

A User's Guide to LTIP Units

A Special Form of Equity Compensation for UPREITs



LTIP Units are a special form of equity compensation that take advantage of the “umbrella partnership” REIT (UPREIT) organizational structure to provide a tax efficient vehicle for UPREITs to attract, retain and motivate management that is generally not available to other types of corporations. In order to better unpack the key corporate, governance, tax, securities, compensation and market considerations driving the use of LTIP Units, a cross-disciplinary team of Proskauer lawyers have co-authored a comprehensive user’s guide on LTIP Units.

Authors



Karen J. Garnett
Partner
+1.202.416.6850
kgarnett@proskauer.com



Joshua M. Miller
Partner
+1.202.416.5828
jmiller@proskauer.com



Steven L. Lichtenfeld
Partner
+1.212.969.3735
slichtenfeld@proskauer.com



Samuel M. Kardon
Special Capital Markets Counsel
+1.212.969.3167
skardon@proskauer.com



David S. Miller
Partner
+1.212.969.3006
dmiller@proskauer.com



Kathleen R. Semanski
Associate
+1.212.969.3658
ksemanski@proskauer.com

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Introduction

In the universe of equity compensation, an “LTIP” is a commonly used term that invokes a “long term incentive program,” which is any form of award of cash or shares paid or issued in order to attract, retain and incentivize management and better align their interests with shareholders generally. For umbrella partnership real estate investment trusts, known as “UPREITs,” however, “LTIP Units” have come to refer to awards of a special class of limited partnership interest that take advantage of the relatively unique structure of an UPREIT: a REIT that is taxable as a corporation that holds all of its assets through an operating company subsidiary immediately below the REIT, known as its “operating partnership,” that is taxable as a partnership.¹

LTIP Units are similar in many ways to other equity compensation awards granted by REITs and other public companies to their directors, officers, employees and other service providers that are subject to time and/or performance vesting conditions and payable in shares of the company’s common stock (or an amount of cash determined based on the value of such shares). Unlike these other awards, however, LTIP Units are structured as “profits interests” for tax purposes and therefore generally carry two fundamental benefits and one fundamental risk:

- if properly structured, there is no taxable event when an LTIP Unit is issued or when it vests; and
- when the taxable event does occur and the holder of vested LTIP Units receives shares of common stock of the REIT, or “common shares,” or the cash equivalent, the long-term capital gains rate generally applies; *however*
- the holder of vested LTIP Units cannot receive common shares or the cash equivalent unless the fair market value of the operating partnership’s assets (most commonly measured by reference to the trading price of common shares) has appreciated sufficiently since the LTIP Unit was issued.

