Morrison & Foerster LLP hesitate to guess.

Faster and cheaper still would be a memorandum or other file documentation prepared by an in-house counsel or tax director having sufficient experience in and knowledge of the subject.

Taken together, a PLR almost never makes sense. It takes too long and is too expensive. Given the "reasonable cause" exceptions under the REIT qualification requirements and the fact that people at the IRS may not know the law any better than you, consider an alternative in the face of tax risk and uncertainty. For example, under Treas. Reg. § 1.856-7, reasonable reliance on the reasoned, written opinion of an adviser can demonstrate "reasonable cause". We are such an adviser, by the way. Really, the regulations acknowledge the reasoned opinion of an in-house counsel can suffice. Ultimately, the regulations simply require "ordinary business care and prudence in attempting to satisfy the [REIT] requirements." In that light, in addition to obtaining reasoned and written advice, every REIT should have in place a system designed in good faith to monitor and attempt to comply with the REIT qualification requirements. If you can afford it, an in-house tax director or department—having knowledge of and involvement in the day-to-day operations and transactions of the REIT—goes a long way. Being subject to the scrutiny of financial audits and regular contact with your advisors counts for something as well.

Of course, there are circumstances in which a PLR may be necessary. A real estate company cannot, for example, build a public REIT on a new asset class for which the REIT treatment is unclear. As the world develops, so do the potential assets and income of a REIT, and it is a shame the IRS cannot move at a more reasonable, or even just less outrageous, pace. In the meantime, talk to your advisors, and your tax director, and keep a written record of your analysis and conclusions for posterity.

PROFESSOR TRUST'S HISTORY OF REITS

In this, Professor Trust's inaugural column delving into the history of REITs, we explore the origin of the "real estate investment trust." Impossible as this may sound to younger generations, our country's income tax laws lacked the concept of a REIT prior to 1960. Enter the Honorable Mr. Wilbur Mills, a representative from Arkansas, who introduced a bill to create the REIT under Subchapter M, Sections 856 *et seq*, of the Internal Revenue Code. In fact, on September 10, 1960, President Eisenhower signed into law the Cigar Excise Tax Extension Act of 1960, an unforgettable extension of the cigar excise tax, which act logically included the substance of Mr. Mills' bill, thereby creating the REIT. Scandalously, neither Wikipedia article for Mr. Mills nor President Eisenhower mentions their crucial role in the creation of the REIT.

That is not to say REITs, in a way, did not exist in the United States prior to 1960. Various states, such as Massachusetts, long had the concept of a state-law "trust" employed to undertake "real estate investments," particularly when a state-law corporation, for various arcane reasons, could not. Such trusts were intended to vest control of real estate assets in the trustees and provide limited liability for the beneficiaries, with care taken to limit the authority of beneficiaries over trust matters to preserve their limited liability and avoid characterization as a state-law partnership.

REITs were created, to some degree, to provide a certain tax status for these passive real estate investment trusts.

Let us quote directly from the Congressional record of 1960:

> [REITs will provide] substantially the same tax treatment for real estate investment trusts as present law provides for regulated investment companies...[The] committee believes that the equality of tax treatment between the beneficiaries of real estate investment trusts and the shareholders of regulated investment companies is desirable since in both cases the methods of investment constitute pooling arrangements whereby small investors can secure advantages normally available only to those with larger resources. These advantages include the spreading of the risk of loss by the greater diversification of investment which can be secured through the pooling arrangements; the opportunity to secure the benefits of expert investment counsel; and the means of collectively financing projects which the investors could not undertake singly...[It also is] desirable to remove taxation to the extent possible as a factor in determining the relative size of investments in stocks and securities on one hand, and real estate equities and mortgages on the other[, which is] particularly important at the present time because of the shortage of private capital [or real estate]...[However, the committee] has taken care to draw a sharp line between passive investments and the active operation of business, and has extended the regulated investment company type of tax treatment only to income from passive investments of real estate investment trusts.

And there you have it. In subsequent columns we will return to this history for utilitarian reasons, such as explaining certain obscure and frustrating principles in the taxation of REITs, such as the need for "transferable" shares and a "board" of trustees or directors, and we will also use our newfound understanding to gain perspective on how far REITs have come and where they might, legally and actually, go, as they seem to be everywhere these days.

ALPHABET SOUP OF REITS

Jargon abounds in the REIT industry. Jargon helps make sentences shorter but also makes practitioners seem smarter and frustrates those outside the "know". The following demystifies some of the terms used most frequently in practice.

Bad Income Bucket or Cushion: 95% or more of a REIT's gross income must come from enumerated passive sources. A REIT's "bad income bucket" or "cushion" refers to the 5% of gross income that can come from most other sources.

Code: Refers to the Internal Revenue Code. There is no other Code.

DownREIT: A REIT structure in which the REIT holds a significant amount of its assets through a subsidiary entity taxable as a partnership, but holds other significant assets outside such partnership. The DownREIT structure allows an owner of property to contribute such property to the DownREIT partnership in exchange for OP Units in a tax-efficient manner. Note: there is nothing "down" about a DownREIT. The "down" simply indicates a structure different than (and not opposite from) an UPREIT. There is nothing "up" about an UPREIT either (see "UPREIT", below).

DRE (Disregarded Entity): A DRE, or disregarded entity, is an entity that is disregarded as separate from its owner for income tax purposes, but is treated as a separate entity for most legal purposes. Single member LLCs are treated as disregarded entities unless they affirmatively elect to be treated as corporations for income tax purposes.

ITSI (Impermissible Tenant Services Income): ITSI, or impermissible tenant services income, generally means income received, directly or indirectly (including through higher rent), by a REIT for services furnished or rendered by the REIT to tenants of its property in an impermissible manner. ITSI is not considered qualifying income for either REIT income test, and if it exceeds 1% of a property's gross income, all income attributable to that property is considered "bad" income for purposes of the income tests. A classic example of ITSI is income attributable to the provision of maid services to a tenant. However, these types of services may be provided by an independent contractor, which must charge separately if the service is not "customary", or a TRS of the REIT.

OP (Operating Partnership): Typically refers to the "umbrella partnership" of an UPREIT, but also used to refer to a DownREIT partnership.

OP Units: Units of limited partnership interests in an UPREIT or DownREIT partnership. OP Units typically are redeemable for REIT stock or an equivalent amount of cash.

Penguins: REITs must be held by 100 or more persons each year after its first taxable year. Private REITs may hire shareholder accommodation firms to raise money from minority investors to meet this requirement. In a typical example, such a firm would source 125 investors (*i.e.*, Penguins), with each investor purchasing a single

preferred share in the private REIT for $1000. Such share would have a $1000 liquidation preference, a market dividend yield (e.g., 12%) and no other voting or economic entitlements. Accommodation firms charge a fee for this. You bet they do.

Prohibited Transaction: A transaction in which a REIT disposes of property held for sale to customers in the ordinary course of business. Similar to a sale of inventory and also referred to as a sale of "dealer" property. A 100% tax applies to the gain recognized by a REIT in such sale. The Code contains a "safe harbor" for avoiding prohibited transaction treatment.

QRS (Qualified REIT Subsidiary): A QRS, or qualified REIT subsidiary, is defined in the Code as a direct and wholly owned corporate subsidiary of a REIT that has not elected to be a TRS. A QRS effectively is disregarded from the REIT for income tax purposes, making it similar to a DRE of the REIT.

REIT (Real Estate Investment Trust): Not everyone knows what a REIT stands for. We touch on the history of REITs in this issue, including the origin of the name.

Smurfs: Another name for Penguins.