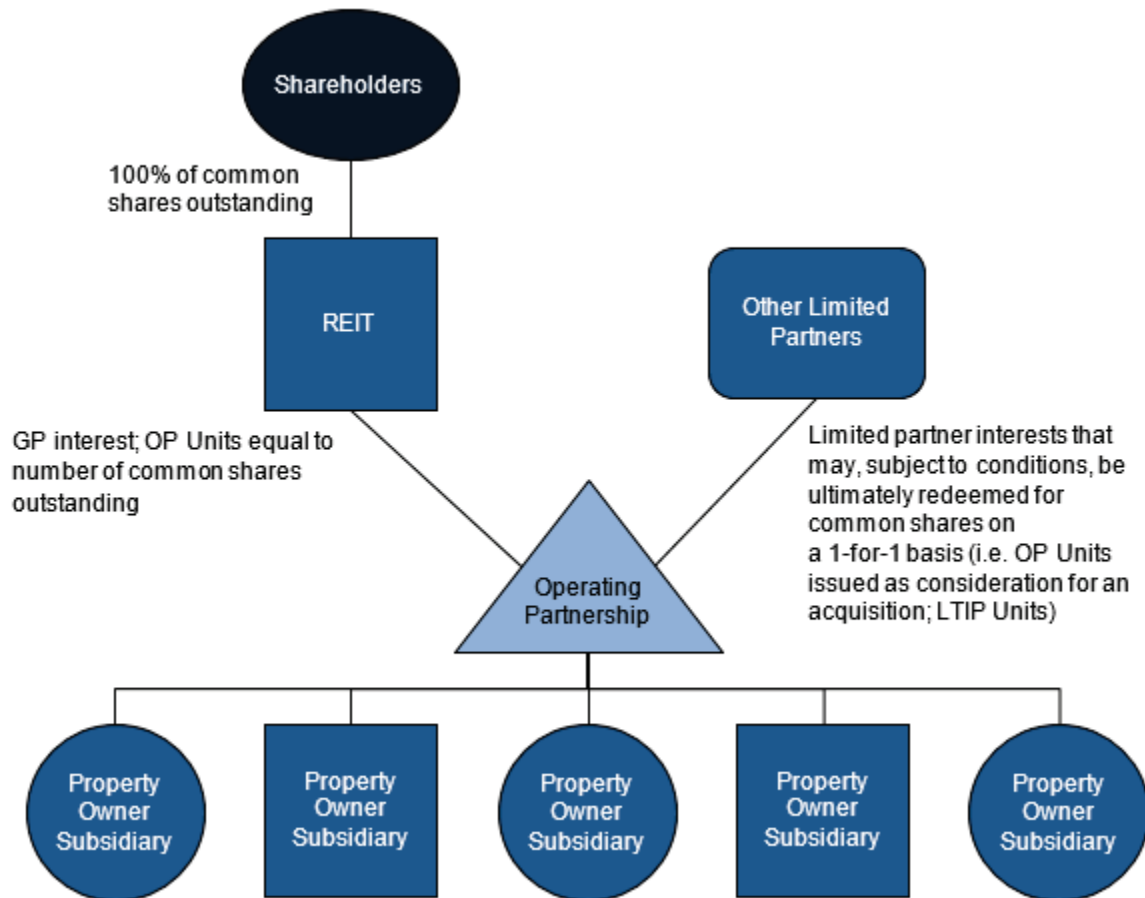
In this article, we discuss how LTIP Unit programs are structured and implemented, as well as a variety of related design and drafting considerations.

The UPREIT Structure

In an UPREIT structure, all of a REIT’s business operations are conducted through its operating partnership, which directly or indirectly owns all the REIT’s real estate investments. The REIT is the general partner of the operating partnership and its only material asset is its equity interest in the operating partnership. The outstanding common shares correspond on a one-for-one basis to the ordinary limited partnership interests in the operating partnership, or “OP Units,” held by the REIT. Every time the REIT issues common shares, it contributes the proceeds to its operating partnership in exchange for an equal number of OP Units. OP Units may also be issued to parties other than the REIT in connection with transactions that do not involve the issuance of capital stock of the REIT, such as the acquisition of properties from third parties in contribution transactions. OP Units generally can also be redeemed for common shares (or, at the option of the REIT, the cash equivalent) on a one-for-one basis and are generally entitled to receive per unit distributions equal to the per share dividends payable to holders of common shares. The voting rights associated with OP Units are very limited and generally

¹ While LTIP Units are most commonly used by UPREITs, they can also be used in so-called “Up-C” structures (i.e., corporations that are not REITs that hold their operating assets through an entity taxed as a partnership).

extend only to matters that would adversely affect the material rights of holders, such as distributions, redemptions and tax allocations.



PRACTICE POINT: If a REIT issues shares of preferred stock, the operating partnership will issue an equal number of a new class of preferred units of limited partnership interest with substantially similar designations, preferences and other rights as the preferred stock. When the REIT receives proceeds from the issuance of preferred stock, the REIT contributes the proceeds to the operating partnership in exchange for the corresponding class of preferred units. Preferred units, which can be senior to OP Units for distributions and upon liquidation, can also be used and structured to serve as currency for acquisition of properties from third parties in contribution transactions.

The UPREIT structure was first developed in the early 1990s to provide an alternative to immediate taxation for owners of appreciated property transferred to new REITs that were being formed. While a contribution of appreciated property to a REIT in exchange for its stock is generally taxable at the time of the contribution, the contribution of property (or interests in limited partnerships that own property) to an operating partnership in exchange for OP Units is generally not a taxable transaction. In an UPREIT formation transaction, a new partnership that will become the operating partnership in a new REIT generally acquires real property assets through nontaxable partnership mergers or contribution transactions, or in taxable acquisitions for cash. Concurrently, the REIT conducts an initial public offering

of common shares and contributes the proceeds therefrom to the operating partnership to acquire properties (or pay down debt) at the time of formation or in the future.

The contribution of real estate assets to the operating partnership of a REIT in exchange for OP Units is a “win-win” for all parties involved. For the seller, not only can recognition of any built-in (or future) capital gains be deferred indefinitely, OP Units are significantly more liquid than real estate assets. As compared to a sale of a real estate asset, the redemption of an OP Unit for a common share (or the cash equivalent) is quicker, easier to execute and has more certain pricing. An additional benefit is the potential step-up in tax basis an OP Unit experiences upon the owner’s death. The step-up can result in permanent non-taxation of capital gains inherent in the OP Units. Additionally, an investment in OP Units is attractive for the same reasons an investment in the REIT’s common shares is attractive: OP Units provide stable periodic income from a diversified pool of real estate assets coupled with the potential for further capital appreciation. From the REIT’s perspective, the ability of the operating partnership to use OP Units as an acquisition currency gives the REIT an advantage over competitors seeking to acquire the same real estate assets if those competitors cannot also offer the seller the option to defer built-in capital gain indefinitely while providing liquidity and a steady income stream from a diversified pool of investments.

These OP Units are “restricted securities” under the Securities Act of 1933 because they are issued in a private placement transaction, exempt from registration under the Securities Act pursuant to Section 4(a)(2) thereunder. A restricted security cannot be transferred except in a transaction registered under the Securities Act or exempt from registration thereunder, such as another private placement. As a result, a recipient of OP Units should also expect to receive customary registration rights from the REIT, which would require the REIT to provide the OP Unit holder with freely tradeable securities by filing a registration statement (or a prospectus supplement to the prospectus contained in an existing registration statement) to register either the redemption of OP Units for common shares or the resale of those common shares under the Securities Act.

PRACTICE POINT: Rule 144 under the Securities Act provides an exemption from registration whereby a restricted security can be resold without restrictions provided certain conditions are met, including a holding period of either six months or one year. Pursuant to SEC staff no-action relief², the holder of an OP Unit that has been redeemed for a common share is permitted to “tack” (i.e., “add on”) the time that the OP Unit has been held to the Rule 144 holding period that would otherwise be applicable to the newly issued common share. OP Units are generally not redeemable until one year after issuance, so the required Rule 144 holding period has usually run its course by the time an OP Unit is eligible for redemption.

While the UPREIT structure is well-established, there are a variety of complex and highly variable issues that need to be addressed in any UPREIT contribution transaction. These issues can lead to contentious negotiations, particularly if the real estate assets being contributed are difficult to value, encumbered by liabilities or have significant built-in gain. Solutions have been developed over the years, but the landscape is a dynamic one and it is essential to have legal and tax advisors with deep experience in the structure and operations of UPREITs to ensure a successful outcome.

² Bank of America, N.A., Merrill Lynch, Pierce, Fenner & Smith Incorporated, SEC Staff Letter (March 14, 2016).

PRACTICE POINT: One of the most essential (and highly negotiated) features of many UPREIT contribution transactions is a tax protection agreement, which indemnifies a contributing partner for taxes on gain recognized as a result of the operating partnership's sale or other disposition of contributed built-in gain property (or certain other transactions) for a specified period following contribution, typically 7-10 years. Depending on the nature of the encumbrances on the assets contributed, specially structured guarantees may also be necessary.

Issuance and Terms of LTIP Units

The process for granting and issuing LTIP Units is similar to the process for granting and issuing any other equity award to a director or executive officer. Prior to issuance, the grant should be discussed and approved by the REIT's board or compensation committee, with support and advice from outside compensation consultants, legal counsel and other advisors (including peer benchmarking and industry surveys as to incentive compensation practices, including size, frequency, form and terms of awards). The material terms of the grant, such as vesting conditions, are memorialized in an award agreement among the REIT, the operating partnership, and the recipient. The grant is usually made pursuant and subject to an omnibus equity incentive plan previously approved by the REIT's stockholders (or in place prior to the REIT's initial public offering) in order to comply with applicable stock exchange requirements.³ The omnibus plan for a REIT that currently uses LTIP Units or is considering using LTIP Units in the future will include LTIP Units (or a more general category of awards encompassing units in the operating partnership) as one of the types of awards that may be granted pursuant to the plan.