TPA (Tax Protection Agreement): An agreement among a REIT, its OP and a property contributor in connection with the contribution of property to the OP in exchange for OP Units. In these agreements, the OP typically agrees that it will indemnify the contributor for taxes triggered by a subsequent sale of the property or a breach of certain covenants related to OP liabilities. Sometimes denominated as a "Tax Matters Agreement" and sometimes contained within a contribution agreement.

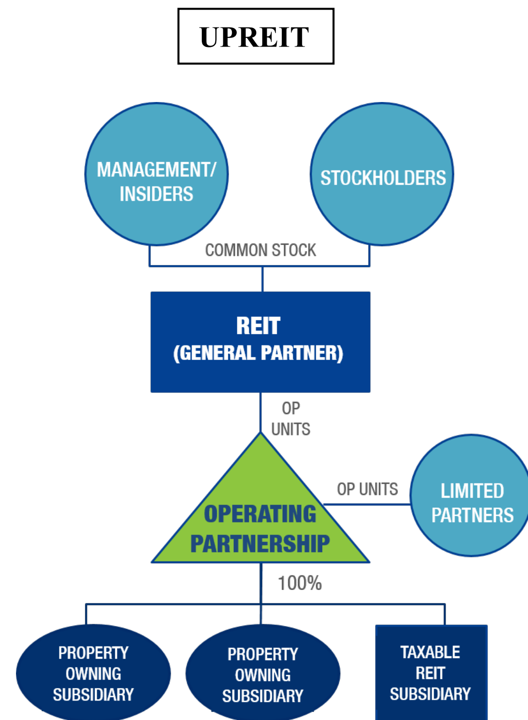
TRS (Taxable REIT Subsidiary): A direct or indirect corporate subsidiary of a REIT for which the REIT and TRS have made an election. Does the REIT's dirty work…in that a TRS can do anything a REIT cannot, such as provide ITSI to tenants, other than operate a lodging or healthcare facility. A TRS is subject to regular corporate income tax.

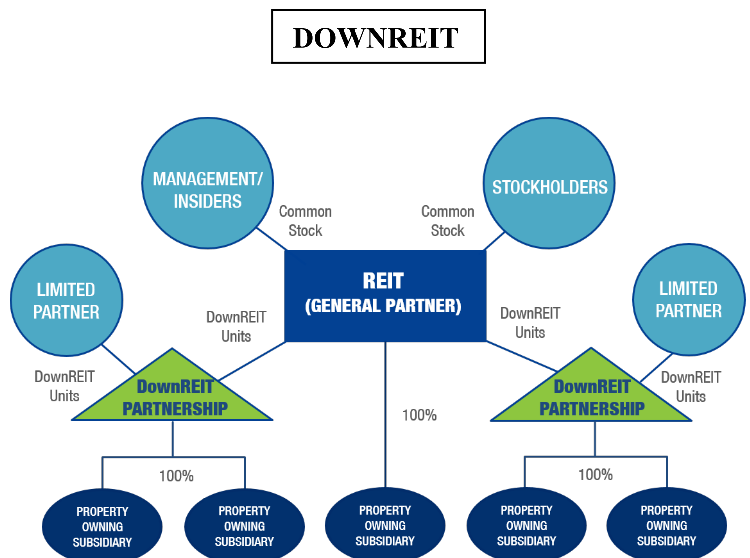
UPREIT (Umbrella Partnership REIT): A REIT structure in which the REIT holds substantially all its assets through a subsidiary entity taxable as a partnership. Like a DownREIT structure, an UPREIT structure allows an owner of property to contribute such property to the UPREIT partnership in exchange for OP Units in a tax-efficient manner.