The other terms of the issued LTIP Units (i.e. the rights, privileges and obligations of a holder of LTIP Units) are set forth in the limited partnership agreement of the operating partnership and all recipients must become (if they are not already) limited partners in the operating partnership at the time they receive their LTIP Units. Different vesting conditions and other different terms (e.g., different distribution rights or transfer restrictions) that may apply to LTIP Units issued at different times under different circumstances can be set forth in the award agreement granting the LTIP Units or in a concurrent amendment to the operating partnership agreement.

In addition to the allocation provisions discussed below under "The Book-Up Condition," the material terms of LTIP Units include:

- **Vesting and Forfeiture** — LTIP Units are awarded subject to vesting conditions similar to those that would apply to any other type of equity award. LTIP Units are subject to forfeiture if the vesting conditions are not met during the recipient's employment, and vesting can be accelerated in connection with a "good leaver" termination of employment, such as a termination without cause or a resignation for good reason, death, disability or in connection with a change in control. Depending on the purpose of the award, LTIP Units may become vested over a period of time based on continued service (which we refer to as "time-vesting LTIP Units") or based on the achievement of performance goals over a performance period in addition to continued service (which we refer to as "performance-

³ Under NYSE Rule 303A.08 and Nasdaq Rule 5635(c), all equity-compensation plans (including, for these purposes, any grant of options or other equity securities that is not made under a plan to any employee, director or other service provider as compensation for services) and material revisions thereto require prior stockholder approval, with limited exemptions.

vesting LTIP Units”). By their terms, LTIP Units may provide that vesting will occur, in whole or in part, during the performance period—for example, based on annual achievement of interim performance goals and/or the occurrence of a sale or other corporate event while the LTIP Units are outstanding.

PRACTICE POINT: For awards of performance-vesting LTIP Units that can be earned at “above target” levels, the number of LTIP Units initially granted generally must equal the maximum number of LTIP Units that would be earned if the maximum performance thresholds are reached, and any LTIP Units that are not earned at the end of the performance period are automatically forfeited. Accordingly, the number of shares available for future issuances under the REIT’s omnibus equity compensation plan will be reduced by the maximum number of LTIP Units that could be earned. REITs should pay careful attention to this when considering the number of shares budgeted for future awards under the plan during the performance period. By contrast, restricted stock units in a REIT can be granted in respect of the “target” number of units, with payment/settlement in amounts in excess of target in the event of above target, or “stretch,” performance.

- **Distributions** — Time-vesting LTIP Units generally are entitled to receive the same regular distributions as OP Units (which correspond to dividends paid on common shares) for so long as they are outstanding, before and after vesting. By contrast, in most cases, performance-vesting LTIP Units receive only 10% of the regular distributions made per OP Unit during the performance period. Any performance-vesting LTIP Units that have vested are then entitled to the same distributions as OP Units going forward and generally have rights to priority catch-up distributions equal to, on a per LTIP Unit basis, the difference between the aggregate distributions paid on an OP Unit during the performance period, less the distributions paid on an LTIP Units during the same period. Liquidating distributions, if any, are made to limited partners in accordance with their positive capital account balances. See “The Book-Up Condition” and “Taxation of LTIP Units” below for further details.
- **Conversion/Redemption** — As mentioned above and discussed below, LTIP Units are structured to be profits interests for tax purposes. In order to qualify as profits interests, vested LTIP Units may be converted on a one-for-one basis into OP Units only to the extent the fair market value of the operating partnership’s assets (most commonly measured by reference to the trading price of common shares) has appreciated sufficiently since the LTIP Units were issued to allow the capital account of an LTIP Unit to become fully “booked up” to the capital account of a “common” OP Unit. If other vesting conditions are satisfied, a fully booked up LTIP Unit can be converted into an OP Unit on a one-for-one basis, and an OP Unit can, in turn, be redeemed for a common share (or the cash equivalent) on a one-for-one basis after expiration of any holding period required by the operating partnership agreement, which is usually one year. Alternatively, the holder of a vested and fully booked-up LTIP Unit may be permitted to simultaneously and concurrently convert the LTIP Unit and redeem the resulting OP Unit for a common share in a single transaction. The REIT, as general partner of the operating partnership, will also usually have the right to force the conversion of any vested, fully booked-up LTIP Unit into an OP Unit.

- **Transfer Restrictions** —LTIP Units are commonly subject to a two-year restriction on transfer in order to qualify for the safe harbor to be treated as a profits interests.⁴ LTIP Units are also subject to the transfer restrictions applicable to privately placed securities under the Securities Act. See “Securities Law Considerations” for more details.
- **Voting Rights** — The voting rights associated with LTIP Units are very limited and generally only extend to matters that would adversely affect the material rights of holders, such as distributions, conversions and tax allocations.

The Book-Up Condition

For equity awards other than LTIP Units, once the vesting and settlement conditions have been met, the recipient can receive the value of the award. For LTIP Units, even if the vesting conditions have been met, receipt of common shares or the cash equivalent is still subject to a “book-up condition,” which can only be met if the fair market value of the operating partnership’s assets (usually based on the trading price of a common share) has appreciated sufficiently since the LTIP Unit was issued.

The award of an LTIP Unit is structured to be treated as a compensatory grant of a profits interest, such that the recipient does not recognize any taxable income at the time of grant or upon vesting. This structure also ensures that when income is recognized at the time a vested LTIP Unit is ultimately redeemed (whether for common shares or cash), if three years have elapsed since the LTIP Unit was issued, the long-term capital gains rate, and not the short-term capital gains rate or the ordinary income rate, will generally apply.

To qualify as a profits interest, the LTIP Unitholder may benefit only to the extent of the income, gain, and appreciation in the operating partnership after the date the LTIP Unit was issued that are allocated to the LTIP Unitholder.⁵ Accordingly, the capital account of an LTIP Unit is zero at the time of issuance and is

⁴ Under a safe harbor in IRS Revenue Procedure 93-27, as described in more detail in footnote 5 below, the grant of a profits interest in a partnership in connection with the performance of services for that partnership is not taxable to the recipient if the interest is not transferred within two years of grant and certain other requirements are met. Additionally, even where the safe harbor does not apply, taxpayers may still be able to take the position that they do not have to recognize income on the grant of a profits-only interest.

⁵ Under safe harbor rules established in IRS Revenue Procedures 93-27 and 2001-43, a contribution of services to a partnership in exchange for an unvested profits interest generally will not be taxable to the recipient service partner or deductible by the issuing partnership either at time of grant or as the award vests, provided the following requirements are satisfied:

- The service partner must receive only a profits interest in the partnership in exchange for the performance of services by the partner acting in a partner capacity or in anticipation of becoming a partner. For this purpose, a profits interest is any interest in a partnership that is not an interest in the capital of the partnership.
- The profits interest must not relate to a "substantially certain and predictable stream of income," such as high-quality debt securities or a high-quality net lease of the partnership.
- The service partner must not dispose of the partnership interest within two years of receipt of the interest.
- The partnership must not be a "publicly traded partnership" (as defined in Section 7704 of the Internal Revenue Code).
- The partnership and the service provider must treat the service provider as the owner of the partnership interest beginning on the date of grant, generally by requiring the service provider to take into account its distributive share of any partnership income, gain, loss, deduction, and credit associated with the interest on a current basis.
- The partnership may not deduct the value of the profits interest granted to the service provider in computing its income at either the time of grant or at vesting.

The first requirement means that the service partner cannot be given a share of current capital in exchange for the contribution of services. In other words, in order for the grant of an LTIP Unit (or any other partnership interest) not to be taxable to the recipient at the time of grant, the

increased by subsequent allocations of income and gain (including unrealized appreciation) to the LTIP Unit. To enable the LTIP Units to “catch up” to OP Units, LTIP Units generally receive special allocations of unrealized gain through “book-ups” or special allocations of gain from certain disposition events. When a “book-up event,” such as an issuance or redemption of LTIP Units or other partnership interests, occurs, the assets of the operating partnership are revalued to their then-current fair market values⁶ and any unrealized appreciation in the operating partnership’s assets since their acquisition (or the last book-up event) is specially (i.e., exclusively) allocated to the LTIP Unitholders until their per-LTIP-Unit capital account balance equals that of a “common” OP Unit and the LTIP Unit is eligible for conversion into an OP Unit.