TAX PROTECTION AGREEMENTS IN UPREIT AND DOWNREIT TRANSACTIONS

BACKGROUND

REITs often are structured as UPREITs or DownREITs. As alluded to in our Alphabet Soup in this issue, we do not know the origin of the "DownREIT" moniker, other than the fact that Down Is the Opposite of Up, although a DownREIT is not the opposite of an UPREIT, as illustrated:





UPREITs and DownREITs (and, to a lesser degree, UP-Cs outside the real estate context) were developed primarily to accommodate investors that sought to contribute real estate assets to a public REIT in a tax-efficient manner. Normally, an investor cannot contribute assets directly to a public REIT tax-free because of certain "control" and "diversification" rules under Section 351 of the Code. Most contributing investors will not control the REIT, and most contributing investors are seeking diversification. However, an investor can contribute real estate assets to the OP of a REIT tax-free because there are no control rules with respect to, and the diversification rules generally do not apply to, contributions of real estate to an entity taxable as a partnership. Other tax benefits can arise from an OP transaction as well.

In an UPREIT or DownREIT transaction, a contributing investor contributes her real estate assets in exchange for OP Units. The OP Units are redeemable, normally after at least a year, for REIT stock or the equivalent amount of cash. We discuss the tax and non-tax aspects of UPREIT OP Unit transactions in our FAQs About UPREITs and OP Unit Transactions. We will discuss some interesting tax-related differences between doing an OP Unit transaction with an UPREIT and a DownREIT in a future newsletter. Below we discuss a common, and very important, component of both: the Tax Protection Agreement.

TAX PROTECTION AGREEMENTS

A Tax Protection Agreement ("TPA") refers to an agreement among the REIT, the OP and a property contributor in connection with the contribution of property to the OP in exchange for OP Units. TPAs sometimes are denominated "Tax Matters Agreements", and sometimes are just a subset of provisions within the contribution agreement governing the property contribution. TPAs typically have 7- to 10-year tax protection periods, although durations range throughout the "market", and the duration of a TPA may vary within itself with respect to different types of protection and different contributed properties. TPAs have a number of potential provisions serving a number of purposes, the primary of which we describe below.

Built-In Gain Protection. A contributed property may have built-in gain at the time of contribution. If the OP later disposes of the property in a taxable transaction, such built-gain may be taxable to the contributor. A TPA generally provides that the OP must pay the contributor's taxes on such gain if triggered during the tax protection period. Among other nuances:

1. Parties often negotiate whether built-in gain triggered in an OP merger or similar transaction is protected, particularly if the contributor is offered a comparable tax-free "roll over" in the transaction and elects to receive cash instead. There has even been litigation on this issue.

2. TPAs often do not, but perhaps should, protect contributors from built-in gain recognized with respect to her OP Units (as opposed to the underlying contributed property) in a transaction in which the contributor is forced to dispose of such OP Units in a taxable transaction (such as an OP merger that cashes out limited partners without triggering built-in gain in the underlying properties).

3. The built-in gain of depreciable contributed property "burns off" over time. For example, assume Contributor A contributes depreciable Property A to OP and Property A has a $10 adjusted tax basis, a $100 fair market value and 10 years of depreciable life remaining. At the end of 10 years, the amount of original built-in gain allocable to Contributor A has been eliminated through "book" depreciation of $100. This can be great for Contributor A, but not great for the other partners of the OP, if Property A later is sold for significant gain despite having been depreciated to nothing, because such gain will be allocated pro rata to every partner. For those interested, see Treas. Reg. § 1.704-3(b)(2), Ex. 2. Further, TPAs often are unclear regarding whether protection only applies to the original (and possibly burnt-off) built-in gain or any gain recognized in a sale.

Liability Protection—Negative Tax Capital Accounts. A contributor often has a "negative tax capital account" (or "negative tax basis") with respect to her contributed property, meaning the contributor's share of liabilities encumbering the property exceeds the contributor's adjusted tax basis in the property. This can happen because a contributor has used such liabilities to extract cash tax-free from the property or generate tax deductions. As a limited partner in the OP, the contributor will receive a share of liabilities of the OP, including a share of the liabilities encumbering the contributed property. Such share of liabilities could be less than the contributor's original share prior to the contribution for various reasons. TPAs address this issue by requiring that the contributor receive a minimum share of OP liabilities through (i) the OP maintaining sufficient non-recourse liabilities such that the contributor is allocated sufficient liabilities under applicable Treasury Regulations, (ii) the contributor

guaranteeing a sufficient amount of OP liabilities, or (iii) a combination of the foregoing.

> Observation: "Bottom-dollar" guarantees used to be the norm. In a bottom-dollar guarantee, the guarantee only came due after the lender lost a certain threshold dollar amount of the liability. Bottom-dollar guarantees no longer work under applicable Treasury Regulations. As a result, guarantees are less common in TPAs. Now, contributors sometimes use "vertical slice" guarantees, in which the contributor effectively guarantees a percentage of every dollar of a liability. Economically, these guarantees are riskier to contributors. Theoretically, properly structured "deficit restoration obligations" also remain an option, but for various reasons we do not see them often in practice.

Liability Protection—Other. Even absent a "negative tax capital account", a contributor may negotiate a minimum share of liabilities for other purposes, such as (i) increasing the contributor's tax basis in her OP Units to absorb more cash distributions or allocations of deductions, and (ii) avoiding a "disguised sale" in connection with the contribution of a property encumbered by "nonqualified liabilities." The Treasury Regulations governing these matters are awfully complex, which we will discuss in a subsequent issue.

Section 704(c) Methods. As mentioned, contributed property typically has built-in gain at the time of contribution. Treasury Regulations require that the OP adopt a method to prevent, in effect, the shifting of the tax incidence of such built-in gain from the contributor to the other partners of the OP. Generally, there are three methods: (i) the "traditional method", which shifts depreciation deductions with respect to the contributed property away from the contributor to the other partners of the OP; (ii) the "traditional method with curative allocations," which shifts both such depreciation deductions and, to the extent necessary and available, additional OP deductions away from the contributor to the other partners; and (iii) the "remedial method", which creates income and offsetting deductions out of thin air (like particles and anti-particles), allocating the income to the contributor and the deductions to the other partners. The traditional method is the most, and the remedial the least, favorable to the contributor. Typically, TPAs require the use of the "traditional" method. See again Treas. Reg. § 1.704-3(b)(2), Ex. 2 for an example in which such method is problematic.

Indemnification. TPAs require the OP to indemnify the contributor for taxes caused by breaches of the OP's protection obligations. The nature and amount of such indemnities vary among TPAs, with several variants subject to negotiation most often. One such variant is whether the indemnity is limited to the tax liability incurred by the contributor due to the breach, or whether it also includes taxes due on the indemnity payments themselves, so that the contributor is made whole on an "after-tax basis." Another variant is whether the indemnity covers the full tax liability through the last day of the term of the TPA, or whether the indemnity amount "ratchets down" toward the end of the term, with the percentage of the tax liability subject to indemnification becoming progressively smaller. Finally, parties often negotiate an assumed tax rate and calculation methodology to avoid having contributors actually demonstrate their resulting tax liabilities through the disclosure, among other things, of income tax returns or the indirect owners of contributors that are entities.

Other Considerations. Depending on the circumstances, numerous other issues can arise with a TPA. As two examples: (i) parties often give little thought to the preparation of the schedules to a TPA, such as the amounts of protected built-in gain and the amounts of protected liabilities, and realize on the eve of closing that such information is unavailable in final form, necessitating a post-closing mechanism for information gathering; and (ii) TPAs that involve large numbers of contributors can become cumbersome, particularly with respect to post-closing matters, such as information gathering, the need to revise guarantees to address refinanced liabilities or the need to address disputes. Mechanisms, such as powers of attorney, representatives for groups and flexible amendment provisions, should be considered.

TPAs are not mere form agreements. They provide substantive economic protection to contributors and should be viewed as an important component of property contribution transactions whose terms, which often are highly technical, should be negotiated carefully.

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