REITs generally use the trading price of a common share to determine the fair market value of an OP Unit, which in turn is used to determine the aggregate fair market value of the operating partnership’s assets, with the result that the aggregate fair market value of the operating partnership’s assets on any given date is roughly equal to the REIT’s equity market capitalization on that date, adjusted to reflect the interests of holders of LTIP Units and OP Units held by limited partners other than the REIT. Once the LTIP Units have vested, the number of LTIP Units that can be converted into OP Units is generally equal to the LTIP Unitholder’s capital account balance divided by the then current capital account balance of an OP Unit.

Because the common share price of a REIT (like any other publicly traded company) can fluctuate for a variety of reasons, many of which are completely beyond management’s control, there is an extra layer of risk for the recipient embedded in an LTIP Unit that is not present in other types of equity awards.⁷ This extra layer of risk is offset, however, by the corresponding advantages LTIP Units have as profits interests: deferral of gain for tax purposes, which, if recognized more than three years after grant, will generally be recognized at the long-term capital gains rate, not the ordinary income rate.

How does this all work in practice? Consider the following example, which assumes common share price is used to determine the fair market value of the operating partnership’s assets (which is the most common method) and that no other items of gain or loss impact the amount of gain allocable to the LTIP Units:

- On the date 100,000 unvested LTIP Units are issued to the REIT’s CEO, the aggregate number of OP Units issued and outstanding is 5,000,000 (all of which are held by the REIT) and the prior day’s closing market price for a common share was \$20. Therefore, the aggregate value of the operating partnership’s assets is \$100 million.

LTIP Unit must not, at the time of grant, be entitled to any of the proceeds of a hypothetical liquidation of the operating partnership as of that date. Stated another way, the LTIP Unit holder is permitted to benefit only from income, gain and unrealized appreciation occurring after the date the LTIP Unit was issued. For this purpose, the allocation of liquidation proceeds among the partners in a hypothetical liquidation of a partnership is determined as though all of the partnership’s assets were sold for their fair market value as of the relevant testing date and all liabilities of the partnership repaid. This is in contrast to a capital interest, which would entitle the holder to a portion of the proceeds of the hypothetical liquidation corresponding to the holder’s capital account balance (which, as of the date of grant, would generally equal the amount of cash and the fair market value of any other property contributed to the partnership in exchange for the capital interest).

⁶ See Section 1.704-1(f) of the U.S. Treasury Regulations.

⁷ Like the stock market, the real estate market is also subject to fluctuations over time for a variety of reasons. The risk of failing the book-up condition exists even if the measurement of fair market value is based on appraisals of the underlying property, rather than common share price

- On the date of issuance, a book-up event occurs due to the issuance of the LTIP Units, the OP's assets are revalued, the capital account of each OP Unit is booked up to \$20 based on the revaluation and the capital account associated with each LTIP Unit is \$0. Assuming the OP receives and distributes all of its income in cash (so that the per OP Unit capital account balance remains static), the amount of gain that must be allocated to an LTIP Unit to reach economic equivalence with an OP Unit, which is often referred to as the "book-up target" for the LTIP Unit, is \$20.
- Three years later, all the LTIP Units vest.
- Subsequent to vesting, a book-up event occurs at a time when the most recent trading price of a common share is \$20.20.
- Based on 5,000,000 OP Units issued and outstanding and the trading price of \$20.20 per common share, the aggregate fair market value of the operating partnership's assets is \$101,000,000.⁸ This \$1,000,000 increase represents unrealized appreciation in the operating partnership's assets since the LTIP Units were issued and is specially allocated to the LTIP Units pursuant to the operating partnership agreement. To determine the number of LTIP Units that can be converted into OP Units, the \$1,000,000 added to the capital account balance of the LTIP Units in the book-up is then divided by the \$20 per OP Unit capital account balance to yield 50,000 LTIP Units that are now fully booked-up and eligible to be converted into freely redeemable OP Units.
- The remaining 50,000 vested LTIP Units would not become fully booked-up until sufficient additional allocable gain becomes available and is specially allocated to the LTIP Units, which may occur in connection with a future book-up event or as otherwise provided under the limited partnership agreement.

This example is simplified and does not take into account a variety of important considerations and complexities (both mechanical and substantive) that are generally addressed in the limited partnership agreement or in the books and records of the operating partnership, but it does illustrate the basic effect of the special allocation provisions: even though the operating partnership's assets must appreciate by a certain aggregate amount before the value of an LTIP Unit can be realized, the required percentage increase may be relatively small in comparison to the total capitalization of the REIT.

Taxation of LTIP Units

Because an LTIP Unit is structured as a profits interest on the date of grant, the recipient does not recognize any income at the time of grant or upon vesting, and the issuer (i.e., the operating partnership) cannot take a deduction for the value of the profits interest. Because the grant of a profits interest is not taxable, the recipient's initial basis in the LTIP Unit is \$0. In the case of an equity award that is not structured as a profits interest, the recipient would recognize ordinary income either at the time of grant or upon vesting (or, if later, settlement) equal to the fair market value of the LTIP Units at that time, and the operating partnership could take an offsetting deduction. This income would be taxed at the ordinary income rate, and the recipient's initial basis in the award would be the amount of the income recognized.

⁸ For simplicity, this figure assumes that all of the value of the operating partnership's assets is allocable to the OP Units owned by the REIT. However, in practice, the diluting effect of LTIP Units on the REIT's OP Units would be taken into account, with the effect that the aggregate fair market value of the operating partnership's assets would be somewhat higher than the \$101,000,000 indicated.

PRACTICE POINT: Under current law, if all the requirements to qualify for the IRS safe harbor (see footnote 5) are satisfied, it should not be necessary to make a protective election under Section 83(b) of the Internal Revenue Code to prevent tax on the vesting of an LTIP Unit. A Section 83(b) election generally has the effect that the receipt of an LTIP Unit (but not its subsequent vesting) would be “taxable,” but only to the extent of its value at the time of grant (generally reported as \$0). Nevertheless, because there is generally no downside to doing so, LTIP Unit award agreements may require a Section 83(b) election as additional protection should the safe harbor requirements not be satisfied.⁹

The operating partnership, like any other partnership, generally is not itself subject to U.S. federal income tax. Instead, holders of LTIP Units, along with holders of OP Units and any other partners, are required annually to take into account their distributive share (in accordance with the allocation provisions of the limited partnership agreement, including any special allocations) of all items of taxable income, gain, loss, deduction and credit (if any) of the operating partnership, without regard to whether any distributions are made by the operating partnership. While, theoretically, this feature creates the potential for “phantom income” (i.e., allocations of taxable income without cash distributions sufficient to pay the associated tax) to LTIP Unitholders, limited partnership agreements in an UPREIT structure typically provide for distributions to the partners of available cash, which in most cases alleviates the phantom income issue.¹⁰ To the extent LTIP Units are allocated a share of the operating partnership’s net income or gain, the per unit allocation may be limited to the percentage in which the LTIP Units participate in distributions (commonly 10% of the distributions made to a “common” OP Unit holder in the case of performance-vesting LTIP Units). Gain allocated to an LTIP Unit as a result of a book-up of the operating partnership’s assets is solely for capital account purposes, is not currently taxable to the holder, and does not result in phantom income.

Ordinary cash distributions paid to partners are taxable to the extent in excess of the partner’s basis in its partnership interests.¹¹ Although the LTIP Unitholders would have a \$0 basis in their LTIP Units at the time of grant, the basis would be increased by any taxable income allocated to the LTIP Units, and reduced by the amount of any cash or the value of other property distributed with respect to those units.¹² Unrealized appreciation allocated to the LTIP Unit in connection with a book-up event is not taxable and does not affect the holder’s basis in the units. Because distributions reduce capital account balances for both LTIP Unitholders and other common OP Unitholders, and are generally allocated in the same manner as partnership net income and losses, distributions should not significantly affect the pace at which LTIP Units are booked up in most cases.

⁹ In 2005, the IRS issued a notice of proposed rulemaking (REG-105346-03) and a proposed revenue procedure (Notice 2005-43) which would supersede Revenue Procedures 93-27 and 2001-43. Under the proposed guidance (which has not yet been adopted as law), an unvested LTIP Unit would generally be subject to tax upon vesting unless a Section 83(b) election is made with respect to the LTIP Unit at the time of its grant.

¹⁰ This helps enable the REIT to meet the annual “distribution” requirement to maintain qualification as a REIT. See Section 857(a)(1) of the Internal Revenue Code.

¹¹ See Section 731(a) of the Internal Revenue Code.

¹² See Section 705(a) of the Internal Revenue Code.

As discussed above, if properly structured, the conversion of a vested, fully booked-up LTIP Unit into an OP Unit also does not result in the recognition of tax.¹³ However, the redemption of an OP Unit for common shares or the cash equivalent causes the recognition of gain or loss to the extent of the difference between the value received in the redemption and the holder's adjusted tax basis in its OP Units. If the holder's basis in the LTIP Unit is \$0, the holder would be taxed on the entire value of common shares or cash received in the redemption. Any gain recognized in connection with the redemption generally is treated as capital gain and is short-term capital gain (currently taxable at a top marginal rate of 40.8%, plus state and local income tax) unless the LTIP Units were issued more than three years prior to the date of recognition, in which case the gain would generally be long-term capital gain (currently taxable at a top marginal rate of 23.8%, plus state and local income tax).¹⁴

Each tax year, the REIT, as the general partner of the operating partnership, will prepare IRS Schedule K-1s for the holders of LTIP Units and OP Units. In addition, holders of LTIP Units may be subject to various state and local taxes and tax filing requirements in the jurisdictions in which the operating partnership's assets are located. These additional layers of complexity (and the associated administrative burden) are a potential downside of LTIP Units (and all partnership interests) as compared to non-partnership equity awards.

Securities Law Considerations

- **Securities Exchange Act of 1934** — In connection with awards of LTIP Units, as with any other equity award made to a director or officer, REITs will need to consider their obligations to report awards under Item 5.02(e) of Form 8-K as a material compensatory arrangement of an executive officer and in the annual disclosure of director and executive officer compensation contained in the REIT's Form 10-K or annual meeting proxy statement.

Awards of LTIP Units to directors and executive officers are subject to the transactional reporting requirements of Section 16 under the Exchange Act. A Form 4 reporting the acquisition of the LTIP Unit as a derivative security is required for any grant of a time-vesting LTIP Unit and may be required for a grant of a performance-vesting LTIP Unit if the performance criteria that determine vesting are tied directly to the trading price of common shares (i.e. total stockholder return). The number of LTIP Units actually earned at the end of the performance period, as determined by the REIT's compensation committee, is also a reportable transaction under Form 4. Moreover, the conversion of a vested, fully booked-up LTIP Unit into an OP Unit and the redemption of an OP Unit are reportable transactions under Section 16.

- **Securities Act of 1933** — A grant of LTIP Units is generally structured as a sale of securities that is a private placement exempt from registration under Section 4(a)(2) of the Securities Act. As a result, LTIP Units are "restricted securities" that may be transferred only pursuant to an effective registration statement or an exemption from registration.

Conversion of an LTIP Unit into an OP Unit is exempt under Section 3(a)(9) of the Securities Act as an exchange by an issuer with its existing holders of one security for another security, where no commission or other remuneration is paid for soliciting such exchange. The ultimate issuance of

¹³ See discussion of IRS Revenue Procedure 93-27 in footnote 5, above.

¹⁴ However, gain attributable to depreciation recapture or to certain "hot assets" of the operating partnership would generally be taxable as ordinary income. See generally Sections 741, 751, 1245, and 1250 of the Internal Revenue Code.

common shares upon redemption of the resulting OP Units may be conducted as a registered offering or a private placement under Section 4(a)(2). The resale of such common shares could be registered, e.g., on a Form S-8 registering securities issued under the REIT's omnibus equity incentive plan, or the resale could be exempt from registration, including under the safe harbor provided by Rule 144.

External Manager LTIP Units

Some REITs that are externally managed also use LTIP Units as a form of equity incentive compensation. An externally managed REIT does not have any employees of its own and instead retains a third-party advisor entity that provides professional management services to the REIT (including executive officers) and is responsible for all the day-to-day operations of the REIT. These services are provided pursuant to an asset management agreement in exchange for fees, which may include incentive fees payable in equity and/or cash. An externally managed REIT usually does not compensate its executive officers directly, and, consistent with this arrangement, an externally managed REIT that issues LTIP Units generally will issue them directly to the REIT's advisor that provides the executive officers of the REIT instead of to the individual executive officers.

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Proskauer's multi-disciplinary, cross-functional team has extensive experience structuring and implementing LTIP Unit programs and a wide variety of other equity compensation, securities and other transactions involving REITs and other public and private companies. Please contact us if we can be of assistance.

